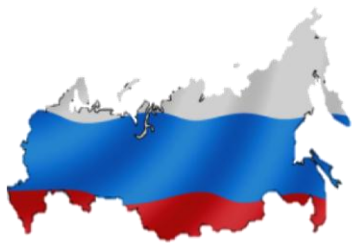
Russia Monthly Economic Developments

December 2014

- The World Bank revised its 2014 growth projection for Russia up from 0.5 percent to 0.7 percent.
- Sliding oil prices led to a fresh round of sharp Ruble depreciation.
- The Ruble weakness and the food import ban continued pushing up consumer prices in November, making a further significant policy rate hike by CBR on December 11 likely.
- But the weaker Ruble appears to have supported industrial activity, which reported robust growth in October, yet we expect the positive lift from import substitution to be short-lived as consumer demand is fading.
- Russia's financial sector outlook deteriorated as the depositors' base continues to erode and refinancing risks increase.
- The government continued using the National Welfare Fund to enhance the stability of the financial system**.**

The World Bank revised its 2014 growth projection for Russia up from 0.5 percent to 0.7 percent as part of its quarterly forecast review. This upward revision is the result of two factors — better than expected growth in the third quarter at 0.7 percent, year-on-year, and potentially stronger net exports in the fourth quarter as imports are now expected to decrease at a faster rate than anticipated due to the sharp Ruble depreciation. In addition, the Ruble weakness created this year more import substitution potential for the manufacturing sector, which could support growth in the remainder of the year in sectors with spare capacity.



The slide in oil prices following OPEC's decision on November 27 not to cut production led to a fresh round of sharp Ruble depreciation. Already in November the slide in crude oil prices (World Bank average) deepened and prices fell by 18 percent, month-on month. The market continued its search for a floor, with prices falling by US$15 per barrel from US$82.9 per barrel on October 31 to US$67.7 per barrel on the last trading day of November. Oil prices remained under pressure from excess supply and a strengthening US Dollar, but the sharpest decline — by 10 percent to around US$70 per barrel of Brent oil, the lowest level since October 2009 — followed the OPEC meeting, which agreed to maintain the production level of 30 million barrels per day (unchanged since December 2011). The free-floating Ruble lost 15 percent versus the US Dollar since the OPEC decision on November 27. This decision, in the face of oversupply in world oil markets, is a turning point in OPEC's strategy from defending oil prices to maintaining its market share. It is expected that over the next months the market will rebalance and establish a new equilibrium level for oil prices.

The Central Bank of Russia resumed interventions in the first week of December in support of the free-floating Ruble, which depreciated by 55 percent since January. Since January, the CBR spent about US$68.9 billion on interventions, with reserves standing at a comfortable US$420 billion at the end of November (11.6 months of imports). After the CBR switched to the free Ruble float on November 10 it did not intervene until December 1. Since then it intervened on three occasions: on December 1 (with US$0.7 billion), December 3 (with US$ 1.9 billion) and on December 5 (with US$1.9 billion), citing risks to financial stability from the large Ruble depreciation and volatility, and doubts that the current exchange rate reflects market fundamentals as reasons. Markets quickly adjusted expectations regarding Russia's risk: Russia's 5-year Credit Default Swaps spreads jumped to 363 basis points on December 3 from 300 basis points a week earlier, to almost 200 basis points higher than in January.

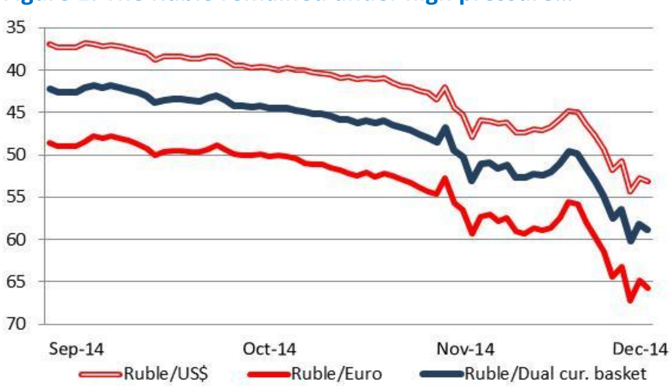
Consumer prices continued to increase in November despite the CBR's recent rate hike as the Ruble weakened and food prices continued to climb. The capacity of the Russian food industry to replace banned food imports appears to be limited. Food prices rose by 12.6 percent in November, year-on-year, and were, together with the Ruble depreciation, the main factor pushing headline inflation up. The twelve-month Consumer Price Index rose to 9.1 percent year-on-year in November, well above the CBR targets of 3.5-6.5 percent set at the beginning of the year and 7.5 percent set in September. The recent hike in the key policy rates on October 31 by 150 basis points appeared to have little impact on inflation dynamics, which remain heavily impacted by the above mentioned two non-monetary factors. But it is the continued weakness of the Ruble which in our view became the key risk for CBR's inflation target and makes a further significant rate increase by CBR at their next scheduled board meeting on December 11 likely.

The weak Ruble supported robust growth of industrial activity in October, yet the positive lift from import substitution is likely to be short-lived. Aggregate industrial output increased by 2.9 percent in October, year-on-year, compared to 2.8 percent in September. The utility sector expanded by 2.8 percent in October compared to a contraction of 0.8 percent in September due to increased demand for heating and electricity during the cold weather. Manufacturing continued to outperform other industries with 3.6 percent growth, supported by the weak Ruble and a continuing expansion of production in the military complex. Yet, growth in food production slowed to 3.5 percent in October from 5.1 percent in September, indicating that the potential for import substitution created by the weaker Ruble is narrowing and will be constrained by production capacity and dwindling domestic demand.

Domestic demand in October was adversely impacted by further climbing inflation and the depreciating Ruble. These two factors undermined the purchasing power of households and, as a result, growth in retail trade slid in October to 1.7 percent, year-on-year, compared to 3.3 percent in October 2013, marginally supported by a 0.3 percent growth in real wages. Demand for market services also slowed further to 1.0 percent from 1.9 percent in September and compared to 2.6 percent growth in October last year. Investment activities contracted by 2.9 percent in October—resulting in a cumulative decline of 2.5 percent for the first ten months of the year—as credit cost increased on the back of external credit restrictions following Western sanctions and CBR's monetary policy tightening. Weakening consumer demand is reflected in the sharp deterioration of the HSBC Russia Services Index, which contracted to 44.5 in November from 47.4 in October.

Global economic developments mirror Russia's challenges of weak demand, which hold back the recovery. In recent months, Euro Area economic indicators have steadily weakened, increasing concerns that it is on a path of secular stagnation. Confidence remains low and investment depressed, including in the more competitive German economy. In line with weak global demand, several large emerging economies continue to see signs of deceleration, including China and Brazil. Japan continues to struggle with the impact of the sales tax hike in April 2014, with third quarter data showing an unexpected contraction in real GDP. With sharp declines in oil prices, oil exporters have also been increasingly under pressure, including Venezuela and Nigeria. In contrast, GDP data for the third quarter in the United States confirmed a broad-based pick-up in demand, while further improvements in labor market conditions and declining energy costs point to strengthening consumer spending ahead. Growth has picked up in India, with a reform-minded government boosting investors' sentiment, and in Mexico, because of extensive trade exposure to the United States. Global growth in 2014 is currently estimated at about 2.6 percent, almost unchanged from the slow pace seen in 2012 and 2013. Disappointing global growth, together with the decline in inflation expectations, continues to keep global interest rates low. As a result, portfolio flows to emerging markets have recovered in November: their sovereign and corporate borrowers have raised a record US$271 billion from international bond issues so far, with China and Latin America benefiting most from a flight to safety out of emerging Europe amid geopolitical tension.

Figure 1: The Ruble remained under high pressure…

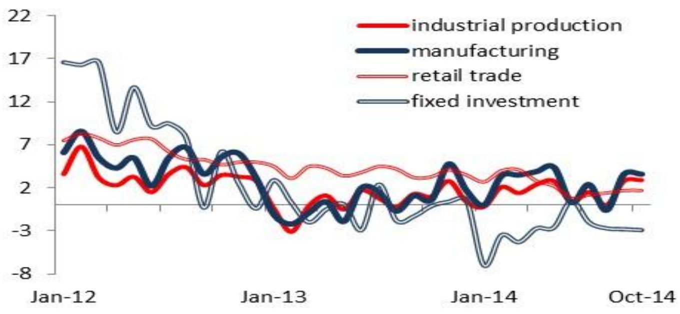


Source: CBR

Figure 2: … as crude oil prices continued to tumble

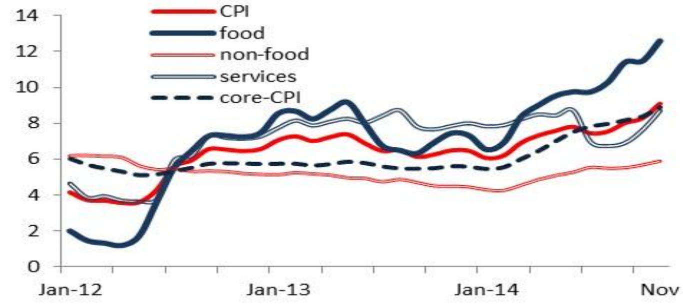
Source: Bloomberg

Figure 3: The weak Ruble supported industrial activity… (percent change, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

Figure 4: … while it is sending inflation close to the double-digits… (percent, y-o-y)



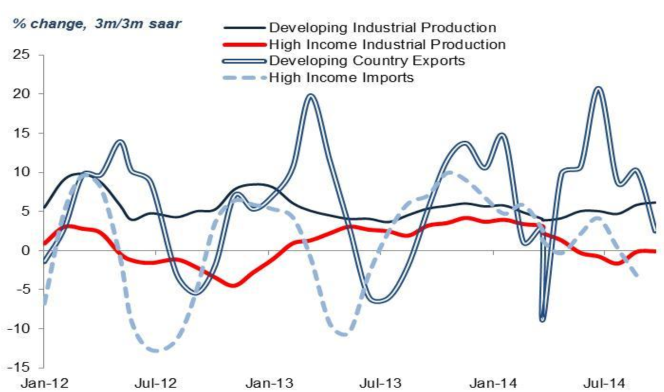
Source: Rosstat, Haver Analytics, WB team

Russia's financial sector outlook deteriorated as the depositors' base continues to erode and refinancing risk increase. The loan-to-deposit ratio for the Russian banking sector increased to 106 percent by September from 101 percent a year ago. This high ratio by international standards makes many banks vulnerable to refinancing, given the restricted access to financing abroad as a result of sanctions. The increased refinancing risk is partly reflected in the soaring risk premium on Russia's corporate debt. Spreads on Eurobonds of several banks rose above the distress level (1000 basis points above US Treasuries). Given the deteriorated outlook for the banking sector and the economy, the yields on major Russian Eurobonds held by banks may increase further. Yet, banks' foreign assets stood at US$166 billion at end-October, allowing for ample resources to meet external payments. The recently introduced repos in foreign currency also help banks to deal with potential funding gaps. The CBR's own reserves at US$205 billion (excluding gold, the Reserve Fund and the National Welfare Fund) are more than sufficient to cover the country's total external payments due in December 2014 (US$33 billion) and due in 2015 (US$125 billion).

The government continued using the National Welfare Fund to enhance stability of the financial system. Following a decree from end-November the Russian National Welfare Fund (NWF) will be used to recapitalize Gazprombank (3rd by assets) with RUB40 billion (US$0.74 billion). The bank's Tier 1 capital ratio fell to nine percent at end-June, below the required ten percent. To improve the capital adequacy ratio of Gazprombank the NWF will purchase the bank's privileged shares, while the bank will repay subordinated loans in the same amount provided through Vnesheconombank in 2008. The government has recently used the same mechanism to recapitalize VTB Bank and the Russian Agricultural Bank with RUB214 billion (US$5.4 billion) and RUB25 billion (US$0.6 billion) respectively. The NFW stood at US$80 billion at the end of November.

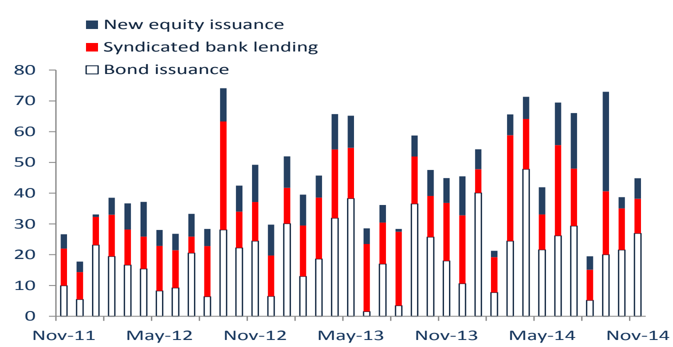
President Vladimir Putin has signed on December 3 the federal law *"On the Federal Budget for 2015 and the Planned Period of 2016-2017,"* without any changes to its underlying macroeconomic assumptions. It was adopted by the State Duma on November 21 and approved by the Federation Council on November 26.

Figure 5: The global recovery remains lackluster …



Source: World Bank Prospects Group.

Figure 6: … but gross capital flows to developing countries rebounded (in US$ billion)



Source: Dealogic and World Bank Prospects Group.

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