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Equity Markets in Russia

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## Equity markets in Russia

### 1 Introduction

In the past few years the Russian economy has been moving towards a market-oriented economy. The allocation of one key factor of production, capital, has been transferred to a large extent from authorities to markets. A large part of the Russian banking system is privately owned, and lending to companies should be based on ability to pay back loans, not on any other criteria<sup>1</sup>. Other features of financial markets have emerged as economic transition has progressed. An equity market of sorts developed from the trading of privatization vouchers and shares of new banks. A currency market based on supply and demand could not be established before currency transactions were allowed on a large scale, but once done, the volume of currency dealing grew substantially. Domestic money market took a leap forward when the government started issuing short-term zero-coupon bonds<sup>2</sup>, which are commonly used to obtain benchmark interest rates in developed financial markets. In a few years Russia has developed at least the beginnings of the type of financial system that allocates funds in modern market economies.

However, the development of the financial system is very far from "complete" (if one understands "complete" as the type of financial infrastructure found eg in large OECD countries). The purpose of this paper is to examine the present state and functioning of one part of the Russian financial system, the equity market. Development of the banking sector, while extremely important to the formation and functioning of equity markets, falls outside the scope of this study. First we sketch out a brief history of the Russian equity market. In section 3 we examine the regulatory framework affecting financial markets, especially the equity market; problems in this area could be the main obstacle to more rapid growth of the Russian financial markets. The functions of the financial system are examined in section 4, and we also analyse how well the Russian equity market fulfils these functions. The conclusion sets out some possible future scenarios for the equity market.

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<sup>1</sup> Naturally things are not quite so clearcut in practice: Many banks continue to extend credit to practically insolvent companies thus increasing future credit losses. In some cases large companies have set up banks which have only one function: to arrange relatively cheap loans to the parent company. This kind of behaviour is encouraged by the implicit deposit insurance. For a recent review of banking sector reform in Russia (and other transition economies) see Borish, Long – Noël (1995).

<sup>2</sup> It must of course be acknowledged that these short-term bonds were issued to finance the large fiscal deficit, which in itself constitutes a considerable problem. The Russian government did not explicitly start issuing bonds in order to build a more diversified asset market. The recent experience in eg Finland is actually quite similar: before the 1990s there was no real market in long-term bonds, as there were no government bonds to act as benchmarks. Now the situation has changed, and the long-term bond market is relatively liquid and efficient.

## 2 Development of the Russian equity market

The launching of the Russian equity market can be traced to the start of the voucher privatization programme in December 1992. This programme placed almost 16,000 large and medium-sized companies into private hands<sup>3</sup>. More than 40 million citizens became equity owners through the programme. The voucher privatization programme was officially completed in June 1994, although in practice the programme did not end until August. There had been stock exchanges even before the start of the privatization programme, but trading was practically nonexistent. Lamdany (1993) reports that the aggregate volume of trading in the five largest stock exchanges was RUR81.3 million (USD 1.4m) in October 1991, but it fell to a mere RUR5.1 million (USD 35,000) in June 1992. When privatization began, a large number of stock exchanges and "stock departments" at commodity exchanges were established. According to EIU (1995), approximately 100 stock exchanges have been licensed so far. However, trading in most of them is quite thin.

After the start of the privatization programme trading in privatization vouchers began. For many investors this offered a cheap way to acquire shares in companies to be privatized. In addition to the privatization vouchers, shares in some of the new private companies were also traded. Especially shares of the new banks have traded actively, as financial information about the banks has generally been more readily available than information, for example, concerning industrial enterprises. Also a number of investment funds and companies started to issue their own shares.

In 1994 the equity market rallied as especially foreign investors sought to buy shares in privatized industrial companies. Although financial information was (and is) still scarce, it seemed quite apparent that many Russian companies were greatly undervalued. Companies in the energy sector were easier to value than many other industrial enterprises, as their oil and/or gas reserves were known, and the implied value of their reserves was a mere fraction of corresponding Western companies. This naturally made these companies very promising for investments.

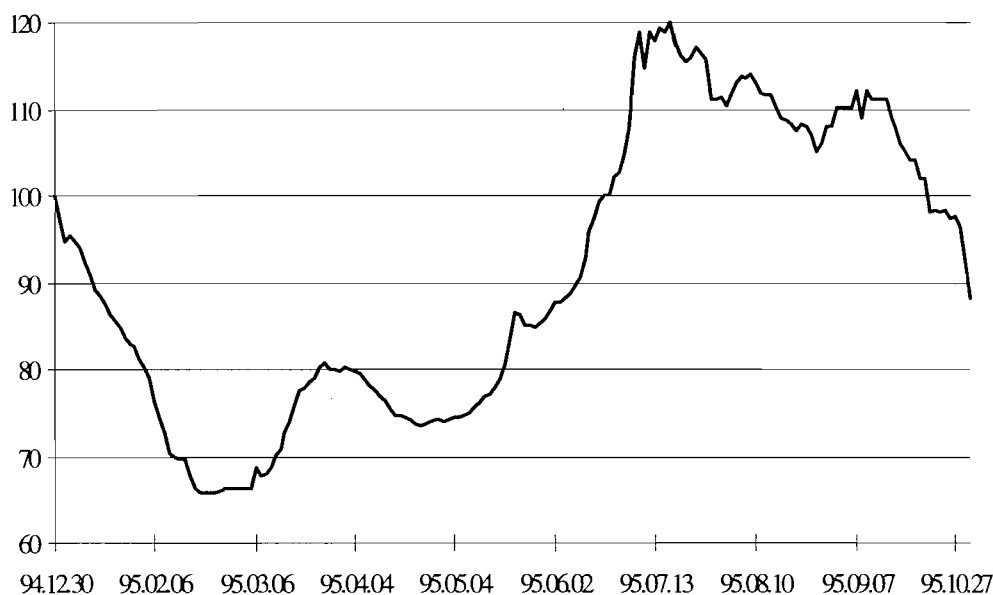
In 1994 approximately USD 2.4 billion of short-term capital flowed into Russia, and a large portion of this ended up in equities. Robinson (1995) says that Western investment funds alone invested USD 1.5 billion in Russian equities. However, the rally was short-lived: Equity prices peaked in September 1994, and by March 1995 prices were down approximately 70 per cent from their peak. The rouble crisis in October 1994 scared off many foreign investors, and war in Chechnya reminded investors of the political risks inherent in a country like Russia. During summer 1995 prices rose somewhat but have again fallen during the autumn. Chart 1 (source Rinaco Plus Equal Weighted Index World Wide Web page, URL: <http://www.fe.msk.ru/infomarket/rinacoplus/indicat/RESI.html>, 14 November, 1995) depicts the Rinaco Plus Equal Weighted Stock Index. This index consists of thirty shares which have at least five market makers. All Russian indices are probably inadequate for depicting true developments in the equity market, but major movements of the market can be readily observed. Price volatility of the prices is high,

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<sup>3</sup> Although the main goals of the privatization, more efficient production in the companies and more effective forms of corporate governance have been hampered by the fact that a large portion of the companies were handed over to the existing management and workers, who may not always have the incentive to adopt eg more effective means of production.

which naturally reflects the volatile political and economic environment but probably also the inefficiency of trading practices.

Chart 1. Rinaco Plus Equal Weighted Index



The actual trading practices on the Russian equity market are still quite different from those on Western markets. From the start of the equity markets, the majority of trading has been conducted on the OTC market. On the OTC market brokers are in contact with each other and with clients. There is no official record of trades, and for a long time no publicly posted firm bids or offers. Brokers can and do post bids and offers on electronic trading systems and their Reuters screens, but these are usually only indicative quotes. The actual trading price and volume must be negotiated separately. Trading may be done in either dollars and roubles, but the larger the deal, the greater the likelihood that it is carried out in dollars. As of late there have been at least attempts to transform the trading system into a more transparent one. In May some brokers started posting firm bids and offers in an electronic trading system in the most liquid equities, but the volume is still a mere fraction of OTC volume. At the present 14 brokers participate in this system. However, all trades must be settled manually, and this adds considerably to the cost of trading. There are several proposals for more automated settlement systems, and if one of these materializes, Russia could get a system similar to Nasdaq, to which all stock exchanges would be linked. At the moment the most promising candidate is the Depository and Clearing Company, which is owned by the Moscow Brokers' Association, six large Russian banks, and Credit Suisse. If this system gains universal approval, it would naturally aid the development of the Russian equity market.

A big obstacle to the development of the Russian equity market has been the current practice of registration and custody of equities. Transfer of ownership must be registered in a company's share register. According to the law these registers

should be independent of the company, but this was rarely the case up until now. Now larger companies have set up their share registers so that at least the letter of the law is fulfilled, and many of these registers are situated in Moscow, not at company headquarters (which could be in Siberia) as was previously often the case. Nonetheless, the registration of shares is still often inconvenient and timeconsuming. If the Russia Registry Company (which is owned by the European Bank for Reconstruction and Development, International Finance Corporation, Bank of New York, and Russian companies NIKoil and Unexim Bank) is successful in its future operations and attracts enough Russian companies as customers, the registration of shares in Russia will be much simplified, and this in turn would mean a more efficient equity market.

Custody is another area in which some progress should be made before the Russian equity market can attract more investors. At the moment investors can hold their securities with a nominee of the broker. For their foreign clients brokers have set up nominees in Cyprus which has a double-taxation treaty with Russia. Some Western banks are also in the process of creating their own custodial services for investors, and this should allow more investors to move into Russian equities as the risks diminish.

### 3 Regulation of Russian equity market

Regulation of the Russian equity market warrants a closer look, as many of the problems stem from the regulation or - more accurately - lack of regulation and implementation of regulations. Recently there have been efforts to correct many of the problems mentioned here, and how successful these efforts are is of great importance to the development of the equity market. Actually, Russian laws and regulations concerning financial markets are already fairly comprehensive, and if they were followed, the financial markets could be expected to operate quite well from this perspective. However, enforcement of regulations is a serious problem. Lack of enforcement and credible sanctions is clearly one of the main obstacles in developing the Russian financial markets.

Most legislation concerning the equity market has been issued in the form of presidential decrees. Parliament has, in the past two years, issued only one law concerning the equity market, the law on the taxation of securities dealing. In principle the presidential decrees must be confirmed by Parliament. However, this rarely happens, and so the decrees have become *de facto* laws. Also, the Ministry of Finance has issued regulatory letters which can be considered as a part of the legislation. For example, on 15 August 1994 the Ministry of Finance set new minimum capital requirements for brokers, investment consultants and investment companies.

There are two fairly recent decrees which have had a large impact on the Russian financial markets. In June 1994 the President issued a decree which regulates the issuance of various securities. All security issues must be registered, and the marketing of securities issues must not be misleading. In addition, companies issuing securities must publish their profit and loss accounts and balance sheet quarterly. These are fairly important rules when one considers the functions of financial system and the equity market in particular. It is important that potential investors be protected against untruthful marketing, and it is even more important that they have access to information concerning the issuing company. This information is naturally important at the time of issuance, but equally important later on: If pricing in the equity market is to function properly, market participants must have reliable information about the companies. This decree provides at least juridical grounds for demanding such information. However, in practice the income statements of most companies are highly unreliable. Many companies still follow the old Soviet accounting formats, although more companies are switching over to Western-type accounting. There is a shortage of trained personnel in both accounting and auditing. The largest private companies, which have already sought out foreign investment capital, have been able to hire international accounting companies to improve the quality and reliability of the information, but for many smaller companies this is not feasible. If the present management owns a substantial part of the company, it might view the other owners as potentially hostile to its own position, and try to withhold as much information from them as possible. This is probably the case in many privatized or to-be-privatized companies. For example, Frydman, Pistor & Rapaczynski (1995), in reporting on their survey of voucher funds, state that only 10.4 per cent of voucher funds have regular access to financial data concerning companies in which they own equity. Of the funds, 12.5 per cent do not have financial information on any of the companies in which they have stakes!

A shortage of relevant company information is naturally extremely harmful to the efficiency of the financial markets, especially the equity market.

The second important decree was issued in November 1994. This decree and its annex established the Federal Commission on Securities and the Stock Market. The decree also contained several provisions concerning the functioning of the market. The Commission is currently the most important single regulatory body in the Russian financial markets. It has been given quite extensive powers for the regulation of the securities markets. It monitors and regulates the issuers of securities and the market participants. The Commission can also take legal action if legislation is violated. However, in practice the Commission has also used other methods in possible breaches of legislation: When Primorsky Shipping issued new shares without the knowledge and approval of major owners, the Commission started negotiations on how the situation could be resolved. The Commission has actually been successful in reversing many of the breaches of law in the security markets, but resolving matters in this way does not seem like a very good way to make people and institutions observe the law. If various breaches of law do not cause sanctions or penalties, then the incentive to observe the law is naturally weakened. However, it is clear that other forces are also at work here, and thus the matter is not so clear-cut. Laws and regulations themselves are often contradictory and opaque. The court system is under severe strain and resolutions on complex issues can take considerable time. In this way, negotiations may provide the only viable alternative for the time being, but it is clear that at some point the legal system should be implemented with more rigour.

The Commission represents a clear step forward in the regulation of the Russian securities markets. It is the first concentrated effort to regulate markets, and at the moment it looks as if the Commission has been granted enough power to do its work. It is perhaps noteworthy that the Commission has been granted de facto ministerial status. This gives it additional influence in the workings of the Russian political system.

As noted earlier, Russia already has in place a body of legislation which, if followed, would be quite sufficient for purposes of establishing and running efficient financial markets. A lack of liquidity and other impediments (for example scarcity of trained personnel) to the development of the equity market cannot be addressed directly by legislation. However, what is missing from the Russian financial markets is the desire to comply with legal regulations. This is the area to which the Russian authorities might consider directing their efforts if the financial markets are to be made more efficient. Establishing the Federal Commission on Securities and the Stock Market probably constitutes a step in right direction.



## 4 Equity market as a part of the financial system

### 4.1 Functions of a financial system

The primary function of a financial system is to facilitate the allocation of scarce resources in an uncertain environment. The allocation is both spatial and intertemporal. The financial system can be viewed to consist of a payment system (which in turn consists of deposit, clearing and payment transfer systems) and various capital markets (this definition of a financial system and its primary function is from Merton 1993).

If one tries to assess the success of a particular financial system in fulfilling its function, looking at the primary function alone is not very informative, as it is very general in scope and necessarily quite abstract. Therefore it is quite useful to disaggregate the primary function somewhat, and try to analyse how a capital market (here, the Russian equity market) fulfils the essential functions. The classification of functions again follows Merton (1993). The primary function of financial markets can be divided into six different functions. These functions can be (and are) handled by different institutional arrangements in different environments, so it is of interest to see how the Russian equity market fulfils the functions equity markets can be expected to fulfil. According to Merton the six functions of financial markets are:

- 1) *Providing a payments system for the exchange of goods and services*
- 2) *Providing a mechanism for the pooling of funds to undertake large-scale indivisible enterprise*
- 3) *Providing a way to transfer economic resources through time and across geographic regions and industries*
- 4) *Providing a way to manage uncertainty and control risk*
- 5) *Providing price information which helps coordinate decentralized decision-making in various sectors of the economy*
- 6) *Providing a way to deal with the asymmetric information problems when one party to a financial transaction has information that the other party has not*

It is apparent that not all capital markets, for example, perform all these functions, and thus we concentrate here on the functions most closely associated with the equity market. However, before we proceed to analyse the functions of equity market, it is worth commenting on the other functions as they affect the way the equity market can fulfil its own functions. Perhaps the most important function of the equity markets is the process of price discovery. This leads to an efficient allocation of resources: If the price discovery process is efficient, economic agents can make a correct assessment of their net wealth and plan for future consumption accordingly. Welfare increases when the volatility of future consumption diminishes. Therefore, it is of great importance to try to assess the efficiency of the price discovery process of equity markets.

It is also worthwhile to look briefly at how the equity market depends on the other functions of a financial system and how it in turn helps to facilitate them. First of all it is quite clear that an equity market has no real way of operating if there is no payments system. If an investor sells securities on the market, she must be able to rely on prompt payment. If this trust breaks down, trading on the markets (not just

the equity market) will almost surely collapse, and then the price discovery function of a capital market will surely not be fulfilled.

If price discovery in the equity market functions efficiently, the second function of the financial system, that of pooling funds, will also be probably be efficient. If economic agents with surplus capital know that they can invest it in securities issued, for example by a private company and that they can sell these securities at any time for their true value, the issuance of such securities (equity, bonds, or any hybrid of the two) is probably easier. This in turn means that economically profitable enterprises can be undertaken.

Efficient capital markets help in the efficient spatial and intertemporal allocation of resources. When the capital markets, and especially the equity market, function smoothly, firm ownership and management can be separated. Then specialization of production is possible, and comparative advantages of different economic agents can determine their production activities.

Also in risk management, capital markets play an important role. One important aspect of risk management in which equity markets have an important role is the process of portfolio diversification. Portfolio diversification reduces the volatility of future wealth and thus increases welfare.

## 4.2 The price discovery function of capital markets

As was argued above, the main function of equity markets (and indeed all capital markets) is price discovery. This function is of great importance to decentralized decision-making in modern market-based economies<sup>4</sup>. Interest rates and prices of various securities are used in the consumption/saving decisions and in deciding the portfolio allocation of the wealth. The prices of different securities also provide important signals to the managers about investment projects. Here the expected yield can act as a benchmark for accepting or refusing a project. The price of equity can also be interpreted as a signal to the owners of the firm of the way the management is running the company. If the manager is responsible for maximizing the wealth of the owners of the company, then an equity market with an efficient price discovery system will reveal how well she is accomplishing this. In this way the price discovery of equity markets can help to achieve greater efficiency in managing companies. If an investor feels that the manager of a company is not performing her duties efficiently, there is always the possibility of removing the management and replacing it with new, more effective management, and if this is not done, a takeover can occur and the management can then be replaced after it. As can be seen from these few examples the price discovery function of the financial system and capital markets is essential both to the efficient consumption/saving decisions and efficient production activities. In the next section we will analyse how these objectives are achieved in the Russian equity market.

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<sup>4</sup> Price discovery is naturally important in all markets, but it probably is most important in financial markets. Since the wealth of economic agents is to a large extent represented by financial claims, the pricing of these claims is very important for all decisions concerning consumption and saving.

### 4.3 The efficiency of Russian equity market

How well does the Russian equity market fulfil the functions described above? At the moment it seems that it is at least approaching some of these goals. The payments system, which can be thought as a prerequisite for an efficient equity market, has developed considerably during the last two or three years. The payments system for large transactions functions reasonably well in large cities, especially in Moscow. According to the IMF (1994) an electronic payments system for cash settlement began in September 1993 in Moscow with eight banks. The number of banks participating in the system has grown considerably (in July 1994 about 60 banks participated), and at the same time efficiency at other cash settlement centres has clearly been improving. However, the payments system overall is still not very efficient, and especially small payments can be delayed for a considerable time. This will probably limit the operations individual citizens can carry out in the equity market. In this way the relative inadequacy of the payment system probably prevents economic agents from engaging in mutually beneficial trades and reduces the efficiency of the equity market. This has adverse consequences for both the price discovery function of capital markets, as price discovery would probably be more efficient if more sellers and buyers were able to participate in the market. Also the allocation function of the financial system suffers, because if one would like to smooth out future consumption by buying securities but finds it practically impossible to do as at reasonable cost and no close substitute for the security exists, then an inadequate payment system clearly reduces welfare. One factor that can reduce the efficiency of the equity market from the point of the view of Russian investors is the fact that many trades are transacted in dollars. If an investor has no access to the currency market, she may have to face an unwanted currency risk when participating in the equity market, which will reduce her welfare.

Does the Russian equity market allow companies to raise capital for their investments? That is, are economic agents able to pool their resources to undertake large-scale enterprises? The answer to this question is not yet altogether clear. The first stage of privatization was carried out by giving away privatization vouchers, and the largest share of these vouchers ended up in the hands of managers and employees of the companies. At this stage companies themselves received no new money. Since the voucher stage some companies have been able to issue equity and thus raise capital, and many new banks have been set up in this way. However, the issuance of new equity has not been commonplace, and the amount of capital thus raised has so far been quite small, but the Institutional Investor (1995) reports that there are plans for equity issues with an aggregate value of tens of billions USD. Even if a mere fraction of these plans are implemented, it would mean a substantial injection of capital to the private sector. Naturally it must be noted that only the largest and best-known companies are able to raise substantial amounts of capital during this initial stage. While this is common also in Western countries, the problem in Russia is exacerbated by a lack of financial information on companies. Large companies have been able to raise their accounting practices to international standards (or have at least begun the process), but many smaller companies apparently do not yet have the resources for this. This will in all probability make it very hard for small and medium-sized companies to raise capital directly from the equity market. Their best chance of acquiring capital in the form of equity investment probably lies in investment funds, which may have the financial know-how needed to assess the

viability of a company's operations. However, building this kind of experience could take years.

As can be seen, efficiency of a capital market requires large amounts of information. In this regard the Russian equity market is hardly efficient. The main obstacle to efficient price discovery in the equity market is the dearth of information on companies. As was mentioned earlier many companies do not have income statements which could convey meaningful information to potential investors. Cash flows are impossible to measure, the quality of receivables and other assets of the balance sheet is uncertain etc. In addition the uncertainty concerning legislation and its implementation persists, and this must discourage all sorts of investment to and in Russia, including investments in equity. One further source of uncertainty is the macroeconomic situation in Russia. Although economic data are readily available, the reliability of this data can be low. But larger and more fundamental uncertainty concerns the future economic policies (naturally this uncertainty is closely intertwined with the political uncertainty). If investors (and all other economic agents as well) cannot predict the future course of economic policies and their consequences with any reasonable accuracy, it is no wonder that financial markets remain small. One could even interpret this situation as a true Knightian uncertainty; economic agents are uncertain which of the possible alternative probability distributions over outcomes will apply. The greater the uncertainty the less willing agents are to engage in a trade.

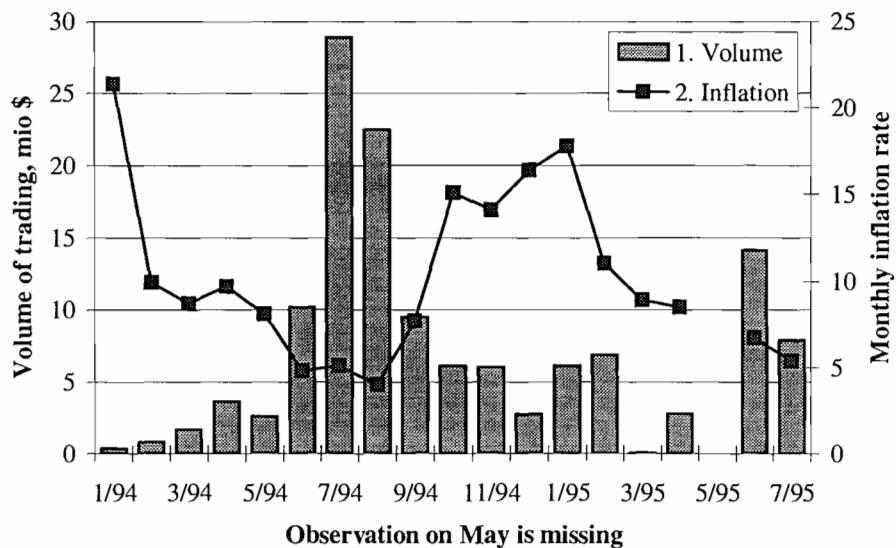
Uncertainty about political developments hinders all the financial markets. If legislation can be abruptly changed, as has actually happened in the past, then the efficiency of financial markets suffers. In addition, this (and high inflation) drives investors with reasonably liquid assets to consider assets in a more stable environment, i.e. abroad. At the moment the uncertainty concerning the future course of economic policies and the political system itself seems to have diminished somewhat. The political system in Russia is by no means stable, but the possibility of a coup or a similar violent upheaval is probably quite small.

One macroeconomic factor creating uncertainty is high inflation. Heymann and Leijonhufvud (1995) discuss the influence of high and volatile inflation on financial markets and financial intermediation in general. In a perfect Arrow-Debreu economy, high and volatile inflation would just add to the number of markets as the possible states of the world increase. However, the experiences of high inflation countries shows that the number of financial markets in fact decreases. The market for long-term debt disappears, banks are unwilling to extend credit for long-term projects and so on. It probably is not a coincidence that eg in Finland and Sweden the longest maturities of government debt do not exceed nine and fourteen years, respectively, whereas in the USA and Germany 30-year bonds exist and are traded actively. The inflation history of Finland and Sweden has been quite volatile, but Germany and USA have reasonably long traditions of low inflation and credible central bank policies towards that goal. Furthermore, the fact that Russia's rouble borrowing at the moment is carried out almost exclusively at 3-month maturity illustrates the case rather well. This uncertainty concerning long-term contracts naturally has implications for the equity market as well, since the maturity of equities is definitely long, theoretically infinite. The volume of trading can grow only when inflation or at least inflation expectations have decreased. This case is tentatively supported by Chart 2, where monthly inflation and the monthly volume of equity trading are plotted (data from various issues of the Bulletin of Banking Statistics, 1994-1995). One can clearly see that the volume of trading has decreased when inflation has accelerated

and vice versa. Also equity prices have reacted negatively to expansionary changes in monetary policy.

Chart 2.

**Trading of Russian Industrial Shares per Month  
(Millions of Dollars) and Monthly Inflation**



## 5 Concluding remarks

As has been pointed out, the Russian equity market is far from efficient in its main functions. At the same time one must bear in mind how long it has taken to build the current financial system in the modern industrial countries. Compared to this time span, the Russian equity market (as well as other financial markets) has developed rapidly. This is impressive in its own right, but the Russian equity market is still not an efficient allocating mechanism for economic resources.

There are some steps which are necessary if the Russian equity market is to truly approach efficiency. First of all, company reporting must be improved substantially. If the type of financial information companies are reporting and the reliability of this information do not improve in the future, one can hardly fathom how a majority of Russian companies can hope to raise equity capital from investors. This also requires the development and implementation of legislation. Accounting standards must be raised in order to increase confidence in the quality of financial information. In this regard it is encouraging that large companies which already have issued or are planning to issue securities have begun this work. This could mean that when new companies try to raise capital their financial information will be measured against these benchmark companies, and this in turn could create incentive for better and more comprehensive financial information even before the company actually needs the additional capital. The need for equity financing is another matter, depending largely on how easy it is to acquire bank credit. Russian banks have been quite lax in their lending practices, and this has meant that in the past companies did not need equity financing. This may be changing somewhat. Inflation in Russia has been brought down in relative terms, and at the same time the continuous depreciation of the rouble has been halted. Real interest rates have risen, and banks are not able to capitalize interest payments as easily as before. These developments have caused a large number of bank failures, but the assets of failed banks have generally been minuscule. (According to *Kommersant-Daily* 7 September 1995, the Central Bank of Russia will deprive approximately 80 banks of their licences. In addition to this, over 100 banks have lost their licences in the aftermath of the liquidity and confidence crisis of last August. In most of these banks the amount of own capital was less than one billion roubles, or USD 220,000.) In this new environment banks can ill afford to subsidize practically insolvent companies, and this could lead to a greater need for equity financing.

The second important step in the development of the equity market is the streamlining of the actual trading, registration, and custody of shares. If the registration of ownership rights is difficult and costly, this will inevitably be reflected in the efficiency of the equity market. The same applies naturally to the custody of shares and to trading itself. Also here some improvements have already been achieved, and if the current projects concerning the registration and custody of shares succeed at least on some scale, the efficiency of the Russian equity market should increase as well.

How will the Russian equity market develop in the future? The efficient functioning of equity markets and capital markets in general is of great importance to the allocation of resources and, through this channel, to economic growth in general. At the moment many things seem to be going in the right direction. Although legislation concerning the financial markets is still probably inadequate and is it most certainly inadequately enforced, companies wishing to raise equity

financing are already implementing Western practices in accounting and auditing. If banks cannot extend credit to companies in the same manner as before, due to positive real interest rates and tighter bank supervision, then more companies could be expected to turn to equity financing as an alternative. This means that the information coming from these companies should improve, and it could also make a difference in the corporate governance of these companies, depending naturally of the resulting ownership structure of the individual firms. If the political situation in Russia remains relatively calm, this could mean an influx of new companies into the equity market. In this way, the equity market and the desire for equity financing could force companies to improve their financial information.

If new and existing companies wish to raise equity capital, are investors willing to supply it? This naturally depends on the expected return and risk of the investment. If Russian companies want to compete for capital with the Russian government, the expected return of an investment must exceed the yield on government securities. In September 1995 the yield on a six-month treasury bill was 130 per cent, and if inflation stays at its present level until maturity, the real annual yield is about 50 per cent. This sets a very high benchmark on equities. In addition, the risks - both political and economic - involved in Russian equity investments are still very high, and this raises the required rate of return even further. As long as interest rates are at their present high level, and the risks associated with equity investments remain high, the supply of capital to the equity market will probably remain fairly low. Thus the policy of low inflation and lower real interest rates (which could be translated into lower budget deficits) is necessary for the development of the equity market.

The aforementioned scenario could be described as the positive one, although it is quite plausible. Any number of developments could prevent this positive scenario from not materializing. Political risks are still great, even if all the major political factions favour market mechanisms at least in principle. Also the general macroeconomic development is by no means stable, although the Russian economy seems to have bottomed out. As noted, these large systematic risks will affect the required rate of return of Russian equities.

The equity market is an integral part of the financial system in modern market economies. At the moment, the likelihood of Russia's return to a command economy seems quite remote, and thus Russia will have an equity market also in the future. The efficient operation of this market is important to the allocation of resources and to the welfare of the whole society. Because of this, further development of the market and changes towards better efficiency are important. The Russian equity market is still in many ways inefficient, and this has negative welfare consequences. However, the functioning of the market can be made more efficient through legislative and organizational reforms. Many reforms are already taking place, and if they are implemented successfully, the efficiency of the Russian equity market should improve. There are large risks associated with the development of the Russian equity market, but at the moment the long-run development of the market appears to be quite positive.

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