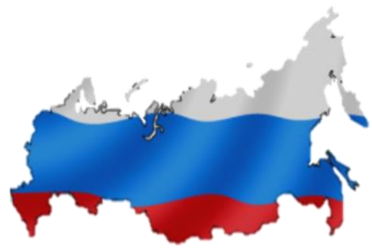
Russia Monthly Economic Developments

September 2017

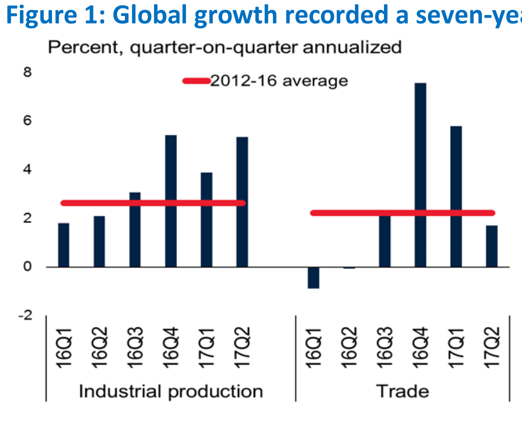
In the second quarter of 2017, global GDP recorded its highest reading since the end of 2010. This acceleration was broad-based: economies in the United States, the Euro Area, Japan, Eastern Europe, and Central Asia strengthened. Oil prices firmed to nearly $55/bbl in mid-September, due to hurricane-induced supply disruptions in the Gulf of Mexico, and news of lower-than-expected supply rises in the U.S., including due to a temporary halt in the upturn in U.S. shale drilling. After buoyant growth in the second quarter of 2017, economic activity in Russia slowed down in July on the back of weak manufacturing performance. A sustainable slowdown of inflation led to the Central Bank cutting the key policy rate by 50 pp to 8.5 percent on September 15. In the first half of the year, the federal budget primary balance reached zero supported by oil price dynamics, improving from the deficit of 2.4 percent of GDP observed in the same period last year. While the authorities have undertaken a number of legal and regulatory measures to increase the resilience of the banking system, preserving its stability remains a key challenge given a number of recent failures of some large banks, including that of the largest private and systemically important bank, Otkritie.

The Global Context



Global growth recorded a seven-year high (Figure 1). Global GDP growth recorded 3.6 percent (q/q saar) in Q2, the highest reading since the end of 2010. This acceleration was broad-based: economies in the United States, the Euro Area, Japan, Eastern Europe and Central Asia strengthened, and global manufacturing PMIs remained robust in July and August, suggesting continued growth momentum in Q3. In China, growth remained unchanged at 6.9 percent (y/y) in Q2, with a shift from state investments to exports and consumption. The financial markets of Emerging Market and Developing Economies (EMDEs) remained buoyant in September, and capital and mutual fund inflows to EMDEs remained robust.

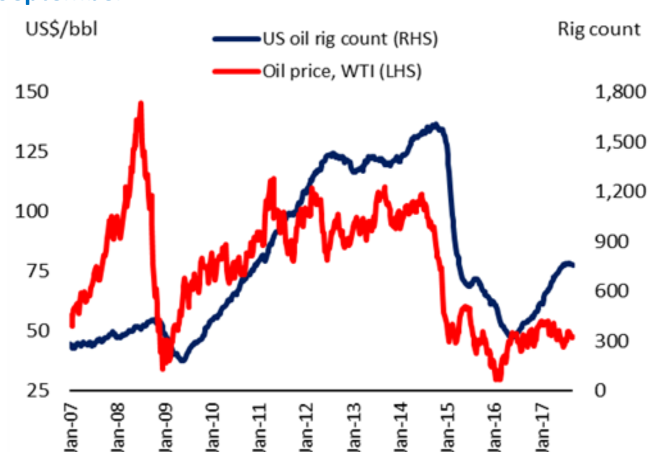
Figure 1: Global growth recorded a seven-year high



Source: World Bank.

Oil prices firmed to nearly $55/bbl in mid-September. Despite an agreement by some Organization of Petroleum Exporting Countries (OPEC) and non-OPEC producers to cut production, oil prices dropped to $46 in June 2017 amid large stocks linked to a rebound in U.S. crude oil output and rising production from Libya and Nigeria, both exempt from production targets. The price dip temporarily halted the upturn in U.S. shale drilling—the count experienced a five-week consecutive decline in August, the first since May 2016 (Figure 2). The subsequent strengthening in oil prices was aided by some hurricane-induced supply disruptions in the Gulf of Mexico and news of less-than-expected supply rises in the U.S.. In line with the World Bank's Global Economic Prospects June 2017 forecast, the oil price is expected to average $52/bbl in 2017 and $55/bbl in 2018.

Figure 2: Oil prices firmed to nearly $55/bbl in mid-September

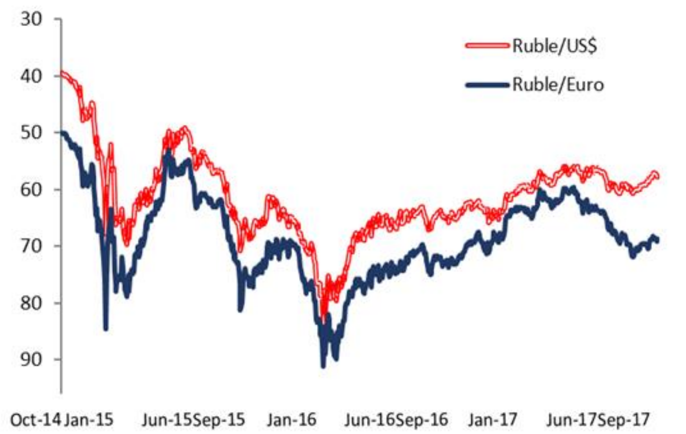


Source: Baker Hughes, Bloomberg.

Russia's Recent Developments

Supported by an increase in oil prices and continued capital inflows to emerging markets, the exchange rate of the ruble with respect to the U.S. dollar stayed flat in August (Figure 3). Though average oil prices (Brent) increased by 5.5 percent in August compared to July, the ruble appreciated by 0.03 percent. As Russia's five-year CDS went down from 166 bp in July to 150 bp in August, suggesting an improved risk perception by investors, corporate dividend payments might be the factor that exercised downward pressure on the ruble in August.

Figure 3: In August, the ruble stayed flat with respect to the U.S. dollar

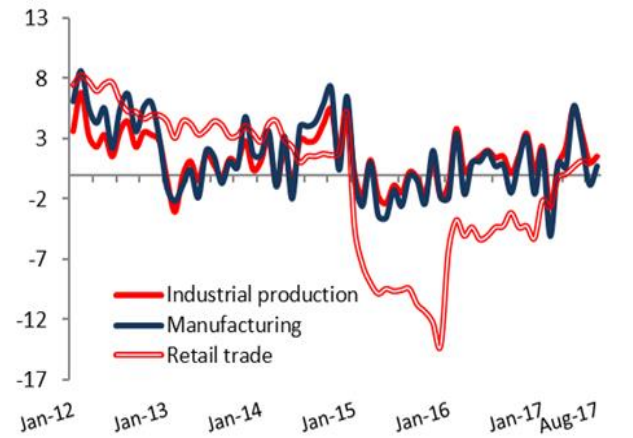


Source: CBR.

Non-tradable sectors were the main engine of economic growth in the second quarter of 2017. Rosstat published production-side statistics for the second quarter of 2017. The contribution of non-tradable sectors to growth totaled 1.6 pp and exceeded the contribution from tradable sectors (0.6 pp). The wholesale trade sector contributed the most to growth, yet this could be a one-off factor. Meanwhile, we expect the recovering construction to support economic growth in the second half of the year.

Economic activity slowed down in July (Figure 4). The index of production in basic economic activities[1] grew by 1.8 percent, y/y, in the month of July compared to 4.5 percent in June and fell by 0.9 percent m/m, sa. While positively affected by significant growth in construction (7.1 percent, y/y), pointing to continued investment growth, as well as growth in transportation (6.2 percent, y/y), production in basic economic activities was dragged down by industrial production. In July, industrial production increased by 1.1 percent y/y, compared to 3.5 percent in June, and it decreased by 0.5 percent m/m, sa. Manufacturing dropped by 0.8 percent, y/y, driven by a drop in the production of other transport vehicles (-33.3 percent, y/y), which is very volatile nature. The August Manufacturing PMI reading was 51.6 compared to 52.7 in July, suggesting solid improvement of operating conditions in manufacturing, albeit at a lower pace.

Figure 4: Economic activity slowed down in July

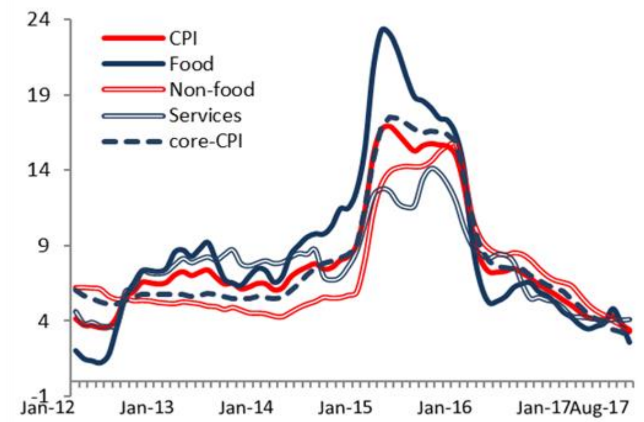


Source: Rosstat, Haver Analytics, World Bank team.

In August, consumer inflation reached a record low of 3.3 percent, decreasing from 3.9 percent in July (Figure 5). Food inflation slowed from 3.8 percent, y/y, in July to 2.6 percent, y/y, in August, and was the main factor behind the decrease in consumer inflation. The Core CPI Index dropped from 3.3 percent, y/y, in July to 3 percent, y/y, in August, indicating subsiding inflation pressures. The sustainable slowdown of inflation allowed the Central Bank to cut the key policy rate by 50 pp to 8.5 percent on September 15. The Central Bank pointed to various medium-term inflationary risk factors such as external volatility and exchange rate movements; the possible lower propensity to save; structural labor shortages in some sectors; and the continued high sensitivity of inflation expectations to changing prices for individual groups of goods and services. The Bank noted the possibility of further key rate cuts during the next two quarters.

[1] Agriculture, industrial production, construction, transport, retail and wholesale trade.

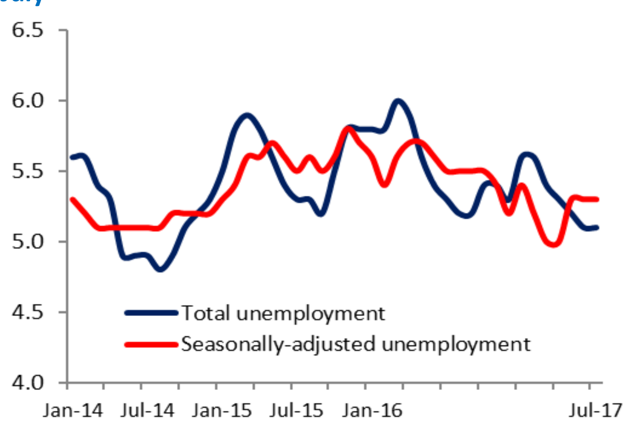
Figure 5: Consumer inflation reached a record low level



Source: Rosstat, Haver Analytics, World Bank team.

Labor market indicators were flat in July. Real wages continued to grow, supporting consumer demand. The unemployment rate in July was at the same level as the previous month, 5.1 percent. The seasonally adjusted rate alsoremained unchanged at 5.3 percent (Figure 6). Real wages continued to grow and increased in July by 4.6 percent compared to the same period in the previous year, but they contracted by 0.3 percent compared to June after seasonal adjustment. Real disposable incomes contracted by 0.9 percent in July compared to the same period in 2016 and did not change relative to the previous month after seasonal adjustment. The average contraction for the first seven months of 2017 was 0.9 percent compared to the same period in 2016. Pensions were indexed in the beginning of the year at the inflation rate, meaning the real growth of pensions was close to zero.

Figure 6: The unemployment level remained unchanged in July

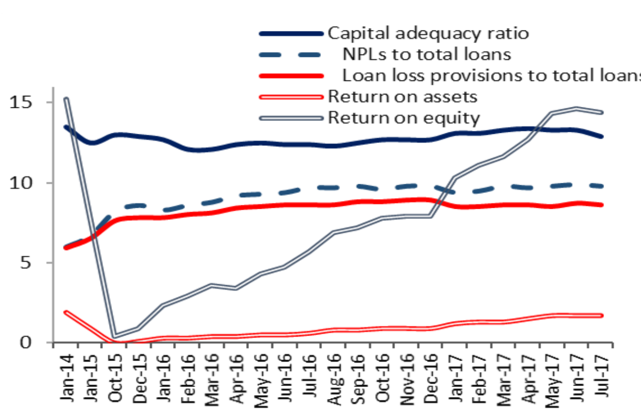


Source: Rosstat, Haver Analytics, World Bank team.

In the January - July 2017 period, aided by higher oil prices, the federal budget primary deficit turned zero compared to a deficit of 2.4 percent of GDP in the same period last year. In January – July 2017, the federal budget revenue stood at 16.6 percent of GDP, an increase of 1.5 percent of GDP compared to the same period last year, with oil revenues higher by 1 percent of GDP. Compared to the same period last year, primary expenditures decreased by 0.9 percent of GDP to 16.6 percent of GDP due to lower spending on defense (-0.5 percent of GDP), security (-0.2 percent of GDP), and health (-0.2 percent of GDP). The non-oil primary deficit improved from 8 percent of GDP to 6.6 percent of GDP due to an increase in non-oil federal budget revenues (corporate income tax, excise tax, and VAT). Overall, the federal budget deficit narrowed to 0.7 percent of GDP from 3.1 percent of GDP last year.

Following the economic recovery, the banking sector's performance has been improving. The return to growth and the stabilization of macroeconomic indicators has supported the operating environment for the banking sector. Credit to households in rubles further increased in July, prompted by slowly recovering consumer demand. Growth of lending in rubles to households accelerated to 7.6 percent in July, y/y, compared to 6.6 percent in June. Credit to firms in rubles continued to grow in low single digits. Key credit risk and performance indicators remained stable (Figure 7). As of July 1, 2017, the sector's aggregate capital adequacy stood at 12.9 percent. Non-performing loans have stabilized at nearly 10 percent. Banks' profitability continued to increase with the return on assets and return on equity at 1.7 percent and 14.4 percent, respectively, as of July 1, 2017.

Figure 7: Key credit risk and performance indicators in the banking sector remained stable



Source: CBR.

While the banking sector's fundamentals are improving, there has been considerable volatility due to the ongoing industry consolidation. The Central Bank continued its efforts to clean up the banking system, cutting the number of banks that are non-compliant with regulations and that conduct risky operations: the number of banks in Russia has fallen from 623 at the beginning of 2017 to 582 as of August 1, 2017. While the authorities have undertaken a number of legal and regulatory measures to increase the resilience of the banking system, preserving its stability remains a key challenge given the recent failure of the largest private and systemically important bank, Otkritie (3 percent of banking sector assets). The Central Bank is going to test a new bank resolution mechanism during the bailout of Otkritie whereby it will take over the direct oversight and rehabilitation of the bank via an equity injection and ultimately potential divestment.

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