

# The Relationship between Government and Business in Russia

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## A. Governance and growth

- Russia's recent macroeconomic achievements are impressive indeed. But much still remains to be done to put in place a framework that will support sustainable long-term economic growth and the modernization of the economy.<sup>2</sup>
- The evidence shows that both macroeconomic stabilization and structural reforms contribute to growth, and that *the more structural reform that has taken place, the more rapidly the economy grows.*<sup>3</sup>
  - In Russia, sustainable growth, which has averaged 6.8% over the last five years, began only following the crisis of 1998. While the immediate trigger was the combination of a devalued exchange rate and higher oil prices, those gains would have been quickly dissipated if not for the strengthened macroeconomic policies, the government's commitment to market-oriented reform, and the improved investment climate .
  - Legislative achievements following the 1999/2000 Duma and presidential elections were impressive and key to reestablishing investor confidence. These include tax reforms, improvements in the allocation of government spending, the Budget Code, the Land Code, the initiation of UES reforms, and other steps such as the initiation of pension reforms and the drafting of administrative reforms.
  - The recent EU-Russia agreement on WTO entry will likely also promote reform, including gradually of the pricing of natural gas and energy.
  - Indicators of structural change taking hold include the boom in M&A activity, double digit annual real wage growth, the net inflow of capital through most of 2003, and the beginnings of the growth of non-traditional production and exports despite the challenges posed by the Dutch disease.

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<sup>1</sup> Vice Chairman, Citigroup. This is the outline of remarks to be delivered at the First International Conference on Corporate Governance and Economic Growth in Russia, to be held in Moscow, June 4, 2004. Views expressed are those of the author, and not necessarily of Citigroup. I am indebted to my Citigroup colleagues, Robert Kahn and Niclas Sundstrom, and to Simon Johnson of MIT and the IMF, for assistance.

<sup>2</sup> See the background paper for this conference by Astapovich and colleagues.

<sup>3</sup> See Stanley Fischer and Ratna Sahay, "Transition Economies: The Role of Institutions and Initial Conditions", April 2004, prepared for Festschrift in Honor of Guillermo A. Calvo, April 15-16, 2004.

- Investment in 2003 was 18 percent of GDP. That percentage needs to rise if growth is to be sustained as the excess capacity of the economy is used up. This requires continued macroeconomic stability and further improvements in the investment climate, including in corporate governance.
- It is often said that the investment climate needs to be improved to attract foreign investment. That is part of the truth, for Russia would benefit from increased foreign investment. But most investment is domestic, and the most important reason to improve the investment climate is to get Russians to invest more in Russia.

## B. Corporate governance<sup>4</sup>

- If the economy is to operate efficiently, *investors and the society as a whole need to be protected against expropriation by entrepreneurs and corporate management and investors, entrepreneurs and managers need to be protected against expropriation by the government and politically connected elites. Employees likewise need to be protected against arbitrary actions.*
- This requires a host of laws and regulations, and their enforcement, to govern the behavior of corporations. Among the key laws and regulations are those relating to the structure and responsibilities of Boards of Directors, the accounting system, and the provision of information to investors. The enforcement framework relates both to the courts and the regulators, including the supervisors of the financial markets.
- Russia has made progress in all these areas, and S&P and others have saluted the improved transparency of Russian corporations. In this regard, the desire of Russian companies to access the international capital markets has helped improve transparency and reporting standards. The approval of a Code of Corporate Governance was also an important step. So was the adoption of improved securities markets legislation.
- However much remains to be done. These issues are well described in the background paper by Astapovich *et al.* In particular, there is a lack of transparency about the true ownership of corporations, and inadequate control over transfer pricing. These problems are reflected in the very low level of Russian stock market issues. A shift to international accounting standards by Russian firms will improve transparency and the confidence of stock market and other investors.

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<sup>4</sup> I draw in this section on a presentation by Simon Johnson, “The Macroeconomic Implications of Corporate Governance”, at the ADB meetings, Jeju Island, Korea, May 2004.

- Firms choose their level of transparency and governance. Once the legal framework is strengthened to the point that firms have to operate within it, the system of corporate governance can become self-reinforcing. For instance, once firms list in the stock market – and provided the stock market is well governed – improved transparency tends to raise their stock prices. This in turn encourages the owners to improve corporate governance. Similarly, the better a firm's corporate governance, the lower the spreads it is likely to have to pay to borrow.

### C. The role of the government

Government policy is also critical in promoting efficient corporate governance.

- The government needs to demonstrate a clear commitment to the rule of law, and the protection of property rights. Investment will be severely inhibited if the owners of firms do not believe they will receive the lawful fruits of their investments.
- Among other things, this requires at the corporate level clear bankruptcy laws and the legal means to enforce them. At the aggregate level, it requires well-understood rules of the game, including clarity on the tax system and its implementation.
- The government needs also to make strong efforts to attack corruption. The planned debureaucratization reforms will contribute importantly to this goal.
- State intervention should be aimed at promoting competition rather than choosing winners and losers, or generating particular outcomes. The state should be viewed as a neutral arbiter.
- On paper, the government program contains all the necessary elements to promote effective competition, improved corporate governance, and more investment. That vision is mirrored in the background document prepared for this conference. Both statements highlight the importance of clarity with respect to property rights and the legal mechanisms required to enforce them: *laws and regulations matter, but their enforcement and the manner in which they are enforced are no less important.*
- The state needs to provide as predictable a macroeconomic environment as possible. This Russia has been doing in recent years. The state also needs to ensure the provision of physical infrastructure. Much but not all of this can be provided in public-private sector partnerships; some will require government spending, which is another reason a strong fiscal position is useful.

- Corporate governance is enhanced by an efficient financial system, including the banking system. The banking system, especially household deposits, has grown rapidly in recent years, despite the absence of structural banking system reforms. Nonetheless at present the total size of the entire financial system of Russia is still only 90 percent of GDP, well below the average level in industrialized countries, and even below the average in developing countries. The development of the financial system in all its aspects – including in banking sector reform, where progress has been slow – should remain a key priority.

#### **D. Monitoring markets and identifying vulnerabilities**

- Corporate governance standards in Russia have improved rapidly in recent years. This progress is visible to the naked eye. It is reflected in stock market prices, in increased foreign investment, and in the comments of the rating agencies.
- But there are vulnerabilities, including
  - The concern that the state will act arbitrarily and fail to protect property rights. This concern has been heightened by the Yukos case and its complexities. These fears can be mitigated by ensuring that laws and regulations are enforced strictly, predictably, and transparently.
  - The fear that the owners of firms will behave badly, and that investors will find themselves dispossessed as a result. This has been a problem in many countries in recent years, including the United States, but also in Russia. This fear can be mitigated in individual cases by negotiating self-enforcing contracts and by seeking government support for business deals. But the more general need is to enhance transparency, strictly enforce investor protection regulations and laws, and ensure that corruption is reduced – and none of that is easy.
  - The fear that Russia's recent growth is based on high oil prices, and that macroeconomic stability is too dependent on the price of oil. I believe that this concern is greatly exaggerated: Russia has managed the macroeconomy very well, and while a lower price of oil would slow growth, the strong fiscal position and flexible exchange rate would absorb the shock well.
- This conference, the quality of the presentations and the attention it is receiving, together with recent trends in corporate governance, the quality of economic management, and the reform program laid out by the President at the end of last month, provide cause for optimism that corporate governance and the investment climate in Russia will continue to strengthen. And that will be an essential contribution to the continued rapid growth of the economy and the goal of doubling GDP within a decade.