Russia Monthly Economic Developments

April 2016

- The World Bank growth projection for 2016 was revised to -1.9 percent.
- Oil prices rose in March to over US$35 per barrel from under US$30 per barrel in January.
- Increased ruble demand and higher oil prices supported the exchange rate in March.
- Inflation continued to slow in March in large part due to the base effect of record high inflation a year ago.
- Business confidence improved moderately in the first quarter of 2016, yet it remains constrained by weakness in domestic demand and heightened policy uncertainty.

The World Bank growth projection for 2016 was revised to -1.9 percent. The revisions are largely due to changes in the oil price assumption. Oil prices are projected to average just US$37 per barrel in 2016, before rebounding to US$48 per barrel in 2017. In 2017 GDP growth is projected to return to a positive, albeit modest, growth rate of 1.1 percent. The Ministry of Economy will submit in April its new growth outlook for government's approval which will provide the macroeconomic assumptions for the 2016 budget revision. Their underlying oil price assumption for 2016 is significantly higher than the World Bank oil price forecast, exceeding it by about US$5 per barrel (Urals). Ministry of Economy's preliminary projection also expects a second year of contraction in 2016, after which growth would resume in 2017.

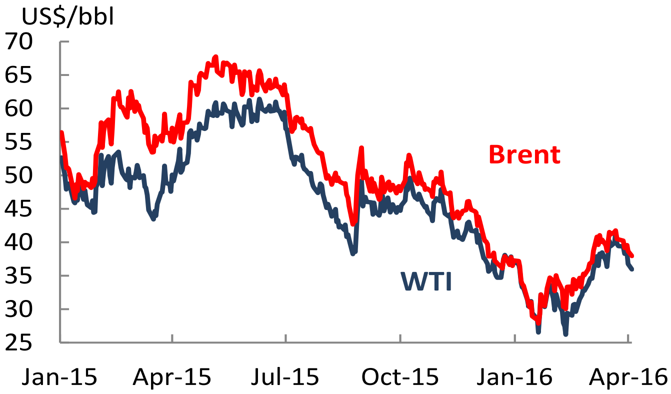
Oil prices rose in March to over US$35 per barrel from under US$30 per barrel in January. Driven by an uptick in Chinese demand indicators, a weaker US dollar, and supply outages in a few countries (Iraq, Nigeria, and the UAE). Despite discussions among major oil producers, including Russia and Saudi Arabia, to freeze output at January levels, the price rally stalled because the market remains oversupplied with large stocks, particularly in the US. OECD stocks also reached a record high of 1.2 billion barrels in early 2016. However, December already marked the first reported year-on-year decline in US oil production in more than four years. The US rig count has declined by 75 percent to less than 400 rigs, the lowest in more than 7 years, and supply rebalancing is underway—despite reduction in costs and efficiency gains.

Increased ruble demand and higher oil prices supported the exchange rate in March. The average oil price (Brent) recovered by 18.7 percent in March relative to its February level. At the same time, the ruble appreciated by 8.8 percent against the US dollar. The US Federal Reserve's March 16 decision to delay monetary tightening supported demand for the ruble during the second half of the month. Meanwhile, Russia's central bank kept its key policy rates unchanged, propping up demand for ruble-denominated assets, as interest rate differentials remained attractive for investors. As a result, the ruble appreciated by around 4 percent against the US dollar in the second half of March despite little movement in oil prices.

Other emerging market assets and foreign exchange indexes also jumped in March. Emerging market currencies have rallied as stabilizing commodity prices and a more dovish tone from the US Federal Reserve boosted investor appetite for riskier assets. A gauge of 20 developing-country currencies against the dollar rose to a four-month high in mid-March, led by the Brazilian real and the Colombian peso. The index is up over 3 percent this year after plunging by more than 30 percent during the past three years. More recently, several commodity exporters have devalued their currencies or moved to floating regimes (e.g. Azerbaijan, Kazakhstan, and Russia), and some non-commodity exporters have also followed the same path (e.g. Egypt and Turkey). After initial bouts of volatility and weakening, their exchange rates appear to be stabilizing.

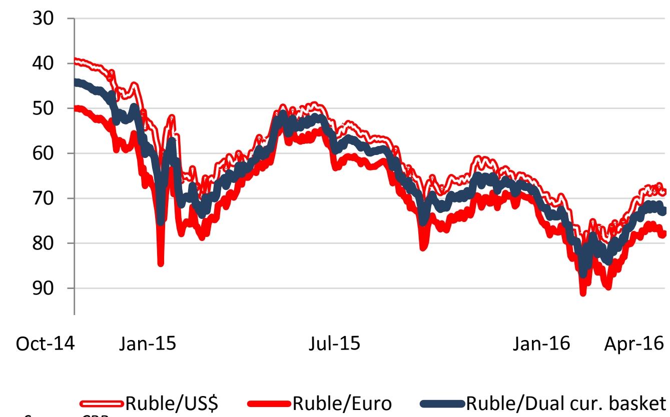
Inflation continued to slow in March in large part due to the base effect of record high inflation a year ago. The 12-month consumer price index decreased to 7.3 percent in March from 8.1 percent in February, while core inflation slowed to 8.0 percent from 8.9 percent in February. As households' real incomes continued to fall sharply at the beginning of this year, demand pressures grew, resulting in an annual deflation on main food products like meat, poultry, fruit and vegetables. Annual food inflation decelerated to 5.2 percent from 6.4 in February (compared to 23.0 percent in March 2015), and was the main reason for the slowdown in headline inflation. However, despite the observed deceleration in overall inflation, the March central bank survey continued to indicate high inflation expectations, and, in its meeting on March 18, the central bank kept the key policy rates unchanged at 11 percent.

Figure 1: Oil prices rose on improved sentiment …



Source: Bloomberg

Figure 2: … and the ruble appreciated



Source: CBR

In February, output statistics in the production and services sectors improved, partly driven by the added working day of the leap year. Industrial output growth turned positive in February, to 1.0 percent, year-on-year, compared to -2.7 percent in January, while the contraction in manufacturing slowed to 1.0 percent from 5.6 in January. Some of this improvement was due to the leap year that added one working day to February. Yet, seasonally adjusted output growth in industries slowed to just 0.1 percent, month-on-month, from 0.9 percent in January. More working days in February benefited the services sector: the contraction in the retail sector decelerated to 5.9 percent year-on-year from 7.3 percent in January, while demand for other services decreased by only 0.4 percent, compared to 2.7 percent in January.

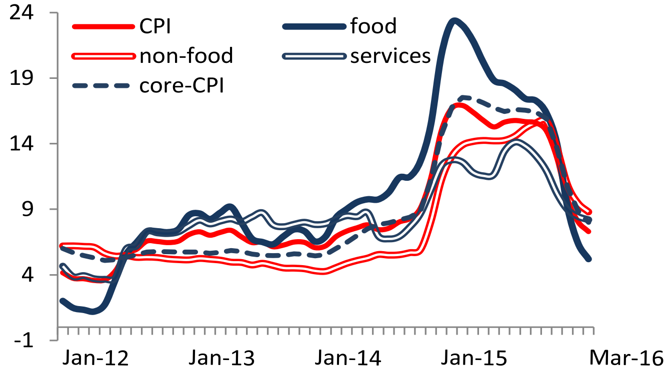
Business confidence improved moderately in the first quarter of 2016, yet it remains constrained by weakness in domestic demand and heightened policy uncertainty. Rosstat's business confidence index in manufacturing improved to -5.6 in the first quarter of 2016, compared to -7.0 in the corresponding period of 2015 (and -9.3 in the last quarter of 2016). The constraint of policy uncertainty became the most frequent mentioned business obstacle after weak domestic demand. The manufacturing PMI index deteriorated in March to 48.3 from 49.3 in February, averaging 49.1 in January-March 2016 (compared to 48.5 in the corresponding period of last year), indicting continued contraction.

In February, total credit to the private sector grew by 3.1 percent year-on-year in real terms, compared to negative growth of 3.3 percent in January. This positive trend was largely the result of growing credit to firms, which in real term increased in February by 8.5 percent year-on-year, compared to zero growth in January. Meanwhile, real credit to households dropped by 12.0 percent in February from -14.0 percent in January. The share of nonperforming loans increased from 8.3 percent at end-2015 to 8.6 percent in January, driven primarily by weak performance of consumer loans. The banking system remains moderately capitalized with an aggregate capital adequacy ratio of 12.1 percent in February (compared to 12.7 percent in January). However, weakening asset quality and low internal capital creation rates are likely to lead to a declining trend in capital adequacy. Starting 2016, the CBR relaxed its regulatory capital adequacy requirements from 10 percent to 8 percent, following the implementation of the Basel III framework. Russian banks' key financial performance indicators remain weak due to slow loan growth and higher provisioning, with a return on equity at 2.9 percent and return on assets at 0.3 percent. The central bank has continued to withdraw licenses from problematic banks, reducing the number of banks from 733 in December to 718 in February.

Real income dynamics showed signs of improvements in February and unemployment remained below end-2015 levels. Real disposable income declined in February by 6.9 percent year-on-year, but increased by 1.7 percent in seasonally adjusted monthly terms. A similar trend was observed for real wages and pensions, which contracted in February by 2.6 percent and 4.7 percent year-on-year, respectively, but grew by 1.8 percent and 2.0 percent month-on-month in seasonally adjusted terms. The unemployment rate grew only marginally in seasonally adjusted terms from 5.3 percent in January to 5.4 percent in February and remained below December levels.

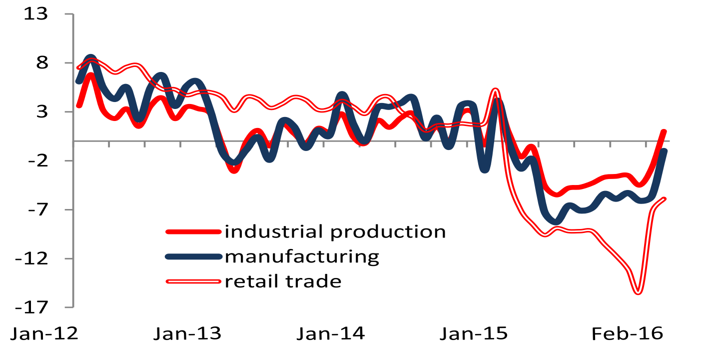
In March, the international rating agency Moody's withdrew all its national scale ratings of 108 Russian companies. According to legislative changes introduced in Russia in early 2016, international rating agencies can only issue national scale ratings starting in 2017 through Russian affiliates. As a result, Moody's withdrew all its national scale ratings, but will continue assigning ratings to Russian companies on a global scale.

Figure 3: Inflation continued to slow … (percent, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

Figure 4: … and output slowly recovers (percent change, y-o-y) (percent change, y-o-y)

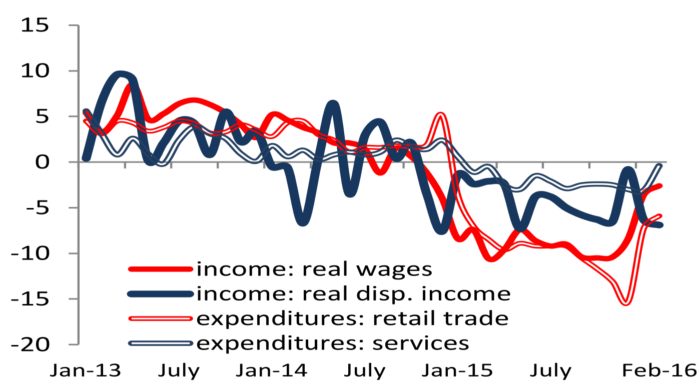


Source: Rosstat, Haver Analytics, World Bank team

In February 2016, the federal budget registered a primary surplus of 0.1 percent of GDP, compared to a primary deficit of 5.1 percent of GDP in February 2015, as a sharp decrease in expenditure overcompensated a further decline in revenues. In the first two months of 2016, federal budget revenues fell by a massive 4.6 percent of GDP, year-on-year, from 19.8 percent in February 2015. This was primarily due to a decline in oil revenues by 3.4 percent of GDP to 5.7 percent of GDP as the price for Urals oil nearly dropped by half from US$51.8 per barrel in January–February 2015 to US$29.7 per barrel in January–February 2016. However, non-oil revenues also fell by 1.2 percent of GDP, year-on-year, to 9.5 percent of GDP mainly due to lower returns of targeted grants and transfers from the previous year from regional budgets. Meanwhile, primary expenditure dropped by about 36.0 percent in nominal terms compared to January-February 2015 when the government had heavily front-loaded spending on defense. As a result, primary expenditure declined even more than non-oil revenues: by 9.8 percent of GDP, from 24.9 percent of GDP to 15.1 percent of GDP, resulting in the non-oil deficit improving to 6.6 percent of GDP from 15.0 percent of GDP. The two top-spending categories in January–February were social spending (40.5 percent of primary expenditure) and defense (18.7 percent of primary expenditure).

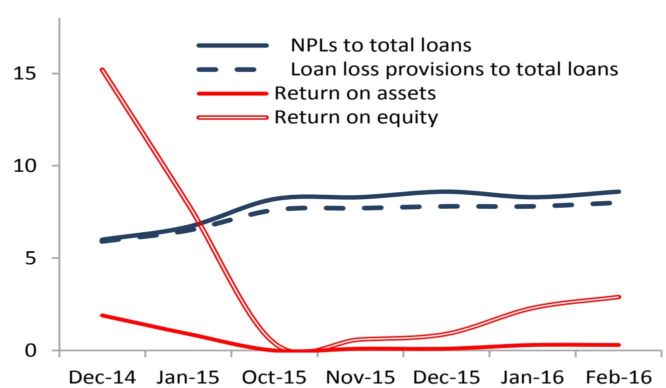
The government approved RUB150 billion (US$2.2 billion) to recapitalize the state-owned development corporation Vnesheconombank (VEB). VEB's assets amount to 9 percent of GDP and it might need RUB1.2 trillion in state aid to cope with bad loans and assets (particularly related to the 2014 Winter Olympics and Ukrainian enterprises), and to honor its debt obligations. In addition to the approved RUB150 billion government recapitalization financed by the federal budget (from the president's contingency fund), negotiations are currently ongoing for a possible buy-back of (also state-owned) Gazprom shares in the amount of US$1.3 billion.

Figure 5: Income dynamics improved (percent change, y-o-y) …



Source: Rosstat, Haver Analytics, World Bank team

Figure 6: Non-performing loans are increasing (percent)



Source: CBR

Please contact Birgit Hansl: bhansl@worldbank.org

Prepared by a World Bank team under the guidance of Birgit Hansl, consisting of John Baffes, Olga Emelyanova, Sergei Ulatov and Katya Levitanskaya.