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The Role of Institutions for Diversifying the Economy in the Russian Federation

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Добрый день, уважаемые друзья и коллеги. Для меня большая честь выступить на этой представительной конференции с докладом об экономике России, или, точнее говоря, с докладом о роли институтов в диверсификации экономики России.

Good morning, dear friends and colleagues. It is a great honour and a great pleasure for me to make a report at this very high and representative conference. My report will be devoted to the Russian economy, - or, to be more exact, to the role of institutions for diversifying the Russian economy.

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- Concept of the Institutions
- Concept of the Diversification of the Economy
- State Development Institutions
- Institutions of Corporate Governance
- Institutions of Financial Markets
- Institutions of Small Business Support
- Institutions of Property Rights Protection

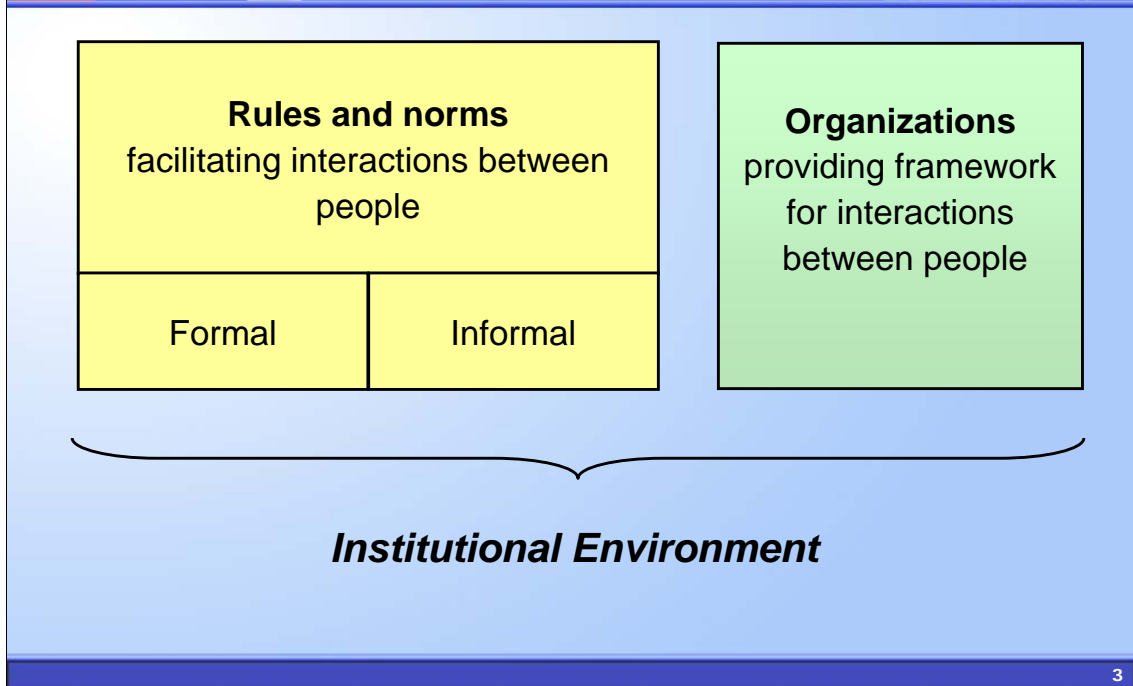
Несколько слов о структуре моего доклада. Я хотел бы вначале определить, что мы будем понимать под институтами и что мы будем понимать под диверсификацией, а также обсудить возможные действия государства в условиях слабой институциональной среды. Затем я планирую рассказать о тех изменениях институциональной среды, которые, на мой взгляд, сегодня стоят на повестке дня для России. Речь пойдет о государственных институтах развития, об институтах корпоративного управления, об институтах финансового рынка, об институтах поддержки малого бизнеса и об институтах защиты прав собственности.

Я хотел бы уточнить, что данный доклад в силу своей краткости не может претендовать на исчерпывающую характеристику институциональной среды в России, равно как и на исчерпывающий анализ всех необходимых изменений.

I would like to say briefly about the structure of my report. First of all I am going to give a working definition to such notions as the **institutions** and the **diversification of the economy**. Then it will be necessary to discuss the possible state policies in the situation of the **weak institutional environment**. After this I shall speak about the main institutional changes which are, in my opinion, most urgent in the current agenda for Russia: that is, about the state development institutions, about the corporate governance institutions, about the small business support and so on.

I would like to mention, that this report is short enough, so it cannot pretend to give an exhaustive description of Russian institutional environment as well as an overall analysis of necessary institutional changes.

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Что предлагается понимать под институтами для целей нашего анализа? Единого общепризнанного определения не существует. Как правило, в экономическом и политическом языке институтами называют либо правила и нормы, как формальные, так и неформальные, организующие взаимодействие между людьми: институт прав собственности, институт фирмы, институт контракта, институты защиты прав собственности и т.д. Вместе с тем институтами могут называться и организации, обеспечивающие взаимодействие между людьми, - и тогда мы можем говорить о таких институтах, как банки, биржи, государственные институты развития, и т.д. Я буду употреблять термин «институты» в обоих значениях.

Совокупность институтов образует институциональную среду.

What are we going to mean by the **institutions**? In the economic and political language institutions mean **rules and norms** (both formal and informal) facilitating interactions between people. We may then speak about the institution of property rights, the institution of market, and so on.

At the same time we may apply the term “institutions” to the **organizations** providing the framework for interactions between people, so that one can speak about a bank, or about a stock exchange, or about a state development fund as of institutions. I shall use the term “institutions” in both meanings.

The sum total of institutions comprises **institutional environment**.

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- Lowering the share of oil and gas industries in GDP and in export
- Increasing the share of small and medium business in GDP

Which industries should be developed instead of oil and gas:

- traditional with high value added, or
- innovative industries?

Когда говорят о необходимости диверсификации российской экономики, обычно имеют в виду, что в этой экономике слишком велика доля сырьевых отраслей, прежде всего топливно-энергетических: добычи нефти и газа. Велика доля в ВВП, велика доля в экспорте. Соответственно под диверсификацией имеют в виду снижение этой доли за счет более быстрого роста других отраслей. Иногда, говоря о диверсификации, имеют в виду и другие аспекты, - например, повышение доли малого бизнеса в ВВП.

При этом остается не менее важный второй вопрос: какие именно отрасли надо развивать форсированно быстро? Другие традиционные отрасли экономики, но с более высокой добавленной стоимостью? Или же инновационные отрасли, за которыми будущее? Россия склонна дать второй ответ: утверждается, что нам необходим курс на построение инновационной экономики. Впрочем, наряду с собственно инновационными отраслями возможно и внедрение инноваций в традиционных отраслях.

(Russian GDP was 33 trillion rubles in 2007, or more than 1,3 trillion dollars.)

Why is it necessary to **diversify Russian economy**? Russian economy depends on oil and gas **too much**, these industries have an excessively high share in Russian GDP and export. This is **not** an altogether acceptable situation. So diversification implies in our case the lowering of the share of oil and gas in GDP and in export through the rapid development of other industries. Sometimes the other aspects of diversification are discussed, for instance, the increasing of the share of small and medium business in GDP.

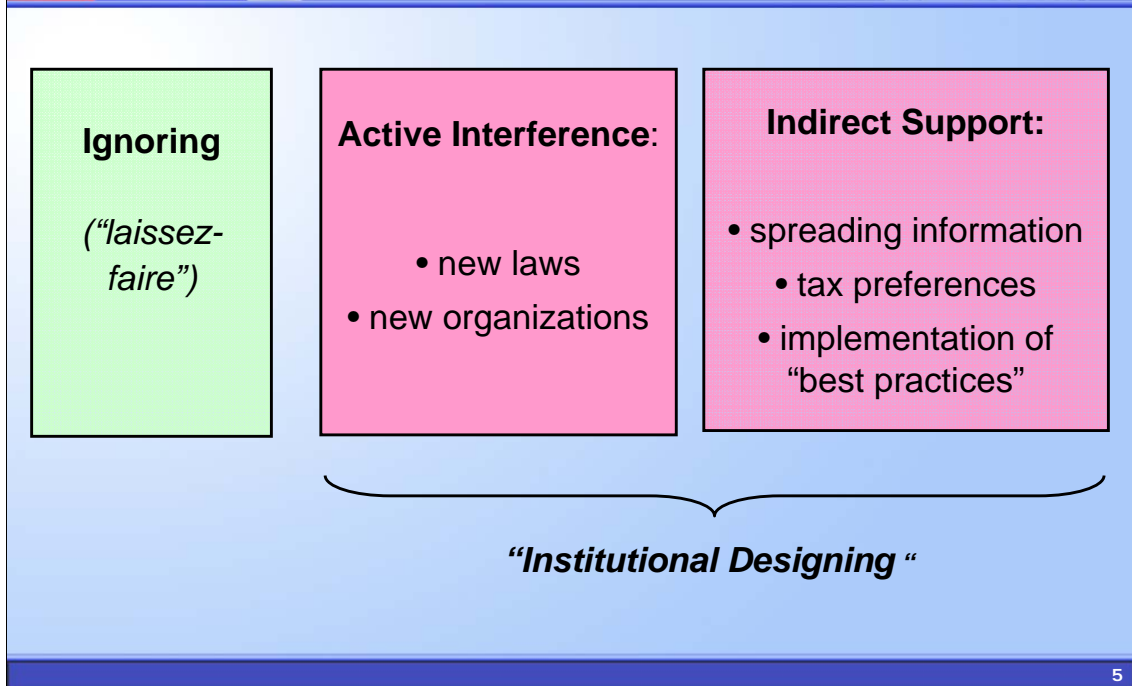
(The share of oil export in total Russian export was 38% in January of 2008; the share of all fuel and energy goods export in total Russian export was 70%.)

But which industries should be developed more rapidly: **traditional industries** with higher value added, or **innovative high-technology industries**? Russia prefers the second variant and declares the course towards “innovative economy”. In the draft of the Strategy of Long-Term Social and Economic Development of Russia which is now broadly discussed we can read the following: “By 2020 the share of high-technology industries and of “knowledge economy” in GDP must reach 17-20% (confront 10,5% in the year 2006- two thousand six).

It should be mentioned, however, that for the truly “innovative economy” the innovations must take place not only in the new industries, but in the “traditional” industries as well.

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What is the State to Do with the Inefficient Institutional Environment?



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Общим местом является утверждение, что в переходной экономике слабая институциональная среда, что является, в частности, препятствием и для внедрения инноваций. Что это значит? Как правило, речь идет не про полное отсутствие институтов вообще, а про их неэффективность: то есть институты существуют, но экономические агенты неохотно используют их – либо из-за недостатка информации о них, либо из-за высоких издержек их использования, либо из-за их противоречия другим институтам (в том числе противоречий между формальными и неформальными институтами). Возможна и ситуация, когда институты прямо вредны: избыточные административные барьеры, коррупция.

Что должно делать государство, если оно считает, что институциональная среда неэффективна? Можно ничего не делать, ожидая, что «рынок все расставит на свои места»; но это не лучший путь, ибо для рынка институтов достаточно характерны «провалы рынка», требующие именно государственного вмешательства. Можно вмешиваться активно и насаждать новые институты, принимать необходимые законы, создавать организации, которые будут их реализовывать. И можно мягко стимулировать использование новых или существующих институтов экономическими агентами: через налоговые льготы, через распространение информации, через внедрение «лучшей практики» в сфере деятельности самого государства.

It is a commonplace idea that the transitional economies have weak institutional environment (which may hinder in particular the implanting of innovations). But what does it mean “weak institutional environment”? Total **absence** of institutions in some spheres? This is doubtful: even if some formal institutions are absent, we are likely to find the informal ones instead. But the existing institutions may be **inefficient**. That is, the economic agents don’t use them or use them infrequently because of **lack of information**, or because of **high costs** of using them, or because they **contradict** other institutions. That is what we see in Russia. And some institutions may be directly harmful for the economy (corruption, for instance, or *excessive administrative barriers*).

What is the state to do with the inefficient institutional environment? One possible way is to do nothing in the hope that “the market will manage by itself”. But it is not the best way. Another variant is **active interference**: state may adopt new laws, or create new organizations specially to promote new institutions. And there is also a third, middle way, that is of **indirect support**: the state may spread information about the new institutions, or give tax preferences, or implement the “best practices” where it can (for instance, it may invite independent directors to the boards of directors of state-owned companies).

Both active interference and indirect support of new institutions may be called “Institutional designing”.

Next slide, please

- State Development Institutions
- Corporate Governance
- Financial Markets
- Small Business Support
- Protection of Property Rights

Теперь перейдем к пяти основным направлениям институциональных изменений, о которых я намерен рассказать.

Государственные институты развития: что это такое?

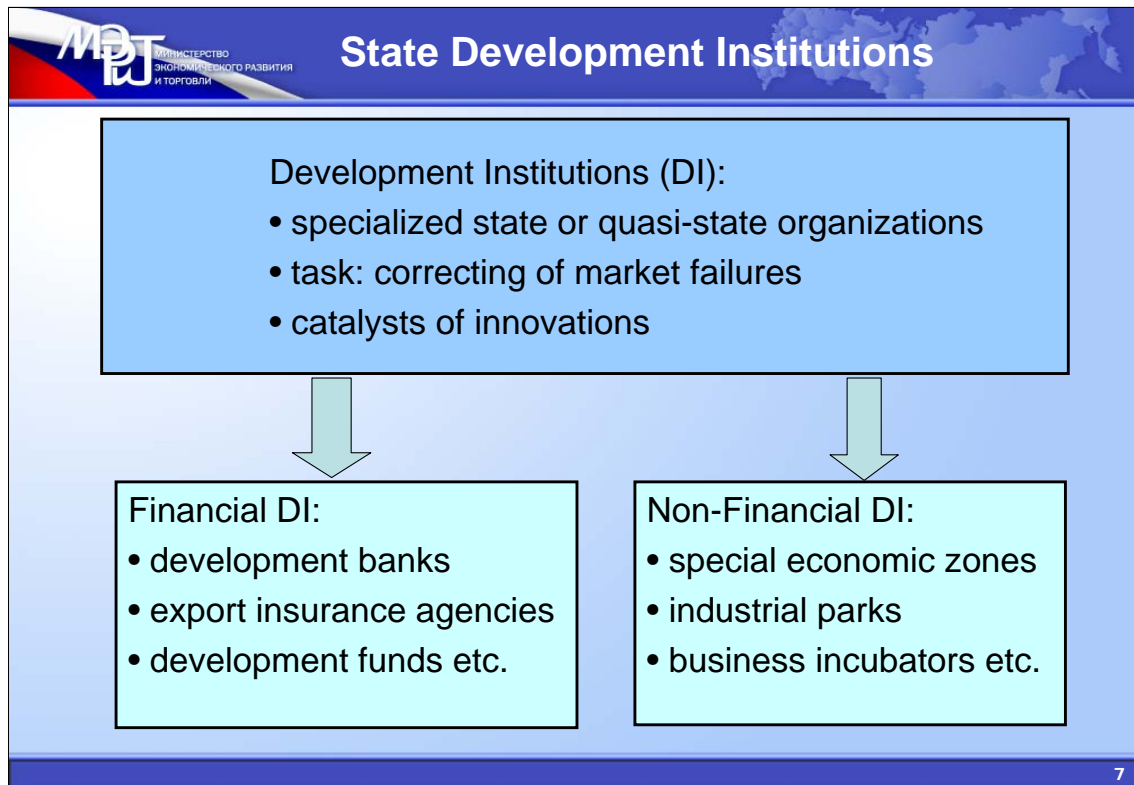
Now let's turn to the main spheres of institutional transformations. Among them we may single out:

- state development institutions,
- corporate governance institutions,
- institutions of financial markets,
- institutions of small business support,
- institutions of the protection of property rights.

(Maybe the list is not complete, but these ones are the most important, to my opinion.)

What are the **state development institutions**?

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Финансовые институты развития предоставляют софинансирование для проектов, которые важны для национальной экономики, но недостаточно привлекательны для частного бизнеса. Участие государства через институты развития в тех или иных проектах становится позитивным сигналом для частного бизнеса, снижает их рискованность и / или повышает их доходность. При этом институты развития не конкурируют с частными финансовыми институтами, а сотрудничают с ними и дополняют их. Это банки развития, фонды развития, агентства по страхованию экспорта и др.

Нефинансовые институты развития не предоставляют прямого финансирования бизнесу, но развивают необходимую для него инфраструктуру, - как материальную, так и финансовую, информационную, консультационную. Это, в частности, особые экономические зоны, промышленные парки, технопарки, бизнес-инкубаторы и др.

This term has become very popular in Russia during the last year, but there is no exact definition for it. We use the following approach: development institution is a **specialized state or quasi-state organization**, created for correcting **market failures** in a concrete sphere. Such institutions may promote **infrastructure development**, or they may work as **catalysts of innovations**. In most cases they are basing their activities on private-public partnership principles.

Financial development institutions provide co-financing to the projects necessary for national economy but unattractive for private business. The state participation in such projects through the development institutions reduces the risks and increases the return for private business, or at least it gives a positive signal for private business. These are development banks, development funds, export insurance agencies etc.

Non-financial development institutions do not provide direct financing to business, but they develop the infrastructure necessary for it, - the material one as well as the financial, informational and consulting infrastructure. These are industrial parks, techno parks, business incubators, special economic zones etc.

Next slide, please

- ✓ The Bank for Development and Foreign Economic Affairs (Vnesheconombank)
- ✓ The Investment Fund of Russian Federation
- ✓ The Russian Venture Company
- ✓ The Russian Corporation of Nanotechnologies
- ✓ The Agency for Housing Mortgage Lending
- ✓ The Russian Agricultural Bank
- ✓ Regional venture funds
- ✓ Techno parks, industrial parks, business incubators,
- ✓ Special economic zones etc.

Как видно из этого слайда, в России существует большое количество институтов развития самых разных форм. Некоторые из них уже имеют опыт работы, другие созданы буквально в течение последнего года и только приступают к своей работе. Многие из них имеют значительный капитал, измеряемый миллиардами долларов. Сферы их деятельности – самые разные: и развитие инновационных отраслей, как у ВЭБа, РВК, Роснано, и поддержка экспорта; и развитие венчурного бизнеса; и содействие развитию жилищной ипотеки; и поддержка малого бизнеса, в том числе в регионах; и поддержка сельского хозяйства...

Большинство из них созданы в силу прямых решений государства, их капиталы оплачены преимущественно средствами Российской Федерации (а в некоторых случаях – с участием средств регионов или муниципальных образований).

As we can see from the present slide, in Russia there exist a great number of state development institutions of various kinds. Some of them already have a certain **experience** of functioning while others have been created **recently** and are only beginning to work. Many of them possess considerable **capital** amounting to billions of dollars. They operate in diverse spheres, such as promotion of innovations, export support, venture business development, promotion of housing mortgage lending, small business support, financing of agriculture etc.

Most of them have been created by **direct order of the state**, and their capitals were provided by Russian Federation (sometimes also from regional and municipal budgets).

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- Clear definition of the mission, strategy and activities
- Definite criteria and procedures for project selection
- Public-private partnership
- Self-sufficiency without profit maximization
- Systemic approach at the national scale
- State control
- Transparency of activities, etc.

При всем разнообразии форм институтов развития мировой опыт показывает, что есть определенные принципы, которых следует придерживаться для обеспечения эффективности институтов развития. Они отражены на следующем слайде.

The development institutions may work in quite various forms and ways. But despite this variety the international experience shows us a very important thing. There exist certain principles which provide the efficiency of the development institutions. These principles are enumerated on the present slide, and I would like to underline that in Russia we are trying to put these principles into life.

First of all, it is necessary to give a **clear definition of the mission, strategy and activities** of each development institution, in order to avoid non-profile activities. It is very useful if such a definition is given in a law or in a government directive.

Second, it is necessary to give **definite criteria and procedures** (просиджез) for the **selection of the projects** which receive financial support from the development institution. This must minimize the risk of corruption.

Third, the principles of **private-public partnership** must be widely used.

Fourth, the financial development institutions must be **self-sufficient**, but they **must not maximize their profits**. (Such institutions do not compete with the private financial institutions, but cooperate with them and complement them).

I would also mention the necessity of **systemic approach** to the development institutions at the national scale in order to coordinate their activities: this will help to cover all the necessary spheres by different development institutions. It is also necessary to provide efficient **state control and supervision** over development institutions as well as **transparency** of their activities.

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- Created in 2007 as a **state corporation** (non-commercial organization)
- Charter capital of 180 bln. roubles (7,5 bln. dollars)

Instruments of financial support:

- credits
- guarantees
- acquiring shares in capital
- purchasing securities.

Priorities in activity:

- infrastructure
- industries
- support for exports
- support for small businesses
- environment protection.

I would like to give some details on two Russian development institutions which in my opinion are the most interesting ones: Vnesheconombank and The Russian Venture Company.

The Bank for development and external economic activity (Vnesheconombank) is one of the biggest Russian development institutions with numerous tasks and functions. It was created in 2007 by a special law in a form of a state corporation (non-commercial organization). Its charter capital is 180 bln. rubles, or 7,5 bln. dollars.

Vnesheconombank has the following priorities in its activity:

- Co-financing of **infrastructure** projects connected with transport, energy, housing and utilities
- Co-financing of investment projects in such **industries** as aircraft construction, shipbuilding, electronics, nuclear industry, transportation machinery, power engineering machinery, etc.
- Support for **small businesses**
- Support for **exports**
- Co-financing of projects connected with **environment protection**, etc.

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- Open joint-stock society with 100% state share
- Capitalization 30 bln. roubles (1,25 bln. dollars)
- Purposes:
 - facilitating venture investment in Russia
 - development of the innovative branches of the economy.
- Business model: “Fund of funds”
- Functions:
 - selection of the best management companies
 - investing into venture funds
 - non-financial support of venture business.

The Russian Venture Company (the RVC) was created in order to facilitate venture investment in Russia and to develop innovative branches of Russian economy. To my mind, it realizes the principles of private-public partnership and of non-competition with private business in the most consistent way.

The Russian Venture Company is a joint-stock society with 100 per cent state share. Its capitalization was of 5 bln. rubles when established in 2006, and by now it has increased up to 30 bln. rubles.

The Russian Venture Company works like an investment fund which invests into other investment funds (a “**fund of funds**” model). It does not deliver financing to venture companies directly, because it must not compete with the private financial institutions. The RVC acts otherwise: it selects the best venture management companies on a competitive basis and contracts them to organize venture investment funds. 51% of shares of these funds must be bought by private investors, and after this the Russian Venture Company purchases the rest 49% of shares, thus stimulating the venture investments.

In addition to this activity the Russian Venture Company is to provide non-financial support to the venture business in such spheres, as information, consulting, communications, education.

(Analogues: YOZMA in Israel, CITRA in Finland.)

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Prevention of the illegal corporate takeovers (“raidership”):

- Elimination of contradictions in the proceedings legislation
- Better regulation of the shareholders’ meetings and of shareholders’ registry
- Better information disclosure

Flexibility of management in joint-stock companies:

- Recombination of competencies of managing bodies
- Legalization of the shareholders’ agreements

The institutions of corporate governance develop rapidly in Russia during the last 10 years, but there still exist serious problems. Among them are the “**illegal corporate takeovers**”, that is robbing of corporate property; the inflexibility of corporate relations; the weak responsibility of managers and directors to shareholders.

What is to be done in this sphere? First of all the state must put an end to the practice of the “illegal corporate takeovers”, otherwise called “raidership”. A set of necessary measures is the following: elimination of contradictions in proceedings legislation, better regulation of the shareholders meetings and of the shareholders registry, reduction of the costs of obtaining information for shareholders and stakeholders. These are clearly institutional problems.

The other problem which hinders the development of Russian companies is the **insufficient flexibility of management** in joint-stock companies. For instance, the distribution of competencies and duties among managing bodies of a company is too rigidly determined by the law, and it leaves little space to recombine them. But for different purposes the shareholders may need different systems of corporate management and corporate governance, so it is necessary to permit the **recombination of competencies** among managing bodies of a company.

It is also useful to give the shareholders a legal opportunity to conclude agreements about the mode they will effectuate their rights (the so-called “**shareholders’ agreements**”). For instance, one shareholder promises to another that he will vote at the shareholders’ meetings according to the demand of his counterparty, and for this the latter will pay to him the dividends which he is to receive on his shares. Such agreements may regulate the questions which are not subject to the company charter and thus make the corporate relations more flexible.

Next slide, please

Stronger responsibility of the managers and directors:

- for the information disclosure
- for the deals containing conflicts of interests
- for leading the company to a bankruptcy, etc.

Other measures:

- promotion of independent directors
- transparency of information about beneficiary holders
- better regulations of affiliated persons, etc.

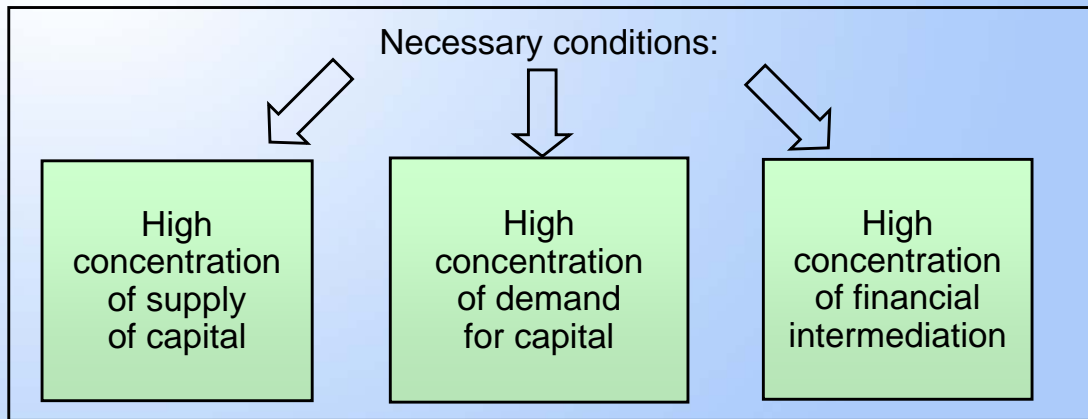
The “agent problem” well-known to the economic theory reveals itself in Russian corporate governance system as a problem of **insufficient responsibility of managers and directors** to the shareholders. It is a problem both for the minor shareholders and for the major ones, as well as for the creditors. Thus it is urgent to increase the responsibility of the managers and directors to the shareholders and to the stakeholders for the following violations:

- for not providing the information which is to be disclosed;
- for deals undertaken in the situation of conflict of interests;
- for leading the company to a bankruptcy;
- for a misconduct during the company’s liquidation, etcetera.

Among the other key policy measures in the sphere of corporate governance I would name the promotion of such an institution as **independent directors** (for example the inviting of independent directors to the boards of directors of state-owned companies). I should also mention the **transparency of information** about final beneficiary holders in the joint-stock societies, the better **regulating of affiliated persons**, etcetera..

Next slide, please

Full economic sovereignty in the XXI century
requires having strong domestic financial market



What is the situation with Russian **financial market institutions**? The Russian financial market is developing fast, but it is still smaller and weaker than the leading financial markets, - both in terms of capitalization and of institutions.

And the XXI century is an age of markets' globalization. In order to **retain full economic sovereignty** Russia needs to possess strong domestic financial market. More than that, it is quite desirable that Russia should become one of the **international financial centers**.

There are three necessary conditions for it, and these conditions are closely linked with each other.

Firstly, it is high concentration of the **supply of capital**. To achieve this goal, the state must provide:

- Tax incentives for the investors
- Openness of financial market for foreign investors
- Financial literacy of the population
- Effective use of the development institutions' capitals.

Secondly, it is high concentration of the **demand for capital**. For this it is necessary to reduce administrative barriers for the companies-issuers, including the innovation companies. It is also crucial to facilitate new financial instruments, including derivatives and securitization instruments.

Thirdly, the market needs high concentration of the **financial intermediation** in order to provide interaction between investors and recipients of capital. To achieve this goal, the state must stimulate the increase of capitalization of national banking system and insurance companies. At the same time the creation of integrated national stock market infrastructure is crucial. It must be technologically developed and well-capitalized, and it must include a stock exchange, a clearing house and a central depository.

Next slide, please

- Simplifying market entry for a new enterprise
- Limiting the scope of state control
- Improving access to the infrastructure:
 - office spaces
 - electricity networks etc.
- Improving the availability of financing:
 - state banks and development institutions
 - microfinancing etc.

We have mentioned that the diversification of Russian economy implies not only the lowering of the share of oil and gas in Russian GDP and export through the rapid development of innovation industries. It also implies the increasing of the share of **small and medium business** in GDP. But as it is, the small business doesn't feel very well in Russia. Its share in GDP is only about 17%, and its share in the total amount of those employed in the economy is just about 7%.

Which institutions for the small business support are to be developed? And which policy measures can the state undertake in order to facilitate the small business development?

First of all, it is **the simplification of market entry**: reduction of the administrative barriers for company registration and licensing.

Secondly, it is **the limitation of the scope of state control**. For this it is necessary to set up clear procedures for all possible inspections of the small enterprises (including the tax inspections).

Thirdly, a great part of small companies suffer from the unavailability of the infrastructure. **Improvement of their access to infrastructure** will give a significant impetus to their development. Here we mean non-discriminatory access to electricity networks, availability of office spaces, as well as the mass organization of industrial parks, techno parks, business incubators and so on.

Finally we should mention the **availability of financing** for the small business. It may be carried out through the credit programs of Vnesheconombank and of the banks with state participation. It may be augmented also through the development of venture financing through the Russian Venture Company and the regional venture funds. There also exist such new instruments as the regional guarantee funds and the microfinance institutions.

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- ✓ Increasing the effectiveness of the judiciary
- ✓ Increasing the transparency of the courts
- ✓ Increasing the independence of judges
- ✓ Regulating the conflicts of interests
- ✓ Obligatory declaring of the incomes, property and liabilities of the judges

Finishing my report I would like to say a few words about the institutional changes necessary for the sphere of the **property rights protection**, that is about the **improvement of the judiciary**. The Federal Program “Development of Russian Judiciary System” adopted in 2007 suggests the following directions of activity:

- Increasing the **effectiveness of the judges’ work** (*the automatization of the workplaces, the implementation of electronic documentation*)
- Increasing the **transparency of the courts** (*creating of web-sites of all courts, obligatory publication of the courts’ decisions, audio-taping of the proceedings*)
- Increasing the **independence of judges**, including the establishment of more definite and clear rules of their removal
- Regulation of **conflicts of interests** (*including prohibiting attorneys who are spouses or relatives of the judges to participate in hearings, obligatory declaration by judges of all informal requests received on the case prior to proceedings, etc.*)
- Obligatory **declaring of the incomes**, property and liabilities of judges.
- *Introducing procedures for out-of-the-court resolution of the disputes.*

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Thank you very much for your kind attention!

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That is all I wanted to speak about. Thank you for your kind attention, and I will be very eager to answer your questions if you have any.