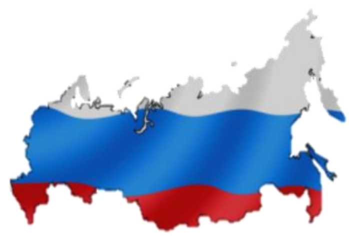
Russia Monthly Economic Developments

June 2018

The global economy experienced divergent growth in the second quarter of 2018 characterized by a rebounding in advanced economies, continued moderation in China, and a slowdown in commodity exporting emerging markets and developing economies (EMDEs). Despite the OPEC announcement of an increase in production, oil prices rose in June, supported by geopolitical events. In June, buoyed by relatively high oil prices and strong macroeconomic fundamentals, the ruble exchange rate with respect to the U.S. dollar performed better than other emerging market (EM) currencies. In the first six months of 2018, Russia's current account surplus strengthened to US$53.2 billion, up from US$23.9 billion in the same period last year. Industrial production grew solidly in May, helped by robust growth in manufacturing. Labor market dynamics were also positive in May. From January – June 2018, aided by higher oil revenues and lower expenditures, the federal budget primary surplus strengthened to 2.7 percent of GDP, up from a 0.2 percent GDP primary deficit in the same period last year. The Ministry of Finance released draft guidelines for its budgetary and tax policy for 2019-21, which imply budget consolidation through revenue increases. In June, consumer price inflation dropped, while inflation expectations rose. In May, the banking sector's statistics showed mixed trends in lending activity, with weak corporate lending growth continuing to be outpaced by retail lending.

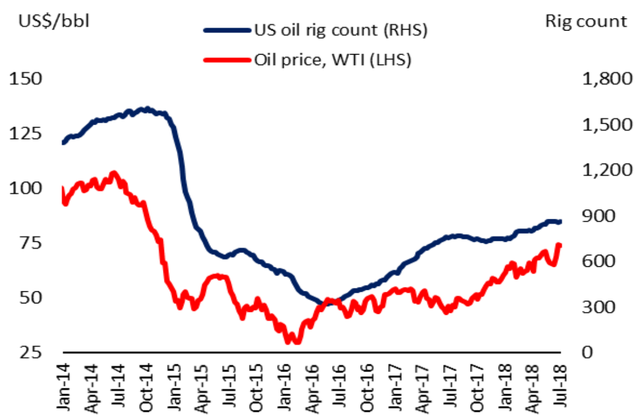
The Global Context



There was divergence in global growth in 2018Q2 with a rebounding in advanced economies following weak growth in 2018Q1 (especially in the United States), continued moderation in China, and a slowdown in commodity exporting emerging markets and developing economies (EMDEs). EMDE financial markets remain under pressure over concerns around global trade tensions, a strong dollar, and tightening monetary policy across advanced economies. In global trade, the outcome of some negotiations remains uncertain, and new tariff announcements by the United States have led to retaliatory responses. Increasing trade protectionist measures are contributing to policy uncertainty and could have significant adverse effects on global trade and investment if there is further escalation.

Geopolitical events drove oil prices higher. Brent, the international marker, reached US$78/bbl in July while WTI, the U.S. barometer, reached US$74/bbl. At their meeting on June 22-23, 2018, the "Vienna Agreement" group of OPEC and non-OPEC oil producers announced their intention to increase oil production amid concerns about rising oil prices and potential future supply reductions in Iran and Venezuela. Despite this announcement, oil prices rose after the meeting as markets were disappointed by the ambiguity of the group's agreement and there was concern that any increase in production would be insufficient to offset potential supply losses in Iran and Venezuela. Rising oil prices were also supported by the geopolitical landscape in Libya, which resulted in the temporary closure of several major ports, and this substantially reduced oil production. In the United States, the rig count has been flat since the end of May, but the surprise fall in U.S. inventories of 8.7 million barrels in June provided further support to WTI (Figure 1).

Figure 1: Despite the announcement of an increase in production, oil prices rose after the OPEC June meeting

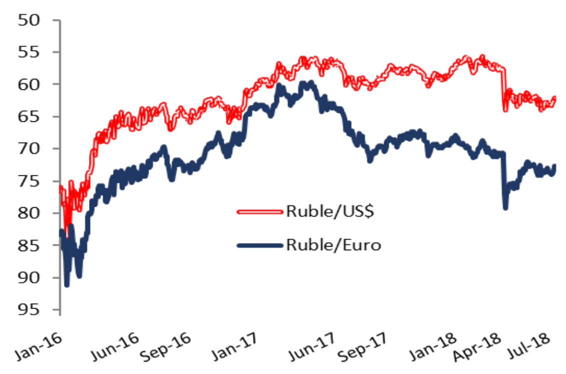


Source: Baker Hughes, Bloomberg.

Russia's Recent Developments

In June 2018, the ruble performed better than many other emerging market (EM) currencies (Figure 2). Concerns over global trade tensions, a policy rate increase by the U.S. Federal Reserve on June 14th, and a hawkish Fed statement weighed on the EM currencies. Supported by relatively high oil prices and strong macroeconomic fundamentals, the ruble exchange rate with respect to the U.S. dollar depreciated by 0.9 percent in June compared to the 6.6 percent depreciation of the South African rand and the 4.2 percent depreciation of Turkish lira. Lower scheduled debt payments by the banking sector compared to the previous month also supported the ruble. In June, the Ministry of Finance continued its purchase of foreign currency as per the fiscal rule framework (US$5.8 billion).

Figure 2: In June 2018, the ruble slightly depreciated with respect to the U.S. dollar

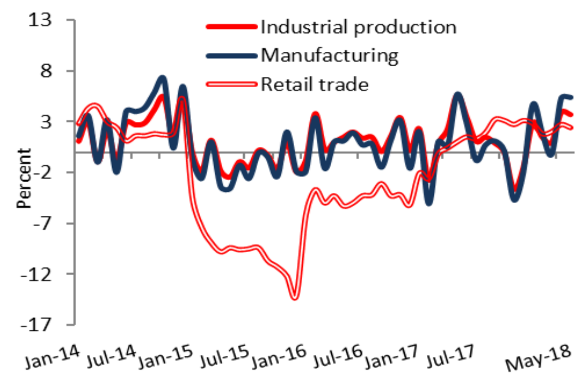


Source: CBR.

In the first six months of 2018, Russia's current account surplus strengthened to US$53.2 billion, up from US$23.9 billion in the same period last year. The key factor behind this was the strengthening of the trade surplus due to positive terms of trade and robust external demand. The export value growth of oil and gas drove an increase in the export of goods (+US$29.5 billion), and non-energy exports also increased (+US$16.1 billion). From January – June 2018, net capital outflows[1] shrank to US$21.6 billion, down from US$23.8 billion in January – June 2017. While net capital outflows from the banking sector decreased, net acquisition of financial assets by the non-banking sector grew. International reserves rose by US$26.4 billion (compared to US$9.4 billion in the same period last year), largely a result of currency purchases by the Ministry of Finance within the fiscal rule framework.

Growth momentum was robust in May (Figure 3). Output in five basic sectors[2] grew by 3.7 percent, y/y, the same rate as in April. Industrial production expanded by 3.7 percent, y/y, and 0.5 percent, m/m sa. Growth in industrial production was mainly driven by manufacturing, which rose by 5.4 percent, y/y. In May, growth in mineral resource extraction stood at 1.3 percent, y/y, driven by coal and gas production, while oil production remained more or less flat in the framework of the OPEC+ agreement. In May, growth in construction accelerated to 5.6 percent, y/y, compared to 1.4 percent, y/y, in April.

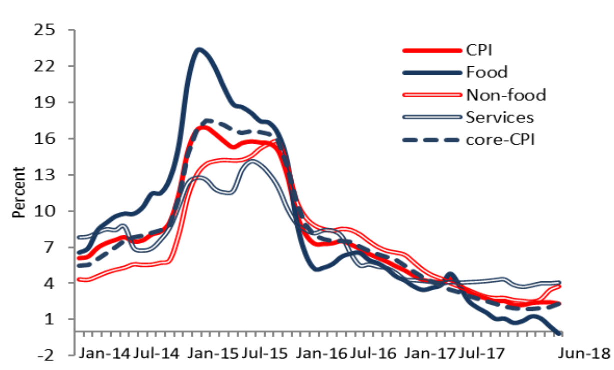
Figure 3: Industrial production demonstrated solid growth in May 2018



Source: Rosstat, Haver Analytics, World Bank team.

In June, inflation pressures increased. The 12-month core inflation rate increased from 2 percent, y/y, in May to 2.3 percent, y/y, in June, indicating growing inflation pressures. Meanwhile, the 12-month Consumer Price Index (CPI) dropped to 2.3 percent, y/y, in June from 2.4 percent, y/y, in May (Figure 4). This was a result of disinflation in food prices: Food inflation appeared to be negative in annual terms partly due to the base effect, yet the growth of non-food and services consumer prices accelerated in June to 3.7 percent and 4.1 percent, y/y, respectively (compared to 3.4 percent and 4.0 percent, y/y, respectively, in May). Lower excise taxes on gasoline (since June 1, 2018) contributed to lower monthly inflation on gasoline: 2.1 percent, m/m, in June compared to 5.6 percent, m/m, in May. Inflation expectations rose to 9.8 percent in annual terms in June compared to 8.6 percent in annual terms in May. The government's proposed increase of the VAT rate (from 18 to 20 percent next year), and growing gasoline prices could have contributed to this increase.

Figure 4: Consumer price inflation dropped in June 2018 as a result of disinflation in food prices



Source: Rosstat, Haver Analytics, World Bank team.

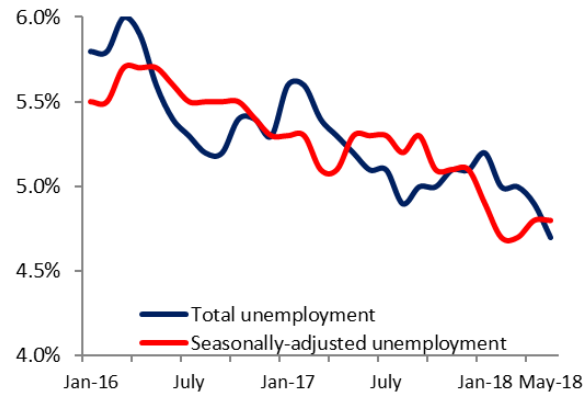
[1] *Adjusted for currency swaps and correspondent accounts of resident banks in the Central Bank, as well as repayments of foreign-currency loans by large banks to the Central Bank.*

[2] *The index of output in five basic sectors of economic activities is calculated based on volumes of output in agriculture, industrial production, construction, transport, and retail and wholesale trade.*

Economic growth in the first quarter of 2018 was driven by exports and household consumption. Rosstat released data regarding the demand-side composition of growth in 2018Q1. Supported by robust external demand and a real effective exchange rate (REER) depreciation, the exports of goods and services grew by 6.8 percent (y/y, by volume) and contributed 1.9 percentage points (pp) to GDP growth. Despite the REER depreciation in the first quarter of 2018, and partly due to deferred demand, imports continued to grow, albeit at a lower rate (9.6 percent, y/y, in the first quarter of 2018 compared to 15.4 percent, y/y, in the fourth quarter of 2017), making the contribution of net exports to GDP growth negative. In the first quarter of 2018, domestic demand continued to expand, driven largely by household consumption (+1.5 pp to GDP growth) and supported by growing real wages, real disposable incomes, and credits. Yet household consumption growth slowed down to 2.7 percent, y/y, in the first quarter of 2018 compared to 4.3 percent, y/y, in the fourth quarter of 2017. On the back of destocking, gross capital formation decreased compared to the same period last year. In the first quarter of 2018, growth of gross fixed capital formation slowed down to 1.8 percent, y/y, down from 3.4 percent, y/y, in the fourth quarter of 2017 as investments in exploration of new fields of mineral resource extraction and transportation via pipelines decreased, and some public infrastructure projects were also completed (including projects connected to the 2018 FIFA World Cup).

Labor market dynamics were positive in May 2018. The unemployment rate decreased marginally by 0.2 pp to the level of 4.7 percent. However, this decrease was driven by seasonal factors as the seasonally adjusted rate did not change and stayed at the level of 4.8 percent (Figure 5). Real wages continued to grow and increased in May 2018 by 7.3 percent compared to the same period in the previous year, and they increased by 0.7 percent compared to April 2018 after seasonal adjustment. Real disposable incomes increased in May by 0.3 percent compared to the same period in 2017, and they also increased by 3.2 percent compared to April 2018 after seasonal adjustment. This indicator is volatile and is driven, to a large extent, by sources of income that are not registered by statistics. Pensions were indexed in the beginning of the year and their real growth in May was 0.8 percent compared to May 2017.

Figure 5: The labor market demonstrated positive dynamics in May 2018



Source: Rosstat, Haver Analytics, World Bank team

From January – June 2018, aided by higher oil revenues and lower expenditures, the federal budget primary surplus strengthened to 2.7 percent of GDP, up from a 0.2 percent GDP primary deficit in the same period last year. While higher oil prices and the ruble's depreciation prompted an increase in federal budget oil revenues, from 6.8 percent of GDP in January – June 2017 to 8.4 percent of GDP in January – June 2018, non-oil revenues remained flat at 10.1 percent of GDP in the first half of 2018 compared to 10.0 percent of GDP in the same period last year. Federal budget primary expenditures decreased from 17 percent of GDP in January – June 2017 to 16.1 percent of GDP in January – June 2018, and this was mainly due to lower spending on social policy (-1.2 percent of GDP) resulting from the one-off pension payments in January 2017. The overall federal budget stance improved from a 1.0 percent GDP deficit in January — June 2017 to a 1.9 percent GDP surplus in the January — June 2018 period. The general government budget surplus improved from 0.5 percent of GDP in January – May 2017 to 3.3 percent of GDP in January – May 2018.

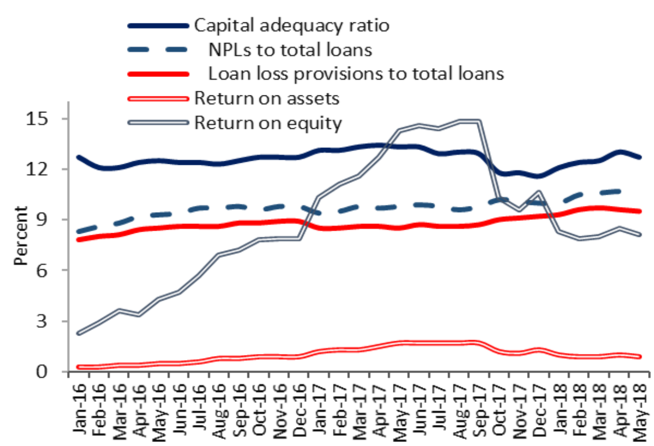
The Ministry of Finance released draft guidelines for its budgetary and tax policy for 2019, 2020, and 2021. The guidelines are based on the latest economic projections produced by the Ministry of Economy, which envisage economic growth rates gradually increasing to 1.4 percent, 2.0 percent, and 3.1 percent in 2019 – 2021, respectively, amidst declining oil prices (US$63.4/bbl, US$59.7/bbl, and

US$57.9/bbl in 2019, 2020, and 2021, respectively[3]). The guidelines imply budget consolidation through revenue increases. Federal budget oil and gas revenues are expected to decrease gradually from 2020 on the back of decreasing oil prices and a lower effective tax rate as exhaustion of fields grows. Non-oil and gas revenues are expected to increase in 2019 by 1.1 percent of GDP (mainly on the back of the VAT rate increase and dividend payments by public companies) and stay more or less at this level. Meanwhile, primary expenditures would increase by 0.4 percent of GDP in 2019 and slightly decline in the medium-term, but remain higher in 2021 than in 2018. According to the Ministry of Finance, the main priorities of federal budget expenditures will include increasing healthy life expectancy, building high environment standards, providing for 100 percent access to pre-school education, and enabling Russia to be in the top five countries for Research and Development in areas of scientific development. A special fund (Fund for Development) will be created for infrastructure development within the federal budget in 2019, and it will be financed through debt financing. Creation of this Fund requires certain modifications of the fiscal rule, which was supposed to become effective in 2019. Previously, the fiscal rule was targeting a zero primary balance at the "base" oil price (see RER #38). The new guidelines suggest a 0.6 percent of GDP, 0.5 percent of GDP, and 0.5 percent of GDP primary deficit at the "base" oil price.

In May 2018, the banking sector's statistics showed mixed trends in lending activity - weak corporate lending growth continued to be outpaced by retail lending growth. Credit to the corporate sector in rubles grew by 6.9 percent, y/y, in May compared to 7.5 percent in April. Meanwhile, credit to households in rubles increased by 18.5 percent, y/y, in May compared to 17.1 percent in the previous month. The CBR plans to revise the scale of risk ratios for consumer loans depending on their effective interest rates (EIRs). The reason behind these changes is an acceleration of unsecured consumer loans. This decision will ensure quality growth of banks' loan portfolios on the one hand, and monitoring of household debt burdens while improving the financial system's stability on the other hand. Requirements will extend to banks holding universal and basic licenses and will apply to consumer loans issued after September 1, 2018. To push the banks to further de-dollarize their loan portfolios, the CBR tightened risk-weight requirements for foreign-currency-denominated loans. New requirements affect foreign-currency loans to legal entities purchasing commercial real estate, and to Russian export-oriented corporates and other legal entities. They will apply to loans originated after July 1, 2018. As of July 1, 2018, the share of the foreign-currency-denominated banking sector assets stood at 21.7 percent.

Key credit risk and performance indicators remained stable (Figure 6). As of May 1, 2018, the capital adequacy stood at 12.7 percent (against a regulatory minimum of 8 percent). The non-performing loan ratio has slightly decreased, standing at 10.6 percent compared to 10.7 percent a month before. The banking sector showed a total profit of 527 billion rubles in the January – May 2018 period compared to 653 billion rubles in the same period of 2017. This amount was affected by the performance of three banks (Otkritie, B&N, and Promsvyazbank) under the financial recovery process via the CBR's Banking Sector Consolidation Fund. As of May 1, 2018, the return on assets and the return on equity slightly decreased to 0.9 percent and 8.1 percent, respectively, from 1 percent and 8.5 percent, respectively, a month ago. The CBR continued to clean up the banking system, reducing the number of operating banks to 530 as of June 1, 2018, down from 561 at the beginning of the year.

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



Source: CBR.

[3] The growth projection for 2019 was reviewed downwards due to the expected slowdown in investment and consumer demand. The one-time increase in inflation due to the VAT rate increase will negatively affect real income growth. In addition, growth of wages in the public sector will slowdown from a high base of 2018.

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