

International Financial Centre in Moscow: Progress in Regulation, Lack of Domestic Investors

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Last year was breakthrough in the process of developing a legislative base for the establishment of an international financial centre in Moscow. In the last 17 months, four fundamental laws have been passed:

- «On Prevention of Illegal Use of Insider Information and Market Manipulation» (The Insider Dealing Act) (No. 224-FZ from 27.07.2010);
- «On Clearing and Clearing Activity» (Federal Law No. 7 from 07.02.2011);
- «On Organized Auctions» (No. 325-FZ from 21.11.2011);
- «On the Central Depository» (No. 414-FZ from 07.12.2011).

For some of these laws, it took fifteen years to develop and prepare.

Adoption of these laws effectively means the completion of the process of the legislative base development for the Russian financial market. Therefore, the rule-making agenda for 2012 includes only bylaws to complement and detail the adopted legislation. Further improvement of the efficiency of regulation will depend on the correct implementation and application of the system rather than on new laws. At the same time, there are some important issues that remain unresolved at the legislative level, namely those connected with the taxation of income from investments in financial instruments. These issues, if unresolved, will continue to have a negative impact on the global competitiveness of Russia's financial market.

The merger of Russia's two largest stock exchanges, which together accounted for 99.97% of the total securities turnover, was another event of significant importance.

The new exchange, which was temporarily named by a simple merger of the two brands, MICEX-RTS, has immediately demonstrated the benefits of the merger. For example, unlike in the period of competition between the two exchanges, in the process of development of new listing requirements the incorporated exchange takes much more into account interests of investors and the world's best practices. In particular, in the development of corporate governance requirements the current approach of the Russian exchanges is very close to the one adopted by their Brazilian colleagues. Besides, as early as this year the newly created MICEX-RTS exchange plans to carry out an IPO, in which many large and authoritative financial institutions plan to participate. This will certainly increase the appeal of MICEX-RTS in the eyes of foreign investors.

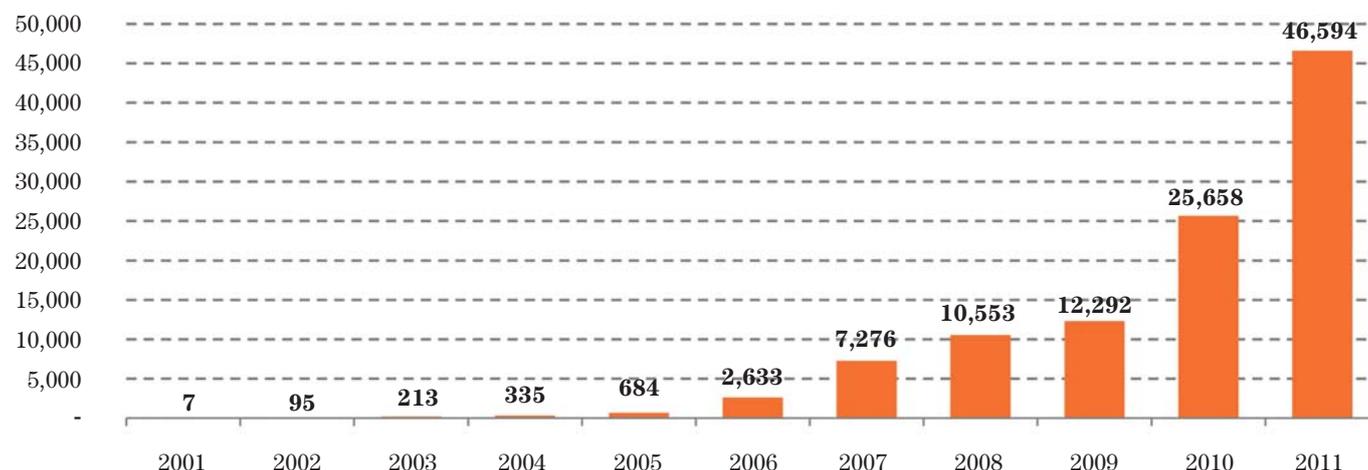
At the same time, if in respect of the legal base formation the job is 90% complete, in the area of improving the effectiveness of institutional environment there have been only one achievement, namely the stock exchange merger, which correspondingly led to the incorporation of the registration and settlement institutions and the establishment of a central depository. However, indemnification funds are

yet to be established, as well as the mechanisms providing effective access on the financial market for small investors are to be developed and implemented.

According to the estimates of the management of the incorporated exchange, the merger and the adoption of the aforementioned legislation should lead in the short term to the three-fold increase of the trading turnover, in particular due to the redistribution in favour of the Russian stock market of the external turnover of Russian assets that are traditionally concentrated in London. At the same time, there are opposing opinions that the adoption of the law «On the central depository» and Russia's accession to the WTO will result in the outflow of operations with Russian financial assets from Russia due to the fact that foreign investors would want to carry out transactions with Russian financial assets through international settlement organisations. At present, the discussion about the possibility of such a scenario developing, its consequences and ways to mitigate the resulting risks is very active in the Russian financial sphere.

The domestic market sees a continuing positive trend of the increasing stock exchange turnover. Since 2008, significant growth has been observed in all segments of the market; however the fastest rates were seen on the forward market. Since 2006 every year (except

Futures and options on index and single shares, trading volume (notional value), RUR bln



for 2009) the volume of transactions with futures and options on certain securities and share indexes doubled, and in 2011 the volume of transactions in derivatives was 68 times higher than that in 2005. As a result, the Russian forward market became one of the world's largest ones.

Unfortunately, there is also another important aspect of the process of development of an international financial centre in Moscow, which remains quite weak. It is the investments. In Russia there is still no long-term domestic investor. So, by the ratio of net assets of open-end and interval investment funds to gross domestic product (0.17% as at the end of 2011) Russia is the last among the countries monitored by the Investment Company Institute. The ratio of total assets of investment funds (including the closed ones), total pension reserves and pension accumulated funds to the gross domestic product is as low as 5.2% as at the end of 2011.

After the sharp phase of the crisis, in 2010-2012 domestic savings and investments did not increase significantly. The real growth of capital investments was mainly driven by the state spending and accounted for a moderate 6%. Investment activity of private companies remains at a very low level, resulting in the net capital outflow of USD 84 bln in 2011 and of about USD 30 billion in 1Q 2012.

On the contrary, the consumer activity is high despite the fact that the real disposable income somewhat stagnated. Household savings are falling in spite of the fact that inflation is decreasing and interest rates on bank deposits are going up. The population returned to the credit model of consumption – about 30% of the retail turnover increase is financed

by bank credits. Moreover, the growth of consumer loans at a rate exceeding the growth of GDP is fixed in the government's forecast till 2030.

The structure of savings of the Russian population remains the "upside-down" one: on the first place there are bank deposits which are during the crisis periods being replaced by foreign currency purchases, on the second – real estate investments; on the third – accumulation of cash rubles, and only on the fourth – purchases of securities and shares of investment funds. The share of the latter in the total savings of households went down during the last twelve years from 15.6% to 1.7%.

Absence of domestic investors is the major factor underlying many negative tendencies observed on the Russian financial market, in particular, the escape of Russian IPOs abroad. Not finding stable and sufficient demand on the domestic market, Russian enterprises prefer to carry out share placements in London and Hong Kong. Last year, in addition to the "emigration" of issues, there was also the "emigration" of issuers, when some large Russian holdings changed their jurisdiction. Besides, there is an emerging process of delisting of Russian companies from the national exchange, which is being restricted mostly by administrative methods.

In the new political cycle, the programs and strategies for long-term social and economic development of Russia are being elaborated. On the order of the Russian Government, a group of experts prepared a report «Strategy-2020: new model of growth – new social policy», which is an amended version of the strategy that was prepared in 2008

before the crisis. In the original report the emphasis was on oil revenues and high degree of state participation in the economy. The newly released version concludes that in order to sustain Russia's economic growth, the state should cut back on its participation in the economy, thus spurring modernisation, and that innovations can be stimulated by supporting human capital assets and the so-called "creative class". The Ministry for Economic Development of the Russian Federation presented to the Government «Scenarios for long-term social and economic development of the Russian Federation up to 2030». In this long-term outlook, two main scenarios for Russia's economic development are presented – the resources-oriented development and the innovation-focused one. The report offers to choose the innovation-focused scenario, which is based on active development of high technologies, improvement of labour productivity and human capital, and country-wide introduction of new technologies. Clearly, innovative development and modernisation of the Russian economy is high on the government's agenda, and it should include measures to ensure progressive development of the financial market and private investments.

Unfortunately, so far the government plans do not envisage strong actions to stimulate the emergence of long-term domestic investors, including retail investors or investors that would utilise household savings. It seems that the overcoming these structural disproportions should become the Government's priority in the sphere of the financial market development, along with the objective to improve the country's investment climate.

Retail turnover and household's real disposable income, % Y-o-Y

