Global growth momentum continued in the first quarter of 2017, with global industrial production and goods trade growth rebounding from a pronounced weakness in the first half of 2016. Financial markets and capital flows to emerging market and developing economies (EMDEs) have remained buoyant despite policy uncertainty and heightened geopolitical risks. Oil prices gained ground thanks to the prospects that the OPEC/non-OPEC cuts will be extended in the scheduled OPEC meet on May 25th. In April, higher oil prices and continued capital flows to EMDEs resulted in the ruble appreciating for the fifth consecutive month. The Russian economy gained momentum in March, but the manufacturing PMI for April was surprisingly low. Inflation slowed further in April, almost reaching the end year target of 4 percent. Noting this, as well as decelerating inflation expectations, the Bank of Russia cut the key rate by 0.5 p.p. to 9.25 percent. Key credit risk and performance indicators in the banking sector have been showing positive dynamics as the Russian economy gradually improves. In the first three months of 2017, the federal government balance strengthened on the back of increasingly robust oil revenues; however, increased spending marginally widened the non-oil primary balance.

The Global Context

The global growth momentum continued in the first quarter of 2017. Following a pickup in the fourth quarter of 2016, global growth continued to be supported by a recovery in manufacturing activity in early 2017. Global industrial production and goods trade growth have rebounded from a pronounced weakness in the first half of 2016. Consumer spending hit a soft patch in the United States, but growth generally remains solid across advanced economies; economic activity continued to be strong, albeit gradually decelerating in China, and appears to have gained momentum among major commodity exporters. Financial markets and capital flows to emerging market and developing economies (EMDEs) have remained buoyant despite policy uncertainty and heightened geopolitical risks. Oil prices have become more volatile since March.

After dropping below $48/bbl in early May, oil prices gained ground at the prospect of a likely extension of the OPEC/non-OPEC cuts (Figure 1). Oil traded below the $50-mark during the first half of May due to stubbornly high stocks and the quicker-than-expected rebound of U.S. shale oil. After bottoming out at 8.7 mb/d in the third quarter of 2016 (down from a high of 9.6 mb/d in April 2015), U.S. crude oil production rose to 9.0 mb/d in March 2017 while the US oil rig count reached 712 in early May, up from 316 a year ago. The rebound of U.S. oil production (mainly from shale), along with higher-than-expected Libyan and Nigerian output, pushed up oil stocks in OECD countries, particularly in the U.S., to near record levels. OPEC’s net compliance with pledged production cuts as agreed in November has been almost 100 percent; non-OPEC compliance has also been good, estimated at just under two thirds. OPEC is scheduled to meet on May 25th, and there are signs that cuts may be extended. Indeed, Saudi Arabia and Russia (the world’s top oil exporters) announced on May 15th that they would support such cuts for nine months. The announcement pushed Brent prices above $52/bbl. According to the World Bank’s April 2017 Commodity Markets Outlook, oil prices are projected to average $55/bbl in 2017 ($60/bbl in 2018), up from $43/bbl in 2016. The forecast is unchanged from the October 2016 and January 2017 assessments.

Figure 1: Oil prices gained ground following the likely extension of the OPEC/non-OPEC cuts

Source: Baker Hughes, Bloomberg.
Russia’s Recent Developments

In April, higher oil prices and continued capital flows to EMDEs resulted in the ruble appreciating for the fifth consecutive month (Figure 2). The ruble appreciated by 2.9 percent with respect to the U.S. dollar to 56.4 Rub/USD as oil prices increased and capital flows to EMDEs remained buoyant.

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

The current account surplus increased on the back of higher oil prices. According to preliminary information from the Bank of Russia, the current account surplus increased to US$25.7 billion in January – April 2017 from US$13.5 billion in the same period last year. This implies a current account surplus of US$2.9 billion in April 2017 compared to US$0.6 billion in the same period last year. On the back of higher oil prices, a higher trade balance supported the current account. In January – April 2017, net capital outflows increased to US$21.0 billion (US$5.6 billion for April only) compared to US$9.8 billion (US$3.7 billion in April only) in the same period last year. This mainly reflected the accumulation of foreign assets by the banking sector amidst lower debt payments and net capital inflows to the non-banking sector.

After a weak performance in February, a number of economic activity indicators gained momentum in March (Figure 3). The index of production in basic economic activities1 grew by 1.3 percent, y/y; industrial production expanded by 0.8 percent, y/y, and manufacturing grew by 1 percent, y/y. Growth in manufacturing was registered both in consumer and investment goods production. Metallurgic production and metal goods were the only manufacturing subsectors that contracted on an annual basis in March. Contraction in metallurgical production (which accounts for 13 percent of manufacturing), linked to subdued investment demand in Russia, continued to drag manufacturing down in March despite strong readings of business confidence indices in metallurgy as reported by Rosstat. The April PMI reading of 50.8 points disappointed after the March reading of 52.4, indicating a substantial slowdown in the improvement of business conditions in the manufacturing sector. The Markit Russia Services Business Activity Index posted 56.1, down from 56.6 in March, indicating slightly weaker growth but a sound expansion nonetheless.

**Figure 3: The Russian economy gained momentum in March**

High frequency indicators point to a smaller contraction in consumer demand in March. Retail trade contraction decelerated in March to 0.4 percent compared to the same period in 2016 after 2.8 percent in February (Figure 3). Retail services also declined by 1.3 percent in March compared to the same period a year ago and contracted by a marginal 0.1 percent compared to February after seasonal adjustment.

Inflation slowed further in April, almost reaching the end year target of 4 percent (Figure 4). Supported by a stronger ruble, the m/m inflation totaled 0.3 percent in April 2017 compared to 0.5 percent in the same period last year. The 12-month Consumer Price Index (CPI) decreased to 4.1 percent from 4.3 percent in March. Non-food inflation continued to contribute most to the annual headline

---

1 Agriculture, industrial production, construction, transport, retail and wholesale trade.
inflation although its contribution slightly decreased compared to that in March. The Core CPI index dropped from 4.5 percent, y/y, in March to 4.1 percent in April. On April 28, 2017, the Bank of Russia cut the key rate by 0.5 p.p. to 9.25 percent due to the movement of inflation towards the end-year target and declining inflation expectations amidst recovering economic activity. The next meeting of the Bank of Russia will be held on June 16, 2017.

**Figure 4: Consumer inflation almost reached the end-year target in April**

![Figure 4](image_url)

**Labor market indicators improved in March.** Both original and seasonally adjusted unemployment rates decreased by 0.2 percentage points in March and reached 5.4 and 5.0 percent, respectively (Figure 5). Real wages continued to grow and increased by 1.5 percent in March compared to the same period last year and they also increased by 0.9 percent compared to the previous month after seasonal adjustment. In March, real disposable income contracted by 2.5 percent compared to the same period in 2016 but increased in monthly terms after seasonal adjustment. Pensions were indexed in the beginning of February at the inflation rate: that is, real growth of pensions was close to zero.

**Figure 5: Unemployment decreased in March**

![Figure 5](image_url)

In January-March 2017, the federal government balance strengthened on the back of increasingly robust oil revenues; however, increased spending marginally widened the non-oil primary balance. The oil and gas revenues of the federal budget rose by 2.2 percent of GDP to 7.6 percent of GDP on the back of higher oil prices, compared to the same period a year ago. Federal budget primary expenditures increased by 0.2 percent of GDP to 18.6 percent of GDP. The increase in expenditures was a combination of the following expenditure changes: higher spending on social policy (+1.1 percent of GDP) on the back of the one-off payment to pensioners in January, as well as higher spending on national economy (+0.2 percent of GDP), environmental protection (+0.1 percent of GDP), housing and communal services (+0.1 percent of GDP), and lower spending on national defense (-1.0 percent of GDP), national security (-0.2 percent of GDP), health (-0.2 percent of GDP), and state management (-0.1 percent of GDP). The federal government balance consequently registered a primary deficit of 0.5 percent of GDP in January-March 2017 (compared to -2.4 percent of GDP deficit in the same period last year). However, on the back of higher expenditures, the federal non-oil primary deficit marginally worsened to 8 percent of GDP in January-March 2017 (compared to 7.9 percent of GDP in the same period last year).

**Key credit risk and performance indicators in the banking sector have been showing positive dynamics as the Russian economy gradually improves (Figure 6).** As of April 1, 2017, the sector’s aggregate capital adequacy stood at 13.4 percent supported by solid profit generation against the background of weak loan growth. As banks’ financial performance has been steadily improving, both the return on assets and return on equity stood at 1.5 percent and 12.7 percent, respectively, slowly moving back to pre-crisis levels. Non-performing loans remained stable at 9.7 percent.

While credit to firms in foreign currency continued to decrease, credit in rubles continued to register modest growth. Credit to firms in foreign currency decreased by 13.6 percent in March, y/y, building from a similar reduction of 13.7 percent in February, y/y. Credit to firms in rubles expanded by a marginal 1.4 percent, y/y, the same rate as the previous month. Growth of lending in rubles to households accelerated to 4 percent in March, y/y, compared to 3 percent in February. Consolidation in the banking sector continued - the number of banks in Russia...
has fallen from 623 at the beginning of 2017 to 607 as of April 1, 2017, as the Central Bank continues to tighten sector supervision and withdraw licenses from problematic banks. The industry landscape is expected to change further with the implementation of a proportionate regulation of the banking sector starting in 2018 – the respective law was passed on May 2, 2017. The new regulation establishes a three-tier banking system in Russia: systemically important banks (10 largest banks, already in effect), banks with a universal license (minimum capital requirement of RUB 1 billion), and banks with a basic license (capitalized at between RUB 300 million and RUB 3 billion).

Figure 6: Key credit risk and performance indicators in the banking sector have been showing positive dynamics