Russia: Bank Assistance for Private Sector and Financial Sector Developments

Barbara Blaszczyk and Alexander Radygin
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## Acronyms and Abbreviations

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<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>ARCO</td>
<td>Agency for Restructuring of Credit Organizations</td>
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<td>BRU</td>
<td>Bank Review Unit</td>
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<td>CAE</td>
<td>Country Assistance Evaluation</td>
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<td>CAS</td>
<td>Country Assistance Strategy</td>
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<td>CBC</td>
<td>Case-By-Case Privatization</td>
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<td>CBR</td>
<td>Central Bank of Russia</td>
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<tr>
<td>CEE</td>
<td>Central and East European (countries)</td>
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<td>CMDC</td>
<td>Capital Market Development Center</td>
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<td>CMDP</td>
<td>Capital market development project</td>
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<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
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<td>ERP</td>
<td>Enterprise Reform project</td>
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<td>ESP</td>
<td>Enterprise Support Project</td>
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<td>ESW</td>
<td>Economic and Sector Work</td>
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<td>EU</td>
<td>European Union</td>
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<td>FCSM</td>
<td>Federal Commission for Securities Market</td>
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<td>FDI</td>
<td>Foreign direct investments</td>
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<td>FFPRIS</td>
<td>Federal Foundation for Protection of the Rights of Investors and Shareholders</td>
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<td>FIAS</td>
<td>Foreign Investment Advisory Service</td>
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<td>FIDP</td>
<td>Financial Institutions Development Program (Project)</td>
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<td>FG</td>
<td>Financial Industrial Group</td>
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<td>FPPC</td>
<td>Federal Center for Project Financing</td>
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<td>FSD</td>
<td>Financial Sector Development</td>
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<td>GKI</td>
<td>State Committee of the RF for State Property Management</td>
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<td>GKO</td>
<td>Government short-term bonds</td>
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<td>GOR</td>
<td>Government of Russia</td>
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<td>HIID</td>
<td>Harvard Institute for International Development</td>
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<td>IACC</td>
<td>Inter Agency Coordination Committee</td>
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<td>IAS</td>
<td>International Accounting Standards</td>
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<td>IBRD</td>
<td>International Bank for Reconstruction and Development (World Bank)</td>
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<td>IS</td>
<td>Institutional strengthening program of FIDP</td>
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<td>IFC</td>
<td>International Finance Corporation</td>
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<td>IFO</td>
<td>International Financial Organizations</td>
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<td>ILBE</td>
<td>Institute for Legally-Based Economy</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IPP</td>
<td>Investor Protection Program</td>
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<td>IPSDSA</td>
<td>Institute for Private Sector Development and Strategic Analysis</td>
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<td>IT</td>
<td>Information technology component of FIDP</td>
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<td>JSC</td>
<td>Joint Stock Company</td>
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<td>MOF</td>
<td>Ministry of Finance of Russia</td>
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<td>MPP</td>
<td>Mass Privatization Program</td>
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<td>MSP</td>
<td>Ministry of State Property of RF (currently Ministry of Proprietary Relations of Russia)</td>
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<td>OFZ</td>
<td>Federal bonds</td>
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<td>PIAL</td>
<td>Privatization Implementation Assistance Loan</td>
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<td>PSD</td>
<td>Private Sector Development</td>
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<td>REHAB</td>
<td>Rehabilitation Loan</td>
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<td>RPC</td>
<td>Russian Privatization Center</td>
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<td>SAL</td>
<td>Structural Adjustment Loan</td>
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<td>SD</td>
<td>State Duma or the Federal Assembly of the RF</td>
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<td>Task Force</td>
<td>Interagency Group for Strategic Issues, FIDP</td>
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<td>TATF</td>
<td>Technical Assistance Trust Fund</td>
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<td>TCA</td>
<td>Technical Cooperation Agreement</td>
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<td>TCP</td>
<td>Technical Cooperation Program</td>
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<td>USAID</td>
<td>US Agency for International Development</td>
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<td>WB</td>
<td>World Bank, or the International Bank for Reconstruction and Development</td>
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<td>WGAR</td>
<td>Working Group on Accounting Reform</td>
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Preface

This paper is one of the background papers prepared by outside experts as an input to the Russia Country Assistance Evaluation (CAE Task Manager, Gianni Zanini) by the Operations Evaluation Department (OED) of the World Bank. Findings are based on a review of project appraisal and completion reports, sector reports, research papers in the academic literature, and a number of other documents produced by the Borrower and the Bank. The authors visited Russia in February 2001 and interviewed current and retired government officials and Russian experts. Bank staffs were interviewed at both headquarters and in the field office. An earlier preliminary version was discussed at a small workshop in Moscow in February 2001, with the participation of central government officials, academics and members of policy research institutes, and representatives of project implementation units of Bank-supported projects. Their valuable assistance and feedback is gratefully acknowledged.

The authors—Ms. Barbara Blaszczyk, a professor and research fellow at the Institute of Economics, Policy Academy of Sciences, and President of the Board of the CASE Foundation (Center for Social and Economic Research) in Warsaw, Poland and Dr. Alexander Radygin, a member of the Board of the Scientific Council, Head of the Division for Ownership Structure and Corporate Governance, Institute of the Economy in Transition (IET) in Moscow, Russia—are grateful for the comments received on previous drafts by the OED peer reviewers (Mmes. Alice Galenson for Private Sector Development and Laurie Effron for Financial Sector Development), CAE task manager, and other contributors to the CAE background work (Mr. Ivan Szegvari of EBRD), ECA staff (Messrs. Michael Fuchs and Paul Siegelbaum) and Mr. Russell Cheetham (former ECA director of the department including Russia), which have been taken into account in the July 2001 version. However, the views expressed in this paper remain entirely those of the authors. They do not necessarily represent the views of the World Bank.

An earlier draft dated July 31, 2001 was sent to the Russian Government for review. No comments were received.
Executive Summary

1. From the beginning of its work in Russia a decade ago, the World Bank has recognized that privatization and support for private sector development are important priorities.

2. A joint study by the Bank and three other international financial institutions, completed in December 1990, laid out the reforms necessary to transform the Soviet economy into a free market economy. Ten years of reform in Russia have confirmed the validity of most of the study’s recommendations, many of which, however, remain to be fulfilled. The superiority of quick, radical reforms over gradual ones was justified by reasons of political economy and by the experiences of other transition and developing countries. The study stressed the need to achieve economic stabilization and price liberalization before introducing other systemic reforms—privatization, institutional reforms, and legal reforms—that would take much longer to implement.

3. In privatization and private sector development—one of the main reform areas—the joint study strongly recommended, as an introductory and necessary step, the clarification and legal protection of property rights. It recommended a flexible approach, tailored to the type of activity and size of enterprise and making use of the advantages of "giveaway" and commercial methods of privatization. Revenues from the latter method were to help cover some of the costs of the economic reforms. De-monopolization and the enforcement of hard budget constraints on enterprises were noted as crucial measures for effective enterprise reform.

4. Since late 1991, the Bank has helped the Russian privatization agencies prepare the mass privatization program, define policies for private sector development, and design the legal framework for a market economy. Together with the European Bank for Reconstruction and Development (EBRD), the Bank helped to establish a large consortium, funded by the European Union, aimed at assisting in the design and implementation of the Russian privatization program. Although only partly successful, these early efforts under the Technical Cooperation Program (TCP) were efficient and valuable. The TCP was especially useful in preparing Russia for Bank membership. Work done under the program was used in preparation for subsequent lending operations. However, real progress toward reform was mixed, with the major constraint being the very difficult cooperation of the Bank with the Russian authorities, resulting from the lack of agreement among the government branches, the Central Bank of Russia, and the parliament, among other factors.

5. Beginning in early 1992 and ending in June 1994, the Russian Government launched a very ambitious and impressive1 mass privatization program supported by a Privatization Implementation Assistance Loan (PIAL) from the Bank. The government’s goal was to make irreversible changes in the basic economic relationships of the economy, while putting a stop to spontaneous quasi-privatization of enterprises by insiders. This stage of the privatization program was assessed as very successful, both by the Russian reformers and by the international community.

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1 In terms of time efficiency and logistic achievements, this program was remarkable. It was also the largest privatization program in world history in terms of its scope, both the number of enterprises and the number of participating citizens-shareholders.
6. The reformers in government and their external advisers, including Bank staff, were aware of the limitations of the mass privatization method in terms of corporate governance, and they understood that the restructuring process required new and committed investors. Therefore, they designed ownership structures to be as open as possible, allowing free trade in and redistribution of shares after privatization, expecting an improvement of enterprise governance and performance over the medium term.

7. Mass privatization should have been followed by systemic reforms to sustain transparent ownership, assist in the secondary redistribution of property, and protect shareholders from fraud and abuse. Basic capital market reforms, for example, should have included a watch-dog institution for the capital market, independent registers or depositories for shares, disclosure of information from companies issuing shares, and other means to protect investors. Unfortunately these reforms were initiated only after a delay of two or three years and still remain incomplete. This important loophole in the mass privatization program’s design and implementation diminished the chances of the long-term success of the program.

8. These shortcomings could have been at least partially avoided with intensive help from Western advisers, assuming equal interest on the Russian side. In addition to drafting the necessary regulations, it was necessary to prepare the country (a) by explaining their role and importance in market economies and (b) by providing technical assistance to educate business and government personnel. The inability to do either must be judged an important deficiency in the World Bank’s operations in Russia. After almost ten years, it is difficult to assess whether the Bank could have done more in this area or whether it could have pressed the Russian government for the needed reforms more strongly. We can only conclude about the final results: While voucher privatization created many owners, the absence of some other institutional reforms precluded the development of effective capital markets.

9. In spite of some achievements, the general progress of reforms in enterprise restructuring and financial sector development was unsatisfactory until the mid-1990s. The planned second stage of the privatization program, in the form of case-by-case privatizations was never implemented, despite intensive work on its preparation from the Bank’s side. A 1995 Bank assessment concluded that the relatively positive outcomes of mass privatization and small-scale privatization had not had enough impact on enterprise restructuring and had not created a competitive economy. Besides mass privatization, which proved to be an early success, only limited progress was made in other areas, and few of the long-term objectives that were to accompany or follow up mass privatization have been achieved.

10. In the early 1990s, most intellectual attention and, later, implementation energy were devoted to the mass privatization program and other large-scale privatization transactions. These were indeed highly relevant priorities. Much less attention was paid to the “grassroots” privatization of the economy that would emerge from the natural entrepreneurship of the people if the right incentives were to be put in place. Bank assistance in this important area, which should have included assistance to ease entry for new enterprises and for basic legal reforms, was deficient, probably because the Russian government paid insufficient attention to the constraints on the grassroots development of the new private sector in Russia.

11. This sin of omission was not for lack of adequate analytical and economic work by the Bank. The main barriers to the development of new enterprises had been well identified: the

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2 This program succeeded remarkably well in chosen regions, largely due to the valuable involvement of the IFC.
lack of stable rules in the economic environment, an archaic tax system, the lack of a real estate market, and, most daunting of all, an inadequate legal system, characterized by unclear and unstable laws, the absence of a modern framework of civil and corporate law, discretionary interpretation of laws, and weak law enforcement.

12. In 1994, the Bank suggested a more coordinated and ambitious strategy for legislative reform and the strengthening of legal institutions, and it encouraged the government to make a substantial effort in this direction. At the time, however, the government was reluctant to borrow for technical assistance and “non-revenue generating projects.” Only in May 1996 was the Bank able to begin a Legal Reform Project, and with a much smaller scope than was proposed in 1994. Several grants from official donors and private organizations were not sufficient to give the Bank’s efforts the “critical mass” needed for effective legal and judicial reforms. Instead of addressing this major challenge more forcefully or clearly reporting the Russians’ lack of readiness for deeper reforms to the international community, the Bank decided to focus on several narrow projects that were less ambitious and politically sensitive, but also much less important for reform.

13. The transition countries of Central Europe never completely lost their understanding of the rules and values of a market economy and its institutions. The fact that such an understanding was practically absent in Russia after more than 70 years of Communism made the task of introducing legally protected private property rights very difficult. Russia’s failure to ensure the security of private property is one of the main causes of the deficiencies of the Russian privatization program and of the limited growth of a grassroots private sector.

14. The other main cause for the lack of serious enterprise restructuring and solid corporate governance in Russia after privatization was the weak budget constraints facing enterprises, whether private or state-owned. The insider-owners of newly privatized companies were never forced either to start intensive restructuring measures or to attract outside investors. Until 1998, the government’s policy became increasingly permissive of inter-enterprise arrears and other non-payments. Non-payments, a hidden and untargeted form of state subsidy, were the product of piecemeal, gradual reform after 1995. The Bank seemed not to have an adequate understanding before 1998 of the negative effects on newly privatized enterprises of the country’s loose monetary (up to 1995) and fiscal policies (up to 1998).

15. From 1995 to 2000, the privatization process slowed down dramatically. Factors contributing to the slowdown included the lack of demand for residual state shares resulting from unresolved problems with land use and share trading, unclear property rights in privatized companies, and a generally unfriendly environment for domestic and foreign investment. The “loans for shares” scheme, carried out during the last quarter of 1995, was the most significant step in reversing the formerly transparent logic of the privatization program and consolidating the fortunes of a few financial-industrial groups controlled by Russia’s new “oligarchs.”

16. In the area of financial sector reform, the joint 1990 study stressed that banking legislation should be enacted as soon as possible and recommended quick development of the banking sector. It also recommended the establishment of a strong system of bank supervision, a common regulatory framework for commercial and cooperative banks, and stronger prudential regulations. In addition, accounting standards were to be upgraded and professional staff trained at all levels of bank management. The commercialization and privatization of banks and the intensification of competition through the involvement of foreign banks in joint ventures with privatized Soviet banks were suggested.
17. Through 1992–1993, the Bank focused on improving its knowledge, notably through a comprehensive field study. In 1994, the Financial Institutions Development Project (FIDP) was developed with the aim of raising the quality of banking services by strengthening a group of leading commercial banks that were willing to establish high standards for their operations and reporting. The project also included support for banking supervision and inspection, as well as for raising the quality level of financial reporting by banks to international standards. In our view, the main focus of the implementation of this project was not properly set, because, in the given situation, it should have concentrated on prudential regulations and the implementation of other civilized rules in the banking sector, rather than on the rapid development of the investment capacities of private banks.

18. The project can claim some achievements, particularly in upgrading the technical equipment of the participating banks and promoting the improvement of bank accounting standards and financial reporting. However, it did not strengthen the stability and quality of intermediation services in the banking sector, despite its ambitions for “systemic” banking reform. While asset management and risk management were very poor, prudential regulations were not imposed on participating banks. The project suffered a major setback with the financial crisis of August 1998 and was subsequently restructured. The restructured project wisely did away with a flawed accreditation procedure that had allowed too many banks (some of them completely unqualified) to participate in the project.

19. Beginning in 1995, the Bank recognized, in a deeper and more precise way than before, that market reforms in Russia needed much more time than in Central European countries and that stress should be laid on establishing the basic institutions and legal rules of a market economy. After the Russian presidential elections of 1996, the Bank assumed that the political and macroeconomic conditions for comprehensive structural reform were more favorable than ever before—it described the situation as “a window of opportunity for structural reforms.” As before, however, many of the provisions of the government’s 1997–2000 reform program remained on paper, and the lack of borrowers’ ownership of proposed reforms remained unchanged.

20. Nevertheless, the Bank committed itself to a series of large, quick-disbursing adjustment loans to assist the government in undertaking key structural policy and institutional reforms that would help restore macroeconomic stability and lay the basis for sustainable economic growth. The progress of reforms supported by the first two structural adjustment loans (SALs) was uneven and unsatisfactory, in the sense of renewing economic growth and stabilizing the

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3 The following clarifies why we think that the project was ambitious. According to the Staff Appraisal Report on FIDP of April 6, 1994, the project objectives and description are as follows: “The ultimate objectives of the program are to increase the quantity and improve the quality of banking services, promote banking stability, and contribute to a more efficient mobilization of financial resources and allocation of bank credit (including any bank lending financed by the Bank or other international sources). The immediate goal is to strengthen a core group of banks which will: (i) set higher banking standards and create a dynamic for improving the quality of banking activities in Russia; (ii) provide the basis for a private clearing system operating at the federal level; and (iii) qualify as on-lenders of Bank and other international lines of credit. The project will consist of four components: (i) a commercial banking component, consisting of institutional strengthening programs, and systems modernization and automation programs for participating private commercial banks; (ii) a bank supervision component, consisting primarily of the development of on-site supervisory capabilities and legal assistance for the Central Bank of Russia; (iii) a bank accounting component, which will support the modernization of accounting and auditing standards and practices; and (iv) a Project Implementation Unit (PIU) component which will contribute to the establishment and early stages of operation of the PIU.”
economy. The poor outcome was largely a result of the unstable political environment and insufficient support for reforms in Russia.

21. On the threshold of the Russian financial crisis, a third major SAL was approved in mid-1998, of which only the first tranche was disbursed. Unlike the two preceding operations, SAL III conditionalities were tied to multiple tranches. For the first time with this operation, the Bank gave full priority to the improvement of the overall business environment in most important dimensions. SAL III was a very well structured operation, with clear and relevant priorities backed up by a sound analytical base. However, it was not possible to prove the efficacy of the new approach, because the financial crisis and subsequent events led to its cancellation in August 2000.

22. After the financial crisis, the Bank’s thinking changed. Sobriety and realism characterized the Bank’s new attitude. In its December 1998 CAS Progress Report, the Bank seems to take on the status of an observer rather a participant. The Bank’s attention, in line with the priorities of the government, was on the strategy and working plan for banking sector restructuring and on evaluating the social consequences of the crisis in order to identify specific social assistance interventions, rather than on long-term issues of private sector development.

23. By the end of 1999, with macroeconomic performance improved, the Bank’s attention had returned to the lagging structural reforms. In the area of private sector development, the Bank focused on supporting the improvement of the overall business and investment environment, first under the restructured SAL III and, after its cancellation, through analytical work and policy advice. In mid-2000, a new government incorporated in its program all of the significant reform proposals advanced in SAL III.

24. During the 1990s, the Bank’s program was directed not at a strong, reform-minded government—as in several other transition countries—but to a small group of reformers who tried to move the government in the right direction without the benefit of broad political support. The Russian government’s ownership of reforms throughout the decade was low, improving only after the 1998 financial crisis. Nearly all economic processes have been strongly politicized, and little consensus exists among branches and levels of government. Future progress toward the announced goals of reform will require strong political will and commitment at all levels of government.

25. The Bank’s most significant and long-lasting contribution was to prepare Russian elites for reforms that will have to be implemented if the country is to create the conditions for sustainable economic growth. After a decade of Bank involvement, at least many Russian leaders (from different milieus) have come to understand the essential prerequisites for a market economy.

26. In view of the huge scale of needed reform and the scarcity of reformers within the country’s severely divided political leadership, it is clear that the Bank’s attitude toward Russian reforms was overly optimistic during much of the period under study. The Bank repeatedly tried to provide Russia with best practices. When the government proved unwilling to adopt them, the Bank did not give up, but provided second- or third-best solutions. In so doing, the Bank may have been too permissive.

27. Not wishing to lose contact with the government and understanding the pressures facing Russian reformers, the Bank often was willing to implement “small step” reforms in the hope
that they would take root and grow. Unfortunately, a decade of experience has shown that the soft and partial reform attitude has failed, especially in areas such as macro-stabilization, banking, corporate governance, and the legal environment, where systemic change is required.

28. The following topics, identified by the Bank as necessary for private sector development and financial sector reform in Russia, remain highly relevant today:

- General conditions affecting private sector development, including obstacles to the entry of new enterprises, excessive government intervention, and equal conditions of competition at the federal and provincial levels.
- The legal and judicial framework for bankruptcy.
- Property rights and effective corporate governance.
- Anti-corruption measures.
- Adherence to international standards of disclosure and audits.
- Definition of real property rights and development of real estate markets.
- Banking supervision and governance.
- Reform of the financial sector to minimize systemic risk in the banking sector.
- Judicial reform—a necessary precondition for resolution of many other problems.

29. In the future, the Bank must make further lending contingent on the achievement of visible progress toward reform. For the first time in Russia, there exists today a common understanding between the Bank and a broad spectrum of policy makers of what is crucial and a much better ownership of reforms by the client country. That should make the Bank’s task easier.

30. However, caution is still in order. The economic, social, and political situation in the country remains very difficult, in spite of the remarkable recovery after 1998. The structure of the Russian economy is distorted by huge, monopolistic organizations that are difficult to regulate. Far-reaching changes in laws and institutions are still needed to create the stable, predictable environment that investors and entrepreneurs need. The necessary legal and institutional improvements will require changes in Russian habits of mind—changes that will not occur overnight. This challenge calls for a long-term commitment to an ambitious program of lending and non-lending services.

31. The international financial institutions may not appreciate the gravity of Russia’s predicament, given 10 years of only partially effective reform efforts and a very serious financial crisis. The scope and quantity of economic and sector work, for example, are not what they were in the mid-1990s. A new report on the state of the country, similar to the one prepared in 1990 by the Bank and three other institutions, would be very useful.

32. What should the Bank do better? The experience reviewed in this report reveals a great need for institutional strengthening of the agencies responsible for implementing reforms and more flexibility of the Bank in its relationship with the Borrower. Lack of flexibility and institutional shortcomings have led repeatedly to disappointment, for example—the failure of the Capital Market Development Project.4

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4 This project is but one very visible example in which the Bank had rejected the principle used in other projects of this block of initiatives, that is, a flexible approach concerning the use of the loan in accordance with changing needs of the borrower.
33. The Bank should conceive and implement its projects in such a way that projects complement each other or leverage other developments. Legal reform, for example, could have made faster progress if it had been backed up by collaboration between the Bank and the Russian government on structural reform of the economy.

34. Within the framework of individual projects, it is crucial that all project components be completed in a timely manner. Projects have been sometimes poorly timed and subject to serious delays. The time between drafting, acceptance, and beginning work has sometimes been so long as to make the project irrelevant, leading to project restructuring and further delay. An example is the Privatization Implementation Assistance Project.

35. The Bank should react strongly and quickly to visible abuse of some projects and to government decisions that neutralize reform efforts, unlike its weak and belated reaction to problems that developed under the Financial Institutions Development Project or to the “loans for shares” privatization.

36. The Bank should avoid frequent reshuffling of its project staff, which, combined with frequent changes in the Russian government, has led to frequent delays in project implementation, long theoretical debates, and a scattering of the consensus required to implement projects successfully.

37. The Bank should sharply increase its control over project implementation, but without micromanaging. Setting clear targets for implementation, and monitoring progress toward those targets, are the keys to successful control.

38. The Bank should work closely not only with line agencies responsible for project implementation, but also with representatives of the government who are responsible for the general course of reform in the country.
1. Introduction

1.1 This draft assessment of the World Bank’s assistance to private and financial sector development in Russia from 1990 to 2000 has been prepared on the basis of an extensive review of formal and informal World Bank documents, economic and sector works (ESW), and other literature, and a field visit to Moscow in February 2001. Lists of people interviewed and literature consulted (other than World Bank and Russian Government official documents) are appended.

1.2 The description of the Bank’s activities is preceded by a short presentation of the starting point of Russian reforms—from the internal and external points of view. For the more detailed analysis of sectoral projects the study period has been broken up as follows:

- 1990 to the first half of 1992: Initial phase of assistance preceding membership in the Bank
- 1992 to 1994: The learning and policy lending phase
- 1995 to the first half of 1998: The changing agenda for reforms
- August 1998 to 2000: Financial crisis and subsequent changes in Bank strategy

1.3 Support for private sector development (PSD) and assistance for financial sector development (FSD) have been analyzed separately, wherever possible.

1.4 In assessing the quality of the Bank’s projects, the authors concentrated on the most important products and services in the most relevant programs of the World Bank. Several other Bank programs are related to some extent to the private or financial sector; however, they have been not considered here, because they are included in other sectoral papers. Examples include evaluations of public management, social issues, and energy-related issues.

1.5 This draft represents a merger of two papers prepared in the earlier stage of evaluation. The first paper was prepared by the Center for Social and Economic Research (CASE) and authored by Barbara Blaszczyk. The second was prepared by the Institute for the Economy in Transition (IET) and authored by Alexander Radygin. Chapters 2 and 4–6 are based primarily on IET’s analysis; chapters 3 and 7 derive primarily from CASE. This draft should not be quoted without the permission of the authors and the director of the country evaluation team. The authors will be grateful for comments and corrections.
2. Sector Performance and Challenges

Preliminary Remarks

2.1 Privatization is a fundamental element of the systemic reforms carried out in the transition of the Russian Federation’s economy. Its purpose is to ensure the basic conditions for normal operation of a future market economy. Privatization transforms ownership relations, creates new incentives for economic actors, and establishes the prerequisites for rational change in the structure of the economy and for increases in efficiency on a nationwide scale. Privatization is necessary to promote political democracy, notably by forming new social strata of people interested in avoiding a return to Communism. A telling characteristic of the essential goal of privatization in transition economies is given by Shleifer: “Privatization amounts to permanent reallocation of control from bureaucrats to firms’ insiders and outside shareholders. Privatization has very clear benefits for economic efficiency because it establishes genuine private property rights.” [1994, p. 3]

2.2 In the conditions of the transition economy, privatization does not automatically lead to the appearance of stable and viable enterprises; it does serve, however, to create the necessary economic and legal prerequisites for such enterprises. The experience of all transition countries shows that privatization can be successfully implemented only when combined with a package of other reforms. The prospects of any privatization program depend also on the former share of the private sector in the economy, the development of financial markets, the presence of legal guarantees for foreign investors, the policies of government and social partners, and the presence of a favorable institutional and legal environment. Thus the presence (or absence) of a proper environment to some extent determines how effective privatization will be and how large or small its scale becomes. In turn, privatization shapes that environment, primarily through the creation of a sector of market-oriented companies independent from the state (even if only formally in the initial stage).

2.3 In all post-Communist countries, in comparison to developed market economies, the following problems arise in the initial stage of privatization:

- The links between privatization and changes in power relations in society oblige the government to make ideological choices.
- Choices must be made between the scale and scope of privatization and other priorities (such as budget revenues).
- The market environment is not yet competitive.
- Deficiencies in technological and market know-how are vast.
- Necessary laws, regulations, and institutional market infrastructure are lacking.  

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5 Such as setting hard budget constraints on economic entities, macroeconomic stabilization, liberalization of prices, opening of the economy for the import of goods and capital, de-monopolization of the economy, and development of financial markets.
6 For more detail, see the papers dated 1989–1995 in the list of references. The most complete treatment of the approach of international financial organizations to economic reform in Russia and other transition economies is in International Monetary Fund et al., *A Study of the Soviet Economy*, Vols. 1–3 (Paris, February 1991), discussed in section 2.1 of this report. Other examples of publications discussing the similarities and differences between Russia and other transition countries are: Commission of the European Communities (Brussels, 1991); Farid Dhanji and
2.4 Despite many systemic similarities between Russia and other transition countries, their starting positions for market reforms in general and privatization in particular differed in essential ways. Throughout the entire period of the command economy, some of the countries of Central and East Europe—notably Poland, Hungary, the former German Democratic Republic, and Yugoslavia—had a private sector, to a greater or lesser extent, in agriculture, retail trade, consumer services, or small industry. The prior existence of private-sector entities facilitated rapid creation of a market environment, because many people owned private resources or were willing to become owners of state property, and because of the existence of legal rules governing this sector. The lack of such a private sector in Russia and the absence of any legal rules in this area proved to be a serious barrier to privatization in Russia. In addition, in certain countries (Hungary and Poland) state-owned enterprises for many years enjoyed a measure of economic freedom that brought them closer to a market environment. That was not true of the state-owned enterprises of the former USSR.

2.5 The development and implementation of privatization policy became especially complex in Russia due to the more intensive influence of the following factors, compared with other countries in transition:

- A vast, spontaneous transformation of state-owned enterprises and property into other forms of property (collective, quasi-collective and quasi-private forms of ownership) paralleled the political reforms of the late 1980s.
- The high level of concentration and relative backwardness of many sectors of Russian industry hindered the process of structural change.
- The privatization process in Russia was highly politicized.
- The contradictory and unstable nature of the legislative base was manifest in the absence of an integrated and uniform approach to privatization. Regulations were contradictory; rules changed frequently; in some cases, regulations and acts conferred exclusive and extralegal rights on private parties; and decisions were frequently reversed or repealed.

2.6 The chief differences between the course of privatization in Russia and certain countries in Central and Eastern Europe were:

- In Russia, rapid privatization prevailed over other privatization goals, such as maximizing budget revenues.
- Shares were widely dispersed among insiders in the initial phase of privatization.
- Access to the Russian market was made difficult for foreign investors, who, therefore, played a small role.
- Russia lacked any form of property restitution to pre-Soviet owners.
- Russia did not succeed in splitting up large industrial monopolies before privatization.
- Differing interests between the federal and the regional government levels influenced the privatization model and the distribution of privatization revenues.

2.7 To summarize, Russia emphasized a rapid, formal transfer of property to private ownership, which was only very loosely linked with financial stabilization, antimonopoly policy, structural change, and attraction of new investment (including foreign investment). Once most of the enterprises were privatized, the opportunities for state influence were

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Branco Milanovic (OECD, 1990); Soo Im, Robert Jalali, and Jamal Saghir, (World Bank, 1993), and Barbara Blaszczyk and R. Woodward (1996).

7 In this report, “regional” refers to “Oblast-level.”
drastically lessened. The economy did not establish a base for necessary future growth. In contrast, those countries of Central and Eastern Europe that partially sacrificed the rate of privatization, while pursuing macroeconomic stabilization, were able to achieve greater potential for growth.

Privatization

2.8 Russia’s modern-day private sector formed itself from naught beginning in the mid–1980s. The mass privatization of 1992–1994 was an important stage from the point of view of the future development of a new system of property rights. Its result—with all the problems of its future development—was the appearance of new economic and legal mechanisms and institutional structures: a corporate sector of some 32,000 joint-stock companies created out of government-owned companies, a corporate securities market, a system of institutional investors, and a new social stratum of private owners.

2.9 During the next stage (“money privatization” in 1995–2000) the privatization process slowed down dramatically. New privatization instruments were an exception. Examples included loans-for-shares auctions, federal stock transfers to the regions to cover federal budget arrears, and conversion of debt into securities. Many objective and subjective factors caused this slowdown in privatization. The most substantial economic factor was the lack of demand for the “residual” government stock on sale. This lack of demand resulted from other factors, such as unresolved problems with land use and land trade, unclear property rights in privatized companies, and a generally unfriendly environment for domestic and foreign investment. When setting up major privatization sales in 1995–2000, the government acted out of short-term budgetary considerations, even when strategic industries were auctioned. The government’s position was discouraging for serious private investors. Additionally, regional authorities hindered privatization with their attempts to establish control over regional industries, including those owned by federal bodies.

2.10 The “loans-for-shares” scheme, carried out during the last quarter of 1995, was the most significant step in reversing the initially transparent logic of the privatization program. According to reports, the auctions were not prepared in a transparent manner; the winners were generally the banks that managed the auctions. As a result, four major Moscow banks became controlling shareholders of some of the largest industrial and service companies (including large oil and metal companies). This allowed the creation or enlargement of the so-called financial-industrial groups (FIGs) and was one of the sources of the fortunes of Russia’s new “oligarchs.”

2.11 The financial crisis of 1997–98 did not help to establish a higher degree of fair and transparent privatization procedures, despite the fact that transparency had been declared as a top priority of the government. Many unresolved problems remained in 2001, such as the need for a radical reduction of unitary enterprises (as well as the continued lack of a clear general concept of government property management), insufficient legal protection of investors’ (shareholders’)

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8 The list of analytical papers on privatization in Russia (including sectoral works of the World Bank) is long indeed. See, in particular, Bohm (1997); Boyko, Shleifer, and Vishny (1995); EBRD (1995–2000); Frydman, Gray, and Rapaczynski (1996); Radygin (1995); World Bank–OECD (1997); World Bank (1996); World Bank (1998); Carlin, Fries, Schaffer, and Seabright (1999); Claessens, Djankov, and Pohl (1997); Djankov (1999); Earle, Estrin, and Leshchenko (1995); Frydman, Gray, Hessel, and Rapaczynski (1997); and Stiglitz (1999).

9 In some cases, the winners were designated before the auctions, and bidders were disturbed to take part in them. See I. Lieberman et al., “Russia: The Rise and Fall of Russian Privatization”, Internal Report prepared by World Bank, January 1996.
rights, insufficient improvement in law enforcement procedures, insufficient transparency in individual privatization transactions, lack of an inventory of government property, the absence of clear lease arrangements related to government property, and the lack of a shortened procedure for the sale of land under privatized facilities.

2.12 Under present circumstances, privatization is increasingly losing its major role as an element of economic reform, due to unresolved problems of corporate governance and ownership structure and to the generally poor institutional and legal environments for private sector development.

Banking Sector

2.13 Until 1989, Russia had a one-tier banking system—loan operations were being conducted by specialized government banks, each of which served a share of the client pool. The first commercial banks appeared after 1989, and, from 1991, their number started to grow quickly (to about 2,500 entities by 1997–98). The Central Bank of the Russian Federation (CBR) and its territorial offices were established. Under the law that created it, the CBR refines commercial banks, manages federal budget accounts, performs interbank clearing, issues banking licenses, and supervises the operations of commercial banks.

2.14 Commercial banks were allowed to conduct cash operations for their clients. From 1991, banks of the second tier were permitted to handle foreign currencies, domestically and abroad, to handle transactions with government securities and non-financial corporations, and to perform trust and leasing operations. In 1992, settlements by and between commercial banks were rearranged to clear through correspondent accounts, which were either set at the CBR’s clearing centers or directly opened by one bank at another bank. Requirements for banks remained quite liberal. The low level of minimum charter capital was further devalued by the high inflation of 1992–93, and bank registrations were not accompanied by serious analysis. The number of banks increased quickly in the first half of the 1990s.

2.15 The development of the markets in government short-term bonds (GKO) and federal bonds (OFZ) played an important role in banks’ adaptation to new financial conditions. The volume of the GKO market by the end of 1994 was 5 percent of the consolidated Russian banking balance. By the middle of 1996 it was 18 percent, and by the middle of 1997 more than 30 percent.

2.16 The problem of foreign banks’ access to the Russian banking services market has generated a heated discussion. Banks with 100-percent foreign ownership and joint banks created with the participation of foreign capital during the years of reform in Russia have not been able to win a notable place in Russian banking services. For the purpose of regulating the entry of foreign banks into Russia, “transitional periods” were set, within which Russia reserved the right to limit operations by foreign banks (“Agreement on Partnership and Cooperation with the European Community,” June 1994). In 1996–1997, major Russian banks expanded their access to more inexpensive resources of the foreign financial markets by issuing Eurobonds and syndicated loans, and by opening of lines of credit with Western banks.

2.17 At the stage of transition from extensive to intensive development of the Russian banking system, the problems of supervision, regulation, and improvement of commercial banks’ solvency took on special significance. This stage, which began in 1995, directly relates to the implementation of the policy of financial stabilization. After access to cheap centralized
resources and the ability to redistribute inflationary taxes to their benefit were curtailed, many banks found themselves in rather complicated positions, as shown by the growing number of banks whose licenses were revoked. By the middle of 1997, only 40–60 percent of banks were considered more or less financially stable. The financial crisis of 1998 fully exposed the problems of Russia’s banking sector and led to calls for a radical reform of the system of banking regulation.

2.18 Despite many attempts to reform the banking sector in Russia (in particular, see the special analysis of the Financial Institutions Development Program, FIDP, below)\textsuperscript{10} the sector has remained a weak part of the economy with many problems—including the lack of competent banking staff, weak corporate governance, poor risk management, insufficient transparency and monitoring of operations, inefficient banking supervision, a lack of working prudential regulations, and insufficient protection of clients’ and creditors’ rights.

Securities Market

2.19 The securities market in Russia began to take shape in the beginning of 1991. The first stage of its development was characterized by the appearance of open joint-stock companies, issuance of government bonds through stock exchanges, establishment of hundreds of exchanges, and the appearance of the first investment companies.

2.20 The second stage started after the 1992 privatization law introduced voucher-based privatization—a decisive factor for the subsequent development of the securities market infrastructure. The second important factor was the establishment and development of an organized market of government securities after 1993.

2.21 In 1994, the Russian securities market for the first time produced dangerous effects for the economy as a whole and even for the political development of the country. A dramatic and sudden increase in the amount of individual savings and the lack of securities market regulations brought to life an enormous number of operators who worked without any prudential standards and with an exceptionally low level of solvency. At that time, the government was unable to fight fraud, propose attractive savings instruments, and counteract the mounting financial pyramids.

2.22 Expansion of the GKO market in 1994 reduced to some extent the amount of free money in the economy, which was having a negative influence on the ruble and the inflation rate. However, the government securities market, with its favorable interest rates, hindered the development of other activity in the corporate segment of the market and finally became one of the reasons behind the collapse of the financial markets in 1998.

2.23 In 1994, for the first time investments were brought into Russia in the form of contributions to the shares of privatized enterprises. The lack of an adequate system of regulation and incentives for domestic and foreign investments made the Russian corporate securities market dependent on the patterns and cycles of speculative portfolio investments funds from abroad.

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2.24 With the close of the mass privatization program (1992–1994), Russia saw the end of the quantitative stage of institutional change, as the needs of issuers and investors came to exceed the capabilities of the market’s infrastructure. Whereas, in 1992–1993, one could speak about the development of infrastructure running ahead of the development of the market, in 1995–1996 the situation changed to the reverse. The need appeared to create an infrastructure of a different qualitative level, one based on a new legal foundation.

2.25 The third stage of the development of the securities market (1996–1997) was a response to the needs mentioned above. A new legal foundation was established with the enactment in 1996 of new federal laws governing joint-stock companies and the securities market.

2.26 The third stage brought a considerable development of infrastructure—the number of professional market participants grew, licensed registries and depositaries were set up, the Russian trading system was created, and the system of self-governed market participants was developed. These changes were accompanied by an improvement in market stability and by more beneficial microeconomic tendencies that resulted in sufficient reserves for the development of liquidity and market capitalization.

2.27 The financial crisis that broke out in Asia in 1997 dealt a strong blow to emerging markets, and Russia was no exception. However, external shocks explain only part of the catastrophic collapse of the Russian stock market in 1998. They aggravated the accumulated negative tendencies of the Russian economy. The situation in the domestic government debt market, for example, was defined by its short terms. A substantial volume of that debt belonged to nonresidents. Internal debt consisted primarily of short-term securities, most with a one-year maturity. As a result, the funds necessary for a monthly payment against issued bonds (without accounting for coupon payments for 2–3 year coupon papers in the OFZ market) reached 10–15 percent of monthly GDP in the first half of 1998. Broad participation of foreign investors in financing the government budget deficit made the Russian economy dependent on the situation in world financial markets. With that, the corporate securities market in 1995–1998, in its volume and its dynamics, depended completely on the status of government debt. The banking crisis certainly related to losses in financial markets; however, the very fact of the elimination of a substantial source of revenue—the GKO-OFZ market—led to a worsening of the crisis of arrears, which directly affected the players in the securities market as well.

2.28 After the financial crisis, many important issues remained unresolved through mid-1999: uncertainty about debt and incurred interest, the scheme of GKO debt restructuring, a clear program of banking sector regulation, and cleansing in the crisis environment. Particularly salient were the drawbacks of the domestic securities market in the wake of the financial crisis:

- Speculative profit was the players’ main goal; few were interested in long-term investments.
- Very few domestic individual investors could be found in the securities market.
- Issuers had little interest in an open type of market because of the continuing fight for corporate control, among other reasons.
- Government regulators of the securities market coordinated poorly—when they were not in conflict.
- The securities market’s legal environment contained substantial gaps and contradictions.
The legislative base of the market still appears fragmentary and does not protect investors’ rights adequately. Among the critically important lacunae are the following:

- No meaningful penalties apply to non-licensed operations resulting in surrogate securities (public placement of securities that did not undergo government registration).
- Legal mechanisms have not been established to identify and prevent fraud.
- Insider trading is not strictly regulated.
- Price manipulations remain difficult to prevent.
- Regulation of transactions between affiliated entities is still at a very early stage.

2.29 The problem of law enforcement is still acute and very closely related to corporate conflicts. Efforts to improve the legal framework for orderly change of ownership are wasted when the means and the will to comply with the law are lacking. Further intensification of enforcement by regulators of the security market is needed, as evidenced by the volume and variety of offenses in the respective area.¹¹

¹¹ Among the typical offenses committed from 1998 to 2000: the issuance of unregistered securities, operating in the securities market without a license, the absence of a register of the owners of registered securities, illegal refusals of ownership rights and illegal insertions in the register of owners by specialized registrars, trading securities without instructions from their owner or the failure to carry out such operations with the respective commission in place, abusing the set procedures of corporate governance in joint-stock companies, abusing the set procedures for information disclosure by issuers of the securities and professional participants in the security market.
3. Evolution of the Bank’s Sector Assistance Strategy

3.1 The Bank’s usual objective is to help its clients make structural transformations that ensure progress in economic development. That mission could not be accomplished in Russia in the absence of a private sector. The Bank’s strategy therefore focused on measures to reform enterprises, support the emerging private sector—particularly small- and medium-size entities—and reform the financial sector. The latter goal included the establishment of an adequate banking system and a modern securities market.

3.2 The fundamental strategic objective of the Bank’s policy toward Russia, as formulated in its first analytical studies of 1990–1991, was to ease the country’s transition from a command economy to a market-oriented one. That objective is found in practically all documents prepared through 2000. One component of that objective was development of the basic institutions of a market economy and a favorable environment for private initiatives. In other words, privatization was considered a cornerstone of the reforms.

The Starting Point: The Consensus of the International Financial Organizations

3.3 At their July 1990 economic summit in Houston, the heads of the G-7 countries requested the International Monetary Fund (IMF), World Bank, European Bank for Reconstruction and Development (EBRD), and the Organization for Economic Co-operation and Development (OECD) to undertake, in cooperation with the European Union, a detailed study of the Soviet economy. The study was expected to make recommendations for reforms and establish criteria for effective economic support of those reforms from the Western world. Completed in December 1990, the study was the first comprehensive analysis of the economic situation of the country. The study showed very clearly the tremendous scope of the reforms that were needed to change the Soviet system into a market-based economy.  

3.4 The authors advocated a quick, radical reform rather than a gradual one, mostly for reasons of political economy, but also because of the experiences of other transition and developing countries. They also stressed the necessity of achieving economic stabilization and liberalizing prices before introducing other systemic reforms (such as institutional and legal reforms), which needed much more time. Most of the study’s general recommendations remain valid, confirmed by the experiences of 10 years of reform and non-reform in Russia.

3.5 In the area of privatization and private sector development, one of three main directions of reform, the authors stressed that “property can hardly be commercialized and privatized until ownership is clarified and rights to private property fully protected.” That statement explains some of the deficiencies of the Russian privatization program even today. Elsewhere the authors stressed that a market economy is underpinned by a legal and institutional infrastructure, with private property rights at its foundation. While it will take time to complete the necessary reform of the legal system, security of private property must be assured from the outset in order to encourage private initiative.

3.6 The second part of the last sentence is a general answer to questions about why the private sector in Russia has not grown as it has in the transition countries of Central and Eastern Europe. In contrast to those countries, Russia’s understanding of the rules and values of the market economy and its institutions was practically absent after more than 70 years of Communism. The reconstruction of legally protected private property rights remains very difficult.

3.7 The study emphasized that, although the industrial sector consisted almost entirely of huge and overly specialized state-owned firms, a growing number of small cooperative firms had been established that leased and operated units or whole plants from the state enterprises in a process of spontaneous privatization outside the control of state or local government. Given the uncertainty of ownership rights, the incentives of managers operating under such leasing arrangements were concentrated on short-term income maximization at the cost of decapitalization.

3.8 The recommendations of the authors of the study were to privatize smaller enterprises quickly and to commercialize and later privatize larger firms. They noted that if privatization occurred before price liberalization, assets could not be valued properly and might become concentrated in the hands of a few individuals with money and connections. The report also showed that privatization through a give-away voucher system would result in poor corporate governance, because shares would be too widely dispersed. The potential role of intermediary organizations (holding companies) was considered positively in this context. The study recommended a flexible approach that varied according to the type of activity and size of the enterprise, and that offered the advantages of give-away methods of privatization and commercial methods through which revenues would help cover some of the costs of reform.

3.9 De-monopolization and the enforcement of hard budget constraints on enterprises were also identified as crucial measures for effective enterprise reform. However, as an introductory and necessary step, clarification of property rights and their legal protection were strongly recommended.

3.10 In the area of financial sector reform, the study reviewed the situation in the banking sector and the nascent capital market and addressed possible reforms. At that time, the banking reforms that had begun in the USSR in the late 1980s amounted to little more than removing commercial activities from Gosbank (the central State Bank) and converting four existing commercial state banks into joint stock companies. Borrowers and depositors could now choose among banks. A 1988 law permitted the establishment of small cooperative banks, and state-owned enterprises were allowed to build their own financial institutions. This change resulted in a rapid proliferation of commercial financial institutions, which numbered more than 400 in September 1990 and about 1,000 by the end of 1991. At the same time, the foundations were laid for cross-ownership between banks and industrial enterprises; those relations subsequently developed into FIGs.

3.11 The study recommended rapid development of the banking sector and stressed that banking legislation should be enacted as soon as possible. It also recommended establishment of a strong supervisory authority to set a common regulatory framework for commercial and cooperative banks and to strengthen prudential regulations. In addition, accounting standards had to be upgraded, and large-scale training of bank professional staff at all levels of management was recommended.
3.12 The commercialization and privatization of banks should have followed—indeed, should still follow—the principles of reform of state enterprise reform set forth in the study, including the recommended involvement of foreign banks in joint ventures with privatized Soviet banks.

3.13 Other financial aspects of this document are less convincing. For example, the proposal to deal with bad debts either through write-offs or through a special agency to collect and liquidate them proved ineffective.\(^\text{13}\)

3.14. Another example is the statement that the legal gaps in regulation of the developing capital market are less important than strengthening the legal and regulatory framework of the banking system.\(^\text{14}\) The deficiencies of the 1990 study may be explained by a lack of experience in the area of financial reform in transition countries at that time.

3.15 Nevertheless, the 1990 document was very important for the future Russian state and for international organizations and foreign governments, a fact stressed often during our visit to Russia. First of all, the preparation of the study had a very strong moral effect, demonstrating the readiness of the West to help Russia on its way to reforms. Second, it was perceived as an agreement on the part of the international financial organizations to assist Russia in its reforms. Third, it greatly increased the limited knowledge that international financial organizations had about the Russian economy, knowledge that could be used in future lending projects. Last, but not least, addressing the most needed reforms and the recommended methods of introducing them gave a clear picture of what was expected from Russia if it was to be recognized as a credible reformer.

The Pre-Membership Phase of Reform: 1990 through June 1992

Strategies and Their Relevance

3.16 The World Bank’s involvement in Russia began before Russia joined the Bank in June 1992. In August 1991, the Executive Board established a $30 million trust fund to provide technical assistance grants to the republics of the former Soviet Union, and, on November 5, the Bank and the USSR signed a technical cooperation agreement (TCA). At the same time, the Bank created a Technical Assistance Trust Fund (TATF) to finance a technical assistance program during the period of transition until the USSR became a member of the Bank.

3.17 When the USSR was dissolved, only 4 of 15 newly independent states were interested in continued participation in the Technical Cooperation Program (TCP). Following Russia’s independence at the end of 1991, the Bank started to prepare its work program for Russia, issued in February 1992. The resident mission was established in Moscow at the same time.

\(^{13}\) An example is the very bad experience of the Consolidation Bank (Konsolidacni Banka) in the Czech Republic. An individual approach for each bank to cope with its bad debts, backed and supervised by the government, as implemented in 1993 in Poland, proved to be more successful.

\(^{14}\) This strange attempt by the Bank to give priority to the development of the banking system over that of the capital market was also visible in later stages of the Russian reforms. This view was difficult to understand at the time and remains so today, since in our view the banking sector and the capital market should have been developed in parallel.
3.18 The overall program objective under the TCA was “to provide assistance in the efforts of the USSR and its republics in transforming their planned economies into market-based ones.” Among the four program priority areas, besides macroeconomic stabilization and liberalization, were systemic transformation (including advisory services on private sector development and financial sector reform) and reform in priority sectors.

3.19 At the very beginning of its activities, therefore, the World Bank recognized privatization and support for private sector development as one of its main priorities.

3.20 Under the TCA, the Bank provided assistance to the Russian Center for Privatization in preparing the mass privatization program, formulating private sector development policies, and advising on the legal framework for a market economy. The World Bank and the European Bank for Reconstruction and Development (EBRD) signed an agreement with the Russian Government to act as lead advisers on a broad range of privatization issues. Together with the EBRD, the Bank helped to establish a large consortium funded by the European Union to assist the Russian Federation’s State Committee for Property Management (GKI) in planning for implementation of the Russian privatization program.

3.21 The relevance of choosing privatization as a high priority for the Russian reform program was unquestionable at the time and remains so today. Without private ownership rights, a market economy in Russia was not possible. There is no example of a modern market economy without sustainable and well-defined private ownership rights. However, private ownership can be born in different ways in a country where it was long prohibited, for example, through privatization of the state sector or by encouraging the emergence of new enterprises.

3.22 From the very beginning of the reform effort in Russia, intellectual attention and implementation energy were concentrated on the mass privatization program and other large-scale undertakings. Much less attention was devoted to privatizing the economy at its roots by encouraging the natural entrepreneurship of the people through proper incentives.

3.23 One has to assume that the Bank and the Russian Government had important—and possibly differing—reasons for pursuing the strategy which they did in the early 1990s. The Bank, under strong international pressure to help Russia and without much experience in or knowledge of the country, needed some widely accepted and clear goals that were also easy to operationalize and measure. The Russian Government’s draft program to privatize a huge number of enterprises in two years seemed to fill the bill. The Bank would have much more difficulty providing effective measures to improve the business environment for the new enterprises, since legal reform and impediments to entry were politically sensitive.

3.24 Given the very unstable political situation, the government wanted to take visible action to forestall efforts to return to a Communist system and to prevent the broadening of the “spontaneous privatization” of state enterprises. The government believed that insiders were carrying out such privatization on a massive scale by stripping assets from state-owned enterprises under one-sided leasing contracts. In the government’s opinion, there was an urgent need to reassert its ownership rights in state enterprises and generally improve

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15 These topics are discussed in other CAE papers.
16 With respect to entry impediments, it was reported in interviews that the rules governing registration and licensing of new firms were changed many times in different ways, and that administrative barriers had been reestablished, mainly by provincial and local authorities.
transparency in property rights. The new mass privatization program was expected to establish clear rules for privatization and so create transparency.

3.25 In the end, the government chose a combination of insider-oriented and popular (voucher-based) privatization in order to gain support among the population for its reform policies.

3.26 The Bank and the Russian Government both needed an early success in Russia to gain credibility and develop support for very difficult macroeconomic stabilization and structural reforms. Under the circumstances, it was understandable that the Bank and the government gave preference to the mass privatization program, deferring the broader concept of private sector development.

3.27 Similarly, in the financial sector, the Bank was not ready to propose broader reforms, though there was a clear understanding on the Bank’s side that the reform of the financial system, and of the banking sector in particular, was crucial for the success of the entire reform program. Some attempts were made to improve the Bank’s knowledge of the Russian financial sector, and some foundations were laid for future programs in areas such as adopting international banking standards, insuring deposits, and strengthening the banking law.

3.28 In summary, the Bank focused at the time on the right priorities, and its program was highly relevant. No doubt because of political reasons, the Bank missed some important areas that later proved critical, such as easing entry for new enterprises and carrying out basic legal reforms.

Bank Products and Services

3.29 Disbursements under the Technical Cooperation Program (TCP) that began in November 1991 totaled $29.5 million and were completed on June 30, 1992. The Russian Federation received $13.6 million for individual projects. An additional $1 million was spent on the establishment of the Bank’s Moscow office.

3.30 The TCP included three privatization subprojects totaling $2.7 million and three subprojects in financial sector reform totaling $0.5 million:

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17 A developed argumentation for the government position on this issue was presented in: Mau, V. (2000), “Russian Economic Reforms as Seen by an Insider. Success or Failure?” The Royal Institute of International Affairs.

The series of articles of J. Stiglitz, and Stiglitz and Ellerman, published in 1999 and 2000 on this topic, do not recognize this situation in its reality at all, in our view. The authors would be in support of continuing the “spontaneous privatization,” which had a clear predatory character and was massively used by the former nomenklatura to strip out assets from state-owned enterprises. On the other hand, they criticize the mass privatization program as an “institutional shock” to the society and its institutions. This is a strange view, since the program gave great benefits to the enterprise insiders and additionally allowed some limited benefits for the whole population—thus, it could rather be called a “positive shock.” Generally, the views presented by the authors on the topic of Russian reform give evidence of either a total disregard of the reality and preconditions of this country, or of a hidden sentiment in favor of the former Communist order and its collective nature (see also Dabrowski et al., 2000).

3.31 **Privatization project ($1.7 million)** The purpose of this subproject was to assist the Russian privatization agency by involving a team of foreign consultants in the design and implementation of the mass privatization program (MPP), including the design of the voucher program and the regulations governing the program. This project laid the foundation for subsequent financing from the European Union and the U.S. Agency for International Development, and for loans from EBRD and the World Bank.

3.32 **Private Sector Development ($0.5 million)** Advisory and technical assistance (TA) services were provided to two local institutions to establish the institutional capacity to address constraints to the development of the private sector. The importance of this project seems not to have been fully recognized by the government. No direct continuation in subsequent lending programs has been noted.

3.33 **Foreign Direct Investment ($0.5 million)** This subproject was implemented by the Foreign Investment Advisory Service (FIAS), a joint service of the International Finance Corporation (IFC), the World Bank, and the Multilateral Investment Guarantee Agency (MIGA). Its objectives were to assist the Russian government in designing its policy toward foreign investment, including such important tasks as the recommended legal framework for foreign direct investment (FDI), issues of taxation, liberalization of foreign exchange, and other issues. An additional task was to assist the state regulatory agency for foreign investment in designing its strategy.

3.34 The project aimed at “establishing trust between FIAS and the Russian counterparts in charge of policy related to FDI.” As a result of this cooperation, a comprehensive study on the climate for foreign direct investment in Russia was done that could have been very helpful if it had been adopted at least partially. Unfortunately, most of its recommendations (for instance, restrictions were placed on FDI in banking) were refused by the Russian side. The project was not directly continued in subsequent Bank lending.

3.35 **Financial Sector Project ($0.1 million)** This project focused on two objectives: the development of a program encouraging commercial banks to employ sound international banking standards and the development of a deposit insurance scheme. The project was continued in subsequent lending programs.

3.36 **Bank Legislation Project ($0.2 million)** This project focused on the preparation of appropriate banking legislation.

3.37 **Accounting Project ($0.2 million)** This project was designed to prepare accounting standards for banks that would meet the needs of market systems. The standards have been set, but no instructions for their adoption have been issued by the Central Bank of Russia, and their implementation was made voluntary, which undermined the success of the project.

3.38 In spite of achieving only partial success, the overall effects of the TCP were very valuable, given the amount of money involved. The program prepared Russia and other former Soviet countries for Bank membership, and was useful for the preparation of subsequent lending operations. However, real progress was mixed. A major constraint was poor cooperation between the Bank and the Russian government and among the government,  

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20 The Working Center for Economic Reform and the International Center for the Development of Small Enterprise.
the Central Bank, and parliament. Overall, the Bank’s performance was generally good, whereas the Russian government’s performance was mixed.

**Sector Assistance Strategy, 1992–2000**


*The Learning and Policy Lending Phase (June 1992–1994)*

3.40 The Bank’s Board approved the first country assistance strategy (CAS) for the Russian Federation on July 22, 1992, in conjunction with preparation of Rehabilitation Loan I, the Bank’s first lending operation in Russia.\(^{21}\) The primary focus of the CAS was “to help establish an environment conducive to the growth of market-oriented institutions.” Among other important objectives was the need for industrial restructuring through enterprise reform, privatization, and financial sector reform. The 1993 and 1994 CASs expressed similar objectives, with special attention to strengthening market-oriented institutions, including the private sector, and establishing and strengthening viable financial institutions operating according to sound commercial principles.

3.41 The strategic objectives of Rehabilitation Loan I were largely based on the Russian reform agenda outlined by President Yeltsin in October 1991 and included in the Memorandum of Economic Policies submitted to the International Monetary Fund (IMF) in March 1992. The objectives included privatization, regulatory reforms, antimonopoly policies, and improvements in the financial sector.

- Enterprise reform was expected to be implemented through an accelerated privatization program (mass privatization, small privatization, and case-by-case privatization), corporatization of all remaining state enterprises and improvement of their corporate governance, and establishment of appropriate legal frameworks for bankruptcy and liquidation, among others.

- Antimonopoly policies and controls were to be reformed through antitrust legislation

- Foreign direct investment was to be supported by enacting an amendment to the foreign investment law, eliminating barriers to FDI and restrictions on the repatriation of interest and dividends, and giving equal treatment to foreign investors in the privatization of state enterprises.

- Financial sector reform at that time was directed at achieving more supervisory power by the government over the fast-growing banking sector, which already included 1,500 banks (many of them insolvent and dependent on industrial enterprises, which were their

\(^{21}\) Rehabilitation Loan I, in the amount of $600 million, was approved in August 1992 and declared effective in December 1992. It was closed in September 1994, after a delay of nine months.
borrowers and founders at the same time). Thus, the reform in this sector envisaged revision of the banking law and the enacting or amendment of several laws (including laws on collateral, on payment systems, and on securities) as well as establishment of a revised system of auditing and accounting.

3.42 The relevance of the strategic objectives listed above for the reform agenda in Russia in the first half of the 1990s was and is obvious. Subsequent CASs and Bank lending operations (e.g., Rehabilitation Loan II and structural adjustment loans) contained the same or very similar objectives. Except for mass privatization, which proved to be an early success, not one of these objectives was fully achieved. Hindsight reveals that the agenda for reforms was overoptimistic.

3.43 Despite the constitutional crisis in Russia that hampered fundamental reforms in the country’s economy, the Bank in 1993 believed that progress in the field of economic liberalization and privatization was a sufficient precondition for the appearance of the new class of entrepreneurs. That belief underpinned some very optimistic long-term projections related to private sector development, including privatization progress, restructuring and post-privatization support for enterprises, support for small and medium-size businesses, and reform of the financial sector. Directing financial flows through viable financial institutions operating on commercial principles was identified as the key element in the reform of enterprises (later implemented in the Enterprise Support Project).

3.44 To “support the initial stage of the privatization process,” a Privatization Assistance Project totaling $90 million was conceived. Besides privatization, the project was to include elements to promote a pro-competition policy, capital market development, and other issues linked with privatization. One of the difficulties of the program was the delay of its initial stage, as a result of which the project had to be restructured.

3.45 Beginning in early 1992 and ending in June 1994, the Russian government launched the very ambitious mass privatization program. The government’s goals in implementing this fast privatization program were, as noted earlier, to make irreversible changes in the basic economic relationships of the economy and to stop non-transparent privatization. Producing fiscal effects from privatization were absent in the first stage.23

22 The international organizations strongly encouraged Russia to embark on this quick privatization project and were significantly involved in its design and implementation. Besides IBRD and EBRD, the European Union and the U.S. Agency for International Development (AID) were leading supporters of this program. In December 1992, the World Bank approved a $90 million Privatization Implementation Assistance Loan (PIAL), but it became effective only in December 1993. U.S. AID became the primary source of financial means for this program in 1992 (after completing the TCP), with grants in the amount of $58 million. With the involvement of AID, the World Bank seemed to lose its main impact on the program design and implementation. However, all important solutions of this program and its institutional component, that is the establishment of the Russian Privatization Center and the rules of their activity were discussed and agreed earlier with the Bank. See more on the PIAL implementation in paragraphs 4.1-4.18.

23 Over 16,500 large and medium state enterprises, representing more than one-half of Russian industry, have been transferred to the ownership of more than 40 million Russian citizens with the use of privatization vouchers. As broadly admitted, this project was the largest and quickest privatization program of all transition countries in the world. Taking into account the scope and the complexity of this program, it became a great success, at least as a huge logistical operation. It should also be added that providing individual and tradable property rights to people deprived of these rights during the three past generations was a very important historical event. As an effect of this program, new ownership structures emerged in the privatized enterprises, mostly dominated by insiders (managers and non-managerial employees), providing significant privileges for employees and management in the privatization procedure. Three-quarters of Russian enterprises chose from three basic alternatives the second privatization model, which provided for private placement of 51% of shares
3.46 Voucher-based privatization programs are perceived, for many reasons, as inferior to commercial-sale methods of privatization. However, in the Russian case, there was a rationale for using this method. Basic legal regulations and a capital market were lacking, and there was too much political risk for foreign investors. A voucher program was the only realistic method for fast privatization at the time.

3.47 Privatization through commercial sale would have imperiled the goal of achieving irreversible changes in the ownership structure because of the threat that conservative interest groups opposing privatization would have time to consolidate their opposition and block further stages of privatization, as occurred in Ukraine and Belarus. On the other hand, as Russian history has shown, rapid privatization can be easily reversed if post-privatization policy does not produce results.

3.48 The government’s reformers seemed to be aware of the limitations of mass privatization from the corporate governance side and understood that real restructuring would begin once enterprises had new investors. Therefore, the first ownership structures were designed to be as open as possible, allowing free trade and redistribution of shares following privatization.

3.49 The Bank’s thinking on this subject was similar:

All energies are focused on rapid privatization in the first phase of creating a market economy, while recognizing that in many cases extensive restructuring at the enterprise level will need to take place and/or continue after privatization. 24

3.50 The similarities are explained by a very intensive dialogue on the privatization program and by extensive economic and sector work done by the Bank in Russia during this period.

3.51 Any mass privatization in transition countries should be viewed as an initial framework for establishing private ownership structures that are expected to evolve later on in the process of secondary redistribution (Nellis, 1994). However, in the case of Russia appropriate steps should have been taken immediately after mass privatization to sustain transparent ownership, assist in the secondary redistribution of property, and protect shareholders from fraud and abuse.

3.52 Clearly, where new owners are unable to exercise their rights, there is no opportunity for good corporate governance. Basic capital market regulations should have been introduced immediately, such as establishing a watch-dog institution for the capital market, building independent registers or depositories for shares, demanding at least minimal disclosure of information from companies issuing shares, and providing other means to protect investors.

3.53 Neither the Bank nor the Russian government was prepared to take such steps in the aftermath of privatization—even now they remain only partially completed.

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24 Staff Appraisal Report. Privatization Implementation Assistance Project, paragraph 3.2.
3.54 This was, in our view, one of the largest loopholes in the mass privatization program’s design and implementation, a loophole that diminished the chances of the program’s long-term success and, finally, led it into an unexpected and dangerous direction that could have been at least partially avoided with intensive help from Western advisers—assuming an equal interest on the Russian side. The Russian reformers were clearly not prepared to draft such regulations, and this is understandable. However, the World Bank and other international organizations understood the situation and possessed the necessary knowledge and experience to produce such basic regulations.

3.55 Beyond the question of drafting regulations, it was necessary to prepare the country for such regulations by explaining their role and importance in market economies and by providing technical assistance to educate business and government personnel. The inability to do either must be judged an important deficiency in the World Bank’s operations in Russia. After almost ten years, it is difficult to assess whether the Bank could have done more in this area and whether it could have pressed the Russian government more strongly for the needed reforms. We can only conclude about the final results: While voucher privatization created many owners, the absence of some other institutional reforms precluded the development of an effective capital market.

3.56 Why did this happen and to what extent must the Bank bear responsibility for it? Today, we have many reasons to assume that the political economy made these reforms impossible because of the strength of interest groups opposing them. As we were often told in interviews, there was no real policy dialogue on such “sensitive” questions between the government and the Bank. However, even if this were so, the Bank should have demonstrated the shortcomings of the mass privatization program to the government and to the international community, and should not have been overoptimistic in reporting progress, as it was.

3.57 Also missing or only verbally present in the Bank’s strategy at that time were measures for private sector development, besides privatization.

3.58 As mentioned earlier, during the early 1990s, the Russian government paid insufficient attention to grassroots development of the new private sector in Russia, despite a large body of analytical and economic work by the Bank on this topic. Economic impediments included the lack of stable rules in the economic environment (such as rules governing the creation of new businesses), an archaic tax system, and the lack of a commercial real estate market. The inadequate legal system—characterized by unclear and unstable laws, discretionary interpretation of laws, and weak law enforcement—also posed formidable barriers. The laws enacted since 1995–1996 cover only a small part of what is needed.

3.59 As reported in 1994, the World Bank tried to provide a more coordinated and ambitious strategy for legislative reform and for strengthening legal institutions through a proposed Legal Reform Project, and it encouraged the Russian government to make a substantial effort in this direction.\textsuperscript{25} However, the government was at that time reluctant to borrow for technical assistance and for “non-revenue generating projects.”\textsuperscript{26} Law-related grants from official donors and private organizations did not achieve the necessary “critical mass” of institutional reforms. Instead of addressing this major challenge, the Bank decided

\textsuperscript{26} Only in May 1996 was the Legal Reform Project approved, and then only with a much smaller scope than was proposed in 1994.
to focus on several narrow projects that were less ambitious and not so politically sensitive, but that, at the same time, were much less important for the future of reform.

3.60 Weak budget constraints have undermined privatization. Much has been written about insider domination of privatized Russian enterprises and the exclusion of outsiders. All this is true. However, the reason lies not only in the lack of a proper corporate governance system or weak legal regulations. Until the economy undergoes a successful macroeconomic stabilization that cuts all subsidies and toughens budget constraints on enterprises, nothing will induce managers and employees to sell their shares to outsiders.

3.61 In a competitive environment and under hard budget constraints, as in some CEE countries, the incentive to find outside investors often comes from insiders wishing to obtain additional capital and to avoid elimination from competitive international markets. In Russia, insider-owners of newly privatized companies have used soft budget constraints to obtain additional financial sources, sparing them the effort of intensive restructuring measures and the need to attract outside investors. This is an example of a close interconnection between reform dynamics and microeconomic privatization outcomes.

3.62 Many authors point out today that the lack of serious enterprise restructuring and solid corporate governance in Russia after privatization was a consequence of the government’s policy, which was more and more tolerant of inter-enterprise arrears and other non-payments (Pinto, 2000). They also argue that non-payments, as hidden and untargeted state subsidies, are a product of piecemeal, gradual reform.

3.63 Some Russian reformers were conscious of these important interconnections when the first stage of privatization was completed in 1994. They urged the State and Western donors not to pump resources into the economy without first establishing sound mechanisms for fair market control and related laws, properly enforced (Radygin, 1996).

3.64 It is not clear, however, whether Bank staff at that time understood the interconnections well enough to appreciate the influence of loose monetary and fiscal policies on the limited privatization results. In its statement regarding the policy toward state-owned enterprises, the Bank advised “gradually hardening the budget constraint and reducing subsidies over time” (paragraph 5.20 of the Privatization Implementation Assistance Project). The efficacy—indeed the feasibility—of such a gradual approach must be seriously questioned.

3.65 The Bank’s most recent economic and sector work includes a striking report (Desai and Goldberg, 2000) that confirms our thinking about interconnections between soft budget constrains and inefficient privatization. The findings of the study show that insider-owners of enterprises who hinder the entry of outside strategic investors have common interests with local (provincial and municipal) governments, which view privatized companies as producers of social benefits such as employment protection for the region. Local governments have not been interested in serious restructuring that could cause unemployment and have tended to interfere deeply in the companies’ activities. In exchange, they have allowed tax debts and barter payments and have protected poor performers from bankruptcy. In such a context, the insider-owners have little interest in raising the value of their firms or in higher productivity and profits, but rather focus on producing losses and debts and extracting private benefits from their enterprises. This, in turn, has made the enterprises more and more resistant to
marked-oriented reform and restructuring and, therefore, increasingly less appealing to outside investors.


3.66 In spite of some achievements, the general progress of reforms until the mid-1990s in privatization, enterprise restructuring, and the financial sector was assessed by the Bank as not satisfactory. The planned second stage of the privatization program, in the form of case-by-case privatizations was never implemented, despite intensive work on its preparation from the Bank’s side. The relatively positive outcomes of mass privatization and small-scale privatization27 did not have, in the Bank’s opinion, enough impact on enterprise restructuring and shaping a competitive economy. CAS 1995 anticipated that the Bank ought to follow a gradual response strategy directly connected to the progress in macroeconomic stabilization and structural reform.

3.67 The medium-term program titled “The Reforms and the Development of the Russian Economy in 1995–1997” (Russian government resolution #439, 28 April 1995) came as a formal response. However, many of its provisions in section four, “Institutional Changes,” concerning the private and financial sectors, were not fulfilled.

3.68 The Bank continued to view as its main objective “support for the market-oriented economy, based on initiatives by the private sector.” However, at the same time, certain accents shifted—the Bank believed that “it is necessary to support institutions and procedures of the state sector which cannot be supported by the private sector” (competition, law, institutional infrastructure, and the like).

3.69 The Russia CAS from May 1995 included the following assessments:

- “The [privatization] effort has been largely successful in separating ownership responsibilities for enterprises from state control, although certain sectors of the economy, such as agriculture, coal, and defense production continue to operate under substantial state direction because of their dependence on budgetary funding.”
- “Many enterprises have not started the restructuring process. Financial stabilization, as well as continued structural and institutional reforms, will be needed to ensure that enterprises operate subject to market constraints.”
- In agriculture, “many state and collective farms have been technically privatized, although generally they remain under collective ownership and most have not been significantly restructured.”

3.70 From these opinions, the following priorities for the Russian government have been suggested:

- Continued privatization of the remaining large state-owned enterprises.
- Liquidation and restructuring of the largest loss-making enterprises.
- Improving the performance of public utilities and natural monopolies.
- Restructuring and privatizing former state-owned banks, and strengthening and consolidating the commercial banks.

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27 This program succeeded remarkably in chosen regions, largely due to the valuable involvement of the IFC.
• Promoting capital market development and establishing conditions for effective corporate governance.

3.71 The issue of corporate governance was addressed here first as a sign for more critical thinking about the limitations of the mass privatization program. Stressing the need for liquidation of loss-making companies was also very crucial.

3.72 On the other hand, the same document stated that statement can be interpreted as an excuse for more state intervention: “It is becoming increasingly clear that industrial restructuring presents a range of very difficult issues, not all of which can be dealt with effectively through normal market mechanisms. These include such problems as single enterprise towns, enterprises that continue to be largely dependent on budgetary resources, and declining industries.”

3.73 In the same document, we find an accurate assessment of foreign investment in Russia: “FDI inflows have been disappointing in relation to the size and potential of the Russian economy, on the order of only $1.2 billion on a cash basis in 1994, with the bulk of investment concentrated in the energy sector. Portfolio investment rose from negligible amounts to reach about $500 million per month in the middle of 1994, but it declined sharply at the end of 1994 due to concerns about financial and political stability and the future direction of the privatization program. The government has attempted to restore investor confidence by replacing the head of the privatization agency and offering various incentives. However, the restoration of political and economic stability will matter much more. Also important will be the provision of an appropriate legal framework for foreign investment, which has been a major stumbling block for many potential investors, and the development of institutional structures to increase the transparency of financial markets.”

3.74 During preparation of CAS 1995, efforts were made to renew cooperation between the Ministry of Economy and the FIAS, which prepared in 1991-1992 an early diagnostic study of the environment for foreign investment. Additionally, during the next two years, the Bank planned to guarantee operations to facilitate foreign investment in sectors that had already implemented reforms. The Bank declared its commitment to use in greater scope the guarantee facility to enable foreign investment in key infrastructure projects, as well as to create the potential opportunity for industrial restructuring, especially in natural resource development.

3.75 Finally, on the establishment of the institutional and legal framework for the market economy, we can read in the CAS from May 1995 that, in spite of impressive progress in this area: “Much of the institutional structure is incomplete and it will take a long time to establish the experience needed to operate effectively. Of particular importance is the need to develop an independent judiciary in order to promote greater respect for the rule of law, secure property rights, and provide an impartial forum to resolve commercial disputes. These actions are essential for the longer-term sustainability of the stabilization program (e.g., by encouraging the repatriation of financial capital held abroad), to support the growth of new enterprises, and to provide a facilitating environment for foreign investments.”

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28 Foreign Investment Advisory Service
3.76 The Bank said it was paying particular attention to institutional and legal issues as an integral part of its lending and policy advice activities.

3.77 In June 1996, the Second Rehabilitation Loan (Rehab II) was approved for $600 million. This loan focused on liberalizing the trade regime and on some macro stabilization issues; consequently, it did not include direct tasks for private sector development and financial sector development. Some systemic issues, such as needed improvement of financial reporting, of commercial bank supervision, and establishing the legal and institutional framework for the private sector (especially tax issues), were repeated as goals of Rehab II.

3.78 The CAS progress report of 1996 became a continuation of the strategy described in CAS 1995. More attention was being paid to privatization and the development of commercial banks. The Russian government was correctly criticized for the lack of transparency in privatization deals, particularly those related to major enterprises.

3.79 The CAS progress report from February 1996 addressed again the unsatisfying progress in privatization, saying that “the second stage of privatization, involving cash sales and tenders for the government’s residual shares, has been widely criticized for a lack of transparency. The challenge ahead for the government is to maintain the momentum of privatization by continuing cash auctions, while improving transparency and the quality of privatization, especially with respect to the largest firms.”

3.80 On the financial reform, there was added: “A liquidity crisis in the interbank market in late August (1995) was an indication of more fundamental problems in the banking sector, and a substantial downsizing can be expected as the stabilization program takes hold. This adds urgency to the need for improving regulation and banking supervision, which is being addressed both by the IMF and the Bank.”

3.81 Russia took two important steps during this time in the reform agenda for the private sector:

On 26 December 1995, the federal law “On Joint Stock Companies” was enacted.
On 22 April 1996, the federal law “On the Securities Market” was enacted.

3.82 These two important laws are foundations for the corporate sector in Russia, but other very important laws were still absent.

3.83 To summarize, in 1995–1996, the Bank recognized, in a deeper and more precise way, the time for reform needed for Russia. This led to considerations that market reform in this country needs much more time than in other Central European countries, and that stress should be on quickly establishing institutions and legal rules basic for a market economy to make real progress with reforms. As a consequence, the Bank’s lending and non-lending activities were to be restructured, according to the basic reform directions. The Bank’s dialog with the government also needed to be improved.

3.84 The next CAS, in May 1997, showed a change in the Bank’s attitude toward more determination in targeting important goals, but also toward being more critical in assessing areas of reform that have made little progress. After the presidential elections in 1996, the Bank assumed that the political and macroeconomic conditions for comprehensive structural
reform were more favorable then ever before and described this situation as “a window of opportunity for structural reforms.” In addition, Bank project implementation has improved substantially as a result of earlier efforts of the Bank and government.\textsuperscript{29} Anticipating a greater chance for structural reforms, the Bank remained aware of possible risks: opposition interests (concerning the political basis for the reforms), the “fragility” of economic achievements, the high project risk of the Russian portfolio, and a low institutional ability of the Russian government to digest the increased number of the banks.

3.85 The 1997 CAS was very comprehensive and included numerous additional materials based on deep analytical work and economic and sector work. In the private and financial sectors, the Bank envisaged a broad spectrum of goals—to a large extent the ones that had been set in the past, but not fulfilled):

- Acceleration of transparent privatization (a priority of tender solutions, as opposed to insider domination).
- A “case-by-case” method for major enterprises (residual stock).
- Development of capital markets (it was also recognized that the securities market requires strengthening of the regulatory basis for private investments and improvement of corporate governance).
- Actual application of insolvency procedures.
- Elimination of formal and informal obstacles to entry and exit for businesses.
- Strengthening of the commercial banking system, recognized as one of the most dynamic sectors, but with limited loan availability for enterprises. (Many banks faced financial difficulties; hence the Central Bank of Russia launched a program of identification and supervision of the troubled banks).
- Reform of natural monopolies (rationalization of prices and introduction of competition).
- Improvement of the legal environment for contractual obligations and the protection of property rights. The latter appeared for virtually the first time.

3.86 This would have been an impressive list of reforms, if many of these tasks had not been formulated in earlier program documents many times. However, it should be noted that in this CAS the Bank, for the first time, placed the same priorities for the business environment as for other structural reforms. A special annex was devoted to private sector development strategy, with a large part discussing the insufficient development and support of the private business environment. The high costs of doing business in Russia and insufficient foreign investment were reported in this part, and instruments for improvement were discussed.

3.87 In the area of financial development, priorities were set for enhancing bank supervision, implementation of further reforms of the payment system, and strengthening the regulatory framework of the capital market. Structural Adjustment Loans I (June 1997), II (December 1997), and III (August 1998) continued these areas of reforms and extended them in a more detailed form.

3.88 The Russian government’s response to this broad set of reforms was the adoption of the Program of “Structural Reorganization and Economic Growth in 1997–2000” (Russian government resolution, # 360, 30 March 1997). Section Five, “Institutional Reform,” acknowledged that during the stage of reforms, which first and foremost are aimed at the

\textsuperscript{29} Satisfactory projects increased from 39 percent in 1995 to 65 percent at the end of 1996.
structural reorganization of the economy, institutional changes acquire special importance. Their objective is to create the necessary prerequisites for transition to the stage of economic growth that yields a greater return on investments. The requirements of structural reorganization determine the main areas of development of market institutions: enterprise reform, government property management, land privatization and the development of a real estate market, setting up financial markets and financial institutions, development of the securities market, development of the banking sector, encouragement of competition and a more active antitrust policy, business support, natural monopolies regulation, improvement of legislation, and strengthening of the judicial system, including the development of the system of arbitration courts, and a more resourceful law enforcement.

3.89 As in the previous case, many of the provisions of the Russian Government’s program remained on paper. The implementation of the Bank’s requirements could only be possible through a comprehensive effort (that is, protection of property rights and judicial reform). Instead, progress had quite a fragmented character. Two comments are worth mentioning here.

3.90 First, both the Bank and the Russian Government, for the whole range of issues, repeatedly stated their inclination to pursue a policy of immediate and serious reforms, which, in practice, have not been implemented. Apparently, this was a sort of informal political consensus about financing the Russian government in case there were appropriate (“market type”) declarations by the Russian side. The paradox is that practically all of the enumerated objectives were very vital.

3.91 Second, the Bank’s proposals often encountered serious difficulties stemming from the realities of the Russian economy and political system (for example, hostility toward foreign control of corporations, or the use of state institutions as an instrument for the redistribution of property that made a transparent “monetary” privatization impossible).

3.92 In summary, the 1997 CAS showed a growing understanding by the Bank of the most important Russian reform needs and a high readiness for supporting those important reforms. There were also some signs of a better policy dialog between the Bank and the government. The unique character of this CAS is due to its preparation by the Bank at the same time that the Bank was preparing large lending operations, which followed the CAS in few months.

3.93 The Bank committed itself to a series of large, quick-disbursing adjustment loans. Among them, two structural adjustment loans (SALs)—SAL I and SAL II—are of greatest interest for our topic, as well as the third loan of the same character (SAL III), which could not be disbursed because of the crisis of 1998.

3.94 SAL I, in an amount of $600 million, was disbursed in June 1997 and closed in March 1998. SAL II amounted to $800 million and was disbursed in two tranches in December 1997 and January 1998, and completed in December 1998. The principal objective of SAL I and SAL II was to assist the Russian Government in undertaking key structural policy and institutional reforms that would help restore the macroeconomic stability and lay the foundation for sustainable economic growth. To meet these objectives, SAL I focused on four strategic areas:

- Improved fiscal management.
- Reform of infrastructure monopolies.
• Private sector development.
• Financial sector reform.

3.95 SAL II continued the focus on these four areas, adding a fifth: reform of the trade and foreign direct investment policy regime (in connection with the planned accession to the World Trade Organization).

3.96 The choice of these five strategic areas illustrates the Bank’s understanding that these were the most critical fields needing further changes. Additionally, the Bank was, at that time, fully convinced that sustained growth could be achieved only through further strong efforts and progress in developing and strengthening the fundamental institutions of the market economy. This was, in our opinion, a very positive evolution of the Bank’s approach, which started by preferring fast and spectacular projects (which sometimes were more or less superficial) and then undertook difficult and long-lasting projects that promised deep and sustainable changes.

3.97 The progress of reforms supported by the two SALs was uneven and, although meeting specific formal requirements, was generally not seen as satisfactory. In areas especially interesting for us (private sector development), there were mixed results. Under SAL I, there was no progress at all in the area of large privatization, and the SAL policy targets were not met. Under SAL II, case-by-case privatization remained stalled. On the other hand, some progress in developing a legal environment for business was achieved. There was substantial progress on drafting the new bankruptcy law under SAL I, and, under SAL II, this law was enacted. There was also important progress in the preparation of the legislation on land transactions. Work began on introducing accounting principles consistent with IAS (international accounting standards).

3.98 With respect to the banking sector, under SAL I, the Central Bank of Russia introduced payments system reforms. Under SAL II, improvements were made in prudential regulation, and introduction of international accounting standards began in the banking sector.

3.99 Summarizing, the relevance of both SAL I and SAL II was high, but their implementation was assessed as only marginally satisfactory by meeting only specific, and not general, targets, and as unsatisfactory in the broader sense of renewing economic growth and stabilizing the economy. 30 The above assessments were formulated after the financial collapse of the Russian economy in August 1998. One should agree with the view of the Bank’s staff that the unsatisfactory outcome of the two SALs was largely a result of external factors, mainly the unstable political environment in Russia. It is also true that an even more satisfactory fulfillment of the SAL tasks could not have prevented the crisis, although its negative effects could have been somewhat reduced. The only question remaining is if and when the Bank recognized that the crisis was approaching and realized that it was unavoidable. Another question can be posed for the future: Does the Bank have the analytical potential sufficient for recognizing that a new crisis is nearing (not necessarily in Russia)?


3.100 On the threshold of the Russian financial crisis, a third major SAL lending operation was in preparation. The project was approved in June 1998 and made effective on 7 August 1998, only 10 days before the crisis explosion. The loan was divided into three tranches ($300 million, $500 million, and $700 million) that were to be disbursed at intervals of six months. Only the first tranche was disbursed in August 1998. In contrast to the two preceding SALs, SAL III included a large number of conditionalities to allow Russia to receive each succeeding tranche of the loan. This seems to be the lesson learned by the Bank from the previous quick-disbursing loans, when the underlying objectives never were fulfilled in a satisfactory manner. However, it was not possible to prove the efficacy of the new approach because of the financial crisis and subsequent events. For the first time, the objectives of SAL III in the area of structural reforms gave full priority to the improvement of the overall business environment in its most important dimensions. In more detail, the program was designed to:

- Improve the competitiveness, transparency, and accountability of infrastructure monopolies.
- Enhance the development of the private sector, encourage competition, and improve corporate governance incentives.
- Enhance fiscal management.
- Reform the financial sector.

3.101 Private sector development was to be fostered by enhancing and accelerating the program for transparent and competitive privatization, establishing institutions and policies that would promote rules-based competition and facilitate market-based entry and exit, developing effective corporate governance incentives and labor mobility, creating functioning markets for urban land and real estate (critical for new startups), implementing financial accounting and auditing practices in line with international standards, and liberalizing the policy regimes for international trade and foreign direct investment.

3.102 The banking sector was to be reformed by:

- Resolving the problems of weak and insolvent banks.
- Strengthening supervision and compliance.
- Improving the accounting, legal, and regulatory framework, including the payment system.
- Formulating a long-term strategy for developing competition in the banking sector.

3.103 As we can see, SAL III addressed very clearly some crucial steps for the Russian reforms, and it was unfortunate that this happened too late. Since the structure of SAL III was perceived as very good, priorities were perceived as set well and the analytical base was perceived as sound, there are expectations that it will be continued in the near future, probably under a new name.

3.104 After the severe crisis in August 1998, the Bank’s thinking on Russia changed. Sobriety and realism, accompanied by an attempt to step back from the events, characterized the Bank’s new attitude. In December 1998, the Bank prepared its CAS progress report on Russia, in which it tried to take the role of an observer, rather than of a participant in the process. The Bank described in this document the pace of the crisis and the activities of the
government in dealing with the crisis—among others, a return to more activist industrial and trade policies.

3.105 For obvious reasons, a dramatic decline in structural reform took place (including those within SAL III). By means of urgent measures, the Bank started to design a strategy and working plan for banking sector restructuring, and subsequently worked on an evaluation of the social consequences of the crisis in order to provide specific social assistance. The relative importance of private sector development diminished in this regard.

3.106 There was a new attitude from the government’s side as well. There was now a visible demand for Bank support in areas such as banking sector restructuring and crisis emergency response, which were not envisaged in the 1997 CAS. The CBR and the government showed strong interest in areas in which they were not ready for reforms in the past, such as accounting reform, the legal framework for bank liquidation, upgrading and refocusing of bank supervision, and strengthening of ARCO (the bank restructuring agency). Thus, the policy dialog between the Bank and the government improved, and both sides focused on similar issues. New topics appeared in the Bank’s list of priorities—social protection of those hit by the crisis, and the strengthening of public resource management. However, the former priority of supporting institutional development remained as important as it was before.

3.107 In December 1999, a new country assistance strategy for Russia, from the end of 1999 to mid-2001, was presented by the Bank, which pointed out the main changes in its strategy toward Russia. The economic situation in Russia was characterized in this document as uneven: macroeconomic performance in 1999 was very good, but the structural reforms lagged seriously.

3.108 The main operating objectives and broad strategies remained the same as in previous years, but the program focus and instrument mix had to be changed in the direction that was outlined in the previous CAS. One of the main priorities was the issue of poverty reduction and another was institutional reform as a key for sustainable growth. The need for fighting corruption as an important condition for public sector reforms and for general reform sustainability was raised for the first time as a new priority issue.

3.109 Additionally, a shift from regional and sectoral lending (in infrastructure, energy, and the like) in favor of increased emphasis on systemic and structural aspects of institutional development was announced. While the Bank was expected to concentrate on main systemic reforms, commercial lending projects were to be shifted to IFC.

3.110 In the areas of private and financial sector development, the CAS focused on indirect support for private sector development through activities targeted at the improvement of the systemic business environment. Thus, the Bank Group declared to support:

- Elimination of formal and informal constrains on entry and exit and other barriers to competition.
- Strengthening corporate governance.
- Labor market reforms.
- Development of a sound, efficient banking system and capital market.
- Reform of infrastructure monopolies.
- Transparent case-by-case privatization of public sector enterprises.
• Improved tax regimes.
• Improvement of the legal framework for contract enforcement and protection of property rights.

3.111 In this document, the Bank tried to assess the economic situation in Russia and its own attitude toward assisting this country. It was stated that the transformation process in Russia was much more difficult and complex than expected and that the Bank had to position itself for a long-term relationship with Russia in support of its reforms. Commenting on the lack of a workable political consensus for reform in Russia and the inability of reformers to promote needed reforms, the need for a much wider public debate on reforms was expressed. It was noted that commitment and consensus for reform should be built at regional and municipal levels and not only at the level of the central government. The Bank would try in the future to take part in such a broad debate. In addition to these plans, the Bank decided to invest in its knowledge base to deepen its understanding of the Russian economy and provide the best possible policy advice and financial support in the future. The Bank also declared that its portfolio management had to be improved, because of the high proportion of unsatisfactory projects.  

3.112 Another very important point was that, because of insufficiently effective previous adjustment lending that had not delivered substantial progress in structural reform, adjustment lending needed to be constrained in amount and disbursed only progressively, in association with significant structural reform.

3.113 In the area of enterprise reform, the Bank decided to withdraw its direct lending activities from private enterprises and to focus on the development of the overall policy environment for business, as explained above. It should be noted here with high satisfaction that, at the end of the 1990s, the Bank finally included in its main reform priorities the essence of those fundamental elements that were missing before: the establishment of a friendly business environment by building the badly needed legal and institutional framework for economic subjects. It is true that such reforms need more time, but they are necessary for real changes.

3.114 The CAS progress report of December 2000 kept the CAS 1999 strategy in effect. The Bank acknowledged that the program of the Russian government (July 2000) was a good foundation for the implementation of structural reforms. With that, it stressed that the proposed reforms of economic policy in support of the development of the private sector were consistent with the previous loans aimed at structural economic reforms (structural adjustment lending) and with the current programs as well. The Bank declared that primary attention would still be paid to strengthening institutions and to improvement of reporting procedures in the government sector, further restructuring of enterprises, a better investment climate, and strengthening of the public social security system. Attempts were to be undertaken to achieve progress in the following areas, which were of vital importance for the establishment of new enterprises and the restructuring of existing enterprises: reduction in the amount and volume of current taxes and actual subsidies, reduction of excessive government intervention into the operations of enterprises, reduction of exceptionally high overhead costs related to such

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31 Overall portfolio performance fell sharply after the 1998 crisis, resulting in over $700 million in cancelled commitments. By July 1999, Russia had the weakest portfolio in the Bank, with only 33 percent of projects judged satisfactory. However, by June 2000, a significant improvement had been achieved, with 73 percent of projects judged satisfactory.
intervention, and improvement in the efficiency of expenditures in the public social security system.

3.115 In January 2001, the Bank presented its second progress report of the CAS approved at the end of 1999. In this document, the findings from the previous CAS progress report were repeated and the same priorities were declared. It was announced that a new country assistance strategy would be presented by late 2001. In the Bank’s assessment: “The positive developments in Russia, particularly with respect to economic and political stability, as well as country ownership of the economic reform program, combined with the significant improvement in the performance of Bank Group-supported projects, provides the basis for a stronger operational engagement by the Bank Group than has been the case since the August 1998 crisis.”

3.116 It was announced that the Bank Group assistance program would continue to focus on systemic and institutional reforms, while pursuing related efforts at the regional and local levels to inform the overall policy dialog. The emphasis was to be on strengthening public sector institutions, advancing enterprise restructuring, improving the investment environment, and strengthening the safety net. The division of work among IBRD and IFC was formulated in the same way as in the previous year.

3.117 Since the government had incorporated into its program all significant reform proposals from SAL III, the Bank decided to use this program as a basis for assessing the progress of reforms in Russia and for planning future adjustment lending. This meant, for the first time in Russia, a common understanding of what is crucial, and better ownership of reforms by the client country.
4. Bank Products and Services Assessment

Privatization, Protection of Investors’ Rights, and the Capital Market

Privatization Implementation Assistance Loan (PIAL)

4.1 Objectives pursued by the Bank and the amount of borrowings. The main objective of this project was to conduct structural reform in the industrial sector by providing technical assistance and institutional support to the Mass Privatization Program (MPP). Other objectives were to provide assistance to case-by-case privatization of large enterprises, post-privatization structural reorganization, and the design of a strategy for key areas related to privatization, such as bankruptcy and anti-trust policy.

4.2 The volume of the loan amounted to $90 million, including the International Bank for Reconstruction and Development (IBRD) and the European Bank for Reconstruction and Development (EBRD) facilities. The loan was supported by grant monies from other sources; among them, the most important were the United States Agency for International Development (USAID; $58 million), EU (Tacis), the British “Know-How” Fund, and the German Bilateral Assistance Organization. Among the main areas of work were:

- Facilitation of the implementation of the state privatization program (institutional support, design and implementation of MPP, a large-scale public relations campaign, and privatization of small and medium-size businesses on an individual basis).
- Post-privatization support (structural reorganization of the privatized enterprises).
- Facilitation of reforms in the areas overlapping privatization—the antitrust program and the competition development program, legal reform, and insolvency procedures.
- Facilitation of the development of business (research on economic policy with regard to opportunities for business in the private sector, training, and publishing).
- Social assets conversion (transfer of social assets from the privatized enterprises’ books).

4.3 Project execution and management. It was stated in one of the internal papers of the Bank that the management of this project and its execution were satisfactory only until the resignation at the end of 1996 of the first executive director of RPC (the implementation unit for the project), following which, the project became unsatisfactory. One could agree with that assessment only to some extent. More important reasons for the deterioration of the situation were that, at the beginning of the next stage of privatization in 1995 (privatization of major enterprises on an individual basis and post-privatization enterprise support), the Russian Government was either not interested in receiving the Bank’s assistance or was unable to use it because of economic and political difficulties.

4.4 Because the grant money was used for project implementation until then, the loan amount remained practically intact, but it could not be spent on the basis of the former

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32 These issues are considered in the same section, particularly due to technical considerations: IPP was separated from PIAL, while CMDP for some time functioned along with IPP, and they both were run by the same organization.

33 The total disbursement of this loan amounted to $86.05 million.
approved program. A very high level of Bank flexibility made it possible for some funds to be redirected to more vital objectives such as the IPP. Others were redirected to deal with the necessary but difficult goals (to facilitate post-privatization support and conversion of social assets). The remainder was left to “serve” the main task—next stages of privatization. However, with so many contradictory interests converging around this process, the use of technical assistance became impossible. Thus, the real decline in the quality of the project management and execution was due to external factors.

4.5 Results, contribution to institutional development, stability. Besides the fact that the implementation of the project took substantially more time than anticipated, the degree to which the aims of the project were achieved varied: in certain areas, there were successes, while, in others, only partial progress or very small changes were noted. The original project was formulated in general terms only, and made it possible to take into account the changes in the program of economic reforms of the country and to redirect its tasks. This was in the concrete situation a quite positive feature, which was not typical for other Bank activities and projects in connected areas—for example, lack of flexibility was the main reason for the failure in implementation of the capital market development project (CMDP).

4.6 In the beginning of the project, the loan was extended to facilitate the establishment of conditions for MPP and the development of trust in it. Indeed, the project was instrumental in creating an all-Russian system of auctions, within which various procedures and software systems were produced. Such systems and procedures helped to organize privatization voucher auctions all over the country. Other substantial and successful work was done in strengthening the institutional potential of the management authorities, conducting privatization, and the organization called upon to act as its “think-tank” (the Russian Privatization Center, or RPC).

4.7 However, further events showed that the results were not stable. First, RPC was not able to play any significant role in such areas of project implementation as post-privatization restructuring of enterprises, privatization of large enterprises on an individual basis, or the transfer of social assets. This was one of the reasons for the achievement of only very modest results in these areas of the project. The functioning of the RPC practically ceased with the end of the project, although plans called for the organization to continue operating in the fields of privatization and the implementation of post-privatization and other related projects.

4.8 Nevertheless, nearly every component of the project had certain positive results—perhaps more modest than expected and of a more experimental, rather than practical, nature. This meant that, in the majority of cases, the result was the gathering of experience in one or another process. The results of the program could have been more impressive if only the Russian Government and other government agencies could have worked out a better strategy for a more efficient application of the grants donated for economic reforms in Russia.

4.9 Assessment of the borrower’s contribution and main conclusions. The effectiveness of the borrower’s work has been very unpredictable. At the beginning of the project, the recipient’s work was quite satisfactory. However, the program’s efficiency declined dramatically later on, because of frequent changes of the persons responsible for project implementation in the Russian government and the resulting frequent changes in the management of RCP. Additionally, because the project’s objectives and goals were so

34 On the early success of the Mass Privatization Program (MPP), see also paragraphs 3.20–3.26 and 3.45.
35 For conclusions related to all the projects, see also Sections 5 and 6.
broadly formulated, the Russian government was unable to define the most important priorities, which it was expecting to achieve in the course of the project implementation. This could be a specific reason for relatively modest achievements after the completion of MPP.

4.10 In summary, the process of privatization and structural reorganization of enterprises is far from perfect and complete. Despite the fact that many strategic issues were resolved, there remains an acute need for the continuation of the work in the area of privatization, related to privatization of major enterprises on an individual basis, structural reorganization of enterprises and provision of post-privatization support, structural reorganization in the social area, and strengthening of the legal framework.

4.11 Antimonopoly policy and business environment promotion. The antimonopoly component of the Bank’s privatization program was relatively insignificant by its size, but it received a positive response (the opinion of the Russian Financial Ministry for Antimonopoly Policy). First, in 1995, the development of the methodology of antitrust control in the area of economic concentration allowed an amendment of the law of 1991 on competition, mergers, and acquisitions. At the same time, the amendments of 1998 with respect to affiliated persons were elaborated without the participation of the Bank’s experts, an approach that was likely to affect the Ministry’s capacity in terms of evaluation of the existing approaches and apparatus. Second, the technical support program delivered by the Bank to the Ministry of Anti-Monopoly Policy received a positive response.

4.12 Beyond the framework of the privatization project, the Bank’s role was exclusively “political.” There is, in particular, the opinion that it was structural adjustment loan (SAL) III that became a catalyst for the domestic discussion on restructuring natural monopolies in transport and communication.

4.13 The combination of SALs and technical support mechanisms (the institutional strengthening of the government agencies concerned) usually is recognized as being optimal. As concerns priority spheres that require the Bank’s support, one should single out the problems of railway restructuring, access to the natural monopolies’ infrastructure, reform of the telecommunications market, and support of small businesses.

4.14 The post-privatization enterprise restructuring component aimed to provide services for privatized companies, mainly in industries adversely affected by the opening of Russian markets, such as textiles and machinery. Pilot projects for investigating the need for such services were conducted in 1996–1998. Soon, it became evident that the absorptive capacity of Russian privatized enterprises for such restructuring work was quite low (implementation completion report of PIAL, June 2000). Therefore, the project never became effective.

4.15 While the business climate for domestic entrepreneurs remained as bad as it was at the beginning of transition, and foreign investors were still not welcome, how could the newly privatized sector find new investors? To enable such an evolution, many further steps related to the business environment (easing entry, developing competition, and the like) and to corporate governance (mainly, protection of shareholders rights) should have been taken.

4.16 Additional components of the PIAL were indeed designed to identify national and regional barriers to private sector development. A number of systemic changes, critical to the appropriate operating of a private sector, were identified, such as:
• Market liberalization (price liberalization, domestic and foreign trade, foreign exchange, and interest rate regimes).
• Development of competitive markets based on a legal system for private property and market-based activity.
• Stimulation of new entry and competition.
• Change of the regulatory framework of the economy.
• Legal reforms (including the definition of property rights, creation and enforcement of contracts, company law, insolvency law, and so on).

4.17 Most of these important measures (excluding market liberalization) which was dealt by the Bank under the Rehabilitation loans, but mostly by the IMF were only addressed in this program. However, the task of identifying them more concretely—not to mention their implementation—was delayed for a considerable time.

4.18 Taking into account the limited capacities of the government, one may understand that may not have been possible to focus at the same time on (a) the quick implementation of the privatization program and (b) assurance of the preparation of its further steps, i.e., allowing an efficient functioning of privatized enterprises. However, a more important reason for the failure of the government in this area seems to be its political weakness. On the other hand, the Bank clearly recognized these problems at that time, which was visible in its economic and sector work (ESW) studies and board discussions. However, it seems that there was not enough policy dialog between the Bank and the government and a lack of sufficient public activity to change this situation and explain the future dangers of such an inconsistent approach to the public. These shortcomings on both sides created the first signs of the serious future problems in Russian privatization process.

4.19 The only positive (but still insufficient) activity in this area was the business promotion component of the privatization implementation assistance loan (PIAL), which consumed $7 million and was handled with the help of the Working Center for Economic Reform and the Institute for Private Sector Development and Strategic Analysis IPSDSA. IPSDSA conducted research on private sector and small business development in Russia from September 1995 to December 1998, providing technical assistance and training to entrepreneurs, government, and private and public business organizations. The public policy achievements of IPSDSA were impressive, since it managed within the three years to conduct more than 70 seminars in 30 regions of Russia and to publish more than 60 books and brochures on development issues for small and medium-size businesses. IPSDSA research and dissemination of information were assessed as very helpful and valuable. Unfortunately, this cooperation was not continued after 1998 because of (unclear) formal reasons.

**Investor Protection Program (IPP)**

4.20 Objectives pursued by the Bank and the amount of borrowing. This program was separated in May 1996 from PIAL as an independent, separately managed and implemented component. This was done upon request from the Russian government, which, in the first half of 1996, faced a drastic increase in social tension in the society, brought about by the

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accumulation of negative effects from the operations of illegal financial companies, with an increasing number of deceived depositors falling victim to these companies’ fraudulent operations. Thus, the main objectives of the Investor Protection Program (IPP) were to help the Russian government to liquidate the aftermath of the fraudulent operations of financial pyramids and to create relevant legal and institutional conditions that could (a) exclude any repetition of such violations, (b) facilitate the emergence of new forms of collective investment, and (c) function in accordance with internationally recognized standards. The volume of borrowing was $28.2 million, made up exclusively of IBRD loans.

4.21 Main areas of influence. The following areas of influence should be mentioned:

- Financing for the creation and initial functioning of the Federal Foundation for the Protection of the Rights of Investors and Shareholders (FFPRIS), including: operational costs; preparation of litigation and arbitration hearings; search for and evaluation of property; design of insolvency schemes; preparation of unlicensed companies (both their assets and lists of their depositors/investors); design of models for compensation fund operations and of procedures for the transfer of the assets of unlicensed companies under the management of compensation funds; preparation of compensation payment packages, etc.
- Legal reform (joint-stock company legislation, bankruptcy, investor protection, and taxation of securities markets).
- Development of the collective investment sector: (a) design of standards and methods of functioning and control, and of legal, regulatory, taxation, and accounting principles, and (b) implementation of pilot projects for the establishment of collective investment institutions.
- A public information service.

4.22 Project execution and management. The management and implementation of this component was separated from the general management and execution pattern of PIAL and transferred to the Federal Commission for the Securities Market (FCSM) and the Institute for a Legally-Based Economy (ILBE). The latter was made responsible not only for project management, but also for drafting relevant legislation. Execution and management of this component was influenced by two negative external factors:

- First, a legal scandal between U.S. AID and the Harvard Institute for International Development (HIID), which essentially destroyed the project management system—the Bank’s IPP management staff was changed twice, and the Russian managing entity was replaced with a new one.
- Second, new political, social, and economic conditions in Russia, under which the protection of investors’ and savers’ rights lost its appeal, while serious obstacles to the development of a new collective investment sector arose (in the form of an unbalanced government budget and a pyramid of government short-term bonds).

These developments led to a declining interest in the execution of the program and resulted in delaying the process of re-establishing IPP manageability and its normal implementation. Both of these problems were solved by a joint effort by the Bank and the borrower, although this substantially undermined good will. This affected the implementation of another project in the sector under consideration—the Capital Market Development Project (CMDP).
4.23 **Results, contribution to institutional development, stability.** Without doubt, the main result of IPP, testifying to its stability, is the functioning FFPRIS. Various procedures have been designed for it, on the basis of which the fund’s structure has been replicated in a number of Russian regions. A mechanism also was put in place for financing the fund’s operational expenses, which enabled it to be in business for a year and a half after the completion of the project. As far as the main criterion for evaluating the efficiency of the fund’s work is concerned, it is without doubt the amount of compensation paid to the depositors of financial pyramids. The fact that compensation payments took place constituted a major success, especially if the whole range of negative circumstances under which the project had to operate is taken into account. The objectives of IPP in creating a new sector of collective investments have been largely achieved. The new sector has been fully armed with methodological and procedural instructions. A major package of methodological materials was prepared and verified, including the functioning of such share funds in their different modifications, as well as various infrastructure institutions. Pilot projects of the program held in several regions were targeted toward trying the best methods and international practices, their adaptation to the Russian conditions, and a follow-up dissemination of experience among all the interested parties, through different teaching methods (training, publishing, radio and television, work with mass media, and so on). The results were confirmed by the August crisis of 1998. Now, almost two years after the crisis and one and a half years after the completion of the program, we can see that the new sector has successfully adjusted itself to the post-crisis conditions.

4.24 **Estimation of the borrower’s contribution and main conclusions.** In the case of IPP, there was a very clear and effective identification of targets, which led to the successful achievement of practically all of the objectives established for the program. The management of the program on the borrower’s side was extremely professional and clear, which positively influenced its effectiveness. However, at the very end of IPP implementation, under the influence of a whole set of negative external circumstances, the borrower lost confidence in the correctness of the objectives and weakened control over the situation. This led to the termination of IPP implementation at the very last stage and the development of new forms of collective investment, which, in the post-crisis period, caused further weakening of this new sector.

4.25 Another negative item in connection with the borrower’s attitude was the borrower’s total inability to resolve the taxation problem (problems of value-added tax on contracts concluded, payment of property and profit taxes, and so on).

4.26 Despite the obvious political content of the project, its results can be viewed as positive. Mechanisms for maintaining relations with the victims of “pyramids” and for compensation payments were created. Stable institutional structures were also established for the practical application of these mechanisms—federal and regional compensation funds. IPP created new regulatory and institutional foundations for the new collective investments.

**Capital Market Development Project (CMDP)**

4.27 **Objectives pursued by the Bank and the volume of borrowing.** The structure of the project and its objectives were determined in the course of negotiations between the Bank and the Russian government in 1995. The loan agreement under the project was activated in December 1996, while the first real steps in implementing the project were undertaken as late
as fall 1997. As the result of this delay in the start of the project, a decision was made to reconsider its structure and adapt it to the newer stage of development of the domestic securities market.

4.28 The main objective of the project then became the strengthening of the institutional potential of the Federal Commission for the Securities Market (FCSM) by improving its regulatory, supervisory, and law enforcement functions, by augmenting its staff with skilled individuals, and by creating a modern computerized technical architecture. In addition, one of the project’s key goals remained the design of a comprehensive strategy and the regulatory basis necessary for the development of the Russian capital market. Another objective was the creation of an efficient government debt management system. The original objective to create a modern-day market system was excluded, but was periodically revived by both the Bank and the Russian Government in the form of an attempt to establish a central depository. Achievement of the objectives set required the development of a higher level of investor trust toward the Russian capital market, and the creation of the institutional and legal prerequisites for a significant amount of both domestic and foreign investment in the Russian economy. In the post-crisis period, the project faced another necessity: to work out an independent and comprehensive study of the reasons for and ramifications of the 1998 crisis and to suggest guidelines related to a set of anti-crisis measures.37

4.29 The original amount committed was $89 million. However, by the middle of 2000, the project was completely restructured, leading to a cancellation of $33.75 million and the extension of the project implementation term by another two years. Thus the final amount of borrowing equaled $55.25 million.

4.30 Main areas of influence. The project had to include a comprehensive system of measures aimed at protecting the rights and legal interests of investors, and an increased role for the stock market in attracting investments into the real sector of the economy. It was anticipated that these measures would be applied to the following main areas: legal reform, expansion and improvement of the legislative and regulatory basis of the securities market, development of an effective system of law enforcement in the securities market, strengthening of the FCSM’s institutional potential by establishing a professional system of information disclosure, creation of a computer-technological architecture for FCSM, strengthening of FCSM’s capabilities for information dissemination and public relations, design of a strategy for the support of Russian enterprises during the transition to International Accounting Standards, encouragement of the investment process through improvement of the taxation system, design of a general concept for the development of institutions for individual savings and collective investments, creation of an automatic monitoring system and a government debt management system, and training of regulatory personnel, militia, and judiciaries in law enforcement practices.

4.31 Project execution and management. The Capital Market Development Center (CMDC) was an entity originally established to complete the implementation of IPP and, later, the implementation of the Capital Market Development Project (CMDP). In August 1997, the Bank and the borrower reached an agreement in principle on the new project structure and the system of its management. However, it took more than six months to finally agree on the system of management and to start implementation of those main areas which had been cleared.

This 1999 report, known as Cadoghan's study, has not fulfilled expectations in this regard, according to the opinion of numerous Russian experts.
4.32 By then, the Bank had rejected the principle used in other projects of this block of initiatives, that is, a flexible approach to the use of the loan in accordance with the changing needs of the borrower. Moreover, there was a general disagreement between the Bank and the borrower regarding the priorities of the project. These problems became visible during the discussion of the strategy for the post-crisis revival of the financial services market in Russia. The Bank’s position was to place priority on the re-establishment of the banking sector, which was inconsistent with the approach of FCSM.

4.33 Despite certain compromises, the implementation of the project was practically stopped. The process of project execution practically boiled down to only covering its management costs and the support of FCSM in its public relations work (the first project component approved both by the borrower and the Bank even before they started debating the concept and structure of the project in general). After the necessary restructuring of the project in mid-2000, no other important actions were taken apart from the total loan amount reduction and the extension of the project completion date. Further, there is a feeling now that this state of affairs became acceptable to the borrower as well, who was spending the project’s money to cover its operational expenses. Execution of the component on government debt management before and after project restructuring cannot be clearly identified, and no proper action has been noticed on the part of the borrower in this field throughout all the years of operation.

4.34 Results, contribution to institutional development, stability. In the case of CMDP, despite a four-year history of project implementation, there are no important results. This is due to the lack of readiness of the Bank to support the development of the Russian stock market. At the same time, even such modest results in the area of legal reform would hardly have been possible without the relevant financial resources of the Bank.

4.35 One of three core objectives of the project—strengthening of the institutional potential of FCSM—has been achieved only in part. The most important component of the project concerning state debt management is not being implemented.

4.36 The current state of affairs in forming the project’s implementation strategy and in its execution points to a deep crisis between the Bank’s views and the borrower’s position on the development of the domestic capital market. In such a situation, the spending of loan funds for another two years would hardly bring any positive results in reforms and development of a future capital market.

4.37 Estimation of the borrower’s contribution and main conclusions. One cannot assess the borrower’s work as fully satisfactory. The performance of the Ministry of Finance, in its capacity as a co-executor of the project in the part related to government debt management, is impossible to evaluate at all, since, for the past four years, there have hardly been any activities in this area. However, a constructive approach by the borrower should be noted in strengthening law enforcement and providing for the disclosure of information in the securities market.

4.38 Generally and most apparently, the representatives of the Russian government and the Bank would find it worthwhile to terminate implementation of this project and start a new round of negotiations to work out joint approaches to reforms of the Russian capital market.
Legal Reform Project

4.39 This project, at an amount of $58 million, was also approved in June 1996 and made effective in September of the same year. Its overall objective was to improve the Russian legal system’s performance so that it can function effectively in the market economy. Specific objectives were to:

- Improve the process of drafting economic laws and regulations.
- Help design an appropriate method of classification of legislation (including computerized systems).
- Promote innovative methods of legal education, with increasing exchange between academia and practitioners.
- Improve the quality of judicial training.

This project has been delayed, as have been other projects that started shortly before the financial crisis in 1998. After the crisis, it was implemented within the same structure. At the time of writing this report, the project still has some $35 million undisbursed. As reported during the Country Project Portfolio Review (CPPR) in February 2001, good progress has been achieved in all of the project components during the past six months. Besides successes in legal education and judicial training, the implementation of a very ambitious program for a computerized legal information system to be used by courts has been advanced. Important legal drafts have been also prepared as part of the project. This project is very innovative and is aimed at one of the most important goals that should be achieved step by step through Russian reforms: reestablishing the rule of law and its understanding by the public.

Banking Sector

Financial Institutions Development Project (FIDP)

4.40 Objectives, anticipated advantages of the project and its political context.

The FIDP was developed as part of a package of other measures proposed by the G-7 countries and aimed at providing comprehensive support to Russia in transition. Prior to the development of this project, the Russian Government and the Bank analyzed the condition of the banking system. The results and conclusions of the analysis were presented in the Bank’s paper “Russia: The Banking System in Transition” (1993). This paper addressed the prospects for development in the next 3–5 years and the reforms to be implemented for the banking system to be able to perform its functions in a market environment.38 It should be noted that the Russian authorities were at that time reluctant to liberalize laws and regulations for the entry of foreign banks, which could have substantially eased the problems of lack of capital and of modern banking know-how. It also would have established competition in the banking sector and would have accelerated the process of elimination of noncompetitive banks. Taking into account this limitation, the 1994 FIDP project was expected to provide a “second-best” solution to the Russian financial sector. It was expected to “improve the soundness of commercial banks in a gradual approach,” by improving their standards and

38 The following measures were mentioned: gradually discontinuing provision of targeted budget loans, using market methods of credit flow management, developing and implementing prudential norms for banking, improving the banking infrastructure (the payment system in particular), reforming specialized state-owned banks. The FIDP was expected to contribute to the implementation of this strategy.
providing better supervision by the Russian Central Bank. The program was to be targeted only at a small number of accredited commercial banks that would agree to be subject to stricter supervision by the Central Bank of Russia (CBR) in order to gain better credibility and enjoy some privileged relationship with the CBR. It was expected that this group would form the core of the banking system of the future.

4.41 The FIDP main parameters were determined in the report on FIDP preparation (#12707 RU 6, April 1994). The main objectives of FIDP were: expansion of the volume and improvement of the quality of banking services, improvement of banking sector stability, facilitation of access to financial resources and placement of credit facilities (including all types of loans financed from the Bank’s portfolio or from other international sources).

4.42 The direct aim of the project was to strengthen a group of leading commercial banks, which were expected to establish high standards and create a dynamic mechanism for raising the quality of banking services in Russia, to provide a basis for implementation of inter-bank exchange, and to conform to requirements extended to credit agencies which refinance funds from the Bank and other international financial institutions. In addition, the project included plans to finance a number of measures to improve the function of banking supervision and inspection, as well as to convert bank financial reporting to international standards.

4.43 It was expected that implementation of the project could bring additional advantages for economic growth by (a) increasing stability in the financial sector and (b) adding to the efficiency of placement of financial resources by offering market-rate loans to viable enterprises in the real sector of the economy. Further, it was expected that the project would contribute to the process of harmonizing banking systems and enhance the potential of the payment system. As the result of improvement and reform of banking legislation, regulation, and supervision, further convergence with international standards was expected. Improvement of financial reporting and auditing was supposed to contribute to improvement in the credibility of financial reporting and the level of transparency both of banks and enterprises.

4.44 Preparation of the project took into account the provisions of CAS 1992, which required a stricter budget discipline in the sphere of government finance (the Ministry of Finance made FIDP resources available to commercial banks and the Central Bank of Russia on a repayment basis). The need for gradual elimination of centralized extension of credit was declared.

4.45 Risks recognized at the stage of project preparation. The report on the preparation of FIDP (#12707 RU, 6 April 1994) assessed the risks of its implementation. The following were defined as the main ones:

- The uncertainty of the macroeconomic situation and the financial stability of participating commercial banks.
- The lack of experience and familiarity with the procedures of the Bank on the Russian side.

4.46 Factors that might lower such risks were also envisaged, specifically: (a) improvement of banking supervision, which might allow the project to identify banking risks at the earliest possible stage and to take the necessary steps to neutralize such risks or to take
problematic banks out of the project, and (b) institutional strengthening of the participating banks, aimed at higher levels of risk management.

4.47  **Components and results of 1995–1998.** The agreement between the Russian Government and the Bank on a $200 million loan was signed June 22, 1994. The project consisted of four components:

- The commercial bank component, which included programs for institutional development, modernization of information systems, and automation of participating private commercial banks.
- The banking supervision component, which was aimed mainly at strengthening the functions of banking inspection, as well as at improvement of legislation for the banking sphere.
- The accounting and auditing component for enterprises.
- Project management.

4.48  Implementation of FIDP started in 1995. An interagency task force for strategic issues, created through an agreement between the Ministry of Finance and the Central Bank of Russia on February 29, 1995, managed the project. The responsibilities of the task force included policy issues and the strategy for project implementation.

4.49  In 1995–1997, a group of 40 banks were accredited, with 29 of them gaining access to the project’s funds. Programs for institutional strengthening were initiated in 15 banks; however, only three institutional strengthening programs were completed by the end of August 1998, when FIDP spending stopped.\(^{39}\)

4.50  The information technology component was implemented in 25 banks; the total amount of money appropriated in this component was $77,600, including the IBRD’s $53,396. FIDP’s funds were usually used to purchase better computer equipment (servers and work stations), modern communications equipment, and service support terminals related to plastic cards. A meaningful component of the automation strategy related to purchasing or upgrading banking software, including information management systems. The banks were not very much interested in buying consulting services on information technology, preferring to receive the maximum of such services through the institutional development programs, although several projects in information technology planning were financed out of FIDP’s funds.

4.51  Implementation of the institutional strengthening and information technology components helped to improve the quality of banking services. In the post-crisis period, many banking experts, having upgraded their skills through the twinning programs, were very much sought after by those banks which managed to stay afloat. Human capital development in the banking sector is thus one of the most durable positive effects of FIDP. In addition,

\(^{39}\) Two out of four banks that completed institutional strengthening programs have been liquidated, and one bank is still in a very complicated financial condition. At the same time, the institutional strengthening programs in three other banks turned out to be quite successful, and two of them were extended by the participating banks at their own expense during the post-crisis period. In one of these banks, a foreign partner decided to participate in the operations through a debt-to-equity swap. The third program was completed in the post-crisis period and quite successfully so (as assessed by the bank itself, as well as by its foreign partner and by the Bank review unit). In sum, $32,237 was spent on the institutional development of banks within FIDP, and $12,755 came from the banks.
thanks to their accreditation by FIDP, many participating banks became recognized participants in international financial markets by 1997–1998; the aggregate debt of FIDP-participating banks to their Western counterparts was $5 billion on October 1, 1998, including unregulated forward contracts obligations.

4.52 The project served as a catalyst for the introduction of international auditing and for a general improvement in the level of transparency of the Russian banking system. In 1993 and 1994, more than 20 banks went through international audits as part of the FIDP program; in 1995, more than 30 banks underwent international audit services; And, in 1996, this figure grew to 60 audits. Obviously, the level of information disclosure and the general quality of such reports was not similar in all cases. For example, on the request of their customers, some auditors did not disclose the names of their counterparts, which substantially hindered financial analysis, particularly in risk concentration analysis. Delays in the preparation and submission of financial reports under international accounting standards (IAS) have been and still are a major problem.

4.53 A study of the financial status of major private banks as of September and October 1998 was a substantial contribution by the project to the analysis of the banking system in the period after August 1998. According to this research, the main factors that led to the collapse of the banking sector were not the big portfolios of government securities that a number of banks had at the time, but the low quality of loan portfolios and excessive treasury risks accumulated by the banks in 1997–1998.

4.54 The drawbacks of project implementation before the 1998 crisis. The project in general was not able to reach the goal of improving the stability of the banking sector (despite its orientation on “systemic” banking structures), and, thus, many positive achievements of the implementation of the project had no effect.

4.55 To a great extent, major drawbacks of the project were due to the fact that only the component for commercial banks was started. At the same time, measures to improve banking legislation, supervision, and inspection, and the adoption of international accounting standards were constantly slowed down. This occurred despite the fact that the existing agreements between the Russian side and the Bank in this area had also been included in the conditionalities and agreements for the granting of the structural adjustment loan (see he official documents).

4.56 However, the commercial banks component also experienced some serious drawbacks. The financial status monitoring function of the commercial banks was initiated by the Bank Review Unit (BRU) only after a new head of the group was appointed in September 1996. On the basis of the first nine studies conducted by BRU in September and October 1996, the parties to the project were informed that none of the nine commercial banks could be defined as financially stable. This original conclusion was confirmed in subsequent studies by BRU, reported on a regular basis to the heads of the project (the task force, the Bank, and EBRD). However, before 1998, no sufficiently stringent measures—such as disaccreditation from the project or recollection of funds—were applied to those banks which were in a difficult financial condition, which did not start the implementation of institutional strengthening, or which broke the rules of accreditation.

4.57 Often, there were cases when a number of banks (particularly when it concerned the banks of “the first wave” accredited in 1995) were given access to the automation funds before they started implementing institutional strengthening, which was a mandatory element
for all of the program participants. Implementation of institutional strengthening in a number of other banks either took too long because of some serious obstacles or did not produce any substantial positive effect on their financial status.

4.58 A number of banks used FIDP either as a source of relatively cheap long-term funding for their automation programs (such as SBS and Uneximbank), or exclusively as a means to promote their names among foreign counterparts (for example, Menatep). In general, the concept of accreditation of banks “at the entry point”—meaning before they actually started work under the project—turned out to be wrong in many ways, since many banks started misusing their accreditation status without working toward the objectives of the project. The Western counterparts of the banks participating in FIDP in many ways undermined the importance of the project in negotiations with participating banks, because BRU’s conclusions on higher risk and the lack of prudential behavior, noted in a number of participating Russian banks, were ignored by these Western banks. Further, banks demanded unlimited access to Western financing. Such banks as SBS-Agro, Uneximbank, Rossiiskii Kredit, and Imperial were most notorious for this. At the same time, political lobbying by these and other banks prevented the task force from resorting to strict action based on the conclusions drawn by BRU.

4.59 At the stage of preparation and implementation of the project before the 1998 crisis, higher-level risks characterizing the financial sector in general had been underestimated, namely:

- Macroeconomic instability combined with the lack of the necessary institutional infrastructure and substantial shortcomings in the course of privatization (as a result of the loans-for-shares deals, a number of banks practically abandoned commercial crediting of independent third parties).
- Banks’ concentration of attention on related parties (e.g., enterprises in which they had come to hold shares), which seriously undermined their financial stability and later simplified the process of illegal export of assets from insolvent entities into newly created or acquired structures.
- The interdependence of all the segments of the financial sector.

4.60 Insufficient attention was also paid to the issue of corporate governance in participating banks. This added greatly to the due diligence risks of the World Bank, since the project financed a number of banks whose owners could not conform to generally accepted international criteria of “fitness and property.” Issues related to the ownership structure of the banks, sources of capitalization, or the independence of the management attracted greater attention only within the newly restructured FIDP.

4.61 Generally, it should be noted that the 1998 crisis produced a mixed effect on the project. The Bank terminated project spending and implementation of the information technology and institutional strengthening program components, most of which had not been completed by the banks. The project suffered definite losses as the result of financial problems becoming more acute in a large number of accredited banks.

4.62 At the same time, as the result of rigid fiscal monitoring undertaken from the second half of 1996 within the FIDP project framework, it was possible to avoid a substantial allocation of funds to financially unstable banks. That was how the total amount of funds appropriated for the implementation of information technology and institutional strengthening
amounted only to $97 million. At the same time, the crisis served as a catalyst for negotiations on restructuring the project, which helped to substantially redirect it toward support for higher-priority measures in banking sector restructuring (see below).

4.63 The FIDP restructuring. In the wake of the 1998 crisis, project restructuring measures were initiated. The main direction of the FIDP restructuring was identified in compliance with government resolution # 1642-p of 20 November 1998, which provided for the use of a part of undisbursed Bank and EBRD loans to fund measures for the banking system restructuring. The Russian Government undertook certain obligations in this area, including implementation of measures to improve the banking law, strengthen banking control, undertake a transition to international accounting and reporting standards for credit institutions, and restructure or liquidate banks according to international practices. The restructured project met the agreements stipulated in SAL III, and in the Bank's medium-term strategy for the development of the Russian financial sector under the 1999 CAS.

4.64 In its most concentrated form, the concept of the project’s restructuring was laid out in a report to the Board of Directors of the Bank in April 2000. Within the framework of the project, it is envisaged to provide support in the following areas:

- Technical assistance to the Central Bank of Russia (simplification of bankruptcy and liquidation procedures for banks, improvement of their financial reporting, and strengthening of banking control).
- Support for ARCO’s measures in banking system restructuring (evaluation of ARCO’s financial, operational, and organizational activities; design and implementation of restructuring blueprints for banks; support for ARCO’s liquidation measures).
- Support for the restructuring of banks.
- Transformation of state-owned banks (with the purpose of creating a competitive and mostly private banking sector).
- Enterprise accounting procedures.

4.65 The long process needed for the adoption of the amendment to the agreement on loan # 3734A (signed by the bank on June 14, 2000 and by the Finance Ministry on July 3, 2000) has caused substantial uncertainty about the possibility of funding the work identified in the project frame, particularly according to the request of the Central Bank of Russia on July 27, 1999, # 016-15-3/3539, and that of ARCO on April 1, 1999, # 01/9. (Roughly 1.5 years were needed since the adoption of the decision on reorientation of the project’s funds toward support of measures undertaken by the Russian authorities for banking sector restructuring.) The implementation of the work is also constrained by the absence of an amendment to the agreement on the Japanese grant # TF 025149.

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40 As of the start of 2001, $25.4 million of that money was repaid; $10.8 million is being serviced according to schedule. In regard to $26.5 million, there is an ARCO moratorium in place (in one case payments have been renewed following the lifting of the moratorium); on the remaining debt of $12.5 million negotiations are underway to regulate this debt between the Ministry of Finance and two banks. Thus the total amount of bad debt under the project is $22 million, or less than 25 percent of the appropriated funds. However, it is still possible to retrieve part of these funds, either through a bankruptcy procedure, liquidation, or through the successor banks (Rosbank, for example). Additionally, part of the losses can be compensated for by interest payments, which are collected by the Ministry of Finance from viable participating banks.

As reported from Bank sources, the delay in the process was mainly due to the lack of a common position between the government and the CBR in this issue.
4.66 Nevertheless, the implementation of a number of areas under FIDP has been underway since late 1998. These include: (a) improvement of the legislative base in the area of banking regulation; (b) rendering assistance to ARCO in the area of institutional and organizational improvement of the agency itself, as well as in the area of the restructuring or liquidation of the banks managed by the agency; (c) rendering assistance to the Central Bank of Russia for the improvement of banking supervision; (d) evaluation of the financial state of large banks; and (e) work with the nucleus of viable banks on improvement of their operations within the framework of programs for adjustment measures.

4.67 Despite the project restructuring in mid-2000, a decision on the expediency of further implementation would be dependent mostly on the Russian authorities, and primarily on the Central Bank of Russia’s eagerness to confirm their interest in conducting the measures on banking sector reform stipulated in the aforementioned report to the Bank’s Board of Directors, as agreed with the Ministry of Finance, the Central Bank of Russia, and ARCO. Additionally, it should be noted that the partial achievements of FIDP have not changed the general picture of the Russian banking sector, which is still evaluated by numerous experts as very unstable and risky. With hindsight, it may be suggested that the main focus of the implementation of this project was not properly set, because, in the given situation, it should concentrate on prudential regulations and implementation of other civilized rules in the banking sector, rather than on the quick development of the investment capacities of private banks.

Enterprise Support Project (ESP)

4.68 Stated objective and amount of borrowing. In compliance with the report on the design of the Enterprise Support Project (ESP, 12953 RU of 1 June 1994), the project was implemented as part of a package of measures put forward by G-7 countries to extend comprehensive help to Russia over the post-privatization period.

4.69 Designed as a twin to FIDP, ESP was a financial intermediary loan from participating banks intended to provide credit to new private enterprises and newly privatized enterprises. The program had a dual goal: (1) to support enterprise restructuring and growth and (2) to strengthen the participating banks by developing proper risk management practices.

4.70 The dynamics of privatization, a considerable deterioration of capital assets at medium-size and large enterprises, and unsatisfied demand for financial resources on the part of the newly established private sector called for the presence of a reliable source of in-country financing, and necessitated the introduction of market investment mechanisms. The ESP was understood as a model of normal funding for the real sector under market conditions, which, in the view of its authors, could not appear spontaneously at that time. One may suggest today that the Bank was correct in its assessment of a substantial need for this type of product, but some of the ways and methods of achieving these goals were not entirely acceptable.

4.71 Under the auspices of ESP, the Bank earmarked as much as $200 million, while another $100 million was provided by EBRD. Credits were disbursed to 43 final borrowers (enterprises), representing 24 industries in 21 regions. The amount spent totaled $50.7 million.
4.72 The mission of ESP was as follows:

- To extend long- and medium-term funding (not available at the time the project was designed) to private enterprises for the purpose of financing their investments and increasing their liquid assets.
- To help a group of commercial banks to begin providing long- and medium-term credit to private enterprises.

4.73 **Anticipated benefits and risks identified at project design.** It was envisaged that the disbursement of short- and long-term credits to the private sector would constitute the benefit of the project. The disbursement of the credits, in turn, should have helped private enterprises to increase their efficiency, viewed in the overall context of their efforts to restructure, expand, and capture growth opportunities.

4.74 Besides positive effects in the real sector, activities under ESP were expected to help in shaping the Bank’s positive image among the Russian population in over 20 regions—people could experience actual benefits from Russia’s integration into the world community in the form of the creation of additional job opportunities, growth in salaries and wages, an increased flow of tax revenues to federal and local budgets, a substantial renewal of production capacities, and the replacement of obsolete equipment.

4.75 In the course of the project’s design, risks related to its further implementation were identified, notably the unstable macroeconomic situation, which increased credit- and borrowing-related risks.

4.76 Another risk was the institutional underdevelopment of the banking system, that is, banks’ inability to form their assets and liabilities adequately, and their failure to establish divisions that might be qualified for risk management. A further risk was the lack of skills and experience in issuing long-term commercial credits. The actual situation (particularly as related to the credits formed from ESP funds by the banks participating in the project) did not show adequate estimation of the risks involved.

4.77 The commercial banks’ operations in the securities market and in the market for foreign exchange also became problematic, as did a significant part of the credit portfolio that the banks had formed from their own capital, due to the considerable depreciation of the ruble and insufficient collateral. In contrast to the sound commercial practices of Western banks, Russian banks were much more likely to concentrate their efforts on more profitable, but more risky, operations in the foreign exchange and securities markets, rather than on the issuance of credits. The Bank also considered the prevalence of short-term credits for financing liquid assets, versus financing borrowers’ investments in capital assets, as one of the possible risks.

4.78 In the authors’ view, the priorities of the ESP project were correct. However, the assumption (resulting, to a great extent, from the FIDP project) that this project could effectively oversee the simultaneous operation of 20 to 30 commercial banks at a high level of quality was a mistake. In suggesting such a high number of participants, the Bank failed to evaluate the heterogeneity of the nascent banking system in Russia. The Bank also was not

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42 For example, the absence of commercial estimation of credit return, extension of credit based on personal relationship, extending credit to affiliated parties and insiders, offering credit to newly created enterprises without credit and financial records, and legal illiteracy in the drafting of credit collateral agreements.
able to judge the banks’ financial positions and skills in corporate governance. Furthermore, the Bank failed to estimate correctly its own ability to monitor the banks’ positions. It relied fully on the Ministry of Finance and the Central Bank of Russia to exclude problematic banks from the project. However, the latter institutions behaved rather passively, at least at the pre-crisis stage of the project.

4.79 To date, the Bank has not made clear which regulatory approach it favors in the banking sphere: (a) natural selection and equalization of the situation in the banking sector, with accompanying social problems, or (b) strict regulation by the Central Bank and domination by government banks.

4.80 Project management. The Bank showed sufficient flexibility when adjustments proved necessary in the course of implementation. For instance, with respect to procedures for the approval of contracts for the delivery of work and commodities, commercial practices were introduced.

4.81 The Bank assessed the consequences of the 1998 financial crisis, and, to a significant extent, structured the project to better protect the interests of creditors at all levels. The main problem revealed by the 1998 financial crisis was that the participating banks were reluctant to reinvest in new end loans the principal returned by the first borrowers. This problem was solved using a mechanism of special correspondent accounts connected to the approval of new final loans.

4.82 The project output. Although the ESP project could not support the private sector nationally, the mere fact of its existence and the implementation of final loans helped to shape the infrastructure of commercial banks. Simultaneously, the final consumers of the funds—private enterprises—received the funds they needed for efficient growth and development.

4.83 The implementation of ESP (as a model) also had some additional positive effects on the institutional development of the economy, such as:

- Promoting a sound business culture by issuing credits to enterprises according to international credit standards;
- Introduction of competitive and transparent methods for the selection of suppliers and contractors, i.e., the opportunity for national suppliers and contractors meeting selection criteria to gain access to project funds;
- Demanding that the participating banks act on the basis of international standards of banking activity (prevention of issuance of credits to affiliated parties, lowering the concentration of risks on large borrowers, sectoral differentiation of the credit portfolio, and structural changes in participating banks);\(^45\)

\(^43\) By reducing the term and size of the already issued loans, introducing a mechanism of concession of the end loans by “problematic” banks in favor of those whose financial positions appeared acceptable, introducing a mechanism by which the final borrowers paid off the principal to special corresponding accounts of participating banks with Vneshekonombank, providing that such accounts had a limited use mode and were designated exclusively for ESP-related transactions, departing from the notions of “accreditation” of participating banks, transition toward simultaneous approval of the final loan, and confirmation of the participating bank’s adequacy for the purpose of re-crediting the project funds.

\(^44\) Despite the fact that such an obligation was included in the loan agreement.

\(^45\) A vigorous involvement of banks in issuing credits under the auspices of ESP encouraged the growth in profitability of the banks’ operations from credit and related operations, elaboration of strategic programs of comprehensive services to clients. Practically all the borrowers hold main turnovers on their accounts in the
• Encouraging transparency in financial reporting.
• Using procedures implying an environmental check on borrowers and their respective projects.\textsuperscript{46}

4.84 Without such a project of support to enterprises, the aforementioned benefits would not have been available, in part or in full. Obviously, ESP cannot be viewed as a project designed to solve the problems of all of the enterprises needing funding in all sectors throughout Russia. Nonetheless, the mere fact of the existence of such a project was important as a pattern for other enterprises and had a substantial impact on the development of competition in the issuance of bank credits. The proportion of credits disbursed in Moscow and the Moscow Oblast accounts for as much as 30 percent of the total amount of approved credits, meaning that about 70 percent was disbursed in other cities and provinces. Such a geographic pattern of allocation of the ESP funds was determined by market approaches and testified to the trend to renewal of economic life in the regions.

4.85 As mentioned, the Bank considered the prevalence of short-term credits for financing liquid assets versus financing investment by private enterprise borrowers in capital assets as one of the project’s possible risks. Due to rigid procedures of approval of final loans, this concern was not justified. Under ESP, all end loans were used to fund purchases of capital assets, while liquid assets were funded only in the initial stages to ensure that the equipment purchased was put into operation. As for the insufficient demand for the credit resources of ESP, during the first two years of its implementation, the project suffered as expected, because of problems caused by the inefficient actions of participating banks, insufficient credit demand from enterprises, unfamiliarity with application requirements, etc. According to the Bank’s sources, in early 1997, the program had gained momentum. By August 1998, 16 banks participated in the project by having at least one final loan approved and disbursed. At that time, the overall amount of agreements for the disbursement of funds between the Ministry of Finance and the participating banks amounted to $222 million, while the 62 approved end loans totaled $126.5 million, and 18 applications on final loans totaling $46.3 million were under consideration. Another 46 projects worth a total of $107 million were at the stage of preliminary consideration.

4.86 The pre-crisis experience of ESP showed that the principles of managing credit risks under the project proved their viability: Forty-seven percent of the final loans have been paid off, and nearly all of the final borrowers under the project continue now to service their obligations (once restructured after the financial crisis). The high quality of the ESP credit portfolio proved the adequacy of the principles and procedures for project approval. The evaluation conducted with respect to the overall credit portfolio assembled using ESP funds has demonstrated that 84 percent of the credits extended were viable.\textsuperscript{47}

\textsuperscript{46} The activity with respect to ecological aspects is coordinated by EBRD.
\textsuperscript{47} In the meantime, ESP is to complete research into secondary results of the project (change in the coefficient of capital assets modernization, the impact of implementation on tax payments, increase in the salaries and wages fund, number of employees, and competitiveness of products).
4.87 However, the Russian financial crisis in August 1998 led to the closure of some participating banks and cancellation of a number of commitments. Out of 60 loans committed to enterprises, 17 have been cancelled, two were suspended, and, in another 6 cases, payment problems occurred. Meanwhile, 13 sub-loans were fully repaid and 22 were paying regularly. After August 1998, the project was frozen, and no new loans were approved for enterprises until 2001. The main task in 2000 was to gain acceptance for continuing the work on selecting candidates for participation in ESP. However, the most difficult problem to resolve remained on the banks’ side—after all these bad experiences, there was a question whether private banks were the right intermediaries for disbursement of ESP funds or whether the program should rely on state banks instead.

4.88 The future success of the project depends substantially on resolution of the aforementioned questions and on the general enhancement of Russia’s legal system. It is also necessary to increase the level of protection of creditors’ interests under credit agreements and contracts for fulfillment of obligations under credit agreements (collateral and guarantees).

Conclusion: Evaluation of FIDP and ESP

4.89 The assumptions of both projects (FIDP and ESP) were that banks (instead of shareholders) would exercise outside control over enterprise managers, and that bank credits would be the enterprises' main source of growth and restructuring. On the other hand, the projects had to promote the development of sound commercial banks and the Central Bank's supervisory function. The concept was imaginative and ingenious, but its design, in our opinion, was based on false assumptions:

- That the professionally weak, underdeveloped, and undercapitalized banks of Russia could efficiently provide the privatized companies with credit from Western loans and control the restructuring activities of enterprises.
- That the government (represented by the Central Bank and the Ministry of Finance) would be able to control and discipline the activities of the banks without efficient supervision instruments.
- That the enterprises would be willing to make use of such credits in a highly unstable macroeconomic environment, including inflation.
- That the banks would be highly motivated under the program to restructure themselves and to begin to use sounder business practices.
- That unreliable banks with questionable practices would not have access to the funds provided under the project.

4.90 By the mid-1990s, all these assumptions proved to be wishful thinking.

4.91 The detailed reasons for the failure of the FIDP are clearly explained in another sectoral draft paper prepared for the CAE. The most significant barriers of the banking
system at that time were: (a) accounting and reporting standards that provided unreliable and misleading information about the financial condition of the banks and the performance of their managers, (b) a barely incipient understanding of modern bank supervision in CBR, (c) weak legal definition of property and creditor rights, (d) a continuing tradition of soft budget constraints in both state enterprises and state banks, (e) inadequacies of bank and corporate governance that included ownership interlocks among them, (f) lack of both the political will and legal framework for resolving failed banks, (g) strong resistance to any foreign participation in the banking sector, and (h) the growing political power of financial-industrial groups (FIGs) whose interest was to maintain these obstacles in place.52

4.92 It should be noted that FIDP became effective one or two years too late to expect considerable reform prospects. By July 1995, major commercial banks were already far along in their consolidation efforts, establishing huge financial-industrial groups (FIGs) resistant to outside regulations and, surprisingly, supported by the government. The banks were also on their way toward making the “largest jump” in Russian reform history. That jump was the government’s “shares for loans” program, introduced later that year. They already represented a huge concentration of economic power, without any effective control, and it was difficult to force them to do anything against their will. Many of the participating banks were involved in insider lending and risky treasury operations. This cast doubt on their role in paving the way for a sound and safe banking system. Thus, the prospects for the success of the project at its start were very modest. The banks recognized early on that accreditation by the FIDP project made them more credible to foreign partners. This was the reason behind their strong pressure to be accredited. After being accredited, massive borrowings abroad made them even more vulnerable to the crisis.

4.93 The FIDP project had some achievements, particularly in upgrading the technical equipment of the participating banks and promoting the improvement of bank accounting standards and financial reporting. However, the supervision of the Central Bank was not strengthened, and the accreditation procedure also failed, allowing too many banks to participate in the project (39 banks representing about 50 percent of the country’s private banking assets). Prudential standards were not really imposed on these banks, and asset and risk management was inadequate with respect to risky operations. The project came to a halt with the financial crisis of August 1998 and was later restructured, with cancellations of $25 million in loans.

4.94 The lessons learned by the government and the World Bank from this experience were clear. Since the crisis, the government has focused on:

- Introducing prudential standards for the whole banking sector (including state-owned banks).
- Strengthening supervision by the Central Bank of Russia.
- Drafting new legislation in this area (such as the law on bank failures).
- Establishing new institutions such as the Interagency Coordination Committee (IACC) and the Working Group on Accounting Reform (WGAR)
- Strengthening existing institutions such as ARCO, the bank restructuring agency.

52 Fred Levy, as above.
The accreditation formula has been changed. At the beginning, 21 of the 39 accredited banks were abruptly disqualified from participation in the program. Later work was done to establish new accreditation criteria. In the future, banks may receive some help in meeting international standards, but the banks will be selected for this assistance under the strict supervision of the Bank Review Unit of the Ministry of Finance, subject to objection by the World Bank. Taking into account the lessons learned, it may be useful to continue the FIDP loan in its new version, as proposed by the Bank.

The ESP took a different course. According to the latest internal ESP report for 2000 year-end, ESP loans were extended to 43 sub-borrowers from 24 industries in 21 regions. The ESP sub-borrowers are enterprises that are at least 75 percent privately owned and meet appropriate international lending criteria. Investments are made regardless of sector and company size. The report points out that the ESP loan remains the only source of relatively cheap long-term investment financing. As noted above, 47 percent of approved sub-loans have been fully repaid, and all remaining sub-borrowers continue to service debts (except for one case of debt restructuring after the financial crisis in 1998). Analysis of the ESP aggregate loan portfolio shows that 86 percent of granted loans are viable. It may be supposed that the overall satisfactory results of the project were achieved thanks to good program management, in spite of the difficult affiliation with the FIDP project. Another factor that influenced its performance is the relatively detailed supervision it received from the Ministry of Finance after the financial crisis.

Because a large portion of the ESP credit (one-half of the $300 million from the World Bank and EBRD) remains undisbursed and applications for new loans are pending, continuation of the program is under discussion. In July 2000, the project completion date was extended through September 2002. The choice and supervision of banks as intermediaries for participating enterprises remain critical points in the discussion. It is anticipated that the Ministry of Finance and the Bank will supervise the banks closely. The detailed and strict state supervision that proved to be necessary in the implementation of both programs made evident that the primary idea of a self-regulating and self-strengthening mechanism for FIDP and ESP could not work properly in real life.
5. Development Effectiveness Impact Assessment (Outcomes and Results)

The Bank’s Vision of Major Challenges and How to Tackle Them

5.1 Generally, it may be stated that the Bank’s vision of major challenges and ways of solving them was correct. Despite the fact that the Bank did not participate directly in some of the aforementioned measures (for instance, the reform of trade and pricing), the measures proposed by the Bank were fulfilled by the Russian government with a certain level of success and ensured, as the Bank had envisaged, a fundamental basis for the further transformations.

5.2 Further progress on the path of structural reforms, including those in the private sector and the financial sector, was constrained by numerous factors. However, there were some clear drawbacks in the Bank’s strategy:

- There was no strong countervailing action against the Russian Government’s employment of “non-standard” methods in the course of the privatization of large enterprises—particularly the loans-for-shares auctions;
- There was no implicit pressure on the Russian government in terms of enforcement-related matters (although, objectively, one should take into account the political factor in the Bank’s activity and the presence of an opposition in Russia);
- The Bank in effect supported the strengthening of the pseudo-banking system, which now it attempts to reform persistently. The tasks of the banking surveillance stipulated practically in all the documents were far from being accomplished;
- Too little was done by the Bank to develop the national securities market prior to the crisis, while the Bank’s stance afterwards in effect was to ignore the problem; and
- The Bank was ready to financially support the Russian government, despite the latter’s systematic failure to fulfill its commitments in the area of structural transformations.

Project Execution and Management—The Role of the Bank’s Moscow Office

5.3 As far as the nature of the management of the projects in the financial sphere and the level of their implementation are concerned, it is possible to single out some specific characteristics of such projects:

- Sooner or later, the function of managing the projects becomes dominant, and the project begins to exist for itself.
- In the course of some projects, the bank provided to the borrower insufficient expert support, which was needed to correctly orient the technical assistance flow in the framework of the implemented areas of the transformations.
- From time to time, both the Bank and the borrower tended to lose their control over the projects’ implementation.
- External factors manifested their notable and, sometimes, crucial impact on the processes of the projects’ management and implementation.
- In cases of successful cooperation between the bank and the borrower, the quality of the projects’ implementation was more than satisfactory.
5.4 The role played by the Bank’s Moscow office was approximately the same in all the projects, which is also noted in the Bank’s papers. The projects were managed directly from Washington, D.C., and the role of the field office evidently was diminished; this became one of the reasons both for the absence of promptness in the decision-making process in the Bank and for purely bureaucratic problems. One may argue with confidence that practically all these phenomena could have been avoided, should the local representative office have held a larger mandate and responsibility in terms of the management of projects.

Evaluation of the Bank’s Contribution

5.5 In the course of the implementation of PIAL and IPP (except the last stage of the latter), the Bank demonstrated a reasonable flexibility in terms of adjusting the directions of its operations, creating new components and attracting a wide circle of experts and advisers, thus ensuring the borrower’s prompt reaction to the frequently changing economic and political situation. At the same time, the Bank practiced frequent replacement of the Project’s heads and even transferred the Project from one department to another, which caused considerable delays and periods of idleness in the course of the Project implementation.

5.6 Except for the initial stage of project implementation, the Bank’s performance was insufficient in terms of cooperation with the central government in discussing the problems to which the projects were addressed, because the Bank was focused mostly on the concrete agencies that supervised the projects. Proceeding from that, sometimes it was impossible for the Bank to advocate its firm stand in terms of the spheres and nature of particular transformations. In the course of project implementation, while conducting standard procurement procedures, the Bank practiced fairly long and unexplainable delays which can only partly be attributed to the limited involvement of its Moscow representative office in the process.

5.7 The positive role played by the Bank’s counselors deserves a special acknowledgement, for they rendered their assistance to the borrower both in terms of compliance with the Bank’s procedures and in matters of project implementation strategies and their components. This experience illuminates the need for a broader dissemination of such methods of the Bank’s interactions with the borrower.

5.8 In contrast to operations in the framework of the two projects in question, under CMDP, the Bank changed its approach toward building its relationship with the borrower. During the whole period of this project’s implementation the Bank showed practically no inclination to compromise with the borrower on approaches to identifying the necessary transformations and their key directions, or on ways to accomplish even those objectives agreed upon. The Bank did not provide the borrower with the necessary technical assistance in the areas of strategic planning and methodological management of the project. It can be argued that, in general, the four years of the project’s implementation showed that the Bank lacked a strict commitment to the objectives of developing the domestic capital market, at least in the form in which they are formulated by the Russian Government, regardless of any changes which occurred in the latter.

5.9 With respect to FIDP, one can speak about the problem of weak control in the pre-crisis stage and inadequate reaction to the reports on the poor financial state of its participants, and
also of a long hesitation\textsuperscript{53} with respect to a proper post-crisis restructuring of the project. In ESP, the Bank has demonstrated a notable flexibility; however, the problems of the further functioning of this project still are not finally resolved.

5.10 The Bank undertook extensive ESW in PSD and FSD during this period and in later years. Most reports had a high quality and were published in the years 1994–1996. They focused first on privatization outcomes and difficulties, and later concentrated on corporate governance issues and the weaknesses of the financial sector. Less work was done on the issues of general barriers to business activity in Russia, which might be the reason for—or the result of—less interest shown in this issue by the Bank and the Russian Government.

\textbf{Assessment of Optional Scenarios (Counterfactual)}

5.11 An answer to such questions as to what would have happened (a) had the Bank done nothing in the particular area or (b) had done it differently very often provides the clearest assessment of the efficiency of a particular intervention. We propose the following answer to the first part of the question: The actions taken by the Russian Government would have been very similar, but the situation would have been much more difficult.

- For instance, mass privatization and some related projects would have been implemented, since the Russian authorities were determined to do so, and they were reluctant to choose other systemic ways (for instance, commercialization and step-by-step privatization). However, without the massive technical support from the Bank, this program would not have been able to achieve such a remarkable success in terms of speed and scope.
- The small-scale privatization process in chosen regions was an example of a visible positive influence of the Bank’s group (IFC). ESP also was a positive example in terms of real influence on the enterprise sector.
- In the area of commercial privatization, the Bank was not able to exert its influence on the Russian side.
- The process of creating the new industry of collective investment would have been more complicated and more costly without the Bank’s help. However, it seems that this industry, with the huge costs incurred and mistakes made in the course of its creation and functioning, would have been created anyway, even prior to the 1998 crisis.
- As far as the banking sphere is concerned, the situation there evidently would have been the same, at least up to the 1998 crisis.
- The only unique contribution by the Bank and other donors was their assistance to legal reform. Without that, Russia would have found itself in an extremely difficult situation, providing that the country hardly would be capable to carry out the size of the necessary work that faced Russia at that time.

5.12 The other part of the question (as to what would have happened if the Bank’s impact had been different) leads to a broad field of consideration and evaluation, providing that the latter may be quite concrete, rather than based on theoretical assumptions. It seems that that might also become a subject for a separate research project. In this paper, it can be argued that much better qualitative results would have been achieved if the Bank could have been and would have been more consistent in implementing the ideas that constituted the base for the

\textsuperscript{53} However, according to Bank sources, the long delay in this process was mainly due to a lack of agreement between the Russian Government and the Central Bank of Russia.
projects designed by the Bank in cooperation with the borrower as far as the output of all the
projects is concerned. (Note that one can hardly find any ideas that were clearly wrong.) It is
clear that the main obstacles were in the area of political economy, which strongly influenced
the relationship between the borrower and the Bank, as well as in the borrower’s behavior, both
in terms of project implementation and its economic policy as a whole.
6. Attribution of the Results of the Bank’s Program

External Factors

6.1 The success of projects can be attributed to the following main factors:

- The existence of government programs in the respective areas.
- The borrower being committed to the objectives set.
- The availability of technical assistance on the part of other donors.
- A broad determination of objectives that allow solutions to newly arising problems.
- The Bank’s flexibility and eagerness to react promptly to the Russian Government’s requests and to restructure the projects.

6.2 Project implementation was affected by the following negative factors:

- Frequent changes in the Russian government’s composition, which led to changes in some political and economic objectives.
- A fairly incomplete commitment by the borrower to the principles of the economic transformations which it had declared.
- Resistance to market processes that took place in a number of state bodies—the Supreme Council of the Russian Federation (RF), the RF Federal Assembly, and the RF Accounting Chamber—and in some regions that blocked the reform process and implementation of projects alike.
- Politically motivated critical evaluation caused by conflicts between different branches of power and between political forces, both in Russia and abroad.
- Frequent reshuffles of state officials who participated in project operations.
- A clash of interests between different government agencies seeking financing from the Loan’s funds.
- The instability of the financial and economic situation in the country, especially the 1998 crisis.
- The absence of a clear Russian government strategy for the efficient consumption of various donors’ grant and loan funds.
- The scandal raised by U.S. AID regarding the legal and financial transparency of the implementation processes of some of its projects in Russia.

Aid Partners

6.3 In the course of the implementation of the Privatization Implementation Assistance Loan (PIAL), the coordination of numerous kinds of assistance provided for the conduct of the Mass Privatization Program (MPP) was exercised from a single center—The Russian Privatization Center (RPC), the entity that was established, in part, for this purpose. The level of coordination was fairly high; however, its main objective was to ensure a rational (in the view of the Russian government) spending of donors’ and creditors’ funds, rather than to ensure mutual supplementing and consistency of various assistance programs and to eliminate possible duplication. By itself, such a mission is a necessary element of the process of coordination of
resource spending, but it should not substitute for the actual purpose, thereby implying the prevalence of purely fiscal tasks over the essence of the project. It seems that such a situation has emerged in RPC, in which the solution of the task of first spending primarily funds from grants, and only then spending borrowed capital (which is quite understandable from the financial viewpoint) has led, as noted above, to a certain loss of momentum in project implementation and to some “dispersion” in terms of the application of resources and forces among numerous tasks that remained unresolved. In fact, when the time came to spend the borrowed resources, the majority of the tasks related to the PIAL’s mission had been already accomplished at the expense of the resources of the grants. That entailed an unavoidable PIAL restructuring, and, moreover, the need to elaborate new areas for its activities.

6.4 Formally, IPP and CMDP did not have any co-sponsorship. However, in practice, after 1994, the international community pursued a broad program of assistance aimed at the establishment of a modern and efficiently functioning capital market in Russia. The assistance was rendered mostly on a bilateral basis (U.S. AID, the Know-How Fund, Tacis, and the Canadian government), and, since 1996, also by international financial institutions. In order to coordinate the Western assistance to the creation of the Russian securities market, the donor organizations and the Federal Securities Commission established a special coordination center—the Secretariat for Resources—an informal ‘umbrella’ for all the technical assistance projects in the area of capital markets, along with a small group of managers, experts in the respective sphere and in the area of finance. At the beginning of organizing the noted informal structure (1996), the Bank was supportive of the concept and the form of coordinating such cooperation, although the concept was dismissed afterwards.

6.5 The co-financing of FIDP was carried out through IBRD (loan # 204, with a total of $100 million committed, of which $42.5 million was disbursed). The grant funds for the implementation of the project were extended by the government of Japan ($13.3 million committed, $8.1 million disbursed), the European Union ($16.7 million committed, $9.2 million disbursed), and the Dutch government ($1.5 million). In general terms, project cooperation among the Bank, EBRD and bilateral and unilateral donors was rather successful, regardless of its non-comprehensive nature. However, the implementation of institutional development programs found itself affected by the EU’s long, bureaucratic grant approval procedures.

6.6 One should also note that, between 1993 and 1997, U.S. AID was helping to carry out a project on strengthening the role of the Central Bank of Russia in terms of inspecting commercial banks. In the framework of the project, over 800 officers of CBR (including its territorial branches) took professional training in the area of good practices of banking surveillance and inspection. A number of trainees then participated in joint inspections of banks under the auspices of FIDP.

6.7 In the course of implementing ESP, the Bank and EBRD succeeded in establishing close cooperation. The Bank exercised control functions with regard to compliance with the procurement procedures, while EBRD coordinated the activity that concerns an ecological inspection of the projects underway. In addition, EBRD provided substantial help in the post-crisis period by contributing to the elaboration of the document package on concession of final loans that were developed on the basis of standard agreements of the Small Business Crediting Program of EBRD.
7. Lessons and Recommendations

7.1 This paper assesses the World Bank’s success in promoting private sector development and financial sector reform in Russia from 1991 to 2000.

7.2 The Bank’s most significant contribution during the period was to prepare Russian elites for reforms that will have to be implemented if the country is to create the conditions for sustainable economic growth. After a decade of Bank involvement, Russia’s leaders have come to understand the essential prerequisites for a market economy.

7.3 The Bank’s program was directed not at a strong, reform-minded government—as in several other transition countries—but to a small group of reformers who tried to move the government in the right direction without the benefit of broad political support.

7.4 The Russian government’s ownership of reforms throughout the decade was low, improving only after the 1998 financial crisis. Nearly all economic processes have been strongly politicized, and little consensus exists among branches and levels of government. Future progress toward the announced goals of reform will require strong political will and commitment at all levels of government.

7.5 In view of the huge scale of needed reform and the scarcity of reformers within the country’s severely divided political leadership, it is clear that the Bank’s attitude toward Russian reforms was overly optimistic during much of the period under study. The Bank repeatedly tried to provide Russia with best practices. When the government proved unwilling to adopt them, the Bank did not give up, but provided second- or third-best solutions. In so doing, the Bank may have been too permissive.

7.6 Not wishing to lose contact with the government and understanding the pressures facing Russian reformers, the Bank often was willing to implement “small step” reforms in the hope that they would take root and grow. Unfortunately, a decade of experience has shown that the soft and partial reform attitude has failed, especially in areas such as banking and corporate governance, where systemic change is required.

7.7 In the future, the Bank must make further lending contingent on the achievement of visible progress toward reform. The fact that Russia now appears to recognize and has begun to define its needs for reform should make the Bank’s task easier.

7.8 However, caution is still in order. The economic, social, and political situation in the country remains very difficult, in spite of the remarkable recovery after 1998. The structure of the Russian economy is distorted by huge, monopolistic organizations that are difficult to regulate. Far-reaching changes in laws and institutions are still needed to create the stable, predictable environment that investors and entrepreneurs need. The necessary legal and institutional improvements will require changes in Russian habits of mind—changes that will not occur overnight. The challenge calls for a long-term commitment to an ambitious program of lending and non-lending services.

7.9 The international financial institutions may not appreciate the gravity of Russia’s predicament, given 10 years of only partially effective reform efforts and a very serious financial crisis. The scope and quantity of economic and sector work, for example, are not
what they were in the mid-1990s. A new report on the state of the country, similar to the one prepared in 1990 by the Bank and three other institutions, would be very useful.

7.10 What could the Bank have done better?

7.11 The experience reviewed in this report reveals a great need for institutional strengthening of the agencies responsible for implementing reforms. Institutional shortcomings and lack of flexibility have led repeatedly to disappointment—the failure of the Capital Market Development Project is but one very visible example.

7.12 The Bank should conceive and implement its projects in such a way that projects complement each other or leverage other developments. Legal reform, for example, could have made faster progress if it had been backed up by collaboration between the Bank and the Russian government on structural reform of the economy.

7.13 Within the framework of individual projects, it is crucial that all project components be completed. The failure to complete the banking surveillance component of the Financial Institutions Development Program—a failure due to the permissiveness not only of the Bank, but also of the Russian government and the Central Bank—had negative effects on the banks participating in the project.

7.14 Projects have been poorly timed and subject to serious delays. The time between drafting, acceptance, and beginning work has sometimes been so long as to make the project irrelevant, leading to project restructuring and further delay. An example is the Privatization Implementation Assistance Project.

7.15 The Bank has reacted weakly or belatedly to visible abuse of some projects, such as the Financial Institutions Development Program, and to government decisions that neutralized reform efforts, such as the “loans for shares” privatization.

7.16 The frequent reshuffling of Bank project staff, combined with frequent changes in the Russian government, has led to constant delays in project implementation, long theoretical debates, and scattering of the consensus required to implement projects successfully.

7.17 The Bank should sharply increase its control over project implementation, but without micromanaging. Setting clear targets for implementation and monitoring progress toward those targets are the keys to successful control. The Bank should work not only with line agencies responsible for project implementation, but also with representatives of the Russian government who are responsible for the general course of reform in the country.

7.18 The following topics, identified by the Bank as necessary for private sector development and financial sector reform in Russia, remain highly relevant today:

- General conditions affecting private sector development, including obstacles to the entry of new enterprises, excessive government intervention, and equal conditions of competition at the federal and provincial levels.
- The legal and judicial framework for bankruptcy.
- Property rights and effective corporate governance.
- Anti-corruption measures.
- Adherence to international standards of disclosure and audits.
• Definition of real property rights and development of real estate markets.
• Banking supervision and governance.
• Reform of the financial sector to minimize systemic risk in the banking sector.
• Judicial reform—a necessary precondition for the resolution of many other problems.
Selected Bibliography


