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- A fluid situation on global financial markets and yet again lower growth prospects led to oil prices losing ground in early July.
- Ruble depreciation pressure remained throughout June as demand for foreign currency increased while supply declined slightly due to lower oil prices.
- Russia's first quarter GDP growth was revised from -1.9 to -2.2 percent—still slightly less than projected earlier—while May high frequency statistics show a deepening recession.
- On June 25, the government approved the main parameters for the 2016–2018 budgets, foreseeing persistent deficits and evaporating fiscal buffers despite significant expenditure cuts.

In June, the European Council extended EU economic sanctions against Russia for another six months while Russia extended its food import ban against Western countries for a year.

The EU measures were originally imposed in July 2014 and reinforced in September 2014. They target certain exchanges with Russia in the financial, energy and defense sectors and dual-use goods. The latest decision on June 22 follows an agreement at the European Council in March 2015, when EU leaders linked the duration of these sanctions to the complete implementation of the Minsk agreements, which is anticipated by 31 December 2015. A few days later, Canada extended the list of sanction individuals and companies, including Gazprom. On 24 June, President Putin announced that Russia is extending its ban on food imports from EU and other developed countries for another year, until August 6, 2016. There was no significant impact on the markets, but major ratings agencies announced that, as a result, Russia's sovereign rating is likely to remain below investment grade.

Risks to the global outlook remain tilted to the downside; in particular, tighter financial conditions could combine with deteriorating growth prospects in commodity-exporting countries, to raise the possibility of greater financial stress.

Euro area growth has gained momentum and has been revised upwards to 1.5 percent for 2015, yet the recovery is still fragile (World Bank Global Economic Prospects, June 2015). Additional easing by the European Central Bank in 2014-15, including the launch in March 2015 of a quantitative easing program, brought long-term interest rates to record lows in both core and periphery countries. However, an extended period of uncertainty and Euro area stagnation—perhaps triggered by spillovers from renewed economic and financial stress in its periphery—could have global repercussions,



especially for countries with tight trade, remittance, and bank links. A slowdown in the Euro area, which accounts for more than one-sixth of global GDP, and in excess of one-quarter of global trade and cross-border banking system assets, could raise sovereign and corporate risk premia, as investors reassess growth prospects, and might force some countries to tighten fiscal policy. Global growth is expected to average 2.8 percent in 2015, slightly lower than the 3 percent anticipated in January. While China is slowing as expected, and the recession in Russia appears slightly less severe than initially predicted, deteriorating prospects in Brazil and across major oil exporters are contributing to the downward revision of developing country growth to 4.4 percent (from 4.6 percent in 2014).

A fluid situation on global financial markets and yet again lower growth prospects led to oil prices losing ground in early July.

During June, Brent prices averaged US\$64 per barrel, slightly lower than in May. The global oil market is still oversupplied with OPEC's oil output exceeding 31.3 million barrels per day (1.3 million barrels per day above its stated quota, which is becoming increasingly obsolete). Iran has agreed on a deal to enable the lifting of sanctions, and if (or when) those sanctions are lifted, Iran could add some 0.6 million barrels per day to the global market by the end of 2016. U.S. oil production has been robust with oil output expected to average 12.3 million barrels per day next year, (U.S. Energy Information Agency). The U.S. oil rig count (indicating U.S. future oil supplies), reached a low of 628 at end-June but increased in early July for the first time since December, signaling a likely end to the downward adjustment. The World Bank projects oil prices to average US\$58 per barrel in 2015 and US\$64 per barrel in 2016.

Figure 1: Oil prices fell again ...

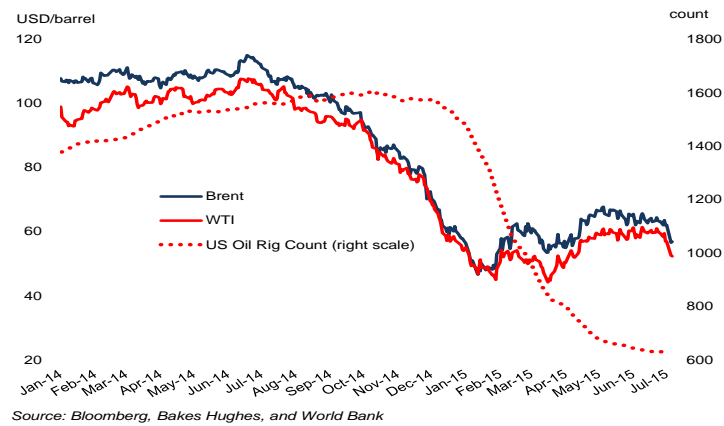
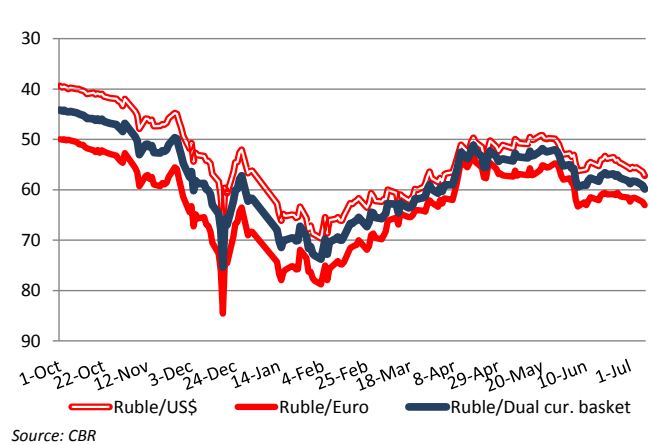


Figure 2: ... and depreciation pressure on the ruble is mounting



Ruble depreciation pressure remained throughout June as demand for foreign currency increased while supply declined slightly due to lower oil prices.

The average ruble exchange rate depreciated by 7.3 percent in June relative to May levels, partly due to lower foreign currency supply as the average Brent oil price fell by 2.9 percent. Depreciation pressure came mostly from increased demand for foreign currency: first, external debt payments almost tripled in June to about US\$9 billion compared to US\$3.5 billion in May (and US\$17 billion in the second quarter). Second, additional demand for foreign exchange came in June from the Central Bank of Russia (CBR) which purchased US\$4.3 billion on the market to replenish its foreign currency reserves. Lastly, with the start of the tourist season there has been a seasonal increase in demand for foreign currency by the population. Unless oil prices adjust upward, pressure on the ruble is likely to mount given high external debt payments of US\$29 billion due in the third quarter.

In June inflation slowed, yet higher utility tariffs will likely push up inflation in July.

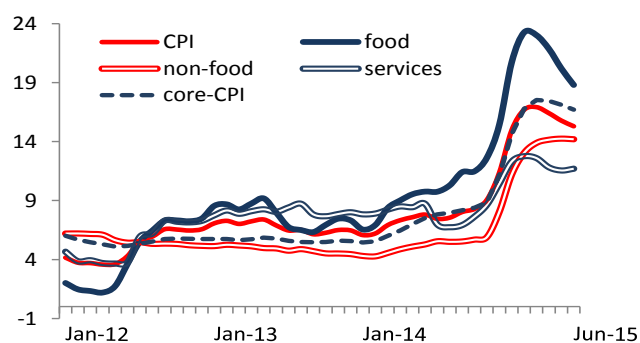
The 12-month Consumer Price Index decreased to 15.3 percent from 15.8 percent in May as food inflation continued to decline from its record level of 23.3 percent in February to 18.8 percent in June. The monthly deflation in food prices by 0.4 percent was largely due to the seasonal decline in fruit and vegetable prices. Continued weakness in consumer demand, which is constrained by the recent sharp declines in real wages and incomes, helped non-food inflation to stabilize at 14.2 percent (compared to 14.3 percent in May). However, higher utility tariffs will likely push inflation up in July and keep core inflation (at 16.7 percent in June) above headline inflation. In its meeting on June 15 the CBR cited remaining inflation risk as the main reason for its

decision to cut key policy rates by 100 basis points, less than the 150 basis points reduction in April.

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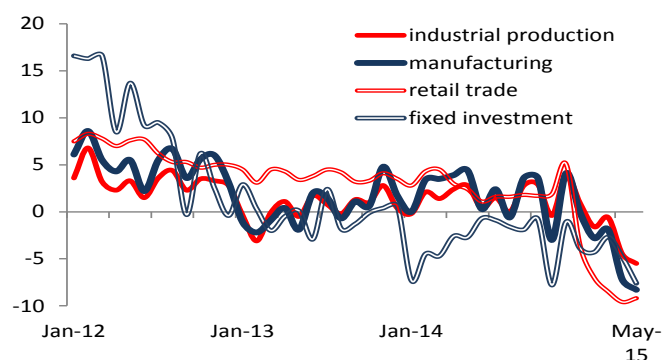
The World Bank growth forecast for Russia in 2015 is -2.7 percent. The first quarter contraction was mainly driven by depressed domestic demand which continued to weaken in May. Household consumption plummeted by 9 percent in the first quarter given negative real income growth and high consumer credit cost. In May, real incomes shrank by 6.4 percent, contributing to the drop in retail trade by 9.2 percent, year-on-year, compared to -9.8 percent in April and the decline in market services by 3.5 percent, compared to -2.6 percent in April (and growth of 1.5 percent in the first quarter). As consumer demand weakened, the massive destocking of inventories continued in the first quarter and fixed investment declined by 8.8 percent, putting the contraction of gross capital formation at 28.5 percent (from -4.5 percent in quarter four of 2014). Only buoyant export growth (4.5 percent) and a sharp contraction in imports (-25.0 percent) limited the first quarter GDP contraction. In May, economic activity deteriorated with manufacturing posting an 8.3 percent contraction (compared to -7.2 in April). Industries that produce investment goods reported again the strongest declines: machine building (-24.9 percent); transportation vehicles (-17.8 percent); and production of electro-technical equipment (-12.4 percent). A sharper decline in construction output in May (10.3 percent compared to 5.7 percent in April) confirms fading investment demand with fixed investment contracting by 7.6 percent in May, year-on-year, compared to -4.8 percent in April.

Figure 3: Inflation slowly subsides ... (percent, y-o-y)



Source: Rosstat, Haver Analytics, WB team

Figure 4: ... amid weak economic activity (percent change, y-o-y)



Source: Rosstat, Haver Analytics, World Bank team

In January-May, the federal budget primary deficit improved slightly from its 5 percent levels in previous months to 3.0 percent of GDP. In the first five months, federal budget revenue decreased to 19.0 percent of GDP from 21.2 percent of GDP over the same period a year ago (a nine percent decrease in nominal terms) due to a drop in oil revenues to 8.8 percent of GDP from 11.4 percent of GDP in January-May 2014. Non-oil revenues ticked-up slightly to 10.3 percent of GDP (from 9.9 percent in May 2014). Federal budget expenditures rose to 22.8 percent of GDP in January–May from 19.5 percent of GDP over the same period a year ago, mainly due to increased military spending (6.5 percent of GDP compared to 4.7 percent of GDP in May 2014, a 42.3 percent increase in nominal terms) and somewhat higher spending for social policy (5.9 percent of GDP compared to 4.8 percent of GDP in May 2014, a 23.5 percent increase in nominal terms). The non-oil deficit stood at end-May at 12.5 percent of GDP compared to 9.6 percent of GDP in May 2014.

On June 25, the government approved the main parameters for the 2016–2018 budgets, foreseeing persistent deficits and evaporating fiscal buffers despite significant expenditure cuts. The macroeconomic assumptions used for calculating the new budget parameters suggest a recovery of the economy to 2.5 percent growth in 2016, 2.3 in 2017 and 2.4 percent in 2018 while the Urals oil price is projected at US\$60, US\$65 and US\$70 per barrel, respectively. Economic sanctions are expected for the entire planning period. Within that framework, the federal budget deficit is projected to improve from 2.4 percent in 2016 to 1.9 percent in 2017 and 0.7 percent in 2018. Federal budget expenditures would decrease (from 20.8 percent of GDP in 2015) to 19.2 percent of GDP in

2016, 18.3 percent in 2017 and 16.7 percent in 2018. To bring about the decrease in expenditure, government expects to follow the principles of the 2015 budget: cutting non-wage spending by 10 percent and not indexing wages of civil servants and military personnel in 2016. Pensions would be indexed, but less than inflation. Changes to the 2015 federal budget law would consist in 2016 of cuts to the military and national security (by 1 percent of GDP) and to the national economy (by 0.3 percent of GDP). In 2016 and 2017 the federal budget deficit is expected to be financed mainly by the Reserve Fund, which will shrink by 2018 to RUB500 billion from RUB4.9 trillion in January 2015. In 2018 the deficit would be covered by internal borrowing. The draft budget will be considered by the Duma in September.

Continued monetary easing led to lower interest rates, but had little impact on credit activity in May while credit risks moderately rose. The stock of ruble credits to firms decreased by 0.4 percent in May, month-on-month, and to households by 0.5 percent. Credit growth further slowed to 14.4 percent in May, year-on-year, compared to 14.9 percent in April and almost 30 percent in January. A continued fall in real incomes negatively affected the capacity of households to repay debt in May with the share of non-performing loans increasing to 7.4 percent from 7.1 percent in April. Banks increased provisioning for bad loans by 3 percent in May, which further lowered their profits. Thus the number of loss-making banks increased to 264 in May from 245 in April, compared to 126 at the end of 2014. In May, the CBR revoked licenses from five small banks mostly on grounds of low capital adequacy and risky and suspicious operations.

Please contact Birgit Hansl: bhansl@worldbank.org

Prepared by a World Bank team under the guidance of Birgit Hansl, consisting of John Baffes, Olga Emelyanova, Sergei Ulatov and Eka Vashakmadze.