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It’s the economy, stupid

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Bill Clinton famously won the first of his two presidential elections using the slogan: “It’s the economy, stupid”. He recognised that while support for the first Gulf War had been strong, people were starting to focus much more on the poor state of the US economy and fearful about their jobs. The incumbent president, George Bush Snr, had mistakenly assumed that war euphoria would remain strong enough to carry him to a second term. British wartime prime minister Winston Churchill also found that out in 1945 when he finally ran out of war victory credits and lost the general election to the Labour Party, which had focused on jobs and social welfare reforms.

Is Russian President Vladimir Putin about to learn a similar lesson which, while not exactly costing him a re-election in March 2018, might substantially reduce his currently very strong majority support and lead to much less social and political stability during his fourth term in the Kremlin? Or, will the combination of growing public concern and weakening economy lead to a greater effort to calm the situation in eastern Ukraine, bring an early end to sanctions and finally put Russia on a more serious path towards long overdue reforms?

Cracking support

Throughout most of 2014, Russian public support for the government's stance in eastern Ukraine remained very strong. A majority of people initially supported even the absorption of the region into the Russian Federation, although that changed relatively quickly to support for independent statehood with close ties to Russia. But remember that was against a backdrop of a stable ruble, high oil and generally stable macro trends. That strong support for the Kremlin’s position on Ukraine has started to noticeably crack in recent months as the deteriorating trend in the economy has become much more noticeable. A growing percentage of the population are now less convinced the country is heading in the right direction, albeit a majority still does, and are focusing much more on the rising rate of inflation and on the fear of wage cuts or job losses. And they are certainly right to be concerned. The next three to six months will be awful in terms of economic indicators and that is bound to have an impact on public support for the government and the president.

Is Russia Headed in the Right Direction?

	Jan '14	Dec '14	Nov '14	Oct '14	August '14
Yes	55%	56%	59%	60%	66%
No	27%	27%	20%	23%	19%
Don't know	18%	18%	19%	17%	15%

Source: Levada Center

Russia’s economy managed to record modest growth of 0.5% for 2014 which, frankly, was a good result given the huge headwinds battering the country. As expected the growth in the consumer sectors, which have been the main engine of growth for most of the past dozen years, fell sharply to only 2.5% and investment spending, which expanded by over 6% two years earlier, contracted by 3.5% last year. The steady rise in the cost of borrowing, declining wage growth, rising inflation and the growing uncertainty over the future of the economy all combined to cut activity.

But against these negative trends, there was a positive in the form of import substitution. The sharply weakening foreign exchange value of the ruble and the block on some imported food from last August helped boost demand for locally produced goods. That helped the manufacturing sector grow relatively strongly in the latter months of the year, ending with full year growth of 2.1%.

Year of living dangerously

The trend for the next few months will be severely downwards. A contraction of up to 5% is expected in the current quarter and, possibly, for the first half year. Retail sales will be hit hard as the cost of servicing existing debt was pushed up even more by the Central Bank of Russia's decision to raise its Key Rate to 17% in mid-December, albeit it has pulled that back modestly to 15% since. Headline inflation was already at 15% by early February and seems destined to reach 20% in the coming months. The CBR will not cut its Key Rate again until convinced that inflation has peaked and is heading lower. That may not be until the mid-June policy meeting.

Last year real disposable incomes fell by 1% and that was the first contraction since 2000. This year that contraction will be larger, as nominal wage growth will be a lot lower than the expected inflation rate. Russian companies have a preference for cutting wages rather than jobs during times of crisis, albeit we are already seeing more of both since the start of 2015. Across the board, indicators are expected to be well down on last year, as already evidenced by the 25% cut in the volume of new vehicle sales in January when compared with the same month of 2014. That said, the trend in industrial production is expected to remain positive because of the import substitution effect plus the still fast rising spending in the defence modernization programme.

The oil price is the critical factor for the economy and the key determinant for the country's fiscal and monetary policies. However, sanctions, especially the block on accessing external credits beyond 30 days, are also hurting. Russia will do nothing to try to revive the oil price, but easing the financial sector sanctions later this year will help to stabilize the economy. Hence the greater impetus to try and achieve a peace deal in eastern Ukraine; the assumption probably being that if a deal can be achieved and peace holds, then there is a greater likelihood that the most damaging sanctions may not renewed by the EU when they expire on August 1. Although the US is expected to keep a tougher position, ie. especially by the candidates for the November 2016 election, the hope is that the White House may be pressured by the EU to at least ease on some restrictions if the war has stopped.

The forecasts in the table below represent our base-case assumptions. The core assumptions are that sanctions start to ease from the EU expiry date, albeit not entirely removed until mid 2016, and that the oil price tests the 2009 lows of $40 per barrel in the coming months but has a more solid rally in the autumn. A more optimistic scenario, based on financial sector sanctions easing earlier and oil staying close to the $60 per barrel level, is possible and would result in a stronger second half rally. Equally, the case for greater pessimism can be made and lead to a much larger contraction in the economy, also extending into 2016.

Russia: Macro Trends - Base Case

	2011	2012	2013	2014E	2015E	2016E	2017E
Growth, real % YoY	4.3%	3.4%	1.3%	0.5%	-4.0%	0.0%	1.5%
Industrial production, real % YoY	5.0%	3.4%	0.4%	1.7%	0.5%	2.5%	4.0%
CPI - year-end, % YoY	6.1%	6.6%	6.5%	11.4%	12.0%	8.0%	6.0%
Gross fixed investment, real % YoY	10.2%	6.0%	-0.3%	-3.5%	-10.0%	-2.0%	2.5%
Central Bank Key Rate, %				17.0%	12.5%	8.5%	7.0%
Retail sales, % YoY	7.2%	5.9%	3.9%	2.0%	-6.0%	0.0%	2.0%
Unemployment, % EOP	6.6%	5.7%	5.6%	5.2%	6.5%	6.0%	5.5%
Budget, balance % of GDP	0.8%	0.0%	-0.5%	-0.5%	-2.0%	-1.5%	-1.0%
Current account, % GDP	5.1%	3.7%	1.6%	3.0%	2.5%	1.8%	2.0%
RUB/US$, year-end	31.4	30.8	32.9	63.1	70.0	55.0	50.0
RUB/EUR, year-end	41.5	40.3	45.3	72.0	77.0	60.0	55.0
Urals, US$ p/bbl, average	$109	$110	$108	$100	$50	$70	$80

Source: State Statistics Agency, Central Bank, Macro-Advisory estimates

Survival mode

Right now the Kremlin is in what can best be described as survival or damage limitation mode. The CBR's Monetary Policy team has been restructured, which along with some administrative changes in the ruble market, should help prevent a repeat of the volatility seen late last year. The Finance Ministry has provided RUB1 trillion to support the banking system, which may not be enough but is a strong commitment to prevent a crisis. Almost 200 companies have been designated as strategically important, which means that they can get fast access to state support should they need it. Inevitably, many companies will have financial problems this year but the bigger companies should not. Survival mode can only go so far of course. The actions taken, and others expected in the next few months, should prevent a credit crisis or a collapse in the important industries. There is enough money in reserves to allow for that if managed efficiently. But by late spring or summer the pressure will have grown for a more effective response if, by then, there is not a clearly improving trend in key indicators such as inflation and interest rates, and stability in the ruble market. The table below shows that while most people are not interested in taking part in street protests, a rising number believe that these are possible if the trend in the economy continues to weaken.

The next parliamentary elections will take place in December next year. If the poor state of the economy and low confidence in the government's management is not to dominate that election, there needs to a more effective response later this year. A greater effort to bring peace to eastern Ukraine and, hopefully, an easing of sanctions later this year, are at least part of the required response.

Public view of Protests

	January '15	Autumn '13
Street protests are possible in Russia today	27%	14%
Would not take part personally	77%	
Protests are a viable freedom of expression	23%	36%
Protests are not a viable mode of expression	33%	22%

Source: VTsIOM