Russia Monthly Economic Developments

April 2015

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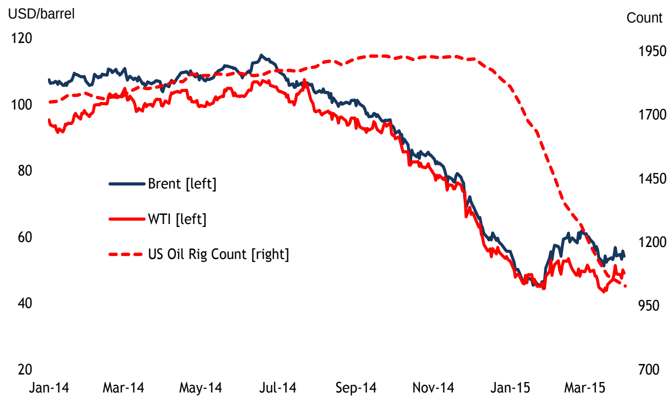
- Russia's recession deepened in February - indicators show a broad-based decline in economic activity and increased credit risk.
- Crude oil prices averaged in March US$52.8 per barrel−a drop of 3.5 percent compared to February.
- The Ruble appreciated by 6.9 percent against the US dollar, reflecting improved external balances and subsiding geopolitical tension.
- Inflation increased to 16.9 percent in March−a 13-year high, yet the Central Bank of Russia cut its key rates to support growth.
- Poverty increased during the fourth quarter of 2014; the unemployment rate reached 5.8 percent in February−the highest level in the past two years, and real wages contracted.

Russia's recession deepened in February as high frequency indicators show a broad-based decline in economic activity. Industrial production slipped into negative territory, contracting by 1.6 percent, y-o-y, compared to 0.9 percent growth in January. Aggregate manufacturing output decreased by 2.8 percent in February, y-o-y, after reporting flat output in January. Major manufacturing industries, which mostly target domestic markets, reported deep contractions as a result of depressed domestic demand: machine building by 12.8 percent, y-o-y; transportation by 22.4 percent; and light industries by 19.3 percent. However, some export-oriented industries continued to benefit from the weak Ruble: chemical production grew by 5.8 percent, y-o-y; wood processing by 4.0 percent; and production of coke and oil products by 3.3 percent. Also, food processing continued a robust expansion in February at 4.6 percent. Investment demand deteriorated further: fixed investment dropped by 6.5 percent in February, y-o-y, on top of a 4.5 contraction in February 2014. High inflation and high cost of credit further eroded consumer demand. As a result, retail trade plummeted by 7.7 percent in February, y-o-y, after a 4.5 percent contraction in January.

In February, banking sector indicators continued to deteriorate while credit activity further slowed. Russia's banks carried on to rebalance their portfolio to reflect higher funding costs and increased credit risks. As a result, credit growth slowed to 22.6 percent growth in February, y-o-y, from 29.6 percent in January. In part, this slowdown can be explained by the re-evaluation effect of the stronger ruble on credits extended in foreign currency. However, the stock of ruble credit contracted for the third consecutive month in February by 1.2 percent, m-o-m, due to high cost of new credits and greater risk aversion by banks. Although the central bank statistics on overdue loans does not fully reflect the size of non-performing loans (NPLs) due to the classification and regulatory forbearance (introduced in December 2014), the February trend suggests a further increase in credit risk: the share of NPL's on consumer credits increased to 6.6 percent from 6.3 percent in January (compared to 4.9 percent in February 2014). The share of NPL's on credits extended to entrepreneurs increased to 9.6 percent from 8.8 percent in January (compared to 5.6 percent in February 2014). This implies that banks had to increase provisioning for NPL's, which is likely to have negatively impacted bank's liquidity, profit margins and capital adequacy. As a result, the number of loss-making banks almost doubled to 249 in February from 126 at the end of 2014. The banking sector ended February with aggregate annual losses of RUB35.8 billion, compared to profits of RUB590 billion in December and about RUB1 trillion a year ago. In March and the first week of April, the CBR revoked the licenses from four banks, while in 15 banks continued procedures to prevent bankruptcies.

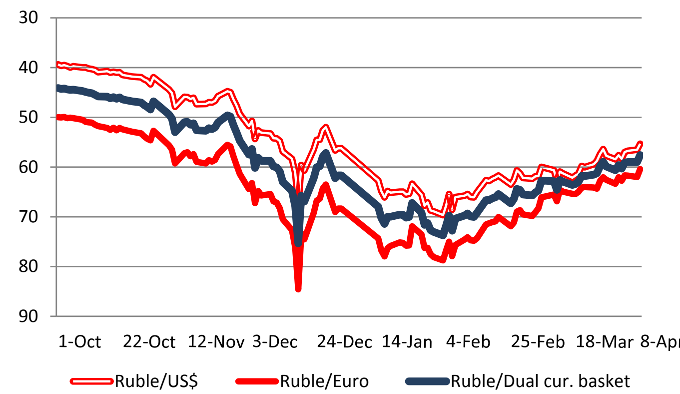
Crude oil prices averaged in March US$52.8 per barrel−a drop of 3.5 percent compared to February. Geopolitical tensions in Yemen and post-election issues in Nigeria briefly pushed up prices in March. However, there are signs for a further accumulation of inventories which are already at record high: U.S. production growth was resilient—despite a nearly 50 percent drop in the U.S. rig count—and there was weak demand amid the refinery maintenance season. More importantly, the preliminary framework agreement towards lifting Iran's oil embargo at the beginning of April has added to the bearishness of the oil market. New Iranian crude exports are not likely to materialize for at least six months due to weak capacity, yet will play a key role in the longer term. The World Bank expects oil prices to average US$53 per barrel in 2015 and recover marginally to US$57 per barrel in 2016..

Figure 1: Crude oil prices were range bound in March …



Source: Bloomberg.

Figure 2: …yet the Ruble appreciated



Source: CBR

In March, the Ruble appreciated by 6.9 percent against the US dollar supported by improved external balances and subsiding geopolitical tension. The Ruble exchange rate was less sensitive to oil prices. Three factors contributed to this: first, the market continued pricing out the premium on geopolitical risk after the truce agreement in Ukraine in mid-February. Second, it appears that the foreign exchange repo facility by the Central Bank of Russia (CBR) provided excess foreign exchange liquidity which was converted into Ruble-denominated assets of higher return, suggesting that the repo rate is too low and further downward adjustments in the key policy rate are possible. Finally, the sharp fall in imports and a decline in net capital outflows (including the sale of foreign currency by population) improved external balances in favor of the Ruble. Going forward, pressure on capital accounts is likely to subside further given lower external debt payments by the private sector: US$21 billion in Q2, compared to US$36 billion in Q1. Additionally, the capital account could be supported by carry-trade inflows, relatively high returns on Ruble assets (compared to other emerging markets) and the decreased devaluation risk. Investors' perception of lower risk is reflected in the 5-year Credit Default Swaps spreads which dropped more than 200 basis points by end-March since their January 30 peak of 628 basis points.

Consumer price inflation increased in March, yet at a slower pace than in February. The 12-month Consumer Price Index (CPI) inflation edged up to 16.9 percent from 16.7 percent in February. Core inflation increased to 17.5 percent from 16.9 percent. It was increasing non-food inflation which pushed headline and core inflation up, increasing to 13.9 percent, y-o-y, from 13.1 percent in February. Meanwhile, food inflation decelerated in March to 23.1 percent from 23.3 percent in February. Monthly statistics show a continued inflation deceleration across all CPI components likely due to the weakening pass-through effect of the Ruble depreciation and rising downward pressure from weak consumer demand. On March 13, the CBR lowered its policy rates by another 100 basis points to 14 percent, citing downside risks to growth as the reason for its decision.

Labor market indicators weakened in February. The unemployment rate increased by 0.3 percentage points (0.5 percent in seasonally adjusted terms), m-o-m, reaching 5.8 percent in February–the highest level in the past two years. The HSBC PMI employment index slightly improved in March, but remained in negative territory. Real wages contracted by 9.9 percent, y-o-y, corresponding to a decline of 1.6 percent m-o-m seasonally adjusted. Real disposable income declined in February by 0.6 percent y-o-y, but grew by 4.4 percent, m-o-m, seasonally adjusted, partly due to the February pensions' indexation of 7.9 percent.

Rosstat released GDP growth estimates for the fourth quarter of 2014 and confirmed the annual growth rate at 0.6 percent. The revision of quarterly statistics verified that the 2014 growth was largely a result of the positive carry-over effect from the robust GDP expansion in the last two quarters of 2013 (0.4 and 0.5 percent respectively, q-o-q, sa); while growth momentum in all four quarters of 2014 was near zero. Rosstat has also revised the demand composition of GDP that shows even weaker consumption growth (0.9 versus 1.5 percent in the first estimate), lesser contraction in fixed investment (2.0 versus 2.5 percent) and export demand (0.1 versus 2.0 percent). The revision suggests that aggregate domestic demand in 2014 was weaker than previously estimated which is reflected in a deeper contraction of imports (7.9 versus 6.8 percent).

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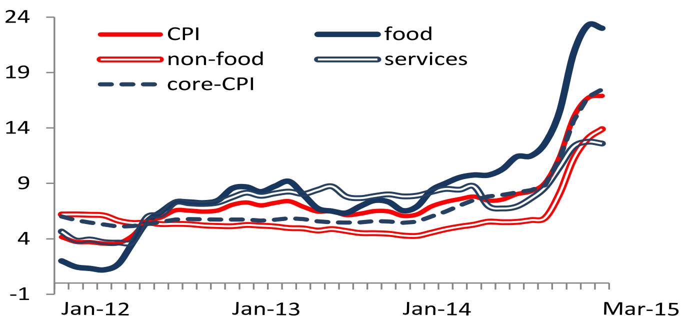
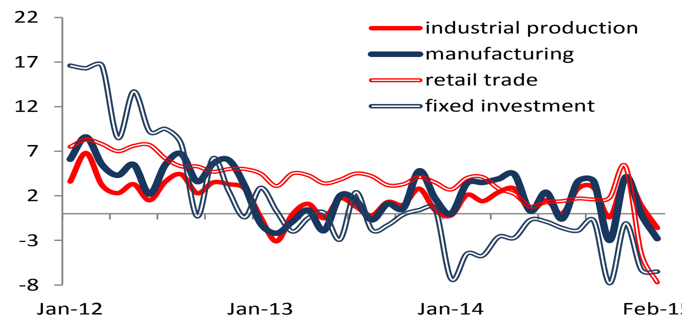
Figure 3: Non-food inflation increased … (percent, y-o-y)



Source: Rosstat, Haver Analytics, WB team

Figure 4: … economic activity weakened (percent change, y-o-y)



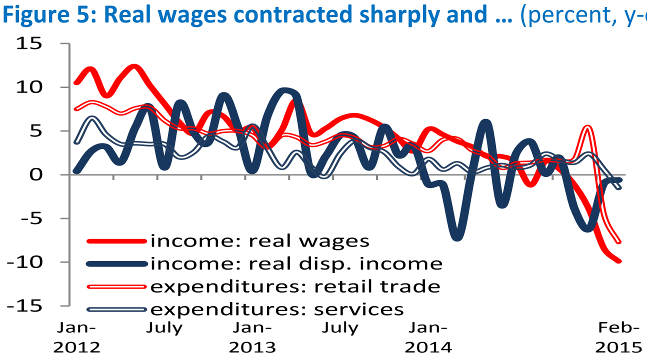
Source: Rosstat, Haver Analytics, World Bank team

Preliminary poverty statistics for 2014 shows an increase in the number of poor people compared to 2013 from 15.5 million (10.8 percent of the population) to 16.1 million people (11.2 percent of the population). The increase was mainly due to changes in the final quarter of 2014.

The federal budget deficit soared to 7.4 percent of GDP in the first two months of 2015 as oil revenue slumped and the government advanced military spending. In January–February 2015, federal budget revenue decreased to 21.9 percent of GDP compared to 23.1 percent of GDP a year ago (a 3.8 percent decrease in nominal terms). Oil revenue dropped by 1.9 percent of GDP to 10.1 percent of GDP in the first two months, but non-oil revenue increased by 0.8 percent of GDP to 11.9 percent of GDP, mainly supported by interest earned by the oil funds and VAT proceeds. Federal budget expenditure increased in the first two months to 29.3 percent of GDP from 22.0 percent of GDP over the same period last year due to higher military spending. In January–February 2015, military spending accounted for 43.2 of total federal budget expenditure as the government advanced spending in this category to about 40 percent of the budgeted amount for 2015. Expenditure for social policy increased by 1.2 percent of GDP and support for the economy increased by 0.6 percent of GDP y-o-y. The non-oil deficit soared to 17.5 percent of GDP in the first two months of 2015 compared to 11.0 percent of GDP during the same period last year. The federal budget deficit was mainly financed by selling US$7.8 billion (RUB500 billion) of foreign currency from the Reserve Fund in February.

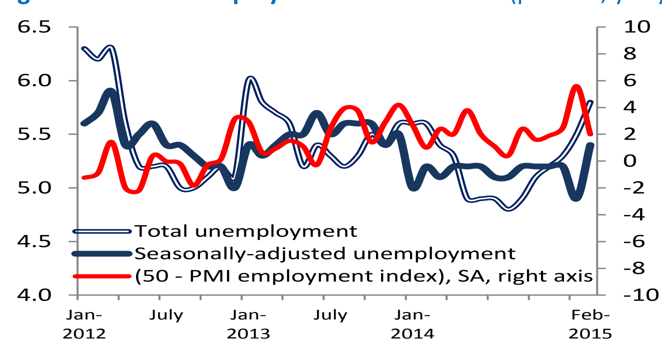
In March, the government continued investing National Welfare Fund resources to revive domestic demand. This means it commits an increasing share of Russia's second reserve fund to off-budget investments, in addition to dipping into the Reserve Fund to finance the rising budget deficit. In March, the government invested RUB50 billion into privileged stocks of Russian Railways for the modernization of the Baikal-Amur and Transsib Railway and RUB57.5 billion into privileged stocks of Atomenergo for building a nuclear station in Finland. The government also placed RUB26 billion into VTB deposit at 8 percent interest for Moscow's new Central Ring Road.

Figure 5: Real wages contracted sharply and … (percent, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

Figure 6: … the unemployment rate increased (percent, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

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