Following a third quarter boost in 2016, global growth remained broadly stable in the fourth quarter at 2.5 percent (q/q, saar). Moderate growth in advanced economies was offset by stronger growth in emerging market and developing economies (EMDEs). Oil prices fluctuated tightly around $55/bbl since early December until the end of February. Prices were supported by production cuts, particularly from OPEC producers, and the expected decline in crude oil inventories in the second half of the year. The ruble gained 2.6 percent vis-a-vis the U.S. dollar compared to last month, on the back of higher oil prices and a global rise in portfolio flows into emerging market funds. In January, industrial production grew, driven mainly by mining and manufacturing. Inflation currently at 4.6 percent – slowed further in February, supported by the ruble appreciation and last year’s good harvest. The federal government balance weakened to a primary surplus of 0.4 percent of GDP in January 2017 (from 7.4 percent in the same period last year) as government expenditures outpaced revenues by a significant margin. Key credit risk and performance indicators in the banking sector remained largely unchanged through the end of 2016.

The Global Context

Global growth momentum shifted to emerging market and developing economies (EMDEs) in the fourth quarter of 2016. Following a pick-up in Q3, global growth remained broadly stable in Q4 with 2.5 percent growth (q/q, seasonally adjusted annual rate --saar) as more moderate growth in advanced economies, including the U.S., and to a lesser extent the Euro Area and Japan, was offset a recovery in the EMDEs, including India, Russia, Indonesia, and Nigeria. PMI and industrial production suggest a further strengthening of global activity in Q1 of 2017. Inflation rates are converging. For commodity exporters, high inflation rates (initially driven up by weak currencies) have fallen rapidly towards target levels since mid-2016. Inflation rates for commodity importing EMDEs and advanced economies have seen a sustained rise from very low levels.

Oil prices fluctuated tightly around $55/bbl from early December until the end of February (Figure 1). Prices have been supported by production cuts, particularly from OPEC producers, and expectations of lower crude oil inventories in the second half of the year. However, price gains have been capped by the strengthening U.S. shale oil production and rising Libyan output. OPEC has yet to announce whether it will extend cuts into the second half of 2017. Oil demand, which has been steady, is entering a weak period due to refinery maintenance in March and April, but it is expected to pick up in May. The U.S. oil rig count has nearly doubled since a May low of 318 rigs, and crude oil production is expected to rise with the higher activity, and in response to lower costs and improved efficiency. U.S. crude oil production, which bottomed in 2016Q3 at 8.7 mb/d, is expected to exceed 9.4 mb/d in 2017Q4 and reach 10 mb/d in 2018Q4, according to the March update by the U.S. Energy Information Agency. 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 have fluctuated tightly around $55/bbl since early December

Russia’s Recent Developments

The ruble appreciated in February on the back of higher oil prices and a global rise in portfolio flows into emerging market funds (Figure 2). Overall, the ruble gained 2.6 percent with respect to the U.S. dollar compared to the previous month. Slightly higher oil prices and a global rise in portfolio...
flows into emerging market funds backed this exchange rate dynamic. With oil prices exceeding the $40 bbl cutoff price, the Ministry of Finance started purchasing currency in the domestic market to replenish the reserve fund, in line with its envisaged fiscal rule.

**Figure 2: The ruble appreciated in February**

<table>
<thead>
<tr>
<th>Ruble/USD</th>
<th>Ruble/Euro</th>
<th>Ruble/Dual cur. basket</th>
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<tbody>
<tr>
<td>10</td>
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<td>80</td>
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<tr>
<td>80</td>
<td>90</td>
<td>100</td>
</tr>
</tbody>
</table>

*Source: CBR.*

Rosstat changed the statistical classification of economic activities and classification of products by activity, aiming to harmonize them with the ones used in the European Commission (Nace Rev 2 and CPA 2008)\(^1\). As a result, the industrial production slump in 2015 appeared to have been shallower than previously considered: -0.8 percent, y/y, compared to -3.4 percent, y/y. Manufacturing output dynamics were revised the most, from -5.4 percent, y/y, to -1.3 percent, y/y. Industrial production dynamics in 2016 improved slightly from 1.1 percent growth, y/y, to 1.3 percent growth, y/y, with growth in manufacturing output changing from 0.1 percent, y/y, in 2016, to 0.5 percent, y/y. The new classifications will be also introduced to national accounts statistics for the first quarter of 2017 and could also lead to substantial revisions of growth composition.

Fixed capital investment by large and medium-sized enterprises dropped by 1.2 percent in 2016, y/y, reflecting soft growth prospects, policy uncertainty, continued adjustment to the earlier terms-of-trade shock, restricted access to international financial markets, and limited fiscal space. Fewer manufacturing sectors (namely paper, pulp and publishing, chemicals and metals) saw investment growth in 2016 than in 2015, While output expanded in real terms in economic activities such as food production, textiles, leather products, wood products, rubber, machines and equipment, and electronic equipment (partly reacting to external demand, partly reflecting import substitution and inventory restocking) -- investment in these sectors dropped (Figure 3). Capacity utilization increased in some of these sectors but new investment will be necessary to sustain growth. As in 2015, fixed capital investment was mostly financed from enterprise profits, and the share of this financing increased in 2016, mainly due to lower investment financing from the federal budget. Investment, financed by means of banking credits, increased compared to last year.

**Figure 3: Output growth was not followed with investment growth in many manufacturing sectors**

*Source: Rosstat.*

In January, industrial production grew, driven mainly by a growth in mining and manufacturing. Industrial output expanded by 2.3 percent in January, y/y, compared to a 0.2 percent increase in December (Figure 4). Seasonally adjusted output growth in industries stood at 0.8 percent, m/m, compared to -1.5 percent in December. Growth was registered in all components of industrial production, with manufacturing expanding by 2 percent, y/y, after a 1.6 percent contraction in December. Russia’s manufacturing PMI dipped to 52.5 in February from 54.7 in January, pointing to growth rolling over to February, albeit with lower momentum. A smaller rise in output and new orders, mainly for exports, was registered in February, yet the expansion was still solid.

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\(^1\) NACE is the statistical classification of economic activities in the European Community and is a basic element of the international integrated system of economic classifications, which is based on classifications of the UN Statistical Commission (UNSTAT), Eurostat as well as national classifications; all of them strongly related each to the others, allowing the comparability of economic statistics produced worldwide by different institutions. The present NACE Rev. 2, is the outcome of a major revision work of the international integrated system of economic classifications which took place between 2000 and 2007. CPA stands for Classification of Products by Activity and the regulation establishing CPA 2008 was adopted in April 2008.
Figure 4: Mineral resource extraction and manufacturing drove growth in industrial production in February

![Graph showing industrial production, manufacturing, and retail trade from Jan-12 to Feb-17](image)

Source: Rosstat, Haver Analytics, World Bank team.

Consumer demand strengthened in January. Retail trade contraction decelerated in January to 2.3 percent, y/y, after a 5.9 percent, y/y, decline in December. This also corresponds to an increase of 4.2 percent in real terms, m/m, seasonally adjusted. Retail services also increased in January by a marginal 2.2 percent, y/y, and 1 percent, m/m, after seasonal adjustment.

Inflation slowed further in February, partly aided by temporary factors (Figure 5). Supported by a stronger ruble and last year’s good harvest, the m-o-m inflation was unprecedentedly low for February and totaled 0.2 percent compared to 0.6 percent last year. The 12-month Consumer Price Index (CPI) decreased to 4.6 percent from 5 percent in January. The monthly inflation deceleration was registered across all CPI components: food prices increased by 3.7 percent compared to 4.2 percent a month ago; non-food prices grew by 5.7 percent compared to 6.3 percent a month back; and service prices decelerated from 4.4 percent to 4.3 percent. The Core CPI index dropped from 5.5 percent in January to 5 percent in February. Inflation expectations followed a declining trend, yet the level of inflation expectations remains elevated.

Despite an up-tick in unemployment, real incomes increased in January 2017 (Figure 6). The unemployment rate, seasonally adjusted, increased to 5.4 percent in January from 5.2 percent in December. Real wages continued to grow and increased in January by 3.1 percent, y/y. They also increased compared to the previous month after seasonal adjustment. Real disposable income grew in January 2017 by 8.1 percent, y/y, largely due to the base effect and the one-off payment to pensioners.

The federal government balance weakened to a primary surplus of 0.4 percent of GDP in January 2017 (from 7.4 percent in the same period last year). While federal budget oil revenues rose by 1.4 percent of GDP to 7.8 percent of GDP on the back of higher oil prices, federal budget expenditures increased by 8.4 percent of GDP to 19.9 percent of GDP. The increase in expenditures was due to higher spending on social policy (+7.3 percent of GDP), namely the one-off payment to pensioners and a slightly higher indexation of pensions, as well
as higher spending on national defense (+1 percent of GDP), education (+0.5 percent of GDP), and state management (+0.4 percent of GDP). On the back of higher expenditures, the federal non-oil primary deficit worsened to 7.4 percent of GDP deficit in January 2017 compared to 1 percent of GDP surplus in the same period last year.

The fiscal deterioration followed the tracks of 2016 developments. Just-released official figures suggest that the general government budget primary deficit worsened to 2.8 percent of GDP in 2016 (from 2.6 percent of GDP in the previous year) as higher non-oil revenues compensated for the drop in oil revenues, while expenditures increased slightly. In 2016, general government primary expenditures increased by 0.2 percent of GDP compared to 2015 and remained almost flat in real terms. As in 2015, public salaries were frozen. Public pensions were indexed below annual average inflation. National defense, environment, and health were the only categories for which expenditures increased in real terms in 2016. The non-oil primary fiscal deficit improved to 8.4 percent of GDP (from 9.6 percent of GDP in 2015) as non-oil revenues grew mainly due to the Rosneft privatization.

Key credit risk and performance indicators in the banking sector remained largely unchanged through the end of 2016. There are signs of a nascent turnaround in the sector as nonperforming loans slightly declined to 9.4 percent and the aggregate capital adequacy ratio increased to 13.1 percent (above the regulatory minimum of 8 percent stipulated in Basel III) as of January 1, 2017. Banks’ financial performance has been improving with the return on assets at 1.2 percent and the return on equity at 10.3 percent as of January 1, 2017 (Figure 7).

Credit to firms, however, continues to contract at an increasing pace. Adjusted for exchange rate movements, credit to firms decreased by 4.2 percent in January, y/y, compared to a contraction of 3.2 percent in December. Lending to households, adjusted for exchange rate movements, grew by 1.8 percent in January, y/y, from 1.5 percent in December. Consolidation in the banking sector continued - the number of banks in Russia has fallen from 623 at the beginning of 2017 to 619 as of February 1, 2017 mainly due to the Central Bank’s ongoing efforts to clean up the sector and close weak and noncompliant banks. To reduce the costs for the state and to strengthen the bank resolution framework, the Central Bank is preparing changes, which will include the creation of a bank resolution fund and introduction of statutory bail-in by 2018. The regulator plans to establish a fund through which it will provide equity instead of long-term funding, which under the existing regime is being provided via the Deposit Insurance Agency for bank recapitalizations.

Figure 7: Performance indicators remained largely unchanged through the end of 2016

| Source: CBR. |