Positioning for the upturn

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The challenge facing Medvedev and Putin is to demonstrate that the country is more than simply a resources play, and that they are effecting a lasting transformation of the economy

Ordinary Russians have benefited from the transformation in the time of Vladimir Putin's two terms in Presidential office that produced a six-fold increase in gross domestic product to US$1,270 billion (bn) by 2007. Annual economic growth has averaged nearly 7 per cent for ten years. Powered by the devaluation of the ruble after Russia's financial crisis a decade ago, and then by record oil, gas and commodity prices, the country experienced growth on a par with the other BRIC countries, Brazil, India and China. It has in the process amassed US$500bn of gold and foreign exchange reserves, the world's third-largest after China and Japan.

Russia now vies with Saudi Arabia to be the world's top oil producer; it has the world's second-largest reserves, the largest gas reserves and the fourth-largest gold reserves. Little wonder that Putin was described as a lucky President. His elevation to the position coincided with the commodity boom, and the manner in which he rode it has proved popular with the Russian electorate – after two terms as President he has been elected Prime Minister and continues to command high approval ratings.

Putin's relationship with new President Dmitry Medvedev commands attention both within and outside the country. How will the Medvedev/Putin "tandem" work? As Sir Andrew Wood, former UK Ambassador to Moscow, now an adviser to blue chips such as BP, Ernst & Young, GlaxoSmithKline and Unilever observes, "It will be interesting to see if they can avoid the instability associated with Russia's periodic experiences of dual-power structures in the past."

Medvedev, shortly after his election, commented in an interview with the Financial Times: "The... President is an effective leader and he's ready and able to continue to work to advance the development of our country...This is why this tandem...was formed. I am confident [it] will prove absolutely effective." If you are struggling with wood and trees over this, you are probably not alone. He did add: "What struck me first was his [Putin's] meticulous attitude towards information and how he tries to investigate to the most thorough degree every problem...And how he takes decisions only on the basis of a complex and overarching analysis...Here is something for many people to learn from President Putin," which at least is less opaque.

Whatever transpires, Putin deserves plaudits for managing economic growth, having arrived two years after Russia stunned the international investment community by defaulting on its debts, triggering a collapse in the ruble and a crisis in emerging markets around the world. He has also husbanded the country's resource wealth sensibly: the stabilisation fund, designed to conserve the oil and gas windfall and to prevent it distorting other parts of the economy, had reached almost US$160bn by the end of 2007. And there are, as mentioned, those foreign exchange reserves.

Russia's growth strategy mirrors those of China and India: empowering and enriching its 140 million consumers while investing to improve backward infrastructure. Oil is undoubtedly crucial. It accounts for two-thirds of exports, a quarter of GDP and half of Russia's stock market value. The challenge facing Medvedev and Putin in the longer term is to demonstrate that the country is more than simply a resources play, and that they are effecting a lasting transformation of the economy.

The scope for boosting consumer demand will be considerable. While Moscow is a showcase, the next wealthiest area of the country, Tyumen Oblast (heartland of the Siberian oil barons) is less than half as rich as the capital, while the poorest areas have as little as 4 per cent of Moscow's wealth. But cities such as St Petersburg are now growing far more rapidly, and Medvedev aims to increase the proportion of middle classes from the current 20 per cent to half.

The property market, both domestic and commercial, illustrates one such area of opportunity. While everyone owns their own home having been given it after the fall of the USSR, the stock is decrepit. Two-thirds of housing stock is more than 30 years old, and many apartment blocks erected during the Krushchev era and designed to last just 20 years are only now being demolished. Almost 40 per cent of Russians have no running water or sewerage systems in their houses.

Putin has promised between 70 and 80 million square feet of new housing, 10 million of which will be state housing, so that the number of Russians who can afford to buy a home should rise from the current 5 per cent to a third. The number of mortgages has doubled annually in recent years, and is targeted to reach 1 million within two years – still by Western standards a very low ratio, and an area likely to command attention from Western banks seeking growth out of the current credit crunch. Consumer credit has also surged as Russians have begun to abandon their suspicions that banks are where you risk losing your money and instead embrace the notion that rather they offer a way to buy cars or houses.

In the commercial sector, a shortage of suitable space has seen an explosion of projects such as "Gazprom City" and St Petersburg's IT parks, designed to capitalise on the area's IT expertise and draw investment away from Moscow. Gazprom itself has seen remarkable changes in its operations, as company head Alexey Miller is the first to admit. "Contemporary business undergoes rapid globalisation and is run far beyond industry and national market boundaries. Two years ago Gazprom decided to start creating a global energy company" says Miller.

"Not only do we develop a unique resource base, build up production potential and invest considerable funds in the pipeline system modernisation, but we also conquer new sales markets, diversify energy transportation routes as well as developing new types of business. We are active in entering into the power industry, the oil business and in developing the entire hydrocarbon processing chain. Furthermore, Gazprom is becoming a prominent player on the LNG market. This implies actively expanding business types and regions of operation as well as achieving an additional reduction of risks," he adds.

"Gazprom is already ranked second among the global energy businesses. Moreover, we will continue progressing. Specifically due to a prompt development of Gazprom's business in recent years, we have probably a keener sense than our colleagues and partners of the disaccord between the existing "rules of the game" in the energy sector and present-day challenges facing the global economy," Miller concludes.

Elvira Nabiullina, Russia's Minister of Economic Development commented: "Inflation has a direct negative impact on the investment process. Several factors are important; the country's investment climate, the judicial base, tax system and the opportunity to invest in infrastructure." She is though, relatively sanguine on the other key area of concern for investors: the role of the state. Few dispute that during the 1990s the Russian oligarchs were given state assets too cheaply, and much of the current focus is on ensuring no repeat of that situation. Despite the raid on BP's Moscow offices and the problems experienced by Shell, Sir Andrew Wood comments: "Business can make a considerable contribution to Russian security, but they have to understand the way business behaves. And investors must understand that regulatory law is still extremely loose in Russia."

Elena Shaftan, manager of Jupiter's New Europe fund, says that the key factor is that the regime is both "stable and predictable", echoing Nabiullina. Shaftan says that, while not everyone may agree with the way that the Government has operated or the role of state-controlled resource companies, everyone should know the state of play: "If you listen and abide by the rules, you are fine."

Oleg Deripaska, head of aluminium giant Rusal, says of Anglo-Russian relations: "The West fails to give Russia credit for its progress in the past 15 years and concentrates on its failure to progress to a western European-style democracy."

Russian Union of Industrialists and Entrepreneurs President Aleksandr Shokhin has a somewhat different take on events. He does not rule out the possibility that British companies in Russia and Russian companies in Britain may end up at the centre of increased attention from the monitoring agencies. "This is the continuation of the exchange of diplomatic blows. The next step that the business community will find unpalatable will be increased attention from the oversight and inspection agencies," Shokhin said last year.

In doing so he highlighted that investment is a two-way process. Finance minister and deputy prime minister Alexey Kudrin recently commented: "President Medvedev wants Russia to be an international financial centre. Today, our companies have capital and some good experience. Until recently, we had a certain psychological barrier; we were patriots and we only invested at home. Now it's a freer, more liberal policy." However Kudrin cautioned that Russian banks could suffer from a liquidity crunch if the global economic problems sparked by the US subprime mortgage meltdown are aggravated in the near future.

"We expect certain problems [with Russian banks' liquidity], if the international crisis events are exacerbated, but on the whole I think we are prepared for this situation, and can cope with it," Kudrin said. The head of Russia's largest state-owned bank Sberbank, Herman Gref, has said the bank would be able to support the liquidity of the country's banking system.

Analysts perceive Russia to offer plenty of opportunities among companies with young dynamic managements and built up by a new class of entrepreneurs that will prosper from growing consumer wealth.

It was Winston Churchill – not, it must be said, a particular favourite of the nomenklatura – who famously said of Russia that it is "a riddle, wrapped in a mystery, inside an enigma". Less often quoted was the second half of his statement – "but perhaps there is a key. That key is the Russian national interest". Spotting where that and Western commercial interests coincide or conflict remains the secret to successful international business development in the country.

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