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The Latest Sanctions on Russia

What is their impact on business and the economy?

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Curriculum Vitae of Dr Daniel Thorniley

Danny Thorniley is President of DT-Global Business Consulting GmbH (a LLC company), Danny's own consultancy company based in Vienna through which he works with some 330 key clients on business strategy in global and emerging markets in the CEEMEA region and Russia. The services he provides include written position papers, presentation slides and private client meetings as well as in-house presentations. He is also invited to make some 60 speeches/presentations by clients across the world on global business trends, business operations, emerging markets, corporate best practice.

Sir John Major, the former British Prime Minister has called Danny "The world's leading business expert on emerging markets"

For 23 years Danny was Senior VP at The Economist Group, Vienna on global corporate business trends.

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. 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.

He has worked on a personal basis with 330 companies operating in emerging markets for 27 years and has personal contacts with most senior western MNCs operating in the CEEMEA region and beyond. He makes frequent presentations at CEO and Board level (over 100). He has personal friendships with leading executives in Coca Cola, Procter & Gamble, Ernst & Young, Raiffeisen, Robert Bosch and many, many others.

He holds and has held a number of non-executive and advisory board memberships with major European and US corporations including the Global Advisory Board of the US company Aecom.

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.

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Sanctions Outlook

Food for thought

- US sanctions on Russia hurt Russia
- US sanctions on Iran help Russia by jacking up the global oil price
- US sanctions on Turkey hurt Russia (and other emerging markets) with downward contagion from the lira

The new wave of US sanctions

Western and Russian companies operating in Russia were getting accustomed to the impact from April sanctions when new ones were announced by the US for this month August.

We sent a full review of these sanctions just last week and the key facts are:

The sanctions are based on the Chemical and Biological Weapons Control and warfare Elimination Act of 1991 (The Act). They revolve around the use of nerve agent Novichok against Sergei Skripal and his daughter Julia in the UK earlier in 2018.

The first set of August sanctions may prove limited in impact given the existing US export bans as they mostly focus on goods and technology with a sensitive security status.

Further sanctions will be applied in November if the Russian government does not meet certain stipulations. These November sanctions (IF applied without waivers) could include broad import-export bans, prohibitions on US bank loans to the Russian government and suspension of flights by Russian national carriers. These could cause much more damage to business. But the Act includes “contract sanctity provisions” which would limit harm to existing contracts which could include long-term ones.

> **The KEY point is that the initial sanctions and any later ones in November are eligible for US Presidential waivers. The degree of waivers will determine just how damaging or not these new 2018 sanctions will prove.**

The wording of the State Dept announcement hints that some waivers may be applied. Partial waivers have been applied to sanctions on Syria in 2013 for example.

Russia is required by November to ensure that 1) it is no longer using chemical weapons in violation of international law, 2) it will not engage in future activities and 3) will provide on-site inspections.

Most commentators believe the Russian government can provide assurances but will not accept inspections.

Therefore, future sanctions in November could include 3 or more of the following:

1) Extensive export ban
2) Extensive import ban
3) Air transportation ban
4) Bank loan prohibition to the Russian government

5) Curtailment of development bank assistance

6) Diminishing diplomatic relations

If points 1 and 2 were imposed without waivers, that would be extremely serious. But the Russian economy and business could live with most of the other items. Russia could also resort to other financial routes for loans as it also already done so with Chinese financing.

We do not belittle the impact of sanctions but based on the way the April sanctions worked out, we suspect that any future sanctions will not be unlimited and prove manageable but not comfortable for the Russian economy and business in Russia.

It seems unlikely that the US would effectively ban trade with Russia while engaging in severe sanctions with Iran, engaging in an escalating trade war with China and threatening tariffs on European manufacturers.

Sanctions and the Russian economy and rouble

Current levels of sanctions and future ones in November should not have any major appreciable impact on the already sluggish GDP figures (about 1.8% for 2018 and 2019), while the fall in the rouble should add about 0.2% to weak but rising inflation figures. The volatility and uncertainty created means that the Central Bank will probably limit further interest rate cuts to 0.25% during the next 3-6 months.

- We presume that the nuclear option of sanctions which curtail trade entirely does not transpire.
- Some US companies could be potentially severely damaged in their trade with Russia even with the middle case or best-case scenario.
- But in the current main sanctions scenario, most FMCG, consumer product companies and B2B companies will face little deterioration in their direct, operational business.
- The outlook also depends on whether further counter measures are adopted by the Russian side.
- But this round of sanctions and any in November have already damaged the mood.
- Also, by setting a November deadline, further extreme insecurity and instability have been built into the measures: all companies are affected by this.
- The rouble is down on the dollar by -5% compared with its summer 2018 average and down -13% on its 2016-17 average.
- Versus the Euro the rouble is down -4% on its summer average and -10% on its 2016-17 average.
- We think that if November sanctions include waivers, then the rouble fall can be contained close to these levels with some downside risk of a further fall of 2-4%.
- Bear in mind that the dollar is rising against all currencies at the moment and will probably stay strong for most of the next 18 months as US interest rates rise faster than other markets like the Eurozone and Japan.
- The rouble and other emerging market currencies are also hurt by contagion from a crashing Turkish lira.
- If wide ranging sanctions are imposed on Russian sovereign debt (which is still not certain), then the rouble would fall by a further 5-10% from its current levels of 67 to the dollar and 77 to the Euro.

Reasons that will support the rouble in the coming weeks and in 2018-19

in USD billion	2015	2016	2017	2018	2019
Value of exports	340	282	353	415	430
Trade surplus	150	90	112	150	155
Current account surplus	70	25	35	63	58

We don't overplay or over-rate these factors below. Politics and sanctions are driving the exchange rate for now.

1. The oil price is a big support and keeps the rouble up by an extra 10-15%.
2. **The Russian Central Bank will tend to hold the rouble back from over-appreciation but it will monitor the FX rate and step in if required to avoid any collapse. It did just this in August.**
3. The rouble still offers a high yield and this will support the currency when things calm down: the central interest rate is 7.25% in mid-August but with average inflation at about 3.0% in 2018, this means that the yield will fluctuate at 3-4% which is one of the highest in the world.
4. <u>Capital flight amounted to about $25bn in 2017 compared with a trade balance of about $100bn and a current account surplus over $35bn. Capital flight could now rise in 2018 to $30-35bn while the trade balance and current account match the high numbers of 2017. Capital flight was $60bn in 2015 for comparison.</u>
5. Some two-thirds of Russians are still willing to keep their deposits in roubles rather than FX. A shift of -10% will not change this much. But another -10% to -15% fall could impact this positive trend.
6. Total external debt has fallen by -35% in the last 18 months and total debt exposure of $500bn is very manageable because total debt repayments in 2017 were actually only about $60bn.
7. Russia also benefits from the low levels of debt to exports and public debt (15-17%) compared with EU levels of 80% to 110%.
8. As the authorities buy FX, the FX reserves continue to rise from $390bn in January 2017 to $458bn in August 2018.
9. And finally, Russia benefits from a current account surplus which distinguishes it from most other emerging markets especially for example Turkey: the Russia surplus was a large 5.0% in 2015, still a solid 2.0% in 2016 and 2.8% in 2017.

Key summary: sanctions hurt, oil helps, the Central Bank is adapting

- The World Cup (and that feel good mood) suddenly seems to be far away…at least in economic terms, although it did boost TV and Smart phone sales by 20% in May and June!
- The August imposition of new US sanctions with more probably to follow in November has dampened the mood significantly.
- BUT it remains to be seen what the impact will be on business and economic results: it may still actually turn out to be mild.
- At year-end, on a best-case scenario the rouble will be down by an extra -6% to -9%, inflation could be up by an additional 0.2%, interest rates will be at 7.0% rather than 6.75%.
- A handful of US companies may be severely damaged and disrupted but if consume sectors are left alone, then many retail, FMCG and general B2B companies will be left mostly untouched from where they stood in June.

- But on the down side, once again the framing of these sanctions heightens the degree of uncertainty (we now wait until November): what new sanctions will follow in November and will waivers apply?
- IF some or many waivers apply, then the impact will be certainly mild. But if restrictions are imposed without waivers, then the impact will be moderately or more serious.
- But the investment mood has already been damaged and could deteriorate further and the way companies look at Russian from international headquarters is more strained and doubtful.
- We anticipate the average oil price for Brent at $73-75 per barrel for the next 18 months and this is the consensus view. And in mid-August the price is $73.
- There is a growing possibility that with enhanced US sanction on Iran, the oil price could spike further for the remainder of 2018 and there is now more chance that the oil price could top $80.
- With the oil price over $60 per barrel, the Russian economy survives fine and the macroeconomic factors assist business and the rouble holds up; with oil over $65, the support for the rouble is stronger.
- But the strong consensus for annual Russian GDP growth from 2018-2025 is in a range of 1.9% to 2.3% even with oil over $65. This means the Russian economy is performing sub-par: the reasons include weak rule of law, capital flight in the past and lack of confidence in investing in Russia by the private sector; corruption, and the lack of SMEs which stems from these prior reasons.
- Sanctions knock off about -12% to -14% from the value of the rouble but the higher oil price adds about +10% to +15%.
- Government currency policy and the transfer of "excess" energy earnings to reserve funds tends to drag the currency. As we expected the Central Bank modified this policy in August and started to sell fewer roubles and on 10 August the Bank bought only 8.4bn roubles of FX which is about 50% of its recent daily rate.
- The oil price "ought NOT to be" above $65 because the US shale producers should be flooding the market at that price level. But the oil price is above $70 per barrel because the Mid-East risk factor is out-weighing the influence of US shale producers.
- The consequences of sanctions, Mid-East risk on the oil price and government policy have broken the traditional link between a certain oil price and a certain rouble FX rate. The two do not march any more in tandem.

The point remains that the Russian external and internal economic outlook is for a mild-moderate stabilisation at sub-par growth. But at a level which provides some support for business.

Companies will face more operational challenges (brands, pricing, distribution, regulations, retail changes, e-commerce) than macro-economic ones.

- Government summer proposals included a rise in VAT from 18% to 20% next year and a rise in the pension age for men and women spread over the next decade. Resistance to the pension reform is sharp and Putin could step in as a "good tsar" and dilute the proposed pension changes.
- The same could apply to the recent announcement of "surcharge taxes" on metals, mining and chemical companies. The initial proposal argues for some $7.5bn worth of extra taxes. Again, we imagine that this will be diluted.

But it is clear that the government is hunting around for finances to support more social spending announced by the President after his election.

There is some irony here in that in order to support social spending and garner popular support, the government has initiated pension cuts which alienates social support and undermines consumer confidence.

- GDP for 2017 finished on a disappointing trend with industry and investment struggling in the fourth quarter and also due to tight government spending. The final figure for the year was 1.5% compared with the consensus of 1.7%.
- Because of very tight fiscal policy and high interest rates, Russia will report one of the lowest rates of GDP growth among the emerging markets in the next 2-3 years.
- Inflation is at 2.3% in June is still close to a 27-year low. We expect a mild rise in the rest of 2018 to average 3.0% this year. Prices will rise a bit more in 2019 due to the VAT hike to average 4.2%+.
- The Central Bank kept rates at 7.25% at its July meeting. Given external volatility, we now expect only one further cut this year in the final quarter to 7.0%. Interest rates are falling but in real terms they are still very appealing and this attracts foreign portfolio investment.
- Industrial output rose by a mere 1.3% last year and we expect just 1.7% in 2018.
- But conversely investment is performing a bit better about 3.5% at the start of 2018 thanks to expansion from Gazprom, Rosneft, banks, World Cup, Moscow city, bridge to Crimea. This has helped B2B sales and such companies report that “The big Russian players are buying more now”.
- ***BUT the stop-go nature of the Russian economy is reflected in the ups and downs in industry and investment figures and this was exemplified in May when the manufacturing PMI dipped below 50 to 49.8, the worst figure since July 2016 and deteriorated to 48.1 in July.***
- The main driver of GDP growth in 2017 and 2018 will be consumer spending rather than industry and investment.
- Nominal wages, the minimum wage and real wages shot up at the start of 2018 and this must eventually have a positive impact on consumer spending.
- Real wages after inflation were rising by more than +10% in the first months of 2018, probably the highest level in the world. There is of course quite some catch-up going on here from 2014-15 period but the trend is good. Real wages will grow this year by about +5%, an excellent number.
- BUT we have argued in several recent reports why consumer product companies are often struggling because of operational factors (promotions and discounts, changing spending patterns).
- Lengthening the start of the pension age and raising VAT will push inflation up a little in 2019 and may hurt consumer confidence.
- Consumer credit expansion was up by 14% in January and averaging above +10% in the first half year but most of this is spent on mortgages and cars and in fact inhibits spending on other consumer product items (a lot on mortgages though).
- New loans to Russian companies are rising at in mid-single digit percentage terms.
- As a result, household spending is up by more than 3% in 2017 and 2018 while retail sales were averaging under 3.0% growth in the first months of 2018. Ok but not great.
- We are still unsure about government spending intentions. The aim is to balance the budget which requires spending cuts. But presidential comments suggest that there will be some increase in social and health spending in the next 2-3 years.

The economic numbers

Category	Indicator	2012	2013	2014	2015	2016	2017	2018F	2019F	2020F	2021F	2022F
Country	GDP	3.4	1.3	0.6	-2.8	-0.2	1.5	1.8	1.9	2.1	2.1	2.1
	Inflation (year-end)	6.6	6.5	11.4	12.9	5.4	2.5	3.6	4.6	4.3	4.4	4.5
	Budget balance (% of GDP)	0.0	-0.5	-0.5	-3.5	-3.7	-1.5	-0.2	-0.2	-0.5	-1.9	-1.8
	Current-account (% of GDP)	3.6	1.6	2.7	5.0	2.0	2.8	2.8	2.6	1.9	2.0	1.5
FX	FX reserves (USD Bil.)	528	509	385	370	377	431	470	485	510	540	565
	Rouble/USD (year-end)	30.4	32.9	58.0	73.0	61.1	57.8	65.0	64.0	66.5	67.5	68.0
	Rouble/EUR (year-end)	40.1	45.1	72.0	78.0	64.0	67.0	74.0	74.5	75.0	76.8	76.0
Industry/ Consumer	Retail sales	5.7	3.9	2.5	-9.8	-3.5	1.5	2.7	3.0	3.0	2.8	2.9
	Household spending	7.9	4.7	1.8	-8.5	-2.6	3.3	3.3	2.9	3.0	2.8	3.2
	Real wages	8.2	5.2	1.9	-9.5	1.5	3.4	5.8	3.0	3.0	2.9	3.0
	Disposable income	3.7	3.3	2.1	-4.0	-5.2	-1.0	2.2	2.4	2.5	2.4	2.4
	Unemployment rate	5.3	5.5	5.3	5.4	5.8	5.2	4.9	5.1	5.2	5.1	5.1
	Gross fixed investment	6.0	-0.3	-4.8	-7.6	-2.7	4.4	3.4	3.3	3.3	3.2	3.1
	Industrial output	2.6	0.3	1.7	-3.4	1.1	1.3	1.7	1.9	2.6	3.0	2.9

Please note: real annual change in % unless otherwise stated

Key statistics by Year and Monthly

		2017												2018					
Category	Indicator	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Country	Inflation (end of period)	5.0	4.6	4.3	4.1	4.1	4.4	3.9	3.3	3.0	2.7	2.5	2.5	2.2	2.2	2.4	2.4	2.4	2.3
	Budget balance (% of GDP)	-3.9	-3.5	-3.1	-2.8	-2.4	-2.3	-2.2	-2.0	-1.9	-1.2	-1.3	-1.4	-1.3	-1.1	-0.9	-1.3	0.3	0.1
Industry/ Consumer	Retail sales	-2.3	-2.6	-0.4	0.0	0.7	1.2	1.0	1.9	3.1	3.0	2.7	3.1	2.8	1.8	2.0	2.4	2.4	3.0
	Real wages	3.1	1.0	1.5	2.5	2.8	3.9	4.6	3.7	2.6	4.3	5.4	4.6	11.3	9.7	8.7	7.8	7.1	7.2
	Disposable income	8.1	-4.1	-2.5	-7.6	-0.1	0.0	-0.9	-0.3	-0.3	-1.3	-0.3	1.8	0.0	4.4	4.1	5.7	0.3	0.2
	Unemployment	5.6	5.6	5.4	5.3	5.2	5.1	5.1	4.9	5.0	5.1	5.1	5.1	5.2	5.0	5.0	4.9	4.7	4.7
	Gross fixed investment	-0.9	-0.9	-0.9	2.3	2.3	2.3	4.8	4.8	4.8	4.2	3.5	3.5	3.5	3.5	3.5	2.2	3.7	3.7
	Industrial output	2.3	-2.7	0.8	2.3	5.6	3.5	1.1	1.5	0.9	0.0	-3.6	-1.5	2.9	1.5	1.0	1.3	3.7	2.2

Please note: real annual change in % unless otherwise stated

Inflation and interest rates in 2018-19:

Inflation has fallen faster than most expected and has been below the Central Bank's target of 4.0% since July 2017. After averaging 15.5% in 2015 and 7.0% in 2016, prices grew on average 3.7% in 2017 and prices fell further to 2.3% in June this year.

The June inflation figure was the lowest in 27 years.

The stronger rouble (until April and then August) has helped and the good harvest last year pushed food prices down.

- Inflation was at a 27-year low of 2.3% in June. As we anticipated this started to rise in July by 2.5%. We expect inflation to finish the year December 2018 at 3.6% and average inflation will trend at about 3.0% given the slow start to the year.
- If the harvest proves to be good, then these numbers would be a little high.
- Consumer prices seem not to have been hurt too much by the temporary rouble devaluation in April.

- The planned rise in VAT from 18% to 20% in January 2019 will tick-up inflation next year (2019) to average 4.2% and with a year-end 2019 figure of 4.6%.
- Any further rouble depreciation would add a little more upward risk.
- Interest rates are falling, but in real terms they are still very appealing (+3-4%) and thus provide some base support for the rouble.

Inflation Outlook	**2017**	**2018**	**2019**
Average annual inflation	3.7	3.0	4.2
Year-end inflation	2.5	3.6	4.6

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

11 August 2018.

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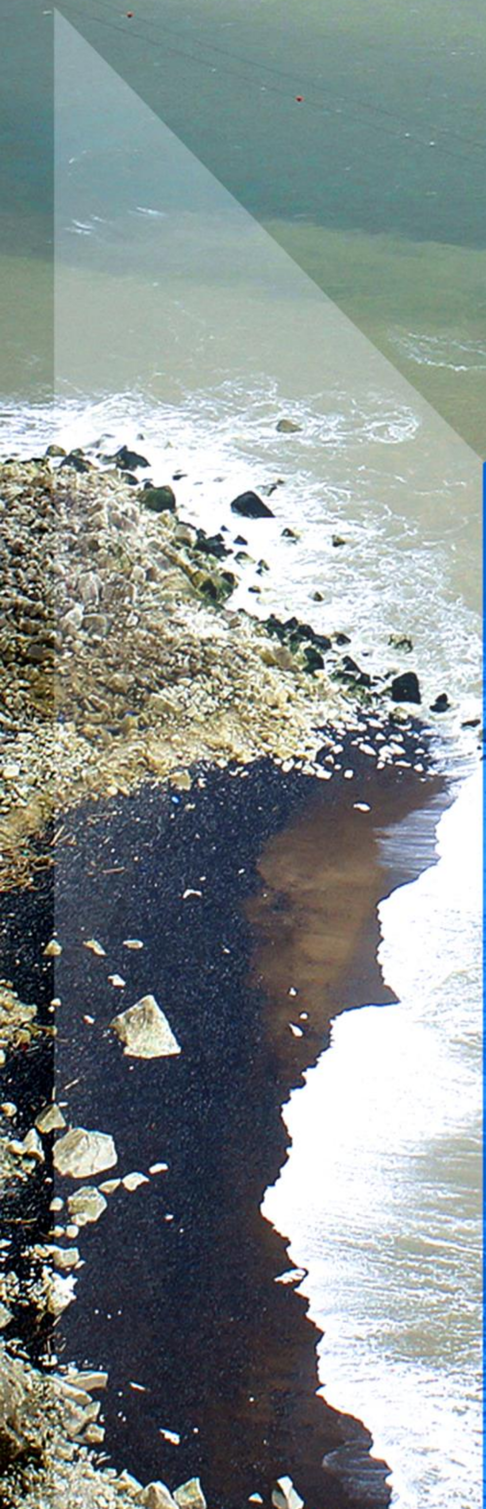

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