Russia Monthly Economic Developments

March 2016

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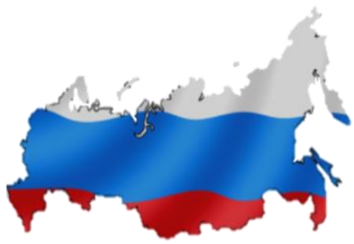
- Oil prices recovered slightly to US$38 per barrel in early March from their 12-year low in January.
- High U S dollar demand led to a divergence between the ruble exchange rate and oil price movement in February.
- Inflation eased significantly in February, largely because of the high base effect.
- Industrial activity showed some signs of recovery in January, but a sharp contraction in incomes hinders an improvement in the demand for services
- On March 1, the government approved the new anti-crisis plan of RUB685 billion or 0.8 percent of GDP.



On March 6, the US and the EU extended sanctions against Russia. The US has extended its targeted sanctions against senior Russian officials, businessmen, and state-owned companies for one year, freezing their assets within US jurisdiction and prohibiting US persons from doing business with them. The EU has decided to extend its asset freezes and travel bans against 146 Russian officials and pro-Russia separatists, and 37 entities for six months. The duration of sanctions are tied to the implementation of the Minsk peace agreements.

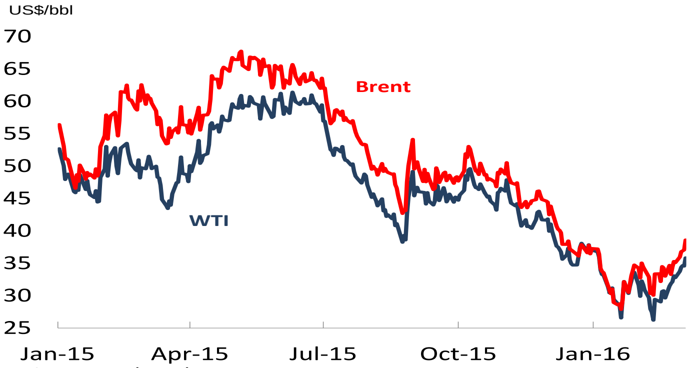
Oil prices recovered slightly to US$38 per barrel in early March from their 12-year low in January. Already in February, average prices inched up to US$31 per barrel from US$29.80 per barrel in January. Prices have risen due to supply outages (in Iraq and Nigeria) and an increasing probability that some producers, including Russia and Saudi Arabia, may freeze production at January 2016 levels. Meanwhile, non-OPEC production, including in the US, is declining, yet, the oil market remains oversupplied with OECD countries sitting on large stocks and potential increases in supply expected from Iran. The World Bank oil price forecast remains at US$37 per barrel for 2016.

High U S dollar demand led to a divergence between the ruble exchange rate and oil price movement in February. In February, average oil prices increased by 8.4 percent, compared to January, while the ruble appreciated by only 0.8 percent with respect to the US dollar. Contributing factors included a high demand for US dollars, in part the result of uncertainty surrounding oil market volatility, and Russian large upcoming external debt payments, estimated at US$8.2 billion in February and US$12.4 billion in March, compared to US$4.4 billion in January. In February, the average amount of foreign currency provided by the Central Bank of Russia (CBR) to banks in 3-month repo auctions increased by 24 percent, from US$5.1 billion in January.

Inflation eased significantly in February, largely because of the high base effect. The 12-month Consumer Price Index decreased from 9.8 percent in January to 8.1 percent in February, compared to 16.7 percent in February 2015. Food inflation slowed the most, to 6.4 percent year-on-year from 9.2 percent in January, also largely due to the base effect of February 2015 when it peaked at 23.3 percent. Non-food inflation retreated less to 9.5 percent from 10.9 percent in January year-on-year as the pass-through from the January ruble deprecation still impacted non-food prices. Meanwhile, core inflation decelerated substantially to 8.9 percent in February from 10.7 percent in January, indicating that inflation risk might begin subsiding.

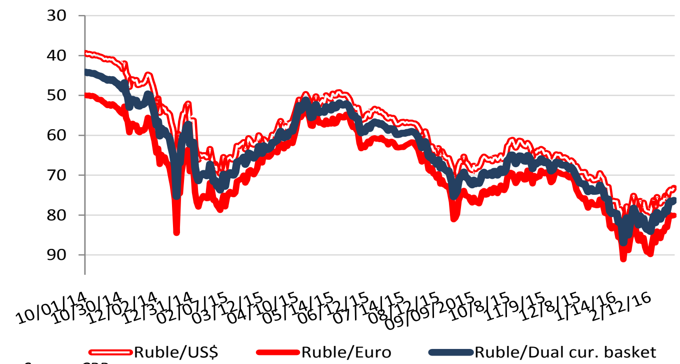
Industrial activity showed some signs of recovery in January, but a sharp contraction in incomes hinders improvement in the demand for services. In January, the contraction in aggregate industrial output decelerated to 2.7 percent, year-on-year from 4.5 percent in December. Manufacturing also posted a lesser contraction of 5.6 percent, compared to -6.1 percent in December. On a seasonally adjusted monthly basis, industrial output grew by 0.4 percent in January, for the first time since September last year. This frail industrial recovery was largely driven by a slight expansion in extractive industries and moderate growth in utilities due to the cold January weather. Real disposable incomes dropped in January by 6.3 percent year-on-year, compared to -0.8 percent in December. As a result, demand for services continued to report a sizable contraction of 7.3 percent year-on-year in January, and other services declined by 2.7 percent. While the sharp income drop makes a recovery in services demand less likely, surprisingly, the business activity index for the services sector in February suggests the likely return of growth momentum, jumping to 50.9 from 47.1 in January.

Figure 1: Oil prices continued to inch up …



Soource: Bloomberg

Figure 2: … while the ruble appreciated only slightly



Source: CBR

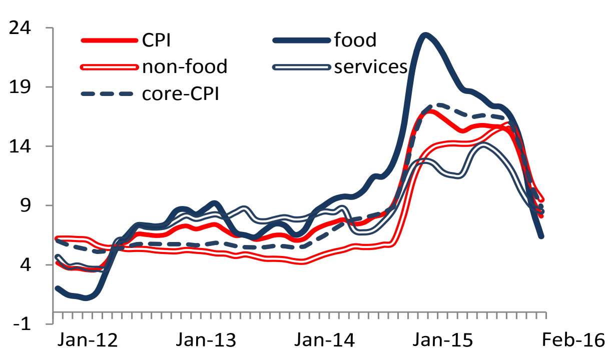
Rosstat data on the financial performance of the real sector in 2015 reveals an astonishing 53 percent growth in aggregate net profits. This compares to a 9 percent drop in 2014. Adjusted for the producer prices index, real profits grew by 36 percent, despite a sharp contraction of economic activities last year, a drop in consumer demand by more than 10 percent and an 8.4 percent drop in fixed capital investments. Real profits doubled in the transport and communication sectors and grew by 46 percent in manufacturing while real profits in the trade sector grew by 34 percent in 2015. Data suggests that Russian producers successfully shifted the recession burden to consumers and employees, by sharply increasing prices on final goods–consistent with persistent core inflation in 2015–while at the same time restricting wage growth. Most of all, this points to lack of competition in the goods and services markets.

Challenging economic conditions increased bank's risk aversion and most performance indicators remain weak. A drop in real disposable incomes and public spending is putting pressure on bank's asset quality and is the reason why banks show less risk appetite in new lending. As of end-January, the banking system assets totaled RUB83.7 trillion (103 percent of GDP) and the aggregate capital adequacy level was 12.7 percent. Nonperforming loans remained flat since the end of 2015, amounting to 8.3 percent of total loans. Tentative signs of asset-quality improvement were evident in January as new loan generations with better asset quality are gradually improving the portfolio. In January, total credit to the economy grew by 1.6 percent, with the loans to corporates increasing by 2.4 percent, while credits to households declined by 0.6 percent. Banks' profitability has dramatically declined in 2015, with a return on equity dropping from 7.9 percent at end-2014 to 2.3 percent at end-2015, but it showed some positive trend in January. The central bank revoked the licenses of 13 banks since January, bringing the total number of banks to 733.

Standard & Poor's confirmed in February the long-term sovereign credit rating for Russia at the level of BB+, one category below investment grade and kept a negative outlook. S&P also confirmed the long-term rating in national currency at investment grade in category BBB-.

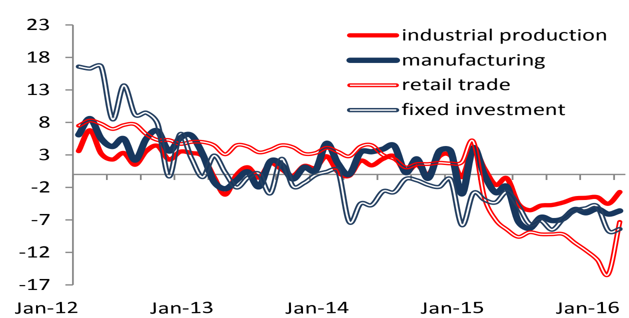
On March 3, Russia's largest gas company Gazprom announced that it had secured a €2 billion (US$2.17 billion) loan from Bank of China. Gazprom did not disclose the terms of the largest single-bank loan in the company's history, but is likely to use it for refinancing. Gazprom's biggest shareholder remains the Russian government. Gazprom has the gas monopoly in Russia, having the exclusive right to export gas from Russia.

Figure 3: Inflation pressure is slowly easing … (percent, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

Figure 4: … and output started to recover (percent change, y-o-y) (percent change, y-o-y)

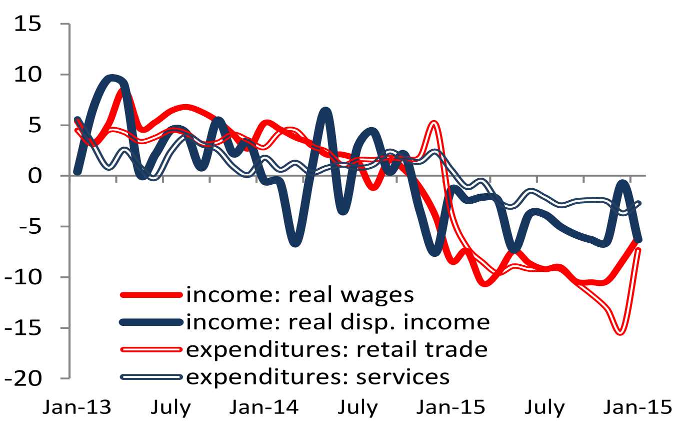


Source: Rosstat, Haver Analytics, World Bank team

In January 2016, the federal budget registered a primary surplus of 7.9 percent of GDP as a sharp decrease in expenditure overcompensated a decline in revenues. Rosstat recently changed the methodology for GDP calculation, but did not provide yet a new series for monthly GDP. This makes monthly GDP data for 2015 and 2016 not comparable, hence we do not report fiscal data as a percentage of GDP compared to the previous year. In January, federal budget revenues fell by 17.8 percent in nominal terms year-on-year, mainly due to a decline in oil revenues by 28.3 percent in January, and a 10.7 percent drop in non-oil revenues. Primary expenditures dropped about twofold in nominal terms compared to January 2015 as the pace of spending on defense and the economy decreased significantly. The two top-spending categories in January were social spending (51.1 percent of primary expenditures) and national security (15.6 percent of primary expenditures) while spending on social policy, housing and communal services, and health were the only expenditure items which registered an increase in nominal terms compared to last year.

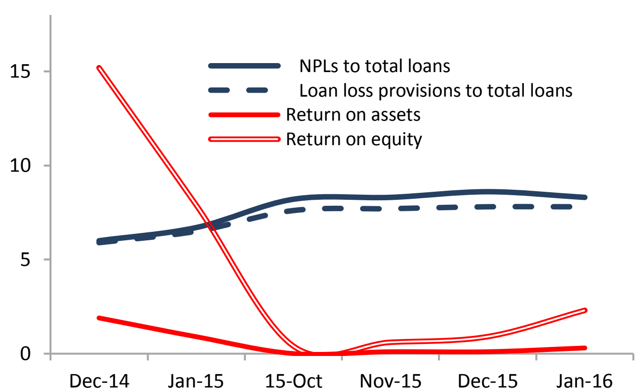
On March 1, the government approved the new anti-crisis plan. The *Plan of Government Actions for Stable Social-economic Development in 2016* envisions spending on anti-crisis measures in the amount of RUB684.8 billion (0.8 percent of GDP), but 22 percent less than the RUB880 billion proposed by the Ministry of Economy earlier in February. The bulk of financing in support of the economy (RUB440 billion) has already been included in the 2016 budget. RUB40 billion will come from the National Welfare Fund to support the Russian Railway Company to build train engines. The financing for RUB158 billion is still unresolved and will need to be approved later. Potential other sources of financing could be: the anti-crisis fund held by the government (RUB120 billion, mainly undisbursed resources from the 2015 anti-crisis plan); the anti-crisis fund held by the president (RUB 342 billion, consisting of the frozen second-pillar pension contributions); privatization proceeds; or other expenditure reallocations. The plan focuses on immediate and medium-term economic development measures in four areas: restructuring of the economy and improving the investment climate; supporting the regions; helping selected industries; and social support. In the short-term, the government plans to support several sectors through industrial policy-like measures. These include the automobile industry, light industry, agriculture, pharmaceutical production, and housing and communal services. The plan also includes measures to support employment. As medium-term economic development measures, the plan proposes the privatization of state-owned companies; a significant reduction in business audits; increasing the predictability of legislation; and steps to improve the judicial and law enforcement systems. The latest version of the plan left out RUB150 billion slated for the recapitalization of the state development bank VEB, although it kept the promise to support the institution. A possible second indexation of pensions (in addition to the one envisioned in the current budget proposal) in the second half of 2016 is suggested by the plan, but the final decision will be taken considering actual budget revenues in the first half of 2016. A new spending item will support producers of generics (RUB50 billion).

Figure 5: Incomes dropped sharply (percent change, y-o-y) …



Source: Rosstat, Haver Analytics, World Bank team

Figure 6: Bank's return on equity improved (percent)



Source: CBR

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