Russia Economic Outlook 2015-2019

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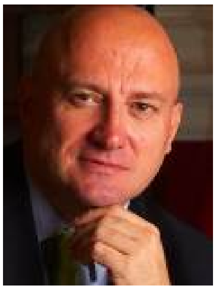

Dr Daniel Thorniley

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

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

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

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

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

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

He holds and has held a number of non-executive and advisory board memberships.

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

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

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

The GDP and economic summary

- The consensus GDP for 2015 has been downgraded in the last three months from -3.5% to -3.9% and we are only marginally more upbeat at -3.8%.
- The second quarter economic results were disappointing and have been followed since the summer by either mediocre or disappointing figures.
- The softening of oil prices generally in the last 3-4 months is a key factor to the downgrade although there has been some recent stabilisation; inflation has also not helped the GDP figure given it remains sticky and we have raised our estimate for average inflation this year to 15%, although we still think that year-end inflation could be as low as 12-13%; weaker global confidence and the slowdown in China all added to concerns; financing remains tight and demand in several sectors is still well below par; other CIS markets have also been contaminated and suffer slower growth and weaker currencies.
- The consensus GDP figure for 2016 has also been downgraded from 0.4% some three months ago to -0.1% currently and some commentators argue for -1.5% but this level would require a weaker than consensus oil price.
- Again presuming an oil price averaging $53-58 in 2016 we are slightly more upbeat again at +0.2% for 2016.
- We should add that this oil price range is exactly that of the consensus which predicts oil at $53 at the end of 2015 and at $58 toward the end of 2016.
- Bank Governor Nabiullina thinks positive annualised growth will only start in mid-2016 and some date in March-May looks most likely.
- Retail sales at -10.4% in September have reverted to close to the worst in 20 years.
- Three factors are preventing a deeper slump: import substitution, defence spending and more links with Asian partners.
- But none of these are a panacea for Russia's challenges.
- But the story remains one of only a slow recovery after this recession and the mid-term economic outlook remains below par with GDP growth reaching +2.0% only in 2017 and then trending at 2.3% to 2.7% from 2017 to 2023.
- US sanctions are unlikely to be removed in the next 2-5 years unless there is a major political shift; there is 25% chance that European ones are diminished in the next 18 months.
- We often explain that 60% of Russia's economy problems stem from the oil price and 40% from western sanctions; but this ignores the underlying economic problems facing the Russian economy. As we note below, industry and investment started to shrink in January 2013, well before Crimea and the oil price collapse.
- 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.
- But industry and investment, while still negative, show the very first signs perhaps of slower decline. At the same time consumer indicators are still stuck close to recent low levels. The explanation for this is that industry and investment have been collapsing for much longer and therefore perhaps will recover a bit earlier.
- That said there are some contradictory trends going on: the PMI indictor jumped up in October to the best figure in one year while at the same time business confidence dipped to its worst in the last 12 months and industrial output drifted sideways/upwards!
- Inflation will average 14.5% this year while trending down to about 12.5% or 13% in December and then averaging about 8.5% in 2016 with a year-end figure of 7.5%.
- New consumer credit was a massive +30% in 2013 but declined to an average of 5-10% in 2014 on a steeply declining trend, and this year we expect consumer credit to be negative at -5% to -15%.
- Trade turnover is down -37% by September 2015 with exports negative by -39% and imports down by -34.3%.
- The good news is that public debt is only about 13% of GDP at the end of 2015 and 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 in the summer.
- The Bank kept its key interest rate stable at 11% at the end of October. The likelihood is that the Bank will cut the rate to 10.5% at its next December meeting providing that inflation is moving slightly downwards and the rouble has re-discovered some moderate stability.

- However, if the US Federal Reserve raises interest rates at its December meeting which currently looks like a 65% chance, the global financial markets and emerging market currencies could come under severe, if temporary, pressure and then the rouble could be stressed and the Russian Bank could postpone its own rate cut.

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 for any current stabilisation to stay in place:

1. The oil price needs to stay in a range of $53 to 63 per barrel over the next 9-15 months and the current consensus is for about $52-58 which would assist the Russian outlook.
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 80-20 probability at the moment.
4. How the markets respond to the eventual increase in US interest rates: these will either rise in December or first quarter 2016 and when they do, there is the risk that the financial markets will over-react and all emerging market currencies and the rouble will experience a short and possibly sharp shock.
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.

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.

The economic numbers suggest that western consumer goods companies should be performing worse than they are doing. 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 is relatively much better than the pure economic numbers would suggest.

- Nominal wage increases in September were only up by +4.5%.
- This kept real wages (after inflation) down by -9.7%.
- Consumer confidence has not recovered much in the third quarter from the second quarter this year. This indicator collapsed to the second worse 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.
- Poor real wages and weak consumer confidence entail real retail sales still struggling at minus -10.4% in September.
- Disposable income also only improved marginally in September (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.
- Finally all this means that private consumption declined to -8.9% in September compared with -7.8% in August.

- We think that many western consumer products are relatively performing remarkably well against this economic background and some/many companies are still able to maintain a moderately decent business thanks in large part to price increases.
- However, 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%.
- Retail sales at -10.4% in September are again back to nearly the worst in 20 years.
- 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 9 months of this year at 133,000: so minus -30% on a weak 2014.

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 33 months and looks like reporting 3 years negative growth.

At the start of November there is a small sense that the start of slow recovery for industry and investment is 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 -7 in September and -8 in October after averaging -5 to -6 all year) and industrial output drifts sideways/upwards!

- Industry and investment are 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 this year 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%.
- There has been a mild recovery in recent months in industrial output but we must remember this is coming off the May figure at -5.5% which was the worst in 20 years; the latest September figure is "only" -3.7% and hence why we may expect a small positive figure next year.
- 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.
- The poor investment figures and low levels of industrial output mean that trade turnover is down by -37% to September this year.
- On the very positive side the Purchasing Managers' Index jumped to 50.2 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.
- 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; 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 -11% to September 2015.
- Despite these difficult numbers above, business confidence stayed strikingly resilient though most of 2015 at -5 or -6 after hitting lows of -10 at the turn of 2014/15. But the number has recently started to dip to -7 in September and -8 in October.

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 form 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.

Economic numbers from this sector of the economy seem to be just at the start of some improvement but some numbers are ambivalent and it is too early to talk of a sustained recovery. But there seem to be first signs. Nonetheless, the recovery, when it does kick in, will be mild and moderate as we noted above: 2016 will still be flat or negative and the real recovery only sets in during 2017.

The rouble, the oil price and inflation

The consensus for the rouble versus the euro in 2016 among western executives is:

- 51% of executives forecast 70-75
- While 23% predict something weaker
- And 18% see the rate stronger than 70

For the dollar:

- Some 64% forecast a range of 65-70
- 20% of respondents predict something a bit weaker
- And 15% see the arte stronger

The consensus for the rouble among economists (!) is also 65 to the dollar and 71.5 to the Euro.
This consensus also predicts that the rouble will be stronger in 2017 at 61.5 to the dollar!

Generally this is fairly good news because it seems hardly anyone is predicting a rouble crash next year and at these FX rates western business can continue to survive and even meet many of the moderately optimistic budget targets for 2016-17.

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

Almost bizarrely until late summer this year the Russian Central Bank was working to push the rouble down after it reached spring highs of 50 to the US dollar. This summer the Bank did announce that it wants to raise its FX reserves back up again to $500bn by 2018 which would entail further sell-offs of the rouble: Central Bank FX reserves started 2014 at $500bn and fell to $385bn by the start of 2015. In the 4 months to July, FX reserves were fairly stable at about $360bn but since then, following Bank policy, they have strengthened to $375bn.

We share the Bank's view that the remaining Russian corporate debt repayments due this year are manageable at a time when domestic banks have a FX buffer of at least $43bn. But there will be a spate of debt repayments due from September to December so these could be moments when the rouble wobbles a bit more.

The medium-term oil outlook

These FX ranges would stem from the oil price range we talk of at about $53 to $58 per barrel.

While the price is in the $50s it will support the Russian economy, it seems hard to find a scenario for sustained higher oil prices:

- Global demand is not going to surge.
- China's growth outlook and demand for commodities will not surge in the coming years.
- US shale gas will never go away and shale producers will adapt to new lower price levels and show themselves more productive.

- There is a clear likelihood that Iranian energy supplies will start to enter the market in the coming 6-15 months and thus ensure high supply to weaker demand.
- And Saudi Arabia seems determined to continue with it low oil price in its search for higher market share. This goal is proving harder to fulfil than the Saudi authorities assumed. But it does look like they are intent to carry on with this policy even if it means lower GDP growth, a much higher budget deficit and higher debt levels.

Economic scenarios for 2016 at different oil prices

Average oil price 2016	GDP	Inflation	Rouble/US$	Rouble/€
			Average	
$80-85	2.30%	5.80%	42-48	46-55
$70-80	1.90%	6.00%	48-52	55-59
$60-70	1.80%	6.60%	53-58	59-64
$55-60	1.40%	7.50%	58-65	64-69
$50-55	0.20%	9.00%	64-70	69-75
$45-50	-1.50%	13.00%	72-75	75-82

Central Scenario - 2016 economic outlook

GDP	0.2%
Inflation (year-end)	7.7%
Inflation (average)	9.5%
Consumer spending	0.0%
Investment	-1.2%
Industrial output	0.5%
Rouble to US dollar average	63-67
Rouble to the Euro average	69-74

The inflation outlook

With the rouble volatility prevailing this year, inflation has proven more sticky 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 is only down to 15.7% by September. Core inflation (excluding food and energy costs) is also still elevated and was stuck at a high 14.7% in August for example.

We expect inflation in December 2015 to be around 12-13% and thus to average about 14.5% in the whole of 2015; average inflation next year will be about 9% on a declining trend and by December 2016 inflation ought to be 7.7%.

We base our assumption of weaker inflation in 2016 on:

1. The presumption of a more stable rouble rate.
2. A more stable oil price.
3. 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.
4. And of course maintained overall weaker demand and sluggish household spending will keep prices down.
5. There will be little wage push on demand next year 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.

Interest rates

- Presuming continued decline in inflation and some stabilisation of the rouble against the back-drop of weak GDP, we assume that the Central Bank will continue with interest rate cuts: the key central rate was jacked up to 17% last December and since then the Bank has chosen whenever possible to help growth rather than worry about inflation and the central rate in early November is down to 11.0% which 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 conversation about new projects.
- We think that with inflation sticky but coming down to 12-13% in December and with the rouble possibly experiencing continued relative stability then interest rates will be brought down to 10.5% at the bank's December meeting. Unless global market volatility interferes.
- With inflation scheduled to average about 9% next year, the central interest rate could fall to about 8.0.

Budget summary

The 2016 draft budget suggests that the Russian government will allow a deficit of about -2.6% or higher after recording -3.4% in 2015 and -0.5% in 2014.

The budget deficit in 2015 and 2016 will be financed and restrained by a combination of tax increases, continued spending cuts and by dipping into the current FX reserves of $375bn.

And how will the country pay for the rising deficit?

The budget deficit will widen this year to -3.4% from -0.5% last year. The government will finance the deficit in at least three ways:

1. Continuing to make federal budget cuts and in local municipal budgets. In 2015 overall government spending was to be reduced by -10% and with some compensatory increases in social spending and defence spending, we think the overall reduction will be about -7% which explains why selling to the government and local authorities is so challenging.
2. We also think that some taxes will be raised selectively and we have seen this happen to the major energy players.
3. And finally the government can always resort to dipping in to its welfare and stabilisation funds which amount $170bn.

Economic statistical tables

Consumer-related statistics: by year and monthly

	2012	2013	2014				2015								
	year	year	Q1	Q2	Q3	Q4	Jan	Feb	Mar	Apr	May	June	July	Aug	Sep
Disposable income	3.7	3.3	-2.4	1.6	2.1	-3.3	-0.8	-1.6	-1.8	-4	-6.4	3.5	-2	-4.9	-4.3
Real wages	8.2	5.2	4.3	3.4	0.6	-1.3	-8	-7.4	-11	-13	-7.3	-7.2	-9.2	-9.8	-9.7
Real retail sales	5.7	3.9	3.5	1.9	1.4	2.9	-4.4	-7.2	-8.7	-9.6	-9.2	-9.4	-9.1	-9.1	-10
Unemployment	5.3	5.5	5.6	5.0	4.9	5.2	5.5	5.8	5.9	5.8	5.6	5.4	5.3	5.3	5.2
Industrial output	2.6	0.3	1.1	1.9	1.4	2.1	0.9	-1.6	-0.6	-4.5	-5.5	-4.8	-4.3	-4.3	-3.7
Fixed investment	6	-0.1	-4.9	-1.6	-2.5	-3.4	-6.3	-6.5	-5.3	-4.8	-7.6	-7.1	-6.8	-6.8	-5.6
Consumer prices	6.6	6.5	6.4	7.6	7.7	9.6	15	16.7	16.9	16.4	15.8	15.3	15.8	15.8	15.7
Budget deficit (running)	0	-0.5	0.7	-0.2	-0.2	-0.6	-1.6	-1.8	-1.8	-2.1	-2.5	-2.3	-2.9	-3.1	n/a

Macro-economic data 2009-2019

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
GDP	-7.9	4.3	4.3	3.4	1.3	0.6	-3.8	0.2	1.7	2.0	2.7
Retail sales	-5.5	6.3	7.2	5.7	3.9	2.5	-8.8	1	2.4	2.8	2.9
Household spending	-7.6	5.5	6.8	7.9	4.7	1.8	-6.3	1.0	2.1	2.8	3.0
Real wages	-2.8	4.4	4.9	8.2	5.2	1.9	-8.9	0.0	2.8	3.0	3.3
Disposable income	1.0	3.7	2.8	3.7	3.3	2.1	-3.3	1.0	2.4	2.9	3.1
Inflation (year-end)	8.8	8.7	6.1	6.6	6.5	11.4	13.0	7.7	6.6	6.3	5.9
Unemployment rate	7.9	7.6	6.5	5.3	5.5	5.3	5.7	5.7	5.7	5.5	5.4
Gross fixed investment	-17.9	5.6	9.8	6.0	-0.3	-4.8	-8.8	-1.2	3.2	4.2	3.9
Industrial output	-10.8	8.3	4.7	2.6	0.3	1.1	-3.3	0.5	2.4	3.0	3.1
FX reserves ($bn) year-end	447	485	510	528	509	385	365	360	370	375	380
Rouble/$ (year-end)	30.3	30.4	32.1	30.4	32.9	58.0	64.8	68.0	71.0	75.0	78.0
Rouble/Euro (year-end)	43.4	40.0	41.5	40.1	45.1	72.0	71.8	72.5	75.2	78.7	84.8
Budget balance (% of GDP)	-6.3	-3.5	-0.2	0.0	-0.5	-0.5	-3.2	-1.9	-1.0	-0.5	-0.2
Current-account balance (% of GDP)	3.8	4.9	4.9	3.6	1.6	2.7	3.1	2.8	2.5	2.2	1.0

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.

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Reliability Across Borders

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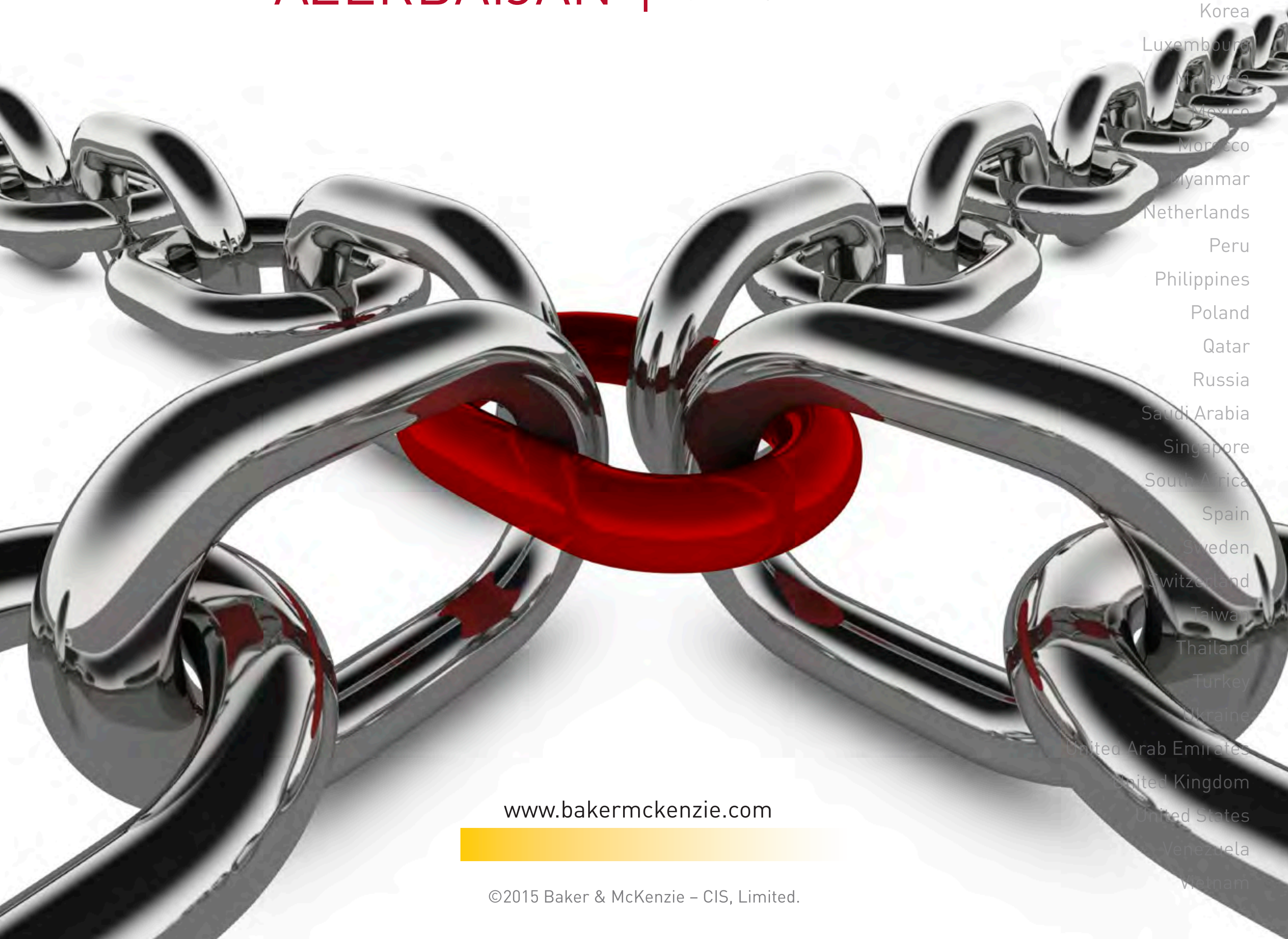

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