"Statements about direction, supported by consistent behaviour and results can help bring the type of long-term stability, which will aid Russia's continued re-emergence into the world economic community and further encourage positive publicity about progress"

Photo: RosBusinessConsulting

Roger Munnings is Managing Partner of KPMG's Russia/CIS region and Chairman of KPMG's Global Energy and Natural Resources Practice, the role which first took him to Russia in the mid '90s. In mid March, ahead of the Eighth Annual Russian Economic Forum, he talked to the Review about recent developments in Russia and the current business environment in the country

What has surprised you about the last year in Russia? To what extent has what you anticipated one year ago occured?
The apparent lack of clear direction for economic policy following the Presidential elections surprised me – particularly after the economic successes of President Putin's first term.

At the time of last year's interview, just before the elections, I was concerned about two things. Both had the potential to hinder continued economic progress. The first was the possibility of the economy overheating through an excess of liquidity resulting in poor investment decisions and irresponsible lending at the micro-level and debilitating levels of inflation. With a landslide victory forecast for the incumbent president, I was also concerned that overwhelming electoral success might result in complacency, factional infighting or a lack of high-quality challenge in policy formulation in the administration and government.

In the event, GDP growth has continued with around 7.5% expected for this year. There has been moderate to high, but not debilitating, inflation. There have been positive signs of strong economic management – particularly recently with the decision not to lower the rate of VAT and to restrict the use of the Stabilisation Fund. There have also been recent indications that the allocations of property arising out of the privatisations of the '90s will not be reopened.

We have not yet seen however the emergence of the level of clarity on economic direction which would set a firm foundation for the advanced levels of growth in the 'real economy' sought by the administration.

Ironically this lack of clarity has served to take some of the overheating potential out of the economy – along with the vigilance of the Finance Ministry against inflation.

What has caused the lack of clarity?
I am not sure. It could have been complacency due to electoral success or to high oil prices, but I doubt it. It could have been factional infighting within the government or administration.

Another way to look at this second possibility is that there has been a valid debate taking place at the most senior levels about the exact type of economy which will best facilitate economic growth for Russia. By that, I mean which parts of the economy are best left to market forces in the search for growth and efficient use of resources, and which, because of Russia's physical characteristics – geography, climate and natural resources – and economic legacy require government control and intervention to create security of supply and to avoid the sometimes intolerable social tensions inherent in economic transition. This debate, if it has been occurring, will have been a valuable dialectic if it results in clarity and unanimity on direction for the future.

Two powerful sentiments now seem to be present. The first is that, irrespective of international comment or pressures, Russia will seek to determine the type of economy which best suits its aims of rapid economic growth in the particular circumstances with which the country is faced – and that such an economy necessarily needs to be allowed time to develop and mature. The second is that Russia's raw material wealth, particularly its hydrocarbons, are a strategic asset and should be used to create maximum value for the Russian economy. Direct investors in the oil and gas sector, particularly foreign investors, who hope to take profit out of the country, will need to be able to demonstrate clearly how they will generate value for the Russian economy for the profit they earn.

There are three other factors which are likely to have had impact on the speed of policy development since the presidential elections: the terrorist attacks last summer, the reorganisation of the structure of government and the experiences of the Yukos case.

The terrorist attacks – the two airplane explosions and the Beslan tragedy – occurred just as the country was preparing to gear up, following summer holidays. These atrocities would have had a profoundly deflating and depressing effect on the country's morale at any time but their incidence, at the time when economic impetus at the micro-level was picking up, was severe.

At the time of the attacks, the government had, since the election, been involved in a review and reorganisation of its executive structure with the aim of reducing numbers of senior ministers and creating clarity on accountabilities. It is likely that this process had created internal uncertainties about roles as organisational change frequently can do. Such uncertainty may have limited the enthusiasm and the output of the various ministries.

The government reorganisation and the terrorist attacks combined to present an atmosphere of uncertainty to the business world in Russia throughout most of the last three quarters of 2004.

The Yukos case was also with us throughout the year. It has been complex and multi-layered from the start and subsequent turns of events during the year have made it more so. Certainly there are aspects which, to observers outside Russia, are – or appear to be – unfair, politically motivated or even barbaric. The western media has frequently focused on these areas, asking questions about how such events affect the stability of the investment platform within Russia. The layered complexity of the case makes it difficult to understand in its entirety and, therefore, to comment on in a balanced fashion. It has, however, gained the sort of profile internationally that means that questions are asked about it whenever and wherever those connected with Russia are interviewed. It is undeniably affecting perceptions of Russia around the world.

What would you like to see?

On the specifics of the Yukos case, it must follow due legal process and be conducted transparently with a self-evidently fair outcome which is properly and readily communicated. Proper and thorough conduct of the case has been and will be time-consuming – but the quicker it can now be brought to proper conclusion the better.

On economic direction, we would welcome unequivocal general statements or reiterations on what Russia is aiming to achieve for its economy and how – with indications of in which parts of the economy there will be government involvement and why. Confirmation of the government's attitude to foreign financial and direct investment will also be helpful. The upcoming presidential address to the Duma of the Russian Federation on the state of the nation provides an opportunity for such statements to be made and in the past the address has been used for such purpose.

Clear statements about the direction and intention when supported by observable and consistent behaviour and results over time can help bring the type of long-term stability, which will aid Russia's continued re-emergence into the world economic community and further encourage positive publicity about progress. President Putin's first term hinted at such and stability in Russia increased markedly between 2001 and 2004. Clear direction and a track record should also allow progress occasionally to falter and mistakes in implementation sometimes to be made without external observers and commentators drawing the conclusion that economic policy is changing or reverting, that a different faction or interest group has take control or that the economic environment in Russia is inherently unstable.

Nor should Russia be reticent about setting out the way it wants to move its economy forward. It is, after all, its economy and the economic framework is rightly the responsibility of the Russian government.

Internationally, Russia should look for an understanding and acceptance that it aims to define the future shape of its economy to meet the specific circumstances of the country, including the level of control it wishes to exercise over its natural resources. That it should want to control the exploitation of its natural resources should be readily understandable as Russia's hydrocarbons are a strategic asset of global consequence for the country and will be one of the routes by which Russia's continues to re-establish itself as a significant part of the global politico-economic environment.

The current proposals for external involvement in the oil and gas industry are no more onerous than regimes in other countries of the world where hydrocarbons are strategically important and, indeed, current concerns of potential foreign investors in the oil and gas industry are more likely to centre around ultimate security of title and tenure and the need for a stable environment against which to assess project economics than about the fact that Russia wants to retain significant control over its resources.

You talk a lot about the external perception of Russia. Is there a difference, if you are based in the country?

There seems to be – to the extent that many businessmen, Russian and non-Russian, who are based here find that external comment sometimes lacks broad understanding of the environment and penetration of the root causes of issues. There also seems to remain something of a legacy of 'cold war' suspicion and thinking. I am not suggesting that investors should not be vigilant and appropriately diligent. Quite the opposite. Russia is a complex and unusual environment in which to invest. There are, however, many, many foreign investors in Russia, who having assessed opportunities and relationships thoroughly before investing, now have businesses here which are yielding results that are competitive with the best of their operations elsewhere in the world.

External comment also sometimes picks up on statements on issues which have been made by senior participants in political and economic life as part of their setting up a negotiating position or exposing an idea for comment – and reports on them as actually happening.

Being based here, you begin to recognise this tactic and develop an approach which allows continual assessment of as many possible outcomes as can be imagined from the information being presented until the underlying reality becomes absolutely clear.

This is not ideal for the would-be investor who has little experience of Russia. Having clear statements about economic direction would provide some stability for market entrants or others not experienced or well-briefed in this environment.

Is there a danger that the deterioration of Russia's image in the west will lead to long-term underinvestment in Russia's economy? ➔

Russia's image has deteriorated over the last year, but your question is complex and I preface my answer with some observations.

The Russian economy is in the process of modernisation against a background of the constant development of the world's advanced economies. Modernisation is, therefore, a process which cannot stop if Russia is to join the world's leading economies again. It will need to be continuous and will need to accelerate while avoiding the dangers of overheating. What is needed is an economic framework which will stimulate modernisation and efficient use of resources continuously.

Advanced market economies tend to have innovation and continuous efficiency gains built in because market forces tend to drive these outcomes at the microeconomic level.

Russia does have the 'umbrella' of its natural resources – particularly its hydrocarbons – under which to develop the foundations of this type of economy but natural resource production, while bringing wealth and cash flow to the country, will not of itself provide growing economic well-being for the broad population or provide meaningful, value-producing, lives for people. Only a broadly based advanced economy made up of many small, medium, and large companies will have the potential to achieve that outcome.

Creating the circumstances where Russia has an economic framework which will stimulate and drive investment and protect investors is a foundation stone of such a broadly based economy , but the construction of such foundation, the building of investors' confidence in it and the development of an advanced economy on the foundation takes time, commitment and stamina.

It is critical that commentators on Russia have an appreciation of this time requirement and of the fact that, all the while, those who are working to taking the economy forward both at the micro-level and the macro-level have the existing legacy of economic and business systems and structures as well as people's attitudes and memories to deal with. The people responsible for growth at the corporate level and in the country have to achieve progress by continuously both fighting against and building on existing legacies.

Against this complex background, a deterioration of the investment climate over one year – provided it is reversed –- will not lead to long-term underinvestment in Russia's economy.

How can a better understanding of Russia be achieved?

As I have said, it will be helpful in removing uncertainties if Russia makes its ambitions for its economic (and political) systems clear to the international community – notwithstanding that it wants to develop systems which are relevant to and effective in its particular circumstances. My guess is that the increasing nationalism which has developed around the world during recent years has been one factor which has transpired against Russian openness in these areas.

Stability will also be assisted as the international community shows itself sensibly supportive and sensibly challenging of Russia's progress so that continuous dialogue and improved confidence and understanding are facilitated both at government-to-government and business-to-business level. Such positive support does not require a subversion by other countries of their own systems and values. Rather it needs sensitivity to diversity and an understanding of the value of and pride arising from self-determination and also, as I have said, an understanding of the unavoidable time that effective and long lasting change takes.

What positive trends would you identify in the development of Russian companies over the last year?

The Yukos case, whatever its rights and wrongs, has had a positive impact on the way many companies conduct themselves.

Companies now want to be demonstrably beyond challenge and to show that they are good corporate citizens. They have become more transparent and have been keen to ensure that they can show that they are meeting their obligations to the budget. There is also a sense that companies which are profitable – and businessmen who have been successful – should be re-investing in the Russian economy and ensuring that they are taking care of their broader obligations to stakeholders – that they are observing appropriate levels of corporate social responsibility.

In terms of self-generated trends at the micro-level, KPMG sees many positive developments in our interaction with our clients. The leading companies in every industrial sector want to be better at what they do and how they administer their businesses. It can be speculated that businessmen remaining in Russia running their companies are people who are unequivocally committed to the effectiveness and growth of their businesses and to fulfilling the responsibilities of their custodianship. They want to know about and take account of leading developments around the world in their industries and in business administration. Many have aspirations to be significant participants in the global economy and many are making progress towards that ambition through the nature of their products, by acquisition or by becoming listed on the world's major stock exchanges. The trend of Russian companies acquiring businesses or directly investing in businesses around the world is one which we expect to see increasing.

Such developments for these companies are facilitated because they are increasingly efficient in the way in which they generate funds internally but also through increasing access to external sources of capital.

Historically, Russian companies have looked to the capital markets based around London and New York for external capital because of the lack of a sophisticated domestic market. Over recent years a number of companies have made their debut on the London and New York stock exchanges. This trend continues and accelerates. It is now supplemented by a growing and innovative domestic capital market in Russia which makes use of instruments which are designed to meet the specific circumstances of investors and investees. We will certainly hear more about such instruments at the Economic Forum in London from the investment bankers who are developing them.

The risk management and information requirements of external investors drive companies to be able to demonstrate to their investors the effectiveness and speed of their internal control and financial information production systems and to have their auditors opine on their effectiveness in those areas.

The market for the services of an Audit and Advisory business like KPMG is ➔

dominated at the moment in the Audit area by more and more companies wanting to produce financial information using International Financial Reporting Standards ("IFRS") or US GAAP and wanting to have that information audited to international standards using international methodologies. These companies want to have global standards of financial information communication.

In the advisory area, our clients want KPMG to assist them with reporting and control systems improvements, more transparent structures of management and corporate governance and, of course, preparation for and raising capital on international and domestic capital markets.

Which areas should companies focus on when improving their practices?

The most important requirement for a company is to understand how it adds value or, put another way, why its products or services sell. The key challenge then is to keep its offering relevant and to increase the amount of value generated in the production process, including of course, maximising the efficiency with which resources are used.

Effective business administration should provide the operational and strategic information and techniques to enable executives to keep their company's offering at the forefront of the market.

External investors will want to know that not only does the company have an offering which the market needs, wants and will pay for and that the company is capable of varying its offering as market needs change – but also that its business structures are designed to sustain success and to insure against rogue or weak management, fraud and the many day to day risks which can undermine efficient operation.

Well-run companies have systems which support management in their effective conduct of the business by providing fast, focused management information of an operational and financial nature. They also have systems of internal control which enable their boards of directors (who are usually the custodians of the business on behalf of the owners) to be confident that the assets and performance of the business are safeguarded against business risks, bad management or deliberate mismanagement.

If a company wants to be attractive to investors or simply to be regarded as well-run, it must work for continuous improvement in all of these areas.

Being demonstrably good corporate citizens and being cognisant of and responsive to the needs of stakeholders also becomes increasingly significant. Paying appropriate amounts to the Budget and complying with legal and regulatory infrastructures are fundamental. Also important are the way in which employees are treated and given opportunity and the ways in which a company deals with its suppliers and its impact on the environment.

Recently KPMG opened a new office in Yekaterinburg. Is this just one sign of the growing importance of economic development in Russia's regions?

There is a clear market for our offering in the Sverdlovsk region and we were pleased to open in Yekaterinburg and to staff our office with a mixture of first-class professionals trained in our Moscow and international offices and those recruited locally.

Yekaterinburg is the fourth office KPMG has opened in Russia following Moscow, St Peterburg and Nizhniy Novgorod. We are, at present, looking at least another three cities where economic growth is significant.

Russia has some seventeen or eighteen cities of over a million inhabitants, which is not a dissimilar number to Western Europe or North America. We have an office in each city of that size in Western Europe and North America and we expect KPMG to develop in a similar way in Russia. Each of the offices in Western Europe and North America is staffed by predominantly local people and some 95% of the members of KPMG in any country will be nationals of that country. We are almost at that position in Russia, employing close to a thousand Russian people.

Although KPMG is known as one of the Big 4 international firms, it is not accurate to regard us as a foreign investor in Russia and its regions. It has always been our aspiration to be part of the developing economic framework of Russia. We have, therefore, built a strong Russian practice with predominantly Russian clients and Russian people as part of KPMG's global organisation. Our Russian practice uses KPMG's globally developed methodologies in our Audit and Advisory businesses and we aim to bring to bear our international experience to assist Russian companies. We do not, however, take profit out of Russia but reinvest it in the development of our people and our businesses here.

Reinvestment in Russia and representation in Russia's regions is fundamental to our approach and to our sustaining our reputation as the leading business of our type. Russia's economy continues to grow solidly at over seven per cent a year. We find that the demand for our services grows at in excess of 30% per year. We expect the natural resources and Moscow led growth which we have experienced increasingly to spread to other industries and to other economic centres within Russia and our aspirations for KPMG require that we are engaged in and providing services to those industries and economic centres.

You sound confident about KPMG's future in Russia. Are you?

Yes. Provided those guiding the country have economic growth and the generation of an advanced economy as key drivers of economic policy, ideally for the benefit of the broad population.

I would also welcome emphasis being given to the continued development of an effective domestic capital market as part of the economic framework.

At the micro-level, our experience is that the people leading, managing and administering Russian businesses are as capable as those anywhere else in the world – and sometimes more innovative – so provided the macro-economic framework is conducive to growth while being strongly managed against debilitating inflation or deflation, the Russian economy should continue to make strong progress – with a consequent increasing demand for the Advisory and Audit capabilities which KPMG offers.

We also need to be satisfied that we are able to operate our business in line with the underlying values which are important to KPMG worldwide and which underpin our brand. To date, we have had no problem in doing this and we expect to be able to continue to do so. rir