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Embracing isolation: Russia's new protectionism

Summary

Russia is now more isolated than at any time since Mikhail Gorbachev became General Secretary of the Communist Party of the Soviet Union in 1985. This is a consequence of President Vladimir Putin's response to the Maidan revolution in Ukraine. The western sanctions and Russian counter-measures pose more than just a set of legal questions for trade lawyers to understand. Russia is attempting to reduce its exposure to the west. This means protecting and supporting home-grown Russian enterprises. It also means prioritising trade and investment relationships to the east and south. For western businesses with operations or trading partners in Russia this poses a new set of questions about the merits of doing business there. This Global Counsel Insight note explains the current trends, the risks that these pose and the implications for business.

Russia's economic isolation

Sanctions against Russia have been tightened progressively since March this year. Initially the focus was on entities or persons directly associated with the Russian interventions in Crimea and eastern Ukraine. Since July and the controversy surrounding the crash of the Malaysian airliner the focus has shifted to target sectors of the Russian economy. EU and US financial institutions may no longer buy or sell financial instruments issued by major state-owned banks with a maturity exceeding 90 days. In addition, there is an embargo on arms sales, trade in dual use technologies, and the export of certain energy-related equipment and technology.

The direct impact of this has been significant, particularly for energy firms with large external financing needs, such as Gazprom and Rosneft, with the latter alone reported to have requested around $40bn in financial support from Russia's National Wealth Fund. The indirect impact has, however, been more significant. Most Russian corporates are now effectively shut out of western capital markets. This has contributed to a doubling of capital outflows in the first half of this year and could see some corporates struggle to meet bond redemptions. $228bn of the $653bn in non-rouble debt owed by Russian corporates needs refinancing by the end of 2015. At the same time a number of western firms are lowering their Russian ambitions, with businesses like ExxonMobil winding down its joint exploration project with Rosneft in the Arctic, Schlumberger withdrawing expatriate staff and Carlsberg mothballing some Russian production facilities.

On top of this Russia has imposed its own counter-sanctions in the form of a food embargo on fruit, vegetables, meat, fish, milk and dairy imports from the US, the EU, Australia, Canada and Norway. In 2013 food accounted for 9% of total EU exports to Russia, around $14bn. The impact is already being felt in countries like Denmark where pig farmers are expecting to lose $680m in exports as a result.

Over the longer term the biggest threat to Russia's economic relations with the west may come from efforts by EU countries to reduce their dependence on Russia for fuel imports, which in 2013 accounted for 78% of total imports from Russia. These efforts include finding new sources of supply, particularly from LNG imports and through the Southern Gas Corridor from Turkey and Central Asia. Member states that rely heavily on Russian gas are examining alternative fuels, such as domestic coal supplies. The Commission is promoting infrastructure projects, including investments in interconnectors and storage capacity.

Many of the steps are incremental, but could over time amount to a significant upgrading of European resilience to energy supply disruption. They have the potential to weaken Russian leverage in negotiations over gas prices, just as oil prices are declining. The real game changer, however, could be the 'Energy Union', which has been identified as one of five strategic priorities for the new European Commission. While currently underdeveloped, the more ambitious visions for it would see member states leveraging their aggregate economic weight in collective negotiations with third country energy suppliers – a concept strongly endorsed by the next Council President Donald Tusk, and incoming Commission Vice-President for Energy Union Maroš Šefčovič.

Russia's new protectionism

How is Russia responding to this new environment? One part of the response is to open up new channels for trade and finance, particularly with China. The $400bn gas supply deal signed in May showed Russia's intent. This was followed by Gazprom securing a dual-listing on the Singapore stock exchange in June, with Sberbank seeking to follow suit and Lukoil announcing preparations for a possible SPO in Hong Kong in 2015. Gazprombank and Promsvyazbank are applying for Hong Kong banking licences. A delegation led by First Deputy Prime Minister Igor Shuvalov visited key Chinese business hubs in September, followed by Chinese Premier Li Keqiang's official visit to Moscow in October. This month Putin also called for non-dollar denominated energy trade with Asia to be boosted. The volume of renminbi traded in Moscow during the last 12 months has increased nine-fold although it is still a tiny fraction – about 1% - of its US dollar or euro trade. Both government officials and market experts agree, however, that Russia's own 'pivot' to China will take a generation to achieve. It is a long-term project and one where the rhetoric is running ahead of the reality.

President Putin's instinctive response to western sanctions has been to embrace them. The food embargo is a case in point. This is not just a political 'tit-for-tat' measure, even though it is deliberately designed to punish producers in neighbouring states that have been the most hawkish in the EU on Russia. It is in part also being justified in Russia as an opportunity to boost domestic agriculture through import substitution.

What does the embrace of isolation look like in policy terms and how does it differ from old-style protectionism? Policymakers are being creative in finding new ways to protect industries and interests that comply with the letter, if not the spirit of their obligations. Recent policy announcements show both how the Russian government is and will continue to do this and the extent of their determination to pursue this path.

Sector	New measure
All	Formal accreditation for professional activity required
IT	All personal data to be stored on servers or "clouds" in Russia
Food	Sanitary breaches at over 200 McDonald's outlets are being investigated
Media	Foreign ownership of media firms is to be limited to 20%
Financial services	VISA and MasterCard will have to pay huge security deposits to operate

Table 1: New isolationist measures in 2014 targeted at foreign companies

Working in tandem with these measures to hinder western businesses operating in Russia has been a concerted attempt to boost Russian businesses using a combination of policy tools and bail-outs.

These domestic policy measures match President Putin's belligerent critique of Western foreign policy. He argues that Russia felt obliged to act first in Crimea and then Ukraine because the US and EU has created a series of 'global imbalances' and 'a uni-polar' world since the end of the Cold War, often neglecting Russia's interests and voice on the international stage. This critique highlights

Sector	New measures
Car manufacturing	'Cash for clunkers' scheme re-introduced to boost car sales
Financial services	- $5.7bn capital boost to state-owned Russian Agricultural Bank and VTB - Bank of Russia is delaying Basel III implementation by six months to give banks a breathing period
Engineering	Guarantees of nearly $1bn to support the sector
Agriculture	Delayed privatisation and financial support to substitute imports

Table 2: New isolationist measures in 2014 to support domestic companies

anything from the growth of NATO and the EU in Eastern Europe, through to the bombing of Libya in 2011 and ends with the Association Agreement that the EU offered to Ukraine earlier this year. The introduction of sanctions has strengthened Putin's argument and arguably provided the Kremlin with a convenient scapegoat to blame for the failure of its own pre-crisis domestic reform agenda, which has done little to diversify the economy away from energy. The Russian federal budget is more reliant on hydrocarbons today than when Putin first became President, with the sector now accounting for over half of government revenues, compared to about a quarter in 2000.

Putin's mantra has been projected to great effect by the Russian state-owned media. TV stations have provided uncritical coverage of the Russian-backed insurgency in east Ukraine and blamed foreign actors for domestic problems. The polling shows the results with the proportion of Russians worried about international isolation dropping from 56% in March to just 32% in August. Indeed, the majority of Russians – some 78% - believe the effects of the food embargo will be positive. A slice of meteorological good fortune has helped to reinforce this perception with a bumper harvest this year putting agricultural output up 17% in the year to September.

The implications for business

President Putin has tapped into a strong nationalist sentiment in Russia and enjoys extraordinarily high approval ratings according to opinion polls, standing at 88% in October compared with 65% in January. Despite the Russian economy stumbling (growth for 2014 is likely to be around 0.5%) and real wages falling (down 1.2% in August, the first decline since the 2008-9 crisis) Putin appears to have convinced the public to put up with this and to continue to sacrifice their political freedom.

Given the political backdrop and the trends outlined above, what are the most important issues for businesses exposed to Russia? First, while it is important to consider the prospects for sanctions and counter-sanctions, corporates need to assess the ways in which a particular industry may be exposed to government interference aimed at reducing the exposure of Russia to western pressure. This can take many forms, including creating indigenous platforms, demanding localisation requirements, or pressure to enter into partnerships with approved local operators. Both the extent of the risk and the form it might take varies. Moreover, the Russian authorities may take a sequential approach, concentrating their efforts on what they regard as the most exposed and strategically important industries first, before turning their attention to others later. Western businesses will want to anticipate this before it happens. Moreover, these risks may well outlive sanctions and be an enduring feature of the remainder of Putin's term in office.

Second, the confluence of sanctions, the fall in the oil price and long-standing economic weakness means businesses need to consider macroeconomic and political risks alongside each other. As well as currency risks, businesses will need to evaluate their exposure to likely austerity measures. The Finance Ministry is said to be preparing to submit a revised budget for 2015-2017 to the Duma even while the previous one is still being discussed. Up to 10% spending cuts are envisaged for 2016-2017. A deep understanding of the political influences on the current government and its policy priorities is required in order to anticipate how the pain is likely to be distributed, particularly if the fiscal pressures are sustained.

Finally, increasing exposure to Russia is not for the faint hearted. But it is worth noting that not all western businesses are retrenching from Russia. In October GE opened a new gas engine plant in Rybinsk in partnership with two Russian state-backed corporations. Their first customer will be Rosneft, one of the primary targets for sanctions. Belgian VLM Airlines has agreed to lease two Russian-built Sukhoi Superjet aircraft from a Russian lessor in 2015. France's Hachette Livre has recently increased its stake in Russian publisher Azbuka Atticus from 25% to 49%. German Metro has launched its small retail outlets chain in Moscow city centre. And Swiss cheese producers have increased exports to Russia this year almost five-fold, converting the food embargo into a market opportunity. While this crisis has brought increased risk so did the collapse of the rouble in 1998 and the global crash in 2008. The question now is whether Russia can find a way back as in these previous crises or whether the current frosty climate is the new normal.

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