Bank of Russia

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TALKING TRENDS
Economy and markets

Research and Forecasting Department Bulletin

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The views and recommendations expressed in the bulletin do not necessarily reflect the official position of the Bank of Russia.
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EXECUTIVE SUMMARY

MONTHLY SUMMARY

- Price trends are still influenced by a combination of competing factors. On the one hand, the reintroduction of a range of restrictions in Russia and abroad is adversely affecting demand, hindering economic recovery and creating disinflationary pressure. On the other hand, this extends the duration of supply-side shocks having a proinflationary effect. The accommodative monetary policy continues to support economic activity and domestic demand. According to our estimates, inflationary pressure adjusted for temporary and one-off factors stays close to 4%.
  - In November, annual inflation exceeded 4% and is likely to start going down no earlier than in the middle of 2021 H1, after reaching a local peak. This is partially explained by the low base effect. The pass-through to consumer prices of the ruble's weakening since March 2020 has a slower and longer impact than previously. Considering this effect, we assume that the rise in consumer prices is still in line with the 4% seasonally adjusted inflation path, with the movements of prices for certain products and price index components remaining highly volatile.
  - High-frequency indicators for November generally suggested that economic growth discontinued, while trends across industries became more diverse. Specifically, individual industries, particularly the service sector, recorded a faster decline in demand as a response to the resurgence of coronavirus cases. Exports continued to rebound.
  - At the end of November, positive trends prevailed in the financial market as a result of rising global risk appetite amid the past US election and inspiring news about the development of vaccines.

IN FOCUS

- Since the beginning of 2020, Russia's Ministry of Finance has increased borrowing in the domestic market to 5.1 trillion rubles, to be able to finance the state budget deficit. We believe that the funds currently raised by the Ministry of Finance are an important factor of replacing corporate borrowing with government borrowing, as investments in floaters (floating-rate coupon government bonds OFZ-PK) and corporate bonds differ in nature. Banks invest in floating coupon government bonds to cover interest rate risk. In contrast to corporate bonds, these investments involve no burden on bank capital and positively influence liquidity ratios.
- The Russian bond market has significantly expanded, while market segments have changed unevenly: the sector of government securities has increased the most owing to the extensive OFZ offerings by Russia's Ministry of Finance. The sector of corporate bonds has also grown, although three times less.

- As companies continue to demonstrate demand for borrowing, the corporate bond market, just as lending, seems to be an efficient instrument for borrowers to raise debt financing. This is evidenced by increasing primary offerings.
- However, a lower liquidity of the corporate bond market compared to the OFZ market, coupled with low premia on primary offerings, makes corporate bods less attractive for the most active investors (banks). Uncertainty about external factors, also generating various scenarios for the implementation of the monetary policy over the medium-term horizon, increases the probability of a rise in asset value volatility. This risk affects the relative attractiveness of corporate bonds for banks. Moreover, we believe it to be the main drag on the development of the corporate bond market that has reduced banks' participation in primary offerings.
- The liquidity of the corporate bond segment has worsened even more due to the specifics of the market recovery after the period of elevated volatility in March–April (no considerable expansion of credit spreads and decreased amounts of corporate bond purchases by banks being the most active market players).
- An increase in Russian banks' OFZ holdings reduces the liquidity surplus in the banking system, until the funds raised by the government are allocated to finance expenditures. Nonetheless, some banks may offset a possible temporary liquidity outflow, when needed, through repos with the Bank of Russia and the Federal Treasury or in the interbank lending market. In this case, investments in floaters have the lowest possible impact on the usage of banks' market limits and are not expected to affect corporate bond purchases by trade and investment units.

1. Inflation

Annual inflation came in at 4.4% in November. The leading indicators of inflation, including producer prices of consumer goods and business survey data, as well as a lagged impact of ruble weakening on prices, suggest that the current increased monthly inflation rates (in seasonally adjusted terms) may well persist in the months to come on the back of cost increases, despite demand weakening in response to soaring coronavirus contagions. Given the low base of last year, this will likely prompt some further annual inflation increase up until the middle of the first quarter of 2021, to be followed by its slide back to 4%.

The explosive growth in coronavirus contagions adversely affects economic activity and may boost demand-side disinflationary risks, despite the ongoing faster narrowing of the output gap in consumer industries. At the same time, a price rise acceleration across a wide range of consumer basket components in November reflects an impact of several concurrent supply-side factors, a part of which may be more long-lasting, given the reinstatement of some coronavirus-related restrictions.

As a result, the concurrent effects of disinflationary and pro-inflationary factors will likely continue in the immediate future. That said, the impact of pro-inflationary factors on prices, mostly temporary (in particular, brought about by ruble weakening), will gradually subside. Meanwhile, the impact of disinflationary factors will depend on the duration of coronavirus-related restrictions' impact and the pandemic's implications for aggregate demand.

This year's monetary easing will, with a lag, offset the influence of demand-side disinflationary factors in 2021. Whether this will require an additional compensation of demand recovery extended longer over time, will depend on a variety of circumstances, including the strength and duration of pro-inflationary factors' impact.

1.1. Inflation remained elevated in November

- Annual inflation climbed to 4.42% in November from 3.99% in October, driven by a monthly price rise acceleration to 0.71% NSA[1] and an exit of the lower inflation rate in November last year from the calculation base.
- Seasonally adjusted monthly inflation remained elevated in November at 7,34% SAAR,[2] up from 5,86% SAAR in October. The full-year inflation rate will likely rise above the Bank of Russia's official forecast, reaching a local peak in the middle of the first half of 2021, given the low pace of price rises last winter. Over a medium-term horizon, demand-side disinflationary risks continue and may well gain strength if the worsening of the epidemic situation lasts long.
- That said, November's price rise acceleration affected a wide range of consumer basket components and was fairly uniform, pointing to a concurrent impact of several supply-

[1] NSA – *Non-Seasonally Adjusted*.

[2] SAAR –*Seasonally Adjusted Annualised Rate*

side pro-inflationary factors, which, at that particular time, outweighed the effect of demand-side disinflationary factors. Part of these pro-inflationary factors may be persistent and long-lasting amid toughening coronavirus-related restrictions. Still, the impact of pro-inflationary factors is mostly estimated to be short in duration.

Consumer prices rose 0.71% MoM NSA in November, up from 0.43% MoM NSA in October, which, given the low base of last year, resulted in continued acceleration of annual inflation to 4.42% from 3.99% in October (Figure 1).

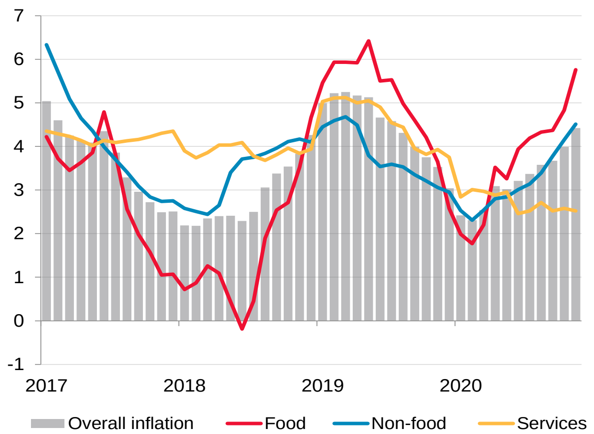
Monthly consumer price inflation climbed above a path corresponding to 4% in annualised terms (Figure 2) for the second consecutive month in November. A seasonally adjusted price rise[3] remained elevated at 7.34% MoM SAAR in November after 5.86% SAAR in October (Figure 3).

November's price rise acceleration affected a wide range of CPI components, which may suggest an impact of concurrent supply-side pro-inflationary factors, both temporary and sustainable. *On the one hand,* November saw a continued notable effect of short-term factors, such as a fall in the supply of some food categories and a rise in costs under the impact of the ruble weakening pass-through extended over time since March 2020. *On the other hand,* the protracted influence of measures to combat the epidemic may boost the related costs per unit of output (especially in the services sector) which producers partially pass through to consumers. This process is becoming sustainable.

Prices of goods and services weakly sensitive to exchange rate movements also suggest the presence of sustainable pro-inflationary factors. Indeed, the median remained stable in this group beginning from March–April, hovering around 4% most of the year, unlike the categories considerably correlated with the ruble exchange rate (Figure 4).

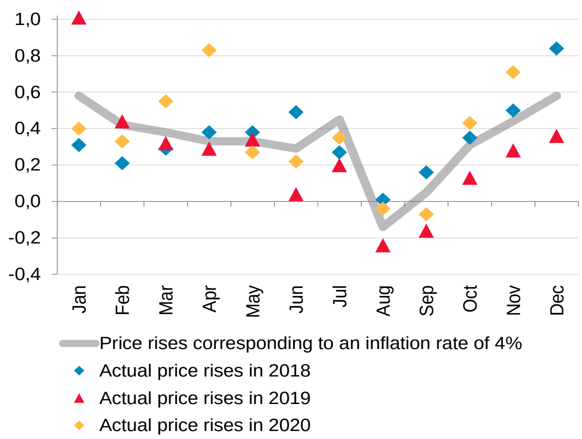
Apart from that, a fast output gap narrowing in some consumer industries reduces the disinflationary impact of aggregate consumer demand.

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.

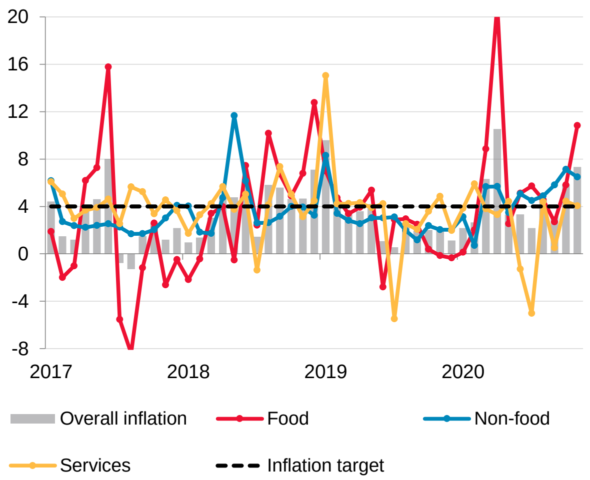
[3] Here and further on, the seasonally adjusted preliminary estimates for November 2020 are provided.

Inflation gained pace notably in November to reach 10.83% SAAR (0.86% MoM SA), up from 5.81% SAAR (0.47% MoM SA) in October. As in October, sugar and sunflower seed oil remained the key drivers of price rises. That said, the number of categories which saw a price rise acceleration increased notably. This primarily affected bakery goods along with pasta and cereal products. World grain price rises coupled with ruble weakening pushed domestic grain prices up to record highs despite a strong grain harvest. Grain price hikes may have also translated into chicken meat and egg price rises on the back of fodder price increases. On top of these food categories, accelerated price rises were recorded in fish and fish products

Non-food price rises continued at an elevated pace in November as the effect of ruble weakening pass-through materialised. This segment's prices hikes stood at 6.48% SAAR (0.52% MoM SA), down from 7.13% SAAR (0.58% MoM SA) in October. The pace of price rises remains elevated in goods which depend on exchange rate moves, such as passenger cars, electrical goods and other household appliances, personal computers, some types of construction materials and furniture. November also saw continued medication price increases, driven by rising demand on the back of the worsening epidemic situation.

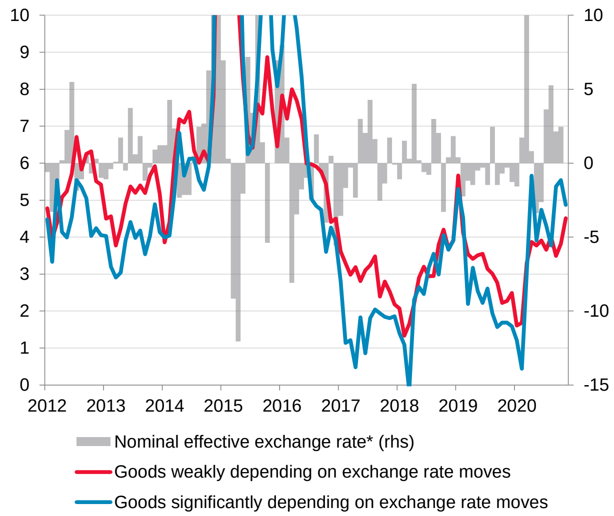
Services prices climbed 4.05% SAAR (0.33% MoM SA) in November versus 4.44% SAAR (0.36% MoM SA) in October. Price increases in this CPI component stay around 4% in annualised terms. With the effect of ruble weakening pass-through being insignificant, this suggests that the disinflationary effect of weak demand on retail prices is offset by rising costs.

Figure 3. Seasonally adjusted inflation, % SAAR



Sources: Rosstat, R&F Department estimates.

Figure 4. Median rises in goods and services significantly and weakly dependent on exchange rate moves, % SAAR



Note: Nominal effective ruble exchange rate. Plus stands for ruble depreciation against foreign currencies; minus stands for ruble appreciation against foreign currencies.

Source: Rosstat, R&F Department estimates.

1.2. Price pressure mounting in manufacturing

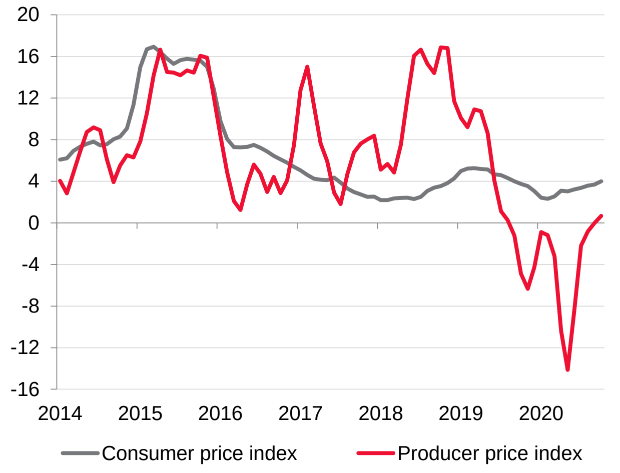
- Producer prices of industrial goods showed a year-on-year increase in October for the first time since August 2019, climbing 0.7% YoY (Figure 5). This was driven chiefly by manufacturing, where price rises accelerated to 3.1% YoY from 1.5% YoY in September. The producer price hikes continued to be restrained by a price decline in the oil extraction and petroleum refining sectors. (Figure 6).
- A rise in producer prices of *consumer goods*[4] continues to gain pace, accelerating to 7.5% YoY in October from 5.5% YoY in September (Figure 7). The key contribution to the price rise acceleration was provided by producer prices of food products, up 8.3% YoY in October versus a 5.4% YoY increase in September. Many categories of food products saw a price rise acceleration (cessation of a decline) under the impact of continuing cost increases, due to, among other things, ruble wakening in the third quarter. Producer prices of sugar continue to climb at an increased pace (up 56.0% YoY[5]). The same is true of oils and fats prices, which rose 32.0% YoY, fuelled by domestic production cuts and increasing world prices. If ruble strengthening seen from the start of November against a backdrop of some improvement in the external environment, is sustainable, this may contain further price increases in the consumer segment. But even under this scenario, a gradual recovery of consumer demand, whose performance remains stable despite the renewed pandemic surge in the autumn, will likely hamper a strong reversal in producer prices of consumer goods.
- Producer prices of some consumer goods[6] weighted using the structure of the household consumer expenditure for CPI calculation, climbed 4.5% YoY in October compared with 2.7% YoY in September (Figure 8) to stand 0.9 pp above the CPI calculated for a similar basket of consumer goods. This suggests a likely continuation of a significant impact of producer prices and costs in the months to come.
- A rise in producer prices of *investment goods* has also accelerated but remains moderate overall. After a long decline, producer prices of *intermediate goods* started climbing in year-on-year terms. The key factor behind this is a sharp acceleration of price increases in the manufacture of basic metals, up 11.1% YoY in October after a 5.0% YoY gain in September, which may result from a pass-through of ruble weakening to prices.

[4] The calculation of producer prices for groups of manufacturing industries producing consumer, investment and intermediate goods is carried out using the structure of weights for the calculation of the PPI of industrial goods in line with the Economic Activity Types under the OKVED 2 classification.

[5] The sugar price rises represent a rebound from a significant decline over the previous years.

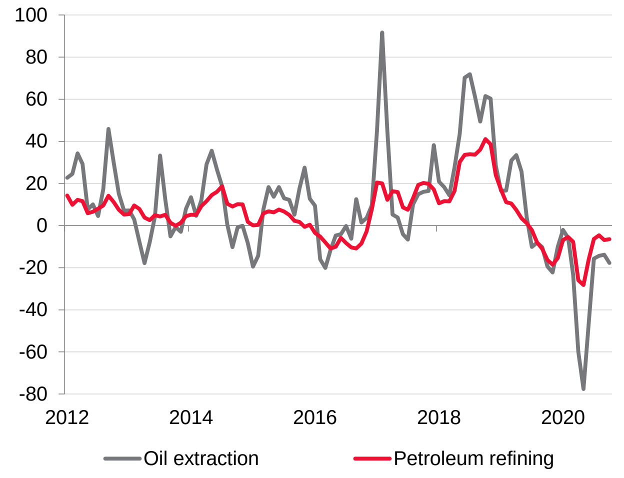
[6] Unlike the above calculation, instead of aggregation based on activity types, we used aggregation of similar goods in the CPI and PPI structure, such as meat products, fish products, butter and fats, dairy products, pasta, sugar, coffee, wearing apparel, footwear, detergents and cleaning solutions,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

Figure 5. Change in the producer price index and consumer price index, % YoY



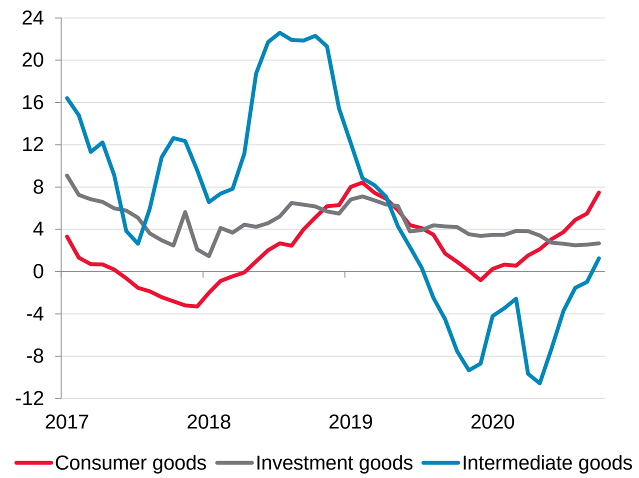
Source: Rosstat.

Figure 6. Producer prices in oil extraction and petroleum refining, % YoY



Source: Rosstat.

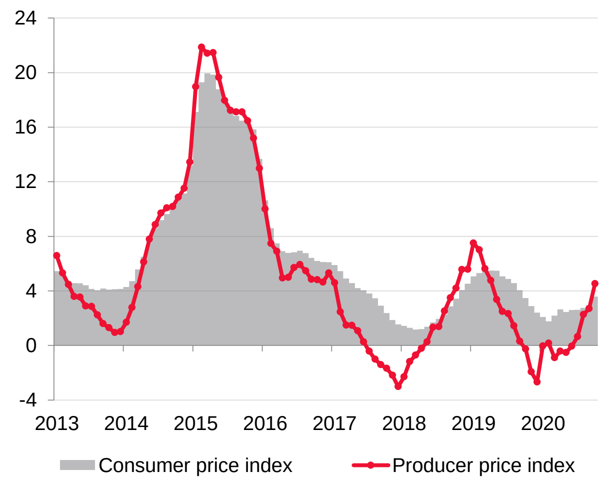
Figure 7. Producer prices for groups of manufacturing sector industries, % YoY



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 8. 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.

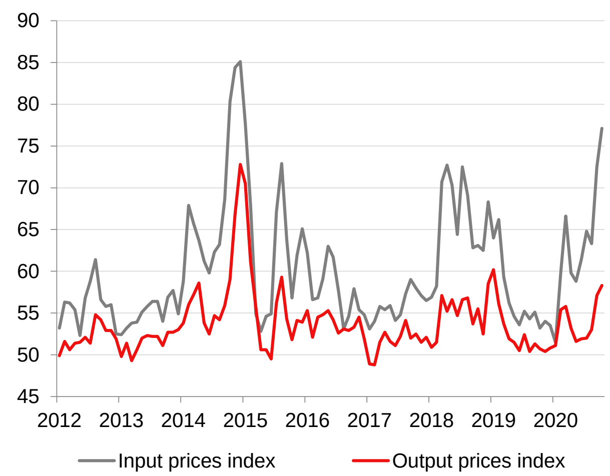
Sources: Rosstat, R&F Department estimates.

1.3. PMI price indexes in November: inflationary pressure on the rise

- PMI price indexes point to the acceleration of output price rises in manufacturing and a still increased pace of their hikes in services, despite the weakening of economic activity. The key reason for this is the pass-through of the accelerating input price growth, driven by ruble weakening and other, not only temporary, factors pushing companies' costs up.

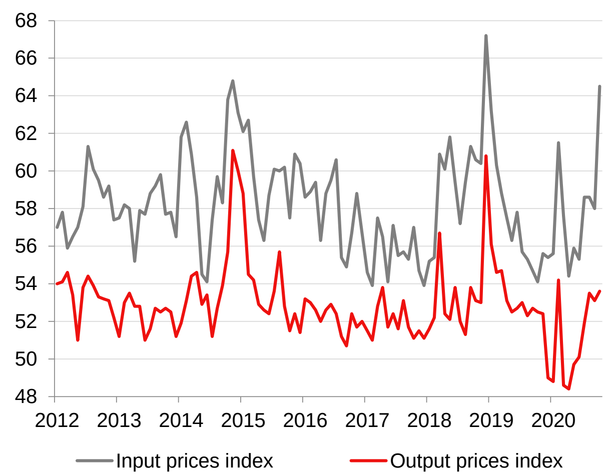
- The output price index in manufacturing climbed to 58.3 in November from 57.1 in October, suggesting an acceleration of final products' price rises to the highest pace since the start of 2019, when price moves were affected by the VAT base rate hike from 18% to 20%. The price rises are gaining pace amid the weakening of output and new orders, suggesting the pass-through of rising costs to final prices. The input price index jumped to 77.1% in November, the highest level since February 2015, on both ruble weakening and raw material price hikes by suppliers.
- The output price index in services stabilised in the 53–54 range (53.6 in November), pointing to elevated inflationary pressure compared with the second half of 2019 – the start of 2020 (Figure 10) owed to a partial pass-through of cost rises. November saw the input price index climb to 64.5, hitting the highest level since January 2019. In addition to ruble weakening, which is a temporary factor, the respondents cite such factors of cost rises as an increase in spending on maintaining sanitary safety in working places and wage raises (even amid an employment decline indicated by the surveys). The impact of these is more long-lasting and persistent.
- In the first half of the year, a fall in demand brought down inflationary pressure in services: the output price indexes even plunged below the 50 mark, signalling a possible price decline. The current spell of epidemic situation worsening is accompanied by a milder reaction of economic activity in services, which does not generate a significant disinflationary pressure.

Figure 9. Change in PMI manufacturing indexes, pp



Source: IHS Markit.

Figure 10. Change in PMI services indexes, pp



Source: IHS Markit.

2. Economic performance

It appears from real-time data that the Russian economy saw a near-zero change in November relative to October. Based on Q4 2019 growth, an annual GDP decline will likely intensify in the fourth quarter of 2020 in comparison with the third quarter. The resumption of economic recovery is expected in the first half of 2021 as the pandemic subsides and most of the coronavirus-related restrictions are lifted.

Until the epidemic situation gets back to normal, the conservative model of consumer behaviour will likely prevail, accompanied by an increased propensity to save and shifts in demand from consumer services towards goods, primarily food, and towards goods and services of lower price categories. The November real-time consumption data bears out the emergence of the austerity trend.

At the same time, the absence of large-scale activity restrictions during the autumn's rise in contagions along with a moderate decline in people's mobility, give reason to expect much less pronounced negative effects on economic activity than in the spring of this year. Producers and consumers' increasing adaptation to life amid restrictions should also help the economy make its way through the period of restrictions more easily.

Meanwhile, credit activity remained high in October, thanks to, among other things, loose monetary policy, regulatory easing and government measures of support. This continues to buoy domestic demand, further alleviating the effect of restrictions on economic activity.

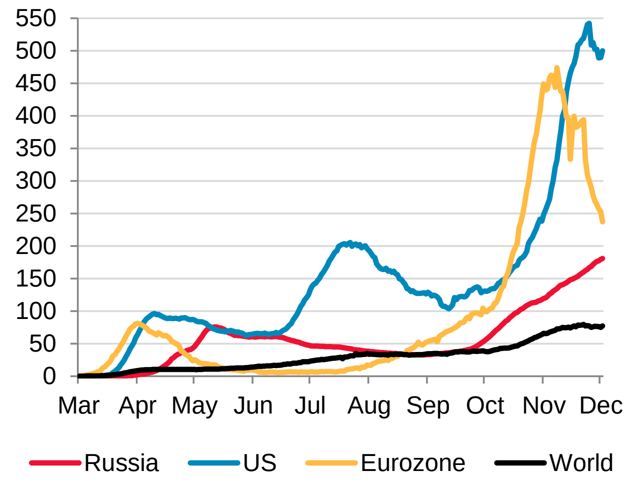
At the same time, some worsening of the corporate credit portfolio's overall quality is to be expected. This will be owed to a rise in the share of relatively less creditworthy borrowers as regulatory easing expires and their debt burden increases. The latter will arise from the shortening of average time to maturity of loans taken and borrowers' income decline during the pandemic. It is therefore important to strike a balance between maintaining lending growth, timely setting aside required provisions for loans issued, and gradual discontinuation of lending to insolvent (zombie) companies, ousting them from the market or having them recapitalised by new owners (if there are realistic prospects for recovering their solvency after debt restructuring).

2.1. Economic activity's moderate reaction to epidemic situation worsening in November

- The epidemic situation worsening in the autumn is more massive than in the spring (Figure 11). That said, real-time indicators suggest that the negative effect of the pandemic on economic activity in the fourth quarter will be much less severe than in the second quarter. This is owed, above all, to the current restrictions being milder. Moreover, people's mobility decline is now less significant than in the spring even in countries which have imposed nation-wide quarantines (Figure 12).

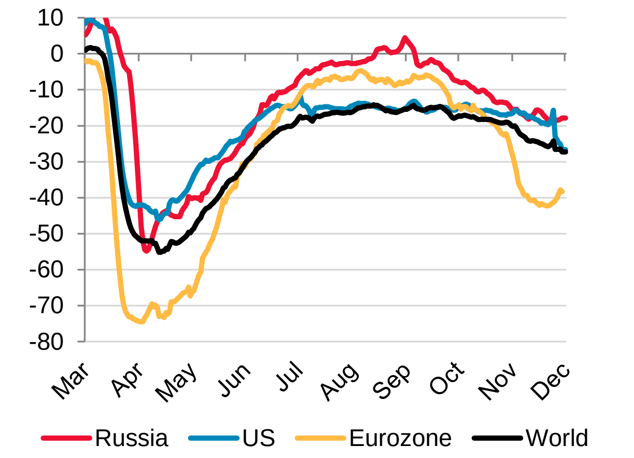
- The amassed experience of imposing restrictions, resulting in, among other things, better preparedness of health care systems, allows authorities to strike a finer and more precise balance between the risks of a further disease spread and the curtailment of economic activity. Also, there is currently no massive buildup of problems with global production chains. First, the epidemic situation in China, which is involved in a significant part of global production processes, has recently stabilised. Second, restrictions imposed in major economies in the autumn, do not, as a rule, significantly affect production activities.
- Real-time indicators of business activity point to the signs of Russia's economic activity stabilisation on the September–October level, with no pronounced reaction to the epidemic situation worsening, except in some services sectors.
- The four-week rolling average deviation of incoming financial flows from the pre-crisis ("normal") level in nominal ruble terms moved into positive territory in late November (Figure 13). Exclusive of mining and quarrying and petroleum refining, the deviation has stayed in positive territory for several weeks in succession. One should bear in mind that individual industries' financial flows are nominal values, and the level of incoming flows relative to the pre-crisis performance includes a rise in costs accumulated since the start of the year. Nevertheless, payment flows in October–November indicate that there are no clear signs of a renewed economic activity worsening.
- In industries meeting consumer demand, the level of payments remains stable, staying above the pre-coronavirus performance (Figure 14). Within this group, meanwhile, there is a redistribution of demand from consumer services towards the consumption of goods under the influence of the partial reinstatement of restrictions and tougher self-imposed constraints. Other indicators also show a change in the consumption structure on the back of the rising contagions and a marginal consumer activity decline in November.
- Indirect indicators show that production activity remained stable in November. A year-on-year decline of electricity consumption, an indicator of activity in power-intensive industries, remained moderate in November, just as in October (Figure 15). Rail shipments decreased somewhat in November (Figure 16). The resumption of an output and new orders decline is evidenced by the relevant PMI indexes.
- The key risks for global economic activity arise from further developments as part of the epidemic situation. *On the one hand,* the news about the development and successful trials of the vaccine and prospects for conducting mass inoculation by the end of 2021, reduce the risks of the pandemic's substantial negative impact on economic activity. *On the other hand,* the increased level of uncertainty will have a long-lasting effect on both consumer activity and investment, hampering further global economic recovery even as the expected gradual normalisation of the epidemic situation materialises.

Figure 11. Daily rise in coronavirus contagions per million people (7-day average)



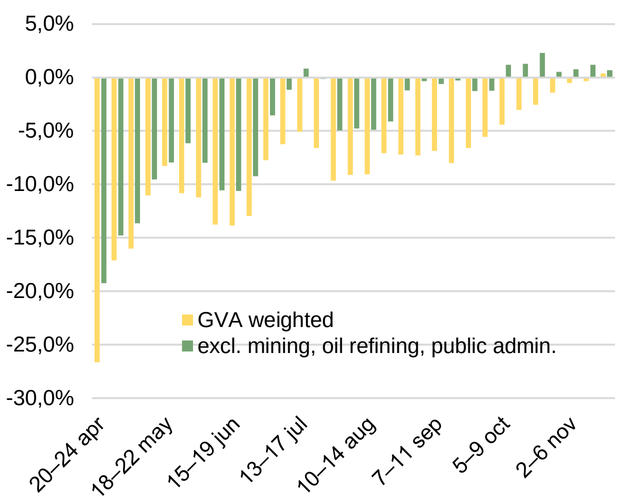
Source: Bloomberg Finance L.P.

Figure 12. Visits to shops and leisure facilities, as a percentage of the median from 03.01 to 06.02, (7-day average)



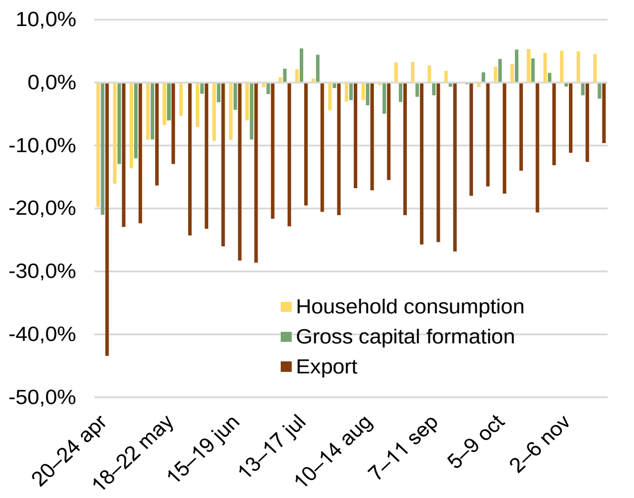
Note: The 2019 GDP was used as weights in calculating weighted average mobility values for groups of countries, Source: Google, WorldBank

Figure 13. Four-week rolling average deviation of incoming payments from “normal” level



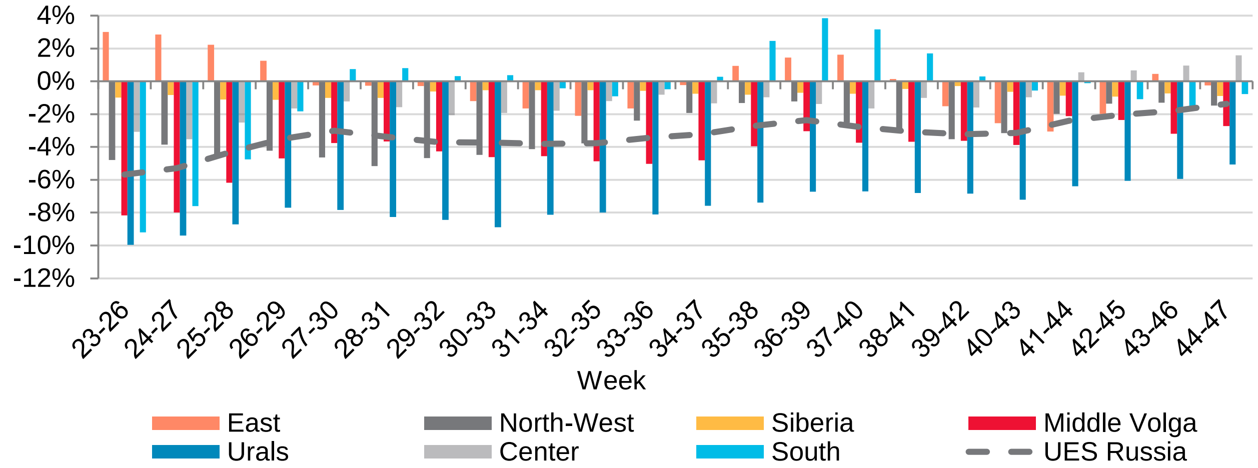
Source: Bank of Russia (Monitoring of financial flows).

Figure 14. Four-week rolling average of incoming payments from “normal” level by industry group



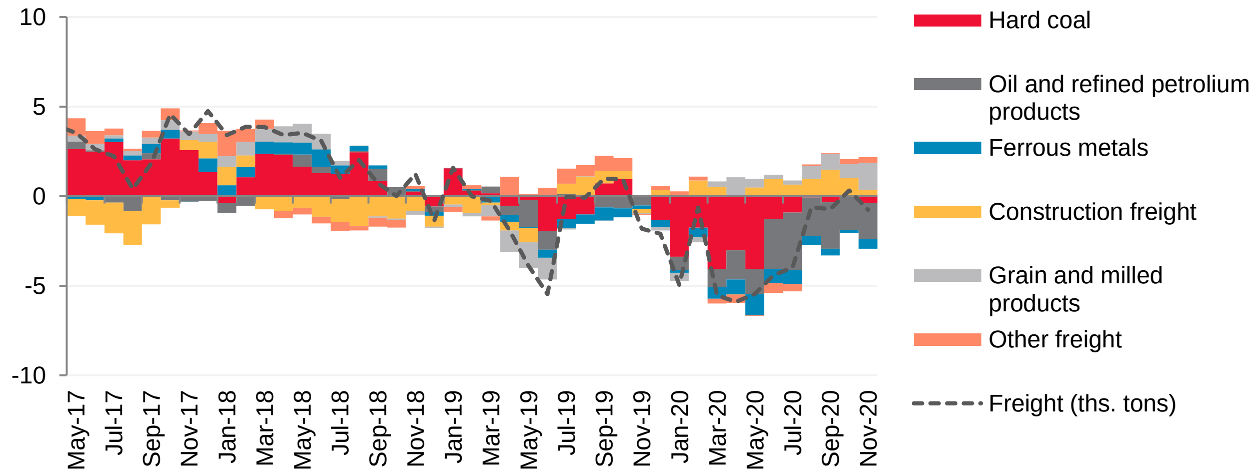
Source: Bank of Russia (Monitoring of financial flows).

Figure 15. Electricity consumption growth rate, 4-weeks moving average adjusted for temperature and calendar factors, % YoY



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

Figure 16. Decomposition of rail shipments in the Russian Railways network, % YoY



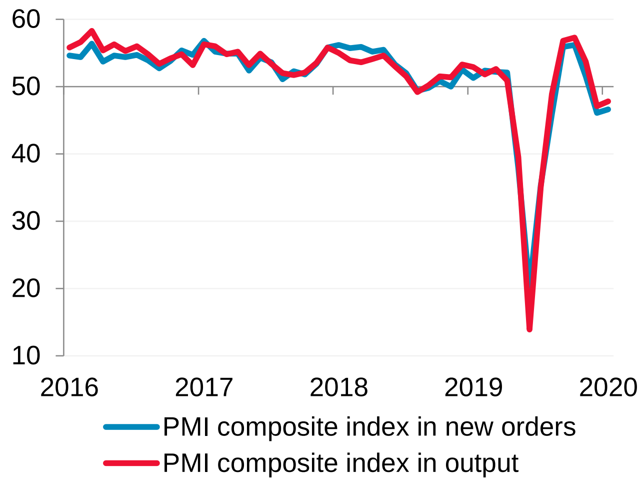
Source: Russian Railways, Rosstat, R&F Department estimates.

2.2. PMI indexes in November: economic growth put on hold in fourth quarter

- November's decline in the IHS PMI index for Russia suggests a pause in the recovery of business activity due to the epidemic situation worsening.
- Domestic demand and output suffered a setback. That said, industrial enterprises have enjoyed a rise in external demand for the second consecutive month, while the services sector sees its continued decline.
- Overall, the negative effects on economic activity will be much more limited compared with the spring of this year thanks to more selective restrictions in place.

The PMI composite index for output inched up to 47.8 in November from 47.1 a month earlier (Figure 17), suggesting an output reduction for the second consecutive month as demand weakens. This in turn provoked a further employment contraction (Figure 19, Figure 20), since the respondents report a fall in capacity utilisation. November survey data showed mixed trends in export orders: growth acceleration in manufacturing and a steeper decline in services. This may reflect more stringent restrictions in Russia's trade partner countries, restraining activity in the services sector to a greater extent.

Figure 17. Change in composite PMI indexes for Russia, pp



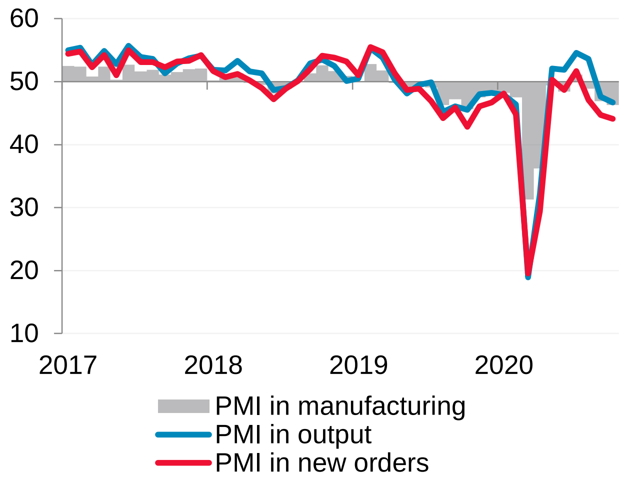
Source: IHS Markit.

The decline slowdown in the PMI composite index and overall busines activity in the economy is owed to November's slower fall in services than in October. We note that the current spell of activity contraction is much different in its structure and nature from what was brought about by restrictions imposed in the spring. In March–May, the services sector, which showed a much weaker performance than industrial companies, was hit the hardest by restrictions. The IHS survey indicates that the current restrictions had a stronger effect on manufacturing, with the manufacturing PMI index suffering a deeper fall than in services. It is important to note that the current worsening of market conditions was less severe than in the spring months. This is owed to a milder nature of restrictions in place and less serious supply disruptions within Russia and from abroad.

The PMI index for manufacturing shows the sector's business activity decline in November, sliding to 46.3 from 46.9 in October (Figure 18). This was above all due to the negative effect on domestic demand of restrictions' partial resumption following the aggravation of the pandemic. Despite October's fall in the index, the economy will likely post a near-zero change in the fourth quarter. In fact, the PMI is a diffuse index, therefore, the magnitude of its decline does not always correspond to the depth of decrease in actual indicators. We saw a similar picture in 2019, when industrial output in fact showed growth. November's PMI slide may reflect an increase in the number of respondents reporting a moderate/minor demand and output contraction.

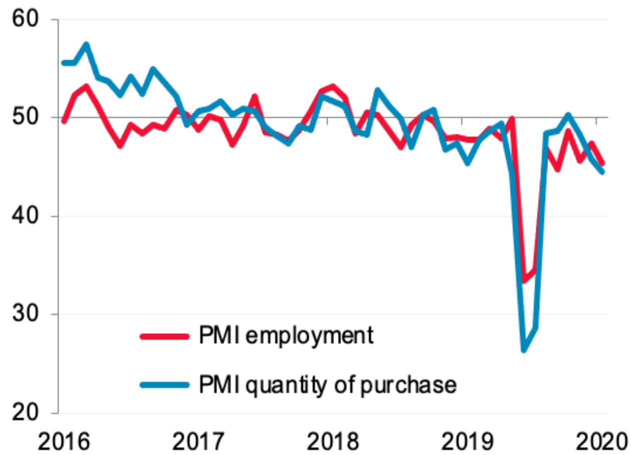
The business activity decline in November resulted from demand weakening: the new orders index slid to 44.1 from 44.7 in October. This index deterioration was driven by a fall in domestic deliveries, since export orders climbed for the second consecutive month (52.4 in November and 50.3 in October).

Figure 18. Change in PMI manufacturing indexes, pp



Source: IHS Markit.

Figure 19. Manufacturing PMI indexes for quantity of purchase and employment, pp



Source: IHS Markit.

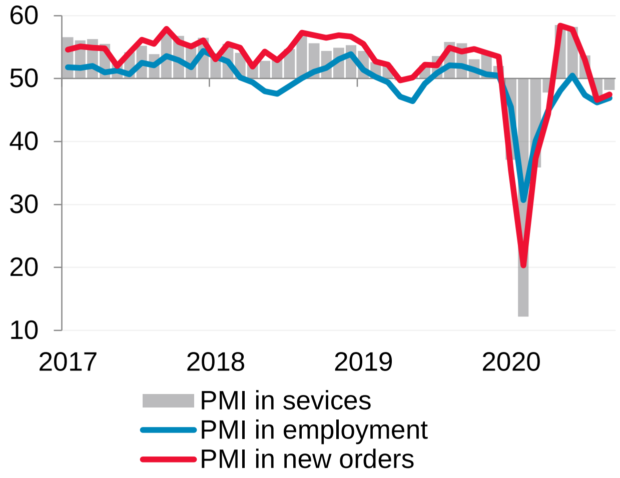
The softening of domestic demand duly caused output to weaken: the index fell to 46.7 from 47.6 in October (Figure 18). The output contraction in turn hurt employment and purchasing activity. Respondents indicated a further reduction in employment, purchasing activity, and streamlining of raw materials and supplies inventories in November (Figure 19).

Business expectations for future output improved marginally in November compared with October (60.5 after 59 in October). The retention of moderate optimism regarding the prospects of business activity recovery confirms that many producers view the current episode of a business activity decline as transient (Figure 21).

The services PMI climbed to 48.2 in November from 46.9 in October but remains below the borderline 50 mark (Figure 20). Fall of business activity in services was driven by a new orders contraction (47.5). The respondents attributed this to problems/disruptions in their customers' flow of funds/income, which may have arisen from restrictions. Services suffered an acceleration in an external demand decline to 41.4, at the fastest pace since May 2020. Unlike manufacturing, trade partners in this sector are hurt by restrictions more seriously.

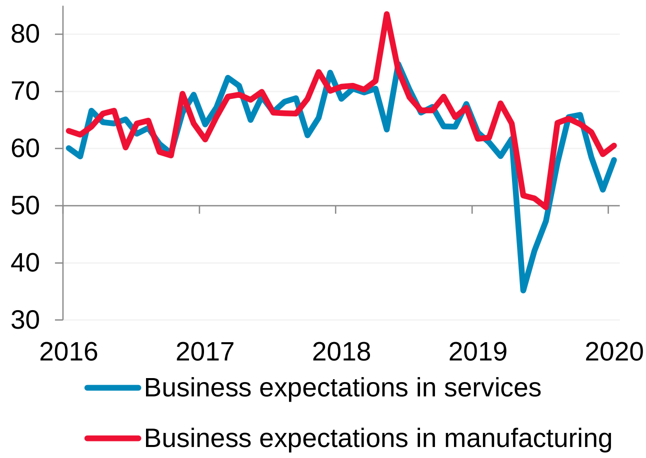
The services sector posted an employment decrease for the third consecutive month (46.9) in November. Weak demand and, as a consequence, a fall in capacity utilisation, also affected uncompleted orders, with the relevant sub-index plunging to 42.2. Business expectations regarding the prospects for the next 12 months rose to 58 in November, but this level equals an all-time low if the period of restrictions put in place in the spring of this year is not taken into account (Figure 21).

Figure 20. Change in PMI services indexes, pp



Source: IHS Markit.

Figure 21. PMI for business expectations, pp



Source: IHS Markit.

2.3. Core industries' output contraction accelerated in October

- The core industries index (CII[7]) calculated by the R&F Department[8] plummeted in October 2020, down 4.4% YoY after a fall of 2.3% YoY[9] in September (Figure 22). The worsening of the epidemic situation in the autumn put on hold the economic recovery trend which emerged in the summer as the tougher restrictions imposed in the spring were gradually eased. The CII YoY decline was also owed to a calendar effect (a smaller number of working days than in October 2019) and a high base. At the same time, the ongoing economic slowdown will be much milder than in the second quarter thanks to the selective nature of restrictions. We estimate that GDP contraction will come in at around 4% or even lower for the full-year 2020s (Figure 23).
- All of the key core industries, including the agricultural sector, which posted an output contraction for the first time since 2028, showed negative growth in October. Manufacturing and wholesale trade saw a year-on-year output decline after a rise in the previous months. The pace of decline was all but unchanged in the construction and transportation industries. A marginal improvement was recorded in mining and quarrying and retail trade.

[7] The core industries index (CII) is calculated by aggregating seven industry-specific indexes (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 2019. 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. The indexes show generally similar performance. 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 the economic situation in individual regions on a real-time basis.

[8] Research and Forecasting Department.

[9] Rosstat has updated the September 2020 data for industrial sectors, wholesale trade and freight traffic.

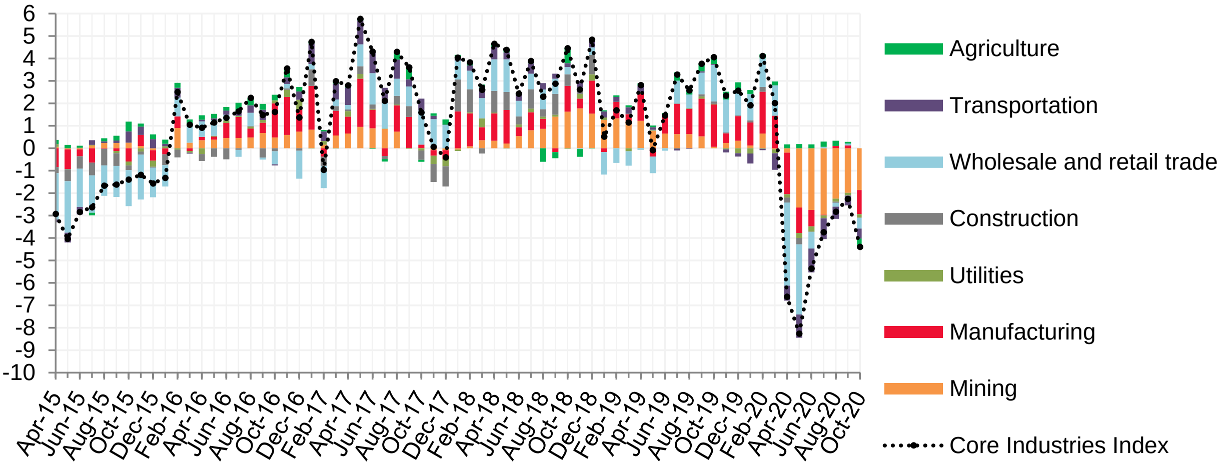
- Mining and quarrying output contraction slowed somewhat to -8.8% YoY in October from -9.4% in September, but this industry continues to provide the largest negative contribution to a downward deviation of the CII from last year's level (accounting for about half of it).
- October saw a worsening of the situation in manufacturing. After a positive performance in August–September[10] output contracted 4.4% YoY in October compared with a 0.5% YoY rise in September. Among the laggards are the manufacture of refined petroleum products, construction materials, electrical equipment, motor vehicles and other transport equipment, leather and related products.
- The industrial sector's decline is taking a toll on the transportation industry's performance, down 4.0% YoY after a fall of 3.9% YoY in September. The pipeline transport posted a 7.4% YoY traffic decline due to an oil extraction fall. At the same time, rail shipments expanded for almost all of key freight types, except for oil and refined petroleum products, iron ore and ferrous metals.
- Negative growth continues in retail trade, but the pace of year-on-year contraction slowed to -2.4% YoY in October from -3.0% YoY in September. An improvement was posted in both food sales (-3.6% YoY after -4.6% YoY) and those of non-food goods (-1.1% YoY after -1.3% YoY. At the same time, weak consumer activity and an industrial output downturn had a negative effect on October's wholesale numbers (down 1.9% YoY after a 2.3% YoY increase).
- The construction industry's output remained all but unchanged from last year, down 0.1% YoY).[11] In terms of federal districts (FD), among the leaders were the Central FD with a rise of 9.8% YoY, fuelled mainly by a few regions, including Moscow and the Moscow Region; the North Caucasian FD, up 18.9% YoY, thanks to expansion in almost all regions, the Urals FD, up 14.7% YoY, due to an extensive infrastructure construction for the energy industry.
- The agricultural sector posted an output decline for the first time since 2018, down 6.6% YoY after a gain of 1.4% YoY in September. Gross output contraction was recorded amid a year-on-year fall in the output of the key agricultural crops harvested in the autumn: those of sunflower seeds, sugar beets, potatoes, and vegetables as of 1 November. On top of that, animal husbandry posted a 0.3% YoY drop in the output of meat products, brought about primarily by a production fall in the poultry segment. This arose, above all, from a fall in producers' margins, with producers' costs rising (due to an increase in the prices of mixed feed and imported components on the back of ruble depreciation) and weak domestic demand (from households and public food services).The rising exports, meanwhile, are not sufficient to compensate for the cost increases.

[10] Adjusted for Rosstat's revision to manufacturing data.

[11] The preliminary estimate of construction output may change substantially after full statistics have come in.

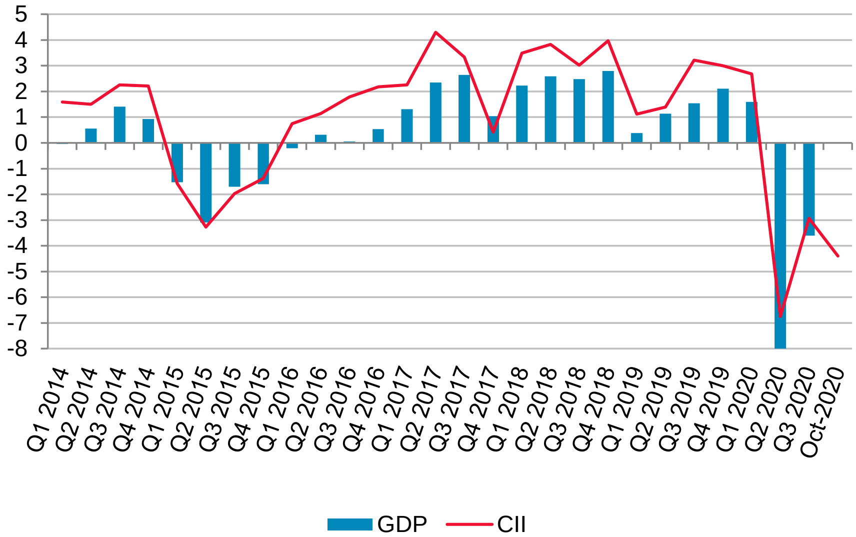
- Thus, the structural year-on-year output fall in the core industries was primarily driven by mining and quarrying and related industries (transportation and wholesale trade). The consumer and investment (the construction industry) segments of the economy trailed last year's performance much less significantly.

Figure 22. Contribution of industries to the CII in 2015–2020, % YoY



Source: Rosstat, R&F Department.

Figure 23. Quarterly index of GDP and CII in physical terms, % YoY



Source: Rosstat, R&F Department.

2.4. Output performance remains weak in industries meeting intermediate demand

- Industrial output contraction accelerated to 5.9% YoY in October after falling 3.6% YoY in September. In monthly terms, output declined marginally by 0.2% MoM SA.[12]
- Mining and quarrying output edged up 0.3% MoM SA as oil extraction stabilised.
- The industrial output decline was driven by a 0.4% MoM SA manufacturing contraction due in large part to a renewed fall in the manufacture of refined petroleum products. A negative contribution came from the manufacture of fabricated metal products, down 6.1% MoM SA, and pharmaceutical products, a fall of 7.4% MoM SA, prompted by difficulties in launching a system of monitoring medication flows.
- Most of other manufacturing industries recorded a month-on-month expansion in seasonally adjusted terms, including in the major industries, such as the manufacture of basic metals, up 2.7% MoM SA, and food products, a rise of 0.8% MoM SA.

A year-on-year industrial output contraction accelerated to 5.9% in October after a 3.6% YoY decline in September.[13] The contraction acceleration is in part owed to a calendar factor,[14] adjusted for which the decline came in at 5.4% YoY. The elevated volatility of annual data in September–October also arose from a temporary positive spike in October 2019, which produced a high base effect. Seasonally adjusted, industrial output posted a 0.2% MoM SA[15] decrease (Figure 24). This is close to a Centre for Macroeconomic Analysis and Short-term Forecasting estimate adjusted for seasonal and calendar factors (a decline of 0.4% MoM SA), which is based on the initial calculation of the index using a comparatively narrower range of representative goods and the elimination of outliers stemming from, among other things, reporting errors. October data from Rosstat indicates seasonally adjusted zero-growth in industrial output.

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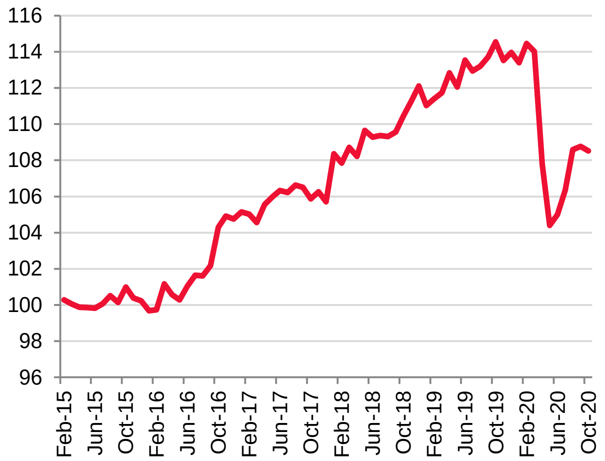
[12] Here and further on, seasonally adjusted monthly growth rates are based for Bank of Bank of Russia estimates.

[13] Rosstat has revised up the indexes of industrial output, mining and quarrying output, and that of almost all manufacturing industries, with manufacturing industries affected the most: September's fall of 1.6% YoY was revised up to produce a 0.5% YoY growth (a 2.1 pp upward revision). The most significant upward revision to manufacturing indu stries' output included that of the manufacture of paper and paper products, with September's fall of 5.5% YoY changed to 4.7% YoY growth (a 10.2 pp upward revision) and the manufacture of other transport equipment, with September's contraction of 11.7% YoY was revised to produce a smaller 3.2% YoY decline A 8.5 pp improvement).

[14] October 2020 had one day fewer than in October 2019.

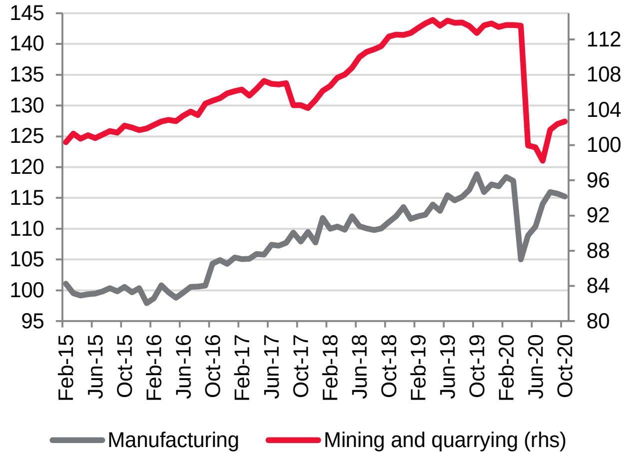
[15] Following Rosstat's data revision in October, we revised the specifications of the adjustment procedure. As a result, the volatility of some adjusted series increased, especially that of the series for the manufacture of motor vehicles, as well as computer, electronic and optical products.

Figure 24. Change in industrial production index (2014 = 100)



Source: Rosstat, R&F Department estimates.

Figure 25. Change in mining and quarrying and manufacturing indexes (2014 = 100)



Source: Rosstat, R&F Department estimates.

Mining and quarrying saw a continued year-on-year contraction slowdown – to -8.8% YoY in October from -9.4% YoY in September. In month-on-month terms, mining and quarrying output edged up 0.3% MoM SA in October. Daily oil extraction remains stable, complying with the OPEC+ deal, up 0.4% in October versus 0.7% MoM in September.

The overall industrial output contraction was chiefly driven by a manufacturing decline of 0.4% MoM SA (the Centre for Macroeconomic Analysis and Short-term Forecasting estimates the decline a little higher at -0.9% SA). In year-on-year terms, output fell 4.4% YoY in October (Figure 25). A positive impulse from the lifting of most restrictions put in place in the spring produced a confident manufacturing output expansion in the summer months, but as it ran its course and the overall economic performance weakened in the face of the worsening epidemic situation, output recovery came to a halt beginning in September. One can therefore expect manufacturing output performance to remain moderate in the coming months.

In analysing output performance in terms of larger groups of industries, it should be noted that sectors meeting *intermediate demand* suffered the heaviest fall. After three months of recovery, output declined 2.4% MoM SA in the largest industry – the manufacture of refined petroleum products. This sector, following in the footsteps of oil extraction, trails the pre-coronavirus level by about 10%. The manufacture of fabricated metal products saw a continued output decline, down 6.1% MoM SA. The weak performance of this industry was evidenced by the still depressed level of incoming payment flows in this group of industries.

Industries producing intermediate goods were supported by the manufacture of basic metals, up 2.7% MoM SA. The manufacture of paper and paper products enjoyed an output recovery, up 2.7% MoM, helping it rise above the pre-coronavirus level of early 2020 after a protracted downturn.

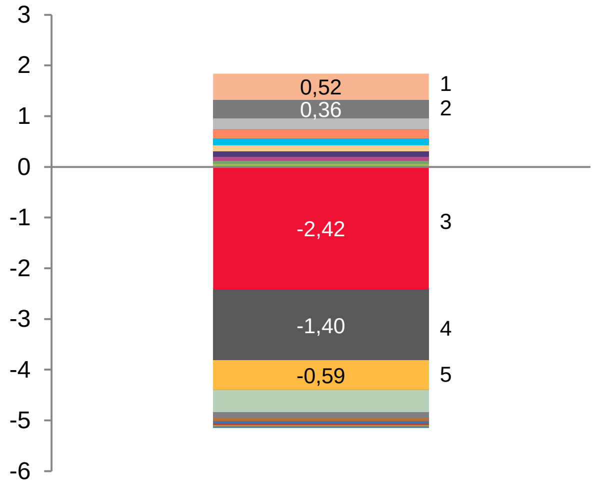
Practically all industries manufacturing durable *consumer goods* showed moderate output performance. The manufacture of motor vehicles, trailers and semi-trailers, up 5.9% MoM SA, contributed positively to the output of durable consumer goods. Despite a growth slowdown in passenger car sales (up 0.6% MoM SA), they stayed 5–6% above the average

2019 level in the last two months in seasonally adjusted terms and exceeded the pre-coronavirus level recorded at the start of 2020.

Industries producing *FMCG* posted mixed results in October. The manufacture of food products resumed growth, increasing its output 0.8% MoM SA and almost bringing it back to the level of the start of the year. The manufacture of pharmaceutical products and preparations, by contrast, saw a deep contraction of 7.4% MoM SA. According to Centre for Macroeconomic Analysis and Short-term Forecasting estimates, this may have stemmed from difficulties in launching an information system for monitoring medication flows. This hypothesis is indirectly supported by the fact that the pharmaceutical industry's incoming financial flows temporarily declined in October from their increased values to the pre-crisis levels. The resumption of revenue growth registered by the Monitoring of Industry-specific Financial Flows at the start of November seems to evidence a turnaround of output performance.

The group of industries producing investment goods contributed positively to manufacturing output, helped, most of all, by the manufacture of other transport equipment, up 3.2% MoM SA. Manufacture of other non-metallic mineral products was another source of growth, up 2.6 MoM SA: its output resumed growth in October after a small decline a month earlier, bringing the indicator back to the pre-coronavirus level of the start of 2020. Other industries producing intermediate goods showed a much more moderate output performance.

Figure 26. Individual industries' contribution to manufacturing growth, p.p. YoY



1 Manufacture of chemicals and chemical products

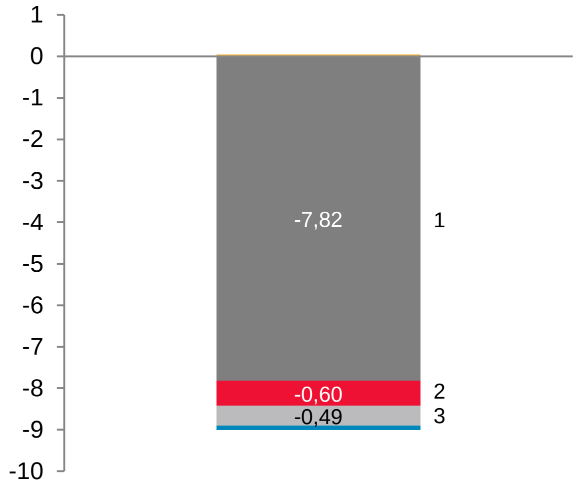
2 Manufacture of basic metals

3 Manufacture of coke and refined petroleum products

4 Manufacture of fabricated metal products

5 Manufacture of computers, electronic and optical products

Рисунок 27. Individual industries' contribution to mining and quarrying growth, p.p. YoY



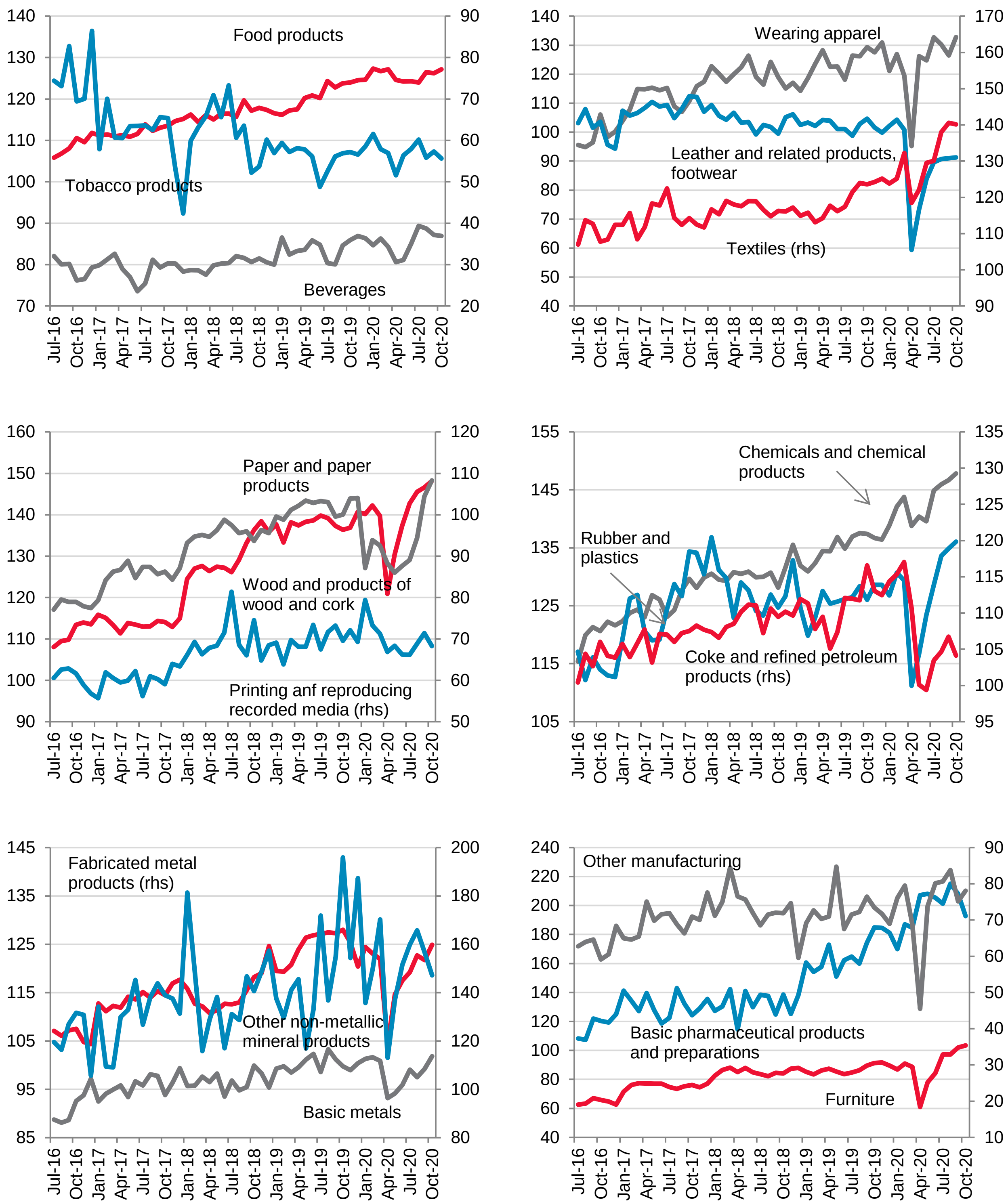
1 Extraction of crude oil and natural gas

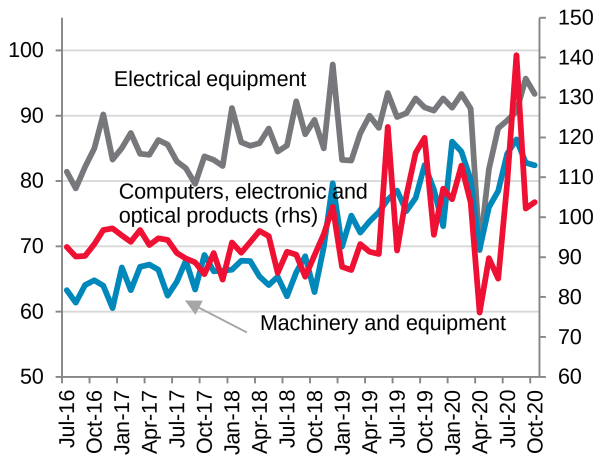
2 Mining support service activities

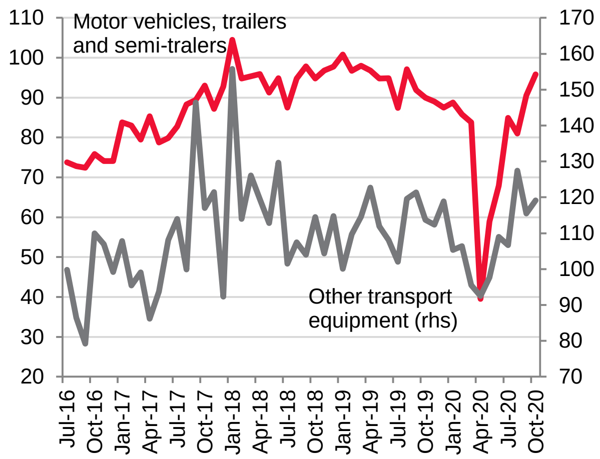
3 Mining of coal

Source: Rosstat, R&F Department estimates.

Figure 28. Manufacturing industries' output, December 2012 = 100%, seasonally adjusted







Source: Rosstat, R&F Department estimates.

2.5. Consumer demand stabilized in October–November

- The absence of large-scale activity restrictions during the autumn rise in contagions allowed retail sales to continue their moderate growth in October (up 0.3% MoM SA). Growth was fueled by an accelerated expansion in the consumption of food products (a rise of 0.7% MoM SA), which may be due to hoarding food purchases, as well as a shift of consumption away from public food services as self-imposed restrictions were stepped up.
- A decline in people's mobility considerably slowed the recovery of the paid services sector. Its year-on-year output decline accelerated for the first time since May (down 13.4% YoY), with month-on-month seasonally adjusted growth slowing to 2.0% MoM, according to estimates.
- The conservative model of consumer behavior, accompanied by an increased propensity to save, will likely prevail until the epidemiological situation has come back to normal. November's real-time consumption data bears out the emergence of the austerity trend, pointing to demand weakening in non-food and services categories, with food retail sales remaining stable.

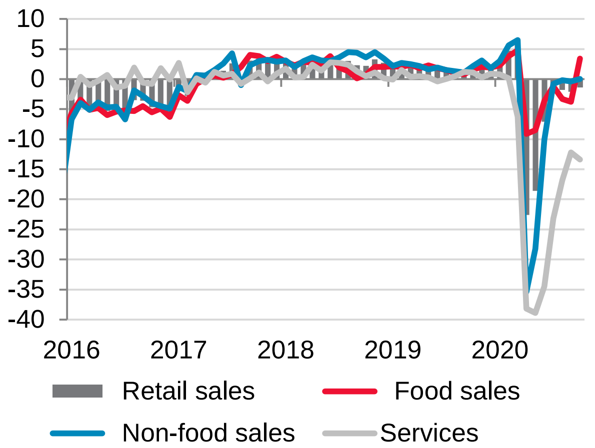
Although daily growth in contagions was much more massive in October than the spring's peaks, milder and more selective restrictions put in place in the autumn allowed retail sales to continue their moderate growth, up 0.3% MoM SA after 0.1% MoM SA in September.[16] In year-on-year terms, the retail sales decline slowed from 3.0% YoY in September to 2.4% YoY in October (Figure 29). The retail sales improvement is driven by accelerated growth in the consumption of food goods. This may partially be due to hoarding food, albeit much less

[16] Here and further on monthly rates are seasonally adjusted.

pronounced than in the spring. Food sales expansion may have also been supported by a rise in people's self-imposed restrictions, reflected in, among other things, a shift away from public food services (cafes, restaurants, canteens, etc.) towards the consumption of food goods. Non-food retail sales showed near-zero month-on-month growth in seasonally adjusted terms for the third consecutive month (down 0.1% in October after 0.0% in August and September) (Figure 30).

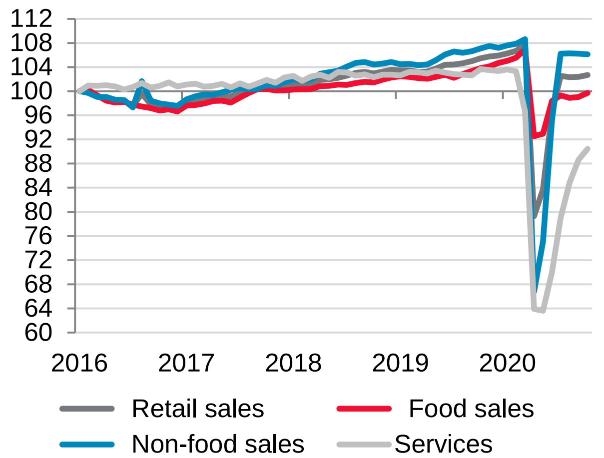
As the epidemiological situation worsened, people's mobility[17] decreased, sharply slowing the recovery of the paid services sector, which for the first time since May posted an acceleration of a year-on-year fall to 13.4% YoY (versus a decline of 12.2% YoY in September), while in month-on-month terms, it rose 2.0% MoM SA compared with 7.4% and 4.5% in August and September, respectively. In terms of October's expenditure items, the ongoing epidemiological situation worsening brought down transportation expenses: those for air fares (down, 49.6% YoY), railway and local transport travel (-30.3% YoY), car-sharing and taxies. At the same time, as people switched to work from home, telecommunications services showed steady growth, up 20.1% YoY.

Figure 29. Food and non-food retail and services sector sales, % YoY



Source: Rosstat.

Figure 30. Retail and services sector sales (January 2016 = 100%, seasonally adjusted), %



Source: Rosstat, R&F Department estimates.

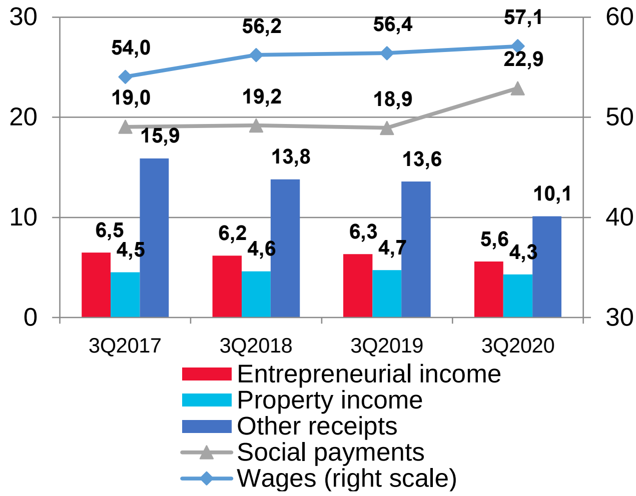
After a certain consumer optimism rise in September, prompted by, among other things, wage growth acceleration to 6.0% YoY in nominal and 2.2% YoY in real terms, less positive trends started to prevail at the start of the fourth quarter. Real-time data on personal income tax revenue in October suggested a likely slowdown in the growth of wages, whose share in the structure of household income, together with social payments, remains almost 5 pp above that of three previous years (Figure 31). Household income will also likely be depressed by the instability of entrepreneurial income amid the pandemic, a fall in investment income and the cessation of social support programmes.

In this environment, Russian households decreased their expectations regarding the economic situation in the near future. The VTsIOM-calculated consumer confidence index slid

[17] The Apple mobility index slid to the level of the start of the summer towards the end of November.

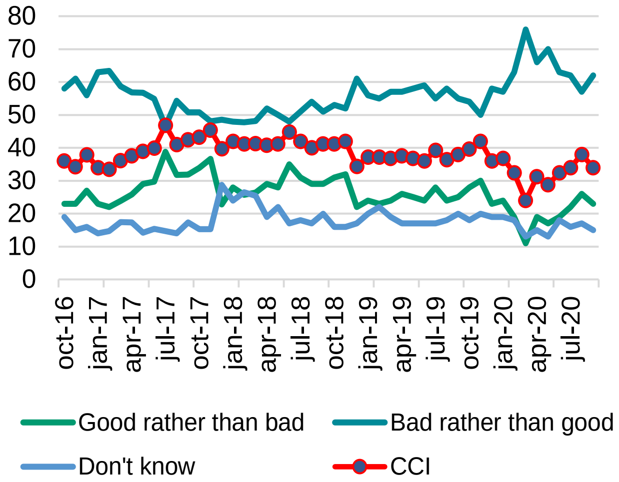
back to its August level (Figure 32). Moreover, whereas the number of respondents who were uncertain about whether it was a good time to take loans, to increase spending or savings, was quite significant in the summer months, household expectations became more certain in October, and those who were previously not sure joined the ranks of pessimists. Against this background, a moderately conservative pattern of consumer behaviour with its increased propensity to save will prevail until the epidemiological situation has come back to normal.

Figure 31. Household income structure, %



Source: Rosstat.

Figure 32. Consumer confidence index WCIOM, p.; "Is it a good time for large purchases?"



Source: VTsIOM.

We expect consumer activity to stabilize over the next few monthsamid the worsening epidemiological situation. This will likely be accompanied by a strengthening austerity trend with respect to both daily expenses and lifestyle in general.[18] According to a Romir estimate, the shares of customers choosing inexpensive brands and only buying goods at a bargain price will continue rising to stand at 38% and 26%, respectively, next year. Responding to this, retail chains are adjusting their selection of goods in favour of the budget segment and launching new formats for thrifty consumers.[19] Online marketplaces have also doubled their sales on bargain shopping days (the "Worldwide Shopping Day"). Delivery services, meanwhile, point out an average check decline. Overall, an increasingly large number of people are giving up their adhoc buying habits.

The November real-time consumption data confirms a shift to the austerity trend, showing demand weakening in non-food (down 3.8% YoY over three weeks of November, according to Sberbank data) and services (down 29.5% YoY) categories, with food sales remaining stable (up 3.5% YoY). The deviation of financial flows to the retail sector shrank from 19.9% YoY in October to 10.8% YoY in November, with weekly growth in daily expenditure slowing from 5.3%

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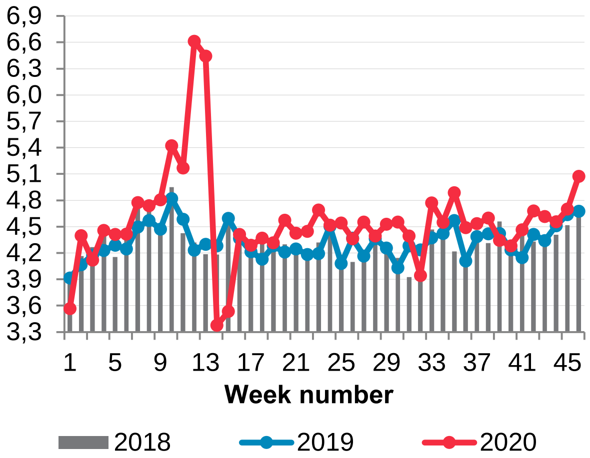
[18] According to data from Nielsen, the share of private label goods, discounters and promo sales in retail sales has risen. 10.11.2020.

[19] Magnit and X5 are launching hard discounter shops, Fix Price closed the largest regional deal in the warehousing property market. 13.11.2020.

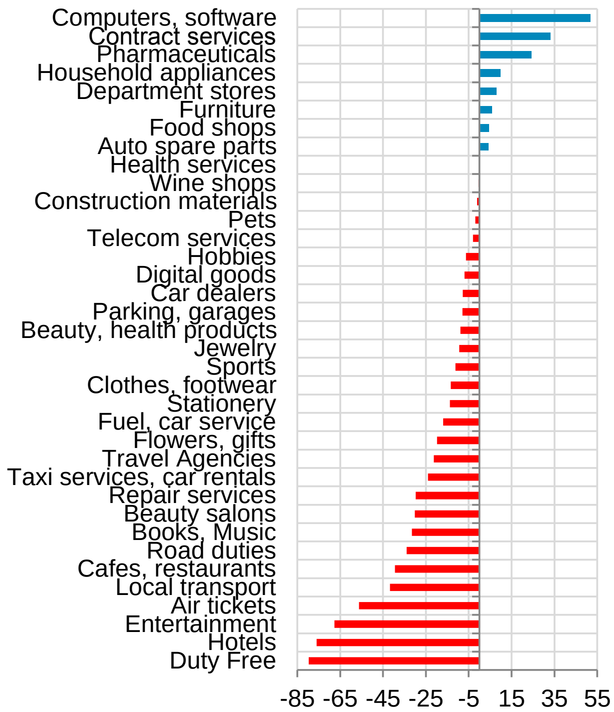
YoY to 3.6% YoY, according to Romir data[20] (Figure 33). The beneficiaries of people's self-isolation are the same segments as in the spring (Figure 34).

Figure 33. Nominal weekly household expenditure, thousand rubles.



Source: Romir.

Figure 34. Change in real expenditure on goods and services in November, % YoY



Source: "SberData" Lab.

2.6. Labour market situation improving

- The unemployment rate declined for the second consecutive month in November, with growth in the number of vacancies placed accelerating. The improvement in the labour market situation is helped by a trend of gradual business activity recovery which emerged after most restrictions imposed in the spring were lifted. This is not even hampered by indications that the partial reinstatement of restrictions in the fourth quarter following a renewed pandemic surge in the autumn is having a restraining impact on economic performance.
- It is, however, important to bear in mind that significant pandemic-related risks to the economy will remain after the current surge in contagions has passed. This will be one of the factors restraining the process of further business activity recovery involving the normalisation of the labour market situation.
- The driver of September's 2.2% YoY growth in average real wages was the resumption of private sector wage increases, with a public sector wages rise moderately slowing.

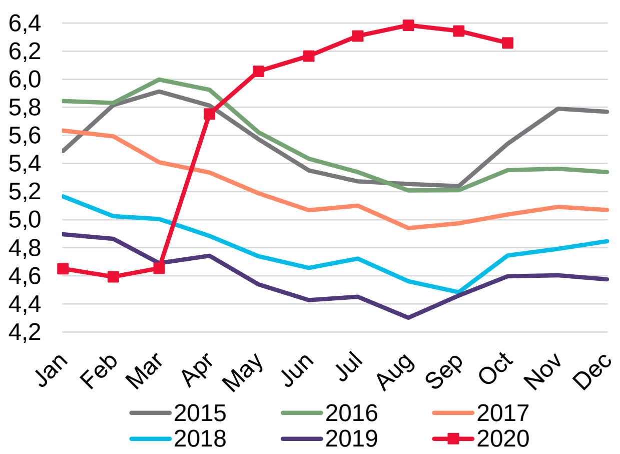
[20] Weekly expenditure hits the highest level since April / Romir research holding. 17.11.2020.

Unemployment continued to decline in October, sliding to 6.3% in seasonally adjusted terms from 6.5% in September (in seasonally unadjusted terms, unemployment saw a token decrease of less than 0.1 pp to 6.3%, Figure 35). The unemployment headcount dwindled by 83 thousand persons to 4.694 million people.

The unemployment reduction was helped by the discontinuation of unemployment benefit supplements as of 1 October and a gradual recovery of economic activity, spurring labour demand. According to data from employment services, September saw an increase (of 3.0% YoY) in the number of vacancies placed for the first time since the start of the coronavirus epidemic (Figure 36). Alternative data from the HeadHunter agency, whose 2020 data is similar to official statistics, indicates an acceleration of labour demand growth in October. Moreover, a rise in the number of vacancies outpaced an increase in the number of CVs (18.0% YoY versus 11.0% YoY) for the first time since mid-2019. We, however, believe that since this data varies across industries, its interpretation in terms of overall labour demand recovery should be treated with caution. This is especially important to bear in mind, given the non-uniformity of industries' economic performance amid the consequences of the crisis. In particular, the PMI sub-index for employment posted a deterioration in November.

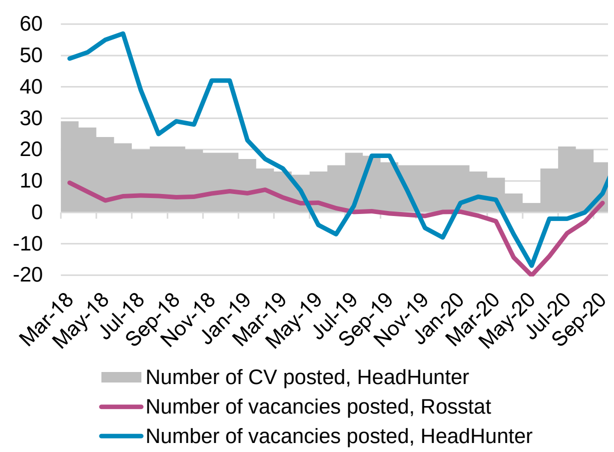
Wage growth saw an improvement. An average real wage rise accelerated to 2.2% YoY in September from 0.1% YoY in August (Figure 37). We estimate that this was helped by the recovery of private sector wage growth to 4.0% YoY versus 0.5% YoY in August, whereas a public sector wage rise slowed to 11.3% YoY from 13.2% YoY in August amid a gradual winding down of budget-funded household support programmes. A more modest public sector wage indexation (by 3.0% as of 1 October versus 4.3% a year earlier) will be another factor slowing further annual wage growth.

Figure 35. Unemployment rate in 2015-2020, %



Sources: Rosstat.

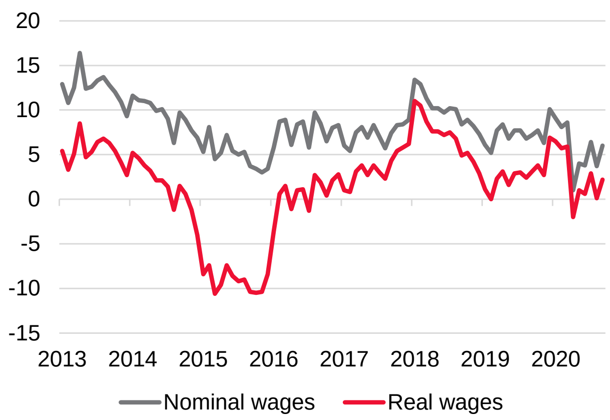
Figure 36. Labour demand from employers, % YoY



Sources: Rosstat, HeadHunter.

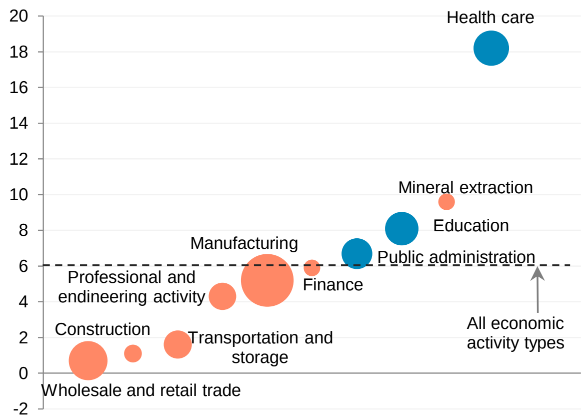
A further change in the labour market situation will directly depend on the trajectory of economic activity recovery in the face of the continuing epidemic risks. Although the current rise in contagions is accompanied by milder, more selective, restrictions than in the second quarter of 2020, real-time data indicates that the epidemic situation worsening is having a restraining impact on the economy in the fourth quarter.

Figure 37. Wage growth rate, % YoY



Sources: Rosstat.

Figure 38. Nominal wage growth by industry in September 2020, % YoY



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

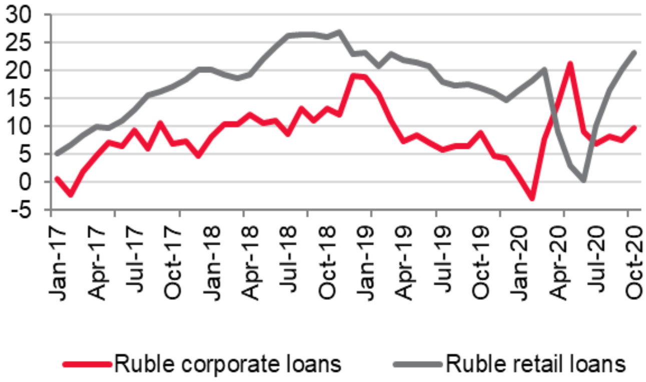
Source: Rosstat, R&F Department estimates.

2.7. Banking sector in October: growth acceleration in key lending segments

- Bank lending is gaining momentum, responding to a substantial monetary easing, as well as regulatory and macroprudential measures put in place. Moreover, the epidemic situation worsening had just a minor effect on the key indicators of banking sector performance. One exception was a worsening in household deposits, dragged down by a rise in demand for ruble cash, contrary to the usual seasonal pattern.
- Retail lending expansion accelerated to 2% MoM, thanks, above all, to mortgage loans. The subsidised loan programme extension and all-time lows of interest rates may buoy mortgage lending growth in the months to come. An acceleration is also posted in the unsecured consumer lending segment.
- Corporate ruble lending growth accelerated to 1.2% MoM owing to long- and medium-term loans, with faster growth in loans to financial organisations continuing.
- The banking sector's profit remains solid (thanks to, among other things, the Bank of Russia's regulatory easing), helping banks expand lending.

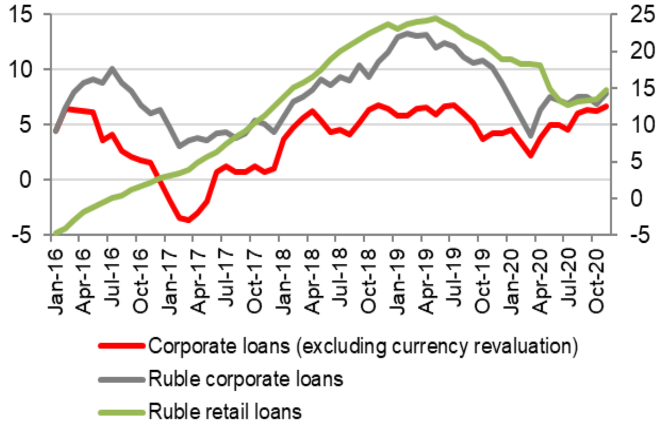
Retail lending growth continued to gain pace in October 2020, accelerating from 1.7% MoM SA to 2.0% MoM SA, with three-month annualised pace of growth standing at 23.2% (Figure 39). Annual growth accelerated from 13.5% YoY to 14.7% YoY (Figure 40).

Figure 39. Lending performance, 3-month annualized average, %



Source: Bank of Russia.

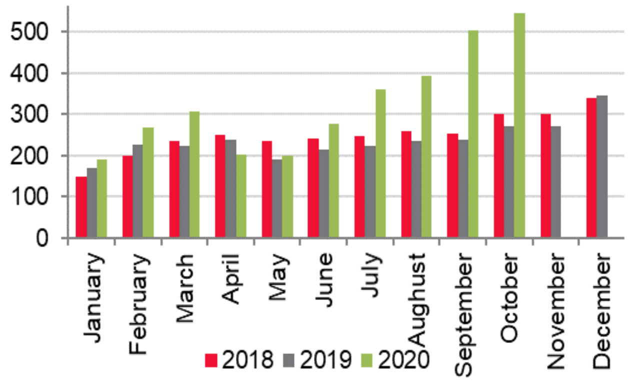
Figure 40. Banks' credit growth % YoY



Source: Bank of Russia.

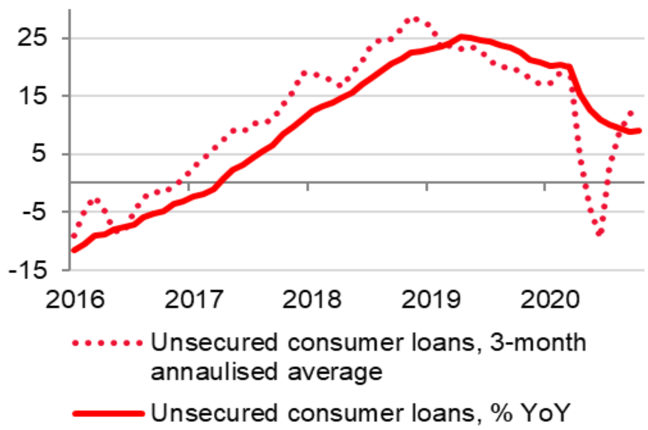
Retail lending growth continues to be buttressed by mortgage loans. A total of mortgage loans issued in October 2020 was double the number of October 2019 (Figure 41), while September's growth was even stronger at 110% YoY. A three-month average rise in ruble debt stood at 2.8% MoM SA[21] and 2.5% with mortgage-backed securities included. An increase in the number of loans issued continues to be driven by subsidised mortgage lending programmes and low interest rates (Figure 43), boosting growth in demand for refinancing and loans to buy housing in the secondary market.

Figure 41. Dynamics of new mortgage loans, billion rubles.



Source: Bank of Russia.

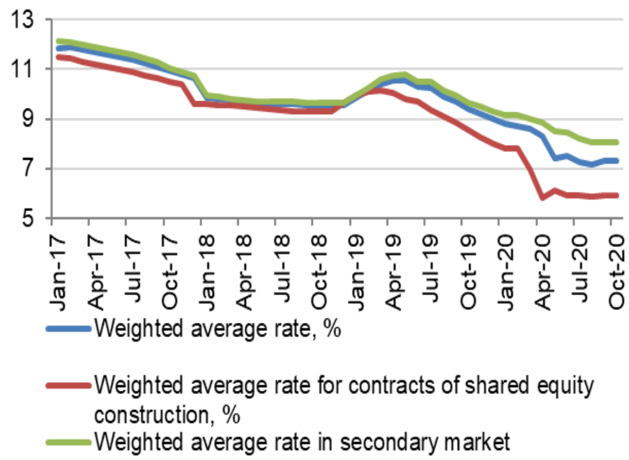
Figure 42. Unsecured consumer loans' dynamics, %



Source: Bank of Russia.

[21] Annual outstanding debt growth stood at 22.2%, three-month annualised growth equalled 39.7%, or 34%, with mortgage-backed securities included.

Figure 43. Interest rates in mortgage loan market, %



Source: Bank of Russia.

Auto lending expansion accelerated from 0.8% MoM SA to 2.0% MoM SA.[22] The continuation of subsidised lending programmes and a shift of the car sales structure towards loan-financed car purchases will keep up this segment's moderate pace of growth.

Based on a preliminary estimate, the pace of unsecured consumer lending expansion rose to 1.2% MoM SA in October 2020 from 0.9% a month earlier, remaining, however, below the 2019 level[23] (Figure 42). According to National Bureau of Credit Histories and United Credit Bureau data, the issuance of credit cards contracted substantially, while cash loans remained almost unchanged. The acceleration may, therefore, have been supported by POS loans. The next few months will provide no conditions for a considerable rise in unsecured consumer lending. Banks have adhered to conservative policies, which may be tightened further as the epidemic situation worsens. Further acceleration may be hampered by the petering out of pent-up demand and a more cautious consumer behavior.

Growth in ruble lending to non-financial organisations accelerated to 1.3% MoM SA[24] in October from 0.3 % a month earlier, fuelled by long- and medium-term loans (Figure 44). A continued rise in longer-than-1-year loans may be fuelled by investment demand, as suggested by individual industries' financial flows.[25] It may have also been supported by the launch of new apartment housing construction projects, up 70% YoY, and monetary easing. Short-term lending contraction may be owed to companies' decreasing need for compensating an income shortfall and discontinuation of some support programmes.[26]

October saw continued growth in loans to financial organisations, exceeding previous years' seasonal patterns. This may suggest indirect corporate sector support via the channels of non-banking financing.

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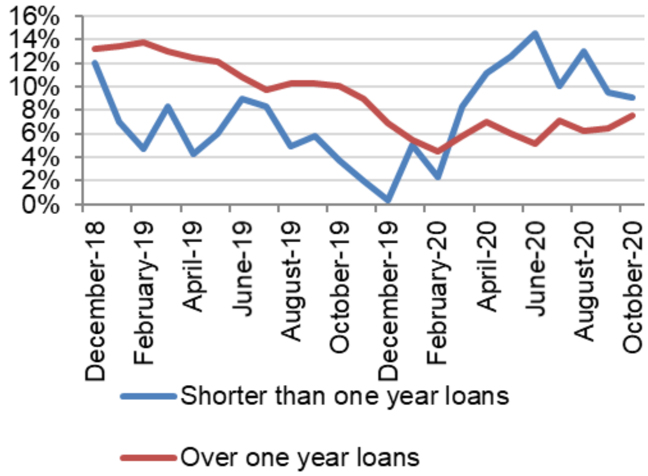
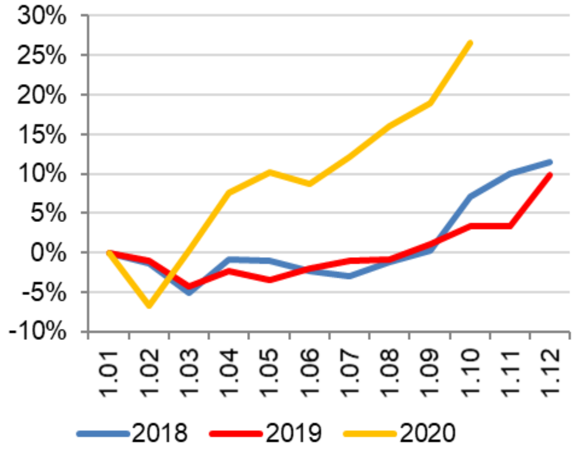
22 Three-month annualised growth accelerated to 15.6%.
23 Three-month annualised growth stood at 12.4%.
24 Three-month annualised growth stood at 9.7%.
25 In industries meeting investment demand, incoming flows rose 0.4% above the "normal" level in October and were 0.2% below it in September.
26 Under RF Government Decree No. 696-P of 16.05.2020, subsidised loans for the resumption of operations are provided to businesses until 01.11.2020.

Figure 44. Dynamics of loans for non-financial organization, % YoY



Source: Bank of Russia.

Figure 45. Loans to financial organisations, accumulated growth from the beginning of year

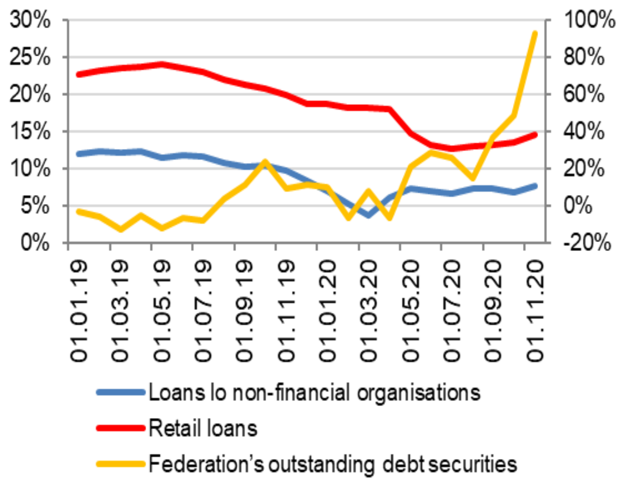


Source: Bank of Russia.

Lending growth is accelerating in parallel with banks expanding investments in OFZ securities (Figure 46). Banks are beefing up OFZ investments to manage interest rate risks and comply with liquidity requirements. This has no effect on their lending potential, which depends on credit risks and the size of capital.

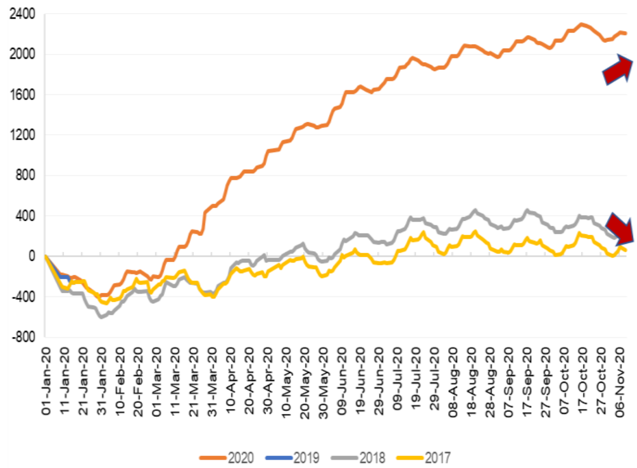
Household deposit expansion slowed to 0.2% MoM SA in October from 1.3% MoM SA, while net of escrow accounts, deposits dwindled 0.3% MoM SA. Growth in demand deposits and deposits with maturities of up to 30 days continue to rise, with a total of other deposits contracting. Contrary to the usual seasonal pattern, October's decline was accompanied by a currency in circulation increase (Figure 47) as the epidemic situation worsened. We saw a similar picture when contagions rose in the spring.

Figure 46. Annual growth in bank lending and OFZ investments, % YoY



Source: Bank of Russia.

Figure 47. Cash growth accumulated from the start of the year, billion rubles



Source: Bank of Russia.

October saw the share of overdue ruble loans inch down from 8.0% to 7.9% for non-financial organisations and from 2.8% to 2.7% for financial organisations, and remain at 4.7% for retail loans. The share of non-performing retail loans[27] contracted from 7.7% to 7.6%, that of corporate loans fell from 10.7% to 10.5%. The cessation of the credit vacation period has not so far had a significant effect on debt servicing quality, October did not see a significant rise in loan restructuring applications from households and SMEs. This suggests the stabilisation of banks' overall loan portfolio quality.

The banking sector earned a profit of 1,588 billion rubles from the start of the year, down just 6.4% on January–September 2019. The profit is buttressed by lending, a reduction in the cost of funding, an overall rise in business activity, including in financial markets, as well as the Bank of Russia's regulatory easing, which allowed the setting aside of additional loan-loss provisions to be adjourned. Next year, setting aside additional provisions may reduce banks' profit.

2.8. Stepped up funding of national projects boosted budget expenditure in October

- General government *revenue* returned to growth in October, rising 4% YoY in real terms. An acceleration of non-oil and gas revenue growth stemmed from consumption tax revenue moving into positive territory and non-tax revenue expansion gaining pace. The oil and gas revenue decline intensified due to the lagged impact of the oil price fall in September.
- Annual *expenditure* growth accelerated to 11% in real terms on the back of stepped up purchases of goods and social spending, above all as a result of a significant rise in the funding of the national project Demography. Capital expenditure, meanwhile, decreased in October.
- The 12-month rolling overall and non-oil and gas primary budget deficit were little changed relative to September. OFZ bonds remain the key deficit financing source: their net issuance hit a record 1.44 trillion rubles in October.
- We expect the budget's positive effect on GDP growth to peter out and to have a restraining impact on it starting from the second quarter of 2021. A moderate restraining impact of the budget on inflation is also expected in 2021.

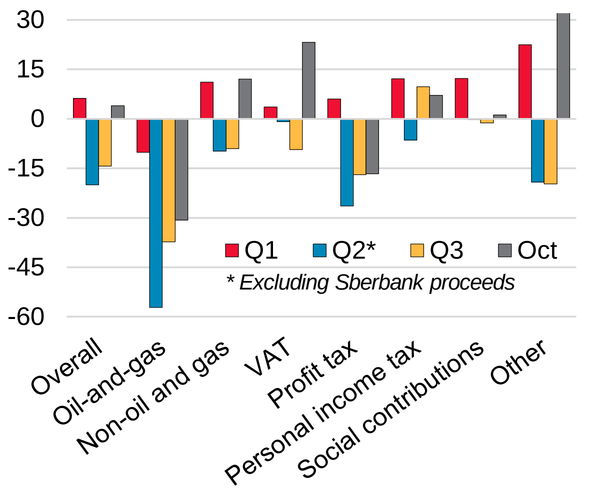
Revenue. According to RF Treasury data, overall revenue of *general government* returned to growth in real terms[28] in *October,* rising 4% YoY after a fall of 5% YoY in September (Figure 48). This revenue performance stems from an acceleration of non-oil and gas revenue expansion to 12% YoY from 1% YoY in September. This is in turn owed to consumption tax revenue (VAT, excise taxes) moving into positive territory along with a substantial acceleration

[27] Non-performing loans are deemed to be loans of the IV–V quality categories, defined in compliance with reporting form 0409115.

[28] We use a mean between the CPI and PPI as a proxy for the deflator, 1% and 2% in the third quarter and October, respectively.

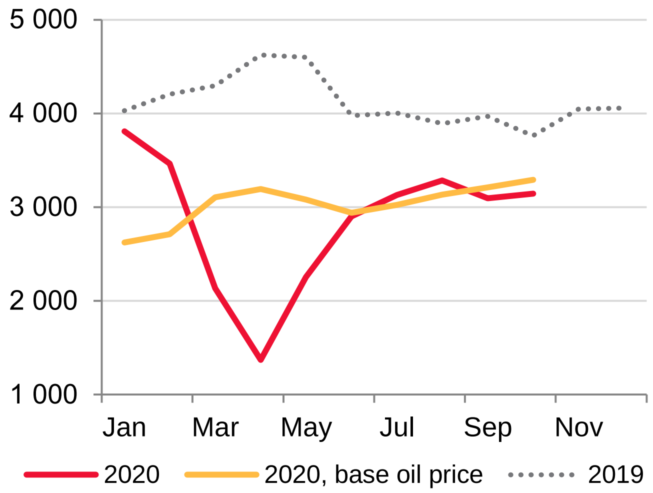
of a rise in non-tax revenue, which is characterized by high volatility. At the same time, profit tax revenue resumed its annual decline after a spike in September. The continued slowdown of annual growth in personal income tax revenue signals a likely wage increase slowdown at the start of the fourth quarter. What is more, oil and gas revenue contraction accelerated to 31% YoY in real terms from 27% YoY in September, driven, above all, by a lagged impact of an oil price decline in September (Figure 49).

Figure 48. General government revenue, in real terms, % YoY



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

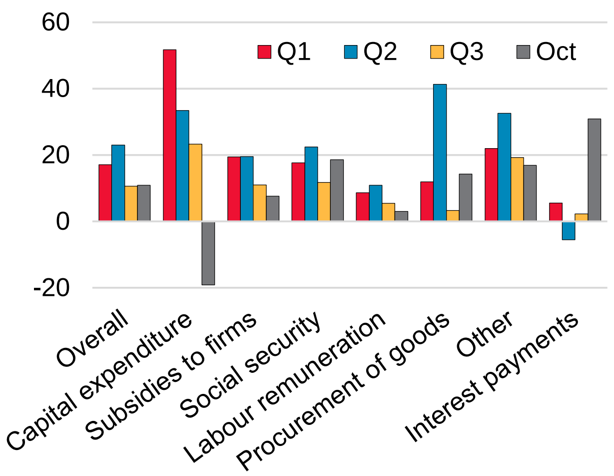
Figure 49. Urals oil price, rubbles per barrel



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

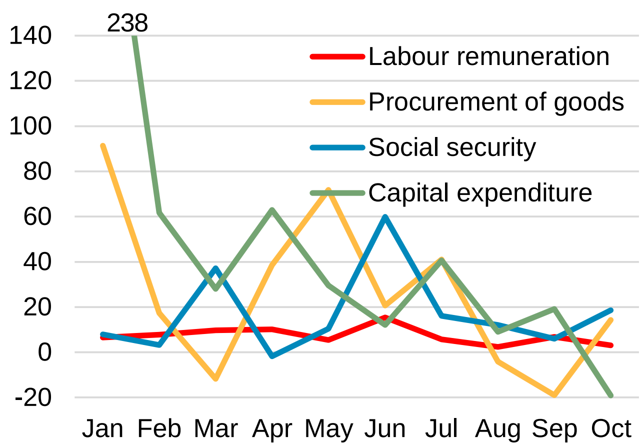
Expenditure. Real annual growth in general government expenditure accelerated to 11% YoY from 5% YoY in September (Figure 50). Annual expansion in the purchases of goods and services, as well as social support expenditure, gained pace, with capital expenditure declining (Figure 51). One key factor for this development was a sizable rise in the funding of the national projects (up 52% YoY in October), the bulk of it going to the Demography project.

Figure 50. General government expenditure, in real terms, % YoY



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

Figure 51. Selected general government expenditure in real terms, % YoY



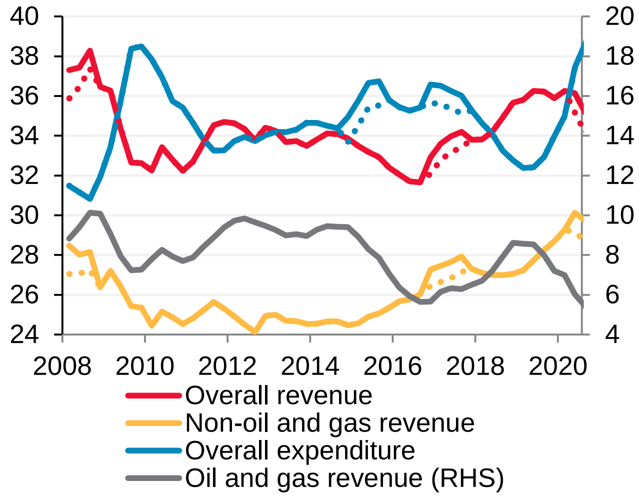
Source: RF Treasury, Rosstat, R&F Department estimates.

Budget balance and financing sources. October saw a rise in the 12-month rolling average of general government revenue and expenditure as a percentage of GDP (Figure 52). The 12-month rolling average total deficit and non-oil and gas primary deficit were little changed relative to September[29] (Figure 53). The countercyclical impact of fiscal policy is diminishing but it continues to contribute to the recovery of economic activity, smoothing out the consequences of the epidemiological situation worsening.

Domestic borrowings remain the key source of financing the budget deficit. The Finance Ministry continued to issue OFZ bonds at a faster pace. The net OFZ issuance totalled 1.44 trillion rubles in October (3.74 trillion rubles from the start of the year).[30]

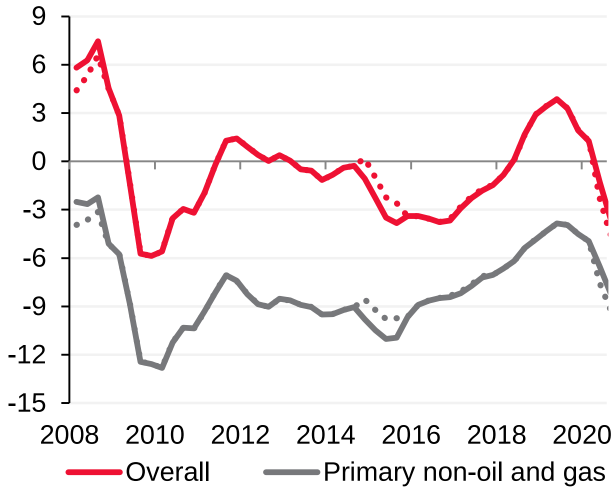
October saw foreign currency sales from the National Wealth Fund expanded in compliance with the fiscal rule to compensate the shortfall of oil and gas revenue (an equivalent of 0.13 trillion rubles was sold).

Figure 52. Key indicators of general government (% of GDP, 12-month rolling average)



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

Figure 53. General government balance (% of GDP, 12-month rolling average)



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

Note. Dotted lines represent estimates, exclusive of major unconventional one-off factors: YUKOS debt payment in 2007, recapitalization of banks in 2014, expenditure for early repayment of defense sector loans and Rossneft privatization in 2016, proceeds from the sale of Sberbank shares in 2020.

Forecast. In the coming months we expect a moderate 12-month rolling average decline in general government revenue and expenditure increase. The budget's positive impact on annual GDP growth will continue but its dampening effect will diminish as a result of passing an expenditure growth peak and a revenue decline through. Starting from the second quarter of 2021, we expect it to have a restraining effect on annual GDP growth on the back of fiscal consolidation and a gradual return to the fiscal rule. A moderate restraining impact of the budget on inflation is also expected in 2021.

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[29] We estimate that, net of revenue from the sale of Sberbank shares, the total deficit rose to 7.4% of GDP, with the non-oil and gas primary deficit dwindling to 9.2% of GDP.

[30] Actual revenue.

IN FOCUS. Is there crowding out effect between growing OFZ market and market for corporate bonds?

- To finance the national budget deficit, the RF Finance Ministry expanded its domestic borrowings to 5.1 trillion rubles from the start of 2020. The Finance Ministry's current borrowings are not, in our view, an important factor of crowding out corporate borrowings by government debt, because investments in floaters (OFZ-PK) and corporate bonds are different in nature. Banks' investments in floating-coupon OFZ securities seek to cover interest rate risk and, unlike corporate bonds, do not burden bank capital and are beneficial from the perspective of liquidity requirements.
- While the Russian bond market is expanding considerably, change in its segments is non-uniform: the sector of government securities has risen most of all owing to their extensive issuance by the Finance Ministry. The corporate bond sector has also expanded but three times less massively.
- Given companies' continuing need for borrowings, the corporate bond market is, along with loans, an efficient instrument for raising debt finance. This is borne out by the growing volumes of new bond issues.
- At the same time, the corporate bond market's low liquidity versus the OFZ market, coupled with modest new issue premiums, make corporate bonds less attractive to the most active investors (banks). Uncertainty over external factors, which also give rise to a variety of monetary policy scenarios over a medium-term horizon, increases the likelihood of higher volatility of asset prices. This risk has an adverse effect on the relative attractiveness of corporate bonds to banks, and is, in our view, the key factor restraining the corporate bond market development and reducing the share of banks' participation in new bond issues.
- The specific features of the market's recovery after the period of elevated uncertainty in March–April (the lack of a significant credit spread widening, dwindling corporate bond purchases by the most active market participants, such as banks) further reduced the corporate bond segment's liquidity.
- An expansion in banks' OFZ positions reduces a liquidity surplus in the banking system as long as finance raised by the government does not finance expenditure. However, some banks can, if needed, compensate possible temporary liquidity outflows via repo transactions with the Bank of Russia and the Federal Treasury or in the interbank market. That said, investments in floaters have a minimal effect on the use of a bank's market limits and are not supposed to affect corporate bond purchases by banks' trading units.

The need to finance massive measures of government support for the economy amid the global crisis triggered by the coronavirus and unprecedented in scale and structure, sparked, among other things, a substantial rise in borrowings from the financial market.

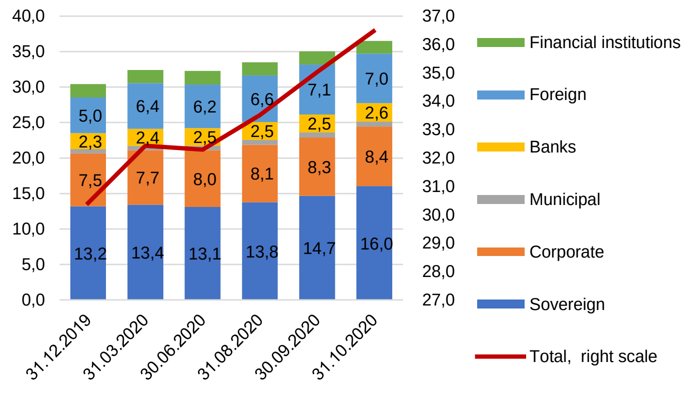
An increase in government borrowings from the financial market often changes the shape of yield curves and affects the cost of finance raised by financial and non-financial companies. Government bond yields are risk-free interest rates underlying pricing in the rest of bond market segments. We have tried to analyse, from the perspective of this potential impact on corporate borrowings, how the market of public debt for corporate borrowers recovered after the high volatility period in March–April and how it was affected by the rise in OFZ issuance.

The market in 2020

According to depository reporting data,[31] the Russian bond market expanded 20%[32] over the first 10 months of 2020. The strongest growth in absolute terms was posted in the government securities segment totalling more than 36 trillion in nominal terms[33] (an increase of 3 trillion rubles) (Figure 54 and Figure 55). But in relative terms, the government sector's share increased just 0.6 pp. The largest gain was posted in the share of foreign issuers' bonds,[34] up 2.6 pp, or 1.94 trillion rubles, but the share of other bond market segments shrank in percentage terms.

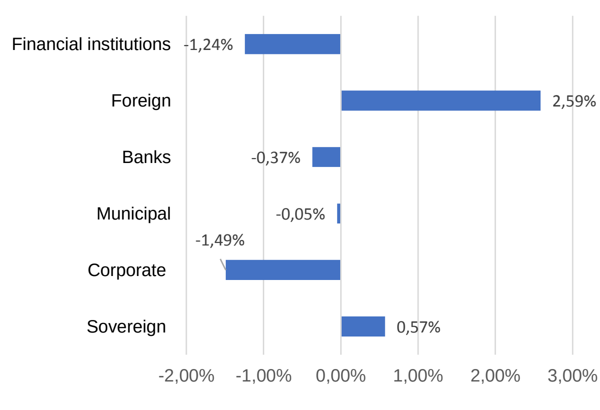
Credit institutions remain the key investors in the Russian bond market (Figure 56), followed by pension funds (non-government pension funds and the Pension Fund of the Russian Federation) and other financial organisations, whose share of investments has dwindled by 1.2 pp. Nonresidents are also a large group in the Russian bond market (14.3%), but their specific feature is the concentration of investments in the government bond segment (these represented 83.5% of nonresidents' investments recorded in Russia's depository accounts as of 30.10. 2020). Retail investments in bonds have also increased, up 0.8 pp, but they account for less than 10% of the market (7.1%).

Figure 54. Volume of Russia's bond market, trillion rubles



Source: Bank of Russia.

Figure 55. Change in shares of bond market segments, %

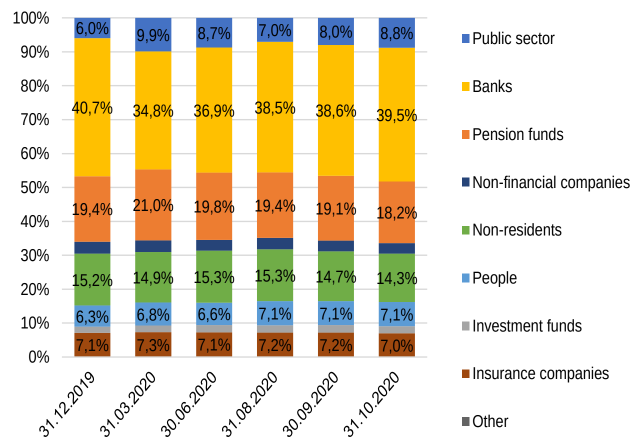


Source: Bank of Russia.

[31] Forms 0420415 and 0409711.
[32] A total of bonds in Russia's depository accounts, including the Russian Federation's Eurobonds and bonds from foreign issuers.
[33] Government bonds include the issues of OFZ (Federal Debt Issue), the Russian Federation's Eurobonds, government savings bonds, and Bank of Russia's bonds).
[34] Bonds from foreign issuers in Russia's depository accounts include both Eurobonds issued by foreign subsidiaries of Russian companies and other foreign issuers' bonds purchased by Russian depositories' customers.

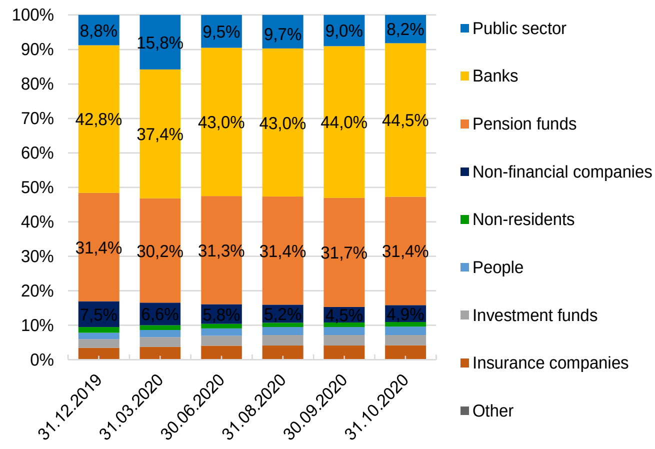
Government sector investments[35] are comprised of both proprietary bond portfolios and securities obtained through repo transactions with Russian banks, and therefore an increase in their share largely stems from the redistribution of bonds in Russian depository accounts from credit institutions as part of repo transactions with the Bank of Russia and the Federal Treasury. In the *corporate bond* segment (to which we assign non-financial companies' bonds traded in the Russian market, Russian banks and pension institutions account for the bulk of investments (Figure 56).

Figure 56. Investors in the Russian bond market, %



Source: Bank of Russia.

Figure 57. Investors in corporate bonds, %



Source: Bank of Russia.

Despite the OFZ issuance expansion, investments in corporate bonds by the key investor types do not decline. However, the pace of the government bond market's growth, driven by a rise in OFZ supply by the Finance Ministry, may cause growth in the issuance of corporate bonds to slow (the corporate bond market has expanded less in relative terms than the OFZ market in 2020). To get an insight into the causes of the corporate bond market's slower growth, we shall look in more detail at how this market segment recovered after the March–April period of elevated volatility.

Recovery after the acute phase of the crisis

With the advent of the coronavirus crisis, bringing along elevated volatility to the Russian financial market, the corporate bond segment has encountered the loss of buyers and sellers alike. As a result, market liquidity has worsened drastically. A decrease in the number of buyers in periods of increased volatility is quite understandable. The Russian investors' unwillingness to get rid of positions falling in price is in turn due to the following causes.

First, there are practically no buyers during a market fall, while investors that would be willing to buy this issuer's bond price into it a fairly large discount allowing market and credit risks to be compensated. That said, there are almost no nonresidents among corporate debt

[35] Bank of Russia, the Federal Treasury, and other organisations.

holders, since in times of crisis nonresidents seek to get rid of the riskiest bonds as fast as possible at any price in order to minimise losses and switch to risk-free assets.

Second, the sale of bonds by Russian investors in the falling market at a buyer's price means that the seller fixes a loss in the position, which may have a negative effect on the assessment of a trader or portfolio manager's work. In the case of Russian investors, such a sale, as a rule, only occurs in the event of a sharp rise in credit risk or a threat of default on bonds. In the absence of a default threat, investors prefer to hold a bond to maturity, receiving periodic income and a bond's face value upon its redemption.

The crisis which markets encountered in March did not trigger a wave of corporate defaults (thanks to, among other things, measures of support and regulatory easing in place), unlike previous crises, when elevated volatility heightened credit risk notably. But a sharp rise in yields, mounting uncertainty, and the lack of market players willing to sell securities which had fallen in price, led to a loss of liquidity in the secondary corporate bond market.

The recovery of the market this year was much different from the previous bouts of elevated volatility. After the previous crisis periods, liquidity, as a rule, returned to the corporate bond market in the wake of the first new issues from high-quality issuers of first echelon (companies with a high credit rating). Such issuers' bonds were sold at new, post-crisis yields, setting a credit spread benchmark for other issuers.

Thanks to brisk trading in new market issues, liquidity started to return to the market, while the price of such bonds went up fast, allowing investors to receive additional income in the form of a rise in a bond's principal. Meanwhile, the greater part of bonds issued prior to the crisis period did not, as a rule, return to the secondary market, staying in the portfolios of end-investors until maturity.

We saw a different picture after the March–April period of elevated volatility associated with the coronavirus crisis. *First,* as we have already noted, the market fall did not trigger a significant widening of "first echelon" issuers' credit spreads. The first post-crisis issues of corporate bonds were undertaken amid a rally in the OFZ market, but they failed to trigger liquidity inflows to the corporate bond market.

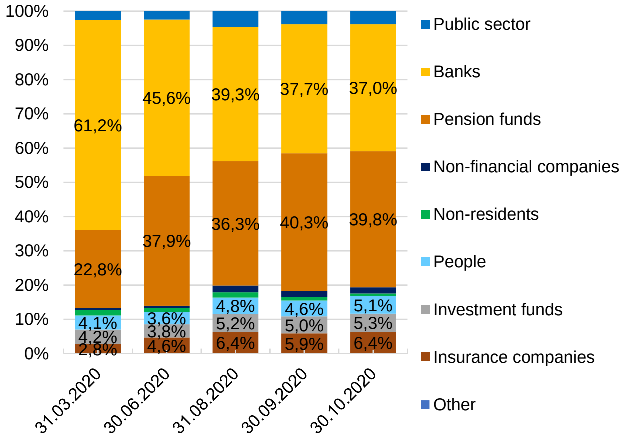
Second, despite a relatively slack secondary market, new issues continued to expand. According to the Cbonds information portal data, a total of outstanding ruble bonds from corporate and financial sector issuers exceeded 2.1 trillion rubles as of 25.11.2020 (it compares with 2.6 trillion rubles of bonds in 2029 and 1.5 trillion rubles in 2028).

Demand structure

Another interesting trend which we see in the corporate bond market is a change in the demand structure. The bulk of investments in nonfinancial companies' new bonds shifted in 2020 towards pension institutions and other financial organisations as well as insurance companies (Figure 58). Pension funds and insurance companies are classical institutional investors, which usually buy securities to hold them to maturity.

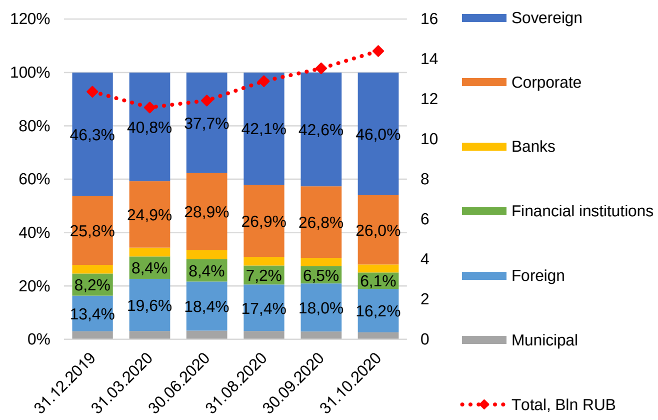
Meanwhile, the share of the most active investors that can buy securities in order to, among other things, receive income from a rise in bonds' face value (credit organisations) has declined from 61% to 37%. It seems that a fall in Russian banks' investments in new bonds is one cause of the secondary corporate bond market's insufficient liquidity.

Figure 58. Investments in non-financial issuers' bonds sold in 2020 (progressive total, % of total issuance)



Source: Bank of Russia.

Figure 59. Credit organisations' investments in bonds, %



Source: Bank of Russia.

Growth in new OFZ issues

At first glance, a contraction in banks' investments in new corporate bond issues may seem to be an obvious consequence of a rise in OFZ issuance. From the start of the year to 18.11. 2020, the RF Finance Ministry raised 5.1 trillion rubles in the domestic market through OFZ issuance. According to National Settlement Depositary data, Russian banks were the key buyers at OFZ auctions in September–November[36] (the Finance Ministry sold over 60% of total OFZ issuance in that period), buying 89% of bonds issued in that time interval .

On the one hand, raising liquidity through selling OFZ instruments to banks before the time of spending, the Finance Ministry reduces the banking system's surplus liquidity, but credit institutions can temporarily (until credit organisations receive funds for financing public expenditure) increase funds obtained from the Bank of Russia and the Federal Treasury through repo transactions or in the interbank market. This is exactly what we have recently seen in the Russian market (for more detail, see the analytical comment Banking sector liquidity and financial markets, No. 10 (56), October 2020).

On the other hand, the purchase of floating-coupon OFZ securities (OFZ-PK) account for 91% of OFZ bonds issued from the start of the year), return on which depends on the accrued RUONIA rate, is interesting not so much to banks' trading units as to units in charge of asset and liability management. First, OFZ-PK bonds help manage banks' interest rate risk, reducing the sensitivity of a bank's income to the level of money market rates; second, they allow banks

[36] As of 18.11.2020.

to increase liquidity requirements. Coupled with the ability to obtain, if needed, funding from the Bank of Russia or the Federal Treasury through repo transactions, expansion in investments in OFZ-PK bonds is not supposed to complicate trading units' purchases of and trading in assets, including corporate bonds.

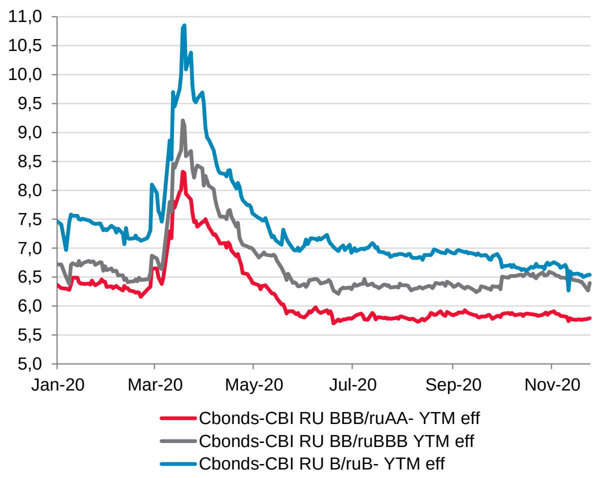
Issuers are the issue?

Banks' declining interest in buying corporate bonds may be due to the lack of issuers' need or willingness to tap the new issues market.

After a sharp market fall in March, bond yields have been on the decline. Thanks to loose monetary policy which the Bank of Russia adopted in 2020, as well as the absence of a credit risk rise, yields of bonds from "first echelon" issuers (roughly, those rated BBB-/Baa3 and higher) slid below the pre-coronavirus levels (Figure 60) as early as the start of the summer. Meanwhile, the cost of raising debt in the bond market for the "second echelon" issuers (companies with credit ratings from BB-/Ba3 to B+/Ba1) declined to levels at which the first echelon issuers raided debt a year ago.

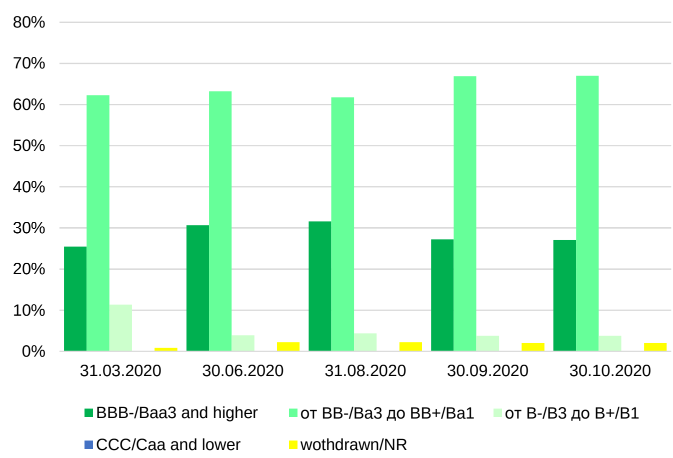
It should be noted that in 2020 the market has not seen a significant redistribution of new issues towards issuers of any rating classes which could have affected demand from credit institutions (Figure 61). Another important factor should be taken into account: in 2020, banks considerably expanded their corporate loan portfolio, whose growth from the start of the year hit the highest level since 2014 at 8.7%.[37]

Figure 60. Corporate bond yields, % p.a.



Source: *www.cbonds.ru*, Bank of Russia.

Figure 61. Rating structure of corporate bonds issued in 2020 (progressive total, % of total issuance)



Source: *www.cbonds.ru, Bank of Russia.*

This circumstance suggests banks' sustainable need for debt finance. Thus, growth in banks' loan portfolio concurrently with a slowdown in investments in corporate bonds may stem

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from either issuers' unwillingness to use bonds as a tool for raising finance or bonds' lower attractiveness to banks compared with loans.

A fairly active new issues market and growing issuance indicate issuers' continued interest in the bond market. We believe that the key factor behind banks' decreasing interest in new corporate bond issues is bonds' lower attractiveness compared with lending in the current environment.

It is important to note that in comparing loan terms and those of bond purchases by a bank, prices are not always of critical importance. Moreover, the comparison of loan interest rates and bond yields is not quite relevant because of the difference in the specifics of debt instruments. Unlike bonds, which are a public debt obligation, loan is bilateral agreement which can specify debt securing conditions and whether a creditor is entitled to demand an early loan repayment or to change an interest rate on it. Also, in providing a loan, a bank can factor in its relationship with a customer or its own wish to develop sales of fees and commission products (tacit agreements which are not recorded in the loan agreement but can affect loan pricing). These specifics have, however, always been part of banks' operations.

Measures to support borrowers have, to a certain extent, helped more extensive lending to higher-risk borrowers. But banks are traditionally not investors in the high-yield bond segment (where borrowers rated B+/B- and lower are, as a rule, found.

We believe that change in market conditions and expectations regarding interest rate and credit spread moves were key to banks' declining interest in corporate bonds.

Being the most active part of investors, banks consider it important to earn more income from a rise in bonds' principal upon selling them. But the corporate bond market's lower liquidity versus the OFZ market and uncertainty regarding external factors increase the likelihood of a higher bond pricing volatility.

Therefore, the decline in banks' corporate bond purchases currently does not, in our view, stem from the OFZ issuance expansion. Loans can be viewed as a more preferable option because of the current level of credit spreads, an inadequate market liquidity, and uncertainty of expectations regarding monetary policy in 2021.

At the same time, the Finance Ministry's borrowings are not an important factor of corporate debt being crowded out by government borrowings, since the purposes of investments in corporate bonds and floating-coupon OFZ bonds are different. Banks' investments in the floating-coupon OFZ instrument are to a greater extent owed to its low interest rate risk, and, unlike corporate bonds, they do not burden bank capital.

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