THE IMPACT OF PERESTROJKA ON THE BANKING SYSTEM IN THE SOVIET UNION

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The political and economic changes in East European countries are gaining attention and analysis in many Western forums. Some of these changes, such as the economic transformations taking place in the Soviet Union, and the difficulties faced in the transition to a more market-oriented economy, have already been debated; I would like to continue this line of thought and look at the impact of *perestrojka* on the Soviet banking system.

Nobody 70 years ago who dared to announce or predict the influence of the October Revolution on the world, the missionary power of its ideology, its capacity to modify the very behaviour of our capitalist system would have been believed. I believe that only from an academic perspective can one forecast the impact on the banking system of the new Soviet "revolution", prudently called "reconstruction" (*perestrojka*) and so avoid prophecy while allowing analytical rigour.

This contribution should be considered as a first attempt at analysing this particular subject, since information is greatly lacking because *glasnost*, it seems, has not yet reached the Soviet financial world. A panorama of the banking system in the Soviet Union up until a few years ago, i.e. before *perestrojka*, and some comments on the impact which it had on the Soviet economy will first be given. This is followed by an analysis of the changes brought about by *perestrojka* in the banking world. Finally, an attempt is made to evaluate the system towards which banks in the Soviet Union seem to be going. Personal comments on the role that the Soviet banking system could play as a catalyst in this really passionate process of "reconstructing", "restructuring" or "modernizing" the economy have been included.

1. The State Banking Monopoly

It is a fact that the Soviet economy is governed by a centrally planned system, and the underlying logic behind it is a belief that political leaders, and members of the Central Planning Committee who serve them, are able at any given moment to give the best diagnosis of society's needs, and take all the decisions, in a centralised way and through directives that have to be fulfilled, as well as issue all the necessary instructions so that satisfactory solutions are found to these needs.

The Central Planning Committee and its delegation in several Republics have, thus, been responsible in the past 70 years for dictating for each sector

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and every company in the Soviet Union production plans setting out the activity, the raw materials to be used, who must be its suppliers, who is to receive its final products, prices, and the funds for each company and who should supply them. It is clear that in such a situation the financial system must play a very special role.

But before judging the Soviet financial system we should remember that the banking system of any country, given the functions of mediating and guaranteeing the system of payments which it carries out, cannot be explained, nor understood, as something self-contained hermetically sealed. It always has to be closely set against the economic model of the financial system to which it belongs and to whom it is providing services. There is a close and permanent relation between the economy and the banking system and it is almost always the banking system, which acts as the catalyst and dynamic agent for economic development.

This has not been the case in the Soviet financial system, because, relegated for decades to a marginal role for ideological reasons, it has not been able to exercise the role of catalyst.

In order to explain this we have to take as a starting point the fact that in a centrally planned economy, supply and demand of the necessary funds for the normal development of companies does not depend, as it does in Western economies, on market forces, where interest rates perform the function of adjustment, but is determined by the financial plan, a plan which makes the banking system provide the funds which companies need, and which establishes where they come from and their composition.

The Soviet financial system was like this until a few years ago. This means that over a period of more than 70 years the Soviet banking system has worked on the basis of the so-called "single bank", a system consisting of three banks, a central bank, an investment bank and a foreign trade bank. I would like to look at each one:

– A central bank (*Gosbank*) which has been performing the functions of a central bank such as issuing money and looking after the money supply, managing state reserves and controlling the other credit institutions. But, moreover, at the same time it has carried out almost alone, the functions of commercial banking and the functions of a savings bank for individuals and which, also, has carried out, in particular, a series of functions related to the financial features of a centralised economy such as assuming the responsibility for social accounting, acting as the body for registering payments between companies, organizations and the government and enacting the state budget. Gosbank carries out this very wide range of functions via 82,300 offices.

– An investment bank (*Stroibank*), which has specialised in long-term financing of all sectors of the economy and short-term financing for construction. With 2,000 offices it has distributed funds from the budget through unrecoverable subsidies.

– And a foreign trade bank (*Vneštorgbank*) which has provided services to the whole Soviet trade framework, maintained correspondent bank relations with Western banks and administered all payments to and from abroad. It had 18 offices in the main cities.

This, broadly speaking, is the banking system which the Soviet Union has had, with slight modifications, for more than 70 years since the October Revolution. Karl Marx seemed to be thinking of a society without money when, in *Das Kapital,* he wrote that workers would receive coupons which they could change for consumer goods in state shops, in an amount equivalent to their time at work. Although, for greater precision, he added that these coupons were not money, and, therefore, they would not circulate. I believe that Marx's thesis concerning the scant importance given to developing functions for money in society and, by the same token giving scant significance to banks, explains the considerable underdevelopment of the Soviet banking system during this period, and the negative impact on the development of the Soviet economy.

And this is because the banking system, almost exclusively, has been an instrument at the service of the administrative apparatus of the Plan and State, an instrument which leaves a tiny margin of manoeuvre for the management teams of banks.

And because it was a system where interest rates played a marginal role, acting, as we have seen, not as a price for matching supply and demand for money, but as one more element of planning.

It was a system in which granting loans was determined, and required, by the Plan, and as it ignored the concept of risk it prevented the adequate assigning of funds to economic projects or socially more profitable ones.

It was a system in which the central guidelines of the Plan limited the amount of freely available funds to banks to practically the amount necessary to cover their operating costs, regardless of profitability, and this prevented any chance of competition, and there were no incentives to improve the range or quality of services.

It was a system in which such elementary and basic banking principles as competition, profitability and risk evaluation had disappeared and where productivity and efficiency were nothing more than empty words.

However, the feature which should most strike our attention when judging the Soviet banking system is its peculiar idea of savings as, in the present circumstances, this is the most pressing and important economic issue.

2. The Era of Changes

In this economic-financial framework, characterised by failure and by waste in assigning funds caused by centralised planning of the activities of several hundred thousand companies, *perestrojka* arose. The idea was first mentioned by Gorbačev on April 23 1985 at a meeting of the Central Committee of the Communist Party when he recognised the need to carry out a "reconstruction" and make substantial changes to the Soviet economy. The idea was fleshed out a year later in 1986 at the 27th Congress, and as of 1987 began to take effect with substantial changes, thus launching an unstoppable process of liberalisation. A summarised calendar of what has happened so far would read like this:

– January 1987, in its first liberalisation move, the Soviet authorities authorised the establishment of joint ventures with foreign capital;

– January 1988, a new law on state companies allowed a greater degree of decentralisation and autonomy;

– August 1988, a new law on cooperatives liberalised their activity and injected a considerable stimulus to expansion in this sector;

– April 1989, a decree on rents and free access to foreign markets for almost all state companies and cooperatives brought almost complete liberalisation;

– March 6, 1990 a new property law for the first time allows private ownership.

All these measures have introduced substantial changes to the regulatory framework of the Soviet economy. All imply a major dose of competition. And all bring the Soviet economy closer to the Western system.

Maintaining a banking system such as the one I have described in this situation is more and more difficult, if not absolutely impossible. The Soviet Prime Minister, Nikolaj Ryžkov, in 1987 labelled the banking system as "too sluggish and inefficient to meet the challenge of the revolutionary changes taking place in the Soviet Union".

This statement gave the starting signal for the immediate launch of a series of measures which will completely change the Soviet banking system. These measures will shape a completely different financial system. They contemplate a new role for interest rates, a more rational idea of credit and risk, greater management autonomy for financial entities and an emerging competitive market. All of these has been carried out in four principle steps, in little more than 24 months.

The first step was in January 1988 when there was a total reorganisation of the state banking monopoly. A new Gosbank was created with functions more clearly limited to those of a central bank, such as managing the monetary system, enacting the state's credit policy, coordinating the activities of banks and budget payments. With this cutback in Gosbank's functions, the rest of the activities it carried out were split up among five specialised state banks. The assets, the network of branches, and the customers of the old structure were distributed among these five banks, leaving Gosbank with just 15 of its 82,300 offices, one for each Republic.

The five new banks continue to carry out the role of providing financial support for fulfilling the state economic plans and channelling credit to different sectors of the Soviet economy. But they specialise according to their functions, which makes the framework more rational and more efficient. The new banks are:

– *Promstrojbank*, dedicated to industry, construction, transport and communications, with more than 10,000 offices;

– *Agroprombank*, dedicated to agro-industrial companies and consumer cooperatives, with 3,000 offices;

– *Žilsocbank*, for the housing sector and municipal services, with more offices in more than 1,000 cities;

– *Sberbank*, a system of savings banks, serving individuals, with 80,000 offices;

– *Vnešekonombank*, or Bank of Foreign Business, involved with everything to do with foreign transactions, with 18 offices in the main cities and five abroad.

There is little information about the activity of the new Soviet banks and it is very difficult to obtain what little there is. To give us an idea, Agroprombank has assets of around $379 billion which makes it one of the largest Western banks on the basis of assets; and Sberbank has deposits amounting to some $420 billion which makes it the biggest bank on the basis of deposits.

There is no doubt that the new system is more rational, and apparently more efficient, because it has greater agility and autonomy. But the specialised banks continue to maintain a situation of monopoly because customers still cannot choose their bank and because these banks cannot deny finance to companies assigned to them. Efficiency is thus more apparent than real.

In March 1989, a little more than a year after the reform, when the speed of change can be appreciated, new measures were taken to restructure state banks. Five new banks with no separation of activities were authorised, which meant that customers could choose with some freedom.

This was a substantial change. Perhaps, from the point of view of quality, it was the most important one. That is because it allows companies to choose their bank, and banks to choose customers and open branches and subsidiaries, so introducing the beginning of competition.

A second step was taken in the middle of 1988, six months after the one above, when the setting up of commercial banks and cooperatives was almost fully liberalised. The number of banks has grown enormously since then. At the end of 1989, 18 months after liberalisation, 205 new banks had been created, of which 129 were commercial and 76 cooperative banks.

The creation of new banks is a fundamental step and signifies a definite break with the state banking monopoly. These 205 banks enjoy full commercial and operational independence, and must only adhere to Gosbank regulations as regards financial prudence. They are completely free to set interest rates on deposits, and with this the system is beginning to attract large volumes of deposits from their partners and customers. Logically, these banks are also free to set whatever interest rate they want for loans.

The third measure was to liberalise slightly more the legislation regulating the establishment of foreign banks. In order to attract capital and gain closer access to the techniques and banking practices of the West, more authorisations were given for foreign banks to open representative offices. Fifty three foreign banks have offices in the Soviet Union, and 32 more are awaiting permission.

The last step was to allow Soviet-Western banking consortiums. The first such operation began in early 1989 with a view to financing large projects and joint activities in the Soviet Union. A big consortium was created at the beginning of 1989 and a second one in the middle of that year.

3. Evaluation of the Current Banking System in the Soviet Union

We can now ask ourselves what the current banking system in the Soviet Union is like and how it works. And particularly in what direction is it heading.

The answer is clear: it is still a system with considerable dependency on the past, but it is a system which is advancing towards the Western banking model, accepting the majority of its basic operating principles and granting an increasing role to the market and competition.

It must be recognised that the reforms commented on have injected into the Soviet banking system a high dose of autonomy and freedom of activity. Of course it is still a long way from the Western system, but it will be sufficient, if the degree of freedom achieved is assimilated, to produce a gradual liberalising effect on the whole economy. Meanwhile, the reforms are making the system less sluggish and more efficient. And they are introducing incentives to improve products and services.

I believe, however, that the main qualitative change has been to accept the principle that customers can choose the bank they want and that banks can open offices where they want to attract new customers, as well as reject those operations they consider to be of no interest. This means that the managers of Soviet bank branches, on the basis of increasing acceptance of the risk concept, are beginning to assume responsibilities and take initiatives. It is also important to highlight the new role which interest rates are beginning to play. Because even the state banks now have greater freedom to set prices for loans.

All of this has unleashed greater competition and a search for profitability via efficiency.

I would say, in short, that we are witnessing a very important qualitative change in the Soviet banking system: the ending of the state monopoly, and the introduction of competition, are bringing the Soviet system closer to the Western model.

However, we cannot hide the difficulties that this transformation entails, because it requires dramatic changes in behaviour and human attitudes, both in the professional field and in the scale of values of Soviet society, and this is very important. The difficulties of this transition period, particularly in the field of banking, are enormous for the Soviet people, although they are no more than another obstacle, albeit an important one, in a series of obstacles which are making change difficult.

4. Reflections on Savings

I would like now, before ending, to make some remarks on savings in the Soviet Union. We are all aware of the important role played by savings in Western economies. Savings, through the agency of the intermediaries where they are deposited, provide funds which make it possible to increase and technologically improve productivity, thus strengthening future economic growth. We also know that savings are not only the result of a decision not to consume on the part of economic agents, but that they also create and stimulate. And we know that in this creation and stimulation, the financial system plays a fundamental role. Because it is clear that the financial intermediaries operating in modern markets, stimulate savings with a wide range of different and attractive financial assets, and present different combinations of profitability, risk and liquidity, in order to adapt to the different needs of customers.

However, this has not been the case in the Soviet Union where, conceptually, savings have some peculiarities and meet other factors. The main difference is their residual character, because it is the financial plan, as we have seen, which assumes the responsibility of matching, on the one hand, demand and the supply of funds by companies and, on the other hand, matching incomes distributed with the value of consumer goods available. In this situation there should be no room for savings, at least in theory. However, since the plan has consistently failed a chronic shortage of consumer goods has arisen, leading to forced saving by families.

This forced saving has increased considerably in the past few years, because of higher salaries and the failure to produce consumer goods, and faced with unattractive and unsophisticated banking products, families have taken to keeping their money in their own homes. This situation has reached worrying levels. Reliable estimates put the amount of money under Soviet mattresses at 200 billion rubles, which represents one quarter of the GDP. This level of cash in public hands is excessive, particularly when compared to the situation in Spain and Japan (8%), Germany (6%) and France and the United States (just over 4%).

The Soviet authorities are tackling this problem at its two main sources. On the one hand, they are trying to neutralise the destabilising potential of these savings, by absorbing or draining that part of forced savings which is simply the result of the lack of consumer products. It is being done through various measures, such as selling homes, or restructuring companies which formerly produced weapons and are now producing consumer goods.

And it is also being done through the so-called monetisation of the economy, by offering new assets to the public. It seems that the Soviet authorities are increasingly aware of the positive effect of savings, and that accepting and introducing the concepts of profit and interest rates are producing important changes in the volume of savings. At the moment they are studying measures to create and attract savings to the financial circuit in order to make it economically productive. Consideration is being given to providing more attractive interest rates for bank deposits, debt issues by the state and companies, and also share issues. A draft company law on share capital is being discussed which could lay the foundation of a future stock market.

All these ideas, projects and measures show that *perestrojka* has introduced into the Soviet Union, although in a rudimentary way, a new concept of money and savings.

5. Future Prospects

I will end my contribution with some reflections on the role which the Soviet banking and financial system could play in the future in the framework of *perestrojka*. As I said at the beginning, the potential for development of the Soviet economy will increase considerably if the banking system can become the advance guard, the launch pad for transforming the economy. And it does not seem very certain, at least at the moment, that this is going to happen.

Of course there is no doubt in the Soviet Union that the idea is gaining force that the restructuring of the economy should be speeded up. And nor is there any doubt that the idea of the market is constantly being given priority in the measures and official interventions.

Meanwhile, the measures taken to reform the banking system guarantee, apparently, the creation of an efficient and competitive banking market. I say apparently, and before I said that I am not very sure that the banking system is really going to be the launch pad for developing the Soviet economy, because, despite declarations, some observers believe that the reforms undertaken are more on paper than in practice, and because we cannot forget that a large part of the Soviet apparatus of power, and the population, openly distrusts the market and its capacity to direct economic development. From a financial standpoint, one can harbour fears that the more there is a confused idea on how the market works in general throughout wide sectors of Soviet power, the less categorical and positive will be the conviction of the need to create a really free and competitive banking market, in which interest rates without limits will come into play, with all that this entails in image and reality, thinking that the financial aspect is precisely the most visible, the maximum expression of the market economy. And this regardless of the fact that for many years financial matters have been considered as something absolutely marginal, and outside the field of ideology.

However, the Soviet authorities are mistaken if they leave to one side financial reform and concentrate on reforms in the productive economy, or if they give it marginal importance, because the financial system can, and must be, one of the motors for restructuring the economy. Personally I believe that it will be difficult for *perestrojka* to be successful without a modern and competitive financial system which works on the principle of being an efficient channel for distributing funds, and optimising investment.

Gorbačev seems to have understood this, by making greater reform of the banking and financial system one of his priorities. This will be done with a new banking law which replaces the current government decrees. It is hoped that it will lay the groundwork for a new banking and financial system, which gradually progresses towards creating a really competitive and liberalised market. However, these are all hopes which could find, and are finding, many difficulties. Because in order to reach them very ambitious goals have to be met. For example it will be necessary, as the degree of financial autonomy of companies increases, for state banks to gradually lose their role as agents of the Plan.

It will be necessary to accept interest rates as the instrument for balancing supply and demand, and as a way to efficiently assign funds. And this means a substantial reform of the system of prices.

It will also be necessary to establish measures aimed at giving confidence to depositors and ensuring them that their funds are safe and can be recovered, in the face of discretionary actions by the administration.

And it will be necessary to introduce competition and end the situation of monopoly in foreign banking operations, currently held by the Bank of Foreign Business.

If the Soviet authorities decide to use this banking law to resolve all these problems, they will have taken a gigantic step in the direction of creating a modern and efficient financial system, which will be, without a doubt, the motor of *perestrojka*, of this restructuring and renovation of the economic and social framework of the Soviet Union. It would also be a catalyst for business enterprise which seems to have already begun judging by the success of cooperatives and the boom in joint ventures.

And talking of business enterprise I will end by saying that one of the main problems facing the modernisation of the Soviet financial system lies, precisely, in the lack of teams, of businessmen, of bankers, of entrepreneurs and efficient managers, and in the lack of familiarity with the Western techniques and modern communication technologies. Overcoming these shortages will depend to a large degree on the collaboration of Western countries. Indeed they are already doing it through joint banking consortiums recently set up and through initiatives such as Mirbis, a joint venture with 51% owned by the Soviet government and 49% by Italian companies, which in the Plekhanov Institute has opened a business school to retrain according to the principles of the market economy the chairmen of large companies and senior officials of the economy ministries.

On March 15, as the new President of the Soviet Union Gorbačev took up his post, he gave an important speech to the Soviet Parliament. Starting from the point that the main conquests of *perestrojka* are democracy and glasnost, he did not hide the enormous and increasing sacrifices, and difficulties, which are needed to achieve this. He referred to the lack of training and the lack of adequate public awareness to carry out the reforms, as well as the "slowness" and "delays" in adopting some of the measures of what he called the "preparatory" stage. It was a speech in which he placed great emphasis on stating that what the Soviet Union needed now was action to resolve the radicalisation of economic reform. Of the reform he said that "one cannot run a new system of setting prices, a new financial control and a credit policy without establishing interest rates in line with the real economy".

The task in the Soviet Union is not easy. It seems almost impossible. But we never know what is really impossible until we try to do it. And there is no doubt that the Gorbačev team is trying to do it using every means available. The Western banking world is following the process closely, and studying the possibilities for collaboration, but it is doing so with great prudence, because the risks and dangers involved are large, as Professor Šmelev, one of the main people behind *perestrojka*, has said.