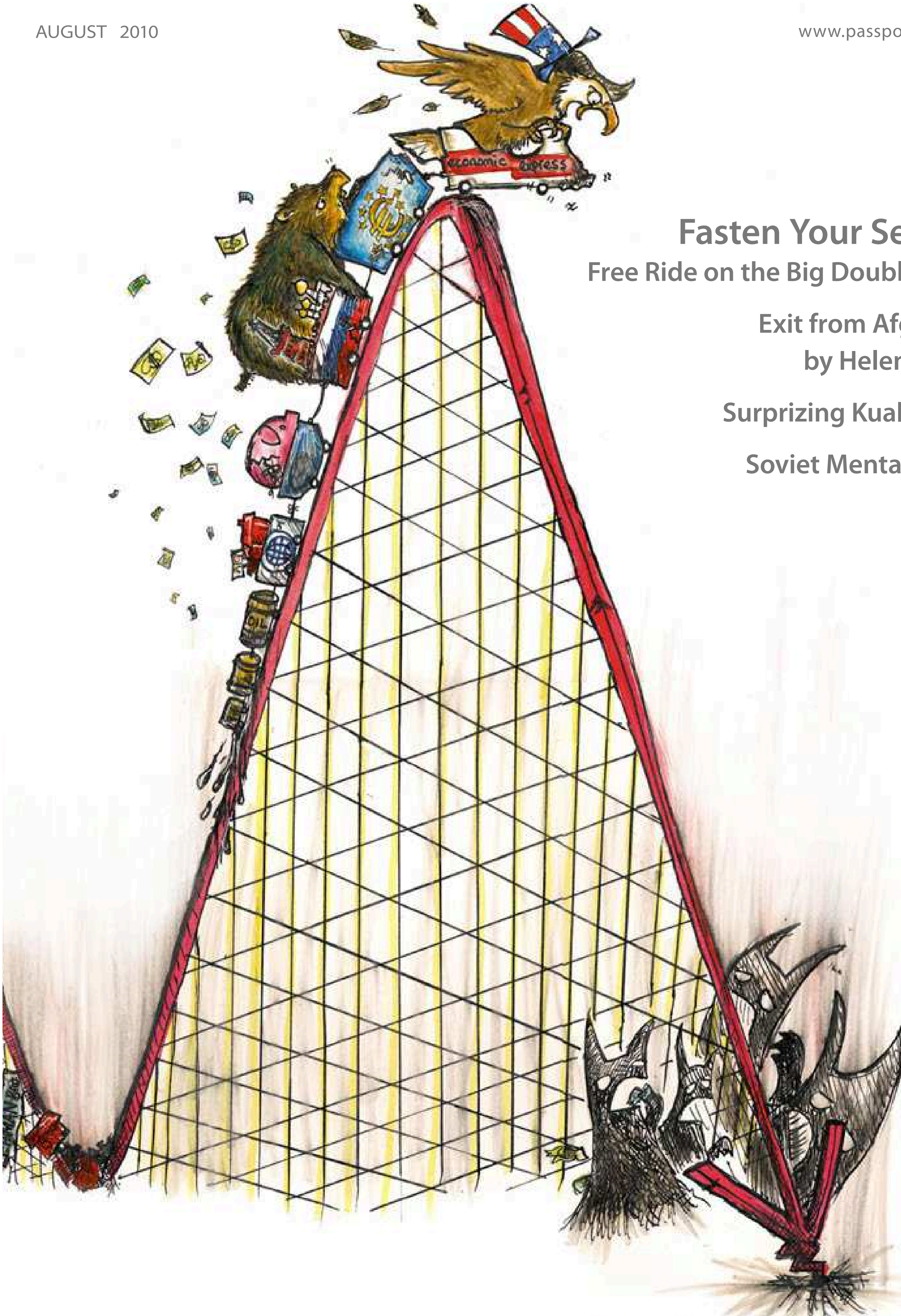
PASSPORT MOSCOW

AUGUST 2010

www.passportmagazine.ru



Fasten Your Seatbelts

Free Ride on the Big Double Dipper?

Exit from Afghanistan by Helen Womack

Surprizing Kuala Lumpur

Soviet Mentality Today

Tipping point

By Art Franczek

It seems that every newscast I see in Russia or abroad, such issues as naked shorts selling, decrease in GDP, unemployment rates, price per barrel of oil, the list goes on and on, are discussed. These are not abstract numbers that affect economic and financial specialists. Rather they are issues that affect peoples' lives. If unemployment is rising perhaps my job is at risk. If the price of oil declines rapidly, Russia's economic prospects may decline and this could threaten my job and my investment portfolio. When we look at these issues we are not talking about some statistical studies but rather economic dynamics can affect all of our lives.

In June of 2008, while Europe and the US were suffering from the early stages of the world financial crisis, Russia was considered to be a safe haven that was immune from the virus that was engulfing the West. In 2008, GDP was expected to grow by 7% as it had the previous 8 years. Government officials were encouraging Westerners to invest in the 2014 Sochi Olympics and other development projects. Moscow was being touted as a major financial centre and Russia was projected to be Europe's leading auto market by 2009. Oil was selling at US$140 per barrel and Gazprom's General Director was predicting that it would soon reach $200. A feeling of euphoria was in the air wherever you went in Moscow.

In the US, chaos was spreading throughout the financial services industry. In March 2008, Bear Sterns declared bankruptcy. Merrill Lynch was sold to Bank of America and finally in September the stock of AIG was purchased by the US government, and Lehman Brothers was declared bankruptcy. The root cause of all of these events was investments in securities that were backed by sub-prime mortgages. Many banks invested in these securities because they were rated AAA by the credit ratings agencies and it was unlikely that they would default. When US housing prices declined by 20% in 2007, default rates greatly increased because homeowners owed the bank more than their home was worth. US investment banks and many foreign banks lost many billions of dollars because the value of these investments was significantly reduced. As mentioned, many of the banks who held these CDOs (Collaterised Debt Obligations) had to declare bankruptcy.

The bankruptcy of Lehman Brothers in September of 2008 was the tipping point of the subprime crisis because Lehman was so interrelated with banks in the US and internationally that trust in banks almost dried up, like international credit. By the time Lehman Brothers declared bankruptcy the US was already in a recession as a result of the sub-prime crisis and the price of oil had declined from US$140 to US$40 per barrel.

On the day Lehman declared bankruptcy, the MICEX declined by 20% and Russia suddenly realized that it was deeply impacted by the crisis. This impacted Russia in a number of ways:

– Foreign investors no longer invested in Russia. This was because they became risk adverse and fled to quality investments such as US Treasury Bills.

– Foreign Banks could no longer lend to Russian Banks because credit was no longer available.

– The sharp drop in the price of oil severely reduced budget revenues and forced Russia to use its reserves.

The Russian stock market lost 2/3 of its value because investors were risk-adverse and many stocks were based on natural resources.

In 2009, Russia's GDP declined by 8%, this was more than any major country. Manufacturing declined by 15% (auto manufacturing declined by 50%). Construction declined by 17% and retail declined by 9%. In addition the unemployment rate increased from 4% to 9 %.

Like most countries, Russia established a stimulus program that channelled US$62 billion to critical financial and industrial companies. Another US$200 billion was used to stabilize the rouble and the banking system. By the first quarter of 2010, the World Bank estimated that Russia's GDP would grow by 4.5 %. Construction was projected to decrease by 9% and the retail sector would show 0% growth. Unemployment would remain at 9% in what the World Bank calls the "jobless recovery". Although the oil price is projected at around US$75 per barrel. Russia faces new competitive pressures in natural gas production because the US, Canada and other countries have developed methods to extract huge amounts of natural gas from shale rock. In addition Europe has developed alternative supplies of natural gas. While the Russian economic situation is improving this improvement is mainly the result of government stimulus and not private sector growth. World economic growth for 2010 is projected to be 3.3%. Most of this growth is the result of government stimulus programs. World and Russian economic growth is quite fragile and not yet self-sustaining.

Recent economic data from the US is quite negative. Housing starts decreased by 33% because the US$8,000 tax credit expired. The official unemployment rate in the US is stuck at 9.5% while the real unemployment rate is close to 17% . In Europe the fear of default of sovereign debt by PIGS (Portugual, Italy, Greece, Spain) fills the business news every day and many analysts are suggesting that the European Monetary Union be dissolved.

A growing number of economists are predicting that a double dip recession is going to occur. Nouriel Rabini (Doctor Doom) believes that there is greater than a 50% chance that Europe will fall back into recession (negative GDP growth) and that GDP growth in the US will be anaemic at 1%-2%. Russia's economy is undoubtedly integrated with the rest of the world so if there is a double-dip recession in Europe and the US the price of oil is likely to be $50 per barrel which would create significant problems for the Russian economy.

The recent G20 Summit highlighted the different economic positions among the leading economic powers. The UK and Germany want to encourage austerity budgets and enforce significant deficit cutting among G20 Countries. This is because of economic chaos caused by PIGS. The US wants the G20 countries to continue their stimulus packages at least until the economic recovery becomes self-sustaining. Many economists such as Paul Krugman believe that removing fiscal stimulus too soon would repeat mistakes that were made during the Great Depression in the 1930s and may trigger a Third Depression. The World Economy is truly at a tipping point between austerity and stimulus and the wrong decisions by policy makers could have catastrophic consequences. P