RUSSIAN FEDERATION
Monthly Economic Developments
August 11, 2014

- Second quarter GDP estimates and high-frequency indicators suggest continued weakness in the economy even before the latest round of economic sanctions introduced by the EU, the US, and other countries in late July. The World Bank maintains its current 0.5 percent growth projection for 2014.
- Inflation slowed in July, but the wide-ranging ban on food imports the Russian authorities introduced in early August will likely increase short-term inflationary pressure and put the Central Bank’s 2014 inflation target further out of reach.
- Pressure on the Ruble resumed on the back of escalating geopolitical tension and advanced sanctions.
- The continued slowdown in Russia comes amid a sharp rebound in economic growth in the US in the second quarter and a modest pickup in activity in China, while external financing conditions for developing countries remain favorable, reflecting continued accommodative policies in high-income economies.
- Global oil prices reversed their course in July as geopolitical risks emanating out of Iraq abated, but the ban of EU exports of oil drilling technology to Russia could drive up prices again.

In August, the US, EU, Japan and Switzerland introduced additional economic sanctions on Russia. As in earlier rounds, some of the sanctions were aimed at specific individuals and companies directly involved in Ukraine or at goods produced in Crimea. This time the US introduced sanctions on several companies and three banks that prevent them raising financing with maturity longer than 90 days in the US. The EU adopted sanctions aimed at curbing arms sales, exports of high-tech equipment for the oil sector, and cutting off external financing for several banks. In retaliation, on August 7, Russia banned the imports of meat, fish, seafood, vegetables, fruit, milk, dairy products and a wide range of processed foods from the US, the EU, Australia, Canada and Norway for a year.

According to Rosstat’s preliminary estimate, Russia's economic growth moderated from 0.9 percent y-o-y in Q1 2014 to 0.8 percent in Q2 2014. This GDP growth estimate is slightly better than the 0.7 percent market consensus, but lower than the 1.1 percent expansion predicted by the Ministry of Economic Development. Our estimates suggest that the economy expanded in seasonally adjusted terms in the second quarter after contracting in the first. The World Bank maintains its current growth projection of 0.5 percent growth for 2014.

Most high-frequency statistics for June revealed continued weakness in the real sector, yet investment demand started to pick up and business confidence strengthened into expansionary territory. A high base effect was part of the reason and lower external and domestic demand adversely affected several industries, in particular, the metallurgical, chemical and machinery and equipment production. In line with developments in manufacturing, industrial production surprised on the downside, with output slowing to a 0.4 percent growth in June (y-o-y) from 2.8 percent in May. Yet, the July HSBC Russia Manufacturing PMI suggests that business confidence strengthened with the index increasing to 51.0 from 49.1 in June, moving for the first time since October 2013 back in expansion territory. Investment demand moved into positive growth territory for the first time since December 2013: fixed investment registered 0.5 percent growth compared to a contraction of 2.6 percent in May and 3.8 percent in the first five months of the year. A decline in real incomes, accelerated inflation and increasing household indebtedness negatively affected consumer demand in June. Retail trade...
grew at 0.7 percent (y-o-y), the lowest reading since December 2009. Demand for market services also remained sluggish in June: paid market services registered a 0.6 growth (y-o-y).

Inflation slowed in July thanks to a decline in services prices growth, but the newly introduced ban on food products will increase short term inflationary pressures and put CBR’s inflation target for 2014 further out of reach. Consumer prices increased 0.5 percent in July (m-o-m), while 12-month inflation slowed to 7.5 percent in July from 7.8 percent in June. Prices for food fell in July compared to June slightly, thanks to the typical summer seasonal decline in fruit and vegetable prices. Yet, food prices are likely to remain the main inflation risk in coming months. It is expected that the introduced ban on imports of food products from the EU, the US and some other countries will wipe out those seasonal effects and will result in acceleration of food prices. Together with the recent tightening, this will make reaching CBR’s already revised inflation target for 2014 further unlikely.

Concerns about inflation pressures led the Central Bank of Russia (CBR) to increase its key policy rate by another 50 basis points on July 25 to 8 percent despite slowing inflation and a continued sluggish economy. This increase brought the cumulative increase to 250 basis points this year. Twelve-month inflation, meanwhile, rose from 6.5 percent in December to 7.8 percent in June. The central bank explained its move with concerns about new inflation risks arising from potential changes in tax and tariff policy, increased geopolitical tension and its potential downward impact on the Ruble. These factors could contribute to an elevation in inflation expectations and pressure, thus threatening the 4 percent medium term inflation target. CBR projects inflation to decelerate to a range of 6.0-6.5 percent by end-2014. Lending rates for non-financial organizations climbed from 9.2 percent in January to 10.6 percent in May – remaining little changed in real ex-post terms - and the tightening could potentially further increase the cost of credit for the already stagnating economy. The situation is exacerbated by the recently introduced sanctions from US, EU and Canada against several Russian companies and banks which limit their access to longer-term international funding.

In early August and throughout July, pressure on the Ruble reappeared on the back of escalating geopolitical tension and further round of sanctions introduced by the US and EU. In the first 13 days of August, the official Ruble exchange rate lost 0.9 percent with respect to the dual currency basket. In July, the Ruble depreciated by 0.5 percent against the dual currency basket on an annual average basis (and 5.3 percent by end July compared to end June). Yet, the Ruble was traded within the by the regulator established band, which did not require CBR’s interventions. International reserves decreased by US$9.5 billion in July to US$468.8 billion mainly due to euro/dollar exchange rate dynamics.

Credit growth slowed rapidly, but banks saw some recovery in deposits during June. Credit to households expanded 20.9 percent (y-o-y) compared in June, down from to 22.6 percent in May and 28.7 percent in December 2013 while lending to firms companies decelerated to 15.7 percent (y-o-y) compared to 17.3 percent average growth registered in the first five months of 2014. Individual depositors returned to banks in June after a second unexpected large pull-out we observed this year in May. However, the reported growth in private deposits (0.8 percent, m-o-m) was not enough to restore it back to the pre-February 2014 base levels. In fact, households’ deposits base eroded further in June, growing at 8 percent (y-o-y) compared to 10 percent in May (and over 20 percent during 2013). Falling profit margins of firms and
slowing income growth of households led to a worsening of the quality of the outstanding credit portfolio. The share of non-performing loans (NPLs) by households continued increasing to 8.2 percent in June from 7.7 percent in May. The share of NPLs by firms also rose to 5.5 percent in June from 4.7 percent in May. However, banks reported adequate provisioning and capitalization.

Balance of payments data for the second quarter show a significantly improved current account and a further deterioration of the financial account. The current account (CA) surplus rose to US$17.1 billion in April-June from US$1.8 billion a year earlier. Higher energy exports, lower imports of goods and lower earnings to foreign direct investors were the main contributors to the larger surplus. Energy exports increased to US$91.3 billion in Q2 2014 from US$83.9 billion a year earlier on the back of higher oil prices and increased volumes of oil products and gas exports. The Ruble depreciation and stagnating economy contributed to the last quarter’s decrease in imports of goods to US$80.2 billion compared to US$84.5 billion in Q2 2013. Lower profits of FDI companies resulted in lower earnings to foreign direct investors of US$28.1 billion in Q2 2014 (compared to US$31.4 billion in Q2 2013). The financial account deficit deteriorated to US$16.6 billion in Q2 2014 (compared to US$7.8 billion in Q2 2013), negatively affected by the ongoing geopolitical tensions and slowing economic growth: net capital outflows from the private sector—corrected for currency swaps and foreign exchange deposits of resident banks—reached in Q2 2014 US$12.3 billion, still exceeding capital outflows of US$4.6 billion in Q2 2013, but showing a significant improvement compared to net capital outflows of US$62.0 billion in Q1 2014 (and annual net capital outflows in 2013 of US$61.0 billion). Russian households also decreased their foreign exchange purchases from US$10.3 billion in Q1 2014 to (still elevated) US$1.8 billion in Q2 2014.

The federal budget surplus improved to 1.9 percent of GDP in the first half of 2014 from 1.2 percent of GDP a year earlier because of higher oil-related revenues, while the non-oil deficit remained at the same level of around 9 percent of GDP. Federal budget revenues rose to 21.1 percent of GDP in January-June 2014 from 20.4 percent a year earlier in line with the surge in oil-related revenues by 0.9 percentage points to 11.0 percent of GDP. Noninterest federal budget expenditures were little changed at 18.5 percent of GDP during the first half of 2014. However, within the budget, execution patterns shifted slightly: on a year to year basis, defense outlays increased by 0.8 percentage points while social expenditures fell by 1.0 percentage points in the first six months of 2014. Payroll contributions for the private pension funds were channeled to the state-administered pay-as-you-go system that pays current pensioners, reducing transfers to the Pension Fund by the equivalent amount and thus federal social policy expenditure.

Developments in Russia occurred in a global economy where recovery is gaining tentative traction, led by a rebound in the US and China. In the US, a broad-based expansion of output of about four percent (q/q, saar) took hold with a wide range of lead indicators—including service and manufacturing PMI—pointing to continued recovery. In China, growth
policy support measures combined with robust demand for imports in the US and the Euro Area, contributed to a rebound of output growth to 7.5 percent (q/q saar) from 6.1 percent in the first quarter. In contrast, in the Euro Area economic activity eased, weighed down by weaknesses in France, Italy, the Netherlands, and Portugal. However, lead indicators point to a cyclical recovery, even if uneven across member states. Monetary measures by the European Central Bank should be supportive of economic activity by keeping borrowing costs down and improving credit flows to the private sector. Despite global economic activity accelerating in the second half of the year, the World Bank’s global growth forecast for 2014 may be revised downward due to weak first quarter outcomes one-off factors.

The strong rebound in capital flows to developing countries that resumed in March has continued through June, supported by favorable global financing conditions with little spillover effects of local crises. The strong pick-up in June was largely due to a surge in syndicated bank lending reflecting large loans to corporates in East Asia and Latin America. Strong bond and equity flows were helped by a surge in Mexico’s equity issuance, and bond issuance by borrowers in Europe and Central Asia. Euro-denominated developing-country bond issuance picked up sharply this year (by more than six times compared to a year ago) as countries took advantage of lower borrowing costs in Europe. Overall, spreads on emerging market bonds have declined, but violence in Eastern Ukraine and payment default in Argentina pushed up Credit Default Swaps (CDS) spreads for sovereign bonds of those two countries up by more than 150 basis points.

In July, oil prices reversed their upward course as geopolitical risks emanating out of Iraq abated, but the ban of EU exports of oil drilling technology to Russia could drive up prices again. After peaking in late June, prices eased one the news that Iraq’s oil production remained unaffected by the ongoing insurgency. Brent price (the international marker) was down 4.4 percent (m-o-m) while WTI (the US mid-continent price) fell by 2.2 percent (m-o-m). WTI prices were influenced by high commercial crude inventories in the US, which remain above 370 million barrels in spite of exceptionally high demand by the refineries. At present, Brent is largely determined by geopolitical events in Libya and Ukraine, which has a more of direct impact on the European market while the US is isolated from this affect. Libya reopened ports which had been closed for nearly a year, but fresh clashed around the capital among different militia groups highlighted how fragile the security situation remains. This positive news was until now enough to limit any increase in Brent prices, but the increased sanctions by the EU against Russia, which ban the export of advanced technology that could be used to drill for oil in Russia could drive up Brent prices again.

Compiled by a World Bank team under the guidance of Birgit Hansl, consisting of the following members (in alphabetical order): Damir Cosic, Olga Emelyanova, Mizuho Kida, Mikhail Matytsin, and Ekaterine Vashakmadze.