Dancing with the Bear

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Mother Russia is on the move, she can't stand still, she's restless and she can't find rest, she's talking and she can't stop—Yuri Zhivago

BY MARY D'AMBROSIO

The wish of investors had been granted. Boris Yeltsin was back in the presidency. Part two of this vision: Some $30–60 billion would start flying into Russia—from the bank accounts of Cyprus and Switzerland, from the mattresses of Moscow and St Petersburg, from the great hesitating emerging markets portfolios of London and New York. It was all cash assumed to be eager to crack the Russian markets the moment Yeltsin was returned to power.

The opposite happened.

Investors watched gloomily as cash flows stagnated and the stock market plunged a terrifying 33% in the postelectoral weeks. The central bank intervened in a mounting number of insolvent banks. Yeltsin held a hasty inaugural, as people whispered that his health was failing. The focus veered to the Chechen war, and analysts whipped up new scenarios—in case the president died.

Fickle Russia had tricked its investors once again.

WAITING FOR PARTNERS

"This was the big cliché—waiting for the money to come in," says Dirk Damrau, research chief for Moscow-based Renaissance Capital. Alexandre Babian, strategist for the Russian consulting firm Centre Invest, predicts that only about $1 billion will enter the Russian markets during the rest of 1996. "Just because Russia is one-sixth of the world territory doesn't mean it will get one-sixth of emerging markets money," he says.

Investing in Russia can still feel like dancing with an exciting but unpredictable partner. Eight quick sidesteps to cope with new rules. Retroactive taxes to send you spinning. But investor behavior has been just as hard to gauge. "We've seen extremely high levels of volatility in the Russian markets," ING Barings East Europe analyst Philip Poole points out. He calls the tiny $19 billion stock market—the same size as the Czech Republic's—one of the most volatile in the world.

Would-be foreign investors in Russia seem to be mostly thinking it over, according to a survey made by Pennsylvania-based AUS Consultants last February. Of 174 Western portfolio managers surveyed, 41% said they were "somewhat" to "very" interested in making investments in Russia. But only 27% had tried it. Interest was greatest from the United States (57%) and France (52%), but just 19% of the US managers had put down money, and a handful of the French (8%). UK portfolio managers were by far the most experienced (40%), but only 33% were enthusiastic. Not a single German was interested.

And yet, Russia is bursting with capitalist intent, and thirsting for money in quantities that can only be met by the West. The demand for cash—combined with Yeltsin's free-market stance—is bound to make Russia a more graceful partner one day.

Moscow is thriving, enjoying a real estate boom that has meant new offices, restaurants, shops. ADRs are being prepared, including one for giant gas monopoly Gazprom. Securities laws are improving. With the help of Deutsche Bank, the government is about to close an important deal that will revive payments on $32 billion in defaulted foreign debt, returning Russia to international creditworthiness; its first eurobond, being prepared by J.P. Morgan and SBC Warburg, will bring Russia its first sovereign debt ratings.

Russia has vast natural resources, and unlike most emerging markets, excellent infrastructure. In five years, "there's going to be an explosion," Babian predicts. "This is virgin land."

Promisingly, Yeltsin has chosen a team of smart reformists to run the economy: Viktor Chernomyrdin as prime minister (and potential Yeltsin successor), respected Anatoly Chubais back as chief of staff, reliable Sergei Dubinin appointed to a four-year term at the central bank, and ex-economic adviser Alexander Livshits as finance minister. The government is likely to put forth economic policies Western investors like.

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Far from talking doom, many financiers and economists think the foundations are in place for Russia to become a booming market within a decade. By August the Russian stock market had rebounded, and modest amounts of incoming cash were sighted. Says Salomon Brothers Moscow managing director James Dannis: "We've seen tanks firing on the [Russian] White House. We've seen Yeltsin with approval ratings of 8%. [Yegor] Gaidar was fired: end of the world. [Anatoly] Chubais was fired: end of the world. We've seen too many ends of the world to believe in the end of the world."

ACHING TO GROW

Yeltsin's top challenge is making Russia grow. The country has struggled through four miserable years of shrinkage—contracting 14.5% in 1992, 8.7% in 1993, 12.6% in 1994, and 4% last year, according to figures kept by the Moscow-based Russian-European Centre for Economic Policy. As many as one-fourth of Russians live below the poverty line, forgoing basic goods and relying on their backyard gardens to avoid going hungry in winter.

"The Russian economy is like a young woman," says Alfa Bank chairman Leonard Vid. "She knows already what love is, but she doesn't know whom to love."

Russia is still shrinking. Yet key conditions are in place to encourage growth at last. Inflation—an unmanageable 130% last year—is falling steadily and could dip to 20% this year. The once zigzagging ruble has stabilized, at about 5,000 to the dollar. Dubinin is carrying out a prudently tight monetary policy. With the backing of a $10 billion IMF loan, the government is poised to undertake key steps: improving tax collection, cutting the budget deficit, reforming the pension system, and boosting production and exports.

But Russia desperately needs greater investment, too. Industrial production has been plummeting for five years—it is only half what it was in 1990—though some sectors, such as metallurgy and chemicals, are strong. Flight capital must flow back if Russia is to grow powerfully—and the capital of the West must flow in beside it.

CHOOSING A BANK

It's tough. Russian banking isn't collapsing, but it's experiencing a shakeout. Amid general economic crisis, the central bank has intervened in or shut dozens of Russia's approximately 2,500 banks. More shutdowns are likely.

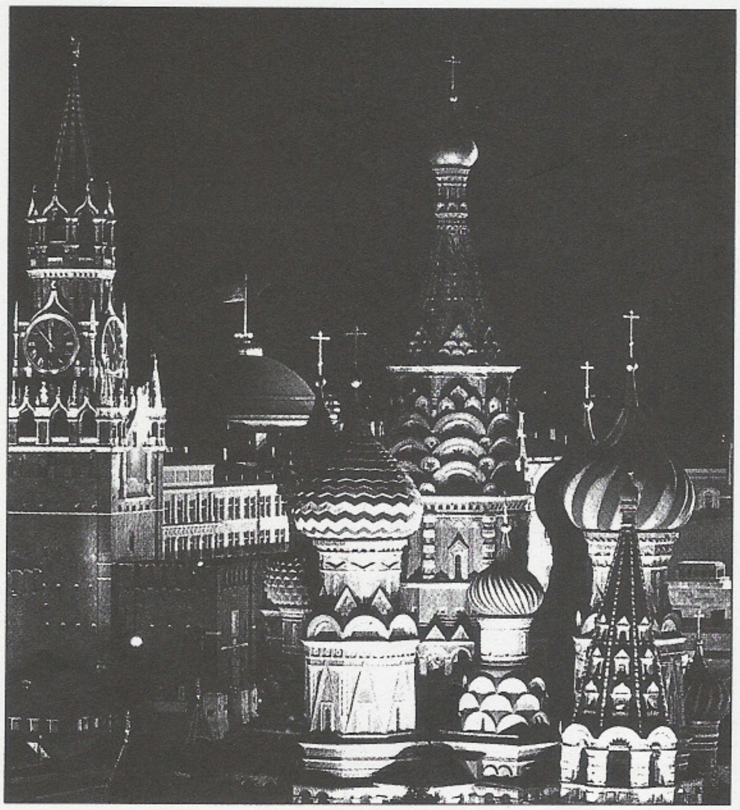
"It's Darwinism," says Vid, who leads a midsize bank that subjects itself to Western-style audits. "Only the strongest will survive."

"It's logical and natural but quite painful," agrees Alexander Zurabov, president of Menatep, one of Russia's most powerful banks. "I wouldn't dare say which banks will survive."

Others consider the whole system in crisis. "I wouldn't minimize it," warns Damrau. Squeezed dry by the dictates of its IMF program, "Russia potentially faces a slow-motion banking-system meltdown, in which large bank after large bank will face consolidation or bailout," he suggested in an analysis earlier this year.

Risky credit policies, heavy nonperforming loan portfolios—some swelled with illiquid real estate holdings and loans to insolvent friends—have made things worse. It didn't help, either, that some banks relied heavily on trading high-yielding Russian GKO bonds. When yields plunged, so did profits. Too, many banks are undercapitalized. "The most difficult question is attracting financial resources to the banks," says Dmitri Lebedev, the central bank's deputy director in St Petersburg.

Investors should look for banks with strong Western relationships and universal banking capabilities, says Alfa's Vid. Alfa, for example, has relationships with more than 80 Western banks and eschews the federal funding upon which some big ex-Soviet banks depend. Alfa does participate in state-led investment programs—lending for nuclear energy development, for example—but uses only its own



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