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Reasons to Be Reasonably Bullish About Russia

By Danny Thorniley

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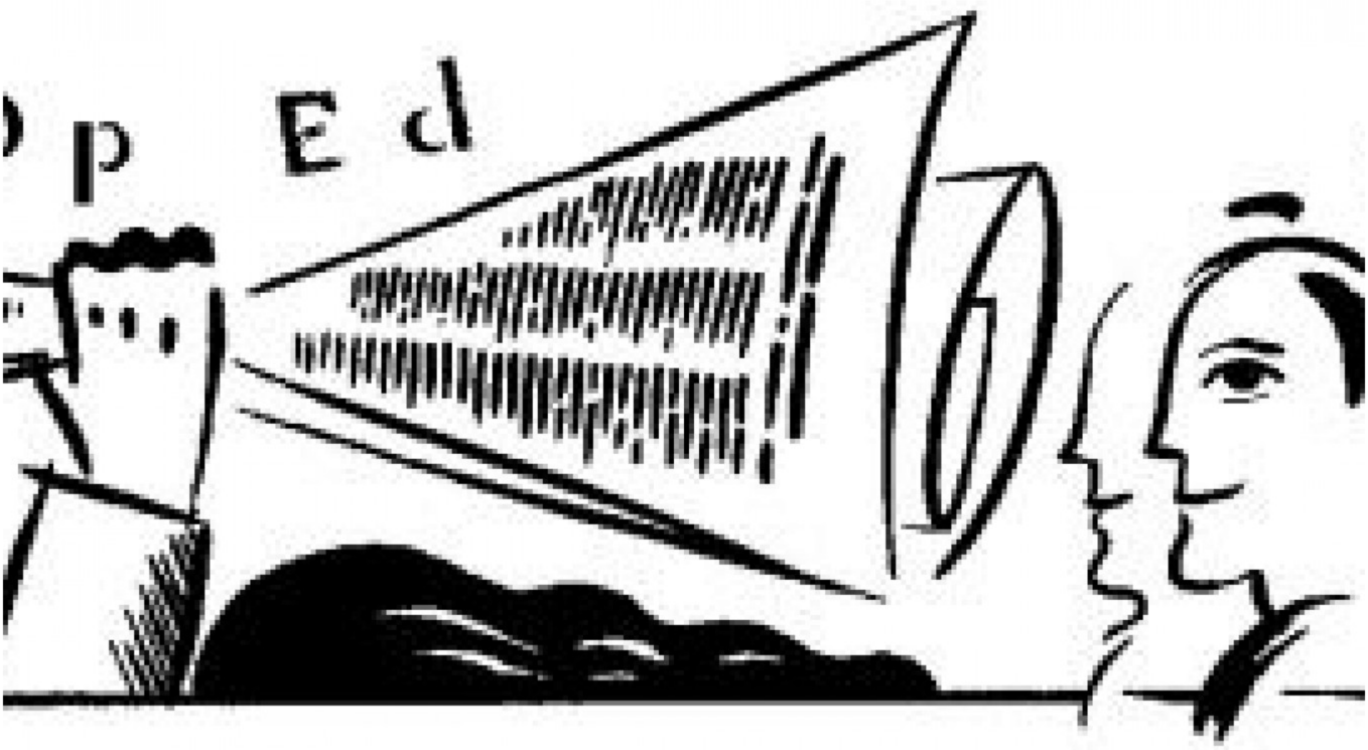

Russia is a part of the global economy and is being negatively affected by it. Miserable economic results out of the U.S., European Union and other economies dragged down the Russian economy. Will this slowdown continue?

A number of indicators suggest that growth and consumption can be maintained at steady, if lower, levels. Presuming the global economy muddles through, Russia will bounce along with many key indicators at 3 percent to 4.5 percent instead of 4 percent to 5.5 percent. At the same time, though, while the economy is decelerating in Russia, it will remain the best in Europe and one of the best globally.

The outlook for gross domestic product growth has deteriorated at the margins. Russian authorities have announced 2012 GDP growth at 3.4 percent. This is down from the 4.3 percent recorded in 2010 and 2011, but it is still a respectable number in the current global environment. The consensus view for 2013 GDP growth has fallen to 3.3 percent, but if oil stays above $95 a barrel, there is some upside risk to 3.7 percent.

But one needs also to be cautious in the medium term because of the possible effects of shale gas and fracking on global energy prices. One could argue that the GDP outlook for the next two years is going to be at about 3 to 4 percent, providing oil stays above $95 per barrel. But if shale gas trends bring down energy prices substantially by 2020, then the Russian economic outlook and business would suffer accordingly with GDP growth ranging from 0 to 2 percent.

This is a real threat, but China's growth, moderate U.S. expansion and cartel energy pricing could perhaps cushion prices. If energy prices do start to tumble, this could be an impetus for economic reform and diversification by the Russian government. But will they be up to the job?

As expected, most consumption indicators slowed through 2012. But on the plus side, unemployment is low and retail sales, with growth rates of between 5 percent to 6 percent, are still quite strong but lower than last year. Interest rates will stay stable at current levels but could be cut in spring or summer as inflation declines and GDP softens. Liquidity is still quite tight, but the Central Bank loosened up in recent weeks thanks to the strong ruble. The budget balance will stay close to zero with a small deficit this year and next, which may somewhat help support growth.

Consumer spending has been hit by rising inflation, which was at a 20-year low last spring of 3.5 percent and finished December year on year at 6.6 percent with core inflation excluding food and energy, under control at about 4.8 percent. During the first months of 2013 inflation could breach 7 percent, but the Central Bank predicts that inflation by summer should be down to 6 percent and finish 2013 at about 5.5 percent. On the whole, Russia's inflation risk looks acceptable.

Real wages after inflation have fallen recently as inflation rises and nominal rates decline against a slower industrial picture. Real wages slumped to just 0.3 percent in December year on year compared with 7.3 percent in November. This big falls stems from the fact that nominal wages slumped from a 14.2 percent increase in November to 6.9 percent in December. A 5 percent increase in real wages is expected this year, compared with 8.2 percent last year.

So does this presage a period of falling wages and consumption through 2013 at much weaker levels? Perhaps not, because today's comparison is with a high base figure from one year ago. What will happen with wages in the future? Low unemployment at 5.3 percent should logically keep wages and consumption up, although probably at lower levels than in the past.

Fixed investment weakened at the end of the year and went to negative 0.7 percent in December, but much of that could have been because of some of the coldest weather in 12 years. But investment was already weakening in the fall. In the short- and medium-term, investment ought to be helped by the Sochi Olympics in 2014 and the World Cup in 2018.

Here are the eight main reasons why the Russian economy is slowing:

1. Higher government spending at the end of 2011 prior to the presidential election.

2. Government social subsides slowed through the rest of 2012.

3. Administrative price increases and those for utilities were postponed from January to July

2012. As a result, inflation climbed from its 20-year low of 3.5 percent in spring last year to 6.6 percent in December.

4. Tariffs, taxes and utility fees were raised in January 2013.

5. Tight liquidity and relatively high interest rates curbed growth.

6. Growth was also brought down by a weak regional harvest.

7. Total new bank credits are slowing from a rate of 25 percent expansion last year to a still steady 15 percent this year and consumer credits at about 20 percent.

8. By spring last year, Russian exports were contaminated by slower European and global growth, which in turn brought down results in industry and investment, and this mirrors trends in most other European economies.

A growing number of corporate executives are now reporting a slowdown in business — nothing catastrophic but a visible deceleration. Companies will find it harder meeting targets. Some executives in Russia may have gotten caught in a "budget trap" last autumn when the outlook was stronger and find themselves locked into ambitious budgets. This has happened in Poland, Ukraine and Germany. The marketing director for one consumer product company in Russia reports: "We made our budgets for 2013 a few months ago, and essentially we are looking at 15 percent organic top-line growth until 2018. About four or five months ago, that seemed a challenge, but plausible. Now it just seems like a bigger challenge thanks to recent flat volume sales." As volume sales soften, companies continue to rely on price increases, as many consumer product firms raised prices from 6 percent to 7 percent in January. But for how long can price increases continue?

Some executives are waiting to see what the first weeks of this year bring. Was the end of the year just a bump or something worse?

In the business-to-business sector, business may be comparatively better. But here too, there is softening which appears inevitable given that exports are flat or negative and that industrial output has softened with industrial growth at 2.6 percent last year compared with 4.8 percent in 2011. The weaker number was attributable to stagnant hydrocarbon output, stiff competition from imported consumer goods and shallow investment demand. The business-to-business sector had already seen sales moderate from 33 percent in early 2011 to a range of from 14 percent to 20 percent today. Any further sustained softening though would be an added concern.

We could see business grow at a slower rate in 2013 than in 2011 and 2012, at a time when global headquarters is exerting more pressure for top- and bottom-line results. But compared with nearly all other markets, Russia is still attractive. If you don't believe that, then call a colleague in Prague, London or Cincinnati and listen to their hard-luck stories.

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