FACTORS AFFECTING THE FOREIGN DIRECT INVESTMENT IN RUSSIA

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Abstract

This paper analyses some links between the last crisis of the banking sector, the system of corporate governance and the level of investment (and foreign direct investment in particular) in Russia. Russian contrasting outcomes are the result of a complex set of factors depending on investment, regulation inadequacy, reforms structure and transition process consequences. We start with a short analysis of the transition process. The analysis is consistent with the hypothesis that both macroeconomic stabilization and structural reforms are necessary for growth. Afterwards we analyse the outcomes of the banking system in Russia with special emphasis to the reform strategy proposed after the crisis of 1999, as well as some of the associated controversies with the current system of corporate governance. The Russian experience of corporate governance is unique; and the lessons that Russia teaches are not trivial. Russia's enterprise pathologies improve our basic understanding of how corporate governance works.

Keywords: banking sector in Russia, corporate governance, investment

Introduction

This paper aims to recall recent economic events connected to the actual observed level of investment in Russia. The economic performance of the former Soviet Union has shown very contrasting outcomes since the beginning of its transition process. In this paper we attempt to understand the origins of a not-fully satisfactory economic performance. We also analyse some links between the policies of investment and the role played by the banking sector and the system of corporate governance. We start our work with a review of Russian transition process. We then provide an analysis of the determinants of economic growth. The analysis is consistent with the hypothesis that both macroeconomic stabilization and structural reforms are necessary for growth. Afterwards we analyse the outcomes of the banking system in Russia with special emphasis to the reform strategy proposed after the crisis of 1999, as well as some of the associated controversies. In the concluding section we recall some of those questions and analyse the broader political economy issues that dominate the prospect for the transition economies. The comprehension of what went wrong in Russia is an interesting lesson not only for transition policy, but also for the more general corporate governance theory.

Ten years of transition and reforms

The Russian transition experience stands out as unique. Given the territorial extension and the political role of Russia in the worldwide landscape it was inevitable. The key question is why-despite a promising start in 1992, a rapid privatisation in 1994-95 and the stabilization in 1995 the following reform process has been slow and halting. Russia has lacked in the implementation of structural reforms, especially in regulation, protection of property rights and trust. The answer lies in large part in lacks of reforms following the presidential election of 1996 (see Chang and Velasco 1998). Powerful

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vested interests of election, mainly created by loans for shares scheme, strengthened their hold on political and economic power, in an increasing generalized corruption.

Another aggravation has to be connected to the inexperience of the Russian socialist economy in the field of financial market and their relative role of intermediation. A diversified financial policy would probably guarantee efficiency inside banking administration. In the beginning of the transition process, banking managers border made a serious mistake evaluating both interest rates on the banks credits and deposits interest rates in the same way. As reported in the work of Fox and Haller (1999) this lack of experience and evaluation resulted very costly in terms of solvency. It was not easy for Russia banking to recover the gap of skills and knowledge since they could not afford the cost of a fast updating and monitoring. This difficult situation brought to a situation of very high risk of insolvency and a high amount of inherited loan. High loan interest rates pushed to choose risky policy to cover future payments (see Bank of Russia 2002b). This created disincentives for the destruction of real sector economy. Besides low monitoring efforts was aggravated by the low implementation of bankruptcy legislation. This made bankruptcy laws less credible than ever.

In 1997 Russia showed numerous positive economic signals: low level of inflation, stable exchange rates and a positive economic growth rate (see IMF WEC). At the same time, significant problems also existed: an increasing government indebtedness, a big budget deficit, a weak tax system and a low level of investment. The fiscal deficit that Russia faced in 1996 and 1997 was supported by government indebtedness (see IMF WEC and OECD 2000). The interest rate of government bonds rose significantly and attracted several foreign investors. The major Russia banks, instead of investing in real sector economy, preferred to invest in government bonds so that in 1997 the total bank investment in government bond became triple than in 1996 (see Bank of Russia 2002c). The failure of Russia to solve its fiscal problems - combined with easy access to external capital (particularly in 1997) and with a continuing capital flight- led to an excessively large fiscal deficit, to a significant short-term debt (the stock of which, however, was not large relative to GDP) and to the 1998 financial crisis. The collapse of the fiscal system conducted to the financial crisis of August 1998 and to the fail of Russian banking system. The collapse of the fiscal system in 1998 was mainly due to incentives not to pay taxes and to the lack of fiscal resources (see Fox and Haller 1999 and Black et al. 1999). When the external environment turned bad-with the cost and availability of foreign financing worsening, with weak banking system and an excessively inflexible exchange rate- a financial collapse could not be prevented. If reforms had been vigorously pursued from 1996, the collapse could have been avoided.

In a recent report, the World Bank (World Bank 2003) claimed that new Russian firms established since the start of economic reforms, represent the most important contributors to economic growth. New firms are, by history and nature, mostly small and medium sized enterprises (see Williamson 1996). Former socialist countries with a large share of the population working in new firms have performed better than countries where this segment was relatively underdeveloped.

It is a shared opinion inside observers (see Dolan 1997) and academic researchers (Ansmann 1996) that Russia still belongs to the second category. Reasons for this basic conclusion originate by the fact that new enterprises tend to concentrate in profitable niches, which makes them more productive and profitable, in a privileged position to create additional employment. Old enterprises quite often need to spend part of their investment resources on "restructuring". New and old enterprises are not independent from each other. If a thriving segment of new, small and medium firms is already in place, it becomes easier to impose the conditions leading to restructuring on old enterprises, because it is relatively easy for people to find new jobs elsewhere. Some of the main restructuring "standard" obstacles listed by Russian firms are identified by tax level, the implementation of the tax code, corruption, lack of a functioning judiciary and lack of access to finance (see BOFIT 06/2002).

It is very hard to establish a new small business in Russia and besides there are strong regulatory obstacles preventing small firms from growing into medium sized firms. Small firms thus face a double bind in the form of entry barriers and growth barriers. While the smallest firms under 7-8 employees manage to stay off the radar screens of regulatory agencies and officials, their further growth and innovation attract unwanted attention resulting in higher monetary costs, more time spent with government officials and higher risks of harassment from regulatory agencies.

Investments[1]: a close look to the last events

The growth rates of fixed capital investment in 2002 were lower than in 2001 or 2000 (see BOFIT 02/2003). In September 2002 the average growth of fixed capital investment was 2.5 percent, compared to 7.5 percent of September 2001. The bulk of investment expenditure (more than 60 percent) was in the fuel and energy sectors, or in sectors driven by government demand, such as transportation, public housing and utilities. Capacity utilization rates in the main industrial sub-sectors remained flat in 2002, after the rapid post-crisis recovery since 1999. Reported utilization rates tend to be low. It appears that large parts of industry operate at full capacity. In line with this assessment, financial intermediation shows signs of improvement. According to the latest Central Bank of Russia (Bank of Russia 2002) estimates, the share of long and medium-term bank credits (above one year maturity) increased from 10 percent in the first half of 2001 to 27 percent during the same period of 2002. Real lending rates recovered enough to enter positive territory, moving from negative 0.7 percent in 2001 to 2.5 percent in the first half of 2002. Despite this increase in lending costs, total net credits to the private sector increased by 17 percent in nominal terms, or 7.3 percent in real terms. Although they are still tiny, the share of consumer credits in total credits increased from 4.7 percent at the end of 2000 to 7.1 percent in June 2002. Why then, after three years of high growth, with an economy running at full capacity, with private sector demand for real credits at a record high and a good macroeconomic environment, has investment demand not improved?

Partially because a prolonged period of real income growth has led to an income effect, where imported consumer goods are being substituted for domestic production, even as real exchange rate appreciation has slowed down. Imported goods have increased from USD 4.2 billion per month in the first three quarters of 2001 to USD 4.7 billion for the same period in 2002 (see OECD 2002b).

Russia's economic growth and progress with reforms have yet to tempt higher levels of foreign direct investment. According to Goskomstat (march 2002), FDI inflows decreased in 2001 by 6-10% compared to 2000 and 1999. They amounted to a modest $4 billion, or 1.3% of GDP. The trade sector garnered more than a quarter of all FDI, while the transport sector's share fell to 17%.

Foreign direct investment flows into Russia, according to Goskomstat data (June 2002), shrank from $960 million in First quarterly 2001 (1Q01) to about $830 million in 1Q02. Preliminary balance of payments data from the CBR indicates a rise of FDI to about $700. The industrial sector received a bit more then 1Q01 as FDI into crude oil production and machinery and equipment industry were up. The trade sector again attracted over a third of the total, including a fifth in foreign trade. The stock of FDI in Russia rose to about $17 billion at the end of 1Q02.

In February 2003, British Petroleum decided to invest in a joint venture with two Russian oil companies: TNK and Sidanco. The company will be the third largest oil producer with a daily production of about 1.2 million barrels. The immediate reaction was optimism in the markets about Russia's improved business climate and was followed by rises in Russian stock and bond prices. According to Goskomstat (march 2003), foreign investment inflow to Russia amounted to $19.8 billion in 2002, a 39% rise from 2001. The increase was almost entirely due to borrowing, while foreign direct investment and portfolio investment remained stable. The growth in borrowing continued in January 2003, when Russian companies attracted $1.1 billion from abroad as loans and bonds (for detailed data on FDI in 2002 see Bofit 5-2003).

Looking at Goskomstat detailed data (relative to 2002) it emerges that there was a change in the structure of the investment financing since external funding increased its share at the expenses of enterprises' own funds and banks continued to play a small role in the enterprise financing. The proportion of bank credits in fixed investment financing amounted to about 5% in 2002, slightly up from the previous year.

The financial and banking sector

The failure of Russia to solve its fiscal problems led to an excessively large fiscal deficit and significant short-term debt.

[1] Data to write this paragraph have been extracted from BOFIT Report on Russian Economy, various issues, World Bank Report 2003 and OECD 2001 and 2002a

Collected data (source: FIAS 2000 and for the general investment climate FIAS 2003) show some criticism of the Russian financial and banking sectors. It emerges that gross domestic investment and foreign direct investment under-performed and contracted seriously from 1990 to 1998. At that time, foreign direct investment constituted less that 1% of Russia's GDP. This rate is much lower if it is compared with other central and Eastern Europe's GDP (i.e.: Poland and Romania GDP respectively 3% and 4%).

Nowadays Russian banks are improving significantly in terms of deposits, loans, assets, equity and profits even if the bank sector reflects and amplify the magnitude of the structural weakness of the Russian economic system.

The need of reforms in Russian banking system is considered an overall priority for the development of banking and financial systems in Russia, nevertheless study reform and the way to approach reform is a controversial topic among analysts and Russian policymakers.

The results of an insufficient development of banking legislation and slow process of reforms caused a slow, inefficient, inconstant and messy process of reconstruction of the banking sector.

An important line of research (Chang and Velasco 1998) emphasised the role of self fulfilling bank-runs, extending the seminal work of Diamond and Dybvig (1983) to an open economy framework.

In the preparation study and collection of all the useful material existing on the covered topic, we surprisingly realized that several useful information were reserved (or confidential) and not available for public matters.

Recently a lot of effort has been done by Russian (private and public) financial institutions in view of a disclosure of bank data bulletins and now it is possible to use a wide range of data sets (i.e.: OECD, Central Bank of Russia, World Bank, Statistic Bulletin of Russia, BOFIT, Sberbank and the most important Russian financial magazines: Expert and Profile).

Learning from the World Bank (World Bank 2003), some rigorous criteria for Russia's economic analysis have been established. These criteria consider the level of desegregation of data, the attrition bias in the sample due to the entry and exit of banks into the financial market and the advantages of using pooled data. A better knowledge and understanding of regulation constraints, legislation in force and high level of corruption present in Russia appears crucial for the comprehension of Russian Developing Economic System. A wide range of scientific analysis on links among Russian crisis, corruption and law structure is now available (for a good survey see Cooter and Eisenberg 2000). Furthermore, it is widely acknowledged (see Stiglitz 1999) that Russian regulatory arrangements are still in their infancy.

Since the collapse of the Soviet Union, the banking sector had evolved in an unregulated fashion. Banks, instead of playing their institutional role of financial intermediaries, had primarily been involved in speculating in financial markets. Given the existence of a large and high-yielding government debt, buying and selling Russian treasury bonds became the core and sole business of some Russian large banks. Weak Central Bank supervision failed to impose coherent risk management and respect for international standards on capital adequacy ratios. Cross-shareholdings, poor transparency and corruption led to serious corporate governance abuses.

The high concentration of assets among highly leveraged and badly managed banks, an extraordinary exposure to foreign exchange risk and the loss of client confidence have been the major causes for the Russian systemic financial crisis.

When devaluation took place, Russian banks became unable to repay their obligations on forward contracts (see EBRD 1998). Connected lending and excessive risk-taking in the financial market were the most destructive factors. Russia's top banks found that the greatest damage to their capital was dealt not by losses on securities but by extending risky loans, many of which never returned.

Soon after crisis, the government adopted two important measures that greatly helped in the survival of banks and provided a partial protection of deposits. The first of these measures was the 90-day moratorium on the repayment of banks' foreign debts and foreign exchange term contracts. The second was the transfer of personal deposits from several troubled banks to Sberbank.

The second step of the government intervention was to choose Sberbank as a vehicle for protecting personal deposits. Sberbank was the only bank that granted deposit insurance; therefore, other large troubled banks were requested to transfer the accounts of their clients to it.

In Russia banking sector restructuring encountered several difficulties since it began. The major obstacle was the conflict of political interests among the involved parties: bank owners, the Central Bank, the Duma and the government. The government had good incentives to restructure the banking system, both since it needed tools for implementing industrial policy and because banking reform was a main condition for further IMF financing.

But at the same time, the Duma intended to remove some regulatory functions from the CBR and to obtain some control over cash flows in the country by regulating procedures for reorganising banks. In the period between the end of August 1998 and the end of March 1999, the Central Bank withdrew approximately 88 licences for violations of banking laws and CBR regulations, which was 46 less than in the same period a year before. This was despite the fact that many banks had left their creditors stranded. The total number of banking licences recalled in 1998 was 229, 105 lower than in previous year (Data BOFIT various issue). While other banking sectors responded to crisis by closing down 20-40% of their banks (from a much lower base than Russia's), the Russian banking sector saw just a 12% decline in the total number of institutions over the year following its collapse in August 1998. ARKO – the Agency for the Restructuring of Credit Organisations - was officially founded by the Russian government in the first quarter of 1999. ARKO capital was supposed to be supplied half by the state and half by the CBR.

But this plan had to be changed when the Duma rejected the amendment to the law 'On the Central Bank of Russia' that allowed the CBR to be an ARKO shareholder. In the end, however, although the government owned 100% of ARKO share capital, the Central Bank obtained de facto control over the Agency.

The 25th February 1999 the Law on the Insolvency (Bankruptcy) of Credit Institutions has been approved by Duma and started regulating bankruptcies and the liquidation of financial institutions.Until then, credit institutions did not have any bankruptcy regulation. Since the August crisis, the Russian banking system has grown in terms of assets, equity, loans and deposits (see Goskomstat 2002).

By the way Russian banking sector remains very small, by a number of parameters. The relatively low level of development of the banking sector depends on close linkages between economic growth and banking sector development.

Banking assets amount to only ca. 30% of GDP compared to more than 100% in developed countries (source Goskomstat 2002). Furthermore, the Economic Development and Trade Ministry estimates that only 3 percent to 5 percent of investment financing in the country is from banks, compared to 15 percent to 30 percent in many other countries. Data shows (source: BOFIT 04/2001) that while investment picked up between October 1999 and April 2000, bank lending began to increase only by mid-2000. Similarly, the deposits-to-GDP ratio, at 10%, is well below international standards. In general, an increase in the volume of assets and capital goes along with greater portfolio diversification. However, in the case of Russian banks it is rather the opposite. Recent figures (BOFIT 02/2003) show that banks have extremely concentrated portfolios.

It is useful to study the ratio of concentrated credit to a bank's own capital. The largest banks are relatively more exposed to risk, with the largest credit accounting on average for 31.5% of the bank's capital (source BOFIT 04/2003). This violates the norm established by the CBR that requires a maximum of 25%.

An increase in the capital of banks hardly ever leads to more risk diversification. Summing up, Russian banks nowadays are apparently less vulnerable than in 1998. Devaluation exposure is low, as their foreign-currency assets on average exceed their foreign currency liabilities. They also lack exposure to liquidity risk since interbank market remains weak and their state bond portfolios represent only 15% of banking assets (BOFIT 04/2003). Finally, the share of non-performing loans is very low. But the high concentration of risk (also deriving from related-party lending), the adverse selection of borrowers and the portfolio concentration in few sectors stress the persistent vulnerability of the Russian banking sector.

Structurally the Russian banking system still suffers from three major problems. First, the dominant role played by state-owned banks, both in terms of volume of activity and number of branches across the country. Second, the existence of a large number of bank-like institutions. Third, the presence of a multitude tiny size banks.

The 1998 financial collapse brought to public attention the vulnerability of Russia's banking sector, which emerged from the crisis severely stressed. Russian authorities failed to exploit a unique chance to carry out significant reforms in the financial sector. Although, on the surface, contemporary Russia's banking sector appears to have fully recovered from the crisis. A deeper inspection reveals that many of the flaws afflicting Russian banks before 1998 are still present.

Russian banking rescue achieved a 'reactive' rather than a strategic restructuring of the sector. The 'first phase' of the rescue, which primarily consisted of restoring liquidity, was not followed by other far-reaching reforms, i.e. a 'second phase'. The 'first phase' of the rescue, in the second half of 1998 and the early months of 1999 was quite successful. The measures taken by the government in the immediate aftermath of the crisis were essential 'first aid', which succeeded in restoring minimum operating conditions for the financial sector.

Laws and economics in the banking sector in Russia

During 2001, Russian government economic policy covers a variety of banking legislation amendments including tightening bank licensing and criteria for managers and shareholders. The innovative changes into the banking sector oblige the CBR to pull a bank's licence whenever the bank does not meet capital adequacy requirements. Other duties of the CBR include the demand that a bank write down its charter capital if it exceeds the actual equity capital. During 2001 and 2002 ARCO has been engaged for the restructuring of about fifteen banks under its control, and prepare them for re-privatisation. During the year 2001 political climate resulted favourable for the implementation of institutional reforms. The good relationship between Putin and the Duma Ministries opened the way for an incoming progress in structural reforms. Russia was moving in the direction of implementing quality of institutions and sustain and promoting a more transparent business environment. By the way we need at least five years time to see realized significant reforms in institutions, banking and financial sectors. Sustaining banks competition is a possible strategy to support banking sector reform in Russia. By the 2004, following the accounting reform, started gradually in 2001, all Russian banks would shift to the international accounting standards (IAS). The key aspect of this reform is substantially ambiguous since it is not clear if this move will be the finish or the start of the shift-similar to the corporate sector that is supposed to adopt IAS during the second half of this decade. Banking sector reform seems a difficult task to be reach in 2004 if we consider that:

1. Russian state holds majority stakes in about 20 banks, representing a third of banking sector total assets.
2. Russian state holds minority stakes into 200 Russian banks.
3. Banking reform strategy is ambiguous and unclear about the state ownership in the banking assets.

The state should take a detached and distant position from some banks. In 2001 CBR planned to exit Vnershtorgbank in 2002 and that Vnesheconombank will be split in a state debt agency and in a commercial bank.

Sberbank, in which the CBR holds the majority stake, controls a fifth of the banking sector's total assets. Sberbank has the power to undercut loans of other banks with better terms. Bank reform strategy forecast very unlikely the future possibility of privatising Sberbank while the task of banking reform is to empower competition by increasing the state's ownership control in Sberbank policies. The issue of Sberbank, (the Russia's largest bank to be owed by CBR) is pospones until after Sberbank has joined the general deposit guarantee system, control of Sberbank'operations will be enhanced.

The role of foreign banks in Russia is still underdeveloped inside the Russian economy environment. This depends mainly on the protection measures adopted in Russia and on the tradition inherited by Soviet Union. Joint venture in any sector of the Russian economy, including banking sector became possible only in 1987. In 1993 the first entirely foreign bank subsidiary was set up.

Despite the fact that the financial market environment has several holes to be filled, Russia has been able to attract 26 fully foreign bank subsidiaries and 11 banks with foreign majority ownership (see CBR 2001 and 2002). The ability to attract foreign investment in the banking sector is one of the major promising Russian businesses in forthcoming years

The evolution of transparency of Russian banks should reach real disclosure in short time, and banks' managers have not yet received formal pressure by institution and legislation to open their credit institutions (see Koen et al. 2001). Only Sberbank has a part of its shares publicly quoted. Nowadays Russian company can borrow money from foreign banks abroad without the authorization of the Central Bank of Russia (CBR) and big international banks, for all the 2003 and the 2004, can make major acquisitions of Russian banks.

The process of banking reform in 2003 started with slight progress in the fields of ownership issues and of protection in banking business. Almost of the reforms are in progress through the Duma or the government. By the way the 12% upper limit of aggregate foreign ownership in banking sector has been eliminated and CBR first had to transfer its virtually full ownership in Vnershtorgbank to the government and secondly had to reduce its stake in three major banks abroad by selling their shares to Vnershtorgbank. Sberbank, which is majority-owned by the CBR, was not involved in the big question of ownership changes. The reason of such delay and/or omission could be mainly attributable to the social importance of the Sberbank and to the regional services it is able to offer the Russian people. This meaningful change in its internal structure could result destabilizing for the whole banking sector in Russia. Concerning the legislative aspects in banking reform something has been done and something else is a core goal inside the unfinished agenda of Russian restructuring process. For example banking business protection laws are in progress and a legislative measure act to enforcing mortgages is already in force. Such laws and legislations program in 2003 is at its second refined "edition". In previous year we assisted at an extensive programme aiming to reform legislation but bankruptcy law and almost all new reforms failed their purpose. The reform programme has been considered indispensable for Russia economic growth since 2002. The scarce diversification and the dependency on exports of energy and other prime materials in last year hindered reform to apply. During these first months of 2003 a lot of effort has been done to diversify the economy in view of an imminent sustainable growth. In 2002, Russian banks improved their performance in the basic banking function of transforming deposits into credits. Growth of bank deposits (source BOFIT various issues) accelerated reaching the 18% year-over-year in real terms for the stock of deposits at the end of the year (14% in 2001).

The level of bank deposits remained at 20% of GDP. The growth of deposits continues very fast in terms of household's deposits. Banks increased their lending to private companies, even if in real terms it slowed from 30% in 2001 to 18% in 2002. Domestic bank credit to companies is about the 15-16%, slower compared to the 25-40% of the other Central Europe transition countries (Source Goskomstat 2003). In the first three months of 2003 (Source BOFIT 04/2003) bank assets, equity, deposits, loans and profits exceed pre-crisis levels. One of the weak point in the Russian banking system remains its "embryonic" role of financial intermediate.

Delay and a non-unanimously strategy in producing effective and efficient banking reforms can only damage the economic growth of Russia and its integration into a global financial world and prolong its agony.

Corporate Governance

In this section we focus on the consequences of corporate governance problems for the real economy in Russia and why these problems are so widespread and persistent.

To analyse some consequences of the Russian system of corporate governance, we define it 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 maximize residuals and make pro rata distributions to shareholders (Black 2001b). Bad corporate governance is just the failure by a firm to meet one or both of the above conditions. Whether managers operate their firms in ways that meet these ideals 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.

It is commonplace to say that a market economy requires an institutional infrastructure of laws, regulations, accounting procedures, markets, and the institutions to enforce them, including a judiciary (see Dolinskaya 2001 and Black 2001a). We saw in previous sections that the need for legal reform, the creation of financial markets, the creation of an effective central bank and fiscal system, were widely recognized from the start of the transition process (see Frydman et al. 1996 and

Frydman et al. 1999). Indeed, there has been some success in reducing corruption via limiting opportunities for rent seeking by reducing excessive and complex regulations, such as licensing requirements and various tax exemptions, as well as by engaging in civil service reforms. There can be little doubt that the absence of a predictable legal framework has hindered growth, most visibly by reducing the flow of foreign investment, but no less importantly by reducing domestic investment and encouraging capital flight. The cure for these problems lies mainly in domestic politics, but external assistance to encourage transparency and strengthen institutions, and the conditioning of future assistance on progress in these areas, can contribute. We should also hope that the reforms implemented by Putin's government will produce an effective incentive to economic growth.

To analyse why corporate governance problems are widespread and persistent, we need something more than standard causal explanations of poor corporate governance, such us low level of corporate transparency, lack of effective adjudication of corporate law violations, weak enforcement of judgments, and the absence of a network of trust among Russian businessmen (see Dickerson et al. 1997, McFaul 1996, Rautava 2001). We need to focus more clearly on 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 (see on this point Pistor 1996, Nellis 1999). A short focus on four issues can explain why Russian corporate performance shows more "opacity" than in other transition countries.

First, the Russian system of corporate governance needs to provide helpful solutions when an non-reformable value-destroying firm can dissipate cash reserves or salvageable assets. Obviously corporate governance is not the key issue when firm has no reserves or salvageable assets, or when subsidies or unsuitable credits are present.

Second, if a viable firm fails to use its existing capacity efficiently such as when costs are not minimized, the best price is not obtained for given output, or a non profit-maximizing output level is chosen. In the Russian economy, the role of takeover can increase the efficiency in a relevant way. Furthermore it can be fundamental even when a firm identifies positive NPV projects even if fails to act on them. Managers tend to be risk averse because they can't diversify away unsystematic risk of a firm's project (see Starodubrovskaya 1996). If others do not pick up the opportunity, the firm's failure also reduces social welfare.

Third, the options of "exit" or "voice" need to be more "accessible" in the Russian system. In fact they can play a fundamental role if a firms uses internally generated cash flow to invest in new negative net present value projects instead of paying out this cash flow to shareholders who could invest the funds better elsewhere.

Fourth and last, more often in the Russian economy some residual owners of a firm can manipulate corporate, bankruptcy, and other laws to shift ownership away from other residual owners – often by diluting shares held by outside minority shareholders causing the firms fail to prevent diversion of claims. This can even be worst if firms fail to prevent diversion of assets such as when some residual owners privately appropriate assets and opportunities belonging to the firm, but leave the firm's formal ownership structure intact.

A typology of Russian corporate governance can offer useful lessons for corporate governance theory (see Lossani and Tirelli 1999). In fact, the existing literature on comparative corporate governance (for a good survey see Shleifer and Vishny 1997) reflects the range of firm boundaries and dominant shareownership patterns in the United States, Western Europe and Japan. The Russian experience falls, at least initially, outside this range and hence suggests useful lessons about the roles that firm boundaries and ownership structure may play in corporate governance theory, lessons that may benefit Russia, other countries in transition, and even the United States (especially after the Enron scandal and all the others that followed). In the United States, it is unusual for a corporation to maintain a share ownership pattern over the long term that involves a majority of shares owned by insiders and a minority owned by outsiders who trade their shares publicly. The understanding of the mechanisms that constrain management to act in relatively share-value-maximizing ways[2] is built

[2] Namely one share, one vote, the hostile takeover threat, share price based management compensation schemes, board elections, shareholder approval of certain interested and extraordinary transactions, ex post court review, the managerial labour market and other reputational incentives

primarily against the U.S. backdrop because the typical American corporation forms the paradigm for theorizing (see Black 2001b, Kang 1998).

Russia corporate governance case introduces an analytic focus not immediately obvious from studying such long-established systems. The rich array of deviant behaviour observed in Russia helps to links corporate governance failures to real economy effects. In the Russian economic system, the social welfare losses caused by poorly incentivised managers (see Starodubrovskaya 1996) may be inflicted in differing degrees through the four issues previously examined. Identifying which pathology predominates may help to point to more appropriate corporate governance reforms.

Conclusions

Russia’s macroeconomic performance has improved over the course of 2002, but growth rates have stabilized at a lower level than the previous year. The balance of payments shows a sharp decrease in capital outflows. Business surveys indicate growing confidence in some regions and sectors, and Russia’s enterprises find it easier to finance their activities, domestically or abroad, than in previous years. Despite the recent recovery of the Russian economy, the investment climate remains not very positive. This is due to unfinished institution building (and this caused failure in the corporate governance system) and to the several crisis of the banking and financial sector.

It resulted very difficult for Russia to attract foreign financial resources, since foreign business complain mainly about Russian regulations, uncertainty connected to inflation and policy instability, insecure property rights and inefficient bank system.

Foreign direct investment is an effective stimulant to growth, by providing new sources of capital and new technologies and the most effective management and marketing methods. The very essence of economic development is the rapid and efficient transfer and adoption of “best practices” across borders. Foreign direct investment is particularly well suited to affect this and translate it into broad-based growth, not least by upgrading human capital. There is also significant evidence that these benefits of foreign direct investment have substantial spill-over benefits to the domestic economy.

Despite three years of high growth, high oil prices and political stability, and with much of the economy now operating at full capacity utilization, the growth rate of fixed capital investment and GDP have slowed.

Which role can play a good corporate governance environment and an efficient banking system? According to Goskomstat, Russia is likely to lose at least $7 billion in foreign direct investment annually because of *opacity*. Opacity is affected by the level of corruption, the legal system, macroeconomic and fiscal policies, accounting, and the regulatory regime. The effects of opacity are a sort of a surtax on investment. If the system of corporate governance is able to reduce “opacity” and if the bank sector will be more stable there will be a direct increase in the level of foreign direct investments.

The government has an important strategic "asset" for rapidly improving the investment climate: improving the banking system and the system of corporate governance. The Russian experience of corporate governance is unique and the lessons that Russia teaches are not trivial at all. Russia’s enterprise pathologies improve our basic understanding of how corporate governance works.

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