MACRO-ADVISORY
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IN CONTEXT
Providing a proper understanding of economics, politics and business realities in Russia & CIS

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Myths and Misconceptions about Russia

A comment recently made by an executive at a multi-national company, and which we highlight prominently on our web-site is

"We don't want to invest ahead of some crisis but we also don't want to wake up in five years and find our competitors have taken the market and making money while we were watching the headlines."

That comment more or less sums up the dilemma faced by many investors and businesses when considering Russia. They have seen that over the past decade or more that many investors and businesses have come to Russia and have made a great deal of money. They also see that others have faced major problems. They also understand that despite the volatility of the past five years, Russia and the CIS region generally offers considerable potential for future growth and profit generation.

Of course it is not all about the headlines and history. The Russia and CIS region does present many challenges for investors. In this report we look at the fifteen most popular negative perceptions about Russia risk. Some are indeed very valid and are hardly improving. Some have been valid in the past but either have been resolved or are being improved. Others are simply wrong.

There are many reasons for investors and businesses to approach Russia carefully, as is the case with most emerging economies. By definition there is a near constant state of evolution taking place which change investment risk and opportunities.

Many of these issues faced are no different, or not much different, to the problems multi-national companies face in most developing economies. The country is hardly a dozen years old in as modern business, social and political format. Seventy-five years of communism gave way to a decade of near chaos and economic collapse before modern Russia started to emerge from 2000. Since then the country has seen a huge boom in hydrocarbon wealth, totalling close to $2 trillion over the past twelve years, and that has greatly accelerated the change in the country's socio-economic profile.

But while "oil boom" has rapidly improved some parts of the economy and business environment, a great deal more needs to be done. The economic crisis of 2008-'09 has shaken previous complacency and shown very clearly how urgent is the need for increased investment in infrastructure and economic diversification, both from Russian based investors and businesses and from international companies.

That is the challenge now facing the government as it targets a return to sustainable growth closer to the 5-5.5% range. For that to be achieved, Russia needs to both actually improve the safety and ease of doing business in the country and also the perception of Russia in terms of risk.

In this report we look at the issues and highlight how they have changed and why we believe they are changing, or not as is sometimes the case.

Several high profile disputes over the past fifteen years have a disproportionate impact on how investors view overall Russia risk.

In many instances companies which run into problems in Russia do so because they planned poorly, again a common problem seen across many emerging economies. But for every negative headline there are dozens of successful business stories. Major international companies, such as Pepsi, Boeing, John Deere, Nestle and DHL, have built very successful operations in Russia. They conducted due-diligence, made the right preparations and have dealt with any problems using local resources and taking the right advice.

Corruption is a major obstacle to business

Corruption is a big problem in Russia. Estimates of the total annual value vary widely and fall into the category of "best guesstimates". The official estimate from government sources places the annual cost between $250 bln and $350 bln or 12.5%-17.5% of GDP. A lot of the corruption is concentrated in the state sector, e.g. in big infrastructure projects and spending by state enterprises but there is also a great deal of corruption spread across all layers of business and society.

Large multi-national corporations consistently declare that they do not pay corruption and maintain their corporate standards across all areas of the world in which they operate. The evidence is that these large corporations do indeed have the muscle to side-step corruption. Other companies have made the issue very public in an effort to avoid getting sucked in. Sweden's IKEA is one example where a company fought back in a very public way and succeeded in escaping the corruption trap.

A campaign has started to root out corruption amongst state officials

In general foreign companies who stick with a no corruption policy from day one may for sure find it takes longer to process paper-work and to get approvals, etc, but once they acquire a clean reputation the issues tend to fall away from them.

The Annual Corruption Perceptions Index Table is compiled each year by Transparency International. It is mainly how foreign investors and businesses perceive corruption in a country. Russia has been rising slowly in the rankings, from 154th place in 2010 to 133rd last year, but is still firmly rooted in the lower quartile. The declared aim of the government is to get into the 2nd quartile within the next five years.

Corruption Perceptions Index - Annual Reading

	2012	2011	2010	2007
Georgia	51	64	68	79
Turkey	54	61	56	64
Brazil	69	73	69	72
China	80	75	78	72
India	94	95	87	72
Armenia	105	129	123	99
Belarus	123	143	127	150
Kazakhstan	133	120	105	150
Russia	133	143	154	143
Azerbaijan	139	143	134	150
Ukraine	144	152	134	118
Kyrgyzstan	154	164	164	150
Tajikistan	157	152	154	150
Turkmenistan	170	177	172	162
Uzbekistan	170	177	172	165
Total Survey	174	182	178	179

Source: Transparency International

But the perception of corruption in emerging markets amongst foreigners is somewhat at odds with how the locals view the extent of corruption and the trend in their respective countries. The table below is from the 2013 Corruption Barometer which is also conducted by Transparency International but is based on answers from Russian nationals. Here the picture is still bad not relatively better than the results from many of Russia's emerging market peers.

How Russia Compares within EM - How has corruption changed in the past 2 years?

	Russia	Brazil	India	Indonesia	South Africa	China*
Increased a lot	37%	29%	40%	54%	54%	N/A
Increased a little	13%	18%	31%	17%	18%	N/A
No change	39%	35%	23%	20%	16%	N/A
Decreased a little	9%	15%	6%	8%	10%	N/A
Decreased a lot	3%	3%	1%	0%	4%	N/A

Source: Transparency International

* Unable/prevented from carrying out 2013 survey

One of the reasons why locals have a slightly better view of corruption trends is because the government launched a major campaign against corruption after the March 2012 presidential election. One of the reasons behind the street protests during the election period was frustration with pervasive corruption affecting people's daily lives. Since the summer of 2012 a number of senior federal and regional officials have been fired and investigated for alleged corruption and the number of lower ranked officials charged with corruption offences has greatly increased.

Both the actual and perceived problems are equally daunting

From August 2013, elected representatives and senior government officials are prohibited from owning foreign bank accounts or shares and must declare all off shore assets. The measures have also been extended to their family members.

The jury is still out as to whether these measures, the first real campaign against corruption in Russia, are simply cosmetic or the start of a real effort to tackle the problem. Opinion polls show people are almost equally split between the optimists and the cynics. Only time will prove that one way or the other.

Bureaucracy is much worse in Russia

Excessive business bureaucracy and far too many procedures to be followed to carry out business are amongst the most commonly voiced criticisms about Russia from both foreign and domestic business owners. A review of procedures to be followed in many industries does certainly show an excessive amount of process to be followed and with lengthy delays and high costs.

But this does not apply to all areas. There have been many procedural changes and improvements put in place over the past couple of years which have cut time and costs for new businesses and the government has now targeted the World Bank's Ease of Doing Business rankings as a measure of future progress.

The government has targeted a ranking of 20th by 2018 as it looks to attract more investment into the country.

The Ease of Doing Business survey is published by the IFC/World Bank each year. It measures the time, cost and number of procedures to be followed by a business looking to either set up a new venture or to get licences. The survey covers a number of areas relevant to business expansion and finally publishes the overall ranking based on a compendium score. The table for 2014, published in November, is below and shows Russia to be ranked in 92nd place overall, out of a total survey of 189 countries.

Doing Business Ranking - C.I.S.

CIS Countries	2013	2014
Georgia	9	8
Armenia	32	37
Kazakhstan	49	50
Belarus	58	63
Kyrgyzstan	70	68
Azerbaijan	67	70
Russia	111	92
Ukraine	137	112
Tajikistan	141	143
Uzbekistan	154	146
Other EMs		
South Africa	39	41
Turkey	71	69
China	91	96
Brazil	130	116
India	132	134
Total Survey	**185**	**189**

This is up from 111th position in 2013 (revised from 112th) and better places Russia than India, Brazil or China.

Although showing improvement, Russia still ranks poorly in some areas, e.g., the time it takes to get a construction permit and access to an electricity supply. It also ranks poorly in the ease and cost of cross-border trade and in protecting investor rights. In other areas, such as the ease of paying taxes and in enforcing contracts, Russia is already very favorably regarded.

Russia ranks well in some areas but is far too low in others

There is a published timetable for cutting time, cost and procedures in several of the industries covered in the World Bank survey so that, in theory, Russia should be able to move up the rankings if that time line is adhered to. Several of these planned changes are also part of the WTO membership agreement.

The table below shows the breakdown for the main sub-sets in the World Bank survey and it can be seen that in some areas Russia is already favourably ranked. These include the ease of paying taxes, contract enforcement and the ease of registering property. Some other areas are very poorly ranked and these are the areas where the planned time line is targeting.

World Bank Ease of Doing Business Survey - Breakdown of Russia Ranking 2013 & 2014

Starting a new business	**2013***	**2014**	**Registering Property**	**2013***	**2014**	**Getting credit**	**2013***	**2014**
Rank	100	88	Rank	46	17	Rank	105	109
Procedures	8	7	Procedures	5	4	Disclosure Index (0-10)	3	3
Time (days)	18	15	Time (days)	44	22	Depth of credit Info (0-6)	5	5
Cost (% of income p/capita)	2.0%	1.3%	Cost (% of income p/capita)	0.2%	0.1%	Public registry coverage (% of adults)	0.0%	0.0%
Minimum Capital (% income p/ capita)	1.4%	1.2%				Private registry (% of adults)	45.4%	59.2%
Construction permits			**Enforcing contracts**			**Protecting investors**		
Rank	180	178	Rank	10	10	Rank	113	115
Procedures	42	36	Procedures	36	36	Extent of disclosure (0-10)	6	6
Time (days)	344	297	Time (days)	270	270	Extent of Director liability (0-10)	2	2
Cost (% of income p/capita)	129.2%	89.0%	Cost (% of income p/capita)	13.4%	13.4%	Ease of Shareholder suits (0-10)	6	5
						Strength of investor protection (0-10)	4.7	4.7
Getting Electricity			**Paying Taxes**			**Trading Across Borders**		
Rank	188	117	Rank	63	56	Rank	162	157
Procedures	10	5	Payments per year	7	7	Documents to export	8	9
Time (days)	201	182	Time (hours)	177	177	Days to export	21	22
Cost (% of income p/capita)	1,573.7%	293.8%	Total tax payment	54.1%	50.7%	Cost to export ($ p/container)	$2,820	$2,615
						Documents to import	11	10
						Days to import	36	21
						Cost to import ($ p/container)	$2,920	$2,810

Source: IFC, World Bank. Ease of Doing Business report **2013 rankings and scores have been revised.*

Legal protection for investors is weak…agreements can be changed

This perception has grown because of a relatively small number of very high profile cases in which powerful state companies or companies owned by well connected local owners, i.e. so-called Oligarchs, have used the courts to push out foreign competitors or to take control of a business/activity.

People are very familiar with the case of Yukos, previously owned by the country's richest man and now state owned, or the various battles between BP and its local partners in TNK (the company is now owned by state controlled Rosneft) and between Norwegian based Telenor and its local partner in mobile operator VimpelCom.

The Magnitsky – Hermitage case has also caused a great deal of concern for foreign companies looking at Russia.

High profile negative cases have dominated the headlines

But there is a big difference between the high-profile exceptions and the experience of a majority of businesses operating in Russia. Foreign business representative bodies, such as AmCham Russia and the Association of European Businesses (AEB) report that four out of every five disputes between a foreign company and a local partner are resolved in favour of the foreign party. The experience "on the ground" in terms of business dispute resolution is quite different to the few high-profile cases which have created the negative perception.

Very often the problems have more to do with poorly drafted agreements or legislation, especially when it comes to new business areas such as the relatively new Public Private Partnership (PPP) projects.

All of the world's major law firms are represented in Russia and are very well experienced to help foreign businesses resolve disputes and conduct ordinary business.

It used be a case that signing a legal contract only marked the start of real negotiations. Those days are gone.

The World Bank's annual survey (see previous page) ranks Russia in a very favourable 11th place (out of 185 countries) in the area of contract enforcement. But in terms of investor protection the ranking is a very lowly 117th place.

Eliminating what Prime Minister Dimity Medvedev has called "legal nihilism" is one of the key policy priorities for the government. It is well understood that the perception of poor legal protection is a major obstacle to foreign investment.

You need a local partner to conduct business

This is not the case legally. In some industries it is better and more efficient to have a local partner while in others one can operate and grow completely independently. The broad categories are as follows;

State dominated industries. These sectors are dominated mainly by big state owned or controlled enterprises. Industries include oil and gas, production and transportation, ship building, defence equipment manufacturers, etc. In these sectors the only practical route in for foreign investors is via JVs on a project by project basis. A recent example is the ExxonMobil deal with Rosneft to explore for oil and gas in the Arctic.

R.D.I.F. The examples we have seen recently include the $5 bln Abu Dhabi commitment to infrastructure investment in partnership with the Russia Direct Investment Fund (www.RDIF.ru). This followed several other high profile deals with large international investors such as Blackstone, TPG along with several Gulf and Asian investment funds.

High importance industries. I differentiate these industries from the so-called strategic sectors because they are mostly not controlled by state enterprises but are viewed as important either in terms of regional employment, contribution to the economy or some other identifiable reason. Russia's entry into the WTO (August 2012) does set a time line for how long these industries can be protected by the state but, right now, it is better to look at JVs or equity partnerships. A good example is the Renault-Nissan JV with Russia's largest auto maker AvtoVaz. The state facilitated this deal with political and financial support and the joint operation is now very successful.

Commanding heights industries. Examples include banking, insurance, telecoms, airlines and some areas in transport. Here there is a mixture of state and local ownership dominance which makes it very difficult for foreign competitors to gain a foothold. Foreign enterprises who can add some technical expertise or who may barter access to parts of their foreign operations have a better chance to get access.

Franchise business. Companies such as McDonalds and other retail orientated businesses initially set up their own operations across Russia but are now expanding via franchise deals. That will allow for faster expansion and access to areas and regions previously slow to penetrate.

All else. Mostly free and open for foreign operators to set up and expand independently.

Russia is simply ignoring WTO rules

One of the arguments proposed as to why the legal concerns are now being addressed is because of Russia's membership of the World Trade Organisation. Russia was admitted as a member from August 2012*. The proposition is that Russia has to abide by WTO trade rules and that will mean a more transparent legal environment for business. Very importantly it also means that foreign companies will have a new, external and powerful, body to take any complaints and to seek arbitration.

In practice Russia's entry into the WTO has not been without controversy and, barely one year since membership, both the EU and Japan declared their intention to take formal proceedings against Russia because of an alleged infringement in the tariffs applied to imported vehicles. Russia has also been accused of "bending the interpretation" of some safety rules to block imports of some farm machinery. In turn, Russian monitors claim that many of the restrictions and tariffs blocking Russian exports remain in place while the terms of membership required them to be removed on entry.

The government is very committed to the WTO and will use the membership timetable to force through economic and industry reforms.

The first year of membership has been difficult across a number of areas and keeps in place the suspicion that rules may continue to be ignored or evaded to provide protection for some ailing domestic industries.

In practice such disputes are not unusual and, at any one time, the WTO is dealing with dozens of conflicts involving even the most developed economies. The most important factor is that Russia, from the very top of government, is strongly committed to the WTO and sees membership as a necessary catalyst for domestic economic and industry reforms.

President Putin and his senior officials have also publicly stated that membership will force inefficient domestic industries, some of which are still protected from the Soviet-era, to become more competitive. Of course they are complaining and lobbying for state help but the clear intention is to allow the WTO timetable to force the changes which have so far moved far too slowly.

* See the separately published WTO note for greater detail across the most important industries.

Implementing Government planning has been poor

This is a problem. For many years the government has been talking about the need to improve the investment and business climate but has actually achieved little relative to the grand plans. The good news is that, today, there is evidently greater awareness of the need for changes and of the urgency to make them.

The legacy of the 2008-'09 economic crisis is the simple fact is that Russia now needs foreign investment and the expertise of foreign investors to pull the economy out of the current state of near stagnation and if it is to achieve the targeted annual growth of 5.0-5.5%.

The recent evidence has been more impressive with, over the 15 months, alone several important steps taken or now in train. These include

- Russia joined the WTO and has adapted a programme of reforms
- The fiscal rule is in place which will curtail oil revenue dependency in the future
- There is a more active effort to tackle corruption with many high profile actions
- Bureaucrats now have to abide by tougher standards
- The business amnesty legislation has been passed which gives better protection to small businesses
- President Putin's demand that Russia targets position 20 on the World Bank's Ease of Doing Business ranking (see comment earlier). It is currently 112th
- The work of the Russia Direct Investment Fund has resulted in a commitment from Abu Dhabi to invest $5 bln into infrastructure projects and follows several other agreements totalling $9 bln over the past two years
- Changes to the stock market which make it easier and safer for foreign investors to invest in Russia's domestic equity and debt markets. That will make it easier for Russian companies to raise capital in the future

So there is much more of an effort to improve both how Russia is perceived and, much more importantly, the actual business and investment processes.

Corporate Governance is very weak

Bad corporate governance practices dogged the market just after the 1998 crisis for several years. The egregious way in which some core shareholders pushed aside the economic interests of minority shareholders (*) was certainly a factor in raising the risk premium and has led to a legacy which still persists today.

There is no doubt that standards have greatly improved since then, although more progress to bring all corporate actions up to international standard is still needed. This year the refusal of Rosneft to extend its buyout offer to the minority shareholders in TNK (Rosneft acquired 95% of the equity from BP and AAR) plus the lack of clarification about the status of the Surgutneftegaz Treasury Shares led to widespread investor criticism.

But generally there is now a much greater awareness amongst the core shareholders in Russian enterprises that good corporate governance practices directly leads to a high market valuation and easier access to new capital. That is even more significant given the move towards executive remuneration through share options. This directly links their personal well-being with how investors view the company.

The state is also playing its part as it still wants to sell about $100 bln of privatization assets over the next five to eight years. State companies have been adding internationally experienced and respected directors to their boards and the state has recently raised the minimum dividend payout ratio for companies in its portfolio.

(*) Troika Dialogue's report "How to Steal an Oil Company" is one of the classic studies of that period.

Russians are taking their cash out of Russia

Since the onset of the economic crisis in 2008 the official Central Bank statistics shows that almost $400 billion has been taken out of Russia, including just under $40 billion in the first half of this year. The widely reported view is that this is Russian people and businesses, having lost confidence in the government and the country's future, taking their wealth out to but property and other assets in foreign countries. And indeed there are constant reports of wealthy Russians buying trophy assets and high profile expensive properties in Europe and the US to support this view.

Capital flight is not all about Russians taking cash out of the country

But the reality is different. Yes, many wealthy Russians have been stashing some wealth overseas and buying properties, etc, but the bulk of the capital transfer has been for more mundane reasons. The list includes:

- Repayment of foreign currency debt – this was a big part of the outflow in 2008 and 2009
- Servicing of remaining foreign debt by both corporations and the state
- The imbalance between the sale of raw material (which is recorded as a present receipt) and the actual repatriation of the sale proceeds. At a time of rising oil prices the "time gap" can widen the capital flight volume
- Private individuals taking cash out of the country
- Overseas acquisitions by Russian companies and investors

The table below shows the breakdown between banks, private individuals and corporations based on Central Bank data. The bottom line is that Capital Flight does not represent a huge loss in confidence by Russians. It is more of a mixed package. What is does show, however, is how little inward investment is taking place to pace the outflows.

Breakdown of Russian Capital Flight, $ bln

Year	Capital Flight	Banks			Personal	Industry Sectors		
	Total, $ bln	Total	Assets	Liabilities	Total	Total	Assets	Liabilities
2008	-$133.7	-$56.9	-$65.1	$8.2	-$25.2	-$51.6	-$150.2	$98.6
2009	-$56.1	-$30.4	$11.8	-$42.1	$4.3	-$30.1	-$64.3	$34.2
2010	-$34.4	$15.9	-$1.8	$17.7	$14.2	-$64.5	-$89.4	$24.9
2011	-$80.5	-$24.2	-$32.0	$7.9	$4.0	-$60.4	-$122.6	$62.2
2012	-$56.8	$23.6	-$15.9	$39.5	-$2.5	-$77.9	-$106.8	$28.9
2013*	-$38.3							

Source: Central Bank of Russia * Year to end June '13

Russia is on the verge of a political crisis

A popular external view is that President Putin is a deeply unpopular autocrat and the government is suppressing popular protests in order to prevent a Russian version of the Arab Spring or the popular movements which forced political change in Ukraine and Kyrgyzstan. This is far from the truth.

Vladimir Putin remains consistently popular with an approval rating above 60%. The opposition movement is still relatively fringe and attracts less than 20% popular support in national elections. The opposition groups and their leaders do however enjoy a disproportionate amount of coverage in the western media, thus creating the impression of suppression and an unpopular government.

Russia is a very stable country with no real threat of social or political disruption

The table below shows the trend in the public approval rating for Vladimir Putin based on the monthly surveys carried out by the independent and widely respected Levada Center. There is simply no current evidence of the threat of major public protests or political disruption in Russia.

Vladimir Putin has remained consistently popular

	May '08	Aug '10	Jan '11	Jan '12	July '12	Dec '12	Mar '13	June '13	July '13
Vladimir Putin									
Approve	84%	78%	72%	64%	67%	65%	63%	63%	65%
Disapprove	12%	16%	25%	34%	32%	34%	36%	36%	37%

Source: Levada Center

The reasons for Putin's continued popularity are clear enough;

- The economy has grown rapidly since 2000 with the near $2 trillion of hydrocarbon exports providing considerable spending power for the budget. That has meant that state funded wages and salaries have grown very fast in real terms, as have social payments.
- Disposable income and employment opportunities have grown strongly across the whole population since Putin became president and are still improving. Real wages rose 6.6% in 1H '13 and the rate of unemployment is at 5.3%
- The country was in a chaotic state through most of the 1990's with high levels of crime and poverty. Putin's presidency has seen a complete transformation
- Opinion polls show that people support Putin because he has made the country again relevant in geopolitics
- Putin is a populist in that he responds quickly to genuine grievances made by a large number of "ordinary people"
- There are no popular opposition leaders to challenge Putin's position, albeit mainly because any who do emerge are quickly supressed by state organisations

That said, the country is changing and people are starting to look for change. A recent opinion poll, also from Levada, showed that now 55% of people, while supporting Putin, prefer him not to be president from the next election in 2018. There is a growing understanding that the country and the economy have reached a point where it is stagnating and will continue to do so without real reforms and changes.

Pressure for change is growing steadily but slowly. T there is no negative impact on the business environment.

To say that the situation is complicated is an understatement. There are very powerful groups at the top of government, often referred to as Kremlin Clans, who have a considerable vested interest in ensuring that the status quo remains. At the same time the evidence is growing that the need for economic and business evolution is also well understood.

The country is changing. The middle class is growing, people travel a lot and Internet usage is the highest, in per capita terms in the world. People slowly but steadily want to have the same sort of lifestyle with economic and political and freedoms which they see in the west. That is a pressure which will continue to grow and cannot be supressed. For now the Kremlin is still trying to manage the political process and that means making life difficult for fledgling opposition groups in an effort to ensure no focal point leader emerges. That may be more and more difficult coming up to the next election cycle.

At the recent election for Moscow Mayor the main independent challenger won almost 30% of the vote. Many people believe that to be solid evidence of change which will be much more evident at the next election cycle.

Next election dates:

- December 2016 – Parliamentary (Duma) elections
- March 2018 – Presidential election
- 2nd Sunday September – each year regional and Mayor/governor elections take place on one date in September

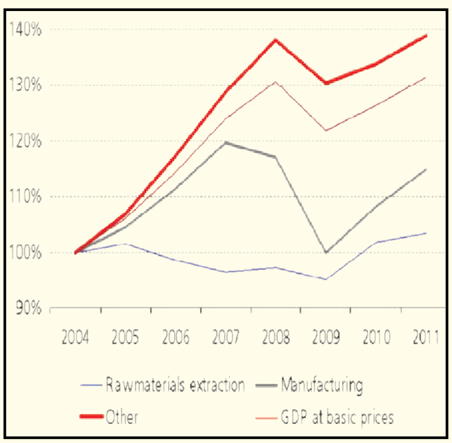
The economy is dangerously vulnerable to oil revenues

It is true that the rise in both oil wealth and the oil price from 1999 was the major factor supporting the country's recovery from the 1998 crisis and to move on from the chaos of the 1990's. But oil revenues have not been the biggest driver of economic growth since 2003/'04. The growth in the consumer and service sectors has been the major growth driver and remains so today.

Oil revenues are important for the budget and fiscal stability but the main economic growth driver has been the Russian consumer and expanding economic base

That's not to say that oil and gas revenues are not very important. Approximately 50% of the federal budget revenue is from the oil and gas sector and around 30% of GDP is accounted for indirectly by oil & gas spending. But these revenues are not the major drivers of the economy. It is the expansion of the economic base, which has been mainly led by the consumer in recent years, which is the growth driver. The graph below shows that raw material extraction stopped being the major growth driver in 2003.

Russia: GDP Growth Drivers



Source: State Statistics Service, Central Bank, Sberbank-CIB

It is of course fair to say that oil & gas revenues support the budget, the current account and allows Russia keep a low level of national debt plus large financial reserves. So while not directly contributing the majority growth driver, the trickle-down effect plus the state spending and the confidence element all underpin the spending and investment elsewhere in the economy. On the other hand, it has been shown many times that oil wealth complacency is one of the major problems holding back long term reforms. If the price of oil were lower, the budget run at a deficit, requiring an increase in borrowings (from a very low base), but we would likely see faster reform implementation. This was the case through 2009 until oil recovered strongly and complacency again set it.

Currently the federal budget balances just below $110 p/bbl Urals. But at $80 p/bbl the budget deficit is a manageable 4% of GDP, especially given Russia's very low sovereign debt load. So oil would have to collapse well below that level for there to be a real crisis.

The table below shows the GDP components for the past five years with wholesale and retail trade accounting for the biggest portion. Since 2000 retail sales in Russia have grown by a compounded 20% per annum and while the base effect has now cut that to a more modest annualized 5% (1st half 2014) growth in real terms, consumer spending is still a major factor in the country's growth story.

- Russia the 2nd largest consumer market in Europe (by $ value). It is on course to be the biggest, and the fourth largest in the world, within a few years.
- The value of annual consumer spending is $700 bln, split equally between food and non-food
- Based on OECD parameters Russia's Middle Class, as a % of the population, is the largest amongst emerging economies
- Russia has the largest number of wealthy households (OECD data) amongst emerging economies
- Russian households are still very under-leveraged compared to other countries

Components of GDP (Market Prices)

	2007	2008	2009	2010	2011
Wholesale & retail trade	17.3%	17.3%	15.6%	16.3%	16.2%
Manufacturing	15.1%	14.9%	12.9%	12.9%	13.6%
Real estate	9.3%	9.6%	10.9%	10.6%	9.9%
Mining	8.6%	8.0%	7.4%	8.5%	9.1%
Transport & Communications	8.3%	7.9%	8.4%	8.3%	7.5%
Public services	4.4%	4.6%	5.7%	5.2%	5.0%
Financial services	3.8%	3.7%	4.4%	3.9%	3.6%
Agriculture	3.6%	3.6%	3.9%	3.3%	3.4%
Utilities	2.6%	2.5%	3.6%	3.3%	3.2%
Helathcare	2.9%	2.9%	3.5%	3.2%	3.2%
Education	2.3%	2.4%	2.9%	2.6%	2.5%
Hotels & restaurants	0.9%	0.9%	0.9%	0.9%	0.8%
Net taxes	14.3%	14.8%	12.8%	14.0%	15.1%
Other	6.6%	6.9%	7.1%	7.0%	6.9%
Total	100.0%	100.0%	100.0%	100.0%	100.0%

Source: State Statistics Service

The wealth gap is dangerously wide and getting worse

This is another of those frequently used headlines about Russia, i.e. that the wealth gap is so wide that the country is heading into another revolution. The underlying assumption being, one may assume, Russian Oligarchs are so conspicuously wealthy that the gap “must” be huge between the different social groups.

It is true that there is a big gap between the wealth of the top 10% of the population and the bottom 10%. It is well above 10 times and higher than the global average. But that is not a good way to look at the problem when trying to assess the risk of social instability and also the outlook for consumer spending, etc. The GNI Coefficient is a better indicator as it looks at the broader wealth distribution across the population.

Russia’s GNI Coefficient is actually better than that of the U.S.

The GNI Coefficients table is based on the last set of complete data from the C.I.A. published World Fact Book. The lower the number the more equal is wealth distribution in the country. Sweden had the lowest reading in the survey with a Coefficient of 23. South Africa is the highest with 65 while the world average is 39.

The report shows that the GNI Coefficient in Russia is at 41.7, which is the 2nd highest within the CIS (because of the Oligarch effect) but actually lower than the result for the United States, China or Brazil. The conclusion is that there is no social or economic risk in Russia – or no more than in the US.

GNI Coefficients*

CIS Countries	
Belarus	27.2
Ukraine	28.2
Kazakhstan	28.9
Armenia	30.9
Tajikstan	32.6
Kyrgyzstan	33.4
Uzbekistan	36.8
Russia	41.7
Georgia	46.0
Other Ems	
India	36.8
Turkey	40.2
China	47.4
Brazil	50.8
South Africa	65.0
EU average	30.4
United States	45.0

Source: C.I.A. World fact Book 2011

There are no freedoms in Russia

This is one of the mostly widely report misconceptions about Russia. There are certainly legislative and administrative restrictions in some areas but, generally, these restrictions are restricted to special areas.

Russia has the highest Internet penetration and usage in the emerging market world and is close to the highest in the world. Internet traffic is generally unrestricted except for some designated sites which are mainly political or pornographic in content. Mobile telephone penetration is at over 200% in Russia’s largest cities and service usage is unrestricted.

Compared to some emerging economies, notably China, Russia has very few freedom restrictions.

Political rallies must be pre-approved in terms of location, duration and expected crowd size. Over the past 24 months there have been very few complaints about restrictions in holding rallies by the mainstream opposition parties. The fact is, of course, that there is currently a very low level of interest in politics in Russia so rallies are not well attended.

Most Russians outside of the big cities still rely on TV and newspapers for news and information. The state is very dominant in this area so there is a lot of criticism that content is filter in these media.

While the issue of social freedoms often dominates headlines, there has rarely been any discernible impact on business.

Russians have been travelling for business and tourism in increasing numbers over the past decade and airline traffic is expected to continue to grow rapidly. The only restrictions are the difficulties regularly faced by Russians in getting visas to some foreign countries.

Russia's population is in steep decline

During the 1990s several studies were conducted predicting a very steep decline in the population of Russia. The studies were based on the trends at the time and extrapolated the birth versus death trends using the early 1990's birth rates and the life expectancy at the time.

The most extreme forecasts predicted that the country's population would fall from around 147 million, at the end of the Soviet era to about 125 million by 2025 and as low as 100 million by 2050. Based on those projections the assumption was further made that the economy would not sustain any meaningful growth and, eventually, the empty vastness of Russia's territory would invite an invasion from resource hungry China. All very gloomy…and thankfully all very wrong.

Russia's population has fallen from 147 million to 142 million since 1990 but has now levelled off.

Russia's population has fallen over the past twenty years from 147 million to just over 142 million currently. There has been some emigration in this period but that has been balanced with immigration of workers from Central Asian states. The birth rate has improved, partly helped with a financial incentive provided by the state, and the death rate has fallen as health care and lifestyles have improved.

It is still too early to be sure if the population decline has been arrested and, as the graph below shows, there is still a wide gap between the latest optimistic and pessimistic scenarios for the next two decades. The population in 10 years' time, for example, may be either 135 million or 146 million depending on whether life expectancy can continue to rise and the birth-death balance continues to improve. Crucially the level of net immigration will be key especially for the available workforce and, therefore, for the economic growth rate.

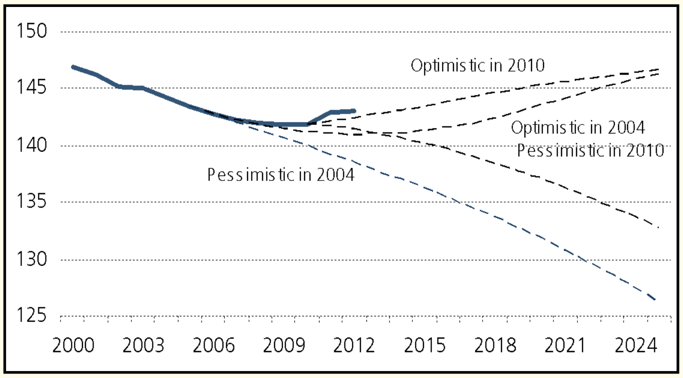
But even as the size of the population has now levelled off, there was a big drop in births during the 1990's as people were unsure of the future. That means that fewer people are now entering the workforce to compensate for those retiring and, even more important, the number of women now entering prime child bearing years is also less than it should be. So there will be a gap for may be 20 years until the babies born today enter the workforce and start having families of their own. That factor, i.e. the gap in births through the 1990's and into the last decade, is one of the reasons the pessimists are convinced that the current stability is only temporary and a steep decline will again take place over the next decade.

The population is set to age before eventually levelling off. There are 31.6 million people in the age group 15 to 29 years. The Federal Statistics service estimates this will fall to only 25 million in ten years.

The big problem is the expected loss of up to 8 million active workers over the next fifteen years unless replaced with immigrants.

The key problem the government must address is how to compensate for the estimated loss of 8 million people to the active workforce between now and 2030, according to Federal Statistics data. How that problem is resolved, or not, will have a big impact on the budget (cost of pensions and tax revenue) and overall economic growth.

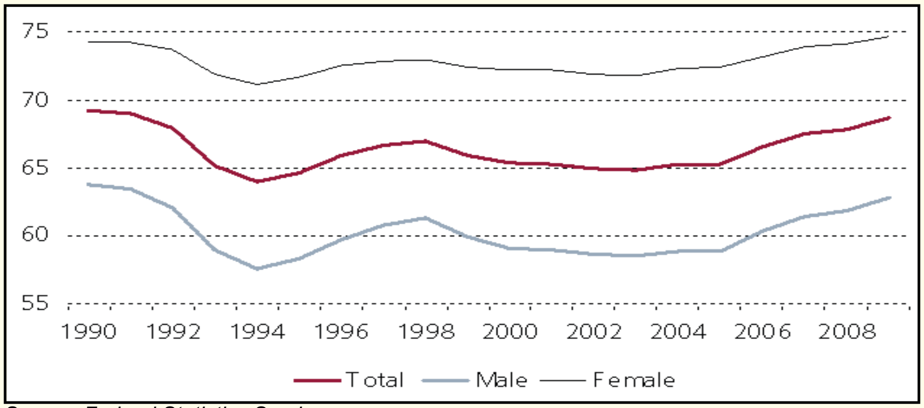
Previous Population Decline Projections Have been Revised



Source: Federal Statistics service, Sberbank-CIB

The average life expectancy for men in Russia is 64 years and for women it is 76 years, giving an overall average of just under 70 years. The government has set a target to raise the national average life expectancy to 74 years by 2018. In Moscow, according to recent data published by the City, the average life expectancy is now at 75.5 years. The table below shows how the trend dropped in the mid-1990's but has been recovering since 2005.

Life-Expectancy Has Been Improving



Source: Federal Statistics Service

Siberia/Far East is vulnerable to economic collapse

The de-population of Siberia and the Far East is a big concern for the country. Of the country's current population of 142 million, over 100 million live to the west of the Urals Mountains in the European side of the country. That area covers only about one-quarter of the total land mass of Russia. To further exacerbate the problem, the steady migration of people, especially young people, from rural areas to the cities is continuing.

The population has been moving to cities west of the Urals, leaving three-quarters of the country with a declining population

Russia has 14 cities with a population of 1 million or greater. That covers 21% of the total population according to the Federal Statistics Service. Cities with a population between 0.5 million and 1.0 million account for a further 36% share of the population while towns and cities with at least 20,000 people and up to 0.5 million account for a 25% share. In total, 82% of the Russian population live in large towns or cities and most of these are to the west of the Urals.

It has been estimated that between 1991 and 2010 a total of 20,000 villages in Siberia and The Far East were abandoned. There are still an estimated 133,000 villages scattered across the eight time zones from the Urals to the Bering Straits but, of these, 80,000 are thought to have fewer than 100 people still living there and 35,000 of that total have 10 people or less.

Reversing this trend is now one of the most important state policy priorities.

Most of Russia's resources are located in Siberia and the Far East and the concern that is regularly voiced in the international media is that energy hungry and people rich China may simply decide to "walk-in" one day. Russia has a current population density east of the Urals of 46 people per square kilometre – and falling - while China's current density is 140 people per square kilometre.

The government has started to address this issue and several specific programmes have been set up to try and boost economic activity and to encourage urban dwellers to move back to Siberia and the Far East. The 2012 APEC Summit in Vladivostok provide the opportunity for a big investment programme in the coastal region around the city and plans have been agreed for a major investment into highways, upgraded rail links and airports to better link East and West Russia. Apart from the issue of de-population many of the towns and cities in Siberia/Far East are in the category of Mono-Gorods or one industry cities. And many of those industries are inefficient Soviet legacies. An economic crisis across the region might quickly develop into a political crisis for the Kremlin.

Investors moving into Siberia and the Far East can often get very attractive incentives.

For investors the issue presents both challenges and opportunities. The government and regional governments are very keen to set up new industries and attract investment into regional areas and, in many instances, provide attractive incentives to make that happen. For several already announced projects, e.g. infrastructure, the state is ready to co-invest with a foreign partner under PPP style structures. Agriculture development is also expected to get even more state financial support and investors can gain good entry terms.

However, keeping a critical eye to the local and regional demographic trends is critical.

The Russian Federation is at risk of breaking up

This is worth mentioning simply because it has been a favourite theme of some western politicians since the break-up of the Soviet Union. At this point in time there is zero evidence that this is a realistic possibility. The Kremlin has made it clear that it will not cede even one square inch of territory to anybody for any reason.

The threat of a break-up, which was real in the 1990s, is no longer valid

That said, several regions may get more autonomy and a certain amount of local legislative freedom while remaining part of the Russian Federation. Regions and republics in the mainly Muslim dominated southern regions may get that extra freedom as a means of containing religious resentment. Russia does face a strong likelihood of a more troublesome southern corridor when western forces leave Afghanistan as that may allow militant action to move north to the Russian regions.

For investors these are the most difficult regions to invest in and are likely to remain so for some time.

CONTACT US

Myasnitskaya 24/7
Dom 3-4/4
Moscow 10100
Russian Federation

Email: info@macro-advisory.com

Telephone: +7 916 349 2039