

# Feasibility Analysis of International Financial Centers in the Priority Development Areas of Russia's Far East

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**Abstract.** This paper presents the authors' feasibility analysis of international financial centers in the Priority Development Areas of Russia's Far East. It analyzes the international experience of creating, and the types of, International Financial Centers in the geographical, legal, and national contexts with a breakdown by the services such centers provide. The authors assess the investment climate, the financial state-of-the-art, and the favorable conditions for business in Khabarovsk Krai and Primorsky Krai. The paper also analyzes the strengths and weaknesses of banking, financial law, and various kinds of business to determine which of Russia's far-eastern regions will host an international financial center as part of the Priority Development Areas. The authors have devised a set of measures to tackle the challenges that might face the International Financial Centers in Priority Development Areas.

## 1. Relevance

The need for an international financial center in the Russian Federation is what makes this research effort relevant. Russia's Far East has the economic prerequisites to become an International Financial Center. P.V. Akinin and Yu.O. Boldareva in their paper *Prospects of Creating an International Financial Center in Vladivostok as a Part of the Eastern Vector of Russia's Financial and Economic Development* propose establishing International Financial Centers in Vladivostok. This paper analyzes the socioeconomic indicators applicably to creating an International Financial Center for Vladivostok alone. The **novelty** of this research is that the paper is the first to consider creating an International Financial Center in a Priority Development Area in Russia's Far East.

## 2. Introduction

Today, numerous countries compete to become part of the global economy. Being a major player in Eurasia, the Russian Federation is also inherently involved in the process. Growing financial and credit markets as well as stronger regional currency are prerequisite for integration in the global economy. The rapid growth of such strong Asia-Pacific economies as the Republic of Korea, Japan, Singapore, and China (including the special administrative region of Hong Kong) was driven by founding the world's top International Financial Centers there [1].

## 3. Theory

Russia's Far East is close to major economies in Asia and is itself a major gateway for international investment in the Russian economy. Investment in this macroregion has grown considerably since 2015 thanks to creating Priority Development Areas (PDA) there.

A Priority Development Area is a part of Russia's territorial entity (including restricted-access entities), for which the Government of the Russian Federation has established special legal conditions for entrepreneurship and other economic activities to make such location more attractive for investors, to boost its socioeconomic development, and to improve the standards of living for the local population;

PDA's are what makes Khabarovsk Krai a promising region. The region has three PDA's around three cities: Khabarovsk, Komsomolsk-on-Amur, and Nikolayevsk-on-Amur.

As of today, the Khabarovsk-based PDA shows the best promises. The city of Khabarovsk has four PDA-related sites: Airport, Avantgarde, Rakitnoye, and Lazo.

These sites specialize in:

- (1) manufacturing;
- (2) metallurgy;
- (3) agriculture;

Investment in Khabarovsk Krai's PDA's has so far totaled 60.6 billion rubles based on signed agreements alone. So far, the PDA residents have in fact utilized some 15.5 billion rubles in investment, resulting in over 2,100 new jobs. 1,022.3 million rubles has been paid in tax [18].

Specialization is not without flaw, as the PDA lacks financial sector, which often constitutes a major source of investment. International Financial Centers are perfect for giving rise to the financial sector in PDA's.

An International Financial Center is a location that concentrates international banks or their branches, other financial and credit structures, as well as stock and currency exchanges running large-scale international currency, credit, or financial transactions, and process deals involving securities, precious metals, and derivatives [13].

An IFC is mainly tasked to attract domestic and international capital through flexible legislation, large-scale currency transactions, purchase and sale of securities and precious metals, as well, as through large-scale, currency-agnostic lending to domestic and international companies [14] [15].

For the state, an IFC provides an opportunity to coordinate all financial transactions in a single area for economically simpler cash flow management [4]; for businesses, an IFC provides a range of currency, credit, and financial services to facilitate entrepreneurship [5][6].

Being at the core of the global financial system, International Financial Centers form the mechanisms to attract and manage capital flows from all over the world[9].

While previously an International Financial Center had to be based on a major stock exchange and a well-developed system of national banks in a country of stable currency, today, it only needs a fairly flexible legislative framework that will be the primary driver of investment [3].

Today, there are four categories of International Financial Centers that are distinguished by their geographical, legal, and national contexts, as well as by the services such centers provide [12].

The global IFCs are London and New York. These provide a broad range of financial services on a global scale and are based on strong economies and well-developed domestic financial markets [2].

Local IFCs are Paris, Frankfurt-am-Main, and Tokyo; they provide a limited range of cross-border transactions and mainly focus on their domestic markets. While they have well-developed domestic financial markets and infrastructures behind them, such centers lag behind their global counterparts [11].

Regional IFCs are Hong Kong, Singapore, and Dubai. They specialize on intraregional transactions [10].

Finally, there are offshore IFCs: Zürich, Geneva, the Cayman Islands, etc. These make use of more lenient legal frameworks, making them attractive for worldwide financial flows.

In post-Soviet Asian regions, one IFC that shows promise today is Astana, Republic of Kazakhstan. In the Global Financial Centres Index that consolidates over 29,000 IFC rankings by the World Bank and the Organization for Economic Cooperation and Development (OECD), Astana ranks 61st, while St. Petersburg and Moscow rank 80th and 83rd, respectively.

What are the advantages of Astana as an IFC?

1. A special legal regime for business and financial operations;
2. State-of-the-art digital infrastructures and well-developed online business environment;
3. A single-window system that quickly provides specialists employed at the Astana International Financial Center with a visa, a residence registration, and a residence permit;
4. New direct flights to other international financial centers help the AIFC quickly integrate in the global financial system as a major partner;
5. Tax benefits such as zero tax on corporate and individual income, on profits from sales of securities, on dividends and premiums from securities for 50 years.

All of this means that the basic tool for any successful IFC is an attractive national legislative framework that enables the hosting country to attract considerable foreign investment.

To determine which region of Russia's Far Eastern Federal District (FEFD) suits best as an IFC host, this paper assesses the investment climate and analyzes the regional banking sector.

#### **4. Assessment of the Financial and Economic Indicators of Russia's Far Eastern Regions**

Assessment of the investment climate and other financial and economic indicators compares Khabarovsk Krai and Primorsky Krai, both of which are on the list of the 11 FEFD regions. The reason why the assessment is limited to two regions is that compared to other FEFD regions, these two have better economic growth and more favorable location, as they neighbor developed Asian economies. The Republic of Sakha (Yakutia) is not an option since its geographical location is inconvenient, and the financial infrastructure is lackluster.

**Table 1.** Top 20 regions of the National Investment Climate Rankings 2018.

<b>Region</b>	<b>Rank in 2018</b>	<b>Rank in 2017</b>	<b>Change in rank YoY</b>
Tyumen Oblast	1	6	5
Moscow	2	3	1
Republic of Tatarstan	3	1	- 2
St. Petersburg	4	17	13
Tula Oblast	5	4	-1
Krasnodar Krai	6	7	1
Voronezh Oblast	7	8	1
Chuvash Republic	8	2	- 6
Moscow Oblast	9	9	0
Ulyanovsk Oblast	10	10	0
Belgorod Oblast	11	23	12
Leningrad Oblast	12	20	8
Kaluga Oblast	13	5	- 8
Khanty-Mansi Autonomous Okrug, Yugra	14	30	16
Kaliningrad Oblast	15	39	24
Tambov Oblast	16	11	- 5
Yaroslavl Oblast	17	25	8
<b>Khabarovsk Krai</b>	<b>18</b>	<b>40</b>	<b>22</b>
Novosibirsk Oblast	19	27	8
Sverdlovsk Oblast	20	33	13

Based on these rankings by the Agency for Strategic Initiatives, Khabarovsk Krai had risen outstandingly through the ranks. The nearest of the adjacent regions, Primorsky Krai, dropped from being 71st in 2017 to 76th in 2018 [15].

Here are the basic criteria for investment assessment:

- 1.) Regulatory environment, i.e. technological connection procedures, permit formalities, and property rights registration.
- 2.) State-of-the-art of business institutes [7].
- 3.) Infrastructures and resources for HR training and investment projects.
- 4.) Support for SMEs in the region.

**Table 2.** Investment in fixed capital in Khabarovsk Krai's medium-sized and large companies, breakdown by economic activity (based on fixed assets).

	Utilized in January to March, 2019 thousand rubles	% YoY
Total	17,491,344	95.0
including:		
Agriculture, forestry, hunting, fishing, and fish farming	253,109	122.7
Mining and fossil fuels production	2,098,436	135.2
Process manufacturing	1,480,052	52.4
Electricity, gas, and steam; air conditioning	1,753,448	136.2
Construction	333,854	132.6
Wholesale and retail; vehicle and motorcycle repairs	338,430	2.3x
Transportation and storage	8,373,448	97.2
IT and communications	1,136,470	86.4
Finance and insurance	100,495	74.6
Real estate transactions	189,931	55.4
Professional activities and R&D	399,369	91.0
Other services	...	2.9x

In the breakdown of investment in fixed capital in medium-sized and large companies by economic activities, the proportion of investment in finance and insurance rose by 74.6% in Q1 2019 YoY, see Table 2 [16].

Further analysis of Khabarovsk Krai's banking sector reveals that:

- Khabarovsk has 17 branches of major credit institutions from other regions and one online bank [8];
- a single bank office services 4.5 thousand natural persons and 141 legal persons on average; credit institutions have 7.4 accounts per person, which is above Russia's average.
- Banks from other regions present in Khabarovsk Krai include foreign-invested banks: Khabarovsk branch of Bank of China; Far Eastern offices of PAO Promsvyazbank, AO OTP Bank, and Home Credit and Finance Bank LLC.

– International correspondence in place with more than 30 foreign banks, including Bank of New York, Bank of Tokyo, Eurobank, Deutsche Bank, Bank of China. This enables foreign trade with most of European, Asian, and North American countries.

Primorsky Krai has equally developed banking sector. There are 24 banking organizations in Vladivostok, 3 of which are regional banks headquartered there. International correspondence is in place with banks in Europe, Asia, and North America. However, Primorsky Krai is lackluster in terms of investment projects compared to Khabarovsk Krai.

Exchange analysis reveals the latter's advantage over the former. In June 2019, the Government of Khabarovsk Krai signed an agreement with the Saint-Petersburg International Mercantile Exchange, which is now to open a site in Khabarovsk Krai [19]. This will enable Khabarovsk Krai to make commodity transactions not only in Asia, but worldwide. It is the commodity exchange in Khabarovsk Krai that will be fundamental to inaugurating an International Financial Center here, to boost the region's financial development.

### **5. Russian Financial Laws and Their Suitability for IFC**

Detailed analysis of the Russian financial legislation identifies issues that hinder IFC establishment not only in PDAs, but in Russia in general.

The first challenge is the lack of a regulatory framework per se. Russian law today has no definition of an IFC, nor does it set forth IFC functions. Instead, IFCs are only mentioned in the *Forecast of Long-Term Socioeconomic Development of the Russian Federation for Until 2030*, a document drafted by the Ministry of Economic Development. The document only proposes that IFCs be opened in Russia and explains the benefits of doing so.

The second issue is that the Russian law is not unified and lacks international norms and standards.

Unification of law and legal regulation must focus on:

- (1) customer service outside the country;
- (2) foreign capital;
- (3) foreign investors and intermediaries;
- (4) foreign instruments and assets.

A newly created IFC must be able to provide the basic financial instruments, which must therefore be clearly defined in the Russian law.

What favors establishing an IFC in the context of the geopolitical dominance of financial and economic systems in the Far Eastern Vector is that:

- 1) the project is independent; the Far Eastern IFC will be independent from Moscow rather than a branch of it;
- 2) it will boost the regional financial market by reforming non-state pension funds, improving corporate law and management, provide analytical support for the financial macro-regulator, enhance the tax laws, and advance the exchange infrastructure;
- 3) the project is expected to bolster services as a contributor to the regional economy that will focus on providing a wide range of services to Asian investors, banks, and industrial groups;
- 4) the project will further lead to significant export projects in the Asia-Pacific market;
- 5) the region is close to the Asian financial centers and provides a comfortable time zone for Oriental partners to work with;
- 6) a mechanism could be established in place to transform portfolio investments into direct investments.

To conclude, it's worth noting that an IFC as a newly-established institution will definitely depend on the regulatory framework to govern IFCs. Basics must be set forth in the legislation to prevent any loopholes that could negatively affect the entire IFC. Analysis of the Khabarovsk PDA reveals that Khabarovsk is a good candidate to host an IFC, as innovation taking place in the PDA will drive further investment.

Analysis of regulations has led the authors hereof to the following solutions.

To enable an IFC to function properly in a PDA, the country needs a Federal Law on International Financial Centers in the Priority Development Areas of the Russian Federation.

This act will define IFC as a concept, its venues and infrastructures, as well as the financial operations of PDA residents. Definitions will make legislation clear for foreign investors.

Thus, it's necessary to set forth that an International Financial Center (IFC) is defined as a legal person that combines banking and financial institutions to carry out financial operations and do business on an international level for effective management of international financial flows: currencies, securities, and precious metals;

IFC infrastructure is defined as the set of banking, financial, and credit institutions and organizations;

IFC actors are defined as natural and legal persons doing business in the financial sector governed and controlled by the Russian International Financial Centers;

Financial operations of PDA residents are defined as the provision of financial services by PDA residents.

It is further necessary to set forth that International Financial Centers are established in Priority Development Areas primarily to boost the financial operations in PDAs as well as the economy of the hosting region. It should also be set forth that IFCs will occupy specially allocated sites within PDAs specializing in finance.

To consolidate the supervisory role and functions of the special regulator (the Central Bank of Russia), it must be set forth that legal and financial supervision be provided by the executive bodies of the Russian region hosting the IFC while the Bank of Russia will separately monitor currency transactions.

For cases any economic issue arises that requires court ruling, the law must set forth that any legal dispute pertaining to the businesses of legal and natural persons at the IFCs be resolved either by Russian or International Arbitration Courts.

For case an IFC ceases to operate, it must be set forth that an IFC being part of PDA might cease to operate on the basis of FZ-473 On Priority Development Areas in the Russian Federation, i.e. after the PDA lifecycle of 70 years is over.

The herein proposed legislative definition of International Financial Centers in Russia's Priority Development Areas will enable the country to establish such IFCs, to eliminate major loopholes and gaps in the Russian law, and to boost the economic growth of the PDA in Khabarovsk Krai.

## **6. Conclusions**

Analysis of the financial and economic indicators of FEFD regions concludes that Khabarovsk Krai, including the Khabarovsk PDA, has everything to host an International Financial Center.

Apparently, the IFC will need special preferential legislative framework to attract investors. Today's Russia lacks legal regulation of IFCs, which is why it seems advisable to use the best practices of foreign IFC-hosting countries.

An IFC in Russia's Far East will reinforce the economic vector of Russia's long-term cooperation with Asian countries.

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