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Russia Really is the Best Market in the World

Surviving the global credit crunch

“Russia versus Chindia”

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by Dr Danny Thorniley

danielthorniley@economist.com

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Executive Summary

- Russia is the best placed market in the world to survive the global credit crunch
- Compared with other markets, it is relatively insulated
- But its banks are definitely under more pressure
- Companies are re-investing their profits when they can't get bank loans
- Sales and profits in Russia are better than in China and India
- Profits repatriated from Russia are larger than all those from CEE
- But costs and inflation are rising with global trends
- The depth of HR is also superior
- Macro-economically Russia is one of best economies in the world
- Russia's GDP per capita equals that of Croatia and is catching up on Poland
- Russia is the biggest factor behind EU export growth
- Russia is the biggest infrastructure play in Europe and one of the best in the world
- The rouble will stay strong and stable
- Political risk is acceptable

Introduction

Let's start with the standard opening:

“If you do business in Russia, you will lose all your money because your Russian business partner will steal it from you because he or she is a thief and you will die because the Russian mafia will murder you in your hotel bedroom when you visit Moscow or St Petersburg”.

This is the view on Russia of the Wall St Journal, CNN and many renowned business journals and it is 97.45% wrong, rubbish, garbage.

Business success in Russia is the best kept business secret in the world; more rubbish is written and spoken about Russia than any other country on the planet earth.

A note to sceptical readers

This paper is intended to assist regional managers in their business planning and investment strategies. It argues that on many criteria, Russia is the best placed emerging market in the world today. This is NOT to denigrate business opportunities in China and India. These are two excellent emerging markets and in fact western companies in China are reporting strong sales and good profits, while in India the results are of strong sales and moderate profits. As this paper underlines, Russia is reporting very strong growth AND very strong profits and its medium term outlook and resistance to risk is better. For the best-operating companies global business in emerging markets is not a zero sum game; such companies look to expand business in all three major emerging markets at the same time. Then again, resource allocation is finite and SWOT analyses are made. The point of this paper is that Russia comes out very well in comparison with any and all markets in the world.

This paper does not examine the critical issues of distribution, compliance and human resources as these topics were dealt with at length in a 3-set kit of some 150 business slides on Russia distributed in November 2007. Please contact me if you would like these re-sent to you.

Part 1

Russia goes to new levels – an upward change in gear

I have argued for more than 15 years that Russia is one of the best global markets for western business in the world. But I have changed my views entirely on Russia: instead of being optimistic, I am now very optimistic (this sentence is written for impact effect – there are of course serious risk issues that Russia faces but these are manageable and again better than those in most emerging markets)

But Russia appears to be on the edge of exploding... in a positive sense into one of the major economic powerhouses of the world and certainly of Europe.

Recent features that distinguish Russia

Russia is relatively the best market in the world to be in at the moment.

Before we go into an analysis of the global credit crunch, consider the following:

- 1) Economic (and political) power in the 21st century will lie with those markets which have energy resources and pipelines.

Russia is the only BRIC market which has independent net resources of oil and gas. China and India have to run around the world trying to buy energy companies and beg access to pipelines (including from Russia).

- 2) Intercontinental ballistic missiles are simply passé or déjà vu. That's why the US looks increasingly like a paper tiger stuck in the bog of Iraq.

The former prime minister of Singapore, Lee Kwon Yew, noted wisely when speaking of the Chinese leadership:

I believe the Chinese leadership has learned if you compete with America in armaments, you lose. You will bankrupt yourselves. So avoid it, keep your head down and smile for 40-50 years"

If China, India and Russia follow this advice, they will entrench their economic dominance in the next 40-50 years.

The biggest mistake the Russian government could make now is to divert serious resources into egregious defence spending. Admittedly defence spending is set to

rise but this should be seen by the Russian government as giving the generals some toys to play with while the rest of the country concentrates on getting rich.

Power lies with the Sovereign Wealth Funds and the major US banks have to go cap in hand to them to be bailed out.

- 3) One of the world's largest FMCG's reports sales in Russia now of \$2.6bn. This sales total represents 65% of this company's sales in China. But Russia's population is only 10% that of China. So, 10% population transforms into 65% of sales. What does this say? It means that Russian consumers are European consumers and Chinese consumers are Asian consumers. China and India are closer to the peasant countryside than urban Russia

\$2.6bn is clearly big but many more western companies are reporting annual sales over \$1bn in 2007-08 and a large number now have sales in the region of \$400-700mn

- 4) Astoundingly Russia accounted for 40% of the EU export growth in 2007. European exporters can count their blessings that Russia is compensating for slower sales to the US. German companies in particular have benefited from the business opportunities but French and Italian ones too. The two big Anglo-Saxon countries (US and UK) perform relatively poorly in the Russian market with a handful of corporate exceptions.
- 5) FDI into Russia in 2003 was about \$2bn; last year it was \$7bn... in the Russian electricity sector alone.

In 2007 total FDI exceeded \$55bn and will stay at about \$40bn per annum in the next 5 years. Russia was the largest emerging market recipient of FDI after China

- 6) GDP per capita in Russia in 2007 was the same as in Croatia! In 2008 Russian GDP per capita is 92% that of Poland! And will overtake it by 2012.
- 7) Russia now represents about 30-50% of all CEE business for the major western players in the region. The Russia business for a growing number of companies will start to be the driver of European business. As Peter Brabeck then CEO of Nestle said,

"Russia will be our biggest European market in 10 years". He said that almost four years ago and Russia is on target.

- 8) Russia's spending expansion into infrastructure will be one of the biggest investment opportunities globally for western companies.

The Swedish engineering company SKF is investing some €100m into Russia because it sees investment into Russian railways as one of the biggest infrastructure opportunities in the world.

An explosion in spending and the macroeconomics to allow it

The Russian economy is probably on the edge of exploding - in a positive sense.

Russia is the most macro-economically stable country in Europe (perhaps the world).

In the global credit crunch Russia, like China, has tremendous reserves to cushion the economy. Put brutally, when an economic problem crops up the authorities can go to their wallet and throw money at the problem (the comparison in western Europe would be Sweden and Spain which have budget surpluses to help them along, whereas the UK is at the limits of its budget deficit position at -3.0%).

What are the key economic indicators?

- Budget surplus is running at 3.5% and the country will run a budget surplus until at least 2010. The main reason the surplus will fall is that funds will be expended on infrastructure and social spending.
- Stabilisation fund of \$160bn (8% of GDP) (split now into two funds: the Reserve Fund \$128bn and the National Welfare fund \$32bn).
- Central bank reserves of \$490bn (23% of GDP).
- Total debt at a mere 11% of GDP.

All this means the economy can weather severe storms.

And the implications are

- Russia has the potential to be one of the world's most powerful economies in the next 7-20 years
- With a GDP (at PPP) of \$2,078bn in 2007 Russia is already the 7th largest economy in the world, virtually the same size as the UK (\$2,138bn)
- Government plans a one trillion dollar investment into dilapidated infrastructure
- This is the world's largest investment programme outside China and, unlike China, Russia is not going it alone
- It wants public-private investment—from private Russian investors and foreign ones
- Western funds are pouring into the electricity sector; 26 nuclear reactors are planned in the next 12 years
- Railways will get \$400bn by 2030 and airports \$30bn
- The good news is that the government will not treat foreign investors in infrastructure as they do in the energy sector
- In infrastructure the Kremlin wants and needs foreigners

Russia is already the best market in the world for western companies in many/most business sectors (see below) and it is soon going to be the biggest infrastructure market in Europe and among the top three in the world. This will create huge new business opportunities in sectors which were relatively dormant for western companies.

Part 2

Comparing Business in Russia and “Chindia”

Russia and “Chindia” – sales comparisons

Table 1: Comparative top-line annual sales growth for western companies 2007: Russia, China and India

	Russia	China	India
FMCGs*	25%	18%	20%
Food & beverages	20%	16%	18%
Pharma/health	30%	18%	17%
Industrial products	33%	19%	16%
IT**	36%	23%	20%
Financials	28%	20%	13%
Prof. services	35%	22%	11%

Source: EIU company surveys and personal reports to the author

Notes:

These are average figures which disguise wide shifts

* In the FMCG sector market leaders are growing “only” at 15-17% because of increasing competition. But this is compensated by the scale of business.

** These averages mask wide variations. Microsoft reported that its Russian business was growing at 90% in 2006-07 while another major US company recorded 100%+ sales growth. These numbers depend on piracy levels (improving) and government tenders.

Russia tends “to beat” China and India by 10-12 percentage points and by 3-5 percentage points in FMCG and foods.

Russia is the fastest growing market in the world for:

- Pharmaceuticals
- Industrial products
- IT

- Professional services
- FMCG products
- Food and beverages

Russia and “Chindia” – profit comparisons

While we do not have analytical data for profit numbers we do draw the following conclusions. Russia is the best profit market in the world among the major emerging market ones (in comparison with Chindia, Brazil and Turkey).

We summarise the argument as follows:

- 1) In the 1990s China was a horrible market for profits. Nearly all companies complained of unrealistic expectations: some reported reasonably high sales levels but little profit. This has improved since accession into the WTO and survey results show that a growing number of western companies are making reasonable or good profits in China. But one could still only call this market a moderate profit one and at very best a moderate-to-good one. Sales levels are strong, often in the ball-park of 15-20% and profits are reasonable and picking up.
- 2) Survey results suggest that business for western companies in India is the best it has been in 50 years. India was under-performing until the early 1990s when the Raj license system was overhauled by the then finance minister Manmohan Singh (current prime minister). But corporate results languished and were poor to moderate in terms of sales and profits. Business has picked up sharply since 2004. Western companies report that sales are strong (slightly slower than in China in a range of 12-

20%) but profits are harder to achieve than even in China. India in fact lags in profitability behind Japan, Korea and the rest of south-east Asia. The poor profit showing may be due to the fact that many western companies are only just entering the market and so investment and start-up costs are eating into profits.

- 3) But the news from Russia is one of consistently high sales levels (20-35% levels) and very strong profits. Most companies rank Russia in their top 5-10 profit markets globally and the majority include it in their top 3 within Europe.

One major consumer goods company has reported net profit income of €100m in Russia in 2007 which was the second highest net profit income in Europe behind Spain. Poland comes about 6th in profits and Germany languishes in about 12th position with €16m profits. In other words Russia is making 6 times more absolute profit than Germany. This says a lot about how good Russia is and how tough Germany is.

Another good thing about Russian rouble profits for western companies has been that these profits have been denominated and booked in company accounts in strongly appreciating roubles. For US companies this has been an added blessing. For some years (2004-06) companies were able to book their costs in a falling dollar and report their earnings in a rising rouble: happy days. The dollar is still falling but more companies have now “roublised” more of their costs, but the good news is that more have done so for their invoicing as well. Rather than play the exchange rate game, companies are rightly more comfortable when their costs and revenues are in the same currency so that risk is mitigated. Still for those with remaining dollar costs, these have fallen in the last 18 months; but Russian suppliers are of course raising their prices as a consequence.

We have argued elsewhere why Russia is such a good profit market but two reasons stick out:

- i) Because western companies have been circumspect and ignorant about the Russian market and therefore competition is less fierce. Certainly Russia is 2-4 years behind Poland in terms of competition, but executives rightly point out that Moscow and other major cities are becoming intensely competitive. The good thing about the Russian market is that you have the chance to expand into other regions which still have potential.
- ii) My experience suggests that Russia is the best premium price market in the world. If you have a top-quality product, you can sell it at a top-quality price more readily in Russia than anywhere else in the world. The reason is twofold: Russians, like the

Chinese, are brand aware (maybe not yet brand loyal, also as in China) but they are extremely quality conscious; dozens of western companies report that their Russian clients are the most IT, technical and product-savvy in the world.

There is one quick proviso: selling at the top end of the market segment is great and long may it last—and that will be another 2-4 years. But the strategic market is in the lower-middle end of the market in all emerging markets in the next 10 years: the so-called lower-middle class or upper-working class. Russia is also well-blessed with such consumers (about 85m). This has been addressed in earlier papers.

And you can repatriate your profits

The myth that you cannot repatriate profits out of Russia is just that—a myth. In over 20 years working on the market hardly one company has ever mentioned to me profit repatriation as an issue. And sizeable profits are being sent home.

Table 2: Repatriated profits from CEE and Russia 2002-2006 (\$bn)

	CEE	SEE	Russia
2002	5.0	0.3	2.3
2003	5.6	0.4	5.1
2004	8.0	0.5	4.0
2005	11.8	2.0	8.0
2006	14.1	2.1	16.1

Repatriated profits out of Russia in 2002 were only half those from all of the core CEE markets but in 2006 Russian repatriated profits exceeded all such profits from CEE and south-east Europe. Profits out of Russia doubled in 2006 and ought easily to have surpassed \$20bn in 2007. This merely testifies to the size of business in Russia.

Repatriating profits though is not the name of the game. The clever western companies who are making lots of profits are re-investing them in the market, so these figures do not represent the full reality on profits. Much of the repatriated profits reported here probably stem from the western oil majors who are making lots of money in Russia but who are loath to confess it!

But the profit outlook is under pressure. Western companies note that in 2002-06 they had 5 wonderful years: sales were booming through the roof and costs were under sharp control. As elsewhere in the world, and this is not a specific Russian problem, top-line sales are coming

under cyclical and competitive pressure and costs are rising in Russia (and other big emerging markets) for:

- rental office space, land and warehousing costs
- advertising costs
- utility costs—general input costs
- staff costs/salaries
- the rouble is still appreciating in real terms

Russian companies (and western ones operating in Russia) have enjoyed a set of implicit subsidies in 2002-07, all of which are decreasing simultaneously. The subsidy from workers is ending as wages play catch up with the real component lost during inflation in the 1990s; the temporal subsidy from over-investment in the Soviet period is ending as inherited capital is replaced; the energy subsidy is evaporating as prices rise to world-market levels (still with some leeway); and the subsidy from importing consumers falls as the rouble has appreciated so strongly.

Managing profits will be one of the most challenging aspects of global business in the next 5 years. Global inflation is picking up and will not moderate soon. Companies will have to get use to higher input prices. Pricing power with customers though is under severe pressure: the result is revenue under pressure and costs rising = profit squeeze globally. Regional executives in all markets of the world will struggle with this issue and will have to manage the expectations of senior management at HQ.

Human resources in Russia and Chindia

Salary costs globally and certainly in the main emerging markets will be under continued upward pressure. We have addressed this at length in a paper on Russian HR in 2007 and in another global paper. The bottom line is that western companies in Russia in 2001-05 were getting away with paying cheap salaries for what they were getting. The market has changed: supply does not equal demand = rising salary costs.

But the point is that these are not out of control and compare well with Chindia:

Table 2: Annual salary increases for white collar staff in western companies operating in Russia, China and India 2007

	Russia	China	India
annual average salary increases	17%	15%	17%
average inflation (approximate)	10%	5%	4.5%
Variance over inflation	70%	200%	300%

The first thing to note is that average salary increases are about the same percentage figure in the three markets. But the variable over inflation is hugely higher in Chindia. Russia comes off much better in this indicator. That said, things are not out of control in Chindia: productivity levels are high in both markets which makes the salary increases bearable. Rising inflation in all three markets in 2008 will put upward pressure on salaries everywhere.

Annual staff turnover in Russia, China and India

These are very comparable, with Russia levels at 12%, China 14% and India 13%.

Regarding the quality of staff, this is better in Russia than in Chindia. The reason is the quality of the Soviet educational system and the Russian system has been living off its heritage for too long without insufficient investment. While the quality of the top 2-5% of talent in all three markets is world class, as you go deeper down the segments of the human resources market, the quality deteriorates more quickly in China and India. Whereas maybe only the top 12-20% of Chinese and Indian graduates are acceptable quality for western companies, this percentage rises to 30-60% in Russia.

Part 3

Will Russia be impacted negatively by the global credit crunch?

The answer is categorical: absolutely not... but probably, maybe somewhat!

On many indicators Russia ought to be one of the economies in the world the least impacted by the financial collapse in the West.

One statistic is quite shocking in supporting this. Contagion from a downturn in the US ought to be minimal because: *Russian-US trade accounts for 1% of total Russian trade!*

The Russian banking sector: credit, loans and debts—the risks

Financing costs are rising and access to credit is getting more difficult or not possible at all. This is a global trend and it's happening in Russia to some extent with western banks and Russian banks holding back on loans. The cost of borrowing has risen: the spread on credit default swaps which benchmarks risk against US treasury bonds has widened for Russia 107 points between June 2007- February 2008. The spread has widened further though in markets such as Hungary (173 points), Croatia (136), Romania (214) and Kazakhstan (237). The figure for Poland is 87 and 61 for Slovakia; only Czech Republic with its minimal debt exposure has seen the smallest rise of 36 points. The point is that, relatively, Russia comes out not badly on this indicator.

This will have an impact on western investment plans but, as we have noted when referring to repatriated profits, western companies are making good profits in Russia and can use these as a source for their investment plans. This is a key distinguishing and positive feature for Russia. As we will see below, the Russian government has the spare cash to pump-prime the financial system and the economy. The Central Bank has also raised its refinancing rate to 10.25% which is still not high in real terms and this will certainly continue to rise through 2008 as interest rates play (slowly) a bigger role in the economy. As in other markets, the private sector is ahead of the Central Bank: Bank of Moscow and Alfa Bank raised their rates ahead of the Central Bank, as did many others. In January the rate on the average rouble-denominated mortgage rose 16 basis points to 11.48%—again there looks like scope for further increases when inflation is about 11%.

Credit growth reached 50% in 2007 in Russia (76% in Ukraine and 53% in Romania) and is expected to fall to 26% growth this year. This looks like a healthy correction. The banking sector overall is still expected to grow at about 25-35% in 2008. And western companies are not frightened off: two years ago Raiffeisen invested €500m to buy Impexbank. More recently in March 2008 Barclays Bank bought Expobank, a mid-sized bank with retail and commercial operations, for \$745m. Other banking investments in 2008 include: Lehman Brothers announced that it had won a full brokers licence and HSBC announced that it was investing \$200m in expansion plans. During a January 2008 visit to Moscow the CEO of Merrill Lynch named Russia as one of the most important growth markets for his bank and talked of Russia being “more insulated” than other emerging markets from the global markets.

The Russian authorities are boosting liquidity and this is an easier job for them than in Kazakhstan. Another benefit for Russia and the CEE/CIS region is that local financial markets are small in relation to the size of the economy: bank assets in the Eurozone are equivalent to 235% of GDP but only 45% in Russia (75% in CEE). The mortgage exposure is miniscule: a

mere 1.2% of GDP in Russia (11% in Poland). At such small levels the threat of a collapse or contagion in the rest of the economy is manageable.

The consumer credit business is coming under most downward pressure after several years of a bubble. Russian Standard, Russia's top consumer credit lender, has come under most scrutiny. The bank was reportedly approving 90% of credit applications for the purchase of consumer electronics. It achieved record profits in 2006 of \$550m, a leap of more than 140% on the previous year, and ranks as the 15th largest bank in Russia. This bank, as many others, will find the Eurobond market closed to it but funds can still be raised via securitisation, bilateral deals and retail deposits. Russian Standard hopes to raise its deposits from \$300m last year to \$800m this year. As an example of what is going on in the first three months of 2008 some \$11.5bn in syndicated loans were signed by Russian companies and banks with another \$7.5bn still upcoming for this first quarter.

To fund their rising lending Russian banks have been borrowing extensively abroad with such foreign borrowing doubling year on year to \$140bn (total corporate and bank borrowing abroad was \$400bn) by mid-2007. Russian Standard and other private-sector consumer lenders such as Home Credit and Finance relied on international markets for half of their finance—shades of the UK bank Northern Rock. While the overall level of Russian corporate (and bank) borrowing is not yet a concern, the cost of servicing the debt has had a noticeable negative impact on the current account: interest payments of foreign credits in 2008 will amount to \$40bn.

Of the total \$400bn of loans referred to above, some \$100bn is short-term due in 2008. Russian companies managed to pay off \$20bn in foreign debt in the fourth quarter of 2007 and raised enough re-financing to bring in another \$15bn.

Obviously Russian IPOs, like global ones, have been knocked sideways with little action in the first quarter of 2008 compared with total offerings in 2007 worth \$42bn.

The good news is that this does look like a healthy correction as alluded to by Raiffeissen International CEO Herbert Stepic. The top 10-15 private sector and state-owned financial institutions may actually see an opportunity to expand at the expense of marginal players of which there are many. While the days of ultra-easy money are over, increased discipline, mostly imposed from abroad could create a healthier financial environment.

A big supporting factor for domestic liquidity and the rouble bond market in 2008-09 will be the Development Institution Funds and the government plans to increase the Funds' capital by \$26bn this year. The distribution is as follows:

- The Russian development Bank \$7.5bn
- Nanotechnologies Fund \$5.5bn
- Housing Infrastructure Fund \$9.5bn
- Investment Fund \$3.8

Over the next 12 months the earmarked funds will be only partially run down. Much of this capital will be placed in deposit with commercial banks to support rouble liquidity and to mitigate the effects of the credit crunch. The banks that will benefit will be Sberbank, VTB, Gazprombank and Bank of Moscow as well as other government-controlled banks. It looks unlikely that such Developing Institution Funds will be invested in the equity market this year, but support for the bond market including mortgage-backed securities is probable.

Capital to the Funds was already being deposited at the end of 2007, with \$4.5bn being allocated. In addition the Ministry of Finance plans to place an additional \$15bn equivalent of surplus budget funds on deposit in commercial banks.

It appears unlikely that global credit markets will bounce back much in the first half of 2008 and money globally and within emerging markets and Russia will stay tight for most this year. That's why such funds will differentiate the Russian banking system positively. The Russian government will be using these Institution Funds' capital to buttress the banking sector but it has additional capital at the ready to squirt more liquidity into the system as and when needed.

Russia is more than an oil economy

Russia makes money on oil at \$18 per barrel, good money at \$25 and it's party time at \$30 per barrel. It will be making huge profits on oil for the next 10 years and as a consequence Russia is going to be one of the most cash-rich countries in the world. Its oil stabilisation fund has been supplemented by a second Future Generations Fund and the Sovereign Fund already has \$30bn per annum at its disposal to buy assets in the West. Russia is unlikely to follow China's steps in propping up the US dollar by buying low-yield US treasuries. Instead Russia (and Russian firms) will go out shopping and the President-elect Medvedev encourages this trend.

But what if the oil price falls? Well, first of all it won't—or at least not enough to damage the Russian economy. The gloomiest forecasts put oil at \$60 per barrel in 2012. But the point is, even if the price does fall, Russia is cushioned. One of the most astonishing statements in years was made by the Russian government at the start of 2007. Their comment was that “the global oil price can fall to \$20 per barrel and remain at that price for three years and the

Russian budget will not be damaged". This indicates how frugal Russian finances have been under Finance minister Alexei Kudrin.

But the sceptics still argue: *"Russia is just an oil economy, we shouldn't invest there"*

This was true in the past and is not a ridiculous comment now, but can be countered by reference to strong growth in:

food and beverages, retail, consumer goods, banking, real estate, construction, mobile telephony, aerospace, mining, metallurgy, automotive and parts of engineering and parts of chemicals

Another response is that the Russian energy sector has only grown at 1-2% in the last two years; but the overall economy is growing at 7-8%. This clearly indicates that something else is going on in the Russian economy. The downside of this is that since taking over large chunks of the energy sector, the government has done a poor job on investment and modernisation (and will need to use more partnerships with European and some US energy companies sooner rather than later).

Drivers of the economy which will cushion it during the credit crunch

Oil, energy and metals will remain fundamental catalysts, but many other sectors are strong.

Real GDP has averaged annual growth of 6.6% this decade, one of the fastest in CEE; recent quarterly growth has been averaging 8%. Many commentators have argued constantly in the last years that Russian GDP growth rates would start to fall, but this has consistently proven to be wrong. Over the next five years, we expect growth of about 6%+, with a small risk factor that it could fall to 5-5.5%. There are many drivers to growth: personal consumption is booming; fixed investment has caught the growth bug trebling between 2005 and 2007 to 20% annual expansion; investment will stay buoyant in 2008 and decline to a still solid 15% annual growth in 2009-12. This will be a strong catalyst to companies selling manufactured, industrial and engineering products. And this part of the economy certainly needs investment as 80% of Russian machinery is over 15 years old (on average the capital stock is estimated to be 20-25 years old). In compensation, the engineering sector was growing at about 20% in 2007, as was real estate and construction.

In addition to industrial investment and consumer spending, exports remain strong in value thanks to the high oil price. This mix of growth drivers is good news as growth risks are spread. There is some threat of a house price bubble in Moscow at the top end, but average

property prices in the capital are also rising. This will give consumers a feel-good factor, but poorer people and youngsters trying to get on the property ladder will find it hard.

Consumer spending is a big growth stimulant: private consumption has risen on average 11% in the last three years and will stay at that level until 2010. As in much of CEE, real wage growth and credit expansion are fuelling the consumption boom. Real wage trends in Russia are the best in the world. There are usually only two ways honest people can make money: through their wages or by borrowing. Real wages (after inflation) were growing in 2005-06 by 18%+ the highest level the world; in 2007 they were still rising at 15% and will grow by 10% per annum in the next three years. These figures compare starkly with those in developed markets and in other emerging ones:

Real wage growth annual average in 2004-08

Germany	0%
Japan	0%
USA	0.2%
CEE	4%
China	12%
Russia	17%

These numbers are quite shocking and help explain why some western markets are so dreadfully difficult for FMCGs.

Part 4

Latest key economic issues in 2008-09

Inflation

Inflation is the biggest macroeconomic concern. Inflation spiked at the end of 2007 and the start of 2008. This appears to be quite cyclical as the same trend occurred in December/January the year before (06/07) and the year before that (05/06). But this time it may prove more ingrained because it is driven by global energy and food prices, which look like staying high-ish for some time. But this is a global feature and not a special Russian problem. There were, in addition, Russian factors which contributed to the rise in inflation: some fiscal loosening in the first half of 2007 and a poor harvest for some crops in the summer. But at the start of 2008 Russian monetary policy tightened and this could produce a beneficial impact in the second half of 2008.

The business threat is that the government extends or deepens current price restrictions; this is already impacting the share price of some Russian food suppliers.

Clearly the need is to control inflation but the problem remains that too strong a rouble (which helps reduce inflation) reduces Russian competitiveness. While that is a standard problem for Russia, the fight against inflation is complicated by the need for the Central Bank to ensure sufficient liquidity in the financial system in order to avoid the worst effects of the global credit crunch.

After reaching 11.9% at the end of 2007, inflation will remain stubborn at 11.3% at the end of this year before falling to 9/9.5% at the end of 2009. As with all global markets, there is upside risk if the oil price surges beyond \$100 per barrel.

The current account surplus will fall, but not as quickly as some think

In 2009 the central bank will be in a better position to control inflation as it will be able to resort more to interest rate policy, which has had limited effect in the past. This may depend on how quickly the Russian current account surplus shrinks. The Bank has not been able to fully sterilise anything like the huge amounts of surplus funds in the economy. The argument goes that if the current account surplus shrinks to 0.5% or zero, then sterilisation and interest rate policy becomes more effective. The theory may be fine but I doubt that the current account will shrink so much. The current account balance is only likely to fall to zero in 2011/12 if and when oil prices stabilise/fall. Therefore an estimate of a flat or negative current account by 2009 seems premature.

The falling current account is not just attributable to any potential fall in oil prices but also due to huge imports rising at 30% per annum in the last 2-3 years and scheduled to increase this year by 23%. This explains those large EU exports to Russia.

But the point is that when interest rates do start to function more extensively in 2009 or 2011, the era of cheap money in Russia will be over (although companies will continue to reinvest big profits). More stringent interest rate policy and any curb on GDP growth will be compensated by the government's massive engagement in infrastructure spending.

The rouble

The rouble will be steady against the US dollar with small fluctuations either up or down; the larger probability is for slight upward appreciation. The rouble ended 2007 at 24.5 to the

dollar. The rouble ought also to strengthen against the Euro after ending 2007 at 35.9. This is based on the presumption that US GDP growth will overtake the Eurozone's growth in 2009 and then the dollar will start to appreciate versus the Euro pulling the rouble upward with it. There is a clear triangular relationship going on between the rouble, dollar and Euro with the rouble rising along with one of them as the other falls and vice versa.

With inflation picking up and the rouble not strengthening massively, the real appreciation of the currency which was running at an annual rate of 10% for several years will slow to 3-6% in 2008-11.

But the bottom line is that we have predictability and broad stability for the rouble over the next 5 years.

The only small-ish threat on the horizon is that when the current account surplus does shrink in either 2009 or 2011, Russia's external position will become more sensitive to swings in capital flows; hence the importance of accumulating FX reserves at the moment, which is precisely what the government is doing. The threat of any severe volatility will also be mitigated by strong inflows of FDI as well as portfolio investment: FDI stormed to a record \$55bn last year and will stay in an annual range of \$40-45bn for the next 5 years. This will be a useful anchor for the economy.

All of the above is substantiated by the fact that the rating agencies are upgrading Russia's sovereign rating (just as they did on sub-prime mortgages—just joking). S&P upgraded Russia from stable to positive in March 2008 and Moody's is likely to follow suit this year.

Part 5

The political risk outlook

This section examines new issues in the political scene. Several issues are omitted here which were analysed in the slides of November 2007.

As we argued, the transition process to a new president ran smoothly. How will Medvedev differ from Putin? How influential will Putin remain? Will Putin return as president? How will the newcomer survive against the hard-nosed hard liners, the so-called "siloviki"? Will Medvedev bring in a new broom against corruption? One answer to all these questions might be, "We don't know yet", but the political outlook at least at the margins seems set to improve. Medvedev seems set to pursue the same policy lines as Putin at home and abroad but with a lighter touch.

Personalities and background do matter. Putin and Medvedev trust each other; Medvedev does look up to Putin as a big brother figure. Personal relations play a big part in politics and business and liking and respecting each other is a good starting point. That said, life shows that good relations can sour.

Certainly in the first and second years of the new presidency, Putin will seek to protect his protégé; any failures by Medvedev will reflect badly on Putin and his heritage. After about two years in power, Medvedev and Putin will start to decide their joint future and whether Putin will look to come back for another 4-8 years starting in 2012, or not. By 2010 Medvedev may decide that the president's seat suits him just fine. The good news is that this underscores our message of continuity and stability. In other words, we are in the middle of the Putin/Medvedev era. Infighting will of course take place as Medvedev institutes some of his own programs. This will attract a lot of western media but this should be seen as run-of-the-mill bureaucratic behaviour much as you get in the higher echelons in the USA.

The consensus view, and I share it, is that Medvedev is capable, may well want to clamp down on fairly rampant government corruption and may want to act as a new broom. One point I would underline is that in a recent speech he advocates Russian companies investing and expanding westwards. This can be judged as good-old commercial nationalism but it also carries an important consequence with it: if Russian companies expand their M&A activity in the West, then they will have to clean up their act on compliance and corporate governance. This positive, domestic side-effect is assuredly not lost on Medvedev.

Medvedev is a lawyer by training and he is probably personally offended by the rampant corruption that has taken over at the highest echelons of government as more ministers were appointed to key economic and corporate positions. One very knowledgeable western banker assured me in Moscow a few weeks ago that the going rate for an important licence for a Russian company is \$20m. To date, direct requests for bribes to western companies has been more limited; the officials probably know that most western companies are no longer interested in this type of business. But western companies can easily be adversely affected when a tender goes to a Russian company who was out-bid by a western competitor but was able to grease the right palms.

Corruption at government levels

We have argued elsewhere that corruption and malpractice in the Russian corporate world has improved vastly in recent years and that the trend is a positive one. This is not the case at the federal and municipal government levels. The year 2004 was pivotal when at the start of Putin's second term he became more authoritarian and allowed greater corruption at high

levels. In 2003-4 several events coalesced: the “colour revolutions” put Putin on a back foot in foreign policy and made him more hard-line; the oil price started to rocket giving the government a financial cushion and a bigger pot to steal from; re-nationalisation took off along with the Yukos campaign and more of Putin’s cronies from the KGB and St Petersburg days took key positions in companies; and corruption became rampant in several of them; in 2004 Fradkov was nominated as PM and the ensuing government reorganisation weakened the reformers. Official action to improve the economic and business environment has been shelved after useful reforms in 2001-03. The early years of this new presidency could be the time to introduce unpopular but necessary reforms and such reforms would encourage the co-financing that Russia is seeking in its many PPI initiatives and allow it to rebuild its infrastructure and remain competitive in the face of an appreciating rouble.

Medvedev has talked this year of creating a properly functioning legal system. This is good to hear but Putin said the same and did not follow through. Medvedev does seem more serious. He wants to overcome “legal nihilism”. He rightly highlights the need to improve the courts system radically; he is looking to raise salaries in the judiciary and wants to make students aspire to working in law and to becoming top judges.

He talks of the four “I”s which are institutions, infrastructure, innovation and investment. He also rejects further state expansion into others sectors of the economy. This is extremely important for western companies as it represents one of the major commercial risks today. He is content with state ownership in the commanding heights of the economy and where state security is a question: all well and good. But thankfully he sees the diminishing returns of state involvement in other sectors and he also wants to reduce the number of state officials in companies i.e. companies should be run by business executives not state officials doubling up.

This all sounds good and it appears that risks of the new presidency are on the upside. The only negative factor is that cleaning out the Augean stables always takes time. Even if legal and mind-set changes are imposed quickly, results will take years rather than months to be become visible in any widespread fashion. Change will be incremental but it will be welcome nonetheless. Nor is this anything new. As the nineteenth century satirist Mikhail Saltykov-Shchedrin noted, “the severity of Russian laws is alleviated by the lack of obligation to fulfil them”.

The key elements of Russia policy can be summarised as follows (and these are mirrored in very large part by China):

- 1) Rapid GDP growth—economic growth is seen as primary

- 2) Because this ensures political stability and stability is at the heart and soul of Russian policy (and even more so for China)
- 3) GDP growth also allows the authorities to “buy off” the middle class. The latter is growing rapidly in Russia and for the time being the government wants to keep them quiet while they buy up goodies: western brands, cars, housing
- 4) A nice dose of nationalism. China has been more restrained than Russia because it sees any external instability as potential for causing domestic turmoil (which make the Chinese handling of the Tibet issue in 2008 even more cack-handed). Russia though has been quite happy, especially in the election run up to kick sand in the face of the US and to play hard ball with what they see as the US poodle dog, more commonly known as the United Kingdom (their thinking is, “We can upset the US but shouldn’t go too far, but lets have real fun with the British”. Here again Medvedev may be looking to smooth Russo-UK relation quickly). The Russians see their current behaviour as pay-back time for the 1990s when in their view a weakened Russia was exploited by the West.

One final word: the middle class in Russia and China are indeed being bought off, but how long will that last? Probably longer in China than in Russia. The rising Russian middle class is more urban, better educated and more sophisticated than the more peasant orientated middle class in China. The Russian middle class in 2012-15 will probably start banging on the political door saying that, “We want more of a political voice and we want to start our own political parties”. The good news is that by then Russia’s political system will be able to absorb that kind of change, especially when the current regime’s stance is broadly centre-rightist and unlikely to change in the next decade.

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Economist Intelligence Unit, Corporate Network
Oelzeltgasse 3/7, 1030 Vienna, Austria
Telephone: (43 1) 712 41 61 40, Fax: (43 1) 714 67 69
www.corporatenetwork.com

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