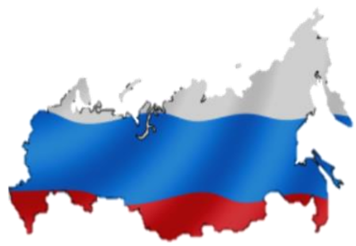
Russia Monthly Economic Developments

November 2015

- Despite low oil prices the ruble strengthened slightly due to increased appetite for ruble-denominated financial assets.
- The contraction in industrial activity lessened, but the services sector continued to suffer from falling consumer demand.
- Credit growth slowed while central bank continues its efforts to limit the systemic risk in the banking sector.
- The current account surplus shrank in the third quarter of 2015 due to lower energy exports.
- In January–September 2015, the federal budget registered a primary deficit of 0.6 percent of GDP compared to a 2.9 percent surplus a year ago.
- On October 23, the government submitted the federal budget law for 2016 to the State Duma.

Oil prices continued to trade below US$50 per barrel, driven by high OPEC output and increasing Iranian production while OECD stocks remained resilient. OPEC output is expected to stay elevated, especially due to higher exports from Iran. It is anticipated that if Iranian sanctions are lifted most of the 40 million barrels of its oil currently in floating storage would find its way into the global market to which new Iranian production is expected to add during 2016 some 0.5-0.7 million barrels per day. US crude oil production has begun to decline and the rig count, a measure of future oil production in the US, dropped to 572, two thirds below its all-time high of August 2014. It is expected that next year weakening US supplies will help rebalance the market and reduce the large inventory overhang. The World Bank projects oil prices to average US$52 per barrel in 2015 and just under US$50 per barrel in 2016.

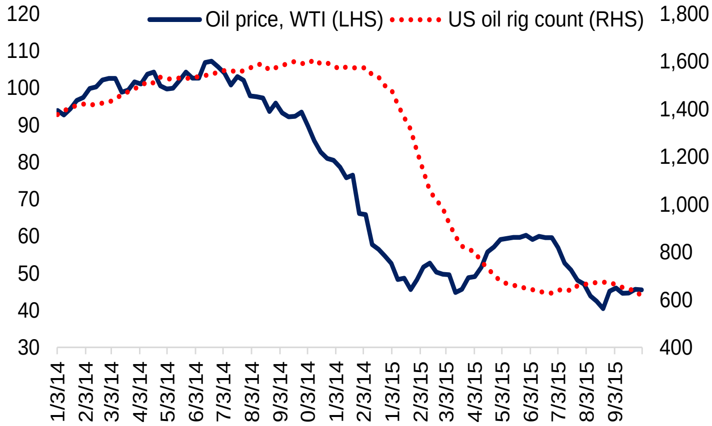


Despite low oil prices the ruble strengthened slightly in October due to increased appetite for ruble-denominated financial assets. The average ruble exchange rate appreciated by 5.4 percent with respect to the US dollar, while the average (Brent) oil price increased by 1.5 percent relative to September. Behind this divergence appears to be increased demand for ruble-denominated financial assets by foreign and domestic investors which offer now attractive returns. Especially Russia's treasury bonds (OFZ) were in high demand and heavily oversubscribed (by 3.5 times in October's auction and by 2.4 times in the November 11 auction) which might have been also partly due to domestic investors moving into perceived safe government securities as geopolitical tensions around Syria increased.

Annual inflation remained high in October, driven by the continued pass-through from the past ruble depreciation. The 12-month Consumer Price Index remained elevated at 15.6 percent (compared to 15.7 percent in September) while core inflation stood at 16.4 percent (compared to 16.6 percent in September). Both food and non-food inflation are still impacted by the continued pass-through from the ruble depreciation in October: 12-month non-food inflation accelerated slightly to 15.6 percent (compared 15.2 percent in September), while food inflation was flat at 17.3 percent (17.4 percent in October). On a monthly basis, food inflation accelerated to 1.0 percent from 0.4 percent in September, as the effect of seasonal declines in food and vegetable prices waned. Given the sustained inflation pressure, the central bank kept policy rates unchanged at 11 percent in its meeting on October 30.

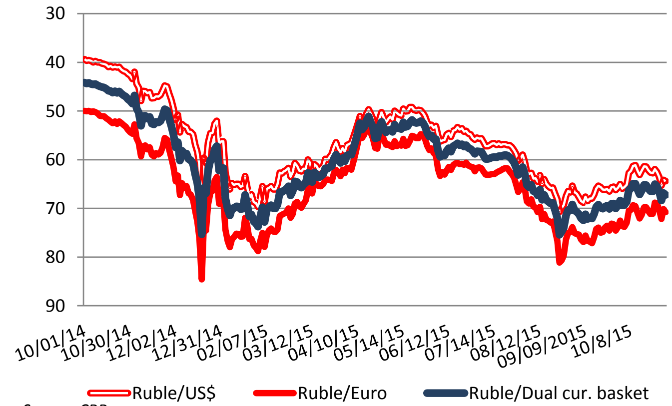
Difficult external conditions persist for Russia as global growth weaknesses persist and capital flows to emerging economies dropped in the third quarter of 2015. Since the World Bank's June Global Economic Prospects report, growth projections for 2015 have been revised downwards from 2.8 percent to 2.5 percent for the global economy, and from 4.8 percent to 4.3 percent for developing countries. Growth in developing and emerging economies is held back by the slowdown in a number of large commodity-exporting economies, including Russia, Brazil, Indonesia, Malaysia, Nigeria, and South Africa. Growth in high-income economies, such as the US and the Euro Area, is recovering moderately. Bond and equity flows to developing countries were particularly weak in August-September and halved in the third quarter of 2015. In October, bond and equity issuance activity showed signs of improvement as market sentiment began to turn more favorable: emerging-market bond and equity funds recorded inflows for the first time in three months. Furthermore, emerging-market assets have rallied this month amid revised expectations on the timing of the US Federal Reserve's rate hike, rebounding from sharp losses in the summer.

Figure 1: Oil continues to trade below US$50 per barrel …



Source: Bloomberg, Bakes Hughes, and World Bank

Figure 2: … while the ruble strengthened slightly



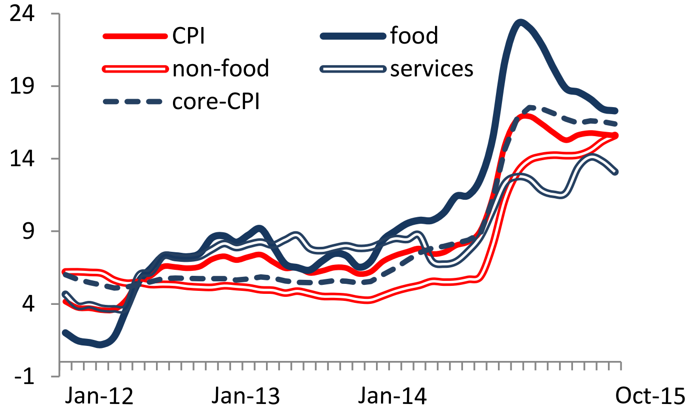
Source: CBR

In September, the contraction in industrial activity lessened, but the services sector continued to suffer from falling consumer demand. Selected manufacturing industries (food processing and chemicals) continued to take advantage of the weak ruble, reporting robust output expansion in September. In addition, the weaker ruble stimulated demand for domestically produced investment goods, which is reflected in better fixed capital investment, decreasing less in September by -5.6 percent, year-on-year, compared to -6.8 percent in August. This also corresponds with a deceleration in the output contraction in manufacturing industries that produce investment goods: in machine building to -9.7 percent from -14.7 percent in August, and in transportation production to -8.2 percent from -16.7 percent in August. Overall, aggregate industrial output contracted less in September by -3.7 percent, year-on-year, compared to -4.3 percent in August. At the same time, consumer demand remained deeply depressed in September due to a continued sharp fall in real incomes and wages (-4.3 and -9.7 percent, year-on-year, respectively) while inflation was high. As a result, the contraction in retail trade in September accelerated to -10.4 percent, year-on-year, from -9.1 percent in August, while demand for service fell by -3.5 percent, compared to -3.1 percent in August.

Credit growth slowed while the central bank continues its efforts to contain the systemic risk in the banking sector. Credit growth to the private sector slowed in September to 15.2 percent, year-on year, from 17.6 percent in August as annual credit to firms also slowed to 23.0 percent (compared to 26.0 percent in August). However, on a monthly basis the stock of firm credits decreased in September by 0.2 percent while banks also continued reducing their stocks of household credits, which shrunk in September by 3.1 percent, year-on-year (compared to -1.8 percent in August). After central bank forbearance, the share of non-performing loans remained stable at 8.2 percent. At the same time, overall profitability of the banking system improved in September and the number of loss making banks decreased to 206 from 232 in August. In part, this was the result of the continued clean-up efforts by the central bank to close financially non-viable banks. Nine banking licenses were revoked in October and nine in the first weeks of November. So far, the CBR has been able to contain the system risk in the banking system, yet some large banks continue to face weak capital adequacy and liquidity indicators. In October, the central bank approved the purchase of an 82 percent stake in Uralsib Bank (26th by assets) by businessmen Kogan in order to avoid bankruptcy.

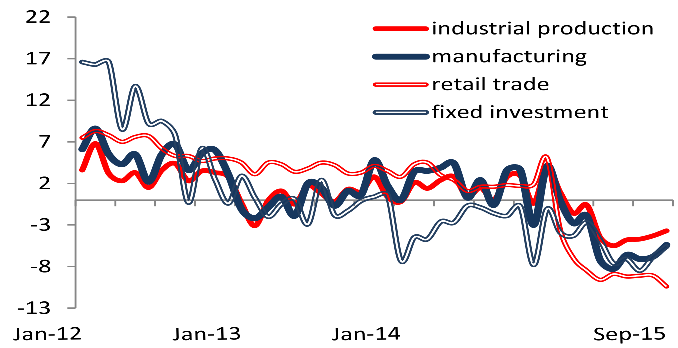
The current account surplus shrank in the third quarter of 2015 due to lower energy exports. The seasonally adjusted current account balance decreased in the third quarter from US$18.5 billion in the second quarter to US$13.7 billion as the trade balance weakened. While the real effective exchange rate depreciated by 13.7 percent in the third quarter compared to the second quarter, imports contracted less than energy exports in seasonally adjusted terms. Unexpectedly, net capital outflows of US$18.0 billion in the second quarter of 2015 reversed to net capital inflows of US$5.3 billion for the first time since 2009. As in the first half of 2015, there was substantial pressure on the capital account from scheduled debt payments in the amount of US$36 billion. This pressure subsided as banks repaid most of the scheduled amount by reducing their foreign assets or by refinancing parts of their debt. The central bank accumulated almost US$10 billion in new reserves as it purchased US$4 billion through open market operations during July when oil price for Brent exceeded US$50 per barrel. Reserves now total US$371.3 billion. Domestic banks repaid US$6 billion of their debt to the central bank which they had borrowed through the central bank foreign exchange repo facility, which amounts now to US$26.8 billion.

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



Source: Rosstat, Haver Analytics, WB team

Figure 4: … further limiting demand for services (percent change, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

In January–September 2015, the federal budget registered a primary deficit of 0.6 percent of GDP compared to a 2.9 percent surplus a year ago. Federal budget revenue decreased in the first nine months of 2015 on a yearly basis as oil and gas revenues dropped by 2 percent of GDP, partly compensated by a 0.8 percent of GDP increase in non-oil revenue. Federal primary expenditure increased in the first nine months by 2.2 percent of GDP (14.1 percent in nominal terms) compared to the same period a year ago due to higher spending for defense, social policy, and subsidies to the economy. The non-oil deficit expanded to 9.9 percent of GDP at the end of September from 8.2 percent in September 2014. In September, the federal government spent RUB402.2 billion of the Reserve Fund to finance the deficit.

Amendments to the federal budget law of 2015 were submitted for approval to the State Duma. The amendments adjusted federal budget revenues up from 17.1 percent to 18.0 percent of GDP, and expenditure from 20.8 percent to 21.0 percent of GDP. Expenditures in the amount of RUB202.5 billion were redistributed. Expenditures are expected to grow for social policy (RUB92 billion), national defense (RUB58.4 billion), and regional support (RUB48 billion). If the amendments are approved, federal primary expenditure will slightly contract in real terms. VAT receipts are expected to be the main contributor of somewhat (0.6 percent of GDP) higher non-oil revenues. Oil prices above the ones expected in the revised budget (US$50 per barrel) would bring 0.2 percent of GDP in higher oil revenues. The budget deficit is now estimated to reach three percent of GDP compared to 3.7 percent of GDP projected in the previously revised budget law. The non-oil deficit is expected to reach 10.9 percent of GDP, the same level as last year.

On October 23, the government submitted the federal budget law for 2016 to the State Duma. The federal budget for 2016 is based on a conservative oil price assumption (US$50 per barrel, Urals oil) and GDP growth of 0.7 percent. The end-of-year inflation is projected at 6.4 percent. The budget deficit is projected at three percent of GDP and the non-oil deficit at 10.7 percent of GDP. The planned deficit is proposed to be covered primarily with the Reserve Fund, which is expected to decrease from 4.0 percent of GDP to 1.3 percent of GDP (RUB1 trillion). Public borrowing is projected at 0.5 percent of GDP, with up-to US$3 billion in external borrowing (and Ministry of Finance planning to offer the issuance of medium maturity bonds at the Chinese market). Both, federal budget revenue and expenditure are projected to shrink slightly as a percent of GDP. However, large nominal expenditure cuts are expected in health (-7.8 percent), education (-8.4 percent) and communal and housing services (-39.0 percent) while subsidies to the economy would rise by 12.8 percent, and defense and national security by two percent. For the second year in a row, no wage increases for public sector employees are envisioned. While the government did not take any decision on a pension age increase, it decided to index pensions by 4 percent. The second pillar of pension funding will continue to be frozen, although these funds will be reserved for special needs, leaving some space for additional pension increases.

Please contact Birgit Hansl: bhansl@worldbank.org

Prepared by a World Bank team under the guidance of Birgit Hansl, consisting of John Baffes, Olga Emelyanova, Sergei Ulatov and Eka Vashakmadze.