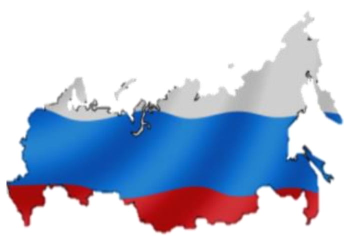
Russia Monthly Economic Developments

July 2019

Global economic activity continued to soften in June 2019, with global trade and manufacturing showing signs of marked weakness amid rising economic policy uncertainty. Oil prices fell sharply in June, with the price of Brent crude oil falling by $7 per barrel (bbl) to $63/bbl and WTI falling by $6/bbl to $55/bbl. However, oil prices rose substantially towards the end of June and into July, with the recovery in prices largely due to rising geopolitical tensions in the Middle East. Prices were also supported by an announcement of OPEC and its partners that production cuts would be extended by nine months to March 2020. In June, the global environment was conducive to major emerging market currencies, including the ruble, which strengthened with respect to the US dollar. Lower exports, attributed to lower prices for major commodities exported by Russia, along with softer global economic growth, weighed down on Russia's current account surplus in the second quarter of 2019: Economic growth was sluggish in May, with output in five basic sectors[1] tumbling to -0.3 percent, y/y, from +2.9 percent, y/y, in April. After peaking in March, the 12-month consumer price inflation continued to decrease in June, totaling 4.7 percent. Labor market dynamics were strong in May. On the back of stronger non-oil revenues, the federal budget surplus improved to 2.7 percent of GDP (cash basis) in the first five months of 2019, up from 1.4 percent of GDP in the same period last year. In May, lending to both retail and corporate segments continued to grow. Key credit risk and performance indicators remained largely stable.

The Global Context

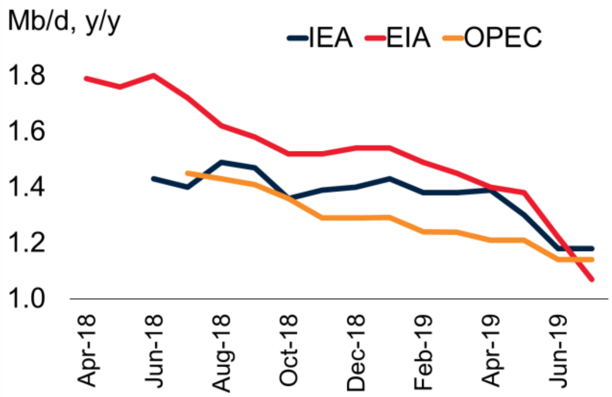


Global economic activity continued to soften in June, with global trade and manufacturing showing signs of marked weakness amid rising economic policy uncertainty. Incoming data suggest activity will continue to be subdued going into 19Q3, with sustained deterioration in both business confidence and the global manufacturing PMI. Trade indicators also point to continued weakness, with new export orders continuing to contract, reaching a six-year low. Although the services sector has been more resilient, activity has begun to slow down along with declining consumer confidence and retail sales growth. Bond yields in advanced economies remained near multi-year lows in early July as major central banks continued to signal more accommodative monetary policy stances amid signs of weakening global activity and subdued inflation. Headline inflation in EMDEs, however, have drifted up on the back of rising food costs.

Oil prices fell sharply in June, with the price of Brent crude oil falling by $7 per barrel (bbl) to $63/bbl and WTI falling by $6/bbl to $55/bbl. The drop in prices was primarily driven by worries about slowing global demand for oil, amid weaker global growth and rising trade tensions. Most major forecasters have substantially downgraded their expectations for oil demand in 2019 over the past few months (Figure 1). However, oil prices rose substantially towards the end of June and into July, with the price of Brent crude oil rising to $67/bbl in mid-July and WTI reaching $60/bbl. The recovery in prices was largely due to rising geopolitical tensions in the Middle East. Prices were also supported by an announcement of OPEC and its partners that they would extend their production cuts by nine months to March 2020. The OPEC+ deal could translate into negative annual growth of oil production in Russia in the second half of 2019. Russia has now reopened the Druzhba oil pipeline, which had been closed since late April as a result of contamination.

[1] Agriculture, industrial production, transportation, construction, retail and wholesale trade.

Figure 1: Oil prices fell sharply in June 2019

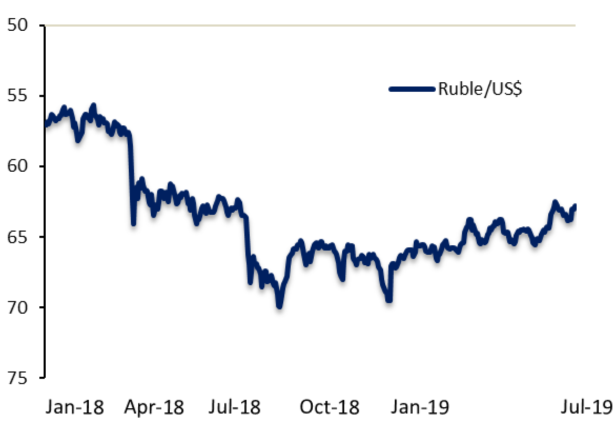


Source: Energy Information Administration, Internatonal Energy Agency, Organization of Petroleum Exporting Countries.

The recent economic developments

In June, the global environment was conducive to major emerging market currencies, including the ruble. Despite a 11.3 percent drop in oil prices, the ruble nominal exchange rate appreciated by about 1 percent with respect to the dollar (64.2 Rub/USD on average) (Figure 2). Expectations of further monetary easing by the Central Bank of Russia (CBR) and lower risk perception supported foreign investors' appetite for government bonds. Tax payments due in June were another factor supporting the ruble.

Figure 2: The average ruble nominal exchange rate strengthened in June 2019



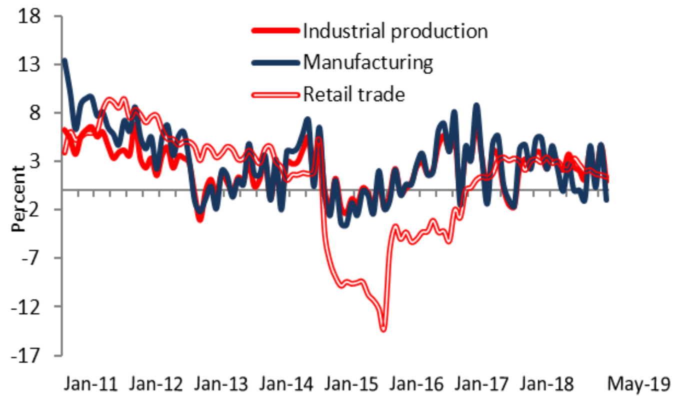
Source: CBR.

Lower exports weighed down on Russia's current account surplus in the second quarter of 2019. The current account surplus fell to US$12.1 billion in the second quarter of 2019, down from US$17.9 billion in the same period last year. Lower export revenues due to lower prices for Russia's major commodity exports, along with softer global economic growth, were the main factors behind the drop. Net private sector capital outflows totaled US$3 billion in the second quarter of 2019 compared to a US$5.1 inflow in the same period last year. FDI inflows remained subdued at US$2 billion, the same level as last year. In the second quarter of 2019, international reserves rose by US$17 billion, mainly due to currency purchases in the fiscal rule framework. Overall, in the first half of 2019, the current account surplus totaled US$45.8 billion (5.9 percent of GDP) compared to US$47.7 billion (6.0 percent of GDP) in the first half of 2018.

Economic growth was sluggish in May. Growth of output in five basic sectors[2] tumbled to -0.3 percent, y/y, from +2.9 percent, y/y, in April (Figure 3). All sectors except for construction posted slower growth. Industrial production contributed the most to the slowdown: +0.9 percent, y/y, in May, compared to +4.6 percent in April. Within industrial production, manufacturing appeared to be the weak spot (-1 percent, y/y, in May, compared to +4.7 percent, y/y, in April). Calendar factors (fewer number of working days in May 2019 compared to May 2018) partially explain this poor performance. Mineral resource extraction posted slower growth of +2.8 percent, y/y, in May compared to +4.2 percent in April. This slowdown was a result of lower growth in crude oil extraction due to limitations resulting from the OPEC+ agreement and the contamination of the Druzhba pipeline. Retail trade and market services growth continued to slow down, reflecting subdued domestic demand.

[2] Agriculture, industrial production, transportation, construction, retail and wholesale trade.

Figure 3: Economic growth was sluggish in May

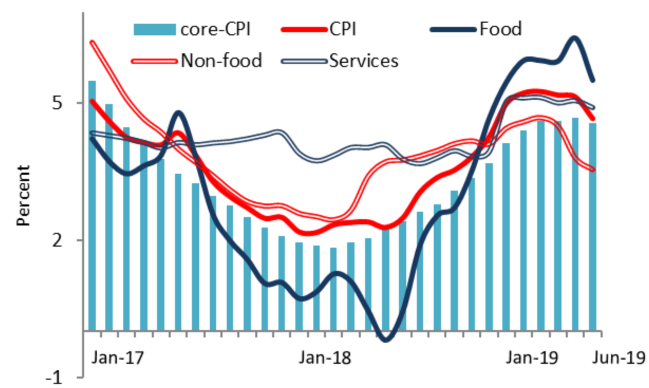


Source: Rosstat, Haver Analytics, World Bank team.

Weak investment demand weighed down on GDP growth in the first quarter of 2019. According to Rosstat, which published the demand and supply side composition of GDP for the first quarter of 2019, GDP growth in the first quarter was confirmed at modest 0.5 percent, y/y. Gross fixed capital formation growth tumbled to -2.6 percent, the first negative reading for the last 11 quarters. High frequency statistics on fixed capital investment for large and medium enterprises show that while fixed capital investment grew robustly in agriculture, mineral resource extraction, manufacturing, construction, ICT, finance, and education, a sizable negative contribution from negative investment growth in real estate and transportation via pipelines weighed down on overall investment growth. In addition, this low reading could reflect lower military production, which is reflected as part of gross fixed capital formation. Change in inventories also contributed negatively to GDP growth. This could be partially explained by higher stocks created by companies in the end of 2018 ahead of the VAT rate increase. Consumer demand was the main driver, contributing 1.1 pp to GDP growth. Household consumption growth slowed down to 1.6 percent, y/y, from 2.3 percent, y/y, in 2018. This deceleration was expected given the rise in the VAT rate, a relatively tight monetary policy, and some skewness of public spending in the second half of the year. The close to zero contribution from export growth (exports posted negative growth of -0.4 percent, y/y, on the back of the OPEC+ agreement limitations and lower global growth) was offset by shrinking imports, and net exports contributed 0.6 pp to GDP growth. We expect GDP growth to pick up in the second half of 2019 with investment demand accelerating along with national projects' implementation. From the supply side, growth was led by mineral resource extraction, financial services, and transportation. In contrast, retail and wholesale trade, as well as real estate, appeared to be major drags of GDP growth in the first quarter of 2019.

In June, the 12-month consumer price inflation dropped to 4.7 percent, down from 5.1 percent in May (Figure 4). The 12-month food inflation deceleration contributed the most to the decrease in headline consumer price inflation. Core consumer price inflation edged down to 4.6 percent in June from 4.7 percent in May. Inflation expectations remain elevated: In June, household inflation expectations edged up slightly to 9.4 percent from 9.3 percent in the previous month.

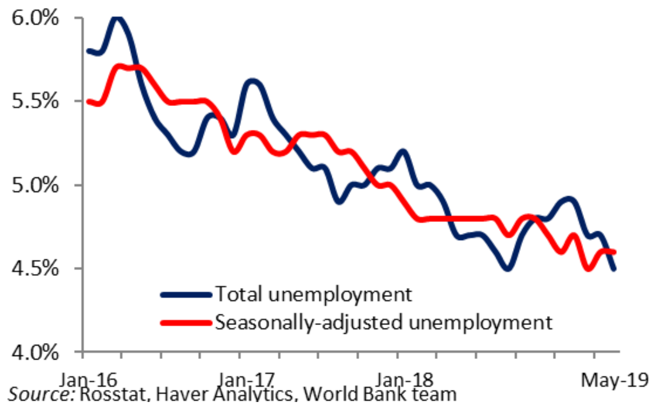
Figure 4: Consumer price inflation slowed down in June 2019



Source: Haver Analytics.

Labor market dynamics were strong in May. The unemployment rate decreased by 0.2 percentage points to the level of 4.5 percent, mostly driven by seasonal factors. The seasonally-adjusted rate did not change, remaining at 4.6 percent (Figure 5). Real wages increased by 2.8 percent in May 2019 compared to May 2018 and by 1 percent compared to April 2019 after seasonal adjustment. Pensions grew by 0.9 percent in real terms.

Figure 5: Labor market dynamics were strong in May



Source: Rosstat, Haver Analytics, World Bank team

In the first five months of 2019, the federal budget surplus improved to 2.7 percent of GDP (cash basis), up from 1.4 percent of GDP in the same period last year. This came on the back of stronger non-oil and gas revenues, which grew to 10.5 percent of GDP in the January – May 2019 period compared to 9.7 percent of GDP in the same period last year. This was largely the result of a VAT rate increase and a weaker ruble in the first five months of 2019 compared to the same period of 2018. Oil and gas revenues dropped to 8.1 percent of GDP from 8.3 percent of GDP in the same period last year as the weaker ruble was unable to offset lower energy prices. Primary expenditures declined by 0.5 pp. Spending on the national economy dropped by 0.3 percent of GDP, and spending on defense dropped by 0.2 percent of GDP. Lower primary expenditures and higher non-oil/gas revenues led to an improved non-oil/gas federal budget primary deficit, which reached 4.7 percent of GDP. In January - April 2019, the general government balance improved to 5.7 percent of GDP from 2.6 percent of GDP in the same period last year.

On June 21, 2019, the Ministry of Finance sold US$1.5 billion dollar-denominated Eurobonds maturing in 2029 at 3.95 percent, and US$1 billion dollar denominated Eurobonds maturing in 2035 at 4.3 percent. According to the Ministry of Finance, the initial benchmark yield on the 2029 Eurobonds was around 4% and about 4.45% for the 2035 Eurobonds. Overall, in 2019, the Ministry of Finance issued US$6.5 billion worth of Eurobonds.

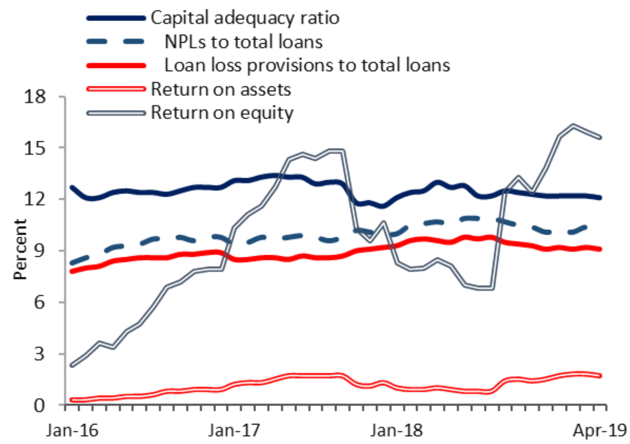
In May, lending to both the retail and corporate segments continued to grow. As of June 1, 2019, credit to the corporate sector grew by 6.3 percent (after adjusting for FX changes) compared to 5.5 percent, y/y, in the previous month. Credit to households in rubles continued to grow in double digits – at 23.5 percent, y/y. To slow down unsecured consumer lending, the Bank of Russia (CBR) imposed a series of new caps on how much lenders can charge retail borrowers, including caps on "payday loans". This was announced on July 1, 2019. One of the CBR's new rules limits how much lenders can charge on consumer loans with a maturity of up to one year. The maximum charge on these loans, including accrued interest, fines and fees, will be twice the amount of the loan principal. Starting in October 2019, the Russian consumer lending market will be subject to new regulations, according to which banks will be required to take into account the prospective borrower's debt load when issuing a loan. The debt load will, among others, affect the true interest cost. This approach should discourage banks from excessively issuing unsecured consumer loans.

Key credit risk and performance indicators remained largely stable (Figure 6). As of May 1, 2019, the capital adequacy ratio stood at 12.1 percent (against a regulatory minimum of 8 percent). The non-performing loan ratio slightly decreased to 10.2 percent from 10.4 percent in the previous month. For the first five months of 2019, the banking-sector's profits totaled RUB 867 billion (US$13.2 billion), an increase compared to RUB 527 billion (US$9 billion) in the same period of 2018. Return on assets (ROA) and return on equity (ROE) have been growing steadily, reaching 1.7 percent and 15.6 percent, respectively, as of May 1, 2019.

The CBR has formally completed the bail-out procedure of the bank Otkritie and it has approved a re-capitalization of the Moscow Industrial Bank (MIB). Otkritie became the first bank to be bailed out under the new scheme involving the Banking Sector Consolidation Fund (BSCF), created by CBR in 2017. Currently, the Bank complies with all CBR's requirements for financial resilience and creditworthiness, and it will be supervised under the general terms. The CBR intends to sell a part of its portfolio of the Bank's shares in 2021. The number of shares to be sold will be determined based on the market situation and the Bank's performance. The CBR will provide RUB 128.7 billion (US$ 2 billion) to support MIB, which was bailed out via BSCF in January 2019 (at the time, it was the 33rd largest bank in the country in terms of assets). Following the re-capitalization, MIB will be fully-owned by the CBR.

The CBR continues to remove insolvent banks. The number of banks in Russia has fallen from 484 at the beginning of 2019 to 467 as of June 1, 2019.

Figure 6: Key credit risk and banking performance indicators remained stable



Source: CBR.

Main Economic Indicators																			
	2018												2018	2019					
Output Indicators	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec		Jan	Feb	Mar	Apr	May	Jun
GDP, % change, y-o-y	-	-	1.9	-	-	2.2	-	-	2.2	-	-	2.7	**2.3**	-	-	0.5	-	-	-
Basic sectors, % change, y-o-y	2.3	2.7	1.9	3.7	3.7	1.6	2.8	1.2	0.7	3.6	1.8	2.1	**2.9**	0.3	2.3	0.2	2.9	-0.3	
Industrial production, % change, y-o-y	2.4	3.2	2.8	3.9	3.7	2.2	3.9	2.7	2.1	3.7	2.4	2.0	**2.9**	1.1	4.1	1.2	4.6	0.9	
Manufacturing, % change, y-o-y	4.3	4.7	2.2	5.3	5.4	2.2	4.6	2.2	-0.1	2.7	0.0	0.0	**2.6**	-1.0	4.6	0.3	4.7	-1.0	
Retail trade	2.9	2.0	2.2	2.9	2.6	3.3	2.7	2.8	2.2	2.0	3.0	2.3	**2.6**	2.0	2.1	1.7	1.6	1.4	
Extraction of mineral resources, % change, y-o-y	0.8	1.2	2.4	2.5	1.3	2.8	3.2	4.5	6.9	7.4	7.8	6.3	**4.1**	4.8	5.1	4.3	4.2	2.8	
Construction, % change,y-o-y	12.2	9.4	-2.5	11.0	7.9	3.1	-0.7	3.3	5.9	5.7	4.3	2.6	**5.3**	0.1	0.3	0.2	0.0	0.2	
Fiscal and Monetary Indicators																			
Federal government balance, % GDP	2.8	1.6	1.8	0.9	1.4	1.9	2.5	3.1	3.5	3.6	3.7	2.6	**2.6**	4.8	2.0	2.2	2.1	2.7	
Inflation (CPI), %, y-o-y	2.2	2.2	2.4	2.4	2.4	2.3	2.5	3.1	3.4	3.5	3.8	4.3	**2.9**	5.0	5.2	5.3	5.2	5.1	4.7
Inflation expectations, %, y-o-y	8.9	8.4	8.5	7.8	8.6	9.8	9.7	9.9	10.1	9.3	9.8	10.2	**10.2**	10.4	10.1	9.1	9.4	9.3	9.4
Balance of Payment Indicators																			
Trade Balance, billion $ (monthly)	17.0	12.2	15.0	15.0	15.2	15.2	13.1	15.8	18.8	19.9	19.0	18.2	**194.5**	14.4	16.5	15.9	13.7	11.8	
Current Account, billion $, ytd	12.9	20.7	30.0	39.3	46.9	47.9	56.7	64.5	75.4	89	102.7	113.8	**113.8**	10.3	22.7	33.7	45.5	48.7	45.8
Export of goods, billion $	33.4	31.2	36.9	36.2	36.5	36.6	34.4	37.4	38.7	41.3	40.5	41.4	**443.4**	30.8	34.8	36.8	35.7		
Import of goods, billion $	16.4	19.0	21.9	20.9	21.4	21.0	21.0	21.6	19.8	21.6	21.5	22.5	**249.0**	16.4	18.2	20.9	22.0		
Financial Market Indicators																			
CBR policy rate, %, end-o-p	7.50	7.50	7.25	7.25	7.25	7.25	7.25	7.25	7.50	7.50	7.5	7.75	**7.75**	7.75	7.75	7.75	7.75	7.75	7.5
Credit to households in Rub, % change, y-o-y	14.5	15.2	16.1	17.1	18.5	19.4	20.3	21.1	22	22.5	23.1	22.6	**22.6**	23.2	23.6	23.7	24	23.5	
Credit to the corporate sector in Rub, % change, y-o-y	5.1	5.5	6.3	7.5	6.9	7.4	8.1	9.5	8.4	9.7	10.6	12.0	**12.0**	12.3	12.1	12.3	11.4	11.8	
Capital adequacy ratio	12.1	12.4	12.5	13.0	12.7	12.8	12.2	12.2	12.5	12.4	12.3	12.2	**12.2**	12.2	12.2	12.2	12.1		
NPLs to total loans	10.0	10.5	10.6	10.7	10.6	10.9	10.9	10.9	10.7	10.5	10.4	10.1	**10.1**	10.2	10.1	10.4	10.2		
Loan loss provisions to total loans	9.3	9.6	9.7	9.6	9.5	9.8	9.7	9.8	9.5	9.4	9.3	9.1	**9.1**	9.2	9.1	9.2	9.1		
Return on assets (ROA)	1.0	0.9	0.9	1.0	0.9	0.8	0.8	0.8	1.4	1.5	1.4	1.5	**1.5**	1.7	1.8	1.8	1.7		
Return on equity (ROE)	8.3	7.9	8.0	8.5	8.1	7.0	6.8	6.8	12.4	13.3	12.4	13.8	**13.8**	15.7	16.3	15.9	15.6		
Income, Poverty and Labor Market																			
Real wages, % change, y-o-y	11.0	10.5	8.7	7.6	7.6	7.2	7.5	6.8	4.9	5.2	4.2	2.9	**7.0**	1.1	0.0	1.3	3.1	2.8	
Unemployment (%, ILO definition)	5.2	5.0	5.0	4.9	4.7	4.7	4.7	4.6	4.5	4.7	4.8	4.8	**4.8**	4.9	4.9	4.7	4.7	4.5	
Exchange rate																			
USD/ RUB, average	56.8	56.8	57.0	60.4	62.2	62.7	62.8	66.1	67.7	65.8	66.2	67.3	**62.5**	67.3	65.86	65.14	64.62	64.82	64.22
Euro/ RUB, average	69.0	70.3	70.4	74.2	73.7	73.2	73.4	76.2	79.0	75.7	75.3	76.6	**73.9**	76.9	75.78	73.75	72.61	72.51	72.43
Oil price																			
Brent, $/ bbl	69.0	65.4	66.5	71.6	76.7	75.2	74.4	73.1	78.9	80.5	65.2	56.5	**71.1**	59.3	64.1	66.4	71.2	70.5	63.3

Source: Rosstat, CBR, EEG.

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