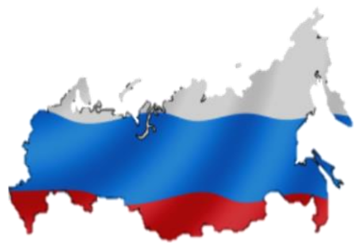
Russia Monthly Economic Developments

February 2016

- The ruble reached new lows in late January, as the oil price plunged to the lowest levels in the last decade. Oil prices rebounded in early February to above US$35 per barrel.
- In January, inflation decelerated to single digits, but upside risks to the CBR inflation target are likely to limit the space for monetary easing in the near-term.
- December 2015 output data show a sharp contraction and January business sentiments surveys also continued to be negative, although slightly improved.
- Since late January, a draft anti-crisis plan for 2016 in the amount of RUB750 billion is being discussed within the government.
- Russia's fiscal outlook for 2016-2017 is highly uncertain, in the anticipation of new privatization and expenditure consolidation measures.



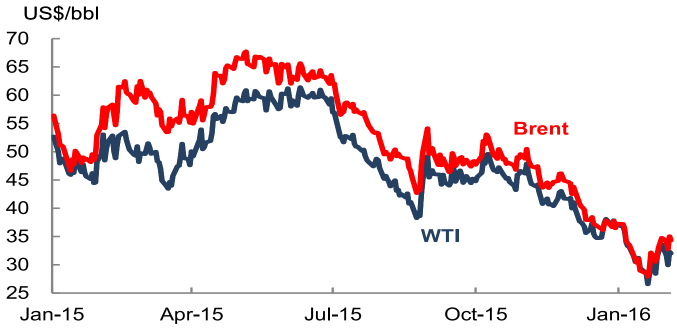
Oil prices rebounded in early February to above US$35 per barrel after plunging in late January to the lowest levels in the last decade. The price of Brent, the international crude oil marker, recorded US$26.4 per barrel on January 20th, a level not seen for more than 12 years. However, prices rebounded in early February due to a further weakening of the US dollar and speculations about a coordinated supply cut by Russia, Iraq and Saudi Arabia, which were later dismissed. The oil market is expected to remain in surplus for the first half of 2016. Iran's exports are rising, seasonal demand remains weak, and there is a large inventory overhung. The US shale oil production is slowly decreasing, after growing as much as two million barrels per day in 2014. However, it remains resilient and its operating costs are still below current oil prices. The World Bank oil forecast was revised downwards to US$37 per barrel on average in 2016 and to US$48 per barrel in 2017.

The sharp downward adjustment in oil prices in January, led to a significant weakening of the ruble and increased market volatility. The average ruble exchange rate depreciated by about 11 percent with respect to the US dollar, while the average oil price (Brent) fell by 17 percent relative to its December 2015 level. The exchange rate market was extremely volatile−especially during the third week of January, when oil prices dropped below US$30 a barrel−and the ruble exchange rate hit a new record low of 83 RUB/US$ on January 22. The Central Bank of Russia (CBR) refrained from interventions, considering the exchange rate adjustment in line with fundamentals and without major threats to financial stability. On January 29, CBR kept the policy rates unchanged at 11 percent, despite slowing inflation.

In January, inflation decelerated to single digits, but upside risks to the CBR inflation target are likely to limit the space for monetary easing in the near-term. The 12-month Consumer Price Index decelerated from 12.9 percent in December 2015 to 9.8 percent in January 2016, compared to 15.0 percent in January 2015. The slowdown was broad-based with 12-month food inflation slowing to 9.2 percent (from 14.0 percent in December), and non-food inflation to 10.9 percent (from 13.7 percent in December). At the same time, the renewed pass-through effect on prices from the depreciating ruble and the impact of the food import ban on Turkish products kept monthly inflation in January at 1.0 percent, compared to 0.8 percent in December. This means that there remain significant upside risks to the CBR inflation target which are limiting the space for monetary easing over the next months.

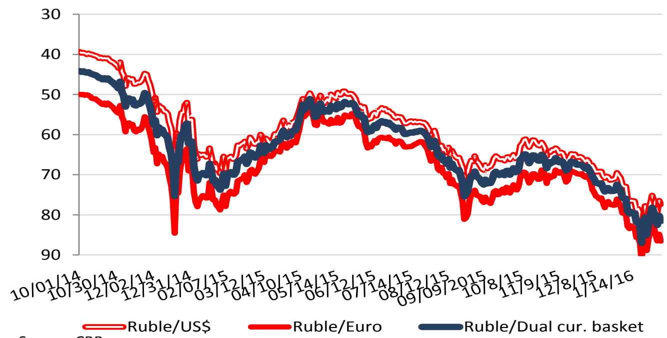
December 2015 output data show a sharp contraction and January business sentiments surveys continued to be negative, although slightly improved. The contraction of industrial production accelerated in December to 4.5 percent year-on-year from 3.5 percent in November and manufacturing output fell by 6.1 percent, compared to 5.3 percent in November. Slowly increasing unemployment and plummeting real wages further weakened consumer demand. As a result, retail trade diminished by 15.3 percent year-on-year, compared to -13.1 percent in November. As credit conditions remain tight and oil prices continued to decline, investment demand deteriorated further in December: fixed capital investment dropped by 8.7 percent year-on-year, compared to -4.9 percent in November. January business sentiments surveys showed little improvement and remained negative: the composite PMI Outputs index edged up from 47.8 in December to 48.4 in January.

Figure 1: Oil prices rebounded slightly from the January lows …



Source: Bloomberg

Figure 2: … with the ruble following this trens



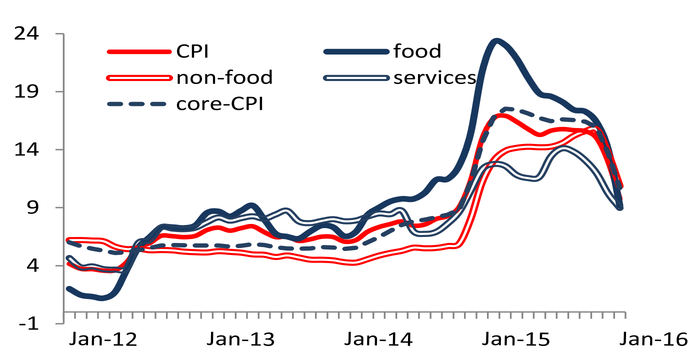
Source: CBR

According to Rosstat's preliminary estimates, Russia's GDP declined by 3.7 per cent in 2015, slightly above the World Bank forecast of -3.8 percent. Real GDP contracted in the final quarter of 2015 by about 3.7 percent year-on-year, compared to -4.1, -4.6 and -2.2 percent in the other three quarters. Globally, a further deceleration of activity in key emerging and developing economies overshadowed a modest recovery in advanced economies in 2015. Sharp declines in commodity prices created a particular challenging external environment for commodity exporters, such as Russia.

The Balance of Payments was stable in 2015, despite unfavorable external conditions and limited access to international capital markets. A steep decline in export receipts (US$174 billion) was largely compensated by a sharp decrease in imports (US$148 billion) thanks to the downward adjustment of the real effective exchange rate. The current account balance improved to US$65.8 in 2015 from US$58.4 billion in 2014. Non-fuel exports contracted by 18 percent, year on year, pointing to an uncompetitive non-resource sector. The fall in imports was the result of the sharp ruble depreciation, the import ban on Western food items (since 2014) and travel restriction to Egypt (since November 2015). Net capital outflows fell threefold to US$56.9 as non-debt related capital outflows decreased and net acquisition of foreign assets by the private sector evaporated. In part, liquidated foreign assets were used by banks to pay off external debt as access to international capital markets remained constrained by sanctions. In addition, the ruble depreciation and falling consumer demand cut companies' profits in dollar terms and limited the appetite for foreign assets investment by the banking and non-banking sectors. Thus, net capital outflows moderated in the face of a US$64.3 billion decrease in private sector net external liabilities. Reduced net capital outflows improved the financial and capital account deficit from US$172.2 billion in 2014 to US$61.3 billion in 2015 and eased pressure on international reserves. The central bank largely refrained from interventions in 2015 with the exception of US$2.4 billion in January 2015. As a result, international reserves stood by the end of 2015 at US$368.4 billion (17 months of imports), compared to US$385.5 billion (11 months of imports) at end-2014.

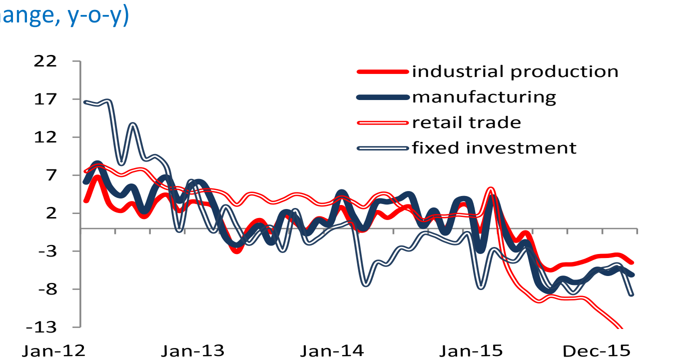
In January 2016, a presidential decree placed the Federal Customs Service, the Federal Agency for the Regulation of the Alcohol Market and the Federal Agency for Budget Monitoring under the auspices of the Ministry of Finance. This new institutional framework is expected to improve federal tax administration as well as transparency in the collection of import duties. It is also planned that the Federal Tax Service Agency will collect social contributions, which are currently collected by the Pension Fund.

Figure 3: Inflation pressure is slowly easing … (percent, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

Figure 4: … but output data continues to disappoint (percent change, y-o-y)



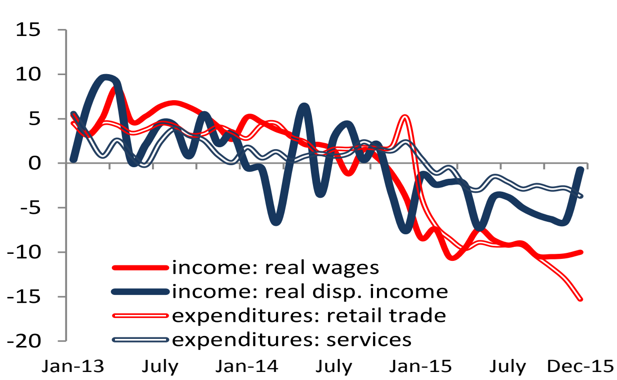
Source: Rosstat, Haver Analytics, World Bank team

In 2015, the federal budget registered a primary deficit of 1.9 percent of GDP, close to the 2.1 percent anticipated in the 2015 budget law. In contrast, in 2014 there was a primary surplus of 0.1 percent of GDP. The non-oil deficit slightly improved to 10.6 percent of GDP from 10.9 percent of GDP in 2014. Oil and gas revenues dropped by 2.4 percent of GDP, while non-oil revenue increased slightly by 0.7 percent of GDP. Federal primary expenditure increased in 2015 by 0.3 percent of GDP‒a 3.5 percent increase in nominal terms compared to 2014‒due to higher defense and social spending. Spending to support the economy decreased by 1.1 percent of GDP. Russia's policy to limit state purchases of foreign goods reportedly resulted in a 40 percent cost increase and a decline in the quality of purchased goods in 2015. The federal budget deficit of RUB2.2 trillion was mainly financed with the Reserve Fund. The Reserve Fund halved form US$87.9 billion in December 2014 to US$46.0 billion at end-2015. The National Welfare Fund balance declined moderately from US$78.0 billion to US$71.7 billion. In 2015, RUB440 billion from the National Welfare Fund were invested in assets of state-owned banks and enterprises.

Russia's fiscal outlook for 2016-2017 is highly uncertain, in the anticipation of new privatization and expenditure consolidation measures. The 2016 budget, approved at the end of December, was based on an oil price of US$50 a barrel and planned a 3 percent federal budget deficit. However, sliding oil prices in January forced the government to consider a 10 percent budget cut and might lead to a broader revision of budget parameters. The Minister of Finance announced that federal budget cuts beyond 10 percent would require structural changes in the budget. The government is considering an ambitious privatization plan to finance a larger than expected deficit. The process of privatization of selected state assets could start in the second half of 2016. The privatization might include the sale of stakes in the banking group VTB, the main oil company Rosneft, the Russian airline Aeroflot, the diamond mining company ALROSA, the shipping company Sovcomflot, the oil pipeline monopoly Transneft and the telecom operator Rostelecom. The President also indicated support for plans to consolidate government agencies and services. At the same time, it is being considered that Russia's fiscal planning horizon could continue to be based on a one-year state budget (as in 2015 and 2016).

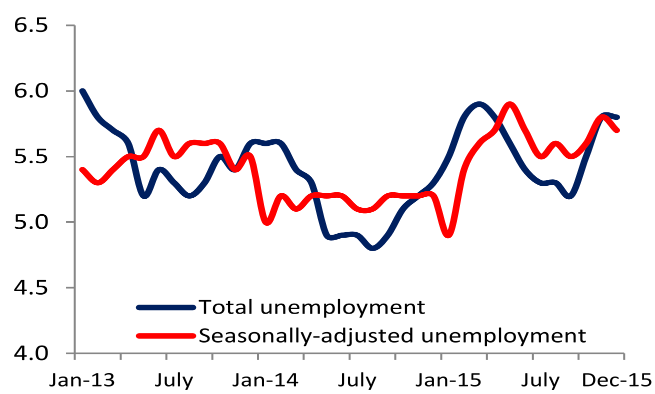
Since late January, a draft anti-crisis plan for 2016 in the amount of RUB750 billion is being discussed within the government. About 96 new measures are planned, focusing on immediate and medium-term economic development measures in four areas: restructuring the economy and improving the investment climate; supporting the regions; helping selected industries; and social support. Part of the financing for the plan was already included in the approved 2016 budget (RUB310 billion rubles in budget credits to the regions) while other funding sources are still being discussed. Compliance with social obligations is a key priority of the plan, including the full indexation of pensions in 2016, as opposed to the 4 percent increase foreseen in the 2016 budget law. State aid is planned to various industries (including agriculture) and to exports. As to the medium-term economic development measures, the plan proposes the privatization of state-owned companies, a significant reduction in business audits, increasing the predictability of legislation and steps to improve the judicial and law enforcement systems.

Figure 5: The decline in real wages steadied … (percent change, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

Figure 6: … while unemployment edged down (percent)



Source: Rosstat, Haver Analytics, World Bank team

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