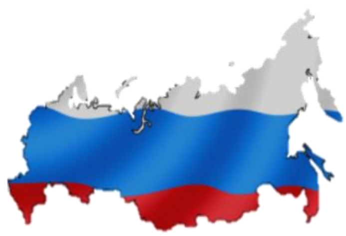
Russia Monthly Economic Developments

February 2018

Global growth continued to be strong in the fourth quarter of 2017, reaching an estimated 3.1 percent (q/q saar). This was slightly weaker than the previous quarter's readings as growth somewhat moderated in the United States and Euro Area. Following seven consecutive monthly increases, oil prices — which reached more than $66/barrel (bbl) in January 2018 — retreated in early February. In January, the ruble strengthened on the back of higher oil prices and a weakening of the U.S dollar. A favorable external environment (higher oil prices) supported Russia's current account in 2018. In December 2017, industrial production dynamics improved on a month-to-month basis, but industrial production growth in the fourth quarter of 2017 appeared to be negative. Labor market indicators were relatively stable in December. In January 2018, consumer inflation dropped further, reaching 2.2 percent, y/y. Low inflation and lower inflation expectations allowed the Central Bank to cut the policy rate by 25 bp to 7.5 percent in annual terms on February 9. In 2017, aided by higher oil prices, the federal budget registered a primary deficit of 0.7 percent of GDP (on a cash basis) compared to a deficit of 2.7 percent of GDP last year. The banking sector started off the new year with growth in both retail and corporate lending. After two years of recession, Russia registered GDP growth of 1.5 percent.

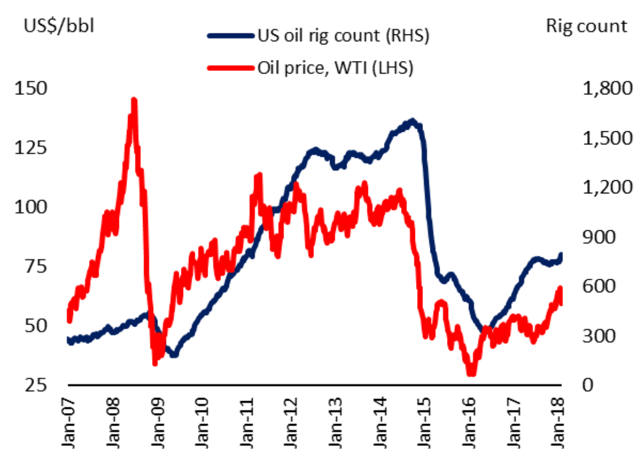
The Global Context



Global growth continued recovering. Global growth rates were robust in the fourth quarter of 2017, reaching an estimated 3.1 percent (q/q saar). This was slightly weaker than the previous quarter's readings as growth somewhat moderated in the United States and Euro Area. Growth in China slowed to 6.3 percent amid continued rebalancing of its economy to the services sector. Global industrial production showed renewed strength in November and December, and the global manufacturing PMI remained at a near 7-year high in January 2018. Following a prolonged period of benign global financing conditions, a market reassessment of inflationary pressures and the pace of monetary policy normalization in the United States led to a sharp increase in U.S. long term Treasury yields and a sudden drop in U.S. and global equity prices. This was associated with tighter financing conditions for emerging markets and developing economies and a slowdown in capital inflows.

Following their seventh consecutive monthly increase, oil prices, which reached more than $66/barrel (bbl) in January 2018, retreated in early February (Figure 1). The strengthening in oil prices was supported by a number of factors including OPEC's strong compliance with the agreed-upon cuts, a fall in inventories, especially in OECD countries, and robust global demand growth. However, recent news that U.S. crude oil output reached its highest level since 1970, coupled with a rebound in the U.S. rig count, which reached 791 in the first week of February (up from 747 in mid-January), exerted downward pressures on oil prices. The WTI—the U.S. barometer—dropped below the $60-mark in mid-February from its early-January peak of $66/bbl; similarly, Brent—the international indicator—declined to $63/bbl in mid-February from its January peak of $70/bbl. Oil prices are projected to average $58/bbl in 2018 and $59/bbl in 2019. In the long term (2025), they are expected to reach $65/bbl (based on January 2018 Global Economic Prospects forecasts).

Figure 1: Oil prices retreated in early February 2018



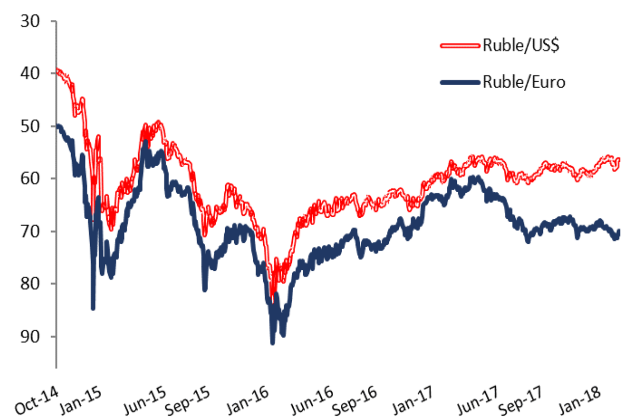
Source: Baker Hughes, Bloomberg.

Russia's Recent Developments

In January 2018, the ruble strengthened on the back of higher oil prices, yet currency purchases by the Ministry of Finance exercised pressure for depreciation. While the average oil price (Brent) increased by about 7.4 percent in January, the ruble appreciated by 3.5 percent with respect to the U.S. dollar

(Figure 2). The dollar also weakened with respect to other currencies (euro, Chinese yuan renminbi, Japanese yen). Currency purchases conducted by the Central Bank on behalf of Ministry of Finance, which amounted to about US$270 million daily, compared to US$60 million in October 2017, exercised pressure for depreciation.

Figure 2: The ruble appreciated in January 2018

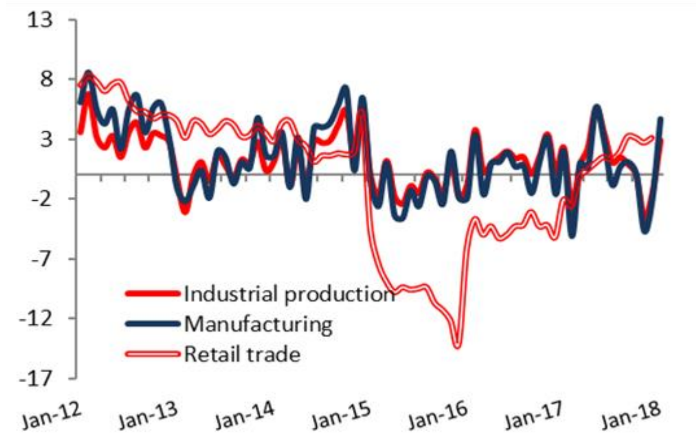


Source: CBR.

A favorable external environment supported the current account in 2018. In January 2018, the current account increased to US$12.8 billion from US$8.0 billion in the same period last year. An increase in the trade surplus due to higher energy prices was the key factor behind the strengthening of the current account. This was also mirrored by higher net capital outflows: US$7.1 billion in January 2018 compared to US$3.1 billion in the same period last year. Net capital outflows were largely the result of an increase in the net foreign assets of banks and the non-banking sector. In January 2018, international reserves increased by US$11.7 billion due to currency purchases by the Ministry of Finance and debt repayments by resident banks.

Despite an improvement in industrial production in December, the sector shrank for the year as a whole (Figure 3). Industrial production fell by 1.5 percent, y/y, in December 2017, but it increased by 0.4 percent, m/m, sa. Compared to December 2016, all components of industrial production registered negative growth in annual terms: mineral resource extraction (-1 percent, y/y), manufacturing (-2 percent, y/y), electricity and gas production and distribution (-5.5 percent, y/y), and water supply (-4.2 percent, y/y). Negative dynamics in metallurgy and other types of transport vehicles (possibly due to lower defense spending) were responsible for negatively weighing down on the country's manufacturing performance in December: In the fourth quarter of 2017, industrial production decreased by 1.7 percent, y/y.

Figure 3: Industrial production dynamics improved in December 2017 on m/m basis

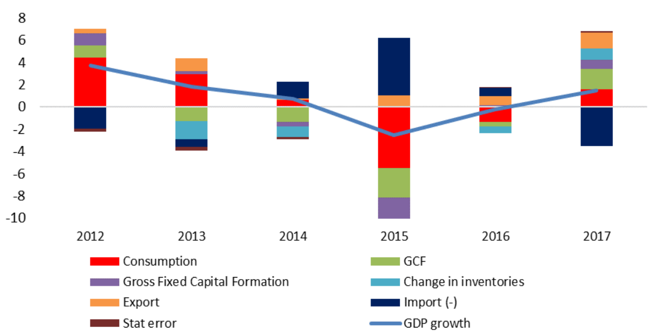


Source: Rosstat, Haver Analytics, World Bank team.

The non-tradable sectors drove the country's economic recovery in 2017. After two years of recession, Russia registered GDP growth of 1.5 percent, which appeared to be slightly below our projection of 1.7 percent. Recovery in retail and wholesale trade, as well as transportation contributed the most to GDP growth in 2017. While retail trade was supported by growth in household consumption, which increased on the back of increasing real wages, macro stabilization, and a stronger ruble, wholesale trade also benefitted from high growth in gas extraction. The total contribution of non-tradable sectors to GDP growth totaled 1.4 percentage points (pp) in 2017. Apart from the construction sector and the activities of households as employers, all non-public non-tradable sectors registered growth in 2017. The contribution of tradable sectors to GDP growth amounted to 0.2 pp in 2017 compared to 0.3 pp in 2016. Despite a bumper harvest, growth in agriculture totaled 1.2 percent, y/y, partly due to the high base of 2016. In 2017, strong growth in natural gas production supported mineral resource extraction, which increased by 1.4 percent, y/y, despite the almost flat rates of oil production as Russia joined the OPEC+ agreement. Growth in manufacturing totaled a marginal 0.4 percent, y/y, as growth slowed down in the second half of 2017.

Domestic demand, which increased by 3.6 percent, y/y, in 2017, was the main engine of growth. Rosstat published its first estimates of the demand-side composition of growth in 2017. Both household and investment demand expanded (Figure 4). Private consumption, supported by growing real wages and pensions, and by reviving credits to households, contributed 1.8 pp to growth. With macro stabilization, a stronger ruble, and improved business sentiments, capital formation increased as both fixed capital investment (which grew 3.6 percent, y/y, and contributed 0.8 pp to GDP growth) and change in inventories (which contributed 1 pp to GDP growth) contributed positively to growth. Stronger momentum in global demand supported exports (+ 5.4 percent, y/y), but prominent increases in imports (+17 percent, y/y) accounted for a negative contribution of net exports to GDP growth.

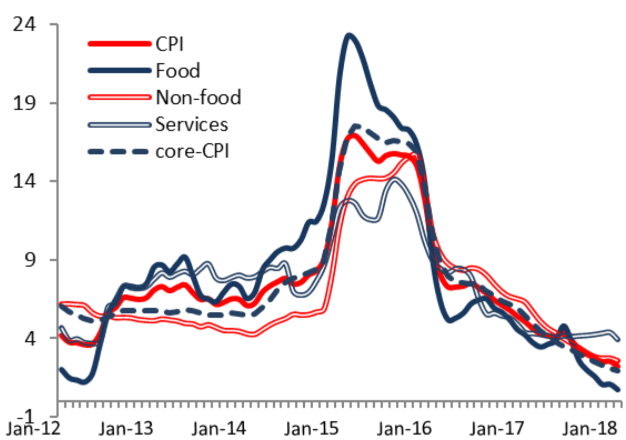
Figure 4: Domestic demand was the main engine of growth in 2017



Source: Rosstat, World Bank staff calculations.

In January 2018, consumer inflation dropped further. The 12-month Consumer Price Index reached the level of 2.2 percent in January (Figure 5). The slowdown in the growth of prices occurred in all categories: food, non-food, and services. Low inflation and lower inflation expectations allowed the Central Bank to cut the policy rate by 25 bp to 7.5 percent in annual terms on February 9. The Central Bank refrained from a bigger cut given the increased volatility in global financial markets. The Central Bank announced that it could complete its move to a neutral monetary policy in 2018.

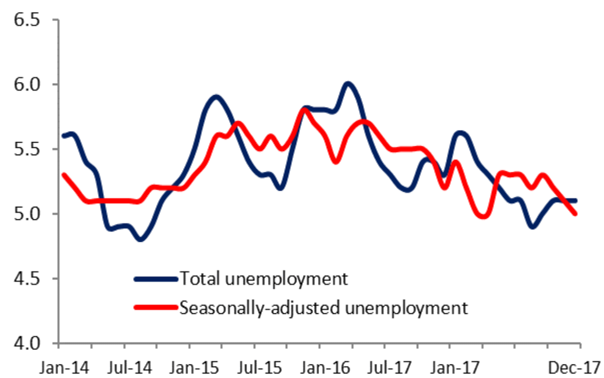
Figure 5: Consumer inflation dropped further in January 2018



Source: Rosstat, Haver Analytics, World Bank team.

Labor market indicators were relatively stable in December 2017. The unemployment rate did not change and stayed at the level of 5.1 percent. However, the seasonally adjusted rate declined by 0.1 percentage points to the level of 5 percent (Figure 6). Real wages continued to grow and increased in December by 4.6 percent compared to the same period in 2016, and they increased by 1 percent compared to November 2017 following seasonal adjustment. In December, real disposable income contracted by 1.8 percent compared to the same period in 2016, and it increased by 2.5 percent compared to the previous month after seasonal adjustment. This indicator is highly volatile and is, to a large extent, driven by sources of income that are not registered by statistics. The average contraction of real disposable income in 2017 as compared to 2016 was 1.4 percent. Pensions were indexed in the beginning of the year at the inflation rate, and with the deceleration of inflation, the real growth of pensions increased to 1.6 percent compared to December 2016.

Figure 6: Labor market indicators were relatively stable in December 2017

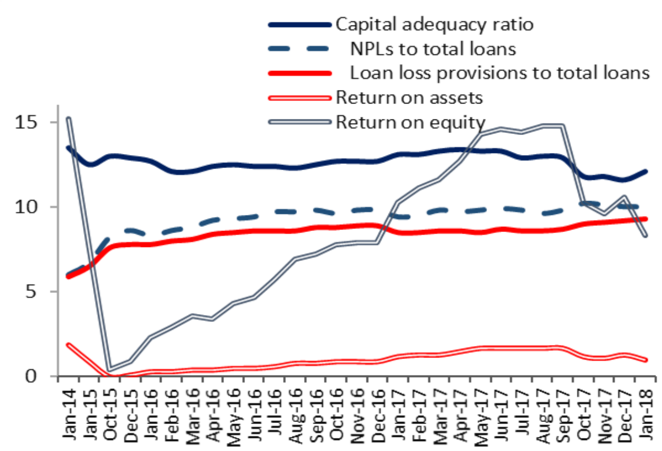


Source: Rosstat, Haver Analytics, World Bank team.

In 2017, aided by higher oil prices, the federal budget strengthened, registering a primary deficit of 0.7 percent of GDP (on a cash basis) compared to a primary deficit of 2.7 percent of GDP in 2016. In 2017, the federal budget revenue stood at 16.4 percent of GDP, an increase of 0.7 percent of GDP compared to the same period last year, with oil and gas revenues growing by 0.8 percent of GDP. Adjusted for one-off receipts from privatization proceeds in 2016, non-oil/gas revenues also demonstrated growth. Compared to the same period last year, primary expenditures decreased by 1.3 percent of GDP to 17.1 percent of GDP due to lower spending on defense (-1.3 percent of GDP), national security (-0.1 percent of GDP), and health (-0.1 percent of GDP). In 2017, the non-oil/gas primary deficit improved from 8.4 percent of GDP to 7.2 percent of GDP mainly due to lower spending. Overall, the federal budget deficit narrowed in 2017 to 1.4 percent of GDP from 3.4 percent of GDP in 2016.

The banking sector started off the new year with growth in both retail and corporate lending. Retail segment has been the main driver of growth fueled by the recovery in the consumer demand. In January, credit to households in rubles increased by 14.5 percent, y/y, compared to 13.3 percent in December. Meanwhile, credit to the corporate sector in rubles grew by 5.1 percent, y/y, compared to 3.8 percent in December. Sector non-performing loans remained stable at 10% as of January 1, 2018 (Figure 7). The banking sector profitability was hit in December by significant losses at Promsvyazbank due to the imposition of additional provisioning of RUB 104 billion, following the intervention by the Central Bank via its Banking Sector Consolidation Fund. As of January 1, 2018, the banking sector profitably has declined to the levels of 2016, with the return on assets and the return on equity at 1 percent and 8.3 percent, respectively. The capital adequacy remained stable and stood at 12.1 percent (against a regulatory minimum of 8 percent).

Figure 7: The banking sector started off the new year with growth in both retail and corporate lending



Source: CBR.

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 561 at the beginning of 2018 to 558 as of February 1, 2018. The ongoing financial recovery process for the three banks bailed out under the new bail out mechanism (Bank Otkritie FC, B&N Bank and Promsvyazbank) – the CBR's Banking Sector Consolidation Fund – will bring the CBR ownership to 45 percent of bank system assets, once recapitalization of the banks is complete (expected by the end of 1Q2018). This creates a potential conflict of interest between the CBR's regulatory and shareholding roles. Recently the Russian government announced its plans to turn Promsvyazbank into its financial arm to serve the defense sector, so ownership will be transferred from CBR to the government after the capital injection into the bank.

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