

Russia: The Rouble and Economic Outlook

If this is 2016, then roll on 2017!



by Dr. Daniel Thorniley

President, DT-Global Business Consulting

danielthorniley@dt-gbc.com

9 January 2016

IN ASSOCIATION WITH:

BAKER & MCKENZIE

CUSHMAN &
WAKEFIELD

EY
Building a better
working world

Radius
GROUP

About the author	2
Some snapshot phrases and thoughts	3
Introduction	3
The GDP outlook	4
Economic statistical tables	5
Macro-economic data 2009-2019	5
Consumer-related statistics: by year and monthly	5
The oil price and the rouble: what factors will affect the rouble in 2016?	5
The \$33 scenario	6
Why \$50 scenario?	6
Other influencers on the rouble	6
Economic scenarios for 2016 at different oil prices	7
Central Scenario - 2016 economic outlook (oil averages \$40-45)	7
The inflation outlook	8
The interest rate outlook	8
The Big-5 factors driving Russian GDP	8
Consumer indicators summary	9
Industry and investment	10
Appendix on Oil Price	12
Some interesting figures	12
Why has the oil price collapsed?	12

© 2016 CEEMEA Business Group, a joint venture between

DT-Global Business Consulting GmbH, Address: Keinergasse 8/33, 1030 Vienna, Austria,
 Company registration: FN 331137t
 and GSA Global Success Advisors GmbH, Hoffeldstraße 1, 2522 Oberwaltersdorf, Austria
 Company registration: FN 331082k

Source: DT Global Business Consulting GmbH and CEEMEA Business Group research. This material is provided for information purposes only. It is not a recommendation or advice of any investment or commercial activity whatsoever. The CEEMEA Business Group accepts no liability for any commercial losses incurred by any party acting on information in these materials.

Contact: Dr Daniel Thorniley, President, DT Global Business Consulting GmbH
 E: danielthorniley@dt-gbc.com / www.ceemeabusinessgroup.com

About the author



Dr Daniel Thorniley

danielthorniley@dt-gbc.com

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.

Some snapshot phrases and thoughts

- If this is 2016, then roll on 2017!
- When China sneezes, the Russian rouble (and everything else) catches a cold.
- The global financial markets have reported their worst start to a year for 20 or 55 years depending on definition!
- 2016 will not be funny for business in Russia or globally: there is much to be said for “hanging on in 2016” with a serious chance that the economy and business will improve moderately in 2017
- Everything depends on the oil price scenarios (see tables below).
- On our central scenario of oil averaging \$40-45 in 2016, we see a delayed GDP recovery with 2016 GDP now negative at -0.4%, inflation slightly higher than it would have been in 2016 averaging 10.8% and the rouble close to its current levels (i.e. around 71-77 to the dollar and 77-83 to the Euro).
- One slightly encouraging factor is that: even with oil at \$33 per barrel, the rouble is “only” down to 81 to the Euro and 75 to the dollar. It could have been worse than this.
- The consensus for Russian GDP for 2015 has been downgraded in the last three months from -3.5% to minus -3.9% and we are only marginally more upbeat at -3.8%.
- Similarly, the consensus for 2016 has come down in recent months: 6 months ago the consensus was +0.8%, but today it has sunk to -0.3% and on current trends we predict -0.4% with many downside risks.
- But 2016 GDP could also sink to -1.5% or worse if oil prices stay closer to \$30 rather than \$40.
- Until 15 December the consensus for the oil price for 2016 was \$53.
- We think the consensus will have to come down after the turmoil of recent weeks.
- If oil does go down to \$25 in the coming weeks, the rouble could hit 85-90+ to the Euro and 77-82 to the dollar.
- BUT we do think that oil is now over-sold on the downside.
- Capital flight: this has been at elevated levels for years with stabilisation at high levels in 2015. But in Q3 2015 the first net capital inflow took place since 2010 as “re-on shoring” of capital occurred.
- We forecast 2016 inflation at 10.8% average and 8.7% year-end with downside/worse risks.
- Executives are monitoring “which way will the Russian consumer go?”
- The economic numbers suggest that western consumer goods companies should be performing worse than they are doing.
- Nominal wage increases in autumn 2015 were only up by +4.5% and weaker in October; this kept real wages (after inflation) down by -10.9% in October and -9.0% in November.
- Poor real wages and weak consumer confidence entail real retail sales still struggling at minus -13.1% in November. This is the worst figure in 20 years.
- Unemployment has been relatively restrained at 5.3% to 5.4% but this was achieved thanks to many staff being put on short-time with less pay.
- Business confidence dipped to its worst figure in the last 12 months (falling to -11 in November).
- Industrial output and investment will be negative in 2015 by -3.3% and -8.8% respectively.
- These sectors will only really recover properly in 2017 and are expected to be negative or close to zero in 2016 with industry at 0.5% and investment still negative by -1.2%.

Introduction

The last paragraph of our last report in 2015 warned of the risks to the rouble and the economy from falling oil prices (when oil had hit \$44) which in turn stems mostly from a slumping China and overall weak global growth indicators. We are not surprised by the latest developments in the oil price, only by their accelerated timing. As we argue below, much indicates that the oil price will be soft for the next 1-3 years.

But in addition to the wild fluctuations in the oil price stemming from panic reactions to news out of China or the Middle East, oil prices will be weighed down by weak global demand. The global business and economic crisis has lasted 6 years; companies globally have never fully recovered and the ills of the global economy remain CHRONIC.

Just 6 weeks ago the consensus for the rouble in 2016 was 67 to the dollar and 71 to the Euro. As we pointed out then though:

The only trouble is that the consensus can always be wrong!

The GDP outlook

- 2016 has started miserably for the global economy and after 5 continuous years of inflated expectations, most commentators now think that 2016 will grow more slowly than 2015.
- The “Global happiness Indicator” (not consumer confidence) is at its lowest level since 1989.
- We think global GDP growth this year will be about 3.0% or even 2.8% on a PPP basis after 3.1% in 2015
- Business is tough in Russia, but it’s getting increasingly tough everywhere.
- The consensus for Russian GDP for 2015 has been downgraded in the last three months from -3.5% to minus -3.9% and we are only marginally more upbeat at -3.8%.
- Similarly, the consensus for 2016 has come down in recent months: 6 months ago the consensus was +0.7%, and then 3 months ago +0.2% and today its trends at -0.3%.
- We believed that GDP (quarterly and year-on-year) would turn positive in March-May 2016 but with current trends we have pushed this back to June- September and this means that 2016 GDP is very unlikely to turn positive for the whole year 2016 and we expect 2016 annual GDP at -0.4% (slightly below the consensus of -0.3%) with risks still much more to the downside.
- Bank Governor Nabiullina thinks positive annualised growth will only start in mid-2016.
- But 2016 GDP could also sink to -1.5% or worse if oil prices stay closer to \$30 rather than \$40.
- Three factors are preventing a much deeper slump: import substitution, defence spending and more links with Asian partners. But none of these are a panacea for Russia’s challenges.
- We often explain that 60% of Russia’s economic problems stem from the oil price and 40% from western sanctions; but this ignores the underlying economic problems facing the Russian economy. Industry and investment started to shrink in January 2013, well before Crimea and the oil price collapse.
- Everything depends on scenarios and see our tables below in the text.
- There is a clear scenario that oil slumps to \$25 or even \$20 for a period of time in the coming weeks if more bad news comes out of China; the markets are spooked and over-reacting.
- Until 15 December the consensus for the oil price for March 2016 was \$49 and \$55 at end 2016.
- We think the consensus will have to come down after the turmoil of recent weeks.
- While the oil price may fly around in the coming weeks with high volatility (taking the rouble up and down with it), the important figure is the annual average oil price and the average rouble rate.
- If oil does go down to \$25 in the coming weeks, the rouble could hit 85-90+ to the Euro and 77-82 to the dollar.
- BUT we do think that oil is now over-sold on the downside.
- I think that in the short-term there are reasons why oil can crawl back to \$45-50 in the coming 2-5 months.
- BUT, as I have argued for several years, most factors suggest a generally soft oil price for the next 1-3 years
- This in turn means that without significant structural economic changes in Russia, the medium-term trend (2017-2022) for Russian GDP is not 2.5% or 2.8% per annum but more like 1.6% to 2.0% with oil at about \$45-50.
- There is though, quite a strong consensus view that oil will rally by 2017 and the range here is for \$50 to \$58 but as we keep saying the consensus is often wrong.

One strategy is to hope for the best through 2016 but to plan for a worse scenario. And to hold on to the hope that 2017 will provide some easing. We did quote recently the MD of a pharmaceutical company who stated: “The next 18 months will be hard but I do think a better business environment will develop from mid-2017”.

Economic statistical tables

Macro-economic data 2009-2019

	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	-0,3	1,7	1,8	2,0	2,0
Retail sales	-5,5	6,3	7,2	5,7	3,9	2,5	-8,8	1	2,4	2,8	2,9	2,9
Household spending	-7,6	5,5	6,8	7,9	4,7	1,8	-8,5	1,0	2,0	2,6	2,8	2,8
Real wages	-2,8	4,4	4,9	8,2	5,2	1,9	-8,9	-0,8	2,4	2,8	3,0	3,2
Disposable income	1,0	3,7	2,8	3,7	3,3	2,1	-3,8	1,0	2,0	2,2	2,8	2,9
Inflation (year-end)	8,8	8,7	6,1	6,6	6,5	11,4	12,5	8,7	6,6	6,3	6,1	6,0
Unemployment rate	7,9	7,6	6,5	5,3	5,5	5,3	5,7	5,7	5,7	5,5	5,4	5,3
Gross fixed investment	-17,9	5,6	9,8	6,0	-0,3	-4,8	-8,8	-1,2	3,2	3,7	3,9	4,0
Industrial output	-10,8	8,3	4,7	2,6	0,3	1,1	-3,3	0,5	2,3	2,9	3,1	3,3
FX reserves (\$bn) year-end	447	485	510	528	509	385	365	360	370	375	380,0	385,0
Rouble/\$ (year-end)	30,3	30,4	32,1	30,4	32,9	58,0	73,0	76,0	79,0	82,0	84,0	89,0
Rouble/Euro (year-end)	43,4	40,0	41,5	40,1	45,1	72,0	80,0	82,0	84,0	87,0	91,0	96,0
Budget balance (% of GDP)	-6,3	-3,5	-0,2	0,0	-0,5	-0,5	-3,2	-3,0	-1,9	-1,2	-0,8	-0,7
Current-account balance (% of GDP)	3,8	4,9	4,9	3,6	1,6	2,7	4,3	4,2	3,0	2,5	1,4	1,3

*Inflation figure is year-end.

Consumer-related statistics: by year and monthly

	2012	2013	2014	2015										
	year	year	year	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov
Disposable income	3,7	3,3	2,1	-0,8	-1,6	-1,8	-4,0	-6,4	3,5	-2,0	-4,9	-4,3	-5,6	-5,4
Real wages	8,2	5,2	1,9	-8,0	-7,4	-10,6	-13,2	-7,3	-7,2	-9,2	-9,8	-10,4	-10,9	-9,0
Real retail sales	5,7	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
Unemployment	5,3	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
Industrial output	2,6	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
Fixed investment	6,0	-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
Consumer prices	6,6	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
Budget deficit (running)	0,0	-0,5	-0,5	-1,6	-1,8	-1,8	-2,1	-2,5	-2,3	-2,9	-3,1	-3,0	-3,0	na

*Inflation figure is year-end.

The oil price and the rouble: what factors will affect the rouble in 2016?

Why will oil stay at \$33 per barrel or why it will rise to \$50?

The \$33 scenario

- 1) News out of China continues to disappoint.
- 2) Weak Chinese numbers and disappointing ones globally mean less demand for energy.
- 3) As sanctions are eased, Iranian oil starts flowing into the market during 2016-2017.
- 4) Saudi Arabia continues with its persistence to damage other suppliers (particularly Iran) and US shale producers and to capture more market share by keeping the price low via maintained production. News coming out of Saudi Arabia suggests this is the case as the authorities prepare for more cutbacks and austerity measures.
- 5) OPEC remains a busted organization.
- 6) US shale producers do not disappear and prove more resilient, productive and sustainable than the Saudis imagined.
- 7) The markets are panicked and speculative: 20-25% of the total drop in price is due to short-selling and pure speculation.

Based on these factors the consensus for the oil prices declines from \$40-50 to \$30-35 per barrel.

Why \$50 scenario?

- 1) Any good news coming out of China.
- 2) While the markets are spooked at the moment, they will grab hold of any tiny bit of good news to spike the price back up.
- 3) Increasing tensions in the Middle East; worsening relations between Iran and Saudi Arabia. So political risk could pop the price upwards.
- 4) But one factor lying behind the upbeat perception on oil is that soon we will arrive at equilibrium: this view argues that energy companies have cut back so much on investment that sometime soon weaker supply will balance fallen demand. Some argue that if this happens and coincides with any political risk or supply-chain blockage (fires at refineries etc), then the market could panic upwards very quickly.

Certainly any equilibrium in supply and demand would be the key underlying driver for a recovery in the oil price.

If any of these above factors occur, then the oil price could rally to \$43-50+ range.

But it does seem hard for me to find the scenarios for sustained higher oil prices above \$50-55 per barrel and oil will be "lucky" to get back to \$50 during 2016.

Other influencers on the rouble

The rouble will also be impacted by economic and financial criteria and some possible political developments. Many of these factors are positive or potentially so, but they do not have enough leverage to counter the massive impact of the crashing oil price and worsening perceptions of the Chinese market.

- Positive political risk potential: briefly at the end of 2015 it looked as though some sort of West Europe/USA/Russia coalition might be created over events in Syria. This is still a possibility but recent tensions between Turkey and Russia have not helped and enthusiasm has waned.
- FX reserves have been replenished to a level of \$374bn compared with a recent low of \$360bn in the late spring after the Central Bank bought \$10bn of FX since the summer. But this level is down compared with around \$500bn at the start of 2014.
- Within these numbers the Reserve Fund at \$59bn is down 33% year-to-date and the Welfare Fund at \$72bn is down -10%

- Capital flight: this has been at elevated levels for years with stabilisation at high levels in 2015. But in Q3 2015 the first net capital inflow took place since 2010 as “re-on shoring” of capital occurred.
- Public debt: the good news is that public debt is only about 13% of GDP at the end of 2015.
- The government implemented effective spending cuts in 2015 of 8-10% in 2015 and is aiming for a similar range in 2016 (-8% cuts). This is not enough to prevent the budget deficit worsening to at least -3.0% in 2015 with some slight downside risk depending on the December figures. We also expect the budget deficit to be in the same range in 2016 (about -3.4%). Russia was lucky to have as its starting position a budget deficit of just -0.5% in 2014.
- The current account surplus widened though 2015 and we estimate a positive surplus of 4.2% of GDP and about the same in 2016. Normally for a currency this would be extremely positive but the rouble is swamped by other factors.
- According to the Central Bank private sector external debt redemptions will be only \$76bn in 2016 compared with \$110bn reported in 2015 and this will be easily covered by the current account surplus. Again this ought in normal circumstances be a solid support for the rouble.

Just a quick comparison: in the last 12 months the following currencies have fallen against the dollar thus:

Russian rouble	down by 21%
Brazilian real	down by 15%
Indian rupee	down by 10%
Turkish lira	down by 30%
Polish lira	down by 11%

Economic scenarios for 2016 at different oil prices

Average oil price 2016	GDP	Inflation average	Rouble/US\$ Average	Rouble/€
\$80-85	2.30%	5.8%	42-48	46-55
\$70-80	1.90%	6.0%	48-52	55-59
\$60-70	1.80%	6.6%	53-58	59-64
\$55-60	1.40%	7.0%	58-65	64-69
\$50-55	0.60%	7.5%	64-68	69-73
\$45-50	0.0%	9.0%	68-72	73-76
\$40-45	-0.4%	10.5%	73-77	78-83
\$33-40	-1.3%	14.5%	78-80	83-86

Central Scenario - 2016 economic outlook (oil averages \$40-45)

GDP	-0.4%
Inflation (year-end)	8.7%
Inflation (average)	10.8%
Consumer spending	1.0%
Investment	-1.2%
Industrial output	0.5%
Rouble to US dollar average	73-76
Rouble to the Euro average	76-81

The Russian government 2016 budget predicates GDP growth of 0.6% to 0.7% but based on an oil price of \$50 in 2016 and \$56 in 2017. These figures are actually sensible and reasonable considering when they were compiled in late 2015. They are now quite optimistic.

The inflation outlook

With the rouble volatility prevailing this year, inflation has proven stickier than imagined and a rise in utility prices combined with a bit more fiscal loosening has ensured that after inflation reached its peak this year in March at 16.9%, it remained stubborn through the summer and was still 15.0% in November. But, as we anticipated, it did fall to 12.8% in December because of **base effects** (i.e. when you compare inflation this year with that of 12 months ago as the base, the base then was very high because the rouble was collapsing in December 2015 and so there is less possible upward bounce).

We base our 2016 inflation outlook of 10.8% average and 8.7% year-end with downside/worse risks on:

1. The impact of “base effects” i.e. inflation was so high at the start of 2015 that it will not rise so much in comparison in 2016.
2. And of course maintained overall weaker demand and sluggish household spending will keep prices down.
3. There will be little wage push on demand in 2016 as we expect nominal wages to range close to levels of 2015 at around 5-9% so probably trending below inflation or just close to it.
4. Price competition will be fierce BUT companies and western brands will push up prices to compensate for the falling rouble.
5. But IF the rouble remains weak on average throughout 2016, then certainly inflationary pressures will be heightened and this is a BIG risk.

The interest rate outlook

In response to the rouble collapse in December 2014, the Central Bank spiked the key interest rate to 17.0% and has tried hard since then to bring that down. In February it started cutting rates and by August this was down to 11.0%. The Bank is enthusiastic to promote GDP growth but is restrained by the stubborn inflation we have talked about above. A central rate of 11.0% means that effectively market rates are in range of 15-16% after reaching 22-25% at the start of the year. These lower, but still high rates help explain why some B2B companies report a small rally in deals and opening conversations about new projects.

The fact that inflation dipped to 12.9% in December will help but we do not expect the Central Bank to reduce rates further especially now against a backdrop of currency volatility and with inflation perhaps proving stickier than anticipated in the first quarter of 2016.

There may be room to cut the rate to 9.5% by summer 2016 but now all depends on the oil price, the rouble rate and consequent inflation levels.

The Big-5 factors driving Russian GDP

There used to be the BIG-3 underlying factors to Russia’s economic growth and this year these have expanded to the Big-5 factors on which much else depends:

1. The oil price drives the rouble, inflation, confidence and growth. Until recently I expected an oil price of \$50 to \$55 to provide some stability of low growth to the economy and to support business. But below \$40 for oil, then the Russian economy comes under increased strain and negative growth will appear again in 2016 and weak growth for 2017.
2. The situation in eastern Ukraine must continue to be “perceived” as stable by the western media and western authorities. This seems possible and is probably 65-35 on the positive side. We stress that perceptions are what count and not actually the reality on the ground.
3. Western sanctions must not be intensified and this looks an 80-20 probability at the moment. US sanctions look set to remain in place for 1-3 years. There is a 25% chance that European sanctions will be moderated/reduced during summer 2016 which would boost the rouble by at least 10%.
4. We need to monitor how global currency markets will respond to the ticking up of US interest rates. The outlook for the dollar is continued strength and this will put some downward pressure on all emerging market currencies.

5. China: this is really a proxy for the oil price: when the Chinese GDP growth outlook wobbles downwards, then oil automatically follows in that downward direction and takes the rouble down with it.

We wrote these last lines about China several times in reports in 2015 and unfortunately for business in Russia, they have come to take effect.

Many commentators argue that the Russian government policy response has been rather limited and confined to expending emergency funds on some large state or para-state companies. The budget deficit has been allowed to expand but at the same time budget cuts have been introduced. Increased defence spending has diverted much-needed funds from other sectors of the economy. Interestingly, it seems that in the latest draft of the 2016 budget defence spending is targeted to be noticeably reduced proportionally, but we will see whether this can encompass developments in Syria.

Consumer indicators summary

Executives are monitoring “which way will the Russian consumer go?” and rightly many executives wonder and are amazed at the resilience of Russian consumers to absorb price increases. This was still the status in mid-December and we will see what the latest rouble wobble does to consumer confidence.

The economic numbers suggest that western consumer goods companies should be performing worse than they are. Some executives in the “softer parts” of consumer goods would reply that their numbers are not so great in roubles and struggling badly in FX. This is true but the overall results of the consumer goods sector are relatively much better than the pure economic numbers would suggest. Companies have adapted their brands, pricing and cost structures pretty well.

Our updated figures and comments follow:

- Nominal wage increases in autumn 2015 were only up by +4.5% and weaker in October.
- This kept real wages (after inflation) down by -10.9% in October and -9.0% in November.
- Consumer confidence has not recovered much in the third quarter from the second quarter this year. This indicator collapsed to the second worst figure in 20 years at -32 in the first quarter after the rouble collapsed at the turn of 2014-15. Consumer confidence then improved relatively to -23 in Q2 but thanks to weak oil prices and a wobble in the rouble in August-September consumer confidence stayed strained at -24 in Q3. We think this indicator will stay flat in the fourth quarter or may deteriorate a bit.
- Poor real wages and weak consumer confidence entail real retail sales still struggling at minus -13.1% in November. This is the worst figure in 20 years. The autumn trend was a worsening one (see economic tables) and again this testifies to how many western consumer goods companies have been able to adapt in a tough environment. It is no surprise though that executives were sober about the run-in to the Christmas period.
- The numbers also explain why more food & beverage companies are feeling the strain and reporting organic sales in roubles falling from +6 to +12% at the start of 2015 to levels of +1% to +5%.
- Disposable income stabilised at -5.4% in November (we remind readers that this is an indicator we do not like as it strangely includes consumer transactions with foreign currency). We think real wages and retail sales are much more accurate for business.
- Real wage trends virtually match those of retail sales.
- New car registrations continue to struggle: monthly levels were about 220,000 in 2011 but were down to an average of 180,000 in 2014 and have averaged the first 11 months of 2015 at 135,000: so minus -55% on a weak 2014.
- Unemployment has been relatively restrained at 5.3% to 5.4% but this was achieved thanks to many staff being put on short-time with less pay and with the tacit agreement of the government; many migrant workers have been laid-off and returned home. Otherwise unemployment would have shot up. Even so, the November monthly figure climbed to it the joint highest figure for the last two years.
- New consumer credit (in roubles) was a massive +40% in 2011 and still +30% in 2013 but declined to an average of 5-10% in 2014 on a steeply declining trend. By 2015 the year-end figure was -12%. WE expect this number to stay about -10%+ negative though 2016. FX retail lending has been negative for several

years. Non-performing retail loans have risen from 8% at start of 2015 to about 14% today while NPLs for corporates are running at 6%.

Industry and investment

The trouble with the Russian economy in this second recession in 7 years really started in January 2013, some 14 months before events in Crimea. From that date output for industry and fixed investment turned negative and has been negative every month since for 36 months and has reported 3 years negative growth. The on going forced deleveraging and limited mobility of capital against a backdrop of high interest rates means that under-investment in non-energy sectors will continue and thus overall investment and industrial output will be sluggish. Unfortunately, consumer indicators started to “catch up” the negative industrial/investment numbers from January 2015.

At the start of November there was a small sense that the start of slow recovery for industry and investment was beginning. But there are some contradictory trends going on: the PMI indicator jumped upwards in October to 50.2, the best figure in one year while at the same time business confidence dipped to its worst figure in the last 12 months (falling to -11 in November after averaging -5 to -6 all year) and industrial output drifts sideways/upwards!

However, any mini-recovery in this sector may be derailed by the most recent rouble and oil price slumps.

- Industry and investment are also held back by high interest rates, diminished financing options, deleveraging, reduced capital mobility, weaker FDI, lower confidence and ineffective policy.
- Industrial output and investment will be negative in 2015 by -3.3% and -8.8% respectively.
- These sectors will only really recover properly in 2017 and are expected to be negative or close to zero in 2016 with industry at 0.5% and investment still negative by 1.2%.
- To November 2015 the relatively better sectors were food and chemicals and refined petroleum whereas sectors taking double-digit hits included transport, electronics, machinery, non-metal minerals, paper, leather and textiles.
- Falling interest rates (see below) from 17% in December to 11.0% at the start of November has started to help the industrial and real estate sectors.
- Trade turnover is down -38% by November 2015 with exports negative by -39% and imports down by -36% and this cuts back industry and investment.
- On the very positive side the Purchasing Managers' Index jumped to 50.2 in October from 49.1 in September and 47.8 in August and it seems that the recovery was due mostly to domestic orders rather than external trade. The PMI stayed at 50.1 in November.
- However, while these are good monthly improvements the number remains only just above the threshold of 50, which is the standard benchmark for recession of growth.
- The PMI figure is also still one of the weakest in the whole CEE region and many core CEE markets are currently posting near record high levels of 52-54.
- Curiously PMI figures do not include defence procurement while figures for industrial output do, so it seems that any on-going PMI rally is due to some recovery in the domestic economy or at least a forward indicator.
- We think industry picked up a bit at the start of the year on the back of a lot of defence procurement in January-February which could not sustain this recovery as defence spending decelerated after this initial surge.
- The construction sector is down -7% to November 2015.
- Despite these difficult numbers above, business confidence remained strikingly resilient through most of 2015 at -5 or -6 after hitting lows of -10 at the turn of 2014/15. But the number did slump to -11 in November. This is a seasonal trend but at a lower level than in previous years.

There are a couple of small glimmers of light in this sector but the developments of the last 2-3 weeks could accelerate or maintain deterioration.

We think that any previous mini-rally and any future recovery for industry, investment and exports stem from at least three factors:

1. Import substitution: this is helping the economy in parts of agro-food, metallurgy, chemicals and some engineering products. BUT there is an intense debate on-going about just how effective or not import substitution is proving. Some western B2B suppliers are supplying to Russian purchasers who want to upgrade their own production thanks to import substitution.
2. Defence spending has caused some spurts to the economic output numbers and explains some ups and downs in industrial production. But this presumably diverts resources from other economic sectors.
3. The turn to Asia: yes, this is certainly happening but it is questionable to what degree this is actually benefitting the Russian economy.

Most commentators believe that import substitution and the pivot to Asia are of limited benefit so far.

As ever, I hope you have found this report useful and enjoyable. If you have any queries or comments, do get in touch on danielthorniley@dt-gbc.com.

9 January 2016

Appendix on Oil Price

Some interesting figures

- The USA has become the largest global energy producer.
- US oil output is 80% 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.
- Russia is a big loser. A \$1 decline in the oil prices entails losses to the Russian budget of about \$2bn and so with oil at \$60, the Russian treasury forfeits in 2015 \$80bn on 2014 revenues. A 10% reduction in the oil price also means Russian GDP declines by 0.7%.
- We have seen these trends in effect in Russia which have brought 2015 GDP down to -3.8%. If oil stays at \$35-40 range, it will prevent a possible rally to +1.0% GDP growth in 2016 and ensure that GDP declines by -0.4% to -1.5%

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.

Reliability Across Borders

RUSSIA
UKRAINE
KAZAKHSTAN
AZERBAIJAN

Moscow

White Gardens
9 Lesnaya Street
Moscow 125047 Russia
Tel.: +7 495 787 2700
Fax: +7 495 787 2701
moscow@bakermckenzie.com

St. Petersburg

Bolshoy Center
4A Gritsova Lane
St. Petersburg 190000 Russia
Tel.: +7 812 303 9000
Fax: +7 812 325 6013
st.petersburg@bakermckenzie.com

Argentina
Australia
Austria
Azerbaijan
Bahrain
Belgium
Brazil
Canada
Chile
China
Colombia
Czech Republic
Egypt
France
Germany
Hungary
Indonesia
Italy
Japan
Kazakhstan
Korea
Luxembourg
Malaysia
Mexico
Morocco
Myanmar
Netherlands
Peru
Philippines
Poland
Qatar
Russia
Saudi Arabia
Singapore
South Africa
Spain
Sweden
Switzerland
Taiwan
Thailand
Turkey
Ukraine
United Arab Emirates
United Kingdom
United States
Venezuela
Vietnam

www.bakermckenzie.com

WELCOME TO CUSHMAN & WAKEFIELD



SAVE YOUR MONEY



**GET BEST
REAL ESTATE SOLUTIONS**

**Full support for commercial real estate
occupiers including:**

- Transactions management
- Renegotiation of current lease agreements
- Portfolio analysis
- Real estate strategies elaboration and implementation
- Full outsourcing of all commercial real estate functions

Savings exceeding

30%

Volume of Transactions 2014-2015

195 000 m²

Savings of Occupier Services Clients
through 2014-2015

\$85 000 000

Corporate Investor & Occupier Services

Investor Services
Tenant representation
services
Integrated Real Estate
strategies
Real Estate outsourcing
for large companies

Transaction Services

Office
Retail
Warehouse & Industrial
Land

Capital Markets

Acquisitions and
Dispositions
Investment Management
Investment Banking
Debt and Equity
Financing

Research

Market Monitoring
Market analysis and
forecasting

Project Management

Construction consultancy
Project and fit-out
management

Advisory

Valuation
Highest and best use
analysis
Concept development
analysis
Feasibility studies

cushmanwakefield.ru



**CUSHMAN &
WAKEFIELD**

PAUL HARTMANN AG was seeking to co-locate our first factory in Russia with a national distribution center. Also, the project had to meet stringent global quality standards and risk mitigation requirements, which made this project even more complex. With Radius Group, we found a responsible development partner who provided a comprehensive build-to-suit development and financing solution, and delivered a high-quality building on-time and on-budget.

Dr. Felix Fremery
Chief Process Officer, PAUL HARTMANN AG

HARTMANN



We designed, implemented and financed a robust real-estate solution meeting Russian codes and German manufacturing best-practices, as well as PAUL HARTMANN AG's exacting requirements. Radius Group is proud to have fully realized PAUL HARTMANN AG's high expectations.

Chris Van Riet
Managing Director, Radius Group

2

DETAILS DELIVERED.

- (1) High-powered ventilation & extraction system designed to German engineering standards maintain a dust-free manufacturing environment
- (2) Co-location of manufacturing and distribution drives cost efficiencies and lowers lead times
- (3) Information systems implementation provides seamless connectivity with PAUL HARTMANN AG operations worldwide
- (4) Facility achieved BREEAM's highest rating for sustainable construction of any building in Russia in 2013

WWW.RADIUSRUSSIA.COM

MILLENNIUM HOUSE 12 UL. TRUBNAYA 7TH FLOOR MOSCOW 107045 RUSSIA
T +7 495 662 5550 F +7 495 662 5551



PAUL HARTMANN AG

South Gate Industrial Park, Moscow

Radius
GROUP



Building a better
working world

How can you gain altitude when the winds are too strong?

EY professionals can take your business to new heights. Our integrated approach uniting all our service lines – Assurance, Advisory, Tax and Transaction Advisory Services – enables us to find the optimal solution for each client.

Learn more at ey.com



The better the question. The better the answer. The better the world works.