

Section 4. Institutional and Macroeconomic Challenges

4.1. The Dynamics of the Privatization Process in Russia

As the name suggests, the entire period of the so-called ‘cash’ privatization (from 1994 until now) was primarily influenced by budget considerations and it was not uncommon for biggest and most important deals to get governmental approval only by the end of the year, incidentally also the time for reconciliation of budget revenues.

All the more heartening that since 1999 the government at least no longer expects on receiving a fixed amount of revenue from privatization, which hopefully would translate itself into a sounder privatization policy.

Table 1

Revenues from Sale and Use of State Property between 1995-2003 (in current terms¹)

	1995	1996	1997	1998	1999	2000	2001	2002	2003 (est)
Actual Number of Privatized Enterprises									
	6000	5000	3000	2583	595	320	170	2200 (planned)	1063 (planned)
Revenues from Sale of State Property (non-renewable source) in billion Rubles									
Approved Budget in rubles	4,991 all revenues	12,3 all revenues	6,525 all revenues	8,125 (c)	15 (e)	18	18	35	51
Actually Received Funds in rubles	7,319 (a)	1,532	18,1 (b)	15,442 (d)	8,547	31,368	10,11	91,2 (f)	-
Actual Revenues from Use of State Property (renewable source) in billion Rubles									
Dividends on Federally-Owned Stakes in Enterprises	92,8	118 (35 JSC)	270,5	575 (200 JSC)	848 (600 JSC)	3,675 (1050 JSC)	6,478	10,25 (708 JSC)	10,5
Payments on Lease of State Property	116,7	N.D.	305	466	2,191	3,427	4,896 on assets 3,917 from land	7,843 on assets 2,3 from land	7,3
Revenues (profits) from State-Owned Enterprises	-	5	26	783 from Vi-etsovpetro (VS)	5,675 from VS	11,687 from VS	13,622 from VS; 209 from 131 State Unitary Enterprises	9,9 – VS .9 from 809 State Unitary Enterprises	12,3 – VS, 2,5 from State Unitary Enterprises
Total	209,5	123	610,7	1,824	8,714	18,789	29,122	31,19	-
Cumulative Revenue from Use and Sale of State Property in billion Rubles									
Actually Received	7,529	1,655	18,702	17,266	17,262	50,157	39,233	122,39 vs. 70,6 planned	-

Since 2001 another positive trend regarding state property and its effect on the budget came with a shift of reliance from non-renewable to renewable sources of income. In other words instead of receiving big one-off sums for selling its property the government is now

¹ a) approved budget was adjusted in December 1995, 70.8 % of actual revenue came from share-for-loans auctions; (b) including US\$1.875 billion from sale of stake in Svyazinvest holding; (c) adjusted to 15 billion rubles in April 1998 (on governmental level); (d) including 12.5 billion rubles from sale of 2.5% stake in Gazprom; (e) from 1999 funds from privatization are not included in the budget revenue; (f) includes .775 and 1.86 billion from the sale of state stakes in Lukoil and Slavneft respectively

more keen on extracting stable revenue via retaining and better management of its assets. Thus in 2001, 75% of government's cumulative revenue from its property (includes sale and use) came from renewable resources, whereas in 1997 that number amounted to only 3%. Encouragingly enough the trend continued in 2002 and the government's revenue from renewable resources 3 times exceeded the sums received from privatization (excluding a deal on Slavneft and Lukoil shares which remained uncertain till the end of the year).

Preliminary 2002 data from the Ministry of Property the cumulative budget revenues from use and sale of state property amounted to 122.39 billion rubles, three times the number from previous year. Cumulative income from use of state-owned property came up to be 31.19 billion rubles including the 7.8 billion from property lease, 10.25 billion from dividends on state-owned shares, 9.9 billion from the shares in Vietsovpetro, 2.3 billion from lease payments on federally-owned land and 0.9 billion from profits in state unitary enterprises. In the meantime revenues from sale of state property in 2002 were only 91.2 billion rubles with more than 80% of that sum coming from 2 large deals in (surprise!) December of 2002 (sale of stakes in Slavneft and Lukoil). Sale of state-owned land brought in .6 billion rubles.

Although the new privatization Law came into force only in 2002 much of the privatization program for the year is based on changes introduced by this legislation. Thus the privatization program expects that thanks to a row of newly available methods of privatization the government would be able to get rid off its minority stakes and illiquid holdings and thereby drastically reduce the number of entities in state ownership, a goal that has been widely discussed since the mid-nineties. This should also apply to state unitary enterprises a number of which, especially with November 14, 2002 enactment of Law on State and Municipal unitary Enterprises, is expected to be cut to 2.5 thousand by the end of 2003. In addition, reorganization of such enterprises (mergers, liquidations, incorporation, partial sale, etc) would also affect their subsidiaries.

However ambitious the Property Ministry's plans appear at a first glance, most of actual privatization revenues come from large individual sales. Often, final decisions on whether to put a particular enterprise up for sale are made abruptly and arbitrarily, regardless of an approved privatization plan. At the same time sale of other enterprises can be put off a year after a year, and similarly, a deal on a verge of being closed can be cancelled at the last moment.

In 2002 state-owned stakes in the following enterprises were expected to go for sale: Lukoil (5.9%), Slavneft (19.68%), Eastern Oil Company – EOC (36.817%), Svyazinvest, a telecom holding (25% minus 2 shares), Vorkutaygol (38.41%), Magnitogorskii Metallurgic Plant (17.77%) and a number of others.

On May 24, 2002 results of the EOC auction were announced and Yukos' victory did not come as a surprise. Since Yukos is already a majority stakeholder the final bidding price exceeded the starting bid (\$225 million) by only \$.4 million. Conveniently, TNK, Yukos' main contender made a decision to withdraw from the auction following a scandalous court row and, also, perhaps, due to an understanding that Yukos was unlikely to let go of shares of EOC subsidiaries.

State-owned 5.9 % stake in Lukoil was planned to go up for sale in the form of ADR on London Stock Exchange in August 2002. The Board of Directors presiding over Privatization Project Company, an outfit responsible for the sale deemed the price offered at the time too low (close to current price offered at the Russian Stock Exchange) and suspended the sale. The stake was finally sold in December 2002 for what some sources cite was a maximum feasible price of \$15.5 per share with demand outstripping supply by a factor of 2 and the Rus-



sian government walked away from the deal with a total of \$775 million. It still owns a hefty 7.6% in Lukoil and has no immediate plans to sell the stake, although any decision to do so would obviously depend on the world oil prices as well as the company's success at restructuring.

Sale of government's stake in Svayzinvest, a telecom holding was also scheduled for 2002 but did not go through and is now included in the 2003 privatization plan. A need for further consolidation of the holding and creation of 7 interregional operators, which would be completed only by the end of 2002 were cited as possible reasons for the sale postponement. In addition, the government hopes that a tariff reform would help the company raise its capitalization, and with it the value of state stake in the company.

Table 2

2002 Privatization Program

	Total number of Entities in Possession of the Russian Federation	% of total registered in the Russian Federation	Designated for Privatization in 2002 (2001 Privat'n Plan)	Additional list of Privatization Designated Entities from the new Law
Federal <i>UNITARY</i> Enterprises (FUE) Total FUE 20,000, and 65,000 municipal	9394 (9708 as of October 2002)	12	152	1500
Joint Stock Companies with shares owned by the state	4407	9	426	700
Including state stakes of:				
100%	90	-	6	-
above 50%	646	-	33	-
25-50%	1401	-	127	-
25% and less	2270	-	260	-
<i>GOLDEN</i> share	750	-	-	-

Source: data from the Ministry of State Property, and the currently updated Property Registrar of the Russian Federation. Data from this Table can be compared with data from September 1, 2001: 9855 federally owned *UNITARY* enterprises and stakes in 4308 joint stock companies. Some sources claim that the number of joint stock companies with state stakes exceeds 6,000 far from completion and creation of Federal *UNITARY* Enterprise Registrar.

A more complicated story concerns the sale of state-owned 19.68% stake in Slavneft. Initially, a simple auction was scheduled for October-November 2002 with an expectation that it would raise somewhere between \$300-350 million. The mechanism of sale, however was subsequently changed several times and scandals involving changes in Slavneft management all but guaranteed a 'delicate' nature of the deal. First of all, the stake in Slavneft was the last Russian oil company where a major state-owned stake was offered for sale (the government has not plans to privatize Rosneft anytime soon). Add to that a bitter feud between various industrial and financial clans, an "international" element brought in by the Belarusian-owned stake of 10.83% and here is a Russian privatization drama.

Prior to the privatization, the Russian government owned 75% of Slavneft shares (55.27% were held by the Ministry of Property, 19.68% belonged to *RFII*). DKK, a closed joint stock company owed another 13.18% (Sibneft and TNK owed 25% each of the remaining stake and the rest of the shareholders are unknown).

The battle for the government's stake fired up well before the start of the auction. In April, 2002 Mr. Gutziriev was replaced from this post of President of the company by Mr. Sukhanov who was widely seen as a Sibneft favorite. While the government was busy discussing various models for privatization of Slavneft, Sibneft and TNK were buying up shares of Slavneft subsidiaries. Such acquisitions (blocking stakes in Yaroslavnefteorgsintez and Megionneftegaz among others) allowed TNK and Sibneft not only send an unambiguous warning to potential rivals but also gain considerable leverage for making changes in the Board of Directors and issue additional shares. Control over subsidiary companies also reduces a risk of harsh competition for buying up the holding company itself and lays out the necessary groundwork for consolidating the companies' shares and ultimately obtaining a controlling stake in the future.

The government in the meantime has reconsidered its initial plan to sell only 19.69% of Slavneft stake thus retaining government control and changed a scenario in favor of what some experts argued was going to be a more transparent and competition-enhancing deal of selling an entire controlling stake of 74.95%.

Sadly when the sale did go through on December 18, 2002 competition hardly triumphed. The 74.95% stake of about 3.5 billion went to Investoil, a Sibneft's and TNK frontage for \$1.86 billion, a merciful increase over the starting price of \$1.7 billion and significantly below expert estimates of \$2-4 billion. Although the high end of that range was probably exaggerated given the TNK and Sibneft control over major stakes in Slavneft's subsidiaries, a fair auction and a higher return for the government could have taken place.

Even a faintest chance for competition was eliminated when TNK's and Sibneft's main possible rivals in the bid, Lukoil, Surgutneftegas and Yukos withdrew literally on the eve of the auction. The spokespersons for the companies muttered something about unexpected financial and legal difficulties. Rosneft's participation in the auction (legally murky from the very start, it is after all a state-owned company) was ordered to withdraw by a regional Court. CNCP, a Chinese petroleum company and potentially the most dangerous rival was also forced to pull out under threats that its victory would be deemed invalid. Apparently the government suddenly changed its initial zeal to attract foreign bidders to the deal. All in all, 7 companies withdrew from the auction and the 7 remaining were in one way or the other affiliated with the interests of TNK and Sibneft. Clearly, large privatization deals in Russia remain beyond mere economics, while political muscle still generates a lot more than simple respect.

As a result of the auction, the two winning companies now owe 98.96% of Slavneft shares. Although at this point it is unclear what kind of re-structuring the new owners plan to undertake, their attitude to minority stakeholders is obvious. Article 80 of the Law on Joint Stock Companies clearly states, that a majority shareholder (30% of shares and above) must make an offer to purchase shares from minority shareholders at a price no-lower than a 6 month weighted average. The new majority shareholders at Slavneft, however, intend to avoid the 'cumbersome' procedure by pushing for an appropriate vote in the general shareholder meeting.

Such unfair moves could be forestalled with right changes in the Law on the Joint Stock Companies that would specify minority shareholder rights in cases of mergers and buy-outs of 95% of shares and above. A similar law is already planned in the European Union.

The government approved the new 2003 privatization plan on August 20, 2002 (amended on October 9, 2002), according to which the revenue from privatization in 2003



should amount to about 51 billion rubles. Please see table 1 for details on renewable sources of income. Land privatization is expected to generate approximately 2.2 billion rubles.

The privatization plan also calls for sale of 628 joint stock companies (including 598 joint stock companies, or 95% from the total thus completing the privatization process) and 435 Federal unitary enterprises (fue). The remaining state-owned joint stock companies would continue to have state ownership of 51 and 25.5% of charter capital respectively (this sentence makes little obvious sense). fue, privatization of which is considered at the Ministry for Property as a primary goal for this year, would be re-organized into joint stock companies or sold in their entirety as commercial or industrial complexes.

In 2003, joint stock companies and fue in the agrarian, energy and defense industries would be affected the most.

In the energy sector, the plan calls for sale of government stakes in oil and gas companies, electricity generation and transmission enterprises as well as a completion of privatization of the coal-mining sector.

Most of the agrarian sector is already in private hands and the plan focuses on further privatization of baking and food storage companies.

A number of enterprises listed in the 2003 privatization list are in the maritime and auto transport industry.

Some of the larger planned privatizations concern the sale of government stakes in Svyazinvest (25.5% minus 2 shares), Magnitogorsk Metallurgic Plant (17.84%), commercial port Pevek, Baikal airline, etc.

The government also plans to divest of its stakes in 600 (714 apparent) commercial banks, a majority of which (about 80%) are currently held by the Ministry of Property.

Beside launching of a whole row of new privatization models, the new 2001 Privatization Law brought about another interesting innovation specified in the December 3, 2002 Governmental Decree # 845. The Law now allows exchange professionals (i.e. brokers and brokerage companies) to take part in privatizations, who for instance, can win a right to represent the government when it tries to sell its stakes on the market. A well-meaning innovation, granted of course, that the selection process for a market intermediary is based on objective professional factors and not on a whim and fancy of a bureaucrat in charge.

Appendix 6. New Privatization Methods and Their Legal Provisions

The numerous changes proposed by the 2001 Law on Privatization acquired a more concrete shape by summer of 2002.

On May 31, 2002 the Russian government passed a Decree On Affirmation of Rules for Determining a normative Price for Privatization of State and Municipal Property. normative price is defined as a minimum price at which state divestiture of a particular piece of property is acceptable.

According to the aforementioned decree, such normative price for privatization of a federal unitary enterprise has to be based on figures from an interim accounting report prepared in compliance with Russian legislation on privatization of clean assets belonging to a state unitary enterprise. That includes the following guidelines:

- a) value of land that is a part of an enterprise being privatized has to be calculated in accordance with norms and regulations envisaged by the Russian legislation for purchase of land plots

- b) value of a stake (share, contribution) to charter (*joint*) capital of enterprises as short-term and long-term financial contributions has to be calculated on the basis of the normative price for the said property;
- c) value-added tax has to be levied on assets purchased as a result of privatization
- d) book value of assets that are not covered by a privatization deal should not be included in the calculations
- e) Expired debt obligations should not be included in the price calculations

Normative price of a unitary enterprise calculated for its transformation into a joint stock company can only be used for determining a share price of the newly created venture.

If no more than a year passes by since the date of a jsc registration (transformed from a unitary enterprise) and till the date when a normative price for its shares is determined, the latter shall be adjusted by multiplying the normative price of a firm's assets by a proportion of state-owned shares intended for sale, lawfully determined control coefficient and "golden share."

Otherwise, i.e. more than year passes by since the date of a JSC registration till the date when a normative price for its shares is determined, or if a firm has not been transformed and registered as a jsc, then a normative price for its assets intended for sale is equals a weighted average of the following figures in a company's last accounting report (value of shares based on net profits, value of shares according to sales results, market value of shares, and book value) multiplied by a "golden share" coefficient.

A government decree #512, from July 9, 2002 lays down the **rules for establishment of terms and condition for privatization of federal property**. The decree states that in establishing of these rules the government first has to specify a list of all federal property it intends to privatize, methods it expects would be used for that purpose, estimated revenues as well as other information necessary in the process.

The decree imposes the responsibility for preparation of the aforementioned information on the Ministry of Property and its regional offices, which have to consult with Russian Federal Property Fund in issues pertaining to a preferred method of privatization.

In addition, the Ministry of Property also has to specify any obligations/conditions imposed on a prospective buyer of a particular federal property as well as future use of federal property ineligible for privatization.

Naturally, all Ministerial decisions for privatization of a particular asset have to correspond with the annual general privatization plan. Should a first attempt at sale of a federal asset fail, the privatization method shall be re-considered or a decision to privatize it be cancelled altogether.

Details pertaining to sale of state and municipal property via public offering with and without prior price announcements are provided by a July 22, 2002 eponymous governmental decree #549.

According to the Article 23 of the Privatization law, **a sale of state and municipal property via public offering with prior price announcement** shall proceed only if an auction for a property in question was deemed invalid. In these cases an auction organizers have to announce the following: a starting maximum price, time period during which lower bids are accepted and a minimally accepted 'cut-off' price at which a federal/municipal property can be sold. In addition, the starting maximum price can be set lower than a starting minimum price of a previous auction that was deemed invalid. A normative price for such fed-



eral/municipal asset equals 50% of a starting bid of a previously held auction that was deemed invalid.

A federal/municipal property sold via such public offerings is awarded to a first bidder whose offer equals the starting maximum price. If no such bids are submitted, then the price is lowered within the appropriate period specified in the initial public announcement. In these cases, a first bid received in the amount specified by the new starting price wins. Upon the registration of the first appropriate bid, no other bids are admitted. The price can be lowered successively down to a cut-off price.

According to the Article 24 of the Privatization Law, a **sale of state or municipal property without prior price announcement** can proceed only if a property was not sold via public offering with a prior price announcement. In these cases, normative price of such enterprise does not have to be calculated.

A purchase deemed valid and a buyer is recognized in the following instances:

- a) Only one bid was submitted and he/she was the bidder
- b) Several bids were submitted and he/she submitted the highest bid
- c) Several bids were submitted, all with the same offers, and he/she submitted their bid first, prior to others

Should no bids be submitted a legally allowable period, or no bids were accepted for consideration, such sale is annulled and a record of that is included into final sale report.

On August 12, 2002 the government passed another decree (#585) this time specifying the rules for auctions of state and municipal property. According to the Article 18 of which an enterprise can be offered for sale via an **auction** only in cases when a future owner is to have no obligations concerning the property. The property is to go to a highest-bid participant. Such auctions can be held either publicly or carried out via submission of bids in written form.

The Article 19 of the Privatization Law states that a **specialized auction** is a sale of shares at an open auction during which all winners receive the shares of a purchased enterprise at one price per share, which has to be calculated in accordance with the following rules:

- a) only bids/offers submitted by the eligible participants of a specialized auction can be considered in the final price calculations
- b) the final price must be equal to a maximum share sale coefficient, which in its turn, equals to a ratio of a number of shares being bought at the auction to the total number of shares made available for sale.

The share sale coefficient can be no lower than .95. Each winning participant of a specialized auction receives a number of shares that corresponds to the ratio of an amount he/she specified in his/her submitted bid to a final price per share.

Another governmental decree# 584, signed on August 12, 2002 details rules and regulations pertaining to the sale of state and municipal property via **tender**. According to Article 20 of the decree, an entire enterprise or its shares in the amount exceeding 50% of its charter capital can be sold via a tender in cases, when an eventual buyer has to carry certain obligations as to its purchase. An eligible participant with a highest bid wins a tender. Tenders with participation of only one bidder are deemed invalid. In cases when two or more highest bids are equal, an enterprise in question is awarded to a bidder who submitted his/her bid prior to others.

A buyer's obligations as to a tender purchase may, for instance, require the following:

- retaining of a certain number of employees

- providing re-training or professional development opportunities for an enterprise's employees
- restrictions on changing a type of industrial/commercial activity; or restrictions on cancellation and/or launch of certain types of communal services of, for instance, transportation, educational or similar nature
- repair, restoration and/or upkeep of certain important objects of cultural/historic heritage or high communal service value

List of conditions/obligations imposed on a buyer of particular enterprise offered on a tender shall be complete and not subject to change. A new owner of such enterprise shall take no longer than a year for delivery of obligation imposed on it by the tender.

Sale via a tender of joint stock companies gives its buyer a right to cast votes according to the number of shares he/she purchased at the company's shareholders meetings even before an official transfer of the deed. Such right for early vote-casting, however, excludes voting on the following subjects:

- changes and/or amendments to a company's founding charter documents
- divestiture, giving up as a collateral or lease or other such measures able to cause a divestiture of a company's assets, if these assets exceed 5% of a company's charter capital or 50,000 times federal minimum wage
- giving up as a collateral or divestiture of a company's real estate
- securing a loan in the amount exceeding 5% of a company's free assets
- subsidiary creation
- issuance of securities not convertible into a company's shares
- approval of a company's annual reports, accounting records, profit and/or loss statements as well as decision on distribution of profits and/or losses

In addition, a buyer is precluded from early voting on issues pertaining to a company's re-structuring and/or liquidation. Prior to fulfillment of all tender imposed obligations, a company's shareholders may not make decisions altering a company's charter capital, new share issuance and other securities with a potential to be converted into a company's shares.

On the other hand, a newly purchased joint stock company may not make the following decisions prior to the official transfer of an ownership title to a tender winner without his/her approval:

- reduce number of a company's employees
- sign off on a deal, or a combination of deals, whose total value exceeds 5% of a company's assets book value according to a last accounting report or 50,000 times a federal minimum wage;
- sign off on a deal, or a combination of deals that may directly or indirectly lead to a divestiture of a company's assets in the amount exceeding 5% of a company assets book value according to a last accounting report or 50,000 times a federal minimum wage;
- secure loans
- issue securities
- create subsidiaries or wholly new companies as well as purchase or divest of their shares/stakes in charter/joint capital of such companies

Should a new owner fail to timely deliver on any of the obligations in accordance with the terms and conditions specified by a tender, the contract of purchase of a state property



shall be terminated upon the parties' agreement or in accordance with a court's decision. In addition, the delinquent party shall be subject to payment of an appropriate penalty, and shall cede all authority as to his/her purchased assets, which are to be transferred back into the state ownership.

Details on **Lease of federal property with a subsequent right for its purchase** are specified in an eponymous September 25, 2002 governmental decree # 707. The said decree specifically regulates all federal property lease agreements that were signed prior to enactment of a 2001 Federal Law on Privatization.

According to the decree, a lessee of federal property may submit a request to purchase it to a local office of the Ministry of Property. The latter shall within the following 2 months consider a request, retain an independent valuator and render an appropriate decision. If an independent valuator values a property at 10,000 times federal minimum wage or less the lessee's purchase request shall be approved.

If a property, however, is valued at more than 10,000 times federal minimum wage, a local office of the Ministry of Property shall propose the lessee to create a joint stock company, with the property in question becoming a government's contribution to the charter capital. The lessee may, in its turn, contribute assets obtained as a result of the lease of state property or any other assets in its lawful possession.

Should a lessee agree to that proposal, a local office of the Ministry of Property, shall in a month's time review all relevant documentation submitted by a prospective buyer and in its turn prepare relevant paperwork for registering the property as a contribution of the Russian Federation towards a new company's charter capital. The lessee and a new co-owner of the property shall have a primary right for buying the state's stake in the company.

Although the government has provided details for use of 6 out of 10 privatization methods made available by the new Law on Privatization, the remaining 4 methods still require further clarification and detailed legal base for their successful application. The need for further legal guidance is made especially apparent by the fact that these 4 remaining methods are the least familiar in Russia but potentially the most attractive privatization models in the eyes of many prominent interest groups:

- 1) sale of Russian government stakes in foreign joint stock companies through issuance and underwriting of depositary notes
- 2) sale of state-owned shares of joint stock companies through brokers
- 3) contribution of state-owned property towards a company's charter capital
- 4) sale of state-owned shares of joint stock companies upon results of trust management.

4.2. Key Issues for Improving the Current Privatization Legislation in the Russian Federation

By 2003 the legal base for property reform in Russia has matured and acquired a wealth of new legislative acts and presented a marked contrast to the state of the affairs back in the nineteen nineties.

A bitter confrontation between the Legislative and the Executive branches of the Russian government led to a situation where the privatization's key objective (structural reform enforcement and establishment of an institutional framework for property transformation) was carried out single-handedly by the Executive through its ability to pass decrees such as for

instance, the Presidential decrees on Voucher Model Establishment, Loans-for-Shares Auctions, etc. The 1997 Privatization Law was aimed to resolve the conflict and officially leveled the Executive and the Legislative ability to affect the privatization process.

The confrontation, however, did not fully subside since certain poorly drafted parts of this well-meaning law rendered it practically unenforceable. The government's attempts to circumvent the inopportune piece of legislation proved futile and by the end of the nineties the privatization process had slowed significantly, although other objective reasons (please see next paragraph) were also responsible for the trend. Despite the slowdown however the government's task to raise funds via privatization kept more or less on track (please see Table 1, Chapter on The Dynamics of Privatization Process).

The aforementioned deceleration in the privatization process also had its objective roots in the nature of the "left-over" state property that placed certain limitations on its investor attractiveness. Thus most of these enterprises either offered only minority share packages and were unattractive because of an already formed majority-vote shareholder control; or offered a majority package, appeal of which however was undermined by enormous investment requirements.

On the other hand, attractive and potentially lucrative opportunities that offered controlling or blocking stakes in national monopolies now had to be pursued in a competitive market and bought at a market-set price with strict adherence to all legal norms which also decelerated the process of privatization.

In 1999-2000 the changes in the political landscape of the country saw an end to the long-standing dispute on privatization between the two branches. On December 21, 2001 the conflict was resolved by yet another law on privatization, this time titled, the Federal Law on Privatization of State and Municipal Property, # 178.

The new law came into force on April 26, 2002 (only 3 months after the day it was first published) and its approval by the Federal Council (Russia's Upper Legislative Chamber) was made possible thanks to a compromise that divided the power to privatize between several governmental layers. Thus privatization of all so-called strategic enterprises as well as decisions for including an enterprise into a "privatization forbidden" list were to be made by President. Privatization of big natural monopolies, such as Gasprom, RAO UES and Federal Railroads was assigned to the Federal Council and required enactment of a separate law, while jurisdiction for all other federal enterprises was given to the government. Municipal and regional properties were to be privatized by local authorities.

In general the law provided for 10 various methods for privatization, based on an enterprise's size, liquidity and/or results of initial sales:

- 1) transforming a closed, single-owner enterprise into a publicly listed company;
- 2) sale of state and/or municipal property through actions
- 3) sale of shares of publicly listed companies through special auctions
- 4) sale of state and/or municipal property via tenders
- 5) sale of state-owned open joint stock enterprises abroad
- 6) sale of shares of open joint stock companies through brokers and exchanges
- 7) sale of state and/or municipal property via Dutch-style auctions open to general public (where final sale price or the cut-off point is exactly a half of the price offered at the onset of the auction)
- 8) sale of state and/or municipal property without disclosure of target prices (should it fail then the sale proceeds via Dutch-style public auctions)



- 9) incorporation of state and/or municipal property as charter capital contributions for open joint stock companies
- 10) sale of share of open joint stock companies in accordance with results of trust management with a subsequent right to buy shares.

In addition, under the Law state-owned share packages whose value at the time of sale exceeded 5 million units of minimum wages (annual?) were to be privatized only by means of becoming a joint stock companies via auctions, specialized auctions, sold abroad, or in accordance with terms and condition specified in the presidential decrees, by contributing of federally owned assets to the charter capital of a strategic joint stock company.

All other types of state properties could be auctioned off, turned into joint stock companies, tendered, or privatized by contributing shares to charter capital, etc. Should a first attempt at a tender and/or an auction be deemed invalid, due, for instance, to a lack of bidders, the Law allowed for the pursuit to continue through other privatization methods described above.

The 2001 Privatization Law undoubtedly introduced important new mechanisms for transferring state assets into private ownership. Thus the Law officially recognized that: a) land of a privatized enterprise constituted an integral part of a privatized property; and b) intellectual property could be counted as a contribution to a charter capital.

By and large the new Law upheld a view, a traditional one of late, that privatization must maximize its fund-raising utility by concentrating on big-ticket sales pursued with individual strategy based on prevailing market conditions and use of newly available methods of privatization.

The next two to three years should demonstrate whether these newly devised methods of privatization provided by the Law are successful and conducive to the government's overall aim of financial stability, maintaining budget surpluses and ensuring that its revenue sources are diversified and do not run dry even in the event of tumbling oil prices and peak external debt servicing. The first such results can come as early as in the current 2003, the first year in which the legislation can be applied in its full spectrum.

In theory, the variety of models for privatization should boost growth, hearten institutional reform, cut government's costs and help it get rid off illiquid assets while stimulating a minimum demand from individuals and small businesses. Encouragingly enough, the experience with privatizing a number of enterprises since 2000 demonstrates that given a continued economic growth and enough political will the government may indeed reap significant benefits from new privatizations.

Because transferring assets into private hands will not merely cut government's costs but also create new holding-type structures that would promote competition and growth in a number of key industries such as defense, research and development, transport and communications. Unfortunately, such hopeful prospects stand less assured for small and medium-sized companies, which in all likelihood would remain bogged down by taxation and administrative barriers.

Lastly, the inclusion of an enterprise's land under its privatization as well as a revamped access to market financing give reasonable hope that investment will indeed be followed by a much-needed restructuring. Please see more on the subject of new privatization models in the attachment to the Chapter on The Dynamics of the Privatization Process.

In spite of the number of aforementioned positive *technical* advances the Law fails to lay out a comprehensive *strategic* vision of how the privatization process should be pursued and what indeed it hopes to achieve.

Such long-term strategy, for instance, should first of all, in addition to overall budget goals, outline which enterprises in which industries would not be subject to privatization whatever the circumstance. Only upon determining a list of these off-privatization enterprises should the government decide which remaining entities go for sale in the short-, medium- and long-term based on an enterprise liquidity status.

The 2001 law also falls short of curing some of the biggest “headaches” of Russian privatization such as transactions transparency and lack of buyer equality in the conditions of systematic corruption – issues that obviously should come to the forefront of any technical aspects of the process. Sadly this lack of focus on bigger picture means that the Law is riddled with a number of loopholes a detailed account of which is provided below.

A first questionable innovation brought about by the Law concerns the abolition of a previous 1997 requirement to annually pass a federal law specifying a list of enterprises available for privatization in the next year, as well as expected terms and conditions for their privatization. That, in effect, takes the Duma out of the decision process and grants the executive an exclusive right to determine annual privatization program.

Curiously enough the law officially lifted another 1997 requirement for setting up separate list of enterprises that must remain in federal control, thereby giving a misleading impression that no enterprise may be beyond the privatization’s reach. The impression is false because deeper in the body of the Law, article 6 line 43 to be exact, it clearly states that unless legally specified otherwise, all state property that had been included into the privatization-banned category up to January 1, 1995 (date of enactment of the 1st section of Russia’s Civil Code) must remain in the same.

Thus the new Law in effect upheld the 1993 privatization program, which banned privatization for 44 categories of enterprises over the less restrictive 1992 program, which did the same for only 22 categories.

Secondly, just as its 1997 predecessor the 2001 Law also failed to provide clear selection criteria for enterprises for which privatization is banned on the grounds of their strategic importance, because goods and service they produce are essential for national security. With an aim of policy consistency in mind the 2001 Law instead entrusted the government with an authority to form lists of such strategic enterprises and then subject it to approval by the President. The definition of a strategic enterprise included all federal enterprises and state-owned joint stock companies which produce goods and services essential to national security, public health and morals (hereinafter referred to as strategic enterprises and strategic joint stock companies respectively)².

If earlier these strategic privatization-banned category amounted to approximately 700 enterprises (211 enterprises and 495 joint stock companies) the new list may be cut in half. With respect to joint stock companies and perhaps also unitary enterprises which undergo incorporation the new Law introduced one important criteria: to qualify as a strategic entity the

² Earlier these enterprises were included either in a 1996 List of Defense Enterprises not Eligible for Privatization or a 1996 List of Enterprises which Produce Goods and Services Essential to National Security not Eligible for Privatization. Clear principles for lists inclusion were also lacking although the Ministry for State Property did have 7 criteria. It is currently absolutely unclear whether the enterprises from either of these 2 lists would also be banned from privatization.



government's stake in an enterprise should exceed 50%. According to the 1997 law the requirement was that an enterprise was carrying out government orders and more than 70% of its goods and services were defense-related.

In January 2003 the Russian government produced a list of 18 federal joint stock companies, where the state's position on all issues pertaining to their management, governing and oversight was to be determined by the government.

A third loophole can be found in a requirement that all amendments, changes and recommendations to the existing lists of strategic entities (including proposals for decreasing government's control over such enterprises, their gradual or immediate removal from the list for the purpose of their eventual privatization) be made in the same manner, i.e. initiated by the government and then sent to president for approval review.

The new Law however is vague on the process and details of the presidential review of government's proposals. One would imagine that the President would have to rely on technical expertise provided to him by his staff and that is, of course, granting the President does indeed review and not merely rubber-stamps government's proposals. In any case, it is unclear whether the technical expertise should come from staff in his own administrative apparatus, Security Council or some other institution. Coupled with the lack of clear criteria for selection of strategic entities this confusion certainly does little for improving the already hazy environment surrounding Russian privatization.

Yet another, fourth loophole of the new 2001 Law arises from an implication that annual privatization programs should be handed for parliamentary review together with an annual budget draft. The Law however provides no guidance to a situation where a budget draft along with the privatization program is not approved, as if the creators of the Law simply deemed such "difficult" scenario as too unlikely ever to occur.

Fifthly, the 2001 Law also fails to set unambiguous criteria for dividing the large notion of "state" property into federal, regional and municipal subclasses. Last such criteria were set in 1991 by the Supreme Council of Russian Soviet Federative Republic and are obviously outdated. The lack of clarity is muddled further by a number of often conflicting bilateral agreements made between the federal center and various regions back in the nineties following the break-up of the Soviet Union.

Many hoped that the 1999 Conception for Management and Privatization of State Property and a row of new legislation that followed it would provide better guidance. Disappointingly enough most of these new laws concerned only federal enterprises and federal joint stock companies and thus was not entirely helpful for sorting out the municipal and regional property concerns. One exception was the January 11, 2000 Governmental Decree on Registrars for Economic Efficiency of Federal Enterprises and Federally-Owned joint stock companies. The latter merely *recommended* that regional governments set up the aforementioned registrars.

In other words the regulation of regional and municipal property, which as of 1999 consisted of over 65 thousand entities, continues to be in local governments' domain and to a large degree because of that is plagued by a particularly heightened form of inefficiency and waste so typical of all state-owned enterprises in general.

On a more encouraging note, the government as of late is pursuing a policy of delineating authority and accountability between the federal, regional and municipal governments. An administrative reform, of which such vertical division of powers is an important element, is in

the making and a special Committee set up at President's behest in 2000 had already produced a first draft of a Federal Law on State and Municipal Property.

The latter document is seen as radical in its strict and rather narrow-minded classification of state property, which according to the draft can only come in federal, regional or municipal form (the latter type concerns mostly education-related property). All other property that does not fall in either of these 3 categories is considered as commercial property eligible for lease, trust management and/or privatization. According to the draft unless a property falls clearly under the 3 mentioned categories or is a public-concern not-for-profit organization in which government's participation is required³, all federal, regional and municipal governments are prohibited from purchasing it.

The reasoning behind the restriction is that it will help complete the process of delineation and neat classification of property. Once the law passes and appropriate changes are made in the Civil Code, the logic goes, the legal institution of state-run business will cease to exist.

In reality it means that all current state-owned unitary enterprises must either be transformed into *kazennye* (i.e. managed on an operational basis as all *uchrezhdenia*)⁴, incorporated or liquidated altogether. An exception is made for certain state social-aid agencies, which will be offered an interim form of ownership and may be transferred into concession.⁵

A draft of the Law on General Principles of Local Self-Governance, yet another piece of legislation that will affect the privatization future, is scheduled for Duma discussion in February 2003. A lot of it will be based on the reform concept put forward by the State Council, which calls for a complete inventory review of all state and municipal property, its classification and 'optimization.'

The suggested classification of property would necessarily include re-allocation of property between federal and regional governments with many items falling into municipal ownership. The proposed re-allocation would not only affect enterprises themselves but also their land (if it is within a municipality's boundaries) and even some utility companies. The State Council says that this re-allocation would serve a purpose of 'solving socio-economic problems of municipalities, improving living standards and creating a beneficial environment.'

The process is likely to involve some kind of mechanism of determining value of municipal holdings, however the Ministry for Property Relationships reckons that municipalities should be prohibited from starting and owning enterprises for purpose of extracting profit. The Ministry instead proposes that municipalities get by with collecting property taxes, of which Russia now boasts to have 5 kinds, as well as assistance from the regional and federal governments.

Although at this time it is difficult to predict in what form, if at all, these drafts become laws, the radical nature of the proposed legislation is bound to accelerate the privatization process. Given the exact opposite trend of the judicial reform such 'unnatural' acceleration may seriously hamper the process' and outcome's quality, not to mention heavy social costs as well as a strong reluctance from regional elites.

³ Type and degree of such government participation is to be determined by the President.

⁴ I.e. unlike on unitary enterprises the government carries a subsidiary responsibility on *kazennye* enterprises perhaps that was the reason why such forms of state ownership never took off in Russia. As of 2002 out of 9393 federal unitary enterprises only 33 were *kazennye*.

⁵ Ministry for Economic Development is due to submit appropriate legislation for consideration.



Finally, it is important that the government continues with a management reform of the property under its control. Such reform can be based on a simple inventory recount, which also has to include clear delineation of authority between various level of government over its particular holdings.

Efficiency problems of using Russian property abroad are just one area that would benefit enormously from such reform. Ever since the start of the privatization process, Vitsovpetro has been the only revenue source of all Russian state property situated abroad. The Russian accounting chamber reckons that Russian agencies, various enterprises and organization that own property beyond Russia's borders knowingly present inaccurate data to the Ministry of Property. Similarly, information on government stakes in foreign-registered entities that belong to Russian organizations is also understated. The Russian government in the meantime is losing, as some sources claim, about \$1 billion in dividends a year. It has to be said that about 80% of all Russian state property abroad belongs to Russian embassies, consulates and other such diplomatic structures.

The following two measures would especially be relevant for addressing the need for better management of Russian property abroad:

- creation of a complete up-to-date registrar of all federal property abroad
- establishment of clear rules and principles for dividend payment policy on Russian assets in foreign entities

In the past few years there virtually has been no disagreement on the need for a law on nationalization, in the very least for detailing appropriate articles in the Constitution and the Civil Code. A fairly high degree of political sensitivity of the subject and existence of few alternatives ensured that the process for creating such law has been rather slow.

The Ministry for Property prepared a draft of it's called a Law on Turning Private Property to that of the State (in short, nationalization), which underwent Duma discussions on October 21, 2002. This Ministerial draft gives two reasons for invoking the law: ensuring defense abilities of the state and national security.

According to the proposed draft, the government would each year specify the country's needs in strategic goods and services necessary for ensuring national security in one of the classified articles of the budget and set aside funding for their purchase and/or production. If the government finds itself unable to purchase these strategic goods on a market or find a state-owned enterprise that is able to produce these strategic goods, the government has then a right to nationalize an enterprise that has an ability to produce the strategic goods. In these cases, the government upon consultation with the President makes a list of assets subject to nationalization and retains a valuator for determining a market price of these assets. If an owner of an enterprise marked for nationalization disagrees with the government's decision he/she has a right to appeal in court.

4.3. State property management

General approaches

In the course of development of privatization along with contraction in the volume of government property in Russia over the '90s, the problem of an operative and strategic management of public enterprises (shares) has become increasingly pressing. The whole sectors of

the economy needed solutions to that (fuel and energy and defense, transport, communications, among others).

It was governmental Resolution # 1204 of September 9, 1999 on approval of the Concept for management of government property and privatization in the Russian Federation (below referred to as the Concept) that launched a new stage of property relations reform in Russia. Notably, apparently it has become the first attempt since 1992 to put the problem of state property management higher in the priority hierarchy than a formal change of property form. A drastic downfall in prices for enterprises and their stock packages after the Rub. depreciation naturally determined in 1998-99 the shift of the federal center's focus of attention towards boosting non-tax budget revenues by means of using government property. That in turn automatically required an introduction of a greater clarity to the relationship between different tiers of the government.

In the meantime, it can be argued that it is the implementation of the action plan aimed at improvement of the existing government property laid out in the Concept that forms an urgent task in the public property management area for the years to come. The document cited state unitary enterprises and economic entities with the government participation in their capital among other main objects of the property policy. The document emphasized a gradual qualitative contraction in the number of the objects in parallel with the implementation of the action plan on improvement of their management.

The Concept forms a perspective guidelines document and proceeds from the need of concluding strict contracts with managers, which will hold them responsible for 'their' enterprises' performance, as well as carrying out a constant economic monitoring, and the need in a register of economic efficiency that would specify future performance of an enterprise or a company.

To address these tasks, one needs to implement long-awaited measures: to introduce standard reporting forms for government representatives in open-end joint-stock companies (OAO) (October 1999); to pass a decision on establishment of a register of economic performance indicators of federal state unitary enterprises (FSUE) and OAO whose shares are owned by the federal government (January 2000); transition to an annual approval (for FSUE and OAO with the federal government share over 50%) of economic performance indicators and control over observance with them and the use of property, identification of the share of FSUE's profit subject to transfer to the budget, the recommended volume of dividends to be voted for by RF representatives in OAO boards (February 2000), the regulation of procedures of appointment of governmental representatives and their interaction with the Ministry of Property Relations and the respective sectoral agencies depending on the size of the government package, including timelines for notifications, submission of proposals, and provision in writing directives and reports on their participation in enterprises' governing boards (March 2000).

The measures undertaken under the Concept over the past three years have already brought about some results. The period between 2001- 2002 has been notable for a qualitative shift in the structure of the federal budget revenues from privatization and the use of the federal property (see Section 1).

Some general matters that concern managing both unitary enterprises and economic agents with the government participation are worth a separate analysis.

First, as long as the state property management is concerned, it is the governmental staff policy that becomes especially important. Nowadays, in addition to a higher qualification of



those who carry out managerial procedures, it is the staff selection and a resolute battle against corruption that remains very urgent. Whilst putting the possibility of using the civil and criminal law provisions aside, one can offer a range of fairly visible measures to address the above:

- introduction of the provision on a mandatory expulsion in the future from the state property managers community those who were dismissed from their duties because of their unfair performance (with a detailed description of such abuses and a respective penalty), along with the creation of a database to store complete information on all the staff ever representing the government interests in the property management area (directors of FSUE, governmental representatives in AO, trust managers);
- introduction of the provision of a compulsory information by directors of FSUE and governmental representatives in AO of their income and property as a variant of adoption of a special law on labor compensations for heads of public companies or amendments to the tax law. The enforcement of this particular measure with regard to heads of economic agents with the government share in them is under discussion (and can be related to the size of the government share).

Secondly, there exists a serious challenge in the unitary enterprises management area that fall under the RF Subjects' property and municipal unitary enterprises (as of late 1999, their overall number made up some 65,000) as well as economic companies with the local governments' share in their capital presents.

The problem is it is FSUE and AO whose shares constitute the federal property that falls within the purview of practically the whole legal base developed over 1999-2001. The exception is RF Government Resolution # 23 of January 11, 2000 "On the register of economic efficiency indicators for federal state unitary enterprises and open-end joint-stock companies whose shares are in the federal property". The document *recommends* executive agencies in RF Subjects to organize the work on creation and conduct of registers of economic efficiency of state unitary enterprises owned by RF Subjects (as well as of open-end joint-stock companies, whose stock belong to RF Subjects).

It is evident that the priority mission is to spread all the management patterns and mechanisms emerged over the past three years onto the property of RF Subjects (in analogue to the federal property objects). This should concern, at least, the enterprises the federal center is going to assign to local governments. The respective Government resolution (# 1366 of December 9, 1999) relates the assignment of such FSUE=s to the ownership of RF Subjects just to decrease in the amount of funds the federal budget transfers to regions. Enterprises with arrears on compulsory payments to the federal budget and state off-budget funds, as well as backwages, outstanding over 3 months were bound to submit a business plan. The latter should provide for a liquidation of such arrears over a certain period of time (with concrete sources of funding of necessary measures), among other things. At the same time, the respective standard Framework Agreement and Assignment Deed approved by the Ministry of State Property with its Decree # 2-p of May 23, 2000, were not registered by the RF Ministry of Justice. So, the matter has been suspended so far.

The launch of the process should be preceded by a detailed examination of the actual state of affairs in the property relations area in a specific region, including the situation at the enterprises that have earlier been assigned to local governments. It would be appropriate to conjoin the possibility of assigning the federal property to the RF Subjects with the size of the

existing regional property (including stock packages), efficiency of privatization procedures and local property managers' performance over the prior period, and to include all the above in official documents on interbudgetary relations.

Third, there exists a group of questions associated with the rate and quality of economic growth. It is not accidental then that the Concept regards encouraging production and its diversification, improvement of such enterprises' financial and economic performance, attraction of investment, optimizing managerial costs, implementing institutional transformations in the economy as independent objectives in the state property management area.

The above objectives can be reached by the following means: the use of state-owned stock packages to secure credits and investment; capitalization of enterprises' debts to the budget and an contribution with their land sites to AO=s' authorized capital, with the consequent sale of, or trusting the newly issued stock; establishment of vertically-integrated corporate structures; enterprise restructuring with a separation of the property complex needed to solve problems of the national scale, and sales of other assets; and, finally, the use of various privatization procedures.

The nature of the above instruments and a well - known fact of the transition of a main mass of attractive enterprises to the non-government sector show that the above processes to a greater extent concern companies with the government share in their capital, while to a less – unitary enterprises.

At the same time, one should take into account that any job on enterprise restructuring that implies separation of any production should involve a great deal of cautiousness and is time-consuming. That can be explained by the need of a thorough account of the whole set of related circumstances and primarily of evaluation of the possibility of downsizing the objects that once were built as a single technological complex. As well, it should imply studying into technical aspects of the problem. The task to create competitive holding structures with the governmental participation poses a serious challenge, too, as the account of the technical aspect of the problem (compatibility, inter-relation and mutually complementary functions of such integrated enterprises) is complemented by demand for concentration of government-owned assets to the extent allowing exercise an efficient control with minimal managerial costs involved.

Obviously, these problems can be solved and visible results can be achieved only in the long run (within 5-7 years), when both unitary enterprises and companies partly owned by the state demonstrate a steady and qualitative implementation of their functions set while fixing them in the government ownership and a considerable increase in non-tax receipts to the budgets of all levels is ensured. By that time, by and large, a sound management system of state-owned assets in unitary enterprises and mixed companies should be built. The system should be based on an individual approach towards each such object and a program-targeted principle that implies a mandatory identification of objectives of the state participation in the given enterprise's capital and, consequently, a strict formulation of tasks and a documentary fixing of means of influence on the given object, providing existence of efficient control instruments.

Naturally, the implementation of all the aforementioned measures, along with a sound staff policy pursued by sectoral and functional management agencies, does not guarantee absolute protection of the state acting as a principal from potential offensive acts of the manager as an agent. This notwithstanding, it appears that such measures can considerably lower an integrated risk of bankruptcy of unitary and mixed enterprises, inhibit stripping them off assets and eventually lower costs in the public entrepreneurship area.



In all fairness, it should be noted that such negative effects caused by the functioning of an economic institution as poor current performance indicators, stripping an enterprise off its assets, false bankruptcy, etc. in principle appear characteristic of economic agents of other organizational and legal forms, too. For instance, in Russian economy, many privatized companies do not perform as expected, nor they proved to be manageable even under new, private owners. This manifests a universal nature of difficulties arising in the relationship between managers and owners in the transitional conditions.

With all their similarity, the processes of improvement of management of unitary enterprises and economic companies with the government participation and the legal regulation of the state property rights towards these different kinds of objects have their own specifics⁶, which allows better understanding of the nature of challenges facing them.

Overall, one should recognize that currently the 1999 Concept needs a serious update, primarily from the perspective of shaping a single public property (asset) management system, which would allow to ensure a material provision of implementation of public functions and optimization of the federal property's structure. The idea of shaping such a single system basing on a classification of the federal property and improvement of new mechanisms of managing federal property objects should become a core one in the course of furthering the legal base of privatization and public property management.

Unitary enterprises

It was in 1999 (in the frame of the Concept) that unitary enterprises along with government-owned stock packages (shares) in economic companies (primarily AO=s) and real estate were for the first time singled out as a separate object of the government policy. Accordingly, it was for the first time ever that the number of FSUE=s became known – 13,786, which was roughly twice lower than as of January 1, 1998 (29,666). By summer 2000, there were 11, 200 unitary enterprises, as of September 1, 2001 – 9,855, and as of January 1, 2002 – 9, 394 (or at some 32% less than stipulated in the Concept)⁷. Such a decline in the absolute number of FSUE=s is explained by the implementation of a complex of measures provided by the Concept. They are aimed at contraction in their number (reorganization, privatization, liquidation), while at the moment it is impossible to unambiguously argue that in the future the vector of quantitative dynamics of FSUE=s will be heading steadily for a decrease in their number.

The data in *Table 3* (though its covers different dates) clearly show differences between the federal unitary enterprises on the one hand, and regional and municipal ones, on the other.

⁶ Obviously the problems related to management of budget institutions (reforming the budget network in the social sphere sub-sectors), natural monopolies reform (associated with antimonopoly regulation, encouragement of competition, and corporate governance), restructuring the bloc of law enforcement and military agencies and sales of property freed due to that (associated with the military reform) also bear their great functional specificity, which is related to the nature of the respective agencies' operations. However, the present paper does not deal with them.

⁷ The process of creation of the Register of Federal Unitary Enterprises has been far from completion. This can be attributed primarily to the absence of a distinct division of powers and rights for a certain property between different tiers of the government and, in a number of cases, to the fact that regional administrations and unitary enterprises there are keen to avoid the application of accounting and control procedures on the part of federal agencies. For example, according to the Department for Accounting the Government Property of the RF Ministry of State Property, by mid-2000 in 69 Russian regions there were found 1,232 legal entities having the status of federal enterprises in the region but not included into to the respective federal agencies' lists.

They both prove to be very closely associated with the level and limits of the respective government tiers' competence.

As concerns the structure of regional and municipal unitary enterprises, it is the housing sector that has the greatest proportional weight (27.6%), followed by trade and public catering (25.2%). As long as all economic agents of this particular organizational and legal form are concerned, the overall proportion of both sectors stands nearly 53%. By contrast, their share in the group of federal unitary enterprises is just 11.4%, while the proportional weight of agrarian and forestry sectors is notably big there (14.6% vs. 5.4% in the group of regional and municipal unitary enterprises), followed by sectors for transport and communication (11 vs. 4.9%). However, it is 'other' sectors whose respective rate is especially great (almost 33% vs. 12.2%), of which almost 2/3 falls on science and scientific services. The proportional weight of industrial and building sectors in the group of federal unitary enterprises (some 30% in all) does not bear a fundamental difference from the respective proportion of these sectors in the group of regional and municipal enterprises (24%).

Under a detailed disaggregating of the sectoral FSUE structure, it becomes evident that as of early 2002, it was the proportion of science and scientific services that was the greatest one (15.2%), followed by agrarian sector and forestry (14.6%), transport and communication (11%). An absolute number of enterprises in these particular sectors exceeds 1,000. This group is closely followed by the construction sector (10.5%) and trade and public catering (9.7%) that currently comprise 988 and 909 FSUE=s, respectively. As concerns the industrial sector whose share in the overall number of existing FSUE=s roughly accounts for 1/5, it is machine engineering and metal processing whose share is the largest (some 48%, or 9.4% of the overall number of FSUE in the economy), followed by enterprises dealing with material and technical supply and sales (7.4%), while the proportional weight of all other sectors does not exceed 2.5%.

The number of FSUE in a certain sector to a great extent mirrors the level of the pre-reform production concentration on the one hand, and the level of the given sector's attractiveness for outsider (and not only foreign) investors and the quality of the government property management policy over in the past, on the other. In this regard, a very insignificant (up to 50) number of FSUE=s can be found in the fuel and energy sub-sectors, metallurgy and the sector or chemicals that due to technological reasons would have a high level of production concentration yet in the conditions of the centralized economy. With the outset of market reforms, their export-oriented production plus a compulsory integration of a great number of the former public enterprises into holdings at the pre-privatization stage raised such a great interest in them on the part of private capital that pursuing its privatization program the government practically abandoned these most attractive sectors, though maintained some property in the form of shares in AO=s' capital. Thus, there are only 6 unitary enterprises survived in the oil sector, 1 in the gas sector, and none- in the oil and gas construction sector.

Table 3

Sectoral structure of federal, regional and municipal unitary enterprises between 2000- 02

Sectors	Federal state unitary enterprises as of January 1, 2002		Regional and municipal unitary enterprises as of January 1, 2000	
	Number	Proportion	Number	proportion
<i>Industrial sector, including:</i>	1844	19,6	6044	16,4
- machine engineering and metal processing (exclusive	879	9,4	...	...



of the sector for medical equipment)				
- forestry, wood-working and paper and pulp industries	229	2,4	...	...
- polygraphic	219	2,3	...	...
- light	153	1,6	...	...
- building materials	83	0,9	...	...
- food	64	0,7	...	...
- medical	59	0,6	...	...
- chemical	42	0,4	...	...
- fuel	35	0,4	...	...
- electricity	31	0,3	...	...
-non-ferrous metallurgy	27	0,3	...	...
- ferrous metallurgy	16	0,2	...	...
- microbiological	7	0,1	...	...
- milling and gruel and feeder	-	-	...	...
Agriculture and forestry	1368	14,6	2000	5,4
Transport and communication	1033	11,0	1818	4,9
Construction	988	10,5	2799	7,6
Trade and public catering	909	9,7	9627	25,2
Housing	162	1,7	10155	27,6
Other, including:	3090	32,9	4477	12,2
- science and scientific services	1431	15,2	...	...
- material and technical supplies and sales	692	7,4	...	...
- healthcare, physical culture and social security	226	2,4	...	1,0
- geology and sub-soil exploration, geodesic and hydrometeorologic services	218	2,3	...	...
- management	158	1,7	...	...
- culture and fine arts	155	1,6	...	...
- other kinds of activity associated with material production	140	1,5	...	...
- public education	60	0,6	...	0,4
- finance, credit and pension security	10	0,2	235*	0,6
total	9394	100,0	36795**	100,0

*Finance, credit, audit

** Subfederal and municipal unitary enterprises that submitted their financial accounts for 1996 and 1999

Source: the RF Ministry of State Property Homepage: www.mgi.ru; Kordyukova T., Galkin M., Eugel F. Unitary predpriyatia- potentsialny dokhod ili potentsialnye riski dlya regionalnykh I mestnykh administratsiy?// Credit Russia. An analytical bulleting of EA-ratings, the strategic partner to Standard and poor's, # 19-20 (56-47), October 2001; ACIS project "Povyshenie effektivnosti upravleniya gosudarstvennymi I municipalnymi unitarnymi predpriyatiyami" Materialy k seminaru of 7 December 2001 (draft). GBRW, EA-Ratings. Part 1.P.7.

The opposite pole is formed by a number of processing industries (primarily machine engineering) where the original level of concentration aggravated by the crisis in sales and the policy on 'atomization' of economic agents pursued at the initial stage of privatization allowed a great number of enterprises to stay out of potential investors' sight, thus retaining their public status.

The problem of *reforming unitary enterprises* is related primarily to deficiencies in the legal construction of the economic right. Its essence lies with an asymmetry of powers exercised by the subject of such a right and those granted to the government as a title owner. Article 296 of the Civil Code of RF grants the title owner with a strictly formulated circle of functions: 1) establishment, reorganization and liquidation of an enterprise; 2) identification of the subject and purposes of its operations; 3) appointment of its head (director); 4) control over the property assigned basing on the economic right; 5) the right for a part of its profit (without reference to concrete mechanisms of realization of such rights).

At the same time, enjoying its economic right, a unitary enterprise controls its property, except the real estate, while in compliance with p. 5 Art. 113 of the Civil Code, it meets its obligations with all its assets. In the absence of the law on government and municipal unitary enterprises, its heads would have a greater freedom of action with regard to incomes and

property, which they de-facto own and control. So, there emerges a possibility to burden SUE with debts and the risk that counterparts or creditors would seize the enterprise's property, which for the government means a great probability of loosing it. More specifically, such obligations may arise, should a unitary enterprise participate in capital of various economic agents associated with the UE's head. Such companies are not limited by the necessity to coordinate their operations with an owner in the frame of special procedures, as it happens in joint-stock companies.

It is these particular circumstances that gave a rise to a strategic decision on reducing the number of unitary enterprises of all levels. It is intended to transform them in open-end joint-stock companies (OAO) in the medium run, with 100% of their stock owned by the government or a municipal administration, or to assign them to the Treasury. This allows not to use a special control mechanism – rather, delegating governmental representatives to the boards of such AO=s, which has become fairly ordinary means over recent years. The period between 2001-02 saw a preparatory work on incorporation of such enterprises. Some 2/3 of FSUE received proposals on their restructuring, including reorganization of 1,669 and liquidation of 531 of them.

The main ways of transformation of unitary enterprises were identified by the Government in its Resolution # 1438 of December 6, 1999 “On federal state unitary enterprises established on the basis of economic right”. The document provided the following situation under which the maintenance of the organizational and legal form of unitary enterprises based upon the economic right (as well as their transformation into treasury enterprises) is allowed:

- the use of the property whose privatization is prohibited, including the one needed to ensure the national security, functioning of the aircraft and fleet, and realization of other strategic interests of RF;
- carrying out operations aimed at solving social tasks, including sales of certain goods and services at a minimal price, as well as at organization and conduct of procurement and goods intervention for the purpose of ensuring the food security of the state;
- the development and manufacturing of single kinds of products falling into the sphere of national interests of RF and ensuring the national security;
- the production of single kinds of goods that are withdrawn from the civil turnover or the use of which in the civil turnover is limited;
- carrying out operations that the federal laws reserves exclusively for public unitary enterprises;
- carrying out single subsidized kinds of activity and unprofitable production;
- carrying out research and scientific-technical activity in the sectors related to ensuring the national security.

In addition to retaining enterprises in the form of unitary enterprises based upon the economic right, the government identified still 4 variants of transforming organizational and legal structure of such enterprises:

- reorganization, including their transformation into open-end joint-stock companies;
- creation of federal treasury enterprises on the basis of their property;
- their sales as property complexes; and
- liquidation.



It is liquidation of the institution of SUE that appears the most radical decision. At the same time, a low liquidity of their assets and specifics of their operations makes the scenario of a gradual bringing the number of state unitary enterprises into line with the state's managerial capacity (which implies retaining some 3,500 of them) more probable. In parallel with that, there should exist a complex of measures to improve their management, as stipulated in the Concept. The realism of such a scenario can be proved by the fact that the governmental medium-term program's projections that by 2001 the program of transformation of unitary enterprises into joint-stock companies should be complete, with the state owning 100% of their stock, have proved to be far from reality. Let us remember that in 2002 there were 9,394 FSUE=s and only 90 AO=s fully owned by the state. During three years after the enactment of the 1997 privatization law (i.e. in 1998-2000), it was just a sole AO created in 1998 on the basis of enterprises owned by the federal government.

Whilst considering the above, one has to admit that quantitative estimates quoted in the scenario-based forecast of privatization of the government property appear overly optimistic and radical. The proposed contraction of the public sector to 1,5-2,000 federal enterprises by 2004 implies privatization of some 3- 3,500 of them annually. By itself, such a figure does not seem significant, however, it would be appropriate to compare it with the number of privatized enterprises objects during the monetary privatization period (See *Table 1* of the Section "Dynamics of the privatization process").

The scenario-based forecast of the government property privatization conjoins the reduction in the number of public enterprises and institutions with the amount of the government funding (in the form of direct financing and payment for the state order), which cannot be considered correct. In developed market economies, state orders are placed with companies of all kinds of property - furthermore, for decades the private sector viewed them as especially profitable and went into a cut-throat competition to get them. The actual problem lies with the level of economic agents' maturity in Russia's non-governmental sector and their capacity to accomplish these or those tasks of the national scale and to relate such a mission to the overall strategy of the country's development. So, it is just single cases in which the approach that unambiguously conjoins the number of public enterprises and institutions with the government's financial capacity can be applicable.

It is also important to note that a mass and accelerated incorporation of public unitary enterprises inevitably narrows the room for the restructuring privatization, when an enterprise is sold as a whole property complex – production equipment together with facilities, buildings, the site (a popular privatization option in the former GDR). Should such enterprises be transformed into AO, it will most likely result in problems with splitting their equity into separate packages for sale and their appraisal. Naturally, one cannot exclude the option of implementing a restructuring scheme of privatization by means of liquidation of the given public enterprise and launching a new business basing on its facilities and equipment.

It is the government's impotence in carrying out its proprietor's functions that serves as an argument in favor of the most urgent transformation of public enterprises into AO=s. However, in the conditions of the national transitional economy where many privatized enterprises, even under new, private owners, do not meet expectations in terms of their efficiency and manageability, it is hard to expect that a mere change of an organizational and legal form in the public sector's frame would have an immediate positive impact on their state. To prove

this, one can cite numerous problems inherent in the largest joint-stock companies with the governmental participation⁸.

Using the 'survival and growth capacity' characteristics for the purpose of qualifying enterprises for the respective group and solving the problem of their privatization appears a profound error. The economic practice of the '90s proved that these were different criteria, to say nothing of such well-known things as an extremely insignificant volume of outside investment even in the most attractive Russian companies. As concerns enterprises that currently are fully owned by the state, such a prospect appears more than doubtful.

Overall, in the meantime one can argue that the government's organizational capacity for reforming unitary enterprises *has entered in a serious conflict with the quantitative restrictor – that is, the scope of the sector for SUE*. There also is a visible conflict between a radical orientation towards complete liquidation of SUE=s with the abolition of the right for economic performance as a whole and specifics of their economic operations related to the output of goods and services and completion of works whose main consumer is the state and the society on the whole, as well as a low liquidity of their assets. Finally, there is, though limited, a circle of state tasks (and public interests), the mandate on solving which can be delegated to SUE=s. However, this can be viewed as a sound option only if the respective regulation is improved.

The actual progress in privatization over the past 4 years, i.e. the period of the effect of the 1997 privatization law makes the scenario of a long existence of unitary enterprises most likely. Proceeding from this, it is the focus on a gradual contraction in the number of state and municipal unitary enterprises and a parallel implementation of a set of measures on improving their management laid out by the Concept that appears more grounded.

Retaining FUE=s as economic agents in Russian transitional economy in the foreseeable future makes it urgent for the government to focus on such a specific regulative matter in the property relations area as minimization of deficiencies generated by the right for economic activity.

In practical terms, this implies *minimization of commercial risks arising in the course of carrying out government entrepreneurship via unitary enterprises*. The list of the most evident and widespread commercial risks in this particular sphere comprises:

- the possibility of a partial alienation of the property the government assigned to FUE=s;
- a low probability of generating revenues from FUE=s' operations, which may be attributed both to their sectoral specifics (a low profitability and low asset liquidity rates, focus on state orders and the consequent problem of the government honoring its obligations) and to the possibility of outsider structures intercepting the respective financial flows;

⁸ The planned transformation of the federal railway transport under the auspices of the RF Ministry of Railway Transportation into joint-stock company 'Russian Railroads' at 100% owned by the state at least is unlikely to ensure a considerable effect. In this regard, one should refer to the respective experiences of the electricity and gas sectors that have passed the incorporation stage yet in 1992 and consequently been transformed into giant holdings (RAO 'UES Russia' and 'Gasprom'), with their control blocks owned by the state: these companies have failed to show a substantially greater efficiency compared to the railway sector, which in turn was carrying out its inner changes in the frame of natural monopolies reform program. These three sectors were bearing a great deal of similarity over the past three decades: non-transparent financial flows, cross-subsidizing, and the aging of capital assets being close to critical.



- the danger of aging of the production assets due to a non-targeted use of investment funds and ‘eating up’ profit;
- the risk of FUE=s’ bankruptcy and the government completely losing its property rights for the assets assigned to them to conduct economic activity.

The main remedies the government should seek in order to minimize the risks are:

- *bringing FUE=s’ operations* in line with requirements provided by the legal acts of the RF Government and the RF Ministry of State Property of 1999-2001: more specifically, they imply re-registering their renewed charter documents with the RF Ministry of State Property; appointing of enterprises’ heads on the contract basis; fixing in their charters the government’s right for a share of their profit; introduction of a new accounting and control system;
- *an efficient exercising by the owner of his powers in the frame of the effective law and the aforementioned requirements* (identification of the volume of powers; control over the use of property and attaining certain indicators of FUE=s’ economic performance; contributing to the non-tax revenues of the budget system by means of FUE=s regular transferring a pre-set share of profit from current operations; pursuance of staff policy through the respective rulings of attesting boards and cancellation of contracts);
- specification and organizational optimization of the governing impact of the state on FUE=s (creation of specialized FUE=s to manage a great volume of relatively small, dispersed assets; integration of unitary enterprises into holding structures; strengthening the governmental control functions in large FUE=s by means of establishment Supervisory Boards that would comprise representatives of all the government agencies controlling the given enterprise; as concerns FUE=s of strategic importance, they should be directly subordinated to the RF Government);
- continuation and completion of the work on inventorying the government property in the part of inclusion of public unitary enterprises in the Property Register of RF basing on a clear distinction drawn between federal, regional and municipal tiers (and preclusion of a situation when a federal unitary enterprise exists without clearly defined subordination to a certain agency).

It is also necessary *to amend the effective legal base* underlying unitary enterprises’ operations.

First, the urgent need to pass a special law to regulate their operations cannot be questioned. Though the need in such a law has become visible since 1995 (when the Civil Code of RF was promulgated), its final version was passed on November 14, 2002 (# 161-FZ ‘On state and municipal unitary enterprises’).

The mission of the law is to minimize drawbacks of the right for economic operations. The quintessence of the new law became a certain narrowing of the level of a unitary enterprise’s economic freedom (a strict definition of purposes of its creation and allowed kinds of operations, the volume of legal capacity), strengthening of regulatory procedures of its management by the state and protection of its property rights (regulation of entering in large-scale deals, transactions that involve interest, restriction of their rights for establishing daughter unitary enterprises, an assumption of the possibility of withdrawing a part of their property in favor of the state).

The list of major innovations that allow speaking about toughening the system of management of SUE=s comprises the following provisions, among others:

- Unitary enterprise may not establish, as a legal entity, another unitary enterprise by assigning a part of its property to that (the daughter enterprise), which effectively blocks organizational possibilities for stripping the parent enterprise off its assets;
- Unitary enterprises may become participants (members) of commercial and non-for-the-profit organizations where the participation of legal entities is allowed. The decision of the given unitary enterprise to participate in a commercial or non-for-the-profit organization may be made only upon the consent of the owner of the unitary enterprise's property. As well, managing the share (contribution) in the authorized (equity) capital of the newly established economic structure or partnership, as well as the stock belonging to the unitary enterprise, may become possible only upon the noted owner's consent;
- Unitary enterprises may not become founders (participants) of credit institutions (thus, the possibility for their heads to control financial flows is limited⁹);
- Unitary enterprises have no right to sell the real estate belonging to them, lease it, use it as a collateral, contribute with it to an economic company's (partnership's) authorized capital or otherwise manage the property without the owner's consent;
- Without such a consent, unitary enterprises have no right to exercise deals related to disbursement of loans, guarantees, receipt of banking guarantees and other charges, assignments, debt transfer, and to conclude agreements on society in participation;
- Establishment of a treasury enterprise is possible both on the federal (as provided by the Civil Code) and regional and municipal levels, though the list of grounds for their establishment is limited (only for the purpose of using the property whose privatization is prohibited, solving social tasks, and manufacturing products associated with the national security and defense or single kinds of products withdrawn from the turnover);
- Restrictions have been introduced for heads of unitary enterprises with regard of combining their position with commercial operations: it is just research and creative activity which is allowed for them in addition to exercising their immediate functions;
- All large transactions in excess of 10% of the given unitary enterprise's authorized capital or of 50,000 minimal salary rate have to be reconciled with the owner;
- Public enterprise carries out its operations following a revenue/expenditure estimate approved by the owner;
- The owner is granted with the right to transform a unitary enterprise into a public or municipal establishment;

⁹ In 2001, to inventory the governmental share (SUE=s) in commercial banks, a special interdepartmental commission was established. The Commission reported that the government owned shares in 424 banks (including control blocks in 62 banks). Some 600 SUE=s control 714 stock packages worth a total of some Rb. 2.5 bln. in 250 credit institutions. All the agencies were bound to assign their stock to the RF Ministry of Property until July 1, 2002. SUE first reacted by distorting the information on their participation in credit institutions, while some of them attempted to increase commercial banks' authorized capital to dilute the governmental share. Nevertheless, as of late October 2002, the Ministry has received some 90% of all the stock. An analogous attempt should be launched with regard to insurance companies and investment funds.



- The procedures have been specified of formation of an authorized capital of unitary enterprises founded upon the right for economic operations.

In compliance with the Civil Code of RF, the law defines the legal status of government and municipal unitary enterprises, powers and obligations of owners of their property, procedures of establishment, reorganization and liquidation of unitary enterprises. Commercial organization not granted with the property rights for the property fixed with it by the owner is not recognized as a unitary enterprise. It is only government and municipal enterprises that can be established in the form of unitary enterprises. The property of a municipal enterprise belongs, on the basis of property rights, to the Russian Federation, a Subject of the Russian Federation or a municipal establishment. However, *the most crucial defect* of this particular organizational and legal form is still there.

As well, one cannot help but note that the adopted law bears a whole range of other substantial deficiencies, such as:

- unsound provisions that identify cases of possible establishment of unitary enterprises and primarily an excessive number of grounds for establishment of public enterprises;
- the absence of the much-needed development of the respective provisions of the Civil Code that define a special legal capacity of unitary enterprises;
- an insufficient development of the provisions that concern changing the kind of unitary enterprises and reassigning its property to another owner of the public or municipal property;
- inconsistency between some provisions of the said bill with the Civil Code of RF, other effective laws (more specifically, the federal law 'On auditing activity' and inconsistency between the terminology applied therein with the one used in sub-acts, etc.)¹⁰

Second, the fact of enactment of the law 'On state and municipal unitary enterprises' should not imply refusal of the government policy aimed at strengthening its controlling impact on unitary enterprises by improving the effective legal base developed between 1994 to 2001, i.e. by means of further development of the Standard Chapter of FSUE and the Standard Contract with its head, improving the work of Attestation Commissions with the overall emphasis on enhancement of the level of maintenance of public property.

The main means to ensure the above is to introduce to the said documents provisions on restricting opportunities for heads of unitary enterprises to carry out certain kinds of operations without a prior consent of the owner's representative, extending the incentive system to encourage them honor already concluded contracts, including a range of grounds for their cancellation, consequent penalties, and labor compensations.

Third, as far as contracts are concerned, there may appear new items, such as, for instance, the obligation of heads of unitary enterprises not to combine their position with a paid job in commercial structures, entrepreneurial and political activity, not to take part in transactions involving interests, and to report regularly their personal income and property to their superior agencies. At the same time, the enterprise head labor compensation system should be modified, so that to ensure an interrelation between various bonuses designated for comple-

¹⁰ For more detailed comments on the law, see: Povyshenie effektivnosti budgetnykh raskhodov na finansirovaniye udghetnykh organizatsiy (uchrezhdeniy), upravlenie gosudarstvennymi unitarnymi predpriyatiyami. M., IEPP, 2003

menting a reasonable fixed salary and economic performance of their enterprises, the presence or absence of disciplinary punishments, and honoring terms and conditions of their contracts. One should also extend the circle of grounds for canceling their contracts at the owner's initiative (in certain cases along with paying off a compensation).

Fourth, from the perspective of organization of an efficient system of management of, and control over operations of heads of unitary enterprises and restricting their excessive freedom of action, a charter of such an enterprise has to comprise provisions on restricting opportunities for heads of unitary enterprises to carry out certain kinds of operations without a prior consent of the owner's representative. On 19 November 2001, the Ministry of Justice registered a joint order of the RF Ministry of Economic Development, the Ministry of State Property and the Ministry of Taxes and Levies which identifies the list of procedures of identification of the above indicators.

It will be transferring profit to the budget according to pre-set standards and the adoption and implementation of a program of development of unitary enterprises for a certain period of time, which should be reconciled with government agencies that should form indicators of success in the government's managing impact.

Economic companies with governmental participation

The implementation of main provisions of the governmental Program with regard to economic companies with governmental participation, the majority of which is represented by AO=s, is capable to contribute to a better realization of the government's interests in the corporate governance area. However, in practice a lot will depend on concrete mechanisms, some of which are analyzed below.

In the medium run, the main question is a more precise specification of the governmental legal rights for property in different AO=s. It is based on a number of criteria, of which the most important one is the size of the governmental share in AO=s' authorized capital. As concerns majority packages, there should be formed a set of provisions and procedures that would allow the state as a strategic owner to exercise control functions. As far as minority blocks are concerned (under 25%), there should be a set of provisions and procedures allowing the state, among other owners, to exercise the respective control functions.

Today, specifying legal rights the state exercises as a co-owner in various AO=s requires addressing three particular tasks:

1. a greater level of clarity and regulation of operations of those individuals who represent the government's interests in AO=s by means of amending the effective legal acts on these issues (mostly beyond the frame of law-making processes in the Federal Assembly of RF);
2. introduction of elementary control mechanisms over financial flows and the process of at least simple reproduction of capital in mixed companies with the governmental participation in their capital and integration of such mechanisms in operational patterns of individuals representing state interests in AO=s;
3. inventory and ranging of the stock packages the government owns in regional-sectoral terms from the perspective of execution of the revenue part of budgets of all the tiers, completion of the much-needed institutional reform, not excluding pursuing a more pro-active structural and industrial policy in the future.

Let us remind that while being aimed at improvement of economic companies with the state participation, the aforementioned Concept for management of government property and



privatization in the Russian Federation generally lies in the frame of guidelines and principles analogous to those applied to unitary enterprises. This can be proved by similar reporting procedures for heads of FSUE=s and representatives of RF in open-end joint-stock companies, monitoring of operations of OAO whose stock is owned by the federal government, which is conducted along with unitary enterprises, by means of inclusion into the register of indicators of their economic efficiency, and transition to an annual approval of economic efficiency indicators both for FSUE and OAO (with the share of federal property over 50%).

It appears that further necessary elements of improvement the process of managing stock (shares) remained in the government's property could be:

- bringing the effective standard contract on representation of state interests (approved in May 1996 and not revised since that time) in consistency with the above documents;
- cancellation of the right of government representatives (both trustees and civil servants) for independent decision making on the circle of matters due for reconciliation, unless there are instructions of their superior governing bodies, in order to minimize manifestations of an opportunist and interest nature;
- to solve the problem of the mechanism of direct encouragement of the work of each of government representatives and trustees by granting them with a certain amount of dividend receipts from the state-owned packages (the Concept suggests allocating not less than 10% of dividends payable on the stock owned by the federal government to fund expenditures associated with managing the stock, however, it does not provide any concrete recommendations in this regard);
- provision of the representation of the state interests in the largest and most important AO=s by government executive agencies' staff, for whom such an activity should become a major one, along with the approval of the program of their annual operations by the Government (an introduction of the institution of the authorized government representatives). In this regard, an adoption of 'Regulation of protection of rights of the Russian Federation as an owner' may form a major innovation. The Regulation provides the transition of the said institution to a professional basis. Such a transition highlights two necessary components – that is, tougher requirements to those pretending to represent state interests in AO=s' boards and defining financial sources of their operations;
- improvement (setting limits of remuneration and compensation for costs incurred by a trustee, solving the problem of licensing trustees' operations proceeding from the law on securities market', along with the organization and conducting of a register of trustees), and a gradual extension of the practice of application of the trusteeship mechanism in the part of stock packages of enterprises of no strategic importance that are owned by the federal government (the most radical variant suggests a transition to this particular form of governance as a solely possible, though considering the effective legal base and current practices, this appears a complex issue);
- development of a set of responsibility measures, including the possibility of amending the Criminal Code of RF in the part of protection of state interests in the event of professional representatives dishonestly exercising their duties;

- a realization of an alienation strategy with regard to minority stock (up to 25%), except those in the largest and financially significant enterprises;
- a differentiated approach to evaluation of efficiency of government representatives' performance depending on the size of the state-owned stock and chances to exercise influence on the decision-making process.

4.4. Sectoral Peculiarities of Unitary State Enterprises

Federal unitary state enterprises have been reformed at the level of individual sectors within the framework of the Concepts of Public Property Management and Privatisation.

The most profound changes from the perspective of sheer numbers were made to the railway transport as part of preparation to reform the sector and establish RAO "Russian Railway". In 2001 the Ministry of Railway (MR) reorganised 396 enterprises depriving them of their legal entity status, of which the vast majority (395) were involved in primary operations, i.e. were part of the railway.

There were as much intensive changes in unitary state enterprises under the Ministry of Industry, Science and Technology. They reorganised 20 federal level enterprises of which one half (10) were liquidated as part of bankruptcy proceedings, 6 transformed into joint-stock companies and 4 passed over to constituent territories of the Russian Federation. 38 enterprises were under bankruptcy proceedings, 12 ceased to be operational (to be liquidated) while another 5 petrochemical engineering enterprises in the territory of Chechenya are in the process to be passed over to the Chechen Republic. The table below shows changes in the structure of enterprises under the Ministry of Industry across sectors in more detail.

Table 4

Changes in Sectoral Structure of Federal Unitary Enterprises under the Ministry of Industry, Science and Technology, 2000-2001

Sector	Number of Federal Unitary State Enterprises				
	Listed in Russian Government Resolution No. 813 dated October 12, 2000	Liquidated	Bankrupt and no longer operational	To be passed over to the Chechen Republic	As of late 2001



Ministry of Industry, Science And Technology (Minprom):					
- Mechanical engineering;	400	19	50	5	326
- Metallurgy;	153	7	21	5	120
- Chemical industry;	40	-	5	-	35
- Medical and biotechnological industry;	43	2	4	-	37
- Wood and timber complex;	51	2	4	-	45
- Defense industry;	55	7	10	-	38
- Light industry;	28	2	3	-	23
- Intersectoral enterprises	14	-	3	-	11
	16	-1*	-	-	17

* One federal entity was transformed into a unitary state enterprise.

Table 4 demonstrates that 60-70 percent of liquidated, bankrupt and non-operational unitary state enterprises are part of mechanical engineering and wood/timber complex.

At the same time changes in the composition of federal unitary state enterprises again confirmed that the process of improvement of the governance system will reveal new and previously unaccounted for enterprises to be added to the list of subordinated enterprises. In 2001 41 unitary enterprises associated with the State Construction Committee and 28 associated with the Ministry of Industry were identified.

Efforts to harmonise charters of unitary state enterprises with new requirements. The first priority task of sectoral management agencies in implementing measures to improve management of unitary state enterprises envisaged in the Concepts of Public Property Management and Privatisation was to perform Russian Government Resolution No. 104 dated February 3, 2000 as regards harmonising charters of subordinated entities with the effective law. Given below are data describing this process as of early 2002 (Table 5).

Table 5

Harmonising Charters of Federal Unitary State Enterprises with New Requirements

Ministry (Agency)	Total enterprises as of late 2001 – early 2002, units	Enterprises with new charters:					
		approved		to be agreed		other status (refined etc.)	
		Unit	%	Unit	%	Unit	%

RUSSIAN ECONOMY in 2002
trends and outlooks

Ministry (Agency)	Total enterprises as of late 2001 – early 2002, units	Enterprises with new charters:					
		approved		to be agreed		other status (refined etc.)	
		Unit	%	Unit	%	Unit	%
Ministry of Transport (Mintrans):	834	134	16,1	176	21,1	524	62,8
- Road network;	396*	30	7,6	97	24,5	269	67,9
- Automobile transport;	236	70	29,7	10	4,2	156	66,1
- Airlines;	146	8	5,5	57	39,0	81	55,5
- Sea transport;	36	14	38,9	9	25,0	13	36,1
- River transport	15	12	80,0	3	20,0	-	-
Ministry of Railway (MR)	459	...	...	...	...	...	...
Ministry of Industry, Science and Technology (Minprom):	326	180	55,2	87	26,7	59	18,1
Ministry of Natural Resources (MNR):	290	113	39,0	89	30,7	88	30,3
- Geological services;	193	83	43,0	53	27,5	57	29,5
- Forestry;	83	29	34,9	25	30,1	29	34,9
- Environmental protection service;	8	-	-	7	87,7	1	12,5
- Water service	6	1	16,7	4	66,6	1	16,7
State Construction and Utilities Committee (Gosstroy)	174	103	59,2	46	26,4	25	14,4
State Fishing Committee (Goskomrybolovstvo)	40	...	...	...	...	...	...
State Metrology and Standards Committee (Gosstandard)	39	...	...	...	...	...	...
Precious Metals and Jewels Agency under the Ministry of Finance	33	-	-	23	69,7	10	30,3
Federal Weather and Environmental Monitoring Service (Rosgydro-met)	6	6	100,0	-	-	-	-

* Documents of the Russian Road Service (Rosavtodor) contain other assessments of the number of associated unitary enterprises (314, 368 and 433_).

The above data suggest that the process of harmonising charters with new requirements was the most successful at the Federal Weather Service where all 6 enterprises had their charters agreed with the Ministry of Public Property and approved by the sectoral management agency by early 2002. This work is drawing to a close at the Federal River Transport Service (under the Ministry of Transport) where 12 out of 15 enterprises had their charters re-registered. The State Construction Committee and Ministry of Industry were also performing adequately, with 50-60 percent of enterprises having their charters re-registered. This work



was completed at the Ministry of Communications and apparently at the State Standards Committee.

This situation is contrasted by the majority of divisions under the Ministry of Transport, with 50-70 percent of enterprises yet to start re-registering their charters. The majority of departments under the MNR also have a large amount of work to do but, unlike the Ministry of Transport, most enterprises have their charters in the process of agreement. The Ministry of Nuclear Energy (Minatom) was expected to complete the work to approve charters of its enterprises by mid-2001 but we have no information whether this process has been completed. Efforts to harmonise charters with new requirements are still under way in the MNR, Precious Metals and Jewels Agency under the Ministry of Finance, and the Federal Land-Surveying and Cartography Service (Roscartography). We do not have any information on the process of harmonising charters in the MR, Ministry of Agriculture (Minselkhoz) and State Fishing Committee.

Staffing policies. In implementing the Russian Government's decisions to improve management of unitary state enterprises (Resolution No. 234 dated March 16, 2000), many ministries and agencies have set commissions to organise tenders for management positions with these enterprises and certification. In particular, these commissions were set up at the MNR (Ordinance No. 367 dated October 9, 2000), State Construction Committee (Ordinance No. 79 dated April 16, 2001). At the same time the procedure of these measures, list of issues and tests were defined. Thus, the Ministry of Agriculture issued Ordinance No. 1075 dated December 27, 2000 to approve the procedure of tender for position of the manager of unitary state enterprises and the certification procedure.

Certification of directors in 2001 suggests that the process was formal, the maximum share of managers acknowledged incompatible with their position being only 4 percent (in the Ministry of Industry). At the same time we have no information on certification commissions being set up and certification being held in the majority of departments under the Ministry of Transport, MR, Minatom, Ministry of Communications, State Fishing Committee as of early 2002.

With regard to the staffing aspect of improving management of federal unitary state enterprises, one should mention tenders for vacant managerial positions and employment contracts.

We have this information only for two agencies: Ministry of Industry and State Construction Committee. By early 2002 the former held 19 tenders, with 18 managers acknowledged as the best bidders (i.e., covering nearly 5.5 percent of all subordinated enterprises as of late 2001, with 7 tender yet to be held), the latter – 11 tenders in 2001 (i.e., covering nearly 6 percent of subordinated enterprises or 8 percent if not counting the enterprise which became associated with this agency in late 2001).

Table 6

Certification of Managers of Unitary State Enterprises in Line with New Requirements

Ministry (Agency)	Total enterprises	Number of enterprises with managers
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	as of late 2001 – early 2002, units	to be cer- tified	made their presentations	decisions was made on their compliance with their position	
				people	% of presenta- tions
Ministry of transport (Min- trans): - Road network	433*	419	361**	354	98,1
Ministry of Industry, Sci- ence and technology (Min- prom)	326	230	221	212	95,9
Ministry of Natural Re- sources (MNR)	290	...	147	144	98,0
State Construction and Utilities Committee (Goss- stroy)	174	...	13	...	...
State Standards and Metrol- ogy Committee (Gosstan- dards)	39	...	...	...	...
Federal Weather and Envi- ronmental Monitoring Ser- vice (Roshydromet)	6	5	5	...	...

* Data of the Labour, Wages and Personnel Department in the road network of Rosavtodor.

** Not counting 58 directors whose certification was postponed until 2002.

Moreover, the Ministry of Industry documented 205 additional agreements to effective contracts with managers of unitary state enterprises including 147 agreements which enhanced their responsibilities in line with requirements defined in Government Resolution No. 234 dated March 16, 2000.

The State Construction Committee entered 15 contracts with managers, with 7 more to be coordinated with the Ministry of Public Property. Taking this into account, the share of subordinated unitary state enterprises with new contracts entered with managers will be 12.6 percent.

Financial and economic position of federal unitary state enterprises as influenced by ministries and agencies. Financial and economic position of these enterprises is ambiguous. Given below are data describing financial and economic position of enterprises subordinated to specific sectoral agencies.

Table 7 shows that a part of federal unitary state enterprises is in a critical condition but their share is relatively small, if one is to believe reports of ministries and agencies. In any event, it is considerably smaller than the share of loss-making enterprises across the economy (37.9 percent in 2001).

Enterprises associated with the Precious Metals and Jewels Department under the Ministry of Finance were in an especially bad position. Positive performance in 2001 was shown by the Weather Service where all unitary state enterprises were making profits and by the Ministry of Interior with less than 8 percent of loss-making enterprises in 2000.

Despite satisfactory financial and economic position of many enterprises, the problem of transferring part of their profits to the federal budget is yet to be addressed. Thus, the Ministry of Nuclear Energy was expected to develop and implement deduction ratios from profits



of its subordinated enterprises to the federal budget as late as in the IV quarter of 2001. No profit was transferred by enterprises under the Weather Service and Cartography Committee.

Table 7

Financial and Economic Position of Federal Unitary State Enterprises Subordinated to Specific Sectoral Agencies

Ministry (Agency)	Total enterprises as of late 2001 – early 2002, units	Number of enterprises with					
		no economic operations		negative or small-value net assets		conservatorship or bankruptcy proceedings	
		unit	%	unit	%	unit	%
Ministry of Industry, Science and Technology (Minprom)	400*	12*	3,0	8**	2,0	38*	9,5
State Construction and Utilities Committee (Gostroy)	174	18	10,3	12	6,9	6	3,4
State Standards and Metrology Committee (Gosstandard)	39	...	...	...	...	3	7,7
Precious Metals and Jewels Department under the Ministry of Finance	33	...	...	...	...	10	30,3

* Enterprises associated with the Ministry of Industry in line with Government Resolution No. 812 dated October 26, 2000, bankrupt enterprises and no longer operational enterprises from this list.

** Enterprises with authorised capital less than the minimum required by law.

In 2001 only a few ministries and agencies adopted regulations on this issue.

It is worth mentioning the MNR which issued ordinances No. 351 and 353 dated April 24, 2001 to define the following deduction ratios from profits to be transferred to the federal budget as proprietor's income in 2001:

- 10 percent for enterprises allocating less than half of profits at their disposal to finance capital expenditures for primary operations;
- 20 percent for enterprises allocating minimum 40 percent of profits at their disposal to finance capital expenditures for primary operations;
- 30 percent for enterprises allocating minimum 30 percent of profits at their disposal to finance capital expenditures for primary operations;
- 60 percent for enterprises allocating less than 30 percent of profits at their disposal to finance capital expenditures for primary operations.

Moreover, enterprises allocating minimum 90 percent of undistributed profits at their disposal to finance capital expenditures for primary operations were fully released from any transfer of proprietor's income to the federal budget.

On the basis of economic performance of unitary state enterprises associated with the MNR in 2000 it was established that enterprises allocating minimum 90 percent of undistributed profits including previous years' undistributed profits at their disposal to finance capital expenditures for primary operations were released from any transfer of proprietor's income to the federal budget.

The share of profits to be transferred to the federal budget as proprietor's income including any previous years' undistributed profits was generally 50 percent. Where undistributed profits were the security for the enterprise development under the capital expenditure programme for primary operations approved by the MNR, the share of profits to be transferred to the federal budget was 10 percent of undistributed profits including previous years' undistributed profits.

It was established that regional departments of natural resources should ensure:

1. Approval of capital expenditure programmes for primary operations;
2. Control over transfer of resources by enterprises to the federal budget as proprietor's income;
3. Control over efficient use of resources allocated by enterprises as capital expenditures for primary operations.

The State Construction Committee issued Letter No. IZ-2025/14 dated April 19, 2001 to define deduction ratios from profits of subordinated enterprises to be transferred to the federal budget on the basis of performance in 2000 taking into account the nature of the sector and their operations.

A year later Ordinance No. 65 dated April 26, 2002 defined the following deduction ratios from net profits received in 2001 and left at the disposal of enterprises (line 190, form No. 2 of 2001 Profit and Loss Account):

- 15 percent for construction (installation) entities, scientific maintenance entities, utilities sector maintenance entities and state farms;
- 10 percent for manufacturing entities, surveying entities etc.;
- 7 percent for research and design entities, entities of engineering protection of territories.

Enterprises allocating minimum 40 percent of profits at their disposal to finance capital expenditures for primary operations and compensate for previous years' losses, and also "Radon" special radiation safety enterprises had zero deduction ratio from profits to be transferred to the federal budget on the basis of performance in 2001.

The deadline for full transfer of part of profits to the federal budget was June 15, 2002.

The public property department under the State Construction Committee was expected to ensure:

1. Control over transfer of resources by enterprises to the federal budget on the basis of performance in 2001;
2. Control over use of assets held by enterprises and analysis of efficiency of their operations
3. Review of capital expenditure programmes for primary operations;
4. Review of grounds to change deduction ratios from profits to be transferred to the federal budget on the basis of performance in 2001.

The Ministry of Communications agreed 10 percent ratio with the Ministry of Public Property with respect to performance in 2001.

This suggests that the sectoral management's approach to define deduction ratios from profits to the federal budget was largely based on taking into account the nature of operations of specific enterprises.



In its turn, this suggests that in practice deduction ratios for transfer of profits to the federal budget were defined for a narrow range of enterprises. Thus, the deduction ratio for profits to be transferred to the federal budget in 2001 on the basis of performance in 2000 was defined for only 170 unitary state enterprises of the Ministry of Industry (or approximately 52 percent of enterprises subordinated to with this ministry).

The Ministry believes that transfer of net profits to the federal budget was prevented by either their lack or negligible amount which owed itself to part of profits at enterprises' disposal being allocated to increase the authorised capital up to the statutory minimum, upgrade technical and production facilities, and open up new product lines.

Enterprises under the Ministry of Transport were touched by these proceedings to even lesser extent, with 10 percent deduction ratio defined for 3 out of 36 sea transport enterprises, 20 percent for 1 enterprise; 10 percent deduction ratio from net profits defined for 4 out of 15 river transport enterprises, 5 percent for 2 enterprises. No deduction ratio from profits was defined for road and air transport enterprises (including the Air Traffic Control Department).

This owed itself to extensive wear of fixed capital which, given scarce budget financing, required allocations for investment to maintain the operational infrastructure of air (airports) and river (ports, canals etc.) transport, and mobilisation readiness of road transport (formation of numbered army-type columns). Entities providing services to water transport and central offices of the respective agencies (advertising, communication, computing entities, sectoral printed media, maintenance and health entities) do not have available profits at their disposal either. Weather forecasting and environmental monitoring enterprises are in a similar plight. In stating the lack of deductions from profits as a compensation for using federal property in 2001, the Russian Weather Service indicated that the profits at the disposal of enterprises were used to maintain their facilities.

At the same time one needs to underline that sector-specific nature of unitary state enterprises, for instance, scientific research, does not indicate that they fail to generate enough profits to be transferred to the budget. Thus, 3 out of 6 river transport enterprises covered by deduction ratios in 2001 were research institutes and design offices. 3 more were associated with provisioning and foreign economic activities.

Plans for 2002 adopted by a number of agencies (Precious Metals and Jewels Department and Russian Weather Service) envisaged, apart from defining economic performance benchmarks, approving ratios and amounts of profits to be transferred to the federal budget, something that was lacking in the previous years.

The most important aspect of sectoral management's operations to comply with the Russian Government resolutions to improve management of unitary state enterprises was setting up balance sheet commissions or commissions for review of performance and management reports to:

- define the economic position of subordinated enterprises;
- assess the efficiency of use of federal property;
- define and approve economic performance benchmarks for subordinated enterprises, and define deduction ratios from profits to be transferred to the federal budget.

An example of approval of economic performance benchmarks is the following specific values approved by the MNR for 2002:

- Proceeds from sale of goods, products, services (minus value-added tax, excise taxes and other mandatory payments) – at least 2001 benchmarks times 1.12.
- Net profits – on the basis of general performance indicators:
 - minimum 12 percent for enterprises involved in geological prospecting;
 - minimum 9 percent for other enterprises.
- The amount of net profits to be transferred to the federal budget is defined as the amount of net profits minus part of net profits allocated to finance capital expenditures for primary operations times 1.5 provided that depreciation deductions in the reporting period are fully used to finance capital expenditures for primary operations. Moreover, deduction ratios from net profits to be transferred to the federal budget are minimum 10 percent and maximum 90 percent.
- Net assets – at least within the amount defined in the enterprise charter.

The MNR's Department for Subordinated Enterprises was required to:

- maintain the sectoral database of approved benchmarks and actual economic performance of enterprises;
- submit for approval any capital expenditure programmes for primary operations, to be provided to the MNR together with annual reports, and opinions on such programmes;
- define a share of profits to be transferred to the budget and absolute values of economic performance benchmarks for each enterprise.

At the same time the management reporting procedure and methodological recommendations to organise and perform economic performance analysis were approved and made available to federal unitary state enterprises.

Thus, the Ministry of Industry issued Ordinance No. 88 dated November 2, 2000 to approve the Procedure for defining economic performance benchmarks for subordinated enterprises. Actual performance under the benchmarks were assumed as reference values for commissions to define targets for the period following the reporting period, to be used in maintaining the register of economic performance indicators of enterprises. Targets were used by enterprises in drafting their development programmes. The Ministry sent to the Ministry of Economic Development its proposals to monitor financial and economic operations of subordinated enterprises under the Monitoring and Operational Planning Programme whose development is under way. The proposals, in particular, included special criteria for assessment of operations of the scientific sector's enterprises, which make up nearly half of subordinated unitary state enterprises (sectoral science and scientific support).

In 2001 managers of 262 enterprises (nearly 80 percent of enterprises subordinated to the Ministry of Industry) made presentations at commission meetings. Operations of 232 out of 262 were acknowledged as satisfactory. This was approximately in line with the share of enterprises, which reported to the Ministry of a regular basis (277 out of 326 unitary enterprises associated with the Ministry). The available reports were analysed, generalised and used by commissions in their work.

Moreover, it should be noted that a profound analysis of financial and economic operations of enterprises would in many cases invite auditing. Unfortunately, the reports of ministries and agencies on improvement of management of unitary state enterprises had very little information on actual audits of subordinated enterprises. The only exception was the Ministry of Industry which reported audits of 57 out of 72 enterprises to be audited under Government



Resolution No. 81 dated January 29, 2000 on the basis of their performance in 2000. Audits of another 15 engineering and timber enterprises were delayed until late 2001 due to the high cost of auditing services.

Settlement of property issues. Settlement of property issues was part and parcel of efforts of ministries and agencies to improve management of federal unitary state enterprises. This primarily involves building an inventory of federal property and its legal documentation (making it part of the Public Property Register of the Russian Federation), and focusing on any construction in progress.

Table 8

Intermediate Results of Sectoral Management to Build Inventory of Subordinated Federal Unitary State Enterprises

Ministry (Agency)	Total enterprises as of late 2001 – early 2002, units	Enterprises with assets registered with the federal property register	
		units	% of available
Ministry of Transport (Minstrans):	834	...	...
- Road network;	396	...	...
- Road transport;	236	...	...
- Airlines;	146	...	...
- Sea transport;	36	...	...
- River transport	15	...	...
Ministry of Railway (MR)	459	361	78,6
Ministry of Industry, Science and Technology (Minprom)	326	311	95,4
Ministry of Natural Resources (MNR)	290	200	69,0
State Construction and Utilities Committee (Gosstroy)	174	132	75,9
State Fishing Committee (Goskomrybolovstvo)	40	...	...
State Standards and Metrology Committee (Gosstandard)	39	39	100,0
Precious Metals and Jewels Department under the Ministry of Finance	33	...	...
Federal Weather and Environmental Monitoring Service (Rosgydromet)	12*	11	91,7

* Taking into account 6 enterprises set up in the first half of 1990s without coordination with the Russian Weather Service by separating pilot production units from research institutes.

Table 8 shows that inventory in the majority of federal ministries is not expected to be completed soon. From 20 to 30 percent of enterprises associated with the Ministry of Railway, Ministry of Natural Resources and State Construction and Utilities Committee have not yet received certificates of registered assets. The situation was better at the State Standards and Metrology Committee, Ministry of Industry (considering only actually associated enterprises) and the Federal Weather and Environmental Monitoring Service. There is no data available on the enterprises associated with the Ministry of Transport, Ministry of Communications, Minatom, Precious Metals and Jewels Department under the Ministry of Finance, Ministry of Agriculture and State Fishing Committee.

Also, it should be noted that lack of certainty regarding the assets of unitary state enterprises is acting as a brake on harmonization of new charters and new requirements. The charters of 13 enterprises under the State Construction and Utilities Committee are being under reworking due to lack of attachments, which requires from the enterprises to settle the issues of documents specifying their right to assets or settlement of property disputes in court. In specific cases, the issues of previous illegal privatization or assignment of the constituent territories or municipal units arise. Likewise, property issues of 19 enterprises under the Ministry of Industry are settled at territorial agencies.

Throughout 2001 many ministries and agencies carried out inventory of construction-in-progress objects owned by enterprises and institutions subordinated to sectoral management agencies. Propositions were designed on their involvement in economic operations, which normally included the following options:

- Construction completion with specifying of sources of financing (core capital and borrowed funds, federal budget funds);
- Privatization (joint-stock companies, selling by tender under investment conditions, auction under conditions of further utilization);
- Assignment to constituent territories and municipal units;
- Leasing.

This work resulted in registration of 185 objects (by 99 organizations) under the Ministry of Railway, 97 units (by 46 organizations) under the Ministry of Industry, 12 units under the Federal Weather and Environmental Monitoring Service, 8 units under the State Standards and Metrology Committee, 5 units (only major ones) under the Ministry of Communication.

It should be noted that the majority of the organizations with construction in progress are non-profit units rather than unitary state enterprises. This specifies the nature of proposals on involvement of these objects into economic operations in which completion of construction is essential and financed mostly with the federal budget.

Specifically, of 185 objects of the subordinate organizations, the Ministry of Natural Resources suggests to write off 12 units (including 10 units of unitary state enterprises), assign 8 units (including 2 units of unitary state enterprises) to regions and municipal units, sell 7 units (including 4 units of unitary state enterprises), and lease 2 units (including 1 unit of unitary state enterprises). Thus, even without regard for the objects, which have not been mentioned, about 80 percent of the objects with construction in progress need investments for completion. Only in two cases construction can be completed by financing with the core capital of the enterprises.

Of 12 of the construction-in-progress objects under the Federal Weather and Environmental Monitoring Service, 2 units are suggested to be completed by extrabudgetary financing and partial selling by tender under investment conditions, 1 unit is suggested to be financed with the budgetary funds. No suggestions have been made with regard to other objects.

Of 8 objects under the State Standards and Metrology Committee, 5 units (including 3 units of unitary state enterprises) are suggested to be completed by financing with budgetary funds, 2 units by financing with the funds of institutions (Standards and Metrology Centers) generated from authorized economic operations, 1 unit is suggested to be written off (by assigning the site to local administration).



The State Construction and Utilities Committee has collected a data bank on the objects with construction in progress as part of the assets of the subordinated enterprises. Actual changes in the structure of these assets were represented in legal documents and balance sheets of the enterprises. This resulted in a significant downtrend of the construction-in-progress objects.

Table 9

Preliminary Proposals of Agencies of Sectoral Management on Reorganization of Unitary State Enterprises

Ministry (Agency)	Total enterprises as of late 2001 – early 2002, units	Reorganization methods proposed							
		I	II	III	IV	V	VI	VII	VIII
Transport (Minstrans): - Road network;	396	...	...	30	...	...	...	...	...
Ministry of Industry, Science and Technology (Minprom)	326	12	...	60	...	8	...	...	...
Ministry of Natural Resources (MNR):	290	1	68	48	15	39	1	49	87
- Geological services;	193	1	68	29	15	8	1	37	52
- Forestry;	83	0	0	17	0	30	0	11	25
- Environmental protection service;	8	0	0	0	0	0	0	1	7
- Water service	6	0	0	2	0	1	0	0	3
State Construction and Utilities Committee (Gosstroy)	174	8	9	16	1	...	...	...	...
State Standards and Metrology Committee (Gosstandard)	39	3	-	-	3	1	-	-	32
Federal Weather and Environmental Monitoring Service (Rosgydromet)	6	-	2	-	-	-	-	-	4

Note: methods of reorganization are designated by figures as follows:

I – acquisition; II – merging; III – privatization and incorporation; IV – assignment to constituent territories; V – liquidation (including enterprises with negative net assets on which no decision has been made yet); VI – reorganization into federal agencies; VII – exclusion from the subordinated enterprises register; VIII – maintained as a unitary state enterprise.

Methods of the ministries and agencies aimed at further reforming the unitary state enterprises in various industries. On the basis of the requirements of the Ordinance No. 1348, dated December 6, 1999, of the Government of the Russian Federation, throughout the period of 2000-2001 of sectoral management agencies had been involved in development of proposals and reorganization of the unitary state enterprises. The data specifying the quantitative part of the issue are presented in Table 6.

In addition, we can refer to privatization of 4-5 unitary state enterprises, reorganization of 3 enterprises by acquisition and 2 by merging, as scheduled by the Ministry of Communi-

cation for 2002-2003. The Federal Land-Surveying and Cartography Service has scheduled to maintain the previous legal form of its organizations.

Table 6 shows that the work on development of reorganization plans is being in full pride. Only the Ministry of Natural Resources, the State Standards and Metrology Committee and the Federal Weather and Environmental Monitoring Service have a final view of their future.

In spite of different approaches at various agencies, it should be noted privatization unitary state enterprises by incorporation is accepted only for 15-20 percent of the total: 18.4 percent at the Ministry of Industry, 16.5 percent at the Ministry of Natural Resources and 9 percent at the State Construction and Utilities Committee. Assignment of the enterprises to constituent territories looks even more unlikely. The Ministry of Natural Resources is expected to use this option for about 5 percent of the enterprises, the State Standards and Metrology Committee for about 8 percent.

In general, one may state that the reorganization plans developed by the sectoral management agencies tend to maintain the existing organizational and legal form unchanged or changed (after acquisition or merging) for the majority of the enterprises.

This is often substantiated by the following:

- considering an object or type of operation as an exclusive federal property;
- ban on privatization;
- manufacturing and service provision related to the national security, withdrawn from or restricted for business;
- participation in federal programs and provision of unique technological processes;
- registration with the Federal property Register.

To date, the procedures of reorganization of the unitary state enterprises by restructuring of their assets through separating various units with their further isolation and integration with educational institutions (to create scientific and educational establishments) are being developed or tested as pilot projects.

In summarising the work performed by the federal executive agencies over the last few years regarding improvement of management of unitary state enterprises, we may note a significant progress in terms of asset inventory and harmonisation of the charters of the enterprises and new requirements at the majority of the ministries and agencies. However, lack of data on a series of sectoral management agencies (Minatom, Ministry of Agriculture and State Fishing Committee) and on the majority of structural units of the Ministry of Transport suggest that these agencies are at the initial stage of implementation of a package of measures provided for by the Concepts of Public Property Management and Privatisation.

In addition we have to state that a token character of certification of managers along with poor advancement of practice of competition for vacancies and conclusion of contracts limit a positive effect of the measures provided for by the Concepts. A certain positive experience has been gained at the Ministry of Industry and the State Construction and Utilities Committee.

Lots of efforts will have to be made to resolve the issues of allocating a part of the profit to the federal budget (so far, only the Ministry of Natural Resources and the State Construction and Utilities Committee have been leading in this respect) and preparing sound proposals on fu-



ture reorganisation of the unitary state enterprises. At present they are strictly conservative and tend to maintain previous organisational and legal form and receive budgetary financing for completion of construction in progress.

It should be taken into account that the foregoing analysis is far from being complete. The data presented by the ministries and agencies cover less than a quarter of the total of 9.4 thousand enterprises as of early 2002. Specifically, the analysis has not covered almost the entire military-industrial complex under specialised government agencies as well as enterprises under power ministries (State Customs Committee, Ministry of Internal Affairs, Ministry of National Emergency, Ministry of Justice, Federal Information Agency, Federal Security Service), whose operations are strictly specialised. A good example is the Ministry of Internal Affairs which includes, for instance, specialised instalment and operation enterprises involved in instalment, operation and introduction of technical means of traffic control (traffic lights, road signs, etc.), which are considered for assignment to the executive agencies of constituent territories of the Russian Federation.

4.5. Certain Trends in the Corporate Sector Development

Among basic tendencies that are typical of the corporate sector development in 2002 it is noteworthy to single out both the continuing process of share capital concentration, amalgamation of enterprises and reorganisation of already existing business-groups and a whole series of new tendencies related to intracorporate programmes of a number of the largest companies (groups). It is essential that an analysis of reorganisation changes in 2002 allows us to reveal different strategic motives – depending on the groups' "maturity"¹¹.

The development of corporate governance standards within a company is directly connected with its reorganisation and long-term strategy. Peculiarities of the latter, judging by the experience of 2002, are also defined by potential views of group's owners on the features of its international expansion in the nearest years.

Concentration, amalgamation and merger of corporations

In oil, coal and metal branches in 2002 *the intensive process of redistribution of property was to a great extent finalised* (due to the fact that the last government share holdings got privatised and spheres of influence between the largest industrial groups got distributed). A further development in the redistribution processes in these sectors is primarily defined by transactions connected with reorganisations of large holdings, optimisation of their assets (withdrawal of non-profile assets), or alliances among groups.

In this way the control in ferrous metallurgy is performed by 7 largest groups, which in its turn does not exclude the possibility of their further consolidation. At the end of 2002 leaders of the metallurgical works in Novolipetsk (NLMK) and Magnitogorsk (MMK) announced about a possibility of their companies' amalgamation. Though at present stage a "mild" amalgamation with the aim of joint investments and saving of their resources is most probable, establishing of a unified holding structure is also possible, which can give

¹¹ When choosing concrete examples to give the analysis objectivity the author made a point of using only undeniable facts or several sources that in their aggregate show opposite tendencies. In addition to the author's own data there were used data from WEB-sites of the issuers, SKRIN and other Internet resources, periodicals of publishing house "Commerzant", "Finansovaya Rossiya", "Vedomosti", "Expert", "Finansovye Izvestiya", "Companiya", "Zhurnal Dlya Aktzionerov", "Rynok Tzennykh Bumag" and a number of others.

grounds to place the new holding among ten largest world producers in the branch. It is worth noting that also other might-have-been variants of amalgamations of the largest metallurgical companies were announced previously (an alliance between OAO "Severstal" and the MMK versus an alliance between NLMK and "Eurasholding" with sales of government shares in the "Kuzbassugol" company, a non-commercial partnership established by the NLMK and "Eurasholding" with "Russkaya Stal"). As will also be shown below, at present stage the branch is to a greater degree characterised not by amalgamations but by restructuring and assets consolidation programmes within the framework of already existing ones that have the branch under their control.

In the copper industry the market is controlled by 3 companies, in the aluminium industry in 2002 only two holdings were left. In the aluminium branch as a result of the fact that OAO "SUAL" (the second largest in the branch) amalgamated the aluminium assets of "Sevzapprom" (the managing company of aluminium works in Volkhov and Volgograd, Pikalovsky GZK and a number of others) the SUAL-holding company has actually divided this market with "Rusal" and controls now 25% of production of aluminium and 60% of production of alumina. The owners of OOO "Upravlyayuschaya Compania (managing company) "Sevzapprom" got 18% of the shares of OAO "SUAL".

An indication that rather stable influence spheres are being formed in the branch can be the insignificant at first glance transaction with the shares of Nadvoitzky aluminium works (NadAZ), which is significant first of all for the development of SUAL. In 2002 65% of NadAZ's shares were bought by the SUAL-holding, and 32% by "Russkiy Aluminium". It was rather evident that a joint management of this enterprise by the two rivals in the branch could hardly be promising and was fraught with a lengthy confrontation within the corporation, that is why the situation was decided in a civilised way at the end of 2002, when SUAL bought 32% of the above shares. Though the transaction conditions are unknown, it is easy to suppose that "Russkiy Aluminium" got a considerable premium on its renunciation of the joint management.

An institutional result of the military-industrial complex reform in the nearest years shall become the appearance of a rather limited number of large holdings controlled by the government. Pursuant to the government programme adopted in May 2002 in the aircraft industry there shall be established 5 integrated structures by 2004, including 2 multi-profile holdings that will produce both military and civil products: in March 2003 the shares of VASO, MAK "Ilyushin" and Ilyushin aircraft complex will be unified and holding OAO "Corporatziya "Ilyushin" with a 51% government share will be established; by the beginning of 2004 "Tupolev" corporation will be established.

In autumn 2002 legal registration of the process of consolidation of telecommunication companies within the framework of "Svyazinvest" holding was finalised. The result of this process was establishment of 7 inter-regional companies (Tzentrtelcom, North-West Telecom, Uralsvyazinform, The Southern Telecommunications Company, SibirTelecom, VolgaTelecom, Dalsvyaz) on the basis of 72 telecommunication operators. The formal consolidation, no doubt, envisages an even more labour-intensive subsequent stage – actual consolidation of inter-regional subsidiary companies, a tougher management control on the part of the holding, and a capitalisation growth programme.

Concurrently in 2002 subsidiaries of "Svyazinvest" company with the help of bounded debts in roubles attracted 2.5 bln roubles. In 2002 inter-regional subsidiaries plan to float bonds for 3.2 bln roubles. (OAO "VolgaTelecom", "SibirTelecom", "The Southern Tele-



communications Company". A considerable part of the acquired means shall be used to go on with the policy of assets consolidation: by OAO "VolgaTelecom" to buy 50% of shares of mobile operator ZAO "Nizhegorodskaya Sotovaya Svyaz", and by "SibirTelecom" also to buy two mobile telephone companies.

At the same time a certain stabilisation in the sphere of property interests (in a certain sense - a post-crisis fixation of property interests' spheres) creates prerequisites for a new phase of hostile absorptions. Both the deficit of "available" takeover objects and gradual exhaustion of available financial resources give ground to suppose that the takeover style in the nearest years will to a considerable extent be "administrative", using debt schemes, actions at law about insignificance of previous transactions, etc.

On the other side in a number of branches that possess a considerable growth potential and/or relatively scattered assets *intensive concentration (takeover) processes and glaring corporate contradictions persist*, the latter being typical of unstable institutional structures.

A concentration process of relatively scattered assets in the meat industry started in 2002, which was initiated to a considerable degree by agricultural sub-holdings belonging to large oil and metallurgy groups. On the whole the tendency of interest growth on the part of largest Russian groups to the agricultural sector has been characteristic for the past 3 years, which is connected both with the effective demand outlooks in this branch and the possibilities to legalise capitals.

In contrast to the meat industry, where in spite of the starting consolidation no corporate conflicts have been registered so far, the "timber" war will in all probability persist also in 2003 (including in London arbitration tribunal). Though in 2002 the court decisions retained the rights of "Ilim Pulp Enterprises" on shares of pulp and paper mills in Kotlas and Bratsk, its major rival "Continental Management" (a subsidiary of "Bazovy Element") is hardly going to refrain from its struggle and its further expansion in the branch. It is evident that in this property conflict of two largest companies in one of the most attractive branches in Russia's economy the real confrontation will be happening between the largest extractive groups that are diversifying their assets. According to assessments most effective in this kind of conflict turned out to be takeover methods traditional for the past years – made to order bankruptcies, tampering with registers and the "administrative resource". One should also take into the consideration that according to the assessments as of the end of 2002 all in all 12 independent structures are present in the branch, they form both vertically and horizontally integrated holdings (structures belonging to the Alpha-group, OAO "Severstal", and others).

Among other known conflict of 2002 one can name the failed attempt by "Alpha-Echo" to take over the metallurgical works in Taganrog that turned for help to the MDM-group, seizure of a block of shares of Krasnoyarsk coal company, paralleled stockholders' meetings of "Dalvostokugol", suits by minority shareholders of "Rosneft" about transfer price formation in the holding, tampering with registers of a fat-and-oil factory in Nizhny Novgorod and NPZ in Moscow¹², a multi-layer conflict around "Severnaya Neft", a clash between officers of justice and "employees" of "Moskomplektmebel", and others.

A parallel process of getting rid of non-profile assets and diversification allows us to speak about moving of financial resources between branches that started in the past two years

¹² An analogous procedure (seizure of the register pursuant to a court decision and its transfer to another registrar with follow-up "changes" in the list of shareholders), as far as we know, was used to shift the control of the timber factory in Ust-Ilimsk, metal works in Taganrog, etc.

and is being serviced by the absorption market. Meanwhile, two basic features are typical of the recipient branches: lack of strategic (controlling) owners and an acceptable (higher than the average) level of profitability. The acuteness of corporate conflicts persistent in the majority of branches also testifies to the effect that hostile takeovers (including those containing specific Russian features – usage of the “administrative resource”¹³) keep being the predominant method of share capital concentration. For the nearest years (taking into consideration the plans to privatise state-owned enterprises and turn them into joint-stock companies) one can also forecast corporate conflicts connected with shift of control at these enterprises prior to and in the course of privatisation transactions. Nevertheless, the results of 2002 allow us to speak about certain quantitative changes.

As is well known, single instances of using classical takeover methods were typical of the initial privatisation stage (post-privatisation stage since the middle of the 1990s until the crisis of 1998). If privatisation deals are taken into account, it is this very period that can clearly be characterised as “takeovers through privatisation”. This method was both used as an independent mechanism and within the framework of expansion strategies of the first financial and industrial groups (first of all non-formal ones, originating in banks).

The second stage (the post-crisis boom) was typical of the period from the middle of 1999 until 2002, when specific reasons that caused a wave of amalgamations and takeovers in Russia became particularly apparent. Nevertheless, due to peculiarities of the methods used, some analysts prefer not using the “amalgamation and takeover” notions to describe them, restricting themselves to a more regular word-combination “redistribution of property”. In this period the expansion of industrial groups was combined with a growing process of assets consolidation.

The third stage (reorganisation “slump”) starts in all probability at present. It can be characterised by a certain decrease in the existing groups’ expansion tempo slowdown, finalisation of consolidation processes and a transfer to restructuring of groups and legal reorganisation (first of all legalisation of amorphous holdings and groups)¹⁴.

Restructuring Programmes

It should be noted that restructuring concepts are visibly varied in different surveys (a detailed analysis of these is not included in the present research). They agree only in the part of a most general approach to restructuring, when it is defined as “changes in operations, in-

¹³ The “administrative resource” notion (materially motivated decisions of courts, federal and regional authorities, etc), which is so wide-spread at present and being rather evident in its essence, is at the same time difficult to be interpreted and even more difficult to be legally proved (which was spoken of with confidence in one of his interviews by the president of “Alpha-Bank” and leader of one of the most aggressive Russian groups in the sphere of corporate absorptions M. Friedman). The president of “Sibneft” Y. Shwidler stated for example that each of oil companies in the course of its development got its share of the administrative resource and it is namely this fact that defines the real competitions at the oil market (Kommersant-Vlast, 2003. January 20-26, p. 25). It is noteworthy that according to the original version of the same source, the standardisation and the mass character of using the procedure of the “administrative resource” in 2002 led to a reduction of its price and simultaneously caused a situation when rivalling parties use same methods (balanced support actors) and are most often incapable of bringing their cases till final victory of one of the parties. In such a situation expenditures that correspond to the corporate conflict become comparable to the real price of the assets and civilised negotiations become more economical.

¹⁴ For more detail about theoretical and legal aspects of this problem see in *Radygin A., Entov R., Shmelyova N. Problemy Sliyaniy I Pogloscheniy V Korporativnom Sektore*. Moscow, IET. 2002.



teractions (interplay) and motivations in the direction of reaching success in the changing market situation”¹⁵. In practice the traditional meaning of “restructuring” both in Russia and in the West is “improvement of enterprise’s activities”¹⁶. On the whole the restructuring process, being a multidimensional concept, includes the following components:

- restructuring as a legal matter (the subject of it is solely reorganisation of a juridical person (company) as a subject of the law, including amalgamation and joining in Russian law-terms);
- restructuring of a group of companies (legalisation of a holding and its owners);
- restructuring as a matter of production, that is changes in the production and technical structure of an enterprise, restructuring of an enterprise as a subject of company’s property (object of restructuring here is the property used for business undertakings as subject of law);
- restructuring of the owner or restructuring of a company as a subject of property of its owners, including shareholders (only at the initiative of owners themselves), including amalgamation and joining;
- restructuring of the system of daily management;
- restructuring of financial flows;
- restructuring with respect to employees.

There exist also other approaches based upon Russian peculiarities: the major problem of restructuring Russian companies lies in the fact that when they are being restructured there is made a redistribution of shadow business, when there is no credence attached to one’s partners; in the majority of cases restructuring of Russian companies does not sue any economic purposes, but political ones, it is not done to optimise company’s activities, but to withdraw money flows from it, and finally, restructuring today is a mere continuation of privatisation and a subsequent redistribution of property¹⁷.

It is rather evident that the goals pursued within the framework of restructuring programmes are to a considerable degree defined by *concrete development stages of enterprises (groups of enterprises)*.

Table 10

Formation of formal standards for corporate governance in the oil sector and some of their related characteristics

	Lukoil	Yukos	Surgut-neftegaz	TNK	Sibneft**	Tatneft
Withdrawal of non-profile assets	2001	1998*	-	-	1997	2002
US GAAP reporting	1998	2001	2002	-	1998	2000
Dividends at least 10% to the profit (“western” analogues – from 30 to 70%)	1993 (about 15%)	2001 (about 15%)	2-5%	-	2001 (about 15%)	2-5%

¹⁵ Ericson R. Restructuring in Transition: Concept and Measurement. Comparative Economic Studies, 1998, 40. P. 103–108.

¹⁶ Blake E., Levis F. Mify O Restrukturizatsii V Rossii / Rynok Tzennykh Bumag, 1998. #6. p. 24-27.

¹⁷ See materials of conferences arranged by the Publishing House “Commersant”: Restructuring of companies, alliances, merger, take-over. Moscow, October 2000. Successful restructuring of enterprises. Problems and practical solutions. Moscow, October 2001. To describe general processes of changes at enterprises (within groups) we will further on use notions “restructuring”, “reorganisation” and “transformations” of enterprises (groups) as synonyms, meaning not only legal aspects, but also economic and first of all “property” aspects of the process.

RUSSIAN ECONOMY in 2002 trends and outlooks

Independent directors	2002	2000	-	-	1998	-
Code (charter, principles) of corporate governance	-	2001	-	Draft in February 2003	1998	-
Presence of a corporate governance committee in the board of directors	-	2000	-	-	1998	-
ADR issues	1996	2001	-	-	2000	1998
Disclosure of data about the property structure	-	2002	-	-	-	-
Withdrawal of major owners (shareholders) from the management	-	-	-	-	1996	-
Share of free float shares, in % to the authorized capital stock, December 2002	52-54 (>25 after 2000)	20-25	N/a	10-15	15	N/a
Possibility for minor shareholders to influence the level of income (compensation) of the managers and to obtain corresponding information	2001	-	-	-	-	-
Equality of market's subjects with respect to the issuer (ban to use insider information at purchase of shares by employees (affiliated persons), ban to transfer not published information of vital importance to private persons and organisations)	-	-	-	-	-	-
Option programmes	-	2001	-	-	-	2001
Place in the corporate governance rating (IKPU), in all 25 companies, 3 rd quarter (2 nd quarter) 2002	7(9)	5(5)	17(19)	20(20)	6(7-8)	21(22)
**SKRIN-Naufor popularity rating, 50 issuers, January 2003 (January 2002)	1(1)	7(10)	4(4)	16(18)	14(15)	17(14)

* At the end of 2001 – beginning of 2002 (prior to privatisation of the remaining government owned shares) the problem of assets withdrawal from “Yukos’s” subsidiary VNK was discussed, though it never got a univocal interpretation. The problem of acceptable economic and legal limits (conditions) for withdrawal of assets and transfer price formation acceptable from the viewpoint of minority shareholders is typical of the majority of holdings (groups), though.

** The company’s reports in 1998, as well as its “independent directors” called for a whole series of criticisms on the part of analysts. It was quite evident that 90% of the profit paid out in 2001 as dividends could not be interpreted in the context of standard goals of a dividend policy.

Source: companies’ WEB-sites; “Commerzant – Neft I Gaz”, 2002. # 114; assessments by the author.

Finalisation of institutional formation (consolidation) processes of stable business groups in the oil branch by the beginning of the 2000s does not exclude a further expansion in oil and other industries. Nevertheless, the current restructuring programmes for the largest oil companies are rather similar and in the first place are aimed at an optimisation of property assets, lower per barrel cost prices in oil production, raised oil production and increased exports of oil products, development of the gas producing sector.

Programmes of oil companies “Yukos”, “Sibneft” and since 2002 of “Lukoil” include also a set of standard measures to increase the companies’ capitalisation: US GAAP reports, withdrawal of service and non-profile structures, inclusion of independent directors in their boards, dividend policies, etc (*table 10*). For example “Lukoil” that has lost its leading position in the branch recently plans sales of 206 non-profile companies, shutdown of ¼ of non-commercial wells (about 5000), staff reduction. The board of directors consisting of 11 member at the annual shareholders’ meeting in 2002 got 3 independent directors (in “Yukos” the board of directors elected in 2002 in addition to two top managers of the company includes 9 independent directors or directors at least not directly connected with the company). Never-



theless, the existing complicated structure of the holding and the level of transparency do not quite correspond to the task of increasing the company's capitalisation. On the contrary, one of the major corporate events of 2002 was the fact the "Yukos" disclosed its data on the structure of the group's property, which also had an effect upon capitalisation growth (an incentive for it was listing by the New York stock exchange and floating of ADR of the 3rd level).

It is evident that capitalisation growth that from the viewpoint of the investors automatically testifies to a high effectiveness of assets management gives the company a whole number of advantages – an effective participation at the stock market, good image and enhanced prestige of its managers, accessibility of credits on the security of its shares, profitable sale of the company and its merger, realisation of compensation programmes for its employees, etc. At the same time (and this is not just a Russian trait, which is testified to, for example, by the case of Enron) capitalisation does not necessarily reflect the dynamics of the basic showings, but can be connected with the inertial "fashion" for already overestimated securities in conditions of a limited market (due to insufficiency of traded securities) and an effective information support (PR, positive financial reports by analysts, etc).

To give an example, according to estimates "Surgutneftegaz" is one of the most effective companies in Russia that has a substantial basis for its growth (production increase, volumes of extracted resources) supported by large investments. At the same time the company's policies are characterised by privacy of data, it ignores interests of minor shareholders and has much smaller dividends compared to its rivals. In 2002 "Surgutneftegaz" published its financial reports for 2000-2001 according to US GAAP meaning to publish quarterly reports in future and to develop a programme of a better corporate image. Nevertheless, the company plans to hold the annual stockholder' meeting as early as in March, not at the end of spring – beginning of summer 2003 as is usual in other companies, which can be viewed as an indirect evidence that the company will continue to pursue the above policies also in 2003. The reason for that in all probability is a possibility that soon there will be made amendments to the Law "On Joint-Stock Companies", which will give a more precise definition to the "net profit" notion. Using the current, not defined by the law approach there is an opportunity to interpret the net profit as profit after deduction of taxes, investments and amortisation, while the new amendments (1st reading on December 25, 2002, 2nd reading on February 14, 2003) give a clear definition to the net profit as profit after deduction of taxes. For establishing preferred dividends, which shall be at least 10% of the net profit, this makes a great difference.

State-owned "Rosneft" in 2002 also published its financial reports for 2000-2001 based on US GAAP. Nevertheless, from the point of view of property relations that are being established in the holding the company still lags behind its rivals. When the latter have actually finalised their processes of consolidation of subsidiaries and went over to single shares at the end of the 1990s – beginning of the 2000s, the consolidation policy in "Rosneft" is far from being finalised. One of the problems in this respect is the pattern of its property in its subsidiaries – 51% in equities, but only 38% in the authorized capital stock (should "Rosneft" fail to pay preferred dividends it will thus lose control, which already happened in 1997). "Rosneft's" clear final goal is achieving a qualified control over its subsidiaries with a follow-up transfer to single shares. This becomes even more pressing for the company taking its conflicts with minority shareholders in 2002 about transfer price formation in the holding into consideration.

Many events connected with "Lukoil's" activities in 2002 (denunciation of the Iraq contract within the framework of the production sharing agreement (PSA) on "Western

Curna-2" field, its withdrawal from Azeri-Chirag-Gunashli Consortium, sales of the tanker fleet of the ice class, taking out of bonds that can be converted into "Lukoil's" shares started by British Petroleum in advance in January 2003, cancellation of its application to participate in privatisation of "Slavneft", etc) cannot be unambiguously interpreted with respect to assessments of the company's development. At the same time as distinct from the overwhelming majority of the largest oil producing companies in Russia "Lukoil's" freely floated shares at the market as of the beginning of 2003 according to assessments can account for 52-54% of its authorized capital stock. This free float figure alongside with the transparent property pattern, information openness and the profit shares in dividends are of decisive importance for portfolio investors (with respect to assessment of the issuer's and its affiliated structures' capabilities to manipulate the market). In comparison with "Lukoil" free float of TNK amounts only to 10-15%, "Sibneft" – 15%, and "Yukos" – 20-25%. One more potential advantage of "Lukoil" are its investments into petroleum refineries and sales companies in Eastern Europe, which allows the company to feel to a certain degree comfortable in cases of crude oil price falls.

Also rather indicative – in the context of consolidation as a general tendency and corresponding outlooks for Russia's equity market – is the negative position taken by TNK with respect to floating its shares on the domestic market after its consolidation. Among reasons for the company's actually closed character and its unwillingness to publicly float its shares are named the following: a minimal number of minor shareholders, fears of scandals and corporate blackmailing that can harm the company's reputation, its disinclination to use "cheaper" internal price quotations.

The policies of corporate image enhancement and artificial "pumping" of capitalisation can in particular be an evidence of preparations for sales or an international parity merger. Should all other conditions persist appearance of foreign co-owners in some of Russian oil companies (in different organisational forms) is being assessed as only a matter of time, which is conditioned in the first place by Russian companies' reaching a certain level of their correspondence in price to their foreign counterparts if their value is recalculated taking into account their oil stocks, and secondly by presence of other alternatives to invest proceeds into the Russian economy¹⁸.

In 2002 a number of large holdings (groups) embarked on restructuring programmes aimed at tightening control and consolidating the management of the purchased assets, thus following the example of the oil sector. The two main aspects of such a restructuring are as follows.

Firstly, it is *the strategy of asset regulation* (getting rid of the companies that are not in the main line of business (non-specialised assets) that was typical not only of the oil sector but also of the majority of large, relatively organised groups in 2002.

The restructuring programme of OAO Obyedinennye Mashinostroitelnye Zavody (OAO OMZ) is not related to asset consolidation; it provides for establishing in 2003 six business following divisions within OMZ, without legal independence at the first stage, but with independent balance-sheets and budgets: Mining, Nuclear, Metallurgy, Oil and Gas Equipment, Special Steels and Shipbuilding. It is possible that subsequently the divisions will be transformed into independent companies and sold. OAO Severstal started a similar programme of

¹⁸ Used assessments by investment company "Tzentrinvest", IC "Finans-Analytic", The Institute of Financial Research, IC "NIKOil", IC "Prospect", IC "Aton", surveys at RusEnergy.com.



asset restructuring in 2002. It is assumed that three holding will be formed (the metallurgical company OAO Severstal, car-building company OAO Severstal-Avto and mining company OAO Severstal-Resurs) under the control of ZAO Severstal-Group. The purpose of such a restructuring is to clear the Group's main business, steel production, of non-specialised assets and increase its capitalisation so as to enter the US stock market subsequently.

RAO Gazprom's policy of asset regulation seems much more complicated, in particular due to the need to return to the company some of the previously stripped assets that belonged to its core business. The control regained over SIBUR in 2002 is not enough for efficient management, and Gazprom needs to increase its share to qualified majority. It should also be noted that in 2002 control was regained over the companies Zapsibgazprom, Purgas, Vostokgazprom, the South Russian Deposit and others. At the same time, non-specialised assets are being sold (the revenues in 2002 were RUR 7 billion and expenses of returning the core business assets cca. RUR 9 billion). Still, it is obvious that Gazprom's status of a federal natural monopoly prevents one from regarding these processes as a restructuring programme. More serious reforms in Gazprom must have been frozen at least for the next 18 months.

Secondly, *the tightening of management and property control*; this is typical both of the groups that have completed their expansionist programmes and of the groups that are continuing the corporate formation. In contrast to the relatively widespread Western practice of consolidating only the management, in Russia management consolidation usually follows property consolidation and is never considered sufficient (or only provisionally, at the phase of gaining control over property).

The creation of industrial sub-holdings of the MDM group has been practically completed. According to group officials, the concluding deal was the acquisition of 80 percent of AO Azot by the Mineral and Chemical Corporation Evrokhim. The first step of the restructuring, like in a number of other groups, is vertical tightening of the asset management structure. In the first place, the holding's representation in the boards of the main companies has been strengthened. In the second place, management functions are being consolidated: instead of general directors appointed and dismissed by the boards of directors or general meetings of shareholders companies should be locally governed by executive directors appointed by the holding and acting on the basis of a power of attorney.

The next logical step would be to transfer each of the holdings (MCC Evrokhim, the Tube and Metallurgical Company, Baikal-Ugol) to a single share (creation of a single legal entity that would include all the companies under control as divisions), transform it into a public company and enter the stock market (IPO in 2003 or 2004). As a result of the restructuring, the MDM Group core may also subsequently decentralise its subholding management.

Tougher strategies of control over group companies have also been introduced in the Russian Aluminium (under parity control by Sibneft through Millhouse and by O. Deripaska's group). The issue of creating a subsidiary company OOO Rusal - Upravlayushaya Kompaniya, a single management body for the holding's eight companies, was considered in early 2002. It was proposed that the companies belonging to the group's main specialisation (the main assets) should remain legally independent and all auxiliary assets should be centralised. According to that proposal, the former directors of the holding's companies would lose their general director status and would carry out their functions by proxy as executive managing directors working in a close-end company. But as soon as in the autumn of 2002 consolidation of the holding's 27 companies into six business areas and transfer to a single share gained greater priority (at least, according to official statements). While there is a number of legal

issues that need to be solved (obtaining the permission of the RF Ministry for Antimonopoly Policy to purchase more than 20 percent of shares, the procedure for transformation of open-end companies into close-end companies for a number of companies, forced exchange / buy-back of minority blocks in an acquisition / merger), OAO SUAL carried out a similar acquisition of the works under its control in January 2001.

Interestingly, the restructuring started in 2002 in the car-building plant GAZ controlled by Bazovy Element is going in the opposite direction – from a single company to a classical holding – and is in fact selling off structural units into subsidiaries. Such subsidiaries can be established on the basis of the Mold and Press Form Works, Gearset Works, Car Bridge Works, Foundry Works, Passenger Car-Building Plant and Lorry-Building Plant, etc. Besides cutting production costs, the plan is to establish joint ventures on the basis of the subsidiaries.

The industrial holdings going through the forming period and continuing asset expansion are introducing tight control over the newly purchased assets.

An expansion example in the food industry is Gosinkorholding, which is currently forming a horizontally iterated confectionery subholding on the basis of the blocks of shares of Rot Front, Krasny Oktyabr and nine regional candy factories. The plan for 2003 is to acquire five more candy factories and gain full control over Babayevski. Starting from 2003 general management of the holding has been transferred to the management company United Confectioneries (Obyedinyonnye Konditery) and sales and marketing have been centralised in the trading house Obyedinyonni Torgovy Dom that have been established for these particular purposes.

The continuing expansion of the Ural Mining and Metallurgical Company (UGMK) is related to the forming of a vertically integrated copper holding that comprises, through a system of off-shore assets, over 20 companies in the mining and non-ferrous metallurgy sectors. At the same time UGMK acts as the Management Company. At present the task is to ensure 'legally clean' control over a number of companies that are already involved in the Group (it is necessary to obtain a permission of the Ministry for Antimonopoly Policy to acquire large blocks of shares of the Gaisky Ore Mining and Processing Enterprise, Uralelectromed and others). The next logical step in the process of legalising (increasing the transparency of) the system of the Group's assets would be to transfer the controlling blocks of the Group's member enterprises from off-shore companies to UGMK, then convert to a single share and float the shares of the consolidated public company on foreign stock markets. Still, experts believe that the Group's acquisition strategy has not been completed yet.

Further restructuring of Evrazholding implies transition of the holding's steel-casting enterprises (the Novosibirsk, Kuznetsk, West-Siberian and Nizhny Tagil Metallurgical Enterprises) to a single share by 2005; however, a precondition for such an operation is the potential problems relating to management of the enterprise (obtaining the powers of an executive body) should be regulated. In particular, it is planned that the holding should obtain the status of a management company in relation to the North-Siberian and Nizhny Tagil Metallurgical Plants (this requires at least 75 percent of votes in a shareholder meeting). It should be noted that liquidation of the general director's functions and transfer of executive powers to a special management company (and this implies qualified control) has the indisputable advantage of limiting the top management's ability to act in an opportunistic manner (the extreme case: control take-over in agreement with the management). Thus, the current phase of reorganisation can be aimed only at defence; however, the strategies purpose, like in some other companies, may be to enter the stock market or to sell the company.



It should be noted that the issues of tightening the control over the top management's activities have been considered in state-owned holdings, too: one may refer to the Government's Decree No. 1512-r of 29 October, 2002 "On Introducing Changes in the Charter of the Federal Unitary State Enterprise Rosspirtprom" as an example. According to this decree, the holding's right to borrow independently, put the election of boards of directors and executive bodies on the agenda of the companies whose shares have been transferred in the Enterprises charter capital and terminate the authorities of the subsidiaries is withdrawn. From now on all such operations may only be carried out with the permission of the Government that would make recommendations on the amount dividends to shareholder meetings of the said companies and decide on changes in their constituent documents and charter capitals. Appointments of the general directors of subsidiaries and of deputy general directors and the chief accountant of the holding itself will be co-ordinated with the Ministry for Agriculture of the Russian Federation. Previously Rosspirtprom's limitations related only to additional share issues and the conversion of shares into bonds. The main reason cited by the Government for such a step is the necessity to cut the number of deliberate bankruptcies in the alcohol production sector.

Moreover, several relatively *new trends* related, as we have mentioned above, to inter-group programmes of a number of the largest companies were typical of 2002. Besides the above-mentioned tightening of management control, the following trends are of interest.

Firstly, the restructuring and consolidation processes in 2002 were distinguished by the clarity of interim purposes, in particular, the task of entering the Russian and international stock markets. Such purposes have been cited by the industrial subholdings of the MDM Group, UGMK and Severstal; it is also highly probable that Evrazholding, Rusal and a number of machine-building enterprises will embark on such programmes. According to estimates, in the next one to two years, as a result of the concentration of capital in the machine-building sector continuing against the background of a growing appeal of machine-building company stocks, a number of the sector's largest holding structures and groups (Russian Machines, Power Machines, Severstal-Avto) will enter the stock market. Several large companies in the agroindustrial sector have also declared their intent to enter the stock market: the agroindustrial enterprise Cherkizovsky (the blocking stake worth cca. US\$ 150 million will be placed on NYSE in 2003), agroindustrial farm Rusagrocapital (the blocking stake worth US\$ 25 to 30 million will be sold in 2005) etc.

Obviously, the consolidation of property and management control is a condition that is indispensable but not sufficient. It is just as crucial to create the image of transparency for prospective investors. In this connection one may predict a growth in real demand for new corporate governance initiatives related to information disclosure and corporate financial accounts.

At the same time, it would be wrong, from our point of view, to overestimate these prospects. On the one hand, just like in the past, the Russian stock market cannot carry out the redirection of investment flows. Although the RTS index has grown almost 35 percent in 2003, approaching its maximum pre-1998 values, market capitalisation does not exceed US\$ 90 billion and ten companies account for 90 percent of turnover (and out of these, two companies – Lukoil and RAO UES – account for 45 percent). It is quite obvious that the overall prospects of realisation of the bank reform and of the possibilities to grant bank loans to small and medium companies have considerable impact on the Russian financial market. The forecast for international financial markets do not give cause for optimism, either, despite the rise of Russia's credit ratings and of the interest to Russian securities in 2002 on the side of for-

eign institutional investors that operate with longer term investments and use corporate fundamental indices as a benchmark.

On the other hand, the fact that IPOs are few and far between does not one allow to join in the celebrations of many analysts (especially their interpretation of 2003 as 'the IPO year' that will replace 2002 as 'the year of corporate RUR bonds'). It is significant that the relatively successful placements relate so far to the companies that have been private from their inception and have well-known brands, and their buyers are financial institutes, not strategic investors. It is also important that the IPO procedure is only very briefly described in the Russian legislation, so each project requires by far more consultancy and legal expenses than it would be the case if there existed standard detailed regulations. Usually, potential benefits of an IPO (such as low cost of the obtained funds, as compared with other funding methods, growth of capitalisation, liquidity etc.) exceed total expenses (on information disclosure, fees of advisors, legal experts, underwriters etc.) only at a relatively mature stage of a company's development. E.g., empirical tests carried out on the basis of the life cycle theory demonstrate that during the past 20 years companies performed the IPO at an average age of seven (if one does not count in the dotcom boom of the late 1990-s).

The experience of foreign IPOs is rather modest: Vimpelcom (1996, US\$ 100 million), Mobile TeleSystems (2000, US\$ 300 million) and Wimm-Bill-Dann (2002, US\$ 200 million) at floated their stocks at NYSE. Besides the above-mentioned enterprises, the following companies plan to float their shares in the USA in the next years: Kalina concern (cca. 25 percent of shares, upon publication of an IAS report), MefaFon (cca. 20 percent of shares) and OAO Baltika Brewery (upon integration of the holding's subsidiaries into a single structure).

OAO Rosbusinessconsulting Information Systems was the first Russian entity to carry out an IPO in Russia (at MICEX and RTS, 16 percent of shares). In January 2003, the drug-store network Aptechnaya Set 36.6 floated 20 percent of its shares. In both cases the placement price was lower than the initial estimates by the underwriters (still, this is not typical of the Russian market), and no forecast are made in respect of active secondary circulation.

Corporate Ruble bonds remain so far the only instrument – at least, due to the lack of an adequate alternative. Nevertheless, according to certain estimates, the interest to shares as a financial instrument is going to grow in the course of the next two years¹⁹. This means, inter alia, that many issuers can (as an easier alternative to an IPO) convert their privileged shares into ordinary shares. And, the other way round, the debt instruments will be of interest to the relatively limited circle of investors (and these will not compete with the investors interested in placements in Russian shares). As regards the IPO, the future placement will be most probably divided into two segments: the external segment for large companies and the Russian segment for small and medium companies (i.e., in fact, the Small Caps market will be created in Russia). For instance, development of the latter segment is fundamentally important for the transition to classifying Russian companies by capitalisation and not by liquidity.

Secondly, the trend towards legal 'closing' of a number of companies has been expressed more clearly.

¹⁹ *K. Lynch* 2002: the corporate bond year. 2003: the IPO year/ *Securities Market*, 2002, Issue # 5, pages 60-62; Interview with P. Helloran, Chairman of the Board of Directors of IC Aton./ *Securities Market*, 2002, Issue # 9, pages 48-50; *V. Petrov, P. Suprunov, O. Petrova*, Is Russia expecting an IPO boom? / *Securities Market*, 2002, Issue # 20, pages 20 - 26.



In the 1990-s oil holdings were transforming their subsidiaries into close-end companies by exchanging their shares for the shares of the holding. In 2000 - 2001 the most consolidated of the companies started to consider the issues of transforming into a non-public single consolidated company. In 2002 the Russian Aluminium considered transforming open-end joint-stock companies comprising the holding into close-end joint-stock companies. IN November 2002 the issue of transforming open-end joint-stock companies comprising the holding into close-end joint-stock companies was, for the first time, regarded in practice: Uralkali included it on the agenda (Uralkali: the largest potash fertiliser producer, over 70 percent of shares belong to the controlling shareholder, 10,000 shareholders, IAS accounting since 1996, listed at RTS since 1999). Taking into account the company's characteristics, it is not quite clear what the reason for the possible transformation is: 1) the management was trying to neutralise minority shareholders and stop the attempts at collecting the blocking stake (like in the Russian Aluminium, in which the presence of a lot of open-end joint-stock companies in the group is regarded as a significant problem); 2) fixing the established structure of ownership that, following the reorganisation, would be difficult to question in court (including the privatisation deals); 3) speculating for the fall of the open-end joint-stock companies' shares (without real reorganisation purposes) so as to consolidate a block exceeding the qualified majority with lesser expenses; 4) according to the version proposed by the company: the necessity to transform into close-end joint-stock companies corresponds the companies business purposes since de facto, from the viewpoint of ownership, it is a close-end company not interested in outside investments.

This issue has a wider aspect, too. For many medium-sized Russian companies that have been forced to become open-end in the course of the mass privatisation and are highly concentrated from the point of view of the shareholder capital structure there is a number of advantages. Still, such transformation is possible on a large scale only in case there would be created the necessary conditions or, to be more precise, obvious incentives for transforming from an open-end joint-stock company into a close-end joint-stock company²⁰.

One of self-contradictions in the Russian law is that operations of public companies are not sufficiently regulated while the companies with a close-end organisational and legal forms (non-public) are burdened with excessive regulation. E.g., from the viewpoint of the Ministry for Economic Development of Russia, it would be expedient to introduce such novelties for close-end joint-stock companies as eliminating the requirement on the constituent agreement (which often is a duplicate of the charter but is necessary in the course of different voting procedures), introducing the possibility of unlimited member walkout (in accordance with the charter), registering members in the state register etc.

Thirdly, in 2001 - 2002 a number of companies developed option programmes, thus undertaking another innovation. Granting to the company's management options for its shares has been traditionally regarded an efficient tool of boosting capitalisation and the management's interest in the company's development strategy (although the Enron case introduced a pessimistic note into the generally accepted idea and put the issue of tightening the corresponding regulation on the agenda).

²⁰ In other words, the policy of 'squeezing' companies into other forms by means of a system of incentives and legal limitations seem reasonable. A similar approach (already legally fixed in 2002) has been envisaged for unitary state enterprises.

In Russia certain rules were introduced on 9 January, 1997, when the regulation of the Federal Securities Market Committee ("On an Options Certificate and Its Application and on Approving the Standards for Issuing Options Certificates and their Prospectuses"). The first issue of options certificates, for the shares of OAO Tatneft, was registered in May, 2001. In August 2001 RAO GAZ prom approved a programme of granting options for the company's shares. The board of directors of YUKOS approved in April, 2001, an incentive programme for the remuneration of personnel that envisaged using options for shares and granting shares free of charge. The total amount of shares that may be transferred to the staff in the course of the next three years should not exceed 85 million, or 3.8 percent of the total number of the shares issued by the company. In doing so, the company does not contemplate any additional issues to realise the programme. In October, 2002, a long-term programme of "remunerating the best employees with the company's shares" (by means of an agreement of gift) was announced.

A programme of options for the personnel (the management of subsidiaries and dependent entities) of power industry sector companies was envisaged as part of the overall reforms of RAO UES. The scheme approved by the board of directors in June of 2002 envisages that the management of parent companies of RAO UES would be granted an option right to one percent of the shares of RAO UES and the management of AO-energос would be offered from 0.5 to five percent of the shares of AO-energос. At the same time, general problems of restructuring the joint-stock company, including the relationship between the management and minority shareholders, complicates such schemes considerably.

As far as the companies that were private from their inception are concerned, similar programmes are being developed at Vimpelcom (a system of participation in profits for the staff and a system of options for top management). Undoubtedly, it would be possible to assess the efficiency of such schemes only three to five years after they commenced. Still, just like in the case with the IPO, the existing legal norms require considerable detailed elaboration and revision (despite the amendments to the Law "On the Securities Market" that came into force in January 2003). Likewise, it is possible to apply such schemes at a certain stage in a company's development. It is obvious that, in addition to the considerations of capitalisation, option schemes may be applied in Russia as part of consolidation of corporate control and legalisation of the management's income.

Fourthly, the new development trend typical of established Russian holdings that have exhausted the internal resources for expansion is that they are entering the international market. It is not a purpose of this survey to discuss the exact definitions or concepts of the development of multinational corporations²¹, however, certain fundamental differences are important, above all the motives behind and the type of internationalisation.

²¹ See, e.g., works by S. Heimer, C. P. Kindleberger (the monopolistic advantage model), R. Vernon (the product life cycle model), J. Galbright (technological model), J. Casson, J. McManus (internationalisation concept), S.P. Muggy (appropriation theory), J. Dunning (eclectic model), the materials of the UN Centre Multinational Corporation etc. It should also be noted that the applied definitions are relatively conventional: companies that are similar in their features may be termed 'international concerns' in Germany, 'multinational corporations' in the countries of the Anglo-Saxon tradition etc. And similarly, there is no standard criterion for the international nature of a company (presence of at least one branch or a certain portion of business operations (assets) abroad, a certain amount of export-import operations, foreign shareholders, capitalisation, the share of free float on international markets etc.).



In addition to the traditional motives (first of all, the advantages of vertical or horizontal integration that vary subject to the country and sector specifics), the following motives typical of the Russian holding can be pointed out at the present stage:

- increase in the 'physical' power and search for an integration model that would allow to reach a level of international competitiveness that is commensurate with the foreign analogues;
- restoration and development of the supply and sales structure that was established in the times of the USSR and Council for Mutual Economic Assistance and has retained its economic importance for Russian companies;
- business diversification (within the main specialisation of the Group) so as to protect oneself against changes in the global commodities markets;
- the wish to support the company's reputation and ensure the most favourable conditions from the viewpoint of attracting foreign investments (in case powerful outside strategic partners become group members);
- political insurance against internal Russian risks.

Transfer pricing - this classical know-how of international companies - obviously deserves special attention. According to P. Lindert's definition, 'transfer pricing is an artistic form of evading the corporate income tax that may be applied by any accountants operating with assets or products that cross national borders'²². Considering the discussion of transfer pricing going on in a number of Russian federal bodies, the forming of a foreign network of subsidiaries and branches can become a preventive measure against possible tightening of the approach.

The above-named features of the present stage of reorganisation in many Russian holdings are obviously directly connected with the owners' strategic ideas on the prospects of their further transformation. Consequently, two development scenarios are possible in the context of the groups' business globalisation.

1) The forming, on the basis of consolidated Russian assets, of really *multinational* corporations (lack of a single base country, registration of the parent (holding) company outside Russia, broad international membership of influential shareholders).

In future it will evidently be possible to contemplate creating a consolidated international industrial group (members: SUAL International, coal assets of Access Industries in Russian and Kazakhstan, tantalum works in Mozambique and ferronickel works on Cuba owned by Fleming Family and Partners and FFP's investment liabilities worth cca. US\$ 3 billion). From the point of view of SUAL, such an alliance significantly increases the efficiency of the group's access to international stock markets (the IPO will presumably take place in two years) and means, in particular, real internationalisation of the company. In fact, the new company is created on the basis of SUAL-International, and FFP's share should in future achieve 25 percent. Contrariwise, the Russian Aluminium, SUAL's direct competitor, does

²² Lindert P.H. International Economics, IRWIN, 1986. E.g., a company overprices products or services delivered from a country with beneficial taxation to its branch in a country with a high level of taxes. As a result, the net amounts of taxes paid by the multinational corporation are reduced. It is assumed that it is possible to prove the tax evasion by comparing intercompany prices and market prices but there are ways to disguise the transfer pricing. In the 1980-s a single tax was introduced in a number of states (California, Montana.); according to this tax, a the portion of total declared profits received by a multinational corporation on the territory of the state equals the portion of its total assets, paid salaries and sales falling to the share of this state; profit statements presented by the corporations were *a priori* recognised inadequate.

not consider entering international stock markets and / or selling a share of its business; obviously, it counts on its internal economic and political reserves.

It is quite possible that a number of Russian oil companies boosting their capitalisation and creating a favourable corporate image can take this road in future, too. According to a number of estimates, some of the companies do not position themselves in their statements as Russian companies any more²³. In our viewpoint, this development scenario is not going to be widespread (even when other Russian companies, now at the stage of asset consolidation and tightening of management control, have 'matured').

2) The *multinational expansion* version (the headquarters are in Russia, foreign assets are acquired as part of vertical or horizontal integration of the group's companies, group assets are transferred to foreign profit centres etc.) was typical of many Russian industrial and extractive sector companies and groups already in the 1990-s. Numerous examples include the Russian Aluminium (alumina processing plants in the Ukraine, in Guinea etc.), Lukoil, YUKOS, Norilsk Nickel, the MAIR Group etc. This is also true for the companies that have been private from their inception. E.g., in 2002 it was announced that Mobile TeleSystems would purchase 57.67 percent of the Ukrainian mobile communications operator UMS (deal amount: US\$ 194 million).

Thus, on the whole, one may say that in 2001 - 2002 the largest Russian groups started to look for their place in the system of international economic relations. Still, the fundamental issue that we rose back in 2001 (to what extent will the current reorganisation of the big Russian business correspond to the aim of achieving its competitiveness at the international level²⁴) has retained its vital importance. Whether the selected strategy is appropriate depends to a large degree on the owners' aims (strategic development of a competitive group or going out of business with fixation of profits) and can be confirmed only in future.

These processes have to a certain extent been reflected in the discussion on the aims and principles of the potential industrial policy in Russia that livened up in 2002. The gist of the discussion lies in talks over two fundamental interconnected aspects: 1) more general alternatives of Russia's long-term economic development: either preserving the status-quo²⁵ or rejecting the orientation towards production of raw materials, tightening export taxation so as to level profitability in the raw materials and in the processing sectors; 2) absolute government support to 'integrated business-groups' (according to the Russian Union of Industrialists and Entrepreneurs) or 'limiting the absolute power of national financial-industrial groups'.²⁶ However, in reality, at the present time the notion of industrial policy represents a mutating symbiosis of lobbying efforts by the largest industrial and financial groups, on the one hand, and ambitious statements by political groupings, on the other hand. Obviously, for the indus-

²³ *Tremasov K.*, Industrial Policy. Why there are No Investments. // *Vestnik NAUFOR*, 2002, Issue # 3, page 9.

²⁴ See: *Russian Economics in 2001*, Moscow, IET, 2002, Volume 2.

²⁵ An extremely clear position has been formulated in an economic report by Brunswick UBS Warburg, one of the leading broker firms in Russia (published 31 January, 2003): "In a post-industrial world, a nation's prosperity is determined by the country's integration in the global economy by concentrating on its relative advantage. Such an advantage for Russia is exports of raw materials and energy carriers (as opposed to capital- and labour-intensive industrial products)".

²⁶ *Mau V.A.*, Results of Year 2002 and Specific Features of Economic Policy in the Election Year/ *Kommersant*, 2003, Issue # 15, Page 20; *Tremasov K.*, *ibid.*; etc.

As regards the issue of oligarchic capitalism against the background of decreasing rates of the economic growth and a sharp deceleration of structural reforms, see also: E.T. Gaidar's Speech at the Council of the Party "Union of Rightist Forces" on 22 December, 2002. (www.iet.ru).



trial policy to be really efficient it requires not just a formal document of general nature, but a series of concrete measures based on clear aims in the field of tax policy, economic concentration (according to the definition of the Ministry for Antimonopoly Policy, stock market, enforcement and the foreign policy of Russia.

And, finally, one can point to certain rather *contradictory changes in the market's approach to corporate governance issues* on the whole.

The 're-decoration' started in many large corporations relating to the improvement of corporate governance ('codes of corporate governance', 'independent directors', 'departments of shareholder relations', ensuring 'transparency' etc.) will hardly be able to delude anybody. Obviously, this renovation is predominantly a re-decoration that does not affect the system of relations established in the Russian corporate sector in the 1990-s. This has been caused, above all, by lack of serious conditions for fundamental improvements in this field (especially within the context of equal treatment of all shareholders and of shareholder rights) – lack of serious conditions in the structure of ownership and control, in the field of funding sources and business organisation charts, in the outside environment (taxes, politically engaged selective enforcement etc.)²⁷.

In this connection, it would hardly be wise to take seriously declarations made in 2001 - 2002 by a number of large Russian companies on the problems that the business faces due to the lack of civilised ethical business norms. Such declarations partly expressed in the so-called Charter of Corporate and Business Ethics of the Russian Union of Industrialists and Entrepreneurs adopted on 25 October, 2002. The advocates of 'generally accepted moral rules and ethical norms' that put their signatures on the Charter include participants of the notorious 'loans for shares' deals of the mid-1990-s and initiators of many corporate conflicts and scandals of the late 1990-s - early 2000-s. The Slavneft deal in December, 2002, does not inspire any optimism in this connection, either.

At present there exists one more factor that supports the above statement. In reality, initial interest in corporate governance appeared only upon the mass privatisation of 1992 - 1994, although a number of economists had recognised the importance of its long-term nature for Russian companies earlier. The Law "On Joint-Stock Companies" (No. 208-FZ of 26 December, 1995) became a legal landmark, but one can contend that the discussion on corporate governance (or, to be more precise, on the discrimination of outsider rights) shifted into the sphere of practical application against the background and as a result of the stock boom in 1996 - 1997. The most notorious conflicts of that period (Noyabrskneftegas, YUKOS, Yuganskneftegas, Samaraneftegas, Sidanco, Nosta, Varyeganeftegas, Chernogorneft, the Vyksun Metallurgical Plant, Magnitogorsk Metallurgical Enterprise, Baltic Shipping Company, Leningrad Metallurgical Plant, Akron, numerous telecommunication and power industry companies etc.) became a joint signal testifying to the problem's mass and chronic nature. The discussion was to a large extent initialised by foreign investors not yet accustomed to the Russian corporate standards. The financial crisis of 1998 brought about another wave and created new tools of property redistribution, which made the discussion only more intense. This occurred primarily owing to and in the course of strengthening of the management's property positions and to appearance of new shareholders that bought out

²⁷ For details see: *Radygin A.* Corporate Governance in Russia: Limitations and Prospects // *Voprossy Ekonomiki*, 2002, Issue # 1, Pages 101 - 124; *Radygin A., Sidorov I.* Russian Corporate Economics: One Hundred Years of Solitude? // *Voprossy Ekonomiki*, 2000, Issue # 5, PAGES 45 - 61.

property positions and to appearance of new shareholders that bought out blocks of shares in the post-crisis period at a low price.

While in the mid-1990-s the calls for reforming corporate governance norms were generated rather by Western portfolio investors, at present the factor of 'pressure from the West' is losing dwindling.

Let us take the survey of investment fund managers carried out in 2002.²⁸ While several years ago the p/e ratio was a reason enough to buy the shares of a Russian company, at present to make an investment decision it is necessary to perform an independent due diligence by such significant parameters as the company's management profile, presence of independent directors on the Board, ownership structure (preference is given to investments in companies with foreign strategic investors and no government share), transparency (business plans, management accounting, IAS / GAAP financial accounting, listing at RTS or MICEX). Most of the largest Russian companies interested in capitalisation growth already formally comply with these requirements.

Apparently, at present one may speak of *adaptation* of the Western business community to the specifics of corporate relationship organisation in Russia: above all, conducting business through a groups of formally unconnected companies reporting to one owner or a number of partners, and the corresponding structure of financial flows²⁹. Thus, one could assume that many Western partners have found creation of a formal image of the company (group) with elements of civilised corporate governance standards sufficient and taken the fundamental system of business organisation (including non-dividend sources of income and transfer pricing) as a matter of course.

Undoubtedly, there are a number of objectively positive trends in the development of corporate governance standards applied by Russian issuers. According to the Institute for Corporate Right and Governance (ICRG), corporate transparency has been increasing in the course of the past year (information is disclosed in greater detail and quicker, in particular, in issuers' quarterly reports and on the web-sites), the contents of the companies' constituent and internal documents have considerably improved.³⁰ These shifts are reflected, in particular, in the ICRG corporate governance ratings. E.g., during the 12 month-period (Quarter II, 2001, to Quarter II, 2003) out of 23 companies that account for 90 percent of capitalisation of the Russian stock market, corporate governance improved in 18, deteriorated in four and remained unchanged in one. The data for Quarter III confirm this trend, too. Certainly, the companies in question are the largest Russian companies, therefore it is so far impossible to speak of large-scale changes in the corporate sector in relation to the corresponding standards. The new revision of the Law "On the Securities Market" ought to have a positive influence on the quality of corporate governance in Russian companies. In particular, the Law introduces new requirements as to the contents of information disclosed in the form of quarterly reports (on financial and administrative operations, on members of the management, on the issuer's members, on transactions involving interest etc.)

²⁸ Criteria for Investment Decisions. 2002 Fund Manager Survey on Russian Investment. Ernst & Young, Moscow, 2002.

²⁹ E.g., I. Rozinski gave this assessment of the present situation at the conference of the Higher School of Economics "Modernising the Russian Economy: Results and Prospects" (Section 2, "Institutional and Structural Reforms"), 3-4 April, 2002.

³⁰ E.g., in a number of cases the authorities of the general director signing the deals had been illegally extended. It is quite obvious that the possibility of declaring such a deal void increases shareholder risks.



Although legal novelties in the field of corporate law proper (protection of shareholder rights) had, to a considerable extent, achieved their limit from the point of view of the existing economic conditions, the prospects for the improvement of the existing norms are quite good. This regards both the fundamental law "On Joint-Stock Companies" and the more specialised fields, such as reorganisation, acquisitions, groups of companies, affiliates, insider deals, information disclosure, reporting, bankruptcy and others. It is also apparent that it will be impossible to develop the methods used to protect shareholder rights any further without adequate general measures in the field of enforcement and changes in the law of procedure.

4.6. The Banking Sector

The year of 2002 was a good period for Russian banks: the overall sector's growth continued with assets in real terms increasing by 20%, loans to non-banking sector by 26%, deposits by 27%, including an encouraging 39% growth on deposits from individuals.

On an equally inspiring note, Russian banks have also stayed away from devoting too much of their funds to securities, which, as of December 1, 2002, constituted only 14.9% share of banks' overall assets with only non-Treasury bonds registering a small rise.

The year of 2002 was particularly favorable for banks investing in Russian Treasury foreign currency-denominated (FCD) bonds, whose rise throughout the year allowed banks to book healthy profits in ruble-terms. Despite such good performance, the number of Russian banks investing in their country's sovereign FCD debt remains limited with usual suspects, Sberbank and Vneshtorgbank holding largest portfolios.

In 2002, as in the past, Russian banks continued to act as main investors in the Federal ruble-denominated debt, although its concentration in the banking sector has slowed down somewhat. The end-year data also show that in 2002 an average Russian bank has reduced its FCD assets in favor of ruble-denominated instruments.

Credit to the Real Sector

In 2002 crediting the non-banking sector (NBS) continued its 2001 trend to *relative growth*³¹ (i.e. outpaced growth of banks' other assets). Thus proportion of loans to NBS in the bank's overall assets notched up to a 48.9% level from a 46.7% a year before, although in inflation-adjusted terms the 2002 pace of growth was somewhat lower than in 2001. Loans to NBS at the start of 2002 made up 44% of overall assets and by the end of the year this figure rose to 48%. For 11 months in 2002 the growth of banks' aggregate loan portfolio constituted 17.4% (18.9% in annual terms) against a 25.4% level in 2001. And although proportion of overdue loans have risen somewhat from a 1.7% in the start of the year to 1.9% in the last month, their share remains at a very low and stable level (annual average of 1.8%).

However, while proportion of NBS loans has risen relative to banks' other assets, it has to be noted that this base (i.e. funds made available to banks) has declined from 31.4% to 29.8% within 11 months. Again, without Sberbank in the picture the reduction is even more pronounced – from 38.8% at the start of the year down to 34.4% by December.

About 94% of country's banks are engaged in NBS loan activity. With 30% of all NBS loans outstanding, Sberbank is by far the largest creditor with Alfa Bank, its closest rival, holding five times less. Sberbank, in general, holds a leading position for all ruble-denominated loans. As of December 1, 2002 it controls 37.2% of the market. Sberbank's grip

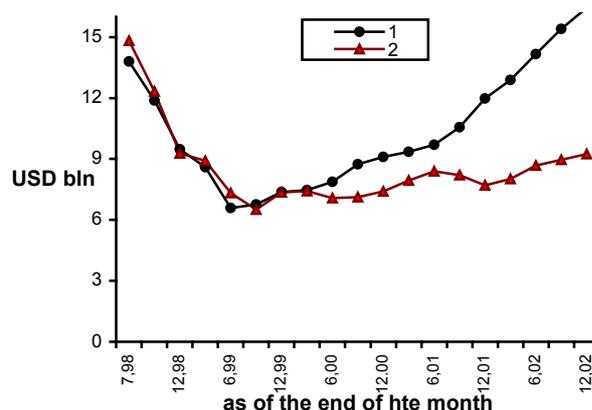
³¹ Here and further throughout the text without regard of ARCO-managed banks

is less deadly on foreign-currency denominated loans where its 14.8% market share is not too far ahead of Vneshtorgbank's 9.9% share, although this gap is greater if only loans to resident-enterprises are taken into consideration.

In contrast to 2001, in 2002 growth of foreign-currency denominated loans outpaced that of the ruble loan portfolio. Thus foreign currency segment of the NBS loan market has grown in the year from 32% to 34.3%, while the proportion of ruble loans has declined from 68% at the onset to 65.7% by the end of the year. Excluding Sberbank figures, the share of foreign currency denominated loans has gone up from 39.5% to 41.3%. It has to be noted that the changes in the correlation between ruble and FCD loans were happening against backdrop of expansion in both of the segments.

For loans in foreign currency, the banks in 2002 had to rely more on local demand (enterprises and private individuals' resources) (see *Fig. 1*). If prior to 1998, banks' liabilities before non-resident customers exceeded banks' foreign currency loans extended to non-banking resident clients, by the end of 1999 those figures leveled and by the end of 2002 banks' liabilities before non-resident customers amounted to only 58% of the loans proffered to resident non-banking clients.

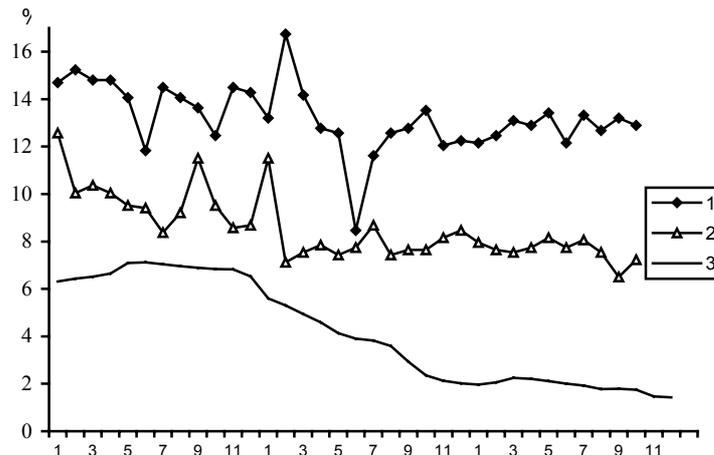
One of the important factors behind the growth of foreign currency loans was the increase in the time foreign currency-denominated deposits from private individuals, which in 11 months of the year has grown by 49% in dollar terms.



1 – loans to resident enterprises
2 – liabilities before non-residents

Fig. 1. Foreign Currency Loans to Resident Enterprises vs. Banks Liabilities Before Non-Resident Clients (in US\$ millions)

Unfortunately, the reality of Russian banks' inability to attract adequate funds from world's financial markets translates into higher lending costs for Russian economy. As *Fig. 2* demonstrates, interest rates paid in 2002 on 6 months to 1 year deposits from individuals fluctuated within 6.5%-8% range, while 6-month LIBOR rate for the same year hardly exceeded 2.5%



1 - weighted averages of interest rates charged on foreign currency loans with .5-1 year maturity
 2 - weighted averages of interest rates offered on foreign currency .5-1 year savings deposits from individuals
 3 - weighted averages for LIBOR .5 year rates
 Source Russian Central Bank and Finmarket data

Fig.2. 2000-2002 Weighted Averages of Rates Charged on Foreign Currency Loans with 6 month-1 year maturity vs. Rates Offered On Foreign Currency Individual 6 month- 1 Year Savings deposits (as %, including re-investing)

Another 2001 trend that did not continue in 2002 was the proliferation of short-term loans, number of which has fallen from 23.4% in the start of the year to 22%. At the same time, the market saw an increase in mid-term (more than a year) loans both in the ruble and foreign currency segments (see *Table 11*).

Table 11

Time Structure of Loans to the non-banking sector (NBS) in 2000-2002

Type of NBS Loan	In Proportion to Base Loans (%)			
	Jan 1, 2000	Jan 1, 2001	Jan 1, 2002	Dec 1, 2002
All NBS Loans	100	100	100	100
up to 90 days	17.8	16.9	23.4	22
90-180 days	10.8	15.7	14.2	14.6
180 days- 1 year	33.2	34.4	31.1	28.7
More than 1 year	38.2	33	31.3	34.7
Foreign Currency NBS Loans	100	100	100	100
up to 90 days	9.5	8	10.7	9.3
90-180 days	9	8.4	10.7	12.1
180 days- 1 year	25.1	28.1	28.6	24.8
More than 1 year	56.3	55.4	50	53.8
Ruble NBS Loans	100	100	100	100
up to 90 days	24.5	21.7	29.3	28.5
90-180 days	12.2	19.6	15.7	15.9
180 days- 1 year	39.8	37.7	32.3	30.7
More than 1 year	23.5	20.9	22.7	24.9

Source: computed basing on STIiK's data

As to lender profiling, 2002 data show that banks are giving more loans to private individuals. In 2000 their category accounted for a little over 5% of all banks loans, while by the

end of 2002, that number has grown to 8.2% (see *Table 12*). This general tendency could be seen both at Sberbank and other private banks. For 11 months of the year Sberbank has increased loans to private individuals by 65.6, while other banks by 47.3%.

Bank financing for government and public enterprises has reversed its 2001 decline and has also seen an increase, albeit, of a less significant nature.

Table 12

NBS Loans by Lender Type

Type of Loan	Loan Break-up in % terms*			
	Jan 1, 2000	Jan 1, 2001	Jan 1, 2002	Dec 1, 2002
Loans to Government and Public Enterprises	5.8	1.7	1.3	1.6
Loans to Resident Enterprises	82.8	88.1	87.8	86.9
Of those state-owned	8.4	8.1	5.6	5.9
Of those Private	74.4	80	82.2	81
Loans to Non-Resident Enterprises	6.1	5	3.9	3.4
Loans to Private Individuals	5.3	5.2	7	8.2

*Includes overdue loans.

Source: data from STI&K consultancy.

Entrepreneurs accounted for a fairly large percentage of *all loans issued to individuals* (19% as of late 2001 and 21% as of late 2002). Another 1-2% was issued to non-resident individuals with the remaining three quarters taken out as consumer loans. At the end of the year the latter category amounted to RR113.3 billion, a half of which was issued by Sberbank alone. Most of these consumer loans were issued in rubles (80% for all banks and 70% for all banks excluding Sberbank). Sberbank leading position for this category of loans comes in especially strong for consumer loans with re-payment term of over a year. Conveniently, most consumer loans are taken out for periods of over 3 years.

Other banks, unable to compete with Sberbank's massive branch and product structure, try to beat the rival by offering a quicker service. Russkii Standard Bank and First O.V.K., for instance, advertise 'express loans' when a loan can be issued within the day of the application. The catch is that due dates for these 'express' loans rarely exceed 1 year, while interest and service fees are higher than those offered by more conservative banks.

Table 13

Consumer Loans Term Structure

Type of Loan	All Banks		All Banks, except Sberbank	
	Jan 1, 2002	Dec 1, 2002	Jan 1, 2002	Dec 1, 2002
Consumer Loans Total	100	100	100	100
Overdraft	.5	1	.6	1.7
Up to 90 days/recall date	6.6	5.3	11.1	9.4
90 to 180 days	2.8	2.9	4.6	5.1
180 days to 1 year	17.8	18.5	27.9	29.5
Over 1 year	72.3	72.3	55.8	54.3
Including loans over 3 years	50.6	51.5	31.7	28.2

Source: data from STI&K consultancy

Banks' Role in Market for Government Debt

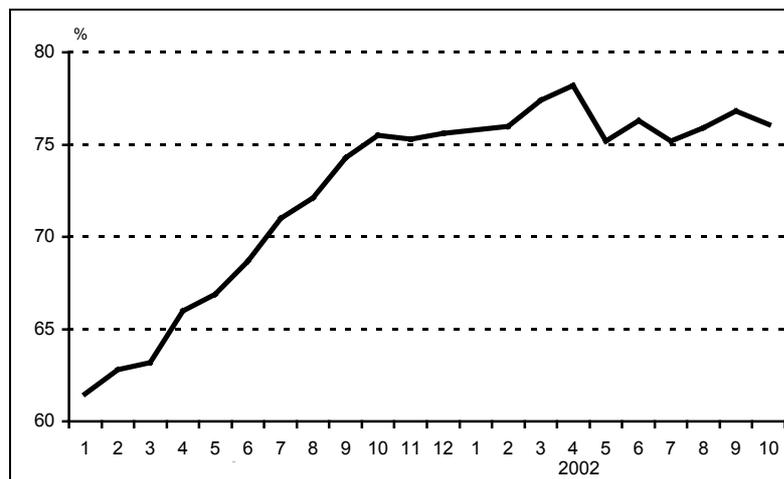
As mentioned, in 2002 banks have stayed away from significantly increasing their securities portfolios. In fact, their levels barely nudged from 13.9% of banks total assets in January to 14.9% by the end of the year. Even then, this 1 percentage point rise was mainly achieved by an increase in non-government securities. Whereas holdings of government bonds did not rise, they did undergo a change in denomination terms, with banks now preferring ruble-denominated instruments (up to 4.9% from 4.2%) to foreign-currency debt (from 7.8% down to 6.9% of all assets).

Ruble Denominated Government Bonds

Russian banks remain large holders of Russian Government ruble denominated debt. In 2002, however, the process of further concentration of government issued ruble debt in banks was somewhat halted. In 2001, banks' share of the debt grew impressively from 61.5% to 75.6%. In 2002, however, after a brief rise up to 78.2% in February-March, banks' holdings of government debt plummeted down to 2001 level and by the end of the year amounted only to 76.1%.

A conventional explanation attributed this halt in concentration to the 2002 launch of a savings element of the Russian pension system, which allowed investing earned insurance premiums into *GKO-OFZ*.

A closer look at the dynamics of banks' share of government debt, however, does not necessarily point to such an easy explanation. Rise of banks' share of government debt had already showed signs of softening in the fall of 2001 (please see Fig. 3), a good few months before first premiums for the new pension system were collected. While investing these premiums since April 2002 have not yet caused banks to reduce their holdings of government debt as compared with December 2001.



Source: Russian Central Bank

Fig 3. Banks' Share of Government Debt in the Aggregate *GKO-OFZ* Portfolio in 2001-2002.

Unfortunately, data on government debt published by the Central Bank does not differentiate between holdings of the Central Bank itself and those of commercial banks. In this

case, commercial banks' balance statements are the only sources for establishing the amounts of government debt held by banks.

As of January 2002, out of a total number of 1,300 existing banks, only 500 had investments in government ruble-denominated bonds. By the end of November that number has further dwindled down to 434. At the same time, total value of government bonds in banks' possession has risen in 11 months of 2002 by 38% (from RR114.1 billion up to RR158.3 billion). Curiously enough, Sberbank's share of government debt grew at a slower pace than at the rest of the banks (34.2% vs. 58.7%), which lead to an annual reduction in Sberbank's total holdings of government debt (from 81% to 79%).

In 2001, on the other hand, things were different. Banks' share of government debt grew at a much slower pace (10.8%), most of which was achieved by rises in Sberbank's holdings. Its portfolio of government debt rose from RR63.4 billion at the start of 2001 to RR92.9 billion by the year's end, a staggering annual rise of 46.5%. While other commercial banks were undergoing a reverse process and reduced their government securities holdings from RR39.5 billion to RR21.2 billion in the year, a staggering annual decrease of 46.4%.

In 11 months of 2002, Sberbank's holdings of *GKO-OFZ* have increased somewhat (11.5% to 12% of total assets). The same insignificant rises of *GKO-OFZ* were seen at other commercial banks (from 1% to 1.3% of total assets). As of December 2002, government ruble-denominated bonds made up 45% of Sberbank total assets. For commercial banks that figure was much lower, and at the end of last year stood at only 25.5% of total assets.

Number of banks involved in *GKO-OFZ* transactions has had wide fluctuations throughout the year. Thus in December 2001, turnover for that particular instrument surfaced in balances of 378 banks, in September the figure rose to 384 and in November it dropped to 285. In absolute terms, cumulative turnover of all existing Russian banks has had somewhat different dynamics. In December 2002, the turnover amounted to RR51.4 billion, by September it declined to RR31.2 billion and in November it rose again to RR54 billion, the latter change, perhaps, being a reflection of a general vibrancy experienced by the secondary market in the last quarter of 2002. Sberbank participation in that market, on the other hand, was fairly stable throughout the analyzed period.

In general, *GKO-OFZ* market elicited only a lackluster interest and monthly turnover values on corresponding accounts (calculated as sum of sales and purchases per month) were lower than account balances. For comparison, in pre-crises months of 1998, turnover value exceeded account balances by 2-3 times. In November 2001, ratio of turnover to balances was 54.8% (87% if Sberbank figures are excluded). Whereas in November of 2002 the same ratio stood at 153% (283% exclusive of the data on Sberbank).

GKO-OFZ trading takes place on 8 Russian trading floors, with MICEX in the lead. Most of participants in the market for secondary trading of the government ruble bonds are banks. At MICEX more than 90% of the dealers represent various banks.

The following is a detailed account of banks, major participants of *GKO-OFZ* market. Data for this analysis is based in MICEX-compiled lists, which include market dealers with largest trading volumes for secondary transactions, which includes both the operations dealers undertake for themselves and on behalf of their clients. Thus for November 2001 and 2002, the list included 22 banks. Data for the market behemoth, Sberbank were clearly outliers and therefore excluded for the purpose of avoiding distorted average values.

November 2002 cumulative turnover for banks, leading participants in the market for ruble denominated government securities at MICEX (excluding Sberbank), amounted to



52.3% of the total cumulative turnover for *GKO-OFZ* operations of all existing banks (excluding Sberbank), a 1.5 times increase over its November 2001 level.

In absolute terms, both the turnover and balances on government ruble-denominated bonds accounts at leading banks were on the rise during the year, although at a varied pace. Thus, turnover growth was rising at almost twice the pace of balances growth.

Between November 2001 and November 2002 the turnover value for *GKO-OFZ* operations rose by 44.6% (from RR10.6 billion to RR15.6 billion in current prices), whereas, balances on these accounts in the same period grew by only 21.3% (from RR10.9 billion to RR13.8 billion). Thus the ratio of turnover to account balances on transactions for government ruble debt at largest banks had an annual increase from 97.6% to 116.4%.

The situation is reverse for average mid-size Russian banks, where (excluding Sberbank) turnover values for government debt operations remain below the balances on these accounts, with the ratio falling from 91% to 87% in the last year.

In general, the proportion of government ruble-denominated securities to other assets is higher at banks with leading positions at MICEX than the industry average (1.9% vs. 1% in December 2001 and 1.8% vs. 1.3% in December 2002).

In contrast to 2001, a rift between a strategy for government ruble bonds pursued by banks- MICEX leaders and average Russian banks grew larger in 2002. From December 2001 to a year later, trading volumes of government ruble-denominated bonds for MICEX's leading players, in absolute terms, rose by 21% (from RR10.9 billion to RR13.2 billion). The same figure in the analogous period for all Russian banks (Sberbank and ARCO-managed banks excluded) stood at only 3% (from RR32.7 billion to RR33.7 billion).

Similarly, average value of assets at a leading MICEX bank-participant, as of November 2002 stood at RR34.4 billion – a considerable difference over RR2 billion, estimated asset value of an average bank in the same period.

Contrary to dismissals that low participation in markets for government ruble-denominated bonds is nothing but a sign of the instrument's low returns, profit margins for banks, MICEX's largest participants provide no such evidence. For the past 11 months of 2002, banks with large positions on MICEX posted significantly higher profits than an average Russian bank, with ratio of returns on assets for the former standing 4.4% against an average bank's ratio of 2.9%.

Government Foreign –Currency Denominated Bonds

Largest portfolios of government foreign currency-denominated (FCD) debt belong to Sberbank and Vneshtorgbank, which as of December 2002, accounted for 70% of all FCD bonds at Russian banks. From the start of the year, their share declined by 3.2 percentage points.

To get other banks' views on the attractiveness of FCD debt instruments, let's compare absolute values of FCD bonds in US dollars and their proportion to banks' other assets. Until November 2002 (please see Graph 4), the cumulative portfolio of FCD bonds was expanding in parallel to their price increases (due to the lack of investment indexes on *OVVZ* and Russian Eurobonds, we chose Fed-30, the largest volume bond in circulation as our price indicator). Data on proportions of FCD bonds to banks' other assets appears more complex and does not easily lead to unambiguous conclusions.

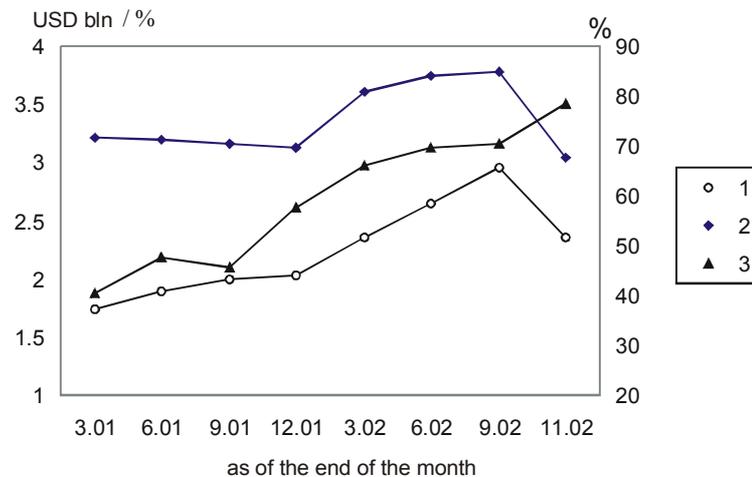


Fig. 4. Government FCD Bonds in Russian Banks Portfolio (except Sberbank, Vneshtorgbank), 2000-2002

By December 2002, the number of banks with holdings in FCD bonds has declined from a January high of 237 down to 208. Considering that the total number of banks with licenses for this sort of activity is 1000, the current number of participants appears very small. Oddly enough even the incredibly favorable price dynamics for the product in 2001-2002 has failed to amend that situation.

On average, for banks with holdings in FCD bonds, the latter share in proportion to banks' other assets is 9.2%. In addition, there are 20 banks, in which FCD bonds take up in excess of 15% of their total assets. Below is a more detailed analysis of banks with leading positions in holdings of FCD securities. Since Vneshtorgbank and Sberbank figures are clear statistical outliers in that batch, their data will be excluded from this analysis. With the two giants out of the picture, the average proportion of government FCD securities holdings to banks' total assets is 49%.

To be included in the analysis banks had to satisfy the following criteria:

- as of December 2002, share of government FDC bonds in a bank's total assets was above the industry's average (average value calculation excluded Vneshtorgbank and Sberbank);
- in the period from December 2001 to November 2002, a bank had non-zero balances on its account for FCD bonds operations, and was actively engaged in transactions for FDC bonds, i.e. reported non-zero turnover values on that account.

Overall 51 banks satisfied the above criteria and were chosen for the analysis. To begin with, the concentration in the group turned out to be very high. Thus just 4 top banks held a half of the group's entire FCD bond holdings, while 20 top banks covered 90%.

Let us now compare data on this select group of FCD debt 'leaders' against average Russian banks. First we have to note that only large banks are currently engaged in an active trading of FCD bonds. The average value of total assets for the select group, as of December 2002 was RR9.6 billion, while the average Russian bank analogue stood at only RR1.9 billion. Proportion of FCD bonds to overall assets for the select group of banks amounted to 11.2%, which exceeded the industry's average value by 3.7 times. Surprisingly enough, the



select group's figure has not increased much during the year even despite higher market valuations of the product.

During 11 months of the past year, prices for most issues of *OVVZ* and Russian Eurobonds were rising faster than their share in banks' portfolios. Thus, prices for *OVVZ* in that period, depending on the issue rose within the range of 9.2 to 39.5%, and Eurobond prices changed within the range of -2.7 to 39.2%, also depending on the issue.

In addition, the select group of banks has a higher than the industry average of foreign-currency deposits from corporate clients, however there is no statistically valid relationship between the amount of a bank's foreign currency deposits and value of its government FCD bond holdings.

As to profitability, for 11 months of 2002 the select group of banks' ratio of returns on assets did exceed the industry's average, but fairly insignificantly (2.6% vs. 2.4%).

Curiously enough, banks in this particular group of the most active FCD bond-players appeared to have smaller capitalization than their more average counterparts, with the ratio of balance capital to assets for the former group at 11.8% vs. industry average of 18.5% (although these particular figures for two groups are not quite comparable due to large difference in asset values). Having said that, both groups are showing a tendency for a decrease in the ratio of balance capital to assets. For select group of banks, assets growth, in 11 months of 2002, was outpacing that of capital balance by a factor of 1.5 (32.3% vs. 21.3%). Average banks' gap in growth was smaller and for the same period assets grew by 25.3%, while balance capital at 22%.

Table 14

Some Balance-sheet Statistics for Banks with Leading Positions in FCD Bond Holdings (in % terms of total assets; end of month data; exclusive of Sberbank and Vneshtorgbank)

Balance Statistics to Assets (in %)	Average Banks*		Banks with High Share of FCD Bonds	
	Dec 01	Dec 02	Dec 01	Dec 02
Assets in Foreign Currency	40,8	38,7	51,7	49,6
Funds in Banking Sector	39,4	34,5	37,1	31,9
Including those in foreign currency (FC)	19,0	15,3	20,5	14,7
NBS Loans	44,0	47,8	39,0	42,4
Including those in FC	16,3	18,6	17,3	20,4
Bonds and securities	6,5	8,9	15,4	18,8
Incl. Those in FC	3,6	4,1	11,9	12,7
Government Bonds	4,2	4,4	12,5	13,6
Incl. Those in FC	3,1	3,0	11,1	11,2
Funds of Non-Resident Banks	6,7	7,5	8,6	9,0
Accounts of non-financial clients	27,6	25,1	27,9	27,7
Incl. Those in FC	5,1	5,6	6,6	6,6
Deposits	21,5	21,9	27,5	28,2
Incl. Those in FC	14,7	13,8	20,9	20,1
Corporate Deposits	12,8	10,1	19,5	16,0
Incl. Those in FC	9,3	6,7	15,5	13,2
Individual deposits	8,7	11,8	8,0	12,3
Incl. Those in FC	5,5	7,2	5,5	6,9

Balance Statistics to Assets (in %)	Average Banks*		Banks with High Share of FCD Bonds	
	Dec 01	Dec 02	Dec 01	Dec 02
Balance Capital	19,0	18,5	12,8	11,8
Profit	2,0	2,4	1,9	2,6
For reference: The average size of assets of the banks of the sample, as Rb.bln.	1,5	1,9	7,2	9,6

*All existing banks, except Sberbank, Vneshtrogbank and ARCO-managed banks.

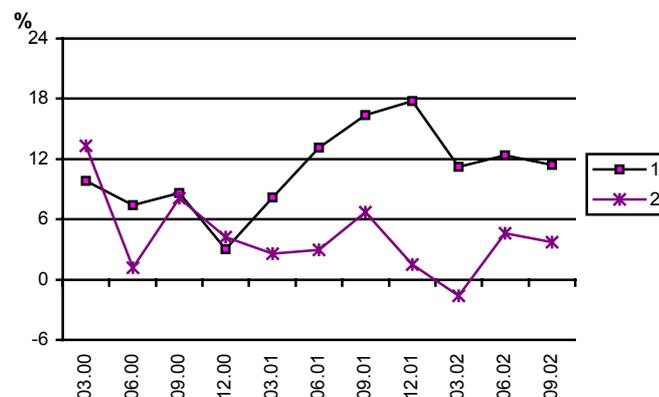
Source: STI&K consultancy

Private individual's Deposits

The year of 2002 made up for a lively year in this segment of banking services. If in the aftermath of the 1998 crisis, number of private deposits was slashed by a half (excluding Sberbank) and by the of 1999 fell to a measly 5.6% of banks' liabilities, then by the end of 2001 the number recovered to 8.4% and by October 2002 has grown further to 10.9%. If we consider only banks that purposefully attracted individual deposits, the numbers become respectively 8.6% for the end of 2001 and 11.3% for October 2002. in constant prices, for 9 months of 2002, a total value of individual deposits attracted by banks (excluding Sberbank) grew by 39% (a bit lower than 42.4% growth achieved in 2001). In general, from the end of 2000, private deposits grew faster than banks' assets (please see Graph 5). The above facts all point to a conclusion that banks slowly but surely are restoring back to the pre-crisis individual deposits level.

Against this dynamic picture seen at most commercial banks, Sberbank deposit growth of only 18,7% appears rather modest. In fact, Sberbank's share on that segment of banking services has been contracting throughout the year and by October fell to 69.8% from a high of 73.5% it enjoyed at the start of the year (excluding funds linked to debit card accounts). At the same time, the decline was rather smooth (please see Graph 6). In other words, cuts in interest rates, which Sberbank undertook on both ruble and foreign currency accounts, had no discernable effect on its customers.

Sberbank aside, about 8% of all private deposits is at Alfa-Bank, another 5.6% is at Moskva Bank, which on the past 3 quarters managed to practically double the number of its private deposits.

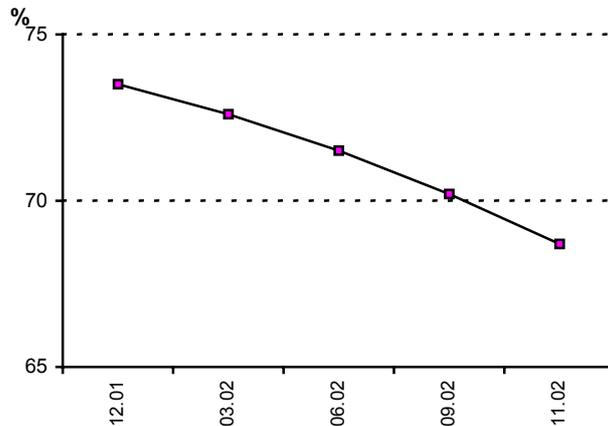


1 – individual deposits

2 - bank assets

Source: STI&K consultancy

Fig. 5. Asset vs. Deposit Growth in Constant Terms, excl. Sberbank
(% change over previous quarter)



Source: STI&K consultancy

Fig.6. The 2002 Sberbank's Share in Total Number of Private Deposits

Individual deposits are playing an even bigger role for regional banks (please see *Table 15*). There, deposits from individuals in the banks' liabilities make up twice the analogous figure at Moscow banks, and more than 90% of regional banks are actively pursuing private deposits while in Moscow that number is only 83%. However, since banks are heavily represented in Moscow, as of September 2002 Moscow-based banks accounted for 63.5% of all deposits in the country.

Table 15

Individual Deposits Share in Banks Total Liabilities (as %)*

	Moscow Banks				Regional Banks				Average Banks (excl. Sberbank)			
	Jan00	Jan01	Jan02	Oct02	Jan00	Jan01	Jan02	Oct02	Jan00	Jan01	Jan02	Oct02
Individual Deposits	4,7	4,7	7,0	9,2	9,6	9,2	13,6	18,0	5,8	5,8	8,6	11,3
Incl. In FC	3,7	3,7	5,4	7,2	4,2	3,8	5,6	7,4	3,8	3,7	5,5	7,3
Incl. In Rubles	1,0	1,0	1,6	2,0	5,4	5,4	8,0	10,6	2,0	2,1	3,1	4,0
Reference: Number of banks attracting individual de- posits	533	535	546	541	627	617	639	624	1160	1153	1175	1165
Average assets size in billion rubles	1,4	2,15	2,85	3,4	0,35	0,6	0,78	0,91	0,84	1,32	1,74	2,06

*Start-of-a-month data for banks attracting private deposits

Source: STI&K consultancy

In 9 months of 2002, Moscow banks have increased the total value of individual deposits by 55% (from RR110 billion to RR 169 billion). Regional banks have managed to raise the same figure by an equally commendable 52% (from RR69 billion to RR102 billion).

Moscow banks also differ from their regional counterpart in the currency type of their deposits. For years now, most of Moscow deposits (80%) come in foreign-currency, while the regions appear to be more patriotic and there foreign-currency deposits account for only 40%. In general, however, after a slump in 2000 and 2001, foreign-currency deposits (please see *Table 16*) are again becoming popular in 2002 (excl. Sberbank). For Sberbank, ruble deposits were growing at a faster pace than foreign-currency accounts.

Table 16

Bank Deposits by Currency Type

Private individual's Deposits	All operating Banks, exclusive of Sberbank		Sberbank		All operating Banks, exclusive of Sberbank		Sberbank	
	bank	1, 2000	bank	1, 2001	bank	*1, 2002	bank	1, 2002
In FC	66.1	21.1	63.4	23.6	63.7	25.5	64.2	27.6
In Rubles	33.9	78.9	36.6	76.4	36.3	74.5	35.8	72.4

* All Banks Excluding Sberbank

Source: STI&K consultancy

As to term type of deposits, 2002 saw customers continued preference for *savings* deposits and a continued decline in the number of settlement accounts. The latter's share has dropped in the past 3 quarters from 23 to 19% for all existing banks and 33 to 29% if Sberbank figures are excluded. A high number of settlement accounts in the Table 17 is associated with a generally high proportion of ruble settlement deposits at commercial banks.

Table 17

Resident Individual Bank Deposits by Term Type* (in %)

Individual Deposits	All Banks, incl. Sberbank				All Banks, excl. Sberbank			
	1.1.00	1.1.01	1.1.02	10.1.02	1.1.00	1.1.01	1.1.02	10.1.02
Current ac-accounts**	28,8	29,5	23,2	18,8	34,1	37,1	33,2	29,3
Incl, debit card accounts	2,6	2,2	1,6	1,0	8,7	9,6	5,1	3,1
Up to 3 months	8,9	6,3	4,8	3,7	14,8	9,8	7,6	5,4
3-6 months	49,2	41,4	32,8	29,6	19,9	21,7	21,6	18,3
6-12 months	8,1	11,4	14,7	17,6	17,0	21,6	27,3	32,5
Over 1 year	5,0	11,4	24,5	32,8	14,2	9,8	10,3	14,5
Total	100	100	100	100	100	100	100	100
In Foreign Currency								
Current **	28,0	25,4	22,1	18,8	34,7	34,5	28,2	23,9
Incl, debit card accounts	4,9	3,6	1,4	1,0	8,6	8,4	2,8	1,9
Up to 3 months	7,9	4,6	4,0	2,7	15,8	9,7	8,0	5,3
3-6 months	40,3	41,5	35,0	26,8	15,5	18,4	20,0	16,2
6-12 months	16,0	20,0	24,4	27,8	19,1	26,5	32,6	38,3
Over 1 year	7,8	8,5	14,5	23,8	14,9	10,9	11,2	16,3
Total	100	100	100	100	100	100	100	100



In Rubes								
Current **	29,1	31,4	23,7	18,8	33,1	41,2	41,1	38,4
Incl, debit card accounts	1,5	1,6	1,7	1,1	8,8	11,5	8,8	5,3
Up to 3 months	9,4	7,2	5,3	4,3	13,0	9,9	7,1	5,4
3-6 months	53,0	41,4	31,6	27,0	28,2	27,1	24,1	21,7
6-12 months	4,7	7,3	9,4	11,4	12,8	13,8	19,0	22,9
Over 1 year	3,8	12,7	30,0	38,5	12,9	8,0	8,8	11,6
Total	100	100	100	100	100	100	100	100

*Share of bank deposits by non-resident individuals is less than 1% of the total individual deposits

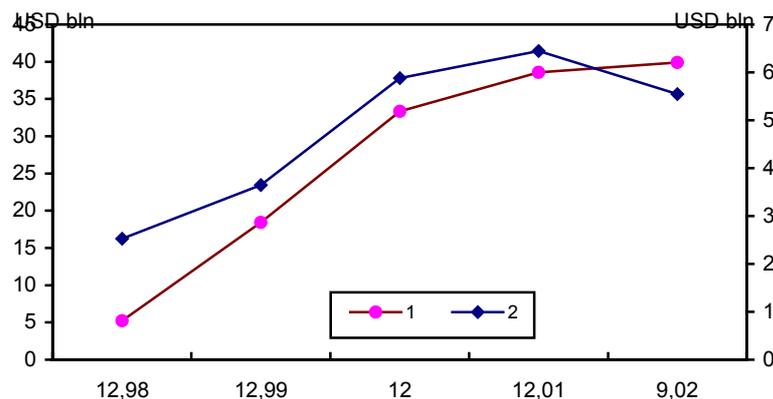
**Settlement deposits also include funds linked to debit card accounts

Source: STI&K consultancy

As in 2001, Sberbank continued to attract more savings deposits with longer terms and most of its accounts carry terms of over 1 year. Sberbank numbers in this segment of banking services is so large that it affects the entire industry's average, i.e. making savings deposits with over 1 year term the most popular item in the account variety (32.8). If Sberbank data is excluded, then deposits with 6-12 months terms take up the leading position for both ruble and foreign-currency denominated accounts. Accidentally, this type of account is also a most popular service for Sberbank's foreign-currency deposits.

Corporate Deposits

After a period of bubbly expansion in 1999-2000, 2002 was marked as a year of after-party calm and stabilization for this segment of the market³. At the start of the year, total volume of deposits from banks' corporate clients stood at almost RR270 billion⁴. By the end of the 3rd quarter that number waned to RR262 billion, which in percentage terms translated into a 3% annual fall.



1-ruble corporate deposits in early 1999 constant prices
2-foreign-currency corporate deposits

³ Corporate deposits do not include government agencies' ones

⁴ here and below only operating banks, without regard of ARCO-managed banks, are considered

Fig. 7. Ruble vs. Foreign Currency Corporate Deposits

From the banks' balance sheet perspective, corporate deposits fell within the year from 9.4% to 7.6% as of banks' liabilities and from 11.4% to 9.1% as proportion of banks' total liabilities.

Although some firms, in addition to conventional deposits, place some of their funds as depositary certificates, their share accounted for less than 10% of the total amount of regular deposits and they therefore would be excluded from the analysis below. Similarly, deposits from non-resident corporate clients also make up less than 10% of the deposits total. Therefore, only figures for resident corporate deposits will be considered in this analysis.

For the 3rd quarter of 2002, a total value for corporate deposits has fallen, in current terms, by 2.6% (in constant terms, by 11.8%). The decline was caused by two opposing phenomena - a 4.1% fall in the number of deposits attracted by banks in our analysis sample (i.e. private commercial banks) and a 19.3% rise in corporate deposits attracted by Sberbank, whose figures we exclude on the basis of their strong statistical outlier influences.

Corporate Deposits' Currency Structure

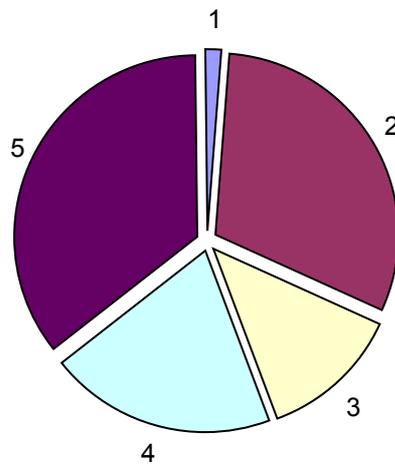
Most of corporate deposits in today's Russia are denominated in foreign currency. In 2002, however their proportion has declined from 69.3% to 64.7% and it is widely believed that this decline has attributed to an overall fall in the amount of corporate deposits. Ruble-denominated corporate accounts, on the other hand, have in the past 3 quarters risen in value by 12% and, in current terms, amounted to RR83.8 billion.

As in 2001, only two thirds of all existing banks (253, as of October 1) have been attracting corporate deposits in 2002. Both ruble and foreign-currency segments of the market remained fairly non-concentrated with leading positions often fluctuating between various banks. Thus, typically for the Russian banking sector, in the start of the year Surgutneftegas Bank with its 29% of all foreign-currency deposits enjoyed the leading position but managed to let Moscow International Bank (MIB) to claim the title later in the year. MIB's market share now exceeds that of its predecessor by 2.5 times. Market share of the segment's top three banks is less than 50%.

Concentration level for the ruble segment of the market, despite its relatively modest volume, is even lower. Cumulative market muscle for the three top banks, as of October 1, 2002, amounted to only 19.3% of the total. Sberbank, number one bank enjoyed only 9%.

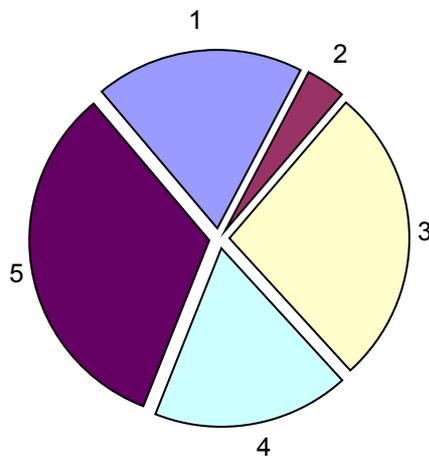
The structure of deposits by the term of attraction of funds

Term structure for corporate deposits in 2002 was vastly different from the situation we described for the individual segment of the market. If settlement deposits made up almost 19% of all individual accounts, its corporate counterpart stood at just 1.5% (please see Graphs 8 and 9). Similarly, for savings accounts of less than a year individual clients preferred savings accounts with 3-6 months term, corporations instead seemed to fancy shorter-term variants of up to 3 months. Though, more similarities between individual and corporate segments could be detected for savings accounts with terms of over 1 year.



1. Current deposits
2. Less- than- 3- month deposits
3. 3-6 month deposits
4. 6-12 month deposits
5. over- 1- year deposits

Fig.8. Resident Corporate Deposits by Term Type
(as of October 1, 2002, including Sberbank)



1. Current deposits
2. Less- than- 3- month deposits
3. 3-6 month deposits
4. 6-12 month deposits
5. over- 1- year deposits

Fig. 9. Resident Individual Deposits by Term Type
(as of October 1, 2002, incl. Sberbank)

Corporate savings ruble deposits with terms of less than a year saw some changes in 2002. If at the start of the year, most of these funds were deposited for 3 months or less (please see *Table 18*), then by the end of 3rd quarter deposits of 3-6 months and 6 months became more popular, which increased their weighted share by 33-36%. At the same time, share of less than 3 months deposits has declined on average from 40 to 28% in the year. While share of savings deposits with terms over 1 year has increased, particularly the deposit category of over 3 years.

Table 18

Corporate Ruble Deposits by Term Type

Term type	Share of Total Corporate Ruble Deposits in %	
	January 2002	October 2002
Settlement	2.7	2.6
Up to 90 days	40.2	28.1
91 days to 180 days	14.6	19.8
181 days to 1 year	15	19.9
Over 1 year	27.5	29.6
Incl. Those of over 3 years	14.6	16.4
<i>REFERENCE</i>		
Average Account Value (in current terms, RR billion)	3.4	4
Number of Banks	797	826

Source: STI&K consultancy

The shift towards longer-term deposits was brought about mainly by changes in strategy of Moscow banks. In other words, regional banks have not undergone the same changes with over 1-year ruble deposits registering only insignificant increase from 35.1% at the start of the year to 36.2% by the end of 3rd quarter. Moscow banks, on the other hand, have increase their share of corporate ruble deposits with over 1 –year term in the same period by 4.3 percentage points. Similarly, regional banks, unlike their Moscow counterparts have not to the same degrees been engaged in cutting the numbers of shorter-term corporate ruble deposits. Thus deposits of less than 3 months saw only a 26% annual decrease in regional banks, while in an average Moscow bank their number fell by 30% (from 51.4%to 35.7%). Capital and regional banks also differ on currency structure of their corporate deposits, with regions boasting twice the share of ruble deposits as compared with their Moscow counterparts. Though, both groups are now seeing a rise in ruble deposits from their corporate clients.

Table 19

Term Structure of Corporate Ruble Deposits in Regional vs. Moscow Banks

Term type	Share of Total Corporate Ruble Deposits in %			
	Moscow		Regions	
Current	3.8	3.7	1	1.1
Up to 90 days	51.4	35.7	24	17.8
91 days to 180 days	11.1	16.2	18.2	22.2
181 days to 1 year	10	16.4	21.7	22.7
Over 1 year	23.7	28	35.1	36.2
Incl. Those of over 3 years	16.3	18.6	14.2	16.7
<i>FOR REFERENCE:</i>				



Average Account Value (in current terms, RR billion)	4.43	5.01	1.03	1.16
Share of Resident Corporate Deposits in Banks' Liabilities	3.5	3.1	7.2	6.7
Number of Banks	333	354	462	471

Source: STI&K consultancy

In foreign-currency segment of the market, a clear decline in the number of short-term 90 days deposits was accompanied by various changes in share of longer-term deposits. Thus 3-6 months deposits rose by 2.5 percentage points while the next layer deposits of 6-12 months fell by 9.3 percentage points. At the same time, number of 1 year and over deposits practically doubled. To be fair, though, the latter increase came almost solely due to Moscow International Bank, which in 9 months of 2002 has increased its share of such deposits from 3 to 30 billion rubles. If MIB number are taken out of the picture, then the rise in the number of 1 year and over deposits, at 2.4 percentage points becomes far less spectacular. Clearly, it is too early to speak of any considerable industry-wide changes in the numbers of foreign-currency deposits from corporations.

As was the case with ruble deposits, foreign-currency deposits also differ in their structure between Moscow and regional banks. For instance, if an average regional bank has seen its corporate deposits of up to 3 months reduce by 23%, the same figure for an average Moscow bank has grown by 13%. Although to be accurate, a single regional bank, again, was responsible for decrease in this type of deposits. Surgutneftegasbank, a major regional bank accounted for 59% of all 3-month foreign-currency deposits attracted in the period. In addition, within the bank, these 3-month deposits made up over 80% of the bank's all foreign currency deposits from corporate clients. Obviously, when Surgutneftegasbank figures are excluded, the overall picture is rather different (please see *Table 20*).

Table 20

Term Structure of Foreign Currency Corporate Deposits

Term type	Share of Total Corporate Ruble Deposits in %	
	January 2002	October 2002
Current	7	.9
Up to 90 days	43.3	31.6
91 days to 180 days	5.6	8.1
181 days to 1 year	29.6	20.3
Over 1 year	20.8	39
Incl. Those of over 3 years	9.2	10.8
<i>FOR REFERENCE:</i>		
Average Account Value (in current terms, RR billion)	10.3	11.2
Number of Banks	230	254

Source: STI&K consultancy

At the start of the year, the segment of the market for 3-month corporate deposit did not vary significantly between Moscow and regional banks. However, throughout the year, growth in the number of this type of deposits was more pronounced at regional banks and by the end of 3rd quarter the gap in the number of these deposits between the regional banks and

their Moscow counterparts has reached 11.8 percentage points – a considerable increase from 2.7 percentage points in the start of the year (please see *Table 21*).

Table 21

**Term Structure of Foreign Currency Corporate Deposits
Moscow Banks vs. Regional Banks**

Term type	Share of Total Corporate Ruble Deposits in %			
	Moscow		Regions	
	01.02	10.02	01.02	10.02
Current	1.1	1.2	0	0.1
Up to 90 days	20.7	23.4	19.5	35.2
91 days to 180 days	5.6	5.6	11.7	13.4
181 days to 1 year	41.9	22.7	41.2	17.1
Over 1 year	30.7	47.1	27.6	34.2
Incl. Those of over 3 years	15.6	14.2	5.8	5.2
<i>FOR REFERENCE:</i>				
Average Account Value (in current terms, RR bil- lion)	10.04	10.31	2.59	3.09
Share of Resident Corpo- rate Deposits in Banks' Liabilities	9.2	9.0	5.7	4.4
Number of Banks	127	147	100	104

Note: Surgutneftegasbank figures are excluded from the regional group

Source: STI&K consultancy

Similar changes occurred in the segments for 3-6 months and over 12 months corporate deposits. While the number of 3-6 months deposits has been stable during the year for Moscow banks, the regional banks have managed to increase their share from 2.4% to 16%. Likewise, corporate foreign-currency deposits of over 1 year have risen 1.5 times at Moscow banks and by almost 2.5 times at regional banks.

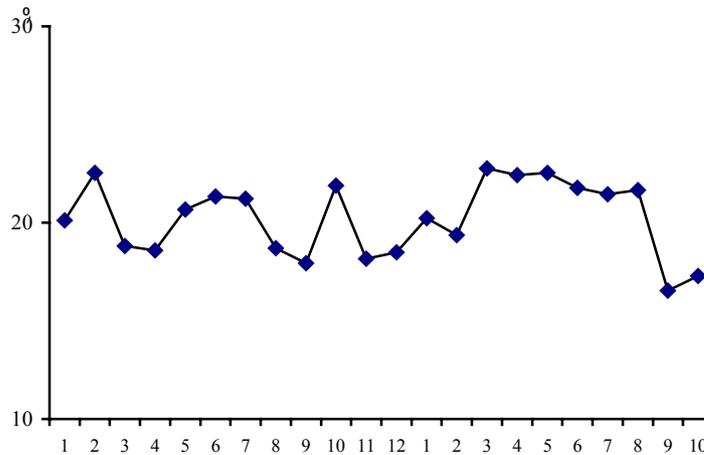
In contrast, 6-12 months deposits have significantly fallen in number both at Moscow and regional banks. If at the start of the year both groups had more or less similar positions on the market, by the end of September, the number of these deposits fell by 19.2 points for an average Moscow bank and by 24.1 points for its regional counterpart.

Banks' Operational Efficiency

Compared with the previous year, the returns on assets ratio (ROA) for three quarters of 2002 seemed to demonstrate that Russian banks were more efficient last year than they were in 2001. Thus returns on assets ratio for all existing banks (excluding Sberbank and ARCO managed banks) for three quarters in 2002 amounted to 3.3%, whereas in 2001 the figures stood at only 2.9%. 2002 gross operational income (the sum of net interest and net non-interest revenues) figures were also high relatively to assets (9.5% vs. 10.4%, see *Table 12*). The growth was achieved through increases in *net interest income* as banks managed to raise margin rate from 4.9% to 5.2%, while *net non-interest income* stayed at 2001 levels. An accelerated reduction in interest costs rather than an accelerated reduction in interest revenue has contributed to the rise in the *net interest income*. If interest revenues fell in 2002 by 0.9 percentage point (from 10.3 to 9.4%), then rate-based costs in the same period dropped by 1.2 percentage points (from 5.4 to 4.2%).



Rates on most popular type of corporate loans (6 –12 months) continued to fall throughout 2001 and 2002, although their reduction did not proceed in a consistent manner.



Source: Russian Central Bank

Fig. 10. Profits on Corporate Ruble Loans with 6-12 Months Maturity Including Refinancing in 2001-2002 (in %)

In 2002 banks also appeared to be more efficient in their operations with securities. For 3 quarters of 2002, banks' net revenue raised from transactions with securities has grown from 0.8 to 1.1% - a pleasant reversal of fortunes from a dismal performance in 2001 during which banks' net securities revenue fell almost twice (from 1.9 to 0.8) on the previous year. The share of non-interest revenues did less well and their share in gross operational income for 9 months of the year has fallen a bit from 46.8% in 2001 to 45.3% by the end of 3rd quarter of 2002.

Table 22

Banks' Costs and Revenues

Statistic (in % to assets)	2000	2001	3 rd Q 2002
Gross Operational Income	10.4	9.2	9.5
Net interest Income	3.3	4.9	5.2
interest Revenues	11.9	10.3	9.4
interest Costs	8.6	5.4	4.2
Net interest Income	7.1	4.3	4.3
Revenues from commission and fees, incl:	2.8	2.0	1.6
On financial market operations	2.7	1.5	1.7
Foreign-currency transactions	0.6	0.6	0.5
Gold and precious metals	0.1	0.1	0.1
current operations on Foreign-currency and deposits	0	0.1	0
operations with securities	1.9	0.8	1.1
revaluation of forex reserves and securities	1.0	0.6	0.6
revaluation of forex reserves	0.2	0.3	0.4
revaluation of securities	0.8	0.3	0.2
Leasing	-0.1	-0.1	-0.1

RUSSIAN ECONOMY in 2002
trends and outlooks

Other operational revenues	0.9	0,3	0,5
Administrative Costs	5.7	4.9	4.8
Incl. Wages and Social Security Payments	1.9	2.3	2.3
Depreciation deductions	0.3	0.2	0.2
Property Lease	0.5	0.4	0.4
Taxes, allowable for costs deduction	1.1	0.5	0.5
Net Operational Income	4.7	4.3	4.8
(-) Changes in reserves	2.6	1.6	1.8
Net result from occasional operations	0.3	0.2	0.4
Pre-Tax Profit	2.4	2.9	3.3
Pre-Tax Profit to Balance Capital	10.7	13.9	16.8

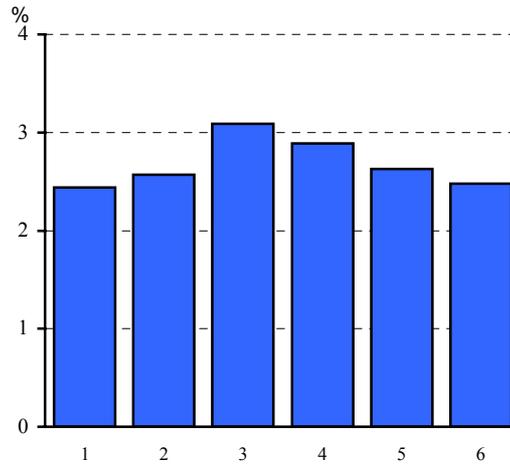
Note: Data for all current banks as of 3rd quarter 2002, excluding Sberbank and ARCOARCO-managed banks

Source: STI&K Consultancy

Thus, although banks 2002 profitability beats the previous year results, they still failed to match margins achieved in 2000. Administrative costs in 2002 continued to decline as a proportion of banks' assets, albeit at a slower pace than in 2001. If in 2001, banks managed to reduce administrative costs from 5.7 to 4.9% of assets, then in 9 months of 2002 the reduction barely made a symbolic 0.1 percentage points cut. Major reason for this belt-tightening was not so much focus on frugality on banks' part, but a change in rules governing assignment of certain tax payments to costs. For instance, in 2000, the value of tax payments that banks were allowed to book to costs amounted to 1.1% of the total costs, while in 2002 the figure stood only at 0.5%. Other types of administrative costs, except wages (which rose almost by a quarter), were cut as well. If in 2000, banks paid only 1.9% of their assets as wages, while in 2001 and 2002 that figure was raised to 2.3% of assets.

For the first time in several years, banks managed to raise (albeit only by 0.1 p. points) their net operational income. At the same time, more resources were designated towards reserves creation. For 9 months of 2002, reserves rose by 1.8% of assets, while in 2001 that figure amounted to 1.6%. Net results on non-regular operations in the same period almost doubled their share in relation to assets. Consequently, returns on assets ratio for 9 months of 2002 climbed up above the entire 2001 level by 16%. Pre-tax profits to balance capital ratio also rose and registered growth of 16.8%, but as was the case with administrative costs reductions, the changes for the better happened slower in 2002 than in 2001.

Interestingly, in 2002 the banks' performance proved to be just slightly dependent on the size of their assets (see *Fig.12*). In contrast, during 1998 crisis the size mattered, and it was the big banks that suffered heaviest losses, while smaller banks outside the top 50 managed to fairly quickly absorb the shock and adapt to a new environment. By 2002, convention of bigger means better seemed to prevail and the country's largest banks finally have visibly improved their profits to assets ratio of.



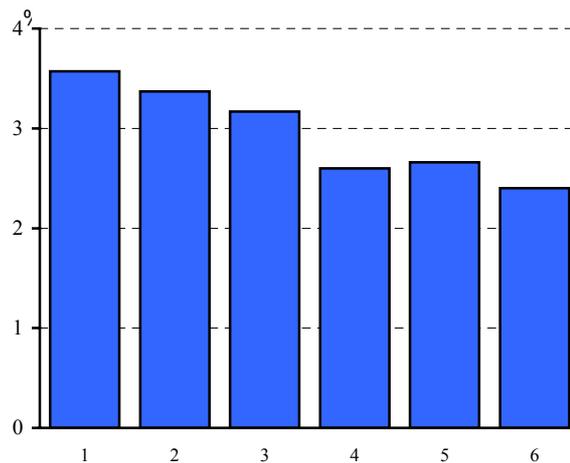
Banks Ranking Based on Assets Size as of January 1, 2002:

1. first 10 top banks
2. ranking 11-50
3. ranking 51-100
4. ranking 101-200
5. ranking 201-500
6. ranking 501- 1304

Note: out of currently existing 1304 banks data for only 1281 were included, because by the end of 2000 some banks have not yet commenced their operations. In addition, Imperial Bank was excluded from the 3rd group, because its data skewed the group's average by a factor of 2 (in 4th quarter the bank was engaged in heavy reserve creation)

Source: STI&K Consultancy

Fig. 11. 2001 Returns on Assets Ratio of Banks Based on their Asset Size (except for Sberbank and ARCO-managed banks)



Banks Ranking Based on Assets Size as of January 1, 2002:

1. first 10 top banks
2. ranking 11-50
3. ranking 51-100

4. ranking 101-200
5. ranking 201-500
6. ranking 501- 1304

Source: STI&K Consultancy

Fig. 12. 3rd Q 2002 Returns on Assets Ratio of Banks Based on their Assets Size (except for Sberbank and ARCO-managed banks)

4.7. The National Market for Housing in 2002 and up to 2003³².

The general situation in the housing market and its dynamics in 2001-2002

The previous analysis of this particular segment of the national economy³³ comprised a conclusion, as follows: having passed through the stage of decline and depressive stabilization, the housing market has entered the stage of stable growth, which was expected to end as early as in 2002.

In December 2002, results of the monitoring of the markets for housing in 9 cities of Russia and particularly Moscow oblast were concluded. The data showed that as of late 2002, the average proportional housing offer price (in USD equivalent) grew in all the cities of the sample.

Table 1 below cites price levels as of late 200, 2001 and 2002, a nominal increment in USD prices over 2001, the first half 2002 and 2002 on the whole, and an actual annual increment rate over the years in question. The actual increment in housing offer prices (IGS index³⁴) suggests an account of the impact of inflation computed both in the Rb. and USD equivalent. According to Goskomstat, in 2001 the Rb. inflation accounted for 18.6 and 15.1% - in 2002, while the USD inflation in Russia (computed against consumer basket) – 10% and 8.8%, respectively. Table 1 also contains average weighted indices across the group of capital cities of the RF Subjects (hereinafter referred to as regional centers), except for Moscow and St. Petersburg. The weighting was done with account of the share of the given city's population in the overall number of population of all the group of cities.

³² The present paper is based upon the housing monitoring data compiled by a group of certified by the Russian Realtor Guild (RRG) analysis of the real estate markets as well as by those due to be certified. The latter represent the following organizations: Agentstvo expertizy investitsionnykh proektov (AEKSIP), Promyshlennostrahovaya kompania (PSK), RAN SAVA, Kompania RMLS, Contact-nedvizhimost agency, Miel-nedvizhimost, NITSA, the sub-department of marketing of the Department of investment programs of building under the Moscow city Government (all from Moscow), Informational-publishing group Bulletin nedvizhimosti, Peterburgskaya nedvizhimost Corporation, real estate agency Itaca (all from St. Petersburg), the Realtor informational center under the Ural Real Estate Agency (Ekaterinburg), Vostochno-Sibirskaya pravda Agency (Irkutsk), Internet-laboratoria (N. Novgorod), Akropoland Kontinent-Sibir real estate agencies (all from Novosibirsk), the Perm league of realtors and appraisers, OAO 'Kamskaya dolina', Perspektiva Corporation (all from Perm), TITAN agency (Tver), ZAO Center nedvizhimosti" (Ulyanovsk)

³³ See: Rossiyskaya ekonomika v 2001 g. Tendentsi in perspektivy (Issue 23). M., IEPP, 2001. vol. 2, p. 169-89

³⁴ IGS was calculated according to the following formula: $IGS = I_{pr}/I_{cp} = I_{pd}/I_{id}$, где I_{pr} – the index of housing prices denominated in Rb., I_{cp} – consumer price index, I_{pd} – the index of housing prices denominated in USD, $I_{id} = I_{ip}/I_{dp}$ – the USD inflation index in Russia (relative to consumer price dynamics), I_{dp} – the index of depreciation of the Rb. to USD



Table 23

Dynamics of the average housing offer price level in 2000-2002 (in USD equivalent)

City	The average proportional offer prices, as \$/ sq. m			Nominal housing cost indices			IGS		
	Dec. 2000	Dec. 2001	июнь 2002	Dec. 2002	Dec. 2001/ Dec. 2000	июнь 2002/ Dec. 2001	Dec. 2002/ Dec. 2001	2001	2002
Moscow*	720	940	977	1096	1,31	1,04	1,17	1,18	1,07
St. Petersburg	370	490	558	641	1,32	1,14	1,31	1,20	1,20
Moscow oblast**	352	471	515	602	1,34	1,09	1,28	1,21	1,18
Regional centers (as a whole)	270	379,7# / 378,4	399	411	1,41#	1,05	1,09	1,28#	1,00
Ekaterinburg	336	484	510	518	1,44	1,05	1,07	1,31	0,98
Novosibirsk	263	470	467	470	1,79	0,99	1,00	1,62	0,92
Irkutsk	...	365	412	422	...	1,13	1,16	...	1,06
Perm	287	390	371	394	1,36	0,95	1,01	1,235	0,93
N. Novgorod	280	301	354	365	1,075	1,18	1,21	0,98	1,11
Tver	203	260	307	311	1,28	1,18	1,20	1,16	1,10
Ulyanovsk	158	216	229	260	1,37	1,06	1,20	1,24	1,11

Notes:

*computed basing on the data of RMLC, Miel-nedvizhimost, Kontakt-nedvizhimost;

** computed as average weighted values across the data on 47 cities. The weighting was based on the share of objects of the given city in the total volume of offer;

#the average weighted value as of December 2001, without regard to Irkutsk: it was used to compute the respective housing price indices across the group of regional centers in December 2001 relative to December 2000, as the December 2000 data on this particular city is lacked (in order to ensure comparability).

The data above allows understanding that in 2002 it was St. Petersburg where the USD nominal price increment was the greatest one (31%), followed by cities around Moscow (28%). Prices were soaring at some 20% in N. Novgorod, Tver and Ulyanovsk, while remained unchanged in Perm and Novosibirsk (notably, the latter, with a 79% rise, was a leader in terms of housing price dynamics in 2001, while in Perm the respective index also grew fairly considerably). In 2001, in most of the cities of the sample the price increment (in USD equivalent) accounted for over 30%, while in Veliky Novgorod the growth made up moderate 7.5%.

It was, again, St. Petersburg where actual housing prices adjusted for the Rb. and the USD inflation levels in 2002 broke a record 20%, followed by Moscow oblast (18%), with the city of Moscow's increment rate lagging far behind with just 7%. Overall, prices remained unchanged across the group of regional centers, though housing prices plunged by 2-8%, while Irkutsk, Tver, N. Novgorod, and Ulyanovsk witnessed a 6%...11% price rise.

By contrast to a number of preceding years, 2001-02 saw changes in regularities on the housing market. More specifically, the factor of differences in market dynamics between groups of cities with different (Rb. and USD) price denomination has lost its significance. At the same time, there arose factors of post-crisis recovery rate and a normal effective demand. However, the data of Table 1 and charts below show that last year's forecasts of the situation on the national housing market were not accurate enough.

In the first half 2002, the nature of the housing price dynamics basically met expectations, i.e. it mirrored the transition from a steady growth in 2002-01 towards recession and

stabilization, except for N. Novgorod, Irkusk and Tver that had been lagging behind in terms of post-crisis price rise renewal. Between January to June 2002 the price increment in this particular group accounted for 13-18%, in the city of Moscow, Moscow oblast, Ekaternburg, Ulyanovsk – between 4 to 9%, while in Novosibirsk they fell by 1%, and in Perm - by 5%. At this point, the St. Petersburg housing market formed a contrast picture vs. the others, with a 14% increment and the price rise being stable rather than fading there.

Price dynamics in the late 2002 proved forecast estimates with regard to the group of regional centers, which cannot be argued about St. Petersburg and Moscow that demonstrated an unexpected growth over the period in question. The results of the 9 months of the year allowed conclusion about contrast price dynamics on different housing markets. All the cities of the sample can be divided into three different groups:

- regional centers, with stabilization being steady there;
- St. Petersburg, with the ongoing price rise; and
- the city of Moscow and Moscow oblast that experienced a new price rise in the late 2002.

The state of housing markets in the groups and single cities

Let us depict the situation in each of the aforementioned groups.

As for the group of regional centers, the strengthening trend to stabilization allowed various scenarios of development of the situation (see *Fig. 1*)

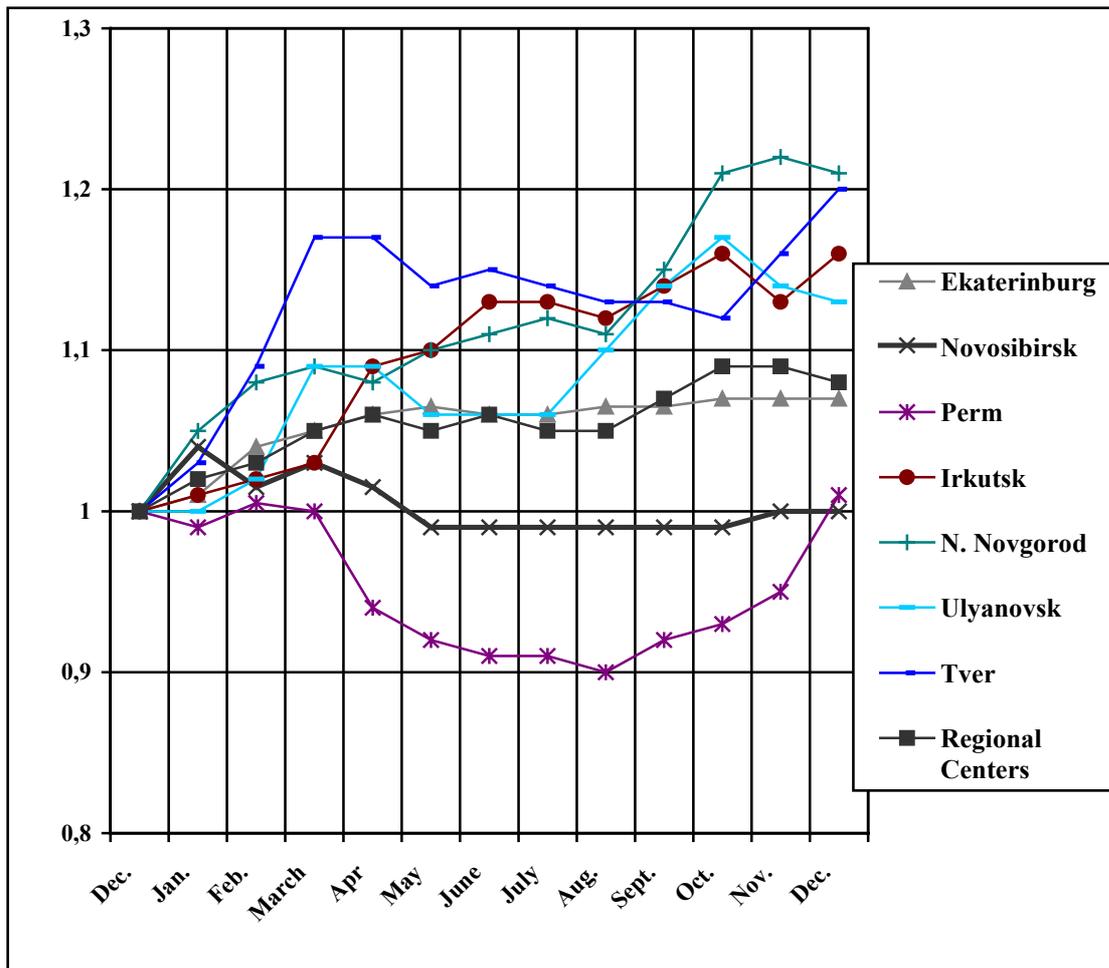


Fig. 13. Housing offer price indices in Russian cities – regional centers, 2002.

It was Perm, Novosibirsk and Ulyanovsk where the price rise was the greatest one in 2001; consequently, as expected, in 2002 stabilization ‘overshot’ an original scenario: given that in winter offers were growing for some time, they dropped between spring to summer, while autumn saw a slight seasonal price rise. It was just Ulyanovsk where prices grew over the year (at 20%). The activity on the market fell, too. For instance, in Novosibirsk the Department of Justice of the oblast reported a 17% decrease in the average monthly volume of real estate transactions vs. 2001 and a 22% one compared with its respective rate of 2000.

In 2002, for the first time ever there has been no autumn intensification of operations on the Ekaterinburg market. Traditionally, it led to a decrease in the volume of offer and acceleration of the price rise. Last autumn, the number of flats for sale was growing, which is not typical for this particular season. The cause for such a situation lies with the lowering demand, because a considerable part of potential buyers had to postpone the purchase of a new flat due to a rapid price rise for them. The time period between the moment the flat is put on the market for sale and until its actual purchase remains stable, which testifies to a low activity on the market, and so far there have been no prerequisites for the market resurgence in the short run.

As last year the N. Novgorod, Tver and Irkutsk markets were slow with the price rise and rebound to the pre-crisis level, the transition to stabilization has followed the ‘crawl-up’ scenario (asymptotically): offer prices continued to grow between winter to spring with a gradual slowdown and transition to a stable level followed by some rise in autumn (with the overall increment rate accounting for 16...21%).

In 2001 the average increment in nominal USD-denominated prices across regional centers accounted for 41%, while in 2002 – 9%.

The situation in St. Petersburg appeared radically contrast to the above (see Fig.2)

The price rise in Moscow and St. Petersburg was taking practically synchronous pace from the lowest point of the post-crisis period (May-June 2000) through the late 2001. Last year, the latter city experienced a non-stop offer price rise, with the respective increment accounting for 31% vs. December 2001. Thus St. Petersburg has become the only city (of all those included in the sample in question) where the offer price level has exceeded the pre-crisis one.

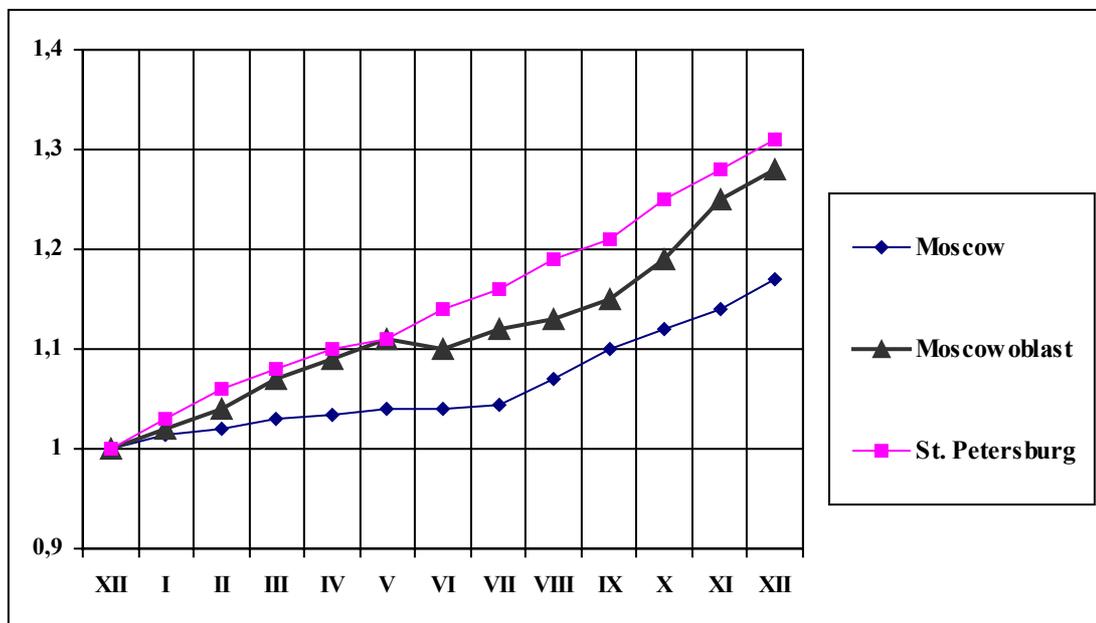


Fig. 14. Housing offer price indices in the city of Moscow, Moscow oblast and St. Petersburg, 2002

There is every reason to believe that such developments in the Northern Russian capital are related to the upcoming celebration of its 300th anniversary. The jubilee and the highest office’s focus on the city (more specifically, by increasingly making it the main arena for various summits and forums) have boosted tourism and ensured more frequent visits of representatives of political and business elites. The opportunity to capitalize on satisfying the increased rise in demand for goods and services generated a trade capital inflow, primarily on the part of foreign and Moscow-based net retail companies (supermarkets). As a result, there arose a very high market demand for trade facilities and offices for lease, which then outspreaded over investment projects on the market for commercial real estate and housing where the ongoing price rise has overrun any expectations.

Notably, the price rise took place chiefly downtown where vigorous efforts are undertaken to transform the so-called ‘communal’ apartments located in the pre-Revolution buildings into attractive objects for representatives of the noted corporations. By contrast, other city’s districts, with their mostly modern standard blocs of flats experienced just a minimal price rise.

Once the celebration and the governor elections are over, one can expect the investment inflow in the city to contract, followed by stabilization and even downfall of housing prices.

As concerns Moscow, stabilization there was attained by summer under the ‘crawl-up’ scenario (a gradual discontinuation of the rise in offer prices). However, there has been no decline in prices and they have been climbing up since August, with the total annual increment accounting for 17% (see *Fig.3*)

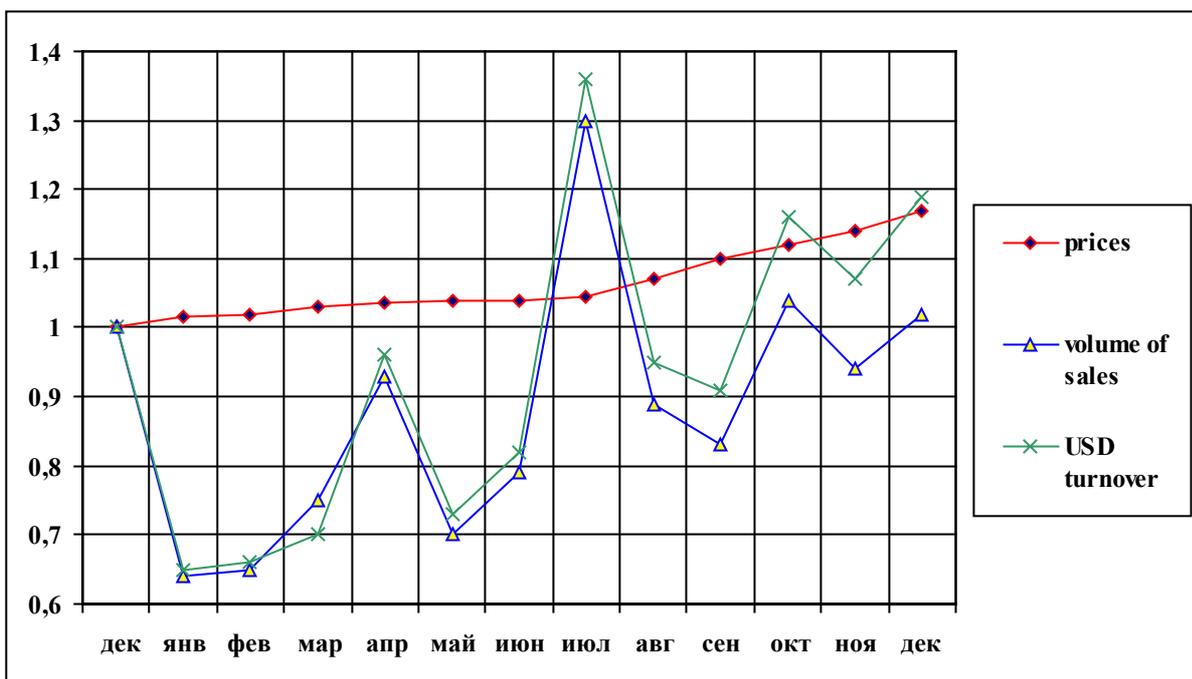


Fig.15 Nominal housing market indices in Moscow in 2002

The pattern of the Moscow oblast’s housing market’s development was analogous to that of the city of Moscow (with a regular half-year time lag vs. the latter’s schedule, though) – the annual increment rate in nominal prices in USD equivalent made up 28% (see *Fig.4*), with a notable rise in operations on the housing market for real estate in the towns around Moscow.

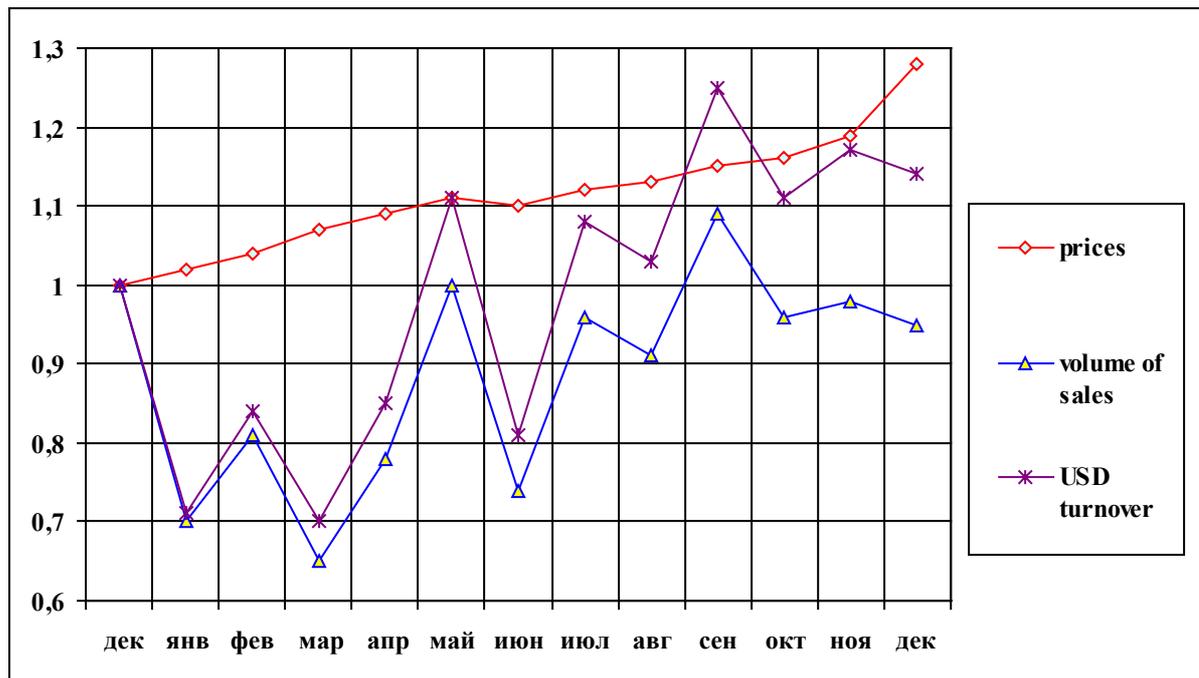


Fig.16 Nominal housing market indices in Moscow oblast in 2002

There are different views on the causes for a new price rise in both regions.

Some experts attribute the autumn growth to an insufficient volume of housing offer on the secondary market, which in turn is related to an accelerated disappearance of flats off the market in the wake of a price stabilization noted between spring to summer 2002. Indeed, according to Miel agency, in April 2002 the volume of offer across the city of Moscow as a whole dropped notably, and until the end of the year it did not exceed the respective level of May 2002. At the same time, since May 2002 the share of flats withdrawn from the market relative to the number of offers was growing practically non-stop.

It is clear that the volume of offer of housing on the market depends on two factors: first, the sellers' eagerness to put their objects on sale and, second, on the volume of sales, i.e. the pace of 'washing' the offer away. It can be assumed that rather a sharp transition from high growth rates on the market in 2001 towards their decline up to stabilization in the first half 2002 has lowered sellers' activity, and the inflow of objects to the market fell accordingly.

At the same time, as noted above, the monthly volumes of apartment sales in the city of Moscow and around it showed a fairly considerable growth.

According to the Moscow City Real Estate Transaction Registration Department, the dynamics of the volume of deals registered in the city appeared different from previous years. The seasonal, January decline in the volume of deals (this time – by nearly 40%) was followed by a regular increase, with the July index breaking the December record rate at a margin of 30%, while at the end of the year the rate was back to the level reported in December 2001.

Overall, during 2002 the volume of registered purchase/sale transactions covered 76,000 flats, thus beating the respective index of the prior year at 9% and the level of 2000 –



at 34%. At the same time, the share of real estate deals stricken in the second half of 2002 made up 57%.

However, these data needs some adjustment, because since 2000, in compliance with newly adopted “Law on registration of property rights for real estate and transactions involving it” of July 21, 1997 # 122-FZ (as amended on March 5, 2001³⁵), the RF Ministry of Justice was keen to alter procedures of registration of deals involving purchase of flats in newly erected houses: more specifically, they insisted on the transition from the so-called ‘re-assignment of the claim right’ from the developer to the buyer³⁶ towards a normal registration of the developer’s property rights for the houses to be put into operation and registration of a purchase/sale deal between the developer and the buyer identical to the ones stricken on the secondary market for housing. At that point, some confusing of purchase/sale volumes in the secondary market with those in the primary markets occurs.

In practice, however, changes in the procedures were taking a slow pace, and sales of most of newly built flats were still being registered according to the said ‘re-assignment of the claim right’ procedure. In reality, in 2002, according to some experts dealing with sales of flats on the primary market, it was just some ¼ to 1/3 of them that was registered as purchase/sale deals. In other words, basing on their investment contract with the city, developers fixed the property rights with themselves and would consequently sell such flats to private buyers, and those were reported as ‘transactions’.

Notwithstanding, if we want to expose the dynamics of the volume of deals on the secondary market only and exclude the double count, this relatively small share of purchase/sale transactions (some 7,000 to 10,000 flats in 2002 and 3-5,000 in 2001 in absolute terms) should be ignored by the official statistics.

The table below highlights on the dynamics of the volume of purchase/sale deals on the secondary market in the city of Moscow between 1994 through 2002.

Table 24

Annual volume of apartment sales on the secondary market of the city of Moscow

year	As Thos. units	as % to the prior year	as % to 1997 (1997 = 100%)
1994	70,817		83,6
1995	79,664	112,5	94,0
1996	71,068	89,2	83,9
1997	84,748	119,2	100,0
1998	77,526	91,5	91,5
1999	76,093	98,2	89,8
2000	63,726	83,7	75,2
2001*	67,0	105,1	79,1
2002*	68,0	101,5	80,2

³⁵ In Moscow, the law was put in effect since early 2002

³⁶ This specific procedure implies the developer-investor signing an Agreement on re-assignment of the claim right for the given apartment with a buyer who appeals to the Moscow City Real Estate Transaction Registration Department and obtains the property right for the flat. Once registered the agreement is qualified for the ‘Registration of Newly Rights’ section, rather than ‘Purchase/Sale Transactions’ one.

*the data for 2001-02 were computed with account of exclusion of the double count caused by mixing of deals on the secondary and primary markets because of the transition from the sales of newly built housing basing on 're-assignment of the claim right' from the developer to the buyer to the procedures of registration of the developer' right for houses put into operation and the consequent registration of a purchase/sale deal between the developer and the buyer.

The data of *Table 2* show that the intensity of operations on the secondary Moscow market began to rise between 2001-02, however, it has not yet hit the pre-crisis level of 1997 when it had reached its peak over the whole period between 1994 to 2002.

The intensity of operations on the Moscow market was as follows: given that in 2000 there were 44,414 registered deals involving purchases/sales of flats, in 2001 – 47,903 (up at 11.4%) and in 2002 – 49,471 (another 3.3% up), of which 56% was stricken over the second half year.

Thus, the rise in the monthly volume of sales over the year could form one of the reasons for contraction in the volume of offer on the market and the consequent price rise. At the same time, this process should have some grounds – more specifically, a rising demand for housing. According to some experts, such a rise, indeed, has taken place since last July and been underway until February 2003. That was noted both by the Moscow and St. Petersburg analysts, as well as those from Novosibirsk, Vladivostok, and Voronezh. This gives a rise to a natural question about the causes of such a change.

The interrelation between macroeconomic parameters and prices for housing in the nation's capital in 2002 and price forecast options for 2003.

It is the contraction in the increment rate in retail goods turnover noted for the first time over recent years that should be considered a major reason for the rise in demand for housing in Moscow. According to Goskomstat of RF, after 3 quarters of 2002 the respective index for Moscow accounted just for 3.5% vs. 7.6% reported over the respective period of 2001. That took place against a continuous rise in the population's real incomes. All that in turn puts an additional pressure onto the market and generates the price rise.

Another reason of the buying rush on the real estate market in January may well be an attempt 'to escape from the USD' caused by the fear of its depreciation due to the potential military conflict with Iraq, the state of the US market, and the strengthening Euro. The lack of clarity may urge holders of USD-denominated assets to invest them in a more stable real estate.

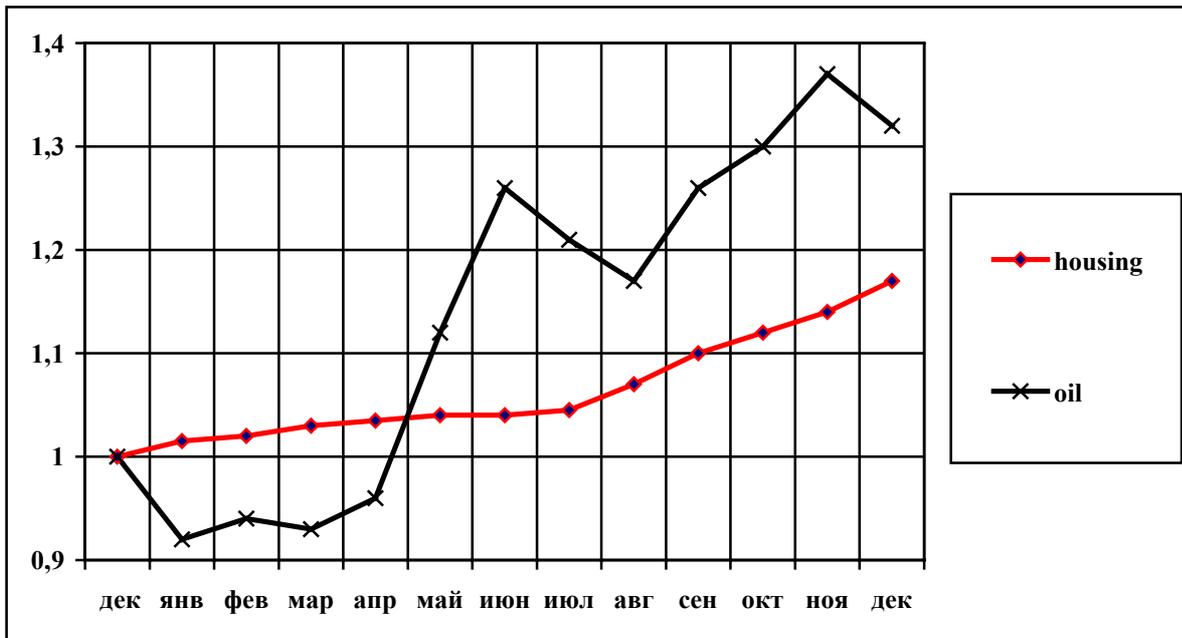
It is well known that Russia's macroeconomic situation is highly dependent on world oil prices. While the price for Russian oil slid to USD 18.8/barrel in the aftermath of 09/11, Russia's economic growth rate immediately dropped to 2.5%.

In the 4th quarter 2001 the output of goods and services of the five basic sectors (industrial, construction, agrarian, transport, and retail trade) fell by 5.5% in comparable prices vs. the 3rd quarter, while in the latter it was at 13.5% higher than in the 2nd one. The decline further intensified in the 1st quarter 2002 (by 11.5% vs. the 4th quarter 2001).

In March-April 2002, the price for Urals surged up to 22-24USD/ barrel, which allowed the economic bloc in the government and CBR to adjust towards increase their projections of the budget, forex reserves, and growth in GDP until the end of the year. The dynamics of the output of goods and services by the five basic sectors once again began to grow from quarter to quarter (7.9% up in the 2nd, 15.1% - in the 3rd quarter). Eventually, the reality exceeded all expectations: in the second half 2002 oil prices continued their growth, while the 2002 annual

results and all the macroeconomic indicators proved to be better than projected (though the 4th quarter once again saw the signs of a slump, which by intensity, could become comparable to that of late 2001).

Whereas under the housing market' transition towards stabilization the influence of external factors is becoming especially visible, there arises a natural question about its interrelation with the situation in the world oil market.



Source: oil price indices were computed basing on the data of the International Energy Agency, housing price indices –according to the data of RMLC, Miel-nedvizhimost and Kontakt- nedvizhimost real estate agencies.

Fig.17. Housing offer price indices in Moscow (in USD equivalent) and the prices of Urals in 2002

Such an interpretation is correct, at least, as far as the Moscow housing market is concerned. In Moscow, it is the capital inflow from oil- and gas-producing regions that forms one of the factors forming the demand for housing (according to some sources, this particular factor contributes to up to 30% of the effective demand on the local real estate market).

The Chart above (see *Fig. 5*) helps compare the 2002 price rise rates for housing in Moscow with those for oil (with account of a 2-month lag related to the delay with repatriation of oil export receipts to Russia) by illustrating the relation between these two parameters. This allows hypothesis that the price rise in the 1st half of the year helped maintain housing prices in Moscow, while the record-breaking rise in the 2nd half of the year has led to a new price rise for housing³⁷.

³⁷ To test this hypothesis one needs a considerable number of observations during a longer time period.

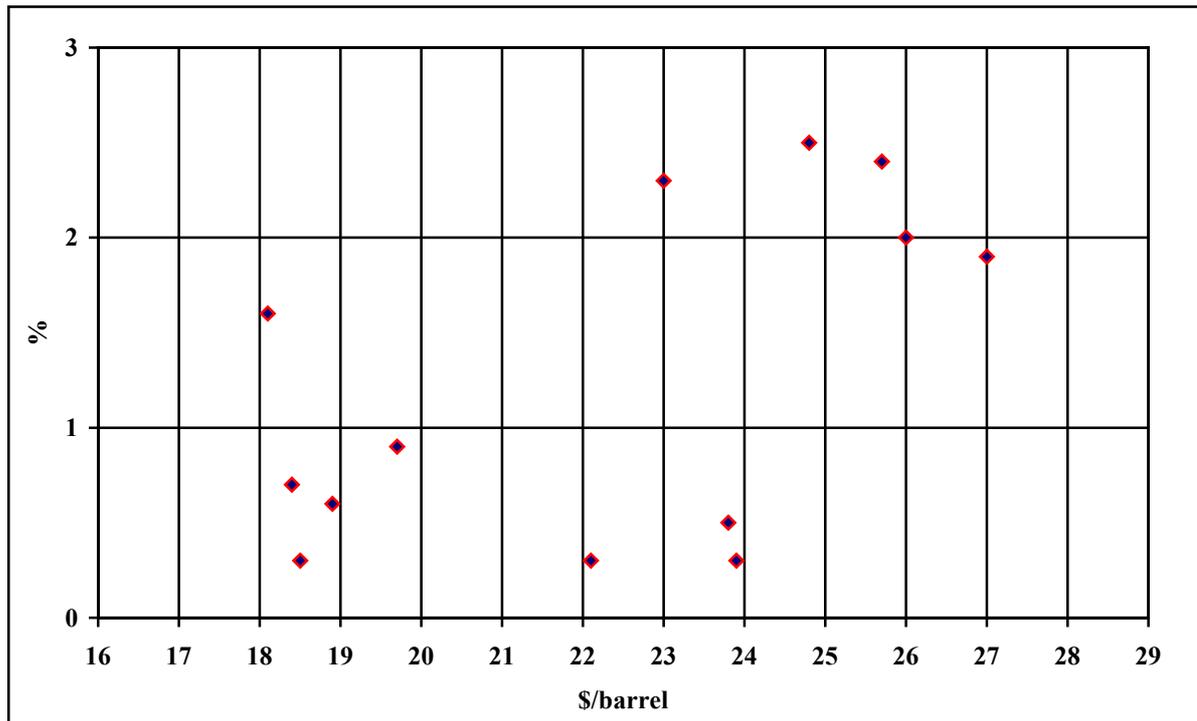


Fig. 18. The correlation between monthly housing price rise rates in Moscow and world prices for Brent basing on the data for 2002 (with a 2-month lag).

Fig. 18. clearly shows that with oil prices being under USD 22/barrel, the price rise for housing was minimal. By contrast, when the oil prices were surging up to USD 27-28/barrel, the housing price index was growing, too.

Such a reaction of the real estate market on changes in oil prices of course serves as yet another proof of the national economy's dependence on this particular factor. Naturally, the demand for housing in Moscow is formed by the capital inflow from the oil and gas sector or more specifically, by both oil and gas producers and banks, trading companies and other economic agents that are indirectly influenced by the oil dollar inflow in Russia. The building sector also benefits from that.

It is worth noting that such a situation results in appearance on the market of both corporate structures themselves, their highly paid managers and, to a certain extent, their ordinary staff, which extends the demand for housing from high-quality segments to mass ones.

Will it be possible to use the revealed regularity to forecast housing prices in 2003?

If one bases his assumption on the RF government's forecast of the average annual oil prices underlying the budget computations, then the optimistic scenario (21.5USD/ barrel) allows forecasting a 1.2% average monthly price increment for housing in Moscow and 14-15%- over 2003 as a whole, while the pessimistic scenario (18.5 USD/ barrel) provides 0.8% and 10-11%, respectively. Let's add to this possible capital inflow into the real estate market due to the start of the pre-election cycle, which should also contribute to the price rise in the market, and one can assume that given other conditions being stable, the annual price change in Moscow may account for 12-16%.

However, the political situation in the country and in the world is such that the margins of the oil price range can expand substantially. As well, there is a probability that other un-



foreseen circumstances may arise that can radically change the ongoing trends in the economy and affect the real estate market.

So, the trends noted in the national market for real estate in 2002 allow the division of Russian cities into three groups: St. Petersburg, where the price rise started in 2002 and is still in place; the city of Moscow and Moscow oblast, where the transition to stabilization noted in the first half year was replaced by the renewed price rise; and the third group formed by all other cities included in the sample that after the period of rapid growth witnessed stabilization of housing prices over last 2-3 years.

Such a division in the market once again stresses the role of main factors that affect price dynamics on the real estate market. Those are currently external (relative to the market) factors: the general economic situation in the country, its particularities in single regions, their investment attractiveness, as well as the real estate market's relative attractiveness vs. other markets from the perspective of investing the growing export receipts in it.