

The global economic slowdown, and Russia's prospects...

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In our previous article featured in the December 2002 Bulletin, we commented on Kondratieff cycles and identified the world economy as being in the early part of a Depression phase: falling prices, rising commodity prices (particularly gold), stable interest rates, falling stock prices, falling profits, and a debt collapse. As the stock market collapses numerous scandals will emerge. A major war occurs that helps contribute to end of the depression phase and the start of the new expansion period.

To add to investor misery and uncertainty, two looming conflicts are now dividing the world and causing mobilization of diplomacy and troops – Iraq and North Korea. One is an emasculated nation with massive, key resources of hydro-carbons, namely oil! The second, a nuclear-conversant destitute nation with two Asian economic engines nearby, namely Japan and South Korea.

Both regimes have little to lose at this point, if pushed, and consequences could become global and secular in nature. G-7 led initiatives usefully distract from domestic economic weakness, with possible perverse Keynesian war economics and nationalism perceived as the antidote to failing fiscal and trade policies.

Russia sits amid conflict as the largest daily producer of oil (it overtook Saudi Arabia in July 2002), with geographical borders stretching from Europe to Asia to the Middle East, and a poor participant in G-8 but with a larger surplus at budget, current account and trade account levels, unlike its developed G-8 cousins. Let us first, however, examine the economies of the USA, European Union, and Japan, before considering the costs and benefits of a Depression phase to Russia's developing market economy.

The USA's: A possible roller-coaster economy may take Americans for a double-dip recession ride in 2003. While the US Dollar remained a flight currency, years of trade deficits were overlooked as investors sought safe haven US stocks and bonds, and a very un-Democratic government under the auspices of Robert Rubin, in conjunction with his Central Banker Alan Greenspan, reined in spending and actually moved to budget surplus. Retirement of US Treasuries helped to keep demand high and rates low, although Greenspan's liquidity flood 1997-1999 during the crises of Asia, Russia and Long Term Capital fuelled the biggest feeding frenzy of all times, the dot.com bubble.

Naturally the last to the party, the household investor, borrowed some cash, raided piggy-banks, and invested in this new paradigm as valuations soared beyond sensible levels, and once the institutions stopped investing and induced brokerages to whip up buying interest as an exit strategy, the foundations for disaster were firmly established. The corpo-

rate sector itself, seeing an infinite appetite for its stock, and exponential growth for its product (so the analysts told it), also piled on cheap debt and waited for earnings growth to outpace the rising debt-servicing costs.

The final straw was the 1999 Y2K expenditure on one-off upgrades, which set the scene for the Millennium hangover. Post January 2000, the Nasdaq has plummeted from 5,000+ to 1,200 approx., and the US has become a debtor nation with a negative savings rate for the first time in 39 years. And who will finance this debt? Not the government, budget deficits have re-emerged as quickly as they disappeared. Credit ratings have plummeted, and some high-profile bankruptcies have dissuaded the banks from getting too involved, and credit cards and re-mortgaging are the only options for the moment. When the housing bubble really bursts, the USA's decline (and that of the US Dollar), could accelerate to the point of Wall Street Crash levels of economic collapse.

The clouds over the UK economy have taken on a darker hue in the past few weeks. So much of its current prosperity relies on the consumer – and particularly the house-buying consumer – made starkly clear in surveys released recently. Last year's signs that Britain's rust belt was pulling itself out of recession are now looking like heralds of a false dawn.

Bleaker still, the rate at which companies are laying off workers is picking up, and there are now signs that the service sector, hitherto one of the economy's main props, is weakening. On the other hand, the latest indices produced by leading mortgage lenders the Halifax and the Nationwide show house prices continue to roar away at rates of between 23% and 25% a year. Meantime, it appears that mortgage lending has leapt 44% to £7.8bn over the year to January.

As with the USA, households, it would appear, are using the soaring value of their house to load themselves up with debt to move home or spend the extra money. The market expects lower pay settlements and higher National Insurance charges from April, together with higher house prices, to cool the market later this year. There are clearly risks that the boom will only be stopped by a violent bursting of the bubble, Japan-style. The Bank of England's Monetary Policy Committee implicitly recognised this in deciding not to cut rates further after February's unexpected quarter-point reduction. Recent quarter-point cut in European lending rates reflect the stagnation affecting the Continental economies. Meantime, the pound has sunk to a four-year low as foreign exchange markets grow increasingly sceptical about the budgeting skills of the Chancellor, Gordon Brown.

The chorus of opinion that not just government borrowing, but taxes too, will have to rise is growing louder. Brown will reveal his latest thinking in the Budget, set for 9 April. But if the prospect of further government imposts were to hit consumer spending – and the signs from the Confederation of British Industry are that it is already wea-



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kening – and the housing market imploded, then the UK economy will start to look seriously troubled.

Germany, Europe's biggest economy, is in the bad shape, having violated rules that require countries using the euro to keep budget deficits under 3 % of gross domestic product. Germany reached 3.75 % in 2002 and with growth prospects not improving, there is a risk it will do so again this year. We remain sceptical about the German government's prediction of 1.5 % growth this year and its ability to bring the deficit down to 2.75 % of GDP this year. Furthermore, the situation in the Middle East and rising oil prices make such forecasts uncertain, as German consumer spending is already stagnating. In France, where President Jacques Chirac has insisted on sticking to tax cuts and budget increases promised in his re-election campaign last year, the risk of Paris breaching the 3 % threshold this year remains large.

The European Union is less pronounced than the USA in its economic situation, although those embarked on Euro adoption would meet the Maastricht criteria of Debt/GDP ratio (60%) and Budget Deficit/GDP (3%) at the moment (Germany only squeaked in by re-valuing its gold reserves!). The Europeans, less speculative than their American cousins, created less of a dot.com bubble.

Happily trading amongst their member nations, the EU's bete-noire is the admission of 10 new member states to the EU, bringing archaic industrial and agricultural practices, further unemployment, fiscal deficits and massive needs for government subsidies. At the very time that fiscal prudence should be exhibited, the EU is fast-tracking charitable donations on a massive scale, with the perceived outcome similar to that of the assimilation of East Germany into West Germany over the last 14 years (e.g. unemployment as high as 26% in cities).

Japan, still representing 60+% of the GDP of Asia, continues to flounder and stagnate, and in avoiding much-needed banking reforms merely delays a pension fund and banking system disaster that will ultimately take the economy into total collapse. The anticipated earthquake in Tokyo Bay will force a massive repatriation of capital from US and European stock and bond markets as rapid liquidation takes place, but such actions will lead to a dearth of investment

capital into the region for decades to come. China is rapidly picking up the baton, with India closely following, and therefore 2.2 billion people continue to place demands of food and energy supply chains in the region.

China and India generate significant implications for the world order where energy and precious metals are concerned, and a favourably positioned Russia can become an increased provider of oil, gas, gold and silver to 45% of the world's population that raises its standards of living annually. Russia is rapidly rebuilding and expanding its pipelines for oil and gas, is consolidating and promoting its precious metals mining industry, and foreign participants are finding more supportive legislation to attract them to the producers' party.

The IMF forecast for economic growth expects Russian GDP to rise by 4% next year, compared with 3.5% this year, basing the prediction on recovery by developed countries, which will stimulate demand for Russian commodities (mainly oil and gas).

First reports on 2003 budget parameters suggest that the Government is looking for growth next year in a corridor between 3.2% and 3.8% with a medium scenario based on oil prices of \$18.5 per barrel – the same as the Government's price prediction for this year. The 2003 budget should show a surplus of at least 1% to GDP, slightly down from this year's target of 1.6%, and the spare cash will be used for early repayment of foreign debt, continuing the healthy precedent of early repayment set last year and (hopefully) this year.

Oil prices remain the important factor and Russia seemed to make a good move recently, when it promised to keep export limits in place for the second quarter of 2000 to support OPEC's price boosting efforts. The news helped prices to move further upwards, adding substance to the hopes for Russian economic growth.

Oil prices may resume their downward course (as a result of double-dip recession in the US, or the return of calm in the Middle East), in which case Russia will have to choose between losses due to low oil prices or losses due to export cuts. The fact that Russian public finances, and the economy more generally, are considerably less dependent on oil revenues than, say, Saudi Arabia, which is overwhelmingly oil-based, is likely to increase Russia's leverage in discussions with OPEC with regard to its "contribution" to stable prices in the oil markets. Russian oil companies are likely to boost production and exports (where capacity constraints are being relieved through the coming on stream of a number of pipelines) in the years ahead, even at the cost of lower oil prices. They are also likely to capture much of the share of growth in demand in countries like China, India and, increasingly, through joint ventures, the US. Russia remains the world's largest gas exporter, exceeding the combined output of the US and the EU, plus Norway and Saudi Arabia.

With our scenario planning suggesting a major run-up in the price of gold in the next two years, and continued Middle East disruption keeping oil prices buoyant, Russia appears set to maintain healthy trade surpluses (Russia boasted the largest developing market trade surplus in 2002 of US\$44 billion).

In turn, a rise in foreign exchange and gold reserves will improve the credit rating of Russia, thus lowering international borrowing rates and creating a more attractive investment climate for the country during a globally difficult period for the institutional investor with little alternative choices. ♣