

V. The Russian Government Exercises Extensive Control Over the Allocation of Resources and Over the Pricing and Output Decisions of Key Enterprises

A. Summary of Comment

The Russian Government remains heavily involved in pricing and allocation decisions, as illustrated starkly by its finely calibrated controls over the distribution of natural gas to end-users. Moreover, the growth of new business, as well as the reallocation of labor and other resources among existing enterprises, has been stifled by the continuation of Soviet-era corporate structures. Finally, the lack of structural reform in the banking sector and involvement of the central bank in commercial banking activities allows the government to distort the allocation of credit.

B. The Department's Standard

Section 771(18)(B)(v) of the Act directs the Department to consider “the extent of government control over the allocation of resources and over the price and output decisions of enterprises.” In applying this criterion in previous cases, the Department has examined such factors as:

- the number of goods and services subject to price controls;
- whether the central bank is independent of the government, and progress in banking reform;
- evidence of the growth in new businesses;
- the development of bankruptcy laws and the exit from the market of insolvent enterprises;
- whether interest rates are set by commercial banks and whether the government is still the primary allocator of capital.

The Department has not required for market economy status the complete absence of government control over prices. In those countries that have been granted market economy status, however, price controls remained on only a very limited number of goods and services, such as public transportation, residential utilities, and postage rates.¹ In some countries, such as

¹ See Czech NME Memo at 12; Hungary NME Memo at 14; Latvia NME Memo at 15; Poland NME Memo at 23; and Slovak NME Memo at 12.

the Czech and Slovak Republics, controls were being gradually phased out over time,² or prices rose as the government sought to reduce consumer subsidies, as in Poland.³ All other prices were set by the market. The central banks of each of the transitioned countries operated independently of the government, generally adhered to tight monetary policies in order to control inflation, and did not have any interest in commercial banks.⁴ Interest rates were set by commercial banks, and banking sector reforms were instituted that, among other things, established commercial banks as the principal allocators of capital, especially as equity and bond markets had been slower to develop.⁵

Finally, the Department has adduced as evidence of market allocation of resources the growth in the number of privately-owned companies, the continuing development and application of bankruptcy laws and the concomitant exit of insolvent enterprises, and the shift of workers from less viable to growing sectors of the economy. For example, in Hungary the number of incorporated and unincorporated businesses grew from 260,000 in 1989 to 863,000 in 1994, and businesses with over 300 employees accounted for just 1 percent of total employment in 1993, compared to 19 percent in 1989.⁶ In Latvia, employment in a number of industry sectors was shrinking in response to increased international competition, while employment in more viable sectors, such as wood processing and services, was increasing.⁷ These signs of successful transition cannot yet be discerned in the Russian economy.

C. The Russian Government Continues to Control Pricing and Allocation of Resources

² See Czech NME Memo at 12; Slovak NME Memo at 12.

³ See Poland Memo at 23.

⁴ See Czech NME Memo at 14; Hungary NME Memo at 15; Latvia NME Memo at 17; and Slovak NME Memo at 13.

⁵ See Czech Memo at 14 and Slovak NME Memo at 13.

⁶ See Hungary NME Memo at 14.

⁷ See Latvia NME Memo at 17-18.

a. The Russian Government Maintains Tight Controls on the Pricing and Allocation of Natural Gas

The Russian Government uses its control of the key natural resource and infrastructure monopolies to funnel massive indirect subsidies to much of the economy via producer prices that are lower – indeed much lower – than would prevail if determined by the market. The Ad Hoc Committee is particularly concerned with the role of Gazprom in the Russian economy, as the law directs it, *inter alia*, to supply natural gas in particular quantities at extremely low prices to specifically enumerated producers and exporters of nitrogen fertilizer. The Ad Hoc Committee respectfully submits that the Department should carefully evaluate the extent of Russian Government intervention in the pricing and allocation of natural gas, as Gazprom “is a microcosm of the whole reform process in Russia.”⁸

The Russian Government itself has declared that “domestic gas prices are regulated by the State.”⁹ Consistent with this declaration, and consistent with its policy of using natural gas supply and pricing to subsidize and to control production in a variety of industrial sectors, the Russian Government has issued a series of laws and decrees specifically directing pricing and supply of natural gas within the Russian economy. For example, Order #12/1 of the Federal Energy Commission of March 24, 1999 (amended June 4, 1999) requires a 50 percent price reduction – from prices that are already artificially low – for sales of specified volumes of natural gas to producers of fertilizer and certain related products. Specifically, Order #12/1, paragraph 1, provides as follows:

The prices for the natural gas delivered to enterprises which produce chemicals and the corresponding raw materials shall be reduced by 50 percent of the state-regulated wholesale prices, as ordered by Decree #256 of the Government of the

⁸ S. Fleming, “But the Bad Old Ways Are Still Typified by Giant Gazprom,” Ex. 2.

⁹ World Trade Organization, Accession of the Russian Federation, Information on State-Trading Enterprises of the Russian Federation, WT/ACC/RUS/18 (March 11, 1997), at 4, attached at Exhibit 3.

Russian Federation of March 4, 1999, and such reduction shall be applied to volumes set forth in Schedule 1 hereto.¹⁰

Notably, Order #12/1 establishes not only the low prices at which Gazprom must sell to certain industrial purchasers, but also the quantities to which the low prices apply. The Ad Hoc Committee believes that these “quotas” establish minimum required supply levels. Also, the order identifies the specific producers that are entitled to benefit from the low prices. The list is long, and includes companies that factor prominently in Russia’s export-oriented fertilizer industry. For example, OAO Nevinnomysskii Azot the largest producer of UAN solutions in Russia, is directed to receive 280.82 million cubic meters of natural gas at the artificially low price decreed by Order #12/1.¹¹

The prices at which Gazprom is required to sell in the Russian market are, by some estimates, less than one-tenth of the market rates at which the company sells in export markets. According to Yelena Karpel, head of Gazprom’s pricing department, “{i}t’s only because of exports and credits that we can keep going,” and “{t}here is no link between domestic and export prices.”¹² Or, put another way, “{t}he government makes Gazprom sell gas at artificially low prices to industrial customers, a practice that perpetuates the inefficiency that plagues Russia.”¹³ Moreover, in another recent state-directed boon to the fertilizer industry, the Russian Government recently banned gas price increases for the rest of 2001.¹⁴

The Russian Government’s continued control of gas pricing and allocation is compelling evidence of the persistence of Soviet-style centralized control, and distinguishes Russia from the

¹⁰ Order #12/1 is attached at Exhibit 4. Decree #256 of the Government of the Russian Federation, referenced in Order #12/1, is entitled “On Measures to Accelerate the Supply of Agriculture Producers with Chemical Products in 1999.”

¹¹ See “Russian Nitrogen & Summary of Fertilizer Industry Performance,” Azotecon Ltd. (Aug. 9, 2001), at 26, describing this producer, attached at Exhibit 5.

¹² “Russian Gas Monopoly Raising Prices,” *AP Online* (June 6, 2001), attached at Exhibit 6.

¹³ “Give Gazprom a Fresh Start, President Putin,” *Business Week International Editions* (June 4, 2001), at 21, attached at Exhibit 7.

countries previously examined by the Department. In the case of Poland, for example, the Department noted that, even though gas prices were regulated, the Government of Poland allowed them to rise dramatically pursuant to market pressures, and thereby to reduce energy subsidies.¹⁵ Similarly, the Department noted in its Slovakia analysis that remaining price controls on energy were “being gradually phased out over time.”¹⁶ There is no evidence of such a commitment in Russia and, indeed, pervasive regulation of the domestic natural gas sector continues today.

b. Soviet-Era Constraints Impede the Growth of New Businesses in Russia

Russia has lagged far behind successful transition countries in spurring new business growth through market reforms. According to the U.S. Commercial Service, Russia has only five to seven small businesses for every 1,000 people, as opposed to forty-five to fifty in developed countries.¹⁷ Russian small- and medium-sized businesses employ only about 13 percent of the Russian labor force, and account for roughly 12 percent of GDP; however, “in comparison with other transition countries, the growth of small and medium-sized enterprises in Russia has been exceptionally slow.”¹⁸ For example, 37 percent of the Czech labor force is currently employed by small- and medium-sized businesses in that country – more than three times the current level in Russia.¹⁹

The rate of growth of new business in Russia contrasts sharply with rates observed in the successful transition countries. In Hungary, the Department found that “{b}oth market entry and

¹⁴ See FSU Update, FERTECON (Oct. 4, 2001), at 1, attached at Exhibit 8.

¹⁵ See Poland NME Memo at 23.

¹⁶ See Slovakia NME Memo at 12.

¹⁷ DOC Guide, Ch. 2, at 13.

¹⁸ H. Broadman, “Competition and Business Entry in Russia,” in Finance & Development (IMF, June 2001), at 5, available at www.imf.org/external/pubs/ft/.

¹⁹ Id.

exit (and the resource allocations that go with it) have occurred on a large scale.”²⁰ Similarly, in Latvia “{t}he highly decentralized, market-based nature of the ongoing reallocation of resources can be seen in the large increase in the number of small- and medium-sized enterprises . . . SMEs now account for 95 percent of active enterprises in Latvia.”²¹ The dynamics observed by the Department in the Czech Republic and in Slovakia were comparable.²²

As mentioned above, the impediments to the growth of new businesses in Russia are attributable at least in part to the nature of Russia’s privatization process, *i.e.*, ownership of those enterprises that have been privatized has, in many instances, simply passed to the existing management and employees of those enterprises. Moreover, according to economist Harry Broadman of the World Bank, “the industrial configuration determined by administrative fiat and central planning during the Soviet era has yet to give way to a regime of enterprise structure, conduct and performance engendered by competitive market forces.”²³ Broadman identified several elements responsible for this rigidity, each a Soviet legacy and each a deterrent to new entrants into the economy: (1) horizontal dominance of large firms;²⁴ (2) extensive vertical integration, or exclusive buyer-seller relationship;²⁵ (3) and regional market segmentation.²⁶

²⁰ Hungary NME Memo at 14.

²¹ Latvia NME Memo at 18.

²² See Czech NME Memo at 13; Slovak NME Memo at 12.

²³ H. Broadman, “Reducing Structural Dominance and Entry Barriers in Russian Industry,” Policy Research Working Paper, The World Bank Group, May 2000, at 1, available at www.worldbank.org/html/extdr/regions.htm.

²⁴ *Id.* at 2-3. Broadman explains that many industrial products (*e.g.*, trolley buses, potato-harvesters, motor scooters, and coal-cutting and tunneling machines) are produced only by a single firm for the entire country. Moreover, horizontal integration is increasing through mergers and acquisitions, as in the aluminum and oil industries. *Id.*

²⁵ *Id.* at 3. According to Broadman, the high degree of vertical integration observed in Russia “largely reflects inertia of the uncertainties and chronic shortages of the old Soviet supply system.” *Id.* Broadman contends that in Russia, given the “hazard of market transactions” and the difficulties in enforcing commercial contracts, there remain strong incentives for vertical integration. *Id.*

²⁶ *Id.* at 3-4. Regional market segmentation is a function of the substantial economic power wielded by regional authorities. According to Broadman, some regional governments have used this power to advance the interests of firms within their boundaries by, for example, imposing tariffs on the import and export of agricultural products or imposing duties on the importation of certain products from other regions. *Id.* Broadman also cites instances of regional governments using their regulatory authority to engage in anti-competitive practices, including the maintenance of Soviet-era monopolies through refusal to grant licenses to putative new entrants. *Id.* at 4.

In the same study, Broadman outlined the barriers to participation in the Russian economy confronting new entrants. According to Broadman, the principal source of expansion of the Russian private sector has not been the creation of new businesses, but the privatization of state-owned ones: “The creation of private *de novo* businesses in Russia is exceptionally weak and continues to lag far behind the pace of other transition economies, especially in Eastern Europe and the {FSU}.”²⁷ The barriers to new entrants include institutional and administrative barriers, in many cases under color of state authority. One example is capricious use by authorities of business registration and licensing requirements, which is often connected to corrupt practices.²⁸ According to Broadman, “virtually all firms pay bribes to tax inspectors, customs officers and a host of local bureaucrats.”²⁹ Another example is the continuing state ownership of warehousing and distribution networks.³⁰ Also, given the failure of the Russian Duma to enact comprehensive legislation governing land reform, there is considerable trade-chilling uncertainty in this respect as well.³¹

Another recent study found that Russia’s privatization campaign has not, compared to other transition economies of the FSU and Eastern Europe, resulted in “major competitive restructuring of incumbent enterprises.”³² Had Russia followed the same path as the successful reformers, there would have been a reallocation of labor from less efficient to more efficient sectors of the economy, with a resulting increase in economic output. Instead, such reallocation

²⁷ *Id.* at 4.

²⁸ *Id.* at 5-6.

²⁹ *Id.* at 6.

³⁰ *Id.* at 6.

³¹ *Id.* at 7.

³² H. Broadman and F. Recanatini, “Is Russia Restructuring? New Evidence on Job Creation and Destruction,” The World Bank, Europe and Central Asia Region, Poverty Reduction and Economic Management Sector Unit (July 2001), at 2, available at www.worldbank.org/html/extdr/regions.htm.

is slow to occur, due in large part to “a still-widespread ‘socialist’ corporate culture,” and economic output has declined.³³

The Russian economy today stands in especially sharp contrast to the economies of the other transition countries examined by the Department. In the case of Poland, for example, the Department noted approvingly that “resources are flowing away from the inefficient government-owned industrial sector to the private sector.”³⁴ In its analysis of Latvia, the Department observed that, upon collapse of Soviet domination, “there was no concerted, system-wide attempt to preserve or otherwise reconstitute the central economic planning apparatus that existed in the Soviet era.”³⁵ There followed, as noted above, a rapid reallocation of resources to more efficient uses.³⁶ But for the reasons outlined above, such reallocation of resources – a hallmark of an emerging market economy – has not occurred in Russia.

c. Russia Has Failed To Undertake Critically-Needed Banking Reform

The list of problems that plague the Russian banking sector is daunting, starting with a central bank that has the power to regulate but declines to do so. According to one account, the head of the CBR, Viktor Gerashchenko, has done virtually nothing to reform the sector during his tenure because the bank benefits from the status quo through its stakes in 23 commercial banks in Russia and abroad.³⁷ One-third of registered banks is state-owned, accounting for two-thirds of charter capital. The banks themselves resist reform for a variety of reasons, including the desire to maintain special privileges such as preferential funding sources, capital injections,

³³ *Id.* at 28.

³⁴ *See* Poland NME Memo at 26.

³⁵ *See* Latvia NME Memo at 14.

³⁶ *Id.* at 17.

³⁷ Catherine Belton, “Commentary: Don’t Bank on Russian Bank Reform,” *BusinessWeek/online* (July 2, 2001), available at <http://www.businessweek.com>. *See also* DOC Guide at Ch. 7, “Efficient Capital Markets and Portfolio Investment.”

and implicit state guarantees, as well as the desire to hide their true financial performance in order to avoid taxes.³⁸ Indeed, the Department itself found very recently that

{t}he banking sector remains one of the weakest legs in the Russia reform program, with little progress on systemic restructuring since the 1998 financial crisis. A fundamental lack of trust pervades the system: depositors do not trust banks, banks do not trust borrowers or each other, and no one trusts the Central Bank of Russia to provide effective, impartial bank regulation.³⁹

Other problems include a system that primarily serves state agencies and the conglomerates of the “oligarchs;” the profound lack of trust in the banking system, so that deposits equal only 6 percent of GDP and people keep their savings – an estimated \$40 billion – in cash at home; and the distorting effects of Sberbank’s primacy in retail banking.⁴⁰ The position of Sberbank provides a snapshot of many of the sector’s problems. The CBR owns a majority of Sberbank, which has over 23,000 branches throughout the country. Sberbank holds over 75 percent of all household savings deposits and accounts for over 25 percent of commercial lending.⁴¹ Its monopoly position is buttressed by the facts that it is the only bank in which deposits are insured by the government and it makes loans at below-inflation rates.⁴² The IMF, World Bank and EBRD have all expressed concern about Sberbank’s position in the economy and its lack of transparency, but the government has not shown any inclination to alter the situation.⁴³

³⁸ See EBRD Profile at 40; “Table: Why Russia’s Bankers Don’t Change Their Ways,” BusinessWeek/online (July 2, 2001), available at <http://www.businessweek.com>.

³⁹ DOC Guide at Ch. 7, “Efficient Capital Markets and Portfolio Investment.”

⁴⁰ See Belton, “Commentary: Don’t Bank of Russian Bank Reform.”

⁴¹ See EBRD Profile at 40 (stating that Sberbank held 76 percent of household deposits as of Oct. 1, 2000 and accounted for 30.4 percent of bank credit); Nations in Transit at 328 (stating that Sberbank held 90 percent of household deposits and accounted for 25 percent of commercial lending).

⁴² See Nations in Transit at 328; Belton, “Commentary: Don’t Bank on Russian Bank Reform.”

⁴³ See EBRD Investment Profile at 40; see also Alla Startseva, “Bank Reform Sparks War of Words,” *Moscow Times* (Sept. 20, 2001), available at <http://www.TheMoscowTimes.com> (reporting that the CBR’s proposed reform program envisions little change in the dominance of state-owned banks and in the state retaining its ownership shares in banks considered strategically important, as well as ruling out any restructuring of Sberbank.).

Rather than reducing its involvement in the banking sector, in fact, the government has increased its presence. It recently established a large new state bank, the Russian Development Bank, which will make loans to industry. In addition, it plans to establish the Russian Agricultural Bank to supply credit to the agricultural sector.⁴⁴ Compared to the successful transition countries, Russia has made virtually none of the reforms in the banking sector necessary to reduce government intervention and place it on a sound, market-oriented footing. Russia in fact appears to be moving in the opposite direction of at least some of the countries previously examined by the Department. For example, in Hungary the Department found that the “privately owned banking sector, not the government, is the primary allocator of capital.”⁴⁵ In Latvia, the Department found that the the banking sector “stands on its own.”⁴⁶

As the discussion above amply illustrates, the Russian Government is still heavily involved in determining prices and the allocation of resources in the economy. Far from taking a declining role, the government has expanded its intervention in key sectors. Consistent with the approach taken in its other analyses of economies in transition, the Department should conclude that the Russian Government’s persistent – and by some measures increasing – control over the allocation of resources in the Russian economy is inconsistent with the role of government in a market economy.

⁴⁴ See id.

⁴⁵ See Hungary NME Memo at 16.

⁴⁶ See Latvia NME Memo at 16.