Russia Monthly Economic Developments

June 2015

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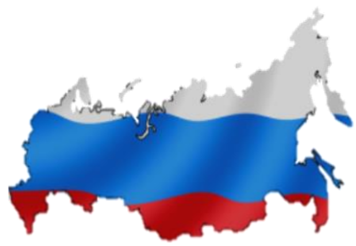
- The World Bank's new growth forecast for Russia projects the economy to contract in 2015 by -2.7 percent, before increasing by 0.7 percent in 2016, largely reflecting a stabilization in global oil prices.
- Russia's real GDP contracted in the first quarter slightly less than projected, but yet as expected, April's high-frequency statistic suggests that the recession is still set to deepen in the second quarter.
- Movements in the ruble exchange rate realigned with oil price trends by the end of May, reflecting effective CBR measures.
- In May, inflationary pressures continued to subside on account of weak consumer demand.
- Real wage contraction still accelerated in April amid somewhat weaker labor market indicators.

The World Bank's new growth forecast for Russia projects the economy to contract in 2015 by -2.7 percent, before increasing by 0.7 percent in 2016, largely reflecting a stabilization in global oil prices. This is a more optimistic scenario than the Bank's April outlook when real GDP was projected to contract by -3.8 percent in 2015 and by -0.3 percent in 2016. The new baseline scenario assumes an average oil price of US$58.0 per barrel for 2015 and of US$63.6 per barrel for 2016, a strengthened ruble exchange rate and lower inflation, which would allow the Central Bank of Russia (CBR) to pursue monetary easing at a more rapid pace. As a result of lower borrowing costs, lending to firms and households would increase, slightly lessening the previously projected contraction in investment and consumption growth.

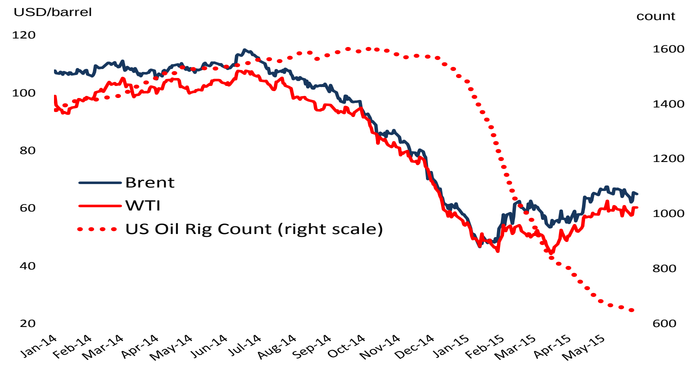


Oil prices were very stable during May averaging US$65 per barrel, and on June 5 OPEC left its production quotas unchanged as global supply remains abundant. In its semi-annual meeting OPEC left production quotas unchanged at 30 million barrel per day. Global oil production from non-OPEC countries is expected to reach 57.79 million barrel per day in 2015, up from 56.96 million barrel per day in 2014 (International Energy Agency, May Update). U.S. crude oil stocks were eight percent higher than a year ago and at historical heights despite a marginal decline at the end of May. Global oil prices could be subject to further supply pressures if a comprehensive agreement that results in the lifting of Iranian sanctions is reached by the end of June. On the demand side, global growth is projected to remain soft despite lower oil prices: growth is gathering momentum in the U.S., Japan and the Euro Area while slowing in China and remaining negative in Russia and Brazil.

Russia's real GDP shrank by 1.9 percent, year-on-year, in the first quarter, slightly less than projected, likely due to front-loaded government spending and stable financial sector performance. Investment demand was supported by front-loaded government spending in the first quarter. Resilient credit growth brought some relief to severely depressed investment and consumption demand, suggesting a positive impact of recent government and CBR policies in support of the financial sector.

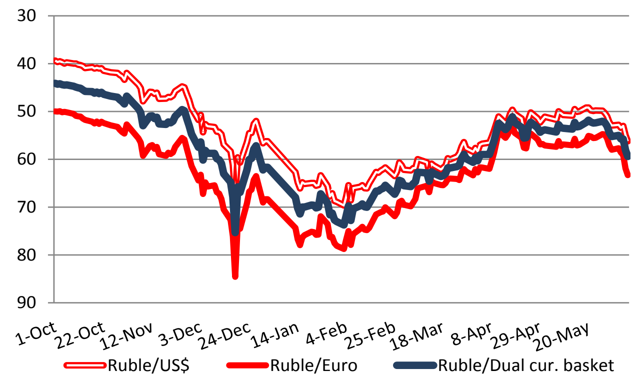
However, April's high-frequency statistic suggests that the recession is still set to deepen in the second quarter. Aggregate output in the industrial sector reported a sharp slowdown in April, contracting by -4.5 percent, year-on-year, compared to -1.2 percent in March. In addition to a negative base effect, the observed slowdown was largely driven by a contraction of -7.2 percent in manufacturing output (compared to -1.9 percent in March). The boost to manufacturing provided by front-loaded government spending in the first quarter might be already waning. As a result, manufacturing industries producing investment goods reported a sharp contraction in April: machinery production fell 14.9 percent, year-on-year, compared to 4.3 percent in March, and production of transportation equipment and vehicles contracted by as much as 22.2 percent (compared to -5.2 percent in March). According to Rosstat's business confidence survey, weak consumer demand remains the key constraint for economic activity followed by uncertainty about the economic policy environment. Demand side indicators in April confirmed this sentiment data: the contraction in retail sales accelerated to 9.8 percent, year-on-year, compared to 8.7 percent in March, while demand for market services decreased by 2.6 percent (compared to -2.0 percent in March).

Figure 1: Oil prices were flat in May…



Source: Bloomberg, Bakes Hughes, and World Bank

Figure 2: … and the ruble exchange rate corrected for this in late May



Source: CBR

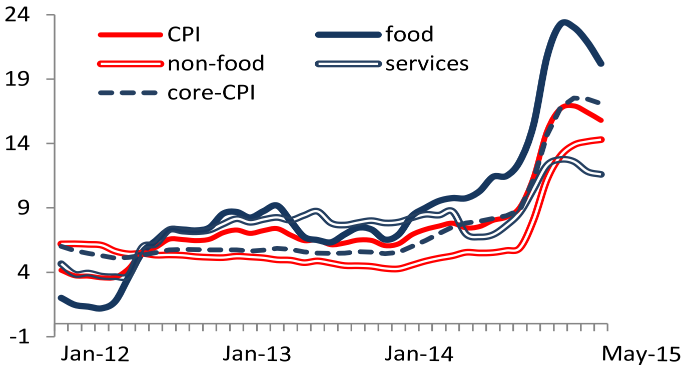
Movements in the ruble exchange rate realigned with oil price trends by the end of May, facilitated by effective CBR measures. During March-April the ruble gained on average 18 percent against the US dollar compared to February while oil prices were up by just 4 percent. To prevent an excessive appreciation of the exchange rate, the CBR first increased the rates on foreign currency repos and cut key policy rates by 150 basis points. These measures had only limited impact on the market and the rally on the ruble continued into the first half of May. The CBR then canceled two auctions for 1-year foreign exchange repo facilities and on May 15 resumed interventions on the foreign exchange market with daily purchases of US$150-200 million. These measures succeeded in triggering a market correction in the last week of May with the ruble depreciating by about 5 percent against the US dollar. With that the oil price and ruble exchange rate aligned again: the average RUB/US$ exchange rate appreciated by 5.1 percent in May relative to April; while the average oil price increased by about 6.0 percent over the same period.

In May, inflationary pressures continued to subside on account of weak consumer demand. The 12-months Consumer Price Index fell to 15.8 percent from 16.4 percent in April; while core inflation decelerated to 17.1 from 17.4 percent. On a monthly basis, inflation slowed for both food and non-food items in the consumer basket, from 0.3 percent to 0.1 and from 0.9 to 0.5 percent, yet it picked up for services from 0.0 to 0.5 percent. Besides the strengthening ruble, the key driving factor is likely to be depressed consumer demand due to a sharp contraction in real wages (-13.2 percent in April).

Real wage contraction still accelerated in April amid somewhat weaker labor market indicators. Real wages contracted in April by 13.2 percent, year-on-year (and 2.3 percent compared to March) seasonally adjusted. The 0.1 percentage point decrease in the unemployment rate, month-on-month from 5.9 percent in March to 5.8 percent in April was driven by seasonal factors: seasonally adjusted unemployment reached 5.7 percent–the highest level since June 2013. However, other labor market indicators, such as the average number of hours worked and part-time employment remained steady compared to a year ago. Real disposable income declined in April by 4.0 percent year-on-year, but grew in monthly terms by 5.7 percent seasonally adjusted partly due to a 10.3 percent indexation of pensions on April 1.

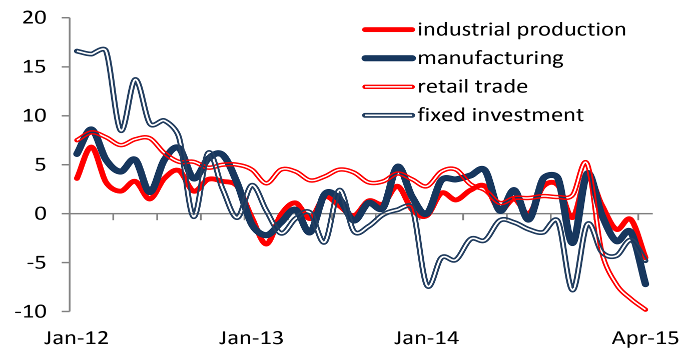
The resilience in credit activity for firms and a deceleration in credit risks are first positive signs. Overall, banks' credit portfolio decreased for the fourth consecutive month in April in an environment of shrinking bank profits due to the high cost of capital. Growth in credit to firms nevertheless showed some resilience and stood at 17.6 percent (compared to 24.3 percent in March and 31.3 percent in December 2014). Annual credit growth to households slowed to just 3.9 percent, compared to 7.0 percent in March and 13.8 percent at the end of 2014. High funding costs further squeezed interest margins, contributing to an increase in the number of loss-making banks to 245 in April (out of 815 banks), compared to 204 in March. At the same time, credit risk continues to mount, albeit at a slower pace than in previous months: the share of non-performing loans by households grew to 7.1 percent from 6.9 percent in March, compared to 5.9 percent at the end of 2014. Deteriorating balance sheets led the CBR to extend its regulatory forbearance for banks until October 1, which was introduced in late December 2014 to ease pressure from a drop in asset prices.

Figure 3: Inflation pressures slowly subside … (percent, y-o-y)



Source: Rosstat, Haver Analytics, WB team

Figure 4: … but economic activity deteriorates further on account of weak demand (percent change, y-o-y)

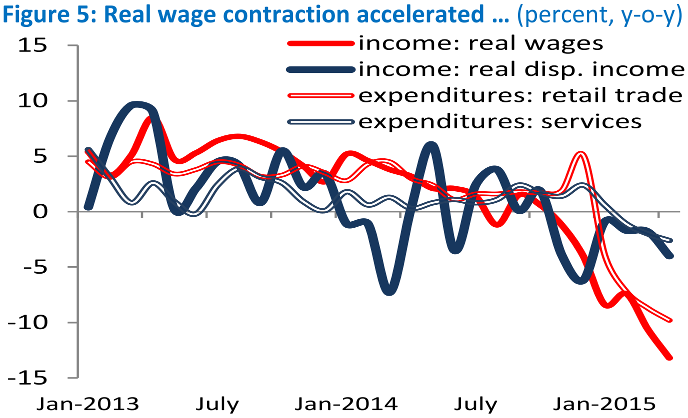


Source: Rosstat, Haver Analytics, World Bank team

In January–April 2015, the federal primary budget deficit improved to 4.4 percent of GDP compared to 4.9 percent in the first quarter as spending growth decelerated. During the first four months, federal budget revenue slumped to 20.3 percent of GDP compared to 21.8 percent of GDP in the same period last year. This was due to lower average oil prices compared to a year ago which saw oil and gas revenues drop by 2.5 percent of GDP from 11.5 percent of GDP in January-April 2014. In April, when the ruble appreciated, oil and gas revenues as a share of GDP shrank to 7.7 percent of GDP. However, non-oil revenue grew and reached 11.3 percent of GDP in January–April compared to 10.2 percent during the same period last year supported by higher VAT and corporate income taxes. This trend is likely to subside during the year as the nominal depreciation rate will decrease compared to last year and inflation will slow down. Federal budget expenditure (without debt service) increased from 20.5 percent of GDP in the first four months to 23.8 of GDP, with the main increase in national defense (2.2 percent of GDP) and social spending (0.9 percent of GDP). Yet, expenditure growth slowed in April, helping the overall deficit to decrease. The non-oil deficit also declined to 13.4 percent of GDP from 14.2 percent of GDP in the first quarter.

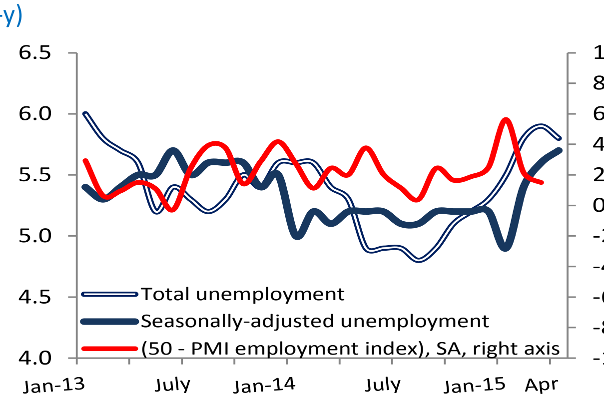
In the first quarter of 2015 the consolidated government budget position worsened to a deficit of -2.8 percent of GDP compared to a 3.4 percent surplus in quarter one of 2014. The consolidated government budget includes the federal and subnational budgets, plus extra-budgetary funds such as pensions and social security. Revenue fell from 38.6 percent of GDP in the first quarter of 2014 to 37.8 percent of GDP in the first quarter this year. At the same time expenditure increased from 35.1 percent in the first quarter of 2014 to 40.6 percent of GDP in the first three months of 2015.

Figure 5: Real wage contraction accelerated … (percent, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

Figure 6: … and the labor market weakened further (percent, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

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