Russia Monthly Economic Developments

May 2015

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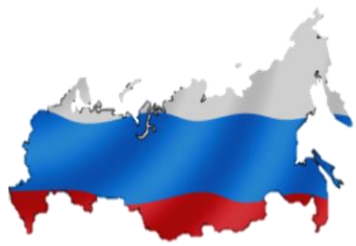
- In April, the ruble appreciated by 13 percent against the US dollar bolstered by favorable external balances due to higher oil prices, continued low import demand and lower external debt payments.
- Inflation pressures began to subside in April, motivating the Central Bank of Russia to cut key policy rates by 150 basis points to 12.5 percent.
- Industrial activity somewhat steadied in March yet indicators point towards continued weakness in domestic demand.
- In the first quarter, the federal budget deficit stood at 4.9 percent of GDP while the non-oil deficit soared to 14.2 percent of GDP amid rising expenditure.



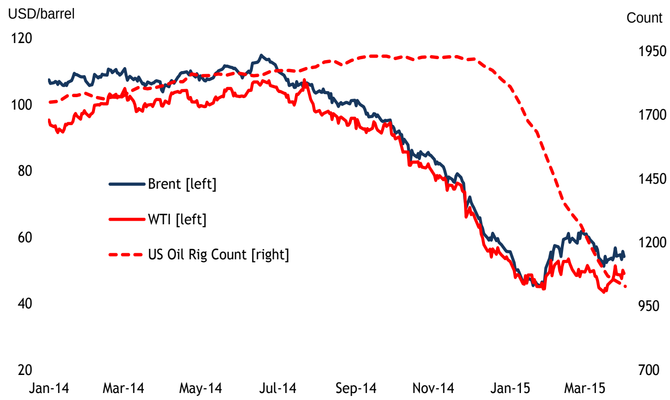
Global oil prices gained strength, averaging during the first week of May US$67 per barrel—the highest since January. Oil price volatility, which increased following OPEC's decision not to engage in supply controls has moderated from its peak of 3.9 percent in mid-February to 2.8 percent in May. Prices have been supported by a weaker US dollar, expectations of lower stocks in the U.S., and increasing demand by some emerging economies, especially India. On the supply-side, the International Energy Agency expects U.S. crude oil production growth to reach a plateau in quarter three of 2015. The rig count in the U.S., a measure of future supply conditions, continued its downward trend, to reach 679 on May 1, less than half from October high of 1,600.

In April, the ruble appreciated by 13 percent against the US dollar bolstered by favorable external balances due to higher oil prices, continued low import demand and lower external debt payments by the private sector. In addition, banks continued to borrow foreign exchange through the repo facility (mostly 28-day and 1-year) taking advantage of the high-margin that Russian Treasury (OFZ) bonds offered. This fueled demand for OFZs, particularly when foreign investors joined in. As a result, the ruble rally which started in mid-March continued through most part of April, prompting the Central Bank of Russia (CBR) to correct its rates on foreign currency repos upwards, first on April 10 and second on April 20. While the first hike had a limited impact, the second one brought repo rates back to the level of October 2014, squeezing the interest rate differential with OFZs and making the repo facility less attractive.

Inflation pressures began to subside in April motivating the CBR to cut key policy rates by 150 basis points to 12.5 percent. The 12-months Consumer Price Index inflation decelerated for the first time in eight months to 16.4 percent from 16.9 percent in March as food inflation–which accounts for 30 percent of the consumer basket–abated to 21.9 percent in March from 23.0 percent in February. At the same time, non-food inflation continued to accelerate to 14.2 percent from 13.9 percent in February as the remaining pass-through from the weaker ruble earlier in the year continued to push prices for non-food items up, in particular for medicine (25.8 percent, year-on-year) and electronics (26.8 percent, year-on-year). Core inflation remained unchanged at 17.5 percent. On April 30, the CBR decided to lower its key policy rates by 150 basis points quoting the lower inflation risk as a key reason.

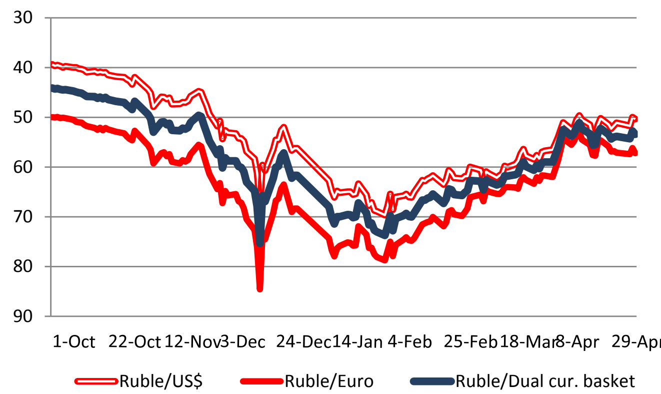
The first quarter current account retained a healthy surplus despite recent oil price trends, with capital outflows almost halving relative to the fourth quarter of 2014. A sharp fall in imports and improvements on the investment income account resulted in a US$23.5 billion current account surplus (compared to US$15.4 in quarter four 2014). Net capital outflows decreased to US$32.6 billion from US$59.5 billion in quarter four 2014. The capital account also benefited from a shrinking foreign asset position by the corporate and banking sector and lower net sale of foreign currency by the population. The financing gap of US$9.1 billion was covered through currency swaps and the repo facility.

Figure 1: Oil prices gained some ground …



Source: Bloomberg.

Figure 2: …supporting the ruble



Source: CBR

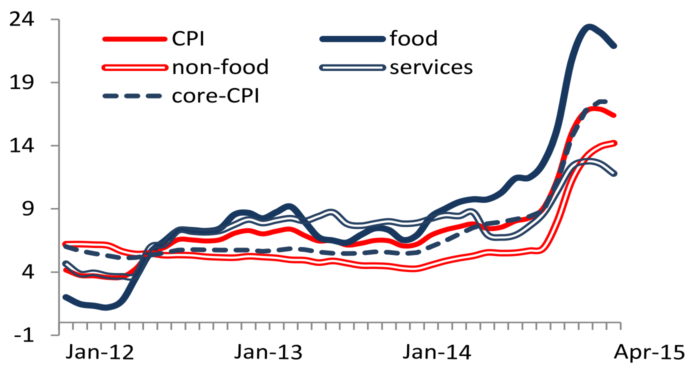
The World Bank 2015 growth forecast for Russia remains at -3.8 percent, based on an oil price projection of US$53 per barrel. In 2016, a modest decline of -0.3 is expected with an average oil price of US$57 per barrel.

Russia's output contraction is mirrored by soft growth in other BRICS countries while global growth remains on track to reach about 2.8 percent in 2015. Growth is gradually resuming in South Africa, but is held back by monetary and fiscal tightening and energy shortages. In India, activity is buoyed by stronger investor and consumer confidence as a reform-minded government implements its agenda and lower oil prices help contain vulnerabilities. Growth in China follows a gradual and carefully managed deceleration (GDP growth was in the first quarter of 2015 7.0 percent, year-on-year, and 5.3 percent, quarter-on-quarter). This slowdown reflects weakening activity in industry and construction due to ongoing adjustments in sectors with excess capacity, in real estate and due to policy efforts to address financial vulnerabilities. More similar to Russia, Brazil is expected to experience a recession in 2015, reflecting fragile confidence and low commodity prices.

Industrial activity somewhat steadied in March yet indicators point towards continued weakness in domestic demand. Industrial output fell by 0.6 percent in March, year-on-year, compared to a 1.6 percent contraction in February. Growth continued to be uneven with only 3 (out of 14) major sub-industries reporting positive growth. Relatively cold weather in the second half of March increased demand for utilities. Manufacturing posted a 1.9 contraction−up from -2.8 percent in February−likely supported by government's front-loaded capital expenditures in the military sector: machine building reported a 4.3 percent contraction in March, y-o-y, compared to -12.8 percent in February and the production of transportation vehicles contracted by 4.3 percent versus -22.0 percent in February. Fixed investment contracted by 5.3 percent, year-on-year, compared to -6.5 percent in February. A sharp fall in real wages (-9.3 percent in March, year-on-year) further depressed household consumption. As a result, retail sales contraction accelerated to 8.7 percent, year-on-year, compared to 7.7 percent in February and consumption of market services fell by 2.0 percent, compared to -1.5 percent in February.

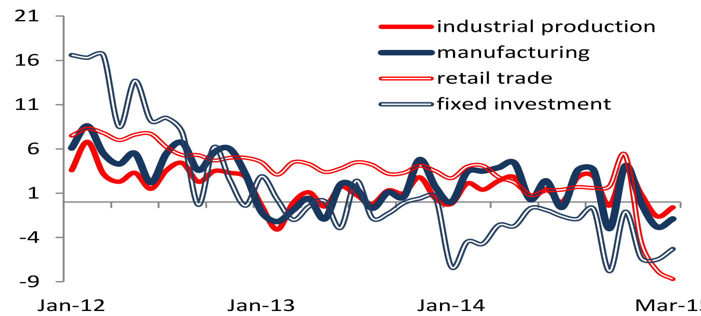
Credit risk remains elevated although banks carried on to rebalance their portfolio, shrinking their assets by almost RUB1.9 trillion. A sharp drop in real wages and higher unemployment in March negatively affected households' capacity to repay debt. The share of non-performing loans in household debt grew to 6.9 percent in March from 5.9 percent at end-2015. This implies that banks needed to further increase provisioning, putting additional pressure on first tear capital and limiting credit activity. In March, the stock of ruble credits decreased by 0.5 percent (RUB188 billion); the stock of credit in foreign currency dropped by 4.7 percent, in part due to the ruble appreciation. However, the ongoing restructuring of banks' portfolio and a decline in funding costs helped to reduce losses: banks reported an aggregate profit of RUB6 billion compared to a loss of RUB 35billion in February and the number of loss-making banks decreased to 204 in March from 249 in February (compared to 126 at the end of 2015). Also, despite lower interest rates on retail deposits, the depositors' base continued to strengthen in March.

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



Source: Rosstat, Haver Analytics, WB team

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

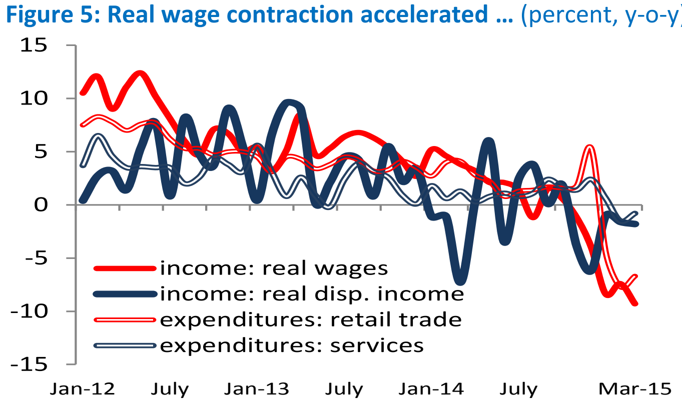


Source: Rosstat, Haver Analytics, World Bank team

In the first quarter, the federal budget deficit stood at 4.9 percent of GDP while the non-oil deficit soared to 14.2 percent of GDP amid rising expenditure. In the first quarter, federal budget revenues decreased to 20.7 percent of GDP from 22.0 percent of GDP over the same period a year ago (a 2.4 percent decrease in nominal terms). As in previous months, this decrease was due to lower oil revenues which dropped to 9.3 percent of GDP in the first quarter from 11.4 percent of GDP a year ago. Non-oil revenues increased in the first quarter to 11.4 percent of GDP from 10.6 percent in quarter one 2014. At the same time, federal expenditures rose to 25.6 percent of GDP from 20.9 percent of GDP a year ago mainly due to increased military spending (3.1 percent of GDP) and higher spending for social policy (1.3 percent of GDP). Military spending remained high at 9.2 percent of GDP, but decelerated slowly from the 12.7 percent of GDP during January-February. This contributed to the improvement in the federal budget deficit to 4.9 percent of GDP by end-March, compared to a deficit of 7.4 percent of GDP in the first two months of 2015. The non-oil deficit soared to 14.2 percent of GDP compared to 10.3 percent of GDP in quarter one of 2014.

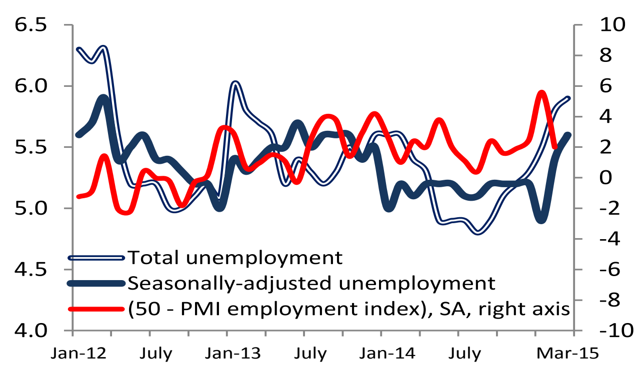
In April, the government used more funds of the National Welfare Fund to recapitalize banks, support domestic investment demand and finance pensions. RUB9.43 billion of the National Welfare Fund (NWF) were spent on financing pensions. The government placed RUB38.4 billion in subordinated deposits at Gazprombank, partly to recapitalize the bank and RUB21.7 billion (out of those RUB38.4 billion) to purchase Avtodor bonds for financing the Moscow Central Ring Road. With that, the NWF resources earmarked to infrastructure project financing increased to RUB460 billion (0.6 percent of GDP) while the total NWF resources stood at a comfortable 5.4 percent of GDP (US$76.3 billion) as of May 1, 2015.

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



Source: Rosstat, Haver Analytics, World Bank team

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



Source: Rosstat, Haver Analytics, World Bank team

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