

A fresh start for US-Russia trade



Providing perspective on how trade between Russia and US has been affected by the downturn of Russian fortunes, **Philip de Leon** speaks to Ed Verona, president and CEO of the US-Russia Business Council (USRBC), based in Washington, DC. Verona has extensive oil and gas experience working in Russia, last serving in Moscow as vice-president of ExxonMobil Russia before joining the USRBC in June 2008.

Russia is a land of sharp contrasts. After a stellar year in 2007, where Russia was one of the best performing markets in the world, 2008 will be remembered for quite the opposite, with the first federal budget deficit in 10 years and the worst financial crisis since the country defaulted on US\$40bn of domestic debt in 1998.

Comparing 2007 with 2008, the numbers are betraying a reversal in trends, and early data for 2009 cast an even grimmer picture, with GDP growth estimated at between 0 to 2.4%. On January 1, 2009 foreign reserves stood at US\$427.08bn but were down over US\$30bn to US\$396.2bn on January 16, 2009 due to efforts to support the ruble. A sequence of events such as the TNK rift, the attack on Mechel and the war with Georgia that preceded the full development of the world financial crisis did not help cast a good image of Russia. Starting 2009 by cutting gas to Ukraine and affecting more than 20 European countries further damaged Russia's credibility in the eyes of the international community.

GTR: Can you give us an update on trade relations between the US and Russia in 2008?

Verona: Growth has been quite significant, especially in the last year. US-Russia bilateral trade reached US\$34.3bn at the end of November 2008. This is a 22% increase over the previous full year, which reached US\$26.7bn. Trade for 2006 was at US\$24.5bn and US\$19.3bn for 2005. It is a very positive story, showing the large, long-term growth potential. This is consistent with what I am hearing from business leaders, many of whom say that Russia is their fastest growing foreign market, especially for consumer goods and the automotive sector. The leading foreign automobile model in Russia is the Ford Focus, and both GM and Ford have seen double-digit growth in Russia for several years running. Both companies have opened factories there and are committed to the market. There seems to be a whole range of iconic American brands and products: Coca-Cola, Pepsi-Cola, Procter & Gamble products, etc. There are a few specific examples of success stories for US exporters: cars showed a 51% increase for the first 11 months of 2008 compared to the full 2007; meat/poultry: 13%; and tractors: 58%.

Russia: Before and After		
	2007	2008
GDP growth	8.1%	6% (est)
Capital inflow	US\$83bn	-US\$129.9 bn
Foreign trade surplus	US\$128.7bn	US\$193.6bn*
International reserves	US\$476bn	US\$438.2bn**
* For Jan-Nov 2008		
** After a pick up at \$598.1 in August 2008		

It's important to note that the base line for these statistics is relatively low, but the rate of growth has nevertheless been remarkable. What I gather from my conversations with business leaders is that they believe they have only begun to tap the full potential of the Russian market. At present, most of their sales have been concentrated in the metropolitan areas of western Russia. There is still considerable latent demand in other regions and smaller cities.

GTR: During her senate confirmation hearing, Secretary of State Hillary Clinton stated her desire to pursue constructive engagement with Russia. How do you see US-Russia relations developing under the Obama administration?

Verona: I am heartened that so much commentary in the press has focused on the possibility of a resumption of dialogue between the US and Russia, both with regard to strategic military and political issues and to economic and commercial relations. Both nations' leaders called for a resumption of an economic and energy dialogue in the Sochi Declaration of March 2008, and negotiations between the US and Russia on Russia's WTO accession have continued, although with difficulty. At some level engagement has continued, but it is fair to say that a change of administration brings the opportunity of revitalising that dialogue.

GTR: The government, which does not want to endlessly deplete its foreign reserves, has allowed the ruble to depreciate by small increments to avoid any popular panic caused by a sudden and sharp devaluation. In the end, the rouble has lost 25% of its value since November 11. What should we expect next?

Verona: Since August 2008, Russian central bank policy has been to manage a gradual depreciation of the ruble within a periodically adjusted corridor, both with respect to the euro and the dollar. The aim has been to minimise volatility and soften the impact of the ruble's decline on the domestic economy, particularly on inflation. As you point out, Russia's foreign reserves have seen a significant decline in the interim – approximately US\$200bn. Nevertheless, Russia's foreign exchange reserves – currently in the range of US\$380bn – are still the world's third largest and continue to provide a considerable degree of credibility to the central bank's exchange rate policy. As we look forward, the situation will depend on the price of oil and gas and other commodity exports which form the basis of Russia's terms of trade. What my experience in the energy and minerals industries leads me to believe is that a significant increase in those commodity prices is unlikely until the global economy begins to recover, and the predictions are that this will occur sometime in the second half of 2009, at best. There are more pessimistic scenarios that envisage a longer recession, perhaps well into 2010. In either case, it is clear there this will be a period of belt-tightening for Russia, as it is for everyone. Finance minister (and deputy prime minister) Kudrin has stated that the federal budget is based on oil prices in the range of US\$60 or US\$70 per barrel, at which level the budget balances. That means that at current oil prices the government will be running a sizeable deficit and will be compelled to draw from the government's stabilisation fund or to resort to public borrowing. Ultimately, either course will exert further downward pressure on the ruble. In addition, there will be major external



Obama’s checklist for US-Russia commercial relations

1. Constructing a new partnership

The US must construct a new partnership with Russia, and the bilateral economic relationship is key. Establishing trade and investment links can have a stabilising influence on political relations.

2. High level dialogue

Create a high level bilateral commission to facilitate regular exchanges on commercial issues. The US-China Strategic Economic Dialogue could serve as a useful model.

3. US-Russia energy dialogue

US needs to work with Russia to diversify its sources of supply and increase its energy security.

4. Russia’s WTO accession

Russia has been negotiating its accession to the WTO since 1993, and the Obama Administration needs to work with the country to iron out the final legislative issues.

5. Graduation from Jackson-Vanik

The Obama Administration needs to support the graduation from Jackson-Vanik, which will jumpstart Russia’s accession to the WTO.

6. Economic diversification

US should advocate policies that are consistent with the development of high-tech industries in Russia, such as investment in scientific education, a fast regulatory approval system, strong intellectual property protection, effective academic industry partnerships and market access.

7. Support for legal reform

US needs to support President Dmitry Medvedev’s efforts to strengthen rule of law and property rights in Russia.

8. Avoiding protectionism

For example, the Russian government announced it will impose a tariff of 15% or €120 per KW on imports of agricultural combines to support domestic manufacturing. Such measures will reduce ability of US manufacturers to compete with domestic producers.

9. Improve regulatory issues in US financial sector

Qualified Russian banks should be given equal access to US market as per other foreign banks. While US banks have operational subsidiaries in Russia, there is only one representative office of a Russian bank in the US, and no bank subsidiaries.

These are summaries of recommendations submitted to the Obama Administration by the USRBC in February. The USRBC is a non-profit association with more than 250 member companies from the US and Russia. It has a 16-year track record of supporting bilateral economic engagement.

debt refinancing requirements in the commercial and banking sectors during 2009, estimated at about US\$120bn. The question is, will those borrowers obtain new credits from foreign lenders, or will the government provide credit? In the latter case there would likely be additional pressure on foreign reserves.

GTR: The 1998 devaluation shocked the country, but one of the positive aspects for Russia was that it enabled domestic brands to gain market shares and consolidate

their positions. What effects do you anticipate this time?

Verona: One would expect from situations like this that domestic manufacturers would benefit, and I’m sure that some are doing so. However, the immediate crisis is as much a question of liquidity as of relative costs. Consumers will sometimes pay a premium for an imported good over its domestic equivalent, but if they don’t have the financial means they cannot buy it either way. Maybe we are at a point where there isn’t

enough liquidity in the system to provide a stimulus to demand. Maybe in a month or two, if that changes, we will start to see evidence of resumption of consumer purchases, then we will get a sense of how much of a domestic substitution effect has occurred.

I assume that consumers will buy more domestic goods as the price differential of imported goods increases. However, some domestically manufactured goods will have a foreign brand since many foreign companies already have manufacturing facilities in Russia. The cost of imported ingredients or components for such goods will still be affected by currency depreciation, but some portion of the cost will be domestic value-added. That is important for the long-term and it is something that both domestic manufacturers and foreign investors should bear in mind: Russians will begin to show a tendency to buy domestically manufactured goods, and as quality improves, they will be less inclined to buy an imported good because it has more “cachet”.

GTR: Many of your members are in Russia for the long-term. How are they coping with the financial crisis and how are they financing their operations?

Verona: A situation like this forces companies to look carefully at costs and to be creative at finding ways to reduce them. That is true of foreign companies investing in Russia and of Russian companies themselves. In this environment, companies that still have access to financing can probably negotiate better deals from suppliers, landlords, and contractors. Conditions may force some of them to make adjustments to their labour force and salary structures. Companies that manufacture and sell primarily for the Russian domestic market do not gain any major advantage in this shift in the terms of trade: their revenues and expenditures are mostly denominated in rubles. Unfortunately, there are relatively few Russian companies outside of the commodities sector that are active exporters, although there are some notable exceptions, such as finished steel products and armaments.

GTR: Your membership also includes Russian companies; do you hear a different story from them?

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Verona: What we are hearing from them is that there is a serious problem with liquidity. Companies that have access to government bailout funds or financing on preferential terms are coping somewhat better than smaller companies, but demand – whether from domestic consumers or from export markets – is simply weak. It is clear to me that this critical situation demands a great deal of attention from the management of our Russian member companies and that it is difficult for them to consider long-term plans. This is true in varying degrees for virtually all of our members, Russian and US.

GTR: You regularly interact with high-level Russian officials. What message have they been conveying lately that may be of interest to finance providers and investors?

Verona: I was in Moscow in November and December and have had meetings in Washington with a number of Russia officials. The messages that I have gotten have subtly changed over the last few months as the economic crisis has worsened. There does seem to be a slight shift in the emphasis placed on foreign investment. Early last year, the emphasis was on limiting foreign participation in certain “strategic” sectors.

In May, the Law on Foreign Investment in Strategic Sectors was adopted, establishing thresholds for foreign ownership, beyond which further vetting would be required. In the past, the government did little to discourage the general view that these thresholds were in fact ceilings. Since then I have heard government officials explicitly state that these thresholds are simply the triggers for a foreign investment review. Nothing in the law has changed, but the emphasis has, in my estimation, changed. All of us, Russians and Americans alike, are trying to understand how this global economic phenomenon is going to affect us. Russians are beginning to come to terms with oil prices in the present range of US\$30-US\$50 per barrel, though it is only gradually becoming clearer how that will play out in various sectors of the economy.

GTR: Any crisis brings opportunities. What immediate or future opportunities do you see in the Russian market?



Ed Verona, USRBC



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Verona: The crisis will focus the minds of Russian policymakers on the need to: diversify the domestic economy; create favourable conditions for foreign as well as domestic investments; have fair established rules and procedures with an independent judiciary; have dispute resolution mechanisms outside the formal courts; and increase efforts to curb corruption, which is one of the main complaints from Russians and foreigners alike. As the government focuses on these issues, there may be opportunities for companies that not only invest in the traditional extractive industries, but that also manufacture electronics and provide high tech services and produce goods and services for the growing middle class. I would venture this: I think there is awareness now that the Russian oil and gas sector has not received the sort of long-term large investments that it needs to maintain production at the levels it achieved during the earlier part of this decade. New opportunities, such as greenfield

projects, would require technological capabilities that right now are predominantly in the hands of the major international oil companies. Now that Russia is looking more at offshore opportunities, such as in the Arctic, there are numerous challenges: ice, delicate ecosystems, and a need for huge amounts of capital. Capital for such projects was already insufficient before the advent of the current financial crisis. This may lead some to conclude that the financial strength combined with the technological capabilities of leading oil and gas companies may be an important element in achieving Russia’s ambitious energy goals. A modality has to be found to allow joint ventures or partnerships between leading Russian companies, such as Gazprom and Rosneft, and international oil and gas companies to work together in these long-term, technologically challenging opportunities. **GTR**

