

# **EXHIBIT 1**

*Report to the President*

# GLOBAL STEEL TRADE

**Structural Problems and Future Solutions**



**July 2000**  
**International Trade Administration**  
**U.S. Department of Commerce**

## 3.1 The Challenge of Integrating Russia Into the Global Steel Market

### Introduction

The Russian steel industry has long operated in a surreal economic environment in which cash was not always necessary, inputs were cheaply provided, taxes and supplier bills went unpaid and few companies were closed due to bankruptcy. In his 1999 State of the Federation address to the Russian Parliament, President Yeltsin described the state of the general economy in which the Russian steel industry operated:

We are stuck halfway between a planned, command economy and a normal, market one. And now we have an ugly model—a cross breed of the two systems.<sup>1</sup>

The Russian steel industry is caught between two systems. It was created and nurtured in one system for sixty years. It has been adapting to another system for the last ten. The industry's relationship with the government, its way of doing business, its current competitive position, and the measures it has taken to adjust to the new system are still very much reflective of its past.

The surge in Russian steel to the United States in 1998 was the culmination of several factors:

- Russia's inheritance of an immense steelmaking capacity.
- A steep decline in Russian domestic demand for steel.
- The production and sale of steel absent hard budget constraints (*e.g.*, the timely cash payment of taxes, wages, and supplier bills).
- The emergence of Russia as one of the world's biggest steel exporters.
- The diversion of Russian steel exports from Asia to the United States following the Asian financial crisis.

The diversion of Russian steel exports after the Asian financial crisis was an important reason for increased Russian exports to the United States. However, understanding what led to Russia's emergence in the course of the 1990s as one of the world's leading steel exporters requires a deeper look at the market-distorting factors at play in the Russian economy.

When domestic consumption of steel dropped, the larger Russian steel producers turned to the export market. While exports often provided the minimum amount of cash needed to operate in the Russian economy, the steel companies were able to otherwise muddle through turbulent times without real restructuring by means of:

- Cheap inputs supplied by government-controlled or subsidized suppliers.
- The pervasive acceptance of bartering.
- Widespread "nonpayment" of suppliers, taxes and workers.
- The absence of any real threat of bankruptcy.

Because of these factors, the prices accepted by Russian steel companies were not necessarily related to their true cost of production. The Russian steel industry's lack of marketing skills and heavy dependence on international trading companies compounded the problem. As the 1990s wore on, the massive volume of Russian steel exports coming on to the global steel market at soft prices—reflecting the lack of hard budget constraints in the domestic market—led to growing instability.

When the Asian economic crisis sapped the demand of the Russian steel industry's major customers, large trade flows of steel had to be diverted elsewhere. With the closure of other export outlets through trade actions of one sort or another, Russian steel companies began selling low-priced steel to the only remaining major open market—the United States. The redirection of sales to different markets in the face of demand shifts is a normal business practice in a global marketplace. The international trade frictions resulting from Russian exports were aggravated, however, by the market-distorting practices under which steel was produced and sold in Russia.

Since 1998, the Russian economy, and the prospects for the Russian steel industry, have greatly improved. The post-1998 economic environment in which the Russian steel industry has more recently been operating is discussed in greater detail in Chapter 5.

### The Breakup of the Soviet Union and the Fall in Domestic Steel Demand

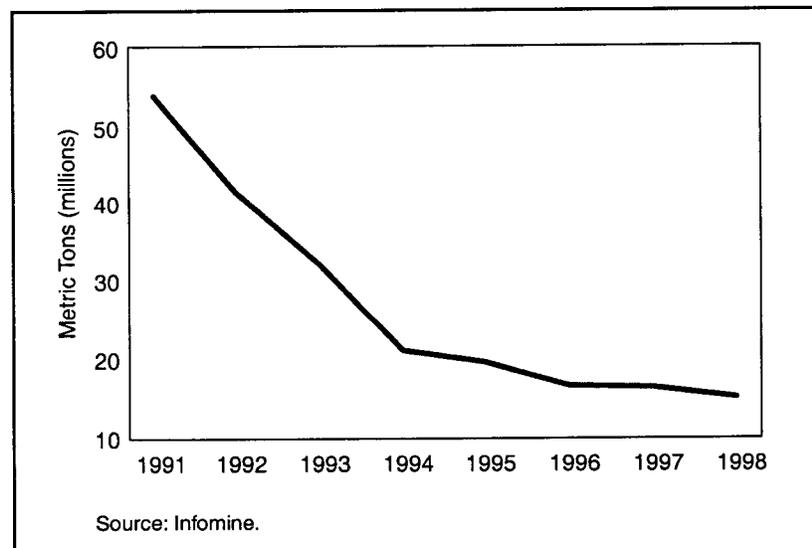
Prior to the breakup of the Soviet Union, Russian domestic consumption of steel was among the highest in the world. Per capita consumption in 1990 was 565 kilograms, on par with the European Union (EU) and North America and nearly three times the world average.<sup>2</sup> During this time, Russia was a net importer of steel, taking in almost 12 million metric tons (MT).<sup>3</sup>

#### The Decline in Domestic Demand

Starting with the dissolution of the Soviet Union in 1991, Russian domestic demand for finished steel plummeted. By 1998, domestic consumption had fallen more than 70 percent from its peak reached nearly a decade earlier (*Chart 3-1*).

The primary reasons for the precipitous decline in Russian steel demand:

- A drop in defense spending.
- The breakdown in the links of the centrally planned production chain and the Soviet bloc trading system.<sup>4</sup>
- The general contraction in the Russian economy.
- The shift in the nature of the Russian economy away from manufacturing and toward services.



3-1. Russian Domestic Consumption of Rolled Steel

**Military Demand for Steel.** The general decline in domestic demand for steel began with declining orders from the defense industry. During the Cold War, the Soviet emphasis on military strength ensured that there was a significant and consistent demand for steel. It is estimated that the defense industry consumed 25–30 percent of all rolled steel produced in the Soviet Union.<sup>5</sup> With the end of the Cold War and government budget shortfalls that began in the early 1990s, military consumption fell dramatically. U.S. intelligence sources estimate that by 1996, defense spending in Russia had dropped by 83 percent from peak Soviet levels in the late 1980s.<sup>6</sup>

The precise degree to which the direct subsidization of the coal industry results in cheaper prices for steel producers located throughout Russia, however, is difficult to calculate. One estimate is that recent prices for coal reflect a 10 percent subsidy (down from 45 percent in the early 1990s).<sup>72</sup> It was also reported in 1997 that Russian steel producers negotiate a price with government-owned coal companies that is close to a market price and pay 80 percent of that price; the “other 20 percent is paid for by the government.”<sup>73</sup>

### **Barter Economics**

The Organization for Economic and Cooperation and Development has commented that the pricing of Russian and Ukrainian steel exports was often “uneconomic” due to, among other things, the use of barter and the orientation toward production rather than profits.<sup>74</sup> Many steel companies lost money on exports (prior to the depreciation of the ruble). According to one investment firm in 1998, “Exports are unprofitable, but they remain the main source of cash for most Russian steel plants.”<sup>75</sup> Yet the companies continued to export because of market distortions, such as the pervasive use of a complex system of cashless transactions and nonpayments of debts that two specialists on the subject, Clifford Gaddy and Barry Ickes, describe as Russia’s “virtual economy.”<sup>76</sup>

Barter in Russia has a long history; with origins in the pre-revolutionary period. It was also widely used during the Soviet era to cope with the inefficiencies of central planning. In fact, the closed-circuit barter chains employed in Russia and the ones used by Soviet managers to trade with one another for goods not provided in their planning allocation are very similar.<sup>77</sup>

Barter is inherently inefficient because it raises transaction costs and leads to the masking of the true value of output, which tends to be substantially below what barter prices indicate.<sup>78</sup> Gaddy and Ickes quantify the price distortion based on the type of transaction: barter (goods-for-goods) prices may be overstated by a factor of two or three, while the price of goods paid via promissory notes (or *veksels*) may be inflated by a factor of five.<sup>79</sup>

A Russian commission was created to analyze the problem and made the following conclusion in 1998.

An economy is emerging where prices are charged which no one pays in cash; where no one pays anything on time; where huge mutual debts are created that also can't be paid off in reasonable periods of time; where wages are declared and not paid; and so on. ...[This creates] illusory, or “virtual” earnings, which in turn lead to unpaid, or “virtual” fiscal obligations, [with business conducted at] nonmarket, or “virtual” prices.<sup>80</sup>

Barter was widely used in the Russian economy as a means of payment (*see box, next page*).<sup>81</sup> Numerous reasons have been given for this. Hyperinflation in 1992–1994 wiped out the working capital of companies. Tight monetary policy implemented by the Russian government led to a significant contraction in the availability of credit to the enterprise sector. The result was that most Russian firms were effectively cut off from access to working capital finance. Barter transactions as a percentage of industrial sales rose from less than 10 percent in 1992 to nearly 50 percent at the end of 1997 (*Chart 3-7*).<sup>82</sup>

**Government Tolerance.** While these liquidity problems may have encouraged barter, its continued use could not have been maintained without the government’s tolerance for barter for taxes and inputs (such as natural gas, coal, electricity, and transportation services).<sup>83</sup>

The government’s willingness to sanction barter largely explains the dramatic increase in its use and the ability of so many unproductive enterprises to stay in operation.<sup>84</sup> To understand this willingness, it is important to examine the difficult position that both the federal and regional governments face in Russia.

potentially more distorting than other government assistance subsidies such as loan guarantees and tax benefits.<sup>90</sup> Preferential barter deals that created an unlevel playing field have been one of the most significant inhibitors to restructuring in the Russian steel industry. The McKinsey study of the Russian economy concluded:

Many of the [small] and a few of the [medium-sized steel] plants are not viable and can not operate without outside help. This support is provided in the form of an implicit government subsidy delivered via barter deals with suppliers and customers who are forced by the local government to deal with the plant. For example, [the] local government can provide cheap gas because it controls local gas distributors. It can also initiate local projects (e.g., a medium size Russian city is now building a metro) where participants receive steel from the local plant in exchange for tax waivers.<sup>91</sup>

The use of barter transactions kept dozens of Russian steel producers operating despite their noncompetitive and unviable positions. In a normal market economy, these companies would go out of business and viable, healthy companies (generally, the larger ones) would be able to expand production and gain market share. This, in turn, would increase efficiency throughout the industrial sector and move the economy back toward cash. Experts agree that in order to reduce barter the government needs to promote real competition.<sup>92</sup> Rather than encouraging companies to become more competitive in the marketplace, the government has tolerated barter, which hinders healthy competition and delays the need for restructuring. Gaddy and Ickes write:

The [virtual economy] has a number of significant negative consequences. ...The effect on enterprise restructuring is the most obvious. Even those admittedly few enterprises that probably could restructure and become viable in the marketplace have not done so because it would be costly and because they can muddle along as they are.<sup>93</sup>

***Barter's Role in Encouraging Exports.*** Because the large and more competitive Russian firms cannot compete for a greater share of their own domestic market, they must turn (in part) to export markets to sell their products. Moreover, to the extent that domestic steel purchasers could not pay in cash, the only source of cash for larger steel producers was export markets. Because all companies must have a minimum level of cash to cover certain costs (e.g., wages and, to a certain extent, taxes), producers ended up exporting for cash, and the price they obtained for their steel was not necessarily a primary concern. As Gaddy and Ickes state, "In fact, many Russian exports lose money. But for participants in the virtual economy, the goal of exporting is not profit, but cash. The losses they incur are considered a necessary cost of staying in business."<sup>94</sup>

### **Nonpayment of Utility Bills, Taxes, and Wages**

Russian steel companies also kept operations going by not paying their bills. Suppliers and taxes were routinely not paid or paid late. Companies in really bad shape also chose not to pay their workers.

This practice has its roots in the price deregulation and tight money supply policies of the early 1990s. These policies were expected to drive the least viable companies out of business. Instead, companies began to issue each other credits and accumulated ever increasing amounts of debts. As one commentator put it, "they just agreed not to pay each other's bills."<sup>95</sup> The problem was endemic to the economy:

- Late payments to suppliers in four key sectors of the economy rose from 553 billion rubles in January 1997 to more than 780 billion rubles by the end of the year.<sup>96</sup>
- Tax arrears represented almost 5 percent of the GDP.<sup>97</sup> In absolute terms, arrears to the federal budget at the end of 1997 were more than 100 trillion rubles.<sup>98</sup> Other arrears to the federal government (e.g.,

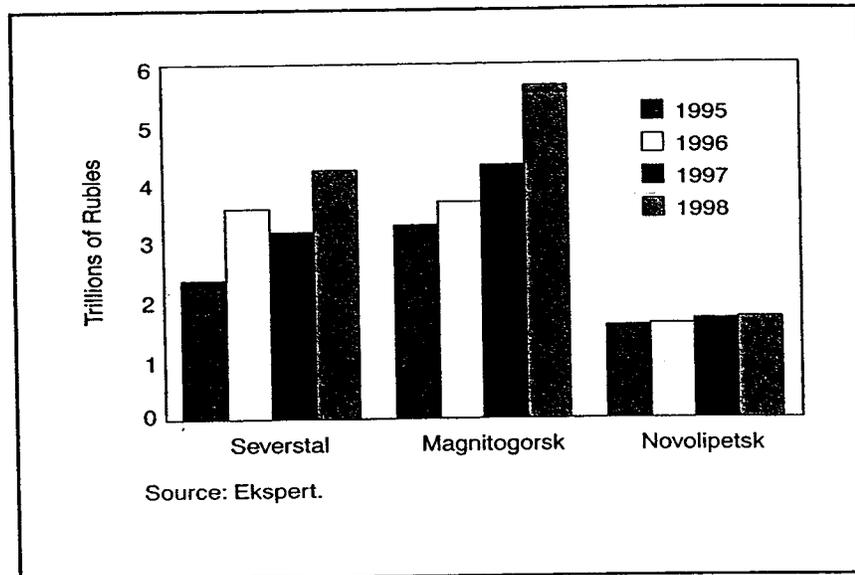
pension payments) reached almost 200 trillion rubles.<sup>99</sup>

- Wage arrears were also staggering. At the end of 1997, economywide wage arrears amounted to 50 trillion rubles, only 10 percent of which was due to government wage arrears.<sup>100</sup>

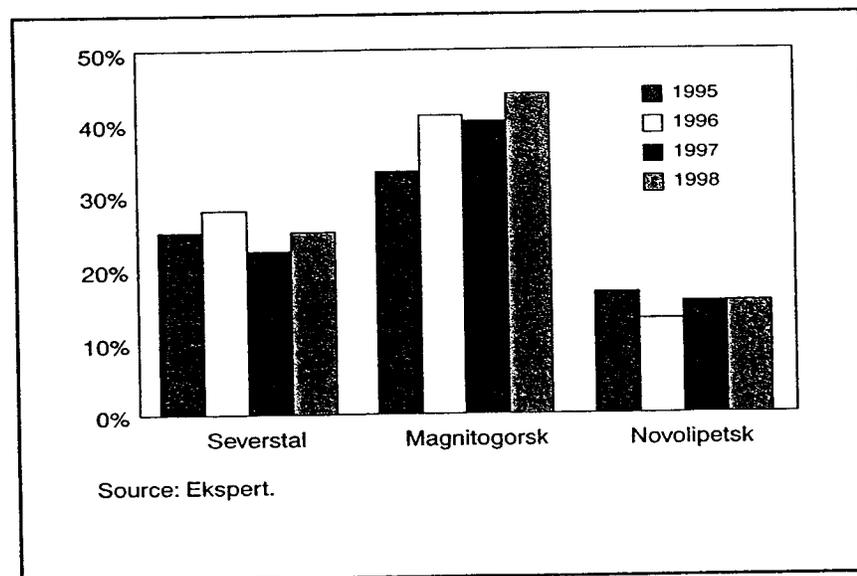
**Supplier Bills.** For the Russian iron and steel industry, overdue payments to suppliers totaled over \$1.2 billion.<sup>101</sup> This figure represented about 55 percent of all outstanding bills and was greater than the overdue receivables owed to the industry by its customers.<sup>102</sup> The amount of money the top three steel producers owed increased by more than 60 percent from 1995 to 1998, reaching 28 percent of their 1998 sales (*Charts 3-8 and 3-9*). Of the top three Russian steel companies, Magnitogorsk was in the worst position; the amount it owed to suppliers grew 73 percent from 1995 to 1998, equivalent to 44 percent of its 1998 sales.

For the mid-sized steel companies, the picture was even more bleak. Payables to suppliers increased by more than 400 percent on average from 1995 to 1998, reaching an average 107 percent of their 1998 sales (*Chart 3-10*). Four of the six companies in this category owed their suppliers more than 100 percent of their net sales (*Chart 3-11*).

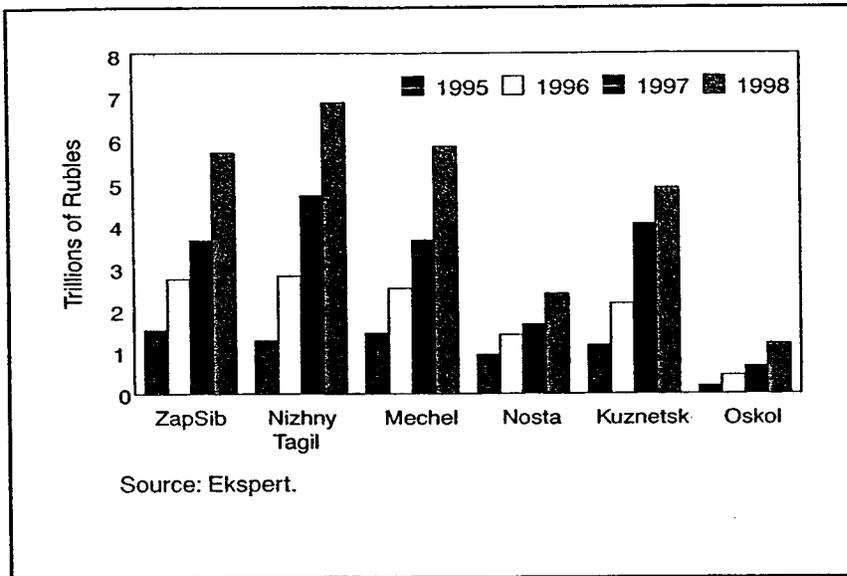
The amount of debt (including overdue debt) left little doubt that many of these outstanding bills from suppliers would not be paid any time soon. Suppliers to the steel industry seemed to realize that many of their receivables would never be collected. For example, the collection rate (including barter) of total receivables by the regional electric companies was between 60 percent and 90 percent, with cash collections usually not exceeding 15 percent. The experience of some regional electric companies in their attempts to resell their receivables indicates the likeliness of repayment. Their resale efforts either found no interest at all or were sold for roughly 25 percent of face value.<sup>103</sup>



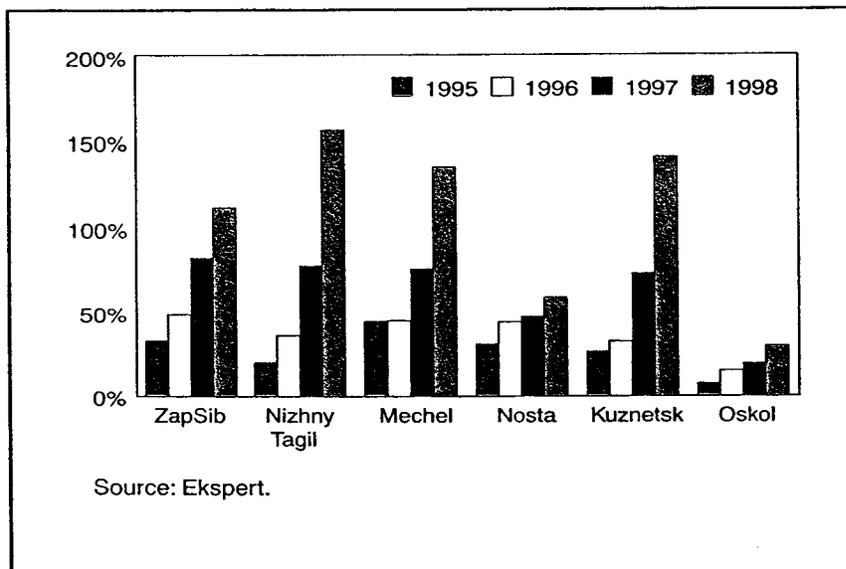
3-8. Payables to Suppliers, Top Three Companies



3-9. Payables to Suppliers as Percent of Net Sales, Top Three Companies



3-10. Payables to Suppliers, Mid-Sized Companies



3-11. Payables to Suppliers as Percent of Net Sales, Mid-Sized Companies

The suppliers of raw materials and energy tolerated this situation for the same reason they complied with government-imposed low prices on their products and services: they were supported by the government or had export privileges. Additionally, suppliers, such as the regional electric companies, were often dependent upon local industries as their only source of cash, fuel, and other goods needed to remain in operation, and “have little incentive to take an adversarial approach.”<sup>104</sup>

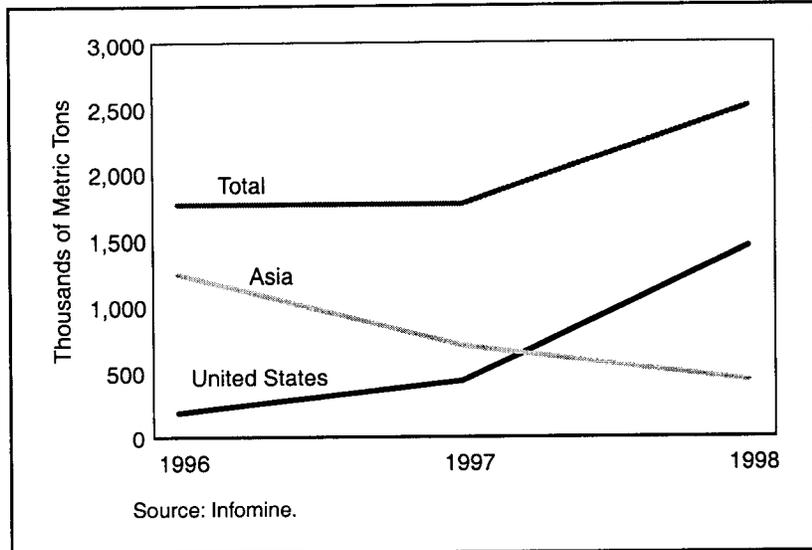
**Government Taxes.** Taxes have also gone unpaid. At the end of 1998, according to one analysis, Russian iron and steel companies owed the government roughly \$836 million in taxes.<sup>105</sup> Moreover, the amount of taxes a company paid was essentially negotiable. The McKinsey study makes the point that the nominal tax burden in Russia is 55–60 percent of GDP, while planned revenues are 35 percent and actual cash revenues are approximately 20 percent. The difference between what was supposed to be collected and what was actually collected in cash left a lot of room for unequal tax payments among companies.<sup>106</sup>

The fact that tax arrears grew while production increased sheds light on the unique economic environment in which Russian steel companies operated. In the words of one analyst, “the state’s systematic failure to force large enterprises to pay [their taxes] amounts to a massive subsidy to those powerful or resourceful enough to negotiate amnesties and settlements.”<sup>107</sup>

- From 1992 to 1995, Magnitogorsk built-up a substantial tax liability to the federal government. In 1996, Magnitogorsk—apparently along with much of the rest of the industry—was so far behind in its taxes that bankruptcy proceedings were threatened.<sup>108</sup> After negotiations with the government, the company was allowed to pay what it owed over several years at a “very, very low” interest rate.<sup>109</sup> While Magnitogorsk was eventually able to pay off its tax debt, after the ruble depreciation made

The story of Magnitogorsk's hot-rolling mill is emblematic of the Russian steel industry as a whole.

- Investments were made despite market conditions.
- Production continued or even increased without regard to domestic demand or serious financial difficulties.
- Huge volumes of steel production were exported at very low prices.
- Massive volumes of low-priced steel were diverted from one market to the next in a matter of months.



3-17. Magnitogorsk Exports of Hot-Rolled Steel

### Conclusion

The lack of normal business considerations at the investment, production and selling stages in the Russian steel industry led to volatility in the global steel market and damage to the steel industry and steel workers in other countries, including the United States. While the Russian steel industry has the potential to be competitive in world markets in the long-term, it must address the underlying market-distorting practices to avoid the kind of trade frictions it has encountered in the past.

# **EXHIBIT 2**

[\[Go To Best Hit\]](#)

Unclassified



Document ID: CEP20010404000219  
Entry Date: 04/04/2001  
Version Number: 01

**Region: Central Eurasia**

**Sub-Region: Russia**

**Country: Russia**

**Topic: CRIME, DOMESTIC ECONOMIC, DOMESTIC POLITICAL, LEADER**

**Source-Date: 03/26/2001**

**Russian "Industrial Feudalism" Described**

*CEP20010404000219 Moscow Novaya Gazeta in Russian 26 Mar 01 10*

[FBIS Translated Text]  
1 [subhead]

I will probably not surprise the owners of means of production present with the claim that there is no private ownership of the means of production in Russia.

The fact is that in Russia observance of the law puts any enterprise on the brink of bankruptcy. Non-observance entails the possibility of the property being confiscated. There is no way out. You can either drown or be hanged.

In these conditions, laws are replaced with personal relations. Private property is turned into a system of vassal rights tying the owner of an enterprise, the governor, the president's representative, the head of the tax police, the head of the FSB [Federal Security Service], and so on.

The oligarchs are at the top of this food chain. The oligarchs are the vassals of the Kremlin. They are the ones who got personal possession of Sibneft, Norilsk Nickel, or Yukos directly from the president. A little lower are the regional magnates like Mr. Avetisyan in Samara, Mr. Fedulev in Yekaterinburg, or Mr. Didenko in Maritime Kray. Their financial prosperity is founded on friendship with the governor.

If the governor changes, any company except an oligarch can lose a factory that it already considered its own. Like Renova lost the Novosibirsk Electronic Plant after Renova-friendly Governor Mukh was replaced by TWG-friendly Governor Tolokonskiy, for

example. If the president changes, those who backed a different president also go down the pan. Vladimir Gusinskiy and the Zhivilo brothers, for example.

This same thesis of the absence of private property can be rephrased in a diametrically opposed way. We can say that it is not so much property that is in private ownership in Russia as the law, the army, and the right to collect taxes -- that is to say, everything that does not belong to private individuals in a market economy.

All in all, this kind of system is called feudalism.

2 [subhead]

In fact, all the techniques for seizing control in joint-stock companies are only a local Russian derivative of universal feudal rules. In our, Russian feudalism, it is not lands but factories that are the objects of feudal rights but that does not change the essence of the culture. The essence is this: In a feudal culture, the cheapest and most profitable way to expand assets is war.

That is to say -- in the framework of industrial feudalism -- seizing control.

The Russian process of unfriendly takeovers is radically different from a market-based one. In a market economy, the unfriendly invader pays more for the company than in a friendly absorption. In the Russian economy, he does not pay anything, not counting paying for the upkeep of various military formations -- courts of arbitration and OMON [Special-Purpose Police Detachment] officers -- and using up munitions.

That is economic war.

I repeat again: No Russian company is protected by any laws. It is protected by an awareness that if you have a go at someone who has bigger claws and teeth, you will get it in the neck.

I will not amuse those present with practical recipes about how to wage war. They are diverse. If you are friendly with local power engineering companies, you can organize electricity blackouts for factories; if you are friendly with Aksenenko, you can suffocate it with a railroad blockade; or you can set the tax police onto it with the aim of frightening it and gathering free financial intelligence as Deripaska did with GAZ [Gorkiy Automobile Plant].

Seizing a factory is war. The tax police, railroad workers, arbitration courts, and governor are simply various tactical formations that are used in proportion to resources. The more troops strike from a greater number of directions, the better. The opponent should not have a second to relax. He should dream of tax police at night and if he is unable to sleep at all, that is even better.

The classic example of taking a fortress by siege is the hunt for NTV [Independent Television]. It is classic because the hunters have almost limitless resources but have much fewer opportunities to use them. I do not doubt that with resources like that, Pavel Anatolich Fedulev, who was declared on the list of rapporteurs, would have taken NTV some time last August. What is happening now is reminiscent of cutting a live dog into

pieces. It is unappetizing and unhygienic -- they have been cutting the animal for six months now but it is still yelping. As regards stress, as a former NTV worker, I have experienced for myself what it is when the bosses are not able to make adequate decisions simply because there is no time.

### 3 [subhead]

But I will not get distracted by tactics; those present have fought more than I have. I will return the science of culture. To two sociological laws.

The first, as I have already said, is that the Russian economy is a military economy. In a situation where it is possible to seize something for free, seizure becomes the most economically profitable means of augmenting assets.

The second law. The Russian economy is an economy of the wheel of Fortune. What do I mean? There is such a cultural concept as capital. Capital is wealth that augments itself. Modern Western logic proceeds from the fact that if a businessperson has a lot of money, he will most likely have even more tomorrow. Plus or minus the fall in the NASDAQ or Nikkei indices.

But this is a comparatively recent concept of wealth. Most ancient and medieval cultures had a diametrically opposed understanding. It proclaimed that the more wealth someone has, the greater chance there is that he will lose it. In ancient Greece, there was even a special term "fthonos theos" -- the envy of the gods. On the verge of the Middle Ages, the last of the philosophers of antiquity, Boethius, devised another term, the wheel of Fortune. If someone is at the top today, he will be at the bottom tomorrow.

In a market economy, if Bill Gates had a billion yesterday, he will have two billion tomorrow.

In a medieval economy, if Jacques Ker [name as transliterated] had the biggest trading fleet, King Philippe would hang Ker tomorrow.

We have an economy of the wheel of Fortune. If you are plump today, you will be eaten tomorrow. There is no need to be plump; that is to say, there is no need to invest. It is bad to invest if only because a factory shining from investment provokes uncontrolled slaving in neighboring feudal individuals.

The only difference between the Russian wheel of Fortune and the medieval one is that you can get off the Russian wheel, get a ticket to Switzerland, and live there. That is to say, the most correct strategy is to grab and run. Which was brilliantly implemented by the first generation of Russian oligarchs like Smolenskiy or Vinogradov.

I would least of all like to play the role of Leopold the cat, who calls on the boys to live in friendship. That is useless. You cannot teach wolves vegetarianism. Weaning an oligarch off hunting for factories is just as unthinkable as weaning a Far East fisherman off poaching crabs. The fisherman understands perfectly well that with this intensity of catching, the crab will disappear altogether in five years' time but he cannot stop himself because if he does not catch it, another will. And the fisherman's personal restraint will not improve the ecology at all; it is simply that his family will have nothing to eat.

## 4 [subhead]

I will only venture to describe two cultural symptoms that are inherent purely in Russia. They do not bear any relation to feudal France.

First, Russian industry, even the raw-materials industry, is fundamentally uncompetitive in comparison with world industry. Energy per production unit eats up twice as much as in the United States or Europe. The same goes for the number of workers -- there are 170,000 people working at Norilsk Nickel while there are 17,000 working at Falconbridge and Inco, which occupy the same market share. In addition to this, Russia is much colder. The workshop, which in California constitutes a corrugated roof on supports, in Russia is reminiscent of a fortress, able to withstand a small nuclear strike or the Siberian winter. This means incomparable building costs. In these conditions, not paying workers their wages is essentially the only mechanism for maintaining the competitiveness of production.

This uncompetitive industry needs modernization in order to survive.

Throughout the world, modernization takes place with the help of loan funds or share placements. The funds that are thus acquired can exceed tenfold the amount that a factory earns in a year. The correlation of price and profitability in a normal company, the so-called price/earnings ratio, fluctuates around 25.

In Russia, this correlation fluctuates around one. The amount for which the new owners bought KrAZ [Krasnoyarsk Aluminum Plant] and BrAZ [Bratsk Aluminum Plant] is comparable to these factories' net -- that is to say offshore -- profit over a year. Correspondingly, the money that can be attracted for reconstructing these production facilities does not exceed the amount of money driven offshore.

That is to say, even in those cases where we have a completely normal company that is difficult to seize because of the particularities of political geography, which has wonderful management, and is not conducting a risky policy of takeovers, like Novolipetsk Metallurgical Plant, Severstal, or Surgutneftegaz, say, it is still threatened with catastrophe on the strategic plane.

The second factor is connected with the methods for distributing property. They are becoming increasingly aggressive. Previous owners are being paid less and less while the law-enforcement protectors are being paid more and more.

Not long ago, control was being seized at joint-stock companies. You had to pay for shares. The Alfa group made bankruptcy fashionable. There was more room for getting things for free here but as a rule you still had to buy the debts. Since the time of Alfa, Sibal, and Chubays's great hunt for aluminum plants, another principle has been used -- driving [a factory] into a corner and suffocating it there.

It seems to me that two techniques could become the hits of the season this year. First, serving lawsuits in the West, as the Zhivilo brothers did with regard to Russkiy Alyuminiy. It is a no-lose scenario. From the West's point of view, all our normal business customs are cannibalism.

Second, the fabrication of criminal cases. Provisionally speaking. If you want to devour

Severstal and it is impossible to do this by any decent, traditional means, you act like this. You get a corpse somewhere. A ten-year-old one. Then you drag someone who has come down in the world from the zone who in exchange for a reduction in his term relates that in such-and-such a year the current director of Severstal instructed him to do in this corpse and that the dead body resulted in the Severstal privatization happening in one way and not another.

In fact, the first swallows have already appeared. I would remind you of the small bag of heroin that was taken from the former general director of Kachkanarskiy Mining and Enrichment Combine, Dzhahalol Khaydarov.

But this means has a drawback. You need brains to organize bankruptcies and hold shareholders' meetings. In order to plant a package of heroin it is enough to have a medium-ranking police sergeant with a vegetative nervous system. At some point, the medium-ranking police officers who have tried the delights of this idea will begin to simply take medium-ranking factory owners, pin corpses on them, and immediately, on the spot, demand, "Now you explain to me -- how should you hand me the factory?" Preferably on your fingers because the comrade cannot count above ten.

In my view, these two factors -- the chronic lack of funds for modernization and the degeneration of techniques for seizing control in a low-intelligence fight -- determine Russia's economic future.

I assure you that cultural stereotypes are more powerful than a default.

It is extremely interesting to compose novels about this Russia, of course; medieval France is on vacation but it is better to live in the Canaries. Sorry if I have distressed you.

[Description of Source: Moscow Novaya Gazeta in Russian -- weekly newspaper specializing in exposes; ownership unclear but friendly to Yabloko and Gorbachev]

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*Unclassified*

# **EXHIBIT 3**

Source: [All Sources](#) > [News](#) > [News Group File, Most Recent 90 Days](#)   
Terms: **russia and market economy and date geq (11/06/2000)** ([Edit Search](#))

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*The Current Digest of The Post-Soviet Press, October 24, 2001*

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Current Digest of the Post-Soviet Press

**October 24, 2001**

**SECTION:** International Affairs -- Western Hemisphere -- UNITED STATES; Vol. 53, No. 39

**LENGTH:** 494 words

**SOURCE:** U.S. PAYING FOR SUPPORT. By Pyotr Netroba and Konstantin Smirnov.  
Kommersant, Sept. 29, 2001, p. 4. Condensed text:

**BODY:**

US trade negotiator Robert Zellick met with Economic Development Minister German Gref in Moscow yesterday and officially announced that the US Commerce Department had begun considering **Russia's** request that it be granted the status of a country with a **market economy**. This is how George Bush is repaying **Russia** for its support of the US war against international terrorism.

Washington is attaching special importance to the Moscow visit by Robert Zellick, who is a presidential staff member equal in rank to a department secretary. After meeting with German Gref yesterday, he will hold talks today with [Deputy Prime Minister and Finance Minister] Aleksei Kudrin and [Prime Minister] Mikhail Kasyanov. Although the talks will focus on a variety of topics, the main issue that was discussed yesterday and that will come up again today is **Russia's** admission to the World Trade Organization. After his talks with German Gref, Mr. Zellick made a point of emphasizing that "**Russia's** further integration into the global trade system is in the interests of American workers, farmers, businessmen, consumers and investors." The US trade negotiator has come to Moscow to speed up the process of admitting **Russia** to the WTO. In 1998, incidentally, the American president at the time, Bill Clinton, ordered his administration to help the Russian delegation reach agreement with its trading partners (mainly the Americans themselves) as quickly as possible on setting the level of customs duties, agreement without which admission to the WTO is impossible. That represented payment for eastward NATO expansion. But the Americans' attempt to pull strings was unsuccessful. Moreover, a session of the working group on Russian admission to the WTO in June 2001 ended in an uproar when the Australian representative, seconded by his American counterpart, proposed that all Russian draft laws relating to WTO membership be subjected to expert analysis. Deputy Economic Development Minister Maksim Medvedkov angrily rejected his partners' proposal. The deadlock was broken only when US Treasury Secretary Paul O'Neill and Commerce Secretary Donald Evans visited Moscow in late July. That was when German Gref asked the Americans to recognize **Russia** as a country with a **market economy**. . . .

[Yesterday] Mr. Zellick said the US would "consider the request [for **market-economy** status] quickly and objectively." US recognition of **Russia** as a country with a **market economy** will help our country in its negotiations with the WTO. . . . "The tragedy in the US has made it clear that we must be more united, and we would like **Russia** to become a member of the WTO as soon as possible," Robert Zellick said yesterday. Mr. Zellick even promised to lean on the other WTO member countries. . . .

In short, Moscow has now another chance to join the WTO -- and quite likely with the maximum transition period that Russian negotiators have been insisting on.

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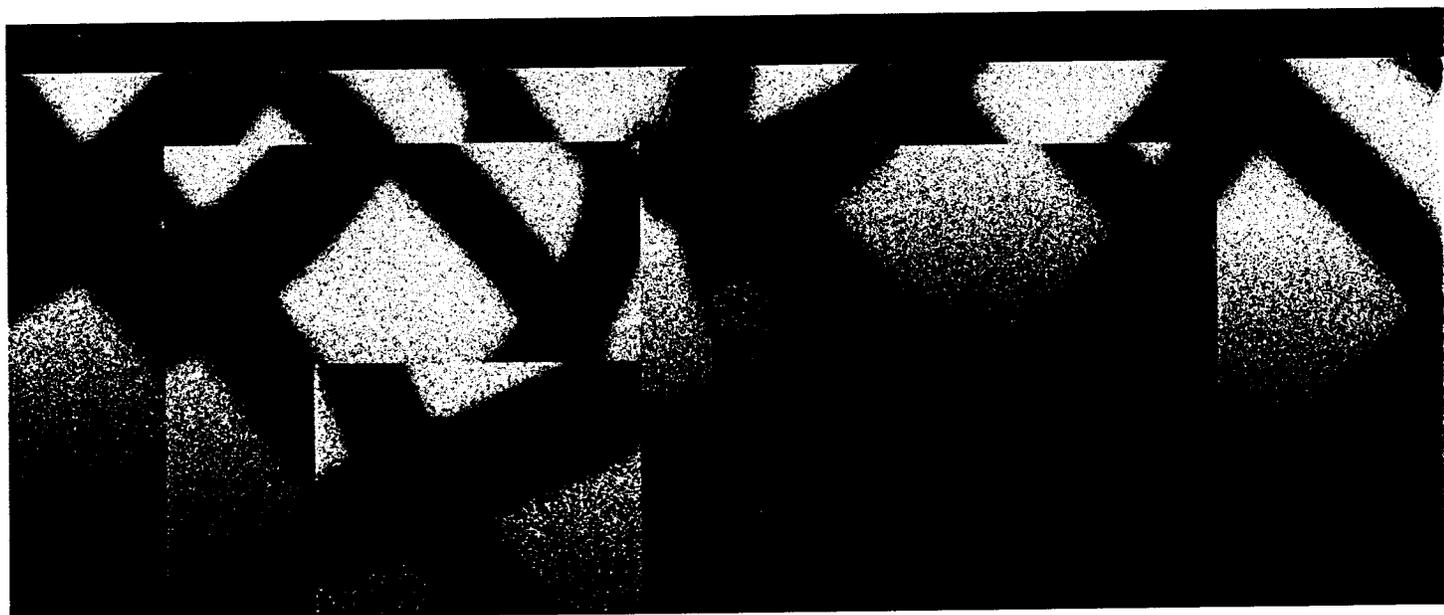
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# **EXHIBIT 4**

**A n n u a l R e p o r t**  
**o n**

**Exchange Arrangements  
and Exchange Restrictions**

**2001**



**I n t e r n a t i o n a l M o n e t a r y F u n d**

Accounts in domestic currency held abroad	n.a.
Accounts in domestic currency convertible into foreign currency	Yes.

### Nonresident Accounts

Foreign exchange accounts permitted	Yes.
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#### Domestic currency accounts

Nonresidents may maintain five types of ruble accounts: (1) "T" accounts, which may be credited with proceeds from current international transactions (including proceeds from sales of goods and services to residents of Russia and interest earnings on the account itself), and debited for the servicing of export-import operations by their representative offices in Russia; (2) correspondent ruble accounts for nonresident banks under the same regime applicable to T accounts; (3) "I" accounts, which may be used for investment activities (including privatization operations); (4) nonresident accounts for natural persons; and (5) "S" accounts for transactions involving government securities. The transfer abroad of balances in T accounts and correspondent ruble accounts accumulated after June 1, 1996, is not restricted. The use of balances accumulated up to May 31, 1996, is limited to domestic transactions. I accounts may be used for a wide range of investment activities, including profit and dividend transfers. Balances maintained in I accounts may be transferred abroad without restriction after payment of applicable taxes. Nonresident natural and juridical persons may purchase foreign exchange only with ruble balances held in I accounts. Before the balances from any of the five types of accounts may be repatriated, they have to be transferred to transit accounts in authorized banks. No interest is paid on these balances.

#### Convertible into foreign currency

Repatriation and conversion of funds in the government securities market are subject to a one-year waiting period and require approval.

#### Blocked accounts

No.

### Imports and Import Payments

#### Foreign exchange budget

No.

#### Financing requirements for imports

#### Advance payment requirements

The CBR requires that all advance payments of Latvian food and consumer goods exported to Russia be limited to a maximum of 180 days. There is an advance import deposit requirement, which can be reduced by the amount of an LC issued by an authorized bank; the guarantee of a nonresident bank; a contract to cover the risk of nonrepatriation in the case of a default of the nonresident payer; a promissory note issued by a nonresident secured by a nonresident bank; or a special permit from the CBR.

#### Documentation requirements for release of foreign exchange for imports

#### Letters of credit

Settlements are to be made with LCs or promissory notes.

#### Import licenses and other nontariff measures

There is a ban on private imports of ethyl alcohol. Licenses are required for imports of various alcoholic products, as well as dual-purpose items, military equipment, medicine, industrial waste, and ozone-destructive substances.

#### Negative list

Yes.

#### Import taxes and/or tariffs

Most customs duties range from 5% to 16%, but a 30% duty is set on a few sensitive goods. The following imports are exempt from duties: insulin, printed material, cotton, some types of livestock, new diamonds, and wheelchairs. Imports from CIS countries are exempt from duties. On imports of commodities from developing countries (except those subject to excise duties) the customs duty rate is 75% of the basic rate.

State import monopoly

No.

**Exports and Export Proceeds**

Repatriation requirements

The repatriation ratio is 100%.

Surrender requirements

The surrender requirement is 75% and must be effected within seven days.

Financing requirements

CBR permission is required for foreign exchange transactions associated with deferred payments for exports of goods from Russia for a period exceeding 90 days and for deferrals granted to residents to make advance payments against deliveries of imported goods exceeding 180 days. All payment of Latvian energy, metals, and raw material imports from Russia are to be settled within 180 days.

Documentation requirements

Letters of credit

Settlements are to be made with LCs or promissory notes.

Export licenses

Export licensing is limited to a small group of products (e.g., military equipment and arms, precious metals and stones, rare animals and plant species, and dual-purpose items). Export licenses are issued by the Ministry of Trade in accordance with application procedures established by the government.

With quotas

Yes.

Export taxes

Other export taxes

Export taxes apply to 175 items, for the most part at a rate of 6.5%, with a maximum rate of 50% for nonferrous scrap. A number of goods are subject to specific duties, including crude oil and petroleum products. Certain goods are taxed by combined duties.

**Payments for Invisible Transactions and Current Transfers**

Controls on these transfers

On June 30, 2000, a special procedure was introduced for purchases of foreign exchange exceeding \$10,000 or its equivalent for the purpose of meeting payments for certain kinds of services.

**Proceeds from Invisible Transactions and Current Transfers**

Repatriation requirements

Yes.

Surrender requirements

Proceeds from invisibles, except those from banking services, are subject to the surrender requirement.

Restrictions on use of funds

No.

**Capital Transactions**

Controls on capital transactions

Yes.

Controls on capital and money market instruments

On capital market securities

The export and import of securities denominated in rubles by residents are subject to regulations established by the CBR, the MOF, and the customs authorities.

*Shares or other securities of a participating nature*

Purchase locally by nonresidents

Nonresidents may purchase from residents securities denominated in foreign exchange with foreign exchange, provided that the residents obtain a license from the CBR for these transactions.

No prior authorization is required to purchase securities denominated in rubles with rubles.

Securities denominated in rubles or in foreign exchange may be purchased with funds from type T ruble accounts. Securities denominated in foreign exchange or in rubles with a maturity of more than one year may be purchased with funds from type I accounts, as well as from ruble correspondent accounts of nonresident banks.

The parties must notify the Federal Securities Market Commission (FKRTsB) of transactions involving the purchase by nonresidents of securities issued by residents. Securities of issuers registered in Russia may be circulated abroad only with the permission of the FKRTsB.

Sale or issue locally by nonresidents	Nonresidents may sell to residents securities denominated in foreign exchange for foreign exchange—provided the residents have a CBR license allowing such transactions—as well as securities denominated in rubles for rubles. The sale by nonresidents of securities denominated in rubles for rubles does not require prior authorization. The parties to such transactions must notify the FKRTsB of concluded transactions for the purchase by residents of securities issued by nonresidents.
	Securities issued by nonresidents are permitted to circulate or to be placed initially in the securities market after registration of their prospectus with the FKRTsB. These securities should be denominated in rubles.
	Foreign exchange proceeds from the sale of securities are credited to foreign exchange accounts opened by nonresidents in authorized banks, from which these proceeds may be freely transferred abroad. Ruble proceeds from the sale of securities and from securities issues may be credited to type T ruble accounts of nonresidents opened in authorized banks, or to ruble correspondent accounts of nonresident banks.
Purchase abroad by residents	Prior CBR approval is required.
Sale or issue abroad by residents	CBR approval is required. Proceeds from the sale are to be credited to current foreign exchange accounts of residents. Securities of issuers registered in Russia may be circulated abroad only with the permission of the FKRTsB.
<i>Bonds or other debt securities</i>	Russia's domestic debt includes primarily the following types of liabilities: government short term—zero coupon bonds (GKOs) and federal bonds (OFZs); government nonmarket bonds (OGNZs); government savings bonds; and domestic foreign exchange securities.
Purchase locally by nonresidents	Nonresidents may effect operations with Russian issuers of securities included in a list compiled by the CBR by using S accounts in authorized banks. Currently, this list includes GKOs and OFZs, two issues of OGNZs, and Russian issuers' shares and corporate bonds that are listed with trade organizers, in compliance with the CBR's requirements. As regards OGNZs, investors may purchase them from the MOF in compliance with an agreement between the MOF and a particular investor, but most of these OGNZs have already been retired by the MOF. OGNZs are not traded in the secondary market.
On money market instruments	
<i>Purchase locally by nonresidents</i>	For nongovernment instruments, the same regulations apply as for capital markets. The purchase by nonresidents of GKOs and OFZs is carried out through type S accounts. Nonresidents are no longer permitted to invest new funds in the government securities market.
<i>Sale or issue locally by nonresidents</i>	The same regulations apply as for securities of a participating nature.
<i>Purchase abroad by residents</i>	The same regulations apply as for securities of a participating nature.
<i>Sale or issue abroad by residents</i>	The same regulations apply as for securities of a participating nature.
On collective investment securities	Transactions with nonresidents in foreign exchange may be carried out only if residents have authorization from the CBR to conclude such transactions. The parties should notify the FKRTsB of concluded transactions.
<i>Purchase locally by nonresidents</i>	The FKRTsB should be notified of purchases by nonresidents of collective investment securities issued by residents.
<i>Sale or issue locally by nonresidents</i>	The prospectus for collective investment securities issued by nonresidents must be registered with the FKRTsB. These securities must be denominated in rubles.

# **EXHIBIT 5**

**EMERGING  
ECONOMIES  
TRANSITION**

# **The Investment Environment in the Russian Federation**

**LAWS, POLICIES  
AND INSTITUTIONS**

**FINANCE AND INVESTMENT**

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activity had some practical significance in the beginning of transition, before the full legal basis for commercial activity was firmly embodied in other major legislative acts, it is now more declarative in nature. Beyond the specific introduction of a grandfather clause with protection against changes in legislation detrimental to investment projects (see Part I, Box 1), both laws serve more to reflect the government's commitment to existing investor rights and full national treatment for foreign investors.

Although legislation at times has proceeded at very rapid pace, with little co-ordination of reforms affecting the same or related areas of economic activity, commercial legal rules are at present sufficiently clear, coherent and operational to support business activity in general. Unresolved legislative issues of major importance for investors remain:

- The adoption of a universal Land Code.
- The creation of adequate registry procedures for non-possessory pledges in line with the provisions of the Civil Code.
- Harmonisation of the Tax and Customs Codes with the provisions in investment legislation, in particular as relates to grandfather clause provisions and production-sharing agreements.

Certain other factors impacting negatively on the legislative framework have not been discussed in depth in this document. These include mutually exclusive provisions resulting from poor co-ordination of legislative acts, and a certain degree of devaluation or undermining of legislation due to the frequency of amendments to laws. In addition there is the general problem of unclear balance of jurisdiction at federal and regional levels, preventing uniform implementation. Another deficiency is the ineffectiveness or even absence of penalties for violation of laws. In addressing these problems, it is of paramount importance that attention be given to safeguarding the stability of laws, particularly by avoiding successive amendments to laws unless absolutely unavoidable to eliminate inconsistencies.

For foreign investors, part of the general legal and regulatory framework described in Part I below deserves to be singled out for immediate reform or rapid advancement of improvements already on the drawing board. This relates in particular to the foreign exchange regulations currently in force and to the area of production sharing agreements (PSAs) for extraction of mineral resources.

Foreign exchange regulation in Russia provides the basic guarantees for investors as concerns repatriation of profits and dividends, and Russia has accepted the obligations of Article VIII of the IMF Articles of Agreement, formally since June 1996. However, current legislation requires the prior authorisation of the Central Bank of Russia (CBR) for most capital account transfers, and the licensing system for such operations is both cumbersome to operate for the authorities

and onerous and non-transparent for private sector participants. Priorities for reform are:

- As an immediate measure, the system of licensing capital account operations should be made more transparent by the issuing of guidelines (including for internal use by the control authorities) which would clarify on what grounds a license would be refused.
- The rules for the present elaborate system for non-resident rouble accounts should be rendered clearer, more systematic and user-friendly.
- The exchange control system for both current and capital account operations should be amended to permit market participants to make freely those payments and transfers which are required under contracts that have been legally entered into and cover transactions not prohibited by laws or regulations. This means that firms should not find themselves unable to perform under legally binding commercial agreements because of the foreign exchange regulatory regime or its discretionary implementation by currency control authorities.
- The 1992 Foreign Exchange Law and its implementing regulations should be revised to simplify the regime and bring it into line with international practice, in particular by introducing a negative list principle for capital account operations, leaving all but a specified number of items completely free of licensing requirements.

As to the legislation and regulatory regime providing the basis for production-sharing agreements, urgent improvements are needed if the full potential of this crucial area for attracting long-term foreign capital and expertise is to be realised. Beyond the already mentioned need for reconciliation with other legislation, (in particular harmonisation with *Part Two of the Tax Code* where a draft proposal is already being considered by the Duma) the following measures are called for:

- The elimination of local content requirements, in particular the stipulated minimum share of Russian equipment (70%).
- The establishment of a clearer and more transparent distribution of powers among different ministries and government agencies with respect to regulating and negotiating PSAs.

#### ***Protection of property, shareholder and contractual rights***

In practice, one of the major problems encountered by investors relates to the protection and enforcement of property rights, as discussed in more depth in Part II, Chapter I below.

The insecurity of property rights in Russia perceived by investors relates in particular to the protection of shareholder/investor rights, protection of secured

## 7. Financial Sector Development

According to the CBR, the most important reasons for the unwillingness of banks to finance production is the lack of information about the true financial condition of borrowers, as well as the inadequate legal basis for creditor rights. Of total fixed capital formation in Russia in 1999 (659 billion roubles) only 4% was financed through bank lending, 17% from budgetary resources and as much as 53% from enterprises' own resources. Data on working capital in the enterprise sector show more than 70% financed by own resources and the remainder through supplier credits and arrears of various kinds (salaries and taxes) while bank credit plays an insignificant role.

Hence it is necessary to increase the competitive pressures on banks to meet the needs of productive firms, in particular smaller clients. The authorities can and should take a lead in demonstrating that lending to start-ups and SMEs can be profitable, through introducing special support schemes and venture capital funds where conditions for banks to participate can be made suitably attractive. That access to external financing of working capital is difficult for smaller enterprises can be attributed to limited competition among banks, which relieves banks of pressure to develop lending schemes for SMEs, and also to the high risks and transaction costs of such lending. In addition, there are problems of information and contract enforcement related to legal and regulatory frameworks that are still evolving (see Part II, Chapter I) and inadequate institutional capacities.

To date in Russia, government-led project co-financing schemes involving commercial banks do not exist. A number of investment credit facilities are provided by the government directly to business firms, either financed from budgetary resources, or, as in the case of SME support, indirectly via a range of different tax incentives.

The government can also play an important role in ensuring that the legal and regulatory framework provided for financial sector activities facilitates development of innovative financial instruments and the setting up of new types of financial institutions. It can even take a catalyst role in innovative financial engineering, by introducing new methods of financing. In the years immediately preceding the 1998 financial crisis, at least two new, important schemes were designed in Russia, which failed to materialise, reportedly for reasons of contentious turf issues between different regulatory authorities. One was the development of a commercial paper market in the Russian context, and the other was a scheme establishing a CBR rediscounting facility for banks of promissory notes (veksels), which could have brought orderly trading and considerably more depth to this unregulated market. These initiatives should be revived.

As to other innovations, there are venture capital funds in the process of being created, and leasing facilities of domestic equipment are being developed

established for state-owned and privately-owned banks, the latter have little prospect of long-term survival.

- Reviewing government participation in specialised institutions and schemes, concentrating on supporting areas where business activity is already beginning to thrive, where additional finance could give a substantial boost.
- Developing co-financing schemes with commercial banks for project finance in general and for SME financing in particular.
- Facilitating access of small, young companies to the equity market through the creation of a special tier of the market where smaller companies could raise equity finance.
- Encouraging the setting up of special credit information and rating agencies.

## 8. Conclusions

Much has been said above, both in general and specific terms regarding the need to deal with crime, corruption, lack of security of property rights and of enforcement of contracts and judgements in dispute resolution so as to improve the business climate for foreign and domestic investors. We have emphasised that rules-based, streamlined licensing and authorisation procedures at federal, regional and local levels need to be imposed, to remove excessive administrative hurdles and arbitrary rule. Transparent guidelines and sizeable sanctions for officials who violate this rules-based system must be put in place. The important role to be played by competition authorities in solving these problems and malpractices has also been underlined.

The urgency of further progress with tax reform has been emphasised, in particular with respect to those disincentives still affecting business investment as detailed in Part II, Chapter III. The need for a clear signal to the investor community regarding the government's intentions for privatisation of remaining government stakes in major companies, including restructured natural monopolies, has also been underlined. Such further sales should be conducted with full institutional and procedural transparency according to best internationally accepted standards. Urgent attention should be paid to designing and implementing coherent policies for further development of financial markets, with particular attention to the financing needs of small and medium-sized enterprises.

A final word deserves to be said regarding the importance of Russia's accession to the World Trade Organisation (WTO) for its ability to attract foreign investment. In view of the complementarity of FDI and trade, co-ordination of trade and investment policies would represent a significant step forward in Russia's case. Benefits would flow from the harmonisation with international economic policy

Box 1. Grandfather Clause (cont.)

of its total volume. The lack of clarity surrounding the question of "priority projects" falling under the grandfather clause is one of its major weaknesses and several government decrees are being drafted by the Ministry of Economic Development and Trade and different government agencies to eliminate the contradictions and discrepancies.

As an illustration of how the concept of national treatment and promotion of investment activity is gradually influencing the domestic investment climate, a grandfather clause provision has been included in Article 15 of the 1998 **Federal Law on Investment activity Implemented in the Form of Fixed Capital Investment** as from 2 January 2000. This provision, which was added as a result of pressure from the Council of the Federation, applies to both domestic and foreign investors alike and there are no quantitative limitations on the size of priority investment projects or on the level of foreign participation.

The controversy surrounding the grandfather clause makes it increasingly apparent that the framework legislation on foreign investment incorporates obsolete and contradictory approaches which make it ineffective or inapplicable in practice. There is a need for clearer formulation of investment incentives and their extension to domestic investors either through an amended framework law on investment activity or through accommodating provisions in the Tax and Customs Codes and in the laws regulating payments to extra-budgetary funds.

depth in Part II, Chapter I below. Other general problems with respect to the legislative framework which have not been discussed in depth in this document include:

- Poor co-ordination of legislative acts, which leads to mutually exclusive provisions.
- Frequent amendments to resolve short-term problems which undermine legislative stability.
- Unclear balance of power at federal and regional levels which is not conducive to uniform and/or coherent implementation.
- Non-existent or ineffective penalties for violation of laws.

Investors' lack of protection against non-compliance with laws is partly a consequence of the failure of the existing Russian judicial system to keep pace with change. There is no special procedure for handling petty disputes and no special courts with different areas of specialisation to develop the necessary expertise for more complex issues. Investors are in fact often deterred from taking cases to court by the lack of independence of judicial procedure and long delays due to

court workloads. Judges, bailiffs and other court officials tend to be too inadequately remunerated to ensure their commitment to protecting the rights and interests of plaintiffs or enforcing court rulings (See Part II, Chapter 1).

## 2. Restricted Areas and Natural Monopolies

### *Restricted areas*

Most countries apply certain restrictions on foreign investment in “strategic companies” and natural monopolies for a number of economic and political reasons. Present Russian legislation exhibits a lack of clarity as to the extent of such restrictions and the time span over which they are to be enforced.

### *Draft law on areas and territories restricted for foreign investment.*

At the present time there is no comprehensive specification of areas restricted to foreign investment. However, a draft law entitled *On the list of sectors, and territories with prohibitions or restrictions for foreign investment* has passed the first reading in the previous Duma and is still under parliamentary discussion. The list itself is in the process of being drafted and is initially to include areas of importance to national security and defence and state monopolies such as distilleries, export and processing of precious metals and other export-oriented industries.

In October 2000, a draft list of restricted areas, including lines of activity ranging from airlines to bakeries where the foreign capital share is limited to a maximum of 25%, was being circulated to a number of government agencies. Fears have been expressed by the foreign investor community that the final bill will contain a very wide list of restricted sectors and territories or provisions giving government bodies power to alter or extend the list at any moment. In the interest of stability and predictability, the provisions in the proposed law should set out a clear and limited list of restrictions, superseding and invalidating the multitude of restrictions on foreign investment and activities of firms with foreign capital previously existing in other acts and regulations, at all levels of government.

### *Financial sector*

#### *Banking*

Restrictions on the activities of foreign banks in Russia were imposed in 1993 by a decision of the Board of Directors of the Central Bank. The Board established a 12% limit on the share of foreign capital in the total capital of the banking sector. Although this limit remained well above actual levels of foreign participation for a number of years, it was exceeded after the financial crisis of 1998 when Russian banking capital contracted dramatically. In the first quarter of 1999, the share of

foreign capital in the charter capital of banks registered in Russia reached almost 20%. As of 1 January 2001, this share had declined to about 8% due to the growing capitalisation of the banking system (especially of banks with CBR participation). More changes, including bankruptcies, mergers and acquisitions, are expected as the restructuring of the Russian banking system proceeds. Many analysts believe that about 1 000 of the 1 300 banks in Russia have little chance of surviving. Investment opportunities should emerge for foreign banks with access to resources and wishing to establish or increase their presence in the Russian banking sector.

A further complication is that the above-mentioned decision of the CBR Board of Directors restricting foreign ownership in the banking sector became void in 1996 through the enactment of *the Federal Law on Banks and Banking Activity* which states that "... the size (quota) of the participation of foreign capital in the banking system is established by a federal law according to a proposal of the government in consultation with the Central Bank of Russia". As no such law has ever been enacted, the restriction has no legal basis. However the Central Bank still issues administrative acts referring to the 12% limit and could potentially refuse to grant licences to banks with foreign capital if the quota is filled. For the time being, there are no cases reported where a non-resident bank has appealed to a court to dispute a decision of the Central Bank not to grant it a license on such grounds.

There is no doubt that the Russian banking sector would benefit significantly from increased foreign participation. This fact is acknowledged by the Ministry of Economic Development and Trade, which is in favour of encouraging foreign capital into the Russian banking system to attract skills and technology, promote competition and improve banking services. It plans to draft a special law governing levels of foreign shareholdings that might impinge on the discretionary control of the Central Bank over the sector. The Central Bank is, for its part, working on amendments to the Federal Law on Banks and Banking Activities, which could broaden its powers to regulate the shareholdings of foreign banks.

At present, as the share of foreign banking capital in Russia is quite low and the number of foreign banks seeking to expand operations in Russia quite limited, the negative impact of the restriction is marginal. However, in the future, its existence could seriously hamper the inflow of foreign capital and overall development of an efficient domestic banking system.

#### Insurance

The Russian insurance sector is relatively underdeveloped, with total premiums written by local firms much lower than that of a single large international company. Just over 1 500 insurance companies were registered in Russia at the beginning of 2000, 60 (4%) of which have foreign participation. Increasing competition has reduced the number of insurers operating in the market, which has

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become subject to tighter control by the insurance supervisory body. Local insurers offer far fewer services than foreign companies and only a small minority of Russians have basic life or property insurance policies.

In 1994 Russia signed an agreement with the European Union obliging it to open up the Russian market to foreign insurers by the end of 1999. Before that foreign insurers could only act through subsidiaries where their stake did not exceed 49%. The intermediary activities of brokers are restricted by the requirement that insurance risks be allocated exclusively to Russian companies and reinsurance to foreign companies.

In 1999 a bill entitled "Amendments to the Law on the Organisation of Insurance Business in Russia" was passed by the Duma and the Federation Council after considerable controversy, containing procedure for the activities of affiliated companies of foreign insurers on the Russian markets. In summer 1999 the President of Russia had vetoed the bill, but it was ultimately passed due to the strong lobbying efforts of the local insurance and banking community. This has effectively limited foreign insurers' capital to 15% of the overall capital of insurance companies operating in Russia, cancelling the previous 49% limit foreigners were allowed to hold in the capital of an individual company. At the same time companies with more than 49% foreign capital and subsidiaries of foreign companies were banned from selling life insurance, all forms of mandatory insurance or insurance services to organisations in which the state holds a stake. The bill requires foreign insurers wishing to gain control of more than 49% of an insurance company to have a 15-year record in their home country and at least two years previous experience in the insurance sector in Russia (through subsidiaries).

This law puts major constraints on the development of the insurance market in Russia. Moreover, according to the law, the minimum charter capital set for foreign insurers – at approximately 20 million roubles or slightly more than US\$700 000 – is ten times higher than that set for Russian entities. This degree of discriminatory treatment is unlikely to attract further foreign capital to the sector.

The insurance market is regulated by a federal executive supervisory body, the Department of Insurance Supervision, which is under the jurisdiction of the Ministry of Finance. Its functions are to oversee the licensing of insurers, set conditions for insurance and reinsurance, rates, standards, and supervise management of insurance reserves, liabilities and accounting procedures.

As a result of consultations between domestic insurers in Russia and the international insurance community the following necessary steps of liberalisation of the market were identified:

- Adoption of a Federal Law on Insurance Supervision.
- Introduction of controls over insurance companies' solvency.

- Application of international accounting standards for the insurance industry.
- Introduction of new sector-specific taxation schemes.

### **Natural monopolies**

Natural monopolies in Russia are defined in the 1995 Federal Law No. 147-FZ. The law governs relations on the Russian market between entities engaged in exploiting natural monopolies, consumers, federal and regional executive authorities and local agencies. The following activities are covered by the legislation:

- Transmission and transport of oil, oil products and gas through pipeline systems.
- Services for the provision of electricity and heating.<sup>1</sup>
- Rail transport.<sup>1</sup>
- Transportation terminal, port and airport services.

The law empowers specific natural monopoly agencies for all the areas listed above to regulate prices and the provision and distribution of commodities to consumers in terms of the rights and interests of citizens, national security and heritage considerations. These agencies oversee government policy in respect of monopolies and monitor transactions involving the right of ownership or use of fixed assets, their capital investments or the sale or lease of their fixed assets in excess of 10% of the value of their latest balance-sheet equity.

No specific provisions for or restrictions on foreign investment in areas classified as natural monopolies are incorporated into this law. Currently foreign participation in several, single-unit natural monopolies considered as "strategic enterprises" is regulated by a number of separate legislative acts.

### **Energy and Gas Sectors**

Among the industries affected by natural monopoly provisions, the energy and gas sectors are of major strategic importance for the Russian economy, accounting for some 45% of Russian exports, 60% of foreign exchange revenue and 20% of GDP. Russia's resources represent about 5% of total world oil reserves and approximately one-third of gas reserves.

The future successful exploitation of these reserves will require considerable foreign capital and technology inputs; to date the level of foreign investment in these sectors has been limited. Output of oil and gas declined by 50% over the ten-year period 1989-1998 and only a major inflow of investment can have a significant impact on this negative trend. The low level of foreign investment is due largely to the unattractive and unstable general and sector-specific investment regime stemming from: lack of comprehensive legislation, property and physical access

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rights; an over-complicated revenue – rather than profit-based tax regime; and market access and price controls. Much of the profits of companies in these sectors have been taken out of the country in recent years instead of being reinvested – although there has recently been a slight reversal in this trend. It is vital that the legislative position of production sharing agreements be clarified and that financing through shares, bonds and loans becomes possible in order to attract and retain external capital in these sectors.

A general legal framework for the exploitation of natural resources, and most specifically the extraction of minerals was established with the enactment of the Subsoil Law in 1992 and its amendment in 1995, although an accompanying Oil and Gas Law is still pending, as are a number of necessary regulations and amendments concerning the *Law on Production Sharing Agreements*.

Conditions of access to oil and gas export pipelines must also be improved, as must investment conditions for private providers of pipeline systems who are currently deterred by the proposed legislation *On Trunk Pipeline Transport* which leaves the control of tariffs and access to the state. Other barriers to investment include the complicated, mainly revenue-oriented environmental legislation which needs to be aligned with international standards.

Licensing of foreign investment projects in energy resources is regulated on a case-by-case basis under the terms of the 1994 government Decree No. 1418 *On the Licensing of Separate Kinds of Activities* and falls under the jurisdiction of different federal entities. Licences are required in respect of the storage of oil and gas and derived products, the generation and distribution of electricity and fuel energy, the erection and repair of energy facilities and equipment. The licensing process is carried out by a number of federal authorities, ministries and local government agencies.

### **Power supply**

The foreign share to be allowed in the capital of the Unified Energy Systems of Russia (RAO UES) is defined by a Federal Law No.74-FZ of May 1998, *On the Particulars of the Management of Stocks of the Russian Joint-Stock Society of Energy and Electrification* where the maximum is currently set at 25%. Paradoxically, this share was exceeded several years ago, before the law in question had been passed, and there now appears to be no legal way to reduce it. Therefore the aforementioned law not only constitutes an infringement of the rights of existing investors, but has no legal basis for implementation. In April 2000 the new management of the Federal Commission for Securities Markets proposed increasing the government stake and decreasing the foreign shareholders' stake through diluting the share capital of the UES. Predictably, this proposal provoked sharp criticism from the investor community and reflected very poorly on the investment climate in Russia.

### ***Gas industry***

Admission of foreign equity to Gazprom, the Russian state gas monopoly, is defined by presidential decrees. The most recent decree of this kind #1316 of October 1998 made it possible to sell off an additional 5% of the government's share in the equity of Gazprom (which was subsequently purchased by Ruhrgas) and brought the maximum foreign participation level to 14%. Gazprom, which controls 25% of the world's natural gas reserves and is Russia's biggest export earner and energy supplier, is in need of substantial reform and restructuring. President Putin has declared his intention to increase government influence over the company and has already taken steps to block the transfer of Gazprom's assets to other subsidiaries or affiliated entities or the dilution of its holdings without board approval. His objective is to transform Gazprom into an efficient and transparent company, restore production levels and profits in line with its access to gas reserves. By putting an end to the present alleged asset-stripping activities of the company and imposing standards of corporate governance, President Putin hopes to send a positive signal to investors regarding his commitment to improving the business and investment climate. With the appropriate regulatory and legislative environment in place, this sector would offer considerable opportunities for foreign investors whose capital is much needed to realise the full potential of Gazprom's resources.

### ***Defense-related industries***

#### ***Aviation industry***

The law regulating the aviation and space industry includes some restrictions on foreign investment activities in the sector. It sets a limit of 25% on the stake of foreign companies in Russian aviation firms and requires that Russian nationals occupy all top management positions in any company. The law has been sharply criticised for a number of years by foreign companies (in particular United Technologies) co-operating with the major Russian aircraft manufacturers.

### **3. Special Rules for Mineral Resource Extraction**

Production Sharing Agreements (PSAs) are used in the Russian Federation to provide a special legal framework for foreign investors in mining, oil, gas and other sectors requiring substantial long-term investment. Such agreements are based on the *Federal Law on Production Sharing Agreements* which was adopted in 1996. They govern relations between federal and local government bodies and foreign investors and have been vital in attracting foreign investment to Russia's natural resource sectors. The main objective of the PSA legislation is to provide a higher

especially letters signed by the chairman of the CBR. All instruments (including the letters and the telegrams) of the CBR are published in its official gazette.

Under Russian legislation presently in force, the CBR lacks the power to require residents to obtain prior approval of the CBR before entering into particular transactions – for example, foreign loan agreements – even when they have a direct relevance for the balance of payments. This problem apparently stems, to some extent, from the view that the imposition of a government approval requirement is, in many cases, an infringement on the freedom of contract enshrined in the Civil Code. In many such cases, however, CBR approval is required in order to make transfers associated with such transactions.

### *Capital flight*

Whether for motives of hiding profits from illegal activities or seeking to avoid reporting income and paying taxes, many enterprises evade compliance with Russia's exchange controls and transfer resources outside of the Russian Federation. In recent years, capital flight has evolved into an endemic feature of the Russian economy, prompting the authorities to fine-tune their use of the artillery of foreign exchange regulations to stem the exodus. Many estimates of capital flight exist, but even on the more modest scale of equating it to part of the net errors and omissions item in the balance of payments, an average level of US\$11 billion per annum was reached during the period 1994-1999. More comprehensive estimates for 1999 and 2000 indicate that the annual level may in fact be closer to US\$20 billion and is increasing, despite the substantial growth in foreign exchange reserves at the CBR.<sup>2</sup>

Given the magnitude and pervasiveness of this problem, it is difficult for the Russian authorities to enforce compliance with Russia's exchange controls. A number of different techniques are used by firms to avoid compliance, and authorised banks do not always adequately perform their obligations as agents of exchange control, nor do they always have the tools required (such as the right to stop a suspicious payment when all accompanying documents are in order). In addition, the sanctions available under Russian legislation to deal with cases of non-compliance are, according to the CBR, inadequate. Additionally, the authorities have encountered difficulties in successfully prosecuting cases of non-compliance in the courts.

The channels of capital flight are well established and recognised, including 1) underreporting of export earnings, 2) overstatement of import payments (including fake contracts), 3) fake advance import payments and 4) a panoply of capital account transactions effected through correspondent accounts of non-resident banks with Russian banks.

Since the August 1998 crisis, the authorities have been seeking to stem capital flight through a number of additional restrictions on both current and capital account regulations, of which some are in contravention of the obligations assumed under Article VIII, thus requiring special approval from the IMF.

#### ***The role of authorised banks in foreign exchange operations***

To transact foreign-exchange-related business banks must be authorised by the CBR. Presently there are about 800 such banks which act as authorised banks and as agents of foreign exchange control. Authorised banks have to examine the documents presented to them by residents and non-residents and on the basis of these documents execute the transactions. In addition, they participate in the foreign exchange market, both in the interbank foreign exchange segment and (the largest banks) also in the sessions of the currency exchanges.

Among this relatively high number of authorised banks, some enter into fraudulent transactions themselves or assist their clients to engage in such activities. Consequently, the system of empowering banks as agents of exchange control does not function as smoothly in Russia as it does in many other countries.

#### ***Controls on current transactions***

Regarding foreign trade-related payments, the Russian Federation maintains a fairly sophisticated system of registration. In the case of exports and imports of goods, export and import shipments are accompanied by "deal passports" that record the most important data concerning the contract, including the payment deadlines. The banks enter the information from the deal passports into their own databases which are directly linked to that of the CBR and the customs authorities. In the case of exports, the authorised bank uses this deal passport to verify whether export proceeds have been repatriated in full into the Russian Federation. If this is not the case, the bank has the obligation to report to the CBR, the tax authorities, the customs, and the Ministry of Finance. As for imports, the deal passport attested to by the bank has to be presented by the importer to the customs authorities in order to receive the goods.

Serious problems arise with the import of services. The authorities do not require residents to obtain prior approval before entering into such transactions. According to the CBR, payments under fraudulent services transactions are apparently a principal avenue of capital flight; the only documentation usually required for the making of payments for the imports of services is a contract (which can be fraudulent). Furthermore, as described above, some resident banks tolerate (and, in some cases, participate in) capital flight associated with fraudulent services transactions.

budgetary execution extremely difficult for regional and local officials. These conditions do not provide incentives for responsible budgetary execution policies, but can serve as partial explanation for the rent-seeking activities by these officials, when coupled with the low pay available to civil servants. In addition, sanctions for such irresponsible activities are not easily imposed, given the size of the Federation and the information and other advantages enjoyed at local level.

It should also be mentioned that local officials enjoy a number of tools other than formal fiscal authority that can be used in their relations with investors to circumvent limits on tax autonomy. The regional and local officials control licensing of various forms of activity, water supply, access to privileges for settling taxes and energy payments, offsets, protection from bankruptcy, inspections and even guarantees for commercial loans. Sub-national authorities are not infrequently partners in local commercial enterprises and financial institutions. The leverage is substantial and every investor in Russia has become keenly aware of the need to maintain good relations with the local administration. Extra-budgetary funds represent an additional tool through which local administrations can exert pressure on investors, by encouraging "voluntary" contributions.

### 3. Investor Concern with Specific Forms of Tax Liability

#### *Experience to date*

Although many foreign investors have complained about the excessive tax burden they have incurred to carry on their operations in the Russian Federation, their problems have not originated so much from the statutory level of the taxes imposed at federal, regional or local level. Statutory tax rates in Russia were in fact not very high by world standards – other than in the case of wage taxes – even before the recent tax reform.<sup>1</sup> It has more been a question of the multitude of different taxes levied and, primarily, the methods of determination of the actual tax base.

Many studies and reports have pointed to the fact that the Russian tax system consistently discourages investment, both through its structure and the way it has been implemented. This fact remains true for domestic as well as foreign investors, whether we discuss start-ups of new business or the restructuring of existing firms. A powerful driving force for the recent reform measures was that the sheer number of particular taxes and exemptions as well as the frequent changes in rules and regulations had created a degree of uncertainty which impacts negatively on business development as a whole.

That this situation has prevailed throughout the transition period cannot be ascribed to a lack of understanding of the importance of a fair and equitable, stable and efficient tax system for furthering investment and output growth. Russian

policymakers and experts drafted a new tax code based on such principles as early as 1993, but this and subsequent reform initiatives have for many years been mired in political controversy, both at federal and regional level, often becoming hostage to other political bargains. It is often pointed out that the primary reason for failure of comprehensive tax reform in Russia is the relationship between federal and sub-federal authorities and the lack of an efficient system of fiscal federalism.

As described above, the situation improved substantially after *Part One of the Tax Code* entered into force 1 January 1999. In addition to clarifying the rights and obligations of taxpayers, it rendered the whole spirit of interpretation of tax legislation more favourable to taxpayers. A further amendment in August 1999 strengthened the tax authorities' ability to enforce tax compliance and collection.

Progress with the reform of other parts of the tax legislation, which addresses the problems of determining actual tax rates imposable at federal, regional and local level has now been confirmed for four major taxes (VAT, excise taxes, personal income tax and unified social tax) through the passage of *Part Two of the Tax Code* in the Summer of 2000. However, the particular reforms that will significantly reduce the profits tax base for enterprises have not yet passed and can probably only enter into force in the year 2002 or later.

From discussions with major foreign investors in Russia within the framework of the FIAC (Foreign Investor Advisory Council) one might conclude that, despite this tangible progress, not all of the previous specific grievances have been eliminated. Many rates and exemptions still remain unstable, being frequently altered with the objective of increasing short-term tax collection. The existence of numerous so-called nuisance taxes at all levels which are not producing significant revenue to the authorities (but rather serve to perpetuate rent-seeking and corruption by individual officials) is still a fact although the practice is being discouraged in the tax reform package. The enforcement of the new, stricter regulation as to which taxes may be introduced by constituent entities within the Federation, and by local authorities still must be strengthened.

A short overview of the major types of taxes that apply to businesses in Russia is necessary to explain where problems have most frequently occurred and/or are likely to persist:

Although quite similar to the major taxes that apply to businesses in more advanced economies, the Russian versions of these taxes often do not apply mechanically or economically. The result is that the total liability of a Russian business for the taxes is usually higher than a simple comparison of statutory tax rates with a modern Western economy would seem to imply.

Table 1 summarises the major Russian taxes, the tax bases for the taxes, and the generally applicable tax rates, followed by an indication of the reforms

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The long-term strategic plan for the Russian economy proposed to the Putin administration<sup>2</sup> clearly recognises the weaknesses in the financial infrastructure, pointing to the lack of attractiveness of banking business and the lack of proper banking supervision as two major reasons for the current unsatisfactory situation. In order to further the development of the banking sector, the plan suggests that an immediate priority is the exit of non-viable institutions from the system, by :

- Withdrawing licenses from institutions with negative capital as well as from those that intentionally fail to observe adequate financial accountability.
- Carrying out a detailed inspection of the 100 largest banks with respect to their calculation of capital cover and compliance with supervisory norms.

A number of other immediate or medium-term measures are also proposed, including the introduction of international accounting standards for banks, elimination of turnover taxes on banking operations, allowing further tax deductibility for loan loss provisioning, removal of general licences for currency operations from a large number of banks that do not comply with attendant reporting requirements, establishing the legal and regulatory framework for specialised credit institutions such as credit co-operatives and mortgage banks. As to banking supervision, it is envisaged to make it more effective by centralising the oversight of the 100 largest banks and creating an interregional structure for supervision of the remaining credit organisations in the territories. Measures for the development of capital markets are also proposed in the plan, with an emphasis on the stimulation of long-term savings, via support for the further development of collective investment institutions, and on the establishment of stricter and more effectively enforced rules of conduct for market participants.

Sections 3 to 7 of this chapter give an overview of the situation in the Russian banking sector and the degree of development in other sectors of the domestic financial market, in order to describe the environment within which investors seek to raise funds for projects and working capital.

## 2. Current Situation in the Banking Sector

### *Legal and institutional background*

The Russian banking sector consists of the CBR, which is responsible for the exercise of monetary policy and banking supervision, and at present<sup>3</sup> some 1 300 active banks and other credit institutions (out of a total of 2 124 registered credit institutions). As of 1 January 2001, the total registered capital of active banks and credit organisations amounted to 207 billion roubles, (US\$7.4 billion) or a mere 3.7% of estimated 2000 GDP.

The 1995 Law on the CBR confirms its status as an independent agency, accountable to the Duma, which appoints and can dismiss its chairman, nominated by the President. Both the Chairman and the 12-member Board of Directors are appointed for 4-year terms. Decisions are based on a majority vote with a quorum of seven, including the Chairman. There are a number of state-owned banks, of which Sberbank, the large savings institution surviving from the communist era, is the largest, accounting for over three quarters of all household deposits and one quarter of all banking sector assets, as well as nearly half of the total number of bank branches across the Federation. Other state banks are Vneshtorgbank (the foreign trade bank) and Vneshekonombank, which handles the external debt operations of the federal government. In addition, the CBR owns a number of commercial banks abroad. The government-owned share of total capital in the banking sector is currently 35.7%, while the share of non-resident institutions is estimated at slightly above 8%.

Only a minority of the over 1 300 private banks have their origin in the commercial banking departments of the former Soviet state banks. The rest are institutions established since 1990, in most cases to participate in lucrative foreign exchange and trade financing operations. Initially, licensing conditions were extremely lenient and capitalisation of most banks has remained extremely low, even though requirements in this respect were gradually tightened by the CBR. In the run-up to the financial crisis, capitalisation levels were still extremely low, with Sberbank constituting a major exception. Bad loan problems were substantial, although in many cases hidden by repeated rollovers of loans with capitalisation of interest. According to CBR's estimates about one-third of all licensed banks were either experiencing serious financial difficulties or were in a critical financial condition at end of 1997.

### **Payments System**

Due to some remaining shortcomings in telecommunications resources and availability software, the Russian payments system is not yet seen as fully up to international standards. The 1998 banking crisis and consequent shrinkage of inter-bank relations explain the fact that the CBR still acts as a clearing centre for many banks with underdeveloped correspondent accounts. Bank transfer is the most frequently use payments vehicle. Cheques are rarely used due to the slowness of the cheque clearing system. The afore-mentioned strategic development plan for the financial sector specifically includes modernisation of the payments system to ensure real-time interregional settlement services for Russian banks as an important objective. Modern systems for electronic settlement have been installed by the major Russian commercial banks, but payments delays still occur even in main business centres. Although banks are technically liable to compensate clients for these delays, such rights are not always enforceable.

### **Intermediation Role**

Despite the large number of banks still in existence, banking accounts for a small portion of economic activity by international comparisons. In mid-1998, total commercial bank assets amounted to about 30% of GDP, while total household and non-government deposits accounted for some 9% of GDP. In December 2000, more than two years after the banking crisis, these figures had risen to 41% and 9.5%. (The 9.5% can be compared to the deposit bases of some other transition countries such as Poland, Hungary and the Czech Republic ranging from 40% to 60% of GDP.) The sector is also highly concentrated, with the 200 largest banks accounting for 90% of the system's total assets as of 1 December 2000. At the top of the pyramid, 93 banks have a capitalisation in excess of 300 million roubles (US\$10.5 million) and the five largest among these accounted for 41% of total banking sector assets. Over 700 banks – *i.e.* more than half of the total number – have a capitalisation at or below US\$1 million. Concentration in Moscow is significant, with over 47% of the active banks headquartered in the capital, a tendency which was further strengthened in the post-crisis period. Very few banks apart from Sberbank have an extensive branch network conducting retail business on a country-wide basis. As of 1 January 2001, there were only 3793 branches throughout the vast regions of the Russian Federation, with Sberbank accounting for nearly half and the troubled SBS-Agro Bank (currently under temporary administration) for another third. According to CBR data, the average density of the banking network across the Federation works out at one office (branch, office or cash dispensary) per 5 thousand inhabitants. Large interregional variations exist, with 14 regions exhibiting a density of only one office per ten thousand inhabitants, and the regions closer to Russia's European borders showing a density of one office per 4 thousand inhabitants.

Nominal deposit rates offered by banks have been substantially below lending rates since 1995, and the average net interest margin narrowed to about 11 percentage points only at end of 2000 with respect to the enterprise sector. For household loans and deposits, the net interest margin was closer to 18 percentage points. This is partly explained by the low penetration of banks, particularly at regional level, and by a lack of competition in attracting household deposits. It is also relevant that Sberbank deposits are *de facto* government guaranteed, while for other banks there is as yet no formal deposit insurance system, although a proposal for a federally funded scheme is under consideration by the Duma. On the lending side, the high rates reflect both the high yield available up to the crisis on government securities and the real risk of lending in an environment with unclear property rights, non-transparent accounting and regulations for claiming collateral which are either seen as lax or unenforceable.

The main activity of the commercial banks is short-term lending, as the macro-economic and political environment have generally combined to discourage

shifted to new, "mirror" banks, leaving impaired loans and liabilities in the original institutions. The adoption by the Duma of a new *Law on Bank restructuring* in June 1999 gave sole responsibility for bank restructuring to ARKO, with new, mandatory powers, including an equitable and transparent mechanism for share write-downs and the possibility to unwind transactions previously undertaken with the intent to defraud depositors and creditors of insolvent banks. The CBR undertook to limit any support to solvent banks or to those undergoing ARKO-approved restructuring programmes, and only offer regular facilities with full collateralisation. Despite the establishment of the institutional and legal basis for restructuring, little progress has been made to date, partly because the court system proved a formidable obstacle to rapid action. The CBR and ARKO are deepening their co-operation in the restructuring effort, from identifying problem banks to enforcing implementation of remedial measures. As to the concrete steps taken by ARKO after being vested with additional powers, a total of 19 banks had been officially brought under its programmes by the end of the third quarter of 2000 – of which 14 were in the process of implementing formally approved restructuring plans.

#### ***Improvements to supervision and oversight***

The *Laws On Banks and Banking Activities* and *On the Central Bank of the Russian Federation* passed by the Duma in 1995 set out rules for licensing bank operations and required reporting to the CBR. These laws, subsequently strengthened by the *Law on Bankruptcy of Credit Organisations* mentioned above, provide the legal basis for the CBR to monitor banking activities and revoke licenses upon a bank's failure to meet its obligations. Since 1995, the CBR has gradually strengthened its supervisory and regulatory control of the banking system, including the formation of a special unit, the OPERU-2, to monitor the activities of the 14 largest institutions. Capital adequacy ratios have been raised, a new Chart of Accounts was introduced from the beginning of 1998 as an important step towards adapting to internationally accepted accounting standards, and there has been an overall tightening of licensing procedures. In 1998, banks were also required to establish internal risk management controls and adopt new provisioning rules for non-performing loans. However, as described above, the 1998 financial crisis dealt a severe blow to the planned up-grading of accountability and compliance within the banking system.

Further progress is now planned on prudential regulation. Minimum capital levels of 1 to 5 million Euros will be effective during 2001 and only those meeting the 5 million level will receive full licenses, while smaller banks will be limited as to activities and geographical scope. Mandatory capital adequacy levels were to be raised to 8% from 1999 but this reform clearly needs to be supported through a