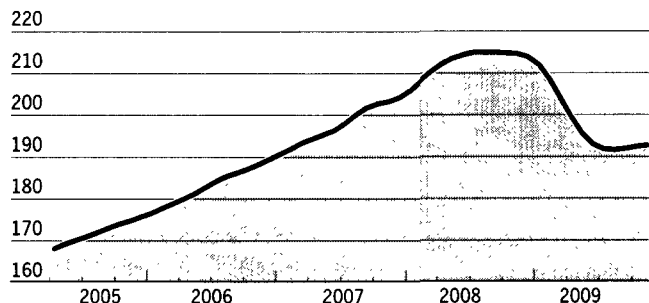


Investing in Russia

Foreign markets are key to recovery

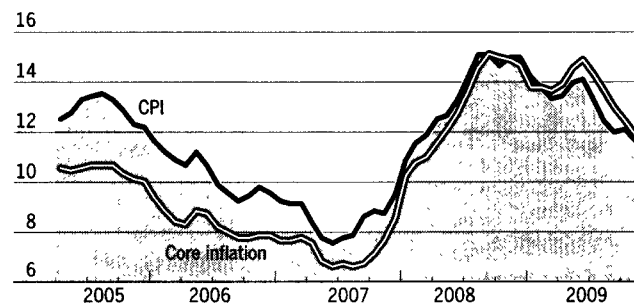
Real GDP

Jan 95 Roubles (bn)



Consumer price inflation

Year-on-year growth (%)



Source: IMF

ECONOMY

Finding long-term investment is the big challenge, writes Charles Clover

Russia's economy is limping back towards growth.

While statistical data can be read in many ways, some non-traditional indicators tell a mainly positive story. For example, it is now difficult, once again, to get a table at many of Moscow's upmarket restaurants – a sure sign that the elite are back to their free spending ways.

More ant-like workers in orange suits and yellow hard hats are now also visible climbing on girders and hoisting cranes atop the gleaming chrome and glass towers of Moscow City, the new financial centre. Construction on some of the buildings had been halted during the crisis.

Sergey Logvinov, director of public relations for the Ritz Carlton, Moscow's swishest hotel, says reservations for December – the time for New Year corporate functions – is back to near pre-crisis levels, having plummeted in December 2008.

The dry statistics are also beginning to look positive: already, seasonally adjusted month on month figures for GDP show small increases, though Kremlin economic adviser Arkady Dvorkovich cautions that the recovery cannot yet be considered sustainable. The IMF predicts that this year, growth will come in at -7.5 per cent, after falling more than 10 per cent

year-on-year earlier this year. Next year, the Fund predicts 1.5 per cent growth.

The end of the recession, even if it sticks, will not be a tidy affair. Alexei Kudrin, finance minister, says that unwinding from a \$200bn stimulus programme of monetary and fiscal measures is going to be "like putting toothpaste back in the tube".

While the Russian government has run a huge budget deficit of 8.3 per cent of GDP in an effort to stimulate the economy, the majority of those funds are scheduled to land later this year. Timing the stimulus is everything: if the money lands when it is no longer needed, or capable of being lent, it could cause havoc with the recovery, threatening the stability of the rouble.

The other problem is bad debts. Elina Ribakova, chief Russia economist at Citibank, says that most people assume the central bank's data on non-performing loans understates the true extent of the problem and that the real rate is close to 20 per cent – higher than the official 4.76 per cent as of September 1. If this were the case, the government would need to pump in \$80 to \$90bn to recapitalise the sector, she says, which could place a strain on the budget.

Working out the bad debts will not be straightforward. To start with, many banks did not even have a bankruptcy department until a few months ago.

With the panic in the marketplace subsiding, the government looks set to allow a long-delayed wave of mergers, consolidations and debt workouts to go ahead.

If handled in an orderly man-

ner, bankruptcy could boost the Russian economy by putting property in the hands of those with the most money and abilities. But if politics is allowed to get in the way, as it has in the past, the result could be chaos.

Meanwhile, the chief worry of the government is the return of economic growth, but a banking system clogged with bad debts is not going to be capable of financing a recovery. Sergei Ignatiev, chairman of the Russian Central Bank, told a meeting of the government's anti-crisis committee in September that the problem was a vicious cycle: "Banks are not crediting the real sector because it is in bad economic shape and therefore represents a risk. And the real sector is in bad shape because the banks are not giving credits," he said.

Many economists agree that in the short term, the recovery is not credit-dependent. Odd Per Brekk, IMF representative in Moscow, told a September meeting of the Association of European Business that fiscal spending will be enough to get Russian industry moving again.

However, once the economy hits pre-crisis levels, it will be near its production capacity and require investment, and there is a dearth of long-term finance options available.

"The recovery of the Russian economy will happen very quickly until we hit the pre-crisis level, because of the excess capacity," says Pavel Teplukhin, chairman of Troika Dialog, the Moscow investment bank. "The most important thing is working capital – we do have enough thanks to Russian government short term liquidity."

But long-term investment is a different story. For this, Russia will either need access to foreign debt markets again, where interest rates are manageable, or commercial rouble interest rates, which start at 20 per cent, will have to be brought down, and that can only be done by lowering inflation.

Access to foreign markets is by far the most straightforward solution – if the foreign banks come back. Experts expect Russia to issue \$20bn of sovereign eurobonds in the coming year to fund its budget deficit, which could be the beginning of a return to capital markets by Russian companies, which were cut off from foreign finance last year during the credit crunch.

Stuart Lawson, CEO of HSBC bank in Moscow says foreign bank appetite for Russian debt is strong. "For Russia not to access the market when it can would be to miss an opportunity," he says. "It needs to get its paper known in the market; it hasn't been issuing recently and that would help." But some Russian policymakers are wary of depending on foreign banks after last year's wrenching experience. Elvira Nabiullina, economy minister, told a meeting of the government's anti-crisis committee in September: "Russia needs to end its reliance on foreign



banks.”

That is easier said than done. Bringing Russian long-term interest rates down to levels that could realistically sustain long-term lending will require a concerted effort to fight inflation that may be at odds with the short term need to stimulate the economy. Russia's inflation rate, despite almost no lending by banks for the better part of a year and high unemployment, still stubbornly remains above an annual rate of 10 per cent.

When Prime Minister Vladimir Putin pledged in September at the Sochi Investment Forum to bring interest rates down to 6 per cent, the pledge was backed by few specifics, but was taken as a signal that the government is going to get tough on inflation.

“The only way the central bank can help the real sector is to keep long-term interest rates low, which means keeping inflation low,” says Mr Teplukhin.

“Unlike the US, we cannot print dollars. So the Russian recipe is very different from the American one. We should not spend money on the real sector – the only way is to bring interest rates down and you can only do that by not spending money.”