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CONTENTS

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EXECUTIVE SUMMARY

MONTHLY SUMMARY

- In March, inflationary pressure remained elevated, including due to the effect of persistent supply- and demand-side proinflationary factors. Accommodative monetary policy and fiscal measures continue to support economic activity and domestic demand, including through the increased demand for loans. The recovery of the global economy positively influences the dynamics of Russian exports and the related industries, and also leads to an increase in prices in global commodity markets. In this context, the effect of stable inflation factors will weaken, albeit gradually, which calls for switching to neutral monetary policy. As a result, the return of annual inflation to 4.0% will be delayed until the first half of 2022.
  - In March, annual inflation reached its local high of 5.8%. The deviation of inflation from 4% was largely related to the effect of one-off factors. However, the contribution of stable price growth components to inflation is increasing.
  - In February, the Russian economy grew adjusted for the negative statistical effect of the leap year and seasonality. In March, economic activity also rose, according to high-frequency indicators (in particular, electricity consumption and sectoral financial flows).
  - In March, the Russian stock market was influenced by predominantly negative external news. A further increase in the yields of long-term US government bonds raised the risk premium for investments in risky assets, including in emerging market economies.

IN FOCUS. Fixed capital investments – in active recovery phase

- Fixed capital investments dropped less in 2020 than economic activity in general. Capital-intensive industries and services accounted for the main decline in investments.
- Broken down by the size of enterprises, investments declined the most in the small business, which has a lower safety margin and is widely represented in the services sector most affected by the pandemic.
- The structure of fixed capital investments in 2020 maintained a positive long-term trend towards an increase in the share of the most productive components: investments in machinery and equipment and in intellectual property.
- Investments reached their lowest level in the second quarter and started to recover a little later than consumption. However, since the end of 2020, investment activity has been rising quickly, having exceeded the level during the pandemic. This is confirmed, among other things, by the stable growth of investment imports, the acceleration of investment goods producer price growth, and the information of high-frequency indicators in early 2021.

- Steady growth of medium- and long-term corporate lending will support businesses' investment demand in the future. At the same time, high uncertainty, cases of administrative regulation in some sectors, a decrease in budget support, as well as the remaining reduced investments in the mining and quarrying industries (due to the OPEC+ deal) will contain further rapid investment growth after the completion of the active recovery growth phase.

1. Inflation

Annual inflation's rise to a local peak of 5.8% in March will likely give place to a decline in April thanks to the statistical effect of the high base in April 2020. Further on, an annual inflation decline may, however, be slow owing to price inertia and the continuing prevalence of short-term proinflationary factors.

The upward pressure on consumer prices arising from cost increases remains, with part of cost increases being *sustainable* in time. Indeed, if the supercycle continues in global commodity markets, with near-zero interest rates and quantitative easing still in place in the major global economies, prices of Russia's commodity exports and imports (the cyclical factor) are likely to rise further. Consumer demand restructuring in Russia and worldwide to adapt to the new post-coronavirus norm is giving rise to supply shortages in markets for goods (for example, semiconductors and chips), services (such as business process digitalisation), and labour (for example, IT professionals), which will take time to overcome. This is a structural factor of rises in costs.

The impact of consumer demand amid cost increases acquires a more pronounced *proinflationary* nature. The low elasticity of supply on a short-term horizon in an environment of continuing logistics difficulties and rising costs adds to the pace of price rises in segments where demand has already recovered or is rapidly recovering. As a result, the response of prices to changes in demand has become asymmetric: prices increase at a faster rate when demand rises than they decline when it falls.

The key measures of persistent inflationary processes (including trend inflation, modified core inflation, median inflation, seasonally adjusted price rises in food and non-food goods and services) exceed 4% in annualised terms. These indicators' rise will decline to 4% gradually as monetary policy returns to neutral. This will pave the way for annual inflation coming back to 4.0% in 2022.

1.1. Inflation hits local peak in March

- Annual inflation hit a local peak of 5.79% in March after 5.67% in February. Month-on-month price rises hold far above a level corresponding to 4% in annualised terms, reflecting elevated inflationary pressure in the consumer market.
- With demand for goods and services recovering, the impact of demand on price moves is becoming proinflationary, even in industries hardest hit by the corona crisis, where this stems from supply-side constraints. The elevated rate of price rises is also driven by the emergence of new transient proinflationary factors and steady growth in producer costs on the back of the pandemic.
- Annual inflation is set to decelerate in April as a surge in prices in April 2020 exits the calculation base. That said, a gradual decline of price rises from their elevated levels will result in a further sustainable annual inflation slowdown only as late as the end of 2021.

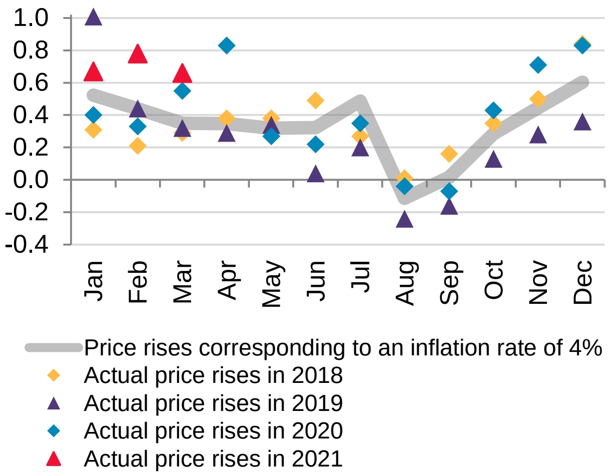
- The launched process of monetary policy return to normal will help inflation stabilisation at the 4% target, to be achieved in the first half of 2022.

Inflationary pressure remains elevated: monthly price growth has held above a level corresponding to an annualised inflation rate of 4% for the sixth consecutive month (Figure 1). Annual inflation hit a local peak of 5.79% in March after 5.67% in February (Figure 2). Inflation will slow in April 2021, given the elevated pace of price rises in April 2020, but further steady inflation deceleration will occur towards the end of the year as monthly price rises slow and the increased rate of price rises at the end of 2020 exits the calculation base.

Inflation dynamics continue to be shaped by a large number of mixed factors, with proinflationary ones prevailing. As consumer demand recovers, its disinflationary effect gives place to proinflationary influence due to supply-side constraints. These constraints arise from the still continuing effect of epidemic-controlling restrictions and some of producers' unpreparedness to promptly expand output in response to an extensive rise in demand. A shift towards goods and some types of services in the structure of consumer demand amplify its proinflationary effect amid an asymmetric response of prices to changes in demand: a faster rise in prices as demand increases than their decline when demand falls.

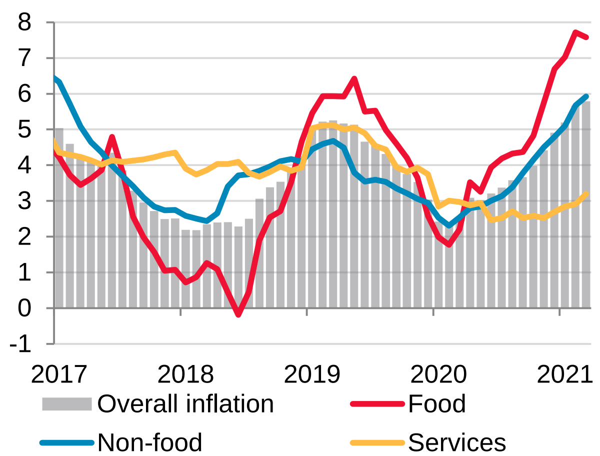
That said, the effect of supply-side proinflationary factors triggering cost increases was more persistent than expected, due to, among other things, the emergence of new factors, the worsening of the epizootic situation being one of them. The key proinflationary factor is the pandemic-related rises in the costs of producers of goods and providers of services stemming from global and local problems with supply chains, epidemic-controlling sanitary requirements, and restrictions still in place. As the global epidemic situation improves and restrictions are lifted, their impact on prices will gradually weaken, causing price rises to slow. If costs decline in the future after the situation with supplies gets back to normal, downward pressure on output prices may emerge.

Figure 1. Price rises corresponding to an inflation rate of 4%, % MoM



Source: Rosstat, R&F Department estimates.

Figure 2. Inflation and its components, % YoY



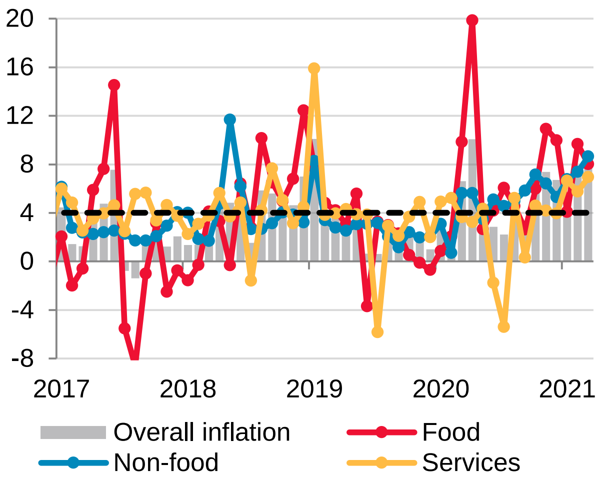
Source: Rosstat.

Month-on-month consumer price rises in *the food segment* remained elevated at 8.0% MoM SAAR in March, slowing marginally from a month earlier, driven by a sharp decline in the prices of fruit and vegetables (Figure 3). A rapid fall in the prices of cucumbers and tomatoes in March was a compensation for earlier, faster than usual, price rises due to the high costs of heating hothouses in the cold weather last winter. Meanwhile, price rises in other vegetables and fruits remains elevated relative to last year: an output fall has brought down the stock of domestic produce, while the supply of new produce may come later than usual because the sowing season started late in Russia's southern regions due to the cold weather. This boosts demand for imports, which have become more expensive on the back of ruble weakening.

A rise in food prices, except for those of fruit and vegetables, sharply accelerated to 14.4% MoM SAAR in March, largely on the back of the worsening epizootic situation (outbreaks of birds' flu and African swine fever, adding to pressure from increased producer costs against a backdrop of price rises in fodder, fertilizers, and imported hatching eggs (Figure 4). Various meats, meat products, and eggs were price growth leaders in March.

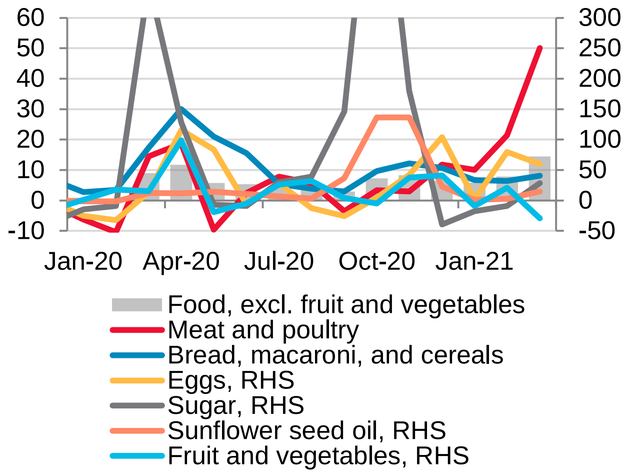
March saw a resumption of sugar price rises, while price increases in sunflower seed oil accelerated sharply, since retail chains had trouble purchasing these goods from producers at fixed prices. This was one of the reasons for the government to extend the agreement on price stabilisation for these products (until 1 June for sugar and 1 October for sunflower seed oil) and introduce as of 1 April additional subsidies for producers. Also, sunflower seed export duties are planned to be imposed as of 1 July, with a damper mechanism for sunflower seed oil exports introduced as of 1 September. Prices may stabilise while new measures are in effect, although they continued rising at the start of April, but the extension of the new measures may cause more significant imbalances to build up, create uncompetitive conditions for big companies and adverse implications for production and investment in the industry in the medium term.

Figure 3. Seasonally adjusted inflation, % MoM SAAR [1]



Source: Rosstat, R&F Department estimates.

Figure 4. Seasonally adjusted price rises for some food products, % MoM SAAR



Source: Rosstat, R&F Department estimates.

[1] "Under the Bank of Russia's methodology for seasonal adjustment of the consumer price index, annual updating of seasonal adjustment parameters was conducted in March, resulting in a time series adjustment."

Seasonally adjusted price rises *in non-food goods* kept accelerating in March to reach 8.7% MoM SAAR as demand for many categories continued to recover, encountering supply-side constraints, including on a global scale (logistics deterioration, component shortages in various links of production chains (Figure 3). Prices of excisable products (tobacco and petrol) continue to rise at an increased pace. That said, retail prices of petrol are going up, driven by a pass-through of rising world oil prices, with an annual indexation of damper mechanism parameters taken into account. The government has adjusted the formula for damper mechanism calculation, which will keep petrol price rises within the inflation target range, eliminating built-up imbalances.

An additional factor boosting the prices of non-food goods was a rebound of demand, which made itself especially strongly felt in the segment of goods related to the construction and acquisition of housing: construction materials, tools and equipment, furniture. Prices of these categories continued to climb in March, probably fuelled by an extensive increase in demand in the housing market.

Worthy of special mention is an elevated pace of a rise in imported and domestically produced car prices. This is largely due to disruptions in the transborder deliveries of cars' electronic components. This has a negative effect on the deliveries of finished cars to the market, prompting further price rises amid the continuing growth in demand (see also Section 2. Economic performance). Indeed, in March, AvtoVAZ revised up the price lists for its model range[2], boosting the prices of Russian cars.[3] The pace of imported car price hikes arein turn staying far above 4% in year-on-year terms.

March saw monthly price growth accelerating to 6.9% MoM SAAR in *the services sector* as the epidemic situation improved gradually, bringing along a continued extensive recovery of demand for services, including in industries hardest hit by restrictions. Indeed, the most notable contribution to price rises came from services related to tourist travel, those of passenger transport, foreign tourism and hotels. The easing of epidemic-controlling restrictions as the coronavirus situation improves continues to help the recovery of demand for other market services, such as personal services, whose prices have continued their climb.

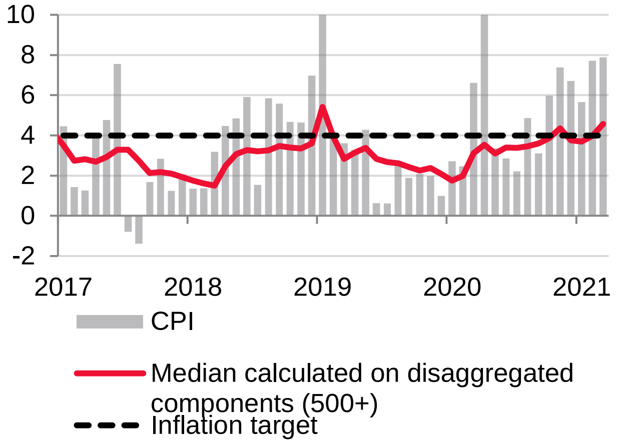
Practically all analytical indicators of price movements suggest that inflationary pressure adjusted for the impact of transient and one-off factors, continues to mount as economic activity rebounds. Indeed, the median distribution of monthly seasonally adjusted price growth across the most disaggregated CPI components[4] came close to 4% SAAR at the end of 2020 (Figure 5). Modified core inflation indicators hold well above 4%, while trend inflation has in recent months started to rise, moving away from the 4% level, around which it has hovered for about a year (Figure 6).

[2] Estimates of the share of imports (direct and indirect) in Russian carmakers' costs and components vary from 30% to 50%.

[3] AvtoVAZ hikes prices of all Lada models / Autonews / 15.03.2021.

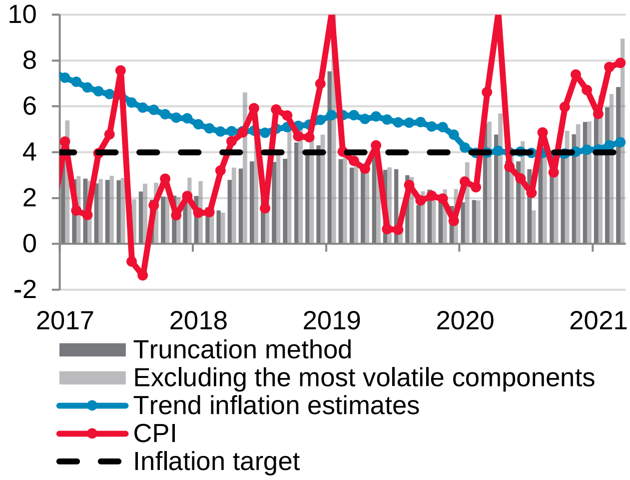
[4] 556 components in the 2021 basket.

Figure 5. Monthly price rise median calculated on disaggregated components, % MoM SAAR



Source: Rosstat, R&F Department estimates.

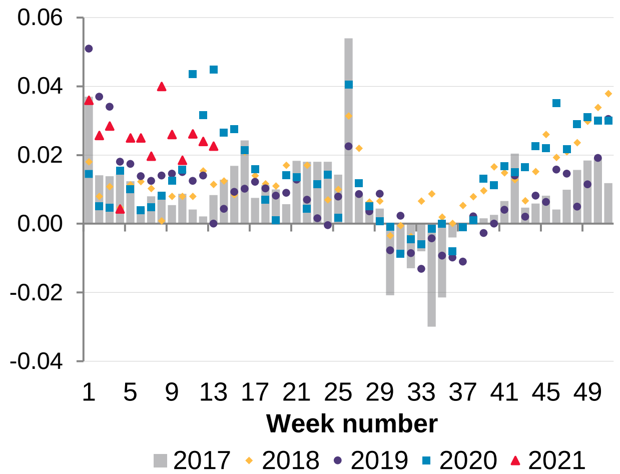
Figure 6. Modified core inflation indicators and trend inflation estimates, % in annual terms



Source: Rosstat, R&F Department estimates.

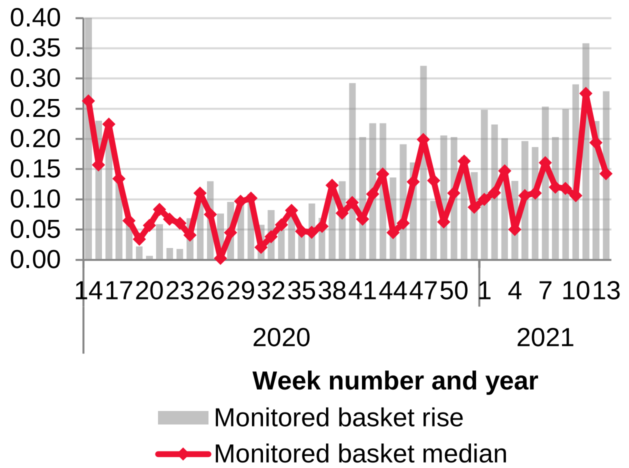
Price rises edged down at the start of April but remained elevated. Consumer prices added 0.1% over the first five days of the month and 0.2% for the full week from 30 March to 5 April. The average daily price growth remained elevated relative to previous years, except for the same period of 2020, when food demand surged on the epidemic situation worsening (Figure 7). Given the high base of April 2020, the estimate of annual inflation had declined to 5.66% by 5 April.

Figure 7.Average daily price increase, %



Source: Rosstat, R&F Department estimates.

Figure 8. Price growth and median distribution of weekly price increases[5], %



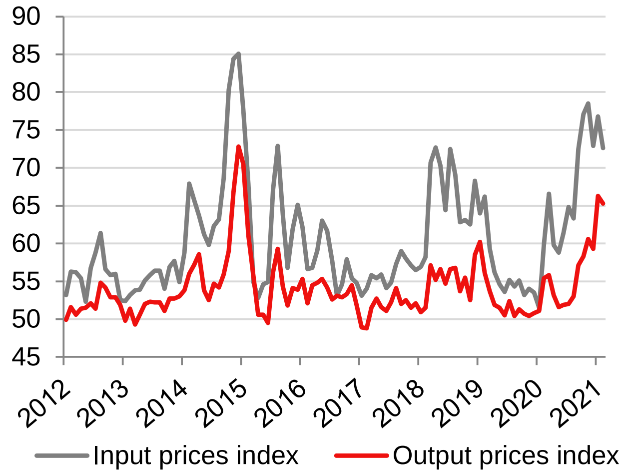
Source: Rosstat, R&F Department estimates.

[5] The calculation used an enlarged list of goods and services (excluding fruit and vegetables and regulated prices. Earlier, Rosstat registered 64 items of goods and services. As of April 2020, the list of monitored items was expanded to 100 categories, as of January 2021 – to 106 items.

1.2. PMI price indices: global rise in inflationary pressure

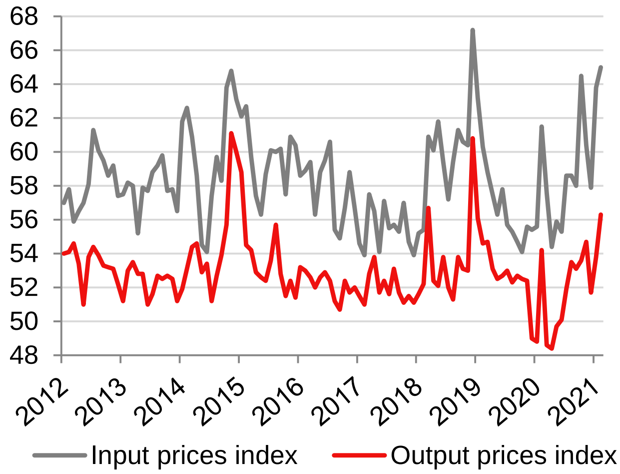
- Inflationary pressure remained elevated at the end of the first quarter as suggested by PMI price indexes. The continued gradual recovery of demand goes along with the aggravation of supply-side constraints due to, above all, the deterioration of global supply chains, thus stabilising price rises at elevated levels or accelerating them. The same is true for most countries, both advanced and emerging market economies.
- The output price index in the Russian manufacturing sector inched down but remained elevated in March (Figure 9) and rose to its highest level since the start of 2019 in services (Figure 10). This stems chiefly from a fast rise in costs (the relevant indexes of input prices), which companies try to pass through to output prices as demand for their products and services recovers.
- Price hikes by suppliers arise from problems with global supply chains: the subindex measuring supplier discipline[6] in manufacturing continues to decline (in Russia and other countries alike). Uncertainty over the duration of the pandemic remains high, therefore the impact of supply on price movements may eventually be protracted.

Figure 9. Change in PMI manufacturing indexes, pp



Source: IHS Markit.

Figure 10. Change in PMI services indexes, pp



Source: IHS Markit.

[6] Suppliers' Delivery Times Index.

2. Economic activity

The Russian economy stayed on a growth path in February. The year-on-year decline in a number of macroeconomic indicators is statistical in nature (a leap year in 2020) and does not accurately reflect the current trends.

In industries meeting final domestic demand (consumer and investment goods), growth has generally returned to its medium-term path after the completion of the recovery process accompanied by an elevated pace of growth. That said, some consumer industries see production restrained by disruptions in transborder deliveries (carmaking), the epizootic situation (chicken meat and pork production), and the shortage of migrant workers (construction).

At the same time, industries meeting intermediate demand and exporting industries enjoy extensive recovery-induced growth, helped by improving conditions in global commodity markets.

Credit activity remains strong in the corporate and retail segments thanks to loose monetary policy, regulatory easing and government support measures. This continues to support further domestic demand expansion.

2.1. Industrial production in February: recovery is still non-uniform

- Year-on-year industrial output contraction steepened in February on technical factors: an additional day in the leap year of 2020 and the high base owed to the closure of major contracts in a number of industries. Monthly change in seasonally adjusted output numbers supports this conclusion, indicating industrial production growth fuelled by mining and quarrying, with manufacturing output stabilising.
- The overall industrial output trend remains positive, while monthly numbers can be affected by verious transient/one-off factors. February saw output decline in the groups of investment and consumer goods industries as some industries' output came back to normal after substantial growth in previous months.
- Output contraction in some industries was in large degree prompted by supply-side shocks (both transient and more enduring): a shortage of components due to new regulatory requirements and the impact of the pandemic on supply chains, cold weather in a number of regions, the worsening of the epizootic situation, a rise in raw materials costs.

Industrial output contracted 3.7% YoY in February after a decline of 1.9% YoY in January. Contraction acceleration was prompted by a variety of factors, such as the leap year effect[7]

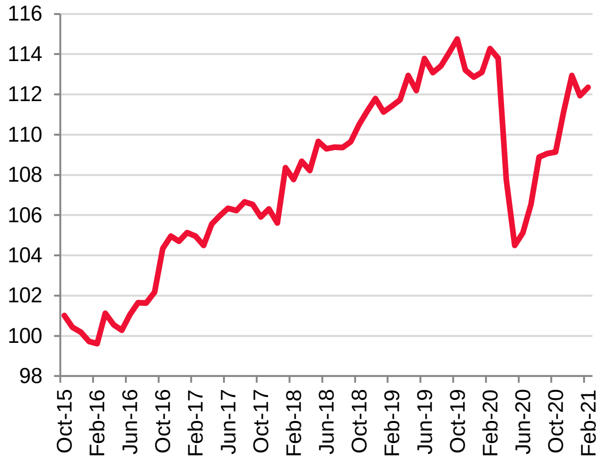
[7] February 2020 had 29 calendar days, while there were 28 days in February 2021. The number of business days was, however, the same in February 2020 and February 2021 – 19 days.

which had an impact on the performance of industries with a continuous production cycle, as well as the high base of February 2020.[8] Adjusted for the calendar effect, February's industrial output decline came out less significant at -1.3% YoY.

Our estimates suggest that industrial output expanded somewhat by 0.4% MoM SA[9] after dropping 0.9% MoM SA in January (Figure 11). The February numbers were affected by upward revisions to the January estimates of overall production, up 0.6 pp, and manufacturing output, an improvement of 0.8 pp, resulting in a higher base for comparison.

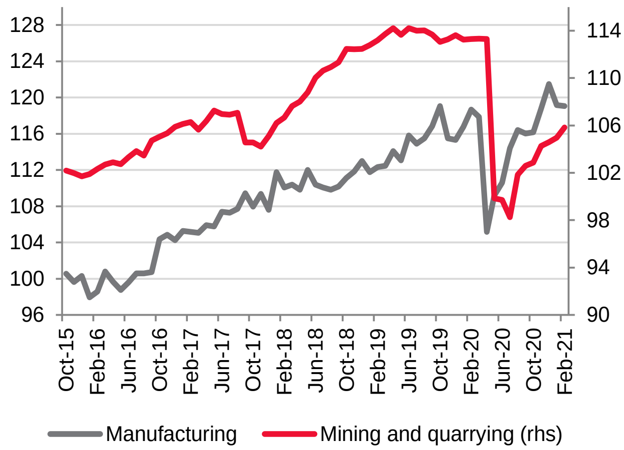
Mining and quarrying output growth accelerated to 0.8% MoM SA, up from 0.4% MoM SA in January (Figure 12). Crude oil and natural gas extraction inched up 0.2% MoM in February to comply with the OPEC+ agreement, but is still more than 10% below last year's. This industry was making the key contribution to a rise in financial flows[10] throughout February, reflecting both extraction growth and climbing world prices.

Figure 11. Change in industrial production index (2014 = 100)



Source: Rosstat, R&F Department estimates.

Figure 12. Change in mining and quarrying and manufacturing indexes (2014 = 100)



Source: Rosstat, R&F Department estimates.

An estimate based on real-time data indicates *manufacturing* output stabilisation at -0.1% MoM SA in February after 1.9% MoM SA contraction in January (Figure 12). Manufacturing output performance maintains an overall upward trend but individual months' output is affected by different transient/one-off factors heightening its volatility.

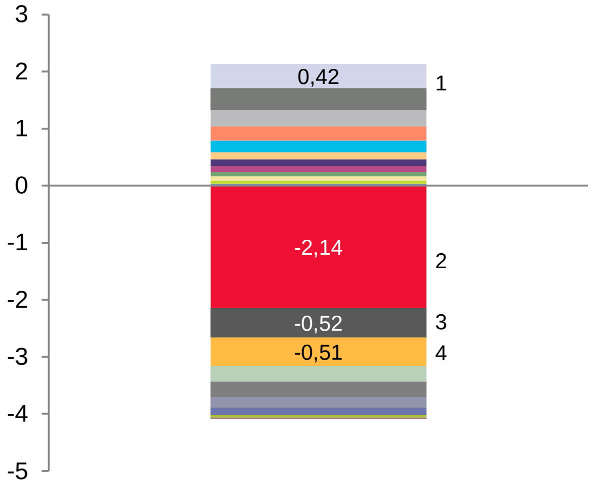
The group of *industries oriented to investment demand* posted output contraction for the second consecutive month, driven in large degree by a decline in the manufacture of computer, electronic and optical products, down 4.5% MoM SA (which steadily expanded at the end of last year) and the manufacture of other non-metallic mineral products, down 4.4% MoM SA, which, on the one hand, may have arisen from a temporary decline in demand from the construction industry on the back of a severe cold spell in February, but on the other hand,

[8] February 2020 saw a number of major contracts closed in high-tech industries, output grew extensively in the petroleum refining and pharmaceutical industries.
[9] Here and further on, SA means seasonally adjusted (including the calendar factor).
[10] Monitoring of industry-specific financial flows.

may be an indirect signal of a more persistent activity contraction in the construction industry, as suggested by a decline in financial flows to the construction industries in March.[10]

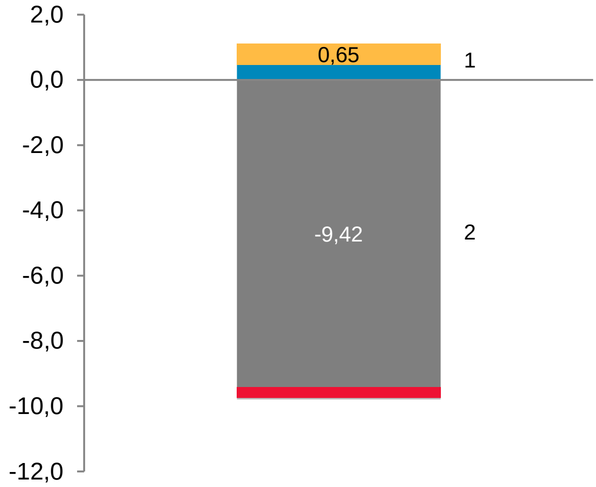
A reversal in the performance of the *consumer demand industries* group arises from February's output contraction of 14.5% MoM SA in the manufacture of pharmaceutical products, likely due to the completion of major orders, including those placed by the government. The manufacture of food products also showed a slight 0.5% MoM SA output decline in sub-industries which encountered cost increases and/or other supply-side shocks (for example, an outbreak of birds' flu). Another key driver of the output drop in consumer industries was a car production decline of 4.3% MoM SA in February after two months' growth. February's car output dip likely stemmed from the shortage of chips which may last as long as half a year, to say the least.

Figure 13. Individual industries' contribution to manufacturing growth in February, p.p. YoY



1 Manufacture of pharmaceutical products and preparations
2 Manufacture of coke and refined petroleum products
3 Manufacture of fabricated metal products, except for machinery and equipment
4 Manufacture of basic metals

Figure 14. Individual industries' contribution to mining and quarrying growth in February, p.p. YoY

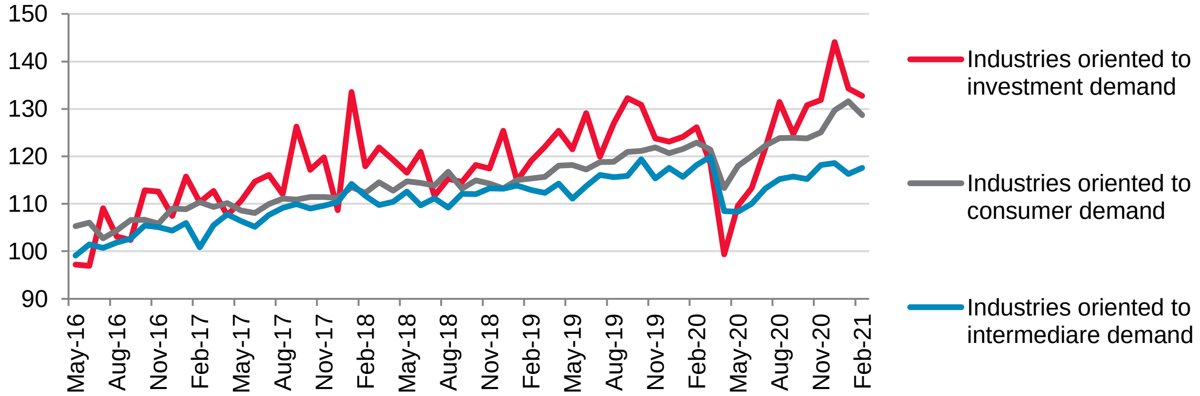


1 Mining of coal
2 Extraction of crude oil and natural gas

Source: Rosstat, R&F Department estimates.

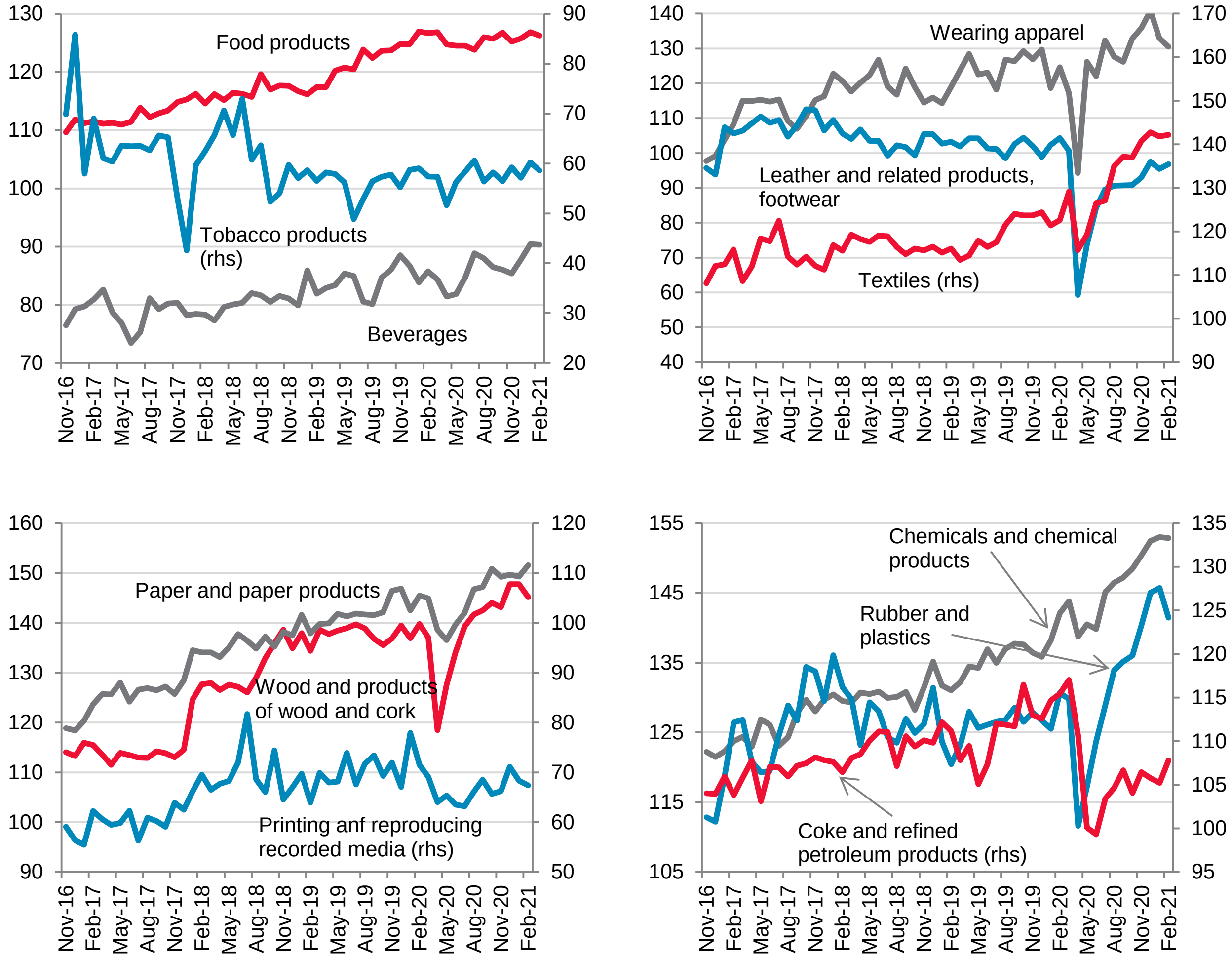
The key support to manufacturing output came from the group of *industries oriented to intermediate demand* in February. The strongest contribution to this group's output upturn came from the manufacture of coke and refined petroleum products (up 2.5% MoM SA in February) which expanded in the wake of crude oil production expansion. Manufacture of refined petroleum products led growth in incoming financial flows[10] at the end of February.

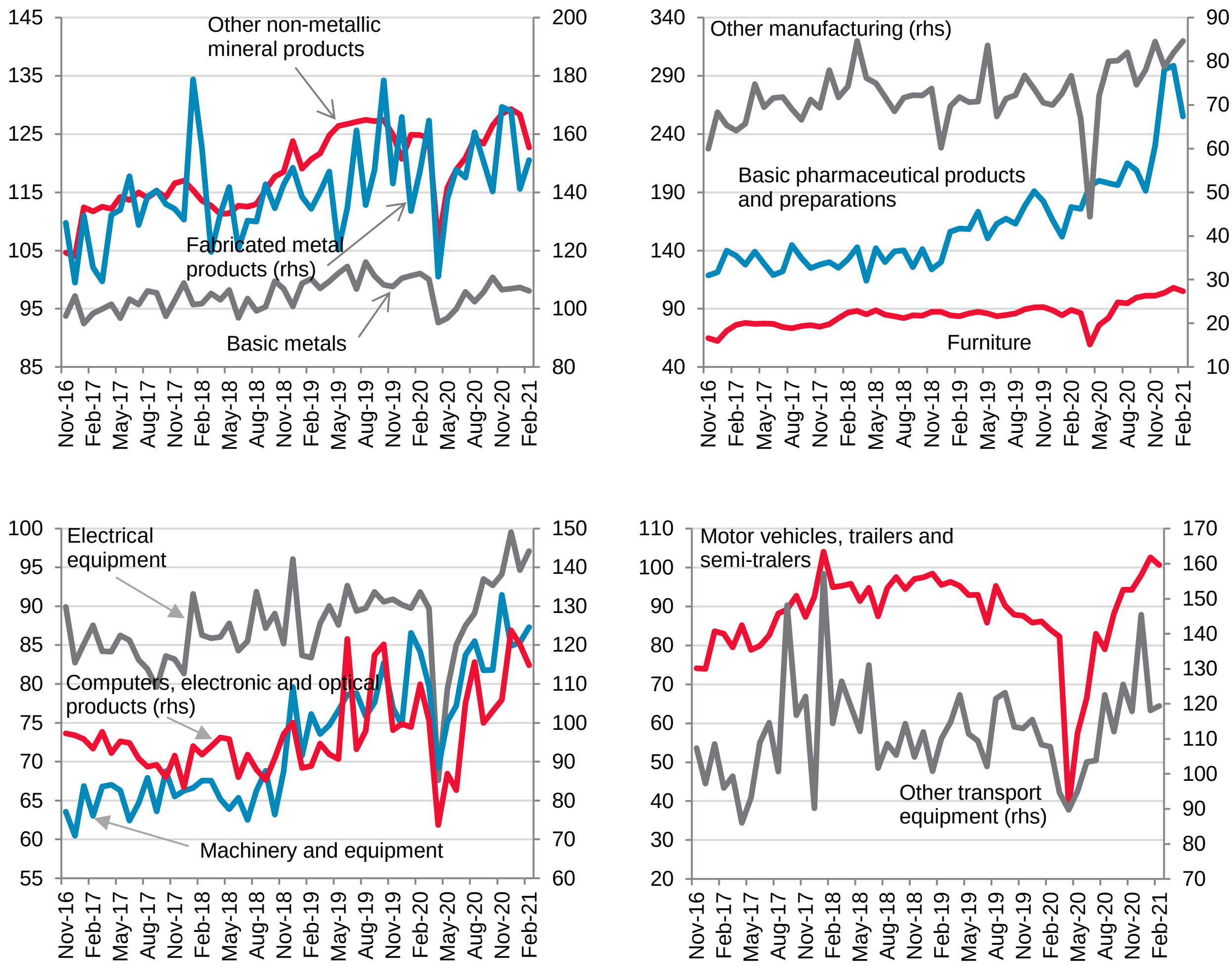
Figure 15. Manufacturing industries' output, Jan. 2016=100%, seasonally adjusted



Source: Rosstat, R&F Department estimates.

Figure 16. Manufacturing industries' output, December 2012 = 100%, seasonally adjusted





Source: Rosstat, R&F Department estimates.

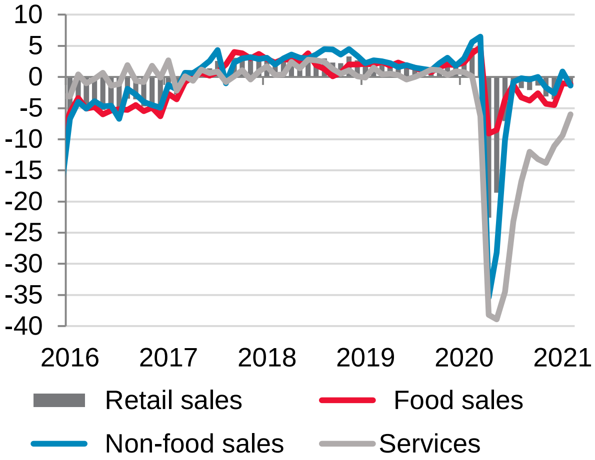
2.2. Further consumer demand growth in February

- The high base of the leap year of 2020 brought retail sales down 1.1% YoY in February. They, however, continue to recover, showing a month-on-month rise of 0.5% MoM SA. Consumption is supported by a continued decline in the rate of unemployment.
- Rising wealth and improving expectations helped households continue to expand food consumption. Consumption of non-food goods remained stable after its strong growth in January, possibly owed to a gradual shift of demand towards the services sector, which continues to recover.
- March's real-time indicators show an annual consumer expenditure rise against a background of the improving labour market situation and expectations of wage growth acceleration.

Consumer demand growth slowed in February. After retail sales had reached the pre-crisis level in January (down 0.1% YoY), February's indicator came in below last year's, down

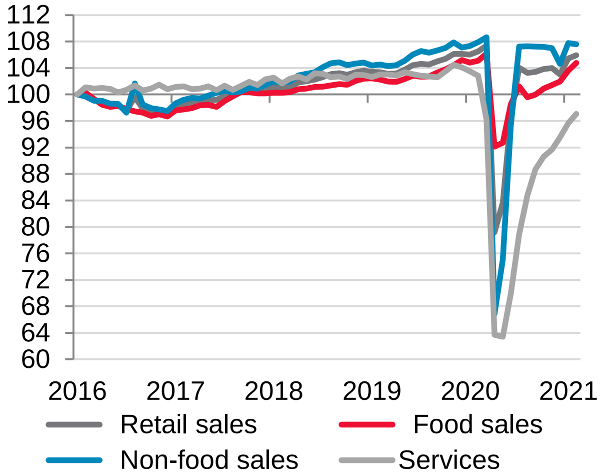
1.1% YoY. This is, however, totally attributable to the high base of the leap year of 2020 (Figure 17). Seasonal adjustment indicates continued consumption growth, up 0.5% MoM SA after a rise of 2.3% MoM SA in January (Figure 18).

Figure 17. Services sector's, retail, food and non-food sales, % YoY



Source: Rosstat.

Figure 18. Retail and services sector's sales (January 2016 = 100%, seasonally adjusted), %



Source: Rosstat, R&F Department estimates.

Growing wealth and improving expectations helped households continue to expand *food* consumption, up 1.1% MoM SA. The consumption of non-food goods stabilised at -0.2% MoM SA after a significant 3.0% MoM SA rise in January, likely driven by the services sector's stepped-up recovery. As the epidemic situation improves, restrictions are further eased and the household perceptions of coronavirus-related risk decline, a fall from last year's consumption narrowed to 6.0% YoY, with month-on-month growth at 1.5% SA.

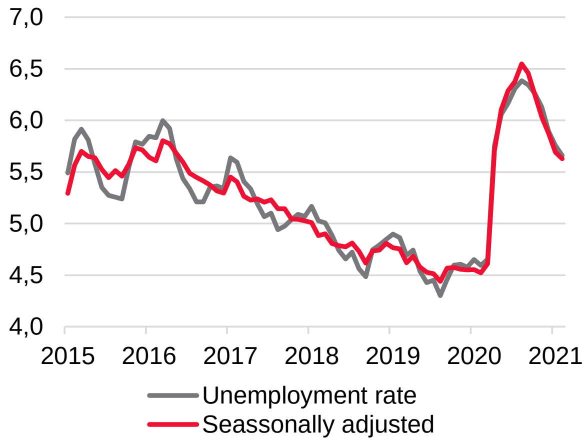
Consumption continues to be buoyed by an improvement in the labour market situation. According to Rosstat data, the employment headcount kept rebounding in February to reach 70.7 million people, down 0.37 million from February 2020. The unemployment rate declined another 0.1 pp, reaching 5.6% (Figure 19). The unemployment decline is helped by continued relatively strong labour demand. According to our estimates based on HeadHunter platform data, exclusive of the health care sector where the situation had come back to normal,[11] vacancies growth accelerated in February.

A substantial input to the employment rise comes from the recovery of the services sector's activity. Amid domestic tourism expansion in the face of closed borders, the number of vacancies in the sector increased 36% YoY. Strong growth in labour demand was also recorded in the sports and beauty sector, up 27% YoY. The extensive recovery in the services sector's industries indirectly suggests that the structural component of the rise in unemployment was small.

[11] The number of health care sector vacancies expanded six times year on year in December and January, likely owing to the deployment of mass vaccination against the coronavirus.

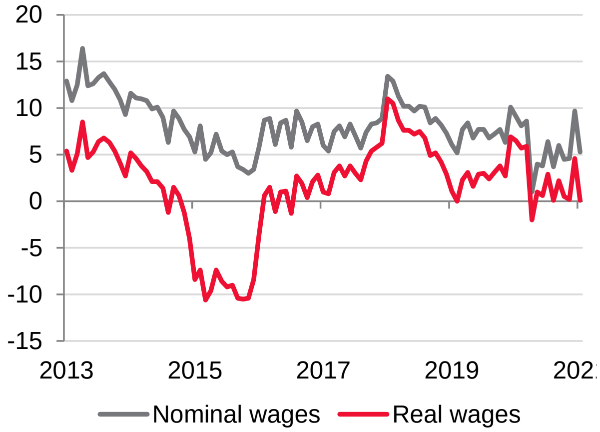
Wage growth slowed dramatically after its sharp rise in December 2020, supporting the hypothesis that the wage spike at the end of 2020 resulted from payments being partially moved from the start of 2021 ahead of a personal income tax hike to 15% for annual income in excess of 5 million rubles. Nominal wage growth came in slightly above inflation at 5.3% YoY, with real wage growth close to zero at 0.1% YoY (Figure 20).

Figure 19. Unemployment rate, %



Source: Rosstat, R&F Department estimates.

Figure 20. Wage growth rate, % YoY



Source: Rosstat.

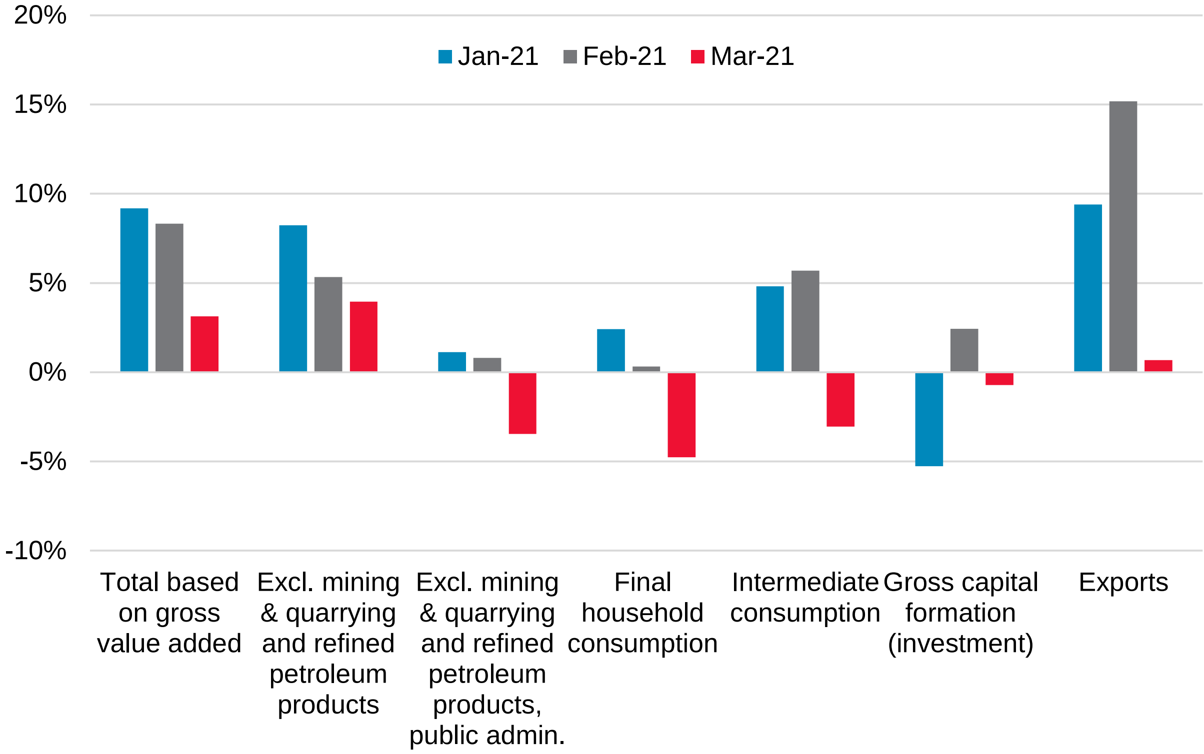
Against a backdrop of the labour market improvement and expectations of wage increase acceleration, March's real-time indicators record a rise in consumer expenditure. The nominal growth in food expenditure reflects an elevated pace of price rises in this category, with real consumption remaining stable. At the same time, March saw continued consumption growth in the services sector's categories which earlier stagnated (cafes, hotels, air fares)

2.3. Economic growth continues in March

- Real-time indicators suggest that economic growth continued in March. That said, the recovery phase accompanied by an elevated pace of growth seems to have been passed. We expect economic growth to slow in the coming quarters, remaining, however, above the potential level as negative output gap is bridged in some industries.
- An index-based estimate on a DFM model using short-term data and real-time indicators, suggests Q1 GDP growth at 0.8–0.9% QoQ SA. Still, given a non-uniform recovery of the economy amid long-term structural implications of the coronavirus crisis, this model-based estimate so far has a wider confidence interval compared with the pre-crisis period.
- One risk factor is still the global epidemic situation which has deteriorated in recent months. This heightens the risks of a slowdown in the recovery of the global economy and hence Russian exports. Output expansion in some industrial sub-sectors starts to be restrained by supply-side problems caused, above all, by the worsening operation of global supply chains.

- According to data on individual industries' payments in the Bank of Russia's payment system, incoming financial flows to all enlarged industries, except for government demand, failed to post a month-on-month rise in March. Overall incoming payments, however, kept close to the Q4 2020 level or somewhat above it (Figure 21).
- Electricity consumption continued to increase, reflecting confident recovery in power-intensive industries (Figure 22). The IPS Center,[12] where steady consumption growth largely stems from industrial output expansion,[13] stays far above the pre-coronavirus levels. Electricity consumption also shows notable growth in the IPS South amid domestic tourism expands in the face of closed borders. On the other hand, the need to comply with the OPEC+ deal contains electricity consumption in the IPS Ural.
- Survey data suggests some growth slowdown in manufacturing: the relevant PMI sub-indexes for output and new orders inched down in March but remained in positive territory. Manufacturing industries' financial flows show similar performance. The services sectors post a dramatic growth acceleration, reflecting gradual easing of restrictions.
- Real-time indicators of consumer activity suggest its continued rise. The consumer activity index stayed at the highest level for this year. Moreover, some categories of the services sector (entertainment, hotels, air fares) which stagnated earlier show a substantial consumption growth acceleration in both year-on-year and month-on-month terms (Figure 23, Figure 24).

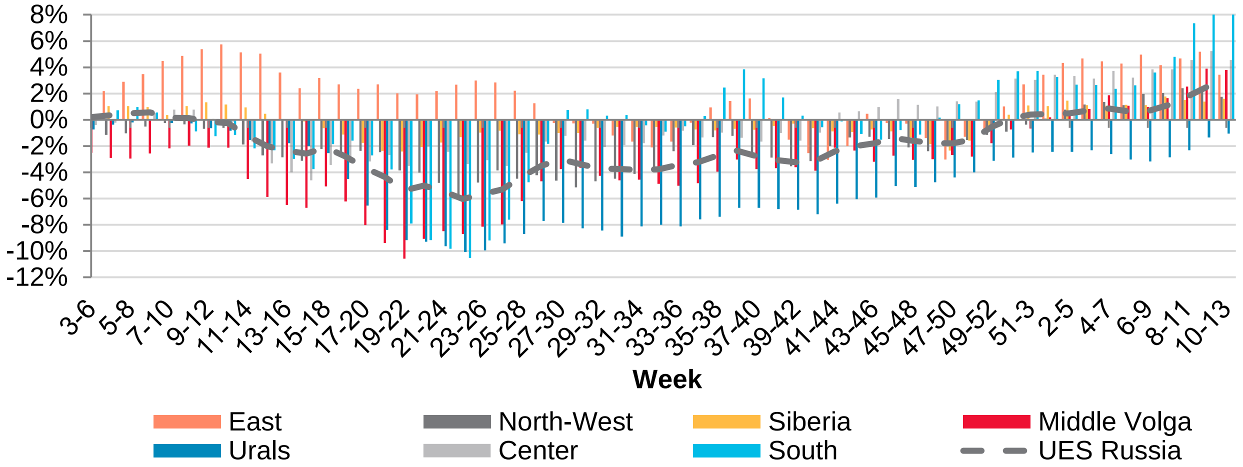
Figure 21. Seasonally adjusted incoming financial flows, % of the Q4 2020 level



Source: Bank of Russia, Monitoring of industry-specific financial flows.

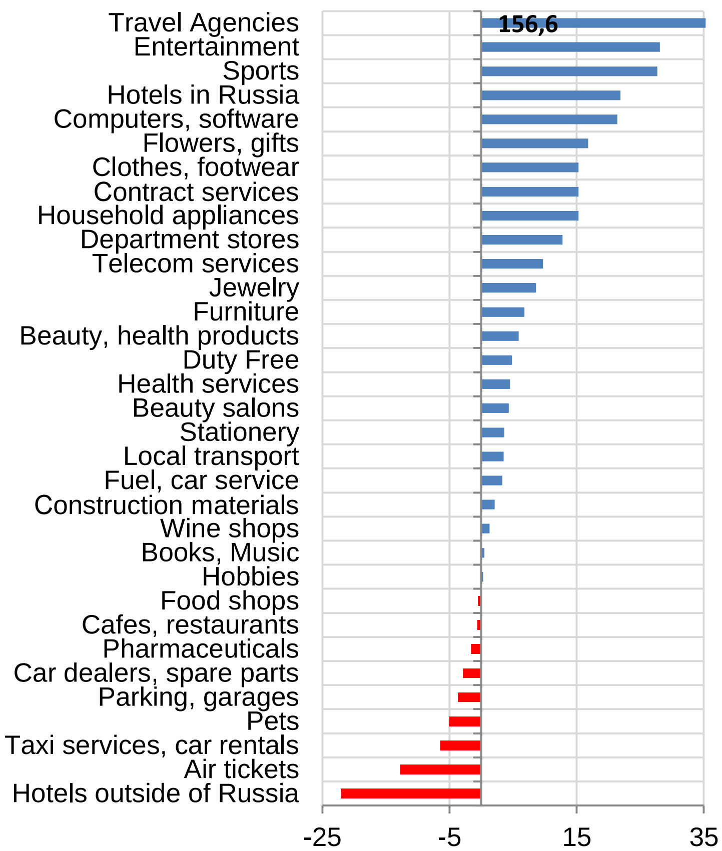
[12] Integrated Power System.

Figure 22. Electricity consumption growth rate, 4-weeks moving average adjusted for temperature and calendar factors, % YoY



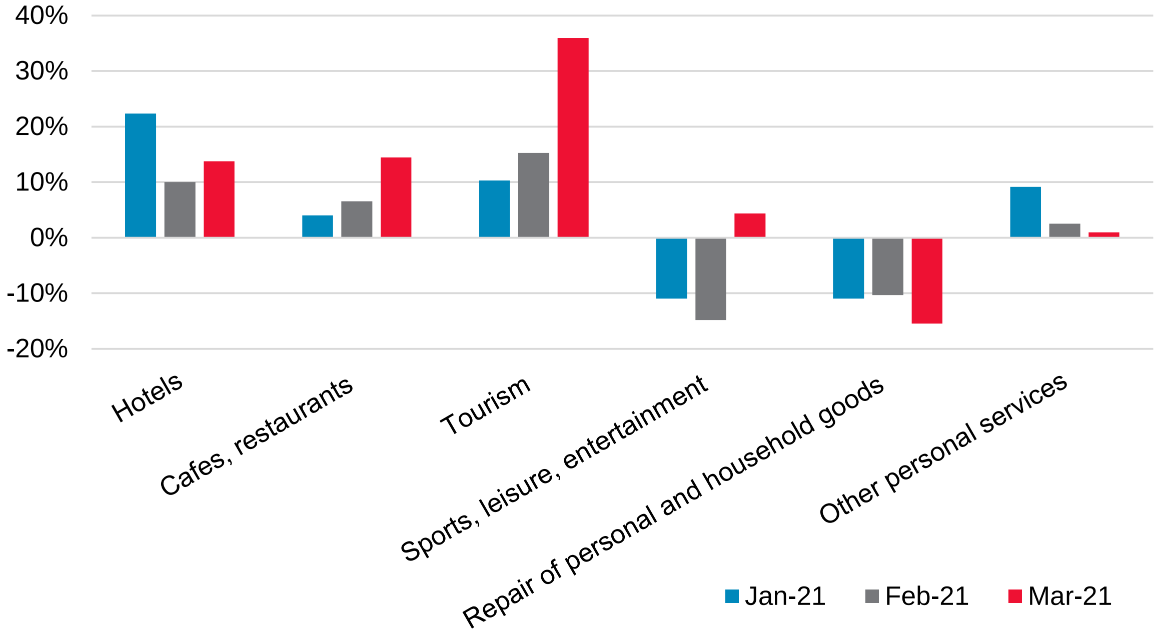
Source: System operator of United Energy System, R&F Department estimates.

Figure 23. Change in nominal spending on goods and services in March, % YoY



Source: SberData Laboratory.

Figure 24. Seasonally adjusted incoming financial flows, % of the Q4 2020 level



Source: Bank of Russia, Monitoring of industry-specific financial flows.

2.4. Confident lending growth

- Fast mortgage lending growth continued in February 2021, helped by loose monetary policy and the subsidised loan programmes But this year mortgage lending expansion will likely slow somewhat relative to the current levels, weighed down chiefly by rising housing prices and the Bank of Russia's gradual return to neutral monetary policy.
- Confident growth is continuing in the unsecured consumer lending and auto loan segments. A gradual return to neutral monetary policy will result in the stabilisation of consumer lending expansion. Despite this, consumer demand will remain the key driver of economic growth in the medium term.
- The quality of retail loans remains stable, helped by the maintenance of banks' conservative policies regarding new loan issuance, along with a steady recovery of economic activity and household income. We expect loan servicing quality to improve gradually going forward, with one exception of restructured loans.

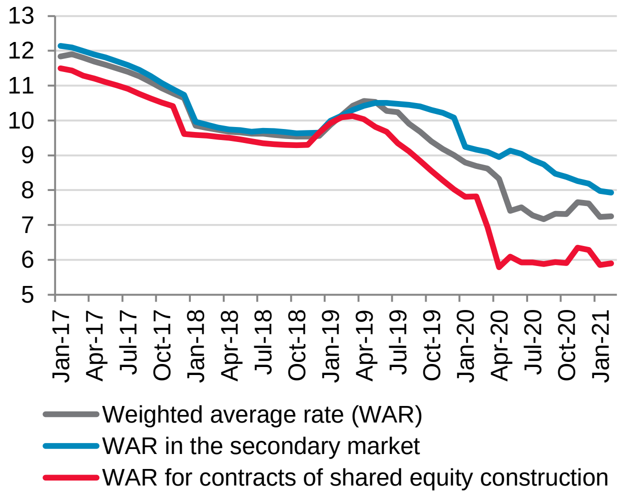
Low interest rates and subsidised loan programmes continued to buoy mortgage lending expansion in February: the issuance of new ruble loans totalled 1.5 times the February 2020 level. Year-on-year issuance growth came in 37% higher than in January but trailed the December 2020 number (62% YoY). Loan issuance expansion for shared-equity construction schemes stood at 50%, accompanied by a rise in apartment housing construction using the escrow account mechanism. Low interest rates also encourages loan refinancing: a total of loans taken to repay debt raised earlier doubled from last year.

The mortgage lending segment will likely remain the key retail lending growth driver in the months to come. That said, one should note a rising average mortgage loan check, due not only to low interest rates and subsidised loan programmes but also to concurrent housing price increases. We expect housing price hikes and a return to neutral monetary policy to slow lending growth somewhat in the mortgage loan segment relative to its current levels.

Unsecured consumer lending growth continued to accelerate to come to 1.6% MoM SA in February. Three-month annualised growth reached 16.27%, which will also boost growth in annual unsecured lending soon. That said, the number of consumer loans issued over that month did not change, according to National Bureau of Credit Histories data, while the average check increased. This stems from rising prices of goods and services as well as the policies of banks, which prefer to extend loans to the most creditworthy customers. Buoyancy in the unsecured consumer lending segment is also evidenced by substantial growth in the issuance of short-term retail ruble loans in February.

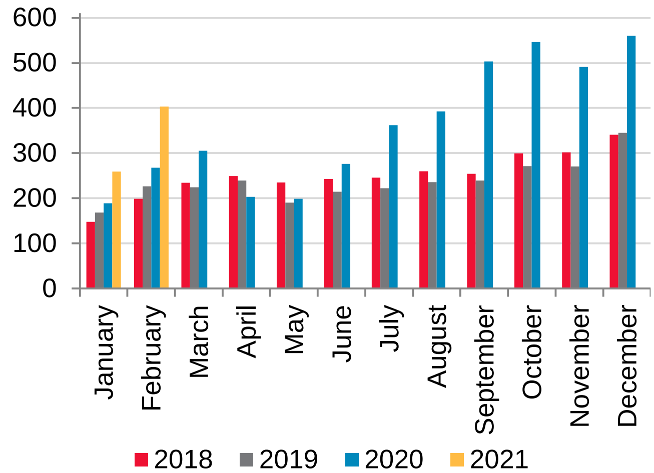
The recovery of unsecured consumer lending has come on the back of rebounding demand. According to SberIndex data, February saw a consumer spending increase, in particular, in segments such as entertainment and sports. On top of that, an improvement in the labour market situation helped household income stabilisation, improving households' chances of obtaining loans. Meanwhile, the recovery of consumer demand slowed somewhat in February compared with January, according to the Monitoring of Industry-Specific Financial Flows, consumer demand recovery slowed someawhat in February, with March maintaining this trend. Unsecured consumer lending also continues to be restrained by banks' conservative policies. All in all, evidence suggests that unsecured consumer lending will in general continue its confident growth in the coming months but its further significant acceleration is hardly to be expected.

Figure 25. Interest rates in the mortgage loan market, %



Source: Bank of Russia.

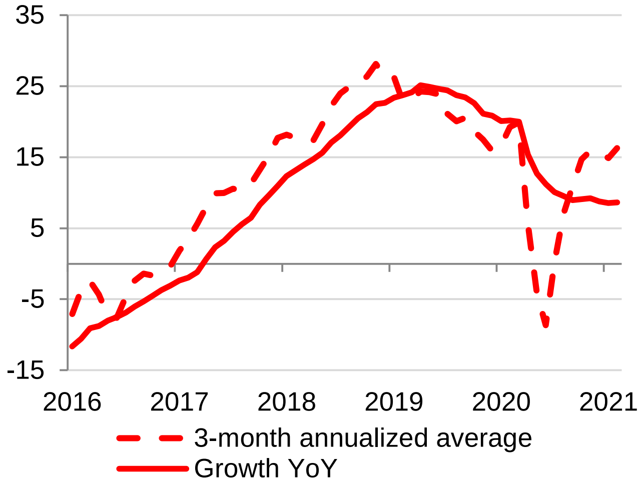
Figure 26. Total of new mortgage loans (billion rubles)



Source: Bank of Russia.

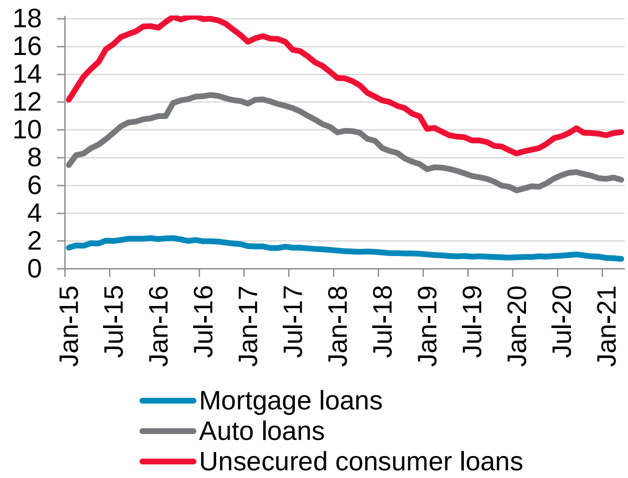
Auto lending expansion came in at 1.3% MoM SA, which is comparable with the July numbers. Total ruble auto loan issuance went up 22% month on month and 28% year on year in February. According to National Bureau of Credit Histories and Avtostat data, an increase in the number of cars bought on credit is driven by subsidised loan programmes14 and expectations of car prices hikes going forward. *On the one hand*, the retention of subsidised programmes will keep up auto lending growth, on the other hand, demand for cars and auto loans may decline somewhat in the event of substantial price rises.

Figure 27. Unsecured consumer loans dynamics, %



Source: Bank of Russia.

Figure 28. Share of loans overdue 90 days and longer in loan claims, %



Source: Bank of Russia.

The quality of retail loan claims remains stable: the share of non-performing and bad loans was almost unchanged at 7.4%[15] in February, the share of non-performing loans[16] is declining for unsecured consumer loans and auto loans, as well as mortgage loans. We expect loan servicing quality to improve (with one exception of restructured loans) as business activity recovers further.

[14] The First Car and Family Car programmes.
[15] Loans of the IV and V quality categories under banking accounting form 0409115.
[16] Loans overdue 90 days and longer under banking accounting form 0409115.

IN FOCUS. Fixed investment – extensive recovery phase

- Fixed investment declined less in 2020 than overall economic activity. The year 2020 saw investment plunge in capital-intensive industrial and services sectors.
- From the perspective of companies' size, investment fall was the steepest in small businesses, which have the lowest safety margin and are widely represented in the services sector, hit the hardest by the implications of the pandemic.
- The fixed investment structure in 2020 maintain a positive long-term trend towards expanding the share of the most productive components – investment in machinery and equipment as well as intellectual property.
- Investment bottomed out in the second quarter, starting to recover somewhat later than consumption did. But investment activity has been rapidly expanding since the end of last year, rising above the coronavirus level. This is evidenced by, among other things, consistent growth in investment imports, an acceleration of rises in producer prices of investment goods and real-time indicators at the start of 2021.
- Sustainable growth in medium- and long-term corporate lending will provide support to companies' investment demand going forward. Still, the continuing high uncertainty, the precedents of administrative regulation in some sectors, declining fiscal support, and still depressed investment in mining and quarrying (on the bacck of the OPEC+ deal) will contain further rapid investment growth after the completion of the extensive recovery-induced growth phase.

Sustainable expansion in medium- and long-term corporate lending, due to, among other things, loose monetary policy, will buoy companies' investment demand going forward. Meanwhile, the continuing high uncertainty, rising risks of regulation in some industries, declining fiscal support, as well as still depressed investment in mining and quarrying industries (in the face of the OPEC+ deal) will restrain further rapid investment growth after the completion of the extensive recovery-induced growth phase.

Fixed capital investment declined just 1.4% in 2020, less than GDP did (-3.0%). Quarterly investment activity variation generally reproduced overall economic performance. Investment bottomed out in the second quarter amid the tightest restrictions across the globe, and was followed by a start of economic recovery. An extensive recovery of consumer demand began as early as the third quarter, with investment demand starting to recover later but at a much higher pace. As a result, fixed investment expanded 1.2% YoY in the fourth quarter of 2020, thus rising above the pre-coronavirus level (Figure 29).

At the same time, the fixed capital investment growth rate was much different from that of gross capital formation[17] in 2020. Gross capital formation contracted 4.3%[18], dragged down

[17] The System of National Accounts.

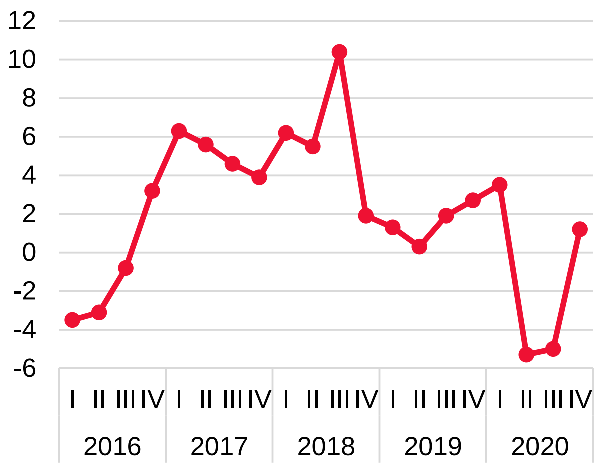
[18] Quarterly numbers also show a significant investment rebound at the end of the year to -2.1% YoY in the fourth quarter from -7.9% YoY in the third quarter.

by a steep fall in net acquisition of valuables, which directly resulted from the Bank of Russia stopping to purchase gold as of the second quarter of 2020. Adjusted for this factor, the figures of fixed investment and gross capital formation came out similar.

Despite the pandemic, investment continued its change towards a more productive structure in 2020. The share of investment in non-residential buildings dropped to 43.4% with the share of investment in machinery and equipment rising to 38.6% and objects of intellectual property rising to 5.3% (Figure 30). The ongoing change in the structure of investment is bringing it closer to that of advanced countries, where capital investment in machinery and equipment exceeds investment in real property, while investment in the objects of intellectual property accounts for over 10% of the total.

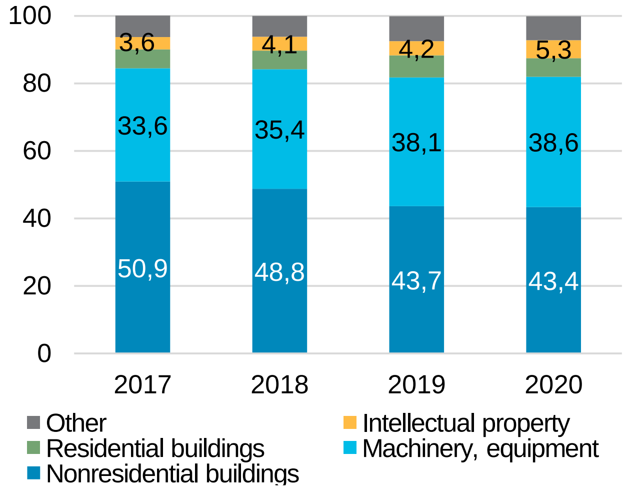
A considerable proportion of investment in machinery and equipment is covered by imports, which in many cases have competitive, including technology-related, advantages. Therefore, the maintenance of an upward trend in this investment component can heighten the structural share of imports in GDP, changing trade balance and balance of payments structure.

Figure 29. Fixed investment, % YoY



Source: Rosstat.

Figure 30. Fixed investment by type, %

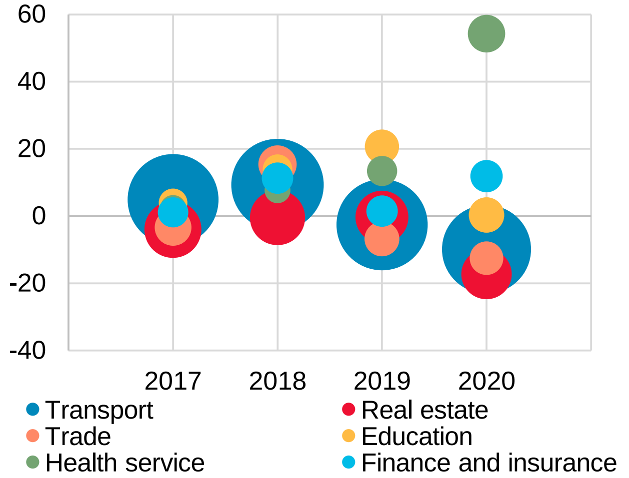


Source: Rosstat.

The pace of fixed capital investment decline varied across industries in 2020: its performance is generally in line with changes in economic activity. Investment was dragged down by capital-intensive subsectors of industry and services hit the hardest by the corona crisis. Capital expenditure plunged in the trade and transport industries amid border closures, the imposition of restrictions and implementation of the OPEC+ deal (affecting the pipeline transport). At the same time, investment dropped in sectors which enjoyed a rise in demand during the pandemic: health service, finance, information technologies, and delivery services (Figure 31). Manufacturing also posted investment growth, helped by industries, such as the manufacture of pharmaceutical products and that of food products (Figure 32) which expanded output in 2020.

Investment also varied across company sizes. Small businesses, which have the lowest safety margin and are the most widely represented in the hardest hit services sector, suffered the steepest investment decline. According to a Higher School of Economics estimate, small businesses' investment dropped 2.3% YoY,[19] whereas large and medium-sized businesses saw just a 1.1% YoY investment decline. This compares with Russian Union of Industrialis and Entrepreneurs data[20] which suggests that serious consequences of the corona virus have hurt 60% of small businesses and only 35% of big companies.

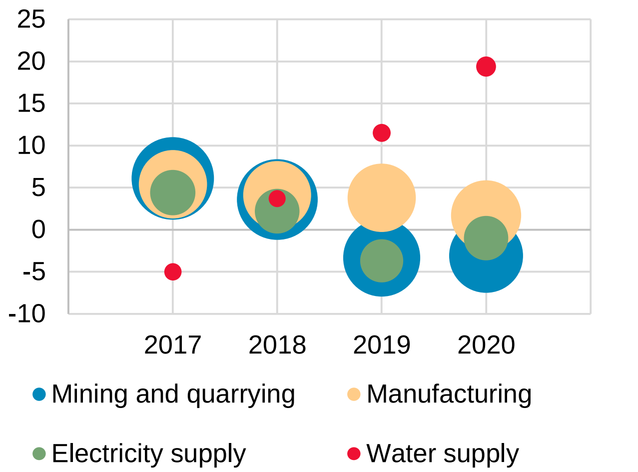
Figure 31. Services sector's investment, % YoY



Note: the size of the circle represents the industry's share in the investment structure.

Sources: Rosstat, R&F Department estimates.

Figure 32. Industrial sector's investment, %YoY



Note: the size of the circle represents the industry's share in the investment structure.

Sources: Rosstat, R&F Department estimates.

For most of the sectors, investment cuts were a logical response to a revenue fall amid the squeeze of demand both directly resulting from restrictions and arising from structural changes in demand caused by the pandemic (Figure 33). In some of the sectors, this relationship was, however, not as straightforward. For example, agricultural and real estate companies cut investmment despite a sizable rise in profits. This may be due to an investment pause which the agricultural sector has experienced in recent years. Agricultural producers may have exhausted their potential to expand supply in limited markets, making them cut investment programmes, planned or being implemented. Therefore, new long-term investment will likely be postponed until after the economic sutuation has stabilised.

Profit growth in the real estate sector was concentrated in non-capital-intensive sub-industries of realtor services. An improvement in this sector's financial result reflects a rebound of the secondary housing market following a rise in demand in the new housing market, supported by monetary easing and subsidised lending programmes. Companies engaged in manufacturing, professional and scientific activities, by contrast, expanded investment as their profits fell. This investment growth may be attributed to government support, while the manufacturing sector's companies may also invest in equipment required to make new pharmaceutiical products, upgrade petroleum refining plants and expand food product manufacturing capacities to meet rising domestic demand.

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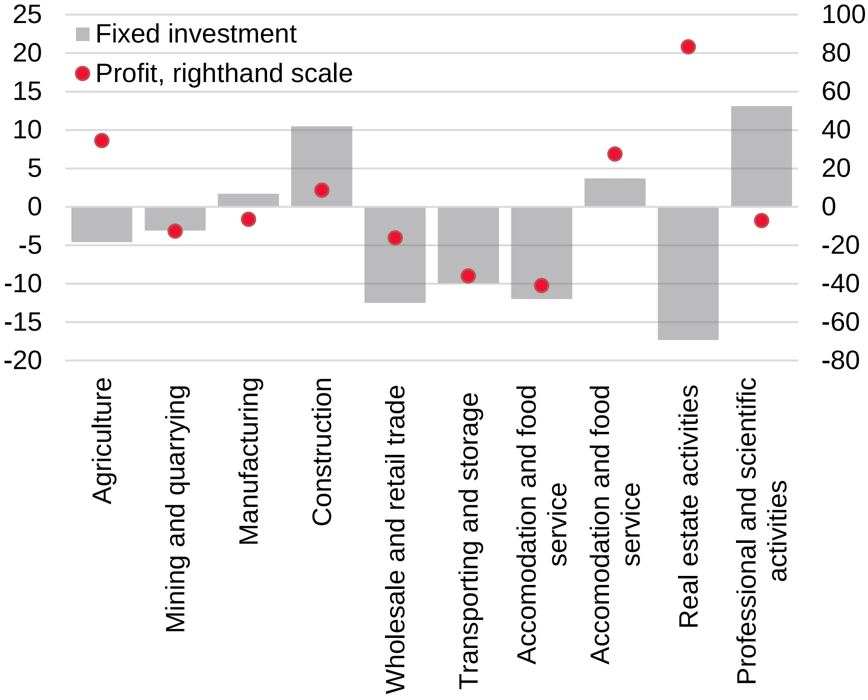
[19] https://dcenter.hse.ru/mirror/pubs/share/direct/451772827.pdf

[20] https://www.rspp.ru/events/pov/u-rossiyskoy-ekonomiki-est-povody-dlya-optimizma-v-2021-godu/

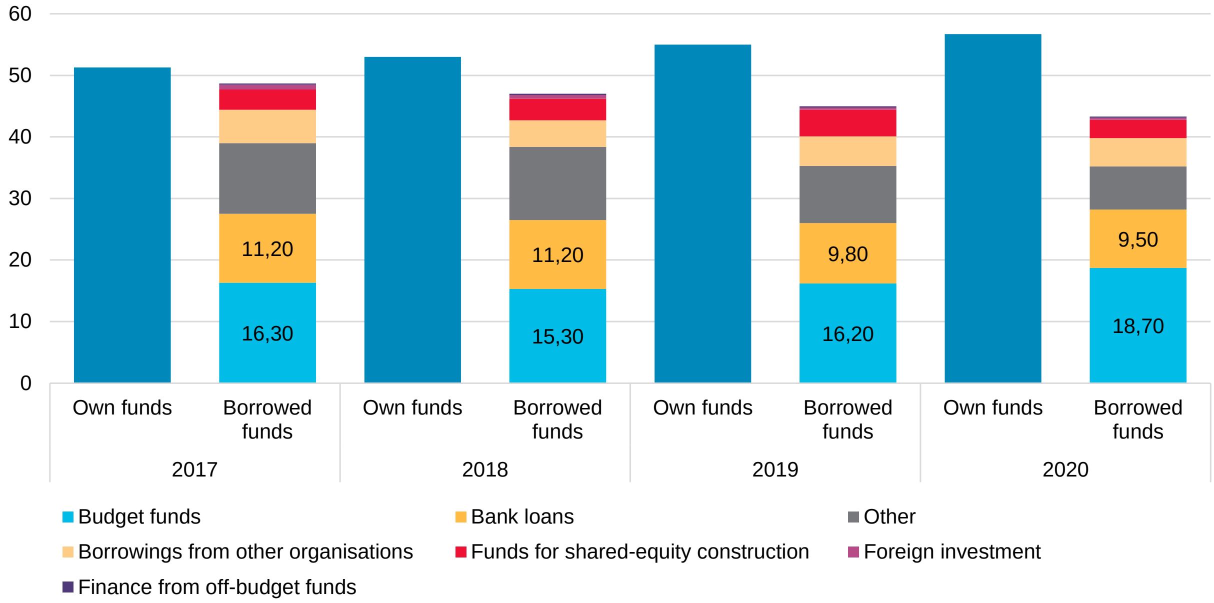
Figure 33. Profits and fixed investment in 2020, % YoY



Source: Rosstat.

The government sector has certainly provided an important support to investment activity. The share of budget funds in the structure of capital expenditure financing rose 2.5 pp to 18.7% in 2020. The share of bank loans, meanwhile, contracted only marginally: lending expansion was supported by monetary easing and Bank of Russia support measures (Figure 34). Companies' internal funds continue to be the key finance source for investment, similarly to other countries across the globe.

Figure 34. Fixed investment by finance source, %



Source: Rosstat.

The recovery of investment activity recorded at the end of 2020 will likely continue into 2021, driven by the recovery of business activity and company earnings. A variety of survey data[21] and real-time economic indicators[22] suggest the continuation of extensive investment growth at the start of the year.

Following the period of fast investment recovery, one can expect its growth to slow to previous years' levels. Uncertainty regarding medium- and long-term consequences of the pandemic remains high, with investment risks increasing in some industries because of unexpected major regulatory changes (for example, in agriculture and the manufacture of food products). Still depressed is investment in capital-intensive mining and quarrying, above all in oil extraction. Under the OPEC+ deal, the full recovery of crude petroleum production to the level of potential is expected as late as the middle of 2022. That said, structural changes triggered by the corona crisis open new opportunities for activities which have proved to be in demand during the pandemic (the manufacture of pharmaceutical products, health service, and delivery services), as well as sectors which will enjoy demand in a new, post-coronavirus economy (online services, information and communications).

[21] The investment component of the RSBI index stays record-high in February, while business activity in the SME segment started to expand for the first time since January last year.

[22] Investment import performance continued to gain momentum at the start of the year.