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Economy and markets

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JULY 2020

CONTENTS

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EXECUTIVE SUMMARY

- Disinflationary factors arising from, above all, a drop in demand continue to prevail in the Russian economy. Despite this, annual inflation expectedly inched up in June, given a very slow pace of price rises in June last year. The recovery of economic activity is gradual, helping maintain disinflationary pressure in the economy. Relative stability and rebounding oil prices alco contribute to this.
    - The current pace of consumer price inflation and slow demand recovery indicate that the balance of risks leans towards disinflationary factors. We expect that in the second half of the year monthly seasonally adjusted consumer price rises will stay somewhat below the level required for annual inflation to stabilise at 4%. At the same time, fiscal stimulus and monetary easing will counter the strengthening of disinflationary trends in the Russian economy. As a result, inflation will stabilise close to the target in 2021.
    - The continuing gradual lifting of coronavirus-related restrictions helps the recovery of economic activity in Russia. This process is, however, gradual and non-uniform. The impact of some coronavirus-related restrictions is extended over time both globally and in Russia. Changes in consumers and businesses' behaviour towards the use of online formats and the remote work regime are taking hold, requiring many business models to be changed in some services sector industries and trade. The persistent supply-side shocks and structural changes in demand cause the potential GDP level to slide in the global and Russian economies alike. All other things being equal, this means that fiscal and monetary stimulus will bring the economy back to potential, with inflation stabilising at the Bank of Russia's target faster than in the absence of this impact on potential
    - The situation in the Russian financial market remained generally stable in June, helped by a further rebound of oil prices. There were no significant risks to the stability of Russian financial markets and financial institutions.

1. Inflation

Inflation slightly accelerated in June after a short pause in May. This acceleration was, however, all driven by a statistical effect since the low numbers of June–December last year exited the calculation of inflation. Overall, the balance of risks, however, still leans towards disinflationary factors. That said, movements in the prices of various categories of goods and services were mixed in June, depending on a combination of demand- and supply-side factors, in particular, current consumer preferences and restrictions on economic activity, some of which were still in place.

Fiscal stimulus and soft monetary policy will counter the current disinflationary trends in the Russian economy.

1.1. Prevalence of disinflationary factors

- May–June saw seasonally adjusted consumer price inflation below 4% in annualised terms. Meanwhile, the impact of a large number of oppositely directed factors on current price movements makes it difficult to estimate inflationary pressure net of one-off and temporary factors.
- Annual inflation accelerated to 3.21% in June from 3.02% in May. The monthly pace of price rises deviated downwards from the path corresponding to an inflation rate of 4% in annualised terms (3.03% SAAR[1]). At the same time, seasonally adjusted price rises in food and non-food goods exceeded 4% in annualised terms in June.
- The estimates of modified core inflation indicators inched up to 0.34% (4.12% SAAR) from 0.32% (3.91% SAAR) in May.
- Prices went up 0.28% in the first six days of July. The weekly inflation acceleration was chiefly driven by the planned indexation of housing and utility services prices as of July 1. Given the low base of the second half of 2019, the estimate of inflation increased to 3.3% in annualised terms.

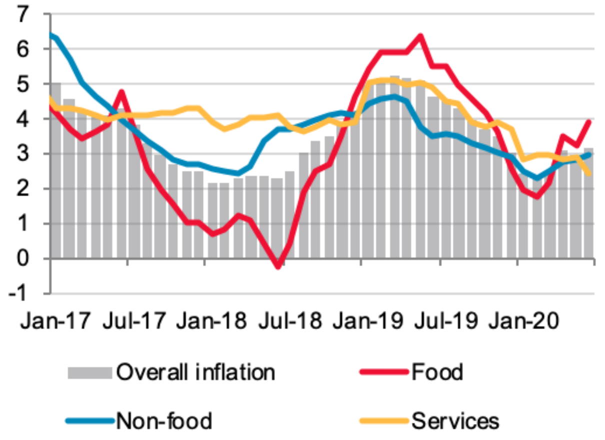
According to Rosstat data, annual inflation stood at 3.21% in June, up from 3.02% in May (Figure 1), restrained chiefly by services prices, whose growth slowed to 2.46% YoY in June from 3.02% YoY in May. The pace of food and non-food price rises, meanwhile, accelerated to 3.94% YoY and 3.01% YoY respectively from 3.26% YoY and 2.84% YoY in May.

Consumer prices went up 0.22% MoM in June (Figure 2). According to our estimate, seasonally adjusted inflation stood at 0.25% MoM in June (3.03% SAAR), down from 0.29% MoM (3.57% SAAR) in May (Figure 3). As a result, the monthly rate of price rises deviated downward from the path corresponding to an inflation rate of 4% in annualised terms. At the

[1] SAAR – seasonally adjusted, annualised.

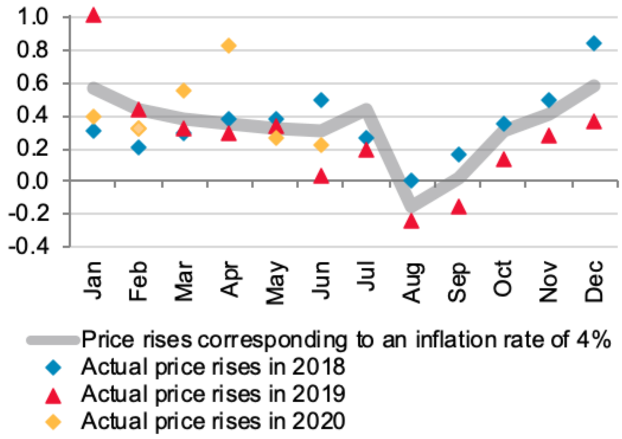
same time, the seasonally adjusted rate of food and non-food price rises exceeded 4% in annualised terms in June.

Figure 1. Inflation and its components, % YoY



Source: Rosstat.

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



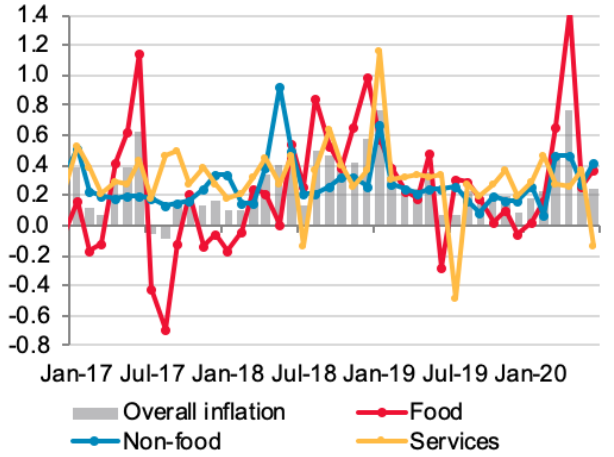
Source: Rosstat, R&F Department estimates.

Seasonally adjusted food price rises accelerated to 0.38% MoM in June from 0.25% MoM in May, mostly on the back of a slower fruit and vegetable price decline of 0.3% MoM in June after a 1.7% MoM fall in May. Net of fruit and vegetables, the seasonally adjusted rate of food price growth remained almost unchanged at 0.47% MoM in June after 0.50% MoM in May. Monthly price movements in individual food items were mixed.

The seasonally adjusted pace of non-food price rises accelerated to 0.41% MoM in June after 0.28% MoM in May, largely driven by a petrol price increase of 0.8% MoM. Petrol and diesel prices went up in June following a wholesale price hike prompted by rising demand for motor fuel as coronavirus-related restrictions were eased (Figure 4). Meanwhile, supply is limited in the Russian market due to a decline in petroleum refining output following oil extraction cuts and a shutdown of some oil refineries for maintenance. As a result, wholesale (exchange) petrol prices came close to their all-time highs, staying above a netback export price (with the damper mechanism effect taken into account). The potential of a further petrol price increase is limited by the damper mechanism, which reduces domestic price fluctuations in response to changes in world prices, preventing domestic prices from rising above the inflation target. Seasonally adjusted non-food price growth, exclusive of motor fuel, stood at 0.33% in June, remaining almost unchanged from May. As in the food segment, price movements were mixed in individual groups of non-food goods. The seasonally adjusted pace of price increases for wearing apparel and footwear, electrical goods and other household appliances accelerated, with price rises slowing (or price decline accelerating) in television and radio goods, construction materials and health care goods.

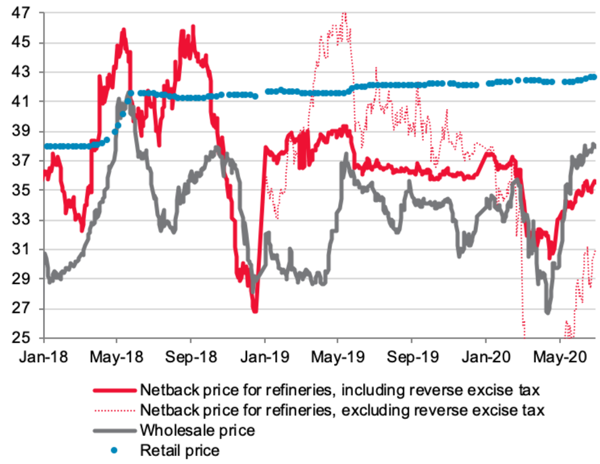
Services prices declined 0.14% MoM in seasonally adjusted terms in June after their 0.38% MoM rise in May. A significant and mixed effect on services prices continues to arise from coronavirus-related restrictions: in some sectors they have already been lifted or eased substantially, remaining, however, as strict and massive as previously in others. For example, a seasonally adjusted price decline in services was helped by slack price movements in health resort and foreign tourism services. Actual health services prices rose but less than seasonally normal, therefore seasonally adjusted price decline in these services has continued for the third consecutive month, equalling -1.25% MoM in June. Prices have not been registered in the foreign tourism sector for the third consecutive month, since foreign travel is effectively closed. This is tantamount to unchanged seasonally unadjusted prices. But foreign travel prices usually rise in June, therefore, in seasonally adjusted terms, these prices fell 1.55% MoM. At the same time, June saw personal services price rises accelerate to 0.35% MoM in seasonally adjusted terms, at the fastest rate since January 2019, which may have stemmed from the opening of a considerable part of this services sector in most regions and a demand upturn. A rise in health care prices has also gained momentum.

Figure 3. Seasonally adjusted inflation, % MoM



Source: Rosstat, R&F Department estimates.

Figure 4. Prices of AI-92 petrol, rouble/litre

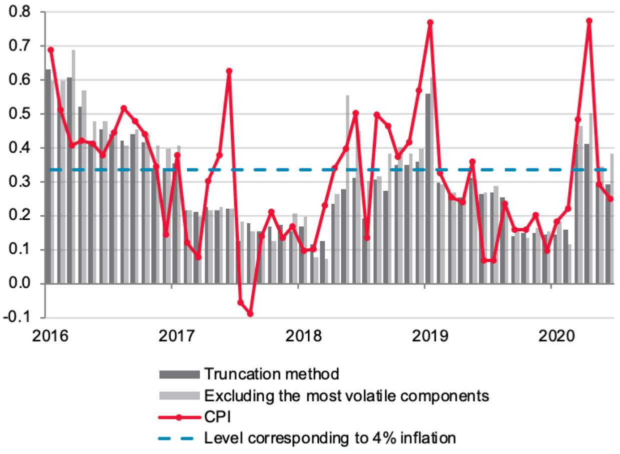


Source: St Petersburg Commodity Exchange, Rosstat, R&F Department estimates.

The mean of modified core inflation indicators stood at 0.34% MoM (4.12% SAAR) in June after 0.32% MoM (3.91% SAAR) in May (Figure 5). Still, given an effect of a wide range of oppositely directed factors on price rises, the June estimate of modified core inflation indicators is subject to high uncertainty.

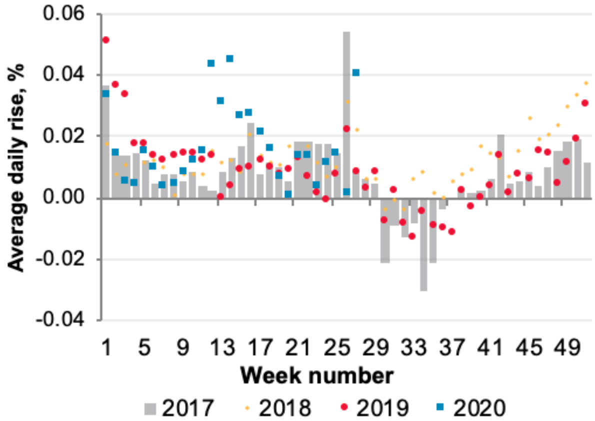
Seasonally adjusted consumer price inflation stood below 4% in annualised terms in May–June. Price movements were driven by a large number of oppositely directed factors which arose from uneven adaptation of goods and services markets to the gradual lifting of restrictions, opening of shops, stabilisation of supply chains. The impact of a broad spectrum of temporary pro-inflationary and disinflationary factors makes it difficult to estimate fundamental inflationary pressure in the Russian economy.

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.

Real-time Rosstat data indicates that consumer prices rose 0.28% in the first six days of July (Figure 6). Housing and utility services prices were traditionally indexed as of July 1. These prices are supposed to increase by an average of 4%[2] in Russia as of July 1. At the start of July, housing and utility services prices went up 3.1%. This is in line with by ZhKKh Kontrol[3] monitoring data, which suggests that the pandemic has made some of Russian regions postpone indexation originally planned for July, raising prices of some housing and utility services less than planned or leaving them unchanged. Therefore, housing and utility services price indexation can be moved to August or September.

1.2. Producer price decline gained momentum in May

- A producer price decline accelerated to 14.1% YoY in May from 10.4% YoY in April (Figure 7). As in the previous month, the relevant index continues to be dragged down primarily by a price decline in mining and quarrying, which accelerated to 46.7% YoY in May from 34.7% YoY in April.
- May saw a price decline continue in oil and gas extraction (Figure 9). Domestic prices respond to world price changes with a one-two month lag. Therefore, the producer price decrease will likely start to slow in June, reflecting the rebound of world oil prices which started as early as the end of April.
- Manufacturing producer prices dropped 3.8% YoY in May, an acceleration from a 3.3% YoY fall in April. We estimate that the rate of producer price rises in many consumer

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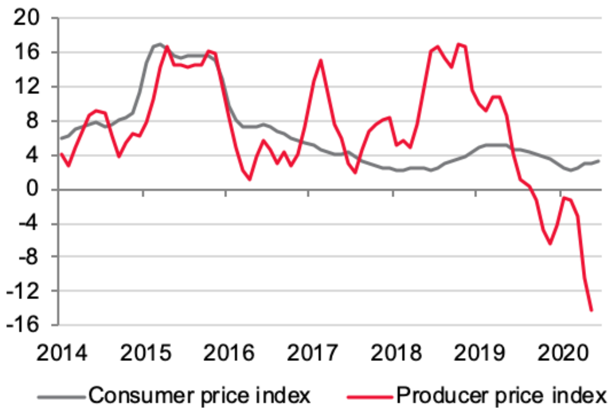
[2] Housing and utility services price indexation was implemented in two stages in 2019: by 1.7% as of January 1 and by 2.4% as of July 1.

[3] [Monitoring: Which regions will cancel or postpone housing and utilities services price hikes from July 1, 2020](#) / Non-profit Partnership ZhKKh Kontrol / 09.06.2020.

goods is close to zero (Figure 8). This suggests the absence of significant upward pressure on inflation from producer prices.

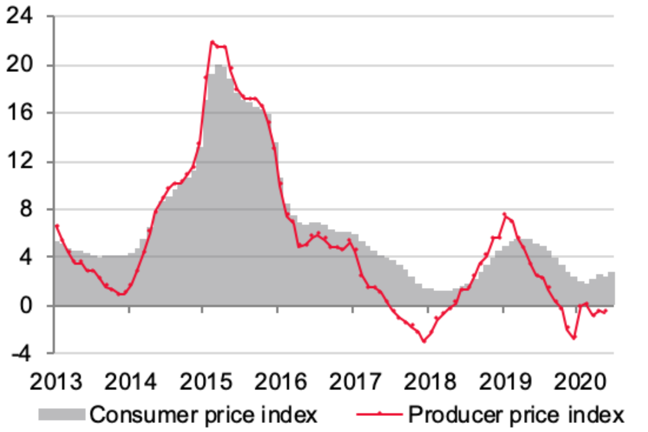
Manufacturing producer prices dropped 3.8% YoY in May, an acceleration from a 3.3% YoY fall in April. We estimate that the rate of producer price rises in many consumer goods is close to zero (Figure 8). This suggests the absence of significant upward pressure on inflation from producer prices.

Figure 7. Change in the producer price index and consumer price index, % YoY



Source: Rosstat.

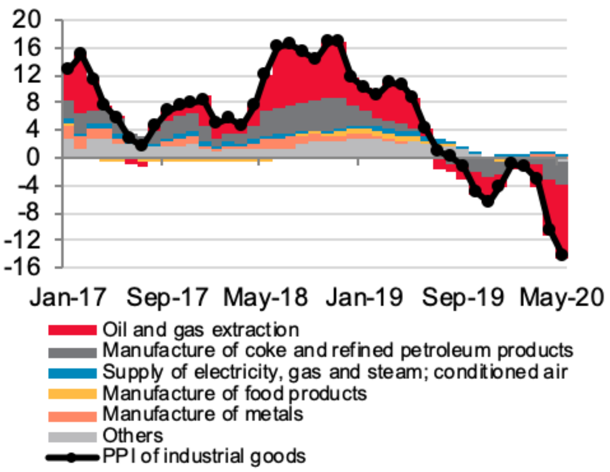
Figure 8. Change in prices of some goods[4], % YoY



Source: Rosstat, R&F Department estimates.

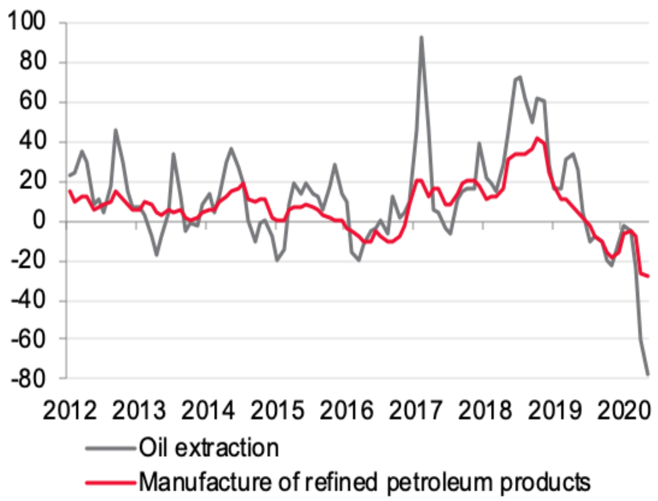
Under Rosstat methodology, the calculation of the producer price indicator excludes VAT, and therefore, does not factor in the impact of the January 2019 VAT hike on producer prices.

Figure 9. Input of top 5 industries to a rise in producer prices of industrial goods, % YoY



Source: Rosstat, R&F Department estimates

Figure 10. Producer price index in oil extraction and petroleum refining, % YoY



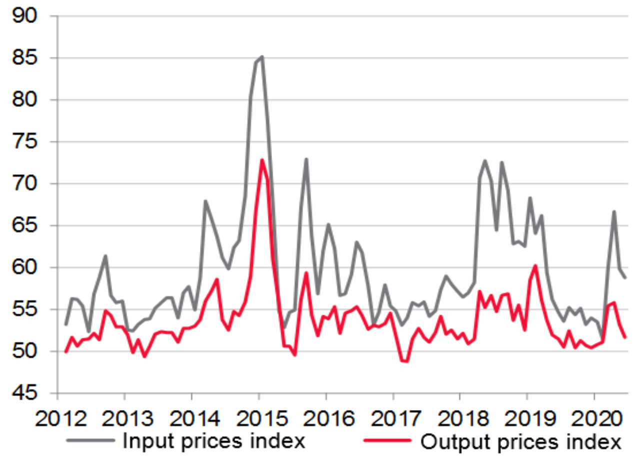
Source: Rosstat.

[4] The calculation used comparable goods in the CPI and PPI structure: meat products, fish products, butter and fats, dairy products, pasta, sugar, tea, coffee, wearing apparel, footwear, detergents and cleaning solutions, perfumery and cosmetic products, household electronic appliances, furniture. They account for about 30% of the consumer basket.

1.3. PMI price indexes in June: further output price decline in services sector

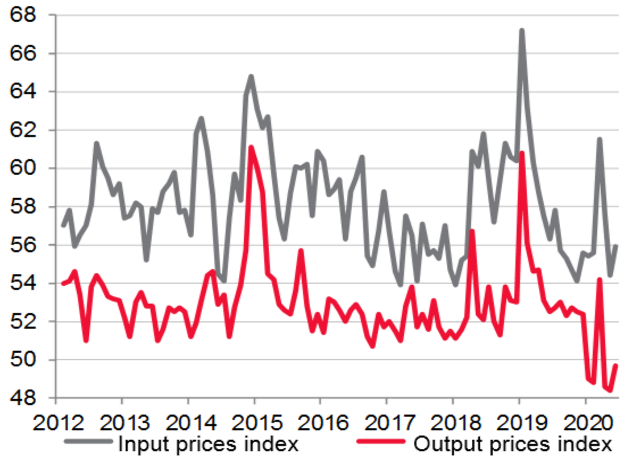
- Changes in PMI price indexes suggest that inflationary pressure continues to attenuate in manufacturing after a surge in March and April driven by temporary pro-inflationary factors, such as ruble weakening and disruption of supply chains triggered by coronavirus-related restrictions. The index of input prices in manufacturing industries declined to 58.8 from 59.8 in May, remaining, however, elevated relative to the start of the year. The index of output prices is sliding faster, dropping to 51.6 in June from 53.2 in May (Figure 11). The respondents report an extensive use of discounts for retaining customers.
- In the services sector, price indexes have, by contrast, edged up but remain close to all-time lows. The input price index climbed to 55.9 from 54.5 as demand recovered. Meanwhile, the output price index has stayed below 50 for the third month running (it went up to 49.7 in June from 48.4 in May). This signals the sector's continued price decline which companies rely on in an attempt to retain existing customers and attract new ones despite rising costs.

Figure 11. Change in PMI manufacturing indexes, pp



Source: IHS Markit.

Figure 12. Change in PMI services indexes, pp



Source: IHS Markit.

2. Economic performance

In May, the Russian economy passed a trough of the downturn triggered by the negative effects of the pandemic. As part of the coronavirus-related restrictions were lifted, some industries saw the start of recovery as early as May, but the slump in the oil sector outweighed the effect of this growth on the economy at large. It appears from the leading indicators that recovery growth gained pace in June and the beginning of July, especially in the services sector and retail.

The secondary effects of full or partial shutdown of businesses and a fall in final demand are still extending to related industries via production chains. The long-term changes in the structure of demand are hampering production potential, especially in the services sector and SME. Oil extraction and refining remain depressed. All this makes the process of further recovery gradual, protracted and uneven across the sectors of the Russian economy. With demand remaining depressed, disinflationary trends are set to prevail.

2.1. Real-time indicators point to economic activity recovery in June – early July

- Real-time indicators suggest the recovery of economic activity in Russia as coronavirus-related restrictions ease or are lifted. At the start and in the middle of June, business activity stabilised at as depressed a level as in May, but beginning from the last ten days of June it has shown clear signs of growth.
- Consumption remains the key recovery engine: the opening of non-food retail and a significant part of the services sector has boosted demand, due to, among other things, purchases deferred while restrictions were in place and the scaling up of budget expenditure as part of measures to support the economy and households. Further consumption trajectory will to a greater extent depend on the trends of labour income, which has plunged in recent months.
- In the face of the global economic downturn, external demand is expanding much more slowly than domestic demand. Uncertainty about further changes in demand for Russian exports remains high, given the risks of a second wave of the coronavirus infection in some countries, fraught with the reinstatement of restrictions.

Short-term Rosstat statistics for May released in the second half of June confirmed the accuracy of real-time indicators. Economic activity picked up in May relative to April (exclusive of mining and quarrying) but remained depressed, with the oil sector, which sharply cut oil extraction in compliance with the OPEC+ deal, expectedly weighing down on overall economic performance.

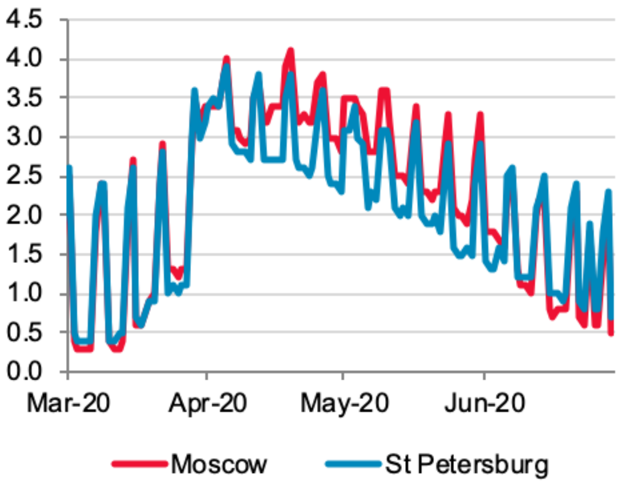
An array of real-time indicators suggests that economic activity was, overall, gradually improving in June. This was evidenced by more than a few real-time indicators reflecting industry-specific financial flows, electricity consumption and consumer activity. A business activity upturn is in large part owed to the easing of coronavirus-related restrictions in Russian regions, including those where restrictions were the most stringent and long-lasting (above all, the metropolitan region). We estimate that a contraction in incoming payments effected through the Bank of Russia's payment system (weighted by relevant industries' shares in GDP) slowed to 4.1% YoY in June from 12.8% YoY in April.[5] That said, exclusive of mining and quarrying, petroleum refining, and public administration, payments added 2.1% YoY in June after a 7.3% YoY fall in May. At the end of June, incoming payments for the first time since the introduction of the "day-off" regime at the end of March, exceeded the "normal" level. [6]

Consumer activity enjoys the fastest pace of recovery. The lifting of restrictions and people's return to work in large cities have brought up the intensity of intracity travel close to the "pre-coronavirus" levels (Figure 13, Figure 14). Moreover, the opening of non-food retail and a part of the services sector has helped demand recover in these segments. The average downward deviation of incoming payments from the "normal" level in industries meeting consumer demand equalled just 1.1% from June 1 to July 3 versus 3.3% in May and 20.2% in April. Continued consumption growth is also evidenced by other real-time indicators constructed using data from banks' payment systems (Figure 17, Figure 18). The consumption recovery this extensive may be driven by the realisation of pent-up demand and a rise in social expenditure as part of measures to support households. The closing of foreign tourism at the start of the summer vacation season, boosting demand for domestic travel, may be an additional factor behind the rise in domestic demand. The April–May statistics, however, indicate a plunge in both individual income tax revenue and wages. Given that the coming months are expected to see the restraining impact of coronavirus consequences on consumer activity as a result of declining household income and likely changes in consumer behaviour, further recovery of the Russian economy will most probably be accompanied by a more modest consumption (see also Subsection 2.5. Retail sales rebounding at a fast pace).

[5] To 7.3% from 11.2%, exclusive of mining and quarrying, petroleum refining, and public administration.

[6] Average level of daily seasonally adjusted payments from 20 January to 13 March 2020 (for details, see Monitoring of industry-specific financial flows, No. 12/09.07.2020).

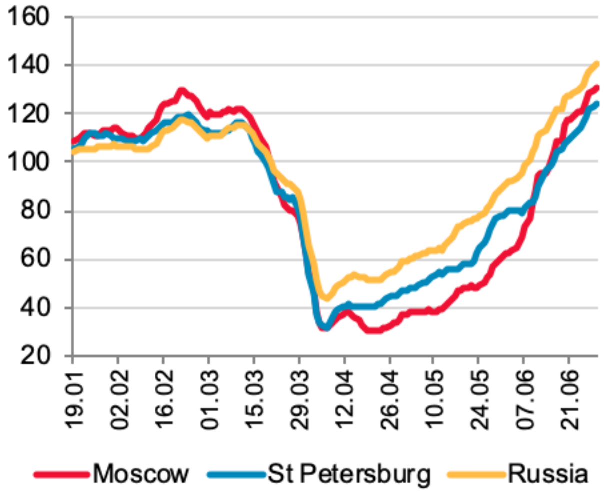
Figure 13. Self-isolation index in Moscow and St Petersburg



Source: Yandex.

Note: the highest score is 5 points – almost no one in sight.

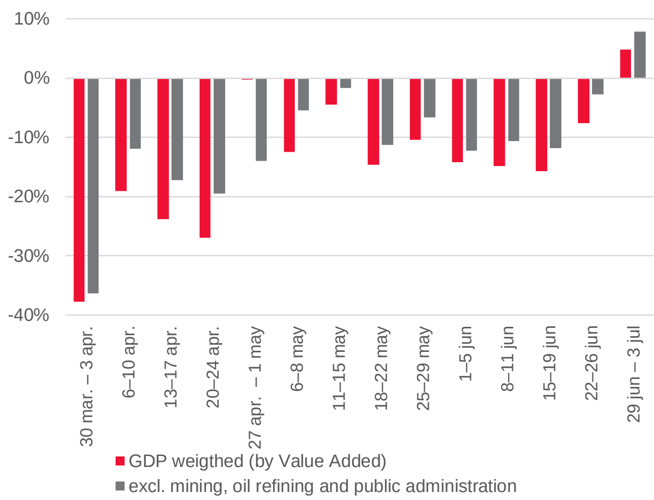
Figure 14. Mobility in cities relative to 13.01.2020, %



Source: Apple Mobility Trends.

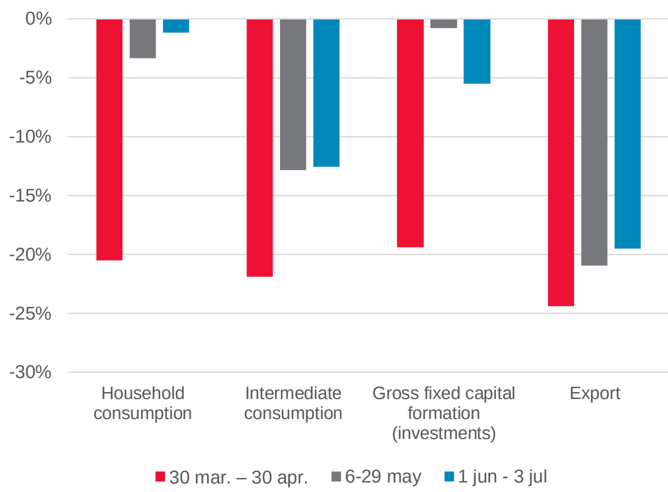
Note: the mean of the index of travel by car and on foot, a one-week rolling average.

Figure 15. Deviation of incoming financial flows from "normal" level



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

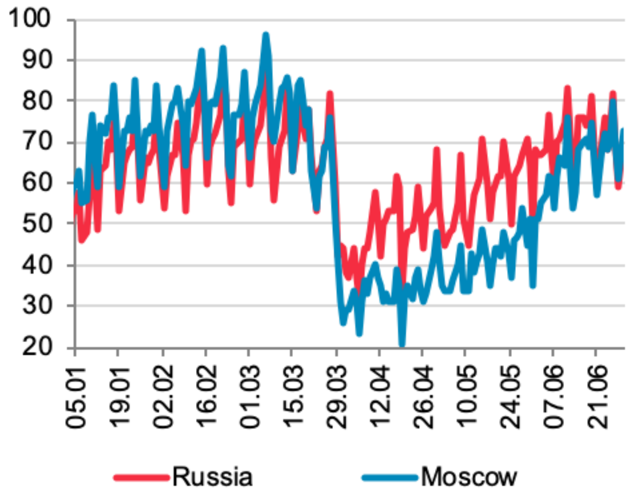
Figure 16. Mean deviation of incoming payments from "normal" level



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

According to a Research and Forecasting Department estimate, a gap between electricity consumption across the Unified Power System with last year's level, adjusted for the temperature factor for the whole of Russia, narrowed significantly at the end of June, providing more evidence of economic activity recovery in recent weeks. This process is, however, uneven across the sectors of the economy. In particular, the OPEC+ agreement to cut oil production was still in effect in June. The reduced oil extraction affects the level of activity in related industries: petroleum refining, transportation, oil field servicing, electricity generation and supply (Figure 19). For example, the largest negative contribution to electricity consumption in June continued to come from Integrated Power System (IPS) Urals and IPS Middle Volga supplying electricity to most of oil producing and petroleum refining regions.

Figure 17. Consumer activity, Sberindex

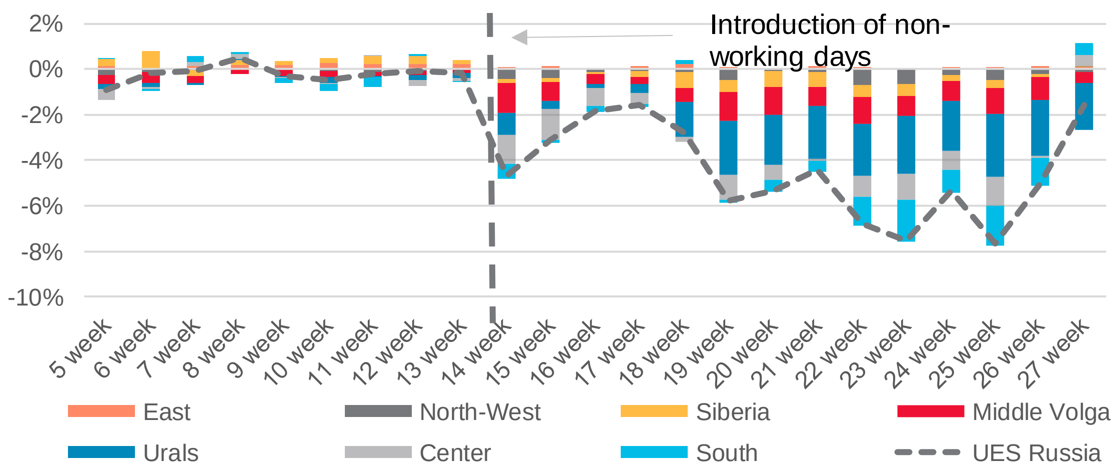


Source: Sberbank.

Figure 18. Consumer activity, Tinkoff Corona Index

Source: Tinkoff Bank.

Рисунок 19. Contributions of regional energy systems to devitation of electricity consumption adjusted for temperature and calendar factors, % y/y



Sources: System operator of United Energy System, R&F Department estimates

External demand remains generally subdued and is recovering much more slowly than domestic demand (Figure 16). The risk of a second wave of the pandemic in many countries heightens uncertainty over the pace of recovery of demand for Russian exports. Depressed activity in exporting industries takes a toll on business activity in industries meeting intermediate demand.

It appears from data on financial flows in the national payment system that investment goods industries' performance also deteriorated in June compared with May. The last two weeks of June, however, saw clear signs of improvement. The average downward deviation of incoming payments from the "normal" level increased relative to May (Figure 16). It would be too early to claim based on real-time payment data that a sustainable recovery trend has emerged in investment goods industries, given an elevated volatility of these payments in this industry group. Therefore, the recovery of investment demand may eventually take longer here than in other industries. A fall in domestic and external demand amid rising uncertainty over the pace of economic activity recovery in Russia leads companies to reconsider their investment plans, negatively affecting investment decision-making. These factors yet again emphasize a special importance of combining government measures to support the economy with fiscal and monetary policy instruments seeking to mitigate the negative effects and achieve further recovery of business activity while maintaining price and financial stability.

2.2. Industrial output: expected contraction in oil industry, recovery in most other industries

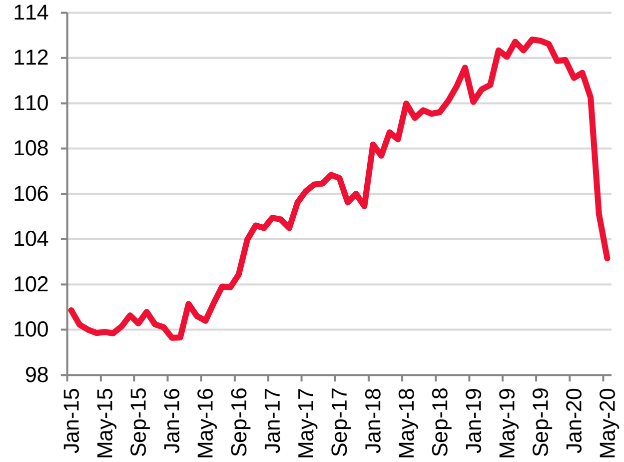
- An industrial output decline accelerated to 9.6% YoY in May from 6.6% YoY in April. Industrial production dropped 3.0% MoM[7] in May, having lost 5.8% MoM in April.
- The continuation of negative performance in May came on the back of a mining and quarrying plunge of 11.2% MoM. As the OPEC+ agreement took effect in May, oil and gas extraction plummeted 13.9% MoM, which was indicated by a significant electricity consumption drop in regions where a large part of oil extraction is concentrated (see also Subsection 2.1). Real-time indicators suggest the recovery of economic activity in June – the beginning of July. Oil extraction will remain reduced in July in compliance with the agreement.
- Manufacturing output started to rebound in May, showing 3.4% MoM growth on the back of improvement in most industries as coronavirus-related restrictions eased. This was also evidenced by industry-specific financial flows: the downward deviation of incoming payments from the “normal” level decreased compared with April.

Industrial output contraction accelerated to 9.6% YoY in May from 6.6% YoY in April. In monthly terms, industrial production fell 3.0% MoM, having lost 5.8% MoM in April (Figure 20).

The continuation of negative performance in May stemmed from a sharp acceleration in mining and quarrying output contraction to 13.5% YoY from 3.2% YoY in April. Relative to April, output fell 11.2% MoM (Figure 21). By contrast, a year-on-year decline in manufacturing output slowed to 7.2% YoY from 10% YoY. This was, above all, owed to the recovery of industries manufacturing durable consumer goods. A positive contribution also came from industries producing investment goods, but their performance remains fairly volatile.

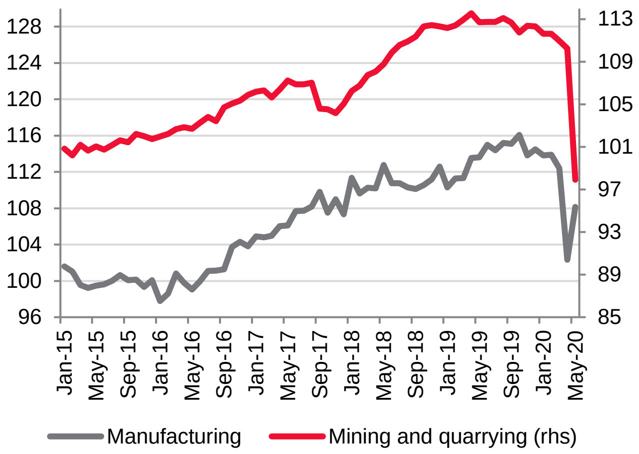
[7] Here and further on, seasonally adjusted.

Figure 20. Change in industrial production index (2014 = 100)



Source: Rosstat, R&F Department estimates.

Figure 21. Change in mining and quarrying and manufacturing indexes (2014 = 100)



Source: Rosstat, R&F Department estimates.

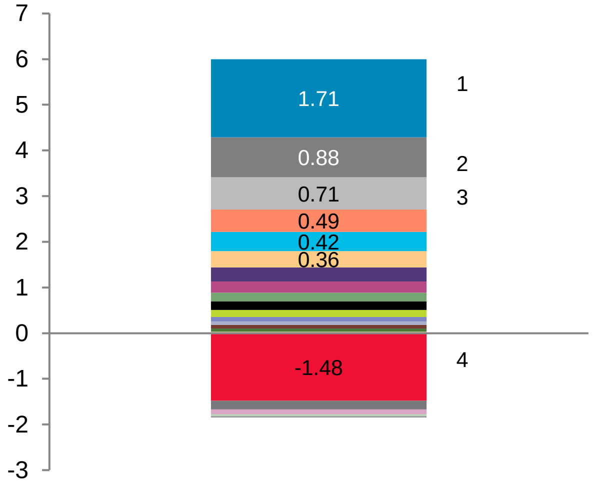
As the OPEC+ agreement took effect in May, oil and gas extraction fell sharply by 13.9% MoM, which was indicated by a plunge in electricity consumption in regions where a large part of oil extraction is concentrated. Oil production will remain depressed in July in compliance with the agreement. Gas extraction maintains a persistent downward trend which emerged in the middle of last year.

Manufacturing started to recover in May, posting an output rise of 3.4% MoM on the back of an improvement in most industries as coronavirus-related restrictions were eased. This was evidenced by real-time indicators of industry-specific financial flows: the downward deviation of incoming payments from the "normal" level decreased compared with April.[8]

After the April slump, the group of industries manufacturing *durable consumer goods* became the leaders of growth. The manufacture of household appliances posted the strongest 117% MoM output expansion, followed by the production of jewellery, up 80% MoM, the manufacture of motor vehicles, a rise of 68.2% MoM, as well as leather and related products, an increase of 26% MoM, all of which, however, failed to reach the March output numbers.

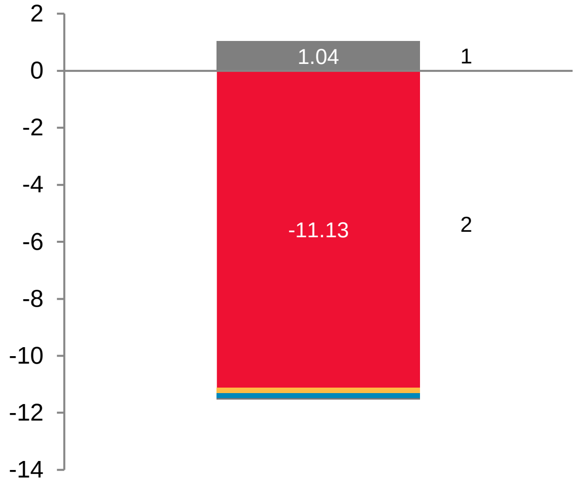
[8] See Monitoring of industry-specific financial flows (Nos. 4-7).

Figure 22. Individual industries' contribution to manufacturing growth, % MoM



1 Motor vehicles
2 Manufacture of other transport equipment
3 Other manufacturing
4 Refined petroleum products

Figure 23. Individual industries' contribution to mining and quarrying growth, % MoM



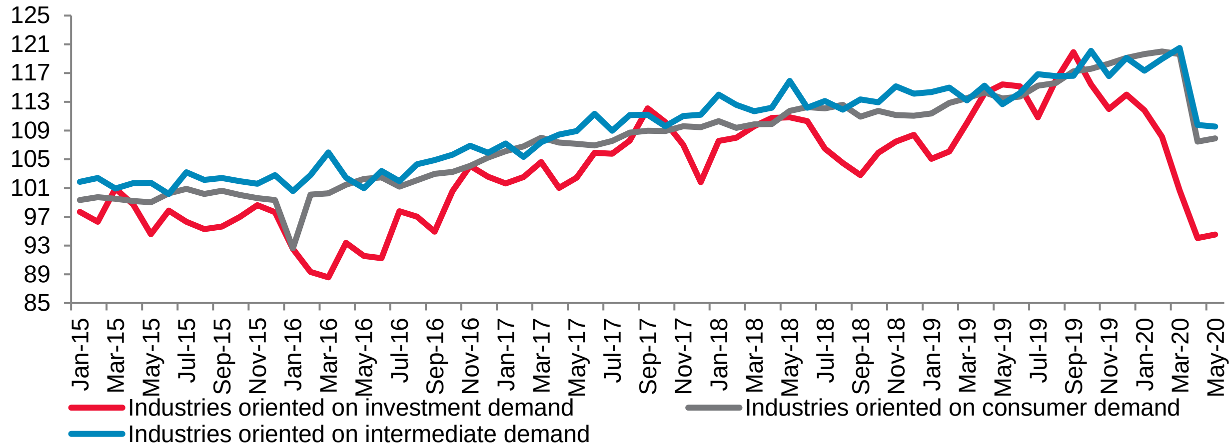
1 Other mining and quarrying
2 Extraction of crude petroleum and natural gas

Source: Rosstat, R&F Department estimates.

Some industries' output, nevertheless, came close to or exceeded the March level, with the manufacture of wearing apparel and furniture, for example, posting an output rise of 31.8% MoM and 38.3% MoM, respectively (Figure 25). Financial flows in these industries stabilised at a level close to "normal" in mid-June. June's output expansion was helped by the resumption of companies' operations and a rise in demand, partially pent-up.

An important contribution to manufacturing recovery was also provided by industries meeting *investment* demand, where a rise in output almost fully compensated for the April fall. Among growth leaders was the manufacture of railway equipment, up 32% MoM. Nevertheless, the output numbers in the manufacture of machinery and equipment were still below those of February, when a sharp output contraction started in this industry's companies as problems of component supplies arose. The recovery of output in the manufacture of construction materials (up 9.5% MoM) slowed due to the continuing decline in the production of ceramic and porcelain products.

Figure 24. Manufacturing output indexes, by industry group, January 2014=100%, seasonally adjusted

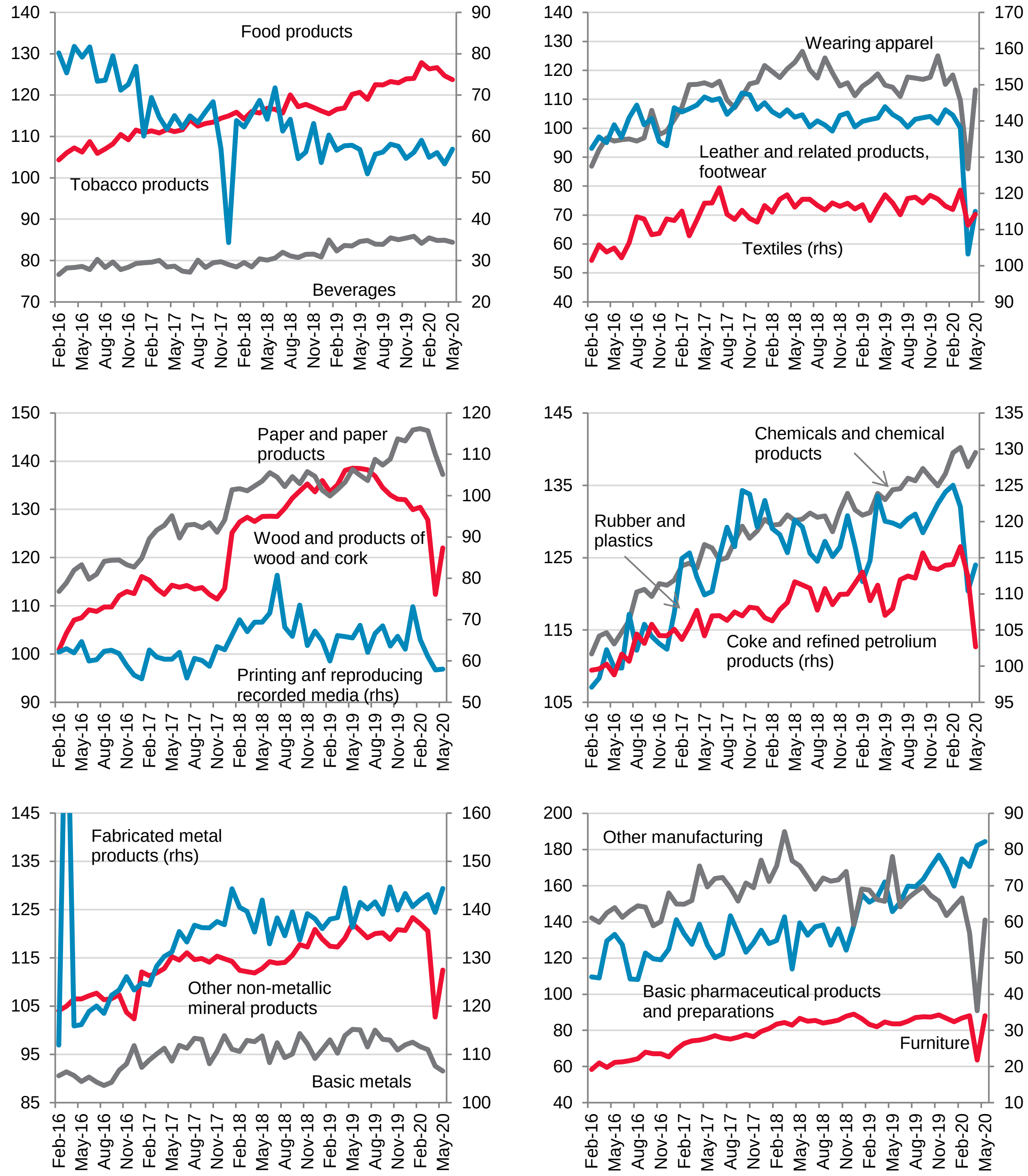


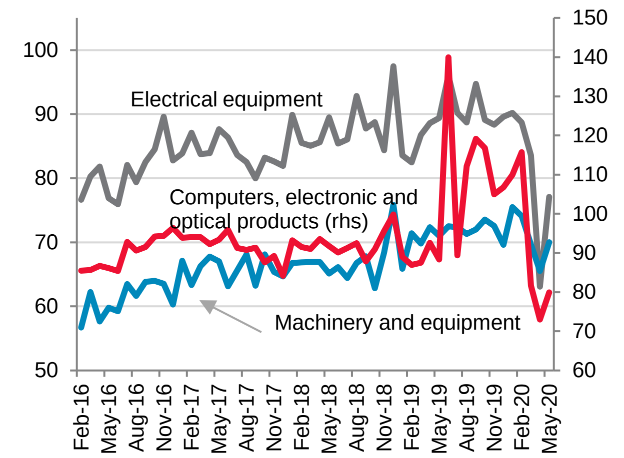
Source: Rosstat, R&F Department estimates.

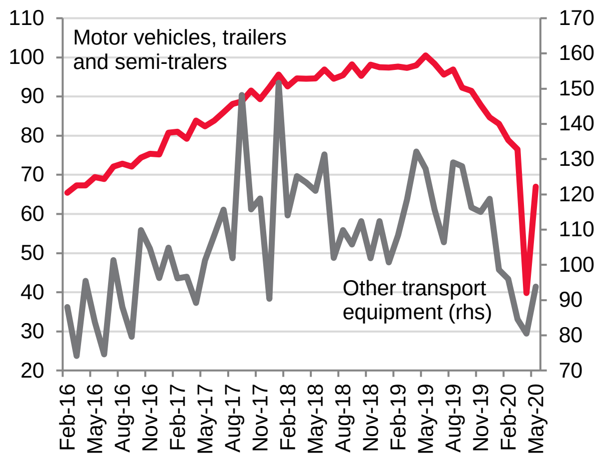
Manufacturing recovery was hampered in May by industries meeting *intermediate* demand. The major petroleum refining industry took most of the blame for it, with its output dropping 8.6% MoM. This stemmed not only from the oil extraction decline but also from depressed domestic demand due to a contraction in travel by transport (both private and public). Net of petroleum refining, manufacturing would have grown 5% MoM in May (Figure 22). Also, the pipe and tube industry maintained its downward trend, down 3.0% MoM, joined by the manufacture of basic iron and steel (a decline of 1.6% MoM), whose recovery is constrained by a fall in housing construction, the postponement (due to the pandemic) of metal-intensive projects under government programmes, and barriers in Russia's key export markets. Support for the group of investment goods industries is provided by the manufacture of chemicals and chemical products. After a fall in April due to, among other things, the repair and maintenance of equipment in the Tobolsk production facility, the industry resumed its upward trend, posting a rise of 1.4% MoM.

Industries manufacturing *FMCG* are enjoying a more stable performance. The output of pharmaceutical products continued to grow in May, up 1.2% MoM. The manufacture of food products provided a negative input to manufacturing performance with a fall of 0.8% MoM. After a drop in April, the manufacture of meat products started to rebound, up 1.6% MoM, while the output of dairy products stabilised, registering a rise of 0.1% MoM. The situation in the flour milling and cereals industry developed in the reverse order: after a spike in April, its output plummeted 11.2% MoM, returning to the February level.

Figure 25. Manufacturing industries' output, December 2012=100%, seasonally adjusted







Source: Rosstat, R&F Department estimates.

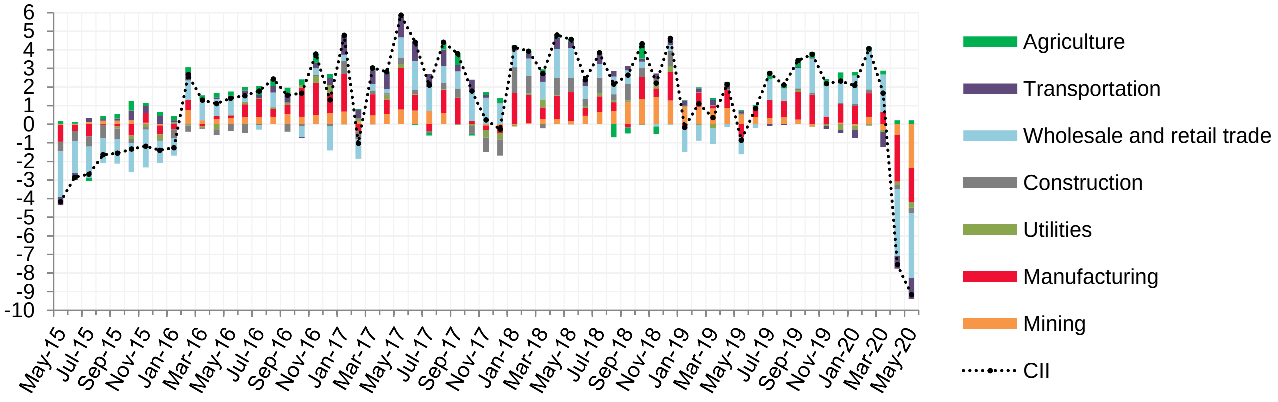
2.3. Core industries index: trough was passed in May

- A business activity plunge in many industries produced a further decline in core industries' output (CII[9]), down 9.2% YoY after a 7.6% YoY fall in April (Figure 26). A dramatic output deterioration was posted in industrial production, driven largely by a downturn in mining and quarrying as the new OPEC+ agreement took effect (down 14.5% YoY after a 3.2% YoY fall a month earlier. Therefore, despite the clear signs of recovery in manufacturing industries, May saw the trough of economic activity.
- The construction industry continued to suffer an output decline, falling 3.1% YoY, after a 2.3% YoY decline in April. Based on data from the Centre for Strategic Research,[10] construction companies' financial indicators (revenue and profits) developed a downward trend towards the end of May, primarily on the back of a construction lockdown and disruptions in deliveries of materials and equipment.
- The agricultural sector is the only one which showed a positive input to the Core Industries Index in May. The sector continued to register steady growth throughout the self-isolation period, up 3.2% YoY in May following a rise of 3.1% YoY in April.
- Bearing in mind that June saw some improvement in the economic situation compared with May, we estimate core industries' output decline in April–June at 8.5%–9.0% YoY, which, according to our estimate, corresponds to a GDP contraction of 9.5%–10.0% YoY in the second quarter (Figure 27).

[9] The core industries' index (CII) is calculated by aggregating industry-specific indexes (agricultural production; mining and quarrying; manufacturing output; freight traffic; wholesale and retail sales; and activities such as water supply; sewerage, waste management and remediation; as well as electricity, gas, steam and air conditioning supply; construction, with weights corresponding to the respective industry's share in Russia's gross value added in 2017.

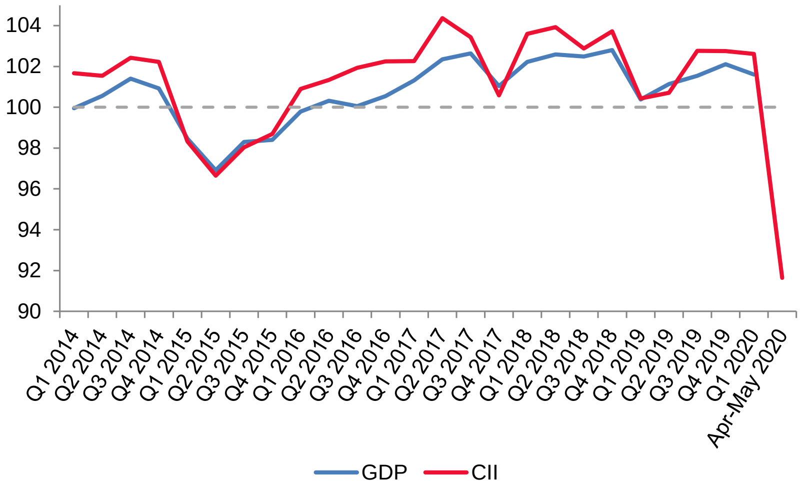
[10] The construction and reaд estate market: drivers of the industry's after the 2020 crisis (as of the end of May 2020).https://www.csr.ru/ru/news/eksperty-tssr-rasskazali-o-barerakh-na-puti-vosstanovleniya-stroitelnoy-otrasli/.

Figure 26. Contribution of industries to the CII in 2014–2020, % YoY



Source: Rosstat, R&F Department estimates.

Figure 27. Quarterly index of GDP and CII in physical terms, % YoY



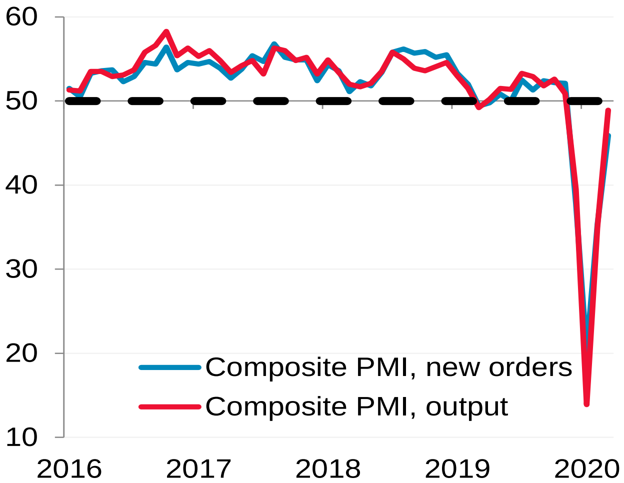
Source: Rosstat, R&F Department estimates.

2.4. PMI indexes in June: gradual improvement in economic activity

- The performance of the PMI index suggests a shift to growth in output and new orders in manufacturing and a significant deceleration of an activity decline in services.
- In spite of this, employment continues to shrink in both manufacturing and services. Nor does external demand show any signs of recovery.
- Business expectations have again returned to the upbeat mode: companies expect output and orders to rise in the next 12 months as the economy opens and activity recovers.
- The recovery of business activity starts from its April low registered as coronavirus-related restrictions and the "week-off" period were put in place. The gradual nature of the recovery process implies that economic activity will reach its "pre-coronavirus" level no sooner than 2022.

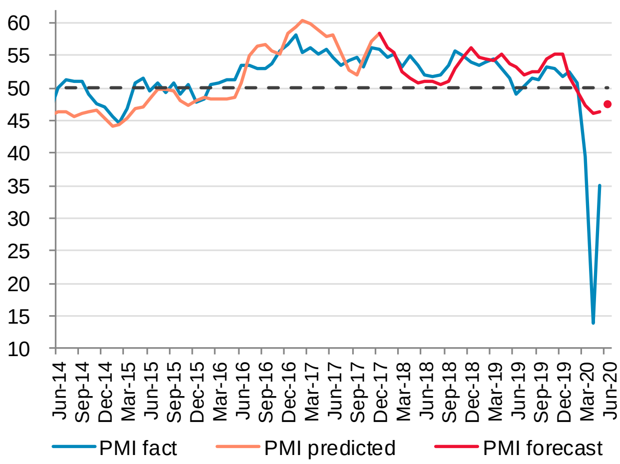
The composite PMI index for output soared to 48.9 in June from 35.0 in May and 13.9 in April (Figure 28). The estimate of the R&F Department news index in June also pointed to an improvement in the composite index performance (Figure 29). Formally, the composite PMI index reading below 50 shows an economic activity decline but in the current situation such conclusions should be drawn with caution. Being a diffuse index, the PMI by construction reflects a difference between the shares of respondents who see growth and fall in output and/or demand for their products relative to the previous month rather than the magnitude of change. In April, under the “day-off” regime in Russia, the overwhelming majority of companies eventually faced an output decline, which was what prompted a sharp drop in the PMI index. At the same time, a variety of real-time indicators point to the recovery rather than a slowdown of economic activity decline in May. In the current situation, a PMI reading below 50 does not have to be inconsistent with this trend. It is not ruled out that a recovery in a small number of industries may in total outweigh a continued decline in a larger number of other industries. Moreover, from the perspective of the PMI index, this will mean an economic activity decline, because the share of respondents reporting output contraction still exceeds the share of those who have not reported an output decline.

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



Source: IHS Markit.

Figure 29. Composite PMI and News-based business activity index, pp

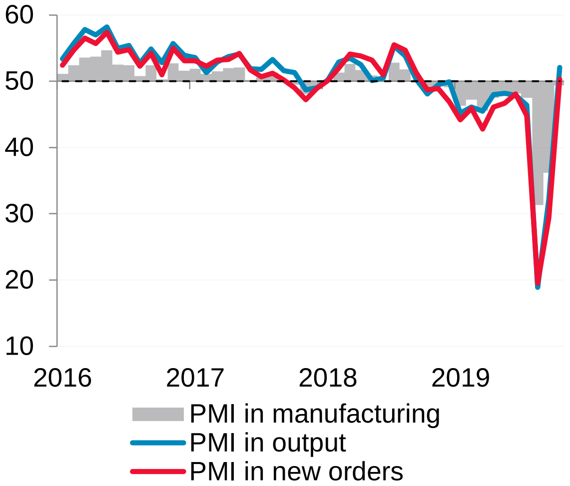


Source: IHS Markit, R&F Department estimates.

Manufacturing saw a faster recovery: the output sub-index exceeded 50 in June, staying just below this level in services. The respondents report resumed optimism regarding future output after restrictions have been lifted more comprehensively (59.3).

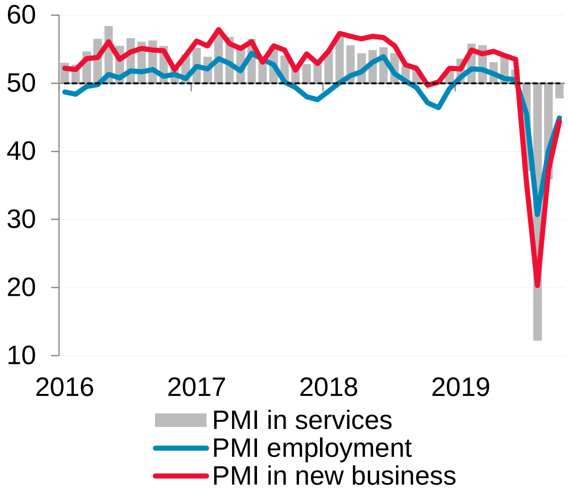
The manufacturing PMI index significantly exceeded its May reading in June, reaching 49.4, the highest level since May last year (Figure 30). Business activity recovery is owed to growth in both output (52.1) and new orders (50.3). The sharp rise in the index stemmed from the opening of companies and enterprises after restrictions were lifted. Growth in domestic orders was driven by a rise in demand for the products of industries meeting intermediate demand, which also evidences the enhancement of business activity. The resumption of business operations provided a driver for a gradual recovery of domestic demand, while external demand remains weak: the number of export orders continues to fall (42), albeit at a slower pace.

Figure 30. Change in PMI manufacturing indexes, pp



Source: IHS Markit.

Figure 31. Change in PMI services indexes, pp

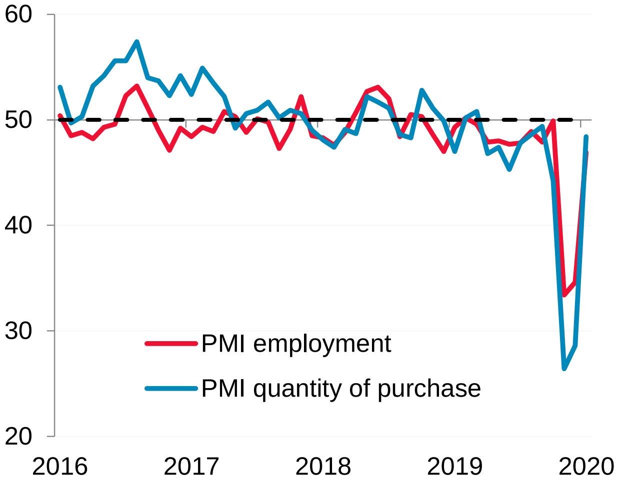


Source: IHS Markit.

Against this background, purchasing activity has intensified considerably: the purchasing sub-index rebounded to 48.4 in June from 28.6 in May. As new orders improve, work backlogs decline, as reflected by a rise in the relevant index to 46.4 in June from 40.7 in May. Despite the recovery of companies' business activity, employment continued to contract in June, albeit at a slower rate than in April and May: the employment sub-index came in at 46.9 versus 33.4 and 34.6, respectively (Figure 32).

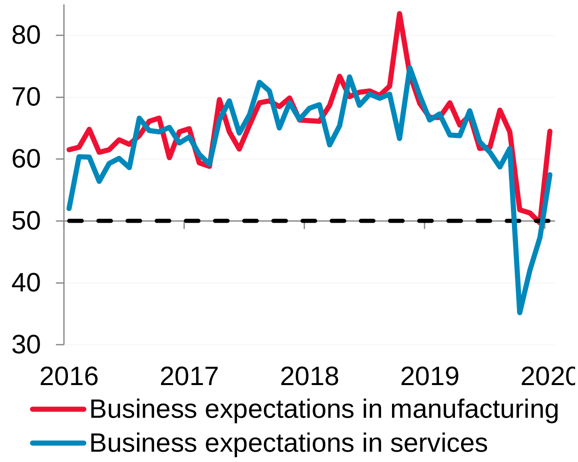
Business expectations regarding future output returned to positive territory. The relevant balance indicator in the manufacturing sector surged to 64.5 on expectations of a rise in demand, having stayed close to the borderline reading of 50 in May (Figure 33). The June reading came close to the average 2016–2019. The negative effect of the pandemic on consumer activity will last long. That said, further demand recovery will be hampered by the recent household income downturn and likely changes in the consumer behaviour model on fears of the pandemic spread, constraining production potential (see also Subsection 2.1. Real-time data points to the recovery of economic activity in June – early July).

Figure 32. Manufacturing PMI indexes for quantity of purchase and employment



Source: IHS Markit.

Figure 33. PMI for business expectations



Source: IHS Markit.

Formally, the services PMI index points to a continuing business activity decline, much slower, however, than in the previous two months: the index went up to 47.8 from 35.9 in May. (Figure 31). Unlike industrial production, the services sector continues to be affected by coronavirus-related restrictions, although to a lesser extent than in April–May. Its individual segments are still under restrictions, locking them down completely or curtailing their business activity. As a result, the recovery of the new orders sub-index (to 44.4 after 37.3 in May) is slower than in manufacturing industries (the respondents report that part of their customers have not resumed their operations yet).

The services sector employment continues to contract (44.9), while the number of incomplete orders declines against a background of free production capacities. Nevertheless, a certain activity recovery helped business expectations rise to a four-month high in the services sector as well: to 57.5 in June from 47.3 in May (Figure 33).

2.5. Retail sales rebounding at a fast pace

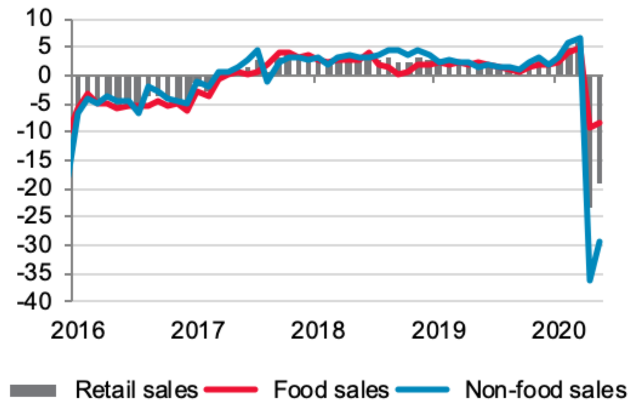
- The May sales indicate the recovery of consumer demand as coronavirus-related restrictions ease. The gap with last year's level shrank from 23.2% in April to 19.2% in May.
- The non-food segment was still suffering the heaviest year-on-year fall of 29.2% in May, an improvement from -36.4 in April, since non-food retail only reopened towards the beginning of June in most regions. However, the resumption of retail operations even in a part of regions produced a non-food sales rise of 11.3% MoM relative to April (in seasonally adjusted terms).
- An improvement in household expectations regarding future income may support retail sales in the months to come. Real-time data of the first weeks of June indicates the continuation of gradual retail sales recovery: in some categories, sales even

rebounded to the March levels. The medium-term consumption performance will, however, depend on economic activity and household income, as well as changes in consumer behaviour and household propensity to save which have arisen during the pandemic.

According to Rosstat data, after a 23.2% YoY slump in April, retail sales moved to a recovery path in May. The decline slowed to 19.2% in year-on-year terms (Figure 34), helped by the recovery of economic activity as restrictions were gradually lifted in some of Russian regions. As a result, retail sales expanded 5.2% MoM SA[11] in May after a 27.1% MoM plunge, remaining, however, far below the “pre-coronavirus” levels.

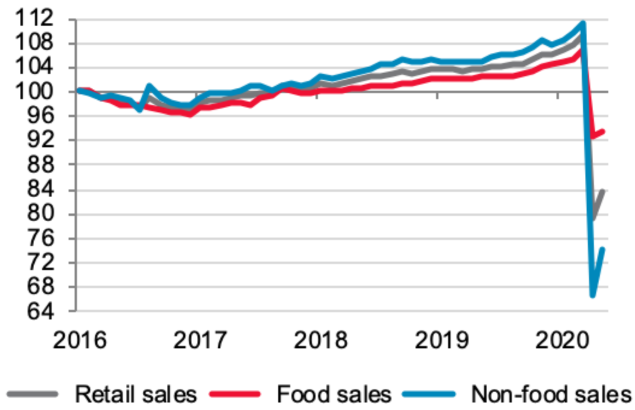
Food sales edged up from April, as evidenced by monthly numbers: a 0.7% MoM rise after a 13.2% MoM fall in April. In year-on-year terms, the decline slowed to -8.6% YoY in May versus -9.2% YoY in April. The retail sales improvement was above all driven by the non-food segment. In May, non-food sales expanded 11.3% MoM following a 40.2% MoM slump in April (Figure 35). In addition to the lifting of restrictions on conventional retail formats (some regions allowed non-food retail shops of up to 400 square metres to operate already at the start of May), retail sales expansion was helped by online trade, whose share stood at 5% of the overall FMCG market in natural terms[12] as early as April. The gradual lifting of restrictions in big cities will be an important development capable of supporting the recovery of non-food retail sales, as shown by real-time indicators for June. In particular, the numbers of new car sales improved to -14.6% YoY in June, reflecting, among other things, the effect of demand pent-up over the period of coronavirus-related restrictions.

Figure 34. Food and non-food retail sales and overall retail sales, % YoY



Source: Rosstat.

Figure 35. Retail sales (January 2016 = 100%, seasonally adjusted), %



Source: InFOM survey at the Bank of Russia request.

[11] Here and further on in this subsection, monthly growth rates are seasonally adjusted.
[12] Online FMCG sales hit new highs. / Nielsen 05.06.2020.

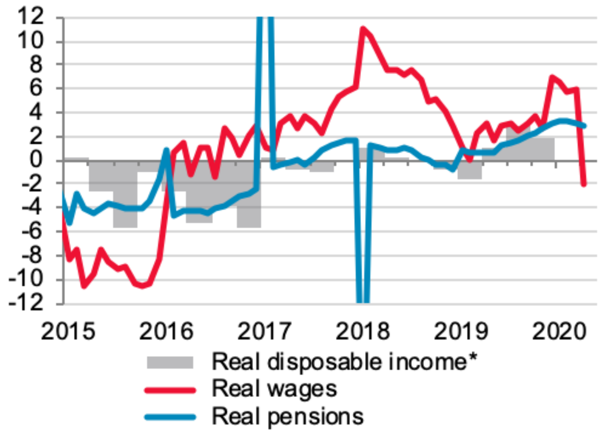
The data of the Bank of Russia payment system also suggested consumption recovery: the retail industry (OKVED2 47) maintained an upward deviation of incoming payment flows from the “normal” level throughout May. The average change in incoming flows stood at 11.2% for May, showing a faster retail recovery than Rosstat data showed. A variety of real-time indicators based on payments effected by banks also pointed to a faster consumption recovery in May than what official retail sales statistics suggested. Sberbank data indicates a 16.8% YoY decline in goods and services expenditure in May, while the structure of decline for the second consecutive month shows a key difference from Rosstat data: the former indicates a 9.0% and 11.1% year-on-year food expenditure increase in April and May, respectively versus a Rosstat report of a 9.2% and 8.6% year-on-year fall. Tinkoff Bank provides numbers similar to those of Sberbank (a 19.2% MoM rise in the bank customers’ average spending on goods and services in May to 80% of the February level).

In a similar fashion, based on the scan panel of households from Research Holding Romir, nominal daily household expenditure went up 10.3% YoY in May. Russia’s largest food retailer X5 also shows a sales rise in May, with a significant increase in the average cheque outstripping the effect of a traffic fall (the cheque rise was only marginally below 15% YoY posted in the first quarter).[13]

Whereas the effect of coronavirus restrictions (a supply squeeze) was the chief determinant of retail sales in April and May, further recovery of retail sales will be restrained by household income. The unemployment headcount increased by 1.5 million in April–May, according to Rosstat estimates, exceeding 4.5 million as of June 1. The unemployment rate reached 6%, up from 5.7% in April. Based on Rosstat data, having risen 5.9% YoY in March, real wages dropped 2% YoY in April. InFOM survey data shows a rising share of respondents reporting a wage fall and worsening in households’ financial position over April–May.[14]

[13] X5 CFO: any crisis secures the advantage of large companies. / 11.06.2020.
[14] Based on four waves of inFOM telephone polls.

Figure 36. Real household income, % YoY



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

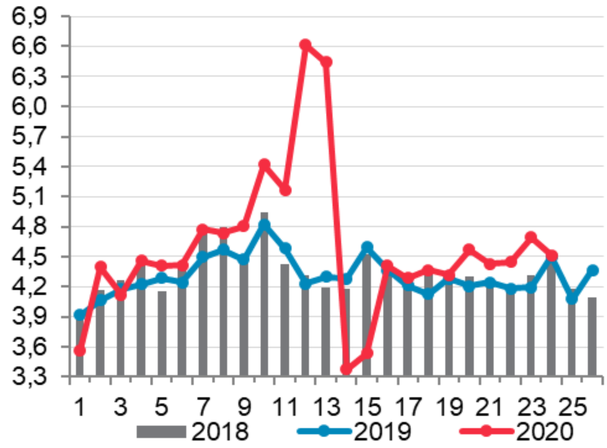
Source: Rosstat, R&F Department estimates.

Amid uncertainty over their future income, consumers avoided increasing their debt burden, with the number of consumer loan applications falling. Banks meanwhile continued to tighten their lending policies, and the number of consumer loans provided by banks across Russia declined 44.7% YoY.[15] The labour income fall in May was partially offset by social benefits which the government started to pay as part of announced measures to support households. But the larger part of these benefits were paid in June, which, together with the lifting of restrictions on retail trade, supported retail sales at the end of the second quarter. The latest inFOM survey suggests an improvement in household expectations regarding their future incomes, which can be attributed to the gradual recovery of economic activity and the resumption of companies' normal operations.

Therefore, further performance of retail sales as retail shops are reopened will depend on consumer income and new consumption models. At the same time, the online trade segment will continue to develop extensively.

[15] National Bureau of Credit Histories: the number of consumer loans issued by banks dropped 44.7% YoY / NBCH, 16.06.2020.

Figure 37. Weekly nominal everyday household expenditure, thousand roubles



Source: Romir.

Figure 38. Change in real expenditure on goods and services in June, % YoY

Source: «SberData» Lab.

Based on BSG and holding company Romir[16] survey, Russian households intend to bring spending back to its usual level just for a narrow range of product categories in the coming months. As restrictions are lifted, more than half of the respondents are planning to return to the pre-crisis spending level in categories such as foodstuffs, clothes and footwear, and cosmetics. The upward spending trend will also continue for other FMCG items, household appliances and computer equipment. In the months ahead, the realisation of pent-up demand will support the sales of cars and other categories of goods, the purchase of which carries a low risk of coronavirus contagion in consumers' view. At the same time, a fall in demand will to a greater extent hurt leisure and entertainment services and public transport. Until the pandemic situation finally stabilises in Russia and globally, expenditure on restaurants, entertainment and travel will remain substantially subdued relative to the "pre-coronavirus" level.

Real-time data on household expenditure for the first two weeks of June indicates continued recovery of consumer demand. According to holding company Romir data,[17] average everyday household expenditure has reached last year's level (Figure 37). A household expenditure rise in Moscow has come in above the Russian average for the first time over a long period. The recovery is concentrated in non-food sales (a rise of 0.8% YoY in June) and is owed mostly to the return of retail (first of all the opening of clothes and footwear shops). Services expenditure tumbled 33.7% YoY in June, according to Laboratory SberData data. That said, this sector also posted a pronounced upward trend in individual categories (the Sports, Beauty Salons and Transport segments) (Figure 38).

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[16] BSG and Romir survey: The quarantine-stricken / BCG и and research holding company Romir, 05.06.2020.

[17] Weekly expenditure has reached last year's level / Research holding company Romir, 16.06.2020.

2.6. Labour market: gradual rise in unemployment

- The seasonally adjusted unemployment rate climbed to 6.0% in May from 5.65% a month earlier.
- A broad measure of unemployment, including underemployment, also went up, showing an increase in the number of employees working shorter hours.
- Real wages declined in practically all private sector industries. The downward trend is expectedly posted primarily in the services sector, hardest hit by the pandemic.

May is normally the best month for the labour market because of rising demand for seasonal workers. This year, however, Rosstat estimates showed an unemployment headcount rise by 227 thousand to 4.5 million in May, with the unemployment rate increasing to 6.1% from 5.8% a month earlier. Seasonally adjusted, the unemployment rate rose to 6.0% in May, adding 1.5 pp from the start of the year (Figure 39). In other countries, however, the unemployment rate showed an even steeper increase over the same period. This provides more evidence that adjustment to labour market shocks in Russia relies primarily on reducing wages and working hours rather than employment.

The Labour Ministry reported in the middle of June that employment centres had officially registered 2.4 million people as unemployed, noting that only a quarter of those lost their job during the pandemic, with the rest of them becoming unemployed right before it or even a long time ago. This suggests that a significant part of the official rise in the unemployment headcount is owed to raising unemployment benefits and streamlining the application and payment procedure as part of measures to shore up the economy and households.

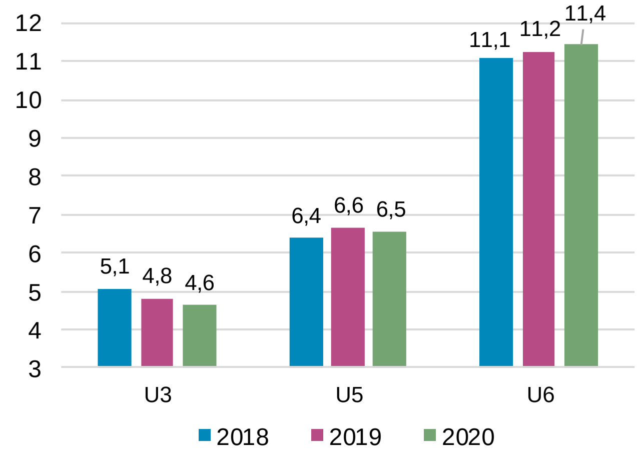
Rosstat labour force survey for the first quarter showed that hidden unemployment had started to rise even before the “day-off” regime was put in place. Indeed, the broad measure of the unemployment rate – U6[18] climbed to 11.4%, up from 11.2% a year earlier, whereas the traditional indicator slid from 4.8% in the first quarter of 2019 to 4.6% in the first quarter of 2020 (Figure 40). This suggests that the number of employees working shorter hours started to rise from the beginning of the year: amid declining demand, employers seemed to have sought to retain part of the personnel by cutting their work hours. A rise in the broad measure of the unemployment rate will likely be more substantial than that in the traditional indicator for the second quarter.

[18] U3 – the unemployment rate under the International Labour Organisation (ILO) methodology.
U5 – the unemployment rate including potential labour force.
U6 – The unemployment rate including potential labour force and workers employed less than 30 hours a week.

Figure 39. Unemployment rate, %

Source: Rosstat, R&F Department estimates.

Figure 40. Broad measure of unemployment,% QoQ

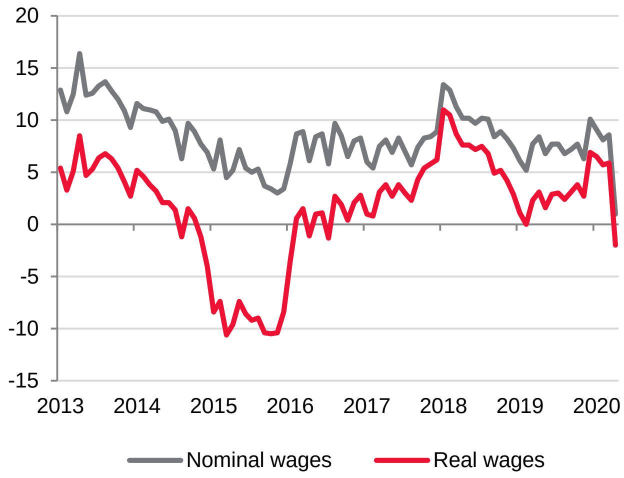


Source: Rosstat, R&F Department estimates.

Nominal wage growth slowed sharply to 1.0% YoY in April, with real wages dropping 2% YoY (Figure 41).

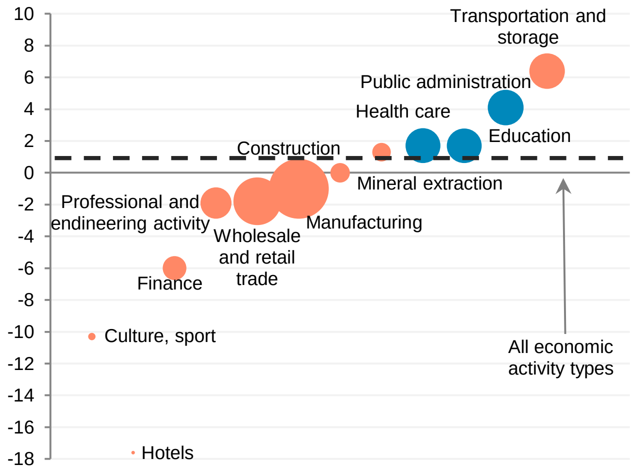
In April, many private sector businesses had to suspend their operations, cut salaries, and furlough their employees. The services sector was hit the hardest: hotel and restaurant employees' wages tumbled 17.6% YoY as these businesses suspended their operations. Wages in the cultural, sports, and leisure and entertainment services sector fell 10.3% YoY (Figure 42).

Figure 41. Wage growth rate, % YoY



Source: Rosstat.

Figure 42. Nominal wage growth by industry in April, % YoY



Source: Rosstat, R&F Department estimates.

The size of the circles corresponds to an activity type share in the payroll fund.

Industries which were the fastest to adapt to the remote work regime recorded the same pace of wage growth as in the previous months. Wages in the information and communications sector rose 10.6% YoY, those in public administration added 9.8% YoY.

The public sector was expectedly less vulnerable to the pandemic, showing a wage increase of 2.5% YoY, based on our estimate (private sector wage growth equalled 0.5% YoY). The slow rate of public sector wage growth in April may have been due to, among other things, a reduced workload, a decrease in the number of students in extracurricular classes at educational institutions. A relatively large share of the public sector may provide one explanation for what official statistics show as a more moderate income decline in Russia than in many other countries.

Based on our estimates, a recovery of real wage growth can be expected in some industries as early as June, but this is least of all expected of the services sector's industries hit the hardest by the crisis.

2.7. Banking sector: resumption of retail loan portfolio growth

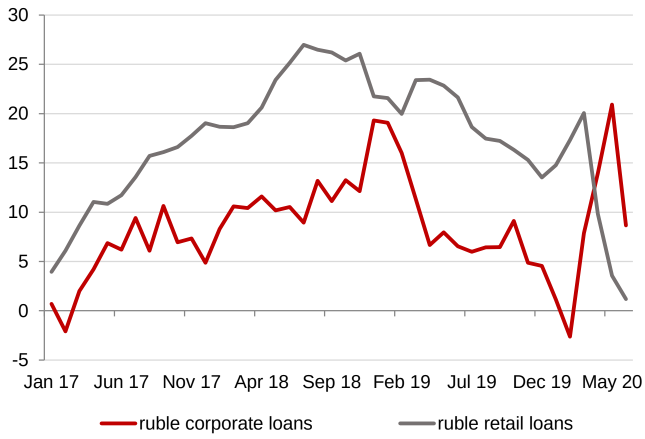
- May saw a resumption of retail loan portfolio growth in large part supported by a subsidized mortgage lending programme, with the provision of new mortgage loans rising above last year's levels. We note that mortgage lending expansion stemmed above all from an increase in the average loan size and was accompanied by a rise in demand for newly constructed housing. The current situation gives reason to expect further growth in the mortgage lending segment.
- Unsecured consumer and auto loan debt continued to decline but at a slower rate than in April. As coronavirus-related restrictions are eased and business activity recovers, so does consumer demand, but borrowers' profile seems to have become riskier, which also scales down the provision of loans.
- We expect a gradual recovery of consumer and auto lending. But banks will likely continue to pursue more cautious policies regarding these lending types, thus keeping their growth rates below the "pre-coronavirus" levels in the months to come.
- Corporate lending expansion has slowed. This may have arisen from falling demand for long-term lending due to a fall in companies' investment expenditure and a lower need for short-term loans as economic activity starts to recover in a number of industries.
- The banking sector's profit contracted drastically compared with a year ago. This may first of all stem from a rise in expenditure for setting aside provisions and from the continuing negative effect of coronavirus-related restrictions on transaction activity and fees and commission income.

After April's decline, retail ruble lending inched up 0.2% MoM[19] in May, boosting growth to 1.0% MoM in June (Figure 43). The recovery of retail lending is above all owed to a rise in

[19] Here and further on, monthly growth rates are seasonally adjusted unless otherwise provided. The seasonally adjusted estimates for June are preliminary.

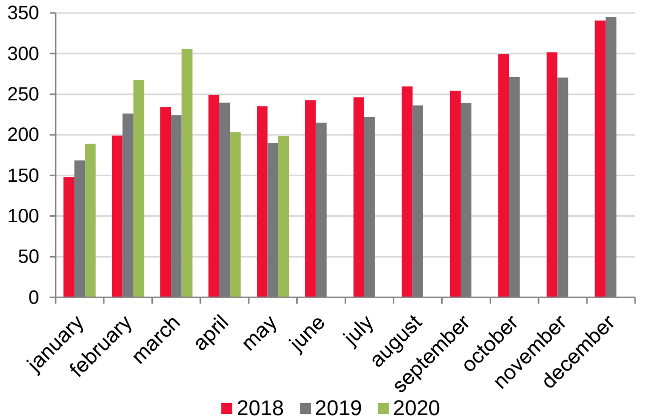
mortgage lending. Monthly loan provision exceeded last year's level in May, whereas April saw a decline compared with the same month of 2019 (Figure 44). Although the number of new mortgage loans remained 0.4% lower than a year ago, their total amount added 4.5% YoY, increasing the average mortgage loan size. According to DOM RF data, mortgage lending continued to expand in June, increasing 23% YoY in terms of the number of loans and 29% YoY by value.

Figure 43. Annualized 3-month average credit growth rates, %



Source: Bank of Russia.

Figure 44. New issued mortgage loans volume, bln. rub

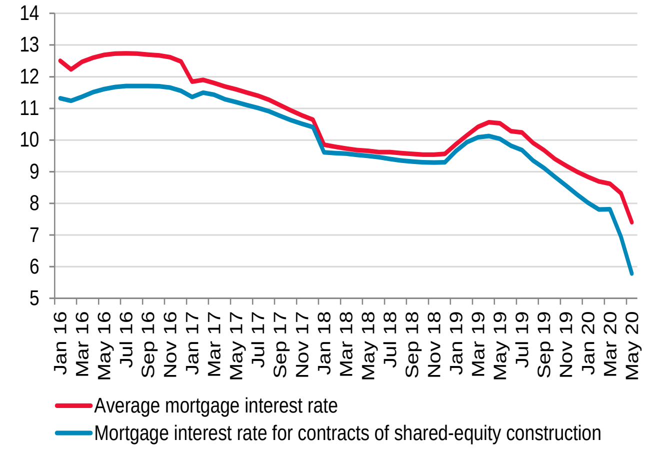


Source: Bank of Russia.

Lending expansion by value is helped the launch of a new subsidized mortgage lending programme. This is what probably caused a sharp decline in average weighted interest rates, especially, in the segment of loans collateralised by claims under co-investment agreements (Figure 45). Annual mortgage lending growth slowed to 13.8% YoY from 14.4% YoY in April.

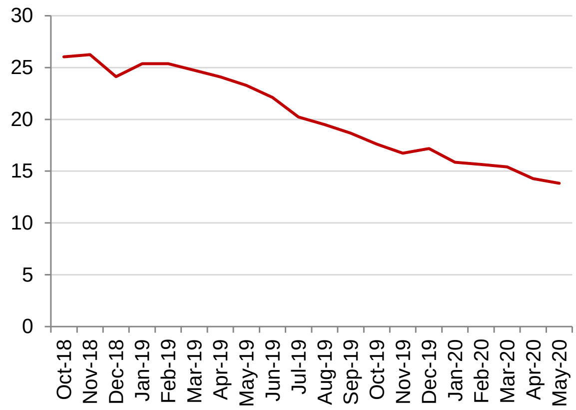
As the "day-off" regime was lifted and restrictions eased, demand for newly-constructed housing started to rebound. According to Rosregister data, the sales of newly-constructed housing returned to the March 2020 level at the end of May. We note that part of these sales may have been carried over from March. Although banks and developers have started to expand online service extensively, the closure of deals to purchase housing may have been postponed until after the "day-off" period is over. Nevertheless, the number of applications for mortgage loans under a new subsidised mortgage lending programme continues to increase rapidly, with 120.8 thousand applications submitted as of 28 May (over six weeks of programme implementation), 145.3 thousand as of 4 May, 169 thousand as of 10 June, 195.6 thousand as of 18 June, 295.3 thousand as of 9 July (after the programme was amended to offer a broader range of loans).

Figure 45. Mortgage interest rates, %



Source: Bank of Russia.

Figure 46. Mortgage loans, year to year



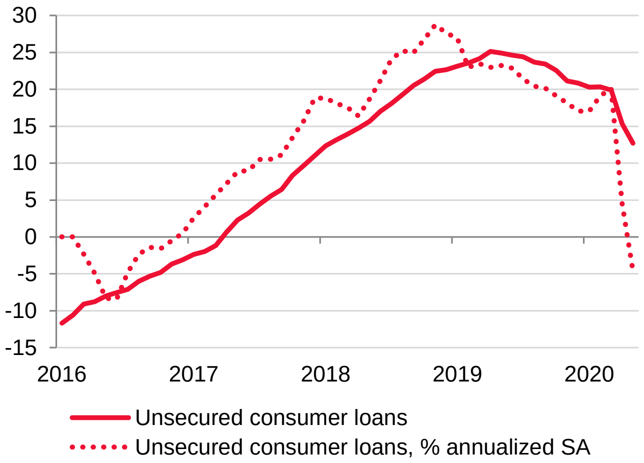
Source: Bank of Russia.

At the same time, activity remained depressed in the secondary real estate market in May. According to Rosregister data, the number of transactions registered in May was two-thirds lower than a year earlier, remaining unchanged from April (the programme does not cover housing purchases in the secondary market). Still, household expectations are improving: the data of the VTsIOM polling agency survey conducted in May at the request of DOM.RF indicates that the share of respondents who believe that the current time is good for buying housing rose 5 pp to 29% from its April low. Therefore, as coronavirus-related restrictions are lifted and monetary policy eases, one can expect an even more confident mortgage lending recovery.

The unsecured consumer lending decline slowed in seasonally adjusted terms to 0.7% MoM in May from 2.1% MoM in April. A three-month average annualised growth stood at -4.8% (Figure 47). Although a total of new loans is much lower than last year's, retail lending shows signs of starting recovery: according to National Bureau of Credit Histories (NBCI) data, the provision of new loans plunged more than 60% YoY in April, while May saw an about 45% YoY decline.

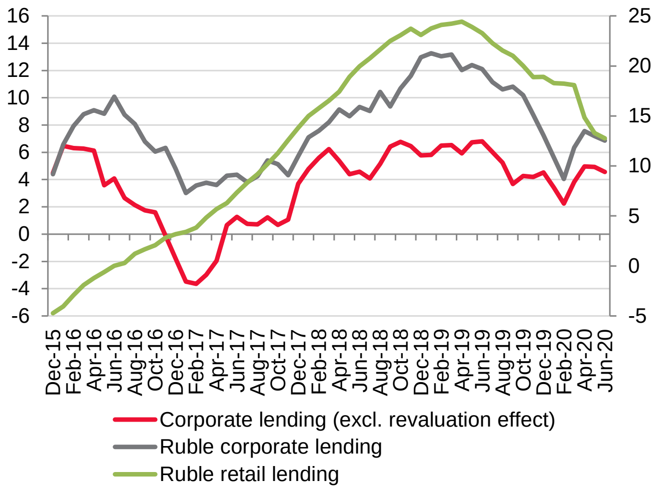
It appears that the decline slowdown is driven by the recovery of consumer demand. Based on the monitoring of industry-specific financial flows, their downward deviation from the normal level shrank in industries manufacturing durable consumer goods. Data from Sberbank and OFD Platform indicates growth in demand for electronic and construction goods in May. Still, the continuing contraction in the provision of new loans stems from lending policy tightening by banks and falling loan demand from reliable borrowers. According to NBCI data, loan demand from borrowers with a low debt service ratio and a high personal credit rating declined significantly in April and May – the number of applications from them dropped by two thirds year on year. This may indicate a shift towards a riskier borrowers' profile.

Figure 47. Unsecured consumer lending dynamics, %



Source: Bank of Russia.

Figure 48. Annual growth rates, y-o-y



Source: Bank of Russia.

The auto loan segment shows a similar trend: a total value of loans declined at a much slower pace of 1.2% MoM than in April (-3.5% MoM). Its three-month average annualised growth rate stood at -8.95%. The provision of new auto loans dropped more than 80% YoY in April and about 50% YoY in May, according to NBCI data. A contraction slowdown may arise from a partial opening of car showrooms and realization of pent-up demand. The average auto loan size decreased, however. First, the regional structure of sales has changed: the most expensive cars are traditionally bought in Moscow and St Petersburg, but this is where the most stringent quarantine restrictions were in place, and therefore car showrooms were partially off limits. Second, banks have tightened their lending policies: the share of loans with a minimal initial down payment has decreased. Third, the structure of demand from borrowers has changed: people use a more rational approach to consumption in the periods of instability, reducing the share of debt finance as much as possible when buying a car. As car showrooms are opened and pent-up demand is realized, better conditions of the government programmes Your First Car and Family Car may help change the situation with auto loans.

Overall, the pace of retail ruble lending expansion slowed drastically from the start of the year.[20] Its three-month rolling average growth slowed to 3.6% in May and 1.2% in June (Figure 43), with the pace of year-on-year growth decreasing to 13.3% YoY in May and to 12.8% YoY in June. Further on, retail lending growth is expected to continue recovering thanks primarily to the mortgage lending segment. The recovery of consumer and auto lending is likely in parallel with the lifting of quarantine restrictions and business activity rebound. Banks are, however, likely to continue their more cautious policy regarding these lending segments, keeping the pace of lending growth below its “pre-coronavirus” levels in the coming months.

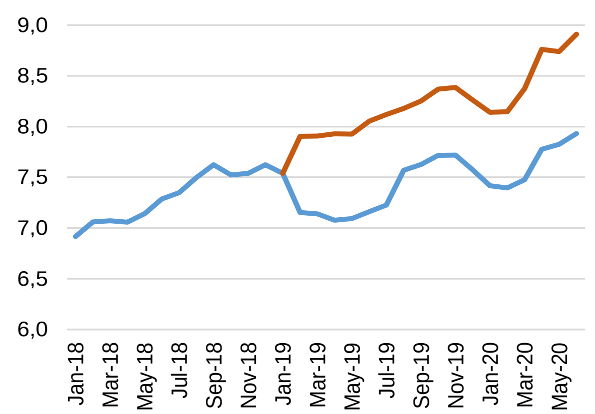
[20] Up 1.3% in January, a rise of 1.7% in February, and an increase of 1.6% in March.

Corporate ruble lending growth slowed from 1.3% MoM in April to 0.5% MoM in May and, according to preliminary data, to 0.3% MoM in June. Meanwhile, its three-month average annualised expansion accelerated to 20.9% in May but slowed to 8.7% MoM in June according to preliminary estimates. The rebound of business activity in a number of industries may have reduced an income shortfall in these industries' companies, bringing down their demand for working capital. But despite the recovery in industries meeting consumer demand, investment demand remains weak. Investment contraction and economic uncertainty will likely continue to hamper demand for long-term corporate lending.

Household ruble deposits growth in May was comparable with that in the previous months[21] but accelerated to 1.4% MoM in June. The rate of deposit expansion remains generally below the numbers seen at the start of 2020 (a rise of 1.2% in January and 0.8% in February), which may have been due to a household income contraction on the back of a rise in unemployment, a resumed decline in deposit rates, and greater attractiveness of cash in the face of uncertainty (Figure 50). The highest interest rate on ruble deposits for 10 credit organisations with the largest amount of retail deposits sank from 5.4% to 5.0% in May, sliding below 5% in June.

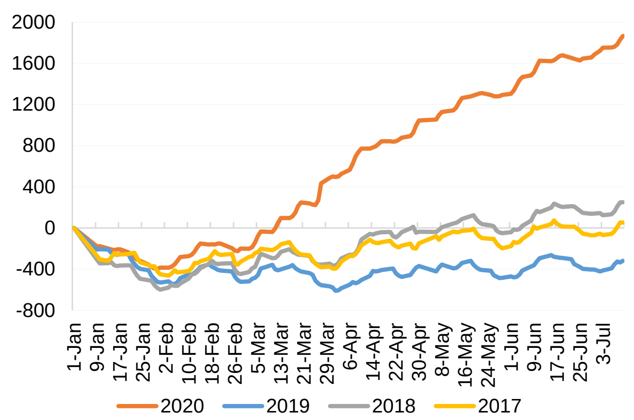
Banks have continued to set aside provisions (Figure 49). This may suggest that they expect the financial position of a part of borrowers to worsen going forward, because regulatory easing by the Bank of Russia allows provisions for restructured loans to be forgone. The banking sector's profit, however, remains depressed at 45 billion rubles in May 2020 versus 117 billion rubles in May 2019 and 79 billion rubles in June 2020 versus 138 billion rubles in June 2019. As some banks' monthly reports indicate, profits are dragged down by a fall in fees and commission income on the back of customers' depressed transaction activity and provision of new loans in general. Activity, however, started to recover in May–June, but so far remains below last year's numbers. A return to normal business activity as restrictions are lifted will boost net fees and commission income, supporting the banking sector's profit.

Figure 49. Loan-loss provisions, trillion roubles



Source: Bank of Russia.

Figure 50. Dynamics of currency in circulation, (at the beginning of year =0), bln roubles



Source: Bank of Russia.

[21] 0.5% in May, 0.7% in April, 0.5% in March.

2.8. Countercyclical fiscal policy mitigates negative effect of restrictions on economy

- Oil and gas revenue slump accelerated year-on-year in May, dragged down by commodity prices and declining oil and gas extraction and exports. A non-oil and gas revenue decline, however, slowed amid some recovery of economic activity.
- Annual real growth in general government revenue accelerated to 23% YoY. The need to finance anti-crisis measures has prompted a change in the spending structure. Accelerated growth in spending on final consumption and social payments was accompanied by a slowed rise in investment and wage expenditure.
- 12-month rolling total balance and non-oil and gas primary balance continued to decline, mitigating the effect of the pandemic on GDP growth.

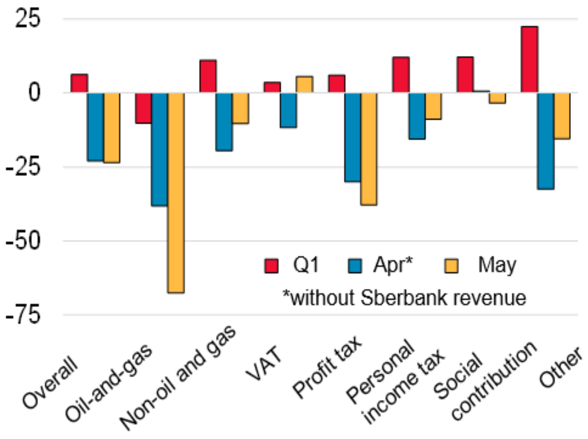
Revenue. A year-on-year fall in the total general government revenue (here and further on, we adjust the April data for the transfer to the budget of proceeds from the deal to sell Sberbank shares) (Figure 51). Oil and gas revenue tumbled 67% YoY in real terms (38% YoY in April)[22] dragged down by falling commodity prices and a fall in the extraction of mineral resources and exports amid a global consumption slump.

A decline in non-oil and gas revenue in real terms slowed to 10% YoY in May versus 19% YoY in April, which can be attributed to some recovery of Russia's economic activity driven by the lifting of coronavirus-related restrictions, as evidenced by a large number of real-time indicators. A contraction in revenue from social insurance contributions reflects, among other things, the government's decision to cut the rate of contributions for small and medium-sized businesses. Annual growth in VAT revenue is due to the time of this tax payment: the first quarter tax liability is paid in the second quarter.

Expenditure. Real annual growth in general government expenditure accelerated to 23% YoY in May, up from 13% YoY in April (Figure 52). That said, the need to finance anti-crisis measures changes the expenditure structure. Noteworthy is strong growth in spending on final consumption, which can be attributed, in particular, to the purchases of medications, supplies and equipment for combatting the spread of the coronavirus. Spending on social benefits showed a significant expansion as budget-funded social support for disadvantaged groups was stepped up. At the same time, the implementation of large-scale anti-crisis measures most probably made it necessary to postpone the implementation of part of investment projects: capital expenditure growth slowed by about half compared with January–April.

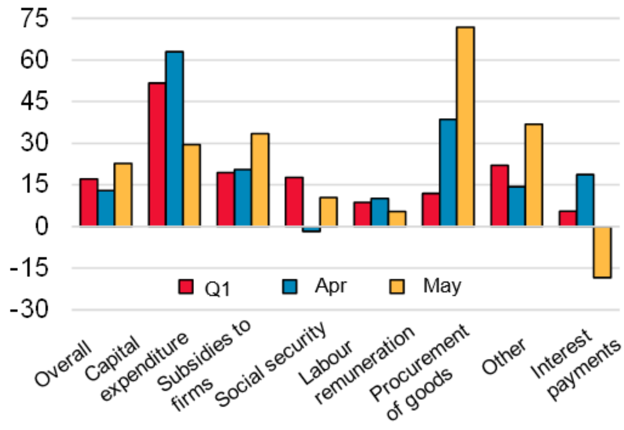
[22] The proxy deflator we use is the average between the consumer price index and producer price index. It equalled -4% YoY и -6% YoY in April and May, respectively.

Figure 51. Change in general government revenue, in real terms, % YoY



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

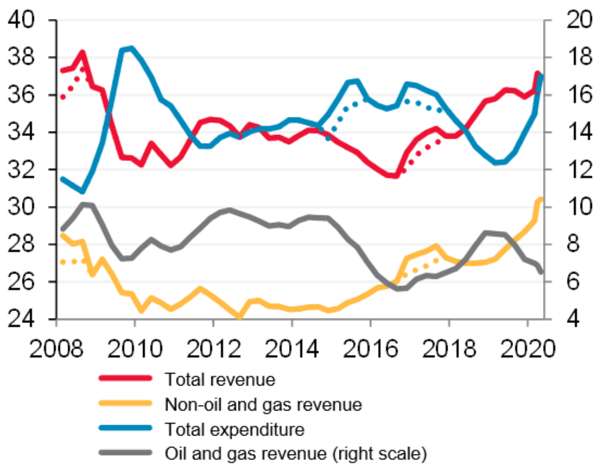
Figure 52. Change in general government expenditure, in real terms, % YoY



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

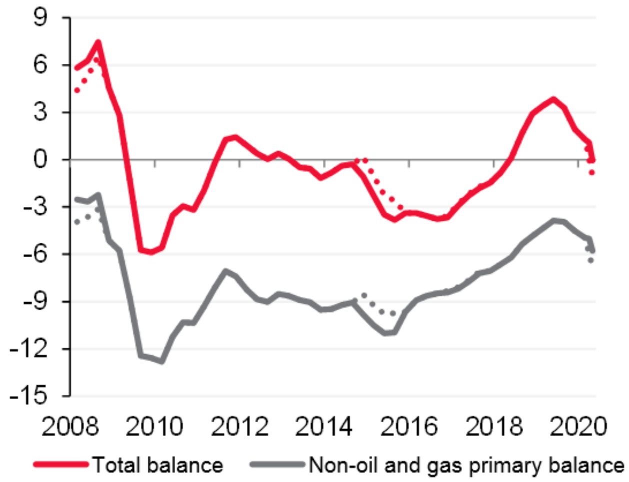
Budget balance and revenue sources. The general government ran a moderate deficit in May. The 12-month rolling average total balance and non-oil and gas primary balance continued to decline (Figure 53, Figure 54).[23] The countercyclical effect of the budget mitigates the negative effect of coronavirus-related restrictions on economic activity.

Figure 53. Key indicators of general government (% of GDP, 12-month rolling average)



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

Figure 54. Balance of general government (% of GDP, 12-month rolling average)



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

Note: the dotted line represents estimates, exclusive of major on-off factors: YUKOS debt payment in 2007, recapitalisation of banks in 2014, expenditure for early repayment of defence sector loans and Rosneft privatisation in 2016, proceeds from the sale of Sberbank shares in 2020.

Shortfall of baseline oil and gas revenue is compensated by National Wealth Fund revenue, with the rest of the budget deficit financed by domestic borrowings. The RF Finance

[23] Unadjusted for budget revenue from the proceeds of the sale of Sberbank shares, both balances shifted to a decline in May.

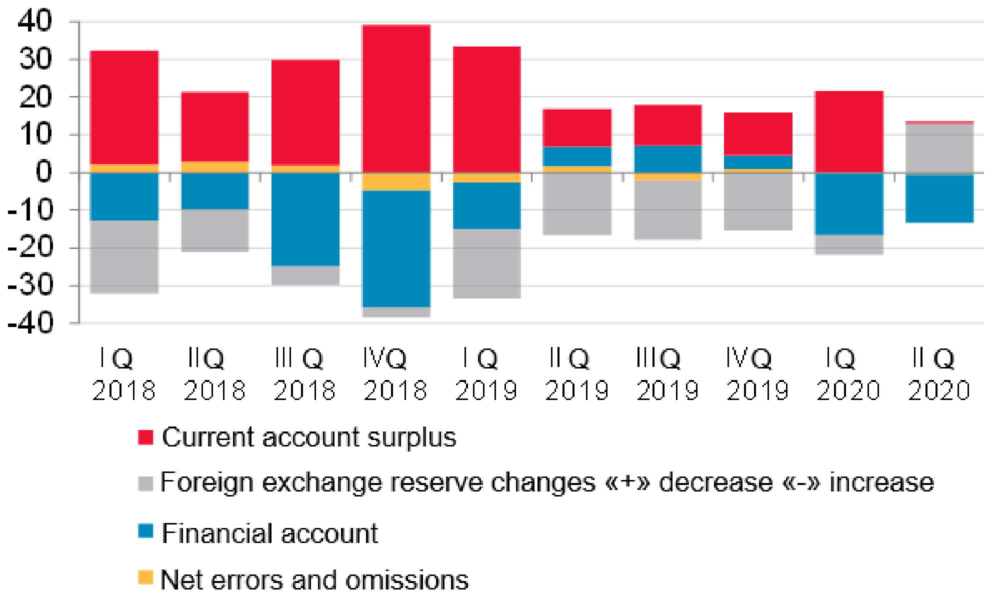
Ministry sold 1.1 trillion of government bonds at an auction (net issuance totalled 0.9 trillion rubles). The third quarter gross issuance plan equals 1.0 trillion rubles.

2.9. Trade surplus in goods narrows, so does deficit in services

- The second quarter current account surplus dwindled in quarter-on-quarter and year-one-year terms on seasonal factors.
- The current account structure saw significant changes. The trade surplus fell sharply, dragged down by faster export contraction amid the global recession. The non-trade current account deficit, meanwhile, narrowed because of a plunge in services imports as foreign tourism and payable investment income closed due to an economic activity slump and ruble weakening.
- A contraction in imports from other than former USSR countries slowed sharply in June. That said, import performance indicates that domestic demand remains depressed. This is, to a certain extent, offset by an import rise associated with health service needs and a gradual lifting of restrictions and social distancing measures both within Russia and abroad.

The current account surplus came in at USD0.6 billion in the second quarter, down from USD9.9 billion a year earlier. This was above all driven by a drastic trade surplus shrinkage to USD14.3 billion due to a sharp export contraction amid the global recession in both physical terms and by value as prices of key exports fell. An import decline only partially offset a worsening of goods exports. The non-trade current account deficit narrowed to USD13.7 billion from USD29.5 billion in the second quarter of 2019, compensating a part of the trade surplus contraction. This was prompted by the effect of restrictions and closure of borders which resulted in a plunge of services imports (primarily tourist travel) to USD9.8 billion from USD24.7 billion. The investment income deficit also narrowed thanks to a faster reduction in income payable as economic activity declined and the ruble weakened: it is the second quarter that will see the trough of the decline.

Figure 55. Base components of balace of payments, bln USD



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

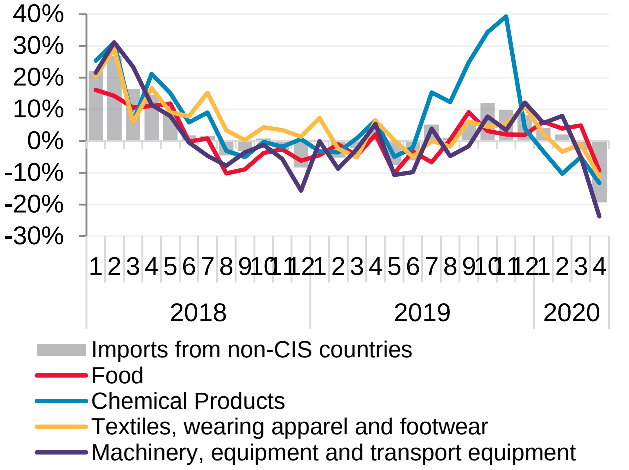
The performance of imports in recent months generally reflects changes in both the Russian and global economy. The import decline started in March (down 3.8% YoY), which saw a peak of ruble weakening. The largest contribution to the import fall came from APEC countries, primarily China, where coronavirus-related restrictions were imposed earlier than in other countries. Import contraction intensified dramatically to 19.6% YoY in April, since this month saw the effect of the most stringent restrictions imposed in various countries to combat the spread of the coronavirus. The decline slowed somewhat to -11.3% YoY in May[24] as economies started to open, with this trend continuing in June as imports from other than former USSR countries[25] contracted 3.8% YoY. According to Federal Customs Service statistics, food imports also showed a marginal improvement, while textile imports resumed their decline after growth in March.

The import of chemical products from other than former USSR countries expanded 19.2% YoY after an 11% YoY fall in May. Among chemical industry products, only pharmaceutical imports improved in June, with April's contraction giving place to an 8.3% YoY rise in May and an almost two-fold increase in June. This may have stemmed from an expansion in the purchase of pharmaceuticals to combat the coronavirus spread. A certain part of the increase may have arisen from the purchase of pharmaceutical products in the run-up to the introduction of their labelling as of 1 July. A contraction in the import of goods related to a number of the chemical industry's key sub-industries, such as perfumery and cosmetics, rubber and polymers, as well as household chemical products, continued in June.

[24] Data provided before Federal Customs Service statistical series was updated in June.

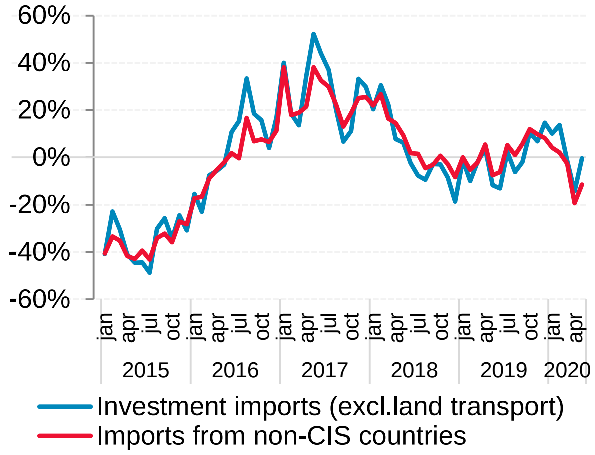
[25] June data for the entire list of countries is not available.

Figure 56. Growth in the components of imports from non-CIS countries, USD, rate of growth, YoY



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

Figure 57. Growth in imports from non-CIS countries and investment imports[26], USD, rate of growth, YoY



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

Machinery and equipment imports posted a notable recovery: their decline slowed to 5.3% YoY in June from 11.4% YoY in May and 22.4% YoY in April, helped most of all by a change to a rise in the import of electronic, optical, and electrical equipment. The last item accounts for about 25% of machinery and equipment imports. The import of land transport equipment, aircraft and railway locomotives, by contrast, worsened.

Data on imports from other than former USSR countries suggests that a significant improvement in textile imports in May was driven by a rise in the import of textile products and wearing apparel. A part of this rise seems to be owed to an increasing need for medical products (the import of ready-made textile goods soared by 347% YoY), since other sub-categories of wearing apparel and footwear imports do not show an improvement. The import of ready-made textile products jumped 2.4 times in June, but a further worsening of performance in other sub-categories was chiefly to blame for a textile import contraction in June.

Food imports continue to decline, with contraction slowing marginally in June to 12.1% YoY from 13.1% YoY a month earlier. Food imports are very negatively affected by a fall in the import of meat, beverages (including alcohol), and as fruit and vegetables. Cereal imports climbed 2.2 times in June. The breakdown of import statistics by country suggests that in the case of wearing apparel and footwear, the continuing import contraction is to a greater extent driven by demand and to a lesser extent by logistic constraints owed to the quarantine across the world.

[26] Investment imports are estimated as the difference between total machinery and equipment imports and land transport imports from other than former USSR countries.

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