From the Iron Fist to the Invisible Hand: a Comparative Analysis of Investment Trends and Political Economic Reform in Post-Soviet Russia.

by

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Introduction

The transition of Russia from the Soviet empire to a democratic state has long been mired in controversy. Allegations of widespread corruption, political suppression, and a disturbing trend toward authoritarianism have dominated the news, leaving some to comment that these recent trends have "systematically diluted the country's nascent democratic institutions."[1] This clearly affects political risk, one of the biggest determinants of emerging market investments, as investors become principally concerned of the vulnerability of their dedicated assets. In Russia, with a government still not dedicated to transparency and a reform structure that is haphazard and often contradictory, political risk is markedly high. The Economist reports that issues in legal risk, such as enforcement and interpretation, coupled with problems in effective infrastructure and administrative development have greatly heightened the risk of investment in Russia, threatening revenue streams and raising financing costs for both equity investments as well as greenfield developments[2].

Yet controversy inevitably comes with transition, and Russia is no stranger to change. Although often limited to one, the data and analysis collected shows Russia has in fact had two distinct transitions; one that began in 1989 and ended in 1998, and another transition in 1998 that continues today. The first is the familiar Washington Consensus-driven transition, which established the fundamentals for Russia's capitalism. The second transition is a direct result of the catastrophic debt default and currency devaluation, which effectively forced the Russian government to address issues of capital flight, taxation and fiscal reform, and overall monetary reform. These reforms, as will be

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[1] Aslund, Anders. "Reverse is the One Way Out of this Cul-de-Sac" *Moscow Times.* 14 February 2007
[2] "Russian Political Economy Review". *EIU World Investment Service*. March 2007. pgs. 8-10

shown, have transformed the market-government relationship; no longer is it adversarial, and no longer does the risk of government planning overtaking market control preclude investor interest. Indeed, as the government further liberalized the economy while strengthening underlying institutions, investors regained confidence in Russia's fragile marketplace. In spite of corruption and an under-developed infrastructure, Russia is an enigmatic beneficiary; it has simultaneously captured the world's attention, but alienated the world's conscience. It has done so by liberalizing the market enough for it to be buffered, and in some ways immune, from government control, and consequently the spectre of government ownership lacks the accompanying fear of government planning. Thus, despite the disturbing political trends surrounding Russia, the marketplace remains immune, as investors have interpreted Russia's second transition as a sign that the free market is much more strongly developed now then ever before.

This investor confidence can be clearly seen in the graph below. Since 1995, the Russian Trading System (RTS), the benchmark index in Russia, has returned a remarkable 2015.62% (on a monthly basis).[3] Even after the currency devaluation and debt default, the RTS regained its pre-default level in about 1 year. Additionally, investor sentiment is unflinchingly positive, and surveys have shown foreign investors and companies ready and willing to expand their investments in Russia.[4] Even on a sector-by-sector basis, there is little change in the positive sentiment. Moreover, equity IPOs have risen in Russia, with 2006 being a landmark year with 16 domestic IPOs[5].

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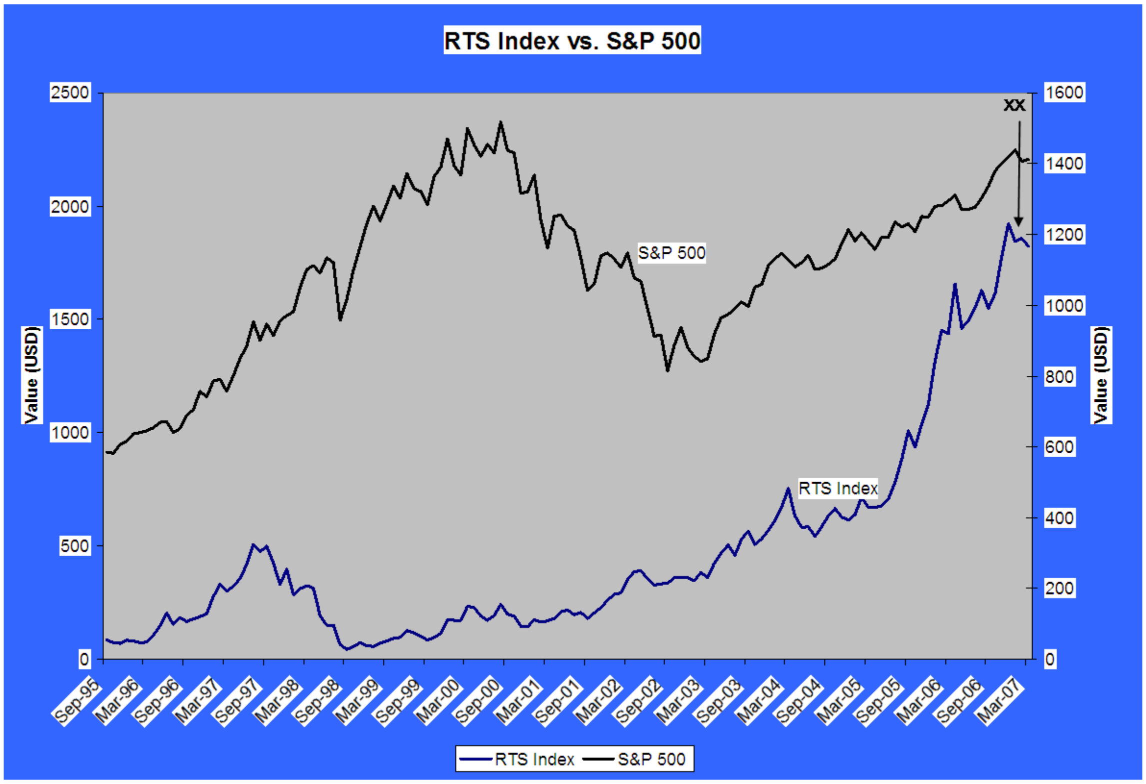
[3] See Exhibit A
[4] "Russian Political Economy Review". *EIU World Investment Service*. March 2007. pg. 11
[5] Data from Russian Trading System (RTS)

Chart 1:



Typically, their omission is due to size, which is factored into the pricing of the sectors. Considering IPO data, there is clear exuberance in the Russian equity markets. Performance is positive, issuance is robust, and FDI flows have matched that positive sentiment, increasing rapidly especially after 2002[6]. One wonders whether any of the investors in Russia listen to the news at all.

In the data presented, the Russian index has been limited to the top 70 firms in the RTS, with some coming from the RTS Index, the institutional equivalent to the Dow Jones Industrial Average in the United States. Also, the RTS itself designates sectoral indices in five areas: Oil & Gas, Industrial, Consumer and Retail, Metals and Mining, and Telecom. Graphical data by sector is derived from these indices, while overall RTS

[6] "Russian Political Economy Review". *EIU World Investment Service*. March 2007. pg. 13

data includes companies from the RTS Index, as well as those in the sectoral indices that are not in the RTS Index.

The upward surge in Russian interest, and its remarkable maintenance in spite of its perilous context, forms the core of this paper. We analyze returns and issuance in a political context – how does the ever-changing corporate governance landscape affect the RTS? How do political and national failures like the Ukrainian gas trade dispute, the Beslan school siege, and the Moscow Theatre scare affect market sentiment, if at all? And perhaps most relevant given the coming election, does the change in pace of the democratic revolution impact the flows of capital into Russia, and is there any economic incentive for the Russian government to favor democracy? The data shows that the reforms passed in Russia, especially after the 1998 default and devaluation, have created a strong free-market will, and this will has effectively gained immunity from political vagaries. It has solidified the belief that the market is there to stay, even in the face of government takeovers; indeed, state-control no longer implies state planning, and this dichotomy has bolstered equity performance and issuance in spite of trends towards government acquisitions in nearly every sector. Investor confidence simply ignores the threat of political intervention, for it sees that such a threat would not materially affect operations.

History of Privatization in Russia

Imperative to any analysis of Russia is first an understanding of its context, and the dynamics and milestones in the privatization of the Russian economy. After the fall of the Berlin Wall, and the dissolution of the Soviet Union, Mikhail Gorbachev was faced with the unenviable task of reforming the aging government in Russia, and somehow reconciling burgeoning democratic tendencies with old-guard Soviet authoritarianism. However, such a task was nearly impossible, with the Kremlin being pulled in multiple directions, and simply unable to reach a peaceful consensus between the "divided and polarized" elites who were either calling for democratic reform or more autocracy[7]. Ultimately, Gorbachev fell, and was replaced by a young reformer named Boris Yeltsin, who undertook a massive reforming scheme that included a dedicated ministry to privatization. This ministry was led by Anatoly Chubais, who worked heavily with the U.S. Department of Treasury mapping out a plan for privatizing Russia.

The plan that was finalized is known today as the Washington Consensus, developed by members of the World Bank, the US Treasure and Council of Economic Advisors, and other bureaucrats from international monetary organizations. The three "pillars" of the Washington Consensus are Privatization, Liberalization, and Stabilization[8]. These pillars were meant to form the basis of transition for any nation that was once under a centrally-planned or authoritative government. However, most controversial with this Consensus was the speed at which it was implemented. "Shock therapy" was the term developed to describe the rapid and often sudden liberalization of prices and state economic controls, as well as the liquidation and sale of state assets[9]. One of the biggest proponents of this policy was Andrei Shleifer, a member of the team led by Yegor Gaidar, the acting prime minister for the second half of 1992. It was Shleifer who, in his seminal book *Privatizing Russia*, advocated that the "principal

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[7] McFaul, Michael. "Evaluating Yeltsin and his Revolution." *Russian After the Fall.* Andrew Kuchins, Editor. Carnegie Endowment for International Peace, 2002. pg. 28-29
[8] Stiglitz, Joseph. *Globalization and its Discontents*. W.W.Norton & Company, New York: 2002. Pg. 53.
[9] Aslund, Anders. "Ten Myths about the Russian Economy." *Russia After the Fall.* Andrew Kuchins, editor. Carnegie Endowment for International Peace, 2002: pg. 112-114

objective of reform was, therefore, to de-politicize economic life."[10] Part of this plan was the "big-bang" reform implemented around the Eastern European theater, including most-notably Poland and Russia.[11] Big-bang and shock therapy are two euphemisms for the mass eradication of state interaction in economic life. Shleifer notes that "the goal of privatization was to sever the links between enterprise managers and politicians, including both the Moscow industrial ministers and local officials, so as to force firms to cater to consumers and shareholders rather than politicians."[12] Thus, the aim of privatization was to give the economy legs to stand on, and one major part of this was to develop a set of shareholder; namely, the private citizen. In Russia, this was done through a voucher system, where state-assets were auctioned off to citizens, and a premature market was born where citizens could buy up to 29% of the assets of many important firms. Russian vouchers, which differed markedly from those in other nations, could be exchanged for cash and were freely tradeable, in an effort to build citizen support and allow for the development of large investors, who could buy up large amounts of vouchers to effectively buyout a firm.[13]

The use of these vouchers was a centralized process, yet was effective in jolting the private sector. However, while economic transition was being undertaken, the Russian government quickly found itself in a political bind – with transition causing many negative externalities to the common populace, the so-called "Red Directors" who controlled powerful industries and firms were clamoring for a return to power. During the voucher privatization, the state maintained control over certain firms that primarily

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[10] Boycko, Maxim et al. *Privatizing Russia.* The MIT Press, Cambridge: 1997. pg. 11.
[11] Sachs, Jeffrey. *Poland's Jump to the Market Economy.* The MIT Press, Cambridge: 1993. pg. 8, 9, 58, 59
[12] Boycko, Maxim et al. *Privatizing Russia.* The MIT Press, Cambridge: 1997. pg. 11.
[13] Boycko, Maxim et al. *Privatizing Russia.* The MIT Press, Cambridge: 1997. pg. 85-94.

operated with natural resources, most especially oil and gas. These firms were referred to as the "commanding heights," as they represented the majority of industrial production as well as most of the wealth in the nation, and were controlled by these Communist Red Directors[14]. During this time, there was a fear that these directors, who were "not attracted to the new regime," would return to power. To prevent the reversal of what was groundbreaking reform, the pivotal loans-for-shares program was implemented, which allowed powerful banks (including Menatep, run by Mikhail Khodorkovsky) to loan money to the Yeltsin administration in exchange for controlling shares of the commanding heights.[15] It was thought that the Russian government would repay these loans, however they never did; as a result, the large banks seized the assets, at a fraction of their value. This was a determining factor for the future of the Russian economy, and possibly the most controversial decision in the transition era. It was known that "the major motive at that moment was a political one," and even Gaidar admits that "a great many characteristically unpleasant features of Russian capitalism today were brought about as a result of that series of compromises."[16] Indeed, the rise of oligarchic capitalism can be directly attributed to this program.

By 1995, more than half the Russian GDP, which was admittedly shrinking, was produced by the private sector, and inflation was reduced relative to previous years by that time as well[17]. By 1995, the measures of shock therapy were fully implemented, and the results of mass privatization were beginning to show in Russian economic

[14] Video: *PBS Series Commanding Heights: Loans-for-Shares.* 2003, PBS.org

[15] This is by far a shortened version of the entire program. For a more detailed exposition, read: Klebnikov, Paul. *Godfather of the Kremlin: The Decline of Russia in the Age of Gangster Capitalism.* New York: Harcourt, Inc, 2000.

[16] "Naïve Capitalism" Interview with Yegor Gaidar. *Up for Debate: Privatization: Who Wins? Russia's Reform Compromise.* PBS Commanding Heights Series, 2003.

[17] Shleifer, Andrei. *Government in Transition.* Lecture at Harvard University, October 1996.

performance. That year, GDP growth was -4% and end-year consumer prices were at 128.6% of the previous year, showing an economy that was still lethargic and weighed down by the vestiges of the communist bureaucracy. However, by the end of 1995, the and it was clear that economic growth was slowly picking up, with GDP growth rising to 1.4% in 1997, and inflation lowered to 11.8% that same year[18].

Current Economics

Russia's macroeconomy today is outpacing its past rates by many multiples, and much of that can be attributed to a geoeconomic condition that favors Russia's natural resource wealth. Price appreciation in oil, natural gas, and precious metals have been incredibly beneficial to Russian firms engaged in the production and export of these goods, and it is these "commanding heights" that form a large portion of the national economy. The Council on Foreign Relations reports that exports of metals have risen 61% from 2004-2006, chemicals rose 28%, and increasing oil production efficiency now accounts for 50% of the worldwide increase in oil production. This increase in production shows a definite improvement in operational efficiency, a major issue that plagued the input-heavy Soviet economy.

In addition, Russia has seen fiscal surpluses for 5 consecutive budgets, and the Putin administration has diligently put away contingency funding in the event of a major commodity price contraction[19]. By early 2006, this Stabilization Fund reached $50 billion, and is continuously growing, with President Putin stating that "[the Stabilization Fund] is part of the federal budget and its means are intended first of all for strengthening

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[18] "Macroeconomic Focus." *ISI Emerging Markets: Russia* and EIU Country Data, Russia.
[19] Independent Task Force Report No. 57. *Russia's Wrong Direction: What the United States Can and Should Do.* Council on Foreign Relations: New York, 2006. pg. 11-13

the financial system, balancing the budget, and curbing inflation in the country," and "may be used to finance the deficit of the federal budget if oil process plummet in the world market [sic]."[20] Russia's current market state shows clear robust growth, and the government is paying attention to the potential for a downfall in the commodity boom.

Figure 1

Comparison of Flows	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
GDP growth	*10.00%*	*5.10%*	*4.70%*	*7.30%*	*7.10%*	*6.40%*
Foreign direct investment, net inflows ($thousands)	$2,714,230	$2,748,286	$3,461,132	$7,958,120	$15,444,370	$15,151,410
Portfolio equity flows ($thousands)	$150,200	$542,400	$2,626,200	$421,800	$233,400	-$215,200
Total Flows	$2,864,430	$3,290,686	$6,087,332	$8,379,920	$15,677,770	$14,936,210

With continuous budget surpluses and GDP growth surging at 6.5% by the end of 2006, FDI inflows picked up into Russia. Figure 1 above is a chart showing post-2000 increase in GDP growth, and the corresponding rise in foreign-direct-investment and portfolio flows into Russia, a sign of increased foreign confidence and interest in the market[21]. FDI specifically is an interesting case – Russia lagged other nations during the 1990s, but after the 1998 default and currency devaluation, and when output appeared to rebound (within 1 year, with GDP growing at 6.4% in 1999, after contracting 5.3% in 1998), FDI began to rise, as did foreign investments by Russian firms[22]. In his recent speech to the 43rd Munich Conference on Security Policy, Putin noted that "up to 26% of oil extraction in Russia is done by foreign capital," boasting of Russia's attraction as a place for confident foreign investment.[23] For example, Lukoil, one of Russia's largest listings on the RTS, owns more than 2,000 retail gas stations in the United States[24]. This

[20] "Putin says Stablisation Fund to be used for financial stability [sic]." *ITAR-TASS Weekly News.* July 12, 2006.
[21] Statistics drawn from "Global Developmental Finance: Russian Federation" from *The World Bank.*
[22] Statistics drawn from ISI Emerging Markets and EIU Country Report.
[23] Putin, Vladimir. *Speech at 43rd Munich Conference on Security Policy.* Transcript, 10 February 2007.
[24] Independent Task Force Report No. 57. *Russia's Wrong Direction: What the United States Can and Should Do.* Council on Foreign Relations: New York, 2006. pg. 12

confidence in economics, fiscal and monetary policy, and private sector investment shows that Russia has indeed come a long way from its days of shaky transition.

However, while official statistics paint a positive picture, the reality is that the Russian economy is incredibly murky. Transparency International ranks Russia equal to Rwanda, Swaziland, and Honduras at 121st among nations in combating corruption. By comparison, Poland ranked 61st, the Czech Republic at 46th, and the best nation in the Eastern European region is Estonia at 24th.[25] This is a definite failure on the part of the Russian government to control the extra-legal aspects of business. In addition, Russia is lagging in basic infrastructure development. While ranked highly in price liberalization and small-scale privatization, Russia has low scores for Road development, Water and Waste management, and Overall Infrastructure Reform, according to the European Bank for Reconstruction and Development's Transition Report of 2006[26]. It appears that while economic theory is in practice, in terms of the liberalization of prices and trade, reforms have not been implemented or enforced with regard to human needs, such as services and infrastructure. This is a potential problem, especially for a nation with a sizable population in poverty, such as Russia.[27] Additionally, this could pose a threat for future foreign investment and greenfield development, the type that goes beyond simple portfolio equity but also seeks to include business and enterprise development.

The Emergence of the Russian Trading System

[25] *Corruption Perceptions Index 2006.* Transparency International. 2006. www.transparency.org
[26] EBRD Country Transition Report, 2006: Russia
[27] Blasi, Joseph et al. *Kremlin Capitalism: Privatizing the Russian Economy.* Cornell University Press, Ithaca: 1997. pg. 119-121

In July of 1995, trading commenced on the Russian Trading System, and an era of free market capitalism began in Russia. This RTS was a modest exchange, but by September the RTS-Index was founded, which is comprised of the "blue-chip" Russian stocks, and is approximately 85% of the entire market capitalization of the RTS[28]. The RTS Index acts as the main benchmark quoted for the Russian stock exchange, although there are other indices that provide securities exchange operations: the MICEX, for currency exchange, and the St. Petersburg Stock Exchange. However, for the purposes of this paper, the RTS Index was used as the benchmark index, as well as the source for all IPO data. The introduction of the RTS was a major step for Russian finance, as it provided a tool for the "commanding heights" not only to raise equity capital, but also for foreign investors to invest in Russian growth. Politically, the existence of a stock market furthered the idea that there would be minority shareholder interest, although at the time of induction there were few laws protecting small shareholders (it wasn't until 1996, 1998, and 2000 when legislation was introduced to help minority shareholders maintain control). Since 1995, the RTS has been volatile but also growing in turnover (shares traded), and has provided a credible proxy for macroeconomic performance in Russia, as it is heavily linked to commodity prices. In fact, 57% of the GDP is done by one sector (oil and gas), and nearly 40% of the Index is comprised of two firms – Rosneft and Gazprom[29]. The risk with this tilt is that conglomerate commodity companies become the dominant play in the Russian trading market, and also run the risk of major linkage to the government due to contractual obligations and political relationships. For example, Gazprom is chaired by Dmitry Medvedev, who also is the First Deputy Prime Minister of

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[28] *Annual Report of the Russian Trading System*, 2002.
[29] Russian Political Economy Review". *EIU World Investment Service*. March 2007. pg. 3

Russia, and a leading presidential candidate; perhaps more startlingly, the Russian government now owns a controlling stake of 50.002% as of 2006[30].

Figure 2:

Since its inception, the RTS has outperformed most equity markets on a relative basis, and as noted earlier, returned over 2000% since 1995. However, there have been times of high volatility and uncertainty, most notably the 1998 debt default, which will be explained in depth in the sections regarding reform. Before 1998, there were 41 IPOs for the RTS Index, and Figure 2 above indicates the sector distribution of these IPOs into the RTS Index[31]. The clear heavyweight in this time were the oil & gas firms; as the government liberalized pricing and encouraged trade, the controlling shares banks had gained during the loans-for-shares program were enhanced through the raising of equity

IPO Matrix	Total	Industrial	Oil & gas	Telecom	Consumer & F	Metals and Mining
1995	**21**	3	8	4	1	5
1996	**7**	0	2	5	0	0
1997	**9**	1	1	3	2	2
1998	**4**	2	2	0	0	0
1999	**0**	0	0	0	0	0
2000	**1**	0	1	0	0	0
2001	**6**	0	3	0	2	1
2002	**3**	0	0	1	2	0
2003	**4**	2	0	0	0	2
2004	**5**	1	1	0	3	0
2005	**4**	1	0	1	2	0
2006	**6**	0	2	0	2	2
Total	**70**	*10*	*20*	*14*	*14*	*12*

capital, to allow for even more robust performance. However, at this time, Russia was heavily dependant on the surge in oil prices, and this left the economy exposed to any major shift in prices. With the 1997 Asian financial crisis raising interest rates, demand for oil unexpectedly fell, and prices subsequently dove more than 40% in six months. This left Russia in prime condition for a currency devaluation, since they would no

[30] http://eng.gazpromquestions.ru/page4.shtml -- Gazprom company website
[31] www.rts.ru/eng Data compiled from historical trades.

longer have sustainable profitability in the oil sector[32]. With the currency unsustainable, and inflation rising to over 84%,[33] foreign governments lost confidence in Russian debt and a default occurred, with the Russian Treasury bill rate rising to over 56%[34].

This was disastrous to the Russian economy at the time, however the default was not necessarily permanently debilitating. The devaluation crisis, in fact, spurred the Russian government to push forward more radical policies toward reform, and protect against undue foreign reliance as well as protection against over-reliance on the commodity industry. Post-1998, the GDP bounced back, and the Duma (the Russian Parliament) began a period of important fiscal reform and balance sheet regulation that had previously been major factors in the default.[35] The RTS reacted as expected: there were no IPOs in 1999, and the index fell dramatically (from 325.5 in March of 1998 to 55.12 in January 1999), but the index began a steady rise by mid 1999, less than a year after default.[36] Post-1998, the RTS became more independent, and functionality increased greatly, allowing for more technology to facilitate trading, as well as a greater independence of and confidence in the market, in spite of the government.

Market Immunity from Government Actions

Joseph Stiglitz provides a particularly biting response to the positive sentiment post-1998 in his Nobel Prize winning book *Globalization and its Discontents*, stating "the

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[32] Stiglitz, Joseph. *Globalization and its Discontents*. W.W. Norton & Company, New York: 2003. pgs 142-147

[33] Data from ISI Emerging Markets

[34] EIU Country Data Profile: Russia

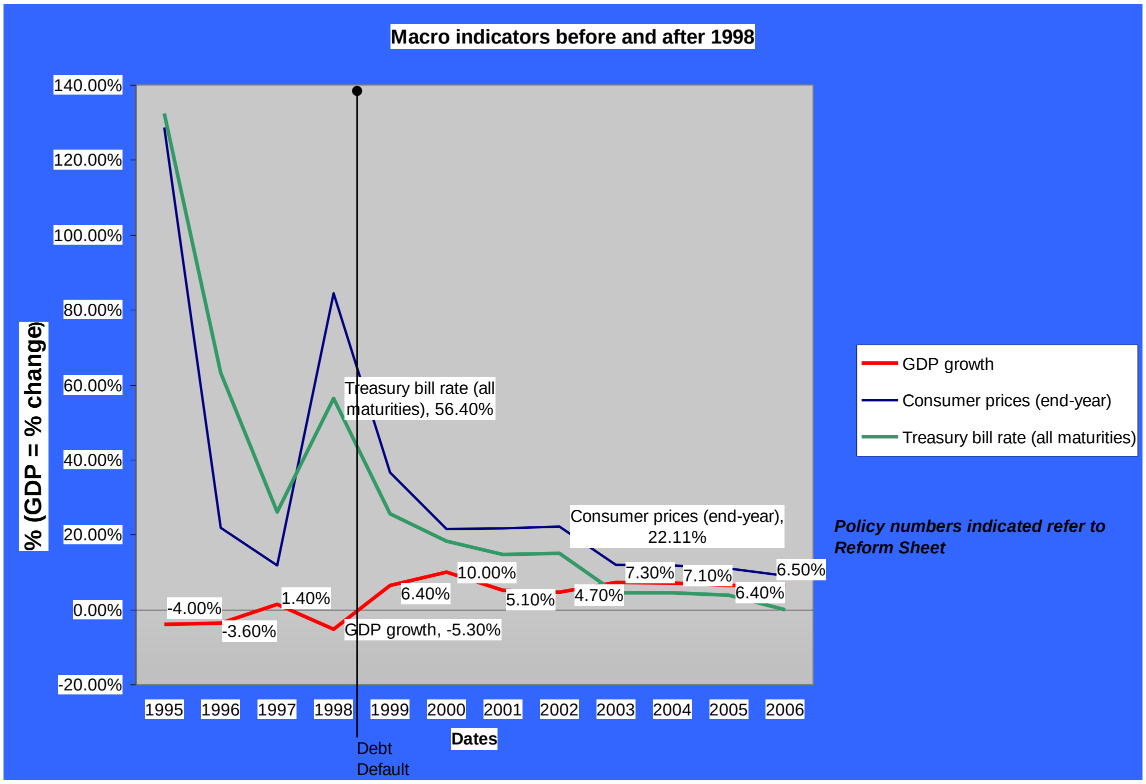
[35] Pinto, Brian et al. "Lessons from the Russian Crisis of 1998 and Recovery." *Managing Volatility and Crises: a Practitioners Guide*. February 2004. This provides an important mathematical assessment of both the cause of and market rebound from the Crisis, including an analysis of the swap and liquidity markets, both of which were hindered by improper government reform (or lack of reform).

[36] RTS Historical Pricing Data

failures of the reforms that were advocated go far deeper – to a misunderstanding of the very foundations of a market economy," and "in hindsight, it is clear that many of the political forecasts of those involved in the reform process were far from clairvoyant; many worries seem, by and large, not to have materialized, while political developments which should have been of concern were not anticipated.[37]" He argues here that the government's inability to understand the basic needs of the market are at fault; yet, within a year, the economy appears to have rebounded and the RTS showed signs of strength, even before many of the important reforms were implemented. The default allowed the market to overcome some debilitating tendencies of the Russian market, such as foreign borrowing, illiquidity, and adherence to administrative regulations. Perhaps this is irrational exuberance on the part of Russian and foreign investors, however at the same time the drastic fall in currency and bond prices opened the door to more radical reform that, otherwise, might not ever have been considered. 1998's crisis showed the Russian government the effect of myopic reform, but perhaps more importantly, showed the market that it *can* determine the future of reform in Russia, instead of the other way around. Chart 2 shows GDP, inflation, and the t-bill rate before and after default, which shows a recovery by the Russian government within 2 years of default. This is partially possible due to an economy largely controlled by private owners, rather than the government, and the ability of these firms to push forth reform, rather than the standard vice versa.

[37] Stiglitz, Joseph. "Whither Reform? – Ten Years of the Transition." Paper presented at Annual Bank Conference on Development Economics. Washington DC, 1999: pgs. 129, 130.

Chart 2:



Additionally, it appears that the private sector, whose deterioration in 1998 obligated the government's rescue plan, gave the market more freedom from improper government control, augmenting control of the market, and allowing it to move in its own direction with even less relevance to political events. It is precisely the fear that improper policymaking would create another 1998 crisis that has allowed the RTS, and the rest of the economy, to rebound and post such positive performance. Because of this fear, the Russian government took on massive reform after 1998, and these reforms not only aided minority shareholders, but over time, it became true that the market was increasingly immune to political actions, even government takeovers, with the implicit understanding that state-control would not imply state-planning.

Going forward, the reforms to be analyzed will systematically show that the liberalization of the market, especially post-1998, allows the RTS to operate independently of political events. This is not to say that the reforms by the government have no effect; rather, cumulatively, the RTS Index constituents have gained independence to such an extent that investor confidence includes a sense of newly formed *disconnection* to the failures (or successes) of politics in Russia. By liberalizing the Russian stock market, and allowing the private sector to access equity and liquid debt capital more easily, the government has effectively limited its effect on the performance of the Russian economy. More than that, it has also given confidence to the market foundations in Russia, and lent credence to the idea that state control and state planning are not mutually inclusive. Indeed, even the idea of a government takeover does not necessarily adversely affect minority holders, nor does it imply that the government seeks to collectivize the economy once more. Since such a contention necessarily requires empirical evidence, we will additionally analyze the effect of important reforms on the market for the RTS Index, as well as for IPOs in Russia. There will be no attempt to quantify investor confidence, however it can be easily inferred through volume, performance, and portfolio equity flows into Russia, all of which has increased since 1998. We show that this disconnection from the government, by the government, explains the unflagging success of Russia as an investment destination, in spite of political vagaries that would otherwise endanger the rate of return of one's investment.

Reforming the Fiscal Economy

After the induction of the RTS in 1995, it was clear that the preliminary stages of shock therapy were over. Indeed, it is mostly agreed that "[Russia] now is a market economy, with a strong and growing private sector asserting its needs," and despite the word of Stiglitz and others, reform has allowed it to enter into this market stage[38]. Parts of this transition were the liberalizing reforms, begun predominantly in 1998, which has allowed the market to distance itself from politics. A major acknowledgement was made in September 1999, as to a strategic approach to privatization. This was the Russia State Property Management and Privatization Concept, approved in the Duma, and assessing the management of state goods[39]. This Concept was extremely important, as it reversed a trend from January 1998 of the "suspension of the privatization process." In 1998, this was achieved by restrictions on foreign borrowing and ownership, partially to prevent capital flight. However, the policies that were supposed to accompany this policy (such as increasing competition, and helping small and medium enterprise) never occurred. Thus, Resolution 1024 was particularly important when it stated "that the state is incapable of an efficient management of its property under current circumstances." [40]

This led ultimately to the creation of many joint-stock companies, some of which are traded today on the RTS. This jump-starting of the privatization process was a boon to the private sector, which desperately needed improved efficiency. In addition to this, there was also important progress made in bankruptcy law towards freeing up firms, including lifting the moratorium on insolvency claims, implemented during the 1998 crisis when banks were under duress due to indebtedness held on and off their balance

[38] Shleifer, Andrei. *Government in Transition.* Lecture at Harvard University, October 1996.
[39] Russian Government Resolution No. 1024, Duma, 9 September 1999
[40] Vasiliev, S.A. *Overview of Structural Reforms in Russia after 1998 Financial Crisis.* 16 February 2000.

sheet[41]. Again, this fosters the privatization scheme of the government, ensuring the power of creditors to hold debt issuers responsible. Additionally, this raised confidence in the Russian debt markets, as evidenced by the reduction in yield a year later (from 56.4% in 1998 to 25.5% in 1999)[42].

Another important piece of legislation was regarding capital flight, a major risk where funds given by international financial institutions were “channeled out of Russia and even into individuals’ bank accounts abroad.” Again, legislation to prevent capital flight was primarily a shareholder move, to encourage foreign legitimacy and prevent Russian capital from being sent abroad illegally. Legislation allowing exchangeability was introduced January 1996, when Russia acquiesced to IMF obligations and eliminated export quotas. But it was not until mid 1998 that restrictions on capital were strengthened, in response to the crisis. In addition to that, the requirement to surrender proceeds for exports was increased from 50 to 75% in 1998. While these are both controversial laws, which could potentially restrict fungibility of capital in and out of Russia, it is believed that “the August 1998 crisis would have been somewhat less virulent in the presence of more stringent capital controls.”[43] In the short-term, the controls on capital flight increased confidence in Russian repatriation of funds, as well as a reduction in corruption. However, worries of longer-term problems as a result of restricted trade led to the lowering of these export proceeds in 2001 (from 75% to 50%),

[41] Pinto, Brian et al. “Lessons from the Russian Crisis of 1998 and Recovery.” *Managing Volatility and Crises: a Practitioners Guide.* February 2004.
[42] Data from ISI Emerging Markets
[43] Loungani, Prakash and Paolo Mauro. *Capital Flight from Russia.* Research Department, IMF. Presented at Conference on Post-Election Strategy, April 2000.

and then in early 2007, where exporters were no longer required to surrender any proceeds[44].

Restrictions on capital flight and movement international refer to a larger issue of structural fiscal reform in Russia pre- and post-1998. Before the crisis, fiscal reform did not move as fast as the "shock therapy" in the monetary markets, which immediately floated once-regulated prices at world levels, and privatized nearly half the market by 1995[45]. Fiscal reform, however, progressed slowly, where administrative tasks would take up lots of time, and business in Russia would require seemingly endless bureaucratic hurdles, such as licensing, permits, and security forms. In addition, the government previously relied on massive deficit spending, which only exacerbated the economic crisis once investor confidence left Russia in 1998. The implementation of a "Spending restraint" has been a major policy initiative by the Putin administration; the OECD estimates that government expenditures as a percentage of GDP is now 10% below pre-1998 levels, and fiscal solvency has consistently been achieved thanks to "conservative oil price assumptions," insulating the government from disaster. [46] In addition to increased fiscal solvency, the government has pushed through reforms satisfying many IMF Assessment programs that have reduced administrative burdens, de-regulated economics, and also improved the investment climate.

The Russian tax code is perhaps the most complex of its kind, and reforming it was not easy. However, after the 1998 crisis, it became clear that the government needed to simplify the tax codes, especially for new enterprises. In 1998, the Russian government

[44] EIU Country Profile: Russia, 2001 and 2007.
[45] Shleifer, Andrei. *Government in Transition.* Lecture at Harvard University, October 1996. pgs 2-3
[46] *Economic Survey of the Russian Federation, 2004.* Organization for Economic Co-operation and Development. 2004, pg. 2-3.

initiated a two-pronged approach to structural fiscal reforms; the first dealt with government expenditures, and ensuring fiscal solvency. The second strategy, beginning in January 1999, established a simpler, easier to understand tax code. This Part I of the tax code (and refined in Part II, submitted to the Duma in January 2000) brought in a variety of groundbreaking fiscal reform: most importantly, it established the "Personal Income Tax," a flat 13% tax on personal income that greatly reduced the burden of tax payment, which used to be a three-tiered system. This one move brought in 26% more real government revenue, and spurred a domino effect of flat tax reform around the Former Soviet Union[47].

In addition, the number of levies and tax provisions were greatly reduced on export business. The OECD counted as many as 50 different tax provisions, but the reforms of 1999-2001 unified all levies with a "unified, highly regressive social tax," and also eliminated all turnover taxes (for intermediate and in-transit goods), except a 1% tax on road usage that was phased out in 2003[48]. Finally, the Duma also approved in this package a reduced 24% corporate tax rate, lower than that of many nations. All of these fiscal reforms reduced the burden administrative tasks held on firms operating in Russia – there were reduction in profit taxes (35 to 30%), and a reduction in tax avoidance, as well as a general reduction in the authority tax collectors had over business, which previously " significantly increase[d] business transaction costs."[49]

[47] Ivanova, Anna et al. "The Russian Flat Tax Reform." *International Monetary Fund Working Paper WP05/16.* January 2005. pg. 4. This provides a quantitative analysis of the successes of the PIT, and its contribution on macroeconomic development post 2001.
[48] "Economic Policy." *EIU Country Report: Russia*. 2000.
[49] Vasiliev, S.A. "Overview of Structural Reforms in Russia after 1998 Financial Crisis." *International Monetary Fund.* 16 February 2000. pg. 4-5

The effect of these structural reforms was not just to be simple for citizens, and reduce the inequalities created by insufficient collection; reforming these codes made it easier for business to be done in Russia, and attracted much more foreign investment. In 2002, FDI flows increased 26%, but in 2003, it skyrocketed to 130% year-over-year; comparatively, in 2001, FDI rose a paltry 1%[50]. This can surely be attributed to a government operating with solvency, reducing government deficits and its reliance on foreign debt, and making it easier to do business.

Table 2:

	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions
1989	1.00	1.00
1990	1.00	1.00
1991	1.00	1.00
1992	1.00	1.00
1993	1.00	1.67
1994	2.00	1.67
1995	2.00	2.00
1996	2.00	3.00
1997	2.33	3.00
1998	**2.00**	**1.67**
1999	1.67	1.67
2000	1.67	1.67
2001	**1.67**	**1.67**
2002	**2.00**	**2.33**
2003	2.00	2.67
2004	2.00	2.67
2005	2.33	2.67
2006	2.67	3.00

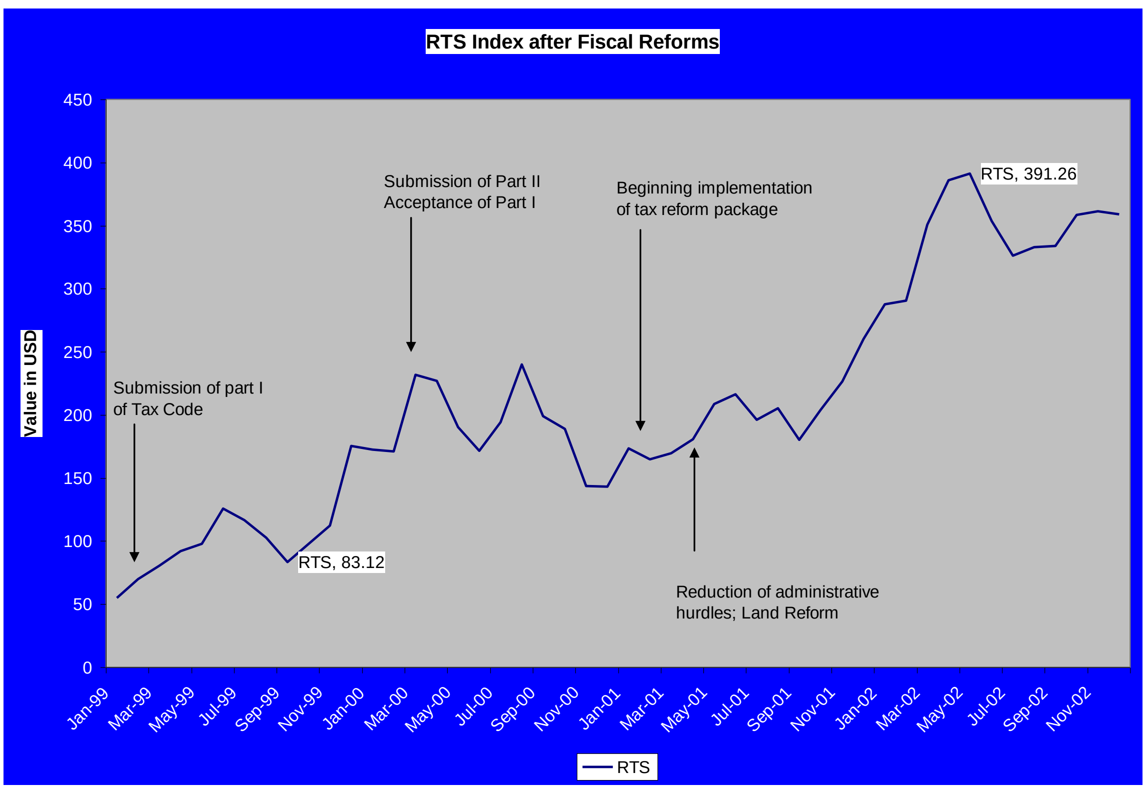
The European Bank for Reconstruction and Development publishes, yearly, a transition report that has a numerical ranking from 1 to 4 for levels of transparency and adherence to free market principals, with 4 being freest, and 1 being the least. In 2002, one year after the structural reforms, the EBRD increased Russia's ranking in both "Banking reform & interest rate liberalization" and "Securities markets & non-bank financial reform" by one-third (see table 2 above)[51]. This increase in ranking, after no

[50] "Global Developmental Finance: Russian Federation" from *The World Bank.*
[51] *2006 European Bank for Reconstruction and Development Transition Report*

increases since 1998, and a major decrease in 1998, shows renewed confidence in financial reform in Russia in the year's following the 1998 crisis.

This renewed confidence in Russia's financial reforms, both monetary and fiscal, continued onward as more reforms were passed to further liberalize the once-centrally planned economy. Finally, after these structural fiscal reforms, the Duma shifted its focus to banking reform, passing 2001 legislation that created a deposit insurance program, which solidified Russia as a definite location for both short and long-term investment[52]. Such performance can be seen in the RTS index (see chart below) between 1999 and 2002, and the growth corresponding to liberalization.[53]

Chart 3



[52] Wines, Michael. "Putin Grows in Job, Raising the Question: For Good or Ill?" *The New York Times.* 13 November 2001. Accessed 4 April 2007
[53] Data from Russian Trading System Historical Pricing

One area of monetary reform that is perhaps most important to investment in Russia was that of banking reform. The strategy to reform the banking sector in Russia, which has long been dominated by large conglomerate banks, began in 2004, much later than the fiscal reforms discussed above. However, it can be inferred that the establishment of a strong fiscal sector is a necessary antecedent to serious banking reform. Without a responsible government budget, and without reforms in place to maintain an investor-friendly financial environment, any banking reform would be useless. The most important part of this strategy was the introduction of deposit insurance, which provided guarantees to both commercial and citizen depositors. This DI legislation is most obviously to gain confidence – indeed, it was principally meant to "attract into the banking system…the population's so-called 'mattress money'," money that citizens kept under their mattress instead of in formerly state-owned banks.[54]

An additional benefit to this was the increased competition in the retail banking sector, something that previously did not exist (as most of Russian banking was dominated by state-owned banks). These large, complex state-owned banks (mainly Sberbank, an original RTS company) essentially hold large amounts of capital, such as pensions and other social payments, rather than make risky commercial loans. However, there is trend towards this retail lending in the banking sector, and the real benefit with this deposit insurance is that it bolsters private banks in this end; in fact, the legislation says that Sberbank would remain out of the deposit insurance system until no longer than 2007, when the deposits of Sberbank would be guaranteed by the same government body

[54] Tompson, William. "Banking Reform in Russia: Problems and Prospects. Economics Department Working Papers No. 410." *Organization for Economic Co-operation and Development.* 9 November 2004. pg 13

as other retail banks. Additionally, there was companion legislation authorizing the creation of a credit bureaux, to further the cause for retail lending[55].

Another aspect of the banking strategy was that of "prudential supervision," which is how the Central Bank of Russia (CBR) seeks to regulate the banks. Rather than focus on "opaque legislation" that allowed banks to be "poorly audited,[56]" the hope is that legislation works towards more substance versus form, and empowering the CBR to make enforcement and regulatory decisions. This streamlined the arbitration process, as well as moved the system of banking to a more market based method, with the onus on the CBR versus the Kremlin directly. Finally, a major tenet of the banking strategy that improved the marketability of Russia as a place for investment was the phasing in of the International Financial Reporting Standards. The IFRS is similar to GAAP in the U.S.; however its main importance is in bringing in more transparency and multinational standardization to financial statements in various countries, ensuring that formats and regulations do not materially differ between companies. This is vital, for an opaque accounting standard not only discourages investment, but is representative of a governing body not intent on the opening up of capital markets. This standardization also helps to reduce corruption and money laundering, as regulatory and accountability standards have also been introduced, in an attempt (that admittedly has proven vain) to reduce what is perhaps now the largest risk for investing in Russia. Indeed, the passage of this Banking Reform Strategy is not the end of reform; in 2006, a corporate governance law was passed that increased the rights of minority shareholders in all listed companies.

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[55] Tompson, William. "Banking Reform in Russia: Problems and Prospects. Economics Department Working Papers No. 410." *Organization for Economic Co-operation and Development.* 9 November 2004 pg.14-15

[56] Chowdhury, Abdur. "Banking Reform in Russia: Winds of Change?" *Bank of Finland Institute for Economies in Transition.* Helsinki, 2003. pg. 11

Currently compliance with the corporate governance code is not mandatory, however "publicly listed companies have to give details of their compliance.[57]" Movement towards mandatory compliance is indeed the next step for Russia, one that for the sake of investors, will come soon.

Finally, one of Soviet Russia's major principles was the abolition of private property, called for by Marx himself in his *Communist Manifesto.* This was clearly impossible for the transition economy; the ability to freely exchange property and declare private ownership is imperative for building collateral and growing private enterprises[58]. The Russian government, however, reversed this communist vestige in a landmark piece of legislation that fundamentally reshaped the issue of property in Russia. The Federal Land Code of 2001 (amended 2003) made "the purchase and sale of non-agricultural land legally permissible, [laid] the foundation for a commercial land market, and [provided] for the use of land as collateral for loans and mortgages or as a contribution to new joint ventures.[59]" This epic legislation effectively created the commercial real estate market in Russia, a booming market that has surpassed many international expectations. In fact, 2007-2008 is predicted to Russia's most lucrative real estate year yet, due not to energy demand but "strong consumer demand" and because the sector is relatively free from "political meddling." In reality, while there are risks in property investments in Russia,

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[57] EIU Country Profile 2005: Russia.

[58] De Soto, Hernando. *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else.* Basic Books, New York: 2000. De Soto provides a groundbreaking analysis of property and capitalism, and the reasons behind the need for property valuations, home equity, and private banking reform.

[59] Russian Political Economy Review". *EIU World Investment Service*. March 2007. pg. 20. This is Federal Land Code No. 136-FZ, perhaps the most important piece of reform legislation passed by the Duma after 1998.

the lack of supply of reasonable commercial space, the emergence of a service industry, and the surge in real wages has made Russia a hot spot for real estate investment[60].

Macroeconomic and Business Reform

Beyond structural reform, which in 2002-2006 shifted its focus toward re-working subsidy management and clarifying codes to facilitate business, the government began empowering employers, especially through the Labor Reform Code and the controversial Pension Reform act. Before 1998, the Russian labor market still maintained vestiges of the Soviet era, where unemployment simply did not exist. However, as the market privatized, efficiency became a major factor in industrial output, and this brought on unemployment. Thus, social safety nets were required, to prevent worker unrest and also to maintain the standard of living, however a problem in many post-Soviet nations was the provision for unemployment was too large, increasing costs for smaller enterprises that perhaps could not pass on that cost to customers[61]. A major part of this labor reform came in the form of pension packages, including a major November 2001 law that allowed the pension system to invest pensions into Pension Funds that gives a rate of return to pensioners, invested through risky government paper, or in corporate debt (an issue strongly supported by businesses in order to help raise capital)[62]. This was similar to the U.S. method of Social Security, and provided a more streamlined method of social security, however more important than that was it also progressively allowed older workers to save more, and thus reduced the burden on firms to provide for older, less efficient workers.

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[60] *CEE Capital Markets Report*. Central and Eastern Europe. Autumn 2006.
[61] Sachs, Jeffrey. *Poland's Jump to the Market Economy*. The MIT Press, Cambridge: 1993. pgs 94-95
[62] "Will Pension-Reform Package Change how Russians Retire?" *St. Petersburg Times.* 13 November 2001. Accessed 4 April 2007.

This pension reform went alongside major labor reform, which strengthened the rights of employers over the hiring of workers and the power of unions, as well as the Labor Code passed in December 2001. This code did increase the rights of employers in determining where workers may be placed, and the policies for at-will employment, as well as the strength of "the internal working regulations [of] the employer", providing the option of termination and replacement previously unseen in Russian labor[63]. A similar code was passed in 2006 to clarify this dense document, and held intact many of the acts in the previous code[64]. The Labor code, which increased employer rights, and the Pension code, which reduced the obligations of employers, are examples of reforms taken by the government to de-politicize the labor market, and essentially keep it in control. These are easy to understand under the context of the Washington Consensus, as well as the need of the Russian government to regain business confidence, and make it easier to do business in their nation. However, essential to this point is that Russian firms, from that day to today, are still in control of labor, and there has not been a major movement towards improving labor relations, even in the election time now. The only exception to this was the 2005 introduction of a welfare system that sought to monetize welfare payments, versus standard entitlements, but this "cash payment" program led to widespread protests. Ultimately, Putin backed off and introduced instead a support program to the pay-as-you-go pension system begun in 2002. This added confidence has

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[63] *Labor Code of the Russian Federation of 31 December 2001*. Federal Law No. 197-FZ of 2001. Articles 15, 31, 32

[64] Reyzman, Evgeny et al. "Law Update: Amendments to Russian Labor Code Introduce Changes." *PRIME-TASS.* 11 July 2006. Accessed 5 April 2007.

quelled political dissent, and again shows the goal of stability being primary to Russia's government[65].

Understanding why this reform was sought is not difficult – it primarily was a reaction to negative foreign beliefs of the Russian economy, and was necessary to build up investor confidence. However, the de-politicization of each policy, whether in the introduction of market-based pensions, or employer-empowering labor reforms, or even structural reform in the fiscal and banking spheres, systematically takes the government out of the investment picture. Each policy rendered the private sector effectively buffered from political vagaries, thereby raising the international financial profile of Russia, and lowering the exposure to political risk in investing in Russia. As each legislative action was passed, beginning in 2001, the market began an upswing that it had not ever seen. Indeed, this reaction to 1998, and the fear of a lack of necessary government policymaking, led to reforms that de-politicized the market in a way not expected by the Washington Consensus. Indeed, the IMF Managing Director Anne Krueger noted that "the developments over the past year provide much reason to be optimistic about Russia's future. They testify to the underlying strength of the Russian economy as well as to the appropriateness of the policies being implemented by the authorities. Sound macroeconomic policies and resolute structural reforms are already bearing fruit. If they continue, then Russia will be well placed to fulfill its considerable economic potential."[66]

Positivity in Russia has been solidified due to reforms that allow investors to prosper, even though the government is trending towards less transparency, and perhaps even

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[65] EIU Country Profile 2005: Russia
[66] Krueger, Anne. "Growth and Reform in Russia." *Conference on Post-Communist Economic Growth.* Lecture. 20 March 2002.

diluted authoritarianism. Having analyzed the reforms after 1998, it is clear that, in a theoretical construct, the market is shifting away and independent from political factors, and has insulated market forces from the threat political control, and transformed the nature of government's relationship to the Russian financial markets. The rest of this paper focuses on the empirical evidence of this fact – based on sectoral and index charts, mapped with important reforms, as well as important political events, often those that are undoubtedly negative for the Russian government or even the entire society. These charts show that the economy maintains a robust pace, both in growth as well as in performance, and the equity markets are in particular slated for success.

The growth of the Russian equity market is not founded solely on the performance of the original 21 companies. In addition to those commanding heights, many large firms have initiated equity offerings, especially after 1998. Although not represented in the RTS Index, 2006 saw the most IPOs of any year in the entire Russian Trading System, with total equity capital raised at $15 billion, (which includes smaller, over-the-counter, less liquid stocks), and 2007 is projected to be even higher at around $30 billion[67]. The RTS market, which includes the largest stocks, does not necessarily reflect that huge amount; however, there were still many important IPOs in 2006, including that of Rosneft, one of the largest oil & gas firms (and owner of Yukos assets, now again in the hands of public investors). Chart 4 shows the performance of the market overlaid with important political events as well as economic reforms, showing that the RTS outperforms on a proportional basis the S&P 500, even a few years after a default. What can be seen in Chart 5 are the IPOs on the RTS Index, coupled with an analysis of GDP,

[67] "Russian Companies Planning IPOs." *IPO-Congress.* 19 March 2007. http://www.ipocongress.ru/eng/news/ipo/id/4999/

Inflation, and the T-bill rate that acts as a proxy for the risk free rate. What this essentially shows is relative stability appearing after 1998, with GDP growth remaining high for recent years, and interest rates not nearly as volatile as they used to be. The Roman numerals indicate reforms made, which can be referenced in Appendix A.

Examining this same graph, however with political disasters, shows the immunity conjectured earlier. Many of these disasters are not simply terrorist attacks, which would undoubtedly have a more pronounced affect on the US or other more established stock markets; they also are times when the government has sought to cut back on democratic tendencies, such as restricting the election of federal governors, or the emergence of the Russian state as a controlling owner of natural gas concern Gazprom.

Chart 4:

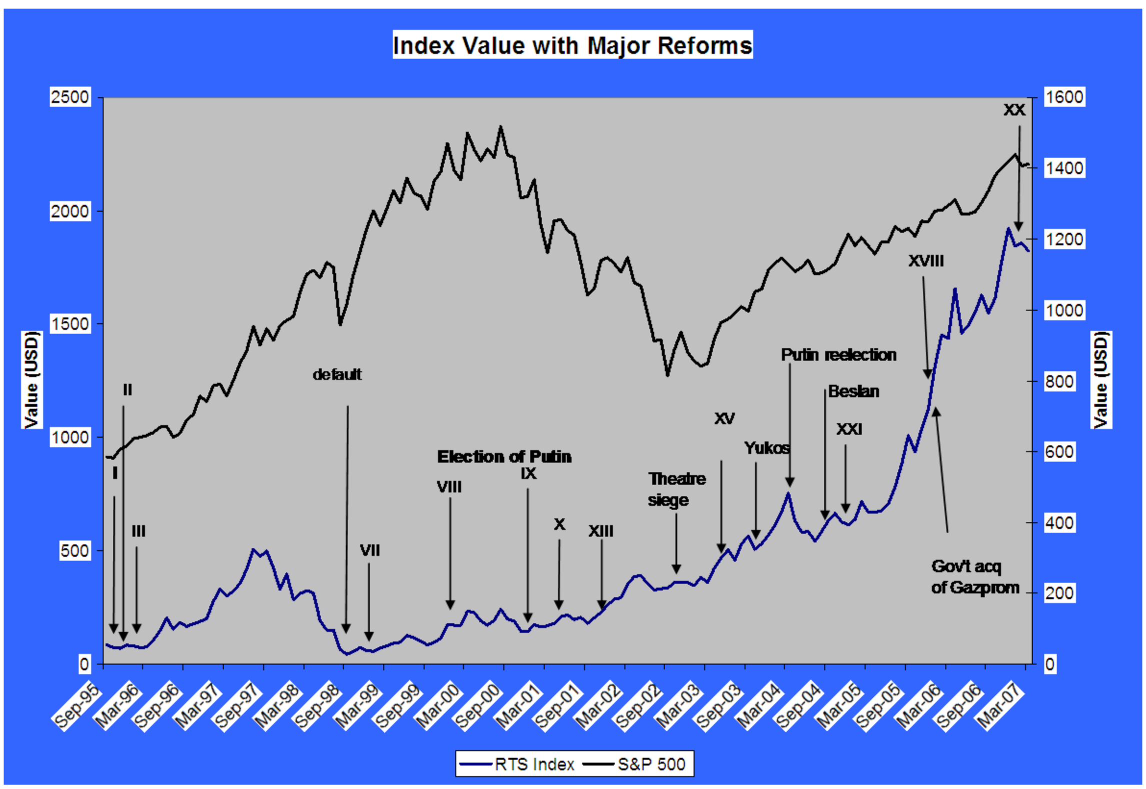


Chart 5:

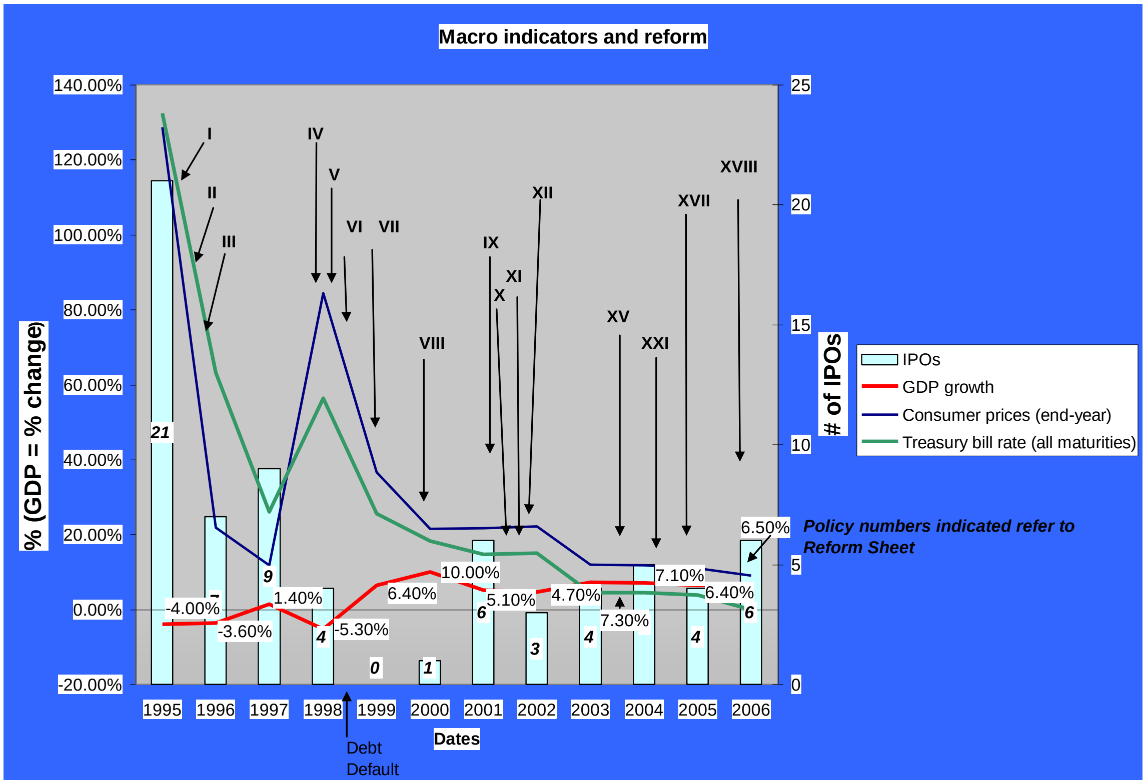
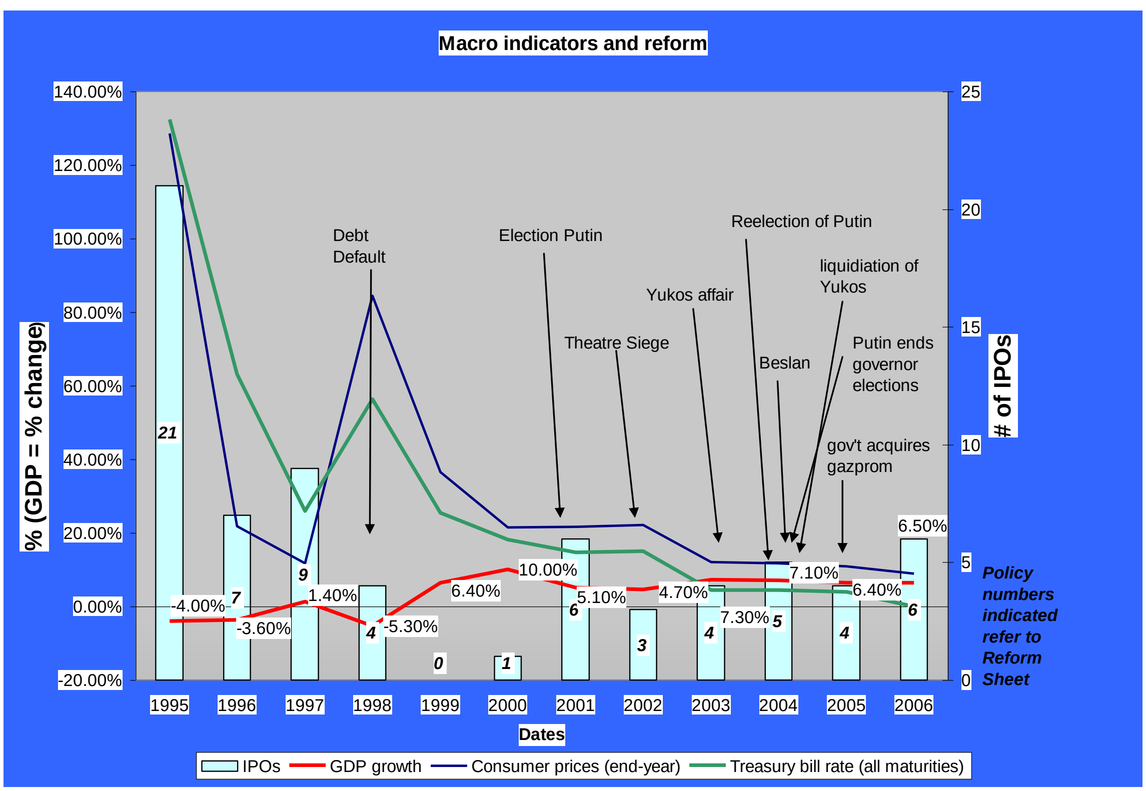


Chart 6:



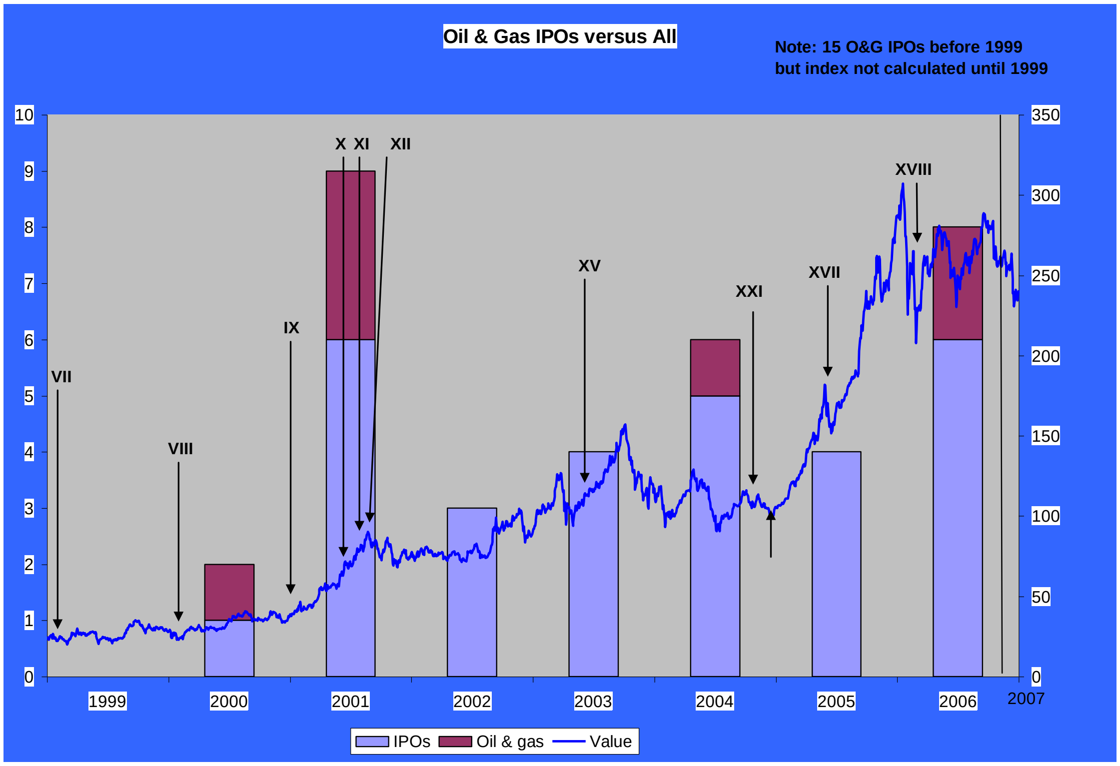
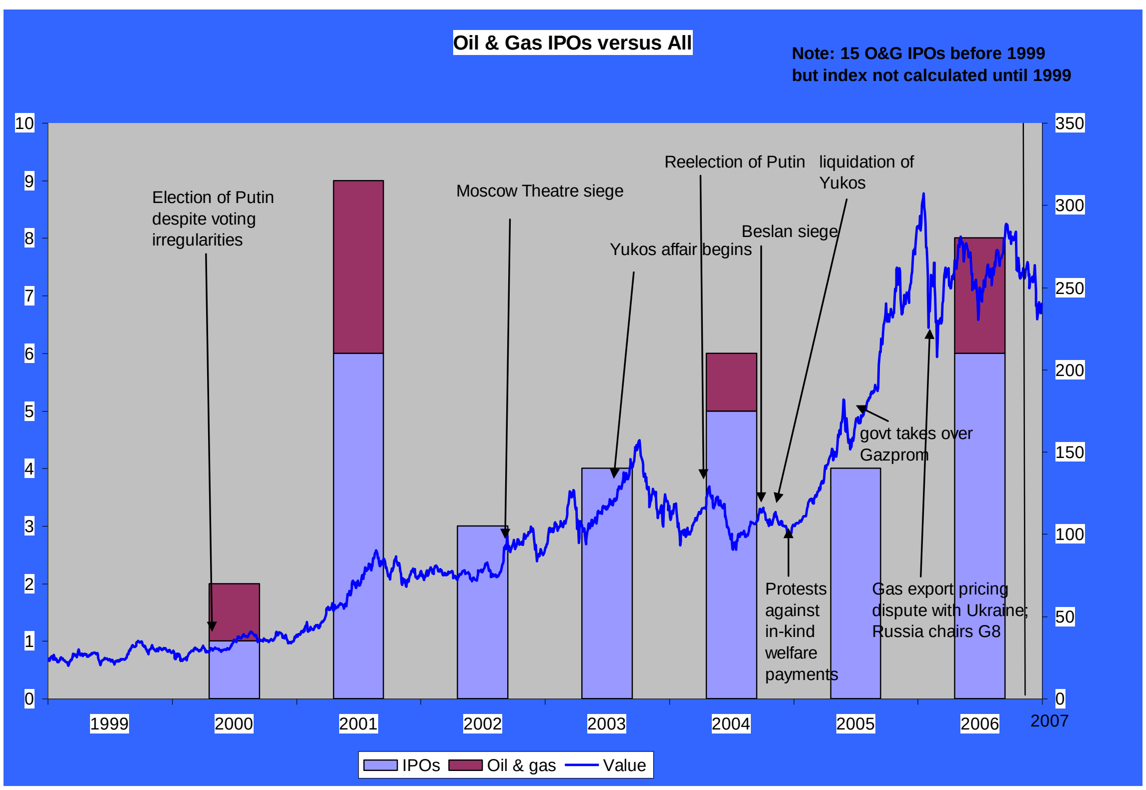


Chart 7 (above)

Oil and Gas

Chart 7 shows another perspective – the Oil & Gas sector specifically, which is by far the most meaningful for Russian investment. For example, Gazprom itself takes up nearly 25% of the RTS Index. That aside, it also serves as a proxy for investor confidence in Russia. As Chart 7 shows, the reforms noted earlier, such as those that streamline administrative hurdles, and reduce the risks of banking, have almost entirely positive effects on the empirical market. In addition to that, many large gas firms, like Gazprom, have their own banking unit, and the development of stronger market fundamentals provide a particularly positive impetus for stock valuations. Most importantly, and perhaps easiest to understand, political reform since 1998 has positively affected this sector, and allowed it a buffer in times where government actions seems adverse to free economies. That can be seen in chart 8, with the same data mapped against negative political events. While the data clearly shows the exuberance in Oil and Gas investments, it is not accurate to say that the sector has been lifted away from government control. On the contrary, most oil firms are heavily regulated, and sometimes even controlled, by the Kremlin. Additionally, the arrest of Yukos Chairman Mikhail Khodorkovsky on largely illegitimate tax charges adds to the worry that "Russia is left more vulnerable to what President Putin's then-chief economic adviser…called the Venezuelan disease – a syndrome in which nationalization is followed by slower growth, inept management, and official malfeasance."[68]

Chart 8:



[68] Independent Task Force Report No. 57. *Russia's Wrong Direction: What the United States Can and Should Do.* Council on Foreign Relations: New York, 2006. pg. 34-35

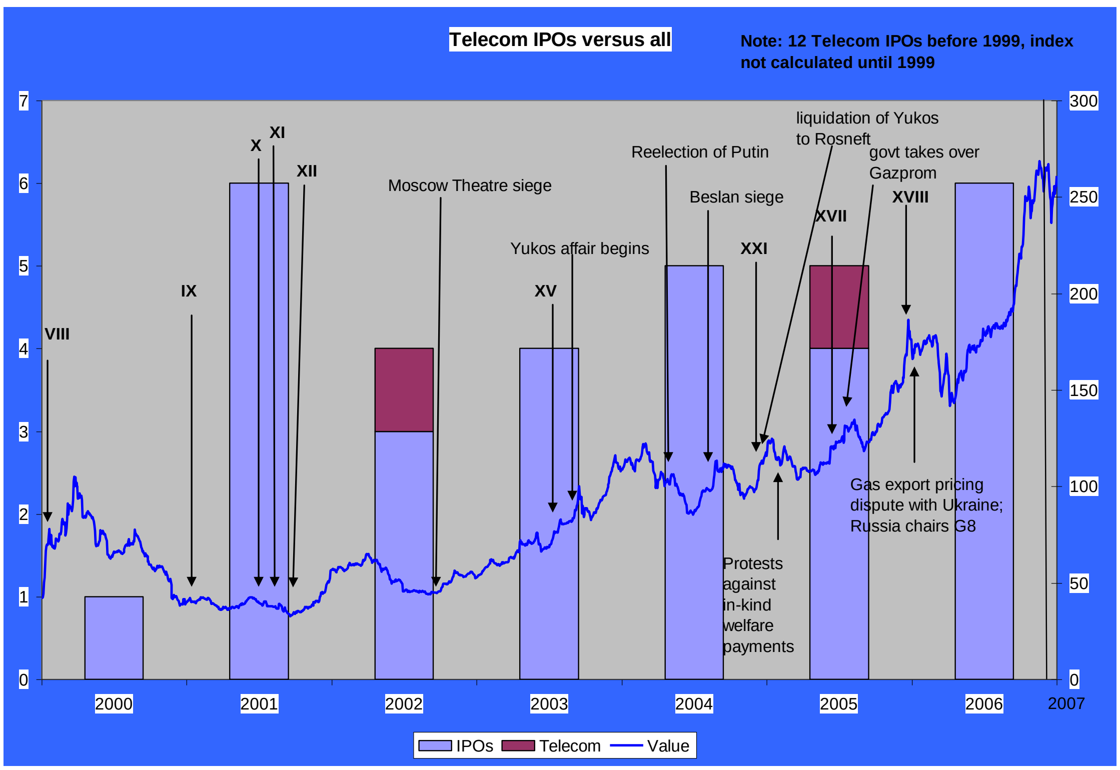
While this concern is certainly valid, given the events of the Yukos affair as well as the government wresting control of Gazprom away from the private sector (the Kremlin holds a 50.002% controlling stake in the natural gas giant), it does not seemingly affect investor confidence in Russia. In fact, a survey of investors done by the Economist Intelligence Unit notes that "foreign investors remain sanguine" in the face of menacing changes in the status of state ownership. Interestingly, the presence of government ownership does not hinder investors from piling in – indeed, this can be seen by the dramatic rise in the overall RTS and the Oil and Gas sector after the 2004 acquisition, despite the acquisition. What this implies is that government ownership simply means a transfer of owners, but not necessarily a transition in management, a spike in costs, or even more corruption in gathering revenues. Investors have had 3 years to digest this information, and the only volatility occurred in late 2006, far after the acquisition. It must also be remembered that these commanding heights were taken from the government at huge discounts, with Khodorkovsky among the band that perpetrated what is often called the biggest fraud in Russian transitional history.

Telecom

The telecom industry in Russia was largely developed as a state concern, but has been privatized and made public, with a total of 14 IPOs since 1995. However, after 1998, there were only 2 major Telecom IPOs, showing that much of the government's privatization was done before the 1998 devaluation. Compared to Oil and Gas, the Telecom sector is much more apolitical, as regulation of the telecom sector has reduced greatly. Chart 9 shows that reforms have for the most part had a flat effect on the

Telecom industry – by 2000, it seems that reforms do not affect the performance of the sector. In addition, by this time, most telecom firms are private and by 2002, the bulk of the major reforms have been implemented, allowing the industry to begin an upswing despite potentially adverse political issues (indicated in Chart 9 as well). However, there has been talk of growing state involvement in the telecom industry, due to speculation in the offering of Svyazinvest, the state-owned holding firm that controlled most of the telecom market.

Chart 9 (below):



Metals and Mining

Like the Oil and Gas sector, the Metals and Mining sector is considered political – many politically charged firms, like steel producers Severstal and Novolipetsk, offered their initial shares early in RTS history (1995),[69] while later came the larger privatized

[69] Data from RTS Historical Pricing

firms, particularly Norilsk Nickel, who is chaired by Mikhail Prokhorov, the former President of Rosbank. Norilsk was one of the largest state-owned firms, and after its IPO, one of the largest investors in the firm is Vladimir Potanin, who recently acquired the shares of Prokhorov. This has started rumors of a state takeover, yet this talk has, again, not adversely affected either the industry or the stock[70]. Again, similar to the market's reaction to the government takeover of Gazprom in 2005, the market appears confident in the face of state control. This again shows the market is immune to issues of politics, even when they intersect with the market. The strength in the market shows that state control of Norilsk, or even the metals market altogether, does not necessarily imply an inefficient state concern similar to those in the Soviet era. Rather, the existence of defined free market principles, through the reforms outlined earlier, has created a market that dictates political actions, not the other way around. A strong market, like that since 1998, means that while the government would own the stock, it would not adversely affect shareholders, especially minority shareholders[71].

While there is much recent activity in the Metals and Mining sector, historical data is sparse. The RTS did not price the sector index until 2004, and it is difficult to back out meaningful pricing data before 2004. However, Chart 10 demonstrates the confidence in the Metal and Mining sector after the reforms of 2004, and the effect of predicted acquisitions in the sector in early 2007. Finally, with a law passed in January 2006 that allows for easier IPO registration, the Metals sector saw 2 IPOs in 2006, major coal producer Raspadskaya, and ex-state-owned gold concern Polyus Gold.

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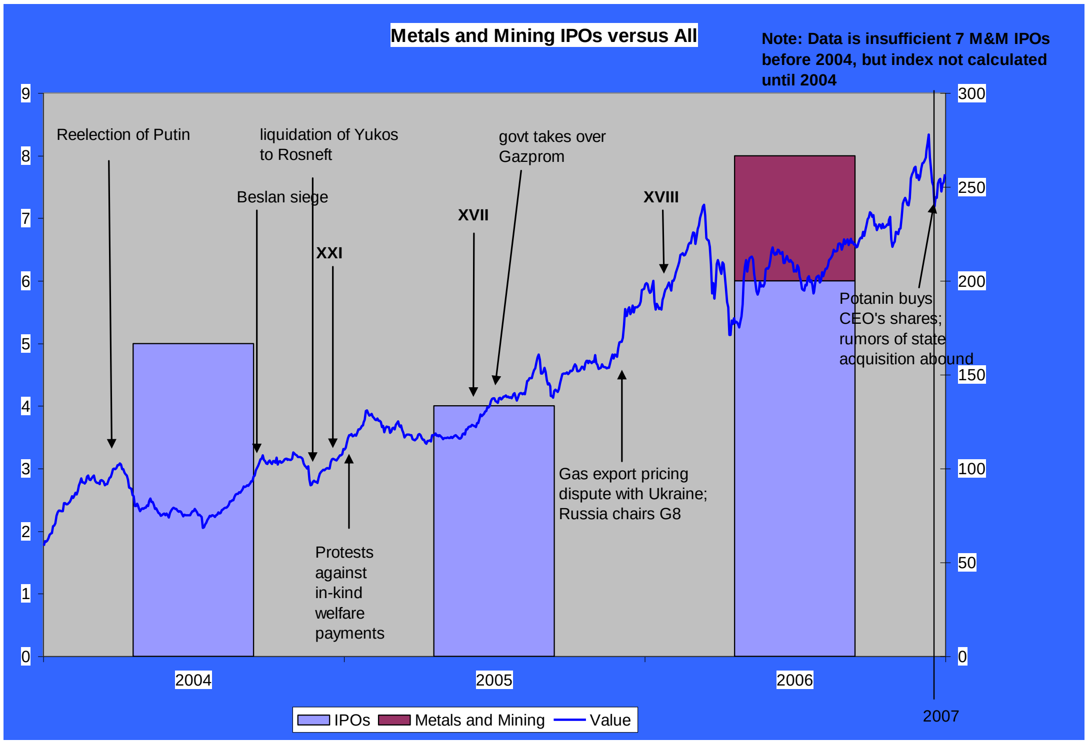
[70] Schriek, Daan van der. "Potanin says State could Buy Norilsk." *The Moscow Times.* 6 February 2007. http://www.themoscowtimes.com/stories/2007/02/06/049.html
[71] *Morningstar Emerging Markets Report*. 7 March 2007. news.morningstar.com/news/ViewNews.asp?article=/DJ/200703071653DOWJONESDJONLINE001090_univ.xml

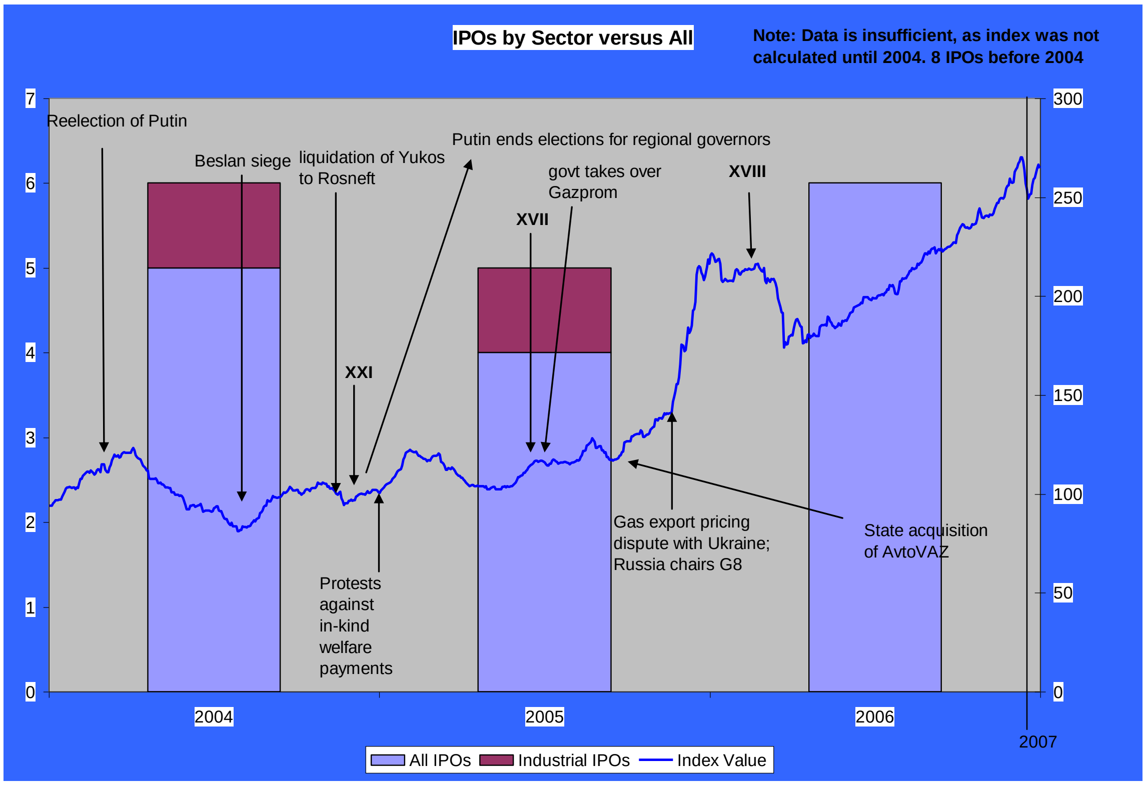
Chart 10:



Industrial

The industrial sector of Russia is a haven for formerly state-owned businesses in major manufacturing areas, such as carmaker Severstal-avto, airline firm Aeroflot, and aerospace firm IRKUT. This is a sector with many political contacts, based on its history, but also one that has profited from the opening of competition and trade policies, as well as the focus on manufacturing efficiencies that previously did not exist under the centrally planned economy. Additionally, these companies are affected by regional policies, as that would affect demand across the nation (unlike other conglomerate sectors that are predominantly based on contracts). Like the Metals sector, data on the Industrial sector was not accurately or meaningfully collected until 2004, which makes a significant graphical analysis much more difficult. However, as is shown on Chart 11, the upward trend in the automotive industry is undoubted; despite issues in regional politics, and the state acquisition of carmaker AvtoVAZ, performance is positive.

Chart 11:



Consumer and Retail

This sector is, like telecom, a beneficiary of the privatization boom. This is not simply due to increased competition, or liberalized trade policies, but because the growth in income per capita, and the improvement in standard of living as well as the availability of greater choice has allowed for an emergence of a previously nonexistent sector in consumer products. Some of these include the pharmacy firm 36.6, WBD foods (one of

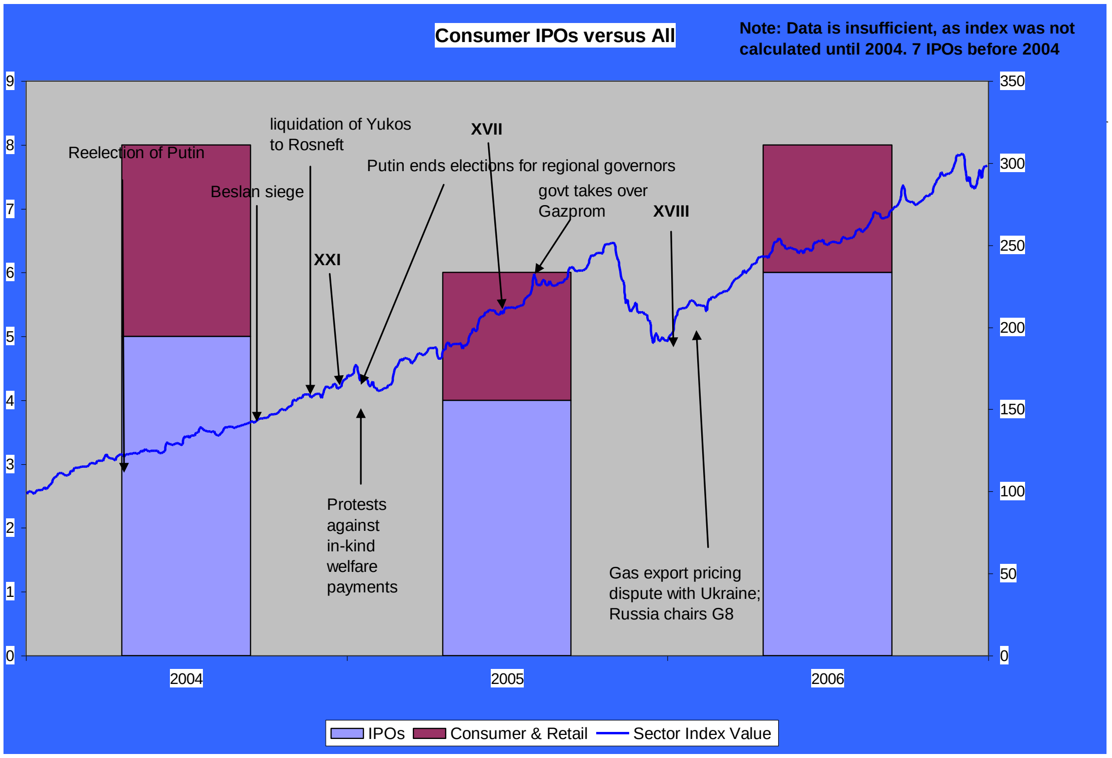


Chart 12

the 5 Russian firms with listings on the New York Stock Exchange)[72], and a collection of Russian brewers, all of whom have foreign owners[73].

The growth in this sector is also seen as symbolic of the rise of the Russian private economy, and opportunities that simply never existed before. Chart 12 (above) shows that initial offerings in this sector were evenly balanced before and after 2004 (when the sector index was priced by the RTS), and the new IPO law of January 2006 has stimulated more domestically listed IPOs. Additionally, performance was just as robust as other sectors, driven by interest from foreign buyers, and also the increase in per capita wages positively affecting demand.

Conclusion

It is clear that Russia's financial markets have taken off, and their attraction to foreign buyers is not in doubt. What is in doubt is sustainability of such success,

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[72] "Russian Juice Firm Wins US listing." *BBC Online*. 8 February 2002. http://news.bbc.co.uk/2/hi/business/1810045.stm
[73] Russian Political Economy Review". *EIU World Investment Service*. March 2007. pgs.12

especially in light of a government that has reduced democratic principles through changing election laws and arresting political opposition, as well as a government interested in regaining positions in strategic sectors like the automotive (AvtoVAZ), Oil & Gas (Gazprom), and precious metals (potentially Norilsk Nickel). Yet, despite these risks, the market surges ahead. What cannot be ignored when considering this sustainability, however, is the proper context of the post-1998 reforms. Indeed, there have been 2 transitions in Russia; the first was from 1989 to 1998, when the political institutions of the Soviet were destroyed, and mass privatization of the economy began through major reform pillars. The second transition began in just as much turmoil, after the debt default and currency devaluation of 1998, when Yeltsin moved the government's attention from massive reform to refining the foundations already laid in place. Indeed, the passage of landmark tax, pension, labor, banking, and land reform opened the door to capitalism, and the refinement of monetary policies attracted outside interest here. Confidence returned, and the market has demonstrated this.

However, just as there are positives, the worries of the economy cannot be ignored. Indeed, corruption is a debilitating problem, and the government does not yet appear committed to staving it off. Additionally, corporate governance in Russia is still relatively low, and while laws are passed for accountability and regulation, enforcement appears weak, as ultra-wealthy owners still hold sway over corporations. Finally, Russia is prohibitively dependant on commodities, a problem that the sensible Stabilization Fund can only delay, not prevent. Yet, the threats of this economy are not without solution; indeed, the market is no longer weak institution, and the confidence surrounding it has

Appendix A – Reference for Reforms

I	1	1995	Sep-95	Introduction of RTS, main Russian Stock Exchange
II	2	1995	Dec-95	Export tax for petroleum and forestry products reduced to 0, for both Russian and foreign firms
III	3	1996	Jan-96	Reduction of commercial bank capital flight through non-export deals (est.to reduce capital flight by 85%)
IV	4	1998	Jan-98	Restriction of foreign borrowing by Russian firms. Banks not allowed to carry liabilities from foreign banks of over 400%
V	5	1998	Jul-98	Restriction of foreign ownership to 25% of UES (energy concern)
VI	6	1998	Aug-98	Short term Russian government bonds default; ruble devalued
VII	7	1999	Jan-99	Establishment of Part I of Russian tax code (definitions and procedures, protection against retroactive tax legislation)
VIII	8	2000	Jan-00	Establishment of Part II of Russian tax code (VAT, excise tax, income tax, new unified social tax
IX	9	2001	Jan-01	introduction of flat tax of 13%
X	10	2001	May-01	Reforms enacted to reduce administrative hurdles (law on state registration, licensing laws, law on state inspections, amended bankruptcy law
XI	11	2001	Jun-01	Revised Joint-Stock-Company law (increased protection of minority shareholders)
XII	12	2001	Jul-01	Reduction of export earnings "surrender" from 75 to 50%
XIII	13	2001	Nov-01	New Labor Code (increases employer's rights)
XIV	14	2002	Jan-02	Reduction of corporate Tax (from 25% to 24%);
XV	15	2003	May-03	Land Code, most important, includes the right to sell agricultural land, which was enacted in the summer of 2003 – much later than the main body of this Code.
XVI	16	2003	Dec-03	Legislating creating Deposit Insurance
XXI	**21**	2004	Dec-04	Banking Reform Strategy begun -- continues deposit insurance, initiates move toward retail lending and private banking
XVII	17	2005	May-05	Approval of credit bureau to build retail lending
XVIII	18	2006	Jan-06	Law forcing 45 day period of pre-emptive rights to acquire floating shares will be repealed -- no more 45-day waiting period (same as US)
XIX	19	2006	Jan-06	VAT lowered from 18 to 16%
XX	20	2007	Jan-07	Exporters no longer required to repatriate of foreign-currency revenues

Appendix B – Standard RTS Information

Number	RTS	Name	Shares outstanding	Industry	IPO Year
1	AFLT	Aeroflot, common	1 110 616 299	Industrial	1997
2	APTK	Pharmacy Chain 36,6, Common	8 000 000	Consumer & Retail	2004
3	AVAZ	AvtoVAZ, common	27 194 624	Industrial	1998
4	BANE	Bashneft, common	170 169 754	Oil & gas	2001

5	BANEP	Bashneft, preferred	34 622 686	Oil & gas	2001
6	CHEP	Chelyabinsk Tube-Rolling Plant, Common	472 382 880	Metals and Mining	1997
7	CHMF	JSC "Severstal", common	1 007 701 355	Metals and Mining	1995
8	EESR	RAO UESR, common	41 041 753 984	Oil & gas	1995
9	EESRP	RAO UESR, preferred	2 075 149 384	Oil & gas	1996
10	ENCO	SibirTelekom, common	12 011 401 829	Telecom	1995
11	ENCOP	SibirTelekom, preferred	3 908 420 014	Telecom	1997
12	ESMO	CenterTelecom, common	1 578 006 833	Telecom	1997
13	GAZA	GAZ, Common	13 131 836	Industrial	1995
14	GAZP	Gazprom, common	23 673 512 900	Oil & gas	1995
15	GMKN	MMC "NORILSK NICKEL", common	190 627 747	Metals and Mining	2001
16	GRAZ	RAZGULIAY Group OJSC, Common	106 000 000	Consumer & Retail	2005
17	GUMM	GUM, Common	60 000 000	Consumer & Retail	1995
18	IRGZ	Irkutskenergo, common	4 766 807 700	Oil & gas	1995
19	IRKT	IRKUT Corp, common	978 131 612	Industrial	2004
20	KLNA	Kalina, Common	9 752 311	Consumer & Retail	2004
21	KHEL	Kazansky Helicopter Plant, Common	154 089 390	Industrial	1998
22	KIRZ	Kirovsky Zavod, Common	10 865 340	Industrial	1995
23	KMAZ	KAMAZ Inc, Common	785 747 574	Industrial	1995
24	KUBN	UTK, Common	2 960 512 964	Telecom	1997
25	LEKZ	Lebedyansky, JSC, common	20 411 300	Consumer & Retail	2005
26	LKOH	LUKOIL, common	850 563 255	Oil & gas	1995
27	MFGS	Slavneft-Megionneftegaz, Common	99 474 705	Oil & gas	1995
28	MGNT	OJSC "Magnit", common	72 000 000	Consumer & Retail	2006
29	MGTS	MGTS, Common	79 829 200	Telecom	1995
30	MGTSP	MGTS, Pref	15 965 850	Telecom	1996
31	MSNG	Mosenergo, common	28 249 359 700	Oil & gas	1995
32	MTLR	Mechel , common	416 270 745	Metals and Mining	2003
33	MTSS	MTS OJSC, common	1 993 326 138	Telecom	2005
34	NLMK	NLMK, common	5 993 227 240	Metals and Mining	2003
35	NNSI	VolgaTelecom, common	245 969 590	Telecom	1996
36	NNSIP	VolgaTelecom, preferred	81 983 404	Telecom	1996
37	NTMK	NIKOM, common	1 310 002 966	Metals and Mining	1995
38	NVTK	NOVATEK, common	3 036 306 000	Oil & gas	2004
39	OGKC	JSC "OGK-3", common	29 487 999 252	Oil & gas	2006
40	OMZZ	United Heavy, Common	35 480 186	Industrial	2003
41	PKBA	Baltika Brewery, common	159 170 667	Consumer & Retail	2001
42	PKBAP	Baltika Brewery, Pref	13 540 115	Consumer & Retail	2001
43	PLZL	OJSC "Polyus Gold", common	190 627 747	Metals and Mining	2006
44	PNTZ	Uraltrubostal, Common	24 340 086	Metals and Mining	1995

45	RASP	Raspadskaya OJSC, Common	781 988 249	Metals and Mining	2006
46	RBCI	RBC Information Systems, common	119 260 000	Consumer & Retail	2002
47	RITK	RITEK, common	99 750 000	Oil & gas	2000
48	ROSN	OJSC "NC "Rosneft", common	10 598 177 817	Oil & gas	2006
49	RTKM	Rostelecom, common	728 696 320	Telecom	1995
50	RTKMP	Rostelecom, preferred	242 831 469	Telecom	1996
51	SBER	Sberbank, common	19 000 000	Consumer & Retail	1997
52	SBERP	Sberbank, preferred	50 000 000	Consumer & Retail	1997
53	SCON	The Seventh Continent, common	75 000 000	Consumer & Retail	2004
54	SIBN	JSC Gazprom Neft, common	4 741 299 639	Oil & gas	1997
55	SILM	Power Machines, Common	7 216 938 708	Industrial	2003
56	SNGS	Surgutneftegas, common	35 725 994 705	Oil & gas	1995
57	SNGSP	Surgutneftegas, preferred	7 701 998 235	Oil & gas	1996
58	SNTZ	Sinarsky Tube Works, Common	6 295 555	Metals and Mining	1995
59	SPTL	North-West Telecom, common	881 045 433	Telecom	1995
60	SVAV	Severstal-avto, common	34 270 159	Industrial	2005
61	TATN	Tatneft, common	2 178 690 700	Oil & gas	1995
62	TATNP	Tatneft, preferred	147 508 500	Oil & gas	1998
63	TRNFP	Transneft, preferred	1 554 875	Oil & gas	2001
64	UFNC	Ufaneftekhim, common	275 330 608	Oil & gas	1998
65	URKA	JSC Uralkali, common	2 124 390 000	Metals and Mining	1997
66	URSI	Uralsvyazinform, common	32 298 782 020	Telecom	1996
67	URSIP	Uralsvyazinform, preferred	7 835 941 286	Telecom	2002
68	VRPH	OSC VEROFARM, Common	10 000 000	Consumer & Retail	2006
69	VSMO	VSMPO-AVISMA Corporation, common	11 529 538	Metals and Mining	1995
70	WBDF	WBD Foods, common	44 000 000	Consumer & Retail	2002