

Russia's crisis offers opportunities

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Despite earlier bravado from some Russian politicians that sanctions would have only a modest effect on the economy, the negative impact is now becoming very clear and serious. Growth is slowing across most sectors, investment plans are being delayed and, because of Russia's retaliatory sanctions against western food imports, inflation looks more likely to rise through the autumn than to decline.

More critically, the much needed flow of inward investment has slowed to a trickle and voluntary sanctions by western banks and suppliers threaten to leave a legacy of disruption well past any resolution in the political disputes. Clearly a disastrous year all round. The critical question for investors, foreign businesses and investment banks is whether this is a short-lived blip, whether it may take several years to return to normal or whether the recent events are a serious game-changer.

Russia is a frustrating country for investors and foreign businesses. One can make a lot of money investing in the country, and by providing goods and services to the economy. The caveat is that none of that is probable in the short term, and you will have to sit out frequent periods of crisis and volatility. So is it worth it? Absolutely. Look at the stock market as an indicator of both frustration and reward; the main stock index has traded as low as 38.5 and as high as 2,500 over the past fifteen years and is today just above 1,200. In the real economy, the value of Russia's GDP rose steadily year by year from less than \$200 billion fifteen years ago to over \$2 trillion today. For businesses and exporters looking to build a long-term base in Russia, it pays not to get overly distracted by the political noise. But you certainly have to understand what is causing that noise as, one day, the cliché "it's different this time" may well prove correct. It rarely ever has in any developing economy.

In Russia, you also have to understand the Kremlin's motives and longer-term priorities. Any suggestion that Vladimir Putin is intent on some sort of latter-day colonialism is just wrong. Crimea was an opportunistic move when Plan A – attracting Ukraine into the fledgling Eurasian Union – failed.

Working to force Kiev into allowing some self-determination and autonomy in the eastern provinces is also an understandable political priority as that would keep Nato and, maybe, the EU away from Russia's western border. Of course, so long as fighting continues and the political stand-off remains unresolved, multiple scenarios are still possible. Moscow is fiercely protective of its near-abroad and, right or wrong, considers it has legitimate interests in keeping the West at bay.

But there is also another, and equally important, consideration for Vladimir Putin. He sees himself as the leader bringing Russia from the wreckage of the post-Soviet period to a country with economic diversification and greater wealth equality. For him, this is a 20 to 25-year process, and he is clearly intent on standing for president again in March 2018. To achieve that, and despite all the talk of authoritarian rule, he needs to retain popular support from a majority of the population.

The structure of Russian society is changing, albeit slowly. A variant of the middle class is emerging, and more and more people expect their lifestyles to improve towards western European standards. A leader hoping to retain public support for another decade (a second presidency for Putin would run until 2024) needs to deliver not just short-term populist actions, such as the "recovery" of Crimea, but needs to ensure long-term progress in the economy and on the expectation of improving lifestyles. On a more optimistic note, a well-worn cliché states that every crisis is also an opportunity. Russia is the largest country on the planet and the largest exporter of energy and industrial metals. Yet it imports almost 20 per cent of food sold in supermarkets, and many manufactured goods and technologies or services in which it used be self-sufficient. Russians who can afford it are still inclined to travel abroad for medical treatment and education, because of the poor state of facilities at home.

Putin first started complaining about this during the 2009 recession, and at the time of the drought in August 2010 which decimated the agriculture sector because of poor irrigation and other infrastructure. It is no coincidence that Russia's initial sanctions response is against imported food with the probable motivation of forcing investment into agriculture and food production.

There is no question that Russia is facing a difficult period in the economy. It is not only, or even primarily because of the sanctions. The cracks in the previous oil revenue plus credit expansion plus consumer boom model had already appeared almost 18 months ago, and pulled GDP growth to only 1.3 per cent last year, from over 8 per cent growth three years earlier. Policy errors and rising debt costs were, and remain, the biggest threats to growth.

But by the end of last year, Putin was among those recognising the need to move to a new growth model based on higher levels of investment into infrastructure and into industries which can create a more diversified and sustainable model. Time and time again, we see that policy planning in Russia translates very slowly into meaningful actions. More often, it requires a crisis to direct resources and effort to fixing a problem. Western sanctions, on top of the already evident problems in the economy, have the potential to create that opportunity.

We already see the latest economy slogan in Russia is "import-substitution". Of course the country will not be able to replicate all existing imports, but there will be a greater effort to slow imports of goods which the country may produce itself. The door to joint ventures and investment into those designated industries, the list of which includes not just food but pharmaceuticals, IT, healthcare and machinery manufacturing, will likely be opened quicker than all import sanctions removed. Foreign companies willing and able to make the transition from suppliers into Russia to investors in Russia will be the best placed to not only survive short-term volatility and periods of uncertainty but to thrive longer term. This current crisis is a period for planning, not for shrinking.

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