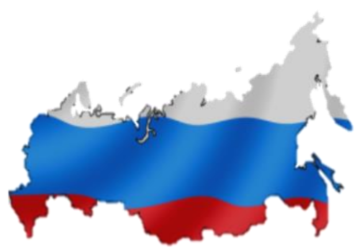
# Russia Monthly Economic Developments

September 2016

- The global economy continues to disappoint but global financial markets are stabilizing, post-Brexit.
- Following a mid-August rally, oil prices weakened again. The price of Brent averaged $46.14/bbl in August. The mid-August rally did not support the ruble, which depreciated by about 0.9% in August.
- Inflation continued to slow down in August and reached 6.9 percent y-o-y.
- High frequency indicators show industrial production shrank by 0.3% y-o-y, as the services sector stabilized. Fixed capital investment showed some positive dynamics.
- The banking system remains stable but still vulnerable to macroeconomic risks. Credit to firms declined in real terms, falling by 2.3 percent in real terms y-o-y in July.
- The primary budget deficit increased to 2.4 percent of GDP as the impact of low oil prices outweighed lower government expenditures.
- The seasonally adjusted unemployment rate was stable at 5.6 percent, while real income dynamics were weak in July.
- The government approved a one-time pension payment for January 2017 and postponed privatization of Bashneft to a later date.



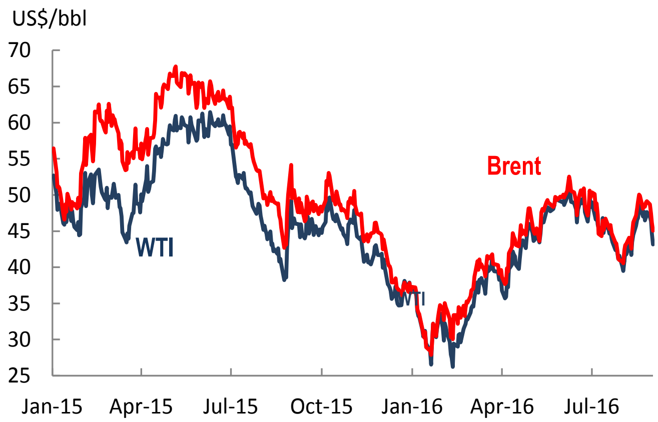
**The global economy continues to disappoint.** Based on preliminary GDP estimates for major advanced and emerging economies, global growth in 2016Q2 is likely to have remained below a subdued post-crisis average of 2.5 percent for the third consecutive quarter. In particular, global industrial activity continued to underperform, held back by weak investment and a drawdown in inventories. However, there were some signs of normalization in June and the global manufacturing PMI improved somewhat in July, stabilizing at a modest 50.8 in August (a reading above 50.0 signals an improvement over the previous month). Together with a stable global services PMI at 51.5 in August, current surveys point to modest ongoing growth. Global retail sales were strong throughout Q2, supported in particular by declining oil prices and further improvements in labor market conditions across advanced economies. While financial markets have recovered from the immediate impact of the U.K.'s Brexit vote, and business confidence in the rest of Europe has remained resilient, activity and sentiment indicators in the United Kingdom have deteriorated sharply. Following an initial bout of volatility, global financial markets rapidly stabilized, with global equity and bond markets lifted by expectations of additional monetary policy accommodation by major central banks. Bleak economic prospects of the EU and slowing down in China (Russia's major trading partners) suggest that they will not contribute positively to a recovery of external demand in Russia.

**Following a mid-August rally, oil prices have weakened again.** The prices of Brent (the international marker) and WTI (the U.S. reference crude) averaged $46.14/bbl and $44.75/bbl, respectively, in August (Figure 1). Global oil inventories remain high and OPEC continues to produce at record levels (including in key producer Saudi Arabia). Iran's production has rebounded sharply since the lifting of sanctions in January and has reached 3.6 mb/d. Yet, the stock overhang is expected to gradually unwind. Crude oil prices are projected to average $43/bbl in 2016 and $53/bbl in 2017, as reported in the July update of the Commodities Market Outlook.

**The mid-August rally in oil prices did not support the ruble.** Despite an increase in average (Brent) oil price by about 1.5 percent to US$46.1/bbl in August, the average exchange rate depreciated by about 0.9 percent, compared to July's (Figure 2). Dividend payments to non-residents, high tourist season, and existing uncertainty about the oil price movement are factors likely to have contributed to elevated demand for dollar.

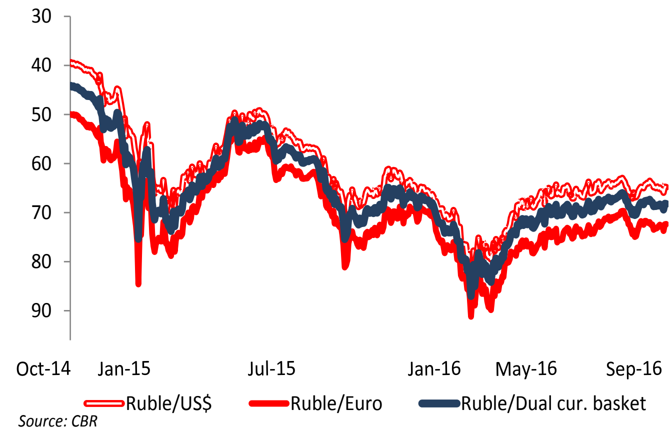
**Inflation continued to slow down in August.** The 12-month consumer price index decreased to 6.9 percent in August, the lowest reading since February 2014, from 7.2 percent in July (Figure 3). In August, the core inflation slowed to 7.0 percent from 7.4 percent in July. The inflation slowdown is partly attributed to the base effect, as inflation increased in August last year on the back of the pass-through from the ruble depreciation. In addition to the observed deceleration in consumer inflation, the August central bank survey indicated relatively lower – but still elevated -- inflation expectations.

**Figure 1: Oil prices weaken again following a mid-August rally....**




*Source: Bloomberg*

**Figure 2: … and the ruble depreciated slightly**




*Source: CBR*

**Industrial production declined as services stabilized.** In July, industrial production shrank by 0.3 percent y-o-y, while contracting by 0.9 percent in seasonally adjusted terms on a monthly base (Figure 4). Growth in mineral resource extraction production volumes could not compensate for a decline in manufacturing. In July, manufacturing production volume dropped by 1.4 percent y-o-y after growing by 1.6 percent y-o-y in June. On the positive side, sectors that produce investment goods, such as machines and equipment, and transport vehicles and equipment expanded. Growth in machines and equipment was mainly driven by agricultural investment goods production. Meanwhile, services sectors demonstrated some signs of stabilization: retail trade and retail services increased by 0.6 percent and 0.2 percent respectively, on a monthly base in seasonally adjusted terms. Aggregate output contracted by 1 percent year-on-year (compared to a contraction of 0.4 percent last month).

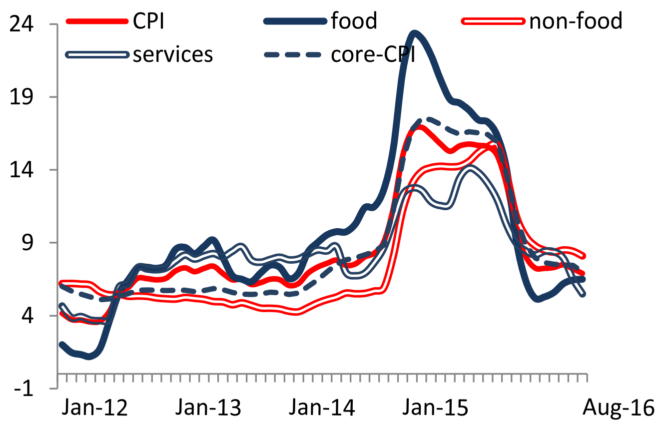
Fixed capital contraction slowed down, contracting by 3.9 percent y-o-y, compared to 4.8 percent in the first quarter. Overall, in the first half of 2016, fixed capital investment contracted by 4.3 percent, y-o-y. High frequency data on fixed capital investment, excluding small enterprises, reveal even better fixed capital investment dynamics and contraction of 1 percent in the first half of 2016, y-o-y. Robust growth of fixed capital investment was registered in agriculture, fishing, mineral resource extraction, real estate, and restaurants and hotels.

**The banking system remains stable but still vulnerable to macroeconomic risks.** The overall capital adequacy ratio resumed its declining trend on the back of low profitability and worsening credit quality: reported NPLs reached 9.7 percent of total loans in the first half of 2016 (Figure 5). Despite the challenging environment, the flow of deposits is increasing, liquidity in both rubles and foreign exchange (FX) has improved, and there are no signs of increased dollarization. Banks' financial performance is still weak, although improving slightly, due to low lending growth and higher provisioning, with a return on assets at 0.6 percent, and return on equity at 5.7 percent. The central bank has continued closing banks, most of them small, in many cases because they are weak or not in compliance with regulations (including under AML/CFT legislation), revoking licenses of 9 banks in August – early September.

Credit to firms kept declining, falling by 2.3 percent in real terms year-on-year in July, compared to -1.1 percent in June. Meanwhile, the contraction in credit to households slightly decelerated: 7.8 percent in real terms, year-on year (compared to -8.3 percent in June).

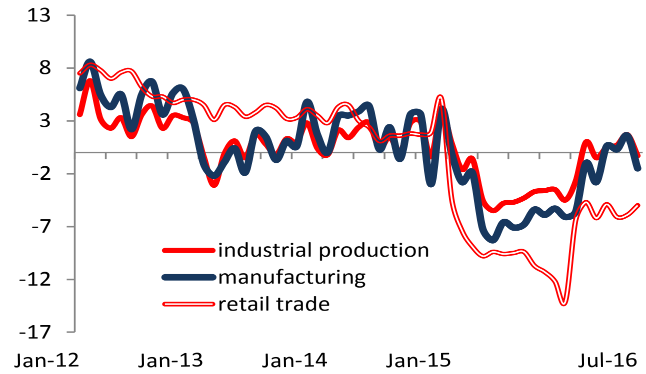
**The primary budget deficit increased as the impact of low oil prices outweighed lower government expenditures.** During January–July 2016, the primary budget deficit increased from 1.7 to 2.4 percent of GDP, year-on-year, as government revenue dropped from 17.7 to 15.1 percent of GDP due to lower oil and gas revenues. Oil and gas revenues fell sharply to 5.5 percent of GDP from 8 percent of GDP in the same period of 2015. Non-oil and gas revenues decreased moderately, falling by 0.2 percent of GDP on the back of lower non-tax revenues and lower corporate income tax receipts. Primary expenditure declined by 1.5 percent of GDP to 17.5 percent of GDP (-5.5 percent year-on-year in nominal terms) in January-July 2016 in line with the government's effort for expenditure consolidation. Defense (-1 percent of GDP or -17.6 percent in nominal terms) and national economy (-0.7 percent of GDP or -20.2 percent in nominal

**Figure 3: Inflation fell** (percent, y-o-y)




*Source: Rosstat, Haver Analytics, World Bank team*

**Figure 4: Industrial production slowed down** (percent change, y-o-y)




*Source: Rosstat, Haver Analytics, World Bank team*

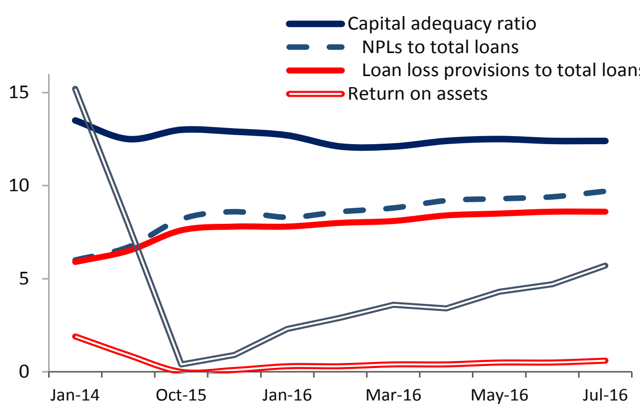
terms) were two categories of expenditure which decreased the most. Social spending increased the most, by 0.6 percent of GDP. Government spending cuts improved the federal budget non-oil and gas deficit to 8.7 percent of GDP in the first seven months of 2016 from 10.4 percent of GDP in the same period last year. Overall, the federal budget deficit worsened to 3.1 percent of GDP in January – July 2016 from 2.4 percent of GDP in the same period 2015. The amount spent from the Reserve Fund for deficit financing from January 2016 totaled 1.17 trillion rubles and the Reserve Fund decreased by about one third to 2.09 trillion rubles (US$32.2 billion).

**The unemployment rate was stable, while real income dynamics were weak in July.** The seasonally adjusted unemployment rate indicator in August stayed stable at 5.6 percent. Real income dynamics remain weak (Figure 6). Wages increased in real terms in July 2016 by 0.6 percent compared to the same period of 2015, while real disposable income contracted by 7 percent. However, real wages declined by 0.7 percent compared to June 2016.

**The government approved a one-time pension payment for all pensioners in January 2017.** In August, the government decided not to index pensions, but instead to support pensioners with a one-off pension payment in January 2017, with all pensioners, working and non-working, eligible for such payment. In addition to this one-time payment, in 2017, the government intends to index pensions with the 2016 inflation rate.

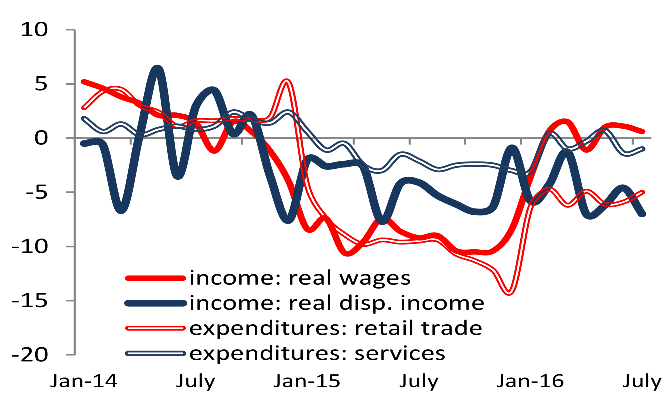
**The government postponed privatization of Bashneft from September – October 2016 to a later date.** Bashneft, which is engaged in oil extraction, is one of the largest producers of high-quality petroleum products in Russia. In mid-May, a Presidential decree allowed its privatization, which has now been postponed.

**Figure 5: Non-performing loans are increasing** (percent)




*Source: CBR*

**Figure 6: Real income dynamics are weak** (percent change, y-o-y)




*Source: Rosstat, Haver Analytics, World Bank team*