

EXHIBIT 6

Russian Federation: Staff Report for the 2000 Article IV Consultation and Public Information Notice Following Consultation

As required under Article IV of its Articles of Agreement, the International Monetary Fund conducts periodic consultations with its member countries. In the context of the 2000 Article IV consultation with the Russian Federation, the following documents have been released and are included in this package:

- the staff report for the 2000 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **July 18, 2000**, with the officials of the Russian Federation on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on August 23, 2000.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during the September 15, 2000, Executive Board discussion** of the staff report that concluded the Article IV consultation.

Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports and PINS allows for the deletion of market-sensitive information.

The Article IV staff report is published—both in hard copy and on the IMF's website (<http://www.imf.org>)—as part of a pilot project.

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**International Monetary Fund
Washington, D.C.**

medium term. The staff also agreed that the medium-term outlook was subject to exceptionally large uncertainty, especially because of the dependence of the balance of payments on volatile commodity prices, as well as uncertainty about the impact of reforms on the savings and investment behavior of both the private and government sectors. This uncertainty also pertained to the fiscal sector, especially due to uncertainty about the sustainability of the expenditure compression and the cost of reform. Staff noted, however, that an early normalization of relations with external creditors could accelerate the restoration of Russia's access to international capital markets, which could also facilitate enterprise adjustment. In any case, staff stressed that the issue of further exceptional balance of payments support from official creditors was an issue that had to be resolved between Russia and its creditors.

45. A detailed medium-term outlook is discussed in Appendix V. Assuming steadfast implementation of structural reforms, the baseline scenario envisages strong investment and productivity gains supporting annual growth of 4–6 percent over the medium term. The scenario suggests that Russia should achieve external and fiscal viability over the medium term, with the ratio of federal government external debt halving to 35 percent by 2005, and external debt service declining from 31 percent of exports of goods and services in 1999 to 19 percent on average in 2006–15. Modest financing gaps may, however, persist over the next few years as reserves are rebuilt. As noted above, the outlook is subject to an unusual degree of uncertainty. A low growth scenario combined with a considerably less favorable external environment would result in persistent financing gaps and a less favorable development of public debt indicators.

Exchange and trade system

46. In the view of the staff, five of the six exchange restrictions and/or multiple currency practices subject to Article VIII approval identified at the time of the previous Article IV consultation remain in place: (i) the inconvertibility of S-accounts; (ii) the repatriation restrictions on nonresidents that did not participate in the GKO novation scheme; (iii) the restrictions on the repatriation of moderate amortization payments from balances on T-accounts; (iv) the restrictions on advance import payments; and (v) the restrictions on certain payments to Latvian residents.¹³ The previously identified restriction and multiple currency practice on the use of a more depreciated exchange rate for conversion of S-accounts established in special auctions by the CBR is no longer in place as no auctions have been conducted in the last 12 months and no further use of this mechanism is envisaged by the authorities. Moreover, the authorities indicated that a series of initiatives that are underway, in particular the proposed amendments to the foreign exchange law, would allow them to remove some of the other five restrictions on current account transactions in the near future. Stressing the discriminatory nature of several of the restrictions, staff welcomed the authorities' plans and noted that the strong

¹³ S-accounts are used by nonresidents for transactions involving government securities. T-accounts are used by nonresidents for current international transactions and some short-term non-government securities transactions.

EXHIBIT 7

2000 Country Reports on Economic Policy and Trade Practices

Released by the Bureau of Economic and Business Affairs

U.S. Department of State, March 2001

RUSSIA**Key Economic Indicators**

(Billions of U.S. dollars unless otherwise noted)

	1998	1999	2000	1/
<i>Income, Production and Employment:</i>				
Nominal GDP 2/	2,696	4,546	2,946	
Real GDP Growth (pct)	-4.6	3.2	3.5	
Per Capita Personal Income (US\$)	1,168	650	459	5/
Labor Force (000s)	72,000	72,000	73,700	5/
Unemployment Rate (pct)	11.2	13.3	12.4	5/
<i>Money and Prices (annual percent growth):</i>				
Money Supply Growth (M2)	19.8	57.2	32.1	
Consumer Price Index (percent increase)	56.4	62.0	12.0	4/
Exchange Rate (Ruble/US\$ annual average)	9.97	24.84	28.21	
<i>Balance of Payments and Trade:</i>				
Total Exports (FOB)	71.3	71.8	47.8	
Exports to U.S.	5.7	5.9	4.5	6/
Total Imports (CIF)	43.6	30.2	15.5	
Imports from U.S.	3.6	2.0	1.4	6/
Trade Balance	27.7	41.6	32.3	
Balance with U.S.	2.1	3.9	3.1	6/
Current Account	1.0	25.0	11.2	
External Public Debt	147	159.7	147.0	8/
Debt Service Payments/GDP (pct)	3.7	5.9	4.0	4/
Fiscal Deficit/GDP (pct)	5.0	1.7	-7.0	5/
Gold and Foreign Exchange	12.2	12.5	25.0	3/
Aid from U.S. (US\$ millions) 7/	639.4	1,937.1	1,062	
Aid from All Other Sources	N/A	N/A	N/A	

1/ 2000 data has been provided for the last available period (6/00) unless otherwise noted.

2/ Billions of Russian Rubles.

3/ Data as of September 29, 2000.

4/ Data for January-August 2000.

5/ Data for the period January-July 2000.

6/ U.S. Commerce Department data for the period January-July 2000.

Agreement Concerning the International Registration of Marks, and the Patent Cooperation Treaty. Russia has also become a signatory to the Bern Convention for the Protection of Literary and Artistic Works (copyright), as well as the Geneva Phonograms Convention.

In 1992-93 Russia enacted laws strengthening the protection of patents, trademarks and appellations of origins, and copyright of semiconductors, computer programs, literary, artistic and scientific works, and audio/visual recordings. Legal enforcement of intellectual property rights (IPR) continued to show a pattern of slow improvement in 2000 with several large raids on manufacturing facilities, wholesale and retail outlets of pirated goods. A new Criminal Code took effect January 1, 1997 that contains considerably stronger penalties for IPR infringements. However, there are still disappointingly few cases in which these penalties have been applied. Widespread sales of pirated U.S. videocassettes, recordings, books, computer software, clothes, toys, foods and beverages continue. The Russian Patent and Trademark Agency (Rospatent) was re-established as an independent agency this year, and was given full authority for intellectual property rights policy.

The Patent Law includes a grace period, procedures for deferred examination, protection for chemical and pharmaceutical products, and national treatment for foreign patent holders. Inventions are protected for 20 years, industrial designs for ten years, and utility models for five years. The Law on Trademarks and Appellation of Origins introduces for the first time in Russia protection of appellation of origins. The Law on Copyright and Associated Rights, enacted in August 1993, protects all forms of artistic creation, including audio/visual recordings and computer programs as literary works for the lifetime of the author plus 50 years. The September 1992 Law on Topography of Integrated Microcircuits, which also protects computer programs, protects semiconductor topographies for 10 years from the date of registration. The government plans to submit new draft legislation by the end of 2000 to the parliament to provide for retroactive protections for copyrights and other measure to bring Russia into compliance with its bilateral and multilateral obligations.

Losses to U.S. industry from pirated products sold in Russia (a significant portion of which are produced in third countries) are estimated to be significant, although there are few reliable estimates of their value. Counterfeit goods also cause significant losses, in many cases for U.S. firms that have local production. Investors in the consumer goods sector increasingly are warning the Russian government that they will not make further investments if infringement of intellectual property rights continues.

8. Worker Rights

a. *The Right of Association:* The law provides workers with the right to form and join trade unions, but practical limitations on the exercise of this right arise from governmental policy and the dominant position of the formerly governmental Federation of Independent Trade Unions of Russia (FNPR). As the successor organization to the governmental trade unions of the Soviet period and claiming to represent 80 per cent of all workers, the FNPR occupies a privileged position that inhibits the formation of new unions. In some cases, FNPR local unions have continued to work with management to destroy new unions. While recent court decisions have supported the right of association and often ruled in favor of employees, enforcement of these

decisions remains difficult. The parliament will consider this fall an amendment to the Law on Trade Unions that could set complicated new re-registration requirements for unions.

b. *The Right to Organize and Bargain Collectively*: Although the law recognizes collective bargaining, and requires employers to negotiate with unions, in practice employers often refuse to negotiate and agreements are not implemented. Past court rulings have established the principle that non-payment of wages (by far the predominant grievance) is an individual dispute and cannot be addressed collectively by unions. As a result, a collective action based on non-payment of wages would not be recognized as a strike, and individuals would not be protected by the Labor Law's guarantees against being fired for participation. The right to strike is difficult to exercise. Most strikes are considered technically illegal, as the procedures for disputes remain exceedingly complex. Moreover, courts have the right to order the confiscation of union property to settle damages and losses to an employer, if a strike is found to be illegal. Reprisals for strikes are common, although strictly prohibited by law. In December 2000 the parliament will consider two draft versions of a new Labor Code. The first was proposed by the government last year and emphasizes labor mobility and a reduction of the so-called "gray economy." The other is supported by pro-union deputies in the parliament and proposes to strengthen trade union rights and workers' guarantees, including indexation of delayed wages.

c. *Prohibition of Forced or Compulsory Labor*: The Labor Code prohibits forced or compulsory labor by adults and children. There are documented cases of soldiers being sent by their superior officers to perform work for private citizens or organizations. Such labor may violate military regulations and, if performed by conscripts, would be an apparent violation of ILO convention 29 on forced labor.

d. *Minimum Age for Employment of Children*: The Labor Code prohibits regular employment for children under the age of 16 and also regulates the working conditions of children under the age of 18, including banning dangerous, nighttime and overtime work. Children may, under certain specific conditions, work in apprenticeship or internship programs at the ages of 14 and 15. Accepted social prohibitions against the employment of children and the availability of adult workers at low wage rates combine to prevent widespread abuse of child labor legislation. The government prohibits forced and bonded labor by children, and there have been no reports that it occurred. However, an increase in the number of children working and living on the streets is largely the result of drastic economic changes and a deterioration in the social service infrastructure.

e. *Acceptable Conditions of Work*: The Labor Code provides for a standard workweek of 40 hours, with at least one 24-hour rest period. The law requires premium pay for overtime work or work on holidays. The government-supported draft of the new Labor Code proposes loosening present restrictions on the work day, including conditions under which women may work and other measures that will reduce government control of the workplace. Wage arrears during the first half of 2000 fell by over 80 percent in real terms compared with the same period in 1998. However, the monthly minimum wage of \$4.70 (132 rubles) remains below the official subsistence level of \$42 (1,185 rubles) and approximately 34.7 percent of the population have

incomes below this survival level. Workers' freedom to move in search of new employment is virtually eliminated by the system of residency permits. The law establishes minimal conditions of workplace safety and worker health, but these standards are not effectively enforced.

f. *Rights in Sectors with U.S. Investment:* Observance of worker rights in sectors with significant U.S. investment (petroleum, telecommunications, food, aerospace, construction machinery, and pharmaceuticals) did not significantly differ from observance in other sectors. There are no export processing zones. Worker rights in the special economic zones/free trade zones are fully covered by the Labor Code.

Extent of U.S. Investment in Selected Industries—U.S. Direct Investment Position Abroad on an Historical Cost Basis—1999

(Millions of U.S. dollars)

Category	Amount
Petroleum	627
Total Manufacturing	(1)
Food & Kindred Products	127
Chemicals & Allied Products	-107
Primary & Fabricated Metals	(1)
Industrial Machinery and Equipment	2
Electric & Electronic Equipment	(2)
Transportation Equipment	0
Other Manufacturing	-67
Wholesale Trade	-124
Banking	-141
Finance/Insurance/Real Estate	(1)
Services	-166
Other Industries	324
TOTAL ALL INDUSTRIES	509

(1) Suppressed to avoid disclosing data of individual companies.

(2) Less than \$500,000 (+/-).

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

EXHIBIT 8

RUSSIA



Polity: Presidential-parliamentary democracy

Economy: Mixed statist (transitional)

Population: 145,200,000

GNP per capita at PPP \$ (1999): 6,339

Capital: Moscow

Ethnic Groups: Russian (81.5 percent),

Tatar (3.8 percent), Ukrainian (3 percent),

other (11 percent)

Size of private sector as % of GDP (mid-2000): 70

NATIONS IN TRANSIT SCORES

	1997	1998	1999-2000	2001
Democratization	3.80 ↓↓	4.10 ↓	4.25 ↓↓	4.63 ↓↓
Rule of Law	na	na	5.25	↓ 5.38
Economic Liberalization	3.50 ↓↓	3.92 ↓↓	4.33 ↓↓	↑ 4.17

KEY ANNUAL INDICATORS

	1994	1995	1996	1997	1998	1999	2000
GDP per capita (\$)	1,867.0	2,343.0	2,829.0	2,953.0	1,848.0	1,268.0	1,697.0
Real GDP growth (% change)	-12.7	-4.1	-3.5	0.8	-4.6	3.5	7.7
Inflation rate	311.4	197.7	47.8	14.7	27.6	86.1	20.8
Exports (\$ millions)	67,542.0	82,913.0	90,564.0	89,008.0	74,883.0	75,306.0	105,000.0
Imports (\$ millions)	50,518.0	62,188.0	67,630.0	71,645.0	57,783.0	39,460.0	44,000.0
Foreign Direct Investment (\$ millions)	500.0	1,663.0	1,665.0	4,036.0	1,734.0	746.0	2,000.0
Unemployment rate	7.8	9.0	9.9	11.2	13.3	11.7	9.7
Life Expectancy (years)	64.0	64.8	66.0	66.9	66.9	65.8	67.0

Russia, announced that the central election commission is expected to make a decision on the referendum in November 2000 and that the referendum could be held in the spring of 2001.

Despite the positive developments, it is clear that more time is needed for the NGO sector to become sustainable. NGO's organizational capacity in management, governance, and planning skills remains uneven. Although some organizations are advanced in these areas, many are just beginning to address such issues. Without adequate skills and information, an organization's ability to survive on its own over the long term is seriously jeopardized. According to experts, organizations with Western funding have tried to emulate Western NGO organizational practices with varied success. The ones that do not have direct or indirect access to Western funding are generally run badly and, in many cases, have no desire to emulate international standards. Groups only began to address accountability and governance issues a few years ago. Although the number of experienced trainers and practitioners is growing, their ability and willingness to act as mentors varies widely. Of course, some do work great; others use their connections simply to increase their own status.

Article 30 of the constitution also guarantees the right "to create trade unions to protect one's interests." Approximately 60 percent of Russian workers belong to a trade union. The sharp decline in membership in the post-Soviet era is a result both of the proliferation of non-unionized jobs in the private sector and of the inability of unions to perform the same functions they did in the previous era. Most workers belong to unions affiliated to the Federation of Independent Trade Unions of Russia (FNPR), the successor-organization to the Communist-era unions and still, by far, the largest labor confederation in Russia. The FNPR officially maintains that over 90 percent of workers belong to its constituent movements, but public opinion data and surveys of enterprises suggest substantially lower figures. Since many of FNPR's officials have long-standing ties to enterprise managers, newer independent unions are at a disadvantage.

An estimated 1.5 percent of employed persons are involved with labor protest movements, and less than 5 percent of Russians have reported ever going on strike. In fact, if the country's Labor Inspectorate is to be believed, the number of reported strikes dropped from nearly 6,000 in the first three quarters of 1999 to only 720 in the same period of 2000. Most labor strikes are related to wage arrears. According to Vladimir Varov, the deputy minister of labor and social development, the country's Labor Inspectorate found more than 1.5 million violations of the country's labor laws during the first nine months of 2000. However, precious little is ever done to deal with such massive violations, and the weakness of organized labor in Russia does not bode well for democratization and the consolidation of reform. Social partnership committees, which are designed to give labor a formal role in policy

making, have become disorganized sideshows and have little power or influence.

The largest farmers' organization is the Association of Peasant Farms and Agricultural Cooperatives. The much smaller Russian Peasants' Party favors private ownership of agricultural land but has no representation in the Duma. Millions of Russians belong to consumer cooperatives, and there are numerous business associations, trade councils, and economic lobbying groups throughout the country. Exact membership figures are not available. NGOs and other interest groups use a variety of means to publicize their views and pursue their interests. The managers of wholly or partly state-owned enterprises and farms are among the principal groups involved in the political and policymaking process.

Independent Media

1997	1998	1999-2000	2001
3.75	4.25	4.75	5.25

Russians are great consumers of the media—whether television, radio, or the print press. A recent study by the National Social Psychology Research Institute found that 97 percent of Russian households have televisions (24 percent have two or more sets). More than 80 percent of respondents watch television on weekdays and weekends, and only 5 percent do not watch television at all. Although approximately 1,600 television broadcast licenses have been issued, the number of private and state-owned television stations is somewhere between 500 and 600. Three television stations reach a national audience: the government stations Russian Public Television (ORT) and Russian Television (RTR) reach 99 percent and 96 percent of the total viewing audience, respectively, and the privately owned NTV reaches 72 percent. Only RTR and the St. Petersburg Channel 5 remain wholly state-owned. There is also a limited degree of foreign ownership of media sources.

In the post-Soviet period, the vast majority of Russia's newspapers and magazines have been privatized, and big business has gradually replaced the state as their principal controller. Boris Berezovsky's Logo-VAZ owns controlling stakes in the daily newspapers *Nezavisimaya gazeta*, *Novye izvestiya*, and *Kommersant*, and the weekly *Ogonek*. (Berezovsky also owns a 49-percent stake in ORT and a 75-percent stake in TV-6.) Vladimir Gusinsky's Media-Most owns the daily *Segodnya* and the weekly *Itogi*, and Vladimir Potanin's Interros owns a substantial stake in the daily *Izvestiya*. Moscow Mayor Yury Luzhkov and the Moscow city administration have built up a media holding that includes Center-TV and the newspapers *Moskovsky komsomolets*, *Vechernyaya Moskva*, and *Literaturnaya gazeta*.

Most privatized media, especially in the provinces, rely on some form of state sponsorship or patronage in the form of reduced prices on printing, distribution, etc. Pri-

probably be a better solution. This could have the effect of reducing the opportunities for corrupt financial practices, which carry over into Western economies, as well as inhibiting the strength of criminal enterprises to utilize their ill-gotten gains.

There is an argument to be made that having the CBR independent from the executive branch of government and from the Duma is a positive attribute. Unfortunately, the potential benefits that might accrue from the bank's autonomy, especially in relation to Putin's consolidation of power, have been wasted because of inadequate leadership and poor policy development. Perhaps a different team at the head of the central bank might even prove to be a boon to the Russian executive.

Greater strides regarding fair business competition also need to be made. Endless bureaucracy, problems obtaining credit, and a tangled legal system make running a small business in Russia difficult. For women business owners, the problems are often magnified. While exact figures are difficult to come by, the Association of Women Entrepreneurs estimates that between 30 and 40 percent of the 890,000 registered businesses in Russia are owned by women. Small businesses employ almost 25 million people in Russia, including part-time workers and family members. They contribute between 10 and 12 percent of GDP, according to the Federal Fund for Small Business Development. Credit for women entrepreneurs is difficult to obtain, although groups like the Russian Women's Microfinance Network makes loans available to them.

On the negative side of the ledger was the Communication Ministry's September 2000 decision to revoke licenses arbitrarily for the use of cellular telephone frequencies by Mobile TeleSystems (MTS) and VimpelCom. In October 2000, the government backed off in its battle over the radio frequencies and announced that the seizure of several bandwidths from the two companies had been annulled. Unfortunately, the ministry's unexplained cancellation of the licenses caused the price of the companies' shares to drop 15 to 25 percent. By the time the cancellation was revoked, pending a further review, the damage had already been done. The wider fear is that if the regulatory authorities renege on the agreements, investors will be less likely to participate in the development of Russian capital markets. On a more hopeful note, discussions regarding the reorganization of all natural monopolies are set to begin in November 2000. The process is supposed to be completed by late 2001.

According to a report by Yuri Maslyukov, chairman of the Duma's Committee on Industry, Construction, and Science-Intensive Technologies, the picture in Russia is not as bright as it seems. Due to the lack of a consistent state investment policy, investments have fallen by a factor of five since 1991, and the share of equipment that is less than ten years old has fallen below a third. He argues that at current rates of reproduction, by 2005 fixed capital will be the main factor limiting development: by 2010, fixed capital will have

shrunk by 25 percent since 1998, with only 55 to 60 percent of the pre-reform capacity remaining. This will undermine any effort to improve the standard of living of the population and, thus, make it impossible to restore the population's confidence in the state and to create constructive motivation for business or labor.

Of Russia's 145 million residents, more than 100 million receive various kinds of state benefits, though by no means does everyone need them. For example, all parents (from factory workers to oligarchs) receive child benefits equal to 70 percent of the minimum monthly wage for each child. Benefits are jealously guarded. For example, two dozen people in Tula Oblast who were disabled during the clean up of the 1986 Chernobyl nuclear disaster went on hunger strike in October 2000. They were protesting amendments to the law on welfare benefits to Chernobyl workers. Subsequently, the Duma approved a law changing the social benefit system for workers who took part in the clean up, dividing them into three different groups that receive monthly compensation ranging from 5,000 rubles (\$179) to 1,000 rubles.

Russia has a number of extrabudgetary funds that finance social insurance policy. Payroll taxes and transfers from the federal budget mainly finance these funds. Since they are constructed on a pay-as-you-go basis, they are unsustainable and inefficient. This is especially true given the graying of the Russian population, 16 percent of which is 60 years or older. Pensions, especially the minimum guarantees, have eroded significantly in real terms over the course of the Russian transition. Many pensioners continue to work, and most do not live alone. The official retirement age is 60 for men and 55 for women. Russia operates a 'pay-as-you-go' pension system that requires companies to transfer 28 percent of their wage bill and individual workers to pay 1 percent of their salary to the State Pension Fund. Pension fund chairman Mikhail Zurabov feels that without pension reform, in the near future the government will not be able to meet its social welfare requirements.

The legislation currently in force (Law No. 113) ties the size of the average pension to the average wage in the country. Thus, as the labor force shrinks, less money will be available. In 7 to 8 years, he asserts, the ratio of pensioners to workers will reach a critical point beyond which the Pension Fund will have to operate in the red. Zurabov is wants to untie pensions from workers' wages and peg them to the minimum living standard. In October 2000, President Putin announced a 10-percent increase in all pensions as of November 1, 2000. The average pension in Russia today is 615 rubles (\$22) per month.

Wage arrears continue to be one of Russia's biggest problems. For instance, the Health Ministry reported in October 2000 that unpaid wages to health care workers had increased by 63.8 million rubles (\$2.29 million) to a total of 648.5 million rubles (\$23.27 million). Health care workers are not the only group that is not being paid on time. In October 2000, striking teachers in the Altai Re-

EXHIBIT 9



from the September 06, 2001 edition - <http://www.csmonitor.com/2001/0906/p6s1-woeu.html>

Russia's bold new proletariat

Independent labor unions are springing up, but a Kremlin-backed bill could nip them in the bud.

By **Fred Weir** | Special to The Christian Science Monitor

MOSCOW - The workers at Ivanovo Mashzavod had quietly endured almost 10 years of enforced idleness and irregular salaries as their machine-building factory struggled to survive the tough post-Soviet economic winter.

But when fresh orders started flowing in last year, and a new manager decided to launch an "American-style" efficiency campaign with layoffs, wage cuts and cancelled benefits, they rebelled.

Experts say that, throughout Russia, workers are beginning to demand their share from the country's two-year spurt of economic growth. Flexing muscle against management is a dramatic departure from the days of the Soviet "workers' paradise," in which labor protests were not tolerated.

"We went on strike," says Anna Smirnova, the engineer who led the 230 workers of the Ivanovo plant, some 200 miles northeast of Moscow, in a week-long walkout that ended when management agreed to negotiate new terms last month. "We were loyal to our factory all through the bad times, and then when things start to get a bit better, the managers wanted to cut us out. We felt there was no alternative but to show them some strength."

Although the Mashzavod workers have always theoretically belonged to a big and powerful national trade union, they had to learn the rudiments of self-organization. The local leadership of the Machine Builders Union advised against taking labor action, and then suggested that union leaders would try to work things out on a personal level with plant management. The chairman of the Ivanovo regional trade union committee, Vyacheslav Stepashkin, admits that approach was a mistake. "The workers took matters into their own hands and won the respect of management," he says. "They showed us that our old style of trade-union work, which was to act as partners of management and enforcers of social peace, is simply not suitable in the new market economy."

As workers get bolder, they find themselves up against not just the tactics of management, but resistance from their own union leadership. Russia's Soviet-era Federation of Independent Trade Unions (FNPR) looks formidable on paper - about 40 million members - but in practice, it is a vast bureaucracy that seems more concerned with staying in the Kremlin's good graces and preserving properties it

inherited from the USSR than in defending the rights of rank-and-file workers.

"The FNPR was schooled for decades in making deals at the top and doling out social benefits in a paternalistic way to its members," says Yevgenia Gvozdova, director of the independent Agency of Social and Labor Information, Russia's only non-governmental group monitoring the labor movement. "There is a big debate over whether the FNPR can be reformed at all."

Although there are no reliable statistics on labor actions in Russia, experts say the grassroots picture has changed radically over recent years. A wave of wildcat strikes followed the 1998 financial crash and ruble devaluation, and led to substantial growth in unions not affiliated with the FNPR.

Last year, by staging road blockades, Zachita Truda, among the most militant of the independent unions, forced a Gazprom subsidiary to relocate workers' housing from a site downwind from the oil producer's poisonous sulfur emissions.

Though strikes are fewer today, amid relative economic stability, workers are restless and inclined to take action locally. "The tendency of the official unions to support the government and pay only lip service to defending their memberships is becoming a big problem for them," says Andrei Ryabov, an expert with the Carnegie Endowment in Moscow. "Russia has yet to develop trade unions that represent workers as their main task, and don't fear confrontation with authority."

For the first time since the Soviet Union collapsed, Russia's economy began growing in 1999. "When businesses were bankrupt and producing nothing, there was nothing for unions to do," says Kirill Buketov, Eastern Europe coordinator for the International Union of Food Workers, which recently helped Russian workers unionize the local branches of McDonald's and Coca Cola. "When you're talking about sharing out an expanding profit, that's completely different."

Some activists fear the dawning of Western-style labor relations could halt if a Kremlin-sponsored bill that would permit only one union to exist in each factory is passed by the State Duma later this year. The controversial new labor code was stalled for more than a year amid union objections to provisions that would reduce the role of collective bargaining, lengthen the working day to 12 hours, and slash Soviet-era worker privileges.

But the FNPR subsequently agreed to support a watered-down version, after a clause was added that mandates registration of only the largest union in each workplace. The Duma passed the revised bill on its first reading in July. "Essentially we will return to Soviet times, where one big state-controlled union represents everybody," warns Oleg Babich, a leader of Zachita Truda. "Of course, FNPR, which inherited its huge paper membership from Soviet times, will be registered everywhere. Other unions will be effectively banned from collective bargaining. But without pressure from independent unions, how will anything ever change?"

Other labor activists are not so pessimistic. In Ivanovo, Ms. Smirnova says there's no going back: "Our managers are on notice that they need to work things out with us."

EXHIBIT 10



U.S. Department of State FY 2001 Country Commercial Guide: Russia

The Country Commercial Guide for Russia was prepared by U.S. Embassy Moscow and St. Petersburg and released by the Bureau of Economic and Business in July 2000 for Fiscal Year 2001.

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CHAPTER I. EXECUTIVE SUMMARY

This Country Commercial Guide (CCG) presents a comprehensive look at Russia's commercial climate. CCGs were established by recommendation of the Trade Promotion Coordinating Committee, a federal multi-agency task force, to consolidate various reports prepared for the U.S. business community. CCGs are prepared annually at U.S. Embassies through the combined efforts of several U.S. government agencies, under the leadership of the U.S. Commercial Service.

- Register with the following funds: the Pension Fund, the Employment Fund the Medical - Fund, the Social Insurance Fund, and the Ministry of Antimonopoly Policy.

After these registrations are completed, permanent registration can be granted. While the official registration fee is low (4 minimum monthly wages, about \$14.5), the actual cost will include other expenditures such as document preparation and legal counsel.

The U.S. Commercial Service can provide additional details on registration requirements, but strongly recommends that firms seek professional legal advice when registering in Russia. Further information is available on the State Registration Chamber website: www.palata.ru

D. Taxation

Russia is in the midst of major tax reform. In August 2000, President Putin signed into force four chapters of the new Russian Federation Tax Code: Value Added Tax, Excise Taxes, Individual Income Tax, and Unified Social Tax. Most of the changes will take effect in January 2001. Further tax changes will be considered in the fall session of the State Duma. The goal of the changes will be to boost tax revenue encouraging honest accounting and investment in the economy. Previously, full compliance with the combined tax burden would have driven most enterprises out of business.

Tax regulations are extensive and complex, and often change on short notice. Compounding this, they are unpredictably interpreted by officials. A general overview of Russian taxes follows, but companies operating in Russia should consult with a professional tax advisor to confirm details and stay apprised of developments.

1. Profits Tax: The profit tax is levied on an enterprise's gross profits. Generally, the maximum profits tax rate is 30%, but rate reduction is pending. Many business expenses commonly deductible in western countries are not fully deductible under current Russian law. The tax reform law should increase reliance on the profit tax in lieu of a number of current small taxes on turnover and usage.

2. Value Added Tax (VAT): VAT is designed as a tax to be borne ultimately by consumers, but is collected on a basis similar to the EU model. VAT is calculated on the sales value and is applied at a general uniform rate of 20%, except for certain foodstuffs and children's clothes, which are taxed at 10%, and certain supplies that are entirely exempt from VAT (certain financial services and pharmaceuticals). Imports are also subject to VAT. The calculation for VAT on imports is based on the customs value of the item plus customs duties and customs fees. If exporters ship before payment is received, they pay no VAT. However, exporters receiving payment before shipment must pay VAT, which is subsequently refundable but often with difficulty.

3. Import Duties: Tariffs are assessed at specified rates, ranging from 15 to 30%. They are also assessed according to classification and are applied to the customs value of the imported goods (including shipping charges and insurance). Goods imported as in-kind contributions by foreign partners to the charter capital of a new enterprise may be exempt from import duties during a period specified in the charter documents under certain conditions.

4. Turnover Tax: This tax is applied to gross sales and the revenue it generates is dedicated to highway maintenance and improvement. The tax has been reduced from 4% to 1%; it is scheduled for elimination.

5. Social Welfare Tax: A payroll tax is assessed on a graduated scale, which starts at 5% and rises to 35%. (The recent tax reform legislation consolidated four previous taxes.)

A. Overview

The Russian economy has shown strength recovering from the August 1998 financial crisis, and real growth in the economy has helped spur limited new investment from both domestic and foreign investors. Many problems persist, however, including chronic difficulties in the overall investment climate and a weak commercial banking sector. President Putin's government has shown a strong interest in attracting foreign investment and has promised to enact structural changes that would improve the environment for investors. However, most of these key steps have yet to be enacted.

1. Bilateral Investment Agreements

Russia inherited from the Soviet Union 14 bilateral investment treaties (BITs) with Austria, Belgium and Luxembourg, Great Britain, Germany, Italy, Spain, Canada, the People's Republic of China, Korea, the Netherlands, Finland, France, and Switzerland. They were ratified in 1989-90 and came into force in 1991. Russia has since negotiated another 34 agreements, of which 19 have been ratified: with Greece, Cuba, Romania, Denmark, Slovakia, Czech republic, Vietnam, Kuwait, India, Hungary, Albania, Norway, Yugoslavia, Italy, Lebanon, Macedonia, the Philippines, Egypt, South Africa, and Japan. The U.S. bilateral investment treaty, signed in 1994, is still awaiting Russian ratification. Discussions with the Russian government about submitting the BIT for ratification remain inconclusive.

2. Openness to Foreign Investment

During Putin's tenure as Prime Minister and now President, the Russian government has strongly stressed attracting foreign direct investment (FDI), particularly through structural reforms. While many regions have also developed legislation and programs to attract FDI, there is increasing scrutiny of regional investment incentives, and laws have been proposed in the Duma to limit such incentives, such as tax breaks for large investment projects. In practice, large investors continue to receive incentives, but these incentives are usually offset by chronic and severe shortcomings in other areas. High tax levels and extremely high costs of complying with the Russian tax regime, inconsistent government regulation, the inability of some investors to obtain redress through the legal system, and crime and corruption all dissuade investors. These systemic problems are exacerbated by weak purchasing power, lack of financing, and concerns about economic and political stability.

The 1991 Investment Code guaranteed foreign investors rights equal to those enjoyed by Russian investors. This principle of national treatment was confirmed by the July 1999 Law on Foreign Investment, but the 1999 law included a grandfather clause that protects certain large investments (over approximately \$41 million) from unfavorable changes in tax or other legislation for a period of seven years. In practice, these protections have yet to be codified, since the implementing regulations are still lacking. Tax and customs administrations have refused to implement the law's provisions until corresponding changes have been made in tax and customs legislation. The administration and the Duma are discussing legislation to complement the 1999 law, which would specify the sectors where foreign investment would be either prohibited or could be restricted.

Explicit restrictions on FDI have so far been limited to specific sectors. A 1998 law on the aerospace industry, for example, limits foreign ownership to 25% of an enterprise. Foreign ownership in the natural gas monopoly Gazprom is technically limited to 20% but use of joint ventures to purchase additional shares has allowed Gazprom to pursue its strategic partnership

with Ruhrgas of Germany without legal problem. A 1999 law permitted majority-foreign-owned insurance companies to operate, but prohibits them from selling life or compulsory insurance, and limits overall foreign capital in the insurance industry to 15%. A 1998 law (not enforced) limits foreign investment in the electric power giant Unified Energy Systems to 25% or less.

In the past, the Russian government limited foreign investment to no more than 12% of total banking capital, but the Central Bank has recently discussed an upward revision of this restriction and has liberally interpreted the law. Prior approval of the Central Bank is required for investment in the following cases:

- new enterprises using assets of existing Russian enterprises
- foreign investment in defense industries (which may be prohibited in some cases)
- investment in the exploitation of natural resources
- all investments over 50 million rubles
- investment ventures in which the foreign share exceeds 50%
- investment to take over incomplete housing and construction projects

Additional registration requirements exist for investments exceeding 100 million rubles. Projects involving large-scale construction or modernization may also be subject to review for environmental considerations. In sectors which require licensing (e.g. banking, mining and telecommunications), procedures often can be lengthy and obscure. Although the situation has improved over the past few years, foreigners encounter significant restrictions on ownership of real estate in some cities and regions in Russia. Investors in some sectors also may face restrictions requiring that a certain percentage of staff be Russian citizens. However, given the small size of expatriate staffs in most operations here, these restrictions have had little practical consequence.

During large-scale and case-by-case privatization from 1994-1997, foreign investment was a contentious issue. The Russian government failed to establish clear and consistent laws in this regard, despite apparent intentions to do so. The high profile loans-for-shares privatization program of 1995-1996 banned foreign investors from auctions in the oil, gas and precious metals sectors. Foreigners have participated in subsequent oil and gas sector privatization auctions, although some foreign firms appear to be affiliates of Russian companies. Foreign investors participating in Russian privatization sales often are confined to limited positions and face problems with minority shareholder rights and corporate governance. The treatment of foreign investment in new privatizations is likely to remain inconsistent. Roughly three-quarters of the Russian economy is now in private hands, but some privatization of remaining state holdings is likely to continue at local, regional and federal levels as governments seek additional cash, and some of these offerings may be considered good buys. Potential foreign investors should work directly and closely with the appropriate local, regional and federal officials who exercise ownership and other authority over companies whose shares they may want to acquire. Of course, investors should also work with experienced and competent legal advisors.

Some economic problems linger from the 1998 financial crisis and continue to dampen foreign investment. Despite recovery, weak purchasing power continues to reduce the attractiveness of investments. Many companies report slight gains in their earnings, although many have not returned to pre-1998 levels. Overall U.S. exports to Russia have risen from a sharp drop in late 1998, but first quarter 2000 exports were still 17% down from the same period in 1998. Given this environment, projects face difficulties qualifying for financing, as few western banks will accept Russian risk.

The rule of law and respect for property rights, although gradually showing some improvement over the years, remains a key concern for foreign investors. Many large U.S. companies remain reluctant to pursue a strategy of growth through acquisition in Russia out of concerns about liabilities associated with existing operations (especially environmental cleanup), hidden financial liabilities, political pressures which would hinder economic restructuring, inadequate bankruptcy procedures, and weak protection of minority shareholder rights.

B. Investment Issues

1. Private Ownership

Both foreign and domestic legal entities may establish, purchase and dispose of businesses in Russia. Investment in some sectors, which are regarded as affecting national security (insurance, banking, natural resources, communication, transportation, and defense related industries) may be limited, and the Duma is considering legislation to codify areas in which foreign investment is prohibited or can be restricted.

2. Protection of Property Rights

The Russian Constitution and a Presidential decree issued in 1993 give Russian citizens general rights to own, inherit, lease, mortgage, and sell real property (usually not including the land on which it stands); however, legislative gaps and ambiguities impede the general exercise of these rights. A 1993 Presidential decree gave joint ventures with foreign participants the right to own real property. The rights of Russian citizens to own and sell residential, recreational, and garden plots is, however, clearly established with over 40 million properties of this type under private ownership.

Although a presidential decree in the spring of 1996 permits the ownership and sale of land, Russia does not yet have a land code to regulate use and ownership. A privatization decree issued in summer 1994 permitted foreign owners of privatized companies to receive title to enterprise land; however, such rights have not been codified. The Duma maintains that the decree is not constitutional. Uncertainty about more general rights to land title and mineral rights will persist until the Duma and Administration agree upon clear and comprehensive legislation to regulate land use and ownership. The government has announced that reforming the land code will be one of its legislative priorities, but given the political sensitivity of the issue, it is not expected to receive consideration until at least the latter part of 2000. In the meantime, regional legislatures are starting to fill in the gap. In 1997 and 1998, Saratov and Samara Oblasts (regions) approved laws allowing the free trade of land in their jurisdictions.

In 1992 and 1993, Russia enacted laws strengthening the protection of patents, trademarks and appellations of origin, and copyright of semiconductors, computer programs, literary, artistic and scientific works, and audio/visual recordings. The patent law, which accords with the norms of the World Intellectual Property Organization, includes a grace period, procedures for deferred examination, protection for chemical and pharmaceutical products, and national treatment for foreign patent holders. Inventions are protected for 20 years, industrial designs for 10 years and utility models for five years. The law on trademarks and appellation of origins introduces for the first time in Russia protection of appellations of origin and provides for automatic recognition of Soviet trademarks upon presentation of the Soviet registration certificate.

Furthermore, the Law on Copyright and Neighboring Rights, enacted in August 1993, protects all forms of artistic creation, including audio/visual recordings and computer programs as literary works for the lifetime of the author plus 50 years and is compatible with the Bern convention. The September 1992 Law on Topography of Integrated Microcircuits protects software and semiconductor topographies for 10 years from the date of registration. Russia has also acceded to the Universal Copyright Convention, the Paris Convention, the Bern Convention, the Patent Cooperation Treaty, the Geneva Phonogram Convention, and the Madrid Agreement. Under the U.S.-Russian Bilateral Investment Treaty (BIT), which has not yet been ratified by the Duma, Russia has undertaken to protect investors' intellectual property rights. The U.S.-Russia Bilateral Trade Agreement mandates protection of the normal range of literary, scientific and artistic works through legislation and enforcement. The Russian government is currently drafting changes in Russian laws to make them conform to WTO standards.

While the Russian government has successfully passed good laws on protection of intellectual property, enforcement of those laws has been a low priority. A new criminal code went into effect on January 1, 1997, which for the first time applies criminal penalties to IPR violations, but there are shortcomings in this law that need to be addressed. In 1997, Russia was elevated to the "priority watch list" category under "special 301" provisions of the U.S. trade act primarily for failing to provide protection for pre-existing U.S. copyrighted works and sound recordings still under protection in the united states.

Until adoption of legislative and judicial measures providing effective IPR enforcement, U.S. industry can expect continued widespread piracy of its videocassettes, recordings, books, software, clothing and other consumer goods. Annual losses to manufacturers, authors and others are estimated to be in the hundreds of millions of dollars.

3. Expropriation and Compensation

The 1991 investment code prohibits the nationalization of foreign investments except following legislative action and where deemed to be in the national interest. Such attempts may be appealed to the courts of the Russian federation, and are to be paid with prompt, adequate and effective compensation.

The current Russian government is unlikely to nationalize foreign investment or engage in expropriation. However, in several cases, local government interference, or lack of enforcement of court rulings protecting investors, has been a problem. The U.S. Embassy tracks a number of cases in which foreign companies are seeking compensation for the loss of their investment or property due to regional government action or inaction. Arbitration or legal proceedings are pending in some of these cases. To date, no award payments have been made.

4. Dispute Settlement

Russia has a body of conflicting, overlapping and changing laws, decrees and regulations, which has resulted in an ad hoc and unpredictable approach to doing business. Independent dispute resolution in Russia can be difficult to obtain in a developing judicial system. Regional and local courts are often subject to political pressure.

Many Western attorneys refer their Western clients who have investment or trade disputes in Russia to international arbitration in Stockholm or to courts abroad. A 1997 law now allows foreign arbitration awards to be enforced in Russia, even if there is no reciprocal treaty between Russia and the country where the order was made. Russia is a member of the International Center for the Settlement of Investment Disputes and accepts binding international

arbitration. However, the enforcement of international arbitration ultimately requires action from Russian courts and follow-up by court officers through a system of federal bailiffs that has yet to prove itself.

There are legal avenues available through Russian arbitration. One choice is the Arbitration Court of the Russian Federation, which is part of the court system. It has special procedures for seizure of property before trial, so property cannot be disposed of before the court has heard the claim, as well as for the enforcement of financial awards through the banks. Additionally, the International Commercial Arbitration court at the Russian Chamber of Commerce and Industry will hear claims if both parties agree to refer disputes there. Applications can be made by parties to foreign trade agreements and by companies with foreign investments. A similar arbitration court has been established in St. Petersburg.

As with international arbitrage, the weakness in the Russian system is in enforcement of decisions. In one case, for example, after four years of successful international and Russian litigation with repeated favorable decisions and court orders for financial restitution, a U.S. investor continues to await compensation from his joint venture partner. However, in another case involving an U.S. investor who was blocked from assuming control of a company by the former management, a settlement was reached this year in favor of the U.S. investor.

5. Crime and Corruption

Crime is one of the most frequently cited concerns of foreign (and Russian) businesses, particularly those involved with large amounts of cash and goods. While organized crime is not new to Russia, recent years have seen an increase in the range and frequency of criminal activity. Unfortunately, legal and judicial reforms have not kept pace with criminal advances. Much crime is tied to commercial activity, and many Russian entrepreneurs report that they must pay kickbacks and protection to stay in business.

U.S. firms have identified corruption as a pervasive problem, both in the number of instances and in the size of bribes sought. Successive Russian governments have designated the fight against corruption as a priority task of government due to its economic costs (particularly the deterring of foreign and domestic investment and encouragement of capital flight). President Putin has repeatedly stressed that enforcement of laws is a high priority of his administration. Russia has laws and regulations against bribery and other forms of corruption, but penalties are often insufficient to act as a deterrent. Crime statistics for 1997 show a slight increase in reported crimes.

6. Transparency of the Regulatory System

The legal system in Russia is still in flux, with various parts of the government struggling to create new laws on a broad array of topics. In this environment, negotiations and contracts for commercial transactions are complex and protracted. Russia has implemented only part of its new commercial code (contained within the civil code) and investors must carefully research all aspects of Russian law to ensure that each contract conforms with Russian law and embodies the basic provisions of the new, and where still valid, old codes. Contracts must likewise seek to protect the foreign partner against contingencies that often arise. Keeping up with legislative changes, presidential decrees and government resolutions is a challenging task. Uneven implementation of laws creates further complications; various officials, branches of government and jurisdictions interpret and apply regulations with little consistency and the decisions of one may be overruled or contested by another. President Putin has stressed the consistent application

Labor mobility continues to be restricted by an under-developed housing and mortgage market, housing shortages in many cities, and difficulties in obtaining residency permits and registration. Housing and utility costs for existing housing are disproportionately low relative to incomes, making workers loath to move. The lack of labor mobility across regions significantly affects wage rates and employment. Nonetheless, labor mobility across professions and within regions is common, as workers attempt to adapt to the needs of a market economy. The labor force is generally highly skilled and well educated.

Total wage arrears were \$1.38 billion in April 2000, of which \$230 million were government arrears (primarily regional governments) and 1.15 billion in enterprise arrears. This is lower than the previous year's level, although it appears that reductions in arrears are leveling off. Even during periods of high wage debts, sometimes exceeding six months pay, strikes have become less frequent than they were in the mid 1990s. Workers have increasingly used methods other than strikes to call attention to their plight. Enterprises that pay wages in full and on time generally have smooth labor-management relations.

The union movement is dominated by the Federation of Independent Trade Unions of Russia (FNPR), which inherited the property of its Soviet predecessors and which consists of formerly governmental unions. Trade unions outside this confederation have found it harder to operate as wage arrears hinder the ability of would-be members to pay union dues. The government has used a policy of favoritism toward FNPR member unions, and on the factory floors FNPR has used tactics which amount to "union busting" and even intimidation to suppress new unions.

The Russian government generally adheres on paper to ILO conventions protecting worker rights, though enforcement is generally lacking. In addition to wage arrears, worker safety is a major unresolved issue, as enterprises are often unable or unwilling to invest in safer equipment or to enforce safety procedures.

2. Oil and Gas

Accounting for half of Russia's export revenues and comprising a major share of the world's undeveloped energy resources, Russia's oil and gas sector holds tremendous potential for foreign as well as domestic investment. After a long delay, new production sharing legislation was adopted at the beginning of 1999. Five years after it passed the initial law on production sharing agreements (PSA), the State Duma finally approved the remaining necessary legislative components of Russia's PSA framework. Nonetheless, by mid-2000 the Russian government had yet to complete drafting the roughly one dozen government administrative instructions ("normative acts") necessary to create a functioning PSA regime. The finance and tax ministries oppose PSA implementation on revenue grounds, while western energy companies insist that PSA and the associated acts are preconditions for major western energy investment in Russia. Companies highlight the importance of harmonizing Russia's draft tax code with PSA legislation. Also important is Duma passage of additional "list laws" approving individual projects for PSA development. The \$1 billion invested to date in the Sakhalin II consortium demonstrates for Russia the tangible benefits of foreign energy investment. Elsewhere in the energy sector, progress on the \$2.5 billion Caspian pipeline consortium project shows that decisive government action can facilitate energy investment projects.

Changes in the ownership structure of the Russian oil industry have resulted in new, more market-oriented partners for U.S. firms seeking to invest in Russia. However, the sector remains

EXHIBIT 11

November 2000

IMF Staff Country Report No. 00/150

Russian Federation: Selected Issues

This Selected Issues report on Russian Federation was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with this member country. As such, the views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Russian Federation or the Executive Board of the IMF.

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even excluding Chechnya. Migration flows across regions have so far had only a limited impact on this variation in unemployment, and they show little sign of increasing over time (Table 14). Labor mobility is greatly hampered by rigidities in the housing market and the sheer geographical size of Russia which makes relocation costs prohibitive for many workers.

32. **The labor market has become more active but a number of serious rigidities remain.** Labor turnover statistics indicate a relatively active labor market, where the annual separation rate and the annual rate of new hires are both around one-quarter of total employment (Table 6). However, the extent of inter-sectoral labor reallocation is slowing down, while formal employment has lagged well behind output movements at the sectoral level (Tables 5 and 7). Enterprises continue to hoard labor for several reasons, including significant political pressures not to lay off workers and legal restrictions on severing labor contracts.¹³ Labor movement is also constrained by the existence of significant non-wage social benefits provided by firms, the inadequacy of the social safety net, and limited opportunities for geographic mobility.¹⁴

¹³ Rigidities in the labor market are discussed in more detail in SM/99/178, 7/14/99.

¹⁴ The range of social services provided by enterprises has actually been increasing over time, partly reflecting the relatively favorable tax treatment of fringe benefits as opposed to cash wages.

Box 8. Fiscal Federalism Issues

Throughout the transition period, Russia has suffered from impaired economic relations between different levels of government. These have contributed very significantly to weak revenue performance, poor expenditure planning and management, and broader problems in the economy such as nonpayments and the generally poor business environment. Nevertheless, there has recently been some important progress in this area. Some of the key issues in fiscal federal relations are discussed briefly below.

Russia's federalist tax system suffers from overlapping tax bases and a lack of control on the part of subnational governments over the revenues accruing to them.

Competition for revenues between the different levels of government is a factor behind the multiplicity of taxes applying to businesses in Russia. Part of the reason for the expansion of minor taxes is regional and local governments' lack of control over their mainstream sources of revenue. Most regional revenues are from federal taxes, even in the cases (as in profit tax and personal income tax) when most or all of the receipts of the tax accrues to the region. Regions have little formal control over the bases or rates of these taxes. This provides an incentive to exercise informal control through the administration of the tax, leading to negotiated tax settlements and nonmonetary tax payments. In this situation the authorities have faced a choice between giving subnational government greater formal discretion over revenues, and imposing stronger federal authority to contain abuse of the current system. The authorities have generally chosen the latter course. They have outlined steps to prevent regional co-optation of federal tax administrations, and instituted new tax-sharing rules from January 1, 2000 which reduce the incentive on regional governments to collect taxes in nonmonetary form (Box 4).

Intergovernment expenditure assignments do not reflect spending needs or financing capacity, and lack an underlying legal framework. During the transition period, expenditure responsibilities have been passed down from federal to regional government in an ad hoc manner, without ensuring that adequate financing capacity is in place, and in the absence of an adequate legal foundation for the assignment. As well as leading to distortions in expenditure allocations, this has resulted in a serious problem of unfunded expenditure mandates, which were estimated by a Ministry of Finance survey to have amounted to as much as 8 percent of GDP in 1998.

in commercial activities and should be classified as enterprises outside the budget. Second, the Civil Code may need to be amended to define and limit the rights of government spending units to enter into contracts with suppliers.

75. **For effective expenditure management in Russia, there is a need to eliminate off-budget activities of budget institutions. As pressure on their regular budgets have increased since the economic transition began, off-budget activities of budget institutions have**

EXHIBIT 12

CORPORATE GOVERNANCE LESSONS FROM RUSSIAN ENTERPRISE FIASCOES

MERRITT B. FOX & MICHAEL A. HELLER*

This Article draws on a rich array of deviant behavior in Russian enterprises to craft lessons for corporate governance theory. First, Professors Fox and Heller define corporate governance by looking to the economic functions of the firm. Based on this definition, they develop a typology that comprehensively shows all the channels through which bad corporate governance can inflict damage on a country's real economy. Second, they explain the causes of Russian enterprise fiascoes by looking to the particular initial conditions prevailing at privatization—untenable firm boundaries and insider allocation of firm shares—and the bargaining dynamics that have followed. This focus offers a new perspective for a comparative corporate governance literature derived from United States, Western European, and Japanese models. The analytic tools created in this Article can inform pressing debates across contemporary corporate law, ranging from the theory of the close corporation to the viability of “stakeholder” proposals.

INTRODUCTION

Russian industry has performed poorly since privatization. The voluminous literature on transition economies explains this poor performance primarily in terms of continued bureaucratic meddling, poor macroeconomic and tax policy, and low human capital; problems in corporate governance often are mentioned as well but little analyzed.¹

* Louis & Myrtle Research Professor of Business and Law and Alene & Allen F. Smith Professor of Law, University of Michigan, and Professor of Law, University of Michigan, respectively. The authors are also the Research Directors for Corporate Governance at the William Davidson Institute at the University of Michigan Business School. Thanks to Gennady Danilenko, Jeffrey Gordon, Anne Meyendorff, Katharina Pistor, and to participants at Law and Economics Workshops at the University of California at Berkeley and the University of Michigan, the Conference on Corporate Governance Lessons from Transition Economy Reforms co-sponsored by the William Davidson Institute and the University of Michigan Law School, the Fourth Annual International Conference on Transition Economics in Beijing, China, and the American Law and Economics Association Annual Meeting. Thanks also to Sean Grimsley, David Guenther, Catherine Jones, Mary Mitchell, Anton Batirev, Matthew Roskowski, Christie Öberg, and Christopher Serkin for able research assistance. The William Davidson Institute and the Cook Endowment provided generous research support.

¹ See, e.g., Organisation for Econ. Cooperation & Dev. (OECD), OECD Economic Surveys 1997-1998: Russian Federation 129-35 (1997) (listing “[b]arriers to restructuring and investment: corporate governance, capital markets, the tax system, and regional protectionism”); Bernard Black et al., Russian Privatization and Corporate Governance: What Went Wrong? 52 Stan. L. Rev. 1731 (2000) (offering comprehensive and thoughtful account of Russian privatization failures); Anders Aslund, A Crisis of Confidence, *Moscow Times*, June 3, 1998, at 8, 1998 WL 11690335 (noting that “the fundamental issue is . . . not

The goal of this Article is to open the black box of “poor corporate governance” by detailing its consequences for the Russian economy and by tracing its causes to the initial structure of Russian privatization. Understanding what went wrong in Russia teaches lessons not only for transition policy in particular, but also for corporate governance theory in general.

After the fall of Russian Communism, state enterprises were privatized rapidly, stock markets created, and a corporate legal code adopted. However, even at its peak, before the 1998 collapse, the total stock market capitalization of Russia’s 200 largest companies only reached about \$130 billion²—less than that of Intel Corporation. In early 1999 the numbers were “phenomenally abysmal; if they could sink any further, shares would literally have a value of zero. As it is, the entire market is made up of penny stocks.”³ These numbers represent a trivial fraction of the apparent value of the underlying corporate assets controlled by Russian corporations.⁴ The low prices reflect severe corporate governance problems, including the high probability that the firms’ underlying assets will be mismanaged grossly and that whatever cash flow is produced will be diverted to benefit insiders or reinvested in unproductive projects.⁵ In this Article, we extract lessons for corporate governance theory by focusing on

primarily macroeconomic. All along, Russia has suffered from serious problems in corporate governance.”).

² See Gary Peach, 1997 an Outstanding Year Despite Market Narrowness, *Moscow Times*, Jan. 13, 1998, Lexis, World Library, Mostms file. This peak represented an elevenfold improvement over 1994, when total stock market capitalization, based on voucher auctions prices, was under \$12 billion. See Maxim Boycko et al., *Privatizing Russia* 117 (1995). By the summer of 1998, “the *Moscow Times* index of 50 leading shares hit an all-time bottom, lower than its starting level four years ago.” Katy Daigle, *Bill Improves Shareholder Rights in Russia*, *Moscow Times*, July 14, 1998, Lexis, World Library, Mostms file; see also, e.g., Patricia Kranz, *Fall of an Oligarch*, *Bus. Wk.*, Mar. 1, 1999, at 44, 44 (“From its peak in October, 1997, the market capitalization of [these] three big industrial holdings—Sidanko Oil, Svyazinvest Telecommunications, and Norilsk Nickel—has dropped from about \$31 billion to \$3.8 billion.”).

³ Gary Peach, *Poor Management Destroys Sberbank, Tatneft, MGTS*, *Moscow Times*, Dec. 15, 1998, at 14, 1998 WL 11691867.

⁴ Put another way, as measured by stock prices, a barrel of proven oil reserves owned by a Russian oil company was worth about one-twentieth of a similar barrel owned by a Western oil company. See Boycko et al., *supra* note 2, at 120; *Das Kapital Revisited*, *Economist*, Apr. 8, 1995, Survey, at 15, 16 (“[A] barrel of oil in the ground owned by a Russian company is worth 10 cents. A barrel owned by a western company is worth \$5.50.”). This disparity is striking because oil is a quintessential export product with a uniform and well-recognized global value. Of course, poor corporate governance is just one important factor in the low stock price equation; other factors include political instability and expropriation risk.

⁵ See Floyd Norris, *The Russian Way of Corporate Governance*, *N.Y. Times*, Apr. 5, 1999, at A20 (noting that Russia’s second largest oil company stock value declined 98% due in part to poor corporate governance).

two questions: What are the consequences of these corporate governance problems for the real economy in Russia? Why have these problems become so widespread and persistent?

To answer the first question, we define corporate governance in a way that looks to the economic functions of the firm rather than to any particular set of national corporate laws. Firms exhibit good corporate governance when they both maximize the firm's residuals⁶—the wealth generated by real operations of the firm—and, in the case of investor-owned firms, distribute the wealth so generated to shareholders in a pro rata fashion. Bad corporate governance is just the failure of a firm to meet one or both of these conditions. Whether managers operate their firms in ways that meet these conditions depends on the structure of constraints and incentives in which they operate, a structure that depends in part, but only in part, on the prevailing legal system. In this Article, we give more precision to the idea of “bad” corporate governance by developing a novel typology of the kinds of damage to the real economy that loosely constrained and poorly incentivized managers can inflict. By canvassing a rich array of deviant behavior, we identify why this damage has been particularly severe in Russia.

As for the second question, we go beyond standard causal explanations of poor corporate governance, such as the low level of corporate transparency, the lack of effective adjudication of corporate law violations, the weak enforcement of judgments, and the absence of a network of trust among Russian businesses, factors that are common to all post-socialist corporate economies. We expand this inquiry by introducing the role of initial conditions—specifically, the initial boundaries of privatized firms and the initial allocation of firm shares to insiders—and the bargaining dynamics that have followed from these conditions. Our new perspective identifies previously overlooked factors that help explain why Russian corporate performance remains so much worse than that of other transition countries.

Our analysis is not confined to the Russian experience alone; rather, it provokes rethinking of corporate governance theory more generally. Though our typology emerges from studying Russian corporate fiascoes, it has global applicability; for the first time and in a comprehensive way, we link poor corporate governance to real economy effects. We create an analytic tool that identifies the complete set of vulnerabilities to corporate governance problems that may arise

⁶ A firm's residuals are defined as the difference between what a firm pays at contractually pre-determined prices for its inputs and what it receives for its outputs. See *infra* Part I.A for a more precise statement of this definition.

In his parting words, former president Filimonov, who retains a place on the board, pretty much admitted the management could not adapt. "Those titles we've become accustomed to hearing, such as deputy chief of finances, are simply not those functions that these people have become used to fulfilling."⁴⁹

Though the firm could be profitable today, Baltic Shipping faces a "spiral of decline" that could "lead to the company's fleet disappearing completely."⁵⁰ According to one official, "'It's difficult to say how many ships we have in operation, because at any moment, we could get another call saying another ship has been seized [by creditors].'"⁵¹

The widespread existence of Pathology 2 may mask the potential extent of Pathology 1. If firms generally are not using their inputs efficiently, the marginal products of these inputs are likely to be lower, and thus, in a competitive economy, the price that needs to be paid for them and the opportunity cost of their use will be lower as well. A wholesale reduction in Pathology 2 will increase the price and social opportunity cost of at least some, and quite possibly all, major classes of inputs.⁵² Input price adjustments may increase sharply the number of firms displaying Pathology 1 as the increased opportunity cost of their inputs makes their continued operation socially undesirable.

3. *Pathology 3: Misinvestment of Internally Generated Cash Flow*

The third type of pathology arises when a firm uses its internally generated cash flow to invest in new negative net present value projects. Instead of making bad investments, such a firm should pay out this cash flow to shareholders. Shareholders could invest these

⁴⁹ Id.

⁵⁰ Id.

⁵¹ Id. (quoting Yury Sukhorukov, foreign affairs chief, Baltic Regional Organization of the Seafarers Union of Russia).

⁵² If the efficiency gains are spread evenly around all classes of inputs, the effect on the marginal product of each would be positive. If the gains were concentrated primarily with respect to one class of inputs, for example labor, the effect on marginal productivity is, as a theoretical matter, ambiguous. On the one hand, the gains increase the number of effective units of labor represented by each actual unit. On the other hand, the increase in effective units of labor relative to other inputs decreases the marginal product of each effective unit of labor. If the first effect outweighs the second, then the marginal product of labor will increase even if the more effective use of labor is the primary efficiency gain from restructuring. Whether this is the case depends on the elasticity of substitution of labor for other inputs. Empirical studies of the United States and other developed economies suggest that the elasticity is large enough that the marginal product of labor would increase even under these circumstances. For a more detailed discussion of these points, see Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 Mich. L. Rev. 2498, 2562-69, 2630-31 (1997).

In one notorious case that has dragged on for years, the incumbent manager at Kuban Gypsum-Knauf refused to vacate even though he had been fired by the *majority* owner, a German company.⁷⁹ Supported by the local government, the manager installed Cossack guards, held his own shareholder meetings, locked out the owners, diluted the owners' stock, and ignored dozens of court rulings against him over the years.⁸⁰ Finally, and for the first time in Russia, the German owners were able to wrestle their way back in, following intervention by a commission headed by the Prime Minister.⁸¹ According to one Knauf lawyer, "It's a sort of legal nihilism. . . . The farther from Moscow, the less attention they pay to the legal side of things. There is no understanding of a final court decision."⁸²

And managers are not the only ones diverting control. Recent reports suggest that local and regional governments with minority share interests have begun engaging in the same game, forcing firms into bankruptcy over unpaid taxes and then asserting control, essentially a form of renationalization in cases where tax rates are absurdly high, exceeding 100% marginal rates.⁸³ Also, outside shareholders such as those associated with financial-industrial groups (FIGs) may take over firms, replace managers, and then also freeze out minority shareholders, including employees.⁸⁴

Many of these tactics are familiar to students of the history of western corporate law, but in Russia this game seems limited only by the creativity of those controlling the firm: The Russian regulatory apparatus has been notoriously ineffective in controlling such diversions. To give one example, in late 1997, insider shareholders had the Sidanko oil company offer exclusively to themselves, for nominal con-

⁷⁹ See Lyudmila Leontyeva, *Red Director's Stronghold in Kuban*, *Moscow News*, Oct. 30, 1997, in Lexis, World Library, Mosnws file.

⁸⁰ See Mark Whitehouse, *Germans Cry Foul in Gypsum Plant Feud*, *Moscow Times*, Nov. 29, 1997, in Lexis, World Library, Mostms file; Mark Whitehouse, *Under Siege*, *Moscow Times*, Dec. 9, 1997, in Lexis, World Library, Mostms file.

⁸¹ See Katy Daigle, *Nemstov Hails Win for Investors' Rights*, *Moscow Times*, Mar. 10, 1998, at 13, 1998 WL 11690493.

⁸² Mark Whitehouse, *Take 'Em to Court*, *Moscow Times*, Feb. 10, 1998, in Lexis, World Library, Mostms file (quoting Innokenti Ivanov).

⁸³ See Elizabeth V. Mooney, *Russia Must Implement Tax, Corporate Governance Reforms*, RCR Radio Comm. Rep., Feb. 28, 2000, at 26, 2000 WL 9540310 ("The tax burden is arbitrary and capricious, frequently more than net earnings because companies are taxed on gross income," [Professor Richard E.] Ericson said. "This amounts to confiscation of the capital available for investment.").

⁸⁴ See European Bank for Reconstruction & Dev., *supra* note 24, at 143 box 8.1 (discussing financial-industrial groups (FIGs) and need to limit their powers); see also *infra* notes 214-27 and accompanying text (discussing FIGs).

shares, each citizen could bid, using vouchers they were given, for some of the remaining shares at auctions. Immediately after privatization, insiders undertook additional share purchases on the open market and typically ended up owning about two-thirds of the shares of firms. On average, managers owned nine percent and workers about fifty-six percent.¹³⁶ Outsiders used vouchers to buy about twenty to thirty percent, split between investment funds and individual investors. The government retained the remainder of shares, and, even more importantly, it often retained control of the land on which enterprises were located.¹³⁷

Postprivatization, senior managers used numerous mechanisms to thwart the power of employees and outsiders and to maintain control. These mechanisms included, for example, keeping share registries locked up in their offices and refusing to acknowledge ownership by people they disfavored, threatening to fire workers who sold shares to outsiders, and reducing the power (as well as the financial claims noted earlier) of outsider shareholders by means of stock dilutions.¹³⁸ Managers also provided little or no disclosure about the business operations or finances of their firms. Even voucher investment funds, which are the most aggressive and informed outside shareholders, often cannot get rudimentary information about the firms in which they hold shares¹³⁹ and instead “resort to spying on their own companies.”¹⁴⁰ Thus, managers did not acquire a majority of shares during the initial privatization, but they locked up nearly unshakeable control.¹⁴¹ Workers, who did acquire majority shareownership, did not

et al., *supra* note 57, at 41 (describing three plans for transfer of shares at privatization, each of which transferred “40 to 51 percent of ownership to managers and employees”).

¹³⁶ See Frydman et al., *supra* note 24, at 189; World Bank, *supra* note 17, at 55.

¹³⁷ See Larsen, *supra* note 40, at III (“Many companies seeking to get a clearer title to their land still face stiff resistance from regional authorities who see land ownership as a source of power in dealing with local enterprises . . .”). This is reported to be a declining problem in the big cities but is still serious in the rest of the country.

¹³⁸ See Galuszka & Kranz, *supra* note 35, at 60 (“[N]ew tricks . . . range from diluting the ownership stake of investors to such simple ploys as erasing the names of outside investors from computerized shareholder lists.”); Carole Landry, *Russia’s Communist Bosses Are On the Way Out*, *Agence France-Presse*, Dec. 15, 1994, 1994 WL 9647596 (“Old-guard managers, who supported privatisation in exchange for assurances they would keep their jobs and full array of perks, are desperately fighting back. Some managers physically threaten challengers at shareholder meetings, rig shareholder votes or illegally change corporate charters.” (citing Prof. Andrei Shleifer and Dmitry Vasilyev)).

¹³⁹ See Mooney, *supra* note 83 (noting that, according to one analysis, “[t]here is a need for transparency and disclosure because accurate information is hard to come by. Companies frequently hold their shareholder meetings in remote places like Siberia.” (quoting Lee Wolosky)).

¹⁴⁰ Frydman et al., *supra* note 24, at 204.

¹⁴¹ A reporter notes:

EXHIBIT 13

Transition report update

April 2001

Transition in
eastern Europe,
the Baltic states
and the CIS

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European Bank
for Reconstruction and Development

Table 2.1

Foreign direct investment
 (net inflows recorded in the balance of payments)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Estimate 2000	Projection 2001	Cumulative FDI-inflows 1989-2000 per capita (US\$ million)	Cumulative FDI-inflows 1989-2000 per capita (US\$)	FDI-inflows per capita 1999 (US\$)	FDI-inflows 2000 (in per cent of GDP)		
Czech Republic	na	na	na	983	563	749	2,526	1,276	1,275	3,591	6,234	4,477	6,000	21,673	2,102	605	434	11.7	9.1
Estonia	na	na	na	80	156	212	199	111	130	574	222	241	300	1,926	1,337	154	168	4.3	4.9
Hungary	187	311	1,459	1,471	2,328	1,097	4,410	1,987	1,453	1,414	1,650	1,650	1,650	19,420	1,935	140	164	2.9	3.5
Latvia	na	na	na	na	50	279	245	379	515	303	331	330	350	2,430	1,027	139	139	5.0	4.6
Lithuania	na	na	na	na	na	31	72	152	328	921	478	355	300	2,367	642	129	96	4.5	3.2
Poland	na	0	117	284	580	542	1,134	2,741	3,041	4,966	6,348	9,299	8,000	29,052	751	164	240	4.1	5.9
Slovak Republic	10	24	82	100	107	236	194	199	84	374	701	1,500	2,000	3,611	669	130	278	3.6	7.4
Slovenia	-14	-2	-41	113	111	131	183	188	340	250	144	133	100	1,534	768	72	67	0.7	0.7
Central eastern Europe and the Baltic states	183	333	1,617	3,031	3,925	3,278	8,961	7,032	7,365	12,431	15,872	17,986	18,700	82,012	1,154	192	198	4.6	4.9
Albania	na	4	56	20	45	65	89	97	42	45	51	92	110	546	161	15	27	1.4	2.3
Bulgaria	na	na	na	42	40	105	98	138	507	537	806	975	900	3,307	407	98	120	6.5	8.1
Bosnia and Herzegovina	na	na	na	na	na	0	0	0	0	100	90	117	164	307	71	21	27	2.1	2.8
Croatia	na	na	na	13	102	110	110	482	344	801	1,374	750	700	4,085	907	304	167	6.8	4.0
FR Yugoslavia	na	na	na	na	na	na	0	740	113	112	50	300	1,015	118	13	6	1.1	na	na
FYR Macedonia	na	0	0	0	0	24	12	12	18	175	27	169	500	437	219	14	85	0.8	5.0
Romania	na	-18	37	73	87	341	417	415	1,267	2,079	1,070	1,000	1,200	6,768	303	48	45	3.1	2.8
South-eastern Europe	0	-14	93	148	274	646	726	1,143	2,917	3,850	3,530	3,153	3,874	16,465	312	73	68	3.1	3.6
Armenia	na	na	na	0	1	8	25	18	52	221	131	150	200	605	159	34	39	7.1	7.8
Azerbaijan	na	na	na	na	0	22	282	661	1,093	1,024	510	500	1,000	4,092	502	64	61	12.8	12.1
Belarus	na	na	na	na	18	11	15	73	198	147	225	90	100	776	78	22	9	1.9	0.8
Georgia	na	na	na	na	8	8	6	54	236	221	60	101	124	687	128	11	19	2.2	3.4
Kazakhstan	na	na	na	100	473	635	964	1,137	1,320	1,136	1,584	1,150	1,810	8,499	571	106	77	9.4	6.3
Kyrgyzstan	na	na	na	na	na	38	96	47	83	109	44	41	65	458	97	9	9	3.6	3.1
Moldova	na	na	na	17	14	18	73	23	71	88	34	100	60	438	102	8	23	2.6	7.1
Russia	na	na	na	na	na	500	1,663	1,665	4,036	1,734	746	2,000	2,500	12,344	85	5	14	0.4	0.8
Tajikistan	na	na	na	9	9	12	10	18	18	25	21	22	19	144	23	3	4	1.9	2.2
Turkmenistan	na	na	na	na	79	103	233	108	108	62	89	100	150	882	165	18	19	4.8	4.5
Ukraine	na	na	na	na	na	151	257	526	581	747	489	594	800	3,345	67	10	12	1.6	1.9
Uzbekistan	na	na	na	9	48	73	-24	90	167	140	121	73	71	697	28	5	3	1.5	1.0
Commonwealth of Independent States	0	0	0	135	642	1,579	3,600	4,419	7,963	5,654	4,054	4,921	6,899	32,967	167	25	24	4.1	4.3
Total	183	319	1,710	3,314	4,840	5,502	13,288	12,594	18,245	21,934	23,456	26,059	29,473	131,444	505	88	89	4	4

Sources: IMF, central banks and EBRD estimates.

Notes:

For most countries, figures cover only investment in equity capital and in some cases contributions-in-kind.

For those countries (e.g. Estonia and the Slovak Republic) where net investment into equity capital was not easily available, more recent data include reinvested earnings as well as inter-company debt transactions.

Gross inflows of FDI are in some cases considerably higher than net inflows on account of increasing intra-regional investment flows.

2.3 Foreign direct investment

The one part of the region that has sustained significant net private capital inflows is CEB, most of which has been in the form of foreign direct investment (FDI). Long-term capital has been attracted to these advanced transition economies by relatively stable and favourable business environments, close geographical proximity to west European markets and growing domestic markets. There is, in particular, a positive and significant association between progress in transition, as measured by the EBRD's transition indicators and cumulative FDI per capita (see Chart 2.4). Annex 2.1 provides an update on recent progress in transition, across the region. The association among FDI, prospects for EU accession and geographical proximity to west European markets is also strong.²

At the same time, cash-based privatisations of enterprises have created significant purchase opportunities in CEB and to a lesser extent SEE for foreign strategic investors. As Chart 2.5 shows, there is a strong association between cumulative FDI per capita and privatisation revenue per capita since the start of transition. Countries that have realised the largest privatisation receipts per capita, such as Croatia, the Czech Republic, Estonia, Hungary, Lithuania, Kazakhstan, Poland, the Slovak Republic and Slovenia, have also tended to attract the most FDI per capita. Few countries have been able to attract sizeable inflows of FDI without cash privatisation of large-scale enterprises. The notable exception is Azerbaijan, which has attracted significant direct investment into its oil and gas sector. The decision of a government to embark on a cash privatisation programme, of course, can be reinforced by the expectation of sizeable receipts. The key to attractive valuations of enterprises undergoing privatisation is to ensure a stable and favourable business environment.

The association between cash privatisation of large-scale enterprises in relatively advanced transition economies and FDI continued in 2000. For example, two CEB countries registered in 2000 their highest inflows of FDI so far, reflecting progress in large-scale privatisation (see Table 2.2).

Chart 2.4

Cumulative FDI per capita and EBRD transition indicator scores

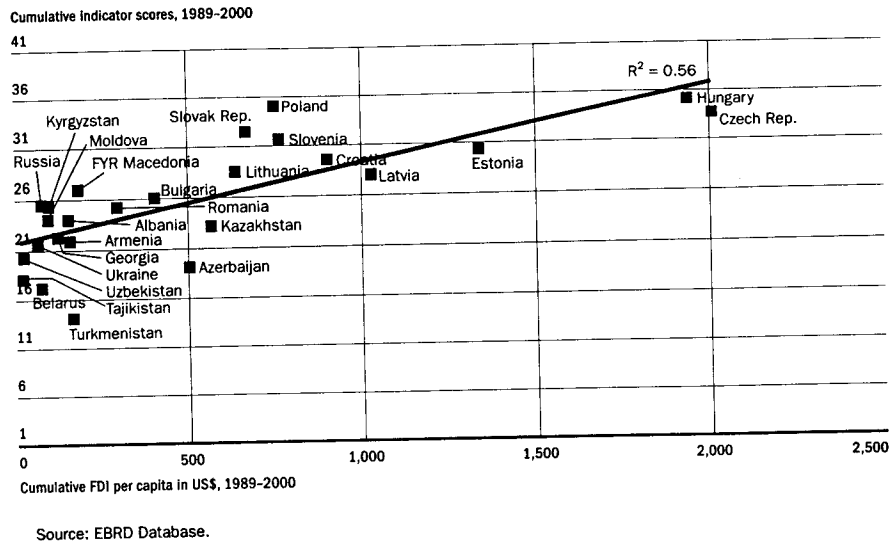
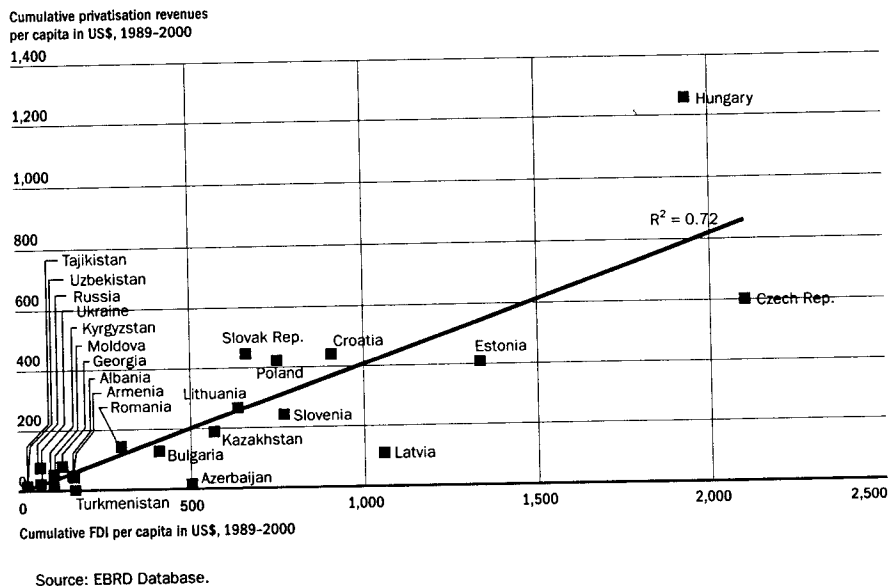


Chart 2.5

FDI and privatisation revenues per capita



Direct investment in Poland topped US\$ 9 billion, boosted by the Government's sale of a 35 per cent stake in the telecommunications operator, Telekomunikacja Polska (TPSA) to France Telecom for US\$ 4.3 billion, a 35 per cent stake in Orbis hotels for US\$ 0.1 billion and stakes in two electric power generators for US\$ 0.1 billion. In the Slovak Republic, FDI reached US\$ 1.5 billion as long-delayed large-scale privatisation advanced. The Government's sale of a 51 per cent stake in Slovenske

Telekomunikacie to Deutsche Telecom for US\$ 0.9 billion accounted for two-thirds of net FDI in 2000. While direct investment in the Czech Republic edged back in 2000 to US\$ 4.5 billion from a previous peak, these inflows were sustained in part by the sale of a 52 per cent stake in Ceska Sporitelna to Erste Bank Sparkasse for US\$ 0.5 billion. These six large-scale privatisations accounted for one-third of the total FDI into CEB in 2000.

² See, for example, Bevan and Estrin (2001) and Economist Intelligence Unit (2001).

Annex 2.1: Recent progress in structural and institutional reform

One of the main findings of the *Transition Report 2000*, Chapter 2, was that the pace of reform, as measured by changes in the EBRD transition indicators, increased in 2000 after slowing down between 1996 and 1999. The average transition indicator rose in 22 out of 26 countries, and declined in only two cases, Turkmenistan and Uzbekistan. The analysis in the Report also showed that the variation across countries in levels of reform was narrowing, as slow reformers continued to catch up on the more advanced countries. However, the Report also cautioned that the evolution towards a market economy was not automatic and that governments in the region have an important role to play in developing and sustaining institutions that support market reforms, and in providing an adequate social safety net. This annex surveys briefly the main developments in reform since the middle of 2000. A country-by-country analysis is contained in the transition assessments at the back of the Update.

The overview focuses on areas of key interest to investors: privatisation, enterprise reform, infrastructure and financial institutions. However, it should be noted that in some countries, the basic requirements for a market economy in terms of liberalisation and stabilisation are not yet firmly in place. Some countries maintain substantial price controls and a multiple exchange rate regime. Others are plagued by problems of high inflation, low tax revenues and, in several cases, an external debt burden that is becoming increasingly difficult to service. There has been recent progress in some cases. The Belarus authorities abolished their multiple exchange rate system in September 2000 and reduced the number of goods and services subject to price controls from January 2001. Similarly, the new reformist authorities in FR Yugoslavia have unified the exchange rate and liberalised most prices. However, there is little sign that the introduction of full currency convertibility is imminent in Uzbekistan. Efforts to improve tax revenue collection have been stepped up recently in

two countries with very low collection rates, Georgia and Kyrgyzstan. The government of Tajikistan has committed to restrictive monetary policy in the framework of a new three-year programme with the IMF.

Privatisation

Many countries in the region continue to make progress on privatisation, even in the advanced countries where the private sector share of GDP is comparable to the share in Western economies. In countries preparing for EU accession, such as the Czech Republic and the Slovak Republic, the main focus is now on selling state shares in the banking sector and large-scale infrastructure enterprises, such as those in the telecommunications and energy sectors. The recent global downturn in technology stocks is causing delays, however. For example, in December 2000, Hungary postponed the sale of the broadcaster Antenna Hungaria.

One region where significant progress has been observed in privatisation during recent months is south-eastern Europe. The privatisation of enterprises in Bulgaria is nearly complete, and the authorities in FYR Macedonia have begun work on the preparation for sale or liquidation of 40 companies where the state retains significant shares. This programme should be completed by the middle of 2002. Albania managed to privatise five medium-sized companies by end-year and the privatisation programme in Bosnia and Herzegovina, although still in the early stages, has gained some recent momentum. The privatisation process in both Serbia and Montenegro has been stalled for years, but the recent political changes in the country are giving a new impetus to the process in both republics. The Serbian Government is drafting a new privatisation law, which is to be presented to parliament in April.

Further east, there has been little recent progress. Large-scale privatisation in Russia has been suspended until a new, more detailed programme is approved.

Privatisation revenues in the Central Asian countries during 2000 were generally low – for example, less than 1 per cent of GDP in Kazakhstan. In many cases, fears of government interference continue to be a deterrent to investors.

Enterprise reform

Progress in enterprise reform has generally been more difficult than privatisation to achieve throughout the region. Even after ten years of transition, no country has achieved a score of “4” in the EBRD transition indicators (see Table 2.1 of the *Transition Report 2000*). However, some important legislative changes have been introduced in the last few months that should lead to improvements in enterprise performance over the medium term. Hungary amended the Competition Act in December 2000, giving increased power to the Competition Office. New commercial codes were introduced in Latvia and Poland, and the civil code in Russia was amended as a step towards development of a market for non-agricultural land. Other important legislative changes are in an advanced state of preparation, including a new land code in Ukraine that is being considered by parliament. The new law would complete the process of land reform that began in 2000 when collective farms were abolished, and would help to develop a land market. In Slovenia, the Government has begun to restructure four major steel companies and will phase out most state subsidies in the industry by the end of the year. In Romania, the new Government announced in January 2001 the creation of a restructuring fund that will help enterprises prepare for privatisation.

In a number of countries, state interference in the running of companies continues to hinder good corporate governance practices and the hardening of budget constraints. In Armenia, political insiders continue to exert *de facto* control over several large enterprises. In Turkmenistan, the Government has created a state fund for the textiles industry.

	1993	1994	1995	1996	1997	1998	1999	2000 Estimate	2001 Projection
Output and expenditure									
(Percentage change in real terms)									
GDP	0.1	2.2	5.9	4.8	-1.0	-2.2	-0.8	3.1	3.5
Private consumption	1.2	5.6	5.8	6.9	1.8	-2.9	1.4	1.4	na
Public consumption	3.6	3.1	-4.2	3.5	0.8	-0.9	-0.1	-0.2	na
Gross fixed investment	0.2	9.1	19.8	8.2	-2.9	-3.9	-5.5	5.2	na
Exports of goods and services	15.8	1.7	16.7	9.2	8.1	10.7	6.6	18.8	na
Imports of goods and services	23.7	14.7	21.2	14.3	7.2	7.9	5.8	18.7	na
Industrial gross output	-5.8	2.9	11.8	11.1	0.1	2.8	-0.4	5.8	na
Agricultural gross output	-3.8	-6.6	3.2	2.5	-1.5	-1.8	2.3	-2.0	na
Employment									
(Percentage change)									
Labour force (end-year)	0.4	-1.1	0.8	0.7	0.1	0.5	0.4	0.2	na
Employment (end-year)	0.2	0.7	2.8	1.2	-1.7	-2.5	-1.7	0.9	na
(In per cent of labour force)									
Unemployment (end-year)	3.5	3.2	2.9	3.5	5.2	7.5	9.4	8.8	na
Prices and wages									
(Percentage change)									
Consumer prices (annual average)	20.8	9.9	9.1	8.8	8.5	10.7	2.1	3.9	4.6
Consumer prices (end-year)	18.2	9.7	7.9	8.6	10.0	6.8	2.5	4.0	5.0
Producer prices (annual average)	9.2	5.3	7.6	4.8	4.9	4.9	1.0	4.9	na
Producer prices (end-year)	11.4	5.6	7.2	4.4	5.7	2.2	3.4	5.0	na
Gross average monthly earnings in economy (annual average)	25.3	18.5	18.5	18.4	10.5	9.4	8.2	7.0	na
Government sector									
(In per cent of GDP)									
General government balance ¹	0.5	-1.1	-1.4	-0.9	-1.7	-2.0	-3.3	-4.9	-9.2
General government expenditure ¹	41.2	41.8	41.5	40.6	40.9	40.8	42.0	44.5	na
Public debt ²	18.8	17.6	15.3	13.1	13.0	13.4	15.0	17.5	na
Monetary sector									
(Percentage change)									
Broad money (end-year)	22.5	20.8	19.4	7.8	8.7	5.2	8.1	7.0	na
Domestic credit (end-year)	19.2	16.0	12.2	12.0	8.6	3.4	0.9	4.3	na
(In per cent of GDP)									
Broad money (end-year)	70.6	73.6	75.3	71.3	73.0	71.2	75.4	77.5	na
Interest and exchange rates									
(In per cent per annum, end-year)									
2-week repo rate	na	na	11.3	12.4	14.75	9.5	5.25	5.25	na
3-months PRIBOR	8.0	12.7	10.9	12.7	17.5	10.1	5.6	5.4	na
Deposit Rate ³	7.0	6.9	6.9	6.7	8.0	6.7	4.0	4.5	na
Lending Rate ³	14.1	12.8	12.7	12.5	13.9	10.5	8.0	8.1	na
(Korunas per US dollar)									
Exchange rate (end-year)	29.8	28.2	26.7	27.3	34.7	30.0	35.7	38.8	na
Exchange rate (annual average)	29.2	28.8	26.5	27.1	31.7	32.3	34.6	38.6	na
External sector									
(In millions of US dollars)									
Current account	456	-787	-1,369	-4,292	-3,211	-1,336	-1,567	-2,369	-2,700
Trade balance ⁴	-525	-1,381	-3,678	-5,877	-4,540	-2,554	-1,903	-3,285	-4,000
Merchandise exports ⁴	14,229	15,929	21,463	21,691	22,777	26,351	26,265	29,034	33,000
Merchandise imports ⁴	14,754	17,310	25,140	27,568	27,317	28,905	28,167	32,320	37,000
Foreign direct investment, net	563	749	2,526	1,276	1,275	3,591	6,234	4,477	6,000
Gross reserves (end-year), excluding gold	3,872	6,243	14,023	12,435	9,800	12,623	12,894	14,078	na
External debt stock	8,496	10,694	16,549	20,845	21,352	24,047	22,615	23,000	na
(In months of imports of goods and services)									
Gross reserves (end-year), excluding gold	2.5	3.4	5.6	4.4	3.6	4.4	4.6	4.4	na
(In per cent of current account revenues, excluding transfers)									
Debt service	5.9	11.3	8.9	10.5	15.0	14.5	14.4	9.5	na
Memorandum Items									
(Denominations as indicated)									
Population (end-year, millions)	10.3	10.3	10.3	10.3	10.3	10.3	10.3	10.3	na
GDP (in billions of koruna)	1,020.3	1,182.8	1,381.1	1,572.3	1,668.8	1,798.3	1,836.3	1,910.6	2,069.5
GDP per capita (in US dollars)	3,386	3,977	5,049	5,620	5,109	5,412	5,148	4,797	na
Share of industry in GDP (in per cent)	33.3	33.6	33.3	32.4	34.3	35.3	34.3	35.2	na
Share of agriculture in GDP (in per cent)	5.3	4.9	4.7	4.7	4.7	4.6	3.7	3.5	na
Current account/GDP (in per cent)	1.3	-1.9	-2.6	-7.4	-6.1	-2.4	-3.0	-4.8	-5.1
External Debt - Reserves, in US\$ millions	4,624	4,451	2,526	8,409	11,552	11,424	9,721	8,922	na
External Debt/GDP (in per cent)	24.3	26.0	31.8	36.0	40.6	43.1	42.6	46.5	na
External Debt/Current Account revenues, excluding transfers (in per cent)	43.6	48.9	56.3	67.2	68.1	68.0	64.9	60.4	na

¹ General government excludes privatisation revenues.

² Consolidated outstanding debt including state budget, health insurance, extra-budgetary funds and local governments, but excluding the indirect debt of transformation institutions.

³ Weighted average over all maturities.

⁴ Break in series in 1995 due to a change in the reporting system.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure									
(Percentage change in real terms)									
GDP	-14.9	0.6	-0.8	3.3	8.6	3.9	1.1	6.6	4.0
Private consumption	na	3.2	0.6	10.3	5.0	6.2	5.5	na	na
Public consumption	na	-0.9	7.7	1.8	0.3	6.1	0.0	na	na
Gross fixed investment	na	0.8	8.7	22.3	20.7	44.0	-6.3	na	na
Exports of goods and services	na	-8.4	3.3	20.2	13.1	4.9	-6.4	na	na
Imports of goods and services	na	-0.7	1.3	28.5	6.8	19.0	-5.2	na	na
Industrial gross output	-38.1	-9.5	-6.5	1.4	6.1	2.0	-8.8	3.2	na
Agricultural gross output	-18.2	-15.0	3.1	-5.3	4.9	-5.3	-8.3	na	na
Employment									
(Percentage change)									
Labour force (annual average)	-2.0	-1.5	-1.9	-1.0	-3.6	-0.4	-1.0	-0.3	na
Employment (annual average)	-6.9	-10.1	-3.5	-2.7	1.9	0.6	-0.5	0.0	na
(In per cent of labour force)									
Unemployment (annual average)	8.7	16.7	18.1	19.4	14.8	14.0	13.5	13.2	na
Prices and wages									
(Percentage change)									
Consumer prices (annual average)	109.2	35.9	25.0	17.6	8.4	4.7	2.4	2.8	3.3
Consumer prices (end-year)	34.9	26.3	23.1	13.1	7.0	2.8	3.2	1.8	5.1
Producer prices (annual average)	117.1	16.9	11.9	13.7	4.1	1.9	-4.0	0.6	na
Producer prices (end-year)	36.3	10.7	15.9	7.7	3.6	-1.9	-1.1	1.0	na
Gross average monthly earnings in economy (annual average)	119.7	52.2	24.5	10.3	21.6	11.1	5.8	6.1	na
Government sector ¹									
(In per cent of GDP)									
General government balance	na	-4.4	-3.9	-1.8	0.3	-0.8	-4.2	-3.0	-2.0
General government expenditure	na	40.5	41.2	39.2	41.0	43.4	44.8	42.0	na
General government debt	na	14.1	16.1	14.4	12.0	10.5	12.9	13.6	na
Monetary sector									
(Percentage change)									
Broad money (M2X, end-year)	na	47.4	-23.1	19.9	38.7	5.9	8.0	25.0	na
Domestic credit (end-year)	na	72.3	-28.2	6.0	39.3	30.6	15.2	43.6	na
(In per cent of GDP)									
Broad money (M2X, end-year)	31.5	33.4	22.3	22.2	26.6	25.7	25.6	29.4	na
Interest and exchange rates									
(In per cent per annum, end-year)									
Refinancing rate	27.0	25.0	24.0	9.5	4.0	4.0	4.0	3.5	na
Interbank market rate ²	56.6	37.8	21.1	9.7	3.9	7.0	2.7	3.3	na
Deposit rate (short-term)	28.4	18.8	15.0	10.0	5.3	6.5	4.2	4.6	na
Lending rate (short-term)	70.8	36.7	31.1	20.3	12.1	16.4	12.5	13.6	na
(Lats per US dollar)									
Exchange rate (end-year)	0.60	0.55	0.54	0.56	0.59	0.57	0.58	0.61	na
Exchange rate (annual average)	0.67	0.56	0.53	0.55	0.58	0.59	0.59	0.61	na
External sector									
(In millions of US dollars)									
Current account	417	201	-16	-279	-345	-650	-646	-485.1	-564
Trade balance	3	-301	-580	-798	-848	-1,130	-1,027	-1,058	-1,226
Merchandise exports	1,054	1,022	1,368	1,488	1,838	2,011	1,889	2,058	2,264
Merchandise imports	1,051	1,322	1,947	2,286	2,686	3,141	2,916	3,117	3,490
Foreign direct investment, net	50	279	245	379	515	303	331	399	350
Gross reserves (end-year), excluding gold	432	545	506	622	704	728	840	851	na
External debt stock ³	355	825	1,538	2,091	2,756	3,098	3,854	4,729	na
(In months of imports of goods and services)									
Gross reserves (end-year), excluding gold	4.1	4.0	2.8	2.5	2.5	2.2	2.8	2.6	na
(In per cent of current account revenues, excluding transfers)									
Debt Service	na	3.9	8.1	10.0	20.5	12.5	17.3	20.9	na
Memorandum Items									
(Denominations as indicated)									
Population (end-year, millions)	2.6	2.5	2.5	2.5	2.5	2.4	2.4	2.4	na
GDP (in millions of lat)	1,467	2,043	2,349	2,829	3,275	3,590	3,897	4,333	4,656
GDP per capita (in US dollars)	848	1,442	1,779	2,070	2,293	2,494	2,799	3,019	na
Share of industry in GDP (in per cent)	27.9	22.5	24.3	23.0	23.9	20.2	17.4	16.3	na
Share of agriculture in GDP (in per cent)	10.7	8.4	9.4	7.9	5.1	3.7	4.0	4.0	na
Current account/GDP (in per cent)	19.1	5.5	-0.4	-5.4	-6.1	-10.7	-9.7	-6.8	-7.1
External Debt - Reserves, in US\$ millions	-77	280	1,032	1,469	2,052	2,370	3,014	3,878	na
External Debt/GDP (in per cent)	16.3	22.6	34.6	40.7	48.9	50.9	57.9	66.2	na
External Debt/Exports of goods and services (in per cent)	22.4	49.1	73.7	80.0	96.0	99.3	132.3	144.6	na

¹ General government includes the state, municipalities and extra-budgetary funds. Privatisation revenues are not included in revenues. General government expenditure includes net lending.

³ Includes non-resident currency and deposits, liabilities to affiliated enterprises and liabilities to direct investors.

² Weighted average interest rates in the interbank market.

Russia

Key reform challenges

- The implementation of the Russian Government's reform programme has slowed in recent months. Stronger political leadership is needed to overcome obstacles and regain momentum.
- State institutions are in need of further reform to curtail arbitrary bureaucratic interventions in the economy and to strengthen the investment climate.
- The continued real appreciation of the rouble will intensify pressures to raise productivity and competitiveness and to restructure enterprises.

Stabilisation

Following an impressive macroeconomic performance in 2000, the economy has begun to falter in recent months, with sharply decelerating growth and higher inflation. The real exchange rate continues to rise, supported in part by a large current account surplus. After some delay, the Government committed to service its Paris Club debt in full and the budget for 2001 was amended accordingly.

Liberalisation

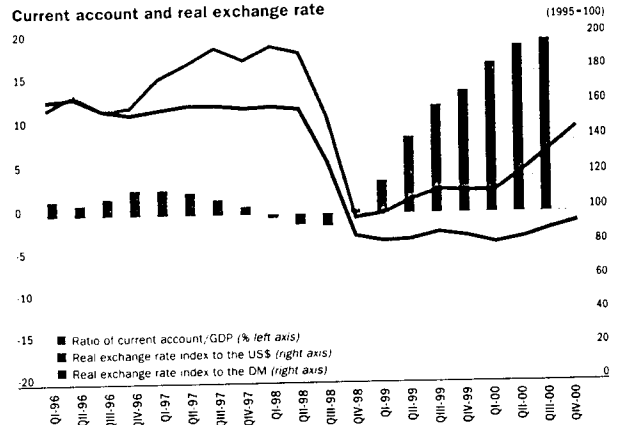
The custom tariff reform measures adopted last year entered into force in early 2001. The number of tariff tiers has been reduced from 7 to 4 while the maximum tariff level has been lowered from 30% to 20%. The January amendments of the Civil Code provide for private ownership, sale, mortgage and lease of the country's non-agricultural land. The Government recently adopted and submitted to the Duma a package of draft laws aiming at deregulation of the economy, including separate laws on licensing, registration and state inspection of businesses.

Infrastructure

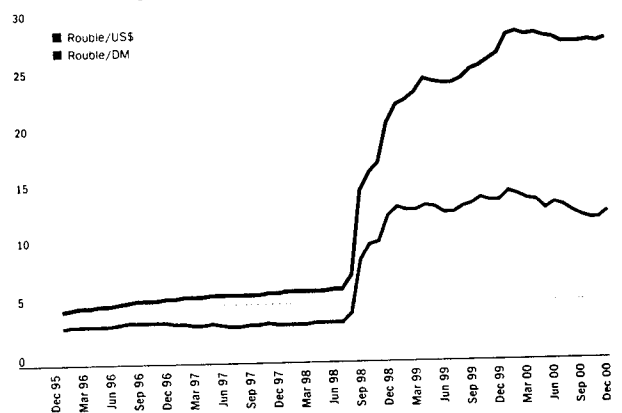
In late 2000 the Government postponed a decision on the details both of railway reform and of the restructuring of United Energy Systems until April 2001. Meanwhile, tariff re-balancing has progressed in both sectors. A decision on the restructuring of Gazprom is scheduled for mid 2001. However, key corporate governance weaknesses of the company, including its relationships with related parties such as ITERA and the ring-fencing of domestic shares, have been strongly questioned by Gazprom board representatives of the state and by minority shareholders.

Financial institutions

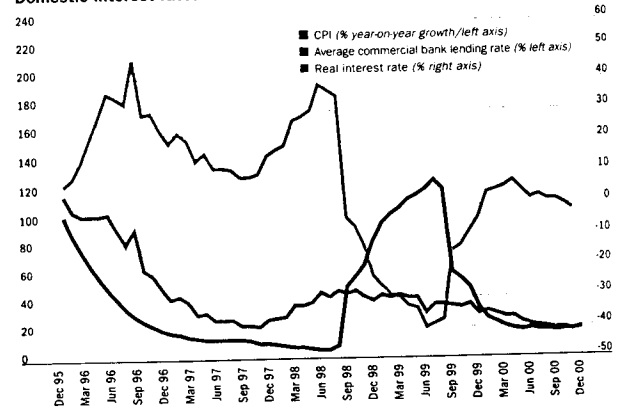
Banking reform remains one of the weakest elements in the overall reform process, despite further substantial growth of the assets and charter capital of the banking sector – by about 40 per cent and 80 per cent respectively in US dollar terms – in 2000. There has been little progress in resolution of the large failed banks, and the dominant role of state banks has further increased. Despite some increase in their share in total capital, foreign banks continue to play a limited role. However, Citibank recently decided to start retail operations in Russia.



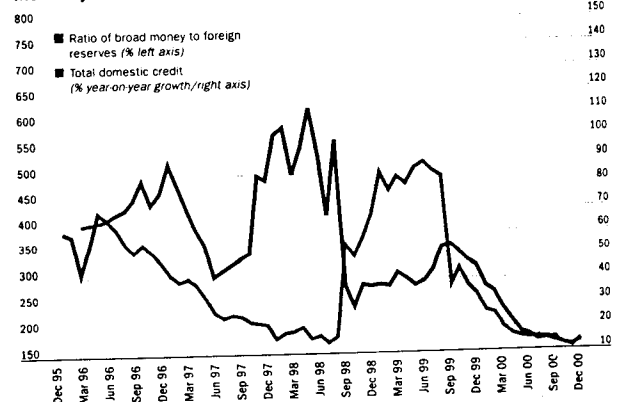
Nominal exchange rate



Domestic interest rates and inflation



Monetary indicators



	1993	1994	1995	1996	1997	1998	1999	2000	2001	
								Estimate	Projection	
Output and expenditure										
(Percentage change in real terms)										
GDP	-8.7	-12.7	-4.1	-3.5	0.8	-4.6	3.5	7.7	3.4	
Private consumption	1.2	1.2	-2.8	-4.7	5.4	-3.6	-3.4	8.0	na	
Public consumption	-6.4	-2.9	1.1	0.8	-2.4	0.6	9.5	2.0	na	
Gross fixed investment	-25.8	-26.0	-7.5	-19.3	-5.7	-11.2	2.4	18.0	na	
Exports of goods and services	na	na	7.3	-2.0	4.2	2.7	-4.5	6.0	na	
Imports of goods and services	na	na	16.6	6.9	10.6	-14.1	-21.7	16.0	na	
Industrial gross output	-14.1	-20.9	-3.3	-4.0	1.9	-5.2	8.1	9.0	na	
Agricultural gross output	-4.4	-12.0	-7.6	-5.1	0.1	-12.3	2.4	4.0	na	
Employment										
(Percentage change)										
Labour force (end-year)	-1.4	-1.4	-1.5	0.5	-0.6	0.2	1.1	na	na	
Employment (end-year)	-1.7	-3.4	-3.1	-0.6	-2.1	-2.0	2.8	na	na	
(In per cent of labour force)										
Unemployment (end-year)	6.0	7.8	9.0	9.9	11.2	13.3	11.7	9.7	na	
Prices and wages										
(Percentage change)										
Consumer prices (annual average)	875.0	311.4	197.7	47.8	14.7	27.6	86.1	20.8	22.4	
Consumer prices (end-year)	840.0	204.4	128.6	21.8	10.9	84.5	36.8	20.1	20.5	
Producer prices (annual average)	941.9	337.4	236.5	50.8	19.7	7.0	58.9	31.6	na	
Producer prices (end-year)	895.0	233.0	175.0	25.6	7.4	23.0	69.8	27.8	na	
Gross average monthly earnings in economy (annual average)	904.7	277.3	119.5	48.4	20.2	15.2	44.4	43.1	na	
Government sector ¹										
(In per cent of GDP)										
General government balance	-7.3	-10.4	-6.0	-8.9	-7.9	-8.0	-3.8	2.5	0.0	
General government expenditure	43.6	45.1	39.1	42.4	44.4	41.4	39.4	35.5	na	
General government debt (domestic)	na	18.9	14.6	20.9	19.8	27.8	12.3	na	na	
Monetary sector										
(Percentage change)										
Broad money (M2, end-year)	na	200.0	125.8	30.6	29.8	40.5	50.6	62.0	na	
Domestic credit (end-year)	na	335.6	87.8	48.3	22.2	68.2	34.1	26.0	na	
(In per cent of GDP)										
Broad money (M2, end-year)	19.0	16.0	13.9	13.4	14.8	19.5	17.4	18.5	na	
Interest and exchange rates										
(In per cent per annum, end-year)										
Central bank refinancing rate (uncompounded)	210.0	180.0	160.0	48.0	28.0	60.0	55.0	25.0	na	
Treasury bill rate (all maturities) ²	103.2	263.0	104.1	33.6	36.6	48.1	16.0	12.0	na	
Lending rate	na	na	320.0	146.8	32.0	41.7	38.3	18.0	na	
Deposit rate	na	na	102.0	55.1	16.8	17.1	9.4	5.0	na	
(Roubles per US dollar)										
Exchange rate (end-year) ³	1.2	3.6	4.6	5.6	6.0	20.7	26.8	28.2	na	
Exchange rate (annual average) ³	1.0	2.2	4.6	5.1	5.8	10.0	24.6	28.2	na	
External sector										
(In millions of US dollars)										
Current account ⁴	na	8,041	7,982	12,562	2,321	1,097	24,963	45,100	29,000	
Trade balance ⁴	15,342	17,024	20,725	22,934	17,363	17,100	35,846	61,000	47,000	
Merchandise exports ⁴	59,646	67,542	82,913	90,564	89,008	74,883	75,306	105,000	95,000	
Merchandise imports ⁴	44,304	50,518	62,188	67,630	71,645	57,783	39,460	44,000	48,000	
Foreign direct investment, net	na	500	1,663	1,665	4,036	1,734	746	2,000	2,500	
International reserves (end-year), excluding gold	na	5,000	14,400	11,276	12,895	7,801	8,457	24,500	na	
External debt stock ⁵	na	126,500	127,000	135,100	134,100	157,700	154,600	142,198	na	
(In months of imports of goods and services)										
International reserves (end-year), excluding gold	na	0.9	2.1	1.6	1.7	1.3	1.9	4.6	na	
(In per cent of current account revenues, excluding transfers)										
Public debt service due ⁶	na	23.6	19.6	16.6	10.9	14.2	20.3	14.2	na	
Public debt service paid ⁶	na	4.6	6.5	6.4	5.5	8.5	10.9	na	na	
Memorandum Items										
(Denominations as indicated)										
Population (end-year, millions) ⁷	148.7	148.4	148.3	148.0	147.5	146.4	145.7	145.4	na	
GDP (in billions of rouble)	171.5	610.7	1,585.0	2,145.6	2,522.0	2,696.0	4,545.1	6,946.0	8,200.0	
GDP per capita (in US dollars)	1,133	1,867	2,343	2,829	2,953	1,848	1,268	1,697	na	
Share of industry in GDP (in per cent)	34.4	32.8	29.0	29.5	28.4	29.1	31.9	32.3	na	
Share of agriculture in GDP (in per cent)	8.2	6.5	7.2	7.3	6.7	6.0	6.9	6.7	na	
Current account/GDP (in per cent)	na	2.9	2.3	3.0	0.5	0.4	13.5	19.7	10	
External Debt - Reserves, in US\$ millions	na	115,900	112,600	123,824	121,205	149,899	146,143	117,698	na	
External Debt/GDP (in per cent)	na	43.7	36.6	32.3	30.8	58.3	83.7	62.0	na	
External Debt/Exports of goods and services (in per cent)	na	159.2	135.9	130.1	130.1	180.7	183.3	121.5	na	

¹ General consolidated government includes the federal, regional and local budgets and extra-budgetary funds and excludes transfers.

² The 1998 figure is the yield on obligations of the Central Bank of Russia.

³ Data in new (denominated) roubles per US dollar. From January 1, 1998, one new rouble = 1,000 old roubles.

⁴ Data from the consolidated balance of payments, which covers transactions with both CIS and non-CIS countries.

⁵ Data includes public debt only. From 1992 debt to former COMECON countries is included.

⁶ Difference between due and paid arises from accumulation of arrears on debt servicing.


⁷ Data as of January 1 of the following year.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure									
<i>(Percentage change in real terms)</i>									
GDP	-3.7	4.9	6.7	6.2	6.2	4.1	1.9	2.2	3.0
Private consumption	-1.5	1.0	3.0	8.2	5.6	5.3	0.1	-3.4	na
Public consumption	-2.2	-11.4	2.1	21.0	4.0	4.0	-6.9	-0.9	na
Gross fixed investment	-5.4	-5.0	5.3	32.0	12.0	11.1	-18.8	-0.7	na
Exports of goods and services	-0.5	14.2	3.0	0.7	17.6	12.2	3.6	15.9	na
Imports of goods and services	-0.8	-3.4	9.2	17.2	13.1	19.9	-6.1	10.2	na
Industrial gross output	-5.4	6.8	8.3	2.5	1.7	3.4	-3.4	9.1	na
Agricultural gross output	-8.1	4.8	2.3	2.0	-1.0	-5.9	1.0	-2.0	na
Employment									
<i>(Percentage change)</i>									
Labour force (end-year)	-0.2	2.2	1.2	2.1	1.0	0.9	0.9	2.0	na
Employment (end-year)	-2.6	-1.0	2.4	-1.4	-2.3	-1.0	-1.8	-1.0	na
<i>(In per cent of labour force)</i>									
Unemployment (end-year)	14.4	14.6	13.1	12.8	12.5	15.6	19.2	17.9	na
Prices and wages									
<i>(Percentage change)</i>									
Consumer prices (annual average)	23.2	13.4	9.9	5.8	6.1	6.7	10.6	12.0	7.1
Consumer prices (end-year)	25.1	11.7	7.2	5.4	6.4	5.6	14.2	8.3	9.0
Producer prices (annual average)	17.2	10.0	9.0	4.1	4.5	3.3	3.8	8.3	na
Producer prices (end-year)	18.8	9.4	7.1	4.7	4.4	1.6	7.7	10.0	na
Gross average monthly earnings in economy (annual average)	18.4	17.0	14.3	13.3	13.1	9.6	7.2	10.8	na
Government sector ¹									
<i>(In per cent of GDP)</i>									
General government balance	-6.0	-1.5	0.4	-1.3	-5.2	-5.0	-3.6	-3.5	-4.0
General government expenditure	47.6	45.5	45.2	47.0	45.5	42.9	43.3	43.1	na
General government debt	31.5	28.0	24.6	24.5	23.7	26.0	28.4	28.9	na
Monetary sector									
<i>(Percentage change)</i>									
Broad money (end-year)	16.8	20.1	19.1	16.6	9.1	2.7	13.0	4.4	na
Domestic credit (end-year)	na	8.2	7.6	14.4	3.1	11.2	7.5	-10.6	na
<i>(In per cent of GDP)</i>									
Broad money (end-year)	63.9	64.3	65.4	68.7	66.2	62.1	64.6	58.9	na
Interest and exchange rates									
<i>(In per cent per annum, end-year)</i>									
Refinancing rate	na	na	na	9.7	19.2	11.3	11.4	8.0	na
3-months BRIBOR	na	na	na	14.9	26.5	18.3	13.7	10.0	na
Deposit rate ²	8.7	9.2	8.2	6.2	8.7	10.4	9.9	12.0	na
Lending rate ²	14.1	14.4	14.8	13.2	16.2	16.2	13.5	16.0	na
<i>(Korunas per US dollar)</i>									
Exchange rate (end-year)	33.2	31.3	29.6	31.9	34.8	36.9	42.1	48.6	na
Exchange rate (annual average)	30.8	32.0	29.7	30.7	33.6	35.2	41.4	46.2	na
External sector									
<i>(In millions of US dollars)</i>									
Current account	-601	665	391	-2,098	-1,952	-2,059	-1,083	-680	-827
Trade balance	-932	59	-228	-2,293	-2,081	-2,293	-1,103	-700	-850
Merchandise exports	5,447	6,691	8,579	8,831	9,639	10,667	10,197	11,000	11,750
Merchandise imports	6,379	6,633	8,807	11,124	11,720	12,959	11,301	11,700	12,600
Foreign direct investment, net	107	236	194	199	84	374	701	1,500	2,000
Gross reserves (end-year), excluding gold	395	1,605	3,306	3,403	3,204	2,867	3,366	4,886	na
External debt stock	3,380	4,660	5,678	7,670	9,896	11,902	10,518	10,804	na
<i>(In months of imports of goods and services)</i>									
Gross reserves (end-year), excluding gold	0.6	2.3	3.7	3.1	2.8	2.3	3.1	4.2	na
<i>(In per cent of current account revenues, excluding transfers)</i>									
Debt service due	8.4	8.6	9.1	10.6	12.4	11.2	16.5	17.5	na
Memorandum Items									
<i>(Denominations as indicated)</i>									
Population (end-year, millions)	5.3	5.3	5.4	5.4	5.4	5.4	5.4	5.4	na
GDP (in millions of koruna)	390,600	466,200	546,000	606,100	686,100	750,800	815,300	933,550	1,051,372
GDP per capita (in US dollars)	2,384	2,721	3,423	3,679	3,802	3,970	3,650	3,742	na
Share of industry in GDP (in per cent)	35.4	30.6	29.1	29.5	26.8	25.5	24.2	25.8	na
Share of agriculture in GDP (in per cent)	6.6	7.4	6.3	5.9	4.8	4.4	4.4	4.2	na
Current account/GDP (in per cent)	-4.7	4.6	2.1	-10.6	-9.6	-9.7	-5.5	-3.4	-3.8
External Debt - Reserves, in US\$ millions	2,985	3,055	2,372	4,267	6,692	9,035	7,152	5,318	na
External Debt/GDP (in per cent)	26.6	32.0	30.9	38.8	48.5	55.9	53.4	53.5	na
External Debt/Exports of goods and services (in per cent)	45.7	52.1	51.8	70.4	83.8	91.8	86.3	80.4	na

¹ General government includes the state, municipalities and extra-budgetary funds and excludes privatisation revenues.

² Weighted average over all maturities. Lending rate excludes loans at zero interest rate since 1995.

EXHIBIT 14

Source: [All Sources](#) > [Secondary Legal](#) > [Law Reviews and ALR](#) 

Terms: **title (russia!) or summary (russia!) and date geq (11/14/1999)** ([Edit Search](#))

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SYMPOSIUM NORMS & CORPORATE LAW: DOES CORPORATE GOVERNANCE MATTER? A
CRUDE TEST USING **RUSSIAN** DATA

Bernard Black+

+ Professor of Law, Stanford Law School. Special thanks to James Fenkner of Troika Dialog for providing the valuation data used in this Article and Andrea Rutherford of Brunswick Warburg for discussing with me the basis for their corporate governance rankings. I thank Cindy Alexander, Jack Coffee, Stephen Deane, John Donohue, Jeff Gordon, Avery Katz, Alexander Raskovitch, Eric Talley, participants in the University of Pennsylvania Law School Symposium on Norms and Corporate Law (Dec. 2000), and participants in workshops at Chicago-Kent Law School, Columbia Law School, Georgetown Law School, the United States Department of Justice, Antitrust Division, and USC Law Center for their comments and suggestions. A more technical version of this Article, using an expanded twenty-one firm sample, will be published as Bernard Black, *The Corporate Governance Behavior and Market Value of Russian Firms*, 2 *Emerging Markets Rev.* (forthcoming 2001), available at http://papers.ssrn.com/paper.taf?abstract_id=263014 (Social Science Research Network).

SUMMARY:

... Does a firm's corporate governance behavior - defined broadly to include both the governance rules that the firm adopts and the behavior of its insiders along governance-related dimensions - affect its market value? For United States firms, evidence that governance practices matter is scarce. ... This Article tests the proposition that corporate governance behavior affects the market value of **Russian** firms (the value that outside, noncontrolling shareholders pay for the firm's shares). ... This Article can be understood as an effort to see whether that qualitative insight will translate into quantitative data that supports the proposition that the corporate governance behavior of **Russian** firms affects their market value. ... My goal is to test whether interfirm variation in corporate governance behavior has a significant effect on the market value of **Russian** firms - and by inference, likely also the market value of firms in other countries with weak corporate governance laws and norms. ... In **Russia**, corporate governance behavior, as captured by the governance ranking, appears not only to affect firms' market value, but to be the dominant determinant of the value ratio. ... The evidence reported here on how much corporate governance behavior matters in **Russia** also has practical significance for investors in **Russian** firms. ...

TEXT:

[*2131]

Introduction

Does a firm's corporate governance behavior - defined broadly to include both the governance rules that the firm adopts and the behavior of its insiders along governance-related dimensions - affect its market value? For United States firms, evidence that governance [***2132**] practices matter is scarce. Most tests of whether interfirm variations in corporate governance practices affect firms' market value or performance come up empty. When effects are found, they are economically small - often only a percent or two.

And yet, perhaps the problem is with the data, not the proposition that firms' corporate governance behavior affects their market value. The minimum quality of American corporate governance, set by law and by norms so widely accepted that almost no public firms depart from them, is quite high. The variation in firm behavior is small, perhaps too small for us to observe large performance differences due to this variation.

A stronger test of whether and by how much governance behavior affects firms' market value could be possible in a country with weak laws governing behavior by firms and their insiders (managers and large shareholders), weak norms for insider conduct, and weak reputational constraints on insider conduct. In such a country, governance differences between firms will be larger and could have measurable effects on market value.

Across all three dimensions, Russia offers a strong test case. Its corporate and securities laws are unenforced and widely ignored. Behavioral norms reinforce bad behavior - self-dealing and often outright looting. And insiders didn't need to develop reputations for honesty so that their firms could sell shares to the public. Instead, major companies were sold in privatization auctions, letting even disreputable insiders acquire control. The low minimum quality of Russian corporate governance leaves huge room for interfirm variation. Some insiders will simply loot their firms; others will try to attract investors through good conduct; still others will steal some but not all of the firm's profits. ¹

This Article tests the proposition that corporate governance behavior affects the market value of Russian firms (the value that outside, noncontrolling shareholders pay for the firm's shares). I use fall 1999 corporate governance rankings for a sample of sixteen large Russian public companies, developed by Brunswick Warburg, a major Russian investment bank. These estimates were not directly, and their creators believe that they were not indirectly, influenced by the firms' market values.

I combine these governance rankings with data on the actual [***2133**] September 1999 market capitalization of these firms and estimates by Troika Dialog, a second major Russian investment bank, of these firms' potential Western market capitalization at that time. The potential Western capitalization is based on the multiples of assets, capacity, or revenue at which Western firms trade. I see no way for a Russian firm's governance behavior to affect these estimates.

The "value ratio" of actual to potential Western market capitalization offers a measure of the discounts that investors apply to these firms. The variation in discounts is huge - the value ratios vary from 0.48 for Vimpelcom to 0.0001 for Yuganskneftegaz.

The correlation between these firms' value ratios and their corporate governance rankings offers a measure of how important corporate governance behavior is, when investors value Russian firms. The correlation is striking. The Pearson product-moment correlation coefficient between $\ln(\text{value ratio})$ and governance ranking is $r = 0.90$, with a t-statistic of 7.63 (significance level of $p < .0001$). These results survive various robustness checks.

My results are tentative because of the small sample size. But they suggest that the governance behavior of Russian firms greatly affects their market value. A measure of how

much: a one-standard-deviation change in governance ranking predicts an 8-fold increase in firm value. A worst (51 ranking) to best (7 ranking) change in governance ranking predicts a 600-fold increase in firm value!

This Article proceeds as follows. Part I offers a brief overview of research in the United States on the extent to which corporate governance attributes correlate with firms' market value or performance. Part II describes my research design. Part III presents results. Part IV concludes and discusses policy implications and possible extensions of this research.

I. Does Corporate Governance Behavior Affect Firm Value?

A. Evidence from the United States

In the United States, efforts to find a correlation between a firm's governance attributes and its market value mostly show weak or no results. For example, the proportion of independent directors on a company's board (or whether the company has a majority-independent board) has no statistically significant effect on **[*2134]** performance.² Similarly, neither overt activism by institutional investors, nor insider share ownership, nor ownership by outside blockholders, nor a firm's committee structure, has a measurable effect on performance.³

When effects are found, they are usually small - a percentage point or two difference in market value. Effects of this size are found, for example, for a staggered board or other antitakeover provisions,⁴ incorporation in Delaware,⁵ or use of cumulative voting.⁶

B. Governance Behavior Should Matter More in Emerging Markets

The weak observed correlation between the corporate governance practices of U.S. firms and their market value or performance could **[*2135]** mean that firms' corporate governance behavior has only a small effect on their market value, compared to other elements such as industry environment, macroeconomic factors, and management skill. But the weak correlation could also reflect the restricted domain of the data. Within a single country, with a well-developed corporate governance system, differences among firms in corporate governance practices may be limited.

In the United States, the minimum quality of corporate governance, set by securities law, corporate law, stock exchange rules, and behavioral norms so widely accepted that almost no public firms depart from them, is quite high. The variation among firms could be too small for performance differences to emerge from the large amount of "noise" (other factors that affect firm performance) that afflicts empirical studies in this area.

To conduct a stronger test, we ought to study a country with weaker laws governing behavior by firms and insiders, weaker widely accepted norms for insider conduct, and weaker reputational constraints on insiders. Governance differences among firms will be larger and the effects of interfirm variation on firms' market value or performance will likely be larger as well.

Across all three dimensions, Russia offers as close to an ideal test case as we are likely to find. It has decent corporate and securities laws, but the laws are unenforced and widely ignored. Cultural norms among managers and large shareholders reinforce bad rather than good behavior. Self-dealing and often outright looting is the norm, not the exception. And insiders didn't need to develop reputations for honesty in order to sell shares to the public. Instead, major companies were sold through privatization auctions, which let even disreputable insiders acquire control in the privatization auctions or thereafter. Indeed, control of many major companies was sold directly to crooks, who got the money to buy them by skimming or outright theft from the government.⁷

Put these factors together and Russia ranked last in a recent survey of corporate governance

practices in twenty-five emerging markets. ⁸ Russian investment banks routinely write reports with such charming titles as Corporate Governance in Russia: Cleaning Up the Mess. ⁹ **[*2136]** The low quality of Russian governance practices leaves huge room for interfirm variation. Some insiders will loot their firms; others will try to attract investors through good conduct; still others will behave more or less typically by Russian standards (stealing some but not all of a firm's profits).

The large variation in Russian corporate governance leads investors to place heavy weight on a firm's governance behavior in deciding which firm's shares to buy and how much to pay. The qualitative evidence for investor concern includes:

(1) frequent reports on corporate governance issued by Russian investment banks, including the rankings and other reports discussed here, and the weekly Corporate Governance Bulletin issued by the Troika Dialog investment bank, which discusses current governance issues affecting particular Russian firms; and

(2) the announcement by Standard & Poor's that it is developing its own corporate governance rankings of Russian firms. ¹⁰

This Article can be understood as an effort to see whether that qualitative insight will translate into quantitative data that supports the proposition that the corporate governance behavior of Russian firms affects their market value.

II. Research Design

My goal is to test whether interfirm variation in corporate governance behavior has a significant effect on the market value of Russian firms - and by inference, likely also the market value of firms in other countries with weak corporate governance laws and norms. I rely on two datasets, generated independently by two prominent Russian investment banks.

A. Russian Corporate Governance Rankings

The first data set is fall 1999 corporate governance rankings of sixteen major Russian firms, developed by the Brunswick Warburg **[*2137]** investment bank. ¹¹ Brunswick Warburg rated Russian companies on a 0 to 60 scale, with higher numbers indicating higher governance risk. The risk factors that influence the rankings and the maximum weight given to each risk factor are listed in Table 1. The risk factors are consistent with the view, which I have expressed elsewhere, that corporate governance concerns in emerging markets focus on information disclosure and control of self-dealing, not on the developed country problem of persuading managers to maximize firm value. ¹²

The firm rankings are shown in Table 2. The highest ranking is 7 for Vimpelcom, which conducted an initial public offering in the United States, is listed on the New York Stock Exchange, and publishes financial statements using U.S. Generally Accepted Accounting Principles ("GAAP"). The lowest rankings are 51 for three subsidiaries of Yukos: Yuganskneftegaz, Samaraneftgaz, and Tomskneft. During 1999, Yukos's controlling shareholder, Mikhail Khodorkovski, was trying to transfer virtually all value from these subsidiaries (and perhaps from Yukos itself) to shady offshore companies. ¹³ The Appendix provides a detailed breakdown of the risk factors that enter each firm's overall ranking.

Potential bias in the regression results: None of the ranking elements directly involves a firm's market value. Most elements rely primarily on objective factors. For example, the dilution-through-share-issuance risk factor uses as subfactors the existence of authorized but

EXHIBIT 15



BUSINESS FORUM
LONDON 22-24 APRIL 2001

Investment Profile

2001

Russian Federation



Held on the occasion of the
EBRD ANNUAL MEETING



The Council's mission is to assist in defining and developing an environment in Russia that:

- makes Russia a preferred investment alternative for foreign investors;
- ensures that foreign investment provides the desired benefits for the Russian economy;
- aligns foreign investment to the short and long-term goals of the government; and
- aligns foreign investment with the need to develop domestic industry.

The Council is a permanent body engaged in activities with three working groups: Image Enhancement, to improve the image of Russia for foreign investments; Internal Barriers, to identify and discuss ways to remove internal barriers to foreign investment; and External Barriers. The Ministry of the Economy, the Ministry of Finance and the Ministry of Foreign Economic Relations have been assigned the task of coordinating the work of these groups. Based on discussion with the FIAC, a Memorandum On the Policy of Attracting Foreign Investments to the Russian Economy in 1995 and Subsequent Years was signed by the Prime Minister and members of the Council. It includes legislative initiatives to stimulate the flow of foreign investments into the Russian economy based on the recommendations of the Council members.

The most recent meeting of the FIAC was held on 9 October 2000.

The discussion focused on the principal development trends in the Russian economy, the progress of and issues related to the implementation of the government's Economic Programme.

The government also committed itself to address on a priority basis the following issues raised at the FIAC working group meetings and the plenary session:

- Accelerating the full transition to International Accounting Standards;
- Accelerating the adoption of PSA legislation and enabling regulations;
- Removing regional and interregional barriers restricting investment and business activities;
- Improving tax, customs and currency laws;
- Improving the banking system in Russia;
- Improving the protection of investors' rights, including the stock market; and
- Adding value to commercial activities of enterprises

The **Russian American Business Council (RABC)**, a new lobbying group, has solicited the support of the Russian government and offers advice to the Prime Minister. The RABC is funded by its members, some 50 of Russia's largest firms, and will serve as a vehicle for Russian companies seeking access to US markets – for raising capital, locating strategic partners and finding distribution

channels for Russian goods. The RABC will also pressure the US administration to ease tariffs and rescind punitive anti-dumping measures against Russian steel firms. The president of the RABC is Yury Vorontsov, former US ambassador and long-time diplomat at the UN. One of the members of the supervisory board is Minister of Economic Development and Trade German Gref.

Privatisation and restructuring

Despite rapid large-scale privatisation in 1992-95, the Russian state sector remains extremely large. On 1 January 2001, according to the United Enterprise Register, there were 367,400 organisations with state or municipal ownership, 2,509,600 privately owned, and 144,500 with mixed ownership.

The privatisation process was slow in the second half of the 1990s and virtually stalled in 1999. Depressed asset prices and unclear policies resulted in modest and controversial privatisation achievements. The few high-profile privatisation deals of 1999, including the sale of minority government stakes in oil companies Lukoil and TNK, were characterised by limited transparency and favours to insiders. By contrast, in autumn 2000, the privatisation of oil company Onako, the second largest privatisation in Russian history, represented a transparent and competitive privatisation tender in which the highest bidder won.

The new government's reform programme has taken a new approach to privatisation and foresees a reduction in the number of state-owned companies to about 3,000 over the next few years. A detailed privatisation programme was submitted to the Duma together with the draft budget for 2001. The Duma has not yet approved the privatisation programme. The new policies aim for accelerated enterprise restructuring rather than maximum budget revenues. Privatisation of 20 major companies is earmarked for 2001, including the sale of smaller stakes in Gazprom, Lukoil, Syazinvest, Aeroflot, Rosneft, and Slavneft.

Restructuring

The authorities have made improved corporate governance a major priority. The Federal Securities Commission is preparing a new corporate governance code, to be introduced from mid-2001. On 8 December 2000 the Duma passed in first reading a package of amendments to the Law on Joint Stock Companies that is intended to strengthen the protection of minority shareholders' rights. The amendments represent the most important changes to the law since it was adopted in 1995.

As part of the government reform programme, there is now strengthened commitment to restructuring of the natural

EXHIBIT 16

Transition report 2000

Employment, skills and transition

Economic transition
in central and
eastern Europe,
the Baltic states
and the CIS

WYJSCIE

BRAMA
NR16



European Bank
for Reconstruction and Development

Table 2.1

Progress in transition in central and eastern Europe, the Baltic states and the CIS

Countries	Population (millions, mid-2000)	Private sector share of GDP in %, mid-2000 (EBRD estimate) ¹	Enterprises			Markets and trade			Financial institutions	
			Large-scale privatisation	Small-scale privatisation	Governance & enterprise restructuring	Price liberalisation	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions
Albania	3.3	75	2	4	2	3	4+	2-	2+	2-
Armenia	3.8	60	3	3+	2	3	4	1	2+	2
Azerbaijan	8.1	45	2-	3+	2	3	3+	2	2	2-
Belarus	10.2	20	1	2	1	2-	2-	2	1	2
Bosnia and Herzegovina	4.1	35	2	2+	2-	3	3	1	2+	1
Bulgaria	8.1	70	4-	4-	2+	3	4+	2+	3	2
Croatia	4.5	60	3	4+	3-	3	4+	2+	3+	2+
Czech Republic	10.3	80	4	4+	3+	3	4+	3	3+	3
Estonia	1.4	75	4	4+	3	3	4+	3-	4-	3
FYR Macedonia	2.0	55	3	4	2+	3	4	2	3	2-
Georgia	5.4	60	3+	4	2	3+	4+	2	2+	2-
Hungary	10.0	80	4	4+	3+	3+	4+	3	4	4-
Kazakhstan	14.8	60	3	4	2	3	3+	2	2+	2+
Kyrgyzstan	4.7	60	3	4	2	3	4	2	2+	2
Latvia	2.4	65	3	4+	3-	3	4+	2+	3	2+
Lithuania	3.7	70	3	4+	3-	3	4	3-	3	3
Moldova	4.3	50	3	3+	2	3+	4	2	2+	2
Poland	38.7	70	3+	4+	3	3+	4+	3	3+	4-
Romania	22.3	60	3	4-	2	3	4	2+	3-	2
Russia	145.4	70	3+	4	2	3	2+	2+	2-	2-
Slovak Republic	5.4	75	4	4+	3	3	4+	3	3	2+
Slovenia	2.0	55	3	4+	3-	3+	4+	3-	3+	3-
Tajikistan	6.3	40	2+	3+	2-	3	3+	2-	1	1
Turkmenistan	5.1	25	2-	2	1	2	1	1	1	1
Ukraine	49.5	60	3-	3+	2	3	3	2+	2	2
Uzbekistan	24.9	45	3-	3	2-	2	1	2	2-	2

¹ The "private sector shares" of GDP represent rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector value added includes income generated by the activity of private registered companies as well as by private entities engaged in informal activity in those cases where reliable information on informal activity is available. Here the term "private companies" refers to all enterprises in which a majority of the shares are owned by private individuals or entities. The roughness of the EBRD estimates reflects data limitations, particularly with respect to the scale

of informal activity. The EBRD estimates may in some cases differ markedly from available data from official sources on the contribution to GDP made by the "private sector" or by the "non-state sector". This is in most cases because the definition of the EBRD concept differs from that of the official estimates. Specifically for the CIS countries, official data in most cases refer to value added in the "non-state sector" – a broad concept which incorporates collective farms as well as companies in which only a minority stake has been privatised.

Classification system for transition indicators¹

Large-scale privatisation

- 1 Little private ownership.
- 2 Comprehensive scheme almost ready for implementation; some sales completed.
- 3 More than 25 per cent of large-scale enterprise assets in private hands or in the process of being privatised (with the process having reached a stage at which the state has effectively ceded its ownership rights), but possibly with major unresolved issues regarding corporate governance.
- 4 More than 50 per cent of state-owned enterprise and farm assets in private ownership and significant progress on corporate governance of these enterprises.
- 4+ Standards and performance typical of advanced industrial economies: more than 75 per cent of enterprise assets in private ownership with effective corporate governance.

Small-scale privatisation

- 1 Little progress.
- 2 Substantial share privatised.
- 3 Nearly comprehensive programme implemented.
- 4 Complete privatisation of small companies with tradable ownership rights.
- 4+ Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradability of land.

Governance and enterprise restructuring

- 1 Soft budget constraints (tax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance.
- 2 Moderately tight credit and subsidy policy but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance.
- 3 Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (e.g. through privatisation combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation).
- 4 Substantial improvement in corporate governance, for example, an account of an active corporate control market; significant new investment at the enterprise level.
- 4+ Standards and performance typical of advanced industrial economies: effective corporate control exercised through domestic financial institutions and markets, fostering market-driven restructuring.

Price liberalisation

- 1 Most prices formally controlled by the government.
- 2 Price controls for several important product categories; state procurement at non-market prices remains substantial.
- 3 Substantial progress on price liberalisation: state procurement at non-market prices largely phased out.
- 4 Comprehensive price liberalisation; utility pricing which reflects economic costs.
- 4+ Standards and performance typical of advanced industrial economies: comprehensive price liberalisation; efficiency-enhancing regulation of utility pricing.

Trade and foreign exchange system

- 1 Widespread import and/or export controls or very limited legitimate access to foreign exchange.
- 2 Some liberalisation of import and/or export controls; almost full current account convertibility in principle but with a foreign exchange regime that is not fully transparent (possibly with multiple exchange rates).
- 3 Removal of almost all quantitative and administrative import and export restrictions; almost full current account convertibility.

- 4 Removal of all quantitative and administrative import and export restrictions (apart from agriculture) and all significant export tariffs; insignificant direct involvement in exports and imports by ministries and state-owned trading companies; no major non-uniformity of customs duties for non-agricultural goods and services; full current account convertibility.
- 4+ Standards and performance norms of advanced industrial economies: removal of most tariff barriers; WTO membership.

Competition policy

- 1 No competition legislation or institutions.
- 2 Competition policy legislation and institutions set up; some reduction of entry restrictions or enforcement action on dominant firms.
- 3 Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates; substantial reduction of entry restrictions.
- 4 Significant enforcement actions to reduce abuse of market power and to promote a competitive environment.
- 4+ Standards and performance typical of advanced industrial economies: effective enforcement of competition policy; unrestricted entry to most markets.

Banking reform and interest rate liberalisation

- 1 Little progress beyond establishment of a two-tier system.
- 2 Significant liberalisation of interest rates and credit allocation; limited use of directed credit or interest rate ceilings.
- 3 Substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalisation with little preferential access to cheap refinancing; significant lending to private enterprises and significant presence of private banks.
- 4 Significant movement of banking laws and regulations towards BIS standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises; substantial financial deepening.
- 4+ Standards and performance norms of advanced industrial economies: full convergence of banking laws and regulations with BIS standards; provision of full set of competitive banking services.

Securities markets and non-bank financial institutions

- 1 Little progress.
- 2 Formation of securities exchanges, market-makers and brokers; some trading in government paper and/or securities; rudimentary legal and regulatory framework for the issuance and trading of securities.
- 3 Substantial issuance of securities by private enterprises; establishment of independent share registries, secure clearance and settlement procedures, and some protection of minority shareholders; emergence of non-bank financial institutions (e.g. investment funds, private insurance and pension funds, leasing companies) and associated regulatory framework.
- 4 Securities laws and regulations approaching IOSCO standards; substantial market liquidity and capitalisation; well-functioning non-bank financial institutions and effective regulation.
- 4+ Standards and performance norms of advanced industrial economies: full convergence of securities laws and regulations with IOSCO standards; fully developed non-bank intermediation.

¹ The classification system is simplified and builds on the judgement of the EBRD's Office of the Chief Economist. More detailed descriptions of country-specific progress in transition are provided in the transition indicators at the back of this Report. The classification system presented here builds on the *Transition Report 1994*. To refine further the classification system, pluses and minuses have been added to the 1-4 scale since 1997 to indicate countries on the borderline between two categories. The classification 4* which was used up to and including 1996 has been replaced with 4+, though the meaning of the score remains the same.

EXHIBIT 17



Work in progress
for public discussion

WORLD BANK TECHNICAL PAPER NO. 471
*Europe and Central Asia Poverty Reduction and Economic
Management Series*

WTP471
June 2000

Dismantling Russia's Nonpayments System

Creating Conditions for Growth



*Brian Pinto
Vladimir Drebensov
Alexander Morozov*

Economic Costs of Nonpayments

Nonpayments has been fiscally costly, has become a critical constraint to economic growth in Russia, and has had ambiguous welfare effects. It has also diluted the credibility of the key strategic reforms undertaken as part of Russia's transition to a market economy.

As is clear from figure 1, nonpayments has been fiscally costly, raising public debt to levels that forced the macroeconomic crisis of August 1998. In retrospect, given the scale of subsidies implicit in nonpayments—estimated in Chapter 3 at 4 percent of gross domestic product (GDP) per year from the energy monopolies alone—it is not surprising that the stabilization collapsed. All that was achieved was a temporary reduction in inflation. The reason is that nonpayments impeded fiscal consolidation so that, in reality, the government had only two choices: either higher debt today with higher inflation tomorrow; or higher inflation today. The former path was chosen. Thus, with nonpayments, stabilization can at best be temporarily achieved and will finally not be credible because of its adverse impact on the fiscal deficit through the erosion of the tax base.

Nonpayments has also prevented attainment of another key strategic goal: the resumption of growth.³ The reason is that by softening budget constraints, nonpayments has destroyed the incentives for enterprises to restructure and use inputs and existing assets more efficiently. As will be discussed in Chapter 4, a new industrial organization has resulted, based on an alliance of interests between managers of viable and nonviable companies, who have had strong incentives to collude and partly siphon off the implicit subsidies. This has fueled corruption, asset stripping, and capital flight. At the same time, by distorting prices, nonpayments has prevented the new relative prices, which resulted from liberalization, from serving as clean signals for resource allocation.⁴ Growth gets stifled, as there is little incentive for efficient companies or new entrants to invest more and increase output in this climate.

A key finding of this report is that the process of institutionalizing nonpayments has been incentive-driven. In other words, Russia's economic problems have resulted from distorted incentives in addition to weak institutions. While a strong institution such as a Federal Treasury is obviously important, distorted incentives might have unnecessarily delayed institution building: consider the vested interests of "authorized banks" that benefited from Russia's weak Federal Treasury. Further, in this atmosphere, tax rules have meant little, as taxes are effectively tailored to individual companies, corrupting the formal tax system and the credibility of tax enforcement and further weakening the development of public institutions. For the system of nonpayments to have grown and flourished would have been almost impossible without the active support of the government. As Chapter 2 will show, this has indeed been the case.

Lastly, the positive welfare impact of nonpayments, in its potential role as an informal social safety net, is at best ambiguous, as discussed later in this Executive Summary and in Chapter 5. Thus, nonpayments has impeded growth while making a questionable contribution to equity.

Key Questions Looking Forward

In many ways, Russia once again faces the same problems that it faced when it began its stabilization and structural adjustment efforts in 1995: it must meet the challenges of fiscal management, provide lasting stabilization, and create a foundation for sustainable growth. A crucial difference is that these must be achieved in an environment where access to commercial public borrowing will be severely limited. The key questions are:

³ The rebound in output following the big devaluation in 1998 is a special case discussed below.

⁴ Pricing in the context of NCS is to a large extent arbitrary, and determined more by personal enrichment goals rather than maximization of enterprise profits.