



August 2015

- Russia's economy contracted 4.6 percent in the second quarter, year-on-year, after a 2.2 percent contraction in the first quarter, but in June the pace of contraction slowed.
- Russia's second quarter balance of payment remained stable despite a weaker trade balance as the current account improved and capital outflows moderated.
- Receding oil prices and a further cut in the key policy rates in July brought the ruble exchange rate down to its lowest level since February.
- Preliminary poverty statistics for the first quarter of 2015 show a significant increase in the number of poor people.

## **Russia's economy contracted 4.6 percent in the second quarter, year-on-year, after a 2.2 percent contraction in the first quarter.**

This remains broadly in line with the World Bank quarterly projections and other analysts' forecasts. However, the decline in real GDP by about 3.3 percent in the first half of the year was accompanied by a larger than expected contraction in consumption due to the continued sharp fall in real incomes and wages in the second quarter while unemployment was below projections (5.7 percent seasonally adjusted in June). Persistently high credit costs for Russian firms and renewed uncertainty stemming from temporary flare-ups in geopolitical tensions combined with increasing global economic and financial stress contributed to continually weak investment demand. The result was an accelerating and broad-based contraction of economic activities in the second quarter.



## **In June the pace of economic contraction slowed, yet remains constrained by continued weakness in domestic demand.**

Contraction in industrial output slowed in June to 4.8 percent, year-on-year, from -5.5 percent in May. Output contraction slowed in all base sectors, including in manufacturing where output decreased by 6.6 percent, compared to -7.2 percent in May. The moderate improvement was largely driven by a 3.9 percent expansion in food production in June, year-on-year, compared to a 1.5 percent contraction in May. Manufacturing industries that target investment goods performed less strongly in June with major sub-industries such as machine building and transportation continuing to report double digit contractions. While fixed investment dropped by 7.1 percent, year-on-year, compared to -7.6 percent in May it was slightly less than the -8.8 percent in the first quarter. June high-frequency data confirm still depressed consumer demand, with retail trade dropping by 9.4 percent in June, compared to -9.2 percent in May. However, real wage contraction levelled at 7.2 percent, year-on-year, from around -10 percent in March-April and -7.4 percent in May, corresponding to 1.2

percent seasonally adjusted monthly growth. Real disposable income dropped in June by 3.5 percent, year-on-year, but less than the -6.5 percent in May.

## **Global second-quarter trends point to an increasingly challenging environment for exports.**

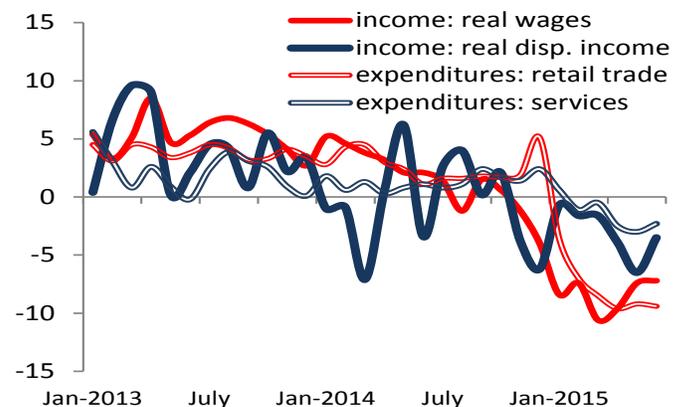
Although the strong dollar is weighing on exports, second-quarter growth in the United States was strong and accompanied by improvements in labor market conditions, as a result of which the Federal Reserve is expected to start gradually increasing policy interest rates in coming months. In the Euro Area, despite renewed economic and financial stress in its periphery, growth is firming. The European Central Bank's quantitative easing program is playing an important role in improving credit conditions and the weaker euro is underpinning manufacturing activity and exports. While growth in China in the second quarter was stronger than market expectations, activity in other emerging and developing countries remained weak, struggling to gather pace (in Mexico, and Indonesia) or turning negative (in the Philippines, Korea, and Thailand) with the June PMI data pointing to further softness. Lingering weakness reflects the ongoing adjustment by commodity-exporting economies to lower commodity prices (e.g. Russia); domestic factors including governance challenges (e.g. Brazil) and mining sector strikes and power shortages (e.g. South Africa); and a challenging external environment for exports, particularly for Asia's manufacturing-oriented economies (e.g. Malaysia, Thailand, Philippines, Singapore, and India). Competitiveness pressures related to the weaker yen and soft demand from China weighed on exports as well as globally weak domestic demand, reflected in large contractions in imports since the start of the year. Global equity flows are also down due to a sharp drop in flows to China, mirroring the 30 percent plunge of its stock markets since mid-June amid concerns for a disorderly correction with spillovers affecting global financial stability and confidence despite continued policy actions.

**Figure 1: The pace of economic contraction slowed ... (percent change, y-o-y)**



Source: Rosstat, Haver Analytics, World Bank team

**Figure 2: ... as real wages and income contraction decelerated (percent change, y-o-y)**



Source: Rosstat, Haver Analytics, World Bank team

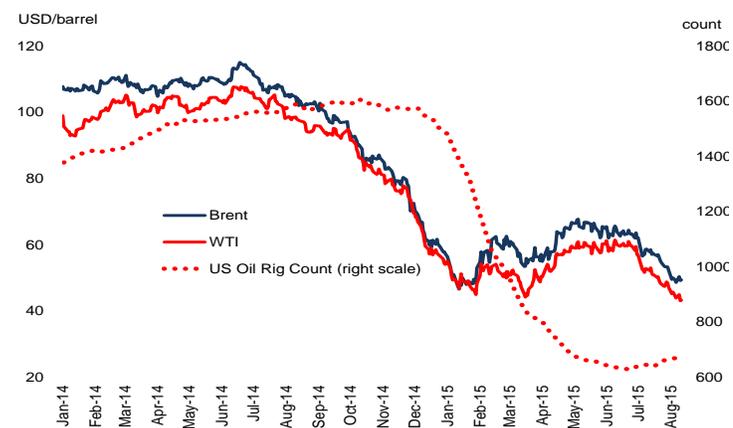
**Russia's second quarter balance of payment remained stable despite a weaker trade balance as the current account improved and capital outflows moderated.** Lower oil and gas exports weakened the trade balance to US\$44.1 billion in the second quarter compared to US\$51.7 billion a year ago. Yet the current account improved from US\$12.1 billion to US\$19.2 billion due to two main factors: a higher investment income balance benefited from lower payments abroad as the economy entered recession and external debt decreased while a higher balance of services was the result of less tourism abroad. Net capital outflows decreased to US\$15.3 billion from US\$23.3 billion in the first quarter of 2015.

**Weak global demand and a persistent supply glut resulted in oil prices slipping further in July-August.** Energy prices fell almost 10 percent in July driven mainly by the continuing decline in oil prices. Crude oil prices reached US\$46 per barrel in early August, close to the lowest January levels. The supply glut appears to grow: OPEC output rose in July to over 31 million barrel per day—the highest level since 2008 and the United

States reported in July a rise in the drilling rig count by 36 rigs to 664. The downward price pressure was also supported by the agreement with Iran over its nuclear program (potentially increasing supply by 0.5 million barrels per day by 2016). On the demand side, weakening Chinese activity and the strengthening of the dollar contributed to the price decline.

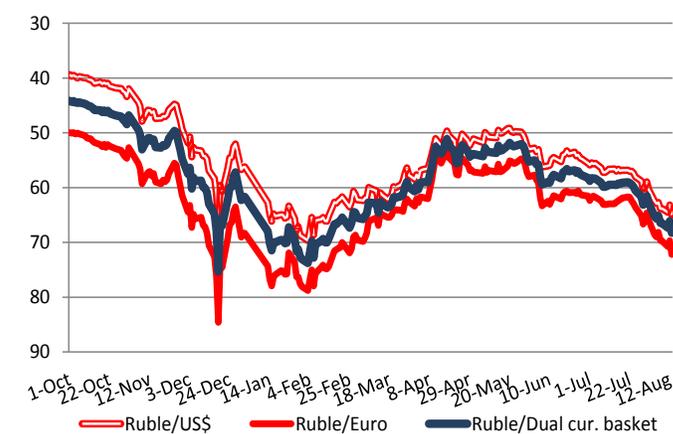
**Receding oil prices and a further cut in the key policy rates in July brought the ruble exchange rate down to its lowest level since February.** In July the ruble average exchange rate depreciated by about 5 percent against the dollar, month-on-month. Mounting depreciation pressure led the Central Bank of Russia (CBR) to stop on July 29 its program of daily purchases of US\$200 million to replenish its foreign currency reserves which it started in mid-May and to cut the key policy rates by 50 basis points on July 31. Due to the continued downward adjustment in oil prices in the first half of August the ruble depreciated by another 6 percent against the dollar, to its lowest level since February 2015.

**Figure 3: Oil prices continued to edge down ...**



Source: Bloomberg, Bakes Hughes, and World Bank

**Figure 4: ... and the Ruble slid close to February levels**



Source: CBR

**The annual indexation of utility tariffs led to a temporary inflation increase in July.**

The 12-month Consumer Price Index increased to 15.6 percent from 15.3 percent in June as aggregate service prices jumped by 3 percent due to an increase in utility tariffs by 8.2 percent in one month. Retreating food inflation—driven by seasonal declines in fruit and vegetable prices—helped to partly compensate the impact of the sharp increase in utility tariffs on headline inflation. While the 12-month core inflation remained well above the headline inflation, it decelerated slightly to 16.5 percent in July from 16.7 percent in June. For that reason and due to renewed depreciation pressures, the CBR remained cautious with further key policy rates cuts in its monetary easing cycle and only cut them by 50 basis points to 11 percent, compared to a 100 basis points cut in June (and 150 basis points in April).

**Rosstat’s preliminary poverty statistics for the first quarter of 2015 show a significant increase in the number of poor people compared to quarter one of 2014.**

The total number of poor people increased in the first quarter of 2015 to 22.9 million people (15.9 percent of the population) from 19.8 million (13.8 percent of the population) in quarter one of 2014. The World Bank estimates that the seasonally adjusted poverty level also increased in the first quarter of 2015 compared to the last quarter of 2014, reaching 2010 levels.

**In the first half of 2015 the federal budget registered a deficit of 2.6 percent of GDP compared to a 1.9 percent surplus a year ago.**

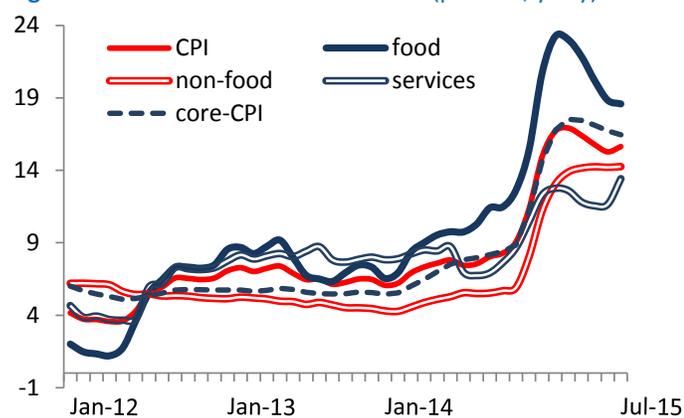
Federal budget revenues decreased by seven percent in nominal terms in the first six months of 2015 to 19.2 percent of GDP from 21.1 percent of GDP in the first half of 2014 due to oil and gas revenues dropping to 8.6 percent of GDP from 11.0 percent of GDP in January-June 2014. Non-oil

revenues remained nearly unchanged at 10.6 percent of GDP (10.1 percent in June 2014) thanks to strong corporate income tax and VAT receipts. Federal budget expenditure increased by 17 percent in nominal terms to 21.8 percent of GDP in January–June from 19.0 percent of GDP over the same period a year ago, mainly due to a 1.5 percent of GDP year-on-year increase in military spending and a 1.0 percent of GDP increase in spending for social policy. The non-oil deficit stood at end-June at 11.2 percent of GDP compared to 8.9 percent of GDP at end-June 2014.

**In June banks reported a slight recovery in credits to firms, a continued improvement in the depositors’ base and further moderation in credit risk.**

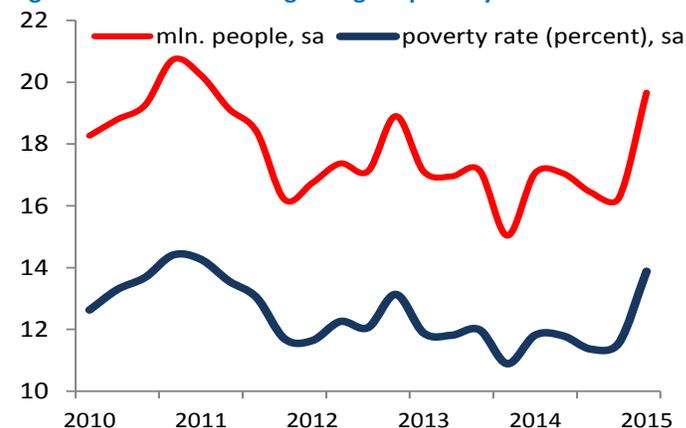
Credit growth to firms increased to 20.7 percent, year-on-year, compared to 18.4 percent in May while banks continued to downsize their credit portfolio to households (by 0.4 percent in June) which further slowed annual credit growth to households to 0.8 percent, compared to 2.4 percent in May. Meanwhile banks’ depositors’ base continued improving in June with aggregate deposits growing by 2.6 percent (in part due to the weaker ruble) and ruble deposits by 1.6 percent. Data also suggests a stabilization in credit risk in June: the share of non-performing loans (NPLs) by households stood at 7.5 percent (compared to 7.4 percent in May) and the share of NPLs to non-financial organization stood at 5.9 percent (compared to 5.8 percent in May). On grounds of overly-risky credit activities, suspicious operations and low capital adequacy the CBR revoked during June-July licenses from 27 (mostly Moscow-based banks), one of which (Rossiskii credit) was in the top 50 measured by its assets.

**Figure 5: Inflation remains elevated ... (percent, y-o-y)**



Source: Rosstat, Haver Analytics, WB team

**Figure 6: ... .. contributing to higher poverty levels**



Source: Rosstat, Haver Analytics, World Bank team

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