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Diversification For Growth: What The Russian Economy Needs

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President Putin has seized upon the global need for more diverse supplies of energy to meet one of his country's highest priorities: Russia's integration with the global economy. As U.S., Japanese, European and Asian companies solidify and expand their access to Russian oil and natural gas reserves, Russian oil companies are adapting to the requirements and norms of the international economy and becoming global energy concerns. But behind these high-profile deals – BP's cash and equity merger with Russia's third largest oil company, Tyumen Oil, to create TNK-BP, and the merger of Russia's second and fifth largest oil companies, Yukos and Sibneft, to create the world's fourth largest oil company in terms of reserves – there is another story unfolding much more quietly. This is the steady expansion of Russia's first-tier companies – primarily these same energy and commodity companies – and of Western multinationals into the domestic manufacturing, retail and commercial sectors.

This much less noted development will, over time, determine whether Putin can deliver on his promises to double GDP in 10 years and extend the promise of a better life to more of the Russian population. If successful, it will provide a more solid basis for future reform efforts and, by expanding the middle class, could speed Russia's transition toward a modern democracy.

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Recent headline-making deals come at a time when Russia is in its fifth straight year of GDP growth (the initial estimate of GDP growth for January - August 2003 is 6.9 percent.) This is a remarkable turnaround since the default crisis of August 1998, even if much of this growth can be attributed to factors largely outside of the government's control, such as the high price of oil on world markets. Presented with favorable macroeconomic circumstances, President Putin and his team have taken some tangible steps to deal with longstanding concerns and to promote growth and stabilization, such as tax and legal reforms, the modernization of Soviet-era Labor and Land Codes, and a new pension system. In addition, Russia was recently removed from the money-laundering "black list" of the Financial Action Task Force (FATF).

But, if some investors are still standing on the sidelines, it may be because they still believe that much of the growth, and at least part of today's political stability, are attributable in large part to high oil prices and the cushion that substantial oil revenues have given the state budget. That would mean that, despite his considerable political skills, Putin's domination of the political landscape may in fact rest in no small measure on economic factors beyond his control.

Fortunately, there seems to be more to the picture than high energy prices and a devalued ruble. Positive economic signs in Russia include a 50 percent increase in foreign investment during the first half of this year and the likelihood that, for the first time since the fall of the Soviet Union, investment in Russia may exceed capital flight. Particularly noteworthy is the fact that this capital inflow – a blend of repatriated funds from overseas accounts by Russians and new investment by foreign companies – is going to a broader economic base than ever before. Russians are reinvesting in Russia at the highest rate since independence in 1991.

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Yet, if business investment is to drive Russia's economic transformation, the Russian government must also strengthen the rule of law and the institutions of civil society, continue to fight against corruption, and to pursue other policies that reinforce the ability of business – Russian and foreign – to invest and grow. Today, the challenge facing Russian leaders is to find a model for economic growth that more efficiently and productively funnels resources beyond the commodity sector and broadens the economic base throughout Russia. Too much of the foreign investment is still in the natural resources sector, and what is not, tends to concentrate in Moscow and the surrounding areas.

In addition, investment levels still remain far below those of other emerging markets. Central and Eastern European nations, for example, average Foreign Direct Investment (FDI) inflow ranges between 5-10 percent of total GDP. In Russia, FDI is below one percent GDP. The World Economic Forum recently published its "Global Competitiveness Report 2002-2003," which compares aggregate growth and microeconomic competitiveness indicators for 80 countries. Russia ranks 64th regarding its growth competitiveness, and 58th in microeconomic competitiveness. However, a recent report by the consulting firm A.T. Kearney places Russia 17th on its 2002 FDI confidence index, which polls foreign investors for their views regarding a country's attractiveness to foreign investment. Perhaps more noteworthy, in the poll Russia ranked only behind the United States and China as a preferred first-time investment target.

But the question is: can Russia's leaders take advantage of the global need to diversify energy supply in order to diversify the Russian economy itself? Can Russia create many more value-added goods and services for the domestic market and for export?

This is not a simple proposition, to be sure. The "easy money" of commodity export has bolstered the coffers of the government, which relies on energy tax revenues to cover almost half of the national budget. President Putin has acknowledged the difficulties Russia faces, but the economic problems are long-standing and complex. The political maneuvering before the December 2003 Duma elections, and the presidential elections in March 2004, makes it that much more difficult to upset current arrangements.

At the same time, Russian companies seeking markets and capital abroad and Western companies seeking to establish themselves or expand in Russia both realize the importance of improving Russia's business climate. Russian businessmen are increasingly focused on growing their businesses in ways that fit the global market, and they are attracting the attention and capital of Western companies.

This is happening across a broad range of sectors. Western private equity firms are taking a serious interest in investing in Russia, and they are finding willing and able partners in the financial services sector. U.S. retailers are catching up with their European competitors as they seek to open stores throughout Russia, and U.S. manufacturers are considering opening or expanding new plants for the domestic market and for export. U.S. commercial interest in Russia is partly attributable to an overall improvement in U.S.-Russia relations and the new emphasis in both Washington and Moscow on enhancing commercial links, but, more importantly, it is being driven by traditional business calculations of risk versus gain.

What, then should Western business think about when making decisions about investment in this evolving climate? First, while the systemic risks of doing business in Russia still have to be factored into economic decision-making – and companies and investors still have to overcome real obstacles – the environment has become more settled and generally more responsive to investor needs. Second, a growing number of companies have been in Russia for a significant period of time, expanding their investments and building a body of precedents in the Russian market and the legal system that others can draw upon to implement strategies that minimize risk and maximize returns. Third, new Russian companies recognize the need for professional Western managerial experience and are beginning to hire and promote a new generation of professional Russian managers. Fourth, the U.S.-Russian commercial relationship is increasingly focused on building strong economic links – and not only in the energy sector. And, finally, it is critical to find and bolster allies in the Russian government and business world who understand the importance of accelerating reforms and making the changes in domestic legislation necessary to join the WTO.

No one can be successful in Russia without investing time and resources into understanding the politics of Russia as well as the market and its players. Russian political developments at the highest levels remain open to interpretation. Intrigue remains a fact of life in the Kremlin and can impact – sometimes dramatically – the fortunes of individuals and companies.

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For much of Russia's independent post-Soviet history, companies that invested in Russia tended to discount current political and financial fears in favor of high potential future gains. This brought in some investment, but not enough. Today, the equation is more balanced because companies need not stake investments solely on the hope of making money somewhere down the line. Many companies are making money in Russia and reinvesting that money in Russia.

To achieve the exponential growth Russia needs to catch up with its European neighbors, Putin's government must expand its vision. Energy revenues can spur some growth, but they cannot substitute for a diversified Russian economy. Russia has to be tied economically to the rest of the world, not just by export pipelines. This is the challenge that lies squarely before Russia's leaders.