



FRONTIER EUROPE FUND

Third Millennium – Sokrat

TALK BACK: Russia's New Focus On Economic Stability

These are the personal views of John T. Connor Jr., who manages the Third Millennium Russia Fund:

Thousands of Russians, frustrated by the sharp economic decline, turned out recently in anti-government protests. While frustration is understandable, the Russian government is taking serious steps to ensure long-term economic stability.

From continuing privatization to spurring innovation to encouraging foreign investment, Russia's top officials see economic modernization as a key to the country's future. The person on whom much of the responsibility falls for making this happen is First Deputy Prime Minister Igor Shuvalov. Along with several other Western investors and analysts, I recently met with Shuvalov in his Moscow office to discuss his vision for Russia's economic future. I liked what I heard, both in his realistic analysis of what has hampered Russia's progress and in his plans for overcoming those challenges.

Russia certainly starts from a deficit. In the past decade, Poland attracted more foreign direct investment than Russia. Still, many leading multinational companies are now happily and profitably doing business in Russia. Shuvalov said he hopes for "real partnerships" attracting "everybody" to take advantage of increasing privatizations of government enterprises across the board in ports, shipping, energy efficiency, nuclear and medical sectors. He especially hopes for enterprises that will educate and train the workforce and bring technologies to Russia. In a market of 170 million potential customers and employees, this spells huge potential opportunity for investors.

A major problem for Russia has been its image as hostile to foreign investment interests. Shuvalov is certainly aware of this. So the discussion focused on the rule of law and corruption.

Shuvalov, who, like President Dmitry Medvedev, is trained as a lawyer, noted that Russian judges are now paid good salaries and receive solid "social packages" (housing and health care), so their conduct is expected to be above reproach and, should they misbehave, sanctions will be

swift. Prosecutions of errant government officials in Russia today are in fact numerous.

Corruption, of course, has an ancient history in Russia and "leakages" from the budget remain endemic. Partly for this reason, it seemed, Shuvalov was open to foreign firms financing projects such as toll roads, for example, in return for 20-year or longer leases, with the title reverting to the public authority after the bonds which financed construction have been retired. By putting projects under foreign control through construction and administration stages, the funds are more likely to go where they are intended. With the pressing need for improved transportation infrastructure throughout Russia, this approach could be a boon for investors.

Shuvalov also recognizes the importance of small and medium-sized enterprises, or SMEs, in spurring economic growth. Reforms have reduced bureaucratic barriers such as licenses, permits, and inspections, all of which increased the risk of bribery and extortion in the past. SMEs also will get credit for housing and health-care expenditures for their workers, drastically reducing their effective tax rates. Shuvalov also spoke admiringly of Kazakhstan's lower 12% VAT rate as being business-friendly perhaps a sign that a similar rate may be introduced in Russia.

Encouraging long-term domestic investment is a priority for Shuvalov, through tools such as life insurance, pension funds and mutual funds. His focus is clearly on the need to stay the course of the last few years in steadily reducing the inflation rate, which is now at about 7%, and to resist political pressure to increase expenditures from the budget. To this end, revenue to the state from an oil price in excess of \$50 will continue to accrue to the reserve fund, which also supports a strong Ruble. Russia's balance sheet is strong; its reserves are currently third highest in the world.

There's no doubt that Russia still has its challenges. Russia remains the only major economy absent from the World Trade Organization. Too many of Russia's oligarchs enjoy



FRONTIER EUROPE FUND

Third Millennium – Sokrat

dividing up its economy among themselves and resist WTO membership, and many new WTO members, such as Poland and Georgia, object to Russia's admission. Nevertheless, Shuvalov calls WTO accession a priority and negotiations continue.

Oligarch self-absorption is a problem that does not necessarily reflect the government's intent or wishes. For example, while the Kremlin denied any government role in the notorious BP affair last year, BP's (BP, BPLN) Russian "partners" were working local government contacts to deny expatriates work permits and drive them out of the country. Private businesses in Russia can be brutal, oblivious to the reputation and policies of the Russian Federation. Whether such conduct separates Russian businessmen from those in my home state of New Jersey, I leave to the judgment of others.

Doing business anywhere profitably is a challenge. But having lived and invested in Russia myself over the decades, it's obvious to me that many Russians are taking advantage of newfound opportunities and freedoms. Within the Russian government there is clear recognition of the need for foreign capital and technology. Shuvalov's efforts could translate into success for increasing numbers of American and other foreign investors in Russia and into more opportunities for those Russians who took to the streets.