Russia Monthly Economic Developments

June 2016

- Preliminary estimates for real GDP growth in the first quarter of 2016 show a contraction of 1.2 percent, significantly lower than the -2.8 percent in the first quarter of 2015.
- Oil prices recovered to almost US$50 per barrel in early June, mostly due to supply-side factors.
- Since February, the ruble exchange rate appreciated only marginally against the dollar, despite a strong increase in oil prices, reflecting a higher demand for dollars.
- Industrial activity continued to recover in April, accompanied by a stabilization in the demand for services.
- Russia's government successfully returned to global capital markets, issuing US$1.75 billion in 10-year Eurobonds.
- Russia's banking sector remains under pressure with the share of non-performing loans rising.

On June 1, the Russian government partially lifted the food import ban introduced in August 2014. The ban on food imports targeted countries which had imposed economic sanctions on Russia in July 2014. The import of food produce (including meat, poultry, and frozen and dry vegetables) is now allowed if used to produce baby food in Russia. Quotas and necessary procedures for such imports are being developed by the Ministry of Finance and Ministry of Agriculture. At the same time, the government has prepared proposals to prolong the remaining ban on food imports until the end of 2017.

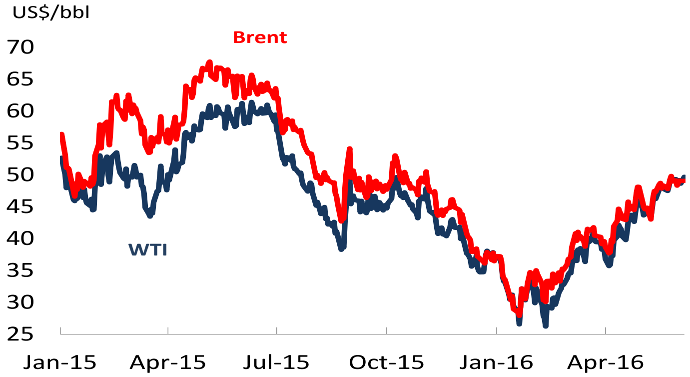
Preliminary estimates for real GDP growth in the first quarter of 2016 show a contraction of 1.2 percent, significantly lower than the -2.8 percent in the first quarter of 2015. In the fourth quarter of 2015 real GDP growth stood at -3.8 percent year-on-year. Although the demand composition of the first quarter GDP is not available, retail trade statistics for the first quarter indicate a lower contraction in consumption than the -9.7 percent registered in the fourth quarter of 2015. High frequency statistics on fixed capital investment also indicate improvement in investment demand. Fixed capital investment contracted in the first quarter of 2016 less, by 4.8 percent, compared to -6.4 percent in the fourth quarter of 2015, with sectors such as agriculture, mineral extraction and retail trade registering positive fixed capital investment growth.

Oil prices have recovered to almost US$50 per barrel in early June due to supply-side factors. Despite the recent pickup, persistent weakness in oil prices has been driven primarily by supply-side factors, including resilient production in non-OPEC countries, continued output increases by OPEC suppliers and near record inventories. Nevertheless supply rebalancing is underway. In May, a number of unscheduled outages (in Nigeria, Ghana, and Canada), and a decline in US oil production contributed, to a gradual rebalancing in the global oil market. Remaining oversupply is particularly noticeable in US crude stocks which stood at a record high of 1.23 billion barrels in March. Demand by China and India was stronger than expected in May, while demand in OECD countries continued to be weak. Yet, during the first quarter of 2016 stocks grew at their slowest rate since the fourth quarter of 2014. The OPEC meeting on June 2 reconfirmed its objective of retaining market share which was set back in November 2014. The next OPEC meeting is scheduled for November 30, 2016. The World Bank oil price forecast remains at US$41 per barrel for 2016 and US$50 per barrel for 2017.

Since February, the ruble exchange rate appreciated only marginally against the dollar, despite a strong increase in oil prices, reflecting a higher demand for dollars. In May, the average oil price (Brent) increased to US$48 per barrel, almost 10 percent higher than in April. At the same time, the average ruble exchange rate appreciated by only 1.3 percent against the US dollar. In fact, the divergence between the ruble exchange rate and oil prices continued widening for three consecutive months: the average oil price increased by almost 20 percent since February while the ruble appreciated by only 7 percent. The beginning of the tourism season and higher projected external debt payments in the second quarter of this year−estimated at US$19.2 billion, compared to US$13.9 billion in the first quarter−have kept demand for foreign currency elevated and contributed to ruble pressure in May.

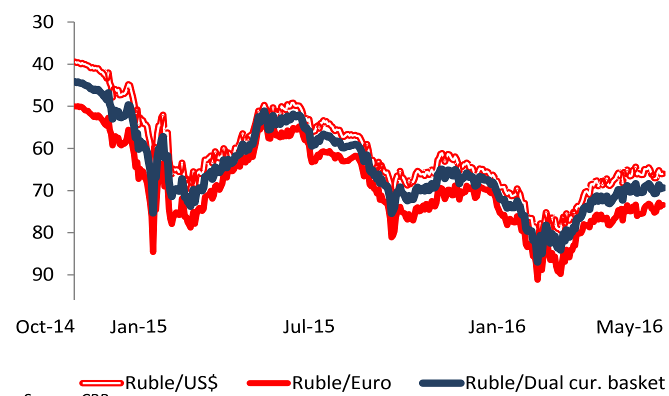
Consumer prices remained unchanged in May. The 12-month consumer price index remained unchanged at 7.3 percent for the second consecutive month. Core inflation decelerated marginally to 7.5 from 7.6 percent in April, while annual food inflation increased to 5.6 percent from 5.3 percent in April. Monthly inflation remained at around 0.4 percent, the same as a year ago. The continued stickiness in inflation points to inflation expectations that are only slowly abating. However, the central bank began to lower it key policy rate by 50 basis points to 10.5 percent during its meeting on June 10.

Figure 1: Oil prices have recovered to almost $50/bbl …



Source: Bloomberg

Figure 2: … and the ruble appreciated slightly



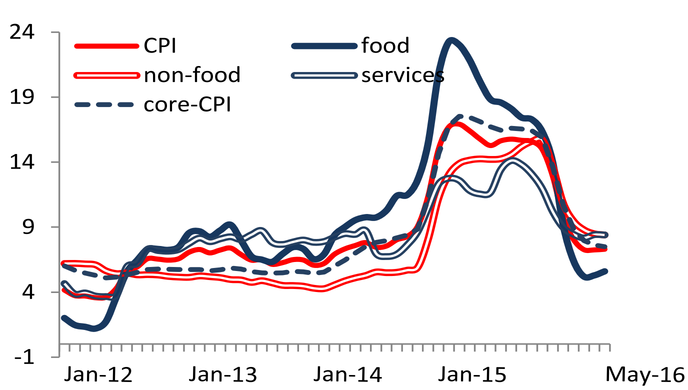
Source: CBR

Industrial activity continued to recover in April, accompanied by a stabilization in the demand for services. In April, industrial production grew by 0.5 percent year-on-year, driven mainly by mineral extraction, while aggregate output contracted by 0.4 percent year-on-year (the same as in March). Manufacturing registered a growth of 0.6 percent year-on-year, for the first time since the end of 2014. Demand for services also showed signs of stabilization: the contraction in retail trade decelerated to 4.8 percent in April year-on-year, from -5.8 percent in March (compared to -12.7 percent in the fourth quarter of 2015). The contraction in other services slowed to 0.8 percent in April (compared to -1.5 in the first quarter of 2016). Russia's services Purchasing Manager Index reached 51.8 in May, suggesting continued recovery in the sector as it remained in expansionary territory for the fourth consecutive month.

In April, credit growth to firms increased. Credit to firms grew in April by 3.8 percent in real terms year-on-year, compared to 1.8 percent in March. Meanwhile, the contraction in credit to households continued to be significant: 9.2 percent in real terms, year-on year (compared to -10.1 percent in March).

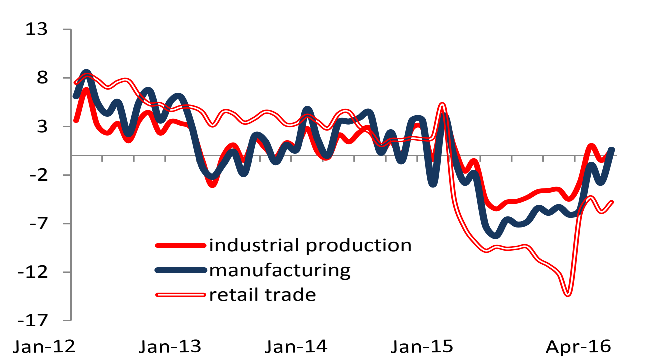
Russia's banking sector remains under pressure with the share of non-performing loans rising. The share of nonperforming loans continued to climb from 8.3 percent at end-2015 to 9.2 percent in March, and a further deterioration in banks' asset quality is expected. This originates mostly from corporate borrowers in domestic demand-driven sectors (such as construction, real estate, and trade) and from those who do not have sufficient foreign-currency revenues to match their foreign currency-denominated debt service. The banking system remains sufficiently capitalized with an aggregate capital adequacy ratio of 12.4 percent, above the regulatory minimum of 8 percent. However, some banks−mainly those ranked 21-50 by asset size−may feel pressure to meet their elevated provisioning needs, especially those with large exposure to consumer or foreign currency-denominated corporate loans. Other key financial performance indicators remained weak due to slow growth in new loans and higher provisioning, with a return on equity at 3.4 percent and return on assets at 0.4 percent. On the positive side, the funding profile of banks has improved: the loans to deposit ratio declined to 110 percent by March 1. This trend was driven by strong deposit growth, which exceeded loan growth and allowed banks to reduce their reliance on central bank funding.

Figure 3: Consumer prices remained sticky … (percent, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

Figure 4: … while the output recovery continued (percent change, y-o-y)



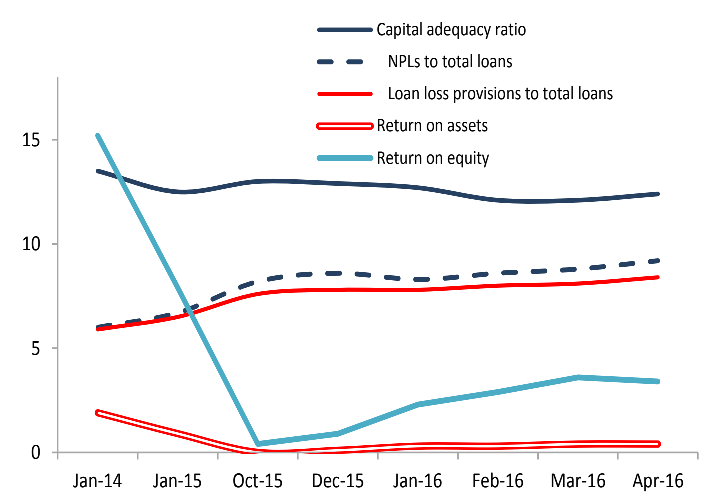
Source: Rosstat, Haver Analytics, World Bank team

In January-April 2016, the federal primary deficit worsened substantially year-on-year as lower expenditures were unable to compensate for the sharp drop in oil revenues. The federal primary deficit stood at 3.4 percent of GDP at end-April compared to 2.9 percent of GDP in April 2015. In the first four months of 2016, federal budget revenues fell by a massive 3.7 percent of GDP to 14.9 percent, compared to the same period a year ago. This was primarily due to a decline in oil revenue by 3.2 percent of GDP to 5.0 percent of GDP. The price for Urals oil dropped by 37.5 percent to US$33.9 per barrel in the first four months of 2016 and the ruble depreciation only partly compensated this fall. Meanwhile, primary expenditure declined by 3.1 percent of GDP (8.5 percent in nominal terms) to 18.4 percent of GDP in January-April year-on-year. This decline was mainly due to the high base of spending in the beginning of 2015. The two top-spending categories in January–April 2016 were social spending (32.3 percent of primary expenditure) and defense (23.8 percent of primary expenditure). The non-oil deficit improved to 9.4 percent of GDP in January-April 2016 from 12.0 percent of GDP in January-April of 2015 on the back of lower expenditure. In May, the government tapped for the second time this year the Reserve Fund to finance the federal deficit in the amount of RUB390 billion (US$5.8 billion), reducing the Reserve Fund to US$38.6 billion by the end of May.

On May 24, Russia's government successfully returned to global capital markets since the introduction of economic sanctions in 2014, issuing US$1.75 billion in 10-year Eurobonds. The government's borrowing plan envisages raising US$3 billion at international capital markets in 2016 to help cover a budget deficit caused by low oil prices. VTB capital, the investment banking unit of the state-owned bank VTB, was the sole operator of the Eurobond placement, after foreign banks and investment companies did not take part in the issuance. Foreign investors bought bonds in the amount of US$1.2 billion, Russian banks bought US$0.55 billion. The bonds were placed to yield 4.75 percent with initial expectations of 4.65-4.9 percent. Demand for the Eurobonds climbed up to US$7 billion, mainly from Russian banks. Foreign investors' interest in the Eurobonds purchase might have been limited by concerns over the settlement of the bonds and due to the continued economic sanctions environment.

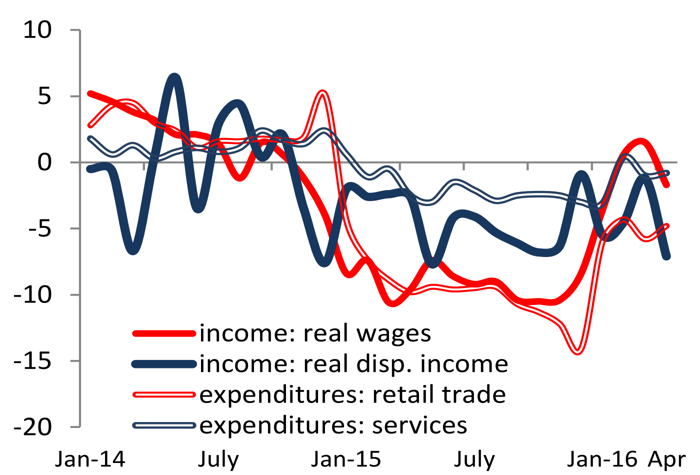
Income dynamics worsened in April and unemployment remained elevated. The seasonally adjusted unemployment rate moved up for the fourth consecutive month to 5.7 percent in April, close to its peak levels of the end of 2015. However, it remained well below the levels seen in the previous crisis of 2008-2009 when it reached over 9 percent in 2009. After promising improvements in real wage and real disposable income during the first quarter of 2016−when both indicators grew in annual and monthly terms−in April, they contracted again. Real wages declined by 1.7 percent year-on-year and by 1.4 percent compared to March, seasonally adjusted. Real disposable income declined strongly in April in annual terms by -7.1 percent, due to the relatively high base of the previous year. Monthly real disposable income declined by 0.9 percent after seasonal adjustment. Pensions showed a similar dynamic and contracted in real terms.

Figure 5: Non-performing loans are increasing (percent)



Source: CBR

Figure 6: Income dynamics worsened (percent change, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

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