Association of European Business

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Preparing for the Next Phase

Challenges & Opportunities for Investors

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Summary

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- The economy is drifting out of recession but needs an additional growth driver to pull out of low growth phase. Oil is not enough.
- That new model is "localization" or "competitive economy".
- For this to work Russia needs the active participation of foreign companies, either as full owners or as part of JVs
- For that to happen on a large enough scale, the start of staged reductions in financial sector sanctions is important, for reputational and risk perception reasons.
- Investment from China, associated with the expanding ***One Belt, One Road*** project, is building slowly and should pick up in 2017
- If the government cannot get the economy back to strong growth then there may be social-political consequences in several years.

Big picture

- **Domestic:** Having been very focused on geopolitics for much of the past 15 years, the priority is now shifting to the domestic economy - strategies to create growth & diversification
- **Slower Future:** There cannot be a return to the previous boom. But, with the right policies and an end to intense geopolitical distractions, the economy may slowly return to more modest and sustainable growth.
- **Ruble:** Regardless of whether the oil price rises, ruble appreciation will be blocked because it is the key element in the competitive economy.
- **Conservative:** One legacy of the crisis will be a conservative approach to future borrowing and spending. There will be no splurge, even with higher oil revenues.
- **Diversification:** The key political strategy is diversification in relationships and to avoid over-reliance on any one country or block.
- **Stable:** There is no reason, based on all current evidence, to fear any threat of domestic social or political instability

Key Assumptions

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- **Oil**: The price of Brent to average $54 p/bbl in 2017 and $65 p/bbl in 2017. US production will rise faster with oil above $55 and that will limit the upside this year. The downside is protected by Saudi determination to prevent sub-$50 oil
- **Sanctions**: No change in 2017 by either the US or EU. But we should see the start of a limited staged-reduction in 2018. For Russia the important sanctions are the financial restrictions, not because of debt access, but because of reputational risk.
- **Geopolitics**: 2017 should be a lot calmer. Syria is expected to remain calmer and while the Trump administration is not expected to "do any favors" for Russia it should also not seek to escalate. The EU will be fully internally distracted. Ukraine is more likely to have to deal with an overdue political crisis.
- **Discipline**: Budget spending discipline to be maintained even if oil revenues spike.
- **Flexibility**: The same policy flexibility we saw since 2014 should remain as and when required.
- **Kudrin:** Alexey Kudrin has a powerful/influential role in the next term

Threats

- **NATO**: Russia is not expected to initiate any fresh confrontations with the West. But with NATO building a presence near the Russian border a confrontation cannot be ruled out. Poking the bear will get a predictable reaction.
- **Trump**: Given President Trump's his lack of experience and acknowledged unpredictability, it is impossible to rule out a 180 degree turn in his Russia policy.
- **Ukraine**: While Moscow is actively seeking to avoid escalation and to try and keep Donbass calm, confrontation could occur for any number of reasons and delay further any sanctions relief.
- **Oil price**: A faster recovery in US production plus a rapid recovery in Libya and Nigeria would place Saudi under a lot of pressure to cut more. If it did not then the price could dip below $40
- **Internal**: A threat to Putin's position from disaffected Siloviki or others within the governing elite, who do not like the direction the country is going
- **Banks:** If Russian banks have to deal with a bigger bad debt problem, this would keep the lending market tight and delay recovery

Domestic Politics

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- 2017 is expected to be a year when preparations for Putin's next term will be completed
- The big personnel changes within the state agencies and amongst governors are probably over
- There is a believe that senior government positions will change at the start of the next Presidential term, e.g. prime minister
- The September Duma election showed that the election process is now back under control and previous problems are fixed
- No evidence of any support for opposition candidates and no appetite for protests
- But, surveys show a growing frustration with the economy and the slow pace of recovery

International Politics

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- The view is Moscow is that the Trump Administration will be more pragmatic and should not seek to escalate any tensions with Moscow…
- ….but the official government position is that while the situation should not deteriorate there is no reason for any quick favors
- The legacy of a bitter election campaign and Russia’s alleged role, will take a long time to overcome
- Moscow views the political challenges in the EU this year to be potentially more important
- No reason to expect any Russia initiatives in Donbass. Moscow appears to be waiting for changes in Europe (to then press Kyiv) or for early elections in Ukraine
- Russia’s stated policy now is political diversification

Sanctions

- It is becoming more difficult for the EU to get a full consensus each time
- The EU faces multiple internal challenges in 2017, the course and outcome of which will impact sanctions relief timing
- Crimea sanctions will remain indefinitely but in the long run they do not matter
- Moscow does not think the Trump administration will make an early move on sanctions because of Congress opposition.
- A great deal will also depend on the outcome of the French and German elections…will Merkel still be Chancellor?
- Our forecasts assume no sanctions change until after March 2018

Medium Term Forecasts

- Economy to decline by between 0.6% and 1.0% in 2016 but should recover to growth of +1.5% to 2.0% in 2017
- Inflation is expected to end this year close to 8.0% and fall to 5% by end 2017
- The CBR should cut its Key Rate to 8.0 or 8.5% by end 2017
- Real disposable income and retail sales to show 2% growth in 2017
- Unemployment can stay under 6% in the winter
- The budget deficit should have ended 2016 at 3.5% of GDP and be cut to 2.5% in 2017
- Depending on oil revenues, it is likely there will be a budget revision mid year

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Better Balance Sheet

- Russia's total external debt has fallen from $740 bln, in early 2015, to just under $500 bln in mid 2016. Total external sovereign debt is just over $40 bln
- CBR has been rebuilding FX and gold reserves, which stand at close to $400 bln today
- External debt repayments totaled $27.4 bln in 2016 from $60 bln in 2015
- Capital outflow was $15.4 bln, down from $57.5 bln in 2015
- The Reserve Fund may be depleted by end 2017. But there are other funds to be tapped into. There will not be a funding crisis

Medium Term Outlook

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Russia: Macro Trends & Medium Term Forecasts   Base Case

	2012	2013	2014	2015	2016E	2017E	2018E	2019E
GDP, RUB bln, nominal	62,511	63,800	70,970	81,530	87,074	92,386	97,929	104,098
GDP, US$ bln	2,010	2,000	1,850	1,315	1,300	1,490	1,554	1,627
Growth, real % YoY	3.4%	1.3%	0.6%	-3.7%	-0.6%	1.5%	1.8%	2.4%
CPI - year-end, % YoY	6.6%	6.5%	11.4%	12.9%	5.4%	4.4%	4.0%	3.8%
CPI- average, % YoY	5.1%	6.8%	7.8%	15.6%	7.4%	4.6%	4.2%	3.9%
Gross fixed investment, real % YoY	6.0%	-0.3%	-3.5%	-8.4%	-2.2%	2.0%	3.5%	4.0%
Industrial production, real % YoY	3.4%	0.4%	1.7%	-3.4%	0.8%	2.0%	3.0%	4.0%
Agricultural output, % change YoY	-3.6%	3.1%	1.2%	3.5%	2.9%	2.8%	3.0%	3.2%
Central Bank Key Rate, %			17.0%	11.0%	10.0%	8.5%	7.0%	6.0%
Bank average lending rate, %	9.1%	9.5%	11.3%	16.0%	13.0%	10.0%	8.5%	7.5%
Retail sales, % YoY	5.9%	3.9%	2.5%	-10.0%	-5.0%	2.0%	3.0%	4.0%
Real disposable income, % YoY	7.3%	4.8%	-1.0%	-6.5%	-5.0%	1.0%	2.0%	3.0%
Unemployment, % EOP	5.7%	5.6%	5.3%	5.6%	5.4%	5.5%	5.4%	5.3%
Budget, balance % of GDP	0.0%	-0.5%	-0.5%	-2.4%	-3.2%	-2.3%	-1.5%	0.0%
Current account, % GDP	3.7%	1.6%	3.0%	5.3%	1.7%	1.9%	1.9%	2.0%
RUB/US$, year-end	30.8	32.9	61.4	73.5	61.3	63.0	64.0	66.0
RUB/US$, average	31.1	31.9	38.6	62.0	67.0	62.0	63.0	64.0
RUB/EUR, year-end	40.3	45.3	72.0	79.7	64.5	65.0	68.0	70.0
RUB/EUR, average	40.0	42.3	51.5	67.0	74.0	64.0	67.0	68.0
Urals, US$ p/bbl, average	$110	$108	$100	$54	$45	$54	$65	$75

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

Scenarios

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- We use scenario analysis for our forecasts and update the mix in our Macro Monthly report. This is the Base Case Scenario
- We will publish a detailed 5 year and a general 10 year outlook for Russia in early 2017

Scenarios for the Economy 2017-19

	2015	2016E	2017E	2018E	2019E	2017E	2018E	2019E	2017E	2018E	2019E
			Optimistic Scenario			Base Case			Pessimistic Scenario		
GDP, US$ bln	$1,315	$1,300	$1,569	$1,696	$1,803	**$1,490**	**$1,554**	**$1,627**	$1,458	$1,488	$1,515
Growth, real % YoY	-3.7%	-0.6%	2.0%	2.5%	3.0%	**1.5%**	**1.8%**	**2.4%**	0.7%	1.1%	0.9%
CPI - year-end, % YoY	12.9%	5.4%	4.0%	3.5%	3.0%	**4.4%**	**4.0%**	**3.8%**	4.5%	4.0%	3.8%
Central Bank key rate, %	11.0%	10.0%	8.0%	6.5%	5.0%	**8.5%**	**7.0%**	**6.0%**	9.0%	8.0%	7.0%
Bank average lending rate, %	16.0%	13.0%	10.0%	8.0%	6.5%	**10.0%**	**8.5%**	**7.5%**	11.0%	9.5%	8.0%
Retail sales, % YoY	-10.0%	-5.0%	2.5%	4.0%	6.0%	**2.0%**	**3.0%**	**4.0%**	1.5%	2.5%	3.0%
Real disposable inc., % YoY	-6.5%	-5.0%	1.5%	3.0%	4.0%	**1.0%**	**2.0%**	**3.0%**	0.5%	1.0%	1.5%
Unemployment, % EOP	5.6%	5.4%	5.5%	5.4%	5.3%	**5.5%**	**5.4%**	**5.3%**	5.7%	5.5%	5.4%
Budget, balance % of GDP	-2.4%	-3.2%	-1.5%	-1.1%	0.5%	**-2.3%**	**-1.5%**	**0.0%**	-3.1%	-2.5%	-2.0%
Current account, % GDP	5.3%	1.7%	3.0%	3.4%	3.6%	**1.9%**	**1.9%**	**2.0%**	2.4%	2.7%	2.9%
RUB/US$, year-end	73.5	61.3	58.0	59.0	58.0	**63.0**	**64.0**	**66.0**	64.0	66.0	68.0
RUB/US$, average	62.0	67.0	59.0	58.0	58.0	**62.0**	**63.0**	**64.0**	63.0	65.0	67.0
Urals, US$ p/bbl, average	$54	$45	$65	$75	$85	**$54**	**$65**	**$75**	$48	$56	$63

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

Confidence will be a big factor

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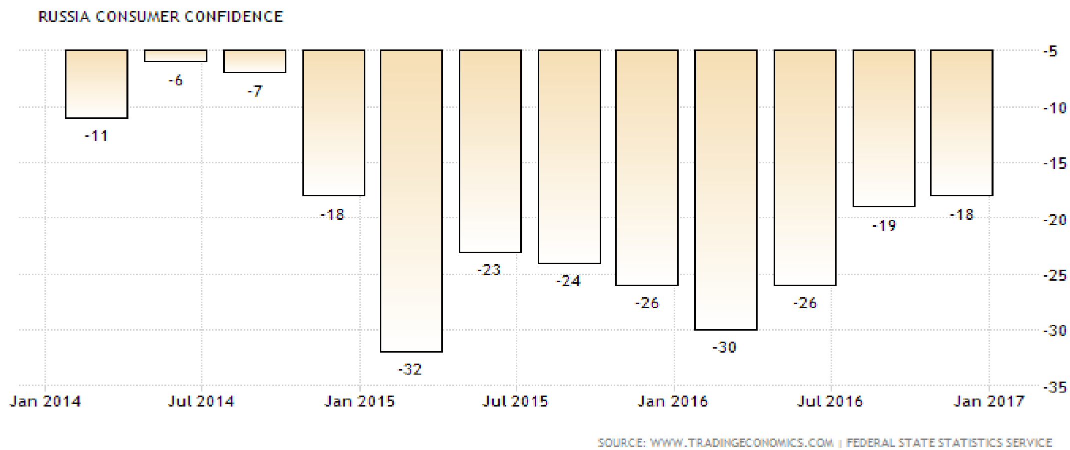
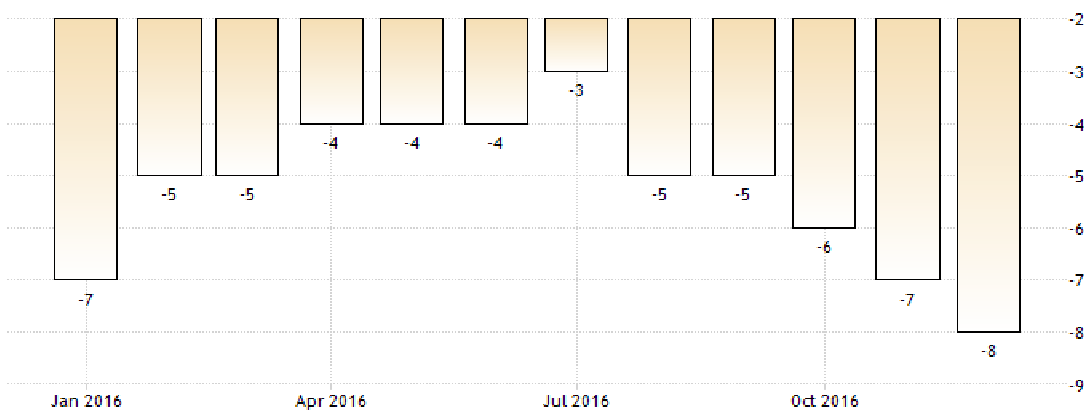
Consumer Confidence Has Been Badly Hurt and Will Take Time To Recover



Source: Tradingeconomics.com, Federal State Statistics Service

Business Confidence – Very Far From Convinced That Better Days Are Coming



Source: Tradingeconomics.com, Federal State Statistics Service

Weak Ruble for Longer

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❑CBR will allow the ruble to fall with a lower oil price. This allows:

- *The CBR to preserve FX reserves*
- *The MinFin to better control the budget deficit*
- *The government to push its localization strategy*
- *More competitive domestic industries*

❑Despite oil price rise, the ruble-dollar rate should be capped near R60 and the oil surplus will be diverted into building FX reserves

❑A weaker for longer ruble is at the core of the emerging localization or competitive economy strategy and has been publicly supported by Putin

Ruble-US Dollar Exchange Rate – Past Two Years

Source: ExchangeRates

Budget – Fiscal Rule

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Finance Ministry Federal Budget Projections 2017-19

	Spending & Revenue Assumptions			Deficit	
	Revenues Trln Rub	Spending Trln Rub	Deficit Trln Rub	US $ ln	% of GDP
2016 (E)					-3.7%
2017 (F)	13.49 ₽	16.24 ₽	2.75 ₽	$40.7	-3.2%
2018 (F)	14.03 ₽	16.09 ₽	2.06 ₽	$30.0	-2.2%
2019 (F)	14.85 ₽	15.95 ₽	1.10 ₽	$15.5	-1.2%

Source: Ministry of Finnace, Macro-Advisory

Federal Budget Projections 2017-19, based on $53 p/bbl Oil

	Spending & Revenue Assumptions			Deficit	
	Revenues Trln Rub	Spending Trln Rub	Deficit Trln Rub	US $ ln	% of GDP
2016 (E)					-3.7%
2017 (F)	14.50 ₽	16.24 ₽	-1.74 ₽	-$25.8	-2.0%
2018 (F)	15.00 ₽	16.40 ₽	-1.40 ₽	-$20.4	-1.5%
2019 (F)	16.00 ₽	15.95 ₽	0.05 ₽	$0.7	0.1%

Source: Ministry of Finnace, Macro-Advisory

Finance Ministry Federal Budget Macro Assumptions 2017-19

	Key Finance Ministry Assumptions				
	Average Oil $ p/bbl	Inflation Average YoY	Ruble-US$ E.O.P.	GDP Growth % YoY	GDP Nominal US $ bln
2016 (E)	$45.0	7.5%	63.0 ₽	-0.6%	
2017 (F)	$40.0	4.0%	67.5 ₽	0.6%	-$1,273
2018 (F)	$40.0	4.0%	68.7 ₽	1.7%	-$1,363
2019 (F)	$40.0	4.0%	71.1 ₽	2.1%	-$1,289

Source: Ministry of Finnace, Macro-Advisory

Oil Outlook & Impact

- Oil taxes contributed approximately 35% of total budget revenues in 2016… oil & gas combined at under 50%
- Russia surprised by backing OPEC's cut initiative. But implementing the cuts will be very difficult
- Saudi appears to be targeting an oil price in the mid $50s for 1H17, a favorable backdrop for the planned IPO of Aramco.
- US Shale is now the default swing producer – the assumption is that at $55 p/bbl or better then volumes will be restored quickly
- Price support may not last long after 1Q17:
  - Libya is targeting 900,000 bbl/d in 1Q17 from 300,000 bbl/d
  - Nigeria may be able to regain control over the Delta and restore exports
  - Kashagan is finally producing and exporting
  - US Shale

Kudrin's Agenda

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- Former Finance Minister Alexei Kudrin says he would only accept the role in the Economic Advisory Council "if the President supports his program"
  - Pension reforms … to cut the burden on the budget
  - Retirement age … raise it by 5 years to EU norm
  - Budget spending … cut back some expensive projects
  - Taxation changes … expect a new sales and personal taxes
  - Privatizations … a more aggressive approach
  - Regional budgets … reduce subsidies
  - State sector subsidies …. To cut support for inefficient bodies
- It is clear that none of this is possible until:
  - After the March 2018 election
  - Financial sector sanctions start to ease

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… and to manage expectations both internally and with Head Office and with investors and partners

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