Russia Monthly Economic Developments

December 2018

THE WORLD BANK
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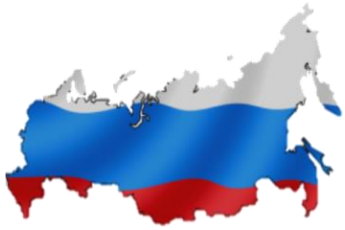
Global growth slowed in the third quarter of 2018, reaching an estimated 2.5 percent (q/q saar), down from 3.4 percent in 18Q2. In November 2018, oil prices fell by 22 percent, their sharpest one-month fall since 2008. This followed an announcement by the United States of temporary exemptions for some countries to continue buying oil from Iran, rising production among OPEC and non-OPEC partners, and continued increases in oil production in the United States. While the oil price tumbled in November, the ruble nominal exchange rate depreciated only slightly, suggesting that the fiscal rule largely shielded the economy from oil price volatility. In Russia, economic growth momentum picked up in October with higher growth in agriculture and mineral resource extraction, and there were signs of a recovery in construction. In view of persistent short-term inflationary risks, the CBR raised the key rate by 25 bp to 7.75 percent. Given the stabilized domestic financial market, the CBR decided to resume FX purchases/sales in the framework of the budget rule, starting on January 15th, 2019. Russia's fiscal balance improved due to higher oil prices combined with a weaker ruble, better tax administration, and a conservative fiscal policy. Key credit risk and performance indicators were mainly stable in October. Lending growth continued in both the retail and corporate segments, though it was much weaker on the corporate side due to weak economic growth.

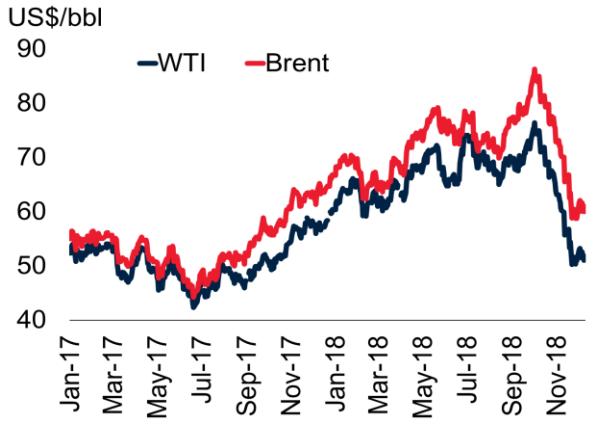


The Global Context

Global growth slowed in the third quarter of 2018, reaching an estimated 2.5 percent (q/q saar), down from 3.4 percent in 18Q2. This was driven by weaknesses in the Euro Area and in Emerging and Developing Economies (EMDEs), reflected in soft manufacturing activities and trade. EMDEs have been under financial pressure in recent months, fueled by a combination of the U.S. dollar's strength, higher borrowing costs, and concerns about softening growth prospects. In the United States, growth remained robust in 18Q3, standing at 3.5 percent (q/q saar), and this was supported by strong consumption and government expenditures.

There was a sharp fall in oil prices, which dropped by 22 percent in November, their sharpest one-month fall since 2008. The price of Brent crude oil dropped from a high of $86/bbl in early October to $61/bbl in December, while WTI declined from $76/bbl to $52/bbl (Figure 1). The fall in prices was triggered by three factors: the announcement of temporary waivers by the U.S. for some countries to continue buying oil from Iran; rising production among OPEC and non-OPEC partners; and continued increases in oil production in the United States, which has overtaken Russia as the world's largest crude oil producer. In August 2018, U.S. production was more than 2 million barrels per day (mb/d) higher than production in 2017. In response to the fall in prices, OPEC and its non-OPEC partners agreed to a production cut of 1.2mb/d, of which OPEC would account for 0.8mb/d and non-OPEC countries would account for 0.4mb/d. Oil prices rose on the day of the announcement but remain little changed overall.

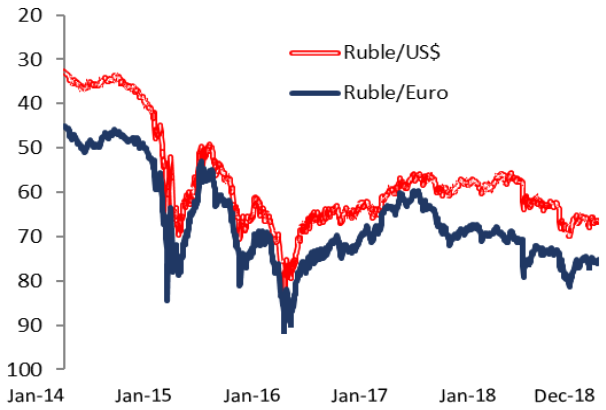
Figure 1: Oil prices fell by 22 percent in November



Russia's Recent Developments

While the oil price tumbled in November, the ruble nominal exchange rate depreciated only slightly, suggesting that the fiscal rule largely shielded the economy from oil price volatility (Figure 2). The oil price dropped by about 20 percent in November, m-o-m, and the ruble exchange rate with respect to the U.S. dollar depreciated by 0.7 percent compared to October.

Figure 2: The ruble exchange rate with respect to the U.S. dollar depreciated slightly in November

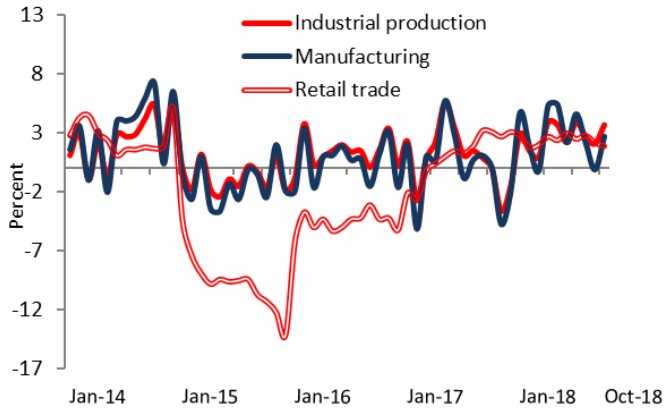


Source: CBR.

Mineral resource extraction (+5 percent, y-o-y) and the financial sector (+9.7 percent, y-o-y) drove GDP growth in the third quarter of 2018. Rosstat revised upwards its GDP growth estimate for the third quarter of 2018 from 1.3 percent, y-o-y, to 1.5 percent, y-o-y. Slowdown of growth momentum in the third quarter appeared to be less drastic as flash estimates suggested: In 18Q3, GDP quarterly growth slowed down to 0.3 percent, q-o-q, from 0.5 percent in the second quarter. A drop in agricultural production combined with weaker performances in manufacturing and state management and national defense services sector weighed down on growth. Mineral resource extraction, which benefitted from the relaxation of production limits in the oil sector in June, became one of the main growth engines, contributing 0.4 pp to GDP growth. The financial sector, expanding on robust credit growth, was another important growth driver, contributing 0.4 pp to GDP growth. Retail and wholesale trade, and transportation, which benefited somewhat from the fast growth in mineral resource extraction, supported growth as well, contributing 0.3 pp and 0.2 pp to GDP growth, respectively.

Economic growth momentum picked up in October with higher growth in agriculture, mineral resource extraction, and construction (Figure 3). Growth in five basic sectors[1] accelerated to 3.5 percent, y-o-y, from 0.7 percent, y-o-y, in September. After a drastic drop in September and October following a weaker harvest and a smaller share of crop area from which the harvest was reaped, agriculture posted growth of 11.9 percent, y-o-y. Industrial production registered stronger growth as well: 3.7 percent, y-o-y, compared to 2.1 percent y-o-y in September. Industrial production growth was mainly supported by mineral resource extraction. Driven predominantly by external demand, gas and oil production contributed the most to growth in mineral resource extraction. After a drop in September, output in manufacturing expanded in October by 2.7 percent, y-o-y, as metallurgical production growth accelerated to 19.6 percent, y-o-y, compared to a drop of 6.5 percent, y-o-y, in September. This acceleration is largely attributed to growth in the production of steel tubes for gas and oil pipes. The construction sector grew by 2.9 percent, y-o-y, showing signs of recovery.

Figure 3: Economic growth momentum picked up in October



Source: Rosstat, Haver Analytics, World Bank team.

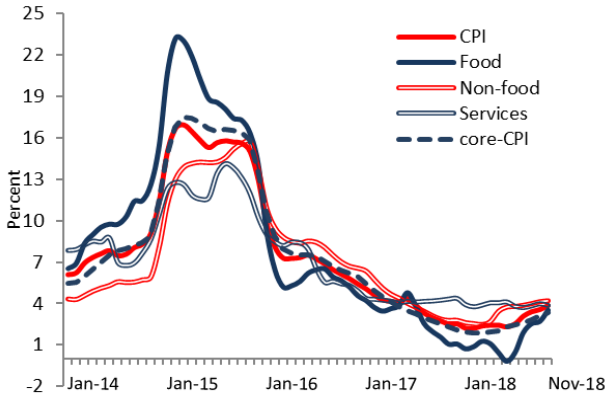
In November, annual consumer inflation accelerated to 3.8 percent, up from 3.5 percent in October, and this was driven by higher food inflation (Figure 4). Annual food inflation increased to 3.5 percent in November, up from 2.7 percent in October, and this was partly due to a pass-through effect and a lower harvest. Prices for sugar and eggs grew in double digits in annual terms, the highest among food items. Core inflation increased from 3.1 percent in October to 3.4 percent in November. Household inflation expectations also increased in November, reaching 9.8 percent, up from 9.3 percent in October. According to the CBR, inflation expectations are sensitive to price changes for certain products (gasoline, meat, poultry). Another reason for the increase in inflation expectations was the growing expectation of higher prices during the holiday season.

On December 14th, the CBR raised the key rate by 25 bp to 7.75 percent and decided to resume FX purchases/sales in the framework of the budget rule starting on January 15

[1] *Output in five basic sectors is an aggregate indicator, which includes agriculture, industrial production, construction, transport, retail and wholesale trade.*

2109. The CBR considers short-term inflationary risks as elevated due to external uncertainty (possible oversupply in oil production affecting oil prices, financial tightening, geopolitical tensions) as well as domestic uncertainty and risks (mainly the reaction of prices and inflation expectations related to VAT rate increase). To tackle these risks the CBR decided to hike the policy rate. The CBR also decided to resume its FX purchases/sales in the framework of the budget rule starting January 15th, given stabilization in the financial market.

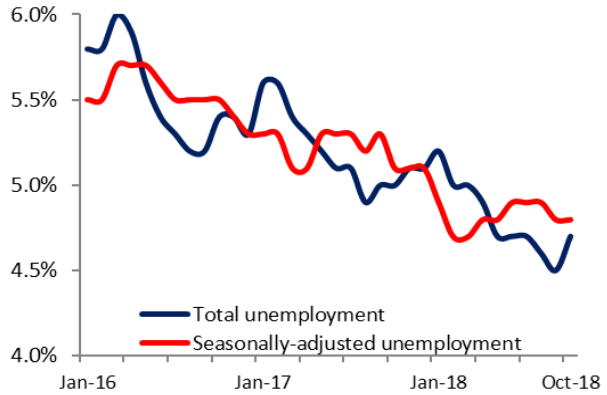
Figure 4: The rising trend of consumer price inflation continued in November



Source: Rosstat, Haver Analytics, World Bank team.

Labor market dynamics were stable in October. The unemployment rate increased slightly to 4.7 percent in October, up from 4.5 percent in the previous month. This was mostly driven by seasonal factors. The seasonally adjusted rate did not change and remained at the level of 4.8 percent (Figure 5). Real wages continued to grow in October, increasing by 4.4 percent compared to the same period in 2017 and by 1 percent compared to September 2018 following seasonal adjustment. Real disposable incomes grew by 1.4 percent in October compared to the same period in 2017 and by 4.9 percent compared to September 2018, after seasonal adjustment. This indicator is volatile and driven to a large degree by sources of income that are not registered by statistics. Pensions were indexed in the beginning of the year and they decreased in October by 0.3 percent compared to the same period a year ago.

Figure 5: The unemployment rate increased slightly in October



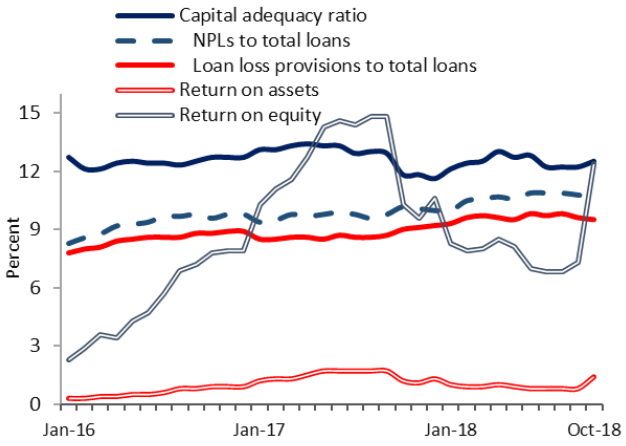
Source: Rosstat, Haver Analytics, World Bank team

The fiscal balance improved at all levels of the budget system. In the period January – September 2018, the general government surplus widened to 4.7 percent of GDP compared to 0.6 percent in the same period last year. The federal budget deficit in 2017 (0.3 percent) turned into a surplus of 3.6 percent in the first ten months of 2018, and the consolidated regional budget surplus improved to 1 percent of GDP from 0.8 percent of GDP in the first nine months of 2018. The across-the-board improvement in the fiscal stance was due to higher oil prices combined with a weaker ruble, better tax administration, and a conservative fiscal policy. The non-oil/gas primary fiscal deficit improved to 4.3 percent of GDP in the first ten months of 2018 compared to 5.9 percent of GDP in the same period last year, mainly due to the conservative fiscal policy. Federal budget primary expenditures decreased from 16.1 percent of GDP to 14.6 percent of GDP, largely on the back of lower social policy expenditures. The cut in social policy expenditure can be explained by the one-time payment made to pensioners in January 2017, which increased the base of 2017. Also, pensions are indexed by the CPI, and the GDP deflator is higher this year on the back of higher energy prices (GDP deflator averaged 9.5 percent in the first three quarters of 2018). Thus, as a percent of GDP, pensions would be expected to shrink.

Key credit risk and performance indicators were mainly stable in October (Figure 6). As of October 1st, the capital adequacy ratio stood at 12.5 percent (against a regulatory minimum of 8 percent). The non-performing loan ratio has slightly decreased, standing at 10.7 percent compared to 10.8 percent in the previous month. For the first ten months of 2018, the banking sector's profit amounted to 1,183 billion rubles, significantly exceeding the result of the same period last year, which amounted to 693 billion rubles. The banking

sector's profit still continues to be affected by the performance of banks under the financial recovery process via the CBR's Banking Sector Consolidation Fund (BSCF). The return on assets (ROA) and the return on equity (ROE) significantly increased in September. The ROA increased to 1.4 percent from 0.8 percent in August, and the ROE stood at the level of 12.4 percent in September compared to 7.3 percent in the previous month.

Figure 6: Key credit risk and performance indicators remained largely stable in October



Source: CBR.

Lending growth continued in both the retail and corporate segments, though it was much weaker on the corporate side due to weak economic growth. In October, credit to the corporate sector grew by 9.7 percent, y/y, while loans to households grew by 22.5 percent, y/y. The growth was predominantly driven by unsecured loans and mortgage loans, and household debt is at an all-time high. Russian banks remain largely funded by customer deposits. In October, retail deposits recovered due to growth in the ruble-denominated segment, which increased by 0.7 percent, m/m, from a contraction of 0.8 percent, m/m, in September. Retail deposits in foreign currency continued to contract and decreased by 0.3 percent, m/m.

The CBR continues its clean-up of the banking sector by removing insolvent banks. From January – November 2018, 62 banks had their licenses revoked for failing to comply with regulations.

Main Economic Indicators

Output Indicators	2017	2018											
		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
GDP, % change, y-o-y	**1.5**	-	-	1.3	-	-	1.9	-	-	1.5	-	-	-
Basic sectors, % change, y-o-y	**2.4**	2.3	2.7	1.9	3.7	3.7	1.5	2.8	1.1	0.6	3.5	-	-
Industrial production, % change, y-o-y	**2.1**	2.4	3.2	2.8	3.9	3.7	2.2	3.9	2.7	2.1	3.7	-	-
Manufacturing, % change, y-o-y	**2.5**	4.3	4.7	2.2	5.3	5.4	2.2	4.6	2.2	-0.1	2.7	-	-
Retail trade	**1.3**	2.9	2.0	2.2	2.9	2.6	3.3	2.7	2.8	2.2	1.9	-	-
Extraction of mineral resources, % change, y-o-y	**2.1**	0.8	1.2	2.4	2.5	1.3	2.8	3.2	4.5	6.9	7.4	-	-
Construction, % change,y-o-y	**-1.4**	0.2	-0.2	-9.7	1.4	5.6	-1.3	-0.7	-0.8	0.1	2.9	-	-
Fiscal and Monetary Indicators													
Federal government balance, % GDP	**-0.6**	2.8	1.6	1.8	0.9	1.4	1.9	2.5	3.1	3.5	3.6	-	-
Inflation (CPI), %, y-o-y	**3.7**	2.2	2.2	2.4	2.4	2.4	2.3	2.5	3.1	3.4	3.5	3.8	-
Inflation expectations, %, y-o-y	**10.3**	8.9	8.4	8.5	7.8	8.6	9.8	9.7	9.9	10.1	9.3	9.8	-
Balance of Payment Indicators													
Trade Balance, billion $ (monthly)	**115.4**	17.0	12.2	15.0	15.3	15.1	15.3	13.4	15.8	18.5	19.7	-	-
Current Account, billion $	**35.4**	12.8	20.8	28.8	41.0	49.9	53.2	60.7	69.0	75.8	87.9	-	-
Export of goods, billion $	**353.5**	33.4	31.2	36.9	36.2	36.5	36.6	34.4	37.4	38.4	41.3	-	-
Import of goods, billion $	**238.1**	16.4	19.0	21.9	20.9	21.4	21.0	21.0	21.6	20	21.6	-	-
Financial Market Indicators													
CBR policy rate, %, end-o-p	**7.75**	7.50	7.50	7.25	7.25	7.25	7.25	7.25	7.25	7.50	7.50	7.50	7.75
Credit to households in Rub, % change, y-o-y	**7.4**	14.5	15.2	16.1	17.1	18.5	19.4	20.3	21.1	22	22.5	-	-
Credit to the corporate sector in Rub, % change, y-o-y	**2.0**	5.1	5.5	6.3	7.5	6.9	7.4	8.1	9.5	8.4	9.7	-	-
Capital adequacy ratio	**11.6**	12.1	12.4	12.5	13.0	12.7	12.8	12.2	12.2	12.2	12.5	-	-
NPLs to total loans	**10.0**	10.0	10.5	10.6	10.7	10.6	10.9	10.9	10.9	10.8	10.7	-	-
Loan loss provisions to total loans	**9.2**	9.3	9.6	9.7	9.6	9.5	9.8	9.7	9.8	9.6	9.5	-	-
Return on assets (ROA)	**1.3**	1.0	0.9	0.9	1.0	0.9	0.8	0.8	0.8	0.8	1.4	-	-
Return on equity (ROE)	**10.6**	8.3	7.9	8.0	8.5	8.1	7.0	6.8	6.8	7.3	12.4	-	-
Income, Poverty and Labor Market													
Real wages, % change, y-o-y	**6.2**	11.0	10.5	8.7	7.6	7.6	7.2	7.5	6.8	7.2	7.6	-	-
Unemployment (%, ILO definition)	**5.1**	5.2	5.0	5.0	4.9	4.7	4.7	4.7	4.6	4.5	4.7	-	-
Exchange rate													
USD/ RUB, average	**58.3**	56.8	56.8	57.0	60.4	62.2	62.7	62.8	66.1	67.7	65.8	66.4	-
Euro/ RUB, average	**65.8**	69.0	70.3	70.4	74.2	73.7	73.2	73.4	76.2	79.0	75.7	75.5	-
Oil price													
Brent, $/ bbl	**54.4**	69.0	65.4	66.5	71.6	76.7	75.2	74.4	73.1	78.9	80.5	65.2	-

Source: Rosstat, CBR, EEG, IMF, WB staff estimates.

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