



RUSSIAN-AMERICAN CHAMBER OF COMMERCE®

Российско-Американская Торговая Палата



Special President's Report

Russia's 2003 Business Forecast:

New Conditions, New Rules, New Challenges

Dr. Deborah Anne Palmieri

A most extraordinary thing has happened, with September 11 a year plus in the past, and a brand-new international and U.S. strategic focus on combating terrorism. Russia has repositioned itself in the global landscape as a result of President Putin's brilliant strategy of alignment with the West in the war against terror. Russia has ratcheted up an amazing number of notches, so that the Russian opinion now matters in U.S. circles, where it did not when George W. Bush first came to power. The Russian opinion is listened to, it is heard and these days it is even respected. Cold War acrimony is now a faded memory for the most part.

This means the beginning of a bonanza for the U.S.-Russian business relationship, which can finally benefit from further warming of the already solid friendship between Moscow and Washington. You can expect a steady improvement in U.S. perceptions of the Russian marketplace in the coming year, notwithstanding lingering concerns about corruption, big disputes over some significant investments, mainly in the regions, and economic troubles at home in America. This improved perception will result in a slow-but-steady increase of cash flow into Russia.

What Drives Putin

Putin is driven by a determined sense of restoring Russian national power and respectability. His *persona* is the perfect vehicle by which this goal can be achieved. He is confident, no-nonsense and has made friends with the world's most important leaders. His strategic schmoozing has enabled him to operate successfully on two fronts: internationally and domestically. Internationally, he gets around everywhere, meeting with foreign leaders, building bridges not only to the west, but also to the east and south. His recent visits to China and India demonstrated his desire to guarantee an undeniable Russian anchor in a "multipolar" world; both Presidents Putin and Jiang Zemin vowed to strengthen their strategic partnership. Protocols were signed with both China and India to strengthen economic and political cooperation. Putin has also spawned improved relationships with the G-8 nations, NATO, OECD and others as part of its repositioning strategy.

Domestically, few would dispute Putin's strong public opinion support—he rates consistently high and enjoys the solid support of Russian citizens, despite an often critical domestic press nipping at his heels over an array of daily grievances. With Putin, to gauge his effectiveness, you have to look at results. There is no denying his tangible track record at home and abroad.

Slow, but Steady

Investors can expect slow but steady Russian economic performance in 2003. You would be well advised to look beyond the typical economist's chatter about conventional economic indicators, to look at certain predictors that, in my opinion, will tell you a lot. Mainly, are there signs that Russian productivity is increasing, and, along with that, consumer confidence which allows Russians to want to spend more money, and to obtain that money through real wage growth?

This is the case in Russia's large cities, especially Moscow. Consumers are buying domestic and foreign goods, buying their own homes and fixing them up, despite indications that, by late 2002, Russian economic growth was slowing somewhat compared with the previous year, due to insufficient demand and lack of money.

Russia's strengths include its energy and metals sector; its space and satellite industry; its nuclear industry and conventional arms production. New growth sectors include information technology (IT) and information services that tap into Russia's advanced knowledge of hardware and software. There is presently a favorable situation for Russia due to the export demand for raw materials, fuel and energy. As a result of the U.S. desire to diversify from a reliance on Middle Eastern sources of oil, there is a surge of cooperation to facilitate U.S. access to Russian oil. Since it is highly unlikely that the U.S. will wean away from fossil fuels in favor of alternative sources of energy, Russia can expect this need to continue for the foreseeable future. This need is also a major incentive for the U.S. to foster political cooperation with Russia.

Important to note also are the upgrades handed out recently by investment rating agencies such as Standard & Poor's and Moody's, whose more positive ratings have boosted Russia's stature and confidence among global investors.

Also a key indicator of stability and economic health is the fact that Russia continues to service sovereign debt without a hitch, according to schedule, without any new outside borrowings.

Moscow's Theatre Crisis

The hostage drama which broke the evening of October 23 (the night before our Annual Meeting in Moscow) was Russia's version of 9/11. Chechen terrorists orchestrated the surprise attack, which killed 129 hostages, and all of the terrorists, who, after they succumbed to lethal gas, were each shot in the head for good measure by entering Russian special forces.

The commentary on this crisis and its aftermath is well known and will not be covered here. But what I find noteworthy about the whole affair is the use of chemical warfare by the Russians as a tool in the war against terror. It has set a precedent, not gone unnoticed by international terrorists, which has opened a Pandora's box for the use of chemical and biological warfare sooner than most may have expected. It is not that Putin should not have exercised this option, which was likely the best under the circumstances. It is that it will likely call for a fearsome encore by the enemy.

Rewards

Russia is finally beginning to reap tangible rewards as a result of its support of the U.S. war against terrorism. In June 2002, the Bush administration acknowledged Russia as a market economy—a major step needed for Russian accession into the WTO. Bush is also expected to support initiatives to lift Jackson Vanik. The Jackson Vanik Amendment, passed in 1994, was a hostile initiative directed at the Soviet Union, linking trade and emigration policies. It prohibited communist countries for enjoyed normal trade relations. Russia now receives an annual waiver, but wants the legislation permanently rescinded, a move likely to come in 2003.

Friendly Policies

Russia continues to implement a slew of policies favorable to foreign investment. Granted, most are still fresh on the books and have yet to be implemented, and they are still a far reach from Russia's remote areas that operate according to their own minds and unique set of rules, but, nonetheless, it is a start. The new Russian Tax Code, which already introduced the 13% flat personal income tax rate and reduced business taxes from 36% to 24%, also brings to bear a simplified Tax on Small Business Enterprises, to take effect January 1, 2003. This hopes to stimulate small business activity. Other favorable codes, including the Labor Code, the Code of Arbitrary Procedure and the Code of Administrative Offences and Laws Concerning the Turnover of Farmland & the Privatization of State and Municipal Assets were implemented in 2002. Other initiatives were geared toward the much-needed reform of Russia's archaic banking sector.

Golden Boy

Russia's president seems immune to the swirl of controversy that he not infrequently finds himself in the midst of.

The tragic Moscow theater crisis resulted in the death of 129 hostages as a result of the lethal gas fentanyl, a quick-acting anesthetic. Despite all of the controversy over the lack of forethought and preparation by authorities, Putin still commanded overwhelming Russian public support for his actions. He managed to dodge attempts by opponents such as Yabloko [DEBORAH?] to investigate. His friend George W. Bush refused to criticize him, and even sympathized with his plight against the terrorists.

The same tolerant and muted reaction over the circumcision controversy flummoxed many international observers. When a French reporter queried the president, exhausted from a long day of talks at the Russia-European Union Summit in Brussels, about anti-civilian policies in Chechnya, Putin lost control.

“They talk about killing non-Muslims, and if you are a Christian you are in danger. And even if you are an atheist, you are in danger,” he said. “If you decide to become a Muslim—even then you are not safe, because traditional Islam contradicts the conditions and goals that they set.

“But if you are prepared to become the most radical Islamist and prepared to get circumcised, I invite you to Moscow,” Mr. Putin told the reporter. “We have specialists that deal with this problem. I suggest that you do such an operation that nothing grows out of you again.”

After a brief firestorm in the media, without a peep from major Western leaders, who seemed to turn a deaf and even sympathetic ear, the controversy all but faded from the scene.

The Russian Enigma

Privately, Russians are smug about the fact that while they are rising from the ashes, most Western economies are struggling to stay afloat. They are especially smug when it comes to the crisis of American corporate governance, with an abundance of scandals like Enron, MCI Worldcom and more. There is the enigma that, despite the instability of the global economy and the malaise of Western economies, the U.S. included, that Russia by comparison continues to prosper. This is a good sign for Russia, that it is somewhat buffered from these negative influences. I attribute it to the fact that, after all of the prolonged suffering by Russians, experiencing one or another crisis, year after year, they are ready to move on to something better. I also attribute it to the wonder of Russia’s young managerial talent (See Vol. 10, No. 2, 2002 of *The Russian Commerce News*). A new generation of young Russians, educated in Western management skills, has become a major force transforming the Russian economy. They are turning around ailing Russian enterprises and expertly running Russia’s largest companies. Unquestionably, they are playing a major role in Russia’s short- and longer-term recovery. And there is a general sense of enhanced self-confidence that Russians now enjoy, and they are exhibiting greater degrees of entrepreneurship and independence than ever before.

Same Old Problems, and More

There is never a shortage of problems to commiserate about having to do with the Russian business climate. This year, the Chamber devoted a huge amount of time to addressing investor disputes, and abuses from the Russian side pertaining to the investment process, and even alarming instances of outright expropriation of foreign investor shares in projects by hostile means. Many of these cases are still in the pipeline. Some have made progress; others have not been so lucky.

Pressing problems we see that need to be addressed, in no particular order, include the following:

- There is an outdated and corrupt administrative machinery that governs the Russian customs clearing process. It causes delays, costs money and acts as a major disincentive to trade. It requires immediate action and reform by the Russian government.
- The war on terror, while cracking down on alleged terrorists, has also cracked down on the free movement of ordinary people, from both sides. It is harder than ever to enjoy the free flow of people, goods and services between Russia and the U.S. It takes more time to get visas to get through airport security and to get in and around town. Time is money, and frustration levels are high at often random and unnecessary delays. A streamlining of procedures would be a big help, with incentives for commercial activities, such as priority processing of visas related to commercial purposes would be appreciated as a gesture from both governments.

- Speaking of visas, their granting and withholding needs to be by consular offices on both sides in terms of the commercial impacts of their actions. The stunting of the unimpeded travel by legitimate parties between both countries is a major obstacle to trade. This fact has not sunk in yet, despite regular complaints by business people trying to get in and out. Both governments need to have a special, streamlined process to facilitate commercial travel. New security requirements since 9/11 have added to already significant problems and logjams in this area.
- Federal oversight in the regions continues to be a problem for foreign investors. Russia wants money to flow away from Moscow into far-flung regions, but when it does, especially in the area of natural resource extraction, it gets into trouble. The government needs to pay attention to these problems on a case-by-base basis.

Bottom-Line Prognosis

Don't give up, it's getting better—that's my mantra. This year I have encountered more problems that have come across my desk than ever before, some of the worst imaginable investor nightmares, ones that would frighten even the most dogged, experienced old hand.

But I see Russia as a rebirth of growth in a landscape that has been burned down by a sweeping wildfire. The wildfire represents the devastation and decay experienced in the country since 1991 and well before. Now, there are flickers of new growth, new shoots coming up from the ashes. Russia will endure, and will eventually prosper, have no doubt. I expect that 2003 will be a productive and stable year for Russia, and that the political and economic romance with America will continue.