

RUSSIA: 2005 Political Risk Outlook

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I. OVERVIEW OF THE CURRENT POLITICAL AND ECONOMIC SITUATION

The absence of clear rules of the game and domination of political whim over economic rationale remain the main reasons of the investment climate deterioration in Russia. Though Kremlin declares that the YUKOS affair should stay an isolated case, aiming to have a "pedagogical" impact on Russian tycoons, the regional power leaders don't follow what the federal power says, they copy what it actually does, initiating tax processes and grabbing local businesses' assets for themselves. The dented economy sends worrying signals to the government. The overall economic growth fell from 7.1 % last year to 4.4 % year-on-year in January and February. Capital flight increased fivefold to \$9.5 billion. Foreign investment remains paltry taking into account Russia's size and potential. The current political trend to spread government control over the assets of the most prosperous national companies makes the investment into Russian private sector in general the least attractive. Another side of the coin is that the deterioration in business climate prevents money from going to the real economic sector, contributing to the growth of the speculative monetary aggregates. The prognosis for inflation in 2005 is very high (from 11% to 15% a year).

The new situation is a striking contrast to the macroeconomic achievements of the previous years, which resulted in a broadly positive government record. Economic growth, helped by high oil and gas prices, has beaten the average 5 % annual rate envisaged in the liberal development plan of 1999, putting Russia among the world's fastest growing economies. The goal to move to a flat rate of income tax of 13 % has been implemented with success, helping restore public finances. The increase of the gold and exchange currency reserves resulted in Russia's achievement of net-creditor status. The Government has managed to pay off a debt to the IMF before the scheduled term and recently declared readiness to pay back the majority of the debt to the Paris club of creditors. These factors led the economic risk analysts from Standard & Poor's in January to increase the long-term credit rating of Russia from "BB+" to "BBB-" level. However the important social reforms, such as pension reform and replacing in-kind benefits with direct payments, have collapsed. As a result, the government's commitment to the next step of social reforms, such as phasing out subsidies on housing, is questioned. The reform of Unified Energetic Systems, the electricity natural monopoly of Russia, has been protracted. The development of small

and medium-sized enterprises is hobbled by the corrupt bureaucracy and underdeveloped legislation. Other structural reforms, such as banking and public-private partnership and so on, make painful progress.

President Putin spent his first term reestablishing presidential power after the weak latter years of the Eltsin presidency. He sought to undermine the political influence of the oligarchs, who had acquired enormous power during Eltsin's period. For these purposes he appointed to his personal staff the so-called "siloviki" - several former members of the security services and military. To balance them he included in his team liberal economists such as German Gref and Alexei Kudrin (economics minister and finance minister, respectively). After his re-election in 2004, Putin was expected to use his power and popularity rating along with extremely high oil revenues to support the liberal economic plan drawn by German Gref on the eve of Putin's first election in 2000. Instead, the "siloviki", who lobby for a stronger state role in the economy, have almost won out over the liberals. Russia seemed to be losing its historic chance for rapid liberal modernization.

II. KEY RISKS FOR INVESTORS

Investment risk represents the likelihood of the loss of investments or income from investments. The general situation of uncertain rules in the relationship between business and power discourage investors from being active on the Russian markets. The Yukos affair along with the other politically driven fiscal processes against big Russian companies and the on-going battle over economic policy between pro-market reformers and intervention-oriented members of the government have all drawn into question the reliability of the future for investors in Russia. Among common political risks that threaten all types of investments in Russian economy it is worth mentioning: 1) the absence of an institutional base and consistent legal regulation for doing business in Russia 2) the hyper-centralized and personalized political system 3) the weak and dependent judiciary system, not capable of vindicating the rights of property 4) the corrupted bureaucracy 5) the centralized (not diversified) economic structure, based on several oligarchic empires, vulnerable to political pressure due to a hidden and contradictory relationship history with the state 6) the lack of a culture of corporate governance and the absence of credit histories among market players 7) terrorism. However, the increasing growth of political risks in Russia does not affect different groups of investors equally.

a) Risks for bond and currency investors in the short term - next 2 months:

The dynamics of the ruble value along with the political decisions to manage these dynamics are of particular importance for bond and currency investors. The increase in value of the Russian currency on the foreign exchange market gives an additional profit for those who invest into any ruble assets and ruble debt instruments in particular. The current rather low discount rate and the secured liquidity on the national capital market due to high oil revenues encourage the companies to borrow on it. Although all the above opportunities are most likely to be spoiled by the Central Bank's politically driven intention to restrain the growth of the ruble (70%). The possible new tax claims to the business leaders of Russia could also seriously damage the financial market.

b) Risks for equity and bond investors in the intermediate term - 1-2 years:

The peak of the risks for this group of investors will fall in 2007, because in this year the final date of abolishment of restrictions for currency operations will coincide with Russia's joining the WTO. It would be a serious challenge for the weak and judicially unequipped banking system of Russia. Though the perspective of convertibility of the ruble, promised by the Central Bank by the beginning of 2007, along with the conditions for fair competition, which WTO membership will impose, could be considered as an encouraging factor for foreign investors in the longer term.

Intermediate term investors should also be concerned with the state of corporate governance in Russia, which encompasses minority shareholder rights, as well as with continuing government activism by the tax police, general prosecutor and Audit Chamber. Although the long-term benefits to minority shareholders of a true cleansing of the Russian business environment are clear, companies targeted by the general prosecutor's investigations or tax police raids suffer from significantly increased uncertainty and become unconfident places for portfolio investors to put their money in. As a result, Russia investors should, in the medium term, focus on those companies that are relatively clean (i.e., solid tax payment record as well as loyal standing with the Kremlin), such as Surgutneftegaz or Lukoil, while being careful with those that are the most likely targets of inquiries, such as TNK-BP and Vimpelcom.

As the oil prices continue to stay on a record high, the oil sector remains the most attractive for the investors. Though, the volume of oil production, according to some prognoses, will decrease. The direct cause for it is the decrease of capital expenditures, which, in turn, is preconditioned by the increasing burden on the oil sector and general uncertainty of the rules of the game between the government and oil giants. The future of investments in the extracting industry is significantly jeopardized by the new edition of the

"Law about the bowels", currently discussed in Duma. There is active lobbying by some interest groups for the version of the law which forbids the award of concessions that give the foreign entities an ownership interest in Russian natural resources and even limits the participation of foreign oil companies to providing technical assistance, construction and maintenance services. The probability of adoption of a protectionist-like edition of the Law is rather high (80%).

The potentially attractive metallurgy industry, which demonstrated a high speed of growth in 2004, is most likely to become the next field of government activism after the oil sector (70%). The growing Kremlin interest to spread control over this sector is connected with the increase of government defense spending and strategic pipeline projects.

The uncertain future of Energy infrastructure reform prevents this sector from attracting investments, though RAO Unified Energy Systems has never left the blue chip list for even a day, despite the scandals around the reforms and all the conceivable and inconceivable accusations hurled at the heads of RAO's managers. The reform -which will split more than 40 regional energy companies into separate generating, transmission and marketing companies, with current shareholders receiving a stake in proportion to their current share - is now being protracted. The key questions of the reform, such as the rules for sale generating companies shares and for functioning of the wholesale market are still unclear, keeping in suspense the future cost of the energy assets. The recent ambush on the head of the energy holding Anatoly Chubais could also scare the potential investors.

The increasing government grip over political and economic spheres in Russia induces the investors to consider the probability of the Russian version of "colored revolution", though the probability of it remains very low (10%). The liberal parties are weakened by their failure to get into the Duma in the last elections and the civil society activism in Russia is underdeveloped. The recent media hype about the forming of the youth revolutionary organization "Golos" only would push "silovics" to strengthen their monitoring over the political sphere and prevent any serious protest movement from growing.

c) Risks for FDI investors in longer term - 5-10 years:

The current political conditions in Russia create a tricky situation for FDI investors. On the one hand, the most safe and therefore attractive assets for investment are the companies, belonging to or affiliated with the state, such as Gazprom or Alrosa, on the other hand, the perspective of granting these companies the "strategic" status could jeopardize their business advantages for foreign investors. According to interviews of Presidential Administration high officials, the Kremlin sees the most proper form of field

mining is when its control stock is owned by a Russian legal entity and foreign companies act as partners. These restrictions will apply to maximum of 10 fields, including the energy sector and several enterprises of the aviation industry and infrastructure transportation.

Investment risk reduction on the regional level could be expected not earlier than 2010, when (and if) the administrative reform will have been completed and the system of vertical power will start functioning not only on the Center-regional level but down to the municipalities.

III. SCENARIOS

Short and medium term (up to 5 years):

Positive scenario (10%):

In spite of the problems, depicted in the above overview, the main reformer in the Russian government, the head of the Ministry of Economic Development and Trade, German Gref remains optimistic about the future of implementation of his liberal plan. In his recent interview with Financial Times he stated that the elaboration of the new legislation, including fair competition and state-aid rules, is currently under way, and the government is committed to further privatization. More than 1500 enterprises are going to be privatized this year, among them Svyazinvest, the telecommunications holding company. Ballooning oil prices and high prices for metals ensured an investing attractiveness and the possibility of early repayment of foreign debt.

The results of the State Duma elections and the current relationship between the Duma and the Kremlin in the investors' view contribute to improving stability in the society as they make impossible any serious confrontation between legislative and executive powers in the process of law adoption. The super-centralized presidential system of vertical power would not prevent foreign direct investments. The new order of the governors' appointment would even have some positive effect on their stimulation on the regional level. Choosing whether to leave the current governors in their posts, the President would have to rely on some respectful criteria for their performance estimation. He would take into account the investment rating of the region and the degree of how successfully the governor has built the relationship with local business community and foreign investors.

In 2008 during impeccably democratic presidential elections the power smoothly transfers to a pro-western oriented candidate such as former prime-minister Michael Kasianov or the governor of Krasnoyarskiy territory Michael Chloponin.

Moderate scenario (75%):

Putin gets disappointed with the attempts to implement the liberal economic policy plan and decides to provide the economic growth, which he needs to secure getting his chosen successor elected president in 2008, in another way. Instead of diversifying the Russian economy, he would try to concentrate it and take control over key sectors such as energy, metals and minerals to make them the foundation for growth. He would go the way of creating formally or informally state-controlled mega-companies in sectors which are growing or where Russia has a comparative advantage. The evidence shows that this scenario is a most likely. Dmitry Medvedev, the president's chief of staff, now chairs Gazprom, the world's biggest natural gas producer. Igor Sechin, the deputy chief of staff, heads the board of directors of Rosneft. Viktor Ivanov, Vladislav Surkov and Sergei Prikhodko - three other deputy chiefs - share the supervision of Aeroflot, the national airline, Almaz-Antey, a missile consortium, Transneftproduct, the pipeline monopoly, and TVEL, Russian nuclear fuel trader. Meanwhile the state-owned oil company Rosneft, which acquired the main Yukos production arm Yuganskneftegaz in December's scandalous auction, is being merged with Gazprom, resulting in the creation of a state-controlled energy giant. In a new model of state-business relationship foreign companies would be most likely allowed to take minority stakes in the strategic sectors to import technology and expertise, but would not be permitted to have a controlling stake or even 50% of stocks. As for the Russian oligarchs, they are warned that they can preserve their empires only if they help Putin to fulfill his economic promise and secure the painless transition of power to a reliable successor in 2008. One of the alternative ways for keeping power in the arms of the present elite is the project of the new constitution, which is currently considered by the Presidential Administration, aiming to transform the presidential republic into a parliamentary one. This change could secure the Duma speaker Grizlov as the new president, elected by the parliament, and Putin - the head of the majority government. Though this kind of power transition is less likely (30%) due to the negative reaction that it might cause domestically and abroad.

In general the above scenario would not mean the full rejection of liberal approaches to economic policy, but they will definitely be slowed or postponed until after 2008.

Negative scenario (15%):

President Putin uses any convenient situation to reiterate that he does not have plans to stand for president again in 2008. Supposing he did not try to influence the presidential elections as well, such populist and nationalistic candidates as Duma deputy Dmitry Rogosin or Krasnodarskiy territory governor Alexander Tkachev could win them.

The possible significant decline of commodity prices and the resulting accompanying economic dislocation could severely hinder economic diversification and growth and increase the chances of conservative inward oriented candidates. It would damage the emerging middle class and turn the population, which is adapting to current conditions, away from the free market and its vagaries. The oligarch empires encounter nationalization or very strict government control. Investors' money flies away from the country.

Longer term (10-15 years):

Positive scenario:

The positive development and growth are integrally connected with effective governance structures. An efficient bureaucracy, predictable rules and regulations, the rule of law and other factors, such as tax policies could stabilize the business climate in the country and allow for an alternative to resource-dependent economic growth. Reforms in these areas can encourage foreign direct investment outside of the energy sector and allow Russia to take greater advantage of its proximity to Europe and Asia. Resource-poor neighboring countries could also benefit greatly from the spillover effect of a dynamic and growing Russian economy, and could cooperate with Russia on development of transportation corridors for energy supplies.

Russia's joining membership in international organizations, including the European Union, NATO and the WTO, could inspire reforms through, for example, the necessity of complying with their norms and rules, concerning energy prices in particular.

Developments in China will have a significant impact on Russia. If strong growth continues in China it will create a huge demand for Russian natural resources and keep prices high. Conversely, a collapse in the Chinese economy could undermine Russian economic development. On a demographic part, China's large population makes it an obvious source for labor, given Russian needs. Should there be a large influx of ethnic Chinese into Russia, however, their presence could be a source of social tension and lead to strains between the two countries.

Negative scenario:

The Russian economy remains dependent upon extraction of natural resources. While this allows for economic growth, the economy does not become diversified. Russia fails to develop efficient and stable institutions of governance. Political power remains highly centralized, competition is highly circumscribed, and governmental structures are not transparent. There remains a tremendously inequitable distribution of wealth with a relatively small middle class. Significant elements of oligarchic structures remain intact. Foreign direct investment, outside of the energy sector, remains low and capital flight

persists. Demographic challenges, including low birthrates and an aging population are not overcome. Labor mobility is limited while brain drain of scientific and technical experts continues. Nationalist rhetoric increases and xenophobic tendencies emerge. Inter-ethnic conflict in the northern Caucasus persists, as do tensions between countries in the Caucasus region.

If the natural resource prices declined and the political grip over social and economic became unbearable, the probability of colored revolution would grow. Though it would most likely to be led by nationalist and fascist leaders.

In Central Asia, Islamic fundamentalism is on the rise. Some of the Central Asian countries, such as Turkmenistan and Tajikistan, face potential collapse. A power vacuum is created and the region becomes a battleground between nationalistic empire-oriented Russia, the United States, Middle Eastern countries, and China.

IV. RISKS IN DOMESTIC POLITICS AND SOCIETAL DEVELOPMENTS

The following current political risks contribute to the above percentage distribution of less likely and most likely probable scenarios:

Risk 1: Risks for the development of small and medium business. Cumbersome registration procedures caused by underdeveloped legislation and indefinite regulation along with corrupt bureaucracy hobbled small and medium business sector of Russian economy from growing. The number of the businesses of such a type produces currently 13 % of Russian GDP while in many western economies they count for 50 % of gross domestic product.

Risk 2: Risk connected with the strikingly inequitable distribution of wealth. National wealth may continue to be concentrated in a small group of key industries, rather than more broadly spread as it would be through measures to foster small and medium-sized businesses. This would stimulate social tensions.

Risk 3: Increasing dependence on commodity prices. The economy may become more dependent on commodity prices and would face an unmanageable crisis when they finally drop.

Risk 4: State ownership could contribute to the development of corrupt practice. State companies may compete unfairly with non-state groups, holding back their development.

Risk 5: Risk connected with mismanagement of high social costs of reforms. It would lead to the aggravation of strike movements, protesting against the further implementation of social welfare reform and provoked by growth of accidents at communal grids in winter time.

Risk 6: Demography and Immigration related risk. The decline in population in Russia and the corresponding population increase in Central Asia could have significant economic consequences. The demographic decline poses challenges for the economy, because of a potential shortage of available labor, for the armed forces, which faces an ever-decreasing pool from which to conscript troops, and for national identity, because one of the primary means through which to address the demographic crisis is through immigration. Related to this is the issue of brain drain.

Risk 7: Risks connected with federalism problems and ethnic tensions. It appears likely that Russia will continue to have weak regions and a strong central state. There is a strong possibility that Russia will have fewer federal units than its current 89 regions, 22 of which are associated with titularly recognized ethnic nationalities. Ethnic unrest could result from changes in federalism if such changes are instituted without consideration of local interests. Areas that are particularly susceptible include the northern Caucasus, Tatarstan and Yakutia. Another potential source of ethnic conflict relates to xenophobia which can emerge in large urban areas and areas of high migration.

Risk 8: Terrorism.

V. COMPARATIVE APPROACH

The latest poll among foreign investors, conducted by the Consultative Council for FDI of the Russian Government, shows that they consider the investment risks in Russia higher and the return from investment lower than in the other emerging markets such as China, India and Brazil. Even Ukraine recently gone through the serious political shake could have better prospects in the view of investors. Fiscal consolidation and tax reform, streamlining the administration, fighting red tape and corruption, and gaining membership of the WTO are all likely to be the priorities for new Ukraine.

The victory of the Orange Revolution provides Ukraine with its best chances to fulfill democratic change and integrate closer with EU, WTO and other international institutions. The government has already reached an agreement about a new deal with the IMF, which would convince investors that Ukraine is committed to economic stabilization. The current agreement with EU contains steps at improving Ukraine's chances for the full-pledged EU membership. Among them are obtaining market economy status, WTO membership, and the Free Trade Area with EU.

Despite the unfolded political crisis the Ukrainian economy growth reached 12% in 2004, which was the highest achievement among Eastern European countries. The newly revised 2005 budget plan cuts the deficit target to 1.56% of GDP from the existing 2.2% of

GDP. The recent research shows that the gray sector of Ukrainian economy starts reducing and now it is of an equal size as the formal one.

The current Ukrainian bond markets are favorable for the investors due to positive expectations from the Orange Revolution. The Ukrainian Central Bank is most likely sought to keep exchange rate stability in the nearest future. The temporary rather high inflation in Ukraine should not jump out of control owing to increasing foreign exchange reserves determined by current account surplus.

Compared to Russia's scale of red tape, Ukraine is a better place for starting business in. Furthermore, the Ukrainian laws allow foreign investors to get up to 100% of a Ukrainian business without any restrictions on the form of investment. The law protects registered foreign investments against state confiscation.

The speedy passage of a number of recent reforms and the near-unanimous approval of the pro-western pro-reform government by Ukrainian parliament sends a clear signal to investors, that all the ambitious plans of new Ukraine would not left on the paper.

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