Russia Monthly Economic Developments

February 2015

- The World Bank crude oil price indicator averaged US$47 per barrel in January, a 6-year low.
- The Ruble continued weakening in the face of falling oil prices, increasing geopolitical tensions and a surprise cut in the key policy rate by the Central Bank of Russia.
- Driven by high food inflation and a strong pass-through effect of the Ruble devaluation, inflation surged in January.
- The World Bank revised its Russia growth forecast for 2015 to -3.8 percent with a projected oil price of US$53/bbl.
- Industrial activity and retail trade increased in December, as the Ruble devaluation facilitated import substitution and led to a spike in demand for tangible assets.
- On January 30, the government revealed an anti-crisis plan of RUB2.3 trillion.

The slide in crude oil prices persisted for a seventh month in a row as the OPEC stood firm on its November decision not to cut production. The World Bank crude oil price indicator averaged US$47 per barrel (bbl) in January 2015, a 6-year low. Yet the market recovered somewhat in early February to above 55/bbl. The WTI, the US mid-continent benchmark, also rallied for a few days, reflecting announcements of sharp cutbacks in investment plans by major oil companies and a production decrease by US oil rigs (of about 20 percent) in December. However, the US crude oil production is still growing at an annual rate of 1.1 million barrel per day due to a backlog of not yet completed wells, falling service costs, and efficiency gains. The price rally ended when US government data confirmed that the world's largest consumer expanded its crude stockpiles to the highest level since 1982, exceeding 410 million barrels, indicating that the crude oil glut is still in place. The World Bank projects oil prices to average US$53/bbl in 2015 and US$57/bbl in 2016.

The Ruble continued weakening in the face of falling oil prices, increasing geopolitical tension and a surprise cut in the key policy rate by the Central Bank of Russia (CBR). Government's measures and the CBR's December key policy rate hike of 750 bps helped to stabilize the Ruble. During the first three weeks of January, the exchange rate largely reacted to movements in the oil prices. The market's reaction to the S&P's January 25 downgrade of Russia's sovereign rating to below investment grade was short-lived and limited. Yet, pressure on the Ruble continued mounting as the tension in Eastern Ukraine escalated again and oil prices reached US$45/bbl. Subsequently, the market reaction to CBR's decision on January 30 to cut its policy rate by 200 bps was sharply negative and required the CBR to intervene with US$700 million to stabilize the Ruble. In January, the Ruble lost a further 18.4 percent of its value against the US$ and 15.6 percent against the dual currency basket.

Inflation surged in January, driven by high food inflation and a strong pass-through effect of the Ruble devaluation. The 12-month CPI headline inflation soared to 15.0 percent from 11.4 percent in December, with food inflation accelerated to 20.7 percent. A stronger pass-through effect of the January devaluation pushed up the monthly inflation for non-food prices to 3.2 percent, year-on-year, from 2.3 percent in December, and core inflation reached 14.7 percent, year-on-year, compared to 11.2 percent in December. In view of the still high inflationary pressures the CBR's policy rate cut appears to be premature.

The World Bank revised its Russia growth forecast for 2015 to -3.8 percent, based on a new oil price projection of US$53/bbl. This constitutes another downward revision after our December adjustment to -2.9 percent, which was based on an oil price of US$66/bbl. For 2016, we project a further contraction of 0.3 percent at a marginally higher average oil price of US$57/bbl. We assume in this forecast an even sharper contraction in consumption in 2015 than in our previous projection, as high inflation would diminish real wages and incomes. Investment growth would be negative due to low sentiments and high credit costs, but will be in the second half of 2015 somewhat supported by import substitution and government's anti-crisis measures. Net exports would strengthen, with the continued contraction in imports projected to more than offset sluggish external demand.

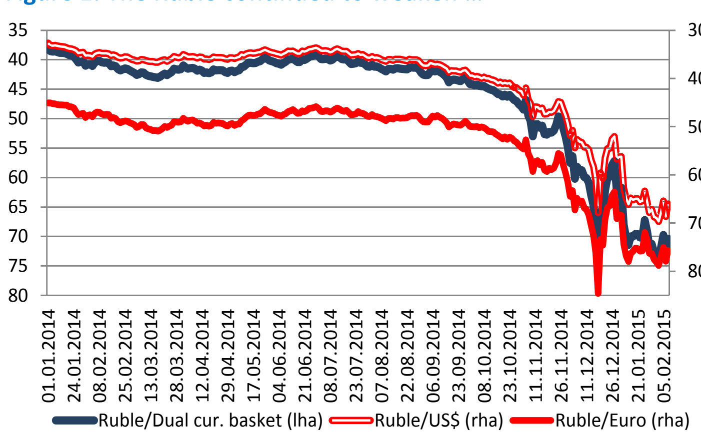
Rosstat's preliminary estimate for Russia's 2014 real GDP growth stands at 0.6 percent, compared to our forecast of 0.7. This decline in growth from 1.3 percent in 2013 was due to weaker domestic and external demand. Consumption remained the main growth driver, yet its pace of expansion slowed to 1.5 percent, compared to 3.9 percent in 2013. Depressed investment demand was reflected in the contraction of fixed capital investment by 2.5 percent, while companies continued destocking. Growth was supported by stronger net exports—6.8 percent lower imports due to the weaker Ruble more than compensated a 2.0 percent contraction in exports. Manufacturing and financial services were the main growth contributors on the production side (expanding at 2.5 percent and 9.6 percent).

The global economy struggled to gain momentum during 2014, as growth increasingly diverged among high-income economies and slowed on average among developing countries. In the US, above-trend growth and job creation are expected to carry over into 2015 and lead to growth of 3.2 percent—the strongest performance since 2005 and the first time since 1999 outpacing global growth. In the Euro Area, 2014 real GDP growth remained subdued, confidence continues to be low, and deflation risks are rising. In Japan, preliminary estimates indicate that GDP growth was just 0.2 percent in 2014, far below previous expectations. Global activity over the medium term should be supported by declining oil prices, but the positive effect will be offset in 2015 by sharp adjustments in oil-exporting economies (e.g., Russia and Venezuela) and persistent headwinds among larger net importers (e.g., Euro Area snf Japan).

Economic activity increased temporarily in December, as the Ruble devaluation facilitated import substitution and led to a spike in demand for tangible assets. Manufacturing growth reached in December 4.1 percent, year-on-year, (2.1 percent for the year) and as a result, aggregate industrial production expanded by 3.9 percent after a contraction of 0.4 percent in November. However, this is likely to be a short-lived development, given the observed deterioration in business sentiments. Rosstat's January survey points to a worsening in business conditions across all major manufacturing industries with the aggregate seasonally adjusted index falling to -7, the lowest level since the 2009 crisis. The survey suggests that weak domestic demand and growing policy uncertainty have become the two most important factors affecting investors' confidence. Already in December, investment activity was negatively impacted by those poor business sentiments and increased credit costs: fixed capital investment decreased by 2.4 percent, year-on-year (2.5 percent for the year). Strong demand for durables boosted retail trade which surged by 5.3 percent, year-on-year, compared to 1.8 percent in November despite a sharp fall in real wages and incomes by 4.7 percent and 7.3 percent respectively. This reflects the consumers' flight from the weakening Ruble in December by converting savings into tangibles.

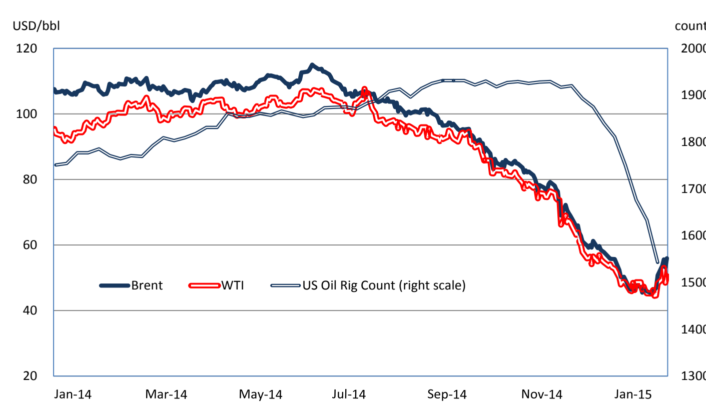
Russia's balance of payments deteriorated significantly in the fourth quarter of 2014, affected by a terms of trade shock and again accelerating capital outflows. Oil and gas export proceeds dropped by US$25.1 billion (-27.3 percent compared to the same period a year ago). This terms of trade shock was partly absorbed by a reduction of imports by US$24.3 billion (-19.3 percent compared to the same period a year ago) due to sharp depreciation of the Ruble. Net capital outflows surged in in the fourth quarter to US$59.5 billion, with cash currency purchases by the population comprising 30 percent of this outflow (US$18.2 billion). To balance the gap between the current and capital and financial accounts the CBR had to use US$50.8 billion of its reserves compared to US$21.8 in the entire year of 2013. For 2014, capital outflows in the amount of US$130.5 billion (7.0 percent of GDP) triggered the deterioration in the BoP and required the CBR to spend US$86.5 billion of its reserves, decreasing its reserve stock by 25.6 percent since the beginning of the year.

Figure 1: The Ruble continued to weaken …



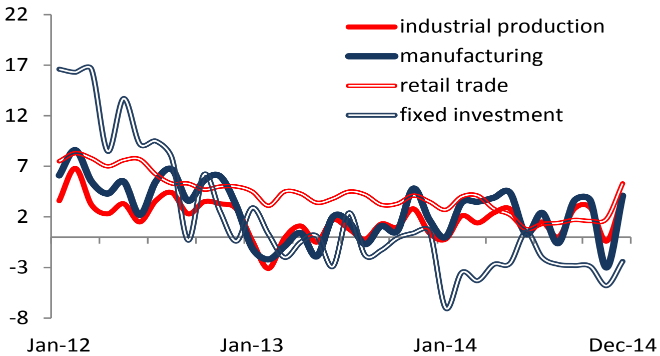
Source: CBR

Figure 2: … as crude oil prices retreat for 7 months in a row



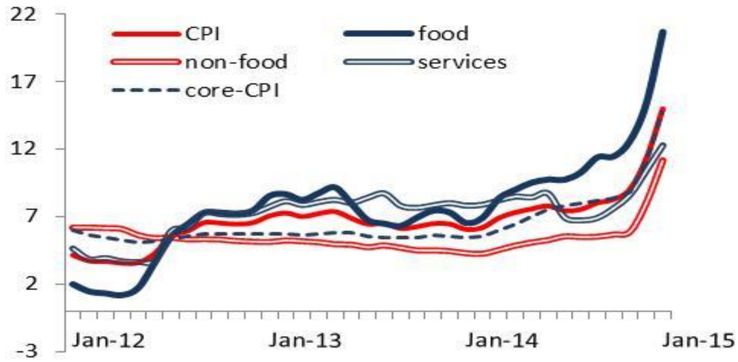
Source: Bloomberg.

Figure 3: Industrial activity was supported by the weak Ruble… (percent change, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

Figure 4: … while the weak Ruble also contributed to the surge in inflation (percent, y-o-y)

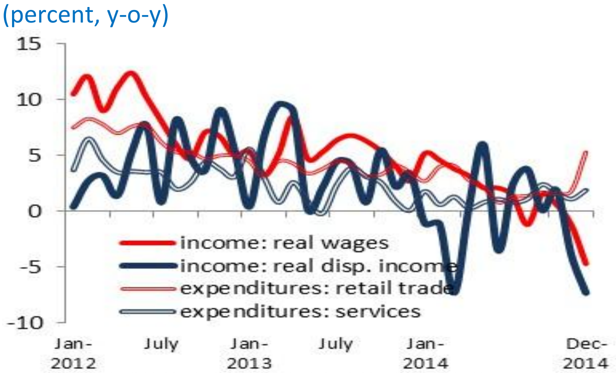


Source: Rosstat, Haver Analytics, WB team

The 2014 federal budget deficit was the result of the measures to support the economy, which saw the Ministry of Finance issue on December 30, 2014 RUB1 trillion in Treasury (OFZ) bonds to recapitalize the banking system. The Ministry of Finance published the preliminary estimate for the 2014 federal budget deficit at 0.5 percent of GDP, slightly higher than the planned 0.7 percent of GDP. The overall budget deficit remained at the same level compared with last year, as did the primary surplus of 0.1 percent of GDP. This was largely the result of the Ruble depreciation, which boosted oil revenues (to 10.5 percent of GDP from 9.9 percent of GDP) and led to an increase in total government revenues to 20.4 percent of GDP from 19.7 percent of GDP a year before. Expenditure increased by 0.7 percent of GDP to 20.9 percent of GDP as a result of the OFZ bond issuance on December 30, 2014 with the goal to recapitalize the banking system. Those bonds in the amount of RUB1 trillion (1.4 percent of GDP) were transferred to the Deposit Insurance Agency.

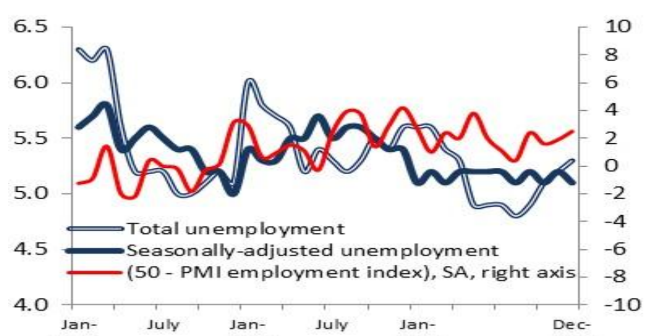
On January 30, the government revealed an anti-crisis plan in the amount of RUB2.3 trillion. It largely resembles the plan implemented during 2009 crisis and proposes 60 measures to support the economy. The bulk of this plan–RUB1 trillion—was earmarked for the recapitalization of banks through the issuance of Treasury (OFZ) bonds on December 30, 2014. Other substantial parts, financed from the National Welfare Fund, are planned to support financial sector stability: RUB250 billion will be used to recapitalize systemic banks and RUB300 billion for the refinancing of Vnesheconombank (Russia's State Corporation Bank for Development). Additional key measures include: state guarantees to large firms (RUB200 billion); pension indexation (RUB188 billion); labor market support measures (RUB52 billion), and support to the agriculture sector (RUB50 billion). The proposed measures are planned to be financed in large by the Reserve Fund while the anti-crisis program itself will have limited implications for the 2015 budget.

Figure 5: Wages and incomes contracted sharply …
(percent, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

Figure 6: … but the labor market remained tight
(percent, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

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