Russia Monthly Economic Developments

December 2015

- Oil prices came under renewed pressure in early December after OPEC failed to agree on new production quotas.
- On November 28, the Russian Federation introduced economic sanctions against Turkey.
- In November, the ruble exchange rate remained relatively stable, despite falling oil prices but started depreciating by the end of the month reflecting increased geopolitical tensions.
- Inflation slowed in November, but it remains high and the pass-through effect from the ruble depreciation continued to push up non-food prices.
- The contraction in services industries deepened while industrial output could not sustain the September recovery.
- The federal budget law for 2016 was approved by the State Duma and the Federation Council.

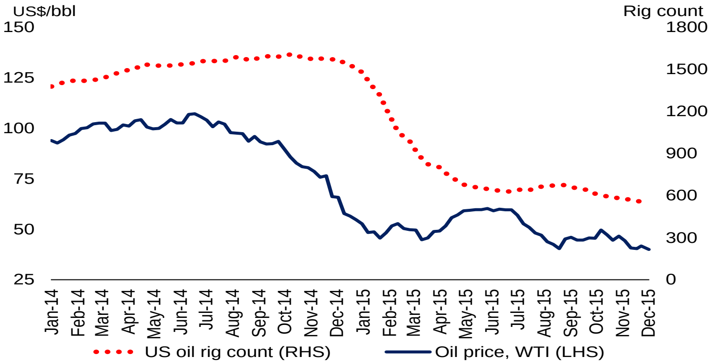
Oil prices came under renewed pressure in early December after OPEC failed to agree on new production quotas to manage the global supply glut. Crude oil prices slid to US$40 per barrel, setting a new record since this year's August low – a level not seen since 2009 – following OPEC's decision on December 4 to neither cut its production target nor to offer certainty on any production ceiling. With OPEC not likely to decide on a new output ceiling (which had been set at 30 million barrels a day last November) until its next meeting on June 2, 2016, there is renewed short term pressure on oil prices. In October, OPEC production reached a record high of 38.4 million barrel per day, with Saudi Arabia and Iraq producing 10.2 and 4.2 million barrel per day, respectively. At the same time, OECD stocks are at record highs as well, estimated at 2.99 billion barrels, 0.24 billion barrels higher than a year ago. Although the US rig count (a measure of future supply response in the US) reached a low of 545, 65 percent lower than a year ago, the global oil market remains in a glut. The World Bank expects an average oil price of US$52 per barrel in 2015 and US$49 per barrel in 2016.

On November 28, the Russian Federation introduced economic sanctions against Turkey. Sanctions are planned in six areas: (1) restrictions on imports of goods, (2) restriction on economic activities of Turkish companies in Russia, (3) a ban on new employment of Turkish citizens in Russia (with the exception for companies from a list to be approved by the government), (4) the suspension of the visa-free regime with Turkey, (5) a ban on the sale of tourist packages to Russian citizens, and (6) a ban on charter flights between Russia and Turkey. On December 1, the Russian government decided on the list of goods consisting of fresh fruits and vegetables, and chicken that will fall under the import ban starting on January 1, 2016. Russia's services imports from Turkey mostly comprise tourism services (20 percent of all trips) and construction services. Turkey accounts for about 15-25 percent of Russian imports of fruits and vegetables. Besides creating upward pressure on food inflation, sanctions will add to the uncertainty of doing business in Russia.

In November, the ruble exchange rate remained relatively stable, despite falling oil prices but started depreciating by the end of the month reflecting increased geopolitical tensions. For much of November, strong demand for ruble-denominated financial assets kept the ruble stable. The average ruble exchange rate depreciated by 2.8 percent with respect to the US dollar while the average oil price (Brent crude) fell by 6.8 percent with respect to October's levels. Relatively high yields on Russia's treasury bonds (OFZs) continued to attract both domestic and foreign investors, with the November auctions oversubscribed by more than two times. Before the final week of November, the ruble-based Micex index rallied by 9.1 percent to a record high for this year. However, demand for Russian assets started to evaporate following the escalation of geopolitical tensions between Russia and Turkey. Since the final week of November the Micex index lost 8 percent while the OFZs auction on December 9 was undersubscribed.

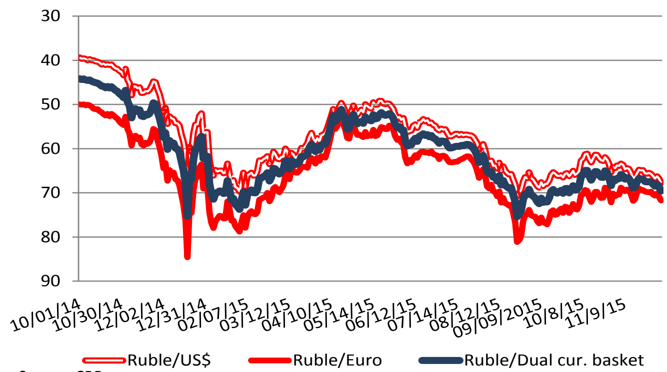
As in Russia, emerging market currencies and equities have stabilized in November, despite the rising probability of an interest rate increase in the US. While the European Central Bank loosened the monetary policy stance in the Euro area in early December, the US Federal Reserve is expected to start the next tightening cycle at its next meeting on December 15-16. Bond issuance by emerging and developing economies remained weak in November, at US$14 billion, compared with the historical average of US$20 billion. Russia saw no new international issuance since October when metals and mining firm Norilsk Nickel had reopened the market for Russia with a 7-year US$1 billion bond that attracted US$4 billion of orders from over 300 mainly US and European fund managers, followed by substantial demand for a €1 billion 3-year note by the state-owned energy firm Gazprom.

Figure 1: Oil prices are under renewed pressure …



Source: Bloomberg, Bakes Hughes, and World Bank

Figure 2: … and the average ruble exchange rate depreciated



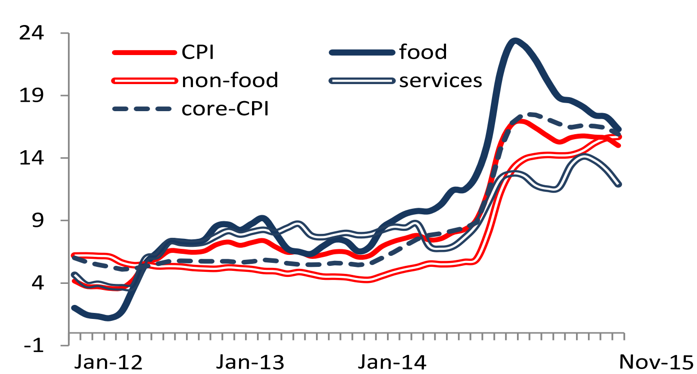
Source: CBR

Inflation slowed in November, but it remains high and the pass-through effect from the ruble depreciation continued to push up non-food prices. The 12-month Consumer Price Index decreased to 15.0 percent in November from 15.6 percent in October, with core inflation easing to 15.9 percent from 16.4 percent, and food inflation to 16.3 percent from 17.3 percent. However, 12-month non-food inflation inched up to 15.7 percent from 15.6 percent in October due to the continued pass-through effect from the depreciated ruble. The monthly inflation remained stubbornly high at 0.8 percent (compared to 0.7 percent in October), despite depressed consumer demand, bringing cumulative inflation for the first eleven months to 12.1 percent. Russia's sanction measures targeting food imports from Turkey are expected to put upward pressure on inflation, making it difficult for the central bank to keep its inflation target for next year.

Real wages and incomes continued to deteriorate in August while unemployment ticked up marginally. The unemployment rate increased to 5.6 percent in October compared to 5.2 percent a month ago but in seasonally adjusted terms it increased by only 0.1 percentage points to 5.6 percent. Yet, real wage contraction accelerated in October to 10.9 percent year-on-year. Pensions contracted by 4.1 percent on a yearly basis in real terms, while real incomes declined in October by 5.6 percent. The 2015 budget planned zero indexation for public wages, however, nominal wages for all federal civil servants increased by 3.8 percent in the first nine months. This is because there were significant differences in nominal wage increases for groups of civil servants: for the 5.4 million employees in public administration nominal wages increased only marginally by 0.3 percent, but nominal wages for the 2.8 thousand lawmakers climbed by 27.9 percent, by 12.4 percent for 76 thousand Ministry of Finance employees and by 6.9 percent for 2.1 thousand employees of the judiciary system.

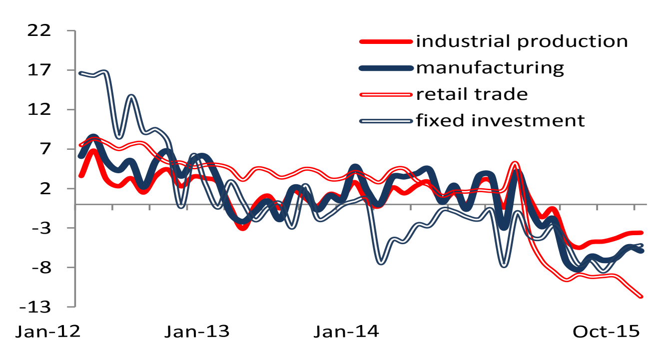
The contraction in services industries deepened while industrial output could not sustain the September recovery. As consumer demand continued to dwindle amid high inflation and contracting real wages, the contraction in retail services accelerated to 11.7 percent in October from 10.4 percent in September – the sharpest decline since 1998. At the same time, seasonally adjusted industrial output contracted in October by 0.1 percent, month-on-month, after expanding by 0.6 percent in September. Manufacturing output contracted by 5.9 percent, year-on-year, compared to -5.4 percent in September, with only food processing and chemical production registering output growth. Investment demand remained weak: fixed capital investment decreased by 5.2 percent, year-on-year, compared to -5.6 percent in September.

Figure 3: Inflation remains high … (percent, y-o-y)



Source: Rosstat, Haver Analytics, WB team

Figure 4: … with the contraction in services deepening (percent change, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

In October, credit growth decreased further while credit risk remains elevated. In October, credit growth to the private sector dropped to 11.4 percent, year-on-year – less than half the level of end-2014 − from 15.2 percent in September as banks continued reducing credit stocks to both firms and households for the second consecutive month. At the same time, the share of non-performing loans remained stable around 8.2 percent for four consecutive months, compared to 6.7 percent at the start of the year. The number of loss making banks rose to 215 from 206 in September. In November, the Central Bank of Russia (CBR) revoked licenses of 17 banks, bringing the cumulative number of banks closed since the beginning of the year to 98 (compared to 94 banks in 2014). As a result, liquidity pressure on the Deposit Insurance Fund (DIF), mounted, requiring an extension of CBR credits of RUB20 billion in October and RUB55 billion in November. Already by end-September, the DIF had been severely depleted, with only RUB 35.8 billion left, compared to RUB83.6 billion in December 2014, and RUB168.1 billon in December 2013. The DIF payed around RUB248 billion to insured depositors in the first ten months of the year.

In January–October 2015, the federal primary balance deteriorated to a deficit of 0.4 percent of GDP from a 2.6 percent of GDP surplus a year ago. Federal budget revenue decreased in the ten months of 2015 on a yearly basis to 18.8 percent of GDP from 20.0 percent of GDP due to a drop in oil revenues (2 percent of GDP) larger than the increase in non-oil revenue (1.1 percent of GDP). At the same time, federal primary expenditure increased by 1.8 percent of GDP (11.7 percent in nominal terms) compared to the same period a year earlier, on the back of higher defense and social spending. The non-oil deficit expanded to 9.3 percent of GDP at the end of October from 8.3 percent in the same period of 2014. In October, the federal government spent RUB260 billion from the Reserve Fund to finance the deficit. In the beginning of November, the Reserve Fund stood at US$65.7 billion US (5.8 percent of GDP), compared to US$87.9 billion (6.8 percent of GDP) at the beginning of the year.

The federal budget law for 2016 was approved by the State Duma and the Federation Council. Throughout the approval process (by the State Duma on December 4 and the Federation Council on December 9), the budget envelope remained largely the same, with some reallocation within that envelope. For example, the State Duma inserted a second increase of pensions for non-working pensioners, yet the amount of the increase will be determined in 2016. Federal budget expenditure is projected at 20.5 percent of GDP and federal budget revenue at 17.5 percent of GDP, based on a US$50 per barrel price for Urals oil and economic growth of 0.7 percent. The Reserve Fund is expected to be the main source of financing of the federal budget deficit of 3 percent of GDP and would shrink from RUB3.4 trillion in January 2016 to RUB1 trillion by end-year. In his speech to the Russian parliament on December 3, the president stressed the importance of adhering to this budget deficit which might require further consolidation if oil prices continue to slide. The internal borrowing limit stands at RUB300 billion, the external one at US$3 billion. The Ministry of Finance considers placing US$0.9 billion in yuan-denominated bonds at the domestic market. As in 2015, the fiscal rule remains suspended for 2016 but is planned to be revised next year.

In late November, the president signed a federal law, which requires the transfer of 90 percent of the CBR revenue of 2015 to the federal budget in 2016. The 2016 federal budget would receive RUB50 billion from CBR revenue which is part of the federal budget law for 2016. In 2015 and in 2014, 75 percent of the CBR revenue was transferred to the federal budget. In 2015 an additional 15 percent of CBR revenue went to Vnesheconombank to enhance financial sector stability.

The government of Russia faces contingent liabilities associated with external obligations by the state corporation Vnesheconombank (VEB). The total outstanding debt of VEB is estimated around US$9 billion. In December, the corporation has to pay back a syndicated loan in the amount of US$800 million, while in 2016 and 2017 external debt payments are estimated at US$863 million and US$1.85 billion respectively. The Ministry of Finance, which opposed the additional recapitalization of VEB through the issuance of government's OFZs bonds, is likely to assume VEB's external obligations beginning January 1, 2016. This transfer of debt would create additional pressure to the 2016 budget.

On December 3, Moody's changed the rating on the outlook for Russia's government bonds to stable from negative. Moody's affirmed Russia's government bond rating at Ba1 (non-investment grade). A stabilization of Russia's external finances and a diminished likelihood of another shock within 12-18 months motivated the change.

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