

## Economics

13 December 2011 | 9 pages

# Russia Macro View

## 2012: Oil Resistance Could Soften Growth Deceleration, but Political Risks Are on the Rise

- **Citi raised its oil price expectations for 2012** — As discussed in [Oil in 2012 – A Year of Tail Risks \(12 Dec 2011\)](#), we now expect Brent to trade in a range of \$100-\$120/bbl and to average \$110 for the year in the base case. Oil prices are already close to the pain threshold for the global economy, and we think around \$120/bbl is a reasonable estimate of a sustainable ceiling. Short-term spikes to as high as \$150/bbl are possible but unlikely and would be unsustainable, in our view. At the same time a price around \$70/bbl looks like a cost support price.
- **Meanwhile, [the era of political stability in Russia appears to be over](#)** — The developments ahead of the Presidential elections on 4 March are hard to call. Events are likely to develop rapidly and there is now a wide range of scenarios. We believe political uncertainty will mean capital outflows and weigh on investment activity.
- **Russia's growth likely to remain consumption driven.** — In a baseline scenario of a Brent oil price between US\$110-20/bbl Russia is likely to enjoy growth of about 3.5% next year. Consumption is set to remain the primary driver of GDP at 4-5%.
- **CBR likely to consider rate cuts as inflation trends down.** — We forecast average inflation to decline in 2012, with CPI growth touching 6% at the beginning of next year. Given risks to growth and decelerating inflation, we expect the CBR to consider a repo rate cut in early 2012 when the ruble usually gets support from a seasonally stronger trade balance.
- **Political situation pressures ruble** — We believe political uncertainty will put pressure on the ruble, in addition to global financial turmoil and a potential decrease in the oil price. We expect the ruble basket at 36-37 in 2012 under the base case. On the other hand, if financial market volatility falls off and the oil price exceeds US\$120, we think the basket could strengthen to 33-34 by mid-2012.

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*With thanks to*

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**Figure 1. Macro scenarios 2012**

Average oil price, USD bbl	Low case	Base case	High case
	<b>\$80-90</b>	<b>\$110-120</b>	<b>\$130-150</b>
GDP, %YoY	2.5	3.5	Above 4
CPI, avg %YoY	6.8	7.2	Above 8
Ruble basket	37-38	36-37	33-34

Source: Citi Investment Research and Analysis

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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## Scenarios 2012

### Oil forecast raised to US\$110/bbl

**We now expect Brent to trade in a range of \$100-\$120/bbl and to average \$110 for the year in the base case** (see note from our commodity team [Oil in 2012 – A Year of Tail Risks \(12 Dec 2011\)](#)). Oil prices are already close to the pain threshold for the global economy, and we think around \$120/bbl is a reasonable estimate of a sustainable ceiling. Short-term spikes to as high as \$150/bbl are possible, but unlikely and unsustainable, in our view. At the same time a price around \$70/bbl looks like a cost support price. Going forward, our global supply and demand balances are moderately bearish for 1Q12, as is the revised price outlook, but from then on Citi's commodity team expects stronger balances and prices. Our analysts are not very optimistic on oil demand growth, modeling just +0.8-mb/d in 2012 and +1-m b/d in 2013, based on Citi's global GDP expectations of 3% and 3.6% (PPP-adjusted) respectively. They are, however, optimistic on supply, forecasting 1.1-m b/d of non-OPEC supply growth. Coupled with the return of Libyan production this would require a cut by OPEC of some 500-k b/d if they want to keep the market tight and prevent a return to inventory builds.

### But political uncertainty has increased

**If the era of political stability is over, political uncertainty will likely support capital outflows and weigh on investment decisions.** On 10 December, an estimated 50,000-100,000 people in Moscow demonstrated for free and fair elections and PM Putin's resignation ([Russia macro flash, 12 Dec 2011](#)). This is 10 times more than expected by most analysts only a few days ago. Demonstrations look set to continue (next planned on 24 December). The Opposition has until 19 January to collect the 2mn signatures required to propose a candidate for the Presidential elections, but Mr. Putin's return is not yet in doubt, we believe. At the same time, the developments ahead of the Presidential elections on 4 March are hard to call. Events are set to develop rapidly and there are now a wide range of scenarios possible.

**Weaker growth and fiscal constraints will limit the ability of authorities to increase social spending, but throwing money at the problem will not help anyway,** in our view ([Global Political Insights - From Arab Spring to Russian Winter, 7 Dec 2011](#)). Russia's middle class has emerged as a new political class and is unlikely to be appeased by higher social spending. We see their demands as more nuanced and far-reaching – free elections, rule of law, and a fight against corruption. Furthermore, economically their interests often do not overlap with that of a broader population, which may have favored higher government spending in return for limited opportunities.

### Russia's growth likely to remain consumption driven

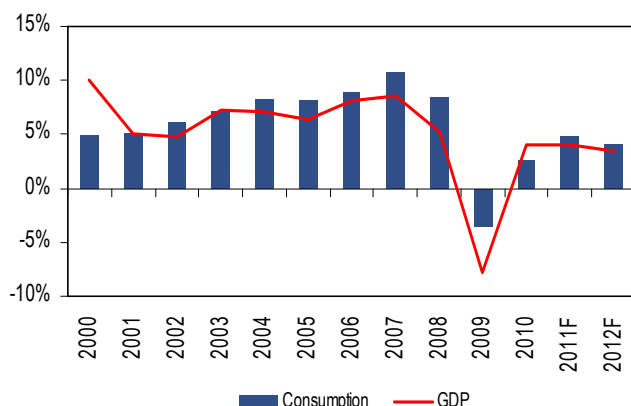
**Uncertain growth prospects and increased political risks will weigh on investment activity next year, we think.** GDP growth picked up to 4.8%YoY in 3Q11, due to the low 2010 base, recovery in investments and robust consumption. Agricultural production was up 14.6%YoY and construction activity grew about 7%YoY, as compared to fall of 20%YoY and 2% in 2010 owing to widespread forest fires. While the low base effect will likely to come to nothing at the end of 2011, there are few incentives for production or investments to accelerate in the near term given tight liquidity conditions and growth uncertainty. In 2012, industrial growth will be concentrated in budget-financed military sectors.

### Consumption likely to remain the primary driver of GDP at about 4-5%<sup>1</sup>.

Household spending is generally a lagging business-cycle indicator, and we forecast it to support economic growth in the beginning of 2012, but the aftermath of the slowdown to affect consumption by 2H12, after less generous budget spending following the presidential elections in March 2012. The current Federal budget's projects are based on an assumption of a \$108/bbl oil price, and consumption stimuli have already been announced for 1Q12: the government will raise military and police wages by 2.5-3x and military pensions will increase by 1.6x. Furthermore, Russia plans to increase military spending by US\$640bn over the next 10 years. We expect the program to weigh on budget-financed investments as well as on wages and social spending in general, subsequently impacting consumption.

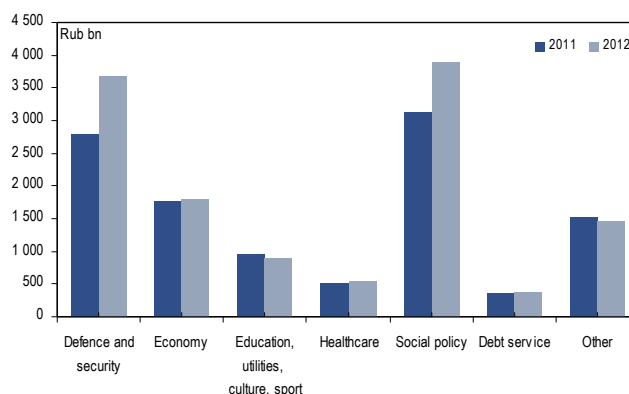
**In our baseline scenario of a Brent oil price at US\$110-120/bbl we expect Russia to enjoy growth of about 3.5% in 2012.** The Russian economy is sensitive to oil, with a break-even oil price for the budget and current account standing at US\$115 and US\$75 per barrel, respectively. We forecast GDP to decelerate from 4% to 2%YoY by end-2012 if the oil price touches US\$80/bbl.

Figure 1. GDP likely to decelerate next year, but remain consumption driven



Source: Haver, Citi Investment Research and Analysis

Figure 2. 2012 budget is more about spending



Source: MinFin, Citi Investment Research and Analysis

## Rate cuts are likely as inflation trends down

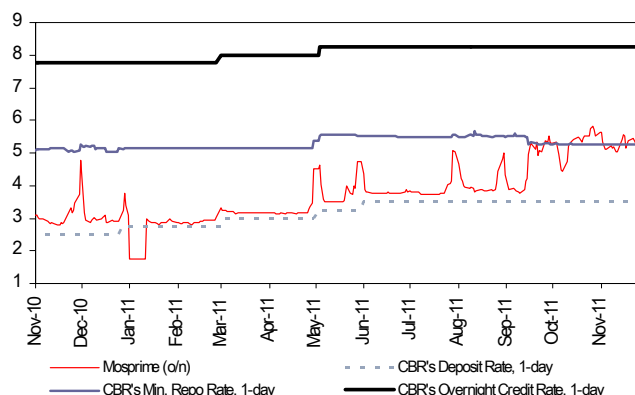
**CPI inflation could decline to about 6% in the beginning of 2012.** Headline inflation decelerated below expectations to 6.8%YoY in November as a high base effect in food prices helped the CPI basket to grow at 0.4% MoM last month. This trend seems set to continue in December. And we expect CPI inflation could come close to 6% at the beginning of 2012, as adjustments to state-regulated prices were postponed to July and some Russian producers started to cut petrol prices ([Russian gasoline pump prices declining](#)). Stable or declining oil prices should help to restrain PPI growth, which should help to limit CPI inflation counterbalancing the boost from inflation due to currency depreciation.

**While money market rates will likely remain elevated, we do not rule out a cut to the refinancing rate at the end of December.** Liquidity is likely to remain tight in the medium term if the CBR continue to support the ruble.

<sup>1</sup> [Russia Macro View: Consumption to remain strong, for now... \(21 Oct 2011\)](#)

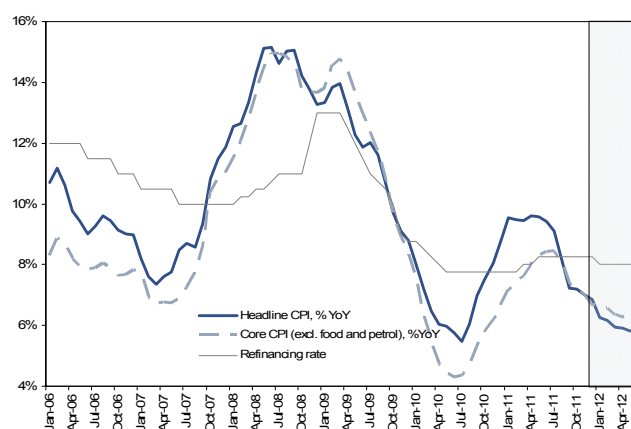
Money market rates were up 30-100bp during the demonstrations held in recent days, as the CBR has limited supply liquidity and cut the one-day repo limit to Rub110-250bn. We think the change in the CBR's stance may have been triggered by: (a) an expected increase in budget spending, and (b) more pressure on the ruble following parliamentary elections. However, we think the CBR will consider rate cuts in the near future given risks to growth and decelerating inflation. We think the CBR might start with cutting the refinancing rate in Dec 2011 and decreasing the repo rate in early 2012 when the ruble traditionally gets support from seasonally stronger trade balance.

Figure 3. CBR may consider rate cuts....



Source: Bloomberg, CBR, Citi Investment Research and Analysis

Figure 4. ...as inflation trends down



Source: Haver, Citi Investment Research and Analysis

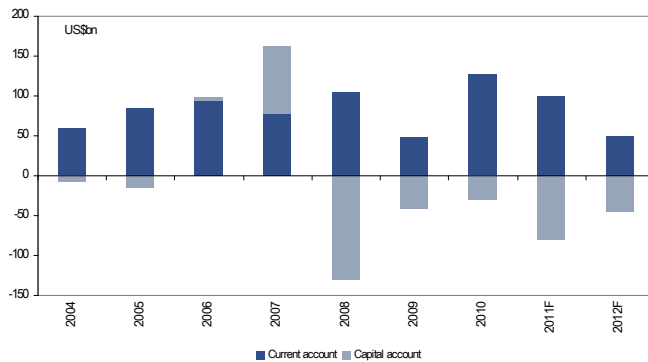
## Political situation pressures ruble

**We believe political uncertainty will put pressure on the ruble, in addition to global financial turmoil and a potential decrease in the oil price.** The CBR is likely to support the ruble ahead of the presidential elections set for 4 March 2012. Therefore, we keep our forecast of a basket at about 36.5-37 by the end of the year and in 1Q 2012. However, we think the ruble is set to weaken next year, unless there is a significant increase in the oil price.

**We expect the current account (CA) surplus to narrow and the capital account to likely remain negative in 2012.** Under the base case (oil price at US\$110/bbl on average in 2012) we expect the CA surplus to fall to about US\$60bn in 2012 from about US\$100bn in 2011 and to be mainly absorbed by continuous capital outflows. Russia has at least US\$80bn of scheduled debt repayments next year, and we expect rollover ratios could fall to 60-80% if international financial markets remain tight. FDI inflows, however, could accelerate ahead of WTO entry, as Russia joining will be a positive surprise given investor fatigue with the 18-year long process. However, private capital flight is likely to remain high unless political uncertainty and reshuffles among local governors come to an end. CA surplus could fall below US\$40bn if the oil price were to decline to US\$80-90/bbl.

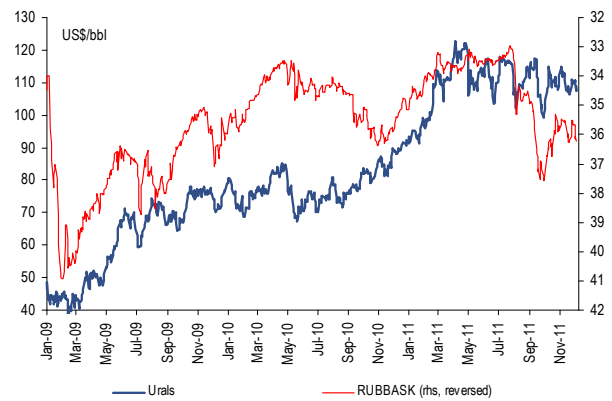
**We expect ruble basket at 36-37 in 2012 under the base case and may move to 37-38 if oil prices fall to US\$80-90/bbl in 2012.** Temporary overshooting is possible if any fall in the oil price is accompanied by increased global financial uncertainty or internal political tensions. On the other hand, if volatility in financial market falls off and the oil price were to exceed US\$120-130/bbl, we think the basket could strengthen to 33-34 by mid-2012.

Figure 5. CA in surplus but beware of capital account



Source: Haver, Citi Investment Research and Analysis

Figure 6. Ruble basket at 36-37 if oil averages US\$110/bbl in 2012



Source: Bloomberg, Citi Investment Research and Analysis

## Appendix A-1

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