

Weathering the storm

INTERVIEW WITH ROGER MUNNINGS

FORMER CHAIRMAN AND CEO, KPMG, RUSSIA/CIS REGION



ROGER MUNNINGS has lived with his family in Russia since 1996 where he has, throughout that period and until recently transferring responsibility, been Chairman and CEO of KPMG in Russia in the CIS Region. He was at the same time Chairman of KPMG's Global Energy and Natural Resources Practice and a member of KPMG's International Council. Before moving to Moscow, Roger was a partner in KPMG's London office

In Roger Munnings's most recent interview for FIRST, he was, despite certain concerns, optimistic about the future for Russia, its economy and its involvement in international affairs. FIRST asked him how he now sees Russia's current position and its future.

At the time of the last interview, Russia's economy was well on the way to growth of over 8 per cent for 2008 having achieved growth of between 6 per cent and 8 per cent for seven consecutive years to 2007. Prudent macro management by the Ministry of Finance and high international oil prices had resulted in foreign exchange reserves approaching US\$600 billion, a Stabilisation Fund approaching US\$160 billion and a virtually nil National Debt position. National self-confidence had revived due to the country's importance as a supplier of oil and gas to the world's economies and some robust performances internationally by its leaders. Russia had a stable political environment internally. Presidential and Duma elections had taken place. A popular president had been succeeded by one who shared his aspirations for the country and had his support yet who was of a different generation with different formative influences. Russia was focused, in the economic sphere, on the modernisation and diversification of its economy and on continuing growth with the aim of catching up with standards of living in Western Europe and North America for all of Russia's people. Not all was going smoothly or as quickly as many wanted, particularly in the areas of corruption and consistent rule of law, and the Presidential Administration and Government were far from complacent, being aware that much remained to be done in the long and difficult process of establishing advanced democracy and a predominantly market based economy which allocated resources efficiently and wealth equitably. Nevertheless strong progress was being made away from the difficult years of the 1990s towards the aspiration, then recently set in the 'Development Strategy through to 2020' of being one of the world's top five economies.

My concerns in early 2008 were, in the economic sphere, the appearance of 'bottlenecks' in the economy with the potential for it to overheat, resulting in debilitating levels of inflation: in international affairs, an apparent lack of understanding around the world of Russia's motivations and a growing resentment in Russia

of this lack of understanding, and of US unipolarity, of infringement on national sovereignties and Russia's strategic interests and of what Russia saw as residual 'Cold War' attitudes, and, in politics, whether President Medvedev and Prime Minister Putin could make their power 'tandem' work consistently and in a credible way and, longer term, the tensions which will likely occur as a multi-party system develops in Russia.

Since mid 2008, Russia has been involved in military conflict with Georgia. It has halted gas supplies to Central and Western Europe through the Ukraine. The country has moved from an environment of rapid economic progress and change to the position where it is experiencing severe economic problems similar to and connected with those now affecting most other countries around the world. There have also been significant changes in political leadership elsewhere and other difficult issues in international relations – some involving Russia, nearly all affecting Russia's relationship with other major powers.

Understanding the consequences of the complex cocktail of recent events and giving a balanced commentary at this proximity is difficult. The speed of change and the fact that a bottom to the global economic problems is not yet in sight also provides a discouraging framework for prediction. Here, however, are some observations and thoughts on the present situation in Russia in politics, international affairs and in the economy.

Despite the recent extreme turbulence and change in many areas, there are reasons to remain optimistic about Russia's internal development and about its involvement in international affairs. There are seeds of opportunity in many aspects of the current issues which if recognised, seized on and managed well can give a positive and improved outcome. One is Russia's and the rest of the world's recognition that Russia is firmly part of the world's global systems and that long term solutions lie in collaboration and effective international structures.

Russia, its economy and its democratic and market economy institutions are much more robust than they were ahead of the financial sector crisis and economic problems in 1998. The next 12 months, however – and possibly longer depending on the global position – will be difficult, and, in many areas of the economy, painful and the human and potential social consequences must not be overlooked or underestimated while considering

and acting on the potentially positive aspects.

My sources are the full texts of the addresses and briefings which the President and the Prime Minister give regularly to Russian and foreign media, the statements they make and the prospectus annually laid out in the President's address to the Duma ('Parliament') of the Russian Federation, talking to senior Russians in business and in politics and government and, through living in Russia, observation of reality against words and prospectuses. My experience over twelve years is that senior Russians predominantly do what they say they will and, accordingly, anybody wishing to have an accurate feel for the state of development of Russia, its progress and its challenges should go to these primary sources, where 'spin' and avoidance of difficult issues is almost completely absent.

Politics

There has been criticism of Russia for an apparent move away from democracy over recent years.

Yet before and since his inauguration, President Medvedev has shown himself committed to steady and progressive democratisation and to the rule of law. In his first Address to the Duma in November 2008 he commented "Our goal is a just society of free people. We know that Russia will be a prosperous democratic country. It will be strong and at the same time comfortable for living; the best country for the most talented, demanding, self-reliant and critically minded citizens. Our goals are unchangeable. Dramatic fluctuations of the political and economic environment, the turbulence of the world economy, and even the military and political tension that is being stirred up will not be an excuse for us to disassemble democratic institutions or to nationalise industry and finance. Political freedoms of citizens and private property are inviolable."

One principal reason for international criticism on democracy in Russia has been that, despite that members of the Duma (the Russian Parliament) and the President are elected, the Russian voter has a relatively limited choice of where to cast his or her vote because of the political dominance of the United Russia party. It should be understood though that the dominance of United Russia comes because, at this stage of Russia's development, its prospectus appeals to most Russians and because at least to mid 2008 it had been almost unequivocally successful in performing against created expectations. It advocates pride in country, support of Russia's interests internationally, pride in Russia's cultural heritage and a rapidly developing economy for the increased well being of the whole population.

United Russia's dominant mandate would be sinister if it were to have been undemocratically obtained, or were to be misused or perpetuated through unconstitutional means. There is some evidence

of abuses in each of these areas – which provides a further source of criticism of Russia's democracy – but not, in reality, to anywhere near a sufficient extent to undermine the fact that Prime Minister Putin and the party which he has led since standing down as President is strongly supported and that the candidate for President endorsed by Putin ahead of the March 2008 elections, received 70 per cent of the vote with a 69 per cent turn out.

The likelihood is that, as the aspirations of United Russia are progressively realised, as standards of living in Russia increase and Russia becomes more involved in international affairs, the many disparate factions and interest groups united at present within United Russia by its prospectus, by power and by its performance in power will fragment and a multi party system will develop. President Medvedev is a strong advocate of such development as indeed was Putin when President.

Medvedev also commented before he became President that he saw the future for governance in Russia as a Presidential Republic with a strong executive authority in line with the Constitution. During Putin's presidency the roles were to a significant extent and for practical purposes combined. With the current tandem we see a migration, conscious or otherwise, to a more balanced, potentially better, self checking system with two strong pillars with the presidency as the guarantor of good governance and civil freedoms.

A strong, focused executive certainly now operates under the direction of the Chairman of the Government,

Despite the recent extreme turbulence and change in many areas, there are reasons to remain optimistic

'Seeds of opportunity to give a positive and improved outcome'



RL4 Novosti

**The likelihood
is that
the many
disparate
factions
and interest
groups within
United Russia
will fragment
and a multi
party system
will develop**

Prime Minister Putin. Mischievous commentators have sought to identify points of conflict between the two men – but most senior Russians will tell you that they do not see any at present. Both are focused on dealing with the country's economic challenges and, overarchingly, on steering it towards their shared vision for its future which the Presidential elections showed was also shared by a significant majority of Russians. The disposition of all responsibilities is strictly according to the Constitution.

There is a detectable concern about whether the current economic problems will cause some loss of support for the tandem and for the methodologies of wealth creation in play and there remains dissatisfaction amongst the broad population with the wide disparities of personal wealth created over the past ten years. In this respect Russia seems to echo the feelings of many around the world.

There is also, in the present economic problems, concern about the potential for social unrest and disturbance, particularly in towns which rely on one faltering industry for their livelihoods.

International Affairs

In international affairs, the current position, despite the Georgian conflict, looks more positive to me than it has done for some time.

Russia's senior political leaders have a strong grasp of the need for new and revised international structures in the areas at least of global security, the battle against terrorism and nuclear proliferation as well as new

economic and financial monitoring and regulation. Of course, Russia has, for a number of years disliked the seeming hegemony of the United States in international affairs and senior Russians have talked about the need for recognition of the reality of a multi-polar, diverse, multicultural world. Their advocacy of new international structures can be seen as part of that policy as well as being an acute observation of what is needed to fit today's world. Russia's position is also unlikely to contemplate, at this stage in Russia's development, the ceding of significant sovereignty to any international body. Nevertheless, they have been advocating developments and improvements from before the economic crisis and before it became widely accepted to do so. In fact, they were among the first to raise the issue.

It is important that Russia is fully engaged in the development and adjustment of international structures both because it recognises that current structures must change and because of its importance in the areas of energy supply and the fights against terrorism and nuclear proliferation. For any country to be engaged, it is important that it is a respected, welcomed and trusted member of the international community. For this position to be facilitated, the country's ambitions and motivations must also be clear and must be acceptable internationally. For whichever reasons – shortness of time since the Cold War, historically based suspicion, differing cultures of communication, differing levels of readiness in various constituencies on all sides and not least some genuinely difficult recent international incidents and developments – achieving this basis for Russia's involvement has been problematic. The situation has worsened over the past two or three years.

Any description by a foreigner of the complexity of the Russian attitude towards the rest of the world is likely to be incomplete and to miss subtleties. Common ingredients, however, appear to be as follows: "Our huge country, made up of many states and people, is rich in natural resources, in academic, scientific and technical achievement and in our culture and values which have developed over a thousand years. We are proud and we are self reliant. Having experienced the experiment of communism, we are now developing our country, its politics and its economy for the long term benefit of all Russian people and to be a reliable part of an increasingly interlinked world. It is a long process but we are working through it. The rest of the world persistently misunderstands what we are trying to do for the future of Russia because they do not appreciate the difficulties and complexity and time scales involved. We receive constant criticism from them. They lecture us on concepts of democracy, the market economy and free trade which has no purpose as the concepts are not difficult to understand and we understood their value a long time ago. They have self

'The 2020 Development Strategy aims to make Russia the world's fifth largest economy'



evidently not yet understood that there are now no ideological differences between us. What we need is practical assistance with our challenges. We also see that those countries which embrace democracy and the market economy are sometimes able to disregard the finer points of those concepts when nationally expedient. Although predominantly effective and fair we also observe current iterations of those concepts not achieving in reality all they aspire to achieve. We would like to avoid those weaknesses where possible. Amongst the 'West' Cold War attitudes and suspicions seem to linger. We are not and do not wish to be a military threat to anyone, but we do have spheres of interest which we expect to be respected. We consider that international relationships should be conducted with peaceable national self determination with no foreign interference as an inviolable principle. A further principle should be that no state should aim to enhance its national security at the expense of others."

An isolationist or extreme nationalist tendency then builds off of this base that "The rest of the world does not trust us or value us and our input to international affairs. They treat us inappropriately. Our country has supported us in isolation and can do so in the future. We do not need others and they have little to offer other than conceptual lectures. We will protect ourselves and our heritage"

The internationalist tendency with the same starting point of pride in country wants Russia to take what it sees as its rightful place as an influence in the world again. They consider that Russia's voice and opinion needs to be heard to move the world towards accepted multipolarity based on mutual respect and unity against terrorism and nuclear proliferation. The internationalists want Russia to engage and continue to be involved in international affairs, but they want Russia to be clearly respected for what it offers. They see progress as best being made through open and honest communication and statement of interests which gives a proper basis for mutually acceptable solutions to international issues.

Medvedev seems to me always to have been an internationalist and Putin was more strongly so at the beginning of his presidency. The West would do well to assist the internationalists to avoid pushing them towards the isolationist or extreme nationalist tendencies.

International reactions to Russia's intervention in Georgia in August did fuel the isolationist tendency. The predominant immediate international response was to blame only Russia. The Russian leadership appeared shocked that their approach, which they characterise as aimed at restoring justice and fairness and protecting Russian inhabitants in South Ossetia and Abkhazia after an initial aggression by Georgia, was not more accurately reported and better understood in

the West. President Medvedev has gone to considerable lengths to explain it subsequently.

The position was rebalanced during September and October by the harsh realisation that, despite its rapid growth and inherent strength, Russia would not be immune from the consequences of the global economic crisis. Both Medvedev and Foreign Minister Lavrov have expressed themselves hopeful that the new US Administration will enable more positive fully fledged relationships to develop between the two countries.

Russia's separate provenance, its differences and its internal diversity can be a positive influence in international deliberations – if it is respected and welcomed. After recent events, we should be clear that the world has not yet found the perfect market economic model nor indeed has democratic governance reached in its implementation an unimprovable state of development.

Having said that, Russia's presentation of its position, its support of its interests and the way it conducts its business can often look brutal and uncompromising to Western eyes and it can be so. Western negotiators – in business and in international affairs – should always be ready for forthright, straightforward, clearly thought through and well prepared advocacy from their Russian interlocutors. Positive engagement with an understanding of the different cultures of communication should help bring both communication techniques and negotiation methodologies closer together over time. Progress will be made if discussions, no matter how difficult the topics, are carried out in a spirit of mutual respect, according

Russia's separate provenance, its differences and its internal diversity can be a positive influence in international deliberations

'Diversification and modernisation of the economy is a work in progress'



RIA Novosti

For 2009, the Minister of Economic Development is estimating very low growth and the possibility of some shrinkage

to protocol and with an understanding of the realities of current motivations not assumptions based on history.

The economy

Despite rapid progress and development from 2000, there was, by early 2008, a real and observed danger that Russia's economy was overheating. Inflation had grown to 15 per cent with high potential to reach really debilitating levels. Spare productive capacity in the economy existing after the break up of the Soviet Union had helped facilitate and sustain growth levels but a paucity of investment in the last two or three decades of the twentieth century, along with potentially more worrying long term human resource issues, was beginning to reveal its consequence in bottlenecks. Russia's country infrastructure, its manufacturing base as well as its human resources were under increasingly severe demand pressure. As an example, salary inflation in late 2007 and early 2008 had reached around 35 per cent with real wage increases significantly outpacing productivity gains.

Myriad opportunities within the fast expanding economy had resulted in huge growth in the internal demand for funding for working capital and for investment and acquisitions. Russia's own banking system and internal capital market, although under rapid development were not large, consolidated or sophisticated enough to meet the funding demand. The Finance Ministry, originally concerned at economic complacency, but by late 2007 mindful of the dangers of economic overheating, had kept most of the liquidity from high oil prices out of the economy through the mechanism of the Stabilisation Fund. Russia's relative political stability, low sovereign debt, quickly accumulated Foreign Exchange Reserves

and Stabilisation Fund, significant oil and gas reserves and a consequentially strengthening Rouble had quickly made it a comparatively attractive destination for international financial institutions to lend into as other economies around the world faltered through rising cost bases.

Now GDP growth for 2008, forecast originally to be in excess of eight per cent, is expected to be at or just below 6 per cent. For 2009, the Minister of Economic Development is now estimating very low growth and contemplating the possibility of some shrinkage. Even this level is to be achieved amidst the current slow-down by stimulating demand through increased salaries of budget-financed institutions and a rise of pensions. Russian stock markets stood at the end of 2008 at some 20-30 per cent of their peaks in May 2008 and the Rouble, though heavily supported out of Foreign Exchange Reserves had fallen in value against a resurgent dollar by approaching 40 per cent.

It is too early for accurate aggregated statistics on company failures, on reductions in work forces and remuneration levels, on curtailment or suspension of investment and acquisition plans but, by report, anecdote and observation, all are happening to differing extents throughout the economy.

The reversal has occurred because the Russian economy, notwithstanding its historical separation, its recent performance and its continuing potential, is connected to other major economies and affected by their health. The connections are many and complex but two stand out as having been important in transferring economic malaise to Russia – the high mid 2008 level of funding into the Russian economy at the micro-level through international capital markets and institutions the withdrawal of which, because of 'sub prime' based problems at the lenders, has sucked liquidity out of the Russian market and, as has always been the case, the price Russian companies receive for Russia's hydrocarbons and other raw materials which is dependent on demand from the world's other significant economies. The fall in prices for Russia's natural resources from reduced demand due to reduced global activity has cut the flow of funds to the Budget from these companies. It has also lessened the notional wealth of the country and is a factor in the downward pressure on the Rouble. These two connecting factors are accompanied by or have caused a loss of confidence, based around Russia's relatively short recent history of stability and the fact that its institution building is necessarily a work in progress as is the diversification and modernisation of its economy and its political systems. The loss of confidence has served further to undermine an already weakening Rouble and to cause Russian stock markets to fall further than is rational. Russian stocks, in particular, look to be oversold.

How Russia and other countries emerge from the

'The Ruble has fallen in value since May 2008 by almost 40 per cent'



Russia's financial reserves give it an ability to cushion the effects of the present reversal and to re-stimulate its own economic development

current economic problems when the bottom is finally reached will depend on their clarity about long term aspirations, the fundamental strengths and weaknesses of their current positions and, absolutely critically, the skills with which the risks and opportunities, the turbulence and global developments, are being assessed and managed.

Russia's financial reserves, established during the last eight years as a result of high oil prices and fiscal-based prudence, if used sensibly give it an ability comparatively to cushion the effects of the present reversal and potentially to re-stimulate its own economic development.

In terms of management, a Crisis Committee has been established by the Prime Minister under the chairmanship of one of Russia's most capable administrators and communicators, First Deputy Prime Minister Shuvalov. It includes the Heads of all key Government ministries and Arkady Dvorkovich, the President's economic adviser. Its task has been to identify how best to use Russia's reserves to protect and then, in due course, to re-energise its economy. It is identifying which banks and institutions and which private as well as public sector enterprises to support directly with funds. Initially, as the global economic problems began to affect the Russian economy severely, the Government sought to push liquidity into the system by providing the banking sector with funds through three key banks. This liquidity did not reach its targets and disappeared in the settlement of foreign positions quickly. It also sought to support the Rouble and to date, has spent over US\$100 billion plus of the country's Foreign Exchange Reserves in that pursuit. Now, since 11th November 2008, it is being allowed to devalue in a managed way against the euro/dollar basket. Using Reserves to support the currency has been a much criticised move, particularly as the weakness has not yet been staunched. Those for a one off devaluation argue that Russia's underlying wealth and terms of trade have changed significantly and a devaluation is necessary to take account of the reality and to restore Russia's competitiveness. A quick decisive devaluation to establish a new effective equilibrium would halt the effects of speculation and the flight to the dollar. Those against consider that the Rouble is oversold against the Dollar, and that equilibrium will be restored as the need for Dollars for settlement is exhausted and as the oil price stabilises at over US\$50 per barrel when global economic activity picks up. They have, in any case, doubts that a decisive devaluation would have had the expected effect.

For the long term, the inherent strength of the Russian economy as a supplier of resources to the world remains as does its potential to modernise and diversify quickly under the natural resources 'umbrella'. These attributes, allied with the desire of its Government to catch-up with the world's most advanced economies in providing

good standards of living for all of its population, give it the opportunity to regain its development momentum comparatively quickly when the massive support packages for liquidity and for economic stimulus around the world begin to produce positive results.

The country's weaknesses largely relate to the stage of development of its post Soviet political and economic systems and of civil society. The development of sophisticated political and governance systems is a work-in-progress with only eight years or so of clear focus invested so far. The complex institutional framework, alongside the 'civilised' political and business behaviours and attitudes which are both the source and the result of such framework, is being built but, because of the time scales involved in such processes, remains necessarily under development.

Russia has relative clarity about its long term economic aspirations. The Presidential Administration and Ministry of Economic Development during the latter stages of President Putin's second term of office, developed a 'Development Strategy through to 2020' to give the sought after clarity of direction to and framework for policy development, macro-economic management and micro-economic progress. A principal aim is to make Russia the fifth largest economy in the world by 2020. The strategy has received some criticism for being a 'throw-back' to the era of the planned economy and for being excessively detailed.

For me, however, the existence of an aspirational macro-economic framework for development, Russia's natural resources wealth, the inventiveness and commitment of its people and its desire to catch up with the leading nations of the world make a powerful combination.

The danger has been that both economic overheating and, if not that, that high hydrocarbon prices take pressure off the country, to achieve its 2020 vision and, in the manner of what has been called the 'Dutch disease', allow a historically high standard of living to be put in place without creating sustainable, invigorated, renewing economic and political environments.

The current reversal allows Russia to take stock of what had been going well and what badly as it made its recent rapid economic progress and where blockages and shortcomings were being revealed – then to use its fundamental strengths to pursue and achieve its long term aspiration of being one of the world's top five economies by 2020 in potentially a more balanced way than it was headed by 2008 by ensuring renewed and redoubled focus on continued diversification, modernisation and productivity and on investment, infrastructure, institutions, innovation and intelligence, the areas President Medvedev identified as critically important to Russia's future in a pre-presidential address to the Krasnoyarsk Economic Forum in February of 2008. **F**