The Moscow Times
30 YEARS
INDEPENDENT NEWS FROM RUSSIA

What Russia Must Do to Become a Normal Nation

By Dieter Wermuth

April 22, 2013

The macroeconomic situation in Russia remains outstanding, with relatively low public and private sector debt, low inflation, a strong balance of payment and, for the time being, a relatively small government budget deficit. But capital spending by Russians and foreigners suffers from the perception of a weak rule of law. Russia has set itself a clear target to improve things and has signed international agreements that commit the government to live by the rule of law. On paper, it has accepted that one of the highest courts is in Luxembourg, outside its area of control. Germany, France, Britain and others have given up sovereignty in this respect. If Russia followed this model in earnest and also implemented an effective system of checks and balances, the investment climate could improve a lot.

One of today's puzzles is the low valuation of Russian equities. On average, they cost just 5.2 times the expected profits of 2012, while Canadian stocks trade at 13.3 times earnings and Norwegian stocks at 10.9 times. The message from price-to-book ratios is similar. If a company is attractive for investors, the ratio should be well above 1. But Russian stocks average only 0.7, whereas Canadian and Norwegian stocks presently trade at 1.71 and 1.52.

Creating conditions that bring valuations on par with those of other stock markets would do wonders for the country's spending on capital goods, including foreign direct investment, the growth rate of real gross domestic product and thus for the standard of living.

If Russia initiates institutional reforms, the value of Russian assets could easily double.

One way to achieve this is to create an institutional framework similar to that of the democracies of Western Europe. This is just as important as broadening Russia's production base and reducing its dependency on raw materials. Indeed, a comprehensive and state-of-the-art institutional framework is probably the precondition for growth and stability. Economists place more emphasis on the role of institutions in development, such as independent courts, media, regulators and central banks. They also highly value a fair and efficient tax system, genuine opposition parties that have a reasonable chance to oust the existing government in free and fair elections, an incorruptible bureaucracy, good and affordable schools and universities and a well-maintained infrastructure.

Russia has serious deficiencies in all these areas and pays the price in the form of undervalued equities and real estate as well as fairly high real interest rates. The investment ratio is simply much too low for a country that aims to catch up with its rich Western European neighbors. Despite its rich natural resources, Russia is an unnecessarily poor country.

One approach to improve things is to use the European Union's "Acquis communautaire" as a guide for institutional reform. Norway and Turkey, very successful economies for some years now, have done this without being members of the EU. The Acquis covers the EU Treaty, the whole body of laws, decrees and guidelines passed by EU institutions as well as the judgments of the European courts. These are binding for all 27 countries, and new members have to fully adopt them. Dauntingly, the complete edition of the text comprises 31 volumes and more than 85,000 pages. But Cyprus and Malta have shown that it can be done, so Russia's parliament and civil service could certainly do it as well.

For years, Russians did not care much about institutional reform. They were able to increase their spending at a higher rate than the growth of production, as export commodity prices have outpaced import prices. Until recently, the general feeling has been that the standard of living continues to improve all the time. Since this was not accompanied by political and institutional progress, the rising middle classes are getting restive, demanding a bigger say in the country's decision making process.

To rely on ever higher commodity prices is not a sustainable growth model. There is no guarantee, of course, that prices will remain high. Every so often they crash and cause havoc in the rest of the economy. The 8 percent decline in the country's GDP in 2009, the 80 percent fall of stock prices between the middle and end of 2008, the 36 percent depreciation of the ruble against the dollar during that time, and the collapse of the real estate market were direct consequences of the crash of raw material prices, in particular the price of oil, which imploded from $147 to $33.50 between July and December 2008. To this day, markets are not yet back to pre-crisis levels.

If Russia had more robust institutions and took the rule of law seriously, investors would demand lower risk premiums for holding shares of companies and government and corporate bonds, which is another way of saying that asset prices could be much higher and the cost of capital correspondingly lower. A big increase in capital spending is needed to wean the country from its reliance on commodities. China's impressive growth model has at its core very high saving and investment ratios. Anything that helps to boost these must have top priority for policy makers.

Right now, the value of Russia's firms that are traded at the stock exchange is about 17 trillion rubles ($536 billion). Incidentally, only about a quarter of that is the so-called free float, the tradable part of the stock market. For a large country like Russia, these are miniscule numbers. Not only that, there is also a notable lack of a layer of medium-sized and mostly family owned firms below the small group of listed companies. In Germany, they are the backbone of the economy.

If the government could credibly show that it will initiate an institutional reform process on the basis of EU standards, the valuation of Russian assets could easily double, cutting the cost of capital expenditures by half. Perhaps more important, Russia would become a more normal country where people like to live, rather than emigrate.

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