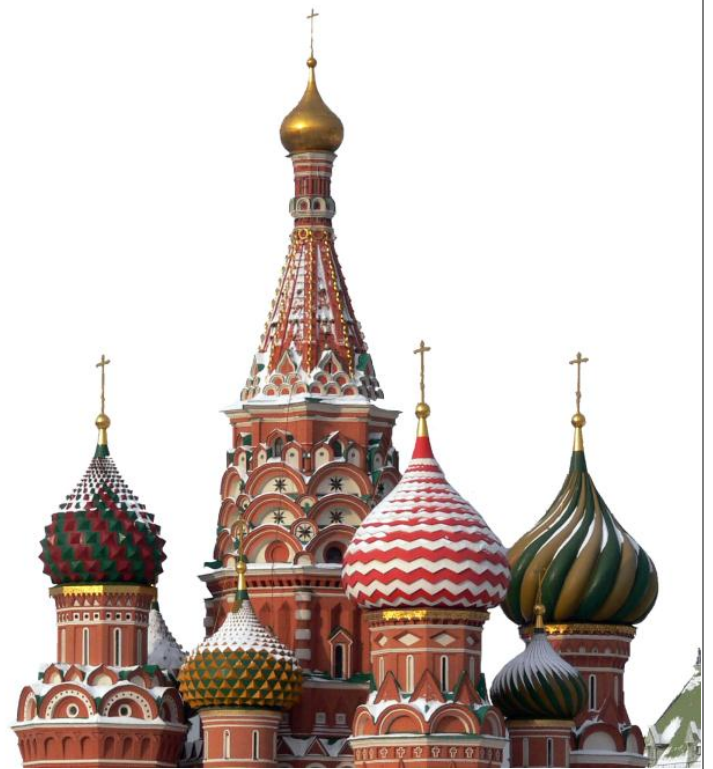


Russia After Putin

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INTRODUCTION

On Sunday 2 March 2008 Russia went to the polls to elect a new president. The result, as we know, was a resounding endorsement of a young lawyer little known outside Russia but well recommended by Vladimir Putin, the outgoing president. The immediate reaction was varied. Opposition parties in Russia claimed that the election had been rigged; that the opposition candidates had been denied fair and equal access to the media in the election campaign; and, perhaps most significantly, that the new president is no more than a mouthpiece for the outgoing president who will stay on as Prime Minister and wield effective power. This brief B2B International white paper examines the major issues that the new president faces and offers a view on the implications for Western businessmen who have interests in Russia or who are thinking about developing these.

WHO IS THE NEW MAN?

Dmitri Medvedev is a highly intelligent lawyer, trained like Putin himself in one of Russia's top law schools. By his mid-to-late thirties he had risen to the top of the cut-throat hierarchy that has always been a feature of Kremlin life, holding a top civil service position and, for a time, working as CEO of Gazprom, one of the world's biggest companies. This requires ruthlessness and political skills in equal measure. The idea that he is Putin's yes-man looks shaky, but it makes for good headlines in London, Washington and elsewhere. Let us remember that Putin used to be thought of as a low-profile protégé of former president Boris Yeltsin and, once elected, he lost no time in criticising many of Yeltsin's policies, establishing himself as the boss and moving against some of Yeltsin's closest allies. Significantly Medvedev has no career links to the secret service. This is both an advantage in terms of personal image at home and abroad and a disadvantage when it comes to getting anything implemented or enforced.

If we take Medvedev's recent pronouncements at face value, it appears that he is in favour of law and order based on a legal and judicial system that is independent of the political structure. Moreover it looks likely that he will retain the members of the liberal wing of economic and business thinking that Putin, for all the talk in the West about his repressive tendencies, appointed to top positions.

It is generally acknowledged that, even if Medvedev's 70% share of the vote has been influenced by one or two "catalysts", he does carry significant majority support within a high total turnout at the polls. So, one can reasonably expect that challenges to the legality and fairness of the process, if made at all, will not have much impact.

WHAT HAS MEDVEDEV INHERITED?

Politically speaking, Medvedev has a fairly hard act to follow – Putin is popular. Economically speaking, Medvedev has inherited an apparently strong but in fact seriously imbalanced economic structure that has a number of intrinsic weaknesses, and there are significant risks associated with these.



Putin gave his support to Medvedev throughout the election campaign and it is in the popularity of Putin that we understand why this endorsement meant so much.

When Putin assumed the presidency eight years ago the Russian economy was in trouble. It had already been bailed out of a principal debt default in 1998 by the support of the international financial community. Capital flight had become a serious issue – a group of gangsters, who had duped the none-too-intelligent Yeltsin into failing to notice how much of Russia's assets were being expropriated in the name of "transition", were storing up the proceeds well outside Russia and beyond the reach of any authorities. Corruption and crime were on the increase. The average Russian was having a very hard time.

Putin took control, and his view was that stability was more important than democracy, given the problems that he had inherited from Yeltsin. This view was supported by the majority of Russians and it also had the support of the secret police and the military. At times, admittedly, Putin's actions went over the top – the excessive campaign against Khodorkovsky ("to encourage the others", as Voltaire might have put it); gagging the media (Putin had learned a lesson from former president Gorbachev, whose "perestroika" had made too little impact and "glasnost" too much); and one or two domestic and overseas assassinations (a political tradition in Russia even before Stalin had Trotsky murdered in 1940). There have been – literally – overkill policies to put down internal nationalist uprisings in ethnically non-Russian enclaves and tacky deals with compliant local dictators in the aftermath.

However, in the mind of so many Russians, Putin's great achievement has been to restore internal stability and the standing of Russia as a world power. He has managed to retain a fairly high level of defence spending, with the result that Russia is still heavily armed and cannot be ignored militarily. Though the former Soviet empire of East European satellite countries that stretches eastwards from Germany has been absorbed into the European Union, Russia remains independent and for the moment the bear can growl quite loudly.

The deterioration of USA-Middle East relations was a windfall. When oil prices soared as part of the oil producers' reaction to a falling dollar, Russia was able to pay off its debts and stockpile hard currencies, effectively hedged against any continuing dollar erosion.

Russia has extensive oil and gas reserves and has regained the position once held by the USSR of being the world's largest producer of both. This could not have come at a better time for Putin and hence now for Medvedev. However, one needs to look at other sectors of the economy in order to get a balanced view.

Activity in oil and gas accounts for more than total growth in GDP and more than the entirety of improvement in the foreign trade balance. Hence the remainder of the economy, at home and in foreign trade outside hydrocarbons, is either stagnating or in decline. A few examples illustrate this problem.

Exports of manufactured goods are declining – in absolute terms and as a percentage of GDP. As markets globalise and the availability of goods at or approaching world-class quality standards manufactured in Asian low-cost centres increases, Russia is significantly uncompetitive. Its previously captive markets of ex-communist Eastern Europe are integrating with the West and are open to affordable alternatives. Additionally the ruble has begun to appreciate in world currency markets.



There has been a boom in consumption financed by the secondary effect of increased oil and gas revenues. Domestic demand for manufactured goods is deficient. The newly rich middle classes prefer to buy non-Russian goods, partly because of brand cachet and partly because price-for-price their quality is higher. However, the majority of ordinary Russians have seen their disposable income eroded and are struggling to make ends meet. Inflation is starting to hit the Russian economy hard. Fortunately there is very little indebtedness of the type that is now hitting Western countries, notably the USA and UK. Credit is a relatively under-developed phenomenon in Russia.

Any softening in oil and gas prices would have a serious impact on domestic economic operations. The question is whether Russia can upgrade its non-military, non-hydrocarbon businesses sufficiently quickly to raise their technological level in terms of output for the home and export markets alike.

WHAT IS THE OUTLOOK FOR RUSSIA?

If we look at the rest of the economy, particularly the manufacturing sector, the outlook is grim. The development of Russia as an energy and financial power has outstripped its development as an industrial economy and Medvedev has to deal with this urgently.

After the collapse of the Soviet Union the economy declined and industrial production all but collapsed in several sectors. Accordingly when the Russian economy returned to growth after the financial bail-out in 1998 the upswing was achieved on the basis of filling productive capacity that had been mothballed for a long time. Labour productivity in the Soviet period was well below that of the developed world and in most sectors this is still the case. The next phase of development will require heavy capital investment to create technologically advanced facilities capable of producing goods for the domestic market at market-determined prices that will bring about a measure of import substitution.

There is a further structural anomaly that distinguishes Russia from most of the developed world. The industrial economy remains weighted towards large companies, with relatively little contribution from small and medium-sized enterprises that characterise most Western economies in the 21st century. Significantly Russia is taking a lot of interest and advice on the economic contribution of Germany's SMEs (the famous "Mittelstand") that over many years have made such a major contribution to Germany's industrial strength.

As a result of windfall oil and gas earnings, there are currently sufficient funds at Russia's disposal to become very active as a sovereign wealth investor on the international scene or to invest domestically in raising the performance of indigenous industry. There is increasing evidence that both paths are being followed, and this is beginning to take the form of economically serious investment in industrial assets rather than the purchase of Monaco property, yachts and soccer clubs. We can also expect Medvedev to take the same view as Putin on the question of the state retaining significant control in strategically significant sectors of the industrial economy. However, both of them, as intelligent individuals, draw a distinction between state intervention (good) and interference (bad) in matters of micro- and mezzo-economic management.



Concerning investment, much of domestic and foreign investment takes the form of loans rather than direct stakes in companies or technology transfer deals. Given the lack of opportunity of investing in SMEs, the majority of such investment goes to state-owned companies. Foreign direct investment in non-oil and gas operations has fallen consistently as a percentage of GDP over the past few years. In short, Russia needs a dose of dirigisme, most probably in the form of industrial investment incentives, to get a more balanced pattern of economic development.

Therefore the outlook for Russia can be summed up in the following major points.

1. The contribution of oil and gas to GDP has risen from about 13% in 1999 to over 30% in 2007 and they contribute about 80% of Russia's export earnings. Since Russia's economic and social structure is nothing like "oil states" such as Kuwait or Saudi Arabia, this risky imbalance has to be corrected.
2. Inward investment needs to be re-directed into industrial projects not into financial projects. Russia needs involved investors not moneylenders.
3. Transfer of technology and know-how into the non-energy sectors is vital.
4. Creation of SMEs looks highly desirable and will probably get policy priority.

WHAT DOES THIS MEAN FOR BUSINESS PEOPLE IN THE WEST?

This has significant implications for anyone seeking to take advantage of this growing economy.

Russia offers significant opportunity at a medium level of commercial risk.

It is not just the large established multinationals that are able to operate successfully in Russia. The business climate for SMEs is attractive provided that a realistic time-scale for establishment and commercial success is estimated and planned for. Earnings in rubles, unattractive during the Soviet period as the ruble was non-convertible and non-exportable, are now worth having. Business is starting to work both ways, as a new generation of very capable Russian businessmen understand the role of two-way collaboration and are beginning to consider investments in the West as an element of business strategy rather than as a get-rich-quick speculation or, as in the 1990s, as a means of getting money out of Russia before the authorities spotted what was going on. Some of the most robust scientific research was done in the Soviet Union and this to a great extent continues in Russia. Its reduction into engineered products was poor, as a result of the centralised system, and progress in rectifying this is slow. Therefore in looking to Russia as a potential market, the inclusion of technology and know-how transfer is a potential deal-winner. The traditional "export trade" model of doing business in and with Russia is all but dead, and has been replaced by a more collaborative and sophisticated approach of supply chain management, involving material, product, finance, technology and knowledge.

The opportunity for new enterprise creation is significant. The formation of new companies is, relative to the size of the economy, fairly low. There is no real equivalent of the "Route



128” phenomenon found in Massachusetts or California’s “Silicon Valley”, but there is clear potential for this.

But the question is often posed as to what happens if the oil and gas prices stabilise or erode and Russia’s money inflow declines from the present level. Part of the answer lies in Putin’s care in putting enough of Russia’s earnings aside to pay off a load of sovereign debt and having enough to underwrite the national budget for some time forward. In the event of an oil and gas price erosion, there is enough time to adjust and to accelerate the process of structural adjustment in the industrial economy that is clearly necessary, given that oil and gas business is, as we in the West know only too well, subject to political turbulence. Russia would still need Western trade partners – more so than if high oil and gas prices could be guaranteed indefinitely.

There is plenty of talk about Russia’s increasingly aggressive stance towards the West. It is by no means clear what Russia would gain from such aggression. Having massive oil and gas reserves is of little significance if you do not have the goodwill of a sufficient number of customers. These are mainly found in Western Europe. In addition a lot of the exploration, production and transportation technology comes from the West. Moreover there is a group of influential Russian businessmen who enjoy the confidence of top politicians and who have substantial business interests in the West that they would not like to put at risk. So the relationship is not one-way in terms of influence and leverage. In contrast the much-publicised recent threat by Putin to turn off the gas tap on supply to the Ukraine is simply a response to slow payment. (How many strong Western supply companies do not exercise this kind of leverage against awkward customers who take too long to pay their invoices?)

So a sense of proportion suggests that we are far from another “cold war” and periodic sabre-rattling is probably as far as relationships will be permitted to deteriorate.

FINAL REMARKS

For all the press hype and the big numbers on economic growth rates, the Russian Federation has only just returned to the level of economic activity that it used to have as the largest member of the 15-state Soviet Union just before its collapse over fifteen years ago. To achieve this Putin has abandoned the command economy but has restored a command society. In the process of re-establishing stability, the creation of free-market institutions and practices has been discontinued and Medvedev will have to find a means of re-launching this process if Russia is to become a major economic force in the world (and, incidentally, merit its membership of the G8 on economic grounds rather than for political expediency on the part of the West).

As far as we can judge from his campaign, Medvedev looks set to continue the course charted by Putin. However, in my view, it would be a mistake to assume that he will inevitably be a one-term “puppet president” who is holding the position until Putin again becomes constitutionally eligible to stand for president in 4 years’ time. This may, of course, happen. However Medvedev might perform well in the job and quite enjoy being president, in which case we could see for the first time in Russia during the 2012 presidential election build-up a set of “primaries” in which Medvedev is pitted against Putin. That might even be considered a sign of further progress towards greater democracy.



Dr Daniel Park has been associated with B2B International since its foundation, and he has acted as adviser and consultant in many of the company's international projects. He qualified in economics at the University of Glasgow, where his PhD research was concerned with Soviet and East European industrial development. A fluent Russian speaker, Dr Park has visited the Soviet Union, post-Soviet Russia and the ex-communist "iron curtain" countries on many occasions. His first book on the internal and international economics of the Soviet oil and gas industries won a BBC "Book of the Month" award.



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