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In spite of considerable risks, Russia is still a good place for investment

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1. In many ways, Russia is a unique place. It has no historical precedent.
 - Almost nowhere else in the world are **living standards rising as fast**.
 - While inflation is much higher than in the countries Russia trades with, the rouble **exchange rate tends to appreciate** rather than depreciate, and the central bank has to intervene to keep it stable.
 - The **trade surplus is one of the world's largest**, but foreign trade has become a major drag on real GDP growth.
 - Compared to China, productivity growth is moderate, yet **Russian real wages are rising much faster than China's**.
 - **GDP per capita is just €4,700** (\$5,920), 18% the euro area average, and the country could thus be expected to rapidly increase the capital stock, because the relative backwardness and the size of the market translate into lots of investment opportunities, however, as it is, **Russia is one of the largest net capital exporters**, along with China and Japan.
 - **Money supply expands by 43% y/y** while headline consumer price inflation is “only” 9.4% y/y.
 - On average and in dollar terms, the stock market has gained 49.8% annually over the past five years, or 654% in total, but **risk premia remain extremely high** which means equities may still be attractively priced.
2. Over the past four quarters through Q1, **nominal GDP has exceeded its year-ago level by no less than 30.1%**. This, of course, is in rouble terms. Since the rouble/dollar exchange rate has been more or less stable between the two periods, this is also the rate of increase in dollar terms. In euros, growth has been about 29%.
3. To put this into perspective, China's nominal GDP expands at a fairly modest annual rate of just 14%; this is in renminbi terms – it is a little more in dollar terms as the renminbi has been allowed to appreciate marginally. The difference between Russia's and China's growth rates is mostly the result of the huge difference in inflation; in volume terms China's most recent GDP growth rate of 11.3% y/y is almost twice as high as Russia's 6.4%. **China is the more**

dynamic economy and thrives in spite of the commodity price inflation while Russia

thrives because of it - in other words, Russia benefits from the improvement of the terms of trade while China suffers from their deterioration which forces it to aim for a correspondingly higher rate of growth of output in order to raise living standards.

4. In Q1, Russia's export prices exceeded their year-ago level by 25.1% whereas import prices declined by 2.2% y/y. Therefore the **terms of trade, ie the ratio of export over import prices, increased by 27.9%**. National income rises much faster than national output because of this. If the terms of trade were flat, ie if export inflation would equal import inflation, real incomes could only rise by the product of the growth rates of productivity and employment. This is presently in the order of 6.4% y/y: Productivity on a per-worker basis is up 6% y/y while employment is 0.4% y/y. Russia is neither experiencing a productivity nor an employment miracle. This is mainly because the capital stock is not growing as fast as one would expect.
5. Even so, **in the wake of rapidly rising oil and other commodity prices, the standard of living is rising in leaps and bounds**. Hourly wages, for instance, have increased by 23.1% y/y in May – adjusted for inflation, ie in volume or real terms, the rate of growth was 12.5% y/y. Real disposable incomes had expanded at a higher rate still – by an average of 16.7% y/y in May and June. This reflects both the very strong increase of profits and the equally strong increase in government transfers which Mr. Putin uses as a means to distribute part of the new wealth from natural resources to the general public. This helps to keep his approval rates at high levels.
6. Outside the group of oil exporting countries **I do not know of any economy with comparable rates of growth of personal incomes**. Moreover, this has been going on for several years and has created an atmosphere of optimism and confidence for the future. Real estate prices have skyrocketed in Moscow and St. Petersburg. For all of Russia, nominal construction orders have increased at an average annual rate of 27 ½% over the past five years which is likely to be in excess of 10% in volume terms (real estate inflation numbers are not available) and thus also a very strong statistic.
7. It does not come as a surprise that the Russian trade surplus has almost exploded in recent years, given that commodities and commodity-related products account for almost 90% of total exports – which in turn now account for 32% of GDP. In May nominal merchandise exports exceeded their year-ago level by 33%. Equally unsurprising, imports are also rising very fast and have lately been up 33.8% y/y. Since imports are still less than half as much as exports, the **balance of trade surplus has reached €107.7bn or 16% of nominal GDP**. This enormous number explains the strength of the rouble and the on-going improvement of Russia's credit rating.
8. This brings us to the **problematic aspect of the country's sudden wealth, the so-called Dutch disease which is now gripping the country**. As mentioned above, import prices are falling, export prices are rising very fast, the exchange rate is stable or appreciating somewhat, and real wage growth is outpacing productivity by a large margin. The traditional manufacturing industry has thus an increasingly tough time, both in terms of export competitiveness and the substitution of domestic products by cheap imports. Unless things change quickly, it is doomed. Giant supermarkets have sprung up around the big cities. They are very popular among Russian consumers who have long been deprived of choice and high-quality products. Or take cars for instance: traffic gets worse by the day as more and more people can afford to buy Asian and West European cars. Russian Ladas who once dominated the roads are disappearing fast.

9. **It is only a matter of time before imports will have overtaken exports.** Assuming that Russian export prices rise by only 2% from here on – because they have increased so much already, and world economic growth could slow – and that imports will continue to expand at recent rates of 33%, it will take less than two years and nine months for the trade surplus to disappear. This means the situation is rather unstable.
10. **The assumptions are very extreme,** though, and ignore the possibility that consumers will scale back their purchases in response to the likely deterioration of the employment situation and much slower wage growth as the terms of trade effect disappears or goes into reverse. The assumptions also ignore the possibility that the political situation in the Near East gets worse and that commodity prices thus rise even further. But if they did, the risk that the world economy slides into a recession would increase considerably which in turn would bring down oil and other commodity prices – and Russia's terms of trade, the source of its consumer boom. Ever-rising commodity prices are not necessarily a blessing.
11. **In real terms, the underlying trend in Russia's foreign trade is negative.** Net exports, the difference between real exports and real imports, are already shrinking fast and are slowing down real GDP growth. In the four quarters through Q3 of 2005, to take the most recent available figures, real GDP was up 6.2% y/y; without the deterioration in real net exports, GDP would have increased by 8.4%.
12. For the coming one or two years it is likely that the consumer, import and construction booms will continue, mostly because so far the nominal trade surplus shows no sign of shrinking. Since exports are so much larger than imports, even relatively fast growth of imports will in the near term lead to even larger surpluses. This in turn forces the central bank to buy euros and dollars in order to prevent the rouble from appreciating. **Money supply growth will thus remain fast,** and even after it has slowed down from its present blistering 42% annual rate (M2), the Russian economy will not suffer from a lack of liquidity.
13. **It is not easy to come up with a clear statement about the current state of monetary policy.** On the one hand, if you take money supply, it is rather expansionary. Real interest rates are quite low which also suggests an easy money environment: retail deposits at government-owned or controlled banks, non-callable for six months, are at 8 to 9%, which is less than inflation. Interest rates on rouble-denominated 10-year fixed mortgages are 12 to 14% which implies that inflation expectations are in the order of 7%. Compared to today's wage increases of 23% these are modest numbers which boost borrowing and discourage saving. Together with strong corporate earnings growth, these low interest rates should also encourage more capital spending and a faster growth of the capital stock. Perhaps it is only a matter of time for this to begin.
14. On the other hand, **the fixed exchange rate vis-à-vis currencies of countries which have much lower inflation rates than Russia will over time lead to a significant reduction of inflation.** The country imports price stability. Maintaining a fixed nominal exchange rate thus suggests policies are restrictive. As in the Bretton Woods system, countries which defend a given exchange rate vis-a-vis a reserve currency basically do not conduct an independent monetary policy – they do whatever is necessary to stabilize the target exchange rate, by lowering or raising interest rates and/or by selling or buying the reserve currency. Russia belongs to this category.

15. **Policies are actually in a bind:** if the central bank stopped intervening in order to gain control of the money creation process, the rouble would appreciate significantly and thus make imports even more attractive and exports outside of commodities even less competitive. Unemployment would rise.
16. So this will not happen. But the present mix of a stable exchange rate, high domestic money and income growth is also not sustainable in the medium term. While inflation will come down, the variable that has to adjust will be domestic employment. Wages are rising much too fast on a wave of intervention-induced money creation. Another way of putting this is to say that the real rouble exchange rate appreciates very fast, too fast for the health of the Russian economy. **The inevitable loss of jobs will over time lead to lower wage increases and thus finally to a devaluation of the real exchange rate which re-establishes, or improves, international competitiveness. This is how a benign scenario could look like.**
17. **Let us then summarize what investors can expect. Over the next two years, the trade surplus will remain very large.** For a sizable reduction of oil prices it needs a significant slowdown of Asian growth and an end to the crisis in the Near East, both of them fairly unlikely events. The CBR will be forced to continue intervening and print money this way. Liquidity will not dry up. Real disposable incomes will grow at double digit rates.
18. Firms exposed to international competition are increasingly getting into trouble, but retailers, banks, insurers, construction and cement companies, perhaps even steel companies will do well (think pipelines), just as utilities and oil, gas and metals producers, of course. **Services will play an increasingly important role as the restructuring process accelerates** and Russia becomes more like an OECD country, indeed like the US which has also shrunk its manufacturing base significantly over the past decades, a process still underway today.
19. **Further out, trade restrictions are clearly a risk** as jobs in manufacturing get lost. Whether the risk materializes depends very much on how fast the service sector can be expanded. So far, there are no reasons to be overly concerned. **The balance of trade surplus will begin to shrink** as imports catch up with exports which in turn reduces the need for FX interventions and thus slows down money growth. Wage inflation will slow, both in real and nominal terms. Consumers will increase their spending at less breathtaking speeds than at present, but Russia will remain an emerging economy and will thus continue its catching-up process.
20. **Large currency reserves and the fact that there will always be a strong demand for commodities provide a favorable framework for years to come.** It can also be argued that much needs to be done in terms of corporate governance and profitability, given the central planning heritage of the country, but the companies which survive the firestorm of the ongoing real rouble appreciation can be expected to be formidable competitors. Overall, one could be quite optimistic for the longer term if there were clearer evidence of vigorous capital spending by the business sector and more infrastructure investment by the state.
21. **A propos the state: since it is running a big budget surplus, it has the means to generate demand at a time when the private sector slows down too much.** In spite of the momentous changes that are going on in Russia, and will continue to go on, the country is fundamentally quite sound as far as the economy is concerned.

22. **It is also some sort of safe haven.** It benefits from political crises around the globe after the decision has been made, not necessarily voluntarily, not to get involved in foreign wars any longer. A sign of this trend is the continuously shrinking yield spread between dollar denominated Russian government bonds and same-duration US Treasuries (now 116 bp in the 2030 maturity).
23. Finally, the question about the **valuation of the stock market**: most brokers put the price to earnings ratio of the dollar-denominated blue chips index RTSI\$ at around 10 ½%, using 2006 earnings forecasts. This translates into an earnings yield of 9.5%. To arrive at the risk premium, one has to deduct the real long-term yield of riskless bonds. In the case of Russia this is 6.2% (the dollar denominated bond mentioned in the previous paragraph) minus the Russian inflation rate of 9.4% y/y, or minus 3.2%. 9.5 subtract minus 3.2 is positive 12.7, the risk premium. For more mature markets, risk premia between 4% and 6% are considered adequate. In other words, investors are still rewarded generously if they decide to risk their money on Russian stocks.