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Can't Build an Economy on Champions Only

By Ian Ivory

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For months, the international and Russian media have hung on every twist and turn of the saga involving Rosneft, TNK and BP. The high-profile deal is undoubtedly important and the numbers are huge, but the fixation with the story is a valuable metaphor for the Russian economy. Everything in the TNK-BP-Rosneft story is about big business, politics and natural resources, and the same appears true of the country's economy.

Compare this to Germany, whose economy is the strongest in Europe and driven by its famed mittlestand: medium-sized, export-oriented businesses. These businesses provide 70 percent of Germany's jobs and contribute about $1.8 trillion, half the country's gross domestic product. In contrast, Russia's small-business and medium-sized-business sector, or SME, represents only one-fifth of the country's GDP.

Against this backdrop, the Russian government has set an ambitious target of tripling the value of its SME to at least 60 percent by 2020 as well as diversifying beyond the energy

sector.

The Kremlin's diversification strategy has already begun at Skolkovo with efforts to create and nurture Russia's own Silicon Valley. It is a commendable start but will need a lot of support, and it is just the beginning.

There are four longer-term shifts that need to take place for Russia to create its own version of Germany's mittlestand:

1. The government needs to help create a broader managerial and business class to harness the country's entrepreneurial talent. Russia must establish more business schools and improve the teaching of business and management in higher education.

2. There needs to be greater statutory and legal improvement for business. The amount of red tape and general bureaucracy that would-be entrepreneurs face is daunting. The World Bank ranks Russia No. 105 out of 185 countries in terms of ease of starting a business and No. 161 when it comes to conducting cross-border trade. The planned amendments to the Civil Code need to protect the practical needs of businesses when they are carrying out complex financing and corporate transactions. The areas covered include startups, seed capital, angel investors, venture capital and small-cap private equity. The current situation, in which deals are often structured in multiple jurisdictions and with different choices of laws, just does not economically work for small startup investments.

3. The venture-capital supply line for startups and entrepreneurs is limited at the moment. More investors and investment firms are needed to give businesses the financial and management support at the start of their life. There are not enough competitors at the small end of the finance market.

4. The antitrust regime is too restrictive and captures a lot of small deals that would not be subject to notifications or clearances in the West. This is additional red tape for small businesses and their investors. The strategic-industries concept should be reviewed to see if there are less sensitive sectors where the rules can be relaxed to encourage more foreign participation.

Interestingly, the biggest driver of Russia's diversification may emerge from the fracking technology used to extract shale gas. Through fracking, the U.S. is increasingly moving toward energy self-sufficiency and is already selling cheap coal and liquefied natural gas to Europe at prices significantly lower than what Russia offers.

Large reserves of natural gas have also been found in Britain, Ukraine, Turkey, Germany and Poland, all of which have been traditionally large importers of gas from Russia. It is clear that Russia will need to find new exports to keep its economy afloat.

Ian Ivory is a corporate finance and private equity partner at Goltsblat BLP, the Russian practice of Berwin Leighton Paisner.

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