



# Calm horizons in Russia?

**Investors in Russia face a wealth of preconceptions about the market's potential difficulties. Philip de Leon takes a look at the realities of Russian risk.**

Stereotypes and generalisations live long, especially when dealing with Russia. The problem is that they somehow become a 'reality' that permeates pragmatic minds, distorts any analysis one will conduct, and can lead to the wrong conclusion. The popular belief that Russia and risk are synonymous is an example.

Yes, Russia is plagued by bureaucracy, corruption, inadequate and inconsistent legislation, infringement of intellectual property rights, and an unpredictable court system. These are well known problems that even the government acknowledges and risk factors that cannot be ignored. Russia's handling of domestic and international affairs has also been the subject of intense scrutiny and regular criticism. This tendency to give greater emphasis to the political situation, and less to the business situation as assessed by the business community at large, tilts the balance to have a country risk perception that is above the real danger level.

If you look at Russia from an economic angle, it was a star in 2007: GDP growth of 8.1%; foreign direct investment at US\$47.1bn; a foreign trade surplus of US\$128.7bn and international reserves at a staggering US\$476bn.

To better understand Russia, we need to put it at the centre of our map and start from there. Similarly, time should be spent listening to or reading what the key decision makers are saying rather than limiting ourselves to the

synopses, analyses, and interpretations of commentators.

A *Financial Times* interview of president-elect Dmitry Medvedev in March 2008 is very insightful as it sets some of the top goals of his upcoming presidency such as: "to maintain economic stability, to develop economic freedoms, to promote social programmes and to ensure that Russia sustains its position in the world".

Similarly, past speeches are useful to understand the set priorities, such as President Vladimir Putin's annual addresses to the federal assembly, as well as his February speech at an expanded meeting of the State Council on Russia's 'Development Strategy Through to 2020', and a speech at the economic forum in Krasnoyarsk where candidate Medvedev laid down his priorities until 2012.

The following article will not aim at deciding or even inferring whether Russia is on the right or wrong path as it is an endless debate, nor will it pretend to say that everything is great in Russia. It will rather try to shed light on what the Russian leadership is striving for, not to justify its actions, but more to understand them and to bring your perception of risk on par with a more objective reality. Then, by looking with a new eye at the global picture, you can decide on your own if your perception and assessment of the political and business risk in Russia are justified and an insurmountable risk factor for your export and investment plans.

## Democracy and political risk

Many see Russia as a political risk because it is not considered as a true democracy, but we need to understand that in the mind of the Russians and its leaders, economic stability is often seen as more important, and democracy should not come in the way of what needs to be done to improve the quality of life for Russian citizens.

When the Soviet Union collapsed, Russia was eager to embrace alien ideas, concepts and principles that had proved successful elsewhere, and democracy was one of them. An army of foreign consultants and advisors poured in and some were later blamed by Russians as the cause of their problems. It resulted in a desire to reclaim control of its own destiny without interference by people who do not know Russia the way Russians do.

The newly gained freedom led to a chaotic situation during some of the Yeltsin years, especially the 1998 financial crisis that is still fresh in the minds of many as the rouble lost two-thirds of its value and prices and inflation sky-rocketed. It is not surprising in this context to see barriers to the free exercise of democracy for the sake of economic stability seen by some Russians as the guarantee for a better future.

Russia does have a conception of democracy that is not the same as in the West. There are those that believe that since the country has never had a democratic system, it will

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take time to complete its transition to one. Though there is some validity to these views, they should not serve as a recurring motto to prevent change or to justify restrictions that do not exist in other democracies. President-elect Medvedev said in the *Financial Times*: "I think Russia has every opportunity to build a developed democratic society and a full-fledged democratic state."

### Dmitry Putin and Vladimir Medvedev

Another element that is looked at to determine the level of political risk is the country's leadership. For Russia, the fact that Vladimir Putin will still be in power as prime minister and that his successor is a loyal collaborator, has some traditional democracies scratching their heads wondering who will really be in charge.

A reality that the west has a hard time comprehending, or should we say registering, is that Putin is immensely popular. In the eyes of many, he is a strong leader who has brought back stability, both political and economic, and who has restored Russia's lost pride and grandeur. It is obvious that Putin has a vision for Russia with economic stability at its core, but eight years in power were not sufficient to do the massive overhaul the country needed.

A recent survey by GlobeScan found that 64% of Russians believe Putin is good for democracy in the country. Interestingly, 56% of citizens in G7 countries believe Putin has thwarted democracy. This is telling that perception is guided by our own reality. Winston Churchill once said: "The best argument against democracy is a five minute conversation with the average voter" and "democracy is the worst form of government, except for all those other forms that have been tried". These quotes might not be as well-known in Russia, but we certainly see a trend towards having a controlled and managed democracy.

The paternalistic approach of government is still a frequent mindset in the former Soviet Union. It then should not come as a full surprise to see efforts to prevent engaged reforms from being derailed by a misguided electoral vote. The democratic process becomes a means to ensure that nothing comes in the way of what has been started and still not completed. With the presidential

elections behind, there is no further domestic obstacle to make of Russia a better place to live.

This is where Medvedev comes into the picture. He has been a long-term and loyal collaborator of Putin. One key question is who will run the show. Interestingly, both have separately and several times referred to the constitution, and that the president and prime minister would solely exercise the powers vested in them. As a French prime minister once said in a famous quote about his relationship to the president: "lui c'est lui, et moi c'est moi" (him it's him, and me it's me). There is no doubt that the little-known Medvedev will make a name for himself, just like Putin did when he succeeded Boris Yeltsin as the chosen one. Putin will remain an influential figure but assuming that Medvedev will not end up running the show could be erroneous.

It must be noted that registered voters did not boycott the elections and that over 67% of them actually participated in the presidential elections of March 2008, casting 70% of their votes for Medvedev.

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### The business risk: who's talking?

Many also see Russia as a business risk, and some numbers can surely make you think twice before going east. For instance, in the 2008 Index of Economic Freedom produced by the Heritage Foundation and the *Wall Street Journal*, Russia's economy is considered as 49.9% free, making it the world's 134th freest economy. The survey

further identifies as significant weaknesses trade freedom, financial freedom, property rights, and freedom from corruption. For comparison purposes, Brazil ranked 101st, India 115th and China 126th. Also, in the 2006 Corruption Perceptions Index, Transparency International ranks Russia as 121st out of 163 countries while Brazil ranked 70th, China 71st and India 74th.

However, these numbers are in sharp contrast with the results of multiple surveys of the foreign business community active in Russia. The political stability through the Putin presidency and which can be expected during the Medvedev presidency, has not escaped the attention of long-term investors. This guaranteed political stability, coupled with the economic stability that both Putin and Medvedev have pledged to protect, render Russia very attractive.

Becoming aware of its need to market the country in a more positive light, Russia's ministry of economic development and trade and the federal investment advisory Council (FIAC) commissioned a survey in 2005 and 2006 to PBN, an international strategic communications company. Though top factors impacting investment such as bureaucracy and red tape (84%), corruption (78%) and inadequate and inconsistent legislation (71%) were mentioned, 90% of the interviewed companies said they planned on increasing their business positions and investment in the next three years.

It could be said that greed and speculation fuel the current infatuation with Russia. Yet, this is not stock market speculation. Companies surveyed are those that are present for the long-term, have invested significant amounts to gain market shares and would certainly not pour in more money if they had doubts regarding the direction the country is headed, at least in the business sense. Revenues from Russia's natural resources means it is able to carry out its ambitious development projects, and the growth of a sizeable middle class should not be underestimated as a growth factor. Others may view the multiple surveys of foreign investors as rigged, as companies could have a tendency to downplay problems so as to not jeopardise their position in this lucrative market, but that would be a lot of lying. It is noteworthy to mention that one of the top foreign investors in Russia is Cyprus.

It is mostly Russian money that had been siphoned out of the Russian economy by Russian businessmen who did not trust their country to be a safe investment destination. The fact that this capital flight money is coming back is very telling.

In an American Chamber of Commerce survey of US business in Russia in 2007, 97% of US companies projected continued sales growth during the next three years and profitability of two thirds of US companies is on or above target. Some companies such as General Electric, Procter & Gamble and General Motors reported sales in excess of US\$1bn. The multi-billion dollar investments and returns in the oil and gas sector have now trickled throughout many sectors of the economy, including the automotive and consumer goods sector.

### Set priorities and challenges Russia will face

For anyone interested in the Russian market, we need to delve further into some of the set priorities and pinpoint some of the challenges Russia will be confronted with.

In 2006, four national projects were identified by President Putin as of critical importance: affordable housing; the development of agriculture; national education; and healthcare. In 2008 Medvedev, in a speech made at the Krasnoyarsk Economic Forum before being elected, mentioned a concentration for the next four years on the four I's: institutions, infrastructure, innovation and investment, which will focus, among other things, on the national projects.

He also stressed the need to cope with "legal nihilism" (disregard for and non-compliance with the law), to diminish bureaucratic barriers, to lower taxes, and to turn Russia into "one of the biggest financial centres in the world" with a stable rouble.

The untold story is that Russia will have to fight devils from its past and its present, presenting major challenges for the future. There is the traditional opposition between slavophiles and westerners, with the slavophiles being the guardians of Russian traditions and culture and the westerners more eager to embrace foreign ideas. When asked if he considered himself more a

slavophile or a westerner, Medvedev dodged the question by saying that he will base his position on Russia's interests.

Another problem for Russia is to get over its fear of losing its national identity in a changing world due to the recurring belief, partly fuelled by a resurrected Russian nationalism, that it is besieged by enemies. Russians could maybe reflect on the example of France, which had heated debates over the presence of McDonald's and Disneyland, icons of American culture.

In the early days, The French Disneyland was referred to as a "cultural Chernobyl" by some while McDonald's was seen as the kiss of death to French gastronomy. Today, France is one of McDonald's most profitable markets in Europe and the quality of French cuisine is still highly-regarded while Disneyland Paris

to a 100mn people; the state mingling with business deals as well as restrictions on labour visas.

Many judgments made about Russia are based on an idealistic vision of how the world should be, easily forgetting our political blunders and the flaws of our own system that have led to the total collapse of Enron or Bear Stearns and to the subprime mortgage crisis. western and Russian mentalities are still tainted by the Cold War rhetoric and imagery that perpetuate the belief that the other side is willingly trying to undermine one's political, economic and cultural status. Factually, it is true that each country naturally tries to advance its own interests, but believing it is always part of a master plan against each other is misguided.

### So what next?

Russia is undoubtedly a market that needs to be on your list of countries with significant growth potential. However, it is an unforgiving one for those who do not do their due diligence and take the time to do a risk assessment.

It will be interesting to see if Putin decides to run again for the presidency in 2012. If he wins and gets reelected in 2016, he would get out of office in 2020 at the age of 68, which is the age at which Charles de Gaulle became president and about two years younger than when Ronald Reagan came to power in January 1981.

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has become a leading tourist destination, both ventures are generating thousands of direct and indirect jobs.

In this context, Russia's full integration into the world economy through the accession to the World Trade Organisation (WTO), which has been on the table since the mid-90s, would be most helpful. It would reduce the ostracism that fuels resentment and at a practical level it would bring down anti-dumping measures, import quotas and tariffs. Russia remains the last large industrialised country to not be part of WTO. Ukraine managed to get its accession terms approved by the WTO's General Council in February 2008.

Other potential problems are: a declining population with predictions forecasting a loss of one third of its population by 2050

