RUSSIA & THE WORLD

FINANCIAL TIMES SPECIAL REPORT | Thursday June 16 2011

Video on FT.com

As leaders gather for the St Petersburg International Economic Forum, Neil Buckley, east Europe editor, looks at Russia's search for a new direction

www.ft.com/ceefocus

www.ft.com/russia-world-2011 | twitter.com/ftreports

Unable to shake off energy dependence

The country is more like a Middle Eastern oil autocracy than a budding European democracy, writes **Charles Clover**

Pumped up: Vladimir Putin, the prime minister, has been keen to give a leading role to state-owned oil groups AFP/Getty

Russia has floated for most of the past decade on a cushion of steadily rising oil revenue, earning about \$1,500bn from oil and gas exports since 2000. Oil revenues alone fund roughly 50 per cent of federal budget revenues and made up 25 per cent of gross domestic product in 2010.

While few would say that having lots of money is a bad thing, it is becoming clear to some of Russia's leaders that dependence on energy exports is actually a hindrance to the country making it into the top league of the world's developed nations.

On the eve of the St Petersburg economic forum, designed to showcase Russia's westernmost aspect, the country increasingly resembles a Middle Eastern oil autocracy more than the budding European democracy that showed so much promise 20 years ago after the fall of the Soviet Union.

Russia has no shortage of leaders who have correctly identified the problem. Alexei Kudrin, finance minister, startled Russian economy watchers with a sobering prediction on April 21 that the era of oil-fuelled growth may be ending, and not just because oil prices may fall from their highs earlier this year.

He said that a further increase in oil prices might even "have a depressive effect" on the Russian economy. A rising oil price, he said, "used to act as an economic stimulus. Now however, this model is exhausted."

The rise in oil prices over the past decade "played a cruel joke on us", he said. To fight inflation, the central bank was forced to strengthen the rouble, which hurt trade in all sectors but oil and gas, further concentrating dependence on energy. "We paid for growth with inflation," he said.

The oil windfall has skewed the economy, pushing up wages without pushing up productivity, and leading to an overvalued currency that has stifled investment and ensured that the other sectors of the economy remain perpetually uncompetitive.

The new mood is a product of the economic crisis. While Russia's GDP doubled in the 10 years before 2009, that year its GDP fell 8 per cent. The causes were not hard to find – energy and commodity prices fell and foreign credit lines dried up. The previously impressive economic growth was shown to be nothing more than the ability to pump oil.

In 2009, President Dmitry Medvedev published a manifesto called "Russia Forward!" in the online newspaper Gazeta.ru, calling his country's dependence on oil "primitive".

But talking about the problem and doing something about it are different things. Two years after the financial crisis started to abate, Russia remains largely unreformed, despite Mr Medvedev's oft-repeated promises.

Increasing investment will be critical to any attempts to modernise the economy. Currently, investment as a proportion of GDP is about 20 per cent, while the average for emerging markets is 30 to 40 per cent (China is 40 per cent). Instead, Russians spend on consumption, and 70 per cent of the federal budget is social spending.

Another reason for lack of domestic investment is low savings rates, which economists say are caused by negative real interest rates. "Russians save when the real interest rate is positive," says Natalia Novikova, senior economist at Citibank Russia. She pointed out that last year, when inflation fell to below interest rates, saving rates climbed sharply, but fell back when inflation picked up.

This spring, the central bank began to raise interest rates for the first time in two years in an effort to fight inflation, but economists are divided on whether the action comes too late and is too slow.

Meanwhile, on March 31, Mr Medvedev outlined 10 reforms designed to raise investment, both domestic and foreign. He targeted the cosy relationships between cabinet ministers and state companies, forcing ministers to step down from the boards of state companies which they have run like fiefdoms for years. These included the powerful Igor Sechin, deputy prime minister and former chairman of Rosneft, the state oil company.

> Russia's oil windfall has hopelessly skewed the economy, pushing up wages without pushing up productivity

But Mr Medvedev's attempts to run economic policy have been stymied by competition between the president's administration and the cabinet, which takes its orders from prime minister Vladimir Putin, Mr Medvedev's former mentor.

Mr Putin stood down from the presidency in 2008 at the end of his constitutional limit of two terms, and all but appointed Mr Medvedev as his successor.

Mr Medvedev is still very much in Mr Putin's debt, say observers, and the two are old friends going back 20 years. However, the difference in their approaches to economics is obvious. Mr Putin increased the state's role in the economy during his eight-year tenure creating a model now called "Kremlin Inc". Mr Medvedev would like to end this. "What worked 10 years ago may not work today. We need to get used to a changing world," he told journalists in April.

Mr Medvedev detects differences between his own approach and that of the prime minister. Mr Putin believes that modernisation is "a calm, gradual movement", Mr Medvedev said at a May 18 press conference in Moscow. "But I think that we have a chance and enough forces to conduct that modernisation faster."

Where possible, the president has been combining the struggle to reform the economy with the fight to broaden his own political power. Over the past few months, this has had some noteworthy successes, weakening rivals such as Mr Sechin, and tackling some of the blatant problems with economic management.

In some ways, Mr Medvedev's strategy is reminiscent of Mikhail Gorbachev, the Soviet leader who, faced with an entrenched communist old guard in the 1980s, identified himself with inevitable economic and political reforms, and used these as a tool to empower himself politically against the Politburo establishment.

The course of reforms is likely to depend on who becomes president in 2012, and this is the most speculated about question in Russian politics.

While many people simply assumed Mr Putin would return to his old job after Medvedev's first term, Mr Medvedev seems to be mounting a convincing campaign for a second term. Most observers, however, believe the two men will work it out among themselves who will stand. This will avoid a prolonged power struggle or even running against each other in the election.

But commentators are split on whether the mystery over who will run is a purposeful tactic, designed to prevent either being seen as a lame duck, or simply that the two men have not hammered out a deal yet.

Mr Medvedev used the first domestic press conference of his three-year old presidential term on May 18 to spin yet more suspense about the decision.

"There is not long left to wait," he said. "Such an announcement is close at hand."

Inside this issue

Improved US ties point to a new era

Foreign relations

Many pitfalls remain, explains **Neil Buckley**

Dmitry Medvedev and Barack Obama chat over hamburgers during a visit to the US last year AFP/Getty

The sight of a relaxed President Dmitry Medvedev chatting over hamburgers with his US counterpart Barack Obama on a visit to the US last year was a sign of just how much relations between the two countries have warmed in the past three years.

A more tangible sign of the improvement since the US "reset" of relations, and Moscow's shift to a more pragmatic foreign policy, was Moscow's abstention at the UN Security Council in March on a motion allowing western intervention in Libya. In days gone by, it might have been expected to exercise its veto.

That was the latest in a series of concrete advances. These have included: the new Start treaty on reducing strategic nuclear weapons; Russian backing for a UN resolution tightening sanctions on Iran; and a deal permitting Nato shipments to Afghanistan across Russian territory.

Cliff Kupchan, a director of Eurasia Group, the political risk consultancy, and a former state department official in the Clinton era, says the turnround in Russian relations is "one of the signature accomplishments of the Obama administration". He says: "If you look at this in the sense of 'Are we better off now than we were three years ago?', there is only one way to answer the question."

Putting the relationship back on a more productive footing was certainly one of the biggest challenges facing Mr Obama when he came to office.

Relations had deteriorated into what some called a "new Cold War" in the final days of the presidencies of Vladimir Putin and George Bush.

The US knew it needed Russian help on crucial issues such as non-proliferation and counter-terrorism, so set out, in the phrase of vice-president Joe Biden, to "hit the reset button".

Dmitry Trenin, director of the Carnegie Moscow Centre, points out that it was helped by the arrival of a new, more youthful president in Russia, perhaps less influenced by Cold War stereotypes. Washington made a point of trying to woo Mr Medvedev.

"Putin isn't in the front office any more," says Mr Trenin. "He sits in the back office and manages the store. The guy in the front office meets the clients and signs things."

For the US, he adds, "We know Putin is somewhere in the back office, but we are not dealing with Putin, we are dealing with the president of Russia."

There are, though, ques-

Continued on Page 2

Russia & the World

Better US ties point to new era

Continued from Page 1

tions over how durable this warming of relations may prove. Russian foreign policy hawks are quick to warn that the reset could be reversed by a future Republican administration.

Sensitive issues still lurk in the background,– above all, expanding Nato to Ukraine and Georgia, right on Russia's borders. Though that question has largely dropped off the agenda since Russia's 2008 conflict with Georgia, it remains a long-term aim of the west.

In addition, the US's planned missile defence system in Europe remains an irritant, despite moves to drop elements that faced the biggest opposition from Moscow.

Grigory Yavlinsky, a liberal Moscow politician and founder of the Yabloko party, suggests relations between the two countries can only really be put on a new footing if they agree to work on building a joint anti-missile system.

"If you can agree on that, you solve all the problems of the US-Russian relationship at once," says Mr Yavlinsky. Though no great admirer of Mr Putin, he notes that this is precisely what Mr Putin offered in the early days of his first presidency when he sought a closer partnership with Washington but was – as Russians see it – rebuffed.

"Looking forward, the challenge is to renew the reset," says Mr Kupchan. "To produce concrete achievements in the economic sphere, on rules of behaviour in Russia's near-abroad, and to make further progress on the arms control agenda, especially on tactical nuclear weapons – these are in many ways tougher issues than those we have already accomplished."

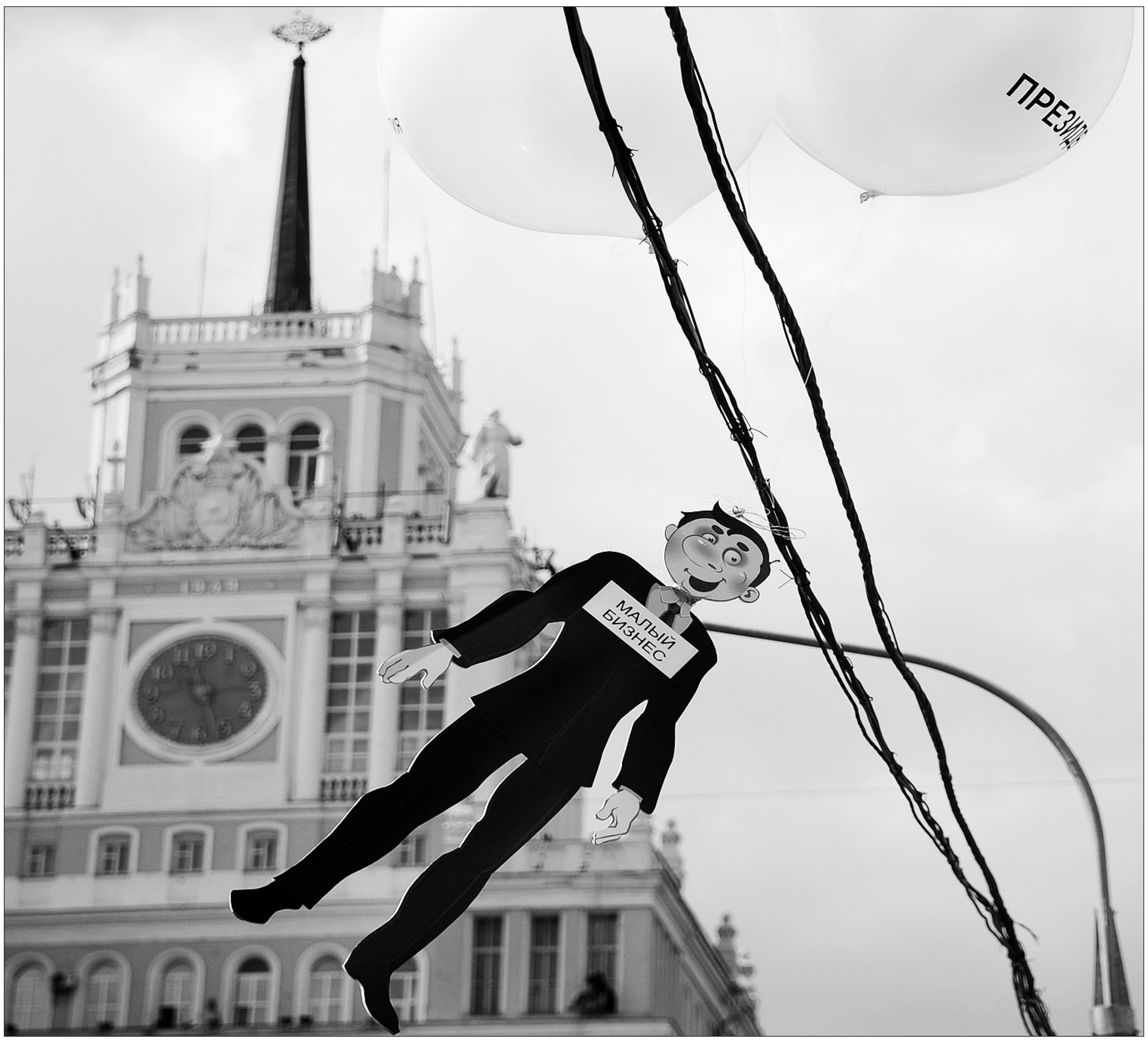
The area where there may be the biggest scope for disappointment on the Russian side is the business relationship. Russia last year recast its foreign policy to be a servant of its biggest domestic policy priority – modernising the economy.

As Mr Medvedev made clear with trips to the Massachusetts Institute of Technology and Silicon Valley during his US visit last year, Russia is in search of US technology and investment.

But here, improved foreign policy relations can only achieve so much. A more constructive US government stance towards Russia is a necessary – but not sufficient – prerequisite for increased US investment flows.

As commentators on both sides note, what is really needed to boost investment from the US and other western countries is improvement in the investment climate and the rule of law, and action to tackle Russia's endemic corruption.

"You can't buy western participation in our modernisation by, say, supporting western sanctions on Iran," says Alexei Pushkov, a professor of foreign relations and television host.



A dummy of a businessman strangled by taxes is seen during a protest against a jump in employees' social taxes that has hurt small businesses AFP/Getty

Slow growth forecast points to stark choice on strategy

Economy

Stagnation is a growing risk, says **Neil Buckley**

Russia, as a recent research note from VTB Capital noted, seems to be described as being at an economic "crossroads" every few years. But the choice between paths it must now make is perhaps the most significant for two decades.

The global financial crisis exposed the weaknesses of the economic model that developed under the presidency of Vladimir Putin – especially the failure to diversify away from natural resources and to develop small businesses.

The less than stellar growth, compared with its counterparts in the Bric nations (Brazil, Russia, India and China) – despite oil being again more than $100 a barrel – is a signal, too, that oil-fuelled expansion is over.

Growth this year is forecast at perhaps 4.5 per cent. That is only just in line with overall global growth, and below China or India – or the level Russia needs to catch up with more advanced economies in any reasonable time frame.

"We're at a bifurcation," says Igor Yurgens, head of the Institute for Contemporary Development, a think-tank that advises President Dmitry Medvedev. "Either we do something to [improve] our 4 per cent GDP growth, or we stagnate."

Another warning signal is the level of inflation, currently running above 9 per cent, and which has rarely been far below 10 per cent in the past 10 years.

Although high fuel and food prices are factors in the inflation rate, the rising prices are also a sign that Russia is running out of spare capacity.

Stimulating consumption – the main economic driver in recent years – no longer results in production growth, but simply drives up prices and imports.

Vladimir Mau, rector of the Academy of National Economy and co-head of a taskforce drawing up economic policy options for Mr Putin, says Russia must shift from a "demand-side to a supply-side approach".

Above all, that means stimulating investment in new capacity and new technologies – which in turn means improving the investment climate.

"Russia is still not very friendly to investors, either domestic or foreign," says Sergei Guriev, rector of Moscow's New Economic School.

An added short-term problem is that the uncertainty over who will be Russia's next president after elections next March is making domestic tycoons even more wary of investing at home than usual. The result is high levels of net capital outflows in recent months.

Both Mr Putin and Mr Medvedev have recognised the need for action to improve the investment climate, though they often seem to differ on the pace and priorities of economic modernisation.

Mr Medvedev, in a speech in the steel town of Magnitogorsk in April, set out a 10-point plan aimed at boosting investment. The step that grabbed headlines was an order that ministers should leave the boards of the state-controlled companies that have come to dominate Russia's economy in the past decade.

> Another warning signal is the level of inflation, running at above 9 per cent

This interconnection of government and state companies was one of the defining features of the Putinist economic system.

However, it created conflicts of interest, as ministers responsible for regulating key economic sectors also played a role in the biggest companies in those sectors.

Several ministers have already stepped down from boards – including Igor Sechin, the deputy prime minister responsible for energy policy, who also chaired Rosneft, the oil group.

The Magnitogorsk plan featured other important steps. These included reversing an increase in social costs for employers, setting up a $10bn direct investment fund to coinvest with foreign investors, and giving the economy ministry power to throw out regulations seen as hindering business activity.

The business community welcomed the package. Many economists, politicians and business leaders, however, warn that the most important way to stimulate investment is to tackle corruption and strengthen the rule of law – and hence safeguards for investors.

Mr Yurgens' Institute of Contemporary Development – whose trustees are chaired by Mr Medvedev – has put forward radical and wide-ranging plans that include moving towards full democracy and separation of executive, legislative and judicial powers.

But it is not clear to what extent these plans are endorsed by Mr Medvedev, or whether, even if he returns to the presidency next year, he would be able to implement them.

Alexei Moiseev, an economist at VTB Bank, suggests much could still be achieved by retargeting economic policy. He says the government should recognise that Russia cannot compete with China in making cheap, basic goods as wages are too high.

So it should stop supporting inefficient manufacturers through subsidies and high import tariffs on certain goods, and use the money to retrain workers and provide subsidised mortgages to improve labour mobility. It should then provide tax breaks and other incentives for "smart" sectors such as higher-technology products.

It should recognise that resource production will continue to be the bedrock of the economy. But it should support development of refineries to produce oil products, and smelters and processing facilities for metals and minerals. A first step would be revising oil taxes that act as a disincentive to investment in difficult environments.

"The choice Russia faces is whether to become a 'developed' supplier of commodities," like Canada, Australia, or Norway, says Mr Moiseev, "or to be constantly 'developing', like many resource exporters from Latin America, Asia or Africa."

Performance disappoints once again

Stock markets

Much-needed reforms have been delayed, writes **Rachel Morarjee**

Russia's stock market saw a storming first quarter, outperforming every other leading market, as turmoil in the Middle East pushed up oil prices.

The stellar performance raised hopes that this would be the year when Russian equities caught up with their peers in the other Bric countries (Brazil, India and China) in attracting foreign investment.

However, performance has become more sluggish and analysts are beginning to ask whether high oil prices are in fact bad for long-term growth in the Russian economy.

"The performance of Russian shares this year reflects the fact that the country is a net beneficiary of Middle East-north Africa instability, the Japanese disaster and the Fed's dollar policy," says Chris Weafer, chief strategist at Moscow-based investment bank Uralsib.

"The country has been blighted with the oil curse, where high revenues from oil have been enough to keep the economy afloat without the government having to tackle reform," he says.

At RBS in London, Imran Ahmad, an emerging markets strategist, concurs: "Oil remains central to the Russia story and the high prices mean we haven't seen the reform needed in the banking sector and elsewhere."

Investors have been quick to cash in on rising commodities prices, but memories of how fast the stock market crashed in 2008 remain fresh. The domestic growth story is not strong enough to bring in foreign money on its own.

Russia is seen as highly exposed to global trends, for both good and ill.

Mr Ahmad elaborates: "After the crisis, the oil price rebounded so quickly that the country wasn't forced to make the reforms it needs. The oil price remains uncertain and domestic growth is lagging and the credit environment will remain a drag on growth."

If one looks beyond the high commodities prices, analysts say, concerns about corporate governance, corruption, the snail's pace of reform, and growing uncertainty about who will win the presidential race in 2012 are beginning to unsettle investors.

Both foreign and domestic investors – as well as the country's consumers – remain wary, because they are uncertain about how the global and domestic economy will develop and are nervously watching the political stage to see how the elections next year play out, analysts say.

"There are concerns that western investors have underestimated the political risk in Russia, and counted too much on a strong Medvedev-Putin axis, when things are in fact more uncertain," says one analyst at a London bank.

"Locals are aware that, despite promises of reform, power and wealth have been consolidated in a few hands in recent years."

During the first quarter of the year, there was $21bn of private capital flight even though the benchmark dollar-denominated RTS stock index performed well – a strong indication that Russian investors are nervous.

Nevertheless, Uralsib's Mr Weafer says there are bright spots in the market, with automotive stocks likely to outperform the broader index, as a string of deals with foreign investors draw new money and expertise into Russia's growing car industry.

"While oil and gas drove the market in the first quarter, we are now in a transition period, and expect to see domestic and infrastructure themes take the lead from early autumn."

Investors should use this period of weakness to build exposure to those sectors that will benefit from the higher-for-longer oil revenues and from the expected infrastructure spending after the March 2012 election, Mr Weafer says.

Dimitri Kryukov, chief investment officer of Moscow-based Verno Capital, says that, with debt

> 'Oil revenues have kept the economy afloat without the government having to tackle reform'

problems weighing down western balance sheets, many Russian stocks still represent good long-term value.

He says: "One case for the Russian market as a faster-growing segment of the global economy still remains intact, which is that it offers faster growth prospects than the Brics as a whole in the short to medium term.

"Debt problems have taken a toll on Europe, while emerging-market balance sheets are healthy, particularly in Russia. Over the long term, it will be strong market but we will see pullbacks like this."

To underpin strength in the Russian market over the long term, investors need to see not just promises of reform but concrete actions. With the political landscape shifting ahead of next year's election, that will not be forthcoming in the next few months.

Mr Weafer comments: "One bright spot is that Russian politicians are now aware of the need for reform, because numerous industrial accidents and the forest fires last summer have shown that the economy will crumble if action is not taken.

"Lip service is no longer enough."

Contributors

Charles Clover
Moscow Bureau Chief

Neil Buckley
Eastern Europe Editor

Courtney Weaver
Moscow Reporter

Leyla Boulton
Main News Integrator

Isabel Gorst
Central Asia Correspondent

Catherine Belton
Moscow Correspondent

Rachel Morarjee
Miriam Elder
FT Contributor

Rohit Jaggi
Commissioning Editor

Steven Bird
Designer

Andy Mears
Picture Editor

Reality check for groups seeking overseas IPOs

Foreign listings

Valuation is the crucial question that would-be issuers need to address, says **Courtney Weaver**

The years leading up to the 2008 global financial crisis saw a succession of Russian issuers listing on various stock exchanges and each time pocketing $1bn or so in equity.

Today, however, companies that try to tap global capital markets are facing a changed landscape, with unpredictable market conditions, greater due diligence, and – most disappointingly – lower valuations.

Of the 11 Russian companies that have tried to list abroad this year, only five have succeeded.

One, Hydraulic Machines & Systems, a pump-maker, was forced to lower its price range, while two others – real estate developer Etalon and pork and sugar producer Rusagro – priced shares at the bottom of the target range.

Bankers working with Russian companies say there could still be equity issuance from Russia and the Commonwealth of Independent States totalling $10bn to $15bn this year, in line with the $10bn issued by companies last year. However, that is a long way from the $40bn raised in 2007.

However, bankers say that if more Russian issuers are to list successfully, there must be more honest discussions with owners about what investors are likely to be prepared to pay for their companies.

One senior western banker says: "What is lacking is a discussion about initial public offering discounts at pitch, largely because clients don't want to hear about it.

"Russian owners poorly understand the need to provide a discount at IPO," he adds, noting that investors are currently requiring 20-30 per cent discounts for Russia issuers. "You tell someone that their business is worth $4bn – and then you have to tell them that the market will only pay $3bn at IPO."

The resulting conversation is a tense one, explains a second senior banker, especially as it tends to be with the companies' owners, who naturally believe their company deserves a higher valuation more in keeping with its global peers.

Ultimately, he says, there is at least one bank that agrees to try to secure the company a $4bn valuation – and placate the company's owners.

"Try getting up in front of [the oligarch Oleg] Deripaska and telling him his company is not one of the best of the world [and does not deserve a higher valuation than its peers] . . . Deripaska is not going to accept it," the banker says.

"If we are realistic [with valuations], we are not going to win the bid. If we are optimistic we are going to have to have a difficult conversation down the line [when the IPO is pulled]."

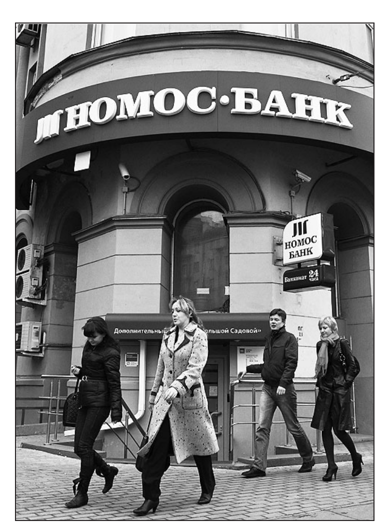
Looking at the offerings that have come to market this year, bankers and analysts are quick to point out that they were all offered at a discount.

Nomos Bank, the country's second-largest private lender, ended up offering shares at a discount to listed peer VTB, allowing the group to fill its book at the middle of the intended range.

Mickael Gibault, head of equity capital markets at Troika Dialog, the Moscow-based investment bank, says that in addition to the valuation of the company in question, there are four factors that determine which Russian groups investors are willing to buy into – and which they are not.

The first is the company's growth potential; the second is how highly leveraged it is; the third is what kind of management it has; and the fourth is global market conditions.

"The market is far from being closed for new issues," he says, "but it is selective."



Banks try to strike right balance

One company that has stood out from its peers is Yandex, Russia's biggest search engine, which completed a $1.3bn offering on New York's Nasdaq exchange in May.

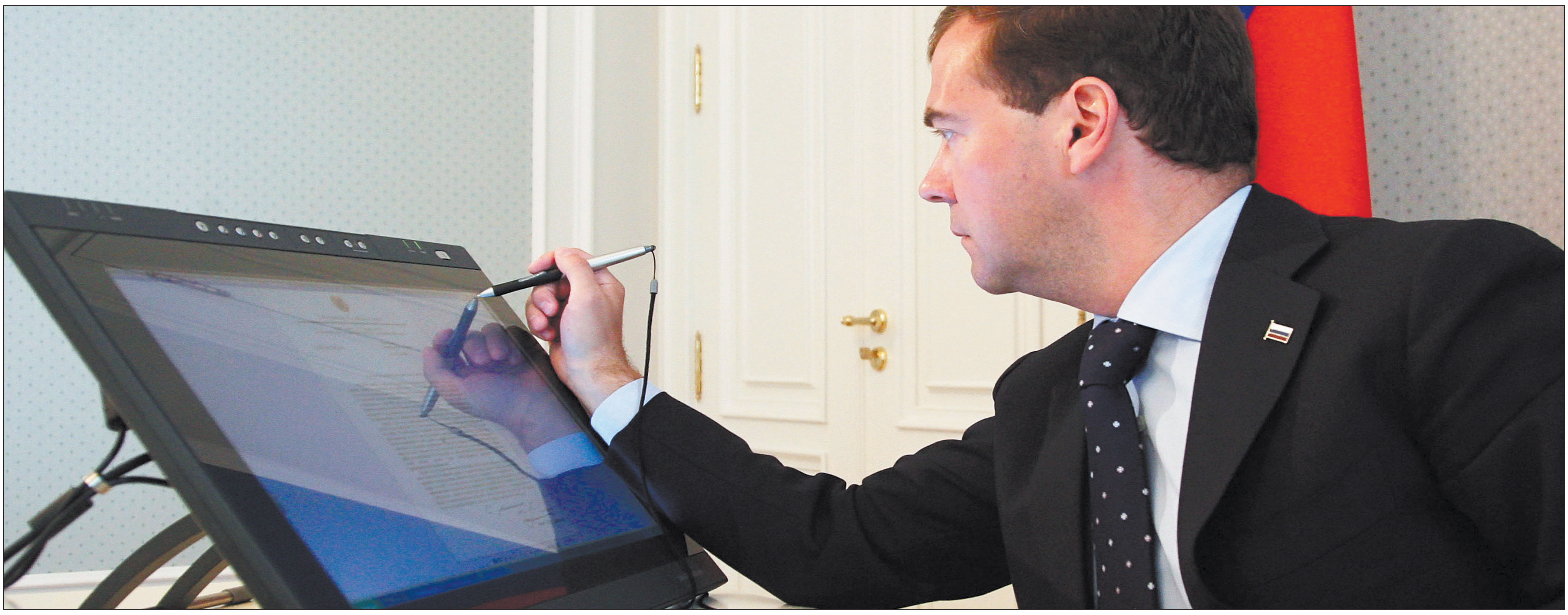
The offering was reported to be 17 times subscribed, and the stock has risen as much as 68 per cent to a high of $42 after listing at $25 a share.

Yet both analysts and those working on offerings are quick to point out that Yandex has benefited from the global demand for internet stocks and should not be regarded as a barometer for the Russian market.

"It's easy for companies to use Yandex as a reference, but you always have the one company [that makes it] . . . You cannot use that as a benchmark," says a senior banker.

The rest of the companies attempting to come to market this year – a line-up that includes a port operator, a potash producer and the country's biggest bank – will face a more sceptical group of investors, who have bought into Russian offerings in the past only to see the shares sputter.

And bankers are aware of this too. As another senior banker says: "One thing I've learnt is that the market is never stupid."



In touch with tomorrow: President Medvedev is keen to promote the country's high-tech image AFP/Getty

Web becomes valued forum for free speech

Internet

An Arab-style revolt driven by social media is not on the cards, however, reports **Leyla Boulton**

When state television showed a dynamic Vladimir Putin at the wheel of a yellow Lada touring the provinces after devastating forest fires, a fuller picture was to be found on the internet.

Video shot by laughing onlookers and uploaded to the net showed that the prime minister was in fact followed by a motorcade of at least two dozen vehicles, including three spare yellow Ladas in case of a mechanical breakdown.

There are few sectors that better reflect Russia's lopsided development than the internet. The web has grown strongly as a business, drawing on the nation's strengths in maths and science to produce a domestic search engine, Yandex, that describes itself as "better than Google".

Yet the government's efforts to foster a Russian Silicon Valley outside Moscow show how a poor investment climate is letting down that human potential.

Politically, the return to an authoritarian system, in which the government controls television but not newspapers or radio, has turned the internet into a valuable – though incomplete – forum for free speech and discussion.

Like jokes in the Soviet era, the internet takes the sting out of Russian life in the 21st century. Unfettered news and comment about everything that television will not touch includes descriptions of high-level shenanigans and mockery of the ruling tandem of Mr Putin and Dmitry Medvedev, the president.

Mr Medvedev's online nickname of "Captain Obvious" refers to his tendency to say the right thing with little to show for it. A few days after he declared that the release from prison of Mikhail Khodorkovsky would pose "absolutely no danger" to society, the former tycoon was sentenced to a second term in prison in what was widely seen as a politically motivated trial.

"You can go on the internet to vent your frustration and that makes you feel like you've done something, although of course you haven't really changed anything," says Sergey Alexashenko, a 21-year-old student at Georgetown University in the US. He is struck by the idealism of his US peers, compared with the cynicism back home.

Exceptions to such apathy include the Duma intern who was fired after he published details of expense-fiddling and time-wasting by parliamentarians on his blog.

Although internet penetration in Russia is expected to increase from 40 to 70 per cent over the next four years, according to Public Opinion Foundation, a Moscow-based polling agency, online debate is confined to a relatively small proportion of the population.

At one end of the range is the slick website of *Snob* magazine. Blogs by subscribers including oligarchs sit alongside interviews with the likes of Bill Browder, a foreign investor banned from Russia, whose lawyer died in custody while trying to protect his client's assets from a scam involving officials.

At the other extreme, right-wing groups used the internet to organise demonstrations against immigration and corruption in December, and more chillingly, to target specific individuals. Oleg Kashin, a reporter, was savagely beaten in November (and filmed for all to see) after his picture appeared on a far-right website labelled "to be punished".

Given widespread apathy, Maria Lipman, a political analyst at the Carnegie Endowment in Moscow, argues that an Arab-style revolt driven by social media is not on the cards. "I see the mood but not the movement," she says. "People are increasingly angry, but this does not change the overall assumption – that 'there is nothing we can change'. "

The authorities, for their part, are taking no chances.

In an embarrassing episode before its IPO in New York last month, Yandex was forced by the FSB security agency to hand over details of contributors to an anti-corruption website run by Alexei Navalny, a popular blogger and whistleblower. The details found their way to Nashi, a nationalist youth group prone to violent harassing of government critics.

And was the Kremlin involved in a cyber-attack on LiveJournal, a blogging site used by Mr Medvedev, Mr Navalny and the Duma intern?

"Yes and no," says Ilya Ponomarev, head of the Duma's subcommittee for high-tech development, who advises the president on the internet.

He believes the attack was the "initiative of people sponsored by the administration to generate pro-government content in the blogosphere . . . but I don't think they were directly ordered to [attack].

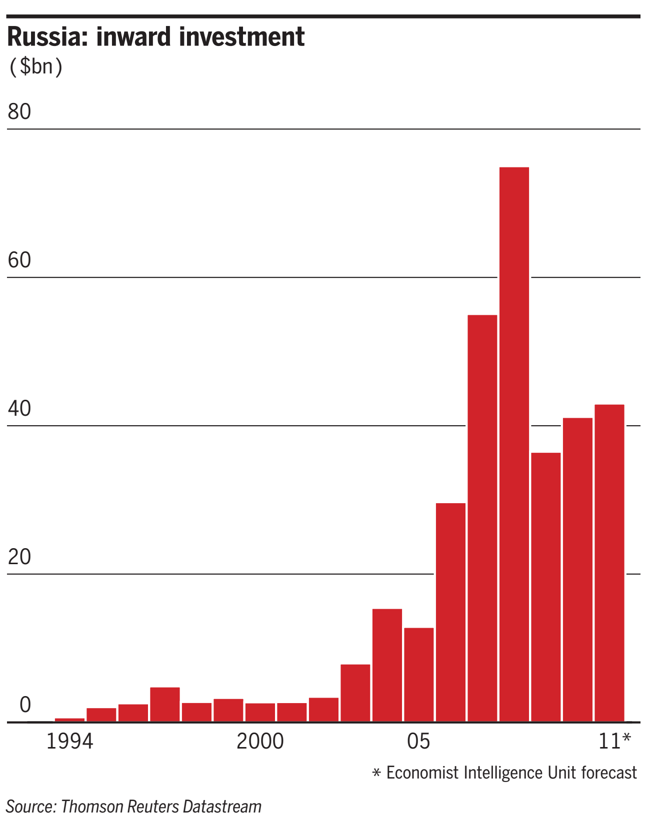
"As this community becomes larger, they invent activities for themselves to prove they are important. The same applies to our nationalist groups. It's a Catch-22. The authorities give them money to gain leverage; they ask for more and go out of control."

But in the absence of "open" politics, says Mr Ponomarev – speaking in a still largely empty mansion housing the president's Institute for Contemporary Development – high-tech remains Russia's most likely engine of progress.

Entrepreneurs live in fear of a government inspector

Inward investment

There are rewards for those who are careful where they put their money, says **Leyla Boulton**



At the height of Stalin's terror, people lived in fear of a knock on the door from the secret police. In modern Russia, the nightmare of foreign investors is a visit from a tax inspector sent by a rival or the state to appropriate their assets.

Horror stories about messy disputes and asset grabs abound in a country whose corruption has grown worse as the political climate has grown colder.

As Lilia Shevtsova put it presciently in *Putin's Russia*, written in 2003, "We see the strengthening of a state that prefers to extend informal rules that constantly change, rather than follow, the law. These are under-the-counter deals which the regime covers up by using the courts and the prosecutor's office."

Yet the rewards are great for companies with the experience, skill and patience to invest in carefully selected areas in Europe's biggest country.

"We have a lack of political competition, and as a result, we lack competition in many economic spheres," says Mikhail Berger, the director-general of United Media, a multimedia group with interests ranging from business to entertainment. "But there are some exceptions, including food, metallurgy, and media that do not cover politics."

After 10 years of operating a joint venture in Russia, Charter International, a British engineering company on the FTSE 250, considered its welding, cutting and automation business as sufficiently "under the radar . . . not like an oil or gas company" to pay $20m for Sychevsky, an electrode manufacturer in the Smolensk region in March.

"We thought about setting up on a greenfield site in Russia, but we found it difficult establishing what the land rights were or getting the utilities to connect at a price that made it economic, so we opted to buy another plant," says Mike Foster, Charter's chief executive.

Selecting the right sector is as important as working with hand-picked partners.

"We look for people with integrity and the ambition to build large and successful businesses," says Elena Ivashentseva, a senior partner at Baring Vostok, which spotted Yandex in 1999 to become the largest investor in the search engine with a 22.6 per cent stake. Along with cash, the private equity firm gave the start-up help in areas such as human resources to help it grow.

Equally important, say some foreign investors, is upholding one's corporate culture in the face of local pressures to do otherwise.

"There can be no doubt on your stance on corruption," says Elizabeth Sullivan, chief operating officer in Russia of UBS, the Swiss bank, whose message is targeted at both external parties and employees. "You have to keep saying 'we don't pay bribes' and lead by example if necessary."

This was a lesson learnt too late by Ikea, when the Swedish retailer was forced last year to dismiss two of its top managers in Russia for paying bribes to secure electricity supplies to a St Petersburg mall.

> 'They've got the consumer market and the human capital but lack the bit in the middle'

More spectacularly, BP, the British energy group, discovered the perils of relying on a nod from one of the government's most powerful officials to secure its deal with state-controlled Rosneft to explore for Arctic oil reserves.

This came unstuck after objections from AAR, the Russian partners in the TNK-BP joint venture.

"What due diligence was that?" asks one western banker, who declined to be named. "If it had been the other way round, and Rosneft and AAR had done a deal, there would have been howls of protest [at injustice being done to BP]."

The state is trying to rectify negative perceptions with initiatives such as the launch of a $10bn private equity fund, and attempts to create a Russian Silicon Valley at Skolkovo business park outside Moscow.

Although Ms Ivashentseva says "any attention to the [high-tech] sector is welcome", others are sceptical.

"They've got the consumer market, and they've got the human capital, but they lack the bit in the middle, which is the business infrastructure, including stock options and an absence of fear, that start-ups need," says one entrepreneur with long experience of Russia.

Ilya Ponomarev, a parliamentarian and government adviser, explains that the Skolkovo project is less ambitious than the Silicon Valley analogy suggests – to create a university with the support of an international institution such as Massachusetts Institute of Technology, and to provide tax breaks for start-ups certified by an irreproachable international panel including the likes of Eric Schmidt, Google's executive chairman.

In the interim, however, Russia is the biggest loser from the poor investment climate.

Yevgeny Yasin, a former economics minister who was one of the architects of the transition to a market economy in the 1990s, says the country faces a choice.

"One path is *tormozhenie* [a braking process], an attempt to modernise from above, with projects such as Skolkovo, but which avoids [structural] reform as politically risky," says Prof Yasin, now at Moscow's Higher School of Economics.

"The other is modernisation from below, where business drives growth, investing and insisting on its rights."

Russia & the World

Romanticised city of cultural icons has a lot to live up to

St Petersburg

Its ambition is to be the voice of the new Russia, says **Miriam Elder**

Svetlana Kryuchkova settles into a small table at the Stray Dog Cellar, a subterranean café off St Petersburg's Arts Square.

"Look at these walls: the heavy brick, imagine what they have seen," she says.

Her voice, deep, with an actress's trained heft, fills with reverence as she lists the names of the poets who made the café legendary nearly 100 years ago: Anna Akhmatova, Osip Mandelstam, Alexander Blok, Sergei Yesenin.

After building a 35-year-stage and film career that has made her one of Russia's most revered actresses, Ms Kryuchkova, 61, has turned to enshrining the country's rich cultural history.

"The generation that lived in those times – near these great poets and artists – is leaving us," she says.

Her response is to take steps to make sure they never really die. She does this by publicly reading and recording the poems of Akhmatova and her contemporaries for generations to come.

Culture lives on in any great city, but there are a select few that continue to draw, century after century, those hoping to become the next voice of their generation.

In Russia, that role has long fallen to St Petersburg, a city that inspires a feeling close to reverence in lovers of Russian culture.

It often feels as though Russia's greatest gifts have simply sprung from the city's winding streets and canals, as if creativity were the birthright of the St Petersburg native.

Yet more often than not, those whose names are inextricably tied to the city moved here from elsewhere in Russia – Alexander Pushkin, Fyodor Dostoevsky, Nikolai Gogol.

"It's a city for peripheral people," says Yury Shevchuk, Russia's biggest rock star. Born in the far eastern port of Magadan and raised in the Bashkir city of Ufa, Mr Shevchuk was already a well-known underground personality as lead singer of rock band DDT when he moved to St Petersburg (always called Piter by its inhabitants) in 1985. "Moscow was too smooth. Piter – its clubs, its scene didn't accept me," says Mr Shevchuk. "So I walked around the city – I learnt it, I lived it, its architecture and museums."

The greatness of St Petersburg's past weighs on those who have chosen to become part of its present, filling them with the sense that they must live up to what has come before.

"The first thing I did was get a membership card to the library on Nevsky," says Mr Shevchuk. "If you want to write poems and songs here, you need to learn its culture."

Mr Shevchuk, now 54, still lives in the city and is about to launch a countrywide tour with a newly reformed DDT. His star has risen in the past few years, as he has grown into one of the most outspoken opponents of Vladimir Putin, the prime minister.

'In your 20s, you're hungry and you sit at the table and feed. When you're older, you give back'

Yury Shevchuk, Rock musician

It is a role that he knows well, having "fed", as he puts it, on the dissident politics of the late 1980s, when St Petersburg was the centre of a passionate counterculture that both helped push forward the collapse of the Soviet Union and enshrined what it felt like.

"In your 20s, you're hungry and you sit at the table and feed," he says. "When you're older, you give back."

Some members of St Petersburg's old guard decry the current state of culture in Russia, and the city does not draw as many great minds as it once did.

The writers currently considered among Russia's best contemporary authors – from Viktor Pelevin to Lyudmila Petrushevskaya – currently live in Moscow, or abroad. Its best popular musicians – from rapper Noize MC to singer Zemfira – prefer to call Moscow home.

One group that continues to see the draw of Russia's northern capital is Voina, the controversial performance art group that moved to St Petersburg last year.

It immediately set to work, winning plaudits both at home and abroad for an audacious stunt that saw the group drawing a huge phallus on a St Petersburg drawbridge, which rose to face the city's FSB (security service) headquarters when the bridge was lifted.

It is a city that is inevitably romanticised by its artistic inhabitants. The homeless and drug-addled are hidden from their view, the corruption is mentioned in passing. People choose to focus on its beauty instead.

Oleg Basiliashvili, the celebrated actor who moved to St Petersburg more than 50 years ago at the age of 22, says: "All of Russia is like a little home – comfortable, a little unpresentable, it smells of pies and mushrooms.

"But St Petersburg is different: it's like a resonant note in this orchestra."

Whether St Petersburg will give birth to the voice that captures today's Russia – as Gogol did in the 19th century, and Alexei Balabanov did with his *Brother* film series in the early 1990s – remains to be seen.

Sochi boosts infrastructure to prepare for the Games

Winter Olympics

Environmentalists worry about the lasting effects on the region, says **Courtney Weaver**

When Sochi won its bid to host the 2014 Winter Olympics four years ago, Alexei Khraban, the city's deputy mayor, likened the night to a new birthday for the city; and so in a sense it was.

Once a Soviet-era resort with little infrastructure, Sochi is now in the process of being transformed into what the Kremlin views as a 21st-century city.

A single road running the length of the city is being replaced with highways, roadways and roundabouts, while high-speed train lines will connect Sochi to neighbouring cities in the Krasnodar region and facilitate transport between the coast and the mountains where the Olympic skiing and snowboarding events will be held.

With fewer than 1,000 days to go before the Games begin, Russia is scrambling to pull off what even the president of the Olympics organising committee concedes is one of the most ambitious projects in the world.

Sceptics will be watching to see whether the country can host the Games on time, on budget and without too much evidence of corruption.

But the legacy of the Games will be just as big a test.

Following the closing ceremony, Russia must prove it can orchestrate an event of that size again with the Fifa World Cup in 2018, and replicate the successful aspects of Sochi's infrastructure overhaul across the entire country.

"There are so many things happening, not only in the region, but on the national level . . . that would never happen if Sochi didn't host the games," says Dmitry Chernyshenko, president and chief executive of Sochi 2014, the Games' organising committee.

"The state leaders consider the big social and sport events as catalysts to accelerate the process of redeveloping the country's environment and the economy," says Mr Chernyshenko. Sochi, he adds, is meant to be a "model city" for Russia.

The task of getting Sochi ready for the Olympics is not a small one. The second-longest urban area in the world after Los Angeles, until recently it had just one road running the length of it, causing traffic jams when trucks transporting construction materials began to clog up the street.

By the end of the year, the committee hopes to complete the partially open Adler ring road, a freeway that will provide an additional route for travelling from the airport to the city centre.

Sochi residents say they are excited about the new road opening but bemoan the traffic conditions they have endured over the past three years, with some complaining that their average commute times have increased from 20 minutes to an hour and a half.

Dmitry Kaptsov, a local resident and vice-co-ordinator for Environmental Watch in the North Caucasus, an advocacy group, says he knows the traffic problem is only temporary, but that he and neighbours worry about what the city will become after the Olympics.

"The traffic problem they'll fix first, because of its effect on the Olympic site," he says. "But all the remaining problems: the trash, the polluted sea, won't be solved. And they won't be resolved, because the cost of fixing them could be as much as the cost of the entire Olympics."

Mr Chernyshenko admits that environmental standards for the project were not at the highest global level, mainly because the standards in Russia had been so low. "We had to create our own standards," he says. Now, thanks to foreign consultants, the situation has much improved, he insists. "Things are really getting better."

Train lines linking Sochi's coast and mountains will provide transport to skiing and snowboarding events Getty

He believes the Games will provide the impetus to raise environmental standards across the country, while simultaneously providing residents with better infrastructure and higher living conditions.

"We are redeveloping the entire region. This is not just infrastructure for the competition. This is roads, power stations, sewage works. It will mean a better living standard for the people who live there," he says.

Meanwhile, the World Cup will extend what is happening at Sochi to the national level, he says. "Thanks to the preparation for the World Cup, high-speed train connections will be built for the majority of cities with 1m people or more. That's the most tangible legacy of the Fifa cup: it will bring our regions closer to each other," he says.

For residents of Sochi, however, it is sometimes hard to believe the legacy of both events will actually be worth it, especially given the number of corruption allegations surrounding construction tenders, and the cost of certain projects.

Alik Le, a local activist, says he has been disappointed by the disregard for people's livelihoods in the course of preparations. He is one of dozens of residents who have been moved from their homes to make way for the Games, and, by his account, not properly compensated.

"The government names its price and you don't have the right to dispute it," he says.

While he wants to believe that the Winter Olympics will provide the type of legacy Mr Chernyshenko describes, he has his doubts. "It is so much money," he says. "And then in a matter of days it is all over."

Old Masters come out of the attic

Auctions

The appetite for Russian art shows no sign of abating, writes **Isabel Gorst**

When Lord Poltimore called and politely withdrew an invitation to a party at the Sotheby's auction house, the MacDougalls took it as a compliment.

"We had become competitors," says William MacDougall, co-founder of the London-based MacDougall's Fine Art Auctions house, a specialist in Russian paintings and art works.

The MacDougalls are a husband and wife team who quit jobs in the City – Moscow-born Catherine was a Gazprom analyst at Kleinwort Benson and William a bond trader at Hill Samuel – for the art business seven years ago.

A minnow among the world's venerable auction houses, MacDougall's has gone head-to-head with Sotheby's, Christie's and Bonhams in one of the most vibrant areas of the art market.

Art collecting became fashionable in Russia in the early 1990s, when the newly rich oligarchs began buying masterpieces of their national heritage that were available at the time for a song.

Prices for Russian paintings have risen by more than 800 per cent in the past two decades – even faster than Russian equities, says Mr MacDougall.

MacDougall's Fine Art has offices in Moscow, but its auction room is in London, the epicentre of the Russian art market.

Specialist art sales are held there by all the main auction houses in the so-called Russia Art Weeks every June and December.

The MacDougalls admit their first auction in 2004 was a "total disaster", but they had a lucky break when someone called from Los Angeles offering to sell a painting by Konstantin Korovin, the Russian Impressionist, that the local branch of a rival auction house had shunned.

"Ballerina in a Green Dress" was part of the collection of Theodore Kosloff, a dancer in the Imperial Russian ballet who emigrated to the US and became a silent movie star. MacDougall's sold the entire collection for £2.5m in 2005, establishing the firm on the London market for Russian art.

Apart from a dip during the financial crisis, MacDougall's earnings have risen steadily since then, reaching £25m last year when it was the largest seller of Russian paintings at specialised London auctions. At least 90 per cent of the bidders at MacDougall's auctions are Russian or Ukrainian and most fly into London from Moscow or Kiev for the sales.

Russian art weeks are society events, but also have a practical purpose, allowing Russian art buyers to bypass rules blocking the export of national treasures from their country. Art works can be taken in and out of Russia legally if they have been bought overseas.

Art collecting was a favourite pursuit of the super-rich in Tsarist times, but after the revolution, the authorities confiscated privately owned works and placed them in state museums. Thousands of icons were burnt and some of the nation's most precious art treasures were sold to repay foreign debt in the 1920s, when the new rulers in the Kremlin were struggling to balance the economy.

The oligarchs, who built their fortunes during the wild early years of post-Soviet capitalism, revived the tradition of collecting, amassing large quantities of mainly Russian art.

Much of the art appearing at London auctions first arrived in the west in the suitcases of émigrés fleeing oppression, or of foreign diplomats serving in Moscow during Soviet times.

Within Russia, art works concealed in attics or KGB vaults for decades began surfacing in the 1990s, as word spread about the surging value of paintings and sculptures largely overlooked in the Soviet era. Many of these have made their way to London auction rooms, enriching their owners beyond their wildest dreams.

Authentication is a serious challenge for auction houses in a market bedevilled by fakes

A troubled history may add value-enhancing poignancy to some art works, but also makes for sketchy provenance.

Authentication is a serious challenge for auction houses striving to uphold their reputations in a market bedevilled by fakes.

"If someone came to you in the west and said they had kept a Goncharova [Natalia Goncharova, the Russian cubist painter] hidden under their bed for 50 years, you would be a bit suspicious. But in Russia, it happens," says Mr MacDougall. Some Russian art buyers have made "bad mistakes," he adds

Peter Aven, president of Alfa-Bank, stopped adding to his huge collection of Russian avant garde art after reports that more fake versions were in circulation than genuine works. Other Russian collectors such as Viktor Vekselberg, the billionaire oil and metals tycoon, have sued auction houses for allegedly selling them forged paintings.

At first, Russian collectors focused on renowned Old Masters. But they are now casting their nets wider, buying contemporary and émigré works unknown in the Soviet era and branching out into European art.

Russians' growing confidence may help the MacDougalls capture more business from traditional auction houses.

They themselves add value, says Mr MacDougall. "Rich Russians no longer need the validity of a brand when buying art.".

Financial reforms slow to reach Moscow

Investment

Efforts to diversify the economy have been blocked, says **Catherine Belton**

As the world's top investment bankers flock to Russia's second capital this weekend for the St Petersburg economic forum, attention will once again focus on Dmitry Medvedev's efforts to transform Moscow into an international financial centre.

The president's initiative is central to efforts to diversify the economy from its dependence on exports of raw materials and to shield it from global market shocks by strengthening the domestic capital market.

Though the drive may still seem quixotic to many investors, the president has in recent months unveiled a series of measures that aim to elevate Russia's standing from a volatile local market widely perceived as plagued by red tape and a mercurial legal system, to a regional financial powerhouse.

Among the first big concrete steps is the merger in February of the country's two main bourses, the RTS and Micex stock exchanges.

This will help centralise capital markets and simplify the structure for investors.

Roman Lokhov, chief executive of Otkritie Securities, the Russian brokerage, says he believes the creation of a centralised clearing house and depositary will follow.

He says the growing appetite among Russian investors for access to sophisticated derivatives means "there is huge potential for the market that is not utilised yet".

Alexander Merzlenko, deputy chief executive of Renaissance Capital, the Moscow investment bank, agrees that the long-awaited merger is now close to being "irreversible", while the government's privatisation drive to sell more than $32bn in state assets over the next three years could also boost domestic capital markets.

While big Russian assets have traditionally headed to the London Stock Exchange to attract deeper, longer-term pools of cash, the government is considering selling big state assets on the local exchange, Mr Merzlenko says.

"One of the [top] priorities is the development of domestic equity markets," he says. "The government is asking investment bankers how to manage the objectives of getting the best price and raising the profile of the company, and also developing financial markets here."

In one potential endorsement of the domestic market, German Gref, chief executive of Sberbank, the country's biggest bank, proposed conducting the selloff of a 7.6 per cent stake in the state-controlled entity via the Micex exchange either this year or next, as part of the privatisation drive.

Improvements must be made to the investment climate and the legal system, though, if Russia is to attract the investments needed to develop into a top ranking capital market.

To this end, Mr Medvedev has unveiled a series of initiatives aimed at empowering minority shareholders and boosting transparency.

There will be little progress without improvements in upholding the rule of law, analysts say

He has ordered the removal of government ministers from the boards of state companies, to start dismantling the system of state capitalism known as Kremlin Inc established under Vladimir Putin.

Mr Medvedev has also called for the adoption of international accounting standards by all companies and for greater disclosure of information to minority shareholders.

Critics say these moves may gain little traction against the entrenched interests of officials. Igor Shuvalov, first deputy prime minister, says government ministers on state company boards are likely to be replaced not by independent directors but by trustees who will vote according to government directives.

"We have a situation where Medvedev is forwarding concrete initiatives but he has no means to implement without the government, which is blocking them," says Alexey Navalny, the corporate governance activist, who recently faced criminal investigation in what some say is a backlash against his activities uncovering corruption at state companies.

Indeed, as long as uncertainty remains over whether Mr Medvedev will lead Russia beyond presidential elections in 2012, or whether Mr Putin will seek to return to the presidency, investors cannot be certain whether the impetus to transform Moscow into an international financial centre will continue.

"The political will is there at the moment and this is very positive. We just need to see if the political will is there over time," says Alexander Branis, head of the corporate governance committee created as part of the Kremlin's international financial centre initiative.

Mr Branis, who is also a fund manager at Prosperity Capital Management, says his committee started work only last December and many proposals are still under discussion.

One of the biggest challenges is deepening the pool of domestic cash available for investing in local capital markets, both by bringing back hundreds of billions of dollars stashed in bank accounts abroad by the country's tycoons, and by embarking on pension reform. This will be impossible without improvements in upholding the rule of law, analysts say.