

Investing in Russia
By Dieter Wermuth
July 27, 2010

Russia is the largest producer of energy and commodities, and China has become the major player on the demand side, having overtaken the US and the euro area. The two countries are in a symbiotic relationship where China is the dominating partner, not only because its nominal GDP is about three times, and its population about ten times larger, but also because its economy is more diversified and thus more resilient.

I am presently on a two-week trip to Beijing, Xi'an and Shanghai to get an answer to the all-important question whether China can maintain its 8 to 10 per cent trend growth rate of real GDP. The investment ratio has been so high for so long that I would not be surprised if a significant portion of capital spending had been used for speculative and unsustainable purposes. Is there a major bubble by now, and when will it burst? What would this do to China's, and indeed global demand for energy and commodities?

As I have shown last month, Russia's output, stock market, balance of trade and exchange rate are, among others, highly correlated with the oil price, a proxy for commodity prices in general.

There are many indicators that suggest overinvestment - which in turn implies falling rates of return and, eventually, asset prices. This year's (relatively moderate) decline of Chinese stock markets and real estate prices could be a bellwether of things to come. The country may be running out of profitable investment opportunities.

To give just a few examples:

- House prices had rocketed to stratospheric levels; in major cities, the relationship between apartment prices and annual income, the so-called affordability ratio, had reached 15 to 20; in Germany, something like 4 or 5 is considered to be normal; the ratio is higher than it was in the US shortly before the end of the housing boom, and comparable to Japan's in the late eighties.
- According to the International Energy Agency, China is now the largest consumer of energy, but it uses energy in an extremely inefficient way, mainly due to misdirected subsidies: per unit of GDP it needs six times more than Italy, and three times more than the US.
- The infrastructure may be oversized by now. The drivers of 43 million vehicles have at their disposal 2.7 million kilometers of paved roads, no less than in the US where 250 million vehicles are registered. There are already 60,000 kilometers of expressways, comparable to America's 80,000 kilometers, and, say critics, many bridges to nowhere (as in Japan).
- At 1.35 million tons of cement, China consumes more than the rest of the world, and on a per capita basis even more than Spain and Ireland at the height of their property booms.
- The same goes for steel: the annual output is about 500 million tons and thus more than the combined output of the European Union, Japan, the US and Russia. Since total capacity is in the neighborhood of 660 million tons, there is a lot of slack and a corresponding downward pressure on steel prices.

Wermuth Asset Management GmbH

Landgasse 38-40
65183 Wiesbaden, Germany
Phone +49 69 959 254 78
Fax +49 69 959 254 79

Bryanskaya 5
Moscow 121059, Russia
Phone +7 495 580 73 00
Fax +7 495 580 73 02

Seat of the Company:
AG Weisbaden
HRB 24805
USt-ID-Nr. DE 200 110 358

Managing Directors:
Jochen Wermuth,
Michael Hyuk Choi

HypoVereinsbank
BLZ: 503 201 91
Account No: 367 905 310
DE62503201910367905310

At least at first glance it is obvious that China is running out of easy ways to boost growth through additional investment in these sectors. It is also obvious that investment is very inefficient by now, as measured by the incremental capital output ratio. It is far higher than in Germany, Japan or South Korea during their respective post-war transformation periods.

Chinese banks must have lots of loans on their books that are of dubious quality. For years, but especially in 2009, loan growth has considerably exceeded the growth rate of nominal GDP. The loans-to-nominal-GDP ratio is now very similar to earlier pre-crisis ratios in Japan or the US. Much of this has been caused by massive dollar and euro purchases by the People's Bank aimed at holding the renminbi exchange stable against the dollar. Sterilization of liquidity created in this way has only been possible to a limited extent.

For many years, borrowing has been cheap relative to expected growth rates of output and easily available, especially for local governments, while interest rates of less than 2.5% on bank deposits have made traditional forms of saving unattractive – stock and housing markets offered seemingly more attractive alternatives.

In China, the ratio of the stock of credit to the private sector to GDP is presently no less than 130 per cent; the corresponding number for Russia is a modest 45 per cent. The ratios of money supply M2 to GDP convey the same message (185% versus 30%): China's economy is highly leveraged and thus seriously exposed to disappointing returns on investment (ROI), i.e. profits, and falling asset prices.

More cyclical reasons why China's economy could soon hit a wall are the weak growth of external demand, especially from the US and the euro area where output gaps remain large. The gradual appreciation of the renminbi against the dollar will have less of an impact than the cooling-off caused by fiscal consolidation policies and the end of the inventory build-up in rich countries. In China itself, the inventory cycle has run its course, suggesting that real GDP growth rates of 10 per cent plus could be a thing of the past.

So for structural as well as cyclical reasons, China could easily stop growing, which would be a catastrophe for the rest of the world, and commodity-dependent Russia in particular.

International Comparisons

		2000	2007	2008	2009	2010F	2011F
Russia	nom. GDP, € bn	281	945	1133	884	1089	
	GDP / capita (€)	1929	6628	7963	6235	7704	
China	nom. GDP, € bn	1028	1877	2224	2647	3081	
	GDP / capita (€)	1296	2467	2940	3521	4121	
India	nom. GDP, € bn	432	667	678	731	899	
	GDP / capita (€)	425	590	590	628	761	
Brazil	nom. GDP, € bn	697	996	1116	1127	1326	
	GDP / capita (€)	4098	5371	5949	5937	6905	
Poland	nom. GDP, € bn	186	309	359	308	368	
	GDP / capita (€)	4802	8078	9395	8116	9660	
Ukraine	nom. GDP, € bn	32	104	123	81	89	
	GDP / capita (€)	654	2221	2632	1754	1935	
Germany	nom. GDP, € bn	2043	2460	2534	2450	2524	
	GDP / capita (€)	24871	29900	30791	29773	30660	

Sources: Bloomberg, Economist

But as we have learned, the Chinese authorities are experts at moving the economy forward on an even keel. They have a way of surprising on the upside. On balance and for several reasons, I am fairly certain that they will succeed once again. This, of course, is good news for investments in Russia.

So here are the reasons why China will probably power on:

- Measures to restrain credit expansion have now run their course. The People's Bank has signaled to the market that it will neither hike reserve ratios nor raise policy rates any more, while credit expansion will accelerate again. Credit growth had slowed significantly over the course of the first six months of 2010. Inflation is not a great concern, given the gradual appreciation of the renminbi (to perhaps 6.6 to the dollar by year-end) and the likely stagnation of commodity prices from here on. CPI will average around 2.8% year-on-year in 2010 which is quite low for a fast-growing emerging economy in catching-up mode.
- The NDRC (National Development and Reform Commission) has just announced an RMB682bn investment plan for 23 new infrastructure projects – this is equivalent to 2.5 per cent of GDP. Growth policies have clearly been resumed.
- Since the income distribution has become very uneven and a major political risk for those in power, it was decided to raise minimum wages at double-digit rates which will strengthen consumer demand. To be sure, it is still possible to hire someone in Beijing for about €100 a month, I was told, a sign that there is still a lot of surplus labor.
- The Chinese government wants to reduce the huge gap in living standards between the coastal areas and the interior. The new catchword is “urbanization”: productivity growth in agriculture is so rapid that unemployment will rise considerably unless workers can find jobs in manufacturing and services. Rather than let people migrate to the cities in the east on a temporary basis it is now attempted to stimulate job creation in the western and southwestern provinces where wages and land prices are low. This is a sensible policy. If successful, the infrastructure boom may well continue and have knock-on effects on investments by private firms and SOEs (state-owned enterprises).
- Incidentally, it seems that car registrations will double in less than two years (to 20 million) – for decades, China's car market will be the world's largest given today's very low penetration rate and the fast growth of household income.
- China's government budget deficit will be in the order of 2.5% this year. This means that a new round of expansionary policies is not restrained by financing problems. Moreover, foreign reserves in excess of \$2.5tr make the country financially independent: it is a net creditor vis a vis the rest of the world (just like Russia).
- In general, bursting bubbles are less of a problem in fast-growing economies such as China. This is different from Japan's experience at the beginning of the nineties. Since per capita GDP is only 13 per cent of Germany's – and 53 per cent of Russia's – the growth opportunities are still huge, provided government policies remain as skillful as in the past which seems a reasonable assumption.
- It also helps that the banking sector is still dominated by the state. Recapitalization will not be a major problem. Moreover, much of the borrowing and lending is de facto within the state sector and thus cancels each other out.

Wermuth Asset Management GmbH

Landgasse 38-40
65183 Wiesbaden, Germany
Phone +49 69 959 254 78
Fax +49 69 959 254 79

Bryanskaya 5
Moscow 121059, Russia
Phone +7 495 580 73 00
Fax +7 495 580 73 02

Seat of the Company:
AG Weisbaden
HRB 24805
UST-ID-Nr. DE 200 110 358

Managing Directors:
Jochen Wermuth,
Michael Hyuk Choi

HypoVereinsbank
BLZ: 503 201 91
Account No: 367 905 310
DE62503201910367905310

To come back to what these developments mean for the future of Russia's economy and markets, it seems a fair bet that the demand for commodities will be held up quite solidly by the ongoing expansion of the Chinese economy. While high-tech sectors play an increasingly important role, just as services, this does not mean that the demand for housing, cars, household equipment, electricity or gasoline cannot expand briskly as well. It will.

To me, the three cities I visited look already very much like Tokyo or Nagoya, places where I have been more frequently. People are well-dressed but seem to live in small apartments, the average age is quite low, everybody is in a hurry but seemingly upbeat, the cars are new and clean and have dark windows, bicycles and small motorcycles have largely disappeared. If these standards spread to other parts of the country, which is now the plan, a very extended period of robust demand for energy and commodities is virtually assured.

To repeat, for investments in Russia, all this is good news: the revenue stream from energy and commodity exports will not ebb. The question is whether the country can turn the extraordinarily favorable position it has into a more broadly based economic expansion.

On the face of it, it should not be difficult to use the financial advantage for structural reforms that move it up further in the value-added chain. The government can certainly learn a lesson or two from China.

Wermuth Asset Management GmbH

Landgasse 38-40
65183 Wiesbaden, Germany
Phone +49 69 959 254 78
Fax +49 69 959 254 79

Bryanskaya 5
Moscow 121059, Russia
Phone +7 495 580 73 00
Fax +7 495 580 73 02

Seat of the Company:
AG Weisbaden
HRB 24805
USt-ID-Nr. DE 200 110 358

Managing Directors:
Jochen Wermuth,
Michael Hyuk Choi

HypoVereinsbank
BLZ: 503 201 91
Account No: 367 905 310
DE62503201910367905310

