Waiting for Oil Recovery is not an Option this Time

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Any discussion about Russia quickly reveals a greater degree of polarization in opinions than is the case with most other topics. In relation to Ukraine a majority of people have a firm view of Russia either as the aggressor or as a wronged party with a legitimate grievance. The same applies to discussions about the economy and how the current crisis will change the country and either destroy the investment case or make it better. The pessimists are as convinced that the data confirms Russia to be little more than an occasional hydrocarbons lottery winner, as the optimists are that the crisis marks an important transition which will force the country to start dealing with long ignored problems and allow it emerge with a more sustainable development model.

A lot of that discussion is still based on scenarios yet to play out and multiple "what-ifs?" But if we take out the emotional element and cut though the considerable noise which regularly shrouds the facts – good and bad – a reasonably clear picture is emerging of where the country is today and of the actions, mostly encouraging, which are being taken to position the economy for recovery.

President Putin and senior government officials have been quite vocal with the message that the country has survived the crisis and that the worst of the downturn was recorded in the 2nd quarter. To say that the economy has reached a bottom and that the dire predictions widely touted late last year, i.e. of a near double-digit recession and severe credit problems, have been avoided is correct. But that is a long way from assuming the economy has bounced off the bottom and entered a recovery phase. It clearly has not and will only do so if effective actions are taken by government. The backdrop to the current recession is that the economy had already started to slow significantly from the middle of 2012. In 2013 GDP expanded by only 1.3 percent, or less than one third the level of two years earlier, and despite the fact that the price of Urals crude average close to $110 per barrel. It means that an oil price rebound will not restore growth. That phase of the economy is over.

GDP contracted by 2.2 percent, year-on-year, in the 1st quarter of this year and the decline for the 2nd quarter has been preliminary estimated at 4.6 percent. That is the same estimate for the decline in July and, hence, the assumption that a bottom has been reached. The main drag on the economy has been the over 9 percent decline in retail sales, which roughly mirrors the decline in real wages this year, and equally big contractions in the construction sector and in capital investment by companies. The reason for those big hits are a combination of the prevailing high interest rates through the first six months of the year, the difficulty in accessing new debt as the big corporations hog the available financial resources to the exclusion of individuals and small to medium sized enterprises (SMEs), continuing high inflation and low confidence.

One layer beyond the statistics is the fact that the low average oil price and the impact of financial sector sanctions continue to squeeze the availability of liquidity and undermine the currency and confidence. Going out one further layer shows the reason why the oil price and sanctions have had such an impact is because the economy has remained too dependent on hydrocarbon wealth and external financing and has made too little progress in improving the business or investment climate.

It is very likely that the 3rd quarter numbers will be equally as bad as the 2nd but should be no worse. The Central Bank (CBR) has cut its benchmark key rate from 17 percent at the start of the year to 11 percent in July and that should help ease pressure on households and SMEs in the 2nd half. The 4th quarter numbers will also show improvement if for no other reason than the base-effect with the weak 4th quarter of last year.

It means the economy is still on track for a full year decline in the range 3.5-4.0 percent and for flat to modest growth in 2016. That's still a long way from talking about recovery. The reality is that growth will remain in very low single digits until the country can again access international debt markets and the government starts to force through remedial and growth orientated programmes.

The country's credit position has also stabilized and there are no longer any concerns about the ability to service external obligations or to cover a modest budget deficit. Officially the country's banks and industrial companies need to pay $110 billion to external creditors in 2015 and 2016. But that number nets down to just over $50 billion for both years when ruble debt and inter-company offshore payments are netted off. That is roughly the size of the current account surplus while the capital outflow has also fallen to roughly equate to debt payments and foreign worker remittances.

The key assumptions supporting that position of no credit risk is that A) the federal budget deficit can be cut to closer to 1 percent of GDP in 2016 and 2017, from a planned deficit of 2.5 percent for this year, and B) the government does not use its cash reserves for anything else. This is also consistent with the survival or damage limitation policy we see from government.

A move to a recovery phase with spending allocations for growth projects will have to wait until the financial sector sanctions start to ease and the Kremlin is confident that it can start to use resources other than for stability programmes.

But against that somewhat depressing backdrop, there is encouraging evidence that the government is more focused on using this crisis period as a catalyst to make real changes and to deal with long-talked about but, so-far, ignored structural problems in the economy.

The most obvious policy shift is towards the ruble. After fifteen years of supporting a strong ruble policy the CBR has now firmly moved to a weak ruble policy. In the aftermath of the 1998/99 crisis the ruble become something of a bellwether of the state of the economy and it was relatively easy to maintain that position up until 2013 as oil and gas revenues grew. In 2008/'09 and again in 2013/'14 the CBR burned though billions of dollars of its reserves supporting the ruble. That changed late last year as efforts to defend the ruble became obviously futile.

By May of this year the changed policy was confirmed when the CBR said that it would effectively stop the ruble from rallying past 55 against the dollar (should the oil price recover) by re-building it foreign exchange reserves and also that it would not intervene to support the ruble as oil weakens further. We saw that latter point proven in August as the ruble weakened to 70 against the dollar as oil fell below $50 per barrel. The reasons for the this major policy shift are;

- The weaker ruble helps counter-balance the weaker oil revenues in the budget and it means that the deficit is more easily contained
- There was very clear evidence that the weak ruble helped boost demand for domestic goods and services in the 1st quarter and helped sharply cut imports, thus also helping the current account surplus
- There was no increase in capital flight as a result of the latest ruble decline. The actual reason is that all nervous money has long since flown the country.

The weak ruble is now the cornerstone of the government's import-substitution policy which aims to cut imports of basic goods and services, such as food and medicines, and also the plan to try and make Russia a more competitive manufacturing base to boost export growth.

This focus on basic industries, such as import substitution the food, medicines and machinery sectors is also more encouraging than the often vague talk of reforms or modernization we heard in previous years. It is much more basic and achievable. The more competitive ruble and the move away from entitlement to automatic real wage growth in the public sector which adversely hurt the cost base in the private sector, is a critical factor for that industrial policy to work. The fact that President Putin views this more as a national security issue as much as good economics doesn't matter. It is a viable way forward to create diversification, reduce imports and to start increasing exports beyond extractive industries.

While the 180 degree turn in monetary policy is an encouraging response and shows that the Kremlin will take the necessary tough decisions when faced with no other choice, a lot more needs to be done before we can start to be optimistic that this particular crisis, which started to unfold in mid-2012 and was only accelerated with weak oil and financial sector sanctions, will be the turning point for the economy that businesses and investors have bene hoping for. Avoiding the opaque talk of reforms, there are some more practical problems which need to be resolved. Included at or near the top of that list are;

- Pension system reform is the proverbial elephant in the room. The increasing annual deficit between receipts and payments is already a big burden on the federal budget and it is getting worse. It is absorbing cash which will either have to be raised with higher taxes in the future or it is diverting money from investment programmes. It is very clear that there needs to be a change in the retirement age (politically unpalatable until after the March 2018 presidential election) and in the way pensions are funded and managed. The dispute over what should be done and what has or has not been done has cost a few senior officials their jobs, most notably former Finance Minister Alexei Kudrin in late 2011.
- One other advantage of addressing the pensions issue is that by adopting international practice Russia can finally start to build a meaningful pool of domestic capital which would be available to fund start-ups and expansion of profitable businesses. It could help the government get back on track with the defunct privatization programme. Selling equity in state assets to domestic pension funds would be a lot more acceptable than selling to foreign investors. One of the reasons why Russia's stock market is thinly traded, is so volatile and has a persistent valuation discount is because it is only a fringe market for global investors and has no meaningful domestic investor base.
- The banking system is long overdue an overhaul, albeit there has bene more progress and greater discussion about the need for changes over the past twelve months. The CBR has cut up to 150 bank licences since the start of 2014 but about 400 more need to go to bring the number down to 300 licenced banks. The top 100 banks carry out almost 95 percent of all banking transactions in any event. The process of further consolidation, also within the biggest banks, is expected to pick up pace when the CBR adopts proposed tougher risk measures and capital requirements. The banking system, ex Sberbank, was given an injection of over $15 billion at the start of the year from the Finance Ministry (Sberbank is directly funded, if required, from the Central Bank) and estimates suggest it may need a similar injection before the end of the year as the full damage to bank balance sheets and NPLs is starting to emerge.
- Other significant issue in terms of economic development is that the state sector has actually got bigger over the past two years and, according to some estimates, now represents about 60 percent of GDP. The SME content is now thought to be only 20 percent. Clearly the economy cannot achieve its potential or recover to sustainable mid-range growth without conditions which allow and support growth amongst SMEs and in parts of the economy outside of state dominance.

To summarise the position of Russia today we can use the analogy of somebody having carelessly slipped off a cliff but is now resting on a comfortably wide ledge. But it cannot stay there for very long and now must decide how to climb back to the clifftop while avoiding falling to the rocks below. Recovery is perfectly feasible with time, determination and the right carefully planned steps.