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An update on Russia – and oil prices

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1. **Russia is still doing well economically.** Real GDP has been up by 7.4% y/y recently. Nominal rouble GDP is actually increasing at a rate of 27.3%. In terms of US dollars, GDP is up about 40% y/y, reflecting the strong appreciation of the currency this year. Among the world's main economies, Russia has by far the highest dollar growth rate; it is more than twice as high as China's 17.3%.
2. **Growth is not only rapid, it is also based on sound fundamentals** such as budget and current account surpluses, large currency reserves, an appreciating currency and a declining dependence on commodity exports and prices. Since per capita GDP at current exchange rates is still only one sixth to one seventh that of Western Europe, the expansion has a very long way to go before the catching-up process will come to an end. Russia will remain a land of opportunity.
3. **The main dark spots** are a very uneven income distribution, old age poverty (the average pension is €91 a month), a rapid loss of competitiveness in areas exposed to foreign trade, such as the manufacturing industries, a consumer price inflation rate of close to 10%, fairly low savings and investment rates – at least when compared to China - and, **on the political side**, rather centralized decision making, no genuine division of power, widespread corruption and an underdeveloped rule of law. Things are not improving as fast as we would like. The Russian government does not strive to become a Western-style democracy. Joining the EU – which would lead to significant improvements on these fronts - is not an issue at all. So it is not more than a hope at this point that increasing wealth, freedom to travel and free access to information via the internet will bring about the desired changes.
4. **People are fairly optimistic about their future, though, and most do not seem to mind being ruled by an authoritarian regime.** Indeed, the approval rates of Mr. Putin are solidly above 70%. We do not have the impression that these are manipulated numbers. Lending support to Bill Clinton's motto "it's the economy, stupid", the fact that real disposable household incomes have been rising at rates of about 10% for several years makes Russians quite forgiving when it comes to their true political situation. They still focus mostly on improving their standard of living and seem grateful to an administration that is seen to deliver the goods.
5. **Consumer spending has become an important contributor to overall growth.** Real retail sales are up no less than 13½% from last year. There is also a boom in housing which is driven by low real mortgage rates, the expectation that house prices will continue to rise rapidly, and a fairly benign labor market: employment growth is 0.4% y/y while the latest unemployment rate is 7.1%. We are not sure how reliable these numbers are, but they seem to be broadly in line with anecdotal evidence.

6. **That incomes are increasing so much faster than real GDP reflects the large improvements in the country's terms of trade.** In Q2, export prices exceeded their year-ago levels by 17.2% while import prices were up only 2.9%. In other words, the terms of trade had improved by no less than 13.9% over the course of one year. This number is a good proxy for the rouble's real trade-weighted appreciation. The flip side of this income-boosting effect is the ongoing loss of international competitiveness which is already showing up in trade flows: Real imports are rising much faster than real exports (19.1% vs. 5.8% y/y in Q2). The monthly data, which are available through September, show that this trend has actually accelerated.
7. **Changes in real external balances have become a drag on GDP growth.** Should export prices stop rising faster than import prices, Russia's real disposable income could only grow as fast as real GDP. We may already be close to such a situation, but because of the large time lag in the data we do not have hard evidence of this yet. It would have a sizable negative effect on consumer spending.
8. Such a development would also quickly reduce the balance of trade surplus. Between August and September, nominal imports increased by 0.7% m/m while exports declined by 8.0%. **The trade surplus is still huge, in fact one of the world's largest, but will continue to shrink unless oil and other commodity prices recover.**
9. **The need for the Central Bank of Russia to buy foreign currencies in order to prevent a rouble appreciation will probably be less than before if the trade surplus shrinks.** Currency reserves have increased massively on the back of the explosion of commodity prices and the trade surplus of recent years: At \$274bn they are no less than \$157bn higher than just two years ago. Capital flows have had little impact on FX reserves.
10. A couple of months ago Mr. **Kudrin, the Minister of Finance, has suggested to Russian firms that they, rather than the central bank, buy more foreign assets.** One well-publicized purchase has been the acquisition by state-owned Vneshtorgbank of a stake in EADS, the company that holds Airbus. Severstal's failed attempt to take over steelmaker Arcelor has been another example. Gazprom, where the state also holds a majority, has been trying for years to buy more downstream assets in Western Europe. For Russia as a country it makes more sense to hold real assets rather than paper claims such as Treasury Bills or German Schatzs, once there is no need for additional liquidity for FX intervention purposes. The short-term effect on the exchange rate is identical: It slows or prevents a rouble appreciation.
11. The central bank's buying of dollars and euros and the simultaneous selling of roubles has been the main source behind the breathtaking **expansion of domestic liquidity** that has been driving real estate and equity prices. The latest readings of M0 and M2 have been 38% and 47% y/y. Both numbers are well in excess of nominal GDP growth.
12. Monetarists may wonder why this has not pushed up consumer price inflation by more than those 9½% mentioned above. They would probably suggest that it will be only a matter of time before inflation rises more strongly. For the time being, though, **import price inflation of 2.9% is the counterweight of wage-driven, or rather unit labor cost-driven domestic inflation in the order of 16% y/y.**

13. **Import price inflation will stay moderate as long as there is a surplus of cheap labor in emerging markets that holds down wage growth there.** Since productivity gains are still very large in those areas of the world - because production processes are not yet very capital intensive, but are getting there -, unit labor costs are rising only very slowly, if at all. In combination with strong currencies, this translates into an average world inflation rate of just 3% (in spite of the so-called Ballassa-Samuelson effect which suggests higher inflation rates in catching-up economies) and means that Russia's inflation rate will be held down as long as the rouble does not depreciate.
14. **How dependent is the country on commodity prices these days? The honest answer is: still a lot.** Energy and raw materials are the main sources of income even though in terms of manpower they are not so dominant. The state is succeeding to drain revenues from this so-called primary sector of the economy and channel them, mostly via the state budget and state-owned firms, into the other sectors. **Services are taking off** these days, especially retail and wholesale trade, maintenance and repairs, hotels and restaurants, financial services, real estate services and the state bureaucracy, including the military. Education and health services are expanding well below par, though, which is not so good from a long-term perspective.
15. **Manufacturing, where 11.6 million people are working, is also growing briskly,** but not nearly as much as Chinese manufacturing – the difference is in the more rapid real appreciation of the Russian currency which hurts competitiveness. Russia grows because of high commodity prices, China in spite of. The boom sector par excellence is construction where employment is increasing at a rate of 4½% y/y, and output at a rate of 12%. The housing stock is in dire need of modernizing and expanding. One defining feature of the Soviet era has been the tiny size and the poor quality of living quarters.
16. **Mining plus electricity, gas and water production and distribution have now a 4.5% share in total employment of 67 million.** Value added in these sectors is growing at a considerably slower rate than the rest of the economy, but it seems that capital spending there is finally picking up strongly. Output prices and profits could not be more favorable.
17. In summing up this section, it seems reasonable to say that **Russia is well on its way toward a more diversified economic structure.** It is thus more shock-proof than it used to be. Still, since the stock market is dominated by oil, gas, electricity and metals companies, the market capitalization and their wealth effects on household consumption are strongly correlated with commodity prices. State revenues are also crucially dependent on the strength of the commodities sectors, as is the strength of the rouble.
18. **So where are oil prices heading?** It seems that both the demand and the supply curves of oil are very inelastic. Small shifts in either will therefore lead to large changes in price. The impression that the risk of a military escalation in the Near East had more or less disappeared after the UN had successfully intervened in South Lebanon has resulted in a slight shift to the left of the demand curve and a 25% decline in price. Equally, if world real GDP growth continues at annual rates of 5%, as forecast by the IMF, the demand curve shifts to the right and triggers a large price increase, by significantly more than 5%. If, on the supply side, OPEC decides to cut production by 2% of total world output, prices will rise by more than 2%.

19. According to the latest Oil Market Report of the International Energy Agency, global **oil demand will grow by 1.7% y/y next year, to 86.02 million barrels a day**. About three quarters of this comes from non-OECD countries; these are growing at rates of more than 6%. Since supply will expand as much as demand, plus minus changes in inventories, oil prices are well supported and could rise again. At which price level the new intersection of the demand and supply will occur is hard to say in the absence of reliable specifications of the curves. On balance, the risk of a further steep fall in prices is smaller than the risk of a stabilization and a new increase, given that prices have already fallen so much and that world growth seems to be more energy-intensive than in the past when the key drivers were the service-oriented OECD countries.

20. **The rouble, meanwhile, continues to push upward and needs to be held down**. The new policy of the CBR seems to be to peg it to the euro rather than the dollar. Trade with the euro block is more than ten times larger than trade with the dollar block. In other words, the interventions seem to be largely in euros rather than dollars these days. Since September last year, the range has been in a tight +/- 2% band around 34.2 roubles to the euro. As the euro appreciates against the dollar, so will the rouble. I wonder whether the CBR has indeed conducted the regime shift suggested by the charts.

21. **The stock market remains characterized by a very generous risk premium**. On the basis of a 4-quarter trailing price-to-earnings ratio of 7.91 I get an earnings yield of 12.6%. No matter with which real riskless bond yield one compares this number, the resulting risk premium looks rather attractive. As I had listed in the third paragraph above, Russia is not an easy place for outside investors, or for people without a good report with political decision makers. Having a presence in Russia helps to understand the opaque goings-on, to avoid risks at an early stage and to identify opportunities. At the moment we would bet on a liberalization of the domestic gas price, ie higher revenues for the gas producers who are presently almost giving away their product free of charge, on strong growth in financial services, construction and retail trade. Even the telecoms sector or steel look interesting.