Not so cold in Russia

Investors should keep their sights fixed on the long-term

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Investors with short memories may be excused for congratulating themselves on profit they made in Russia over the past couple of years as the country's fixed income and equity markets offered some of the best returns in the world. Now with some potentially ominous developments looming over coming months, is there cause to become negative on Russia, which in the past wiped out gains overnight?

Russia's deteriorating relations with the West, a drop in the price of oil and elections later this year aren't as scary as some investors might believe. That's because Russia's economy is almost entirely decoupled from international political pressure and the country is increasingly less reliant on oil as a growth driver. The economic momentum that gathered pace from record high oil prices in 2006 and from relative domestic stability engineered by President Vladimir Putin is likely to continue over coming years.

More than oil

If anything, risk in Russia today is more individual than systemic as it was in the past. Savvy investors will look towards sectors that are essential to modern Russia and its growth. There is more to the country's future than oil and nickel. Russians need money, whether it's to build new highways or upgrade housing to help finance a forecast 7% growth rate.

Even with a construction boom, there simply isn't enough housing around to meet demand. In 2005, 30% of approved mortgages by Vneshtorgbank, Russia's second biggest housing lender, went unused because clients couldn't find suitable property; this grew to 50% in the first half of 2006, according to the Vedomisti newspaper. Demand and growth isn't just centred around Moscow. In some regions, such as Krasnodar in Russia's south, about a third of households want to buy or build a new house, according to the Institute for Urban Economics.

Some investors hearken back to the 1998 meltdown and are voicing concerns that history could repeat itself. What they fail to notice is the economy is significantly more developed than in the 1990s, not just because of the impact from oil and commodity-based revenue but also because many of the old industries that dragged on the economy have been replaced with highly competitive ones.

Importantly, the mindset of Russia's entrepreneurs and government leaders has moved to where they are able to see beyond a short-term horizon. And the Russians have proved that they are capable of beating importers in sectors such as food and drinks, construction materials and engineering, while they have increased exports in key sectors such as steel, timber and speciality chemicals.

Meanwhile, the value of oil and gas revenues has ballooned as energy prices have risen. They were worth $150 billion (20% of GDP) in 2005, compared with just $53 billion in 2000, before prices took off. However, the Stabilisation Fund established by the government in 2004 has successfully insulated the rest of the economy from fluctuations in energy prices. The Ministry of Finance estimates that a $1 change in the price of oil had only a 0.06 percentage point effect on GDP growth in 2005, compared with 0.20 percentage point in 2000.

Extractive industries employ 1 million Russians, just 1.6% of the labour force. Obviously, any Russian government needs to keep the other 62 million workers employed. More than 37 million people are employed in industry, manufacturing, trade and services. The main elements of Russian economic policy can be expected to survive any likely political change. Employment is one of the factors that has motivated Russia to work on joining the World Trade Organization. Russia, which formally applied to join the WTO in 1995, cleared its last major hurdle to membership in November, when it reached a bilateral accord with the US.

It also helps that Russia's reserves have swelled more than 20 times to US$300 billion, making them the third largest after China and Japan. Less than a decade ago – which seems like a lifetime ago if you visit the country now - when Russia defaulted on its domestic government debt, the $13 billion of reserves was worth just a couple of months of imports, compared with two years now.

Big cushion

Back then oil had fallen to about $10 a barrel. Now, the Stabilisation Fund, as well as protecting the non-oil economy from the effects of high oil prices, provides some insurance against a possible future fall in oil prices. If oil prices were to fall, the initial effect would simply be that inflows into the Stabilisation Fund (now worth over $70 billion, or 7.5% of GDP) would slow. A severe fall in prices would require Russia to undertake some fiscal tightening (less than if the Fund didn't exist). And if the price fell below $27, the Fund could be used to support expenditure for up to two years by some estimates. It is a clever device that cushions the economy against fluctuations in oil prices in both directions.

If anything, Russia's growth is stymied by a lack of capital. Many companies cannot get short-term loans from Russia's banks, even though there are almost 1,200 of them. The country's four biggest lenders control 50% of deposits and loans, according to Standard & Poor's. Domestic credit to the private sector and non-financial public enterprises was only 26% of GDP in 2005, compared with 37% for Kazakhstan and 114% for the European Union. Moreover, with 80% of banks operating with capital less than $10 million, it is probable some will fail. This could create a knock-on effect for the payments system. Still, while government surpluses continue and the rouble remains stable the Russian banking system is unlikely to collapse. The swift actions taken by the Central Bank to prevent a full-blown banking crisis in the summer of 2004 are an indication that the government supports structural reform.

Politics did play a major role in the 1998 crash. Now, the Russian authorities are much more open about their financial data and as a result it is unlikely that a similar misinterpretation of the true position could occur again.

A balancing act

There is still a conflict between policy aims of the Central Bank and the MoF, as there is in most countries, although recent actions for a gradual and regular appreciation of the rouble appear to demonstrate that the two interests are now more finely balanced. Continued economic growth does not mean that there won't be volatility in the currency, equity and fixed income markets over coming months. Investors, however, should keep their sights fixed on the fundamental long-term changes in the country. **THFJ**

Fig.1 Russia - Output Growth