Governing the Banking Sector:

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The State after Communism:
Governance in the New Russia

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For many observers the banking sector offers a paradigmatic case of business state relations in Russia in the 1990s. Formed by seizing assets from collapsing state and party organizations, private banks grew from bit players in Russian politics in the early 1990s, to become a crucial source of state finance in the middle of the decade. During the glory days, the cliché of Russia's "high flying" banks became a staple of news reports. Yet the shaky institutional foundations on which Russian banks were built soon proved their downfall. Having bet heavily against a devaluation of the ruble, new private banks suffered an ignominious crash in August 1998 that impoverished many and revealed the fault lines of the Russian transition. Since the crash, Russia's banks have begun to rebound, but governance on the sector remains weak, particularly in comparison to other countries in the region.

Despite agreement on the frailty of banking institutions in Russia, there is heated debate about the source of this weakness. The dominant views root poor governance in private economic interests that captured the state or in a rapid economic liberalization that

[1] I would like to thank an anonymous reviewer, Timothy Colton, Steven Holmes, Kira Sanbonmatsu and other members of the State After Communism project for helpful comments, Quintin Beazer and Sarah Wilson for research assistance, and the Carnegie

impoverished the state.[2] Evidence from the region, however, casts doubt on important elements of these arguments. The former raises as many questions as it answers, while the latter has little empirical support.

This essay traces how budget deficits, political struggles between neo-communist and anti-communist elites, and state ownership of banks shaped the incentives of bankers and state officials to strengthen (or more often weaken) regulatory institutions in Russia. It finds that budget deficits generated largely by subsidies to other sectors of the economy encouraged private banks to lend to the state rather than to private firms. As a result, banks expressed little interest demand for institutions to protect their property rights or to promote lending to the private sector. A focus on how banks translated budget deficits generated by other, more powerful interest groups in the early 1990s into leverage over policy later in the decade offers a twist on traditional capture theory. Relatively weak social groups can come to have vast influence over policy by feeding off the rents created by other groups.

In addition, intense political struggles between powerful neo-communist and anti-communist elites not only blocked the passage of legislation to strengthen regulatory institutions; they also heightened policy uncertainty by increasing the possibility of sharp swings in policy. Policy uncertainty encouraged banks and regulators to adopt strategies at

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Foundation and the Center for Law and Public Policy in Moscow for financial and logistical support.

[2] Joel Hellman, "Winners Take All: The Pitfalls of Partial Reform," *World Politics*, 50:2, (Winter 1998); Joel Hellman, Geraint Jones, Daniel Kaufman, "Seize the State, Seize the Day," World Bank Policy Research Working Paper #2444; (Washington, D.C.: World Bank, 2000); Joseph Stiglitz, "Whither Reform: Ten Years of the Transition," *Annual Bank Conference on Development Economics* (Washington, D.C.: World Bank, 2000); Juliet Johnson, *A*

odds with the long-term requirements of building strong state institutions. This intense political polarization between neo-communists and anti-communist elites sheds light on why, in contrast to many theories of regulation, private banks continued to weaken state institutions even after they grew wealthy and politically influential.

Finally, state ownership undermined governance by allowing state banks to use their privileged access to the state to inhibit competition, while it also exacerbated conflicts of interest between regulators and the regulated. This insight reinforces the importance of drawing sharp boundaries between public and private entities in transition environments. The ongoing influence of state ownership also provides a partial answer for why governance on the banking sector has improved only marginally in recent years, despite a drop in the political power of private banks after the financial crash of August 1998.

1. The Quality of Governance

Well-governed banking sectors have high levels of transparency, clearly defined property rights between borrowers and savers, and a level playing field for market participants. The organization best able to govern banks is the state due to its economies of scope and scale and monopoly on coercion.[3] To promote good governance, states protect property rights inherent in contracts between banks and their clients, and also ensure that banks abide by a set of prudential norms that reduce systemic risks. This is no easy task as indicated by the frequency of banking crises in middle-income countries, the savings and loan debacle in the U.S., and the repeated bail-outs of banks in Japan in the 1990s. Creating

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Fistful of Rubles: The Rise and Fall of the Russian Banking System (Ithaca, NY: Cornell University Press, 2000), pp. 18-25.

[3] Joseph Stiglitz, *The Economic Role of the State* (New York: Basil Blackwell, 1990).

good governance on financial markets in the postcommunist world has been more difficult than expected, especially in Russia.[4]

As in all command economies, the Soviet Union operated with a monobank system consisting of a state bank (Gosbank SSSR) that operated both as a central bank and a commercial bank, but primarily performed accounting functions for the state plan. In 1988 the government created a handful of "spetz" banks, such as Agroprombank and Promstroibank to fund specific state programs in agriculture and industry, respectively. Through the 1988 Law on Cooperatives, the government allowed the creation of "zero banks" that were formed ostensibly from private capital, but reportedly were often financed by elements of the Communist Party. In addition, it permitted firms to open "pocket banks" that acted as accounting (or money laundering) agents for their founding companies. Pocket banks lent almost exclusively to their founding companies. When Russia achieved statehood in 1992, the number of licensed banks exceeded 1300, including hundreds of small, pocket banks, hundreds of weakly capitalized "zero" banks, hundreds of banks closely attached to state bodies, and a few large state banks.[5]

Primary responsibility for governing these banks fell to the Central Bank of Russia (CBR). According to the law "On Banks" passed in 1990 with amendments in 1995, the CBR is responsible for regulating financial organizations. Yet this task was complicated as

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[4] Erik Berglof and Patrick Bolton, "The Great Divide and Beyond: Financial Architecture in Transition," *The Journal of Economic Perspectives*, 16:1, (Winter, 2002), pp. 77-100.

[5] As banks were highly profitable in the early 1990s, allowing a powerful regional official or enterprise to open a bank was a means of gaining some political support. In addition, the granting of licenses offered a rich environment for corruption of CBR officials. Author interview with Alexander Khandruyev, former First Deputy of the Central Bank of Russia, September 19, 2001.

the CBR was intertwined with commercial banks. Many former branch banks of the Soviet-era Central Bank transformed themselves into private commercial banks. In addition, the largest banks, Sberbank, Agroprombank, and Promstroibank, remained in state hands.

Since 1990, the Central Bank has been a prominent player in Russian politics. In addition to being the majority owner of the country's dominant bank, Sberbank, the Central Bank has offices in all of Russia's 89 regions, controls the money supply, and manages currency markets. In the early 1990s, the head of the CBR, Viktor Gerashchenko, was a vocal and colorful opponent of President Yeltsin's stabilization policies who enjoyed strong support in Parliament. The CBR also has a large and well-paid workforce. According to the Audit Chamber of the Russian Federation, the CBR has 86,000 employees, thirty times more than the Bank of England, and three times more than the Federal Reserve of the U.S. The wage bill of the CBR in 1998 was $1.2 billion, or roughly $14,000 per year per employee. In 1997, then head of the CBR Sergei Dubinin earned an official salary of $240,000, almost twice as much as then head of the U.S. Federal Reserve Bank, Alan Greenspan. [6]

Despite the size and wealth of the CBR, by most yardsticks -- expert ratings of the quality of governance, the frequency of banking crises, compliance with international regulatory standards, the extent of lending to the private sector, the existence of non-performing banks, and the extent of preferential treatment -- the banking sector in Russia is governed poorly, even in comparison to others in the region. Each year the European Bank for Reconstruction and Development (EBRD) rates the quality of banking institutions on a scale where (1) equals "little progress beyond the establishment of a two-tiered system; (2) equals significant liberalization and interest rates and credit allocation; and limited use of direct credits; (3) equals substantial progress in establishment of bank insolvency; full interest

rate liberalization and significant lending to private enterprises; (4) equals significant movement of banking laws and regulations to BIS (Bank of International Settlements) standards; well functioning banking competition and effective prudential supervision and (4+) equals standard and performance norms of advanced industrial economies; full convergence of banking laws and regulations with BIS standards." The average score for the 25 economies in transition in the 1990s was 2.1, while for Russia it was 1.7. In 2000, the average score for all countries was 2.5, while for Russia it was 1.7. Between 2000 and 2003, only four countries in the region had weaker banking institutions than did Russia according to this EBRD ranking.

The financial crash of August 1998 provides the most striking example of weak governance on the banking sector. The CBR failed to monitor the vast exposure of Russian banks to swings in the exchange rate. Private Russian banks often backed their loans to buy state treasury bonds known as (GKOs) with ruble-based forward contracts with other Russian banks. Some of these contracts were fictitious and were used to reassure foreign investors that Russian banks could afford the massive dollar-denominated loans that they had taken on to buy GKOs. Given the size of the loans relative to the banking sector, it is hard to believe that the CBR was unaware of this problem.[7] The vast unsecured borrowing of foreign currency by Russian banks with the tacit approval of the CBR ensured that even small changes in the exchange rate would bring the liabilities of the banks to the fore. The crash of August 1998, was in many respects, a banking crisis. One observer noted: "The default/devaluation by the government was precipitated by the imminent collapse of several

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[6]Belton and Semenko, 1999.

[7] Margot Jacobs, "Russian Banks: Sailing Ahead or Sinking Fast?"(Moscow: United Financial Group Research Report, 1998).

leading banks. The August default/devaluation should thus be viewed as a desperate remedial measure, rather a cause of the sector's insolvency."[8] Another noted: "In our view, the banking sector was already insolvent prior to the crisis, and contributed directly and indirectly to it."[9] This governance failure robbed a small and nascent middle-class of its meager savings and impoverished many who had placed their nest eggs in Russian banks.

2. Potential Explanations

Observers have offered several general arguments for the weakness of state institutions in Russia that can also be applied to the banking sector.[10] The most frequently cited reason for the stunted development of governance on the banking sector is that oligarch-dominated banks exerted pressure on the state to keep regulations weak and opaque. Indeed, there is good evidence that large banks linked to powerful economic interests favored weak governance and got their wish.[11] This state capture explanation, however, also raises several questions. Why would a handful of large banks seek to weaken rather than strengthen the regulatory regime? One economic theory of regulation emphasizes that wealthy and well-organized economic interests support stronger state

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[8] David Kuenzi, "Banking on the Ruble: How Reckless Banking Contributed to Russia's Financial Collapse," (Moscow: Creditanstalt Research Report, 1998, p. 1).

[9] Enrico Perotti, "Lessons from the Russian Meltdown: The Economics of Soft Legal Constraints," Working Paper #379, (Amsterdam: University of Amsterdam and CEPR, 2001), p. 1.

[10] In some cases these arguments are based primarily on evidence from the banking sector. See Johnson 2000; Stiglitz 2000.

[11] Christia Freeland, *The Sale of the Century: Russia's Wild Ride from Communism to Capitalism* (New York: Crown Books, 2000), pp. 116-167; David E. Hoffman, *The Oligarchs: Wealth and Power in the New Russia* (New York: Public Affairs, 2002), pp. 297-325; Johnson, 2000.

institutions to protect their property rights.[12] Historical studies from Europe find that property holders often strengthened the state to protect their interests.[13] Based on this argument, some expected that privatization in Russia would clarify property rights and generate demand from property holders for better governance and a more capable state.[14] More cynically, the oligarch banks may have strengthened the state if only to weaken their rivals. Yet, this did not happen.

The oligarch capture explanation raises another point. If the oligarchic banks were the main impediment to better governance, one might have expected rapid progress on banking reform following the crash of oligarch banks in 1998. While the oligarch banks have not disappeared, they have lost much influence to other sectors, such as energy, metals and raw materials lobbies. Nonetheless, governance on the banking sector remains poor.[15] Similarly, in the early 1990s private banks in Russia were bit players, but governance was weak. Finally, it is not clear to what extent the oligarch banks created bad governance or bad

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[12] George Stigler, "The Economic Theory of Regulation," *Bell Journal of Economics and Management Science*, 3, 1971, pp. 3-21.

[13] Douglass North and Barry Weingast, "The Evolution of Institutions Governing Public Choice in 17th Century England," *Journal of Economic History*, 49, (1989), pp. 803-832; Charles Tilly, *Coercion, Capital and European States* (New York: Basil Blackwell 1990).

[14] Andrei Shleifer and Robert Vishny, *Privatizing Russia* (Cambridge: MIT Press, 1995).

[15] Of the so-called "seven bankers lobby" that existed prior to 1998, only Petr Aven and Vladimir Potanin have remained active in lobbying the government, and this is likely due to their holdings in oil, gas, and metals, rather than their ownership of banks. Moreover, of the "third generation" oligarchs that made much of their wealth following the crash of 1998, such as Aleksander Mordashov, Roman Abramovich, Vladimir Yevtushenkov, Oleg Deripaska, and Andrei Melnichenko, only the latter has significant interests in banking.

governance created the oligarch banks. There is much to be said for the state capture explanation, but it also leaves many questions unanswered.

Others argue that neoliberal reforms have gutted the state, leaving it too poor to govern well.[16] That economic reforms impoverished the Russian state is far from clear. Per capita GDP in Russia is roughly one-fifth the OECD average, but state spending as a percentage of GDP was roughly similar in both in the 1990s (42 percent versus 48 percent). Middle-income countries outside of the postcommunist world spend about a quarter of their GDP.[17] In other words, Russia spent like an OECD country on the earnings of a middle-income country. In addition, the most liberal economies in the postcommunist world tend to have the strongest banking institutions. Countries with higher than average scores on the EBRD's 4-point Price Liberalization Index in the 1990s had stronger banking institutions according to the EBRD Index of Banking Institutions (2.4 versus 1.1, $t = 14.5$).[18] If anything, liberal reforms foster better governance in the postcommunist world.

Another explanation emphasizes that the institutional legacy of the Soviet Union left institutions poorly adapted to a market economy.[19] This is true, but countries with similar legacies, like Russia, Ukraine, and Belarus have very different banking sectors. Moreover, this explanation fails to explain why some aspects of banking quickly became rather

[16] Most forcefully, see Stiglitz 2000. Also Peter Stavrakis, "State Building In Post-Soviet Russia: The Chicago Boys and the Decline of Administrative Capacity," Occasional Paper #254, Kennan Institute for Advanced Studies, Washington, D.C. October, 2003.
[17] Geoffrey Garrett and David Nickerson, "Globalization, Democratization and Government Spending in Middle-Income Countries," ms. New Haven, 2001.
[18] *EBRD Transition Report 2000* (London: EBRD, 2000). This relationship holds using cross-sectional and panel data and more sophisticated statistical techniques.
[19] Johnson 2000.

sophisticated, while others did not. Russian banks traded forward contracts, bought foreign stocks, and played currency markets, even as they took weeks or months to transfer funds. [20]

While many factors have fostered weak governance in the banking sector, this essay focuses on several that seem especially salient. First, macroeconomic instability is a critical component for creating sound banking sectors. Budget deficits -- whether financed through inflation or state treasury bonds -- divert the interests of banks from their normal function as intermediaries between savers and borrowers. Because banks in Russia reaped vast gains from various forms of financing the state budget deficit, they expressed little interest in promoting good governance in activities typically associated with banks.[21] Economists have long argued that macroeconomic instability and high budget deficits crowd out lending to the private sector, but they also crowd out demand for good governance.

Perhaps more importantly in the Russian case, budget deficits produced tremendous benefits to banks that turned them from marginal to influential players in politics. This point is important because many have criticized governments in the region for focusing on macroeconomic reforms and neglecting institutional development.[22]

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[20] Some argue that poor governance in Russia is generally rooted in the low salaries paid to state officials. If so, then the banking sector would be the best governed in Russia. The Audit Chamber of the Russian Federation reported that the average salary in the CBR was $14,000. Catherine Belton and Igor Semenko, "The Commercial Empire of the Central Bank," *Moscow Times Business Extra*, October 19, 1999.

[21] Banks that engage in borrowing and lending tend to oppose inflation as it reduces the value of their outstanding loans. However, where banks earn revenue primarily from funding the government, they may benefit from inflation.

[22] See Stiglitz, 2000.

Second, state ownership undermined governance on the banking sector.[23] The two largest banks in Russia that are majority state-owned, Sberbank and Vneshtorgbank, have dominated almost all segments of the market since 1990.[24] State ownership generated conflicts of interest that blocked regulatory changes that would erode the commanding position of state banks. Politicians also benefited from Sberbank's politically motivated lending and purchases of state treasuries bonds. As state ownership increased after 1998, this explanation helps account for the ongoing difficulties in improving governance on the banking sector after August 1998.

Third, political conflict between neo-communist and anti-communist elites led to weak governance in at least two ways.[25] First, because neo-communist and anti-communist camps had very different preferences over policy, and it was far from certain which camp would hold power in the future, businesspeople and bureaucrats alike expected drastic swings in policy. Rather than devoting their efforts to the long-term task of building institutions, businesspeople and bureaucrats adopted more short-term strategies, like

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[23] Rafael Laporta, Florencio Lopez-de-Silanes, and Andrei Shleifer, "Government Ownership of Banks," *Journal of Finance*, (February 2002).

[24] Sberbank is the former state-owned retail savings bank that has deep roots in the Soviet and pre-Soviet period. Vneshtorgbank is a former specialized bank that operated in the Soviet period that was responsible for foreign trade. Both became joint-stock companies in 1990. See www.sbrf.ru and www.vtb.ru for details.

[25] Jakub Svensson, "Investment, Property Rights and Political Instability: Theory and Evidence," *European Economic Review*, 42, (1999), pp. 1317-1341. Here neo-communist elites refer to party leaders or executives who campaigned with backing of the largest communist successor party, held high office in the Party or state apparatus prior to 1989, and advocate a large state sector in the economy.

corruption and asset-stripping.[26] In addition, because political power was roughly balanced between neo-communist and anti-communists, it was very difficult to pass legislation to improve governance. By contrast, in countries where either anti-communist or neo-communist factions dominated, it was easier to pass reform packages because bargaining took place among factions whose policy preferences were similar.[27]

3. Brief Cross-Country Analysis

To begin, I analyze the quality of governance on the banking sector in 25 postcommunist countries during the 1990s. If these three arguments hold across countries, it is likely that they hold within Russia as well. I briefly examine how the three factors highlighted above are related to the quality of banking institutions as measured by the EBRD's Index of Banking Institutions. As noted previously, this measure ranges from 1 to 4.3, depending on assessments made by country specialists at the EBRD.[28] To assess the relations between macroeconomic instability and the quality of banking institutions, I divide the sample of 25 countries into years in which countries have higher than average and lower than average budget deficits and compare the quality of banking institutions in these two groups. Doing so reveals that countries experiencing higher than average budget deficits in a given year had significantly weaker banking institutions (EBRD 2001). A country with a

[26] Timothy Frye, "The Perils of Polarization: Economic Performance in the Postcommunist World," *World Politics*, 54, (April 2002), pp. 308-37.

[27] Alberto Alesina and Allen Drazen, "Why Are Stabilizations Delayed?" *American Economic Review*, 81, (Fall 1991), pp. 1170-1189.

[28] The measure actually includes plus and minus scores for each value, (e.g., 2+, 3-, which are scored 2.3 and 2.7 respectively). Before publication these measures are circulated to experts at the World Bank and the IMF and are then defended before a board of specialists at the

larger than average budget deficit has a mean banking institutions score of 2.0, while a country with a lower than average budget deficit has a mean score of 2.4 (t= 3.8, significant at .0002). Thus, balanced budgets are associated with stronger bank institutions.

I take a similar tack to examine the association between state ownership of banks and the quality of banking institutions. The EBRD provides data on the percentage of assets controlled by state and private banks for each country for most years in the 1990s. In a typical year, the average country has 40 percent of its banking sector assets in state hands. Countries with higher than average portions of the banking sector in state hands have significantly lower quality banking institutions (2.2 versus 2.5, t= 2.4, significant at .02).

Political polarization may also attenuate regulation. I measure polarization by the percentage of seats in parliament held by the largest neo-communist (anticommunist) party when an anticommunist (neo-communist) politician controls the executive branch.[29] This measure excludes the reformed communist successor parties of Poland, Hungary, Lithuania, and Slovenia.[30] In many years in the sample, Russia, Bulgaria, Kyrgyzstan, Albania, and Romania have relatively high polarization scores. Countries whose dominant political factions reside within either the neo-communist or anti-communist camp, such as Estonia, Latvia, the Czech Republic, Turkmenistan, and Kazakhstan, tend to have low polarization scores. Countries with higher than average polarization scores have lower quality banking institutions (2.3 versus 1.7, t= 5.2, significant at .0000).

EBRD. This is a quality measure, particularly given the alternative of relying on dodgy financial statistics.

[29] The executive is a president in a presidential system or the prime minister in a parliamentary system. See fn. 22 for a definition of neo-communist elite.

[30] John Ishiyama, "The Sickle or the Rose? Previous Regime Type and the Evolution of Ex-Communist Parties," *Comparative Political Studies*, 30, (June 1997), pp. 299-330.

This brief comparative analysis is hardly definitive, but it provides a benchmark for comparing banking institutions across postcommunist countries. It also identifies three factors that appear to be associated with the quality of banking institutions in the region.[31] The next section traces in more detail how macroeconomic conditions, state ownership, and political polarization shaped the quality of banking institutions in Russia in two periods.[32] From 1990-1999, these factors contributed to a poorly governed banking sector and a banking crisis in August 1998. However, when the federal budget turned a surplus and polarization declined after 1999, state officials and private bankers began to address governance problems in earnest for the first time since 1990. Nonetheless, the role of state-owned banks increased after the crash and has limited progress in improving the quality of governance on the banking sector.

Budget Deficits, Capture and Demand for Good Governance: 1990-1999

Throughout the 1990s, capital accumulation in the banking sector lay in budgetary instability, rather than in lending to the private sector. As such, banks devoted their resources to extracting resources from the state rather than to creating institutions to govern the market. The means by which banks extracted these rents varied over time, but none

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[31] These results also hold in a cross sectional analysis and in a time-series cross section analysis using data from 1990-2002. See author for results.

[32] See Joel Hellman, *Breaking the Bank: Bureaucrats and the Creation of Markets in a Transition Economy*, Ph.D. Dissertation, Columbia University, 1993; Gail Buyske, *The Development of Financial Systems in Post-Socialist Economies*," Ph.D. Dissertation, Columbia University, 1997; William Tompson, "Russia's Ministry of Cash: Sberbank in Transition," *Communist Economies and Economic Transformation*, 10:2, (1999), pp. 133-157; William Tompson, "Financial Backwardness in Contemporary Perspective: Prospects for the Development of Financial Intermediation in Russia," *Europe-Asia Studies*, 52:4, (2000), pp. 605-625; and Johnson, 2000.

generated incentives for banks to invest their efforts in better governance that would encourage lending to the private sector.

Facing great pent-up demand for goods, a large budget deficit, and powerful interest groups seeking subsidies, the first postcommunist government in Russia launched a stabilization program in January 1992. Initial efforts produced few results for society at large as inflation reached over 2000 percent in 1992 and 1200 percent in 1993, but provided vast revenues to the banking sector. By some estimates, the transfer of wealth to banks through hyperinflation reached 6-9 percent of GDP.[33] Banks earned rents by disbursing (or not) government credits granted to specific sectors or firms.[34] Currency speculation also generated great wealth as banks held dollars against the declining value of rubles held by the population.[35] The weakened budget position of the government led to sharp declines in the ruble in the early 1990s. As a main store of hard currency, private banks saw tremendous appreciation in assets held in dollars, marks, and pounds at very little cost.

Banks turned to a new source of revenue in 1994 as the government began financing its deficit via state treasury bonds, or, GKOs. These ruble-denominated bonds had maturities of 3, 6 and 9 months and were seen as a safe source of lending given the government's guarantee of repayment. Having prospered from inflation, the banking

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[33] William Easterly and Paulo Viera de Cunha, *Financing the Storm: Macroeconomic Crises in Russia, 1992-1993* (Washington, D.C.: World Bank, 1993).

[34] See Mikhail Dmitriev, Mikhail Matovnikov, Leonid Mikhailov, Lyudmila Sicheva and Eugene Timofeev, "The Banking Sector," in *Russia's Post-Communist Economy*, Edited by Brigitte Granville and Peter Oppenheimer (Oxford: Oxford University Press, 2001, pp. 213-239), especially pp. 224-226 on incentives to collude with firms to gain low (or no) interest loans from the central government.

community successfully lobbied to exclude foreigners from the market, which greatly increased profits to local banks. In addition, the CBR sold GKOs only to a select group of banks, which concentrated wealth in a few hands. The rates of return on GKOs fluctuated wildly from 20-250 percent depending on the market's faith in the ability of the Russian government to make good on the bonds, but the transfer of wealth to the banking sector via state treasure bonds was vast. By some estimates from 1994-1998, GKOs provided about $15 billion for the Russian government, but the nominal value of the GKOs issued was about $70 billion, which left $50 billion to the holders of GKOs, mostly private commercial banks and the CBR through Sberbank.[36] Again, the inability of the government to finance its budget led to a vast transfer of wealth from taxpayers to a handful of banks.

In the early 1990s the banking sector prospered beyond its ability to influence state policy. Long-time Yeltsin economic advisor Aleksander Livshitz noted that the banking community played little role in policymaking prior to the mid-1990s.[37] Garegin Tosunian, President of the Association of Russian Banks noted: "the government didn't begin to listen to us until the mid-1990s."[38] The sources of inflation lay not so much in the power of the banking lobby. Rather, banks grew wealthy from inflation sparked by a sympathetic head of the CBR who opened wide the monetary spigot and a government unable to rein in the

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[35] Easterly and de Cunha, 1993; Mikhail Dmitriev, ed. *Rossiiskie banki nakanune finansovoi stabilizatsii* (St. Petersburg: Norma 1996); Dmitriev et al. (2001), pp. 220-221.

[36] *Russian Economic Trends*, 1998: March 5.

[37] Author interview with Aleksandr Livshitz, June 17, 2002, Moscow.

[38] Author interview with Garegin Tosunian, President, Association of Russian Banks, June 19, 2002, Moscow.

demands of sectoral lobbies and regional governments.[39] The inflation of the early 1990s generated a formidable banking lobby in the mid-1990s, but in the first years of the transformation, the banking lobby took a back seat to better-organized interests.

Having growth wealthy off distortions in the state budget generated largely by lending to other sectors of the economy, a small group of banks began to extract rents directly from the state by servicing government accounts. By the mid-1990s, many government agencies and regional bodies transferred their accounts to private banks. For example, Oneximbank and Menatep-Bank held the lucrative account of servicing the funds of the Customs and Finance Ministry, respectively, while Most-Bank and Technobank grew wealthy managing the accounts of the Moscow city government. The State Audit Chamber estimated that the banking community earned more than 1.3 billion dollars from this practice in 1995 and 1996.[40]

Some private banks that earned rents from budget deficits in the early 1990s grew wealthier still off the "Loans for Shares" program. A handful of select banks approached the government with the prospect of alleviating the budget deficit by loaning money to the state using valuable state-owned assets as a pledge.[41] To raise revenue quickly and reward supporters in a year prior to elections, the Yeltsin team allowed select banks to run auctions

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[39] Aslund estimates that subsidies to the tune of about 8 percent of GDP went to agriculture in 1992, while massive tax breaks went to oil and gas sector throughout the 1990s. Anders Aslund, *How Russian Became a Market Economy* (Washington, D.C.; Brookings Institution, 1995), p. 164, 301. On lobbying by regional governments, see Daniel Treisman, *After the Deluge: Regional Crises and Political Consolidation in Russia* (Ann Arbor: Michigan University Press, 1999); On lobbying by economic sectors, including banks, see Vladimir Mau, *The Political History of Economic Reform in Russia, 1985-1994* (Moscow: CRCE, 1995).

[40] Johnson, 2000, pp. 122-123.

for a controlling packet of shares in some of the largest companies in Russia in 1995. As specific banks also received the right to conduct the auctions, the outcome of the auctions was never in doubt. These banks or their related companies won the auctions with a price just slightly over the minimum established by the state. Oneximbank won the rights to Norilsk Nickel and Sidanko, while Menatep won the bidding for shares in the oil giant, Yukos. The government did not buy back the shares after the agreed upon three-year holding period and the banks eventually took ownership of these valuable assets.[42]

In the 1990s, banks earned great revenue from the inflation tax, state treasury bonds, authorized banking and in some cases, "loans for shares auctions." They earned little revenue from the types of borrowing and lending practiced by their nominal counterparts in more mature market economies. One prescient bank analyst noted that these were not banks at all, but "quasi-banks" because they earned little revenue from borrowing and lending.[43] Thus, these banks had weak incentives to demand stronger regulation to support borrowing from and lending to the private sector. The vast transfer of wealth from taxpayers to banks via hyperinflation and budget deficits "demonstrated to these new banks that real wealth was found in currency speculation, not prudent enterprise lending."[44]

Polarization and the Supply of Regulation

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[41] Freeland, 2000, pp. 168-189; Hoffman, 2002, pp. 296-324.

[42] Ira Leiberman and Rogi Veimetra, "The Rush for State Shares in the 'Klondyke' of Wild East Capitalism: Loans for Shares Transactions in Russia," *George Washington Law School Review of International Law and Economics,* 29, (1996), pp. 737-768.

[43] Kim Iskyan, "The Russian Banking Sector: A Crisis of Stagnation," (Moscow: Renaissance Capital Research Report, 2001).

[44] Tompson, 1998, p. 242.

Intense political polarization marked the 1990s in Russia as an anti-communist president tried to push a liberal economic reform program through a parliament largely controlled by groups opposed to these policies. Throughout the decade, the executive branch needed votes from the Communist Party and/or the Agrarian Party to pass major legislation.[45] As a result compromise was very difficult. On laws governing the Central Bank, the privatization of state-owned banks, and bank bankruptcies, the executive and the parliament found little common ground. One example is deposit insurance for banks. All recognized that deposit insurance promised to bring private funds from "under the mattress" into banks, but neither the neo-communist nor liberal factions generated sufficient support from the government and parliament to pass a bill that would guarantee bank deposits despite more than a decade of efforts. Before recounting the twists and turns of the history of attempts to pass a deposit insurance bill in the 1990s, one observer noted: "the draft legislation on deposit insurance may compete for the award for the most unlucky."[46]

The CBR was skeptical of deposit insurance unless private banks paid the lion's share of the costs in large part because Sberbank has an implicit guarantee that the state will bail it out in the event of a crisis – an advantage that it was loathe to cede. Sberbank has great political support among Duma deputies from rural regions – the strongholds of the Communist Party and its allies - because in most small and medium-sized towns Sberbank is the only local option for banking services.[47] Private banks, which also have a strong lobby in

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[45] Vladimir Mau, "Ekonomicheskaia politika: Rossii: v nachale novoi fazi," *Voprosy Ekonomiki* (January 2001).

[46] Igor' Moiseev, "Sberbanku dali dva goda fori," *Vedemosti*, November 15, 2002.

[47] Author interview with Martin Shakuum, chair of banking subcommittee in the Duma, September 18, 2001.

the legislature, have been wary of deposit insurance for fear that they would bear the bulk of the costs of program, but have been willing to support legislation if the price is right.

Liberal deputies called for debate on a government guarantee for retail deposits in the early 1990s, but made little progress.[48] Spurred by the failure of pyramid schemes in 1994, the Duma tried to introduce deposit insurance, but was blocked by the private bankers' lobby and opposition within the government.[49] Following the financial crash of August 1998 and a rise of popular sentiment against banks, both houses of parliament passed legislation backing deposit insurance, but President Yeltsin vetoed the legislation, presumably to keep costs down on struggling private banks that were a base of his support.[50] The rough balance of political power between neo-communists and anti-communists in Russia helped block the adoption of important banking legislation for much of the 1990s.[51]

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[48] Joachim Bald and Jim Neilsen, "Developing Efficient Financial Institutions in Russia," *Communist Economies and Economic Transformation*, 10:1, (1998), pp. 81-92.

[49] Johnson captures the logic well: "The CB wanted the commercial banks to design and fund it, while the bankers felt that the CBR should do so. Both wanted the security, but neither wanted to pay for it." Johnson, 2000, p. 114.

[50]Author interview with Martin Shakuum, chair of banking subcommittee in the Duma, September 18, 2001.

[51] The value of deposit insurance for transition and developing economies is debatable. One study finds that on average introducing deposit insurance in countries that already have relatively capable state institutions leads to fewer banking crises. However, introducing deposit insurance into countries with weak institutions leads to more crises than in countries without deposit insurance. Asli Demirguc-Kunt and Edward Kane, "When Does Deposit Insurance Work?" *Journal of Economic Perspectives*, 16:2, (2002). Since Russia would likely end up in the "weak institutions" category, this suggests that for deposit insurance to work well, other institutions, such as courts and bureaucracies, should also be improved.

In addition, high levels of political polarization reduced the incentives of market participants to improve governance. Given the possibility that their economic gains would be at risk should President Yeltsin lose office, Russian bankers focused on short-term rent-seeking rather than supporting good governance. Banks' sensitivity to the political environment was apparent on markets for Russian privatization vouchers and for state treasury bonds – two markets on which banks were significant players. A surprisingly strong showing by the Communist Party in parliamentary elections in December 1993 and subsequent resignations of liberal ministers in favor of more statist replacements in January 1994 caused a sharp decline in the price of the voucher.[52] Similarly, in the run-up to the presidential elections in 1996, the price of state treasury bonds (GKOs) was tightly linked to the popularity of President Yeltsin relative to his communist challenger, Gennadii Zyuganov.[53] Elections in less polarized settings, as in Poland and the Czech Republic, produced barely a ripple in financial markets, indicating market participants' longer-term view in these less polarized settings.[54]

One anecdote highlights how political polarization shortened time horizons. A prominent Russian banker recounted that in early February 1996 at the Davos meetings of the World Economic Forum George Soros told him: "'Boys, your time is over. You've had a few good years but now your time is up.' His (Soros') argument was that the Communists were definitely going to win. We Russian businessmen, he said, should be careful that we

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[52] Timothy Frye, "Russian Privatization and the Limits of Credible Commitment," in ed. David Weimer, *The Political Economy of Property Rights* (New York: Cambridge 1997).

[53] Roderick Kiewiet and Mikhail Myagkov, "The Emergence of the Private Sector: A Financial Market Perspective,' *Post-Soviet Affairs*, 14:1, (1997), pp. 23-47.

[54] Frye, 2002.

managed to get to our jets in time and not lose our lives."[55] This is hardly an environment conducive to building governance institutions for the long-term.

State Ownership and Governance

State ownership of banking assets also promoted an uneven playing field and much politically motivated lending in the 1990s. Despite the creation of many private banks in the early 1990s, state agents retained a dominant presence on the banking sector. The CBR was a majority owner in the country's largest bank, Sberbank, held 99 percent of Vneshtorgbank, the country's largest bank dedicated to foreign trade, and owned five commercial banks in Europe that previously belonged to the Soviet Union. The inherent conflicts of interest in holding these shares reinforced the lack of a level playing field. For example, Sberbank is the only bank in Russia with an explicit government-backed guarantee on retail deposits, and this guarantee gives it a significant advantage over its competitors.

State ownership also generated a conflict of interest on the market for GKOs. Most observers focused on private banks, but the CBR was technically the largest player and the regulator of the market for state securities. In 1997 and 1998, the CBR and Sberbank held roughly two-thirds of GKOs, an arrangement that allowed the cash-strapped federal government to spend beyond its means and provide largesse to key constituents. The government had a strong interest in keeping the CBR and Sberbank in the GKO market.

This ownership arrangement also provided benefits to the CBR. According to the law "On the Central Bank," the CBR keeps half of its profits and turns over the other half to the federal government. As the government had few tools to compel the CBR to provide

[55] Freeland, 2000, p. 192.

full information, many accused the CBR of underreporting its profits.[56] This ownership scheme added to the opacity of banking sector. The CBR used a variety of means to hide profits, including relying on agents in foreign banks owned by the CBR to buy GKOs. In addition, the CBR held funds in an obscure bank (FIMACO) on the island of Jersey that it did not report to the International Monetary Fund or the Russian government.[57] According to the Audit Chamber of the Russian Federation, more than $50 billion passed through FIMACO, making it a scandal of rare proportions, even for postcommunist Russia.

Recognizing the benefits of state ownership, the CBR blocked attempts to privatize its holdings. In 1995 the Duma passed legislation to reduce CBR stock in state-owned banks, but fierce lobbying from the CBR compelled the Duma to overturn its decision.[58] Moreover, following the crash of August 1998, the CBR pushed for a slow schedule of reducing its ownership in Sberbank, Vneshtorgbank, and the five foreign banks that were majority owned by the CBR. William Tompson notes: "the apparent lack of enthusiasm at CBR for either the privatization of Sberbank or the speedy introduction of deposit insurance further points to a desire to preserve the savings bank's unique position and to ensure that it remains under central bank control for the foreseeable future."[59]

The so-called "spetz-banks" that were formed as spin-offs from the former specialized banks of the command economy exhibited poor performance and little

[56] Victoria Lavrentieva, "Duma to CB: Show Us the Money," *Moscow Times*, December 21, 2001, p.1.

[57] Belton and Semenko, 1999; Johnson, 2000, pp. 64-65.

[58] Johnson, 2000, p. 114.

[59] Tompson, 1998, p. 138.

enthusiasm for good governance.[60] One study found that the "descendants of the 'former' *spetsbanki* appear to have higher labor costs, poorer loan quality, higher loan rates and marginally lower capital than other banks."[61] This poor performance is consistent with the argument made here as these "spetz-banks" and their descendants retained close informal ties to state agents and extensive state ownership. In the 1990s state ownership of banks contributed to the opacity of the market and reinforced the lack of a level playing field.

In other countries in the region banking crises have spurred attempts to reform the sector, but the Russian Central Bank did little to address the roots of the 1998 financial crisis.[62] The CBR withdrew fewer licenses in the year after the crash than the year prior to the crash.[63] Moreover, "the percentage of bank licenses recalled during the year after the crisis, was higher among banks that did not have GKOs in their portfolios on the eve of the crisis than among those that did.[64] This indicates that the CBR and the government were loathe to address governance problems at the largest and most powerful banks.

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[60] The five USSR spetsbanks were Agroprombank, Promstroibank, Sberbank, Vneshekonombank, and Zhilsotsbank, and were responsible for the agriculture, industry, household, foreign trade and housing sectors, respectively.

[61] Koen Schoors, "The Fate of Russia's Former State Banks: Chronicle of a Restructuring Postponed and a Crisis Foretold, *Europe-Asia Studies,* 55:1, (2003), 75-100.

[62] Helena Tang, Edda Zoli, and Irina Klytchnikova, *Banking Crises in Transition Economies* (Washington, D.C.: World Bank, 2001). That the CBR and government faced legal obstacles in closing insolvent banks is a flimsy excuse. Had they demonstrated an interest in improving governance, they would have pushed for stronger legislation on insolvency in the banking sector. Indeed, the CBR lobbied to exclude banks from the Law on Bankruptcy.

[63] Perotti, 2001, p. 35.

[64] L. Sicheva, L. Mikhailov, L?. Timofeev, E. Marushkina, and S. Surkov, *Krizis 1998 goda i vostnaovlenie bankovskoi sistemi* (Moscow: Moscow Carnegie Center, 2000), p. 303.

The CBR and the government spent much of 1999 warding off plans put forward by the IMF and the World Bank to reform the banking sector. Then head of the CBR Gerashchenko proudly announced that he had not read the government's plan on bank reform. When asked about the possibility of having the CBR undergo quarterly audits as required by the G7 countries, Gerashchenko retorted: "To make us perform a striptease every quarter is a little bit stupid."[65] The CBR's plan to modernize the banking sector opposed efforts to reduce state ownership in the banking sector, was skeptical of sharply raising minimal capital requirements, and advocated a ten-year time table for reform.

One aspect of the government's plans was the creation of ARKO, an agency designed to restructure collapsed banks. The CBR vehemently opposed the creation of ARKO and succeeded in keeping the organization poor and weak. Less than thirty problematic banks fell under its initial purview.[66] While the government and international financial institutions bargained over reform plans, Russian banks transferred assets to bridge banks with varying degrees of success. Oneximbank became Rosbank. Menatep became Menatep-St. Petersburg. Bank Rossisskii-Kredit emerged as Impex Bank. Those banks that had substantial industrial assets and/or patrons within the state suffered less than others. Foreign lenders and Russian depositors were big losers as both groups accepted pennies on

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[65] Andrei Ivanov, "Russian Banking Reform: To Be or Not To Be?" (Moscow: Troika-Dialog Research Report, 2000: 1).

[66] Indeed some have argued that ARKO's opaque decisionmaking structure and distribution of assets to some politically well-connected banks has, if anything, increased concerns about the stability of the sector. That ARKO lent money to Alfa-Bank, one of the most prosperous in Russia, to expand its regional operations raised particular concerns. See Dmitriev et al., 2001, p. 235.

the dollar for their losses. The massive asset-stripping that followed the crash, with the tacit support from the CBR and the government, did little to inspire confidence.

In sum, the demand for and supply of good governance on the banking sector during the 1990s was low. Budget deficits and state ownership led banks to favor activities that generated weak incentives to support stronger regulation, while politicians in a polarized setting had little incentive to improve governance. Weak institutions helped spur the financial crash of August 1998 and the poor performance of the sector more generally.

5. The Banking Sector 2000-2004

In addition to wiping out depositors' savings, the financial crash of August 1998 changed the landscape of Russian banking. Large private commercial banks saw their political and economic influence diminish relative to other interests. Some large commercial banks, such as MOST-Bank, SBS-Agro, and Inkombank were closed.[67] Others created bridge banks that were smaller and less aggressive than their predecessors. Two banks that increased their presence were Alfa-Bank, which sold most of its GKO holdings market prior to August 1998 and had a powerful industrial group that included the Tyumen Oil Company, and MDM-Bank, which benefited from ties to the metals giant, MDM-Group.[68]

[67] In a sign of the times, Inkombank, formerly one of the most prominent banks in Russia, was forced to sell to the state its collection of works by Kazimir Malevich, including his "The Black Square" in 2002.

[68] It probably does not hurt Alfa-Bank's position to have one of its former top managers, Vladislav Surkov, as deputy head of the Presidential Administration or that Alfa-Bank had been the authorized bank of the St. Petersburg government while President Putin served there in the 1990s.

In recent years foreign banks have become prominent players in Russia. Thirty-two banks have 100 percent foreign ownership. US-based Citibank and Austria's Raifessenbank are in the 15 largest banks, and foreigners own 5 of the fifty largest banks in Russia.[69]

Some large private banks continue to operate primarily as treasury agents for a single firm or a small group of firms. Banks with founders in the metals and energy sector have displayed considerable growth over the last four years. Examples include GazpromBank, SurgetNeftegazBank, and Metcombank, a pocket bank for the metals giant, Severstal.

Medium-sized banks generally exited the crisis in good stead having largely avoided losses on the GKO market. Some of these banks have been at the forefront of the recent increase in private sector lending. Market observers often point to Bank Russkii-Standart, Probiznessbank, and Moscow Credit Bank as having found niches in the market for borrowing and lending. In addition, two foreign owned banks, KMB and Delta-Capital, have become leaders in lending to small businesses and the mortgage market. Nonetheless, many small and medium-sized banks continue to operate as pocket banks for enterprises or regional governments.

State-owned banks emerged after the crisis in a strong position as private banks offered weak competition. Sberbank and Vneshtorgbank benefited from vast infusions of capital from the federal government in 2000 and 2001. Sberbank and Vneshtorgbank account for roughly 35 percent of all assets held in the banking sector, and state-owned banks combined account for 40 percent of all assets. In addition, Sberbank retains roughly two-thirds of all retail deposits making it by far the largest bank in Russia.

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[69] Russian Business Consulting Newservice, "Foreign Banks Race to Invest in Consumer Lending," January 14, 2003.

The economic and political environment in which these banks operate, however, has changed in important respects. Budget surpluses have limited opportunities for earning easy money by financing the government. In addition, parliamentary and presidential elections in 1999 and 2000 reduced political polarization.

Budget Balance and Governance

According to the explanation cited above, the outlook for raising the quality of governance on the banking sector should improve. The ruble devaluation, rising oil prices, and some restructuring within industry, has markedly improved Russia's macroeconomic condition. The consolidated budget averaged a deficit of 8 percent of GDP from 1991-1999, but averaged a 2 percent surplus from 2000-2004. The stable macroeconomy ended the banks' most profitable practice – lending to the government. As such, the structural position of banks within the Russian political system is weaker than prior to August 1998. If in the mid-1990s, Russian banks had leverage over policy because they were central financiers of the state budget deficit, the budget surpluses of recent years have greatly eroded the political power of Russian banks. While in the aggregate profits on the market are high, profits margins are being squeezed across all types of Russian banks.[70]

As banks have been less able to earn easy money from the state's fiscal imbalances, they are now repositioning themselves by increasing lending to the private sector or to leave the business. Indeed, bank lending to non-financial firms increased from 11 billion US dollars in 1999 to 77 billion in 2004.[71] Loan assets on average grew during the period 2000-

[70] Author interview with Andrei Klepach, Bank Analyst, Center for Development, June 17, 2002.

[71] OECD, Economic Survey of the Russian Federation 2004.

2002 from 34 to 47 percent of all assets.[72] This figure is low in comparison to other countries in the region, but does indicate a sharp increase in loan activity in a relatively short period of time. Indeed, the CBR and others have worried that the rapid increase in loans may leave some banks vulnerable in case of a sharp economic correction.[73] Total retail deposits from individuals have also increased from 18 billion dollars in 2000 to 50 billion in 2004.[74] The latter figure is twice the peak in the pre-crash period. An increase in retail deposits in private banks has cut somewhat into Sberbank's market share which has fallen from 77 percent of all retail deposits in 2000 to 64 percent in 2004 (OECD 2004).

One banker noted: "Those that are interested in banking are repositioning themselves to be banks, while those that do not want to do banking are getting out of the business."[75] Fifteen of the top 100 banks are undergoing some form of ownership restructuring.[76] Several analysts agreed that banks that operate in financial-industrial groups now must justify their high cost of operations to their founders, given the opportunity for the latter to get loans from foreign banks or Sberbank at lower rates.[77] Gazprom reduced its holdings in the sector by selling its 37 percent stake in the National Reserve Bank in an

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[72] *Bulletin of Banking Statistics*, #4, 2002.

[73] "Elena Berezanskaya and Boris Safronov, "U bankov 'portyatsya' krediti," *Vedemosti*, September 17, 2002; Vlastya Demyanenko, "Russian Central Bank Worried About Too Fast Credit Growth," *Reuters*, September 30, 2002.

[74] Boris Safronov, "Vremya roznichnikh bankov: samii bistrii rost obespechivaiyut chastniie vkladi," *Vedemosti*, November 25, 2002.

[75] Author interview with Alex Kotcherguine, Vice President, MDM-Bank, June 20, 2002.

[76] Author interview with Mikhail Matovnikov, Bank Analyst, Interfax news agency, June 13, 2002. See Also Mikhail Matovnikov, "Banki: vremya menyat' strategiyu." *Kommersant'*, June 18, 2002.

[77] Author interview with Natalya Orlova, Bank Analyst at Alfa-Bank, June 17, 2002.

effort to focus on its core business.[78] Moreover, large Russian corporations can turn to foreign banks, bonds, or state-owned banks for loans, an option that further reduces the attractiveness of holding a costly pocket bank.

Medium-sized banks that earn most of their revenue from borrowing and lending are also increasing their capital through mergers or acquisitions.[79] By doing so, they hope to reduce their risks of lending to fairly opaque firms and to compete with larger banks on specific markets. Small banks have begun to recognize their disadvantage and have sought buyouts form larger banks with some success.

This shift in strategy has sharpened incentives for creating stronger regulatory institutions that may promote borrowing and lending to the private sector. For example, in June 2001, the two largest private commercial banks in Russia announced a banking reform plan, in cooperation with the Russian Union of Industrialists and Entrepreneurs (the RSPP).[80] Alexander Mamut, then Chairman of the Board of MDM-Bank, and Petr Aven, the head of Alfa-Bank presented a largely self-serving plan that called for sharply increasing minimum capital requirements, privatizing state-owned banks, making a rapid transition to international accounting standards, and creating a three-tiered banking system, with small banks restricted to only minimal operations. The Mamut Plan called for banks to have 1 billion rubles ($33 million) in capital before they receive their license and to increase their capital to 3 billion rubles ($100 million) within their first two years. As 80 percent of

[78] *Moscow Times*, July 9, 2002.

[79] Elena Berezanskaya and Svetlana Petrova, "Mamut dobilsya svoevo," *Vedemosti,* B1, September 17, 2001.

[80] See "O deiyatelnosti rabochei gruppii byuro pravlenie RSPP po voprosam reformirovaniya bankovskoi sistemi," ms. (Moscow: Russian Union of Industrialists and Entrepreneurs, July 11, 2001).

Russian banks at the time had less than $5 million in capital, this plan would have left only a handful of banks, including, not surprisingly, MDM-Bank and Alfa-Bank, in the market.

That the Russian government in concert with the CBR and an alliance of smaller banks blocked the Mamut Plan indicates the degree to which the government was less dependent on large banks than in 1998. Self-serving elements aside, however, the Mamut Plan marked the first time that the banking community had offered a plan to use the power of the state to bring a degree of order to the banking sector. In addition, the Mamut Plan was backed by the Union of Industrialists and Entrepreneurs, (the RSPP) the largest industrial union in Russia, which indicated recognition from some in industry than an improved banking sector could serve as a source of investment capital. Recent statements by the head of Alfa-Group, Petr Aven echo this sentiment for stronger regulation: "Banking supervision has to be strengthened, as tough as possible…The Central Bank has to be tougher… Hopefully 50 percent of Russian banks will die." [81]

These shifts in lending practices, merger and acquisition activity, and proposals to reform the banking system indicate an increased interest in governance as financial institutions position themselves to engage in the types of borrowing and lending commonly associated with banks. Indeed, the EBRD raised Russia's score on its index of the quality of banking institutions from 1.7 to 2.0 in 2002. While demand for good governance on the banking sector is still fairly low, it is increasing.[82]

Declining Political Polarization and Governance

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[81] Petr Aven, "Aven: Let 50% of Banks Die Quickly," *Moscow Times*, August 8, 2003.

[82] Indeed, the collapse of the 52nd largest bank in Russia, IBK, in March 2002 after receiving a good bill of health from the CBR indicates the continuing opacity of banks in Russia Mikhail Matovnikov, "Predvestniki krizisa," *Russkii Fokus*, 17, 2002, pp. 1-3.

In addition, political polarization fell after parliamentary and presidential elections in 1999 and 2000 gave the Putin team a rough working majority in the Duma. The decline in political polarization strengthened incentives of state agents to supply stronger governance. The Ministry of Economics and Trade, the Finance Ministry, and the executive branch have shown greater enthusiasm for cleaning up the banking sector. The executive branch took a more aggressive stance toward the CBR. In the summer of 2000, the government sought to make the CBR subordinate to the government, but could not get this plan approved by the Duma.[83] The government then pushed for a National Banking Council consisting of representatives from the Duma, the CBR, and the government to oversee the financial activities of the CBR. With members from the Federation Council, the Duma and the Executive Branch, the Council now oversees the spending of the Central Bank on its employees and operations.[84]

President Putin also stepped up criticism of the CBR noting: "it has not done its best to develop the banking system."[85] Facing pressure from a popular executive intent on whittling the powers of the CBR, Gerashchenko resigned in March 2002. The current head of the CBR, Sergei Ignatiev, is thought to be more loyal to Putin.[86] This move indicated that

[83] Igor' Moiseev, "Prezident khochet' sdelat' TsB 'gosuchrezhdenniyam,'" *Vedemosti*, September 29, 2000.

[84] Aleksandr Shokhin, former head of the Duma committee on banking, recently applauded greater transparency in the use of funds within the Russian Central Bank. Vasilii Kudinov, Elena Berezanksaya, Anastasia Onegina, "TsB poluchil rekordnuyu pribiil: aabrav depoziti iz Vneshtorgbanka," *Vedemosti*, May 13, 2003.

[85] Radio Free Europe/Radio Liberty Research Report, December 28, 2000.

[86] Julia Tolkacheva, "New Russian Central Bank Seen as Welcome Reformer," *Reuters*, Moscow, March 19, 2002.

the Putin team was willing to risk some political capital on bank reform and removed what was widely seen as a major obstacle to reform.[87]

The government has pushed for banking reform on the legislative front as well. In 2000, it lobbied the Duma to pass the so-called "IMF package" that included amendments to the law "On Banks and Banking" that more clearly defined relations between banks and related companies; the law "On Insolvency of Credit Organizations" which made it easier to declare a financial institution bankrupt; and the law "On the Central Bank" that would increase the transparency of the budget and decisionmaking at the CBR. Revealing his commitment to the IMF package, Finance Minister Aleksei Kudrin attended committee meetings every day for two weeks to push the legislation through the Duma.[88]

In the summer of 2001, the government pressed the legislature to pass a law "On Money Laundering" that would remove Russia from a blacklist of countries whose financial transactions were seen as suspect by the international community. After intense bargaining, the Duma passed legislation that satisfied the Financial Action Task Force (FATF) who then removed Russia from its blacklist of countries seen as not cooperating with global money laundering. In October 2002, the FATF removed Russia from its black list leaving only 11 countries in bad stead with the FATF.

The executive branch and the new team at the CBR have adopted a more aggressive regulatory strategy. Prior to Gerashchenko's resignation, the government adopted a five-year reform program. The Joint Strategy on Banking Reform published on September 27th,

[87] There is also evidence that the CBR is beginning to enforce restrictions on limits of lending to individual firms. If this rule is consistently applied, it would be fatal for most pocket banks. Evgenii Epshtein, "Gazprom zanyal 500m," *Vedemosti*, April 15, 2002.

2001 promised to adopt international accounting standards for all banks by January 2004; to review the role of state ownership of banks, but also indicated that "a cardinal reformation" of ownership with regards to Sberbank was "not one of the tasks of banking reform"; and to support the creation of a system of deposit insurance, but offered only a vague paragraph on the topic.[89] The document was more limited than some observers expected.[90] Other observers, however, were pleased that the CBR and government had managed to put forward a plan that offered even these changes.[91]

The reforms put forth after the resignation of Gerashchenko in June 2002 were more ambitious.[92] The new CBR First Deputy Ministry Andrei Kozlov reaffirmed a commitment to introduce international accounting standards for all banks by January 2004 and to strengthen efforts to clarify banks' notoriously murky ownership structures. The CBR also issued regulations designed to make it more difficult for banks to artificially inflate their capital and to disguise the identities of their true owners.[93] By 2002, the rating agency

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[88] Author interview with Irina Kotelevskaya, lobbyist for the Russian Union of Industrialists and Entrepreneurs, June 20, 2002.

[89] See "Sovmestnaia strategiia Banka Rossii i Pravitelstva Rossiiskoi Federatsii o razvitii bankovskoi sistemi." *Kommersant-Daily,* September 17, 2001, p. 4.

[90] Svetlana Petrova, "Gerashchenko pobedil, no pobezhdenii svoevo dobilsya," *Vedemosti*, September 17, 2001.

[91] Personal communication with Gail Buyske, bank consultant.

[92] "Voprosy modernizatsii bankovskoi sistemi Rossii," 11th International Banking Congress, June 6, 2002.

[93] "Tsentrobank proverit bankovskiie krediti," in *Finansoviie Izvestiya,* accessed at www.finiz.ru/business/article.11360 on May 12, 2003.

Standard and Poors reported that of the fifteen largest banks, nine identified owners with at least a 30 percent ownership stake.[94]

Most importantly, after eleven years of discussion, the government finally adopted a Law on Deposit Insurance in December 2003. The OECD called the legislation "perhaps the most important banking reform adopted in recent years."[95] The plan insures individual (not corporate) deposits up to 100,000 rubles ($3750) with a government guarantee and is mainly aimed at protecting small retail depositors.[96] Banks wishing to accept deposits from the public have to take part in the program or leave the market. They also must submit to relicensing by the CBR and to adopt international accounting standards. The relicensing program is perhaps the most important aspect of the law as it requires the RCB to conduct a thorough review of all banks accepting retail deposits. By the end of 2004, more than 1100 banks had applied for the program and 400 firms had received new licenses.[97] Observers had mixed views on the quality of the reviews.[98] Richard Hainsworth, a long-time observer of banks in Russia noted: "The criteria that banks have to fill are very strict. Some of the big

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[94] Kiril Koriukin, "For Banks, Going Public is a Very Private Affair," *Moscow Times, Special Report*, June 17, 2003. Christopher Kenneth, "Russian Banks Unprepared for New IAS Accounting." *Russia Journal*, June 4, 2003.

[95] *OECD Economic Survey of the Russian Federation 2004: Banking Reform*, p. 1.

[96] The limited funding of bank deposits may reduce moral hazard problems that plague deposit insurance in countries with weak institutions.

[97] Greg Walters, "Key Changes Set Banking Reform in Motion," *Moscow Times*. February 9, 2005.

[98] It is also potentially important that these reforms were put forward by the regulatory arm of the CBR. Kozlov has assumed a much higher profile than his predecessors and talks with the head of the CBR several times a day according to Sergei Ignatyev.

banks sweated blood, right until the end."[99] Others were more skeptical. Elena Trofimova of the rating agency Standard and Poors observed that the initial results "present a disappointing picture; and even very weak banks have been admitted."[100] By pushing deposit insurance, the Central Bank also sought to increase transparency on the notoriously opaque banking sector. By the summer of 2003, about 100 banks in total, including almost all the top 15 banks, prepared their financial statement using international accounting standards.[101]

The treatment of Sberbank in the bill on deposit insurance provoked special interest. Sberbank is the only bank with a government guarantee on retail deposits and was reluctant to cede this advantage. While the bill was designed to level the playing between state and private banks, the legislation afforded several privileges to Sberbank. It maintains a separate fund for deposit insurance and it will only merge with the general deposit insurance fund in 2007 or until its market share of retail deposits falls below 50 percent.

The Russian government's stance in recent years toward foreign banks has been more mixed. In the 1990s, foreign banks could only own 12 percent of the total assets of the Russian banking system, but in November 2002 the CBR removed formal limits on the size of foreign ownership in the banking sector.[102] This move could have important impact on governance as many credit foreign ownership as promoting stronger financial institutions

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[99] Greg Walters, "Key Changes Set Banking Reform in Motion," *Moscow Times,* February 9, 2005. See also Ben Aris "All Change," *The Banker*, April 2004.

[100] Sveta Skibinsky, "State Muscle Could Be Key to Success for Real Reform in Russian Banking." *St. Petersburg Times*, December 7, 2004.

[101] Christopher Kenneth, "Russian Banks Unprepared for New IAS Accounting." *Russia Journal*, June 4, 2003.

in Eastern Europe.[103] However, the CBR continues to oppose allowing foreign banks to open branches in Russia as currently foreign banks rely on Russia-specific subsidiaries. Recently, the Ministry of Trade and Economic Development supported placing a 25 percent quota on foreign capital in the banking system.[104] It is too soon to tell if this is a bargaining chip for WTO organizations or deeply held policy position.

While it is too early to determine the success of the implementation of these plans, the passage of a law on deposit insurance and a higher profile for the regulatory bodies within the CBR contrasts with previous policy. Many of these efforts remain paper victories, but they are necessary first steps to a better-governed sector and indicate a change in policy from the Yeltsin years.

In addition to these formal changes in CBR policy, lobbyists at the Russian Union of Industrialists and Entrepreneurs, the Association of Russian Banks, and the Association of Russian Regional Banks note that they have found it easier to find a common language with the Putin administration and the new team at the CBR.[105] Some lobbyists noted that their ideas found a more welcome reception at the Ministry of Economics and Trade than elsewhere with the government. Representatives of the Ministry of Economics and Trade

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[102] Oleg Anisimov, "State-Owned Banks May Face Foreign Challengers," *Russia Journal*, August 12, 2003. There is much debate about whether foreign banks will have the right to open branches in Russia outright or to rely on Russia-specific subsidiaries.

[103] Berglof and Bolton, 2002.

[104] Russia Against Foreign Bank Branching, February 11, 2004.

[105] Author interview with Irina Kotelevskaya, head of department for relations with government bodies, for the RSPP, June 20, 2002, Author interview with Aleksander Murichev, President of the Association of Regional Russian Banks, "Rossiya"; June 14, 2002; Author interview with Garegin Tosunian, President of the Association of Russian Banks, June 19, 2002.

noted that this was a conscious strategy.[106] In designing their reform program, they had tried to reach out to the banking community – particularly those medium-sized banks that earned revenue through borrowing and lending – to gain political support and to help identify regulatory problems.

One institutional innovation that speaks to greater input from market participants is the creation of a State Council (Gossovet) to develop a strategy for banking reform.[107] This Council consists of about 40 representatives of state bodies, such as the Ministry of Finance, the Central Bank, the Anti-Monopoly Committee, prominent bankers from Moscow and the regions, and experts on the banking sector in Russia. The initiative to create this body came from the government.[108] The first draft of the State Council became the subject of a lively discussion over the direction of bank reform, the current state of the banking system, and the role of the banking sector in promoting investment.[109]

Of course, a decline in political polarization is not a cure all. While the Putin administration has displayed greater interest in improving governance, bank reform is not at the top of the agenda. In his address to the Federation Council on April 18, 2002, bank reform did not appear until the last third of the speech.[110] In addition, continued high oil

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[106] Author interview with Boris Shentsis, Deputy Head, Ministry of Economy and Trade who is responsible for financial sector reform, June 19, 2002.

[107] Elena Myazina, "Gossovet vzyalsya za banki," *Izvestiya*, June 15, 2002.

[108] One member of the Gossovet recalled that at the first meeting he noted: "Why are we all here?" Author interview with former CBR Deputy Minister Aleksander Khandruyev, June 19, 2002.

[109] Irina Granik, "Bankiri ni odobrili kontseptsiyu bankovskoi reformi," *Kommersant'* June 15:2, 2002.

[110] Poslanie Prezidenta Rossiiskoi Federatsii V.V. Putin Federalnomu Sobraniyu RF April 18, 2002.

prices may have dulled the government's sense of urgency in conducting structural reforms. Moreover, the overwhelming victory of President Putin's party in parliament in elections in December 2003 raises concerns that the opposition will place few constraints on the executive. Nonetheless, the longer-term view afforded by a less polarized political setting has increased efforts to improve governance on the banking sector.

State Ownership and Governance

While dramatically lower inflation and political polarization promise improved governance, the continuing large role of state-owned banks points to the limits of institutional reform. Indeed, state-owned banks dramatically increased their activity on the banking sector after August 1998, and may be an even greater obstacle to reform now than prior to the crash. The government has pushed Sberbank and Vneshtorgbank to lend far more aggressively to large corporate entities than in the past. In 1997, Sberbank held only 14 percent of loans outstanding, but this figure reached 32 percent in 2001 and 30 percent in 2004. In contrast, no private bank controls more than 5 percent of lending.[111] State-owned banks lend at lower rates than private banks, in part because the government stands behind their loans. Recalling the ability of state-owned banks to lend at low rates, the President of the Association of Russian Regional banks noted: "Sberbank dumps its goods on the market." (Sberbank zanimaetsya dempingom).[112] This dominance reduces competition on the market and reinforces the disadvantage of private ownership of banks.[113]

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[111] Gail Buyske, "Russia Case Study: World Bank Consolidation Project," Draft, October 2002.

[112] Interview with Aleksander Murichev, President, Association of Russian Regional Banks, June 14, 2002.

[113] Torrey Clarke, "Retail Banks Struggle under Sberbank Shadow," *Moscow Times*, June 26, 2001, p. 11.

Sberbank has engaged in dubious corporate governance practices in the post-crash era. In the summer of 2001, Sberbank board members voted to make 5 million shares available to majority owners, a move which raised $180 million for the bank, but also diluted the shares of minority owners by more than a third and deepened skepticism toward Sberbank's commitment to good governance.[114] Indeed, in the summer of 2003, Sberbank took the unprecedented step of suing one of its board members who claimed that the bank regularly provided below-market rate loans to its company managers, padded its 200,000 strong workforce, and made money-losing loans at below market rates to politically influential companies.[115] For good measure, Sberbank also sued newspapers that printed his comments.[116]

The CBR and some within the government have been skeptical of reforms for the banking sector promoted by the IMF, particularly plans to reduce the ownership stakes of the CBR. The CBR is not the only beneficiary of state ownership in the banking sector. Politically motivated lending is a valuable tool for any government that seeks to reward supporters without running the gauntlet of budget approval from the Duma – a fact well understood by the current government. In December 2001, Vneshtorgbank placed $700 million at the disposal of Gazprom to help pay its taxes. Not only was the loan at below market rates, the transfer was not announced to the market which led to a mini-run on the

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[114] Igor Semenko, "Sberbank Approves New Share Emission," *Moscow Times,* June 28,2001, p. 5.

[115] Vasilii Kudinov and Tatyana Lysova, "'Sberbank Zasudil Kleinera," *Vedemosti*, June 20, 2003.

[116] Sberbank has a ratio of assets to employees of about $132,000. The corresponding figure for Citibank is $3.9m. Igor Semenko, "Sberbank on the Prowl for Negative News." *Moscow Times*, June 27, 2003.

ruble as traders reacted to a sharp and unexplained decline in CBR reserves.[117] Sberbank has made large loans to companies in which the state is the largest shareholder such as, RAO-EES, Svyaz'Invest, and Rosneft. Sberbank's loan portfolio is highly concentrated on loans to these clients, much more so than would be advisable for a bank that could not count on a government bail out if a client cannot repay a loan. As these firms are primarily state-owned, many doubt the ability of Sberbank to collect should these firms falter. In 1998 one observer noted: "it is no exaggeration to describe Sberbank as the country's number one 'pocket bank' – the pocket bank of the federal government."[118] This insight rings even more true today.

The government in the Putin era has shown increased interest in state-ownership in the banking sector. It created two new state-owned banks designed to fund industry and agriculture. More importantly, it has backed a move to divest the CBR of its 99 percent stake in Vneshtorgbank -- the country's second largest bank -- and to transfer ownership rights to the Ministry of Finance. Initially, the government planned to sell a 20 percent stake of Vneshtorgbank to a strategic investor and negotiations with the EBRD were underway. However, in June 2002, the government announced plans to merge Vneshtorgbank with Vnesheconombank, a government agency created to trade Soviet-era debt. Such a move promised to delay attempts to sell a stake in the newly created entity. The head of the new entity, quickly announced his intention to be a major creditor of strategic industries in Russia. While Prime Minister Mikhail Kasyanov threw cold water on the idea, the merger

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[117] *Vedemosti*, December 25, 2001.

[118] Tompson, 1998, p. 134.

indicates that state ownership in the Russian banking sector is not diminishing. The Prime Minister also noted that the privatization of Vneshtorgbank was only likely in 5-7 years.[119].[120]

That the government named Vneshekonombank to oversee the State Pension fund, despite the fact that it has no license for commercial banking and mainly acts to oversee the government's debt, is further evidence of the increasing role of state banks. One long-time observer of Russian banks noted: "I see no logic here." Another said: "This looks like another move in the Russian elite's game of 'who controls the nation's cash flows.'"[121] That the government has resuscitated the Soviet-era Vneshekombank provides more evidence of the Putin administration's desire to increase the presence of the state on the banking sector.

As the government searches for new sources of investment capital outside of the energy sector, state-owned banks may play a larger role in the economy than prior to the crash of August 1998. Evidence from other post-communist countries and Russia's first decade suggest that this does not bode well for governance on the sector.

In sum, the past four years have seen the first shoots of efforts to improve the regulatory environment for banks in Russia. Macroeconomic stabilization has ended the easy rents that banks could extract from the state. In turn, banks have begun to express increased interest in borrowing from and lending to the private sector. Though much work

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[119] Interfax, June 19, 2002.

[120] Igor' Moiseev, "Blitzkrig udalsya," *Vedemosti*, June 28, 2002. The Duma passed legislation that promised to limit the number of inspections conducted by the Central Bank to one for each matter under investigation. Such a rule would be in contrast to Bank for International Settlement norms and was strongly criticized by international financial organizations, the CBR, and initially by the government.

[121] Victoria Lavrentieva, "Choice of Pension Agent Said Damaging," *Moscow Times*, January 27, 2003.

remains to translate this interest into higher levels of demand for improved governance, recent budget surpluses have at least created a group of banks that would benefit from better governance. In addition, lower levels of political polarization have increased the supply of efforts to reform the banking sector, as indicated by recent government efforts in support of bank reform. By contrast, continued and expanding state ownership in the banking sector is a clear impediment to improving the governance of banks in Russia. As in the energy sector, the Putin Administration appears intent on keeping the state as a prominent owner in the banking sector for the near future.

Conclusion

Creating strong banking institutions is a tall order. Yet even by the relatively low standards of the postcommunist world, the Russian banking sector stands out for its weakness. A 2003 World Bank study noted: "despite improvements overall in medium and long-term credit to the real sector, domestic bank credit still plays an insignificant role in financing enterprise capital formation."[122] This essay found that two common arguments about the quality of banking institutions in Russia were lacking. Rapid economic liberalization was not associated with weak institutions on the banking sector, and while there was stronger evidence in support of the state capture argument, it raised as many questions as it answered.

This essay examined how budget deficits, political polarization, and state ownership of banks shaped the quality of banking institutions. Obviously other factors are important as well, but concentrating on these three factors produces insights that help us understand the development of the Russian state. A focus on how banks benefited indirectly from macroeconomic instability adds some nuance to the state capture argument. In the early

1990s, new private banks were unlikely suspects to gain leverage over the state. The agricultural lobby, regional governments, and the natural resource sectors were far more influential players in Russian politics. Indeed, these groups were especially adept at obtaining subsidies from the state in the early 1990s. As the Russian budget deficit ballooned, however, Russian banks became the main financiers of the state deficit. By serving as a critical source of capital for the state, private banks in Russia became well placed to influence policy. The rise of Russian banks suggests that political influence early in the transition need not be translated into greater power later in the transition in a linear fashion. It also suggests the importance of examining state capture from a dynamic rather than a static perspective. Strategically located groups - even weak ones - can grow politically influential off rents generated largely by other, more powerful groups.

Paying attention to the distributional consequences of macroeconomic instability is also important because many have criticized governments in the region for paying too much attention to macroeconomic stabilization and neglecting institutional development. However, a macroeconomic policy that rewards banks for lending to the private sector rather than to the state is essential to raising demand for better governance.

A focus on political polarization between anti-communists and neo-communists provides some insights into why private banks, having grown wealthy in the early and mid-1990s, did not try to strengthen state institutions. Many expected that Russia's nouveaux-riches bankers would be willing to invest their efforts in creating a more capable state, if only to protect their property rights. However, private bankers in Russia in the 1990s showed little enthusiasm about regulatory reform, even after they had amassed considerable wealth.

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[122] *Russian Economic Report*, August 2003, www.worldbank.org.ru, accessed August 20, 2003.

One factor that contributed to bankers' lack of support for long-term institutional reform was the extent of political polarization in Russia between neo-communists and anti-communists.[123] Facing the possibility of a sharp change in the direction of policy should President Yeltsin fall from office, bankers were reluctant to invest their efforts in the arduous task of building institutions. In contrast, in other settings where shifts in policy were less likely, banks exhibited considerable demand for improving the quality of institutions. For example, in Poland or Slovenia turnovers in government produced little change in policy in part because all major parties were largely committed to building a market-oriented economy.[124]

Political clashes between a large neo-communist delegation in parliament and a stridently anti-communist President also made it difficult to pass legislation in Russia. Having to gain support from the Communist Party and an anticommunist executive made passing regulatory reform on the banking sector particularly difficult in the 1990s. In far less polarized political systems like Estonia or Hungary, governments could cobble together legislation while relying on votes from like-minded parties. In Uzbekistan, and other neo-communist dominated political systems, the commitment of the elite to a state-dominated economy also made bargaining between branches of government a relatively minor

[123] One alternative is that the new rich did not seek to strengthen the state domestically as long as they could park their money abroad in countries where their property would be protected. See Konstantin Sonin, "Why the Rich May Favor Poor Protection of Property Rights," ms. New Economics School, Moscow, 2002; also Karla Hoff and Joseph Stiglitz, "After the Big Bang: Obstacles to the Emergence of the Rule of Law in Russia," ms. Presented at Annual Meeting of the American Political Science Association, Washington, D.C., September 2002.

problem.[125] However, in Russia, opportunities for compromise between an anti-communist president and a neo-communist led parliament in the 1990s were few and far between. An emphasis on political polarization recognizes that the political environment in which successive Russian governments made policy was far less conducive to building strong state institutions than in other settings where either neo-communists or anti-communists dominated the political scene. It also encourages analysts to trace how political configurations shape the incentives of state officials to strengthen or weaken institutions.

Finally, while many have criticized privatization, or more often the manner in which it was conducted, for weakening state institutions, this essay found that state ownership of banks is far from a solution. Indeed, state ownership of banks carries great risk to building strong regulatory institutions. In the Russian case, state-owned banks blocked regulatory reforms that would level the playing field, such as creating deposit insurance, for more than a decade. Extensive state-ownership has also intensified conflicts of interests within the Central Bank, an organization that operates as both a regulator and a player on the banking sector. A focus on the role of state-owned banks can help us understand why progress in banking reform has been so slow even after financial crash of August 1998 trimmed the wings of Russia's most prominent new private banks.

Taken together these findings call into question the prevailing wisdom about the roots of weak banking institutions in Russia. Moreover, they identify the fault-lines in

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[124] See ed. John Bonin, *Banking in Transition Economies: Developing Market Oriented Banking Sectors in Eastern Europe* (Cheltenham: Elgar 1998).

[125] Of course, countries experiencing little political polarization that are dominated by parties intent on maintaining state control may have weak banking institutions for other reasons.

Russian politics that shaped state institutions in the 1990s, and will likely continue to do so for years to come.

Table 1. The Argument in Comparative Perspective

		EBRD Bank Institutions Score	"T" statistic and significance level
Budget Balance	< average	2.0	3.8 (.0002) n= (220)
	> average	2.4	
Political Polarization	> average	1.7	5.2 (.0000) n= (236)
	< average	2.3	
State Ownership	> average	2.2	2.4 (.02) n = (166)
	< average	2.5	

This table reports a comparison of means for countries with higher than average and lower than average budget balances, rates of political polarization and state ownership in the banking sector test for 25 postcommunist countries using annual data from 1990-2000. Data from are taken from EBRD Transition Report, various years. No data from Serbia or Mongolia. n = number of observations. Variables described in text.