Russia Monthly Economic Developments

September 2018

THE WORLD BANK
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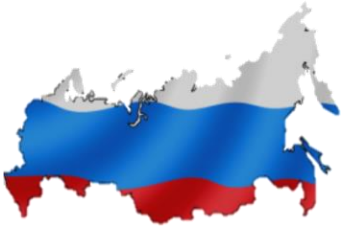
Global growth in the second quarter of 2018 was solid, albeit divergent. Global trade stagnated in Q2, reflecting weakening trade flows in and out of Asia and decelerating imports from some major advanced economies. Financial conditions for emerging economies tightened amid concerns about reduced dollar-denominated funding, escalating trade tensions, softening growth prospects, and rising policy uncertainties. After declining to a 4-month low in mid-August, oil prices have risen steadily, with the price of Brent crude oil briefly reaching US$80 per barrel (bbl) in mid-September. Turbulence in emerging markets, combined with new sanctions, increased uncertainty, and elevated geopolitical tensions, resulted in capital outflows from Russia's financial market and a substantial depreciation of the ruble in August. To curb volatility on the financial market, on September 14th, the Central Bank of Russia (CBR) suspended currency purchases in the fiscal rule framework in the open market until the end of the year. This decision provided the ruble with additional support from relatively high oil prices. Heightened uncertainty about sanctions, elevated inflation expectations and pressures, and a planned increase in the value-added tax rate in 2019 also prompted the CBR to raise the key policy rate by 25 basis points to 7.5 percent. Growth momentum weakened in August. Key credit risk and performance indicators have been relatively stable and lending growth has picked up further. Higher oil prices, improved tax administration, a weaker ruble, and a conservative fiscal policy strengthened federal budget balance in the first seven months of 2018.

The Global Context

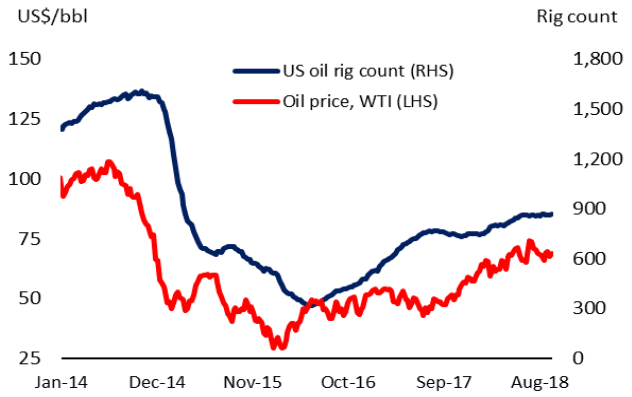


Global growth in the second quarter of 2018 was solid, albeit divergent. It was estimated at 3.6 percent (q/q saar), and supported by an acceleration in the United States following the fiscal stimulus. Growth in other countries was more heterogeneous: Euro Area growth declined in Q2, China shows signs of a slowdown in Q3.

Global trade stagnated in Q2, reflecting weakening trade in and out of Asia and decelerating imports from some major advanced economies. Financial conditions for emerging economies tightened amid concerns about reduced dollar-denominated funding, escalating trade tensions, softening growth prospects, and rising policy uncertainties.

Oil prices have risen on the back of supply concerns. After declining to a 4-month low in mid-August, they rose steadily, with the price of Brent crude oil briefly reaching US$80 per barrel (bbl) in mid-September, an increase of almost US$10/bbl from its August low. The price of WTI, the U.S. benchmark, also increased by US$5/bbl to US$70/bbl. A number of factors have driven the recent increase in oil prices, most notably the fall in Iranian exports of crude oil. These are reported to have already fallen by around 500 thousand barrels per day relative to their April level, well ahead of the reintroduction of sanctions by the United States in November. There have been further falls in crude inventories in the United States, with stockpiles 3 percent below their 5-year average for this period. The U.S. rig count increased slightly this month but has essentially been flat throughout August and September, with drilling limited by the substantial discount of prices in the Permian region to the U.S. benchmark (Figure 1). The U.S. Energy Information Administration also revised down its forecasts for U.S. crude oil production in 2019 by 0.2 million barrels per day (mb/d) to 11.5 mb/d, reflecting more severe capacity constraints in the Permian region than expected.

Figure 1: Oil prices have risen on the back of supply concerns



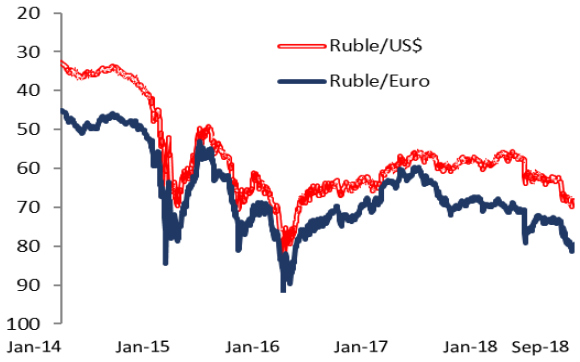
Source: Baker Hughes, Bloomberg.

Russia's Recent Developments

The ruble depreciated significantly in the period from August to mid September (Figure 2). New sanctions, enacted under the Chemical and Biological Weapons Control and Warfare Elimination Act (CBW Act), came into force on August 22nd and banned Russia from obtaining a range of technologies that have national security applications. Additional sanctions could follow within 90 days unless Russia meets conditions, including providing assurances it would no longer use chemical or

biological weapons and would allow on-site inspections. These new sanctions and elevated geopolitical tensions, coupled with turbulence in emerging markets, led to a 5.1 percent ruble depreciation, m/m, with the ruble hitting a 2-year low, and a 7.5 percent drop of the RTS index in August. In the middle of August, Russia's 5-year CDS spreads surged to 174 bps from 132.4 bps in the beginning of the month. In an attempt to reduce volatility on the financial markets, the Central Bank of Russia (CBR) suspended its daily purchases of foreign currency in the fiscal rule framework during the period August 9th – 17th and August 23rd – end September. But as volatility on the financial markets continued in September, the CBR board announced the suspension of currency purchases in the fiscal rule framework until the end of December. The CBR's decision strengthens the link between oil price fluctuations and the exchange rate and provides the ruble with additional support from relatively high oil prices.

Figure 2: In the August-early September period, the ruble depreciated with respect to the U.S. dollar

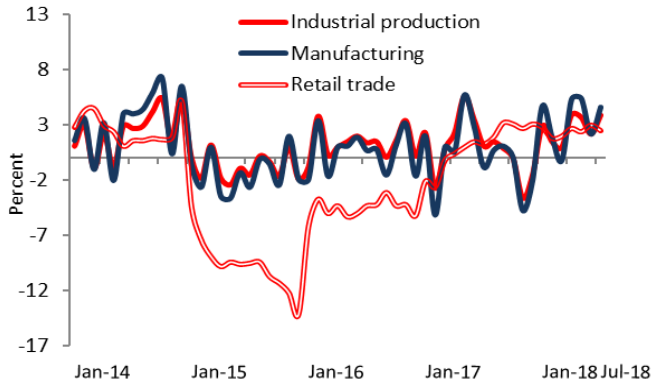


Source: CBR.

In the first eight months of 2018, Russia's current account surplus strengthened to US$69 billion, up from US$19.1 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, robust external demand, and currency interventions in the fiscal rule framework. In the first eight months of 2018, net capital outflows from the private sector totaled US$26.5 billion. In August, on the back of elevated geopolitical tensions and turbulence in emerging markets, net capital outflows from the private sector increased to US$4.8 billion from the US$0.1 billion net capital inflow in July. In addition, non-residents sold government bonds (OFZ) for about US$1.1 billion (share of OFZ bonds held by non-residents dropped to 26.6 percent in the end of August from 28 percent in the end of July). In January – August 2018, international reserves rose by US$36.1 billion (compared to US$25.9 billion in the same period last year), largely because of currency purchases within the fiscal rule framework.

Growth momentum weakened in August (Figure 3). Agricultural production dropped by 10.8 percent, y/y, in August; after a record grain harvest in 2017, Russia expects an overall drop in grain production in 2018. Annual growth in industrial production slowed down in August to 2.7 percent, y/y, from 3.9 percent, y/y, in July, industrial production levels increased by 0.3 percent, m/m, adjusted for seasonal and calendar effects. Growth in industrial production was mainly driven by mineral resource extraction, whose output rose by 4.5 percent, y/y. This was supported by, among other factors, growing oil production on the back of the easing of the agreed OPEC+ production cuts. In August, growth in manufacturing slowed down to 2.2 percent, y/y, from 4.6 percent in July. Output in construction continued decreasing in August (-0.8 percent, y/y), with construction of houses falling by 17 percent, y/y, (-8.1 percent, y/y, in July).

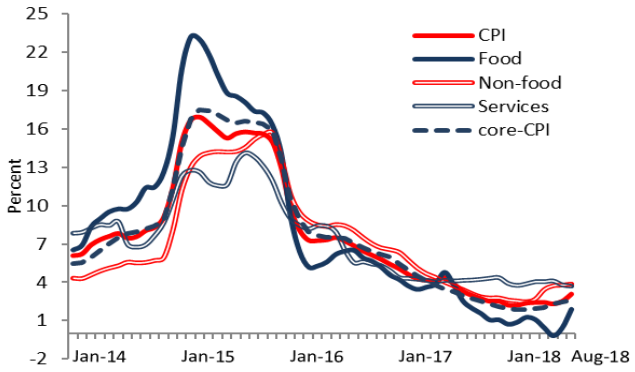
Figure 3: Growth momentum weakened in August



Source: Rosstat, Haver Analytics, World Bank team.

Consumer price inflation grew in August. The 12-month core inflation rate increased from 2.4 percent, y/y, in July to 2.6 percent, y/y, in August. The 12-month Consumer Price Index (CPI) increased to 3.1 percent, y/y, in August from 2.5 percent, y/y, in July (Figure 4). This was mainly a result of the accelerating growth in food prices. Despite the ruble's depreciation, households' annual consumer inflation expectations remained largely unchanged, edging up to 9.9 percent from 9.7 percent in the previous month. The dates of the survey on inflation expectations (August 6 –13th) suggest that a segment of respondents could have not factored in exchange rate movements. Heightened uncertainty about sanctions, elevated inflation expectations and rising inflation pressures, as well as a planned increase in the value-added tax rate in 2019 prompted the CBR to raise its key policy rate by 25 basis points to 7.5 percent in September.

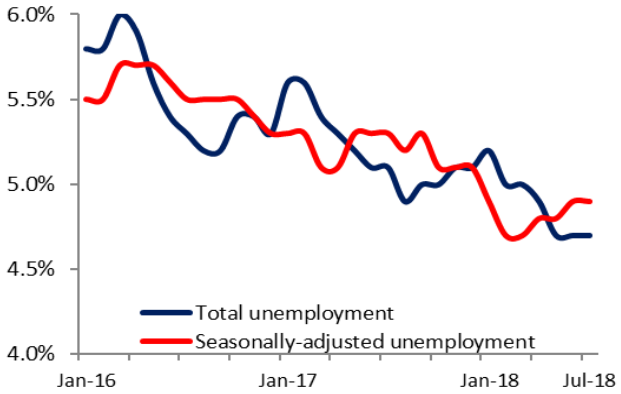
Figure 4: Annual consumer price inflation jumped to 3.1 percent in August from 2.5 percent in July



Source: Rosstat, Haver Analytics, World Bank team.

Labor market dynamics were stable in July. The unemployment rate remained at the low level of 4.7 percent from May to July. The seasonally adjusted rate also remained at the level of 4.8 percent (Figure 4). Real wages continued to grow and they increased in July by 8.0 percent, y/y, and by 0.1 m/m, following seasonal adjustment. Real disposable incomes increased in July by 2.0 percent, y/y. They also increased by 1.0 percent compared to the previous month, following seasonal adjustment. However, this indicator is volatile and is largely driven by unregistered sources of income.

Figure 5: Labor market dynamics were stable in July



Source: Rosstat, Haver Analytics, World Bank team

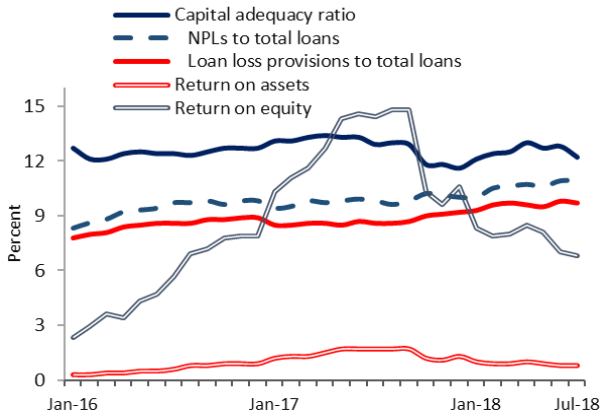
Higher oil prices, improved tax administration, a weaker ruble, and a conservative fiscal policy turned the budget balance into a surplus in 2018. The federal government budget registered a surplus of 2.6 percent of GDP in the first seven months of 2018 compared to a deficit of 0.6 percent of GDP in the same period of 2017. Beginning in 2019, the government plans to increase spending on education, health, and infrastructure. To accommodate higher spending, the government will undertake a revenue mobilization effort (including a value-added tax rate increase and the completion of tax maneuvers in the oil sector) and it plans a temporary relaxation of the fiscal rule. Instead of targeting a zero federal budget primary deficit at the benchmark oil price ($40 per barrel in 2017 prices), the fiscal rule would target a 0.5 percent of GDP federal budget primary deficit. The recent government initiative to raise the pension age could reduce federal budget expenditures in the medium to long term.

Key credit risk and performance indicators have been relatively stable in August and lending growth picked up further (Figure 6). As of August 1st, the capital adequacy ratio stood at 12.2 percent (against a regulatory minimum of 8 percent). The non-performing loan ratio is still high, at 10.9 percent, but it has stabilized at this level. From January-August 2018, the banking sector's profit amounted to 901 billion rubles compared to 997 billion rubles in the same period of 2017. It continues to be affected by the performance of the banks under the financial recovery process via the CBR's Banking Sector Consolidation Fund (BSCF). Consequently, the return on assets (ROA) and return on equity (ROE) declined since the beginning of the year to 0.8 percent and 6.8 percent, respectively. Retail lending continues to grow at the double-digit rate, and the corporate loan growth has begun picking up since the beginning of the year. In July, credit to households in rubles increased by 20.3 percent, y/y, compared to 19.4 percent in June. Meanwhile, credit to the corporate sector in rubles grew by 8.1 percent, y/y, compared to 7.4 percent in June.

The CBR continues its clean-up of the banking sector by removing insolvent banks, rehabilitating systemically or socially important ones, and consolidating distressed assets in a 'bad bank'. From January – August 1, 2018, 43 banks had their licenses revoked for failing to comply with regulations. The CBR has largely finalized the setting up of a 'bad bank' to manage the distressed assets of the failed banks as part of its bank resolution efforts. The legal and operational structure of the 'bad bank' was finalized in August by merging Trust Bank, Rost Bank, and part of the Otkritie Bank (Otkritie Special Bank, which consolidated non-core and problem assets of Otkritie Bank). Trust Bank will perform functions of a 'bad bank' by consolidating and managing distressed assets of the rescued banks, and Trust Bank has already received a loan from the CBR to do so. In 2019, it is expected to be transformed into a fund, with its core banking operations transferred to other banks owned by BSCF. The CBR plans to complete transferring the assets in the amount of approximately RUB 2 trillion (USD 29 billion) from the three large private banks that were bailed out in 2017, via the BSCF, as well as banks that were formerly part of these banking holdings, to the 'bad bank' in 2018. The CBR estimates that 40 to 60 percent of the bad loans could be

recovered. There are plans for the 'bad bank' to function for a 3—5 year period, and all its assets would be sold on market terms. The 'bad bank' will be 97 percent owned by BSCF, with Otkritie owning 2 percent, and 1 percent being owned by the Russia Direct Investment Fund.

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



Source: CBR.

Main Economic Indicators

Output Indicators	2017	2018								
		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept
GDP, % change, y-o-y	**1.5**	-	-	1.3	-	-	1.9	-	-	-
Basic sectors, % change, y-o-y	**2.4**	2.3	2.7	1.9	3.7	3.7	1.5	2.8	-	-
Industrial production, % change, y-o-y	**2.1**	2.4	3.2	2.8	3.9	3.7	2.2	3.9	2.7	-
Manufacturing, % change, y-o-y	**2.5**	4.3	4.7	2.2	5.3	5.4	2.2	4.6	2.2	-
Retail trade	**1.3**	2.9	2.0	2.2	2.9	2.6	3.3	2.7	2.8	-
Extraction of mineral resources, % change, y-o-y	**2.1**	0.8	1.2	2.4	2.5	1.3	2.8	3.2	4.5	-
Construction, % change,y-o-y	**-1.4**	0.2	-0.2	-9.7	1.4	5.6	-1.3	-0.7	-0.8	-
Fiscal and Monetary Indicators										
Federal government balance, % GDP	**-0.6**	2.8	1.6	1.8	0.9	1.4	2.0	2.6		-
Inflation (CPI), %, y-o-y	**3.7**	2.2	2.2	2.4	2.4	2.4	2.3	2.5	3.1	-
Inflation expectations, %, y-o-y	**10.3**	8.9	8.4	8.5	7.8	8.6	9.8	9.7	9.9	-
Balance of Payment Indicators										
Trade Balance, billion $ (monthly)	**115.4**	17.0	12.2	15.0	15.3	15.1	15.6	13.4	-	-
Current Account, billion $	**35.4**	12.8	20.8	28.8	41.0	49.9	53.2	60.7	69.0	-
Export of goods, billion $	**353.5**	33.4	31.2	36.9	36.2	36.5	36.5	-	-	-
Import of goods, billion $	**238.1**	16.4	19.0	21.9	20.9	21.4	21.0	-	-	-
Financial Market Indicators										
CBR policy rate, %, end-o-p	**7.75**	7.50	7.50	7.25	7.25	7.25	7.25	7.25	7.25	7.50
Credit to households in Rub, % change, y-o-y	**7.4**	14.5	15.2	16.1	17.1	18.5	19.4	20.3	-	-
Credit to the corporate sector in Rub, % change, y-o-y	**2.0**	5.1	5.5	6.3	7.5	6.9	7.4	8.1	-	-
Capital adequacy ratio	**11.6**	12.1	12.4	12.5	13.0	12.7	12.8	12.2	-	-
NPLs to total loans	**10.0**	10.0	10.5	10.6	10.7	10.6	10.9	10.9	-	-
Loan loss provisions to total loans	**9.2**	9.3	9.6	9.7	9.6	9.5	9.8	9.7	-	-
Return on assets (ROA)	**1.3**	1.0	0.9	0.9	1.0	0.9	0.8	0.8	-	-
Return on equity (ROE)	**10.6**	8.3	7.9	8.0	8.5	8.1	7.0	6.8	-	-
Income, Poverty and Labor Market										
Real wages, % change, y-o-y	**6.2**	11.0	10.5	8.7	7.6	7.6	7.2	8.0	-	-
Unemployment (%, ILO definition)	**5.1**	5.2	5.0	5.0	4.9	4.7	4.7	4.7	-	-
Exchange rate										
USD/ RUB, average	**58.3**	56.8	56.8	57.0	60.4	62.2	62.7	62.8	66.1	-
Euro/ RUB, average	**65.8**	69.0	70.3	70.4	74.2	73.7	73.2	73.4	76.2	-
Oil price										
Brent, $/ bbl	**54.4**	69.0	65.4	66.5	71.6	76.7	75.2	74.4	73.1	-

Source: Rosstat, CBR, EEG, IMF, staff estimates.

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