Russia: giant of a new economic world order

by Heather Connon via rialator - The Observer *Sunday, May 25 2008, 5:09am*
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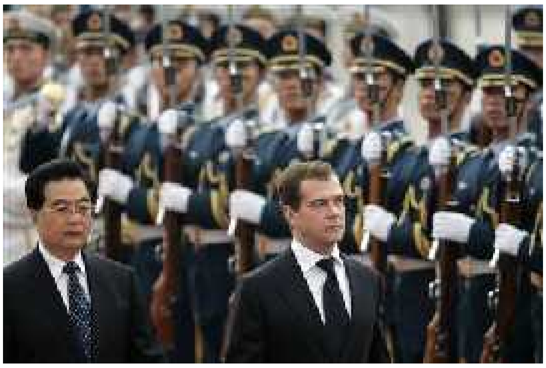
> The 'Bric' [Brazil, Russia, India, China] economies have captured the headlines, but India and China have so far won the lion's share. What about the other half of the acronym? Here, Heather Connon witnesses a revolutionary era in Moscow.



Sino-Russian military alliance, overwhelming

Two decades ago, Russians would always have a string bag known as an avoska - a just-in-case bag - tucked in their pocket 'just in case' they spotted some oranges or other consumer staple for sale in the normally empty shops and market stalls. These days, Muscovites are as likely as Manchester United and Chelsea fans to be sporting carrier bags from GUM, the 242m-long shopping mall that runs along the eastern side of Red Square and is crammed with labels from Hugo Boss to Russian specialist shops.

Russia is booming: there are more '6 series' BMWs in Moscow than in any other city in the world and there is barely a Lada to be seen among the Mercedes, Audis and Range Rovers that clog its congested streets; within the next year or two, Russia will overtake Germany to become the world's biggest car market.

It is not just cars. Ordinary Russians are snapping up everything from baby-food to designer bags as they splash out with their newfound wealth; average earnings have been growing by around 20 per cent a year and consumption has been following close behind. At around $8,500 (£4,300) a year, average earnings are still low by Western standards but they are stratospheric compared with a decade ago, when the average was less than $1,100 and a greater proportion of the population had to get by on less than $1 a day than in India.

Disposable income is also higher than that suggests, given that tax is at a flat rate of 13 per cent and, with every Russian having been given their own flat or house free as the Soviet era ended, mortgages and consumer debts are rare. It is not hard to work out the reason for the transformation: gold, both black and yellow. Russia vies with Saudi Arabia to be the largest oil producer in the world: it has the second-largest oil reserves in the world, the largest gas reserves and the fourth-largest gold reserves. Just over a decade ago, oil was trading at around $10 a barrel; last week it passed through $135 for the first time. Over the same period, the price of gold more than trebled, to over $900 an ounce.

No wonder Vladimir Putin was described as the lucky President: his elevation to that role in 1990 coincided with the commodity boom and his skill in riding it means that, after two terms as President, he has just been elected Prime Minister and can still claim unprecedented popularity ratings.

He deserves plaudits for managing the economy's growth. He arrived two years after Russia stunned international investors by defaulting on its debts, triggering a collapse in the rouble and a crisis in emerging markets across the world. Growth has since averaged a healthy 7 per cent a year and some commentators say it is the world's most successful economy. Putin has also husbanded the resource wealth wisely: the stabilisation fund, designed to conserve the oil and gas windfall and to prevent it distorting the rest of the economy, reached almost $160bn by the end of 2007, while Russia has also built up the world's third-largest foreign exchange reserves.

Oil is undoubtedly crucial. It accounts for two-thirds of exports, a quarter of GDP and half of Russia's stock market. But the challenge facing Putin and Dmitry Medvedev, his handpicked, and some fear henpecked, successor as president, is to demonstrate that the country is more than simply a resources play and that they have effected a more lasting transformation of the economy.

Russia's growth strategy will be familiar to anyone who has studied the spectacular growth in China and India: enriching and empowering its 140 million consumers while investing to improve its decrepit infrastructure.

There is still plenty of scope for boosting consumer demand: Yaroslav Lissovolik, chief economist at Deutsche Bank in Russia, says: 'Moscow is Russia's showcase. Outside Moscow, there is a very different picture.' Tyumen Oblast, heartland of the Siberian oil barons, is the next-wealthiest area but is just half as rich as the capital, while the poorest areas could have as little as 4 per cent of Moscow's wealth per capita. But the cities outside Moscow are now growing far more rapidly and Medvedev aims to increase the proportion of the middle classes from the current 20 per cent to half.

The housing market illustrates just one area of opportunity: while everyone owns their home, the stock is decrepit. Two-thirds of the housing stock is more than 30 years old - many of the five-storey apartment blocks erected during the Khrushchev era during the 1960s and designed to last just 20 years are only now being demolished - and almost 40 per cent of Russians have no running water or sewage systems in their homes.

Putin is promising between 70 and 80 million square feet of new housing by 2010, 10 million of that state housing, so that the number of Russians who can afford to buy a new house should rise to a third, from the current 5 per cent. That should fuel a dramatic increase in mortgages; the number has been doubling annually and, on Putin's targets, should grow to a million within two years. Consumer credit, too, has been surging as Russians are losing their suspicion that banks are where you risk losing your money and realise they could instead offer a way for them to buy cars or upgrade their houses.

'The wealth effect is trickling down,' says Robin Geffen, managing director of emerging market specialist Neptune Investment Management. He points to the recent rapid growth of Aeroflot, the state airline, which has increased its domestic air traffic - where it has a stranglehold - by 18 per cent. 'It has a young and dynamic management which has responsibility for revitalising what was a pretty antiquated company.'

He can see plenty of opportunities among companies like this, which are being built up by a new class of entrepreneur and are prospering from the growing consumer wealth.

Infrastructure spending is also being stepped up - and it is much needed. Roland Nash, managing director and head of research at Russian investment specialists Renaissance Capital, says that only one in 10 requests for access to the power grid is approved, while the number of airports has plunged from 1,300 in the Soviet era to 300. Road and rail services are poor, with virtually no connections from the north to the south - a key route for trade with China.

The biggest challenge is to manage this spending without fuelling the already rapidly rising inflation. With food accounting for around 40 per cent of the average Russian basket compared with between 10 and 20 per cent for developed countries, the impact of soaring food prices is much more severe and inflation, having been falling, is creeping up towards 15 per cent again.

'They do need to get inflation under control,' says Elena Shaftan, manager of Jupiter's New Europe fund. 'In Russia, it is being driven by the same forces as everywhere else - food - but the government has not helped with the massive spending before the election [in December].' She adds that the inflation-fighting Prime Minister remains in his job.

She is also relatively sanguine about the other key concern for Russian investors: the role of the state. Few dispute the fact that, during the 1990s, the Russian oligarchs were given state assets too cheaply and much of the current focus is on ensuring that does not happen again.

Last week, BP's Moscow offices were raided again and both it and Shell have experienced problems with their oil joint ventures there. But, says Shaftan, the key factor is that the regime is both 'stable and predictable'. While not everyone may agree with the way Putin operates or the role of state-controlled resource companies, Shaftan says everyone should know the state of play. 'If you listen and abide by the rules, you are fine.'

Medvedev and Hu, faces of the future

http://www.guardian.co.uk/business/2008/may/25/economics.russia

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