CEEMEA Business Group

Russia Business Outlook 2014-18

Surviving but Sticky and a 'New Normal'

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About the author

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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

- We revise our GDP estimate down for this year to 1.6% and 2.7% in 2014.
- With oil at about $108 per barrel, this is a disappointing outcome.
- It's a puzzle why Russian economic output is quite so weak: or perhaps best explained by a lot of little things combined.
- Poor investment and industrial output numbers are dragging down the economy.
- Automotive sales are down -10%.
- B2B and manufacturing companies have survived well but should watch out that poor industrial numbers do not drag down their own sales into single digits.
- Government spending and dipping into Reserve Funds does not look as though it will come quick enough to salvage growth figures this year.
- The good harvest will help growth a bit, but more significantly pull inflation down.
- Managing directors are telling headquarters that Russia is in a "new normal" and it will stay in this situation for some 9-15 months.
- The message is that for many mature investors with large volume business the big boom days are gone.
- Some executives were caught in a budget trap in autumn 2012 when setting their targets for 2013; managing directors are loath to get caught in this trap a second year running when making budgets for 2014.
- Competition is still rising.
- Some companies talk of the need to diversify from purely premium brands.
- Route to market: do you dump your dealers and go it alone?
- Pharmaceutical sales are holding up quite well but executives note that access to government officials remains difficult.
- Companies in all sectors talk even more of expanding into the regions and look at other CIS markets given the slowdown in Russia – we saw this also in 2008-09.
- The twin-track nature of the economy remains relatively better with consumer-related sectors.
- Despite this noticeable downturn, Russia remains relatively the best sales market in Europe.
- Managing directors are obliged to engage in more "managing expectations" discussions with HQ.
- Inflation is under control and could dip below 6% in December.
- Exports down, imports up = current account down and a bit of pressure on the rouble.
- The rouble recovered as we predicted once the turmoil over US tapering and future interest rates calmed down. In the medium- term there ought to be some more moderate downward pressures although the consensus disagrees.
- The revised federal budget sent to the Duma in recent weeks is disturbing and we hope that revisions will be forthcoming: too much is targeted to defence and too little to health and education with actual cuts envisaged for the latter next year.

We revise our GDP outlook downwards

In September the consensus view for Russian GDP growth in 2013 was 2.0% with a variance as high as 2.5% and as low as 1.6%. The government's own realistic estimate was and remains currently at 1.8%. We stated in our last monthly report that GDP could manage 1.9% this year if the government could boost spending into investment and infrastructure during the last quarter of this year. We stressed then that nearly all the risks were on the downside and while in August and September investment expansion seemed a plausible/possible outcome, this is looking less likely to today.

The economy remains twin-tracked with anything to do with consumer and retail performing relatively better than sectors connected to industry and investment. The consumer related figures are sufficient to keep Russian growth in positive territory excluding any end-of-year collapse which is unlikely with the Christmas period beckoning. But, as we note below, industry and investment are proving too weak to maintain any solid GDP numbers.

> We therefore revise our estimate for GDP growth his year down to 1.6% with risk remaining on the downside. We also revise our estimate for 2014 downwards to 2.7% and then believe that medium-term growth will average over 3% and close to 3.5%.

Our long-term outlook for growth in the next 6-10 years of 3.3% is close to the consensus. One should note that the consensus estimate for Russian long-term growth when made two years ago was 4.5%, that consensus figure fell last year to 3.9% and currently the long-term consensus is 3.5%. As we have pointed out many times, much will depend on the impact of shale gas on energy prices and in turn on the whole global economic structure which could be altered by developments with shale, energy, production location, manufacturing efficiency etc.

A story about best practice

Recently the managing director of one European B2B company commented that sales were under strain but generally far from crisis mode yet. But the executive in question did make some interesting remarks about his own company rather than the sector:

> "We are seeing a slowdown but perhaps we are not adapting well to some of the trends. We have focused understandably on the premium sector and we must do so, but I think we need to deviate from a strategy which is focused solely on premium brands and start to offer more affordable products especially if we want to expand regionally. We also need to consider our route to market as we have maintained our existing relationships with dealers rather than cutting them back and going directly".

However, there are risks here and this executive in question is well aware of them. He went on to explain that, "Our competitors have gone more direct and did cut out their dealers and it did work for some time but eventually they damaged their relationships and now few distributors trust them anymore".

The remarks above obviously relate to all our comments over recent years about the benefits of considering affordable innovation especially as business generally decelerates and as more companies aim to expand in the regions. We have also flagged that while affordable innovation is a very valid business model and companies need to evaluate it, it can be challenging in the Russian business environment where the cost base is so high: how do you make affordable products and services when all your costs for advertising, real estate, warehousing , and salaries are so high?

This is a fair point. And it was underlined by another executive in the automotive sector who said last month in Moscow:

> "Sourcing product in Russia is crazily expensive. If we say that the cost of sourcing in Germany is 100, then Russia is 112 and then Czech Republic is 92 and China is 80".

The comment above on route to market is very germane as well: how do you balance distributor relations with the need to take over more of the business to drive it. Generally we have seen more instances of companies changing the model and facing the consequences with dealers and the supply chain. Of course when companies go at it alone, they need to get the strategy right if they are going to "burn their distributor boats".

A closing point on affordable innovation: executives need to watch out for any future price erosion and some executives have expressed this concern. Companies in Russia can engage in their regular and good premium business and also look at affordable strategies. But it is "best to keep these separate" i.e. not cut prices on premium products and services while introducing affordable innovation as well: this simply confuses the consumer and hurts margins. This view was expressed by the MD of a European B2B company earlier this year:

> "When we came under pressure in western Europe and CEE in recent years we panicked, along with our competitors, and resorted to price cuts on nearly all products; hardly any of the western players survived well. I just hope we don't repeat this in Russia as the market softens. It would simply undermine the business and profit model we have built up over a decade".

Business comments and mood by sector

One general trend that a handful of executives are speaking more often about is the mid-market range (mid-price, mid brand). It is the strong consensus that pre-crisis, during the crisis and since the crisis, this is the range which has fared worse compared with super premium, premium and discount/cheap. Several senior managers in recent weeks have confirmed this widely shared opinion. But also recently a small handful of executives are talking about "re-visiting the middle range". They take the view that nearly everyone is dissatisfied with the sector which is cluttered, fragmented and hard to define. One executive summed up what is perhaps a strand of new thinking:

> "We have left the mid-range alone or certainly looked at it as the lowest priority and we have not done this well in that area. But given most other companies have experienced the same, maybe this is some "open space" which we can cultivate. We are not going to do anything massive quickly, but I am going to get colleagues to do some new research".

B2B sector outlook

Most companies are holding up reasonably well and are still able to report organic sales growth in double-digits or even in the mid-teens. Some categories are weaker and competition levels and niche products can change sales results, but overall the experience is not bad. <u>We do wonder though whether the increasingly poor results in industry and investment will pull down manufacturing companies.</u>

One of the large automotive investors in Russia pointed out last month in Moscow that automotive sales rose 40% in 2011 and 10% in 2012 and will be down -8% this year. He was relatively relaxed about this trend and described it as "the market is taking a breather". He confirmed that his company has faith in the market over the medium and long-term. The Russian government has also been ahead of the field in announcing this autumn subsidy programs once again for the auto sector which ought to prevent any implosion. This executive also argues for the regional approach:

> "The Moscow market is quite frankly really saturated. There will of course be replacement sales but if we are looking for better top line then we need to and are moving more to a regional focus. We already have a big dealership and will expand this".

One supplier in the Russian automotive sector has sobering words, which, given the hefty sales drop in this sector, (-10% to date, see below) is not surprising:

> "The outlook deteriorated in September along with customer behavior and currency fluctuations creating some nerves. Our partners are looking very closely at cash in inventory and some local

> partners talk of the business outlook being worse than in 2008. But despite this bump, we are surviving and numbers are holding up reasonably well. It's just if this outlook materialises, then things would be worse".

Certainly the emerging market wobble this summer and the volatility in the rouble did cause some concern. While in no way belittling the downturn, we do counsel that Russian distributors can be prone to extreme mood changes and many Russian partners like to talk of impending doom and collapse; but we will leave this discussion of the Russian soul for another occasion! Times are tough and one does need risk scenarios but the consensus is for moderate slowdown followed by mild/moderate recovery.

Consumer products trends

As we have noted, consumer product companies were generally clustered in the range of 8-15% at the start of 2013 for annual organic top-line sales growth. This has trended down to 5-10% for most companies with some categories even in low single digits, flat or even negative by -2% to -5%; but overall thanks to real wages, low inflation and steady consumer confidence, sales are holding up quite well.

Consumer confidence in Russia is about the third highest in continental Europe behind only Germany and Sweden. Russia's consumer confidence level is stable at -6 (points not percentage) while most other European and CEE countries have indicators which have improved sharply in recent months still score in a range of -20 to -28. Chinese consumer confidence was positive at +6 but in recent months has deteriorated to about the Russian level i.e. lower but still very good (in passing 86% of Chinese people think their children will have a better life than their own; the figure is 11% in the Eurozone).

We repeat a couple of points that: consumer product firms have been most successful at increasing sales through price rises rather than volumes although the latter do increase as well, just more slowly; secondly, many executives are concerned about how sustainable price rises are in Russia and elsewhere.

Companies selling beer, spirits and tobacco are in a different category for consumer products as legislation, tariffs, access to market and advertising laws have hit these segments hard in recent years: perhaps the spirits industry has suffered relatively better in these sub-categories of consumer products. But beer sales for example have fallen from 15-25% sales growth some years ago to 1-2% now and tobacco sales are not far off. Thankfully volumes, pricing and premium brand sales all help the portfolio.

And good stories still exist! The managing director of one company which sells a range of products to consumers says that:

> "We have a plant in Russia and business is going very well. The Russian plant is the most profitable that we run in the world. People are buying paint as if it's going out of fashion. The start of the year was a bit wobbly but we are improving and current sales this year are up 8-10%. This is one of the best levels in Europe and the volume is healthy and growing sizeable".

But the overall situation for consumer products was summed up in July by the managing director of one of the major US consumer product companies when he stated that:

> "Our business is still very good and now we are growing at 6-9% on volume over $1.5bn. We were growing at 12-13% annualised last January but Russia and the world had changed. This is the new normal, and I and many of my peers simply have to tell headquarters that this is the way it is and it's going to stay like this for another 9-15 months".

A funny contradiction?

There is a very clear distinction between trends in industry and those in consumer goods and the latter is apparently stronger than the former. But it is peculiar and perhaps strange that overall western consumer goods companies are feeling the heat more than the industrial B2B firms or perhaps the managing directors in consumer goods firms express more pain!

Overall B2B companies have seen their top-line organic growth numbers fall from 30%+ in 2011 to a range of 12-18% today. The CIS MD of one major European conglomerate stated in the summer that: “Our top-line sales are still growing at 17-18% even though that is 1-3 % behind the 2013 budget. We are committed to the market at board level and will be investing at least another 125 million Euros over the next 12 months. We agree that if you don’t invest in Russia, where do you invest?”

Generally B2B companies have seen a mild slowdown in 2013 but the sales picture does not reflect the very weak numbers in investment and industry that we mention above.

On the other hand consumer goods companies have seen sales slip moderately this year, matching the moderate deceleration in consumer-related indicators (spending, wages, retail sales etc – and see below).

Perhaps B2B executives should be cautious about future trends: can they hold on? And executives in consumer products should be thankful for what they have (although when sales are down, this is hard!) because the consumer indicators are still relatively good: if consumer numbers were to fall further, FMCG executives would be feeling more pain.

Pharmaceutical and health sector

This sector has survived best of all in Russia and in other markets as well. Pharmaceuticals and health also experienced their major downturn a few years ago and have undergone 3-4 years of legislative turmoil. Executives were very worried about the direction of the market through 2009-2010 and even now some uncertainties remain. But business has stabilised and many larger companies are able to grow sales at about 9-15%. The slowdown over the last 12 months has been more moderated than in other sectors. Still companies are missing budget targets and those that are now reporting 11-14% for 2013 are often lumbered with budgets of 14-22%. One managing director recently complained to me:

> “We will increase sales by 13.5% this year but our budget was set unrealistically at 19.5%. This now means I congratulate the team on a good year but of course no one gets any bonuses and headquarters are breathing down my neck”.

These comments reflect again how executives were caught in a budget trap in autumn 2012 when setting their targets for 2013. Managing directors are loath to get caught in this trap a second year running.

But pharmaceutical sales look good to steady for the coming years. OTC is doing quite well and one major European player in this business stated last month in Moscow:

> “There is a lot of out of pocket sales and as you say this is as high as 60% of total pharmaceutical spending. Consumers are willing to purchase and we think therefore that we can double the business in… several years which is a very positive comment to make”.

Certainly OTC is good and companies here are sometimes able to raise prices. The consumer absorbs such increases providing there are no government price restrictions. Most companies comment that they are happy with the 2020 government health program but they are not relying on it: if business stems from this program in a significant way, then companies are ready to manage this, but if the Program implementation proves disappointing, few companies will be damaged.

Medical equipment firms have done very well in Russia in recent years and the sale of high technology products have flourished. One managing director of a US firm commented to me recently that:

> “2011 and 2012 turned out to be boom years thanks to the modernisation program and we were growing at 80% as were other companies. This ran through into 2013 as any unspent budgets were in fact spent. Given the localisation law and the possibility that local producers can corner the market,

> we think that the market is starting to trend down currently to 8-10% growth and this will be the average in 2014. We can't complain as those glory days couldn't last for ever".

Several executives complained recently that access to government officials is still challenging. Executives in this sector hoped to improve government relations in the wake of the legislative changes of 2009-10 but this has turned out generally disappointing. One local managing director of a major company commented last month:

> "They invite you in for a meeting and then steal your ideas! This is ok because they take on board some of our best practice. But too many scheduled meetings are not that serious and do not discuss real plans".

Consumer-related statistics: by year and monthly

	2011	2012				2013								
	year	Q1	Q2	Q3	Q4	Jan	Feb	Mar	Apr	May	June	July	Aug	Sep
Disposable income	2.8	2.6	3.4	4.4	5.0	0.7	5.7	8.3	7.3	-1.3	2.2	4.2	2.1	-1.3
Real wages	4.9	10.5	11.9	6.5	5.8	8.0	5.2	5.1	4.2	5.7	5.3	6.4	5.9	8.2
Real retail sales	7.2	7.3	6.7	4.7	4.4	3.3	3.0	4.4	4.1	2.9	3.5	4.3	4.0	3
Unemployment	6.5	6.5	5.5	5.3	5.3	6.0	5.8	5.7	5.6	5.2	5.4	5.3	5.2	5.3
Industrial output	4.7	4.2	2.3	2.5	1.7	-0.8	-2.1	2.6	2.3	-4.1	0.1	-0.7	0.1	0.3
Fixed investment	8.0	11.9	6.7	1.6	1.8	1.1	0.3	-0.8	-0.7	0.4	-3.7	2.5	-3.9	-1.6
Consumer prices	6.1	3.9	3.8	6.0	6.5	7.1	7.3	7.0	7.2	7.4	6.9	6.5	6.5	6.1
Budget deficit (running)	-0.2	0.3	0.1	0.1	-0.3	-0.2	0.0	-0.1	-0.1	-0.2	-0.2	-0.6	-0.6	-0.5

Macro-economic data 2009-2017

	2009	2010	2011	2012	2013	2014	2015	2016	2017
GDP	-7.9	4.3	4.3	3.4	1.6	2.7	3.4	3.5	3.7
Retail sales	-5.5	6.3	7.2	5.7	4.2	4.3	4.2	4.6	4.8
Real wages	-2.8	4.4	4.9	8.2	5.4	4.8	4.6	4.7	4.6
Disposable income	1.0	3.7	2.8	3.7	3.6	3.5	3.4	3.6	3.4
Inflation (year-end)	8.8	8.7	6.1	6.6	5.8	5.5	5.2	5.0	5.0
Unemployment rate	7.9	7.6	6.5	5.3	5.6	5.6	5.4	5.3	5.5
Gross fixed investment	-17.9	5.6	9.8	6.0	0.2	3.8	5.5	6.0	6.5
Industrial output	-10.8	8.3	4.7	2.6	0.6	2.8	3.3	4.5	4.4
FX reserves ($bn) year-end	447	485	510	528	512	520	515	500	510
Rouble/$ (year-end)	30.3	30.4	32.1	30.4	32.2	33.3	33.9	34.3	35.0
Rouble/Euro (year-end)	43.4	40.0	41.5	40.1	43.0	43.6	43.7	43.5	43.9
Budget balance (% of GDP)	-6.3	-3.5	-0.2	0.0	-0.5	-0.6	-0.5	-0.3	-0.2
Current-account balance (% of GDP)	3.8	4.9	4.9	4.0	2.5	1.3	0.9	1.1	0.5

The economic outlook

One recent comment was: “It is a puzzle why Russian economic activity remains quite so weak”. On the one hand this is true, but on the other there are many combined factors which weaken growth. Moreover Russian output numbers have not ticked up as the Eurozone has stopped collapsing unlike Poland where we witness a stronger current recovery. Before we look at the weakening factors, a few words about the stronger sectors.

Russian consumer trends

Wages: “highest in the world”

Real wages after inflation were running at 5.9% in August and we may actual tick up our estimate for this full year to an average of 5.4% in 2013. Real wages were growing an astronomical 12% in the second quarter of 2012 when inflation was close to 3% and nominal wages were about 15-16%. Nominal and real wages have “crashed” since then and real wages averaged 5-6% in recent months as inflation hovered at about 7%; this still means that nominal wages are strong at about 11-12% which are among the highest wage increases in the world. Even though real wage levels have almost halved, these too at the current 5-6% remain the highest in Europe and among the highest in the world (real wages in most of the Eurozone, Germany and the CEE region are 0-1% and in the UK they have been running negative for 3-4 years).

The Russian savings level remains high at about 8-9% and with savings and good wage levels combined with almost record low unemployment at 5.2%, this explains why Russian consumer confidence indicators stay among the best in Europe.

Against this background, retail sales, while again having almost halved over the last 12 months to their current growth level of 4.0%, are among the strongest levels in Europe and in the Top-5 or 10 best retail markets in the world especially when considering the volume of sales. Russia will still become the largest consumer products market in Europe by about 2020-22.

Falling inflation (see below) will also help consumer spending.

However, The Central Bank is still waiting for a more sustained fall in inflation before starting its cuts in interest rates; the main refinancing rate is currently 8.25% and we expect that this will be reduced later this year and perhaps one or two more times in early 2014 if inflation stays under control and growth is sluggish.

But why is GDP growth shrinking?

1) European and global growth has ensured negative contamination.
2) The shift in the US interest rate and quantitative easing policy hurt Russia and all emerging markets.
3) Global contamination has damaged Russian exports and the volume of energy exports to the EU and Ukraine is shrinking along with other products. Exports have been negative for 12 months until June when they rose 2%. But overall this year-to-date they are down -4%.
4) There is a statistical effect in that the first 4-7 months of 2012 were artificially boosted prior to the presidential elections and in comparison the numbers this year are compared with a higher base.
5) The Cyprus effect took some shine off the market but not fundamentally.
6) Levels of new credit are decelerating from very high levels (but this s is a slow process).
7) The economy is faring worse because of weaker exports on the industrial and investment side and this is pulling down overall figures despite a good/moderate performance in consumer-related sectors.
8) The much awaited government stimulus program did not materialise much yet.

Investment and industry are the weakest links

Fixed investment slumped year-on-year by -3.9% in August (latest figure) and is averaging a disturbing -5% this year; even with some mini-investment boost in the last quarter we now see investment at best growing 1% this year with a zero figure or even negative investment growth being possible. The figure could only turn positive if a surge of money was pumped into the economy in the coming weeks.

It seems that most of the Sochi investments have already been booked and are not adding to any surge. The risk is also that investment overall could come under further strain due to “a post-Sochi” reaction and this happened in Poland and Ukraine after the 2012 UEFA football tournament. But we think there are enough sports infrastructure programs ahead to ensure some upward support for overall investment.

We explained in our last monthly paper why investment is down and in brief the reasons are:

- Weaker global demand.
- Weaker exports means slower industrial output which equals less confidence to invest.
- Russian companies are concerned about slow economic trends and have expressed heightened concerns over political risk: the mood is not so good.
- But especially the Moscow City authorities have been re-organising for many months and putting projects on ice.
- Similarly Rosneft has been absorbing its TNK acquisition and the company has also postponed a lot of capital investment. Western suppliers have complained of this.
- Combine a generally weak environment with Moscow City and Rosneft slowing down on investment that is a recipe for the investment slump we are seeing.

But we think that investment can stabilise and recover over the next 15 months as Moscow City and Rosneft get their act together and the Eurozone economic outlook picks up. There will also be further spending on railway infrastructure especially the Kazan-Moscow link and modernisation of the Trans-Siberian railway. Preparations for the 2018 FIFA World Cup will also kick in very soon. We still question whether so much sports infrastructure is what Russia really needs instead of 20 new hospitals.

Industrial output is another Achilles heel: with investment slumped and exports soft, industrial output has barely grown in the 4 months to end-September when the year-on-year figure was a mere 0.3% and the average figure for the year to date is running at -1.4%. Industrial output will also struggle this year to exceed zero.

Adding to the industrial pain is the specific deceleration we are seeing in the automotive sector which is part of a global and European re-jigging of demand. This summer auto sales were done -10% and this is hurting everyone directly in the sector, including their suppliers.

This week Deputy Economy minister Klepach warned that the ministry’s figure for industrial growth this year of 0.7% could prove too optimistic and we agree. The deputy minister’s remarks would also entail a necessary downward revision to the overall GDP number for 2013. This recent opinion contradicts the remark made in mid-September by the Economics Minister himself, Alexei Ulyukayev, who said then that, “there is some upside risk to the ministry’s 2013 GDP estimate of 1.6%”. We think this difference of opinion just means that in the last 4 weeks or so the outlook has deteriorated a bit more and downward revisions will be necessary.

Once again, the construction sector is holding up reasonably well: growth here has averaged 6% in the first half of the year, dipped in July but then surged 11% year-on-year in July: so a relative bright spot.

Exports down, imports up = current account down and a bit of pressure on the rouble

Exports, as in most other markets globally, have performed weakly: in May this year Russian exports were down -10% year-on-year and in the first 5 months of 2013 exports were averaging negative growth of -5%. There has been a moderate summer recovery (latest figures) and exports rose year-on-year by 2.6% in June and by a more solid 5.5% in July. The message is that after growing 20% in 2011 and by 4% in 2012, Russian exports this year will be around zero growth with a possible negative figure of -2%; imports on the other hand look set to rise about +5% this year.

Weakening exports are also hurting the trade and current account balances, which in turn does put downward pressure on the rouble; while of course steady imports when exports are falling only add to the worsening trade balance. The current account surplus slowed to a meager $1.1bn in the third quarter this year after recording $3.4bn and $25bn in the previous two quarters. In addition to slower exports, this deterioration can be explained by a surge in service imports and the level of paid investment income (the latter rose 16% in this third quarter).

That disturbing federal budget

Last year the budget deficit was a visible -0.02% and is currently running at a level of -0.6%. Russia does not have a budget deficit problem and the government has the choice whether to spend more or less. The federal budget now in the Duma does propose spending increases and mild future deficits which is sensible in the current low growth environment. However, the direction of spending is a serious concern.

We mentioned in our last report our trepidation over various draft budgets and in recent days our fears have intensified after the government submitted the revised federal budget for 2014-16 to the Duma. This will now have several readings: the proposed cuts to social spending are worrisome and mis-directed.

Spending is set to rise 4% next year, a solid 10% in 2015 and a further 6.5% in 2016 and the budget is reasonably conservative in projecting an oil price of $94 in those years. Based on this average price, the budget presumes a deficit fluctuating between -0.5% and -1.0% which again seems reasonable or even mildly conservative. In terms of the numbers, the IMF stated last month that Russia's monetary and fiscal policies were "broadly appropriate".

But it is the breakdown of spending which causes concern:

- Education spending would be cut by 14% in 2014.
- Healthcare expenditure would be down 9% in the same year.
- An equivalent of $65bn would be allocated to social policy (benefits and pensions) but this represents a cut of 2%.
- On the other hand, defence spending is set to rise at a staggering 19% in 2014.

Defence spending is notoriously inefficient with much of the funds never arriving in their proper place and the end result is not an efficient investment in the real economy. The economy and society is in grave need of more and better investment in health and education sectors. Cuts or a deceleration in social spending (wages, pensions) are also contradictory to the social policies implemented in recent years which have also ensured solid consumer spending and has been a buttress of GDP growth.

Nor does the budget offer much new in the way of trying to create a viable, investment-led sustainable development of the economy in order to boost efficiency and productivity. The message seems to say, "Let's throw some more money at defence".

Let's see what happens as the budget goes through the Duma, but the signs are not encouraging.

Inflation outlook

As we expected inflation did decelerate to 6.1% in September and continues its downward trend from 7.1% at the start of the year. Much of the improvement stems from weaker food prices thanks to this year's strong harvest result. Core inflation (excluding food and energy) is also under control and slowed to 4.0% in September.

The government's budget expects inflation to slow to below 5% in the next 2-3 years. While we can see prices falling to about 5.0%, much lower than this appears a little ambitious for now.

We see average inflation this year of 6.6% and year-end inflation of 5.9% which has been our estimate for some time now. Next year inflation should average 5.8% and end the year at 5.5%.

Upcoming interest rate cuts ought not to boost prices too much and the only feasible threat to inflation at the moment would be any serious depreciation in the rouble.

Rouble outlook

The rouble got knocked this summer but survived the emerging market currency crisis quite well. The rouble in the short term could be stable. In the medium term we see more head winds and some moderate downward pressure.

The rouble weathered the emerging market currency crisis better than most other major currencies despite some dips. As we predicted, the financial market finally realised that they had over-reacted to comments from the Federal Reserve that tapering would begin soon followed by hikes in US interest rates; hence the markets stabilised in September especially after the Fed postponed the start of tapering.

	Rouble to Euro	Rouble to US dollar
1-5 May 2013	40.0 to 41.0	30.5 to 31.5
1 July 2013	44.0	33.0
15 September	43.0	31.7
14 October	43.6	32.3

The discrepancy on the Euro in recent days/weeks is down to the fact that the Euro is rising versus the dollar to a recent high of 1.35.

Key points on the rouble:

- Remarkably in recent weeks, the rouble got detached from the oil price: on one day in mid-August oil rose 3.5% and the rouble actually declined 0.5% while in September the oil price popped down one day by -1.5% and the rouble jumped up 1.5%. The impact of the US interest rate policy superseded that of the oil price. This is very unusual indeed and indicates another new major variable for the currency.
- The rouble did weather the summer storm relatively well.
- But during 2014 the Federal Reserve will surely introduce tapering (buying fewer long term bonds and assets) and raise interest rates slowly. This has the potential to revive summer's turmoil. We think that the markets have priced some of this into their FX rates and also appreciate their earlier over-reaction: for example when US rates do increase, it will be a slow steady process. Nonetheless, watch out for spring-summer emerging market currency turmoil on a smaller scale.
- The Central Bank highlighted its preference for a weaker rouble when it announced changes to its intervention policy earlier this month. These are quite technical measures, but the bottom line is that they will tend to add to any rouble weakness. This reflects the fact that the Bank can live with any moderate rouble depreciation which it sees as a growth stimulus. The fact that a weaker rouble this late summer did not really spike inflation only makes the Bank more relaxed about a weaker currency.
- We repeat again that in any major serious global crash, the Bank has stated that it will let the rouble act as a "shock absorber". This means that for many days or weeks the rouble could sink much quicker than western executives would like. That's the bad news. The good news is that the Bank has experience and the FX reserves (currently $510bn) to protect the rouble at a level of its choosing (as it did in January 2010). And it will do so. Unlike most other emerging markets (excluding China), Russia has the fire-power to protect its currency without resorting to crippling high levels of interest rates.

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

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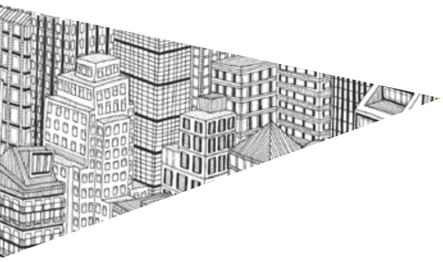

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