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Russia Business Outlook 2015-16

Another tough year ahead

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Content

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About the author

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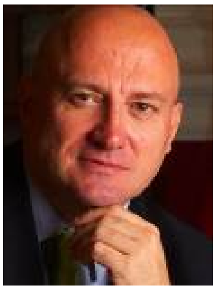

Danny Thorniley is President of DT-Global Business Consulting GmbH (an LLC company) which is Danny's own consultancy company based in Vienna through which he works with some 330 key clients on business strategy in CEEMEA, global and emerging markets especially Russia. These companies are part of the 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

- The events of December (massive rouble volatility and slumping oil prices) have made us downgrade our economic estimates for 2015 and 2016.
- We are estimating an average oil price of $58-65 in 2015 (which is just below the consensus) and no escalation in Ukraine.
- On that basis the rouble could average close to where it is at the start of the year; 62 to the dollar and 72 to the Euro. We think the dollar will continue to appreciate a bit more versus the Euro and this is reflected in our long-term estimates (see tables).
- We now expect GDP to fall this year by -3.8% with possible downside risk.
- Inflation hit 11.4% in December and will increase further to 13-14% in the spring but should then decelerate.
- Consumers will be hit by negative real wages and consumer spending will be down by at least -3.2%.
- But we argue that we are not yet in a 1998 economic meltdown scenario. At the moment the numbers do not justify this comparison.
- We also finish with two very important potential positive factors: what if the oil price stabilises and rallies this year and what if European sanctions are rescinded?
- If either of these two transpires, then the picture could improve significantly but even the best case for now would be for flat growth this year and the rouble at 50-53 to the dollar and 60-63.

The economic outlook for Russia in 2015 is poor and a small recovery will only occur in 2016 on a central scenario. The macro-economic outlook has deteriorated significantly since early December. There are some downside risks to this worsened central scenario but also a couple of upside ones.

The economic outlook is tough but first “flash” results from our January Business Survey, which will be published in mid-January, suggest that many companies are indeed planning for a challenging 12-15 months but few are panicking: many companies aim for good single-digit sales growth in roubles in 2015 (while some do not) but of course when it comes to FX the picture is much more gloomy with the majority of executives predicting sizeable negative results in US dollars and Euros. This is bad news and there is no hiding it. But first feedback from corporates suggests they will continue efficiencies and cost cutting but that much of this may have been initiated already in the last quarter of 2014. More cuts and efficiencies will certainly take place in the first half of this year but at the moment companies do not plan to slash their headcount for example. More on corporate experiences will follow in our survey results and in later reports.

If everything went well

Some/many western companies are now budgeting for organic sales growth in 2015 in mid- or high-single digits with some looking at double digits (all in roubles). We have mentioned before and will do so again that the best business case would be for the oil price to stabilise and sanctions to be removed. If those eventualities came to pass, then the rouble would appreciate strongly. Good single/double digit sales growth combined with a stronger rouble could create quite a positive business situation. However, I stress that for this to happen, everything needs to go right and this has not been the pattern in Russia in the last 18 months.

The new estimate and outlook for 2015

(see tables below for latest monthly results and annual forecasts)

The downward pressures on the Russian economy are well-known:

- The oil price
- Western and Russian sanctions

Related to those:

- The collapsing rouble.
- Spiking inflation.
- Elevated interest rates currently at 17% (Central Bank rate) and therefore tight financing in roubles and FX.
- Decelerating western investment (FDI).

- And also a systemic malfunctioning of Russian investment and industrial output which predates the Ukraine crisis and collapsed oil prices.

One quick point: we "guesstimate" that western sanctions and their impact on confidence, financing and investment account for around 40% of the current economic slump and the falling oil price contributes to about 60% of the decline.

Based on the above, the currency turmoil in December and the oil collapse, which continued in January, we have downgraded our economic forecast for 2015. If oil slumbers at $53-62 and sanctions are maintained into 2016, then the outlook is as follows:

Macro-economic data 2009-2018

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
GDP	-7.9	4.3	4.3	3.4	1.3	0.4	-3.8	0.5	2.1	2.7
Retail sales	-5.5	6.3	7.2	5.7	3.9	1.8	-3.2	1.7	2.7	3.0
Household spending	-7.6	5.5	6.8	7.9	4.7	1.5	-3.3	1.5	2.3	2.8
Real wages	-2.8	4.4	4.9	8.2	5.2	1.9	-3.5	2.0	3.1	3.0
Disposable income	1.0	3.7	2.8	3.7	3.3	2.1	0.8	1.5	2.5	2.9
Inflation (year-end)	8.8	8.7	6.1	6.6	6.5	11.4	8.2	6.0	5.6	5.6
Unemployment rate	7.9	7.6	6.5	5.3	5.5	5.3	6.2	6.0	5.7	5.5
Gross fixed investment	-17.9	5.6	9.8	6.0	-0.3	-5.8	-10.0	2.5	3.2	3.8
Industrial output	-10.8	8.3	4.7	2.6	0.3	1.1	-4.0	1.8	2.4	3.0
FX reserves ($bn) year-end	447	485	510	528	509	405	385	400	405	415
Rouble/$ (year-end)	30.3	30.4	32.1	30.4	32.9	58.0	63.0	64.9	67.4	71.0
Rouble/Euro (year-end)	43.4	40.0	41.5	40.1	45.1	72.0	74.3	76.2	76.1	79.3
Budget balance (% of GDP)	-6.3	-3.5	-0.2	0.0	-0.5	-0.6	-2.6	-1.2	-1.0	-0.5
Current-account balance (% of GDP)	3.8	4.9	4.9	3.6	1.6	2.2	2.4	2.2	1.8	1.8

Consumer-related statistics: by year and monthly

	2012	2013	2014										
	year	year	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov
Disposable income	3.7	3.3	-1.5	1.0	-6.8	1.9	5.8	-2.9	2.3	3.4	0.6	2.1	-4.7
Real wages	8.2	5.2	5.2	4.6	3.1	3.2	5.0	2.1	1.4	-1.2	1.5	0.3	0.5
Real retail sales	5.7	3.9	2.4	4.1	4.0	2.6	2.1	0.9	1.2	1.4	1.7	1.7	1.8
Unemployment	5.3	5.5	5.7	5.6	5.4	5.3	4.9	4.9	4.9	4.8	4.9	5.1	5.2
Industrial output	2.6	0.3	-0.2	2.1	1.4	2.4	2.8	0.4	1.5	0.0	2.8	2.9	-0.4
Fixed investment	6.0	-0.1	-7.0	-3.5	-4.3	-2.7	-2.6	0.5	-2.0	-2.7	-2.8	-2.9	-4.8
Consumer prices	6.6	6.5	6.1	6.2	6.9	7.3	7.6	7.8	7.5	7.7	8.0	8.3	9.1
Budget deficit (running)	0.0	-0.5	0.4	0.3	1.4	-0.4	-0.1	-0.1	-0.1	-0.2	-0.4	-0.5	-0.6

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Central economic scenario 2015

GDP	-3.8% to 5%
Inflation average	10-13%
Inflation (year-end)	8.8%
Consumer spending	-3.2% to -4%
Investment	-10%
Industrial output	-4.5%
Rouble to US dollar average	62
Rouble to the Euro average	73

Industrial output dipped into negative territory in November by -0.4% and the rouble chaos of December pushed confidence and investment down further. Fixed investment has been the weak link for two years now and the rate of decline is accelerating with a figure of -4.8% in November and hence why we estimate that the figure this year will be so bad. Business confidence did tumble in December and fell to a level of -10 on this indicator. This is down from -8 in November. From January 2011 to mid-2013 this indicator averaged 0 to -5 and then worsened through the autumn this past year. The December 2014 number is the worst since January 2010. Given the disturbing currency calamity in December, it is perhaps positive that the number is not in fact worse.

Presumably, the Russian budget deficit will no longer be kept within newly prescribed limits. The recession will necessitate that the deficit shifts from about -0.8% (original estimate) to about -2.5% this year.

Economic scenarios at different oil prices

Average oil price 2015	GDP	Inflation	Rouble/US$ average	Rouble/€ average
$80-85	1.0%	6.20%	45-48	53-58
$70-80	0.0%	7.00%	52-53	62-64
$63-70	-2.0%	8.00%	56-58	67-70
$55-63	-3.8%	9.20%	60-63	72-75

Why GDP should not collapse beyond -5%

Firstly there is a threat that it could deteriorate worse than by -5% in 2015 but in our central scenario, GDP remains in recession territory and not deeper depression. However, some commentators argue that if oil stays below $50 for much of 2015, then GDP could fall by -6% to 7%. At the moment, this looks a little extreme.

- The economy is under-heating (unlike in 1998) and thus has less far to fall. The GDP decline will not “feel” so bad as in 1998 or even as in 2009
- The Central Bank has used the rouble as a shock absorber more quickly than it did in 2009 and this ought to prevent a deeper slump.
- Import substitution helps but we question how viable and sustainable this is.
- Defence spending which explains why industrial output took so long to turn negative (-0.4% in November)
- Some maintained investment in projects related to China such as pipelines. But we do not feel that engagement with China economically and financially for credit etc. will prove a full compensation for lost business, trade and financing from Europe and the USA. To summarise: engagement with China is nice to have but it is not a solution or panacea for Russia problems.
- Until the end of November last year citizens were not yet panicking and pulling roubles out of their accounts and changing into FX and now as much as in 2008-09. We will see what happened with these figures in December after the rouble chaos when many individuals decided to cash out and “invest" in consumer durables as a safe haven. But the point remains that until December there was no private sector panic or “run on the rouble”.

The consumer outlook

Shrinking consumer credit, falling consumer confidence, much lower nominal wages for state employees and those working in corporates and rising inflation should all ensure that consumer spending is negative this year by at least -3.2%, the first negative number since 2009 (this number fits with western corporate expectations).

> The consumer spending sector buttressed the Russian economy in 2013 and 2014 and prevented a recession then and executives have been pleasantly surprised at the resilience of the Russian consumer but it will be impossible for consumers to keep the ship afloat this year.

As we noted in our previous economic report, a major dampener for consumer spending will be the shift to negative real wages this year. For many years Russian real wages (after inflation) were among the highest in the world (8% in 2012 for example). But with the government aiming apparently for nominal wages in the civil service to rise by just 5%, and when Russian and western employers will keep average wage increases below inflation, then with inflation averaging about 9%, it is inevitable that real wages will sink by 3-4% this year. I actually think the government will tweak up some of its wage plans this year and hence alleviate some of the pain but only at the margins.

Interest rates

The central interest rate was hiked to 17% in December during the rouble panic/collapse and rightly so. The Central Bank had to trade-off growth in order to provide support for the rouble. In our central scenario with a weak rouble and rising inflation, interest rates will not come down during most of 2015. If inflation moderates from late spring this year and the rouble stabilises at 60+ to the dollar and 70+ to the euro, the Central Bank could reduce rates by 2-3% in summer/autumn. But companies will have to live with rouble market rates around 20% and above.

Inflation outlook

Inflation is behaving fairly predictably and as we forecast in recent months.

After averaging 6.6% and 6.5% in 2012 and 2013 respectively rising food prices and the shrinking rouble ensure average inflation in 2014 came in at 7.8% with the year-end figure in December 2014 finishing at 11.4% (9.1% in November, 8.3% in October).

We then think that inflation will continue to rise through the first 2-4 months of 2015 as flow-throughs from the recent rouble collapse take effect. Inflation in the first quarter could range about 11.5% to 13%. If the rouble continues to fall or does not rally, then average inflation in 2015 would reach 10-13% for the whole year but the consensus does not look to this level and I share this view for now. There are several factors which ought to make inflation decelerate through the year:

- Weaker domestic demand
- Downtrading and retail price competition (after the price rises to compensate for devaluation)
- Government will postpone utility price rises or limit them
- There will be less consumer credit around: this jumped 33% in 2013 and we average about 10% in 2014 but will be flat or negative in 2015
- Interest rates will stay elevated at 17%

So 2015 will start the year with inflation at 10-12%+, this will rise to 12-14% in early spring and then ought to trend at 7-10% in the summer/autumn month before slowing to 8.0% or just over in December 2015. This would ensure average inflation for 2015 of 9.2%. If the rouble stays weak, this number could be quite a bit higher (9% to 10.5%) but if the rouble stabilises or even strengthens a little, then an average of 8.0% is possible.

Some potential positives: oil and sanctions

We estimate that the oil price slump accounts for 60% of the current economic slump and sanctions and their effects for 40% of the problem (we ignore here systemic investment issues).

It's hard to believe in a bleak January that things could actually spin positively and quickly if a couple of things went right but…

1) If the oil price stabilizes or actually rises in the short term to $65-70 per barrel, then the picture changes for Russia for the better. Many commentators and myself included think oil is over-sold now (as one of my papers points out, Saudi Arabia can only obtain a balanced budget when oil is at about $80 per barrel, so for how long can it maintain the current game of chicken with shale producers and the likes of Iran and Russia?). I think there is a 50% chance that oil will rise in the short-term but I also admit that the long-term outlook for oil price is not strong and very unlikely to get back to $80-100 average for several years. The new consensus price for oil is $62 to $68 as an average for 2015. If this consensus proves correct, then there is room for stabilisation and GDP, consumption and production figures would all improve.
2) While the consensus is that sanctions will remain in place through all of 2015, there is a 25% chance that they are rescinded in spring or summer this year if Putin softens Russian policy (and I think we are seeing some signs of that). Certainly several European countries would like to break ranks and repeal European sanctions given any signs that Russia was implementing properly the cease fire agreement.

   If oil stabilizes or rises and if the sanctions outlook improves, the rouble could easily appreciate in 1-4 weeks by 10-25% with positive consequences for GDP and inflation, business confidence and corporate results BUT I confess this requires things to "go right" for Russia.

Why this is not 1998 … not yet

Some western media have talked up the threat of a repeat of 1998 and the collapse of the Russian sovereign debt outlook and an implosion of the economy. We are not there yet.

1) In 1998 Russia was running budget deficit of -3.7%; it started this year at about -0.5%.
2) The current account deficit was -2.2% whereas today the surplus is 2-3%.
3) FX reserves then were $10bn and covered just one month of imports; today they are $400bn and cover almost one year's of imports. The Central Bank spent just over $100bn in 2014 protecting the rouble and supporting banks. We think FX reserves could fall further this year by another 40-50bn.
4) Corporate debt in relative terms is smaller than in 1998 and the term of debt (long-term/short-term) is also better.

Today, so far, we do not face a sovereign debt crisis: yes, potential loss of investment grade and junk status if it happens, will hurt and the Central Bank will have to be adept at generating rouble financing or bail out Russian firms and also nurture its FX reserves to have enough funds to ensure roll overs of FX debt for "the big boys". But we are still some way from 1998: corporate and government debt exposure is of a smaller relative scale and on different terms compared with 1998.

Some western media articles state that "Russia still has $414bn of reserves but this is below the country's $700bn external debt…" That sounds scary but of course the $700bn figure refers to all total debt; Russian banks and corporates "only" have to re-pay $119bn in 2015. Normally of course much of this could be rolled-over but much less so now with sanctions. But the Central Bank does have enough reserves to get through the debt repayment schedule even though it will have to be extremely prudent in how it uses its FX reserves to support both the rouble and indebted Russian companies. In fact some commentators argue that the $119bn is inflated as it includes a lot of low-risk transactions within multinationals or between parent companies and subsidiaries" as well as trade loans with China. Some of this ought to be re-scheduled and the actual, real debt repayment figure could be as "low" as $75-85bn with a similar figure in store in 2016.

As ever, I hope you have found this paper useful and if you have any queries or comments do get in touch at your convenience danielthorniley@dt-gbc.com.

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