Banking After the Liquidity Crisis

The Monetary Situation in Russia at the Beginning of 1996

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I. The monetary situation at the beginning of 1996

1. The inflation rate and interest rates: Slow progress towards stabilisation

As the year 1996 began, Russia's economic policy makers could point to a success on the macroeconomic front: after months of relatively stable inflation rates hovering around 4.6 % per month, a figure of 3.2% was reported for December 1995, the lowest monthly value since the beginning of thoroughgoing reforms in January 1992 (see Table 1).

Table 1: **Monetary indicators, December 1994 - December 1995**

	Monthly inflation rate	Monthly nominal interest rate (CBR)	Monthly real interest rate (CBR)	Dollar exchange rate 1 US$ = ... Rb (end of period)	Rate of devaluation or appreciation (-): % change on previous month
Dec	16.40	15.00	-1.20	3,550.00	9.77
Jan	17.80	16.70	-0.90	4,048.00	14.03
Feb	11.00	16.70	5.1	4,473.00	10.50
Mar	8.90	16.70	7.2	4,899.00	9.52
Apr	8.50	16.70	7.5	5,130.00	4.71
May	7.90	16.25	7.74	4,990.00	-2.73
June	6.70	15.00	7.78	4,539.00	-9.94
July	5.40	15.00	9.11	4,445.00	-2.07
Aug	4.60	15.00	9.94	4,447.00	0.00
Sep	4.50	15.00	10.05	4,499.00	1.17
Oct	4.70	14.20	9.07	4,504.00	0.01
Nov	4.50	14.20	9.28	4,580.00	1.69
Dec	3.20	13.30	9.79	4,640.00	1.31

Basic Data: Russian Economic Trends

There are a number of reasons for this positive development:

a. During the period August - December, the monthly increase in the monetary base averaged only 4.7%.[1] While no new figures for M2 have been published since

[1] It should be pointed out that in December alone the monthly growth rate was just under 10%; the monthly average for the period August - November was only 3.7%.

September, in the past the growth rate for M2 has moved in tandem with that of the monetary base, and thus we can assume that there has been a corresponding slowdown in the rate of expansion for M2.

b. Nominal interest rates exceeded the inflation rate, at times by a significant margin, which meant that real interest rates continued to be strongly positive. Following the liquidity crisis, the interest rate in the GKO market remained at a level of around 7% per month, whereas due to the increasing segmentation of the interbank market (see Section II), the interbank rate available to prime borrowers continued to decline. However, the impact of the restrictive monetary-policy stance can be seen even more clearly in lending interest rates at commercial banks than in the market interest rates, because lending rates are still oriented more to the central bank refinancing rate - which continues to be very high compared with the inflation rate - than to the cost of funds in the market for deposits or in the interbank market.

c. It proved possible to stabilise the rouble/US dollar exchange rate. The average monthly depreciation rate during the period August - December was only 0.9%, which meant that prices for imports were not a source of inflationary pressure.

d. The government succeeded in limiting its budget deficit - up until the end of November - to 2.6% of GDP, due in particular to cuts in spending. At the end of November 1995, government expenditure as a proportion of GDP stood at 17.7%, down from 22.3% in 1994.

e. The budget deficit was financed almost exclusively through the issuance of treasury bills (GKOs and OFCs) and via IMF loans. Consequently, in the course of the year the significance of central bank credits declined steadily. In September 1995, the last month for which we have data here, they accounted for only 2% of total government borrowing.

f. At the beginning of 1995, nominal wage increases were considerably lower than the inflation rate, and during the rest of the year, as the inflation rate dropped, nominal wage rises were not great enough to offset the declines in real wages registered during the winter of 1994/1995. This is quite unlike the pattern of events during the period of disinflation in the summer of 1994, when the response of the labour markets to the drop in the inflation rate was inadequate, resulting in a sharp rise in the real wage index (see Table 2). As a result, while in September 1994 the real wage index was only 2.3% lower than it had been a year before, the decline for the period September 1994 - September 1995 amounted to 29.1%.

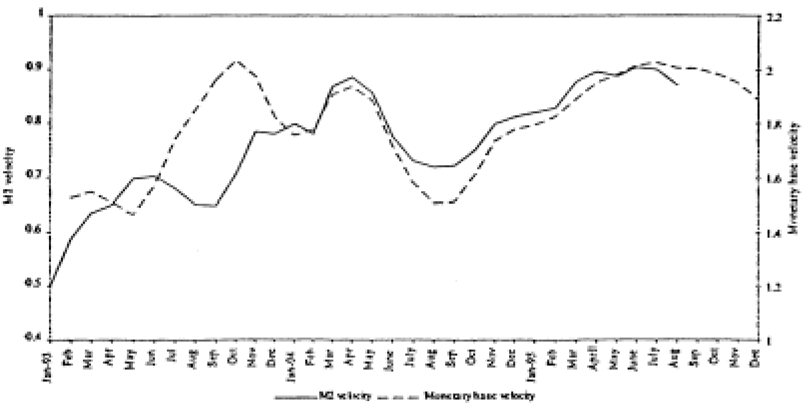
Table 2: **Increases in nominal and real wages in Russia during the periods of disinflation in the summer months of 1994 and 1995**

Month	**Nominal wages** (% change on previous month)		**Real wages** (% change on previous month)	
	1994	**1995**	**1994**	**1995**
June	13	15	7	8
July	7	1	1	-4
August	5	4	1	0
September	9	9	1	4

Source: Granville, B. and Larichev, O.: Monetary and Financial Report, Moscow, November 1995

The fact that the ambitious plans announced at the beginning of 1995 to bring the monthly inflation rate down to 1% by the end of the year could not be realised was attributable in particular to the magnitude of the decrease in the velocity of circulation of the money supply and the monetary base, which was small given the prevailing high real interest rate levels (see Figure 1). Apparently, economic agents were not convinced that the renewed stabilisation efforts undertaken by the government and the central bank would succeed, and, as a result, they were not willing to accumulate or hold monetary assets, as they had been during the first disinflationary period in the summer of 1994.

Figure 1: **Monthly velocity of circulation of the monetary base and M2**



Source: Russian Economic Trends

Thus, in order to assess how inflation and interest rates will most likely develop during the coming months, we will need not only information on probable trends in the fundamental data, but also a set of assumptions regarding the way in which economic agents will interpret these trends. Based on what we know at present, the fundamental data point to a continued stabilisation, i.e. a further decline in the inflation rate and in interest rates:

- The government budget of the Russian Federation for the year 1996 has already been passed by parliament; the projected deficit is equivalent to only 3.85% of GDP. It should be noted that, particularly on the revenue side, calculations were based on realistic assumptions which are roughly in line with the figures that will be recorded for 1995. In view of the upcoming presidential elections, and given the current political climate, the risks in 1996 are clearly on the expenditure side.

- Although, as a former finance minister and vice-president of a large Moscow bank, the new central bank governor, Sergei Dubinin, is familiar with the financing- and liquidity-related problems faced by both the government and the commercial banks, he must be counted among the reformers. Thus, Russia will probably continue to pursue a monetary policy geared to achieving stability.

- The decision to retain a fluctuation band for the exchange rate - the "corridor" - until June 1996 means that while a destabilisation of the rouble/US dollar rate cannot be ruled out, it has become less likely.

- Although the situation in the real economy will probably continue to improve, a sharp rise in demand on the labour market, resulting in upward pressure on wages, is not expected.

It is still unclear whether the IMF's planned three-year Extended Fund Facility for Russia will in fact be granted. If it is, this loan should enable the government to finance the budget deficit without fuelling inflation. Moreover, provision of this facility could be interpreted as a signal that the reforms will continue, despite the most recent changes in the cabinet. Against this background, the presidential elections scheduled for next June will become an increasingly important determinant of inflationary expectations. The key economic variable here - the one from which, on the one hand, these expectations will take their cue, and in which, on the other hand, they will be reflected - is the exchange rate.

2. The exchange rate: The rouble in the "corridor"

While the development of the inflation rate can be regarded as satisfactory, the rouble/ dollar exchange rate is the outstanding achievement of Russian stabilisation policy in 1995. Since the introduction of the "corridor" in July of last year, there has never been a danger of the rate reaching the upper limit and thus forcing the central bank to intervene. To be sure, there were intramarginal interventions during the last two months of 1995, but they are said to have been relatively limited in scope.

While the end-of-month figures and the changes in these values (see Table 1) are a good indicator of the impact of the stabilisation policy, the daily fluctuations in the exchange rate provide even more striking evidence of how successful this policy has been: since August there have been scarcely any daily movements, either up or down, which have involved a shift of more than 10 roubles. There were only two instances of turbulence: in mid-November and during the period before and after the elections to the Duma on 17 December.

Statistically, the progress that has been made on the stabilisation front can most easily be expressed in the form of variation coefficients.[2] As can be seen from Table 3, the coefficient of variation dropped from 9.5% in the first half of 1995 all the way down to 1.5% after the introduction of the "corridor".

Table 3: **The extent of variation in the rouble/US$ exchange rate, 1995**

Period	Coefficient of variation, rouble/US$ exchange rate
01.01. - 30.06.1995	9.5%
03.07. - 31.12.1995	1.5%

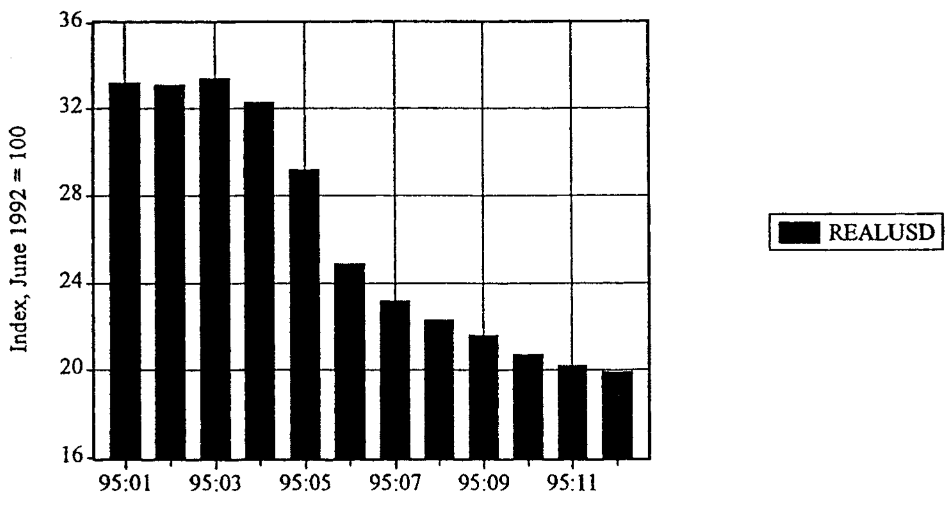
2 The coefficient of variation is the quotient of the standard deviation and the mean value for a time series, and, as a result, it provides a relative measure of dispersion which enables one to compare the degree of variation within distributions whose mean values differ greatly.

In parallel with this development, there was a sharp drop in turnover on the Moscow foreign exchange market (MICEX): the US$ 802 million figure reported for December represented only one-fifth of the turnover in June 1995.

Compared with the degree of stabilisation that has been achieved in terms of prices and interest rates, the government's efforts as regards the exchange rate have been highly successful, and this has two important impacts, an understanding of which can help us to assess whether this stabilisation will prove to be sustainable:

1. The rouble continued to appreciate in real terms against the US dollar, with the real exchange rate rising by just under 13% since June (see Figure 2).[3] On the one hand, the appreciation is conducive to efforts to stabilise the price level because import prices in roubles are stabilised. On the other hand, though, it has adverse consequences for Russia's competitiveness because imports become relatively cheaper compared with domestically produced goods, and Russian goods become relatively more expensive on world markets vis-à-vis the products of foreign competitors. Assuming there is sufficient elasticity of demand, this means that the current account moves into deficit.

Figure 2: **Development of the real rouble/US$ exchange rate, 1995**
(June 1992 = 100)



Source: Russian Economic Trends

3 The real rouble/US$ exchange rate is defined as the nominal exchange rate multiplied by the quotient of the price level in the US and the price level in Russia (REALUSD = [(Rb/US$)x(US price level)/(Russian price level)].

If this effect has been felt at all so far at the level of the economy as a whole, then only in terms of the growth rates of exports and imports. Indeed, while exports increased at a considerably higher rate than imports during the first few months of 1995, it has been the other way round since the middle of the year. Nonetheless, Russia recorded an export surplus for the year 1995 which was equivalent to 4% of GDP, and although the rate of growth of the country's exports has declined, it is still positive.

Although the appreciation of the rouble has had little impact on the economy overall, it should be noted that the decrease in competitiveness brought about by the rise in the real exchange rate has clearly been felt in certain sectors, e.g. the chemical industry. However, when it comes to creating the necessary prerequisites in the country's foreign trade for securing the stability of the rouble/US$ exchange rate, the more decisive question is probably whether the favourable development of import prices will be exploited not only to import more consumer goods into Russia but also to purchase foreign-made capital goods on an increasing scale. Indeed, in the final analysis Russia's ability to compete in world markets will depend on whether it is able to adopt modern technologies with which high-quality goods can be produced.[4] If this happens, there is no reason why the real exchange rate should not be allowed to rise; such rises would not necessarily lead to speculation, and in turn a destabilisation of the nominal exchange rate. On the other hand, if the drop in import prices results merely in the purchase of consumer goods on a growing scale, the central bank and the government will eventually have to act, i.e. accept a nominal devaluation of the rouble in order to restore the competitiveness of Russian export goods.

2. Since the nominal exchange rate remained stable and rouble interest rates stayed at their high levels, rouble-denominated loans (rouble-denominated deposits) became very expensive (very attractive) compared with dollar-denominated loans (dollar-denominated deposits). The key relationship to be considered here is the uncovered interest-rate parity,[5] as expressed by the following equation:

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4 In this connection, it should be noted that the increase in Russian exports was mainly due to a rise in foreign deliveries of raw materials and metals, which accounted for more than 70% of all exports.

5 The uncovered interest-rate parity expresses the relationship between the domestic interest rate, the foreign interest rate and the expected change in the exchange rate which would result in a parity at

$i_{rouble} = i_{US\$} + (e/e)^{exp}$

where:

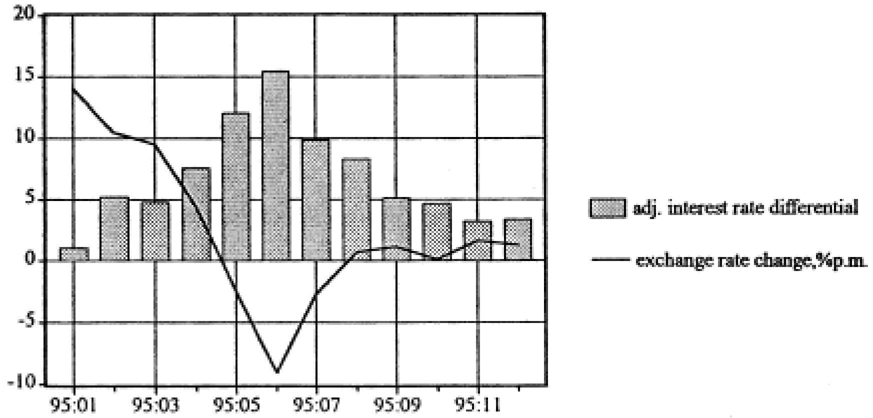
i_{rouble} = rouble interest rate

$i_{US\$}$ = US$ interest rate

$(e/e)^{exp}$ = expected rate of change in the rouble/US$ exchange rate

It is rather difficult to measure expected changes in exchange rates. For this reason, Figure 3 depicts the differential between rouble and US$ interest rates, adjusted for actual changes in the exchange rate, whereby the rouble interest rate was set equal to the interbank rate and a US$ interest rate of 0.5% per month was assumed.[6]

Figure 3: **Differential between Rb and $ interest rate, adjusted for month-on-month changes in Rb/$ exchange rate**



Basic data: Russian Economic Trends

It is clear that the expected change in the exchange rate implied by the interest rate differential did not materialise. In other words, the nominal depreciation of the rouble was not sufficient to compensate for the difference in interest rates.[7] In early

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which an investment in local currency would yield the same return - expressed in local currency - as a corresponding investment in foreign currency. Accordingly, the uncovered interest-rate parity reflects a stock equilibrium between local and foreign financial assets.

6 Here we have followed the procedure employed by Granville; see B. Granville, Monetary Report, Moscow 1994.

7 If implied and actual expectations regarding changes in the exchange rate were identical, there would be no bars in Figure 3, i.e. the adjusted interest rate differential would always be equal to zero.

summer, when the rouble in fact appreciated in nominal terms, the gap between the implicit expectation - expressed by the interest rate differential - and the change that actually took place was particularly wide. Accordingly, short-term rouble-denominated loans were extremely expensive compared with dollar-denominated loans. Thus, it was only logical to respond by expanding the "range of products" of the Russia Small Business Fund, i.e. by introducing dollar-indexed loans in the Micro Loan Programme starting at an amount of US$ 10,000.

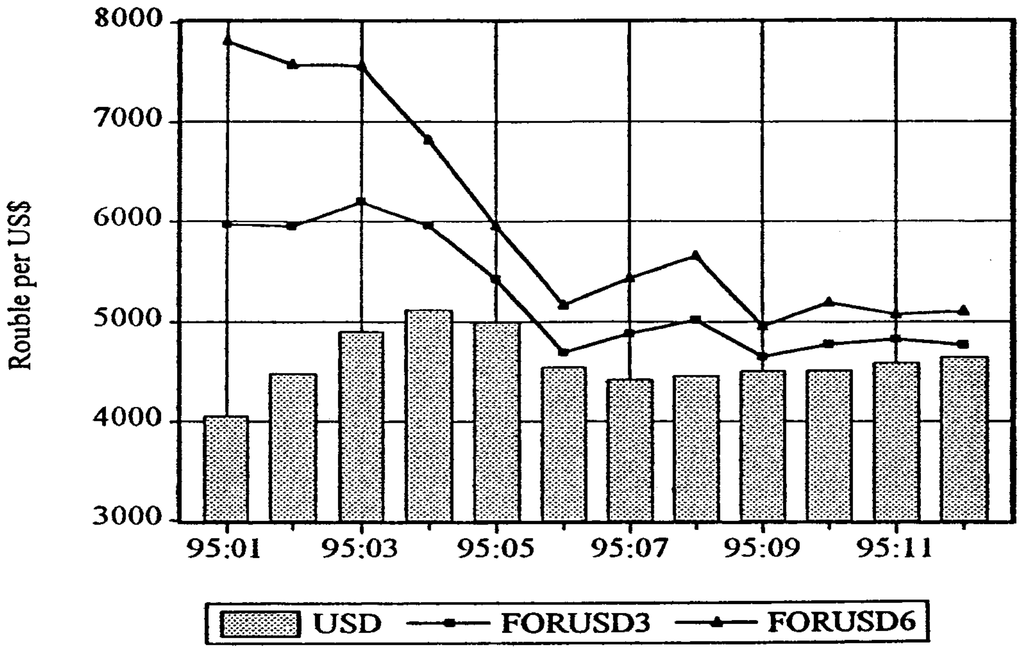
As regards the sustainability of a stable Rb/US$ exchange rate, one must ask whether the stabilisation of the rouble during the past few months was not attributable first and foremost to this very gap. Or, to put it another way: Assuming that the expectations regarding changes in the exchange rate are in fact reflected in the interest rate differential, the rouble should come under pressure vis-à-vis the dollar if rouble interest rates (continue to) drop in the coming months, i.e. if the interest rate advantage associated with rouble-denominated investments is reduced. If, on the other hand, the magnitude of the expected changes in the exchange rate is significantly smaller than the interest rate differential, the Russian currency will remain stable even if real interest rates drop. In any case, the spread between exchange-rate-adjusted US dollar interest rates and rouble interest rates will decrease further. However, disregarding the possible impacts of other parameters such as taxes, dollar-denominated loans will presumably continue to be cheaper than rouble-denominated loans.

An indication of the prevailing expectations regarding changes in the exchange rate at a given point in time is provided by the forward Rb/US$ rates quoted on the foreign currency market. As is clearly shown by Figure 4, there is a close correlation between expectations regarding future exchange-rate movements and current changes in the spot rate. At the beginning of 1995, when double-digit drops in the value of the rouble against the dollar were being recorded, the forward rates were extremely high.[8] As the rouble stabilised, the forward rates also declined. Thus, the forward rate cannot be regarded as even a roughly efficient predictor of the future spot exchange rate, i.e. the

8 In October 1994, when the rouble collapsed against the dollar, the Moscow Central Stock Exchange stopped quoting forward rates altogether.

current forward rate is not a reliable source of information about what the spot rate will be on the future date in question.[9]

Figure 4: **Spot and forward (3-month, 6-month) rouble/dollar exchange rate**

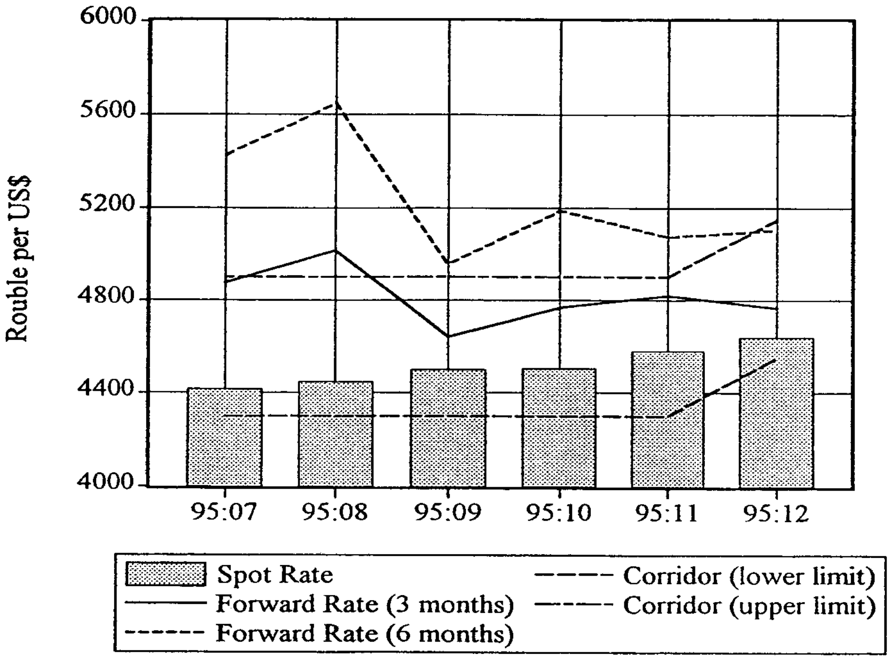


Source: Granville, B. and O. Larichev, Monetary and Financial Report; Expert-Magazin

However, the forward rates are not completely irrelevant, as can be seen from the data in Figure 5. In addition to the spot and forward rates, it shows the lower and upper limit of the exchange rate "corridor". Up until December, the six-month forward rate was not within the fluctuation band. This is not surprising, given the fact that the limits of the "corridor" were always fixed for a period of three months. By contrast, in every month but August the three-month forward rate invariably remained within the "corridor", although in October and November it was moving toward the upper limit.

9 Particularly in transition economies, the fact that new information becomes available before the end of the period for which forward rates are quoted provides a plausible explanation for the lack of predictive power exhibited by such rates. Thus, if a market is defined as "efficient" if it takes into account all currently available information, then the forward foreign-exchange market may be deemed efficient even though the spot rate on a given future date turns out to be very different from the forward rate quoted for that date.

Figure 5: **The "corridor": Spot and forward rates**



Source: Russian Economic Trends, Granville and Larichev (Monetary and Fiancial Report), Expert-Magazin

Seen against this background, the decision by the new central bank governor, Dubinin, to raise the upper limit of the corridor by 250 roubles clearly reflects market signals:

a. The expectations regarding exchange-rate movements that are expressed in the forward rates suggested that the ceiling of the fluctuation band might soon be reached. In view of the fact that defining such a corridor for the exchange rate proves most effective - in terms of its credibility - if it can reasonably be assumed that the upper limit will not be exceeded, a slight upward shift of the fluctuation band was clearly indicated, given recent market data.

b. Considering that the present "corridor" is supposed to remain in effect for (at least) six months, it was also wise to raise the upper limit at least enough to ensure that the six-month forward rate would fall within the new fluctuation band. This was accomplished.

Bearing in mind the various developments discussed above - movements in the real exchange rate, the interest rate differential and expectations regarding changes in the exchange rate, price trends in the forward markets, and the response of the central bank - one can conclude that, in formulating its exchange-rate policy, the central bank has given due consideration to the signals which it has received from the real economy and the financial markets. These signals indicated the necessity of a moderate devaluation so as to avoid a shock-like adjustment at some future date. And this was precisely the kind of devaluation undertaken by the monetary authorities. Not least because of the approach adopted by the central bank, we are unlikely to see sudden, dramatic changes in exchange rates in the coming months so long as exchange rate levels are determined by economic factors, and so long as it can be assumed that the government will continue to adhere to the principles which underlay its economic policy in 1995.

3. Trends in the real economy: Decline in output cushioned by export growth

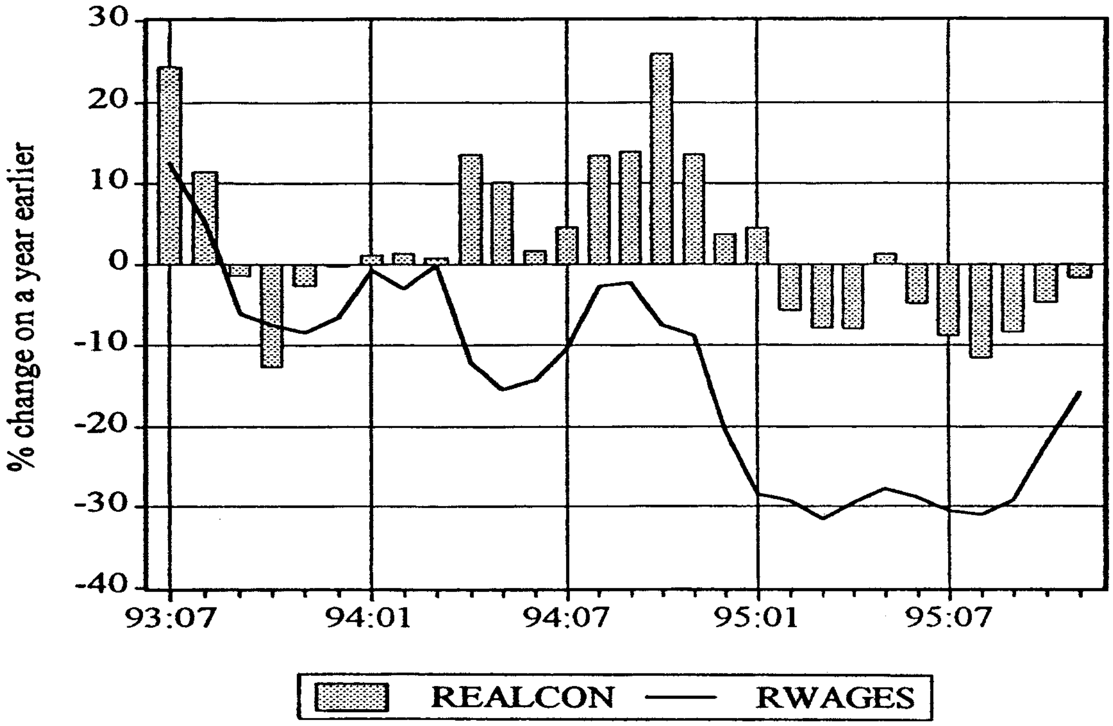
Not only in terms of monetary developments, but also as regards the performance of the real economy, the year 1995 was significantly more successful than the initial period of economic reform, 1992 - 1994. While a further decline in GDP proved unavoidable, the amount of the decrease - 4% - was considerably smaller than in the preceding three years, which had all seen double-digit drops.

As has already been pointed out, this favourable development was attributable above all to the increases in exports: demand for Russian products was up considerably, both in countries outside the CIS and in the former Soviet republics. Thus, it is not surprising that export-dependent sectors in particular - the chemical industry, for example - reported positive output growth rates for the first time since the beginning of the reform process.

While there was an increase in activity in housing construction, the volume of corporate investment continued to fall. However, the decline slowed considerably, with the change on a year earlier amounting to only -1% in both October and November 1995.

Compared with the preceding year, the impact of government spending and private consumption served to restrict rather than promote growth. The limitation of government demand for goods and services was, and is, an integral part of the stabilisation package agreed by the Russian government and the IMF. By contrast, the drop in real spending on consumption in the private sector is an outgrowth, on the one hand, of the decline in real wages discussed above (see Figure 6), and, on the other, of the relative stabilisation of the price level that has been achieved: it is no longer necessary to consume income immediately if monetary assets are capable of preserving purchasing power. Of course, this development is having some adverse effects on the profitability of consumption-oriented economic activity, in particular trade and services. Anecdotal evidence from the regions in which the Russia Small Business Fund operates supports this assessment: profit margins of traders are said to have declined significantly over the last few months.

Figure 6: **Changes in real wages and real consumption** (% change on a year earlier)



Basic Data: Russian Economic Trends

Looking to 1996, it can be inferred from the above discussion of the real exchange rate that exports will probably lose their position as the main motor of growth. On the other hand, it can be assumed that corporate investment will continue to recover, and spending on consumer goods by private households will probably grow again as well, given the fact that in recent months the downward trend here appears to have bottomed out (see Figure 6). With the budget deficit in 1996 approximately equal to the one incurred in 1995, the impact of state spending on economic growth will be neutral. From this it can be concluded that 1996 is likely to be the first year since the beginning of the reform process in which Russia does not register a decline in output.

II. Banking after the liquidity crisis

1. The fallout of the liquidity crisis

In recent years, constant references have been made - especially in the Russian press - to the anomalous fact that while the real economy has been in a state of decline, at least some of the banks and other financial institutions have been posting handsome profits. However, in 1995 the picture was reversed: while for the first time there are signs that the real economy is recovering, the financial sector experienced its severest crisis since the start of the reform era when the interbank market collapsed in late August. This is becoming apparent at several levels:

a. In 1995, the Central Bank of Russia revoked the licences of 315 banks, 232 of which lost their licences after 1 September. At least another 96 are on the verge of losing theirs within the next few months.

b. The central bank imposed restrictions on the business operations of 423 banks, e.g. on their right to accept retail deposits. Five banks - one of which was Avtovazbank - were temporarily placed under direct central bank management.

c. Many of the banks which still hold a licence are in fact insolvent. As of the end of November, according to the Russian Banking Association, 582 financial institutions had insufficient funds to cover their liabilities.

d. Debt issues by banks that have run into liquidity trouble are traded at an exchange organised by Tveruniversalbank. As of 16 January 1996, the securities of 103 banks[10] with a face value of Rb 413.7 billion were being offered at discounts of up to 100%. The issuers include such big names as Lefortovski or Aeroflot Bank. The banks whose debt issues are being traded are located throughout Russia, i.e. including those regions or cities in which the Russia Small Business Fund operates.

Yet the new conditions under which Russian banks are operating are not only reflected in the number of withdrawn licences or the number of banks that are facing liquidity

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[10] It is not always the same banks whose debt issues are traded, e.g. some drop out of the market because even 100% discounts are not enough to summon up demand for their debt. Meanwhile, new banks are joining the market all the time.

problems. They are also manifested in the changes that have taken place in the roles and the relative significance of specific markets and banking operations. And in order to gauge the survival potential of banks in Russia, it is important to recognise the nature of these changes.

2. The interbank market: From the centre to the periphery

Up until the liquidity crisis of August 1995, the interbank market was, alongside the foreign exchange market, the most important financial market in Russia. It was the main source of funds for numerous banks whose stocks of internal funds - e.g. current accounts and deposits held by enterprises or government organisations, or retail deposits - were negligibly small. Up to year-end 1993, thanks to subsidised central bank loans to the so-called channel banks, the supply of funds on the interbank market was plentiful and cheap.[11] When in 1994 the central bank money supply shifted from the channel banks to the government budget, there was little change in the absolute quantity of money available because the government did not limit its budget deficit. Thus, because it continued to finance government spending at subsidised interest rates, the CBR inevitably failed in its attempts at that time to ensure that interbank interest rates became positive in real terms. If monetary and fiscal policy had not been at odds with one another in this respect, the interbank market crisis would probably have occurred as early as the end of 1994.

The decisive turning point came with the signing of the agreement between the IMF and the Russian government in May of last year, which, among other provisions, called not only for a substantial reduction in the size of the budget deficit, but also for a virtual halt to the central bank's financing of this deficit. As has been outlined above, Russia has in fact kept its promises, thereby preventing a surge of inflation in the autumn of 1995 and thus also a relapse into negative real interest rates. The debtors of many banks came under increasing pressure, which was increasingly passed on to those banks. At the same time, the introduction of the corridor and the concomitant stabilisation of the rouble put an end to the speculative profits which the banks had been making on

[11] The mechanisms of the interbank market during this period were described in detail in the Pilot Study to the Russia Small Business Fund.

currency dealing. When in August some banks failed to settle their debts to other banks, or appeared to be on the verge of insolvency, the organised interbank market crumbled.

The figures for interbank interest rates published since then by Russian newspapers and Western institutions have thus taken on a totally different significance compared with their meaning prior to the August crisis. They now represent the cost of funds for prime-quality banks, with Inkombank, Neftechimbank, Orgbank, Promradtechbank, Rossiysky Kredit and Sberbank playing the role of the market-makers. However, funds at these prime rates are only available to a select group of some 10-15 banks.[12] For banks which do not belong to this first-class club, receipt of credit from the club members is contingent on the provision of collateral in the form of treasury bills (GKOs) and the disclosure of information on their financial status. Moreover, they are required to pay considerably higher interest rates: for rouble loans the interest margin is around 30% p.a.

The most obvious sign of the exclusivity of this club which determines the published interbank interest rates is the fact that since September the rate on interbank loans has been lower than that paid on GKOs (see Fig. 7). This would normally imply that loans to banks carry a lower risk than loans to the government, which, against the background of the banking crisis, would seem utterly absurd. In the present situation in Russia, however, this new trend implies that liquidity is in abundant supply in the "safe" segment of the banking sector. Finally, it should be added that the majority of credit transactions between banks have become very short-term in nature. In the immediate post-crisis period, overnight rates or interest rates for seven-day loans were practically the only rates posted. Yet in such an extremely short-term lending environment, purchasing GKOs may not be the most advantageous option from the point of view of the lender, partly because interest rates in the GKO market are prone to relatively large daily fluctuations. Consequently, although the volume of transactions in the interbank market is currently a mere 20% of pre-crisis levels,[13] for banks which are regarded as sound and which have very short-term credit requirements, refinancing conditions have - contrary to the prevailing trend - become better rather than worse.

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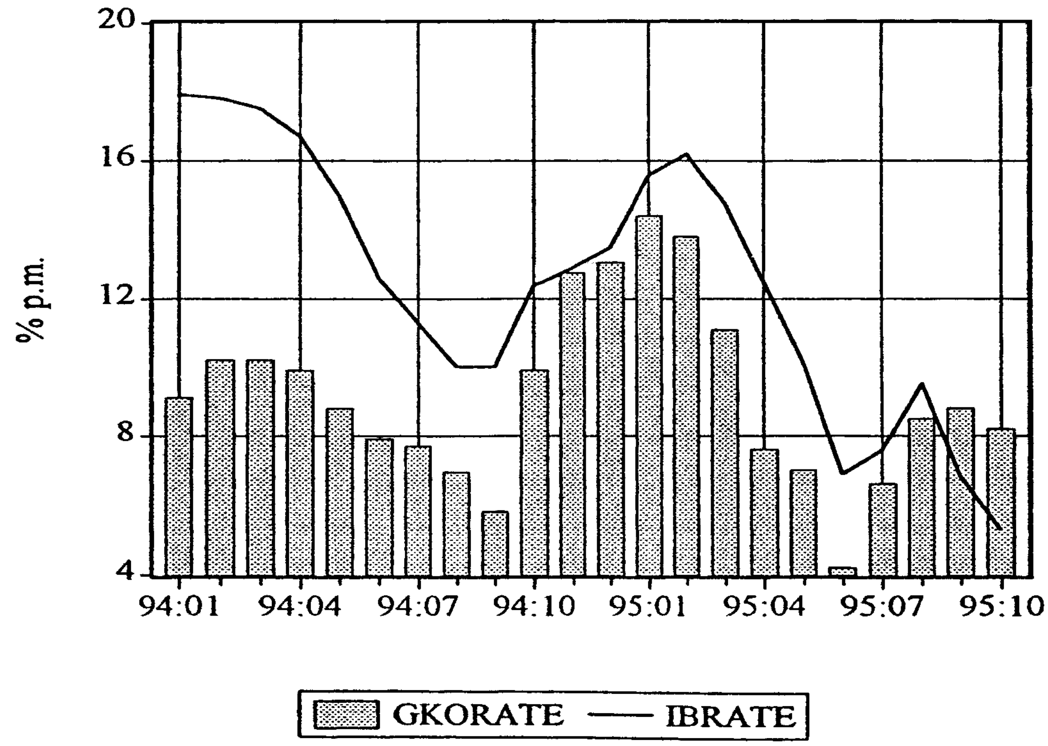
[12] For example, unsecured loans on terms corresponding to the published figures are offered by Stolichny Bank to only some 10 banks.

[13] Turnover is in the range of Rb 1 trillion per week.

Figure 7: **Interbank interest rates and interest rates on treasury bills (GKOs), 1995**



Source: Russian Economic Trends

Banks which do not belong to the first-class club have, for their part, also joined forces to form clubs of their own, membership of which is based on (personal) acquaintanceships and long-standing business relationships. Informational problems are therefore relatively minor, leaving the way open for interbank loans to be extended by one club member to another. However, even here, collateral in the form of GKOs has in the meantime become an almost universal requirement.

Table 4 gives an impression of Russia's interbank market in quantitative terms. It shows the volume of outstanding interbank loans (in absolute terms and as a percentage of total outstanding interbank loans) and the changes that took place between January and September, as well as in the individual months of July and August, both at a national level and in the regions in which the Russia Small Business Fund is active.

Table 4: **Indicators of the trend in outstanding interbank loans in Russia as a whole and in the regions of the Russia Small Business Fund**

Region	**Outstanding interbank loans as of 1.1. 1995, in Rb billions (in % of total outstanding interbank loans)**		**Change January - September 1995 (in %)**	**Change July- August 1995 (in %)**	**Change August - September 1995 (in %)**
Russian Federation	9,041.9	(100)	+ 64.1	- 9.2	- 31.2
Moscow	4,817.8	(53.3)	+ 62.8	- 7.5	- 30.7
St. Petersburg	236.6	(2.6)	+ 86.5	+ 35.7	- 35.7
Tula	2.9	(0.03)	+ 440.0	+ 49.4	+ 2.7
Nizhny Novgorod	53.8	(0.6)	+ 94.4	+ 16.1	+ 3.27
Samara	116.5	(1.3)	+ 85.9	+ 11.9	- 11.7
Yekaterinburg	34.4	(0.4)	+ 162.2	+ 18.9	- 11.7
Novosibirsk	171.4	(1.9)	- 17.0	- 18.3	- 28.4
Tomsk	7.0	(0.08)	+ 52.3	+ 31.7	- 5.6
Kemerovo	50.3	(0.6)	+ 130.0	+ 31.9	- 14.6

Basic Data: Central Bank of Russia

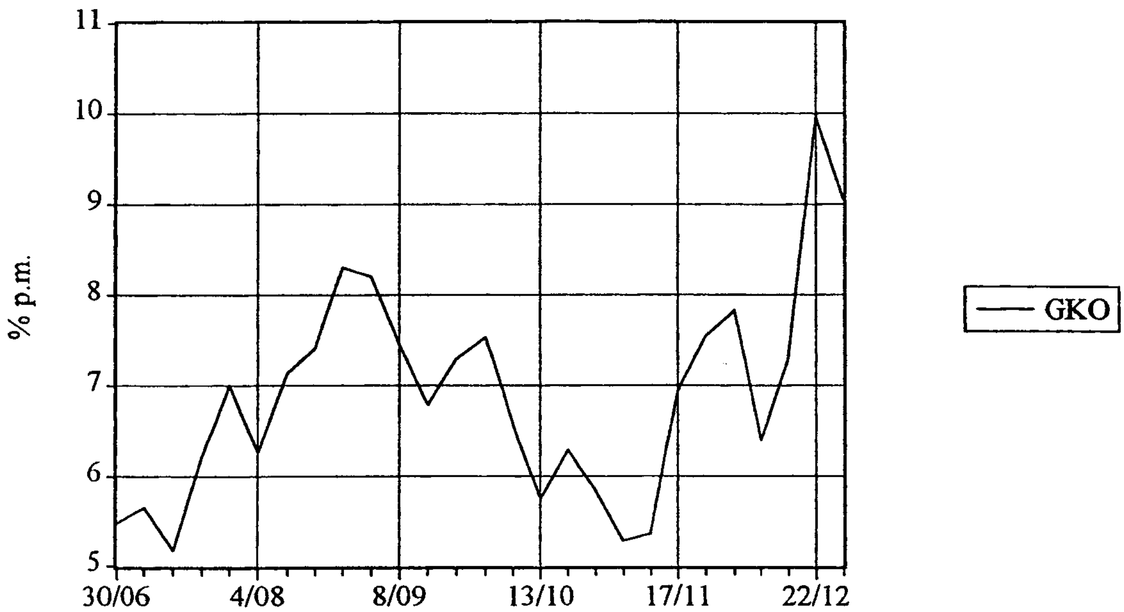
The sharp downturn in August is clearly visible here, although it was not evenly spread throughout Russia. The decline was particularly striking in St. Petersburg[14] and Moscow, while in some regions there was no more than a slowdown in growth. One possible explanation for these disparities is that the interbank markets in the regions may have been less developed, i.e. maturities on interbank loans were longer there, and thus the crisis was not yet reflected as strongly in the figures for the beginning of September. However, anecdotal evidence suggests that the full force of the crisis is now hitting the regions too. And here too, the same patterns of response are emerging as in the capital. Banks are forming local clubs with others that they know or with which they have "friendly relationships", and are thus able to continue lending to one another.

14 In St. Petersburg the crisis would appear to have been particularly severe. Bank after bank defaulted on their payments, creating a serious shortage on the money market. The interest rates payable on seven-day loans at around 20 December ranged from 66% to 140% p.a., compared with only 70% p.a. in Moscow.

3. The GKO market: Moving to centre stage

The GKO market has now replaced the interbank market as the focal point of Russia's financial markets. This is due not so much to the outstanding volume, which has in the meantime grown to Rb 77 trillion, meaning that GKOs are an important investment medium for the banks. Rather, it is due to the fact that GKOs are practically the only available instrument for liquidity management, either directly - banks with surplus liquidity purchase GKOs while banks that require additional liquidity sell them - or indirectly, insofar as GKOs are accepted by surplus units as security for an interbank loan.

Figure 8: **Average interest rate in the GKO market, 1995** (weekly data)



Source: Granville and Larichev; Expert-Magazin.

Accordingly, the interest-rates quoted on the GKO market fluctuate over a wide range, as can be seen from Figure 8.[15] Liquidity shortages due to institutional and seasonal factors also contribute to fluctuations in interest rates. For example, rises in interest

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[15] Thus, sources from the banking industry repeatedly referred to the GKO market as the main "speculative market", which might seem an odd term to use in this context to someone whose first instinct is to equate the GKO market with Western bond markets.

rates towards the end of a month or, particularly, near the end of a year are attributable to the fact that at these times the liquidity requirements of enterprises and households are particularly high.

In mid-November the GKO market came under pressure when the first loan-for-shares auctions[16] took place. Because the government refused to accept GKOs as a means of payment, the banks were compelled to sell GKOs in order to raise the cash they needed.

The wide interest rate fluctuations on the GKO market could be avoided if the central bank were to introduce the kind of monetary policy instruments that would enable it to exercise tighter control on the liquidity of the banking system and thus also on market interest rates. Since the practice of channel-credits was abandoned, the central bank credit auctions have been virtually the only monetary policy instrument which the Central Bank of Russia applies directly to the commercial banks. However, the effectiveness of this instrument has been very limited, not so much because of the low volumes offered at the auctions - since March 1995, the volume has never been higher than Rb 60 billion - but more importantly because the interest rates charged were, in all but a few exceptional cases, based on the CBR's refinancing rate. Given that this rate has for a long time tended to be significantly higher than the interbank interest rate, it is hardly surprising that the central bank was unable to find enough takers even for the low volumes of funds it was offering, i.e. that demand was meeting only a small percentage of supply (see Fig. 9).

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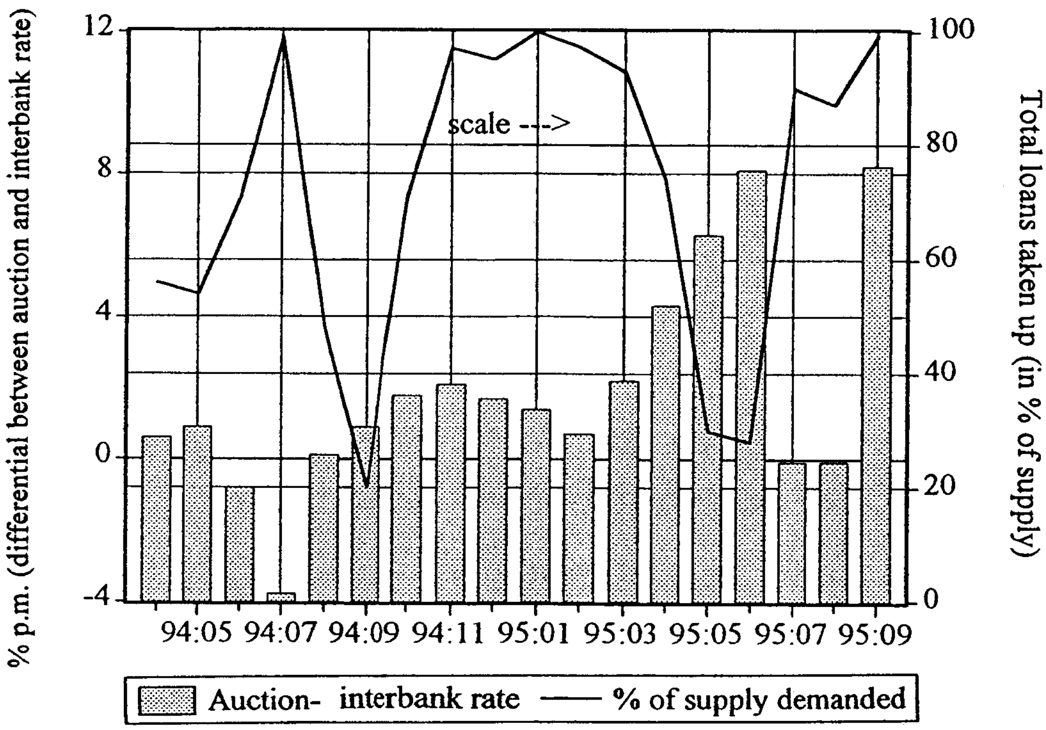
16 The loans-for-shares programme is part of Russia's privatisation effort. It involves 29 big state enterprises, including the so-called blue chips of Russian industry such as oil giants Lukoil, Yukos, Sidanko and Surgutnetegas, as well as other famous Russian companies like Norilsk Nikel, the world's largest nickel producer. The programme was first proposed by a bank consortium in early summer when it became clear that government revenues from privatisation fell far short of expectations. In autumn the Russian government announced a revised version of the bankers' proposal - mainly allowing non-banks to participate in the auctions. In November the first auctions took place giving the winner the right to manage the government's stake in the respective enterprise in exchange for loans. However, the original consortium of banks split into two groups, with Inkombank, Rossiysky Kredit and Alfa-Bank on one side and Uneximbank, Menatep and MFK (Moscow Finance Company) on the other. Apparently, there were irregularities at the auctions themselves which gave the group of banks that was organising the auction an unfair advantage. Thus, at the first auction, which was organised by Uneximbank, this institution won a bid for a 38% share of Norilsk Nikel, even though its offer was only US$ 100,000 over the minimum of US$ 170 million, whereas Rossiysky Kredit, which offered to pay twice as much for the shares, was barred from participating, ostensibly on the grounds of insufficient net worth. The privatisation programme and the way it was being conducted were cited as the official reason for the sacking in January 1996 of reformer Anatoly Chubais from his post as deputy head of government and minister for economics.

Figure 9: **Central bank credit auctions:**
Interest rate (difference to interbank rate) and total loans taken up
(in % of supply)



Basic Data: Granville and Larichev

Prior to the liquidity crisis, the only time that central bank auctions played any significant role was when the CBR adjusted its interest rates down to the levels prevailing in the interbank market - as it did, for example, in July 1994 and in July/August 1995 - or when, as a consequence of rising inflation rates in the winter of 1994/95, the interbank interest rates moved up closer to the central bank's refinancing rate. On those occasions, and only then, 90% or more of the central bank money being offered at the auctions was actually taken up.

Since the liquidity crisis, however, a fundamental change has taken place. In September, as Fig. 9 shows, almost 100% of the money available at the central bank auction was demanded, even though the interest rate, at 15% per month, was almost 10 percentage points higher than the interbank rate. Although no data has yet been made available for the period October-December, the Russian European Center for Economic Policy, to quote just one source, reports that the auctions have been characterised by excess demand for central bank money on the part of the commercial banks. In other words, what is being offered at the auctions are lender-of-last-resort credits, and since the liquidity crisis there has been strong demand for them.

By introducing a Lombard window and/or repurchase agreements, both based on the pledging of securities, the central bank could make available a source of funds which would give it greater control over commercial banks' liquidity and simultaneously enable it to reduce the interest rate fluctuations on the GKO market. Imposing a quota system on both the Lombard facility and the repurchase agreements would act as a safeguard against the misuse of these instruments, thus ensuring that they would not lead to an uncontrolled expansion of the central bank money supply. In other words, if the Central Bank of Russia were to take these steps, those banks which operate as surplus units and extend interbank loans backed by pledged GKOs would lose their current monopoly as providers of liquidity and would no longer be able to control short-term interest rates.[17] This would allow short-term interest rates to become the pivotal instrument of monetary policy and thus a key indicator of the central bank's line on monetary policy, which is the role they play in Western market-based economies.[18]

Various sources in Moscow intimated that one or both of these instruments would be introduced in the near future. If so, it would further enhance the status of the GKO market because holding GKOs would give the commercial banks access to central bank funds.

4. The response of the commercial banks

The Russian commercial banks are responding to the new conditions by making risk-aversion the guiding principle of their lending policies, by intensifying their efforts to attract deposits from enterprises, state entities and private households, and by widening the spread between loan and deposit interest rates.

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17 Historically, the establishment of central banks was motivated by the desire to smooth interest rate fluctuations (see Mankiw, N.G.; Miron, J.A. and D.A. Weil (1987), The Adjustment of Expectations to a Change in Regime, A Study of the Founding of the Federal Reserve, NBER Working Paper, No. 2124). And - at least among central bankers - the view prevails that interest rate volatility is costly to the financial system and to the economy (see Karamouzis, N. and R. Lombra (1989), Federal Reserve Policymaking: An Overview and Analysis of the Policy Process, in: Brunner, K. and A.H. Meltzer (eds.), International Debt, Federal Reserve Operations and Other Essays, Carnegie-Rochester Conference Series on Public Policy, Vol. 30, pp. 7 - 62.

18 See Batten, D.S. et al. (1990), The Conduct of Monetary Policy in the Major Industrial Countries: Instruments and Operating Procedures, IMF Occasional Paper No. 70, Washington.

One likely consequence of the fact that the banks are pursuing an investment policy of giving absolute priority to the criterion of safety is that the GKO market will be further strengthened. Banks whose GKO portfolio exceeds their loan portfolio in volume terms are no longer a rare phenomenon. Conversely, lending operations are becoming a less and less important aspect of the banks' business. At the level of the economy as a whole, this trend is reflected in the fact that, during the first eight months of 1995, the total volume of outstanding loans grew at a rate that was significantly below the rate of inflation; in real terms, the loan portfolio of the commercial banking sector declined by over 25%. Table 5 shows the growth rates of the commercial banks' outstanding loan portfolios for the period January-September 1995 in Russia as a whole and in each of the regions where the Russia Small Business Fund is represented. From the table it is obvious that the situation varies from region to region.

Table 5: **Increase in volume of outstanding bank loans (excluding interbank loans)**

Region	**Growth rate, 1.1. - 1.9.1995** (in %)
Russian Federation	46.6
Moscow	98.3
St. Petersburg	64.4
Tula	67.4
Nizhny Novgorod	22.8
Samara	63.3
Yekaterinburg	67.5
Novosibirsk	85.1
Tomsk	33.5
Kemerovo	60.7
By way of comparison: *Inflation rate, 1.1. - 1.9.1995*	*96.0*

Basic Data: Central Bank of Russia

The caution being exhibited by the commercial banks is even more readily understandable when one considers the extent of arrears as a percentage of the overall loan portfolio. Table 6 gives an impression of how the delinquency rate changed over the first nine months of 1995 in Russia as a whole and in the regions in which the Russia Small Business Fund is operating.[19]

Table 6: **Loans in arrears as a percentage of the banks' aggregate loan portfolio**

Region	1 January 1995	1 September 1995
Russian Federation	31.1	33.5
Moscow	10.6	12.6
St. Petersburg	10.2	15.6
Tula	26.2	24.4
Nizhny Novgorod	18.7	26.0
Samara	20.3	20.2
Yekaterinburg	22.1	19.9
Novosibirsk	25.0	18.8
Tomsk	24.3	39.3
Kemerovo	7.4	14.3

* A loan is defined as being in arrears if an interest or principal payment is more than 30 days (or, in the case of long-term loans, 60 days) overdue. When calculating the percentages, interbank loans were disregarded.

Basic Data: Central Bank of Russia

However, the cautiousness of the banks' lending policies is reflected not only in quantitative indicators but also in qualitative aspects of their credit extension. In particular, the banks are tending to place extremely strong emphasis on collateral, which is their way of compensating for their own lack of credit analysis skills. At the same time, the banks are striving to expand those lines of business which earn them non-interest income, particularly in the area of payment transactions.

Thus, the overall picture in Russia is characterised by a trend which can also be observed in other Central and Eastern European countries that are also going through a phase of extreme disinflation and stabilisation. Financial intermediation, as measured in terms of indicators such as the real growth of outstanding loans to enterprises and

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[19] N.B. One would not be justified in using the table to compare the quality of the commercial banks between one region and another, because it is not clear whether identical standards were applied in all the regions as regards the compilation of the data, the banks' reporting of arrears to the local offices of the central bank, or the local offices' attention to whether the banks had complied with the relevant valuation guidelines.

private householders, or the volume of loans or the money supply relative to gross domestic product, is declining in importance. Yet the reasons for increasing disintermediation differ greatly between phases of (hyper-) inflation and phases of stabilisation. During the 1992/93 period of inflation, the growth of lending volumes was simply unable to keep pace with rising prices, a process in which the banks had a relatively passive role. By contrast, if the rate at which lending volumes are growing falls short of the inflation rate in a phase of stabilisation, it is because the banks are limiting the amount of credit they extend in order to minimise their risk. In other words, they are now tending to play a more active role. Stabilisation, therefore, does not automatically strengthen the role of the financial sector; it can at best be regarded as a precondition for strengthening the role of the financial sector, because now banks must acquire professional competence - not solely but above all in their lending operations - in order to ensure their survival, at least in the medium term.

Buying and selling riskless GKOs may turn out to be only a short-term survival instrument. For, although the Russian public-sector debt is still small in relation to GDP, the debt-service ratio, defined as government spending on interest relative to GDP, will rise rapidly unless there is a significant decrease in the real rate of interest on GKOs, a significant acceleration in the growth of GDP or a further marked reduction in the level of new public-sector borrowing.[20] This means that - assuming current growth forecasts to be realistic - either interest rates or new borrowing will have to be reduced if the government is to avoid having in the near future to spend a substantial portion of its already scant funds on interest payments. As a consequence, the GKO market will become less profitable or will start to grow more slowly, and thus will become a less attractive or less significant alternative to credit extension.

However, solvency, i.e. increasing the quality of the loan portfolio, is not the most urgent problem on the Russian banks' current agenda; rather, their primary concern at

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[20] This can be explained using a simple formula:

$$\lim_{t \to \infty} (U/T) = i / [(g/a) + i]$$

where: U = interest payments on outstanding government debt
T = taxable income
g = growth rate of taxable income
i = interest rate
a = government deficit in % of taxable income

all variables in real terms.

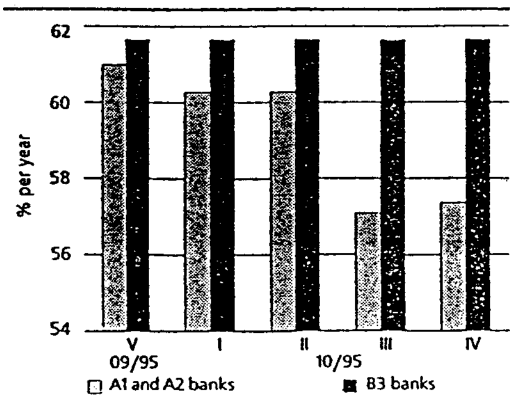
The first economist to draw attention to this relationship was Domar, E.D. (1944), The "Burden of the Debt" and the National Income, in: American Economic Review, Vol. 35, No. 5, pp. 798-827.

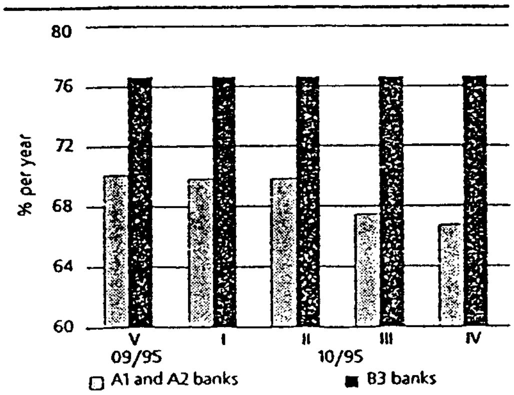
the moment is to secure liquidity. After all, the ability to secure liquidity, or to open up new sources of liquidity, is the crucial factor in determining whether or not a bank will survive the next few months. This is why the crisis has initially strengthened those banks with a sufficiently large deposit base, which in the main has meant those institutions which evolved out of former Soviet state banks or ministries, or were set up by large state-owned enterprises, as well as those banks which serve a large number of customers and/or act as the main bank for large enterprises or state funds or organisations. It may sound paradoxical, but in the short term at least, the main beneficiaries of the crisis have been the banks which, in the broadest sense, have (close) links with government or state entities.

The liquidity crisis has led to an intensification of the competition for depositors, and especially large-scale depositors. This means that, while the sources of liquidity referred to above offer security in the short term, they also make an institution more vulnerable, especially if just a few clients account for a relatively large percentage of a bank's total deposit volume. For example, a hard-fought battle is currently raging in St. Petersburg over the right to manage the city's pension funds.

However, the new situation is posing greater problems not only for the banks but also for the depositors, because now the risk of placing deposits with a bank that may be forced out of business in the near future is considerably higher than it was prior to the events of last August. Conversely, it means that banks which have a reputation for soundness and safety have a distinct competitive advantage. And indeed, these banks are exploiting their advantage, as is shown in Figure 10, which charts the evolution of the interest rates on one- and three-month time deposits offered by Moscow banks which are rated by the Rating Information Center as "very reliable" (A1 and A2 banks) and as "sufficiently reliable" (B3 banks).

Figure 10: **Average one- and three-month time deposit interest rates (on Rb 500 million account), weekly data**





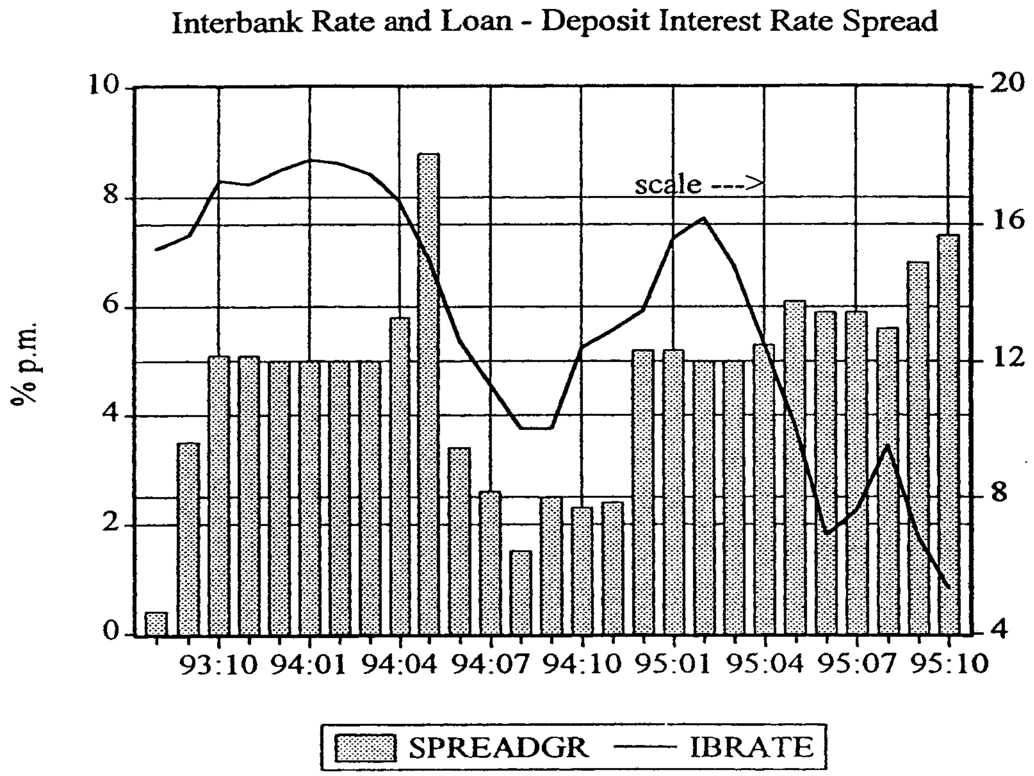
Source: "Financial Markets", December 1995 - January 1996, p. 992

The chart shows clearly that during September and October there was a significant increase in the differential between the interest rates paid by the two categories of banks. Banks that were rated as "very reliable" were able to reduce their deposit interest rates, whereas those judged to be merely "sufficiently reliable" had to keep their rates up to their original levels. Similar developments also took place in the regions: our staff in Tomsk report that the local branch of Kuzbassoc Bank reduced its deposit interest rates in the closing months of 1995.

Sources in Moscow banking circles expressed the view that by the summer it will have been decided which banks will survive the crisis and which will go under. The special competitive situation in the deposit market would seem to confirm this prediction, since it implies that banks can very quickly find themselves in either a vicious or a virtuous circle. Having a reputation for stability enables a bank to attract additional depositors; reliable and loyal depositors enhance the bank's reputation as a stable and safe institution. Conversely, a bank with a reputation for instability is likely to see its customers closing their accounts; when clients move to a different bank, the institution that lost its clients acquires a reputation for being unstable and unsafe. It is therefore hardly surprising that the battle for customers in the deposit market is being fought out with no holds barred. For example, it would appear that some banks have deliberately spread rumours designed to harm the reputation of a competitor or to divert attention away from their own problems.

And finally, the commercial banks' third response to the crisis has been to widen the spread between deposit and loan interest rates. It is noticeable, particularly when compared to the stabilisation phase of summer 1994, that practically none of the gains derived by the banks from lower funding costs are now being passed on to their borrowers in the form of lower loan interest rates (see Fig. 11).

Figure 11: **Interbank interest rates and the spread between deposit and loan interest rate, 8/1993 - 10/1995**



Basic Data: Granville and Larichev; Russian Economic Trends

The main causes of this development are the high percentage of bad loans in the banks' portfolios, the increasingly risk-averse policy they are applying to new lendings, and the lack of competition in the market for credit. It can be assumed that this trend will continue, all the more so as the process of consolidation in the commercial banking system progresses, because large interest margins will be one of the ways in which the banks will seek to safeguard their solvency. In this respect too, the development in Russia is likely to follow the pattern that has been observed in other reforming countries of Central and Eastern Europe.

5. Outlook and implications for the Russia Small Business Fund

In the coming months the consolidation process in the Russian commercial banking sector will continue. At present there are no indications that the central bank will in the near future abandon its recently adopted policy of revoking the licences of banks which are recognisably illiquid. On the contrary: new banking supervisory regulations are currently being drafted which will make the standards which banks must meet - e.g. the guidelines on equity capital, lending and liquidity - more rigorous. For this reason, it can be assumed that once these standards take effect, it will be even easier for the central bank to revoke banking licences. In addition, the central bank is pressing for rapid passage of a law that is intended to define procedures for bankruptcy in the case of financial institutions.

It has already been suggested that "liquidity" has now become the crucial criterion for assessing the viability of Russian banks, and in such a setting the odds of surviving are greatest for certain categories of banks. The main partner banks of the RSBF also fall into these categories, either because they are in any case members of the club of first-class banks mentioned above (Stolichny); or because they are successor banks to former Soviet state banks and have a correspondingly large number of customers (Sberbank, Mosbusinessbank and - at a regional level - Kuzbassocbank); and/or because they serve as the main banks of medium-sized and large enterprises or state funds or organisations (Petrovsky Bank and Orbita Bank).

While it can, however, be assumed that most of the banks that are at present experiencing liquidity problems are in fact insolvent, it would be wrong to conclude that the reverse was true, i.e. that banks which do not have liquidity problems are solvent. Therefore, one must ask how the banks intend to secure their solvency in future and what impacts this will have on the banking environment in which the RSBF operates.

An assessment of the approaches that have been employed so far, and of relevant experience in other transition economies, indicates that, by and large, the strategies which the banks will utilise to safeguard their solvency will be defensive in nature. In particular, this implies:

- A concentration on, and intensive competition to secure the business of, (large) borrowers who are considered to be "safe". The loans-for-shares programme offers an almost ideal vehicle for the implementation of this strategy. For, by acquiring equity stakes in the so-called blue-chip enterprises, the banks involved will not only increase their financial worth and economic leverage; they will also almost automatically assume the role of principal banks for "their" companies, i.e. they will be relied upon to execute the entire range of financial transactions which these firms wish to undertake.

- A concentration on the expansion of largely riskless asset-side operations, such as the purchase of GKOs.

- A concentration on lines of business involving the provision of services that generate non-interest income, in particular in the area of payment transactions.

- A policy of extending credit to enterprises only on condition that they meet extremely high collateralisation requirements and at interest rates which greatly exceed the banks' cost of funds, thus ensuring that they earn an ample spread on lending.

All of the evidence indicates that the significance of lending in general, but in particular lending to small and micro enterprises, will continue to decline, above all because the attendant risks are considered to be too high. Thus, as regards the economy as a whole, small and micro enterprises will probably be subject to credit rationing to an increasing rather than a decreasing extent in the future. Whereas during the (hyper)inflationary phase of 1992/93, credit extension to the target group was seen by the banks as being unprofitable, now it is seen as being too risky because they have so far failed to acquire the know-how needed to carry out appropriate credit analyses and to properly assess credit risks.

But for the partner banks of the RSBF which have adopted a credit technology that is appropriate to the situation of the target group, this means that opportunities to capture a larger share of the lending market will continue to grow, on the one hand because there will be fewer banks in the market, and on the other because the banks that survive will be very unlikely to move into - or expand their existing operations in - small and micro enterprise lending, which is regarded - incorrectly - as a particularly risky business. Indeed, in so far as other banks already provide credits to small and micro enterprises, they will scale back, or phase out altogether, their activities in this sector. This trend will no doubt be more pronounced in some regions than in others: in Moscow and St. Petersburg the volume of lending will not decline as much as in some provincial cities. Thus, it is not surprising that, even now, our partner banks in Tomsk are for all practical purposes the only institutions offering credits to businesses, at least in the loan size categories covered by the Micro and Small Loan Programmes.

While this trend will probably serve to make the Programme even more attractive, there is, however, also a danger that the partner banks will take advantage of this *de facto* monopoly to avoid reducing interest rates on micro loans even if they clearly have scope to do so, which in turn can slow down the growth of the credit portfolio and have an adverse effect on its quality. This is increasingly true even as regards the "large micro-loans", because some of the partner banks assume - incorrectly - that their cost of funds is equal to the rouble interbank rate, and not the EBRD lending rate, which is LIBOR + 3%. Owing to this misconception, some partner banks conclude that dollar-denominated micro loans are not profitable (enough). Thus, it should be made clear to the partner institutions that:

- the EBRD lending rate, and not the rouble interbank rate, currently represents their cost of funds on micro-loans;

- every credit that is not granted because - in the view of a potential borrower - it would carry an excessively high (rouble or US dollar) interest rate, leads to a noticeable loss of interest income;

- high interest rates make banks susceptible to the risk of moral hazard and adverse selection as regards their borrowers, i.e. high lending rates can lead to a decline in the quality of the portfolio, which in turn can cause the effective interest income derived from the portfolio to fall below the level that could be achieved if interest rates were kept at an appropriate level. This is particularly likely to happen if the profitability of enterprises - e.g. in trade and services - suffers an overall decline due to changes in the macroeconomic environment.

Temporarily at least, the consolidation process in the Russian financial sector will also lead to problems in the area of credit analysis because it may impair the ability of borrowers to make their payments: sub-borrowers may maintain their current accounts at banks which become insolvent, and are thus unable to execute orders to transfer funds to the partner banks of the Russia Small Business Fund. Given that it appears to be nearly impossible to obtain a precise picture of the financial status of a given sub-borrower's "main bank", whenever there are doubts as to the solvency of a given institution the loan applicant will be required to transfer his or her current account to the partner bank in order to become eligible for a credit.

However, it is also conceivable that important customers or suppliers of our sub-borrowers will maintain their accounts at - and/or have taken out loans from - banks which become insolvent. In other words, it is conceivable that our clients will be affected indirectly, rather than directly, by such cases of insolvency. But, if this proves to be a significant problem at all, it will probably be encountered only in small loan operations, provided the banking crisis does not assume systemic proportions, i.e. provided the *de facto* bankruptcy of many small banks does not either directly or indirectly threaten the stability of the banking system as a whole.

Thus, it is fair to say that, overall, the trend that has been in evidence since the beginning of the implementation phase of the Russia Small Business Fund is continuing: the macroeconomic stabilisation is putting pressure on the financial sector to adjust, and this is forcing the banks - in so far as they have the liquidity needed to withstand this pressure (and stay in business) - either to reduce the volume of their lending operations, or to familiarise their staff with the necessary credit analysis and monitoring techniques and to adopt, and apply in practice, appropriate lending guidelines. Thus, it is not surprising that the (branches of the) partner banks which have, since the initiation of the Programme, been firmly committed to pursuing the latter course have already seen a significant increase in the size of their RSBF portfolio, and a substantial improvement in its quality as well.