

Russia's return as a global player

RUSSIA HAS REGAINED ECONOMIC POWER AND HAS BEGUN TO EXPAND INTERNATIONALLY. THE OIL AND GAS INDUSTRY, METALS AND TELECOM HAVE TAKEN THE LEAD. FOR THE TIME AFTER THE PARLIAMENTARY AND PRESIDENTIAL ELECTIONS OF 2007 AND 2008, FURTHER COMPANY RESTRUCTURING AND EXPANSION ABROAD IS TO BE EXPECTED. THE WAY THIS WILL BE DONE WILL HAVE A SIGNIFICANT IMPACT ON WHETHER THE WORLD WILL CHEER RUSSIA'S NEW ECONOMIC POWER OR WHETHER ANXIETY AND OPPOSITION WILL RISE.

From transition to crisis

After the collapse of the Soviet Union, the Russian economy underwent a major economic decline at the beginning of the 1990s. Adjusted for inflation, the gross domestic product (GDP) has only in 2006 reached the level of 1991 again (see Chart 1), at least according to official figures which do not (cannot) take the increase in the usefulness of produced goods into consideration. There was an even stronger decrease in investment activity. Inflation rose to over 2500% in 1992 and remained above the 100% mark until 1995. The economy gradually sta-

bilised from 1994 onwards, but public finances were not decisively restructured until 1999. The mix of a loose fiscal policy and a fairly restrictive monetary policy combined with a more or less fixed exchange rate, was becoming increasingly unsustainable. In order to offset low tax receipts – partly a result of the very low oil price at that time – the government financed its activities by issuing government securities. As the yields rose on account of the increasing public debt and because of the Asian crisis, new treasury bills were issued with increasing frequency, promising ever-higher yields. Before the outbreak of the

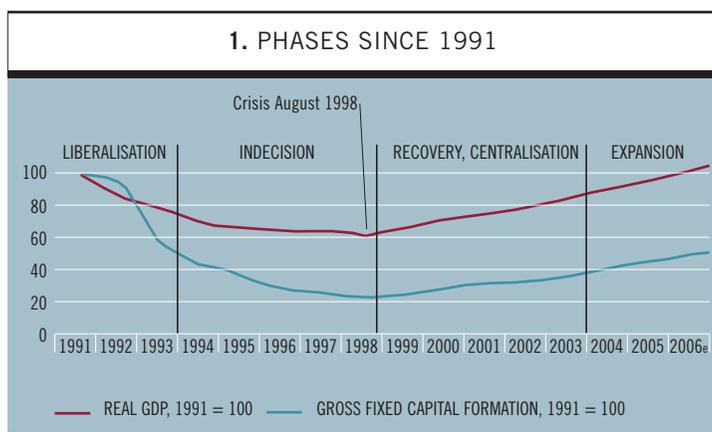
Russian crisis in August 1998, the volume of outstanding treasury bills reached USD 40 billion.

Eventually, the government could no longer issue a sufficient volume of bills to service the debt from the previous issues and suspended all payments. It consequently had to broaden, and then abandon, the rouble's fluctuation band vis à vis the dollar, resulting in a depreciation of the rouble to 21 per 1 USD by the end of 1998 from 6 per at the beginning of the year. The crisis hit the banking system extremely hard. By mid-1999 seven of the 18 major commercial banks were officially bankrupt, while the equity capital of a further eight banks was negative.

From crisis to stabilisation

The 1998 crisis triggered profound changes in Russia's political and economic landscape. Russian history appears to be like a pendulum: revolutions or reforms first weaken the centre and then give way to an authoritative consolidation of central power. In the 20th century the February and October revolutions and Lenin were followed by Stalin. After Khrushchev came Brezhnev. Vladimir Putin led the new swing of the pendulum, this time away from Yeltsin. In this sense Putin can be seen as Yeltsin's Brezhnev.

Thanks to the strengthening of centralised government power under Putin, there was a turnaround in fiscal policy, core of post-crisis stabilisation (see Chart



Source: Rosstat, UniCredit New Europe Research Network

MACROECONOMIC TRENDS

	2005	2006e	2007p	2008p	2009p
Real GDP yoy	6.4%	6.8%	6.2%	6.0%	5.4%
Inflation (CPI) yoy, avg	12.7%	9.7%	9.2%	8.1%	7.2%
Unemployment rate	7.7%	6.9%	6.3%	5.8%	5.2%
Exchange rate / USD, eop	28.8	26.33	25.8	25.0	25.0
Exchange rate / USD, avg	28.3	27.1	26.1	25.4	25.0
Current account balance / GDP	11.0%	9.5%	6.5%	4.6%	3.5%
Budget Balance / GDP	7.5%	7.0%	4.0%	2.0%	1.7%
URALS Price in USD per barrel	50	61	56	54	51

Sources: CBR, Rosstat, International Moscow Bank, UniCredit New Europe Research Network

2). At the same time, the depreciation of the rouble in 1989 led to a marked increase in the foreign trade surplus by curbing imports and stimulating exports. From 2004 on, export growth was helped by the increase in global prices for fuels and metals. Since 2000, both the Federation budget and the general government budget were able to run surpluses. Payment arrears of businesses and the State began declining visibly while bartering disappeared almost completely. The situation returned to normal, with inflation falling from 86% in 1999 to 16% by 2002. Corporate profits recovered, while real incomes grew by approximately 10% each year. Government borrowing declined sharply, while bank lending to businesses and households started to expand rapidly.

Regrouping forces

From 2003-2004 on Russia entered a new phase of econom-

ic development. Bolstered by the recovery in the previous period, Russian big business has begun to focus on mergers and acquisitions not only within Russia, but also cross-border. At the same time, the new period is characterised by intense State involvement in economic activity. Concentrating forces through mergers and acquisitions – to a large extent under the patronage of the State – is a prelude to secure strong positions at home and gain higher presence abroad. Below a number of important examples for domestic restructuring and expansion abroad are listed.

Landmarks in the growing influence of the government are the takeover of Yuganskneftegaz, Yukos' most important oilfield, bought in December 2004 by the mysterious firm "Baikalfinance", which in turn was acquired by the State-owned Rosneft; the State's acquisition of a majority

holding in Gazprom in June 2005; and the takeover by Gazprom of Sibneft in September 2005.

Aircraft industry

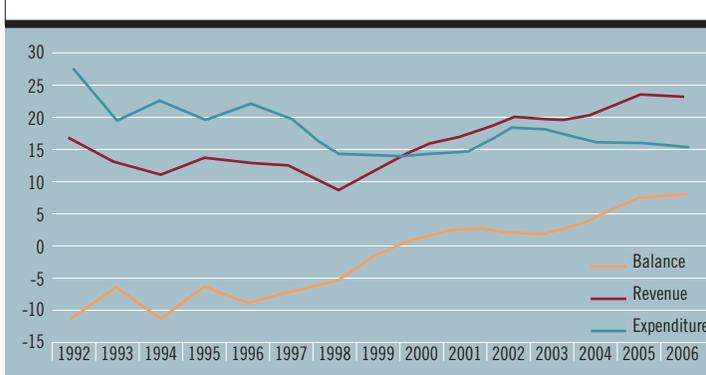
Other important industries, where the State assumes an active role, are the aircraft industry and increasingly the car industry. Upon the initiative of the government, the leading Russian aircraft manufacturers merged in November 2006. The "Unified Aircraft Manufacture Company" (Obedinjonnaja Aviastroitelnaja Korporacija, OAK) will unite the military and civil aircraft manufacturers Tupolev, Ilyushin, Irkut, Sukhoi and MiG. The new company desires to become the world's fifth-largest aviation company by 2013. State-owned Vneshtorgbank (VTB) acquired 6% of EADS shares (the owner of Airbus) in 2006. Although Russia is not likely to achieve a direct influence on EADS's strategy, the cooperation of EADS with the Russian aircraft industry will certainly become closer.

Car industry

To date Russian car businesses have achieved only moderate success and have continuously lost market share to imported vehicles.

The Russian government has now begun to promote setting up of assembly plants for foreign automobiles in Russia. Media report that agreements have already been signed with 15 major global car manufacturers for the joint manufacture of vehicles in Russia, while negotiations with several further companies are in progress. At the same time the Russian State arms exporter Rosoboronexport is "lending" its management to AutoVAZ, the largest carmaker in Russia which produces the Lada.

2. BUDGET OF THE FEDERATION IN % OF GDP



Source: Minfin, UniCredit New Europe Research Network

Metals

Metals is, along with gas and oil, the industry with the strongest drive abroad. After acquiring Rouge Steel of the US and 71% of the Italian Lucchini Group in 2005, SeverStal attempted to merge with Arcelor in 2006. Mittal Steel, which had offered 16.8 bn euro or Arcelor in January, was forced to increase its offer to 26.9 bn euro in June, to prevent a defeat by SeverStal. Now, SeverStal is likely on the lookout for other merger and acquisitions. In November 2006, main Severstal owner, Aleksey Mordashov, floated of 9.1% of SeverStal shares in London for USD 1.06 bn. According to media reports SeverStal might be interested in buying Corus, the Anglo-Dutch steel group, and that it is in negotiations to buy Weirton Steel Corporation of the US from Mittal.

Evrz Group (Roman Abramovich's Millhouse Capital Holding acquired 41% in 2006), one of the largest vertically integrated Russian companies, achieved consent from the US authorities in early 2007 the acquisition of Oregon Steel Mills for USD 2.3bn. Before, it had taken over Highveld Steel & Vanadium of South Africa.

The owners of the Novolipetsk Metallurgical Plant (NLMK) spent USD 805 mn for 50% of Europe's "Steel Invest & Finance", producer of structural steel. Norilsk Nickel bought for USD 408 mn the OM Group and for USD 241 mn the US hydro-power company Plug Power.

Rusal, which makes three-quarters of Russian aluminum and ranks third on the global market, Sual which ranks sixth, and Swiss commodities trader Glencore signed a merger agreement in early October 2006. Rusal will own 66% of the

new firm, Sual 22% and Glencore 12%. The merger created the world's largest aluminum company, overtaking Canadian Alcan and the US Alcoa.

Telecommunications

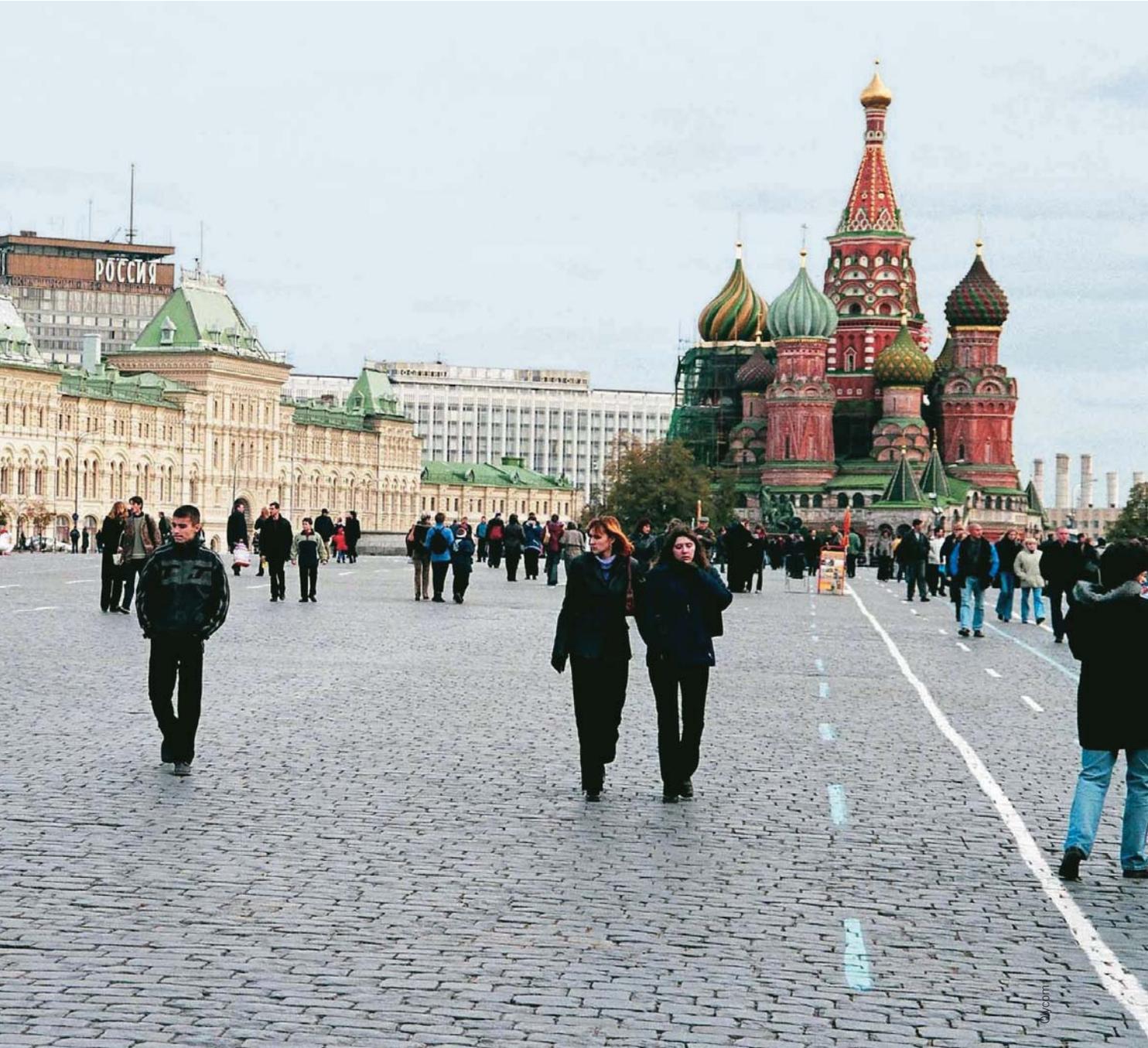
In telecommunications, disputes over domestic restructuring and over expansion abroad are likely to stay a hot topic also in 2007. Companies to publicly express a firm interest in the State's 75% stake in telecoms holding OAO Svyazinvest include AFK Sistema, which acquired the other 25% of Svyazinvest at the end of last year, and Alfa Group. However, the long delayed privatisation might be substituted by merging the company with its subsidiaries, with the government retaining a 42% to 51% stake in the merged business. AFK Sistema launched an IPO in February 2005 on the London Stock Exchange (involving 19% of its share capital), which generated USD 1.56 billion for the company. AFK Sistema has earlier expressed interest in acquiring a stake in Deutsche Telekom, but has said it will only pursue such a deal with the approval of the German government. The latter denied. In 2006, Alpha group spend USD 1.6 bn for a stake in Turkcell Iletisim. Russia's second-largest cell phone company, Vypelcom, bought for USD 436 mn Armenia's major phone and internet operator Armentel in 2005.

Oil and gas

Key area for enhancing the Russian State's role at a domestic and international level is, however, the oil and gas business. Gazprom, in particular, is focusing on strengthening its presence in export markets and



enhancing international cooperation. In Germany, Gazprom is cooperating with E.on-RuhrGas, Europe's third-largest gas company, with RWE, the sixth largest, and with the BASF subsidiary Wintershall, Europe's seventh largest on several projects including the Baltic (now Nord-Stream) pipeline. The cooperation with E.on is all the more significant as E.on wants to take over Spain's Endesa, a move which would put it among the world's leading gas and electricity companies. Gazprom and ENI of Italy, the second largest



European gas company after the Dutch Gasunie, signed an agreement for strategic cooperation already in 1998. This has resulted in the creation of the Blue Stream pipeline running from Russia to Turkey. A new cooperation agreement was announced in late 2006, which is to give Gazprom direct access to the Italian market. ENI will in turn participate in Russian gas production projects. Increasingly also downstream activities are becoming a focus of interest for Russian energy firms. While intensifying its cooperation with

Europe, Russia has initiated diversification towards China and India as well as towards Japan and the US.

In late 2006, Gazprom announced it was paying Shell and its two Japanese partners, Mitsui & Co. and Mitsubishi Corp., USD 7.5 bn to gain a stake of 50% plus one share in Sakhalin-2 oil and gas project. The move came after nearly a year of sustained attacks on the project by Russian regulators over cost overruns and alleged environmental violations. Shell, Mitsui and Mitsubishi will be

required to absorb USD 3.6 bn of the additional costs, however. Shell, which owned 55% of the project, Mitsui and Mitsubishi halved their stakes. Gazprom has now set its eyes on Kovykta, the massive gas field in Eastern Siberia controlled by TNK-BP. Alexei Miller, Gazprom chief executive, met with Victor Vekselberg, TNK-BP's major Russian shareholder, to discuss cooperation between the companies.

Russian oil major Lukoil, which cooperates closely with ConocoPhillips, meanwhile pur-

sues its own international expansion strategy. According to its new long-term strategy, presented in October 2006, Lukoil plans to enter the top ten largest companies in the world by 2016. To achieve this, Lukoil is planning to increase production at a rate of 5.5-6.7% per year to 210 mn tons of oil equivalent and oil processing to 100 mn tons. The company is planning to develop its foreign upstream arm to reach 20% of total assets while foreign downstream part is expected to reach 49% by 2016. Lukoil intends to invest USD 115 bn for the ten-year period relying on own resources as well as borrowing. Next expansion targets include operations in Turkey and possibly in Iran. Lukoil acquired Canadian Nelson Resources for USD 1.2 bn in 2005 with a view Nelson's control of large reserves in Kazakhstan.

Banking

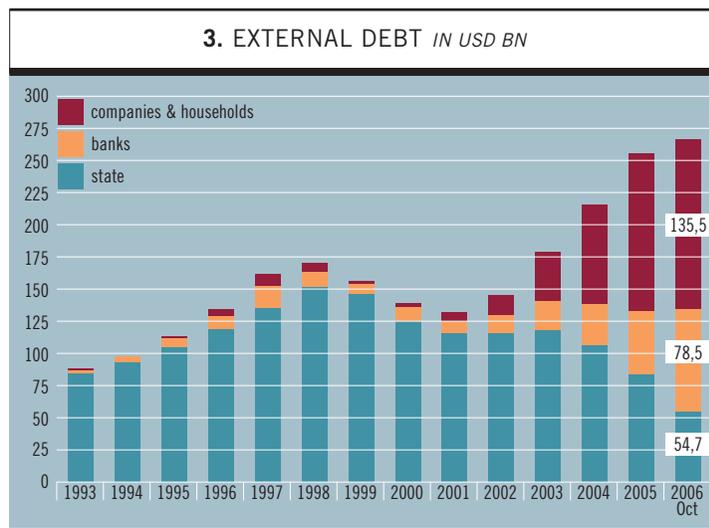
In banking more inward than outward FDI has been observed so far. However, with Russian companies intensifying their activities abroad, banks will follow. Russia's State-owned Vneshtorgbank (VTB), the former State foreign trade bank is taking the lead. VTB acquired the foreign interests of the central bank, including Moscow Narodny Bank (MNB) in London, Ost-West-Handelsbank in Frankfurt, Eurobank in Paris and Donau-Bank AG in Vienna and will merge them into a single unit, which will be called VTB Europe and will be headquartered in London. The VTB Group is one of the fastest growing banks in Russia and is being developed by the State as a second pillar besides Sberbank, which is also publicly owned. VTB plans placing new shares worth RUB 90 – 120 bn (USD

3.5 - 4.6 bn) by May 2007. The issue will dilute the State stake in VTB to 75% plus one share. VTB will use most of the capital increase to boost lending and about one-third to increase the capital of its foreign subsidiaries and for opening new ones in CIS countries. Concurrently, Sberbank's supervisory board has approved an additional issue of 3.5 million shares, at 35% of its total capital. If the issue is fully taken up, Sberbank, Russia's largest bank, would raise at least RUB 230 bn (USD 8.6 bn). But questions remain over whether Sberbank really needs to sell the full 3.5 million shares to strengthen a balance sheet stretched by rapid asset growth.

Foreign funding

As companies enhance their domestic and international positions, they have to raise large sums of money to finance investments and take-overs. In part this is achieved by entering into cooperations with foreign companies. But to the larger part the funds are raised on the local, and especially on the international, capital markets. As a result, the external debt of large companies rises rapidly

and this is likely to continue. After the 1998 crisis, capital inflows to Russia were shifting from the federal government level to the corporate level. The external debt of the corporate sector consequently rose by to USD 136 bn as of October 2006 (see Chart 3) while the State's external debt declined substantially, mainly thanks to early repayments of debt to the Paris Club (official) creditors, made possible by budget surpluses and ample foreign exchange reserves (impressive USD 304 bn as of 1 January 2007). Positive sentiment has enabled an increasing number of Russian companies to be listed on western stock exchanges. Russian companies' initial public offerings rose to an estimated USD 18 bn in 2006 (due to issues in Russia and abroad). Rosneft alone raised a record USD 10.7 bn. IPOs could reach roughly the same amount again in 2007. About one-half will be placed abroad. About 60 companies have announced IPO plans for 2007 so far, among them Sberbank, Vneshtorgbank, Magnitogorsk steel producer MMK, Polimetall and Siberian coal and energy company SUEK.



Source: CBR, UniCredit New Europe Research Network

Russia's drive abroad

The major corporations in the areas of metals, telecommunications but predominantly oil and gas continued to restructure their domestic activities, whilst turning their attention to the outside world. The increased commitment of Russian companies abroad is evident also from looking at foreign direct investment statistics (see Chart 4). In 2006, the outflow of Russian investment was probably slightly higher than the inflow from foreign countries for the first time ever (the figures on both sides are distorted by investments in Russian businesses operating out of Cyprus, Gibraltar and other offshore territories, but the difference is valid).

Russia's drive abroad will become ever stronger in future years. A lot will depend on Russia's social and political development for how this will be perceived by the rest of the world.

In November 2006, Gazprom and Rosneft announced strategic cooperation plans. They include asset swaps and joint development of fields. So far there is no talk of a merger, but it would be in line with the government's policy toward creat-

ing national energy giants. Though both companies are owned by the State, they are seen by many observers as power-bases for rival groups vying for influence in after Putin Russia. The groups are thought to be led by Igor Sechin, Chairman of Rosneft and Deputy Head of the Kremlin administration, and by Deputy Prime Minister and Gazprom Chief Executive Dmitry Medvedev. A merger – already once discussed but not executed – thus might not happen, at least until the 2007 and 2008 parliamentary and presidential elections, and until it has become clear who is in the lead. The struggle for the succession to Putin after his term of office expires in 2008 could influence

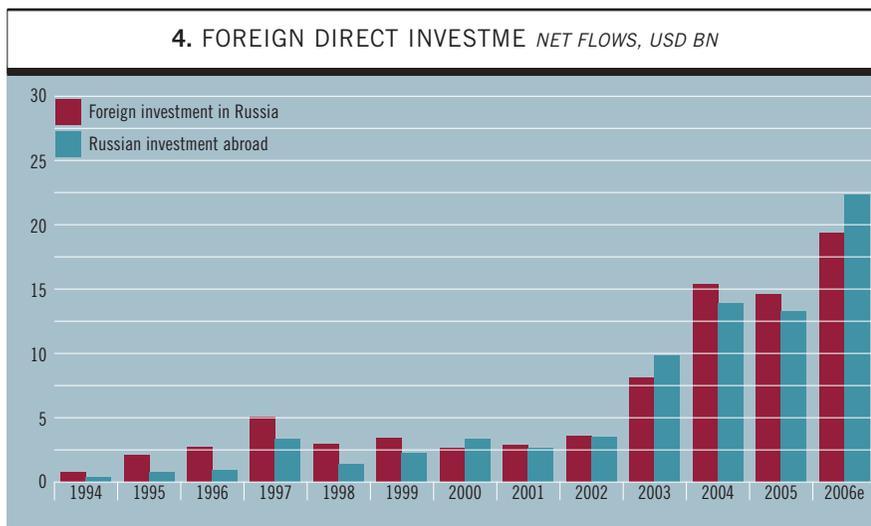
the speed and the extent to what a large energy conglomerate, including possibly also the electricity sector, will be formed. But there is a lot more at stake. If Russia's economic expansion will be based on authoritarian rule and monopolism and have sole aim to earn abroad what can not be earned domestically because poverty restricts the growth of the internal market, the world's anxiety and opposition could grow. But if democracy and market institutions will be strengthened, and the internal market will be developed through increasing welfare for broad slights of the population, the world is likely to appreciate Russia's contributions to global production and welcome Russia's new economic power.

Is Russia Dying? Interview with Judit Shapiro, Professor at the London School of Economics

After a term as Chief of the Transition Economies Section, United Nations Economic Commission for Europe in Geneva, Judith Shapiro was Professor of Health Economics, and academic director

of Moscow's graduate New Economic School, and is at the London School of Economics. Acknowledged as a key pioneer in studies of Russia's mortality crisis, she was the first to hypothesize that the psychosocial stress of the chaotic transition played a major role in the rapid rise in 1990s death rates, against a health background which had long been unsatisfactory.

Let me ask if you agree with this recent assessment by "The Economist": Beneath its petro-rouble prosperity, Russia is not only angry but dying: the population is shrinking by around 750,000 per year, a drop mostly driven by the catastrophic rate of death – by violence, heart disease, tuberculosis and, increasingly, AIDS – among working age men.



Source: CBR, UniCredit New Europe Research Network

The core of the statement is essentially accurate, though necessarily simplified, and I won't quibble here with details. Yes, the Russian population is shrinking dramatically every year, and the major unusual factor is the exceptionally high death rate, that is a low life expectancy. For men life expectancy is still under 60 years of age, or, as I think more revealing, the chances that a 15 year old lad will live to be 60 are still about 50-50.

It is deaths in the prime of life, particularly for men, which mark out the countries of the former Soviet Union from other lands with about the same income per person.

Thus Russia is shrinking remarkably, and yet is not abnormal to have the birth rate Russia is now experiencing. Russia is not well-positioned to do what, say, Italy or Spain can do, to make up for the fact that deaths exceed births by having a positive flow in of migrants. So, if there are not major changes, then by 2050 the UN Population Division projection of a population of 100 million, against today's 142 million, is not wrong.

Why do you say that the picture is necessarily simplified?

This was just a paragraph in a short article, so I would not expect the reader to learn other quite important facts. For example, it is a relief to learn that Russian life expectancy has started rising slowly again, from 2004. If I can tell you the story in a nutshell, Russian life expectancy has not basically risen since Khrushchev was deposed (1964), with a brief few years during Gorbachev's famous anti-alcohol crusade, and this did not last. There was a sharp spike in death rates in 1992-1994 that is with the end of the USSR, a slow

recovery, but then, a few months after the August 1998 default and devaluation, there was a return to the picture of the early 1990s, and even as the economy improved, and poverty rates fell, there was no improvement until recently.

Also, of course, the article cannot be expected to mention that it would be even more accurate to say "Ukraine is dying", but please do tell me every time you spot an article on the Ukrainian mortality crisis. It does not mention the very significant fact that Belarus, which no one accuses of an excess of shock therapy and rush to the wild market, is going through the same processes, with a different tempo.

Do we understand the causes of the high death rates, and the occasional sharp rises?

Partly.

There is a fairly wide consensus about the role of alcohol, especially given the historic pattern of binge drinking. Some experts think this explains half of the excess deaths, some think one-quarter. However, on the question of why drinking rises and falls, there are still differences. Is it because the relative price has fallen against other commodities? Is it because alcohol became all too readily available 24/7? Or was it the stresses which drove people to drink, as a coping mechanism? There is also a fairly wide, related agreement that the stress of a very uncertain transition, and the incredible uncertainties which accompanied it, played a major role. This was my first hypothesis, and it had a remarkable resonance, especially in Russia.

By stress I don't mean hassles. Stress in this technical sense is not, say, the stress of having an article to write, or an annual job evaluation. It is the stress of hav-

ing to meet demands on you in order to survive, and sensing strongly that you don't know what to do to achieve this, or fearing you just don't have the capacity to do it. The rules of the game in Russia changed completely with the fall of the USSR, and then they have kept changing.

You have not mentioned poverty as a factor, but surely the sharp jump in poverty was important?

This is an example of an area where our understanding remains poor, and the assessments of experts, based sometimes on econometric evidence, differ. We do know that the more poorly educated have been the ones bearing the worst burden of increased mortality, but we don't know how much of this is related to income. Since we do know that it has not been children and the elderly suffering, this has suggested to many that it is not mostly poverty.

On the other hand, the fear of poverty, and the constant struggle to avoid it, can be part of the stress and alcohol cycle. You may know that there is a lot of western investigation of the relationship of inequality to health, and Russian inequality really leaped sharply.

Surely the crisis in the health care system has played a role in increased death rates? I read about all the problems from time to time.

No, it is not so clear in fact. The single most telling fact on this which is cited is that death rates from cancer basically did not rise in this period. So it would seem that the rising death rates from deaths due to external causes – accidents, suicides, murders – and to cardiovascular disease (both heart attacks and strokes) are more likely due to

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an increase in incidence, not a decline in treatment standards.

I would say that the typical Russian does not have this view, and does blame the health care system, but that is partly because they still are not oriented to a view about healthier lifestyles. Also, there is kernel of truth: if the health care system had been better, then even if there were a rise in serious accidents, or strokes, more would have survived. Some researchers have estimated the high proportion of avoidable death in Russia today, which improvements in health care would assist.

What about HIV-AIDS? Is Russia going to go the way of Sub-Saharan Africa?

I myself do not think this very likely. When there was quite a flurry of articles about Russia being "too sick to matter" in 2003 and 2004, one American author wrote that it was as if Russia was guilty of "malign neglect" on this front, but I don't think he understood why it was happening. The major transmission belt for HIV was initially

injecting drug users. This new phenomenon for Russia was not handled with anything like our understanding in western Europe. A substantial number of Russians felt that the sooner the drug-user population killed themselves off the better, and if they wanted to share infected needles, why not?

It is absolutely true that if HIV is confined to a drug-injecting population, then our models suggest that it will die out rapidly, as the users will simply die off. The inexorable spread of the infection into the general, indeed into the heterosexual, population, was just not considered. Other country's experience tells us this was going to happen.

It was my view that it was tragic that HIV had been allowed to get a strong foothold, and that it was going to be much more costly in human life and in resources to attack it. However, Russia is a very literate, even scientifically literate, country, with good communications networks. As soon as the government realised that condom use had to be encouraged, that anti-retrovirals had to be available, that education was needed, then after a short interval the situation would improve enough that the acute threat would be removed. That started happening this year, when the government convened its first major conference, and markedly increased the resources going to prevent and treat HIV and AIDS. We will see how long it takes to halt the spread.

Finally, I have read that the government is planning to spend a lot more of this "petrorouble prosperity" on health care. Where do you think it should go? The most important single change in the health care system would be in modernising medical

knowledge, whereas there is instead a tendency to believe that you can do it by going high-tech. It won't be easy to change the way that medical personnel think, but without such changes there just won't be any benefit from new inputs.

A further needed change would be a shift to a more broadly-based sharing out of the prosperity. The rise in population welfare in Eastern Europe has seen shifts in behaviour of the sort needed in Russia. People are starting to wear seatbelts in Poland and Estonia, whereas in Russia it is almost an article of faith not to wear them. They want to live, they are less fatalist. ■