RUSSIA'S LOOMING NIGHTMARE

The St. Petersburg International Economic Forum is the annual showpiece of Vladimir Putin, who began his political career as deputy mayor of St Petersburg.

In its opening session today (5/22), the most senior Western politician attending told Russia's leaders in the bluntest terms that their country will be frozen out of the global financial system and face slow economic breakdown unless the Kremlin steps back from confrontation with the West.

Peter Mandelson, Member of the British House of Lords, former Deputy Prime Minister and EU Trade Commissioner, informed them:

> "A sense of Russia-risk is crystallizing around the events in Ukraine. The great danger is that this negative sentiment will set in concrete around Russia. It is the markets that are leading the way, not governments, and they are quickening the pace. This is the looming nightmare for the Russian economy and it will have to be dealt with very boldly by the Russian government. To be cut off from global capital markets is not a good idea."

He looked around the room to make his point. Everyone knew he was seeing who wasn't there, as the showpiece forum has been boycotted by all serving EU officials and most US companies.

Russia's Achilles heel is the external debt of private companies and banks. They owe $700bn in foreign currencies, mostly dollars. This has to be rolled over continuously at a pace of almost $10bn a month. While spreads have narrowed as tensions ease slightly in Ukraine, there have been almost no bond issues for three months. Most companies have the cash reserves to survive the drought, but new investment is being choked.

One auto executive told the forum that the Russian car industry would wither on the vine if borrowing costs are pushed permanently higher. "We can handle a 1% rise in rates perhaps, but not a 5% rise," he said.

Chris Weafer, from Macro Advisory in Russia, said the risk is protracted decay as investors step back from fresh projects. "What we are afraid of is a return the Soviet stagnation of the early 1980s," he said.

Lord Mandelson warned his hosts that the glory days of the energy boom are gone for good, despite the epic $400bn gas deal with China signed by Mr. Putin in Shanghai this week.

"Russia faces a much more hostile environment. There are profound structural changes in the

global energy markets, not just from US shale or the delinking of oil and gas prices, but also from liquefied natural gas from Australia and Qatar, and after that from the Eastern Mediterranean and Africa," he said.

Russian analysts have already begun to pick apart Gazprom's contract to supply China with 38bn cubic meters of gas for 30 years. There are suspicions that the deal was rushed through to neutralize worries of political isolation, and to convey the impression that Russia can easily switch sales to the East, papering over the fact that little has changed.

Mr Putin's arch-critic, Boris Nemtsov, said the terms -- to the extent that they are known -- amount to "total loss and robbery," leaving Russia having to foot the bill for $55bn of investment needed to find the gas and build the pipeline infrastructure.

Gazprom has not revealed the agreed price. Leaks have hinted at $350 per thousand cubic meters, below the EU average price of $380, but this means little without clarity on details.

It will be four to six years before any gas is delivered to China, if the project comes to fruition. The Kremlin said China may advance up to $25bn to help defray the costs, but conceded that this is not a fixed obligation, a point that has been widely picked up on the Russian blogosphere.

Mr. Putin admitted that the decade-long haggling on terms had been fractious. "Our Chinese friends are difficult, hard negotiators," he said.

The gas deal is double-edged for Russia, leaving it ever more prone to the "Dutch Disease," a resource curse that can deform economies over time and erode their industrial base, leaving them in crisis when the commodity cycle turns.

"We are addicted to oil and gas," said Sergey Kravchenko, head of Boeing's operations in Russia.

"Russia hasn't come forward with any new aircraft on its own in 15 years. The only one we have done is reliant on transfers of Western technology. We don't have our own national projects, and I am quite concerned that we will lose our chance to catch up because of the mood of mistrust emerging towards the West. The sectors will disappear," he told the forum.

Evgeny Gavrilenkov, Sberbank's chief economist, said Russia's woes had already set in as early as 2012. "There have been so many blunders in macro-economic and monetary policy, even worse than the effect of the sanctions," he said.

Sberbank says capital outflows have been $70bn since the crisis began in Ukraine, if swaps are included, but not all of the bank withdrawals have been switched into dollars. Mr. Gavrilenkov said people have been funneling their money into usable assets -- typically fridges, computers or cars -- as a precaution. This perverse effect has helped keep the economy afloat for now and should

prevent contraction of GDP this year. The hangover will come later.

The International Monetary Fund expects growth 0.2% this year, but warned that the figure could be far worse if Western sanctions escalate to the "Stage 3" level against Russian companies.

The IMF's annual "Article IV" health check describes a sclerotic economy with bottlenecks everywhere that desperately needs root-and-branch reform. The 7% growth rates of "Russia's Roaring Noughties" already seems like another world.

The nightmare looms.

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