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Targeting of Investment Activity: Traps of State Regulation

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Abstract: The article deals with the identification and explanation of the basic causes of the ineffectiveness of the existing system of regulation and offering of approaches to targeting investment activity different from existing ones, which, in turn, should be the basis for changes in the methods and tools of financial market regulation. The authors analyze the construction of a system of state regulation of the Russian financial market, causes, purposes and objects of regulation in the field of investment and institutional changes in the financial markets as well as structural aspects of the formation of the domestic financial market.

Key words: Targeting, Investment activity, State regulation, Financial market, Financial institutions

INTRODUCTION

Ensuring the efficiency of the investment process is declared today as one of the main objectives of public policy by most national governments [1, 2].

This is conditioned by the fundamental changes that take place in the global economic and financial architecture: the increasing globalization, the active integration of national economies, as a result-their increasing interdependence and mutual influence, excessive growth of complex structured financial products that carry high risks, high diversified both in terms of instruments and in terms of the participants, a huge dependence of welfare of all other industries and sectors of the world economy on the health of the financial markets, the instantaneous propagation of financial contagions in the twenty-first century and the impossibility of the global economy to protect itself from these contagions within a particular market or territory [3].

At the same time the methods of regulation applied in the investment sphere have been developed for the fundamentally different architecture of markets. Modifying of these methods in order to solve current problems does not provide the desired result. Markets either suffer from excess liquidity, forming in its various segments enormous "bubbles", or collapse in conditions of capital flight because they don`t have internal compensation mechanisms.

Analysis of the emerging markets, especially Russian market, according to the authors, is in this context the most interesting, because formation of modern financial institutions and development of approaches to their regulation in these markets is the most dynamic and, at the same time, the most controversial. At the heart of this article is the authors' hypothesis of high adaptability of investment institutions formed by markets to changes of regulatory impact that causes low efficiency of the latter.

The first part of the manuscript contains the main specific features of the financial sector in Russia. In the second part of the manuscript readers have an opportunity to see the contradictoriness and fragmentariness of the regulatory system, failure of the system to take into account the identified specificity of the market. In the final part of the manuscript there is an attempt to identify and explain the initial causes of failure of the existing system of regulation and to offer new approaches to targeting of investment activity that should become the basis for changing the methods and tools in the field of regulation of the financial market.

Russian Financial Sector: Forming a Model: Now Russia has a speculative model of the financial market with limited competitiveness that depends on dynamics of world prices of exported raw materials, on foreign funding and on "hot money" of non-residents during the replacement of domestic money demand to external demand.

The Model Is Characterized by the Following Features: *First,* in conditions of high yield of the Russian financial market (of debt and equity instruments), with nominally strengthen ruble, giving the opportunity to earn additional foreign exchange gain for the foreign

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Table 1: Key indicators of investment position of Russia[1]

Indicator, billion of U.S. dollars	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Net investment position of Russia	13.1	6.8	0.7	-4.5	4.3	55.5	29.9	26.6	-8.0	-10.7	-31.5	-38.5	-145.4	254.1	118.4
Including															
Net direct investment	2.1	2.3	1.8	2.3	0.3	-12.2	-23.0	-17.8	-14.5	-14.4	-33.5	-49.4	-121.0	-10.9	-63.8
Net portfolio investment	0.3	0.6	0.4	0.8	0.5	-29.8	-45.2	-59.9	-89.1	-122.9	-148.5	-253.5	-336.0	-86.7	-178.3
From them in stocks	-0.1	-0.1	-0.2	0	0	-11.0	-21.4	-31.1	-58.4	-89.1	-118.0	-207.4	-299.8	-79.8	-169.4
Net other investments	-6.5	-11.4	-19.3	-19.8	-9.0	69.5	61.5	56.5	18.7	2.1	-31.7	-39.3	-167.2	-75.4	-79.0
reserve assets	17.2	15.3	17.8	12.2	12.5	28.0	36.6	47.8	76.9	124.5	182.2	303.7	478.8	427.1	439.5

Table 2: The dynamics of the interaction of the Russian financial market with speculative flows of "hot money" of non-resident investors (shares)[2]

Indicator	2000	2007	2008	2009
Foreign portfolio investment in Russia, billion of U.S. dollars	32.1	367.5	112.6	216.4
From them in stocks	11.1	307.2	83.1	171.7
GDP, money supply				
Russia's GDP in current prices, billion of U.S. dollars	259.7	1294.1	1660.0	1229.2
Money supply, in dollar terms, at the end of the year, billion of U.S. dollars	55.4	596.3	571.0	645.4
Analytical indicators				
Proportion of investments in shares in foreign portfolio investments in Russia,%	34.6	83.6	73.8	79.3
Russia's GDP in current dollar prices, % (2000=100)	100	498.3	639.2	473.3
Money supply, in dollar terms, % (2000=100)	100	1076.4	1030.7	1165.0
Foreign portfolio investment in Russia, % (2000=100)	100	1144.9	350.8	674.1
Foreign portfolio investment in Russian shares, % (2000=100)	100	2767.6	748.6	1546.8
Foreign portfolio investment in Russia / GDP, %	12.4	28.4	6.8	17.6
Foreign portfolio investment in Russia / Money supply, %	57.9	61.6	19.7	33.5
Foreign portfolio investment in Russian shares / GDP, %	4.3	23.7	5.0	14.0
Foreign portfolio investment in Russian shares / Money supply, %	20.0	51.5	14.6	26.6

investor, with the growing volume of investment in Russia *there is domination of short-term speculative component* (Table 1) [4].

So, pricing of Russian financial assets predominantly depends on activity of foreign investors.

Secondly, the openness of architecture of the Russian financial market for movement of speculative flows of "hot money" of non-resident investors (Tables 2&3).

According to the data in Table 2 in 2000-2007 constantly, the share of stocks, the most volatile and high-risk financial instrument (except derivatives), grew in the structure of foreign portfolio investment, as far as world financial markets and the Russian financial market became warm in pre-crisis conditions. Shares were absolutely dominant part of them (from 34.6% in 2000 to 83.6% in 2007). During the crisis, the proportion of shares declined to 73.8% in 2008

[1]1995-2008 – according to IMF International Financial Statistics, 2009 – according to the Bank of Russia (international investment position of the Russian Federation (www.cbr.ru). Net investment position is calculated as the difference between accumulated investments aimed abroad from Russia and accumulated investments directed to Russia (direct, portfolio, loans and borrowings and other investments). Net direct investment is calculated as the accumulated direct investment from Russia, net of direct investment in Russia. The excess of the investment from Russia over the investment to Russia is reflected with "+". In contrast, The excess of the investment to Russia over the investment from Russia is reflected with «-». Net portfolio investment, net loans and loans of non-financial companies, net Other investments are determined on a similar principle.

[2] The data at the end of the year. Source: IMF International Financial Statistics, Bulletin of Banking Statistics of the Bank of Russia, International Investment Position of the Russian Federation; IMF World Economic Outlook. Money supply - by the IMF methodology. Investments - accumulated amount at the end of the year, according to the data of the international investment position of Russia.

Table 3: The dynamics of the interaction of the Russian financial market with flows of "hot money" of non-residents (liabilities)[3]

Indicator	2000	2007	09.2008	2008	2009
Foreign debt of the Russian Federation, billion of U.S. dollars	177.7	463.9	540.8	480.5	471.6
Including:					
- State	148.5	39.3	36.0	32.3	45.9
- banks (without contribution in equity)	7.7	163.7	197.9	166.3	127.2
- non-financial businesses (without contribution in equity)	21.5	261.0	307.0	282.0	298.4
GDP, money supply					
Russia's GDP in current prices, billion of U.S. dollars	259.7	1294.1	X	1660.0	1229.2
Money supply, in dollar terms, at the end of the year, billion of U.S. dollars	55.4	596.3	X	571.0	645.4
Analytical indicators					
Russia's GDP in current dollar prices, % (2000=100)	100	498.3	X	639.2	473.3
Money supply, in dollar terms, % (2000=100)	100	1076.4	X	1030.7	1165.0
Foreign debt of the State, % (2000=100)	100	26.5	24.2	21.8	30.9
Foreign debt of the banks, %(2000=100)	100	2126.0	2570.1	2159.7	1651.9
Foreign debt of the non-financial businesses, % (2000=100)	100	1214.0	1428.0	1311.6	1387.9
Foreign debt of the banks / GDP, %	3.0	12.6	X	10.0	10.3
Foreign debt of the banks / Money supply, %	13.9	27.5	X	29.1	19.7
Foreign debt of the non-financial businesses / GDP, %	8.3	20.2	X	17.0	24.2
Foreign debt of the non-financial businesses / Money supply, %	38.8	43.8	X	49.4	46.2

(switching of portfolio investment to debt obligations) in order to increase again in 2009 with the resumption of positive dynamics in the stock market (up to 79.3% in 2009).

In 2000-2007 stocks followed the foreign portfolio investment in their faster growth in comparison with the dynamics of the real economy and the money supply. With an increase of GDP (in current prices in dollar terms) from 2000 to 2007. in 12.9 times and of the money supply-in 6 times the foreign portfolio investment increased in 11.4 times, while non-residents investing in shares-in 27.7 times.

The proof of the openness of the architecture of the Russian financial market for the inflows of "hot debt investments" is presented in Table 3.

Third, Russia has lack of financial depth and low monetization of the economy. And it has a negative impact on capitalization of the stock market.

With the domestic money demand for the shares, the boundary of which-the monetization of the economy in 10-25% of GDP, capitalization of the stock market will not exceed 10-25% of GDP with a significant probability.

When the money supply is going beyond the boundaries of 40-50% of GDP, capitalization of the stock market forms in the corridor of 40-80% of GDP.

We should notice that there is a direct correlation of the level of monetization and the cost of money in the economy: The higher the financial depth (monetization) is, the greater the supply of money to the "unit" of economic exchange (GDP) and the lower the price of money (interest) in economy.

Fourth, there is *excessive concentration*: *of property* in equity capital; *of trading activity* on a limited group of financial instruments (8-10 stocks generate more than 90% of trading volume), *financial institutions*, financial resources in Moscow (in the capital - over-concentration of internal cash resources of the country (more than 60%) and financial institutions (from 40 to 80% of the total), very *small percentage of share capital in free circulation* (small free float-up to 10-15%); the *oligopoly* in the structure of financial intermediaries and institutional investors (concentration of the market on a small group of 8-10 participants and several shares, oligopoly in the institutions of collective investments.

Specifically, 10 broker-dealer companies provide 60-70% of the exchange transaction, 10 operating companies control 60-70% of the NAV of retail unit funds; 10 public unit funds constitute 40-50% of all open NAV of unit funds, 10 interval unit funds make up 70-80% of the NAV interval unit funds, 10 SPC control 60-80% of the pension funds, 10 OFU have 70-80% of the volume of

[3]The data at the end of the year. Source: IMF International Financial Statistics, Bulletin of Banking Statistics of the Bank of Russia, International Investment Position of the Russian Federation; IMF World Economic Outlook. Money supply – by the IMF methodology. State - state bodies, bodies of the monetary regulation.

Table 4: The number of issuer of the securities listed on the Russian stock exchanges [4]

	The number of companies with listed shares			The number of companies with listed bonds	
Stock Exchanges	2007	2008	2009	2008	2009
ММВБ	207	233	234	505	419
РТС	385	329	316	no data	no data

These tables illustrate that the proportion of listed companies (in comparison to the potential number of them) is very low.

funds, 10 management companies control about 70% of trust management).

Fifthly, the continued *weakness of the financial position of the institutions of the financial market*, their weak capital base (on January 1, 2010 23.9% of commercial banks had less than 2 million U.S. dollars in rubles of registered capital, about 40% - less than 5 million. U.S. dollars).

Sixth, traditionally small number of publicly traded financial instruments (Table 4).

Government Regulation: Search of the Causes: The above specific architecture of the financial market of Russia, in turn, was influenced and reflected in the monetary and investment policy of the State, in the tools and techniques of market regulation [5].

We can distinguish the following main characteristics of the monetary and investment policy in Russia at the present stage [6]:

- Russia on a permanent basis emits rubles in circulation against the accumulation of external debt of banks and the corporate sector; there is no common mechanism of emission through the credit commercial banks by the central bank as the base of the growing domestic money demand;
- As a result of low financial depth of the economy there is an excessive price of money in the bank and inter-bank segments;
- The government focuses on the external money demand (the dependence on foreign investments) instead of strengthening the domestic money demand;
- There is no monitoring of systemic risk of the financial crisis; the market of foreign portfolio investments ("hot deals"), derivatives, repos, OTC forward transactions develops without the control of systemic risks that they carry;
- There is the excessive tax burden ((quasi-taxes + taxes) / GDP ratio is almost 2 times higher than in China), the lack of tax incentives for direct resident investors for investment in innovation and modernization of production. As a result-the low savings rate (the share of GDP that goes to the accumulation in Russia is about 25%, in China-about 44%);

Turning to the analysis of the construction of the system of state regulation of the Russian financial market, we should notice that it was formed in the conditions of extreme volatility, frequent crises and high inflation. In our view the state as a regulator of the market spontaneously made a choice between the Anglo-Saxon and Continental models, between the systems of funding, based on the market capitalization (market-based) on the one hand and on the banks and debt (bank-based)-on the other hand. As a result, Russia has a mixed capital market, based on approximately equal terms of commercial banks and broker-dealer companies (investment banks).

As a result of the evolution of the Russian financial market there are the following models of financial institutions: the captives of the state, of big business or top state-owned banks; the institutions focused on work with the funds of residents and / or of retail outlets (instruments-investment funds, internet trading); the financial conglomerates with differentiated access to cheap liquidity; the small group of independent full-service commercial and investment banks, that combine their own operations with multiple client services (private banking, corporate finance, financial engineering, asset management).

Thus, in practice, the model of financial sector according to which the commercial banks as the basis of the payment system and social stability have to carry a heavy regulatory burden and to take on less risk serving primarily the mass retail and the segments of the economy that are more traditional and sustainable was realized.

As for the investment banks, they, being less regulated, assumed higher risk by funding innovative sector of the economy (except for the venture investments), fast-growing companies, small / medium caps, their access to the financial market, the restructuring of the business through the market for corporate control. They focus on the needs of those groups of investors that are ready to assume the mastered risks (non-residents, qualified investors, a part of the middle class with the highest income).

However, food, functional and client boundaries between these types of financial institutions have never been strictly defined in the capital market. They probably evolved as a result of free competition. Commercial banks had more resources, capital, access to cheap liquidity. Investment banks had more benefit of weak regulatory burden, but worse tax conditions, embargo is imposed on a number of services that are allowed to be provided only by commercial banks.

Because of the harder regulatory burden, the hardness of banking supervision and conservativeness of portfolio of investments for credit institutions in comparison with investment companies trading activity of banks was bigger than the activity of investment companies (by value of trading shares) an average of 20-30%.

The evolution of Russian commercial banks and investment banks towards the creation of financial conglomerates is strongly marked. The last began to arise as a result of a conscious strategy of business owners (diversification of sources of liquidity and income, the imposition of a major business beyond a single institution, regional and international expansion, the growth of capitalization by creating networks, etc). In this case, there is a significant savings in regulatory costs. The reason is that in Russia no one financial conglomerate (neither "internal" nor cross-border) is subject of regulation on a consolidated basis.

Artificially of mid-2011, there are at least 20 largest conglomerates based on commercial banks with Russian roots that include all types of financial intermediaries (investment banks, managers, insurance companies, leasing companies, all types of funds, developers, etc.). At least 10 important financial conglomerates with a similar structure have investment banks with Russian origin as the basic framework.

We believe that the mixed model of the Russian market is not only a disadvantage, but also it provides its stability to crisis situations, to the flight of capital of non-residents. Commercial banks hedge the market by their liquidity and inertia with negative scenario and investment banks actively develop the market and its instruments in periods of favorable market conditions, using financial innovations, outpacing credit institutions in the growth phase [7, 8].

Thus, there is a mixed model of the financial market in Russia, which is characterized by the following features:

- Superiority of commercial banks in the institutional structure of the financial system, their higher share in financial assets and in corporate capital; the growing role of financial conglomerates;
- Mostly speculative market, combining low dividends and high speed trading;
- Simplified institutional and product structure;
- Formation of a mixed funding model, based on the captive institutions and active involvement of the state;
- Significant proportion of the property, located in offshore jurisdictions, increasing presence of foreign financial institutions and their key importance in portfolio transactions in the domestic market, the economy's dependence on access to external financing.

Russia attempted to transfer the "market-based system" of the Anglo-Saxon economies on the basis of ownership, more diversified than in continental Europe, the newly industrialized countries of Asia and in most other countries. The latter are characterized by the model of financial sector, based on control ownerships in capital, on banks and debt financing (bank-based system) when the subordinate role of the market of shares, derivatives, financial innovation, retail investments in equity instruments.

As a result we have duplication and fragmentation of the market infrastructure, conflict management, "running ahead" in financial engineering and failure of copying of model of financing innovations, based on venture capital institutions that capitalize high-tech companies through IPO.

As we can see, in this context it is quite appropriate to be asked why the obvious failure of the regulatory impact takes place. As the possible answers of the authors tested the following hypotheses:

- The effectiveness of the regulatory actions is influenced by exogenous factors that are not the object of direct regulation;
- Common targets and approaches to regulation are defined correctly and expectations about their effectiveness are objectively justified and reasonable, but a set of specific management tools, the time and intensity of their application does not comply with the characteristics of the current economic reality;
- The basic efficiency of the system of regulatory

impact is undermined by the inefficient institutions that are aimed to ensure the effective implementation of policy;

- The causes of inefficiency belong to the plane of the goal-setting, to the definition of the object of regulation and providing an idea of the expected outcome.

The analysis revealed the failure of the first three hypotheses. Despite the significant values of the variables themselves (the level of impact of exogenous factors, inefficiency of tools of regulation, inefficiency of regulatory institutions) and their impact on the efficiency of regulation, the existence of these reasons causes the reduction of regulation, but not its failure. Thus, only "the hypothesis of goal-setting" was recognized as working hypothesis.

Targeting: Back to Basics: Setting of the problem in the form illustrated above, involves finding solutions not in instrumental or institutional plane but the return to the basic theoretical orientation of the causes, goals and objectives of regulation in the field of investment. [9]

First of all, we should pay attention to the alarming trend of considering the problem of formation of financial markets in isolation from the discussion and understanding of their role in today's realities. Shift the emphasis in regulating the negative aspects of the functioning of financial markets "by themselves", leads researchers and politicians from the more complex and difficult problem of regulating the impact of financial markets on the pace and quality of economic development.

Otherwise, the purpose of regulation should be "outside" the financial markets themselves and even "outside" the investment component and be in the plane of orientation of economic development in general and include not only the volume indicators (such as value of investments), but also (above all) structural and qualitative indicators. The goals of financial regulation should be formed by decomposition of the objectives of a higher level and not arise "by themselves."

Furthermore, the content, scope and speed of external (regulatory) institutional changes in the financial markets (especially developing markets) should not have to stay ahead of their natural development. Otherwise, there is a regulation of a kind of phantom and real process take place out of the forms and procedures that are adjusted by the regulator. The main efforts of market participants in these conditions are addressed either to ensure the formal compliance with adjusted requirements, or to departure from the control of the regulator, that leads to distortions of the market and the inefficiency of government regulation.

The dilemma of incentives and regulation should be solved properly. In the model of financial market incentives, including tax, for long-term investments, primarily retail, in the real sector and in innovation should be enhanced.

Any strengthen the regulation of financial market, that reflects the practices and normative approaches of the global reform of financial regulation, should take place only with the strengthen of stimulating foundations in the model of financial market [8, 10].

In addition, the Russian financial history shows that it is necessary to pay special attention and the utmost care to transfer theoretical perspectives that arose in another time and in another practice to domestic conditions.

Young growing market, which should mediate the higher risks of advanced development and innovation, cannot bear the same regulatory and tax burden as mature markets of industrialized countries with lower rates of economic dynamics.

Structural aspects of the formation of the national financial market require a separate discussion. Investment companies (investment banks) should carry lower regulatory burden than the banking sector as the basis of the payment system, social stability, a base for the financing of large companies. The nature of risks of these institutions is different. Investment banks, being less regulated, should assume more risk by funding innovative sector and fast-growing companies and by leading them to the financial market, ensure the restructuring of the business (the market for corporate control).

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