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EXECUTIVE SUMMARY

1. Monthly summary

- Annual inflation gradually slowed in May as inflationary pressure stabilised near the target level. Calculations suggest that statistical base effects will strengthen a slowdown in annual inflation in the second half of the year. Inflation expectations have stabilised, though remaining elevated and unanchored, which signals that the associated medium-term pro-inflationary risks persist. Economic activity started to gain momentum in April after moderate slowdown in 2019 Q1 and is expected to reach its potential growth rates in the months to come. This is driven by relative stability in Russian financial markets and lending growth.
    - Under the baseline scenario, consumer price dynamics and the current inflationary pressure in the economy suggest that inflation will slow down to 4% in 2020 Q1. The preemptive key rate hike in 2018 H2 helped balance short-term pro-inflationary and disinflationary risks. That said, the medium-term risks of inflation deviating from target remain dominant.
    - Growth of the Russian economy sped up early in April after a temporary slowdown in the first quarter, which was caused in part by the high base effect attributed to the specifics of value added statistics in construction. Leading indicators suggest that economic activity will continue to expand in line with its potential in the months to come if external factors are favourable or neutral.
    - Russian financial markets remained overall stable as the world economy faced growing risks associated with the escalation of trade disputes between the US and China and increased volatility in global financial markets. However, developments in advanced and emerging market economies and the risks of sanctions are still dominant in the Russian financial market.

2. Outlook

- Our recent GDP nowcast suggests that growth of the Russian economy will accelerate in the months to come to the potential pace after a short-term slowdown in the beginning of the year
- The decline in core survey indicators for US economic activity to local, including many-year, lows raised the market-estimated probability of the US Fed’s rate cut as soon as this year. At the same time, the regulator’s officials have abstained from evident estimates of further policy rate movements in their statements.

1. MONTHLY SUMMARY

1.1. Inflation

Since April, annual inflation hit the downward trend that is expected to strengthen in the second half of the year. As a result, the annual growth in consumer prices will slow down to 4% in 2020Q1. Short-term pro-inflationary and disinflationary risks are balanced off.

Importantly, the most resilient CPI components that are only weakly sensitive to temporary factors showed a steadier growth rate in line with an inflation rate of 4%.

Pro-inflationary risks prevail over disinflationary ones in the medium-term. In particular, trend inflation exceeds 4% both within the five-year and the three-year observation windows. Among the key pro-inflationary risks are geopolitical factors and volatility surges in financial markets, high growth in consumer lending, secondary effects associated with heightened and unanchored business and household inflation expectations, and increasing workforce shortages in the labor market.

1.1.1. Inflationary pressure stabilised

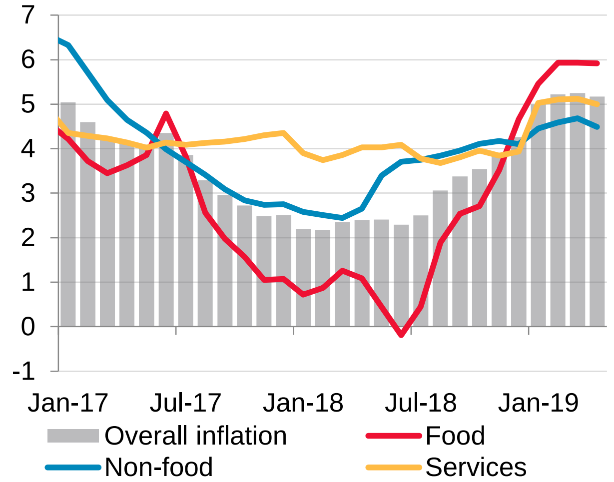
- According to a revised estimate, seasonally adjusted consumer prices growth in April totalled 0.32% MoM, remaining at the March level. Price growth in services was flat. Commodity prices demonstrated a mixed trend.
- Modified April core inflation indicators also remained at the March level, a sign of stabilised inflation pressure. Maintaining modified core inflation indicators below 4% is due to one-off factors containing price rises whose impact is impossible to eliminated through statistical techniques.
- According to our estimate based on Rosstat's weekly data, consumer prices in May were up 0.3% MoM (5.1% YoY). Annualised seasonally adjusted consumer price growth is initially projected at a level close to 4%.
- Under the terms of the Bank of Russia's baseline scenario, the current price movements indicate a slowdown in inflation to 4% in 2020 Q1.

According to Rosstat's revised data[1], annual inflation slowed down to 5.17 in April against 5.25% in March (Figure 1). It marks the first instance of slowdown in annual consumer price growth since last June. The annual food inflation was flat while price growth for non-food goods and services slowed down.

In April, seasonally adjusted consumer price growth was 0.32% MoM, a minor change on the March figure (0.31% MoM). In annualized terms, it is close to a level of 4%.

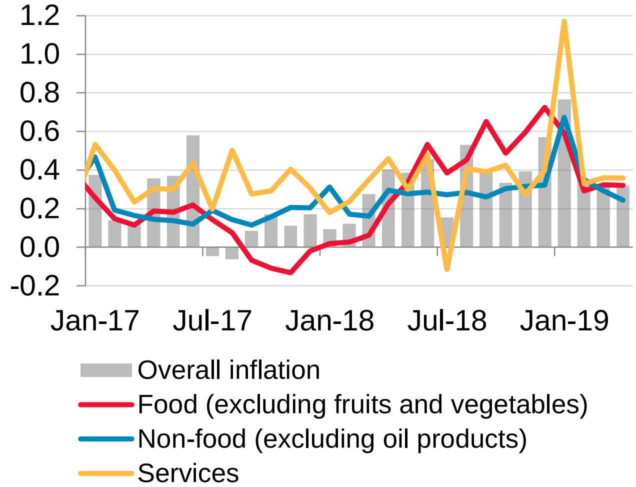
[1] Rosstat releases full data on changes in all CPI components following the official press statement on inflation.

Figure 1. Inflation and its components, % YoY



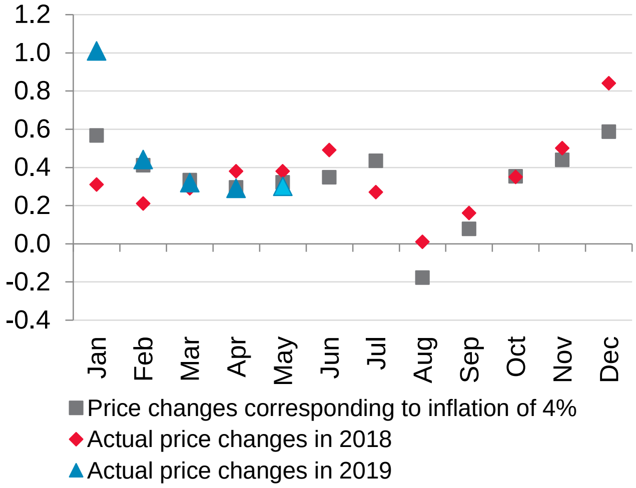
Source: Rosstat.

Figure 2. SA price growth, % MoM



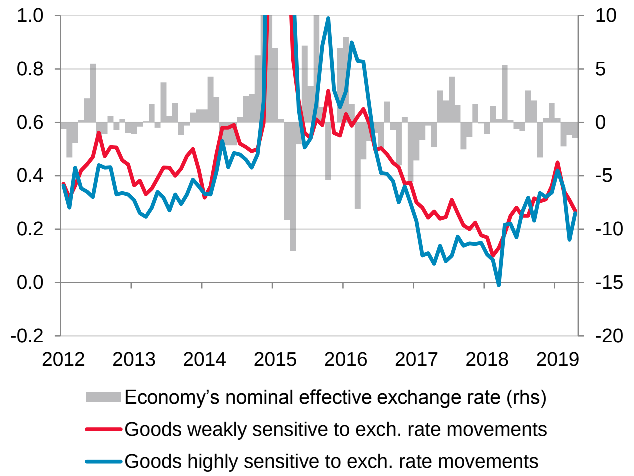
Source: Rosstat, Bank of Russia's calculations.

Figure 3. Price growth in line with 4% inflation, % MoM



Source: Rosstat, R&F Department calculations.

Figure 4. Median price growth for goods and services that are strongly and less sensitive to exchange rate fluctuations



Source: Rosstat, R&F Department calculations.

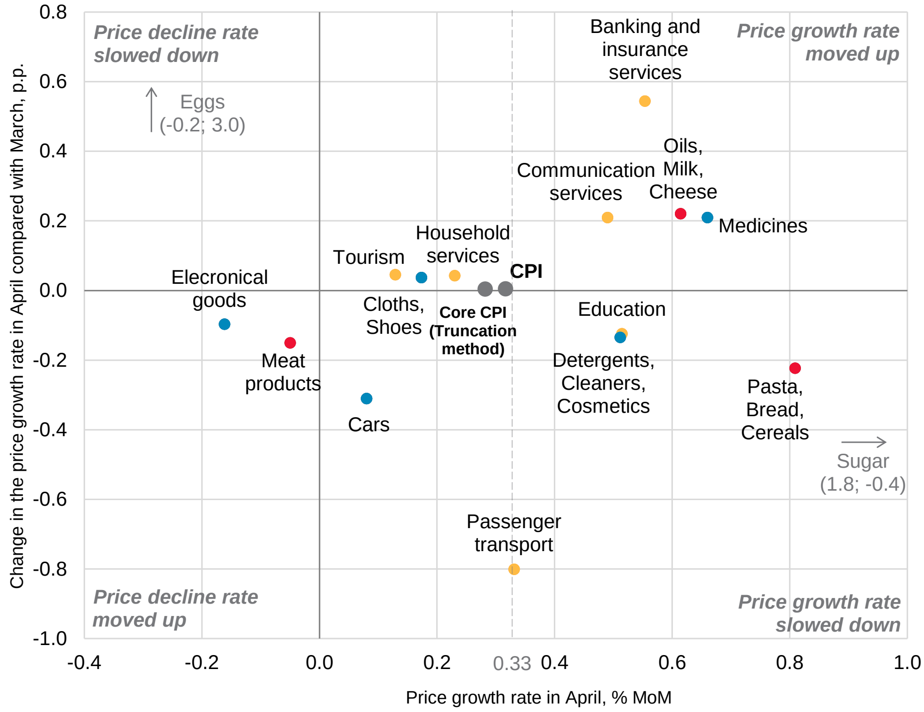
** Plus indicates Russian ruble's depreciation vs foreign currencies, minus indicates Russian ruble's appreciation vs foreign currencies.*

Services price growth in April did not exhibit any significant changes totalling 0.36% MoM: slower passenger transport price rises were offset by faster price growth in telecom, insurance and household services.

April saw a minor acceleration in seasonally adjusted food prices to 0.38% MoM (0.35% MoM in March) due to a slight price uptick in fruits and vegetables. Food price growth excluding fruits and vegetables remains lower than the 2018 H2 level for the third month running (a seasonally adjusted rate of around 0.3% MoM).

Food items continue to exhibit mixed price movements. Meat prices dropped for the first time since March 2018, which might reflect that the balance between demand and supply in the market has fully recovered (Figure 5). Price growth for pasta, bread, and cereals somewhat slowed down in April, however, it still remains at an elevated level. Lower global grain prices and high 2019 harvest forecasts drive expectations of a significant slowdown in grain-based product prices in the coming months. Decline in egg prices, generally subjected to increased volatility, slowed downed in the same period while price growth in milk, dairy products, cheese and butter accelerated.

Figure 5. SA price growth in April and change vs March, % MoM

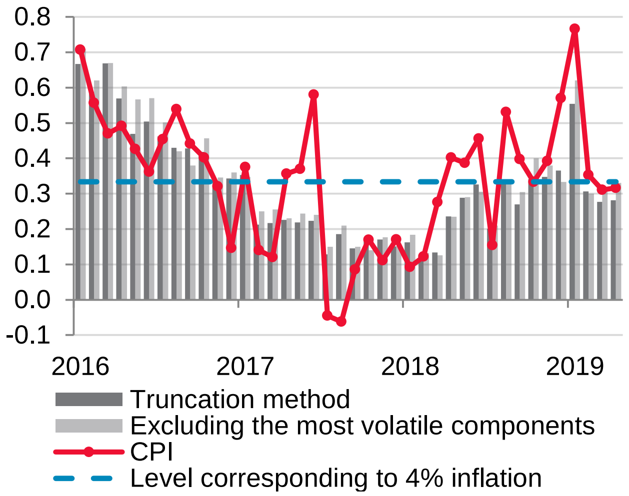


Source: Rosstat, R&F Department calculations.

Non-food growth (after seasonal adjustment) totalled 0.21% MoM in April down from 0.24% MoM in March. Deceleration is primarily due to slower car price growth of 0.08% MoM, a low since August 2017, and due to a favourable exchange rate movement as well as expectations of a weaker demand compared with the 2018 figures. Growth slowdown (or acceleration of the downward trend) is also observed in price movements for detergents and cleaning solutions, perfumes and cosmetics, household appliances, and consumer electronics (including computers and communication devices). Restrained price growth for many non-food items is a signal that the impact of the VAT hike on the CPI had worn off. Continuing slowdown in prices for goods relatively insensitive to the exchange rate is further, albeit indirect, evidence of the trend (Figure 4).

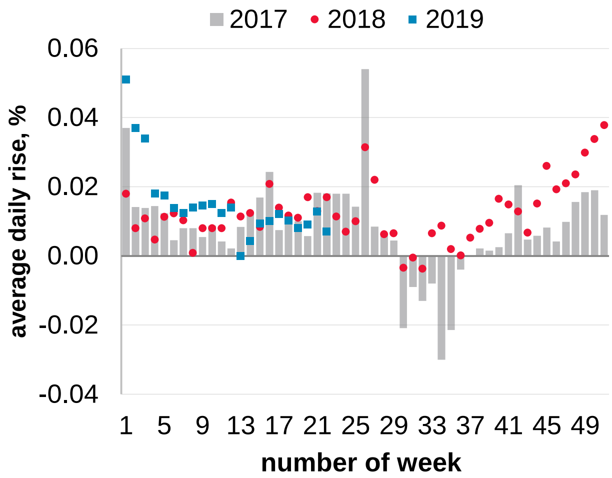
In general, inflation pressure on the consumer market stabilised. One particular piece of evidence is the movements of the modified core inflation indicators that saw little change in April versus the March figures (Figure 6). The mean of the indicators' values calculated using the truncation method and the exclusion method that filters out the CPI's most volatile components is slightly lower than 4% in annualized terms. The reason for this, however, is that fact that their dynamics does not fully offset the downward effect on prices from temporary factors that was observed in March-April.

Figure 6. Modified indicators of core inflation, % MoM



Source: Rosstat, R&F Department calculations.

Figure 7. Daily average price growth, %



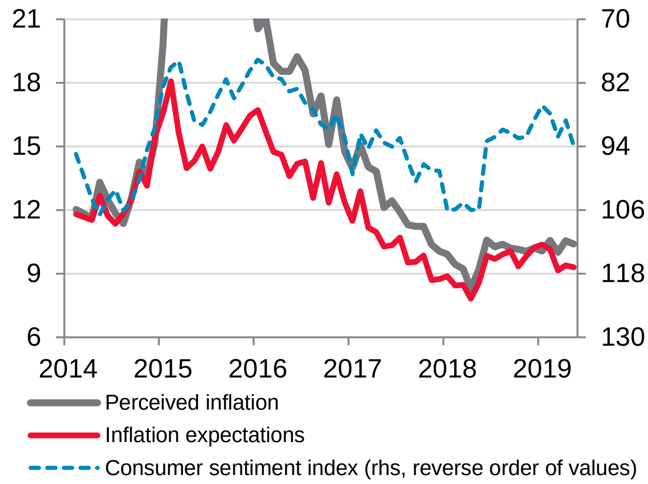
Source: Rosstat, R&F Department calculations.

In May, inflation pressure remained close to the Bank of Russia target, a finding that was supported by Rosstat data. Average daily price growth remained lower than last year's level (Figure 7).

According to our estimate based on Rosstat's weekly statistics, consumer price growth in May totalled 0.3% MoM, which is in line with the annual inflation of 5.1%. The preliminary estimate of annualized seasonally adjusted consumer price growth stands at a level close to 4%. This reflects a balance between short-term pro-inflationary and disinflationary risks. According to our estimates, inflation is set to slow down to the target level of 4% in 2020 Q1 given the current price dynamics.

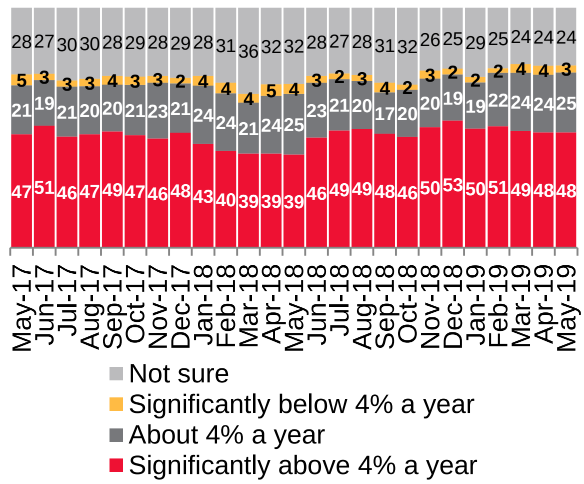
Household inflation expectations remain stable. According to a poll by OOO inFOM from 6-16 May 2019, the median estimate of the inflation rate expected in the next 12 months totalled 9.3% against 9.4% in April (Figure 8). The estimate of observed inflation declined slightly to 10.4% in May from 10.5% in April. Estimated observed inflation remains higher than expected inflation estimates, a sign of confidence by the households in inflation slowdown compared with the current level.

Figure 8. Median estimates of observed and expected inflation by households, % YoY



Source: OOO inFOM.

Figure 9. Inflation level expectations three years ahead[2]



Source: OOO inFOM.

In May, many food items as well as utility and passenger transport services were less frequently mentioned as CPI categories that had a strong growth in prices over the month. According to the weekly Rosstat data, prices dynamics for most of the fast moving consumer products remains fairly moderate, which may help to further improve household inflation expectations.

The long-term inflation expectations trend remains stable over the past three months (Figure 9). The share of respondents who say that price growth will be at a level of 4% or lower in three years' time continues to be at 28%. However, the share of respondents who say inflation will be higher than the target stands at around 48%, which is lower than the December–February figures. Importantly, in late 2018 and early 2019 growth both in long-term and short-term household inflation expectations was influenced by the VAT hike. The results of the latest polls (including responses to straightforward questions on the reasons of price growth in the previous month) indicate that the effect of the VAT hike on household inflation expectations has worn off.

1.1.2. Trend inflation: inflation pressure slightly above target level

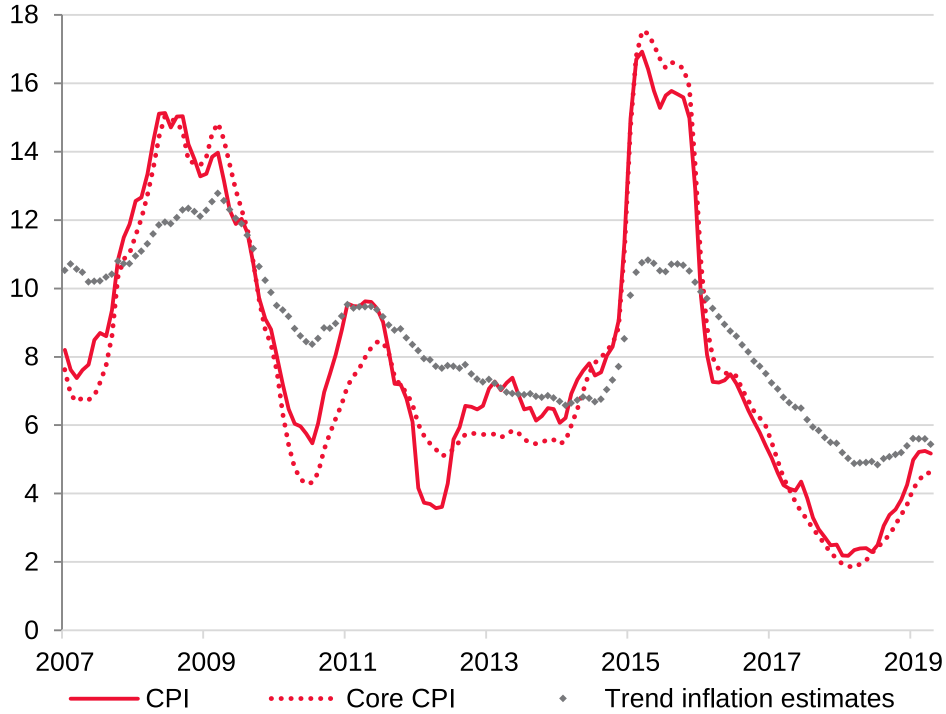
- Trend inflation in April 2019 was estimated at 5.44% vs 5.61% in March (Figure 10). The decline was largely technical in nature due to the exclusion of the heightened price growth rates in March-April 2014.
- In the coming year, trend inflation is likely to decline even further due to the same technical reasons: the five-year rolling window will shed high inflation values of late 2014

[2] Distribution of responses to the question: "Do you think prices will grow faster or slower than 4% a year in three years' time? Or will it be around 4% a year?"

and early 2015. This means the 'technical' slowdown in trend inflation cannot be unambiguously interpreted as lower inflation pressure.

- However, the trend inflation estimate calculated for a shorter, three-year period that does not include the inflation spike in late 2014 and early 2015 totalled 4.20% in April vs 4.18% in March (Figure 11). It is a signal that inflation pressure on the consumer market remains at a level that is slightly above the inflation target.

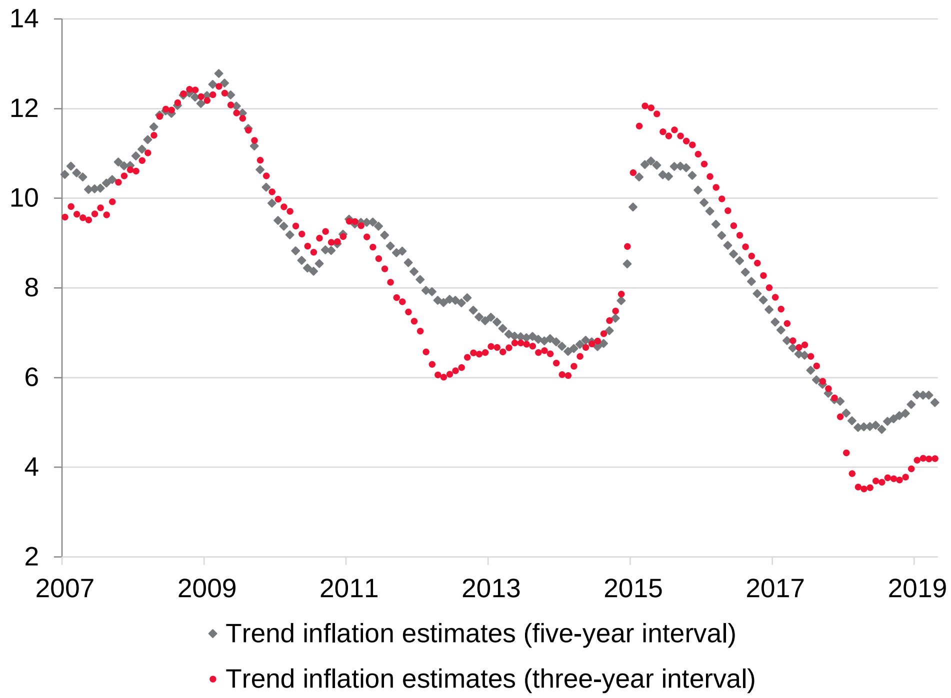
Figure 10. Change in CPI, core CPI and historical estimates of trend inflation by the Bank of Russia[3], % YoY



Source: Rosstat, R&F Department calculations.

[3] The trend inflation indicator is calculated for a rolling five-year period.

Figure 11. Trend inflation estimates calculated on the three- and five-year rolling periods, % YoY

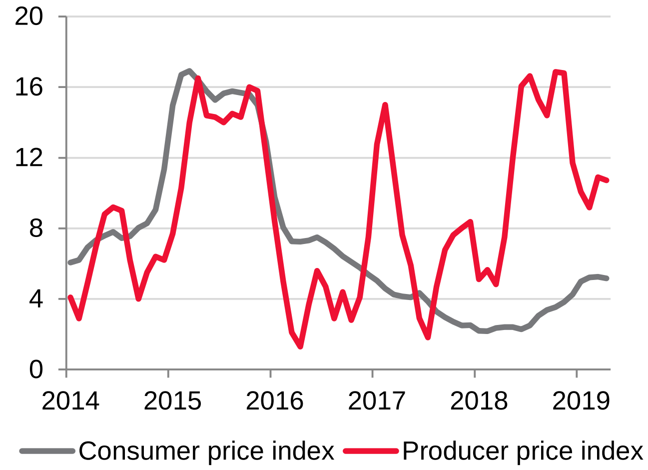


Source: Rosstat, R&F Department calculations.

1.1.3. Manufacturing dragged down producer price growth

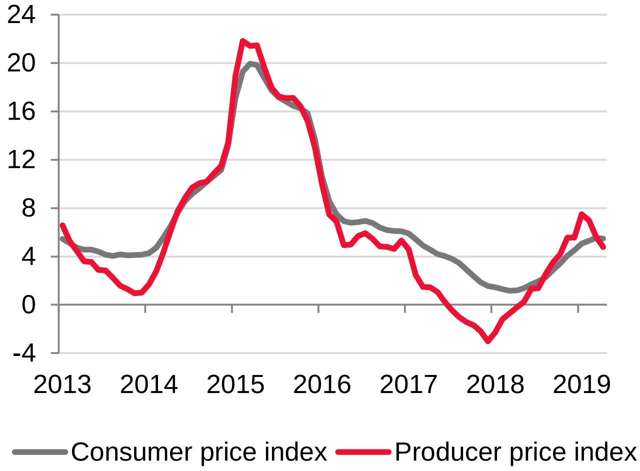
- Annual producer price growth somewhat slowed down to 10.7% in April versus 10.9% in March (Figure 12), largely reflecting manufacturing price changes (down to 6.7% in April from 7.4% in March). Mining saw continued price growth acceleration in April, however, the change proved not as drastic as in the preceding month (up to 25.2% in April from 24.4% in March and 15.0% in February).
- Producer prices for consumer market goods continued to decelerate (Figure 13). Meat processing and sugar production registered a slowdown for the third month running, reflecting a gradual easing of pressure from producer prices on the consumer market in these industries.
- Petroleum product prices accelerated growth in April following a persisted slowdown since late 2018. Petrol price in April rose 0.2% MoM, and diesel fuel prices went up 0.7% MoM. One possible reason for the increase in wholesale prices for petroleum products is a higher export parity following a hike in global oil prices.

Figure 12. Change in the producer price index and consumer price index, % YoY



Source: Rosstat.

Figure 13. Change in prices for selected goods[4], % YoY



Source: Rosstat, R&F Department calculations.

1.2. Economic performance

Russia’s economic growth stalled somewhat temporarily in the first quarter of 2019. Short-term negative factors, such as the easing of the global economy’s growth momentum, the VAT hike, a temporary cut in budget spending in real terms, and inflation acceleration are likely to maintain growth below potential in the first half of 2019. This will also be prompted by the high-base effect due to the idiosyncratic nature of construction data reporting. Nevertheless, corporate and retail lending has had a positive effect on demand. With the negative factors running their course and budget spending stepped up towards the middle of the year, economic growth is poised to accelerate unless new major external shocks emerge.

1.2.1. Temporary slowdown of GDP growth in first quarter

- According to Rosstat's preliminary estimate, GDP volume index in the first quarter totalled 0.5% YoY (down from 2.7% YoY in 2018 Q4[5]). However, Rosstat did not revise GDP growth in retrospect when producing its first quarter estimate. A more detailed picture of GDP dynamics based on the analysis of the growth rates of its end-use components will be available in early July[6].

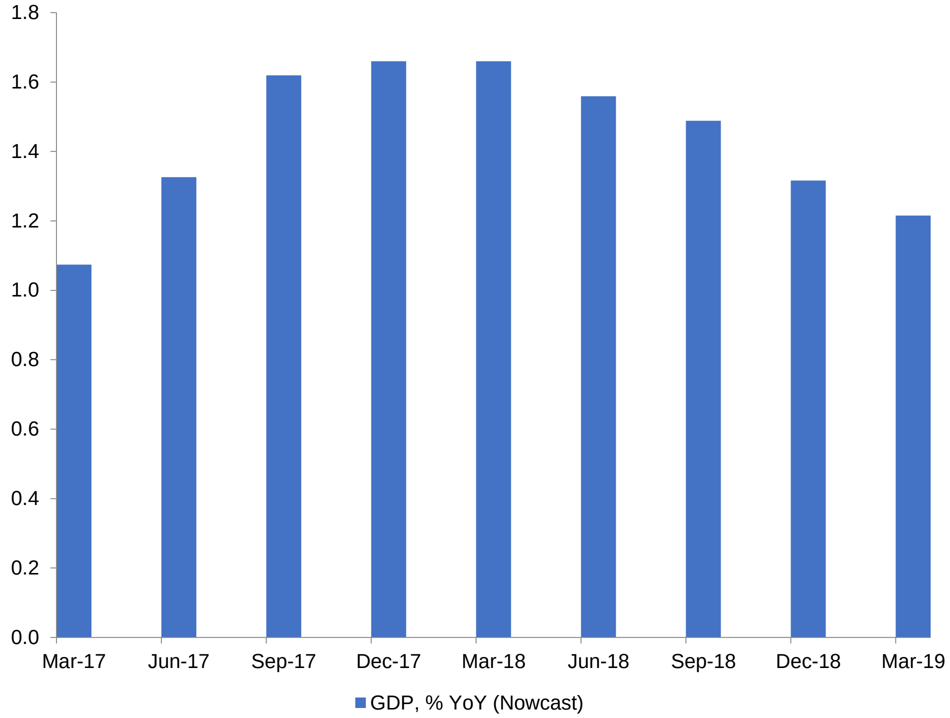
4 The calculation used comparable goods in the CPI and PPI structure: meat and fish products, butter and fats, dairy products, pasta, sugar, tea, coffee, clothes, footwear, detergents and cleaning solutions, perfumes and cosmetics, electronic household appliances, and furniture. They account for over 30% of the consumer basket.

5 According to an estimate as of 2 April 2019.

6 The first 2019 Q1 estimate of GDP by end use is planned to be released by Rosstat on 1-2 July 2019.

- A strong slowdown in GDP growth YoY may largely reflect the idiosyncratic nature of construction data reporting (the effect of the high base in 2018).
- We also tend to link the current deceleration of economic growth with the negative effect of the VAT hike and the temporary cut in expenditures of the consolidated budget in real terms due to less even distribution throughout the year (see 1.2.8. Budget balance reached ten-year high). This factor is expected to be temporary: growth will pick up as expenditures are stepped up by late 2019.
- The slowdown can also be explained by a change in demand for Russian exports (e.g. lower gas exports) and shrinking oil output due to the commitments under the OPEC+ agreement.
- It is important to note that the change in GDP estimated by the R&F Department's nowcast model (based on a broad list of high-frequency data) is characterised by moderate volatility, reflecting a smooth growth trajectory in the past two years, and the temporary slowdown to below potential in early 2019 in particular (Figure 14).

Figure 14. Change in GDP, % YoY
(an estimate based on the R&F Department's GDP Nowcast model in real terms*)



Source: Rosstat, R&F Department calculations.

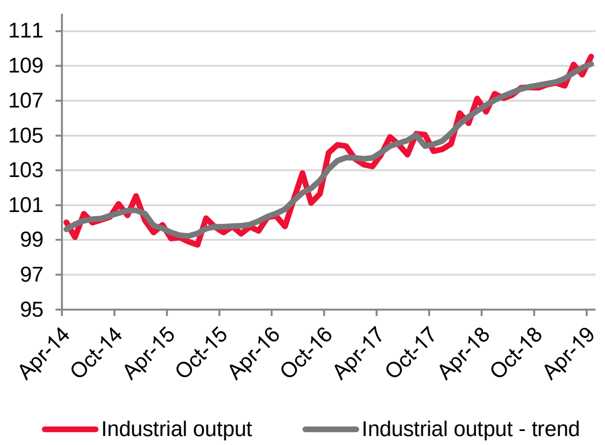
**Note. The values are given based on seasonally smoothed GDP gain estimates in quarter-to-quarter terms from the Dynamic Factor Model, produced at the end of the month following the final month of the reporting period. See Nowcasting and Short-Term Forecasting of Russian GDP with a Dynamic Factor Model. A. Porshakov, E. Deryugina, A. Ponomarenko, A. Sinyakov. The Bank of Russia, Working Paper Series, 2015, No 2.*

1.2.2. Robust growth in industrial production, but it is too early to call it stable

- Industrial production growth in April moved up to 4.6% YoY. Manufacturing continues to witness strong fluctuations.
- Despite the volatility, industry demonstrates growth in the trend component due to mining and quarrying, and manufacturing.
- The level of the daily oil output has reached the target as part of the OPEC+ agreement, oil output can be expected to be stabilised in the coming months.
- Manufacturing output expanded to 4.7% YoY on the back of growth in most industries but its stability is uncertain.

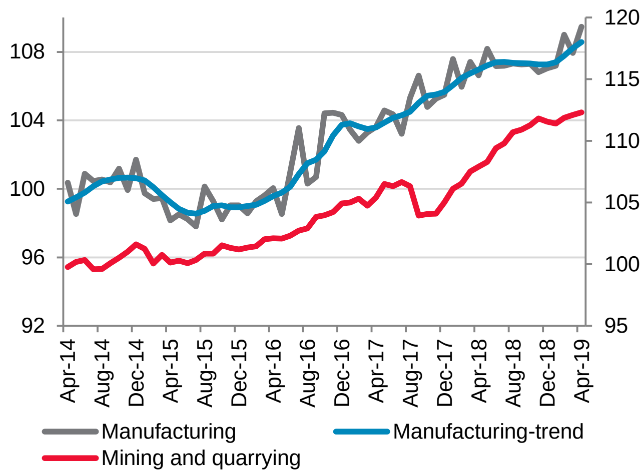
Annual growth in industrial production in April totalled 4.6% YoY. Exclusive of the calendar effect (this April had one more business day than the previous year), growth would have been 4.0% YoY. According to the Research and Forecasting Department's estimate, industrial production grew 1.0% MoM SA relative to March (Figure 15).

Figure 15. Change in industrial production index (2002 = 100)



Source: Rosstat, R&F Department calculations.

Figure 16. Change in mining and quarrying and manufacturing indexes (2002 = 100)



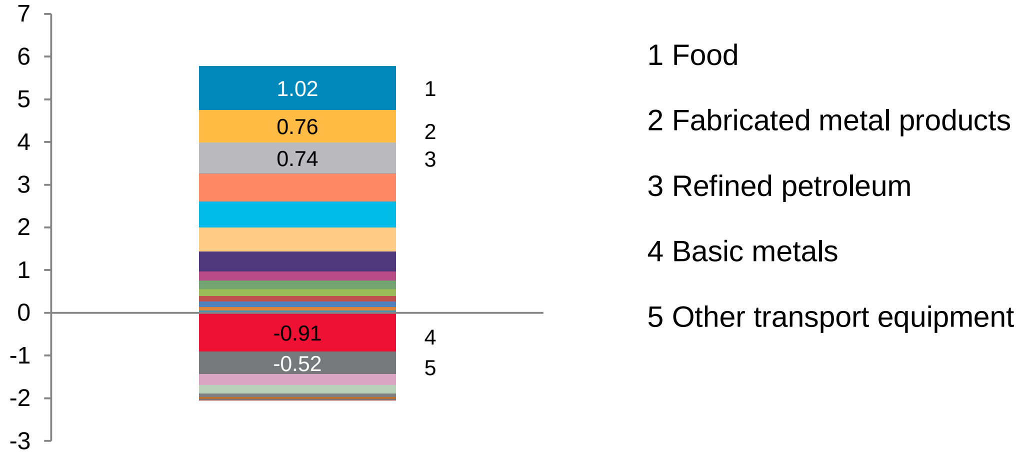
Source: Rosstat, R&F Department calculations.

Sizeable output fluctuations in industrial production largely reflect growth dynamics in manufacturing (Figure 15, Figure 16). Mining and quarrying posts steadier numbers: a marginal decline in early 2019 was followed by a positive trend. Annual growth in April totalled 4.2% YoY. The sector rose 0.2% MoM SA in April relative to March despite a drop in the daily oil output in April (-0.6%). May is likely to see a level of oil output in line with the OPEC+ agreement, and afterwards it will stabilise. It may accelerate growth in mining and quarrying since the negative pressure from the oil sector will end.

Manufacturing output demonstrates fluctuations which are sizeable even by the standards of the traditionally volatile short-term monthly data. For instance, the near zero growth in March (+0.3% YoY) was followed by a 4.7% YoY rise in manufacturing output in April

(Figure 17). Exclusive of the calendar effect, growth would have been 3.9% YoY. Our seasonally adjusted estimate shows a 1.4% MoM SA pickup in manufacturing output in April. One of the reasons for the month-to-month fluctuations is the unstable readings of the biggest industry, oil refinery, which is not typical of the sector. Oil refinery in April was up 3.9% MoM SA following a 4.2% MoM SA decline in March.

Figure 17. Contribution by selected industries to the gain in manufacturing, % YoY



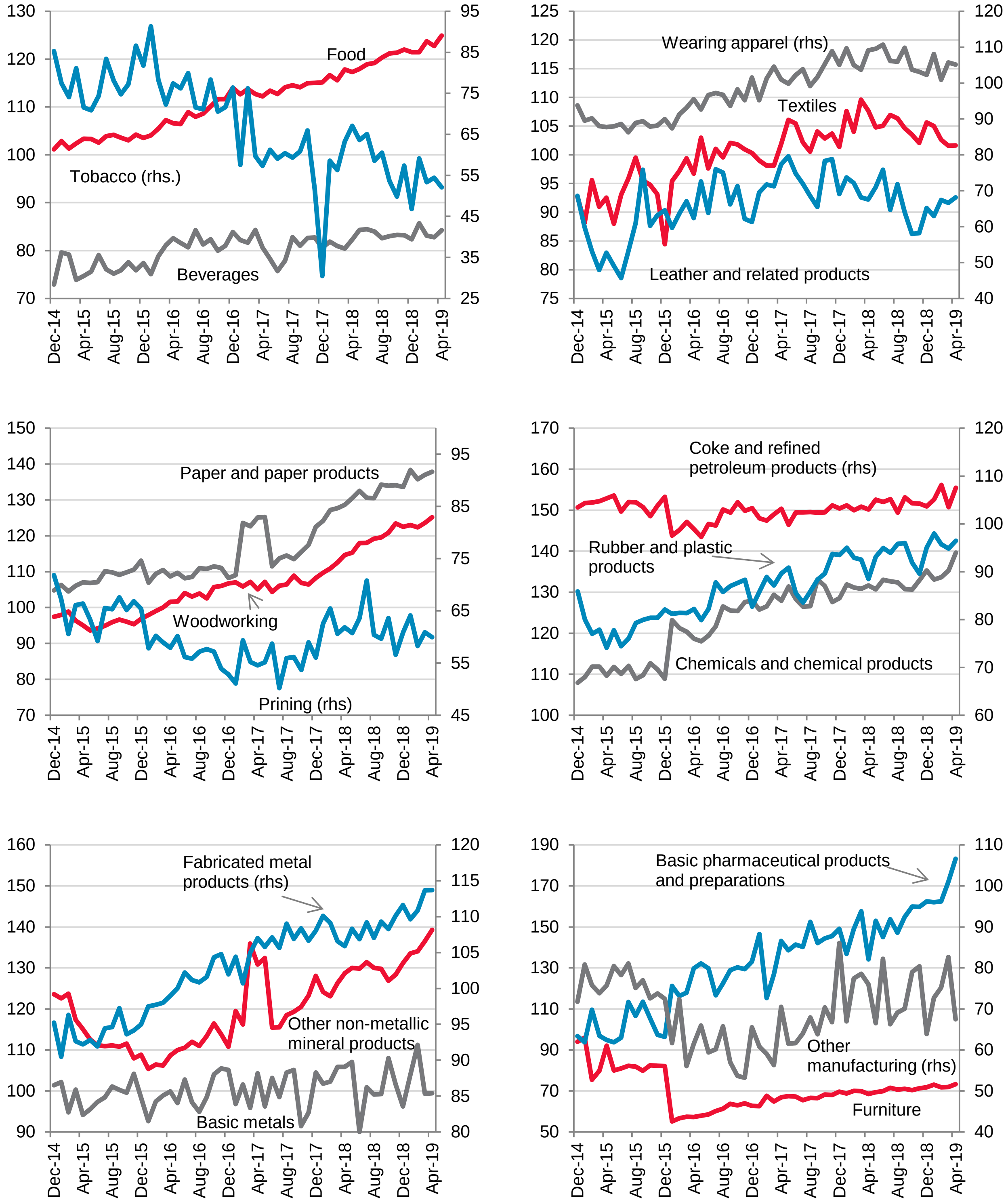
Source: Rosstat, R&F Department calculations.

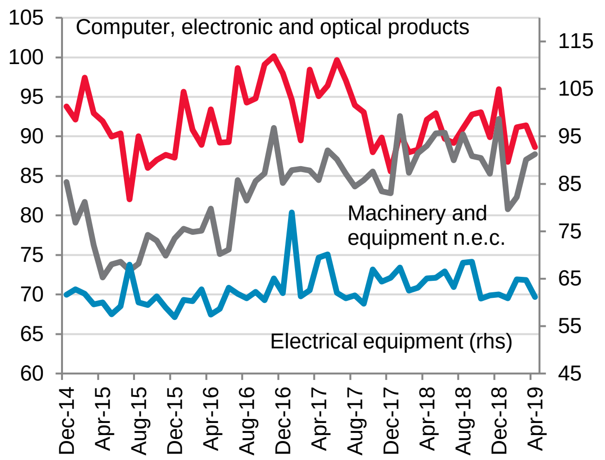
Despite the unstable month-to-month dynamics, the trend component of manufacturing is steadily accelerating after a weak second half of 2018. (Figure 16). Most of the industries posted positive results in April.

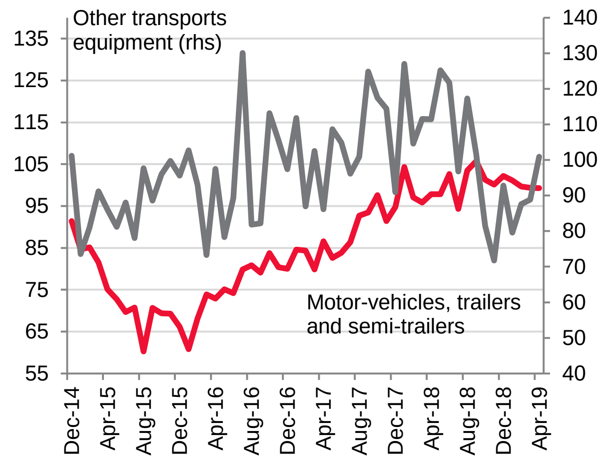
The chemical industry (+3.2% MoM SA) turned out to be one of the growth drivers in April (Figure 18). Among *consumer demand*-driven industries, the largest upward contribution in manufacturing was made by food (1.7% MoM SA) as well as pharmaceuticals (6.5% MoM SA), which continued acceleration. Durables exhibit a more subdued pattern with a negative trend in wearing apparel, tobacco, printing, and stabilisation in beverages, furniture, other manufacturing (including jewellery). Car output shrank 2.1% MoM SA, in line with lower sales numbers.

Investment demand-driven industries are seeing continued recovery in the production of other transport equipment (+13% MoM SA in April). The sector continues to weigh on the annual performance of manufacturing in general. Construction materials continued to post significant growth that started late last year (+2% MoM SA in April). Coupled with growth in fabricated metal products, it may suggest a turnaround in construction.

Figure 18. Manufacturing output (December 2012=100%),SA*







Source: Rosstat, R&F Department calculations.

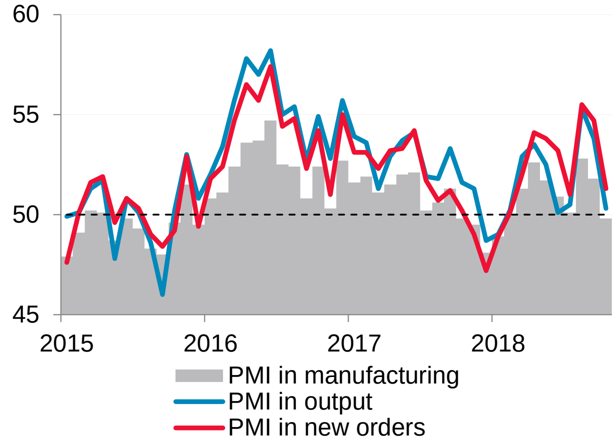
1.2.3. PMI indexes indicate slower growth in second quarter

- Growth in manufacturing slowed down in April-May but remained substantially above the level registered in some months of 2018 and early 2019. Along with a notable slowdown in domestic demand for services, it implies that the economy continued to grow at a slightly slower than potential pace at the beginning of the second quarter.
- Sectoral performance of business activity in Russia runs counter to global trends where the PMI index in manufacturing continues its downward movement indicating an almost stalled sector around the world while PMI in services is close to the 2018 average.

The April data on the PMI manufacturing index signal a more stable upward performance, remaining above the 2018 January-February level. In May, the PMI index dropped somewhat from 51.8 to 49.8 (Figure 19), however, the slowdown is only partial. Production and domestic demand in manufacturing grew slightly slower than in March-April: the Manufacturing Output Index slowed to 50.3, and the New Orders Index from 54.7 to 51.3. However, the subindexes remain substantially higher than the level for the larger part of 2018 and early 2019, suggesting an improved business environment in the last months. Output forecasts for the next 12 months remain quite high, though optimism sagged after fairly positive estimates in April (from 73.7 to 69.0). The respondents name new customers and new products as key factors behind the projected spike in production. Hopeful of stronger demand, sector-specific companies continue to build inventories of finished goods in the past two months for the first time since October.

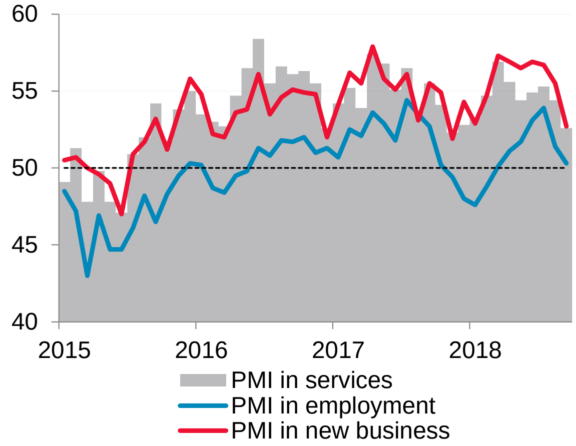
PMI in services plunged notably in April (down to 52.6 from 54.4 in March), reflecting a slower pace of new orders (down to 52.7 from 55.5) (Figure 20). The expansion of the new orders portfolio was supported by faster growth in new exports orders to a record high in the history of the subindex since 2014, subsequently, performance in domestic demand was even more subdued. According to the respondents, a higher level of uncertainty contained sales in April. Despite a more sluggish demand, the companies' optimism regarding business activity trends for the year hence reached a high since July 2011, fuelled, as the respondents say, by the launch of new products and a more active marketing policy.

Figure 19. Change in PMI manufacturing indexes, pp



Source: IHS Markit.

Figure 20. Change in PMI services indexes, pp

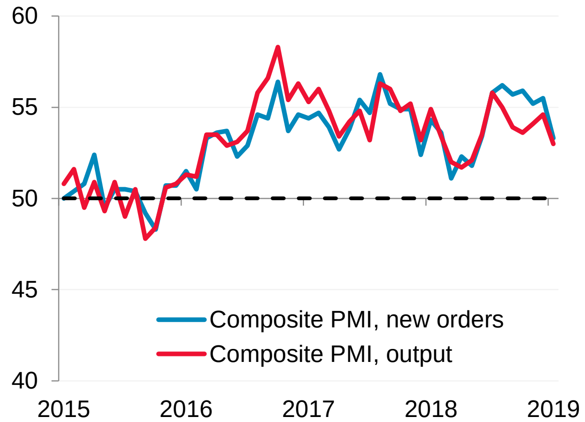


Source: IHS Markit.

Curiously, the performance of Russian PMI indexes is completely opposite to global trends. The Global Manufacturing PMI index continues to move along a downward path, indicating a stagnation in the sector. Global Services PMI is sinking, too but remains close to the 2018 average.

The composite PMI index in Russia dipped from 54.6 to 53,0 in April. (Figure 21), driven by slower expansion both in manufacturing and services. The composite new orders PMI index took a substantial dive from 55.5 to 53.3, largely due to a weaker performance in services.

Figure 21. Change in composite PMI indexes for Russia, pp



Source: IHS Markit.

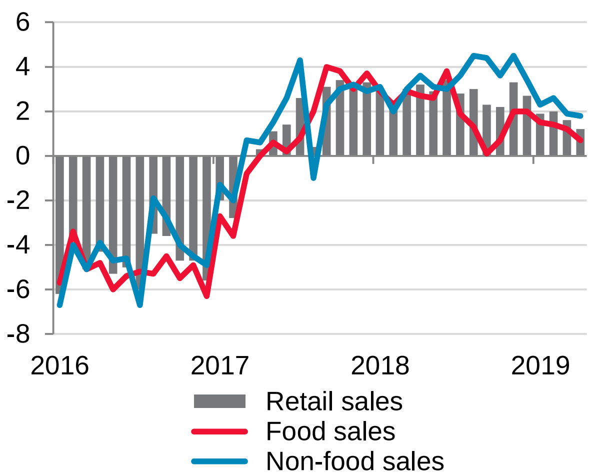
1.2.4. Retail sales lose pace

- The annual growth in retail sales gradually slowed down in April, largely dragged down by slower sales in food products. Cleared of seasonal and calendar factors, retail sales in April remained at the March level.
- The upward performance of real wages offered some support to consumer demand. However, its growth remains not too high.
- The decline in consumer spending in April revealed in a survey by the Romir Research Holding Company is in line with the weak consumer growth during that month.
- Consumer sentiment among households remained subdued.

According to Rosstat, retail sales growth in April slowed down to 1.2% YoY from 1.6% YoY in March, mainly reflecting more sluggish sales in food products (Figure 22). In annualized terms, the pace continued to slow down for the fourth month running, dropping to 0.7% YoY in April from 1.2% YoY in March. Deceleration in non-food sales proved less pronounced, reaching a level close to the previous month’s numbers. The latter may be due to a cut in car sales.

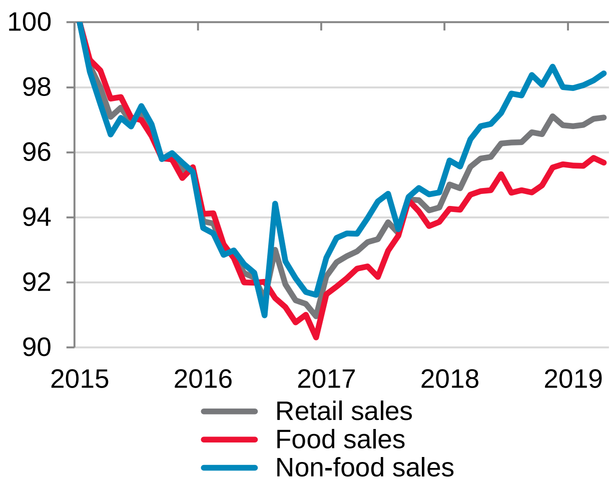
Cleared of the seasonal and calendar factors, retail sales posted zero growth in April relative to March (Figure 23). Though the monthly seasonally adjusted performance in food and non-food in April was around zero, the two categories moved in opposite directions, with -0.1% MoM and +0.2% MoM, respectively. April saw a minor acceleration in fruits and vegetables prices, which to a certain extent could have weighed on retail sales in food.

Figure 22. Change in retail sales of food and non-food goods and retail sales turnover, % YoY



Source: Rosstat.

Figure 23. Change in retail sales turnover, % (January 2015 = 100%, SA)

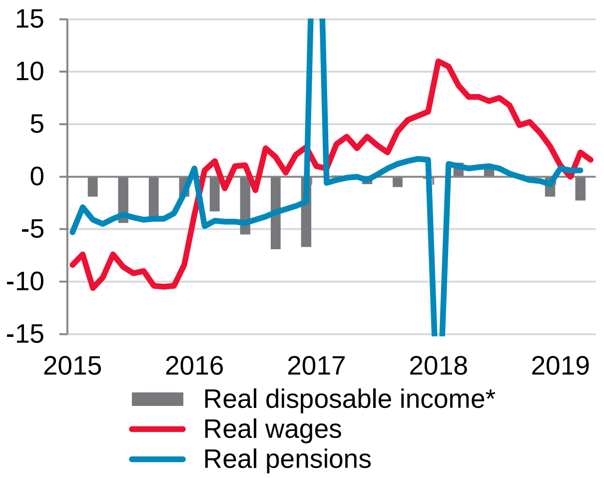


Source: Rosstat, R&F Department calculations.

Real wages continued to grow at a fairly moderate rate but slightly improved after Rosstat posted revised March figures. April saw a rise of 1.6% YoY compared with 2.3% YoY in March

(Figure 24). Importantly, ruble and FX deposits increased in April, which helped real wages outpace consumption.

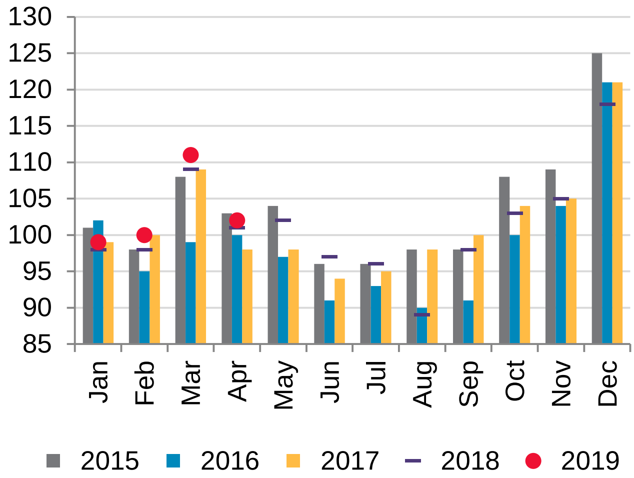
Figure 24. Change in real household income, % YoY



Source: Rosstat, R&F Department calculations.

** Calculation based on the new methodology taking into account the one-off payment in January 2017. The data for 2017, 2018 and 2019 Q1 have been re-calculated so far.*

Figure 25. Change in real daily household spending, % (2012 median value = 100%)



Source: Romir.

The data by the Research Holding Company Romir[7] on the change in real everyday household expenditure are in line with weak consumption growth in April (Figure 25). The survey indicates a traditional cut in daily household expenditure compared with March figures. Notably, this April's reading was close to the 2018 level.

1.2.5. Car demand proved lower than expected

- After seasonal adjustment, demand for new cars dropped (-3.1% MoM SA), below the corresponding period in 2018 (-2.7% YoY).
- According to the estimates of the car data intelligence agency Avtostat and the National Credit History Bureau, demand for cars in the first quarter was supported by a higher number of car loans, whose share in the total market volume reached a new high with almost 60%, partially reflecting the launch of new support measures. However, they are unlikely to have a lasting impact on demand throughout the year.
- Car output in April declined 1.4% MoM SA, with the overall slowdown of the upward trend in car manufacturing continuing.

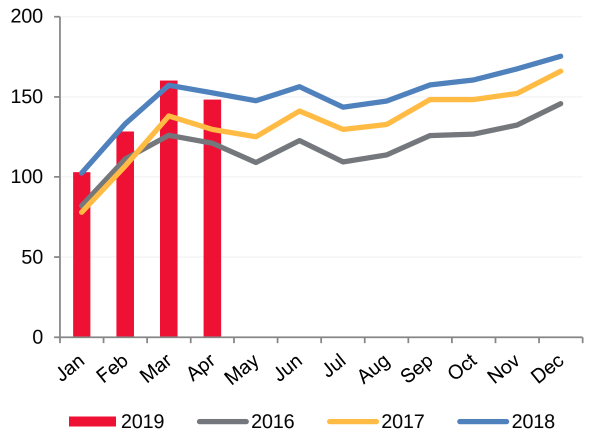
[7] Romir Research Holding Company. "Expenditure declined in April". 13.05.2019.

- The data on consumer prices for new cars in April displayed a certain deceleration, but still remain notably higher than the consumer inflation level.

According to the data by the Association of European Businesses (AEB), the sales of new cars and light commercial vehicles in April 2019 posted negative results for the second time this year: the market dropped 2.7% against last year's figures (Figure 26). The first four months in 2019 saw a decline of 1% YoY, which does not give us enough reason to expect positive yearly results as analysts predicted.

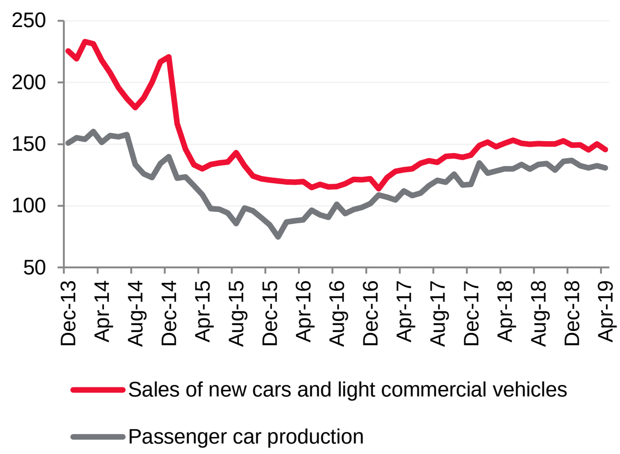
In monthly terms, sales went back to the February 2019 level, shrinking 3.1% MoM without the seasonal effect (Figure 27). The uncertainty related to the seasonal adjustment of car sales figures prompts a cautious interpretation of the estimates. In general, the trend component indicates stabilisation or a very slow decrease in demand. In early 2019, demand was increasingly bolstered by car loans. According to the data by Avtostat and the National Credit History Bureau, the number of cars purchases on loan in 2019 Q1 rose 13.7% YoY to 191,300 units, reaching the 2014 Q1 level (194,100 units). The share of cars purchases with auto loans moved up to almost 60%, partially fuelled by government soft lending programmes launched since March 1 ('First car' and 'Family car').

Figure 26. Sales of new passenger and light commercial vehicles, thousand units



Source: AEB, R&F Department calculations.

Figure 27. Sales and production of passenger cars, seasonally adjusted, thousand units



Source: AEB, R&F Department calculations, Rosstat.

However, government programmes to buttress demand have not provided tangible support to sales. In particular, market participants expressed concerns about their narrow focus and cuts to the financing envelope. In its turn, the Ministry of Industry and Trade is planning to earmark additional funds (656.8 million rubles on top of 7.9 billion rubles that have been allocated earlier) for preferential auto loan programmes and auto leasing, however, there are no plans to scale up the programmes to other segments. 2018 state budget programme-related expenditure totalled 15.6 billion rubles. The programmes accounted for about 7.4% of the total sales. Nevertheless, direct impact on car sales from the demand-supporting government programmes is hard to assess since many buyers who relied on government programmes would have purchased a car anyway, they would have just spent slightly more of their own money or chosen a cheaper car.

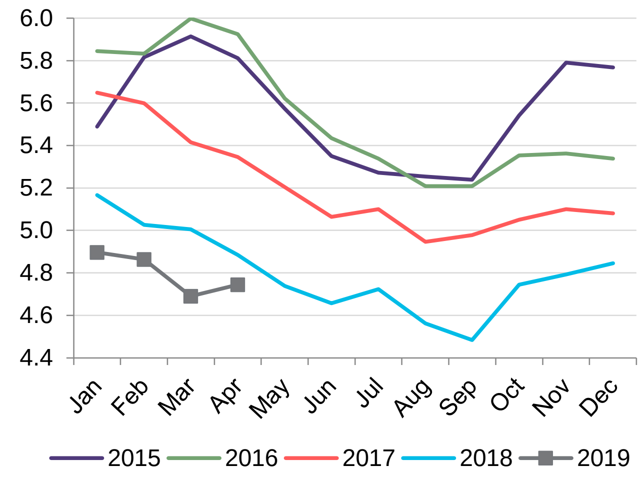
Performance in production, like in sales, somewhat weakened in April: output dropped 1.4% MoM SA relative to March (Figure 27), cleared of the seasonal effect. 2019 Q1 production increase 3.6% YoY. In general, we are seeing a positive trend in the industry with minor fluctuations since early 2016.

1.2.6. Unemployment remains close to historical lows

- Unemployment in April stood at 4.7% and despite an expected slight decrease in line with traditional seasonality, did not display any notable change compared with March (Figure 28). Correspondingly, cleared of the seasonal component, unemployment rose to 4.6% in April from 4.5% in March (Figure 29).
- Unemployment growth, so untypical of April, may be due to staff downsizing in some industries, as the Russian Labour Ministry warned in early 2019. According to the ministry's estimate, 115,7 thousand car manufacturing, transportation, and banking workers may have been redundant in the spring. Cuts in the industries may be related to a halt in production due to the market oversaturation, shipping operators' issues, lower number of operational lending institutions[8] and the development of remote technology.
- Nevertheless, unemployment in general remains close to historical minimum levels, its drop largely reflects the demographic situation amid a lower labour force participation rate.
- Slower growth in demand for labour was confirmed by the unofficial data, too. For example, according to the data by the recruiting agency HeadHunter, annual growth in new vacancies started to slow down since late 2018, falling down to 7.0% YoY in April (including due to the base effect). On the contrary, growth in posts with CVs accelerated in April to 14.0% YoY (Figure 30). *On the one hand*, it indicates a certain slowing in the growth of demand for labour on the part of employers, and *on the other*, fuelled by negative demographic trends, it implies stabilisation of demand and supply in the labour market.
- Real wages growth in March saw an upward revision from 0.0% to 2.3% YoY. Acceleration in real wages took place both in the private and the public sector[9]. According to a preliminary estimate, real wages in April grew 1.6% YoY, nominal wages were up 6.9% YoY.

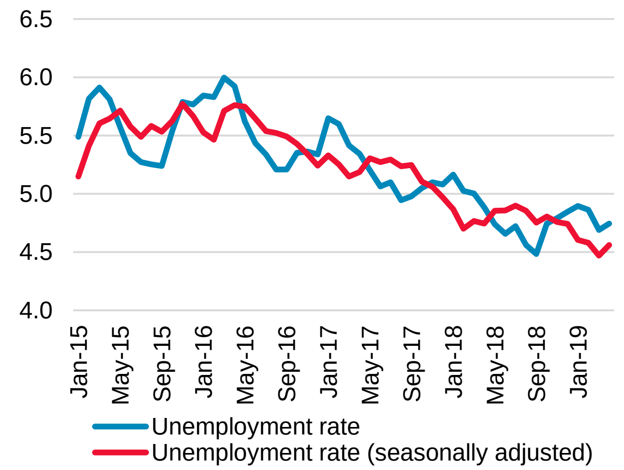
[8] https://iz.ru/850734/anna-ivushkina/mashina-sokrashchenii-komu-vesnoi-grozit-uvolnenie
[9] https://www.kommersant.ru/doc/3982103

Figure 28. Unemployment rate in 2015-2019, %



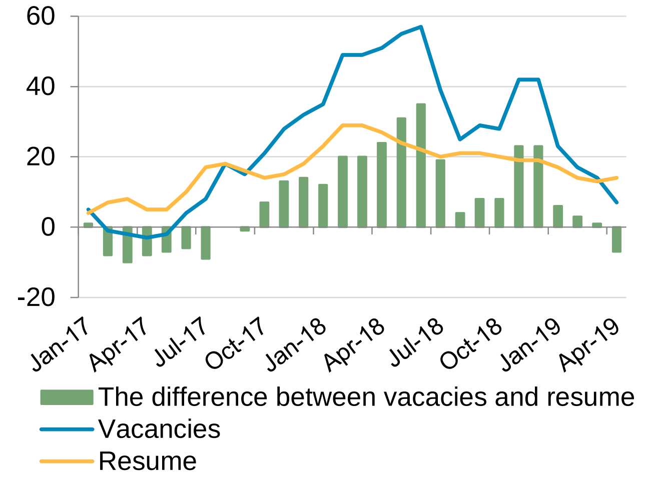
Source: Rosstat.

Figure 29. Unemployment rate (according to Rosstat with seasonal adjustment by the R&F Department), %



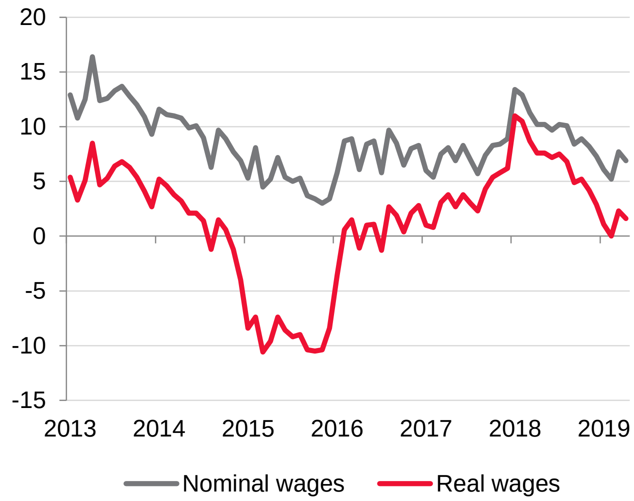
Source: Rosstat, R&F Department calculations.

Figure 30. New vacancies and CVs growth, % YoY



Source: HH.ru.

Figure 31. Change in nominal and real wages, %



Source: Rosstat.

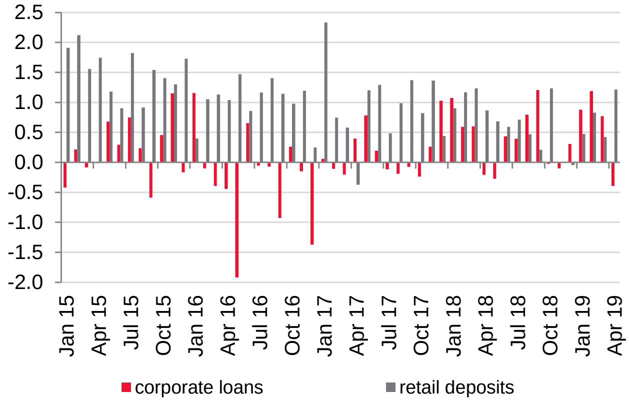
1.2.7. Retail lending continues fast growth

- In April, growth in ruble-denominated loans to non-financial institutions slowed down while growth in foreign currency loans shrank. However, in 2018 H2 – 2019 Q1, the pace of growth in the ruble loan portfolio, remained relatively high.
- The credit registry data indicate a smaller share of the US dollar in foreign currency loans in 2019 Q1.

- Retail lending in April sustained a high growth pace with some acceleration relative to March thanks to unsecured consumer loans and auto loans.
- In April, the size of delinquency went down and the level of provisions without regard for the correction saw a halt in growth. Nevertheless, the profits in April were lower than the April 2018 and April 2017 figures.

Data on the credit portfolio in April indicate slower growth in ruble loans to non-financial institutions that dropped to 0.5% MoM after being cleared of seasonal factors. However, in 2018 H2 – 2019 Q1, growth in the ruble portfolio remained relatively high, close to the estimated optimal lending growth rates (see the box ‘The role of corporate lending in developing financial markets and stimulating economic growth in Russia’). Continuing decline in foreign currency corporate loans drove a 0.4% MoM decrease in the total portfolio of corporate loans after seasonal adjustment and currency re-evaluation (Figure 32).

Figure 32. Change in corporate loans and household deposits, % MoM (cleared of seasonality)



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

Figure 33. New foreign currency loans to residents in ruble terms, million rubles (cleared of foreign currency re-evaluation gain)

	1Q 2018	1Q 2019	growth rates, % y-o-y
US dollar	424 939	286 296	-32.6
Euro	171 217	186 549	9.0
Japanese yen	830	955	15.1
Renminbi	9	234	2 500.0
Others	31 862	33 154	4.1
Total	628 857	507 188	-19.3

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

According to 2019 Q1 preliminary data from the credit registry, the share of the US dollar in the foreign currency component of the portfolio is shrinking due to higher lending volumes in other currencies (Figure 33). However, foreign currency loans are contracting (including the effect from re-evaluation). In particular, the decline in new foreign currency loans is most notable in ‘real estate transactions’ (contribution of -19.4 pp to growth in 2019 Q1), ‘metals production’ (-7.7 pp), and ‘wholesale trade’ (-4.7 pp). Robust growth in new foreign currency loans in 2019 Q1 was observed in ‘car manufacturing’, ‘other fabricated goods’, ‘petroleum coke and petroleum products’, and ‘financial services’.

The role of corporate lending in developing financial markets and stimulating economic growth in Russia

The perspective of the Russian business community on loan availability

Statistical data from regular enterprise surveys indicate the importance of lending terms for business growth. However, none of the surveys[10] lists loan-related costs as top negative factors, while such factors as sluggish demand, economic uncertainty and excessive taxation are more important for business growth. Furthermore, some indicators (average minimum rate of a new loan and loan availability) indicate that the situation with loan availability has been normalised.

Lending as a source of sustainable economic growth

Promoting corporate lending is supposed to stimulate investment activity, efficient distribution of production factors and improvements in risk management. However, this practice must be fully complemented with an awareness of the appropriate financial market deepening that would facilitate strong and sustainable economic growth and support macroeconomic stability. According to a study by the Centre for Macroeconomic Analysis and Short-Term Forecasting,[11] The Central Bank's optimal utility from the efforts to stimulate private sector lending corresponds to the loan-to-GDP ratio at the level of 73%[12] in 2035. That said, the projected effect of boosting banking loans to that level is +0.2 pp of the annual GDP gain. According to the estimates of the Research and Forecasting Department, such a level of banking lending on the horizon specified can be achieved with a 8-11% annual nominal growth in corporate lending.

The estimated range presented above may be interpreted as a certain ceiling benchmark for corporate lending growth, which, *on the one hand,* will facilitate further development and deepening of the financial market and stimulate sustainable economic growth in line with potential, and, *on the other hand,* will not pose overheating risks. The experience of a number of Asian countries (in particular, South Korea, Indonesia, Thailand, Malaysia) can teach a lesson that a pronounced lending boom can speed up economic growth on the short-term horizon and build up imbalances in the longer-run that will exacerbate negative consequences of crises provoked by external shocks.

[10] According to Rosstat's Index of business confidence only 25% of manufacturing enterprises and 15% of the mining and quarrying enterprises indicated that high commercial lending rates are a barrier to output growth. According to business surveys of the industry by the Gaidar Institute for Economic Policy, in 2019 Q2 the share of enterprises satisfied with the borrowing terms totalled 64%. The average minimum rate for ruble loans stabilised at 11.6%. The reading has remained around historical lows since mid-2018, reflecting a sustainable improvement in credit availability for the economy. The annual report to the Russian president also indicates that credit availability is not part of Top 3 factors that restrict companies' operations.

[11] Solntsev et al. Identification of Financial Sector Optimal Depth and Structure from the Perspective of Economic Growth, Macroeconomic and Financial Stability / *Series of reports on economic research by the Bank of Russia, No. 31*.

[12] The estimate is in line with the conclusions of a study by Easterly (2000) that claims that once the borrowings from the banks reach the level of 80–100% of GDP, any further deepening in the lending market no longer facilitates long-term economic growth and leads to a slowdown and higher volatility of economic growth.

At the same time, in an economy enjoying sustainable growth and developed financial market, lending accounts for a moderate share in investment financing. There may be exceptions with the periods of building up of imbalances and risks that would eventually result in a financial crisis, and a prolonged period of stagnation and cooling in investment activity. An artificial acceleration in corporate lending in the absence of demand will not facilitate a faster pace of investment.

International practice indicates that even countries with developed financial markets/institutions see that it is the companies' own funds that are the main source of investments. In the cases of the Czech Republic and Poland, which are comparable with Russia by the banks' role in the economy, the level of economic development and policies to promoting investment financing, the bulk of investments comes from the companies' own funds: 70%[13] in Poland, 66% in the Czech Republic, while the EU average is 62%. In 2018, own funds accounted for 54.3% of investments in Russia while the share of borrowings from banks was 10.8%.

Household lending continued to grow at a high pace in the banking sector statistics, indicating a marginal portfolio expansion in April. Changes in the principal on MBS also imply marginal growth acceleration in the household portfolio (Figure 34). A detailed household portfolio breakdown reveals it was driven by a faster rate of unsecured consumer loans and auto loans growth. According to our estimates, acceleration in unsecured consumer lending in monthly terms took place in March and April 2019. Nevertheless, in general the regulator does not see any risks to financial stability and is taking measures to prevent these risks from materializing going forward. However, it is essential to highlight possible social risks due to a high debt level of less wealthy citizens. Since 1 April 2019, the Bank of Russia increased risk coefficients for consumer loans. Also, starting from 1 October 2019, it would be compulsory for banks to calculate the debt burden ration of an individual with regard to the his liabilities.

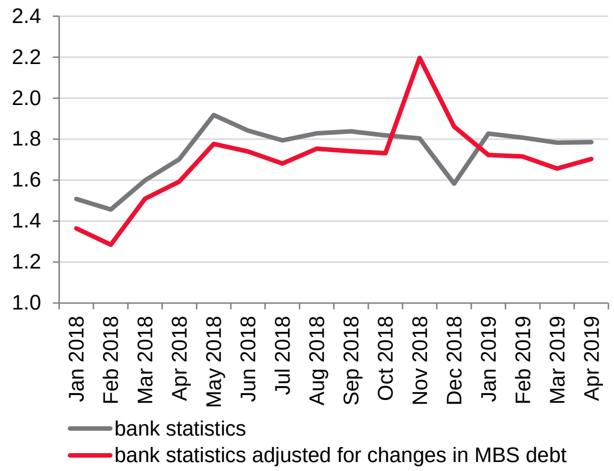
Auto loans saw an upturn, too. National Credit History Bureau reporting a record high number of newly issued auto loans throughout the observation period (since early 2014) and linking the growth to a resumption in the government auto loan support programmes. According to the National Credit History Bureau, the share of cars purchased on auto loans reached 60% of the car market. On our part, we can only see a shift in demand since January-February as being related to the acceleration in the segment. However, the size of government support was lower than last year's figures, which may curtail lending growth in the segment going forward.

Household deposits in April rebounded to the January-February levels (around 1.1% MoM) due to both ruble and foreign currency components. An inflow of foreign currency into the banking sector takes place through a current account surplus, which, according to preliminary estimates, totalled $10.9 billion in April. The latter implies an increase in net foreign assets in the economy and takes place amid a corresponding gain in liabilities,some of which will stay in the banking sector.

[13] Data as of 2017, EIB Investment survey.

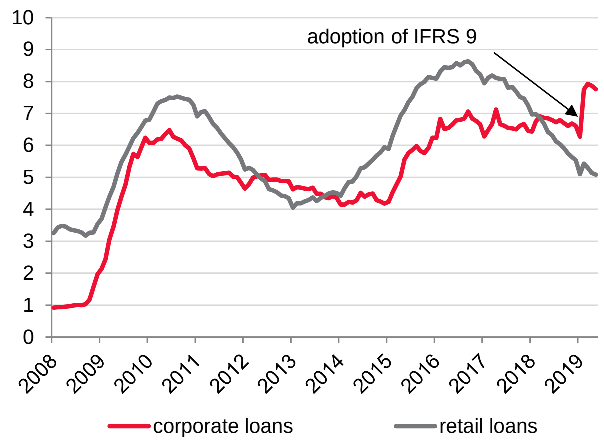
The size of delinquency in household and corporate lending in April shrank marginally, for a second month in a row (Figure 35). However, in April it halted the growth in loan loss provisions without any adjustment being taken into account. If the trend persists, the mechanism to generate income from provisions may be modified in 2019 Q2. As a reminder, banks had to add provisions generally across their loan book in 2019 Q1 while higher profit was driven by sizeable downward adjustments. Importantly, in April, the banking sector posted lower profits (163 billion rubles) than the 2018 April and 2017 April levels.

Figure 34. Ruble household lending growth, % MoM (cleared of seasonality)



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

Figure 35. Share of bad debts in portfolio, %



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

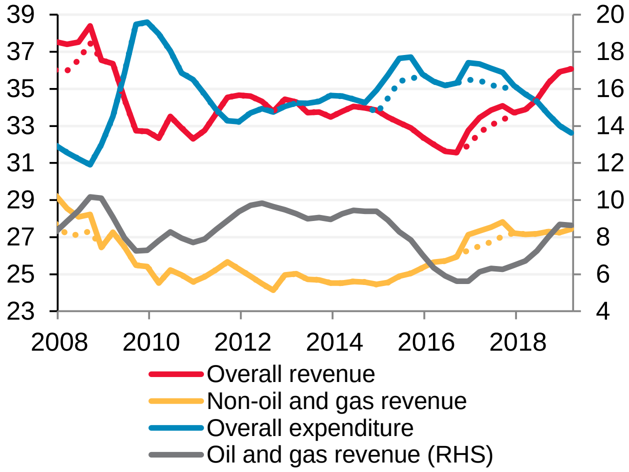
1.2.8. Budget balance reached ten-year high

- General government revenue and expenditure in 2018 underwent an upward adjustment of 0.4 pp of GDP without any change in the size of the balance (2.9% of GDP) as a result of traditional revaluation related to social security.
- Revenue in 2019 Q1 climbed 0.7 pp of GDP, including non-oil and gas revenue rise of 0.9 pp thanks to continuing robust growth in VAT and profit tax receipts. Receipts from the oil and gas sector inched down 0.1 pp of GDP due to a partial shift of the oil industry to the use of the tax on additional income.
- Expenditure in 2019 Q1 shrank 1.5 pp of GDP, including non-interest expenditure by 1.2 pp dragged by a worse distribution of spending throughout the year.
- A surplus of 5.5% of GDP in 2019 Q1 led to the contraction of public debt to 13.3% GDP, an increase in the potential size of the National Wealth Fund (NWF) of 0.4 pp of GDP and a strong growth of balances on accounts with the Russian Federal Treasury and commercial banks, but had a restraining effect on GDP growth of 0.5-1.0 pp (see Subsection 1.2.1. Temporary slowdown of GDP growth in first quarter).

- Under the baseline scenario, budget expenditure reached its lows relative to GDP while revenue, total and non-oil and gas primary balance displayed their highs. Public debt will grow at a moderate rate but the NWF will outpace it, leading to a lower net debt. The contractionary fiscal impact on GDP growth will be replaced with an expansionary effect.

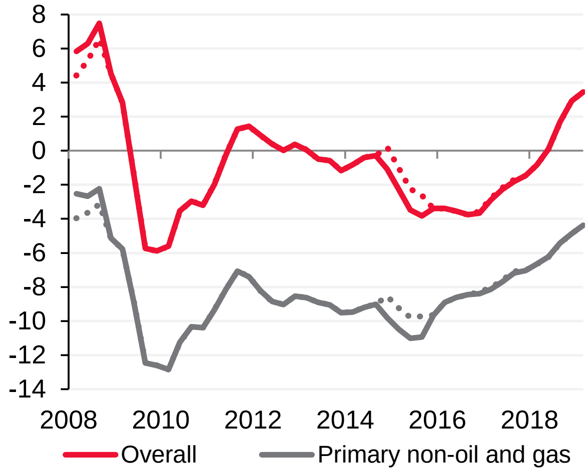
2018 Data Adjustment. In line with our expectations, May saw an upward revision of 2018 budget revenue and expenditure by 0.4 pp of GDP without any change in the size of the balance (2.9% of GDP) (Figure 36, Figure 37).[14] The adjustment was driven by the full account of direct social insurance contributions by employers since its data are produced several months after the end of the year.

Figure 36. General government key indicators (% of GDP, rolling four-quarter measure)



Source: Russian Treasury, RF Finance Ministry, Rosstat, R&F Department estimates.

Figure 37. Budget balance sheet (% of GDP, rolling four-quarter measure)



Source: Russian Treasury, RF Finance Ministry, Rosstat, R&F Department estimates.

** Dashed lines denote estimates excluding major one-off factors: revenues for YUKOS debt repayment in 2007, banks' recapitalization in 4Q 2014, expenditure for early repayment of defense sector loans and Rosneft privatization in 4Q 2016.*

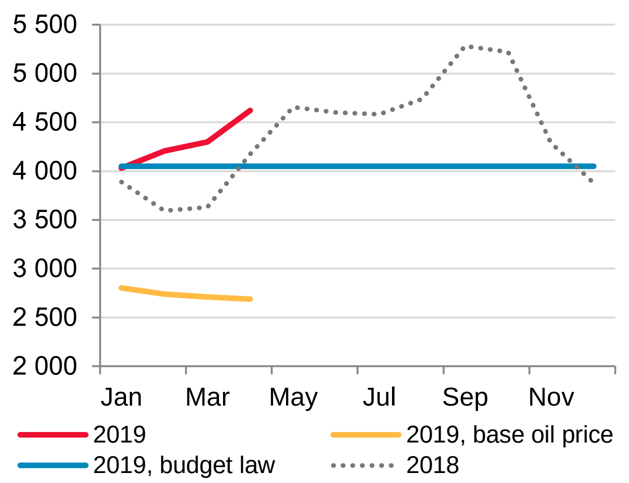
2019 Q1. Revenue. General government revenue in 2019 Q1 climbed 0.7 pp of GDP YoY.[15] The gain was provided by non-oil and gas revenue (+0.9 pp of GDP) by roughly equivalent receipts from the domestic production tax (+0.5 pp of GDP) and import-related taxes (+0.4 pp of GDP). Broken down by the type of taxes, VAT receipts feature prominently (+0.3 pp of GDP) and profit tax (+0.2 pp of GDP). We believe that an improved tax collection rate continues to have a positive impact on budget revenue. If we take into account the fact that the VAT is paid within the quarter following the reporting one, an increase of the base VAT rate by 2 pp so far has had a weak impact on budget receipts and will be more pronounced starting from the second quarter.

[14] See Subsection 1.2.7. 'General government surplus hits a 10-year high', March 2019 Talking Trends bulletin, No. 30.

[15] Hereafter we rely on Russia's Finance Ministry's estimates of 2018 Q1 nominal GDP.

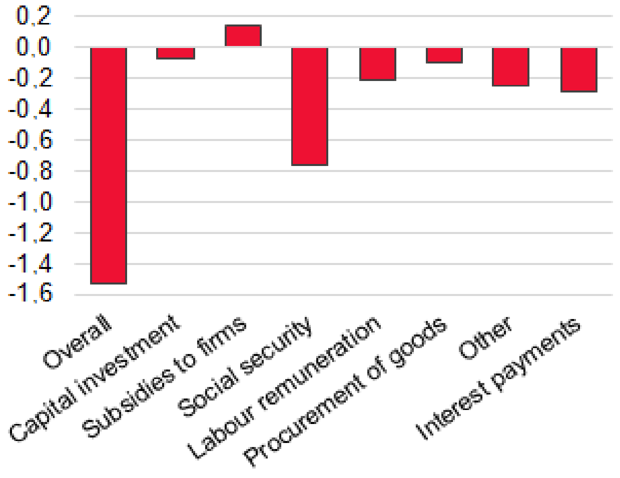
Oil and gas revenue went down 0.1 pp of GDP YoY, reflecting a partial shift of the oil industry to the tax on additional income that is paid on a quarterly basis (the first receipts were transferred to the budget in April). The indicators that have an impact on oil and gas revenue have otherwise demonstrated an average growth on par with GDP: the Russian ruble's 14% YoY depreciation vs the US dollar offset the 3% YoY drop in the dollar price of oil (Figure 38) and the rates of oil and gas output and exports that were below GDP growth (taking into account the tax manoeuvre in the oil industry launched since early 2019).

Figure 38. Monthly ruble price of the barrel of Urals oil in 2018-2019



Source: Bank of Russia, RF Finance Ministry, R&F Department estimates.

Figure 39. Change in general government expenditure under economic classification in 2019 Q1, pp of GDP YoY



Source: Russian Treasury, RF Finance Ministry, Rosstat, R&F Department estimates.

Expenditure. Non-interest budget expenditure in 2019 Q1 relative to the corresponding period in 2018 rose 0.3 trillion rubles, or 4.6%. In real terms, adjusted for the GDP deflator, it dropped 2.4% YoY[16], largely driven by the deflator being higher than the producer price index due to a significant oil price gain in ruble terms (Figure 38).

Total expenditure relative to GDP in 2019 Q1 were down 1.5 pp YoY. Payments on public debt servicing dropped 0.3 pp of GDP in the national and foreign currency in the identical measure. Lower non-interest expenditure (1.2 pp of GDP) was observed across most of the sections both of the functional and economic classifications (Figure 39) and, among other factors, was driven by a worsening in the distribution of funds throughout the year relative to 2018. Expenditure is not yet supported by the national projects as part of the non-oil and gas tax manoeuvre: key spending on its implementation is expected in the second half of the year.

Budget balance. Higher revenue and lower expenditure produced a surplus of 5.5% of GDP in 2019 Q1, which is 2.3 pp higher than in 2018 Q1 and is at maximum since 2011. The four quarters' rolling indicators of total and primary non-oil and gas balance relative GDP are

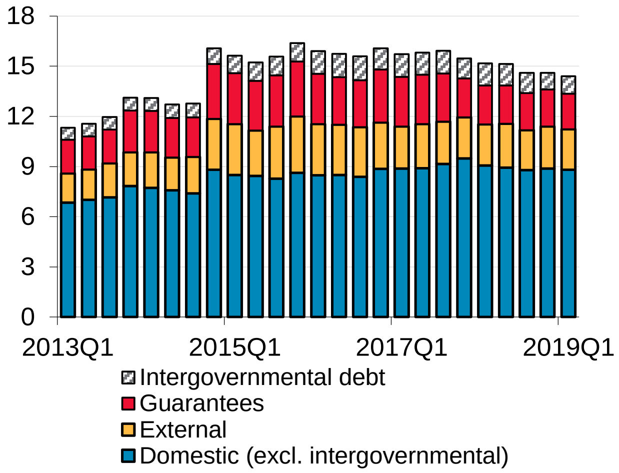
[16] Hereafter we rely on the GDP deflator that we conventionally estimated as a mean between the consumer price index and the producer price index, 7.2% YoY.

at a high since late 2008: 3.5% and -4.4% of GDP, respectively (Figure 37). It allowed cutting public debt and continuing an accumulation of funds that are to be transferred to the NWF.

Sovereign funds, public debt and account balances. Russia's total public debt (excluding the interbudgetary debt) slid 0.3 pp to 13.3% of GDP in 2019 Q1 (Figure 40). External debt sank 0.1 pp of GDP: the placement of Eurobonds was offset by a positive effect from the foreign exchange re-evaluation of the debt (-0.2 pp of GDP). The regions made a traditional replacement of market debt worth 0.1 pp of GDP with central government loans in the first quarter. Furthermore, government and municipal guarantees went down by 0.1 pp of GDP.

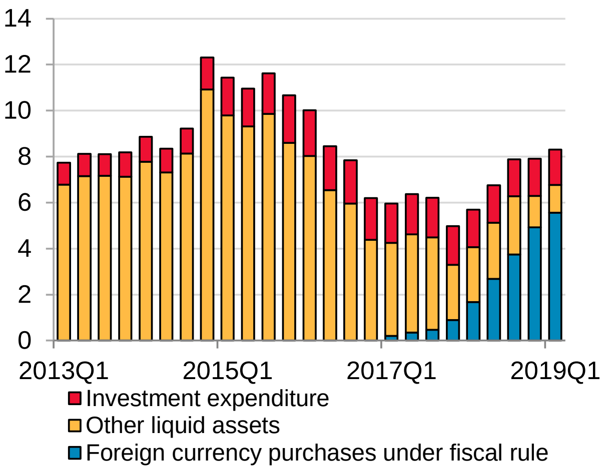
The first quarter saw fiscal rule-based[17] foreign currency interventions worth 0.75 trillion rubles, with the 0.4 pp of GDP valuation gain in the potential size of the NWF. As part of the NWF, investment projects account for 1.5 pp, old format liquid assets totalled 1.2 pp, and liquid assets under a new fiscal rule, including funds to be credited to the NWF accounts in 2019 and 2020, amounted to 5.6 pp (Figure 41).

Figure 40. Breakdown of total general government debt, % of GDP



Source: RF Finance Ministry, Rosstat, R&F Department estimates.

Figure 41. Breakdown of sovereign funds' assets including money that is to be credited to their accounts under the fiscal rule, % of GDP



Source: RF Finance Ministry, Rosstat, R&F Department estimates.

Budget account balances at the Russian Federal Treasury and commercial banks continued their active expansion. In particular, federal budget balances exclusive of the additional oil and gas revenue were up 0.7 pp to 3.5% of GDP.

Impact on GDP growth. According to our estimates, in real terms non-interest expenditure in 2019 Q1 decreased 2.4% YoY, revenue edged higher 3.9% YoY, including a 5.1% YoY rise in non-hydrocarbon revenue. It signals sizeable fiscal withdrawals from the private sector as well as a substantial decline in transfers to the private sector and available end demand. Factoring in delayed impact from the previous quarters which saw generally similar effect from the revenue and expenditure sides of the budget, public finance must have

[17] Exclusive of additional purchases in 2018.

had a significant negative impact on GDP's annual growth in 2019 Q1. Estimates based on fiscal multipliers exhibit a direct negative effect of about 0.5-1.0 pp.[18] That said, fiscal consolidation that ended in 2018 and an improvement of tax administration, which helped bring budget balance to a level that facilitates long-run fiscal sustainability, were poised to have an indirect positive effect in terms of boosting confidence among economic agents. Higher tax burden was not expected to have a direct negative impact on GDP growth in the first quarter and will manifest itself in the next quarters.

Forecast. Under the baseline scenario that implies a softening of the Urals oil price to $55 per barrel by early 2020, with a subsequent stabilisation at the level, we expect that in 2019 Q1 the rolling four-quarter measure of budget expenditure passed its ten-year low relative to GDP while revenue as well as total and non-oil and gas primary balance saw their highs (Figure 36, Figure 37). In particular, growth in non-oil and gas revenue due to the VAT hike will be offset by lower oil and gas receipts. Non-oil and gas primary balance will stabilise at a level of around 5.0% of GDP. Public debt will climb at a moderate rate relative to GDP under the fiscal rule, but the NWF will outpace it, leading to a lower net debt. The contractionary fiscal impact on the economy in 2019 Q1 will be replaced with the expansionary effect in the remaining months of 2019, primarily in the second half of the year, and is expected to further develop in the medium-term.

[18] Calculations rely on fiscal multipliers for the Russian economy used in a number of studies. See, e.g. Vlasov S., Deryugina E. (2018). Fiscal multipliers in Russia // Bank of Russia Working Paper Series.

2. OUTLOOK: LEADING INDICATORS

2.1. Insights from Russian leading indicators

2.1.1. GDP index estimate: economic growth to accelerate to potential by mid-year

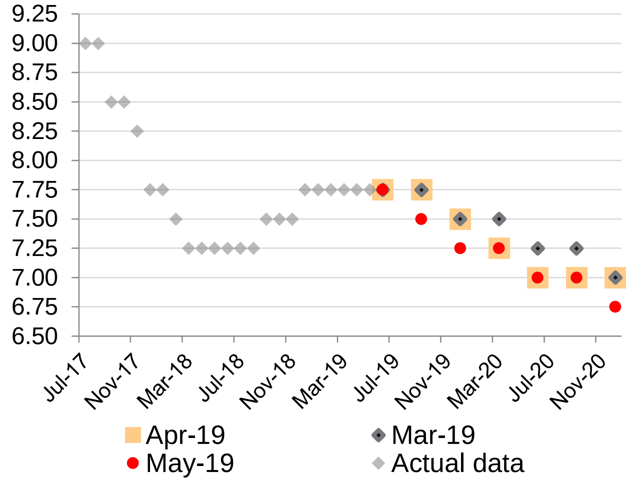
- Based on the data available as of 24 May 2019, GDP growth in 2019 Q2 is estimated to reach 0.3% QoQ SA, which is marginally lower than the April estimate.
- In 2019 Q3-Q4, GDP will grow at around 0.4% QoQ SA, indicating a gradual acceleration following a short-lived slowdown in early 2019.
- In particular, growth may reach the potential rate or climb marginally above it, reflecting a gradual closing of the negative output gap that emerged in late 2018 – early 2019.
- Nowcast estimates may be adjusted going forward as new short-term data are released.

	May **% QoQ SA**	April % QoQ SA
2019 Q2	**0.3**	0.4
2019 Q3	**0.4**	0.4
2019 Q4	**0.4**	–

2.1.2. Bloomberg consensus forecast: analysts' expectations cool in response to Bank of Russia's forward guidance in April

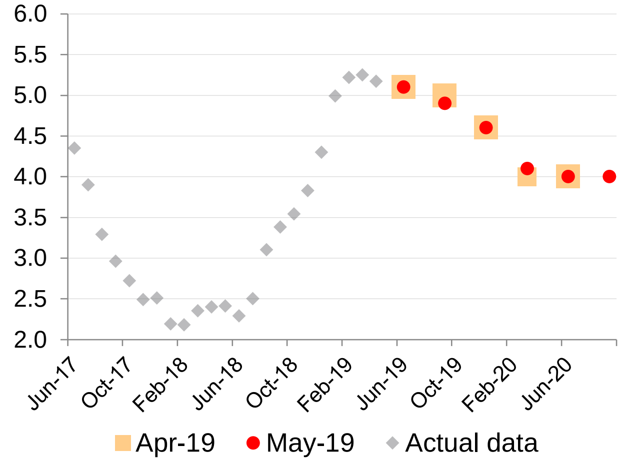
- Analysts' expectations of the 2019-2020 key policy rate declined in May (Figure 42). The current consensus forecast of the policy rate suggests two downward adjustments in 2019 (during the pivotal meetings in June and September) to 7.25% p.a., the 2018 Q3 level that preceded rate hikes in September and December 2018.
- By late 2020, experts expect further key rate cuts to 6.75% p.a., which – given the negative spread between the inter-bank rate and the key policy rate – shall roughly correspond to the middle of the range of neutral rate estimates (6.0–7.0% p.a.).
- Inflation forecast for 2019 remains unchanged at 4.6% YoY. According to analysts, inflation is poised to drop to 4% in early 2020 (Figure 43).

Figure 42. Analysts' expectations for the Bank of Russia's key policy rate, % p.a.



Source: Bloomberg Finance L.P.

Figure 43. Analysts' inflation expectations, % YoY



Source: Bloomberg Finance L.P.

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