Russia Monthly Economic Developments

March 2015

- Crude oil prices rebounded in February, gaining on average 16 percent compared to January.
- The Ruble appreciated in February by 12 percent against the US dollar as oil prices stabilized and geopolitical tensions subsided, yet inflation remained on the rise.
- In January, Russia's high frequency statistics confirmed the expected slowdown in industrial activity and further weakening of domestic demand, verifying that the December trends in economic activity were only temporary.
- In February, government tapped for the first time this year into the Reserve Fund for budget financing, as January federal budget revenue decreased due to low oil prices while expenditure increased as military spending soared.
- In early March, the Ministry of Finance submitted amendments to the 2015 federal budget to the government.

Crude oil prices rebounded in February, gaining on average 16 percent compared to January, after a rout that lasted 7 months. The market found some support at the beginning of March: Brent (the international marker) was trading at around US$61 per barrel while WTI (the US mid-continent benchmark) was trading at a widening discount at around US$50 per barrel. A continuing expansion in US production—despite reductions in oil rigs—resulted in growing storage which is putting pressure on the WTI. Fundamentally, the oil market remains weak and the supply-demand imbalance is set to grow further in the second quarter of 2015. Demand is expected to seasonally decline due to spring refinery maintenance while supply continues to grow unabated. The World Bank expects oil prices to average US$53 per barrel in 2015 and reach US$57 per barrel in 2016.

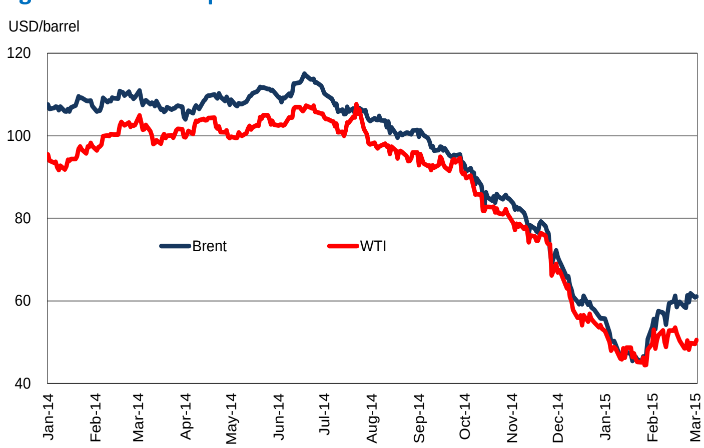
Stabilizing oil prices and subsiding geopolitical tensions helped the Ruble appreciate against the US dollar by 12 percent in February. Oil prices continued to be the key driver for the Ruble exchange rate dynamic. A new truce in Eastern Ukraine, signed in Minsk on February 15 by Presidents Putin and Poroshenko, together with Chancellor Merkel and President Hollande, lessened political tensions. In the two days following the signing, the Ruble appreciated by about 6 percent against the US dollar to mid-January levels. Investors' sentiments were positively affected by the announcement of the deal and markets rallied. Russian Credit Default Swap spreads on 5-year bonds dropped to 480 basis points by end-February, compared to their peak at 578 basis points in December, reflecting the retreating risk assigned to Russia. Moody's downgrade of Russia's sovereign rating to below investment grade on February 21 and new sanctions announced by Canada in February against 37 individuals and 17 companies, including the oil giant Rossneft, had a short-lived and limited effect on the exchange rate and markets.

Inflation remained in February on the rise. The 12-month Consumer Price Index (CPI) surged to 16.7 percent from 15.0 in January, largely driven by food inflation which soared to 23.3 percent. However, monthly inflation—which slowed to 2.2 percent in February from 3.9 percent in January—might indicate some moderation in inflationary pressure, likely as a result of the tapering off pass-through effect of the December Ruble devaluation. The monthly inflation deceleration was registered across all CPI components: food prices increased by 5.7, compared to 3.3 percent a month ago; non-food prices grew by 3.2, compared to 2.1 percent a month ago; and service prices decelerated from 2.2 to 0.8 percent a month ago. During its next scheduled Monetary Policy Committee meeting on March 13, the Central Bank of Russia (CBR) will decide if February trends in inflation risks and expectations support a continuation of the key policy rate cuts it started in January.

A softer global growth momentum is expected in the first quarter of 2015, with increasingly divergent trends between oil importers and exporters. The footprints of sharply lower oil prices on the global economy have been increasingly visible around the turn of the year, with a significant pick-up in retail sales and falling inflation across major oil importing economies, but increasing headwinds among oil exporters and heightened volatility in financial markets. Global growth in the fourth quarter of 2014 is currently estimated at 2.8 percent in annualized quarter-on-quarter terms, down from 3.5 percent in the third quarter, but broadly in line with the average pace predicted for 2015. In the US, mixed manufacturing and retail trade data so far this year point to growth of around 2.5 to 3.0 percent in the first quarter. In the Euro Area, in line with its quantitative easing (QE) program announced in January, the European Central Bank (ECB) will begin purchasing euro-denominated public sector securities on March 9, while continuing the purchase of asset-backed securities and covered bonds it initiated last year. The combined monthly purchases will amount to €60 billion and continue until the end of September 2016, or when there is a sustained lift in inflation. Meanwhile, the ECB left interest rates unchanged for a fifth consecutive month and raised the Eurozone growth forecast to 1.5 percent from 1.0 percent for this year. The 12-month harmonized CPI fell less than expected, 0.3 percent in February, compared to January's 0.6 percent decline. Gross capital flows to emerging markets (at US$84 billion) have remained robust thus far this year, up 12 percent from the first two months in 2014. Bond issuance and equity flows were strong in Asia, reflecting sustained demand for higher-yield debt, low borrowing costs for bonds, and public offerings in China and other East Asian countries.

In January, Russia's high frequency statistics confirmed the expected slowdown in industrial activity and further weakening of domestic demand, verifying that the December trends in economic activity were only temporary. Then a short-lived increase in economic activity was initiated by some import substitution due to the sharp Ruble devaluation and a related spike in demand for tangible assets. In January, economic activity retreated again: aggregate industrial growth slowed to 0.9 percent, year-on-year, from 3.9 percent in December while the manufacturing sector posted a 0.1 contraction compared to a 4.1 percent growth in December. The main cause for the slowdown was a deep contraction in industries which produce investment goods: machine building reported a 9.3 drop in output; while production of transportation vehicles decreased by 12.8 percent. On the demand side, fixed investment dropped in January by 6.3 percent, year-on-year, from the already low base of last year, due to continued weak business sentiments as consumer demand prospects remain negative and credit costs high. Consumer demand weakened in January with retail trade registering a 4.4 percent contraction, year-on-year, for the first time since November 2009. However, the weak Ruble and favorable relative price adjustment supported some manufacturing industries in January, yet could not offset the ongoing economic downturn: the food industry returned to a 3.6 percent growth, year-on-year, after contracting by 2.1 percent in December, and the chemical sector grew by 2.7 percent, compared to zero growth in December. The February composite HSBC PMI decreased to 44.7 in from 45.6 a month ago, indicating a likely deepening contraction of the economy.

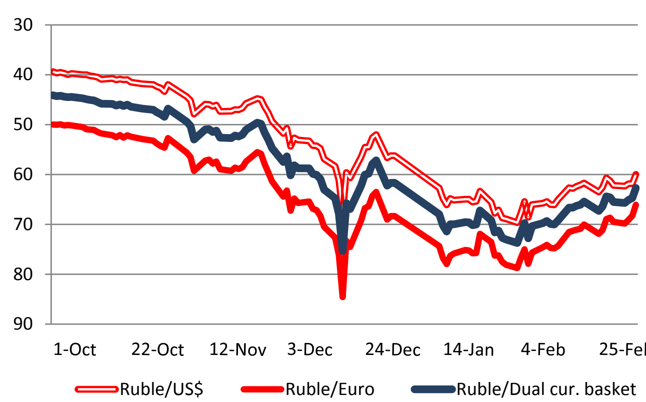
Figure 1: Crude oil prices ended their 7 month rout …



Source: Bloomberg

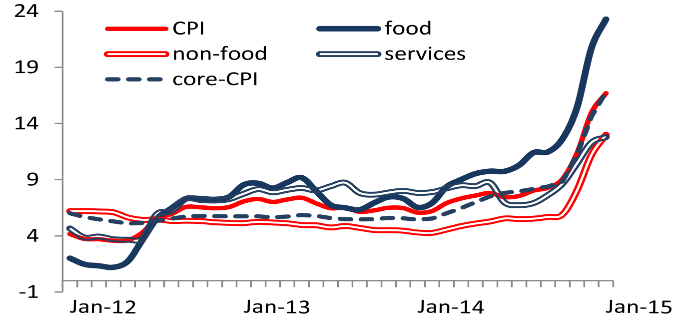
The Russian labor market adjusts to the economic slowdown through declining wages and incomes, putting pressure on consumer demand. Unemployment remains at historically low levels: in January, the seasonally adjusted unemployment rate dropped to 4.9 percent, 0.3 percentage points lower than at the end of 2014. According to the labor market PMI, no major job shedding is expected in February. This is early confirmation that the first channel for Russia's labor market adjustment is through real wage decreases: in January, real wages contracted faster at 8.0 percent, year-on-year, compared to 4.0 percent in December. Disposable income decreased by 0.8 percent compared to 6.2 percent in December, when households engaged in large-scale foreign currency operations as the Ruble devalued sharply.

Figure 2: … supporting the Ruble as geopolitical tensions eased off



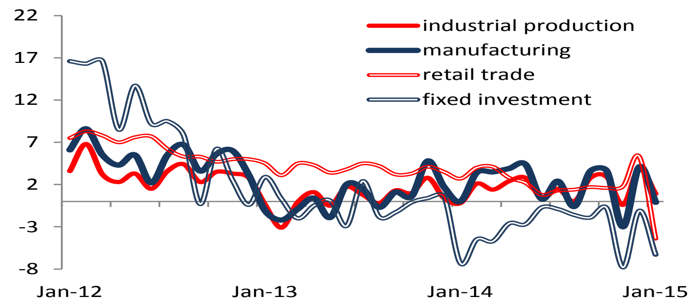
Source: CBR

Figure 3: Inflation still climbed … (percent, y-o-y)



Source: Rosstat, Haver Analytics, WB team

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



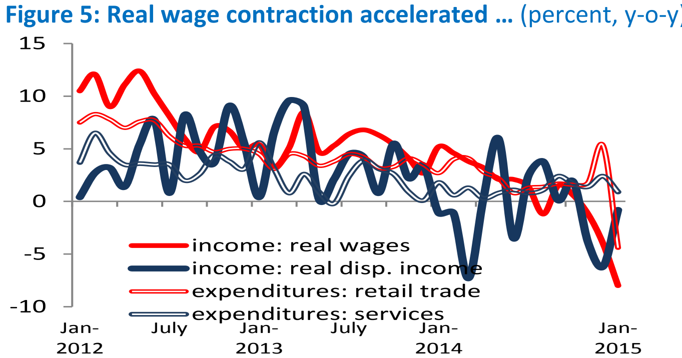
Source: Rosstat, Haver Analytics, World Bank team

In January, federal budget revenue decreased due to low oil prices while federal budget expenditure increased as military spending soared. Federal budget revenue decreased in January to 26.3 percent of GDP from 29.1 percent of GDP in the same period a year ago. This decrease was largely due to lower oil revenues: 10.4 percent of GDP, compared to 13.5 percent of GDP in January 2014. Federal budget expenditure surged to 31.9 percent of GDP from 18.9 percent of GDP a year ago 2014, mainly due to a large increase in (front-loaded) military spending by 11.2 percent of GDP, or 421 percent in nominal terms compared to January 2014. There was also an increase in spending of 1.4 percent of GDP to support the economy and of 0.9 percent of GDP for social policy. The January federal budget deficit stood at 5.6 percent of GDP, with the non-oil deficit reaching 16.0 percent of GDP.

In February, the government tapped for the first time this year into the Reserve Fund for budget financing and also continued to use National Welfare Fund resource to finance domestic infrastructure projects. In February, the Ministry of Finance sold US$7.8 billion (RUB500 billion) of foreign currency from the Reserve Fund for budget financing needs. The total amount of the Reserve Fund decreased to US$77.1 billion from US$85.09 on February 1, 2015. In February, the government also placed RUB75 billion (US$1.16 billion) of the National Welfare Fund (NWF) into bonds of OAO Yamal SPG to finance a gas extraction project at the Yamal peninsula. The total amount of NWF resource placed into securities of companies engaged in the list of government approved infrastructure projects reached RUB80 billion (US$1.3 billion). As of March 1, 2015, the NWF stood at RUB4.6 trillion (US$74.9 billion), compared to RUB4.4 trillion (US$78.0) on January 1, 2015.

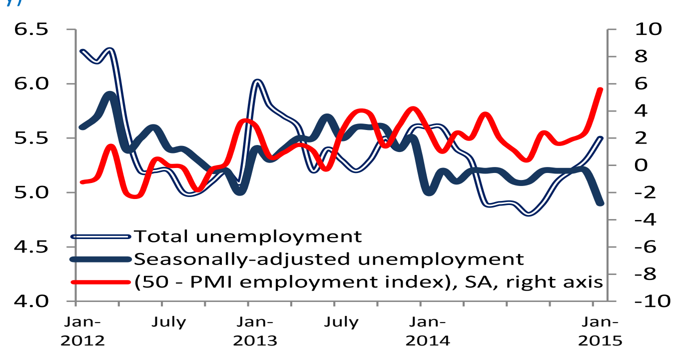
In early March, the Ministry of Finance submitted amendments to the 2015 federal budget for discussion with the government. The new budget is based on a more conservative oil price assumption of US$50 per barrel. Preliminary numbers suggest that federal budget revenue would fall sharply to 17.0 percent of GDP, from 20.6 percent of GDP in 2014, and expenditure will decrease much less to 20.8 percent of GDP from 21.2 percent of GDP in 2014. In nominal terms, expenditures would remain at the same level as in 2014, but shrink by about 11 percent in real terms. The fiscal gap of 3.8 percent of GDP is expected to be covered primarily with the Reserve Fund which would shrink by RUB3.7 trillion from an estimated RUB5.4 trillion.

Figure 5: Real wage contraction accelerated … (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

Please contact Birgit Hansl: bhansl@worldbank.org

Prepared by a World Bank team under the guidance of Birgit Hansl, consisting of Damir Cosic, Olga Emelyanova, Mikhail Matytsin, Eka Vashakmadze and Sergei Ulatov.