Russia Monthly Economic Developments

October 2016

THE WORLD BANK
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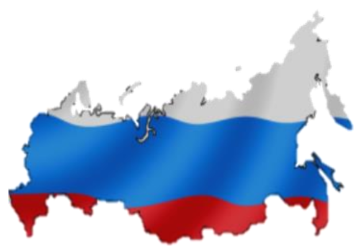
- **Global growth remained disappointing in the second quarter of 2016. Oil prices strengthened following OPEC's announcement of likely production cuts. The ruble gained by 2.4 percent.**
- **Inflation eased in September, down to 6.4 percent in September from 6.9 percent in August. The Central Bank cut its key rate by 50 basis points to 10 percent. The banking system remains stable, but credit growth is limited.**
- **Aggregate output expanded in August by 0.6 percent, y-o-y, the second positive reading in 2016, supported by growth in industrial production and agriculture, as well as lower contraction in construction. Labor market dynamics also improved slightly.**
- **The federal budget primary deficit increased to 2 percent of GDP from 1.1 percent last year as shrinking oil revenues outweighed lower government expenditures. Draft amendments to the 2016 federal budget suggest a further drop in revenues and increased spending on social policy and an undisclosed part of the budget.**
- **On September 27, Russia placed an additional issue of 10-year Eurobonds, with a lower effective yield of 3.9%, compared to the 4.75% of the May 2016 issue.**
- **Privatization of the oil company, Bashneft, is expected to be resumed, with Rosneft, Russia's largest crude oil producer, expected to participate in the privatization.**



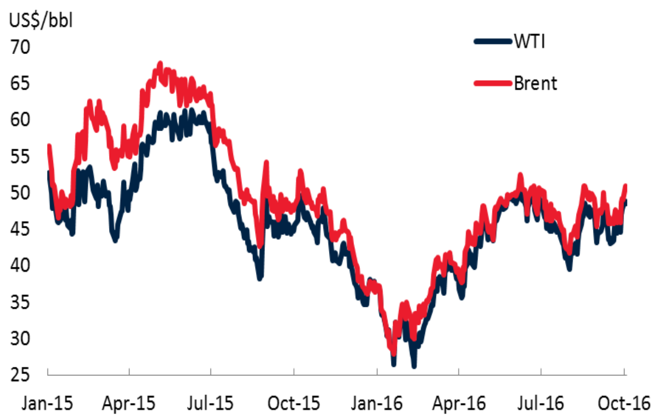
Global growth in the second quarter of 2016 remained disappointing. The growth rate remained below the subdued post-crisis average of 2.5 percent. Global industrial activity was held back by weak investment and a drawdown in inventories. In Q3, high frequency indicators point to continued soft growth. On the other hand, financial markets have rebounded from an initial bout of volatility following the U.K. Brexit vote in June, with global equity and bond markets initially lifted by expectations of more accommodative monetary policies by major central banks. In the Euro Area, growth slowed to 1.2 percent (q/q) in the second quarter, driven by renewed stagnation in France and Italy, as well as moderate growth in Germany. In China, a key trading partner for Russia, growth stabilized to 6.7 percent (y/y) in the second quarter, unchanged from the previous quarter. A steep slowdown in private investment was partially offset by the increase in public investment.

Oil prices strengthened following OPEC's announcement of likely production cuts. In September, prices of Brent (the international marker) and WTI (the U.S. reference crude) averaged \$46.2/barrel (bbl) and \$43.7/bbl, respectively, virtually unchanged from August. However, prices received a boost on September 28, after OPEC announced that it plans to limit production to 32.5-33.0 million barrels /day (mbd), down from 33.5 mb/d in August. The announcement, which came as a surprise, followed two years of market share strategy and unrestrained output. Although both Brent and WTI have gained nearly 6 percent, there is uncertainty as to who will undertake the cuts and when; the details of the agreement will be ironed out during OPEC's November 30th meeting.

The surplus in the oil market is declining as consumption rises and non-OPEC supply contracts, notably in the United States where oil output is down nearly 12 percent from its early 2015 peak. However, global oil inventories remain high, particularly in the United States. Crude oil prices are projected to average \$43/bbl in 2016 and \$53/bbl in 2017 as reported in the July update of the Commodities Market Outlook.

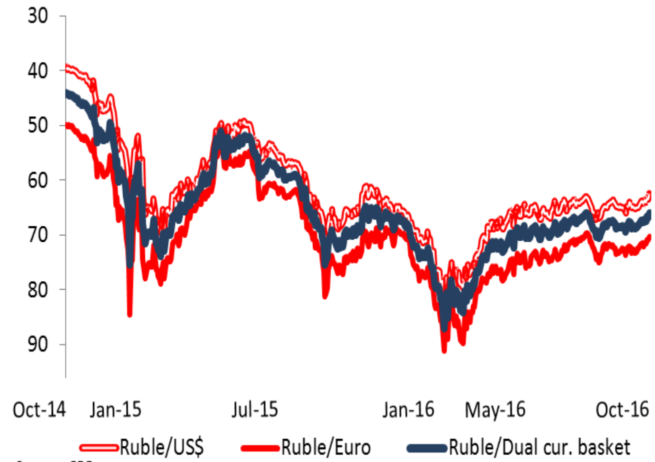
In September, the ruble gained 0.7 percent as oil price (Brent) increased by 2.4 percent. The key policy rate cut on September 16, had a marginal effect on the exchange rate as market players already priced it in. Since the strengthening of oil prices following the OPEC announcement, the ruble gained an additional 2.4 percent.

Figure 1: Oil prices strengthened following OPEC's announcement of likely production cuts....



Source: Bloomberg.

Figure 2: … and the ruble appreciated

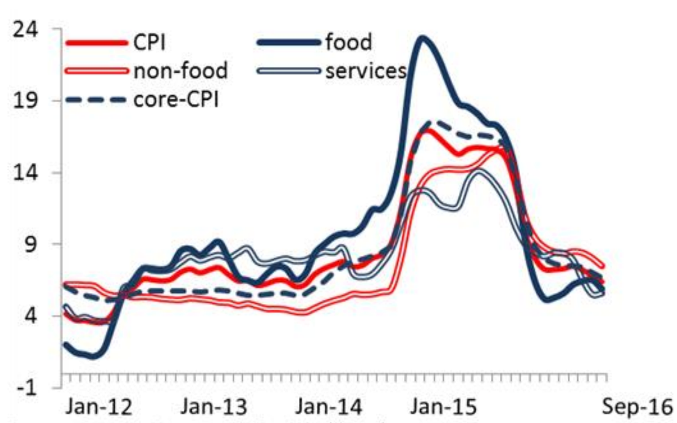


Source: CBR

Inflation eased in September, partly because of the base effect. The 12-month Consumer Price Index decreased from 6.9 percent in August to 6.4 percent in September, compared to 15.7 percent in September 2015. Both food and non-food inflation slowed, while services inflation edged up. Meanwhile, core inflation decelerated to 6.7 percent in September from 7.0 percent in August. In September, inflation expectations for the next 12 months continued subsiding. However, expectations remain sticky, with more than half of respondents expecting the same inflation level next year. In September, lower inflation and subsiding inflation expectations led the Central Bank to cut its key policy rate by 50 basis points to 10 percent. The Bank signaled that the next policy rate cut would only occur in 2017.

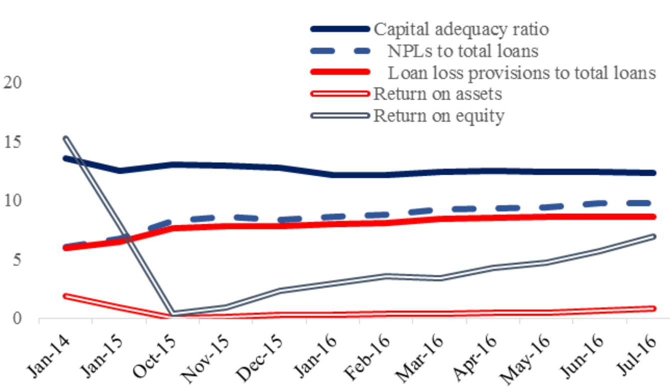
The banking system remained stable but credit growth was weak. The loan portfolio of banks contracted by 1 percent in August compared to the same period last year, or by 0.4 percent controlling for exchange rate movements. The banking sector capitalization remains stable with an aggregate capital adequacy ratio of 12.3 percent (above the regulatory minimum of 8 percent). The share of non-performing loans remained unchanged since June, at 9.7 percent of total loans. The financial performance of banks has shown some improvements, with a return on assets at 0.8 percent and a return on equity at 6.9 percent. The Central Bank has continued closing problematic banks due to non-compliance with regulations, including some larger ones, reducing the number of banks this year from 733 to 659.

Figure 3: There was a fall in inflation (percent, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

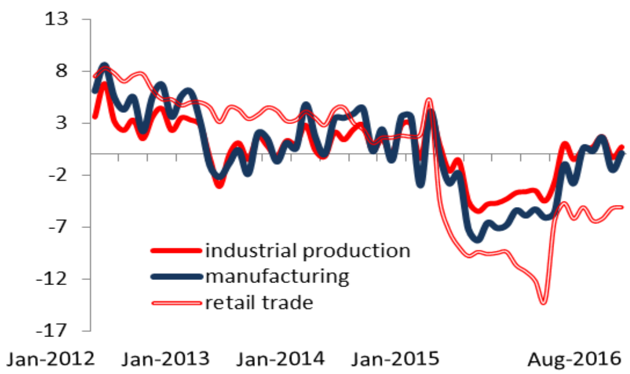
Figure 4: Non-performing loans are increasing (percent)



Source: CBR.

Aggregate output expanded in August, the second positive reading in 2016, supported by growth in industrial production and agriculture, as well as lower contraction in construction. It increased by 0.6 percent year-on-year, partly due to two more working days compared to August 2015. The increase was supported by strong growth in agriculture on the back of a good harvest (6 percent year-on-year), growth in industrial production (0.7 percent year-on-year), and lower contraction in construction (-2 percent year-on-year, compared to -3.5 percent year-on-year last month). Manufacturing positively contributed to industrial production growth, edging up by 0.1 percent year-on-year. Growth within manufacturing on annual basis was broad based, with the exception of metallurgical industries, oil products, and transport vehicles.

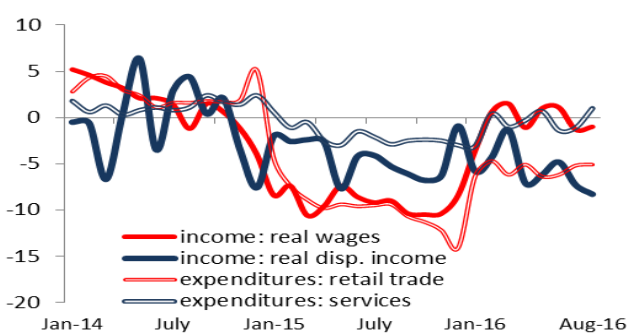
Figure 5: Industrial production expanded (percent change, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

Weak income dynamics could not support consumer demand in August. Retail trade contraction was at the level of 5.1 percent after a drop of 5.2 percent in July. Retail services recorded a growth of 1 percent compared to the same period year ago, which was partly due to base effect.

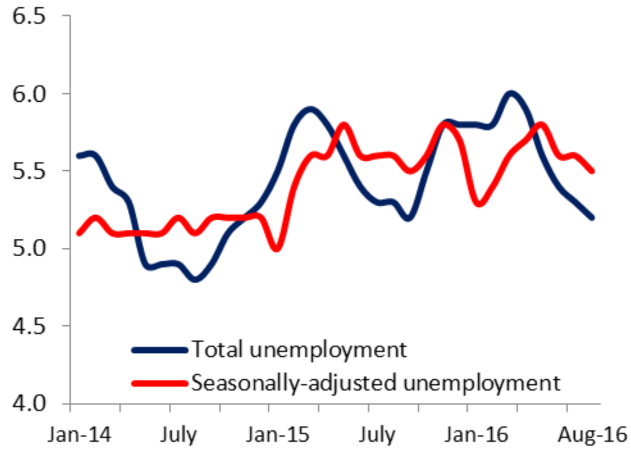
Figure 6: Real income dynamics are weak (percent change, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

Labor market dynamics improved slightly in August. Both original and seasonally adjusted unemployment rates decreased by 0.1 percentage points in August and reached 5.2 and 5.5 percent, respectively. Real wage contraction decelerated in August, decreasing by 1 percent compared to the same period the previous year, and staying at the same level as July 2016. Pensions continue to decrease in real terms, being 3.8 percent lower compared to the same period the previous year. The real disposable income contraction slightly accelerated in August, reaching 8.3 percent in August 2016.

Figure 7: There was a slight improvement in labor market dynamics (unemployment rate, percent)



Source: Rosstat, Haver Analytics, World Bank team

In the first eight months of 2016, the federal budget primary deficit increased to 2 percent of GDP from 1.1 percent last year, as shrinking oil revenues outweighed lower government expenditures. During January–August 2016, government revenue dropped from 17.9 to 15.4 percent of GDP year-on-year due to lower oil and gas revenues. Meanwhile, primary expenditure declined by 1.5 percent of GDP to 17.4 percent of GDP year-on-year. While federal budget spending decreased for national defense (-0.8% of GDP), national economy (-0.5% of GDP), education (-0.1% of GDP), and sports (-0.1% of GDP), social policy expenditures grew by 0.6% of GDP. Government spending cuts were reflected in the improvement of the non-oil deficit from 9.9 percent to 8.5 percent of GDP year-on-year. The federal budget deficit increased from 1.8 to 2.9 percent of GDP year-on-year.

Draft amendments to the 2016 federal budget suggest a drop in revenues and increased spending on social policy and an undisclosed part of the budget. On October 6, the government approved draft amendments to the 2016 federal budget, prepared by the Ministry of Finance. As the current budget law was developed with an oil price assumption of US$50/bbl (Urals), and the average oil price for the first eight months of 2016 totaled US$39.2/bbl (Urals), the draft amendments suggest a substantial drop in revenue by 1.3 percent of GDP. Oil and gas revenue would decrease by 1.9 percent of GDP to 4.8 percent. At the same time, non-oil and gas revenue would grow by 0.6 percent of GDP to 8.6 percent as government counts on privatization proceeds. The authorities plan to stick to budget consolidation of all expenditures except for social policy and defense. Still, quite unexpectedly, overall spending will increase by Rub 300 billion, compared to the current budget law, due to increased spending on transfers to the Pension Fund (+180 billion rubles) and increased spending on an undisclosed part of the budget (+670 billion rubles). As a percent of GDP, total expenditures will decrease by 0.7 percent to 19.8 percent of GDP, compared to the current federal budget law. They will increase by 0.5 percent of GDP and 5.1 percent in nominal terms, compared to 2015. According to the draft amendments, the federal budget deficit will increase to 3.7 percent of GDP from 2.4 percent of GDP in the current budget law. The draft amended budget does not change the limit for the Reserve Fund spending and the government plans to spend 2.1 trillion (2.5 percent of GDP) from the Reserve Fund for deficit financing.

On September 27, Russia placed an additional issue oUS$1.25 billion 10-year Eurobonds with a coupon rate of 4.75%. The effective yield was 3.9%, lower than the 4.75% of the May 2016 issue, when Russia placed Eurobonds for US$1.75 billion.

Russia will resume privatization of the oil company Bashneft. As it was announced on September 30, Russia will resume the procedure to sell its controlling stake in Bashneft, reversing an earlier decision to postpone the privatization. In addition, on October 1, the Government issued a decree allowing Rosneft to buy 50.1 percent of Bashneft shares for an amount not exceeding 330 billion rubles (US$ 5.3 billion), valid until October 15.

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