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TALKING TRENDS
Economy and Markets

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EXECUTIVE SUMMARY

1. Monthly summary

- Annual inflation slowed in June, driven primarily by temporary disinflationary factors. That said, inflationary pressure defined as monthly price rises in the consumer basket's most stable components keeps close to the target. This determines the path of further gradual inflation deceleration to 4% towards the start of 2020 and its maintenance around this level. Inflation expectations stabilized, remaining elevated and unanchored, suggesting the persistence of the related medium-terms pro-inflationary risks. Economic activity was generally subdued in May–June. Still, the second half of the year is expected to see a higher growth rate, helped by likely narrowing of the lag between the actual and planned budget expenditure, loosening of monetary stance and favourable conditions in financial markets.
    - The consumer price movements and the current level of the inflationary pressure in the economy suggest inflation deceleration to 4% in the first quarter of 2020 under the baseline scenario. Meanwhile, short-term disinflationary risks are now prevailing, thanks to a number of transient factors, such as ruble strengthening, motor fuel price stabilization, this year's early harvest, etc. At the same time, the risks of inflation deviating upwards from the target still prevail on the medium-term horizon.
    - It appears from the economic activity indicators that Russia's economy gained some momentum in year-on-year terms in the second quarter. Still, growth remains subdued on the back of a fall in exports and domestic demand weakening amid the global economy slowdown, the workforce contraction, and the Russian economy's other structural and institutional problems. In the second half of the year, budget spending and monetary stance loosening should help overall demand growth in the economy, whereas inflation deceleration should support consumer demand.
    - The US Fed and ECB's willingness to soften monetary policy amid the rising risks for the global economy have propped up risk appetite in global financial markets, Russian markets among them.

2. Outlook

- The index-based GDP estimate suggests that Russia's economic growth rate will accelerate to potential in the second half of the year.
- The situation in global financial markets should largely depend on the ability of the major economies' central banks to stave off further growth slowdown and the outcome of trade negotiations between the US and China.

1. ИТОГИ

1.1. Inflation

Annual inflation has consolidated its hold on the downtrend which will likely continue until the second half of 2020. As a result, annual consumer price rises should slow to 4% in the first quarter of 2020. That said, short-term disinflationary risks have started to prevail, helped by a number of transient factors.

A rise in the most stable consumer price index components that are only weakly sensitive to transient factors keeps to a level providing for an inflation rate of 4%. This creates all essential conditions for a sustainable annual inflation deceleration to the target concurrently with the Bank of Russia's adoption of neutral monetary policy. At the same time, this indicates that elevated inflation expectations fully offset the possible minor disinflationary effect of the temporary economic growth weakening. The pattern of inflation expectations suggests that the short-term neutral interest rate may currently exceed the long-term one. This uncertainty in a situation where the Central Bank is drawing close to neutral monetary policy, requires the regulator to act cautiously and keep a close watch on possible changes in the balance of risks associated with price movements.

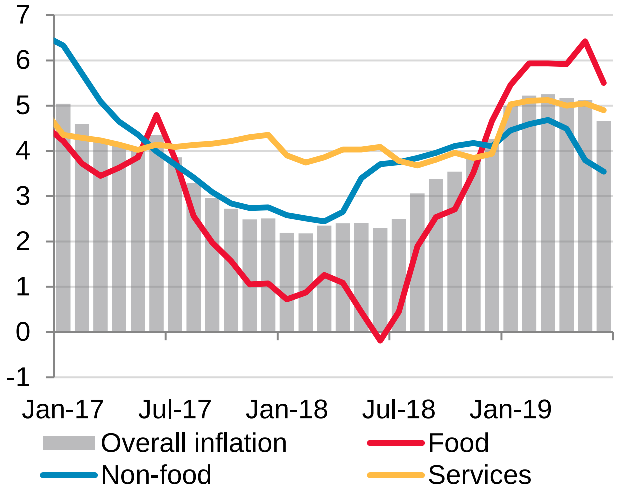
On the medium-term horizon, pro-inflationary risks prevail over disinflationary ones. As such, trend inflation, although declining, exceeds 4% in both five-year and three-year observation windows. Among the key pro-inflationary risks are geopolitical factors and volatility surges in financial markets, fiscal policy uncertainty, secondary effects related to business and household elevated and unanchored inflation expectations, and growing workforce shortages in the labor market.

1.1.1. Effect of temporary disinflationary factors strengthened in June

- Inflation slowed to 4.66% in June from 5.13% in May, with the monthly consumer price rises slowing to fall far below the path securing an inflation rate of 4% in annualized terms.
- The balance of temporary factors shifted towards those restraining price rises, with a lot of help from a drop in fruit and vegetable prices.
- The estimates of core inflation indicators declined marginally, staying, however, close to 4% in annualized terms.
- Consumer prices rose 0.23% over the 1–29 July period. The preliminary estimate of price rises for all of July stands at 0.2%–0.3% MoM (4.6–4.7% YoY), the seasonally adjusted rate being roughly the same.
- Household inflation expectations did not change in July as perceived inflation slowed. The ratio of these indicators suggests that households expect inflation to decelerate from its current level in the future.

Based on Rosstat data, annual inflation stood at 4.66% in June, down from 5.13% in May (Figure 1). Inflation deceleration continued for the third consecutive month. Food price movements were the key inflation restraining factors in June. Nonfood goods and services price rises also slowed in June.

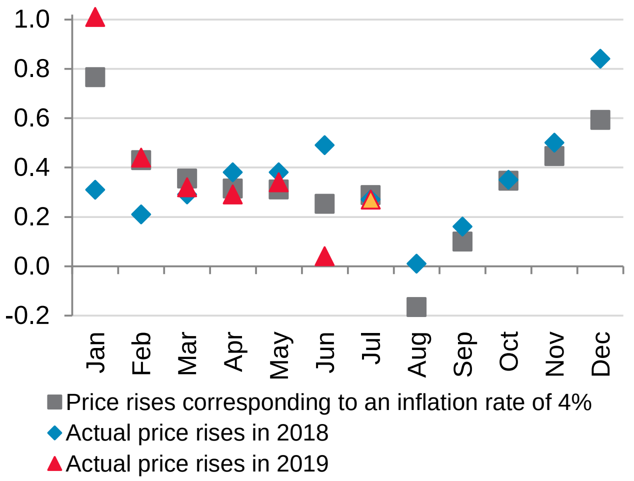
Figure 1. Inflation and its components, % YoY



Source: Rosstat.

In monthly terms, consumer prices rose 0.04% MoM in June, which is far below a path leading to an annual inflation rate of 4% (Figure 2). We estimate that the seasonally adjusted rate of consumer price inflation declined to 0.12% MoM, practically the February 2018 level (Figure 3). The key factor restraining price rises in June was a drop in fruit and vegetable prices by 3.7% MoM in seasonally adjusted terms, driven by an early arrival at the market of fruit and vegetable produce on the back of favourable weather conditions this year.

Figure 2. Price rises corresponding to an inflation rate of 4%*, % MoM

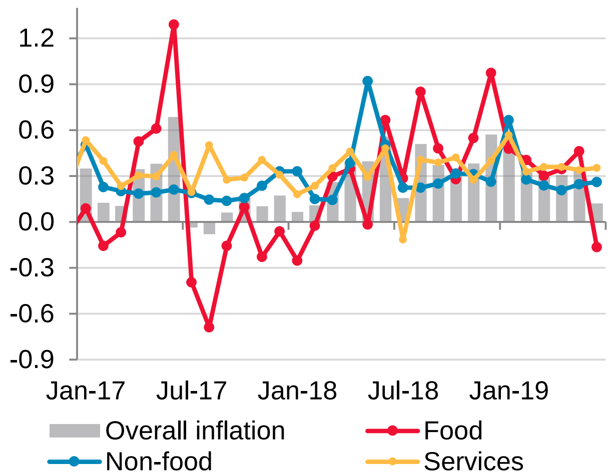


Source: Rosstat, R&F Department estimates.

** The July number is a preliminary estimate.*

The calculation took into account the split of housing and utility price indexation into two periods, January and July, in 2019.

Figure 3. Seasonally adjusted price rises, % MoM



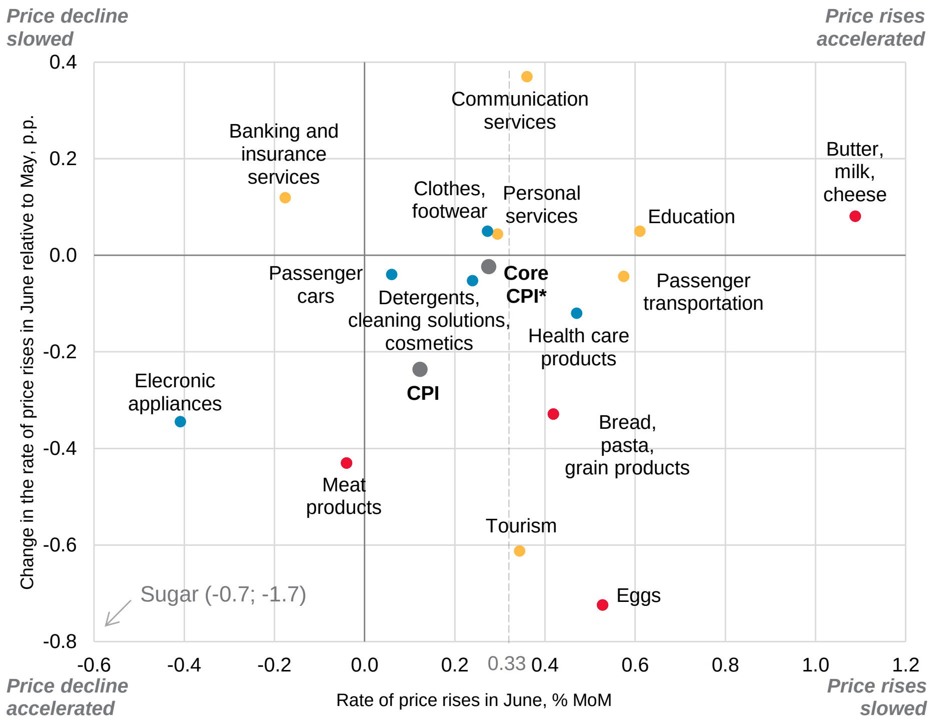
Source: Rosstat, Bank of Russia estimates.

Exclusive of fruit and vegetables, food prices went up 0.33% MoM in June versus 0.50% MoM in May. Price rises slowed (or their decline accelerated) in meat products, eggs, sugar, and grain processing products (Figure 4). This was primarily owed to the petering out of short-term pro-inflation factors, which for a long time drove the prices of the above food items up.

Nonfood prices saw a token rise of 0.26% MoM in June from 0.25% MoM in May. While the overall change in the rate of nonfood price rises was only marginal, price changes in individual items used in the calculation of the overall indicator were mixed. Motor fuel price rises accelerated, whereas increases in the prices of electrical appliances, television and radio goods, personal computers and communication devices slowed, driven largely by ruble appreciation in the last several months.

In seasonally adjusted terms, services price increases remained in the 0.3–0.4% MoM range.

Figure 4. Seasonally adjusted price rises in June and their changes relative to May, % MoM



Source: Rosstat, R&F Department estimates

** Modified core inflation indicator calculated by the truncation method.*

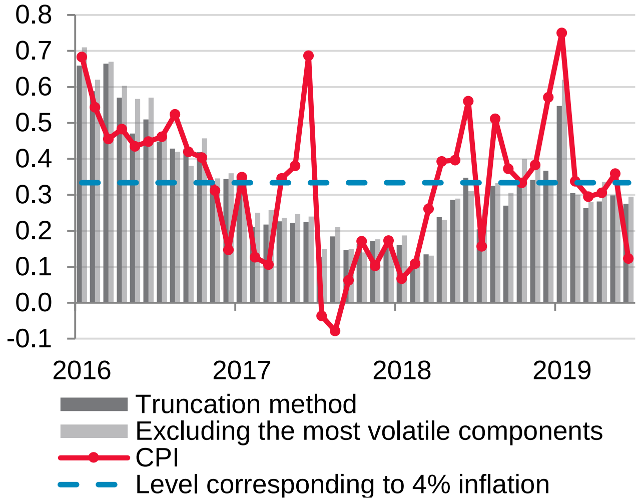
The mean of modified core inflation indicators equalled 0.28% MoM in June, down from 0.32% MoM in May. The negligible decline in the core inflation indicators compared with a much more notable drop in the rate of overall consumer price rises suggests a shift in the balance of pro-inflationary and disinflationary temporary factors towards the latter (Figure 5).

Consumer price inflation remains moderate in July, as indicated by real-time Rosstat estimates. Consumer price increases came in at 0.23% for the July 1–29 period, down from a comparable time span last year, thanks to price movements in the first weeks of the month (Figure 6). This was due mainly to the specifics of housing and utilities price indexation in 2019: indexation planned for July this year was lower than that in July 2018 (2.4%[1] versus 4.0%).

[1] House and utility prices are indexed in two stages in 2019: by 1.7% as of January 1 and another 2.4% as of July 1.

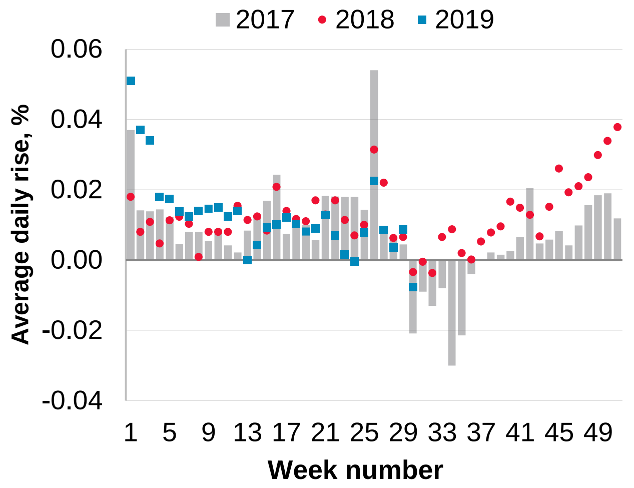
Lower housing and utility price indexation than last year's should cut 0.1 percentage points off the monthly price rise for July.

Figure 5. Modified core inflation indicators, % MoM



Source: Rosstat, R&F Department estimates.

Figure 6. Average daily price rises, %

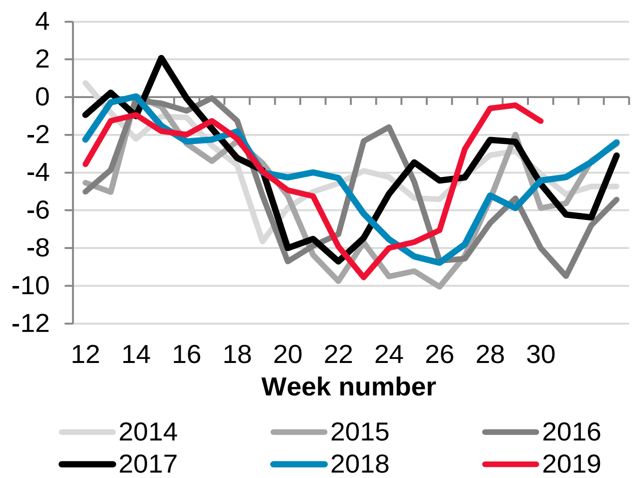


Source: Rosstat, R&F Department estimates.

July's rate of fruit and vegetable price cuts remains very low, uncharacteristically for this time of year. The slower pace of fruit and vegetable price cuts is owed to cucumber and tomato price movements. The current slow pace of price reduction makes up for its faster than usual rate in April–June (Figure 7).[2] The rate of "the borsch mix" price decline remains fast (Figure 8).

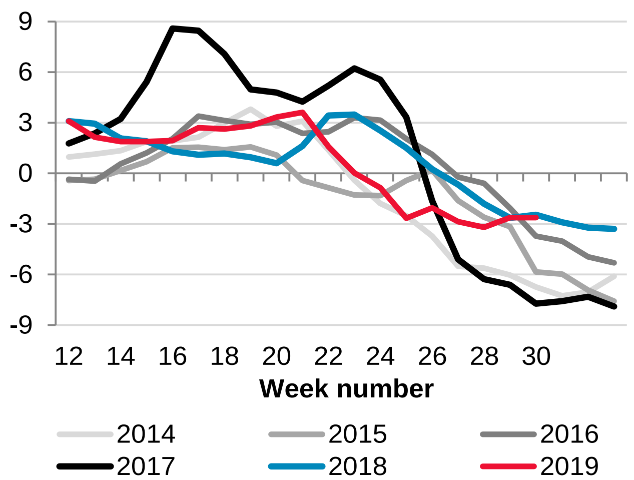
The agreement between the Russian Federation government and the major oil companies aiming to stabilise motor fuel prices expired on July 1. Oil product prices, however, changed only marginally over the July 1–29 period (petrol and diesel prices went up just 0.2%). The key factors behind this were wholesale price stabilization following an export parity price decline in late May – early June, and the reverse excise tax levied on oil companies (Figure 9).

Figure 7. Weekly cucumber and tomato price rises, %



Source: Rosstat, R&F Department estimates.

Figure 8. Weekly "borsch mix" price rises*, %

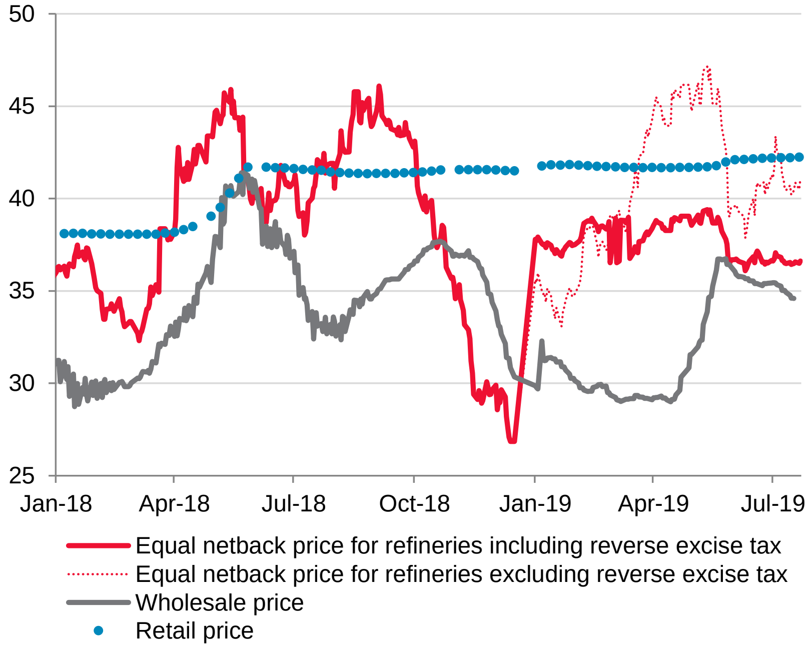


Source: Rosstat, R&F Department estimates.

** Weekly observations include potatoes, cabbages, onions, and carrots.*

[2] Based on our estimate, cucumber and tomato prices fell 8.4% in seasonally adjusted terms in April–June. This decline is tp be offset in July.

Figure 9. AI-92 petrol price movements, rub/litre

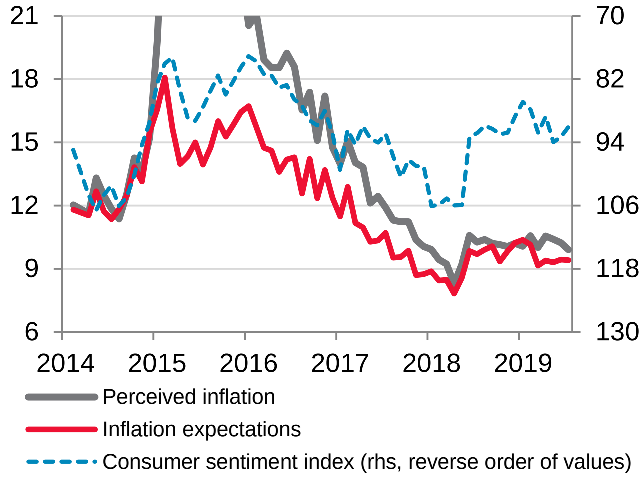


Source: St Petersburg International Commodity Exchange, CEIC, R&F Department estimates.

Based on the weekly data, the preliminary price rise estimate for the whole of July stands at 0.2–0.3% MoM (Figure 2), the seasonally adjusted price rise rate being roughly the same. Annual inflation should stand at 4.6–4.7% YoY.

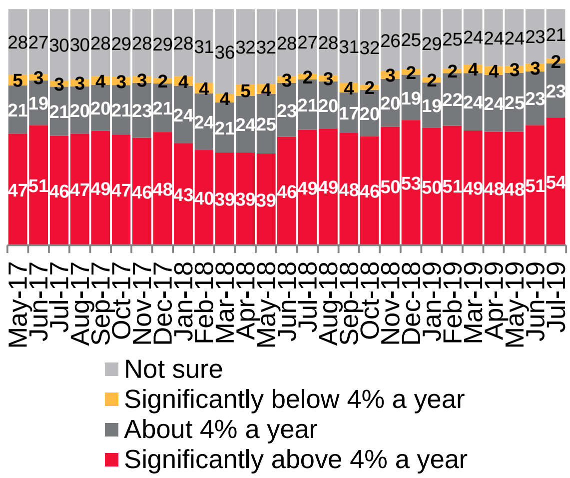
According to inFOM survey conducted on July 1–11, the assessment of inflation expected in 12-months' time was the same in July as in June at 9.4%. The assessment of perceived inflation went down to 9.9% from 10.2% in June. The assessment of perceived inflation still stands above that of expected inflation, suggesting household confidence that going forward inflation will decelerate from its current level.

Figure 10. Median estimates of observed and expected inflation by households, % YoY



Source: OOO inFOM.

Figure 11. Inflation level expectations three years ahead[3]



Source: OOO inFOM.

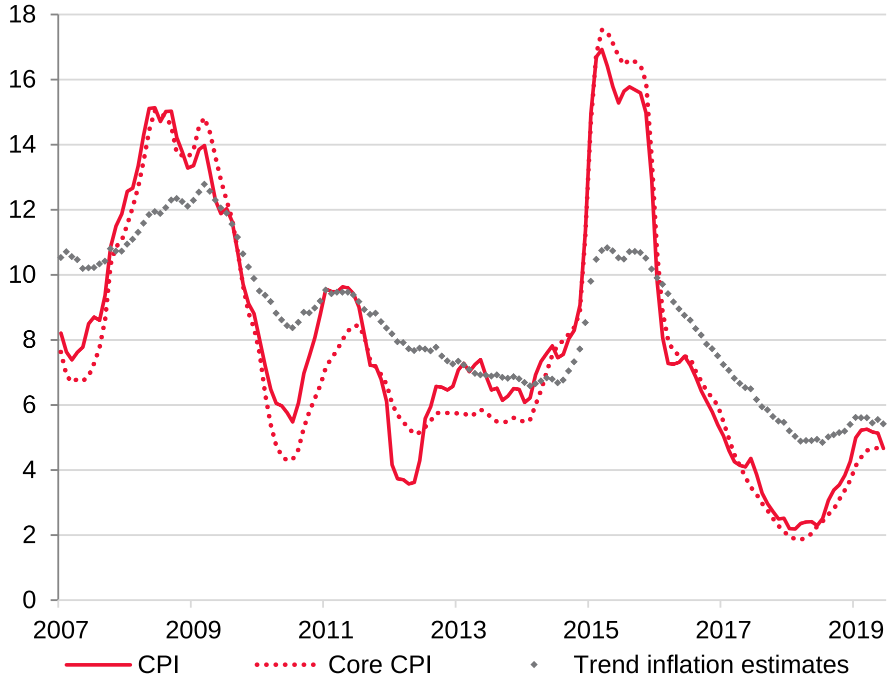
[3] Distribution of answers to the question "Do you think annual inflation will stand above or below 4% in three years' time? Or will it equal about 4%?".

The share of respondents expecting inflation to stand notably above 4% in three-years' time rose to 54% (Figure 11). The share of those who believe that the annual rate of price rises will equal about 4% in three years' time was unchanged at 23%. Overall, the survey results suggest that household inflation expectations are unanchored and very sensitive to transient factors.

1.1.2. Inflationary pressure stays on a level close to 4%

- The inflation estimate dropped to 5.42% in June 2019 from 5.55% in May (Figure 12). The trend inflation estimate computed over a shorter three-year time span declined to 4.08% in June from 4.23% in May (Figure 13).
- The methodology of trend inflation estimation allows for an occasional estimate's response to short-term factors of price movements. We estimate that June's decline in trend inflation estimates was largely driven by a shift of the balance of pro-inflationary and disinflationary temporary factors towards the latter.
- Overall, the pattern of changes in trend inflation estimates indicates that inflationary pressure in the consumer market is on a level close to the inflation target.

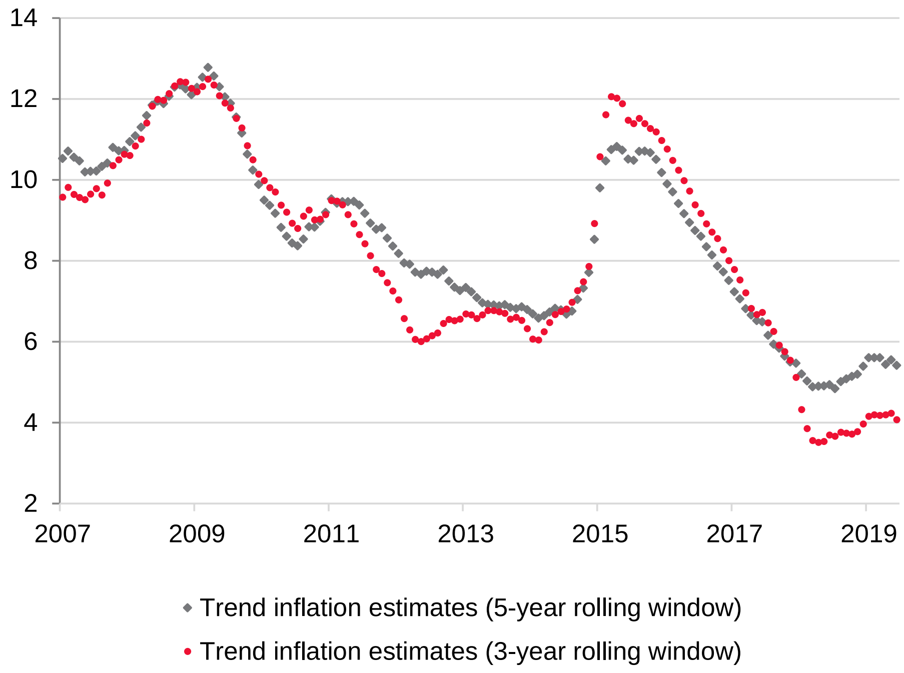
Figure 12. CPI, core CPI, and Bank of Russia historical estimates of trend inflation,[4] % YoY



Source: Rosstat, R&F Department estimates.

[4] This trend inflation indicator is constructed over a rolling five-year period.

Figure 13. Trend inflation estimates computed over three- and five-year rolling windows, % YoY



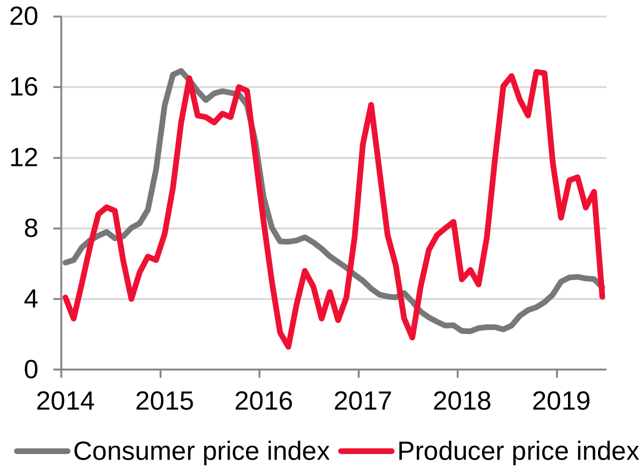
Source: Rosstat, R&F Department estimates.

1.1.3. Producer inflation slows along with the decline in oil prices

- Producer price rises slowed sharply to 4.1% in June from 10.1%[5] in May (Figure 14), with both the extractive and manufacturing industries posting a dramatic price rise slowdown to 5.7% in June from 15.7% in May and to 3.2% in June from 9.4% in April respectively.
- A sizable input to producer price inflation deceleration was provided by external conditions in the form of an oil price drop. Accordingly, the annual rate of price rises plummeted in oil and gas extraction and manufacture of refined petroleum products by 14 pp and 16 pp respectively, owing to, among other things, the departure of the high base effect, since most of last year's oil and refined petroleum product price rises occurred in May–June.
- Rises in producer prices of consumer goods manufacturers slowed to 2.5% from 7.5% in May (Figure 15). Manufacturers from most of the industries represented in the calculation, including the manufacture of food products, wearing apparel, electronic products, perfumes and cosmetic products, posted a price rise slowdown (or decline acceleration). This suggests a gradual relief of pressure from producer prices on the consumer market.

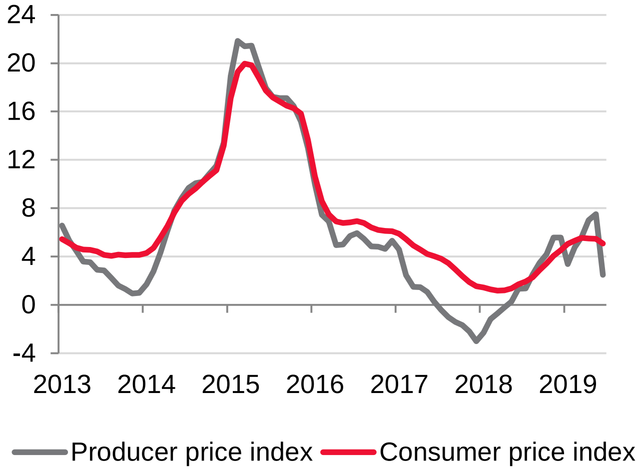
[5] Data since the start of 2019 has been revised. The previous price rise estimate for May equalled 8.6% YoY.

Figure 14 Change in the producer price index and consumer price index, % YoY



Source: Rosstat.

Figure 15. Change in prices for selected goods[6], % YoY



Source: Rosstat, R&F Department calculations.

1.2. Economic activity

According to estimates, Russia's economic growth accelerated somewhat in the second quarter, remaining, however, weak. Short-term negative factors, such as the global economy's slowdown, the VAT hike, a temporary budget spending contraction in real terms, and inflation acceleration, kept growth below potential in the first half of 2019. That said, corporate and retail lending supported demand in the Russian economy. With a number of negative economic factors gone and budget spending stepped up, economic growth should accelerate in the second half of the year, unless there emerge major external economic shocks, such as further slowdown of the global economy.

1.2.1. First quarter GDP growth is owed to private consumption

- The key positive contribution to first quarter GDP growth came from consumption expansion by 1.6% YoY.
- The formally positive input of net exports was in turn driven by a faster contraction in imports than that in exports. Against this background, risks for Russian exports from the global economy's slowdown and hence that of external demand, continue.
- The key factor restraining GDP growth in the first quarter was a 2.6% YoY decline in gross capital formation.

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

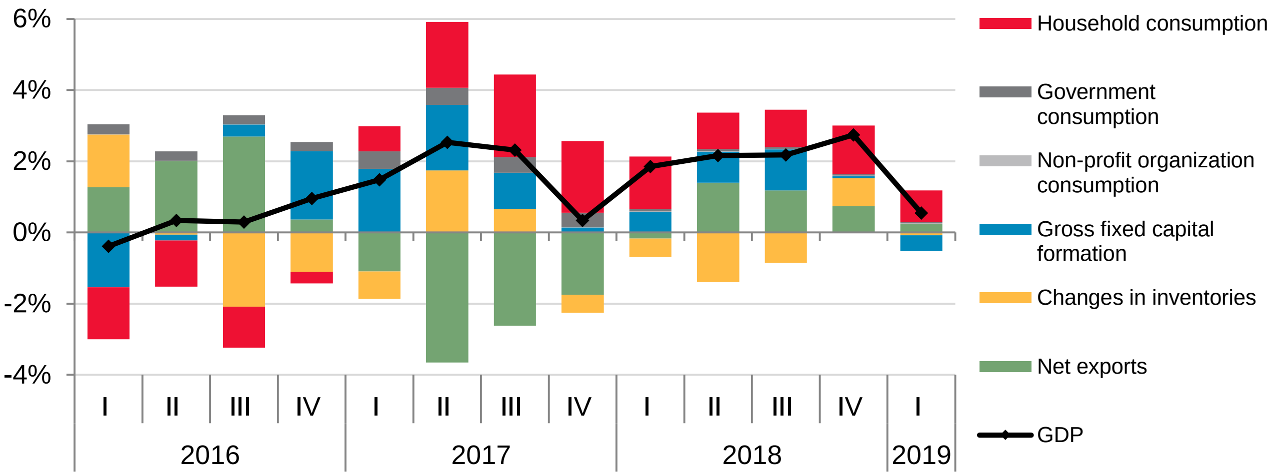
- Moreover, although the first quarter fixed investment remained in positive territory, investment growth was much weaker than a year earlier.
- Overall, Rosstat data on GDP by end use coupled with the performance of short-term leading indicators, suggest growth slowdown in the first half of 2019.
- It is, however, likely that this slowdown is more gradual than what preliminary Rosstat estimates currently indicate. In particular, one should bear in mind that in constructing the first quarter estimate, no retrospective revision of GDP performance was conducted, so the apparent substantial GDP growth slowdown in annual terms may be partly due to the high statistical base of the start of last year.

Rosstat has released the first estimate of GDP by end use for the first quarter of 2019. The estimate of GDP growth has remained unchanged at 0.5% YoY after 2.7% YoY in the fourth quarter of 2018. One should, however, bear in mind that no retrospective revision of GDP performance was conducted in forming the first quarter estimate. Therefore, the apparent substantial GDP growth slowdown in annual terms may be partly due to the high statistical base of the start of last year (and in, particular, may have to do with accounting and reporting specifics in the construction industry.[7]

Based on our preliminary estimate,[8] GDP adjusted for seasonal and calendar factors, declined 0.3% QoQ in the first quarter of 2019 from the fourth quarter of 2018. Seasonally adjusted growth of household expenditure on final consumption slowed to 0.1% QoQ from 0.4–0.6% QoQ maintained throughout 2018. Gross capital formation fell 0.6% QoQ, exports contracted 1.2% QoQ, imports dwindled 0.7% QoQ.

Household consumption was the key driver of annual GDP growth (Figure 16). Household expenditure on final consumption rose 1.6% YoY, making a 0.89 percentage point positive input to the GDP change.

Figure 16. Decomposition of GDP, contribution to annual growth, pps



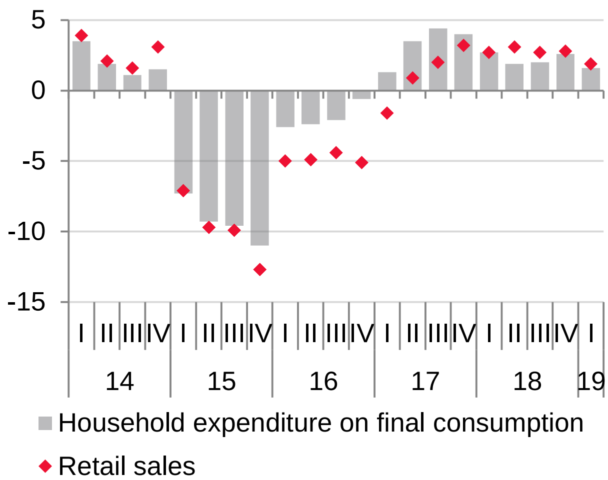
Source: Rosstat, R&F Department calculations.

[7] Talking Trends No 4 (32),Rosstat May 2019, Subsection 1.2.1 "Temporary GDP growth slowdown in the first quarter".
[8] Specifically, the estimate takes into account that Rosstat did not conduct a retrospective revision of GDP performance in constructing the first quarter estimate.

Growth in household spending on final consumption lost momentum compared with the fourth quarter of 2018.[9] Domestic demand growth weakening followed a slowdown in the real wage increase to 1.3% YoY in the first quarter of 2019 from 4.1% YoY in the fourth quarter of 2018. Meanwhile consumer lending expansion remained the key factor supporting domestic demand. The weakening growth in household spending on final consumption is generally in line with the performance of retail sales (a 1.9% YoY rise in the first quarter of 2019, down from 2.8% YoY in the fourth quarter of 2018 – Figure 17) and personal services (an increase of 1.5% YoY in the first quarter of 2019 after 1.9% YOY in the fourth quarter of 2018). Based on Rosstat data, consumer demand continued weakening in April–May (retail sales expansion stood at 1.4% YoY, down from 1.6% YoY in April, paid consumer services dropped 0.3% YoY in May after growing 1.5% YoY in April). This may suggest a certain drop in the contribution of household expenditure on final consumption to GDP growth in the second quarter compared with the first quarter.

The key factor restraining GDP growth in the first quarter was a 2.6% YoY fall in gross capital formation (-0.43 pps), posted for the first time since 2016. Based on Rosstat data, fixed investment expansion slowed to 0.5% YoY in the first quarter of 2019 from 2.9% YoY in the fourth quarter of 2018.

Figure 17. Household expenditure on final consumption and retail sales, % YoY



Source: Rosstat.

In addition to the rise in household expenditure on final consumption, a positive contribution to GDP growth came from an increase in net exports (+0.24 percentage points). This was, however, helped by a faster drop in imports, than export contraction. The performance of imports remained negative for two consecutive quarters (a fall of 1.6% YoY in the first quarter of 2019, following a 0.3% YoY decline in the fourth quarter of 2018), driven mainly by investment demand weakening and, to a lesser extent, by a consumption decrease.

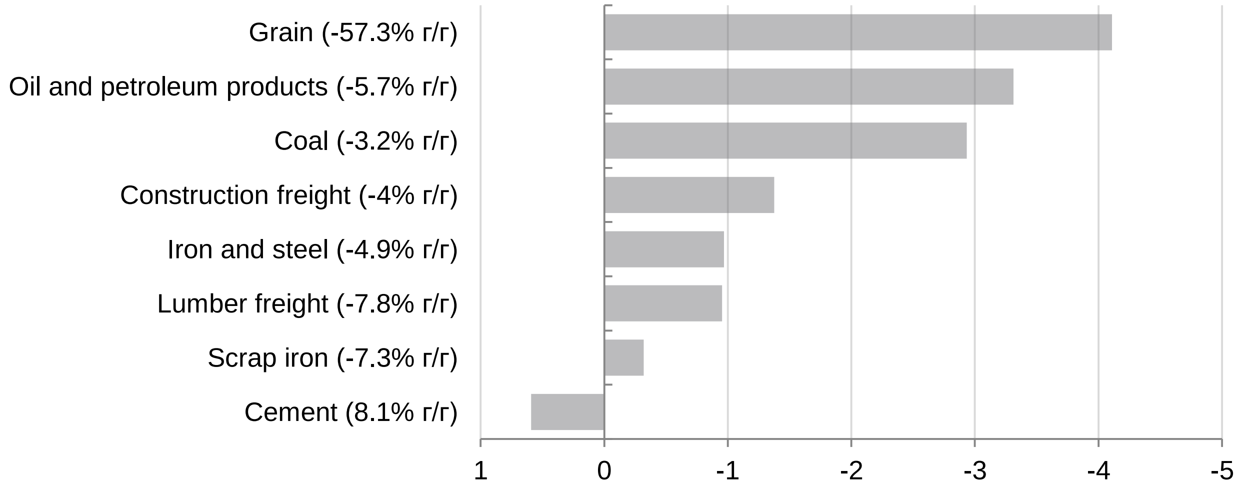
A fall in exports equaled 0.4% YoY (after a 2.6% rise in the fourth quarter of 2016) and was posted for the first time since the first quarter of 2016. Russian Railways' real-time data

[9] The growth of households' final consumption in 2018Q4 was 2.6% YoY.

indicates a 3.7% YoY decline in rail shipments in April–June (a 5.4% YoY fall was posted in June, a 3.8% YoY drop in May and 1.9% contraction in April). The second quarter saw a substantial YoY contraction in the shipments of grain, oil and refined petroleum products, coal, and iron and steel products (Figure 18). Further factors containing freight growth are oil production limits imposed under the OPEC+ agreement, a fall in gas exports, and a temporary shutdown of the Druzhba oil pipeline. All this gives reason to believe that exports will remain weak in physical terms in the second quarter of 2019.

The situation with the contamination of the Druzhba oil pipeline merits a special mention. Risks that the Druzhba shutdown will affect the performance of exports in the second quarter remain, but this is a transient factor, and this fall will be compensated within the next one or two quarters. This factor will not affect exports and GDP growth for the full-year 2019.

Figure 18. Year-on-year change in shipments in April–June 2019, million tons, values in the reverse order



Source: Russian Railways, R&F Department estimates.

Finally, the fact that contraction in Russian imports depends on the foreign exchange component more than the performance of exports, which is significantly affected by the energy market situation and the external demand slump, also suggests substantial risks of a decline in net exports' positive contribution to GDP in the quarters ahead.

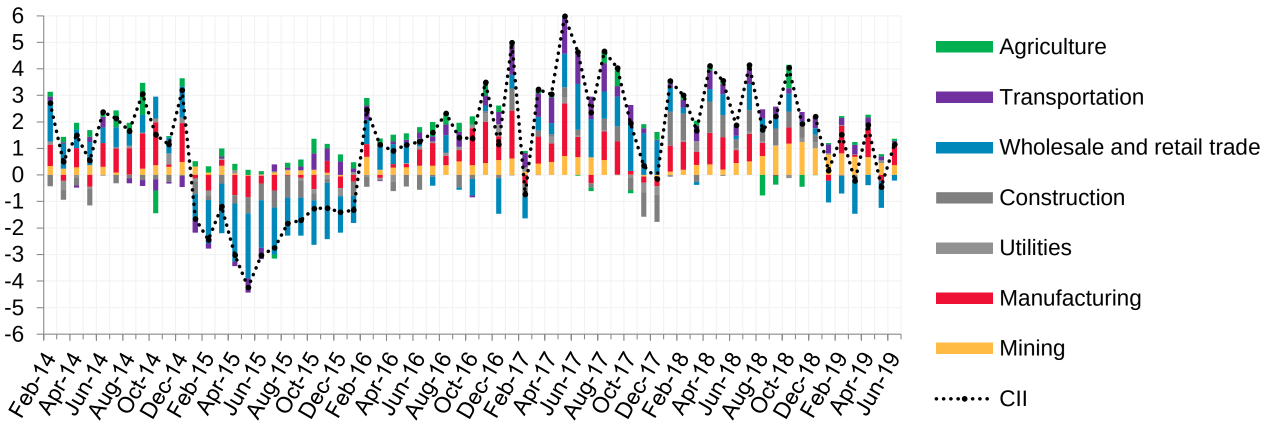
The components of GDP by end use therefore indicates a certain worsening of the economic situation in the first quarter, while the leading indicators (in particular, retail sales, and freight shipments by Russian Railways) point to the continuation of lower than potential annual GDP growth. At the same time, one should bear in mind the high base effect of the start of 2018, which is associated with the methodological specifics of reporting statistics and may be adjusted as Rosstat conducts retrospective revision of GDP performance.

1.2.2. Core industries' performance suggests GDP growth acceleration in the second quarter

- The core industries' output returned to growth in annual terms in June after its downturn in May.
- The core industries' upturn was driven by manufacturing and wholesale trade.
- The core industries' growth accelerated for the whole of the second quarter compared with the first quarter, which gives reason to expect GDP growth strengthening.

The Core Industries' Index[10] (CII) added 1.2% YoY in June after its 0.5% YoY decline in May (Figure 19). The core industries' growth accelerated to 0.9% for the whole of the second quarter from 0.5% in the first quarter, which gives reason to also expect a minor GDP growth acceleration for the second quarter (Figure 20). The CII performance improvement in June was chiefly owed to the manufacturing sector's starting upturn and whole trade's improving performance (although it is still contracting in annual terms). In the other core industries, annual output expansion did not outpace its May performance.

Figure 19. Contribution of industries to the CII in 2014–2019, % YoY



Source: Rosstat, R&F Department estimates.

Manufacturing made the largest positive contribution to CII performance in June, rising 3.4% YoY after a 1.0% YoY decline in May, thanks largely to individual industries improving numbers.[11]

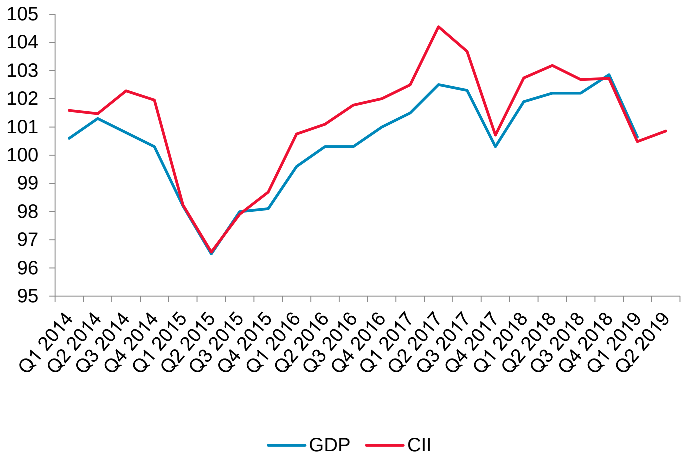
Trade's input to the CII continued to be negative from the start of the year, owing to a fall in wholesale sales. Their decline, however, slowed sharply in June to -2.1% YoY from

[10] The Core Industries' Index (CII) is calculated by aggregating 7 industry-specific indexes (agricultural output; output of the mining and quarrying and manufacturing sectors; transportation freight traffic; wholesale and retail sales; electricity, gas, steam and air conditioning supply; water supply, sewerage, waste management and remediation activities; construction, with weights corresponding to the share of respective industries in Russia's gross value added in 2016.

[11] See subsection 1.2.3. Industrial output growth accelerates, fuelled by some manufacturing industries.

-7.1% YoY in May. *Retail sales* showed no change in their growth rate compared with May, rising 1.4% YoY.[12]

Figure 20. Quarterly index of GDP and CII in physical terms, % YoY



Source: Rosstat, R&F Department estimates.

Growth continued slowing in *mining and quarrying,* which posted an output rise of 2.3% YoY after a 2.8% increase in May, dragged down primarily by natural gas and oil extraction.

Positive performance is also worsening in the *transportation industry,* which registered a 0.3% YoY growth versus 1.1% YoY a month earlier. Freight traffic dropped in practically all transportation sectors (excluding road and pipeline transport), but the key negative impact came from a rail traffic fall of 1.8% YoY, with railways accounting for 45% of the overall freight traffic in Russia. The key freight types which suffered a contraction in shipments were coal, oil and petroleum products, iron ore, and iron and steel.

Construction output growth stayed on last year's level at 0.1% YoY. That said, housing construction keeps up a fast growth rate at 11.4% YoY, owing mainly to the low base of June 2018 (-16.6 YoY).

June's rate of *agricultural output* expansion remained practically unchanged from May at YoY. Its current performance is still adversely affected by a modest meat production rise of 0.8% YoY, restrained by domestic market saturation and the industry's still limited access to foreign pork and poultry markets. In *crop production,* planted areas exceed last year's for most crops, according to a Rosstat estimate. However, given the unfavourable weather conditions in some regions, experts have started to revise down their estimates regarding the anticipated record-high output of a number of key crops. Still, following the revisions, cereal crops are estimated at a higher level than last year's, the output of oil-bearing crops is forecast to be marginally lower but still above the many-year average. Vegetable crops are expected to show a minor growth, while potato output will likely remain unchanged from 2018, but weather conditions during harvesting will be the key determinant.

[12] See subsection 1.2.5. Consumption growth accelerated somewhat in

1.2.3. Industrial output growth accelerates, fuelled by some manufacturing industries

- Industrial output growth accelerated to 3.3% YoY in June, driven chiefly by a substantial rise in manufacturing output. This growth, however, remains unsustainable, since it is owed to a small number of industries, whose performance is hardly predictable and does not depend on the overall economic situation.
- Manufacturing output rose 3.1% MoM in seasonally adjusted terms in June. All of this growth was however concentrated in just one industry, the manufacture of electronic products, where a dramatic output upturn most likely arose from temporary factors.
- The recovery in the output of other transport equipment was sharply interrupted by a severe fall, making the industry the heaviest drag on manufacturing output growth in annual terms.
- A decline in petroleum refining output is continuing. Its recovery to the levels of the start of the year may be put on hold for several more months because of the oil contamination problems.

Annual industrial output growth stood at 3.3% YoY in June, up from 0.9% YoY in May 2019. Industrial output climbed 2.6% YoY for the first half of 2019. Based on an R&F Department estimate, industrial output rose 0.8% MoM in seasonally adjusted terms (Figure 21). The R&F Department estimates that, although varying from month to month, industrial production maintains an overall positive trend: the index added 1.0% QoQ in seasonally adjusted terms in the second quarter, up from 0.6% QoQ in the first quarter.

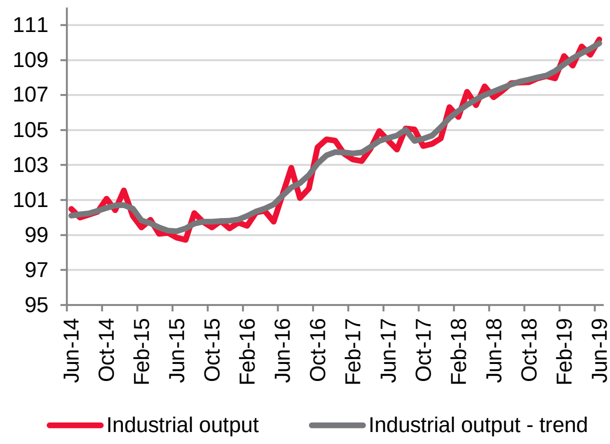
By aggregating three components of the Industrial Output Index using official Rosstat-published weights based on the value added structure for 2010, the R&F Department estimated growth at 2.8% YoY. A significant difference from the officially released Rosstat number, which this exercise produces, stems from using a different methodology than that used in estimating industry-specific indexes. In other words, the weights change, in particular, the share of manufacturing increases appreciably (with the 2010 weights, for example, this share equals about 53.7%. Rosstat mentions a share of over 66% in its comments).[13]

Mining and quarrying output growth slowed for the fourth consecutive month. In June, the sector's output climbed 2.3% YoY versus 2.8% YoY in May. In monthly terms, mining and quarrying added 0.3% MoM SA. (Figure 22). Mining and quarrying output expanded 4.0% YoY for the second half of the year, but we do not see a commensurate increase in oil and gas extraction, the key components of the sector, over the same period: +2.5% YoY and +2.9% YoY, respectively. This mismatch stems from a significant growth in mining support service activities as part of natural resources extraction (a rise of 11.2% YoY in June and 17.5% YoY

[13] https://www.kommersant.ru/doc/4033190

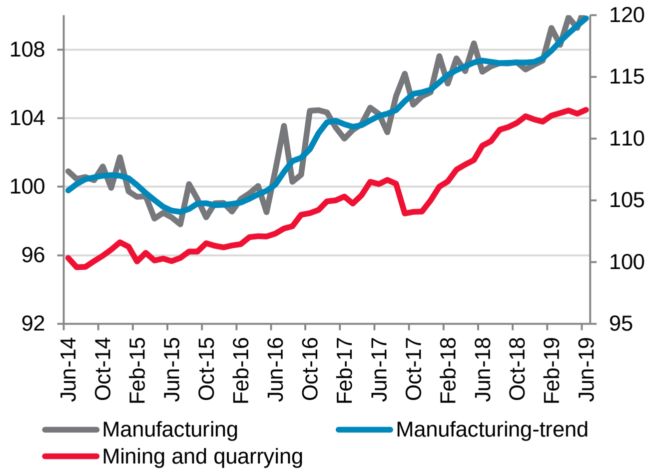
in May), due to the growing intensity and complexity of oil and gas production (for example, the rising volumes of horizontal drilling).

Figure 21. Change in industrial production index (2012=100)



Sources: Rosstat, R&F calculations.

Figure 22. Change in mining and quarrying and manufacturing indexes (2012=100)



Sources: Rosstat, R&F calculations.

Manufacturing posted a substantial output upturn of 3.4% YoY after its 1.0% YoY drop in May. Therefore, the above-mentioned expansion in the share of manufacturing in the overall index made it the key driver of industrial output growth in June. An adjustment for the calendar effect would have produced just a minor output rise,[14] all other things being equal. We estimate that manufacturing output rose 1.3% MoM SA, compensating a fall of 0.6% MoM in May (Figure 23).

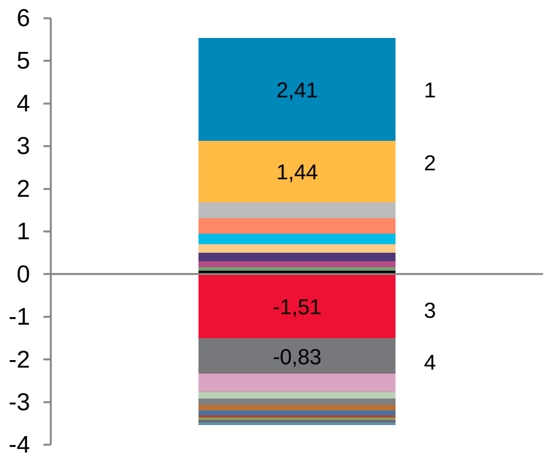
We note that annual manufacturing output growth in June was in effect driven by two industries: metals (a rise of 14,6% YoY) and the production of computer, electronic and optical products (up 37.9%) In metals, however, the key products do not show a significant growth in annual terms, suggesting that this performance may have arisen from temporary factors. This industry did not have a considerable impact on the overall numbers for the first half of the year, and we now see other industries as current growth drivers (Figure 24, Figure 25).

The second quarter saw every month of manufacturing growth followed by that of decline, while manufacturing's overall quarterly result was positive at 1.5% QoQ in seasonally adjusted terms. Growth, however, remains unsustainable, since it is generated by a small number of industries, whose performance is not always predictable and hardly depends on the current economic situation.

In June, a dramatic rise in the output of electronic products had an effect on *industries meeting investment demand* as well as on the overall output of the manufacturing sector. We estimate that net of this industry, June's manufacturing output may have showed a MoM decline. Based on a Centre for Macroeconomic Analysis and Short-term Forecasting estimate, manufacturing output, excluding defence products, added just 0.2% MoM in June.

[14] May 2019 had two working days fewer than May 2018. June had one working day fewer.

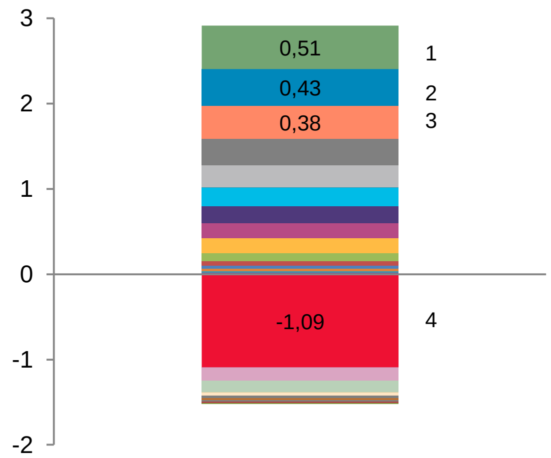
Figure 23. Individual industries' contribution to manufacturing growth in June 2019, % YoY



1. Basic metals
2. Computer, electronic and optical products
3. Other transport equipment
4. Coke and refined petroleum products

Source: Rosstat, R&F calculations.

Figure 24. Individual industries' contribution to manufacturing growth in January–June 2019, % YoY



1. Food products
2. Basic Metals
3. Repair and installation
4. Other transport equipment

Source: Rosstat, R&F calculations.

Other machinery industries, (manufacture of machinery and equipment), as well as electrical equipment also made a positive input to manufacturing performance in June, but a smaller one than the manufacture of electronic products. That said, growth in industries meeting investment demand is hampered by a weak performance of the manufacture of other transport equipment. The output recovery in the manufacture of other transport equipment after the end-2018 slump was interrupted in June by a steep 16.5% MoM fall, despite a continued rise in the manufacture of railway locomotives and rolling stock. This sector's output has already exceeded the level of August last year, which was followed by an output contraction.

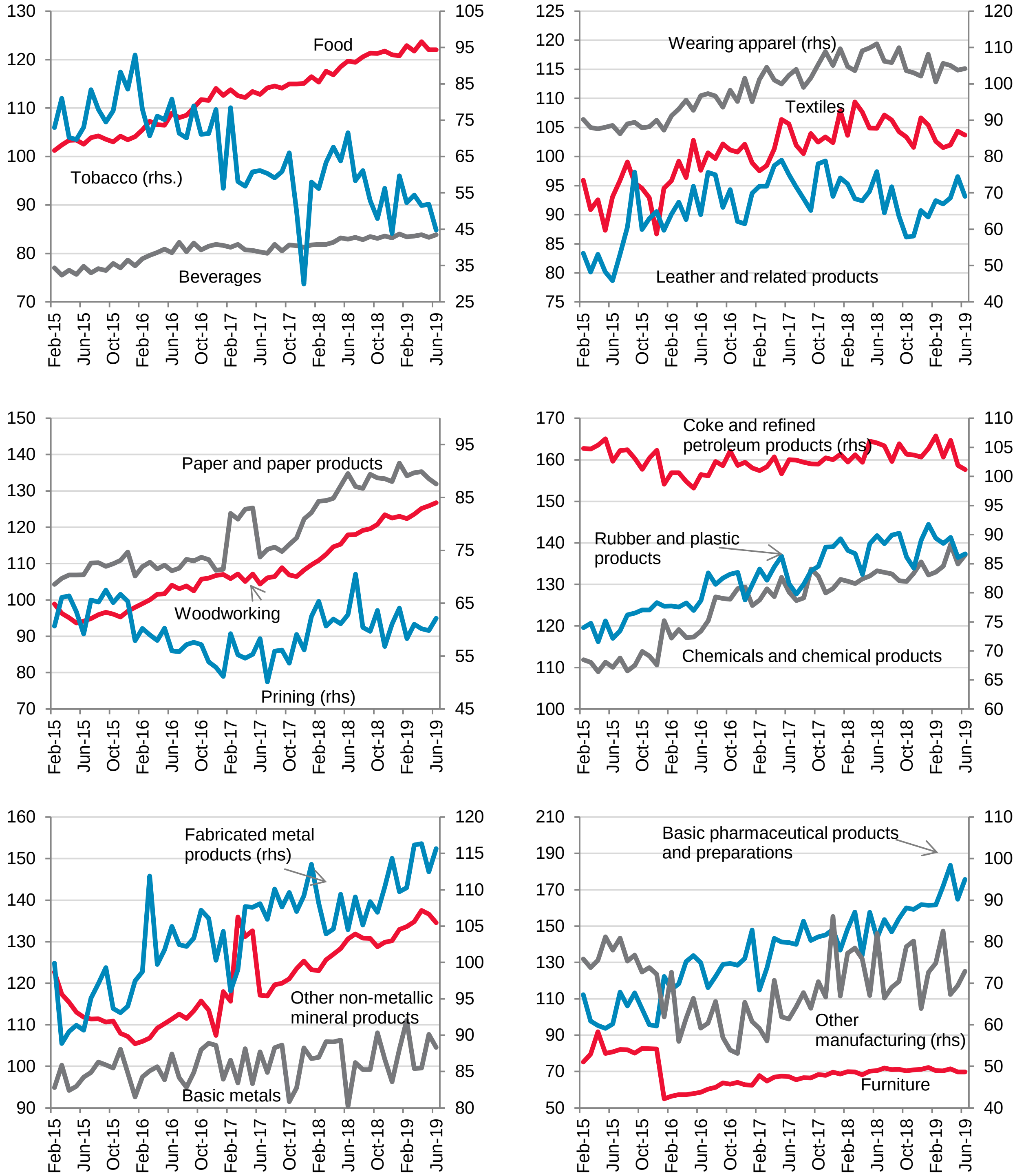
Industries meeting consumer and intermediate demand showed a much weaker performance in June than those meeting investment demand. Output contraction in industries meeting intermediate demand stemmed from, among other things, a drop in the manufacture of refined petroleum products. This decline slowed from -4.1% MoM in May to -0.7% in June, but the restraining effect of the Druzhba oil pipeline underutilization may last for several months.

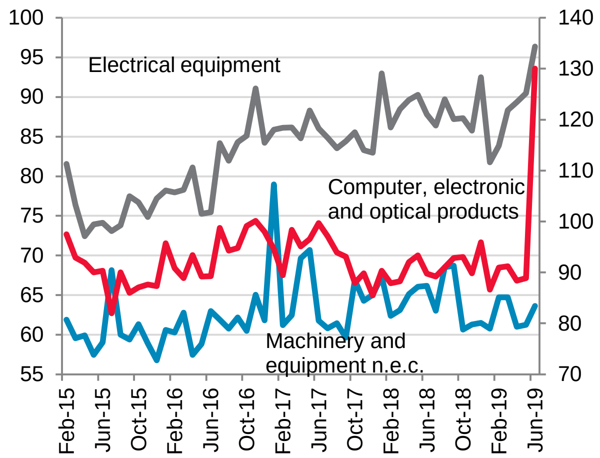
Another major industry, metals manufacture, also posted an output contraction of 2.9% MoM despite a fast annual growth rate of 14.6% YoY on the back of a low base. The metal manufacture's volatile performance is driven by the manufacture of basic non-ferrous and precious metals and nuclear fuel. However, the negative trend that emerged in the manufacture of iron and steel products in recent months continued in June (-0.5% MoM).

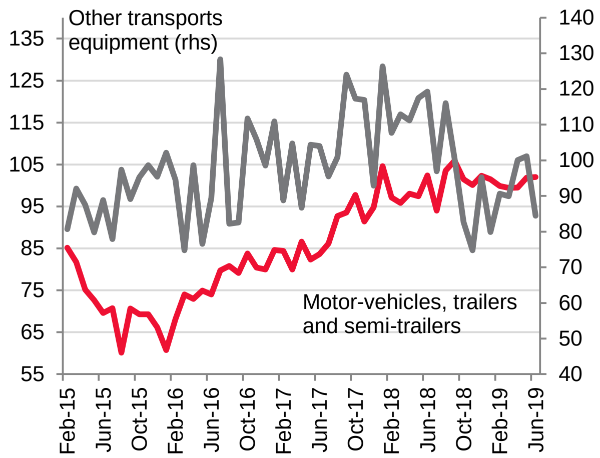
The chemicals industry saw a minor recovery after an output decline in May, joined by the manufacture of rubber and plastic products. The manufacture of wood and of products of wood maintains a positive trend. The manufacture of paper and paper products, by contrast, continued to fall for the second consecutive month.

Industries *meeting consumer demand* showed a weak performance in June. The manufacture of food remained on the previous month's level on the back of a slight 0.2% MoM contraction in meat output. A negative trend continues in the manufacture of wearing apparel and textiles, while the manufacture of furniture and other finished products holds on to a lateral trend. A positive contribution to growth in industries meeting consumer demand came from the manufacture of pharmaceutical products which enjoyed an output expansion of 6% MoM, partially compensating a 10% MoM drop in May.

Figure 25. Manufacturing output (December 2012=100%), SA*







Sources: Rosstat, R&F Department calculations.

1.2.4. June's PMI indexes point to worsening market conditions

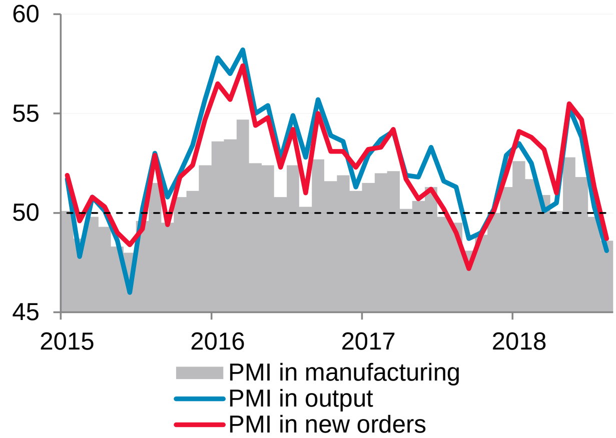
- June's manufacturing PMI again fell below 50 to 48.6, indicating a likely manufacturing growth weakening towards the end of the second quarter.
- The services PMI for the first time since the start of 2016 dropped below a "borderline" reading of 50 to 49.7.
- The composite PMI for Russia pointed to a business activity decline in June, driven by the squeeze of output and new orders in manufacturing and services.

June's manufacturing PMI again came in below 50 at 48.6, thus evidencing a continued contraction of companies' business activity (Figure 26). Manufacturing PMI index deviation downwards from the borderline reading can be regarded as relatively small in magnitude and generally comparable with a survey error. The last point allows one to claim that the manufacturing sector's business activity displays no slowdown trend. Nevertheless, the performance of manufacturing industries continues to be clearly weak.

The negative performance of June's PMI was mostly brought about by output growth cessation and a fall in the number of new orders. The output PMI declined from 50.3 to 48.1, formally the steepest fall since April 2016. The new orders PMI dropped from 51.3 to 48.7, posting the first decline since August 2018. The respondents associate this development with weak domestic and external demand. Employment continued to decline, but not as drastically, the relevant PMI index changed from 47.0 to 49.3.

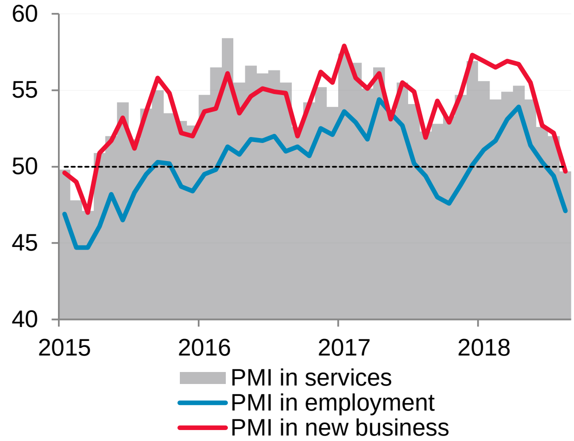
Despite the negative current performance of output and new orders, manufacturing companies generally remain fairly optimistic regarding output growth in 12 months to come: the relevant index came in at 66.7.

Figure 26. Change in PMI manufacturing indexes, pp



Source: IHS Markit.

Figure 27. Change in PMI services indexes, pp



Source: IHS Markit.

The services PMI continued to decline (from 52.0 to 49.7) for the first time since 2016, indicating business activity contraction in services. The respondents attribute this to a drop in new orders (Figure 27). New orders are to a certain extent supported by external demand, since survey data shows a consistent expansion in export orders beginning from April. Against this background, companies for the second month running indicated a job contraction (the employment PMI fell from 49.4 to 47.1, the lowest reading since April 2016. As in manufacturing companies, business expectations, although still high at 66.3, show a downward trend.

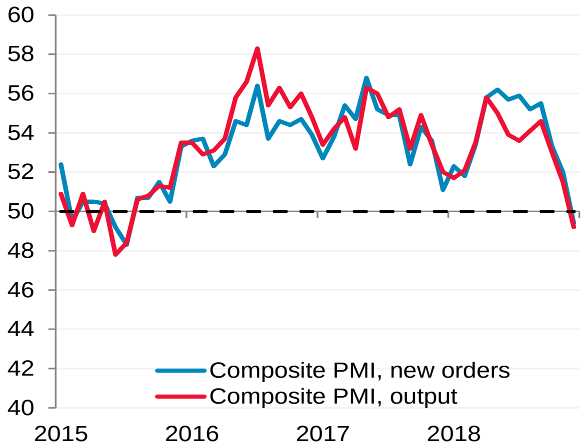
Based on the latest survey data from the manufacturing and services sectors, the composite PMI fell from 51.5 to 49.2 in June (Figure 28). Coupled with other short-term indicators representing the level of business activity, this suggests the Russian economy's growth easing in the first quarter of 2019.

Our estimates show that growth slowdown can only partially stem from slowed growth in China and the euro area – our major trade partners. The long-term correlation between PMI indexes (including with lags) is within the range of 0.2–0.4, which can be viewed as quite moderate. Thus, there should also be other causes behind business activity weakening.

Russian export orders are materially affected by global manufacturing slowdown (Figure 29), aggravated by a number of country-specific negative factors associated with constraints on export deliveries: the Druzhba pipeline, the OPEC+ agreement.

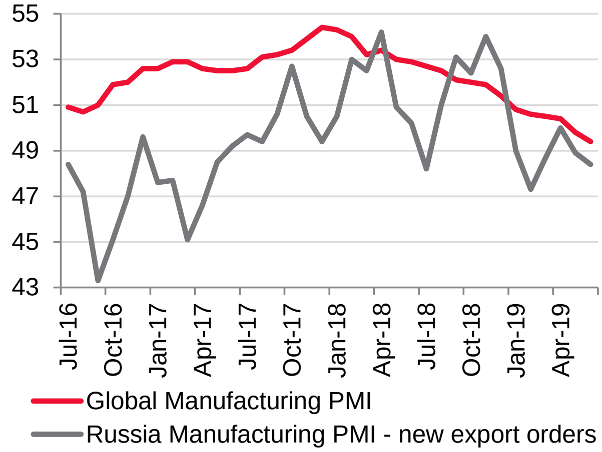
Total demand is meanwhile also weak. June's component of new domestic orders declined below 50 in both manufacturing and services. In addition, the provision of services started to fall (the services PMI dropped below 50 in June), which can be viewed as a proxy variable for domestic demand.

Figure 28. Change in composite PMI indexes for Russia, pp



Source: IHS Markit.

Figure 29. Global PMI index and the new orders component in manufacturing for Russia



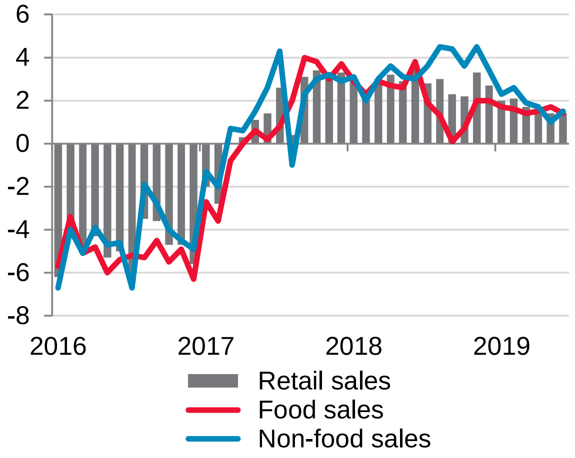
Source: IHS Markit.

1.2.5. Consumption growth accelerated somewhat in 2019Q2

- June saw seasonally adjusted retail sales expansion accelerating, with their annual growth rate stabilising. Retail sales numbers indicate that quarterly seasonally adjusted growth in household consumption gained pace in the second quarter after its easing at the start of the year.
- The softening of consumer lending expansion produces a gradual credit impulse reduction: it may come close to zero towards the year end. Nevertheless, some improvement in the pace of household income growth along with the expected inflation deceleration should support a rise in consumption.
- Consumer sentiment started to recover in the second quarter, indirectly corroborating the temporary nature of consumption growth easing in the first quarter.

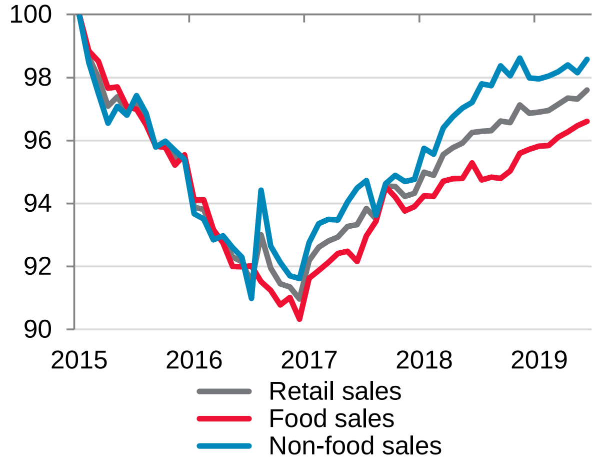
According to Rosstat data, the pace of retail sales expansion remained unchanged from May at 1.4% (Figure 30). The rates of food and non-food sales growth became practically equal at 1.4% YoY and 1.5% YoY, respectively. That said, the former segment suffered growth softening from 1.7% in May, while the latter enjoyed acceleration from 1.0% YoY. The World Cup sparked food sales growth acceleration in June 2018, therefore the current slowdown in food segment growth may have stemmed from the high base of last year.

Figure 30. Change in retail sales of food and non-food goods and retail sales turnover, % YoY



Source: Rosstat.

Figure 31. Change in retail sales turnover, % (January 2015 = 100%, SA)

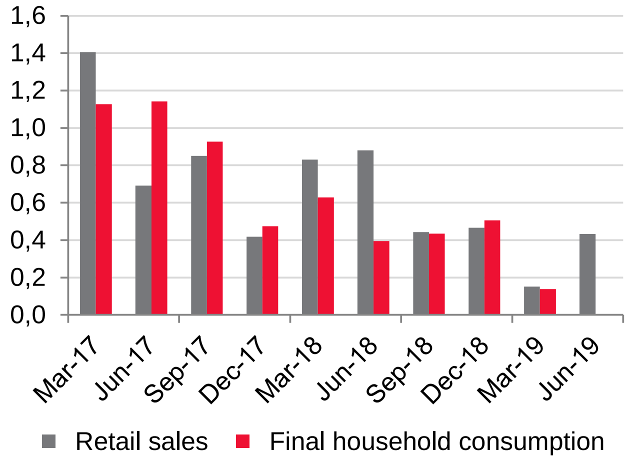


Source: Rosstat, R&F Department calculations.

Seasonally adjusted monthly numbers indicate a retail sales growth of 0.3% MoM, with food and non-food retail sales rising 0.1% MoM and 0.4% MoM, respectively. The weak performance of non-food retail sales in June somewhat recovered, though, thanks to an acceleration in monthly passenger car sales growth (in seasonally adjusted terms).

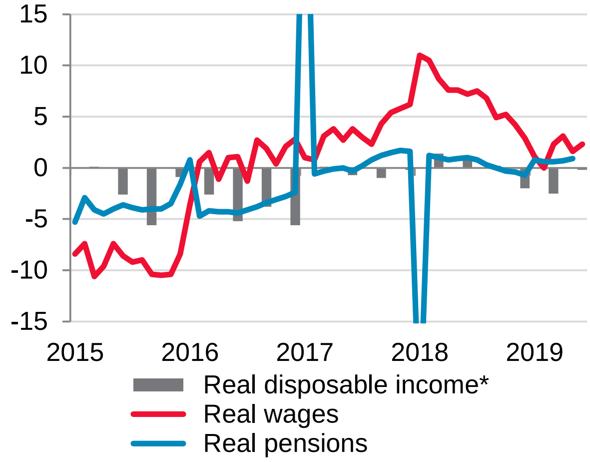
Seasonally adjusted retail sales expansion accelerated to 0.45% QoQ in the second quarter from 0.15% QoQ, suggesting also an acceleration in household final consumption expenditure growth in the second quarter (Figure 32).

Figure 32. Change in retail sales turnover and final household consumption, % QoQ SA



Source: Rosstat, R&F Department calculations.

Figure 33. Change in real household income, % YoY



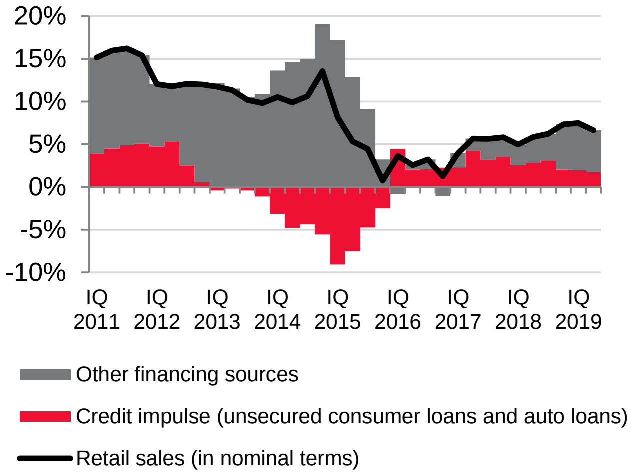
Source: Rosstat, R&F Department calculations.

** Calculation based on the new methodology taking into account the one-off payment in January 2017.*

The faster pace of wage growth in the second quarter improved household income performance. Real disposable income declined 0.2% YoY after a 2.5% YoY drop in the first quarter (Figure 33). June saw continued retail lending growth weakening, with its credit impulse[15] continuing to decline in the second quarter (Figure 34). The importance of this factor on consumption may be compensated by other factors, particularly, growth in household income.

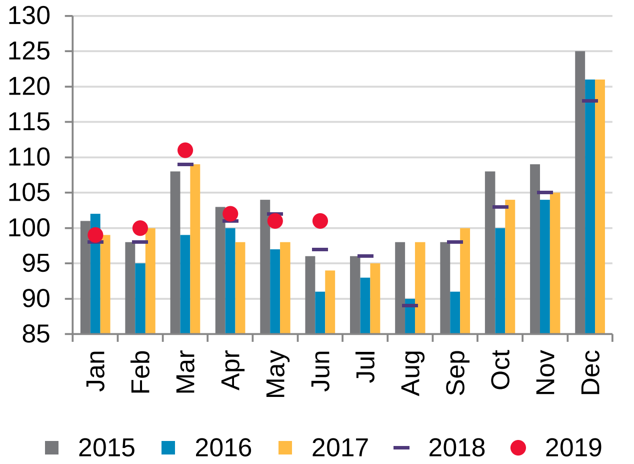
Data from Romir research holding company[16] points to an improvement in real everyday expenditure performance. Contrary to the usual seasonal pattern, it stayed on May's level in June, the highest for this month in recent years (Figure 35).

Figure 34. Retail sales growth and quarterly credit impulse, % YoY



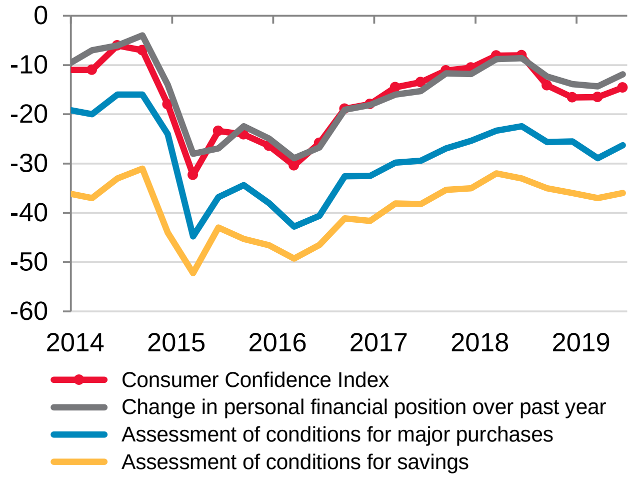
Source: Rosstat, Bank of Russia, R&F Deparment estimates.

Figure 35. Real everyday household expenditure, % (2012 median = 100%)



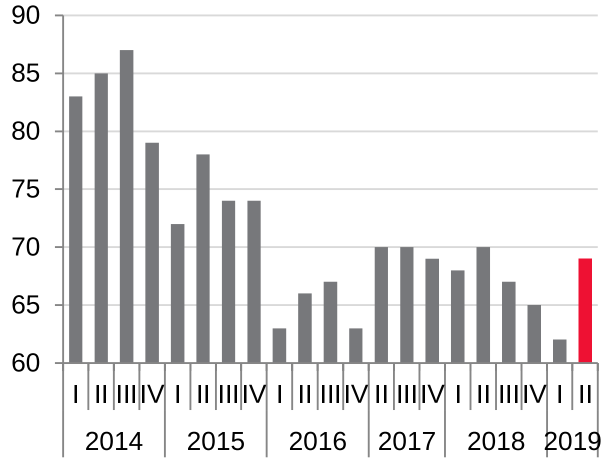
Source: Romir.

Figure 36. Rosstat Consumer Confidence Index and its components



Source: Rosstat, R&F Department calculations.

Figure 37. Nielsen Consumer Confidence Index*



Source: Nielsen.

** Number above 100 indicates the prevalence of optimists in the country, below 100 – the prevalence of pessimists, 100 indicates an equilibrium between upbeat and downbeat expectations for the future.*

[15] Credit impulse – change in lending expansion in absolute terms (second derivative of the lending growth rate).
[16] June's nontypical expenditure growth. Romir research holding company. July 10, 2019.

Household consumer sentiment starts to recover gradually, as suggested by survey data from Rosstat and Nielsen.[17] The second quarter Rosstat Consumer Confidence Index rose 2 pps on the first quarter (Figure 36). All the components of the index enjoyed growth. The assessment by respondents of their current financial position and whether conditions were good for major purchases showed the strongest growth. The Nielsen Consumer Confidence Index also increased 7 points owing to consumers' better assessment of their wealth and willingness to spend their spare cash (Figure 37).

1.2.6. Car demand gradually recovers after a fall

- June saw a fall in demand for new cars slowing in annual terms, while in monthly terms seasonally adjusted sales growth accelerated in both the mass market and premium segments.
- May's production of passenger cars rose 2.4% MoM in seasonally adjusted terms.
- External demand for passenger cars is rising (up 29.6% YoY in May), providing support to the market amid weak domestic demand. Imports are also recovering relative to last year (a rise of 0.5% YoY).
- The pace of consumer price rises for new cars continued to decline in June. The rate of price rises in the new domestic car category stood below headline inflation for the second month running in June.

Based on data from the Association of European Business (AEB), sales of new passenger cars and light commercial vehicles again suffered a YoY fall in June (-3.3% YoY) (Figure 38). Demand dropped 2.4% YoY over the first six months of 2019, prompting many analysts and market participants to revise their forecasts and have even stronger doubts regarding positive results for the year.

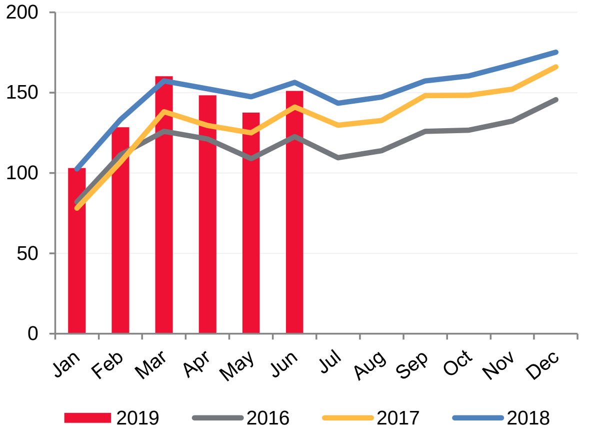
Monthly sales numbers are, however, gradually improving in seasonally adjusted terms. The market even enjoys a minor sales growth acceleration, climbing 0.7% MoM in June after a 0.3% MoM rise in May. Sales growth is seen in both the mass market and premium segments in June (Figure 39) although premium car sales showed a sustainable negative trend from the start of the year, whereas mass market car sales are more stable. In the previous months, demand for this car category had been propped up by subsidised auto loan programs, funding for which had been practically exhausted by May. The number of auto loans extended in that month fell 0.1% YoY based on National Bureau of Credit Histories data. Programs to support demand are to be resumed starting from July, which may buttress sales.

Passenger car output added 2.4% MoM, in seasonally adjusted terms in May, rising 2.1% YoY for the first five months of 2019. In July, the major automaker AVTOVAZ announced a

[17] Consumer Confidence Index embarks on a steady growth path. Nielsen. July 8, 2019.
The index reflects current sentiment and expectations of "online population" and is made up of three components: assessment by consumers of labor market prospects within the next 6 months, the level of their personal financial wealth within the next 6 months and their willingness to spend money at the moment.

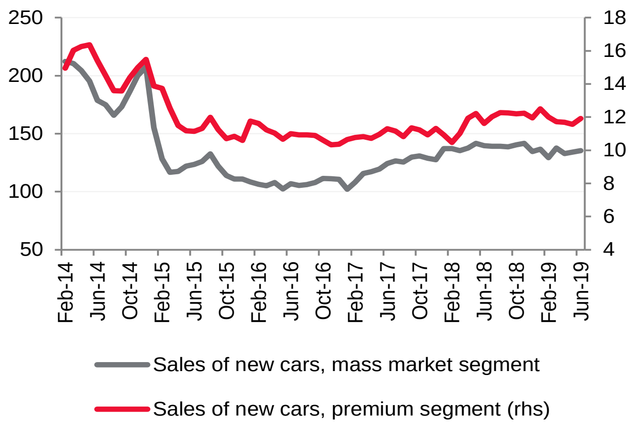
production suspension from July 3 to July 5 on account of component delivery problems. Although this company's share in the total car output is substantial at about 35%, this situation is unlikely to have a significant impact on manufacturing output for July.

Figure 38. Sales of new passenger and light commercial vehicles, thousand units



Source: AEB, R&F Department calculations.

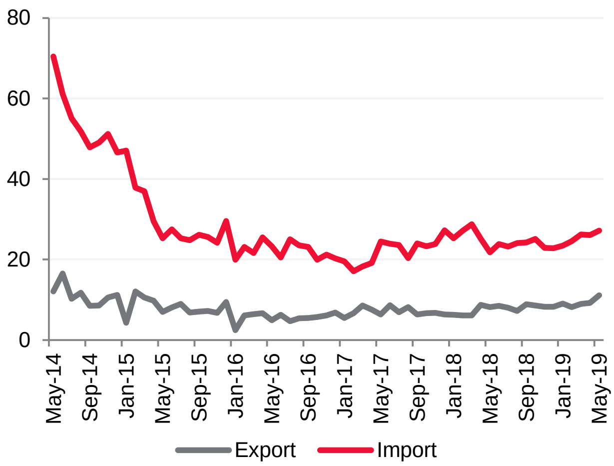
Figure 39. Sales of passenger cars, seasonally adjusted, thousand units



Source: AEB, R&F Department calculations.

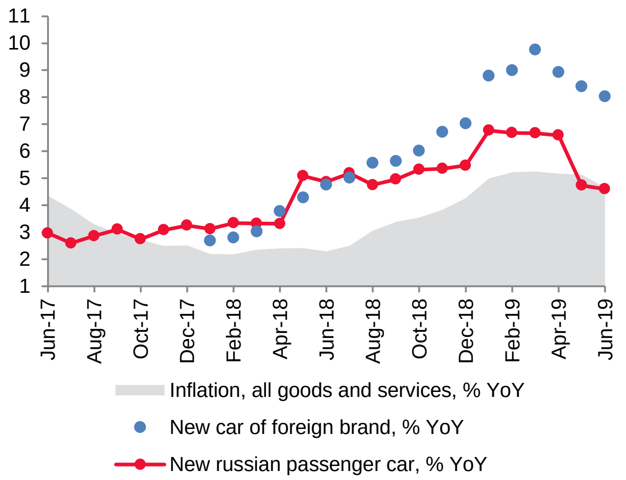
Amid slackening domestic demand, the market is enjoying support from external demand (Figure 40). Based on Federal Customs Service data, car exports expanded substantially in physical terms by 20.8% MoM SA in May, while annual export growth stood at almost 30% YoY. Exports to both non-CIS and CIS countries are rising, with sales to the former growing 38.9% YoY in January–May and deliveries to the latter increasing 26.9% YoY. Non-CIS countries account for about 30% of total auto exports, of which 13% go to Latvia and the Czech Republic. In future, Russian car exports to EU countries may be restricted on account of rising environmental requirements for autos imported to the European Union.

Figure 40. New passenger car exports and imports, seasonally adjusted, thousand units



Source: R&F Department estimates, Federal Customs Service.

Figure 41. Inflation rate and the pace of consumer price rises for new cars, % YoY



Source: R&F Department estimates, Rosstat.

New car imports climbed 4.2% MoM SA in May (Figure 40). As a result, imports reached positive territory for the first five months of the year, posting a rise of 0.5% YoY.

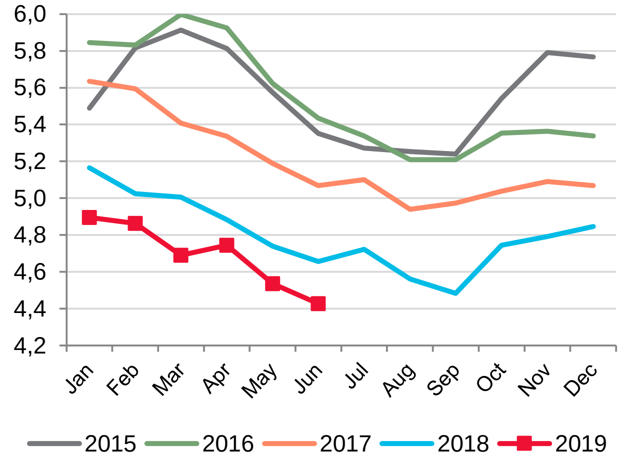
Rises in consumer prices of new cars again slowed in June – to 4.6% YoY for domestic cars and to 8.03% YoY for foreign brands (Figure 41). The maintenance of competitive price advantage for domestic cars is probably required to uphold weak demand.

1.2.7. The labor market remains a source of medium-term risks for growth and inflation

- The unemployment rate and unemployment headcount continue to hit all-time lows. Simultaneously, change in the population's demographic structure drastically reduces the employment numbers.
- This situation points to risks for both further economic growth and inflation in the medium term. Given low unemployment, it will be difficult for employers to hire new workers for production expansion, while strengthening competition for workers may spark wage growth acceleration.
- Wage growth, however, so far remains moderate and does not generate significant inflationary risks.

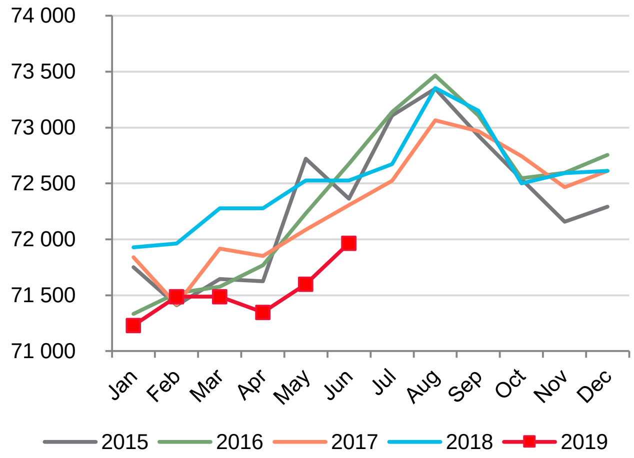
June's unemployment headcount fell below 3.3 million, the lowest level in the entire history of observations. This unemployment headcount fall had an effect on the unemployment rate, which reached an all-time low of 4.4% (Figure 42). The seasonally adjusted number, however, remained unchanged at 4.6% practically throughout the first half of 2019.

Figure 42. The unemployment rate by year, %



Source: Rosstat.

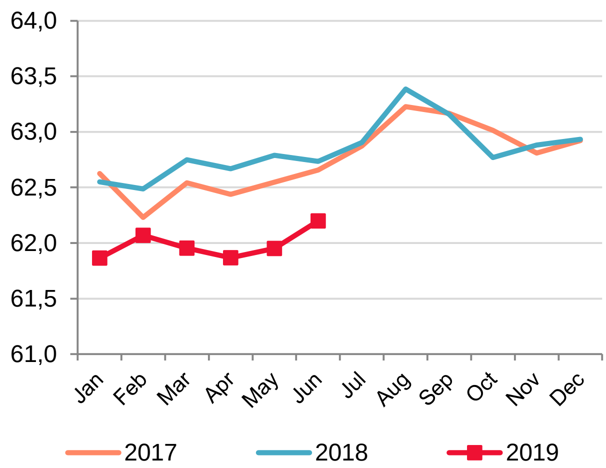
Figure 43. Employment, thousand people



Source: Rosstat.

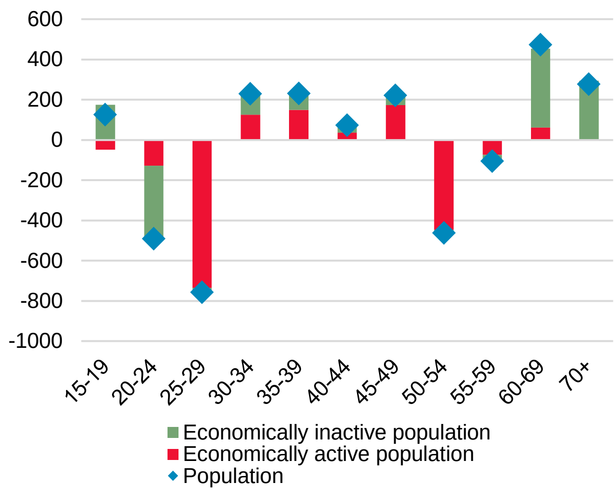
Demographic changes have a significant effect on the labor market situation. Unemployment headcount declines along with the employment numbers and the labor force participation rate (Figure 46, Figure 44). At the same time, we can see no substantial change in the economic activity levels across age groups this year.[18] This means that the decline in the labor force participation along with employment and unemployment headcounts stems mainly from change in the population's age structure. The year 2019 sees a rapid decline in the 25–29 and 50–54 age groups, followed by a labor force contraction in these groups (Figure 45). Meanwhile, a significant rise in the number of people aged older than 60 is accompanied by just a minor increase in the employment numbers among them. Alternative data sources confirm diminishing demand for labor in recent month. Based on the HeadHunter internet resource, demand for employees keeps falling for the second consecutive month: the number of vacancies dropped 7.0% YoY in June (Figure 46).

Figure 44. Labor force participation, %



Source: Rosstat.

Figure 45. Population change by age group in Q1 2019, YOY, thousand



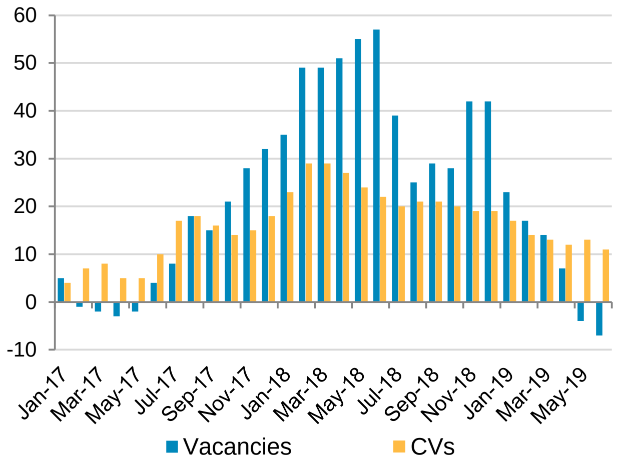
Source: Rosstat, R&F Department estimates.

This decline may arise from a high base effect: last year it was June that saw the number of vacancies rise at the fastest pace. Still, the trend remains negative. IHS Markit survey data also indicates a weaker demand for labor. Companies continued to slash employment in both manufacturing and services in June with both indexes below 50 (Figure 47). The services sector suffered the fastest employment reduction since April 2016 (the relevant index stood at 47.1). The fall in the survey-based employment indicator is likely to have been caused by weak domestic demand and export decline.

The current labor market situation generates risks for further economic growth and inflation. If the greater part of workers leave the market for good (for example, by deciding to retire finally), then, as economic growth accelerates gradually, employers will have trouble expanding personnel amid a record low unemployment headcount. This will restrain their production expansion potential. Moreover, strengthening of competition for employees amid the low unemployment rate may trigger wage growth acceleration, generating inflationary risks.

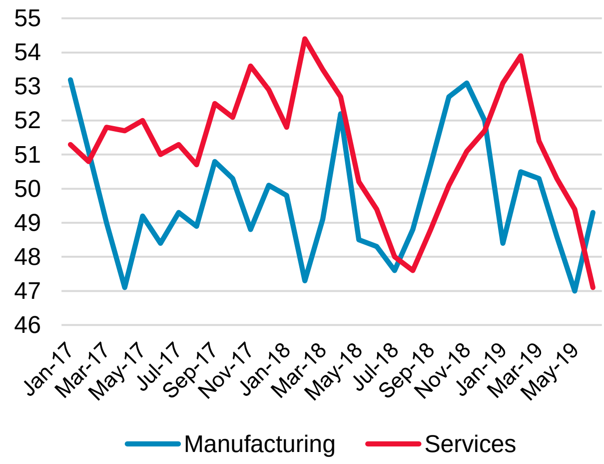
[18] Detailed labor market statistics are now only available for the first quarter. The second quarter labor survey data will be released on August 29.

Figure 46. Growth in the number of vacancies and CVs, % YoY



Source: HeadHunter.

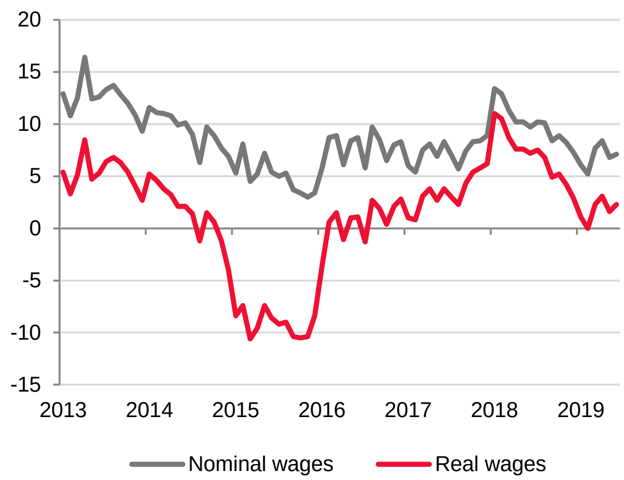
Figure 47. PMI employment indexes



Source: Bloomberg Finance L.P.

But so far wages grow at a moderate pace notwithstanding the shrinking employment headcount. Rosstat has revised its real wage growth estimate down for May to 1.6% YoY from the initial estimate of 2.8% YoY (Figure 48). Wage growth accelerated to 2.3% YoY in June according to a preliminary estimate.

Figure 48. Wage growth rate, % YoY



Source: Rosstat.

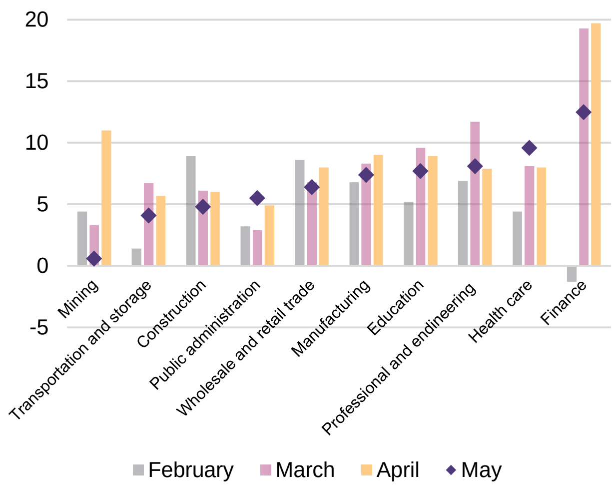
Private sector wages rose 6.5% for May, while the public sector posted a 7.7% YoY growth (Figure 50). Wage growth was weaker in May than in April in practically all private sector industries. The slowest pace of wage rises in May was posted in two industries: mining and the financial sector. An explanation is that the rate of wage increase was uncharacteristically high for these industries in April (Figure 49). The financial sector, for example, saw an elevated rate of wage growth, fuelled by asset management, where wages climbed 6.5 times.[19] In mining, wage growth dropped to practically zero in May after a significant acceleration in April.

[19] This growth rate was only posted in the Kemerovo region.

The “noise” in the growth rates most probably arises from the payment of various bonuses. Wage growth in industries employing the majority of private sector workers (trade, construction, and manufacturing) has been more stable in recent months.

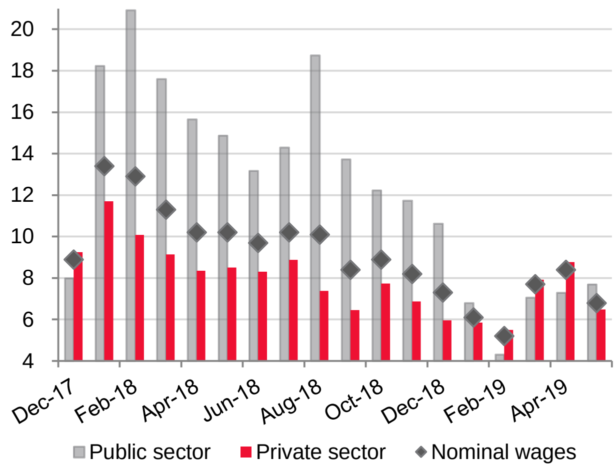
The public sector, by contrast, enjoyed some wage growth acceleration, driven primarily by the health care service. Public sector wages increased 9.6% YoY in May. This may stem from the commitment to maintain the wages of some public sector employee categories on a certain level relative to a particular region’s average in the coming years.

Figure 49. Wage growth by industry, % YoY



Source: Rosstat.

Figure 50. Rate of nominal wage growth in private and public sectors, % YoY



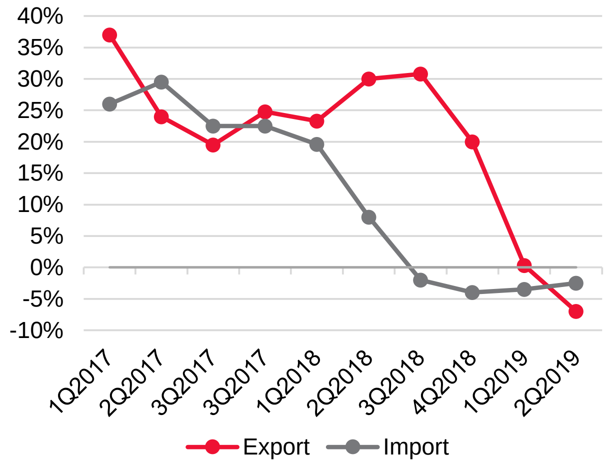
Source: Rosstat, R&F Department estimates.

1.2.8. Balance of payments in 2019Q2: trade balance weakening

- The current account surplus suffered a notable YoY shrinkage to USD 12.1 billion in the second quarter.
- The current account surplus decline arose primarily from a fall in the deliveries of practically all key types of exports due to both price movements and external demand contraction (especially as Chinese imports dwindle).
- The performance of both consumer and investment goods imports remains weak.
- Smaller foreign currency inflows to the current account were accompanied by a dramatic narrowing of banks and companies’ financial account deficit to -3.4 USD billion.
- Foreign direct investment inflows to the nonfinancial sector plunged to USD +2 billion from USD +9.6 billion in the first quarter of 2019.
- The inflow of nonresidents’ funds to government securities expanded to USD 10.5 billion in the second quarter of 2019. Going forward, inflows this big are unlikely to continue.

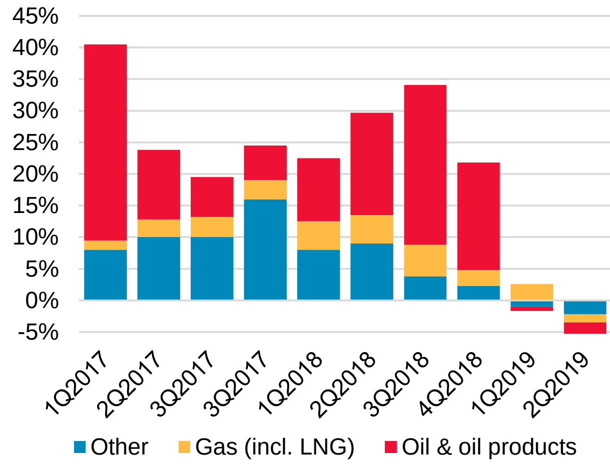
The recent balance of payments data suggests a number of trends. *First,* this is a narrow account surplus stemming from a drastic fall in demand for Russian exports. *Second,* continued contraction in both consumer and investment goods exports notwithstanding quite favourable ruble exchange rate movements and support from seasonal factors. *Third,* modest foreign direct investment inflows after their surge in the first quarter of 2019. Finally, strong inflows of nonresidents' funds to government securities, which, if weakens, may entail a negative correction in other financial account items.

Figure 51. Export and import volumes growth, % YoY



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

Figure 52. Contributions of components to the export volumes growth, % YoY



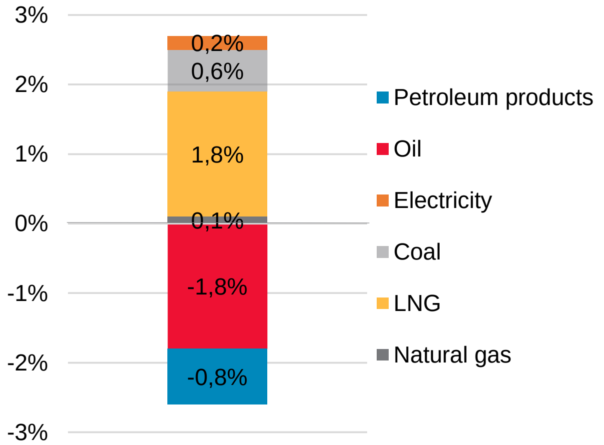
Source: Bank of Russia, R&F Department estimates.

The current account surplus was much lower at USD 12.1 billion in the second quarter of 2019 than a year earlier (USD 17.9 billion) and in the first quarter of 2019 (33.7 billion dollars), including in seasonally adjusted terms. This arose from a plunge in deliveries of the key export categories both in terms of value and in physical terms (Figure 52–Figure 54). Exports fell both quarter-on-quarter and year-on-year in the second quarter by 0.9% QoQ and 6.8% QoQ, respectively.

This export contraction was to a great degree driven by the global economy's slowdown and an import fall in China. Also, exports are adversely affected by oil production limits imposed under the December OPEC+ agreement. Additional pressure came from the Druzhba oil pipeline problems. On top of that, prices of metals and chemicals have fallen, entailing a contraction in the export of these categories in physical terms.

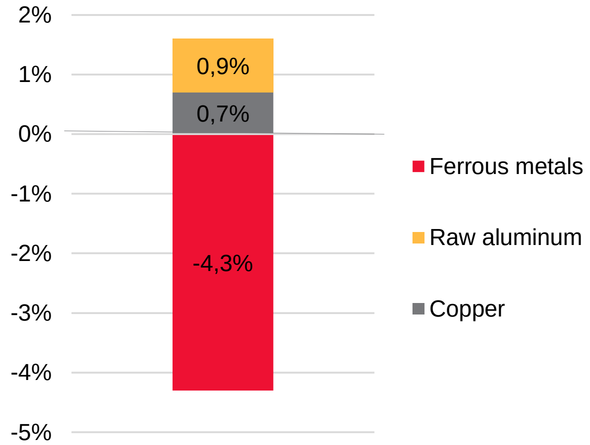
Weak import performance failed to make up for this downturn. Imports recovered expectedly to USD 61.7 billion in the second quarter of 2019 from a seasonally low level of USD 55.6 billion in the first quarter. Import expansion was only posted in quarter-on-quarter terms, whereas the year-on-year slide continued: -2.7% YoY versus -3.3% YoY in the first quarter. Both consumer and investment import segments suffered a decline. The negative input continues to come from a fall in machinery and equipment imports, slackening food imports, and poor performance of chemical products. One should also note stagnation and decline in the import of key consumer goods, including wearing apparel and footwear, detergents and cleaning solutions, etc.

Figure 53. Contributions of commodity groups to mineral product exports in physical terms, January–May 2019, % YoY



Source: Rosstat, R&F Department estimates.

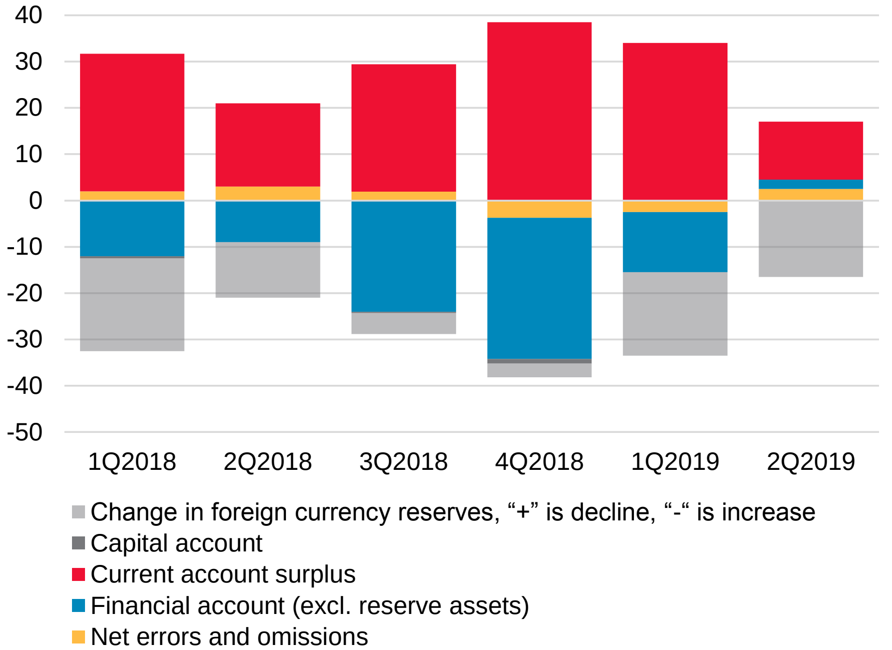
Figure 54. Contributions of commodity groups to the export of metals and fabricated metal products in physical terms. January–May 2019, % YoY



Source: Rosstat, R&F Department estimates.

In the absence of notable ruble appreciation as well as domestic and external demand recovery, it would be logical to assume that a significant current account surplus recovery is hardly to be expected in the months to come: negative price movements continue in many export items, external demand estimates remain relatively low under pressure from import decline in China. The expected implementation of government investment projects should partly support imports, with improved demand for investment goods imports restraining an improvement in the trade and current account surpluses.

Figure 55. Balance of payments components, USD billion



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

The banking sector's forex liquidity situation remained favourable despite the dwindling current account surplus. Indirect evidence of this is provided by an increase in banks' repayment of their external liabilities to USD 7.4 billion in the second quarter of 2019 from USD 3.2 billion in the first quarter. Banks also expanded their foreign liabilities abroad in that period.

As regards companies, other sectors showed no foreign asset expansion trend, in the second quarter. Meanwhile, there was an increase in debt on "other liabilities". What is noteworthy, though, is low foreign direct investment inflows to the corporate sector. They stood at just +2 billion dollars in the second quarter versus +9.6 billion dollars in the first quarter of 2019. Foreign direct investment via ownership stakes, however, remained low in both first and second quarters.

Although financial account components showed mixed trends, the deficit of the private sector's financial account stood at just USD 3.4 billion in the second quarter after USD 23.9 billion in the first quarter. Given the concurrent strong inflows of nonresidents' funds to government securities, this produced a small net financial account surplus of USD 1.9 billion. Net secondary market transactions with nonresidents (mostly in OFZ bonds) rose to USD 10.5 billion from USD 5 billion in the first quarter of 2019. International reserves added USD 16.6 billion, thus absorbing the entire forex inflows to the current account. Practically all of this sum represents foreign currency purchases on behalf of the Finance Ministry under the fiscal rule (just below USD 18.6 billion in the first quarter).

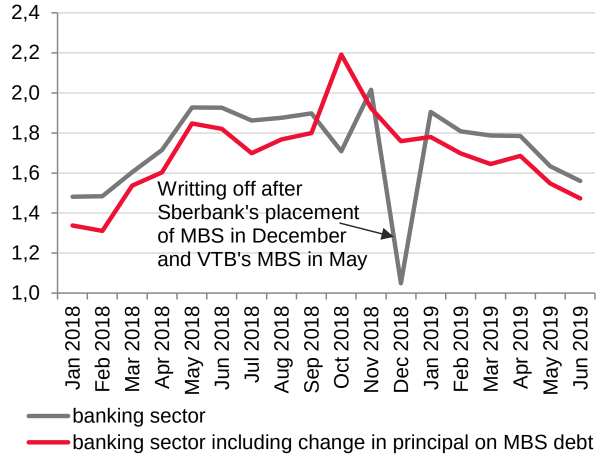
1.2.9. Annual corporate debt expansion at its highest

- Retail lending expansion continued to slow in all market segments, except for auto loans.
- Meanwhile, annual corporate lending growth reached the highest rate in the current phase of portfolio expansion.
- Banks continue their additional provisioning as net interest income growth keeps slowing.

A slight deceleration of retail lending expansion continued in June. According to banking sector statistics, the pace of retail lending growth fell from 1.63% MoM to 1.56% MoM in seasonally adjusted terms (Figure 56, slowing from 23.7% YoY to 23.1%[20] in annual terms. An absolute increase in the banking sector's retail lending portfolio stood marginally lower than last year's (Figure 57).

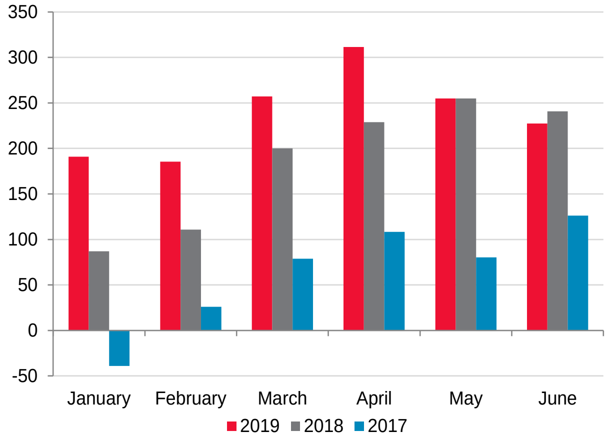
[20] Here and further on in the section, annual growth rates were calculated excluding credit organizations whose licenses were withdrawn and no impact of forex revaluation taken into account.

Figure 56. Retail lending expansion, seasonally adjusted, % MoM



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

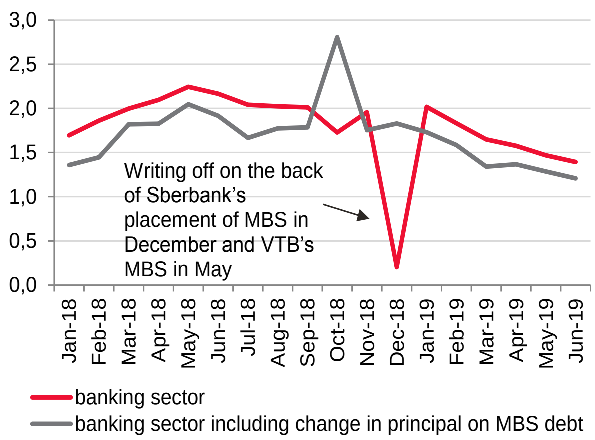
Figure 57. Monthly growth in retail loan portfolio, billion rubles



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

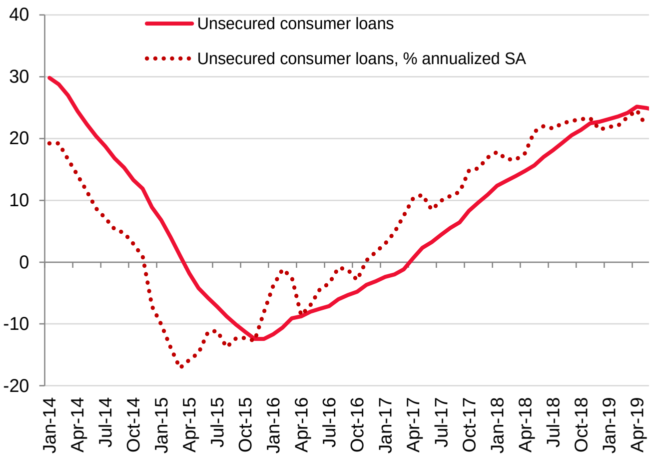
All major segments in the retail lending structure are suffering continued slowdown. Mortgage lending growth weakened to 1.4% MoM in June and to 1.2% MoM with principal on MBS taken into account (Figure 58), lagging growth in the overall retail lending portfolio. Annual expansion in unsecured consumer lending continued easing. Monthly seasonally adjusted lending growth also declines gradually, prompting expectations of a further annual growth slowdown.

Figure 58. Mortgage lending growth, seasonally adjusted, % MoM



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

Figure 59. Unsecured consumer lending growth, %

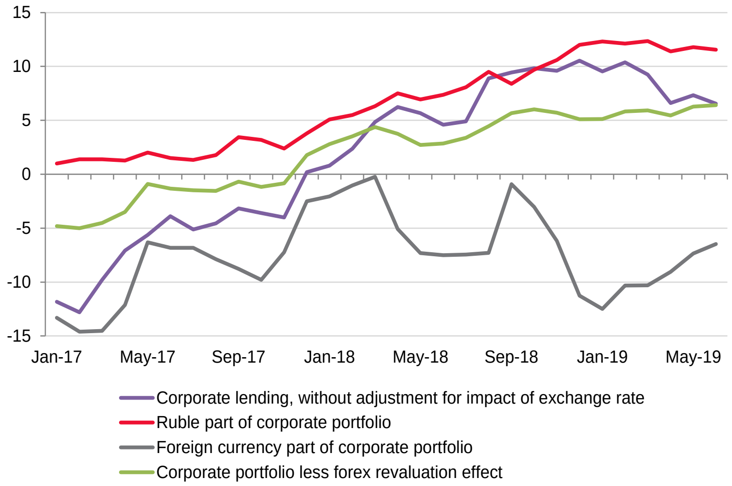


Source: Bank of Russia, R&F Department estimates.

Corporate lending practically replicated May's growth rate (about 0.55% MoM, seasonally adjusted) thanks to a minor rise in the forex part of the portfolio. We note that overall, corporate lending showed slower growth rates from month to month in the second quarter than in the first quarter for both the ruble part of the portfolio and total debt (adjusted for forex revaluation).

Foreign-currency corporate lending contracted since the start of the year to fall 6.4% YoY in June after declining 7.3% YoY in May. Seasonally adjusted ruble lending expansion slowed from 0.8% MoM to 0.6% MoM. Annual growth in this part of the portfolio eased from 12.4% YoY to 12.1% YoY. Total corporate debt growth adjusted for forex revaluation stood at 6.8% YoY after 6.7% YoY in May, reaching the highest level in the current phase of corporate loan portfolio expansion (Figure 60). This suggests that the current monetary conditions help corporate lending growth.

Figure 60. Corporate lending growth in nominal terms (without adjustment for banks whose licenses were withdrawn), % YoY



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

Banks earned 418 billion rubles of profit in the second quarter of 2019, down from 587 billion rubles in the first quarter. The banking sector's net total of additional loan loss provisions equalled 375 billion rubles in the second quarter (there was a net release of provisions for a total of 106 billion rubles in the first quarter of 2019 following adjusting entries under IFRS-9). That said, unlike the first quarter of 2019, the positive sum of adjusting entries[21] did not compensate for setting aside additional provisions in the second quarter and had a much less significant effect on the banking sector's profit. As a result, additional provisions were a factor of profit decline in the second quarter of 2019 (Figure 61).

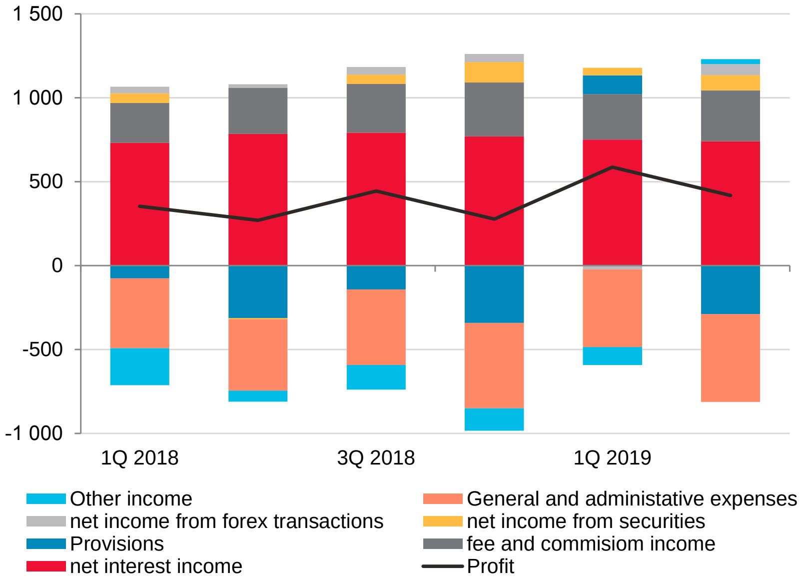
Net interest income (NII) continued its slide in the second quarter of 2019, both quarter-on-quarter (to 740 billion rubles from 752 billion rubles in the first quarter) and year-on-year (785 billion rubles a year earlier), driven chiefly by an interest income decline, even though a change in loan interest rates was insignificant. A possible explanation is that loans issued two-three years ago at higher than current interest rates have been paid off and left banks' income base. Also, a lower NII than a quarter earlier may partly stem from some banks' practice of understating the true loan value (in an attempt to alleviate a burden on capital) and

[21] As part of IFRS-9 adoption, banks now must account for some assets at fair value and release excess provisions set aside previously. This was the key factor behind the downward adjustments to loan loss provisions, which enabled the current profit size to increase by 360 billion rubles in the first quarter, thus exceeding by about 240 billion rubles the effect of setting aside loan loss provisions under conventional mechanisms of worsening the loan portfolio quality, which amounted to 240 billion rubles.

compensating for this understatement by increasing commissions and other charges. In this manner, fees and commissions income rose in the second quarter of 2019 amid the unsecured consumer lending boom. Also, the Bank of Russia yet again raised risk coefficients for such loans as of April 1, which may have boosted this trend.

Going forward, NII performance will be driven by two different factors. On the one hand, the recent key interest rate cuts should push NII down. On the other hand, the replacement (over the first and second quarters of 2019) of loans by new ones extended at higher rates should start making itself felt.

Figure 61. Factors of profit generation, billion rubles



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

Banking sector profit in the first half of 2019

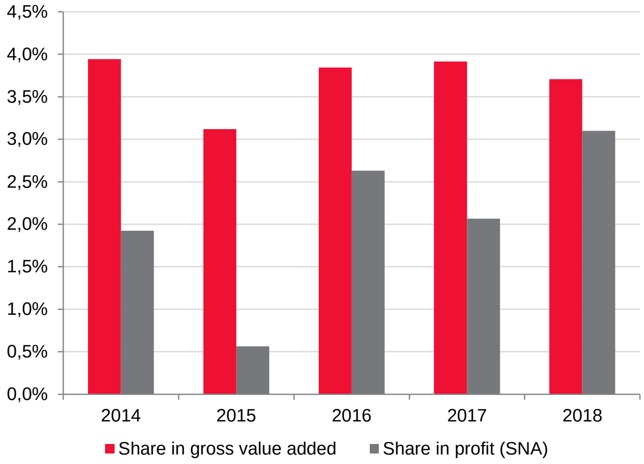
The banking sector's profit totalled over 1 trillion rubles in the first half of this year, up from 634 billion rubles in January–June 2018. Nevertheless, the current amount of profit does not look overabundant.

The share of banks in gross profit under the System of National Accounts is comparable with their share in value added (Figure 62). This means that a rise in the banking sector's profit does not restrain profit growth in other sectors of the economy. Moreover, on top of generating value added in the banking sector, banks indirectly help create value added in the economy via financial intermediation.

Profit is the key source of banks' recapitalization in Russia. Profit dynamics are extremely procyclical, i.e. it grows faster than in the economy's other sectors in the growth phase and also falls faster – in the periods of downturn. Meanwhile, banks need to meet capital adequacy ratios to maintain financial stability, including in crisis periods. Banks should therefore accumulate a capital cushion to keep afloat in hard times (Figure 63).

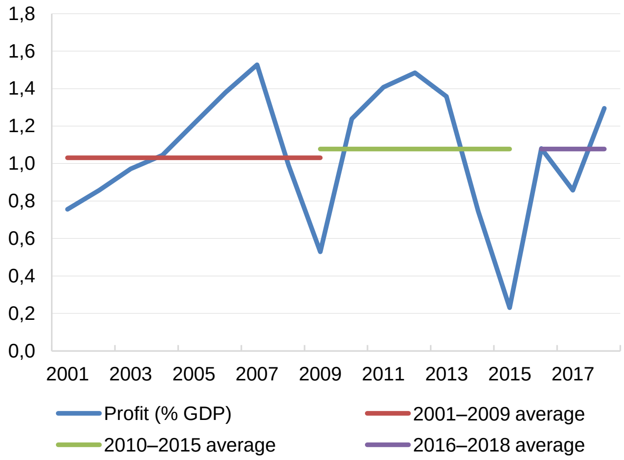
Also, lending expansion requires banks to create capital. In this sense, the banking sector's ability to generate profit is key to lending growth. For example, to maintain the N1.0 capital requirement on its current level,[22] a 10% (about 5 trillion ruble) expansion in nonfinancial organizations' and household loan portfolio requires a capital rise (i.e. profit generation) of 0.6 trillion rubles, at a rough estimate. One, however, has to bear in mind that banks pay dividends (thus diminishing profit which can otherwise be used for increasing capital) and build up other assets, which also requires capital.

Figure 62. The banking sector's share in value added and profit, %



Source: Rosstat.

Figure 63. The banking sector's profit, % GDP



Source: Rosstat, R&F Department estimates.

A part of profit growth arose from one-off technical factors this year, the banking sector's adoption of IFRS-9 among them. Banks now must account for some assets at fair value and release excess provisions set aside earlier. This was the key factor behind downward adjustments to loan loss provisions, which helped increase current profit by 357 billion rubles but were partially offset by setting aside provisions associated with the traditional channel of provisions growth for a growing portfolio. These adjustments totaled just 68 billion rubles in the second quarter.

[22] 12,1% as of 01.06.2019.

2. OUTLOOK: LEADING INDICATORS

2.1 What do Russian leading indicators suggest?

2.1.1. GDP Nowcast: economic growth remained below potential in 2019Q2

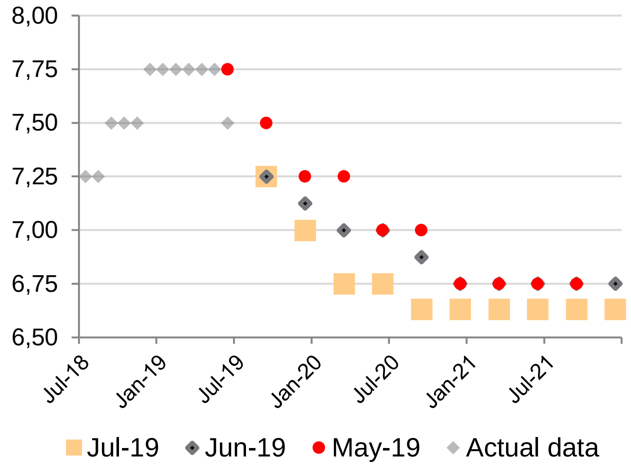
- Based on statistics releasedby July 18, the GDP estimate for 2019Q2 was revised down to 0.1–0.2% QoQ SA. Quarterly growth isthus expected to stay in positive territory, remaining, however below potential.
- As short-term statistics were released over April–June, we consistently reduced our GDP nowcast for the second quarter. This means that recent months' macro data was generally below model expectations at the start of 2019.
- We should, however, note that our GDP estimates constructed using the DFM model may fail to fully capture temporary factors which predetermine the current growth slowdown (in particular, the negative effect of the VAT hike and the significantly lagging financing of budget expenditure compared with the usual seasonal pattern) or may capture them with a slight lag.
- We continue to expect gradual GDP growth acceleration in the second half of 2019. The economy is expected to grow at a rate of 0.3% QoQ SA in 2019Q3 and 2019Q4, which is close to potential. A faster GDP growth is also not unlikely, since the model may fail to fully capture the expected positive turnaround of temporary factors which used to be negative and restrained growth in the first half of the year.
- The estimates of quarterly GDP growth presented below expect GDP growth for the full-year 2019 close to the lower bound of a Bank of Russia forecast range of 1.0–1.5%.

	July **% QoQ SA**	June % к/к SA
Q2 2019	**0.1–0.2**	0.2–0.3
Q3 2019	**0.3**	0.3
Q4 2019	**0.3**	0.4

2.1.2. Bloomberg consensus: transition to neutral monetary policy expected at the start of 2020

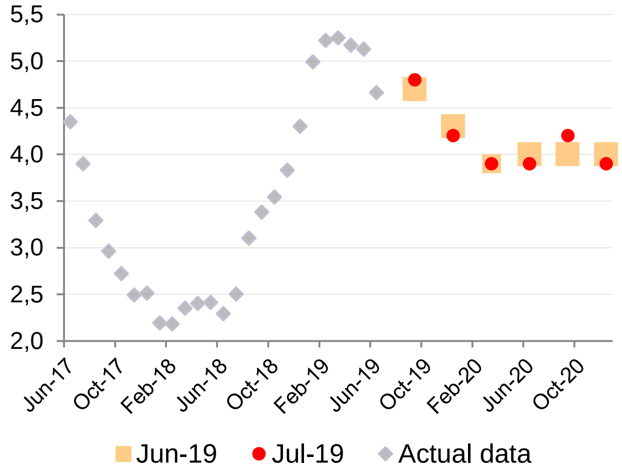
- Analyst key rate expectations for 2019-2020 continued declining (Figure 64). Dovish signals following the June meeting played a key role in this.
- We believe that the new consensus forecast trajectory takes into account the July 26 Bank of Russia Board meeting, which cut the rate to 7.25% p.a., although the survey was conducted before the meeting. An explanation is that the overwhelming majority of analysts had expected the rate to be cut. The current consensus expects the rate to be cut by another 25 b.p. before the end of the year and for it to move to the range of the current "neutral" rate estimates at the start of 2020.
- Inflation forecast has remained practically unchanged (Figure 65). Analyst consensus forecast for end 2019 stands at 4.2% – at the lower bound of a Bank of Russia forecast range of 4.2–4.7%. Analysts' medium-term expectations remain anchored at 4%.

Figure 64. Analyst expectations for Bank of Russia key rate, % per annum



Source: Bloomberg Finance L.P.

Figure 65. Analyst inflation expectations, % YoY



Source: Bloomberg Finance L.P.

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