Russia and the Ukraine: the State of the Banking Sector Remains Precarious

Both the Russian and the Ukrainian banking systems have had to withstand a fundamental change in monetary policy since the beginning of 1995, one resulting not least from pressure from the International Monetary Fund (IMF). Since then, both countries have pursued a policy of extremely high real interest rates. Given that the banking system constitutes an important interface between macroeconomic impulses and microeconomic processes, its performance is of decisive importance for the course of the transition process. The situation in the banking sector has become much more acute since the change in monetary policy stance, due to the rising incidence of bad debts. Although it has so far proved possible to avoid an open crisis of the banking system – largely due to *ad hoc* intervention by the central banks – there is still no sign of a comprehensive solution in the form of a recapitalisation of the banks in conjunction with structural reforms in the corporate sector.

Russia

Structure of the banking system

Moves away from the traditional Soviet "monobank" towards a two-tier banking system began to be made in the *perestroika* era. The former state banks were split off from the central bank and it became possible to establish new financial institutions. Under the central bank law of April 1995 the central bank of the Russian Federation is responsible for the stability of the domestic currency, performs the function of lender of last resort, is responsible for supplying money and supervising the banks, determines the rules for financial transactions within the Russian Federation and sets the statutory accounting requirements for the commercial banks.[1] The rules governing the activities of the commercial banks were changed with the revision of Instruction no. 1 and the implementation of the new banking law.[2] The central aim of both amendments is to stabilise the banking sector.

There are 2 120 commercial banks currently operating in the Russian Federation (as of 1 September 1996). The equity capital base of the banks varies greatly (cf. tables 1 and 2). It seems that the regulations on the equity capital base are being applied primarily to newly created banks. Three of the five largest banks (in terms of the balance sheet total) are products of the Soviet banking system: the Sberbank, the Vneshtorg Bank and the Agroprom Bank (cf. table 1). Many of the Russian banks operate as universal banks.[3] Many banks and industrial firms have taken mutual equity stakes, a trend that has been reinforced with the creation of "financial-industrial groups".

The central bank has so far revoked the licences of 161 banks (as of 1 August 1996) due to their serious solvency problems; a further 130 banks face serious payments difficulties. One in four banks is currently operating at a loss.

Macroeconomic conditions and lending practice

In the course of 1995, not only the market and regulatory framework, but also the macroeconomic environment changed fundamentally. Firstly, the central bank brought a long period of negative real interest rates to an end; since then it has pursued a policy of extremely high real interest rates (cf. figure 1). Secondly, the practice of offering subsidised central bank loans to finance the budget and centralised loans – i.e. politically motivated preferential loans – to individual branches or firms was largely curtailed. Thirdly, the flexible exchange rate regime was replaced first by an exchange rate corridor and later by a so-called pre-announced crawling band with a devaluation rate of around 1.5% per month.

This fundamental change in monetary and exchange rate policy, brought about not least under pressure from the IMF, was associated with a reorientation of macroeconomic credit policy. Since the all but complete abolition of preferential loans in the form of central bank loans or centralised credits by the banking sector to government or individual firms, both the government and

[1] Although the law (Article 25) emphasises the independence of the central bank, particularly from fiscal policy requirements, it does allow scope for the budget law to force the central bank to finance the federal deficit (Article 26). Thus, in one important regard, monetary policy is subordinate to fiscal policy.

[2] The provisions apply to all financial institutions with the exception of the Sberbank. The revision of the banking law became necessary following the passing of the central bank law and the Civil Code in order to harmonise the regulations.

[3] The Russian bank law does not make explicit reference to the universal-bank character of the financial institutions.

Table 1

Russia: The 30 Largest Commercial Banks (as of 1 July 1996)[1)]

	City	Number of branches	Assets	Equity capital		Deposits	Loans	Government bonds	Profits 1995
			US-$ mill.	US-$ mill.	As a % of assets	US-$ mill.			
1 Sberbank	Moscow	34 310	34 082.3	1 998.2	5.9	16 774.3	4 252.4	9 957.5	714.4
2 Vneshtorgbank	Moscow	9	4 633.9	1 056.5	22.8	1 333.3	82.6	593.8	262.6
3 Inkombank	Moscow	–	4 102.9	318.0	7.7	1 961.9	477.8	349.2	85.7
4 Oneximbank	Moscow	0	3 271.0	362.2	11.1	1 796.0	791.4	34.5	15.8
5 Agroprombank	Moscow	–	3 184.0	–	–	–	–	–	–
6 Rossijskij kredit	Moscow	48	2 552.5	144.6	5.7	458.4	195.4	158.0	35.8
7 Mosbusinessbank	Moscow	–	2 528.3	156.2	6.2	569.7	290.8	156.0	34.6
8 Stolichnyj bank sberezhenij	Moscow	10	2 057.7	211.0	10.3	527.8	189.9	9.2	2.3
9 MFK	Moscow	–	1 906.6	346.1	18.2	323.7	275.5	72.7	79.4
10 Menatep	Moscow	20	1 798.5	175.3	9.7	437.8	669.5	28.4	16.7
11 Promstrojbank	Moscow	71	1 721.7	151.6	8.8	681.8	388.3	81.1	30.8
12 Imperial	Moscow	5	1 683.2	206.2	12.2	597.0	256.1	19.5	51.5
13 Natsional'nyj rezervnyj bank	Moscow	0	1 595.9	96.0	6.0	579.5	107.3	380.2	62.6
14 Vozrozhdeniye bank	Moscow	62	1 509.3	88.0	5.8	637.2	509.2	15.2	6.7
15 Bank „Sankt Petersburg“	St. Petersburg	21	1 508.5	39.2	2.6	146.9	79.7	15.7	2.5
16 Moskovskij industrial'nyj bank	Moscow	32	1 368.9	158.8	11.6	419.7	250.5	37.3	32.6
17 Alf'a-bank	Moscow	–	1 263.8	72.1	5.7	368.4	46.5	19.4	8.8
18 Mezhdunarodnyj Moskovskij bank	Moscow	–	1 239.5	246.8	19.9	734.3	4.3	72.5	36.0
19 Tokobank	Moscow	15	1 200.4	186.5	15.5	204.7	50.8	11.9	23.3
20 Avtobank	Moscow	11	1 161.7	197.5	17.0	235.6	132.5	19.7	78.9
21 Promyshlenno-stroit. bank	St. Petersburg	42	1 091.3	142.9	13.1	413.7	166.3	2.2	31.8
22 Most-bank	Moscow	6	985.2	105.2	10.7	281.3	136.5	18.2	3.0
23 Impexbank	Moscow	–	866.0	3.3	0.4	24.1	3.9	1.3	0.2
24 AKB Yenisey	Krasnojarsk	35	856.6	31.6	3.7	86.9	89.0	9.5	12.6
25 Mezkombank	Moscow	9	762.9	108.6	14.2	302.8	43.6	89.6	23.3
26 Moskovskij natsional'nyj bank	Moscow	–	678.0	–	–	–	–	–	–
27 Gazprombank	Moscow	20	671.1	82.7	12.3	426.5	106.6	4.7	18.1
28 Kuzbasprombank	Kemerovo	–	537.2	40.4	7.5	251.0	188.2	13.3	2.6
29 Mosstrojekonombank	Moscow	34	532.3	48.4	9.1	140.1	176.5	1.4	6.3
30 Neftekhimbank	Moscow	6	524.9	105.5	20.1	121.5	57.7	1.2	5.2

1) Figures in rouble converted into US-dollar at the market exchange rate prevailing on 1 July 1996.
Sources: Finansovye izvestiya, no. 79, 1996; own calculations.

state-owned firms must compete with other actors on the financial markets for the resources available. The end of a politically motivated financing of both the corporate sector and the budget has served to increase the importance of the commercial banks in allocating financial resources.

Initially the commercial banks reacted to the changed macroeconomic conditions by significantly

Table 2

Structure of the Commercial Banks by the Equity Capital required by their Statutes

Equity capital endowment in rouble	1 January 1996		1 September 1996	
	Number	Share in %	Number	Share in %
More than 30 bill.	64	2.8	100	4.7
20 to 30 bill.	28	1.2	48	2.3
5 to 20 bill.	410	17.9	551	26.0
1 to 5 bill.	841	36.6	743	35.0
500 mill. to 1 bill.	282	12.3	211	10.0
100 to 500 mill.	628	27.4	435	20.5
Up to 100 mill.	42	1.8	32	1.5
Total	2 295	100.0	2 120	100.0

Quelle: Goskomstat.

widening the interest rate spread. The difference between the interest rates on deposits and those for loans, which under the changed conditions had become the main basis for banks' profits, at times amounted to more than 200 percentage points in real terms (cf. figures 2 and 3).[4] At the same time, the rates of interest on loans to firms rose: annual real interest rates consistently in excess of 100% reflect the costs of refinancing and the considerable risk premium charged by the banks for loans to the corporate sector (cf. figures 2 and 3). It is particularly attractive for the commercial banks to acquire government bonds (GKO) as these pay high interest and carry relatively lower risk (cf. figure 4). Although the real interest rate on such bonds was below that for loans to firms, after adjusting for risk, the yield on government bonds is almost certainly higher than that on loans to the corporate sector. Consequently, a comprehensive restructuring of the portfolio of commercial banks followed the change in monetary policy: while the volume of credits to firms declined – also reflecting weaker demand for loans – loans to government increased. In real terms, loans to the corporate sector were more than 10% down in 1995 on the previous year.

The turnaround in real interest rates had an immediate impact on the financial situation of firms due to the short lending periods for corporate loans. The payments crisis in the corporate sector, the manifestations of which include growing inter-enterprise debt, rapidly rising tax arrears and a huge volume of non-performing loans in the banking sector, has become more acute.

Non-performing loans

For years, the Russian banking sector has been suffering from bad debts. According to figures published by the Russian central bank, non-performing loans accounted for around 12% of the total volume of lending at the end of June 1996. This marks a substantial downward revision compared with the previous year,[5] possibly caused by a change in the classification of payments arrears. It may also be the case, however, that individual banks have used the profits earned on the basis of the substantial interest rate differential (spread) to write off non-performing loans. What is more important than the stock value, however, is the dynamic with which non-performing loans have increased since the start of the year: during the first half of 1996, non-performing loans increased by around 25%. Interest arrears accounted in mid-1996 for 14% of the volume of lending.[6]

Whereas previously the reasons behind firms' inability or unwillingness to repay debts lay primarily in the

[4] Given the extremely short period maturity of loans, the annual real interest rates are calculated by first converting the annual (nominal) interest rates to a monthly basis and then comparing them with the monthly rates of inflation. The resulting monthly real interest rate is then compounded to yield the annual real interest rate.

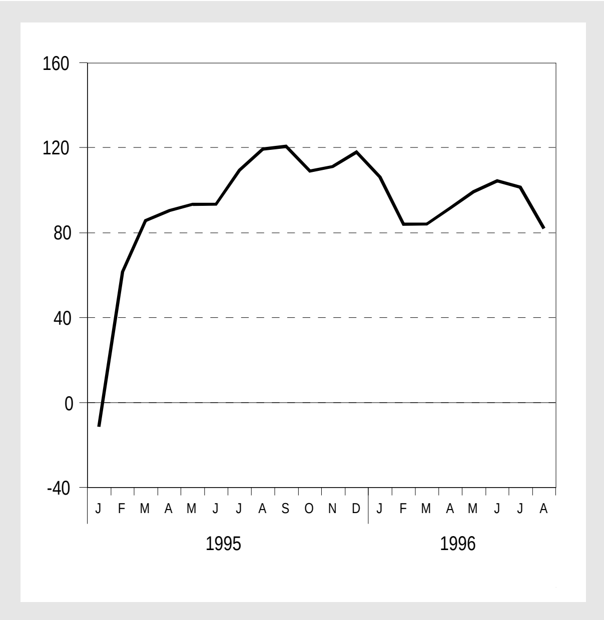
[5] Previously, the central bank put the share of loans classified as non-performing at more than 30% of the total.

[6] Cf. Central Bank of Russia, *Bulletin of Banking Statistics,* no. 8/1996.

Figure 1

Russia: Annual Real Refinancing Rates

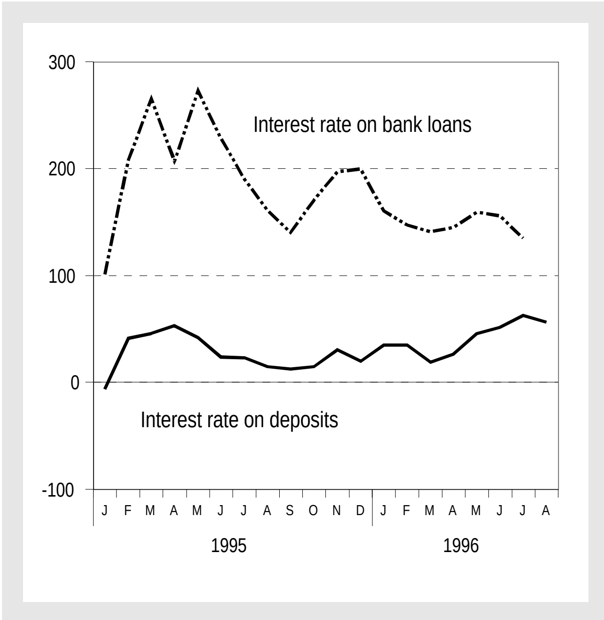
in %



Sources: IMF: International Financial Statistics, September 1996; Government of the Russian Federation: Russian Economic Trends, Monthly Update, September 1996; own calculations.

Figure 2

Russia: Annual Real Deposit and Lending Rates[1]

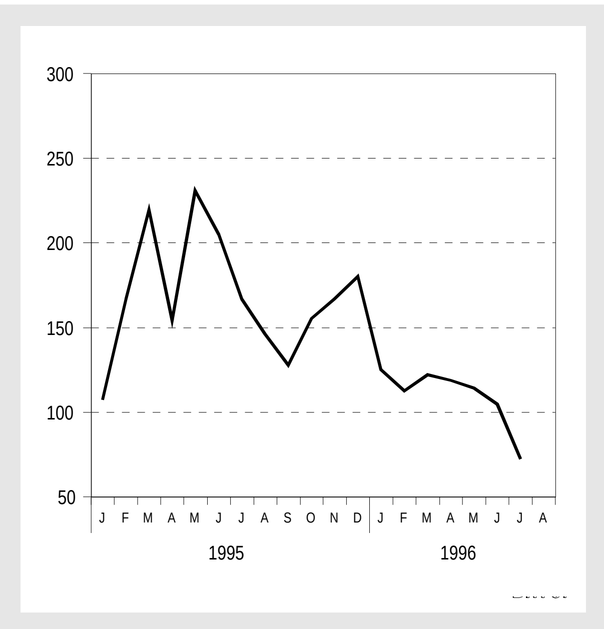


1) Weighted average interest rates, deflated using the consumer price index.
Sources: IMF: International Financial Statistics, September 1996; Government of the Russian Federation: Russian Economic Trends, Monthly Update, September 1996; own calculations.

Figure 3

Russia: Annual Real Interest Rate Spread[1]

in percentage points

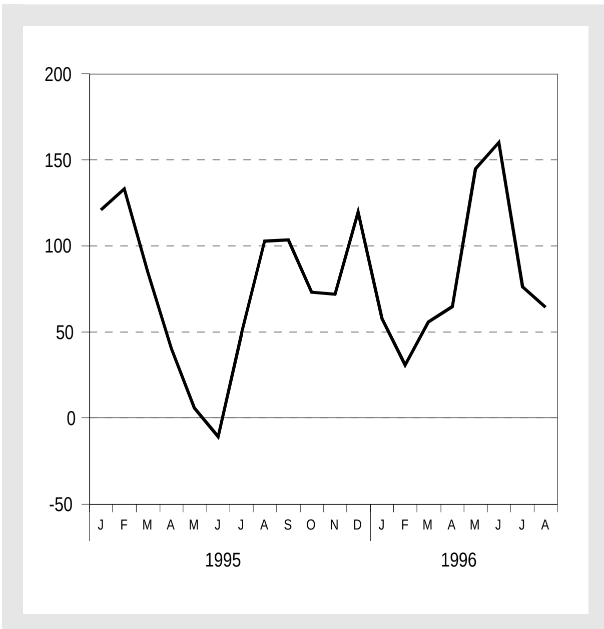


1) Weighted average interest rates, deflated using the consumer price index.
Sources: IMF: International Financial Statistics, September 1996; Government of the Russian Federation: Russian Economic Trends, Monthly Update, September 1996; own calculations.

Figure 4

Russia: Annual Real Interest Rate on Government Bonds[1]

in %



1) Weighted average interest rates, deflated using the consumer price index.
Sources: IMF: International Financial Statistics, September 1996; Government of the Russian Federation: Russian Economic Trends, Monthly Update, September 1996; own calculations.

traditional behavioural characteristics of the banks and in state directives on credit provision, more recently the extremely high real interest rates have almost certainly played a role. It is scarcely possible for firms to earn a yield on investment sufficient to pay real interest rates of more than 100%. Moreover, the relatively weak equity capital base of most commercial banks induces them to continue lending to dubious debtors in order to avoid their own precarious financial position being revealed. Under such conditions banks can exert only a limited controlling function on firms' behaviour. As a result, efficient credit provision remains difficult. Although individual commercial banks earn substantial profits under the prevailing conditions, the Russian banking sector as a whole remains in a precarious state.

The Ukraine

Structure of the banking system

In the Ukraine a two-tier banking system was established following political independence in 1991.[7] Since then the central bank, whose independency is established in the proposed new central bank law, has introduced a number of elementary regulations regarding equity capital requirements and deposit insurance and various liquidity and solvency criteria. It is required that commercial banks' equity capital be increased in stages to ECU 1 million by 1 January 1998.

As in Russia, the commercial banking sector in the Ukraine has developed out of the branch offices of the Soviet Gosbank and the Soviet special banks for industry (Promstrojbank, now called the Prominvestbank), agriculture (Agroprombank, now called the Bank Ukraina), social infrastructure (Zhilsotsbank, now the Ukrsotsbank), foreign trade (Vneshtorgbank, now the Export-Import Bank) and private savings (Sberbank, now the Oshadni Bank). In addition, a large number of new banks have been set up, a trend favoured by the lax equity capital requirements. At the start of 1996, 218 commercial banks were operating in the Ukraine. Of these, however, just ten have a balance sheet total in excess of US-$ 100 million (cf. table 3).[8] The equity capital base is weak, particularly in the larger institutions. Accounting procedures, particularly in the smaller banks, do not meet western standards, so it is unclear to what extent their equity capital will be reduced when non-performing loans, which have so far been neglected and the volume of which is uncertain, are inevitably written off.

The commercial activities of the banks are subject to few restrictions, so they frequently, as in the Russian Federation, operate as universal banks.[9]

Macroeconomic conditions and lending practice

At the beginning of 1995, the Ukraine, like Russia, adopted a restrictive monetary stance and restricted central bank financing of fiscal activities. Unlike in Russia, however, exchange rate determination has been left to the market, although the central bank has sometimes intervened to stabilise the exchange rate. The change in monetary policy is closely linked to the conditions imposed by the IMF. These include (unpublished) targets – in 1995 quarterly and since the start of 1996 monthly – for the budget deficit and certain items in the central bank balance sheet and for the growth of commercial bank loans to firms and private households. The main instrument to reach these targets has been the refinancing interest rate of the central bank.

As is the case with the Russian Federation, the aim of the IMF stipulations was to bring to an end the system of credit provision prevailing between 1991 and the start of serious economic policy reforms at the end of 1994 which to a great extent mirrored fiscal policy. In the past, the majority of loans to firms took the form of politically influenced quasi-subsidies, while at the same time the central bank financed the budget deficit. Since then, there has been a marked cutback in government credit programmes, while, in accordance with IMF requirements, the budget deficit is increasingly being financed by emitting government bonds.

For the commercial banks this IMF programme implies, on the one hand, greater uncertainty regarding

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[7] The central bank law and the law on banks and the commercial activity of banks were passed in 1991. An amended version of the central bank law is expected to come into force during 1997. The law on banks and the commercial activity of banks has continually been supplemented by additional regulations.

[8] The table is based on data published by the Ukrainian Banking Federation. The Federation only uses data made available to it voluntarily by the banks themselves, however. Many banks, especially the relatively large ones, publish annual accounts verified by external accountants and are attempting to move towards western accounting conventions, as it is only then that they get access to loans by western banks. It must be doubted, however, whether these verifications always meet western standards.

[9] In the course of the economic reforms since 1994, the scope for legal commercial activity has been extended and the higher tax rates on banks, compared with industrial and trade enterprises, that applied in 1993 and 1994 were removed. Banks are, however, subject to an implicit additional taxation in the form of the high minimum reserve requirements. The average minimum reserve requirement for deposits was around 15% until the beginning of 1997 when it was reduced to about 11%.

Table 3
The Ukraine: The 30 Largest Commercial Banks (as of January 1996)[1)]

		City	Assets	Equity capital		Number of branches	Profits 1995		
			US-$ mill.	US-$ mill.	As a % of assets		US-$ mill.	As a % of capital	As a % of assets
1	Bank Ukraina	Kiev	957.3	20.1	2.1	540	119.8	594.9	12.5
2	Prominvestbank	Kiev	908.0	19.4	2.1	261	.	.	.
3	Ukrsotsbank	Kiev	650.4	5.0	0.8	137	79.9	1 589.0	12.3
4	Oshadni Bank	Kiev	594.8	3.7	0.6	647	39.4	1 079.1	6.6
5	Export Import Bank	Kiev	.	.	.	.	.	.	.
6	Privatbank	Dnepropetrovsk	323.8	5.4	1.7	61	7.5	138.1	2.3
7	Gradobank	Kiev	282.6	31.6	11.2	32	16.3	51.8	5.8
8	Aval	Kiev	216.1	5.8	2.7	64	16.3	282.1	7.6
9	Ukrinbank	Kiev	158.6	1.4	0.9	33	7.4	549.0	4.7
10	First Ukrainian International Bank	Donetsk	139.0	1.0	0.7	6	17.4	1 702.0	12.5
11	Pivdenkominbank	Dnepropetrovsk	60.2	2.0	3.3	.	0.4	21.5	0.7
12	UkrKreditbank	Kiev	47.6	0.5	1.1	3	2.8	510.2	5.8
13	Sakhidukrkombank	Lviv	44.4	1.5	3.3	17	4.6	315.4	10.4
14	Ba-Bank	Kiev	40.4	1.0	2.4	6	6.1	625.7	15.0
15	Nadra	Kiev	34.6	1.7	5.0	11	3.8	218.9	10.9
16	Energobank	Kiev	33.2	1.7	5.0	3	4.2	256.8	12.8
17	Agio	Kiev	31.9	1.4	4.5	9	5.7	395.4	17.7
18	Pravex Bank	Kiev	28.7	1.1	3.8	16	1.5	138.3	5.2
19	Grant	Kharkov	28.5	1.5	5.4	10	5.5	354.4	19.2
20	Ukrnaftagazbank	Kiev	22.3	5.7	25.5	7	1.7	30.6	7.8
21	Jupokobank	Dnepropetrovsk	21.4	0.4	1.6	3	1.6	451.4	7.4
22	Perkombank	Kiev	19.0	0.8	4.4	.	1.6	195.1	8.7
23	PNK Bank	Charkov	14.8	1.7	11.3	5	0.8	46.1	5.2
24	Bankirski Dim	Kiev	14.6	4.5	30.6	.	0.3	7.3	2.2
25	Elektronbank	Lviv	14.5	2.7	18.4	4	1.3	50.6	9.3
26	Legbank	Kiev	14.3	0.8	5.7	3	2.1	260.3	14.8
27	Ukrsibbank	Kharkov	12.8	1.9	14.8	.	1.1	57.0	8.5
28	Metallurg	Zaporozhye	11.0	2.2	19.6	.	2.4	110.3	21.6
29	Elita	Zaporozhye	8.2	2.5	31.1	.	0.6	25.4	7.9
30	Junex	Kiev	8.2	3.7	45.3	1	0.1	1.6	0.7

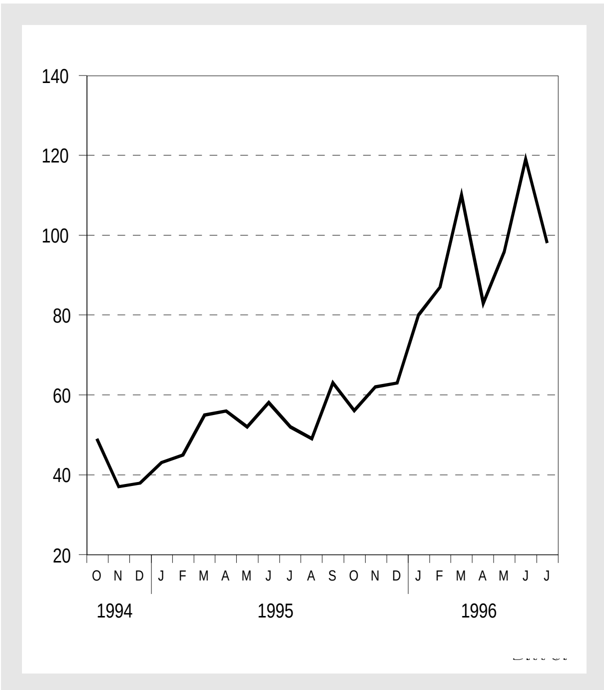
1) Figures in karbovanets converted into US-dollar at the market rate prevailing at the end of 1995.
Source: Anatoli Drobyasko et al., a.a.O.

refinancing with the central bank. Under current law the central bank may exclude individual banks from refinancing facilities and prescribe interest rate margins. In addition, the change in monetary policy – a change associated with high real interest rates – has tended to reduce corporate demand for loans. Net loans by banks to non-banks corresponded to 6.7% of GDP in 1994 and to 3.5% in 1995; in 1996 it is expected to amount to only around 1%. This means that commercial bank lending to firms (including state-owned firms but not government itself) and private households in domestic currency remained below the IMF targets. The sharp rise in inter-enterprise debt since the onset of the reform at the end of 1994 (cf. figure 5) indicates that many firms are to some extent avoiding the high (monetary and other) costs of borrowing by not paying for goods supplied (while at the same time supplying other firms without payment).[10]

In addition, the sharp decline in the growth of the credit volume (cf. figure 6) is partly due to the failure to implement important institutional reforms that would have rendered the capital market more efficient by facilitating provision of collateral and improving the availability of information on the creditworthiness of borrowers. Finally, the increased issue of government bonds may also partially explain the decline in commercial bank lending to firms, particularly when, from the point of view of the banks, the risk-adjusted rate of return on

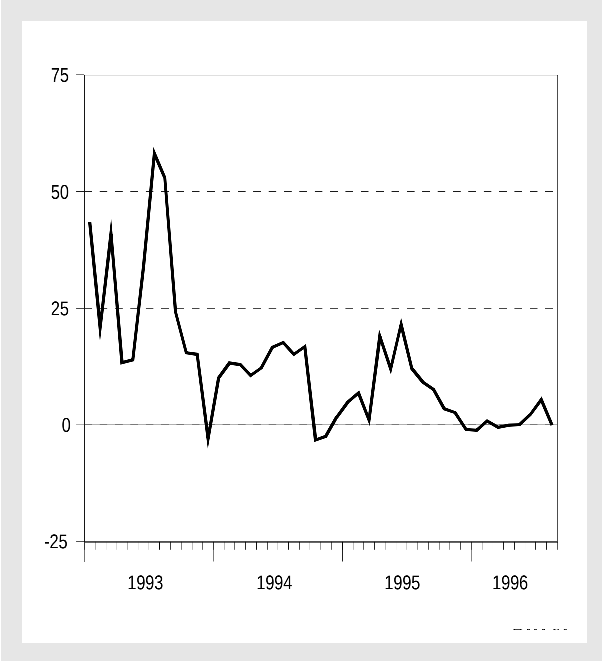
[10] Such behaviour is facilitated by the difficulty for creditors in obtaining access to debtors' assets.

Figure 5
The Ukraine: Intra-corporate Debt[1]
shares in % of GDP



1) Excluding debts to foreign companies.
Sources: Ukrainian Center for Macroeconomic Analysis: Ukrainian Economic Trends, Quarterly Update, August 1996; own calculations.

Figure 6
The Ukraine: Monthly Rate of Growth of Commercial Bank Lending to Firms and Private Households
change on previous month in %

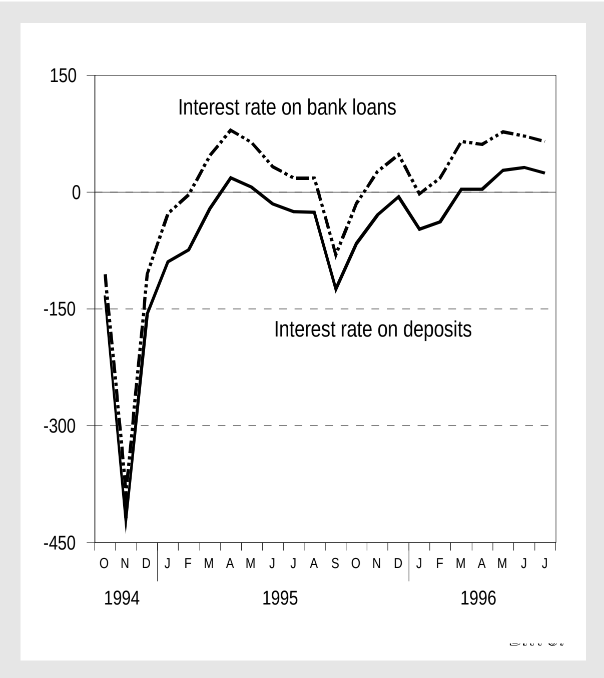


Sources: Ukrainian Center for Macroeconomic Analysis: Ukrainian Economic Trends, Quarterly Update, August 1996; own calculations.

these bonds is higher than the yield on other forms of lending. Although the volume of government bonds issued since 1995 remains relatively small – in mid-1996 the total volume of outstanding government bonds amounted to 2.7% of GDP – in 1996 net public borrowing by these means is expected, at around 1.5% of GDP, to slightly exceed net lending by banks to non-banks .[11]

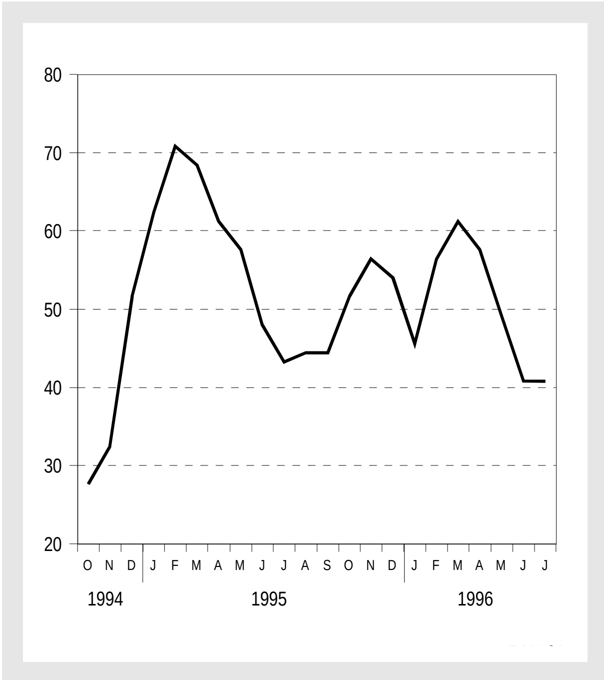
[11] Government bonds are auctioned several times per month at widely varying volumes and with maturities of between 3 and 12 months. Initially foreigners were *de facto* excluded from purchasing such bonds. Since mid-1996 they have been admitted, although only through the mediation of a Ukrainian correspondent bank. There have been substantial fluctuations in nominal effective interest rates. In the first half of 1996 the rates varied between 80% and 180%, falling, alongside the decline in inflation, to between 53% and 97% in the third quarter and around 65% in the fourth quarter. The rate of inflation in 1996 was 39.7%, so the average real rate of interest is very high. Given the freedom of capital movements for foreign investment and for the repatriation of earnings and the virtually constant nominal exchange rate of the US dollar, this high rate of interest also applies to foreigners. The situation regarding the taxation of earnings remains unclear, however: according to the law, interest earnings and capital gains are subject to a 10% withholding tax, although in practice this has frequently not been withheld. The conditions of participation in transactions on the secondary market as well as the respective taxation also remain uncertain, a factor that has hindered the development of this market.

Figure 7
The Ukraine: Annual Real
Deposit and Lending Rates
in %



1)Weighted average interest rates, deflated using the consumer price index.
Sources: Ukrainian Center for Macroeconomic Analysis: Ukrainian Economic Trends, Quarterly Update, August 1996; own calculations.

Figure 8
The Ukraine: Annual Real
Interest Rate Spread[1]
in percentage points



1) Weighted average interest rates, deflated using the consumer price index.
Sources: Ukrainian Center for Macroeconomic Analysis: Ukrainian Economic Trends, Quarterly Update, August 1996; own calculations.

All the evidence suggests that firms are being crowded out of the capital market by government.

Non-performing loans

It is only now that the first steps towards a systematic coverage of non-performing loans in banks' balance sheets are being taken. All the signs are, though, that banks, too, are being affected by the payments crisis in the corporate sector. Other things being equal, rising real interest rates make it more difficult for firms to service their debts, particularly in recessionary phases. One of the problems facing Ukrainian banks is that, due to their weak equity capital base, they can quickly become dependent on large debtors if the latter default on their debts and the bank would be hard hit if they were written off. If non-performing credits accumulate in bank balances the risk of bank insolvency and of a financial crisis increases; such a crisis would, in turn, be likely to exacerbate the recession.[12]

As in Russia, Ukrainian banks have almost certainly utilised the profits generated by the differential between deposit and borrowing rates (cf. figures 7 and 8) to write off non-performing loans.[13] One possible sign of this is the declining trend in the profitability of the banks. In a sample of 95 commercial banks, the weighted profitability of their assets fell from 9% in 1994 to 5% in 1995.

Summary and outlook

The Russian and Ukrainian banking systems grew out of the Soviet monobank system; even though a large number of new banks have since been set up in both

[12] In view of the numerous historical experiences with this problem, it was proposed back in the 1980s that, in addition to strict supervision of the banks in an attempt to limit the inherent risks of banking, the instrument of setting a ceiling on interest rates should also be considered. However, such an intervention in the allocation of capital also has disadvantages, the impact of which are hard to predict, so this instrument has not been deployed to date in eastern Europe. Instead, particularly in eastern central Europe, government support for banks affected by such problems has generally been provided.

[13] In addition to the high risk of default, the size of this differential is also due to the costs resulting from the high minimum reserve requirement.

countries, many of them are of merely regional importance. In Russia a new central bank law was passed in 1995 and the law governing the activities of commercial banks was amended in 1996. In the Ukraine these steps, of vital importance for the transition process, have yet to be taken.

In both Russia and the Ukraine many commercial banks operate as universal banks, the most important implication of which is that they can act both as a shareholder of, and lender to, firms. In both countries efforts to intensify the degree of interdependence between banks and firms have even been stepped up recently.

Since 1995 both the Russian and the Ukrainian commercial banks have had to come to terms with a radical change in monetary policy. A high-interest rate policy was adopted which was one element behind a far-reaching reorientation of credit provision. Simultaneously, government credit programmes in support of firms have been cut back. In Russia the government deficits are no longer financed by means of central bank loans, but solely by issuing government bonds, transfers from international financial organisations and, most recently, through borrowing on the international capital market. In the Ukraine, an increasing volume of government bonds are being issued in order to finance the deficit; the central bank continues to make loans to the budget available, however, although they are of declining importance. In both countries lending to firms has declined dramatically in the wake of the high-interest rate policy. In Russia, the banks have been able, at times, to make substantial profits by acquiring government bonds paying a high real interest rate.

In both countries the efficiency of commercial bank activity is suffering from the existence of – and further increase in – non-performing loans. Whereas in Russia this problem has been evident for a long time now, and the central bank publishes the non-performing loans of the commercial banks in its statistics, the Ukraine is only now beginning to account for such loans in a systematic way. Although some banks seem to have utilised the substantial differential between deposit and lending rates to write off some of their non-performing loans, there is no sign of a comprehensive solution to this problem. In Russia, where the interest rate spread has already narrowed markedly, there are increasing signs of payments difficulties in the banking sector. So far the Russian central bank has sought to resolve problems on a case-by-case basis through *ad hoc* intervention; there is little evidence of a comprehensive strategy to stabilise the banking system, however. The instability of the banking sector may incur substantial macroeconomic costs, manifesting themselves in a loss of confidence in the domestic currency and a further demonetisation of the economy.

In both countries the onset of an open banking crisis could be avoided by means of a managed recapitalisation of the banking sector. Two fundamental steps are required to this end. Firstly, irrecoverable loans must be removed from the banks' accounts and loans to debtors whose creditworthiness is doubtful written off. Secondly, steps must be taken to prevent new high-risk loans being made. To this end information on the volume of non-performing loans is required; such loans must be systematically set out in the banks' accounts and reported to the supervisory authorities, so that the location and extent of the need for write-offs is clear. Of crucial importance for the success of a recapitalisation programme is the creation of incentives to restrict the provision of further loans to dubious debtors and in future to make banks themselves responsible for the provision of these credits (avoiding moral hazard). It is vital that the central bank performs its role of bank supervisor more stringently. Above all, however, a recapitalisation of the banking sector can only prove successful in the longer term if it is coupled with a restructuring of the corporate sector. This requires that the existing laws on bankruptcy be enforced. Continued privatisation of the former state-owned banks will help to improve the efficiency of the banking sector. Competition within the banking sector can also be increased by admitting foreign banks.

Depending on the degree of concentration and the extent of the problem, the recapitalisation programme could be implemented in the form of a one-off exchange of non-performing loans for government bonds or their assumption by a special institution, combined with long-term depreciation and/or special depreciation allowances. Even allowing for all the imponderables, in neither country should the financial resources required for recapitalisation exceed 5% of GDP. This relatively low figure, compared with other transition economies, is due to the low degree of monetisation of both economies.[14] If the resources required cannot be provided out of government budgets, it may well be, in view of the macroeconomic costs resulting from a bank crisis, a sensible move for the international financial organisations to provide funds for this purpose, as they did in the case of Poland.

Besides the systematic removal of bad debts from banks' balance sheets, a reduction in the number of new bad loans requires an improvement in the supervision of the banks, improvements in property rights, particularly for real estate (in order to provide collateral for loans), and the implementation of reforms in the business sector, in particular the implementation of simplified bank-

[14] The degree of monetisation is defined as the relationship between the money supply and GDP.

ruptcy proceedings, so that firms which are unable or unwilling to pay can no longer force banks to provide additional loans. It should be emphasised that such a recapitalisation programme must be embedded in a more general restructuring of the corporate sector, otherwise the resources made available represent nothing more than a further quasi-subsidisation of firms. There would then be little pressure for real economic adjustment and the danger of a systemic payments crisis would remain for the future.

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