

Russia Economic Outlook



by Dr. Daniel Thorniley

President, DT-Global Business Consulting
danielthorniley@dt-gbc.com

22 March 2015

IN ASSOCIATION WITH:

BAKER & MCKENZIE



Content

About the author	1
Executive summary	3
Some major factors	4
Best performing currency in the world in 2015! Yes, well...	4
Where else to go?	4
Why is the rouble up... for now?	5
Volatility - Rouble to Euro and dollar since end December 2014	5
Total Foreign Currency reserves of the Russian Central Bank (\$bn)	6
The GDP outlook	6
GDP outlook 2015-16	6
Macro-economic data 2009-2018	7
Consumer-related statistics: by year and monthly	7
The new estimate and outlook for 2015	7
Central economic scenario 2015	8
Economic scenarios at different oil prices	8
Inflation outlook	8
Investment and industry—weak links	9
The Russian consumer is going to need some of her/his famous resilience	10
Negative real wages - bad news	10
A quick word on disposable income	11
The jobs outlook is not too bad?	11
APPENDICES:	12
“7 New Normals”	12
What you should know about the oil price	12
Why has the oil price collapsed?	13
Why did Saudi Arabia not support the oil price?	13

© 2015 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 5, 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.

Executive summary

- GDP this year will finish about -4.1% and + 0.5% in 2016 and then trend at 2.8% or slightly higher in subsequent years.
- Unlike after previous crises, there will be no big, quick economic bounce-back.
- However, nor do we imagine that this crisis is going to be as severe for GDP as in 2009 and 1998.
- But western business will be hurt due to the rouble acting as a 'shock absorber' thanks to the policies of the Central Bank.
- And companies are hurt more this time round thanks to financing challenges stemming mainly from western sanctions.
- Generally we estimate that 60% of Russia's economic problems stem from the fallen oil price and another 40% is a result of sanctions and financing issues.
- There are of course other fundamental structural issues but we discount those for simplicity's sake.
- We all remember that Russia's economic slowdown pre-dated the events in Crimea; the deceleration commenced in January 2013 with investment and industrial output slowing-down.
- There is a 20% chance that EU sanctions will be rescinded in 2015 but this likelihood is more diminished in recent days given linkage between the sanctions and implementation of clauses in the Minsk agreement regarding control over Ukraine's national border.
- The consensus for the oil price in 2015 is \$60-62 per barrel.
- As we have long argued: with oil at \$62 and relative stabilisation in Eastern Ukraine, the Russian economy and business could survive at the current rouble FX rate or even witness some further currency strengthening.
- But volatility is still dominant as we outline below.
- Inflation carried on its ascent to 16.7% in February after 15% in January and we expect high numbers until May-June and then some deceleration presuming a moderate/steady rouble.
- But average inflation this year will stay in double-digits.
- The Central Bank cut rates again to 14% and we predict that this rate will be at 12.75% by July this year which will be some partial help but market rates remain high and financing is still very tight
- Investment, industry and exports led the downturn but in 2015 consumer-related indicators are starting to fall badly.
- Exports are down by one quarter (denominated in dollars).
- Retail sales at -7.7% year-on-year in February are the worst in 10 years with the exception of December 2009.
- Real wages (after inflation) at -9.9% are the worst in 10 years *and the negative swing in the last 2 years is as high as 15-20% i.e. from +10% to -10%, one of the worst swings in the world in the last decade.*
- Consumer confidence in December at -18 was also the worst for 10 years with the exception of an 8-month period in 2008-09.
- Investment continues its slump with -6.5% growth in February and industrial output declined by minus -1.6% which could be due to a slowing of defence spending after a surge in the previous two months.
- Defence spending affects industrial output numbers and skews them: apparently 20% of the national defence budget was spent in January alone this year.
- New bank credit fell to an average of +10% last year but on a declining trend and ended the year at almost zero. New credit this year will be negative by at least -5%.
- After net capital outflows of \$130.5bn in 2014 (from \$62bn in 2013), we expect this figure to end 2015 at about \$100bn as the rouble partially stabilises.
- Overall government spending cuts are planned at 10% but with some compensatory spending on defence and some social services, net cuts will amount to 5-7%.
- To finance a budget deficit of some -3.2% this year, the government has already secured 3.2 trillion roubles from the Reserve Fund but we doubt the government will use the full amount this year.
- The government does have some \$150bn of funds available to finance the budget deficit and to promote a mini-stimulus.

Some major factors

To summarise the current economic and business “state of play” (see recent March Business Gossip report for full business analysis), there is a sense of economic/business stabilisation but at sharply lower levels - expectations have been managed downwards; some executives fear a worsening business outlook this spring as the consumer is hit; the overall economic numbers are deteriorating by the month and the rouble collapse in December is now impacting consumer-related figures; inflation is spiking this spring and ought to decelerate from the summer (if it does not, then that would represent a major negative risk); 2015 is going to be recessionary and 2016 ought to see the start of a quite soft recovery.

Best performing currency in the world in 2015! Yes, well...

And the good case outlook:

As we noted in a recent commentary, until 15 March, the Russian rouble was the most stable emerging market currency to date this year (!) and the Russian stock market is one of the best performing in the world, although as we noted before, this is only because they were the very worst performers in the whole of 2014.

But we have argued for several months now that there is an upside to the economy and business and in the briefest version, the argument runs like this:

If the oil price stabilises around \$60 for the next 12 months which is at least a 50% chance and if Eastern Ukraine becomes a frozen conflict which is a 40% chance, then there are grounds to suggest that the rouble will stabilise at current levels of about 60 to the dollar and 64 to the Euro. There is even a chance that with any improvement in mood, that the rouble could appreciate another 10% to 55 to the dollar and 60 or lower to the Euro. This is the mid/best case for the Russian economy and overall it has a 45% chance of likelihood for the next 12 months.

The important thing for business is that if a company grows sales at 9% in roubles in this scenario, then that sales growth is broadly replicated in FX which would be quite an achievement. But no one is naively hopeful about the outlook.

Where else to go?

But it is worth stating that many other emerging market (EM) currencies and economies are under pressure (Brazil especially, Turkey somewhat and China continuing its managed slowdown). In one sense for managing directors operating in Russia, there is some comfort to take that global headquarters can't really say:

Business is bad in Russia, so let's move out or downsize massively and take out assets and put them into some great market which is booming... called Nirvana!

There is some sense of stabilisation in the Russian market after the traumas of last December and the turn of the year.

But the sense of stabilisation is on very fragile ground and could turn negative and quickly. And the recent blip downwards in the global oil price could be an early precursor.

Volatility remains elevated even if in recent days/weeks we have seen this on the positive side with the rouble appreciating 12-15% in a couple of weeks.

Why is the rouble up... for now?

The two main factors driving the rouble FX rate are currently good ones:

- 1) The oil price was up at close to \$60 until just a couple of days ago when it dipped down by some 8-10% in recent days and is now closer to \$55 than to \$60. But the rouble last week was at 62 to the US dollar and 64 to the Euro (as of course the Euro is crumbling against the dollar and close to parity).
- 2) There is a sense that events in Eastern Ukraine have stabilised.

Other factors include:

- 3) The Russian Central Bank is managing the repo rate to support the currency.
- 4) Interest rates had spiked upward to 17% and are still high at 14% in mid-March.
- 5) The financial markets have responded to the above factors and there is a (temporary) sense of relative calm.

But there are many short-term and medium-term risks: regarding the oil price, if Western relations improve with Iran and sanctions on that country are removed or lessened, then the markets will assume a larger supply of Iranian oil coming onto the markets and thus the oil price will experience downward pressure as will the rouble.

But in March this year the rouble is doing better than “normal” given the oil price this week stabilised at \$55. Given trends in recent months we would expect the rouble at 65-68 to the dollar and 68-73 to the Euro but:

The rouble is currently performing about 10-15% stronger than “it ought to”.

The reasons are probably due to Eastern Ukraine’s apparent stabilisation providing some extra support for the rouble. In January deteriorating events in Eastern Ukraine hurt the rouble when the oil price was climbing strongly: so it is becoming clear that eastern Ukraine is acting like a swing factor with the oil price i.e. a strong oil price can be damaged by the Ukraine conflict whereas a weak oil price can be supported by stability in Ukraine.

As we note below in our “standard” middle/best case outlook, if the oil price stabilises or strengthens short/medium term and Eastern Ukraine does not deteriorate into worse military conflict then the rouble could stabilise or event appreciate another 10-15%.

But volatility remains enhanced and the rouble rate over the last 90 days points to this.

Volatility - Rouble to Euro and dollar since end December 2014

	Euro	Dollar
22 December	72	57
26 December	64	53
22 January	80	70
20 February	69	61
22 March	64	59

The Russian Central bank has also spent \$150bn since 1 January 2014 in protecting the currency over 14 months until 1 March 2015. The trend was as follows:

Total Foreign Currency reserves of the Russian Central Bank (\$bn)

1 January 2014	509
1 March 2014	493
1 August 2014	468
1 December 2014	418
1 February 2015	376
1 March 2015	360

In comparison the Bank spent \$250 in 3-4 months during the 2008-2009 currency crisis.

The GDP outlook

A 10% reduction in the oil price means Russian GDP declines by 0.8% and this fits our current scenarios very precisely: the consensus a year ago was that GDP would be +1.3% in 2015 when oil was at \$100 per barrel whereas with a 45% cut we are looking at GDP negative at around -3.5% and when we add on negative effects of sanctions and financing then we arrive at our estimate of -4.1% for this year.

GDP 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 0.6% growth in 2014, slightly higher than expected but nothing shocking. A slump this year is unavoidable and the consensus is for about -4.3% this year and 0.4% in 2016. These numbers are presented on a central scenario of the global oil price at about \$55-65 (which is also the current consensus figure), no serious deterioration in Eastern Ukraine and EU/US sanctions presumably lasting through 2015.

Overall the economy does have 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 not 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	0.6	-4.1	0.5	2.1	2.7
Retail sales	-5.5	6.3	7.2	5.7	3.9	2.5	-4.5	1.0	2.5	2.8
Household spending	-7.6	5.5	6.8	7.9	4.7	1.8	-5.3	0.9	2.3	2.8
Real wages	-2.8	4.4	4.9	8.2	5.2	1.9	-8.7	1.0	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	12.0	7.7	6.6	6.2
Unemployment rate	7.9	7.6	6.5	5.3	5.5	5.3	6.5	6.0	5.7	5.5
Gross fixed investment	-17.9	5.6	9.8	6.0	-0.3	-4.8	-10.0	0.3	3.2	3.8
Industrial output	-10.8	8.3	4.7	2.6	0.3	1.1	-3.3	0.7	2.4	3.0
FX reserves (\$bn) year-end	447	485	510	528	509	385	310	280	260	270
Rouble/\$ (year-end)	30.3	30.4	32.1	30.4	32.9	58.0	63.0	66.0	72.0	74.0
Rouble/Euro (year-end)	43.4	40.0	41.5	40.1	45.1	72.0	66.0	69.0	74.0	77.0
Budget balance (% of GDP)	-6.3	-3.5	-0.2	0.0	-0.5	-0.5	-3.5	-1.9	-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												2015	
	year	year	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb
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	-0.8	-0.4
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	-8.0	-9.9
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	-4.4	-7.7
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	5.5	5.8
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	0.9	-1.6
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	-6.3	-6.5
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	15.0	16.7
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	-1.6	-1.8

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 are:

- The collapsed rouble.
- Spiking inflation.
- Elevated interest rates currently at 14% (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 \$60-62 in 2015 and that sanctions are maintained until the end of 2015 and into early 2016, then our central section is as follows:

Central economic scenario 2015

GDP	-4.1% to -4.5%
Inflation (year-end)	11.5%
Inflation (average)	13.0%
Consumer spending	-5.3%
Investment	-10%
Industrial output	-4.0%
Rouble to US dollar average	64
Rouble to the Euro average	68

Presumably, the Russian budget deficit will no longer be kept within prescribed limits. The recession will necessitate that the deficit shifts from an initial target of -0.6% for 2015 and in fact dip to 3.2% this year which is now a government estimate (the budget deficit in 2014 came in at -0.5%).

Economic scenarios at different oil prices

Average oil price 2015	GDP	Inflation	Rouble/US\$ Average	Rouble/€
\$80-85	1.0%	6.5%	46-48	50-52
\$70-80	0.0%	7.50%	48-52	55-56
\$63-70	-2.0%	9.0%	54-56	60-64
\$55-63	-4.5%	12.50%	58-65	66- 68
\$50-55	-5.5%	14.0%	66-72	70-75

Please note that regarding the FX rates above, we are presuming a Euro/\$ average exchange rate in 2015 of about 1.08.

Inflation outlook

Inflation is behaving fairly predictably and as we forecasted in recent months. Prices climbed to 16.7% in February after 15.0% in January: in February non-food prices rose by 13% while food prices leapt by 23%; prices for services were barley up.

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 has admitted that inflation is unlikely to be lower than 12% by year-end 2015.

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 raised 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 rate cuts from 17% to 14% in recent weeks add to the sense that inflation is not the number one priority and this could raise inflationary expectations. Although more recently the Bank did repeat its anti-inflation credentials and mid-term targets of 4% inflation.

Inflation in the first 4-5 months of 2015 could range about 13-19%. We assume that inflation ought to decelerate in the second half of the year presuming some rouble stability and on this basis inflation will average 12-14% 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 averaged 10% in 2014 on a declining trend and was almost negative at year-end 2014 and will probably be negative by -5% this year.
- Interest rates will stay relatively elevated (despite the recent cuts).

But looser fiscal policy and a wider budget deficit at -3.2% instead of -0.6% last year will encourage prices upwards.

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.

Given this scenario, the consensus is that the Russian Central Bank will “put growth marginally ahead of inflation” as a priority and cut interest rates in the coming 3-4 months by 1.25% and so we should see the central rate at about 12.75% in June/July.

Investment and industry—weak links

These two connected sectors have performed below par since January 2013. Industry has been supported by some limited import substitution and especially by defence spending and related procurement and this could be one reason explaining the December industrial growth rate of 3.9%; but since then output has fallen and the latest February number was negative 1.6% (all figures are year-on-year i.e. the month in 2015 compared with the same month in 2014).

Despite the weak rouble (or because of it!) export revenues in dollars are set to crumble this year as oil revenues collapse: exports were valued at \$493bn in 2014 and the consensus is for \$380bn this year, a fall of -25% which is the current export trend in the first 2-3 months of 2015. Thus industry is getting no support from export markets, although some manufactured goods could be assisted; the trouble is of course that Russia doesn't produce many non-energy, non-commodity manufactured goods for export.

Some of the numbers in this sector are a bit “funny”: industry has generally been performing better than the Purchasing Managers' Index and we can explain this by defence spending being included in the industrial figures but not those of PMI. However, in February industry results went down while PMI went up (from 47.6 to 49.7)! This may be due to a slowdown in defence spending in February after a surge of defence procurement at the end of last year and the first weeks of 2015: apparently 20% of the national defence budget was spent in January alone this year. Business confidence indicators also improved in February when you might expect them to fall in line with industrial output. However Russian executives are probably glad to see the back of 2014 especially the traumatic month of December: business confidence rallied to -6 from -9 in January and a recent low of -10 in December. The current number is about the average for mid-2014.

We predict with the consensus that industry will fall by -3.3% 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 declined -4.8% last year and has started this year poorly as well with an average -6.4% in the first two months. Even in 2013, which saw the run-up year to the Sochi Games, investment was just under zero. We think that with continued sanctions, tight financing, low confidence, weak demand and still high interest rates, that 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 we saw with the Sochi investment, the impact may not be as big as anticipated.

The Russian consumer is going to need some of her/his famous resilience

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 even the resilient Russian consumer will be under severe strain this year and next and we see retail sales slumping -4.5% this year and then recovering to 1.0% in 2016 and then averaging about 2.5% in later years.

Household spending and retail sales will necessarily weaken this year due to:

1. Rising inflation: rising prices hit 16.7% in February and the outlook is for an inflation spike in the first 4-5 months of the year with inflation touching 13-19% in these months before probably calming down, but the average now looks to be about 12-13% for this year.
2. Western companies raised prices again this February in a range of 6-18% and further rounds could occur in the summer/autumn. During 2014 many companies (not all) felt the need to raise prices by 10-30%.
3. Combined with rising inflation is weaker nominal wages which when tied to higher inflation means low real wages and less money in peoples' pockets.
4. Consumer credit will turn negative this year by at least -5% after 10% expansion in 2014 and a whopping 30% increase in 2013.

Negative real wages - bad news

Spiking inflation is having quite a brutal impact on real wages in Russia: from being among the highest in the world 2-3 years ago, they are now running at -9.9% in February, the worst result in 10 years; and with high inflation until summer this year and an average inflation of about 13% in 2015, then real wages will average about -8.7% this year with figures perhaps as bad as -12% in late spring.

Two things are happening: nominal wages are falling and inflation is spiking. This is the worst combination and it means that over the last two years real wages will have experienced a negative swing of 15-20%, one of the most violent shifts in the world in the last 10 years.

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 13% this year and so real wages come in at minus -8% (13% inflation minus 5% wage increase leaves -8% real wages).

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

To repeat, at the start of this year inflation will tick along at 14-18% and nominal wages will already be at 5-6% so real wages in the first months of 2015 could fall as low as -9% or -12% for some months so the annual average figure should be as bad as -8.7%.

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

The jobs outlook is not too bad?

Unemployment in December was not bad at 5.3% but has since crawled up to -5.8% which is still far from a crisis number: the average unemployment rate in 2014 was 5.3% and this was still close to record low levels. In other words, unemployment is starting from a low base. 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 6.5% in 2015 which is still not bad.

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

22 March 2015

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 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 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 \$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.

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

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

**25 years of our
practice in the CIS**

**GETTING ALL
YOUR EXPERTS
TO THE SAME
PLACE IS GOOD.
GETTING THEM
ALL TO THE RIGHT
PLACE IS BETTER.**

Being in the same place doesn't mean much without mutual understanding. Our global teams work closely with yours, to help you overcome challenges and grasp opportunities.

Find out more at ey.com