



September 2015

- Oil prices fell to US\$40 per barrel by the end of August, increasing the pressure on the ruble.
- July statistics showed a broad-based contraction in economic activity due to a further deterioration in investment demand and continued weakness in household consumption.
- Moderate inflation pressures resumed in August, with both headline and core inflation increasing slightly.
- In early September the Ministry of Finance announced plans to change the 2016 budget proposal and shorten the budget planning horizon.
- Credit growth remains constrained as banks' lower profit margins make them risk averse.

Oil prices fell to US\$40 per barrel by the end of August, following relative stability around US\$60 per barrel during the second quarter of 2015.

On the supply-side, OPEC production has been rising along with crude inventories. Solid supplies combined with weak world demand is expected to create a surplus of 0.5-1.0 million barrel per day until mid-2016. This surplus would keep oil prices under pressure, especially if Iran adds another 0.5 million barrel per day, should the deal over its nuclear program be finalized. Weak global growth prospects negatively affect oil prices.



Russia's external demand is unlikely to pick up in 2015 as financing and exchange rate pressures are mounting globally.

Prospects of tighter financing conditions, slowing activity in major emerging markets, renewed weakness in commodity prices and exchange rate volatility are weighing on confidence and activity in Russia and other emerging economies, sparking a sharp sell-off in their currencies and equities. Russia's and emerging market borrowing costs rose in line with a broader increase in risk-aversion: the EMBI spread rose 50 basis points since end-July. Outflows from emerging-market equity funds have been significant in August. Half of the 20 largest stock-markets among emerging and frontier economies have fallen 20 percent or more from their peaks, also affecting Russia's stock markets adversely. The currencies of key commodity exporters, including the Russian ruble, depreciated sharply against the US dollar.

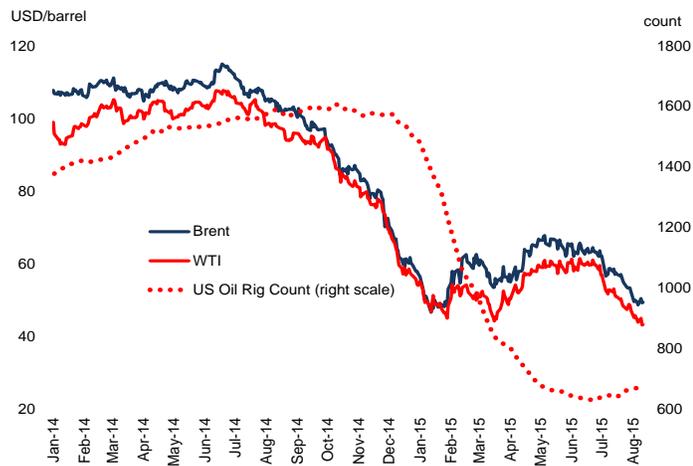
The sharp downward adjustment in oil prices led to increased depreciation pressure on the exchange rate, weakening the ruble to the lowest level since January 2015. The average Brent oil price dropped by about 15 percent in August relative

to July's level and the average ruble exchange rate depreciated by 13.1 percent with respect to the US dollar. Higher external debt payments by the private sector expected for September (US\$14.0 billion, compared to US\$6.8 billion in August) also increased demand for foreign currency. Central bank refrained from interventions, but announced, that it would be ready to reintroduce the 1-year foreign exchange repo facility (which was discontinued in mid-May) in case foreign liquidity pressure materializes.

July statistics showed a broad-based contraction in Russian economic activity due to a further deterioration in investment demand and continued weakness in household consumption.

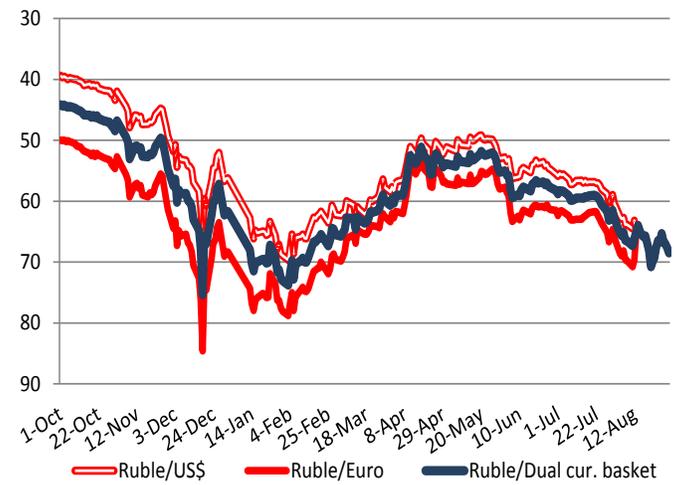
In July, aggregate output decreased by 3.9 percent, year-on-year, marginally better than the -4.1 percent decrease in June. However, manufacturing reported a deeper contraction in July at -7.1 percent, compared to -6.6 percent in June as demand for investment goods continued to decline. For example, the production of transportation devices and equipment dropped by 22.8 percent, year-on-year; while machine building contracted by 11.1 percent. Total fixed capital investment dropped by 8.5 percent in July, year-on-year, compared to -7.1 percent in June, bringing the cumulative contraction to -5.9 percent for the first seven months of 2015, year-on-year. Weak demand remains the key reason behind the sharp decline in retail (-9.2 percent) and other services (-2.5 percent) as real wages continued to decrease: 9.8 percent in July (compared to -7.2 percent in June) while real disposable income shrank by 2.0 percent compared to 3.5 percent in June.

Figure 1: Oil prices fell sharply to US\$40 per barrel...



Source: Bloomberg, Bakes Hughes, and World Bank

Figure 2: ... leading to increased depreciation of the ruble



Source: CBR

Rosstat confirmed a deepening recession in the first half of 2015.

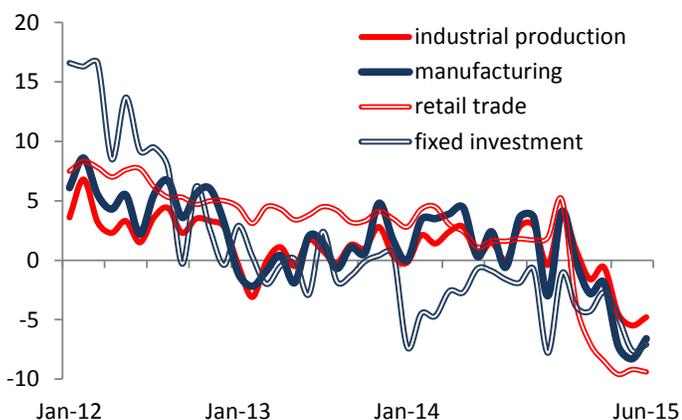
The year-on-year contractions for the first two quarters were confirmed at -2.2 and -4.6 percent respectively. The seasonally adjusted quarterly growth for quarter one was revised further down to -1.6 percent from -1.3, and the first estimate for quarter two was announced at -2.0 percent, which pushed Russia's GDP level back to 2011. The broad-based contraction led by retail trade and the financial sector was confirmed. Despite the weaker ruble in the second quarter, the contraction has also deepened in manufacturing.

Moderate inflation pressures resumed in August, with both headline and core inflation increasing slightly.

The 12-month Consumer Price Index did not decrease as expected, but inched up for the second consecutive month to 15.8 percent (from 15.6

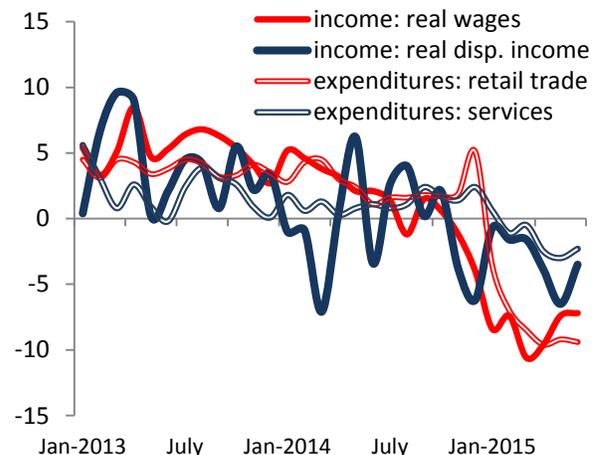
percent in July). Core inflation also remained at 16.6 percent, close to the July level. The pass-through from a since May weakening ruble— which lost about a fifth of its value against the US dollar over this period—also pushed prices up and kept core inflation and inflation for non-food items, including services inflation, elevated. The 12-month food inflation continued to decelerate to 18.1 percent in August from 18.6 percent in July, due to the seasonal decline in fruit and vegetable prices, which dropped by almost 10 percent in August, month-on-month. Prices on other food items in the consumer basket grew by 0.5 percent, month-on-month. Continuous inflation pressures suggest that the CBR is likely to be cautious with the pace of monetary policy easing. Therefore it left on September 11 the key policy rates unchanged at 11 percent.

Figure 3: Economic activity remains weak ... (percent change, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

Figure 4: ... as real wages and incomes continue to contracts (percent change, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

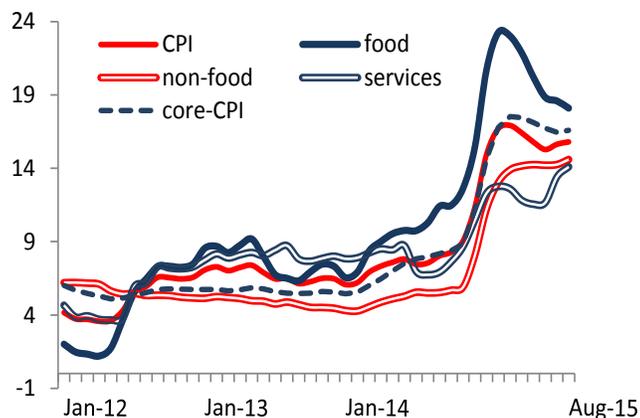
In early September the Ministry of Finance announced plans to change the 2016 budget proposal and shorten the budget planning horizon. A new 2016 budget proposal is being developed, rendering the government's 2016-2018 budget draft submitted to the State Duma in June obsolete. Following renewed oil price declines, the Ministry of Finance quoted increased risks of forecasting errors due to market volatility as the reason for asking lawmakers to delay the deadline for submitting next year's budget and switching to a one-year budget planning horizon as opposed to three-year horizon stipulated by the current legislation. However, this will increase uncertainty for government entities with multi-year programs. The government cancelled medium-term fiscal planning in 2015 when amendments to the three-year budget law were only introduced for 2015. Submission of the new 2016 budget proposal to the Duma is expected for October 25. Discussions on the modification or the abandonment of the fiscal rule are ongoing within government.

In January–July 2015 the federal budget registered a primary deficit of 2.0 percent of GDP compared to a 2.4 percent surplus a year ago. Federal budget revenue decreased in the first seven months of 2015 to 18.9 percent of GDP from 21.9 percent of GDP in the same period of 2014, as oil and gas revenues dropped to 8.6 percent of GDP from 10.8 percent of GDP. Non-oil revenue remained nearly unchanged at 10.5 percent of GDP (9.9 percent in January–July 2014), thanks to strong VAT and corporate income tax receipts. Federal budget expenditure increased in the first seven months in real terms. In January–July they reached 21.9 percent of GDP (from 18.9 percent of GDP a year ago), mainly due to a 2.2 percent of GDP

year-on-year increase in defense spending, 1.2 percent of GDP increase in spending for social policy. Spending on the national economy increased by 0.5 percent of GDP and outpaced in July spending in other categories due to spending increases for transport and road maintenance. The non-oil deficit climbed further to 11.4 percent of GDP at the end of July (9.0 percent in July 2014). The federal budget deficit was in January–July financed in the amount of 700 billion rubles from the Reserve Fund. In August the government spent another 200 billion rubles from the Reserve Fund for deficit financing.

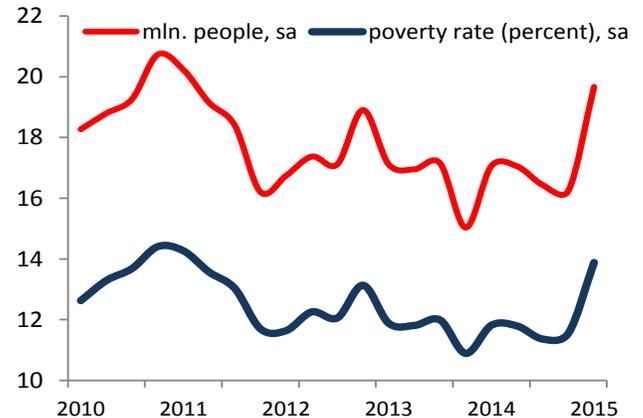
Credit growth remains constrained as banks' lower profit margins make them risk averse. Although credit growth to firms slightly picked up in July, in part due to the reevaluation effect of weaker ruble, overall credit growth to the private sector slowed to 16.5 percent, year-on-year, from 28.2 percent at the end of 2014. This was largely the result of banks' downsizing their credit portfolio to households, particularly reducing the stock on non-collateralized consumer loans, the main cause for the high default rate. Credit growth to households slowed to -0.8 percent in July, year-on-year, compared to 13.8 percent at the end of 2014. Banks' continued portfolio adjustment to higher funding costs appears to have increased their risk aversion, leading to a stabilization in some macro-prudential indicators in July. Especially the share of non-performing loans, which has been growing for more than a year, stabilized at around 8.2 percent in June, taking into account the regulatory forbearance of central bank which was extended until end-2015.

Figure 5 Inflation remains high ... (percent, y-o-y)



Source: Rosstat, Haver Analytics, WB team

Figure 6: contributing to higher poverty levels



Source: Rosstat, Haver Analytics, World Bank team

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