Russia Monthly Economic Developments

October 2015

- The European Council extended its sanctions on Russian individuals and entities until March 15, 2016.
- Foreign direct investment dried up in the first half of 2015 amid policy uncertainty and contracting domestic demand.
- August data suggest that the recession may be bottoming out.
- A 2 percent depreciation of the ruble in September continued the currency adjustment to the sharp oil price drop in August, keeping pressure on inflation.
- Real wages and incomes continued to deteriorate in August while unemployment remained flat.
- On October 8, the government approved the federal budget for 2016.

The European Council extended until March 15, 2016 its measures to freeze bank assets and restrict the entry of 151 Russian officials, politicians and businessmen, as well as officials and 37 entities of the Donetsk and Luhansk republics. The extension of economic sectoral sanctions against Russia will be reviewed in January 2016, and the decision will depend on the implementation of the Minsk agreements.

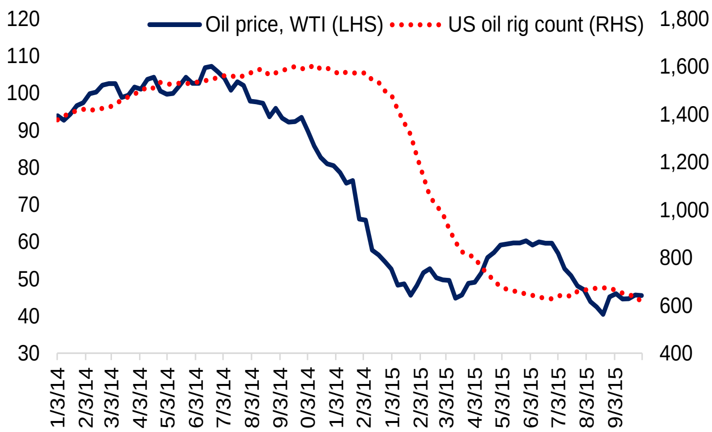
In the first half of 2015, foreign direct investment fell by over US$20 billion compared to a year ago, amid increased policy uncertainty and contracting domestic demand. Revised balance of payments data for the second quarter of 2015 showed a 4.7 percent of GDP (US$15.8 billion) current account surplus – one percent of GDP lower than previously estimated, because of lower exports. This result, however, is better than the 3.7 percent of GDP (US$12.1 billion) surplus recorded last year. Foreign direct investment (FDI) inflows in the first half of 2015 fell to US$4.3 billion from US$24.7 billion during the same period of 2014. In the first quarter of 2015, FDI inflows of US$1.7 billion consisted nearly entirely of reinvested profits as opposed to new FDIs, reflecting high risk perceptions due to policy uncertainty and weak growth prospects. Quarter two net capital outflows were corrected down (by US$2.1 billion) to US$18.0 billion, due to lower banking sector outflows.

A strong contraction in domestic demand, underpins a sharp drop in aggregate output during the second quarter of 2015. The 4.6 percent GDP contraction, year on year, during the second quarter, was driven by a decline in investment demand, including a strong inventory destocking, which reduced gross capital formation by 37.8 percent, year-on-year, compared to 28.5 percent in the first quarter. While weakening consumer demand remains the key factor behind this trend, limited access to working capital due to tight credit conditions also mattered. Driven by the sharp fall in real wages and incomes, households' consumption decreased further by 1.3 percent in the second quarter (quarter-on-quarter, seasonally adjusted), leading to a similar year-on-year contraction of 8.7 percent (9.0 percent in quarter one). Import volume fell by 30 percent in the second quarter, year-on-year (compared to 25 percent in quarter one), in line with the contraction in domestic demand. Similar to the first quarter, stronger net exports could offset only partially the contraction of GDP, which accelerated in the second quarter.

August data suggest that the recession may be bottoming out, as reflected in improving business surveys. In August, the contraction in aggregate output decelerated to 5.2 percent, year-on-year, from 5.9 percent in July. Industrial production shrank by 4.3 (compared to 4.7 percent a month earlier). Investment demand declined by 6.8 percent, year-on-year (8.5 percent in July). The seasonally adjusted Composite PMI Output Index crossed in September the 50 percent expansion line to 50.9 from 49.3 in August. Consumer demand remained weak and the contraction of retail trade was unchanged with respect to July (9.1 percent).

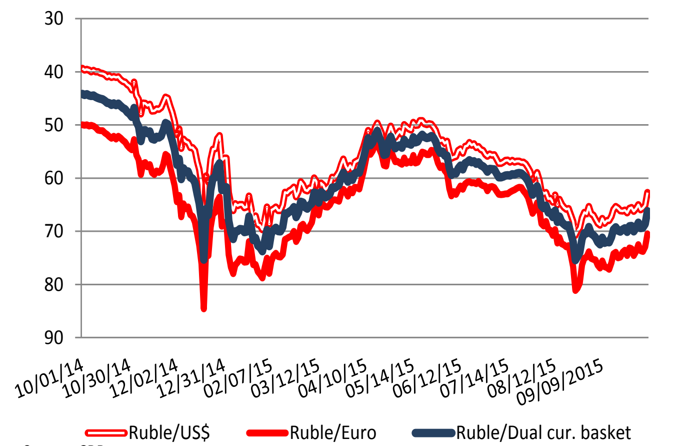
In September oil prices fluctuated around US$45-50 per barrel after the sharp drop to US$40 per barrel seen in August. The weakness in oil prices reflects both the weak growth outlook of emerging economies and the persistence of the supply glut. OPEC production has been rising and is likely to reach 31.5 million barrel per day in the third quarter of 2015. Moreover, Iran is expected to gradually bring to the market some 0.5-0.7 million barrel of crude oil per day during 2016, adding most of its 40 million barrels of oil stock currently held in floating storage. By contrast, there are signs of leveling off of non-traditional oil production, as reflected in a decline in the US rig count, a measure of future prospects of the US shale oil industry. Strong supplies and weak demand is expected to keep the global market in surplus until mid-2016.

Figure 1: Oil prices stabilized …



Source: Bloomberg, Bakes Hughes, and World Bank

Figure 2: … while the ruble adjusted to the August oil prices



Source: CBR

In September, the ruble continued to depreciate, though moderately, reflecting the sharp oil price drop in August. The average ruble exchange rate depreciated by about 2 percent with respect to the US dollar in September, following the 4.9 percent drop in August, realigning the exchange rate with oil price movements. In mid-September, uncertainty regarding the US Federal Reserve decision on interest rates led to increased pressures on emerging market's currency, including the ruble.

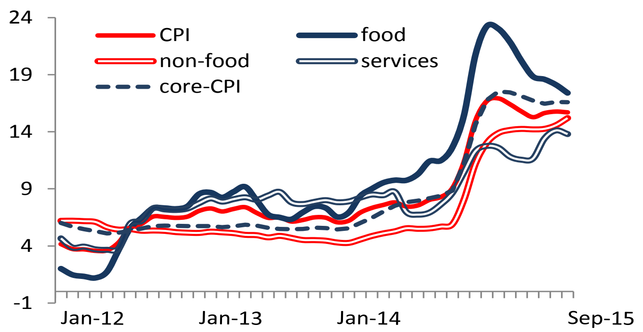
The ruble value of banks' loan portfolio increased, due to the effect of the exchange rate depreciation. In August, the ruble value of existing loans increased by 21.6 percent, year-on-year, from about 18 percent in July, because of the reevaluation effect of the weaker ruble on foreign currency credits, while the stock of ruble credits remained flat. At the same time, banks continued downsizing their consumer-credit portfolio and credit to households contracted by 1.8 percent in August, year-on-year, from 0.8 percent in July (compared to a 13.8 percent growth at end-2014). The profitability of the banking system increased in August. The number of loss-making banks stabilized at around 230 and the share of non-performing loans at around 8.2 percent. The central bank continued its tight supervisory policy, suspending the licenses of six banks in September and of three banks in the first week of October, most for unacceptably low capital-adequacy ratios or for excessively risky or suspicious credit operations.

Inflation pressures remained high. In September, the 12-month Consumer Price Index inflation remained at 15.7 percent close to its August level (15.8 percent), with core inflation unchanged at 16.6 percent. Monthly data show a 0.4 increase in food inflation and a 1.1 percent acceleration in non-food inflation confirming that the pass-through effect from the weaker ruble continues to sustain inflation pressure.

Real wages and incomes continued to deteriorate in August while unemployment remained flat. Real wages contracted in August by 9.8 percent, year-on-year and real disposable income shrank by 4.9 percent. In real terms, pensions fell by 4.1 percent, year-on-year. At the same time, unemployment remained at 5.3 percent – the same level as in July but in seasonally adjusted terms increasing marginally to 5.6 percent.

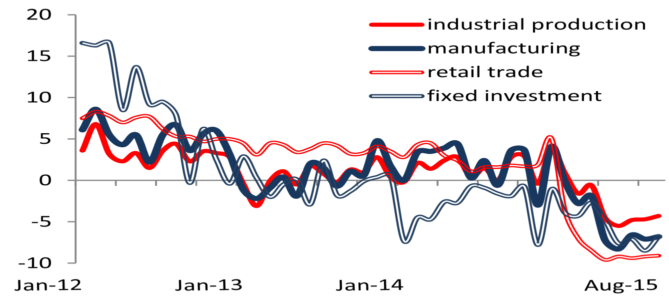
As a result of lower incomes the poverty rate increased significantly in the first half of 2015. The number of poor people rose from 18.9 million (13.1 percent of the population) to 21.7 million people (15.1 percent of the population). This accelerated an already troubling trend in poverty rates, which rose from 10.8 percent in 2013 to 11.2 percent in 2014. The increase in poverty rates was driven by the decline in real incomes but also by food inflation continuously outpacing headline inflation.

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



Source: Rosstat, Haver Analytics, WB team

Figure 4: … August's data suggest a bottoming out of the economy (percent change, y-o-y)

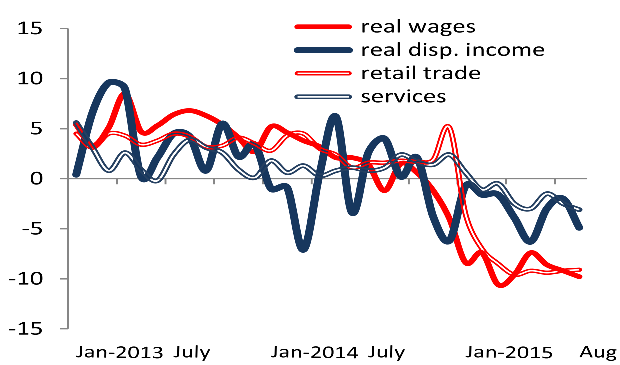


Source: Rosstat, Haver Analytics, World Bank team

In January–August 2015, the federal budget registered a primary deficit of 1.1 percent of GDP compared to a 2.1 percent surplus a year ago. Federal budget revenue decreased in the eight months of 2015 on a yearly basis as oil and gas revenues dropped and non-oil revenue remained largely unchanged. However, federal budget revenues were higher than planned, at 19.0 percent of GDP compared to 17.1 percent of GDP because of higher than expected oil revenues and strong VAT and corporate income tax revenues. Federal budget expenditure increased in the first eight months on the back of higher spending for defense and social policy. However, in August, the pace of spending finally slowed and the federal budget primary balance reached the lowest level since the beginning of the year. The non-oil deficit remained at over ten percent of GDP at the end of August (8.5 percent in January - August 2014). In the first eight months, the federal government spent RUB900 billion from the Reserve Fund to finance the deficit. By the end of 2015, the Ministry of Finance expects a deficit close to 3 percent of GDP, compared to 3.7 percent of GDP stipulated in the budget.

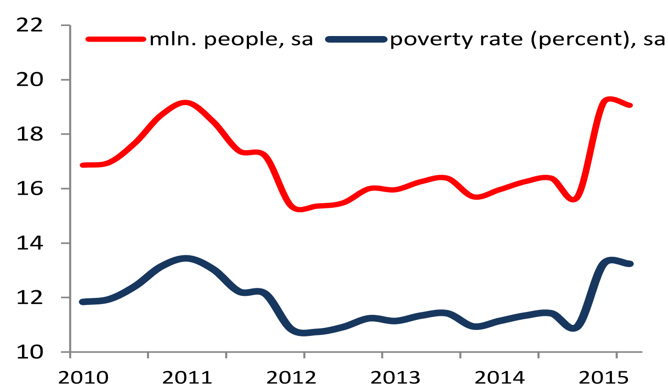
On October 8, the government approved the federal budget for 2016 and is expected to submit it to the Duma before October 25. The budget proposal assumes GDP growth of 0.7 percent for 2016 with an average oil price of US$50 per barrel. The government plans to continue its fiscal consolidation strategy, reducing primary expenditures to 19.4 percent of GDP, compared to 20.0 percent of GDP in 2015. The government decided not to increase the pension age, but pensions will be indexed by only 4 percent and the second pillar of pension funding will continue to be frozen. Other social sector expenditure and defense expenditure were also decreased, yet the government plans will increase subsidies to the economy. Export duties for oil will be not lowered, nor will the oil extraction tax be raised as initially planned. Federal budget revenues are expected to be at the level of 17.3 percent of GDP, compared to 16.8 percent of GDP in 2015. A planned deficit of 3.0 percent of GDP will be covered mainly with the Reserve Fund. The Reserve Fund is planned to decrease from 4 percent of GDP to 1.3 percent of GDP (around 1 trillion rubles).

Figure 5: Real incomes continued to deteriorate … (percent change, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

Figure 6: … and poverty increased in the first half year (percent)



Source: Rosstat, Haver Analytics, World Bank team

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