Russia Monthly Economic Developments

October 2014

THE WORLD BANK
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- Economic sanctions against Russia remain in place, as the Ukraine peace plan is still not deemed fully effective.
- Growth in household consumption fell sharply in the second quarter and investment contracted further.
- Sluggish domestic demand and slowing external demand adversely affected industrial activity in July and August, while the positive effect from currency depreciation on import substitution tapered.
- Consumer prices accelerated in September as the ban on food imports and a depreciating Ruble pushed food prices up.
- Russia's external environment remains weaker than anticipated, with oil prices down more than ten percent since July.

On September 30, the European Commission decided to keep economic sanctions on Russia in place. The EU Committee of Permanent Representatives reviewed the implementation of the peace plan in Ukraine and decided to keep all sanctions in place as the peace deal was deemed not fully effective, though it was noted that there was progress since the agreed ceasefire of September 5.

On September 26, the Public Prosecutor's Office filed a lawsuit to confiscate the oil company assets from AFK Sistema owner Vladimir Evtushenkov. Already on September 16, Vladimir Evtushenkov was placed under house arrest on suspicion of money-laundering related to the alleged illegal privatization of six energy companies in the Republic of Bashkortostan. Bashneft was one of the six companies privatized by the son of the ex-president of Bashkortostan, Ural Rahimov. Currently Bashneft is one of the leading Russian companies in oil production.

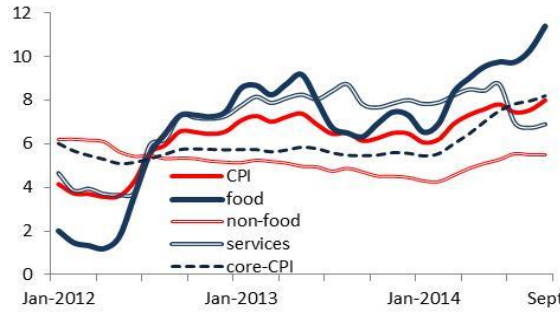
Rosstat left unchanged the growth figures for the first two quarters with surprises on the domestic demand side. Growth in household consumption plunged in Q2 to 0.8 percent year-on-year from 3.7 percent in Q1 and 4.4 percent in Q2 2013. It appears that consumers were impacted substantially by heightened geopolitical tensions, higher inflation, a depreciating Ruble and increased indebtedness. Investment demand continued to contract sharply, down 6.6 percent in Q2 2014, y-o-y, largely due to a deteriorating business sentiment, higher borrowing cost and restricted access to credits. Russia's growth is increasingly driven by the positive dynamics in net exports thanks to a sharp contraction of imports in Q2 by 7.7 percent y-o-y and stable if unimpressive export growth of 1.3 percent. The World Bank keeps its real GDP growth forecast for 2014 at 0.5 percent.

Industrial activity in August was adversely affected by slowing domestic demand while the positive effect of import substitution appears to be tapering. The recovery in industrial activity during the second quarter and July reversed in August. Industrial output was flat while manufacturing output contracted by 0.6 percent y-o-y. This negative trend is partly explained by slowing demand for Russian exports coupled with continued depressed domestic demand. However, the sharp contraction in the production of transportation equipment and vehicles by 9.1 percent y-o-y in August, compared to a 22.0 percent growth in July, was the main factor behind a decline in manufacturing. Few import substituting industries continued supporting growth in August, despite the depreciated Ruble and the food import ban: growth in agricultural decreased to 4.6 percent in August from 8.5 percent in July; food production expanded by 4.1 percent in August compared to 4.7 percent in July. On the demand side, the contraction in fixed capital investment accelerated to 2.7 percent in August from 2.0 percent in July. Retail trade marginally picked up by 1.4 percent in August compared to a 1.1 percent growth in July, yet still considerably below last year growth of 4.2 percent.

Figure 1: Economic activity is trending down …
(percent change, y-o-y)

Source: Rosstat, Haver Analytics, World Bank team

Figure 2: … while inflation is trending up
(percent, y-o-y)



Source: Rosstat, Haver Analytics, WB team

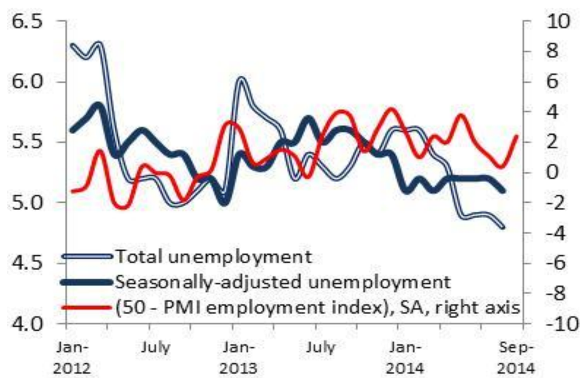
Consumer prices accelerated in September as the ban on food imports and the depreciating Ruble pushed food prices up. Twelve-month consumer price inflation rose to 8.0 percent in September from 7.6 percent in August with food prices up 11.1 percent y-o-y. Banned food items experienced the strongest prices increases: meat and poultry (16.8 percent, y-o-y), milk products (16.2 percent) and sea food (14.1 percent). The deprecating Ruble was another important factor behind elevated inflation pressures: 12-month core inflation rose in September to 8.2 percent from 8.0 percent in August. Given the estimated pass-through effects of depreciation in the range of 15-20 percent, the recent drop in the value of Ruble will continue exerting an upward inflation pressure. This puts CBR's revised inflation target for 2014 of 7 percent and for 2015 (in the range of 3-6 percent and a point target of 4.5 percent) at risk.

The Ruble continued to weaken in September and early October because of sharply falling oil prices – now below the level assumed in the 2014 budget – large external debt payments by Russian companies, and the firming of US monetary conditions. In September, the Ruble depreciated by 4.6 percent versus the US dollar after falling 4.1 percent in August. Against the dual currency basket, the Ruble lost 3.3 percent. First, substantial debt payments of Russian companies subject to restricted access to international capital markets occurred in September. Second, oil prices fell and third the US dollar appreciated—up almost 7 percent against a basket of major currencies since the beginning of July. Yet, the Ruble exceeded the upper bound of the bilateral currency technical corridor only on September 30. The amount of Central Bank intervention in September was small (US$4 million) and practically neutral for the international reserves. Reserves fell from US$465.3 billion at the end of August to US$454.2 at the end of September mainly due to the US dollar appreciation with respect to the Euro. In early October, the Ruble depreciated to a new record low with respect to the US dollar (39.98) and the dual currency basket (44.53) as the US dollar continued its appreciation against other currencies and oil prices slid further down. The Central Bank intervened in the foreign exchange market in the amount of US$1.4 billion; the bilateral currency corridor shifted up by 0.2 Rubles to 35.6–44.6.

Credit growth further slowed in August, but depositors continued returning to banks. Credit growth to firms remained stable in August edging down to 15.9 percent from 16.0 percent in July. At the same time, credit growth to households continued decelerating at a fast pace, to 16.8 percent from 18.7 percent in July (compared to 37.3 percent in August 2013). According to CBR, the share of non-performing loans (NPLs) by households further increased in July to 8.4 percent from 8.2 percent in June. This implies that banks had to increase provisioning which led to a further squeeze in their operational margins and may require additional capitalization. The return of depositors to banks continued in August (0.9 percent, m-o-m) as banks raised interest rates on deposits to keep real rates in positive territory. This inflow of deposits was just enough to keep the annual growth rate at 8.3 percent, compared to 22.4 percent a year earlier. The recent sharp depreciation of the Ruble might lead to another round of deposit decrease similar to March 2014 when banks lost 2.1 presents of their deposits. In addition to the weakening Ruble, accelerated inflation could also be a factor for households to divert part of their saving into buying tangible assets. CBR continued to clean up the banking system revoking licenses from seven banks in September. Most banks were relatively small and participated in the deposit insurance scheme.

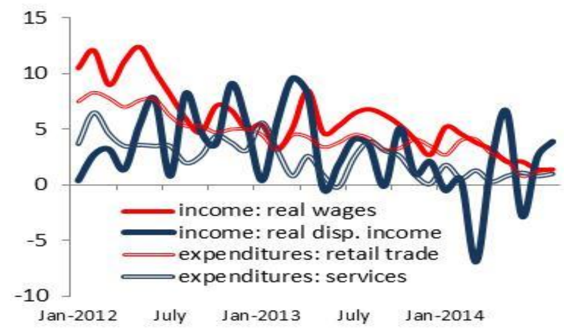
The federal budget reported a sizable surplus in the first eight months of the year, supported by increased oil revenue and conservative expenditure execution. In January-August 2014 the federal budget surplus increased to 2.0 percent of GDP from 1.1 percent in January-August 2013, far exceeding the amended 2014 target of 0.4 percent. Increased oil revenue (by 0.6 percentage points to 10.6 percent of GDP) as a result of the depreciated Ruble and higher than projected oil prices was the key factor behind this improvement. Overall revenue rose to 20.6 percent of GDP from 20.1 percent limited by the marginal reduction in non-oil revenue to 9.9 percent in January-August this year from 10.1 percent a year earlier. A more conservative execution of expenditure this year–18.6 percent in January-August 2014 versus 19.1 percent in January-August 2013–was another factor contributing to improved surpluses. The expenditure breakdown for the first eight months of 2014 indicates that federal spending was cut for social policy (by 1.0 percent of GDP), education (by 0.2 percent) and national security (by 0.1 percent). Yet they grew for defense (by 0.5 percent), the national economy and intergovernmental fiscal transfers (by 0.1 percent). The non-oil deficit decreased marginally by 0.2 percentage points to 8.7 percent of GDP.

Figure 3: Russia's unemployment rate is near record lows …



Source: Rosstat, Haver Analytics, World Bank team

Figure 4: … while real wage growth is stagnating



Source: Rosstat, Haver Analytics, World Bank team

On September 30, 2014 the draft law *On the Federal Budget for 2015 and Planning Period 2016-2017* was submitted to the Duma, the lower House of Parliament. The proposed budget envisages the federal fiscal deficit to remain little changed at 0.6 percent of GDP in 2015-2017. Revenues are projected to remain stable at 19.5 percent of GDP in 2015, and then drop to 19.0 percent in 2016 and 18.4 percent in 2017. Oil revenue is projected to amount to 10.0 percent of GDP in 2014 and 2015 before declining to 9.1 percent in 2017, while non-oil revenue is assumed to remain at 9.3 percent in 2014-2017. To support the oil sector, the government plans to alter its revenue structure. It proposes changes over a three-year period which include the reduction of export duties on oil and oil products (including special tax rates for a number of oil fields in Siberia) and a decrease in excises on oil products, with a simultaneous increase in mineral extraction tax rates for oil and gas-condensate. Expenditure is projected to rise from 19.2 percent of GDP in 2014 to 20.0 percent in 2015, driven by a 0.8 percent increase in defense spending. Yet the discontinuation of the annual indexation of salaries for a wide range of civil servants will help to gradually bring the expenditure level down to 19.6 percent in 2016 and 19.0 percent in 2017. The non-oil deficit is projected to increase from 9.9 percent of GDP in 2014 to 10.5 percent in 2015, and is expected to decline to 10.2 percent in 2016 and 9.7 percent in 2017.

In September, the Ministry of Finance conducted its first auction of OFZ -- Ruble-denominated fixed-coupon bonds – since July. On September 24 and October 1, the Ministry of Finance returned to the domestic debt market after a long pause placing bonds for RUB10 billion in each auction with residual maturity of 8.9 years and 13.7 years respectively at an average weighted yield 9.37 and 9.44 percent.

Figure 5: The global economic recovery is weaker than expected…

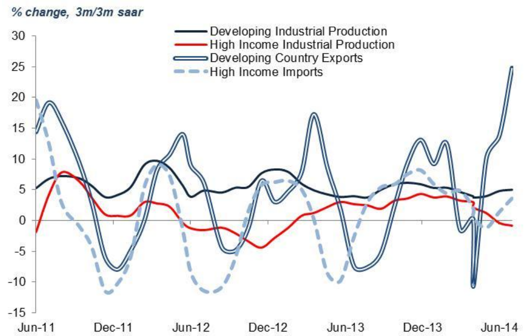
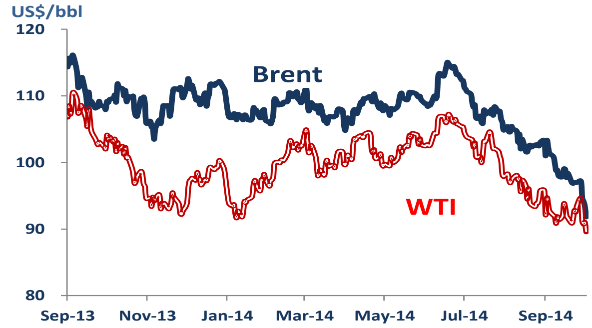


Figure 6: … with crude oil prices trending down



Source: Bloomberg

Russia's external environment remains weaker than anticipated and global growth estimates for 2014 have been revised further down. The World Bank now projects global growth of 2.6 percent this year, little changed from 2013. A robust recovery in the US is contrasted to signs of persistent stagnation in the Euro Area, Japan, parts of Latin America and emerging Europe.

Oil prices have fallen since July. Brent prices fell to US$92/bbl in early October, a 2-year low, after remaining broadly unchanged at about $105 during the first half of 2014. Several factors account for this decline. First, there is an ongoing surge in the value of the US dollar. Second, increased US oil output, which is expected to exceed its 1972 levels by next year, has more than matched oil supply declines elsewhere. Third, OPEC's output has increased, due to high production levels by some of its members, including Iraq, Libya and Nigeria. Lastly, weak economic data in some large emerging economies have curtailed oil demand. Oil prices are likely to remain weak under current projections for the global economy, unless OPEC takes action.

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