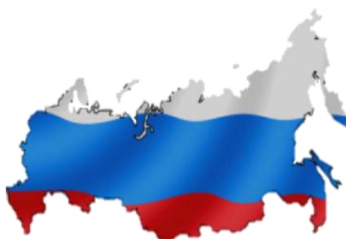
Russia Monthly Economic Developments

January 2015

- The retreat in crude oil prices continued in December and the first half of January with oil prices falling below US$50 per barrel for the first time since 2009.
- The continued downward adjustment in oil prices amplified the Russian currency crisis and the increasing risk to the financial sector, to which the authorities reacted with coordinated stabilization measures.
- Inflation soared into the double digits at the end of 2014 despite the CBR's tightening.
- The 2014 federal budget is expected to be in deficit due to measures to recapitalize Russia's banking sector.
- The World Bank further lowered its 2015 growth projection for Russia to -2.9 percent from -1.5 percent.



The retreat in crude oil prices continued in December and in the first half of January with oil prices falling below US$50 per barrel for the first time since 2009. The oil market is searching for a new equilibrium price in the ongoing competition for market share between OPEC and non-OPEC producers, more so since OPEC's decision not to cut oil output at its November 27 meeting. Brent (the international marker) was trading at around US$46 per barrel (bbl) on January 12, having dropped by as much as US$69/bbl (60 percent) over the last six months from above US$115/bbl. Non-OPEC supply, particularly US output, continues to grow and oil production in Iraq and Russia surged to the highest level in decades. Russian oil production rose in December to a post-Soviet record of 10.67 million barrels per day (bpd), while Iraq exported the highest volume since the 1980s at 2.94 million bpd. On the demand side, only the US market has shown some signs of improvement and the global oil market is expected to return to a new balance only later in 2015.

The continued downward adjustment in oil prices amplified the Russian currency crisis. In 2014, the Ruble lost about 46 percent of its value versus the US$ and 38 percent versus the dual currency basket while the Central Bank of Russia (CBR) spent about US$87.8 billion of its foreign currency reserves to support the Ruble. As a result, the reserves fell to US$388 billion at the end of 2014, which include the balances of the two sovereign wealth funds managed by the CBR (the Reserve Fund with a balance of US$88 billion and the National Welfare Fund with a balance of US$78 billion). In December, pressure on the Ruble had continued, forcing the CBR to resume interventions in support of the free-floating currency with US$10.3 billion during the first half of the month. On December 16, the CBR hiked its key policy rates for the sixth time in 2014, by 650 basis points to 17 percent. This resulted in a cumulative increase of 1,150 basis points in 2014. However, the Ruble continued to devalue, adversely impacted by falling oil prices and financial sector sanctions which contributed to a foreign exchange liquidity crunch. Constrained access to external financing led to the hoarding of foreign currency by Russian banks and corporations in order to be able to service large external debt payments of about US$35 billion due in December. The loss of CBR's reserves, the limited debt rollover capacity of the Russia's banking and corporate sector, high interest rates and rising fiscal pressures prompted Fitch's downgrade of Russia's sovereign rating to BBB- (one notch above junk) on January 10. S&P placed Russia's sovereign rating on watch, suggesting a potential downgrade to below investment grade in the next 90 days. The market perception of increased risk is also reflected in Russia's 5-years CDS spreads which rose to 577 basis points on January 9, 2015 compared to 164 basis points a year ago.

The banking sector saw a further deterioration in its depositors' base in light of recent interest rate hikes. Funding costs for Russian banks increased sharply: money market rates for 3-6 months loans rose above 23 percent compared to about 13 percent before the CBR's rates hike in mid-December. The continuing Ruble weakness and exchange rate volatility also dented the confidence in the local currency and put a drain on deposits. To retain depositors, banks sharply increased interest rates on deposits which also led to a rise in their liability costs and further squeezed interest rate margins. Banks—in particular second tier banks—may face increasing balance sheet problems with capital adequacy falling. On December 22, the CBR announced that the National Trust Bank, which was in the top-30 by assets, was set for a bailout in the amount of RUB127 billion to be executed by the Deposit Insurance Agency and bank Otkrytie. In 2014, the CBR stopped the operations of 70 banks.

The developments on the exchange rate market and in the financial sector prompted the authorities to implement coordinated stabilization measures. The Ministry of Finance

started the sale of foreign currency in the second half of December and the CBR introduced new 28 and 365 days foreign currency loans to banks with a capital over RUB 100 billion (for which 11 largest banks qualify). The government also ordered five major state-owned exporters to reduce their net foreign assets by March 1, 2015 back to the level of October 1, 2014 with the schedule for sales of foreign currency by these companies to be agreed with the CBR. New measures were also introduced to enhance the stability in the banking sector: (i) the government approved a RUB1 trillion recapitalization plan for banks financed with domestic sovereign bonds (OFZ); (ii) the State Duma approved a bill allowing the government to place up to 10 percent of the National Wealth Fund on subordinate deposits and subordinate bonds of Russian banks.

The 2014 federal budget is expected to be in deficit due to measures to recapitalize Russia's banking sector. According to the latest estimates by the Ministry of Finance, the federal budget balance in 2014 will be at a 0.7 percent of GDP deficit as opposed to the previously estimated 0.4 percent of GDP surplus. This deterioration in the fiscal position is due to issuance of OFZ bonds in the amount of RUB1 trillion (1.4 percent of GDP) to recapitalize domestic banks. The government also plans to introduce a revision to the 2015 federal budget law, reflecting the sharp decline in oil prices and the projected contraction in Russia's GDP. The Ministry of Finance estimates that the federal budget deficit would widen in 2015 to around 2-3 percent of GDP from the 0.6 percent of GDP projected in the approved budget law. To bridge this fiscal gap, the government would need to use about 30 percent of the Reserve Fund or raise funds on the domestic and/or external capital markets.

Inflation soared to 11.4 percent in December from 9.1 percent in November—well above the CBR target of 7.5 percent—despite CBR's tightening. Inflation was driven largely by non-monetary factors: A stronger pass-through effect of the Ruble devaluation in December and consumers' flight from the Ruble led to an acceleration in non-food and service inflation which pushed core inflation at the end of December to 11.2 percent (from 8.4 percent in November). Also, in the aftermath of the food import restrictions introduced by Russia at the beginning of August, food inflation reached 15.4 percent in December, year-on-year.

The World Bank further lowered its 2015 growth projection for Russia to -2.9 percent from -1.5 percent. This downward revision is a result of two key factors. First, the assumption of oil prices changed to US$65.5 per barrel compared to US$ 70.0 per barrel. Lower oil prices will result in a shaper depreciation and thus higher inflation which would have an additional adverse impact on consumption growth. Second, the additional policy rates hike by CBR's to 17 percent in December from 10.5 percent assumed in the previous forecast would further increase borrowing costs for firms and consumers thus negatively impacting domestic demand.

High frequency indicators and business surveys for November 2014 show a weakening of economic activity in November and deteriorating investment demand. Aggregate industrial activity contracted by 0.4 percent in November after a robust growth in recent months. Manufacturing industries posted a contraction of 3.0 percent, year-on-year, compared to a 3.6 percent growth in October. This slowdown is partly driven by the deterioration in business sentiments, reflected in the HSBC Russia Manufacturing PMI which slid to 48.9 indicating a contraction. Increasing borrowing costs and weak sentiments led to a further decline in investment activities: the contraction in fixed capital investment deepened to 4.8 percent in November from 2.9 percent in October. On the consumption side, the currency crisis increased demand for durables, cars and real estate which supported activity in the retail and services sectors (1.8 percent, and 1.1 percent, year-on-year) despite rising inflation pressures and marginal growth in real wages.

Figure 1: The Russian currency crisis continues…

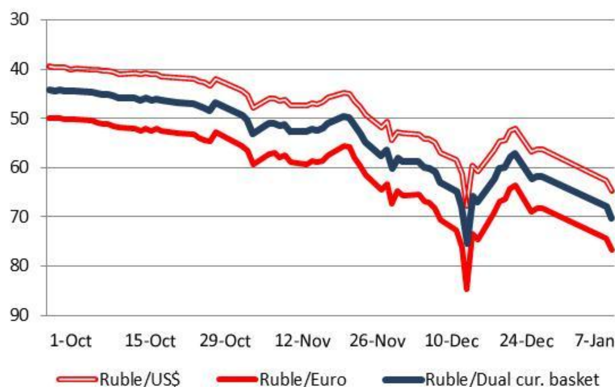


Figure 2: … as crude oil traded under US$50/bbl

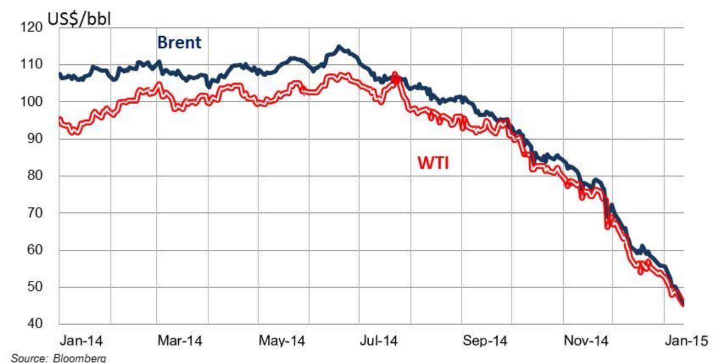


Figure 3: Industrial activity slowed and business sentiments weakened … (percent change, y-o-y)

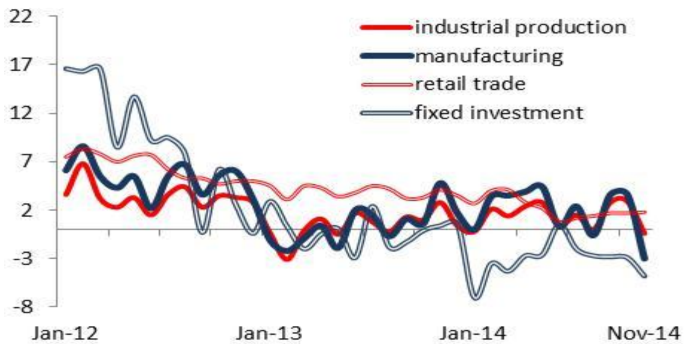
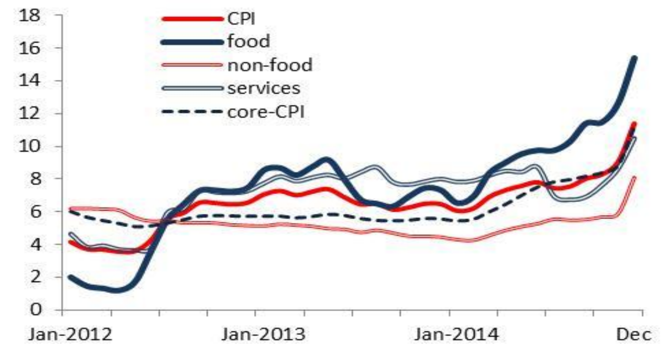


Figure 4: … while inflation soared into the double-digit numbers (percent, y-o-y)



External demand for Russia weakened as the global economy expanded during 2014 below trend. Overall, global growth is estimated to average 2.6 percent in 2014, almost unchanged from the slow pace seen in 2012 and 2013. Growth disappointments in 2014 were particularly significant in the Euro Area and Japan and among emerging markets in Russia and Brazil. At present, the global recovery relies heavily on robust growth in the US, whereas activity indicators in China continue to point to a gradual deceleration. Despite a broadening recovery, inflation expectation is falling, partly as a result of lower oil prices and the strengthening US dollar. The first hike in the US Federal Reserve's rate is expected by mid-2015, but the tightening is likely to be gradual due to subdued inflation expectations. Meanwhile, signs of persistent stagnation in the Euro Area and Japan led their respective central banks to commit to move to aggressive stimulus measures.

Unlike Russia, other emerging and developing countries continued to tap international bond markets at a record pace in 2014. The 10-year US Treasury yield—a key benchmark for international bond markets—is currently predicted to stay below 3 percent until 2018. Such low yield levels, despite a broadening recovery in the US and approaching tightening cycle by the Fed, are connected to falling inflation expectations and safe haven flows. Expectations of divergent policies across major central banks have triggered a broad-based appreciation of the US dollar (8 percent on a nominal effective exchange rate basis since early-June), and renewed pressure on some developing-country currencies, particularly in Eastern Europe (Hungary, Romania, Bulgaria) and some commodity exporting economies (Nigeria, Brazil, Colombia, Mexico). Emerging market bond spreads increased only modestly despite rising volatility on foreign exchange markets and higher risk aversion. Developing-country issuers (sovereign and corporates) and frontier-markets raised in 2014 record amounts from the international bond markets.

Figure 5: The global recovery is limping along …

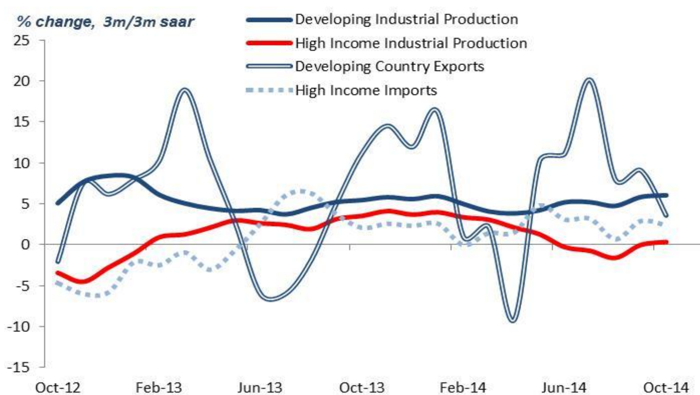
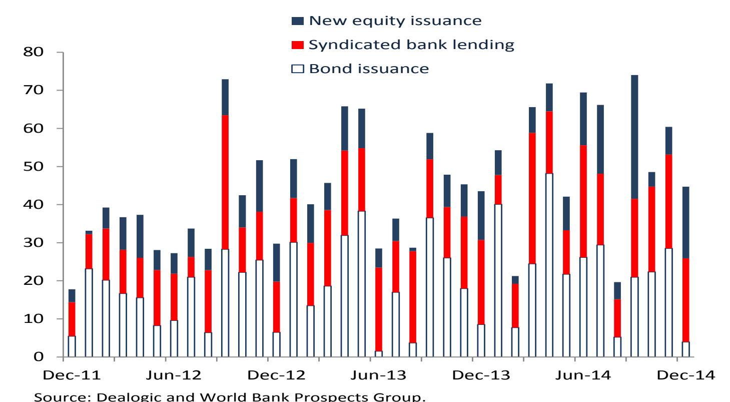


Figure 6: … but gross capital flows to developing countries remain strong (in US$ billion)



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