The external context remains supportive to Russia. In the second quarter of 2017, global GDP reached 3.6 percent (q/q saar), its highest reading since the end of 2010, owing to a broad-based acceleration. The Brent oil price, the main international marker, reached $59/bbl in late-September (up from a low of $44/bbl in late June) before settling back into the low $50s in October. In September, the ruble appreciated by 3.2 percent with respect to the U.S. dollar, supported by stronger oil prices and continued investor interest in Emerging Market and Developing Economies (EMDEs). Economic activity in Russia gained momentum in August, with output in five basic sectors growing by 2.8 percent, y/y, and industrial production expanding by 1.5 percent, y/y. Labor market indicators also improved. The 12-month Consumer Price Index registered another record low in September, increasing the probability of a further key rate cut during the Central Bank meeting on October 27th. In the January - August 2017 period, aided by higher revenues and lower expenditures, the federal budget registered a primary balance surplus of 0.1 percent of GDP compared to a deficit of 1.9 percent of GDP in the same period last year. The government recently submitted a draft law on the federal budget for 2018 – 2020 to the Duma. Expenditure consolidation will bring the primary balance to 0.5 percent of GDP in 2018, down from 1.5 percent of GDP in 2017, and it will keep it at zero beginning in 2019. The banking sector’s overall performance is improving, but remains volatile. In September, the Central Bank announced a bailout of another large private bank, B&N Bank, following the bailout of the second largest private and systemically important bank Otkritie, in August.

The Global Context

Global growth registered its highest reading since 2010 (Figure 1). Global GDP reached 3.6 percent (q/q saar) in Q2, the highest reading since the end of 2010. The uptick is based on acceleration in the United States, the Euro Area, Japan, Eastern Europe and Central Asia, and continued robust activity in East Asia and the Pacific. Global manufacturing PMIs remained robust in July and August, suggesting continued growth momentum in Q3. In China, growth remained unchanged at 6.9 percent (y/y) in Q2, with a shift from state investments to exports and consumption. Incoming data for Q3 in China was mixed. EMDE financial markets remained buoyant in September. Global trade growth continued broad-based recovery in exports.

Crude oil prices gained 2 percent in September. The Brent oil price, the main international marker, reached $59/bbl in late September (up from a low of $44/bbl in late June) before settling back to the low $50s in October (Figure 2). WTI, the U.S. oil price barometer, did not rise as much as the Brent price due to Hurricane Harvey-induced disruptions in refinery capacity (which reduced demand for U.S. crude oil). The overall strengthening in oil prices reflects the gradual disappearance of the large surpluses of 2014-16. In fact, the oil market recorded a large deficit in the second quarter of 2017 for the first time since 2013. Indeed, as oil prices dropped below $50/bbl earlier in the year, the recovery in U.S. drilling activity stalled and declined by 18 rigs from its August high, indicating tightening supplies. The disincentive to keep oil in storage is also confirmed by the slight backwardation (downward sloping) of the futures price curve for the first time since June 2014. The World Bank’s oil price forecast remains at $53/bbl for 2017 and $56/bbl for 2018 (unchanged from the July 2017 Global Economic Prospects).

Figure 1: Global growth recorded its highest reading since the end of 2010

-2 0 2 4 6
Industrial production

Trade

Percent, quarter-on-quarter annualized
2012-16 average

Figure 2: Brent price reached $59/bbl in late September

Russia’s Recent Developments

In September, the ruble appreciated by 3.2 percent with respect to the U.S. dollar, supported by stronger oil prices and continued investor interest in EMDEs (Figure 3). The average oil price (Brent) increased by 7.4 percent in September compared to August. Higher oil prices, continued investor interest in emerging markets, and Russia’s elevated interest rates amidst low inflation all supported the ruble.

Figure 3: In September, the ruble appreciated by 3.2 percent with respect to the U.S. dollar

Investment demand was the main force driving GDP growth in the second quarter of 2017. Rosstat published the first estimate of the demand side composition of GDP in the second quarter of 2017. Investment demand was the driving force behind the GDP growth of 2.5 percent: change in inventories contributed +2 percentage points (pp) to GDP growth and fixed capital investment contributed +1.2 pp. Consumer demand contribution was also substantial, 2.3 pp, largely due to household consumption expansion on the back of growth in real wages and stronger ruble buoyancy in consumer credit. The domestic demand growth of 6 percent drove a vast increase in imports (20.7 percent). Export contribution to GDP growth decreased from 1.9 pp in the first quarter of 2017 to 0.9 percent in the second quarter of 2017.

Economic activity gained momentum in August (Figure 4). Economic activity in five basic sectors expanded by 2.8 percent y/y, compared to 1.8 percent, y/y, in July. As in July, construction and transportation displayed strong growth: 6.1 percent, y/y, and 7.8 percent, y/y, respectively. Output in agriculture increased by 4.7 percent compared to -2.9 percent, y/y, in July, beginning to reflect on the bumper harvest of 2017. Industrial production expanded by 1.5 percent, y/y, compared to 1.1 percent in July. It also increased by 0.3 percent, m/m, sa, after two consecutive months of negative growth. Manufacturing registered growth of 0.7 percent, y/y, and expanded compared to the previous month after seasonal adjustment. Data of the manufacturing PMI from the September survey signaled a further improvement in operating conditions in the Russian manufacturing sector. The seasonally adjusted PMI posted 51.9 in September, up slightly from August’s reading of 51.6.

Figure 4: Economic activity gained momentum in August

The 12-month Consumer Price Index registered another record low in September, leaving more space for monetary easing (Figure 5). The 12-month CPI dropped further to 3 percent in September after the 3.3 percent reading in August. The slowdown in food inflation was the main factor behind the deceleration in consumer inflation, yet inflation of non-food items also decelerated, possibly supported by a pass-through effect from the stronger ruble. In September, core inflation dropped to 2.8 percent from 3 percent in August, suggesting lower inflationary pressures and increasing the probability of a further key rate cut during the CBR meeting on October 27th.
Figure 5: Consumer inflation reached a record low in September

![Graph showing consumer inflation trends over time](source: Rosstat, Haver Analytics, World Bank team.)

**Labor market indicators improved in August.** The unemployment rate decreased by 0.2 percentage points in August, reaching 4.9 percent. The seasonally adjusted rate also declined to the level of 5.2 percent (Figure 6). These are the lowest levels since mid-2014. Real wages continued to grow and increased by 3.1 percent in August compared to July after seasonal adjustment, and they increased by 3.7 compared to the same period in the previous year. In August, real disposable incomes contracted by 0.3 percent compared to the same period in 2016, but they increased by 1.4 percent compared to the previous month after seasonal adjustment. The average contraction for the eight months of 2017 compared to same period in 2016 was 0.8 percent. Pensions were indexed in the beginning of the year at the inflation rate, meaning that the real growth of pensions was close to zero.

Figure 6: The unemployment level decreased

![Graph showing unemployment trends](source: Rosstat, Haver Analytics, World Bank team.)

**In the January - August 2017 period, aided by higher revenues and lower expenditures, the federal budget registered a primary balance surplus of 0.1 percent of GDP compared to a deficit of 1.9 percent of GDP in the same period last year.** In January – August 2017, the federal budget revenue totaled 16.6 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. Compared to the same period last year, primary expenditures decreased by 0.8 percent of GDP to 16.5 percent of GDP due to lower spending on defense (-0.4 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 from 7.5 percent of GDP to 6.4 percent of GDP led by an increase in non-oil federal budget revenues (corporate income tax, excise tax, and VAT). Overall, the federal budget deficit narrowed to 0.7 percent of GDP from 2.7 percent of GDP last year.

**The government is committed to staying on the path of fiscal consolidation.** The government submitted a draft law on the federal budget for 2018 – 2020 to the Duma (Box 1).

**Box 1: Draft law on the federal budget for 2018 – 2020 to the Duma.**

The draft law is based on prudent GDP growth forcasts of 2.1 percent, 2.2 percent, and 2.3 percent in 2018, 2019, and 2020, respectively, and prudent oil prices projections of US$43.8/bbl, US$41.6/bbl, and US$42.4/bbl for the respective years. The draft law was developed in accordance with the new fiscal rule provisions. For 2019 and 2020, primary expenditures are capped by the sum of oil and gas revenues at a threshold price of US$40/bbl (in real terms, prices of 2017) and projected non-oil/gas revenues. In 2018, transitional provisions are applied: primary expenditures are larger by 1 percent of GDP than the ones stipulated by the fiscal rule. Federal budget primary expenditures would decrease from about 17.5 percent of GDP in 2017 to 14.8 percent of GDP in 2020. In 2018, federal budget primary expenditures would decrease by 1.3 percent of GDP (6.6 percent decrease in real terms). Expenditures for all categories, except for national security and education, would drop in real terms. Social policy, national economy, and national defense would contribute the most to expenditure consolidation in 2018. Federal budget revenues are projected to fall from 16 percent of GDP in 2017 to 14.8 percent of GDP in 2020, mainly on the back of lower oil and gas revenues due to price effect, decreasing share of the oil sector in the economy and lower effective tax rate with the increased depletion of stocks. Expenditure consolidation will bring the primary balance to 0.5 percent of GDP in 2018, down from 1.5 percent of GDP in 2017, and it will keep it at zero beginning in 2019. The non-oil/gas primary fiscal balance is expected to reach 6.1 percent of GDP, 5.1 percent of GDP, and 4.9 percent of GDP in 2018, 2019, and 2020, respectively, compared to 7.8 percent of GDP in 2017.
The banking sector’s overall performance has been improving, but its volatility continued (Figure 7). In September, the Central Bank announced the bailout of another large private bank - B&N Bank (ranked 12th in terms of assets, 5th in terms of retail deposits, and with 2.3 percent market share). This followed the bailout of the second largest private and systemically important bank Otkritie, in August this year. Both banks are being resolved with a new bank resolution mechanism recently introduced by the CBR – the Banking Sector Consolidation Fund (BSCF). Otkritie and B&N received liquidity support from a newly created CBR emergency liquidity facility, and will receive capital injection from the BSCF with full details of the bailout yet to be revealed. There was no credit moratorium or bail-in used, but the holders of subordinated debt will contribute to the rescue. While these recent failures of the large private banks have not caused noticeable stress across the broader banking sector, they point to continued banking sector fragility, which could hamper credit recovery.

In August, credit to households in rubles picked up, increasing by 8.4 percent, y/y, compared to 7.6 percent in July. While credit growth to households was largely driven by mortgage loans, contribution from other types of loans increased compared to the beginning of the year, supporting consumption demand. Meanwhile, credit to the corporate sector in rubles grew by 1.7 percent, y/y, compared to 1.3 percent in July. Key credit risk and performance indicators remained stable. As of August 1, 2017, the sector’s aggregate capital adequacy stood at 13 percent. Non-performing loans have stabilized at nearly 10 percent. As of August 1, 2017, banks’ profitability continued to increase with the return on assets and the return on equity at 1.7 percent and 14.8 percent, respectively.

Figure 7: The banking sector’s overall performance has been improving, but its volatility continued