Focus
Ukraine

Scope
Economics

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Economic Insight

Minsk 2: Macroeconomic background

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In a second attempt by Ukraine (supported by the West) and the Kremlin to stop the Donbas war, there is a great deal of uncertainty whether the key sides--Ukraine's leadership and the Kremlin--will fulfil the agreement. The details of yesterday's agreement are available at the following sources: *Financial Times* (http://on.ft.com/1CYFpBD) and *Wikipedia* (http://en.wikipedia.org/wiki/Minsk_II).

While the democratically elected leadership of Ukraine has a mandate to align Ukraine with the EU, the Kremlin is on a mission to restore Russia to its former Soviet Union glory as a pre-eminent global power.

Below is our analysis of the macroeconomic factors behind the second Minsk agreement.

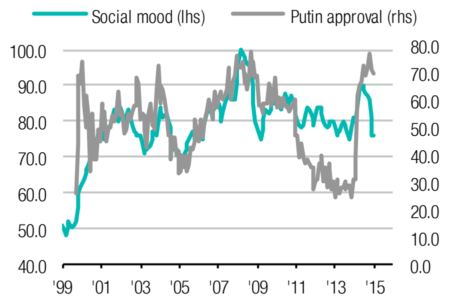
Ukraine

The Donbas war has put a sizable drag on Ukraine's economy. Prior to the war, the economy had been in recession since 2Q 2014, and the war just deepened and prolonged the recession. Hence, the longer the threat of war looms, the longer the recession is going to be – possibly over the next two years. In our view, real GDP declined by 6.7% YoY over the past year and could decline another 6% this year. Extreme devaluation and inflation will continue to endanger the economy this year and could worsen. Kiev's prime focus is not war, which costs US$8m/day, but an immediate economic turnaround. Because there is a direct correlation between political approval ratings and economic well-being, we tend to think that Ukraine's call for a ceasefire in the second Minsk talks is genuine.

The Kremlin

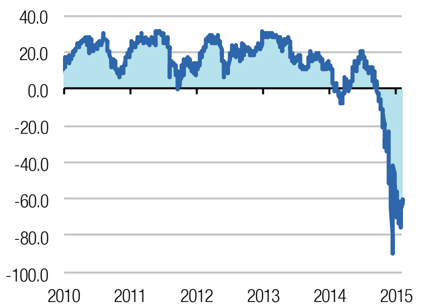
Because the Kremlin has been run by *siloviki* since 2000, including mainly the security services people, the rules of the political game here are different than in other places. The Kremlin's statements should not be taken at face value, according to our observations. In addition, the Kremlin's handling of the Russian economy, in our view, has been populist and ultimately ineffective if not serially mismanaged. That said, it does not mean that the Kremlin avoids the advice of prudent macro economists, but instead it has been hiring them to assist the *siloviki* to govern – names like Kudrin, Gref, Ulyukaev, Nabiulina, Yudaeva are well known. Although they are allowed to speak openly and formulate the problems that should be addressed, ultimately the *siloviki* decide via which tools the problems should be addressed.

Public opinions in Russia 1999-2015
Social mood index vs. Putin approval index



Source: Levada, ICU.

History of RUB misalignment in 2010-15
Measured through CPI-based real trade-weighted index



Source: ICU.

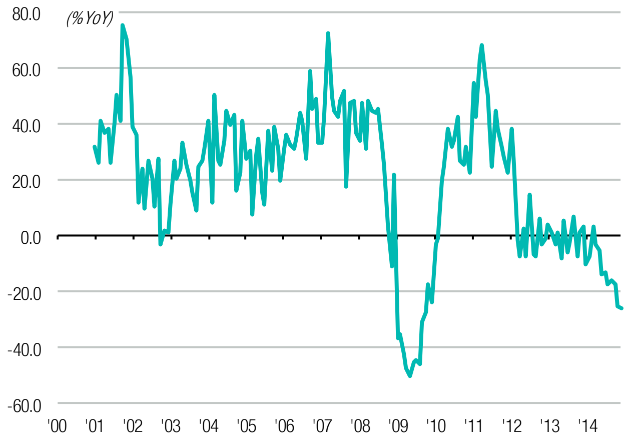
Headline CPI in Russia (%YoY)
Monthly history from Jan-2010 through Jan-15

Source: Bloomberg, ICU.

For example, the Russian ruble’s trade-weighted value from 2002 through 1H 2014 steadily appreciated and became extremely overvalued (see the charts below). When the ruble's FX rate was 33/USD on the market as of 1 July 2013, its so-called fair value was 45/USD[1]. In other words, the ruble at 33/USD was a drag on the economy, but at 45/USD the economy could be doing better. Exactly when the ruble was overpriced, Russian officials (of the class of prudent macro economists) occasionally hinted at the danger of inflation and lost competitiveness. At some point, when real GDP growth was flagging and slowing every year since 2010, and the price of crude oil was certain not to survive next year above US$100/bbl, official policy warmed to a such macroeconomic adjustment through currency adjustment that (if done) should make the foundation for real GDP growth more solid.

Chart 1. On-year change in the seasonally adjusted monthly volumes of Russian imports from Germany (%YoY)

Monthly history from January 2000 through December 2014

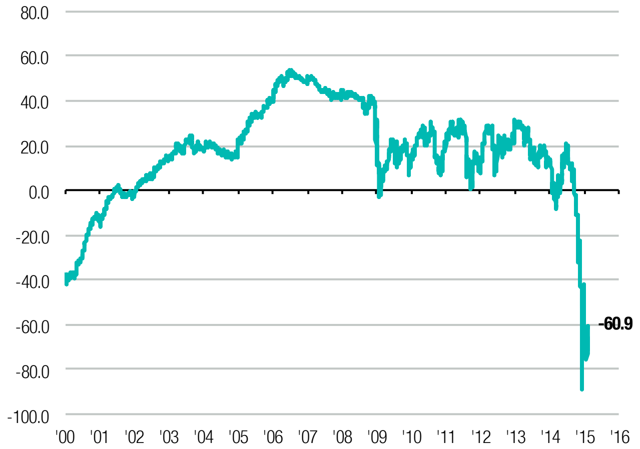


Source: State Customs Service of Russia, ICU.

Chart 2. Ruble misalignment in real trade-weighted terms

Last point as of 12 February 2014 is labelled

Daily history from 1 January 2000 through 12 February 2015



Source: ICU.

However, in 2012, when Putin took office as the newly re-elected president, the Russian public was becoming increasingly negative. In January 2013, Moscow-based polling firm Levada registered Putin approval index hitting a historical low of 24 points (see the chart below). In November 2013, Putin’s approval index touched 24 points again after recovering slightly from the beginning of the year.

During most of 2013, aside from preparing for the Sochi Winter Olympics, Putin spent time corralling Yanukovych not to sign the EU association agreement and instead join the rapidly forming Customs Union. In the early fall of that year, Putin moved his “grey cardinal” Vladislav Surkov from a post in the presidential administration to an appointment as an official adviser over Ukraine. Surkov, well known as a master of orchestrating politics and propaganda in the Kremlin's favor, was designated to devise a scheme for Ukraine.

In late 2013 and early 2014, after Surkov was appointed, Yanukovych was deposed and fled to Russia, Crimea was annexed, and Donbas was in flames following the appearance of pro-Kremlin militants of north Russian descent.

Following the political unraveling that occurred in Ukraine, Levada registered Putin’s approval index up to an all-time high in summer 2014 through January 2015 at above 70 points (see Chart 3, p.4). Two waves of sanctions by the West, countersanctions by the Kremlin, and a raging anti-Western propaganda campaign all helped sustain Putin’s high approval rating.

[1] This is mid of the fair-value range of 38 and 52, which is derived from FX misalignment by CPI- and PPI-based real trade-weighted indices for Russia ruble.

The Russian economy suffered a severe economic adjustment over 2014 as the price of Brent crude oil dropped 53% from US$108 to near US$50, causing a 53% decline in the ruble's FX rate to the US dollar. Inflation rose from 6.1% YoY to 15.0% YoY from January 2014 to January 2015. FX reserves declined 26% from US$506bn to US$376bn.

What is less widely known is that the Russian economic adjustment through FX devaluation has been massive (far more than initially thought) if measured by real trade-weighted terms (see the Chart 2, p.2). The ruble indeed is in tatters, undervalued by 60%, which is a short-lived occurrence and will be quickly eliminated by inflation. Inflation in Russia is just heading up and the ruble should narrow its undervaluation to around 30-40%. Still, with such a currency misalignment, inflation is inevitable, but we project it to be about 20% in mid-2015, a massive increase versus a year ago.

This projection still implies that authorities are enacting nationwide administrative measures to convince private businesses (large and small) to not increase prices. There is anecdotal evidence[2] of a Russian cafeteria that, likely being pressured by local authorities from increasing prices, puts an additional item on a client's receipt, which is called a “ruble devaluation” and amounts to 10% of the total bill. In our view, as private businesses in Russia are unable to pass costs on to consumers, they will be forced to cut back in other areas like labor, which will strain the labor market further. Hence, the inflation problem will be compounded by an unemployment problem.

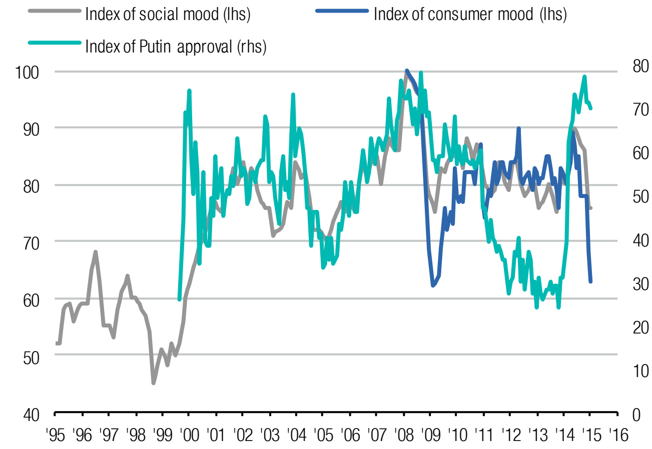
The above-mentioned economic deteriorations are captured by Levada’s opinion polls in its two indices of social mood and consumer mood (see Chart 3 and Chart 4 on p.4). These two indices, in our view, capture a more information about the respondent and how he or she thinks as the poll consists of several questions on politics, the economy, and expectations of the economy and personal fortunes. These are more complex than the binary index of the Putin approval index, where approve and disapprove are the key questions. Between 2000 and 2008 there was strong, positive correlation between the Putin index and the social mood index. In 2008, the positive correlation broke down as the social mood dropped in late of 2008 while the Putin approval decreased much less dramatically. The correlation recovered and stood high for a while and then broke down again and turned negative for several months in between December 2011 and march 2012 when Putin’s approval index was declining while the social mood was more or less stable. In early 2014, the correlation was strong and positive after the annexation of Crimea, but later in the year this correlation has been breaking down as Putin’s approval index remains high while the social and consumer indices have been declining quite sizably. This correlation ratio is running towards zero now and even could stay negative for some time.

The general macroeconomic story in Russia in next 2-3 years means that the social and consumer indices are expected to slide during 2015 because of a 5% YoY recessionary decline in the economy, and the same trend is very much likely in 2016. Sustaining Putin’s approval index is a big issue now despite a year-long anti-Western state propaganda campaign. This task will require the type of creativity and fine-tuning.

[2] https://twitter.com/golub/status/559300696160628736

Chart 3. History of social indicators in Russia: indices of social mood and consumer mood versus Putin approval index

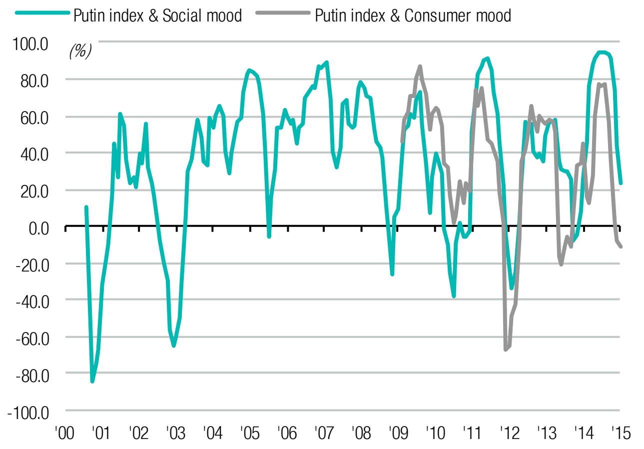
Monthly history from January 1995 through January 2015



Source: Levada.ru, ICU.

Chart 4. One-year correlation ratios between Putin approval index and indices of social and consumer moods (%)

Monthly history from January 2000 through January 2015



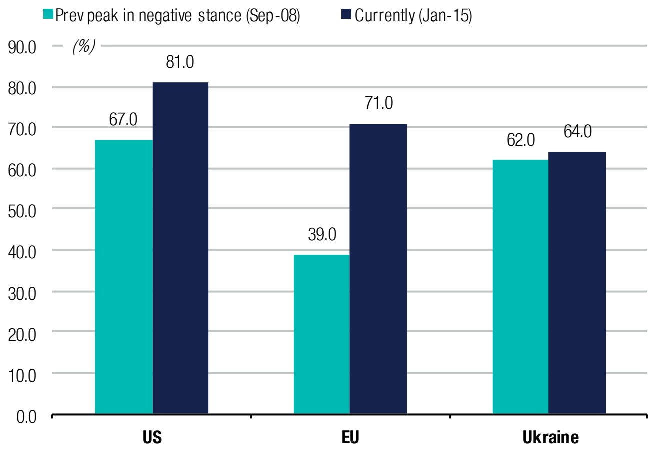
Source: ICU.

At this point, we return to yesterday's second Minsk summit. Prior to the meeting, the Kremlin knew that the Russian economy is in a deepening recession this year and possibly next year as well. The Kremlin's land grabbing and fighting with the West and NATO have been popular domestically. However, the threat of military supplies to Ukraine and more sanctions in the event that Russia refuses to agree to a ceasefire and reduce aggression, caused the Kremlin accept the agreement.

Although it is retreating from the outright escalation of aggression seen over the past two months, the Kremlin in the latest agreement managed to prevent the Ukrainian army from regaining control of the border until the end of 2015. This enables the Kremlin to sustain its proxies in the parts of Donbas occupied by separatists. As the media thrill of an armed conquest of Donbas will not captivate Russian TV viewers after the cease fire and military withdrawal, Russia’s domestic economic problems will not wane. Because of this, we suspect that the Kremlin could engineer another escalation to rejuvenate Russian popular support and divert attention from the severe economic problems. Hence, the risk of reneging on the latest peace agreement remains a possibility.

Chart 5. Share of respondents who say they have 'nagative' (or 'bad') stance to the US, EU and Ukraine (%)

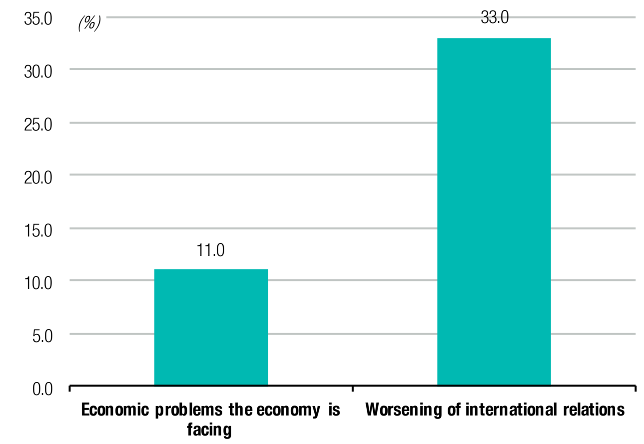
According to polls conducted by Moscow-based Levada Centre



Note: Previous peak in negative stance was under Bush presidency during the Russian war on Georgia. Source: Levada.ru, ICU.

Chart 6. Increase in share of respondents (percentage points), who has become more worried over an issue

According to polls conducted by Moscow-based Levada Centre



Source: Levada.ru, ICU.

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Buy: Forecasted 12-month total return greater than 20%

Hold: Forecasted 12-month total return 0% to 20%

Sell: Forecasted 12-month total return less than 0%

Note: total return is share price appreciation to a target price in relative terms plus forecasted dividend yield.

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