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Less Privatization Means More Economic Woes

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Few were surprised when the Russian government announced last week that the program to privatize state assets had been considerably scaled back. The federal budget can now expect a much smaller amount of privatization revenue, and the state will retain direct control of so-called strategic companies indefinitely. But what was more of a surprise was the forthright comment from Prime Minister Dmitry Medvedev, who directly blamed the lobbying efforts of some ministries and other government officials for effectively killing off what was one of the government's most important policy initiatives. That's quite an admission.

Just as it had been clear for some time that the original privatization plans were under attack and would almost certainly change its scope, it has also been clear for some time that the government is no longer a fully united team. Instead, both investors and the country's population, according to recent polls, believe that the government now comprises of several groups that pursue opposing agendas. This lack of coordination and the uncertainty it promotes is one of the key reasons why both portfolio and direct investors remain wary of Russia risk and why asset valuations are so low compared to other emerging market peers.

So why the change of heart on privatization? The original privatization plan was published in late 2010 as one of the responses to the economic downturn. Three extremely credible and encouraging reasons for the program were cited at the time.

One reason was to set up an extra revenue stream for the budget at a time when the outlook for oil and gas revenues was very uncertain.

The second reason was to start cutting the state's direct role in the economy as a means of boosting entrepreneurial activity and reducing bureaucracy.

The third reason was to bring in established international companies as partners for state enterprises who might then raise their game by learning best-industry practices. The original plan was to raise between $10 billion and $15 billion annually over the next five to seven years by selling almost all of state's equity positions.

Through 2011, it was clear that lobbying efforts had begun to change the program and several alternative drafts were floated that year. But President Vladimir Putin endorsed the original plan in one of the seven policy essays he published as part of the March 2012 election campaign. In late January last year, in an essay published in Vedomosti, Putin strongly endorsed the privatization plan and the reasons for it. He targeted a figure of $100 billion as the total that might be raised by selling almost all of the state's equity in existing listed companies and by pushing ahead with the outright sale or partial sale of other state enterprises that might benefit from cooperation with established foreign competitors. In that essay, however, Putin did clearly state that assets would not be sold without regard to valuation and that there would be no fire sale. He also said equity in the most important enterprises should be sold to domestic investors rather than to foreigners. Putin therefore linked the sale of the most sensitive assets to the creation of a bigger domestic investor base, which he suggested might be achieved with the restructuring and regulation of the pensions and insurance industries, as well as persuading people to switch their savings from purely cash deposits to longer-term mutual funds.

So despite the convictions supported by both the president and the prime minister as well as the economic development and finance ministries, the 2010 plan has been all but abandoned and replaced with a more modest version which targets not $10-$15 billion annually for the federal budget but a more modest $19 billion over a four to five year period starting next year. That leaves the budget with a revenue hole of almost $12 billion for this year alone.

Of course, one important reason for scaling back the original privatization plan is because investor appetite for equities in emerging markets has been nearly nonexistent since mid 2008. Stock markets in those countries with a meaningful domestic investor base have fared better than Russia's markets, where domestic portfolio investors account for less than one-third of the free float. Today, the value of listed companies which are controlled directly and indirectly by the state is about $320 billion, or just about 45 percent of the total of all of the country's listed equities. Releasing some of that equity to portfolio investors would have greatly improved both the free float and the traded volume on Moscow's stock markets. It also would have helped cut the existing high risk premium that weighs heavily on valuations.

But as Medvedev clearly stated, the reason for the change is not purely because of current valuations. A powerful group of people in government and those who influence government policy decisions simply did not want further privatization to happen. This is partly because of a retrograde, Soviet-era ideology that believes that the state must control the most important industries.

Another explanation has less to do with ideology but is more about preserving an existing comfortable lifestyle for those at the top of many state enterprises. Vested interests have already slammed the door on efforts by some foreign companies to establish closer working links via an equity partnership. That's despite the clear benefits to Russia industry in terms of efficiency gains and modernization from equity partnerships that have been allowed. Renault's involvement with AvtoVAZ is a good example.

The fact that Russia does not have a large pool of domestic investment capital is another important factor. Building a global financial center, officially known as "the Financial Services Center," and targeting improvements in such surveys as the World Bank's Ease of Doing Business are certainly positive steps, but unless entrepreneurs can find capital at home, the pace of economic expansion and the valuation of assets will continue to struggle relative to other emerging economies. Reversing the more than $400 billion in capital that has fled Russia since 2008 — an amount equal to more than half of the stock market's current valuation — would certainly help, as would the much-needed pension reforms.

None of this is new to beleaguered investors and owners of small and medium-sized businesses. Notably, last week's announcement of the more modest privatization plan hardly caused a ripple on the markets. If anything, there was probably relief in some quarters that it may now be easier for nonstate enterprises to raise fresh capital via equity issuance since they will now have less competition from the state to contend with. But even that small consolation is worth little when it is clear to everyone that there is a woeful lack of consensus and coordination at the top of government and when state policy, which was initially developed as a response to economic crisis and designed to ease the future path, is forced to take second place to the demands of vested interest groups.

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