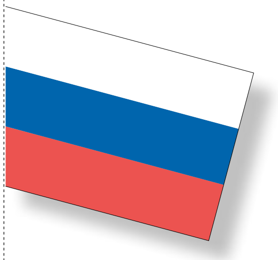

Russia

The world's largest country wants to reduce its dependence on oil, gas and other commodities, says Dieter Wermuth

For more than 20 years, Russia has endured a difficult transition process from being a communist, centrally planned economy to a market economy. The former superpower of the Cold War period is now a large, emerging, middle-income economy, but one that still has considerable military clout. Together with Brazil, India and China, it is a member of the so-called BRIC group of developing nations.

Much has been achieved economically over the past two decades, as any visitor to Moscow can confirm. Traffic jams have become an annoying feature of everyday life. The average age of the cars in those traffic jams is lower and it seems that their average price is just as high, or higher, than in Paris or Milan. Wages for qualified office workers are comparable with those in the metropolitan areas of Western Europe, as are rents for decent flats and offices, or the price of a good meal. The centre of the city is full of glitzy skyscrapers and shopping malls, and young people, in particular, have the money to afford designer outfits and one or more foreign holidays each year.

But impressions can be deceptive. Moscow is not Russia. There is a huge difference between the capital city, where all the political and economic power is concentrated, and the provinces. Using exchange rates from early February 2013, average GDP per capita in Russia last year was about €10,220, compared with GDP per capita of €32,360 in Germany. So it is obvious that living standards outside the Greater Moscow area, with its population of some 15 million, are still quite low. Even in places like Saint Petersburg, Kazan, Yekaterinburg or Sochi on the Black Sea, wages are half as high as in Moscow, or less. This makes them attractive for foreign direct investments.

Income distribution is not only uneven from one region to the next; there is also a large discrepancy between the young and the old. The former are mostly doing quite well because the Russian education system has equipped them with the knowledge and the qualifications that are needed in modern life. Internet access is easy, cheap and widely spread, if not free of state control. Young Russians are well informed about the outside world and integrated into the global internet community. Rapidly modernising firms need workers with these skills and are willing to pay them well. Wages are taxed at a flat rate of just 13%, and dividends for residents at an even more modest 9%. On the other hand, most older people, especially those who are unable or unwilling to adjust, are the losers in the transition processes. State pensions are around €2,500 per year and thus pathetically low. Unemployment benefits are close to, or even below, subsistence levels, and run out quickly. As to the other end of the income scale, judging by the *Forbes* World Billionaires list, as well as plenty of anecdotal evidence, hardly any other country has such a concentration of extreme wealth. The tax system as a whole is very regressive, ie unfair.

COUNTRY FILE

Population size: 143.3 million
Area: 17,075,400km²
% growth in 2012: 3.4
Type of govt: Federal semi-presidential constitutional republic
Official language: Russian
Capital city: Moscow
Largest city: Moscow
GDP (PPP): $2.414 trillion (2011)
Currency: Russian ruble
Currency rate against the euro: 0.03

A defining feature of Russia is its vast open spaces that are spread over nine time zones. It is by far the largest country on Earth. The population density is only eight people per square kilometre (east of the Urals mountain range it is actually less than one), compared with 32 in the US and 229 in Germany. Much of the territory is rather inhospitable because it lies so far north, but there are also large fertile regions in the south. No other country is as well endowed with natural resources. They wait to be developed.

Global real GDP is expanding at a rate of around 3.6% per year (calculated on the basis of the International Monetary Fund's purchasing power parities). Emerging and developing countries, where 85% of the world population lives, are driving growth. But these parts of the world will stay in catching-up-with-the-West mode for decades to come. For the time being, their

The skyscrapers of the Moscow International Business Centre

TOP TIPS FOR DOING BUSINESS IN RUSSIA

1. Remember to address people with their 'patronymic' name, which is based on the first name of their father.

2. **Be careful about compromising as it can be a sign of weakness in business negotiations.**

3. Make sure you look polished and professional – many Russians are very fashion-conscious.

4. **When making small talk, stick to sport and family, and avoid talk of politics if you want to avoid causing offence.**

5. Take time to build up rapport with your Russian contacts before talking business – you will get a better outcome in the end.

focus will be on the production of goods, rather than services, because the priority of poor people is to eat better, improve their houses or build new ones, equip them and buy cars. Industrial production, an energy and commodity-intensive activity, is therefore increasing at an even faster pace than global GDP. Extracting stuff from the ground may be unglamorous, old-economy and not very dynamic, but there will always be a market for it. Not only that, but given their finite nature, it is likely that the relative prices of hydrocarbons and metals will continue to rise in the long term. This is good news for Russia, which remains the world's indispensable supplier of hydrocarbons and metals.

To possess a huge treasure trove of commodities is both a blessing and a curse. It is a blessing because demand will always exist for these products – selling them abroad provides Russia with the financial means to import whatever is needed. In fact, annual revenues from exports presently exceed the cost of imports to the tune of €160bn, or 11% of GDP. This is one of the world's largest trade surpluses and it almost seems that the country cannot spend all the money it receives from abroad. As a result, Russia is one of the top net exporters of capital. Foreign currency reserves of €400bn are only a part of its accumulated foreign assets.

The curse of commodities is that, although the long-term trend is for rising prices, swings around this trend can be extremely wide. Given Russia's dependence on commodity markets, these swings tend to have a strong impact on GDP growth and unemployment. Export of hydrocarbons account for almost 60% of overall exports, metals are another 9% and 'other raw materials and food' a further 6%, totalling 75% overall. Since exports constitute a 30% share of nominal GDP, it is inevitable that the revenues and profits of the export-dependent firms dominate Russia's economy and can cause its stock market to fluctuate wildly. This is one reason why the average price-to-earnings ratio of Russian stocks is less than six and thus only about half as high as the ratios in neighbouring Western European countries. In other words, raising equity capital is expensive, which in turn leads to a relatively low investment ratio of 24. Other emerging economies have higher ratios and are therefore growing at higher rates in the medium term.

When commodity prices are high and rising, another curse comes in the form of income levels that increase by more than is suggested by the growth rate of nominal GDP. Meanwhile, the ruble exchange rate tends to appreciate significantly, reducing import prices. Both factors have the effect of boosting imports – and making exporting non-commodity products difficult. It is also difficult to create a competitive manufacturing industry and to broaden the production base. So real GDP cannot expand much faster than the output of the extracting industries, ie relatively slowly. The growth rate of Russia's potential GDP is in the range of 3.5% to 4%. China and India, which are both net importers of energy and raw materials, but have well-diversified economies, are growing at medium-term rates of 8% and 6% respectively.

Russia is very dependent on revenues from the commodity sector. Oil, in particular, is taxed heavily. Fairly high oil prices at present mean that the Russian government has a lot of money to spend and it will still be able to balance its books again this year. Total government debt is about 10% of GDP. The credit rating of Russian public sector debt is only BBB+, about the lowest possible investment grade, but this has nothing to do with the fiscal situation, foreign balances, inflation, unemployment or economic growth – these are all fine. Investors worry about corruption, the centralisation of power and the dependence of the economy on the ups and downs of commodity prices. Most of all, they do not trust the government. They doubt whether it will always honour its commitments. Russia's default on its debt in 1998 is not yet forgotten. A country without a genuine opposition is not stable in the long run.

Dieter Wermuth
is chief economist and a partner at Wermuth Asset Management, based in Mainz, Germany.
www.wermutham.com