Russia Monthly Economic Developments

November 2014

THE WORLD BANK
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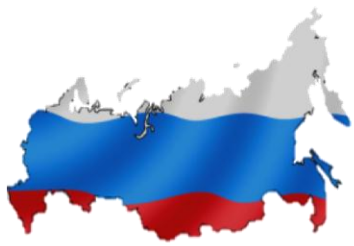
- The Ruble's free fall in November—after a large depreciation in October—is a growing risk for the stability of the economy.
- The Central Bank of Russia intervened heavily in the market, but without much success in stemming the Ruble depreciation it shifted its intervention rule in early November to a much lower level of US$350 million daily.
- With inflation rising further above the inflation target, the central bank increased policy interest rates by 150 basis points.
- The sharp decline in oil prices is negatively affecting the budget and the current account.
- On October 24, the Duma approved the draft budget law for 2015 and 2016-2017 in its first reading.



The Ruble's depreciation intensified in November amid further large declines in oil prices, hoarding of foreign exchange by large exporters, and rising concerns that the ceasefire in eastern Ukraine is not holding up and therefore sanctions against Russia are unlikely to be lifted any time soon. The supply of foreign currency has become tight due to the sanctions and the subsequent hoarding by large exporters. At the same time, the end to the QE program in US at a time of improved confidence in the US economy has further suppressed demand for Ruble-denominated financial assets. Large seasonal demand for foreign exchange—due to external debt payments of about US$55 billion—also added to the pressure on the currency. As a result, the ruble fell 10 percent against the dollar-euro basket in the first week of November after a 13 percent decline in October. Central Bank of Russia (CBR) interventions of as much as US$30 billion in October and further 1 billion in the first week of November have done little to stem the free-fall of the currency. There is a risk that the confidence of citizens in the currency is declining rapidly and is also adding to demand for foreign currency. Some banks already limited sales of foreign currency due to cash shortage. A continuation of this trend could pose risks for financial stability.

To ease liquidity pressures, the CBR started repo auctions of foreign currency in October and announced a change to its intervention rule. In addition to the overnight foreign currency swap facility introduced on September 17, the bank started repo auctions with 7 and 28 days maturity on October 29-30. These, however, saw little appetite from the market. Banks seemed to prefer currency swaps as a less risky and better priced facility for short-term foreign exchange liquidity. On November 5, the CBR announced that it lowered the starting price for next auctions and added a new one with 12-month maturity (planned for November 17). On the same day, the CBR limited its daily interventions to US$350 million compared to an average of US$2 billion spent daily during the last week of October. This policy is part of the move to a flexible exchange rate by the end of this year, accelerated by the decline in the currency. At the same time the CBR reassured market participants that it would extend intervention considerably if there is a threat to financial stability.

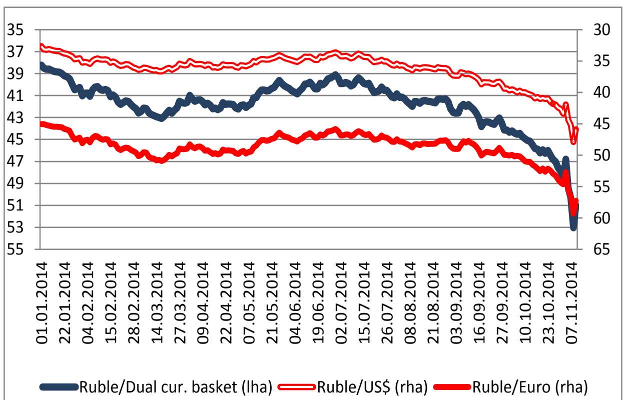
To contain rising inflation pressures stemming from the depreciating Ruble and accelerating food prices, the CBR hiked its key policy rates by 150 basis points to 9.5 percent. This increase on October 31 was the fourth this year leading to a cumulative increase of 400 basis points. Inflation pressures stayed elevated in the first nine months of the year and further increased in October. Twelve-month consumer price inflation rose to 8.3 percent in October from 8.0 percent in September, well above the CBR's target of 7 percent for 2014. Banned food items experienced the strongest price increases: meat and poultry (18.2 percent, year-on-year), milk products (15.1 percent) and sea food (15.2 percent). As a result, food price inflation rose to 11.5 percent in October from 11.1 percent in September and was the main reason for the observed pickup in inflation. Together with inflationary pressure from a weaker currency, this led to a 12-month core inflation of 8.4 percent in October, up from 8.2 percent in September.

Russia's budget and balance of payments are under pressure from the oil price decline which is due to plentiful supplies and weakening demand. Oil prices dropped to US$85/bbl in mid-October from a recent high of $115/bbl in July. The international oil market remains well-supplied with major producers, including OPEC, the US, and Russia keeping production little changed while small-scale supply disruptions (in Mexico and Yemen) have been more than offset by rising production elsewhere. Despite the sharp price decline, OPEC has not reduced production and its Secretary General said recently that "OPEC's oil production is unlikely to change much in 2015 and there is no need to panic at the crude price drop". On the demand side, weak economic data from the Euro Areas and a number of emerging economies, including Russia, have exerted downward pressure on prices.

Partly due to a weaker Ruble, industrial and agricultural activity picked up in September. Industrial production rose 2.8 percent growth in September, year-on-year, after stagnating in August. The recovery was broad-based with manufacturing output expanding by 3.6 percent and extractive industries by 2.4 percent. Import substitution due to the weaker Ruble and increased production in the military complex were key factors for this improvement. Agriculture output expanded by 16.6 percent in September, year-on-year as a result of a rich grain harvest and continued restrictions on food imports. Nevertheless, the manufacturing PMI by HSBC remained practically unchanged at 50.3 in October, narrowly above the 50-point level indicating a contraction.

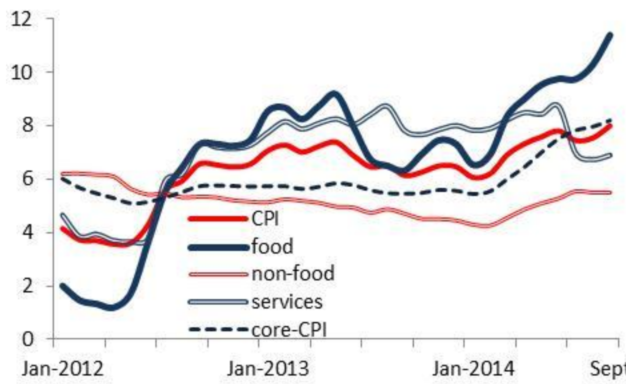
Domestic demand is constrained by slowing income growth and restricted access to international financial markets for Russian banks and non-financial corporations. Retail trade and market services growth edged up marginally, yet growth in both sectors remains at less than half of last year levels at 3.2 and 3.1 percent respectively. Slowing income growth is limiting demand for non-tradable services: real wage growth dipped into negative territory in September (-1 percent) for the first time since the 2009 crisis and real disposable income growth slowed to just 0.6 percent from 3.9 percent in August. Western sanctions imposed on Russia in July-September weigh negatively on investment activities. Increased funding costs due to limited access to external funds for Russian banks and non-financial corporations appear to become a growing impediment to investment recovery. Fixed capital investment shrunk 2.8 percent in September, year-on-year, which translates into a 2.5 percent contraction for the first nine months of the year.

Figure 1: The exchange rate plumbed new historic lows …



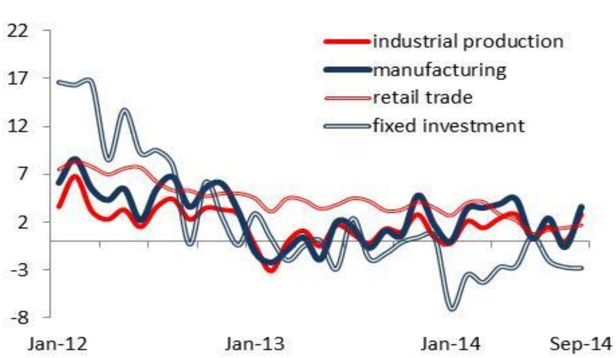
Source: CBR

Figure 2: … while inflation is on the rise
(percent, y-o-y)



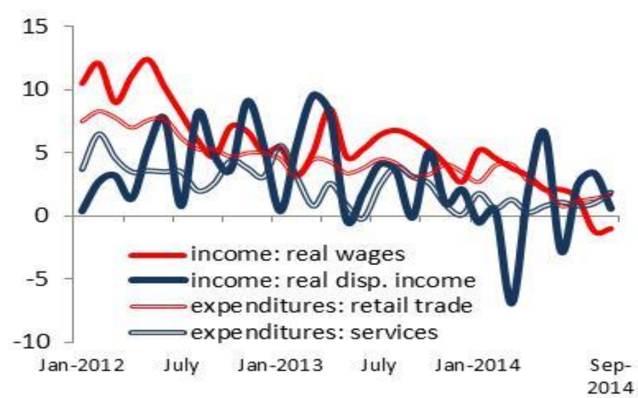
Source: Rosstat, Haver Analytics, WB team

Figure 3: Economic activity is slowly regaining speed …
(percent change, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

Figure 4: … while real wages began declining



Source: Rosstat, Haver Analytics, World Bank team

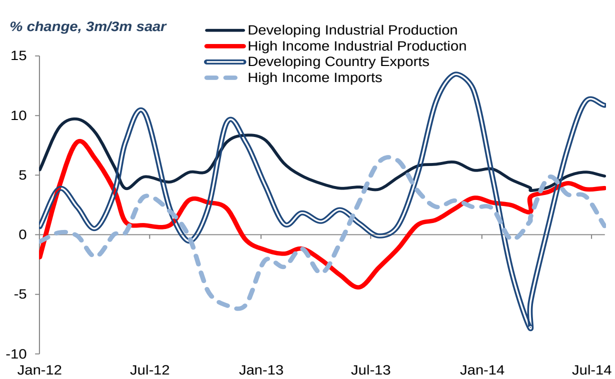
As in Russia, emerging economies continue to show slowing signs while the recovery in advanced economies is uneven. In the US the recovery is firmly underway, with third-quarter GDP numbers confirming a broad-based pick-up in demand, while recent labor market data and declining energy costs point to strengthening consumer spending ahead. In contrast, activity and confidence remain worryingly low in the Euro Area, while growth is still fragile in Japan. In Japan, a weak Yen has failed to boost exports, and, the Bank of Japan surprised markets in end-October by significantly expanding its government bond purchase program. Meanwhile, major emerging economies are moving sideways. In China, high-frequency data continues to show signs of cooling domestic demand, with manufacturing output rising at slower pace, prices declining, and employment continuing to contract. Brazil is currently facing severe headwinds, with growing fiscal imbalances and above-target inflation accentuating a loss of business and consumer confidence.

Russia's balance of payment improved in the third quarter as the stronger current account more than offset net outflows on the capital and financial account. The current account shifted from a deficit of US$0.7 billion in the third quarter of 2013 to a surplus of US$11.4 billion in the third quarter of 2014, supported by a wider trade surplus and improved investment income balance. In the third quarter, the trade balance was positively affected by still high oil prices and a substantial decrease in imports (8.7 percent) due to the Ruble depreciation, the ban on food imports and lower growth. The financial and capital account deficit deteriorated from US$4.7 billion in the third quarter of 2013 to US$11.5 billion in the third quarter of 2014 partly reflecting the sanctions impact which limit the access of Russian companies to the international financial markets. Yet, compared to the previous quarter, net capital outflow decreased to US$5.7 billion from US$10.2 billion due to shrinking net foreign assets of the banking sector which could be explained by the banks increasing demand for foreign liquidity. Net foreign direct investment inflows came out at an extremely low level of US$1 billion compared to US$12.1 billion in the third quarter of 2013. Net foreign currency purchases by households stood at US$1.5 billion compared to US$3.2 billion in the second quarter, yet they were two times higher than in the third quarter 2013. Net capital outflows for the three quarters of 2014 totaled US$77.5 billion with foreign currency swaps and correspondent accounts of resident banks taken into account.

On October 24, the draft law on the Federal Budget for 2015 and 2016-2017 was approved by the Duma in the first reading and is now in the second reading. The budget proposal envisages a constant federal fiscal deficit at 0.6 percent of GDP in 2015-2017. Despite the expectation that with the recent oil price and growth trends the projected budget deficit will be higher, no major changes are likely to be introduced into this proposal. Instead, it is expected that the Reserve Fund will be utilized in line with the fiscal rule and the proposed budget will be adjusted accordingly during its revision next year.

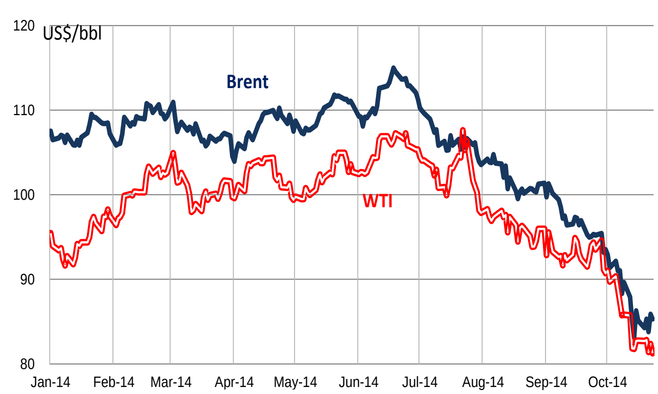
In January-September 2014 the federal budget surplus rose as the weak Ruble led to higher than expected oil revenue while expenditure execution remained little changed. During the first nine months of 2014 the federal budget surplus increased to 2.1 percent of GDP from 1.4 percent a year earlier, well above the amended 2014 target of 0.4 percent. Oil revenue increased (by 0.6 percentage points to 10.5 percent of GDP), largely as a result of the depreciating Ruble. The non-oil deficit decreased by 0.3 percentage points to 8.6 percent of GDP.

Figure 5: The global recovery remains lackluster …



Source: World Bank Prospects Group.

Figure 6: … with crude oil prices tumbling



Source: Bloomberg

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