

### Box I Turbulence in the Russian banking sector

In 1998 the Russian economy was hit by a severe financial crisis which had strong repercussions on world financial markets. There was a sharp decline in asset prices and a drying up of liquidity in a number of markets, which triggered a widespread policy response. Since then, Russia has seen an unprecedented period of economic growth and monetary stabilisation. These developments spurred rapid growth in the Russian banking sector after 1999. In October 2003 Moody's granted Russia its lowest investment grade status. As a result, Russian borrowers regained access to international capital markets, bond issuance doubled in 2003 when spreads on Russian securities reached record lows, and claims of BIS reporting euro area banks on Russian borrowers rose substantially (see Table S4). This Box describes the events that triggered the recent spate of turbulence in the Russian banking sector.

Although the Russian banking sector grew significantly after 1999, many institutions remained small and undercapitalised. They also continued to be dominated by poor governance structures that were lacking in transparency, with many institutions mainly serving as the financial arm and treasury departments of their owners. Thus, while bank lending to the private sector expanded, low levels of interbank lending persisted, indicating a still substantial lack of trust among financial institutions.

In the early summer of 2004, a crisis of confidence struck the private domestic banking sector, reflecting the structural weaknesses that had persisted since the 1998 crisis. It was triggered by the Bank of Russia's decision to withdraw the license of a medium-sized bank on charges of money laundering in mid-May. As rumours spread about the possibility that the licenses of other banks could be withdrawn, tensions spread into the interbank market. Overnight interest rates rose considerably, and for a few weeks there was basically no activity in the market. Instead, lending took place almost solely on a bilateral basis.

The turbulence reached the deposit market in early July, when Gута Bank, the 22nd largest bank in the country, was struggling to meet payments to customers. As a result, depositors began to abandon the private Russian banks, turning instead to the Bank of Russia-owned Sberbank and to the state-owned Vneshtorgbank as well as shifting to cash holdings.

The Bank of Russia responded by reducing mandatory reserve requirements from 7% to 3.5% in order to boost banks' liquidity. It also provided a loan to finance the acquisition of Gута Bank by Vneshtorgbank. In addition, Sberbank was requested to stand ready to grant short-term loans in the interbank market. Russia's parliament, the Duma, extended deposit insurance for all deposits up to RUB 100,000 (approximately EUR 2,850) in banks that had either failed or had declared insolvency since December 2003.

The Bank of Russia's measures effectively put an end to the bank run, and had a positive effect on conditions in the interbank market. Overnight interest rates declined to pre-crisis levels. In the medium to long-term, authorities face the challenge of rebuilding the trust of Russian citizens in private domestic banks while, at the same time, proceeding with policies aiming at sectoral restructuring and consolidation.