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Liberalization of the Capital Market in Russia

A Thesis

Presented to

the Faculty of Social Sciences

University of Denver

In Partial Fulfillment

of the Requirements for the Degree

Master of Arts

by

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Abstract

This paper analyzes the empirical events of capital market liberalization in Russia and refers to the procedure of capital market liberalization described in theory as a benchmark to assess the magnitude of events shaping the capital market liberalization in Russia.

The reformers of Russian regime change did not take a gradual approach of adjustments toward a successful socioeconomic transition. The state failed to create market-supporting institutions and instead rather proceeded with an ambitious program of synchronized application of policy changes and the economic liberalization. Lack of market-supporting institutions and an underdeveloped legal system in Russia have been the key tools through which politically well-connected managers and politicians themselves seized the opportunity and established ownership of former state-owned enterprises. Russian privatization did not provide efficiency incentives to produce new wealth, rather it has redistributed the already existing wealth through dubious methods.

Clearly, the ultimate goal of capital liberalization in Russia was not to disperse ownership of former state-owned enterprises among the people of Russia, but to create a powerful support group that would ensure the second mandate of President Yeltsin's administration. The class of newborn 'oligarchs' in Russia became the ruling minority that was not interested in creating value; rather, they were interested in stealing the value that has already existed. Weak and vaguely defined laws as opposed to explicit legal foundations and the ability to enforce contracts at proper institutions make an enormous difference in development of capital markets.

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Liberalization of the Capital Market in Russia

1. Introduction

After the fall of the Berlin Wall in 1989, the breeze of fresh start, independence, expansion, creativity, and most importantly - freedom from the state-controlled market operations blew from Western Europe to the socialist countries of Eastern Europe and Soviet Union. The drive towards economic development and further economic integration has fostered liberalization of the financial markets and market-based reforms in many Eastern European countries and the former Soviet Union. Liberalization and market - based reforms in the beginning of the 1990's created new market opportunities. These reforms permitted fewer controls on credit, interest rates and gave birth to international transactions. The reforms themselves were fostered by the general climate favoring privatization, deregulation and reliance on market mechanisms, the gradual erosion of the effectiveness of and policy support for capital account regulation, and the influence of international financial institutions in promoting greater integration into the global economy and more robust domestic financial systems (BIS, 2004).

Liberalization of economic activity in the words of Edgar L. Feige is:

“an activity that permits market determined prices to provide the information and incentive signals required to allocate factors, products, and assets to their highest valued uses, including price linkages that permit integration with the world economy”. (Feidge, 3)

Liberalization is a precondition for the provision of a smooth transition from state-controlled market operations to market economy.

Russia has not achieved macroeconomic stabilization during the process of transition, which is a consequence of inter-connected causes. Most importantly, Russia failed to create a macroeconomic environment with explicit market information signals as well as an environment where contracts concerning private property rights are honored. This paper will analyze the impacts affecting liberalization of capital market in Russia and discuss its discontents.

In the example of capital liberalization in Russia, I wish to understand to what extent Russian authorities have carried out the reforms concerning liberalization of the capital market and to find out which factors have been the most influential in the process of determining policies being carried out.

2. Liberalization of the Capital Market

The Soviet Union through its centrally planned economy prevented financial intermediaries in the country from operating at a level in accordance with their technological potential. The capital and banking system in Russia had to evolve from 'scratch', or in other words from what is considered an extreme financial repression (Kemme, 2001).

In the early 1990's, Russia began with an ambitious plan of capital market liberalization. Liberalization reform frees the power of the market to allocate resources more efficiently than they were allocated under the command of central authority. Liberalization of capital market is a way for an economically developing country to interconnect with the global capital market and attract foreign financial resources to finance its growth. Liberalization of the capital market in an emerging economy stimulates foreign funds because of scarcity of capital in developing countries; therefore the cost of capital in emerging markets is high, until the flow of foreign funds lowers it. In theory then, increasing investments raise the capital-to-labor ratio; hence we can expect an increase in output per worker. On the other hand, capital market liberalization puts an emerging country to risk by attracting large foreign investment flows which could create unsustainable foundation for further economic growth. In case of speculative investments or 'hot money' flowing in and out rapidly, the whole financial system could collapse if financial infrastructure is not in place, potentially causing damage to the long-term investor trust and stagnation of economic growth for extended period of time.

Economically developing countries going through the process of capital market liberalization are attractive targets for foreign investors for their high rates, due to the

number of specific risks present in a developing country's investment environment.

Factors that limit the demand for an emerging country's capital are:

- weak enforcement of investor rights;
- lack of transparency;
- legal systems that can be manipulated by residents;
- expropriation risks;
- political risk;
- lack of supporting institutions;
- information asymmetry.

The empirical evidence indicates that in the long-run, successful capital liberalization in a developing country depends on development of the financial infrastructure and protection of investors. Two indicators that either increase or decrease investor confidence in companies of the emerging economies are the maturity level of corporate governance and a sound legal platform (protection of investor rights). Ideally, a liberalized capital market then improves the allocation of resources, increases the capital productivity, and stimulates economic growth.

Summary

The existing literature on economically beneficial liberalization of capital markets in developing economies indicates that the following must generally occur prior to global capital integration:

- countries on the verge of capital integration with the rest of the world need to establish a balanced institutional base;

- develop sound financial infrastructure to protect equity markets from rapid oscillation; and
- arrange a legal platform with great attention devoted to protection of investors to establish confidence and trust among investors.

I will analyze the empirical events of capital market liberalization in Russia and refer to the described procedure of capital market liberalization in theory as a benchmark to assess the magnitude of events shaping the capital market liberalization in Russia.

3. The Collapse of the Soviet Union and Years of High Inflation

3.1 The Collapse of the Soviet Union

The beginning of a historic Russian socioeconomic change is marked by the day of President Gorbachev's resignation as the President of Soviet Union. This day symbolizes not only the beginning of economic reforms, but also the birth of new democratic institutions and cultural liberalization.

Well before the collapse of the soviet regime, the idea of privately owned profit-seeking corporations, not dependent on the government and efficient use of resources by internalizing the costs and benefits of production for industrial enterprise shook the ground of the Communist Party of the Soviet Union. President Gorbachev initiated the transition, but not to the extent of economic, political, and cultural change, but rather for the betterment of the current system.

In 1980s, President Gorbachev sensed that his country was losing its status as one of the world's leading countries. He believed that a major reform needed to be undertaken that would bring the rebirth of economic activities ultimately leading to social change. President Gorbachev wanted to open up the Soviet society to Western economic practices and get rid of the Stalinist governmental control and the way he envisioned this to happen was through the movement of Perestroika, which literally meant 'restructuring'. Some of the goals of Perestroika were the democratization of daily political life, industrial modernization, and most importantly liberalization of the economy from the hands of government, getting rid of the 'Petty Tutelage' from above. 'Petty Tutelage' is a system in which ministries have control over the functioning of enterprises with frequent interferences in day-to-day activities (Gregory & Stuart, 1998).

The ultimate goal of Perestroika was to create a market based economy where the enterprises carried the responsibility of their faith on their own. The Soviet regime allowed the enterprises to stay in business through automatic subsidies, which is not the protection the enterprises receive in the market economy.

The modernization of foreign affairs under Perestroika is referred to as a series of legislative acts beginning in 1986 that brought the monopoly of the Ministry of Foreign Trade to an end and allowed ministries and enterprises increasingly able to enter directly into foreign trade agreements (Gregory & Stuart, 1998). Greater freedom of doing business internally was made attainable through the passage of The Law on Private Economic Activity in 1986, which allowed individuals to engage in economic activities that were heretofore reserved only for the state. Some of the businesses that were deemed up until the passage of The Law on Private Activity were taxi services, dry cleaning, restaurants, etc (McFaul, 1995). However, the country did not prove to be ready for such rapid changes mainly due to the absence of the legal system, bureaucratic resistance (motivated solely by fear and loss of prestige and authority), and uncertainty.

When the West sensed the weakness – Soviet Union's indecisiveness and lack of confidence in the current political system – it offered a number of economic transition models ultimately guiding Russian political and economic transformation towards the market economy. In July 1990, the G7 meeting in Houston established a group, with Western institutions such as IMF, World Bank, OECD, EBRD, and European Committee assigned with the central role to develop and present the Soviet Union with an optimal transition model. President Gorbachev rejected the suggested transition models that the

West had in mind for the Soviet Union and resigned as the President of the Soviet Union in 1991.

The Communist Party of the Soviet Union (CPSU) was still well in charge of the economic activities in the country until President Yeltsin banned the CPSU, abolished the Soviet Congress of People's Deputies, assumed control of Soviet institutions and subordinated them to the authority of the Russian state (McFaul, 1995). President Yeltsin's sudden surge of political power with the Democratic Russia party in 1991 through the putsch established the beginning of a new era in Russian history.

Yeltsin's putsch

On June 17, 1991, it was announced that the signing ceremony of the treaty which would create a Union of Soviet Sovereign Republics was scheduled to be on August 20, 1991. Gorbachev wanted to push for liberalization policies and with respect to the latter, he established the Federation Council, consisting of himself and other leaders of the fifteen republics of the Soviet Union. The treaty would give more independence and control over their local political and economic affairs to the fifteen republics of the Soviet Union.

Sensing that the new treaty would end the great Soviet state, the key Soviet leaders feared they would lose power, thus they have established an Emergency Committee and immediately began with preparations for a coup. On August 19, the Emergency Committee gave orders to arrest Gorbachev, dispatched troops to key positions around Moscow, shut down all independent media outposts, banned all non-Communist political organizations, and proclaimed a state of emergency.

However, Yeltsin, the president of the Russian Republic popularly elected two months earlier, had denounced the coup as illegal and called for a general strike. His actions were televised all across the world, but to the Russian people he has presented himself as the last defender of democracy. It was crucial for Yeltsin to receive support from the Russian citizens and through a three day 'battle' forced the Emergency Committee to surrender (Keller, 1991).

After Gorbachev was released, the people sided with Yeltsin yet again. Yeltsin forced Gorbachev to resign from the Communist Party of the Soviet Union (CPSU) right after his release. Then Yeltsin also banned the CPSU from Russian territory (Zlotnik, 2003).

President Yeltsin was not only interested in the economic transition of the Soviet Union but also in the popularity of his policies amongst the people of Russia. The latter concern prevailed, and there was pressure to act immediately. Therefore Anatoly Chubais (advised by the Clinton administration, IMF, and the World Bank's economists) who was put in charge of the State Committee on the Management of State Property (GKI) in October 1991, pushed for quick privatization also known as "shock therapy", with primary focus on price liberalization, currency stabilization, control of the budget, and finally macroeconomic stabilization (Boycko, Schleifer, Vishny, Fischer, & Sachs, 1993). Mr. Chubias's actions were thus transferred to the economic system instead of the political and legislative platforms. Consequences of preferred short-term over long-term policies implemented by President Yeltsin and Mr. Chubias are currently still present in the Russian economy with a largely underdeveloped legal structure.

Modern Russia has seen incremental changes in the structure of politically powerful minorities; the Yeltsin administration favored a small group of opportunists - powerful regional leaders. In exchange for accountability and political support, the 'oligarchs' benefited from the 'loans-for-shares' scheme and got the opportunity to buy state-assets for 'peanuts' compared to their real value, the unfolding of which I will describe in more detail in the following chapter of this paper.

3.2 The Years of High Inflation

Russian reformers liberalized prices before the macroeconomic stabilization was assured in a sense of clear fiscal and monetary policies being set. The economic policy of price liberalization caused the 'price explosion', driven by distorted forces of supply and demand. The purpose of price liberalization was to bring the market forces towards a supply and demand equilibrium, which was something that the economic agents have not been exposed to under the centrally planned economic system. The factors that added to the pressure of rising inflation were a short supply of consumer goods and increasing prices of oil and gas, due to the disequilibrium between the low price of Russian state subsidized oil and gas compared to the global market prices of oil and raw materials.

The problem of rapid inflation on the verge of the 21th century in Russia presented the biggest obstacle towards the beginning of a smooth economic transition. The rate of increasing incomes could not follow sharp rises in prices, which consequentially led the Russian economy into a deep recession. Application of 'shock therapy' policies proved to be the wrong strategy to take as the inflation in the country skyrocketed when the price liberalization policy was implemented.

	1991	1992	1993	1994	1995	1996	1997	1998
Inflation	161	2506	840	204	128	22	11	85
	1999	2000	2001	2002	2003	2004	2005	2006
Inflation	37	20	19	15	12	12	11	10

Table 1: Inflation, CPI - %, 1991 – 2006

Source: Russian Central Bank

Summary

One of the most perplexing questions of a reformer is whether to liberalize the capital account before or after undertaking macroeconomic reforms. The reformers of Russian regime change did not take a gradual approach of adjustments toward a successful socioeconomic transition. The state failed to create market-supporting institutions and instead rather proceeded with an ambitious program of synchronized application of policy changes and the economic liberalization. In the following chapter, I will analyze and describe the impacts of rapid socioeconomic transition on the Russian capital market and why the privatization phase of Russian transformation is commonly referred to also as the ‘sale of the century’.

4. Privatization Years

4.1 Restructuring and Efficiency

The process of privatization in Russia brought something that was unknown to the economic agents under the communist regime – it created private capital. I believe that it is very important for us to understand the stages of Russian privatization in order to comprehend the development and current situation of the Russian capital market. The general idea behind privatization in Russia was to bring an end to inefficient state-owned enterprises through the process of capital liberalization and thus the creation of privately owned capital. Private capital creation can only be achieved through a proper process of restructuring, which brings in new institutions and puts new policies in place that have an influence on resource allocation, with no parallel to those in planned Socialist era.

Key institutions involved in Russian privatization process

In ‘The Investment Environment in the Russian Federation’ book, the OECD has summarized the institutions involved in shaping the ‘privatization policy as well as responsibilities for and practical execution of privatization transactions’.

- The Russian Federal Assembly compiles, on an annual basis, a list of shares in strategic and non-strategic joint stock companies (JSC) which are to be offered for sale and a preliminary list of state entities that are to be incorporated for subsequent privatization.

- The Russian Government makes decisions on the sale of shares, on the vesting of shares in open JSCs in federal property and on exercising the special rights or ‘golden shares’ with respect to these JSCs. It also defines the procedure for appointing/electing government representatives in management bodies of partially or wholly-owned JSCs.

- The Russian State Property Ministry makes decisions on the sale of shares, exercises the government’s shareholder rights, issues voting instructions for JSC meetings, empowers private individuals to represent government interests in JSCs and assumes responsibility for the registration of federally-owned shares and related filing procedures.

- The Russian Federal Property Fund exercises ownership and other shareholder rights relating to shares offered for sale on behalf of the federal government and records buyers’ obligations as laid down in share purchase and sale agreements. It also issues certificates starting the right to acquire shares of open JSCs and monitors the implementation of investment and social conditions of commercial tenders.

- Separate industrial ministries and other federal executive authorities propose candidates to act as government representatives in JSC management bodies and participate in the decision-making process on the transfer, sale, and disposal otherwise of federally-owned shares (OECD, 149).

Russian public enterprises have been operating inefficiently because of poor information that the government received about their efficiency, such as: employing too many people, producing goods that were not needed, being located in economically inefficient places, and not having upgraded capital stock (Boycko et al., 1993). The policy makers wanted to improve the aggregate economic performance of former state – owned enterprises through stimulation of self –interest among businessmen and motivations of non - insiders (Kuznetsov & Kuznetsova, 1996). Once the process of privatization was completed, the final products created would be the profit – seeking corporations, privately owned by outside shareholders, and not dependent on the government.

As I shall describe later on in the paper, the only thing that stood in a way to successful restructuring process in Russia was the inability to eliminate the political control of capital. It seems that the goals of the Russian restructuring process were only ‘pro-forma’ goals, designed by and for the politicians to exercise their power in order to obtain vast ownership rights in Russian enterprises. Hoff and Stiglitz write that:

“For instance, in Russia the law has been used by some powerful groups to appropriate assets away from others through an abuse of bankruptcy processes. In some cases, the law has been used to create entry barriers to maintain monopoly positions”. (Hoff, K. & Stiglitz, J., 4)

After the privatization process had been completed, policy makers and owners of equity in Russian enterprises were basically the same person. The roots of the ‘Russian problem’ - the inability to keep the politicians and ‘well connected’ managers from acquiring great

equity stakes in Russian enterprises, go back to the time before the collapse of the Soviet regime, when the Soviet institutional arrangements governing private property allowed the key players to obtain the rights of ownership in desired enterprises.

‘Peredel’, which stands for the great redistribution of wealth, was a highly corrupt process that included many of the politicians from the Russian Congress of People’s Deputies, which was the highest state organ next to the Russian Supreme Court. President Yeltsin dissolved the Russian Congress of People’s Deputies in 1993 to intervene into the corruption disease that has hit the country from the top down. His statement was:

“In the last few months Russia has been going through a deep crisis of statehood. All political institutions and politicians have been involved in a futile and senseless struggle aimed at destruction. A direct effect of this is the loss of authority of state power as a whole. In these conditions it is impossible to carry out complex reforms”. (McFaul, 228)

However, at that point it was already too late to intervene in the process of privatization (even for the president).

In 1992, the Russian government had begun Russia’s mass privatization program under the direction of the State Property Committee, headed by Anatoly Chubias (Gregory & Stuart, 1998) . Just to get a feel of how rapidly the implementation of privatization in Russia moved across the country, I should mention that the presidential decree in 1992 required immediate privatization of large enterprises with more than 1000 employees and by mid-1994 approximately 19,000 enterprises were already registered as joint stock companies (Gregory & Stuart, 1998). The evolution of privatization in Russia has witnessed two large-scale forms of state assets transfer into private property, namely the ‘voucher privatization’ and the ‘loans-for-shares’ scheme. Academic articles have

named them Phase One and Phase Two of the Russian privatization process. Closer examination of the privatization stages will help us better understand the magnitude of large-scale privatization in the Russian capital markets.

4.2 Phase One

Phase One began in 1992 with the presidential Decree on Acceleration of the Privatization of State and Municipal Enterprises and was followed by the approval of the Fundamental Provisions of the Program for the Privatization of the State and Municipal Enterprises for 1992 which outlined the procedures to be implemented (OECD, 2001).

In the beginning stage of Phase One the firms that went in mass privatization were divided between firms that were sold for cash by local governments and firms that were later sold for vouchers. The mission of the following stage of mass privatization was to divide firms into groupings of ‘mandatory privatization’ (firms in light industries such as textiles and furniture), firms subject to privatization with permission of the government or more precisely the Privatization Ministry (large enterprises, but not in important industries), and lastly ‘strategic industries’ that were prohibited to privatize (natural resources, defense, space exploration, health, education, etc.). ‘Strategic industries’ were always controlled by the government even if part of the equity in these industries was owned privately. The final stage of Phase One mass privatization was to ‘corporatize’ companies and register them as joint-stock companies partially owned by government (government kept approximately a 20% share in all privatized enterprises), adopt a corporate charter, and assign a board of directors (Boycko et al., 1993).

Once a firm was 'corporatized' the 'insiders' (managers and workers) were given three privatization options to pick from. Once the privatization plan was selected, it had to be submitted to the Privatization Ministry.

Option One:

- 25% of initially offered shares, preferred stocks offered to workers for free. The Managers were allowed to purchase 5% of all shares at nominal price. In addition, workers and managers could buy additional 10% of shares at a 30% discount to book value. The rest of the shares (approximately 40% of total shares) were to be distributed among the citizens through voucher privatization.

Option Two:

- Workers and managers would get 51% of equity, common shares at a nominal price of 1.7 times the July 1992 book value of assets.

Option Three:

- Managers were allowed to purchase 40% of all shares if they assumed responsibility for the business results – the promise of not driving the enterprise into bankruptcy (McFaul, 1995).

Options Two and Three were additional amendments to the initial privatization program, which first offered only Option One. The two options were added to the selection due to intense lobbying and fear of managers that the 'outsiders' would gain the majority of shares. However, the presidential administration insisted that the voucher privatization was supposed to be in favor of all Russian citizens, not only the ones that were employed by the firm. Thus, the most commonly used privatization program was still Option One. Options Two and Three ended up being exclusive deals

for managers who used old networks and bribed the politicians to get the permission for continuance with the procedure of privatization.

After the ‘corporatization’ of state-owned enterprises was completed, the state began with the largest privatization program ever attempted. The Russian State Property Committee called this mass privatization the ‘voucher privatization’ since the government distributed vouchers among 148 million Russians in order to increase public interest in economic development of the country that would ultimately lead to social change.

4.3 Voucher Privatization

Citizens of Russia could get vouchers for a small fee of 25 rubles (5 cents at the prevailing exchange rate) at their savings banks and were widely popular. By January 1993 almost 97% of vouchers had been distributed among 79% of the Russian population (Boycko et al., 1993).

There were roughly 15.000 medium and large Russian companies privatized where the vouchers could buy shares through individual company auctions held in the city where it was headquartered or by investment in an investment fund which acquired and invested vouchers on behalf of investors. The only companies that the ‘voucher investors’ could invest in, were the companies that were included on the Federal Property Fund Privatization List. The face value of a voucher was 10.000 rubles (\$30 at the prevailing exchange rate), which were used as a sole allowable means of payment in company auctions as a tool to acquiring company equity in state enterprises that were being privatized. The company auction process firstly held a closed share subscription

reserved for the employees, which was followed by open public auctions, usually at a regional level (OECD, 2001).

Vouchers became the most liquid security in Russia and an active secondary market developed for vouchers, while they also traded on many Russian exchanges. Vouchers expired at the end of 1993 and once the voucher privatization had come to an end, the shares could be sold and purchased for money, which later led to market prices for shares of companies and set the stage for first Russian stock exchanges.

After the voucher privatization was completed in the end of 1993, the results fell short of what was expected; 21 million Russians (14% of the population) acquired shares in privatized businesses, and another 44 million (30% of the population) invested in investment funds. The main reason why there is such a drastic difference between publicity (vouchers were distributed among 79% of the Russian population) and reality (only 44% of the population owned equity in the newly privatized companies) is because the public auctions were hard to reach and under publicized to say the least. Overall, shares acquired for vouchers accounted for approximately 20% of the equity in the newly privatized companies (Gustafson, 1999).

The voucher privatization turned out to be an 'insider privatization' instead of the envisioned increase in outsider stake in the newly privatized companies. Voucher privatization did not redistribute ownership but instead ended up as a tool for a more concentrated ownership in the hands of the economically and politically powerful, such as Russian mafia, foreigners, insider managers, and politicians. Most powerful and well connected managers have been able to acquire great amount of wealth through the purchase of vouchers from Russian citizens. The managers acquired great quantities of

equity shares in Russia's most valuable properties and then sold the assets for a large profit. Russian 'Mass Privatization' has thus created a corporate sector of mixed ownership structure with an average company's equity structure of 65% internal control, 33% in the hands of external equity holders such as investment funds and banks, and the state owning 17% (OECD, 2001).

By the end of year 1993, the Russian Federation completed the voucher privatization and successfully transferred 40% of state-owned enterprise to 60 million Russian citizens. It is clear that the process of privatization failed to break up large industries and satisfy demands for social justice. Rather, it proved to be a great 'give away' of state property to well connected and politically influential Russian personas. Michael McFaul describes the failure of voucher privatization in his essay 'State Power, Institutional Change and the Politics of Russian Privatization' in the following words: "The regime's inability to withstand short-term demands from enterprise directors undermines the broader, long-term goal of creating and sustaining a capitalist market economy". (McFaul, 236) The 'Masterplan' of voucher privatization was to create a basis for institutional ownership that would monitor management but mainly due to weak legal frameworks the short-term interests of a few key players in the political and managerial circles prevailed and thus postponed the long-term objective of 'Westernization' for an uncertain period of time.

4.4 Phase Two

The voucher privatization phase failed in generating revenue for the state and attracting enough outside foreign or domestic investors to restructure the corporate governance issues that Russian market system inherited from the socialist Soviet Union. Newly established owners of joint stock enterprises did not obtain any new capital through Phase One of the Russian privatization. Therefore the only way to keep their companies from going bankrupt was to obtain government subsidies or to use soft budgeting. Michael McFaul says that:

“The combination of little or no pressure from outside shareholders for profits and no hard budget constraints has been a recipe for inefficient enterprise at the micro level and rampant inflation for the economy as a whole” (McFaul, 234).

In spring of 1992, the Russian Central Bank under Viktor Gerashchenko

“began dispensing massive new lines of credit to ailing enterprises. The bank also approved inter-enterprise debt swapping, an indirect form of subsidization among enterprises. Along the same lines, the Congress also approved significantly higher budgetary allocations for enterprises than those requested by the Yeltsin government. The combination of an undisciplined Central Bank and a soft Congress resulted in an explosion of state transfers to ailing enterprises. From January to July 1992 inter-enterprise debt jumped from 37 billion to 3.2 trillion rubles. By the spring of 1993, state subsidies were estimated to be 22% of GDP. Meanwhile, only one Russian enterprise has declared bankruptcy”. (McFaul, 235)

Phase Two of the privatization program began on July 1, 1994 and was governed by the State Privatization Program under the title of ‘On the Fundamental Provisions of the State Privatization Program for State and Municipal Enterprises in the Russian Federation’ (Gregory & Stuart, 1998).

Phase Two of Russian privatization was even more exclusive than the voucher privatization as far as keeping outsiders away from the dealings. Outsiders did not wish

to participate in this phase by purchasing blocks of shares because most of the joint stock companies were already run by the insiders. During the years 1995 and 1998, some of the most profitable export industries (Yukos, LUKoil, Sufgutneftegas, Novolietsk Iron and Steel) were sold off in order to maximize revenues for the state budget (OECD, 2001). The policy of the second privatization focused on giving the country's most valuable companies away for a fraction of their real worth to the well connected managers and politicians instead of the workers and other Russian citizens such as during Phase One of the Russian privatization.

According to OECD, the goal of Phase Two in 1995 was to:

“sell off the residual state holdings either by free transfer or sale of shares to employees in a closed subscription, sale of equity by investment or commercial tenders or by auction or sale of remaining shares at interregional or nationwide auctions”. (OECD, 147)

Most of the remaining shares of highly profitable enterprises were sold on specialized auctions, also called the ‘loans-for-shares’ scheme. In the ‘loans-for-shares’ scheme, the selected strategic state properties’ shares were auctioned to a group of major Russian banks (Uneximbank, Menatep, Stolichny, Bank Imperial) in return for loans (OECD, 2001). The auctions were not public; they were carried out behind closed doors and did not allow participation of foreign investors. The scheme proved to be highly controversial because the shares turned over ‘in trust’ in exchange for ‘loans’, would a year later permanently remain in the hands of the trustees (Gregory & Stuart, 1998).

The institution in charge of the implementation at municipal and regional level of the ‘loans-for-shares’ program was the Federal Property Fund. The scheme was ‘orchestrated’ by the Russian Central Bank and was a brainchild of Vladimir Potanin,

who was the CEO of Uneximbank at the time (OECD, 2001). Vladimir Potanin suggested the idea to President Yeltsin which:

“involved the Russian State depositing in Russian banks significant blocks of shares from the stocks of the most valuable Russian SOEs (oil companies and other energy and raw materials producers). Banks would consider the stock they held as collateral for the loans they offered in order to bail out a serious fiscal deposit. For each company involved in this device, an auction was opened and the winning bank got a block of shares, remitted the price as a loan to the state, while holding the shares until September 1996. If, on this date, the state had not reimbursed the loan, the bank would be allowed to sell or definitively keep the shares (and ownership in an oil trust, etc.). Since the state obviously was not capable of repaying its debt, banks gained through this scheme the ownership of the ‘crown jewels’ of the Russian industry, for a nominal sum, insofar as auctions were rigged and not exempt from collusion. All the winning banks were owned by a small group of financial oligarchs well-acquainted with the President of the Russian Federation. (Mickiewicz, 33-34)

In fact, the ‘loans-for-shares’ scheme was designed by Yeltsin administration aiming at consolidation of bankers’ support for his reelection campaign in 1996.

The investment activity in 1996 in Russia slowed down after the ‘loans-for-shares’ scheme which was disapproved by both the World Bank and the Russian general public, which showed discomfort with the procedure and became conscious that the insider privatization was a fact in Russia. The investors’ concerns revolved around the unsolved issues of long-term strategy of corporate governance and legal problems.

4.5 The Outcome of the Russian Privatization Process

The initial goal of the Russian privatization process was to sell Russian enterprises to outside bidders who would bring in the know-how, new management, capital, and build a coalition of stakeholders (Gustafson, 1999). The trade-off that Russian policy makers had to work out was either to bring in the foreign know-how at the cost of giving away ownership of companies to outsiders or to sacrifice foreign

managerial skills for the controlling stake of companies in the hands of insiders. Reluctance to give controlling shares of Russian enterprises to foreigners has consequently created privatized industries starved of capital, companies without clear long-term business strategy and large ownership stakes of enterprises in the hands of insiders. Privatization policies were largely created by the Congress of People's Deputies (CPD) and the actions taken steered the outcomes of privatization to a different path than the one envisioned.

The CPD was the core of Russian political corruption. It was constituted by directors of large enterprises in minority, who lobbied extensively for the Option Two (where 'insiders' get 51% of common equity during voucher privatization) to be implemented instead of the proposed Option One (25% of equity to workers for free, 5% of equity to purchase for managers with additional 10% of equity available for workers and managers at 30% discount to book value). Option One offered greater opportunity to outsiders to gain majority of equity shares in the company and the scenario that Russian authorities would potentially avoid if Option One was indeed implemented would be:

- Clearer employee/owner problems;
- Cheap credit would not have been provided by the Russian Central Bank and the corporations would have began behaving as profit seekers instead of being dependent on 'soft budgeting';
- Decisions of power between different branches of government would get institutionalized and create a more effective state (McFaul, 1995).

Yeltsin dissolved the CPD in 1993, but it was already too late. Since Option Two was approved, an avalanche of corruption and opportunism of managers had already been

unleashed upon the institutionally unstable country. The greatest drawbacks of the privatization in Russia are the old-line politicians and bureaucrats, who have not been replaced and still continue undermining all reforms, including privatization (Boycko et al., 1993). Gustafson in his book, 'Capitalism Russian – Style', writes that:

“The main issue [privatization failure] is insider control. The big winners from the privatization program were the former Soviet-era managers. There remain the same instincts, habits, and connections, and the same bend in the spine. It is a rare director that does not rush off to government, that does not seek connections with high-placed officials, that does not beg for subsidized credits, tax breaks, and privileges. Privatization taken by itself is simply a new institutional form superimposed on an old structure”.
(Gustafson, 37)

The Russian privatization process has been a series of events that were compressed under pressure of fast and sweeping reforms that would have taken decades elsewhere to unfold. The urgency for fast completion of Russian privatization did not allow any time for the market-supporting institutions to be created, thus the lack of legal codes (such as still unresolved property rights confusion) was the reason why managers could seize control of many enterprises without much difficulty.

Summary

Lack of market-supporting institutions and an underdeveloped legal system in Russia have been the key tools through which politically well-connected managers and politicians themselves seized ownership of former state-owned enterprises. Russian privatization did not provide efficiency incentives to produce new wealth, rather it redistributed already existing wealth through dubious methods. Clearly, the ultimate goal of capital liberalization in Russia was not to disperse ownership of former state-owned

enterprises among the people of Russia, but to create a powerful support group that would ensure the second mandate of President Yeltsin's administration. Also, the program has not contributed to fiscal stability by providing the government with a source of revenue. In the next chapter, the primal focus of the analysis will be to dissect corporate governance of the newly-born enterprises in Russia and find out if it serves as an institution that should protect the interests of investors by reassuring that the money invested in a public company will be handled with due care by the management of the company.

5. New Class of Owners in Russia – The Oligarchs

5.1 Re-Nationalization

After the second privatization, denoted by the ‘loans-for-shares’ scheme, came to an end in 1995, the opportunities for massive private gains come to an end as well. The ‘loans-for-shares’ scheme was the ‘modus operandi’ in the process of re-nationalization and preserved control of the economy in hands of the few in the Kremlin.

Accessibility to financial capital is the most important condition for quick economic development, most notably so in the emerging markets. In the emerging markets, banks are perceived as the most reliable sources of funds due to the poor conditions of other financial institutions. Thus, it is not surprising that executives of strategic industries constitute the majority of outside directors on the boards of Russian banks. Often the enterprises in the Russian strategic industries are major shareholders of a bank and have enough votes to place their representatives on the board. Companies in the strategic industries, especially oil and gas companies, have significantly more directional ties than companies in other industries in Russia.

Company	Number of ties	Industry
Gazprom	22	Oil & gas
Severstal	14	Ferrous metallurgy
Sibur	13	Chemical & petrochemical
Lukoil	12	Oil & gas
Tatneft	12	Oil & gas
Sibneft	11	Oil & gas
EES	9	Electro-energy
UGMK	7	Non-ferrous metallurgy
Surgutneftegaz	6	Oil & gas
TNK	6	Oil & gas
VSMPO	5	Ferrous metallurgy
Yukos	5	Oil & gas

Table 2: Russian companies with the highest number of directional ties in 2001

Source: Mickiewicz, Tomasz; Corporate Governance and Finance in Poland and Russia

Oil and gas generate more than one-half of Russian exports and are thus considered major sources of financial capital in Russia; hence these corporations maintain the most directional ties. On the other hand, banks are the institutions in the Russian corporate network that receive the most directional ties, also the

“executives of other corporations are rarely invited to boards of Russian banks as knowledgeable experts who may provide information useful in making strategic decisions. Usually they represent on the board interests of those organizations where they occupy executive positions. Often these organizations are major shareholders of a bank that have enough votes to put their representatives on the board”. (Mickiewicz, 142)

The emergence of banking crime mentioned above is called ‘pocket banking’, and it basically means that banks lend primarily to companies that own them. A significant number of start-up companies that are starving for financial capital are unable to obtain loans from Russian commercial banks. The ‘fortunate’ start-up companies that do receive funds from banks become controlled by ‘oil & gas’ companies and eventually get acquired by these companies. ‘Pocket banks’ thus play a critical role in the formation of vast enterprises in Russian economy.

Oil, Fuel, and Gas	64.8%
Metals	13.8%
Machinery and Equipment	5.8%
Chemicals	5.6%

Table 3: Principal Exports 2006

Source: Economist Intelligence Unit

Netherlands	12.3%
Italy	8.6%
Germany	8.4%
China	5.4%

Table 4: Main Destinations of Exports 2006

Source: Economist Intelligence Unit

The Russian banking system is a unique case in global economy as its major sources of funds are constituted by industrial companies. Exciting Russian financial history has contributed to the lack of public trust in the Russian banking system leading consequentially to minimal household deposits held by commercial banks. The majority (80%) of all household deposits in Russia are held by the state-owned Sberbank which guarantees for reimbursement of all deposits in case of economic crisis. I will be more specific later on in the paper as far as the banking system goes in Russia, but what we need to understand at this point is that banks do not have much discretion in using the capital that is provided to them by industrial companies. Industrial companies require the right to control and monitor the way their funds are being used.

Scarcity of capital in the Russian economy gives power to the enterprises in the strategic industries to act as coordination centers in the financial industry as well. It is important to note that these enterprises are still owned by the government. Therefore, state capital is the dominating source of funds that drives the Russian economy through the operations of strategic industries where state kept the dominating share of equity. The government ownership share in large Russian enterprises is known as the ‘Golden share’,

which is commonly between 100% and 25% of the enterprise ownership stake. Russian strategic industries generate a great portion of their revenues through exports and the awareness of being in possession of rich natural resource base. These companies then engage in rent-seeking resulting in concentrated control of assets, with oligarchic structures not interested in competition, freedom of entry and promotion of new entrepreneurship (Mickiewicz, 2006).

The strategic industries – banks’ cooptation theory, as Russian oligarchs like to call it, is more of a top-down approach that does not result in transforming household savings into industrial loans in Russia, but rather in the dependency of large industrial companies as sources of funds. As far as the impact on Russian economic development and ‘Banking cooptation theory’ goes, the results are further capital starvation, crowding-out from the debt market, and reliance on the internal sources of funds to generate investments, which then ultimately leads to lack of ‘de novo’ companies in Russia. The Economist reports that:

“Small businesses, though growing fast, still account for a mere 12% of GDP, as against 30-70% in developed market economies. For sustainable long-term growth, these businesses need a better climate. This is where reform starts to matter”. (Mastrapa, Special Report: Russia Under Putin)

5.2 Corporate Governance in Russia

Russian privatization turned out to be an ‘oligarchic-managerial’ model, with the majority of firms under control by the insiders (principally managers) while the rest of firms are integrated in a number of investment funds, controlled by politicians, tycoons, financial oligarchs, bankers, or state. The concentration of ownership in contemporary Russia is above average, and so it is considered as a country where monopolies prevail in

its industries. Interlocking directorates and outsider – insider alliances have established concentrated ownership of companies in Russia and most enduring networks are of a political nature (Mickiewicz, 2006). Oligarchs or ‘agents of economic and political change’ as they like to be called, are a ‘unique constituency that is both willing and able to lobby for development of market institutions, they are also blamed for weakening Russian democratic institutions; they are ‘large-scale businessmen who control resources sufficiently vast to influence national politics’ (Guriev & Rachinsky, 2005).

“They [the oligarchs] come from different walks of Soviet life, from the nomenklatura and sciences, from the shady world of street hustlers and ranks of Soviet industrial managers. But what distinguished them was an ability to change. Every one of them learnt to manipulate the old system while at the same time making an incredible leap out of it into the world”. (Hoffman, 5)

The rise of oligarchs could be broken down into three separate phases from the early 1980s to the beginning of the next decade. During that period they exploited the opportunities at hand and grabbed as much capital as they could. The first period goes back to the early days of Gorbachev’s reform initiatives when state control allowed the young entrepreneurial members of the Communist Party to start their own small businesses. During the second period the oligarchs began establishing banks through which they were handling the cash flows generated by their businesses. During this period the oligarchs began to search for political sponsorship and influence within the Kremlin in their search for power. The significant development of the second period is the highly controversial ‘loans-for-shares’ scheme, through which the politically well-connected expanded their holdings to include the ownership of natural resource companies and media outlets. During the final period the oligarchic expansion has

‘maxed out’ and stabilized when Putin was elected President of Russia. The era of Putin in the oligarchic rise to power is portrayed by

“the first meeting with the leading oligarchs on July 28, 2000, where President Putin offered them the following pact. As long as the oligarchs paid taxes and did not use their political power (at least not against Putin), Putin would respect their property rights and refrain from revisiting privatization. This pact defined the ground rules of oligarchs’ interaction with central and regional government for Putin’s first term (2000–2004)”. (Gurieiev & Rachinsky, 146)

The definition of oligarchs as large private owners excludes politicians, bureaucrats or executives of public companies even when they de facto control large firms’ (Gurieiev & Rachinsky, 2005). Oligarchs’ ownership stakes are particularly high in natural resources and automotive industry, they are not present in natural gas, energy or manufacture of machinery industries, yet these state conglomerates are horizontally and vertically well integrated with enterprises owned by oligarchs.

Senior partner(s)	Holding company/firm, major sector(s)	Employment, in thousands (% of sample)	Sales, in billions of rubles (% of sample)	Wealth, in billions of US\$
Oleg Deripaska	Base Element/RusAl, aluminum, auto	169 (3.9%)	65 (1.3%)	4.5
Roman Abramovich	Millhouse/Sibneft, oil	169 (3.9%)	203 (3.9%)	12.5
Vladimir Kadannikov	AutoVAZ, automotive	167 (3.9%)	112 (2.2%)	0.8
Sergei Popov, Andrei Melinichenko, Dmitry Pumpiansky	MDM, coal, pipes, chemical	143 (3.3%)	70 (1.4%)	2.9
Vagit Alekperov	Lukoil, oil	137 (3.2%)	475 (9.2%)	5.6
Alexiei Mordashov	Severstal, steel, auto	122 (2.8%)	78 (1.5%)	4.5

Vladimir Potanin, Mikhail Prokhorov	Interros/Norilsk Nickel, nonferrous metals	112 (2.6%)	137 (2.6%)	10.8
Alexandr Abramov	Evrzholding. steel	101 (2.3%)	52 (1.0%)	2.4
Len Blavatnik, Victor Vekselberg	Access-Renova/TNK-BP, oil, aluminum	94 (2.2%)	121 (2.3%)	9.4
Mikhail Khodorkovsky	Menatep/Yukos, oil	93 (2.2%)	149 (2.9%)	24.4
Iskander Makhmudov	UGMK, nonferrous metals	75 (1.7%)	33 (0.6%)	2.1
Vladimir Bogdanov	Surgutneftegaz, oil	65 (1.5%)	163 (3.1%)	2.2
Victor Rashnikov	Magnitogorsk Steel, steel	57 (1.3%)	57 (1.1%)	1.3
Igor Zyuzin	Mechel, steel, coal	54 (1.3%)	31 (0.6%)	1.1
Vladimir Lisin	Novolipetsk Steel, steel	47 (1.1%)	39 (0.8%)	4.8
Zakhar Smushkin, Boris Zigarevich, Mikhail Zigarevich	IlimPulpEnterprises, pulp	42 (1.0%)	20 (0.4%)	1
Shafgat Tahaudinov	Tatnaeft, oil	41 (1.0%)	41 (0.8%)	2.9
Mikhail Fridman	Alfa/TNK-BP, oil	38 (0.9%)	107 (2.1%)	5.2
Boris Ivanishvili	Metalloinvest, ore	36 (0.8%)	15 (0.3%)	8.8
Kakha Bendukidze	United Machinery, engineering	35 (0.8%)	10 (0.2%)	0.3
Vladimir Yevtushenkov	Sistema/MTS, telecoms	20 (0.5%)	27 (0.5%)	2.1
David Yakobashvili, Mikhail Dubinin, Sergei Plastinin	WimmBillDann, dairy/juice	13 (0.3%)	20 (0.4%)	0.2
Total		1,831 (42.4%)	2,026 (39.1%)	

Table 5: Russian ‘oligarchs’ and their wealth in 2003

Source: ‘The Role of Oligarchs in Russian Capitalism’ by Guriev and Rachinsky

	Employment	Annual Sales
Oligarchs	42%	39%
Other private domestic	22%	13%
Foreign owners	3%	8%
Regional governments	6%	6%
Russian federal government	15%	26%
No data	12%	8%

Table 6: Breakdown of the Sample by Ownership Categories

Source: Guriev, Sergei; Rachinsky, Andrei; Journal of Economic Perspectives; The Role of Oligarchs in Russian Capitalism

Sector	Sales 2001, billions of rubles	Oligarchs’ share in sales	Four-firm concentration ratio
Oil	1,256	72%	59%
Natural gas	579	1%	94%
Energy	499	8%	49%
Ferrous metals	275	78%	66%
Automotive	225	71%	71%
Machinery	209	12%	12%
Nonferrous metals (except aluminum)	154	92%	95%
Milk	100	18%	23%
Pulp and paper	93	30%	41%
Coal	89	48%	47%
Aluminum	84	80%	90%
Construction materials	82	6%	32%
Jewelry	74	0%	87%
Meat	69	16%	29%
Fertilizers	61	46%	66%
Beer	59	2%	57%
Tobacco	59	0%	91%

Bakery	58	0%	5%
Rubber	51	4%	65%
Confectionary	50	0%	59%
Timber	48	5%	8%
Vodka	45	14%	33%
Fish	42	0%	22%
Mill	40	5%	14%
Pipes	34	55%	85%
Ore	30	73%	59%
Tyre	28	10%	64%
Pharmaceutical	28	17%	37%
Cable	23	15%	34%
Poligraphy	22	2%	38%
Furniture	20	3%	23%
Nonalcoholic drinks	18	0%	62%
Total	4,500	39%	

Table 7: Oligarchs' Control and Ownership Concentration by Sectors

Source: Guriev, Sergei; Rachinsky, Andrei; Journal of Economic Perspectives; The Role of Oligarchs in Russian Capitalism

Insider ownership and lack of outsider institutional ownership concentration is a result of the vague and weak legal environment in the first years of Russian mass privatization. As I have mentioned earlier in the paper, the 'Fathers of Russian privatization' have envisioned that voucher privatization could have been the basis for institutional ownership, but investment funds lacked liquidity, access to company registers, and an enforcement mechanism that would guarantee their ownership due to privatization plan 'Option Two' of voucher privatization. Russian investment funds have also lacked professionalism and competence. Many investment funds have also proved to be fraudulent, which resulted in a lack of trust in these funds by Russian private investors.

5.3 Entrenchment

Management teams in Russian firms have usually been associated with each other for a long time and that is why the firms where the ownership shares are concentrated in the hands of a few, are called ‘comradeship’ or ‘companionship’ firms. In addition, ‘comrades’ never stop looking for ways to enhance their ownership stakes (Guriev & Rachinsky, 2005).

Countless fraudulent and criminal activities by managers, with respect to obtaining shareholder wealth in Russian companies have become regular practices, disguised in many ways. The most commonly used method of capital concentration by management teams was acquiring vouchers held by workers who owned the majority of company shares. Workers in Russia collectively appeared to be passive; they did not perceive their interests to be aligned with the value of the company, but rather with the job security (Boycko et al., 1993). In many cases workers gave shares to managers for nothing more than a promise that they would not get fired. In more ill-mannered cases, managers secretly acquired shares without workers’ knowledge through ‘pocket companies’. More commonly, when workers wanted to sell their stock, managers came out to be the only buyers since shares were not liquid and securities markets underdeveloped. In other cases, insiders (managers and workers) colluded together in opposition to outsiders, generally by workers’ voting support to keep insider control over privatized enterprises (Mickiewicz, 2006). Still other times, managers would get loans

from the company to supplement their stakes, which led to higher ownership than they got in the 'closed subscription' of privatization plan 'Option Two' (Boycko et al, 1993).

Entrenchment seemed to be the key attitude of managers towards obtaining the majority of shares during Russian privatization. Managerial strategy was aimed at preserving their control of the company: some managers kept share registers locked up in their offices, they kept more than one registry, at times managers refused to register shares, they frequently changed registration from common to preferred stock, which resulted in loss of voting shares for certain shareholders. Other tools used by managers to keep outsiders away from being able to attend shareholder meetings included summoning to meetings at a very short notice or mailing out notifications ex post (Kuznetsov & Kuznetsova, 1996). In an attempt to dissolve this problem, the Russian Duma adopted the Law on Stock Companies and the Law on the Securities Market in 1995 alongside the establishment of National Registry Company in 1995, but that was already much too late, since managers by then had seized over the 51% of equity in most firms. Still, in order to sell their shares, shareholders had to go through management and in many cases managers threatened to fire workers in order to prevent them from selling their shares to outsiders (Lavelle, 2004).

5.4 Agency Problem

Russian corporate ownership structure is heavily concentrated, as 50-60% of the dominant owners hold all or most of the company equity alone, which is the reason why there is skepticism and lack of outside investors (Mickiewicz, 2006). Russian agency problems did not occur with a large block shareholder - manager's failure to satisfy the

objectives of diffused shareholders, but with the crowding-out and expropriation of minority shareholders. The role of the dominant owner and manager became united in Russian companies and it was also typical for the stake of dominant owners to continue growing. Opportunistic managers with large blocks of shares did not pursue the same interests as outsider shareholders who are interested in creating firm value in the long-run. Instead concentrated ownership in companies facilitated managerial strategies in value skimming transfers at the expense of minority shareholders, they put themselves in the position where they accumulated substantial amounts of wealth from loss-making enterprises. The interest of managers thus shifted from obtaining great stakes of ownership to draining resources of the firm. Dominant strategies of corporate governance abuses were:

- share dilution;
- asset-stripping through transfer-pricing;
- non-transparent ownership structures;
- use of bankruptcy as a take-over instrument, spinning-off ‘daughter companies’ in ownership of a small circle of managers. The ‘mother enterprise’ takes the losses, accumulates debt, delays wages and payments, holds back taxes – while profits go to the managers’ pockets (Gustafson, 1999);
- cash-flow diversion through creation of a number of small affiliated firms, which are put in place to ‘control’ the cash flow of the firm. Managers used these small firms then to transfer money into their personal accounts (Mickiewicz, 2006).

From the actions taken by the managers who obtained great ownership stakes in their companies we can see they were not interested in the long-term strategy of their

companies; the only strategy that these managers had, was to get rich quick. General instability of the Russian system regarding property rights, inheritance rights, contract law, judicial protection, and personal safety made managers channel the assets out of the company even faster (Mickiewicz, 2006). If they did not steal from the company now, somebody else would the next day; therefore the standard problem of corporate governance in Russia is not the conflict between managers and owners, but a conflict between different owners. The size of holdings in Russia gives no immunity against raiders. The same institutional weaknesses that made it possible for the managers to obtain great ownership stakes has made these managers insecure about the future value of their investments. The weak, almost chaotic legal environment in Russia was therefore an ideal place for managerial predators to seize enormous amounts of wealth in state owned firms. At this point, the question is: “At whose expense did these large block shareholders get so rich?”

Weak legal protection of minority shareholders was the exact reason why managers could engage in such value–destroying actions. Russia is an example of a country where improvement in the legal structure of minority shareholder protection is crucial to prevent their expropriation. Corporate governance has a powerful effect on market value in a country where legal and cultural constraints on corporate behavior are weak. In January 2001, the Law on Joint-Stock Companies was enforced to solve the issue of minority shareholder abuse by the managerial apparatus.

Law on Joint-Stock Companies (JSC)	Enforced on August 7 2001, Article 7: Rights issues are permitted as long as they do not violate the internal regulations of the company or the amendments to the JSC	The amendments to the law are designed to strengthen the protection of minority shareholders. Amendment to the JSC on February 24 2004 specifies that cumulative voting must be used in the election of board members for joint-stock companies with any number of stockholders. There must be a minimum of five board members.
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Table 8: Law on Joint-Stock Companies

Source: The Economist Intelligence Unit, Financial Report – Russia

Still, Russia is also an example of a country where managers have well-integrated political links and prevent legal reforms that would enhance minority rights from seeing the light of day. In ‘Corporate Governance and Finance in Poland and Russia’, Tomasz Mickiewicz states that:

“Deliberately inadequate legislative framework in Russia may also be a result of rent-seeking behavior of politicians who have strong formal and informal relations with powerful shareholders. Consequentially arrangements regarding corporate governance were not the product of an evolutionary process prioritizing efficiency, but rather the implementation of a certain political agenda”. (Mickiewicz, 173)

5.5 The Root of Problems with the Corporate Governance in Russia

Russian securities law is based on the ‘Anglo-Saxon’ corporate governance structure. However, the actual system of corporate control is far away from the Anglo-

American system where minority shareholders are well-protected and the owners do not diversify their holdings as soon as the opportunity arises (Mickiewicz, 2006).

Russian example of high ownership concentration and insider ownership has proven to destroy value in corporations and affect performance negatively. The role of corporate governance is to create trust between the people who run the company and investors; the case with Russian corporate governance seems to completely undermine its most essential task. The major concern, regarding corporate governance in Russia, is to protect shareholders' rights and enforce laws designed to control equity expropriation of opportunistic managers.

Various domestic and international institutions – private and public – have been actively involved with the process of corporate governance reconstruction in Russia. In 2000, OECD and the World Bank have put pressure on Russian government to promote the principles of good corporate governance developed by OECD and in 2002 the Russian Federal Securities and Exchange Commission introduced the voluntary Code of Corporate Behavior (CCB) (Mickiewicz, 2006). Companies in Russia mostly take no notice of the Code of Corporate Behavior, but the companies that comply with the CCB are usually the ones that seek to attract financial resources from the international markets. The companies that try to attract foreign capital not only comply with CCB, but also with Generally Accepted Accounting Principles (GAAP) or International Accounting Standards (IAS), depending on which financial markets they are focused. Unfortunately there is still wide discrepancy between the standards of good corporate governance and the actual practices (Mickiewicz, 2006).

5.6 Economic Crime

There are three macroeconomic components that dictate market operations in the Russian economy, which are: the state, enterprises, and organized crime. Organized crime, more commonly known as the ‘mafia’, is a multi-interconnected predatory social order in the economy that feeds on criminal activities in the society. Gustafson defines economic crime in his book ‘Capitalism Russian-Style’ as:

“A catch-all category used in Russian law enforcement statistics to cover an assortment of crimes against property, ranging from theft, embezzling, and fraud to counterfeiting, falsifying documents and contracts, and concealing income”. (Gustafson 137)

According to statistics provided by the Russian Presidential Report in 2002, the mafia collects ‘protection’ money from 80% of all Russian private enterprises and commercial banks in the proportion of 15% - 20% of their turnover or 50% of their profits to ensure ‘special relations’ with representatives of authorities. It is said that in Russia ‘protection’ comes with a rental lease (Gustafson, 1999). Organized crime can have such a big share of economic output, because the state has been lagging behind in the following three aspects of order:

- the state has not provided basic law and order as far as protecting of citizens’ lives, property rights, and contract enforcement goes;
- the state has not developed legal framework in accordance with establishing clear distinctions between legal and illegal actions;
- the powers that the state retains have more often negative than positive effects on the macroeconomy, consisting of efforts such as the creation of new regulatory

structures, such as foreign-trade controls that become new opportunities for bureaucrats to claim turf and levy tribute (Gustafson, 1999).

The missing frameworks of order in a laissez-faire market economy, mentioned above, have much to do also with the scale and scope of the initial privatization and thus provide a breeding ground for corrupt practices. In the emerging economy with lack of institutions at its place and not enough enforcement officers, market participants design their own unwritten rules. The state's main direct weakness for its inability to impose stricter order, besides ineffectiveness of contract enforcement, is lack of money coming in from the tax payers. Therefore, the state is not able to raise the low level of salaries paid to the police officers, the customs officials, and the tax collectors who are under-trained and under-armed.

The negative effects that the economic crime has on the Russian economy are the following:

- Inflationary: Organized crime puts pressure on prices of goods and services because transactions that form its existence are based solely on cash, operate in the black economy and have access to foreign currency that the Russian central bank does not have an access to. Cash business and forgery of money thus amount to uncontrolled emission of money in the system. In addition, businesses which are financially extorted by organized crime simply pass their increasing costs on to the customers. The level of inflation in the country consequently increases.
- Distributional: Crime takes away from public goods and increases private ones, mainly by reduction of tax receipts;

- Capital flight and ‘Dollarization’: Investors, businessmen, criminals, and ordinary people are looking for safe heavens abroad due to the weak ruble, increasing inflation, and ineffective of legal framework. People rather than put their money in banks, exchange it for dollars and keep cash under the mattress.
- Inefficient economy: Extortion is very hard to fight in Russia, because everyone has something to hide – victims do not report extortions to the authorities because either they are part of criminal cartels or they fear of revealing their incomes to the tax inspectors. Extortion thus leads to double taxation and adds to the costs.
- Crime creates distrust among people: Fear of being cheated or extorted creates a downward spiral, powered by perception to always expect the worst. Banks have tightened up their commercial loans due to the priority of companies in Russia being an increase of managers’ salaries as opposed to paying off their debts, which consequentially has tended to undermine lenders’ confidence (Gustafson, 1999).

5.7 Transparency Issues

The Russian Accounting Standard (RAS) is the official accounting standard for financial reporting in the country, which was originally designed for a centrally planned economy and is unsuited for the market economy. There is great pressure from foreign investors on Russian companies to adopt and implement the International Financial Reporting System (IFRS) and International Auditing Standards (IAS), which are the standards that Russian companies issuing equity on foreign stock exchanges need to accommodate.

However, RAS is still widely used all over Russia mainly because it gives managers the incentives to under-or over-report companies' profits. The consequence of inadequate financial reporting leads to abuse of minority shareholders through wasted assets and inability of investors to make adequate decisions based on inaccurate financial information about companies. The culture of under-and over-reporting in Russia is widespread due to managerial incentives such as tax evasion strategy and capital flight. I will look at issues such as tax evasion and capital flight more closely later on in this paper, particularly as I will describe fiscal circumstances in Russia.

Disclosure is a new concept to Russian culture of doing business and it will take some time before the businesses will learn how to deal with it. Pressure is exerted on Russian companies from the international investment community; an OECD study found that the flow of capital is increased to the firms with high transparency, low corruption, and an efficient judicial system. Companies of the 'emerging market economies', including Russia, tend to have low disclosure of financial reports, which as a result of inadequate enforcement contributes to attracting less foreign capital than their potential. To keep bringing foreign capital in and adjust to the 'western way' of doing business, Russian authorities have sped up the process by inviting the largest accounting firms, various international organizations such as the World Bank, IMF, the US Agency for International Development, and TACIS to help Russian companies understand the meaning of disclosure (Mickiewicz, 2006).

According to the survey conducted by S&P which measured and compared the 54 largest companies in Russia with the top-10 companies listed in the 2006 Fortune 500, it took an average of 136.6 days after year-end to issue financial statements in Russia,

comparing to an average of 63.3 days in the US (Mickiewicz, 2006). Information is more accurate and available for larger companies and there is some evidence suggesting that it takes more time to report bad news than good news.

Rank	Country	Score
1	Finland	17
1	Belgium	17
1	Germany	17
4	USA	20
4	Chile	20
4	Thailand	20
9	Japan	22
11	Switzerland	25
15	Argentina	30
20	Hong Kong	33
31	Ireland	38
33	Russia	40
38	Czech Republic	44
41	Spain	50

Table 9: Accounting and governance practices in selected countries

Source: Mickiewicz, Tomasz; Corporate Governance and Finance in Poland and Russia; Kurtzman et al. (2004)

Lastly, the question is how much of ‘lack of transparency’ is actually ‘required’ by the Kremlin rules. President Putin likes to have tight control of enterprises in Russia’s strategic industries and transparency advocated by international democratic institutions does not go along well with the instructions these companies receive from Kremlin.

The Rise of Putin

Mr. Putin was elected President in March 2000 and easily re-elected in 2004.

President Putin’s rapid rise to the premiership from serving as the head of FSB (Federal Security Service, formerly the KGB) and President Yeltsin’s Prime Minister has been

mostly the product of President Yeltsin's political support. In President Yeltsin's eyes, Putin could either become a very dangerous enemy or a powerful friend through his extensive knowledge he gained in the intelligence services he has been involved with throughout most of his life – President Yeltsin's main concern was his own and his business friends' protection from investigation and prosecution by the state, which could potentially be triggered by Mr. Putin if his political ambitions would not be satisfied.

Yukos is an example that demonstrates the mission of Kremlin that advocates lack of accounting transparency, fears of transformation of economic into political power, and could be described by a slogan 'mysticism = good, transparency = bad'.

The Tale of Yukos

Yukos was a major Russian non-state oil company that produced about 2% of world's oil production. The company was acquired by Mikhail Khodorkhovsky through the controversial 'loans-for-shares' scheme. Yukos went through the transformation from the company with abusive corporate governance to Russia's most respected company, serving as an example of good corporate governance and transparency. The company has pioneered shipping Russian oil to the U.S. market and it was also known as the 'Russian company most independent from the government'.

Dismantlement of Yukos was initially stimulated by Mikhail Khodorkhovsky's political power aspirations, especially through his financial support of the opposition political parties and his desire to run for president in the 2008 presidential elections. Soon

enough Yukos was charged with tax evasion of US\$7 billion, followed by past charges of irregularities against Yukos's shareholders.

Yukos's 'fall from grace' began with Mikhail Khodorkovsky's arrest due to his anti-United Russia political aspirations, late in 2003. Three years after the company's former CEO's arrest, a Russian court declared Yukos bankrupt. The attack on Yukos by the Russian government severely damaged the Russian stock market, causing the RTS index to fall by over 20% and triggering immense capital flight.



Figure 1: Yukos stock price

Source: Economist Intelligence Unit

Highly transparent enterprises are very difficult for the state to control, because in transparent financial statements each transaction is on the surface, while mystical

financial statements that still dominate the financial reports of extremely profitable Russian companies are very handy for extortion of any kind. Transparency and sound corporate governance are viewed as a tool towards political independence and the Yukos affair demonstrates that the Kremlin elite's biggest fear is the emergence of a powerful political opposition whose beginnings have been detected very early in the pro-Western, economically sound company.

Summary

The art of maintaining the principal rule of political supremacy in a country can well be transformed to preservation of the executive supremacy in an enterprise, where if interrelated, the latter serves the former. Fight for a territory is a constant battle and to satisfy the components of longevity of time and size of a terrain for as long as possible, the governing body has to prevent the opposition from springing up at the early stage. We discover that the liberalization of capital markets in Russia was just a tool in the hands of the political elite that wanted to keep the privileges of the greatest authority on the Russian soil. History tells us that the new class of economic lords or the 'power preserving agents' was a group of wise, law-breaking, and very well connected individuals. The class of newborn 'oligarchs' in Russia became the ruling minority that was not interested in creating value; rather they were interested in stealing the value that has already existed. Hence, the institution of corporate governance in Russian companies does not rise up to the expectations of Western standards.

6. Russian Financial Crisis of 1998

A timeline of Russian currency crisis (Chiodo & Owyang, 10)

April 1996	Negotiations with the Paris and London Clubs for repayment of Soviet debt begin.
1997	Trade surplus moving toward balance. Inflation around 11%. Oil selling at \$23/barrel. Analyst predict better credit ratings for Russia. Russian banks increase foreign liabilities. Real wages sagging. Only 40% of workforce being paid fully and on time. Public-sector deficit high.
October 1997	Negotiations with Paris and London Clubs completed.
November 11, 1997	Asian crisis causes a speculative attack on the ruble. CBR defends the ruble, losing \$6 billion.
December 1997	Year ends with 0.8% growth. Prices of oil and nonferrous metal begin to drop.
February 1998	IMF funds requested.
March 1998	Continued requests for IMF funds.
April 1998	Another speculative attack on the ruble.
Early May 1998	Dubinin warns government ministers of impending debt crisis, with reporters in the audience.
May 19, 1998	CBR increases lending rate from 30% to 50% and defends the ruble with \$1 billion.
Mid May 1998	Oil prices continue to decrease. Oil and gas oligarchs advocate devaluation of ruble to increase value of their exports.
May 23, 1998	IMF leaves Russia without agreement on austerity plan.
May 27, 1998	CBR increases the lending rate again to 150%.
Summer 1998	Russian government formulates and advertises anti-crisis plan.
July 13, 1998	An emergency \$22.6 billion international package is announced. The GKO-Eurobond swap is announced; GKO yields halve.
August 13, 1998	Russian stock, bond, and currency markets weaken as a result of investor fears of devaluation; prices diminish.
August 17, 1998	Russian government devalues the ruble, defaults on domestic debt, and declares a moratorium on payment to foreign creditors.
September 2, 1998	The ruble is floated after \$2.8 billion in reserves is lost between August 17 and September 2.
October 30, 1998	The IMF mission leaves, with large unresolved differences on the budget as well as on the action plan to address the crisis.
December 1998	Year ends with a decrease in real output of 4.9%.

Throughout the years of rapid privatization in Russia (1992 – 1996), the GDP was steadily decreasing, whereas foreign debt has been growing. Russia inherited a great sum of foreign debt from the Soviet Union and the officials began negotiating the postponement of sovereign debt in 1996. In 1997, Russia joined the Paris Club of creditor nations after rescheduling the payment of over \$60 billion to other governments. Russia also negotiated a 23-year debt repayment of \$33 billion with the London Club (Chiodo & Owyang, 2002).

In addition to mounting sovereign debt, Russia did not generate any additional funds from its 'express privatization'. Russian policymakers were in favor of 'freeing up the markets' rapidly instead of taking a gradual approach. Market fundamentalist policies that the reformers implemented echoed the conviction of IMF's economists' beliefs about free markets allowing more efficiency for faster growth. The enthusiasm of prosperous growth that the market-based economy promises, and impatience to get there, have undermined negative effects of rapid policy implementations, or in Russia's case an economic 'shock therapy'.

Market economy transition turmoil began right after the break-up of the Soviet Union, when in 1992 Russian authorities postponed stabilization, de-monopolization and privatization until after the price liberalization action. The prices were freed-up overnight, except on a small selection of goods that were kept artificially low, oil being one of them. The first consequence was an increase in prices due to the demand pressure ('ruble overhang') and inflation that was previously suppressed through artificial determination of prices in the economy (Feidge, 1994). Price liberalization caused hyperinflation, which put macro stability on very shaky grounds and in addition wiped out all

the savings. Next, interest rates were raised in response to high inflation; in effect this action caused general distrust in the economic health of the country. Due to the increase in interest rates, (1) Russian debt increased, which then scared investors, fearing that Russia would devalue in order to finance its non-denominated debt and (2) at the same time high government debt made it impossible for firms to obtain new capital. Hence, the most notable response of economic agents that followed the economic turbulence was the rush of money out of the country, which was not an option before the capital markets were liberalized. ‘Capital flight’ was noted in a form of (1) ‘hot money’ being sucked back into the hands of foreign investors or in (2) transactions of large sums being placed on the bank accounts owned by Russians in Cyprus or Switzerland. ‘Capital flight’ was a maneuver that brought Russia financially on its knees. As we can see the process of liberalization and massive privatization was not a wealth generating progression, rather a contest of ‘asset stripping’ since nobody wanted to have their funds in such an economically volatile country.

The country in the early nineties was extremely rich with natural resources, generating revenue from exporting oil, therefore relying heavily on the global price of oil, but economically very unstable, with great sovereign debt, without the ability to provide pensions for the elderly, without the ability to cover the welfare payments for the poor, without a disciplined taxpayer base, without proper institutions in place, without a sound strategy towards the development of markets. In the words of Joseph Stiglitz:

“They tried to take a shortcut to capitalism, creating a market economy without the underlying institutions, and institutions without the underlying institutional infrastructure. New firms need to be able to raise new capital, and this requires banks that are real banks – a real and effective banking system requires strong banking regulations.

New firms need to be able to acquire land, and this requires a land market and land registration”. (Stiglitz, 139)

Russian officials were counting on 2% GDP growth in 1998; they decreased domestic borrowing, and increased tax collection to meet the interest payments. Next came a disastrous time for Russia, as the ruble came under speculative attack after the ‘Asian Crisis’ in late 1997, global prices of nonferrous metal and oil began to drop and the GDP in 1998 declined by 4.9%. Early in 1998, Russian stock (the RTS index fell in January for 20%, in July for 40%, and additional 30% in August of 1998), bond, and currency markets collapsed due to foreign investor fears of ruble devaluation and default on sovereign debt (Chiodo & Owyang, 2002).

After the global oil prices dropped, the ruble became very unstable, and until the last breath the Russian Central Bank kept borrowing dollars and pouring them on their economy (by the advice of IMF, since the dollar rates at the time were much lower than the ruble rates, the total amount of rescue package from the IMF, World Bank, and Japanese government totaled to \$22.6 billion) thus artificially keeping the ruble ‘sound’ (Stiglitz, 2002). By June, the interest rates on ruble loans (GKOs – the Russian equivalent to US T-Bills) got to 60%, and went up even higher to 150% in a matter of weeks – depleting the foreign reserves (Stiglitz, 2002).

Key Features of Russia’s July 1998 Emergency Financing Package (Kharas, Pinto & Ulatov, 10-11)

- \$22.6 billion in funding (\$15.1 billion from the IMF, \$6.0 from the World Bank, and \$1.5 billion from the Government of Japan), of which \$14.8 billion was to be

received during the second half of 1998 and \$7.8 billion during 1999 upon completion of fiscal and structural reforms. A total of \$5.5 billion was actually disbursed: \$4.8 billion by the IMF, \$0.3 billion by the World Bank, and \$0.4 billion by the Government of Japan. These turned out to be the only disbursements under the auspices of the July 1998 package.

- Fiscal reforms to achieve a primary surplus at the federal government level for 1999 of 3% of GDP; fiscal targets for 1998 were left unchanged.
- Structural reforms to deal with non payments, enhancing competition, intergovernmental fiscal relations, the financial sector, and infrastructure monopolies – in other words, comprehensive reforms to harden enterprise budgets, ensure long-run fiscal sustainability, and create a good climate for private sector development and investment.
- A market-based debt swap designed to convert GKO into long-term dollar-denominated Eurobonds (the GKO-Eurobond swap). This was designed to supplement efforts to move away from domestic debt financing by issuing Eurobonds instead, beginning in early June. Although not formally a part of the package, the swap was seen by the market as an integral component of the overall financing and restructuring effort.

The economic conditions of extremely large deficits and low foreign reserves led the government of Russian Federation and the Russian Central Bank to float the exchange rate, default on its sovereign debt, devalue the ruble, and announce moratorium by commercial banks on foreign credit on August 17, 1998.

The Russian currency crisis was triggered by failed hopes for sustained economic growth, and time-consuming reforms to correct fiscal fundamentals in order to decrease fiscal deficits, which led to rapidly growing public debt (with predominance of high-yielding GKO). In addition Russian policy-makers had to deal with market signals perceived by investors (contagion effects from Asian crisis in combination with a decline in gas and oil prices) of exceptionally high levels of default and devaluation risk. (Kharas et.al, 2001)

Summary

The Russian financial crisis of 1998 is an example of inconsistent policies – high fiscal deficits, low-inflation objectives sustaining a fixed exchange rate. The Russian financial crisis has not only been the product of a toxic mix of policies, but more importantly it delayed the institutional reforms necessary for long-term economic prosperity. The by-products of such inefficiencies in the capital market liberalization model are ruthless asset stripping and capital flight committed by the few fortunate individuals who support the current political structure of the land. Without the legal infrastructure in place, ensuring good corporate governance, those individuals who get control of a corporation are not encouraged to reinvest in the country's future; rather they watch their bank accounts grow in Switzerland and Cyprus. As it turns out, the 1998 bailout policy was orchestrated

by the Yeltsin administration and the IMF, behind which stood the Clinton administration whose aim was to prevent Russia from sliding back into communism.

7. Financial Crisis Revelations

It is a Utopian's dream to liberalize the capital market and expect improvements in allocation of resources, increased capital productivity, equal distribution of wealth among the population, and consequentially causing stimulation of economic growth in a country where prior to a rapid liberalization plan the economic environment lacked market institutions, was absent of asset markets for valuing property, with lack of private savings, and in addition a political environment that was clearly inimical to market activities in the past. What was the purpose of capital market liberalization when the policy makers knew already that the necessary conditions to achieve a successful transition were not in place? What were the incentives of such rapid makeover policies?

I will present the grounds and argue why predominant aspiration for political power and the desire for excessive personal wealth of an existing ruling minority was what initially set-off the events taking place in Russia with regard to the liberalization of its capital market. Liberalization of capital market in Russia was a political move of reformist politicians, aiming to change the political balance in the country by creating a class of supporters and reducing the power of its political opponents. The so-called reformist politicians saw the market ideologies mentioned above as a way to steal and gain both political and economic power.

7.1 Legislative Issues

The Russian financial crisis in 1998 revealed that institutional and legislative reforms in the 90's were anything else but exact. For this reason the institutional

governance was a serious issue in the transition towards a liberalized economy. New legislation was required to keep an eye on managers and to define their legal liabilities. During the phase of restructuring, the internal controls and creditor rights were not clearly defined; therefore little value could be applied to vaguely defined laws, which in effect gave the opportunity to managers to strip the enterprises of their assets. On the other hand, laws were not defined vaguely when the managers' existence came into question.

“Russian bankruptcy law was written under close supervision of the managerial lobby, and allows permanent ‘rehabilitation’ of bankrupt companies under existing management”. (Boycko et al., 164-165)

Contractual agreements in Russia were also an immense obstacle to social justice because they had to be self-enforcing to work since the state could not enforce them, due to an inadequate legal framework.

“The state has also institutionalized a legal system to protect property rights, decrease transaction costs, enforce contracts, and ensure competition. However, the Russian state has devoted few resources to developing a court system capable of defending investors or property owners”. (McFaul, 236)

Thus in Russia, where contracts were not enforceable and bankruptcy impossible, commercial banks were hesitant to give out loans, since bankruptcy procedures gave creditors no rights to seize a borrower's assets in case of a default on the contract. Nevertheless, Russian companies still borrowed heavily from the government and most loans were considered a form of subsidy, since they got repaid very rarely. As a consequence, during 1992 alone “the inter-enterprise arrears have increased from 40 billion ruble to 3.2 trillion ruble”. (Feidge, 15)

The collapse of the Russian financial system has thus exposed the weakness of the Russian government with regards to the inability of supporting contracts and protecting property rights. In order to achieve economic growth, the governments have to be certified with a degree of power, in fact a monopoly of power to have the ability to protect property rights, enforce contracts, and promote the sustainability of reforms.

7.2 Financial Market

The financial crisis of 1998 revealed that long term economic progress can not be built on weak institutional reforms. The crisis also exposed a weak supervisory and prudential regulation of Russian money and capital markets, which lacked depth and breath. Inadequately developed financial institutions did not provide diversification of risks associated with productivity; they did not manage liquidity risk, and were not capable enough to evaluate potential projects properly (Kemme, 2001).

The crisis also demonstrated that the failure of inefficient reforms causes economic stress borne by the weakest and most vulnerable financial market participants – the small savers. The formation of safety net for savers is the most critical part of access to liquidity. Targeting household's deposits is of significant importance to formation of healthy financial market because confidence in the banking system can improve the mobilization of savings and investments, which consequentially leads to the deepening of the financial system. The Russian central bank did not guarantee any safety for saver's deposits in commercial banks except for the savings at Sberbank, the state bank.

How did the financial system in Russia justify the existence of commercial banks if their primary roles were not carried out at all? The distribution of subsidies was highly

politicized in the Soviet banking system in terms of final destination of state credits. The allocation of capital was up to the central bank to take care of and the purpose of commercial banks was merely to serve as financial institutions through which the central banks' credits were channeled through. In the Soviet banking system, financial intermediation services were based upon the mechanisms of political influence which did not provide financial intermediation services as the banking system in the market economy does. The Russian banking industry was highly concentrated, which contributed to inefficient allocation of resources and higher intermediation costs.

7.3 Politicization

The old-line politicians during the Soviet rule, have not been replaced and have continually undermined the reforms of transition. Therefore allocation of private capital and successful restructuring in Russia has been thwarted by political allocation of capital. Managers of firms will always cater to the sources of funds and until the financial crisis of 1998, Russian government has been a major provider of funds through subsidies. In 1993, state subsidies accounted for 22% of Russia's GNP with only a few market institutions created (McFaul, 1995). An example of political influence in the business sector were the so called 'performance contracts', which were contracts between the government and managers of state enterprises. These 'performance contracts' were set up to improve state enterprises by setting targets, which were not ambitious and did not boost an additional return on assets. However, when these lethargic targets were achieved, the managers and staff members were rewarded greatly for project implementation. As it turned out, these 'performance contracts' were not used to

stimulate the business performance of state companies, rather they were used by the company managers to obtain funds from the politicians. Politicians on the other hand subsidized enterprises in order to have a say in the strategy development and convince managers to pursue political objectives, which did not always go along with the lines of profit maximization.

After the financial crisis, the government had minimized soft credits and subsidies, but still a complete de-politicization of capital is required to make availability of capital on commercial terms. Bankruptcy law has to be revised, because firms that go bust simply seek debt relief from the government.

7.4 Institutions

Before I apply the theory of institutional development to the country of Russia, I would like to share some thoughts about the myth of institutions and why they support market order and growth. According to the ‘new institutionalist’ theory, an institution has to satisfy what Williamson calls the “remediableness criterion”: “...an extant mode of organization for which no superior feasible alternative can be described and implemented with expected net gains...”. (Shirley, 31) Further discussion of the role of institution refers to institutions as the pillars of economically developed society with the power to establish common norms, rules, and procedures for economic agents. Economic institutions in particular facilitate economic activity by decreasing transaction costs, decrease the uncertainty of counterparties doing business together, and empower the state to protect private property rights rather than seize the assets from its citizens at their convenience. The first two sets of institutions comprise contract and contract enforcement

mechanisms as its most important elements. The latter constituent that an institution has an influence over, namely the protection of private property rights is of utmost importance to our discussion, because it targets constitutions, electoral rules, laws governing speech, also including legal and civic norms (Shirley, 2005).

Trading and exchange is common to all men in today's economy. According to Coase:

“Transaction costs determine the evolution of institutions; the effects of high transaction costs are pervasive in the economy. If the costs of making an exchange are greater than the gains which that exchange would bring, that exchange would not take place. When information is costly and property rights are poorly protected, contracts become hard to specify and enforce and transaction costs are high. Societies with persistently higher transaction costs have less trade, fewer firms, less specialization, less investment, and lower productivity”. (Shirley, 4)

Thus the institutions determine whether transaction costs are low or high. The more regulated and more transparent the market is, the frequency of trade will increase and it is up to institutions to establish universal third party rules, provide information on trading counterparts, enforce contracts and protect property rights. Development of sound institutions positively correlates with:

“protection of property rights and enforcement, civil liberties, political rights and democracy, and institutions supporting cooperation, including trust, religion, and the extent of social clubs and associations”. (Shirley, 23)

With respect to what I have described above, institutional integration in the marketplace is considered effective when economic conditions are equitably combined among the market participants without the ability of the political regime to expropriate them.

Now, institutional development in Russia took a gradual approach by letting market-supporting institutions develop spontaneously. The policy makers actually believed that until market-supporting capitalist institutions would emerge, the engines of newly created capitalist economy would run on old 'socialist' socioeconomic institutions. In order to lead a successful transition towards the market economy, the state had to be entirely autonomous relative to the ancient regime and special interest groups made up by authoritative managers and old-line politicians. A new set of institutions had to be established, because the re-modeling of old institutions distorted the path of economic transition towards the market economy.

There is a view that the problems were due to the difficulties of trying to achieve change. The first theory that I propose is that the norms, beliefs, and rules embedded in the Soviet system can not be changed overnight and therefore a gradual approach regarding institutional change is needed. Consequentially then, Russian officials acted in good faith and wanted to assure the irreversibility of reforms by gradually and consistently replacing old institutions with new system of legal, administrative, commercial, social security, fiscal, and monetary institutions capable of supporting a market economy (Feidge, 1994).

On the other hand, I suspect it rightful to suppose that the institutional change was not on the agenda of the political elite while everything in the country was already liberalized. Institutional change is a question of 'path dependency' – "those who make policy and design institutions have a stake in the framework they created and resist changes that may rob them of power or property" (Shirley, 29), meaning that 'newly established' capitalist institutions will only be put in place pro forma, but the ultimate

outcome is that the tendency of a past traditional practice will continue. However, there is no reason to give up on progress as far as institutional development in Russia goes,

“changes in beliefs and norms usually require a period of gradual learning. Path dependency and the stickiness of beliefs and norms explain why underdevelopment cannot be overcome by simply importing institutions that were successful in other countries”. (Shirley, 29)

We should not forget that Russia was under the authoritarian regime for a long period of time, where highly centralized institutions disregarded competition, specialization or even industrialization. Politicians in the Soviet Union acted as ‘patrons’ who provided funds and thus solidified their support base. Through such aid projects the ruling elite expected to win the hearts of managers and voters in general. Political analysts believe that aid giving is the most important factor that has been slowing the institutional change by keeping the existing political force to ascend the throne - consequentially preventing political competition. Also, we need to point out that: “Where institutions are weak there are by definition few checks on rulers and conditionality will be met by passing laws without mechanisms for their enforcement” (Shirley, 34), consequentially we can expect state enterprises getting privatized without competition or competent corporate governance (Shirley, 2005). With respect to theft of private property, we can then assume that the state was not too weak to prevent theft of property rights by private actors, but rather so strong that the state itself threatened property rights (Shirley, 2005).

The third option – combination of the former two is one that I shall exclude from further elaboration due to the fact that the policy makers would not have proceeded with rapid liberalization policies if they were actually concerned with intergenerational norms

and beliefs of its citizens demanding time to adjust to the new socioeconomic system. Therefore it is clear the reformist politicians did not act in good faith.

7.5 Property Rights

The analysis of institutional conditions in Russia prior to the financial crisis in 1998 has shown that the state failed to create institutions that would support contracts and protect property rights. Something such as a private property was an unknown to citizens of the Soviet regime; the country had no institutional arrangements that govern the ownership, use, and disposal of property (Feidge, 1994). The foundation for circumstances that prevailed in Russia concerning protection of property rights is the mass privatization program orchestrated by president Yeltsin's administration. His mass privatization program did not redistribute ownership of state property among the entire Russian population; rather ownership of state enterprises was concentrated in the hands of high ranked managers that supported the current political regime and already had the money. The fact that state ownership was wrapped around a cloud of legal fiction and property rights were vaguely defined allowed for a situation in which politically well-connected managers did not hesitate to exploit the opportunity at hand to increase their wealth (Shirley, 2005).

Edgar L. Feidge writes that:

“The absence of real property rights is largely responsible for the system's inefficiency in production and exchange and its poor maintenance of capital stocks and natural resource endowments”. (Feidge, 4)

Without a strong state and institutions in place that can enforce contracts, the creation of private property rights will continue to be altered. It is in their exclusivity and the ability

to exchange them that defines the values of a private property. Private property rights have failed to be created, distributed, and credibly enforced before the liberalization of capital market took place in Russia, therefore the privileged few who supported the political establishment could claim former state property as their own.

Summary

Inevitably, the grounds for failure of Russian financial markets in 1998 were rapid liberalization policies including poor investor protections and loosely defined private property laws. Concentrated ownership is a product of frail institutional protection and can be considered a substitute for weak protection of investors in an economic environment. Weak and vaguely defined laws as opposed to explicit legal foundations and the ability to enforce contracts at proper institutions make an enormous difference in development of capital markets.

7.5 Think outside the box

Could there be more to our arguments explaining why path of capital market liberalization in Russia has taken a detour from its initial plan of equal redistribution of former state-owned assets amongst its citizens?

Thane Gustafson states in his book that:

“Russia is economically unstable, because the present halfway economy cannot produce growth or generate investment. The one sector that has generated wealth in the last decade, the commodity-exporting industries, is spending its inheritance and not renewing it. No significant investment is going into education, science, environment, or health”. (Gustafson, 32)

Russia’s high dependence on oil and gas, coupled with relatively low average productivity in manufacturing, complicates the realization of diversified growth and the effective integration into world markets. The distribution of wealth coming from the exports of natural resources is highly concentrated. The problem with Russian wealth distribution is that the majority of wealth created through revenue generating industries is not channeled to Russian public funds for creation of public goods; rather it is channeled to private entities.

Also, ‘de novo’ companies in Russia have been substantially cut off from public subsidies and credits, which is hampering economic growth in the long run. Besides lack of subsidies and credits, the ‘new age’ entrepreneurs starting a small business in Russia run a gauntlet of confiscatory taxes, criminal extortion, scale credit, thin services, and obstructive bureaucracy. Concentrated wealth distribution, political favoritism, lack of investments in social infrastructure, high dependency on revenue generating oil and gas

exports, and obstructive bureaucracy count a great deal towards Russia being a unique example of a country going through the process of capital market liberalization.

8. Conclusion

The reformers of Russian regime change did not take a gradual approach of adjustments toward a successful socioeconomic transition. The state failed to create market-supporting institutions and instead rather proceeded with an ambitious program of synchronized application of policy changes and the economic liberalization. Lack of market-supporting institutions and an underdeveloped legal system in Russia have been the key tools through which politically well-connected managers and politicians themselves seized the opportunity and established ownership of former state-owned enterprises. Russian privatization did not provide efficiency incentives to produce new wealth, rather it has redistributed the already existing wealth through dubious methods.

Clearly, the ultimate goal of capital liberalization in Russia was not to disperse ownership of former state-owned enterprises among the people of Russia, but to create a powerful support group that would ensure the second mandate of President Yeltsin's administration. The class of newborn 'oligarchs' in Russia became the ruling minority that was not interested in creating value; rather, they were interested in stealing the value that has already existed. Weak and vaguely defined laws as opposed to explicit legal foundations and the ability to enforce contracts at proper institutions make an enormous difference in development of capital markets.

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