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TALKING TRENDS

Economy and markets

Research and Forecasting Department Bulletin

NOVEMBER 2020

CONTENTS

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1. Inflation

Annual inflation came in at 4% in October. The leading indicators of price rises, including producer prices of consumer goods, as well as business survey data and ruble weakening, suggest possible continuation of the current monthly inflation rate in the coming months, driven by cost increases, even if demand weakens further in response to rising coronavirus contagions. This will bring about inflation acceleration from last year's low base.

Soaring coronavirus contagions may have a negative effect on economic activity and amplify demand-side disinflationary risks. That said, the scale and duration of the emerging supply-side proinflationary risks driving costs and retail prices higher are still hard to assess. The inflation targeting policy reduces the effect of exchange rate pass-through to prices, lengthening the duration of this pass-through.

As a result, the impact of concurrent disinflationary and proinflationary factors will likely continue in the immediate future. This will also be true of the ongoing volatility in the prices of some goods and services groups and consumer prices at large.

The ongoing loose monetary policy will help keep inflation within the 3.5%–4.0% range for the full-year 2021, given the lags of monetary easing transmission to final demand and prices.

1.1. Inflation came close to 4% in October

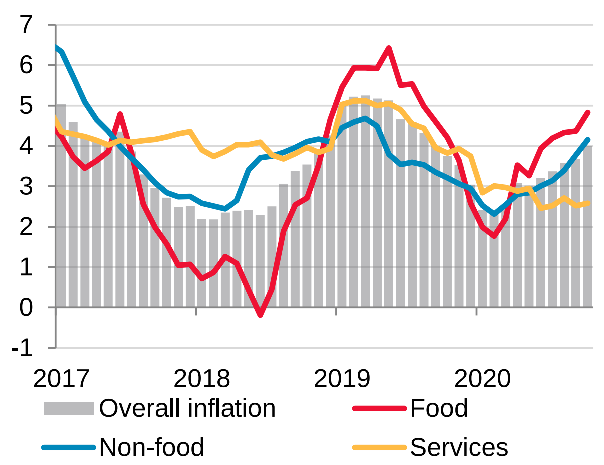
- Annual inflation continued to accelerate, rising to 3.99% in October from 3.67% in September, helped by a higher pace of monthly price increases and the exit of last year's low numbers from the calculation base.
- Seasonally adjusted monthly inflation remains volatile: it accelerated to 5.78% MoM SAAR[1] in October from 3.07% MoM SAAR in September. These fluctuations arise from the continuing impact of both one-off and more sustainable oppositely directed factors on price movements.
- In particular, the impact of short-term proinflationary brought about by contracting supply for some groups of food items and the effect of the ruble weakening pass-through in the third quarter.
- It appears that disinflationary risks prevail over proinflationary ones over a medium-term horizon, given the expected longer impact of disinflationary demand-side shocks than that of proinflationary supply-side shocks and possible amplification of disinflationary risks due to demand constraints on the back of the worsening epidemiological situation.

[1] SAAR – seasonally adjusted annualised rate.

Consumer prices added 0.43% NSA[2] in October, and given the low base of 2019, this resulted in annual inflation acceleration to 3.99% YoY from 3.67% YoY in September (Figure 1). November–December saw a reduced pace of price rises last year (an average of 2% SAAR). Therefore, despite the continuing prevalence of disinflationary risks over a medium-term horizon and their possible strengthening in the immediate future on the back of the worsening epidemiological situation, annual inflation may further accelerate slightly to come closer to the upper bound of a Bank of Russia forecast of 3.9%–4.2%

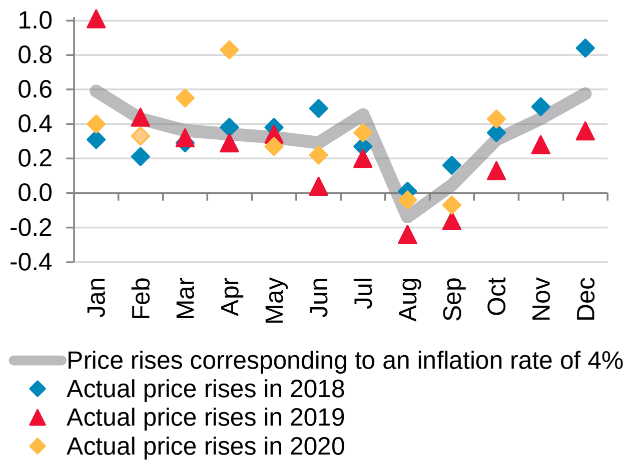
October's monthly consumer price rises came in above the path providing for an inflation rate of 4% in annualised terms (Figure 2). Seasonally adjusted monthly inflation[3] remained fairly volatile, standing at 5.78% SAAR in October after a sharp slowdown to 3.07% SAAR in September (Figure 6). This was owed to a non-uniform impact of a large number of concurrent disinflationary and proinflationary factors, one-off and more sustainable ones alike.

Figure 1. Inflation and its components, % YoY



Source: Rosstat.

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



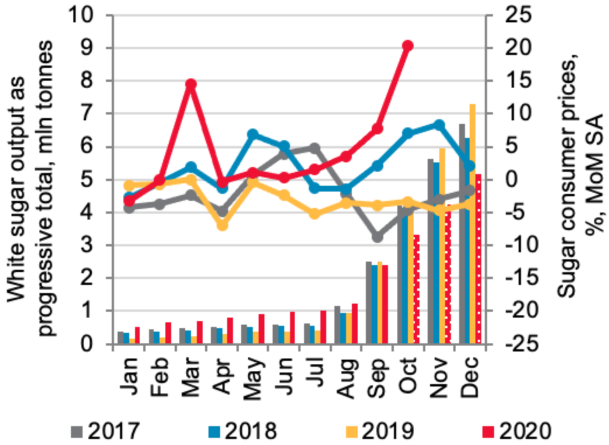
Sources: Rosstat, R&F Department estimates.

The pace of food price increases rose to 5.70% SAAR in October (0.46% MoM SA) from 2.35% SAAR (0.19% MoM SA) in September. The key price drivers in this category were sugar and sunflower seed oil. The sugar-beet and sunflower-seed crops are expected below last year's due to bad weather in the south of Russia and a crop acreage reduction. According to an Institute for Agricultural Market Studies (IKAR)[4] forecast, sugar output may fall sharply to 4.85–5.15 million tonnes for the year. This will affect further movements in the consumer prices of sugar in the months to come (Figure 3). At the same time, a significant rise in sunflower seed oil world prices[5] will exert an additional upward pressure on domestic prices, as already reflected by the current price movements (Figure 4). Domestic ruble prices of agricultural exportables are generally set based on export parity prices (adjusted for transportation expenses). This parity in turn depends on world prices and the ruble exchange rate. Therefore,

[2] Non-seasonally adjusted.
[3] Here and further on, seasonally adjusted estimates for October 2020 are preliminary.
[4] Sugar output may fall below 5 million tonnes / Agroinvestor / 17.10.2020.
[5] Russia's record price rise in sunflower seed oil / Agroinvestor / 20.10.2020.

a relatively high or low harvest in Russia only has an indirect effect on domestic prices in the absence of foreign trade barriers.

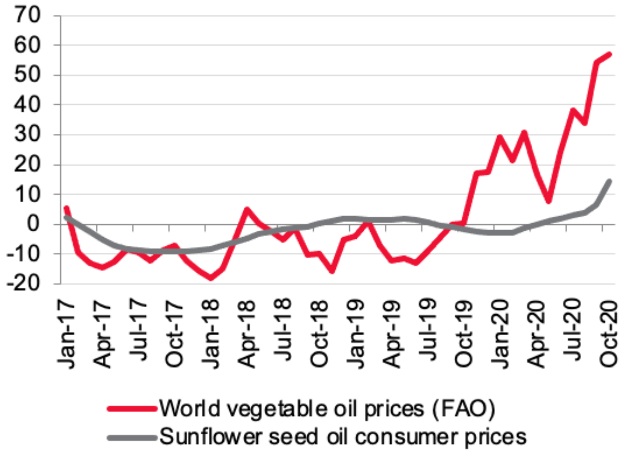
Figure 3. Sugar output and consumer prices



Note: According to an IKAR forecast, Sugar output will total 4.85– 51.5 mln tonnes for the year.

Sources: Rosstat, IKAR, R&F Department estimates.

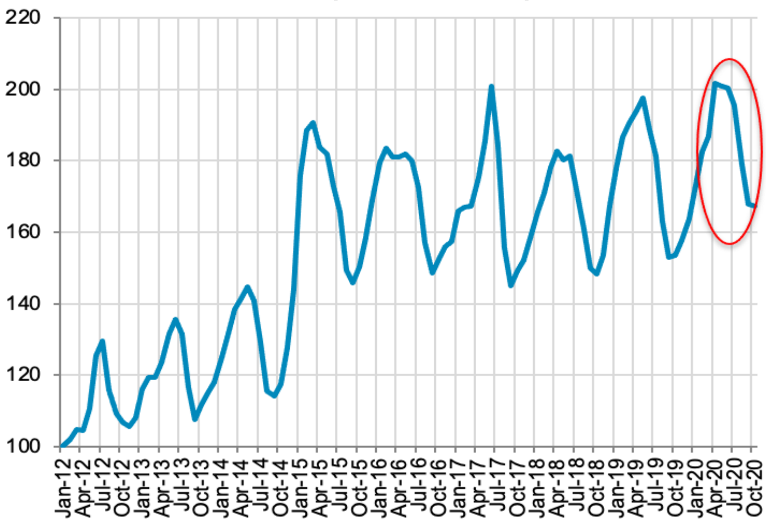
Figure 4. World prices (FAO) of vegetable oils and sunflower seed oil consumer prices, rubles, % YoY



Sources: FAO, Rosstat.

Food price rises were restrained by fruit and vegetable prices, which declined 0.37% NSA, although it is seasonally normal for them to start climbing in October. The seasonal fruit and vegetable price decline in the summer was less pronounced in 2020 than in the previous years, therefore the seasonal autumn and spring price rises may be less steep. This will in turn restrain overall food price increases (Figure 5).

Figure 5. Fruit and vegetable price index, (Jan 2012 = 100)



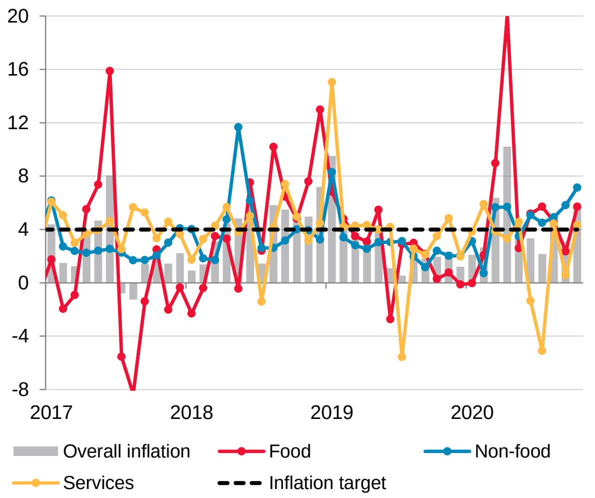
Sources: Rosstat, R&F Department estimates.

Price hikes in non-food goods continued to accelerate in October as the temporary proinflationary factors strengthened, driven by ruble weakening. Price rises remained elevated in this segment at 7.14% SAAR (0.58% MoM SA) after 5.82% MoM SAAR (0.47% MoM SA) in September. According to our estimations relying on standard empirical models which assess the scale and horizon of the effect of exchange rate fluctuations on CPI performance, the contribution of ruble weakening on October's inflation equalled 0.1–0.15 pp. The effect of the ruble weakening pass-through to prices was the most evident in the passenger car segment, where the pace of price rises accelerated for the third consecutive month. Similar price movements were recorded in other goods whose prices depend on the exchange rate, such as electrical goods and other household appliances, construction materials, and personal computers. October also saw notable price increases continue in medications, likely due to growing demand on the back of worsening epidemiological situation.

Services price hikes accelerated to 4.31% SAAR (0.35% MoM SA) in October from 0.58% SAAR (0.05% MoM SA) in September. The oppositely directed effects of various coronavirus-related restrictions continue to distort services price movements. The gradual recovery of demand for services fuelled October's price rises in unregulated services. Indeed, price increases in personal and health care services remain close to 4% SAAR. But the worsening of the epidemiological situation and the signs of weakening demand for "contact" services may restrain further services price growth unless significant supply/cost-side shocks emerge.

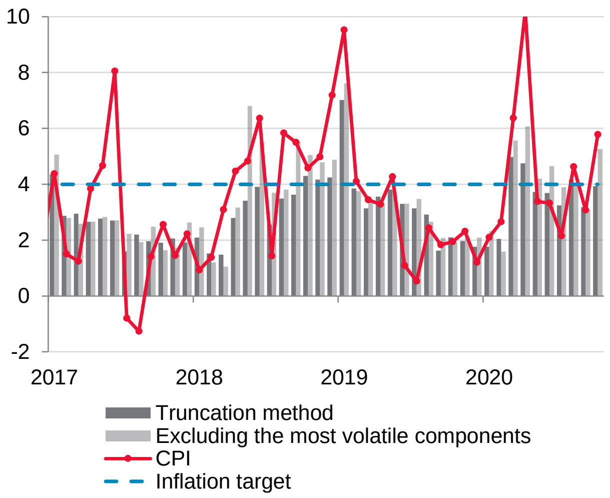
The modified core inflation indicators, which are less sensitive to the impact of one-off and temporary factors than headline inflation, post some increase in inflationary pressure. The mean of modified core inflation indicators stood at 4.59% SAAR in October, equalling 4.27% SAAR for the March–October period (Figure 7).

Figure 6. Seasonally adjusted inflation, % SAAR



Sources: Rosstat, R&F Department estimates.

Figure 7. Modified core inflation indicators, % SAAR

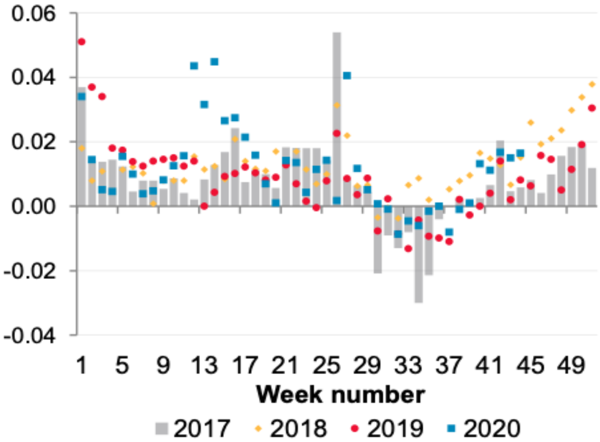


Sources: Rosstat, R&F Department estimates.

Consumer price inflation remained elevated at the start of November. In the week from 27 October to 2 November, consumer prices continued to climb at a rate posted in the previous four weeks of October, increasing 0.1%. The average daily price rises in the week in question once again exceeded the level of the same week last year (Figure 8).

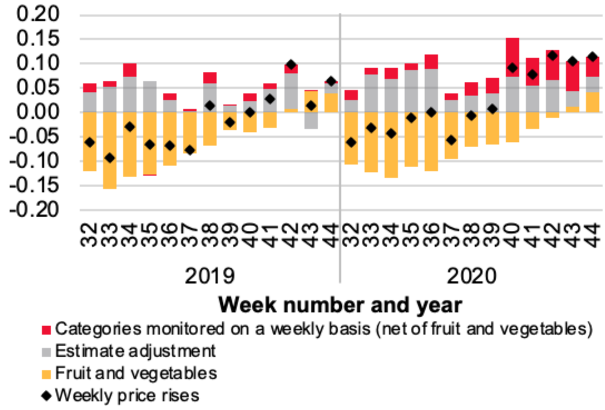
The key positive contribution to weekly inflation continued to come from the basket of goods monitored on a weekly basis (exclusive of fruit and vegetables) (Figure 9). Meanwhile, the pace of this basket's price rises over the week in question slowed, driven in large part by some slowdown in the elevated rate of price hikes in sugar, sunflower seed oil, and eggs. This was offset by the seasonal normalisation of fruit and vegetable price movements: the seasonal factor causes fruit and vegetable price increases to accelerate gradually – to 1.1% from 0.3% a week earlier.

Figure 8. Average daily price rises, %



Sources: Rosstat, R&F Department estimates.

Figure 9. Decomposition of weekly price rises



Sources: Rosstat, R&F Department estimates.

The amplification in October of the effect of short-term proinflationary factors related to ruble weakening and rising producer costs, will likely continue in November. At the same time, a more pronounced disinflationary impact of demand may soon become evident, resulting from a possible restraining effect of the worsening epidemiological situation on consumer activity.

1.2. Rises in producer prices of consumer goods accelerating

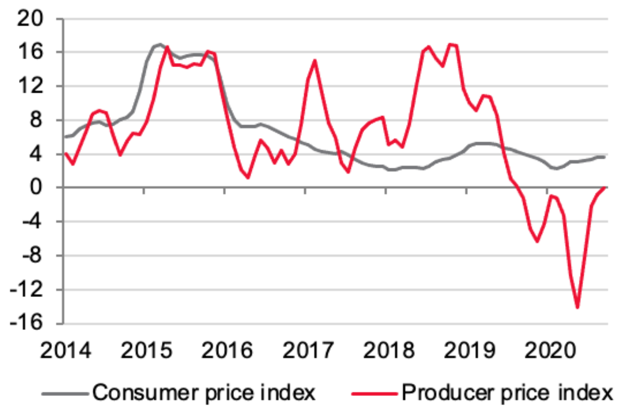
- Producer price movements still vary across individual industries. Producer price hikes gain momentum in the consumer segment as costs rise, driven by, among other things, ruble weakening. This may usher in an acceleration of consumer price inflation over a short-term horizon.
- Producer prices of industrial goods remained unchanged year-on-year in September after their 0.8% YoY decline in August (Figure 10). Producer price increases continue to be contained by a price decline in the oil extraction and petroleum refining sectors (Figure 11).
- Producer price inflation in manufacturing accelerated to 1.5% YoY in September from 1.1% YoY in August, fuelled mainly by industries[6] manufacturing consumer goods (Figure 12). The food products' contribution remained the largest, expanding in September due to producer cost increases prompted by, among other things, ruble

[6] Producer prices for groups of manufacturing industries producing consumer, investment, and intermediate goods were calculated based on the structure of weights used to calculate the CPI of industrial goods for economic activity types in compliance with the classifier of economic activity types (OKVED2).

weakening. In other segments of consumer goods production, prices remained unchanged from August.

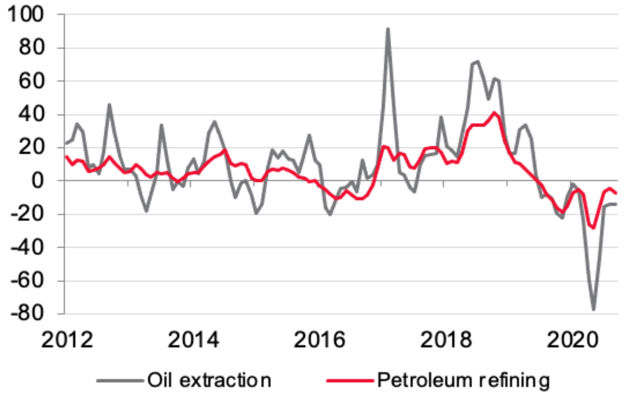
- Increases in producer prices of *investment goods* remain more moderate than those in the production of consumer goods. A decline in producer prices of *intermediate goods* gradually slows, with price changes varying considerably across individual industries.
- Producer prices of similar categories of some consumer goods[7] weighted using the household consumer expenditure structure for CPI calculation, climbed 2.7% YoY in September after 2.3% YoY in August (Figure 13). The price hike acceleration was fuelled chiefly by the resumption of a rise in the producer prices of sugar, up 23.9% YoY, and meat products, an increase of 0.8% YoY (prices of these categories had been declining for about a year).

Figure 10. Change in the producer price index and consumer price index, % YoY



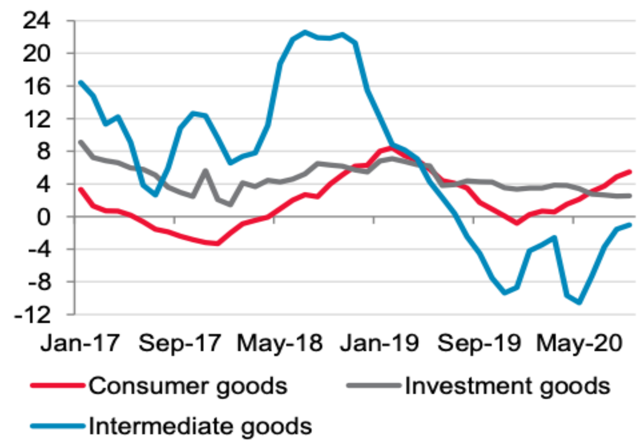
Source: Rosstat.

Figure 11. Producer prices in oil extraction and petroleum refining, % YoY



Source: Rosstat.

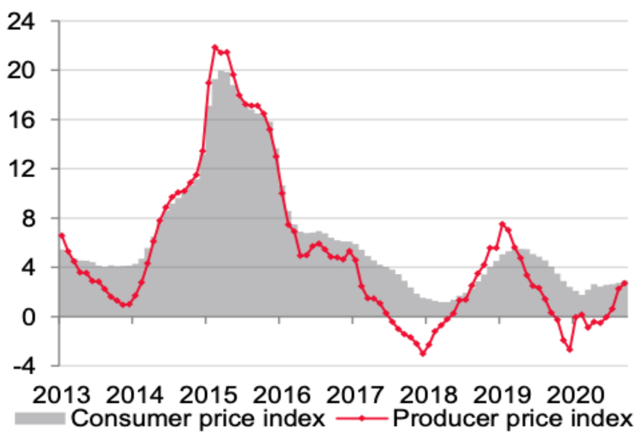
Figure 12. Producer prices for groups of manufacturing sector industries, % YoY



Note: The weights of consumer, investment, and intermediate goods in the CPI of industrial goods are 14.2%, 19.1%, and 30.5%, respectively.

Sources: Rosstat, R&F Department estimates.

Figure 13. Prices of some comparable goods in the CPI and PPI structure, % YoY



Note: Under the Rosstat methodology, producer price trends are calculated net of VAT. Hence the impact of the VAT hike in January 2019 is not factored in.

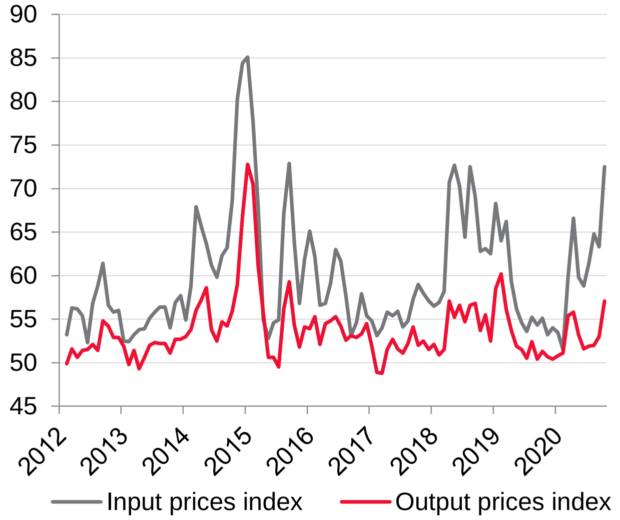
Sources: Rosstat, R&F Department estimates.

[7] Unlike the above calculation, instead of aggregation based on activity types, we use aggregation of similar goods in the CPI and PPI structure: meat products, fish products, butter and fats, dairy products, sugar, tea, coffee, wearing apparel, footwear, detergents and cleaning solutions, perfumery and cosmetic products, household electronic appliances, and furniture. They account for about 30% of the consumer basket.

1.3. PMI price indices in October: strengthening effect of proinflationary factors

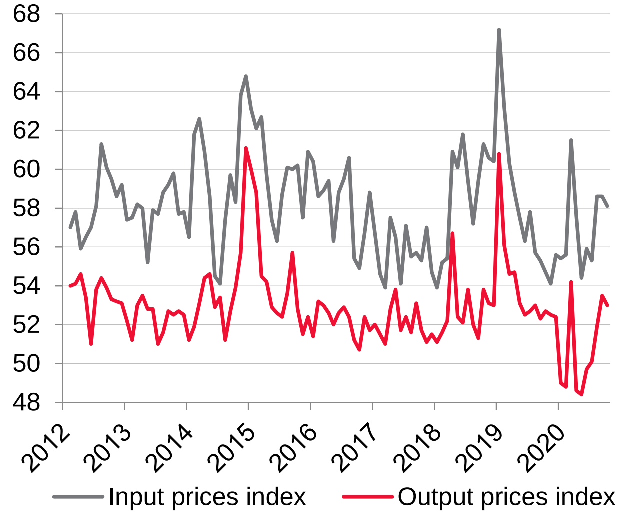
- PMI price indices suggest a significant acceleration of rises in output prices in manufacturing and still elevated price hikes in the services sector despite economic activity weakening. This arises chiefly from a sharp rise in costs as the ruble depreciates.
- The output price index in manufacturing climbed to 57.1 in October from 53.0 in September, suggesting an acceleration of final goods' price rises. All this accompanied output and new orders contraction. This combination of output and price changes indicates a significant proinflationary effect of cost rises. The input price index went up to 72.5 in October owing to both ruble weakening and increases in the prices of raw materials caused by the continuing supply chain problems (the relevant sub-index of delivery times dropped in October).
- The effect of proinflationary factors is less pronounced in the services sector, than in manufacturing. The output and input price indices declined somewhat in October compared with September (Figure 15) but remained elevated relative to the pre-coronavirus level.

Figure 14. Change in PMI manufacturing indexes, pp



Source: IHS Markit.

Figure 15. Change in PMI services indexes, pp



Source: IHS Markit.

2. Economic performance

After a slump in the second quarter and a quick rebound in the third quarter, the Russian economy's recovery continued at a slow pace, judging by real-time data. This stems from the non-uniform recovery across industries and the emergence of new unfavourable factors. Indeed, the extensive economic activity rise in the third quarter relied on the fast recovery of domestic demand for consumer goods and services. At the same time, the oil and gas sector, the related industries, and the production of intermediate goods recovered at a much slower pace.

The output of consumer goods and their sales all but reached the pre-coronavirus level at the start of the fourth quarter, thus limiting the potential of further growth in this group of industries. The recovery stalled in consumer services as self-restrictions intensified due to the expansion of coronavirus contagions. Concurrently, growth slowed in exporting industries and those meeting intermediate demand.

Credit activity, meanwhile, remained strong in September, thanks to, among other things loose monetary policy, regulatory easing, and government support measures. This created additional demand in the economy, helping its further recovery.

The Russian economy's negative output gap continued to narrow gradually in the autumn. The fast recovery of consumer demand resulted in a faster closing of the output gap in consumer industries, although a number of consumer services industries, whose share in consumption is low, were still far below the pre-coronavirus levels. A significant part of the remaining output gap is found to be concentrated in the oil and gas sector and related industries. This structure of the output gap in the economy implies a less pronounced disinflationary impact of *aggregate* demand on the CPI.

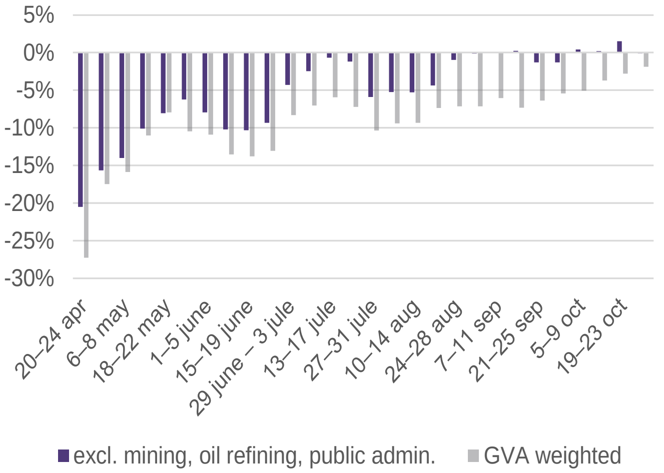
This conclusion is borne out by the normalisation of demand for consumer goods and labour market indicators. In particular, unemployment changed from an increase to a minor decline as early as September, with employment headcount rising. Therefore, while disinflationary risks still on a medium-term horizon, downward pressure on consumer prices from the cyclical downturn in the face of some loss of economic potential so far remains moderate in comparison with a usual economic downturn. Loose monetary policy will, therefore, help maintain inflation close to 4% going forward.

Another specific feature of the coronavirus crisis is that it has given rise to supply-side shocks materialising in supply contraction and/or accompanied by an increase in costs. Such shocks may last long and amplify proinflationary risks. But proinflationary supply-side shocks arising from the expansion in contagions in Russia and across the globe will likely be much milder than in the spring–summer period, unless a need arises for a full reinstatement of restrictions. At the same time, the impact of demand-side factors restraining price rises will likely strengthen. All in all, these factors suggest a likelihood of disinflationary pressure mounting as a result of the ongoing epidemiological situation worsening.

2.1. Economic activity stabilisation in October

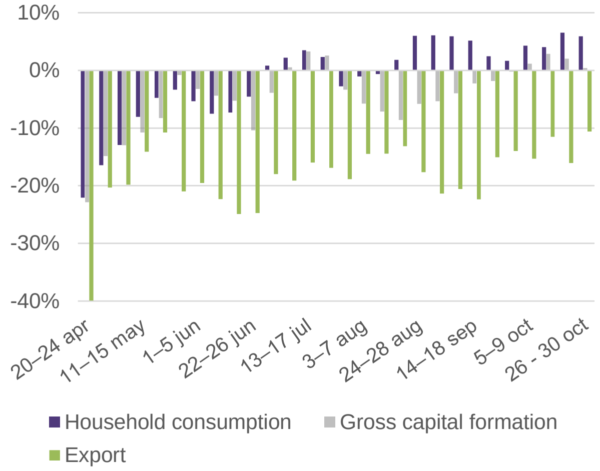
- The real-time indicators of business activity in October point to the signs of economic performance stabilisation close to the September levels without showing a clear response to the worsening of the epidemiological situation, except in some services sectors.
- The four-week rolling average deviation of incoming financial flows from the 'normal' level stayed in negative territory but close to zero in October (Figure 16), suggesting the stabilisation of economic activity. The levels of the flows in industries meeting investment and consumer demand were close to 'normal' in October (Figure 17). That said, one should bear in mind that individual industries' financial flows are nominal values, and the level of incoming flows relative to the pre-crisis numbers includes price and cost rises accumulated from the start of this year.
- The worsening of the epidemiological situation and imposition of some restrictions have already produced a minor decline in urban activity / population mobility (Figure 19). There were, however, no clear signs of a significant negative effect on overall consumer activity up until the end of October. For example, a decline in the Sberbank consumer activity index (Figure 18) so far does not go beyond this indicator's normal volatility range established since the middle of the summer. The last week of October (26 October – 1 November), meanwhile, saw a consumer expenditure deterioration due mainly to a sharp drop in the services expenditure. Romir real-time data also shows a stable performance of daily household expenditure in October along with some signs of structural expenditure redistribution from services towards goods (for details, see Subsection 2.5. Consumption of goods hit a plateau in September).
- Indirect indicators suggest that business activity in October stabilised at the September level. A gap with last year's levels of electricity consumption, an indicator of activity in power-intensive industries, remained moderate in October, just as in September (Figure 20). Rail shipments expanded year-on-year in October for the first time since October 2019, with improvement posted in almost all freight categories (Figure 21). A resumption of output and new orders decline in manufacturing is evidenced by the relevant PMI indices (see Subsection 2.2).
- Further worsening of the epidemiological situation is a factor of risk for economic activity. In some countries, authorities have once again imposed a nation-wide quarantine necessitated by the overloading of the health care system. The continuing increased uncertainty is, already now, one of the factors which may contain the recovery of the Russian economy in the next few quarters. The services PMI, for instance, dropped below the 50 line, dragged down in large part by a decline in demand which is reported by respondents. Meanwhile, expectations of change in output over a 12-month horizon in manufacturing and services alike remained in positive territory, but plunged compared with the summer months.

Figure 16. Four-week rolling average deviation of incoming payments from “normal” level



Source: Bank of Russia (Monitoring of financial flows).

Figure 17. Four-week rolling average of incoming payments from “normal” level by industry group

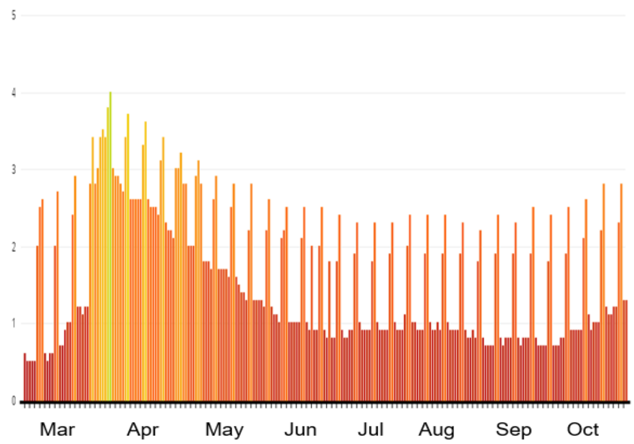


Source: Bank of Russia (Monitoring of financial flows).

Figure 18. Consumer activity Sberindex (7-days moving average)

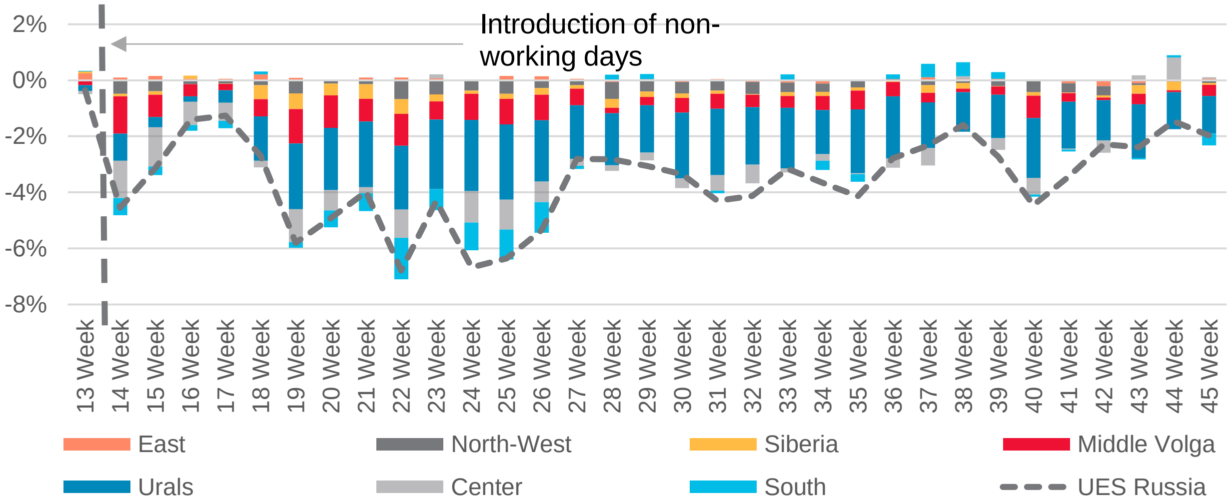
Source: Sberbank.

Figure 19. Yandex self-isolation index for Russia



Source: Yandex.

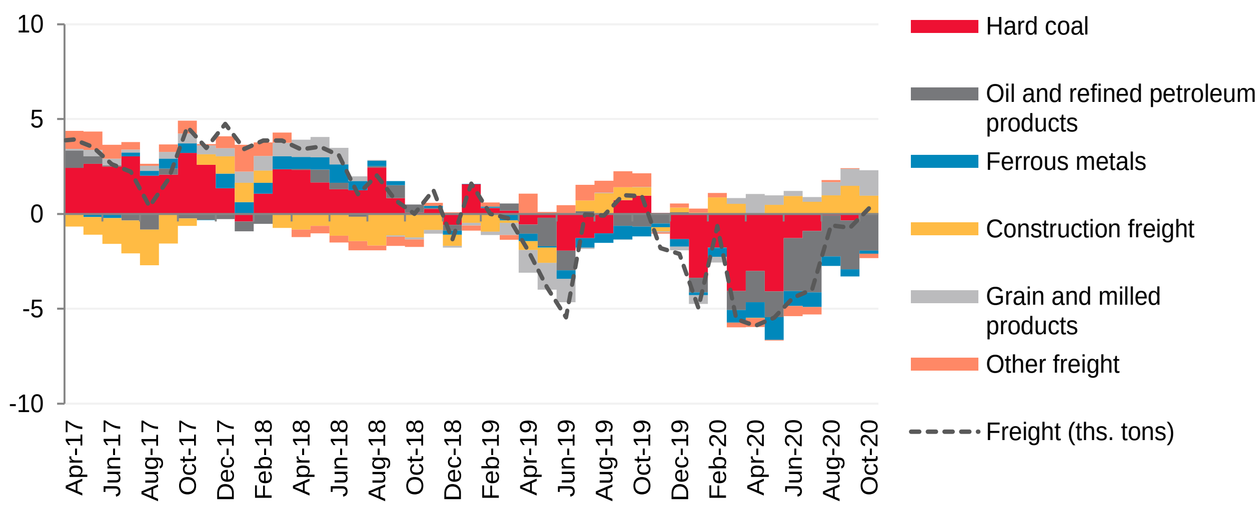
Figure 20. Contribution of regional energy systems to deviation of electricity consumption adjusted for temperature and calendar factors*, % YoY



** At some points the sum of regional energy systems contributions may not coincide with growth estimates for the UES Russia, since the electricity consumption YoY growth rates adjusted for temperature and calendar factors is estimated separately for the UES Russia, i.e. not as the sum of the adjusted growth rates of the electricity consumption in seven regional energy systems. The difference in the adjustment coefficients in UES Russia and regional systems may give small temporal differences.*

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

Figure 21. Decomposition of rail shipments in the Russian Railways network, % YoY

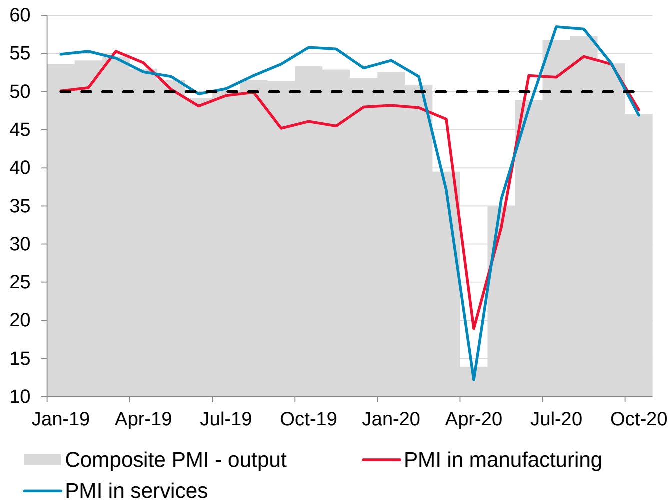


Source: Russian Railways, Rosstat, R&F Department estimates.

2.2. October saw synchronous decline in manufacturing and services PMI

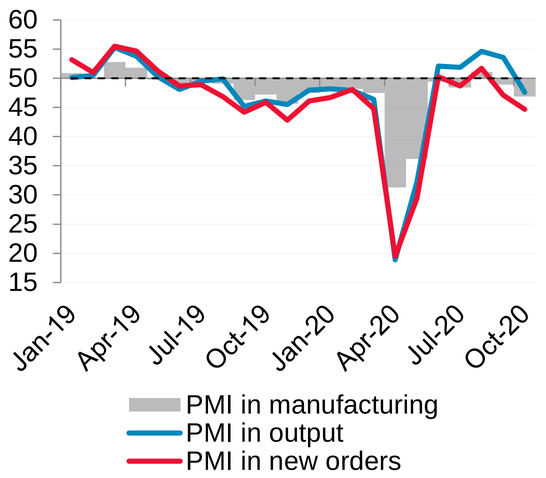
- The composite PMI index came in below the 50 line (at 47.1) for the first time since June. The worsening of economic activity was also suggested by the October estimate of the news index.
- The services PMI indices synchronously dropped to 46.9 (Figure 23, Figure 24). The respondents referred to the impact of the epidemiological situation worsening on both output and new orders.
- In the services sector, the heaviest fall in new orders, driven by the imposition of new restrictions in both Russia and abroad, was reported by respondents from the personal services sub-industry.
- Output expectations over a 12-month horizon remain positive but are much lower than in August–September (Figure 25).
- October's decline in the PMI indices is milder than during the previous occurrence of epidemiological situation worsening in March–April, thanks, above all, to more selective and targeted restrictions put in place in September–October than those in March–April.
- Formally, index readings below 50 signal activity contraction, but the magnitude of deviation from this level does not always accurately represent the magnitude of decline. PMI is a diffuse index showing a difference in the shares of respondents reporting a rise or decline in various indicators of their operating activity. Other real-time indicators do not, however, point to a significant decline in the overall level of economic activity in October, only showing it in some sectors which are directly affected by the imposition of restrictions and a rise in the number of people who have resumed self-isolation.

Figure 22. Change in PMI indexes for Russia, pp



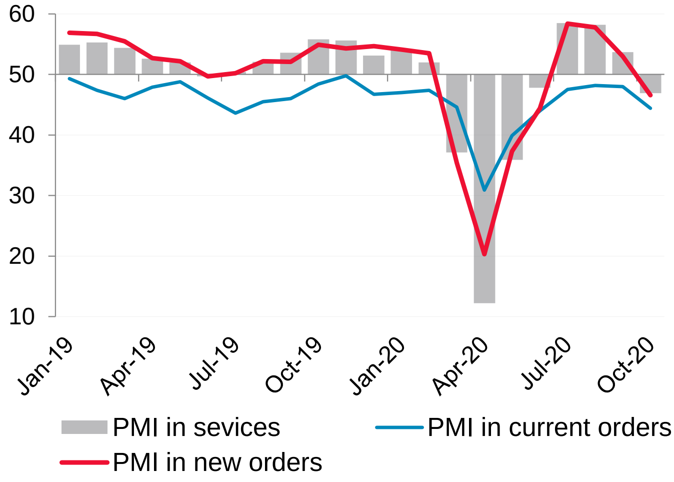
Source: IHS Markit.

Figure 23. Change in PMI manufacturing indexes, pp



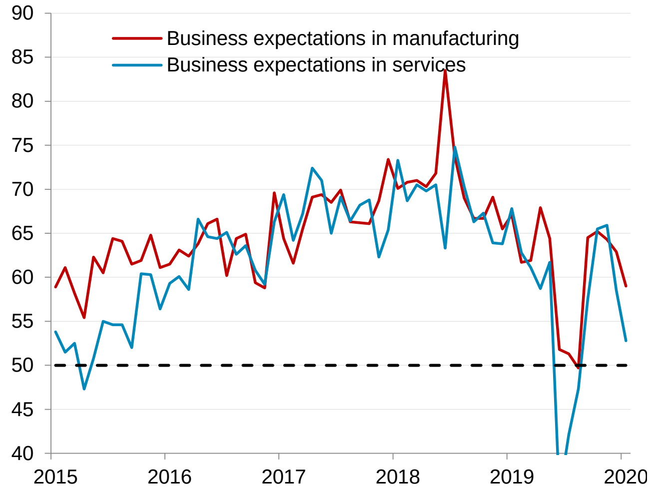
Source: IHS Markit.

Figure 24. Change in PMI services indexes, pp



Source: IHS Markit.

Figure 25. PMI for business expectations



Source: IHS Markit.

2.3. Recovery of core industries' output came to a halt in September

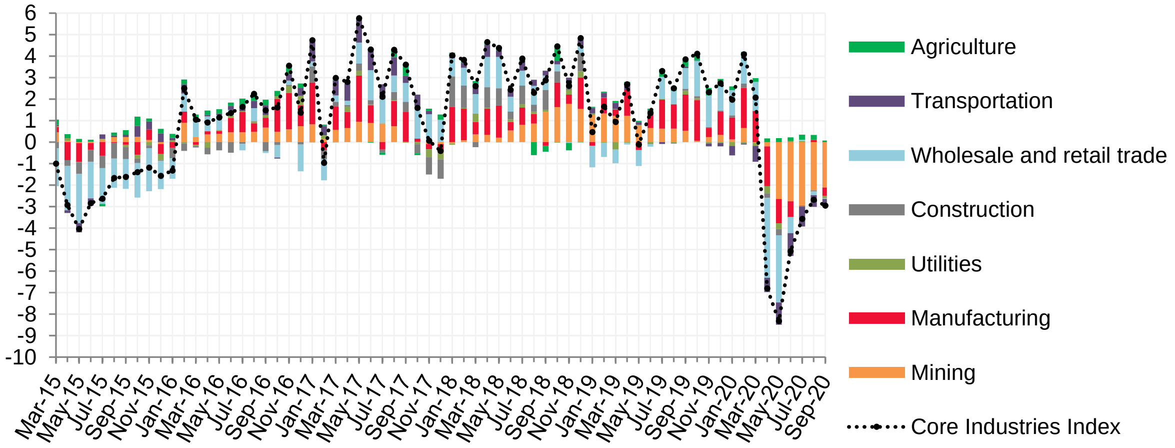
- Core industries' output (core industries index, CII[8]) contraction accelerated to 2.9% YoY in September from 2.7% YoY in August[9], dragged down by a manufacturing and retail sales decline and weakening of agricultural output growth (Figure 26). The rest of the core industries posted an overall output improvement: freight traffic and construction output contraction slowed, while wholesale sales growth gained pace.
- As a result, a fall in core industries' output slowed to 3.1% YoY in the third quarter from 6.7% YoY[10] in the second quarter (Figure 27). One can, therefore, expect GDP contraction to slow to 3%-4% YoY in the third quarter from 8% YoY in the second quarter. Moreover, the estimate of a GDP decline in the second quarter is highly likely to be downgraded following a revision to the 2019–2020 industrial output data (for details, see Section 2.4. September's industrial output: a minor decline from August).

[8] The core industries index (CII) is calculated by aggregating seven industry-specific indices (agricultural production; mining and quarrying output; manufacturing output; electricity, gas and water supply; freight traffic; wholesale and retail sales, with weights corresponding to the respective industries' shares in Russia's gross value added in 2018. The composition of the core industries index calculated by the R&F Department is similar to that used by Rosstat in calculating the index of goods and services output in physical terms for core types of economic activity, with the exception of passenger transportation. Unlike the Rosstat index, the methodology of constructing the CII allows decomposition by economic activity type and enables the core industries index to be calculated on the level of Russian Federation subjects for monitoring of the economic situation in individual regions on a real-time basis.

[9] Rosstat has updated the agricultural and transport industry output data for July–August 2020.

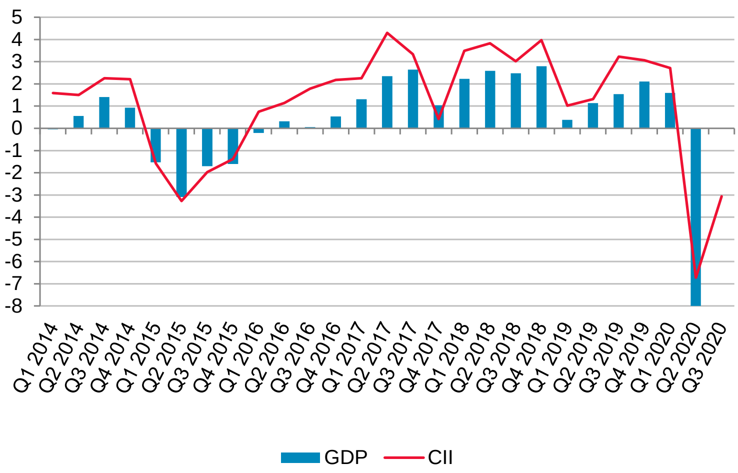
[10] Roststat in September revised industrial output data for individual industries in 2019–2020, thereby improving the QII CII reading from -7.7% YoY to -6.7% YoY.

Figure 26. Contribution of industries to the CII in 2015–2020, % YoY



Source: Rosstat, R&F Department.

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



Source: Rosstat, R&F Department.

2.4. September's industrial output: minor decline from August

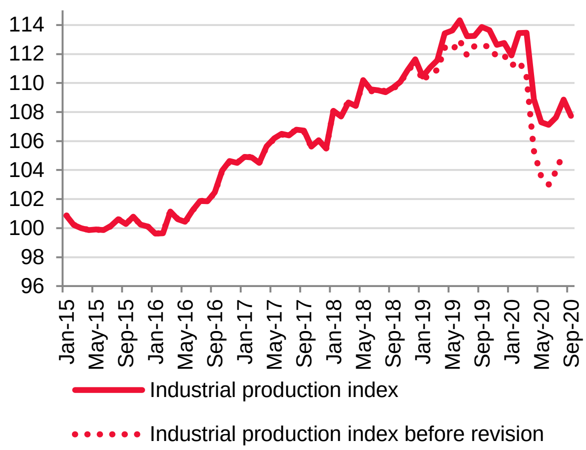
- Rosstat's revision to 2019–2020 industrial output up will reduce the magnitude of GDP contraction in 2020 by about 0.5–0.7 pp, all other things being equal. Based on this revision, many industries' output has already reached the pre-coronavirus level.
- Industrial output fell 1.0% MoM SA[11] in September, dragged down, above all, by a manufacturing output decline of 1.7% MoM SA. Mining and quarrying output dropped 0.4% MoM SA as oil extraction stabilised and the oil field service industry's output declined.

[11] Here and further on, seasonally adjusted monthly growth rates are adjusted for Research and Forecasting Department estimates.

- The key negative contribution to manufacturing output came from an output shrinkage in investment goods industries: output in some sub-industries with long production cycle hit the highest level in many years in August and came to normal in September.
- Industries meeting consumer demand posted a fall in FMCG output, while industries manufacturing durable goods continued to show growth.

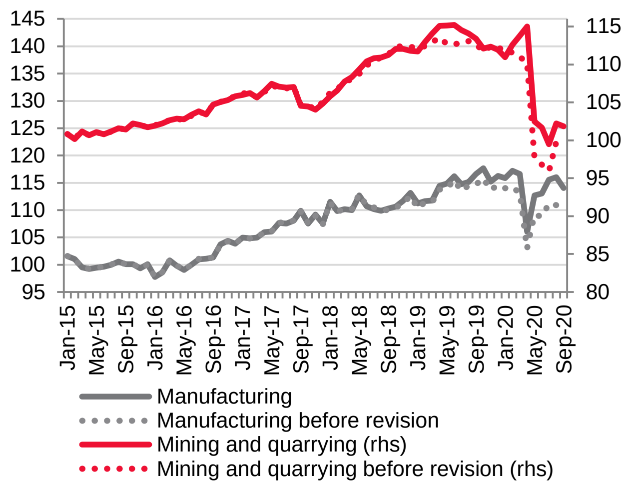
Rosstat has revised the 2019–2020 industrial output data. The indices of industrial production, mining and quarrying and manufacturing output and practically all of the manufacturing components have been revised up. The 2020 data has been revised the most substantially, output contraction, especially that in recent months, has come out much smaller in scale. We estimate that the revision to industrial output numbers will reduce the magnitude of GDP decline by 0.5-0.7 pp for 2020, all other things being equal.

Figure 28. Change in industrial production index (2014 = 100)



Source: Rosstat, R&F Department estimates.

Figure 29. Change in mining and quarrying and manufacturing indexes (2014 = 100)



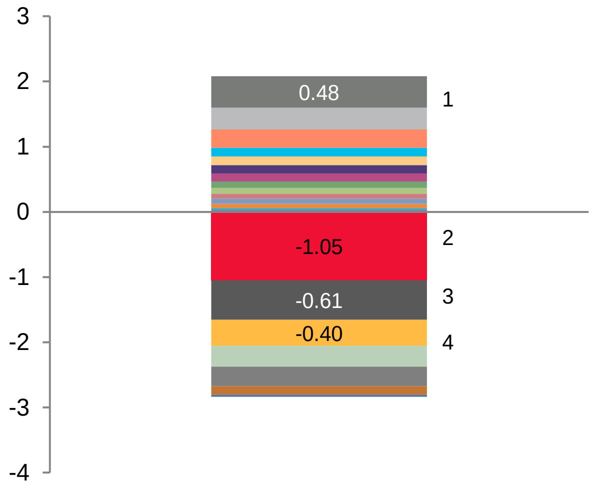
Source: Rosstat, R&F Department estimates.

Industrial output decline accelerated to -5% YoY in September from -4.2% YoY in August. A year-on-year output contraction continued to slow year-on-year in mining and quarrying in September, coming in at -10% YoY after -10.6% YoY in August.

In monthly terms, industrial output changed from growth in August to a decline of 1.0% MoM SA (Figure 28). The Centre for Macroeconomic Analysis and Short-term Forecasting provides a more positive estimate of industrial output performance: output remained almost unchanged in September relative to August (up 0.1% MoM SA) thanks to manufacturing output growth. The Centre uses a more narrow base of goods than Rosstat for calculating output indices and adjusts the numbers for various outliers and highly volatile components.

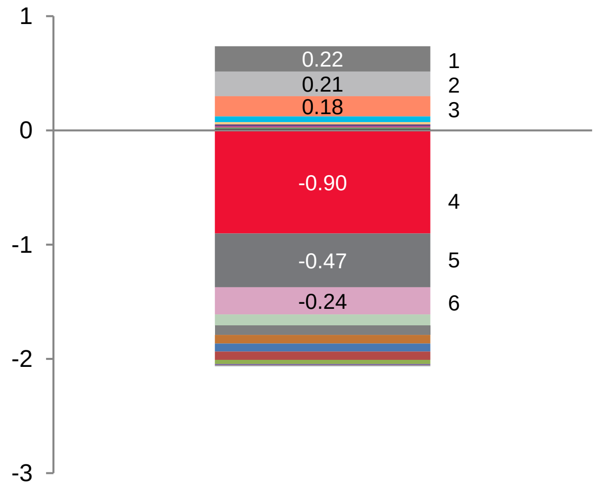
Mining and quarrying output declined marginally by 0.4% MoM SA in September, driven by a field service contraction of 2.6% MoM SA. Oil extraction, in compliance with the OPEC+ deal, expectedly remained on the August level, up 0.1% MoM SA

Figure 30. Individual industries' contribution to manufacturing growth, p.p. YoY



1 Manufacture of chemicals and chemical products
2 Manufacture of coke and refined petroleum products
3 Manufacture of other transport equipment
4 Manufacture of computers, electronic and optical products

Figure 31. Individual industries' contribution to manufacturing growth, p.p. MoM



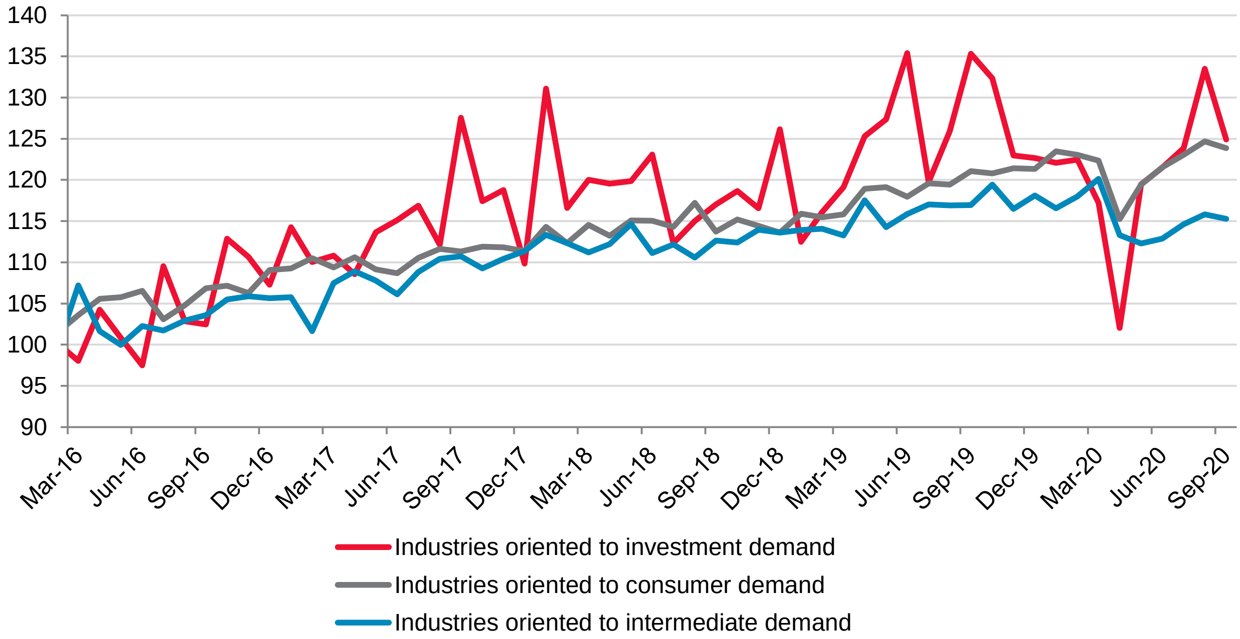
1 Manufacture of coke and refined petroleum products
2 Manufacture of basic metals
3 Manufacture of motor vehicles, trailers and semi-tralers
4 Manufacture of other transport equipment
5 Manufacture of fabricated metal products
6 Manufacture of machinery and equipment

Source: Rosstat, R&F Department estimates.

A month-on-month industrial production decline in September was chiefly owed to a manufacturing output fall of 1.7% MoM SA. The heftiest negative input came from the group of industries producing *investment goods,* most of all from the manufacture of other transport equipment, which suffered a 17% MoM SA contraction after growth of the same magnitude in August (Figure 32, Figure 33). This industry's output shows high volatility, since it includes goods manufactured via a long production cycle: the output of aircraft was the strongest over the last two years in August but returned to normal in September, causing the result to fall 29.1% MoM SA. Most of the other investment goods industries whose strong results in August were close to or rose above the pre-coronavirus level, also showed contraction in September. The production of machinery and equipment fell 6.6% MoM SA, dragged down by a 18.9% MoM SA slump in the output of industrial equipment. A positive trend was only maintained in the manufacture of electrical equipment, with its output exceeding the level of the start of the year for the second consecutive month, up 2.3% MoM SA. August seems to have seen a peak of deferred demand for investment goods, prompting a correction of September output performance. Real-time data on incoming financial flows indicates a steady improvement of the situation in industries producing investment goods throughout September and the first half of October.

Output reached the pre-coronavirus levels in almost all industries manufacturing *consumer* goods but edged down overall in September. Industries meeting FMCG demand suffered an output decline, driven by a 0.6% MoM SA fall in the manufacture of food products, which in turn resulted from a drop in the output of meat products, down 0.4% MoM SA, dairy products, down 1.1% MoM SA, and cereal products, down 3.5% MoM. The production of pharmaceutical products and supplies also declined 5.4% MoM in September. The weakening of this industry's positive trend was evidenced by a persistent decline in incoming financial flows throughout September.

Figure 32. Manufacturing industries' output, Jan 2016=100%, seasonally adjusted

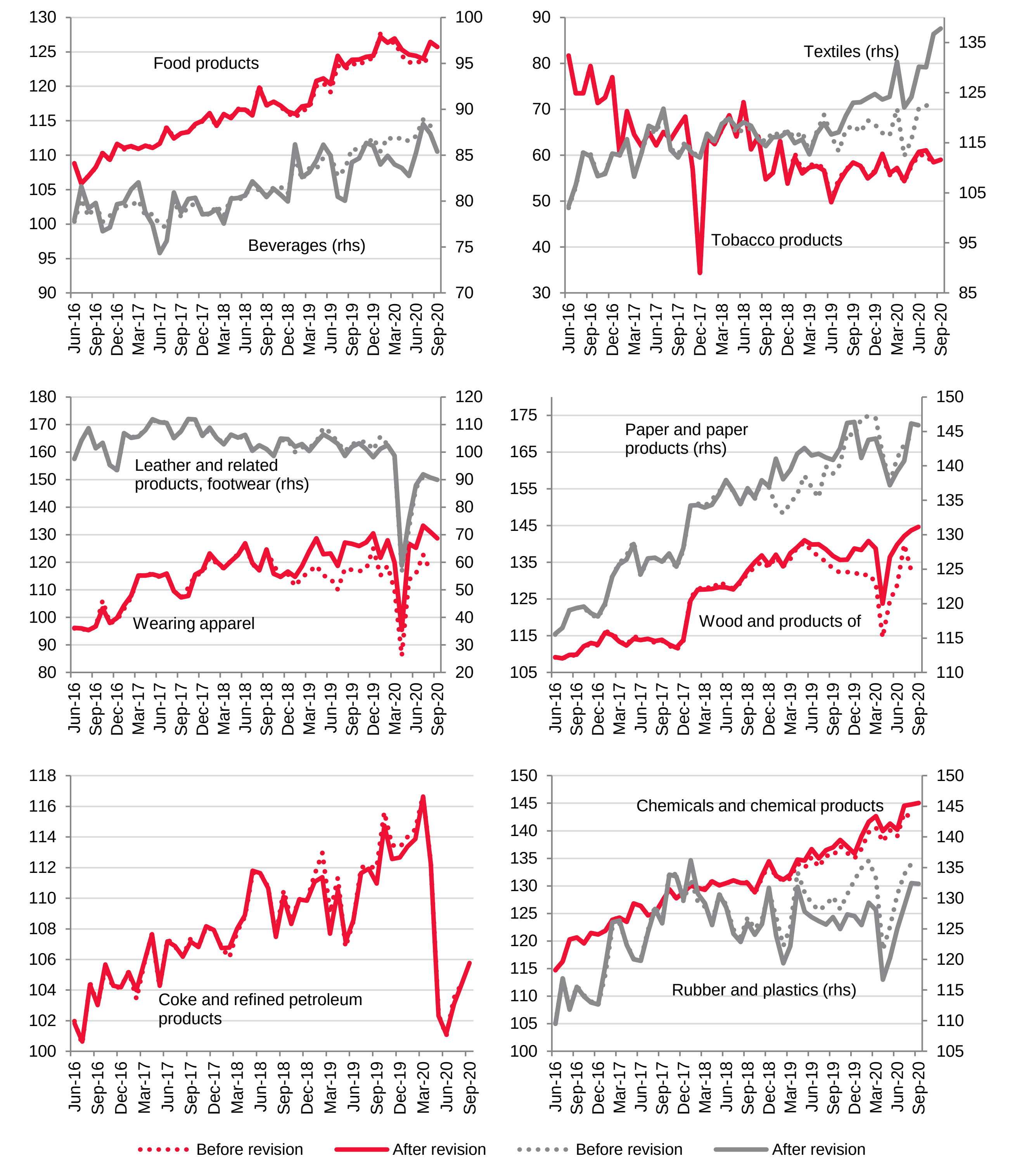


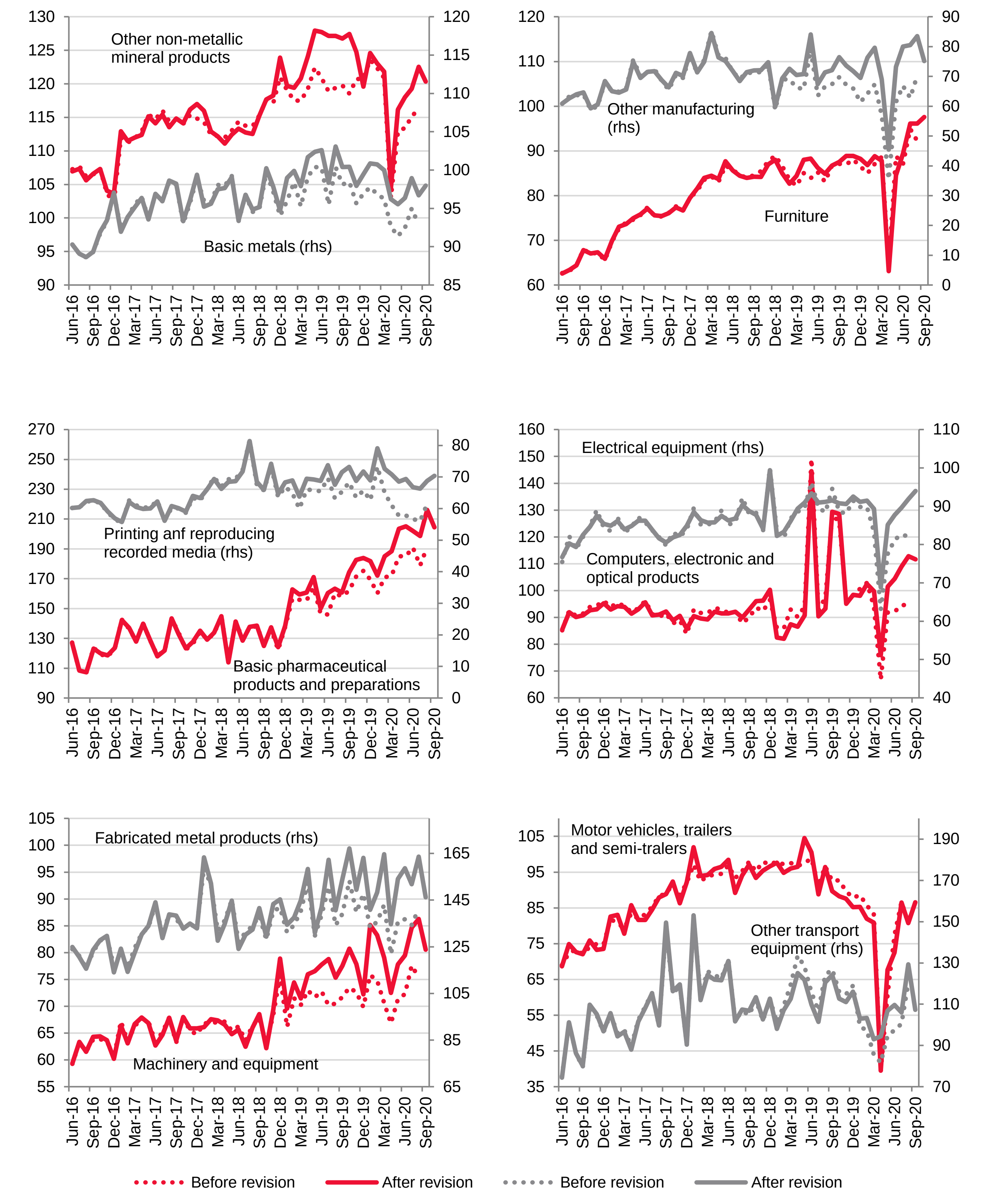
Source: Rosstat, R&F Department estimates.

The positive trend in the group of industries manufacturing durable consumer goods was propelled by the manufacture of motor vehicles, whose output rose 7.2% MoM SA. The sales of new cars increased year-on year in September, encouraging carmakers to expand their output. That said, they have so far failed to keep up a sustainable output level (according to Centre for Macroeconomic Analysis and Short-term Forecasting estimate), causing its significant fluctuations over the last three months. This may be a repercussion of the global component supply disruptions in the spring and the start of the summer. The output of household appliances continued to rise, adding 0.8% MoM SA in September and staying above the pre-coronavirus level. Also noteworthy is continued expansion in furniture output, which quickly recovered after the lifting of restrictions and stood roughly 10% above the pre-coronavirus level in September. A negative contribution to output in industries producing consumer goods came from other manufacturing, down 10% MoM SA. This is owed to a drop in demand for medical instruments and equipment, down 15.2% MoM SA, and that for pharmaceutical products.

The group of industries meeting *intermediate demand,* posted the largest gap with the pre-coronavirus level, given a reduction in the quantity of oil available for refinement. The manufacture of basic metals enjoyed an output rise of 1.3% MoM SA thanks to an upward trend in the manufacture of basic ferrous metals, up 2% MoM SA. The output of coke and refined petroleum products also continued to recover (a gain of 1.3% MoM SA), although it remains far below the pre-coronavirus level in view of the oil extraction caps under the OPEC+ deal. The manufacture of fabricated metal products suffered a heavy output fall of 10.7% MoM SA, driven by the normalisation of the railway tank cars and steam boilers production in September, down 29.2% MoM SA and 53.8% MoM SA, respectively, after a growth spike in August.

Figure 33. Manufacturing industries' output, December 2012=100%, seasonally adjusted





Source: Rosstat, R&F Department estimates.

2.5. Consumption of goods hit a plateau in September

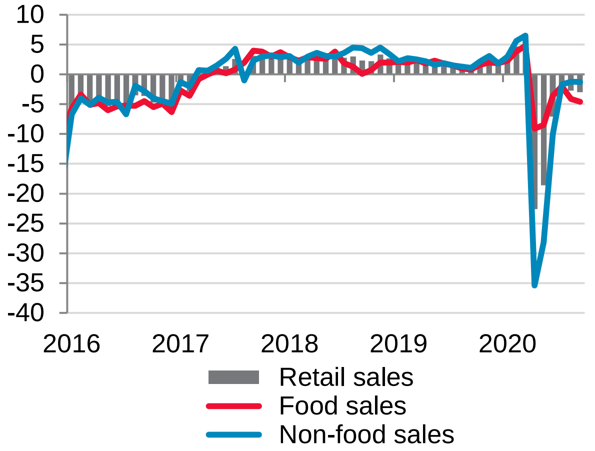
- There were no significant changes in retail sales in September, meaning that the consumption of goods has ultimately hit a plateau: a sales decline accelerated only marginally from -2.7% YoY in August to -3.0% YoY in September. Paid services, however, continued to recover, gaining 6.7% MoM SA.
- Household income recovered partially in the third quarter, with the normalisation of the household expenditure structure (a drop in the savings rate after its surge in the second quarter) allowing a fast recovery of consumption after its slump in the second quarter. Consumption, nonetheless, stays below the pre-coronavirus level.
- Real-time data on household consumption shows the signs of some expenditure contraction, above all in services, amid the worsening epidemiological situation. In the months to come, consumption will depend on households' adjustment to changes in the epidemiological situation and their income. The key difference from the situation in the spring period is that the food expenditure level will likely be maintained and there should be no sizable slump of non-food sales, with demand migrating from services unless stringent restrictions are reinstated.

September did not bring along any significant changes in retail sales, thus indicating that household consumption of goods had ultimately hit a plateau. According to Rosstat data, seasonally adjusted retail sales edged up 0.2% MoM in September, while a year-on-year decline accelerated only marginally from -2.7% YoY to -3.0% YoY (Figure 34). That said, the key negative contribution to this acceleration came from food retail, which, maintaining the August trend, resumed a sales decline acceleration from -4.1% YoY to -4.6 YoY in September. In monthly terms, however, sales inched up 0.1% MoM SA after their 0.7% MoM SA fall in August. Demand for non-food goods also expanded 0.3% MoM SA, still 1.3% below the last year level.

The key driver of household consumption growth in September was the services sector, which, according to Rosstat data, narrowed the gap with last year's level to -12.2% YoY from -18.8% YoY in August. In monthly terms, the recovery accelerated to 6.7% MoM SA from 2.3% MoM SA in August.

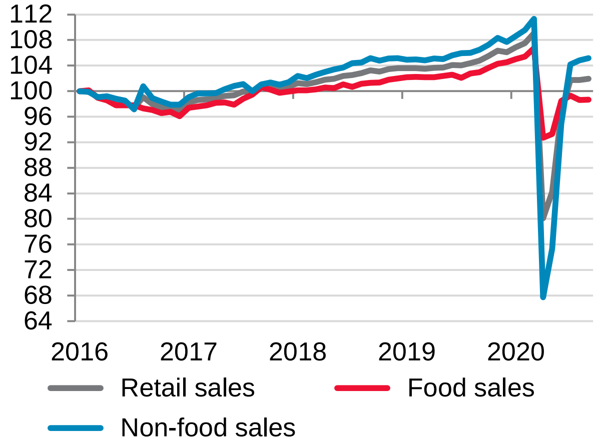
After a 5% YoY contraction in nominal terms in the second quarter, household money income reached last year's level in the third quarter amid a continuing steady rise in social payments (up 19.1% YoY after a 21.9% YoY increase in the second quarter) and a slower decline in entrepreneurial income (down 9.6% YoY after a 34.0% YoY plunge in the second quarter). Labour income increased marginally from last year's, up 1.3% YoY. The income structure, therefore, balanced out, returning to last year's levels overall, with a slight 1 ppt redistribution of the shares of income from property (4.3%) and entrepreneurial income (5.6%) towards the share of social payments (22.9%).

Figure 34. Change in retail sales of food and nonfood goods and retail sales turnover, % YoY



Source: Rosstat.

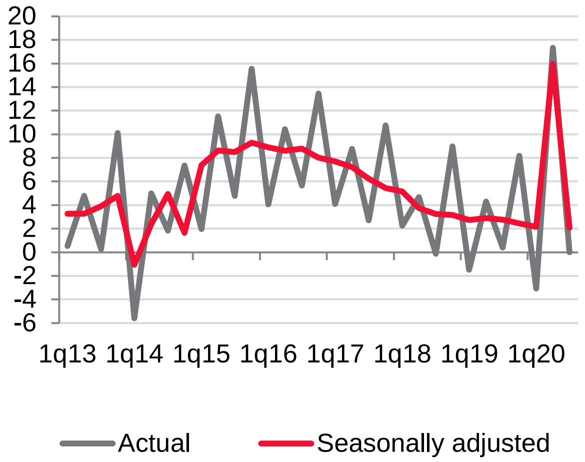
Figure 35. Retail sales (January 2016 = 100%, seasonally adjusted), %



Sources: Rosstat, R&F Department estimates.

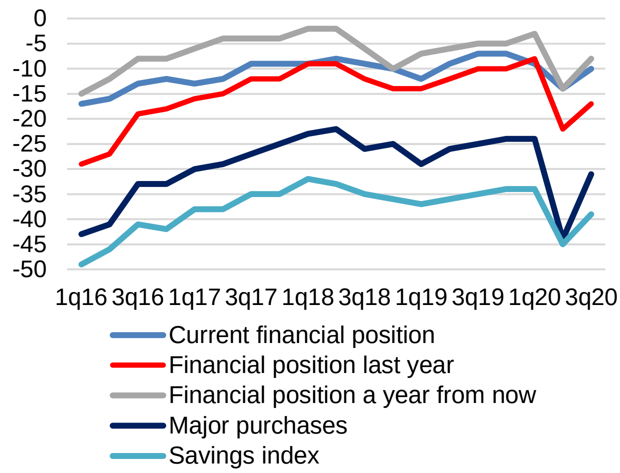
A slowdown in real disposable household income decline to -4.8% YoY in the third quarter from -8.4% in the second quarter and the normalisation of the household expenditure structure in the third quarter after a significant shift in the second quarter helped a fairly fast recovery of consumption after its plunge in the second quarter. Indeed, the inability to spend money on purchasing goods and services because of restrictions in place, along with a rise in uncertainty brought about a record increase of household savings rate, while the share of expenditure on goods and services reached the trough in the second quarter but came back to normal as early as the third quarter, along with the savings ratio, which came close to last year's levels (Figure 36). Household consumption, nonetheless, remains depressed compared with the pre-coronavirus period.

Figure 36. Savings rate adjusted for a rise in escrow accounts, % of money income



Sources: Rosstat, R&F Department estimates.

Figure 37. Consumer confidence index

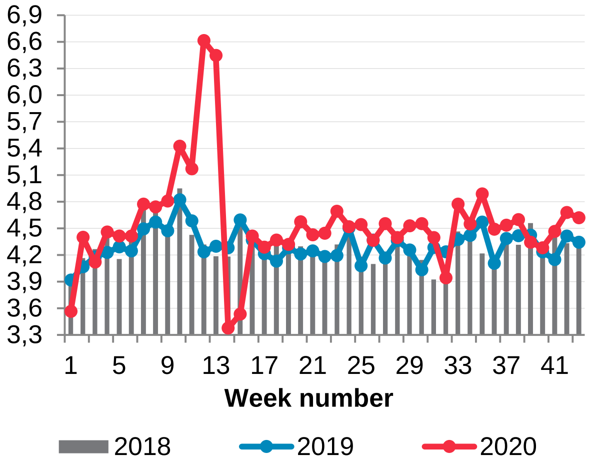


Source: Rosstat.

A significant gain in consumer confidence was also registered in the third quarter. The Rosstat index added 8 points as the number of respondents showing pessimism decreased. The indices of expected and actual changes in respondents' personal financial position gained 6 and 5 points, respectively, compared with the second quarter (Figure 37). The consumer expectations index calculated from InFOM survey data for September registers similar changes. As in the Rosstat index, the largest change from the previous reading was recorded in the sub-index measuring the respondents' perceptions of whether it was a good time for major purchases, up 5 and 13 points in the InFOM and Rosstat surveys, respectively. Although quarterly survey data arenot the most up-to-date indicators of the current consumer activity, the positive changes that we've mentioned will, in our view, buttress consumer demand in the fourth quarter.

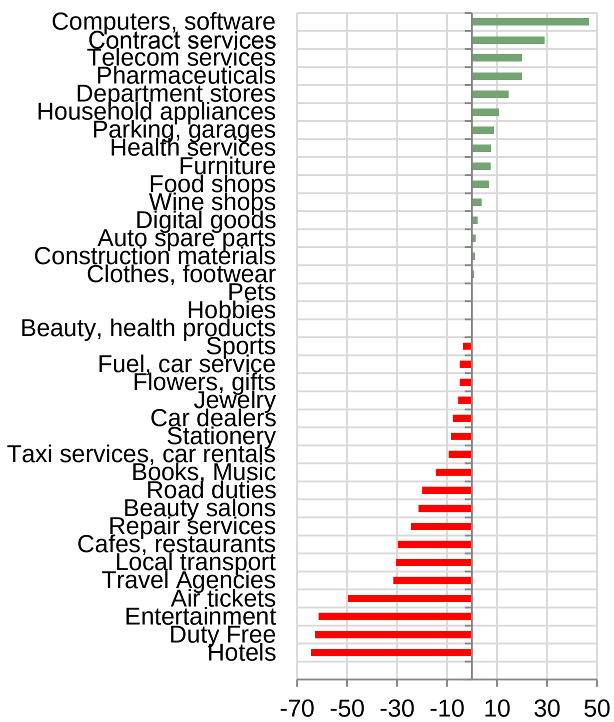
Consumption will, in the next few months, depend on changes in household income and consumer preferences amid the worsening epidemiological situation. Demand for services may well contract, as October's real-time data has already started to reflect. We, however, believe that a surge of FMCG demand similar to what was seen at the end of the first quarter is so far unlikely. Sberbank has registered the start of a gradual services expenditure contraction amid the growing coronavirus contagions. According to Romir[12] data, weekly numbers of daily expenditure, which started to decline early in October, stabilized in the middle of the month, showing a year-on-year increase of 6% in the last two weeks (Figure 38). This may reflect a gradual redistribution of household expenditure from services back towards goods.

Figure 38. Nominal weekly household expenditure, thousand rubles



Source: Romir.

Figure 39. Change in real expenditure on goods and services in October, % YoY



Source: «Sberdata» Lab.

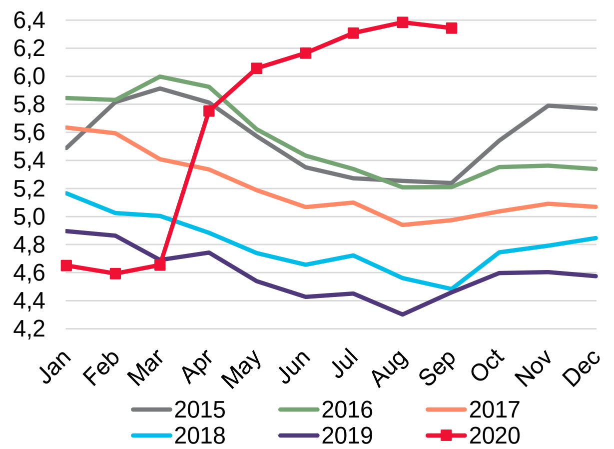
[12] Weekly expenditure continued to rise steadily / Romir Research Holding Company, 20/10/2020.

2.6. First signs of labour market recovery

- The seasonally adjusted unemployment rate declined in September, for the first time since the start of the pandemic. Labour demand, including from industries worst hit during the pandemic, is gradually recovering. The worsening of the epidemiological situation may, however, slow the labour market recovery.
- Nominal and real wage growth slowed in August, driven by private sector companies, whereas the pace of public sector wage expansion remains elevated.

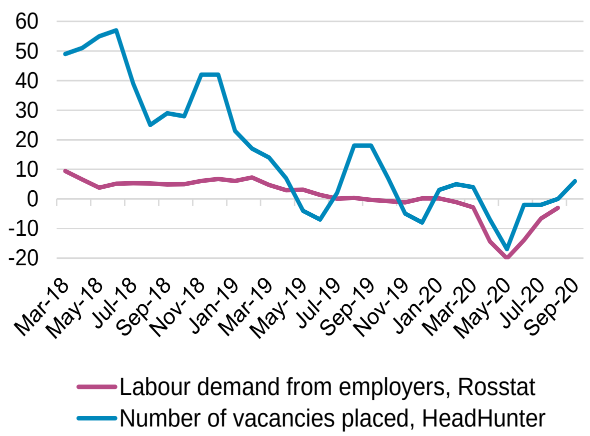
The unemployment *headcount* dwindled by 31 thousand to 4.777 million people in September for the first time since the start of the pandemic. The unemployment rate stood at 6.3% versus 6.4% in August (we estimate that in seasonally adjusted terms it fell from 6.51% to 6.45%) (Figure 40). The unemployment headcount fall from its August peak was owed to a gradual labour market recovery after the lifting of the coronavirus-related restrictions and by the seasonal factor (labour demand rises in the autumn).

Figure 40. Unemployment rate, %



Sources: Rosstat.

Figure 41. Labour demand from employers, % YoY



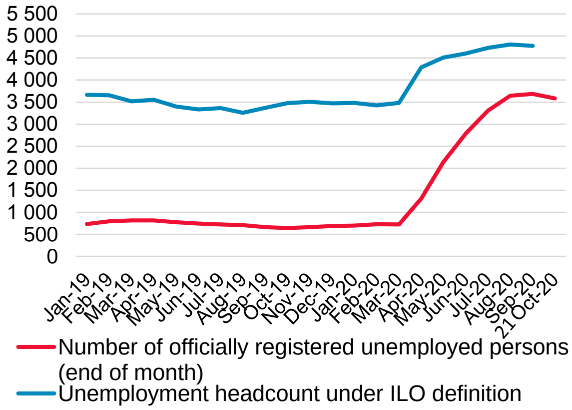
Sources: Rosstat, HeadHunter.

Demand for employees rose year-on-year for the first time from the start of the coronavirus crisis. According to HeadHunter data, the number of vacancies increased 6.0% YoY in September (Figure 41). Moreover, organisations which dismissed their employees during the pandemic, such as tourist industry agencies, beauty parlours, and sports clubs, were the most active in placing their vacancies. Labour demand recovery may have also been fuelled by a reduction in the number of non-resident workers. According to a Centre for Strategic Studies estimate, the departure of migrants may lead 15% of companies to promptly look for new personnel.[13] That said, the worsening of the epidemiological situation may cause a suspension of the vacancy recovery process.

[13] https://www.vedomosti.ru/economics/articles/2020/10/20/843977-ottok-migrantov.

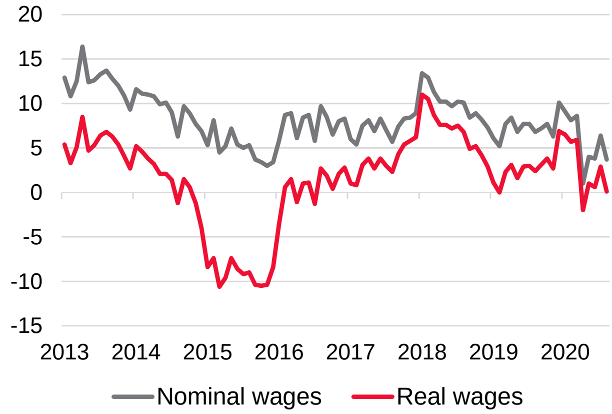
The number of officially registered unemployed persons started to dwindle in October. As of 21 October, their number stood at 3.584 million persons, down 0.103 million from the start of the month (Figure 42). The downward move, in our view, stems from both a rise in labour demand and cessation of increased unemployment benefit payments as of 1 October.

Figure 42. Number of officially registered inemployed, thousand persons



Source: Rosstat.

Figure 43. Wage growth rate, % YoY



Sources: Rosstat.

Year-on-year wage growth weakened in August to 3.7% YoY in nominal terms and 0.1%YoY in real terms (6.4% YoY and 2.9% YoY, respectively, in July) (Figure 43). A notable support for wage growth still comes from public sector wage rises. August saw wages increase 20.5% YoY in the health care sector,[14] 11.3% YoY in the education sector, and 5.8% YoY in public administration. Services sector wages, however, declined, and this trend may continue amid the worsening of the epidemiological situation.

Wage growth recovery helps a recovery-induced rise in the personal income tax revenues of regional budgets (Figure 45). After its 16% YoY plunge in April–May, personal income tax revenue shows accelerating growth from 3% YoY in June to 15 YoY in August.

At the same time, the expansion in personal income tax revenue outpaces wage growth. We believe that it stems from several concurrent factors. *First,* this gap is in part owed to changes in the employment and wages of workers whose data is not accounted for in estimating nominal wages. Indeed, the wages of employees working on a part-time basis in other organisations than those where they are employed full time and people working in large and medium-sized companies as independent contractors grew 10.4% YoY and 8.5% YoY, respectively, in August. Also, growth in the number of people working on a part-time basis in other organisations than those where they are employed full time has started to accelerate, which may reflect organisations' adjustment to the increasing uncertainty (Figure 44). According to our estimate, the omission of data on the above two employee categories accounted for 0.2 pp of the gap between nominal wages and personal income tax revenue. *Second,* an assumed progressive departure from the informal economy may represent another

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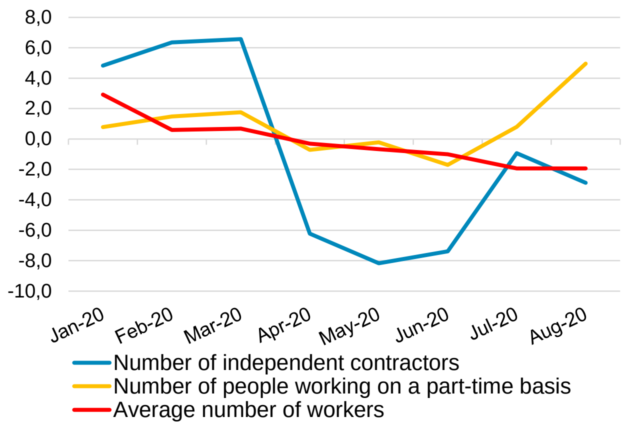
[14] Health care sector wages have been rising 20% YoY since May 2020, driven by increased payments to personnel directly engaged in dealing with coronavirus patients.

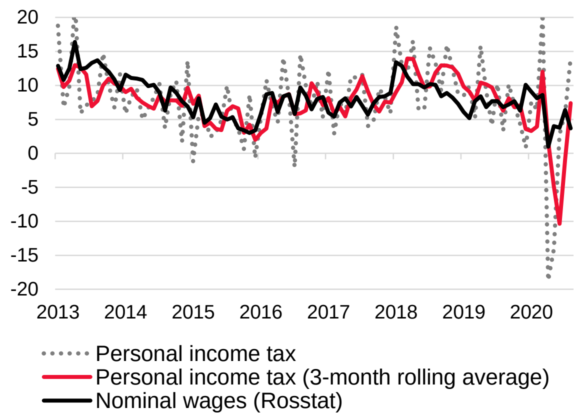
factor explaining this gap. Government support during the pandemic may have encouraged many entrepreneurs to leave the shadow sector. *Third,* on account of the pandemic, the deadline for personal income tax payment by sole proprietorships in the hardest hit industries was extended for three months this year, until 15 October from 15 July last year.

Figure 44. Number of workers outside of small businesses, % YoY



Source: Rosstat, R&F Department estimates.

Figure 45. Nominal wage growth and personal income tax, % YoY



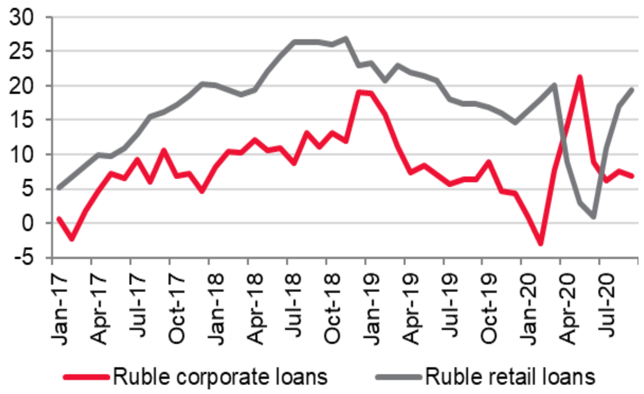
Source: Rosstat, RF Treasury, R&F Department estimates.

2.7. Banking sector in September: non-uniform lending performance

- Retail lending growth accelerated to 1.6% MoM amid a mortgage lending boom. The extension of the subsidised mortgage lending programme and recovery of people's optimism will buoy retail lending expansion despite the signs of growth easing in the unsecured consumer lending and auto loan segments.
- Ruble corporate lending growth slowed to 0.2% MoM as short-term loans dwindled because of companies' decreasing need to compensate the income shortfall.
- Banks' net interest income dropped 5.4% QoQ in the third quarter, dragged down by interest rate cuts amidst monetary easing, subsidised lending programmes, and the restructuring of part of credit claims.
- The banking sector's profit, however, more than doubled after a sharp fall in the second quarter. This was helped by, *first,* net fees and commissions income growth fuelled by economic activity recovery as restrictions were gradually lifted and, *second,* ruble weakening, which brought about a sizable one-off increase in net income from foreign currency operations and derivatives.

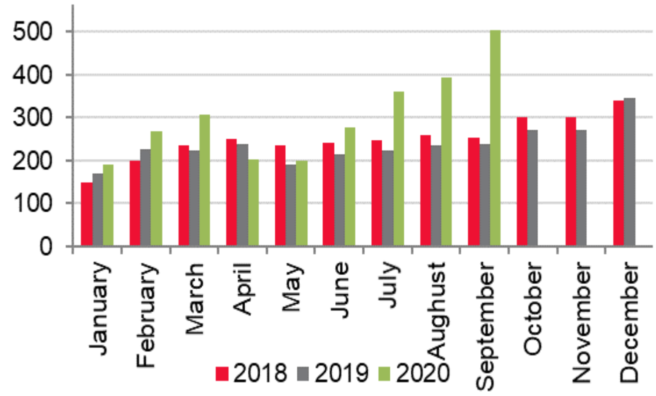
Ruble retail lending continued to expand steadily in September, rising 1.6% MoM[15] SA after 1.5% MoM SA in August. The three-month annualised average accelerated to 19.3% (Figure 46), with year-on-year growth edging up from 13.3% YoY to 13.5% YoY.

Figure 46. Lending performance, 3-month annualized average, %



Source: Bank of Russia.

Figure 47. New mortgage loans issued, billion rubles



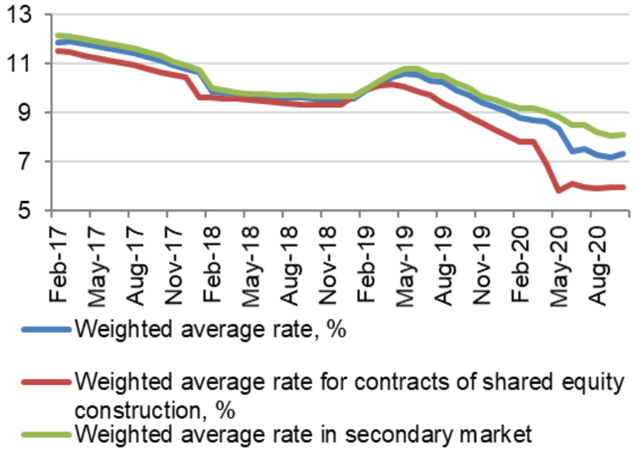
Source: Bank of Russia.

Mortgage lending remains the key growth driver: a total of mortgage loans issued expanded 2.1 times YoY in September (Figure 47). In addition to subsidised mortgage loans for new housing, which accounted for about 30% of all mortgage loans issued, loan refinancing rose in scale. As market (unsubsidised) interest rates declined, the share of mortgage loans in new loan issuance reached the highest level since 2019[16] (Figure 47). As a result, mortgage loan portfolio growth accelerated in September from 16.8% YoY to 18.8% YoY, or from 16.9% YoY to 18.8% YoY with MBS[17] debt included.

Despite a slight growth acceleration in unsecured consumer loans from 0.9% MoM SA in August to 1.0% MoM SA in September, this segment and auto lending (a slowdown from 0.9% MoM SA to 0.8% MoM SA in September) showed signs of growth easing.[18] This came on the back of petering out deferred demand as banks maintained their conservative lending policies, as well as shortages in some car market segments due to car output contraction during the 'day-off' period. These trends will likely cause retail lending growth to slow to a more moderate pace going forward. At the same time, the extension of the subsidised mortgage lending programme and relatively low rates amid the improving household sentiment[19] will buoy mortgage lending and retail loan portfolio growth.

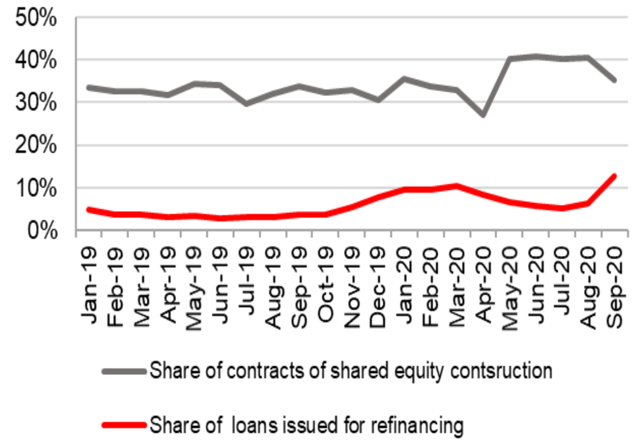
[15] Here and further on, month-on-month growth numbers are adjusted for seasonal factors and the number of credit organisations in operation.
[16] The Bank of Russia started to collect this kind of data in January 2019.
[17] Mortgage-backed securities.
[18] According to National Bureau of Credit Histories data, new loan issuance has declined in the credit card and cash loan segments over the past month.
[19] VtSIOM polls indicate that household sentiment regarding housing acquisition returned to the pre-coronavirus level: about 44% of respondents said it was a good time for buying housing.

Figure 48. Interest rates in mortgage loan market, %



Source: Bank of Russia.

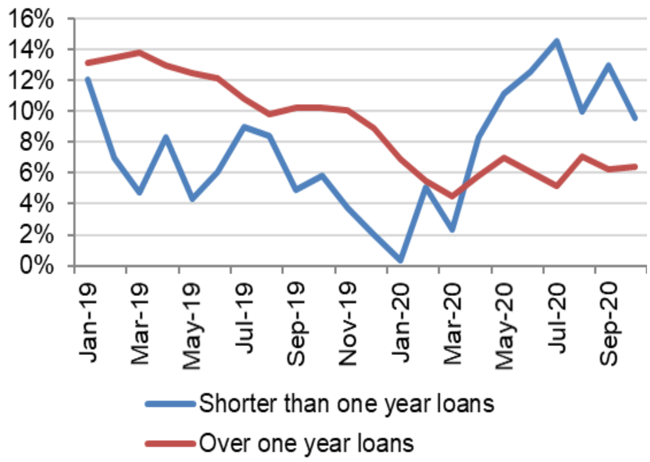
Figure 49. Share of loans by purpose in total mortgage loan issuance, %



Source: Bank of Russia.

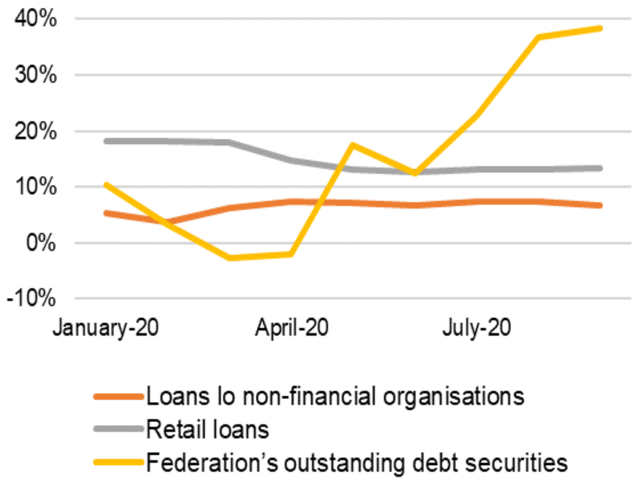
Ruble corporate lending expansion slowed notably to 0.2% MoM SA in September from 0.8% MoM SA in August. Three-month annualised growth slowed to 6.8% from 7.6% (Figure 46). This slowdown is driven above all by a fall in short-term ruble loans as banks' need to compensate an income shortfall[20] declined (Figure 50) amid recovering business activity. Meanwhile, long- and medium-term loans continued to expand (Figure 51) as investment demand maintained its recovery. We note that the corporate lending growth easing does not arise from an expansion in banks' debt security investments. OFZ investments affect the banking sector liquidity (funds on corresponding accounts) which is not needed for providing loans.

Figure 50. Dynamics of loans for non-financial organizations, % % YoY



Source: Bank of Russia.

Figure 51. Annual growth in banks' lending and OFZ investments, % YoY

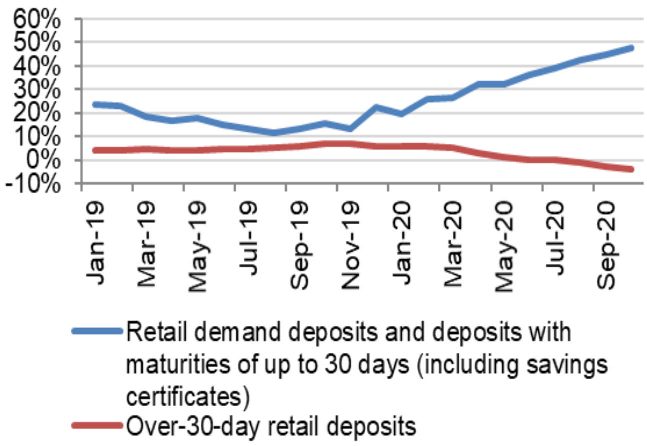


Source: Bank of Russia.

[20] Under various government support measures, companies were offered loans with maturities of up to one year.

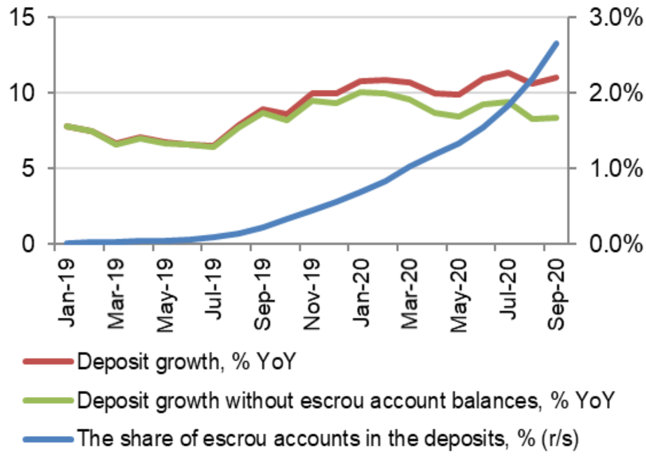
Growth in household ruble deposits accelerated from 0.7% MoM SA to 1.3% MoM SA, helped in part by increasing balances of escrow accounts (Figure 53). The new housing mortgage lending boom pushed their share in ruble deposits up from 2.1% to 2.6% in September. Net of escrow accounts, monthly deposit expansion accelerated from 0.4% MoM SA to 0.9%% MoM SA. Growth is concentrated in demand deposits and deposits with maturities of up to 30 days (Figure 52), whereas longer-than 30-day deposits continue to contract. This stems from the continuing high uncertainty, which boosts demand for liquid assets, the convergence rates on deposits of different maturities, and a rise in retail investment in alternative savings sources, scaling down interest in long- and medium-term deposits.

Figure 52. Annual household deposit growth breakdown by maturity, % YoY



Source: Bank of Russia.

Figure 53. Household deposits and funds on escrow accounts



Source: Bank of Russia.

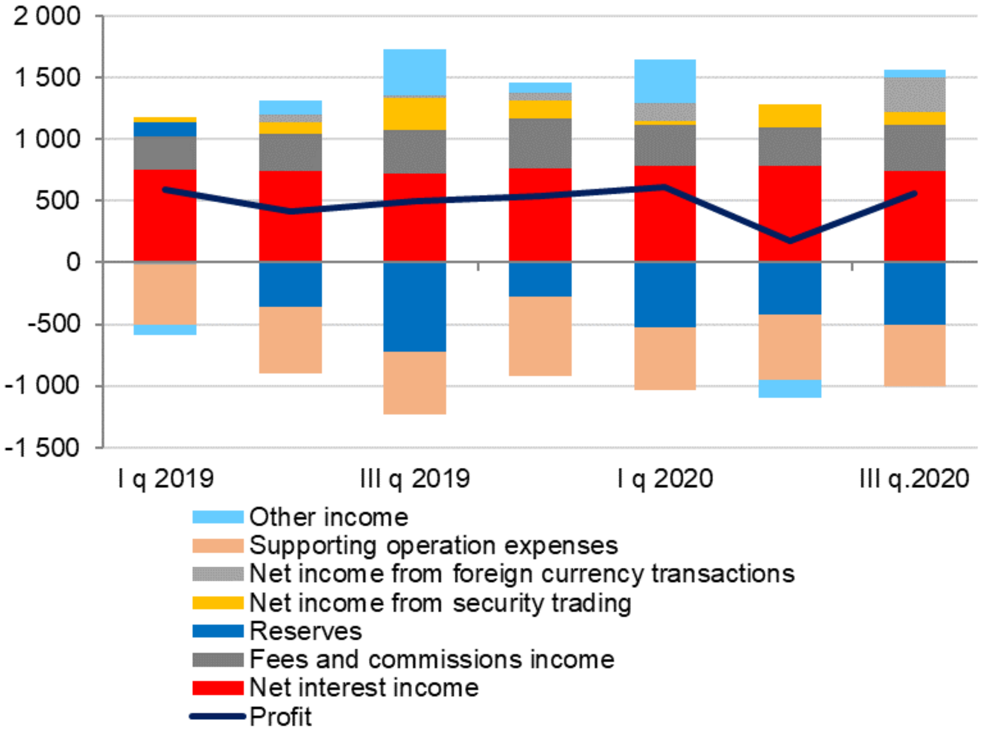
Amid a general interest rate decline in the economy, banks see a decline in both interest income and interest expenses. As a result, the banking sector's net interest income stood at 744 billion rubles in the third quarter, down 5.4% quarter on quarter but up 2.5% year-on-year (Figure 54).

The interest income contraction in the retail banking segment may have arisen not only from the overall interest rate decline in the economy but also from a lending structure change towards less risky, i.e. lower-interest, loans as part of banks' more conservative policies and the launch of subsidised mortgage lending programmes. On top of that, the interest income fall was owed to loan restructuring,[21] which resulted in loan vacations for a total of 78.5 billion rubles as of 3 October, or 7.1% of interest income from retail loans in the Q2–Q3 2020. Interest expenses were also driven by two key factors: a reduction, as of the start of the year, of contributions to the Deposit Insurance Agency[22] and a change in household preferences towards demand and short-term deposits.

[21] A total of over 778 billion, or 4.0%% of total outstanding retail loan debt as of 01.01.2020, was restructured from 20 March to 7 October.

[22] Resulting in year-on-year rather than quarter-on-quarter contraction.

Figure 54. Factors forming banking sector's financial result, billion rubles



Source: Bank of Russia.

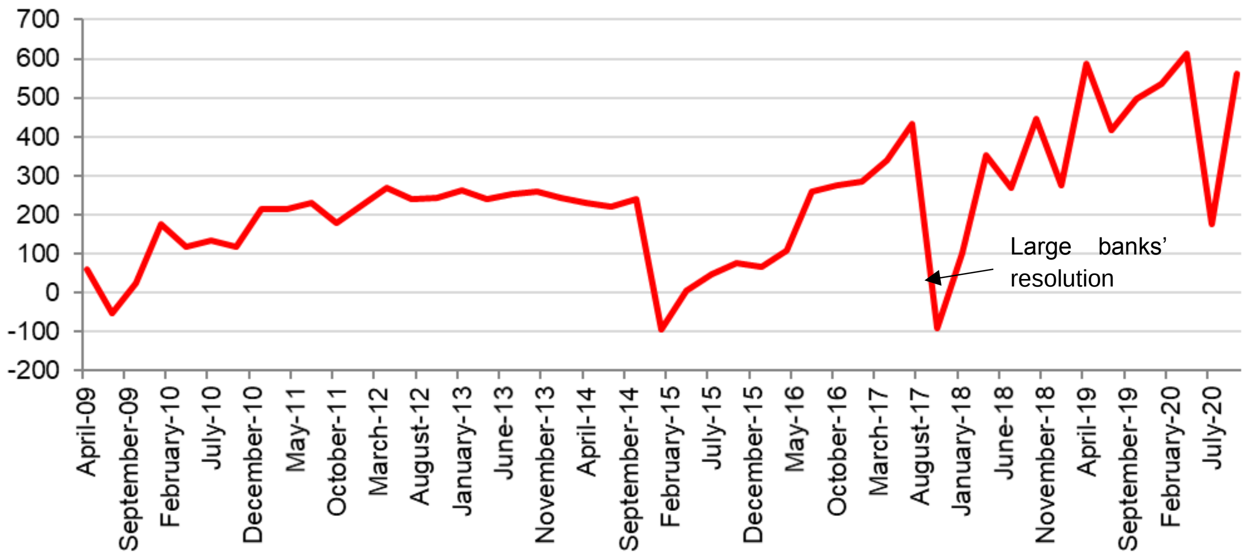
The corporate loan segment saw a faster interest income decline in both quarter-on-quarter and year-on-year terms. The interest income contraction in corporate loans was owed primarily to declining interest rates against a background of loose monetary policy and subsidised lending programmes. Regulatory easing providing for loan restructuring[23] and granting of loan vacations also played a part.

We do not expect a substantial decline in banks' net interest income going forward. From the perspective of monetary policy and its transmission, the key interest rate cuts have already been almost fully passed through to rates on loans to end borrowers. Nevertheless, after some of regulatory easing has been cancelled, the factor of income contraction stemming from loan vacations granted to borrowers will be less important. At the same time, a reduction in average household deposit maturities increases banks' interest risk.

The banking sector's Q3 financial result stood at 561 billion rubles, more than doubling after the Q2 slump and rising 13.1% YoY. The banking sector recovered its profitability faster than after the 2009 and 2015 crises (Figure 55). The key growth factors were net fees and commissions income, up 21.5% QoQ and 7.3% YoY, and ruble weakening, which resulted in a significant one-off rise in net income from foreign currency transactions and derivatives. The fees and commissions income growth concurrently with interest income stagnation/decline is a sustainable trend of recent years, whose expansion may continue going forward. The key short-term risk factor is a possible economic activity decline amid the worsening epidemiological situation.

[23] The portfolio of corporate loans (exclusive of SMEs) restructured by systemically important banks from the start of March amounted to over 4.2 trillion rubles, or 12.9% of the total portfolio. Loan vacations for a total of 138.1 billion rubles, or 31% of debt owed by SMEs from the list of industries hurt by the pandemic were granted in April–September.

Figure 55. Banking sector's financial result, billion rubles



Source: Bank of Russia.

Overall, the profit earned by banks allows the sector to build up a safety cushion, reducing its vulnerability to further risks. But the ongoing crisis is accompanied by a rather non-uniform impact on banks' profits: a financial result gain of 559 billion rubles was recorded by the top 30 banks, whereas the rest of the banking sector shows a more modest pace of recovery. Banks under resolution outside of the top 30 earned a total of 40 billion rubles, whereas banks which do not undergo resolution continued to suffer losses (-37 billion rubles), although only a third of them continued to be deemed loss-making.

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