CEEMEA
Business Group

Russia Business and Economic Update

A Sort of Recovery?

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Content

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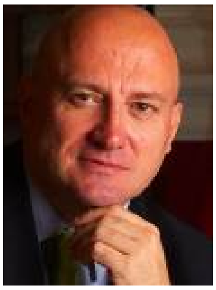

Dr Daniel Thorniley

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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.

Executive summary

- The rouble is the best performing currency in the world in 2015 (see below) after being the worst in 2014 except for the hryvnia.
- We predicted extreme volatility for the market and we have certainly experienced that so far in the last 6 months. Companies state semi-jokingly that they have no mid-term plans for their business as such planning appears impossible/irrelevant!
- The business mood had already stabilised in February at a lower level; today the mood is improving and in some cases substantially.
- But all depends on two imponderables: the global oil price and the (perceived) situation in eastern Ukraine and thus risks remain.
- The consensus for the oil price in 2015 is $60-62 per barrel.
- Most companies are tentatively upgrading their sales and profit forecasts BUT everyone understands that such a currency appreciation must prove a little more sustainable before 2015 forecasts are fully revised
- But risk for now is on the upside/positive side.
- Some companies now believe there is a scenario where they may be able to benefit from at least an element of windfall profits.
- Much depends of course on which FX rate was used in budgets for 2015 set (such along time ago) in September-October 2014. The current rouble improvement is probably getting close or better than what were at that time (autumn 2015) pessimistic levels of 50-55 to the dollar. In any case the FX rate is getting close to many budget levels or the FX deterioration is now bearable.
- As we noted in the past in our medium/best case scenario, more companies are contemplating good high-single digit rouble sales which could entail the same or better in FX.
- But there is a possible mini-backlash against recent price increases: those who raised prices in February could now turn out to be lucky but Russian partners and retailers are asking for rebates or future discounts.
- The competitive environment is changing: more newcomers and mid-sized outfits are taking on Russian risk; Russian champions are reviving thanks to import substitution and as some western firms downsize priorities or certain sectors; we find more western private and family-owned companies willing to take on the Russian market.
- Some companies note that non-tariff barriers are being imposed on some Ukrainian end- products while a few more companies refer to restrictions of transfers of goods from Russia into Ukraine either due to Ukrainian wishes or western companies own self-restrictions.
- The economic numbers could improve marginally if the rouble appreciation stabilises, but the first quarter results were generally bad or worst and this will filter through the next 2-4 months no matter how good the current stabilization.
- 2015 will be a recessionary year and a tough one for business BUT it could prove marginally or even moderately better than anticipated just 4-6 weeks ago.
- First quarter 2015 GDP growth is now estimated at -2.5% year-on-year which is the first negative(year-on-year) quarterly figure since the fourth quarter of 2009: so the worst quarterly growth figure in 6 years.
- Real wages are slumbering at close to -10%, the worst number since 1998.
- Consumer confidence at -32 is the third worst figure reported in 20 years.
- Inflation is the highest in 16 years.
- It will need some time to recover from these lows but it is difficult to gauge the timing of when the Russian consumer could start to recover on the back of a stronger rouble and declining inflation.
- Soft nominal wages will still mean that consumers are strained even when inflation comes down to "just" 10%.
- The Central Bank will reduce the key interest rate from 14% to perhaps 10.5% by year-end on current trends and new bank credits to the economy will be close to zero or negative.
- A stronger rouble is going to help and we can foresee the currency at 53-57 to the dollar for the remainder of this year and at about 59-60 to the Euro. This is our central/best case.
- Inflation has followed the path we predicted and is at 16.9% in March but this could prove close to the top for this year; we now see inflation possibly ending this year at close to 10-11% and averaging 2015 at 12-13% which is a fraction better than earlier estimates.
- Net capital flight was down to "just" $32.6bn in the first quarter of 2015 compared with $72.9bn in the final quarter of 2014; we expect full-year capital flight of about $110bn this year compared with $151bn last year and $60bn in 2013.

- Despite the possible current upsides, we do not see a sustained bounce-back as after 1998 and 2009 because underlying fundamentals are strained and while the oil price is stabilising, we doubt it will surge in price in the next 3-5-7 years.
- The Russian economy can eventually grow in 2017 by 2.8% to 3.2% range on a medium/best case but any better or quicker surge is very unlikely.

Our earlier estimates for GDP growth and inflation were already moderate and balanced and for now we do not think they need much revision. But we are revising upwards our rouble FX estimate and tweaking down the inflation outlook and trimming some intermediary indicators. We do note that more risk is now on the upside/positive side which was not the case 1-2 months ago.

> If the rouble does stabilise at around 53-57 to the dollar this year, then inflation will improve marginally faster than we had anticipated and this in turn will help buttress consumer confidence and spending patterns. This looks like being combined with lower interest rates emanating from the Central Bank and these could be cut from 14% later in April or latest in May. This could help new credit emissions. But the point remains that the year has started quite badly and a recession, perhaps a milder one, is still unavoidable. So things feel a bit better: but all the problems of 2015 and 2016 are far from solved.

Three types of western companies in Russia today?

1. Wait and see with a good element of cost cutting
2. Slowing down, downsizing and pulling out parts of the business; quite sharp cutbacks
3. Investing, growing and expanding

Regarding the third category, a number of retail and FMCG firms are doubling down and building warehouses, distribution and logistics centres in Moscow, the Urals and Siberia in order to fix-in current market share leadership and/or to capture more market share in the future. One European retailer signed off on one of the biggest distribution centre deals in the world at the turn of December-January (!) and other Russian retailers still plan very sizeable store expansion this year of 50-200 new outlets. Another western clothes retailer is in the process of setting up a major e-commerce centre based on current great volumes. But the company cannot do a proper quality job of shipping from the UK and needs a large Russia-based facility.

It is certainly retail and consumer related sectors which are also prospering relatively on the HR side. The MD of one executive search company noted last week in Vienna:

> Our business froze in November to early February but we have seen a rally begin from then and business is much more normalised now and for our business it is the expanding retail sector and consumer product companies especially Russian ones who are seeking more staff to manage their significant expansions planned and being implemented in 2015.

Also among the “grow and expand” companies we find many private and family-owned companies willing to take on the Russian risk and this is changing the competitive environment with more smaller, mid-size newcomers engaging in the market as well as Russian local champions doing well from import substitution.

What are executives saying and thinking?

We predicted in several reports that one scenario would be stabilisation of the oil price and events in eastern Ukraine which would lead to a substantial rise in the rouble with concomitant improvements in inflation and consumer spending: and here we are, for now.

There was already in early-mid February a sense of stabilisation that the very worst of December was over but the level of stabilisation was expected to be sustained at tough and challenging business levels with all of 2015 spent handling a recessionary business environment. In recent weeks with the apparent quiescence on the eastern Ukrainian front, with some stabilisation of oil prices at $57-59 dollars per barrel and the resultant strong rouble, the mood in business in Russia is improving with many executives rightly thinking that we could be at the very start of a stronger stabilisation with the onset of the recovery having been advanced rather than postponed.

Many executives are giving up on certain types of business plans:

As one MD of a European paper company commented last week in Vienna:

> We have long-term plans for 2/3 to 5 years and we run the business operationally by 3-6 week periods. But we don't bother or treat seriously mid-term plans: recent events have made all 6-18 month forecast look ridiculous. For now we will actually work on this premise.

A well-experienced MD of a service company with $1bn investments in Russia concurred this week in London:

> I can see what our colleague is thinking. We run the business a bit more conservatively on a quarter basis which is traditional but we too are giving up on mid-term forecasts of 1-2 years. We have a plan for 3-5-10 years and by the way, that is moderately upbeat. But yes, mid-term plans are crazy!

It is a truism that executives and companies have to remain ultra-flexible and adaptable. Some 18 months ago, the MD of a major FMCG company operating in Ukraine said that, "We always use the F-word in our office: Flexibility. We have to always be flexible in the Ukraine market". That comment was very true then for Ukraine and is equally true now both for Ukraine and Russia.

> And that need for an awareness of flexibility has to be communicated to regional and global headquarters.

The regional MD of a mid-sized European food company noted last week in Vienna that:

> We are seeing an initial recovery and are now running at flat in Euros which is an achievement in my mind. But if things continue like this with the FX rate, then I can see us growing in good single digits in Euros.

This executive states that he is getting better sales from those directed to his own customers who are onward-selling affordable products. This trend fits in with our comments in earlier reports that premium and high-brand will come under more pressure this year while discount and affordable innovation ought to and is doing well.

In a related sector, the Moscow MD of one European mid-sized ingredients company thinks that:

> We are seeing stabilisation and improvement. My mid-case scenario is that sales will increase in 2015 by 15% in Euros and that's due to some volume increases of affordable end products and also FX moving in our benefit.

Companies are also sceptical about likely government/regulatory reforms. A senior executive at a US service company noted last week by phone that:

> We see very few or non-existent positive changes in government policy and regulations. I doubt that anything good will be revealed in the next 2-3 years. We have to live with what we've got.

Given that the worst of the crisis "may be over", then logic suggests that the Russian government will feel less inclined to implement any painful reforms or shift to any further liberalisation within the economy. Given a focus on defence spending and a stronger nationalist spirit, this is even more unlikely: the western model is less in vogue today quite clearly.

What's happening with prices and profits?

A bit of history:

In early 2009 one major US FMCG/food company believed that the rouble would collapse against the dollar to a range of 48-50 and introduced a string of price rises from the end of 2008 to summer 2009. But the rouble went nowhere near the company's estimate and did not lower than the 36-38 range. As a result the company has confided in private that their corporate profits in Russia were then of a windfall nature and that their profit margins and levels in 2009 were substantially higher than in 2008 or even in a bumper year such as 2007. This was also due to the fact that the Russian consumer again proved resilient and absorbed most/all of the price rises.

It does seem that there is some likelihood of this repeating itself this year for some companies. The point is that many companies started their 2015 price increases in February and Russian partners generally accepted them against the back-drop of what had happened in December and January. But if the rouble stabilises at current levels or weakens back to 55-57 to the dollar and 58-62 to the Euro, some companies will still benefit disproportionately and unexpectedly from the price rises introduced in February and perhaps from residual effects of prices increases brought in late last year.

But it is a fraction trickier than in 2009: one question remains whether the Russian consumer this time round will prove as resilient as in 2009 as real wages declined by -10% and consumer confidence has slumped to the lowest level since 2009; also some retailers are already asking for rebates and future discounts. As one consumer goods MD explained last week in Moscow: "Actually, we are hearing that Auchan and some other retailers are already sending letters to suppliers demanding future price decreases".

We summarise here some of the issues:

- Several/many of our Group members introduced price increases in February and now they accept that there is an upside risk that they could turn out to be quite profitable indeed if the rouble appreciation stays strong. They will be wise not to boast too much about this development!
- Some companies postponed price increases in February and planned to bring these in during April-June. Proposing such price rises now will prove highly tricky because while companies would certainly want some compensation for the (brief) December-February collapse, going to partners now saying that "we want to raise prices to compensate for the rouble collapse" when the currency is breaking almost stronger than 50 to the dollar is a challenging argument.
- The other concern is whether by raising prices now as the currency stabilises, will you lose any market share as partners/consumers look negatively on this. On the other hand, end consumers ought to "feel" a bit more resilient now and in perhaps in a mood of "the crisis is over" and be able/willing to absorb increases (maybe, maybe not).
- But the key to this debate is how long will the rouble rally last and at what level? We outline and explain this below but in summary much will depend on the two big questions –the oil price and political risk in Ukraine –and these are imponderables. If we stay in the current status quo situation, then the rouble can hold current levels or drift down to 53-57 to the dollar and 58-61 to the Euro (which actually is my current best guess). We take the view that at 50-52 to the dollar the rouble is somewhat over-valued after being recently under-valued!

Products in and out of Russia and Ukraine

A few weeks ago the MD of a major FMCG company noted that his company's finished products shipped from Ukraine to Russia were facing non-tariff restrictions from consumer quality control organisations. When other companies were surveyed about this issue, it was discovered that a small but noticeable minority of companies had faced such problems but it was far from pervasive or comprehensive.

Companies did report that they face some restrictions in shipping goods from their facilities in Russia to Ukraine and were choosing not to ship in that direction as Ukrainian customers were stating preferences for non-Russia sourced produce. Again nothing comprehensive but a growing feature.

The Rouble outlook: why is it strengthening and where will it go?

Since the start of 2015 (3 January) the rouble has appreciated until 9 April by 19% against the Euro and 7% against the strong US dollar: compared with its low point this year it is up 26% against the Euro and 22% up versus the dollar; many emerging market currencies have fallen in recent months against the USD by 8-15%.

- In 2014 the Russian rouble was the world's worst performing currency.
- In 2015 to date (9 April) it is the best performing currency in the word.
- One thing is for sure: the rouble is the world's most unpredictable currency.

Please note: we did predict overt the last three months that in amid/best case scenario, that the rouble could appreciate by 20% or more and here we are. But is it sustainable?

First though, why is the rouble rising now?

1) There is some stabilisation in the oil price at around $58 to the barrel. I am pleasantly surprised (for Russia) that the recent deal with Iran has not destroyed oil price (because there remain uncertainties about the deal which will in any case take time to fruition) and the oil price has stabilised and strengthened on the news that Saudi Arabia has started to raise prices to China for oil.
2) It is "apparent" to western media that eastern Ukraine has calmed down (whether that is the reality on the ground or not is almost irrelevant as it is perceptions which now count).
3) There is a sense that western sanctions are not going to intensify and there is perhaps a vain hope that some may be rescinded in 2015, although we think, given criteria in the second Minsk agreement, that sanction reductions will be held back until December 2015 or January 2016 , but there is a small upside risk.
4) It seems that households may now be re-converting back into roubles some of the $25bn worth they converted in 2014 out of roubles into dollars and Euros; we see some shopping/consumer trends reflecting greater confidence in the currency.
5) The Central Bank has been working hard with repo rates to manage the currency upwards.
6) It's not surprising that the falling Central Bank interest rate is not weakening the rouble because interest rates have never really been the driver of FX rates for the rouble or not a major influencer.
7) The Bank persists with its view (and probably rightly so) that inflation will start to decline during summer this year and publicity about this feeds into the markets.
8) I think there is also just a sense of "the worst of December 2014" is over and the markets say "we have stabilisation now" and so …we have stabilisation! This becomes a self-fulfilling prophesy and the market mood turns positive.
9) The end of 2014 was also impacted by large debt repayments which came due for Russian companies to pay back to western creditors.
10) Since a series of December and March debt repayments have now passed, the debt repayment curve for the rest of 2014 is more evenly spread and there appears to be less risk.
11) Other emerging market currencies are struggling so there is more a sense of it's not just a Russian thing and in fact the rouble now looks like an emerging market winner: if investors want to get yield and speculative gains, then ride the rouble wave!
12) However, the rally could be temporary and due to "mood" and to foreign investors closing long positions on the rouble and when this latter feature terminates, then the current rally could fade.

In closing I am a bit surprised that the rouble has rallied quite so much when the Brent oil price is still below (today) $60 per barrel.

I actually think we are at a juncture where the oil price could mirror the FX rouble-dollar rate: so that if the oil price fluctuates at $56-60, then the dollar FX rate should be around $56-60 for the rouble/dollar (and the dollar-Euro averaging 1.06 in 2015). According to this rule of thumb, the rouble is slightly over-valued at 50-52 to the dollar (although in recent days it has softened to 52-53).

Where does the rouble go now? One thing to consider is that the Russian Central Bank will soon start worrying about rouble strength (a crazy world!) and if the currency gets close to 50 to the dollar, the Bank could even start selling the rouble. The Bank will be reluctant to see a large fall in oil-related tax revenues, which bolster the budget deficit. In mid-April we may have seen some of this happening and certainly the Bank is giving signs that it will soon reduce its central interest rate from 14% (and this could happen at the end of April). The Bank was more pro-growth than anti-inflation in recent weeks and will find no reason currently to change that position.

Just as 72/75 to the dollar and 78/82 to the Euro seemed excessively weak and not matching fundamentals, then today's strong rates seem marginally to be an over-reaction in the other direction.

However, in addition to oil, Ukraine and sanctions (the Big-3), other factors noted above are driving the exchange rate. The only thing certain is uncertainty, enjoy the current trend while it lasts and let's trust in maintained stabilisation.

FX reserves

The Russian Central bank has also spent $150bn since 1 January 2014 in protecting the currency over 14 months util 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
3 April 2015	355

Note: $20bn of the decline is due to change in the Euro/dollar exchange rate and not entirely on account of currency protection or state enterprise support.

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

25 key business issues that executives have to monitor

1. Short-term financial planning is agony.
2. Companies were caught again in a "budget trap" last autumn when original targets were set for Russia in 2015; companies have to readjust and reforecast and manage expectations.
3. Surprisingly or not many western companies survived 2014 reasonably well at least in rouble terms.
4. The managing director of one major western food & beverages firm with $2bn sales in Russia said in January: "2014 was great; now it's over".
5. Some companies are concerned that a deeper business recession will kick-in during late spring this year as the full impact of inflation and collapsing real wages finally pulls the consumer down; most executives predict a moderate rally for 2016 but a noticeable minority expect still quite hard times at the start of 2016
6. Localisation: western companies realise that to get deeper into the local markets and to access local tenders, they need to be more localised and this is an on-going trend.
7. Diversification: being a diversified conglomerate is proving good for some firms as this spreads the risk and while some sales to some sectors may have slumped (automotive, IT) , they are compensated by comparatively stronger sales elsewhere (consumer related).
8. Several companies report privately that they are making large investments in logistics and warehousing; some companies with large existing market shares want to protect those or plan to expand this market share.
9. Two-thirds of companies report that they are not postponing investments this year: consumer goods and food & beverage companies plan the fewest postponements while pharmaceuticals are also fairly positive with most delays expected in the B2B sector.
10. Market share is rightly the key focus for companies who engage in best practice.
11. Generally pharmaceuticals and health are the favoured sectors, consumer products are average (good/mixed) and B2B is the weakest business sector with recently the IT and automotive industry sticking out as badly strained sectors.
12. For pharmaceuticals and IT firms, selling to the federal government is the biggest challenge as government spending is cut back.
13. IT and pharmacy sales to consumers have been the more upbeat part of these industries.
14. This supports the view that the Russian consumer has proven remarkably resilient until March 2015.
15. Some companies predict that consumer spending will be hit radically in spring 2015 as the full impact of higher inflation and weaker wages sets in.
16. Brand or value? Executives are having strong debates about whether premium brands will hold up this year against the economic odds. One managing director of a food company with two plants in the country states: "Our premium products are weakening while our mid-brands and discount products are performing strongly. I think 2015 will see a big slow down for the premium end". Others think they will have to work harder to sell premium brands. Most appreciate that they will need to widen their portfolio to reach more consumer segments.
17. Related to this, the Russian regions remain important as a part of business strategy and have been so for many years now but companies realise they must do more to compensate for a slowing Moscow.
18. Volume or Price? Executives also debate heatedly about whether to put their business focus on growing and protecting volumes or price increases. Generally volumes are going to be harder to achieve.
19. It does seem that much business growth in 2015 will come from price rises; companies raised prices in 2014 by a 10-30% range and many jacked up prices again in February 2015.
20. Financing will remain challenging for B2B sales even though the central interest rate fell back to 14% in March.
21. Manufacturing firms complain about rising input costs.
22. Aniti-westernism? About 50% of companies report some degree of anti-western attitudes in B2B tenders and B2G ones. Regarding anti-western consumer behaviour, some 23% of companies report this feature but this is more difficult to gauge: do consumers simply prefer cheaper non-western brands?
23. More western B2B firms are being asked by Russian officials, "Where do you source from"? Consequently some are turning to suppliers in Asia or non-Western sanctioning countries to avoid Russian reprisals and also to find cheaper inputs.
24. Some managing directors are very wary of cutting too deeply: "We cannot fully fix most of the short-term problems without taking steps that will certainly damage the long-term health of the business".
25. Generally western companies are not cutting back on staff (75% not at all, not yet) while the rest are so far making small cuts; companies are keeping a tight rein on salaries and paying below inflation (90%).

Economic outlook

We think the recession will mean that GDP falls by just worse than -4% this year. Last month risks were balanced while now they are marginally positive. But as we noted above, the first 3-4 months of the year proved very poor and this will filter through into the annual average figures.

Consumer indicators were "catching up" with the bad ones for investment and industrial output in the first quarter of this year and retail sales, consumer confidence and real wages were all bad or worse. But now, as the rouble strengthens, and as inflation may decelerate more quickly, it is the consumer side of the economy which could rally a bit quicker and better than industry and investment. But the timing of the consumer recovery is tricky to judge and will depend on how much confidence recovers from the poor first quarter figure of -32, one of the worst in 20 years.

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	Mar
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	-1.6	-1.8
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	-9.3
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	-7.2	-8.7
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	5.9
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	-0.6
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	-5.3
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	16.9
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	na

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	-5.2	1.5	2.5	2.8
Household spending	-7.6	5.5	6.8	7.9	4.7	1.8	-4.5	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	11.0	7.7	6.6	6.3
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 ($bn) year-end	447	485	510	528	509	385	310	290	270	280
Rouble/$ (year-end)	30.3	30.4	32.1	30.4	32.9	58.0	58.0	61.0	63.0	67.0
Rouble/Euro (year-end)	43.4	40.0	41.5	40.1	45.1	72.0	61.0	63.5	65.5	69.0
Budget balance (% of GDP)	-6.3	-3.5	-0.2	0.0	-0.5	-0.5	-3.0	-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

Overall the economy does have a few positives still left:

- Import substitution, but we question how viable and sustainable this is. However, western executives do report some exuberance in some sectors such as food, packaging, chemicals, some sectors of engineering and metallurgy and they are able to sell into these Russian customers when financing can be resolved
- Defence spending which explains in part why industrial output is not yet negative.
- The Bank is actively reducing the key interest rate and will probably make a cut from 14% this month or in the next 6 weeks and we think the central rate could be down to 10-11% by the end of the year on current trends
- 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.

Central economic scenario 2015

Our earlier economic estimates tended to be on the upside/positive side of the consensus so the market developments are coming closer to our original forecasts which, for now, require limited changes and we have made some mild tweaks upwards for some indicators. Our biggest change is of course to the FX rouble rate which we have strengthened noticeably. But the figures here are averages and have to take into account the very weak first quarter.

GDP	-4.1%
Inflation (year-end)	11.5%
Inflation (average)	12.5%
Consumer spending	-5.0%
Investment	-10%
Industrial output	-4.0%
Rouble to US dollar average	57
Rouble to the Euro average	61.5

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 3.0% 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/€ Average
$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	57-60
$55-63	-4.5%	12.50%	55-60	59-62
$50-55	-5.5%	14.0%	61-65	65-68

Inflation outlook

Inflation is behaving fairly predictably and as we forecasted in recent months. Prices climbed to 16.9% in March after 15.0% in January but the rate of increase is moderating. Food prices for example rose by “only” 23% in March compared with 23.3% in February; prices for services also ticked down a little in March to 12.6% with non-food products still on a slightly rising trend at 13.9%. Given that prices have been driven by the weak rouble and sanctions on western food products, the appreciation of the rouble ought to accelerate the fall in prices during the coming months which had in any case been predicted. We now think inflation will stabilise or start to decelerate in April or May and the top-line inflation may now not break through 20% or if so, then only very briefly.

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%. We are also tweaking down our year-end figure for 2015 from 12% to 11% and thus the average figure for 2105 will 12-14% this year.

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.
2. Many companies and certainly western ones raised prices during February by 6-17%.
3. The Central Bank is cutting rates and prioritising growth over inflation for now.

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.

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.

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 explained in part why industrial numbers were better than PMI figures (because PMI did not factor in defence spending). But even mild industrial growth numbers could not be maintained and figures have declined more in recent months and were down -0.6% in March and we predict a fall this year of -4.0% with possible upside. Purchasing Manger Index numbers are constantly below the level of 50 which indicates recession: in January the number was 47.5, February 49.7 and down again in March to 48.1. In comparison several CEE markets now report PMI levels of 52-55 which are very strong. We predict with the consensus that industry will fall by -2.8% 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.

Thanks to poor business confidence, high interest rates, lack of confidence, western sanctions, fixed investment is a very weak link in the Russian economy. This was -5% in 2014 and we predict a fall of minus -10% for the whole of 2015; the figure was negative at -5.3% in March. Given the rouble rally and falling interest rates, then this indicator could also face some positive risk in the coming months but the best case would still be about -6.5% for the year. B2B sales will remain strained and this sector will be the weakest business link again in 2015. 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.

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. Again thanks to the rouble recovery, exports denominated in dollars should prove stronger and therefore may not decline by -25%. But exports overall will be strained by the lower oil revenues generated.

However Russian executives are probably glad to see the back of 2014 especially the traumatic month of December: business confidence rallied to -6 in February and March this year from -9 in January and a recent low of -10 in December. The current number is about the average for mid-2014.

The Russian consumer

How deep the crisis is now and for how long – better than expected?

Consumer indicators started to deteriorate in November and started this year badly. There are several inter-related questions to ask:

1) How resilient will the Russian consumer prove this time round in this crisis? Until January-February, the answer was probably "reasonably well" with spending flurry in December 2014, but executives were expecting a business slump in spring this year.
2) Will this business slump now occur at all given the Rouble recovery and/or how deep will it be and when will a fuller consumer recovery kick in? Some possible answers: the slump will occur as consumer-related indicators were bad in the first quarter 2015 and will have to show up in the retail and household spending numbers. The depth of the crisis could be mitigated/lessened and a viable recovery which was probably expected originally in early 2016, could now be brought forward to late autumn.

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 annual figure in 4-5 years and without the December surge, the number would have been bad. But retail numbers since then have been poor averaging minus -6.7% in the first quarter with a figure of -8.7% in March which is close to the worst monthly figure in 15 years. But even the resilient Russian consumer will be under severe strain this year and next and we see retail sales slumping by minus -5.2% this year and then recovering to +1.5% in 2016 and then averaging about 2.8% in later years.

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

1) Rising inflation
2) Western companies raising prices but such hikes could now be limited to one round in the first quarter.
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.

We estimate that household spending will decline by -4.5% this year and then recover to 0.9% in 2016 with some upside risk.

Consumer confidence had hovered around a level of -6 for most of the period from January 2010 to July 2014 which is a good figure compared with other European and global ones. But in the final quarter of 2014 this declined to -18 and then plummeted to -32 in the first quarter of 2015 which is the third worst figure in 20 years after averages of -38 in January 2009 and -60 in 1998. As we noted above, much will depend on how quickly the consumer can respond to a rising rouble and slowing inflation.

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 word 2-3 years ago, they are now running at -9.3% in March, the worst result in 10 years; and with high inflation until summer this year and an average inflation of about 12-13% in 2015, then real wages will average about -8.7% this year with figures perhaps as bad as -10% 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 12-13% this year and so real wages come in at minus -8% (13% inflation minus 5% wage increase leaves -8% real wages).

In 2014 as 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 -11% 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 minus -5% to minus -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.

Consumer credit

After leaping by +30% in 2013, this was closer to 10% in 2014 but on a sharply declining trend through the year with new credits almost flat at the end of 2014. We expected new consumer credits to be in range of -5% to -12% this year but once again with the rouble rally, there could be an improvement with this indicator and credits could stabilize around zero or be slightly above or slightly below. The Central Bank's aim of recapitalising the commercial banks with 1 trillion roubles could put a base under credit to prevent them imploding.

The jobs outlook is not too bad?

Unemployment in December was not bad at 5.3% but has since crawled up to 5.9% in March as anticipated 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. Redundancies by western companies may be fewer now as some companies can contemplate better profitability numbers thanks to the stronger rouble and recent price rises

As ever, I hope this paper has proved useful for you and if you have any questions or comments, please feel free to contact me danielthorniley@dt-gbc.com

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