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FOCUS ON RUSSIA

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CORPORATES AND BOND BUYERS BENEFIT FROM STATUS QUO, BUT SMALLER COMPANIES AND EQUITY INVESTORS WANT CHANGE

*By **Catherine Bolgar***

The R in BRIC; the world's eighth-largest economy with a domestic market of 143 million; the third-largest oil producer and second-biggest gas producer—Russia demands attention.

"Russia has a balanced budget, so the fiscal situation looks very good," says Vasily Astrov, senior economist at the Vienna Institute for International Economic Studies, or WIIW. "The stock of public debt is 11% of GDP, which is almost nothing."

In addition, Russia has a steady current account surplus, thanks to its oil and gas exports, and international reserves of about $500 billion, the third largest after China and Japan. These are all "very strong positive indicators for Russia," says Anders Aslund, senior fellow at the Peterson Institute for International Economics in Washington.

The government forecasts gross domestic product will grow 1.8% this year, from 3.4% a year earlier. The slowing has prompted President Vladimir Putin to announce budget cuts, to keep spending in line with revenues and crush inflation, counting on fiscal rectitude rather than stimulus to get the economy moving again.

In addition, tariffs of certain natural monopolies, such as gas and electricity, will be frozen after years of rising faster than inflation. The idea, Mr. Astrov says, is to help the rest of the economy, which relies on the monopolies for inputs such as energy.

The move could cut inflation by a percentage point, to around 5%, because energy is a big part of the inflation calculation, he says, adding, "but 5% inflation is not very high and is not a big problem."

In the run-up to the presidential election in March 2012, Mr. Putin issued decrees to raise teachers' wages and to ensure that pensions would rise by an inflation-adjusted 40% by 2018. "It caused significant pressure on the budget," says Olga Ponomarenko, economic analyst for Russia at the European Bank for Reconstruction and Development in London.

This spring, setting itself apart from European and U.S. budgets awash with red ink, Russia adopted a fiscal rule limiting borrowing to 1% of GDP. The number of infrastructure projects using the special reserve funds flush with oil revenues was limited to three.

While public-sector wages won't be cut, they aren't likely to rise as quickly as before. Unemployment is at a record low 5.4%, and the labor participation rate is robust, at about 65%. Since salaries in the public sector influence those in the private sector, a slowdown in wage costs is good news for employers and investors.

Costs are a challenge in Russia. "The big problem is there is too little competition in Russia," Mr. Aslund says. "All prices are higher than they should be, by 50% or so. There are too few enterprises and too little competition."

Russia isn't the easiest place to do business—it came in at No. 112 out of 185 countries in the World Bank's Doing Business ranking for 2013, a slight improvement from No. 118 a year earlier. It ranks at No. 133 out of 174 in Transparency International's Corruption Perceptions Index for 2012.

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Yet Russia attracted $31.3 billion of foreign direct investment in 2012. Mr. Aslund breaks out four kinds of foreign investors:

- Big companies that have the skills or resources to deal with the bureaucracy, and which focus on the large domestic market, have found great success in Russia. "They love it. They have high profits because there is little competition," Mr. Aslund says.
- Bond investors also "love it because the political risks are always overestimated, so they get good returns," he adds.
- Private equity investors are now suffering from the environment for midsize enterprises.
- Stock investors are "extremely disappointed" because the Russian equity market is still at only half its 2008 peak, he says.

The bias toward large enterprises is clear in a breakdown of employment by business size that shows large companies account for about 75% of the total, 20% from small businesses and the rest—only about 5%—from medium-size enterprises, says Ms. Ponomarenko of the EBRD.

Part of the problem is that small and medium-sized enterprises don't know how to grow, she says. A survey of small companies a few years ago showed that nearly half said they wanted a foreign partner, for example to make it easier to export their products. "Many of the firms had corporate Web sites. Even though they wanted a foreign partner, only one firm had a Web site in English," she says.

"There are lots of intentions but a lack of actions from small businesses," she adds. "For foreign investors, there are opportunities, but the initiative needs to come from the investor at this stage."