

Rural Finance in Transition Countries

The Russian Federation



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Preface

Rural areas and the agricultural sector continue to be an important factor in the national economy in most transition countries. Like all areas of the economy and society, rural areas in these countries have undergone considerable change over the past few years. Large farms have been broken up and privatised, which has largely led to a change in the size of the farms and to on-site diversification. Growing sectoral diversification and an increasing development of the service sector has occurred. These concrete changes are taking place in a context in which rural finance is also undergoing a process of transformation. A rural finance system commensurate with needs, which represents a major requirement for the sustainable development of rural areas, does not yet exist in most of the transition countries. However, a sound analysis of supply and demand in the existing rural finance system is absolutely vital before any concepts for the development of rural financial markets can be elaborated.

Bearing in mind a close relationship between the development of the financial sector on the one hand and the real sector on the other, GTZ decided to carry out a series of studies on rural finance in order to shed some light on this relationship in rural areas of selected transition countries. Russia, by far the largest country, offers tremendous potential for developing rural finance and has been chosen for a number of reasons. The sheer size of the country, with its current decentralisation tendencies and regional policies, points to the need to develop locally adapted solutions to rural finance which involve national and regional governments. A still comparatively small number of microfinance institutions have been set up in Russia. On the other hand, the banking sector, including former state-owned banks, is on the way to discovering rural finance as a potential market. What are the links between banking and non-banking financial institutions in rural areas? Thirdly, the break up of the *kolkhoz/sovkhos* system has led to a variety of ownership forms for agricultural enterprises. What are the consequences of different ownership forms in terms of access to external finance? Finally, as in many former Soviet countries, non-monetised transactions, i.e. barter and payment in kind, are prevalent. All these aspects of the Russian experience may have interesting implications for other transition countries.

The study has been prepared by a team from *Agrarwirtschaftliche Beratung Göttingen* (ABG), a German consultancy firm that has been working on rural savings and credit cooperatives in Russia for more than ten years. AGB collected and analysed data from Saratov and Yaroslavl Oblast in southern and central Russia, respectively. In addition, the major tendencies of the transformation of the rural economy were analysed. The Russian Microfinance Center in Moscow has also contributed highly valuable research assistance and comments on latest drafts, especially on the financial sector part of the study. Further expert persons in the context of Russian-German technical cooperation have provided valuable insights from their experience. We would like to extend many thanks to all of them.

In an analysis of supply and demand as conducted in this study, it is by no means a case of designing the ideal rural financial institution or financial system as the best practice case. It does not provide a complete picture of rural Russia in either an economic or a financial sense.

The study hopefully will not only help readers to take stock of the achievements to date, but may also point towards major opportunities to further rural financial development in Russia, as an example for more or less similar undertakings in other transition countries.

Rainer Schliwa
Financial System Development

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Summary

Russia's rural economy remains dominated by agricultural production on a large-scale farming basis. Still, agricultural production is much lower than it was at the end of the Soviet Union. With the breakdown of the state-run agricultural supply, the problem of rural and agricultural finance has emerged, and presently concerns the entire agricultural sector consisting of large-scale farming companies, family farms, subsistence farming and a small rural SME sector. On the whole, neither newly emerging private commercial nor state-owned banks cater to financial needs in rural areas, instead concentrating their activities on urban and semi-urban centres. Rather than banking, rural finance in present-day Russia means all kind of commodity credits as well as mixed barter and informal loan transactions between individuals and private or public agricultural enterprises.

Yet, this lack of financial services adapted to the existing enterprise landscape in post-Soviet Russia has not remained unaddressed. The study shows that at both regional and central government levels, tentative responses to emerging demand for financial services have been, first of all, state-driven. Restructuring of state-owned agricultural banks, as shown in the case of Agroprombank, state guarantees and interest subsidies all demonstrate the limited capacity of the transforming financial landscape in financing the rural economy. Financial products and loan procedures showed little distinction with regard to their respective economic environment. Only recently, have banks started to finance the rural economy.

A promising development began in 1996 with the creation of the first rural credit cooperatives supported by various international donor agencies. This marked a revival of the Russian cooperative movement, which has its historical roots in pre-revolutionary Russia. However, today's rural cooperatives are designed as financial cooperatives providing essentially financial services such as savings deposit facilities and credit to rural households, as opposed to the multipurpose cooperatives of former times

The present study draws a comprehensive picture of the situation of rural finance in Russia after roughly ten years of transition. Considering the dimensions of the country, the physical presence of financial institutions in all agriculturally used areas of the country is a huge challenge. In addition, credit technologies must fit the needs of rural producers, which requires a thorough understanding of the rural, and in particular the agricultural, business by banks. Furthermore, commercial orientation in the delivery of financial services is not yet always prevailing. Interest subsidies, for example, only tentatively ease the burden to define cost-covering procedures and products for the rural economy. Finally, as the study also indicates, rural development is constrained by legal impediments. Still, agricultural production takes place under a variety of landownership and related property rights which, in the light of a commercial financial transaction, are often unclear, just as the relevant legal framework provides little transparency, consistency or, most importantly, trust.

Many activities have been launched which, even as stand-alone examples, show positive results as they demonstrate how access to financial services can be improved. The commercialisation of agricultural products has been improved, information has been

disseminated, and regional authorities, taking the examples of Saratov and Jaroslavl, play an increasingly important role in promoting the rural economy. Additionally, in the areas of landownership rights, examples from Saratov show how regional governments can play a supportive role in addressing the most relevant institutional and legal constraints as perceived by rural producers. Recommendations drawn from the insights point to several levels and related actors: landownership; an appropriate legal framework for rural financial institutions; a tax regime as well as comprehensive financial system development approaches integrating newly-created financial institutions such as credit cooperatives with banks located in regional centres; and policy and institutional frameworks pertaining to the rural financial sector. On the demand side, farmers need information on how to improve their business, of which, on closer examination, financial services only represent one aspect.

This study is organised as follows: Chapter I provides context and methodology and offers information about recent developments in Russia and rural areas in particular. Chapter II analyses the transformation process in rural areas in more detail. Chapter III examines the performance of the existing financial infrastructure in rural areas, and points to the setting up of new types of rural financial institutions since the middle of 1990. Chapter IV offers some conclusions and points at opportunities for technical assistance which might deliver a significant contribution to further improving rural finance in Russia.

1. Introduction

1.1 Background and methodology

This study is about rural transformation and rural finance in Russia. Due to the sheer size of the country and the significant differences between the various regions, it is almost impossible to cover the issue on a national scale. Instead, some more general features are briefly outlined with reference to the general Russian context, with more specific and detailed data and analyses provided for two regions in the European part of Russia, namely Yaroslavl in the centre and Saratov in the south. These two regions have been chosen as, first of all, they differ from each other to a considerable extent, and second, both are representative of a larger area, Yaroslavl representing central Russia and Saratov southern Russia and the lower Volga region.

Yaroslavl has limited agro-ecological potentials; agriculture is mainly based on a mixture of arable production and livestock. The policy of the Yaroslavl administration in the past decade of transition was to implement carefully step-by-step reforms and simultaneously maintain stability as far as possible. The rural areas are still dominated by agriculture, and agriculture is still dominated by large-scale farms, which are organised as legal entities. Yaroslavl has not approved any specific laws to support agriculture or rural financing. In spite of the relatively small number of private farms and rural small and medium-sized enterprises (SMEs), Yaroslavl has an active rural credit cooperative movement.

Saratov has very good agro-ecological conditions and quite a large number of private farms. The Saratov administration has approved a specific land act, which goes beyond the national legislation, and a specific law to legalise rural credit cooperatives. The progressive Saratov administration is actively influencing the transition of the rural economy. The rural economy is still dominated by agriculture. Large scale-farms organised as juridical entities dominate the countryside, but private farms are numerous and have significant economic power.

The data used in this study have been collected from official statistical sources of the Russian Federation and from the two regions. Other information was obtained through the Internet. Interviews have been undertaken with officials on the national and regional levels, with private farmers, part-time farmers, and representatives of banks, leaders of credit cooperatives, chairpersons of regional and national associations of credit cooperatives, representatives of different donor organisations, rural entrepreneurs and leaders of large-scale farms.

Since the statistical sources and the federal and regional institutions of the Russian Federation follow different lines in their statistical work, and since there are various approaches to information policy, the structure of data which have been used in this study may vary from one region to the other. The same is true if statistical data are compared which describe the overall situation in Russia and the situation in individual regions. The authors are aware of the fact that these discrepancies tend to make direct comparisons more difficult. However, this lack of uniformity is an undeniable part of reality in modern Russia.

Due to limitations in the timeframe and resources, it has not always been possible to check the different statistics for their validity; the figures concerning migration are especially doubtful, although the broad tendencies are correct. Since 1990, the authors of this study have been working permanently in different regions of Russia (in the early days, still the Soviet Union), where they have been actively participating and augmenting the transition process of the rural economy. Since 1997, they have been involved in the development of a credit cooperative-based alternative rural financing system. The experiences gained during this time have been included in this study.

1.2 Economic development in Russia - a brief overview

The Russian Federation is the largest country in the world, with a territory of 17 million square kilometres and a population of 148 million people. 27% of the population (40 million) live in rural areas. 120 million people live in the European part of Russia, while only 27 million people live in the vast areas east of the Ural Mountains. The Russian Federation consists of 89 regions ("subjects of the Russian Federation"), and if the structure is further broken down, of forty nine oblasts, one autonomous oblast, twenty one republics, six Krays, ten Okrugs and the cities of Moscow and St. Petersburg. The regions are further divided into rayons and below this, into municipalities and rural administrations. Economic and social situations differ from region to region, and can partly be attributed to a variety of factors: their different natural conditions, their geographic location, the availability of oil and gas reserves, their respective distances to the major urban centres (Moscow, St. Petersburg and Novosibirsk). However, they mainly differ because of their different approaches and experience concerning various aspects of economic reform.

Although Russia covers a large part of the northern hemisphere, one has to bear in mind that a large percentage of the soil in Russia is of low quality, except for the very fertile soils in the southern half of European Russia and the Southern Ural. The 221 million hectares of utilised agricultural land in Russia are divided up into arable land (59%), pastures and meadows (40%) and permanent crops (1%). About 2.8% of the utilised agricultural land is under irrigation. The climate varies considerably, but the continental climate, with its cold winters and hot, dry summers, predominates.

The share of agriculture in GDP dropped from 15.4% in 1990 to 7% in 2002, whereas the total percentage of people employed in the agricultural sector increased from 13% to 14% during the same period. However, taking into account the high unemployment rate and the fact that in the rural areas, unemployed people are mainly engaged in gardening and part-time agriculture, it can be assumed that out of the 27% of the total population living in rural areas, two-thirds generate their income (or their income in kind) entirely from agriculture. This adds up to 26.5 million people, or nearly 18% of the entire population.

Gross agricultural output (GAO) declined permanently between 1990 and 1999, but increased slowly in 2000 and 2001, partly because of the good weather conditions, at least in 2001. However, in addition, a slight stabilisation of the sector can be identified, enabling Russia to export wheat in 2001 (according to some people, for the first time since 1913).

It is interesting to note that there is a major disparity between the availability of the production factor soil and the gross agricultural output of the different agricultural enterprises. This is related to productivity: the still predominant large-scale farms produce much less per hectare than the small-scale farms.

Besides the policy stabilisation, the positive economic development of Russia in the past three years is based on two important factors:

- The devaluation of the rouble in August 1998 led to a substantial increase in the prices of imported products, which favoured local producers, especially in the food and car sectors (i.e. import substitution);
- The high world market prices for oil, gas and other raw materials, combined with a stable US\$, led to a high level of hard currency income for the Central Bank and for the major energy and raw material companies, which started to invest more and more money in Russia.

Table 1 Development of GDP in Russia between 1995 and 2002, in %

1995	1996	1997	1998	1999	2000	2001	2002
-4	-3	+0.5	-5	+6	+8	+5	+3.8

Source: Gozkomstat, Dresdner Bank

However, the influence of these factors on the current development is decreasing. After four years, the devaluation effect of 1998 is dissipating, and the world market prices for oil and gas and other raw materials are coming under pressure. For the next few years, analysts see a more moderate growth in GDP based on still-increasing domestic demand. A permanently stable policy framework and the realisation of the initiated reforms on the legal and practical levels are the most important prerequisites for the sustainability of this development. Slightly optimistic prognoses foresee a GDP growth corridor of 4% to 6% per year over the next two to four years. Inflation is no longer as high as in 1999 (86%), but nevertheless still considerable (around 20% per year), and is likely to remain at this level.

Since the August 1998 crisis, Russia has been able to increase its national hard currency reserves to more than US\$ 30 billion (US\$ 5 billion in January 1999). Foreign debt is at very high levels, and Russia has to pay back credits amounting to US\$ 156.5 billion.¹

Flight of capital is still a problem but decreasing, while investment in the country is accordingly increasing. Analysts nevertheless speak about US\$ 200 billion which is brought out of the country every year (mainly via Cyprus).

Laws have been approved to decrease private and company taxes and to increase tax fairness. In practice, tax fairness is far from the reality of day-to-day business. Tax controls and tax regulations are still misused by all levels of the administration to realise private or policy interests.

¹ Source: Russian Central Bank, 30 September 2001.

2. The Transformation Process in Rural Russia

This chapter provides an overview of the transformation process in Russia at the federation level and in the two oblasts of Saratov and Jaroslavl. Major tendencies concern the ownership transformation of agricultural enterprises as well as the socio-economic situation in rural areas. Sectoral trends of the rural economy are analysed, such as agricultural input supply, agricultural product trade and the development of small and medium-sized enterprises. The chapter concludes with a section on rural and agricultural policy concepts.

2.1 Major tendencies

The transition from centrally-planned to market-oriented agriculture and rural development in Russia has turned out to be long and complex. At the beginning, approaches to reforming the post-Soviet rural economy were proposed, including the privatisation of land and the reorganisation of the huge state farms into some sort of western-type farms. However, in the course of the process, and due to the highly complex reality of political, economic and social conditions, progress in both re-establishing former output levels and reorganising rural livelihoods have fallen well behind initial expectations, a decade after the fall of the Soviet Union.

2.1.1 Ownership transformation

First and foremost, agricultural production has been restructured under a variety of farm types and ownership forms. Small family farms coexist with privately-owned corporate agricultural enterprises and a few survivors from the Soviet era, the state farms, successors of the *kolkhozes* and *sovkhozes*.

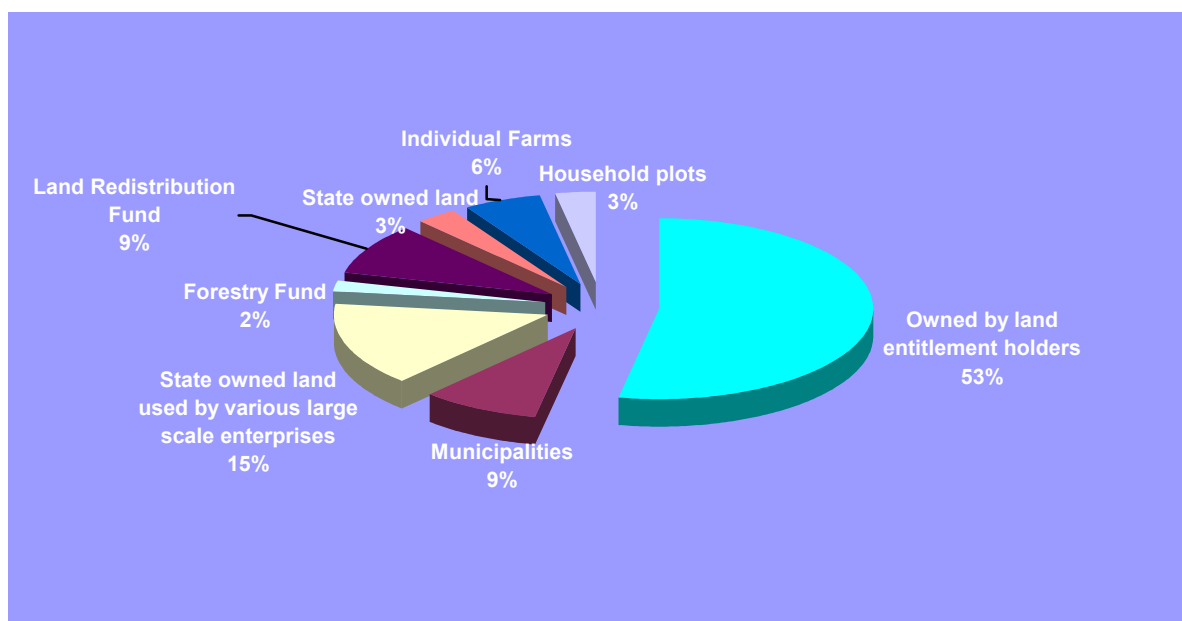
Despite organisational restructuring and creation of new agricultural entities, the legal framework regulating **landownership** and the possession of land titles remains unclear. A mixture of different presidential decrees (especially from 1993 and 1996), laws approved by the Duma and paragraphs of the current constitution have led to various forms of ownership with limited rights and different levels of limitations. Even though a land act was approved, the question of agricultural landownership was excluded.

Presidential Decree No. 323 of 27 December 1991 requires all agricultural enterprises to choose one of the **legal forms** stated in the law "On Enterprises and Entrepreneurship". In this process, all employees, pensioners and social employees in the agricultural enterprises became owners of land and received shares free of charge. Parts of the land came into soil redistribution funds on the rayon level. A physical plot of land was only assigned to those who were leaving the collective to establish a private farm. 280,000 farms were established in these early days. Since then, the number of private farmers has slightly decreased.

Table 2 Ownership rights and organisational structures

	Ownership rights	Ownership / organisational structure
1	Land which belongs to the state and which is managed by state farms.	State-owned companies (assets and land are state-owned). These companies comprise 22.1 million ha of agricultural land.
2	Land belonging to the land and/or forestry distribution fund or the state reserve.	Companies, stock corporations and other forms of collectively owned property, where the right to vote depends on the number of shares. These entities use over 107.6 million ha of agricultural land.
3	Land belonging to "land entitlement holders" with collective ownership: the owners do not have a physically identified plot of land, but a share of the whole, documented by a certificate. They sometimes receive rent for it, and whether this share can be changed into a real plot of land depends on the circumstances, the willingness of the different actors and the interpretation of the existing decrees and laws.	Production cooperatives, among which there are also some unchanged former <i>kolkhozes</i> ; these are companies with collectively-owned property in which every member has one vote independent of the size of their share; enterprises of this type manage 43.5 million ha.
4	Land belonging to individuals, mostly private farmers (it is unclear whether the owners possess land titles which can be sold).	Family farms, managing 10.5 million ha.
5	Land belonging to household plot owners and gardeners (maximum size 0.4 ha /person).	Household plot owners, gardeners, etc. (subsistence farmers) cultivate 20 million ha; 44.5 out of 50 million families throughout Russia belong to this group.

Graph 1: Landownership structure in Russia in 2000



a) Large-scale corporate farms

At the beginning of 2000 there were 27,259 large and medium-sized agricultural enterprises. 5,227 of them can be classified as joint-stock companies, including 679 open joint-stock companies. Furthermore, there were 4,601 limited liability companies and 215 partnerships; 12,652 of these enterprises were agricultural production cooperatives; 2,969 were state enterprises. There were also a number of enterprises with an indefinite status which cannot be classified as any of the organisational legal types stipulated by the legislation of the RF.

According to an official announcement by the Ministry of Agriculture, as of the middle of 2001 the **economic situation** of large-scale farms was described as follows: 22% of all agricultural enterprises could be considered as financially stable and profit-making, 17% were temporarily insolvent, i.e. partly loss-making. 16% of all large-scale farms were insolvent but, given the opportunity, able to recover. 18% of all enterprises were permanently loss-making and protractedly insolvent; they were unable to recover and in need of comprehensive restructuring. The rest of the large-scale farms (27.1%) were bankrupt and not working at all. Their assets had been removed and the land taken over or simply no longer cultivated.

As a consequence, about 70% of the bank accounts of the agricultural large-scale enterprises are blocked. A slight relief occurred during the favourable economic period of 1999-2001, when the share of loss-making enterprises decreased from 88% in 1998 to 54.1% in 2000. Overall, the machinery and tractor fleet, as well as animal farm equipment, have not been replaced over the last 10 years, and the companies especially lack the financial resources to replace equipment necessary for maintaining agricultural production in the long run. Considering the financial performance of most large-scale farms, banks are highly reluctant to advance money. As a result, long-term investments, although badly needed, cannot be financed from either retained profits or banks. Loans to agricultural enterprises do exist, but these funds, often on subsidised interest rates, are only available for profitable units. Less profitable farms are looking for other ways to obtain access to loans, although often on less advantageous conditions.

Due to this lack of funding, most agricultural enterprises have moved into the semi-legal **shadow business**, where barter transactions (sometimes reaching up to 60% of turnover) or local spot market settlements in cash prevail. In 1998 non-cash transactions made up only 12.4% of the total revenue from goods and services. In other words, due to only partly monetised transactions, non-cost-covering prices and the unavailability of financial services, the capital of agricultural enterprises is being depleted.

b) Private small and medium farms

Immediately after the break-up of state farms, the number of private farms increased rapidly at the beginning of 1990s, although their share in gross agricultural production remains relatively low. Since 1995, the number of private farms has even begun to decrease. At the beginning of 2000, there were 261,000 private family farms with an average size of 55 ha.

Table 3 Indicators of development of private farms

	1991	1992	1993	1994	1995	1996	1997	1998
Number of private farms ('000)	49	182	270	279	280	279	274	270
Average size of a farm (ha)	41	42	43	43	43	44	48	51
Share of private farms (% of total land utilisation)	...	3.4	4.9	5.0	5.0	5.3	5.8	5.8
Share of private farmers in gross agricultural production (%):								
Overall gross Production		1	2	2	2	2	2	2
Grain	0.2	2.1	5.2	5.1	4.7	4.6	6.2	6.6
Sunflower	0.4	5.8	9.9	10.2	12.3	11.4	10.6	11.0
Sugar beet	0.03	2.0	3.9	3.5	3.8	3.3	3.5	4.0
Potato	0.3	0.8	1.0	0.9	0.9	0.9	1.0	1.0
Meat (live weight)	0.1*	0.7*	1.1	1.4	1.7	1.8	1.6	1.6
Milk	0.1	0.5	1.1	1.3	1.5	1.8	1.5	1.6

* - slaughter weight

Source: Ministry of Agriculture and Food

Most private family farms use the land given to them into ownership or inherited (58.1 %).

On average, each private family farm is cultivated by 2.4 members. In addition, private family farms hire other employees (in 1999, private family farms hired 235,800 employees). However, most of the work is done by the members of the farmer's family. For example, in 1999, 89% of all work was done by family members, and only 11% by hired employees.

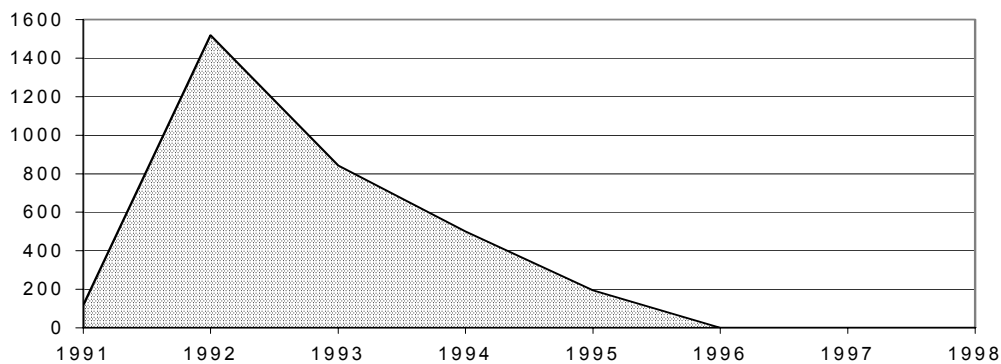
Table 4 Classification of private family farms according to the farm area (figures from 2000)

Enterprises classified according to the size of the farm	Total number of farms		Size of the farms		Average size of the farm (ha)
	Number ('000)	(%)	('000 ha)	(%)	
Less than 10 ha	100.8	38.6	503	3.4	5
10 – 100 ha	130.2	49.8	5,132	35.8	39
101 – 200 ha	18.5	7.1	2,765	19.2	150
More than 200 ha	11.6	4.5	5,984	41.6	516
Total	261.1	100	14,384	100	55

The main factor hindering the development of private farmers and causing their slow growth is their **competitive disadvantage** in market infrastructure in relation to the large-scale enterprises. Processing enterprises and financial institutions prefer to cooperate with solvent large-scale enterprises, thereby avoiding large numbers of cost-intensive small transactions. However, even though private farmers assess their financial status rather pessimistically, the problem of non-payment or bankruptcy is not as acute as with large-scale farm enterprises.

The state supported the development of private farmers especially in the years 1992–1995; after 1995, however, state support declined dramatically (see graph below).

Graph 2: State support to private farmers from regional and state budgets ('000 roubles)



Source: Ministry of Agriculture and Food, RF

c) Household plot owners

An important change in the agricultural sector was the growth of the private household sector. During the reforms, all Soviet-era limitations were abolished, and the break-up of former *kolхозes* and *sovzhoses* accelerated the growth of household plots. The number of subsidiary plots and their area (size) are provided in the table below.

Table 5 Number of subsidiary plots and their area (2000)

	1991	1997	1998	1999	2000
Private household plots:					
Number of families (million).	16.3	16.3	16.4	16.0	15.5
Private household plots ('000 ha)	3 250	5 810	5 923	6 433	6 137
On average per family (ha)	0.2	0.36	0.36	0.4	0.4
Collective and private fruit gardens:					
Number of families (million).	8.5	15.1	15.1	14.5	14.1
Area ('000 ha)	576	1 267	1 264	1 260	1 262
On average per family (ha)	0.07	0.08	0.08	0.09	0.09
Collective and private vegetable gardens:					
Number of families (million)	5.1	7.0	6.6	5.1	5.1
Area ('000 ha)	379	576	545	447	437
Average per family (ha)	0.08	0.8	0.08	0.09	0.09
Total: per private household plots, (1000 ha)	4 205	7 648	7 732	8 140	7 836

The subsidiary plots of the population are characterised by their specialisation in the production of potatoes, vegetables, fruits, berries and wool. During the last few years, the share of subsidiary plots has sharply increased in the production of meat and poultry (1999 - 59.4%) and milk (49.7%). However, this circumstance is not explained by an increase in their production volume, but rather by declining production in the collective farms.

Table 6 Share of household plots in gross agricultural production and in the production of main agricultural products, in %

	1991	1992	1994	1995	1996	1997	1998
Gross agricultural Production	28	32	43.8	46.6	47.4	43.7	50
Grain	n.a.	0.5	0.7	0.9	0.8	0.8	1.0
Sugar beet	n.a.	0.2	0.7	0.7	0.7	0.8	0.7
Sunflower	n.a..	1.2	1.6	2.0	1.6	1.4	1.5
Potato	72	78.0	88.1	89.9	90.2	91.3	91.1
Vegetables	46	54.7	67.0	73.0	76.8	76.4	79.6
Meat	31	39.5	43.2	48.6	51.6	55.9	57
Milk	26	31.4	38.7	41.4	45.4	47.2	48

Source: Gozkomstat

The production of agricultural goods on household plots is a means of **subsistence**, since the goods are intended for consumption and not for sale. Their marketability is low and has decreased even more in recent years. Production on private household plots is based on manual labour and primitive technologies. Working on their private household plots became

in many cases the sole occupation of plot owners following the massive release of workers from the collective farms owing to the reduction of livestock capita and production output.

The **tax law** provides an incentive for subsistence farmers. The owner of a private household plot does not pay any taxes except land tax, which is low, and can otherwise keep the entire revenue. On the other hand, corporate farms are required to pay 10 or 20 kopecks per rouble of revenue, and per each rouble of salary, 26 kopecks to the off-budget fund, 13 kopecks income tax, and 4 kopecks of local tax, which means that no more than 50% of income remains in the hands of the producer.

2.1.2 The socio-economic situation in rural areas in Russia

Collectivisation and the period until 1990 in Russia completely transformed rural life and rural livelihoods. During this period, large-scale farms came to incorporate all aspects of rural life and became the dominant economic and social structures in rural areas. In the past decade, the ongoing transition, combined with the economic deterioration of the large-scale farming system, has had a significant impact on rural settlements and the quality of life of rural inhabitants.

The *kolkhoz/sovkhos* system, supported by significant subsidies and budgetary transfers, provided secure employment and the conditions for a simple but acceptable (at least until the 1980s) life for the majority of rural inhabitants. The deteriorating financial state of the large-scale farms, and the absence of genuine economic reforms in rural areas, led to declining living standards and increased economic difficulties for a significant portion of the rural population.

The rural population, like the population as a whole, is shrinking. Although there is a steady migration to Russian villages from neighbouring CIS countries, the overall rural population growth has been negative, primarily due to declining birth rates in rural areas.

The economic downfall of rural Russia can probably be best represented by the significant increase in **rural unemployment**. In general, unemployment in rural Russia is 18% as compared with the urban unemployment rate of 11%. General and registered unemployment follow different paths, however. The number of the rural unemployed who are registered with state employment agencies is reported to be only 15% of their total number (3.3 million people). Only 12% receive unemployment benefit. Thus, the majority of the rural unemployed are outside the state-regulated labour market and socially unprotected.

Poverty has become a general phenomenon in the countryside. According to data from selective research undertaken by the RF State Statistics Committee in 2002, 47% of the population employed in farming (18.5 million people) and 35% of the urban population had an income that was lower than a living wage. 15% of the rural population had an income half or less than half of a living wage (5.8 million people). According to the methodology of the state statistics bodies, this is defined as the level of extreme poverty.

The root of increased rural poverty is the **economic collapse** of the large-scale farms. Most collective enterprises reduced their volume of production significantly (between 1992-1998,

by 50%), and cut their labour force by 3 million during the same period. The decline in economic activity resulted in a very significant contraction in agricultural salaries, both in absolute and relative terms. The average salary in Russian agriculture was 469 roubles per month in 1998, which amounts to only 44.5% of the average salary of the country as a whole. A further problem is the delay in wage payments. 88% of agricultural enterprises had wage arrears in 1998 that were 5.2 times their average monthly salary. In addition, a significant portion (often 50%-60% of wages) is paid in kind. In-kind payments are contributing to household food security and household-based agricultural production. However, at the same time, they are reducing disposable cash incomes for rural households. In assessing the income situation of rural households, it is necessary to add, however, that a significant proportion of rural household income (at least 30%-40%) originates from private household farming activities (household plots).

Essentially, the countryside is showing all the negative effects pertaining to a **consumer crisis**. The current situation is characterised by an economically and socially dangerous decline in income-related stimuli, a sharp decrease in the current consumption and wealth status of the population, a deep social stratification of the rural population, and a wide gap between the consumer standards of the rural and urban populations. All these developments are culminating in a long-term decrease in the quantitative and qualitative potential of the countryside, and might thus cause social confrontation.

Socially speaking, the rural areas are in an extremely difficult situation. During the reform period, **social investments** in the rural areas decreased by 13-14 times. The social investment volume per rural inhabitant is five times lower than the average volume per Russian citizen, whereas in the 1990s this ratio was close to 83%. As a result of inadequate financing, the public housing sector and the civilian construction volume (of all objects) have sharply decreased. Many rural housing funds provide no elementary communal facilities whatsoever. Running water supply in rural areas is two to four times worse than in urban areas, and the rural areas are also lagging behind in the provision of sewerage systems and central heating. Hot water supply in rural communities is five times lower than in urban areas.

The main part of social sphere potential maintenance costs is paid by **agricultural enterprises**. The funds allocated for this purpose from the state budget remain however predominantly in the cities. In 1999, agricultural enterprises spent over 11.3 billion roubles on maintenance of the social and engineering rural infrastructure. Less than 1 billion roubles were given to them in compensation from the budget of the RF subjects.

Table 7 Regional economic and demographic indicators (2001)

Region	Population in million	Area in km ²	Share of rural population in total (%)	Population density	Share of employment in primary sector (%)	GDP per capita in PPS in Euro
Russia	148	17,000,000	27.0	8.7	11.4	250.42
Yaroslavl	1.4	36,177	19.4	38	5.37	192.82
Saratov	2.73	100,000	26.27	27	8.9	255.50

Sources: Gozkomstat and statistical offices in Yaroslavl and Saratov

Table 8 Structural indicators, regional enterprises and legal forms of business

Region	Share of agricultural land in total (%)	Registered general unemployment (2002)	General unemployment, unregistered (2002) *	Number of agricultural enterprises		
				Large-scale farms	Private farms	Household plots
Russia	13	1,122,700	6,410,000	27,259	261,100	44.5 mio.
Yaroslavl	52	10,100	52,000	369	2,115	390,000
Saratov	84	16,500	97,000	854	8,182	999,500

*according to estimates by Gozkomstat, the official figure of unregistered unemployment; in reality, unregistered unemployment might be even higher

Sources: Gozkomstat and statistical offices of Yaroslavl and Saratov

2.2 Regional aspects: the Saratov Oblast

Saratov Oblast is one of the leading agrarian regions in Russia. It is located in the European part of southern Russia on both banks of the river Volga, and its conditions are famous for growing crops such as wheat, barley, sugar beets, sunflowers etc. Brown steppe soils are predominant, and some regions were cultivated by German emigrants during the 18th and 19th centuries.

Saratov Oblast has 2.7 million inhabitants, 2 million of whom live in the cities, while 0.7 million or 26% live in rural areas.

2.2.1 Ownership transformation

Federal land legislation is based on the land code, the Russian constitution and a number of presidential decrees. Although a "final" land act has been under discussion since 1988, the question has never been settled. In spring 2002, a law regulating the real ownership of land under buildings and for industrial purposes was approved on the national level, but due to pressure exerted by different powerful policy movements, the question of agricultural land was once again excluded. As a reaction to the lack of developed land legislation on the national level, some regions have started to develop their own land acts. The question as to whether such regional acts, which overrule national laws, are in line with the Russian

constitution is heavily under discussion. Nevertheless, Saratov's local government and parliament have approved a local land act.

The Saratov Oblast law on land says that the oblast has the right to define the rules and regulations for landownership. The law stipulates that citizens of the RF can have land plots in Saratov Oblast as private property, life-inherited possession, for permanent use, short-term and long-term use, and as leasehold. Foreign citizens, stateless citizens, foreign legal entities and foreign states can only have land plots in Saratov Oblast with tenant rights.

In Saratov Oblast, land plots which are owned by two or more people belong to them jointly according to the right of joint property. By definition, joint property of a land plot applies whether the owners hold shares of this plot (joint shares in ownership) or not (joint ownership). The right of land, life-inherited possession, and permanent usage are legalised with a standard form certificate.

The right of temporary use, rent and sub-rent is arranged according to agreements between the owner and the user. Forms of agreements and certificates on land rights are proved by the legislation of the RF. Land usage in Saratov Oblast is paid with the exception of cases stipulated by federal and local legislation or agreements.

Landowners in Saratov Oblast have the right to:

- carry out farming activities;
- use minerals available on the land for personal needs;
- build and rebuild constructions;
- make irrigation, drainage, amelioration etc., ponds etc. ;
- sell, donate, pledge, lease out, succeed and conclude other transactions with land plots if not under arrest;
- receive monetary compensation for land plots when the land is taken away because of state and municipal needs.

During the land reform, *kolkhozes* and *sovkhozes* were reorganised; around 6.8 million ha of land were privatised (according to different forms of joint and real ownership), and 322,000 former employees became owners of land shares. In the meantime, 8,182 private farms, which control 1,276,345 ha in total, have been established (the average size of a farm is 156 ha).

999,500 citizens have land plots for house holding, collective gardening, individual house and dacha building. By now, about 108,900 ha are being used by individuals. The average household plot has increased from 0.12 to 0.2 ha, and an average household plot for small-scale gardening from 0.06 to 0.08 ha. For most land plots, the rights of citizens and legal entities have been registered. Documents certifying the right to land have been handed out to 838,000 citizens and 9,300 legal entities and farm enterprises. Partly, land rent has to be paid by the "owner" to the local administration. The rent is paid annually and differs depending on location and soil quality.

The procedure of **landownership registration** is very complicated and takes much time and money. It also costs more than the land itself. This is one of the reasons why no real land market exists and mortgage lending does not work. In practice, land is rented informally without any proper registration. Private farmers in particular often rent land from small landowners in the villages. Since landowners have realised that their land could be of increasing value, they hesitate to sell and prefer to rent. Nevertheless, there is still no clear differentiation between federal, oblast or municipal property.

The Saratov administration has realised that the **national tax rules** and regulations are unclear and represent a real constraint for the development of rural areas in general and of private farming in specific. In the Saratov Oblast Rayon of Lisii Gori, a “single agricultural tax” system has been tested on a pilot basis. The idea is to introduce a simplified system and to use the experience gained to implement an adapted system for the whole oblast. The results are promising: taxpayers prefer such a simplified system instead of filling in about 56 reports and forms per year (14 each quarter). With the new system, only one form one page long has to be submitted. Payments into the local budget have increased and are stable. A draft law on oblast level concerning “the single land tax system” is being discussed in the regional Duma but has not yet been approved.

2.2.2 Social and economic situation

The Saratov Oblast comprises 38 rayons, 18 small cities, 30 towns and 1,762 villages. The main industry in the oblast is agriculture, specialising in wheat, sunflower and sugarbeet production.

The rate of unemployment in rural areas is very high, and salaries and family income are low. Particularly for unemployed people, household plots are the only source of income (in kind).

Table 9 Demographic overview of Saratov Oblast

	1996	1997	1998	1999	2000	2001
population /thousand	2737,5	2726,1	2721,4	2719	2709	2736
urban	2008,2	1992,5	1987,4	1984,1	1975,9	2017
rural	729,3	733,6	734	734,9	733,1	719
specific gravity of rural population	26,64	26,91	26,97	27,03	27,06	26,28
able-bodied population /thousand	1568,2	1562,8	1568,6	1581,8	1595,8	1576

Due to the **migration** of people able to work from former republics of the Soviet Union over the past five years, there has been some growth in labour supply. Since 1992, about 56,000 people, mostly from former central Asian Soviet republics, as well as from the Caucasian republics, have settled in Saratov Oblast (about 30% from Kazakhstan, 25% from Uzbekistan, 10% from Tajikistan, 8% from Azerbaijan, among others).

2.3 Regional aspects: the Yaroslavl Oblast

Yaroslavl is located 240 km northeast of Moscow in central Russia, and the capital of the oblast which gives its name to the oblast is one of the oldest cities of Russia. The Volga divides the region. The city of Yaroslavl has oil-based and machinery industry.

Yaroslavl Oblast covers 3,617,700 ha; out of this, 1,939,800 ha are agricultural land, forest covers 1,016,100 ha, cities and villages make up 188,100 ha, land used by industry and for streets, railway etc. amounts to 44,600 ha, nature resources amount to 53,300 ha, land for water resources amounts to 365,600 ha, and the land of the land fund covers 84,000 ha.

2.3.1 Ownership transformation

By 1 January 2002, 2,115 private farms had been registered; the average size of a private farm is 21 ha, but the farm land is not distributed equally. Farm sizes vary between 3 and 800 ha. 70% of the farms are between 20 and 50 ha. No figures could be found as to which extent private farmers produce for the market. Investigations by the authors have led to the conclusion that only 20% of the farms produce more than 50% of their production for the market; all the other private farms produce most of their production for their own consumption and market the smaller part of their yearly production.

In total, 369 agricultural producers are organised as juridical entities. According to an assessment made by the regional administration, 91 are financially stable, 132 have financial problems, but could still overcome such bottlenecks after a phase of reconstruction. 146 are practically bankrupt and cannot be reorganised.

As in the whole of Russia, Yaroslavl region also features different **types of ownership** covering the whole range of more or less transformed and privatised agricultural enterprises and farms.

Table 10 Agricultural farms and enterprises in Yaroslavl Oblast

Type of entity	Number	Total area (ha)	Average size (ha)	Part of total area owned (ha)	Part of total area rent (ha)
Private farms	21115	46,100	21.7	21,400	24,700
Part-time farmers	390,000	97,800	0.25	60,500	37,300
Large-scale farms	369	1,795,900	4,866	128,800	1,667,100
Total	392,484	1,939,800	-	210,700	1,729,100

Private farms manage only 2.4% of all farm land. 46.4% of the land which is managed by private farms is actually owned by them; 53.6% is rented.

Large-scale farms control the lion's share of the land (92.5%), but own only 7.1% of it. As already described above, the term "not owned but in possession" covers a wide range of possibilities such as joint ownership, state property, rented land, property of different land funds, inheritable possession, etc.

The group of gardeners and part-time farmers can also be subdivided into many groups such as private persons organised in gardening collectives, private persons, private persons organised in trucking collectives, private persons organised in summer residents' collectives (datchniki), owners of physically distributed land shares of collective farms, etc. In each group the status of ownership differs slightly.

The Yaroslavl government has neither discussed nor approved any specific land act. Land distribution is enacted according to the national legislation. One of the core problems is a lack of information; people do not know their rights. Better informed and more powerful people manage to interpret the unclear legislation in their favour.

2.3.2 Social and economic situation

The total population of Yaroslavl increased between 1970 and 1990 and then decreased to the level of 1970 between 1990 and 2001. However, the rural population has decreased significantly, whereas the urban population has increased accordingly over the past 30 years. There has been a clear **movement from rural areas to urban centres** since the early 1970s; only between 1990 and 2001 did the relative share of population in rural areas increase by one per cent. This can be explained by migration from the former Central Asian republics to rural areas in Yaroslavl. These refugees from Kazakhstan, Uzbekistan, Turkmenistan, Kyrgyzstan and the Caucasian republics of Armenia, Azerbaijan and Georgia are the poorest of the rural population. It can be assumed that the migration of Russians from former Soviet republics as well as nationals from those states will not end in the near future. Official statistics speak of 25 million Russians living outside Russia.

Table 11 Population of Yaroslavl region

Year	1970	1980	1990	1999	2000	2001
Population ('000)	1,400	1,429	1,473	1,426	1,413	1,402
Urban ('000)	980	1,116	1,205	1,148	1,138	1,130
Rural ('000)	419	313	267	277	275	271
% rural	29.9	21.9	18.2	19.5	19.5	19.4

People in rural areas are mostly occupied in agriculture, where work on large-scale farms still dominates. Especially in the northern regions of the oblast, people are also engaged in forestry and wood processing. In the different rayon centres, the main employers are small factories, the agro-processing industry, hospitals, shops and administration. Living standards are low, **unemployment** rates are high; official figures speak of 20%. The social infrastructure is still functional; most rayon centres have healthcare institutions and provide school and educational services.

One of the most significant constraints on the further development of private farming and rural entrepreneurship is the lack of information. People simply do not know how to obtain access to their shares of land and assets and, if they know, are afraid of the bureaucratic barriers and the high costs involved in starting and completing the process. The management of large-scale farms use these constraints and simply hinder people from accessing their rights.

Table 12 Relation of age groups of Yaroslavl's population (%)

Year	1990	1997	1998	1999	2000	2001
Part of active employment population (1)	56.0	56.6	57.1	57.8	58.7	59.4
Part economically active in rural areas	48.3	50.3	51.1	52.1	53.3	54.5
Part economically active in urban areas (2)	57.8	58.2	58.6	59.2	60.0	60.6
Younger than 16	21.3	19.0	18.4	17.9	17.2	16.5
Over 59 (men) and 54 (women), respectively	22.7	24.4	24.5	24.3	24.2	24.1

(1) Active employment population: men between 16 and 59 and women between 16 and 54

(2) Both parts do not sum up to 100%

Source: Yaroslavl's official population census

The statistics show that the relative share of economically active people in rural areas is increasing while the number of younger people is slightly decreasing. This development is in line with the shrinking population throughout Russia.

2.4. Structural aspects of the rural economy

2.4.1 Input supply

Over the past few years, **agricultural input supply has much improved**. In principle, inputs required are available on time and in sufficient quantity from Russian or foreign production. Among the input traders are private companies and some state-owned purchasing organisations. Agricultural producers do not tend to dispose of liquidity when agricultural inputs need to be purchased. Generally, neither working capital nor investments in equipment or, often, spare parts can be financed from agricultural producers' own financial resources.

It must be emphasised that the **lack of working and investment capital** constitutes the main bottleneck to proper business development. Rural enterprises and agricultural producers are not able to invest in highly needed machinery, input means, storage, sale

facilities, etc. Most of the equipment and material was purchased during the Soviet era and is totally outdated, overused and not in line with modern technological developments. This puts significant limitations on the quantity and the quality of the products. Field trials, questionnaires and experience gained in practice have shown that existing production potentials are only used to 30–50% capacity.

In periods of high inflation (e.g. 1998), **commodity credits** are the main tool for financing input purchases. To a smaller extent, such credit methods are still common. These types of credits are granted by local administrations, purveyors, processors, suppliers of gasoline and mineral fertiliser. Almost all of them require credit payments in kind. As a result, the exchange proportion (e.g. crop to gasoline) includes the average bank interest rate.

For example, in spite of the low level of financial solvency of agricultural consumers and the lack of budget financing, the Sidanko oil company provided fuel to agro-producers in the Saratov region on the basis of commodity credits over the last few years. In 2000 the company delivered 179,000 tons of diesel for agricultural needs; 60,000 tons of the total amount were distributed under different credit schemes.

Another constraint besides financing is an widespread **information vacuum** in which agricultural enterprises, farms and rural SMEs operate. There is no proper information flow; knowledge of the market situation, advantages and disadvantages, prices, purchase possibilities etc. is very limited. Therefore, input buyers act on the market spontaneously and are often guided by random preference.

2.4.2 Output trade

In Saratov, the output trade (at least for wheat) is much more regulated than in Yaroslavl. Only a quarter of the harvest can be sold on the local market; the rest goes to different state organisations or is used to repay loans in kind.

Table 13 Trading channels of wheat in Saratov Oblast

	Wheat harvest total ('000 t)	State consumer co-operatives ('000 t)	Open market ('000 t)	Barter ('000 t)	Given to population instead of wages ('000 t)
2000	2,247	787.5	506	538	416
Relative share	100 %	36 %	22 %	24 %	18 %
2001	1 954	136.7	547.1	n.a.	547
Relative share	100 %	7 %	28 %	37 %	28 %

2. The Transformation Process in Rural Russia

The pattern of selling agricultural goods as we have seen in Yaroslavl also applies to the Saratov region. Due to very limited pre-financing instruments, the producers are obliged to sell their yields directly after the harvest to pay their debts. This makes producers heavily dependent on the buyers' price dictates, and leaves no room to store and wait for higher prices. The current situation and the relevant fact that yields are sold immediately after harvesting leads to a crop glut on the market in autumn and a deficit situation in summer.

The degree of regional government involvement and interference differs between the two selected regions. Through the following actions, the Saratov government has a direct influence on the input/output trade:

- there are regulations which forbid the "export" of wheat out of the Saratov region,
- a regional agency (the "Oblast food fund") buys a certain proportion of the wheat harvest at fixed prices (the idea here is to stabilise the wheat price),
- the regional administration supports the establishment of an input/output dealer network,
- to overcome the lack of machinery, the regional administration is seeking to reintroduce the concept of machinery tractor stations (MTS); these stations partly offer a full land management service,
- Saratov's administration has sometimes shown a negative attitude with regard to the "export" of locally produced crops to other regions.

In Yaroslavl, private farmers market their products to retail shops, hospitals, kindergartens, schools, restaurants, military organisations, to wholesalers at the city markets, and to other regions. Household plot owners sell their products on the markets, to retail shops, on the streets, to restaurants, etc. Wholesalers visit rural production sites and collect agricultural products directly from the household plot owners. Large-scale farms sell their products to large wholesalers, on the city markets, to other regions, to the canteens of factories, schools etc. Some large-scale farms have their own shops (network of shops), e.g. the large-scale farm "Pakhma" near Yaroslavl has some retail shops in Yaroslavl (milk and meat products, vegetables).

Compared to Saratov, Yaroslavl's administration interferes much less in the markets. In 2000, the organisation "Sodeistvie" (attached to the Yaroslavl regional administration) was responsible for government supply. Sodeistvie organised barter transactions and the procurement of municipal kindergartens, hospitals etc. with agricultural products via public tenders to regional agricultural producers.

Today there is a Committee of Government Supply in the Department of Economic Development, Investments and International Co-operation at the Yaroslavl regional administration. There is a tendency according to which the state organisations get more free rein in selecting suppliers.

2.5 The development of small and medium-sized enterprises

2.5.1 SME development in Russia since 1991

The **small and medium enterprise (SME) sector** is a relatively new phenomenon in Russia, and it was only in 1991 that the term "small entrepreneurship" was mentioned in a government act in a positive sense. A legislative act regulating the development of small entrepreneurship and relations between SMEs and the state was adopted as late as 1995. However, from the beginning, state policy was characterised by an ambiguous approach towards the development of SMEs.

At the **national level**, successive governments have only slowly realised the relevance and importance of SMEs. Late in 1991, the State Committee for Small Entrepreneurship was established on a national level, only to be abolished a few months later. Between 1992 and 1994, the State Antimonopoly Committee acted as the leader and coordinator for other state bodies (Ministries of Economics, State Finance etc.) and implementing agencies of the state's SMEs policy, which included, among other activities, the foundation of a Federal Fund for Entrepreneurship and Competition Promotion. From 1994 to 1995, specific Federal Programmes for SME state support were introduced to strengthen the efforts of the government, at both the federal and the regional levels, including private firms and public institutions towards the promotion of small businesses.

In 1995, the concept was changed once again, with the establishment of the State Committee for the Development and Support of Small Entrepreneurship. Despite this, the main implementer of governmental policy remained the Federal Fund, transformed into the Federal Fund for the Support of Small Entrepreneurship. This twofold approach in state policy regarding SMEs led to numerous conflicts between the two state institutions, and after the resignation of the Kirienko government in August 1998, SME support and development on the federal level fell back into the hands of the State Antimonopoly Committee. This rather unclear situation and frequent changes in the staff of the relevant institutions led, in combination with unclear schemes of state SME support, to an ambiguous and rather inefficient SME support policy on the federal level, a fact that was not exactly mitigated by the 1998 crash. From 1998 onwards, little has changed in the overall approach of state SME support. Russia's political establishment is only slowly realising the relevance and importance of SMEs regarding the creation of employment, securing a tax inflow stream, etc. This is why various programmes have been declined by the Duma and/or changed and reduced to a notable extent.

On the other hand, SME support on the **regional and local levels** has been more successful. The first regional fund for SME support was established in Murmansk in 1990, and in the mid 1990s there were already nearly 60 subjects of the Russian Federation where such funds existed, and more than 70 regions where a specific department of the local administration to support local SMEs had been established. However, right from the beginning, the success of those SME programmes varied greatly from region to region. The front runners in market transition, such as Moscow, St Petersburg, Nizhni Novgorod and

Yekaterinburg, established rather advanced and flexible systems of SME support concepts, including the establishment of institutions providing schemes for training, consultancy services and financial support.

International donor organisations, among them the EBRD, the *New Russia Small Business Investment Fund*, *CARE Small Business Assistance Corporation*, the EU's *Tacis Programme*, *USAID* and *KfW* also contributed to SME development by financing development and training programmes in various regions of the Russian Federation, focusing on the development of self-help opportunities and grassroots initiatives, as, for example, the Small Business Week in October 2001, an event which had the express purpose of promoting small and medium enterprises. With the support of the European Business Club, the American Chamber of Commerce in Russia, and a wide range of private and government organisations, the event focused on such issues as e.g. financing, tax and legislation, franchising, information technologies, human resources, marketing and advertising. High-ranking government representatives participated in this event, which aimed at emphasising the importance of SME development for Russia's national social and political future. In this context, it is interesting to note that the SME sector is the only fast-growing business sector in the Russian national economy.

The share of SMEs in the agricultural sector has been rising on average. According to *Goskomstat*, in 1998 the share of agricultural SMEs in the total number of enterprises rose from 3.3% to 3.5%. On average, Russian agricultural SMEs employ 14 employees. While at the beginning of 1995 (i.e. before the 1998 economic crises, with massive depreciation of the rouble, increasing inflation etc.) the number of employees was subject to a decrease in almost every other SME sector, the number of employees working in agricultural SMEs actually increased by 26%.

However, increased employment did not have a positive effect on labour productivity and profits. This trend was - and still is - the consequence of the changes and the simultaneous ideological standstill which have been emblematic of Russian agricultural policy during the transition period, such as (i) overall decline in subsidy levels, especially in cheap inputs (fertiliser, fuel), (ii) preference for large, formerly state-owned agro-businesses, (iii) regionalisation, (iv) continued gridlock over landownership and use rights, (v) failure to create market relations and market infrastructure, and (vi) the imposition of trade barriers and administrative price controls. Although much of this is true for the whole agricultural sector, it has to be stressed that the development of agricultural SMEs has been very much slowed down or hindered by these outside factors. Continued and streamlined support of agricultural SMEs is needed if they are permanently to play a significant role in supplying the Russian rural population.

2.5.2 Regional SME development in Yaroslavl and Saratov

The Yaroslavl SME sector development is regulated and controlled by the Department of Industry.

Table 14 The situation of SMEs in Yaroslavl Oblast:

	1995	1996	1997	1998	1999
Number of SMEs	7,986	7,989	7,247	8,867	8,020
Number of employees	69,567	72,943	65,961	67,959	62,041
Production value (million roubles)	1,894.8	2,793.2	2,211.3	2,627.3	3,469.6
Turnover (million roubles)	3,747.3	6,193.6	5,805.8	7,995.1	13,187.2
Profit	325.2	190.1	296.6	92.4	361.2
Investments (million roubles)	589	71.8	82.8	93.6	132.4

* figures which differentiate between SMEs in rural areas and in urban areas could not be found. It can be assumed that two-thirds of all SMEs are in urban centres, with a clear concentration in the city of Yaroslavl.

In 1999, 95% of all SMEs in Yaroslavl Oblast were **private enterprises**. The average SME in Yaroslavl region had eight employees in 1999 (10-13 employees in the industrial sector, ten employees in the construction sector and five to six employees in trade). Approximately 18% of all people employed in Yaroslavl Oblast are actually SME employees; 85% of those are full-time (permanent) employees. The economic potential and performance among the SME sub-sectors has remained unchanged over the last few years, with the service sub-sector as the strongest. This tendency can be explained by the characteristic features of SMEs as an economic sector and by the worldwide tendency of a dominant services sector.

In 1999, the Yaroslavl SMEs earned 4,079.4 million roubles (after VAT and fees). This means that their **earnings** have grown 1.6 times compared with the previous year; however, this positive development cannot hide the fact that further long-term investments (i.e. equipment) are necessary to secure and prolong the growth of SME activities. The supply of long-term finance or leasing facilities is not sufficiently available, as the current leasing market is underdeveloped in Yaroslavl Oblast.

The **territorial distribution** of SMEs is as follows: 60% of all SMEs are concentrated in the centre of the oblast, followed by Rybinsk (15.6%), Tutaev (3.5%), Pereslavl-Salesskiy (3.3%), Uglich (2.4%) and Rostov (1.7%). In the districts, excluding Yaroslavl district (6.3%), there is an SME distribution of only 1%.

Table 15 Distribution of employees in the SME sector

	1995		1999	
	No. of employees	%	No. of employees	%
Total	69,567	100.0	62,041	100.0
Industry	15,893	22.9	14,481	23.3
Agriculture	2,649	3.8	3,022	4.9
Construction	22,193	31.9	18,786	30.3
Trade, gastronomy sector	17,863	25.6	18,786	30.3
Technical services	1,579	2.3	1,660	2.7
Miscellaneous commercial activities guaranteeing market efficiency	651	0.9	1,124	1.8
Communal infrastructure	1,525	2.2	313	0.5
Health, sports, social institutions	658	1.0	417	0.7
Education	634	0.9	45	0.1
Culture and arts	346	0.5	653	1.1
Sciences and scientific services	1,380	2.0	612	1.0
Finances, credit services, insurance, pension services	349	0.5	201	0.3
Other services	1,361	1.9	3,710	6.0

As in other regions, SMEs suffer from various problems which are impeding further development: an insecure legal basis for SME development, high taxation, problems related to the overall economic situation, difficulties in obtaining credits and high interest charges, the banking system, high rents, complicated and inappropriately long bureaucratic procedures connected with SME registration, and the rent of infrastructure and land.

The Yaroslavl government is well aware of these market imperfections and shortcomings and is pushing ahead with an active and pervasive **policy of SME support**. This SME policy can be described along the following lines:

- a developed institutional and legislative framework;
- considerable funding from SME Support and Employment Funds;
- participation in international assistance programmes;
- an increasing number of small enterprises.

The Yaroslavl government has already undertaken various steps towards mitigating the problems mentioned and aims at fostering the development of SMEs. The measures already implemented or currently being implemented are as follows:

- improvement of the legal framework
- the design and implementation of a simplified tax system
- a subsidy programme with total subsidies of 4.5 million roubles in 2001 (€ 0.166 million). The subsidies are used to subsidise the interest rates of commercial bank credits to SMEs, to establish a microcredit scheme, to support business planning in SME and to finance infrastructure supporting the SME sector
- organisational support to SMEs in different sectors is planned to be delivered
- half a million roubles (€ 0.018 million) were financed from the oblast budget in 2001 to create a Yaroslavl "Municipal Education Institute for the Support of SME"
- for information campaigns regarding the SME sector, including seminars, business meetings and conferences, 0.4 million roubles or € 0.0145 million are foreseen
- for scientific and methodical support, staff support and image building measures, 0.850 million roubles or € 0.031 million are foreseen.

The subsidies for 2001 alone add up to a total of 6.25 million roubles or € 230,000.

Saratov

Similar to Yaroslavl Oblast, Saratov Oblast is trying to create incentives for the formation of SMEs. Together with the Ministries of Education and Culture and Agriculture, the Saratov Ministry of Economics has elaborated a **concept for small business support** which is reflected in the following government programmes:

- A municipal target programme for the development of small business in Saratov for 2001-2003;
- A draft of "Conception of State Support Development of Small Business in the Russian Federation";
- A municipal Target Programme of Support for Not Sufficiently Provided Citizens in Saratov in 2002.

It is the aim of these programmes to foster SME development in order to enhance the living conditions in and the economic structure of the region. Special emphasis is laid on supporting SMEs from the agrarian complex and SMEs that aim at enhancing the overall living situation of the oblast population (consumer goods, small production businesses, innovative businesses, and service industry). Small entrepreneurs will be supported along the same lines as in Yaroslavl Oblast (i.e. financial and advisory services, schooling, legal support, special incentives such as new credit lines and microfinance).

Table 16 Situation of SME development in Saratov region (end of 2000)

Type of SME	No	in %
Total	11 1000	100
Industry	1 665	15
Agriculture	256	2.3
Building	1 887	17
Transport	211	1.9
Trade and catering	6 338	57
Wholesale trade	133	1.2
Customer service	144	1.3
Public health service and social security	166	1.5
Science	300	2.7

Looking at the agricultural sector, the relevance of SME development in this sphere of business is characterised by the following numbers:

Number of private farms in Saratov Oblast	8,215
Private farms registered as enterprises	3,593
Private farms registered at legal entities	4,622

Since the Saratov government is aware of the difficult economic situation, it is trying to integrate international donor agencies into its development programme. Notable agencies are: ACDI/VOCA and the EU's Tacis projects, which aim at creating an infrastructure for small and medium enterprise development. Other national and international associations and institutions are active in this region, among them the Soros Foundation which support social welfare, education and health projects.

2.6 Rural and agricultural policy concepts

2.6.1 National rural and agricultural policy

National agricultural policy is shifting between different approaches and there is no common understanding about the right future strategy. In the early 1990s, the idea of private farms was favoured. Even until today, the left-wing agrarian party managed to block a real transition of the large-scale farms, new policy concepts promoting so-called "Agroholdings". These are entities comprising several large-scale farms led by a market-oriented management and accommodating a high level of investments. Only a few of these entities have so far been created; one of them (in the region of Brijansk), which was promoted as a positive example, has in the meantime been split into several entities.

Agricultural policies have always used financial instruments. Since the beginning of the 1990s a system of **preferential centralised credit** for the agro-food sector has been

established in the agricultural sector. The credits were delivered through selected banks, mainly Agroprombank. The agricultural producers had to pay the margin to the bank on a monthly basis, while principal and interests had to be paid at maturity. The interest rate was 28% p.a. (1992–1994), while the Russian Central Bank interest rates ranged between 180% to 230% p.a.. With the economic collapse of 1998, the **repayment rates** went down and the system of preferential centralised credits failed. This caused an accumulation of debts in the agricultural sector despite an extensive writing-off of bad loans in the years 1994-1995 and 1997-1998.

In 2001, the Government of the Russian Federation adopted a decree on **subsidising the interest rate** for agricultural credits. Eligible for this scheme were the following:

- agricultural producers using credits for purchasing seeds, forage, gasoline, spare parts for agricultural equipment, mineral fertiliser, agro-chemicals and veterinary medicines;
- food and processing enterprises and organisations of the agrocomplex using credit for the purchase of home-produced raw materials.

The scheme allows these companies to receive an interest subsidy for a loan obtained from a commercial bank. The subsidies are meant for short-term credits (maximum term: nine months), which have to be spent on production means (e.g. forage, fuel, seeds, spare parts for machinery, fertilisers, herbicides and veterinary means) or for the purchase of agricultural raw materials. The interest subsidy is paid monthly and directly to the borrower after a proof of interest payment has been submitted. The subsidy amounts to two-thirds of the refinancing rate of the Central Bank of Russia at the moment of credit delivery. The Ministry of Agriculture is managing subsidies through the regional and oblast administrations. The decree has been prolonged into 2002.

The **major constraint of agricultural policy** is that policy is not made in an interactive participatory approach, i.e. by discussing relevant topics with the affected rural public. Communication between national bodies and regional administrations is very limited. In practice, policy is made by only a few people and interest groups, elaborating a policy concept or new strategies which are then implemented by presidential decrees. Policy is not based on reaching consensus with the relevant parties. National bodies representing farmers, part-time farmers, credit cooperatives or rural SMEs are weak stakeholders and sometimes strongly dependent on different ministries and state bodies.

2.6.2 Regional rural and agricultural policy in Saratov and Yaroslavl

Saratov

Bearing in mind the importance of agriculture to the whole oblast economy, the oblast government has developed a specific policy to develop agriculture and the rural areas. This policy comprises both policy measures and subsidies. Saratov's government has a leading position in Russia in recognising the need to reorganise the agricultural sector. This is demonstrated by the fact that Saratov is one of the few governments in the Russian

Federation to have tried to overcome the bottlenecks of the federal **land act** through local legislative actions.

The Saratov **agricultural policy** is summarised in the 'Agricultural Complex Development Conception for the Period to 2005'. This document is a part of the "Strategic Development plan for Saratov Oblast." The agricultural policy is linked to other oblast programmes which tackle topics like rural development, improvement of the rural infrastructure (water supply), improvement of SME development, land reform, etc.

As described above, since 2001 the Russian government has been running a yearly programme to **subsidise interest rates** for agriculture credits. In 2001, loans of 55 million roubles (€ 2.03 million) were accessed through subsidised interest rates in the Saratov Oblast, split as follows:

- for farms: 5,495,000 roubles (€ 0.2 million) or 10%
- for the agro-processing industry: 28,834,100 roubles (€ 1.0 million) or 50%
- for large scale agro-producers: 20,670,900 roubles (€ 0.765 million) or 40%.

For 2002, the subsidies for interest are 43.5 million roubles or € 1.6 million, split as follows:

- for farms: 8.0 million roubles or 18%
- for the agro-processing industry: 21.0 million roubles or 48%
- for large-scale agro-producers: 14.5 million roubles or 34%.

Household plot owners do not have access to subsidies. Although subsidies were reduced in total in 2002, private farms have been able to increase their share. With the help of the related TACIS project, the credit cooperative movement is trying to make the interest subsidies also available to rural credit cooperatives. If this can be achieved, the private farms will benefit even more from the subsidies made available by the government.

Yaroslavl

In 2001, the Yaroslavl regional agricultural administration developed a policy paper concerning the future development of the agricultural sector. This concept is related to all aspects of the agricultural and rural sector, and it is clearly expressed that its main tasks are "to ensure the easy access of the population to good quality food in the needed quantity, to ensure enough raw material for the regional food processing industry and to improve the situation of the rural population". In order to realise these goals, a broad approach towards improvements in production, management, agricultural education, availability of extension services, availability of financial means, etc. is needed.

It has been indicated that the promotion of private agriculture and of the rural credit cooperative sector will be an important factor in the future development of the region. In addition, it is recognised that the establishment of a legal framework for achieving identical conditions for all "agricultural entities including private farms", will be an important topic.

The following areas are core areas which could receive subsidies from the oblast budget:

- baby food production
- subsidised credits for housing in rural areas
- subsidies for improvement of energy purchase (gas) for rural areas
- restructuring of farms.

Access to financial services is recognised as one of the cornerstones of agricultural development in the region. The oblast agricultural administration has calculated the yearly needed financial means for the agricultural sector in Yaroslavl at 3 billion roubles or € 111 million. This means a yearly financial requirement of roughly € 55 per ha of cultivated land.

Between 2001 and 2003 the oblast government intends to subsidise the agriculture sector with a total of € 12.8 million (i.e. 6.5 €/ha). These subsidies will be given in the form of soft loans, infrastructure payments, the purchase of diesel fuel, price reductions for buses, and direct price subsidies on agricultural products. Additionally, the national government is subsidising the agricultural sector by € 4.1 million or 2 €/ha, while the rayon administrations will allocate € 0.5 million (i.e. 0.25 €/ha). The subsidies allocated to each ha will sum up to around € 9 yearly, which is around 16% of what is needed.

Subsidies spent on infrastructure are an investment in the future if they are maintained properly. Many experiences around the world have however shown that soft loans are not sufficiently paid back. Administrators of these loan programmes face political pressure to deliver loans to the target group, have difficulties in evaluating the borrowers' creditworthiness, and are reluctant to follow up on loans in arrears. An alternative strategy would be a partial compensation of interest rates.

3. The Rural Financial Sector in Russia

This chapter provides an overview of the existing financial services, in particular for rural communities. It also describes in short the transformation of Agroprombank, which was in Soviet times the main financial intermediary between the government and agricultural producers. Finally, the activities of the international donor community will be outlined.

3.1 Sectoral features

The rural financial system consists of banks, credit cooperatives, private lenders, non-financial institutions (e.g. traders, input sellers, entities from the processing industry) as well as pawnshops. In addition, the large gas and oil companies also invest in agriculture. The Russian reality is that without these investments, the farming sector could not be sustained. This has led to an increasing concentration of economic power in terms of agriculture in the hands of a few major players.

This section briefly describes the existing financial institutions and services, additionally highlighting the development of the financial infrastructure in the two regions of Yaroslavl and Sarotov.

3.1.1 The rural banking sector

An overview of the banking sector published by the Central Bank of the Russian Federation shows that by 1 January 2002 there were 1,319 operating credit organisations (banks) in the country. The last decade has shown increasing activity on the part of the Russian banking sector as regards rural finance and the financial needs of small enterprises in rural areas. The economic and financial crises of 1998 led to a deepening of the belief that the Russian banking system is inefficient, and has given rise to distrust that continues to exist even today. Many banks did not survive the financial crisis. The prevailing economic conditions in the years following 1998 did not build up trust in banks as regards small and medium enterprises, especially not those in rural areas. Today, most banks neither collect small savings nor engage in rural lending. They are thus missing out on one of the major functions of any financial system: financial intermediation. The rural banking sector, as the Russian financial sector in general, is mainly a credit delivery system.

Consequently, the lack of attractive deposit facilities in Russia has increased the flight of money abroad. This is mainly true for persons or companies that have developed the capacity to save up money. Money not transferred abroad is often changed into hard currency and kept at home by private individuals. In either scenario, the money is lost to the Russian banking sector and thus to the economy as a whole. 75% of all deposits in Russia are in the hands of the state-owned Sberbank; taking into account just the rouble deposits, Sberbank's share is 90%. In practice, Sberbank has a controlling position in the market with regard to savings. Russians have no alternatives for deposits. Until now, little has been done to develop deposit services and to offer a variety of savings or term deposit products. A

deposit insurance system based on international standards has been under discussion for several years. Plans on how to design such a system mainly concerned full-fledged commercial banks. On the other hand, especially in rural areas, there is a need for deposit services in the proximity of customers – a service which can only be provided by financial institutions that are non-banks, such as credit cooperatives or foundations for microfinance services and other microfinance institutions.

It is not just in rural areas that banks only tend to finance long-term investments – which are a prerequisite for agricultural finance – to a very limited extent. Various factors explain this reluctance. There is deeply rooted lack of confidence in the own economy. Bank staff still do not know much about credit technology and risk management, which results in a high level of risk aversion in rural lending. The problem is aggravated by inadequate loan application documents presented by potential borrowers. As a result, this low level of investment finance in rural areas has a negative impact on the condition of buildings and the maintenance of the machinery of agricultural enterprises of all sizes, as long as those enterprises rely on external finance. External finance is necessary for most enterprises as replacement investments cannot be financed out of retained earnings. This applies in particular to the agricultural sector. To some extent, the need for long-term finance is addressed by international cooperation projects or by state funds from the oblast or federal budgets. In fact, the financial sector has still not greatly adapted to these financial needs.

An example of a newly emerging financial institution is KMB Bank (the Small Business Credit Bank), which was founded in 1992 as the Russian Project Finance Bank, and changed to its current name in December 1999. Its present shareholders are EBRD, the Soros Economic Development Fund (SEDF), the German Investment and Development Fund (Deutsche Investitions- und Entwicklungsgesellschaft, DEG) as well as the Dutch foundation Triodos-Doen (STD). KMB is primarily active in the micro credit sector (loans of up to US\$ 5,000 account for the absolute majority of loans issued). KMB Bank's microcredit scheme provides working capital loans to small businesses. Small loans range up to US\$ 100,000. Further growth (e.g. small factories) is being facilitated through loans of up to US\$ 500,000 US\$ per customer. KMB Bank also aims to satisfy the banking needs of its clients by providing, for example, bank guarantees and leasing operations.

With support from the EBRD and the European Union, the bank is pursuing a regional expansion strategy to reach all major towns in European Russian as well as Siberia. This also represents an opportunity for the rural financial sector, either through direct client relations to rural clients from representative offices, or through cooperation with rural financial institutions, e.g. savings and credit cooperatives. At present, KMB has 6 branches and 14 representative offices in 15 Russian regions. As of December 2002, the bank's total loan portfolio reached RUR 4.1 billion (approx US\$ 135 million), up from 3.3 billion at end 2001.

Agroprombank – the former state agricultural bank

In Soviet times, the main rural financial institution was Agroprombank. After the breakup of the Soviet Union, Agroprombank, which was initially established as a state rural bank

providing finance to state farms, was transformed into a joint stock company in 1993 with the Russian government remaining the only shareholder.

In 1996, Agroprombank was close to bankruptcy thanks to the crisis in the agricultural sector and related non-performing loans of the bank. Agroprombank's shares were worth less than 1% of their nominal value. However, the state Duma showed strong interest in the future of the bank. The government decided to put the bank out to tender and the majority of shares were sold to SBS-Agrobank as a new holding structure. Agroprombank itself was reorganised, while the bank remained a separate entity under the SBS-Agrobank holding. SBS-Agrobank's deal was strongly opposed by many, especially by the Agrarian Party, which stuck to the idea of a state-owned agricultural bank.

One year later, Agroprombank, restructured under SBS-Agrobank, was again close to bankruptcy. With the financial crises of 1998, the whole SBS-Agrobank group ran into trouble and, in October 1999, Agroprombank was liquidated. However, the government classified the SBS holding as of systemic importance, meaning that they regarded the group as too big to fail. The bank was brought under the supervision of the Agency for Restructuring of Credit Organisations (ARKO). Until 1999, SBS-Agrobank had a dominant position in the agricultural financial market, with attempts to control the growing credit cooperative movement in Russia being reported (SBS-Agrobank had tried to turn credit cooperatives into branches of the bank).

In April 2000 a state-owned agricultural bank, the OAO Rosselkhozbank, was established with ARKO as its owner. The members of the board of directors of Rosselkhozbank were recruited from the Ministry of Agriculture, the Ministry of Finance, and the Ministry of Economic Development and Trade as well as two other government agencies.

Rosselkhozbank finances agricultural production, agro-industrial complexes and state and private farms to some extent, as "Agroprombank" had done before. However, based on a new business development strategy, a new branch network was established, depending on potential and positive results from each branch. As of August 2003, 61 branches are operating in addition to 132 branch offices. According to recent information, another 3 branches and 45 branch offices are planned by the end of 2003.

In pursuing its regional expansion, Rosselkhozbank is looking to re-establish a countrywide branch network, like that of the former Agroprombank. However, Agroprombank's branch network, certainly its main asset, was not transferred to the holding under 'SBS-Agrobank'. Rosselkhozbank also aims to offer deposit services to the public, thereby introducing financial intermediation on a regional scale.

In addition, Rosselkhozbank is mainly interested in cooperation with rural credit cooperatives, which would increase the bank's regional presence and enable the bank to collect savings from the members of the credit cooperatives. In recent times, Rosselkhozbank has submitted cooperation proposals to a number of unions and associations and foundations for the financing of rural savings and loan cooperatives. Refinancing of cooperatives at commercial rates could represent an important future activity area for Rosselkhozbank. Representatives

of the bank have attended seminars and conferences on the financial cooperative sector in Russia.

Still, regular cooperation between the bank and existing rural finance institutions has to develop, and the respective roles and functions of each party need to be defined. Currently, the refinancing needs of the Russian financial cooperative sector largely exceed the supply of funds. However, at present, defining the nature of future cooperation between Rosselkhozbank and the credit cooperatives in terms of a takeover and transformation of the credit cooperatives into Rosselkhozbank branches is likely to endanger the confidence of the credit cooperative members in “their” credit cooperative.

From a systemic perspective, a financial institution linking microfinance institutions in rural areas to the Russian financial sector would be a very important element in ensuring financial sustainability in the medium term. The current legal environment does not allow all microfinance institutions to gain access to commercial funds from the Russian banking system. Thus, most rural microfinance institutions rely on external and international donor funds.

According to the Rosselkhozbank, its authorised capital is 375 million roubles (coming from the national budget), its current balance compared with the beginning of the year has increased from 484 million roubles to 6 billion roubles, and its working assets amount to 3.3 billion roubles. Independently from future cooperation with microfinance institutions, Rosselkhozbank, if acting as a financial institution in agricultural lending, could be beneficial to the Russian rural finance system. However, the diversity of the institutions is only respected if none aims at gaining a dominant position that would distort already limited competition. Furthermore, it seems important to the entire system to select clients according to viability criteria.

3.1.2 Commodity credits

Short-term commodity credits play an important role in the financing of the agricultural sector in Russia. Commodity credits have a higher share in the financing of agricultural producers than commercial credits from second-level banks or state preferential credits. Companies dealing with agricultural production offer commodity credits (paying for fuel or other production means) to agricultural producers on condition that they pledge their future harvest as guarantee. This form of credit is more flexible than the state preferential crediting system, and is often offered at interest rates that are even lower than those of state preferential credits.

A wide spectrum of companies provide commodity credits:

- (1) agro-processing enterprises (e.g. sugar factories)
- (2) finance institutions that operate departments for the marketing or processing of agricultural production (e.g. Menatep, Alfa-Capital, Oneximbank, Inkombank et al.)
- (3) production companies engaged in the manufacturing of fuel, seeds etc.

Several major oil companies are dealing with grain on a large scale on the basis of future contracts (forward contracts). These companies also provide credits in cash to the agricultural producers. They often possess their own financial resources or have good access to commercial credits.²

3.1.3 Leasing

Over the last few years, several private leasing companies have started to operate. Leasing provides an important alternative for enterprises with insufficient resources to purchase equipment. A well-known example is a leasing company established by the Vladimir tractor processing factory. SBS-Agro-Bank also established a private leasing subsidiary under its holding which went bankrupt together with the bank. Several western agricultural equipment producers are offering leasing-based operations in Russia.

Delta Leasing, a Russian enterprise that is also supported by EBRD, is offering leasing services to SMEs, facilitated through a US\$ 10 million loan. This loan aims at supporting the further expansion of Delta Leasing. The subsidiary of the US-Russian Investment Fund is already active in 17 Russian cities, offering leasing contracts with terms of up to five years. Contract values range between US\$ 5,000 to US\$ 500,000.

3.1.4 Informal lenders

Little is known about informal money lenders in Russia. Businessmen, artisans, and part-time farmers mostly self-finance their business by using savings and retained earnings, or borrow from informal sources. In fact, they often do not have alternatives. Against the sheer number of part-time farmers, the volume of this type of lending business should not be underestimated.

Investigations show that private persons are now changing their savings into hard currency (mostly US \$), which they either keep at home or lend to family members. Depending on the relation, the lending transaction is done free of interest or against interest, whereby in most cases the interest rates are not formally fixed. Usually, the lenders expect the borrowers to repay the principal in cash plus the interest in kind (for example food).

3.2 International assistance in rural finance

According to various studies, the potential market of microfinance activity in the Russian Federation amounts to approximately two million entrepreneurs, both individuals and legal entities. The market size is estimated at about USD 4 billion.

² The grain company OGO, Lukoil and Agroincom are financing agricultural producers in Krasnodar krai not only on a commodity, but also on a cash basis.

Currently, about 100,000 individual entrepreneurs use services provided by microfinance organisations (MFO), which amounts to 5% of the potential market. Even in the regions, in which several MFOs operate, market coverage does not exceed 20%.

3.2.1 Principle donor organisations

For several years, **ACDI/VOCA**, a US-based NGO network, has been active in Russia, providing financial and to a lesser extent technical assistance to the rural credit cooperative sector. ACDI/VOCA has established a revolving fund to finance the rural credit cooperative sector. Their partner is the Russian organisation Rural Credit Cooperative Development Foundation (RCCDF), located in Moscow. The two organisations are jointly managing the fund on a commercial basis, and it is disbursed to selected credit cooperatives, which have to meet different eligibility criteria. Repayment rates are more than 95%. The TA component is mainly related to the proper management of the fund and aims to increase the repayment and management capability of the rural cooperatives receiving credits.

The **Eurasia Foundation** (USA), which has its Russian headquarters in Moscow, provides financial assistance for local organisations to implement training activities for rural credit cooperatives and to promote microfinance activities in different regions. The implementation of training activities is contracted to different regional or national Russian institutions.

Développement International Desjardin (DID) (Canada) has supported the establishment of credit cooperatives in the Volgograd region of Russia. Significant financial and technical assistance has been delivered over many years since the credit cooperative movement started in Volgograd. Today the Volgograd region is one of the most developed regions in terms of rural credit cooperatives in the whole of Russia.

Deutscher Raiffeisen- und Genossenschaftsverband DGRV (Germany), the umbrella institution of the German cooperative organisation, with financing from **Kreditanstalt für Wiederaufbau (KfW)** - is providing technical assistance on two levels: (1) assistance in the Volgograd region, where the DGRV took over after Desjardin left, and (2) assistance on the national level to promote a law for rural credit cooperatives. In the Volgograd region, DGRV is extending the achievements of the Russian-Canadian project. The project is part of the German "**TRANSFORM Programme**".

- Starting in 1997, KfW/DGRV has contributed to the development of an institutional and legal framework for savings and credit cooperatives as well as the set-up of a national federative structure.
- In addition, KfW/DGRV has since 1999 been assisting at the regional level in the setting up of a savings and credit cooperative network in the Volgograd Oblast. The two-tier system, consisting of primary savings and credit cooperatives on the rayon level, and the credit cooperative on the oblast level (as well as the regional federation) has become a reference point for other regions in Russia. The KfW/DGRV project is helping to replicate the Volgograd experience in three other Russian regions.

Major technical issues addressed were the legal framework on savings and credit cooperatives, an appropriate integration of savings and credit cooperatives into the state banking supervision, assistance in the development of a national strategy on the development of a three-tier savings and loan cooperative with national outreach. German support will have to continue through another form of cooperation, as the TRANSFORM Programme is expected to come to an end in 2004; it is nevertheless expected that German financial and technical assistance will continue to operate at both regional and federative level.

Since 1998, **TACIS** (European Union) has been supporting the Russian rural credit cooperatives, delivering technical assistance and, to a lesser extent, financial assistance. The project has established 69 rural credit cooperatives in 13 different regions, and has trained more than 3,000 trainees. The project has produced manuals, booklets, a film and so on. All these initiatives are related to rural financing and rural credit cooperatives. Together with its Russian partners and supported by the above-mentioned other donor institutions, the project has drafted a national-level rural credit cooperative law which was accepted by the national Duma at its first reading. Besides supporting the national structures, the project has also established regional cooperatives in three regions.

GTZ - Deutsche Gesellschaft für Technische Zusammenarbeit (Germany) - has delivered technical and financial assistance within the framework of an SME component in a regional development project in the Yaroslavl Oblast. The funds have been channelled through the administration in three rayons of the Yaroslavl Oblast.

In addition to the above mentioned organisations, several **international microfinance organisations** are providing technical and financial assistance in Russia, focusing on specific target groups and regions. Loans range between 100 and 5,000 euro. Examples of these organisations are **CCI-RISE**, the **Foundation of International Community Assistance (FINCA)**, **Opportunity International** and the **Russian Women's Microfinance Network (RWNN)**. In addition, international foundations, such as the **Soros Open Society Foundation** have been active in the microfinance sector for many years. A list of the most important microfinance organisations is attached.

3.2.2 Credit unions in Russia

There are currently about 350 credit or consumer cooperatives³ operating in Russia, totalling 180,000 members. Their geographical spread across the regions is however uneven, with most located in the Volgograd Oblast. They tend to operate in areas where the density of private farmers is sufficient to allow a cooperative to function properly, and in particular, where cooperative initiatives have received political, legal, administrative and sometimes

³ Under the current legal framework, credit cooperatives are covered under Federal Law No. 117 FZ, August 2001, "on citizen consumer cooperatives". In addition, credit cooperatives can be registered as agricultural cooperatives (Federal law on agricultural cooperation of December, 1995). Both can only extend credits to their members. They are also non-commercial organizations that are currently not subject to banking regulation and prudential supervision by the Bank of Russia.

financial support from regional governments to some extent (and the rayon administrations). The establishment of cooperatives marks a revival of the Russian cooperative movement, which has its roots in pre-revolution Russia – in 1916, for example, about 16,000 rural credit cooperatives were active. In the 1990s, in some regions farmers have founded credit cooperatives based on statutes and documents from the pre-revolution time (cf. Ustyuchna, statutes from 1904).

Most credit cooperatives are pure credit cooperatives and not mixed or multi-purpose cooperatives. Rural cooperative members are typically individuals such as private farmers, part-time farmers, rural entrepreneurs, although juridical entities are also eligible for member status in most credit co-operatives.

In the four core regions of the above-mentioned TACIS project, data from 34 rural credit co-operatives were collected and analysed. The results can be summarised as follows:

- Loans disbursed are 70% refinanced by external funds (i.e. donor funds or from local commercial sources); less than 10% are refinanced by savings generated from members themselves, while 20% of the funds stem from members' shares.
- Between 1998 and 2001, the average number of members increased from 26 to 47. In each credit cooperative, the share capital is on average 200,000 roubles (equivalent to € 7,407). The average loan size is 35,000 roubles or € 1,297. This amount clearly demonstrates that the rural credit cooperatives are reaching the lower and poorer market segments, i.e. economically active people who have no other banking alternative.
- Each of the rural credit cooperatives managed a loan portfolio of € 70,000, with repayment rates of 97.8% on average. The number of credit cooperatives is constantly growing. The same is true for the number of shares, the loan portfolio, number of loans etc.

Most credit cooperatives have been founded following a bottom-up approach as pure credit cooperatives with individuals and juridical entities as members, attracting savings from outside and trying to associate themselves on the regional level in a oblast **second-tier level cooperative or association** as the nucleus of a financial apex organisation and as special interest representation, especially with the aim of negotiating with local and regional governments (i.e. political lobbying) and of delivering training and other services to its member cooperatives. Currently there are 13 regional associations⁴. The collaboration between the primary cooperatives and the regional organisations is satisfactory, and the regional cooperatives are managed in a democratic process that is influenced by their members, the primary cooperatives.

There is no national apex organisation of credit cooperatives in Russia that represents all credit cooperatives operating on the territory of the Russian Federation. However, several **apex structures with affiliated credit cooperatives** working on a national level have been created.

⁴ See Annex

- The **Union of Rural Credit Cooperatives** and its sister organisation, the **Foundation for the Development of Rural Credit Cooperatives**, represent 205 credit cooperatives, all of which are located in rural areas. Whereas the Union represents the interests of member cooperatives and grants technical support to members and elected representatives, the foundation has been set up as a revolving fund to refinance the member cooperatives. Both organisations were set up with assistance from ACDI/VOCA.
- The **Credit Union League** was established in 1994 as a first apex structure for credit cooperatives in Russia. The Credit Union League is a member of the World Council of Credit Unions (WOCCU). The League and its **Foundation for the Support of Mutual Financial Organisations** support credit cooperatives across Russia.
- **FINCA International, Opportunity International and the Russian Women's Microfinance Network**, among others, are apex institutions working as international NGOs in Russia. They have set up networks of non-cooperative microfinance organisations (such as NGOs or village banks) which have similar clients and products to the credit cooperatives.

Under the current legal framework pertaining to credit (consumer) cooperatives, apex structures can only provide technical assistance, and represent the interests of their member cooperatives. In addition, financial institutions, which function as non-banking and non-commercial organisations under Russian law, have been created with the aim of financing the cooperatives (mostly via international donors).

The technical apex structures mentioned above define their mission as one of facilitating the creation and development of credit cooperation systems as “an institute of civil society in the Russian Federation”⁵. Taking the example of the Foundation for the Support of Mutual Financial Organisations, the following services are offered:

- Provision of consulting services and a document package on the creation and functioning of credit cooperatives
- Information support
- Training of both the members and elected bodies of cooperatives
- Development of start-up programmes for new credit cooperatives in the Russian Federation
- Organisation of meetings, consultations, round tables and conferences on credit cooperatives and their associations
- Targeting of financial and other resources both in the Russian Federation and abroad
- Development of system of quality standards for the cooperatives (accounting, financial norms).

⁵ The mission statement is quoted from the Foundation for the Support of Mutual Financial Organizations.

Depending on the different donor approaches, different credit cooperative models have been implemented and adapted to the reality in Russia. In the formation of these cooperatives, the following four questions have been regularly discussed across the various approaches:

- (1) Can juridical entities be members of credit cooperatives or not?
- (2) Should credit cooperatives be founded on the regional level, and should they then build branches in the regions or the other way round (i.e. following a “top-down” or a “bottom-up” approach)?
- (3) Should the credit cooperatives constitute themselves as multipurpose cooperatives or just as financial cooperatives?
- (4) Should credit cooperatives attract outside funds, or should they exclusively rely on their share capital and mobilised savings?

Beside these questions, which mainly regard the constitution of the individual (or primary) cooperatives, other core issues still need to be solved, particularly ones relying on institution-building of the credit cooperative system as a whole,. These issues include:

- (1) How should the credit cooperative apex organisations be structured so as to enable the primary cooperatives to offer their members and customers sufficient financial services and to develop into a sustainable, fully-fledged financial system?
- (2) What kind of cooperative control and protection system should be developed to ensure sufficient transparency and security for cooperative members and customers, business partners and official institutions as well as the wider public?
- (3) The deposit insurance system currently discussed only applies to banks. If such a scheme is set up, how could the cooperative sector also benefit from such protection?
- (4) A recent inquiry has revealed only one example of cooperation between a local bank and a cooperatives’ foundation in the field of commercial refinancing. The question of linking the cooperative financial system to domestic or international financial markets, while preserving the particularities of the former, urgently needs to be addressed.
- (5) How can the cooperative financial system be covered by state financial supervision and, in general, be accepted as an integrated part of the Russian banking system?

In general, finding appropriate answers to the questions mentioned above is, in a primarily bottom-up cooperative system, first the task of the cooperatives and their members themselves. Therefore, the National Association of Rural Credit Cooperatives is with assistance from the above-mentioned German DGRV/KfW project developing a strategy for the entire Russian cooperative financial sector. This strategy should function as a generally accepted guideline for the promotion and further development of the rural credit cooperative organisation as a bottom-up, three-tier linked-up financial system. These efforts are still very much hampered by the absence of an appropriate legal basis.

Credit cooperatives, like microfinance activities in general, are governed by the following principles:

- Microfinance organisations are set up as non-commercial entities, state, municipal or private funds rendering support to small entrepreneurs or as credit cooperatives. No special permits are required for microfinance activity that is being conducted by non-commercial organisations; microfinance services provision is not licensed. The level of state control of MFO activities is the same as that of the activities of other non-commercial organisations which implement socially important projects.
- Legislation which regulates credit cooperatives' activities consists of several federal laws, the separate norms of which are not fully consistent. Undoubtedly, all existing contradictions should be removed, and the special terminology used in those laws should be standardised.
- Prudential standards set forth by the Russian legislation for credit organisations do not pertain to credit cooperatives, and nor do credit cooperatives fall under banking supervision by the Bank of Russia. However, internal supervision stipulates a credit consumer cooperative of citizens cannot provide loans to individuals or legal entities that are not members. Agricultural credit cooperatives must be members of audit unions, and are subject to regular audits.
- At the beginning of 2003, the chapter of the Tax Code setting forth the simplified taxation system for small business was enforced, a move that was welcomed both by small businesses and MFI. Unfortunately, practical application of the simplified taxation system by small businesses and MFI non-commercial organisations has not always proven possible for various reasons.
- In May 2003, amendments to the Law "About Agricultural Cooperation" were adopted in the third reading by the State Duma. *Inter alia*, the Law is amended by the Article "Peculiarities of Credit Cooperatives' Activities". The adoption of these amendments is supported by credit cooperatives that work with farmers. In line with the new provisions of the Law, agricultural cooperatives shall not be entitled to provide loans to individuals or legal entities that are not members of cooperatives. Such restrictions stipulated by the Law will enhance the sustainability of credit cooperatives and lower the risk of fraud.
- In spring 2002, the Law "About Credit Cooperation" was adopted in the first reading by the State Duma. Currently, the text of the Draft Law is practically ready for its second reading. In the process of the work on the Draft Law, significant amendments considering requests made by the credit cooperatives were introduced. For example, the establishment of a credit co-operative (apart from that for agricultural manufacture) with the participation of legal entities (including small enterprises) is not currently stipulated by the law. Initiatives with respect to the adoption of such laws as "About Mutual Insurance" and "About Credit Bureau" present considerable interest for MFO.
- Funds channelled by international and foreign organisations to solve social problems are important sources of money for microfinance organisations. Unfortunately, the provisions

of the Civil Code which regulate the options for receiving donations exclude some types of non-commercial organisations and consumer cooperatives, including credit cooperatives, from the list of potential beneficiaries of donations.

Assisted by TACIS in collaboration with the other donor institutions mentioned above, a **Law on Rural Credit Cooperatives** has been elaborated by the Ministry of Agriculture and the National Association of Rural Credit Cooperatives. This draft law, which deals with the promotion of rural credit cooperatives, has passed its first Duma reading with 78% of all votes cast. This marks a vital first step towards the creation of a secure legal basis for the credit cooperative sector, especially against the background of other banks which desire to takeover the cooperative's network. The draft law already contains some essential basic rules for the constitution of primary credit cooperatives, but nothing about institution-building in the sense described above. It was the intention to use the preparation period until the second Duma reading to supplement the draft, in particular with rules on institution-building, in order to allow the appropriate development of the rural credit cooperative system. The legal discussion is still ongoing. However, all parties involved are keeping in mind that the legal issue has to be solved urgently. Otherwise, the existing cooperative structure would risk being damaged or, at the very least, could fail to develop its potential as a vital financial provider for the rural economy and population.

In the absence of a coherent federal legal base, in seeking to promote the establishment of rural credit cooperatives, some regions have developed their own regional laws on rural credit cooperatives, sometimes with donor support. For example, in **Saratov**, the TACIS project supported the formulation of a regional law on rural credit cooperatives, one of the cornerstones of the agricultural policy in this region. The law was approved by the Oblast Duma in September 2001 and, since then, has helped significantly to stabilise the rural cooperative movement. Currently, different organisations under the auspices of the Oblast Ministry of Agriculture are elaborating a special programme to further promote the rural credit cooperative movement. In **Yaroslavl**, a regional law to legalise the rural credit cooperative movement is being proposed and discussed among policymakers and representatives of the rural cooperative movement. The law passed the first regional Duma reading in Summer 2002. However, all these regional laws cannot replace the establishment of a federal credit cooperative law. Therefore, legal efforts on the federal level are urgent and should prove decisive.

The rural credit cooperative movement constitutes a progressively growing banking alternative that addresses the capital needs of small rural enterprises. It also offers the possibility of saving small amounts according to an entity's cash inflows and outflows. This provides the opportunity to save up for certain investments, so that entrepreneurs do not entirely have to rely on credit. The cooperative system has high potential regarding further outreach, as massive numbers of small-scale farmers and rural entrepreneurs are still un-banked. The continued support of many donors in this area should help to facilitate this growth without neglecting the viability of the financial business. Only if the rural credit cooperatives are able to develop into sustainable financial institutions rendering demanded services on a continuous basis while operating efficiently and generating profits, can further development of rural areas take place and economic potential be unleashed.

3.3 Regional aspects of rural finance in the Saratov and Yaroslavl Oblasts

3.3.1 Rural finance in the Saratov Oblast

18 banks are currently operating in Saratov Oblast. The most important of these are: Saratov Sberbank, Sinergia, Express-Volga, Volga German Bank (Povolzhski Nemetski Bank), the Volga Society of Mutual Credits, Econombank, Konto, Tavis, Saratov, Narat-Bank and Vneshtorgbank'.

According to central bank information in 2001, more than 54.6 billion roubles were extended in the form of credits to the region. Compared with the previous year, this means growth of more than 160%. These data indicate a gradual recovery of the regional economy after the economic crisis of 1998, which certainly had a detrimental influence on the activity of the banking sector, too. As can be seen from the figures below, the share of agricultural loans as a percentage of all loans is very low compared with other economic sectors:

- Industry: 38%
- Trade and catering: 27%
- Transport and communication: 11.3%
- Agriculture: 3.7%.

Table 17 Overview of the major banks of Saratov Oblast

Name	Share of agricultural loans from all loans in 2001 (%)
Econombank	5.1
Express-Volga	2.0
Vneshtorgbank	0.6

Asked why they were so little involved in agriculture, the banks provided the following reasons:

- Agricultural enterprises face an unstable financial situation, while the state of the rural economy is precarious;
- The long-term demand for credits is incompatible with banks' short-term credit facilities;
- The character of agribusiness is seasonal and contains the risk of an unfavourable climate and low rates of internal return;
- Entrepreneurs face difficulties in marketing their products (infrastructure, information, quality etc.), including non-payment or delayed receipts from sales;
- The question of landownership is unresolved, resulting in a lack of collateral;
- There is no credit history;
- There is a lack of legal and normative bases for agricultural credits.

Besides the issues mentioned above, there seems to be, above all, limited knowledge of the agricultural business within the banks themselves, i.e. credit officers find it difficult to

evaluate credit applications or the offered collateral (e.g. tractor or other farm machinery), let alone the difficulties of selling such collateral on the market. Mortgage lending based on clearly defined real asset property rights is impossible. Typically, the amounts requested by smallholders, such as part-time farmers, are of no interest to banks from a cost-efficiency point of view. In trying to avoid tax payment as far as possible, transactions booked on accounts tend to be incomplete and income statements inaccurate. The rural population in general, including entrepreneurs, is not used to dealing with financial institutions. Last but not least, entrepreneurs do not have the means to increase the readiness of the credit officer to check the credit application positively.

The most active banks in the rural areas of Saratov region are Sberbank and the Volga Society of Mutual Credits (Volga SMC), which have a network of branches all over the oblast. More than two-thirds of all savings deposited in banks are with Sberbank. In 2000 Sberbank started to reduce the number of branch offices. Now, several rayons are served by one branch, whereas in the past each rayon had its own branch. This makes it much more difficult for rural entrepreneurs to obtain access to the services of Sberbank.

Volga SMC bank offers a special credit programme for small businesses. Those eligible for this are customers engaged in production, trade or the service sector with less than 100 employees. The loan must be used for investment in machinery or equipment, purchase of raw materials, buying, building or reconstruction of real estate, general business improvement, or replenishment of current commercial or industrial capital. Volga SMC bank has access to the state-funded interest subsidy programme. In March 2002 Rosselkhozbank opened a branch in Saratov.

Banks in the Saratov region provide mostly short-term credits; investment credits are rather rare. The table below displays conditions as of May 2002 for some typical credits. No information could be obtained as to whether these nominal rates are sufficient to cover the costs related to the lending business, namely administrative costs, costs of funds and loan loss provisions.

Table 18 Credit conditions of commercial banks in the Saratov region

ROUBLE							
Credit duration in months	0.5	1	2	3	6	9	12
Interest rate (% annual)	24	25	26-28	27-30	27-32	27-34	27-38
US\$, EURO							
Credit duration in months	0.5	1	2	3	6	9	12
Interest rate (% annual)	16	16.5	17	17-18	17-19	17-20	17-21

3.3.2 Rural finance in Yaroslavl Oblast

All the relevant Russian banks have branches in the city of Yaroslavl, but only three banks are engaged in the rural areas:

Sberbank has branches in all 17 rayons of the Yaroslavl region. Sberbank offers different credit programmes, as follows:

- for natural persons, a consumer credit of up to five years (the borrower is allowed to repay earlier) with an annual interest rate of 22% plus a one-off 2% fee, which is deducted directly from the credit before disbursement. To receive a credit, the borrower must have worked with one employer for a minimum of one year and provide proof of his/her monthly salary. The borrower also needs three guarantors (warrantors) who in turn have to provide proof of their income. The loan amount is related to the salary earned. The borrower has to fill in a questionnaire with information about himself/herself and about the guarantors. To buy or build a house, flat or garage, Sberbank offers credits for up to 15 years.
- for juridical persons (small entrepreneurs), a microcredit up to US\$ 30,000 and a so-called small-credit of up to US\$ 200,000. The following tables summarise the main features of these loan products:

Table 19 Sberbank credit programme for small enterprises in Yaroslavl Oblast

Type of credit	Microcredits	Small credits
Amount of credit	Up to US\$ 30,000 (or in roubles)	From US\$ 20,000 to US\$ 200,000
Purpose of credit	Small investments and circulating assets	Investments or purchase of (raw) materials
Eligible borrowers	Entrepreneurs and private businesses (trade, production, services)	Entrepreneurs and private businesses (trade, production, services) with less than 100 workers.
Requirements	Operational experience for trade businesses – minimum 3 months, for production sector - minimum 6 months	Operational experience – minimum 6 months
Credit term	1 year	1.5 years
Repayment of principal	In equal instalments (other repayment schedules are possible, taking into account the seasonal nature of the business)	Monthly, in equal instalments
Period of consideration of application	7 days (if all documents are available)	14 days (if all documents are available)
Collateral	Private property, vehicles, production, trade and office equipment, goods in turnover, immovable property: uninhabited funds (storage, shop, office), garage, guarantees of other persons	Private property, vehicles, production, trade and office equipment, goods in turnover, immovable property: uninhabited funds (storage, shop, office), garage, guarantees of other persons

3. The Rural Financial Sector in Russia

The interest rate depends on the loan amount, the business of the borrower, collateral etc. The rates vary between 18% and 30% per year and will have to be paid monthly. These loan products are only offered in some rayons.⁶

Another bank is Poshekhonskiy Regional Agricultural Bank,⁷ which operates branches in 9 rayons (out of 17 in the Yaroslavl Oblast) and provides credits mostly to SMEs for additional circulating assets and for natural persons. The bank is 11 years old, but it only started in 2000 to operate in Yaroslavl. In August 2000 the credit portfolio of the bank amounted to 3 million roubles; as at mid-2002, the bank held a credit portfolio of 40 million roubles. Interest rates vary between 18.75% and 60% p.a. For example, in Lubim (a rayon in the northeast of the Yaroslavl region), all credits are given at a rate of interest that is no lower than 36% p.a. The maximum credit term is one year. As collateral, the bank accepts vehicles (cars, agricultural machinery, etc.) and guarantees of other persons (although this is usually only for small loans).

The two rayons of Yaroslavl Oblast (Rostov and Uglich) each contain a branch of Severgasbank. The bank provides credit to small agricultural enterprises, but not to natural persons. The former must maintain their accounts at Severgasbank.

According to the law on state support of SME in the Russian Federation of June 1995, oblast or republic-based SME support funds have been created in 77 out of the 89 oblasts and republics of the Russian Federation. Their creation is considered as almost completed. At municipal level, SME support funds continue to be created. They are created by state and municipal authorities and managed by a Board of Trustees. Lending operations of these funds are not considered as banking activities and do not require a license. They typically operate at below market conditions and are funded by various public sources.

⁶ Yaroslavl, Rostov, Pereslavl and Rybinsk.

⁷ Poshekhonye is a Rayon/Rayon centre in the northeast of the Yaroslavl Oblast.

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4.1 Findings

This chapter summarises the main findings of this study. Based on this summary, suggestions for further action are made.

The findings can be summarised by grouping them under the following topics:

1) *Supply of financial services by banks to farms and agricultural producers:*

- By and large, the lack of working and investment capital keeps productivity low and limits the generation of profits which would be needed for a stepwise increase of self-financing capacity. The farming sector as a whole, i.e. state-owned or private farms, has difficulties in accessing financial services. For different reasons (the former is associated with political patronage and low profitability, while the latter is linked to unpredictable risks), both find banks hesitant to finance agricultural activities.
- There is a general lack of both information on and interest in agriculture and the rural economy among financial institutions that are approached by potential rural clients. In addition, it is extremely difficult in Russia to offer financial services in remote areas with low-level economic activity, low population density, and purely production for self-consumption or barter transactions. Much of the agricultural production is not sold in markets or, if so, is sold in quantities which do not generate substantial profits. As there is little specialisation, there is also little exchange of products and thus limited market transactions unless transportation of products to urban markets is organised. These structural constraints are to a large extent part of daily life in rural Russia.
- Private farmers and household plot owners, if commercially oriented, have low turnover and limited profits, resulting in a need for only small loan amounts, if at all. Banks, however, use the same credit technology for all clients, so that the administrative cost per unit lent for a small amount is uneconomical, resulting in high interest rates and administrative fees.
- In sum, agricultural production is largely “off-market” for banks.

2) *The prevalence of non-banking financial transactions:*

- Because of the absence of banking facilities, large companies and conglomerates are filling the existing gap in rural finance. Trade and barter transactions, payments and wages in kind are prevalent. Existing credit markets, both in money or in kind, remain non-transparent, uncompetitive and lead to increased dependency of borrowers on both input suppliers and purchasers of agricultural products. As financial and non-financial operations are interlinked, risks are correlated instead of being separated.
- In addition, in the absence of financial institutions and limited self-financing capacities, rural households cannot invest in order to diversify their activities and consequently generate at least some monetary income as a supplier. As this applies

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to many people, with the exception of those with contract incomes, families which receive remittances from emigrants, or those with access to urban markets, purchasing power in rural areas remains therefore generally low.

3) *Savings mobilisation and investments:*

- The prevalence of barter, wages in kind and other non-monetised transactions as well as little specialisation in rural areas in Russia generally create little potential for savings mobilisation except for small personal savings at the household level.
- Without transfer of capital to rural areas, there is no basis for investment.
- In addition, for those with savings capacity, a lack of trust in the banking system in general often hinders savings mobilisation apart from the generally limited outreach of financial institutions to rural areas. Russia experienced a deep banking crisis at the end of the 1990s, whose aftermath is still tangible. When present in rural areas, banks may use savings mobilisation in rural outlets to raise funds for investment purposes outside the region or to reinvest the rural funds in government bonds. In sum, rural financial institutions may, at present, contribute to a further draining away of already limited financial resources from rural areas.
- The newly established rural credit cooperatives in some regions are the only exception to this rule, as they are allowed to mobilise savings from their members, enjoy their confidence, and are close to savers. They are, for the time being, the only institutions to fill the savings gap at local level. Furthermore, as community-committed financial organisations, they motivate their members to save their money with them because, at the same time, they provide access to small loans.

4) *Transformation of former state-owned banks:*

By means of their branch networks, former state-owned banks could continue to play a role with regard to outreach to rural areas. However, the transformation and privatisation of state-owned banks, taking the example of Agroprombank, has been a long process which has not yet come to an end. In parallel, non-financial market transactions in various forms (i.e. state subsidies, direct lending by state administrations) are still taking place. However, as examples from other transition countries also show, fruitful cooperation between former state-owned banks and newly emerging private initiatives in rural finance is possible and potentially meaningful⁸. Rosselkhozbank may take the same path in the future. Nevertheless, banks and rural cooperatives follow different policies and procedures. Cooperation should be based on mutual respect and complementary roles.

5) *Agricultural and non-agricultural small and medium-sized enterprises in rural areas:*

Although the number of SMEs in Russia is growing, it is still far lower than in other transition countries. Russia's SMEs are currently in urgent need of more easily accessible and

⁸ In Moldova, the former Agroprombank was successfully transformed into an effectively-functioning agricultural bank. Since 1998 it has refinanced about 200 savings and credit associations, which have been set up as private initiatives under a cooperative legal form. And in Kazakhstan, several commercial banks are active in rural finance, directly or via newly-created rural financial institutions.

affordable financial services. Unlike in central European transition countries, entrepreneurs in rural Russia do not have any experience in dealing with financial institutions. Generally, interest rates remain at a level which does not allow for any manufacturing activity and only a limited range of services.

At present, the gap between the offer and supply of financial services to emerging SMEs is balanced by state interventions. As in Saratov and Yaroslavl, regional governments offer favourable credit lines or state guarantees. Apart from the fact that SMEs often do not know how to obtain access to these financial means, the point is that the financial supply shows little reaction in view of adapting products and procedures to the newly emerging enterprises.

In sum, the supply of financial services remains highly inflexible and, to a large extent, managed by public administration. Significant market attitudes, such as adapting to demand or stimulating demand, are, with the exception of a few examples, not in evidence. This is an important finding which is based on observation of the rural financial market.

In order to stimulate market development, some regional governments (e.g. Yaroslavl and Saratov) provide SMEs with information; however, this is not the case everywhere. At this stage, no information on the utilisation of funds provided through state credit lines is available. However, an improved information policy and information campaigns concerning SME finance can be observed. Over the past few years, interventions have switched from direct allocation of state credits to partial compensation of interest rates. However, this is not yet a functioning market for financial services to SMEs.

6) *Institutional and legal framework:*

- The issue of land registration and a mortgage market have been under consideration for many years: despite being passed to Parliament in 1998, no fully effective law has been passed. Agricultural producers still do not possess legally accepted land titles⁹. Consequently, they cannot use the land they cultivate as collateral for mortgage lending.¹⁰ Property rights, i.e. landownership, would significantly improve the creditworthiness of agricultural producers, especially in the agro-ecologically interesting areas.
- In Russia, existing laws and regulations cannot easily be understood by rural entrepreneurs. They know little about the legal aspects of rural business and they certainly suffer from this lack of information. The majority of the people are by no means informed about their rights, duties and opportunities; therefore, they are often victims of more powerful people/entities and organisations which simply misuse their

⁹ It should be kept in mind that, in the Russian Empire before 1917, three different types of land ownership existed in parallel: (1) state land; (2) fully private land (mainly in the Ukraine and in Siberia, partly only since the so-called "Reforms of Stolypin" in 1904); and (3) collective ownership of land ("obschtschiny"; here the land belonged to a rural community, where it was reallocated between all male community members at regular intervals of 12–18 years). These historical developments explain the limited tradition of full land ownership, and the historical roots of the movements against land ownership.

¹⁰ However, even with land titles, not all land in Russia is suitable for mortgage lending, because the value is relatively low in some regions.

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power. Furthermore, contradictory laws, decrees and paragraphs in the Russian constitution favour apathy at the expense of capital flows into agricultural production.

- The current legal basis for the financial sector and the effectiveness of state financial supervision has still to be improved. Until now it has actually remained impossible to achieve sufficient transparency on the viability of the banking sector. Even more significant, the existing banking law hinders the establishment and supervision of new forms of serious financial institutions such as credit cooperatives that are urgently needed to meet the financial demands of rural businesses and inhabitants.

7) *Socio-economic and socio-cultural factors:*

- The migration of young and economically active people to urban centres and/or abroad reduces the rural workforce. However, emigration is partly offset by the returning stream of ethnic Russians from other CIS countries. They are very often among the poorest.
- The social and cultural functions linked to the state farm system have not been taken over by private institutions. Healthcare, childcare, cultural events as well as the supply of power and fuel was linked to the former state farms. Against this background, the creation of new social institutions and organisations for the rural communities is of prime importance.

8) *Activities in the regions:*

- The Saratov Oblast has undertaken special efforts to overcome existing legal constraints regarding landownership and the tax regime. The framework conditions for rural financing are more advanced than in other regions of Russia.
- The agricultural sector of the Saratov Oblast shows a higher degree of privatisation due to the given agro-ecological conditions of the area. The economic potential of the agricultural sector is higher than in central and northern Russia, leading to more affluent rural communities and better self-financing potential. However, the income of economically active people and potential borrowers largely depends on political decisions, as is demonstrated by the continuation of regulated markets (i.e. the selling of local products locally). Banks finance agricultural activities only to a very limited extent.
- Yaroslavl Oblast has implemented a well-considered agricultural policy addressed to the needs of the rural sector. This is expressed in the willingness to harmonise the legal framework in order to provide equal or at least similar conditions for all actors in the rural economy. The need for improved availability of financial resources is politically recognised, and significant budgetary funds have been made available through the use of subsidies and soft loans, despite sub-optimal experiences. At least two banks have started to be active in the rural sector with programmes tailored to the needs of SMEs.
- On average, the private farming sector is less developed than in southern Russia. On the other hand, the region possesses a stable and economically active population which provides sufficient demand for financial services. The migration from rural areas to urban centres is not outstandingly significant, but various limitations (such as limited access to information) reduce business development opportunities and lead to an unexplored business potential in rural areas.

9) *International donor activities:*

- Against this complex background, donor activities in rural finance are focused on the cooperative movement and microfinance organisations. Both types of financial institutions differ in their approaches. Cooperatives are member-based organisations which, by law, are allowed to mobilise savings from their members. Microfinance organisations are client-based, are open to a broader public and are not allowed to take deposits from the public. They are mostly refinanced from international development aid sources.
- Rural finance activities are not well coordinated. Financial services in rural areas are provided partly on a commercial basis, partly as soft loans and partly as grants, depending on the organisation in question. The most striking fact is that financial services are very often provided by non-financial institutions. In addition, as has happened in development countries in the past, financial services are often part of broader approaches to regional development projects which do not foresee financial institution-building. The supply of financial services is not sustainable because it is not linked to financial institutions.
- Concerning the cooperative sector, major developments are happening at the primary cooperative level. Measures aimed at sectoral objectives such as the creation of apex institutions, the improvement of the legal framework or regulatory and supervisory activities have encountered many problems as regards their legal entitlements, which do not allow these structures to manage the liquidity of the affiliated cooperatives. Apex structures are separated into network and technical support and foundations which can raise donor funds for on-lending to cooperatives. For the time being, the cooperative sector is not linked to the remaining financial sector through either commercial or concessional refinancing. However, Rosselkhozbank as well as KMB have started to work with rural cooperatives as on-lending institutions.
- Nevertheless, it remains unclear whether there is any strategy with regard to the development of the Russian rural financial market which is based on a common approach and understanding by both the respective Russian authorities and the international donor community. As such, there is no financial sector strategy for rural finance as an area of banking, nor is there a national microfinance strategy.

4.2. Recommendations

The findings listed above concern four areas within which further action needs to be taken to improve the availability of rural financial services in Russia. The areas concerned are: (1) the policy level, (2) the legal framework including tax issues, (3) rural financial institutions and (4) the real sector in rural areas.

Policy level

The rural financial sector and the real sector in rural areas are not sufficiently interacting. The real sector in rural Russia does not systematically receive appropriate financial services where needed. On the other hand, the rural economy is only of limited interest to the financial sector. This interaction can be intensified by addressing structural bottlenecks in both the real sector (access to markets, infrastructure, productive potentials) and the financial sector (financial services, financial institution-building) by means of rural development strategies,

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which may be located at rayon level or below. From a policy point of view, there are a number of issues which have received a high level of attention and still need active support in order to improve rural livelihoods:

1. Strengthening of property rights on real assets: regulation of landownership and registration of land titles.
2. Solutions/workout for old debts from Soviet times.
3. Improvement of rural infrastructure and access to markets.
4. Transparent policies (including financial and non-financial aspects) concerning agriculture and non-agricultural small and medium-sized enterprises.
5. Transparent subsidy management, primarily not in production and market distortion, but in the set-up of infrastructure, institutions, training and capacity-building. Subsidies should weed out market failures or unacceptable market results. They should not interfere where markets occur.
6. Policy interference in input and output markets should be reduced.
7. Bans on inter-regional trade should be abolished (e.g. in Saratov).

Legal framework including the tax regime

The Land Act does not allow the use of land as collateral for lending. Bank legislation needs revision with regard to provisions which discriminate against agricultural production (asset valuation, pledging, risk classification and equity requirements). There is no legal framework for guarantee funds which could facilitate rural lending and diversify the economy in rural areas. However, some oblast governments have granted support to regional guarantee funds based on oblast legislation.

Unclear bankruptcy regulations are frequently reported and need to be specified and applied stringently. The current tax regime is a factor hindering business development (i.e. it drives SMEs and agricultural producers into the shadow economy) and is sometimes misused for private advantages. The flood of different forms for tax declaration purposes needs to be reduced as it is time and resource-consuming.

Rural financial institutions

A strategy for rural finance under market economy conditions still needs to be developed. Any creation or promotion of rural financial institutions, including agricultural development banks, should be based on market principles. Market principles mean that financial services should be provided by markets, i.e. financial institutions operating on commercial principles. A rural financial sector strategy does not imply the direct provision of rural financial services by a state administration.

The reasons why commercial banks have only limited interest in financing agriculture and rural business (e.g. limited branch networks that are mostly limited to oblast centres) should be more thoroughly investigated when regional rural development strategies are defined and implemented. Oblast and rayon administrations can play a more active role in enabling the

establishment of rural bank branches. In general, the knowledge of executives and officers about special features of rural lending and lending to small and medium-sized enterprises does not correspond to the true potential of the sector. The development of different credit technologies is not sufficiently widespread. Furthermore, savings products, apart from those offered by Sberbank, could be tailored more specifically to the rural economy. They should be part of rural financial products as an indispensable risk monitoring and hedging strategies. In addition, derivatives such as commodity options and futures and hedging instruments would make sense in certain areas. Leasing, especially for smaller enterprises, would be an alternative to traditional loan financing of necessary equipment.

At sectoral level the lack of adequate banking supervision for savings and credit cooperatives may limit their institutional development and the range of products they could offer as the branch network of a fully-fledged financial institution. As shown in this study, savings and credit cooperatives as well as microfinance organisations are considered as non-commercial organisations despite their activity in the financial sector. In addition, savings and loan cooperatives operate as consumer cooperatives in the absence of a law on financial cooperatives at federal level. As a result, financial cooperatives are not supervised by the state's Banking Supervision provided by the Bank of Russia.

An effective supervision and regulation system for the majority of rural financial institutions would need substantial investments in at least three aspects:

- Financial accounting and reporting standards as well as prudential rules adapted to the type of financial institution (cooperative, NGO), enabling effective off-site control
- Appropriate regional (at oblast level and below), control and audit services to effectively monitor and control those institutions, which will help maintain their trustworthiness *vis-à-vis* the rural population
- Stability and institutional protection systems which would help overcome liquidity gaps or help in difficult situations to protect depositors of savings and loan cooperatives.

Currently, banking supervision of the newly-established rural financial institutions is not provided. It is uncertain and certainly not recommendable that the Bank of Russia directly conduct on-site control. Instead, forms of cooperation between the cooperative sector's own control, for example as a subordinate unit of a cooperative apex structure at regional level, and the state banking supervision, are suggested. Accordingly, appropriate banking supervision mechanisms for the cooperative and microfinance sectors would have to be defined in order to cover new forms of bank and non-bank financial institutions.

Finally, rural financial institutions need to be linked to the banking sector in order to become an integrated part of the entire financial system. Federative structures of cooperatives or oblast-level financial cooperatives should be allowed to borrow refinancing funds from local banks for on-lending to their member cooperatives. In this connection Rosselkhozbank, via its branch network and outreach to rural areas, could play a significant role as a refinancing institute.

The real sector in rural areas

The reasons for widespread barter transactions should be studied in more detail. They reflect still underdeveloped markets with very limited solvent demand and little diversification and specialisation in terms of supply. Apart from other services mentioned already, advice and extension services (e.g. marketing, management, training, etc.) should be offered. As this might help create and develop the share of marketed output in the rural economy, the propensity to pay for such services will also increase over time.

The ownership structures of farms are often not clear. There is not always a sense of ownership in agricultural production, and the situation of agricultural producers still has to be brought in line with existing legislation. It is in the interests of a borrower that assets and potential collateral be adequately valued and that ownership status be clarified. Incentives should be offered to businesses, in particular SMEs, to leave the shadow economy and accept their tax obligations.

Rural businesses should be supported with the aim of achieving greater efficiency, restructuring and of taking steps towards increased profitability as well as financial planning. Businesses should be supported with the introduction of proper bookkeeping, allowing the establishment of profit and loss statements that are acceptable to banks.

Businesses need to obtain relevant information on credit applications and information required by banks, such as business and investment plans, liquidity status, etc. Further assistance is also needed in handling the respective paperwork, producing accurate financial data and providing collateral.

The attitude of politicians, bankers, donors and support agencies must be coherent regarding the nature of the transaction: borrowed funds based on a contract between two parties are to be repaid with interest. There are different messages spread by different actors providing rural financial services, not all of which are financial institutions based on commercial principles pursuing institutional sustainability as a final aim. Rural finance cannot be based on charity, although it is also clear that many needs of rural communities cannot be met purely following commercial principles either. However, subsidies should be limited to incentives to participating communities to develop the infrastructure and to provide basic services with regard to healthcare, energy, water supply and transport.

The needs of SMEs and small-scale non-agricultural activities cannot be met by providing grants or loans at below-market interest rates, as these distort resource allocation and will never be sufficient to meet demand. A market-oriented strategy for improving access to finance for start-ups and SMEs should emphasise policies that increase competitive pressure on financial service providers, upgrade the capacity of banks and related finance providers to meet the needs of smaller clients, and that address some of the underlying causes of higher risk-related costs. In particular, the risks associated with lending to smaller clients can be reduced by improving not only the laws but also the capabilities of certain institutions (for example, those that enforce contracts, register assets and collect collateral (i.e. apply the law)).

In the area of non-financial service provision, existing programmes should also be reviewed in terms of cost recovery, and wherever possible delivery should rely on voluntary private chambers of commerce, larger firms linked to SMEs through buyer or supplier relationships, and other SMEs.

Support programmes for SMEs could be centred on the following issues:

- monitoring of administrative barriers to SME development;
- monitoring of small business policy on the federal and regional (oblast) levels, and the continuous improvement of these policies with regard to the identified barriers to SME development;
- continuing the development and implementation of entrepreneurial training programmes;
- working on perfecting the legal basis for guarantee funds supporting small business credits;
- development of training programmes for entrepreneurs and government employees responsible for small business promotion;
- spreading of credit technologies in rural lending within the banking communities, encouraging the readiness to financially cooperate with non-banking financial institutions in rural areas.

4.3. International cooperation – some final remarks

International technical and financial assistance should be based on a thorough analysis and knowledge of the realities of the Russian context and should be tailored accordingly. Technical assistance should be close to practice, allowing real needs, problems and opportunities on the ground to be dealt with.

In the Russian framework, technical assistance is obliged to cooperate with target groups and administrations alike. Sometimes in the interest of the target groups it might be necessary and justified to introduce an approach even if it prompts initial resistance on the part of the administration or influential policymakers, as they may become convinced by means of tangible results. I

Technical assistance can only achieve tangible results if it is focused. The existing structures should be strengthened by the provision of new technical assistance; however, new technical assistance should not develop new structures.

Coordination of activities with the other donors acting in the same field is certainly a current weakness of TA programmes in Russia. In particular, financial means delivered under TA should not be delivered without consultation with already existing activities.

Finally, TA should assume more responsibility for the approaches promoted and for advice given.

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6. Annex

List of Institutions

Organization	Address	Responsible Person	Email Address
1. Consumer Cooperative of Financial and Mutual Help ("Raduga")	PO Box 48 Irkutsk 664082 Russian Federation (RF) Tel: (7 3952) 437 657 Fax:(7 3952) 242 056	Nina Klepikova Financial Analyst	klepikov@irk.ru
2. Consumer Union of Financial Mutual Help ("Aurora")	31 Lenin Prospekt, Office 304 Yakutsk 677007 RF Tel: (7 4112) 445 303 Fax: (7 4112) 445 303	Alexandra Gourieva, Executive Director	Status-servis@rambler.ru ; Microfin_aurora@mail.ru
3.FINCA International LLC- Moscow Representative Office	13, 2nd Zvenigorodskaya St., Bldg. 40, 4th floor Moscow, RF Tel: (7 095) 933 3745 Fax:(7 095) 933 3745		lfainzilberg@villagebanking.org ; elya@finca-moscow.org
4. FORA (Fund for Support of Small Entrepreneurship)	Osharskaya St. 52 Nizhny Novgorod 603006 RF Tel: (7 8312) 784 310 Fax: (7 8312) 784 310	Chris Reedy, Director	creedy@forafund.ru
5. Foundation for the Support of Mutual Financial Organisations	Myasnitskaya St. 24, Office 66 Moscow 101000 RF Tel: (7 095) 925 5278 Fax:(7 095) 928 8764	Vadim Kalinchev, General Director	vadim@orema.ru ; info@orema.ru
6. Microleasing Limited Liability Company	79A Moskovskiy Prospekt, Office 204 St. Petersburg 196084 RF Tel: (7 812) 118 6980 Fax:(7 812) 118 6980	Luba Galakhova, General Director	luba@vbi.ru ; microleasing@vbi.ru
7. RosAgroFond	B.Kharitonievsky 21-1 Moscow 103064 RF Tel: (7 095) 208 0750 Fax:(7 095) 925 1992	Svyatoslav Fyodorov , Economist	sfedorov@raf.org.ru ; raf@raf.org.ru
8. Russian Microfinance Center	8/12 Sushchevskaya St, Bldg. 1, Office 322 Moscow 127030 RF Tel: (7 095) 258 8705 Fax:(7 095) 258 8709	Natalya Burtseva , Legal Issues Adviser	nburtseva@rmcenter.ru ; info@rmcenter.ru
9. The Eurasia Foundation	4/6 3 rd Monetchikovskiy Per., Bldg. 1 Moscow 115054 RF Tel: (7 095) 970 1567	Tatiana Kondratova, Grants Analyst	tkondratova@eurasia.msk.ru ; efmoscow@eurasia.msk.ru

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	Fax:(7 095) 970 15 68		
10. The Russian Women's Microfinance Network	Stolovy pereulok 6, Bldg. 2, Office 418 Moscow 121069 RF Tel: (7 095) 202 9812 Fax:(7 095) 203 0807	Ludmila Sklyarenko, Executive Director	rwmn@com2com.ru
11. Union of Rural Credit Cooperatives	3 Orlikov Pereulok Moscow 107139 RF Tel: (7 095) 204 4091 Fax:(7 095) 204 4091	Anatoly Mazuritsky, Managing Director	frskk@orc.ru
12. Consumer Cooperative of Citizens ("Sodeystviye")	Oktyabrskoy revolyutsii, Smolensk Tel: (7 0812)683538 Fax (7 0812)683538, 35292	Marat Ovchiyan, Director	marat@keytown.com
13. Volgograd Association of Credit Consumer Cooperatives	Pr-t Metallurgov 7, Volgograd, 400007, RF Tel: (7 8442) 73-17-53, (7 8442) 73-15-38 Fax: (7 8442) 73-17-53.	Vladimir Lysenko, Deputy Director	consult@vakpk.vistcom.ru
14. Credit Cooperative "1iy Dalnevostochniy"	Pr-t Oktyabrskiy, 36/3, Komsomolsk na Amure, 681021, RF Tel/Fax: (7 42172)5-07-24 (7 42172)5-07-25	Yekaterina Ovchinnikova Director	credit@kmscom.ru
15. Credit Union Alternativa (Credit Consumer Cooperative)	Dubna, Moscow region Tel/Fax: (7 096)2127095 (7 096)2121536	Viktor Turusov, Financial Analysis	alter@dubna.ru
16. Union of Rural Credit Consumer Cooperatives of the Tatarstan Republic	Ul. Dostoyevskogo 74a, Kazan, Tatarstan Republic, 420097, RF Tel/fax (7 8432) 381495 (7 8432) 363124	Gulfira Rizayeva	tatfermer@rambler.ru
17. Credit Consumer Cooperative of Citizens ("Vybor")	Per. Glykhoy 2/1 Office 36, Yakutsk, 677000, RF Tel/fax (7 4112) 445675	Tamara Yagodkina	tomyis@mail.ru
18. SME Resource Center	Ul. Sadovo-Kudrinskaya 11, Moscow, RF (7 095) 2532309, (7 095) 2532313	Igor Mikhalkin	ivm@rcsme.ru