WERMUTH ASSET MANAGEMENT
Delivering Value

Dieter's "Investing in Russia"
2 June, 2011

"Fix the rouble against the euro, introduce capital controls"

- **In my last "Investing in Russia" letter I suggested there were mainly four reasons why it made sense to buy Russian equities:**
  1. they are cheap;
  2. as a middle-income country with plenty of catching-up potential there are numerous growth stories;
  3. the structure of global growth favors producers of energy and commodities;
  4. persistent current account surpluses translate into an appreciating rouble.

- I want to go one step further this month and **ask why Russia is not growing much faster than it is, and what can be done to change this.** Russia is mainly a commodity story rather than a growth story. It is not really satisfying to buy something because it is cheap on the basis of today's earnings. Investors who are in the market for the long haul prefer to buy assets that can be expected to generate not just high but rising profits, even if these stocks are relatively expensive on the basis of today's earnings.

- **With China's growth story in mind, I propose that Russia should try to reduce the volatility of the rouble exchange rate as well as the volatility of export prices. Lower volatility means better predictability and therefore less risk, lower real interest rates, more capital expenditures and thus faster growth.**

- **In my view, the optimal solution is to irrevocably fix the rouble against the euro at an initially undervalued level of perhaps 50 (40 roubles today), introduce capital controls to solve the dilemma that a country cannot simultaneously have a fixed exchange rate and effective independent monetary policies without a control of cross-border capital movements, and use import and export duties in a flexible way to stabilize the balance on current account. A WTO membership would be counterproductive.**

- It is clear that these proposals alone cannot lift the Russian economy onto a steeper growth path. No less important is a thorough **reform of the institutional framework:**

  - both political and economic power is far too centralized; growth and innovation require diversity and competition,
  - the distribution of income and wealth is very uneven,
  - compared to China in particular there is no broad base of small and medium-sized enterprises,
  - the infrastructure is inadequate,
  - the political and regulatory risk is exceptionally high,
  - corruption is endemic, almost like in a failed state,
  - and so on.

- **China has also serious institutional problems**. There is no rule of law to speak of, the communist party does not allow any opposition, the state's control of the media is (almost) absolute, and interference in business decisions is routine. It also lacks Russia's rich endowment with natural resources. Yet the speed at which the general standard of living is increasing is anything if not breathtaking.

Wermuth Asset Management GmbH

Langgasse 38-40
65183 Wiesbaden, Germany
Phone +49 69 95925478
Fax +49 69 95925479

Bryanskaya 5
Moscow 121059, Russia
Phone +7 495 5807300
Fax +7 495 5807302

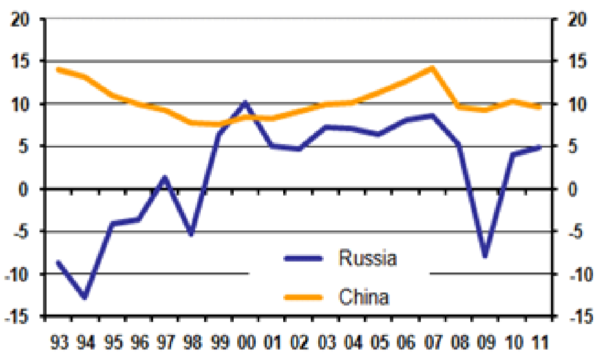
Seat of the Company:
Amtsgericht Wiesbaden
HRB 24805
USt-ID-Nr. DE 200 110 358

Managing Directors:
Jochen Wermuth,
Maarten van den Belt,
Michael Ludwig,
Dr. Dieter Wermuth,
Michael H. Choi

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

- The International Monetary Fund predicts that **its real GDP will expand at annual rates of around 9% in the next five years while Russia will grow by just 4½%.** I just saw a table from economists at Moscow's Alfa Bank who predict a growth rate for the next decade of only 3%.

1. **real GDP growth*) (persent y/y)**



*) 2010 (Russia), 2011 (Russia, China) IMF estimates

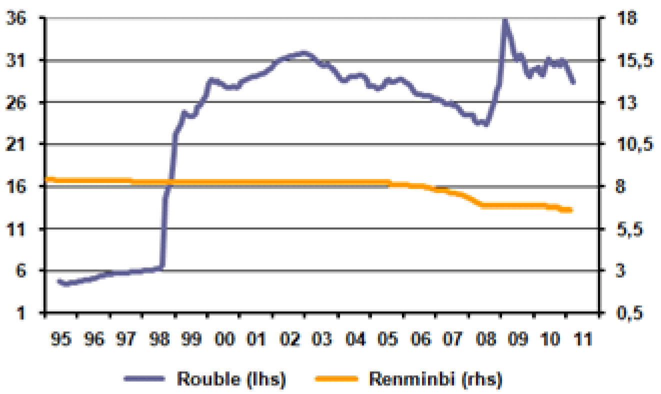
Source: IMF

- Graph number 1 shows the two countries' real GDP performance over the past 18 years – the entries for 2011 are IMF estimates.

- For me, it is **the exchange rate management that explains much of the difference in growth performance.** Some would argue that a low-income country like China will always expand faster than a middle-income country like Russia: productivity gains are a function of the size of the existing capital stock, and China's is smaller on a per capita basis. This is not the case any longer, I would think, and thus not a convincing explanation.

- **What keeps Russia back is its continued reliance on the production of raw materials, the resulting exposure to the ups and downs of commodity prices, and the volatile and overvalued exchange rate. If these problems can somehow be brought under control, growth would accelerate noticeably.**

2. nominal exchange rates (per US dollar)

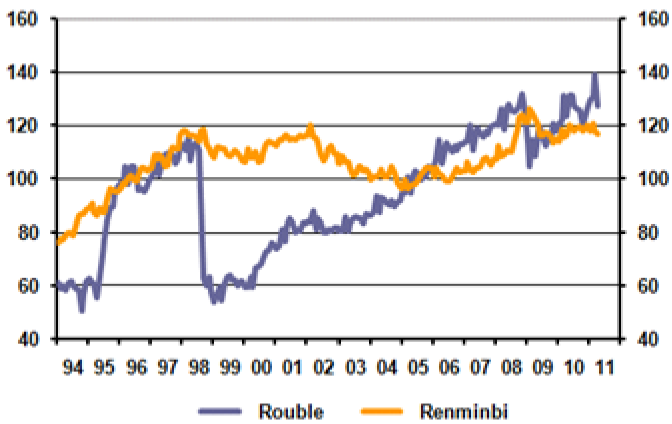


Source: IMF

- The second graph shows the vast volatility difference between the bilateral dollar exchange rates of renminbi and rouble. The rouble is all over the place while the Chinese currency is tightly controlled.

- Graph number 3 compares the two real effective exchange rates. The data are from the Bank for International Settlements, also known as the central bank of central banks. Even on this basis, which takes account of international inflation differentials and the structure of each country's trade the renminbi has been impressively stable: between 1996 and today it has moved sideways in an index range of 100 to 120. The rouble, on the other hand, fluctuated between 55 and 140. Not only that, it has also been appreciating in real terms by more than 100% since the end of the nineties. This has made imports increasingly attractive for Russians and has destroyed

3. real effective exchange rates (2005=100)

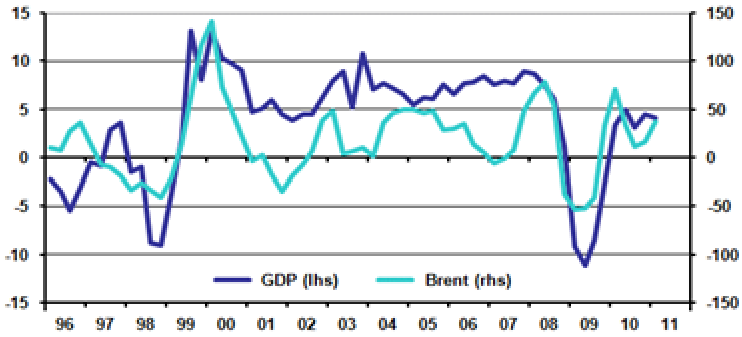


Source: BIS

those large swathes of domestic production that are exposed to international competition.

- The next graph (#4) illustrates the correlation between ye ar-on-year changes in the dollar price of crude oil and Russia's real GDP. Two observations are relevant here: 1. when the oil price moves a lot, Russia's GDP moves a lot as well, and in the same direction, 2. rising oil prices boost GDP growth, and vice versa. In other words, the economy is still a hostage of the oil price, like it or not.

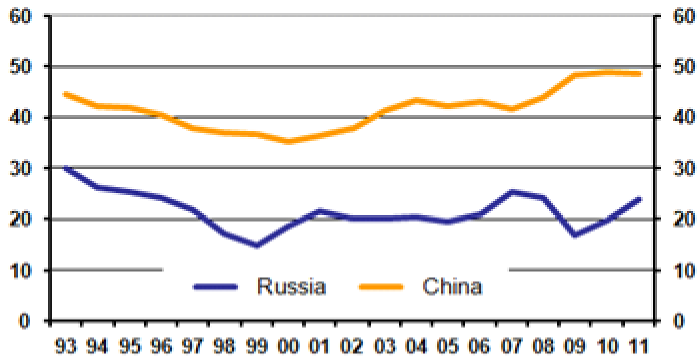
4. Russia" real GDP growth and the oil price (percent y/y)



Source: IMF, Bloomberg

- In the end, it all boils down to how much of its output a country shovels back into capital expenditures. The higher the ratio, the steeper the growth trend of real GDP, all else equal. Graph 5 illustrates the huge difference between China – 40 to 50% in the past decade – and Russia where it is a disappointing 20% or so.

5. investment ratios*) (in percent of GDP)



*) 2010 (Russia), 2011 (Russia, China) IMF estimates

Source: IMF

- **Russia's investment activity must urgently be boosted if the standard of living is to rise more briskly. In a fast-growing economy it is easier to make the necessary institutional reforms than in an economy that crawls along at rates of 3 or 4%.** To be sure, rates of 3 or 4% are not bad at all, considering that trend growth in the OECD region is in the order of only 2%, but compared to other emerging markets which on average power ahead at something like 7%, Russia would be seen as falling back significantly.

- So I suggest, as mentioned above, **several measures that address Russia's sub-par spending on capital goods. The first is to fix the exchange rate.** Up to now, the signals that investors get are starkly contradictory: at one time it is cheap to invest in a Russian business, and soon after the situation has changed completely: at the new exchange rate, investing does not make sense any more. This has to stop. China has shown how it can be done.

- **It does not make sense to peg the rouble against a basket** that contains the dollar and euro in fixed amounts (.55 and .45). If push comes to shove Russia would have to intervene massively in the bilateral euro-dollar market to keep the rouble at a fixed rate against the two currencies. This is de facto impossible, given the fact that Russia's nominal GDP is less than 6% of the aggregated US and euro area GDP.

- **The peg must be against the euro, the currency of the economy that accounts for more than three quarters of Russia's trade and foreign direct investment.** Since the euro area's balance on current account deficit is usually quite small or non-existent, especially when compared to the US, there will in all likelihood not be much pressure to accumulate large euro-denominated currency reserves. This limits the inflationary risk, aside from the fact that the ECB is credibly aiming for a 2% consumer price inflation rate in the medium term. In a currency union or a fixed rate system, inflation rates tend to converge over time.

- The question is which exchange rate to choose. Since the rouble has been so strong, to the detriment of domestic production, a **large one-time depreciation from 40 roubles per euro to 50 roubles could be considered.** In the beginning, the central bank of Russia may have to buy euros on a massive scale, flooding the market with rouble liquidity. This can quite easily be compensated by selling part of the dollar reserves (which leads to an appreciation of the rouble against the dollar).

- China and Germany or Japan during the fixed dollar rate Bretton Woods system have shown that it is **almost impossible to maintain a certain bilateral exchange rate (such as 50 roubles to the euro) without capital controls. These are needed both on the outflow and the inflow side. Russia would have to introduce such controls as well.** The announcement that anybody who wants to export capital across the border would need a permission from the authorities will certainly lead to a wave of capital flight (selling rouble / buying euros). This would bring the exchange rate quickly to the desired point. But afterwards there would be no capital flight no more.

- Russsians will thus be forced to offer their international payment surpluses to the central bank. It would buy without a quantitative limit all foreign currencies that are being offered.

- Restrictions on the export of capital have **the nice side effect that entrepreneurs are forced to look for more investment opportunities at home** – which boosts the investment ratio. To attract foreign direct investors (who like the cheap and newly stable rouble) special arrangements about the repatriation of funds are obviously needed.

- For the neoclassical economists who for decades had dominated the thinking at the International Monetary Fund capital controls are no longer the taboo that they used to be. China's success story which, to a large extent, relies on a fixed undervalued bilateral dollar exchange rate and capital controls, can simply not be ignored. It is the right policy for countries in catching-up mode.

- **Russia must also do something about the wide fluctuations of its export revenues. China does not have this problem.** To stabilize these revenues and the surplus in the balance of trade, and make defending the 50 rouble exchange rate easier, it is sensible to introduce flexible export duties and excise taxes, and put these revenues to good use in the form of financing infrastructure and building reserve funds for the future when the tide turns again. Since this is against WTO rules, Russia should stop considering joining the organization.

- **A stable and undervalued exchange rate, combined with a control of capital flows and opportunistic trade restrictions, is a powerful tool that will increase capital spending and growth in Russia. The country is too small in economic terms to have both a wildly fluctuating exchange rate and wildly fluctuating export prices.**

- This does not mean that other policies to promote growth shouldn't be pursued simultaneously, such as breaking up the state-controlled behemoths, encouraging start-ups, accelerating privatization, providing strong incentives for capital spending and R&D, or improving the energy efficiency, to name just a few.

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