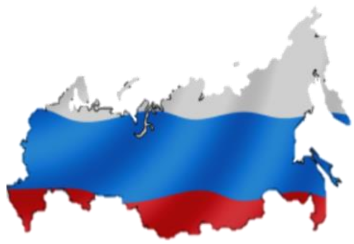
Russia Monthly Economic Developments

May 2016

- The World Bank revised its oil price forecast upwards to US$41 per barrel in 2016 and to US$50 per barrel in 2017.
- The World Bank 2016 growth projection for Russia improved to -1.2 percent as a result of higher oil prices.
- Consumer prices stabilized in April.
- Industrial output continued to recover in March and the recession in the services sector showed signs of abating.
- The banking system remains adequately capitalized, yet non-performing loans are rising and credit growth is weak.
- The current account deteriorated in the first quarter of 2016, coincided with a notable slowdown in net capital outflows.



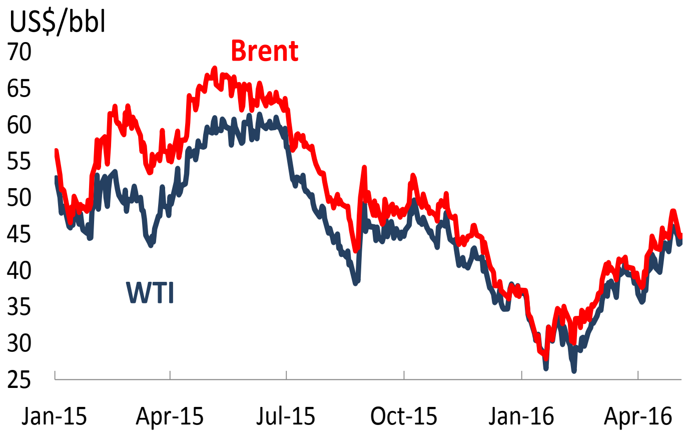
The World Bank revised its oil price forecast upwards to US$41 per barrel in 2016 and to US$50 per barrel in 2017 from US$37 per barrel and US$48 per barrel, respectively, projected in January 2016. After oil prices had plunged below US$30 per barrel in January they rebounded during April and reached US$44 per barrel in early May. This rebound was due to strong crude oil demand from China, supply outages in a few countries and a weaker US dollar. Despite this recovery, the market remains oversupplied with large stocks, particularly in the US. OECD stocks reached a record high of 1.23 billion barrels in February 2016. Globally, the oil price plunge since 2014 has prompted a reduction in the oil rig count by nearly 60 percent compared to November 2014 high. In contrast, the rig count among Persian Gulf producers increased by 13 percent over this period, confirming the willingness of the largest OPEC members to defend their market share. A proposal by key OPEC and non-OPEC producers to freeze oil production at January levels failed to materialize at the Doha meeting on April 17.

The World Bank 2016 growth projection for Russia improved to -1.2 percent as a result of higher oil prices. In 2017 GDP growth is projected to return to a positive growth rate of 1.4 percent. The revisions are based on a smaller contraction in consumption in 2016 and a faster pace of recovery in consumption in 2017, largely due to upward changes in the oil price assumption. Higher oil prices and the upcoming parliamentary elections in September could also lead to pressures for higher fiscal spending, resulting for example in a second pension indexation in the second half of 2016. A similar scenario could present itself in next year's Presidential pre-election year.

The ruble appreciated against the US dollar proportionally less than the increase in oil prices. In April, the average oil price (Brent) increased by 9.5 percent relative to March, and since February cumulatively by almost 30 percent. The ruble appreciated against the US dollar by 5.6 percent and 16.0 percent, respectively. There remains caution among investors to move into ruble-denominated assets despite attractive returns. At the same time, demand for foreign currency remained elevated due to slightly higher external debt payments, which are estimated at US$19.2 billion in the second quarter of this year, compared to US$13.9 billion in the first quarter.

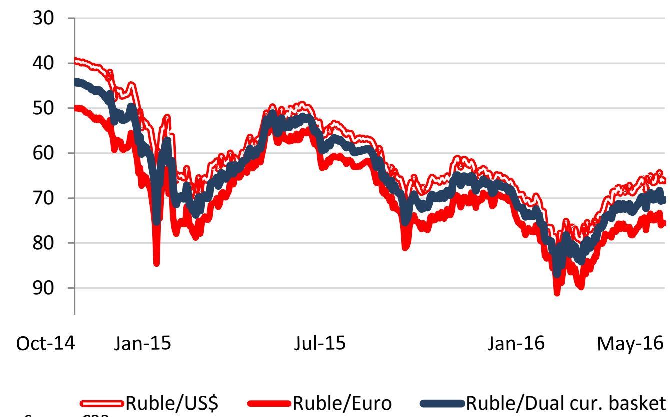
Currencies and equities of emerging economies rebounded while growth remained sluggish, especially for commodity exporters. Following months of outflows, investors have shown renewed interest in emerging market assets, as commodity prices and the US dollar stabilized. Other emerging market equities, bonds and currencies, rebound amid a resurgence of capital inflows. Overall, emerging market borrowers raised US$61 billion on international bond markets in the first quarter of 2016, of which US$30 billion in March. Euro-denominated debt markets are increasingly attractive amid falling borrowing costs in the Euro Area. About US$20 billion worth of euro-denominated emerging market bonds were sold in the first quarter of 2016, up 56 percent from a year earlier. Further sovereign issuances by Ecuador, Guatemala, Kenya, Malaysia, Poland and Sri Lanka are in the pipeline. Still, deteriorating fundamentals and rating downgrades among some commodity exporters continue to elevate their cost of financing. At the same time, growth among commodity exporting emerging market economies was in the first quarter of 2016 lower than historical averages and substantially below that of commodity importers. March manufacturing Purchasing Manager Indices recovered from February lows, but overall remained at the low end of the post-crisis range in commodity exporters.

Figure 1: Oil prices continue to improve …



Source: Bloomberg

Figure 2: … while the ruble appreciated slowly



Source: CBR

Consumer prices stabilized in April. The 12-month consumer price index remained unchanged at 7.3 percent in April, while core inflation decelerated modestly to 7.6 percent from 8.0 percent in March. At the same time, annual food inflation edged up to 5.3 percent in April from 5.2 percent in March. Sticky headline inflation kept the central bank cautious about resuming its monetary easing cycle: in its meeting on April 29 it kept key policy rates unchanged at 11 percent. However, it signaled that if inflation kept on falling it would resume a gradual lowering of its key rate.

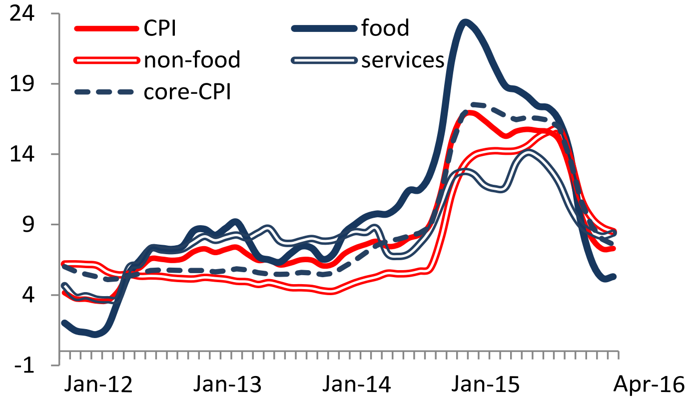
Industrial output continued to recover in March and the recession in the services sector showed signs of abating. The contraction of aggregate output decelerated from an average of 4.0 percent in the last quarter of 2015 year-on-year to 1.1 percent in the first quarter of this year. This improvement was partly driven by a continued recovery in seasonally adjusted industrial output which grew by a cumulative 1.1 percent since end-2015. Positive real wage growth in February-March (by an average of 1.1 percent) supported the demand for services: the contraction in retail trade decelerated to 5.4 percent in the first quarter, year-on-year, from 12.7 percent in the fourth quarter of 2015. The contraction for other services slowed to 1.4 percent in the first quarter, year-on-year, compared to 2.7 percent in quarter four of 2015. Moreover, business sentiments improved for four consecutive months in Rosstat's business survey, although they still remain in negative territory.

In March, credit to the private sector fell by 1.4 percent year-on-year in real terms, compared to a drop of 0.5 percent in February. This deterioration was largely the result of lower growth of credit to firms, which dropped in real terms from 3.6 percent growth in February year-on-year to 1.8 percent in March. Meanwhile, the contraction in credit to households continued to be significant: 11.7 percent in real terms, year-on-year, in February (compared to 10.1 percent in March).

The banking system remains adequately capitalized while the share of non-performing loans in total loans continues to rise. The share of nonperforming loans increased from 8.3 percent at end-2015 to 8.8 percent in February and the deterioration in banks' asset quality is expected to continue this year. Corporate loans in the real estate, construction and trade sectors, and for SME and consumer lending are expected to see continued weaknesses. Although some banks may not be adequately capitalized to meet their elevated provisioning needs, especially those with large retail or foreign currency-denominated corporate loans exposure, the aggregate capital adequacy ratio stood at 12.1 percent, above the regulatory minimum of 8.0 percent. Russian banks' key financial performance indicators remain weak with a return on equity at 2.9 percent and return on assets at 0.3 percent. The decision of the Deposit Insurance Agency to increase banks' insurance contributions by 20 percent is likely to increase pressure on banks' already-weak profitability. The decision was necessary due to the agency's growing demand for state funds as banks' contributions are not sufficient to cover the cost of bank bankruptcies. The central bank has continued to withdraw licenses from problematic banks, reducing the number of banks from 733 in December 2015 to 707 in April 2016.

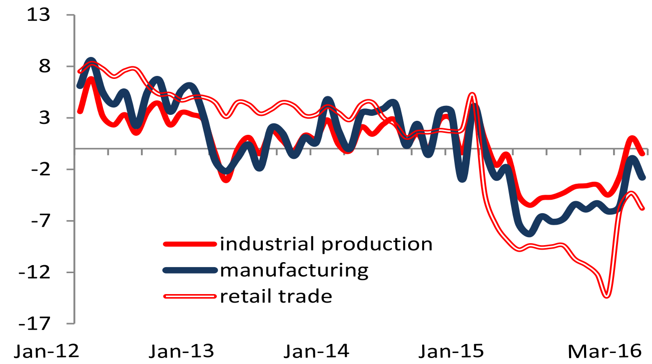
In April, Fitch Ratings affirmed Russia's long-term foreign and local currency rating at 'BBB-' with a negative outlook. The ratings balance Russia's strong external and sovereign balance sheets and low sovereign financing needs against structural weaknesses, low growth potential and geopolitical tensions. External risks have largely abated over the last 12 months and fears about a sharp draw-down in reserves to cover capital outflows and sizeable debt maturities have eased.

Figure 3: Inflation stabilizes … (percent, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

Figure 4: … output continues its slow recovery (percent change, y-o-y) (percent change, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

In the first quarter of 2016, oil prices led to a deterioration of the Russia's current account, which coincided with a notable slowdown in net capital outflows. As oil prices dropped by 40 percent in the first quarter of 2016, year-on-year, the current account surplus narrowed to US$11.7 billion compared to US$30.0 billion in the first quarter of 2015. Low oil and commodity prices led to declines in both oil and non-oil exports by 42 and 23 percent respectively, while the continued decline in imports (by 15 percent) was insufficient to compensate for the drop in exports, thus leading to a notable deterioration in the trade balance. At the same time, moderating net capital outflows helped reduce the capital and financial accounts deficit from US$37.5 billion in the first quarter of 2015 to US$7.5 billion in the first quarter of 2016. Debt payment was the main part of net capital outflows. For Russian banks the debt rollover rate was close to zero and debt repayments were financed by drawing on net foreign assets. Firms refinanced about 90 percent of their debt, yet at the same time nearly halved the acquisition of net foreign assets to US$3.8 billion year-on-year. Central bank reserves increased as banks repaid US$5.6 billion channeled through the foreign currency repo facility.

In January-March 2016, the federal budget primary deficit remained close to the level of March last year, as lower expenditure compensated for a drastic fall in oil revenue. The federal deficit stood at end-March at 2.7 percent of GDP compared to 2.9 percent of GDP in March 2015. In the first quarter of 2016, federal budget revenue fell by a massive 4.0 percent of GDP, year-on-year, from 19.1 percent in the first quarter of 2015. This was primarily due to a decline in oil revenue by 3.4 percent of GDP to 5.7 percent of GDP as the price for Urals oil dropped from US$52.8 per barrel in January–March 2015 to US$32.0 per barrel in January–March 2016. Meanwhile, primary expenditure was comparably lower to the first quarter of 2015, when government heavily front-loaded spending. In March 2016 federal primary expenditure stood 17.8 percent of GDP, 4.2 percent of GDP lower than in the first quarter of the previous year. Government expenditure decreased in nominal terms for all categories over this period, except for social policy and administration. The two top-spending categories in January–March 2016 were social spending (34.8 percent of primary expenditure) and defense (27.5 percent of primary expenditure). The non-oil deficit improved from 12.4 percent of GDP in the first quarter of 2015 to 8.9 percent of GDP in the first quarter of 2016. In April the government tapped for the first time in 2016 the Reserve Fund to finance the federal deficit in the amount of RUB390 billion (US$5.8 billion), reducing the Reserve Fund to US$45 billion as of May 1, 2016.

The government postponed the issuance of a US$3 billion Eurobond. In the face of sanctions and informal pressure on major banks not to participate, the government could not secure sufficiently prominent banks willing to underwrite the bonds, and lining up the participation of clearing services had become problematic. The planned bond would have only financed about a tenth of this year's fiscal deficit, yet Russia's plans to raise financing through privatizations might be also negatively impacted by sanction-related pressures.

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