It's the Financial Markets, Stupid

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Overview

Looking ahead 5-10 years, continued strong economic performance in Russia will depend not on most commentators' favourite mantra of diversification away from natural resources (a decades-long process), but rather on financial markets - and especially the development of domestic markets, as highlighted by the recent move to full ruble convertibility.

Our view stems from two fundamental changes. First, the bounce-back growth phase after the 1990s slump has given way to *investment-led* growth. Secondly, Russia has become a *net international creditor* nation. Monetary policy will tighten on the basis of inflation targeting, and against the background of surging public spending on infrastructure investment. A weaker oil price - or merely a more stable one - will facilitate these shifts. Some froth will be removed from local debt and equity markets. The ruble looks the safest bet of all.

Core Case

Investment-led growth is now the top priority of financial policy; domestic financial markets have been assigned a major role in channelling capital to new investment.

Assumptions and Evidence

A short chart show illustrates the background for the development of domestic financial markets.

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Now that the goal of debt reduction has been met, investment has become the main priority of financial policy; domestic financial markets are set to play a major role in channelling the new investment. It is commonplace that the key question for Russia is the sustainability of its strong economic recovery since the financial crash of 1998. Almost equally commonplace is the notion that sustainability depends on diversifying the economy away from its present concentration in natural resources. This second point is common sense, but of the practically useless variety - suspended as it is between the banal and the unknowable. During the long years in which Russia's economic performance will hinge mainly on the efficient exploitation of its natural resources, new comparative advantages will emerge. For now, intelligent guesses can be made about the pace and extent of this process, and still more the question of where those new advantages might lie: but the exact answers in any case matter little, and only time will tell. We believe that the most important issues for the Russian economy at present lie elsewhere.

The right starting point for thinking about prospects for the Russian economy must be two fundamental changes in the country's recent economic development.

1. **The shift to investment-led growth**. The first phase of economic recovery was the easy bit, based as it was on spare capacity - both labour and capital stock. In other words, not much new investment was needed. The productivity gains consisted in using this spare capacity more efficiently (with labour productivity gains being the 'lowest hanging fruit'). This phase lasted for roughly the first five years after the 1998 crash, with high bounce-back annual growth rates decelerating by mid-decade. Since then, growth rates have picked up again, driven in the short-term by buoyant consumer demand - but now increasingly reliant on investment, as capacity constraints start biting across the board.
2. **The shift to net international creditor status**.The sharp rise in oil prices in recent years brought fiscal windfalls for Russia (enhanced by the introduction of a windfall tax regime for the oil companies). Russia wisely saved the bulk of these windfalls, first via budget surpluses and then beginning in 2004 in a separate Stabilization Fund. The resources of this Fund have since been used for accelerated external debt repayments. As a result, external public debt has fallen to 5% of GDP, and despite the surge in foreign borrowing by the private sector (on which more below), the $300 billion in international financial assets held by the Central Bank and government leaves Russia's international balance sheet showing a solid net creditor position.

These two shifts were linked together in two turning points that occurred during 2006.

- On 23 August, the entire residual stock of debt to official ('Paris Club') creditors was retired in a single $23.7 billion payment from the Stabilisation Fund. The result is that the original goal of debt reduction has been met, and investment is now the top priority for the government's financial policy.
- On 1 July, six months ahead of schedule, the ruble became a fully convertible currency. This move in effect declares that Russia is ready to live in a world of globalised capital.

The economic story unfolding from these developments will revolve around financial markets. This is true in both an external and internal sense.

Full integration with global financial markets. It is far from certain that Russia's top leadership fully understand the implications of this for policy and reform - particularly as the timing of the move to convertibility ahead of the G8 summit in St Petersburg was clearly motivated by prestige and status. But the past few years' combination of high oil prices and sound fiscal policy (debt reduction) has transformed Russia's underlying interests. When you are sitting with virtually no foreign debt and $300 billion, going on $400 billion, in IOUs from abroad, you no longer have the option whether or not to engage with global capital markets, you must engage for self-interested

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reasons. And this includes an interest in translating the country's financial strengths into outward foreign direct investment. As President Putin put it in a speech to German businessmen in October 2006: "The Russians are coming not with tanks and Kalashnikovs...they are coming with money and they want rights." Another case in point is Putin's well-publicised interest in increasing the country's equity stake in EADS.

Russia's overarching international political goal is to reclaim what it considers its rightful place in influencing events on the world stage. Among other means, Russia appears eager to use its new-found financial strength to this end. The country is fortunate that the country's top financial policy makers have the strategic vision to realise that opening to global financial markets is an essential precondition to achieving this goal.

Development of the domestic financial market. In our view, this is the most important point of all. The thrust of policy is to assign a key role for the domestic capital market in financing investment-led growth. Once again the introduction of full convertibility for the ruble offers a key to understanding. This move involved eliminating all the existing barriers to the inflows of foreign capital; barriers to currency outflows had already been lifted earlier. So besides factors such as prestige and this being the logical result of sound financial management, convertibility is clearly also seen as a means to an end - that is, as a means to further the new priority goal of increasing economy-wide investment.

The logic of this new policy is to facilitate the financing of a significant portion of this investment push using foreign capital inflows (including repatriated flight capital) intermediated by Russia's domestic capital markets. Convertibility is essential for attracting inflows into domestic markets. There would have been no need to fast track the move to full convertibility if the plan was to rely on foreign markets to provide direct, non-ruble financing - as has in fact been the case since 2002, a period in which foreign borrowing by Russian banks and industrial enterprises has leapt from 11.5% to 25% of GDP.

There is a further key reason for prioritising domestic markets.

This is the inflation problem, which is the major blot on Russia's otherwise healthy macroeconomic landscape. Russia needs to create effective monetary tools to control domestic liquidity and inflation, a difficult task if much of the country's financing comes via foreign markets and currencies, but potentially feasible by means of Central Bank open market operations if financing is channelled through domestic markets.

Convertibility will only fuel inflation and financial instability if further financial reforms do not follow in its wake. In 3Q06 alone - that is, the first quarter after the introduction of full convertibility - private capital inflows amounted to $13.9 billion, matching the number for the whole of 1H06. An essential reform is the move from the current monetary policy based on a managed exchange rate peg to proper inflation targeting.

The existing practice of massive unsterilised interventions by the Central Bank in the local forex market is not only inflationary but will also become increasingly ineffective in its own terms (of restraining ruble appreciation for the sake of competitiveness) in the face of the increasing capital inflows engendered by convertibility.

Successful inflation targeting based on open market operations by the Central Bank becoming the primary tool of monetary control would limit the real currency appreciation which the authorities fear (because of its negative impact on output and employment). It would also reduce nominal interest rates, which would enhance the accessibility and attractiveness of the domestic financial market to creditworthy domestic borrowers.

We stress 'creditworthy' in this context because of one other crucial effect of this evolution of Russia's financial policy.

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Real interest rates will shift at last from negative to positive.

This shift will be driven by three factors.

1. Effective Central Bank open market operations will need much higher volumes of outstanding government paper.
2. Deeper local markets are also important for ensuring an adequate range of investment opportunities for the growing domestic pensions and insurance industries. As things stand, regulations require the vast bulk of pension savings to be invested in the thin government debt market, resulting in negative real yields.
3. Increasing government debt issuance is in any case on the cards. With its debt reduction project largely complete, the government will henceforward be hiking its share in fixed capital investment - especially the infrastructure investment which is increasingly essential for sustaining overall economic growth. This investment-driven fiscal expansion is coming against the background of a declining oil price. The resulting prospect is one of deficits (at least of current spending exceeding revenue apart from that portion of revenues automatically transferred to the Stabilisation Fund). And those deficits will be financed through domestic debt.

We arrive at a somewhat paradoxical conclusion, that a stable or weaker trend in oil prices is likely to foster financial reforms, including a move to inflation targeting and rising real interest rates.

In this scenario (our base case), the contraction in the current account would be offset by a stronger capital account, as inflows continued into the domestic market. This leads to a second paradoxical conclusion that the ruble exchange rate will continue to appreciate in a softer oil price environment.

Upward pressure on the ruble would of course be maintained in the alternative scenario of continuing strong rises in oil prices. But this would retard the expected policy shifts in macroeconomic management, as fiscal policy would in this case have to go on carrying the major burden of monetary sterilisation, with monetary policy relegated by necessity to a supporting role.

So in any event, **the safest bet among Russian financial assets for the rest of this decade looks set to be the ruble**. In our base case of monetary tightening and increased issuance, some of the froth will disappear from other Russian asset markets, and prices (especially of equities) will have trouble sustaining their spectacular performance of recent years. But the equity market should still deliver attractive double-digit annual returns as, over time, the combination of higher investment rates and lower inflation underpin earnings growth and valuations.

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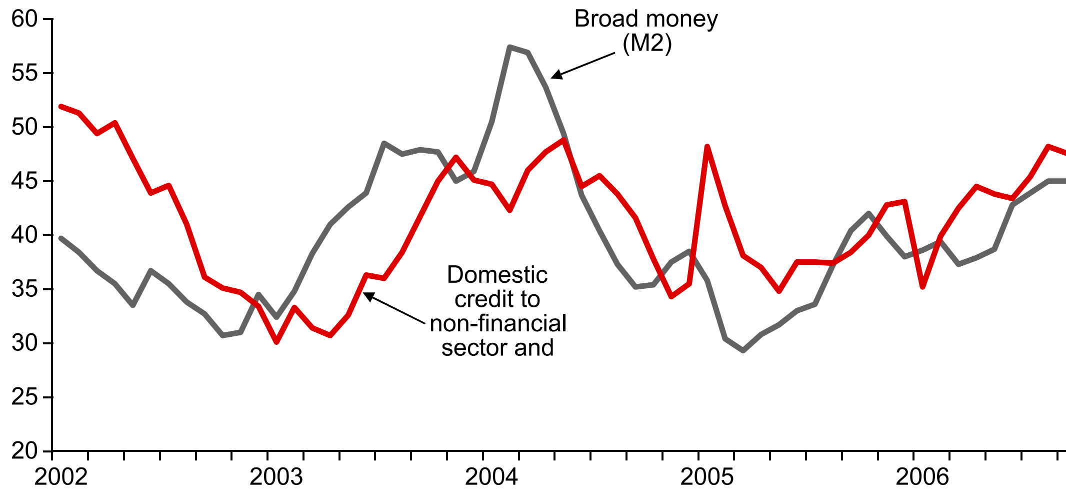
Assumptions and Evidence

A short chart show illustrates the background for the development of domestic financial markets.

The sequence of charts below demonstrates the 'story' of domestic financial market development being the key to investment-led growth with lower inflation.

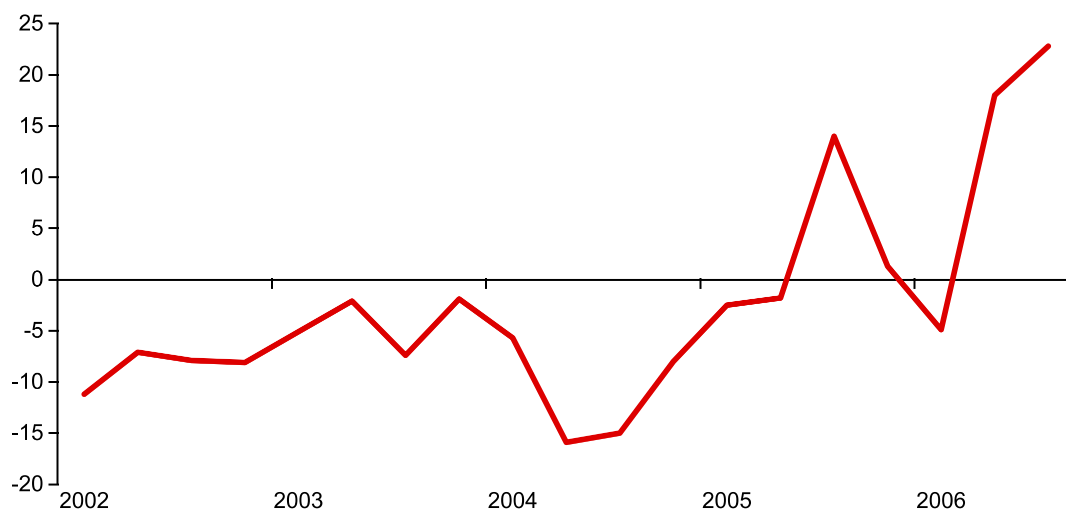
Money supply is expanding at the fastest rates since 2002-04...

Domestic liquidity, % chg yoy



...and the move to convertibility has boosted this expansion...

Net flows of private capital, 4Q mov/ave, $ billion



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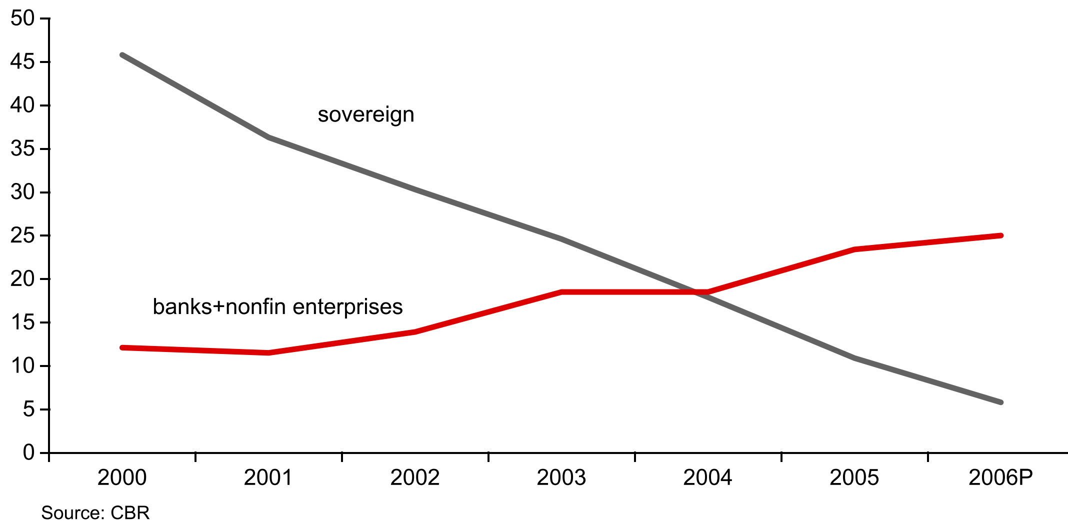
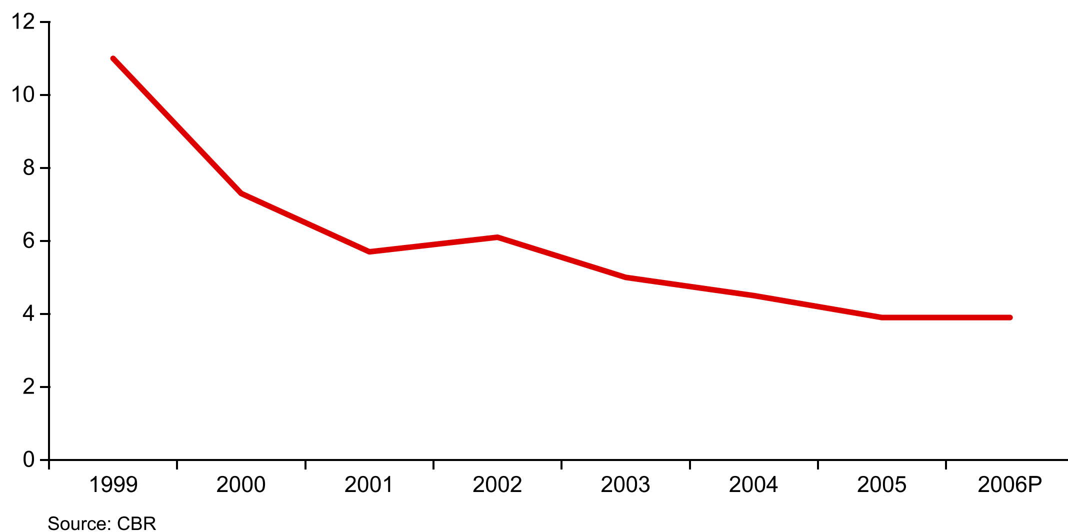
...and despite abundant domestic liquidity, Russian issuers have been on a foreign borrowing spree...

Total foreign debt, % of GDP



...while authorities? local debt issuance has declined to 4%...

Domestic government debt, % GDP



...keeping real rates negative

Inflation and interest rates

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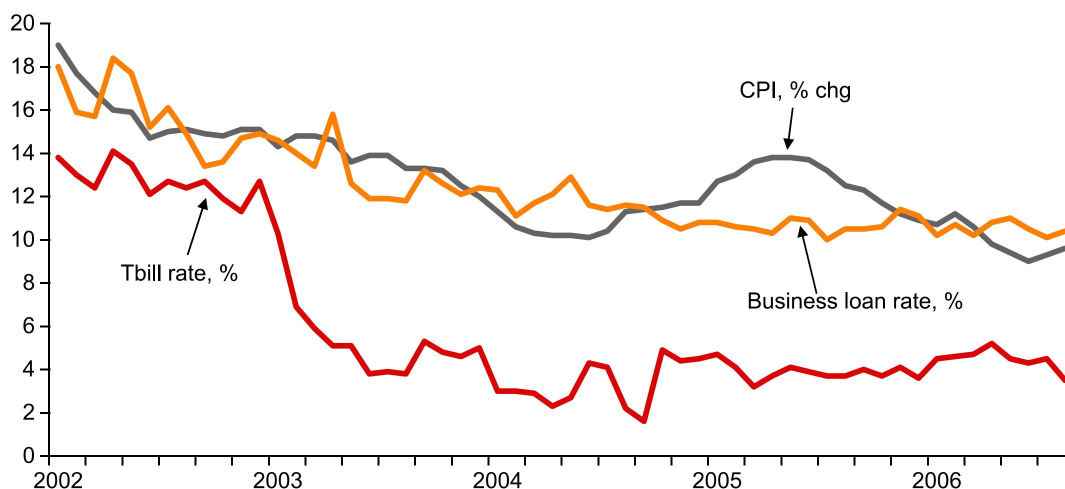

Source: CBR

Meanwhile, public spending and the oil price are moving in different directions

Finance Minister Aleksey Kudrin speaking on 2 October 2006:

In the period up to 2006, we were able to extinguish debt thanks to oil prices; beginning in 2007 we will be forced to go into debt in order to support the level of budget expenditures which has been reached [especially on investment, with nominal appropriations rising 50% in 2007 compared to 2006]...We are forced to go into debt in the domestic market and pay for it.

Source: Prime TASS

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