

Dr. Vasily Vysokov

# Southern Russia Versus the Global Crisis



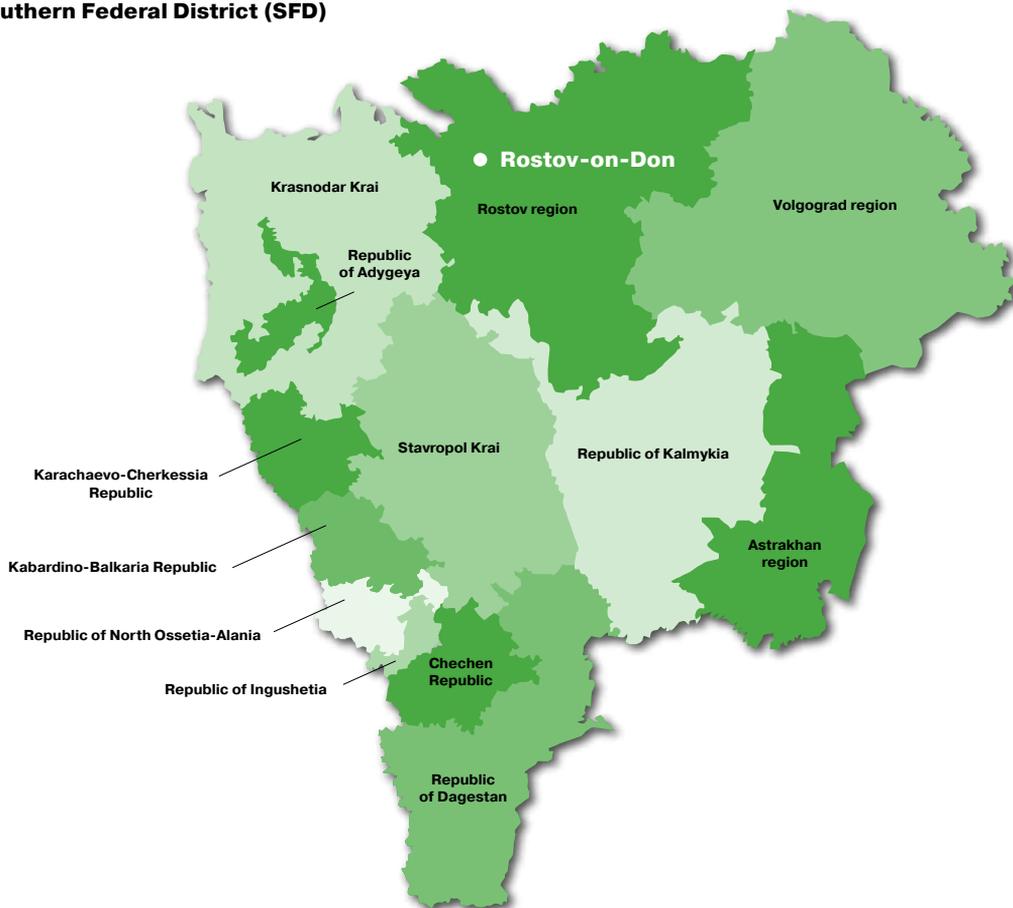
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## The Federal Districts of the Russian Federation (RF)



## Southern Federal District (SFD)



Federal Education Agency  
Institute of the National Economy Rostov State Economics University

**Dr. Vasily Vysokov**

**Southern Russia  
Versus  
the Global Crisis**

*A Theoretical and Practical Handbook*

Rostov-on-Don, 2009

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**Dr. Vasily Vysokov**

*Southern Russia Versus the Global Crisis: A Theoretical and Practical Handbook* — Rostov-on-Don: Institute of the National Economy, Rostov State Economics University, 2009 — 154 pages.  
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This book presents an analysis of the impact of the global financial crisis on the regional economy, taking as its example the Southern Federal District of the Russian Federation.

Drawing on a detailed analysis of statistical data, Dr. Vysokov gives an overview of the development of southern Russia in the pre-crisis years of 2004–2008, highlighting the region's strengths and weaknesses. Statistical indicators for the first half of 2009 show that the region is retaining its advantages during the crisis.

Analysing the development of the current global crisis in terms of economic dynamics theory and the laws of money circulation and their influence on supply and demand, the author explains how companies in southern Russia can use the crisis to increase their competitiveness in the post-crisis economy. He also examines in detail the development and implementation of post-crisis development programmes, using Center-Invest Bank as an example. The presence or absence of post-crisis development programmes is the main determinant of success in overcoming crisis conditions.

In all spheres of the economy, post-crisis development programmes should be based on best international practice, and the public sector is no exception. In his final chapter, Dr. Vysokov bases his proposals for the post-crisis development of the banking system on principles of sustainable development.

This book will be an up-to-date aid for students, teachers, business people and civil servants who wish to study the characteristics of the crisis, monitor statistical indicators by sector and region, and gain an understanding of how to produce a post-crisis development programme and organise a business at regional level during a time of global crisis.

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# Author's Foreword

On different occasions, I have happened to hear opinions which reflect the mind set of the people of Russia:

1. "Even the deepest crisis is not universal." (1998)
2. "The crisis only exists for foolish people." (2008)

There is an important practical corollary to these statements:

***"The crisis will end as soon as you have produced your own post-crisis development programme".***

In Russia, people in official circles began talking about the crisis at the end of September 2008; already by early October, Center-Invest Bank had devised a post-crisis development programme for its customers. When company owners and managers learnt about this programme, they showed new-found confidence: "Yes, difficult times lie ahead, no one will be buying haute couture, but everyone will be buying the jeans made by my factory!" "I shouldn't count on any new boats being built, but they'll be repairing their old ones in my yard!" "Only 40% of meat packing factories will survive, but those that do will be buying my casing to make their sausages!"

Encouraged by this optimism, Center-Invest Bank presented its programme "Southern Russia Versus the Global Crisis" to its western partners in Frankfurt, Cologne and London. They all reacted with a mixture of unmistakeable interest, envy and hope when they heard of the confidence of the business community of southern Russian.

I was invited by Bloomberg to speak live on their television show, which for several months had been broadcasting a “thriller” about the global crisis. After my live interview, the company’s journalists gathered in a small room with questions for me and one request “Please tell us, where exactly is this southern Russia”. To satisfy their interest, and, moreover, the wishes of our customers and partners, we decided to describe in more detail the process of developing and implementing the programme “Southern Russia Versus the Global Crisis”.

Using our experience of implementing this programme we can conceive of a number of scenarios for the development of the global financial world that should replace the “speculative banking business” which led to today’s crisis.

**Dr. Vysokov,**

President and Chairman of the Board of Directors of Center-Invest Bank



# Southern Russia: Development Vector

## 1.1. Introduction

In 2006, Center-Invest Bank's Board of Directors approved the bank's new development strategy for 2006–2011, "South of Russia+".

This strategy was developed on the basis of analysis of the investment appeal of the Southern Federal District (the SFD, southern Russia), using statistical data for 2004–2005\*.

The main findings of the analysis were the following:

1. Southern Russia's ***natural and climatic conditions are conducive to the wellbeing*** of its population and to the development of many different types of activity.

2. Although it only accounts for ***3.5% of the territory of the Russian Federation, 16% of the Russian population*** lives in the Southern Federal District, and one quarter of this number live in rural areas.

3. With a climate that is ***5% warmer*** than Moscow, ***moderate precipitation***, and diverse natural landscapes (ranging from desert and steppes to subtropics and mountain grasslands), southern Russia is ***uniquely suited for the development of agribusiness*** (22% of Russia's agricultural production) and ***recreation and tourism***.

4. Southern Russia does not have an abundance of oil and gas; instead, in contrast with regions where the main industry is natural resource extrac-

tion, it has a ***diversified economic structure*** with a particular emphasis on manufacturing (7% of the Russian total). As such, it is a model for a future, diversified Russian economy.

5. Southern Russia has ***relatively well-developed infrastructure*** (road and rail density is almost four times the Russian average), making it an attractive area in which to establish logistical centres.

6. All of these positive factors had resulted in an investment boom in southern Russia (its share of total investment rose to 10%), turned construction into one of its economic specialisations (8% of the total in Russia), and ***boosted the production of construction materials using local natural resources***.

7. Situated at the intersection of trade routes, inhabited by a free-spirited people (descendants of Cossacks) with a distinctive southern temperament, southern Russia has a ***deep-rooted tradition of free trade and small business***. SMEs in the south are actively investing in their businesses, and southern Russia accounts for 17% of total investments in SMEs in Russia. This clearly demonstrates the region's investment appeal.

8. ***The low level of personal income*** is the key economic problem in southern Russia (60%–70% of the Russian average). The local population partly compensate for this gap by exploiting their household plots of land.

9. Thanks to its growing role, southern Russia is seeing ***increased tourism and trade, and expansion of housing construction*** (with an emphasis on self-builds).

10. ***The banking services market is developing successfully***, but the level of provision is still three times lower than the Russian average and four to five times lower than the level in European countries.

11. By ***introducing international best practice*** throughout its economy, southern Russia will be able to increase the income of the local population, expand output of goods and services, and create modern infrastructure.

Center-Invest Bank's "South of Russia+" strategy, based on sound economic analysis, is proving very successful: in just two years, the bank has seen its capital increase by 2.6 times, its assets 3.6 times, its loan portfolio 4.2 times, its deposits 3 times, its profit 2.3 times, and its branches 2.9 times.

Center-Invest constantly monitors the development of the Southern Federal District, and we regularly inform our Russian and foreign partners about the economic growth trends in southern Russia's different regions and economic sectors\*.

\* [www.centriinvest.ru](http://www.centriinvest.ru)

## 1.2. Development Vector

*In recent years, southern Russia has been calmly and confidently increasing its economic potential.* Given that Russia is one of the four rapidly growing BRIC economies (Brazil, Russia, India and China), it can be said that southern Russia is one of the most successful and promising regions of the global economy.

**Table 1.2.1. Main socioeconomic development indicators.  
The SFD as a % of the RF in 2004–2008**

	2004	2008	+/-
1 Territory	3.46	3.46	–
2 Population	15.91	16.14	0.23
3 Working population	13.07	13.70	0.63
4 Personal income	10.08	11.78	1.70
5 Personal expenditure	10.49	11.85	1.36
6 Nominal wages	9.04	9.37	0.33
7 Gross regional product	7.77	7.70	–0.07
8 Fixed assets	9.30	8.92	–0.38
9 Industrial output	5.06	6.47	1.41
10 Agricultural output	22.71	24.67	1.96
11 Total area of new housing	14.19	15.48	1.29
12 Retail trade	11.05	12.76	1.71
13 Net financial result (profit minus loss)	2.64	5.66	3.02
14 Lending	4.32	5.60	1.28
15 Investment capital	8.74	10.33	1.59

The relatively rapid increases in southern Russia's population and personal income and expenditure are important indicators of its growth potential. Southern Russia is becoming increasingly attractive not only for the people who live in the region, but also for tourists (the rise in expenditure is outpacing the rise in income) and for people investing in housing construction and production. As a result, business has begun to develop in a more responsible and profitable manner. Industrial production is continuing to recover. Even the severe drought in 2007 did not significantly affect the region's position as the country's main agricultural supplier.

### 1.3. Population

Of Russia's seven federal districts the Southern Federal District is the only one in which the population has increased in recent years. It is also the only federal district experiencing natural population growth, and it was the first to do so. It is important to highlight this, as the demographic situation in Russia is a matter of some concern to both the Russian authorities and global experts.

While the overall population of Russia has fallen, the population of southern Russia has risen by 0.23%. The highest increases have been recorded in Dagestan, the Chechen Republic and Krasnodar Krai. The population has fallen in the Volgograd and Rostov regions.

The economically active population has also increased in southern Russia, most notably in Dagestan and Stavropol Krai. However, the level of employment in southern Russia is still lower than the national average; in some republics, it is less than half the average.

**Table 1.3.1 Total population and economically active population in the SFD in 2008 as a % of the RF and compared (+/-) with 2004**

	Territory	Population		Economically active population	
	2008	2008	+/-	2008	+/-
Southern Federal District	3.46	16.14	0.23	13.7	0.63
Republic of Adygeya	0.05	0.31	0.00	0.23	-0.01
Republic of Dagestan	0.29	1.91	0.08	1.33	0.14
Republic of Ingushetia	0.02	0.36	0.02	0.10	0.00
Kabardino-Balkaria Republic	0.07	0.63	0.00	0.46	0.01
Republic of Kalmykia	0.44	0.20	0.00	0.17	-0.01
Karachaevo-Cherkessia Republic	0.08	0.30	0.00	0.24	0.01
Republic of North Ossetia-Alania	0.05	0.49	0.00	0.43	0.02
Chechen Republic	0.09	0.87	0.08	0.33	0.33
Krasnodar Krai	0.44	3.62	0.07	3.29	0.09
Stavropol Krai	0.39	1.91	0.01	1.78	0.14
Astrakhan region	0.29	0.71	0.01	0.67	0.01
Volgograd region	0.66	1.83	-0.02	1.85	-0.04
Rostov region	0.59	2.99	-0.03	2.82	-0.05

Southern Russia is one of the regions that is attractive both to Russians from other areas and also to foreigners, especially those from former Soviet republics. Within the Southern Federal District, migration flows vary: Kuban (Krasnodar Krai), Stavropol Krai, and the Republic of Adygeya are experiencing the highest increase in net migration, while the other republics and the large industrial regions are seeing a decrease. Although industrial regions are still attractive to migrants from former Soviet republics, the existing residents of these centres prefer to move abroad, to non-CIS countries. But the number of people seeking happiness beyond the seven seas has decreased considerably, providing yet further confirmation that *the Southern Federal District is the pearl of Russia! The population growth in southern Russia and southern Russia's increased share of the total population of the Russian Federation is the main indicator of the region's successful social and economic development.*

**Table 1.3.2. Natural population change and migration per 1000 people in 2008**

	Births	Deaths	Natural increase	Number arriving	Number leaving	Increase in migration	Including with the following	
							Non-CIS states	CIS and Baltic states
Russian Federation	12.1	14.7	-2.6	15.6	13.9	1.7	-0.02	1.72
Southern Federal District	13.9	12.2	1.7	14.7	13.8	0.9	0.00	1.35
Republic of Adygeya	12.8	15.0	-2.2	19.5	15.8	3.7	0.14	2.37
Republic of Dagestan	18.2	5.8	12.4	11.4	15.1	-3.7	0.00	0.09
Republic of Ingushetia	18.3	3.1	15.2	10.8	9.0	1.8	0.00	0.18
Kabardino-Balkaria Republic	13.5	9.0	4.5	8.6	11.8	-3.2	-0.04	0.40
Republic of Kalmykia	15.2	10.4	4.8	23.9	34.2	-10.3	-0.06	0.25
Karachaevo-Cherkessia Republic	14.9	11.1	3.8	20.3	24.7	-4.4	0.09	0.40
Republic of North Ossetia-Alania	14.2	11.3	2.9	10.9	14.7	-3.8	-0.01	2.46
Chechen Republic	29.4	4.4	25.0	10.5	11.3	-0.8	0.00	0.06
Krasnodar Krai	12.2	14.3	-2.1	18.0	12.1	5.9	0.04	2.29
Stavropol Krai	12.2	13.4	-1.2	19.1	17.0	2.1	0.05	1.48
Astrakhan region	14.2	13.6	0.6	13.4	13.0	0.4	-0.03	1.56
Volgograd region	11.3	14.5	-3.2	10.7	11.2	-0.5	-0.05	1.30
Rostov region	10.8	15.1	-4.3	14.8	13.5	1.3	-0.04	-0.04

## 1.4. Producers

### 1.4.1. Industry

In recent years, the rate of industrial development in southern Russia has outpaced the national average. This has been especially evident in manufacturing. At the same time, the overall deficiencies in industrial and manufacturing infrastructure in southern Russia are becoming more apparent and must be addressed as a priority. The high growth rates in manufacturing in the Caucasus are due to new production being launched at existing facilities.

**Table 1.4.1. Industrial Production in the SFD as a % of the RF**

	2004	2008	+/-
Southern Federal District	5.06	6.47	1.41
Republic of Adygeya	0.05	0.06	0.01
Republic of Dagestan	0.10	0.11	0.01
Republic of Ingushetia	0.01	0.00	-0.01
Kabardino-Balkaria Republic	0.09	0.08	-0.01
Republic of Kalmykia	0.02	0.01	-0.01
Karachaevo-Cherkessia Republic	0.07	0.07	0.00
Republic of North Ossetia-Alania	0.13	0.09	-0.04
Chechen Republic	0.00	0.04	0.04
Krasnodar Krai	1.21	1.55	0.34
Stavropol Krai	0.60	0.64	0.04
Astrakhan region	0.27	0.35	0.08
Volgograd region	1.12	1.75	0.63
Rostov region	1.40	1.71	0.31

This rapid industrialization can be seen as a result of a “low starting point”: during the reform period, industry in southern Russia experienced a sharp downturn, against the background of which any growth seems huge. At the same time, new, effective company owners are playing an important part in the revival of industry by not simply buying up old industrial enterprises, but also revitalising them. Previously, the arrival of investors

would be accompanied by fears that they would close existing enterprises, which, albeit ineffective, were at least still operating. However, recently, new production facilities have appeared on some old sites, equipment has been upgraded, and new products have been launched to meet market demand. Southern Russia has seen an increase in production of combine harvesters, electric locomotives, helicopters, pipes, ceramic tiles, building materials, denim textiles and shoes.

There has been another important trend: capital has flowed from Moscow to the regions. Priority is always given to those regions that have skilled labour forces and the necessary infrastructure, logistics and land for new industrial sites. On the basis of these considerations alone, southern Russia clearly has strong competitive advantages.

Another important advantage is the structure of industry in southern Russia: mineral extraction does not play a very significant role, the manufacturing sector is highly diversified, and the infrastructure sectors can meet the needs not just of industry but of other economic sectors as well. It is gratifying to note that it was precisely these sectors that were developing more rapidly in the period preceding the localisation of the global crisis in Russia. *Southern Russia provides a model for the future, post-crisis economy of the whole of Russia.*

#### 1.4.2. Agriculture

Following the severe drought in 2007 southern Russia's share of national agricultural output only fell by 0.68%. This is evidence of the stable role played by the south and its key rural regions (Krasnodar Krai, Stavropol Krai, and the Rostov and Volgograd regions) in the country's agricultural production. Even the most terrible natural cataclysms do not affect southern Russia uniformly. Stavropol Krai, the Astrakhan region, and the republics of Dagestan, Karachaevo-Cherkessia and Adygeya compensated for the underperformance of Krasnodar Krai and the Rostov region. Thanks to its diverse natural and climatic conditions, southern Russia maintained its gross grain production at the average annual level for 2000–2004: Stavropol Krai compensated for the Rostov region's weaker performance.

In 2008 southern Russia compensated for the losses of the previous year and increased its share of total grain and meat production.

**Table 1.4.2.1. Agricultural output in the SFD in 2008 as a % of the RF, and changes in the share of the SFD compared to the annual average in 2001-2004**

	Gross agricultural output		Output of the main types of agricultural products					
	2008	+/- against 2004	Grain		Meat		Milk	
			2008	Against average in 2001-2004	2008	Against average in 2001-2004	2008	Against average in 2001-2004
Southern Federal District	<b>24.67</b>	<b>2.88</b>	<b>34.14</b>	<b>4.6</b>	<b>19.41</b>	<b>1.01</b>	<b>16.76</b>	<b>-0.63</b>
Republic of Adygeya	<b>0.40</b>	<b>0.13</b>	<b>0.50</b>	<b>0.14</b>	<b>0.35</b>	<b>0.5</b>	<b>0.32</b>	<b>0.00</b>
Republic of Dagestan	<b>1.57</b>	<b>-0.03</b>	<b>0.20</b>	<b>-0.09</b>	<b>1.66</b>	<b>0.1</b>	<b>1.63</b>	<b>-0.41</b>
Republic of Ingushetia	<b>0.14</b>	<b>-0.01</b>	<b>0.06</b>	<b>-0.01</b>	<b>0.06</b>	<b>0.00</b>	<b>0.22</b>	<b>0.00</b>
Kabardino-Balkaria Republic	<b>0.75</b>	<b>-0.37</b>	<b>0.62</b>	<b>-0.14</b>	<b>0.64</b>	<b>0.04</b>	<b>0.96</b>	<b>-0.06</b>
Republic of Kalmykia	<b>0.38</b>	<b>0.2</b>	<b>0.40</b>	<b>-0.05</b>	<b>0.72</b>	<b>0.42</b>	<b>0.49</b>	<b>0.05</b>
Karachaevo-Cherkessia Republic	<b>0.49</b>	<b>0.09</b>	<b>0.13</b>	<b>-0.02</b>	<b>0.43</b>	<b>0.03</b>	<b>0.67</b>	<b>-0.20</b>
Republic of North Ossetia-Alania	<b>0.57</b>	<b>-0.02</b>	<b>0.48</b>	<b>0.18</b>	<b>0.60</b>	<b>0.1</b>	<b>0.57</b>	<b>-0.02</b>
Chechen Republic	<b>0.31</b>	<b>0.00</b>	<b>0.17</b>	<b>0.03</b>	<b>0.44</b>	<b>0.34</b>	<b>0.80</b>	<b>0.01</b>
Krasnodar Krai	<b>7.39</b>	<b>-0.16</b>	<b>10.77</b>	<b>1.35</b>	<b>5.36</b>	<b>-0.64</b>	<b>4.23</b>	<b>-0.12</b>
Stavropol Krai	<b>3.18</b>	<b>-0.21</b>	<b>7.78</b>	<b>1.21</b>	<b>2.93</b>	<b>0.23</b>	<b>1.88</b>	<b>-0.15</b>
Astrakhan region	<b>0.59</b>	<b>0.21</b>	<b>0.04</b>	<b>-0.02</b>	<b>0.50</b>	<b>0.10</b>	<b>0.43</b>	<b>-0.08</b>
Volgograd region	<b>3.65</b>	<b>0.91</b>	<b>4.80</b>	<b>1.08</b>	<b>2.03</b>	<b>-0.17</b>	<b>1.46</b>	<b>0.14</b>
Rostov region	<b>5.26</b>	<b>1.00</b>	<b>8.19</b>	<b>0.97</b>	<b>3.69</b>	<b>0.27</b>	<b>3.10</b>	<b>0.25</b>

In 2007 there were major changes on the global markets for agricultural products and foodstuffs. The general trend of rising prices for raw materials combined with the increasing demand for foodstuffs in developing countries resulted in an explosion in prices. In this new environment, southern Russia's potential begins to take on global significance, as there are not many regions in the world that can produce foodstuffs on a comparable scale. The problem, however, is one of efficiency. With the same natural and climatic conditions as, for example, Austria, agricultural production in Russia (and specifically in southern Russia) falls considerably behind in terms of efficiency.

**Table 1.4.2.2. Productivity and Equipment in the Agricultural Sector**

	Russia	Rostov region	Austria
Crop yield (quintals/hectare)	Wheat	20.8	52.4
	Sugar beet	199.0	607.0
	Sunflowers	7.8	25.1
Livestock and poultry (kg/head)	31.0	61.0	100.0
Yield per cow, tonnes	2.6	3.5	4.7
Fleet per 1000 hectares	Tractors	16.0	235.0
	Combine harvesters	1.9	9.6
Mineral fertiliser used (* 100 grams per hectare)	13.0	36.0	174.0

If, as a result of industrialization, agriculture in southern Russia reaches the productivity levels of European countries, the sector's output will double and each resident in the south will, in effect, feed another two Russians.

Macroeconomic analysts always used to view the predominance of agriculture in southern Russia's economy as a negative factor: on account of its agricultural sector southern Russia suffered "shortfalls" in gross regional product, personal income, and investment. When prices for agricultural products rose by more than 30% in the second half of 2007 agriculture enjoyed a resurgence in popularity, and global analysts and investors became interested in the sector. Given that agriculture is southern Russia's specialisation, this rise in prices had a greater impact in terms of increasing the role of southern Russia's agricultural sector.

We are starting to see a revival in livestock production in southern Russia as well: in 2008, the region's share of the total cattle population in Russia rose by 2.4% (cows by 3.3%). Undoubtedly, measures implemented as part of national projects have been crucial. While these measures have been applied throughout the whole country, they have had a more substantial impact in southern Russia, especially in the North Caucasus republics.

Unemployment continues to be a very real problem in these republics. The development of livestock production, and, even more importantly, the industrialisation of the sector, will enable these areas to not only increase output but also to address long-standing social problems. The outstanding performance of southern Russia's agricultural sector in 2008 was to be expected, compared to performance in 2007, a year of drought.

But we are pleased to note that even making an adjustment to reflect the climatic conditions *southern Russia is strengthening its position as the main producer of all types of agricultural products, both crops and livestock.*

The implementation of national projects in the livestock sector harnessed the first growth opportunities of southern Russia's farms. Much work remains to be done in the south to establish livestock production that is truly efficient and competitive and that includes all the stages of raising cattle, producing milk, meat, wool and eggs, and processing and selling these products.

Despite the characteristics of the Russian diet (with a large Muslim population), pork production is the most important segment in livestock production in southern Russia, and in Russia in general. The natural fodder supply and the rapid rate of reproduction in the sector are to its advantage.

**Table 1.4.2.3. Share of peasant farms in the production of the main types of products and livestock numbers in 2008**

	Production				Livestock		
	Grain	Meat	Milk	Eggs	Cattle	Cows	Pigs
Russian Federation	21.0	44.7	51.8	24.1	47.5	52.0	38.8
Southern Federal District	23.5	59.9	70.1	46.0	65.9	69.7	50.5
Republic of Adygeya	51.1	21.7	86.8	94.7	79.3	85.6	69.8
Republic of Dagestan	27.4	83.2	83.0	70.3	79.9	81.9	77.0
Republic of Ingushetia	47.5	82.2	85.1	77.5	76.7	81.8	0.00
Kabardino-Balkaria Republic	54.8	64.6	87.7	88.8	81.9	86.5	32.0
Republic of Kalmykia	29.9	77.2	64.2	97.4	46.2	45.5	76.1
Karachaevo-Cherkessia Republic	31.6	73.8	83.3	94.9	78.6	79.9	42.5
Republic of North Ossetia-Alania	34.7	76.9	85.7	82.1	82.6	84.7	68.2
Chechen Republic	25.2	97.5	97.7	62.7	89.2	92.9	100.0
Krasnodar Krai	22.4	48.4	34.5	41.3	27.6	32.1	36.5
Stavropol Krai	17.0	48.4	79.9	56.1	64.3	70.8	47.8
Astrakhan region	50.1	63.3	81.2	15.4	70.6	68.4	62.7
Volgograd region	26.9	65.6	82.2	42.1	76.0	79.8	71.2
Rostov region	23.4	61.9	78.9	33.0	67.0	70.9	60.3

The revival of livestock production is not limited to an increase in livestock numbers and meat production. The development of dairy farming has been one of the most apparent successes of the national agriculture project. This success must be consolidated and expanded through further vertical integration in agribusiness. Given that the increase in milk production is taking place mainly in small, independent farms the next step in integration should be the development of cooperatives amalgamating the production processes of these farms.

The main issue in agrarian reform is the question of who is the owner and who is the main producer. In southern Russia, private “peasant” farms are the dominant producers of animal products. The implementation of national projects has enabled these farms to significantly increase their livestock numbers and their output of animal products. The next step in agrarian reform in southern Russia should be the industrialisation of peasant farms.

### **1.4.3. Construction**

Construction is another industry that is booming in southern Russia and that demonstrates the region’s competitive advantages over other Russian regions. Southern Russia accounts for an increasing proportion of total construction work in Russia. This increase has been driven by population growth, income growth, and the allocation of public money to the development of the territory. Reconstruction work in the Chechen Republic has played an important role here, but other areas of the Southern Federal District are also enjoying a construction boom. To a large extent this is also the result of demand for construction that was deferred during the 1990s reform period. Despite the increased demand, thanks to southern Russia’s developed building materials sector, the cost of construction and installation work is rising more slowly here than in the rest of the country. This gives southern Russia an additional competitive advantage for people who are planning to start up their own businesses.

Housing construction in southern Russia is of particular interest. Given the increase in the birth rate and the number of migrants in the region, it is not surprising that the housing construction boom in the capital has spilled over to the country's southern borders. Although southern Russia's share of

**Table 1.4.3.1. Completed construction work in the SFD as a % of the RF in 2008 and compared to 2004 (+/-)**

	Volume of construction work		New housing		Including self-builds	
	2008	+/-	2008	+/-	2008	+/-
Southern Federal District	<b>10.56</b>	<b>1.58</b>	<b>15.48</b>	<b>1.29</b>	<b>24.26</b>	<b>-0.61</b>
Republic of Adygeya	<b>0.14</b>	<b>0.06</b>	<b>0.13</b>	<b>0.03</b>	<b>0.22</b>	<b>-0.03</b>
Republic of Dagestan	<b>1.01</b>	<b>0.40</b>	<b>1.42</b>	<b>0.01</b>	<b>2.53</b>	<b>-0.36</b>
Republic of Ingushetia	<b>0.08</b>	<b>-0.01</b>	<b>0.10</b>	<b>0.05</b>	<b>0.16</b>	<b>0.09</b>
Kabardino-Balkaria Republic	<b>0.14</b>	<b>-0.08</b>	<b>0.39</b>	<b>-0.15</b>	<b>0.76</b>	<b>-0.35</b>
Republic of Kalmykia	<b>0.06</b>	<b>-0.04</b>	<b>0.09</b>	<b>-0.03</b>	<b>0.18</b>	<b>-0.02</b>
Karachaevo-Cherkessia Republic	<b>0.13</b>	<b>0.04</b>	<b>0.15</b>	<b>0.00</b>	<b>0.30</b>	<b>-0.02</b>
Republic of North Ossetia-Alania	<b>0.25</b>	<b>0.06</b>	<b>0.31</b>	<b>-0.02</b>	<b>0.26</b>	<b>-0.15</b>
Chechen Republic	<b>0.62</b>	<b>0.47</b>	<b>0.09</b>	<b>0.09</b>	<b>0.20</b>	<b>0.00</b>
Krasnodar Krai	<b>4.03</b>	<b>0.61</b>	<b>6.15</b>	<b>1.74</b>	<b>10.27</b>	<b>2.16</b>
Stavropol Krai	<b>0.63</b>	<b>-0.17</b>	<b>1.66</b>	<b>0.08</b>	<b>2.14</b>	<b>-0.72</b>
Astrakhan region	<b>0.62</b>	<b>0.04</b>	<b>0.60</b>	<b>-0.94</b>	<b>1.00</b>	<b>-0.91</b>
Volgograd region	<b>1.10</b>	<b>-0.09</b>	<b>1.28</b>	<b>0.04</b>	<b>1.60</b>	<b>-2.06</b>
Rostov region	<b>1.78</b>	<b>0.37</b>	<b>3.14</b>	<b>0.41</b>	<b>4.64</b>	<b>0.57</b>

housing construction is higher than its share of total construction work, its share of self-builds has started to fall, as large construction companies have moved in to take the place of these projects. However, the population of southern Russia are still much more fond of living in detached houses than is the case in the rest of Russia. Therefore, as well as multi-storey buildings, there will still be demand in the south for villas and dachas, farmhouses and mansions.

The construction boom in southern Russia continued in 2008, underpinned by the construction of a large number of small residential properties and social infrastructure.

Despite the rapid pace of housing construction, the average prices on the new build and resale markets in southern Russia remain the lowest in the country. A significant factor restraining prices is the level of personal income in southern Russia, which, although rising, still lags behind the national average.

#### 1.4.4. Transport and Telecommunications

The accelerated growth of industry and construction has boosted the development of the transport sector in southern Russia. Rail freight volumes have increased considerably in the Rostov region and Krasnodar Krai. Even more rapid growth has been observed in road freight volumes: southern Russia's share of the national total has increased by more than 0.4%. Despite a slight fall in southern Russia's share of total tonnes of freight moved by road (freight tonne kilometres), it is still almost twice its share of tonnes of freight lifted. This demonstrates southern Russia's important role as a road transportation transit region. An increase in the volume of road freight has to be accompanied by development of the road network. Road density in southern Russia is four times greater than the Russian average, but it is still five times lower than in Germany and the U.S. As for rail density in southern Russia, it has almost caught up with the U.S., but it is seven times lower than in Germany.

**Table 1.4.4.1. Development of transport and telecommunications in the SFD in 2008 as a % of the RF**

	Rail transport	Road transport		Telecommunications
	Freight handled	Freight lifted	Freight moved	Revenues from telecommunications services
Southern Federal District	<b>8.2</b>	<b>4.19</b>	<b>8.78</b>	<b>9.1</b>
Republic of Adygeya	<b>0.0</b>	<b>0.51</b>	<b>0.29</b>	<b>0.1</b>
Republic of Dagestan	<b>0.2</b>	<b>0.01</b>	<b>0.00</b>	<b>0.5</b>
Republic of Ingushetia	<b>0.0</b>	—	—	<b>0.1</b>
Kabardino-Balkaria Republic	<b>0.1</b>	<b>0.00</b>	<b>0.01</b>	<b>0.3</b>
Republic of Kalmykia	<b>0.0</b>	<b>0.14</b>	<b>0.12</b>	<b>0.1</b>
Karachaevo-Cherkessia Republic	<b>0.2</b>	—	—	<b>0.1</b>
Republic of North Ossetia-Alania	<b>0.1</b>	<b>0.03</b>	<b>0.07</b>	<b>0.3</b>
Chechen Republic	<b>0.2</b>	—	—	<b>0.3</b>
Krasnodar Krai	<b>2.5</b>	<b>1.27</b>	<b>3.00</b>	<b>2.6</b>
Stavropol Krai	<b>0.8</b>	<b>0.06</b>	<b>0.33</b>	<b>1.2</b>
Astrakhan region	<b>0.6</b>	<b>0.03</b>	<b>0.05</b>	<b>0.4</b>
Volgograd region	<b>1.3</b>	<b>0.71</b>	<b>1.99</b>	<b>1.0</b>
Rostov region	<b>2.1</b>	<b>1.43</b>	<b>2.92</b>	<b>2.1</b>

***Southern Russia is retaining its importance as a transit corridor for both rail and road transport.***

The volume of telecommunications services is also growing at a faster pace. However, the level of provision of telecommunications services in the south is just 60% of the national average.

## **1.5. Consumer Market**

The main change in the consumer market in southern Russia has been a significant increase in per capita income, and a fall of almost 2.5% in the gap between per capita personal income in southern Russia and the rest of the country.

However, in spite of this positive trend, the gap still stands at over 30%. In today's market conditions this cannot be wholly compensated for by favourable natural and climatic conditions and the anticipation of a "bright future" resulting from increased investment in the region.

The revival of the popularity of southern Russia as the country's main holiday destination led to increased numbers of tourists arriving from "richer" regions. The result is that the gap in average per capita consumer spending has fallen by 7.4%, and in sales of consumer goods the differential has fallen by 9.6%. There was no significant differential in the services market, with the exception of Krasnodar Krai and Stavropol Krai, where the volume of services provided to consumers, specifically to visitors to these regions, was actually double the national average. While of course we can be pleased that tourism potential has been restored in individual regions in southern Russia, we must not forget about the actual standard of living in the south.

### **1.5.1. Personal Income and Expenditure, Wages**

It is in part due to the age structure of the population of southern Russia (a predominance of pensioners and children), combined with an active social policy, that the growth in personal income in the south has outpaced the growth in wages.

Southern Russia has the lowest levels of per capita personal income and expenditure. Although the gap relative to the national average is closing, it

**Table 1.5.1.1. Personal income and expenditure in the SFD in 2008 as a % of the RF and compared (+/-) to 2004**

	Income		Nominal wages		Expenditure		Retail trade		Consumer services	
	2008	+/-	2008	+/-	2008	+/-	2008	+/-	2008	+/-
Southern Federal District	11.78	1.70	9.37	0.33	11.85	1.36	12.76	1.71	11.47	1.08
Republic of Adygeya	0.16	0.02	0.13	-0.02	0.14	0.02	0.18	0.03	0.12	-0.01
Republic of Dagestan	1.43	0.58	0.58	0.03	1.20	0.46	1.56	0.52	1.06	0.37
Republic of Ingushetia	0.17	0.07	0.05	-0.01	0.06	0.02	0.04	0.00	0.17	0.10
Kabardino-Balkaria Republic	0.37	0.05	0.25	0.02	0.29	0.00	0.34	0.01	0.26	-0.05
Republic of Kalmykia	0.07	0.00	0.09	0.00	0.05	0.00	0.05	0.00	0.06	0.00
Karachaevo-Cherkessia Republic	0.18	0.02	0.13	0.01	0.13	0.00	0.16	-0.01	0.15	0.03
Republic of North Ossetia-Alania	0.33	0.02	0.23	-0.01	0.25	-0.01	0.27	0.04	0.33	0.01
Chechen Republic	0.00	0.00	0.24	0.00	0.00	0.00	0.15	0.00	0.18	0.00
Krasnodar Krai	2.90	0.02	2.55	0.10	3.28	0.60	3.60	0.61	3.35	0.25
Stavropol Krai	1.30	0.03	1.14	0.04	1.44	0.04	1.46	0.04	1.50	0.08
Astrakhan region	0.52	0.02	0.48	-0.07	0.51	0.01	0.56	0.10	0.44	-0.02
Volgograd region	1.34	0.01	1.33	-0.02	1.31	-0.03	1.34	-0.09	1.74	0.31
Rostov region	2.38	0.03	2.01	-0.02	2.53	0.11	3.04	0.32	2.11	-0.13

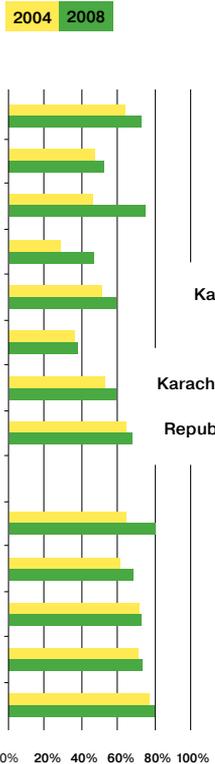
still stands at about 30%. (In the North Caucasus republics the gap is much higher, 65%, though it is closing at a faster pace.) There was almost no change in the gap between the average wage in the SFD and the national average. This is very significant: it means that as the average Russian wage has been increasing, the gap in income levels has been reducing as a result of social security payments, specifically pensions and child benefits. Due to financial constraints, arrears of wages due to local government workers remain high, especially in the North Caucasus republics.

All Russian pensioners face considerable difficulties: pensions are three to four times lower than the average wage. As for southern Russia, pensions are 10% lower than the national average. Of course, the population in the

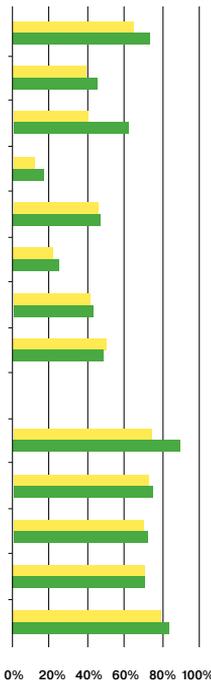
south can depend to some extent on their household land plots, but people deserve to have an easier time in their later years, and this includes being free of financial worries.

The share of total personal expenditure was higher than the share of total personal income in just three SFD regions: Krasnodar Krai, Stavropol Krai and the Rostov region. For the republics in the North Caucasus it is not just low income that is a problem, but also the limited availability of goods and services. In this respect, the Rostov region plays a special role, not only as a cultural and political centre, but also as the main trade centre for all of southern Russia. In the Rostov region, retail sales per capita exceeded the Russian average for the first time, and performance in Krasnodar Krai came close to the national average. Trade in Dagestan developed rapidly.

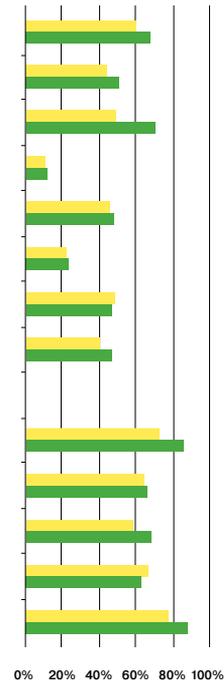
**Per capita personal income in the SFD (RF – 100%)**



**Per capita personal expenditure in the SFD (RF – 100%)**



**Average monthly wage per worker in the SFD (RF – 100%)**



**Table 1.5.1.2. Per capita real personal income, nominal wages, personal income and consumer expenditure in 2008 as a % of 2007**

	Real personal income	Average monthly nominal wage	Personal income	Consumer expenditure
Southern Federal District	110.4	128.4	117.1	123.6
Republic of Adygeya	119.9	125.2	123.4	155.1
Republic of Dagestan	121.8	133.0	143.2	154.3
Republic of Ingushetia	149.8	120.9	110.6	102.2
Kabardino-Balkaria Republic	114.7	131.0	121.6	137.3
Republic of Kalmykia	108.3	129.4	140.1	150.0
Karachaevo-Cherkessia Republic	109.6	123.4	112.7	116.9
Republic of North Ossetia-Alania	113.1	123.1	120.6	123.0
Chechen Republic	—	121.1	—	—
Krasnodar Krai	110.1	129.3	109.9	123.4
Stavropol Krai	107.0	130.2	110.9	106.7
Astrakhan region	110.8	125.3	112.5	120.6
Volgograd region	100.3	127.8	119.9	113.6
Rostov region	108.1	127.9	113.2	121.4

In 2008 southern Russia saw a considerable increase in real and nominal wages, and also in personal income and expenditure. Moreover, in most regions this growth outpaced the national average. This reserve will play an important role in the formation of the post-crisis economy in southern Russia: *the population still remember the relatively low incomes they had in previous years, but they have managed to accumulate a thin layer of “fat” that will allow them to stay calm and survive the crisis.*

The lower levels of personal income relative to the national average had a positive effect on savings accounts in 2008, particularly on accounts held with Sberbank: there were fewer fluctuations in withdrawals in October-November 2008 and in deposits made in December 2008.

Thanks to the rise in the personal income of its population, the revived popularity of its tourism resorts, and the increasing legalisation of its trade sector, southern Russia increased its share of total Russian retail trade. However, wholesale trade in the south is almost half the national average, which itself is not that high in global terms. The service sector in the south also continues to be underdeveloped.

## 1.6. Labour Market

### 1.6.1. Unemployment

Southern Russia accounts for more than one third of total unemployment in the Russian Federation. However, unemployment has started to fall in southern Russia in recent years, and during the current crisis, when people in other regions are losing their jobs, southern Russia's share of total unemployment is actually contracting. *The region adapted to high levels of unemployment earlier than other regions. Together with other factors, this gives us reason to hope that southern Russia will adapt to the post-crisis economy at a faster pace.* The number of jobseekers in southern Russia significantly outstrips employer demand, but the local population are starting to recognise their capacity for self-employment.

**Table 1.6.1.1. Number of unemployed and employer vacancies advertised in state-run job centres in the SFD as a % of the RF\***

	Number of unemployed according to surveys		Number of officially registered unemployed		Employer vacancies	Average time spent looking for work, months	Percentage of unemployed out of work for a year or more
	2008	+/- against 2004	2008	+/- against 2005			
Southern Federal District	24.0	-3.31	36.33	-1.77	11.15	9.3	43.6
Republic of Adygeya	0.3	-0.25	0.43	-0.07	0.24	8.2	38.8
Republic of Dagestan	3.6	-1.34	3.08	-0.32	0.04	10.7	50.4
Republic of Ingushetia	2.1	1.02	2.79	-0.41	0.01	10.1	44.6
Kabardino-Balkaria Republic	1.5	-0.15	1.56	-0.34	0.34	10.3	57.9
Republic of Kalmykia	0.5	0.00	0.35	-0.05	0.04	9.8	50.4
Karachaevo-Cherkessia Republic	0.7	0.18	0.34	-0.16	0.06	12.0	71.5
Republic of North Ossetia-Alania	0.7	0.05	0.72	-0.48	0.11	10.3	47.7
Chechen Republic	3.5	-2.17	19.64	-0.96	0.01	11.7	61.7
Krasnodar Krai	2.6	-0.92	1.49	0.29	4.73	7.1	28.6
Stavropol Krai	2.2	0.19	2.00	0.40	1.02	8.5	39.8
Astrakhan region	0.8	-0.15	0.51	0.01	0.48	7.3	30.6
Volgograd region	2.2	0.07	1.56	0.36	1.72	7.7	33.1
Rostov region	3.1	-0.06	1.87	0.07	2.34	7.1	26.0

\* Data from surveys of the general public and reports by the Federal Service for Labour and Employment, December 2008

## 1.6.2. Education

Southern Russia's higher than average birth rate means that there is a need to develop mainstream (non-specialist) secondary schools. While southern Russia accounts for 14% of all mainstream secondary schools, it has 18% of all the pupils attending these schools. This means that a higher than average burden is placed on each school and class in the south, and that therefore more attention must be paid to the quality of education. A similar situation applies to specialised secondary education, with southern Russia accounting for 10.87% of the number of institutions, but 14.55% of pupils. It is only in higher education that southern Russia has a roughly equal share of the total number of institutions and pupils, approximately 13%.

**Table 1.6.2.1. Numbers of pupils attending school and students in secondary specialised and higher education in the SFD at the start of the 2008/2009 academic year as a % of the RF**

	Population	Number of pupils attending day-time mainstream educational institutions	Number of students	
			in secondary specialist education	in higher education
Southern Federal District	16.14	18.25	14.55	13.22
Republic of Adygeya	0.31	0.32	0.24	0.27
Republic of Dagestan	1.91	2.92	1.16	1.57
Republic of Ingushetia	0.36	0.56	0.11	0.13
Kabardino-Balkaria Republic	0.63	0.72	0.36	0.40
Republic of Kalmykia	0.20	0.25	0.25	0.17
Karachaevo-Cherkessia Republic	0.30	0.36	0.26	0.23
Republic of North Ossetia-Alania	0.49	0.60	0.41	0.47
Chechen Republic	0.87	1.59	0.44	0.42
Krasnodar Krai	3.62	3.70	3.10	2.58
Stavropol Krai	1.91	1.96	1.81	1.87
Astrakhan region	0.71	0.73	1.03	0.57
Volgograd region	1.83	1.70	2.20	1.59
Rostov region	2.99	2.85	3.19	2.94

## 1.7. Foreign Trade

Given that it is situated on the southern borders of a vast country, at the intersection of trade routes, southern Russia's share of foreign trade is less than it should be. Southern Russia accounts for 3.62% of total Russian exports and 4.88% of total imports. However, when it comes to trade with CIS countries, southern Russia accounts for 5.14% of total exports and 10.72% of total imports. Traditional production relationships are the main factor here. To expand its foreign trade, southern Russia must more rapidly develop its trade infrastructure, transport network, railway lines and ports.

The regions most heavily engaged in external trade are Krasnodar Krai and the Rostov and Volgograd regions. The other regions and republics of the SFD still have much work to do in terms of positioning themselves advantageously in a global economy.

**Table 1.7.1. Foreign trade of the SFD in January-September 2008 as a % of the RF (data from the Federal Customs Service) and compared to 2005**

	2008	+/- against 2005
Southern Federal District	3.60	0.00
Republic of Adygeya	0.00	0.00
Republic of Dagestan	0.10	0.00
Republic of Ingushetia	0.00	-0.20
Kabardino-Balkaria Republic	0.00	0.00
Republic of Kalmykia	0.00	-0.10
Karachaevo-Cherkessia Republic	0.00	0.00
Republic of North Ossetia-Alania	0.00	0.00
Chechen Republic	0.00	0.00
Krasnodar Krai	1.00	0.20
Stavropol Krai	0.20	-0.10
Astrakhan region	0.20	0.10
Volgograd region	0.70	-0.10
Rostov region	1.30	0.20

## 1.8. SMEs

Southern Russia offers real opportunities for small and medium-sized enterprises to flourish, and the region's SMEs are acting increasingly in strict compliance with the law.

Southern Russia's share of the total number of registered sole traders in Russia is more than double its share of the total number of businesses in Russia. This is not just because the people of southern Russia, descended from Cossacks and horsemen, value their independence; it also reflects their sense of responsibility for their legal economic activities. Although many of the region's businesses are relatively small scale, they are now operating on a legal basis.

*The SME sector in southern Russia is one of the regional economy's most dynamic growth areas.* Accounting for just one tenth of the total number of SMEs in Russia and also the total number of people employed by these businesses, southern Russia leads in terms of investment in SMEs (21.2%).

**Table 1.8.1. Number of companies in the SFD as at 1 January 2009 as a % of the RF**

	No. of organisations	No. of sole traders
Southern Federal District	9.31	20.69
Republic of Adygeya	0.17	0.49
Republic of Dagestan	0.52	1.55
Republic of Ingushetia	0.13	0.16
Kabardino-Balkaria Republic	0.25	0.65
Republic of Kalmykia	0.28	0.33
Karachaevo-Cherkessia Republic	0.13	0.41
Republic of North Ossetia-Alania	0.24	0.48
Chechen Republic	0.19	0.69
Krasnodar Krai	2.69	6.42
Stavropol Krai	1.16	2.64
Astrakhan region	0.40	0.85
Volgograd region	1.12	1.96
Rostov region	2.06	4.05

**Table 1.8.2. Main indicators characterising the performance of SMEs in the SFD as a % of the RF (excluding micro businesses) in January-September 2008 and compared against the same period of 2005**

	Number of SMEs as at 1 October 2008		Number of jobs filled (workers)		Investment in fixed capital		Total turnover of SMEs	
	2008	+/-	2008	+/-	2008	+/-	2008	+/-
Southern Federal District	14.1	5.8	14.0	3.9	21.19	6.5	11.98	7.11
Republic of Adygeya	0.2	0.0	0.2	0.0	0.45	0.4	0.11	0.06
Republic of Dagestan	0.4	-0.1	0.5	-0.1	0.29	-0.8	0.21	-0.46
Republic of Ingushetia	0.0	-0.1	0.0	0.0	0.00	0.0	0.01	0.00
Kabardino-Balkaria Republic	0.2	0.0	0.1	-0.1	0.35	0.4	0.07	-0.05
Republic of Kalmykia	0.1	0.1	0.1	0.0	0.01	0.0	0.02	-0.02
Karachaevo-Cherkessia Republic	0.1	0.0	0.1	0.1	0.03	0.0	0.06	0.00
Republic of North Ossetia-Alania	0.6	0.4	0.3	0.2	0.13	0.1	0.09	-0.04
Chechen Republic	0.0	0.0	0.0	0.0	0.01	0.0	0.03	-0.12
Krasnodar Krai	2.5	-1.0	3.1	-0.3	9.16	1.3	3.72	2.54
Stavropol Krai	1.8	-0.1	1.7	0.4	0.42	-0.2	1.11	0.37
Astrakhan region	0.5	0.1	0.7	0.1	1.08	0.3	0.33	0.03
Volgograd region	5.2	-3.7	3.9	2.6	1.85	1.0	2.03	1.17
Rostov region	2.6	-0.4	3.2	0.9	7.40	3.2	4.19	2.99

Moreover, it has reinforced this position in recent years, taking 6.5% from other federal districts. It is pleasing to see that this leading position is to a large extent due to the results of regions where Center-Invest Bank has branches, in particular, the Rostov region, Krasnodar Krai and the Volgograd region. By upgrading their equipment and technology, SMEs have managed to almost double their share of the national output of products and services to 8.94%. The positive experience of SMEs in southern Russia will play an increasingly important role in establishing southern Russia's capacity for innovation. The ability to introduce new ideas and to use investments effectively is a good basis for success in this field.

## 1.9. Investment

**Production and investment.** As agriculture accounts for a high percentage of production in southern Russia, and its agricultural produce is not extensively processed, the level of added value in the regional economy is very low. The price disparity in favour of energy products also reduces southern Russia's share of gross regional product in comparison with other regions. In recent years other regions have renewed their fixed assets more intensively, and even the higher growth rate of investment in southern Russia has not compensated for this gap.

The leaders in terms of investment activity were Krasnodar Krai, the Rostov region and Dagestan. Per capita investment reached the national average level in Krasnodar Krai and the Astrakhan region.

**Table 1.9.1. Gross regional product, fixed capital and investment in the SFD in 2008 as a % of the RF and compared (+/-) to 2004**

	Gross regional product		Fixed capital in the economy		Investment capital		Foreign investment	
	2008	+/-	2008	+/-	2008	+/-	2008	+/- against 2005
Southern Federal District	7.70	-0.07	8.92	-0.38	10.33	1.59	3.10	1.30
Republic of Adygeya	0.10	0.02	0.12	-0.04	0.13	0.05	0.00	0.00
Republic of Dagestan	0.59	0.12	0.71	-0.04	0.98	0.49	0.00	0.00
Republic of Ingushetia	0.05	0.01	0.07	0.02	0.06	0.03	0.00	0.00
Kabardino-Balkaria Republic	0.18	-0.05	0.17	-0.07	0.16	-0.03	0.00	0.00
Republic of Kalmykia	0.00	-0.02	0.16	0.04	0.09	-0.01	0.00	0.00
Karachaevo-Cherkessia Republic	0.00	0.00	0.15	-0.03	0.12	0.02	0.00	0.00
Republic of North Ossetia-Alania	0.19	0.01	0.19	-0.08	0.19	0.05	0.00	0.00
Chechen Republic	0.17	0.17	0.31	0.31	0.43	0.26	0.00	0.00
Krasnodar Krai	2.32	-0.06	2.29	-0.13	3.67	0.42	1.10	1.60
Stavropol Krai	0.78	-0.17	1.00	-0.16	0.80	-0.08	0.70	0.60
Astrakhan region	0.37	-0.10	0.61	-0.06	0.74	0.06	0.00	-0.10
Volgograd region	1.18	-0.01	1.46	0.06	0.94	-0.09	0.10	-0.10
Rostov region	1.60	0.02	1.67	-0.20	2.01	0.42	1.20	0.40

**Table 1.9.2. Breakdown of investment in fixed capital by sources of finance in 2008, %**

	Own funds	Third-party funds	Including government funding	of which federal budget	regional budgets	bank loans
Russian Federation	40.0	60.0	21.0	8.1	11.4	11.1
Southern Federal District	33.4	66.6	31.0	21.2	7.9	9.9
Republic of Adygeya	24.6	75.4	39.1	25.6	13.4	11.6
Republic of Dagestan	13.9	86.1	49.0	27.1	21.9	1.1
Republic of Ingushetia	2.9	97.1	79.0	50.4	28.5	0.2
Kabardino-Balkaria Republic	9.1	90.9	49.1	34.5	14.5	3.0
Republic of Kalmykia	20.9	79.1	62.0	55.7	4.5	1.6
Karachaevo-Cherkessia Republic	25.8	74.2	39.9	33.1	4.6	18.0
Republic of North Ossetia-Alania	14.6	85.4	27.1	24.9	1.6	1.8
Chechen Republic	5.2	94.8	93.0	75.5	17.0	0.0
Krasnodar Krai	41.7	58.3	22.8	14.4	6.7	12.3
Stavropol Krai	36.0	64.0	22.9	12.7	9.2	14.1
Astrakhan region	12.6	87.4	26.1	20.0	4.1	3.5
Volgograd region	51.5	48.5	21.5	12.1	6.4	9.4
Rostov region	37.0	63.0	28.0	18.7	6.1	12.9

Most of the investment was associated with housing construction and the completion of construction projects. Krasnodar Krai, the Rostov region and Dagestan were also the leaders in terms of housing construction.

Southern Russia is typically more dependent than other regions on public finance for investment, primarily on funding from the federal budget. However, in those SFD members where federal finance is insufficient, schemes are being set up for the co-financing of investment projects using bank loans and regional budgets.

The considerable efforts made to attract investment for large companies and to make the region more attractive to investors have proved successful: southern Russia's share in total investment increased by 1.6% over two years, reaching 10.33% in 2008. Public finance still accounts for a large proportion of investment in southern Russia. ***The region must also attract private capital, including on the basis of public private partnerships.***

Southern Russia's share of total foreign investment in Russia doubled, to more than 3%.

## 1.10. Finances

*The Southern Federal District improved its financial position in 2008, in terms of both public finance and private sector financial performance.*

Due to an objectively lower starting point, i.e. low personal income and the “late start” of structural reforms in southern Russia, its share of total taxes and duties paid to the government remains small for the time being. However, this share has at least increased, providing further evidence of positive socioeconomic development trends. The structure of the economy and the nature of tax regimes mean that an increasing share of taxes are being received by the regional authorities, thereby stimulating regional economic development. Unfortunately, arrears of tax and duties remain fairly high. Given general trends, such arrears could result in the property of debtor companies being transferred to state ownership; indeed, most of the debt is money due to the federal government.

**Table 1.10.1. Implementation of the consolidated budgets of RF constituent members, payment of taxes, duties and other mandatory payments, and tax and duty arrears in 2008\*, as a % of the RF**

	Income	Expenditure	Payments	Arrears
Southern Federal District	9.87	9.66	5.40	8.50
Republic of Adygeya	0.17	0.16	0.10	0.10
Republic of Dagestan	0.85	0.79	0.20	0.20
Republic of Ingushetia	0.21	0.14	0.00	0.20
Kabardino-Balkaria Republic	0.31	0.31	0.10	0.50
Republic of Kalmykia	0.14	0.14	0.00	1.40
Karachaevo-Cherkessia Republic	0.17	0.16	0.00	0.10
Republic of North Ossetia-Alania	0.33	0.32	0.10	0.40
Chechen Republic	1.04	1.04	0.20	0.40
Krasnodar Krai	2.26	2.31	1.70	2.10
Stavropol Krai	1.01	0.98	0.60	0.80
Astrakhan region	0.56	0.58	0.40	0.30
Volgograd region	1.12	1.13	1.00	0.90
Rostov region	1.70	1.61	1.10	1.30

**Table 1.10.2. Financial performance, accounts payable and receivable of large and medium-sized companies in the SFD in 2008 as a % of the RF**

	Net profit (+) and loss (-)		Profit	Loss	Accounts payable		Accounts receivable	
	2008	+/- against 2004			Total	Including overdue	Total	Including overdue
Southern Federal District	<b>5.64</b>	<b>3.02</b>	<b>5.25</b>	<b>-4.18</b>	<b>5.94</b>	<b>10.15</b>	<b>5.27</b>	<b>8.02</b>
Republic of Adygeya	<b>0.02</b>	<b>0.02</b>	<b>0.02</b>	<b>-0.04</b>	<b>0.05</b>	<b>0.08</b>	<b>0.04</b>	<b>0.04</b>
Republic of Dagestan	<b>-0.03</b>	<b>-0.08</b>	<b>0.06</b>	<b>-0.28</b>	<b>0.15</b>	<b>0.26</b>	<b>0.09</b>	<b>0.20</b>
Republic of Ingushetia	<b>-0.01</b>	<b>-0.01</b>	<b>0.00</b>	<b>-0.04</b>	<b>0.03</b>	<b>0.19</b>	<b>0.02</b>	<b>0.09</b>
Kabardino-Balkaria Republic	<b>-0.01</b>	<b>0.00</b>	<b>0.01</b>	<b>-0.08</b>	<b>0.10</b>	<b>0.31</b>	<b>0.06</b>	<b>0.20</b>
Republic of Kalmykia	<b>-0.05</b>	<b>-0.04</b>	<b>0.01</b>	<b>-0.17</b>	<b>0.04</b>	<b>0.19</b>	<b>0.02</b>	<b>0.09</b>
Karachaevo-Cherkessia Republic	<b>0.00</b>	<b>0.05</b>	<b>0.02</b>	<b>-0.05</b>	<b>0.05</b>	<b>0.16</b>	<b>0.04</b>	<b>0.10</b>
Republic of North Ossetia-Alania	<b>0.00</b>	<b>0.06</b>	<b>0.02</b>	<b>-0.06</b>	<b>0.08</b>	<b>0.35</b>	<b>0.08</b>	<b>0.30</b>
Chechen Republic	<b>0.01</b>	<b>0.03</b>	<b>0.03</b>	<b>-0.11</b>	<b>0.34</b>	<b>3.39</b>	<b>0.27</b>	<b>2.31</b>
Krasnodar Krai	<b>1.77</b>	<b>0.56</b>	<b>1.76</b>	<b>-1.73</b>	<b>1.68</b>	<b>0.90</b>	<b>1.55</b>	<b>1.16</b>
Stavropol Krai	<b>0.60</b>	<b>0.06</b>	<b>0.54</b>	<b>-0.36</b>	<b>0.70</b>	<b>0.93</b>	<b>0.75</b>	<b>0.74</b>
Astrakhan region	<b>0.57</b>	<b>0.40</b>	<b>0.45</b>	<b>-0.13</b>	<b>0.48</b>	<b>0.18</b>	<b>0.22</b>	<b>0.59</b>
Volgograd region	<b>1.99</b>	<b>1.43</b>	<b>1.58</b>	<b>-0.43</b>	<b>0.74</b>	<b>0.58</b>	<b>0.71</b>	<b>0.87</b>
Rostov region	<b>0.78</b>	<b>0.53</b>	<b>0.76</b>	<b>-0.71</b>	<b>1.52</b>	<b>2.61</b>	<b>1.42</b>	<b>1.33</b>

Companies have started taking a more responsible approach, running their businesses profitably and in compliance with the law. Ahead of the crisis, companies knew it was important to build up “rainy day funds” so that they could survive difficult times to come.

A cause for some concern is that the accounts receivable of companies in southern Russia exceed the national average level, and the percentage of accounts receivable and accounts payable overdue is considerably higher among companies in the south. This poses additional threats at a time of crisis, both to lenders and to the companies themselves.

Positive trends in the development of market economy relations in southern Russia include an increase (+3.02%) in the region’s share of the total profits of Russia’s companies and a fall in its share of the losses. Loss-making companies in southern Russia are usually the main employer in a

town and were created back in the Soviet days. The lack of demand for their products means that they are viewed simply as potential sites for launching new production. However, even although they already have infrastructure in place and the ownership rights to the buildings and production sites are properly documented (whereas they were not always in the past) investors are increasingly less interested in these companies, preferring instead to build on new sites using new, modern infrastructure. In this situation, both the owners of loss-making companies and the local authorities are responsible for devising a strategy for the future operation of these companies. Given the relatively high level of accounts payable overdue among companies in southern Russia, lenders should also be actively involved in developing such strategies.

The fall in southern Russia's share of total accounts receivable is evidence that payment discipline has been strengthened and tighter control exerted over the timeliness of payments by customers.

## Part 2.

# Southern Russia Versus the Global Crisis

## 2.1. How Can We Survive the Crisis?

*Of late, people keep asking, “How can we survive the crisis?” Scenario No.1 proposes that we totally relax until better times arrive. Scenario No.2 requires a concerted effort to control liquidity, monitor markets, reconsider plans and projects, and establish new business in new markets. Over time, those who choose the second course of action will find that they too can relax.*

The word “crisis” has negative connotations, although it simply means “a sharp, abrupt reversal in something”. If development occurred independently of the surrounding environment, then we would be able to see economic reproduction in a “pure” form, i.e. growth proportional to the level of development achieved. In reality, as different resources develop at different rates, “pure” reproduction is limited. A positive aspect to the crisis is that it is stimulating the economy to overcome the limitations of some resources and replace them with others so as to restore economic reproduction. Admittedly, this reproduction is beginning to look cyclical, but each slowdown in growth is just a signal that the development model should be changed. Whoever is first to find the new model will enjoy competitive advantages, albeit in new market conditions.

With respect to the current crisis, when the bubble of virtual securities burst, it was not just money supply that fell, but also confidence between market participants. Following the sharp drop in money supply, many goods must find a new equilibrium point. The reason market participants feel uncomfortable in a crisis situation is simply because in the early stage it is hard to identify which goods will see a more rapid drop in production volumes, and which will see a more rapid drop in prices. Whoever is first to guess the movement of prices and goods will also obtain competitive advantages. Drawing a parallel, the first banks to start trusting one another again will also enjoy genuine competitive advantages, not just administrative advantages provided by non-market players.

Many governments have been fighting inflation recently, although inflation is not in itself an evil, but rather a reflection of accumulated economic problems. The crisis will bring comfort to those who are fighting inflation: the prices for goods will start to come down, and inflation will be replaced by deflation. But there will be a downside to this, as wages and salaries will also decrease. The fall in personal income in waves will eventually affect the most profitable market players: the treasury and oil and gas suppliers. The general fall in demand will lead to structural changes: demand will switch from property to consumer durables, and from durables to essential products, and then within this category, demand will be for the cheapest products. Whoever is first to find a means to supply the market with the cheapest goods and services in each group will also receive competitive advantages in the new, post-crisis economy.

Applying all the above to the economy of southern Russia, it is already very clear that, unless we are lazy and stupid, there are no fundamental grounds for the crisis to worsen in the region. With personal income of 30% less than the Russian average, the relatively poor population of southern Russia could not afford to gamble heavily on the stock market and, accordingly, they have not suffered significant losses that would have reduced money supply in the region. However, the losses of large financial players that have branches in towns in southern Russia will lead to a withdrawal of capital back to Moscow. The outflow of speculative capital is giving local business people a new chance.

Changes in global demand are creating favourable conditions for southern Russia to promote its goods and services. At a time of recession, the following sectors are at an advantage in terms of the “price to quality” ratio they can offer: agricultural products, food, machinery, energy resources, transport, residential housing construction, and even tourism and recreation.

The development of southern Russia is a priority in all the long-term scenarios for the development of the Russian economy until 2020, i.e. the “inertia” scenario, the “energy/raw materials” scenario, and the “innovation” scenario. Moreover, the resources for developing the region should be allocated in the near future, with the implementation of plans for the construction of facilities for the winter Olympics, the development of transport infrastructure, and an increased geopolitical role for southern Russia. The regional authorities and the business community of southern Russia must, in a timely fashion, produce projects that are to be publicly funded and bid

in tenders for the implementation of these projects. In fact, this is a task for everyone who wants their business to benefit from the advantages enjoyed by southern Russia at a time of recession on global markets. For example, even when global energy prices are falling, internal prices will approach global levels, i.e. they will increase between three-fold and five-fold. This means that both the general public and businesses in southern Russia will require European energy saving technologies.

For southern Russia, it is not of fundamental importance to try to identify which sectors will thrive following the crisis (an agonising process). The diversified economic structure gives everyone working in the region an opportunity to find their niche in the new market. There are success stories in every sector, and a common formula can be derived from these cases: a successful business person knows his business, knows the markets in which he operates, and uses any advantages he has in terms of production, marketing, human resources and finance. He also has a clear business development strategy.

Of course, any bank would be happy to have this kind of business person as a customer, but in southern Russia, Center-Invest Bank goes one step further and actually helps its customers become this kind of business person. Almost every week, during meetings with its business customers, Center-Invest Bank informs them of the latest changes to legislation and best international practice, and helps them tackle the challenges they are facing. Center-Invest Bank has the same attitude towards its retail customers. The crisis has forced many people to reconsider their plans, and the bank is working together with its customers to help them identify acceptable options in the new conditions.

In October 2008, Center-Invest Bank conducted a survey among its customers and 80% of the respondents said they intended to increase sales of their goods and services despite the crisis. In Russia as a whole, only 30% of people surveyed have expressed the same optimism. Regular meetings with customers who are working in a variety of economic sectors and in different locations have confirmed that their optimism is not feigned, but well-founded: business people in southern Russia really do know their businesses, their markets, their strengths, and the risks, and they do not want to try to survive the crisis by relying on scenario No. 1.

The measures taken by the government to pump money into the state banks to support state companies have not had a significant impact on the

region's economy. We could complain: "They've forgotten about us again", but the southern Russian mentality is such that we are more likely to think, "It's good they didn't remember us, that they're letting us tackle our problems ourselves, as we will find a way out."

Given the contraction in overall money supply and the reduced circulation of money, the priority for both the business community and the authorities of southern Russia is to manage liquidity. And we do not even need to find new ways of doing so. In 1996 Center-Invest Bank published a guide for its customers: NON-PAY-ME-NTS\*.

Most of our business customers are remembering our recommendations, and they are passing them on to the new generation. But in the current situation, as well as controlling liquidity, it is essential to act to restore both the circulation of money and lending to the real economy. Provided that money is not taken out of the region, and that it is not hidden away under mattresses, then even with only a small amount of money it will be possible to maintain economic growth rates despite the global crisis.

In view of this, the most important task is to restore the trust of the population by ensuring that obligations to the population are met: obligations to pay wages and salaries on time, and obligations to depositors. It is only by showing faith in people that we can gain the trust of depositors, ensure that taxes are paid in full, and, ultimately, maintain social stability in the region.

Large companies need time to adjust to new conditions. Center-Invest Bank is in regular dialogue with its customers, and we can see that the new environment requires a new way of thinking. Here is an example: A customer is willing to pay upfront in full (at today's prices) for an order that will not be delivered until November of next year. The supplier, who has only just managed to survive inflationary pressure, is worried that prices of materials will go up again during the course of the year. In fact, the cost of money will increase, and whoever has this money will start dictating the prices to suppliers. In the new conditions, companies must constantly monitor markets and prices, and regularly review their own pricing strategies, customer bases, product ranges and sales channels. To manage liquidity in the new conditions, companies must, on the one hand, monitor customer defaults, and, on the other hand, introduce measures to boost sales.

The crisis forces us to reconsider our plans and programmes time and time again, find new ways of financing projects, pool our efforts to develop

### **Principles of the post-crisis economy**

1. This crisis is not the first, nor will it be the last; it is just the latest one.
2. The crisis is ridding us of illusions and making us act faster to correct mistakes, including those made in business, state regulation and public administration.
3. To survive the crisis, we need to know what direction to take; we need to know what the post-crisis economy will look like. There is no need to continue struggling with an economy that is based on raw material exports, excessive regulation and outdated infrastructure, and in which incumbency confers undue influence.
4. If we put aside legislative and executive agencies, regulators and watchdogs, partners and competitors, then in a pure form we can see the post-crisis economy as a new equilibrium point between new demand and new supply.
5. To build the post-crisis economy, you will need to know your business, your markets and your advantages, and you should have a development strategy.
6. To know their businesses, our children will need to be 20 times more intelligent than us. Unfortunately, their learning is constrained by the limits of the current educational standards. Business should support independent learning and help change these standards.
7. Global trends can be seen in the anti-crisis programmes of a majority of countries: the environment, energy efficiency, new infrastructure.
8. In global markets, southern Russia will retain its advantages in terms of its location, natural environment, climate, diversified economic structure, and its naturally business-minded entrepreneurs.
9. Developed in line with global trends, southern Russia's advantages in production, marketing, human resources and financial engineering will allow a doubling or even a tripling in efficiency in agribusiness, energy saving and the industrialisation of SMEs in all sectors of the economy.
10. In the post-crisis economy, administration costs will come down and businesses will be more accountable and more willing to work in accordance with Russian and international standards. This will be on the basis of international ratings, codes of corporate conduct, and proper internal control and risk management systems.

## Interaction between the measures in the Southern Russia Versus the Global Crisis Programme

	Money and loans	Finances	Social welfare	Marketing	Prices	Plans and programmes	Organizational framework
Money and loans	Formalizing the requirements for 10% of the funds provided as state support to be used for interbank lending	Restoring lending to the real economy	Meeting obligations to depositors	Monitoring partner banks	Floating-rate loans	Reviewing the customer base	Centralised management of the non-committed funds of state-owned companies
Finances	Restoring the circulation of money	Managing liquidity	Timely payment of wages	Measures to accelerate the circulation of goods	Stimulating sales	Accelerated implementation of planned, publicly funded projects	New regulatory requirements for market participants
Social welfare	Restoring depositors' confidence	Restoring tax payments by the population	Meeting all obligations to the population	Monitoring consumer demand	Reducing prices on artificially inflated markets	Anti-crisis social support programmes	Encouraging direct corporate spending on social programmes
Marketing	Reviewing lending limits	Search for new solvent markets	Providing new products and services	Monitoring markets	Revising pricing strategies	Marketing analysis	Establishing new markets
Prices	Expanding interbank lending auctions	Monitoring customer defaults	Changing wage payment systems	Reassessing market segments	Monitoring prices	Analysing price fluctuations	Establishing new pricing methods
Plans and programmes	Reviewing loan products	Timely provision of public finance	Training staff for the changed markets	Reviewing product range	Reassessing the effectiveness of programmes	Reviewing plans and programmes	Private-social partnerships
Organizational framework	Developing the syndicated loan market	New mechanisms for interaction between public and private finance	Additional guarantees for deposits and investments	Reviewing distribution channels	Flexible combination of floating and fixed prices and tariffs	New ways of financing projects	New financial market system

infrastructure, and require the local authorities to try harder to find public money to fund projects. Ultimately, rather than being backward steps, the measures we are taking should help southern Russia secure the place it deserves in the global economy, with new markets, new companies, and new regulation.

President of the Russian Federation, Dmitry Medvedev, has outlined the contours of this new financial world order: effective supervision, proper risk management, information disclosure, accountability of auditors and ratings agencies, and removal of international barriers. Center-Invest Bank's own experience confirms the wisdom of this approach. Thanks to its cooperation with international financial institutions, Center-Invest Bank has introduced codes of corporate conduct and ethics, as well as modern systems for risk management, internal control and strategic planning. Also, for over 12 years it has been successfully audited in accordance with both international and

Russian accounting standards. The ratings agency RusRating has upgraded the bank's rating to "BBB-", and with a Moody's international rating of "B1" the bank has managed to maintain its reputation, attract a \$60 million syndicated loan (October 2008), and be included on the list of 50 Russian banks whose guarantees are accepted by the Bank of Russia.

Thanks to these measures, in October 2008 alone we managed to grant more than five billion rubles in loans to retail and business customers in southern Russia, and to attract about 5,000 new customers. How is southern Russia developing amid the global crisis? How viable is the proposed "Southern Russia Versus the Global Crisis" programme? A chronicle of events answering all these questions follows below.

## 2.2. Southern Russia in 2008: Results

*In January 2009, the Federal State Statistics Service published the first results for the pre-crisis year broken down by region\*. This allows us to once again assess 2008 in southern Russia, but this time in terms of pre-crisis expectations. How did southern Russia fare in the pre-crisis year?*

**Demography:** 16.14% of the Russian population lives in southern Russia. At a time when the overall population of Russia is falling (-2.6%), the Southern Federal District is still the only federal district whose population is increasing (+1.7%).

**Income and expenditure:** In 2008 the increase in personal income and expenditure in southern Russia was considerably higher than the national average: real wages increased by 10.4%, nominal wages by 28.4%, personal income by 17.1%, and consumer expenditure by 23.6%. Despite these results, the population of southern Russia still have to tighten their belts: the average per capita income is almost a quarter less than in the rest of the country (76.01%).

Thanks to the rise in personal income and the greater formalisation and legalisation of trade operations, southern Russia increased its share of total retail trade in Russia (12.8%). However, its share of total wholesale trade in Russia (6.54%) is almost half the national average. The region's service industry also remains underdeveloped (11.47% of the national total).

**Labour market:** Southern Russia accounts for exactly one third of total unemployment in the Russian Federation (33.33%). The region adapted

\* [www.gks.ru](http://www.gks.ru)

to high levels of unemployment earlier than other regions. The number of jobseekers in southern Russia significantly outstrips employer demand (11.15% of all vacancies in Russia), but the people of the region have already recognised their capacity for self-employment and setting up their own businesses.

***Institutional transformation:*** Southern Russia offers real opportunities for small and medium-sized enterprises to flourish, and the region's SMEs are increasingly acting in strict compliance with the law. Southern Russia's share of the total number of registered sole traders in Russia (20.69%) is more than double its share of the total number of businesses in Russia (9.31%).

***Finances:*** The Southern Federal District improved its financial position in 2008, both in terms of public finance (southern Russia accounts for 9.87% of revenue and 9.66% of spending under the consolidated state

**Table 2.2.1. Main socioeconomic indicators for the SFD in 2008 as a % of 2007**

Indices	Russian Federation	Southern Federal District
Industrial output	102.1	103.4
Mineral extraction	100.2	93.6
Manufacturing	103.2	105.0
Production and distribution of electric power, gas and water	101.4	100.5
Construction	112.8	112.3
Housing	104.5	104.4
Retail sales	113.0	116.5
Consumer services	104.9	108.3
Agricultural output	110.8	122.1
Crop production	117.6	135.2
Livestock production	103.4	101.8
Investment in fixed capital	109.8	111.2
Real personal income	105.0	110.4
Real wages	110.3	111.6
Number of unemployed	104.4	87.8
Birth rate	106.7	107.2

budgets) and also in terms of private sector financial performance (5.64% of the net financial result of Russia's large and medium-sized enterprises). Companies have started taking a more responsible approach, running their businesses profitably and in compliance with the law. Ahead of the crisis, companies knew it was important to build up "rainy day funds" so that they could survive the difficult times to come.

**Investment:** The investment boom in southern Russia continued in 2008 (10.33% of total investment in Russia). Krasnodar Krai and the Rostov region proved particularly popular with investors (3.67% and 2.01%, respectively).

Investment in southern Russia is typically more dependent on public finance than is the case in other regions: 31% of investment in southern Russia is state investment, primarily from the federal budget (21.2%). However, in those Federation members where federal finance is insufficient, schemes are being set up for the co-financing of investment projects using bank loans and regional budgets.

**Industry:** There are important advantages to the structure of the industrial sector in southern Russia:

- mineral extraction does not play a very significant role (1.58% of total Russian shipped output, labour and services);
- the manufacturing sector (7.70% of the Russian Federation total) is highly diversified;
- the output of infrastructure sectors (8.75% of total Russian electric power, gas and water production and distribution) is sufficient to meet the needs not only of industry, but also of other sectors of the economy.

It was precisely these sectors that were developing more rapidly in the period preceding the localisation of the global crisis in Russia.

Southern Russia provides a model for the future post-crisis economy of the whole of Russia.

**Construction:** The construction boom in southern Russia continued in 2008 (10.56% of construction work in Russia). This was driven by the construction of a large number of small residential properties (15.35% of new housing in Russia) and social infrastructure (16.58% of new capacity for non-specialist educational institutions, 18.5% for preschool educational institutions, and 14.03% for outpatient clinics).

Southern Russia is particularly popular with servicemen and women, who after their time in the armed forces prefer to buy a property under

the southern sun (16.09% of all flats purchased in Russia). Judging by the area of residential space purchased, they are also buying larger properties (19.59% of the total area of residential space purchased).

**Agriculture:** The tremendous growth in southern Russia's agricultural sector (+22.1%) was predetermined by performance in 2007, a very dry year (+0.2%). But we are pleased to note that even making an adjustment to reflect the climatic conditions, southern Russia is strengthening its position as the main producer of all types of agricultural products, both crops (+34.9%) and livestock (+1.8%).

**Transport:** Southern Russia retains its importance as a transit corridor both for rail transport (8.2% of freight handled), and road transport (4.19% of Russian freight lifted and 8.78% of freight moved).

### **2.3. The Russian Government's Anti-Crisis Measures: Focus for Southern Russia**

The programme of anti-crisis measures for 2009 adopted by the Government of the Russian Federation allows us to assess opportunities to use southern Russia's potential as the crisis continues.

Recently, southern Russia's rate of development has been higher than the national average, and it can be hoped that the economy of southern Russia will be less affected by the general downturn than other regions: the experience of the 1990s has not been forgotten, and at a time of general recession, the south can retain its economic potential.

The economy of southern Russia is more diversified than the economy of Russia as a whole. The south is less dependent on oil and gas exports, and in terms of the price to quality ratio, goods produced in the south are particularly competitive during times of economic crisis.

In the last few years, the government has provided money for investment to compensate for southern Russia's underdeveloped banking system and financial market. The new economic environment will require broader application of the practice of co-financing projects by attracting government and private sector investment.

In the light of the anti-crisis programme published by the government, what measures must be undertaken in southern Russia?\*

This is an especially important question as "the package of anti-crisis measures will not only

mitigate the negative impact of the crisis, but will also stimulate progressive structural and institutional improvements and promote the renewal of the Russian economy and society”. In this respect, southern Russia provides the optimal arena for the implementation of the government’s anti-crisis measures.

***Social obligations and investment in people.*** The government has confirmed that it will meet all the obligations that it assumed before the crisis: indexing state benefits, raising pensions, and increasing control over the quality and prices of medicines. But simply having a healthy lifestyle and producing affordable, good quality, safe medicines is just as important. Southern Russia offers unique opportunities for healthy living and for the Russian pharmaceutical industry to become more competitive at an international level.

In anticipation of redundancies, the government is planning training, retraining and professional development for the workforce. This will partly be within the context of developing enterprise and self-employment. The education infrastructure in southern Russia is excellent at all levels. The region has a long tradition of self-employment, and the SME sector in southern Russia is developing rapidly.

Southern Russia has a particular appeal for ex-servicemen and women. With considerable life experience behind them, these people could help drive reform in many spheres of the economy of southern Russia, including public utilities and municipal services. Center-Invest Bank’s experience of financing projects in these sectors shows that operating expenses can be reduced by at least 30%.

***Retaining and developing industrial potential.*** Southern Russia does not account for a very large share of Russia’s industrial output (6.47%). However, companies that have managed to upgrade their technological capabilities will retain their competitiveness not only in the crisis economy but in the post-crisis economy as well. Agricultural products, southern Russia’s main specialisation (24.25% of total Russian production), must be more extensively processed. Special solutions are required for mechanisms to finance machine building in southern Russia (combine harvesters, tractors, hydroplanes, helicopters, electric locomotives, river boats and cars).

If the performance of the machine building sector as a whole is to improve, the machine-tool industry must be developed. To this end, international cooperation between equipment suppliers and consumers, and

foreign and regional banks will be important. Reduced business taxation, amending budget legislation to permit the use of leasing schemes for state procurement, advance payments under government contracts, and subsidised interest rates will only prove effective if these mechanisms are introduced without delay.

**Reducing administrative barriers.** Thanks to the crisis, many issues on which discussion had previously reached stalemate have now been resolved:

- the notification principle for starting up a business has been extended to 13 types of business;
- limits have been introduced on the frequency of inspections of small companies;
- tariffs for connecting small companies to power grids have been reduced;
- an obligatory state contracts quota for small businesses has been introduced for both state and municipal institutions;
- funding for regional programmes to support small businesses has been increased.

The effectiveness of these measures can be increased by publicly announcing planned investments to develop a region's social and production infrastructure. Making this information accessible and transparent will force local businesses to revise their plans, be more proactive in generating new ideas, and operate as cost-efficiently as possible. The numerous federal agencies working in the regions should not just be issuing inspection reports; they should also be putting forward proposals for the development of enterprise in the regions.

**Making the national financial system more stable.** Ultimately, this crisis will radically change the existing model of global and national finance. The most critical phases of the financial collapse are already behind us, and at this stage it is important that we restore not only individual institutions, but also the financial system itself: money circulation and interbank lending mechanisms. In particular, banks that have received state assistance should make at least 10% of these funds available on the interbank lending market. Lower interest rates on the interbank market will result in lower interest rates and reduced risks when lending to the real sector of the economy in the regions.

**Macroeconomic policy.** The Russian government's anti-crisis measures should provide social stability, stimulate internal demand, and also sup-

port the ruble exchange rate, low inflation and an “acceptable” budget deficit. At the same time, these objectives can be achieved by reducing taxes, cutting public spending, and redistributing resources through the budget. In this scenario, taxes would be used to support effective companies, and the government would stop paying for ineffective managers and owners. Steps in this direction will be taken as the crisis develops. It is reassuring that the government has postponed non-priority public spending, the ruble exchange rate has already changed “smoothly”, and tariffs are to be regulated more carefully. If all these measures have the anticipated effect, southern Russia will be able to fully realise its potential as a food producer; provided that it further develops its transport and logistics infrastructure, the region will be able to satisfy internal demand, providing affordable goods for various social groups, and with minimal pressure on the public purse.

***Regional aspect to the anti-crisis measures.*** Although the federal government is to co-finance anti-crisis measures in the regions, regional authorities must also make the best use of their budgets. It is important that the authorities at different levels are willing to enter into dialogue to agree specific actions to provide employment, support the agricultural, construction and SME sectors, and attract investment. For southern Russia, with respect to developing the region’s social and engineering infrastructure, it is especially important that it is “singing from the same hymn sheet” as both the federal authorities and investors.

Macroeconomic policy reflects the priorities of the politicians themselves. All the leading politicians are now committed to stability as a development priority for southern Russia. The federal government obligations listed in the anti-crisis programme do not leave southern Russia any opportunities to maintain social stability, stimulate internal demand, and retain economic growth rates apart from the “innovative scenario” for the development of each economic sector. Therefore, the regional elite should view the Russian government’s set of anti-crisis measures as the very minimum that is required to support stability in the region and as a starting point for building the post-crisis economy of southern Russia. While in autumn of last year a fall in demand for goods and services of less than 30% was considered a success, in the post-crisis economy the only businesses that will survive will be those that reduce their costs by at least 30%.

## 2.4. Problems in Production. January 2009

All sectors of the economy in southern Russia ended 2008 with strong growth. However, these results masked problems caused by the global crisis. January 2009 was the first month when the real situation could not be concealed behind the successes of preceding periods. As half of January is taken up by the New Year and Christmas holidays and weekends, the growth rate can only be compared against January of the previous year.

This comparison shows that:

- thanks to a low starting point, the revival of production in the North Caucasus republics in January resulted in growth of more than 200%;
- modern food producers in southern Russia that have managed to retool and that are producing competitive goods saw their output increase 100–150%;
- oil, gas and electric power production remained at more or less the same level as in the previous year;
- there was no great change ( $\pm 10\%$ ) in output of the goods in which southern Russia specialises (special equipment for the oil industry, ceramic tiles, electric locomotives, cardboard boxes, mineral fertilisers);
- outdated food producers experienced a sharp drop in output (about 20%);
- production of cement, aggregates and coal fell by 30-40%;
- production of cars, combine harvesters, and agricultural equipment fell by more than 40%.

There is nothing unexpected in this first snapshot of the crisis economy in southern Russia, with the exception of the underlying influence of the post-crisis economy: demand for food products will be stable, but these products will be produced at modern enterprises; the infrastructure will provide for increased production, but demand for raw materials and components will depend on the Russian economic growth rates; machine building will require special finance schemes, as investment in machines (cars, tractors, combine harvesters) has a payback period of several years while the salaries of the workers who build these machines have to be paid straightaway.

First and foremost, it is pleasing to note that the production of food-stuffs, including alcohol and tobacco, grew more in January 2009 than in January 2008. The contraction in the production of oil, gas and electric power was insignificant, and production actually increased in a number of regions. The production of construction materials fell 30-40% overall, but

some individual segments (producing high-quality goods such as ceramic tiles) escaped this marked contraction. It is important to emphasize that companies that have already upgraded their equipment are producing high-quality products and will therefore remain competitive in the post-crisis economy. There was a major downturn in machine building. But this was partly because the consumer does not yet know the market trends, and also because not all the types of goods produced by the industry are competitive in the post-crisis economy. Overall, January's figures confirm that southern Russia remains competitive in those sectors in which it specialises (agriculture, foodstuffs), and in the infrastructure sectors. Also, companies that have already adapted their production to post-crisis conditions will remain competitive. The sectors that are having problems are those in which huge investments are required to achieve the end results (the production of construction materials and equipment). This is a signal to accelerate the modernisation of companies in these sectors.

In the first month of the new year, the contraction in *industry* in southern Russia (-15.5%) was less pronounced than in Russia as a whole (-16.0%). Some sectors even recorded growth: manufacturing in Dagestan, Ingushetia and North Ossetia, and the extraction industry in Stavropol Krai. The most industrialised regions experienced a sharp fall in industrial output: the Volgograd region (-22.5%) and the Rostov region (-23.8%). In almost all of the regions of southern Russia the downturn in manufacturing was due to the fall in prices for manufactured goods (-5.5%). Conversely, prices for the production and distribution of gas, water and electric power rose equally in southern Russia and the rest of the country. However, these government-regulated price increases did not prevent a fall in output by these sectors in physical terms.

In January, *construction* in southern Russia suffered less of a downturn (-7.4%) than the country as a whole (-16.8%). Although housing construction had overtaken other types of construction, southern Russia experienced a slightly bigger fall in demand for housing (-5.39%) than the country as a whole (-4.0%). Krasnodar Krai experienced the most significant contraction in housing construction, as booming demand fell off more abruptly.

It was a positive sign that in January the *agricultural sector* in southern Russia produced more fodder (+32.5%) than in the previous year, and also more than in the rest of Russia (+20.0%). This fodder supply demonstrates that the national projects in agriculture in southern Russia are working.

As well as crop production, livestock production is recovering: available resources mean that more of the livestock and poultry populations are being preserved rather than being sold for meat (−10.4%). The milk yield of the cattle population has increased significantly, especially in the Rostov region (+22.6%), North Ossetia (+17.5%), Kabardino-Balkaria (+8.7%) and Krasnodar Krai (+3.8%). Amid the crisis, poultry factories in southern Russia are using their competitive advantages, and growth rates in egg production are considerably higher than in Russia as a whole (+5.2%).

In January, the *retail trade* in southern Russia grew much faster (+8.9%) than in Russia as a whole (+2.4%): amid the crisis, people in southern Russia have been making purchases of imported goods that they had previously deferred. But the downturn in the wholesale sector in southern Russia was more pronounced. While in the country as a whole, there was only a small dip in wholesale volumes (−1.6%), in southern Russia the sector contracted by almost 17%. Shortcomings in the development of the wholesale sector will lead to a revival of the “shuttle” trade. Reduced personal income will lead to a change in demand: demand will shift to durable goods, and from houses and flats to property maintenance and repair services.

Thanks to the overall strengthening of financial discipline in southern Russia, *wage arrears* were very low in January 2009 (10.8%). Most of this debt was in the Chechen Republic (6.2%) and companies in the Rostov region (2.3%).

Changes in the *consumer price indexes* in southern Russia in January reflected national trends: tariffs for services went up appreciably (+6.6% and +6.3%, respectively), there were small increases in food prices (+1.6% and +1.4%, respectively), and there were slightly lower price increases for non-food items (+0.7% +0.8%, respectively). Given that there has been a fairly serious increase in the cost of the basket of basic foodstuffs (+4.2% in southern Russia and +4.6% across the Russian Federation) then even although in southern Russia this basket costs 5% less than the national average, it can be said that demand has shifted towards cheaper products and that this is precisely the segment in which prices have increased (the Giffen effect). If this trend continues throughout Russia, then southern Russia will continue to benefit: in terms of the price to quality ratio, southern Russia is producing highly competitive goods for the crisis economy. It is important that southern Russia takes advantage of this opportunity to build up its reserves and construct a post-crisis economy.

A particular feature of the structure of industry in southern Russia is that it consists mainly of production (versus services) and energy, gas and water distribution (the prices for which have increased during the crisis), and this resulted in *higher prices for the region's industrial output* (+0.2%). Meanwhile, prices in this sector fell in Russia as a whole (-2.7%). In January 2009, prices for *agricultural products and construction* fell more rapidly in southern Russia than in the country as a whole (-0.5% and -0.6%, respectively). After several years of prize freezes, regulated charges for passenger and freight carriage in southern Russia had to be increased (+29.1%).

## 2.5. Southern Russia Q1 2009: Picks Itself Up Again

With the publication of quarterly figures by the Federal State Statistics Service we are already in a position to consider southern Russia's economic development in the first three months of this year.

**Industry.** January brought a considerable year-on-year fall in industrial production both in Russia as a whole (-16.0%) and in the south (-15.5%). By the end of the first quarter the downturn was still very noticeable nationally (-14.3%), but industry in southern Russia had adapted more quickly to the new conditions (-7.8%). Moreover, the signs of psychological adaptation were seen as early as February: 6.4% growth in industrial production throughout Russia as a whole, and 2.8% growth in industry in the south. In March, the respective growth rates were 11.1% and 11.0%. The highest growth rates were seen in the republics of Dagestan (+8.8%), Ingushetia (+8.9%), Kalmykia (+17.1%), Chechnya (+4.0%), Kabardino-Balkaria (+3.1%) and North Ossetia-Alania (+1.2%). The more industrialised regions of Rostov (-17.1%) and Volgograd (-21.8%), which have a higher percentage of heavy industry, are taking longer to recover from the first shocks of the crisis, but they too have started to adapt to the new environment. It is significant that demand in the electric power industry picked up faster in southern Russia (-2.7%) than in the country as a whole (-5.7%). This was especially the case in those Federation members where a large percentage of the power is generated at hydroelectric plants: Dagestan (+38.1%), and the Volgograd region (+12.6%).

**Agriculture.** Comparative data are only available for Q4 2008, and to a large extent they reflect the impact of the drought in 2007 (growth in 2008

as against 2007 was 21.0%). But it should be pointed out that the alternation between good years and bad years underscores southern Russia's role as the main supplier of agricultural products in Russia (+15.6%).

**Construction.** There was a dramatic contraction in the construction industry in January compared to December both in Russia as a whole (-65.1%) and even more so in southern Russia (-81.9%). However, a comparison of the same periods in different years shows that there is no need to panic: there is traditionally a decline in construction in January. By the end of the quarter, the downturn in the sector was less severe: -19.3% nationwide and -10.3% in southern Russia. Moreover, it is harder for those Federation members that had the strongest pre-crisis results to now demonstrate high growth rates in the current environment. Nevertheless, southern Russia's share of new housing constructed during the crisis remains fairly high: 15-20% of all new housing in Russia.

**Transport.** While in the 2008 pre-crisis period freight transportation by road grew faster in Russia as a whole (+6.4%) than in the south (+2.0%), in Q1 2009 southern Russia suffered less of a decline (-9.5%) than the rest of the country (-21.6%). Freight moved by road actually increased in southern Russia, by 10.9%, while nationally it decreased (-10.3%).

**Trade.** While sales in comparative prices fell 1.1% in the first quarter nationally, southern Russia saw a 5.0% increase. Moreover, sales grew fastest in those Federation members with the lowest levels of personal income: the people of southern Russia were trying to make the purchases that really mattered to them, be that foodstuffs (up 7.1% in the south against a national decline of 0.7%) or non-food items (+5.2% in the south and -1.0% nationally). It is true that by March even the south had started to see a fall in demand (-2.0%), but less so than in Russia as a whole (-5.1%).

**Services.** Sales of consumer services in comparable prices fell by 1.5% nationally, but grew by 2.2% in the south. This was due to the introduction of price increases for regulated tariffs that had been deferred in previous years. The new tariffs allowed providers to offer services that had previously been suspended and to expand provision of existing services.

**Investment in fixed capital.** Data are only available for January-February, but the figures confirm that despite the general decline in investment activity (-10.4%), to a large extent southern Russia is retaining its investment appeal (-4.5%).

**Accounts payable.** Companies in southern Russia reduced their share

of the total accounts payable of Russia's companies from 6.24% in January to 6.0% in February. But the south's share of accounts payable overdue increased from 9.49% to 9.65%. Lacking in state support, some companies in the south have become bad debtors. As a result, despite efforts to reduce accounts receivable, companies in southern Russia have been forced to accept an increase in the sums due from debtors. In this context it is important to note that in January-February the percentage of loss-making companies fell both in Russia as a whole and in the south. However, there were slightly fewer loss-making companies in the south (38.0%), than in Russia as a whole (38.5%).

**Prices.** In Q1 2009 the consumer price indexes rose at almost the same rates in southern Russia as in the rest of the country. The rises in food prices were lower in southern Russia (+4.4% compared to +5.0%), while the opposite was true for non-food items (+4.2% compared to +3.8%). The prices of consumer services also rose faster in the south (+9.7%) than the national average (+8.5%). The increase in the cost of housing services was especially noticeable: +17.0% nationally and +17.8% in southern Russia. Some regions of southern Russia saw particularly high increases: the Rostov region +21.5%, Krasnodar Krai +21.1%, and the Chechen Republic +34.1%. In terms of individual services, the charges for the supply of hot and cold water increased the most.

**House prices.** Amid a general downward trend in house prices, the differential between prices in the south and average prices is falling. The reason for this is that prices in the south were more realistic at the outset, and while prices are falling overall, in the south they are remaining unchanged. Moreover, in the resale market in Krasnodar Krai the price per square metre actually exceeded the Russian average.

**Personal income.** It is paradoxical but true that the gap between nominal personal income in the south and the rest of the country increased from 25.0% in January to 28.6% in February, but real personal income grew faster in southern Russia (+3.4%), than in the rest of the country (-3.3%). In January, nominal wages in southern Russia were 69.78% of the Russian average, but in February they increased to 70.31%.

**Wages arrears.** The bulk of the debt is in the Chechen Republic and reflects the cyclical nature of payments from government budgets. Southern Russia's share of total wage arrears fell from 14.42% at the beginning of the year to 10.08% at the start of the second quarter. To a large extent, this is

thanks to the considerable efforts made by local administrations to prevent arrears from increasing. It is also significant that there has been a fall in the percentage of workers in the south whose wages are overdue: from 12.59% at the start of the year to 11.26% at the start of the second quarter.

**Employment.** Unemployment in southern Russia has always been higher (12.0%) than the national average (9.5%). During the crisis, there has been an increase both in redundancies and in the number of people being hired. It should be noted that the increase in the former is higher than the increase in the latter. However, southern Russia accounts for a higher share of the total number of people hired (11.77%) than the total number of redundancies (9.85%). The figures show that hidden forms of unemployment are not very popular in Russia, such as part-time work (6.80% of the total number of part-time workers in Russia) and partially compensated leave (5.03% of the total in Russia).

## 2.6. Southern Russia in January-May 2009: Life Continues

Ratings agencies are issuing increasingly pessimistic forecasts for Russia. Politicians are looking for signs of recovery. Using new data published by the Federal State Statistics Service for southern Russia in January-May 2009 (Information for Monitoring the Socioeconomic Position of the Constituent Members of the Russian Federation in January-May 2009) we can obtain an objective picture of the processes at work in the south. A comparison of growth/decline rates in May against the same period of 2008 makes the situation look worse, as in May of last year southern Russia experienced accelerated growth. A comparison of the figures for January-May 2008 and January-May 2009 improves the picture, as there is the cumulative effect of the results in the first months of last year when growth was just starting to gather pace. Five months is a sufficiently long time frame for analysing the economic development trends in southern Russia. But it must be borne in mind that the rapidly developing Southern Federal District experienced a sharp slowdown in January, and the subsequent growth represents the restoration of a positive growth trend after negative trends in January.

**Industry.** Since March 2009, industrial output has been falling at a slower pace in southern Russia than in the country as a whole. In January-May

industrial output fell by 15.4% nationally, but by only 14.6% in southern Russia (–20.2% in the Volgograd region and –18.9% in the Rostov region). Looking just at the last month, national industrial output was down 2.1% against April 2009, but southern Russia recorded a 5% growth in the same period (the Astrakhan region +73.1%, the Rostov region +1.0%, the Volgograd region +1.7%, Krasnodar Krai +2.5% and Stavropol Krai +3.1%).

The south experienced a larger year-on-year fall in the extraction industry (14.1%). If we look at specific regions, extraction in the Rostov region was down 35.3%, primarily due to coal mining; oil production was down 13.7% in Krasnodar Krai, and gas production in Stavropol Krai was down 9.2%. In Russia as a whole, the extraction industry recorded a 3.4% year-on-year fall. But compared against the previous month, April, the sector grew by 2.1% nationally and by 4.3% in southern Russia (the Volgograd region +2.0%, the Rostov region +13.0%). Southern Russia may have fallen down, but is clearly picking itself up again.

The situation is more complex in manufacturing. Russia as a whole saw a 23.7% year-on-year fall, and southern Russia a 16.3% fall. Looking again at specific regions, manufacturing contracted by 22.1% in the Rostov region, 24.2% in the Volgograd region and 18.1% in Krasnodar Krai, while both Dagestan and Stavropol Krai recorded growth (+25.3% and +7.7% respectively). In the period January-May there was a 22.4% fall nationally, and a 16.3% fall in southern Russia (–16.5% in the Volgograd region and –18.1% in the Rostov region.) Viewed against the slump in April, May's growth rates in manufacturing were encouraging: +0.7% nationally, +7.9% in southern Russia, +2.5 times in the Astrakhan region, +26.8% in Stavropol Krai, +9.9% in the Volgograd region, +4.5% in Krasnodar Krai and +1.1% in the Rostov region.

In the production and distribution of gas, electric power and water, the contraction in May was less than in the previous year: –9.5% nationally and –9.1% in southern Russia. Adygeya (+19.9%) and the Rostov region (+3.1%) actually recorded growth. If we look at the whole January-May period, the infrastructure sectors performed better: –5.3% nationally and –5.4% in the south. Paradoxically, when compared against April, it was in May that the biggest decline was recorded in this sector: –25.0% nationally and –12.2% in southern Russia. Growth was recorded in Dagestan (+42.0%), Kabardino-Balkaria (+38.0%), and North Ossetia-Alania (+2.2 times). A downturn has started in the infrastructure sectors, due to the general

downturn in industry, though growth is being seen in individual regions, reflecting their aspirations to be economically self-sufficient.

It is significant that electricity production fell by 7.8% in Russia as a whole, but only by 4.9% in southern Russia. At the same time, growth was recorded in Dagestan (+21.2%), Karachaevo-Cherkessia (+16.4%), and the Rostov region (+14.6%). The same trend is seen for the whole January-March period: a downturn nationally (−5.8%) and in the south as a whole (−3.2%), but growth in Adygeya (+8.2%), Dagestan (+3.5%) and the Volgograd region (+3.0%). In May there was a 7.9% fall in national production, but 3.4% growth in southern Russia (including +48.1% in Dagestan, +2.4 times in Kabardino-Balkaria, +3.0 times in Karachaevo-Cherkessia, +2.5 times in North Ossetia-Alania, +27.8% in the Volgograd region and +12.0% in the Rostov region).

**Agriculture.** In Q1 2009 the index of agricultural production rose nationally by 2.1% and in southern Russia by 1.9%.

**Construction** contracted nationally by 11.9% and in the south by 8.8%. If we take the whole January-May period the difference is even greater: a decline of 19.2% nationally and 10% in southern Russia. At the same time, growth was recorded in Adygeya (+34.9%), Dagestan (+16.5%), Ingushetia (+11.3%), Kabardino-Balkaria (+1.2%) and North Ossetia-Alania (+0.7%). Comparing May with April yields even more striking results: growth of 0.6% nationally, 9.0% in southern Russia, 28.5% in Dagestan, 60.1% in Ingushetia, 62.6% in the Chechen Republic, 2.6 times in Kalmykia, 2.6% in Krasnodar Krai and 38.2% in the Rostov region.

In January-May, there was higher than usual activity in the housing construction sector, as construction companies focused on completing projects. In Russia as a whole, growth was 4.1%, and in southern Russia it was 1.7%, but there was almost threefold growth in North Caucasus republics: Adygeya (+194.3%), Dagestan (+30.4%), Ingushetia (+88.8%), Kalmykia (+58.4%), the Chechen Republic (+47.7%), and the Astrakhan region (+40.6%).

**Transport.** The transport sector was affected by the fall in production. In Q1 2009, tonnage of freight lifted by road fell 21.5% nationally and 18.5% in southern Russia. While freight moved by road fell 10.3% in Russia as a whole, the south recorded growth of 10.9%. This differential is further evidence of southern Russia's role as an important transit region for the Caspian Basin ports: freight moved by road increased 7.9 times in Dagestan,

2.6 times in Kalmykia, and 22.2% in the Astrakhan region; the Black Sea ports: a 10.4% increase in Krasnodar Krai; and also for border trade with CIS countries: a 31.1% increase in the Rostov region.

**Retail trade** in May 2009 was down year-on-year by 5.6% in Russia as a whole, but by just 2.9% in southern Russia. Moreover, increased sales were recorded in Adygeya (+6.1%), Dagestan (+16.0%), Kalmykia (+2.1%), North Ossetia-Alania (+13.6%) and the Chechen Republic (+1.9%). Demand is contracting at a slower pace in the south, as the population had not managed to satisfy this demand previously. Only the Rostov region recorded a fall in sales (-14.4%), and this was due to a change in supply routes: goods that had previously been supplied to retail chains in the North Caucasus via the Rostov region were being supplied directly instead. The same trend was even more evident for the whole January-May period: a 2.2% fall in sales nationally, but a 1.8% increase in southern Russia. Moreover, growth was recorded in every area of southern Russia with the exception of the Rostov region (-5.9%), the Astrakhan region (-2.8%), and Stavropol Krai (-0.3%). Unfortunately, the potential for growth as a result of previously unsatisfied demand is gradually diminishing: in May, sales were up 1.0% nationally, but the south recorded a 0.7% month-on-month fall.

Compared to May of last year, sales of foodstuffs, including drinks and tobacco products, fell by 2.7% nationally and 2.3% in the south. In the period January-May, food sales fell nationally (-0.9%), but increased in the south (+1.6%). The highest rises were recorded in the following areas: the republics of Adygeya (+24.9%), Dagestan (+20.8%), Kabardino-Balkaria (+4.8%), Kalmykia (+7.4%), Karachaevo-Cherkessia (+3.5%), North Ossetia-Alania (+14.2%), the Chechen Republic (+25.4%), Stavropol Krai (+3.5%) and the Astrakhan region (+8.9%). In May 2009, there was a 1.7% month-on-month growth in food sales across Russia as a whole (due to a change in the structure of demand in favour of foodstuffs), but sales fell in the south (-2.0%). The reason for this was that consumers are replacing shop-bought goods with food grown on their own land plots.

Sales of non-food items fell at a slower pace (-3.4%) in the south compared with the national average (-8.4%). Moreover, sales increased in Adygeya (+8.6%), Dagestan (+14.2%) and Karachaevo-Cherkessia (+0.5%). The same trend was seen for the whole period January-May: sales of non-food items fell by 3.7% nationally, while southern Russia recorded

a 1.9% increase in sales. Even in May, when sales picked up in Russia after the downturn in April (+0.4%), the increase in sales was higher in the south (+0.5%), although it does seem that demand for non-food items is gradually reaching saturation point in the south also.

**Services.** Sales of consumer services in comparable prices fell in the country as a whole (−7.5%), but increased in the south (+0.8%), primarily thanks to the republics of Dagestan (+27.9%) and Ingushetia (+24.4%), and the Chechen Republic (+25.5%). The higher growth in consumer services in southern Russia compensates for the underdevelopment and lack of transparency in this sector in previous years. This growth was seen in the whole January-May period in all regions of southern Russia (+3.2%), in contrast with the rest of the country (−2.9%).

In the first quarter, **investment in fixed capital** fell in Russia as a whole (−15.6%), but increased in the south (+2.6%). This growth was due not only to the allocation of government money in the North Caucasus but also to the completion of investment projects that had been started earlier. The “multiplier effect” is essential, whereby investment in one project leads to investment in other, related projects. Unfortunately, this effect is starting to dissipate: in January-May, investment fell in Russia as a whole (−8.3%), while in the south there was still growth (+0.4%). But in May investment fell month-on-month both in the country as a whole (−14.0%) and in southern Russia (−3.4%). In Q1 2009, the SFD’s share of total foreign investment in Russia was just 3.4%, and, of this, 1.4% was foreign investment in the Rostov region, 1% was in the Volgograd region, and 0.8% was in Krasnodar Krai.

In January-May, **financial performance** in the private sector (the profitability of large and medium-sized enterprises) fell both in the country as a whole (−59.3%), and in the south (−62.3%). This means that the south does not have sources of finance to develop production and a lack of working capital is a growing problem. It is interesting that in January-April the profits of profitable companies fell in Russia as whole by 31.6%, but by only 15.3% in southern Russia. Therefore, companies in southern Russia that have managed to upgrade their production capabilities are remaining competitive even during the crisis, but loss-making companies that have not managed to find effective owners are distorting the general picture in the region. In Russia as a whole, 60.5% of companies are profitable, despite the crisis. In southern Russia the overall figure is 61.0%, although in most of its

regions less than half of the companies are profitable; the picture is altered by the Rostov region where 65% of companies are profitable.

In January-April **accounts payable** increased in the country as a whole by 4.0% and in southern Russia by 6.3%. Accounts payable overdue rose at a faster rate: +4.6% in Russia as a whole, +8.0% in southern Russia, including +77.3% in Dagestan, +64.5% in Kalmykia, +31.0% in North Ossetia-Alania, +26.0% in the Krasnodar Krai, +34.8% in the Volgograd region, and +15.0% in the Rostov region. Accounts payable overdue peaked everywhere in March, when senior government officials announced that state assistance would be forthcoming. However, this assistance has not yet reached the regions, and this is reflected in a fall in lending and an increase in accounts payable overdue in southern Russia. In April, accounts payable increased by 0.34% in the country as a whole, but fell 0.22% in southern Russia. However, while accounts payable overdue fell in Russia overall (-0.63%) they increased in the south (+1.77%).

At the macro level, the same trends are seen for **accounts receivable**: in January-April, they increased 4.2% nationally, and 6.1% in southern Russia, while accounts receivable overdue increased 5.4% in Russia as a whole, and 13.5% in southern Russia. The failure to observe contractual obligations is dangerous: it ruins economic relationships, reduces trust between partners, and criminalises the economy and society. Companies in southern Russia recognise this danger, but they are forced to trust their partners more, while at the same time taking measures to reduce the debts of their debtors: in April, accounts receivable fell in the country as a whole (-0.69%), but increased in the south (+1.33%). In the same month, accounts receivable overdue increased 0.8% in the country as a whole, but fell in the south (-1.94%). It can be supposed that even although government financial assistance had not reached the Southern Federal District by April, more funds had been made available to state companies in Moscow and these companies had settled their accounts with their suppliers, including in the south.

**Prices.** May brought year-on-year price increases of 6.8% in Russia as a whole and 7.3% in southern Russia. Prices for foodstuffs rose 6.5% in Russia as a whole, and 6.7% in southern Russia. Prices for non-food items increased more in southern Russia (+5.9%) than in the rest of the country (+5.5%). In line with what is said above concerning the growth in retail sales, here it can be said that demand in the south for non-food items is being maintained despite rising prices.

The higher price rises for consumer services in southern Russia in May (+10.8% compared with a national average of +9.1%) were due to annual increases in regulated tariffs. Compared with December of last year, the cost of housing services rose 17.6% in the country as a whole and 19.2% in the south. While there were very similar trends in national average prices and prices in southern Russia for heating (+17.8% and +16.6%, respectively) and hot water (+22.6% and 21.5%), there was a considerable difference in prices for the supply and disposal of cold water. The cost of these services rose 22.5% in Russia as a whole and 27.5% in southern Russia (+57.6% in the Chechen republic and +44.7% in the Rostov region).

The industrial production price indexes rose nationally (+7.7%) and in the south (+6.4%). For agricultural products the results were -0.1% and +1.9%, respectively. The price rises began in March, when demand increased for grain from the last harvest.

Construction companies in southern Russia reduced their prices by 2.5%, while nationally prices came down by just 1.6%. The highest decrease in prices was recorded in Krasnodar Krai (-7.6%), and the lowest in the Rostov region (-0.6%).

Tariffs for freight transportation increased overall (+2.5%), but fell in the south (-2.8%), with the exception of border regions: Dagestan (+21.0%), Krasnodar Krai (+9.1%), and the Rostov region (+4.9%).

**House prices.** In Q1 2009 compared with Q4 2008, prices on the new-build market fell 3.88% in Russia as a whole, and 2.35% in southern Russia. At the outset, new housing in the south was 30% cheaper than in the rest of Russia: prices had not been marked up speculatively, allowing more realistic prices to be maintained during the crisis. Prices on the new build market contracted sharply in just two areas: Krasnodar Krai (-8.27%) and the Volgograd region (-9.65%). Many regions in southern Russia actually saw prices rise: Stavropol Krai (+10.0%), the Astrakhan region (+9.68%), and the Rostov region (+5.4%). The reason for this phenomenon (Giffen goods) is that the population are realising their pre-crisis expectations. On the resale market, these expectations resulted in an increase in house prices both in the country as a whole (+2.32%) and in southern Russia (+1.80%). Looking at specific regions, prices increased 18.59% in Kabardino-Balkaria, 19.58% in Karachaevo-Cherkessia, 10.90% in North Ossetia-Alania, 16.68% in Stavropol Krai, 2.4% in Krasnodar Krai, and 14.59% in the Rostov region.

**Personal income** increased year-on-year at almost the same rate nationally (+14.2%) and in the south (+14.8%). A considerable rise in personal income was recorded in the North Caucasus republics. Real personal income increased by 0.8% nationally, and by 1.5% in southern Russia. The large, developed regions in southern Russia, i.e. the Rostov region and Krasnodar Krai, are seeing a fall in real personal income (−2.5% and −1.6%, respectively), and this is due to a high starting point in these regions. If we look at the whole January-May period, real personal income fell 0.4% throughout the country as a whole, but rose in southern Russia (+2.5%) as a result of deferred consumption and an increase in the salaries of government workers. The average wage in Russia increased by 8.3% in the year; in southern Russia, it increased by 13.4%.

In January-May, wage arrears increased both nationally (+87.8%) and in the south (+35.9%). Moreover, arrears increased more than fivefold in the Rostov region, and more than eightfold in the Astrakhan region. At the outset, wages in southern Russia were lower and they were not paid regularly. In recent years, much work has been done in a number of regions to rectify this situation. However, in various sectors the crisis periodically manifests itself in a sharp fall in production, an increase in accounts receivable, and wage arrears. The south's experience of overcoming such problems allows us to hope that these problems will continue to be addressed successfully. The obligations to southern Russia in the federal budget are being met in full.

**Unemployment** in the south (11.5%) remains higher than the national average (8.5%). However, in May, there was a general downward trend in unemployment figures both at regional level (−0.9%) and at federal level (−1.0%). This same trend is seen in the Federation members. It can be said that people have learnt to have more regard for their work, and this is indirectly confirmed by the fall in the number of redundancies.

Overall, analysis of development trends in May 2009 confirms that life continues, and that *southern Russia is using its particular strengths to achieve stable development, and is maximising its potential to overcome the crisis with much lower losses.*

## 2.7. Southern Russia's Markets in 1H 2009

In Soviet times, statisticians would use a comparison with the year 1913 to show the progress being made towards constructing a communist society.

When people tried to use another baseline to study the economy of “developed socialism” the Communist Party would tell them, “Our growth rates are slowing, but each percentage is starting to count for more”.

Today, analysts are studying the current economic crisis in Russia by comparing statistical indicators with the pre-crisis year, 2008, which was a very successful year. Experts are predicting that the Russian economy will have recovered from the downturn by 2013. But the crisis has its own trends, analysis of which is important if we are to properly assess conceptions of post-crisis development:

- Which sectors, regions and markets will grow after the crisis?
- How stable is this growth?
- What markets might emerge in the process of this growth?

Two documents published by the Federal Statistics Service provide a fairly objective picture of the new economic development trends: Information for Monitoring the Socioeconomic Position of the Constituent Members of the Russian Federation in January-June 2009, and Russia’s Socioeconomic Position (January-June 2009)\*. The results of this analysis are presented below, and an attempt is made to analyse these trends in terms of market mechanisms.

**The population** has shown fortitude in the face of the crisis: the birth rate has gone up, the death rate has gone down, and there is less migration. Family ties have been strengthened with an increase in the number of marriages and a decrease in the number of divorces. If we look at the figures per thousand population, southern Russia outperformed the Russian average by approximately two people for each of these indicators. Even the traditional southern temperament, reflected in higher than average marriage and divorce rates, has changed during this crisis: the people of southern Russia are being more pragmatic and are trying to preserve and increase even very modest family assets.

**Labour market:** Southern Russia adapted to unemployment long before the crisis, and this experience has proved advantageous for the labour market in the present conditions.

Throughout the country, including southern Russia, the crisis has forced into work even those people who previously were not working for one reason or another. According to a statistical survey, between February and May 2009, the employment rate for people of working age increased by 1.6% nationally and by 1.8% in southern Russia. Unemployment fell in the same period: by 1.0% nationally, and by 0.9% in southern Russia.

These trends are confirmed by the Federal Labour and Employment Service's comparison of data for May and April of this year: the numbers of economically inactive people and registered unemployed, and even the number of unemployment benefit recipients, are all falling. In southern Russia, the crisis has not resulted in a sharp increase in the number of economically inactive people, registered unemployed, or unemployment benefit recipients. The impact of the crisis on employment has been 7-10 times less in southern Russia than throughout the rest of country. Yet, despite the positive trends, unemployment in southern Russia as a whole is 3% higher than the Russian average. In the republics of the North Caucasus it is 4-6 times higher, although in these areas too unemployment is falling.

Following the redundancies in winter, there has been an increase in the number of job vacancies advertised in government-run job centres in the Russian Federation (+13.4%). In southern Russia, the increase has been considerably lower (+2.2%), with the exception of those regions where large federal projects are being implemented: Ingushetia (+7.9 times) and Krasnodar Krai (+22.2%).

The labour market in southern Russia has proved to be more mobile amid the crisis: June saw an increase in redundancies (+12.0%), but also an increase in the number of people hired (+17.8%) and the number of vacancies (+5.9%). The respective results for Russia as a whole were: +7.8%, +15.8% and -0.2%. This indicates that southern Russia's labour market is seeing a more active attempt to find a new equilibrium point: both employees and employers are trying to find new ways in which existing human resources can be used. There are also a number of objective factors behind the greater mobility: southern Russia's diversified economic structure; the absence of a large number of single-industry towns; and the population's fairly high education level, allowing workers to quickly adapt to new working conditions in new jobs.

In addition to objective factors, subjective factors also influence the trends and the mechanisms at play in the labour market. While in June 2009, southern Russia accounted for 10.63% of all redundancies in Russia, the percentage of redundancies that were voluntary was higher in the south (12.13%). Worker behaviour in southern Russia's labour market is determined by the workers' strong self-esteem, the independent behaviour of the population of the south, and confidence among workers that there is demand for their skills. The strong sense of self-worth among the workers is

forcing employers to take a more responsible approach to making redundancies (southern Russia accounts for 10.42% of the total number of intended redundancies in the country), and to retaining vacancies (11.49% of the total in Russia). Relationships in the labour market in southern Russia are sufficiently transparent that there is no need for extensive use of hidden forms of unemployment, such as part-time work (6.26% of the total for Russia) and compulsory leave (5.0% of the total for Russia).

Another factor behind the dynamic development of southern Russia's labour market is self-employment. Under new Russian legislation, the statistics now combine the number of people employed by small enterprises (up to 100 employees) and medium-sized enterprises (up to 250 employees). Using these new indicators, we see that in the first quarter of 2009 it was medium-sized enterprises that were most affected by job cuts (−12.1%). In Russia as a whole, 4% of jobs were shed. But in southern Russia, the high percentage of individual entrepreneurs (20.69%) and the number of people working for small enterprises (14.0%) more than compensate for this.

The crisis is forcing a reassessment of many resources, including human resources. In May 2009, the nominal wage was still going up compared with May of last year (pre-crisis). Moreover, the increase in southern Russia (+12.1%) was higher than the national average (+7.5%); in the pre-crisis period, wages in southern Russia barely kept pace with the Russian average. But, relative to April, there was no increase in wages in Russia as a whole, and only a very small increase in southern Russia (+0.7%). In a number of areas, the nominal wage actually fell: the Chechen Republic (−1.0%), Kalmykia (−0.4%), and the Volgograd region (−0.2%).

In June 2009 alone, thanks to government measures and the efforts of regional commissions aimed at preventing the late payment of wages and salaries, total wage arrears in Russia were down by 18% and in southern Russia by 50.1%. There are now virtually no wage arrears in Dagestan, North-Ossetia-Alania, the Rostov region or Krasnodar Krai. There are occasional spikes in wage arrears at individual companies, but these are addressed through the efforts of the local authorities, employers and federal debtors.

**Consumer market.** In May 2009, real personal income in absolute terms fell by 5.5% in Russia as a whole and by 4.3% in southern Russia. While in southern Russia the population is still delighted with their increased wealth relative to last year (+1.8%), the rest of Russia is no longer under any illusion (−1.3%).

Consumer behaviour is also changing. March saw an increase in both personal income and consumer expenditure. Moreover, the growth in spending exceeded the growth in income, both nationally (by 1.6%) and in southern Russia (by 2.5%). The population were trying to carry out their pre-crisis plans. In April, spending rose at a slower pace than income: in Russia by -6.9%, and in southern Russia by -5.4%. The population had started to save. In May, income and consumer spending both showed negative trends, but spending less so: consumption had almost reached the level when any further reduction would mean that basic needs were not met.

The January festive season saw retail sales fall by 25.6% throughout Russia as a whole, and by 29.2% in southern Russia. But then in February the consumer market quickly recovered, with sales up by 28.2% overall, and 36.7% in the south.

After that, normal free market laws began to take effect in the consumer market: the fall in the rate of growth of personal income led to a contraction in sales, or to lower prices for individual types of goods. Given that pricing in the service sector is not dictated by the market, but instead is subject to regulation, the emergence of market mechanisms can be more clearly illustrated by comparing trends in sales volumes and prices for food and non-food items.

In June, the Russian consumer market reacted to the previous month's fall in per capita income (-4.9%) with an increase in purchases of non-food items (+1.1%) and a decrease in purchases of food products (-0.6%). In June, food prices in Russia increased by 0.5% and prices for non-food items by 0.8%. The government's attempts to regulate food prices did not increase food sales.

In May, average per capita income in southern Russia fell by 3.5%. Despite this, sales of non-food items and food products in the region were up (+4.0% and +3.0%, respectively). The higher sales were accompanied by higher prices for both non-food items (+0.6%) and food products (+0.8%).

The market itself will find a new supply and demand equilibrium, but this requires market conditions.

In this respect, a comparison of data for Krasnodar Krai and the Rostov region for May-June 2009 is revealing.

In Krasnodar Krai, in May, personal income fell by 3.78%, the food price indexes increased by just 0.4%, and food sales were up by 7.1%.

The corresponding results for the Rostov region were as follows: in

May, average per capita income fell by 2.65%; in June, the food price index increased by 1.2%, and food sales increased by 1.2%. Besides other factors, it should be borne in mind that there are large retail chains in the Rostov region. These chains have been forced to focus on imported goods, which have become more expensive as a result of the devaluation of the ruble. The local population are responding to this pricing policy with a reduction in demand.

Despite the higher prices, demand for non-food items in the south remains steady: the population still fear a new inflationary spike and are trying to make previously deferred purchases.

One fifth of all of Russia's covered and outdoor markets and 27.6% of their trading stands are concentrated in southern Russia. With its tradition of holding markets, the economy of southern Russia has better chances than an economy dominated by retail chains. This is especially true in the summer season.

**Table 2.7.1. Changes in personal income, sales and prices in May-June 2009, %**

		Russian Federation	Southern Federal District	Rostov region	Krasnodar Krai
Per capita personal income, May to June		-4.92	-3.48	-2.65	-3.78
<b>Sales in June</b>					
Food		-0.6	3.0	0.2	7.1
Non-food items		1.1	4.0	3.2	5.2
Consumer services		1.5	3.3	2.0	10.0
<b>Consumer price indexes in June</b>					
Food		0.5	0.8	1.2	0.4
Non-food items		0.8	0.6	1.0	0.4
Charged services		0.5	0.7	1.0	1.5
For information, as a % of the total for Russia	Number of outdoor and covered markets	100	19.78	3.39	5.74
	Number of trading stands in these markets	100	27.61	5.65	6.71

In the first half of the year, retail sales in Russia as a whole fell by 3%, while in southern Russia they rose by 0.5%. In June, there was very little change in retail sales nationally (+0.2%), but the south saw a 3.5% increase on the previous month. It was only in the Volgograd and Astrakhan regions that sales declined, and these regions also experienced a much more substantial contraction in wages, and an increase in wage arrears.

At the start of the crisis, wholesale trade in southern Russia suffered considerable losses, with sales down 30% on the previous year; in the country as a whole, they only fell 3.2%. But this sharp contraction has boosted accelerated growth in the new crisis conditions: in June compared to May, wholesale trade in southern Russia was up 5.5%, against a national increase of 1.1%.

As is to be expected in a partial market economy, the service sector, in which prices and tariffs are largely government regulated, has reacted less to the fall in personal income: both the prices and the sales of services are going up. The service sector, which contracted last year by 8% in the country as a whole and by 3.1% in southern Russia, is trying to recover its position: in June 2009, sales of services grew by 1.5% nationally, and by 3.3% in southern Russia. Moreover, the prices and tariffs for services increased: by 0.5% in Russia as a whole, and by 0.7% in southern Russia.

**Producers' markets.** The downturn in industry as a result of the crisis was felt equally by southern Russia and the rest of the country: in the first half of the year, the index of industrial production fell by 13.5% in the south and by 14.8% nationally.

However, the south is overcoming the crisis in industry more rapidly, with growth of 15.3% in June compared to May, while Russia as a whole showed growth of just 4.5%. Moreover, June's growth was even higher in manufacturing: 19.9% in southern Russia, compared to 9.9% nationally. The extraction industry is recovering more slowly: growth in June did not reach May's level either in the Russian Federation as a whole (-0.1%) or in southern Russia (-2.1%). As for the generation and distribution of electric power, gas and water, these sectors also saw a fall in June compared to the previous month (-14.0% nationally and -12.5% in southern Russia) but this was largely due to seasonal factors.

The shock from the contraction in industry at the beginning of the year is gradually starting to dissipate. Food production and local industry continue to be at the forefront of post-crisis growth. Electric power generation and

the manufacturing of electrical goods and local construction materials are achieving pre-crisis levels. There has been a decline of more than 10% in the manufacturing of combine harvesters, paint and coatings, man-made fibres, fabrics, pipes, electric locomotives, tractors and cars. The very diverse results for different types of industrial output are partly the result of government assistance for engineering. But even if this support was taken out of the equation, southern Russia would still have advantages in the post-crisis economy: its diversified economic structure, its emphasis on food production, and improved efficiency at the company-level in all sectors.

For agriculture we should wait until autumn to draw our main conclusions. In terms of interim results, we can see an increase in the area sown with cereal crops and leguminous plants, a decrease in the area sown with sunflowers and sugar beet, and an increase in the area sown with potatoes and vegetables. Farmers are not confident that the prices they will receive from sunflower and sugar beet processors justifies the cost of producing these crops. On the other hand, there will always be demand for potatoes and vegetables, especially when the population has less money to spend. Regardless of the specific situation, southern Russia will always be the country's larder, accounting for more than 40% of sunflower and vegetable production, and more than 20% of cereal crops.

In the first half of the year 2009, compared with 2008, livestock and poultry production increased by 5.9% nationally, and by 1.8% in southern Russia. Milk production in Russia as a whole fell slightly (-0.5%), but in the south it was up 2.5% compared to the same period of 2008. Egg production increased both in Russia as a whole (+4.0%) and in southern Russia (+4.4%). During the crisis, agriculture seems to be the only sector of the Russian economy that is experiencing growth, and given that southern Russia dominates this sector, it is the south that is starting to drive post-crisis development.

In the first half of the year, as a rule, the agricultural sector predominantly sells animal produce. In the first six months of 2009, prices for agricultural products in the Russian Federation fell by 2.0%, but sales increased: meat by 5.9%, and eggs by 4.0%. Only milk production experienced a fall in sales, of 0.5%.

In the south, despite the 1.3% increase in prices, sales volumes for milk and eggs have increased steadily (+2.5% and +4.4%, respectively), but

meat sales have not expanded rapidly (1.8% growth compared to the first six months of 2008). Experts predict that the drought of 2009 will result in further price increases for the agricultural products that farmers have not managed to produce in the same record quantities as in 2008.

In construction, despite the view widely disseminated by the media that the sector is in a disastrous state, the reality is less dramatic: nationally, the sector has contracted by 19.3%, and in southern Russia by 9.1%. The amount of new housing has fallen by 0.3% nationally and by 4.0% in southern Russia. Until a new equilibrium between supply and demand emerges in the housing construction market, construction companies cannot continue to mass produce properties. In the meantime, in the first half of 2009, prices on the new-build market fell by 6.1% nationally, and by 5.7% in southern Russia.

Looking in more detail at the results for southern Russia, while prices fell by 12.6% in Krasnodar Krai and 17.3% in the Volgograd region, the Rostov region saw prices on the new-build market increase by 4.9%, Stavropol Krai by 6.3%, and the Astrakhan region by 9.7%.

It can be expected that the contraction in prices in the construction industry will slow down, but this will depend on growth in income.

The reaction by the construction industry in southern Russia to the crisis has been more in line with free market principles than has generally been the case in the rest of country: in the first half of the year, prices fell by 2.5% in southern Russia and the volume of completed work by just 9.1%. In Russia as a whole, construction companies agreed to just a 1.8% reduction in prices, but then volumes of construction work fell by almost 20%.

In the first half of 2009, tonnage of freight lifted by road fell by 13.4% in Russia as a whole, and by 19.2% in southern Russia. Nationally, there was a decline not only in tonnage of freight lifted, but also in tonnage of freight moved (-14.8%). Meanwhile, in southern Russia the tonnage of freight moved by road increased by 3.9%. Southern Russia's border regions saw the most significant increases in the tonnage of freight moved by road: the Rostov region (+30.5%), Krasnodar Krai (+5.6%), and the Republic of Dagestan (13.4 times).

Although the data on freight tariffs and the volumes of road freight shipped by large and medium-sized enterprises are not wholly comparable, it is revealing that in southern Russia tariffs fell by 3.0% in the first half of the year, and the tonnage of freight moved by road increased by 3.9%. In

Russia as a whole, freight rates increased by 2.5% and tonnage of freight moved by road dropped by almost 15%.

**Foreign trade:** The downturn in foreign trade has been the most apparent result of the crisis. In the first quarter of 2009, compared to the same period of 2008, Russian exports fell by 47.7%, and imports by 38.9%. There was a decline in exports to non-CIS countries (–48.0%) as well as to former Soviet republics (–46.0%). Imports from non-CIS countries fell by 37.5% and from former Soviet republics by 47.7%. Although southern Russia's foreign trade is not extensive, it is based on stable relationships with both groups of trade partners (former Soviet republics and non-CIS countries). Consequently, the crisis has adversely affected southern Russia's exports to both of these groups of countries to a lesser and approximately equal degree (–17%). Southern Russia's imports from CIS countries fell very considerably (–61.8%).

In the first quarter of 2009, southern Russia imported food (8.6% of Russia's total food imports) mineral commodities (8.8%), fuel and energy products (11.0%), metals and metal items (9.0%), timber and pulp and paper products (3.6%), machinery, equipment and vehicles (3.7%). In terms of total Russian exports, southern Russia accounted for 32.4% of food exports, 7.4% of exports by the chemical industry, 6.6% of textile goods and shoes, 5.1% of metals and metal items, and 4.7% of machinery, equipment and vehicle exports. Along with food products, southern Russia's import and export trade is well balanced for a wide range of goods. However, southern Russia's foreign trade does not yet match its role in the Russian economy; it is less than half what it should be. The regions most heavily engaged in overseas trade are the Rostov region and Krasnodar Krai.

The example of the textile industry in the Rostov region deserves mention. Textile companies created in mining towns in the Soviet Union were mainly intended to address demographic problems. During the years of reform in the 1990s, these companies retooled and today they account for 4.7% of total Russian textile imports.

**Finance and investment market:** Amid a general decline in Russia's investment activity of more than 15.6%, southern Russia's performance in the first quarter of 2009 stood out with a 2.6% increase in investment in fixed capital. This growth was connected with the completion of construction projects, work that was financed primarily using public money. Looking at January-May we see that the breakthrough achieved in terms

of investment activity is diminishing, but for the time being southern Russia (+0.4%) is outperforming the national average (-8.3%). Data for May shows a slowing in investment activity both in Russia as a whole (-14.0%) and in southern Russia (-3.4%), but this does not allow for investment in preparation for the Sochi 2014 Winter Olympics: investment in Krasnodar Krai was up 29.7%.

Obviously, during a crisis, ambitious, but inefficient investment projects should be rejected, especially those that are financed by the government. However, the desire to conserve public funds should not entail a failure to make the necessary investments for the social development of future generations. Given that public money is limited, mechanisms to get real value from this money must be put into action, drawing on international best practice.

In the end of the first quarter of 2009, southern Russia accounted for 9.39% of total investment in the Russian Federation, and for 3.4% of foreign investment. In Krasnodar Krai the respective results were 3.4% and 0.8%, and in the Rostov region, 2.16% and 1.4%.

Companies suffered their largest losses in January. In the south, companies only started seeing profits in March (in some regions, in April). From that point, southern Russia's contribution to the consolidated financial result of the country's businesses began to increase, reaching 4.32% in May. Although this was 1.32% lower than in 2008, it was much better than January's result, when the south accounted for 9.0% of total losses.

In January-May 2009, the profitability of large and medium-sized enterprises in Russia fell by 48% in comparison with the same period of the previous year, while southern Russia showed a decline of only 39.8%.

Due to the fall in company revenues, southern Russia accounted for 0.6% less of total payments to the state, but there was no change in its share of payments overdue.

The crisis has engendered a specific type of "investment" activity: buying up assets that have fallen in price. Recognising the danger in this, companies in southern Russia are trying to manage their liquidities and control their accounts receivable and payable.

In the first half of the year, southern Russia's share of the total accounts payable of Russia's companies did not change, standing, on average, at about 6.3%. Its share of accounts payable overdue has also remained steady, at about 9.5%.

In terms of accounts receivable, southern Russia is responsible for about 5.4% of the national total, and about 7.5% of accounts receivable overdue. There is some fluctuation depending on when the latest tranche of government financial assistance is received, as well as public finance for Russian companies working on government contracts, and payments by debtors to southern Russia's companies.

As there will be cutbacks in the scale of government assistance, there will be an increased risk that Russian debtors will fail to make timely payments to companies in southern Russia. At the same time, every effort must be made to ensure the timely payment of work carried out in southern Russia under government contracts.

*The main thing that southern Russia has demonstrated in the first half year of its development in crisis conditions is its commitment to using market mechanisms to overcome the crisis: in the labour market, in the consumer market, in the producers' markets, and even in the investment and finance market. Market mechanisms in southern Russia differ from the speculative rises and falls on the global market: they demonstrate confidence that persistent efforts can achieve a new market equilibrium and respect for those people who work hard and who are trying to adapt their business plans to the new market realities. So far we are only seeing the early results, the preservation of social stability at a time of crisis. We must make the transition from social stability to being socially proactive, creating new investment projects to win competitive advantages in the post-crisis economy.*

## Part 3.

# The Sustainable Bank for Southern Russia

### 3.1. Introduction

*Our success story began many years ago when the directors of the first privatised companies in southern Russia asked a number of lecturers from the Rostov-on-Don Institute of the National Economy to set up a modern bank that would meet the demands of the new era. Established in 1992, Center-Invest Bank was involved with all the stages of reform and quite rightly became known as a “reform laboratory” in southern Russia. Methodological guidelines produced by Center-Invest proved very popular among Russian government officials, politicians and business people. More than thirty of Center-Invest’s employees hold PhDs and higher doctorate degrees. Over the years, we have provided work experience for hundreds of students, many of whom have gone on to head up the Financial Divisions of leading Russian companies.*

One of the latest stages in Center-Invest Bank’s history began on 26 April 2006, when our main shareholders met in London. We had successfully implemented the strategy approved by our shareholders two years previously, and it was now time to discuss our plans for the future.

Three scenarios for the development of the bank were presented for discussion: 1) concentrating on the existing market in the Rostov region, 2) expanding our operations throughout southern Russia, 3) creating a major bank with a federal network.

Center-Invest Bank was already well established in the Rostov region, but entering other regions would mean accepting new risks. On the one hand, we had the following advantages: ten years of audits under International Financial Reporting Standards, a Code of Corporate Conduct, ratings by an independent agency, and experience of working with international financial institutions: the EBRD, IFC, KfW, and USAID. On the other hand, in terms of its size, southern Russia is comparable with many European countries: it occupies an area of 589,000 square metres and has a population of 22.8 million. It seemed that the discussion might be inconclusive, but our highly

experienced independent director, E. Welteke, former president of the Bundesbank, came out in favour of scenario 2, proposing a wise solution: “Let’s call the strategy “South of Russia+”. If the conditions are favourable, then we can use this “plus” to take our operations to a federal level, and in the meantime we will continue replicating our work in the Rostov region and in other regions of southern Russia”.

When they realised how much investment scenario 2 would require from each shareholder, the participants in the meeting asked for a detailed report justifying our position. In addition to providing Center-Invest Bank’s operating and financial performance indicators, we conducted an analysis of the investment appeal of southern Russia\*.

We used all available official statistics for this study, but our analysis was focused on determining the potential of the markets in question. It became apparent that southern Russia is a region with a “low starting point”: the gap between indicators for southern Russia and the average figures for Russia as a whole is such that there is considerable potential for dynamic and effective growth. And it is specifically these kinds of regions that are of particular interest to investors.

Two years passed. During this time, not only was southern Russia’s potential confirmed, but many opportunities were realised: Sochi was chosen as the host city for the 2014 Olympic Winter Games, Center-Invest Bank achieved the annual targets set out in its “South of Russia+” Strategy ahead of schedule, and we were a runner-up in the “Sustainable Bankers 2007” category of an international competition held by the International Finance Corporation (IFC) and the Financial Times. Tatiana Vysokova, Chairman of Center-Invest Bank’s Audit and Compliance Committee, received a Women in Business 2008 Award from the EBRD.

The global financial crisis abruptly changed the situation. But careful analysis showed that amid this crisis southern Russia actually has even greater opportunities to realise its potential and consolidate its advantages in the post-crisis economy. Center-Invest’s work in southern Russia gives the bank an important competitive advantage. At the same time, the experience and best practice that we, our partners and our customers are promoting in southern Russia create additional advantages for the development of business as a whole in this region. The nature of these advantages and the ways in which Center-Invest Bank is promoting the development of southern Russia are the subject of this second part of the book.

### 3.2. Corporate Governance

Since 1991 the team at Center-Invest Bank have provided consultancy services to more than 300 companies in southern Russia undergoing the process of privatisation. In 1993 experts from the bank wrote and published Russia's first textbook on corporate governance. This book contains recommendations for new shareholder companies on the procedures for holding shareholder meetings and adopting internal rules and regulations\*. In 2002 Center-Invest Bank became the first participant in the IFC's corporate governance programme\*\*. We had already been through the advisory process before the programme officially began in Russia.

Center-Invest Bank has always acted in strict compliance with Russian legislation. Our work with international organisations has meant that we must also observe international standards. In a short space of time, with the help of consultants, we developed and approved all the requisite documents and policies for the bank to voluntarily assume responsibility for observing best international practice in reconciling the interests of shareholders, staff, customers and partners.

The main elements of these voluntarily assumed obligations were: clearly formulated additional (to mandatory principles) corporate governance principles, a transparent structure for the governing bodies, procedures to improve the guarantees of the rights of minority shareholders, a transparent dividend policy, information policy standards, and a code of corporate governance.

In contrast to the way in which relationships within shareholder companies are traditionally managed in Russia, the adoption of the following principles required the bank to display a degree of courage:

ACCOUNTABILITY (Executive Board — Board of Directors — Meeting of Shareholders);

EQUITY (treating all shareholders as equals);

TRANSPARENCY (timely and reliable disclosure of information);

RESPONSIBILITY (recognising the rights of other stakeholders);

Experience showed that despite all the risks, the voluntary acceptance of these principles was justified not only from the point of view of investors, but also because it creates a new atmosphere in the relationships within a shareholder company.

The creation of a transparent governance structure was also important;

\* <http://www.centriinvest.ru/ru/pub.html>

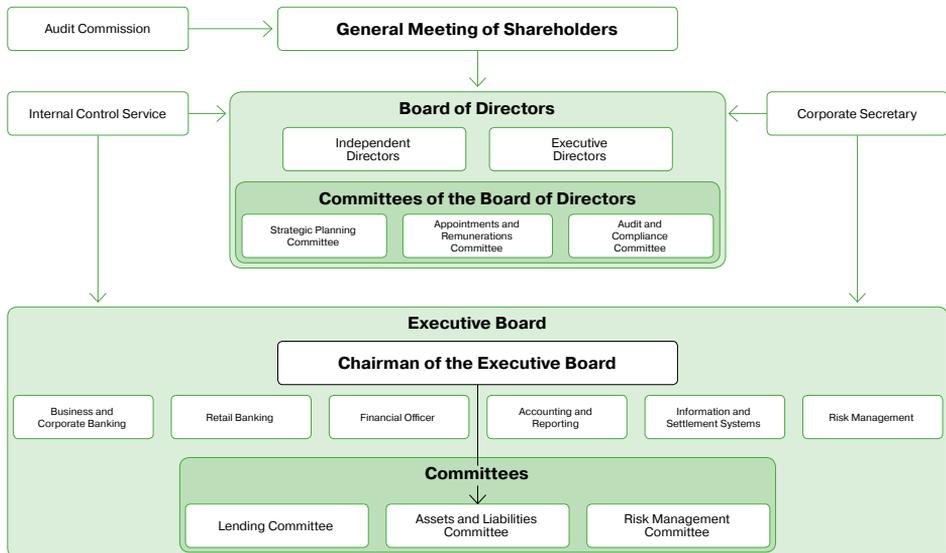
\*\* <http://www.ifc.org/corporategovernance>

a clear division was established between the competencies of the Meeting of Shareholders, the Board of Directors and the Executive Board. Committees composed of members of the Board of Directors were set up (for strategic planning, audit and compliance, and appointments and remunerations). Their purpose is to consider in more detail issues relating to the day-to-day management of the bank and to ensure that the necessary decisions are taken quickly.

To further improve Center-Invest’s corporate governance system, a transparent structure was established for its executive bodies. As a result, we have a transparent and effective governance structure that has enabled us to minimise the impact of the financial crisis on our operations.

Due to ambiguities in Russian legislation on the rights of shareholders, it was necessary to introduce special provisions on the location and timing of meetings, and speeches and voting, so as to procedurally guarantee the participation of all shareholders in meetings. To protect the rights of minority shareholders, independent directors are elected to the Board of Directors and the shareholder register is maintained by an independent registrar. There is a special procedure for considering and confirming related party transactions.

### Center-Invest Bank Management Structure



The ***dividend policy*** is designed to promote the sustainable development of the bank. It sets an upper limit on dividend payments (not more than 50% of net profit) and a lower limit (not less than the bank rate of the Russian Central Bank). In 2007 the bank paid 18% of par in dividends on ordinary shares, and 20% of par on preferred shares. In 2008, the shareholders unanimously voted to pay dividends on preferred shares only, at 20% of par.

The ***information policy*** sets out the procedures and channels for presenting and distributing public information about the bank. It also details commercial confidentiality measures, specifies what is considered to be insider information, and sets out our advertising requirements and the procedures for the submission of information to the bank. As part of our information policy we use traditional mass media, new information resources, and direct contact with our customers through our branch network's front offices. Center-Invest Bank has become a newsmaker in southern Russia, regularly informing the general public of its progress. Using all these various channels, we distribute information to 14 million people in southern Russia. In addition, Center-Invest works with international media channels and publications: Bloomberg, CNBS, The Banker, Euromoney, and the Financial Times. It is important to understand that a real achievement lies behind every news story from Center-Invest.

The ***Code of Corporate Ethics*** establishes the principles and standards for internal company relationships and relationships with customers and partners, and also the rules for auditing ethical standards.

The initial aim of introducing a corporate conduct system for Center-Invest Bank was to meet the requirements of our Western partners. This was with the goal of accessing long-term funding. In the process of producing the documentation, existing procedures were reassessed and more effective solutions and governance standards were proposed. Through the formalisation of procedures, Center-Invest introduced more clearly defined rules on the relationships between shareholders, management, staff and customers. Ultimately, ***a new corporate culture was established.***

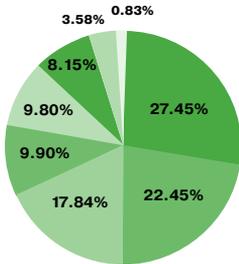
In 2005 an independent director was elected to Center-Invest's Board of Directors: the former president of Deutsche Bundesbank, Ernst Welteke. The independent director represents the interests of the owners and managers, guarantees the bank's customers that the bank's activities are transparent, and ensures that there is an independent decision-making process. The former minister for economic development and trade, German Gref, praised

this development, saying “They must be a progressive bank to have invited a person of such high standing as Ernst Welteke to a Russian region. It gives a signal to investors that they should be rushing here (to southern Russia).”

Today, Center-Invest Bank’s corporate conduct system is not a static code; rather, it is a set of documents that are constantly updated, reflecting changes to legislation, best international practice, and our own experience. Center-Invest Bank’s main shareholders include international financial institutions, leading European banks, and investment funds. Minority shareholders enjoy all the rights provided for by current legislation and the bank’s code of corporate conduct.

Our transparent corporate conduct practices enabled us to rapidly adopt the programme “Southern Russia Versus the Global Crisis”, as well as measures that will ensure the bank’s successful, sustainable development not only during the crisis but also in the post-crisis economy. To a large extent, it is thanks to shareholders, managers and staff openly discussing the real situation that we have managed, at all stages of the crisis, to mobilise and effectively use all of our resources to implement our post-crisis development programme.

### Structure of shareholders in Center-Invest Bank

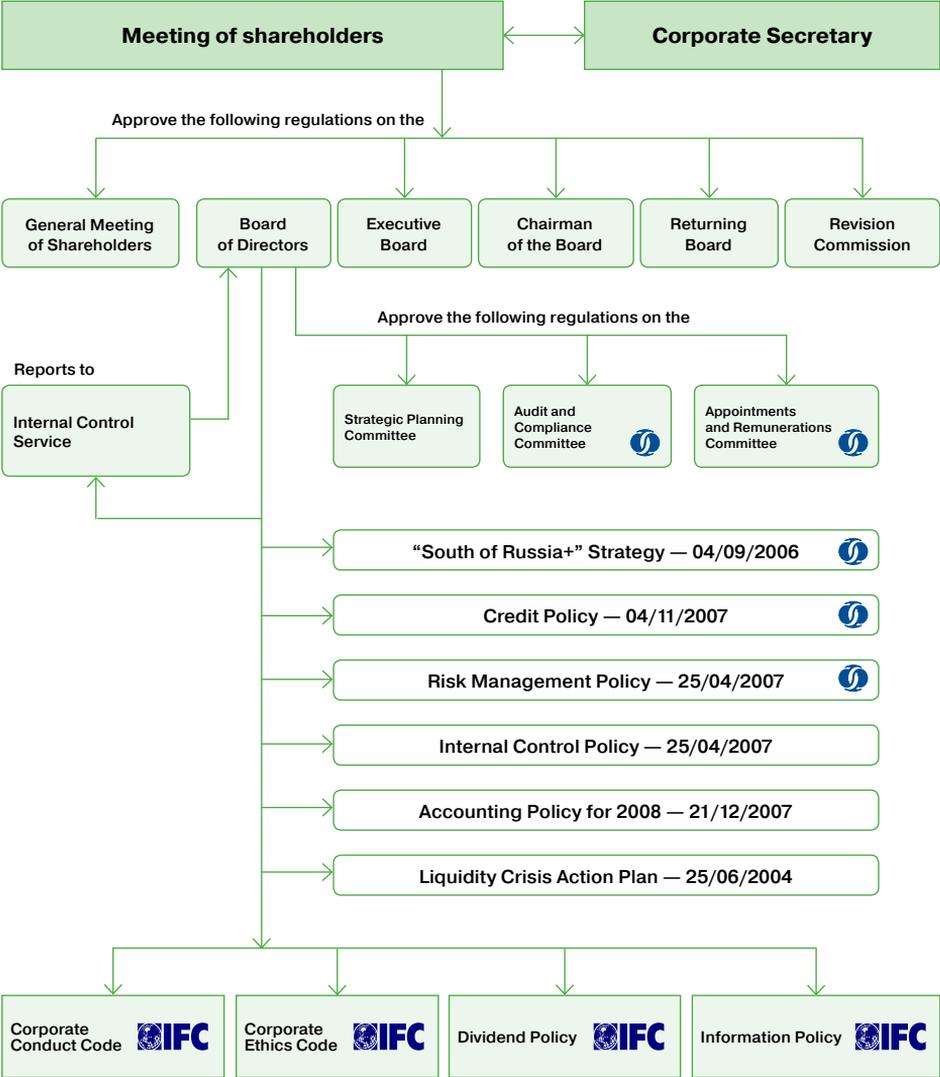


- 27.45% — EBRD
- 22.45% — DEG
- 17.84% — Dr. Vasily Vysokov, Mrs Tatiana Vysokova
- 9.90% — Firebird Investment Fund
- 9.80% — Erste Group
- 8.15% — Renaissance Capital
- 3.58% — Raiffeisenlandesbank Oö
- 0.83% — other shareholders

### Foreign shareholders in Center-Invest Bank



**Center-Invest Bank Corporate Governance Structure**



With the participation of:

The European Bank for Reconstruction and Development (the EBRD)

The International Finance Corporation (IFC)

### 3.3. Mission, Strategy, and Business Planning

*Center-Invest Bank's mission is to provide our corporate, business and retail customers in southern Russia with a comprehensive range of banking services in compliance with international best practice.* Identifying your mission in today's complex world is an important step in terms of correctly understanding and positioning your business. Companies that lack a clear mission are left at the mercy of the waves in the free market sea.

A mission statement should be concretised in specific figures as part of a development strategy. Since the very beginning, Center-Invest Bank has been meticulous in developing its growth strategies. This has allowed us to achieve our set objectives, moreover, ahead of schedule. The secrets to the successful implementation of a strategy are the following:

Firstly, strategic plans are not simply long-term plans. In strategic plans, both resources and objectives are viewed as variables from the outset. This approach allows companies to consider a wider range of options and choose the course of action that provides for balanced growth.

Secondly, there is no such thing as an absolutely ideal strategy. Every strategic decision has its strengths and weaknesses, and contains opportunities and threats. By carrying out a timely SWOT-analysis we can reinforce the positive aspects of a strategy and propose ways of compensating for the negative aspects.

Thirdly, a strategy is not just a document for shareholders and senior management. The best results are achieved when all the staff are involved in discussing the bank's overall strategy and can see how they personally fit into it. This discussion should be seen as an iterative procedure for agreeing aims and resources at all levels of management.

Finally, the strategy of a regional bank should be based on thorough analysis of trends and any sudden changes in the global, national and regional markets.

A distinctive feature of Center-Invest Bank's planning system is that it applies best practice in economic planning and forecasting for a market economy.

Center-Invest's **planning system** is based on clear organisational procedures using an iterative process to agree:

- strategic plans, annual and quarterly business plans;
- development plans for individual products and business units (Head Office divisions and departments, and the bank's branches);
- technology, data management, and human resources development plans.

All of the bank's business units are involved in developing these documents. Consequently, not only are solutions found iteratively, but staff are able to propose ways of making business processes more effective. The main outcome of this dialogue is that each member of staff is aware of the bank's growth prospects, feels involved in its successes, and views targets as personal objectives. Strategic and personal objectives are well balanced in terms of resources, time frames and the parties responsible.

***The methods for developing plans*** include a wide range of analytical procedures and comparative calculations: trends analysis allows us to identify trends in the global, national and regional economy; using development potential analysis we can assess the business's maximum development opportunities; SWOT-analysis provides a comprehensive assessment of the proposed scenarios. The financial indicators for the plans are calculated using International Financial Reporting Standards (IFRS) and Russian Accounting Standards (RAS).

***The methodology for developing plans*** is based on modern views that banking is essentially the purchase and sale of risks: all the indicators for the plans are developed with due regard for the risks and the limits to the accountability of the employees taking decisions.

***Organisation of planning.*** In accordance with the procedures for approving plans and for monitoring and reporting on their execution, the Board of Directors receives quarterly updates on the implementation of the approved strategy and annual business plan. The risk management and internal control systems track not only negative consequences, but also new opportunities arising in the course of plan implementation. As a result of this creative and flexible approach, Center-Invest Bank has been surpassing the targets in its Strategy and business plans, and every year has seen a doubling of our financial performance.

We gave full consideration to all these elements when developing the bank's "South of Russia+" Strategy. The strategy reflected the bank's objectives for the development of:

- products (SMEs, agribusiness, energy efficiency, retail);
- services (payments and settlements, direct marketing, plastic cards);
- branch network (standardisation of products and services);
- operations (risk management, internal control, the introduction of a new information system, management of human resources, equipment and technology).

All of these measures were well balanced, and were integrated into the work of all our business units and employees. This allowed us to exceed our targets for the “South of Russia+” Strategy well before the global crisis began, as confirmed by our main performance indicators.

**Table 3.3.1. Performance indicators (IFRS) for Center-Invest Bank’s “South of Russia+” strategy.**

Rubles, billions	01.01.06	01.01.07	01.01.08	01.10.08 Achieved	01.01.09	01.01.10	01.01.11
	“South of Russia+” Strategy						
Capital	2.2	4.2	5.2	5.7	5.7	6.9	8.8
Assets	13.6	23.8	39.5	48.5	45.7	64.0	89.6
Loans	8.2	15.8	28.7	34.2	32.0	44.5	62.2
Deposits	7.7	12.4	19.2	23.0	22.8	32.0	44.5
Profit	0.3	0.5	0.7	0.7	1.1	1.3	1.9

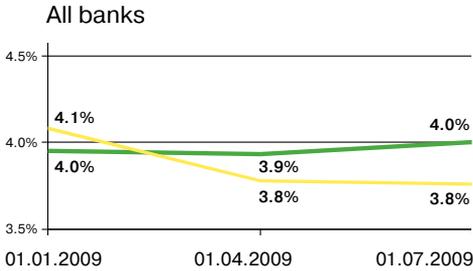
The strategy is then given specific form in annual and quarterly business plans. Naturally, different scenarios for developments in global and regional markets are identified, as are opportunities and threats. The plans also include targets for the development of products, services and operations, cost estimates, and scope for increased efficiency. The 2009 business plan provides a good example. From the outset, the plan was based on the most negative scenario for the course of events. The government’s optimistic forecasts were gradually replaced with more negative assessments. By being realistic in our assessment of the current situation, we were able to meet all our obligations to our partners and focus our resources on our core objectives:

- actively lending to our customers to ensure they enjoy competitive advantages in the post-crisis economy;
- replacing short-term resources with long-term funding;
- reducing operating costs.

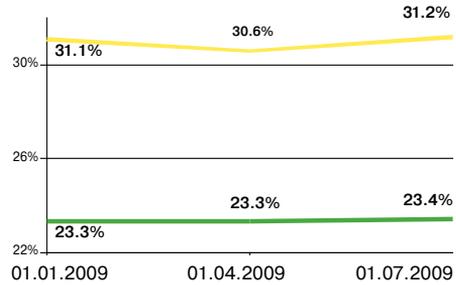
**Table 3.3.2. Implementation of Center-Invest’s business plan in 2009**

Rubles, billions	01.01.09 achieved	01.07.09 achieved	01.07.09 plan	01.01.10 plan
Capital	5.5	5.5	5.7	5.8
Assets	50.7	39.7	39.1	41.5
Loans and leasing	30.7	25.0	30.1	32.0
Deposits	21.3	21.4	22.9	24.3
Profit	0.3	0.04	0.0	0.1

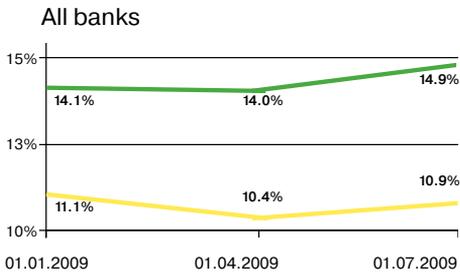
**Center-Invest's share of the SFD market**



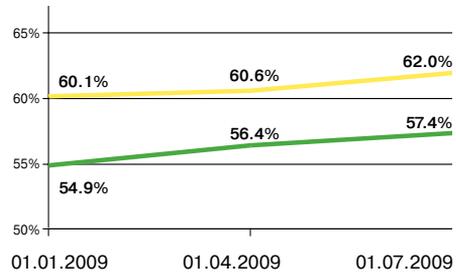
**Local banks**



**Center-Invest's share of the Rostov region market**



**Local banks**



Deposits      Loans

As a result, Center-Invest Bank retained its share in a shrinking market, and as early as Q2 2009 it began increasing this share.

**Table 3.3.3 Center-Invest Bank's observance of regulatory ratios**

Balance sheet ratios	Limit (IFRS/RAS)%	Actual as at 01.07.09 (IFRS/RAS)%
Capital adequacy	≥ 12 / > 10	23.26 / 18.13
Maximum risk per borrower	≤ 25 / ≤ 25	14.04 / 17.72
Maximum risk per party dependent on the bank	≤ 10	0.09
Maximum risk per group of borrowers related to the bank	≤ 25	0.15
Maximum size of the open foreign currency position for each currency or group of currencies as a percentage of capital	≤ 10	1.70
Total size of the open foreign currency position for a group of currencies	≤ 20	3.01
Operating ratio	< 80	61.54

An even more significant result was that the bank met the requirements on capital adequacy and respected all other covenants imposed by Russian and international agreements.

The experience of the 1998 crisis showed that Center-Invest achieves its pre-crisis positions within a year after a crisis ends.

**Table 3.3.4. Center-Invest Bank's performance indicators, IFRS and RAS**

RUR, millions		2008	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996
Capital	RAS	5,934	4,230	3,644	2,010	1,087	686	628	421	205	101	53	51	27
	IFRS	5,479	5,227	4,188	2,179	1,141	779	678	414	210	83	41	46	15
Assets	RAS	50,939	38,250	22,875	13,058	8,359	5,132	3,026	1,604	991	540	340	234	151
	IFRS	50,653	39,461	23,833	13,637	8,493	5,257	3,124	1,635	960	525	252	186	97
Profit	RAS	337	616	777	501	212	130	63	27	17	6	5	9	8
	IFRS	308	701	513	311	131	94	14	4	(7)	2	(4)	6	0.4

There is no need to radically change the balance of elements in the “South of Russia+” Strategy, and the main targets for the final year of the strategy (2012) will be achieved by 1.01.2013.

### 3.4. Financial Accounting and Reporting

International Financial Reporting Standards (IFRS) and Russian Accounting Standards (RAS) are different methods of classifying banking operations. Since 1996, Center-Invest Bank has reported under IFRS, and its accounts have been audited by PricewaterhouseCoopers.

Working with IFRS has taught the bank to evaluate every product and operation, not only in terms of Russian and international standards, but also in terms of tax accounting. We are obliged to use RAS for the Central Bank of Russia and IFRS for shareholders, international partners and ratings agencies. Naturally, this creates additional expenses, but the bank has sufficient experience to ensure that it operates efficiently regardless of the accounting system used. Regulators, financial institutions and Center-Invest's foreign partners have rightly praised our consistently high performance indicators under IFRS and RAS. In 2007 the Rostov Region tax authorities awarded the bank a Gold Confidence Certificate for the high quality of its tax accounting.

### 3.5. Independent Ratings

Ratings are another means of obtaining an aggregative independent assessment of bank's performance. Ratings agencies assign their ratings by analysing all of a bank's operations, and the quality of its loan portfolio and governance system (including internal control and risk management). The Russian agency RusRatings has rated Center-Invest Bank since 2004, and in this time it has upgraded its rating from B+ to BBB- "outlook stable".

In 2006 Center-Invest was rated B1 stable by Moody's. In 2007, the agency strengthened this rating, assigning it a "positive outlook". When international ratings agencies rate companies in developing countries they consider the general situation in the national economy, including the actions of regulators and government agencies. Consequently, when Moody's downgraded the country rating for Russia, Center-Invest Bank's outlook was also adjusted, first in October 2008 to "stable" and then in May 2009 to "negative", reflecting the worsening economic and financial situation in the country. However, the change in outlook has not affected our relationships with our partners.

### 3.6. Sustainable Development Business Model

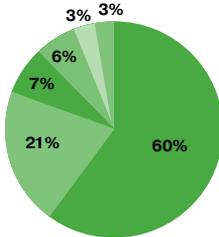
For its own sustainable development, a bank must ensure that its assets and liabilities are balanced in terms of time periods, risks, profitability and currencies. Thanks to its carefully developed strategy and business plans, the balanced structure of its assets and liabilities, and its effectively structured loan portfolio, Center-Invest is able to maintain the necessary ratios for these elements.

The bulk (63%) of Center-Invest Bank's assets are loans and leases to the real economy in southern Russia. Customer accounts constitute more than half of the bank's resource base. When considered together with shareholders' equity (14%), customers contribute 68% of the bank's total resources. Therefore, Center-Invest Bank is using resources from southern Russia's population and business community for the sustainable development of the region.

Companies in southern Russia lack their own long-term sources of finance for accelerated development. Therefore, Center-Invest attracts long-term

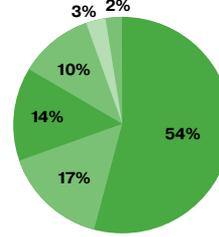
## Assets and Liabilities as at 01.07.2009

### Total assets, 39.718 billion rubles



- 60% — net assets
- 21% — cash and mandatory reserves with the Russian Central Bank
- 7% — fixed assets
- 6% — other assets
- 3% — net leasing
- 3% — securities

### Total liabilities, 39.718 billion rubles



- 54% — customer accounts
- 17% — due to international organisations and other borrowings
- 14% — shareholders' equity
- 10% — due to other banks
- 3% — bonds and notes
- 2% — other liabilities

resources on the Russian and international markets. Aware of the regional risks and managing them effectively, we use our reputation as a transparent and reliable bank to provide businesses and the general public with access to global financial markets. We use the opportunities offered by IFC and market mechanisms to encourage our partners to invest in successful business in southern Russia.

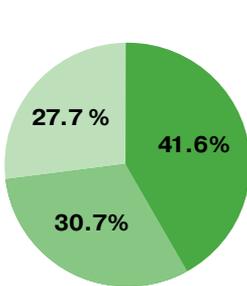
**Table 3.6.1. Center-Invest Bank's main transactions with international financial institutions**

Capital contribution	EBRD (2004, 2005, 2006), DEG (2005, 2006)
Subordinated loan	IFC (2004), BSTDB (2007), EBRD (2008), DEG (2009)
Guarantee	USAID (2002, 2004)
Trade finance	EBRD (2002)
Mortgage	DEG (2005), EBRD+FMO (2007)
Small business	IFC (2002, 2004), EBRD (2004, 2007, 2009), KfW (2004, 2008), DEG (2005, 2009), EBRD+FMO (2007), Russian Development Bank (2008), OeEB (2009)
Energy efficiency	IFC (2006), EBRD+FMO (2007), KfW (2008)
Agribusiness	EBRD (2008)

**Table 3.6.2. Center-Invest Bank’s main transactions with international financial institutions**

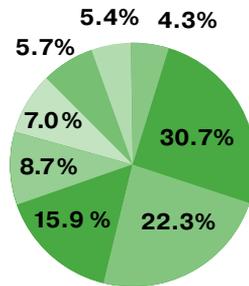
Date	Transaction	Arranger	Sum	Term, months	No. of participants
June 2006	First international syndicate	EBRD	USD30+15m	18+18	14
October 2006	Debut issue of ruble bonds	Rosbank	RUR1.5bn	36	—
October 2006	Syndicated loan on the Russian market	MMB (now UniCredit Bank)	RUR1.5bn	12	10
February 2007	International syndicate	Standardbank PLC Commerzbank AG	USD80m	12	37
March 2007	Debut CLN issue	TRUST Commerzbank AG	USD175m	24	> 50
September 2007	Syndicated loan for: mortgage lending, SMEs and energy-efficiency	EBRD + FMO	RUR1bn	5-7	2
October 2007	Syndicated loan on the Russian market	ZAO Raiffeisenbank	RUR1bn	12	8
February 2008	Extension of 2006 EBRD syndicate	EBRD	USD30m	18	11
February 2008	Extension of 2007 international syndicate	Standardbank PLC Commerzbank AG	USD145m	12	37
October 2008	International syndicate	Erste Group Bank AG	USD16m EUR30.8m	12	8

**Center-Invest Bank’s loan portfolio as at 01.07.2009**



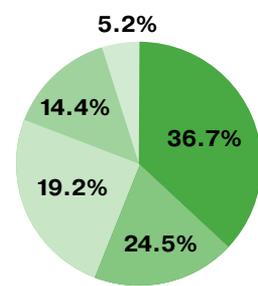
**By borrower**

- 41.6% — SMEs
- 30.7% — retail lending
- 27.7% — corporate lending



**By sector**

- 30.7% — retail lending
- 22.3% — trade
- 15.9% — agriculture
- 8.7% — other
- 7.0% — industry
- 5.7% — transport and communications
- 5.4% — construction
- 4.3% — energy



**By term**

- 36.7% — >1 year
- 24.5% — 91-180 days
- 19.2% — 181-365 days
- 14.4% — 31-90 days
- 5.2% — <30 days

Center-Invest Bank's total loan portfolio is RUR 25bln. We are very careful to ensure that we maintain the necessary balance in the structure of this portfolio:

- We lend to SMEs, retail customers and corporate customers in roughly equal proportions, while giving priority to SMEs;
- Consumer lending is split almost equally into consumer loans, car loans, and mortgage loans;
- The structure of the loan portfolio in terms of sectors avoids a concentration of risks and takes advantage of the diversification of southern Russia's economy;
- Thanks to our cooperation with international financial institutions and our sensible policy on expanding our deposit base, we successfully provide loans with a term of more than one year to retail customers, SMEs and the agricultural sector (more than 37% of the loan portfolio).

Our balanced loan portfolio enables us to select the best customers and maintain a high-quality portfolio. The audited accounts for 2008 showed that only 2.81% of loan payments were overdue. By the middle of 2009, the increase in loan arrears had stabilised at 5.89%.

Moreover, the bank's capital adequacy is almost double that required to comply with international standards.

### 3.7. Lending to the Real Sector

#### 3.7.1. Services for Business Customers

***Working with chains.*** Thanks to our extensive branch network in southern Russia, we can offer tried and tested services to chains: payment collection and centralisation of settlements (“bank to bank”), factoring, lending to head offices and divisions, and business promotion. Today, these services are used by a wide range of chains, including food retailers, car dealerships, telecommunications companies, construction companies, and heating, gas and water suppliers.

***Developing our customers' businesses.*** To help our customers grow their businesses, Center-Invest Bank finances customer projects to upgrade equipment, update products, and enter new market segments. To this end,

we use leasing, and project and structured financing, and we attract long-term financial resources from international banks and agencies.

As the Russian economy continues to undergo reform, companies must keep developing new products and services. Examples of Center-Invest Bank's successes in this area include: acting as a guarantor for the construction of infrastructure in the town of Bataisk, and developing special services for housing management and maintenance companies. Within the framework of national projects, in addition to retail lending, we lend to farmers for the construction of livestock production facilities, construction companies, and public health institutions; we act as a guarantor for our customers who are bidding in state and municipal tenders for the supply of goods and services; we provide our customers with guarantees for customs agencies; we guarantee contracts; and we also act as a counter-guarantor. In 2008 the bank issued guarantees totalling more than 1.7 billion rubles (32% — contract performance guarantees; 31% — customs guarantees; 26% — guarantees for tender bids; 11% — counter-guarantees).

Center-Invest participates in the EBRD's trade finance programme and is accredited with the agencies Hermes and Sace.

**Service packages.** By providing business support, Center-Invest can offer its customers the widest range of banking services. We can also help them find the best combination of services, which might include the co-financing of national projects and programmes and public private partnership projects.

When putting together a service package, the bank assesses the combined risks for each customer and selects the optimal range of products to enable the customer to develop their business. We take into account the risks of each product and the areas in which the customer operates.

**Securities.** With 80% of its risks concentrated in the real sector of the economy, which is performing well, Center-Invest Bank successfully trades on the securities market on behalf of its customers. The Bank Managed Mutual Funds (BMMF) set up by Center-Invest, "BMMF1" (corporate shares) and "BMMF2" (bonds and real estate mutual funds), are among the most profitable bank managed mutual funds in Russia. With extensive experience of assisting companies through the process of privatisation, and experience of using a corporate governance code and applying current legislation on shareholder companies, we help our customers to trade securities and build up investment portfolios.

### 3.7.2. SMEs

Center-Invest Bank introduced its first SME development programme in 1997. In addition to banking services, the programme provided legal support for SMEs, advice on taxation and business planning, and outsourced accounting. To break even the programme needed 150 participants; just two months after it was launched, more than 400 SMEs were taking part in the programme.

This success was recognised at federal level: experts from Center-Invest Bank were invited to give a new lease of life to the Federal Foundation to Support SMEs. The results of this work are discussed in the book “SMEs: made in Russia”\*.

Today, approximately 40,000 SMEs and sole traders bank with Center-Invest. In 2008, we lent these customers more than 14 billion rubles for business development. In just the first half of 2009, we have lent SMEs and sole traders more than 6 billion rubles. In terms of the scale of our lending to SMEs, Center-Invest ranks first among all banks in southern Russia. Nationally, we rank 7th for the number of loans and 9th for the volume of loans.

During these years of working with SMEs, many stereotypes have been overcome and *a new ideology established*.

Contrary to conventional wisdom, the reason the SME sector is growing is not due to any advantages of being small, but because these companies have been operating more effectively from the outset. It is in SMEs that the most effective projects are being set up, and that the most successful business people are working. The secret of their success is that they know their businesses, their markets, and their advantages in these markets, and they have a business development strategy.

A stereotype inherited from the communist era persisted for a long time: SMEs only operate in the shadow economy. A closer look at the situation revealed that the “shadow” was cast over SMEs by corrupt officials and bad laws. In response to this, for several years now Center-Invest has sponsored a “hot line” providing entrepreneurs with free advice on legal and financial issues. We regularly hold seminars on SME lending and advisory sessions on economic and legal issues\*\*, and arrange meetings with suppliers of new equipment to which we invite entrepreneurs from southern Russia.

\* [www.centriinvest.ru/ru/book/0201.html](http://www.centriinvest.ru/ru/book/0201.html)

\*\* [www.centriinvest.ru/ru/servicec/020902/html](http://www.centriinvest.ru/ru/servicec/020902/html)

A more contemporary stereotype is that SMEs need state support. In fact, state support for small and medium-sized enterprises is an enterprise in itself, one run by government officials. First of all they introduce laws, which make it impossible to run a business, and then they provide their “state assistance”. Developed countries already understand that assistance for SMEs must take a variety of forms, and that financial assistance alone is not always effective. Unfortunately, in Russia the emphasis remains squarely on financial support. By participating in the work of Enterprise Councils, the Chamber of Trade and Industry and the Union of Employers, representatives of Center-Invest are promoting at the regional level the provision of more effective forms of state support: methodological, legal, information, and staffing. In 2009, together with the Rostov Region administration, regional universities, and job centres, Center-Invest launched a new educational project “Enterprise for All”. This project is training the general public in basic enterprise skills\*. Amid the crisis, the hugely effective SME sector is actually capable of providing the state with support, in terms of creating employment and restoring economic growth and social stability. As they say in southern Russia, “If the SME sector didn’t stand between the authorities and the people, there would be a change in the ruling power”. This is why the government needs the support of SMEs.

In 2004, Center-Invest Bank assessed the potential of southern Russia’s SME sector to reach the same size as the SME sectors in developed countries (approximately 50 SMEs per 1000 residents). To reach this level in the SFD, investment of more than 200 billion rubles would be required to create more than 90,000 SMEs. In 2008, actual investment in the fixed capital of 40,000 existing SMEs was in the region of 45 billion rubles. Therefore, this sector in southern Russia has very good growth potential.

The last stereotype stems from the process of globalisation, which is apparently killing off SMEs. In reality, SMEs are quicker at adapting to new methods and finding new applications for developments in science and technology. Energy efficiency projects are a striking example of this adaptation.

Center-Invest Bank responds rapidly to any changes in the market, and this is reflected in our new loan products. We are constantly expanding our range of services for SMEs through the direct marketing of “standard” projects for target segments and groups of business people (replacing equipment in the service and trade sectors (including franchising), road

\* [www.centriinvest.ru/ru/business\\_education.html](http://www.centriinvest.ru/ru/business_education.html)

freight transportation, construction and repair work, the artisan business). We continue to provide assistance with the following:

- bringing the operations of SMEs into compliance with the law (through legal support, outsourcing accounting services, consulting services),
- the application of Internet technologies and Internet consulting to accelerate business development,
- international cooperation between SMEs,
- financing energy saving technologies.

Center-Invest Bank is a co-participant in the Regional Targeted Programme for SME Development in the Rostov Region for 2008-2012. In 2008 we won the right to work with the Not-for-Profit Partnership “Regional Guarantee Fund”, which provides SMEs in the Volgograd region with support in the form of loan guarantees.

Center-Invest Bank will expand its range of services for SMEs in the spheres of production, trade and services, including franchising, road transportation, construction and repair work, and agriculture. We have developed standard projects for small towns in southern Russia.

### **3.7.3. Energy-Efficiency Financial Engineering**

Russia is an energy-rich power, but it is five times less energy efficient than developed countries.

Center-Invest Bank is experienced in the successful implementation of energy efficiency projects, using financial engineering methods and working together with international financial institutions (IFC, the EBRD, FMO, KfW). We started running energy efficiency projects together with the IFC back in 2003, two years before the IFC officially launched its energy efficiency programme in Russia. As at 01.06.09 our portfolio of energy efficiency projects exceeded one billion rubles.

At the moment, it is hard to convince companies to invest in energy efficiency technologies, as energy prices are currently low in Russia. We have developed financial engineering methods that allow our customers to use integrated solutions and modern banking products to implement energy efficiency projects. Our programmes allow borrowers to obtain special-purpose finance for a term of up to five years. Tariffs will continue rising, and in the near future companies will need money to replace their

fixed assets. *However, Center-Invest Bank customers are already enjoying competitive advantages in energy efficiency.*

Center-Invest Bank only finances projects that are internationally recognised as effective. As a rule, energy efficiency projects are accompanied by cost savings in all other areas, and increase the efficiency of production across the board. Furthermore, the introduction of energy efficiency projects is accompanied by a review of the legal relationships between suppliers and energy consumers and increased transparency in these relationships. And last, but not least, the new, modern production processes are changing the social structure at companies, as young specialists are keen to work for companies that use modern equipment.

Center-Invest Bank works closely with consultants when introducing energy efficiency projects. Drawing on their experience, we can reduce the risks in lending for energy saving technologies, conduct more aggressive marketing, employ reference projects to promote the idea of energy efficiency, and also offer a range of banking products:

— consumer loans for energy saving purposes;



*Center-Invest Bank opened an office in Taganrog following the modernisation of a boiler house and the installation of energy efficiency equipment. This project was implemented as part of the EBRD's Sustainable Energy in Russia Initiative.*

- energy efficiency equipment leasing;
- factoring services for companies that install metering devices in blocks of residential apartments;
- outsourcing energy efficiency technologies;
- trade finance for contracts for the purchase of energy efficiency equipment.

Here are a few examples of successful energy efficiency technology projects:

- The modernisation and re-equipment of a factory producing French baguettes (investment – 8 million rubles) reduced harmful emissions and cut energy costs by 375,000 rubles a year;
- The installation of a boiler fuelled by husks resulted in waste-free production and reduced the cost of producing one Gcal by 46%. The project cost 40 million rubles, and the payback period was four years;
- New printing equipment increased productivity 1.4 times and almost halved energy consumption. The total cost was 20 million rubles, 17 million rubles of which was financed by Center-Invest.
- A furnace modernisation project in a brick factory in the city of Taganrog, which cost 10 million rubles, and had a 3 year payback period.
- Upgrading a pipeline in the Neklinovsky district prevented water loss and achieved a threefold reduction in electricity and oxygen consumption.

Center-Invest Bank's customers can also obtain a free of charge energy audit of their production. Our website contains information about typical energy efficiency technologies in all sectors of the economy. The modernisation project of the district heating company Teploenergo, in Taganrog, is a striking example of a successful energy efficiency project. By replacing equipment in three old boiler houses, the company achieved a threefold reduction in the cost of producing one Gcal, reduced CO<sub>2</sub> emissions by 200 tonnes a year, electric power consumption by 66% and water consumption by 80%. The opening of a Center-Invest office in one of the modernised boiler houses is symbolic of the success of this project.

After the success of this project, the EBRD purchased an equity stake in the company and provided a long-term loan for a new boiler house modernisation project. The project will cost 356 million rubles, and it will reduce gas consumption by 2,000 cubic metres annually (4% of current consumption) electricity consumption by more than 1GWh (10.5% of current consumption), and the number of staff working in a hazardous environment by 172 (40.1%). An annual CO<sub>2</sub> reduction of 6,800 tonnes is anticipated.

Twenty dangerous boiler rooms are to be closed in Taganrog. In the

Rostov region, 200 old boiler rooms need to be shut down. In southern Russia, there are approximately 700 such boiler rooms, and across the country there are more than 2000.

### 3.7.4. Agribusiness

Agriculture in southern Russia is a historic sector of the Russian state, and it is the region's primary industry. It is of social and political importance, it is profitable, and it is stable in terms of demand. Center-Invest has long and successfully worked with agribusiness in southern Russia. Our agribusiness loan portfolio, including loans to agricultural producers, agricultural processing companies, and companies engaged in the trade and transportation of agricultural products, is 6.5 billion rubles (15-20% of our total loan portfolio). Western ratings agencies are uncomfortable about banks lending to agribusiness. However, we understand both the potential and the risks of this sector, and we can effectively manage these risks. Our experience of lending to agribusiness shows that:

- The re-equipment of southern Russia will require loans with a term of up to five years. The harvest is usually poor in two out of every three years. Therefore, in a five-year period there should be two good years, which will be sufficient for the borrower to repay their loan;
- The re-equipment of agribusiness will entail more than simply replacing individual tractors and combine harvesters; whole systems of machines and technologies require modernisation. Using best international practice and technical assistance, this could cut costs by up to 30%;
- Due to the underdevelopment of the land market, agriculture is lacking sufficient collateral. Therefore, leasing is the most acceptable form of lending for equipment modernisation. Leasing operations in Russia do not require special licensing, and are recorded in the bank's balance sheet;
- The equipment for storing and processing agricultural products at farms also requires modernisation, as losses are currently as high as 30%.
- Increased lending to agribusiness by state-owned banks, which have access to long-term and cheap funds, is squeezing agribusiness out of the portfolios of those few commercial banks that are willing and able to lend to this sector. Given the higher levels of bureaucracy in state-owned banks, this can be said to be to the detriment of agribusiness. However,

Center-Invest Bank has major competitive advantages in southern Russia's agricultural sector:

- We were the first to become proficient at using agricultural land as collateral, with due regard for Russian legislation;
- We are in close proximity to our customers thanks to our extensive branch network;
- Our credit officers understand the specific nature of agribusiness;
- We manage regional risks effectively;
- We support new technologies in agriculture;

Southern Russia accounts for 25% of the country's total agricultural output. At the same time, agriculture in Russia is less productive than in European countries with similar natural and climatic conditions. This lag is due to the lack of modern equipment for producing, storing and processing agricultural products. With modern equipment and technologies, Russia's agricultural sector could increase its output by 50%-100%.

In addition to new equipment, southern Russia also needs qualified and skilled staff. To this end, there is a need in rural areas for professional training, good housing, and improved infrastructure.

The global trend of rising food prices requires international financial institutions to act very responsibly and to take timely and appropriate decisions in response to the crisis on food and financial markets. This should take the form of:

- a willingness to finance the modernisation of agricultural equipment. This is especially important given that ratings agencies continue to consider lending to agribusiness to be more risky than mortgage lending;
- the availability of long-term resources to finance reference projects showcasing international best practice;
- an indication to financial markets that lending to agribusiness in developing markets is an attractive proposition, and that it can take the form of long-term finance, leasing, securitisation of loans to agribusiness, and long-term syndicated loans (e.g. A-B structured loans).

In August 2008, the EBRD provided Center-Invest Bank with a loan to develop agribusiness in southern Russia. This was the first time that the EBRD had provided a Russian company with a loan for this purpose. The five-year, 600 million ruble loan is to be used to introduce and demonstrate international best practice and equipment and technologies for producing, storing and processing agricultural products.

Upgrading the equipment at a farm with a crop acreage of 7,000 hectares requires investment of about 3 million dollars and 1.5 million dollars in seasonal credit. The return on investment in a farm in southern Russia is more than 60%. Modernising the farms of Center-Invest Bank's customers alone would require 600 million dollars in investment loans and 300 million dollars in seasonal credit.

### 3.8. Retail Business

*A sustainable development business model presupposes a balanced policy on accepting retail deposits and providing retail loans.* Center-Invest Bank is aware that personal income in southern Russia is one third less than the average in Russia, and that the provision of retail banking services in the south lags three to five times behind that in European countries. However, this does not justify the use of certain “new” lending methods, such as express lending and lending by supermarkets and other retail outlets. While such practices enable a bank to build up its loan portfolio more rapidly, scratch below the surface and you will see deceitful, inflated interest rates, future defaults, and the personal tragedies of real people.

In addition to accepting deposits and lending, we provide a wide range of retail banking services: money exchange, cash transfer for non-account holders, including through Western Union; acceptance of utility bill payments; the sale of commemorative and investment coins; safekeeping of valuables and cash in individual safe boxes; and tax advice for individuals.

At the end of the first half of 2009, Center-Invest Bank had deposits of 14 billion rubles. Every month, our foreign currency exchange operations exceed 7 million dollars and 1.5 million euros.

Nineteen of the bank's branches, in twelve towns and cities in the Rostov region, Krasnodar Krai and Stavropol Krai, have specially equipped rooms with individual safe boxes.

We have signed agreements on accepting bill payments with all the main utility providers. Our customers pay their utility bills either in cash or by direct transfers from their bank accounts.

Customers can access our banking services 24 hours a day.

More than 7,000 VIP customers use our Private Banking Centre. Each VIP customer is assigned a personal manager and a tax consultant.

**Retail lending.** From the outset, we have been very careful in our approach to retail lending. We have procedures that must be followed for our standard retail product line (consumer loans, car loans, mortgages) to assess whether the borrower and his family have a steady income, the future plans of the borrower's relatives, and the immediate and long-term plans of the borrower himself. With all of our loan programmes, both at the advisory stage and loan agreement stage, we inform customers of the total cost of the loan, including all possible additional costs for issuing and servicing the loan (such as mandatory insurance, the cost of valuing real estate, annual service charges for bank cards).

Center-Invest Bank is able to keep growing its consumer loan, car loan and mortgage loan portfolios without increased risk. This is thanks to: our well-developed branch network, our many years of experience, the fact that we are ahead of our competitors when it comes to developing new products, our use of plastic cards, and the application of scoring methods with information from credit agencies. Our branches and Head Office are open to our customers six days a week, and agree a new loan every minute. As a result, as at 01.07.2008 Center-Invest had a retail loan portfolio of more than 10 billion rubles. More than 55,000 people from southern Russia had Center-Invest Bank loans, and this included customers who had left the region for new challenges in Moscow, St. Petersburg and European capitals.

In the first half of 2009 the number of borrowers increased to 76,000, amid an insignificant fall in the loan portfolio to 8.5 billion rubles. According to different criteria, Center-Invest ranks 25th, 35th, and 49th among the top 100 Russian banks for retail lending.

The standard consumer loan is issued for a term of up to three years. The purposes for which these loans may be used include: purchasing durable goods, paying for education, medical treatment, unforeseen expenses, and vacations. The borrower's salary, property (including third-person property), and guarantees from legal entities or individuals may be used as security. The loan is repaid in equal monthly instalments.

Car loans are medium-term loans. Center-Invest has a wide range of loans to help its customers acquire vehicles, including new cars and commercial vehicles. A down payment is one of the loan conditions.

Mortgage loans are long-term loans. Depending on the market situation, the term can be for up to 30 years. To obtain a mortgage, the customer generally needs to have a certain amount of his own money for a deposit.

A considerable competitive advantage for the bank is that together with standard programmes (off-plan house purchases, purchases on the resale market), it offers non-standard products, including mortgage loans for the construction/completion of the construction of houses, the purchase of land plots, and the purchase of commercial real estate.

Center-Invest Bank credit cards give customers 24-hour access to credit all over the world, without the need for collateral or a guarantee, and the credit limit is restored once the balance has been paid. The bank offers a flexible payment system: customers can make a minimum monthly payment, or pay the balance in full, and they can make payments on any day of the month. This allows customers to plan their payments to suit their financial position at a given time. A grace period allows customers to avoid interest charges if they pay the balance in full before a certain time.

Customers can also deposit some of their own funds on their Center-Invest credit cards, as they will be paid interest on them. As they also use less of their credit limit, they pay less in interest charges.

### **3.9. Operations Development**

A modern bank is a complex, living organism, in which strict, formal procedures should ensure the uninterrupted performance of all operations. Center-Invest Bank manages approximately 40,000 business accounts and 170,000 personal accounts.

One of our competitive advantages is that all our branches respond very promptly to customer needs. Our business customers really appreciate that it only takes an hour to open a ruble or foreign currency account, and that all the paperwork is certified in the bank itself.

Accounts are managed on the basis of written instructions from the customer and remote banking. Information about account status and transactions can be provided either by a personal manager or by telephone. The customer support telephone line, which uses an interactive voice response system, has an easy to remember number: 2-000-000. The bank executes customer payment instructions on the day they are received. In the event that a customer does not have enough money in their account at the time a payment falls due, they are not penalised provided that the funds are in their account by the end of the day. Accrued interest is paid on balances

over a certain sum, and we provide free of charge inter-branch payments between any of our 129 branches in southern Russia. Moreover, the money is transferred in just ten minutes.

Center-Invest Bank is one of the leading banks in southern Russia in terms of the amount of money handled for business customers. The total balance in Center-Invest Bank business current and deposit accounts is more than six billion rubles. Every day we make about 40,000 payments for our business customers, totalling more than four billion rubles.

Customers can make cash deposits and withdrawals six days a week, and cash collection and delivery services are available for our business customers 24-hours a day.

For our customers with foreign currency accounts, Center-Invest Bank provides very rapid international payments to anywhere in the world; services foreign trade contracts; provides trade finance services; and advises on compliance with currency legislation.

Operations development is supported by the information system, which is itself constantly being developed, and also by the internal control and risk management systems.

### **3.9.1. Developing the Information System**

Today, all Russian banks face the challenge of updating their information systems. Center-Invest Bank began its latest project to address this challenge in 2005.

We have been able to draw on our own experience of independently developing information systems. Until 1995, the bank's system had comprised autonomous modules based on FoxPro. In 1996 we began developing a system based on Informix, which gave us the flexibility to introduce new products at the right time and adapt to the ever-changing regulatory framework. The system also supported branch expansion and proper inter-branch coordination.

In line with the objectives in our business development strategy, Center-Invest agreed an IT Development Strategy, based on the following principles:

- The information system (IS) should have a centralised architecture;
- An integrated system will be used as the core bank system, and it will be supplemented with specialised solutions (the “best of breed” approach);

— The information system should be highly reliable, fault tolerant, and disaster proof. It should be designed to process large volumes of transactions rapidly, seven days a week, 365 days of the year. To ensure the proper functioning of the bank and its development, the IT Strategy envisages a range of measures, which can be divided into processes and projects. Generally speaking, processes are used to automate the company's operations, and they are grouped into main categories: planning and techniques, delivery and development. In accordance with its IT Strategy, Center-Invest uses the COBIT\* standards and the ITIL library\*\* to increase the effectiveness of its process management.

Work on complex or lengthy measures to improve the information system is grouped into projects, according to objectives, and in turn the projects are grouped into programmes of projects. Project management in the bank is conducted in accordance with the PMBOK Guide\*\*\*. We bring in contractors, primarily Russian consulting companies, when an IT project entails large amounts of work. Particularly successful projects include the introduction of software for the plastic card processing centre, a remote banking system for business customers, and a system for handling payments between Center-Invest Bank and the Russian Central Bank.

By far the largest block of work is the programme of projects to replace the automated banking system, which we developed ourselves, with a centralised SAP for Banking system. We chose the system in 2005 on the basis of a tender. SAP for Banking was selected out of the 16 bidders because it offers the following advantages:

- commercial productivity and scalability;
- division of business and accounting layers;
- a built-in mechanism to manage business processes;
- a software code that can be reviewed and edited.

In addition to the benefits mentioned above, SAP has the following advan-

\* COBIT (Control Objectives for Information and Related Technology) is a set of open documents, approximately 40 international and national standards and guidelines on IT management, audit and IT security. At present, the main developers of the standard are the IT Governance Institute and the Information Systems Audit and Control Association, ISACA. Their aim is to develop and promote IT management principles.

\*\* ITIL (Information Technology Infrastructure Library) is a series of books describing the best IT practices for IT divisions and companies. The library was set up about 20 years ago by the British government. At present, it is published by the UK's Office of Government Commerce and it does not belong to a commercial entity. The seven books describe all the processes required to provide consistently high quality IT services and to increase customer satisfaction. The approach used in the library is consistent with ISO 900 standards (GOST R ISO 9000).

\*\*\* PMBOK (Project Management Body of Knowledge) is a set of documentation encompassing the sum of professional knowledge on project management. As is the case in other professional spheres, such as jurisprudence, medicine and accounting, the body of knowledge is created by practitioners and theoreticians, who use and deepen this knowledge.

tages: it is modular, adaptable, integrable with other systems and platforms, ready for further development, and its process solutions apply best international practice. We intend to use these benefits to strengthen our own competitive advantages. The new information system is being introduced in accordance with an agreed schedule and within a budget approved by the Board of Directors. The system will guarantee the bank the reliability of its operations for the next 8-10 years, and it will make our operations three to five times more efficient.

In 2006 all of Center-Invest Bank's business units began standardising their products and services: standard descriptions were produced for products, sales techniques, methods of working with customers, and risk management. On the basis of this exercise, updated versions of document flows and interfaces between business units were introduced, and changes were made to the product development system, the risk management system, and sales techniques. This will enable us to reduce the costs of promoting our products and will make our work more responsive while maintaining optimal risk levels.

The following stages have been completed: planning, designing the main functionality, making and testing most of the modifications, and putting the personnel management module into commercial use. It is planned that by the end of the year the centralised customer database and the forms for mandatory reporting to the Central Bank will also be in commercial use. The next stage will be to launch the business functionality in a pilot branch and then in Head Office, and after that the system will be rolled out in the remaining eight main branches.

*Performing its social role and addressing the issue of staff training, in partnership with SAP CIS and the Southern Federal University (SAP University Alliance Program), in 2008 Center-Invest Bank opened a centre to train specialists in SAP applications. In 2008-2009 the centre and Center-Invest Bank ran the first international project. Participants included students from Germany (Munster University), Moscow (Higher School of Economics) and Taganrog (Southern Federal University)\*.*

### **3.9.2. Expansion of the Branch Network**

Using our in-depth knowledge of the regional market of southern Russia and careful studies of the growth prospects of each area, we are ex-

panding our regional network in the most rapidly developing towns and districts of the Rostov, Volgograd and Astrakhan regions, Krasnodar Krai and Stavropol Krai\*. In addition, we are helping our business customers make contacts in other Russian regions that have close ties with the SFD, and also international contacts. To this end, Center-Invest Bank has correspondent arrangements with Russian and international banks, providing reliable payment and settlement services, including payments by bank cards.

As we further expand our branch network, we will use our strengths and advantages in the following sectors: SME development (including the recreation and service sectors), lending to agribusiness, retail banking (including mortgages and car loans), trade finance (including the supply of modern equipment), investment projects (including leasing), energy efficiency lending, and working with chains.

The aim of expanding the branch network is to duplicate Center-Invest's products and services. All of our branches provide customers with a full list of banking products and services.

Before deciding to open a branch, we study the market and calculate the payback period. We then select premises and train the staff.

The branch network is developed in accordance with business plans for each branch, which have a payback period of 1.5 years on average. The branches, which are uniform in design, are situated in buildings that the bank either owns or rents in business districts. We are particularly careful to ensure that there is a clear title when we purchase or rent property for branches. The growing role of banking technologies based on bank cards means that we must continue expanding our ATM network. We already have more than 200 ATMs and we have issued 150,000 plastic cards. In 2007, Center-Invest successfully introduced its own processing centre. The authorisation centre now processes all of the transactions carried out at Center-Invest bank machines, whether using our own bank cards or those of other issuers, and also the transactions made using our bank cards in third-party networks.

***Managing the regional network.*** The operation of the branches and sub-branches is organised as follows:

- At the start of the year, the branches are provided with an annual business plan with quarterly targets and cost estimates. Budget execution and progress against the business plan is reviewed quarterly, while the

\* [www.centriinvest.ru/ru/pub.html](http://www.centriinvest.ru/ru/pub.html)

**Table 3.9.2.1. Indicators for the expansion of the branch network in the SFD as at 01.07.2009**

Structure of the branch network in the SFD	No. of branches	No. of employees	Loan portfolio, millions of rubles	Deposits, millions of rubles
Rostov region	93	636	14,858	9,270
Krasnodar Krai	22	163	4,019	994
Volgograd Region	6	56	1,082	134
Stavropol Krai	8	44	443	185

branches' main performance indicators are monitored weekly. This allows us to plan the introduction of new products, procedures and technologies, as well as staff training, and subsequent monitoring.

- When a new branch is being opened, the staff undergo in-house training at Head Office and at similar sites. To promote the successful operation of the branches, we operate a “guardian” system: each functional business unit at Head Office has a member of staff (a “guardian”) who is responsible for providing assistance to the bank’s branches, for example, advising them on the launch of new products. Every month, we provide forums for the sharing of experience between branches and between Head Office and branches. Bonuses for branch employees are based on the return achieved by the branch relative to its wage fund. Branch managers are also responsible for ensuring that their team meet certain quality parameters.

Center-Invest Bank has a total of 131 branches: 93 branches (including 9 main branches), 36 sub-branches and 2 representative offices in London and Moscow.

In the SFD, up to 60% of sales of goods and services is intraregional (within the SFD). Our developed branch network in southern Russia allows us to work with customers who are engaged in trade with other federal districts, and to compete and use our advantages and knowledge of our customers in southern Russia.

The bank’s new information system and developments in telecommunications are enabling us to speed up payments between branches, expand our Internet banking services and the Bank-Client system, reduce requirements for working capital, and increase the amounts of money that

our customers pay into their current accounts. Using direct marketing we will be able to expand the uptake of our existing quality services, and be proactive in offering our customers a range of international-standard services. The standardisation of charges has allowed us to achieve a high level of return on our payment and settlement operations, including for foreign trade contracts.

At Center-Invest Bank we maintain very close contact with our customers, regularly offering them new products and services, and advising them on new areas for business development and the introduction of new methods, equipment and products. We also offer our business customers “standard” projects for energy saving technologies, leasing, trade finance, bank cards, and social packages for their employees, including payroll mechanisms.

In addition to direct contact with individual managers, we also make considerable use of briefings and seminars, advertising and information campaigns and free-of-charge public advisory sessions.

In 2006 Center-Invest Bank started using a new customer list management system. The manager of each branch puts together a list of its ten largest customers and its ten most rapidly developing customers, and the branch then works logically through this list. As a result, our very best customers are informed promptly about our new products, and the customer list is constantly updated. As Center-Invest works in various economic sectors, we can promptly identify new areas and trends of interest to our customers. And drawing on the experience of our international partners, we can recommend best international practice for introduction in southern Russia.

Our personnel policy is based on the idea that we should nurture our people. Every year, more than 100 students are accepted for year-long work placements at Center-Invest Bank. At the end of these placements, we offer the best students employment with Center-Invest. The innovative nature of our work attracts creative people; the need to strictly adhere to banking regulations and procedures teaches them to combine this creativity with a disciplined approach. Every year at least two employees complete their PhD thesis.

As we continue to expand our branch network, we must continue improving the competitive selection process for branch managers, as well as their training and retraining. We operate a system of horizontal staff rotation, whereby prior to becoming branch managers, employees work as managers in other departments, so as to gain a broad understanding of our operations.

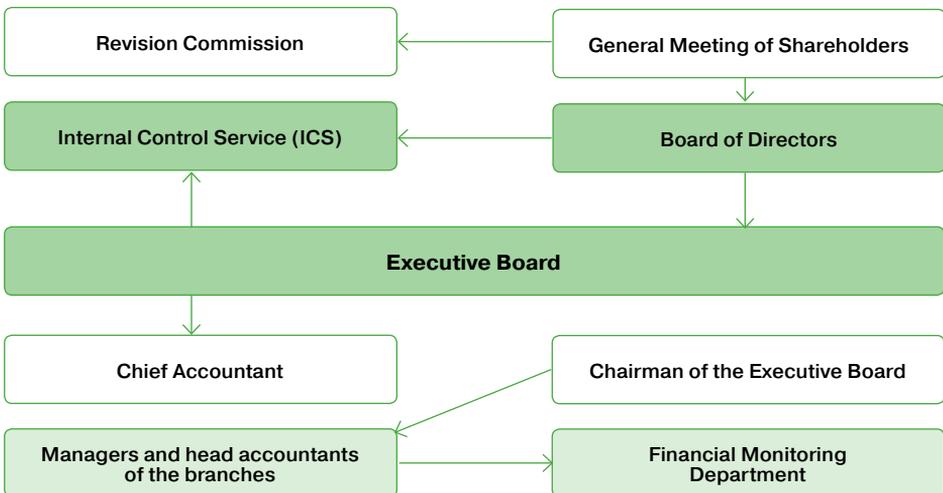
We are continually training our staff, moreover, to international standards. As part of this training, we invite consultants and experts to talk about the latest issues in banking.

### 3.9.3. Internal Control

Internal control is often viewed as an additional business expense. Assisted by international consultants, Center-Invest Bank has created a practical internal control system, encompassing all of its governing bodies and business units and the functional areas of its business. The work of the Internal Control Service (ICS) is based on procedural regulations on the planning and organization of inspections, monitoring, and reporting. Internal control does not just reveal violations of rules and procedures; it also generates proposals on improving these rules. In December 2008-January 2009 Center-Invest Bank passed the latest routine Russian Central Bank inspection unconditionally, clearly demonstrating the effectiveness of our internal control system.

In creating our internal control system, we were guided by the requirements of the Russian Central Bank, the recommendations of the Basel Committee on Banking Supervision, and international practice.

#### Center-Invest Bank's system of internal control bodies



Internal control is carried out by the internal control bodies acting in accordance with the competencies stipulated in the bank's charter and internal documents. It is important that internal control is not limited to the internal control service, but encompasses all levels of management.

The Board of Directors determines the general principles for the management of the bank, and is responsible for the creation and functioning of a suitable internal control system throughout the whole business.

The Executive Board is responsible for the day-to-day management of the bank, with a view to addressing the tasks set by the Board of Directors.

The chairman of the Executive Board is responsible for the implementation of the bank's strategy and policy, as approved by the Board of Directors, and for performing the functions assigned to him/her to ensure an effective internal control system.

The General Meeting of Shareholders elects a Revision Commission to oversee the bank's financial and business activities.

The chief accountant and his deputies ensure the execution of a properly formulated accounting policy, examine shortcomings that are identified with respect to reporting and accounting, and also oversee the movement of property and the bank's compliance with its obligations (including by means of inventory taking).

The managers (and their deputies) and the head accountants (and their deputies) of the bank's branches are responsible for achieving certain qualitative and quantitative milestones for each area of the branch's activities, as determined in accordance with the bank's strategy and policy and approved by the Board of Directors, and for performing the functions assigned to them to ensure an effective internal control system.

The Internal Control Service (ICS) is a key part of the internal control system. The ICS was created on the basis of a Board of Directors resolution. Its purpose is to carry out internal control and help the bank's governing bodies assure the effective functioning of the bank. The ICS acts in accordance with the "Regulation on the Internal Control Service of Center-Invest Bank", as approved by the Board of Directors.

The Financial Monitoring Department takes measures to identify and prevent money laundering and the financing of terrorism.

**Areas of internal control.** The internal control bodies monitor the organisation of the bank's activities; the functioning of the risk management system; the assignment of competencies to bank employees, and employee

compliance with these competencies when carrying out banking operations and other transactions; and the level of information security in the bank.

The functioning of the risk management system is monitored on a constant basis. This entails identifying, measuring and determining the acceptable level of risk, constantly overseeing risks, and taking measures to maintain risks at the permissible level.

The bank ensures that duties and limits on responsibilities are allocated among employees so as to avoid conflicts of interest, the commissioning of crimes, and any other unlawful behaviour when carrying out bank operations and other transactions.

The bank monitors employee compliance with assigned competencies when carrying out bank operations and other transactions. This includes monitoring compliance with the following: the procedures for bank operations, the hierarchy of authorisation limits that runs throughout the organisation, and the procedure for notifying violations, errors and shortcomings so that measures can be taken to rectify these problems and prevent the occurrence of similar mistakes.

With respect to information security, the bank monitors information flows (the receipt and transmission of information); prevents unauthorised access to confidential information; and produces internal documents on monitoring the management of information flows and providing information security.

***The internal control system is constantly monitored*** with the aim of assessing the extent to which it satisfies the bank's requirements, identifying shortcomings, producing recommendations, and monitoring the implementation of agreed improvements to the system.

***The ICS is an independent service.*** It reports to the Board of Directors, represented by the Audit and Compliance Committee. The Board of Directors determines the structure and composition of the ICS. The head of the ICS is appointed and relieved of his duties by the Board of Directors. The employees of the ICS are bank employees.

The ICS's remit extends across all areas of the bank's activities, and to inspecting the work of all the bank's business units and employees.

The ICS's functions are: checking and assessing the effectiveness of the internal control system and the procedures for risk management, information security, reporting and accounting, and the safekeeping of assets and property; and checking the compliance of the bank's internal documents

and operations with legislation and regulations, assigned competencies, and observance of legislative requirements on financial monitoring.

The ICS operates according to the following principles: the going concern principle, independence, impartiality and objectivity, honesty, confidentiality, and the all-inclusiveness of checks.

The ICS assigns a rating to the bank's business units according to two groups of factors: 1) the level of risk inherent in the operations being performed (the volume of operations and the rate at which this volume is increasing per business unit and per employee); 2) the quality of the management and the monitoring of the operations being performed (the relevance of current regulations; the extent to which operations are automated; the number of staff, the staff turnover rate, and staff experience and professionalism; the existence of proper limits; the execution of the business plan; whether any violations were revealed by previous inspections, and the extent to which they have been eliminated; and a number of other factors).

The ICS's work plan for the year is decided on the basis of three main groups of considerations: ICS's structure and number of staff; the bank's structure (Head Office and the branch network), and the bank's products (the areas of the bank's activities).

Following an inspection, the ICS compiles an auditor's report which it submits to the Audit and Compliance Committee of the Board of Directors. At the same time, a copy of the report is submitted to the Chairman of the Executive Board. The final report is issued to the head of the business unit that was inspected and, in the case of branches, to the guardians at Head Office. These members of staff are then to organise the work required by the audit findings and take measures to eliminate any shortcomings identified.

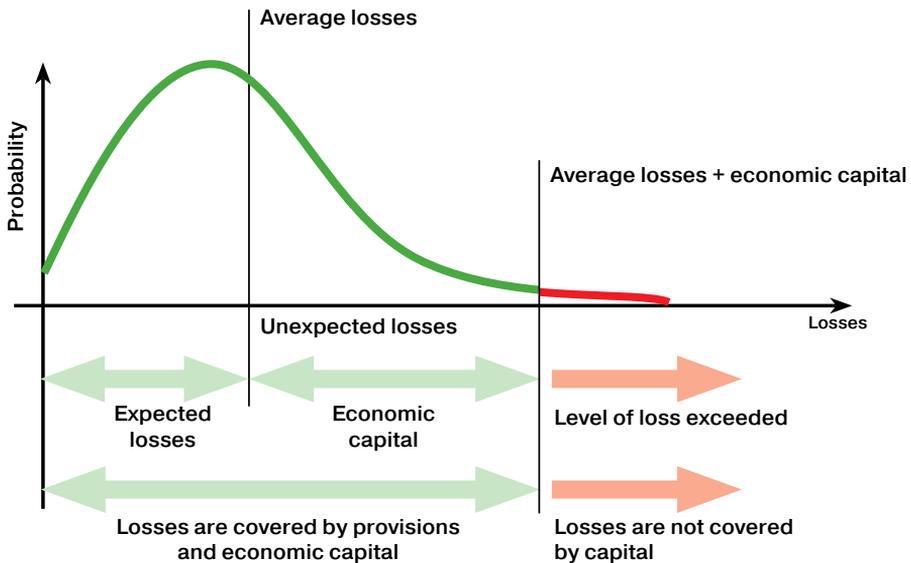
The head of the ICS reports every quarter to the Board of Directors on progress in implementing the ICS's work plan.

#### **3.9.4. Risk Management**

Risk management is a new area of work, connected with the transition to the Basel II principles. These principles are based on the idea that banking is essentially the buying and selling of risks. Accordingly, capital adequacy is determined with due regard for the risks (credit, market, operational) that the bank assumes as it endeavours to make a profit. When we were working

on our new risk management policy, we invited international consultants to advise us, and we arranged for some of our experts to have secondments with German and Austrian banks. Ultimately, working within the parameters of the Center-Invest Bank Strategy and business plan, we calculated the risk limits for our business areas and our capital adequacy. **The calculations showed that Center-Invest Bank's capital is double the amount of minimal economic capital required to cover the risks of unexpected losses.**

### Approach to assessing risks and distributing losses



Risk management in Center-Invest Bank is seen not just as a means of controlling the quality of the work of our support and business divisions; it is a full set of measures designed to protect the bank's assets. The main aims of the risk management system are: increasing the bank's assets with due regard for the risks; ensuring that risk exposures are covered with adequate provisions and capital; managing risks and keeping the size of these risks within the set limits; supporting the decision making procedures for accepting risks; optimising business processes with due regard for risks; developing procedures and methods for managing risks; and protecting our property interests and strengthening Center-Invest Bank's image.

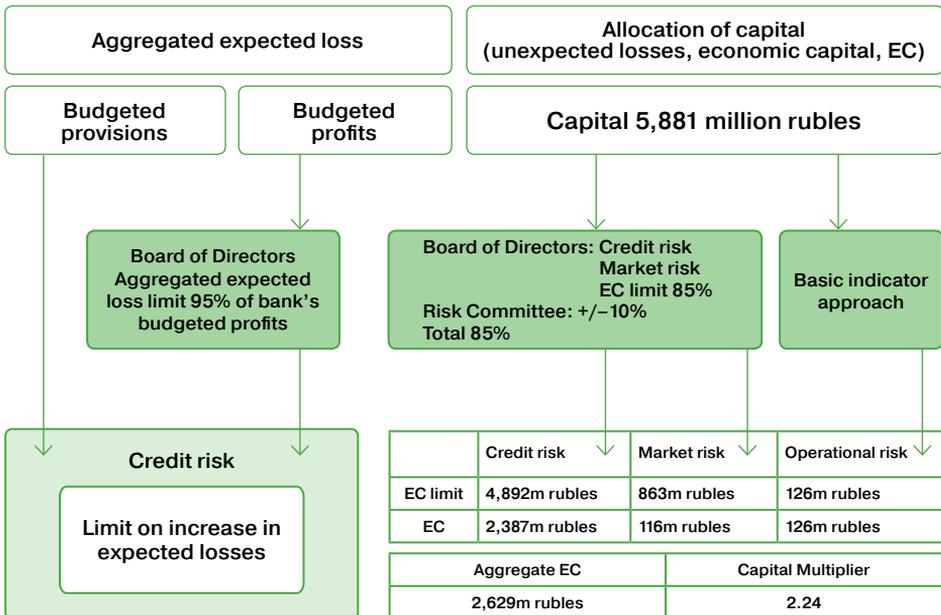
Center-Invest Bank’s risk management policy is approved by the Board of Directors and sets out:

- the risk management strategy and the procedures for its implementation;
- the areas and types of risks that must be monitored;
- the procedures for the interaction between business units in the risk management function.

Center-Invest Bank’s risk management strategy envisages the following: the bank will accept risks with reference to the profitability and the risks of the different business areas; priority will be given to developing lending, as this is the type of risk that is most effectively controlled by the bank; the market risks of assets will be re-evaluated regularly; risks will be taken into account when evaluating the effectiveness of business areas; and capital and provisions will be managed effectively.

When measuring risks in general, consideration is given to expected losses, which are covered by provisions, and unexpected losses, which are absorbed by the bank’s capital.

**Risk coverage as at 01.07.2009**



Expected losses are covered by provisions created out of the bank's profits. When it approves the latest business plan, the Board of Directors determines the budgeted provisions and the limit on aggregate expected losses, which sets an upper cap on the additional (above budget) provisions that may be created in the reporting period. This is expressed as a percentage of the bank's budgeted profit for the period.

In accordance with Basel-II, Center-Invest Bank's capital is allocated between credit, market and operational risk. We use the following methods to allocate capital:

1. Allocation of capital to operational risk (calculated in accordance with the BASEL-II Base indicator approach);
2. Allocation of the remaining capital between credit and market risks in accordance with the ratio approved by the Board of Directors;
3. Each kind of risk (credit, market and operational) must be covered by allocated capital.

The level of risk exposure relative to the bank's capital limits characterises the bank's stability in terms of its approved business model and available capital. In 2009 this ratio was consistently above 150%.

The level of aggregated expected loss is determined for each area of banking activity.

Center-Invest Bank's risk management policy envisages the use of a wide range of risk management methods, including:

- Avoiding risk by refusing to take on assets or perform operations which are unacceptably high risk;
- Restricting risk exposures and concentrations of risks by setting limits;
- Providing a collateral base;
- Insuring risks;
- Allocating adequate provisions to risks;
- Allocating adequate capital to risks;
- Hedging risks;
- Securitisation of assets.

The introduction of the BASEL-II principles in Russian banks is complicated because the banks have not yet had time to accumulate the necessary historical data to use the advanced approaches permitted by BASEL-II. Also, the distributions of losses are unstable and subject to change. To resolve this problem, we use a synthesis of analytical mathematical tools, data warehousing, and expert assessments by specialists with many years of practical experience.

We categorise our main risks as follows: credit, market, operational, and liquidity.

Credit risk	Market risk	Operational risk	Liquidity risk
<ul style="list-style-type: none"> <li>— Individual approach to analysing loans issued to legal entities;</li> <li>— Obtaining security for credit lines, and evaluating collateral and other forms of security;</li> <li>— Monitoring information about the borrower and the collateral;</li> <li>— Centralised online loan origination system (system for loan decision-making);</li> <li>— The one obligor principle;</li> <li>— Allocation of appropriate capital;</li> <li>— Making provisions.</li> </ul>	<ul style="list-style-type: none"> <li>— Monitoring currency risk;</li> <li>— Monitoring and controlling the trading book;</li> <li>— Daily evaluation of VaR;</li> <li>— Using swaps to hedge open currency positions;</li> <li>— Interest rates GAP analysis;</li> <li>— Stress testing;</li> <li>— Allocating capital to cover market risk.</li> </ul>	<ul style="list-style-type: none"> <li>— Quality of internal procedures and processes;</li> <li>— Gathering and storing information on operational losses;</li> <li>— Allocating capital;</li> <li>— Insurance;</li> <li>— Checking source information and fraud detection;</li> <li>— Internal security procedures, and security of the operational environment;</li> <li>— Internal audit and compliance;</li> <li>— Information security and audit of systems;</li> <li>— Business continuity management and planning.</li> </ul>	<ul style="list-style-type: none"> <li>— Managing assets and liabilities;</li> <li>— Monitoring liquidity indicators;</li> <li>— Assessing liquidity deficit;</li> <li>— Diversified sources of finance;</li> <li>— Liquidity crisis action planning.</li> </ul>

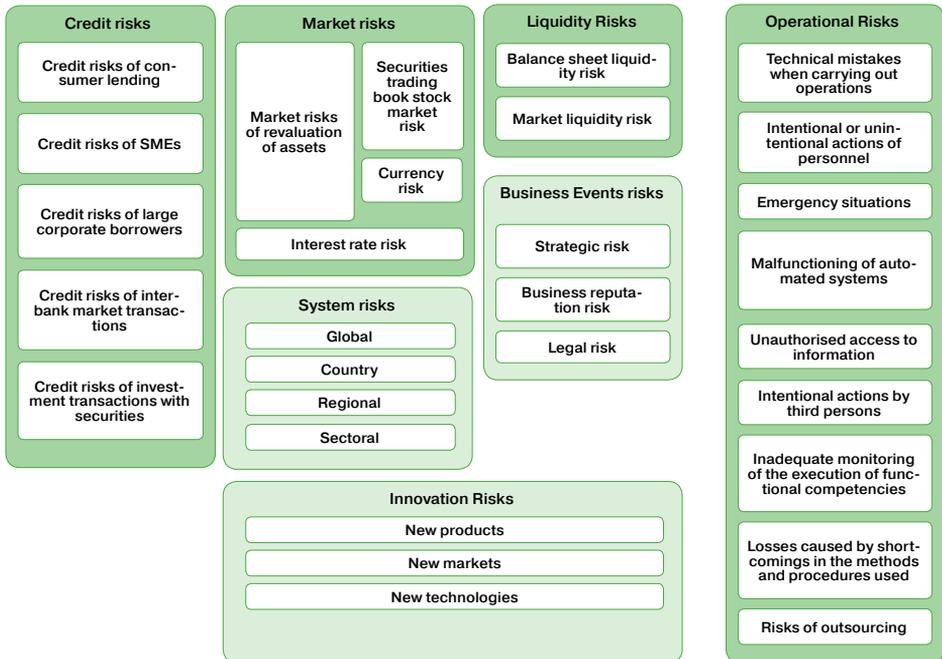
***The management of credit risk entails:***

- Verifying the source information obtained from customers and other sources;
- Developing scoring for retail customers and internal ratings for SMEs;
- Individual assessment of corporate borrowers;
- Observing the one obligor principle;
- Creating and properly evaluating a collateral base;
- Monitoring borrowers and their collateral;
- Diversified decision-making procedures, depending on the product, sum and risk involved;
- Making adequate provisions to risks;
- Allocating adequate capital to risks.

***Managing market risk:***

- Monitoring open currency positions;
- Monitoring and managing the trading book;

## Main types of risk classification



- Assessing VaR. The bank uses parametric VaR, calculated daily;
- Interest rates GAP analysis;
- Net interest income and cost of capital vulnerability to interest rate changes;
- Stress testing;
- Allocating adequate capital to market risks;
- Hedging open currency positions through swaps.

### ***Managing liquidity risk:***

- Managing assets, creating a reserve of highly-liquid assets;
- Managing liabilities;
- Control of liquidity indicators;
- Diversification of sources of finance;
- Crisis action planning.

### ***Managing operational risk:***

- Constantly monitoring and improving processes and internal procedures;
- Identifying and classifying operational risks;

- Developing regulations and measures to reduce operational risks;
- Collecting and storing information on actual operational losses;
- Making plans to ensure business continuity in emergency situations;
- Allocating sufficient capital to the bank’s operational risks;
- Insuring operational risk with a BBB policy;
- Verifying information and fraud detection;
- Internal security procedures and operational environment safety;
- Internal audit and monitoring compliance;
- Information security and audit of systems in compliance with ISO17799;
- Managing and training personnel with the aim of reducing personnel risks and potential human error.

***In this way, Center-Invest Bank’s risk management system:***

- Covers the whole range of risks arising from the bank’s areas of activity;
- Is appropriate for the bank’s risk exposures;
- Is consistent with international risk management standards;
- Emphasizes the risk/return ratio;
- Can guarantee business continuity, and allows for the bank’s rapid and sustainable growth, including its territorial expansion.

### **3.10. Center-Invest Bank’s Post-Crisis Development Model**

Only those companies that make their business processes 30% more effective will survive in the post-crisis economy. With the introduction of a tougher regime of checks by watchdogs and regulators, tighter control, and stricter requirements with respect to the accepting of deposits and lending, every bank must seriously reconsider their processes and procedures.

Center-Invest began the process of restructuring its operations back in 2006, as part of the “South of Russia+” Strategy. The main objective of this process was as follows: To retain, in accordance with the bank’s mission statement, and within the context of accelerated growth, the best mechanisms for the interactions between the following processes: developing and introducing new products, making sales more effective, developing our customers’ businesses, and effectively managing risks. The crisis has shown that our stated objective was very appropriate, and, moreover, that our proposed

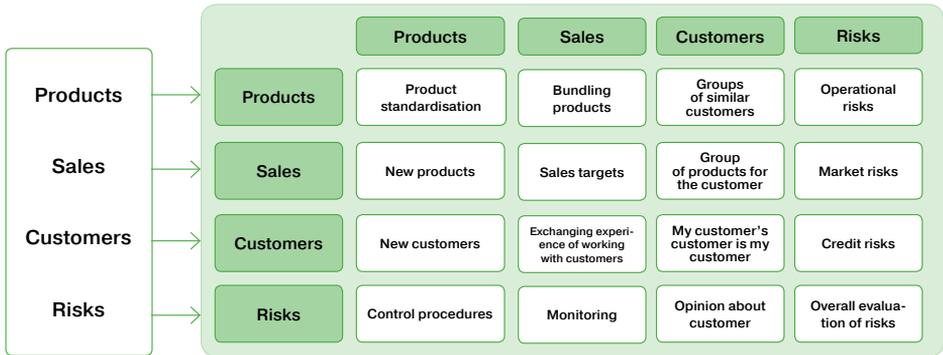
approaches to achieving our objective were practical. Center-Invest Bank’s model for post-crisis development has truly passed the stress-test posed by the global financial crisis.

A competitive advantage of a small bank is that the processes of developing products and sales, expanding the customer base, and managing risks are very closely interlinked. A typical problem when a banking business expands is that all these procedures become disconnected, split between different functional business units. While the effectiveness of each procedure increases, the relationships between functional units become more complex, which, ultimately, could negate the benefits of specialisation.

To avoid making this mistake, we produced a table showing the interactions between the main processes. A simplified version of this table is given below.

Each functional block was expanded to list the main interactions. For example, “standard loan products for retail and business customers” was expanded to include sales techniques, working with customers, and risk management.

**Interaction between business processes**



By introducing this new standard representation of the functions of business units in terms of interactions we were able to standardise our products, while still ensuring that they meet the needs of different types of customers, and include risk management at an earlier stage as part of the “expanded” product. Therefore, not only did we ensure that functional units interacted properly, but we also optimised new product development processes.

The ideology of the “expanded” product has been incorporated into the work of all the bank’s business units, and also into our new information system based on SAP for Banking.

### 3.11. The Sustainable Bank for Southern Russia

*In 2007 Center-Invest Bank became the first Russian bank to be a runner-up in the Sustainable Banking Awards held by the Financial Times (FT) and the International Finance Corporation (IFC) (Sustainable Banker of the Year category). In 2009, we again made it into the final competition, short-listed for “Sustainable Emerging Markets Bank of the Year”.*

In the Russian language, the word “ustoichivost” refers both to patching up holes to stop a ship from sinking, and to stable, sustainable growth. The word is increasingly being used to mean the latter, equivalent to the English term “sustainability”, i.e. development in the interests of current and future generations. There is a fairly substantial legal framework for sustainable development in the form of the Equator Principles, the Global Compact, etc. In practice, for a company, sustainability means not focusing on short-term benefits, but instead running one’s business so as to maximise profits over an unlimited period of time, taking into account social and environmental risks. Businesses benefit from this approach through the introduction of new technologies, products and services; the acquisition of new knowledge by their employees; the growth of the regional economy; and increased transparency. Also, the risks of unscrupulous behaviour by partners, environmental problems, and damage to reputations are reduced. As a result, new relationships are established with suppliers, customers and employees. For sustainable development, as a minimum, companies should adhere to a Corporate Governance Code, be audited in accordance with international and Russian standards, obtain independent ratings, and have a sustainable development strategy and risk management and internal control systems. For the authorities also, sustainable development implies that they will have a Corporate Governance Code, a sustainable development strategy, and transparent plans for infrastructure development and social and economic development. For the population, sustainable development means independent learning, a healthy way of life, and conscientious work.

The objective of sustainable development is more complicated for tradi-

tional Russian business, and, to a large extent, it is a new objective. It is an interesting one, however, as it enables companies to select a more sustainable, long-term strategy and to start using products and methods today that will become standard and widely used in the future. In practice, it means, for example, that Center-Invest does not engage in predatory express-lending. The bank does not finance grain export deals if the revenues will only reach the intermediaries, not the agricultural producers. A few years ago, we financed the introduction of modern technologies for producing grain crops, which allowed farmers to cut their costs by one third.

In 1997 Center-Invest Bank launched its first programme to support companies in the Don area. In 2000, the Rostov region started devising programmes that were aimed at actually expanding enterprise, rather than simply supporting it. As well as money from government budgets, bank loans were included in the figures for these programmes. Without any additional expenditure, purely using the competitive environment, the participation of banks multiplied the government funds by 1000. This is the highest indicator in the country for all of the publicly funded special-purpose programmes, and it is the most striking example of a sustainable approach in the relationship between business and the authorities.

Here is another example of the sustainable development principle in action. A ten year-loan has been obtained from the EBRD to modernise the boiler houses in the city of Taganrog. The project has a payback period of 12.5 years, but the new boilers will operate for 25 years for the benefit of future generations. Clearly, the emphasis is on long-term gain, rather than instantaneous profits. As part of the project, 20 boiler rooms that posed a fire risk will be closed, and ten new ones constructed. Annual CO<sub>2</sub> emissions will be cut by 6,800 tonnes and costs by 30%.

In October 2008 we presented our customers with a post-crisis development programme, “Southern Russia Versus the Global Crisis”. The programme makes recommendations on restoring money supply in the region, the management of liquidity by companies, the meeting of social obligations by all market participants, the monitoring of markets and prices to identify promising areas for business development, and the revision of business plans.

Standard payment calendars and the flexible management of cash flow will not be enough to restore money supply and for companies to manage their liquidity. Accordingly, we have expanded the range of financial engi-

neering instruments available to our customers, the payment methods, and the means of settling accounts with partners.

The fall in demand and prices means that companies must monitor markets more carefully and react faster to changes in market segments, products, pricing strategies, distribution channels, and sales promotion methods. Large companies have a delayed reaction to these changes, whereas SMEs have a better sense of the market, and adapt to it quicker. This is why Center-Invest Bank is actively continuing to finance the best SME projects in southern Russia. Through dialogue with our customers, we help them identify and design these projects. There is no such thing as a bad project, only bad financial engineering.

The task of banks today is to support their customers' businesses through the application of modern banking practices and financial engineering instruments. Many banks today dream about having reliable borrowers and hope to obtain them through unfair competition. At Center-Invest Bank, we have never tried to carve up the market; instead, we have concentrated our efforts on helping our customers grow their businesses. In October 2008 alone, we held over ten briefings and seminars, at which we presented our vision of how customers can not only survive the global crisis, but in fact benefit from a crisis situation.

This work is being carried out in companies in the Don area. Many of them are realigning their business processes in order to be successful today and competitive in the post-crisis economy. If a business shrinks by less than 30%, then it can be considered a successful business. But if it manages to cut its production costs by 30%, then it is a competitive business, one in which people can and should invest. So far in 2009 alone, Center-Invest has attracted 55 million dollars from international development banks to finance the post-crisis development projects of these companies (two separate loans, both for five years).

Unemployment is the most painful manifestation of the crisis. People who have lost their jobs find themselves in very difficult situation. But it is actually this extreme situation that compels people to become entrepreneurs. A crisis is the best time for investment in independent learning. It is hard to wait for help from others during a crisis, but everyone should know how to help themselves. This was the reasoning behind Center-Invest's decision to launch a new educational project, "Enterprise for All", which will help SMEs in southern Russia and the local population to overcome economic

challenges by applying sustainable development principles and using the intellectual support of Center-Invest specialists.

Every entrepreneur has had a day when they have woken up literally unable to feed their family. At these times it is best to start the day by putting together a list of “What I know, what I am able to do, what I can do, what I want to do”. You should then look at the world around you as potential market segments and put forward your products, services, and prices. You should find distribution channels and sales drivers. Taking into account the current market situation, you should determine sales volumes, outgoings, and the break-even point for your future enterprise. You should assess the initial costs and the payback period, and identify the cost of the financial resources required to start up the new business, and also the terms on which these can be obtained. You should find specialists, determine the terms and conditions of their work, and ensure they have a clear picture in their minds of the model for the new business.

Everyone living in southern Russia should possess this minimum level of knowledge. The “Enterprise for All” project includes:

- free training seminars, open lectures, and information briefings for customers, partners and the general public;
- free copies for educational institutions and training centres of the Center-Invest Bank’s enterprise skills training materials;
- participation by Center-Invest specialists in its partners’ educational and training events.

The first people to attend an “Enterprise for All” lecture were the Rostov higher education students and teaching staff that are in receipt of scholarships and grants from the Education and Science in the SFD Endowment Fund, and also participants in the “Southern Federal University-2020” (SFedU-2020) project. Students and teaching staff from Rostov State Economics University were also introduced to the project during a university round table on equipping the general public with basic financial skills. Together with the Rostov Region administration, the local branch of the Federal Employment Service, teachers, and business people who work as trainers, we held a train the trainer course.

At the dawn of privatisation, Center-Invest Bank helped the “red directors” (the directors of Soviet era enterprises) become the managing directors of joint stock companies. Today, the bank is helping the people of southern Russia become entrepreneurs.

In terms of practical steps to ensure the sustainable development of southern Russia, there is much to be done. The Southern Federal District must:

- make each ruble of public money work harder by: better informing businesses about planned infrastructure projects; holding municipal and government tenders for the supply of goods and services on a wider scale and in a more transparent manner; and co-financing infrastructure projects;
- draw on the knowledge and experience of supervisory and regulatory bodies when producing proposals for the development of enterprise at the municipal level;
- together with business associations, put together and implement proposals for the sustainable development of individual sectors and spheres of activity, including proposals for implementation at the municipal level.

In Russia, when people talk about the social responsibility of business, they usually want to talk at length about socially irresponsible policies. Center-Invest’s track record is important because the bank has not used sustainable development as charity, nor has it used it as a means of “maximising” its unofficial relationships with government agencies. Instead, we have viewed sustainable development as investment in the sustainable post-crisis development of the economy of southern Russia:

- Annually, **260 higher education students** in the Rostov region win Center-Invest Bank scholarships, each for **20,000 rubles**.
- Fifteen teachers participated in the project “SFedU-2020”. This was a series of public lectures on the latest scientific and academic issues. The bank awarded each lecturer **RUR100,000** for their successful lectures.
- The six best young lecturers, as voted for by the best students, receive grants from Center-Invest Bank.
- In the last four years, thanks to our financial support, **40,000 schoolchildren** have visited the “Treasures of the Don Steppes” exhibition at the Rostov Region Local Studies Museum for free. This is an exhibition about the history of the settlements in the area of the Rostov region from the 3rd century BC to the 5th century AD.
- **3,245 schoolchildren**, including disabled children, have received free Internet skills training (Center-Invest Bank sponsored the programme).
- More than **2,000 veterans** are customers of Center-Invest Bank and enjoy special banking services. Every year for Victory Day we send them our congratulations and a gift.

- **38 members** of staff are studying on post-graduate courses in the Rostov region.
- Every year we award a prize to the winner of the “Best Coursebook” category in the “Don Region Teacher” competition.
- We have provided **3,290 loans for education**, totalling more than **203 million rubles**.
- Together with SAP CIS and the Southern Federal University, under an agreement signed as part of the SAP University Alliance Program, we have set up a centre to train SAP specialists.
- In 2008/2009 Center-Invest Bank allocated 6.4 million rubles to educational programmes. On the one hand, we can view the global crisis as an “objective” factor. On the other hand, we can say that Center-Invest Bank has made full use of its “subjective” factor, attracting funds from its shareholders, partners and customers in good time. This has allowed us not only to maintain a large liquidity “cushion”, but also to continue lending to our customers, concentrating on the most effective projects in the SME sector, agribusiness, and energy efficiency technologies, and also on priority lending to our depositors.

The time that has passed since the crisis began has underlined:

- the soundness of Center-Invest Bank’s business model, balanced in terms of assets and liabilities, timescales, products, and geographical presence;
- the bank’s ability to analyse in-depth both the surrounding business environment and business processes; and
- the willingness of the Center-Invest team to use all their energy and knowledge in the interests of professional and responsible work.

The “stress test” presented by the global financial crisis has provided further confirmation that Center-Invest Bank is right to incorporate sustainable development principles in its work:

- Sustainable development starts with the personal belief of every individual that this is the right path for humankind;
- “Ideas are stronger when they are taken up by the masses”. Therefore, we must educate people in the ideas, methods and practical experience of introducing sustainability principles;
- With regard to risks, sustainable approaches are more economically advantageous, especially in terms of long-term rather than immediate profits;

— Sustainable development requires a global approach in every business, in terms of responsibility for global processes, and in terms of using best practice in one's management methods and systems. International organisations, specifically IFC, the EBRD, FMO, KfW, and OeEB, have worked with Center-Invest Bank to test their pilot projects for Russia in the areas of energy efficiency, agribusiness, corporate governance, risk management, internal control, and the development of banking operations. This has been to the benefit of the population of a region whose personal income is 70% of the Russian average.

Center-Invest Bank is continuing to develop its business on the basis of sustainability principles, and we will continue to encourage our customers, the authorities, and non-governmental organisations to adopt these principles. We will take a wide range of public measures (from publishing information to participating in legislative discussions and business associations) to promote sustainable banking business as the foundation of the post-crisis global and national financial architecture, based on our own example.

# Sustainable Banking as the Basis for the Post-Crisis Banking System

## 4.1. A G20 for 139

In 2007, 36 children were born to Center-Invest Bank employees, and in 2008, the number more than doubled, to 76. In the first half of 2009, another 27 children were born to our staff. Per capita, these indicators are two to three times higher than in the G20 member states. Center-Invest's highly professional team cares not just about the bank's sustainable development; it also cares about the sustainable development of its customers, i.e. the general public and business community of southern Russia, as well as environmental protection, and the maintenance of social stability in the region.

The global crisis has clearly demonstrated that sustainability today depends not only on your own personal efforts, but also on the rules of behaviour in national and global markets. Center-Invest Bank is a regional bank with a global outlook. Our many years of cooperation with international financial organisations and foreign partners have allowed us to study best international practice, including its limitations. (Even the very best practice has its limitations.) We have also been able to assess opportunities to adapt best international practice to specific, local conditions.

The new forums of the G8 and G20 summits are being called upon to find a new structure for the world's financial markets. But the global crisis runs so deep that altering the organisation, methods and methodologies of the financial world order will not be enough; its very ideology needs to change. It is revealing that in their speeches political leaders are increasingly voicing ideas such as the rejection of speculative approaches, a return to socialism, a transition to Islamic banking, and stricter control of banking and supervision of the financial markets.

The global financial crisis is forcing us to seek an alternative to the current financial system and a banking business that is focused on instantaneous profit (speculative). The most radical alternative is the Islamic banking business, which prohibits the charging of interest and requires that banking transactions be carried out in accordance with Sharia principles. Sustainable

banking (“SB”) envisages business development in the interests of current and future generations. This business model retains profit as an incentive, but the emphasis is on long-term profit, with due regard for environmental and social risks.

Most likely, as well as issuing general declarations, the participants in these summits will propose some solutions. But there is a danger that these solutions will be aimed at, first and foremost, preserving the status of the political leaders participating in these international meetings, safeguarding their geopolitical ambitions, and supporting the existing economic structures in their own countries. There is a certain point when these meetings and discussions are essential to maintain stability. However, the depth of the crisis requires new ideas for the construction “from scratch” of a new economic structure, new rules of the game in geopolitics, and new leaders with new knowledge. Ultimately, the leaders of all countries must provide new rules for the financial markets to ensure sustainable development, not only for the 139 children born recently in southern Russia to Center-Invest Bank's employees, but also for the millions of other children born around the world amid this global crisis.

The first thing that must be understood by those leaders who boldly take it upon themselves to formulate new rules is that they must not make a fetish of any economic concept, even if it has been awarded a Nobel Prize. Political desires and ambitions to accelerate the pace of economic development have resulted in growth that has been artificially stimulated by low interest rates and the bundling of high risks in high return derivatives. Ultimately, this has resulted in disbalances both at country level and worldwide. Any unrestricted growth will have the same result. In their attempts to outwit the recession, political leaders feel compelled to introduce stimulus measures to revive those sectors for which there might not even be demand in the near future. The post-crisis economy is a new equilibrium point between new demand and new supply, and we should not promote outdated products on new markets or moribund rules of the game.

Ideally, the children born after the crisis will learn more lessons from their parents, or, at least, not repeat their mistakes. Unfortunately, every generation is bound to make their share of errors. All that we can require is that these mistakes are not so serious as to halt the succession of generations. Whatever the shape of the post-crisis economy, it should provide for sustainable economic growth in perpetuity.

The second thing that is important if politicians are to gain a new understanding is the role of state regulation. In a free economy, there are no unequivocally optimal decisions. There are decisions that are optimal according to the Pareto principle, or according to the so-called state of equilibrium, when the effect of one participant can only be improved at the expense of other players. The art of economic management lies in finding compromises between the market participants, so that they do not find themselves in the position of Buridan's ass. In normal market conditions, the government is expected to determine, from a multitude of possibilities, those rules on the basis of which an unequivocal choice will be made. However, if these rules have not been broadly agreed, if they contradict one another, then the Buridan's ass will find itself in a worse position and its death becomes inevitable. In recent years, many restrictions have been imposed on the financial markets, and stricter requirements have been introduced for information disclosure, the protection of the rights of minority shareholders, and the prevention of money laundering. Each of these measures was a reaction to a specific historical situation. However, in terms of their quantity and content, these rules have gradually started to contradict normal economic stimuli and indeed one another. As a result, the crisis has become, first and foremost, a crisis of government overregulation. The inconsistency in the rules of economic behaviour poses a very serious threat to sustainability, to the functional sustainability of economic development.

And now we come to the third issue. All politicians come to power under slogans of social justice, but each interprets this notion in his or her own way. The only justification for the resulting plethora of ideas is that unequivocally equitable solutions do not exist; the tasks of equitably distributing income, bonuses and wages belong to the same category of mathematical problems as the task of making the optimum choice of spouse. For a marriage to be based on love, interference from external parties is impermissible. There must, however, be greater sharing of information between the bride and the groom, just as there must be between market participants. In the same way, for social stability there must be a wider sharing of information about the income not only of politicians, but also of all big earners, their property and assets. Traditionally, the market has considered this information to be confidential, and it to be bad form to count the money in other people's pockets. But when the income gap has become considerable, popular revolutions have completely cleaned out these pockets.

In the modern information society, it is impossible to conduct a transaction safe in the knowledge that information about this transaction will never become available to an unlimited circle of people. This is to be welcomed, as any restrictions on information will only worsen the manifestations of the crisis.

Finally, we can say that if there is no unequivocally optimal programme to deal with the crisis, if there is no ideal system for allocating income, benefits and services, if even the best state regulators can contradict one another, then one of the most stable economic states is stagnation. In the economy of stagnation, either no efforts are made whatsoever, or they are made in various directions with the result that everything remains as it was. Sustainability is a type of stability that provides movement. We consciously stay away from definitions like “movement ahead” so as to avoid the temptation to fetishise individual directions of movement. For sustainable development, it is important to always retain the capacity for development both now and in the future. Therefore, in our view, the following definition is more accurate: Sustainability = stability + development.

## 4.2. The Banking Business

Not many children dream of becoming bankers. As a rule, people who become bankers are people who can solve complex problems on the basis of a large quantity of official and informal information. For those who dreamt of becoming astronauts, it is opportune to compare the work of a bank to that of a spaceship, flying in a “meteorite” stream of customers, regulatory requirements and competitors, and obliged to allow for the effect of the gravitational fields of the galaxies of financial and other markets.

Economic theoreticians substantially simplify this picture, giving these different explanations of the banking business:

- an attempt to divide the surplus product of the worker between industrial capital and bank capital;
- the ability to obtain profit from the difference in the current and future cost of money;
- the purchase and sale of risks.

Each of these concepts is valid, but fetishising any point of view will only serve to discredit it:

- The nationalisation of banks and factories deprives the workers not only of surplus product, but also of necessary product;
- Maximising the differential between short-term liabilities and long-term assets encourages the creation of financial pyramids;
- The purchase and sale of risks force banks to inflate bubbles from risks and sell them attractively packaged as derivatives and sub-primes. To construct a sustainable theory about the nature of the banking business, we must view banking itself as a sustainable system, which provides services together with other infrastructure sectors. Initially, the economic situation stimulated the development of the banks, and then the banks themselves started to more actively stimulate economic growth;
- The strengthening of international trade led to the consolidation, and, ultimately, the globalisation of banking services;
- The development of banking operations and faster settlements heightened temptations to actively use temporarily uncommitted funds;
- The rapid growth of the stock market and other markets encouraged banks to finance operations on these markets without due regard for the situation in the real economy.

All of these market surges boosted the development of banking services. Unfortunately, the euphoria from these stimuli ended with major and minor crises, followed by the restoration of the banking sector and a renewed search for a new sustainable banking model.

Setting aside the state-controlled administrative command system, as existed in the Soviet Union, we can clearly identify two major groups in the banking services sector today: a banking business that is focused on profit (speculative) and a non-profit banking business (Islamic). In the modern world, the Islamic banking business, based on the respected principles of Sharia, has managed to avoid many of the mistakes of the speculative banking business, but this is no reason to fetishise Islamic banking.

A sustainable banking business includes various aspects of sustainability: temporal (maximising long-term rather than instantaneous profits), environmental (consideration for the environmental consequences of projects financed), social (reducing the risks of social conflicts), and legal (consistent and meaningful legislation). But even this view of banking should not be fetishised.

According to an objective view of development, one that is free of any fetishes, “development is a change in overall movement”. The fetishisation

**Table 4.2. Comparison of banking business models**

	Soviet banking system	Speculative banking business	Sustainable banking business	Islamic banking business
Profit	Set by the state plan	Instantaneous	Long-term	Risks shared with the customer
Personnel management	According to ideological principles	Headhunting	Nurturing personnel	Educated in Sharia traditions
Price setting	In accordance with the state plan	Market	In accordance with risks	On the basis of risk sharing agreements
Branch network expansion		Profit centres	Developing the regions where the bank has a presence	Supporting fellow believers
Planning		Aggressive growth business plans	Development strategy	Focused on promoting Allah
Customer relationships	Financing and monitoring execution of the state plan	Focused on products	Supporting customers' businesses	Supporting customers' businesses
Operations		Purchase and sale of risks	Risk management	Consistent with Sharia compliance

of any of these changes reflects subjective interests and imposes a choice of specific directions. A sustainable banking business assumes that the choice will be made in favour of those directions that do not forestall a change in the direction of movement either at the present time or in the future. Banks should detect chance changes in the surrounding world, adapt to individual changes, and, as individual changes lead to a new equilibrium, they should change their own activities. To ensure that in the process of these changes banks do not turn into protozoa, adapting to any change whatsoever, they should have their own interests and their own development criteria, and this is where profit comes in. So that banks, in the pursuit of profit, do not choose directions that will lead to their self-destruction, in the first approximation they should use long-term profit with regard for environmental and social risks. In practice, this should mean that not only the financial accounts but also the strategic plans of banks should be made public.

A sustainable banking business focuses on:

- long-term, rather than instantaneous profit;
- fostering staff development, rather than buying managers;

- the participation of banks in the development strategies of the regions in which they operate, rather than unrestrained regional expansion;
- the application by banks not only of market indicators, but also of their own ideas about the price of the risks accepted.

From the above, it is evident that sustainable development differs both from the speculative growth of market bubbles, which give rise to deep crises, and also from development based on the principle of “follow the leader” and focal points for growth, which result in short-lived waves in the economy (upturns quickly followed by downturns).

The overall mistake made by all countries providing government assistance to tackle the current crisis is that they have not in any way linked this assistance to the long-term development plans of the recipient banks and companies. Unfortunately, it could not be any other way: government financial support has been directed at supporting existing sociopolitical structures. But this does not guarantee that these structures will be resilient to new changes. In contrast, a sustainable banking business does not just imply stability; it means the development of the banking system.

#### **4.3. A Sustainable Banking Business**

Success in building a sustainable banking business lies not in the radicalness of individual steps, but in the harmonisation of the changes being made. These changes will affect the banking institutions themselves, the systems of bank ratings and regulatory standards, internal planning and control procedures, human resource management, risk management, price setting for bank products and services, and also interactions with the outside world: corporate conduct, financial policy, the development of the interbank market, branch networks, and payment and settlement systems. Once all these changes are complete, it will be important that the banking system itself has retained the capacity for further development. But at every stage of these reforms it is important that the sustainability and the viability of the banks are retained.

In recent years, there has been a substantial increase in the speed at which banking operations are performed: payments and settlements can be effected around the world at the speed of light. These new technological advances gave rise to the illusion that banks were using their customers'

uncommitted balances as they saw fit. Since many customers had not given instructions as to how their money should be used, banks started viewing this money as their own. As living (but not sustainable) economic organisms, the banks were trying to make a profit, and one of their methods was to use the money of their “silent” customers in more risky transactions that took longer to yield a return. As a result, money that had been intended for payments and settlements started being used (in full or in part, depending on how conservative a bank's strategy was) to inflate “bubbles”. Moreover, in many ways the money of the “silent” customers encouraged banks to use this money as they saw fit. When the bubbles burst, the investments made were no longer sustainable, and the ability of banks to effect payments and settlements was threatened. This situation is a classic example of how the very best changes in banking products (an increase in free balances and the effective use of these funds) resulted in banks losing their ability not only to expand, but also to maintain their core business, i.e. the ability to effect payments and settlements. If banks were to maximise long-term profit (rather than instantaneous profit), through competition, then the first thing they should do is meet all their obligations as an agent for payments and settlements. Only after that should they openly inform the customer of the opportunities in potential investments and lending, and share with him both the future revenue from the loans and the risks of unexpected losses.

Dividing banking business into payment and settlement systems on the one hand, and lending and investment on the other, would result in a more sustainable construction:

- The settlement functions of banks would be retained for an infinitely long period of time (temporal aspect to sustainability);
- If customers were invited to share the risks and profits of lending, they would start to be more responsible for the decisions taken concerning the use of temporarily uncommitted funds (social aspect to sustainability);
- It would no longer be necessary to further tighten banking supervision and regulation to ensure that banks properly respect maturity and interest rate gaps (sustainability in terms of legislation);
- There would be a clearer separation between the interests of the customer in the guaranteed reliability of payments and settlements, and his possible interests in lending and investing on an equal basis with the bank (sustainability in the current situation and in the future).

Payment and settlement systems would become an element of the global infrastructure, and their operations would be strictly regulated. These systems would join forces, forming alliances similar to airline alliances. Banks would conduct their lending and investment activities solely on a commission basis; the customers themselves would bear the risks of investing their money. Banks would no longer engage in the risky practice of using short-term funds to finance long-term projects. Every “silent” depositor would be obliged to clearly state how they intended their funds to be used. If this information were unknown, the funds would be recorded in the balance sheet as call deposits, and no one would have the right to calculate any revenue on the balance of these funds.

The division of modern banking functions into payment and settlement systems and lending and investment would recreate a sustainable foundation for the banking business as a whole, and give a new impetus to its sustainable development.

At the same time, these changes would require a paradigm shift in other banking business sub-systems.

#### **4.4. Payments and Settlements**

So as to prevent banks from being tempted to use the uncommitted funds of “silent” depositors for investment purposes, payment and settlement systems should not be permitted to place uncommitted funds anywhere except in deposits with central banks. Banks could then cover temporary cash gaps by buying short-term funds in central bank auctions. With these restrictions, the central question becomes the price of the funds in payment systems. Central bank auctions would create a transparent base for establishing the price of these funds. The interest paid on customer balances and the interest charged for overdrawn current accounts could easily be set as percentages of the auction rates. Banks could determine the limits on overdrafts and loans on the basis of the turnover or balances of their customers' settlement accounts. In addition, banks could charge commission for making payments. At first sight, the payment and settlement systems do not look especially profitable, and indeed they should not be, as the task of ensuring a high degree of reliability is incommensurable with the risks and profits of lending and investment. Market concentration of payment

and settlement systems would be based on the technological advantages of information and communications systems. The profitability of the payment and settlement systems would depend on their scale, the number of participating banks, and the range and quality of additional payment and settlement services offered.

Payment and settlement systems should be used not only for the money of commercial organisations, but also for public money. In effect, the Russian treasury system was created to ensure reliable public spending. However, the system built up enormous sums of unused money. Starved of this money, the market economy suffocated, and ultimately this led to a fall in government tax revenues. Another reason for the creation of the treasury system was to avoid public money being improperly used by commercial banks and in other corrupt schemes for risky short-term investments. The transparency of setting prices in central bank auctions would automatically resolve this problem: it would no longer be possible to give bribes using “free of charge” public money.

Silent depositors would receive a guaranteed income, and this income would be determined by the system of interest rates set in accordance with the cost of money in open central bank auctions. Many other rates for short-term lending, including lending outside the banking sector, could also be established using the prices in open central bank auctions.

In the longer term, payment and settlement systems would become the main participants in the short-term interest rate markets (including LIBOR, EURIBOR, and MOSPRIME). It would be important that these are systems for short-term markets. The payment and settlement systems would analyse money supply and demand (including fundamental and technical analysis of tax and special payment periods).

#### **4.5. Investment Financing**

There are risks in any investment. This is primarily because the money needs to be spent today, but the return on that money takes time. There are technological, operational and legal risks to investment. But the “collectors” and recipients of money for investment prefer not to talk about this, or else they just mention it casually, focusing instead on the potential earnings, which in many cases are indeed achieved. Whether consciously

or not, material information is being hidden from end investors, information about the risks that they are being asked to take in exchange for the stated return. Banks, investment funds, management companies and other brokers distort information about risks even more, replacing it with the financial reports and ratings of intermediaries involved in the investment process.

Participants in the investment process hope that government regulation will limit these distortions. Indeed, government agencies are working hard to show that the measures they are taking are ensuring that information is largely reliable. But the risks in the investment process will not disappear of their accord. Moreover, the ambitions of leading politicians to provide economic growth, to attract investment for the construction of “millennium” facilities and so on, can actually increase the distortion of information.

Self-regulating organisations of market participants can improve the reliability of information about risks only if there are a sufficiently large number of these organisations. But in this case also, the risks will not actually disappear.

The most honest and direct means would be to inform each end investor of the risks that he accepts when he provides money to finance investment. Questions immediately arise: Who will guarantee that this information is reliable and objective, and who will hand over their money if they know the full truth about the risks? The honest answer to the first question is “no one”, and the correct answer to the second question is “anyone who wishes to accept the stated risks in order to make a profit.”

The government can control every investment risk itself, introducing all kinds of rules for the disclosure of information; self-regulating organisations can introduce various standards on the description of risks for their members. But, ultimately, the investor is obliged to assess the risks and the returns of an investment himself. Just like on a packet of cigarettes, every investment agreement and every security issued should carry a warning about the risks: “Investment kills”.

It is hard to be sure that people would still want to invest if such negative information were provided, but at the same time there would not be any disillusioned investors, and, consequently, the investment market itself would become more sustainable. The market would “subside” so it could be reborn in a more sustainable form.

Banks would be obliged to voluntarily accept responsibility for apply-

ing best international practice when complying with banking regulation and supervisory requirements. The deliberate, voluntary application of best practice will show, once again, that purely formal compliance with tougher regulations is not a guarantee that the crisis will be overcome. A successful banking business will be invariant with respect to accounting, supervision and ratings systems. Moreover, a successful banking business will make it easier to see the shortcomings and limitations of external assessment methods.

#### **4.6. Market Interactions**

The division of the banking business into payment and settlement systems and investment would not mean that there would be an impenetrable wall between these two markets. On the contrary, the division of bank balance sheets into short-term payment and settlement operations and investment financing should be accompanied by a strengthening of market mechanisms for the crossflow of funds between short-term and long-term money markets.

Investment banks would be able to attract long-term money directly from investors or from other intermediaries, but only if the investment banks had the right to manage this money for a correspondingly long period of time. The short-term funds managed by banks could be used to finance investments, but only on the basis of the results of auctions held among payment and settlement systems. Bids by investment banks in these auctions could be limited in terms of the investment finance risks assumed by the bidders in the auctions, but the cost of the funds for the investment banks would be based on the cut-off price of all bids, of both investment banks and settlement banks.

In this way, the sustainable interaction between payment and settlement systems and investment would be like the relationship between communicating vessels: at the lower level, both mechanisms would fill up with customers' money. These customers would be dividing their risks between current payments and investment, according to their preferences. If no one wanted to risk investing their money, then this money would remain in the payment and settlement system, and it would only become accessible to the investment market through short-term money auctions,

when there was surplus supply of short-term funds. In this case, the money would overflow at the upper level: surplus short-term liquidity would flow over the brim into the investment finance vessel. Thanks to the price formation mechanism mentioned, these funds could not be used to inflate new bubbles; rather, they would act like a cold shower if the investment market overheated.

#### **4.7. Market Regulation**

The corresponding vessels system is more sustainable than the existing model for banks, in that: it avoids insider deals using short-term liabilities to finance long-term assets, it makes information about all the investment projects in the market public, and it creates a more objective basis for setting the price of money. Under the current system, liquidity is regulated at individual bank level, which allows, or, to be more precise, provokes, the use of short-term money to finance long-term projects. This is done while the outside world is under the illusion that the regulator and watchdogs will detect the violations on time. In contrast, if the banking business were divided into payment and settlement systems on one hand, and investment on the other, such provocative situations would simply not arise.

There should be no liquidity crises: a prompt end should be put to banks that do not manage to meet their obligations on time, and their senior managers should be banned from the profession. Moreover, there should be no exceptions to this rule. Any attempted blackmail along the lines of, “We are major players. They won't leave us to the whims of fate”, should be grounds for closer scrutiny by both the market and partners.

It is entirely possible that the investment market could find itself short of funds with the required maturities. In this situation, there would still be a small chance that the investment market could use short-term funds from the payments and settlements market. But a more effective mechanism should be used, namely, the provision of additional guarantees and insurance for investment risks. This would make it possible to fill the market with money from the low level, using funds from primary investors.

There is one more stress test for the proposed system: what would happen if there was not enough money for payments and settlements? In this

case, the source of short-term money would be the emission of money. The participation of central banks in the auctions would create a level playing field for all the participants in the payment and settlement systems, and the bank rate would not be based subjectively on the professional opinions of a select few.

#### **4.8. Independent Opinions**

There is no doubt that the Basel Committee is facing the same fate as befell the builders of the Tower of Babel. Yet, with the calls to standardise approaches to assessing the financial positions of banks, and to make ratings and accountancy rules uniform/tougher, we see that the ideas of establishing common rules of the game and treating everything alike return again and again. Here it is important to realise and accept that a “one size fits all” assessment cannot properly represent the multifaceted operations of a bank.

Ratings and international and national financial reporting systems are nothing more than different means of grouping banking operations. There is no ideal way of “bundling” the enormous number of performance indicators for banks. But it can be asserted that the sustainable work of a bank is invariant with respect to the independent assessment system. Each system will reflect certain professional stereotypes about the importance of one or another indicator in the overall representation of a bank's operations. Any attempt to fetishise these stereotypes will result in other aspects of a bank's work being undervalued. For example, hearing analysts from ratings agencies talk about the high risks in lending to agribusiness, you could conclude that they decline to eat all food, so as to avoid excess risks.

Just because there is no unequivocal solution to the task of providing an independent assessment of banking operations does not mean that every such assessment is worthless. Moreover, every new generation of analysts will propose their own “optimal assessments”. For a bank, every such assessment provides another means of checking the risks involved in its operations and so contributes to sustainability. But if these assessments are not just the prerogative of a select group of ratings agencies, and instead can be pronounced by anyone who so wishes, then everyone must assume responsibility for their own assessments.

Today, both auditors and ratings agencies intentionally stipulate limits to their spheres of responsibility: as a rule, they say they are not responsible for the reliability of the source data used in their assessments, for evaluation of the market situation, or for many other factors. But both the investors and the banks do bear real responsibility for the decisions that they take using these independent assessments.

We can consider two polar opposites in the use of independent opinions: on the one hand, there is the decision to not take them seriously, and on the other hand, there is the decision to hold ratings agencies and auditors jointly and severally liable for losses. Between extreme positions there is always a multitude of combinations, and any party can look at these combinations and choose a particular assessment to suit a particular set of operations or their potential partners. The more independent assessments a bank has, and the more similar these assessments are, then, all other things being equal, the more sustainable the bank.

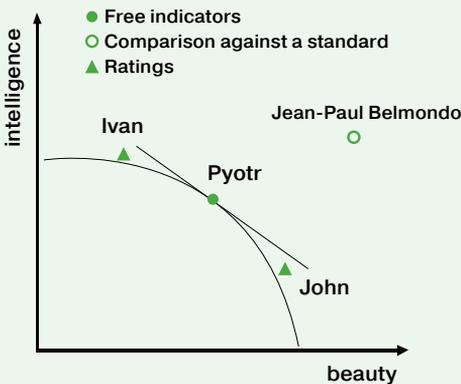
Variations in assessments will most likely reflect differences in the assessment methods. A bank should have only as many independent assessments as it requires to run its business properly; assessments should not be sought for PR purposes.

Ratings agencies will concentrate on evaluating investment projects and products, and not banking institutions. Moreover, every project and product should have several independent ratings, and these should be based on analysis of at least 20% of the market for similar projects and products. Professionals are under no illusions about the limitations of ratings. They understand that they are an attempt, using various types of manipulations, to make the multifaceted operations of banks fit into a procrustean bed of symbol-based classifications. In strictly mathematical terms, this task comes under the category of tasks of “vector criterion of optimality to the scalar transformation”, which do not have an unequivocal solution, just like the tasks of “making the best choice of spouse” or “equitably distributing bonuses”. This task is even more difficult for a bank, because the operational indicators that compensate for the negative influence of the risks in the market environment (direct work with customers, internal control procedures and risk management) directly affect all the other indicators of a bank. Ratings agencies do not make a separate allowance for this.

**Objective: Making the optimum choice of spouse.**

The work of ratings agencies comes under the category of vector optimisation tasks that do not have unequivocal solutions. To illustrate the attendant problems and manipulations we can take the example of making the best choice of spouse using just two criteria: intellect and beauty (For banks, liquidity and profitability can serve as analogies for these criteria.)

**Task: Making the optimum choice of spouse**



**Task: Collective choice of a spouse**

	Bride-to-be	Mother	Grandmother	Family advice
Ivan	1	0	0	1
Pyotr	0	0	1	1
John	0	1	0	1

A. From the many permissible options, let us focus on three, presented in the table (John, Ivan and Pyotr). Depending on the predilections of the bride (of the ratings agencies' analysts), preference can be given to intellect (liquidity) or beauty (profitability). It is also possible to choose a compromise or to make a comparison against a standard. The duality theorem, well-known in mathematical economics, does not leave any scope for the ideal choice: each candidate has their own criteria that allows them to achieve the maximum score among all the available options, and for each criterion an optimal candidate can be found. Increasing the number of criteria outwardly complicates the task, but does not fundamentally change it: there is no such thing as a best choice of spouse, just as there is no such thing as an unequivocal rating of banking operations.

B. Advice given by the family. Ratings agencies love to refer to the collective opinion of their ratings committees. Continuing the comparison with

the task of making the best choice of spouse, we can say that advice given by the family is analogous to such a committee, and we can show that there is also no such thing as an unequivocal choice in collective decision-making. This situation is demonstrated by the well-known Arrow's Theorem on the impossibility of aggregating individuals' preferences to establish community-wide preferences. Ratings committees, taking collective decisions, play the same role as a meeting of Native American shamans or beauty pageant judges.

C. Procrustean bed. It is mathematically more correct to try to classify different groups of suitors (banks) using pattern recognition methods. But this entails comparison of a large number of observations. And even in this case it is inadmissible to try to make the patterns so identified fit into the procrustean bed of symbol-based ratings classifications. Today, even royal families are relaxing their dynastic standards when it comes to choices of spouse.

D. Contrary to the algebraic rule, changing the order of terms changes the rating. Attempts to split up criteria and use different weightings for different groups of criteria, and manipulations using combinations of weighted average ratings and comparison against standards, create the impression of thorough, well-considered work. Yet it is actually the work of illusionists, as, in reality, criteria influence one another and they can only be totalled using a table showing these influences. It can be supposed that beauty depends on intellect. But liquidity and profitability are two sides of the same coin, and, as part of their operational activities, every hour bankers assess the influence of one factor on the other. Unfortunately, this influence is still under-researched even in statistics, and the associative rule remains valid only in the case of independent terms.

E. Fulfilling approximately the same deciding role as do matchmakers helping unconfident brides make an unequivocal choice of spouse, ratings agencies became popular among investors with a weak grasp on the complexities of the market. For most investors, faceless investment firms, and banks with ill-defined objectives and strategies, ratings have become a convenient screen for the lack of personal responsibility of the investor. Of course, in such a situation it is hard to find someone capable of saying, "The Emperor has no clothes!"

In this way, ratings agencies, manipulating public awareness, try to demonstrate that there are solutions to problems that are essentially unsolvable, and they serve as a means of concealing investors' irresponsible behaviour. Different stances can be taken on this, but most importantly we should:

- not fetishise ratings;
- not consider them independent (they depend on the stereotypes of the originators of the ratings methodology being used);
- require every ratings agency to cover at least 20% of comparable companies operating in similar markets;
- use, alongside respectable agencies, simpler and more obvious methodologies, and issue public ratings of the ratings agencies themselves;
- take responsibility for our investment choices, just as we take responsibility for our choice of life partner.

The way that agencies operate will change considerably in the post-crisis economy: they will no longer be elitist, and it will become mandatory for them to cover at least 20% of similar markets. For financial institutions, it will become necessary to have a large number of ratings, but the operations of a sustainable bank should be invariant with respect to the different ratings.

Accounting and reporting systems will retain their national and methodological differences, but thanks to information technology and software, reports will automatically be generated for any system of aggregating bank transactions. Regardless of which system is used, bank financial reporting will be public.

One of the many systems available would be a sustainable accounting system, which would value liabilities, assets, flows and profits not at their initial (book) value, nor at their current (speculative) market price, but at their future expected price.

#### **4.9. Self-Regulation**

With the shortcomings and failings of market mechanisms, government regulators and independent assessments, there is only one option left for banks that want to be sustainable: self-regulation. Given that no one can provide an objective assessment of a bank and its operations, banks are forced to explain the meaning and the nature of their activities themselves.

Like other market participants, banks also need investment. First and foremost, if the banking business is divided into payment and settlement

systems and investment, then a bank will have to clearly indicate to which of these spheres it belongs. Then, it should convince investors that its risk exposures are covered by expected income and that they are regulated by the bank's day-to-day operations.

The "gentlemen's set" of obligations voluntarily assumed by banks with respect to their efforts to attract funds should include: clearly delimiting money by maturities; using independent ratings and auditors; and using rules of corporate conduct, risk management mechanisms, internal control, strategic planning and operations management. Here also, attempts could be made to introduce various standards by means of regulation, but the inevitable shortcomings in any standard would make this not only pointless, but also dangerous. Moreover, as well as the obvious danger that the standard would be incorrect, there would be a secondary danger that the approved standard would fall far short of reflecting best practice in the banking business.

At first sight, the voluntary acceptance by banks of additional obligations looks like self-torture, a source of additional expense. But the objective of a sustainable banking business when accepting these obligations would not be to receive good publicity; it would be to obtain real competitive advantages.

Let us look for example at corporate governance. A bank introduces additional regulations and procedures to govern the relationships between its shareholders, staff and customers. During the process of revising the existing procedures, various options are compared, and the best practices are revealed. This reduces the costs of managing these relationships, and, ultimately, a new culture of corporate governance is established. Thanks to this new culture, communication processes become more effective, costs are cut, there is no longer any ambiguity in decision-making, and conflict resolution procedures are standardised. All of this will enable the bank to attract more resources for its own development.

In a similar way, given the enormous number of regulators and watchdogs, independent auditors and ratings agencies, transparency of information is more financially advantageous than restricting information. Even the risks of improper use of this information are reduced if a bank is firmly committed to information transparency.

Good corporate conduct will require banks to provide fuller disclosure of their internal procedures and operating principles. Corporate conduct requirements will become stricter not only for banks, but also for regulators and watchdogs: these bodies will be obliged not only to desist from any

wrongful acts, but also to avoid any actions that could be construed as an attempt to violate rules or standards of conduct.

The introduction of corporate conduct standards is in the interests not just of shareholder companies, but also of government, municipal, supervisory, and inspection agencies. Standards should be introduced for these bodies to prohibit not only direct violations of the law, but also any action by an official that could be interpreted as an attempt to use their official position for personal gain. Every official should provide advance notification of their potential interest in a given situation and of any potential conflicts of interests. If it becomes known that an official did not provide such notification, then he should automatically be dismissed.

Risk management has become fashionable, thanks to much vaunted ideas of mathematical statistics and computer systems. But it is important not to fetishise complex mathematical formulae; we must see the underlying financial content and the limitations of the premises for applying the normal distribution. When people start using other statistical methods (Robust statistical methods, nonparametric statistics) in addition to standard risk management methods, they will be able to identify new trends and approaches in the body of data. A risk management system will become an integral part of banking activity, but the complex methods for calculating risks, proposed by the Basel Committee, will be complemented by specific, meaningful analysis, building up quantitative and qualitative analysis like a “layer cake”.

The Babel Tower of the Basel Committee. The key idea of the “new” capital requirements is that capital should be allocated between credit, market and operational risks. Under the standard approaches, these risks are automatically determined on the basis of independent ratings. More advanced approaches recommend the use of reliable statistical data based on many years of observations (3-7 years), as standard mathematical distributions can then be applied properly.

A. The crisis reduced all these many years of effort to a pile of sand, in that the bodies of data gathered became heterogeneous, and the members of the Basel Committee have not yet mastered the mathematical tools to apply robust statistical methods. As a result, the principles for the construction of the Tower of Babel must be looked at anew.

B. The unifying of capital requirements on the basis of risk weighted assets reflects the same insuperable desire of analysts to make the multifaceted banking business fit into a procrustean bed of standard representations.

But in contrast to ratings methodologies, as a “scientific justification” of the proposed solution to a task that in principle cannot be solved, weighted coefficients are calculated on the basis of many years of statistical observations or the probabilistic assessments recommended by regulators.

C. The summation of credit, market and operational risks to calculate capital requirements distorts the very essence of banking activity, because when banks invest in their own operational systems, they try to reduce the risks of their asset and liability transactions. It can be recommended that as a first approximation, the summation of operational and other risks be replaced by the correlative relationships between them.

Internal control can easily become ridiculous if every overseer is himself watched over by an additional overseer. The system of “overseeing the overseers” becomes bureaucratic and unsustainable. However, if everyone in a bank has the right to oversee their colleagues, then the system of oversight is not just total, it is also more sustainable: it is hard to violate rules or procedures if you know that any member of staff can ask you to explain your actions, and that they will be obliged to inform other colleagues of these actions. In such a system, internal control will mean that every transaction is checked not only against current bank instructions, but also against the best practice of other colleagues and business units. Internal control will become not just the prerogative of internal control services, but a work principle for all of the bank's employees. Moreover, actions and transactions will be checked for compliance both with legislation and with best banking practice.

***Internal control and type 2 errors.*** Internal control is designed to identify deviations from standard procedures and rules. In statistics, these deviations are known as type 1 errors. Something that appears to be a mistake in terms of current standards may be a precursor of new areas for development. To reject or prohibit something new is to make a type 2 error with respect to future standards (rejecting a certain event).

#### **4.10. Planning Sustainable Development**

Taking into account the different aspects to sustainable development that were mentioned at the very beginning of this article (temporal, environmental, social and legal), sustainable planning by a bank includes producing a system of planning documents with various planning horizons, broken

down into different business units and types of operation.

The speculative banking business prefers to work without long-term plans, just “reacting to the situation” instead. The sustainable banking business requires the development of not just long-term plans, but also strategic plans, which view both the objectives and the resource limitations as variables, and consider environmental, social and legal risks. The work of sustainable planning is more complex, but it is also more fascinating: it allows you to see a wider range of options, and to view different situations in such a way that any current situation can be regarded as one of the options of your chosen strategy. One of the main requirements of sustainable planning is the combination of succession and continuity planning: the long-term plan includes a description of the main processes after the achievement of strategic objectives, and current plans are reconsidered as each of the previous stages is accomplished. Strategic planning will take into account not only the risks based on SWOT-analysis for products, business units and operations, but also post-project evaluation.

In sustainable planning, together with an overall description of the bank's operations, it is important to include specific targets for individual business units, products and operations. To this end, iterative procedures are used, meaning that not only the senior managers give thought to the bank's future, but also the staff of each business unit. This constructive dialogue allows the bank to choose the most effective product strategies, and to also obtain additional benefits by providing a full set of services, bundling its products and services, and reducing the costs involved in agreeing procedures and improving the quality and flexibility of the services offered.

Often, an individual bank's sustainable planning activities require a degree of coordination with its customers' development plans. To this end, briefings and seminars are organised for customers, business communities, local politicians, and community organisations. This information exchange entails additional expenditure, but it is a good marketing avenue for disseminating information about the bank's plans in specific market segments.

#### **4.11. Sustainably Nurturing Personnel**

The communist slogan, “The workers are all-important!” is becoming especially pertinent in sustainable banking. Headhunting is a typical practice

of speculative banking: following the latest trends and the state of the market, banks buy “professionals” from one another in the hope of obtaining certain advantages in the short-term. After implementing two or three effective measures, the “professionals” are happy to move straight on to a new bank. While not casting aspersions on anyone's professionalism, we can see that managing personnel on the basis of headhunting destabilises the sustainable work of a bank, and increases the risks of staff losses and also of uncompleted projects. The succession factor in the bank's personnel policy is weakened, and its corporate culture loses its individuality. Sustainable personnel management entails selecting specialists when they are still in the earlier stages of their development. They are then given the opportunity to combine theoretical knowledge with practical work, and to study best practice and its implementation. Knowledge acquired is passed on to the next generation. This “chain” of succession in the bank's team creates a particular environment, resilient to external influences and capable of internal development. Personnel management will be based on employment legislation and the Global Compact principles, and the interests of every employee will be taken into account when developing internal regulations, strategic development plans, and investment projects and programmes.

#### **4.12. Operations Development**

The division of banks into payment and settlement systems and lending/ investment would allow each group of operations to be improved without increasing the risks that promote various ways of using short-term funds to finance long-term projects.

The independent development of operations would give a new boost to efforts to improve the quality of payments and settlements, and would encourage the constant introduction of new information and telecommunication technologies for customer settlements. But these innovations would be limited to settlement operations only, and would not extend to speculative operations. Surplus funds in the payment systems would be used to finance investments centrally, and these funds would be distributed among equally profitable participants in the payment and settlement systems. The integrity of the funds in the payment and settlement systems should be fully guaranteed by the state.

The investment market would see the emergence of a large number of market participants, which would compete with one another for the chance to use their available funds to finance various projects with various timescales and returns. However, as each agreement would establish that the investor had been warned of the risks they were accepting, there could be no guarantees on the part of the government or society, with the exception of the standard anti-fraud measures provided for by criminal legislation. For such extreme cases, legislation could stipulate that the perpetrators are to be banned from working in banking. Indeed, professionalism and the reputation of market players would become the main stimuli for operations development in the investment sphere. Government agencies would be freed of unnecessary supervision and regulation, and the market participants would themselves become motivated to disclose in detail all kinds of information about investment projects. Instead of just perfunctorily reporting to government agencies, as they competed with one another, investment companies and banks would voluntarily include information about their environmental and social responsibility policies in their issue prospectuses.

In a similar way, investment companies and banks would select their customers and partners more carefully, taking into consideration their observance of good environmental and social practices. As a result, the investment market would be reborn on a new operational base as a sustainable banking business. Competing with one another for customers and investment projects, banks would develop their operations in such a way that they genuinely provided for sustainable development, rather than in name only.

When expanding their branch networks, banks would consider what effect investment projects and programmes would have on the comprehensive, balanced development of territories, and the environmental and social milieu.

#### **4.13. Product Development**

It is hard to imagine that investment activity will recover quickly after such a large-scale crisis. In terms of budgets also, it will be some time before there are source of finances for investment projects. Therefore, the most popular projects will be infrastructure projects, financed and managed on the basis of private-social partnerships. These projects will have the additional benefit of cost savings and economies of scale.

The development of trade finance is becoming an important area. The overall shortage of money supply amid the crisis and the slower circulation of money will lead to companies selecting their partners more carefully, and to the revival of trade on the basis of promissory notes, guarantees and letters of credit. Structured finance will play a more important role in international trade to help overcome the gap between the effective methods used by developed countries and the risks of working with emerging markets.

In the consumer sector, credit cooperatives, which have a long history, will replace predatory express lending schemes.

#### **4.14. International Anti-Crisis Marketing**

The first natural reaction to the news that there is “global financial crisis” is to hide from globalisation behind national borders. There is a rule in innovation theory: “More often than not, the true solution lies in the opposite direction to the initial one.” Armed with this rule, it is worth trying to use the advantages of globalisation to overcome the crisis.

Opportunities for demand growth have been virtually exhausted in most developed countries. The only areas that might see further growth in demand are new, exotic areas (for example, subprime). At the same time, in developing countries, there is not only a need, but also a demand for proven technologies. Given that developing countries lag 3-5 times behind the developed world in terms of technological efficiency, investment will yield returns even when the personal income of the local population is very low. All that is required is financial engineering: for many companies, making real money from real investments, even if the return is over a longer period of time, is better than risky speculation on the stock exchange.

As a result of the recession, developed countries now have a surplus of engineers, designers, builders and equipment suppliers. Moving these freed up resources to other regions would prove more effective than governments propping up internal demand. For example, building one more road in the United States will have little effect on the sales of American cars. However, constructing the same road in a developing country could vastly increase demand for cars, including cars exported by the United States. There is demand in Russia for European experience in energy efficiency. Investment in infrastructure allowed the United Arab Emirates airline to become one of the leading carriers in the world.

In addition to responding to the gap in technological efficiency, for national and global economic growth it is essential that barriers between countries are cleared away: customs, border, and legislative barriers. In the Soviet Union, the term “international cooperation” was thought up to justify the excessive expenditure of bureaucrats. The market economy mantra “from contacts to contracts” should hold true for meetings of political leaders. In particular, any meeting of political leaders should include a mandatory discussion about simplifying customs and visa procedures and expanding contacts between SMEs.

In an attempt to protect their citizens from the crisis, governments are tightening immigration rules. World history gives us the classic example of the United States: a country of immigrants that became the leading global power. Most developed countries apply double standards in their immigration policies: during growth periods, they attract “guest workers”, but at the first signs of a downturn these immigrants are literally thrown out on the street. Just as national constitutions guarantee citizens freedom of movement, to revive the world economy we need freedom of movement of different peoples between different countries. For tolerance between different peoples, nations have to mature psychologically. Countries have to ensure that the economic conditions are right, and create the necessary legal and regulatory frameworks.

We must see the future global economy as an uninterrupted whole, without any extra national restrictions. Then, the development of infrastructure, and careful choices about the best locations for production facilities, will allow the potential of each country to be used in the most rational way. Most often, national restrictions are introduced not in the interests of the people residing in the country, but in the interests of the ruling bureaucratic elite. The free movement of resources, goods and services is in the interests of everyone.

As the corollary of all this, in the near future, experts in financial instruments will have to retrain and look for work closer to the real sector of the economy. The reinforcement of the materialistic worldview of global financial analysts is an important result of the crisis, and is promising in terms of future development.

By accepting the higher risks of entering new markets, foreign banks operating in developing countries have made a lot of money. They have also benefited financially from the introduction of more modern operations and

tested products and services. To build the post-crisis economy, banks should not only offer financial schemes for cross-country transactions; they should also promote international trade.

Even the deepest crisis is not universal. After analysing global trends and adding up which market players did not survive the crisis, we must look for new areas of growth in the real economy, by sector and by region.

It will be especially interesting to compare how the same sectors fare in different countries. In sectors from raw materials extraction to services, some countries are 5-6 times more efficient than others. The introduction of more efficient ways of working in individual countries will be a real source of returns for lenders and investors.

By comparing the levels of infrastructure provision in different countries and the availability of different types of resources and products, we will be able to identify growth areas, both for investment and for international trade. We will be able to see the material flows that require investment and loans. Traditional analytical approaches: potential assessment, GAP-analysis, SWOT-analysis, and complex analysis, will enable us to identify the risks and barriers preventing the growth of material processes. Political and legal risks should be compensated for by international financial institutions, while macroeconomic risks should be compensated for by international agreements and state guarantees. National governments should remove customs, tax and bureaucratic barriers standing in the way of new flows of goods.

For those who have grasped the direction that post-crisis development will take, the crisis is not a tragedy; rather, it is a launch pad for capturing new markets and reaching new customers. It was our aggressive marketing policy that allowed Center-Invest Bank to become the leading bank in the region as early as November 1998, and to acquire new customers from the real economy. We returned to this aggressive approach in September 2008, and this enabled us to increase our customer numbers, assets and lending.

During the same period, Center-Invest Bank was looking at how it could attract more funds into southern Russia. We saw that our aggressive marketing strategy strengthened our position not only vis-a-vis our customers, but also with respect to our partners. Our partners who have suffered from the crisis have either declined to participate in syndicates for Center-Invest, or have offered “above market” rates. Those of our best partners who had not been very active in the subprime market have supported both the syndicated loans and the new ruble bond placement of Center-Invest Bank. Moreover,

**Table 4.14. Interaction of the measures involved in the transition to sustainable banking in the post-crisis economy**

	Money and Credit	Planning	Institutions	Finances	Social protection	Markets	Prices
Money and Credit	Division of banks into payment and settlement systems and investment management companies	Consulting and analysis by investment bankers	Large number of payment systems and investment funds	Companies repay loans with funds obtained from issuing bonds	Separation of investment risks from the population's means of payment	Borrowing only on the securities market	Regulated prices for settlement and cash services
Plans and Programmes	Issue prospectuses	Sustainable development plans for sectors and regions	Large number of ratings for projects	Balance between plans and sources of finance	Plans take social consequences into account	Competition between different sustainable development plans	Market prices to be used in planning documents
Institutions	Inclusion of corporate conduct in assessment of issuer	Voluntary introduction of programmes of corporate obligations	Corporate conduct	Obligations to finance public goods and services	Social obligations of corporations	Large corporations and SMEs to interact as equals	Market assessment of the risks of issuers
Finances	Applying market conditions to financing of public projects	Infrastructure development projects	Private-social partnerships	Replacing taxes with payment for public goods and services	Direct payments for public goods and services	Right to choose the public goods and services to be funded	Market prices of public goods and services
Social protection	Division between the guarantees of payment systems and the risks of investment	Social development and enterprise development plans	SME development	Charity	More infrastructure to be developed through private-social partnerships	Issuing loan certificates for the population	Market prices for investment in the social infrastructure of services
Markets	Large number of issuers of securities and means of payment	Technical market analysis	Pools of banks belonging to payment systems	Rules on the interaction between different market segments	Competition on the market for public goods and services	Investment and securities markets	Market prices for money flows between different market segments
Prices	Currency, securities and payments clearing	Price monitoring	Segmentation of security and bond markets	Rules for determining commission charges	Reducing prices on various markets	Procedures for money flows between different markets	Floating prices in various market segments

we have attracted new partners, organisations that are confidently and rapidly overcoming the crisis, and which will have a more important place in the post-crisis financial market.

Center-Invest's focus on lending to the real economy is the basis of the bank's success and financial development. Realising this, our partners are more confident about providing us with long-term funds for lending to the real economy.



## **Dr. Vasily Vysokov**

*PhD, Professor, President and Chairman of the Board of Directors of Center-Invest Bank (Rostov-on-Don)*

### **Education and academic work**

1995 — Doctorate in Economics from the Central Institute for Economics and Mathematics, Russian Academy of Science.

1976-1991 — Senior Lecturer, Associate Professor in the National Economy Planning Department of the Rostov State Institute of the National Economy, Rostov-on-Don.

Graduated from the Rostov State Institute of the National Economy in 1976, and from Novosibirsk State University in 1982.

### **Business experience**

2002 — Present Chairman of the Board of Directors of OJSC Center-Invest Bank.

1992–2002 — Deputy Chairman of the Board of Directors of OJSC Center-Invest Bank.

1997–98 — General Director of the Federal Foundation to Support Small Enterprises, Moscow

1991 — Head of the Market Transition Economic Support Center, in co-operation with the Rostov Region Administration.

Also:

- Vice-President of the Rostov Region Chamber of Industry and Commerce
- member of the Banking Council reporting to the Governor of Rostov Region
- member of the Investment Council reporting to the Governor of Krasnodar Krai
- member of the Rostov Region Small Enterprises Council
- member of the European Economic Association.

Frequently participates in the World Economic Forums in Davos, the annual meetings of the World Bank, the annual meetings of the European Bank for Reconstruction and Development, and other international economic forums.

## **Awards**

In both 2004 and 2008, voted “Business Person of the Year” by the readers of the Rostov region financial newspaper Gorod N.

Runner-up in the “Sustainable Bankers of the Year” category of the international competition “2007 FT Sustainable Banking Awards” (held by the Financial Times and the International Finance Corporation);

Winner in the “Financial Services” category of the competition “Entrepreneur of the Year – 2003” held by Ernst & Young;

## **Books and articles**

Dr. Vysokov has written over 200 books and articles on the challenges of the transition economy, privatization, and the post-privatization development of small business in Russia.

**Dr. Vasily Vysokov**

# **Southern Russia Versus the Global Crisis**

*A Theoretical and Practical Handbook*

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