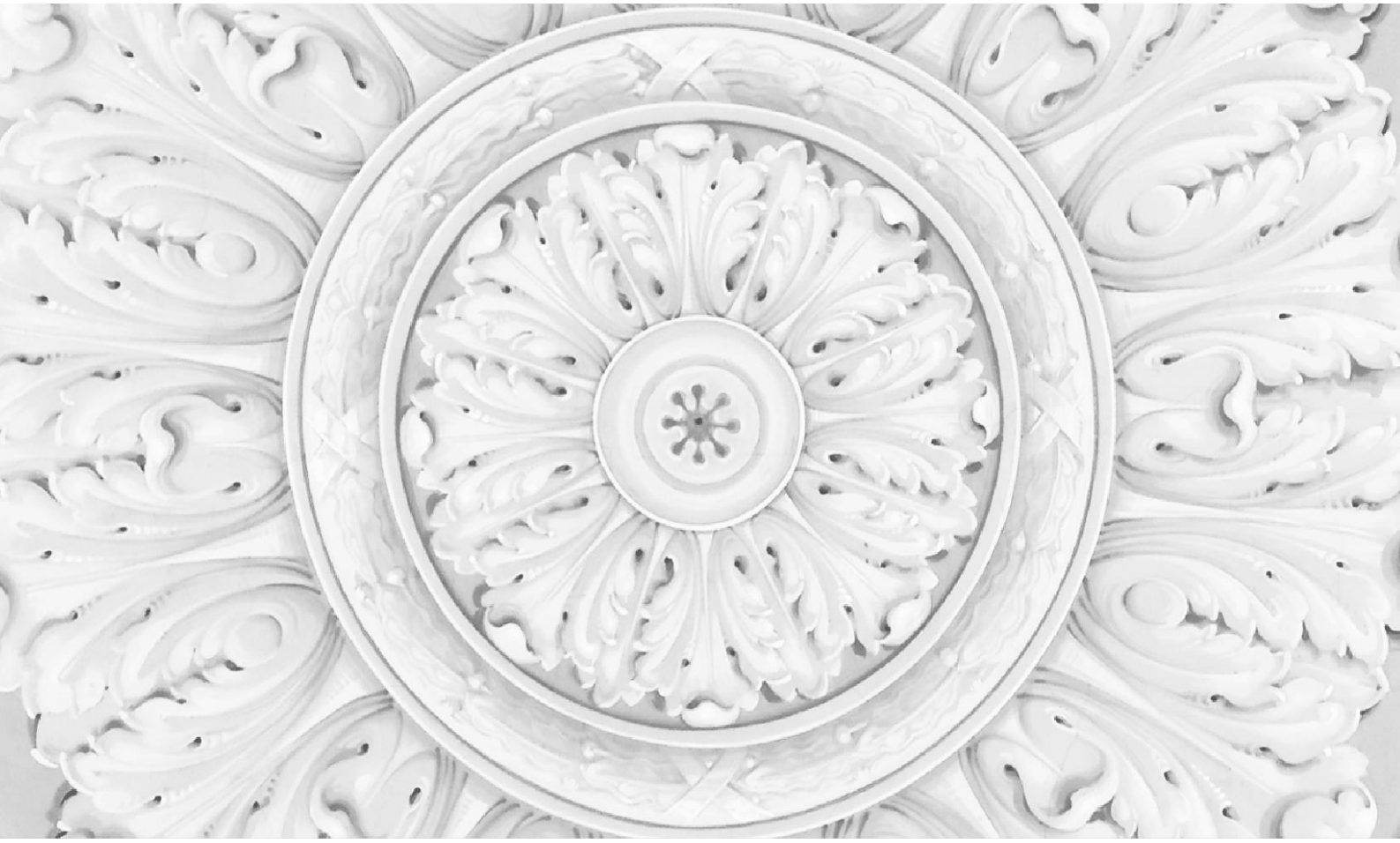
Bank of Russia

The Central Bank of the Russian Federation



TALKING TRENDS

Macroeconomics and Markets

August 2016

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No. 9

The views expressed in the Bulletin are solely those of the authors and do not necessarily reflect the official position of the Bank of Russia.

Please send your comments and suggestions to dip_bulletin@mail.cbr.ru

CONTENTS

Summary

1. Monthly summary

- In August, inflation moved in line with the Bank of Russia's baseline scenario, while foreign economic and financial conditions were overall favourable. The economy is poised for some growth in the third quarter, with substantial heterogeneity seen in sectoral economic data.
  - Inflation remains on a downward path thanks to, inter alia, the current monetary policy; however, the recorded slowdown in price growth appears insufficient to ensure that inflation reaches the 4% target in 2017. The strongly inertial inflation expectations of both households and businesses, coupled with the uncertainty over individual mid-term budget dimensions and the risk that a consumption-oriented behaviour pattern may return, are all factors that check the reduction in inflationary pressure. The current moderately tight monetary policy stance helps lower inflationary pressure.
  - The current data point to overall economic stabilisation including in consumer expectations. Q3 data suggest more confidence in economic performance than Q2 – to defy the negative industrial output data in July. Signs emerge of the economy poised to move towards a slow growth track.
  - The monetary conditions, remaining tight, continued to trend softer, reflecting a deferred impact from the June key rate downgrade and expectations for inflation slowdown.

2. Outlook

- Despite the somewhat deteriorated index estimates of Russia's GDP for the next few quarters, the economy is gradually moving to hit a slow growth path.
- Financial analysts' expectations for economic performance and inflation in Russia were downgraded.
- The entrenched expectations for loose monetary policies to hold in advanced economies promote stronger interest in risky assets including in the emerging markets.

3. In focus: the paradox of weaker consumption amid growing wages

The marked discrepancy between the positive wage growth rates and the decline in household consumption are most likely connected with: 1) slow growth seen in other household income components; 2) repayments of household loans, leading to the persistence of an elevated savings ratio; 3) outrunning wage growth in high-margin sectors with a higher savings ratio as against economy-wide; 4) outrunning growth of salaries of the highest paid employees in high-margin industries.

1. Monthly summary

1.1. Inflation is slowing down, but the risks of failure to deliver on the 4% target for inflation in 2017 are still in place

Inflation remains within the bounds of the Bank of Russia baseline scenario. However, the rates of its decline are insufficient to ensure the economy is on a path whereon it will show inflation of 4% by the end of 2017. Inflation expectations of households are more inertial compared to previous years, checking the slowdown of inflation, especially in the current context of slightly rebounded consumer activity, expected before the year-end. Nevertheless, the current moderately tight monetary policy stance helps lower inflationary pressure, facilitating further deceleration of inflation.

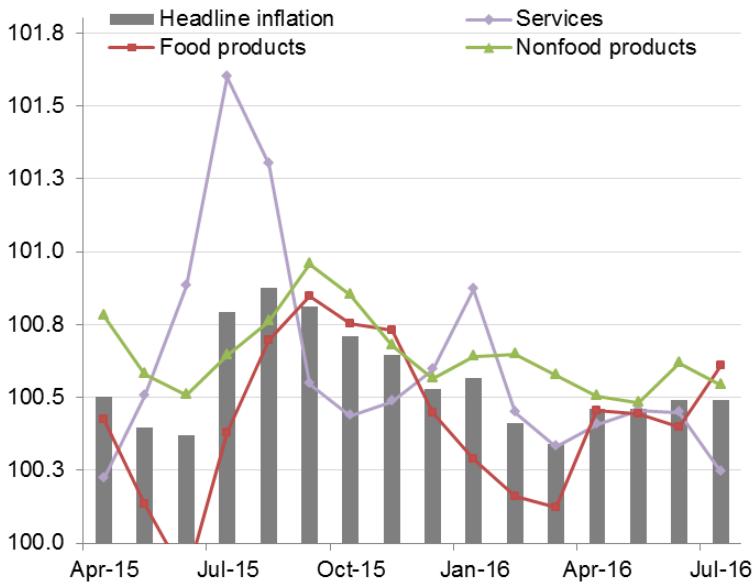
1.1.1. The favourable fruit and vegetable price movements look insufficient to lower inflationary pressure

- Seasonally adjusted inflation in July persisted at 0.5% MoM, to defy the decelerated prices for nonfood goods and services.
- Nonfood inflation pressure remains heightened, which brings risks to the needed further price deceleration.
- Early August, prices were trending lower, temporarily, influenced by the seasonal changes in fruit and vegetable prices; however, the acceleration seen in the other consumer basket components causes the price level to return to the reading of the start of the month.

Seasonally adjusted inflation in July was level with June at 0.49%[1]. Although price growth was steady, meaningful changes were seen in the way prices performed in product and service categories. July saw a substantial acceleration in food inflation from 0.4% to 0.61% MoM, while nonfood prices posted a slowdown (Figure 1).

[1] Note the slight correction of June's price growth from 0.52% MoM based on data updates.

Figure 1. Inflation component growth rates (% YoY)



Sources: Rosstat, R&F Department calculations.

The July acceleration in food prices was triggered by the reverse trend in fruit and vegetable prices[2], which grew 0.5% MoM following the 0.4% drop in June. However, the latest weekly inflation data suggest that seasonally adjusted growth rates are very likely to show a decline, which is likely to give rise to overall price decline in food prices.

Nonfood products in July were rising slower at 0.54% MoM, following the unexpected jump in June. Having said this, price pressure in this product category remains elevated in comparison with late spring. Inflation in the service sector dropped almost twofold in July from 0.45% to 0.24%, which was quite in line with expectations considering more moderate indexation of utility rates – as compared to the July 2015 indexation.

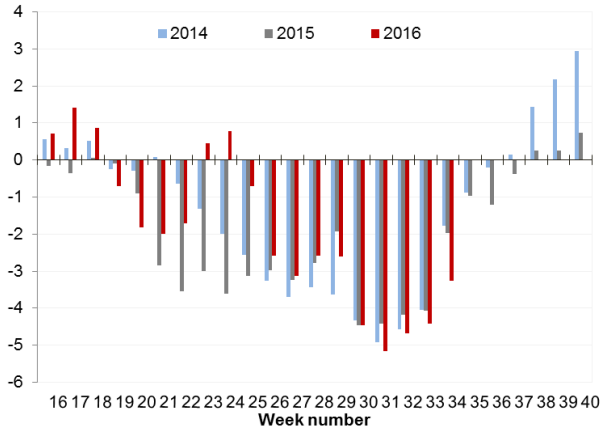
According to Rosstat data, in the week of 16-22 August, consumer price index totalled 0.053% as it interrupted its three-week decline underway since the end of July. As a result, the index won back almost all the drops of the first weeks of August: prices since the start of the month have resided in symbolically negative territory. Annual growth rates remain at the level of 7.1%. Based on the total August data, inflation is set to amount to 0.0–0.1% MoM and 6.9–7.0% YoY.

The drop in prices for fruit and vegetables was ongoing into the second half of August, albeit more moderately, which is in line with the past year's price movements (Figure 2). The highest rates of price reduction in vegetables and fruit are normally seen in the first half of August, whereafter they tend to slow down. The plentiful year, as well as the fact that no pressure is coming from the foreign exchange rate, was driving the slowdown in prices for fruit and vegetables in August from 3.4% YoY, as of 1 August, to

[2] We refer to seasonally adjusted MoM price growth rates.

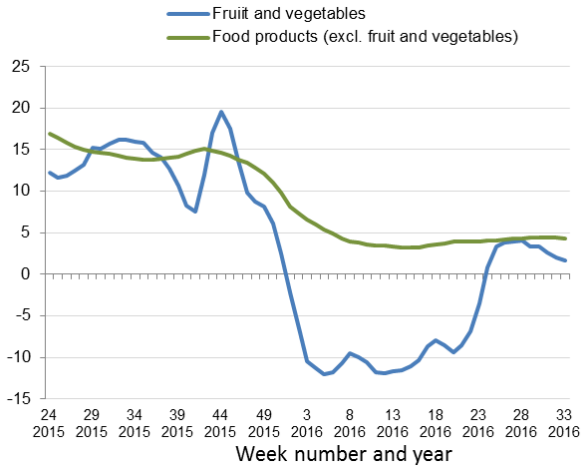
1.7% YoY, as of 22 August (Figure 3). As this takes place, the rates of growth in prices of other food products tend to slow down more moderately: from 4.5% as of 1 August to 4.3% as of 22 August.

Figure 2. Price changes in the fruit and vegetable basket on a WoW basis, %



Sources: Rosstat, R&F Department calculations.

Figure 3. Price movements in weekly monitored baskets*, % YoY



Sources: Rosstat, R&F Department calculations.

**Calculations are bases on a narrower selection of product categories compares to montly data*

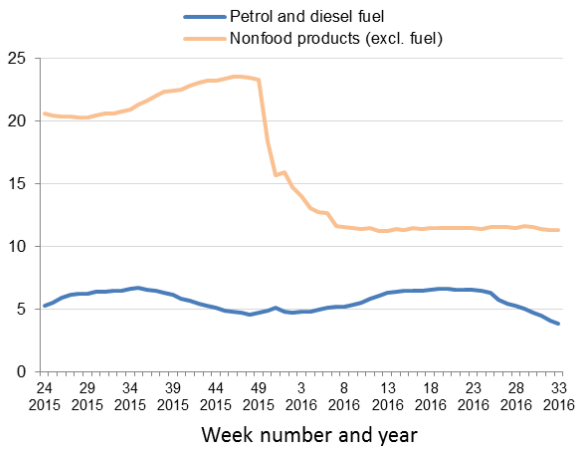
Mixed data are seen in the nonfood category where growth rates of motor fuel prices are retreating quickly (from 4.7% to 3.9%), while prices of other nonfood categories are still growing at quickened paces[3] (Figure 4). August last year saw prices starting to rise at increased rates as the pass-through effect from the weaker ruble unfolded[4]. This year, given that the ruble exchange rate has been stable through the summer, this slow decline in annual inflation in the first half of the month suggests that inflationary pressure is stubbornly elevated.

According to our estimates, the week of 16-22 August saw some growth in prices, excluding those for fruit and vegetables, as they edged up 0.15%, a level comparable to the average of the February to April period of this year (Figure 5). This bears out the advancing price pressure in the product and services basket monitored on a weekly basis, to defy the tailwinds from fruit and vegetable prices.

[3] 11.5% and 11.4% as of 1 August and 22 August, respectively. The nonfood basket monitored on a weekly basis is a lot narrower than the one used to calculate monthly inflation. Its performance is however representative for the overall nonfood inflation.

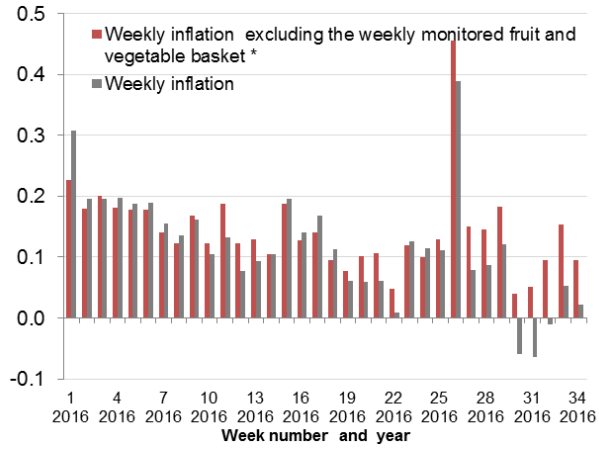
[4] In the period between early May through late July 2015 the ruble depreciated 26% against US dollar.

Figure 4. Price movements in weekly monitored product baskets, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 5. Weekly inflation, %

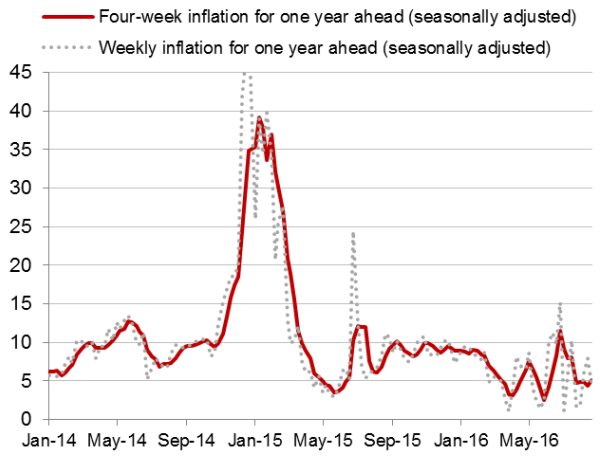


Sources: Rosstat, R&F Department calculations.

**Based on weekly monitored price movements. In 2016, CPI accounted for 2.2% of the basket.*

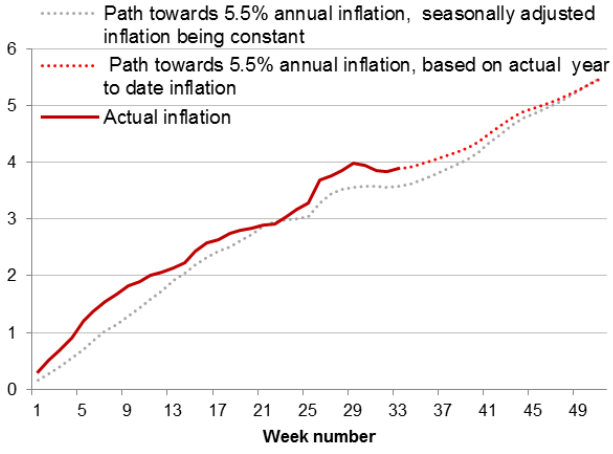
Some increase in inflationary pressure is also supported by other indicators. Seasonally adjusted annualised inflation (calculated for one year ahead based on the average daily rate of the reporting week) rose to 8.0%. In this context, seasonally adjusted four-week inflation (calculated for one year ahead), considered to be more stable, was down to 4.4% once the low readings of early August were included in the calculations (Figure 6). Up was the deviation of inflation accrued since the start of the year from the path whereon it is set to total 5.5% by the end of the year (the intermediate target on the way toward the final destination) (Figure 7).

Figure 6. Seasonally adjusted weekly inflation calculated for one year ahead, %



Sources: Rosstat, R&F Department calculations.

Figure 7. Inflation accrued since the start of the year (weekly data)



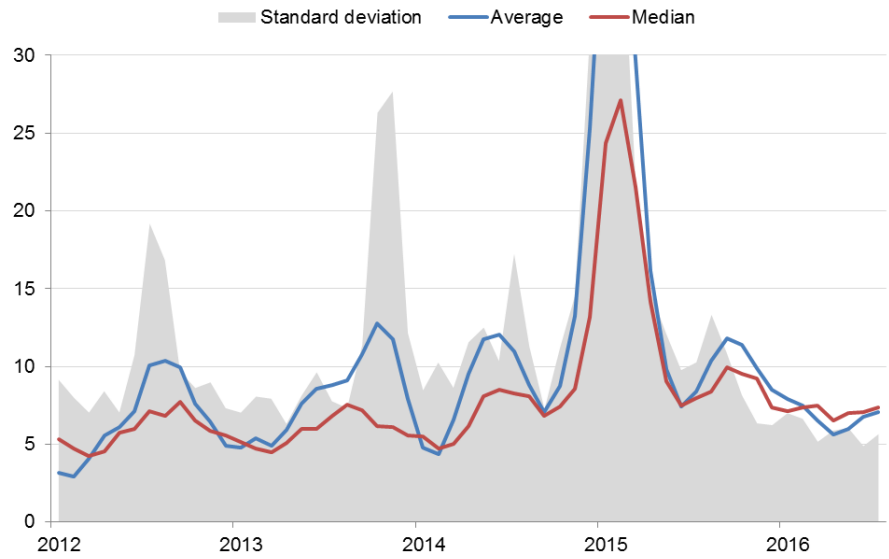
Sources: Rosstat, R&F Department calculations.

1.1.2. Convergence of price growth rates into an elevated level

- The recent developments include a rapid convergence of price growth rate across various CPI components into a point above annual inflation.
- This may well cause inflation expectations to become anchored at higher levels.
- Nonetheless, as the Bank of Russia is implementing its intent, communicated on repeated occasions, to hold its moderately tight monetary policy, inflation is set to slow down and inflation expectations are expected to slow so as to enable the target to be delivered in 2017.

In the last few months, a gradual convergence was seen between the median and average values of price growth rates, both annualised and seasonally adjusted, as the standard deviation was considerably down (Figure 8). This means that prices across various components in the consumer basket are starting to advance at a similar rate as the effect from a variety of shocks, responsible for the change in relative prices, is dwindling. Importantly, the rate of price growth to which this convergence is leading to is above the annual inflation (7.2% in July). This trend shows that inflation pressure is elevated.

Figure 8. Price rate growth distribution, 53 CPI components (3-month seasonally adjusted annualised inflation), %

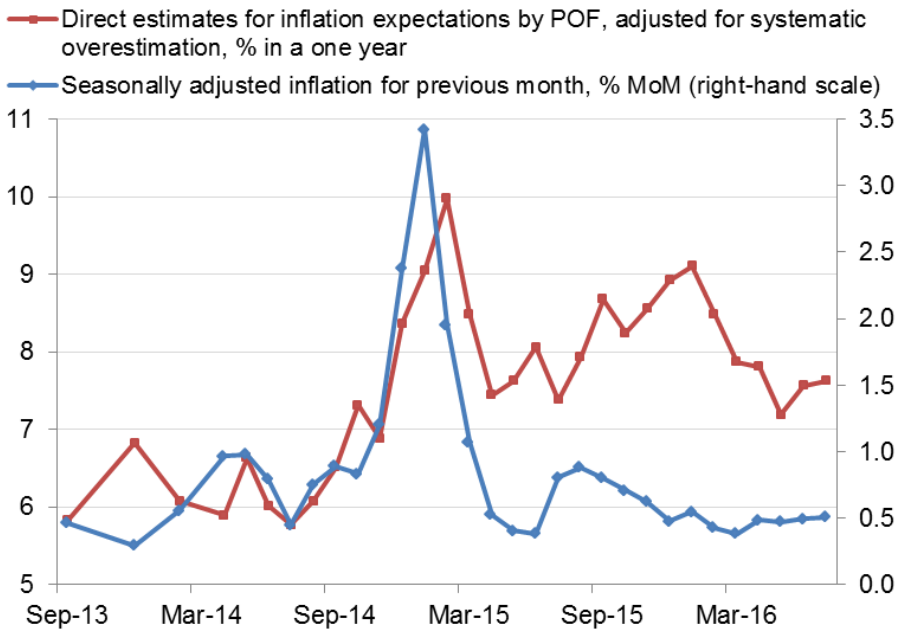


Sources: Rosstat, R&F Department calculations

Stabilised and stubbornly elevated inflation could lead to inflation expectations becoming anchored at this same level, preventing their decline. To a degree, this tendency is already visible (Figure 9): household inflation expectations between June and July rose slightly, following the strong drop in the January to May period. Anchored at a higher level, inflation expectations contribute to the risks that inflation may decrease at a slower pace and that it may deviate from the intended path whereon it would reach its target for the end of 2017.

At the same time, the high expected real interest rates hold back inflation and reduce inflation expectations; hence the need to maintain the current moderately tight monetary policy.

Figure 9. Inflation expectations



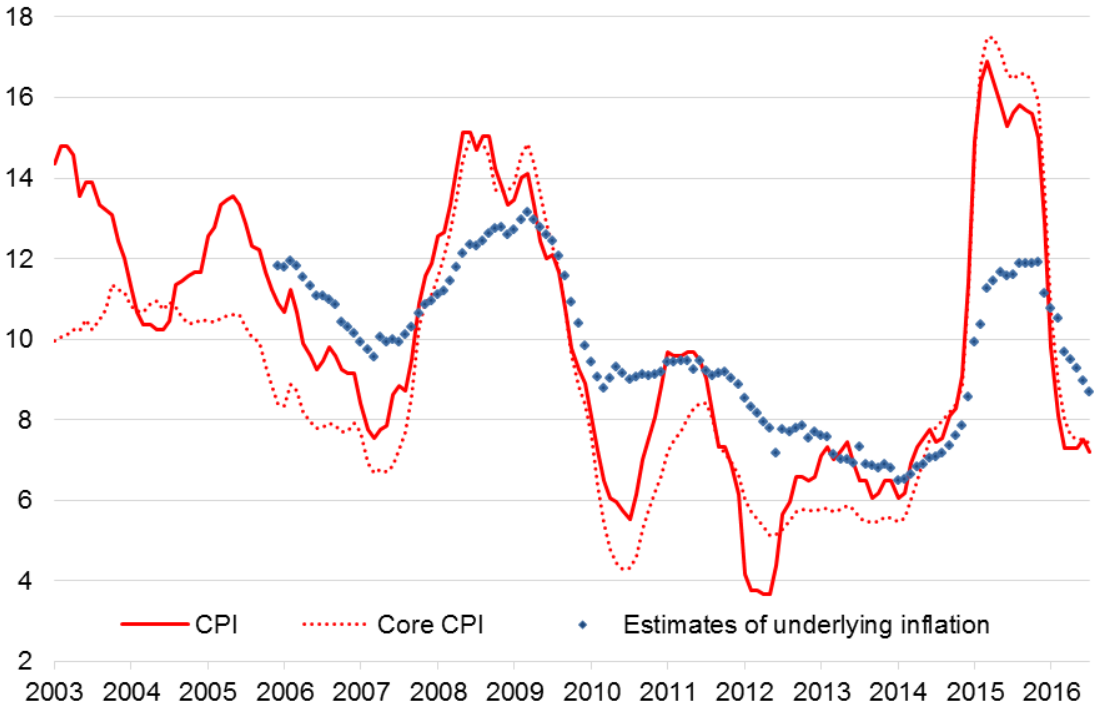
Sources: Rosstat, inFOM, R&F Department calculations.

1.1.3. Gradual slowdown of underlying inflation [5]

- Estimated annual rates of underlying inflation in July were revised downwards to 8.7% on 9.0% in June, reflecting weakened inflationary pressure (Figure 10).
- Provided that the current performance of prices and monetary aggregates hold, we expect further gradual downgrades in estimates of underlying inflation.
- The risks for inflation to move away from target in the end of 2017 are still there. Currently, high underlying inflation holds and its downward movement remains slow.

[5] The underlying inflation is understood to be the median value of the three estimates based on the identification of the unobserved general component in the set of price indicators, enabled by dynamic factor models. This method of measuring underlying inflation is detailed in the Bank of Russia's economic research papers: E. Deryugina, A. Ponomarenko, A. Sinyakov, K. Sorokin 'Evaluating the underlying inflation measures for Russia' / *Working Paper Series*, March 2015, No. 4. See also: R&F Department Analytical Note, 'Measuring Domestically Generated Inflation', May, 2016. No. 2.

Figure 10. CPI, core CPI and historical unverlying inflation estimates by BoR, % p. a.



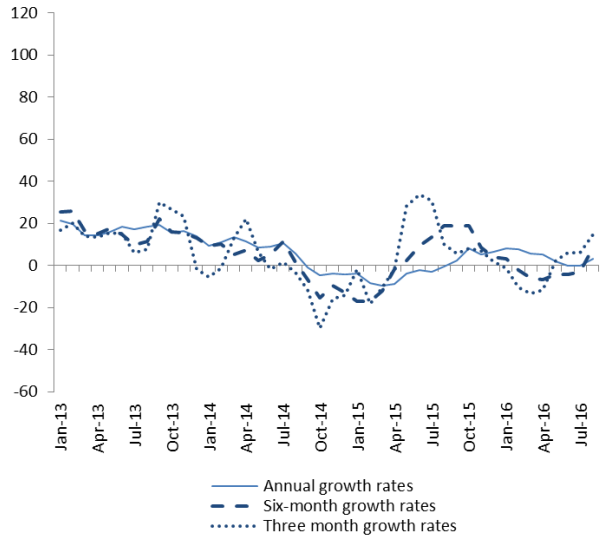
Sources: Rosstat, R&F Department calculations.

1.1.4. The shrinking share of foreign-currency deposits is expected to reduce inflation risks

- The large share of foreign-currency deposits in the structure of money supply is expected to shrink over the medium term.
- This is certain to diminish inflation risks.

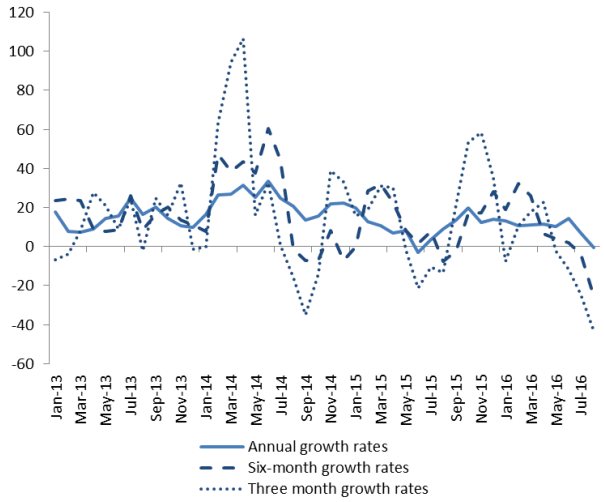
Tentative data show that the annual increment in M0 totalled 12%, while foreign-exchange deposits (in ruble terms) rose 15% as of the beginning of August. This signals an increase in the foreign exchange component of the money supply, triggered by revaluation of its ruble amount. At the same time, there was a notable drop in forex-exchange deposits in dollar terms over the last four months.

Figure 11. Foreign-currency deposits in USD equivalent (growth, %): households



Sources: Bank of Russia, R&F Department calculations.

Figure 12. Foreign-currency deposits in USD equivalent (growth, %): corporate sector



Sources: Bank of Russia, R&F Department calculations.

Over the last several years, fluctuation in foreign-currency bank deposits, as unrelated to forex revaluation, were normally determined by deposits of legal entities. The ongoing reduction in foreign-currency deposits, in dollar terms, is also observed exclusively in the corporate sector (Figure 12), while those of the population are changing but slightly (Figure 11). The way corporate deposits perform can be viewed as a response to exchange rate fluctuations. On the background of strengthening of the ruble, similar dynamics were observed in the middle of 2014. At the same time, the share of corporate foreign-currency deposits in the structure of money supply is likely to drop over the medium term, taking into account its present abnormally high level[6].

Dedollarisation of deposits, with its positive impact on net capital outflows, observed in the recent months, is also explained by other factors beyond the stable ruble in the aftermath of the winter's oil price shocks. In the absence of new external upheavals, further dedollarisation of foreign-currency deposits (primarily in the corporate sector) may be in store.

Further dedollarisation will help keep capital outflows at a lower level. It means that the current account surplus of the balance of payments may be modest for a long time without threatening the ruble.

Lower dollarisation in the corporate sector's deposits is fraught with lowest inflation risks over the medium term, as long as it is not directly linked to consumer demand.

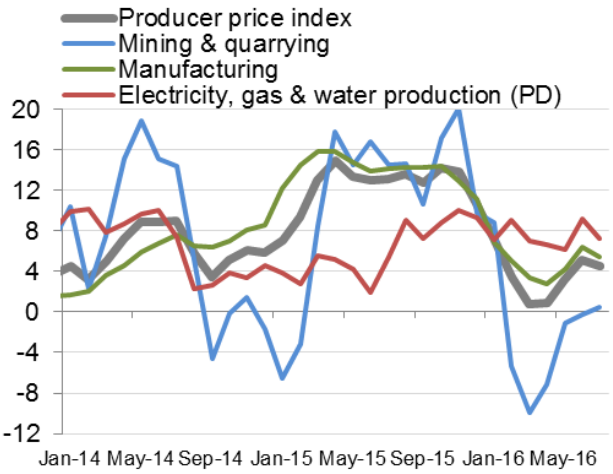
[6] For details please refer to R&F Department Analytical Note 'Money Stock Composition and Inflation Risks', May 2016, No. 3).

1.1.5. Producer prices decelerate except in the consumer segment

- July saw industrial producer prices slow down; this mainly came as a result of slower growing oil product prices.
- PMI price indices in manufacturing register reduced price pressure in these sectors as a whole.
- However, the stronger paces of price growth in some consumer products create some consumer inflation risks.

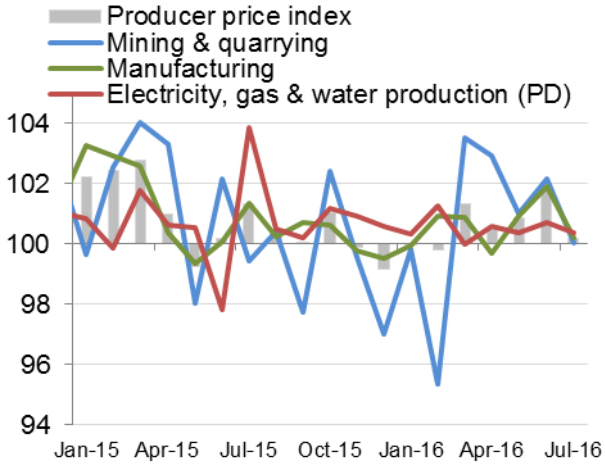
Industrial product inflation slowed down from 5.1% YoY in June to 4.5% YoY in July (Figure 13). This is driven by the decline in paces of price growth in manufacturing from 6.4% to 5.5% YoY; in the production and distribution of electrical power, gas and water – from 9.2% to 7.2% YoY. In the mining sector, inflation edged up 0.5% YoY. Slowdown in industrial inflation occurred mainly on the back of the positive data seen in the production of oil products and chemicals.

Figure 13. Core PPI components, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 14. Core PPI components, % MoM seasonally adjusted



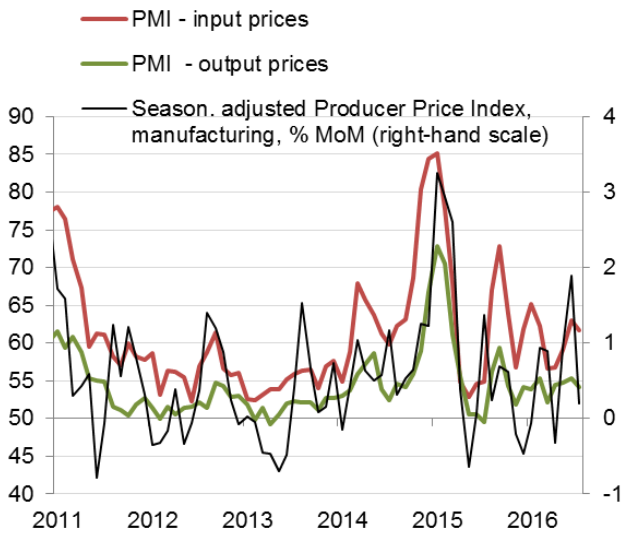
Sources: Rosstat, R&F Department calculations.

Seasonally adjusted growth rates in industrial product producers decreased in July to 0.2% MoM from almost 2% MoM in June, on the back of the decline across all three types of activity (Figure 14). The particularly strong reduction in prices was observed in the production of oil products and metallurgy. The growth paces here slowed down by more than 7 pp and 4 pp, respectively.

Price indices in manufacturing PMI indicate abated inflationary pressure. This is explained by the fact that the performance of prices in manufacturing is strongly correlated with that in manufacturing PMI. In this way a slowdown or acceleration of growth rates of output and input prices will normally coincide with the movements of prices in manufacturing (Figure 15). Therefore, PMI price indices for manufacturing,

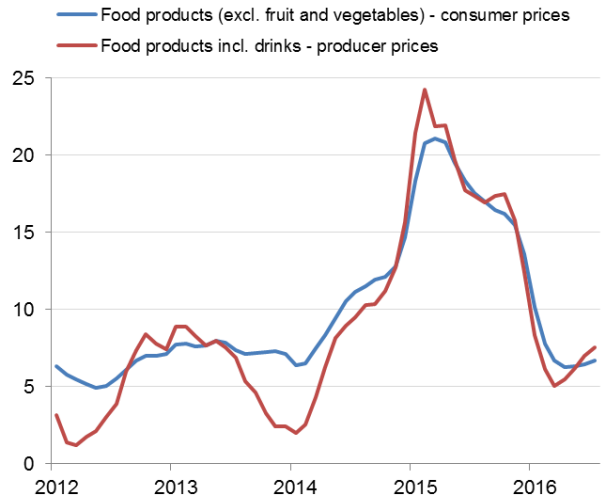
released much in advance of official producer price statistics, can serve as leading indicators of price growth rates in industrial production.

Figure 15. PPI and PMI price indices, manufacturing



Sources: Rosstat, R&F Department calculations.

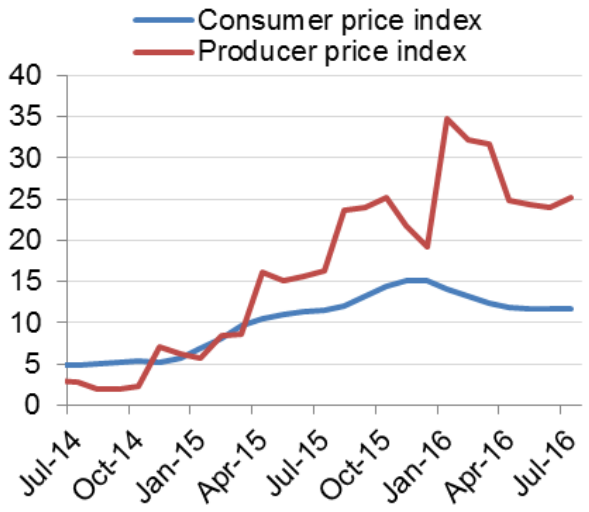
Figure 16. Food prices, % YoY



Sources: Rosstat, R&F Department calculations.

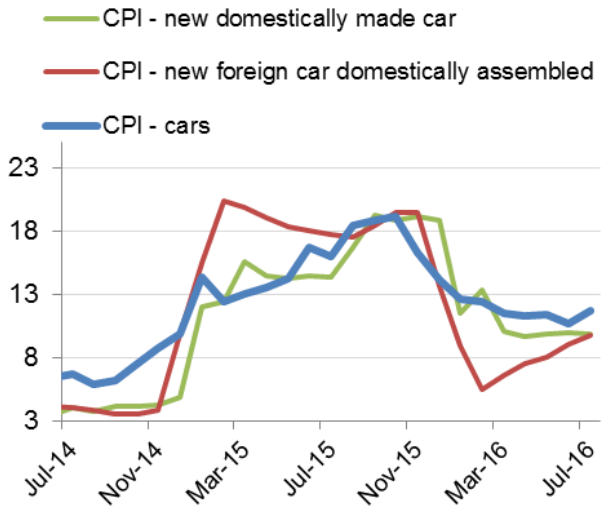
Annualised producer price growth rates are still below consumer inflation. However, it is important to factor in the heavy weight in the price index of raw material and investment production sectors with their indirect impact on consumer prices with a long lag. Also, the dynamics of consumer goods producers' prices signal the presence of risks of growth in consumer prices. In this way, the rise in output prices of food producers (including drinks) for the second month in a row comes higher than consumer food inflation (Figure 16). This is also the case for some nonfood markets (Figure 17 и Figure 18). Eventually, retail prices will have to be aligned with output prices, which may trigger accelerated price increase in these commodity groups.

Figure 17. Footwear price index, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 18. Car prices, % YoY



Sources: Rosstat, R&F Department calculations.

1.1.6. Wholesale and retail markups[7] are lower

- 2016 Q2 wholesale and retail markups across the country are at their record lows.
- At the same time, nonfood retail markups were showing a recovery, together with a rebound in demand for several product categories – a result of retailers' drive to set off the rise in costs.
- In the food sector, markups are checked by regulated prices for socially important food products as well as the flexibility of food retail operations.

The retail industry is undergoing adjustment to the currently low effective demand of households, with markups being cut in several product categories. This is the conclusion drawn from Rosstat's regular survey[8].

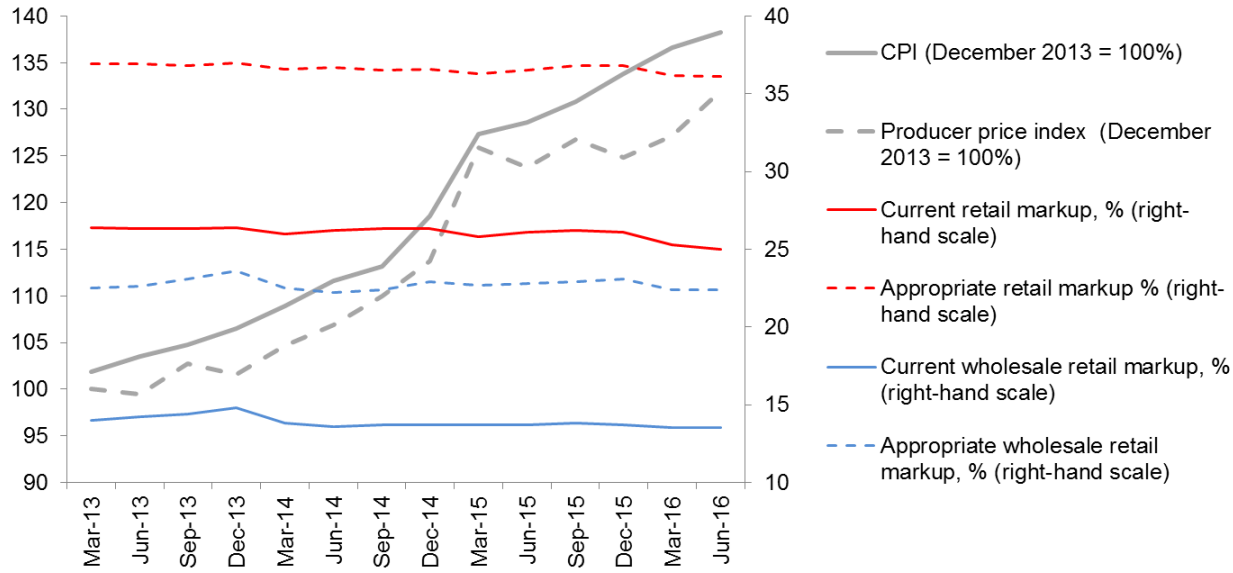
In 2016 Q2, the country-wide retail markup dropped to 25.0%. This is the lowest rate for the period of observation (since 2013 Q1) (Figure 19). In 2015 Q4, the average retail markup stood at 26.1%. At the same time, respondents noted that the appropriate markup (such that enables them to recoup costs of sales and make a profit) was also down from 36.8% to 36.1% in the half-year. A similar performance is shown by the wholesale sector where markups dropped to 13.5% in 2016 from 13.7% at the end of last year.

[7] As a percentage of selling price.
[8] The survey addressed the average *actual* retail margin and the *appropriate* average retail margin (which retailers think is sufficient to recoup costs and make a profit).

The above survey results in general tally with 2016 Q1 financial statements of major retail companies. The data there suggest that markups did reach a local minimum early this year. This development may have been the outcome of retailers' temporary inclination to sacrifice markups on the background of the winter's weakening of the ruble, as well as the consequence of the weak accompanying demand and heightened overall uncertainty. Having said this, the April-June operating data by Magnit, a major retailer, point to the emergence of some buildup in its corporate margin.

This margin growth could be explained by the survey breakdown by individual product category. Once the amounts of markup in food and nonfood products are compared[9], a variety of trends is observed.

Figure 19. Retail markups*: current and appropriate (sufficient for earning profit) levels



** to the cost of products sold*

Sources: Rosstat, R&F Department calculations.

Food retailers, in order to ensure against sales slump, are cutting down retail markups. In the second quarter of the current year, retail markup was at its record low at 21.3% (against the top value of 22.4% seen at the end of 2014) (Figure 20). Markups were down in several product categories including meat products, milk and dairy products, confectionery, bread and bakery. Most such products fall within the category of socially important food products with statutory price ceilings. This comes as a constraint to rising costs of food. Also, retail food companies may have some buffer enabling them to fully cover operating costs despite the shrinking margins as a result of, inter alia, a rapid turnover, product mix changes, the rollout of private labels and rental savings[10] .

[9] Average retail markups for food and nonfood goods were broken down in line with the shares of core products in the population's cost structure as used for calculating CPI (Rosstat data).

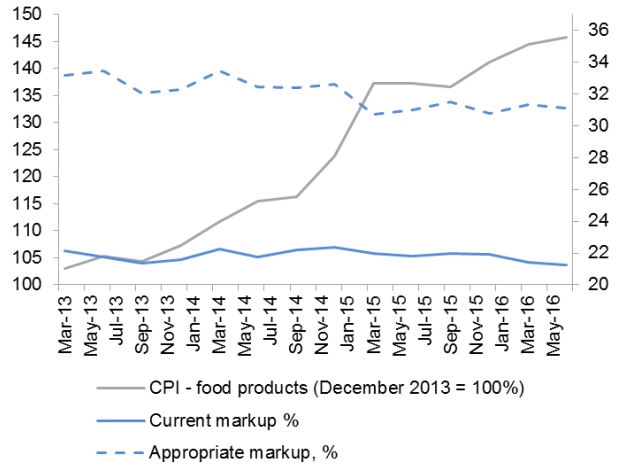
[10] Most retail space is currently owned by grocery chains.

Nonfood retail markup is higher than that in the food retail sector. Over the period of observation it remained within the 27.3%–28.6% range (Figure 21). Following a slight dip in late 2015 (to 27.6%), as some signs of rebound in demand emerged, it was up again to 28.5% for 2016 Q2. Retail markups in this period were expanding in such product categories as clothing and linen, footwear, printing, audio visual goods, construction materials, gasoline and medical products.

Significantly, in the cases described above, the sought-after retail markup was rising quicker than its current level. This can be explained by the fact that in the nonfood sector, with its deepest decline in demand, 'the safety cushion' was brought to a minimum as the markups were being cut back and, in some cases, the markup was unable to cover the total of actual expenses. Unlike in food retail, most expenses of nonfood retailers comprise rental payments, including under foreign exchange contracts. Therefore, provided that the population's effective demand continues to grow, the chances are that retail markups in the sector of nonfood sector will be rising further.

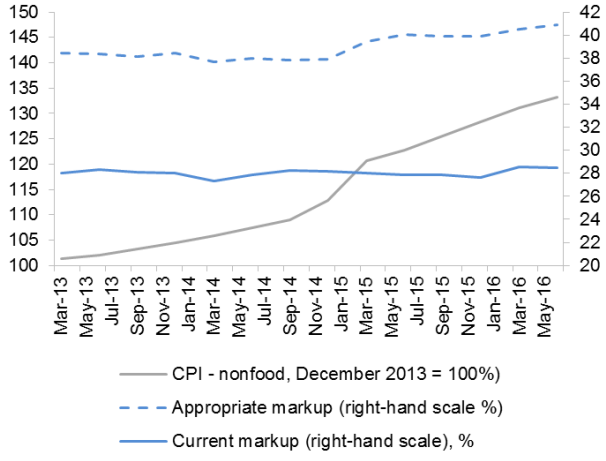
Moving forward, this means that this product category will keep accelerated paces of price growth through at least the end of the year.

Figure 20. Food retail markups



Sources: Rosstat, R&F Department calculations.

Figure 21. Nonfood retail markups



Sources: Rosstat, R&F Department calculations.

1.1.7. The one-off supplementary pension payment will have but immaterial implications for inflation and economic growth

- The one-off payment of supplementary pension in the amount of 5,000 rubles due in January 2017, financed through reallocated budget items, is likely to trigger an incremental price growth of 0.15 pp in 2017 Q1; yet its overall annual impact is expected to be minimal.
- The rise in 2017 budgetary expenditure to fund this one-off payment is expected to cause prices to rise incrementally 0.2 pp in 2017 Q1 and 0.1 pp for the total year.

According to the governmental decision, pensioners will receive 5,000 rubles each in January 2017. Our estimates show that this non-recurring payment will cost the 2017 federal budget as much as 0.22 trillion rubles.

To enable this payment, no additional costs will be provided in the budget but cost items will be reallocated within the year. Our estimates suggest that, provided the spending of the federal budget retains the even rate of 2016, as much as 0.17 trillion rubles will be reallocated from 2017 Q2-Q4, that is, we refer to the approximate expenditure of 0.9% of GDP in 2017 Q1. Comparing to the scenario, where the one-off payment is not provided for, this may result in inflation growth of 0.15 pp[11] and additional economic growth of about 0.4 pp[12] in 2017 Q1. With borrowings in the beginning of the year normally low, we expect the sources of deficit financing to be in the same manner shifted within the year, as the additional costs in the first quarter will be funded through extra drain on sovereign funds. This move is also set to expedite the transition to a liquidity surplus. As budget funds would be utilised less in the remaining quarters, compared to the no one-off payment scenario, the implications for inflation and economic growth would gradually weaken. Inflation and economic growth would still be positive (albeit close to zero) thanks to pensioners' relatively stronger propensity to consume.

In a scenario where the decision to implement this one-off payment leads to the corresponding growth in federal budget expenses in 2017 (by 0.22 trillion rubles, 0.25 pp of GDP), additional resources of the Reserve Fund and the National Wealth Fund would need to be drained; alternatively, budget revenue sources would need to be enlarged. Considering this scenario assumes a larger volume of expenditure in 2017 Q1 against the baseline one and no cost-cutting in the subsequent quarters of the year, the impact on inflation and economic growth would be more notable and extended. We estimate that the additional growth of inflation, contrasted to the no-payment scenario, would total 0.2 pp, and economic growth 0.5 pp. At year-end 2017, the effect on inflation would be under 0.1 pp and that on economic growth about 0.1 pp.

1.2. Signs of a nascent slow growth in Q3

Economic indicators suggest an ongoing slow improvement as mixed trends hold across various sectors. The signs that consumer demand is becoming steadier, coupled

[11] The estimates are based on the modified BVAR model described in Deryugina E., Ponomarenko A. (2015). Accounting for Post-Crisis Macroeconomic Developments in Russia: A Large Bayesian Vector Autoregression Model Approach, Emerging Markets Finance and Trade, vol. 51(6), pp. 1261-1275, supplemented with fiscal variables.

[12] In our calculations we assume that the fiscal multiplier for pension expenditures is considerably higher than the multiplier for the total of public expenditures, which we estimate to be about 0.3 for Russia. This is because most pensioners can be referred to non-ricardian households, i.e. those spending all of their disposable income (see, for example, alternative estimates for the EU in Coenen G., Kilponen J., Trabandt M. (2010). When does fiscal stimulus work? ECB Research Bulletin, No. 10).

with more optimistic survey data, set the stage for more sustainable, albeit low, paces of economic development.

1.2.1. GDP in Q2: balancing between weak growth and stagnation

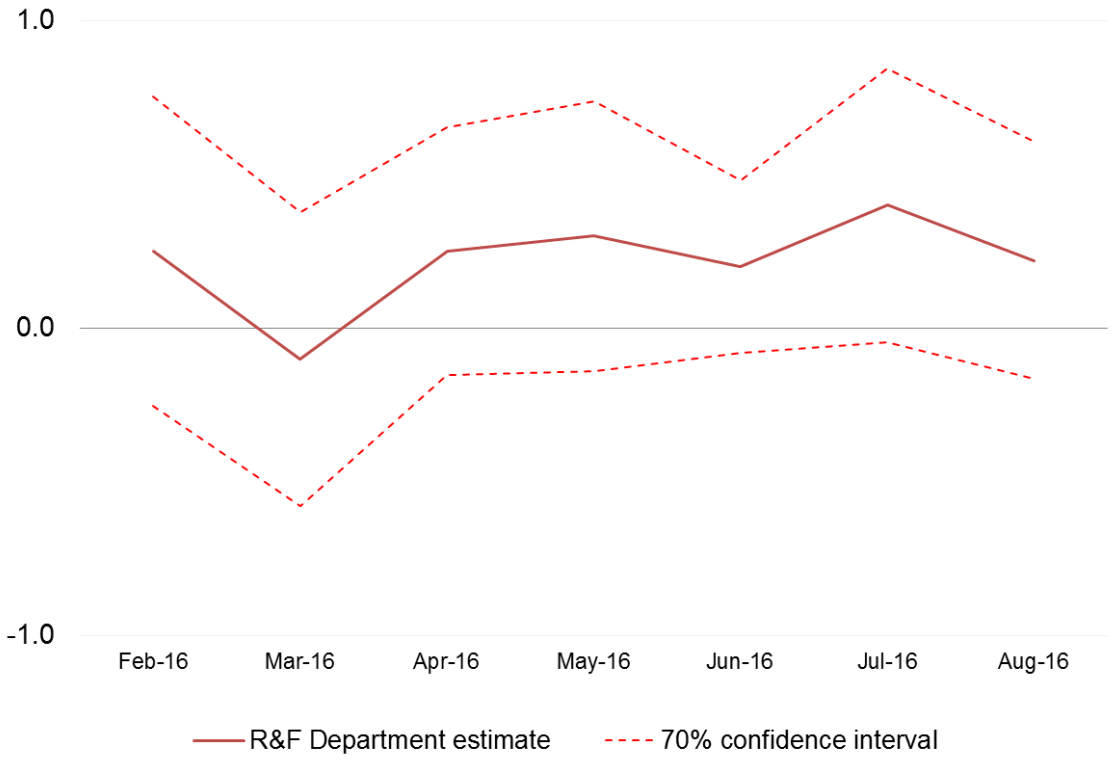
- Rosstat-released first Q2 GDP growth estimate (-0.6% YoY) is close to R&F Department's model estimates.
- Suggesting a symbolic economic advancement, our estimates still suggest the lack of a pronounced trend.
- The economy in the past quarter appears to have been close to stagnation as it has yet to start growing slowly.

The first estimates by Rosstat of an annual GDP gain in the second quarter show its drop against the same period last year of 0.6% in constant prices. According to R&F Department estimates, Rosstat data assume a quarterly GDP rise, seasonally adjusted, between April and June to be in the range of 0.1%-0.2%. This is close to our index GDP assessment based on a dynamic factor model with the use of a wide range of short-term monthly indicators (in the middle of June, this estimate was 0.2% QoQ, before the subsequent upgrade in July to about 0.2–0.3% QoQ).

Tentative R&F Department calculations also show that if quarterly GDP growth rates, seasonally adjusted, stay in the second half of the year within the levels of the second quarter, GDP will post a 0.5-0.6% drop at year-end 2016, which is in line with the Bank of Russia baseline scenario. This picture generally tallies with the currently unstable and multidirectional output data across various branches of the economy. This is why a slow and unsteady recovery appears to be in store for the next few quarters, barring the emergence of any new shocks. If the GDP index assessment for Q3-Q4 (0.4% QoQ and 0.5% QoQ seasonally adjusted, respectively) the R&F Department unveiled in July this year proves accurate, 2016 GDP will post growth at the level of the upper bound of the interval in the Bank of Russia baseline scenario (0.3% lower).

Having said this, any conclusions on a full-fledged rebound look premature, despite the estimated positive quarterly GDP growth rates. In such a way, the distinction between the weakly, as our estimates suggest, positive rates in the second quarter and the comparable moderate recession is a matter of statistical error. This is also supported by the confidence intervals in the R&F Department-used estimation model (Figure 22). In particular, the 70% confidence interval in our June estimate covered the negative zone, too – which is indicative of weak recession. In July, the lower bound of the confidence interval moved upwards to a point closer to zero, which nevertheless can hardly point to any solid growth in the past quarter.

Figure 22. Estimated 2016 Q2 GDP growth rate based on the R&F Department's dynamic factor model, % QoQ



Source: R&F Department calculations.

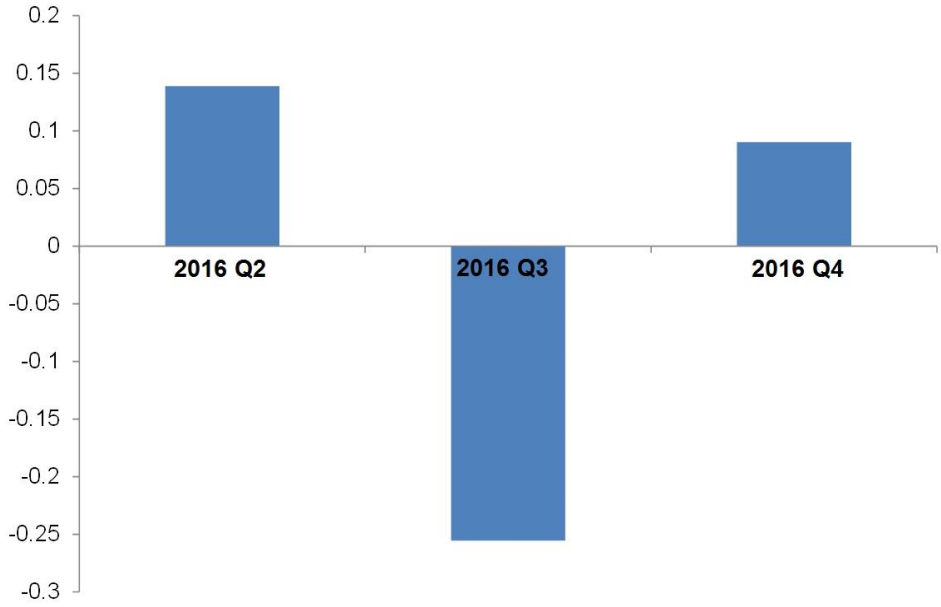
Also, uncertainty has found its way into the estimate of seasonally adjusted GDP quarterly growth rates, as follows from the annual figure released by Rosstat. This uncertainty is caused, first of all, by the selected seasonal adjustment technique, temporal interval and some other objective dimensions. A seasonally adjusted assessment could be corrected as new observation data for subsequent quarters become available.

In particular, our calculations show that if GDP gains in Q3-Q4 are assumed to come close to the middle of the interval in the Bank of Russia's official forecast for 2016 (-0.5%), with subsequently added new quarterly observed data through the end of the year, the estimate of actual seasonally adjusted GDP growth rates in the second quarter could be corrected by 0.2-0.3 pp (Figure 23)[13].

Consequently, the economy appears to continue to teeter on the brink of stagnation and has yet to hit a recovery path.

[13] TRAMO/SEATS-enabled results came closer to the official seasonally adjusted quarterly GDP estimate by Rosstat (prior to early 2016, when Rosstat stopped releasing these data release for reasons related to methodology).

Figure 23. Q2 GDP growth estimate made with subsequently added quarterly updates through 2016 in line with the Bank of Russia's baseline scenario, % QoQ, seasonally adjusted



Sources: Rosstat, R&F Department calculations.

1.2.2. Industrial output: high volatility and heterogeneity remain

- In July, seasonally adjusted industrial output fell 0.2% MoM, following the growth of 0.4% MoM in June; taking into account seasonality changes, manufacturing is poised to resume growth by August.
- Manufacturing posted contraction in output as individual investment products turned in growth and consumer goods manufacturing was adjusting to low domestic demand.
- Industrial outputs are set to remain volatile as the economy is moving to hit the path of slow recovery growth.

According to Rosstat, industrial output in July contracted 0.3% YoY, having grown 1.7% YoY in June. As a result, the gains in output accrued between January and July totalled 0.3% YoY. The indicator was pressured by the calendar factor in July: there were two work days fewer in the past month than in July last year.

This same factor may have been responsible for lowered industrial outputs as per official estimates of decline rates, seasonally adjusted and calendar factor adjusted, as long as the standard procedures here fail to capture appropriately the real contribution of the calendar factor. Rosstat estimates show that industrial production dropped 0.9% MoM, seasonally and calendar factor adjusted. R&F Department estimates this

seasonally adjusted contraction for July to be substantially lower at -0.2% MoM, appearing to replace the expansion of 0.4% MoM in June.

Moreover, there may have been no real drop in the output in July at all. Under our estimates, seasonally and calendar factor adjusted industrial outputs have been balancing from negative to positive territory for five sequential months. This trend appears to owe its existence to 'new seasonality' which manifest itself every second month, which is, in its turn, related to a production cycle in one of manufacturing activities. Suppose that this assumption is correct, then in August production would yet again turn in growth, seasonally and calendar factor adjusted. We should keep in mind also that from a quarterly perspective August data stand ready to set off the July slump thanks to the tailwinds of this year's calendar effect.

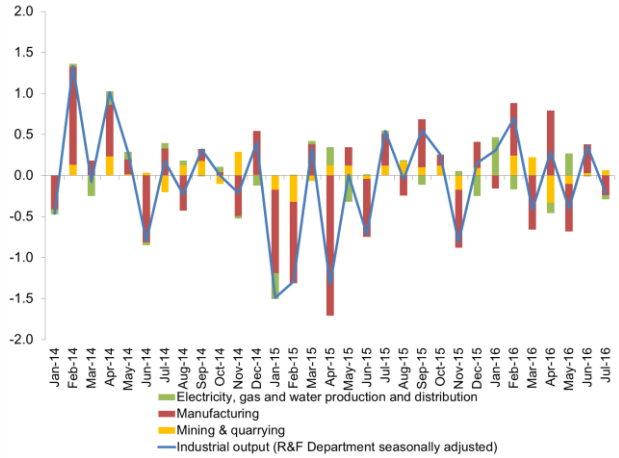
The July drop in industrial production, seasonally adjusted, was mainly linked to the contraction in manufacturing of 0.5% MoM and less so to the production and distribution of electric power, gas and water (Figure 24). Mining also made some positive contribution to seasonally adjusted industrial production index, registering a growth of 0.2% MoM, which partially set off the slump in other sectors.

Although the drop in MoM industrial production, seasonally adjusted, as estimated by the R&F Department, is materially lower that Rosstat estimates, the key driver in either case was contraction in manufacturing. This contraction is only in partial alignment with the output data per PMI index, lower than one month ago, and Rosstat data on surveys of producers (surveys were focused on change in the output of core products). Although there was a downgrade in the estimated output in comparison with the past, the business confidence index increased (from -4 to -3). Also, some improvement was seen in the estimate for overall sectoral demand and in the current month's assessment of economic activity.

The breakdown by product category revealed uneven dynamics. Increased production of investment goods was welcome news. However, a more detailed analysis of investment sectors' outputs affords the conclusion that the current positive movements are observed only in several components, namely, machinery manufacturing, and are unlikely to be sustainable in future periods (for more details see '1.2.3. Consumer and investment product outputs are still held back by demand factors').

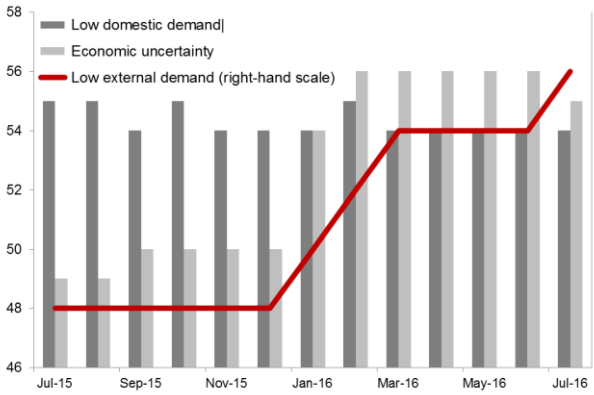
Dwindling outputs in individual manufacturing subsectors may have come as a result of low external demand, which is confirmed by Rosstat polling data. Insufficient demand for production from foreign markets was the sole production constraint, and its impact was stronger in July. The diffusion indicator rose to 24 points, having reached the maximum value since the beginning of the year (Figure 25). Taking into account the stronger rates of decline of new order intakes in the manufacturing sector, according to PMI survey, there are reasons to believe that some subsectors contracted production because of lower external demand. On the whole, July showed a decreased role of a number of limiting factors, while the rest of them held steady.

Figure 24. individual components' contribution to the industrial production index, % MoM (seasonally adjusted)



Sources: Rosstat, R&F Department calculations.

Figure 25. Manufacturing output constraints, (% respondents)



Sources: Rosstat, R&F Department calculations.

Strong data on construction and agriculture, with multidirectional dynamics seen in manufacturing subsectors, point to the absence of a pronounced tendency and suggest no change for a slow industrial turnaround. Taking into account the polling indicators, there is no reason to believe that the state of manufacturing in July deteriorated; yet we expect the volatility of industrial performance to persist in coming months.

1.2.3 Consumer and investment product outputs are still held back by demand factors

- Signs of growth emerge in investment demand sectors, which is most likely to be temporary; this comes as a result of a higher agricultural machinery output.
- Consumer demand sectors still post slowdown in growth as the demand for durable goods is limited.
- The negative trend in intermediate demand sectors is due to falling output in metallurgy, which occurs on the background of weaker impact from chemicals, a key growth driver in this group.

In July, the overall production index in the group of investment demand sectors entered positive territory for the first time since September last year (Figure 26.). However, it would be premature to say that investment demand sectors have hit a steady growth path. The rebound in the output of investment sectors is mainly caused by improvements in machinery production, mostly in the agricultural machinery sector. With the signs of import substitution emerging there, growth can be temporary. This must have been the result of the efforts to meet budgetary obligations under government support programmes for both manufacturers and buyers of agricultural machinery and related equipment. The rest of investment demand sectors show either some slowdown in the

rates of decline (construction materials, vehicles and equipment) or a persistent decrease in production (electronic and optical equipment).

The slowdown in the rates of expansion in consumer demand sectors (Figure 27.) occurs against the background of the negative trend seen in the retail sector. Positive dynamics in this group of industries are, as before, supported by the food industry. At the same time, the production of durable consumer goods (e.g. furniture), remains in decline as the demand for such products is limited.

Intermediate demand-oriented sectors are still dominated by negative performance (Figure 28). Metallurgy is the key negative contributor of the last few months. The impact of chemicals, previously a key growth driver in this group of industries, is weakening. Over a span of two-three years, the chemical industry is unlikely to grow at the 2014-2015 rates when new polymer production capacities were rolled out.

Figure 26. Investment demand-oriented manufacturing output index (trend), MoM %

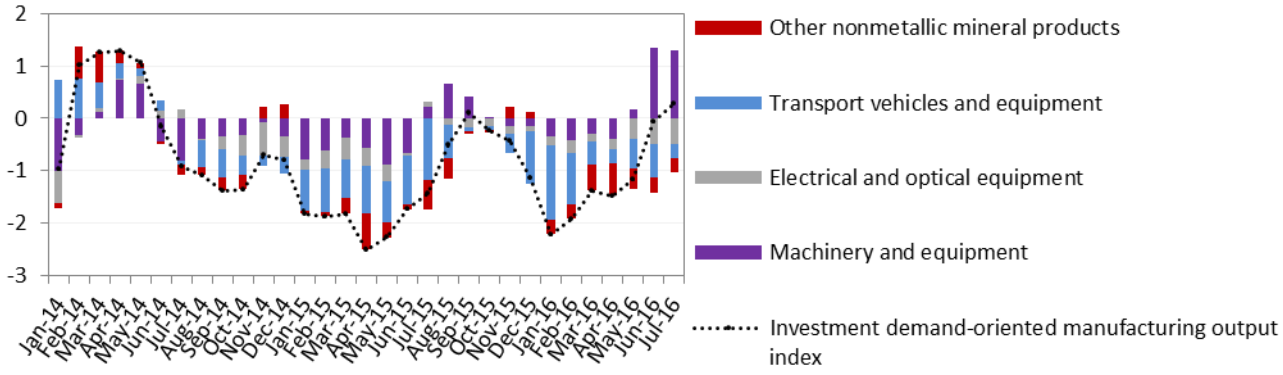


Figure 27. Consumer demand-oriented manufacturing output index (trend), MoM %

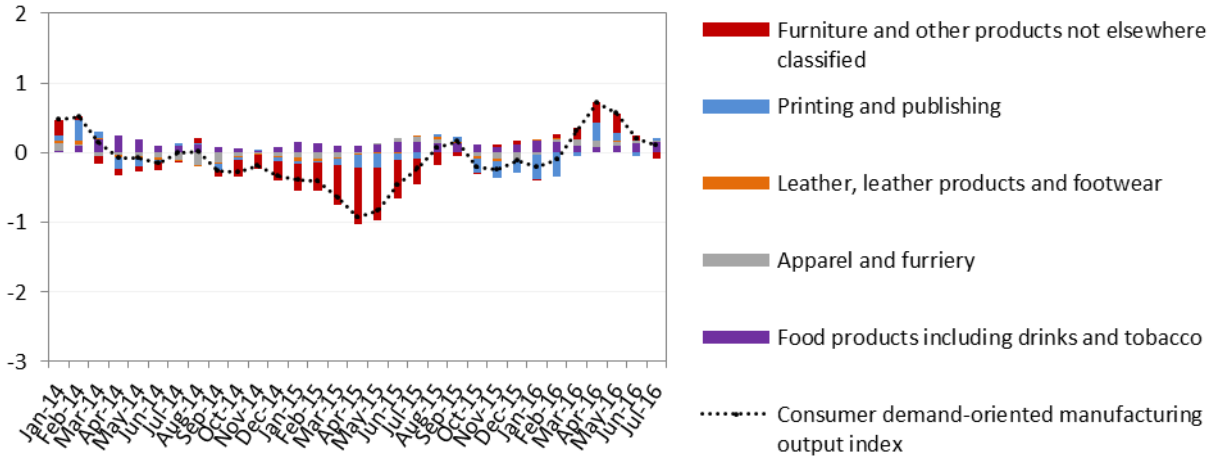
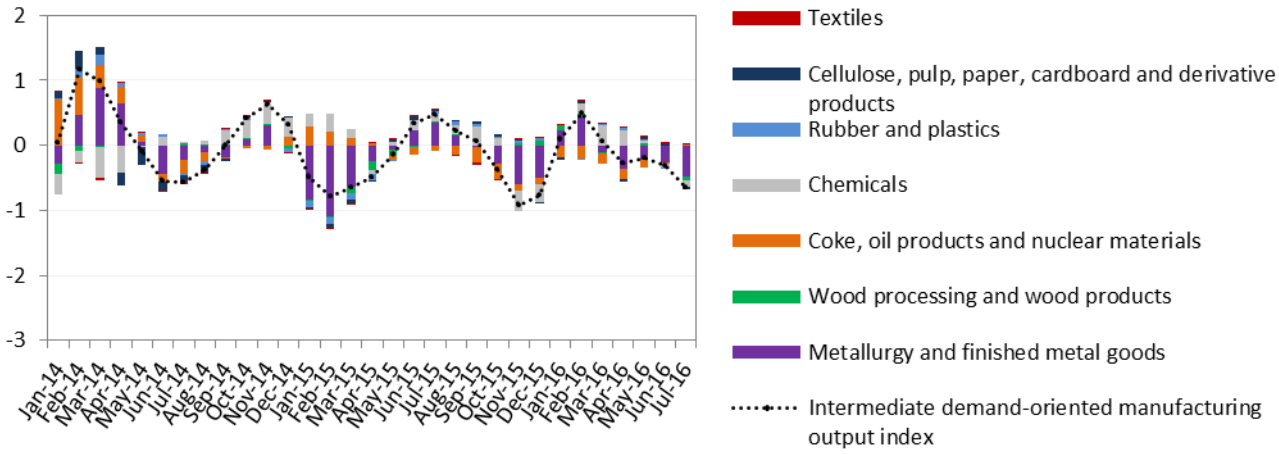


Figure 28. Intermediate demand-oriented manufacturing output index (trend), % MoM



Sources: Rosstat, R&F Department calculations.

1.2.4. Consumer activity is growing steadier

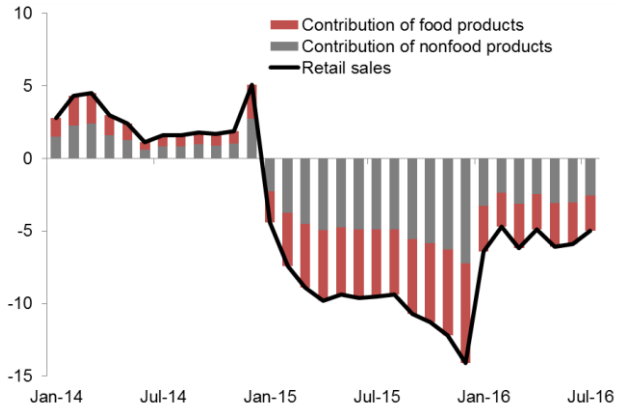
- The annual rates of decline in retail slowed down in July to 5% YoY, beating market expectations substantially.
- Seasonally adjusted rates of decline slowed down to 0.1% MoM, on 0.4% MoM in June.
- Stabilised real wages are set to help in a further rebound in turnover, to enable a gradual movement to positive rates, seasonally adjusted, before the year is out.

According to Rosstat, contraction of retail sales in July slowed down to 5.0% YoY from 5.9% YoY in June. This is seen once seasonal adjustment is applied for monthly data: July's sales dropped 0.1% MoM, following a drop of 0.4% MoM in June.

July also posted slower annual rates of decline in both food and nonfood products, with sales of the former having dropped 5.1% YoY, and those of the latter 5% YoY (Figure 29). Seasonally adjusted data evidence only an immaterial slump in food sales (0.1% MoM), against zero contraction in sales of nonfood products.

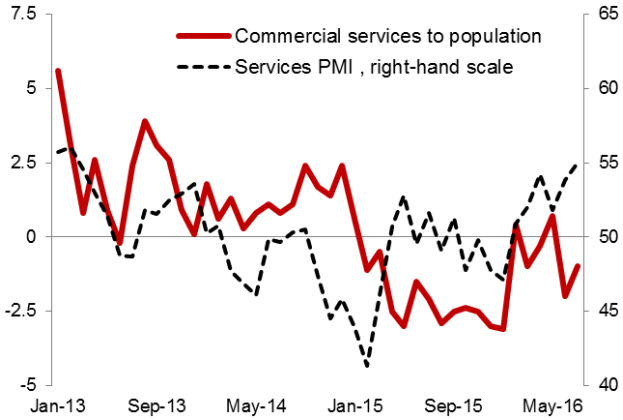
Continued heightened volatility is noted in commercial services to the population. The annual rates of contraction in the volume of such services fell to 1% YoY, with 0.7% MoM of growth. Given the positive readings of the PMI index, this sector's growth rates may be expected to gradually move to positive territory (Figure 30). Recent data suggest that the drop in commercial services to the population has slowed down to as much as 0.8% YoY since the start of the year, against the drop of 0.9% YoY in the first six months, which also points to steadier performance, although the indicator remains volatile.

Figure 29. Shares of food and nonfood products in retail sales, % YoY



Sources: Rosstat, R&F Department calculations.

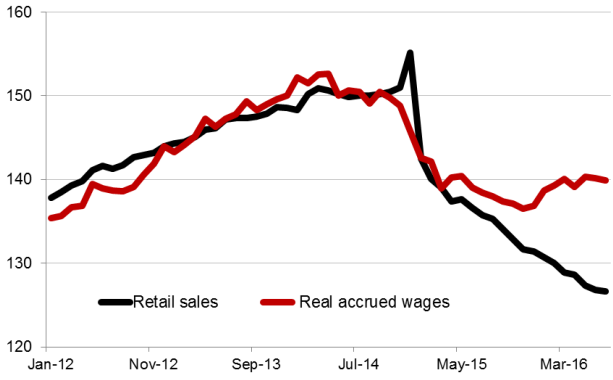
Figure 30. Commercial services to the population (% YoY) and Services PMI



Sources: Bloomberg Finance L.P., Rosstat, R&F Department calculations.

Gradual recovery of retail sales was accompanied by a 0.6% YoY growth in real wages, albeit with the unchanged zero annual rates for the period since the start of the year. Seasonally adjusted data indicate a decelerated pace of decline of real wages to 0.2% MoM, following the contraction of 0.3% MoM in June. As a result, we see the gap between retail sales and real wages starting to diminish (Figure 31).

Figure 31. Retail sales and real accrued wages (January 2007 = 100%, seasonally adjusted)



Sources: Rosstat, R&F Department calculations.

In coming months, retail sales, especially in the consumer sector, will be buoyed by a 20.9% MoM upgrade on July (25.7% YoY) in the minimum wage, to 7,500 rubles. The move may narrow somewhat the income gap across segments of the population.

The ongoing recovery in real wages and improved consumer expectations with regard to future incomes raise the possibility of a rebound in consumer activity in coming months.

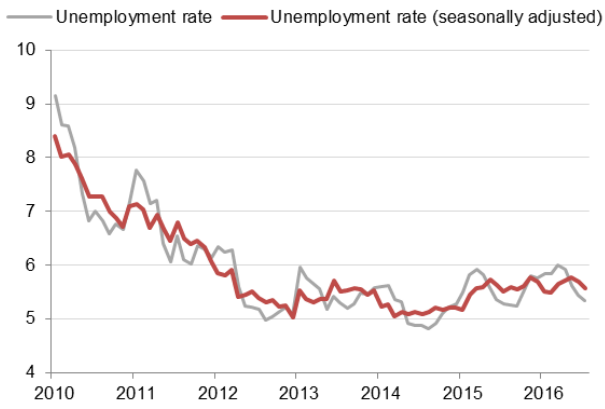
1.2.5. Improvements in the labour market continue

- The rate of unemployment in July went down to 5.3% (5.6% seasonally adjusted).
- Our estimates suggest that the economic activity index, standing at over 70%, has reached its maximum value.
- The risks of growing unemployment are low, constrained by demographic factors.

The rate of unemployment in July went down to 5.3% from 5.4% in June. Unemployment normally drops in summer months, driven by a seasonal rise in demand for labour. With this in mind, even once seasonality is factored in, unemployment is down to 5.6% on 5.7% in June (Figure 32). Compared to July last year, both the numbers of employed and unemployed were up.

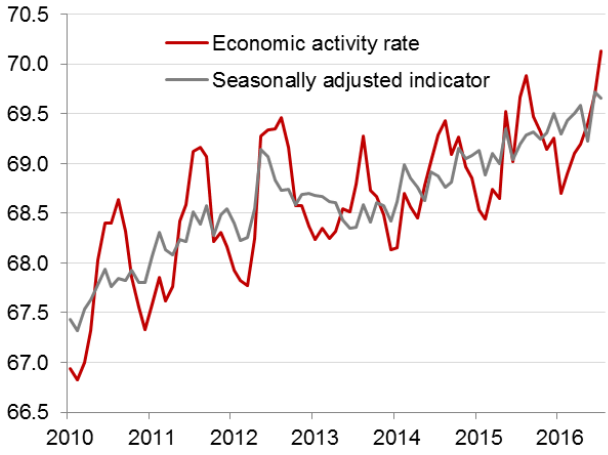
This ratio suggests rising economic activity of the population, supported by our estimates, too: July's labour force participation rate[14] was over 70%, for the first time (Figure 33).

Figure 32. Unemployment rate , %



Sources: Rosstat, R&F Department calculations.

Figure 33. Labour force participation rate, %



Sources: Rosstat, R&F Department calculations.

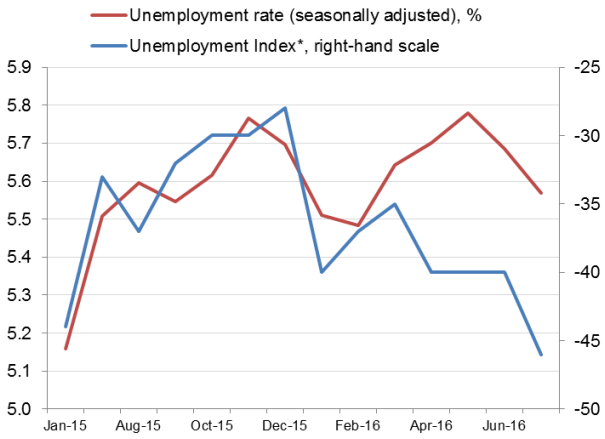
The rising economically active population can be indicative of improvements in the population's assessment of the labour market, which VCIOM (Russian Public Opinion Research Centre) polling data confirm[15]. According to the July data, respondents noted less unemployment-related fears (Figure 34); even so, the complexities related to job search (in the event of job loss) have been unvaried since the start of the year.

The rise of labour force participation is pressured by negative demographic tendencies, in particular, decreased working-age population, which drags down the risks of unemployment growth and could potentially lead to labour shortages. The latter factor could be a reason behind the fairly consistent 2016 wage growth. In July, the growth of

[14] The economically active (employed + jobless) to working age (15-72 years) population ratio.
[15] http://wciom.ru/index.php?id=236&uid=115817

wages in real terms was ongoing, albeit at lower paces compared to June's: 0.6% against 1.1% YoY (Figure 35). The improvements in the labour market, underpinned by rising remuneration, could be among potential drivers for the potential recovery of household consumption.

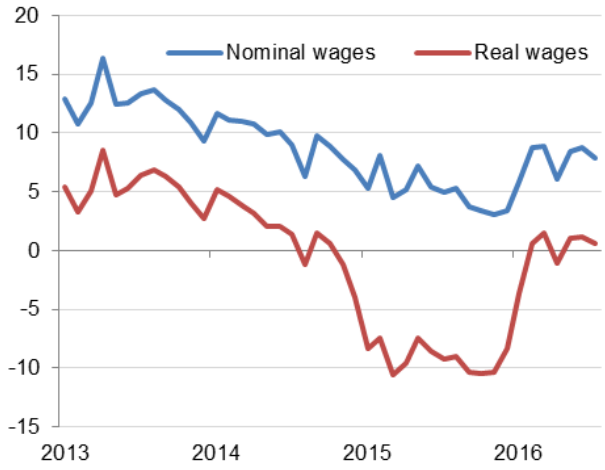
Figure 34. VCIOM Unemployment Index[16] and unemployment rate



Sources: Rosstat, VCIOM, R&F Department calculations.

**A lower index implies that the problem relevance is down.*

Figure 35. Wage performance, % YoY



Sources: Rosstat, R&F Department calculations.

1.2.6. The savings ratio is down

- The savings ratio in June was down against the previous month and markedly down on June 2015.
- The average propensity to save in the first half of the year is a value typical for a moderate savings period, so its further rapid decline appears unlikely.

Rosstat data on the use of households' monetary income in June indicate substantially redistributed resources, compared to May, from spending on goods and services to savings, purchase of foreign currency and more cash on hand. In this way, the savings ratio increased to 13.1% in June from 9.7% in May, according to the updated data; deposits and spending on securities meanwhile increased by a comparable amount.

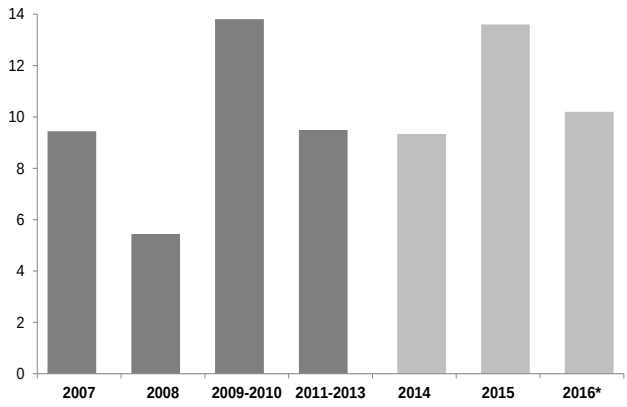
The higher savings ratio in June appears seasonal in nature, rather than signals a change in behaviour of the population as regards saving (Figure 36). Nevertheless, the movements in this indicator continue to bear out a gradual return of the savings ratio to its

[16] **The Unemployment Index** indicated the relevance of the unemployment problem. The index is calculated as the difference between positive and negative responses to the question 'How many of your relatives and friends lost jobs in the last 2-3 months?'. It is measured in points, ranging between -100 and 100. The higher the value of the index, the more relevant the problem is to the respondents.

long-term level, as a result of gradual reduction in buffer savings accumulated in the aftermath of the crisis.

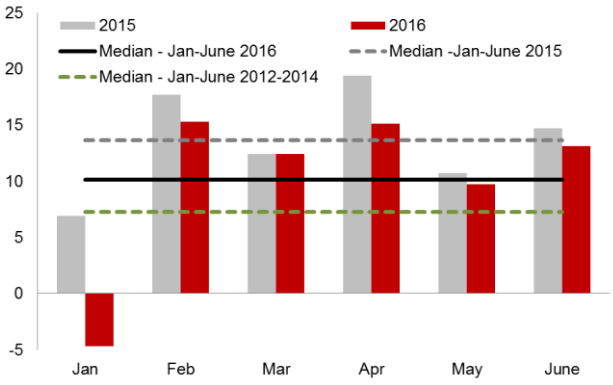
In such a way, the gap between this and prior year's savings ratios in comparison with May is up (Figure 37). This change does not come as a result of a shrinking income: monetary income posted annual growth (3.1% YoY in June). Therefore, there is every reason to believe that in the absence of external shocks this year's savings ratio will be closer to its 2011-2014 readings, rather than its level in 2015.

Figure 36. Dynamics of savings ratio in households' monetary income, %



Sources: Rosstat, R&F Department calculations.

Figure 37. Savings ratio in households' monetary income, %



Sources: Rosstat, R&F Department calculations.

Dwindling savings ratio in household monetary income, on the backdrop of a wage rebound will mean more spending on goods and services (Figure 38). 2016 Q2 data are indicative of this dependence: as the savings ratio descends, the share of expenses on goods and services rises. Consequently, the potential return of the savings ratio to its pre-crisis levels will trigger a gradual recovery of retail sales and turnover of services and catering.

Having said this, the uneven dynamics of incomes across various segments of the population is a factor holding back consumer activity. With uneven dynamics across various population segments' incomes, the share of the people without savings is still high. According to an inFOM poll, this share expanded from 57.6% in July 2015 to 61.1% in July 2016. Also, the share of people who failed to make any savings in July saw a contraction to 71.1 % from 71.9% in June. The contraction is still more material as compared to May when 73.1% of respondents admitted to have failed to make any savings (Figure 39). This is the second highest reading of the indicator after January. It was brought about by the active spending in the period of May holidays, rather than a change in a saving model.

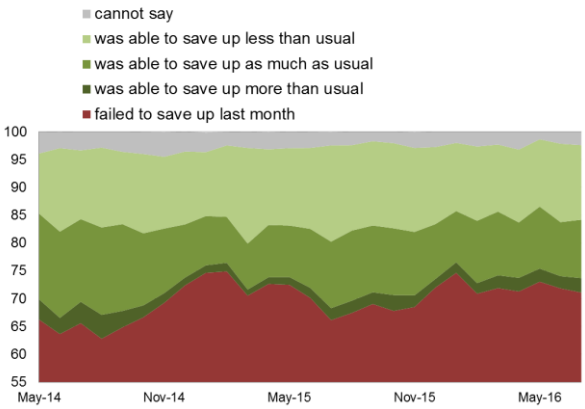
The share of those who still were able to make savings rose to the February 2016 point of 26.5%, a maximum value since the beginning of the year. The share of the

population who managed to save up less than usual was down at the expense of those who either saved up as much or more than usual. In July, the share of the latter was highest since the beginning of the year, as indirect evidence that there was some improvement in the financial position of some part of the population.

Figure 38. Share of expenses on goods and services and the savings ratio in monetary income

Sources: Rosstat, R&F Department calculations.

Figure 39. Household saving behaviour, % of respondents



Source: inFOM survey.

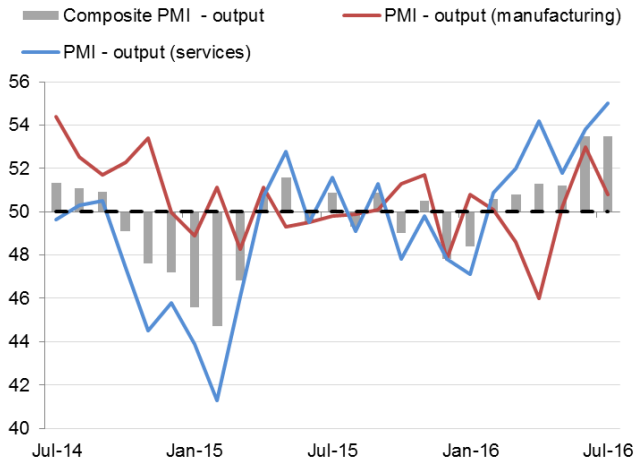
Considering the high share of those who fail to make any savings in their disposable incomes, the recovery in the durable products segment and services and catering will mainly ride on expected movements in the incomes of average and higher-than-average earners. At the same time, the turnover of consumer goods will be determined by the current incomes of the population with lower-than-average incomes, as well as by the pace of price growth.

1.2.7. PMIs: acceleration in services as some cooling finds its way in manufacturing

- Consolidated PMI for Russia remained at its top mark since February 2013: the contraction in manufacturing was set off by the substantial growth in the service sector.
- Low demand and high capacity utilisation are still key constraints to output advance in manufacturing, with less pressure coming from uncertainty.
- Acceleration in the service sector to a top mark since February 2013 comes amid better business expectations, which are level with 2014.
- July PMI data bear out the higher probability of a gradual recovery in economic activity in coming months.

Consolidated PMI remained unchanged at 53.5 points, a top reading since February 2013 (Figure 40). This came with some deterioration in business activity in manufacturing and accelerated growth in services.

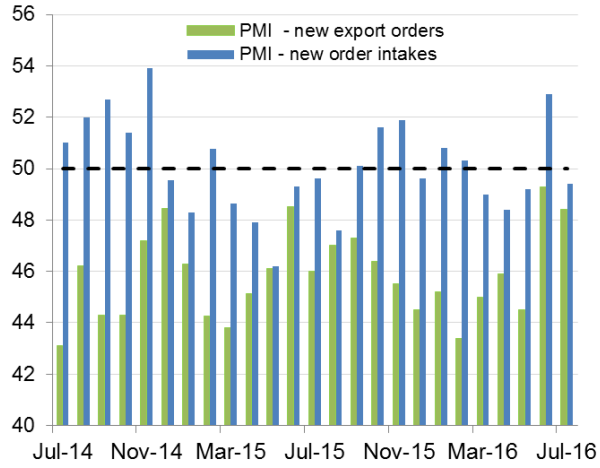
Figure 40. PMI for Russia, output, points



Source: Bloomberg Finance L.P.

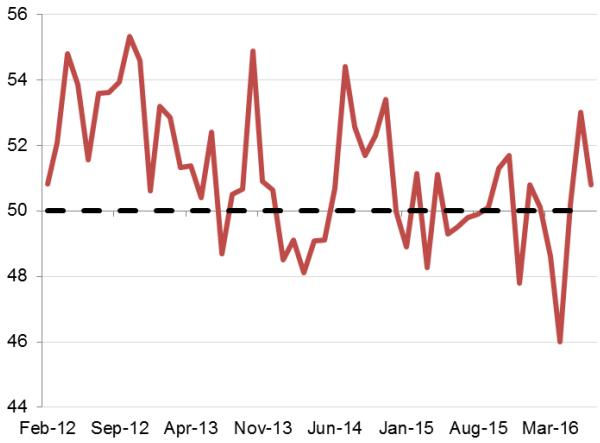
In July, manufacturing PMI tumbled to 49.5 points from 51.5 points in June, having dropped yet again below the breakpoint of 50 points, which separates growth from recession. Lower business activity was triggered by the weakness in both domestic and external demand: the slowdown in new domestic order intakes resumed and the contraction of new export orders quickened (Figure 41). However, new orders fell but slightly: the July drop was smaller than a monthly contraction in the period between March and May, with the lowest decrease in export orders since June 2015 (except for the June 2016 reading). This being the case, some companies attributed the decline in new orders to the shortages of capacities, which is partially confirmed by a growing number of incomplete orders, for the first time since January 2013.

Figure 41. Manufacturing PMI – new orders



Source: Bloomberg Finance L.P.

Figure 42. Manufacturing PMI – output

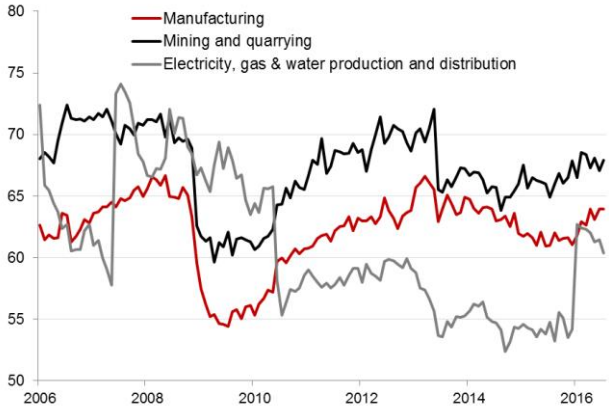


Source: Bloomberg Finance L.P.

To defy the contraction of new orders, output in the sector posted growth for the third month in a row, albeit at smaller rates: manufacturing output PMI fell by some 53.0 points in June to 50.8 points (Figure 42).

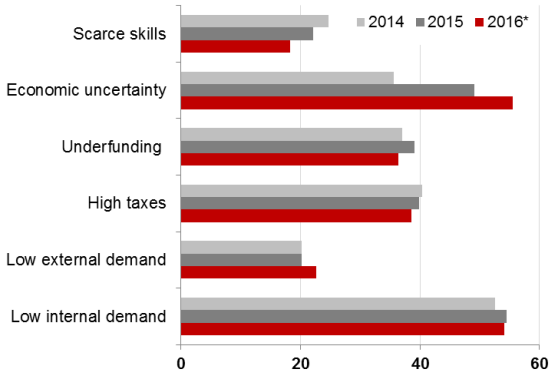
As follows from Rosstat-conducted monthly surveys, growth in manufacturing is still constrained by the capacity utilisation which has been close to a local maximum over recent years, the continued economic uncertainty as well as low demand (Figure 43 and Figure 44). However, in the absence of new shocks the pressure from uncertainty is set to fall in coming months as the share of respondents who refer to this factor as a constraint dropped in July to reach the minimum value since January 2016. In such a way, growth in the manufacturing sector is likely to continue into the months to come.

Figure 43. Average capacity utilisation, % (seasonally adjusted)



Sources: Rosstat, R&F Department calculations.

Figure 44. Manufacturing growth constraints, (% respondents)



**The 2016 reading is the mean value for January-July.*

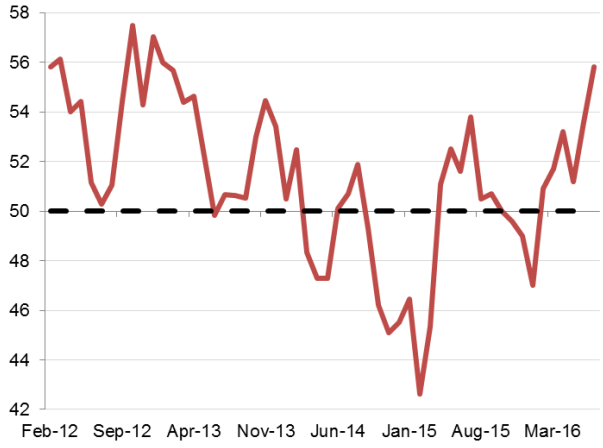
Sources: Rosstat, R&F Department calculations.

In July, services PMI reached its maximum value since February 2013, having increased to 55.0 points from 53.8 points in June. The growth of business activity in services, underway since February, occurred on the back of the increase in new order intakes to a maximum point since January 2013 (Figure 45). This significant rise in new order intakes drove employment in the sector to increase, for the first time since February 2014 (Figure 46).

The slight growth in employment came as a result of multidirectional data on subsectors of the service sector. In such a way, poll data suggest a substantial growth of employment in July in the subsector 'Hotels and Restaurants' and a considerable contraction in the subsector 'Financial Intermediation'. New jobs in the former subsector are indicative of stabilised expectations of this sector's companies amid a rebound in demand for the respective services. The drop in catering in 2016 Q2 slowed down to 2.5% YoY, following the pace of decline of 4.9% YoY in the first quarter, while the volume of hotel and similar accommodation services grew 9% YoY in the first half of 2016. At the same time, the slump in employment in the financial mediation sector suggests continued low demand for such services as companies seek to cut back costs by lowering headcounts.

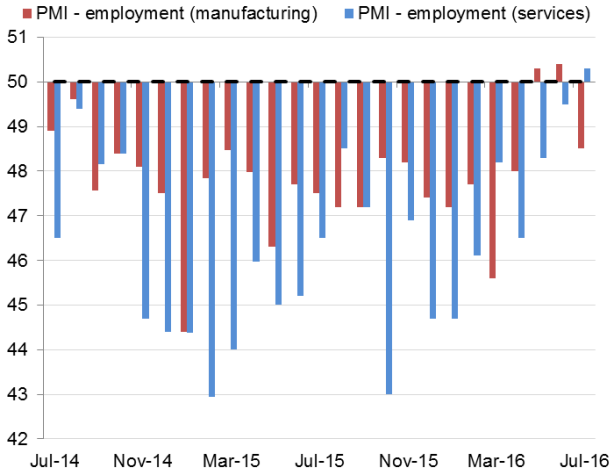
Although the growth in employment was rather weak, the fact itself of this growth having reached positive territory indeed signals improved expectations of companies within the service sector. This was reflected in the rise, to a maximum point since February 2014, of business expectations as regards economic activity in the next year. In addition to these stronger employment data, welcome news comes from the recovery in incomplete orders, ongoing for five years and a half, to a symbolic growth (50.1 points).

Figure 45. Services PMI Russia – new orders, points



Source: Bloomberg Finance L.P.

Figure 46. PMI – employment, points



Source: Bloomberg Finance L.P.

Overall PMI indices in July point to the high probability of a start in gradual recovery growth in the months to come. At the same time, early deterioration in the external

environment underway since July could negatively impact economic agents' expectations, which creates risks to economic performance.

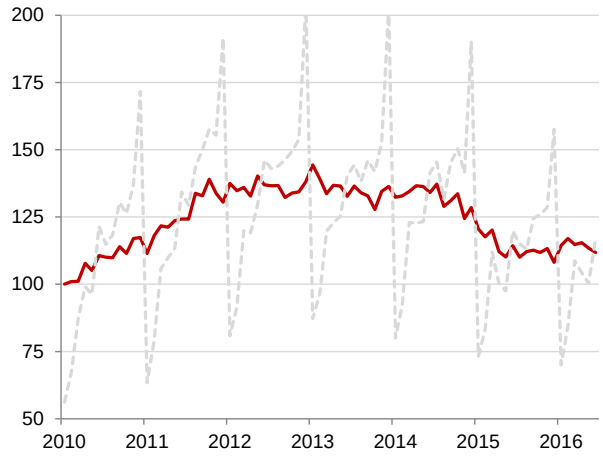
1.2.8. Slow investment recovery is likely to begin in the third quarter

- In the second quarter, the investment activity index declined as construction dynamics worsened against the Q1 readings.
- However, improvement in machinery and equipment imports from non-CIS countries points to a likely recovery of investment activity in the third quarter.

The improved performance, seen in the first quarter, gave place to slightly worsened dynamics of the investment activity index[17] we calculated in the second quarter (Figure 47). Construction works were the key reason behind the drop. The other index components showed better performance, allowing it to grow in the second quarter as compared to the 2015 readings for the same period (Figure 48).

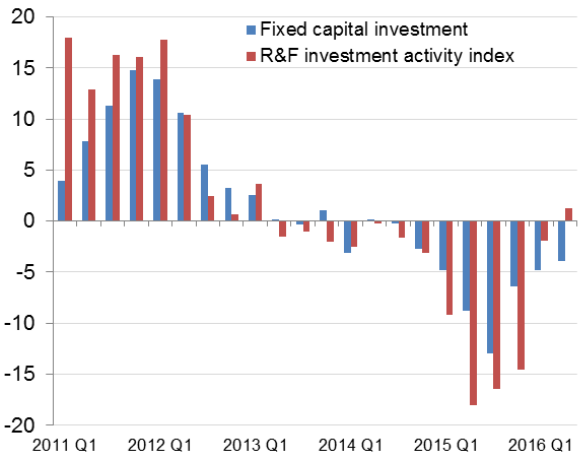
The investment activity index conflicts with fixed capital investment because the former characterises supply rather than demand. As inventories go down, our index may underestimate investment dynamics, and overestimate them when inventories go up. Annual fixed capital investment is likely to have improved in the second quarter against the Q1 readings, but unlikely to have reached positive growth rates.

Figure 47. Investment activity index (January 2010 = 100)



Sources: Rosstat, CEIC, R&F Department calculations.

Figure 48. Quarterly investment (% YoY)

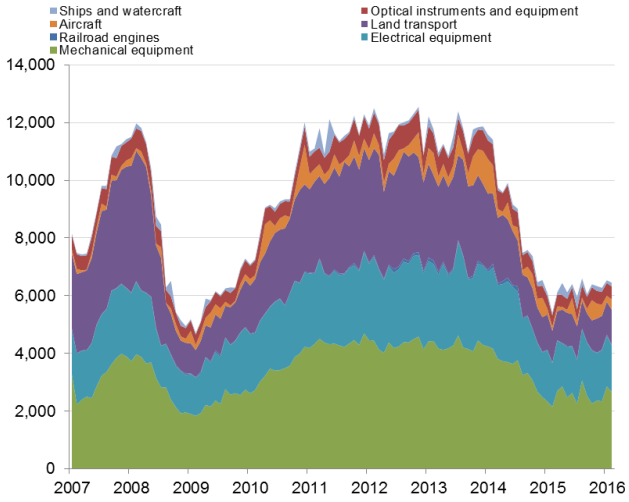


Sources: Rosstat, R&F Department calculations.

[17] The calculation is based on data on completed construction, production and net car and equipment imports (less passenger cars).

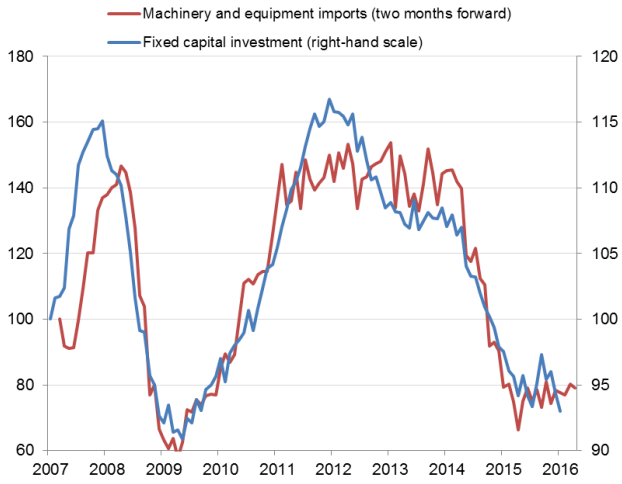
In the third quarter, investment may begin to slowly recover. The overall dynamics for the past months signal that machinery and equipment imports have stabilised and even grown modestly (Figure 49), although the provisional July data on machinery and equipment imports from non-CIS countries show a slight decrease against the June readings[18]. Growth in investment goods imports in the past months points to a likelihood of slow investment recovery in the months to come (Figure 50). Machinery and equipment imports may serve as a leading indicator for all investments, because it takes less time to upgrade equipment and production assets than to launch capital construction. Therefore, these investment demand components are the first to start growing.

Figure 49. Machinery and equipment imports from non-CIS countries ($ billion, seasonally adjusted)



Sources: CEIC, R&F Department calculations.

Figure 50. Machinery and equipment imports from non-CIS countries and fixed capital investment[19] (index, June 2007=100)



Sources: Rosstat, R&F Department calculations.

1.2.9. Direct foreign investment performance confirms a structural shift towards the tradables sector

- Direct foreign investment (DFI) in the non-banking sector shrank considerably in 2016 Q1.
- Investment is growing in tradables and mining and quarrying.

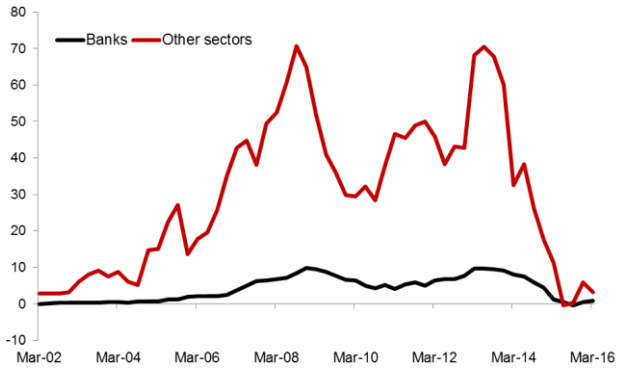
In 2015, net DFI continued to decline in Russia from $22.03 billion in 2014 to $6.5 billion in 2015. Investment in the non-banking corporate sector, which used to be pivotal,

[18] By 1.3% MoM, seasonally adjusted. In June, a growth of 4.2% MoM was recorded.
[19] Calculation of 2016 dynamics is based on the investment activity index.

went further down in 2016 Q1 (Figure 51). Given the negative balance of banking sector investment, Russian DFI balance stood at $-0.28 billion.

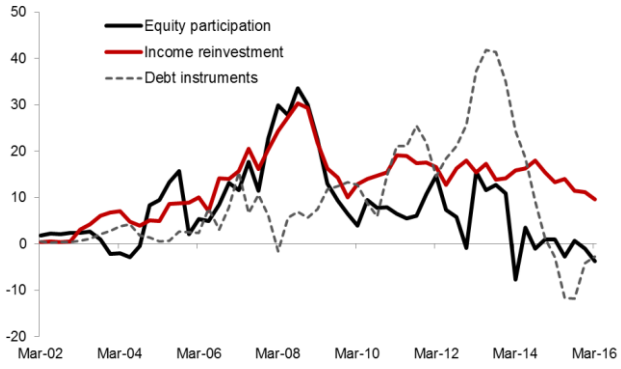
As for investment in other sectors, income reinvestment continues, although reinvestment dropped 31% YoY in 2016 Q1. It means that direct investors choose to put money into the company's current operations rather than withdraw their dividend income. The inflow of direct investment in the form of debt instruments expectedly dropped in 2015 (about 25% as against 2012-2013) on the back of sanctions, after the active lending growth between 2012 and 2014 H1.

Figure 51. Balance of direct investment in Russia by institutional sector, $ billion (sliding amount for four quarters)



Sources: Bank of Russia, R&F Department calculations.

Figure 52. Balance of direct investment in Russia by instrument, other sectors (sliding amount for four quarters)



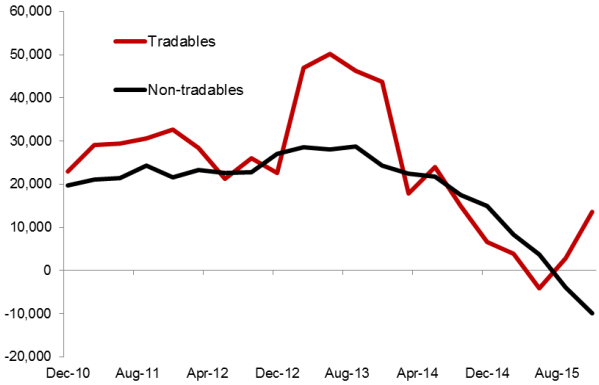
Sources: Bank of Russia, R&F Department calculations.

The analysis of DFI dynamics by economic activity shows that fund inflow resumed in 2015, after having been slowing sharply since 2014 H2 (Figure 53). For example, the balance of direct investment in mining and quarrying more than doubled in 2015 as compared to 2014[20]. The overall positive DFI dynamics in tradables in 2015 were driven by growing investment in almost every sector of this group, including manufacturing and agriculture.

Unlike the tradable goods sector, non-tradables saw further outflow of direct foreign investment in 2015. The negative DFI balance in non-tradable goods results from the investment curtailment, which hit almost every sector in 2015, including finance, insurance and other services, energy, and construction.

[20] Mostly following the growth in investment in fossil fuels, but investment in mining and quarrying (other than fossil fuels) also shows positive dynamics.

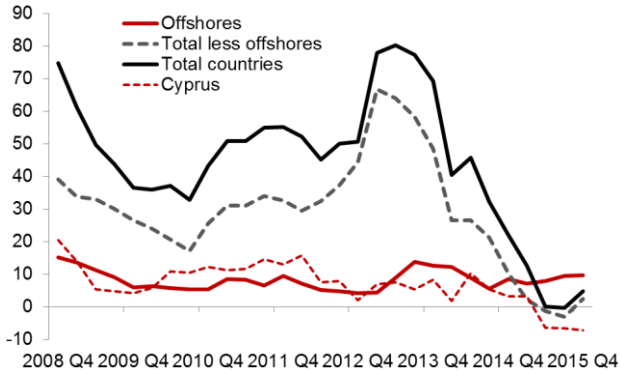
Figure 53. Direct investment in Russia by sector, $ billion (sliding amount for four quarters)



Excluding data not distributed by sectors.

Source: Bank of Russia, R&F Department calculations.

Figure 54. Direct investment in Russia geographical distribution (sliding amount for four quarters)[21]



Offshores include the Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands, and Panama.
Source: Bank of Russia, R&F Department calculations.

Investment breakdown by investor-state points to a gradual investment recovery in 2015, excluding investment inflow from key offshores (Figure 54). The 2015 recovery resulted from a sizeable growth in investment from Europe (excluding Cyprus) in 2015 Q4. So far, deoffshorisation efforts seem to have curtailed only direct investment from Cyprus. Investment inflow from other traditional offshores remained stable and even was up in 2015.

1.2.10. Budget system is to add 0.5 pp to the Q3 GDP dynamics

- The contribution of budget expenditures to the Q3 economic growth will be neutral. Having said that, the budget system will contribute about 0.5 pp to the Q3 economic growth, given the income-side positive effect.
- July registered a negative impact of federal budget operations on liquidity following low budget deficit, privatisation and OFZ placement. The likelihood of budget overhang in late 2016 has increased.

Federal budget spending was consistently modest in July. Provisional data suggest that non-interest federal budget expenditures (net of interbudget transfers) fell 16% YoY against 2% YoY in January-June 2016. July expenditures to annual allocations ratio was the lowest since 2008.

[21] Total countries include investment not allocated by countries and investment of international organisations and institutions.

According to our estimates, in the period between January and July 2016, the total of 52.1% of non-interest federal budget expenditures were executed as compared to 56.6% and 54.3% in the same periods in 2015 and 2014 (Figure 55). The July data enhance the likelihood of a sizable budget overhang[22], but still allow expecting the contribution of public expenditures to the economic growth to be neutral in the third quarter.

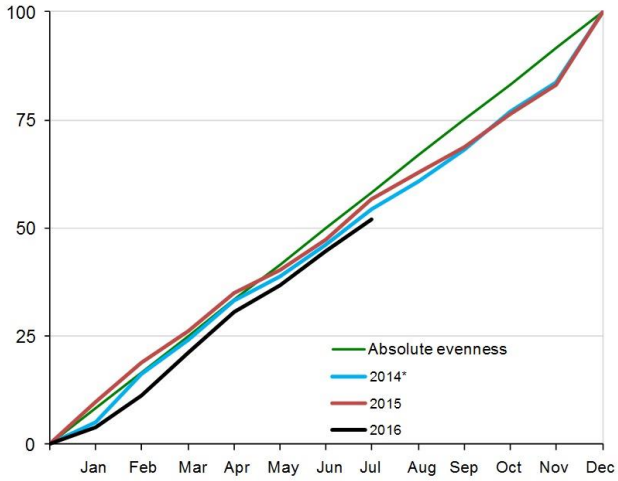
We estimate that the budget system will contribute about 0.5 pp to the economic growth in the third quarter after 0.2 pp in the first quarter due to the positive impact of lower fund withdrawal from the economy to the budget in the third quarter.

July also registered a negative impact of the federal budget on liquidity. A decline in idle fund depositing with commercial banks, inflow of funds from ALROSA privatisation, and net security placement (total of over ₽0.15 trillion) set off the low budget deficit (below ₽0.1 trillion).

In July, net OFZ placement in the 2016 reporting period exceeded ₽300 billion, the amount projected for the whole year. It confirms considerable market demand for OFZ, and once it is met, a shift to structural liquidity surplus may be delayed.

We still expect the budget to have a moderately positive effect on liquidity in the months ahead of the year-end. Higher borrowings (primarily, by regional authorities) and withdrawal of idle funds from commercial banks will largely offset more active spending of budget funds and a growing budget deficit.

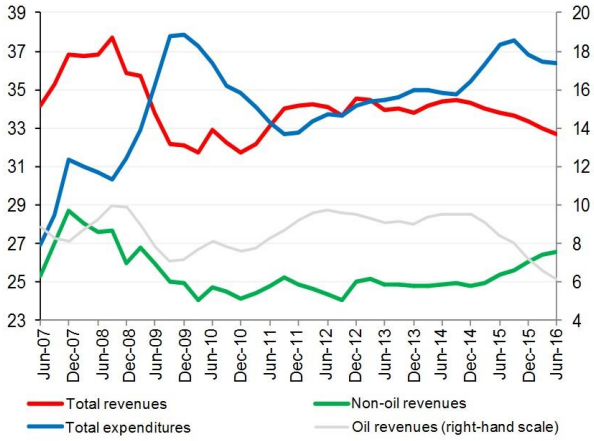
Figure 55. Spending of non-interest budget funds net of interbudget transfers, accrued over a year



**Excluding funds for capitalisation support to the Deposit Insurance Agency in December.*

Sources: Federal Treasury, R&F Department calculations.

Figure 56. Four-quarter sliding key budget system indicators, % of GDP



Sources: Federal Treasury, Russian Ministry of Finance, R&F Department calculations.

[22] Expenditures falling on the last months of the year.

Uncertainty persists over the macroeconomic forecast, budget revenue and expenditure, and deficit funding sources, primarily proceeds from privatisation of the state property and borrowings in 2016-2018.

1.3. Global economy, financial and commodity markets

1.3.1. Central banks continue to soften their policies

- In August, central banks of some advanced economies continued to soften their monetary policies. The ECB may join them in September.
- The Fed is likely to raise its policy rate only once until the year-end.
- Macroeconomic risks in China continue to grow, calling for new stimulus efforts to back up the economic growth.

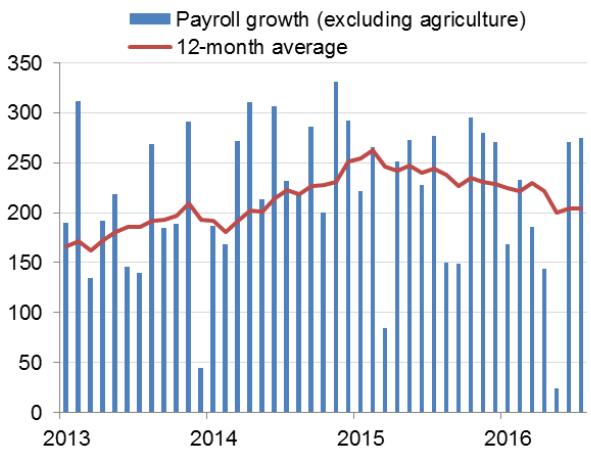
Central banks of some advanced economies continued to soften their monetary policies in August. The Bank of England's policy easing was the most pronounced amid a looming downturn in the British economy in the aftermath of Brexit. The Reserve Bank of Australia and the Reserve Bank of New Zealand cut their policy rates, too, in line with market expectations.

USA: the economy is getting close to full employment

The July labour statistics have ultimately confirmed that the drop in May was temporary. The economy added 255 thousand new jobs in July after having expanded by 292 thousand in June (Figure 57). Despite the growing number of employed, unemployment persisted at 4.9% on the back of the ongoing recovery of labour force participation rate (Figure 58). The labour market environment continues to improve, as seen in the dynamics of nominal wages, where the annual growth was entrenched at 2.6%. Such a wage growth and employment were seen at the end of last year, when the Fed decided to raise the policy rate.

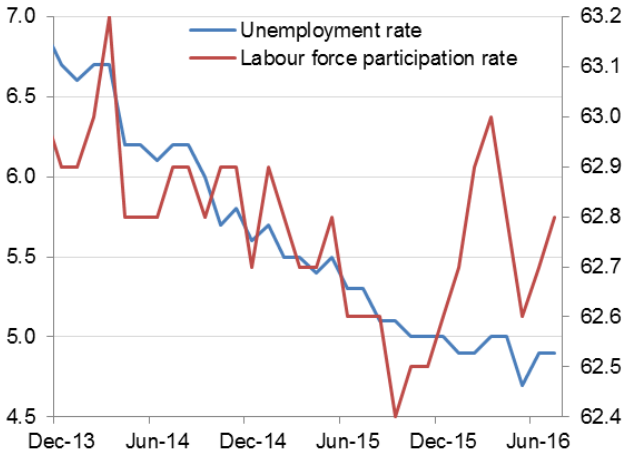
The overall dynamics of various labour market indicators signal that the US economy is getting closer to full employment. However, given the weak investment dynamics, the Fed is unlikely to venture more than one rate hike until the year-end. Growth of interbank rates and the upcoming presidential elections will hinder the rate hike at the upcoming September meeting. History shows that the Fed hardly makes any efforts in the run-up to the US presidential elections.

Figure 57. Growth in non-farm payrolls in the US, thousands MoM



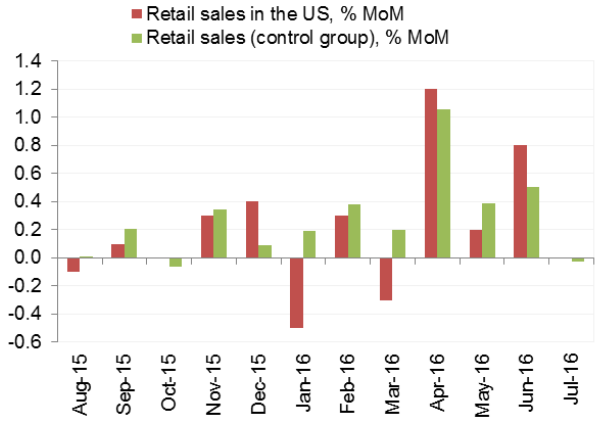
Source: Bloomberg Finance L.P.

Figure 58. US labour market, %



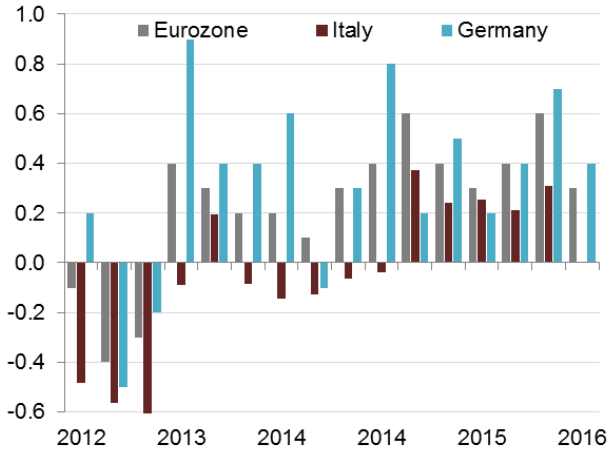
Source: Bloomberg Finance L.P.

Figure 59. Retail sales in the US, % MoM (seasonally adjusted)



Sources: Bank of Russia, R&F Department calculations.

Figure 60. Eurozone GDP, % QoQ (seasonally adjusted)



Sources: Bank of Russia, R&F Department calculations.

Eurozone: expected slowdown in the second quarter

In the second quarter, eurozone GDP growth expectedly slowed to 0.3% QoQ after having accelerated to 0.6% QoQ in the first quarter (Figure 60). Germany is still leading, while other countries, like France and Italy, failed to show any growth in the second quarter. Italy's economic performance is likely to continue to lag behind the eurozone due to the banking sector woes. The Italian government intends to stimulate the economy through fiscal channels, particularly, through lowering corporate income tax, but these measures are to become effective only next year. Low growth of the eurozone's economy and the ongoing divergence between some countries put pressure on the ECB, spurring more monetary policy easing in the near future.

In mid-August, a report on the ECB meeting held on 20-21 July was published. It noted that short-term Brexit repercussions were less deplorable than expected. However, the ECB is still keeping a wary eye on possible fallouts of Britain's decision to leave the European Union, which may manifest themselves in a decline in mutual trade, and other less predictable channels. The overall content and tenor of the report signal that the ECB is very likely to continue softening its monetary policy on the upcoming meeting to be held on 8 September. This approach will be in line with the Bank of England's moves, which put policy easing on hold at its first post-Brexit meeting. To ease its policy, the ECB is most likely to extend the asset purchase programme (€80 billion a month) and expand the list of eligible assets.

The Bank of England: an unprecedentedly dovish narrative and a new £100 billion bazooka[23]

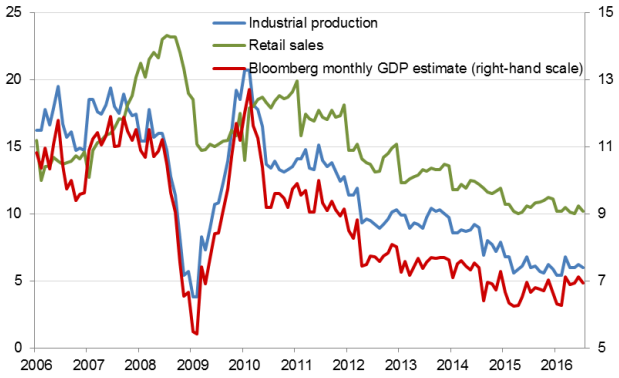
After having taken a break, considerable enough for markets to stabilise in the aftermath to the Brexit referendum, the Bank of England finally sprang into action. In early August, the Monetary Policy Committee decided to cut the bank rate by 25 bp to the record-low 0.25% p.a. That was the first easing since the acute repercussions of the 2009 global financial crisis had come to the fore. At the same time, the official statement in the follow-up to the decision clearly signalled to the market the possibility of further easing in the months to come. The additional BoE stimulus provides for expanding the ongoing quantitative easing programme to £435 billion and injecting another £10 billion under a new programme to purchase corporate bonds issued by systemically important companies.

China: risks of economic slowdown go up

In July, key macroindicators returned to the April-May readings after having surged in June. Thereby, industrial production grew 6.0% YoY (6.2% in June), retail sales were up 10.2% YoY (10.6% in June), and Bloomberg monthly estimate of China's GDP growth added 6.9% YoY (7.1% in June). At the same time, these indicators considerably exceed those registered in January-February, when concerns over the state of the Chinese economy were voiced.

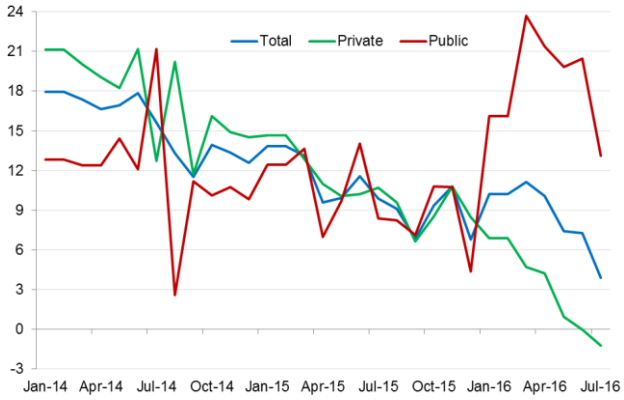
[23] A reference to the Term Funding Scheme with £100 billion capacity.

Figure 61. GDP growth, industrial production and retail sales in China, % YoY



Source: Bloomberg Finance L.P.

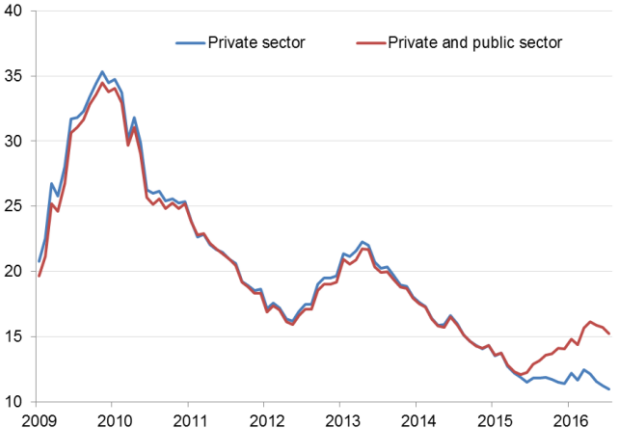
Figure 62. Fixed capital investment growth by activity, % YoY



Sources: Bloomberg Finance L.P., CEIC, R&F Department calculations.

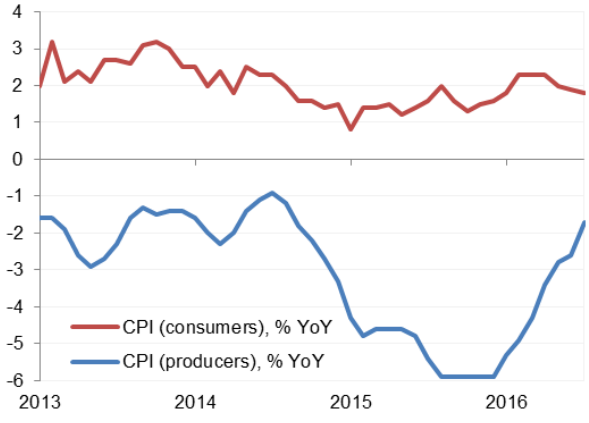
We can also see risks to China's economic growth exacerbate in future periods. In July, fixed capital investment growth saw a decline to 3.9% YoY (7.3% in June) with the private sector indicator shifting to the negative territory (-1.2% YoY) for the first time in years (0.0% In June) (Figure 62). Debt financing of the private sector also fell to a multi-year low of 11.0% YoY (11.3% in July) (Figure 63). These developments give an ever clearer picture of structural problems in the economy, which check investment activity of companies, accumulating funds on current accounts instead of investing in the economy. The public sector still sets off these trends, but the growth rates of the corresponding indicators are slowing, having already affected the investment activity in July.

Figure 63. Debt financing in China, % YoY



Sources: Bloomberg Finance L.P., CEIC, R&F Department calculations.

Figure 64. Consumer and producer price indices in China, % YoY



Source: Bloomberg Finance L.P.

Poor macroeconomic statistics in July partially result from the large-scale floods. Having said that, we believe that the effect of the government's stimulus efforts increasingly risks being exhausted, calling for new stimulus to underpin elevated economic growth rates. Thus, in early August the National Development and Reform Commission recommended that the People's Bank of China take additional measures to stimulate the economy by curtailing the required reserve rate and the policy rate.

Inflation dropped in China to 1.8% YoY in July (in June, it stood at 1.9%) following the lower growth of food (mostly pork) prices (Figure 64). Consumer price growth is unlikely to pose a serious threat in the upcoming quarters, allowing the PBC to proceed with economic stimulus, if necessary.

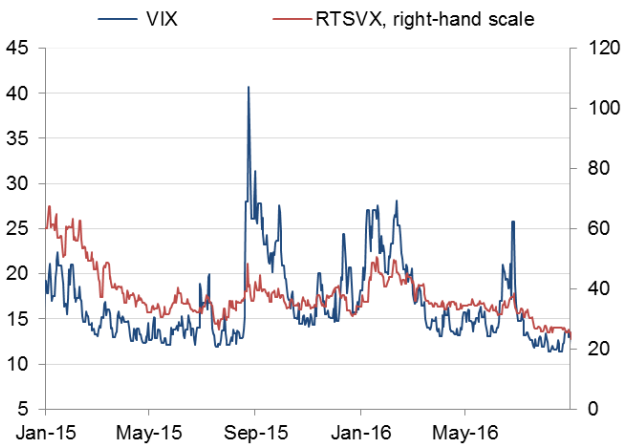
1.3.2. Soft monetary policy keeps volatility down

- Against the backdrop of soft monetary policies in advanced economies, low yields of conventional defensive assets push investors to riskier segments: emerging market bonds and high-yield bonds.
- Libor's growth on the back of the US money market fund reform equals to policy tightening, reducing the likelihood of the Fed's rate rise in September.
- Higher geopolitical tensions set off the positive effect of oil price recovery for Russian markets.
- Short-term money market rates remain in the lower range of the BoR interest rate corridor, but their deviation from the key rate has stabilised.

Global markets

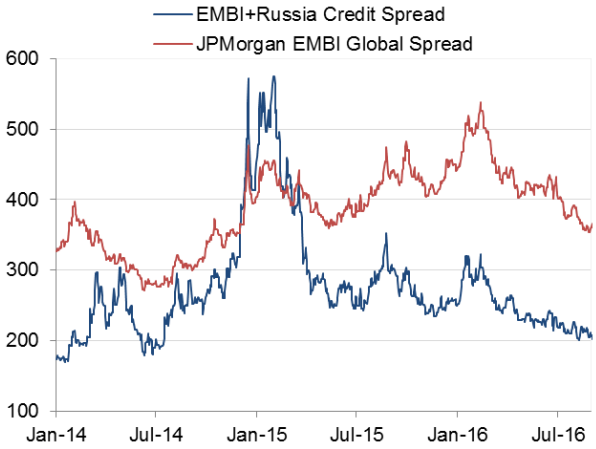
Further easing of monetary policies in some advanced economies and expected additional stimulus from major central banks, like the ECB and the Bank of Japan, are the key reasons behind the stabilisation of market volatility at the lowest levels (Figure 65). It allowed key security indices in the US to hit a new high. Other equity markets are far from the maximum levels, but show a steady growth.

Figure 65. VIX (S&P500) and PTC (RTSVX)



Source: Bloomberg Finance L.P.

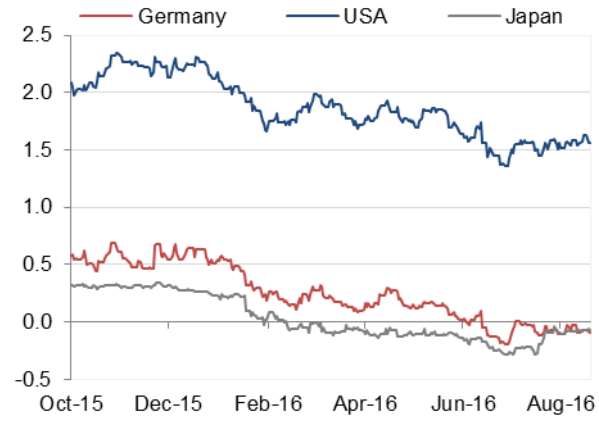
Figure 66. EMBI+Russia and JP Morgan EMBI Global



Source: Bloomberg Finance L.P.

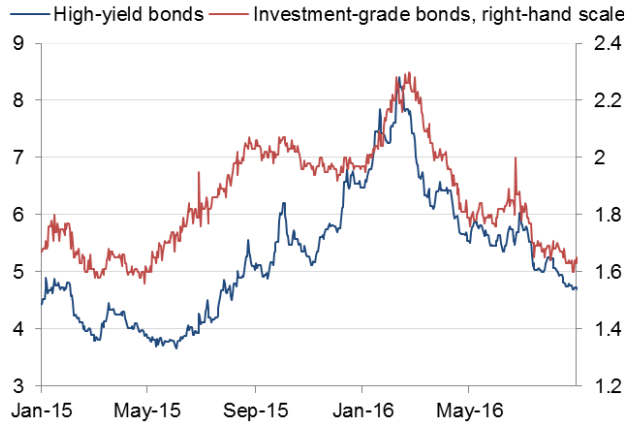
Advanced economies' bond yields have not changed considerably and persist at their lows (Figure 67). However, the nominal volume of negative-yield bonds reached $13.4 trillion[24] in mid-August. Investors, especially the long-term ones, are shifting to other instruments. As a result, credit spreads in risky market segment drop further (Figure 66 and Figure 68). The ongoing fund inflow to emerging markets triggers bond rally and drags yields down (Figure 70).

Figure 67. Yields on 10-year bonds of developed countries, %



Source: Bloomberg Finance L.P.

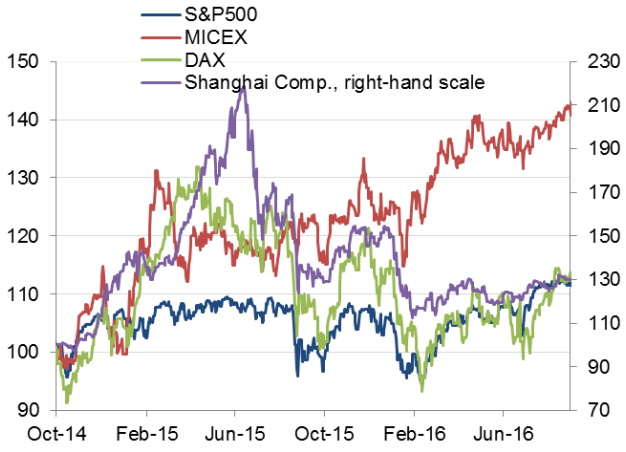
Figure 68. Credit spread of corporate bonds of developed countries, %



Source: Bloomberg Finance L.P.

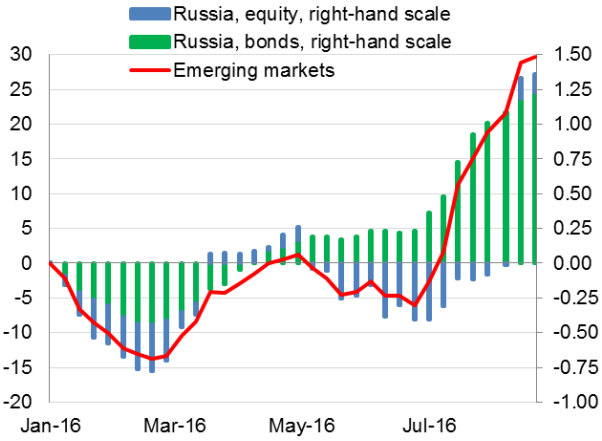
[24] As reported by the Financial Times.

Figure 69. Equity indices in local currencies (index, 1 January 2014 = 100)



Source: Bloomberg Finance L.P.

Figure 70. Cash flows into Russian and EM funds (accrued, '+' - inflow), $ billion

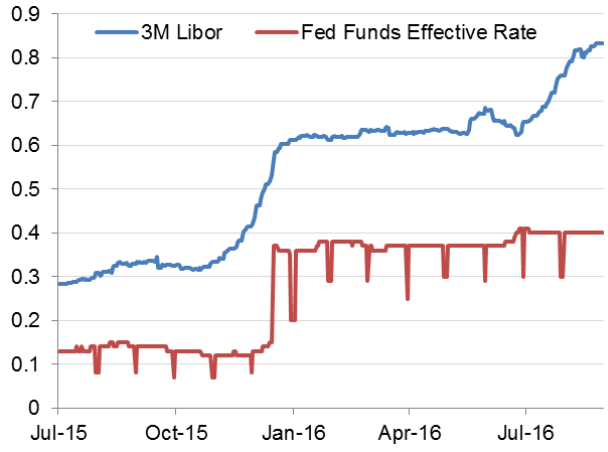


Sources: EPFR Global, Bloomberg Finance L.P.

LIBOR dynamics

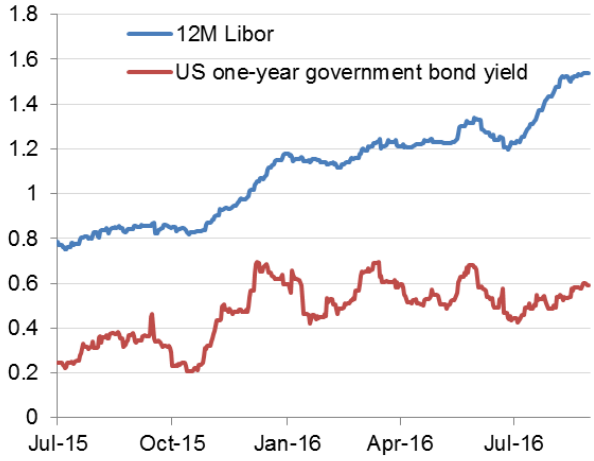
Over the past six weeks, money market Libor rates in US dollars grew 20-30 bp depending on maturities (Figure 71 and Figure 72). This is in contrast with the situation in the bond market and results from the US money market fund reform: starting from October 2016, funds will be allowed to impose commissions and establish moratoriums for cash withdrawal if the market climate worsens.

Figure 71. 3-month LIBOR and US Federal Funds rate



Sources: Bloomberg Finance L.P.

Figure 72. 12-month LIBOR and US one-year government bond yields



Sources: Bloomberg Finance L.P.

This may be unacceptable for institutional investors, major shareholders of these funds. Money market funds (prime funds) are a key source of short-term funding for commercial and investment banks[25]; they buy their short bonds (commercial papers). Beware of cash withdrawals, fund managers have started to create a liquidity cushion in their funds or accumulate government bonds in their portfolio, while reducing demand and investment in less liquid bank bonds. Lower funding from money market funds boosted banks' demand for other sources of US dollar liquidity, resulting in money market rate hike.

Libor rate is used as a baseline in many instruments with floating yields[26], therefore its hike is equal to monetary policy tightening by the US Fed. This situation may be of temporary nature depending on the results of transition of the money market fund market to new operation rules. Nevertheless, market participants expect Libor to remain elevated at least until mid-October. This is another reason why the US Fed will not take any steps at the September meeting.

Russian markets

Growth of geopolitical instability affected Russian financial markets through a modest increase in CDS risk premium, while risk premiums in other emerging markets stabilised or went down. On the other hand, oil price growth backed up Russian markets; therefore, the overall dynamics in August were favourable. For example, following the recovery of oil prices the MICEX index hit a new high in August and grew 12% since the beginning of the year (Figure 69).

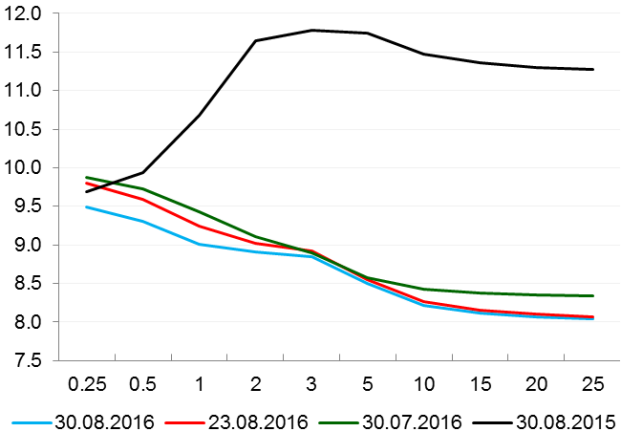
Russian eurobond yield hardly changed in August (Figure 73) amid falling bond yields and credit spreads of other emerging markets (Figure 66). Ruble bonds showed more favourable dynamics. OFZ yields continued to go down after having adjusted in July (Figure 74) along with corporate bonds (Figure 76[27]).

[25] Especially for the latter, as they are unable to take deposits.
[26] Syndicated loans, floating-rate bonds, mortgage loans, etc.
[27] Corporate bond index yield hike resulted from the revision of index calculation base on 1 June, rather than market dynamics.

Figure 73. Russian eurobond yield, %

Source: Cbonds.

Figure 74. GKO-OFZ yield curve, %

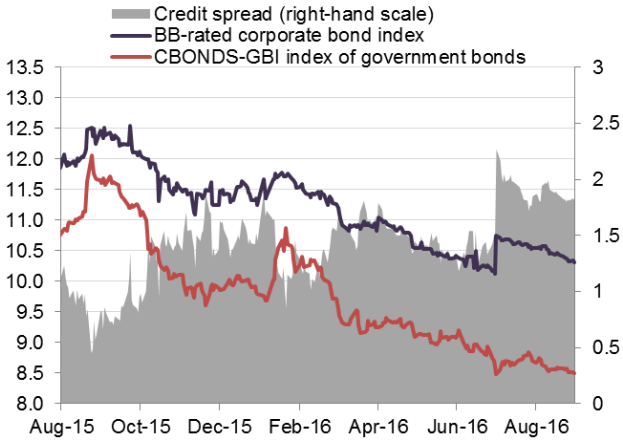


Source: Moscow Exchange.

Figure 75. FRA3X6 and 3M Mosprime spread, % p.a.

Sources: Bank of Russia, Bloomberg, R&F Department calculations.

Figure 76. Ruble bond yield, %



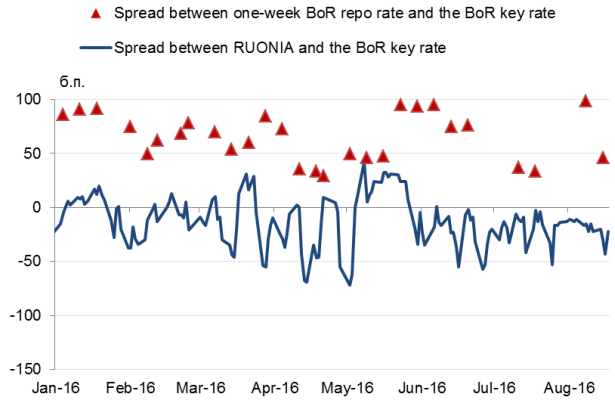
Source: Cbonds.

Monetary conditions continue to soften due to the expected inflation slowdown and the BoR rate cut. FRA 3×6 and 3-month Mosprime spread has been wobbling around -0.5% since early summer (Figure 75). It points to stable market expectations of the BoR rate cut at the forthcoming meetings.

August 2016 turned out to be favourable for banking sector liquidity and short-term money market rates. A sizeable liquidity inflow from the budget to the baking system could be observed since the beginning of the month. In 1-25 August, the aggregate net liquidity inflow to the banking sector stood at ₽510 billion (Figure 80). Nevertheless, it failed to bring short-term money market rates down, because liquidity inflow was fully absorbed due to the banks' repayment of debt on BoR refinancing instruments[28].

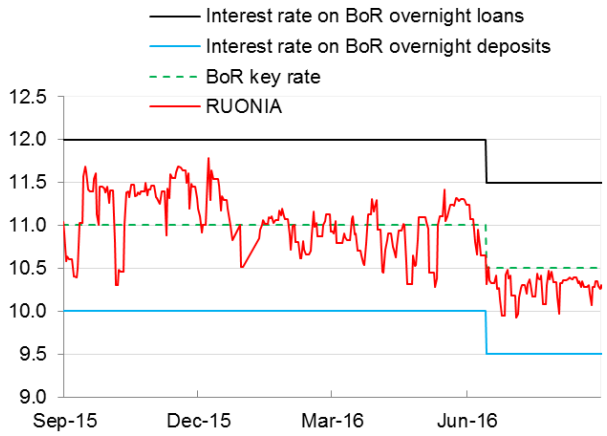
At the same time, RUONIA held on the average 20 bp below the BoR key rate in 1-25 August (Figure 77 and Figure 78). It is noteworthy that its deviation from the key rate hardly changed as compared to July data, and the spread between RUONIA and the BoR key rate had been negative since early June 2016. On 9 August, the Bank of Russia held the first deposit auction in this year. This instrument, designed to absorb excessive liquidity, shall replace liquidity provision instruments as the economy shifts to a liquidity surplus, when demand for funds provided through auction-based repo vanishes[29].

Figure 77. Spread between RUONIA and one-week auction-based BoR repo rate to the BoR key rate, bp



Sources: Bank of Russia, R&F Department calculations.

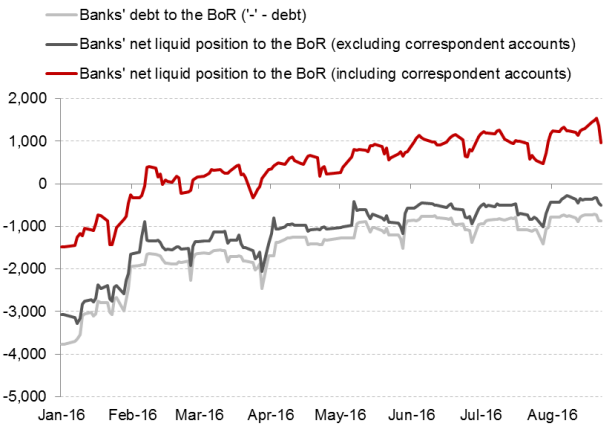
Figure 78. BoR interest rate corridor and short-term interbank lending rate, % p.a.



Sources: Bank of Russia, Bloomberg Finance L.P.

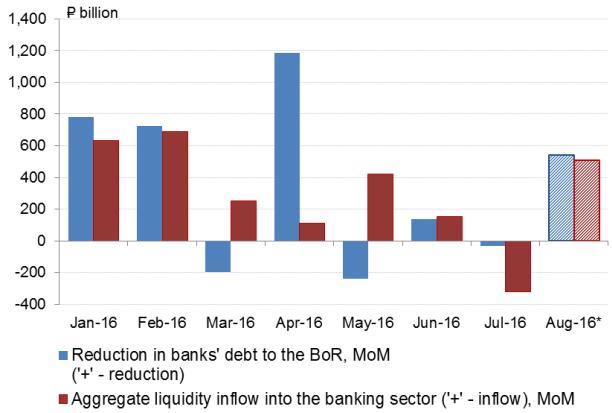
[28] In 1-25 August, debt on BoR repo decreased by ₽364 billion, and banks' debt on loans backed by non-marketable assets shrank by ₽175.5 billion.
[29] In the morning 26 August, debt on BoR auction-based repo stood at ₽320.7 billion.

Figure 79. Banks' net liquid position to the BoR, ₽ billion



Sources: Bank of Russia, R&F Department calculations.

Figure 80. Reduction in banks' debt to the BoR and net liquidity inflow, ₽ billion



Sources: Bank of Russia, R&F Department calculations.

** R&F Department estimate based on the data for 1-25 August.*

Reasons behind the high demand at the deposit auction[30] could be as follows. First, the auction-based deposit rate is higher than the fixed BoR deposit rate. Second, major banks are likely to have accumulated liquidity surplus recently amid a decline (nulling for some banks) in dependence on ruble refinancing as inflows from the Federal Treasury accounts increased. Stabilisation of debt on fixed BoR repo allows concluding that the situation with liquidity does not deteriorate in minor banks and their demand for BoR refinancing does not go up[31] (Figure 79).

The increase of required reserve ratio from 1 August will hamper liquidity surplus formation putting structural liquidity surplus on hold. Deposit auctions along with other monetary policy instruments shall stabilise the negative spread between short-term money market rates and the BoR key rate.

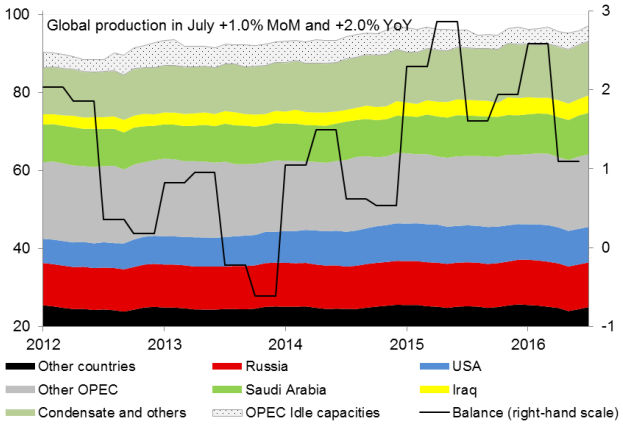
1.3.3. Commodity markets: oil prices in the grip of frail hopes

- In August, fundamental factors continued to put pressure on oil prices: global production growth, including in the US, increased commercial oil and petroleum product inventories.
- Meanwhile, oil prices grew on the back of the expected new agreement on production limits.
- This agreement seems less likely to be reached than before.

[30] Demand at the deposit auction exceeded supply almost twofold, amounting to ₽187 billion against the announced ₽100 billion at the weighted average rate of 10.22% (against the 10.5% maximum).
[31] During the periods of low- and zero-limits of the BoR auction-based repo in August, the average debt on fixed repo amounted to ₽270 billion.

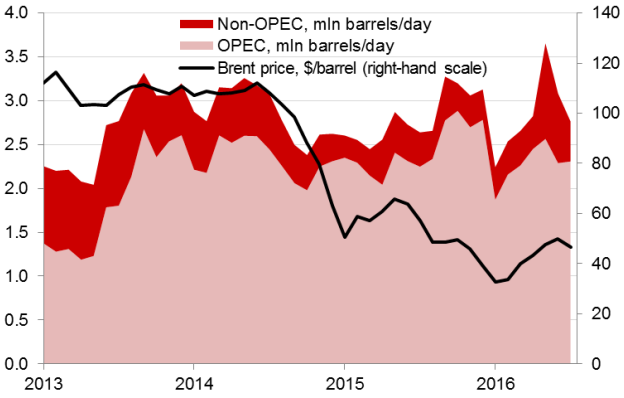
Prices for most agricultural goods and metals went down in August. At the same time, oil prices grew despite the pressure exerted by the fundamental factors in the second half of the month. The positive dynamics resulted from the new expectations for producers' joint efforts to stabilise the global oil market. This time, markets expect the decision on production limits to be taken at the informal meeting on the sidelines of the summit to be held on 26-28 September.

Figure 81. Production and balance in the oil market, million barrels/day



Sources: EIA, R&F Department calculations.

Figure 82. Unplanned oil production outages and Brent crude price

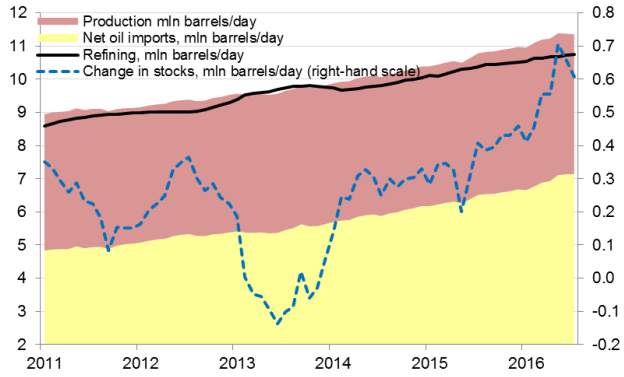


Sources: EIA, Bloomberg Finance L.P.

According to Bloomberg, a considerable upsurge in global oil production continued in July (Figure 81) following a decline in unplanned outages (Figure 82) and a rise in production in individual OPEC countries due to the summer period. Production in Iran approached its pre-sanction level, while Iraq almost hit its historical high. Saudi Arabia set a new record in oil production, while Russia sustained its production close to the record 10.9 barrels a day. Provisional estimates suggest that this trend may hold in August. This signals higher competitiveness between major producers and exerts downward pressure on oil prices.

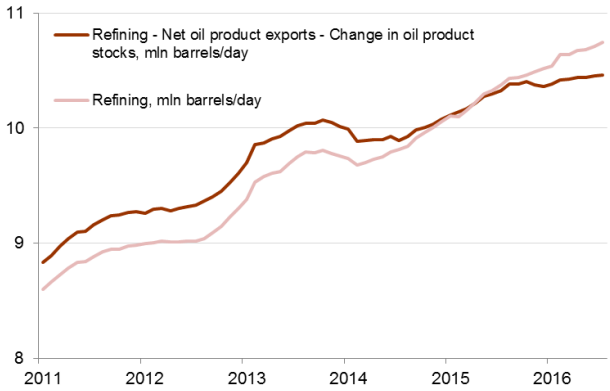
Weaker demand from China checks oil prices. In July, the 12-month average of net oil and petroleum product imports to China continued to go down after having spiked in May. Amid a year-long stagnation of domestic consumption (Figure 84), such dynamics are explained by slower inventory formation (Figure 83).

Figure 83. Production, net imports, processing and changes in oil stocks in China (12-month average)



Sources: Bank of Russia, Bloomberg, R&F Department calculations.

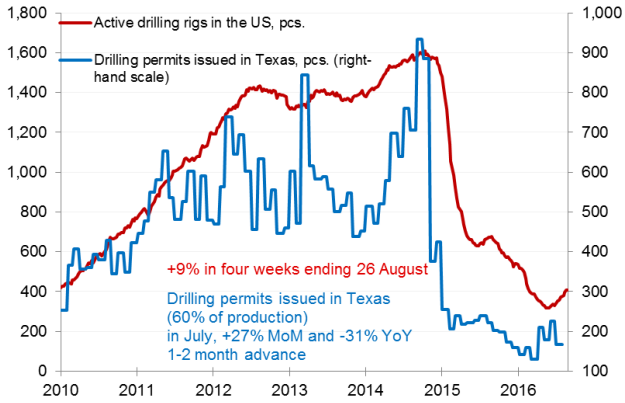
Figure 84. Oil processing and consumption in China (12-month average)



Sources: Bloomberg Finance L.P., Xinhua News Agency, R&F Department calculations.

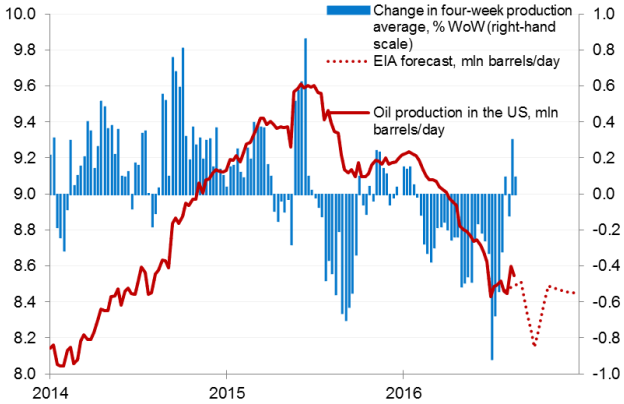
Being the key oil price driver, statistics from the US oil market also continue to affect prices. We have registered an eight-week growth in total commercial oil and petroleum product inventories. Like in the first quarter, its path repeats the elevated dynamics of the previous year[32] while deviating from its usual seasonality forecast by the US Energy Information Administration (EIA) for the rest of the year (Figure 88). If we assume that capacities, used to stock oil inventories in all the countries other than the US, are close to their maximum, and the United States is the only destination of all oil surplus, we can expect the situation of the past year-start to repeat. In the second half of the first quarter and most of the second quarter, growth in the US inventories was held back by large-scale production outages and elevated demand from China to accumulate strategic oil inventories.

Figure 85. Active drilling rigs in the US and drilling permits issued in Texas



Sources: Baker Hughes, Railroad Comission of Texas.

Figure 86. Oil production in the US

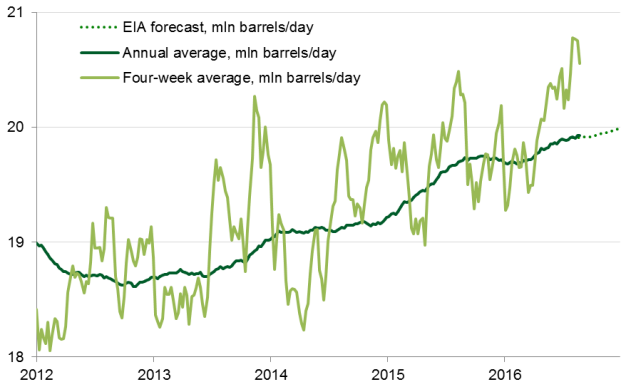


Sources: EIA, R&F Department calculations.

[32] Upper border of the inventory change interval.

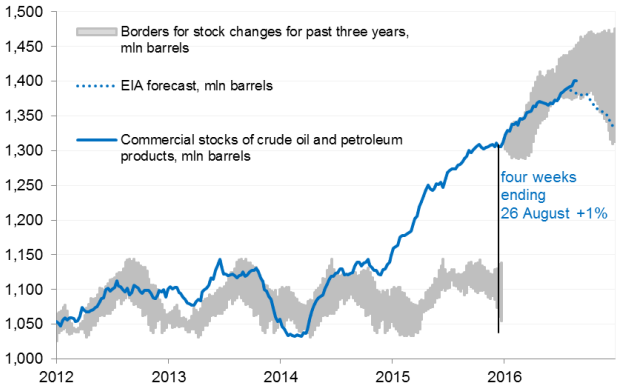
High resistance of shale oil producers to oil price drop remains a key risk of persistently excessive supply in the oil market during a long period of time. The number of drilling rigs has been going up since early June and their average growth rate has anchored at about 10% (Figure 85). It already affects current oil production, which has revived after the July low and exceeds the EIA forecast (Figure 86). The Wall Street Journal has mentioned that shale oil producers are becoming firmer in their conviction about sustainability of current oil prices, and therefore announce their plans to increase investment in drilling new wells in attempt to get ahead of their competitors in launching full-scale production.

Figure 87. Oil product consumption in the US



Sources: EIA, R&F Department calculations.

Figure 88. Total US commercial oil and oil product stocks



Sources: EIA, R&F Department calculations.

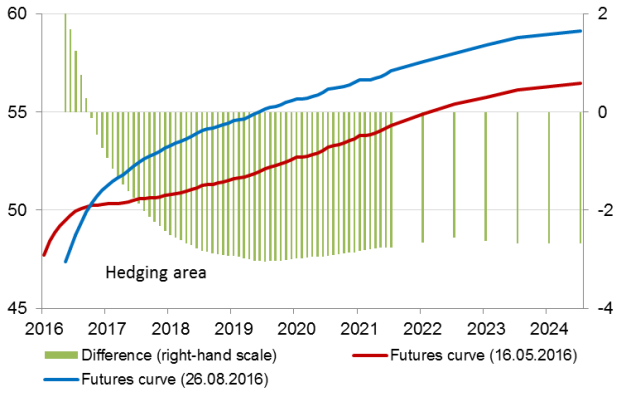
The WTI futures curve remains in contango[33]. However, as witnessed in May-June this year, when the price of WTI crude approached $50 a barrel, shale oil producers started to hedge oil prices flattening, the futures curve (Figure 89). We expect the situation to repeat if oil prices continue to go up.

Against this backdrop, growth in petroleum product consumption remains high, particularly in the US, but is in line with the EIA forecast (Figure 87), which is insufficient for bringing inventory dynamics to their usual seasonality.

Expectations of a rapid market balancing may be underpinned either by new production outages, or a deliberate restriction. We believe the agreement to freeze or limit production is less likely to achieve than before, given the elevated competition between the major producers and the ongoing market balancing. Production restriction is also likely to be declined by the countries (primarily, Nigeria) where production is low anyway due to temporary factors. In addition, as mentioned above, further price growth may trigger a large-scale and fast return of shale oil producers to the market, dragging oil prices down again. Finally, the experience suggests that agreements to limit production are often violated (Figure 90).

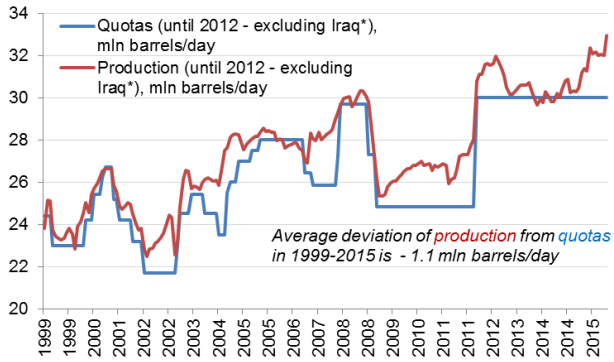
[33] The futures price is higher each month than in the previous month.

Figure 89. WTI futures curve



Sources: Bank of Russia, Bloomberg, R&F Department calculations.

Figure 90. Quotas to actual production in OPEC countries



** Iraq is not included in the system of quotas.*

Sources: Bank of Russia, Bloomberg, R&F Department calculations.

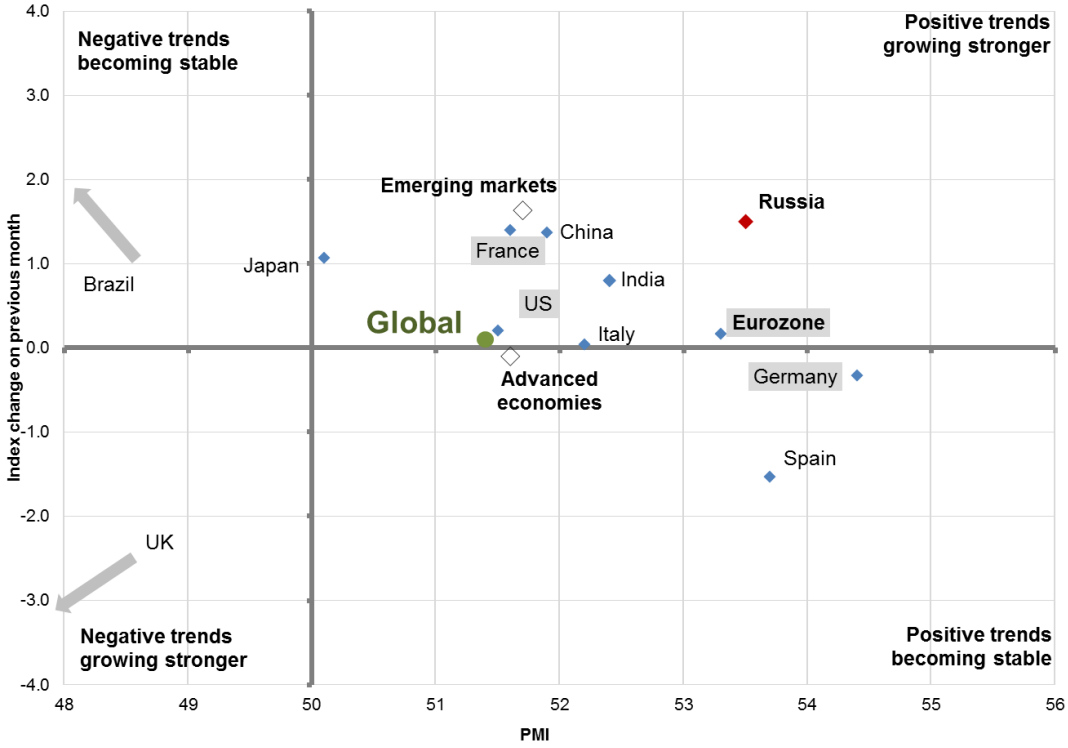
2. Outlook: leading indicators

2.1. Global leading indicators

2.1.1. Economic growth in the US and the eurozone may remain low in the months to come

Provisional composite PMIs in June (Figure 91) point to a persistently modest economic growth in the US and the eurozone. Indices hardly changed in August and stayed close to the three-month average. Manufacturing output indices went up in the US and the eurozone, but services registered more modest dynamics. Moreover, a drop in new orders in manufacturing and fading optimism in services in the eurozone signal that the economic growth is not expected to accelerate in the months to come. Leading PMI components do not provide for considerable growth acceleration in the near future, either.

Figure 91. Composite PMI in July and change against the average value in the second quarter



** Highlighted in grey are provisional August data and change against the average value in May-June.*

Sources: IHS Markit, Bloomberg Finance L.P.

2.2. What do Russian leading indicators suggest?

2.2.1. Index GDP assessment: the economy is slowly taking an upward path

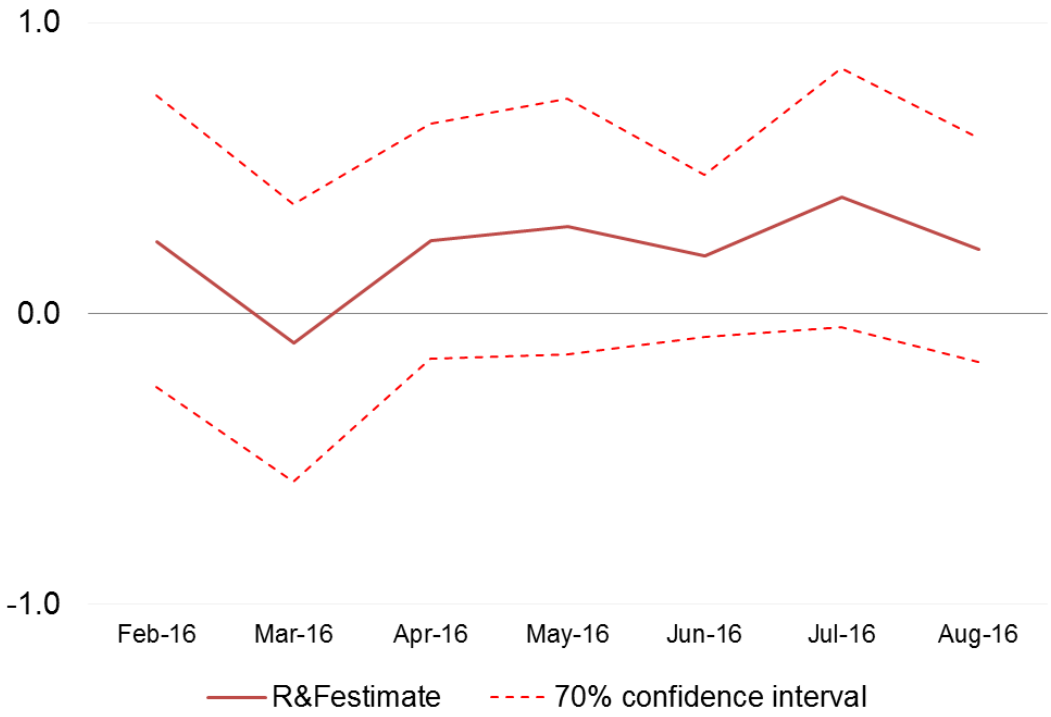
- Index Q3 GDP estimate was down to 0.2% QoQ in August (seasonally adjusted), while the last month estimate stood at 0.4% QoQ (Figure 92).

	August 2016	July 2016
	% QoQ	% QoQ
2016 Q2	**0.1-0.2***	0.2–0.3
2016 Q3	**0.2**	0.4
2016 Q4	**0.4**	0.5

** estimated values take into account the provisional Rosstat estimate for Q2 GDP at the level of -0.6% YoY*

- We have revised our estimate down following, primarily, the July slump in manufacturing. We consider it to be more moderate, seasonally adjusted, as compared with the Rosstat estimate.
- Our Q4 estimate has not changed considerably as it mostly relies on leading indicators (in particular, manufacturing and services PMI).
- According to our estimates, slow economic growth in the second half of the year remains the most likely scenario. In 2016, GDP growth is most likely to be close to the lower border of the BoR baseline forecast (a downturn of 0.3-0.7%).

Figure 92. Estimate of GDP growth in 2016 Q3, % QoQ

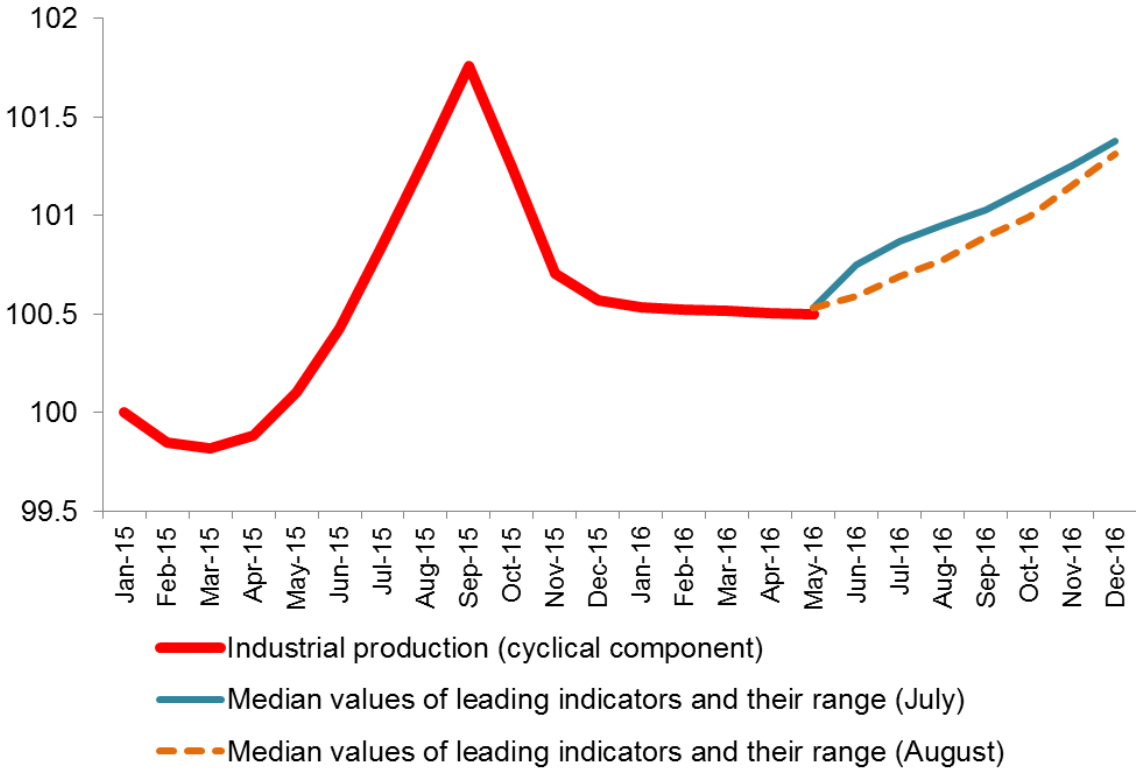


Sources: Rosstat, R&F Department calculations.

2.2.2. Leading business indicator: short-term growth prospects deteriorated

- The estimated composite leading business indicator was revised downwards as compared to the July estimate (Figure 92).
- This resulted, primarily, from poor production dynamics in manufacturing and had a negative impact on our forecasts of cyclical component of industrial production on the horizon from one to three months.
- The August recovery of oil prices made a positive contribution to the estimate of the composite leading indicator for two quarters ahead.
- However, unsustainable oil prices make economic activity estimates uncertain.

Figure 93. The cyclical component of industrial production (January 2015 = 100, seasonally adjusted) and leading business index



Sources: Rosstat, HSBC, Bloomberg Finance L.P., R&F calculations.

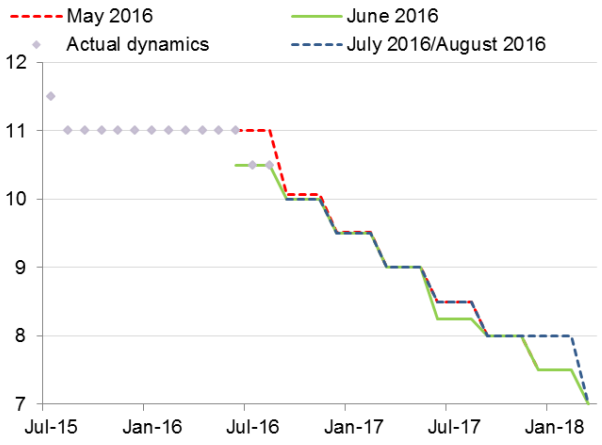
2.2.3. Consensus forecast for inflation in late 2017 deviated from the BoR target

- Inflation expectations for 2017 Q4 grew 5.2%, deviating from the BoR target.
- Financial analysts continue to expect the key rate to be cut to 9.5% by the end of 2016.
- Analysts believe that GDP is to switch to the annual growth in 2017 Q1 (rather than in 2016 Q4, as previously expected).

A Bloomberg survey held in late August suggests that financial analysts stick to their inflation expectations for 2016 and 2017 H1 (Figure 95). At the same time, inflation expectations for late 2017 grew to 5.2% from 4.7% in July, exceeding the BoR target considerably. Estimates vary significantly from 4.0% to 6.7%.

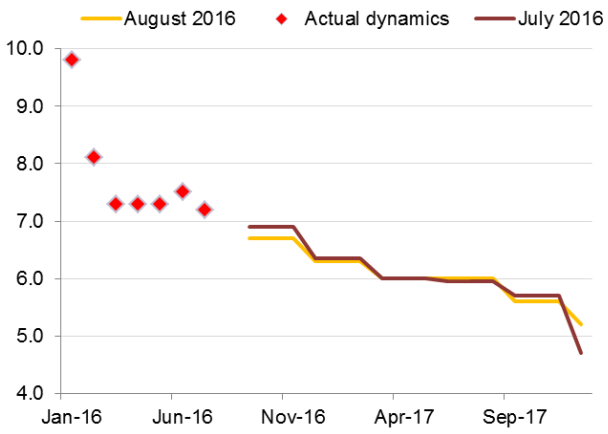
Expectations for the 2016 key rate dynamics remained unchanged compared to the July survey (Figure 94). Market participants expect the Bank of Russia to cut its key rate by 1 pp by the end of 2016 and by another 1.5 pp in 2017.

Figure 94. Analysts' expectations of the BoR key rate



Source: Bloomberg Finance L.P.

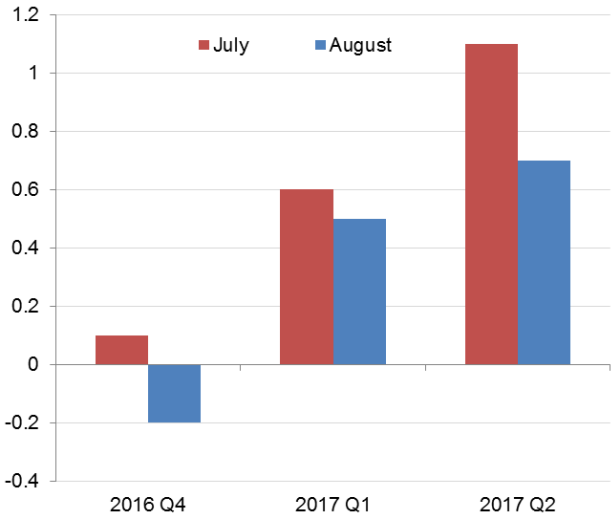
Figure 95. Analysts' expectations of inflation, % YoY



Source: Bloomberg Finance L.P.

Importantly, the GDP consensus forecast for the next three quarters deteriorated (Figure 96). Mixed data on industrial production in June seem to have dragged down the expectations that GDP would show a positive growth rate in 2016. Expectations of GDP growth in 2017 remained at the 1.3% level.

Figure 96. Analysts' expectations of GDP growth, % YoY



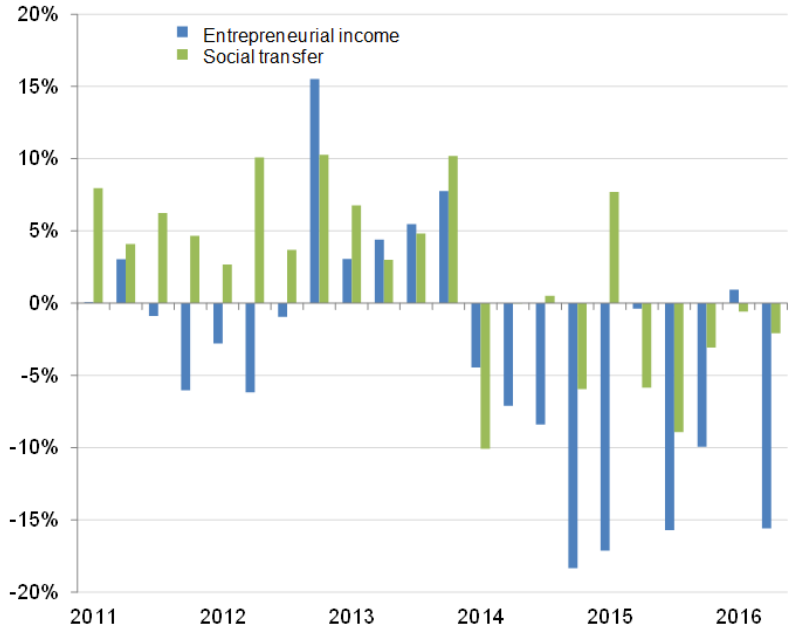
Source: Bloomberg Finance L.P.

3. In focus: the paradox of weaker consumption amid growing wages

The recent trend seen in Russia is as follows: positive wage growth fails to push household consumption growth to positive territory. Seasonally adjusted household consumption keeps falling month-on-month while wages are taking an upward path. Such inconsistency may result from several factors.

First, wages make only a part of households' income. As wages grow, other incomes continue to drift down in real terms (Figure 97), partially offsetting the positive effect of wage growth on income. Consequently, total household income still shows weak dynamics, and the current low consumer activity looks logical against this background.

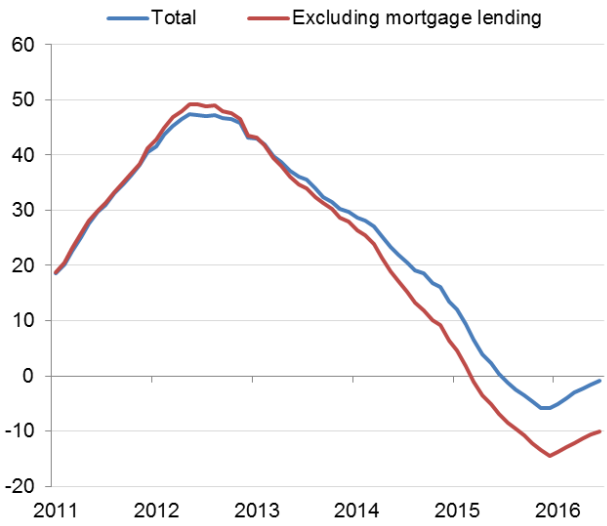
Figure 97. Household income components, quarterly data, YoY



Sources: Rosstat, R&F Department calculations.

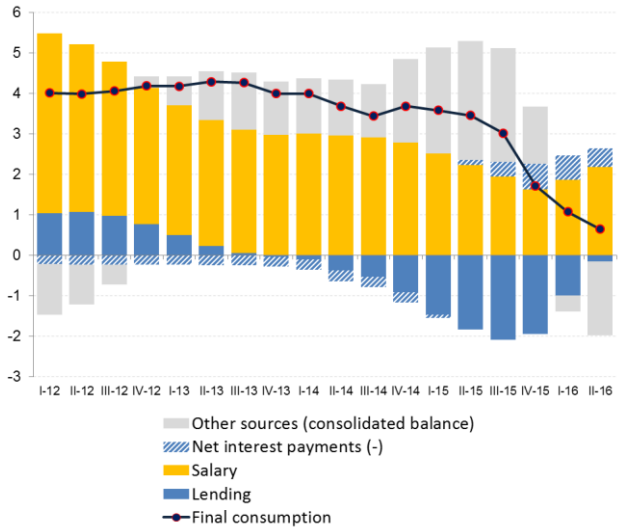
Second, we shall take into account households' loan redemptions. Burdened with high debt on loans, households have long spent considerable funds to repay loans (reduce general debt, Figure 98) instead of consuming. Principal debt repayment increased the savings ratio. As loan burden abates and consumer lending revives, this consumption underminer progressively loses its grip. According to our estimates, the total contribution of lending and net interest payments as households' expense funding sources entered positive territory in 2016 Q2 (Figure 99). Loan repayments started to decline, and the reduction of households' debt on loans is likely to have been completed. It allows releasing funds which households may spend on consumption. Consequently, the credit factor shall not hinder consumption upsurge in the near future.

Figure 98. Ruble loans to households, % YoY



Source: Bank of Russia.

Figure 99. Growth in ultimate consumption of households and its funding sources*

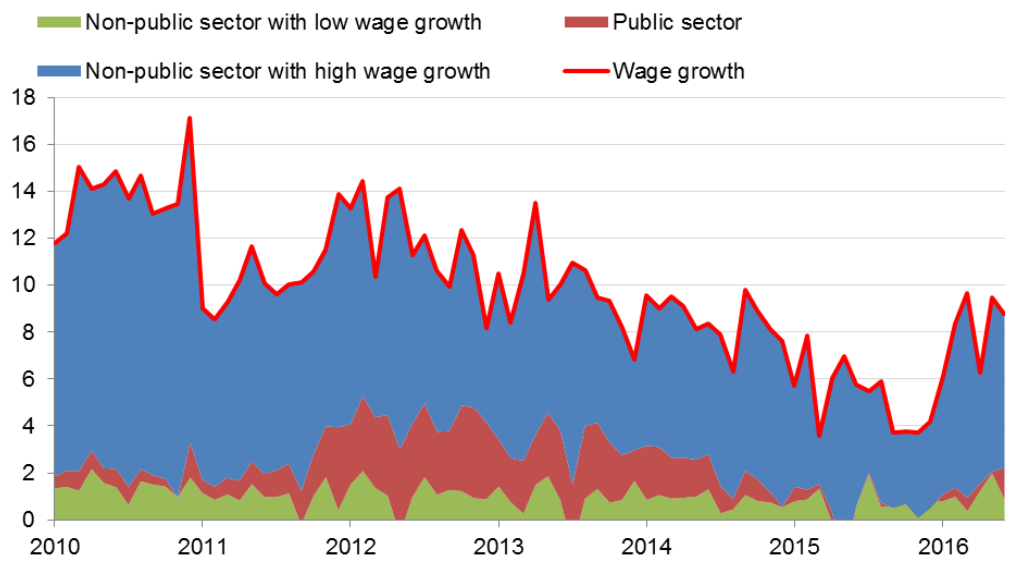


** Excess in the rolling-year amount over the previous rolling-year amount, ₽ trillion.*
Sources: Rosstat, R&F Department calculations.

The third reason behind the discrepancy between consumption and wage dynamics is the inequality of income growth across social groups. We have analysed components of nominal wage growth and concluded that the current wage growth recovery is concentrated in the industries which historically show a higher income as compared to other sectors (Figure 100)[34]. These industries with fast-growing wages historically account for a larger share in GDP (over 70%) and, therefore, have a considerable impact on the aggregate wage index. As a rule, savings of high-income groups are, by default, higher as compared to lower-income households. Consequently, the impact of wage growth on consumption in high-income sectors turns out to be lower than in the case of a similar wage growth in low-income sectors. In effect, it may turn out to be even lower given these sectors' high share in GDP. According to our estimates, wage growth in these sectors currently accounts for about 75% of the total wage growth.

[34] Key industries are mining and quarrying, wholesale and retail trade, transport and communications, finance, and operations with real estate. For a complete list of industries see Appendix 1.

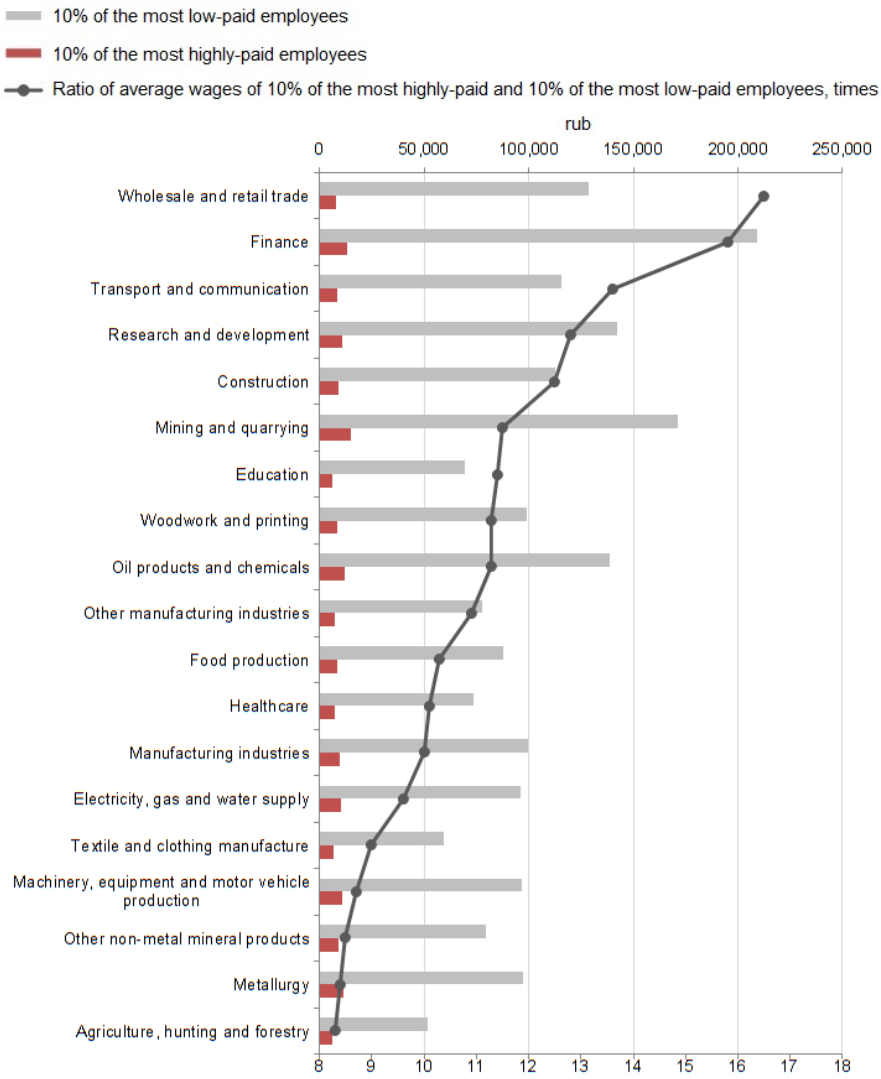
Figure 100. Sector-based decomposition of nominal wage growth, % YoY



Sources: Rosstat, R&F Department calculations.

Although the share of industries where employees enjoy a higher savings ratio has always been significant, it used to have a less constraining effect on consumption being offset by high wage indexation in the public sector, where the income is usually lower and propensity to consume is higher. Wage growth in the public sector is currently very low on the back of fiscal consolidation. Consequently, wage growth of one percentage point is translated into considerably lower consumption growth.

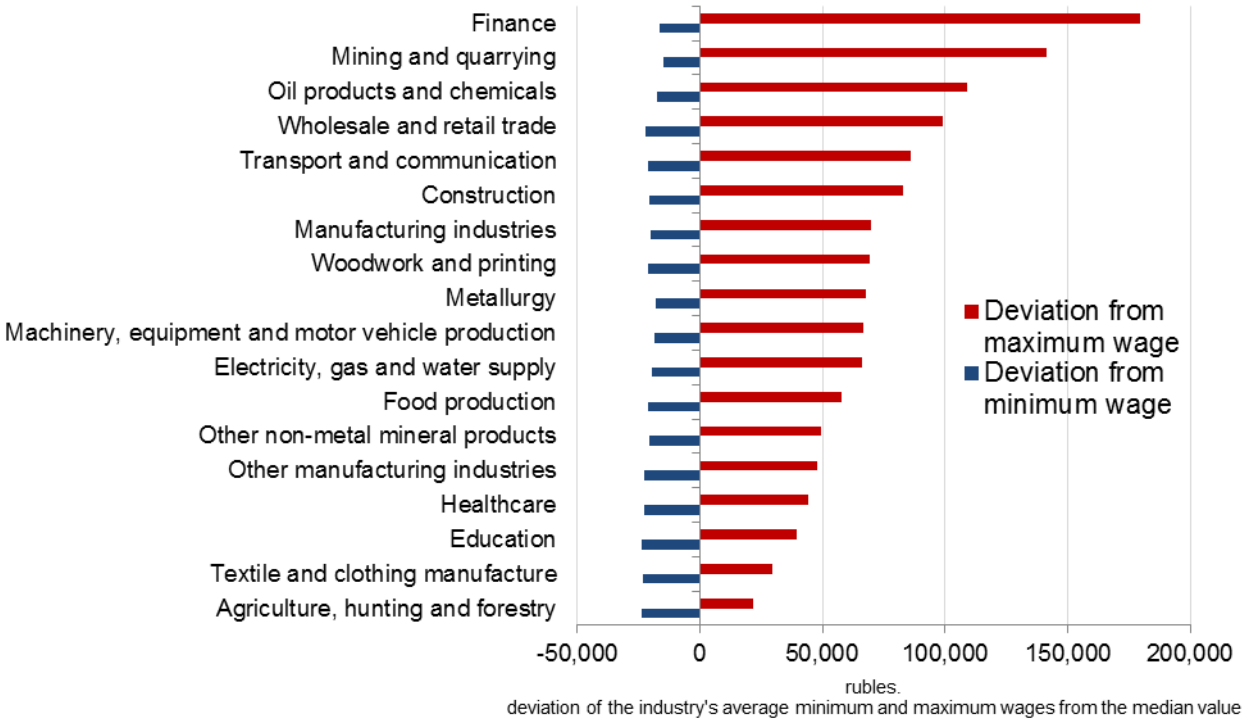
Figure 101. Wage differentiation ratio in 2015



Sources: Rosstat, R&F Department calculations.

Fourth, sectors characterised with high wage growth and high income are also characterised with high income *inequality (*Figure 101*).* At the same time, our analysis shows that income inequality in different sectors is shifted towards the most highly-paid employees, that is, top management (Figure 102). It confirms the assumption that the number of employees ready to considerably increase consumption after a wage increase is low. These sectors have the highest differentiation ratio and the most pronounced deviation of the average maximum wages from the median value. It means that wages are growing in the social group with a high savings ratio. It renders the overall impact of growing wages even less significant for consumption.

Figure 102. Deviation of average maximum and minimum wages from the median value* by sector in 2015



** The conditional median value is based on the average wages in the sector with account taken for the number of filled vacancies in each sector.*
Sources: Rosstat, R&F Department calculations.

Given the above restrictions, the recovery of household consumption amid the improved wage performance shall be expected to be slower than before. It results from the change in the household income structure, uneven wage growth and its shift towards high-income households.

Having said that, stabilisation of the overall debt level of households after a long decline shall boost consumption in the months to come.

Appendix 1.

The group ‘Non-public sector with high wage growth’ includes categories marked by a high wage growth:

- Mining and quarrying;
- Wholesale and retail trade;
- Transport and communications;
- Finance;
- Operations with real estate;
- Coke and petroleum production;
- Food production;
- Agriculture;
- Construction;
- Chemicals;
- Metallurgy.

* Data in this category is highly volatile; therefore a considerable decline in wages can be seen during certain periods in the middle of the year. However, this sector is included in the category of industries with fast-growing wages, because it shows rather high annualised wage growth.

Historical data suggest that these categories account for a considerable share of GDP (over 70%) during the whole period under review.

The group ‘Public sector’ includes general government and military security, obligatory social security, education, healthcare and welfare (this sector is supposed to be public).

The group ‘Non-public sector with low wage growth’ includes other categories not included in the groups ‘Public sector’ and ‘Non-public sector with high wage growth’.

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