

Russia: Avoiding Wrong Crisis Lesson



Microscope

The Russian economy has been badly affected by the spread of the global financial crisis in late 2008. Fortunately, the country retains huge reserves to help to stabilize the situation, but macroeconomic stability will be threatened if oil prices keep falling while access to external financing is restricted. The possibility of a sharp ruble devaluation is the greatest risk to macroeconomic stability in the short term too. The impact of the global financial market turmoil, a global slowdown and falling commodity prices will lead to a sharp deceleration in economic growth in 2009, to just 3%, according to the Economist Intelligence Unit. The prospects for joining the WTO have been damaged following Russian military intervention in Georgia. In fact, Russia is now more resilient than in the late 1980s, when the then Soviet economy collapsed. Ten years ago, the fragile post-Communist government could not boost the economy to stability, as the emerging markets got caught in financial melt-down. But since Putin became president, the Russian economy has grown at a real term average of 7%. It takes time to see whether Medvedev can do it now. **IB**

As the crude oil price is tumbling, Russia's economy will sink into a recession next year. While the price of Urals crude oil, the country's main export blend, tumbled 77% from a record high in July, Urals has fallen to \$32.34 a barrel, less than half the \$70 Russia needs to balance its budget next year. Meanwhile, the ruble fell to a record low against the euro as Russia's central bank extended six weeks of devaluations to compensate for falling oil prices. The currency has weakened 15% against the dollar and 12% against the euro this year as oil, the nation's biggest export earner, lost 62% and the global credit crisis prompted investors to pull out of emerging markets. Russia's foreign reserves, the world's third largest, have fallen by a quarter since August to \$451 billion as the central bank sought to prop up the currency and export revenue declined. Standard & Poor's cut Russia's credit rating this month for the

first time in nine years to BBB on concern Russia is wasting reserves defending the ruble, according to Bloomberg. With regard to the performance of stockmarket, while western markets have fallen by 35 to 45% in the past six months, the Russian market, as fragile as other emerging markets, has "corrected" itself downward by 70%. The economy had been expanding an average 7% in the eight years to 2007 as surging oil prices helped the country recover from the government's debt default and ruble devaluation in 1998. Amid the financial crisis, Russia became sick now. Russia's industrial production shrank the most last month since 1998, when the country defaulted on \$40 billion of domestic debt. Nevertheless, the strong government was eager to stabilize the faltering economy. According to Bloomberg, the Russian

government approved a list of 295 companies including OAO GMK Norilsk Nickel, partly owned by billionaire Vladimir Potanin, for priority access to state loans and guarantees. Companies representing 26 sectors of the economy are on the list, including transportation, retail, construction and oil production, according to a statement published on the government's Web site last week. The list of companies critical to the Russian economy includes Oleg Deripaska's OAO Russian Machines and OAO Gazprom, Russia's biggest exporter of natural gas. Moreover, Russia is deploying more than \$200 billion in bailout measures to ease taxes, refinance foreign debt and encourage lending. Industrial output last month contracted the most in a decade, while investors have pulled \$211 billion out of the country since August. **IB**

MARKET BRIEFING

YTD % (local curr)

US DJ
8,515 (-35.8%)
Nasdaq
1,530 (-42.3%)
Euro Stoxx 50
2,377 (-46%)
HSI
14,184 (-49%)
Japan NK225
8,739 (-42.9%)
China Shanghai Composite
1,851 (-64.8%)
Singapore
1,725 (-50.2%)
India BSE30
9,328 (-54%)
Brazil BOVESPA
36,864 (-42.3%)
Aus All Ord
3,515 (-45.3%)
US-10yr Bond
Yield 2.13%

As at 26/12/08

Insight: "Behavioral Finance"

Behavioral finance highlights certain inefficiencies, which are underreactions or overreactions to information, as causes of market trends and in extreme cases of bubbles and crashes. Such misreactions have been attributed to limited investor attention, overconfidence, overoptimism, and herding instinct. Herding instinct explains why people tend to imitate others. When a market is moving up or down, investors are subject to a fear that others know more or have more information. As a consequence, investors feel strong impulse to do what others are doing. Behavior finance has found that investors tend to place too much

worth on judgments derived from small samples of data or from single sources. Occasionally, investors' beliefs are not easily shaken. One belief that gripped investors through the late 1990s was that

any sudden drop in the market is a good time to buy. Indeed, this view still pervades. Investors are often overconfident in their judgments and often pounce on a single "telling" detail rather than the more obvious average. The big lesson is that behavioral finance theory doesn't tell people how to beat the market. Instead it tells us that psychology causes market prices and fundamental values to diverge for a long time. Behavioral finance offers no investment miracles, but perhaps it can help investors train themselves how to be watchful of their own behavior and, in turn, avoid mistakes that will make them poorer. **IB**

A-Z Financial Tools

Index Arbitrage is an investment strategy that exploits divergences between actual and theoretical futures prices. An example is the simultaneous buying (selling) of stock index futures (i.e., Hang Seng Index) while selling (buying) the underlying stocks of that index, capturing as profit the temporarily inflated basis between these two baskets. **IB**



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