CEEMEA Business Group

Russia: The Rouble and Economic Outlook

Still getting a bit better

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Content

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About the author

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Danny Thorniley is President of DT-Global Business Consulting GmbH (an LLC company) which is Danny's own consultancy company based in Vienna through which he works with some 330 key clients on business strategy in CEEMEA, global and emerging markets especially Russia. These companies are part of the CEEMEA and Russia Business Group, which is an advisory and consultancy service. The services of the Group include written position papers, presentation slides and private client meetings as well as in-house presentations.

Danny writes a well-received monthly position paper on the Russian market as well as quarterly presentation slides on other CIS markets. He visits Moscow on business every 2-3 weeks and hosts 8-9 private meetings of the Russia Business Group annually. The most recent one was attended by some 140 senior executives. He is also invited to make some 50 speeches/presentations each year by clients across the world on global business trends, business operations, emerging markets, corporate best practice. Many of these speeches are focused on Russia and the CIS and he has made some 60 "Russia presentations" to visiting western CEOs explaining the positives of the market without being naïve.

For 23 years (until the closure of the Vienna office) Danny was Senior Vice President and Senior Consultant at The Economist Group, Vienna on global corporate business trends, with specialisation in BRIC.

Danny has exceptional skill sets in global business strategy, business in emerging markets and CEEMEA and hands-operational knowledge of business operations, distribution, partnerships, investments and human resource issues.

Danny is regarded as a charismatic speaker who can present detailed business and economic analysis in an easily digestible fashion with a great deal of genuine humour. Danny is renowned for not using PowerPoint presentation slides - never. Dr Thorniley has also given guest presentations at Executive MBA courses on behalf of Oxford University, the University of Chicago, IESE (Spain) and the Central European University in Budapest. The executive MBA students at Chicago rated him "best speaker" on 12 occasions out of 12 over 5 years.

He has worked on a personal basis with companies operating in emerging markets for 26 years and has personal contacts with most senior western MNCs operating in the Russia and the CEEMEA region and beyond. He makes frequent presentations at CEO and Board level and has long-standing personal friendships with leading executives. He holds and has held a number of non-executive and advisory board memberships.

Dr Thorniley was educated at Oxford University. He holds a Bachelor of Arts degree, a diploma and a doctorate degree in Soviet political economy.

He has published three books, including one on Russia with Macmillan (UK/USA) and two with Profile books on Doing Business in Global Emerging Markets.

His beloved daughter is called Natasha after he read Tolstoy's War and Peace when he was a young man. One of his other favourite books is Master and Margarita by Bulgakov.

Executive summary

- We upgrade the GDP outlook for 2016 to -0.7% instead of -1.3%
- The consensus view for 2016 is still -0.7% for this year.
- Medium-term GDP growth will hover around 1.8% to 2.5% over the next 3-6 years
- The rouble is stable and we expect it to move sideways for the next few months presuming oil stays at $46-52 over the coming months
- The rouble is doing a bit better than the oil price in July (see below for reasons)
- Some two-thirds of Russian are still willing to keep their deposits in roubles rather than FX
- Inflation is also trending downwards and came in at 7.5% in June; we expect an average figure this year of 7.7% and year-end of 6.8% with continued moderation through 2017
- Capital flight is shrinking: down to $7bn in the first quarter of 2016 compared with $33bn in the first quarter of 2016
- Total external debt has fallen by -30% in the last year and total debt exposure of $550bn is very manageable with total debt repayments in 2016 at about $70bn with much already paid off
- Retail and household spending will be negative this year by -2.5% and -2.8% respectively and then turn positive in 2017 by 2.1% and 1.8%
- Consumer confidence improved a little in the second quarter as we predicted from -30 in Q1 to -26 in Q2
- Investment and industry remain weak as well as construction: investment will be down this year by -3.2% and industry negative by -0.2% before turning positive by 2.4% and 1.7% in 2017
- But the June PMI figure at 51.5 in June suggest more positive trends in the second half of this year
- Agricultural/grain output this year could be good and helpful to GDP
- The banking sector is stabilising and corporate credit growth is positive but still negative to consumers
- The budget deficit will come close to -4.0% this year and while commentators fear financial problems, we think there are enough available options to avoid crisis in the next 18-24 months providing oil stays over $40 per barrel

Economic outlook

We anticipated in our last report (May) that GDP and other indicators would continue to improve and we have accordingly upgraded most of our figures for this year. But it still means that Russia will ensure a second year of recession although at the moment the risks are to the slight upside (i.e. better) than we report below presuming oil stays around $50 plus or minus. We upgrade our GDP forecast for this year from -1.3% to -0.7%.

And executives must reflect how deep this recession has been:

> If we are correct and GDP turns positive in the third quarter of 2016, this will mean the economy was in negative territory for 7 quarters compared with only 5 quarters in the last crisis of 2008-09.
>
> Negative growth in 2015 and 2016 also means that Russia will report two consecutive years of negative growth for the first time since 1996.

But after a better oil and rouble outlook, the third important factor behind current improvements is that inflation is coming down a bit faster than anyone expected and this will be good news for consumer spending and confidence; and it will also help the Russian Central Bank to bring down key interest rates which ought slowly to help investment and industrial trends which are still weak. Lower inflation also means better real wages and we are seeing all these effects take place.

Related to low inflation is the fact that significant things are happening with nominal and real wages: they are improving.

> For much of 2015 nominal wages in Russia (paid by Russian companies and the civil service) hovered around 5%. BUT with inflation averaging 15% last year this meant that real wages (after inflation) were

on average -9% last year. In fact in December and January nominal wages dipped for a couple of months to just 2-4%, one of their lowest levels in decades.

In recent months we saw inflation come down to 7% and nominal wages have popped back up to 7-8% (instead of 2-3% at the turn of last year). In fact in May nominal wages were at 6.2%.

What does this mean? Well real wages turned positive in February and March for the first time in 15 months but have since dipped to -1.7% in April and -1.0% in May. Still the big point remains: real wages were terrible at the turn of the year and are now almost at zero which is relatively much better.

We presume that nominal wages across the economy will hover about 6-7% for the next 1-3 years while the government seeks expenditure cuts and companies look for productivity, and with inflation trending at 5-7 during this period, real wages will be flat for the coming months and then creep upwards towards the end of 2016 and into 2017. This of course will benefit retail sales and household spending.

The background was that the Russian economy started to weaken visibly in January 2013 (14 months before events in Crimea) and this was led by very poor results in investment and industry and it took another 15 months before consumer and retail figures were negatively affected. Until recent weeks nearly all indicators combined were doing very badly and consumer-related numbers were extremely poor at the end of 2015 and the first weeks of 2016.

But again several factors are better for now:

- The oil price is hovering close to $50 per barrel (and we did predict at the start of the year that $28-35 was too low).
- The rouble is bobbling at 71-72 to the Euro (close to levels recorded in February and September 2015).
- Inflation is down to 7.3% in April and May and at 7.5% in June.
- Real wages therefore are improving as noted above.
- The key interest rate was cut from 11.0% to 10.5% in June and more cuts will be coming and bring the central rate to 9.25% to 9.0% by the end of 2016 or first quarter 2017.

The GDP outlook

The GDP figure at minus -1.2% was actually better than expected by most commentators and better than the upbeat estimate from the Russian Central Bank which was -1.4% and it compared much better with the -3.8% recorded in Q4 of 2015. We estimate that GDP will turn positive during the third quarter of this year.

Many indicators, after being the “worst in 15-20 years” in December 2015 (comparing that month with the same month in 2014), are now some of the best in 9-15 months. Once again we stress this does not make them absolutely good numbers but certainly in comparison with last year the numbers are better and trending in the right direction. For now we have marginally improved our GDP assessment for 2016 to -0.7% and there are fewer downside risks today than there were 3-8 months ago, so a range of -0.7% to 0.0% is also possible on the upside. The consensus view for 2016 is -0.9% and this is an improved outlook on the consensus of 3 months ago which was -1.5%.

We expect the political and global environment to help the Russian economy a bit this year and in 2017 and we predict GDP will start quarter-on-quarter growth in the third quarter of this year as do most commentators and the Russian Central Bank. This means some GDP growth at the end of 2016 but not enough to compensate for the negative numbers in the first 8-9 months. But this does mean that 2017 will turn positive by about +1.4%.

We assess the industrial and consumer sectors below. Companies operating in the agricultural sector speak reasonably positively about business trends and receivables. A possible record grain harvest of 106-110mn tonnes could prop up GDP this year.

The long mid-term outlook to 2025

It is clear that (without any unexpected boom in the oil price to $65-75) there will be no quick bounce-back from this recession. GDP will increase about 1.4% in 2017 and then average around 1.9% to 2.5% during 2018 to 2022 depending on the oil price.

We do not anticipate much serious and quick structural economic reform over the next 3-5 years and so the dependency on the oil price and potential volatility remains in the foreground.

As many executives argue, “This is what we’ve got. This is not a crisis anymore, this is the new normal and the daily reality and we better get used to it”.

The big 5 factors influencing the Russian economy

1. The oil price (currently positive for Russian economy)
2. The rouble (The oil price is the rouble value, and again seems positive at the moment)
3. Eastern Ukraine (mixed impact but not trending worse)
4. Western sanctions (possible reduction (40% chance) of EU ones from December 2016)
5. China and the USA (moderate growth in both markets and good for Russia)

And the 3 big factors which help industrial output from being worse

Industrial output is helped in part by

1. Import substitution
2. Defence spending and
3. Trade and investment with China and Asia.

But we have underscored that none of these factors offer any golden solution to Russian industry and GDP.

Central scenario - 2016 economic outlook (oil averages $45)

GDP	-0.7%
Inflation (year-end)	6.8%
Inflation (average)	7.7%
Consumer spending	-2.2%
Investment	-3.2%
Industrial output	-0.2%
Rouble to US dollar average	63-69
Rouble to the Euro average	72-77

Economic scenarios and the rouble for 2016 at different oil prices

Average oil price 2016	GDP	Inflation average	Rouble/US$ average	Rouble/€ average
$80-85	3.2%	5.8%	45-52	52-58
$70-80	2.4%	6.0%	52-57	58-64
$60-70	2.2%	6.4%	57-60	64-66
$55-60	1.8%	6.6%	60-63	66-69
$50-55	1.3%	7.0%	61-66	69-72
$45-50	0.3%	7.7%	62-68	72-75
$35-45	-1.3%	8.2%	63-69	74-78
$25-35	-2.5%	11.5%	80-84	86-92

The rouble outlook

The rouble is 22% stronger than it was at its recent low on 11 February (71.0 to the Euro on 16 July compared with almost 91 on 11 February).

On the back of a rising oil price, the rouble has strengthened by 15-20% in the last 4-5 months making it one of the strongest currencies in the world…at least for a few weeks after being one of the weakest for many parts of the last 18 months. Executives crave and yearn for rouble stability and while we certainly have some relative stability in March-May, it is too early to talk of currency stabilisation.

But everything depends on the oil price, which has followed the trend we expected. We argued that $28-32 per barrel in recent months "felt low" and we predicted a rally given issues of more limited supplies to the market. Because the consensus for oil ($52 at end of 2016 and $56 in mid-2017)) is close to the current price of $48 today or above it, then there is some possible upside for the rouble. BUT every reader knows this is a volatile indicator with no guarantees: speculation and herd mentality drive the oil price as well as the rouble.

Our central scenario is for oil to average around $42-$46+ per barrel in 2016 and end the year at $52+ and then average $49-57 in 2017.

Based on this oil scenario we now expect the rouble to fluctuate on average within 5% of either side of current (July) levels so about 73-77 to the Euro and 63-69 to the US dollar. We also expect the Euro-dollar to average around 1.08 during 2016.

Our estimate for rouble exchange rate here is close to current (mid July 2016 levels). We base these estimates on the assumption that the oil price ought to improve somewhat during 2016, which would mean some mild strengthening. But we think that other non-oil factors could mean some counter-balancing depreciation. Hence why in net terms we don't see much fluctuation. FX rates will vary of course depending on the oil price and see our scenarios table above. We think, with others that the rouble will broadly be moving sideways over the next 6-8 months.

Other factors affecting the rouble

Why is the rouble a bit over-strong this summer?

In mid-July (17 July) the rouble seemed to be out-performing the oil price a little when in the last 18 months or so the correlation had been very tight.

Brent oil at $47.5 per barrel
Rouble – Euro 70.3 (having touched 69.5 the day before)
Rouble – dollar 63.5
Euro-dollar 1.10

At this oil price, based on trends of the last 9 months or so, the rouble "feels" about 5-8% stronger than previous levels. This could be due to:

1) Real interest rates being reasonable high with inflation at 7.5% in June and the central rate at 10.5% offering a premium of 3%
2) External tourism may be considerably less this year, despite the removal of travel bans on Turkey. This means that there is less personal demand for dollars to travel abroad and perhaps more demand for "holiday roubles" as people go on holiday in Russia
3) As the rouble strengthens, there is some self-perpetuation in the rise of the currency especially with individual citizens as they become more confident with the rouble and we note below that two-thirds of Russians are happy to hold their bank deposits in roubles rather than FX.

On the downside the summer months often see corporate dividend payments and a need for dollars so this may put some marginal downward pressure on the currency in June-August.

Other factors for the rouble

Interest rates: the central rate was stuck at 11.0% for 10 months and then cut to 10.5% in June and with some economic stabilisation apparently taking place, with the rouble a bit stronger and most importantly of all, with inflation trending downwards, it seems likely that the Russian Central Bank will take the central rate down to about 9.50% to 9.25% by the end of 2016. In a best case this could be down to 9.0% by the end of the year. Weaker interest rates ought to imply downward pressure on the currency but to be honest, interest rates (unless massive shifts) do not do much benefit or damage to the rouble when other factors (oil) drive the currency. But lower interest rates will have a positive effect on investment and output at least after some delay.

We note that (excluding a massive collapse) the Russian Central Bank will not support the rouble because it rightly thinks that trying to combat the markets is wasteful when they are in a selling mood and when the oil price is a factor outside the Bank's control; the Bank's wise view is best to "keep its powder dry" and wait on events. By June 2016 FX reserves at the Central Bank had actually risen to a recent high of $392bn (from $368bn on 1 January), which testifies that the Bank has little intention of protecting the rouble against the oil price.

By June the stock of the Reserve Fund was down to $39bn (from $60bn in January) and the Well-Being Fund was more stable at $73bn (actually up a little on the January figure of $71bn). Both these funds each amounted to about $80bn some 15 months ago and the Reserve Fund has been drawn down to finance the budget deficit and to support economic sectors and to bail out some companies stressed by the rouble devaluation. These funds form much of the country's FX buttress against a weaker rouble. We can note that the Central Bank is seeking to protect them along with the rest of their FX reserves. This also helps explain the recent stabilisation in both funds in recent weeks.

But western commentators fear that the Reserve Fund will run out by the start of 2017 and that financing the growing budget deficit will become more difficult. This is true but we and others presume that the government will resort to more domestic debt issuance (bonds), more external borrowing, some privatisation revenue and tighter fiscal and monetary policy tweaking when necessary.

But a key factor dictating Bank policy is preventing any popular "run on the currency". If the Russian population panicked and a massive run on the currency happened, then the Bank would implement a full range of emergency measures to bolster the rouble. BUT we are far from this situation.

> **Russian citizens still have some faith in the rouble and 67% claim to prefer holding rouble savings rather than FX ones.**

The strong current account surplus and the "quite tight" fiscal policy ought also to support some rouble strengthening: for other currencies such results and polices would ensure a strong currency but the rouble is more influenced by the oil price and global/Chinese growth factors.

Capital flight is shrinking: down to $7bn in the first quarter of 2016 compared with $33bn in the first quarter of 2016.

Of a total external debt of $515bn (down by -30% in the last year), only $90bn to $110bn is due in 2016 and $66bn in 2017. Such payments are manageable.

Inflation outlook

The inflation outlook has improved at the start of 2016 and is better than expected.

Inflation is improving even better than we predicted. The so-called "base effect" (i.e. the high level 12 months ago means that any comparison with such numbers should entail downward movement this year) is having a deeper impact than anticipated and is also taking place as the rouble appreciates instead of falls. Also the flow-through impact from the rouble slump at the start of the year has been less sharp than anticipated. These are the two key factors explaining the fall in inflation. One then adds on weaker demand and vibrant price competition, which also brings prices down and this was anticipated.

As we noted above this is having a palpable positive effect on real wages, which ought in time to benefit consumer spending and consumer confidence.

Employees will also be a bit more cheerful as they feel the rouble in their pocket go further while their real wages (after inflation) get stronger.

- We expected the base effects (see above for explanation) to ensure that inflation would start to decline in early 2016 and this has come to happen. But the fall in inflation has been slightly quicker than expected.
- Inflation has come down since December reaching 9.8% in January and to 7.3% in both March and April and May before popping up slightly to 7.5% in June. The previous decline had also been driven by lower food prices and the small rise in June was also due to food prices while service prices eased more in that month.
- Core inflation, excluding food and energy, also declined to 7.0% in April from 9.1% in January but then rose to 7.5% in June.

The consensus and the view of the Russian Central Bank is that inflation will pick up to 7.8% in the mid-summer months as the base effects run out of steam and then inflation will start to trend downwards again by year-end 2016 to 6.8%.

- IF the rouble stabilises at current levels and if the base effects turn out stronger than expected, then inflation in 2016 will average 7.7% and finish in December 2016 at about 6.8%. We then see inflation averaging 6.8% in 2017 and ending that year at 5.8%.
- Interest rates will follow inflation downwards and end 2016 at about 9.5% to 9.25% or even 9.0% around the turn of the year 2016-17.
- Inflation is also ticking down of course due to weaker household spending and consumers are downtrading thanks to competitive retail prices, although western brands are raising their prices solidly.
- Lower energy prices also play a part as they do globally.
- It also seems that the trade restrictions with Ukraine and Turkey (and plans to remove the latter ones soon) have not had much upward impact and we do not imagine there will be any strong future flow-through.

Industrial-investment indicators (updated)

- The first quarter 2016 figures were better than expected and the figures for April and May and initial ones for June point to a steady recovery but one which will not take the economy out of recession this year. But indicators related to industrial output and investment are still either mixed or remain at negative levels. There is some improvement but we are still some way from sustainable industrial/investment/economic recovery. This means that companies in the B2B sector will still face pressures.

Industrial output actually grew in February by +1.0% for the first time in 15 months and then recorded slight positive growth in April and May.

- Business confidence improved again in April to -4 from -7 in January and then remained stable at this level through June. This number is very seasonal (always weak at turn of the year) but the numbers do indicate a strong positive seasonal trend, which is being maintained so far.
- Another indicator entitled the business sentiment indicator stands at a 3-year high in June.
- The PMI indicator improved to 49.8 in January (and a figure of 50.0 suggests growth) but then sank to a low of 48.0 in April. But then rose in May to 49.6 and notched a very solid 51.5 in June, which is one of the best numbers in 3-4 years
- The services PMI also rose to 53.8 in June, which is also at 3/4–year high so services are helping to buttress output.
- Car registrations were up by 122,000 in June compared for example with a high of 291,000 in April 2008. But the numbers reflect only a sluggish seasonal improvement and are close to a 5-year low level, which suggests that the automotive industry still has many months of struggle ahead.

- Car production in June was 89,000 which matches the low levels of 2010.
- Given that 4 months out of 6 have been positive for industrial production in 2016, we upgrade our annual 2016 industrial growth figure from -0.5% to -0.2% with some small upside.
- The June figure for industry at +1.7% is the best figure since autumn 2014.
- But the construction sector still struggles with a -9.0% figure in May.
- Through the spring months the production of wood, leather, chemicals, rubber and plastics continued to grow strongly through May whereas products targeted more at investment continued to shrink such as machines and equipment and investment goods.
- Banks' funding and liquidity profile continues to improve and the banking system is sufficiently capitalised with an aggregate capital adequacy ratio of 12.5%, which is above the regulatory minimum of 8.5%.
- Corporate bank deposits went negative in January by -3% for the first time since 2009 after generally increasing by 10-20% in recent years. On the other hand, corporate loans (in roubles) are still available: new corporate loans increased annually by 15-20% in 2013-14 and by around +6-8% last year and were growing by 4% in April.
- Non-performing loans have risen to 9.3% in April.
- But before we get too carried away, investment numbers are still bad. Gross fixed investment was down by -7.6% in 2015 and we maintain our weak estimate for this year at -3.2%. This is based on another weak first quarter figure of -8.4% and -4.8% in the second quarter 2016. Sanctions, finances, interest rates, foreign investment trends and weak confidence in the medium-term are all holding back the investment numbers.
- Other bad news is that exports denominated in dollars, after a traditional weak January at $17bn, have only averaged around $21bn monthly through June. Exports are running at about -28% on last year. Weak exports entail less demand for investment to produce exports and this then flows through into weaker industrial production.

We often state that 60% of Russia's economic problems stem from the oil price and 40% from western sanctions impacting financing and confidence. But we know that this ignores the fact that GDP growth started to trend downwards in January 2013, well before Crimea, and that it was industrial and investment figures which led the downward trend. Russia's economic problems pre-date the Ukraine crisis.

Consumer indicators

- Consumer indicators at the end of 2015 were very bleak and chalked up some of the worst figures in 15-25 years for nominal wages, real wages, retail sales and consumer confidence.
- The economic numbers were simply very bad.
- Retail sales slumped by -15.3% in December with the whole year figure for 2015 negative at minus -10.0%. <u>The December 2015 retail sales figure was the worst monthly one in 25 years and the annual retail figure was the joint worse in 25 years along with 2009.</u>
- AND wages were bashed: nominal wages rose by only 1.6% in December after weak growth through the autumn of about 3%. <u>The December 2015 nominal wage increase was the worst since 1993.</u>
- This meant that real wages (after inflation) were close to 20-year lows at -10.0% in December and -9.5% for the whole of 2015.

Against that back-drop, as most executives will agree, the resilience of the Russian consumer was and is remarkable. With these economic numbers, Russians shouldn't be going into shops!

That's the recent backdrop and thankfully since then there has been some mild but not fundamental improvement. We still need to wait and see.

- Retails sales in January were negative -7.3% compared with -15% in December. And improved again in February to -4.3% but then stumbled again to -5.8% in March with food sales down by -5% and non-food declining -6.5% and were down again in May by -6.1%. Based on this trend, retail sales will average about -2.5% in 2016 which will be close to the decline in household spending of -2.8%.
- Household spending in the first quarter of 2016 compared with the same quarter in 2015 was down -3.5%.

- We have noted in another report recent executive comments that the "Russian consumer is finally getting tired". It is too early to say when the improvement in real wages will transfer into sales in the shops and the consumer may be adopting a wait and see approach.
- As noted above, real wages improved in January to -6.1% and then turned positive for the first time in 16 months to +0.6% in February and +1.6% in March as both inflation came down and nominal wages rose from their recent slumped figures. BUT this could not be sustained and real wages went negative again in April by -1.7% and by -1.0% in May.
- Nominal wages were 6.1% in May for example.
- It looks like most government and Russian corporate employees will receive average nominal pay increases of 5-7% in 2016 and with inflation at 7.7% average this means real wages will still be down -1.7% this year. BUT this is a huge improvement on last year.
- Still nominal wages will not be strong and it appears that pensions will rise below inflation as well.
- The retirement age for government employees will gradually rise to 65 for men and 63 for women. Starting in 2017, the retirement age for all government employees will rise by 6 months each.
- Unemployment actually improved in May back to 5.6% after being at 6.0% for two months, which is good news but we note that many workers receive shorter hours and less pay per hour.
- Disposable income was down -6.9% in February and then bounce up to just -1.8% in March and then slumped again to -5.7% in May. BUT we argue that this indicator is of little value as it includes FX sales and purchases by citizens and the first quarter figures were probably warped by the rouble fluctuations.
- Consumer credit was exploding by +35-40% annually in 2012-2013 and then decelerated to 20% growth in 2014. New consumer credits (in roubles) were still rising at the start of 2015 by about 10% but by the end of last year they had turned negative and remain so through the first half of 2016 at an average of -6% to -8%. Of course less available credit will hold back household spending and is a major reason we keep our spending estimate in negative territory this year, combined of course with the effect of negative real wages.
- Consumer confidence at the start of 2015 was the second worst figure in 25 years (excluding 2009) at -32 and then improved by Q3 to -24 but slipped back in Q4 to -26. The first quarter 2016 was a roller-coaster and rouble volatility and international tensions (Syria/terrorism) helped keep the indicator down at -30. Our "guesstimate" in May for the second quarter this year was for "a slight pick-up" and that is exactly what happened with consumer confidence improving to -26. We expect this indicator to continue improving on the back of a stronger rouble and sinking inflation which will bring real wages back into positive territory on a monthly basis during this summer-autumn.

The budget deficit

And the budget deficit improved in January narrowing to -1.8% from -2.6% in December 2015, and was reasonably stable in February at -1.9% before widening to -2.6% in March and -3.0% in May. The widening in the spring was due to a pick-up in expenditure that rose from 15% of GDP in January (always a slow month) to 17% of GDP in March but this figure is still lower than average expenditure of 19-20% of GDP as recently as 2015. The revenue side is also noticeably weaker falling from 17.6% of GDP to 14.3% in the first 5 months of the year.

The good news is that the Russian government arrived at this crisis with some fat: the budget deficit in 2014 was a mere -0.5% and deteriorated to -2.8% last year. Current numbers suggest that the full-year deficit 2016 will be about -4.0% and the government has adequate external and internal borrowing options to finance such levels for 18-24 months. As we noted above, some domestic borrowing, external borrowing, some limited funds from Asia, some privatisations and slightly tighter expenditure and not loose monetary policy ought to make things manageable as long as the oil price stays above $40.

The Ministry of Finance has noted in recent weeks that the budget deficit this year is unlikely to be better than -3.0% and current trends suggest a figure closer to -4.0%.

Discretionary spending by the government was down by -8% to -10% in 2015 and we expect similar numbers in 2016. This will make selling to the federal and local authorities continuingly difficult.

GDP and the Russian economy in 2015 and 2016

Macro-economic data 2009-2020

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
GDP	-7.9	4.3	4.3	3.4	1.3	0.6	-3.8	-0.7	1.4	1.8	1.9	2.0
Retail sales	-5.5	6.3	7.2	5.7	3.9	2.5	-8.8	-2.5	2.1	2.8	2.8	2.9
Household spending	-7.6	5.5	6.8	7.9	4.7	1.8	-8.5	-2.8	1.8	2.6	2.6	2.8
Real wages	-2.8	4.4	4.9	8.2	5.2	1.9	-9.2	-1.7	1.9	2.7	2.9	3.2
Disposable income	1.0	3.7	2.8	3.7	3.3	2.1	-4.0	-2.5	1.8	2.2	2.6	2.7
Inflation (year-end)	8.8	8.7	6.1	6.6	6.5	11.4	12.9	6.8	5.8	5.5	5.2	5.0
Unemployment rate	7.9	7.6	6.5	5.3	5.5	5.3	5.4	5.8	5.6	5.5	5.4	5.3
Gross fixed investment	-17.9	5.6	9.8	6.0	-0.3	-4.8	-7.6	-3.2	2.4	3.5	3.9	4.0
Industrial output	-10.8	8.3	4.7	2.6	0.3	1.1	-3.4	-0.2	1.7	2.5	3.1	3.3
FX reserves ($bn) year-end	447	485	510	528	509	385	365	410	390	400	415.0	420.0
Rouble/$ (year-end)	30.3	30.4	32.1	30.4	32.9	58.0	73.0	68.0	71.0	76.0	78.0	79.0
Rouble/Euro (year-end)	43.4	40.0	41.5	40.1	45.1	72.0	78.0	74.0	77.0	82.0	84.0	84.0
Budget balance (% of GDP)	-6.3	-3.5	-0.2	0.0	-0.5	-0.5	-3.6	-4.1	-3.2	-2.6	-2.2	-1.8
Current-account balance (% of GDP)	3.8	4.9	4.9	3.6	1.6	2.7	4.3	4.1	3.8	3.2	2.5	1.9

Key statistics by year and monthly

	2013	2014	2015												2016				
	year	year	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	March	April	May
Disposable income	3.3	2.1	-0.8	-1.6	-1.8	-4.0	-6.4	3.5	-2.0	-4.9	-4.3	-5.6	-6.5	-0.7	-6.3	-6.9	-1.2	-7.1	-5.7
Real wages	5.2	1.9	-8.0	-7.4	-10.6	-13.2	-7.3	-7.2	-9.2	-9.8	-10.4	-10.9	-10.4	-10.2	-6.1	-0.6	1.6	-1.7	-1.0
Real retail sales	3.9	2.5	-4.4	-7.2	-8.7	-9.6	-9.2	-9.4	-9.1	-9.1	-10.4	-11.7	-13.1	-15.3	-7.3	-4.3	-5.8	-4.8	-6.1
Unemployment	5.5	5.3	5.5	5.8	5.9	5.8	5.6	5.4	5.3	5.3	5.2	5.5	5.8	5.8	5.8	5.8	6.0	5.9	5.6
Industrial output	0.3	1.1	0.9	-1.6	-0.6	-4.5	-5.5	-4.8	-4.3	-4.3	-3.7	-3.6	-3.5	-4.5	-2.7	1.0	-0.5	0.5	0.7
Fixed investment	-0.1	-4.8	-6.3	-6.5	-5.3	-4.8	-7.6	-7.1	-6.8	-6.8	-5.6	-5.2	-4.9	-8.7	-8.4	-8.4	-8.4	-4.8	-4.8
Consumer prices	6.5	11.4	15.0	16.7	16.9	16.4	15.8	15.3	15.8	15.8	15.7	15.6	15.0	12.9	9.8	8.1	7.3	7.3	7.3
Budget deficit (running)	-0.5	-0.5	-1.6	-1.8	-1.8	-2.1	-2.5	-2.3	-2.9	-3.1	-3.0	-3.0	-3.3	-2.6	-1.8	-1.9	-2.6	-1.4	-3.0

As ever, I hope you have enjoyed this report and found it useful. If you have any queries, do get in touch at **danielthorniley@dt-gbc.com**

17 July 2016

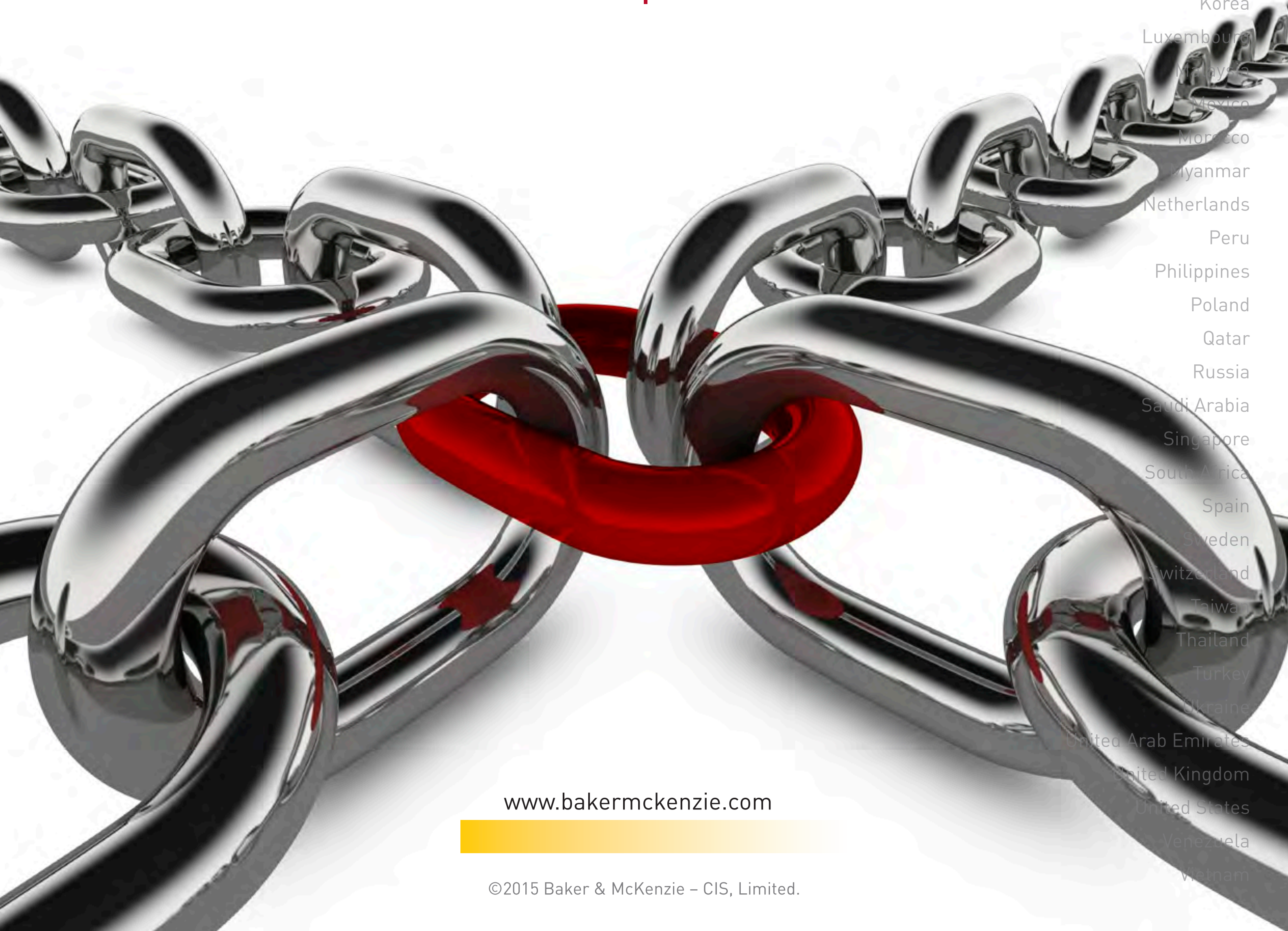
Appendix: the oil price drivers and consequences

Some interesting figures

- The USA has become the largest global energy producer.
- US oil output is 70% up on its 2008 figure.
- China has taken over from the USA as the largest global energy consumer.
- Currently US energy imports are the lowest since 1960.
- A 10% drop in the oil price adds about 0.15% to global GDP so the current 45% decline could increase global GDP by about 0.3% in 2016 after a 0.7% stimulus. BUT other factors are holding back global growth so we do not see or anticipate such upward swings
- A 20% drop in the oil price results in $70bn of extra disposable income for US consumers but so far US consumers and global ones are not splurging this money.
- Total oil exports in 2013 were worth about $1.1 trillion and a 40% drop in the oil prices entails losses of about $400bn for energy producers.

Why has the oil price collapsed?

- Shale/energy production is accelerating quicker than anticipated against a weak demand back-drop
- Global demand is stagnating as China slows down and the US buys from itself.
- We are entering “the age of the dollar”; several trends dictate that the US dollar ought to be relatively stronger in the coming years. The oil price and dollar value move in inverse proportion to each other so this ought to impart downward pressure on oil.
- The US is also supplying more to the world and buying less energy from it.
- Speculation and shorting account for at least 20% of the price movements.
- Saudi Arabia decided in November 2014 not to support the oil price and thereby broke the OPEC oil cartel.
- Global stock markets started getting spooked at the low oil price fearing it was more an indicator of weak demand and not just low supply.
- Saudi Arabia was fed up with acting as the oil supporter of last resort.
- The Saudis felt that other suppliers would not stick to agreed limitations and thus they would lose market share.
- The Saudis wanted to retain market share to the relatively lucrative Asian market where GDP growth remains comparatively strong for now.
- It is assumed that the Saudis are also engaging in some economic warfare with Iran whose budget is only balanced at an oil price of $140.
- It is also thought that the Saudis are playing a sort of “game of chicken” with the US shale producers who are only profitable with an oil price in a range of $55-70.
- But US shale producers are proving efficient and productive: the numbers of wells has dropped markedly this year but overall production has not fallen much
- It is estimated that Saudi Arabia’s own break-even point for a balanced budget is around $75-80 per barrel and thus current prices are also hurting Saudi Arabia.



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