

Outcomes Predictable

The previous foreign exchange management act embodied a system of bans and limitations setting tight restrictions on FX operations regarding both size of transactions and technical parameters. The act aimed at minimizing the possibility of emergence of economy-unfriendly factors such as capital outflow that could significantly worsen the balance of payments for the country and the banking system liquidity. The regulatory measures meant to relieve the consequences of the 1998 financial crisis have had a positive influence on the national currency appreciation. However, as the Russian economy started recovering, inefficiency of the state-controlled international relations became increasingly evident.

The new edition of the foreign exchange management act is more liberal: the document sets out what foreign exchange operations are subject to regulation, it considerably broadens lending and borrowing opportunities, extends time for foreign exchange return, and provides a clearer and more straightforward interpretation of many important provisions. In fact, the act promotes the 'what is not prohibited is permitted' principle thus making the first step towards deregulation of foreign trade relations. However, although the list of the direct-action provisions has been extended, the act contains many clauses referring to other legislative documents thus sophisticating the foreign exchange legislation.

Remarkably, the act that is taking effect soon can be seen as an interim document on the way to complete liberalization of foreign exchange regulations and is set to take several years. In particular, the terms for some provisions have been determined. For instance, compulsory sale of 30% of currency swap proceeds will be valid through 2007; afterwards it will be cancelled. The transition period is vital for completion of the already started reforms in the taxation, exchange and monetary policies, while foreign exchange management at this stage is expected to substitute the missing mechanisms of efficient capital redirection. Meanwhile, according to our estimates, exporters of major raw materials presently sell around 50% of their foreign exchange earnings to provide the required RUR payments 'at their own discretion'; and while prices for exported goods are high and tax paying is profitable this trend is likely to last. Hence, the market is not likely to promptly respond to the emerging possibility of the compulsory FX proceed sales being cut, so ruble settlements will be under pressure.

The new act ensures freer foreign trade for major market players revoking the requirement to obtain a permit for effecting transactions. The document lays down a list of operations to be regulated but the stated provision empowers them, if required, to close foreign exchange deals without any limitations. Exchange market players extensively use imperfectness of the legislation to their advantage both in Russia and abroad.

Importantly, under the new act, the Bank of Russia retains its duty of a 'swap transaction inspector' as well as the right to choose forms and methods of foreign exchange regulation under crisis conditions. Besides, the law does not outline the notion of 'a crisis situation' when the Central Bank is entitled to impose restrictive measures. This provision leaves unanswered when exactly the Central Bank can undertake measures and what outcomes this can bring - which worsens Russia's overall investment environment and raises interest rates thus impeding the economic growth.

The restrictive measures set forth in the act are aimed primarily at eliminating negative effect of the international capital flow on the economy. The restrictive measures include special reports whereby the Central Bank and the government can track financial relations and provident fund creating. Notably, the new act tackles situations when depositing is required to bring down interest

towards this or that transaction. They are related to certain transactions with capital rather than trade operations – while all the rest can be made without any restrictions.

The first type of provisioning is applied to operations related to outflow of capital. Here rainy day fund deposits must equal to 100% of the currency swap transaction for a term not exceeding 60 calendar days. When incoming transactions are performed, the provident fund, worth 20% of the value of the FX transaction, is to be created for a period of up to one year. Foreign exchange management of this type was practiced in Chile in the early 1990s. At the time, depositing of the incoming capital had a short-time influence on the cash flow, so that measure was later cancelled. Evidently, such measures raise the value of the goods and reduce attractiveness of the Russian financial market for foreign investors. These provisions have an especially negative impact on players of the exchange market where even an hour-long shortage of cash flow can be crucial for receiving or not receiving incomes. According to many countries' experience, provident funds do not bring expected long-lasting results, so companies engaged in international trade often avoid tying up their FX gains.

The possibility of opening accounts abroad will be the most popular innovation in the foreign exchange legislation. In November 2002, the Bank of Russia permitted Russian citizens to open accounts in 24 FATF member countries. Now this provision is laid down in the act. The cash from overseas accounts can be used for various purposes: realty acquisitions, education, business transactions and medical treatment. Previously, opening accounts overseas was time-consuming and partly illicit; after the act takes effect, this will be absolutely legal for all Russian citizens. Russian banks are deeply concerned with this innovation however. According to our estimates, removal of barriers on the way to international loan issuers will cause the domestic banks to lose 10 to 15% of personal finance and around 15 to 20% of assets; this will strongly impact the entire banking system. Our banks will be losing their VIP clients and mid-class customers – the backbone of the banking system. Thus, Russian banks will be less competitive than foreign. Without taking measures (including those banks-initiated) aimed at raising competitiveness and sustainability of the banking sector, domestic loan issuers will be inevitably affected by the emerging global market of banking services.

Despite the progressive nature of the new act, it should not be seen as a cure-all. Many companies are searching for roundabout ways to avoid being affected by the restrictions, and this ways are not always illegal. At this stage, foreign capital can become an effective means of securing the economic development and foreign exchange management aimed at ensuring economic stability in Russia. At the same time, it should be clearly understood that without raising capitalization of the banking system, introduction of international financial reporting standards for loan issuers, completion of the tax reform and adoption of public debt management, no stable financial system can be built up in the country.