CEEMEA Business Group

Russia
Latest Economic Results and Outlook 2014-18

It's not going to be easy in the short term

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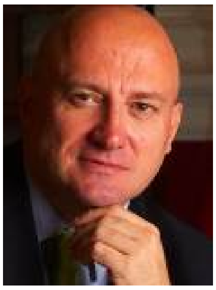

Danny Thorniley is President of DT-Global Business Consulting GmbH (an LLC company) which is Danny's own consultancy company based in Vienna through which he works with some 330 key clients on business strategy in CEEMEA, global and emerging markets especially Russia. These companies are part of the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

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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 Russian Central Bank announced in January that inflation will not fall below 10% until the end of 2015.
- The Bank recently cut interest rates by 2 percentage points in a surprise move which indicates the Bank's concern about GDP growth.
- But the Bank's decision raised worries about the inflation and rouble outlook.
- In the last week the rouble did not fully respond to the oil price increase and we explain below.
- The consensus at the end of January 2015 is that the oil price will average $62 this year. This offers a little bit of upside for the Russian economy and rouble.
- A $1 decline in the oil prices knocks off about $2bn from the Russia budget and so costs in 2015 could reach $80bn for the Russian Treasury.
- A 10% reduction in the oil price also means Russian GDP declines by 0.7% and this fits our current central scenario of -3.5% with downside risk
- Average GDP growth in the 4 years of 2013-2016 looks set to average just 0.4%.
- Inflation was 11.4% in December and 13.2% in January and, given the Bank's recent statement, inflation will be high at start of 2015 and then average 12-13% after reaching 13-17% in early spring.
- The Ministry of Economic Development forecasts that real incomes will fall this year by -2.8%.
- The government has announced an anti-crisis package but much funding will be devoted to supporting the top-20 major corporations, including Rosneft, and some 27 major banks and creating "a bad loans bank".
- This will entail a rise in the budget deficit to about -2.5%.
- But federal spending will cut by 10% with the exception of some social sectors and the defence industry and thus overall spending will be down by -5% to -7%.
- Some commentators suggest that defence spending and law enforcement will account for 34% of the federal budget (i.e. excluding regional ones).
- Capital flight shot up to $150bn in 2014 compared with $61bn in 2013 after a surge in the 4^{th} quarter last year.

Before we examine latest trends and the outlooks for the rouble and oil and before outlining a couple of potential positive outlooks, we need to refer quickly to some worrying trends in recent days: these may prove short-lived or more permanent.

The point is that in the last week (5-6 days) the oil price has risen about 20% from $48 per barrel to $57 (Brent oil). By the way, we have predicted that oil ought to average higher than $48 and this is the consensus view and we expect an average oil price this year of about $55-65 but we are not making judgments on weekly variations. But while the oil price has increased 20% in the week, the rouble has only risen by some 5-6%. One would have expected a bigger bounce. There were even a few moments when oil was rising quite sharply and the rouble lost about 5-8% before staging a mini recovery.

What's going on? Sadly the situation in eastern Ukraine is deteriorating and this rising political risk is curbing the rouble when oil is rallying. Also the recent Central Bank decision to reduce interest rates (see below) spooked the markets and it seems the Bank is more concerned with the GDP outlook rather than inflation and the rouble. Recent days were not rosy either given that the rating agency S&P downgraded Russian debt to junk status.

So what? The worrying conclusion is that even a strong oil price is not having the presumed positive effects it should have because of other factors. As we said above, let's see if this is a temporary feature or more engrained. If it is the latter, then this indicates that events in eastern Ukraine are having a larger negative impact on the rouble than anticipated and "positive oil" can be countered by "negative Ukraine".

Why did the Central Bank reduce interest rates last week and what does it entail?

After raising rates rigorously throughout 2014 to protect the rouble and cub inflation, the Russian Central Bank surprised almost everyone by cutting the central rate by 2 percentage points from 17% to 15% at the end of January. Coming so soon after the December spike in rates from 9.5% to 17.0% during the rouble rout, and implemented when inflation is surging, the decision caused quite a shock and some concerns.

- It is clear the Central Bank is now very worried about the GDP growth prospect.
- No doubt the government and industrial lobbies were arguing for an early rate cut given that financing costs had leapt to 19-24%+.
- But the message seems clear that the Bank for now is less worried about inflationary trends and what may happen to the rouble compared with GDP growth prospects.
- In the announcement of the cut the Bank failed to mention its medium-term target of 4% inflation.
- The only logic can be that the Bank thinks that the depressed economy will surely lower prices in the medium-term and therefore it can get away with such a rate cut.
- Critically the Bank commented that rates were unlikely to fall below 10% until the end 2015.
- But one can question whether a 2 percentage interest rate cut will be enough to stimulate growth when much of the problem rests with confidence and even access to capital given sanctions and the growing pressure on Russian commercial banks.
- We therefore think that this cut will not have much appreciable positive effect on GDP unless it is to be followed by a series of more cuts which currently would be quite peculiar and damage the Bank's credentials for inflation targeting etc.
- The cut has probably contributed to preventing any recent "oil rally" for the rouble and could be a further upward stimulus for inflationary expectations.

Summary: while we understand that corporations are struggling badly with financing costs, we doubt that this rate cut will have sufficient positive effects to compensate for the quite visible negative ones.

How did 2014 finish and what's going to happen in 2015?

Latest news

A 10% reduction in the oil price also means Russian GDP declines by 0.7% and this fits our current scenarios very precisely: the consensus was that GDP would be +1.4% in 2015 when oil was at $100 per barrel whereas with a 45% cut we are looking at GDP negative at around -2% and when we add on negative effects of sanctions and financing then we arrive at our estimate of -3.8% for this year.

Eastern Ukraine and interest rates are holding back the rouble

We did warn in earlier papers that the oil price was "only game in town" as hardly anything else matters for the economy and the rouble. But we flagged one other risk: at the moment the conflict in eastern Ukraine is a nasty, frozen/hot conflict which will harm the Ukrainian and Russian economy as long as it lingers. However, there is a downside risk. Global financial markets have decided that the Ukraine crisis (from their perspective) is over and done. If there was any manifest escalation which was declared in the West as further Russian involvement, then the financial markets would react quite brutally: there would be severe downward pressure on the rouble and either the currency would plunge further or the Central Bank would have to intervene. This is not our central scenario but something to bear in mind. At the moment we are not in this disaster scenario BUT it is clear that the rising tension in eastern Ukraine is holding back what ought to have been a rouble mini-rally at the start of the year. Other factors (interest rate policy) contribute to currency weakness but eastern Ukraine is still very influential on Russia's financial outlook.

GDP in 2014 and outlook 2015-16

GDP last year finished with a bit of a flourish in the final months especially among consumers but other indicators were less good and the outlook is very challenging. GDP came in at 0.8% growth, slightly higher than expected but nothing shocking. A slump this year is unavoidable and the consensus view has shifted radically in recent weeks with a range of predictions for 2015 from -2.0% to -6.5% and with continued sanctions, tight financing, low confidence, weak demand and still high interest rates and rising inflation, then we forecast negative growth of 3.8% this year. Looking forward to 2016 presuming some rouble/oil stabilisation and reduced/eliminated sanctions and inflation on a downward curve, we see growth picking up at about +0.5%.

Overall the economy has a few positives still left:

- Import substitution, but we question how viable and sustainable this is.
- Defence spending which explains in part why industrial output is not yet negative.
- 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.

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	-0.8	-3.8	0.5	2.1	2.7
Retail sales	-5.5	6.3	7.2	5.7	3.9	2.5	-4.0	1.0	2.5	2.8
Household spending	-7.6	5.5	6.8	7.9	4.7	1.8	-4.4	0.9	2.3	2.8
Real wages	-2.8	4.4	4.9	8.2	5.2	1.9	-4.5	1.2	3.1	3.0
Disposable income	1.0	3.7	2.8	3.7	3.3	2.1	-2.0	1.0	2.5	2.9
Inflation (year-end)	8.8	8.7	6.1	6.6	6.5	11.4	10.0	7.7	6.6	6.2
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	0.3	3.2	3.8
Industrial output	-10.8	8.3	4.7	2.6	0.3	1.1	-4.0	0.7	2.4	3.0
FX reserves ($bn) year-end	447	485	510	528	509	385	340	310	280	290
Rouble/$ (year-end)	30.3	30.4	32.1	30.4	32.9	58.0	70.0	72.1	75.0	79.0
Rouble/Euro (year-end)	43.4	40.0	41.5	40.1	45.1	72.0	78.5	79.3	77.3	79.0
Budget balance (% of GDP)	-6.3	-3.5	-0.2	0.0	-0.5	-0.5	-2.3	-1.6	-1.0	-0.5
Current-account balance (% of GDP)	3.8	4.9	4.9	3.6	1.6	2.0	2.6	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	Dec
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	-7.3
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	-4.7
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	5.3
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	5.3
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	3.9
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	-2.4
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	11.4
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	-0.6

Investment and industry—weak links

Because of the above, industry grew in December by 3.9% which was a high result but the figure for the full year was a lukewarm 1.7%. Industrial output was actually on a rising trend in the final quarter (see tables above) but we do not imagine this can be sustained and predict with the consensus that industry will fall by -4.0% this year with some possible upside. But with weak investment and tight financing, it is hard to see many positives. Next year (2016) we see industry crawling into positive territory of 0.7% expansion.

Gross fixed investment has been the weakest link in the Russian economy for two years now and in December was down -2.4% and was negative every month of 2014 and finished the year at -2.5%; but we think with continued sanctions, tight financing, low confidence, weak demand and still high interest rates, then investment could crash this year by as much as -10%. Again if there is a change in sanctions and the rouble, there could be the start of a soft recovery in the final quarter of 2015, but again it seems likely this will be weak. Investment will start to recover in 2016 at 0.3%. Eventually spending on new sport facilities will kick-in but, as with saw with the Sochi investment, the impact may not be as big as anticipated.

And finally the consumer is going to get hit

The consumer sector kept the economy afloat or in passable shape in 2012 and 2013 and at the end of 2014 a flourish of consumer spending in order to "get ahead of inflation and devaluation" meant that consumers spent their roubles merrily in November and December buying cars, consumer durables and a whole array of products. Retail sales in December rose 5.3%, to their best figure for 12 months and this helped this indicator finish 2014 as a whole at 2.5% growth; but this is by far the weakest figure in 4-5 years and without the December surge, the number would have been bad. But worse is to come and we see retail sales slumping -4.0% this year and then recovering to 1.0% in 2016 and then averaging about 2.5% in later years.

Many companies in this sector reported record rouble sales at the end of 2014. But in a sense this was "panic buying" or "safety buying" and will not be sustainable. Three related factors will ensure this:

1. Rising inflation: prices rose 11.4% in December and 13.1% in January and the outlook is for an inflation spike in the first 4-5 months of the year with inflation touching 13-17% in these months before probably calming down, but the average now looks to be above 10% for this year (see below for details).

2. Western companies also plan to raise prices again this February in a range of 6-18% and further rounds will probably occur in the summer/autumn. During 2014 many companies (not all) felt the need to raise prices by 15-30%.

3. Combined with rising inflation is weakening nominal wages which with higher inflation means low real wages and less money in peoples' pockets.

Negative real wages - bad news

In December real wages recorded a -4.7% decline, the worst result in 5 years, and this was on a declining trend: real wages in 2014 averaged 1.3% growth but during 2015 they will collapse by -5%. This is because the Russian government, Russian corporates and western companies will be providing nominal wage increases of about 5% when inflation will average at least 10% this year and so real wages come in at minus -5% (10% inflation minus 5% wage increase leaves -5% real wage).

In 2014 as whole total nominal wages were 9.1% up which means slightly positive with average inflation at 7.8%. But nominal wages were in fact already down to 6.1% in December which explains the bad figure for real wages in that month. The downward trend has started and is accelerating.

Also at the start of this year inflation will tick along at 12-16% and nominal wages will already be at 5-6% so real wages in the first months of 2015 could fall as low as -7% or -9% for some months so the annual minus -5% average figure could turn out worse unless there is a good inflation improvement in the second half of the year.

As we noted in our most recent economic overview, wages in the public sector have been declining for 2-3 years from a high level of 20% when inflation was 5-6% thus entailing real wages of 12-14% range, among the highest in the world. But over the last two years and in recent months nominal wages have declined to 10% and then to low-single digits in autumn 2014 which meant that public wages were rising slower than inflation. The Russian corporate sector has always offered lower average salaries than the public sector and so Russian corporates are also now paying below inflation. Western companies are following the same pattern. The Russian federal budget plans public sector pay rises in 2015 at about 5.5% which means that real wages would be down by -5% to-9% depending on average inflation of 10%. So unless the government steps in, we see quite severe negative real wages in 2015 which will have inevitable negative impact on consumer spending.

A quick word on disposable income

As we have reported often in previous papers, this is not an indicator that we value as it includes curious categories including the buying and selling of foreign currency. It does not always reflect household spending patterns; real wages and retail sales are better indicators. For what it's worth disposable income slumped by -7.3% in December but again this could be affected by FX buying. We assume it will fall by -2% in 2015

Bank lending will stagnate and turn negative

Bank credits in the economy and to the private/consumer sector were still booming in 2013 at 30%+ and by 20% to corporates. We always expected these numbers to decline in 2014 and predicted a level of 12-15%. The trend has been in this direction and actually dipped into single-digit credit growth in the autumn 2014. The average figure of credit growth for 2014 will be about 10% on a falling trend and in 2015 will see new credits stagnant or more likely at -5% or worse presuming that fewer consumers and corporates will want to take on credit and that the Russian banks will be retrenching and not want to take on any new credit risk. So credits will not boost the economy and will press down on household spending.

The jobs outlook is not too bad?

Unemployment in December was not bad at 5.3% and this was also the average figure for all of 2014 and this is still close to record low levels. In general western and Russian companies so far are tending to retain as many staffers as possible but are tightening wages levels to compensate. But we think the downsizing in staff in western companies and Russian ones will accelerate at the start of this year as companies try to get their 2015 budgets to work. Companies will tend to offer deeper pay cuts to staff who want to hang on but redundancies will rise: we think unemployment will grow to 6.2% in 2015 which is still not bad.

What could go right: two potentially big positive scenarios?

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/February 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 $60-65 per barrel (the consensus at end of January 2015 is that oil will average $62 this year), then the picture changes for Russia for the better. Many commentators and myself included think oil is over-sold now (see below: Saudi Arabia can only obtain a balanced budget when oil is at about $78 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 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 (admittedly, this does not look good at the start of February). 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/or if the sanctions outlook improves, the rouble could easily appreciate in 1-4 weeks by 10-20% with positive consequences for GDP and inflation, business confidence and corporate results BUT I confess this requires things to "go right" for Russia.

   Additionally as pointed out above in the Box, it now seems possible that negative events in eastern Ukraine can eliminate in large parts the positives stemming from any oil boost.

The new estimate and outlook for 2015

(See tables above 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 15% (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.

Presuming that oil averages about $60-65 in 2015 and that sanctions are maintained until the end of 2015 and into early 2016, then our central scenario is as follows

Central economic scenario 2015

GDP	-3.8% to 5%
Inflation average	10-13%
Inflation (year-end) Inflation (average)	10% 12.5%
Consumer spending	-4.4%
Investment	-10%
Industrial output	-4.0%
Rouble to US dollar average	68
Rouble to the Euro average	77

Presumably, the Russian budget deficit will no longer be kept within newly prescribed limits. The recession will necessitate that the deficit shifts from an initial target of -0.6% for 2015 and in fact dip to about -2.3% this year (the budget deficit in 2014 came in at -0.6%).

Economic scenarios at different oil prices

Average oil price 2015	GDP	Inflation	Rouble/US$ Average	Rouble/€ Average
$80-85	1.0%	6.20%	45-50	53-55
$70-80	0.0%	7.00%	52-55	58-62
$63-70	-2.0%	8.00%	57-62	65-69
$55-63	-3.8%	12.50%	65-69	73-78

Please note that regarding the FX rates above, we are presuming a Euro/$ average exchange rate in 2015 of about 1.12.

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, the rise in food prices, sanctions and the shrinking rouble ensured average inflation in 2014 came in at 7.8% with the year-end figure in December 2014 finishing at 11.4% (which was followed by 13.2% in January). The Central Bank admitted last week that inflation would not dip below 10% until the end of 2014.

Inflation is going to spike as anticipated through the first 3-5 months of 2015 for at least three reasons

1) The full effects of the December rouble crash will flow through the system and we are already seeing this.
2) Many companies and certainly western ones will be raising prices during February by 6-17% and this will bounce prices upwards; more rises could be introduced in summer/autumn.
3) The Central Bank's announcement last week of lower interest rates will add to the sense that inflation is not the number one priority and this could raise inflationary expectations.

Inflation in the first 4-5 months of 2015 could range about 13-17%. We assume that inflation ought to decelerate in the second half of the year presuming some rouble relative stability and on this basis inflation will average 12-13% through all of 2015. We then see inflation averaging 9.0% in 2016 and ending the year on a downward trend at 7.7% i.e. in December 2016.

The Central Bank probably cut interest rates last week on the assumption/hope that medium-term inflation is not a threat. There are some possible 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 much more likely negative in 2015.
- Interest rates will stay relatively elevated (despite the recent cut).

So, 2015 will start with high prices and then probably trend downward in the second half. Stabilisation or even appreciation of the rouble would improve these numbers but of course any further rouble volatility and depreciation would push inflation upwards: our numbers here are the central scenario.

As ever, I hope you have found this paper useful and if you have any comments, please contact me at daneilthornilrey@dt-gbc.com.

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Appendices

These four sections are repeated from earlier papers but for readers who may have missed them they will prove useful in enumerating the key underlying the drivers of the oil price and the section on "new normals" is a good reference point.

"7 New Normals"

When trying to rationalise the situation in your Russian market, you can refer to at least 7 "new normals" since the start of 2013 and 6 of these have occurred in 2014 with three of them in November alone.

January 2013	New Normal No 1	Russian economy starts cyclical slowdown with investment and industry leading the downward path
January 2014	New Normal No 2	Rouble starts to wobble
Early March 2014	New Normal No 3	Annexation of Crimea
July 2014	New Normal No 4	Shooting down of Malaysian airplane and intensification of sanctions
November 2014	New Normal No 5	Free float of rouble, search for equilibrium rate / rouble slumps
November 2014	New Normal No 6	OPEC declines to support oil price. Rouble sinks
End November 2014	New Normal No 7	Russian government announces recession for 2015 GDP

What you should know about the 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.
- In August the US imported not one barrel of oil from Nigeria which is normally one of its biggest suppliers
- Other suppliers have contributed to the relative supply glut: Libyan output increased in 2014 by a remarkable 400%.
- A 10% drop in the oil price adds about 0.15% to global GDP so the current 40% decline could increase global GDP by about 0.6% in 2015.
- A 20% drop in the oil price results in $70bn of extra disposable income for US consumers and they will now have more than $120bn extra spending power which will add yet another stimulant to the US GDP growth outlook.
- But conversely Russia is obviously hurt.
- Total oil exports in 2013 were worth about $1.1 trillion and a 40% drop in the oil prices entails losses of about $400bn and Russia is a big loser among those.
- 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%.

Why has the oil price collapsed?

- Shale/energy production is accelerating quicker than anticipated against a weak demand back-drop
- Global demand is weakening with the Eurozone crippled and China implementing a managed GDP slowdown.
- 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.
- As we noted above, the US is supplying more to the world and buying less energy from it.
- Libya and Iraq have increased their output significantly and somewhat surprisingly.
- Speculation and shorting account for at least 25% of the price movements.
- Assessment of the Middle East risk has changed and improved radically: in summer 2014 it was feared the extremists of IS would dominate large swathes of the Middle East but this is now perceived as a contained conflict.
- All these factors sent the oil price down from $105 per barrel to $82 where it looked set to stabilise
- But then OPEC (Saudi Arabia) decided in November not to support the oil price and this sent oil tumbling to $70 and then $60.
- Several organisations then added to the pain for Russia predicting less global demand though 2015
- 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.

Why did Saudi Arabia not support the oil price?

There is much speculation about this and several conspiracy theories prevalent!

1) Saudi Arabia was fed up with acting as the oil supporter of last resort.
2) The Saudis felt that other suppliers would not stick to agreed limitations and thus they would lose market share.
3) The Saudis wanted to retain market share to the relatively lucrative Asian market where GDP growth remains comparatively strong for now.
4) 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.
5) It is also thought that he 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 $50 to $100 and the average profitability level is thought to be around $70. So if prices stay noticeably below $70, then some shale producers will become unviable. But how long will that take?
6) Finally, there is the well-known conspiracy theory that the Saudis and the US are working in tandem to bring the oil price down to hurt the Russian economy. On balance if there is any vendetta going on here, I fancy the Saudis want to harm the Iranians more than they do the Russians and as we note below, there is a cost to Saudi Arabia as well for playing such a game.

In recent days China has announced slightly lower growth projections and any such announcements always plunges the oil price downwards. Last week OPEC announced one of its lowest future estimates for global oil consumption in 2015. With OPEC unable and/or unwilling to cut back on supply, then the demand-supply model speaks for itself i.e. the market in 2015 will be over-supplied and the oil price has fallen further as consequence.

In the short-term oil prices could go anywhere and oil could range between $50 to $68 in 2015 but there is a case to suggest that there could be some stabilisation and even a short-term mini-rally medium term for at least two reasons:

1) It is estimated that Saudi Arabia's own break-even point for a balanced budget is around $80 per barrel and thus current prices are also hurting Saudi Arabia. With the background of the failed Arab Spring, the Saudi authorities will want to dispose of sufficient funds to provide pump priming to their own economy or at least to allow for maintained social spending. It seems in the self-interest of the Saudis for the oil price to rise at least a little.

2) Some shale producers will soon become unprofitable and others will face financial strain: decreasing confidence and investment in shale ought to rebalance some of the supply and demand equation to favour some price increase.

This is in the short-term. However, over the next 2-5 years shale developments ought to exert a softening impact on energy prices (unless the shale industry is disrupted due to lower prices) and the trend for a weaker US dollar ought also to ensure over the medium-term that energy prices are not rallying. At the moment with soft-ish global growth, the case for any strong energy price rally seems very distant and the Russian economy and government will probably have to work with this massive energy "new normal" for several years. This will have consequences for the GDP outlook and business and also for Russian government policy and the prospects of economic reform and diversification.

I and others have long-argued that economic reform in Russia would only start to take place when the oil price was low and not strong. Well here we are.

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