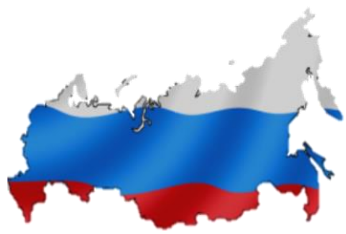
Russia Monthly Economic Developments

December 2017

Driven by strong investment and manufacturing, global GDP remained robust, reaching 3.4 percent in the third quarter of 2017. Oil prices strengthened in November 2017, reflecting a reduction of large surpluses due to rising OECD oil demand and the extension of the OPEC/non-OPEC agreement through the end of 2018. In November, the ruble depreciated despite the higher oil prices, reflecting increased concerns over the expansion of sanctions and larger purchases of currency by the Ministry of Finance. In Russia, growth weakened in October, and industrial production dropped in November on the back of poor performance in manufacturing. The 12-month Consumer Price Index registered another record low in November. In December, the Central Bank of Russia (CBR) cut the key rate by 50 bp to 7.75 percent in annual terms as the extension of the agreement to reduce oil production brought down pro-inflationary risks over a one-year horizon. Another systemically important bank was bailed out by the CBR in December, making it the third bank undergoing resolution by the Banking Sector Consolidation Fund this year. Loss of capital and the recognition of negative financial results of banks under resolution (Otkritie and B&N Bank) weakened the overall performance of the banking sector in October.

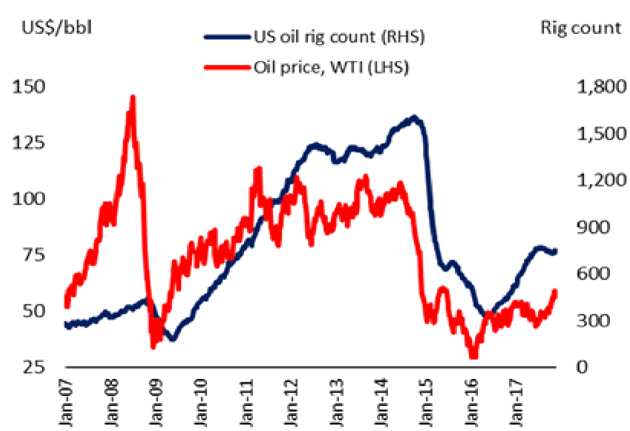
The Global Context



Global growth remained robust, with global GDP reaching 3.4 percent (q/q saar) in Q3 of 2017 driven by strong investment and manufacturing. The uptick is based on acceleration in the United States and consolidated strength in the Euro Area. Global manufacturing PMIs remained robust in November, suggesting continued growth momentum in Q4. Growth in China edged down to 6.8 percent, y/y, in Q3 and high frequency data suggest further softening in Q4. Tightening of financial sector regulations is in progress in China. EMDEs' financial markets remained buoyant in September. Global financial conditions remain benign and trade growth rebounded in Q3 after a temporary slowdown in Q2.

After strengthening in November, oil prices stabilized at around $60/bbl (Figure 1). Brent oil, the international price barometer, averaged nearly $63/bbl in November, up from $58/bbl in October (and almost 35 percent higher than a year earlier). WTI, the domestic U.S. price indicator, experienced similar gains. The strengthening reflects a reduction of large surpluses due to rising OECD oil demand and the extension of the OPEC/non-OPEC agreement through the end of 2018, which was expected and priced in by the market. Two notable outcomes of the agreement were (i) the promise by Libya and Nigeria not to exceed their 2017 output levels, and (ii) that the agreement will be reassessed at the OPEC meeting of June 2018. The oil price pick-up reversed the downward trend driven by the U.S. rig count—a rough measure of future U.S. crude oil supplies. The count, which reached a low of 729 in early November, increased to 749 within a month, underscoring the increasing flexibility and resilience of the U.S. shale oil industry. Oil prices, which are set to average $53/bbl in 2017, are expected to average $59/bbl in 2019.

Figure 1: Brent strengthened in November



Source: Baker Hughes, Bloomberg.

Russia's Recent Developments

In November, the ruble depreciated despite higher oil prices. While the average oil price (Brent) increased by about 9 percent in November, the ruble depreciated by 2.1 percent with respect to the U.S. dollar (Figure 2). These dynamics reflect some concerns over a possible expansion of sanctions and somewhat larger purchases of foreign currency by the Ministry of Finance.

Figure 2: In November, the ruble depreciated by 2.1 percent with respect to the U.S. dollar

Source: CBR.

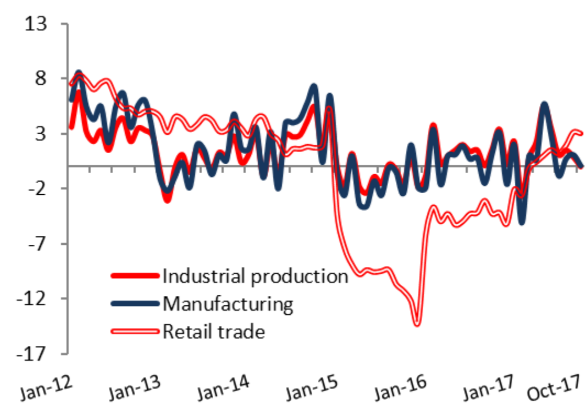
The current account surplus increased on the back of improved terms of trade. According to preliminary information from the Bank of Russia, the current account surplus increased to US$35.6 billion in January – November 2017 from US$18 billion in the same period last year. This implies a current account surplus of US$6.7 billion in November 2017 compared to US$4.9 billion in the same period last year. Higher current account surplus was mirrored by higher net capital outflows, which increased to US$28 billion in the first eleven months of 2017, compared to US$8.2 billion in the same period last year. An increase in net capital outflows came mainly from the banking sector which continued external debt repayments.

In the third quarter of 2017, fixed capital investment annual growth decelerated to 3.1 percent, y/y, from 6.3 percent, y/y, in the second quarter. According to available high frequency statistics, the slowdown comes primarily from large and medium enterprises' investment in mineral resource extraction (namely mining support service activities). Transportation, financial services, retail and wholesale trade, and culture and sport (most likely related to the soccer World Cup) continued supporting fixed capital investment in the third quarter of 2017. Thus, high fixed capital investment growth in the second quarter was mainly due to temporary factors, and third quarter dynamics were more in line with the trend.

Growth in Russia weakened in October (Figure 3). Economic activity in five basic sectors expanded by 0.5 percent, y/y, compared to 2.4 percent, y/y, in September. Despite a bumper crop, output in agriculture decreased by 2.5 percent compared to an increase of 8.5 percent, y/y, in September. Industrial production disappointed with zero growth. Contraction continued in mineral resource extraction due to lower oil production on the back of Russia's participation in the OPEC agreement on production cuts and the high base of production at the end of 2016. Manufacturing growth was flat, 0.1 percent, y/y, compared to 1.1 percent in September 2017. In October, construction shrank by 3.1 percent, y/y, pointing to possible weak growth of fixed capital investment in the fourth quarter.

In November, industrial production dropped mainly due to weak performance in manufacturing. Industrial production contracted by 3.6 percent, y/y, and 1.4 percent, m/m, sa. Contraction continued in mineral resource extraction, -1 percent, y/y, in November compared to -0.1 percent, y/y, in October. Water and electricity supply also dropped in November, the latter partly due to warm weather. Manufacturing production shrank by 4.7 percent y/y, partly due to the high base of November 2016. Overall, in the first eleven months of 2017, manufacturing increased by 0.4 percent y/y, compared to 0.8 percent, y/y, in the same period last year. Such modest performance largley reflects continued weak domestic demand. Meanwhile, the November PMI survey signaled a further improvement in operating conditions in the Russian manufacturing sector. In November, the PMI increased to 51.5 from 51.1 in October, with overall growth in goods production reflecting a solid expansion in new orders. Detailed statistics on manufacturing subsectors' performance are not yet available.

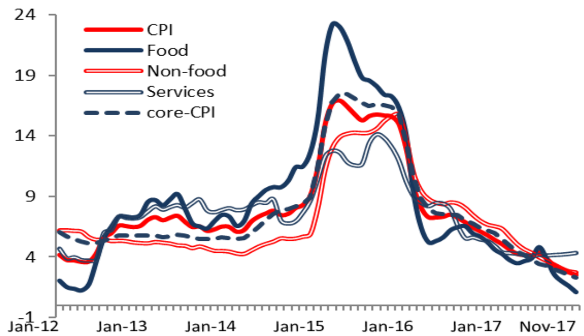
Figure 3: Economic activity weakened in October



Source: Rosstat, Haver Analytics, World Bank team.

The 12-month Consumer Price Index registered another record low in November (Figure 4), dropping further to 2.5 percent after the 2.7 percent reading in October. The slowdown in food inflation was the main factor behind the deceleration in consumer inflation. In November, the 12-month core inflation rate dropped to 2.3 percent from 2.5 percent in October, suggesting lower inflationary pressures.

Figure 4: Consumer inflation reached a record low in November

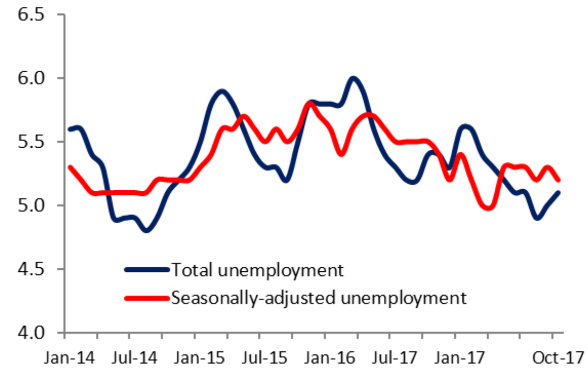


Source: Rosstat, Haver Analytics, World Bank team.

In December, the CBR cut the key rate by 50 bp from 8.25 percent to 7.75 percent per annum. The majority of market players had expected a 25 bp cut. Accoriding to the Central Bank, the decision obeyed to the inflation holding below 3 percent in annual terms and the lower pro-inflationary risks over a one-year horizon on the back of extension of the agreement to reduce oil production. Yet, the weak industrial production reading for November could have also influenced this decision. The Bank of Russia noted that it would continue its gradual transition from a moderately tight to neutral monetary policy, and it would hold open the prospect of a key rate reduction in the first half of 2018.

Labor market indicators showed mixed dynamics in October. The unemployment rate increased marginally by 0.1 percentage points in October 2017 to 5.1 percent. However, this was mostly seasonal growth as the adjusted rate declined to the level of 5.2 percent in October from 5.3 percent in September (Figure 5). Real wages continued to grow; they increased by 4.3 percent in October compared to the same period in the previous year, and they also increased by 0.8 percent compared to the level in September after seasonal adjustment. Real disposable incomes contracted by 1.3 percent in October compared to the same period in 2016, and they also contracted by 0.4 percent compared to the previous month after seasonal adjustment. This indicator is very volatile and is driven to a large degree by sources of income that are not registered by statistics. The average contraction for the ten months of 2017 compared to same period in 2016 was 0.9 percent. Pensions were indexed in the beginning of the year at the inflation rate, and with the deceleration of inflation, they increased by 1.5 percent in real terms compared to October 2016.

Figure 5: The unemployment rate decreased



Source: Rosstat, Haver Analytics, World Bank team.

In the January-October 2017 period, buoyed largely by higher revenues, the federal budget registered a primary surplus of 0.4 percent of GDP compared to a deficit of 1.4 percent of GDP in the same period last year. In January-October 2017, the federal budget revenue totaled 16.5 percent of GDP, an increase of 1.2 percent of GDP compared to the same period last year, with oil revenues higher by 0.8 percent of GDP. Despite the appreciating ruble, oil and gas revenues grew, mostly due to increases in energy prices. Non-oil/gas revenues increased by 0.5 percent of GDP compared to the same period last year, largely due to improved tax administration and higher CIT[1], excise, and VAT receipts from recovering domestic demand. Compared to the same period last year, primary expenditures decreased by 0.6 percent of GDP but slightly increased in real terms. In the first ten months of 2017, federal budget spending decreased largely due to lower spending on defense (-0.5 percent of GDP), security (-0.2 percent of GDP), and health (-0.2 percent of GDP). In this period, the non-oil primary deficit narrowed by 1.1 percent of GDP. Overall, the federal budget deficit narrowed to 0.4 percent of GDP from 2.2 percent of GDP last year.

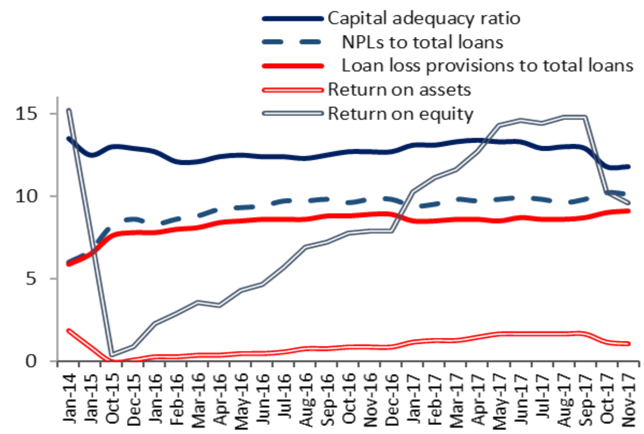
Another systemically important bank was bailed out by the CBR in December, making it the third bank undergoing resolution by the Banking Sector Consolidation Fund this year. Promsvyazbank, the ninth largest by asset size as of December 1, was placed by the CBR under temporary administration. The CBR has launched a bailout of Promsvyazbank through the Banking Sector Consolidation Fund. The bank will continue to function as normal and receive extra liquidity support. Full details of all three bailouts are yet to be revealed, including the extent of resources to be injected in the banks. The CBR announced the recapitalization of Otkritie in the amount of RUB 456.2 billion (approx. US7.6

[1] An increase in CIT receipts comes largely from a higher share of CIT channeled to the federal budget, compared to 2016: out of 20 pp tax rate, 3 pp belongs to the federal level, compared to 2 pp last year.

billion), while the assessment of the B&N and Promsvyazbank is still underway.

Loss of capital and recognition of negative financial results of banks under resolution (Otkritie and B&N Bank) weakened the overall banking sector performance in October (Figure 6). While key credit risk and performance indicators remained largely stable, the sector's capital adequacy declined to 11.8% (against a regulatory minimum of 8 percent). Profitably has been also declining with the return on assets and the return on equity at 1.1 percent and 9.6 percent, respectively. Non-performing loans have stabilized at around 10 percent. Lending growth was uneven as demand recovered faster in the retail sector than in the corporate sector and SMEs. In October, credit to households in rubles picked up, increasing by 10.7 percent, y/y, compared to 9.5 percent in September. Meanwhile, credit to the corporate sector in rubles grew by 3.2 percent, y/y, compared to 3.4 percent in September. As of November 1 2017, the strongest growth was observed in the mortgage segment (30 percent in the first ten months of 2017 compared to the same period last year), supported by a large unmet demand for housing and more favorable conditions brought by declining interest rates, which are at their historical minimum. Beginning 2018, the CBR plans to introduce higher risk weights for mortgage loans with a low down payment (less than 20 percent) to curb growth of the riskier loans.

Figure 6: The banking sector's overall performance has been improving, but its volatility continued



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