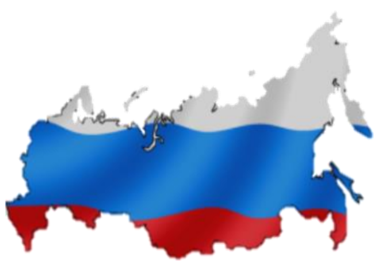
Russia Monthly Economic Developments

April 2017

Global growth momentum continued in the first quarter of 2017. Global financial conditions remain favorable for emerging economies amid increased risk appetite and improved growth prospects. Oil prices bounced back after weakening in early/mid March, and the oil market continues to rebalance. In March, the ruble appreciated by 0.5 percent with respect to the U.S. dollar despite a drop in oil prices. Signals from the U.S. Federal Reserve to tighten policy at a gentle pace contributed to the appreciation of emerging market currencies, including Russia's. The recovery in economic activity, which started in Russia in the second quarter of 2016, appears to be fragile. After expanding in January 2017 by 0.7 percent, m/m, industrial production dropped in February by 1.5 percent, m/m. Consumer demand also weakened in February. Inflation slowed further in March, partly aided by the ruble's appreciation. The Bank of Russia reduced the key rate by 0.25 p.p. to 9.75 percent on March 24, 2017, amidst the inflation slowdown and persistently lower inflation expectations. The federal government balance strengthened to a primary surplus of 0.4 percent of GDP in January - February 2017 (from a 0.2 percent GDP surplus in the same period last year). Key credit risk and performance indicators in the banking sector remained largely stable since the beginning of the year, signaling that the weakening trend may be over.

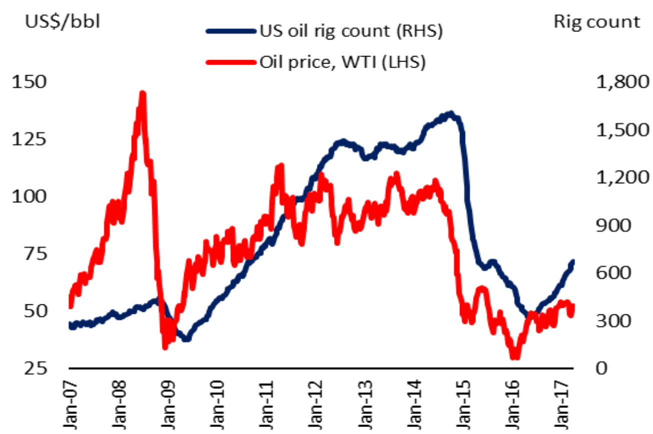
The Global Context



Global growth momentum continued in the first quarter of 2017. It strengthened in the fourth quarter of 2016 with 3 percent growth (q/q, saar). High frequency data suggests a similar growth rate in the first quarter of 2017. At the country level, PMIs point to solid performance in the Euro Area, the United States, and Japan. A policy-guided transition to slower and more sustainable growth continues in China. Global financial conditions remain favorable for emerging economies amid increased risk appetite and improved growth prospects. Signals from the U.S. Federal Reserve to tighten policy at a gentle pace contributed to the appreciation of emerging market currencies; the JP Morgan Emerging Market Currency Index increased 4.2 percent in the first quarter.

Oil prices bounced back after weakening in early March (Figure 1). Oil prices dropped below $50/bbl in early/mid-March due to stubbornly high U.S. crude oil inventories, robust recovery in U.S. shale activity, and concerns from Saudi Arabia and Russia regarding progress on production cut commitments. The U.S. oil rig count reached 672 rigs in the first week of April, up from 318 rigs in May 2016. The recent price recovery has been partly due to outages in Libya, Canada, and the North Sea. Nevertheless, the market continues to rebalance, aided by OPEC production cuts, expectations that stocks will begin drawing soon, and the resumption of refineries following maintenance. OPEC is scheduled to meet on May 25, and there are growing signs from most producers that cuts will be extended into the second half 2017. Oil prices are projected to average $55 per barrel in 2017 ($60/bbl in 2018), up from $43/bbl in 2016. The price forecast is unchanged from the January 2017 Commodity Markets Outlook.

Figure 1: Oil prices bounced back after weakening in early March

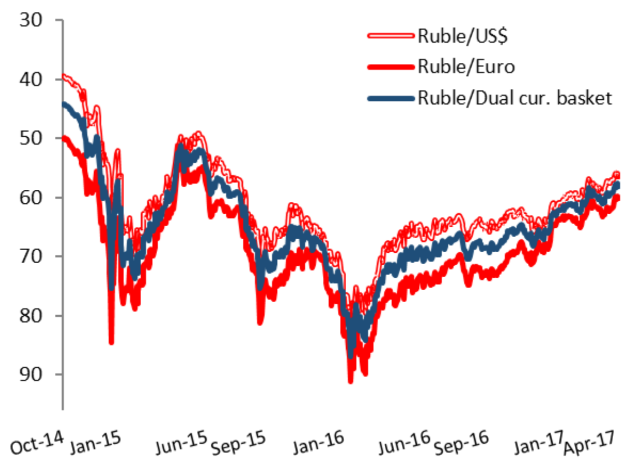


Source: Baker Hughes, Bloomberg.

Russia's Recent Developments

In March, the ruble appreciated by 0.5 percent with respect to the U.S. dollar, despite a drop of 6.4 percent in oil prices (Figure 2). Signals from the U.S. Federal Reserve to tighten policy at a gentle pace, affecting all emerging markets, as well as attractive returns of Russian assets amidst a relatively tight monetary policy, could be the factors that significantly outweighed the decrease in oil prices.

Figure 2: The ruble appreciated in March

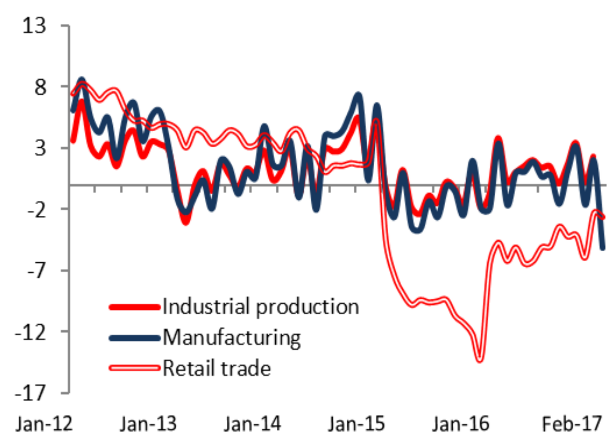


Source: CBR.

Higher oil prices supported the current account in the first quarter of 2017. The current account surplus increased to US$22.8 billion from US$12.9 billion in the first quarter of 2016. A stronger trade balance was the key factor behind the current account growth. Substantially higher oil and gas prices in the first quarter of 2017, compared to the same period last year, provided for higher hydrocarbon exports. In addition, higher prices for other commodities and partly export diversification supported non-oil exports, which expanded by 18 percent in the first quarter of 2017, y/y. On the back of the ruble appreciation and recovery in economic activity, imports also expanded substantially, rising by by 25 percent, y/y. This increase could reflect continued restocking and purchases of equipment by companies, as protracted stall in fixed capital investment is projected to stop in 2017. Yet, the substantial increase in imports did not override the improvement in exports, and the trade balance strengthened from US$22.3 in the first quarter of 2016 to US$34.5 billion in the first quarter of 2017. The stronger current account translated into higher net capital outflows, which rose from US$14.1 to US$22.3 billion. This reflected mainly the accumulation of foreign assets by the banking sector, as the latter refinanced a substantial part of its debt. The non-banking sector increased its net foreign liabilities and registered a net capital inflow. In the first quarter of 2017 Russia's international reserves[1] rose by US$4.4 billion, largely due to the foreign currency interventions conducted by the Central Banl of Russia on behalf of the Ministry of Finance since February.

While industrial production indicators were mixed, signs of a recovery in the Russian economy persist. On the one hand, after expanding in January 2017 by 0.7 percent, m/m, industrial production dropped in February by 1.5 percent, m/m, (2.7 percent, y/y) (Figure 3). This dynamics were explained both by the statistical effect of two less working days in February, compared to the same period last year, as well as the REER appreciation observed in the same month (which took the rubleback to the level of October 2014, and was not supportive of manufacturing activity. Indeed, while mineral resource extraction stayed flat, y/y, manufacturing output contracted by 5.1 percent, y/y during February; a slump in metallurgical production (-13.8 percent), production of metal goods except for machines and equipment (-16.6 percent), and production of vehicles used in river and railroad transportation (-40.7 percent) put the largest negative drag on manufacturing dynamics. Meanwhile, many other sectors associated both with private household consumption and investment demand demonstrated robust growth: production of clothes, pharmaceuticals, leather, paper, electric equipment, chemicals, and machines. At the same time, this slump was not reflected by the February manufacturing PMI[2], which reached 52.5 percent, signaling growth in the sector. The manufacturing PMI for March decreased by 0.1 p.p. compared to February, still pointing to growth in the sector.

Figure 3: After expanding in January 2017, industrial production dropped in February



Source: Rosstat, Haver Analytics, World Bank team.

Following a buoyant performance in January, consumer demand weakened in February. Retail trade contracted by 0.4

[1] Adjusted for foreign currency swaps and foreign liquidity provided by the Bank of Russia to resident banks.

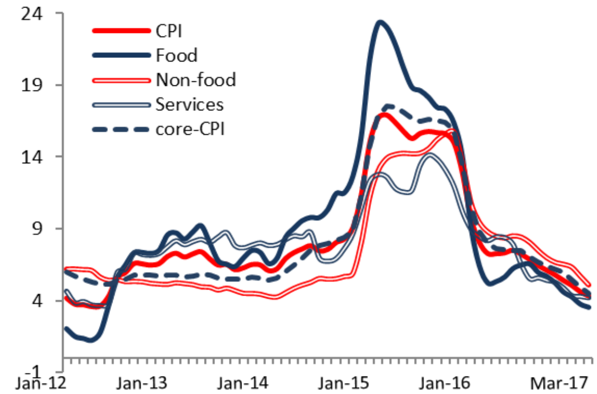
[2] The Purchasing Managers' Index (PMI) reflects manufacturing sector activity. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

percent in real terms, m/m, seasonally adjusted, compared to growth of 4.2 percent last month. This also corresponds to a decrease of 2.6 percent, y/y, in February, compared to a contraction of 2.3 percent in January. Retail services decreased in February by 3 percent, y/y, and 2.3 percent, m/m, sa. The effect of the one-off pension payment could have partially rolled on to February, still supporting annual dynamics of retail trade and retail services.

Rosstat published quarterly statistics for 2016, consistent with the annual growth rate. The positive GDP growth rate on an annual basis was already registered in the fourth quarter of 2016 (+0.3 percent, y/y). Rosstat has not yet published seasonally adjusted quarterly data, but according to the Bank of Russia estimates, the recession in Russia ended in the second quarter of 2016. Rosstat revised upwards household consumption growth by 0.5 p.p. to -4.5 percent y/y, in 2016, and revised downwards the growth of fixed capital investment and capital restocking. As a result, the contribution of investment demand to GDP growth decreased to 0.3 percent with net exports being the major engine for growth (+1.7 p.p.).

Inflation slowed further in March, partly aided by the ruble's appreciation (Figure 4). Supported by a stronger ruble, the m/m inflation totaled 0.1 percent in March 2017 compared to 0.5 percent in the same period last year. The 12-month Consumer Price Index (CPI) decreased to 4.3 percent from 4.6 percent in February. As in February, the monthly inflation deceleration was registered across all CPI components: food prices increased by 3.5 percent compared to 3.7 percent a month ago; non-food prices grew by 5.1 percent compared to 5.7 percent the previous month; and service prices decelerated from 4.3 percent to 4.2 percent. The Core CPI index dropped from 5 percent, y/y, in February to 4.5 percent in March. On March 24, 2017, the Bank of Russia reduced the key rate by 0.25 p.p. to 9.75 percent. It noted the accelerated inflation slowdown compared to the forecast as well as persistently lower inflation expectations. While stating its adherence to relatively tight monetary policy, the Bank of Russia indicated possible further gradual key rate cuts over the second and third quarters.

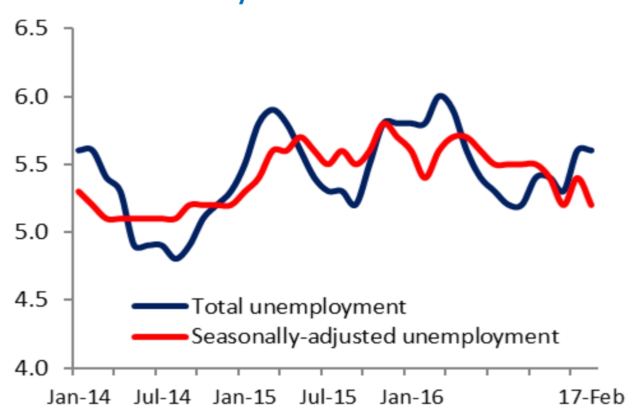
Figure 4: Consumer inflation continued to slow in March



Source: Rosstat, Haver Analytics, World Bank team.

Unemployment decreased slightly in February (Figure 5) while real wages continued to grow. Unemployment declined from 5.4 percent to 5.2 percent in February, sa. Real wages continued to grow, rising in February by 1.3 percent compared to the same period of previous year; however, the growth decelerated. Real wages also increased compared to the previous month after seasonal adjustment. Real disposable incomes contracted in February by 4.1 percent compared to the same period in 2015, and they decreased in monthly terms after seasonal adjustment. Pensions were indexed at the beginning of February at the inflation rate; that is, the real growth of pensions was close to zero.

Figure 5: Seasonally adjusted unemployment slightly decreased in February



Source: Rosstat, Haver Analytics, World Bank team.

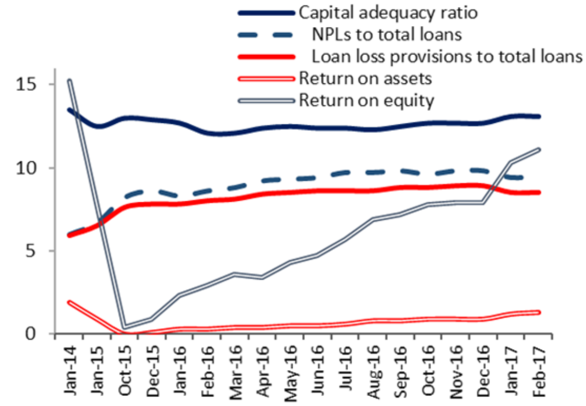
The overall federal government balance has strengthened on the back of increasingly robust oil revenues, but raising spending has widened the non-oil balance in the last year. The federal government balance strengthened to a primary surplus of 0.4 percent of GDP in January - February 2017 (from 0.2 percent of GDP surplus in the same period last year). Federal budget oil revenues rose by 2.5 percent of GDP to 8.1 percent of GDP on the back of higher oil prices. Federal budget non-oil revenues grew by 0.8 percent to 10.2 percent of GDP due to higher VAT and excise tax receipts. Federal budget primary expenditures increased by 3 percent of GDP to 17.9 percent of GDP. The increase in expenditures was due to higher spending on social policy (+3.2 percent of GDP), namely the one-off payment to pensioners in January, as well as higher spending on national defense (+0.5 percent of GDP), state management (+0.2 percent of GDP), and environment protection (+ 0.1 percent of GDP). On the back of higher expenditures, the federal non-oil primary deficit worsened to 7.7 percent of GDP in January - February 2017 compared to 5.5 percent of GDP in the same period last year.

The National Welfare Fund totaled US$73.3 billion (4.9 percent of GDP) as of April 1, 2017, compared to US$71.9 billion (4.8 percent of GDP) in the beginning of the year. In February 2017, the government transferred Rub 70.8 billion (US$1.2 billion) from the National Welfare Fund to the deposit in Vnesheconmbank. As of April 1, 2017, the Reserve Fund totaled US$16.2 billion (1.1 percent of GDP). The government did not conduct any operations with the Reserve Fund in 2017.

Key credit risk and performance indicators in the banking sector remained largely unchanged since the beginning of the year, signaling that the worsening trend may be over. Capital adequacy remained stable at 13.1 percent due to profitable performance of banks and weak loan growth. Banks' financial performance has been steadily improving with the return on assets at 1.3 percent and the return on equity at 11.1 percent as of January 1, 2017 (Figure 6). Nonperforming loans still remain high by historical levels – 9.5 percent – but there are no signs of further deterioration.

The collapse in private sector credit is deepening. Adjusted for exchange rate movements, credit to firms decreased by 4.7 percent in February, y/y, compared to a contraction of 4.2 percent in January. Lending to households, adjusted for exchange rate movements, grew by 2.2 percent in February, y/y, from 1.8 percent in January. Consolidation in the banking sector continued - the number of banks in Russia has fallen from 623 at the beginning of 2017 to 616 as of March 1, 2017, as the Central Bank continues to withdraw licenses from problematic banks.

Figure 6: Performance indicators remained largely unchanged



Source: CBR.

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