

SMEs Entering Russia: The Economic and Political Climate

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There has never been a better time to invest in Russia, almost regardless of the sector one operates in. The last five years, since the crash of the rouble in August 1998, have seen steady year-on-year growth of between 4 and 7%; inflation has fallen from 36% in 1999 to an estimated 13% now; and imports have risen by approximately 65% during the same period. That the picture is so comparatively healthy has something to do with the high price of oil in recent years, but most believe that the underlying trends are towards real stability.

One clear result of this macroeconomic development is a steady rise in living standards, most prevalent in Moscow but increasingly discernible in major cities elsewhere. Average disposable income in Moscow is something in the region of USD550–650 per month, and some 2 million Muscovites now earn more than USD20,000 a year.

That the average Russian is much better off than ever before has prompted a significant expansion of the retail market. Consumer spending is estimated to have reached somewhere around 250 billion dollars in 2002, and to be growing at between 15 and 20% per year. The retail market accounts for about 75% of this sum. In 2002 retail spending grew by 14% in nominal terms; this year growth is expected to be between 16 and 17%, resulting in a market worth some 140 billion dollars.

So market conditions are good, and many western companies have been taking advantage of them. The last year has seen some highly significant deals involving Russian and western companies. BP invested some USD6.75 billion in the oil company TNK, creating Russia's third largest oil company, TNK-BP (many wondered how you could spend six billion dollars and still have your name come second). At the other end of the chain, Bentley opened its first dealership in Moscow, which is said to have immediately become its busiest in Europe, and Ikea opened its first superstore, also in Moscow and always busy. And the investment has not all been one-way. For the first time Russian companies have been making significant investments outside Russia: Norilsk Nickel, for instance, the country's largest precious metals group, bought a controlling stake in a US palladium producer earlier this year – the first time the Russians have taken control of a US listed entity. And recent weeks

have seen a Russian businessman increase his stake in the UK–Dutch steel producer Corus.

Economically, then, everything in Russia looks as rosy as it ever has done. Politically, things are a little more complicated. As anyone who has read a single copy of the *Moscow Times* will have learnt, every act has a political dimension in Russia; and while much of the economy can now operate without direct political interference, no business operating there can afford not to monitor political developments in Moscow and locally. Business is still definitely political, as Mikhail Khodorkovsky knows and many of his peers increasingly fear. And in the eyes of many observers, the only thing that might get in the way of Russia's economic advancement at the moment is the uncertainty created by political instability of any kind.

This is a particularly striking truth for any small or medium-sized business looking to forge or develop a presence in Russia. For large businesses with a fairly short-term view (the banks), recent events are unlikely, they believe, to affect equity or debt prices significantly over the whole of the next twelve months; and long-term businesses (natural resources companies), many of which have made considerable commitments to Russia, see the Khodorkovsky affair as likely to prove only the smallest of blips in the country's progress over the next twenty years. Whether these businesses are right is another matter, but for a moment this is an accurate statement of the general view.

In this light, the Khodorkovsky affair should be of real interest to everybody else for three reasons: because however it turns out it will have reconstituted the political and business landscape in a way more striking than at any time since Yeltsin stood on a tank outside the White House in 1991; because it is the first sign of marked potential instability affecting business conditions since the devaluation of the rouble; and because for small businesses even short-term changes in policy or even political atmosphere can seriously affect revenue and stability. SMEs, in short, cannot afford to be nonchalant.

On my trips to Moscow in recent months, Russian businessmen have talked of little else but Khodorkovsky; and the reason it is so important to them is that they feel that it could presage some huge change in the way business in Russia operates.

Russia has weak formal protections for private property – chiefly because the legal system is very much subservient to political power – but in recent years there has been a growing, pragmatic consensus that state management has failed and that companies are more likely to prosper in private hands – save for a few strategic monopolies. The most prominent private businesses in the country are those which acquired significant state assets, often conspicuously cheaply, during Russia's rapid privatisation programme in the mid-1990s; and the most prominent trend in Russian business over the last decade has been the emergence, consolidation and growth – in size and power – of these private groups.

When Khodorkovsky, the richest man in Russia and the foremost of the oligarchs, was arrested on charges of fraud in October 2003, observers agreed that the outcome of the affair, and its repercussions, would decide just how firmly entrenched that consensus is. That was all that they agreed: opinion on the significance and likely outcome of the affair remains otherwise highly fractured. The optimists believe that what is happening to Khodorkovsky is the result of a political and personal battle between him and the Kremlin, and that it will have little effect on business life on Russia beyond encouraging the other oligarchs to check their political ambitions; the pessimists, however, fear that the arrest is just one in an inexorable series of deliberate actions whose effect will be to pass much of the oligarchs' empires back into the control, if not the ownership, of the state.

As a broad rule, the Russians are less optimistic than western companies operating in Russia. There are two likely reasons for this: one economic, one historical and deeply felt in Russian culture. The economic reason is that the Russians have more to lose. There is a general feeling on both sides that whatever happens, the positive trends in the Russian economy are likely to continue; that people will continue to make money as a result; and that westerners are very unlikely to be ousted from their investments, because President Putin values his standing outside Russia. But the Russian businessmen who have made fortunes in the last decade feel that some domestic redistribution of property is increasingly likely. There is not merely a fear but a belief that the President wants to see the country's chief economic assets held by organisations that are not hostile to quiet state influence.

The historical reason is that for Russians the prospect of an abrupt political change to a more controlled economy and society is not unfamiliar. This is a country whose political climate tends to severe swings every ten to twenty years. The experiment in capitalism and nominal democracy feels very young to

most Russians and very vulnerable; most feel that it could easily be undermined or even reversed by a powerful President – or by a weak President with aggressive interest groups lobbying him behind the scenes. And the reason that the Khodorkovsky affair has caused such concern amongst educated Russians is that it touches on the stability of private property – still the most powerful emblem of a free society in Russia and historically a particularly sensitive battleground for some occasionally savage political interests. It also involved a high profile and carefully stage-managed arrest, something which still resonates with upsetting associations for any Russian over forty.

It should be said that no-one is predicting a return to a communist society. Nevertheless, there is a real feeling amongst some Russians that recent events indicate a willingness by the Kremlin to exercise control over certain aspects of private business – and this willingness, they feel, is unlikely to limit its attentions only to one man. In short, further investigations are likely, and the effects may be widespread.

The irony is that the man overseeing this process is the man who is most responsible for creating anything like stability in the first place. In his first term as President, Vladimir Putin has done much to check various unruly elements in Russia: he has very effectively exercised control over the generals; over the regional governors, many of whom used to operate their provinces as independent states; and over the oligarchs, who four years ago were probably too powerful for the nation's good. The price for this stability has been a small but distinct loss of civil freedom, most notably in the disappearance from Russian society of any independent television broadcaster.

The optimists – and there are many of them – believe that the economic momentum that this stability has helped to create will be very difficult to stop. In the short term there will clearly be anxiety about how developments in Moscow may turn out; but in the medium term domestic and foreign businesses will almost certainly continue to make money from an increasingly vibrant Russian economy. As the former head of General Motors' operations in Russia suggested recently: 'people are getting richer in Russia, and when people get richer they buy more and better things. That's not going to stop.' For westerners considering Russia as a market, or as an investment proposition, that may be all they need to know.

For the time being, it is not really possible to predict with accuracy how events will play out. One thing is, however, for certain – it will take some time for the President's intentions to become clear but his influence over the economy will not diminish during his second term.