Against a backdrop of improving global growth, Russia’s economy has remained in recession in the third quarter of 2016, with non-tradable sectors being the main driver of the GDP contraction. However, the pace of contraction has slowed somewhat relative to early 2016, as tradable sectors supported GDP growth and the contraction in construction decelerated. In October, industrial production (led by manufacturing) strengthened somewhat, but retail trade continued to contract—suggesting that private consumption is further retrenching, driven by faltering incomes and mixed labor market dynamics. The world oil-price increase observed since end November (as a result of the recent agreement reached by OPEC to cut oil production starting January 2017) has had an appreciation impact on the ruble, partly offset by a simultaneous tightening in global financial conditions (linked to the US monetary policy). The combined impact of lower oil revenues and expectedly rising primary spending is likely to take a toll on the fiscal accounts, which are projected to end 2016 with a deficit of 3.7 percent of GDP (relative to 2.4 percent in 2015), even after the government’s largest privatization deal for the year (Rosneft) is taken into account. The financial sector seems to have stabilized, although the level of NPLs remains high, and private sector lending is retrenching.

The Global Context

Global growth improved in the third quarter of 2016, while financial conditions have tightened in the fourth quarter. Supported by stronger growth in the United States and Japan, global growth and trade gained momentum in the third quarter. Growth was broadly unchanged in the Euro Area and China, while emerging countries recorded mixed growth rates. However, elevated policy uncertainty and expectations of higher inflation in the United States following the November presidential election—hinting at a possible increase in the US Federal Reserve Board’s rate—tightened financial conditions for emerging markets. In particular, upward trends in foreign portfolio inflows to emerging markets were sharply reversed in late November, and currencies in major emerging markets weakened. Long-term interest rates in the United States also increased.

Oil prices surged at the end of November in response to the deal reached by OPEC member countries to cut production (Figure 1). Although oil prices moved within a tight band ($43-46/bbl) during the month of November, they surged following OPEC’s deal on November 30th. Brent (the world market barometer) gained a cumulative 17 percent in the first three trading sessions following the deal, and WTI (the US price indicator) gained 17 percent. According to the deal, effective in January 2017, OPEC members agreed to cut production by 1.2 mb/d to 32.5 mb/d, much higher than the expected cut of 0.5-1 mb/d. The OPEC cut—the first such cut in eight years—is also contingent on the participation of non-OPEC countries, which are expected to account for half of the cut (0.6 mb/d), of which half will come from Russia. Within OPEC, the overall reduction will reach 0.6 mb/d, largely from Saudi Arabia (0.5 mb/d) and other GCC members (0.1 mb/d). Libya and Nigeria are exempt, while Iran is allowed to increase production. The cuts are effective for six months, but could be extended for another six-month period.

The OPEC deal, if fully implemented, is expected to bring forward large inventory reductions and balance the market within six months. Yet, risks remain regarding the deal and its implementation. First, historically, OPEC has been producing 1 mb/d above quotas. Second, the cuts will be slow to take effect in the first quarter of 2017 since they refer to production, not exports, which could come from inventories in the first quarter of 2017. Third, Libya and Nigeria could increase production if political conditions turn favorable. Fourth, there may be difficulties with non-OPEC cuts, and fifth, US shale production may respond quickly to the price increase. The next OPEC meeting is in May 2017, and the World Bank oil price forecasts remain as in the October 2016 Commodity Markets Outlook: $43/bbl for 2016 and $55/bbl for 2017—the latter was raised from $53/bbl in the July Commodity Market Outlook, based on the likelihood of production cuts from a likely OPEC deal.

Figure 1: Oil prices surged at the end of November
Russia’s Recent Developments

The ruble’s dynamics have partially reflected the impact of the oil price changes, as the ongoing tightening in global financial conditions has played an offsetting role. In particular, the ruble lost 2.7 percent (m/m) as oil prices (Brent) decreased by 8.4 percent in November (Figure 2). When the oil price gained 19.9 percent in response to the deal among OPEC countries on November 30th, the ruble appreciated by 6.3 percent, as expectation of higher inflation in the United States following the November presidential election and expectations that the US Federal Reserve will increase interest rates by mid-December partly offset pressure for appreciation.

Figure 2: In December, the ruble depreciated as oil prices increased

In the first 10 months of 2016, the current account contracted on the back of a weaker trade balance, despite some support from the improving balance of services. In January – November 2016, the current account shrank to US$22.2 billion from US$63.7 billion in the same period last year. According to the central bank’s statement, lower exports and recovering imports weakened the trade balance, although a lower deficit in the services account provided some support to the current account. Net capital outflows contracted to US$16.1 billion from US$54.1 billion last year, largely due lower debt payments in the banking sector and increased liabilities in the non-banking sector.

According to Rosstat’s flash estimate, Russia’s GDP declined by 0.4 percent, y/y, in the third quarter of 2016. Non-tradable sectors continued being the main driver for GDP contraction as in the first half of 2016. However, the pace of the GDP contraction has slowed somewhat relative to early 2016, as tradable sectors contributed 0.3 pp to GDP growth, compared to 0.1 pp of GDP in the second quarter of 2016, and the pace of contraction in construction decelerated. GDP shrank by 0.7 percent in the period from January–September 2016 (Figure 3). This is in line with our projection in our November Russia Economic Report that GDP will contract by 0.6 percent overall for 2016.

In October, industrial production strengthened somewhat, driven mainly by an improvement in manufacturing output dynamics. Industrial output growth contracted by just 0.2 percent in October, y/y, compared to a 0.8 percent reduction in September (Figure 4). The improvement was observed even as October this year had one less working day compared to last year. Meanwhile, seasonally adjusted output growth in industries stood at 0.3 percent, m/m, compared to -0.3 percent in September. The contraction in manufacturing slowed to 0.8 percent, y/y, from 1.6 percent in September, and was the main driver for improved industrial production output dynamics. Russia’s manufacturing PMI increased from 52.4 in October to 53.6 in November (maximum reading in 5½ years), pointing to higher demand for the sector’s output and possible continued improvement in manufacturing output dynamics in November.

Low incomes could not support consumer demand. In October, the contraction in retail trade worsened to 4.4 percent in the period from January–September 2016 (Figure 3). This is in line with our projection in our November Russia Economic Report that GDP will contract by 0.6 percent overall for 2016.

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Figure 3: GDP contracted by 0.4 percent, y/y, in the third quarter of 2016

Figure 4: In October, industrial production increased, m/m
percent compared to the same period a year ago and 1.6 percent compared to the previous month after seasonal adjustment. Seasonally adjusted retail services shrank by 2.1 percent in October compared to the same period a year ago and 1.8 percent compared to the previous month.

**Fixed capital investment improved in the third quarter of 2016**, increasing by 0.3 percent, y/y, partly due to the low base effect. For the first nine months of 2016, fixed capital investment contracted by 2.3 percent, y/y, compared to a 9.6 percent contraction for the same period last year. This improvement was mainly driven by stabilization and a less severe contraction in fixed capital investment of non-tradable sectors.

**Consumer inflation continued to slow down in November.** The 12-month consumer price index decreased to 5.8 percent in November from 6.1 percent in October, while core inflation slowed to 6.2 percent from 6.4 percent (Figure 5). Annual inflation decelerated for all the categories (food, non-food, and services), while decelerating food inflation was the main reason for the slowdown in headline inflation. At the same time, the November Central Bank Survey continued to indicate that inflation expectations were only slowly abating and remain elevated and volatile. This may limit the space for monetary easing. Annual consumer inflation for January – November totaled 7.2 percent compared to 7.4 percent in January – October, in line with our projection of annual average inflation of 7.1 percent in 2016.

**Figure 5: Consumer inflation continued to slow in November**

![Graph showing consumer inflation trends](image)

**Labor market dynamics have been mixed.** Seasonally adjusted unemployment decreased slightly to 5.5 percent in October from 5.6 percent a month ago (Figure 6). Real wages grew by 2 percent, y/y, in October but dropped marginally, compared to previous months once adjusted for seasonality. Pensions continued to decrease in real terms, contracting by 3.1 percent, y/y, in October. Real disposable income dynamics worsened as real disposable incomes contracted by 5.9 percent y/y, compared to a contraction of just 1.5 percent, y/y, in September 2016.

**Figure 6: Seasonally adjusted unemployment decreased slightly in October**

![Graph showing unemployment trends](image)

**Source:** Rosstat, Haver Analytics, World Bank team.

In January-October 2016, the federal primary deficit worsened as lower expenditures were unable to compensate for the sharp drop in oil revenues. The federal primary deficit stood at 1.5 percent of GDP in the January-October period compared to 0.3 percent of GDP in the same period last year. In the first ten months of 2016, federal budget revenues fell by 1.9 percent of GDP to 15.4 percent compared to the same period a year ago. This was primarily due to a decline in oil revenues of 1.9 percent of GDP to 5.7 percent of GDP. Meanwhile, primary expenditures declined by 0.7 percent of GDP to 16.9 percent of GDP in January-October 2016. On the back of lower expenditure, the non-oil deficit improved to 8 percent of GDP in January-October compared to 8.6 percent of GDP in the same period last year.

**The amended 2016 federal budget was approved.** According to the amended budget law, primary expenditures will increase from 18.7 percent of GDP in 2015 to 19 percent by the end of 2016 because of increased spending on national defense (+0.8 percent of GDP) and social policy (+0.3 percent of GDP). This will result in an overall expansionary fiscal policy in 2016. Meanwhile, government expenditures would decline for the majority of other expenditure categories: state management (-0.1 percent of GDP), national security (-0.1 percent of GDP), national economy (-0.3 percent of GDP), housing and communal services (-0.1 percent of GDP), education (-0.1 percent of GDP), health (-0.1 percent of GDP), and intergovernmental transfers (-0.1 percent of GDP). Due to higher non-oil revenues, the non-oil and gas primary deficit would improve by 0.3 percent of GDP to 8.7 percent of GDP. Federal budget revenues are expected to drop by 0.8 percent of GDP mainly on the back of lower oil and gas revenues. The
government increased its projection for non-oil and gas revenues due to the privatization of Rosneft. The projected federal budget deficit for 2016 will increase to 3.7 percent of GDP from 2.4 percent in 2015.

**Russia’s largest privatization deal of 2016 is in its final-stage negotiations.** Glencore and the sovereign wealth fund of Qatar are to acquire a 19.5 percent stake (worth about 10.5 billion euros) in Russian giant oil company Rosneft. The federal budget is expected to receive about Rub700 billion from the privatization deal, which is already accounted for in the amendments to the budget law 2016, adopted in the beginning of December.

The banking system has largely stabilized but it remains vulnerable to macroeconomic risks. These include the ongoing economic recession, depressed consumer demand, and interest rate uncertainty. Credit growth is still weak and non-performing loans (NPLs) remain at the highest levels since the beginning of the recession: 9.6 percent as of October 1, 2016 (Figure 7). In October, the corporate loans issued by banks contracted by 1.2 percent, y/y, while lending experienced a modest growth of 0.4 percent. However, the banking sector’s capitalization remains stable with an aggregate capital adequacy ratio of 12.7 percent (above the regulatory minimum of 8 percent, required by Basel III) as of October 1, 2016. The financial performance of banks has shown some improvement as the banking sector returned to profitability this year. The return on assets was 0.9 percent, and the return on equity was 7.8 percent as of October 1, 2016. The Central Bank has 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, leading to an erosion in their capital base. The number of banks in Russia has fallen from 733 in the early 2016 to 643 as of November 1, 2016.

Figure 7: Non-performing loans remain at the highest levels since the beginning of the recession