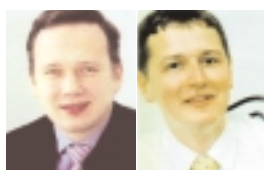


ON THE ROAD TO REFORM



RUSSIA STILL HAS FAR TO GO BEFORE TRULY MEETING INTERNATIONAL STANDARDS, SAY **ALEXEI BOGDANOV** AND **BORIS KOLMAKOV**.

While there are many positive signs in the reforms in Russia, the country has yet to undergo the changes that will improve its investment climate and make it more attractive to investors. In this article, we shall consider the issues on a macro- and microeconomic level.

During the past few years Russia seems to have recovered from the financial and political crisis that shook the country in the middle of August 1998. The rumours about a new crisis, typical for the month of August, have intensified again, but this time without any solid reason. Indeed, the country has something to be proud of. The consequences of the 1998 economic crash are almost overcome, and the prospects for further developments are bullish.

MACROECONOMIC LEVEL

In terms of macroeconomic parameters, we have witnessed healthy changes. The country's GDP has risen steadily, at the rate of 6% on average. The inflation rate has dropped to 14.3% (projected for 2003) from as high as 85.7% in 1999. The domestic stock market has demonstrated outstanding growth over the past five years, with the RTS Index¹ increasing year-on-year to 540.533 and reaching the pre-crisis level. Russia's central bank reserves have risen almost six times since the all-time low in April 1999. This may be a reflection of higher crude oil prices, of which Russia is one of the leading exporters.

The domestic currency, the rouble, has stabilised over the US dollar, and during the current year has even appreciated, returning to the level of January 2002, at R30.55 to the dollar (as at 1 September 2003). The two-thirds devaluation of the rouble in 1998 gave an extra push to the economy, making Russian exports more attractive and domestic production far more effective.

The Russian population is growing wealthier. Even though the Russian middle class is still in the embryonic stage of development, there is a trend for steady growth and development, and with real wage appreciation in double-digits, this looks set to continue. In addition, many Russians working abroad are returning home to take up senior positions in domestic companies. Overall, the demand for experienced professionals remains high and is growing.

Such positive developments are the results of both favourable political and economic factors. Russia's President, Vladimir Putin, enjoys high ratings and is viewed as the favourite for next year's presidential elections. While 1998 witnessed four new prime ministers, public confidence is strong on the back of the current stable and predictable political domain.

Continuing tax reform is a welcome feature of the current domestic environment. The typical situation with taxes in Russia used to be that it was impossible for a bank or a company to operate in the country without breaking a law or regulation. The reason for this was the tax system's complexity, as well as the absence of basic laws, such as a tax code. The situation is now changing and the fiscal system is becoming more transparent, although it does not prevent tax consultants from charging high fees. To stimulate economic growth, and to encourage residents to pay more taxes, the tax collection system has been completely overhauled, with the aim of introducing easy-to-comprehend taxes. The income tax rates in Russia are perhaps some of the lowest in Europe: 24% for companies and a 13% (flat rate) for individuals.

The country is getting prepared for the adoption of International Accounting Standards (IAS) from 1 January 2004, a step already made by the vast majority of the former Soviet Union countries.

Despite these positive developments, there are emerging issues that need to be addressed for the country's economy to continue its growth. Despite political stability, there is still a risk that some unforeseen restrictions may be enforced.

In the fiscal area, even though liberalisation is the current policy, there are risks that some hardening actions may eventually take place. The reasons behind these may not be entirely economic ones, but rather based on the ambitions of the authorities. For example, the situation surrounding the application of profit tax deductions has been turned on its head this year.

The new law does not allow capital investment spend as a deduction from the profit tax base, and therefore accountants have used assets revaluation to compensate for extra losses (which at the time was legal). This was not well received by the government, which has now issued an amendment to the tax code, effectively

imposing a tax on revaluation which becomes payable immediately after the revaluation has taken place.

The Russian legal system needs to be brought up to speed with the current developments in the economy and the needs of the Russian legal companies and individuals. Currently, there is no proper mechanism that allows judicial and extrajudicial decisions based on the 'fair judgement' approach. Rather, the existing system is often used for manipulation by various groups of shareholders to prevent other shareholders from acting. Often, it is used as a threat rather than a place to solve issues as they arise. With judges' salaries being minimal (some are paid even below the country average) there is often a reason for the judicial system to work in someone's favour.

Bankruptcy law is another priority for the legislators to look at. Still there are no procedures that would allow the application of the Chapter 11-style procedures which would allow management to enforce special measures to restore a company's financial position, and the bankruptcy procedure is still very complicated and yet not comprehensive. Bankruptcies are not common. But this is not because everything runs smoothly, rather because there is no widely accepted practice. Even individuals find it almost impossible to declare bankruptcy. Courts are busy with law suits, yet staffing is inadequate and it usually takes months for a case to be reviewed.

In the Russian banking system, the number of credit institutions has decreased, which suggests a transition stage from quantity to quality. The presence of Western banks has intensified competition in the banking sector and improved the quality of service. Access to cheap credit facilities and technologies gives them a considerable advantage over local banks. However, foreign banks have mostly subsidiaries of foreign enterprises as clients, while key Russian companies and firms are served by a narrower range of controlled Russian banks.

Despite the perceived stability, the Russian banking sector still has a long way to go. Even though Russia-based customers receive almost all the same banking facilities as the rest of the world, there are some fundamental issues that act as an obstacle to further developments. One of the key problems rests in the unavailability of cheap long-term funds and low capitalisation. This problem stems from the following factors.

First, the absence of long-term investment instruments leaves the treasurer with little investment choice. Existing instruments available on the market do not compensate for the potential risk to be borne by investors. Low liquidity of state securities denominated in roubles, which are used in considerable numbers by predominantly passive investors, skews investors' interest in short- and medium-term securities. This results in a drop in yield on these tenor of investment, which, as a result, makes it hard to achieve any kind of a return on surplus funds. The effective yield on short-term government paper has reached an all-time-low of 7% in the domestic currency.

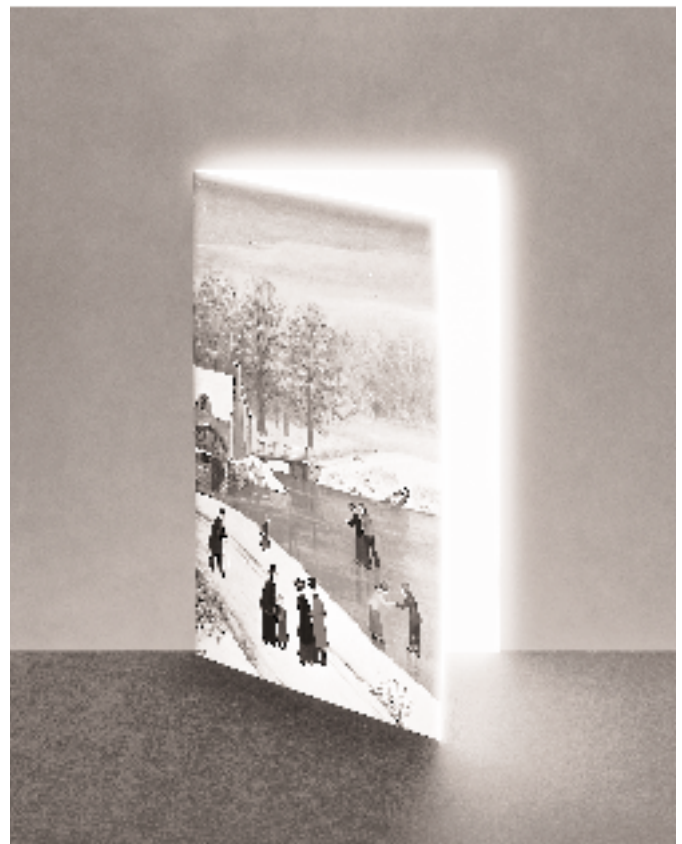
Second, the discounting system of the Central Bank of Russia (CBR) is not functioning. Cases where commercial banks have borrowed in this way are extremely isolated: the funds disbursed under such schemes were dedicated to special programmes and had to be agreed on an individual basis. Therefore, the CBR discount rate, which is currently 16% for the domestic currency, is just a vague indicator of the prevailing base interest rate in the market, and the banks use it to adjust their base rates.

Therefore, there is a paradox: a consumer price index of more than 14% and 7% for state securities' yield on one hand, and a

16% base interest rate on the other. This, coupled with a constantly appreciating dollar, leaves little room for money-making opportunities. This results in banks significantly lowering interest rates on deposit accounts or even refusing to take deposits.

Another reason behind the funds' weak distribution system is the total absence of an infrastructure for risk assessment and management. In government, there are continuous discussions about creating credit-scoring agencies, yet it is unclear when this will crystallise. Complex accounting rules, with most companies still working on a cash basis, make it difficult for the reader of financial statements to make a sound judgement. Political risks, together with a lack of confidence in the security of investments, result in banks willing to compensate possible risks with a hefty interest premium. This situation, combined with the absence of reliable indicative interest rates, forces financial institutions develop their own systems for risk management and credit decisions.

As a result of the above, the interest rate applied to funds offered to the potential borrower often becomes too high for the latter to accept (with the refinancing rate at 16%, loans are often offered at 25-30% APR). This presents another paradox: those who have cash available are limited in their investment choices, but those seeking affordable financing have difficulty in finding something that would suit their needs. In such circumstances, banks fight hard for good customers: loans to such clients seem to be one of the major sources of income. In the retail sector, rates are significantly lower,



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making buying a new car or other expensive items attractive as ever. The battle for customers, however, often leads to less prudent decisions being made by banks and there is a slight trend for banks' credit portfolios to weaken. But this has yet to reach critical levels.

Overall, Russia has yet to see an investment boom. While the Russian stock market has attracted a flood of funds, investment into the industry remains problematic and unpopular. Major foreign investments are usually subject to special agreements with the federal government and are still quite rare. The reason for such low activity may be the lack of state insurance, special favourable tax treatments and other elements aimed at stimulating investment. The rules for repatriating profits are complex and are subject to close scrutiny by the regulating authorities: your bank will be your currency control agent.

One of the key tasks the government faces is the reform of the state-owned monopolies, namely the power supply and housing and communal infrastructure. Despite lengthy discussions of how to reform them painlessly, these industries impose a heavy tax burden on society, while being rather ineffective and opaque. These are the industries with which it is especially hard to deal without increasing social tensions. In December, the parliamentary municipal elections will take place, followed by presidential elections in June 2004, which is perhaps why this topic seems to have been set aside by the authorities for the time being.

MICROECONOMIC LEVEL

Subsidiaries of foreign companies that operate in Russia set the standards for the corporate culture and raise the bar of corporate governance standards. Because of the weak financial infrastructure, many treasurers prefer to carry out hedging and other treasury operations through their headquarters, which does not help the Russian market. The establishment of an exchange for derivatives and other instruments is still in the future. Most of the deals, when they take place, are on an over-the-counter (OTC) basis.

Generally, Russian companies still have a lot of work to do to come up to world class standards, but the trend is positive: treasurers are willing to learn how to better manage cash and aid financial planning.

Cash management, in its modern understanding, is still a target for the majority of companies. Until recently, it was performed on an ad hoc basis – that is, the placement of cash would be planned as proceeds arrived.

Management accounting is increasing in popularity, and many managers have come to realise the need for actionable planning and

control of activities. However, in many instances, companies face competition on price rather than on cost, as the accounting and reporting systems lack adequate procedures to support sound decision-making processes. The transition to the IAS and adoption of generally-accepted accounting practices is a critical step on the way to a modern economy for Russia.

Since investment mechanisms are still inadequate, most businesses rich in cash often prefer to export the proceeds abroad, where funds are consolidated for re-export back into the economy in bulk amounts. For many investors this route is preferable, as it seems to offer greater security.

Generally, capital investment budgets are created and realised on an ad hoc basis. Such budgets are rarely purposefully created and maintained and, in the current economic climate, it is difficult to properly assess risks and find products with suitable maturities.

Hedging opportunities are still vague, and those offered are often expensive solutions. This pushes treasurers to solving their needs in other ways, often in the foreign markets.

In terms of financing, during the course of the past few years, several Russian companies floated in other countries, most often in the US (like one of Russia's largest cellular telecoms providers, Vimpelcom, and food concern Wimm-Bill-Dann). In contrast, there was only one initial public offering (IPO) on the Russian stock market. Treasurers are forced to seek other options for raising funds, and domestic corporate loans in Russian and foreign currency are growing popular. This market is set to grow, and the average maturity is expected to increase from one to three years, to a longer period.

All in all, the reforms are set to continue and provided the political situation remains stable, the country is on course to become an attractive investment haven. The journey continues.

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Notes

¹Russian Trade System Index, includes major companies in various industries; for more information please visit www.rts.ru. (click on 'ENGLISH' to translate).

The ACT is delighted

to be raising funds for the NSPCC at the ACT's Annual Dinner on Wednesday 12th November at the Grosvenor House, London. Guests will be asked to take part in a 'speech betting' sweepstake - top prize is a weekend for two at The Celtic Manor Resort, venue for The Treasurer's Conference 2004.



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