Russia Monthly Economic Developments

September 2014

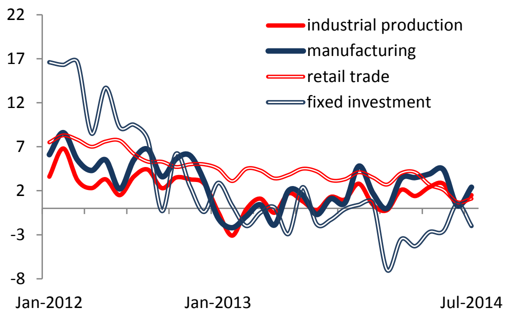
- On September 12, the EU and the US introduced new sanctions against Russia's financial, defense and energy sectors.
- The economy escaped recession, but economic activity is stagnating. We maintain our 0.5 percent growth forecast for 2014.
- Exchange rate depreciation resumed in August, pushing the Ruble to a record low.
- Higher food prices and Ruble depreciation elevated consumer prices inflation in August.
- Prospects for Russia's external environment remain subdued after a good second quarter. Oil prices have weakened.

On September 12, EU governments and the US adopted new sanctions against Russia. The sanctions restrict access to European capital markets for three major state-owned oil companies: Gazpromneft, Transneft, and Rosneft, preventing them from raising funds of maturity longer than 30 days. Three major defenses companies (Oboronprom, United Aircraft Corporation and Uralvagonzavod) will also be banned from future fundraising on EU markets. The US introduced a new set of sanctions the same day. In the financial sector it extending the access restrictions to the US capital market for Gazpromneft, Transneft and Sberbank and tightened the debt financing restrictions to five sanctioned banks by reducing the maturity period for new debt issued by these banks from 90 to 30 days. In the defense sector, the US cut access to financing exceeding 30 days maturity to Rostec, a Russian defense conglomerate and added five new companies to the list of sanctioned defense sector entities by blocking their assets. In the energy sector, it imposed sanctions that prohibit the export of goods and services (not including financial services), or technology in support of potential oil exploration or production for Russia's deepwater, Arctic offshore, or shale projects to five companies: Gazprom, Gazprom Neft, Lukoil, Surgutneftegas, and Rosneft.

Growth slowed in the first half of this year as weak business and consumer confidence combined with continued structural weakness weighed heavily on economic activities. The economy escaped recession, but seasonally adjusted quarterly growth number showed stagnating economic activities. Compared to a year ago, growth changed little at 0.9 percent in the first quarter and 0.8 percent in the second quarter. The GDP breakdown on the production side for the second quarter indicates deteriorating growth in the non-tradable sector and recovery in tradable manufacturing industries. The World Bank growth forecast for 2014 remains at 0.5 percent.

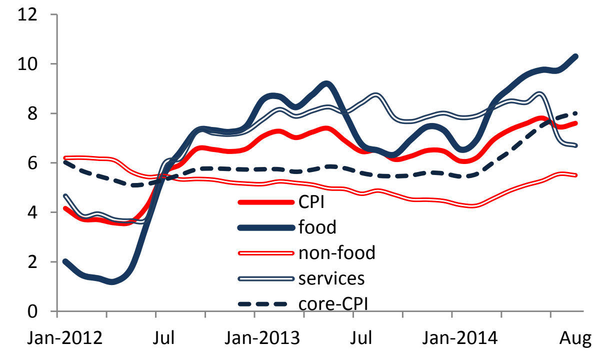
High-frequency statistics for July and August confirm sluggish domestic demand and some positive effect of import substitution in food production. A positive impulse to manufacturing came from the weak Ruble and some import substitution, especially in the food production sector. In July, industrial production registered growth at 1.5 percent (y-o-y), but slid back to zero growth in August. Manufacturing accelerated to 2.4 percent growth in July, but contracted in August by 0.6 percent, mainly due to weak demand for transportation vehicles. Business confidence surveys suggested that manufacturing might retain its expansion path with the seasonally adjusted HSBC Manufacturing PMI at 51 (above the 50 threshold) for two consecutive months. The agricultural sector benefited from favorable weather conditions and some import substitution, expanding 8.5 percent in July compared to 5.4 percent in July 2013. However, on the domestic demand side, weaknesses persisted: demand for non-tradable market services was constrained in July by slowing income growth, accelerating inflation and increasing household debt burdens. Retail trade growth, somewhat recovered in July to 1.1 percent (compared to 0.7 percent in June), but was considerably lower than a year ago (4.5 percent). Transportation and communication services also saw decelerating demand in July 2014. After a feeble recovery in June, investment demand slipped in July back into negative territory with fixed capital investment registering a contraction of 2.0 percent (y-o-y).

Figure 1: Russia's high frequency indicators, percent change, y-o-y



Source: Rosstat, Haver Analytics, World Bank team

Figure 2: Russia's CPI by components, percent, y-o-y



Source: Rosstat, Haver Analytics, WB team

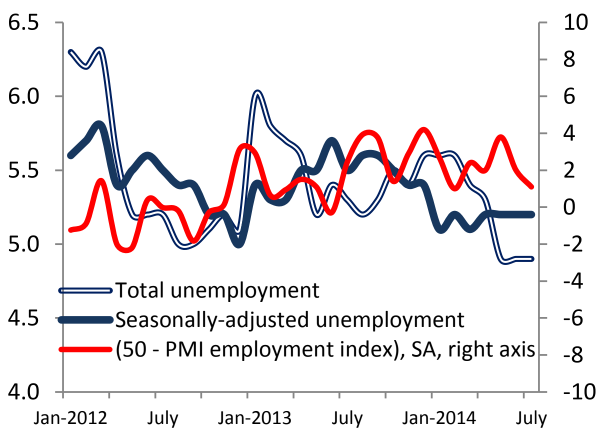
Inflation pressure remains elevated with core inflation accelerating to 8.0 percent y-o-y in August. By end-August, the 12-month Consumer Price Index increased to 7.6 percent from 7.5 percent in July. An elevated inflation pressure is also evident in stubbornly high core inflation. We believe, the ban on imports of food products from Europe and the US was the main cause for elevated inflation expectations. The usual seasonal deceleration in food prices did not happen. As a result food prices accelerated to 10.3 percent in August (y-o-y) and continued to push the headline inflation up despite seasonal declines in fruit and vegetable prices. Given the importance of imported goods in the consumption basket, the ban on food imports could continue adding to inflation pressures in coming months. The authorities already raised concerns about price surges and articulated potential measures to restrict speculative increases in food prices.

The exchange rate weakened in August as political risks increased. The pressure on the Ruble resumed in August as a result of heightened geopolitical tension and new rounds of sanctions. Volatility on the market especially increased at the end of the month after the military confrontation in the Eastern Ukraine had intensified. In August, the Ruble depreciated by 3.3 percent against the US$ and by 2.4 percent versus the bilateral currency basket from its end-July levels and broke historical maximums on September 15 (reaching Ruble/US$37.99). Yet, despite increased exchange rate volatility, the Central Bank of Russia (CBR) refrained from interventions on the market since the Ruble was traded within the targeted currency band. Therefore the impact on CBR's foreign currency reserves was neutral—reserves stood at US$465.2 billion at the end of August compared to US$468.8 billion at the end of July. Moreover, CBR further relaxed intervention rules in mid-August reiterating its commitment to finalizing the move to inflation targeting by the end of 2014. The following policy changes were introduced: (1) the corridor for the bilateral currency basket was expanded from RUB7 to RUB9, the first expansion since mid-2012; (2) CBR will no longer conduct interventions when the exchange rate is within the corridor, and (3) the amount of accumulated interventions required to make a 5 kopek shift in the corridor has been lowered from $1bn to $350mn, back to the amount seen in the beginning of the year, before the Russia-Ukraine crisis.

Credit growth slowed in July while CBR continued delicensing of financially non-viable banks. Financial statistics for the first seven months of 2014 show a continued decrease in credit activity, largely explained by a substantial slowing in the growth of credit to households. Fundamental factors, such as high levels of household indebtedness, slowing income growth and an increasing number of bad loans, restrict banks' lending to households. As a result, credit growth to households slowed to 19.7 percent in July 2014, compared to 32.6 percent in December 2013. Credit growth to firms edged up to 16.0 percent in July from 15.7 percent in June. This slowdown relates in part to the increased cost of credit following CBR's tightening in March and April. Temporary subsiding geopolitical tension, a stronger Ruble and increased interest rates on individual accounts returned some depositor to banks in June and July. Yet, the rate of growth for individual depositor shows erosion in the depositors' base—slowing to 8.3 percent (y-o-y)—compared to 21.0 percent in December 2013. The share of non-performing loans (NPLs) by households rose in June to 8.2 percent from 6.5 percent at the end of 2013 as households find it increasingly difficult to service debt in an environment of slowing income growth and low debt-rollover potential. CBR continued to clean up the banking system with the goal of maintaining the overall quality of the credit portfolio, revoking licenses from eight banks in August. Most banks were relatively small and participated in the deposit insurance scheme.

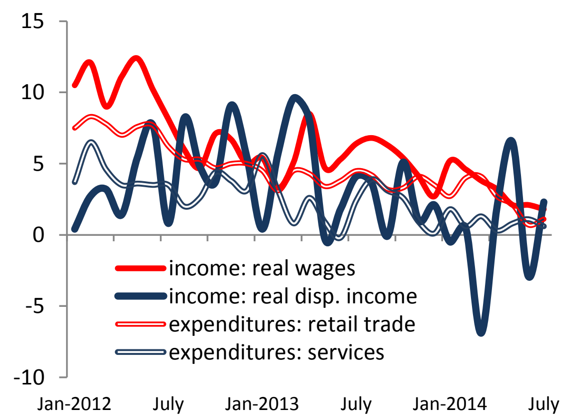
The federal budget remained in surplus during January-July 2014, supported by the depreciating Ruble and favorable oil prices. The federal budget surplus increased to 1.7 percent of GDP in January-July 2014 compared to 0.6 percent in January-July 2013, exceeding the originally planned (0.5 percent of GDP deficit) and amended (0.4 percent surplus) budget targets for 2014. Total federal budget revenue rose to 20.4 percent of GDP from 19.8 percent a year ago. Oil revenues increased to 10.7 percent of GDP from 9.8 percent over the same period a year ago, compensating for the slight decline in non-oil revenue (to 9.7 percent from 10.0 percent a year ago), which reflects the impact of the economic slowdown. The improved budget balances also reflect tight control of expenditure execution: federal budget expenditure decreased to 18.8 percent of GDP in January-July 2014 from 19.1 percent over the same period a year ago. On a year-to-year basis, federal expenditures decreased most for social policy (by 0.9 percent of GDP), but increased for defense (by 0.6 percent of GDP). As a result the non-oil deficit decreased by end-July marginally by 0.2 percent of GDP to 9.0 percent.

Figure 3: Russia's unemployment rate, percent



Source: Rosstat, Haver Analytics, World Bank team

Figure 4: Russia's real growth rates of consumer incomes and expenditures, percent change, y-o-y



Source: Rosstat, Haver Analytics, World Bank team

The government replenished the Reserve Fund and altered investment decisions for the National Welfare Fund. The Reserve Fund increased by more than US$6 billion, reaching US$91.7 billion or 4.7 percent of GDP by September 1, 2014. The transferred amount represents higher than originally budgeted oil revenue accrued to the federal budget in 2013. A new government resolution from August 22 allows the National Welfare Fund (NWF) to invest the amount of 239 billion Rubles into privileged stock of two sanctioned Russian banks: Vneshtorgbank (VTB) and Rosselkhozbank (in a mutual settlement for subordinated loans given to those banks and their affiliates during 2009 crisis). There are discussions to expand the NWF investment into banks' stock to several other banks which received subordinated loans back in 2009 and which currently suffer from sanctions (e.g. Gazprombank). Companies from the sanctions list such as Rosneft (Russia's state-oil company) presented applications for support from the NWF in the amount of 1.5 trillion Rubles, claiming almost half of NWF, and it is understood that more firms are lobbying for NWF resources.

The Ministry of Finance continued to refrain from borrowing money on the domestic market due to unfavorable market conditions. It cancelled all its scheduled OFZ bond auctions in August and until now in September. The last auction took place on July 16.

Figure 5: Global economic activity, percentage growth, 3m/3m, saar

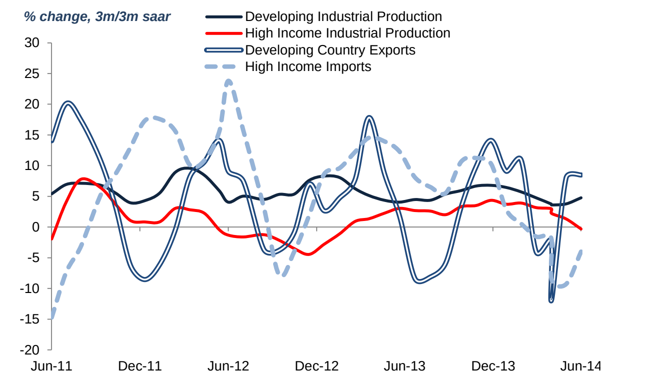
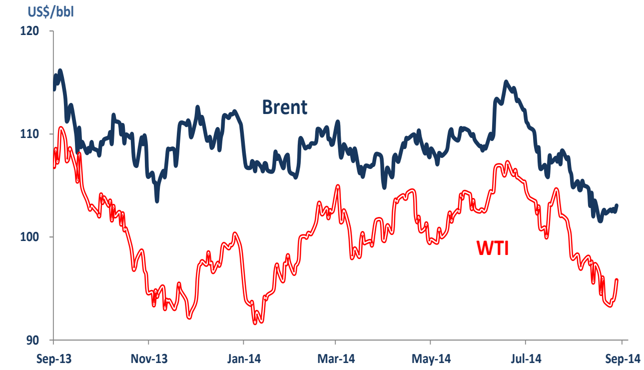


Figure 6: Crude oil prices $/barrel



Source: Bloombnerg

Russia's external environment saw improved growth in the second quarter in some countries, but prospects for the rest of the year are subdued. Global growth picked up in the second quarter, despite weak growth in Euro Area and Japan. Activity rebounded in the US to 4.2 percent (q/q saar) from a sharp 2.1 percent contraction in Q1, supported by rising employment, firming confidence, and stronger investment growth. In developing countries, growth also rebounded in Q2, supported by firming import demand and capital flows from high-income countries. China's Q2 GDP growth was broadly steady at 7.5 percent (year-on-year) supported by a rebound in exports and earlier stimulus measures. However, in the Euro Area, Q2 GDP growth was a disappointing 0.2 percent (down from 1.1 percent in Q1), held back by the continued weakness in France and Italy since the beginning of the year and a contraction in Germany (down 0.2 percent in Q2 from growth of 0.8 percent in Q1). In Japan, GDP growth contracted by 6.8 percent in the second quarter, as a result of the 3 percentage-point sales tax hike in April, offsetting strong first quarter growth (6.1 percent). The Organization for Economic Cooperation and Development cut on September 15 its 2014 economic growth forecasts for the US and other large developed economies, but left China's growth forecast unchanged. It cited inadequate recovery from the crisis, slowing potential growth and persisting external balances and threats to financial stability as reasons for their subdued outlook.

After several months of robust inflows, gross capital flows to developing countries slowed sharply in August. Emerging markets are estimated to have received significantly smaller portfolio inflows in August (currently available rough estimates indicate somewhere around $17 billion, down by 40 percent from $28 billion from the same time last year). Syndicated bank lending led the slowdown, based on the currently available estimates. This slowdown could signal weaker appetite for risk and greater selectivity toward emerging market assets amid rising geopolitical risk and stronger signs of accelerating recovery and hence the normalization of monetary policy in the US.

Following a short-lived surge in mid-June, oil prices weakened. Brent prices, the international marker of oil, declined to almost $100/bbl by the beginning of September. WTI, the mid-continent U.S. indicator, followed a similar pattern—it declined to $94/bbl in late August, down from $105/bbl in mid-June. Neither the Iraq crisis nor the Russia-Ukraine conflict affected the market in any significant way.

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