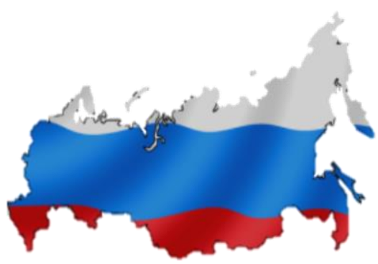
Russia Monthly Economic Developments

February 2017

Global growth remained broadly stable in the fourth quarter of 2016. After a volatile fourth quarter, oil prices fluctuated within a remarkably tight band of $53-55/bbl in early 2017. Portfolio flows into emerging market funds and bond issuance activity have picked up since the start of the year, contrasting with a subdued performance in late 2016. Global financial flows, higher oil prices, and expectations of lower geopolitical pressures contributed to the ruble's appreciation in January. Russian GDP contracted less than expected in 2016. While consumer demand remained depressed on the back of a protracted fall in real incomes, investment demand picked up on inventory restocking. Net exports were the main driver for economic growth. Inflation slowed down in January with the 12-month consumer price index dropping to 5 percent from 5.4 percent in December. In 2016, the federal budget primary deficit worsened compared to 2015 due to an overall drop in revenue and increased expenditures. In February 2017, the Central Bank, on behalf of the Ministry of Finance, started currency operations in the domestic market. These operations largely comply with the fiscal rule, which the Ministry of Finance plans to implement in 2020 and which aims to link the exchange rate with the cut-off oil price. The banking sector has mainly stabilized as key credit risk and performance indicators remained largely unchanged in the fourth quarter of 2016. Consolidation in the banking sector continues: the number of banks in Russia has fallen from 623 at the beginning of 2017 to 619 as of February 1, 2017. Overall, the Russian economy has coped well with the dual shocks of lower oil prices and restricted access to the international financial markets, heading towards moderate growth in 2017.

The Global Context



Global growth momentum remained relatively stable in the fourth quarter of 2016. Following a rally in the third quarter, global growth appears to have remained broadly stable in the fourth quarter as more moderate growth in the United States was partially offset by stronger growth in the Euro Area, Asia, and other regions. In January, PMI surveys suggest that both advanced and emerging market economies remain in recovery mode. In global financial markets, while U.S. long-term interest rates have increased substantially since November 2016, driven by a combination of rising inflation expectations and prospects of a faster normalization of U.S. monetary policy, current U.S. bond yield levels remain well below previous tightening cycles. Following subdued developments towards the end of 2016, portfolio flows into emerging market funds and bond issuance activity have picked-up again since the start of the year.

After a volatile fourth quarter and a rally to $54/bbl in December (up from $45/bbl in November), oil prices have fluctuated within a remarkably tight band of $53-55/bbl (Figure 1). Oil prices rose in December following agreements by OPEC and non-OPEC producers to reduce output by nearly 1.8 mb/d in the first half of 2017. The oil market continues to slowly rebalance amid steady, broad-based growth. On the supply side, sharply lower investment in non-OPEC countries has led to lower production, especially from the short-cycle U.S. shale sector. Global stocks, however, remain stubbornly high, especially in the U.S. despite a lengthy period of low prices. The World Bank expects oil prices to average $55/bbl in 2017—an increase of 26 percent over 2016—reflecting an expected rise in non-OECD oil demand and a tightening supply under the assumption of partial compliance to the OPEC/non-OPEC agreement. The market is expected to move into deficit in 2017, particularly in the second half of the year, which will help reduce the large stock overhang. Prices are projected to increase to $60/bbl in 2018, assuming a balanced market and no additional supply restraints by OPEC and non-OPEC producers.

Figure 1: Oil prices fluctuated around a remarkably tight band of $53-55/bbl

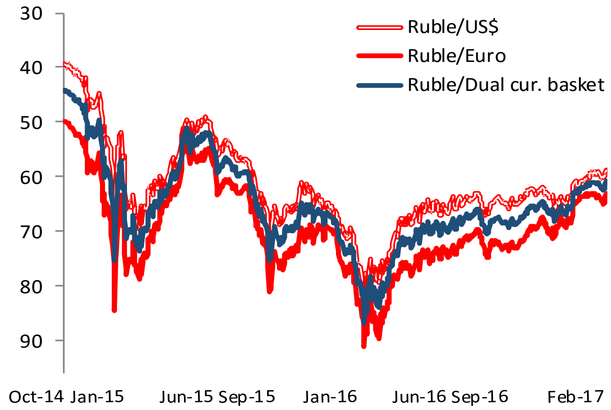
Source: Bloomberg.

Russia's Recent Developments

While oil prices (Brent) increased by a modest 1.5 percent in January compared to December, the ruble appreciated by 4

percent with respect to the U.S. dollar (Figure 2). In addition to higher oil prices, a global rise in portfolio flows into emerging market funds and bond issuances, as well as expectations of reduced geopolitical pressures, influenced the exchange rate dynamics in January. The currency operations by the Bank of Russia on behalf of the Ministry of Finance, which started on February 6th, has had limited observable effect on the ruble exchange rate.

Figure 2: The ruble appreciated in January

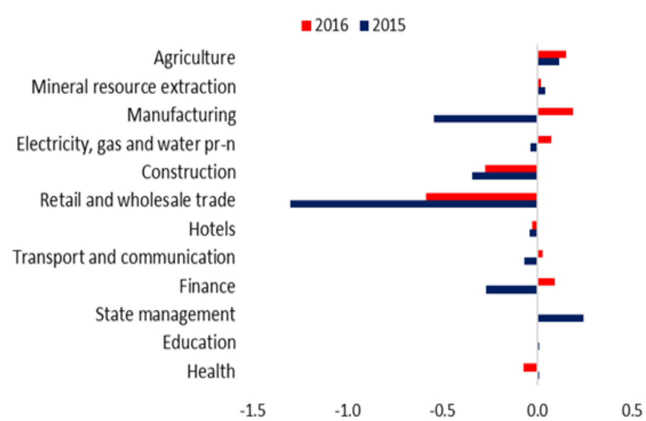


Source: CBR.

In 2016, the current account surplus shrank threefold as the trade balance weakened. In 2016, the current account surplus dropped to US$22.2 billion (from US$69 billion last year) as the trade balance dropped from US$148.5 billion to US$87.8 billion. Lower energy prices and lower prices for other commodities exported by Russia in the first half of 2016 were the main reasons for a drop in export proceeds by US$62.3 billion (although these prices did stabilize in the second half of the year). The real effective exchange rate (REER) depreciation in the first half of 2016, compared to the same period last year, as well as shrinking real output provided for lower imports in the first six months of 2016. In the second half of 2016, imports increased compared to the same period last year as the REER rate appreciated in August - December compared to the same period in 2015. Overall in 2016, imports decreased by US$1.6 billion. An improved balance of services and labor income balance provided some support to the current account, which was not enough to compensate for the fall in export proceeds. The lower current account corresponded to lower net capital outflows. Net capital outflows declined from US$57.7 billion to US$15.4 billion due to lower debt redemptions in the banking sector and increased net liabilities in the non-banking sector. While the Bank of Russia refrained from interventions in the currency market in 2016, its international reserves increased by US$8.2 billion according to the Balance of Payments, largely due to repayments of foreign currency loans by large banks. These loans were originated by the Central Bank in 2015 to support large banks' external debt payments under the imposed sanctions regime.

The GDP contraction in 2016 appears to have been milder than initially envisaged. Rosstat published the first GDP estimates for 2016: GDP contracted less than expected (-0.2 percent compared to -0.6 percent, and a consensus projection of -0.5 percent). According to the data available now, the contraction in the first three quarters totaled 0.7 percent of GDP, y/y. To decrease by 0.2 percent in 2016, GDP had to grow by a prominent 1.5 percent, y/y, in the fourth quarter – a rather sharp recovery. Tradable sectors, which competitiveness increased on the back of the real effective exchange rate depreciation (23.6 percent in 2014 - 2016), were the main drivers of economic growth, contributing 0.4 pp to GDP growth (Figure 3). Agriculture, which benefited from a heavy harvest and Russia's restrictions on the import of food items from Western countries, increased by 3.5 percent, y/y. Manufacturing expanded by 1.4 percent, y/y, compared to a decline of 4.1 percent, y/y, last year. In 2016, non-tradable sectors shrank by 0.8 percent, y/y. Construction (-4.3 percent, y/y), retail and wholesale trade (-3.6 percent, y/y), and hotels and restaurants (-3.5 percent, y/y) contracted the most.

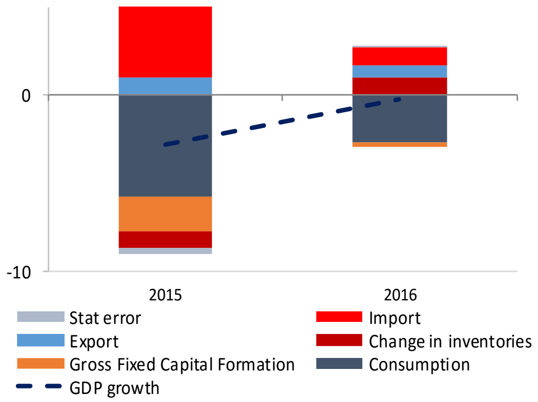
Figure 3: Tradable sectors were the main drivers of growth



Source: Rosstat.

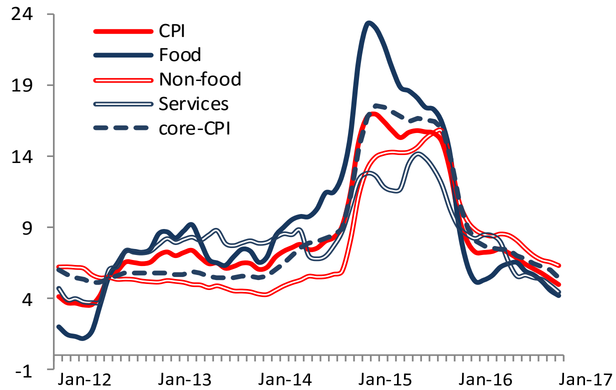
On the demand side, a continued sharp fall in consumer demand, on the back of a protracted fall in real incomes, kept domestic demand depressed (-2.3 percent, y/y). Meanwhile, inventory restocking, which started in the third quarter of 2016, resulted in investment demand picking up with a positive contribution of 0.7 pp to GDP growth (Figure 4). Net exports were the main driver of growth from the demand side as exports increased and imports continued contracting. Overall, the economy has coped with the shocks of low oil prices and restricted access to international financial markets, heading towards moderate growth in 2017.

Figure 4: GDP contraction appeared to be milder in 2016



Source: Rosstat, World Bank staff calculations.

Figure 5: Consumer inflation continued to slow in January



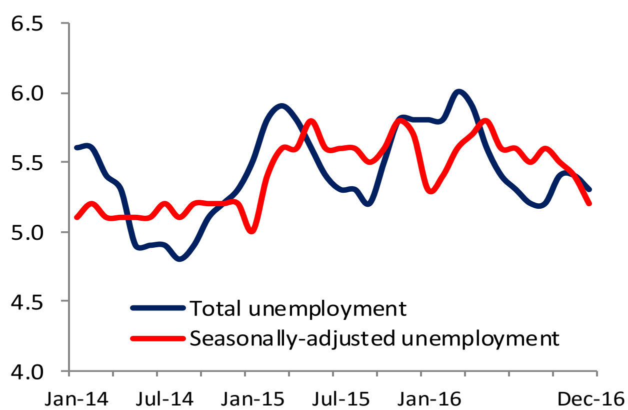
Source: Rosstat, Haver Analytics, World Bank team.

Rosstat revised GDP growth upwards for 2015. The revision was made on the basis of a full survey of small and medium enterprises, which is conducted by Rosstat once every four years. In addition, Rosstat used some new information from the Russian Treasury. As a result, GDP growth was revised from -3.0 percent, y/y, to -2.8 percent, y/y. The nominal value of GDP increased by 1.8 percent in 2014 and 2.4 percent in 2015 compared to the last revision at the end of December 2016.

Consumer inflation slowed down further in January. The 12-month consumer price index dropped to 5 percent in January from 5.4 percent in December. Core inflation slowed to 5.5 percent from 6 percent in December (Figure 5). Annual inflation decelerated for all categories (food, non-food, and services), while non-food inflation contributed the most to headline inflation. Despite progress in slowdown of inflation and inflation expectations, the Bank of Russia's Board of Directors kept the key rate unchanged at its meeting on February 3rd. The Bank noted that part of the decline in inflation was attributed to temporary factors — the pass-through of the ruble's nominal appreciation and last year's heavy crop. To maintain the propensity to save and anchor a sustainable inflation slowdown, monetary conditions should remain moderately tight. The Central Bank has noted the presence of elevated external political and economic uncertainty, which may negatively affect expectations for exchange rate and inflation. Moreover, maintaining moderately tight monetary conditions would help contain inflation risks, including in the short term, arising from the launch of the finance ministry's foreign currency operations. The Bank of Russia stated that considering the change in the external and internal environment, there is now less monetary policy space to reduce the key rate in the course of the first half of 2017.

Labor market dynamics improved in December. The unemployment rate, sa, decreased in December 2016 to 5.2 percent from 5.4 percent in November (Figure 6). Real wages continued to grow and increased in December by 2.4 percent, y/y. They also rose compared to the previous month after seasonal adjustment. Real disposable income contracted in December by 6.1 percent y/y, but increased in monthly terms after seasonal adjustment.

Figure 6: Seasonally adjusted unemployment continued to decrease in December



Source: Rosstat, Haver Analytics, World Bank team.

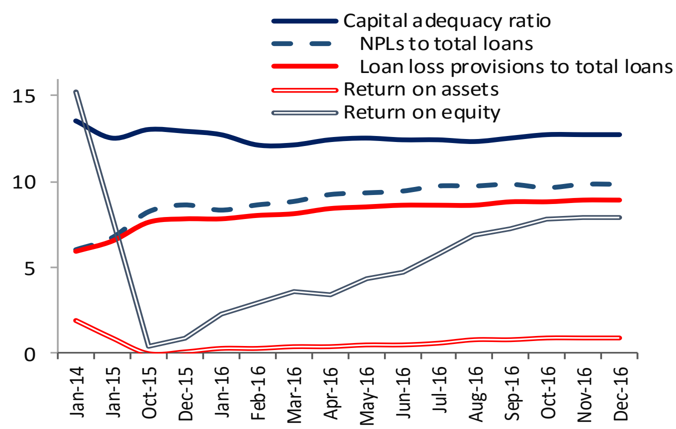
In 2016, the federal budget primary deficit worsened compared to the previous year, as higher non-oil revenues were unable to compensate for the drop in oil revenues, while expenditures increased slightly. The federal primary deficit stood at 2.8 percent of GDP in 2016 compared to 1.8 percent of GDP the previous year. Federal budget revenues fell by 0.8 percent of GDP to 16 percent. This was due to a decline in oil revenues of 1.5 percent of GDP to 5.7 percent of GDP and an increase in non-oil revenues due to the privatization of Rosneft, Russia's largest oil company. Meanwhile, primary expenditures increased by 0.2 percent of GDP to 18.8 percent of GDP. State management (-0.1 percent of GDP), national security (-0.1 percent of GDP), national economy (-0.2 percent of GDP), housing and communal services (-0.1 percent of GDP), and education (-0.1 percent of GDP) were the categories for which expenditures were lower, as a share of GDP, compared to 2015. Federal budget expenditures for social policy increased by 0.3 percent of GDP as did expenditures for national defence, by 0.6 percent of GDP. On the back of higher non-oil revenues, the non-oil deficit improved to 9.3 percent of GDP in 2016 compared to 9.6 percent of GDP in the same period last year. In 2016, the federal budget deficit increased to 3.5 percent of GDP from 2.4 percent in 2015.

At the end of January, the Ministry of Finance announced its decision to conduct currency purchases/sales in the domestic market, beginning in February. The Ministry of Finance aims to purchase currency when the oil price exceeds US$40/bbl and it intends to sell currency if the opposite happens. The amount of currency purchases will be defined by additional oil and gas fiscal revenues received by the federal budget compared to the baseline scenario, as stipulated in the federal budget for 2017: oil price (Urals) US$40/bbl and exchange rate 67.5 Rub/US$. The amount of currency sales is limited by the sum of purchases accumulated before. The total amount of purchases for each month will be calculated and announced by the Ministry of Finance no later than the third working day of each month. The Bank of Russia will operate as an agent for the Ministry of Finance, conducting daily currency purchases/sales. The currency operations largely comply with the fiscal rule, which the Ministry of Finance plans to introduce in 2020 based on the oil cut off price of US$40/bbl. The fiscal rule aims to de-link the expenditures from externally driven volatility in commodity prices. The currency purchases will create a downward pressure on the ruble, linking the exchange rate with the cut-off oil price. Estimated purchases for February will total Rb 113.1 billion (US$1.9 billion).

The banking sector has mainly stabilized, as key credit risk and performance indicators remained largely unchanged in the fourth quarter of 2016. Nonperforming assets remained flat at 9.8 percent and the aggregate capital adequacy ratio stayed at 12.7 percent (above the regulatory minimum of 8 percent stipulated in Basel III) as of December 1, 2016. Banks' financial performance has been improving with the return on assets at 0.9 percent and the return on equity at 7.9 percent as of December 1, 2016 (Figure 7). Credit to firms, adjusted for exchange rate movements, contracted 3.2 percent in December, y/y, compared to -2.1 percent in November.

Lending to households, adjusted for exchange rate movements, increased by 1.5 percent in December, y/y, from 1.2 percent in November. Consolidation in the banking sector continued - the number of banks in Russia has fallen from 623 at the beginning of 2017 to 619 as of February 1, 2017, mainly due to the Central Bank's efforts to close weak and non-compliant banks.

Figure 7: Performance indicators remained largely unchanged in the fourth quarter of 2016



Source: CBR.