Guide to Invest in Russia

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Executive Summary

From 1917-1991, the Union of Soviet Socialist Republics (U.S.S.R.), which included Russia, operated as one communist state, meaning the government decided what to produce, how much to produce, and set prices.[1] After the U.S.S.R. disintegrated, Russian President Boris Yeltsin instituted a plan for economic reform that focused on price and trade liberalization, macroeconomic stabilization, and privatization[1]. Since then, Russia has shifted from an isolated, communist economy to a more market-based, globally-integrated economy[2].

We are considering investing in the country, ethier in the form of direct investment or security investment. In order to do so, it is necessary to understand the performance and underlying risk in the economy. Based on our analysis, we believe although Russia still has some structural, systematic problems, the country is on the right macroeconomic policy track and its federal government is in a strong position.

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Chapter 1

Soverign Risk Accessment

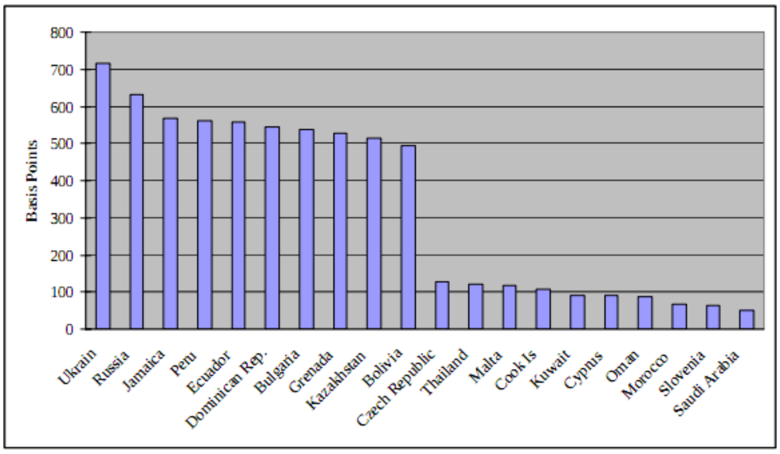
Overall, Russia's economy is subject to three categories of risks that can have negative impact on its future growth: volatility in commodity prices, freezing global liquidity, and uncertain progress of privatization. The country is rated Baa1 by Moody's and BBB by S&P and Fitch. In general, it is a risky nation to invest in.

Russia is a major exporter of commodities, with trade(exports plus imports) accounts for 48% of its GDP[10]. This makes it directly exposed to swinging commodity prices. The government since 2007 has embarked on an ambitious program to reduce this dependency and build up the country's high technology sectors, but with few results so far[2].

Furthermore, Russia's Sovereign Bond Risk spread has been among the highest in emerging economies, as illustrated in the graph below; and Russia's foreign exchange reserves relies heavily on international borrowing. Hence, a global-wise liquidity shock will cause financial distress to the economy. For instance, in 2008 recession, the spread is driven up to over 900bps, forcing Central Bank of Russia to use a large portion of its reserves to increase liquidity in the banking sector and aid Russian firms unable to roll over large foreign debts coming due[10].

Average Sovereign Bond Spreads of New Issues by Developing Countries

(20 countries with highest and lowest bond spreads)



Data source: J.P. Morgan EMBI Global composite index. Figure shows the average weekly stripped spreads from 12-31-1997 to 8-6-2003.

Given the painful lesson in 1990s' shock therapy, the federal government is acting carefully selling off state-owned assets and creating a truly functioning "laissez faire" system. It recently confirmed a list of 900 companies that will be partially privatized[5] in the near future. Detailed terms has yet to be decided, whether this action give investors enough confidence about the economy's fundamental growth ability is still in question.

Chapter 2

Macro Analysis

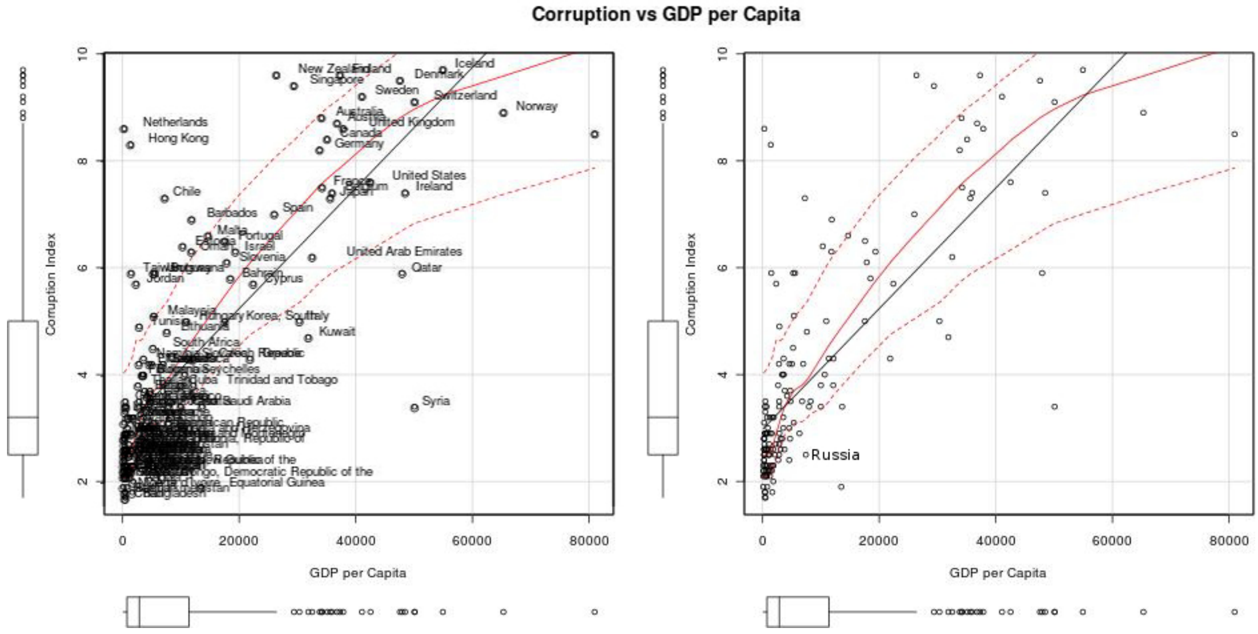
2.1 Government and Political Environment

Russia's government is organized as a federation, meaning a union of self-governing regions united by a central federal government[2].There are eighty-three regions divided into six legal categories (forty-six oblasts, twenty-one republics, four autonomous okrugs, nine krays, two federal cities, and one autonomous oblast[2]). The executive branch consists of a chief of state (President Dmitriy Medvedev) and the heads of government (Premier Vladimir Putin), two first deputy premiers, and several deputy premiers. The president is elected for a four-year term by popular vote with a maximum of two terms (effective after the 2012 election the term will be extended to six years) and the premier is appointed by the president with Duma approval[2].

A potential threat to doing business in Russia involves questions of the legitimacy of the government. Recently published U.S. diplomatic cables posted on the website Wikileaks characterized Russia as a virtual mafia state' with widespread corruption, bribery and protection rackets.[3] In other cables, U.S. diplomats referred to Premier Putin as Batman and President Medvedev as Robin,[3] essentially insinuating that Putin was really in control of the Russian government and that Medvedev was merely his puppet. In an interview with Peter Aven, a founding owner of one of Russia's largest private business groups, he commented that foreign investment is low because of the lack of competitive environment, corruption and the legal system which is completely inadequate.'[4] Based on these allegations, it seems investing or conducting business in Russia involves substantial risk.

Although government corruption exists in and adds risks to many emerging economies, an horizontal comparison suggests that Russia has relatively higher corruption level. We plot Corruption Index vs. GDP per capita across countries, and find out that Russia is significantly below the regression line, meaning among comparable countries with similar GDP per capita, Russia's corruption's level is higher than its peer nations.[1]

[1]Source: author' s calculation, Data From: World Bank, http//www.transparency.org/, Latest release in 2005.



2.2 Macroeconomic Policies

2.2.1 Economic facts and Industrial Structure

Russia' s economy depends heavily upon exports of commodities. In 2009 it was the world' s largest exporter of natural gas, the second largest exporter of oil, and the third largest exporter of steel and primary aluminum. On the other hand, a revival of Russian agriculture in recent years has led to Russia shifting from being a net grain importer to a net grain exporter. [2]. The net effects of the two trends in international trade results a steady declining of Russia' s Balance of Current Account (18.036% of GDP in 2000 to 3.87% in 2009.[2])The heavy reliance on exports makes Russian economy exposed to global business cycles and big swings of commodity prices. Russia's economy was hit hard both in 1998 Ruble Crisis and 2008 Global Financial Crisis.

Historically, Russia has experienced tremendous income redistribution during early 1990s' economic reform. During 1990s, the percentage of population living under poverty line peaked at 33%. After the turning of the millennium, the GDP enjoyed a 7% annual growth, and the Population below poverty line was reduced to 15.8%[3] bringing forth a new middle class. Russia' s Gini Coefficient in 2008 was 42.3 rising from 39.9 in 2001, yet still around the median value for all countries and comparable to US (46.7 in 2008)[4].

Some of Russia's remaining challenges includes a shrinking work force, poor infrastructure and need of large amount capital investment[2].

[2]Data Source: IMF
[3]Data Source: http://www.economicwatch.com
[4]Data Source: CIA

2.2.2 Increasingly Credible Fiscal Policy

The federal government maintained a budget surplus for the past decade (5-10% of GDP[5]). This allows it flexibility in fiscal policies. It also has a low debt-to-gdp ratio of 6.8%, as compared with 60.8% in US. The government's recent focus has been deficit reduction, by raising taxes in extractive sectors and selling off minority stakes in state assets. It is estimated that the public divestment of shares will raise USD 59 billion over the next five years[5].

By doing so, the government tried to sent a promise of continuous privatization progress and long-term growth to foreign investors. Yet given the low credibility of the government and the fact of failed privatization in 1990s, a detailed watch and analysis of the terms and conditions of such sales(yet to be released) is necessary to determine the soundness of these policies. In general, Russia's fiscal policy reveals better commitment of fiscal reform in reducing the overall risk of the economy, as compared to its actions in 1990s.

2.2.3 Conflicting Monetary and Exchange Rate Policy

Central Bank of Russia (CBR) serves as the policy making body in Russia's monetary and exchange rate regime. Its two primary goals have been: to fight down inflation and prevent the real appreciation of Russian Ruble-aimed at boosting exports. CBR maintained a partial fixed exchange rate regime and tried to manipulate exchange rate movement and money supply at the same time by sterilized purchasing. Yet in a environment of rising oil prices and appreciating Rubble, there's a trade-off between loss of exports and inflation.

According to Victoria V. DOBRYNSKAYA, 2008[6], there is empirical evidence that the degree of exchange intervention during periods of Rouble appreciation is significantly higher than the optimal level and should be reduced gradually. The results is double-digit inflation for the past decade, big swings of real lending rate, and heavy reliance of commodity exports for Russia's economy. In addition to that, CBR's preference of exchange rate tools over interest rate and other monetary tools also contributes to a export-focused policy portfolio.

In 2008, the Central Bank of Russia spent one-third of its USD 600 billion international reserves to intervene in exchange rate market[2]. For post-2008 recession period, CBR tried to adjust Ruble exchange rate to a new oil price environment-an action costly due to the reserve losses. It also started to lower interest rates and permit a more flexible Ruble exchange rate. This a sign of CBR trying to shift its policy focus towards inflation targeting and flexible exchange rate system, in other words a more transparent, independent monetary system.

[5]Data Source: The World Bank

Chapter 3

Conclusion

After twenty years from the original economic reform, Russia is still distant from a fully functioning market economy. However, unlike the miserable experience in 1990s, Russias recent macroeconomic policies are on the right track. The federal government has a healthy fiscal position, is less dependent on borrowing to finance itself, and with spending effective cut to a moderate level. On the other hand, government corruption level is high, which creates inefficiency and scares off investors. Russias monetary and exchange rate policy has been consistent, but over-addressed exchange rate stability and export competitive advantages while undermining the inflation goal and creating oscillations in domestic economic environment. However, CBR is loosening its exchange rate control, placing more of monetary policy focus upon inflation targeting. Hence its reasonable to expect a more transparent,efficient monetary system in Russia.

With all these evidence, we believe the BBB sovereign rating of Russia undervalued the economy and its growth potential. With proper risk management, it is the right time to invest in Russia.

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