Opinion **FTfm**

A demographic trap and low growth are Putin’s biggest challenges

Moscow has an urgent need to close the trust deficit with the public

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Vladimir Putin announced a cabinet and policy shake-up, including the introduction of maternity and child care subsidies © Maxim Shemetov/Reuters

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News from Russia is supposed to be dark and foreboding, like an unending second chapter to one of its 19th century novels. Westerners expect to read about sanctions, secret services, mercenaries in sandy countries, conspiracies in Ukraine or interference in foreign elections.

In the real world, Russia is adopting expansionary economic and social policies that appear to be financially sustainable. These are intended to overcome what Vladimir Putin and the rest of the Russian leadership consider their most serious challenges: a demographic trap and low growth.

Everyone at the top of a system, whether in Silicon Valley or the Kremlin, wants immortality. The cabinet and policy shake-up announced on Wednesday by Mr Putin seems intended to achieve that through institutionalisation. State power will be (somewhat) decentralised.

Tax rates will remain flat and stable, while investment protection standards will be raised. Part of the budget surplus will be redistributed to mothers and schoolchildren.

You might be surprised that, according to MSCI indices, Russia had the best performing equity market in the world last year. The MSCI Russia index (US$) rose 50.1 per cent, and has risen another 4 per cent in the first half of January. Even so, Russian financial assets are still cheap. The MSCI Russia index has a dividend yield of close to 7 per cent and a price/earnings ratio of 6.1.

After western sanctions were imposed in the wake of the 2014 Ukraine/Crimea invasion, Russia aggressively deleveraged its finances and imposed strict budget measures and social austerity. The policies were not popular, but they have paid off with structural stability. Russia now has a 3 per cent budget surplus, foreign exchange reserves larger than its foreign debt and a rapidly developing domestic capital market.

At the time of Mr Putin's ascent to power 20 years ago, Russian oil companies and the Russian state needed an oil price above $110 to balance their accounts. Now they can break even with an oil price of about $45.

The central bank has conducted an orthodox monetary policy, while banking regulators have purged the commercial banking system of weak actors. Even with rate cuts in the past year, Russia has base rates close to 6 per cent compared with an inflation rate of about 4 per cent.

One of the effects of western sanctions on Russian businesses and individuals is the reshoring of the country's savings. Low to negative interest rates in western countries, compared with high real interest rates and low inflation at home, accelerated the process. Cuts to state pensions, while unpopular, pushed the public to add to their private savings.

Harvey Sawikin, whose New York based Firebird Fund has invested in Russia and eastern Europe since 1994, says: "The real force driving this market is the Russian public's need to do something with their money. Bank deposit rates have been coming down, and the central bank will probably cut its rates by another 100bp or so this year. So there has been a 50 per cent increase in the number of Russian retail trading accounts over the past year, to over 3m.

"Foreign investors tend to move in a pack, while Russian retail investors provide more diversification and liquidity for the equity market. They also have been able to identify value in small and mid-cap companies that are not major index components."

Even with all this increased domestic investor interest and last year's rally, Russian equities are still relatively cheap, certainly within the emerging market universe. Much was made of Saudi Aramco's IPO and its 5 per cent dividend. Russia's Lukoil, though, has a 20-year record as a public company and still has a 7 per cent dividend yield. Is corporate governance in Saudi Arabia that much better than in Russia?

The Russian leadership, including Mr Putin, have their own reasons for institutionalising better corporate disclosure, reducing corruption, and shifting away from oligarchical model. Their real concern is they need to keep young and talented people in the country and even attract immigrants from the "near abroad".

Russia's depression in the 1990s led to a birth dearth not dissimilar to the effect of a major war. Young people need to be assured that they have a good chance for meritocratic advancement and that society will support their family formation.

That will require not just the maternity and child care subsidies announced this week, but a sharp increase in infrastructure investment. With a net state debt less than the government's cash balances, that should be largely financeable in Russia's domestic capital markets. Assuming, that is, that Russians develop more trust in corporate and government integrity.

Mr Putin and the rest of the Russian government appear to understand that they have an urgent need to close the trust deficit with their public. That requirement, not foreign prosecutions and lawsuits, is what will lead to Russia's closer convergence with western corporate governance standards.

Russian securities are still among the lowest cost, highest yielding investments left in this overvalued world. As Firebird's Mr Sawikin says: "You still need to have some clue to what you are doing, and bad situations to avoid. But looking at the values, there are discounts here that are hard to explain."