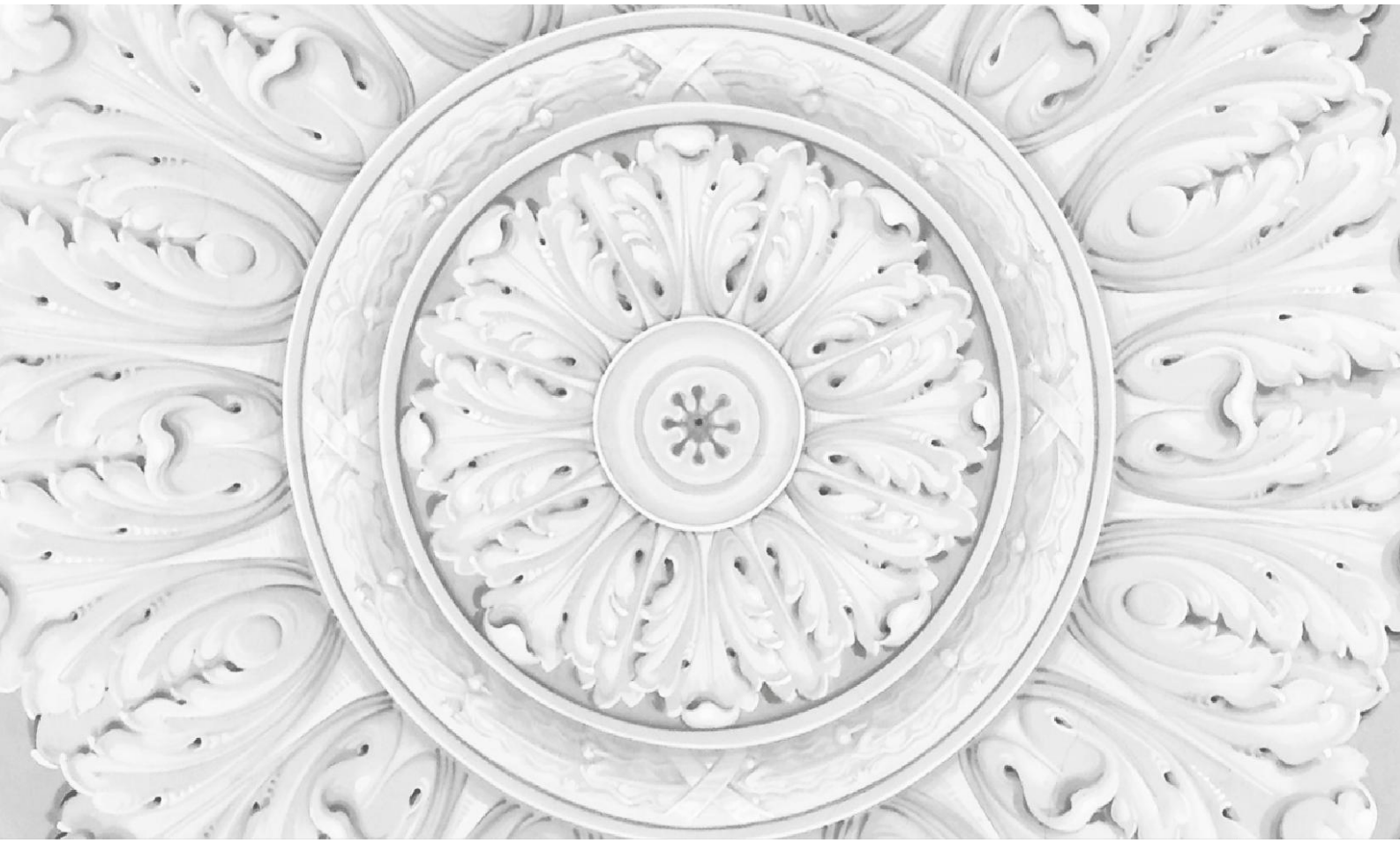
Bank of Russia

The Central Bank of the Russian Federation



Talking Trends

Macroeconomics and markets

April 2017

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The views expressed in the Bulletin are solely those of the authors and do not necessarily reflect the official position of the Bank of Russia.

Please send your comments and suggestions to dip_bulletin@mail.cbr.ru

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1. Monthly summary

1.1. Inflation

In March, consumer price growth was unchanged and low, while annualised inflation slowed down faster than assumed in the Bank of Russia's forecasts. This trend may well continue into the whole first half of 2017. Household inflation expectations reached a local minimum; however, moving forward, their volatility and sensitivity to exchange rate fluctuations can combine to push price growth higher. The potential realisation of inflation risks stemming from a rebound in consumer demand alongside the expiring impact, in the second half of 2017, from temporary tailwinds are unlikely to prevent inflation target from being delivered before the year-end. However, the potential growth in inflationary pressure around the second half of the year could pose higher risks in terms of the need to sustain inflation close to the target over a medium-term horizon. While the present balance of risks does not rule out a gradual reduction of the Bank of Russia key rate, these risks invariably make the case for a continued moderately tight monetary policy stance.

1.1.1. Consumer prices grew low in March

- Consumer prices in March and in the first quarter of 2017 turned in rates substantially lower than their annualised target readings.
- This is explained by, among other things, the effect from temporary factors that may well continue into the second quarter and thereby push annual inflation down to a point below 4% as early as April or May.
- These temporary tailwinds are poised to run their course in the second half, which would create additional inflationary pressure and risks that inflation targets may fail to be delivered in 2018.

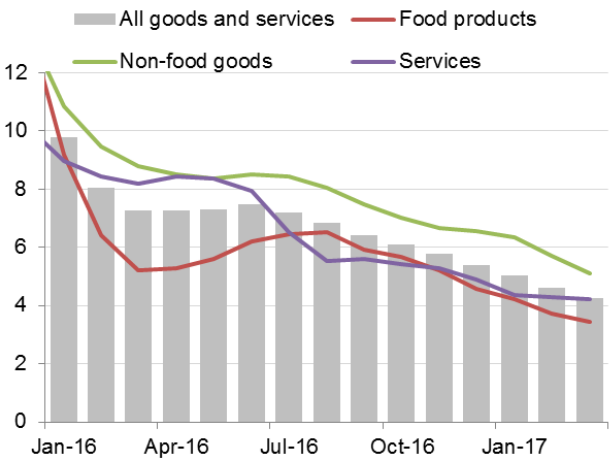
According to Rosstat data, March saw a continued downward movement in consumer price growth: prices posted 0.1% MoM growth vers. 0.2% in February, triggering a decline in annual inflation to 4.3% YoY (Figure 1). Food prices posted a MoM growth of 0.1%, with the cost of services unchanged and an increasingly strong uptick in nonfood prices of 0.2% MoM.

Seasonally adjusted price growth in March decelerated slightly to 0.12% on 0.14% seen in February (Figure 2). Food products made a weaker impact on price downturn in comparison to the previous month as the downward movement of prices[1] in this product category was almost zero. The data on food prices were unchanged: as before, the downward trend is finding its way across prices for fruit and vegetables, pasta, cereals, eggs and sugar. Services turned out the core contributor to seasonally adjusted inflation

[1] Seasonally adjusted.

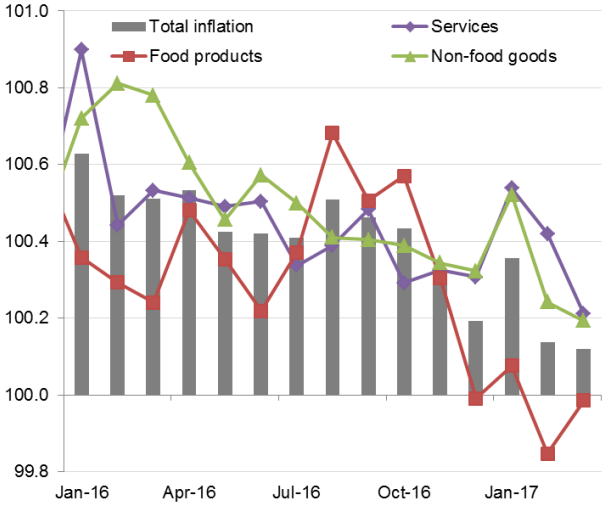
slowdown as their growth showed a twofold reduction from 0.42 to 0.21%. Non-food prices posted a slower reduction in growth as it totalled 0.19% MoM against 0.24% MoM seen in February.

Figure 1. Inflation, % YoY



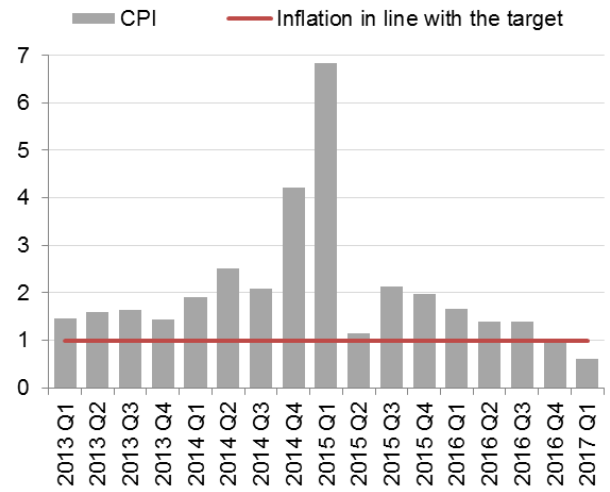
Sources: Rosstat, R&F Department calculations.

Figure 2. Seasonally adjusted consumer price growth, % MoM



Sources: Rosstat, R&F Department calculations.

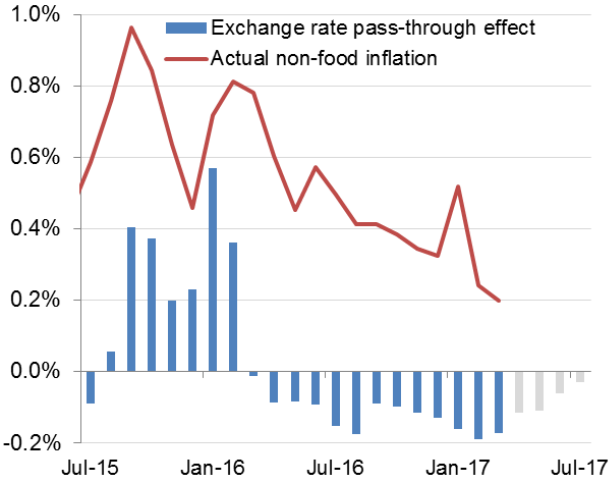
Figure 3. Seasonally adjusted consumer price growth, % QoQ



** Q1 estimate is tentative.*

Sources: Rosstat, R&F Department calculations.

Figure 4. Seasonally adjusted nonfood inflation, % MoM



** Grey-highlighted are estimates for the strengthening ruble pass-through effect observed through March.*

Sources: Rosstat, R&F Department calculations.

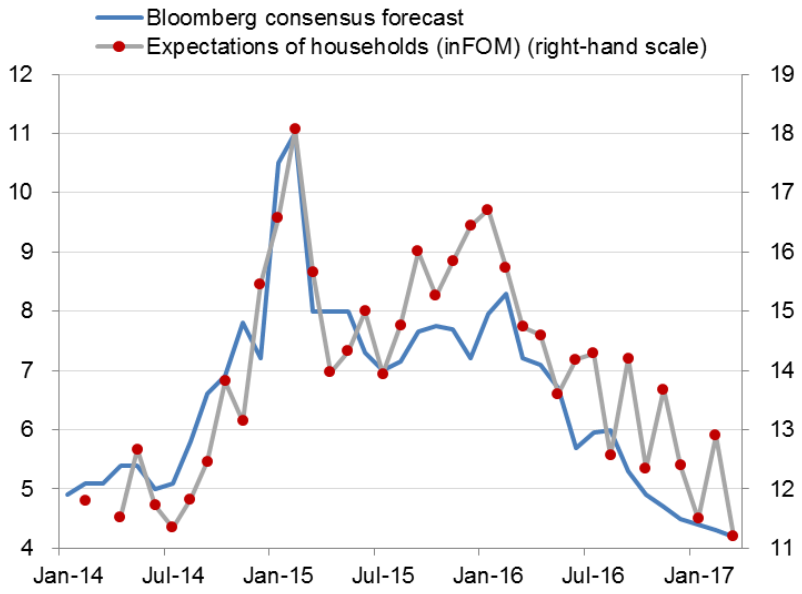
Preliminary estimates suggest that seasonally adjusted price growth in the first quarter was slightly above 0.6% MoM (Figure 3). The impact from a stronger ruble is still a considerable contributor to inflation slowdown. As our estimates based on non-food prices suggest, the accrued effect from the already realised exchange rate fluctuations peaked in February-March and is expected to wane gradually, absent strong shift in the

exchange rate (Figure 4)[2]. That said, this effect is set to extend into the second quarter. This is why the chances are strong that seasonally adjusted price growth will be under 1.0% for a second quarter in a row, which is a reading consistent with 4% of annual inflation.

This kind of 'margin' suggests that the chances are strong that the target inflation will be delivered by the end of 2017 even if inflationary pressure should rise in the second half of the year. Having said that, there are still risks posed to the target of inflation sustained at around 4% in 2018-19, which spells the need for a moderately tight monetary policy stance and the Bank of Russia's cautious approach towards a further downgrade of its key rate.

Data by inFOM found that the median of household inflation expectations for the next 12 months was down to 11.2% from 12.9% in February. Inflation expectations of households for the period since early 2014 were overall aligned to those of financial analysts (Figure 3). Households' inflation expectations are still heightened at a point which is almost twice the reading of actual inflation; they are also highly sensitive to change. Also, as the ruble passed through its second weakening phase in the second half of 2015, household inflation expectations grew faster than analysts', in a sign that they can increase substantially should the ruble become considerably weaker. Accelerated growth rates of actual prices would follow.

Figure 5. Inflation expectations for 12 months ahead, %



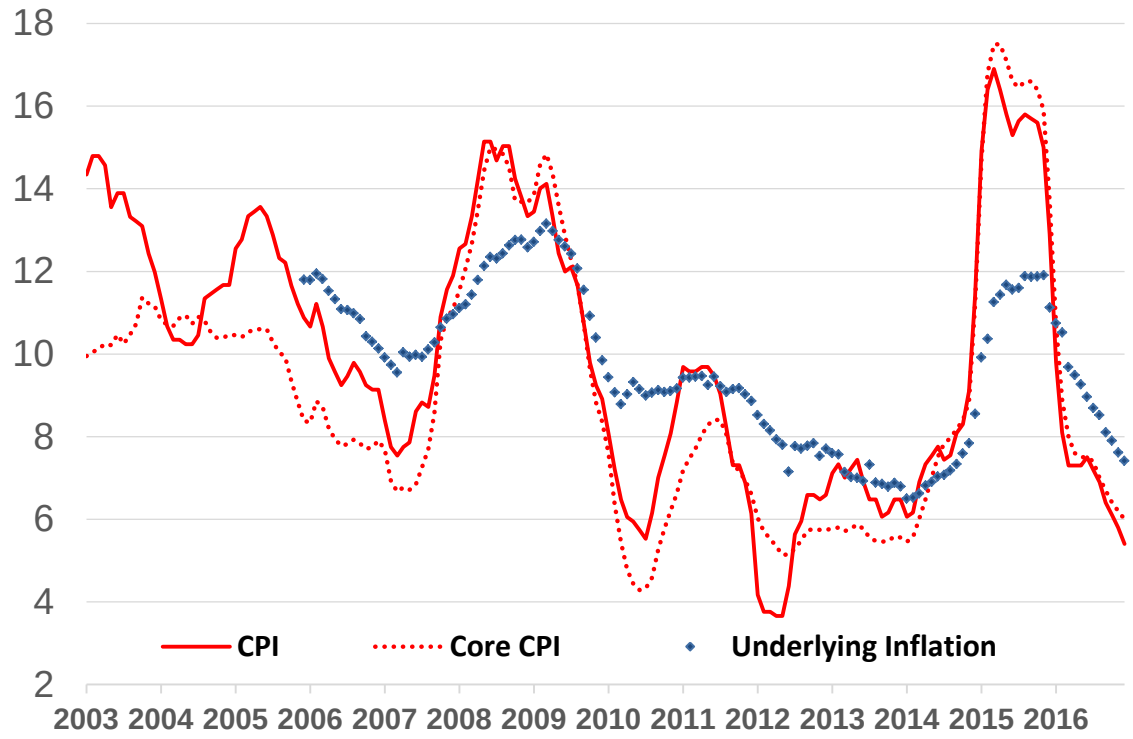
Sources: Rosstat, R&F Department calculations.

[2] However, the econometric study may fail to capture precisely the asymmetrical nature of the pass-through effect of the exchange rate changing in either direction.The influence from a stronger ruble can therefore be more stretched out than that from a weaker ruble, with the highest effect falling on the second quarter.

1.1.2. Underlying inflation continues its slow decline

- Estimated annual rates of underlying inflation in March 2017 were revised downwards to 6.7% from 7.0% in February, reflecting a further easing in inflationary pressure (Figure 6).
- Underlying inflation declines at a moderate pace and its slowing is deterred by the heterogeneous disinflationary contributions of various components.
- Although the disinflationary effect of temporary tailwinds is likely to subside before long, we expect underlying inflation estimates to become progressively downgraded in the course of 2017.
- Although the risks that inflation may deviate from target in late 2017 have become lower in recent months, risks remain that inflation may fail to be sustained at around the target level over a medium-term horizon.

Figure 6. CPI, core CPI and historical estimates for underlying inflation, % YoY



Sources: Rosstat, R&F Department calculations.

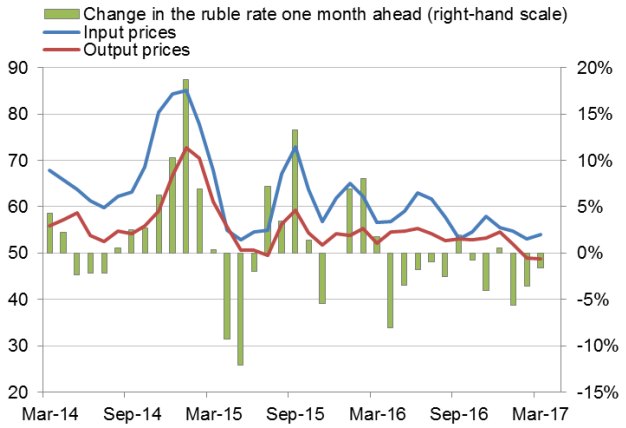
1.3.1. March PMI indexes: output prices in manufacturing are down again

- Output prices in the manufacturing sector have dropped for a second consecutive month, in a sign that the impact of temporary favourable factors, linked to a strengthening in the ruble, is ongoing.

- The sustainable downturn in price indexes in the service sector, which is more resistant to exchange rate fluctuations, is a reflection of a general downward trend in inflationary pressure across the whole economy.

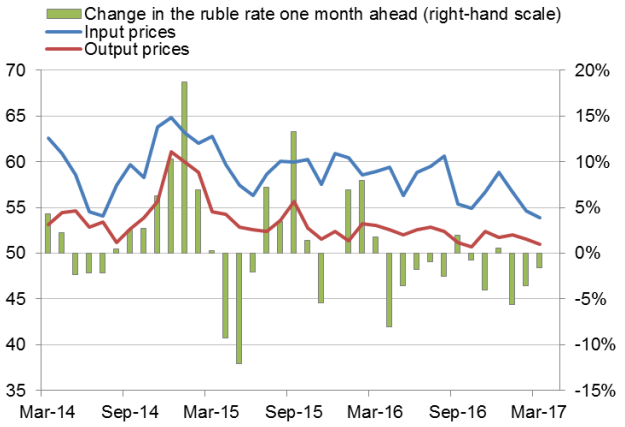
March saw almost all PMI price indexes either continually declining or stabilising, save for the purchase price index in manufacturing, which edged up (Figure 7, Figure 8).

Figure 7. Manufacturing PMI price indexes, points



Sources: Bloomberg Finance L.P.

Figure 8. Services price PMI indexes, points



Sources: Bloomberg Finance L.P.

The manufacturing sector's output price index has been below 50 points for a second month in a row, which means a price drop is occurring in the sector. This appears to be a result of the strong impact from a temporary tailwind - a stronger ruble: the last time input prices showed a two-month consecutive decline, was 2009 Q2, when the ruble was paring its shock weakening seen between late 2008 and early 2009. Importantly, respondents considered the rise in the input price index to be a result of global growth in prices for raw material including steel, chemical supplies and plastics.

Similarly to the consumer market, prices for services were invariably growing stronger than those for products. The former group' sensitivity to exchange rate fluctuations is far lower, in a further sign that product price movements are strongly affected by temporary favourable factors.

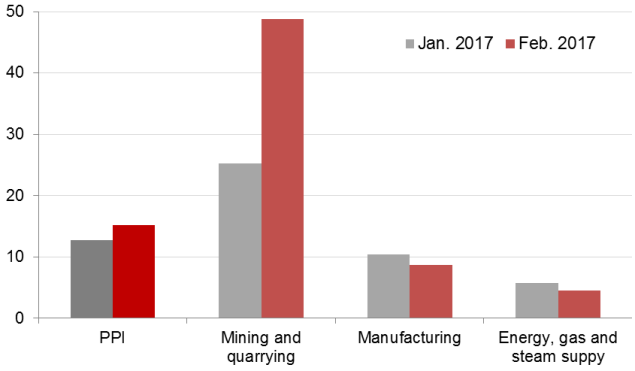
At the same time, the overall price downturn in the service sector points to inflationary pressure receding on the back of factors beyond the above-mentioned temporary tailwinds.

1.1.4. Accelerated growth rates of producer prices are explained by energy price changes

- February's acceleration in the growth of producer prices occurred mainly on the back of the global rise in energy prices.
- Across many consumer product categories, producer prices grew slower than consumer prices.
- PMI price indexes suggest that a further slowdown in producer price inflation is possible in manufacturing.

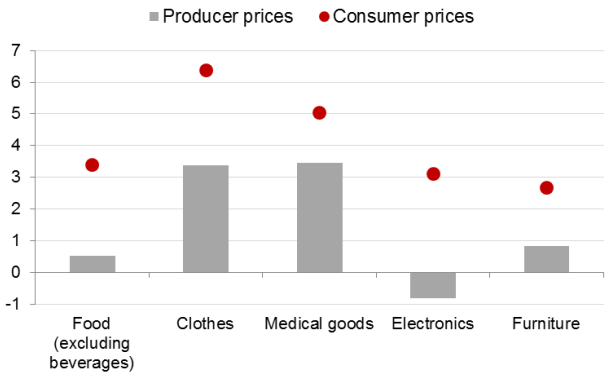
According to Rosstat data[3], price growth accelerated to an annualised 15.1%, which is 2.5% pp above the January reading (Figure 9). The acceleration was mainly driven by the developments in fuel energy production: coal (75.5% YoY), crude oil and natural gas (73.7% YoY), explained by the substantial rise in global energy prices in 2016.

Figure 9. Core CPI components, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 10. Movements in some consumer product prices, % YoY



Sources: Rosstat, R&F Department calculations.

Price growth in the manufacturing sector decelerated to 8.7% (from 10.4% in January), with such deceleration observed across most sectors[4]. The same is true of the electrical power, gas and steam supply and air conditioning sector that posted a 4.5% annualised growth rate (5.8% in January).

In annual terms, industrial producer prices have for the past two months been above the consumer price index. Yet, high growth rates are mainly specific to energy production and investment demand-oriented sectors where price fluctuations weigh in on consumer

[3] Effective 1 January 2017, Rosstat has launched a new version of the Russian National Classifier of Economic Activities (OKVED2). This new version sets out a new approach to classing industrial producer prices: Mineral Production; Processing Industries; Electrical Power, Gas and Steam Supply and Air Conditioning; Water Supply, Wastewater Disposal and Waste Treatment and Disposal and Emergency Management.

[4] Excluding tobacco products, rubber and plastics, metal products (except for machinery and equipment) and furniture.

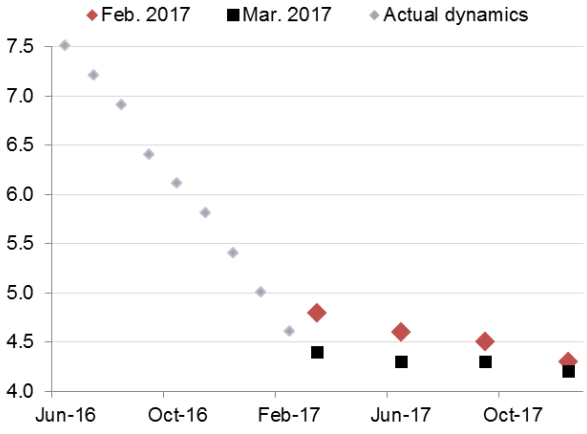
inflation in an indirect way and with a lengthy lag. Consumer goods were in most cases growing higher than producer prices (Figure 10).

1.1.5. According to a consensus forecast by analysts, inflationary pressure is set to strengthen by year-end

- Despite the noticeable inflation slowdown of the first quarter, analysts' consensus forecast found that inflation is expected to fall by a mere 0.1 pp to 4.2% YoY.
- We estimate that such a reading would come with strengthened inflationary pressure in the fourth quarter to a point which corresponds to a 5.1–5.3% annualised price growth.
- The consensus forecast for the Bank of Russia key rate for the end of the year was meanwhile unchanged.

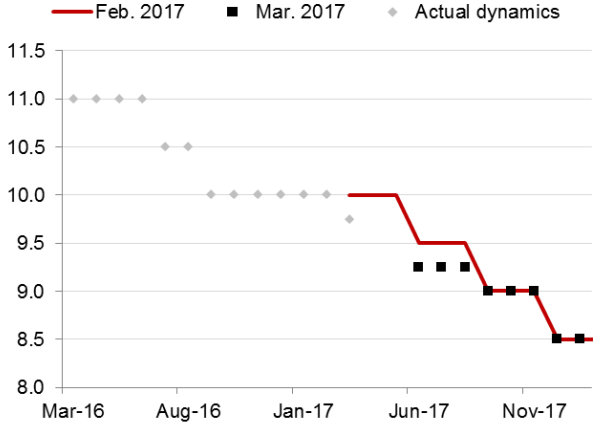
The actual slowdown in annual inflation had a positive effect on analysts' expectations. A Bloomberg survey in March found the consensus forecast for late 2017 edging lower to 4.2% from 4.3% (Figure 11). Analysts polled by the agency expected inflation to hit between 3.7% and 4.5%, with only one of them projecting a reading of 5.0%.

Figure 11. Analysts' expectations for inflation, % YoY



Sources: Bloomberg Finance L.P.

Figure 12. Analysts' expectations for the BoR key rate, %



Sources: Bloomberg Finance L.P.

Given the strong enough inflation slowdown in the first quarter[5] this slight downgrade in the consensus forecast is causing concern. Our estimates suggest that if inflation between January and March were to send prices higher by only 4.2%[6] by late 2017, the annualised increase in prices for the remaining three quarters of the year would

[5] Tentatively, 0.6-0.7% QoQ SA in Q1.
[6] The calculations leave out analysts' estimates which were non-updated as of March 2017.

on average exceed the target level of 4%. That being said, if Q2-Q3 annualised growth were to meet the target, 2017 Q4 inflation would have to accelerate in annual terms to 5.1–5.3% to enable the current consensus forecast to materialise. This potential acceleration would pose strong risks to the target of inflation sustained at around 4% in 2018.

Importantly, the median forecast of analysts for Urals in 2017 is still above $50 a barrel, in a sign that there was no significant review in the external settings for the medium term in experts' calculations. Nor was there any substantial revision in experts' exchange rate projections in the past month, this forecast suggesting that the ruble will weaken by 5% at most from its current readings before the year-end. This means that this not-so-significant decrease in consensus forecasts for 2017 for the current rates of disinflation, in contrast to last month, has nothing to do with any drastic upgrade of forecasts for inflation for the next quarters; rather, the conclusions in favour of inflation climbing higher in the second half are derived implicitly, in contrast to the previous February forecasts.

It is also highly probable that expert forecasts are not free of a substantial adjustment component; changes in the forecasts meanwhile may fail to account fully for short-term price growth data. Our understanding is, these conclusions may also be driven by the perception of 4% annual inflation as a psychological mark, so analysts tend to provide forecasts close to this figure without any clear assumptions / quarterly change calculations.

1.1.6. Anchoring of inflation expectations in countries which enacted inflation targeting

- When the dynamics of actual inflation in countries which implemented inflation targeting are analysed retrospectively, there emerges a common problem: households' inflation expectations remain persistently high as a central bank moves progressively towards delivery on its inflation target (Figure 13 – Figure 16).
- As suggested by many such countries, a central bank-set inflation target as a desired range may entail market players' expectations tending to become anchored close to its upper bound (the Czech Republic, New Zealand, South Africa: See Figure 13 – Figure 15).
- At the same time, based on inflation targeting practices in both emerging and advanced economies[7], as inflation trends down towards target (or a target range)

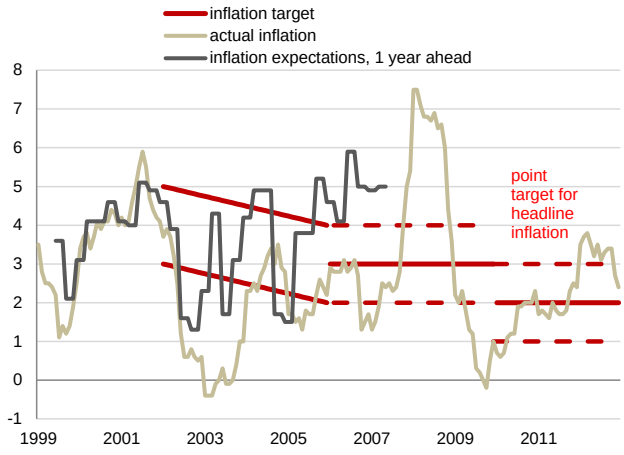
[7] We explored historical data on inflation dynamics and inflation expectations in the following countries: Brazil, Israel, New Zealand, Turkey, the Philippines, the Czech Republic and South Africa. The period under study per country spans the first year of inflation targeting.

inflation expectations tend to remain persistently high, with actual and projected prices showing a similar performance.

- The latter may be explained by the imperfect statistical approaches to the measurements of price dynamics, which fail to make a full adjustment for systematically overvalued expectations of households.
- The findings on systematically overvalued household expectations are indirectly supported by financial analysts' expectations for price growth. In the countries under study these were more moderate and near to a central bank's mid-term target rate of inflation (the Czech Republic, New Zealand, Israel, Turkey, Brazil: See. Figure 17)
- The episodes, occurring at times, of expectations being stuck at elevated levels may partially be explained by the high base effect behind the actual inflation slowdown, which respondents' answers may fail to fully account for (the Philippines, the 2009-2010 episode, see Figure 16).
- Where central banks were relatively successful with inflation targeting and targeting of inflation expectations, the periods of short-term proinflationary shock did not automatically trigger a surge in inflation expectations (New Zealand, the 2008 and 2011 episodes, see Figure 14).
- In many countries, inflation expectations were declining towards the median of the price range at a time when actual inflation was attaining a reading below the lower bond (New Zealand, the Philippines, South Africa).
- The analysis of inflation expectations for the first year of inflation targeting is complicated by, inter alia, the fact that the relative estimates were only available several years following the rollout of inflation targeting.

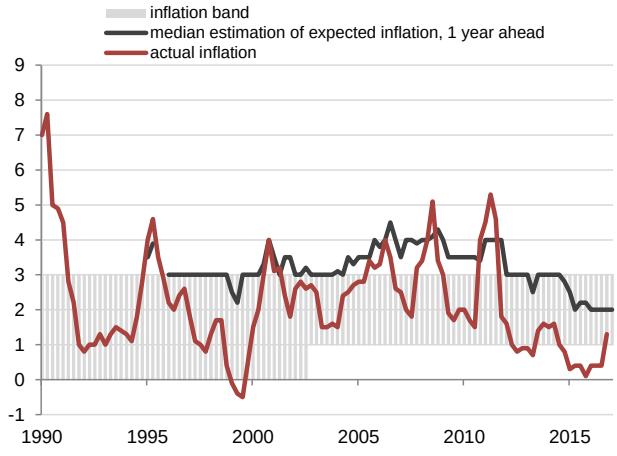
Households' inflation expectations:

Figure 13. Inflation and inflation expectations (the Czech Republic), % YoY



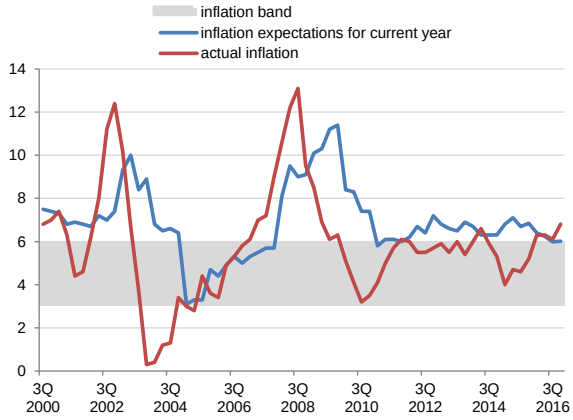
Sources: CEIC, Czech National Bank

Figure 14. Inflation and inflation expectations (New Zealand), % YoY



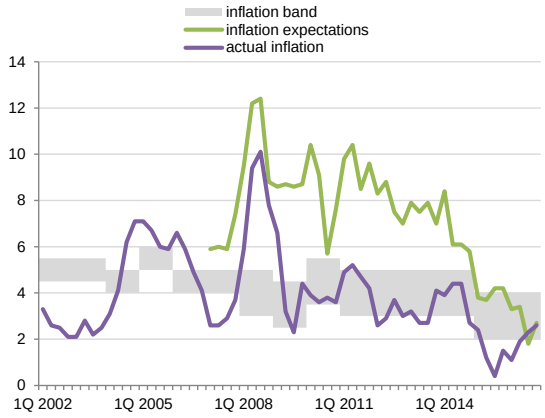
Sources: CEIC, Reserve Bank of New Zealand

Figure 15. Inflation and inflation expectations (South Africa), % YoY



Sources: CEIC, South African Reserve Bank

Figure 16. Inflation and inflation expectations (the Philippines), % YoY



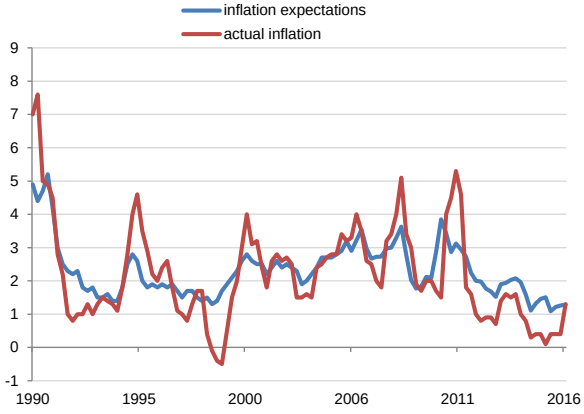
Sources: CEIC, Central Bank of the Philippines

Analysts' inflation expectations:

Figure 17. Inflation and inflation expectations of financial analysts (the Czech Republic), % YoY

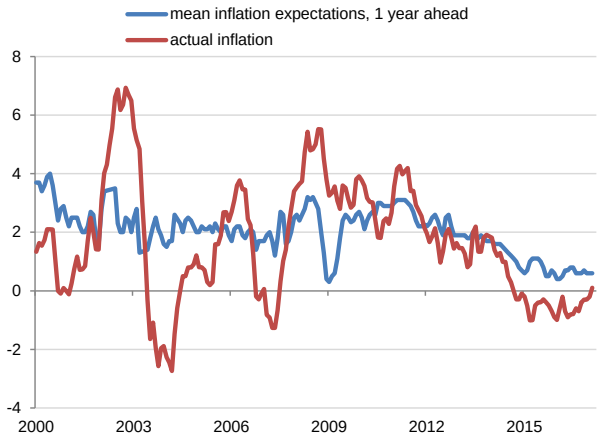
Sources: CEIC, Czech National Bank

Figure 18. Inflation and inflation expectations of financial analysts (New Zealand), % YoY



Sources: CEIC, Reserve Bank of New Zealand

Figure 19. Inflation and inflation expectations of financial analysts (Israel), % YoY % YoY

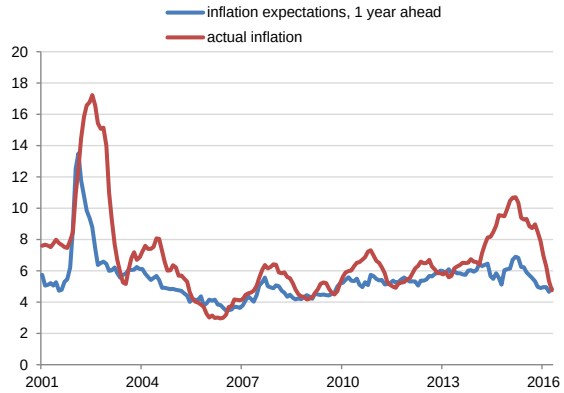


Sources: CEIC, Bank of Israel.

Figure 20. Inflation and inflation expectations of financial analysts (Turkey), % YoY

Sources: CEIC, Bank of Turkey.

Figure 21. Inflation and inflation expectations of financial analysts (Brazil), % YoY



Sources: CEIC, Bank of Brazil.

1.2. Economic performance

The positive trends, which first emerged back in the second half of 2016, have been advancing in the economy. This is attested by both shot-term macroeconomic indicators and leading business indicators. A progressive rebound is seen in consumer and investment demand; the labour market is also undergoing adjustment to new economic conditions. Economic recovery in 2017 Q1 slightly outperforms the Bank of Russia's forecasts, helped by, inter alia, the current favourable external and financial conditions observed since late 2016.

1.2.1. 2016 GDP: the economy is set on a recovery path

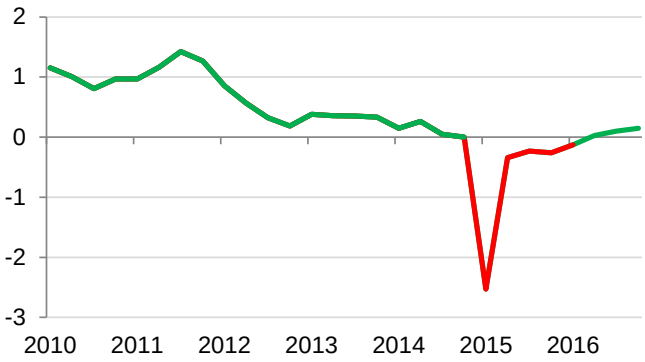
- Updated and seasonally adjusted data suggest that 2016 Q4 GDP growth proved faster than 2016 Q3; it also became more vivid.
- The upgraded estimates in GDP components point to a strengthening in favourable trends, which include a rebound in fixed capital investment and better consumption data.

In late March, Rosstat released an upgraded estimate for 2016 GDP, wherein 2016 Q4 data are of most interest to analysts. Quarterly GDP estimates including by component were aligned to the previously released estimate of annual GDP growth. Minor corrections were made to the way GDP 2014-2016 components[8] were estimated,

[8] Substantial revisions were made to quarterly data on fixed capital investment and inventories. This is partially attributed to the treatment of military equipment costs, which new rules recognise as part of fixed capital accumulations.

with finalised annual GDP data however left unchanged (0.7% in 2014, -2.8% in 2015 and -0.2% in 2016).

Figure 22. GDP in constant prices, % QoQ (seasonally adjusted)



Sources: Rosstat, Bank of Russia calculations.

The updated data are relevant as long as they signal that the economy was showing early signs of recovery in the second half of 2016. As suggested by seasonally and calendar factor adjusted estimates for quarterly GDP growth rates, the Russian economy has been declining for four to five consecutive quarters since 2015 Q1 (Figure 22). Economic stagnation continued throughout the whole first half of 2016; slow economic growth was not beginning to emerge before the second half of 2016: GDP rose 0.1% QoQ in the third and fourth quarters of 2016.

These periods saw a trend towards recovery taking hold, so GDP growth rates were becoming much more manifested. A strengthening positive economic trend is further evidenced by the latest macroeconomic indicators released in early 2017.

The new data with 2016 GDP component updates found that more active investment came as the core source of improvements in economic performance. Based on the recently released statistics, positive trends were taking hold in the course of the fourth quarter of 2016. Gross accumulation showed positive quarterly growth rates, seasonally adjusted, starting from the third quarter of 2016; meanwhile, household consumption on a quarterly basis was still contracting albeit at slower paces.

Seasonally adjusted estimates for 2016 Q4 suggest that the growth of gross accumulation continued and accelerated. This upward movement was seen in both Fixed Capital Investment and Inventories categories. Recovering inventories remain a core driver for advancing gross accumulation. Importantly, inventories were showing faster paces of recovery in comparison with those for investment in the third and fourth quarters of 2016. This unsurprising trend is typical of an initial phase in economic revival when producers are adjusting their expectations to better domestic demand.

At the same time, growing domestic demand spurs acceleration in the growth of imports. This does not however lead to net exports negatively contributing to GDP, which is helped by rising crude prices. These pushed exports of goods and services upwards in the fourth quarter of 2016. Once seasonal adjustments are made to exports, their growth

in 2016 Q4 increased to 1.3% QoQ on 0.1% QoQ seen in 2016 Q3. The acceleration in growth enabled to offset the negative effects of rising volumes of imports. As oil prices are set to remain at higher levels in the next months, this trend is expected to hold. Moving forward, however, as business indicators improve alongside the accompanying growth of imports, the positive contribution of net exports to GDP is projected to gradually wane.

Recovered investment activity is expected to become a key driver of GDP growth in the near future, also helped by growth in other GDP components. These developments will be helped by improved investor and producer expectations as to the outlook for a rebound in domestic demand, to be triggered by the continued downward movement of inflation, higher oil prices and the resulting improvements in corporate profits. The favourable movements in domestic demand are further supported by survey data confirming an improvement in business activity and consumer confidence. Indirect indicators suggest that the positive impact from recovering inventories are increasingly independent of imports, supporting the assumption on improving producer expectations and potential GDP acceleration. Longer term, however, this driver is likely to fade given that the net contribution of inventories[9] to GDP is set to contract gradually as imports expand.

We believe that over several months' horizon GDP growth may continue to gain momentum on the back of better investment activity and a sustainable trend towards robust exports.

1.2.2. February's decline in industrial production was mainly caused by the calendar factor

- Industrial production in February contracted 1.5% MoM and 2.7% YoY owing to the high base effect of 2016, a leap year.
- Calendar effect adjusted industrial production continued to expand robustly thanks to, inter alia, cold weather and mounting gas exports.
- The manufacturing sector in February was in the grip of stagnation; however, positive PMI movements are indicative of continued growth in future.

As Rosstat estimates suggest, industrial production in February contracted 1.5% MoM and 2.7% YoY. Annual growth rates were considerably affected by the calendar factor. The high base of February 2016, a leap year, was, other things being equal, responsible for slashing annual growth rates in continuous production by 3.4%[10]. The

[9] Including imports.
[10] 28/29=96,6%.

fewer work days in February (18 in 2017 against 20 in 2016) led to a 10% YoY reduction in continuous outputs[11].

R&F Department estimate suggest that seasonally and calendar effect adjusted[12] outputs dropped 0.3% MoM in February, following a 0.9% MoM growth seen in January. However, with the set of observations based on the new method being limited, we treat the current estimates with caution mainly owing to the wagging tail problem: as data are subsequently added, notable changes may occur in these data.

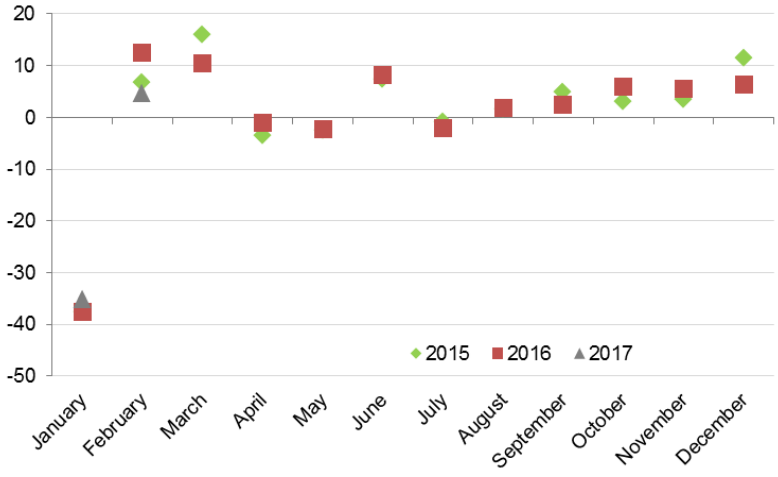
Broken down by sector, data in mining appear fairly optimistic. The contraction in oil output to comply with the OPEC cut deal (-0.7% YoY) was offset by larger coal (+2.9% YoY) and gas (+12.1% YoY) outputs. The weather helped alongside the strong demand for exports, with the average temperature in February being 4.6ºC lower than one year ago. The cold weather seems to have been the key growth driver in Energy, Gas and Steam Supply and Air Conditioning sector. This is the only sector that turned in a YoY and calendar factor unadjusted growth.

Once adjusted for the calendar effect, the manufacturing sector showed data which suggest that the industry is creeping into stagnation. The product breakdown suggests that growth points are still in place in the food industry, the light industry and chemicals. At the same time we note a material[13] drop in outputs of petrol, propellant and fuel oil, as well as slower growth in the engineering industry. The sharp contraction (-19.3% YoY) in Water Supply, Wastewater Disposal and Waste Treatment and Disposal and Emergency Management came with higher outputs of steam and hot water (+6.2% YoY), which fails to clarify what triggered the so significant decline in the overall sector.

Calendar effect adjusted industrial outputs in the January to February period expanded at a fairly robust pace. The manufacturing sector's statistics were indicative of stagnation even once calendar effect adjustment is applied, which is a key concern. The February' paces of expansion in production outputs, at 2%+ YoY after calendar effect adjustment came as a result of the cold weather and non-CIS-bound gas imports. Having said that, the behaviour of leading indicators points to continued robust rates of expansion in the next few months including in the manufacturing sector.

[11] 18/20=90%.
[12] Including the leap 2016 year factor.
[13] ~-10% YoY.

Figure 23. Monthly growth in manufacturing industries, % MoM



Sources: Rosstat, R&F Department calculations.

1.2.3. Growth in manufacturing is held back by the engineering industry, which fails to post sustainably positive data

- February 2017 saw a drop in the engineering sector's and metallurgy's outputs.
- Signs of recovery are seen in the light industry. As before, there are growth points in chemicals; outputs of food products remain steady.
- The production of construction materials posted a surprise growth.

Yet, the manufacturing industries are overall on the verge of stagnation. As we have noted, February 2017 manufacturing outputs were considerably impacted by the calendar effect as the past year was two work days longer. In this regard, once seasonal and calendar effect adjustments are made, a MoM growth vers. February last year appears more moderate than when analysing unadjusted data. With Rosstat's switchover to the new product classifier (OKPD2), no historical output data per product are available, so their full-pledged seasonal adjustment is impossible.

Early in the year, the engineering sectors posted unsteady outputs with sharp fluctuations and drops. As a result, the overall trend in the engineering industry is still negative. In Computers, Electrical and Optical Products, a lacklustre January was followed by a 7.8% MoM seasonally adjusted rise. The sector's output is however invariably less than in late 2016. The upward trend that emerged in Machinery and Equipment outputs in 2016 has yet to secure a footing. February's seasonally adjusted

volume of production was down 2.3%. The industry is still reliant on agricultural machinery production as its key growth driver, with its 2016 outputs at all-time high. In this way, we saw a twofold increase in outputs of field engines compared with last year, with grain harvesters growing 2.5 times. Electrical equipment outputs were unchanged in February against January, seasonally adjusted; the industry recovered to the levels of early 2015.

February saw a drop in outputs of vehicles. The auto industry turned in a slight drop of 1.4% MoM, seasonally adjusted. Production is expected to rise in the near future as producer expectations optimistically assume that demand is deferred and set to grow. Outputs of Other Vehicles are sharply down by 4.7% MoM, seasonally adjusted.

Despite an improving global environment, outputs of Metallurgic Products (both ferrous and non-ferrous) are still on a negative trend. In an export-friendly environment, Russian metallurgists are raising prices after global producers, which has yet to translate into higher outputs. In the production of finished metallurgical products, stagnation is due to low investment demand of the domestic market.

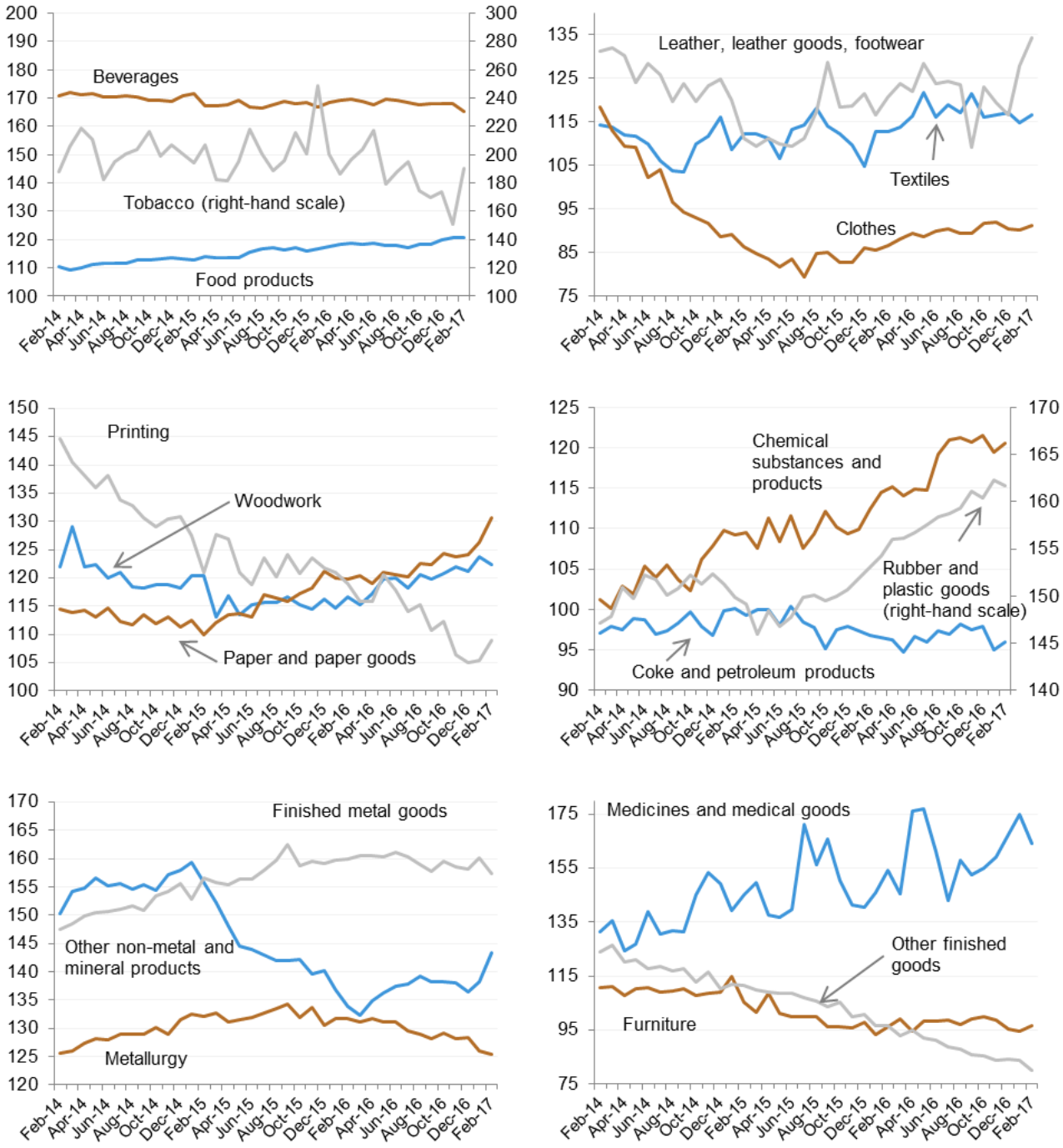
February's outputs in the light industry were on the rise. Following a contraction in January, textiles rebounded with seasonally adjusted growth hitting 1.6% MoM (largely on the back of fibre-bonded fabrics). The positive long-term trend, which first emerged in the middle of 2015, is continued; its strength has however been fading since mid-2016. Growth is mainly driven by special-purpose clothing with everyday clothing expected to shore up the sector once its planned localisation bear fruit in 2017. Outputs of leather and leather products hit their highest levels since early 2014 (+4.8% MoM, seasonally adjusted) and mainly occurred on the back of higher outputs of rubber and plastic footwear for special / military purposes.

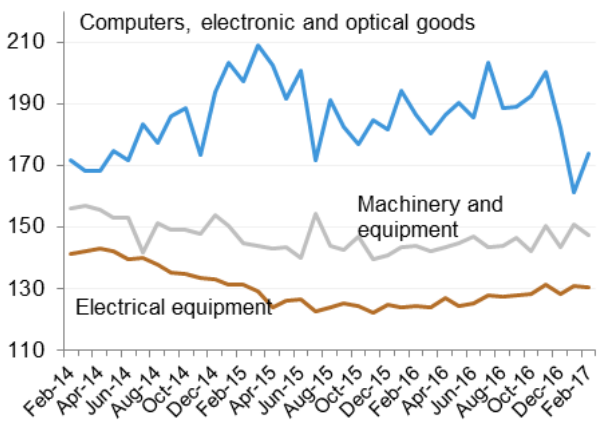
The chemicals sector post continued positive figures. In this way, February saw the volume of chemical substances and products rise 1% MoM, seasonally adjusted. Fertilisers grew by 9.1% YoY, pushed by advancements in the government-backed agricultural industry. The sustainable long-term positive trend in rubber and plastic products unchanged, their output edged down 0.3% MoM, seasonally adjusted. Tyres remained a key growth driver for the industry as their output in February was up 3.9% YoY. Volatility persists in pharmaceuticals and medical supplies. Their seasonally adjusted contraction in February was 6.1% MoM. The overall industry is growing on the back of import substitution.

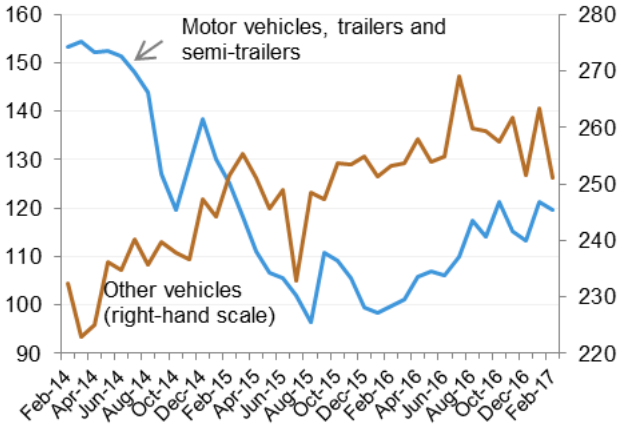
Volumes of food products have remained steady. In the timber industry, the long-term positive trend dating back to 2015 is continued.

Construction materials are also posting strong data with 3.8% MoM growth, seasonally adjusted. The output reached a reading of mid-2015. This may be a reflection of upbeat mood in the construction market, brought about by low interest rates and real estate costs, which is expected to galvanise a recovery in demand for residential property.

Figure 24. Outputs in manufacturing industries, January 2014=100%







** Data in the graphs were seasonally adjusted.*

Sources: Rosstat, R&F Department calculations.

1.2.4. The composite PMI for Q1 hit the top reading for the period since 2008

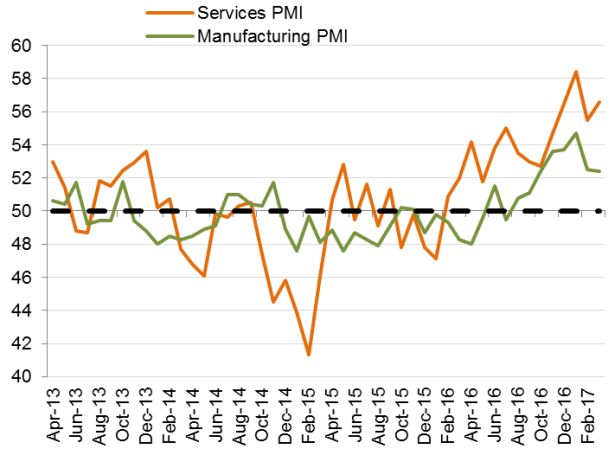
- The composite PMI index in the first quarter reached the top mark for the period since 2008, indicating that acceleration in business activity is continued.
- As before, domestic demand is the key source of growth, whereas external demand (export orders) is still in decline.
- High corporate expectations alongside robust orders bode well for a further advancement, in the second quarter, of the early favourable trends.

Manufacturing and Services PMIs, well above 50 points (Figure 7), indicate that economic rebound is ongoing. The composite PMI index for the first quarter reached its highest level in the period since 2008 Q2. Historically, this reading of the index was a match to a 1–1.5% QoQ GDP growth (4–6% in annual terms). The current index value of Q1 GDP growth is 0.5% QoQ[14]. This is not to say that PMI is becoming 'decoupled' from real economic processes. With potential GDP growth, currently estimated at around 1–2%, far below its 2000 reading, PMI growth, other things being equal, is consistent with a slower GDP growth pace.

Higher outputs are buoyed by growing orders both in the manufacturing sector and services. The source of growth is domestic rather than external demand, which is clear from export orders (Figure 27). This trend will most probably continue so domestic demand is set to remain a key economic driver in 2017.

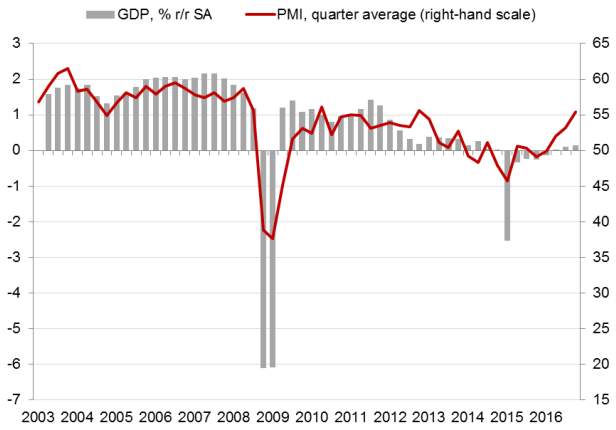
[14] Seasonally adjusted.

Figure 25. PMI indexes



Sources: Bloomberg Finance L.P., IHS Markit.

Figure 26. GDP and Composite PMI

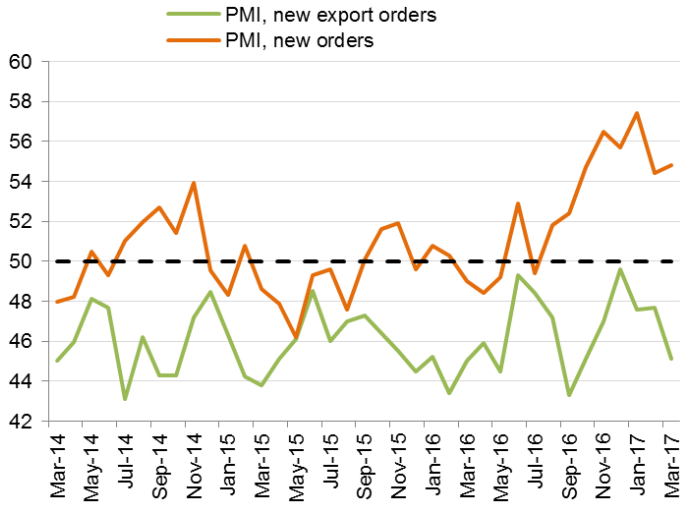


** Q1 GDP growth – R&F index estimate.*

Sources: Bloomberg Finance L.P., IHS Markit.

Corporate expectations, reaching a 22-month low in the manufacturing sector and decreasing slightly in services, were still at a point higher than their historical average. Coupled with positive new orders data, this indicator gives reason to expect that an upward trend in industrial production and services will continue in the second quarter provided that no meaningful shocks occur.

Figure 27. Manufacturing PMI: orders



Sources: Bloomberg Finance L.P., IHS Markit.

1.2.5. Retail sales, seasonally and calendar effect adjusted, are steady

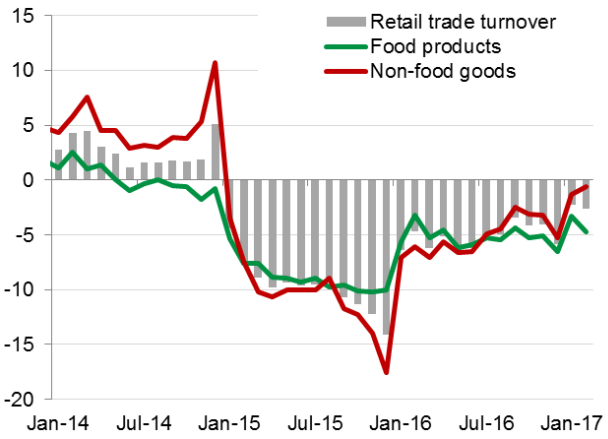
- Retail sales accelerated their decline to 2.6% YoY on the back of the leap year effect.

- Once seasonal and calendar effect adjustments are applied, sales in February are found to be level with January.
- The consumer confidence index suggests improved consumer expectations in March.

Rosstat data show that retail sales were declining faster at an annualised 2.6% (against 2.3% in January). Annualised sales of food products (4.7%) slumped much more than nonfood sales (0.6%) (Figure 28). This is explained by the leap year effect, when February in 2016 was responsible for the high base to calculate February YoY data. This effect was more vividly expressed in food sales, this category including more fast moving consumer goods (FMCG).

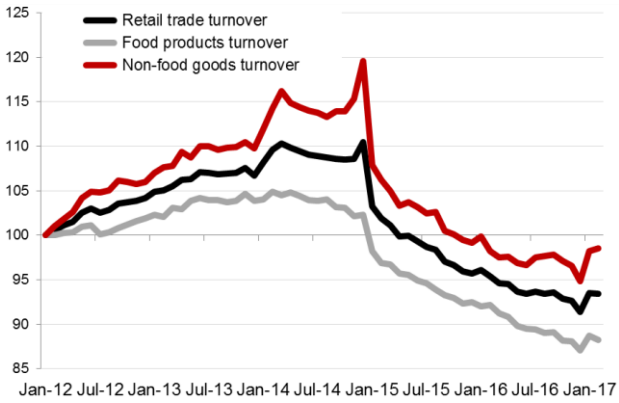
Once seasonal and calendar effect adjustments are made, we estimate sales in February to be level with January (Figure 29). Seasonally adjusted sales of nonfood products rose 0.3% MoM, while those of food slumped 0.4% MoM. March may put in a slight slump in seasonally adjusted indicators as the positive impact from the one-off pension payment (5,000 rubles per pensioner), implemented in January, was still at play in the course of February. That said, retail sales will most likely be above the level of the last few months of 2016.

Figure 28. Retail sales, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 29. Retail sales
(%, January 2012 = 100%, seasonally adjusted)



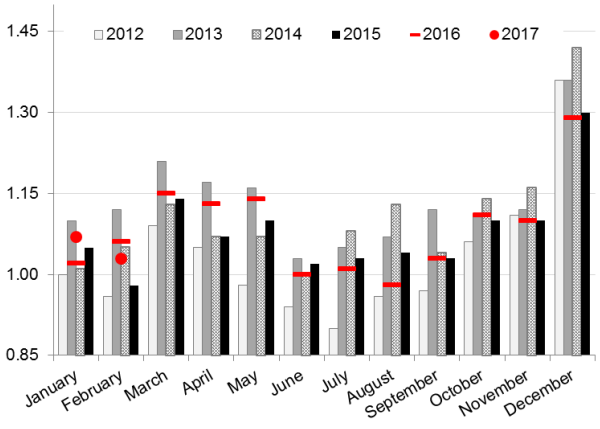
Sources: Rosstat, R&F Department calculations.

A study by Romir[15], a pollster, found that real income of the population was in February lower than the past year's readings (except for 2012 and 2015) (Figure 30). Spending was 3.7% down on January. The share of food in the consumer basket fell from 53% in January to 50% in February, which suggests that spending on FMCG was declining stronger than on durables. This is a match with Rosstat data which affirm the impact of the calendar effect on every-day spending, as well as the influence of the one-off January pension payment on spending on durable products.

[15] Romir Research Holding «Опять экономим», 09.03.2017.

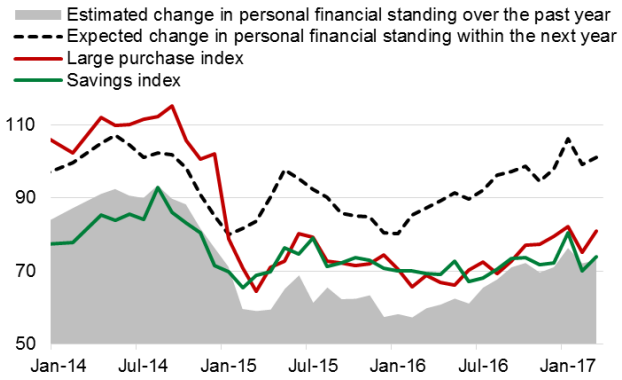
A study by inFOM found that consumer sentiment was in February less optimistic in comparison with January. In this way, respondents showed a more negative attitude towards major purchases as their current and future financial standing expectations were downgraded[16]. For all its negative nature, negative consumer sentiment in February was not protracted, with a better picture as regards both individual financial standing and attitude towards major purchases (Figure 31) emerging in March. Considering that consumer sentiment remains overall positive, albeit sensitive enough to the impact of temporary factors, consumer demand can be expected to rise in the course of 2017.

Figure 30. Real consumer spending (% January 2012 = 100%)



Sources: Romir Scan Panel.

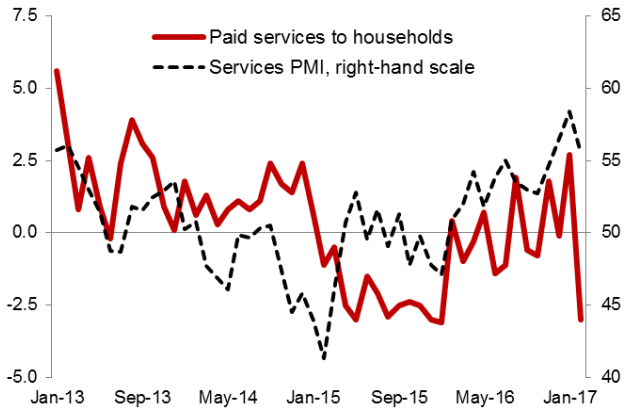
Figure 31. Consumer sentiment index and its components, pp



Sources: InFOM.

The population' demand for commercial services was lower in February; however, this indicator is very volatile. Preliminary Rosstat data show that the volume of commercial services provided to the population was down 3.0% YoY. PMI index was meanwhile positive, albeit having slid slightly in February (Figure 32).

Figure 32. Commercial services households



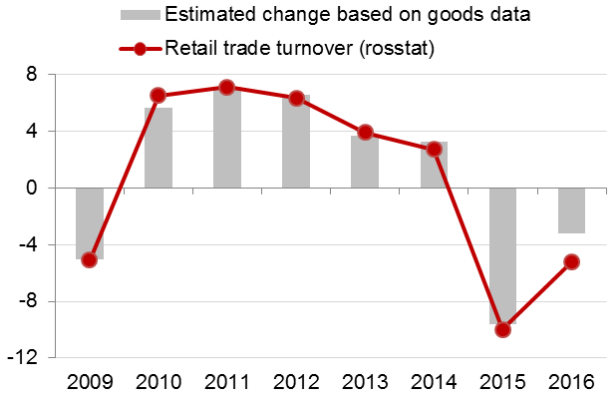
Sources: Rosstat, Bloomberg Finance L.P., R&F Department calculations.

[16] 'Inflation expectations and consumer sentiment'. No. 2 February. 2017.

Estimated sales of individual representative products cast doubt on sales figures by Rosstat

The past year's retail sales as calculated based on swings in individual product categories[17], proved more optimistic than Rosstat's overall estimate. According to Rosstat estimates, 2016 retail sales contracted 5.2% YoY. However, when sales are broken down by product and individual categories are analysed, the drop totals 3.2% YoY (Figure 33).

Figure 33. Retail sales, % YoY



Source: Rosstat.

Calculations show that the decline in food sales was not so pronounced as in nonfood (2.3% YoY against 4.1% YoY). Rosstat data suggest the opposite trend (a 5.3% YoY drop in food sales and a 5.1% YoY contraction in nonfood sales), which can hardly be attributed to consumer behaviour: as incomes dwindle, consumer tend to save on big-budget purchases, not on food.

Updated data from Rosstat are due on 17 April for the calendar year - these will be based on broader observations as per annual accounting forms. A review in retail sales figures is not impossible with a downgrade in the amount of contraction.

1.2.6. Both employment and unemployment showed a surprise downward movement

- February's unemployment rate, after seasonal adjustment, fell to 5.3% from 5.35% seen in January.

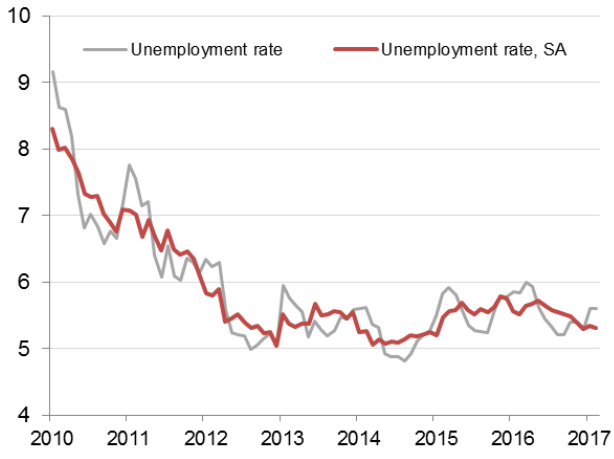
[17] The index is the weighted average of core food and nonfood products which account for about 75% of total sales. The conclusions are based on the commodity composition for the year that proceeds the accounting year.
For details see Talking Trends No.1. February 2017. Section 3. In focus. Consumption evidence for decline or growth?

- At the same time, Rosstat data point to a sharp decrease in the number of employed and in the level of economically active population, in defiance of polling indicators (for example, PMI).
- Wages were growing slower in February at 6% YoY; at the same time, growth of real wages is buoyed by slower inflation.

A survey related to employment problems put February's unemployment rate at 5.6%, unchanged from one month before. Seasonal adjustment lowered this indicator from 5.35% to 5.3% (Figure 34). The survey reveals that the level of economically active population declined drastically (Figure 35), as the number of employed contracted sharply - in contrast with a smaller drop in the number of unemployed[18]. This means that those currently unemployed for some reason are out of the economically active population category, that is, they are not active job seekers. This behaviour is typical of the retirement age population, when those reaching the pension qualification age cease to be active labour market participants after they retire. With monthly age breakdowns for workforce participation rate unavailable, there are no hard data to support this conclusion.

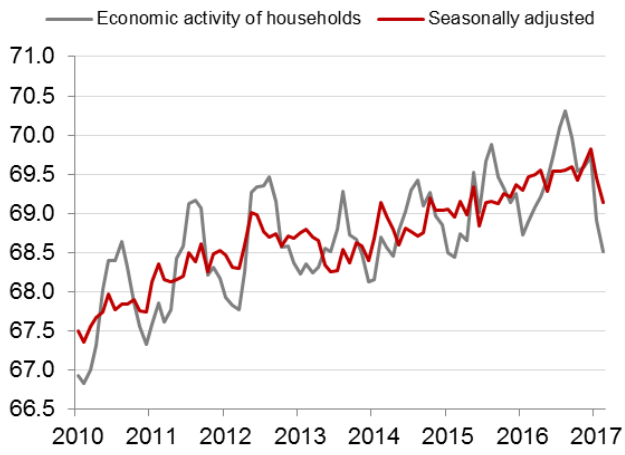
The drop in the number of employed in February is inconsistent with movements in survey data. In this way, PMIs for employment signalled growing numbers of those employed in both services and the manufacturing sector. One month's data are hardly sufficient to conclude in favour of any meaningful change in the labour market. Yet, the March data may help classify the drop in February as either temporary or a start to a sustainable trend.

Figure 34. Unemployment, %



Sources: Rosstat, R&F Department calculations.

Figure 35. Labour force participation rate, %



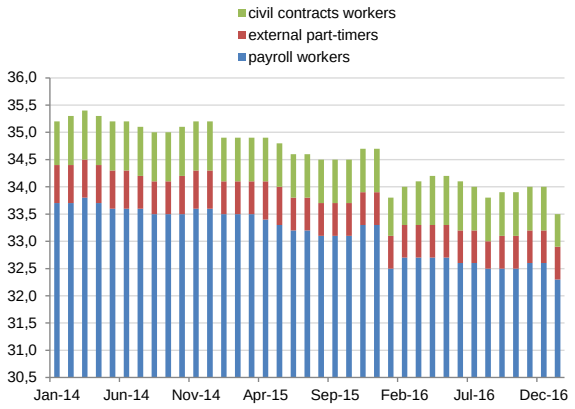
Sources: Rosstat, R&F Department calculations.

Organisations saw a continued decline in full-time equivalent (FTE) positions: in January, this figure reached 33.5 million (Figure 36). According to a Centre for Strategic

[18] Seasonally adjusted.

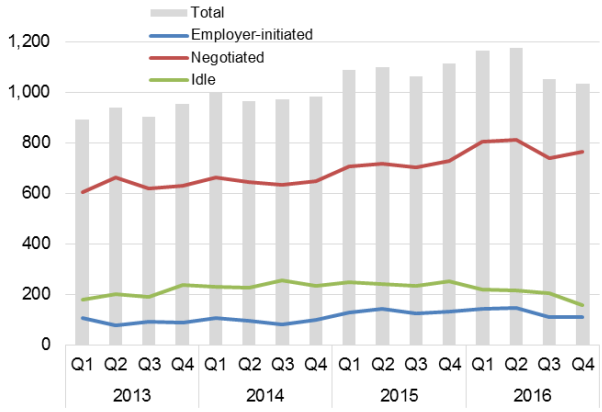
Development [19] report, FTEs are draining away from big and medium-sized enterprises to other segments of the economy including small businesses, the informal sector, etc. These movements within the economically active populations carry no risks of growing unemployment. As for big and medium-sized enterprises, employment terminations relate to both structural change (machinery displacing human labour) and temporary unfavourable (economic) factors. At the same time, 2016 Q3 and Q4 saw a drop in part-time employees (Figure 37), in a further sign of economic recovery unfolding since late 2016.

Figure 36. Full time equivalents in organisations (excluding small enterprises), million people



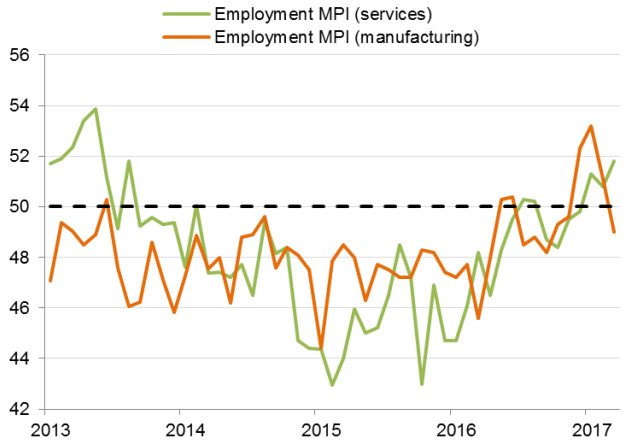
Sources: Rosstat, R&F Department calculations.

Figure 37. Part-time employees (seasonally adjusted), thousand



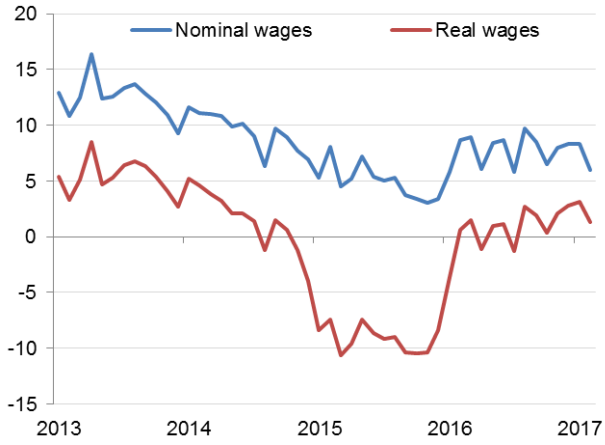
Sources: Rosstat, R&F Department calculations.

Figure 38. PMI employment indexes



Source: IHS Markit.

Figure 39. Nominal and real wages, % YoY



Source: Rosstat.

According to preliminary estimates, nominal wages grew 6% YoY, which puts average wage increase (adjusted for inflation) at 1.3% in annual terms (Figure 39). The seasonally adjusted data are further evidence that wage growth continued early in the year. With Rosstat's introduction of new statistical accounting rules (OKVED2), wage data broken down by economic activity are only available for January 2017, which renders wage data calculations in the public and private sector impossible.

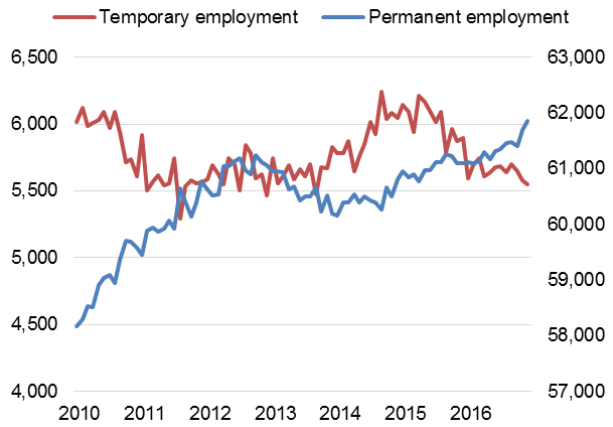
[19] «Российский рынок труда: тенденции, институты, структурные изменения» под ред. В. Гимпельсона, Р, Капелюшникова, С. Рощина.

1.2.7. Concealed unemployment is still moving downwards

- Q4 employment data revealed a continued downward trend in concealed unemployment (U5 and U6).
- This was accompanied with a marked jump in permanent employment occurring on the back of small enterprise employees, individual entrepreneurs' and private individuals' employees.
- Demand for labour is rising on the backdrop of the continued decline in labour resources, which may result in accelerated wage increase with a strengthening in inflationary pressure it entails.

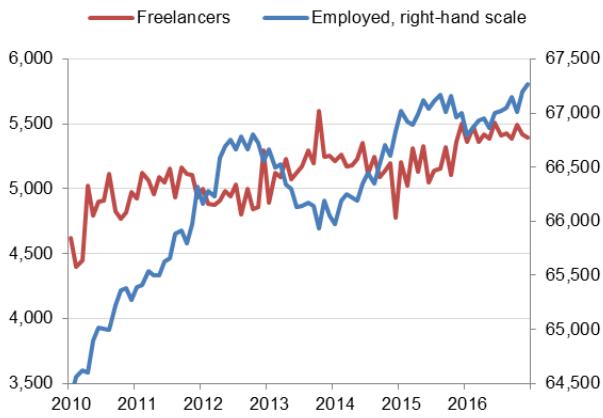
In late March, findings of Rosstat's sampling of opinion were out (workforce analysis). According to the statistical bulletin, permanent employment rose sharply in December 2016[20] moving close to 62 million people (Figure 40), accounting for roughly 80% of the total economically active population. Conversely, the number of temporary employees[21] was beginning to decline to reach 5.5 million people in late 2016. Overall, temporary employment was down on the back of drops in the number of employees working on a verbal agreement basis / under fixed-term employment contracts.

Figure 40. Primary employment (main jobs) per employment contract types, seasonally adjusted, thousand people



Sources: Rosstat, R&F Department calculations.

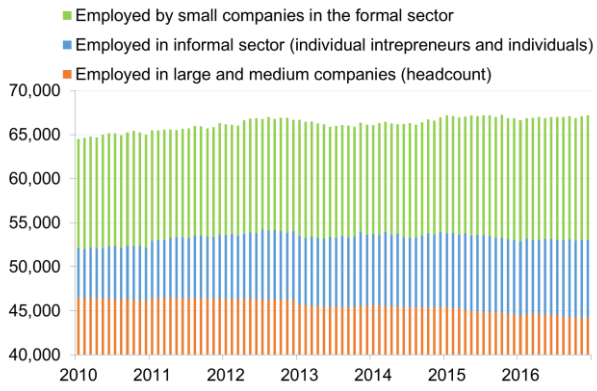
Figure 41. Economically active population, employed and self-employed (seasonally adjusted)



Sources: Rosstat, R&F Department calculations.

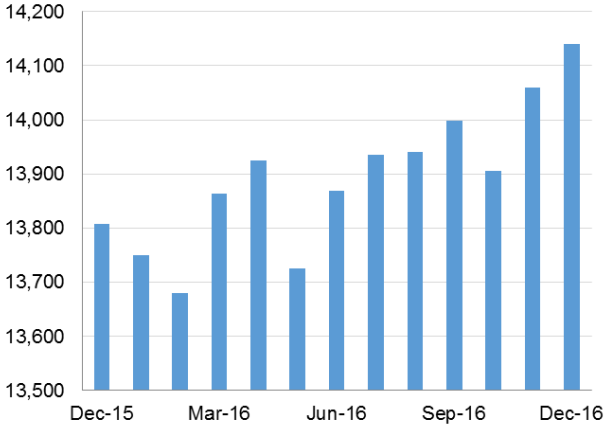
[20] Employed under permanent employment contracts.
[21] Fixed-term employment contracts, civil law contracts, etc.

Figure 42. Employment (seasonally adjusted), thousand people



Sources: Rosstat, R&F Department calculations.

Figure 43. Formal sector's small enterprise employees, thousand people



Sources: Rosstat, R&F Department calculations.

New permanent jobs came with a positive impact on employees. At the same time, the number of self-employed was unchanged (Figure 41). As follows from reports of major and medium-sized enterprises, the average number employed in the sector continues to decline. This means that the numbers of working population are growing at the expense of small enterprises in the formal and informal sector[22] (Figure 42). Importantly, in late 2016, the formal sector's small enterprises saw a substantially accelerated growth (Figure 43).

The informal sector employment in 2016 Q4 was still growing albeit at more moderate paces (Figure 44). As mentioned above, this growth was mainly seen in the numbers of those employed by private individuals and private entrepreneurs. The numbers of private entrepreneurs and self-employed in private households remained steady (Figure 45).

[22] Rosstat assigns any incorporated company to the formal sector. This means that informal employment as defined by Rosstat is not equal to off-the-books employment.

Figure 44. Informal employment (seasonally adjusted), thousand people

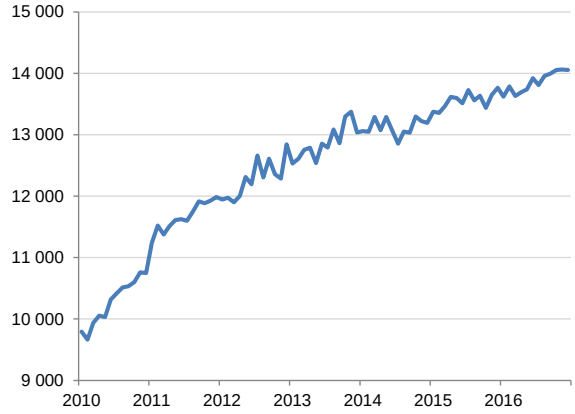


Figure 45. Informal employment by component (seasonally adjusted), thousand people

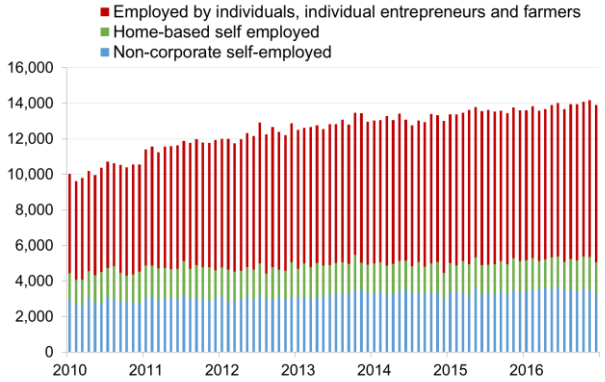
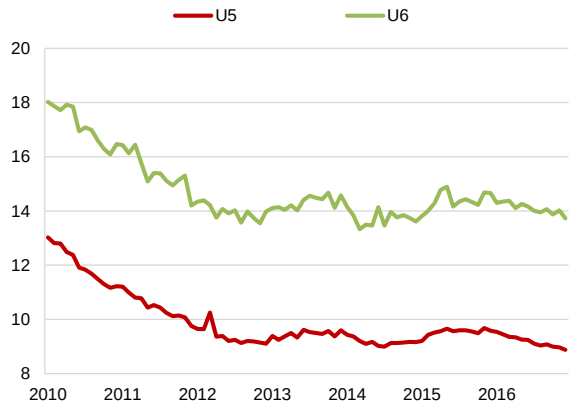
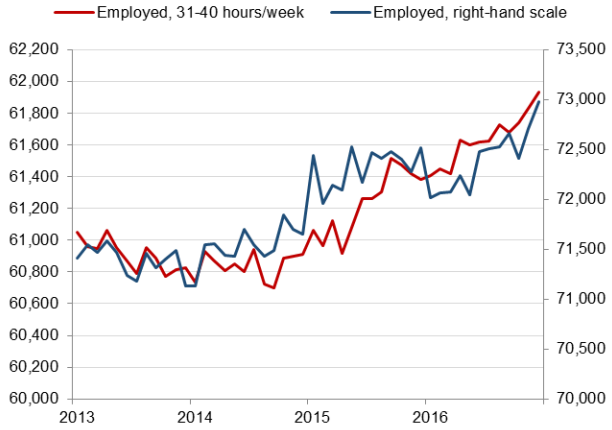


Figure 46. U5 and U6 unemployment rates (seasonally adjusted), %



Sources: Rosstat, R&F Department calculations.

Figure 47. Total working population and the numbers of those working 31-40 hours a week (seasonally adjusted), thousand people



Sources: Rosstat, R&F Department calculations.

A better labour market situation is also confirmed by more granular unemployment data[23]. In 2016 Q4, U5 rate of unemployment continued to slide, which testifies to a reduction in the economically inactive population willing to work (Figure 46). U6 was also down: in the fourth quarter, as many as 250 thousand people left the numbers of those working part-time. Moreover, in late 2016 there was a marked jump in the number of those working 31-40 hours a week (Figure 47), which indicates that the working population is re-joining regular employees.

The across-the-board improvement in employment indicators seen in the fourth quarter, alongside the decline in all unemployment data, is another sign of the economic rebound advancing seen late last year. It is of more interest to note that it is small

[23] U5 includes Rosstat's employment survey-based jobless numbers and the numbers of economically inactive population willing to work.
U6 is a sum of U5 and the population working less than 30 hours a week.

enterprises that account for most of this growth, which is indicative of structural economic change at play.

Given that the able-bodied population is expected to decrease, the fairly robust growth in the numbers of employed, together with the drop in concealed unemployment numbers, may lead to the current wage growth persisting or even accelerating; this is likely to add to inflationary pressures.

1.3. Global economy, financial and commodity markets

1.3.1. Global economy: global central banks' Board meetings in March

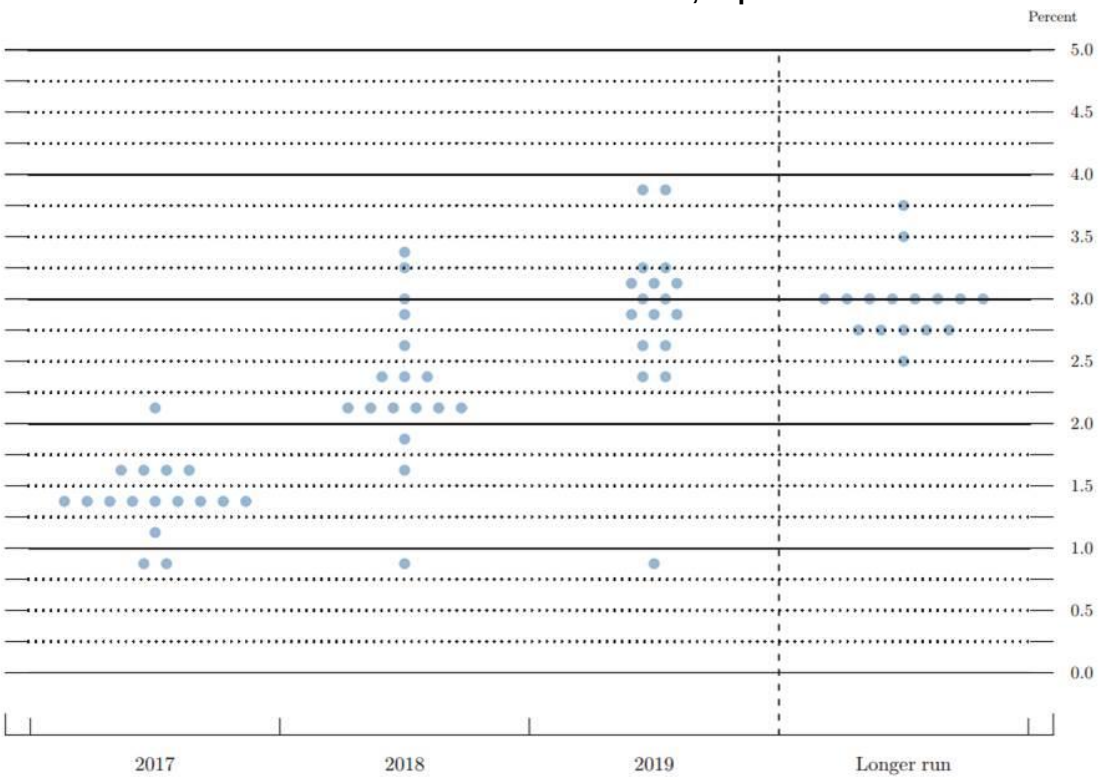
- The outcomes of key central banks' March meetings came with no surprise, markets have expected the regulators' decisions.
- There were no essential changes to monetary policies in Europe, the UK and Japan. The US Fed raised its interest rate by 0.25 bp.
- China reported continued economic growth, with strong support from the investment side. China continues to tighten its monetary policy.

USA: three federal funds rate hikes expected in 2017-2018

The Federal Open Market Committee (FOMC) 14-15 March meeting decided to raise the federal funds rate by 25 bp, in line with expectations. With strong labour market data (+235 thousand new jobs in February) in the lead-up to this policy decision, together with the policymakers' tough rhetoric, dispelled doubts over the regulator's determination to carry on with its monetary policy normalisation course this March. According to Bloomberg estimates, the market put the probability of the rate rise at 100% one week before the meeting. Financial and commodity markets were fully pricing in the expected decision.

While there was total clarity in respect of the Fed's short-term actions, the paces of monetary policy normalisation over the mid-term horizon remain unclear. According to a March median forecast by FOMC members, there will be two more upgrades to the federal funds rate in 2017 and three sequential upgrades in the course of 2018 (Figure 48).

Figure 48. Federal Open Market Committee members' votes on the future federal funds rate, % p.a.



Source: US Federal Reserve.

The current macroeconomic situation in the US matches FOMC policymakers' expectations or even beats them slightly. In this way, the regulator left unchanged the following parameters of its December forecast: in the long term, the regulator expects GDP to grow at 1.8% YoY, unemployment at 4.7% and inflation at 2.0%.

The official rhetoric of the Fed's recent meeting was essentially unchanged. The FOMC intends to continue to increase the rate progressively if the economic situation evolves in accordance with the official forecast. That said, of particular interest is the regulator statement's paragraph discussing inflation. The US Fed made clear that the target for inflation is viewed as symmetrical, which implies that the policymakers allow for a certain swing, within reason, in inflation. This suggests that markets should await no more aggressive steps from the regulator to further normalise the monetary policy.

Beyond the move to increase the rate, the normalisation agenda will include the action to lessen the public debt amounts held on the Fed's balance sheet, accumulated as a result of the quantitative easing. The March meeting records reveal the US central bank's intention to launch this procedure by late this year, by repealing the policy of reinvesting bond redemption payments (or making corrections thereto).

Eurozone: the ECB declared victory over deflation risks, leaving its monetary policy unchanged

The 9 March meeting of the ECB Governing Council predictably left its key monetary policy parameters unchanged. In its statement, the ECB confirmed that it 'continues to expect the key ECB interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of the net asset purchases'. However, ECB president Mario Draghi recognised during his press conference that no one expects a further reduction in the key rates.

Mario Draghi went on to repeat at the press conference that there was 'no signs yet of a convincing upward trend in underlying inflation' as its uptick was temporary and occurred on the back of more expensive food and energy. There was a slight upward revision in the CPI outlook albeit for 2017 only (Figure 49). Underlying inflation remains low, preventing the ECB from switching to normalisation of its monetary policy. The ECB President also recognised that the risks around weak growth had become 'more balanced', but had not disappeared altogether. 2016 Q3 and Q4 GDP was growing 0.4% QoQ, with both leading indicators and surveys suggesting that this robust growth would continue. There was a slight upward revision in the CPI outlook albeit for 2017 only (Figure 49).

In a sign of growing optimism of the ECB, the statement text made no mention of 'the ECB's intention to use all its monetary policy instruments'. Accordingly, the TLTRO2 programme, driving up the ECB's balance sheet, was not prolonged.

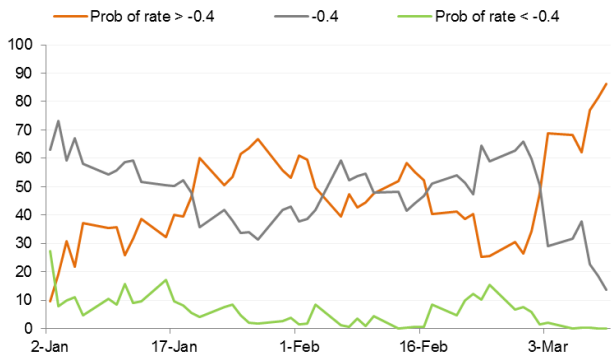
The markets gave a positive response to the ECB meeting outcomes, despite the fact that its monetary policy stance was essentially unchanged. The probability of a rate increase due before the ECB meets in June 2018 went up from 34% to 86% (Figure 24). However, it is more likely, in our view, that the regulator will implement asset-purchase tapering in the course of 2018 and will raise the rate in 2019 at the earliest. In early April, Mario Draghi moved swiftly to play down speculation that the ECB might renege on its course of action, saying there was no reason for the ECB to change its current policy.

Figure 49. ECB's macroeconomic forecasts (*March 2017 December 2016)*

	GDP	Inflation, % YoY	Unemployment, %
2017	1.8	1.7	9.4
	1.7	1.3	9.5
2018	1.7	1.6	8.9
	1.6	1.5	9.1
2019	1.6	1.7	8.4
	1.6	1.7	8.7

Source: ECB.

Figure 50. ECB key interest rate forecasts for the period before 2018 H2,%



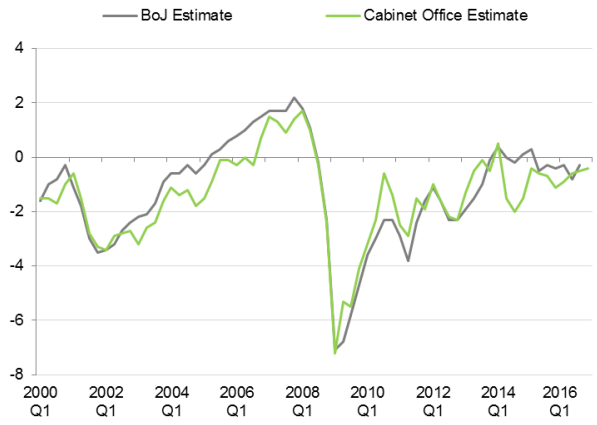
Source: Bloomberg Finance L.P.

Japan: no change in monetary policy in the near future

The Bank of Japan's (BoJ) 15-16 March 2017 policy meeting left key dimensions of its monetary policy unchanged, in full accordance with analysts' consensus forecast. Experts expect no changes in the monetary policy stance through the end of 2017.

The BoJ governor, speaking at the followup press-conference, highlighted the factors which may force the policy makers to review the rate currently used to target 10-year bond yield. These include factors, beyond domestic conditions, potentially impactful on the dynamics of short-term inflation: output gap, inflation expectations and overall economic conditions. The output gap is estimated at -0.4% GDP as of the end of Q4 2016 (Figure 51). It will take at least two years of growth above the potential point (~0.8%) for the output gap to close and begin to create inflationary pressure. Inflation expectations have been steadily declining for the past two years, stemming a potential acceleration in inflation (Figure 52). This suggests that the target yield is unlikely to change in the next one to two years.

Figure 51. Output gap estimates, % of potential GDP



Source: Japan Macro Advisors.

Figure 52. Shares of households expecting price growth, %

Source: Japan Macro Advisors.

UK: a tightening in the Bank of England's monetary policy stance is unlikely - despite a tougher tone of its press release

The Bank of England's March meeting left its monetary policy stance mainly unchanged. However, one policy committee member voted for policy tightening, citing faster inflation (Figure 53). This means that policy tightening cannot be ruled out completely - which the bank also makes clear in the caveat of its press release.

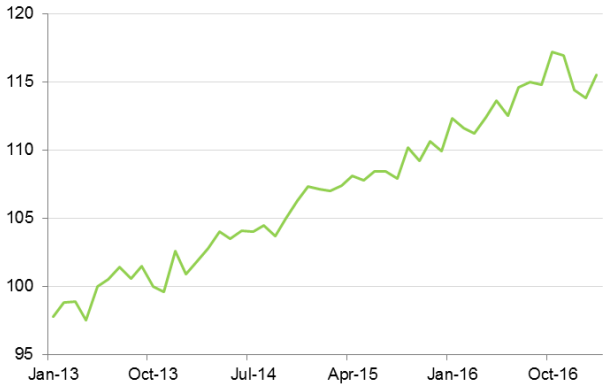
According to the BoE's February quarterly inflation report, the economy is set to grow 2% YoY in 2007, whereas its 2016 YoY growth totalled 1.8%. This forecast however runs counter to statistical data and leading indicators, which are combining to suggest that the UK economy is set for a slowdown. In this way, although February's retail sales expanded, their growth was insufficient to offset the prior several months' contraction. In a further complication, the sustainability of consumer growth in February is questioned as

inflation accelerated to levels above the paces of wage indexation. In March, households reported a notable drop in their expectations about future financial standing. Moreover, slower PMI data are indicative of a continued slowdown in industrial production (Figure 54). As a result, February's NIESR, a measure for GDP growth, lowered to +0.6% 3Mo3M, after +0.8% 3Mo3M seen in January 2017. Therefore, despite the strong inflation acceleration and the tougher rhetoric of the Bank of England, a rate hike in the months ahead looks unlikely.

Figure 53. Consumer inflation, % YoY.

Source: Office for National Statistics.

Figure 54. Retail sales, 2013=100 (seasonally adjusted)



Source: Office for National Statistics.

China: the economy is in good shape

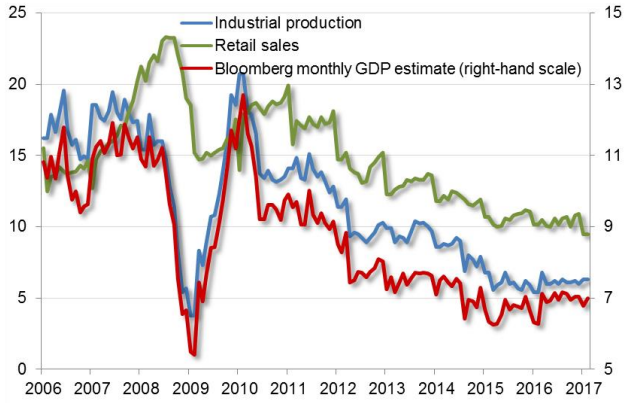
Macrostatistical data for January-February[24] suggest that the Chinese economy still posts solid growth rates, buoyed by strong investment activity. Industrial production accelerated to 6.3% YoY (vers. 6.0% YoY in December) (Figure 55). Although retail sales grew slower at 9.5% YoY (10.9% YoY in December), these growth paces are, according to Mizuho, essentially attributed to one-off factors, specifically, a rise in the population's demand for travel abroad. According to Bloomberg and Capital Economics estimates, China GDP growth between January and February indeed slowed; yet, it is only 0.1–0.2 pp behind 2016 Q4. March PMIs suggest that this trend will overall be sustainable (Figure 56).

The relatively high better-than-expected growth of the Chinese economy early in the year owes much of its origin to resumed growth in investment (Figure 57). Investment into infrastructure, public investment in the first place, remain a key driver. In parallel, the contribution to economic growth from private investment is growing; its recovery may be explained by both expanded corporate resources on the back of growing profits, as well as the willingness to invest in an improving economic environment. Exports and imports data are also indicative of solid external and domestic demand (Figure 58).

[24] With floating New Year dates, China's National Bureau of Statistics usually releases most of its macrostatistics for the period of January and February in aggregate.

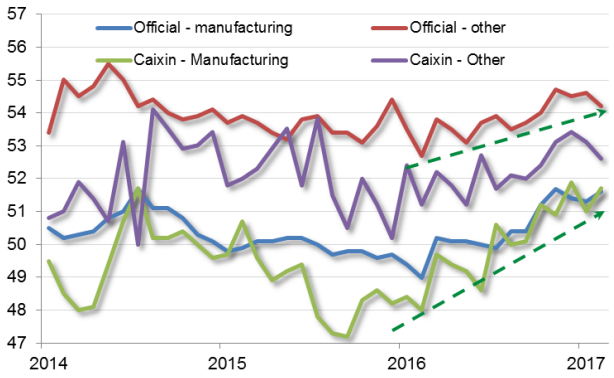
At the National People's Congress in March the authorities articulated a target for 2017 economic growth as 'around 6.5%'. As follows from the state of the Chinese economy in the start of the year, this target may be delivered without any additional economic stimulus. The target budget deficit was unchanged at 3% GDP; however, considering the specifics of budget generation in China (closely linked revenue and sources of deficit funding) as well as the massive amounts of budget resources), fiscal policy may be loosened within the bounds of this target.

Figure 55. Industrial production, retail sales and Bloomberg estimates of China GDP growth, % YoY



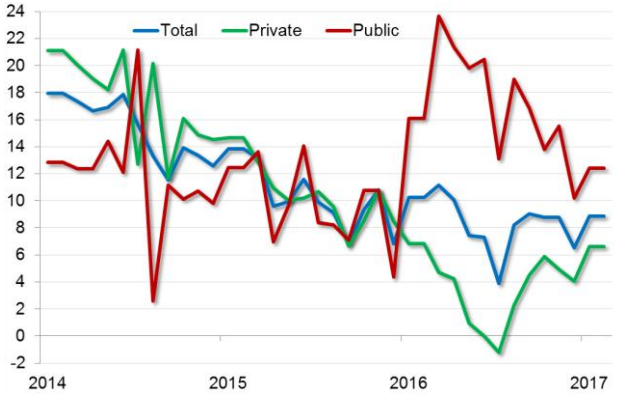
Source: Bloomberg Finance L.P.

Figure 56. PMI and official Caixin in manufacturing and other sectors, points



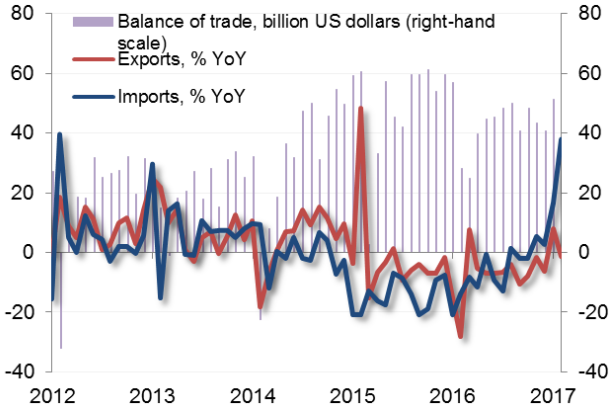
Source: Bloomberg Finance L.P.

Figure 57. Paces of fixed capital investment growth per type of property, % YoY



Sources: CEIC, R&F Department calculations.

Figure 58. China exports, imports and trade balance



Source: Bloomberg Finance L.P.

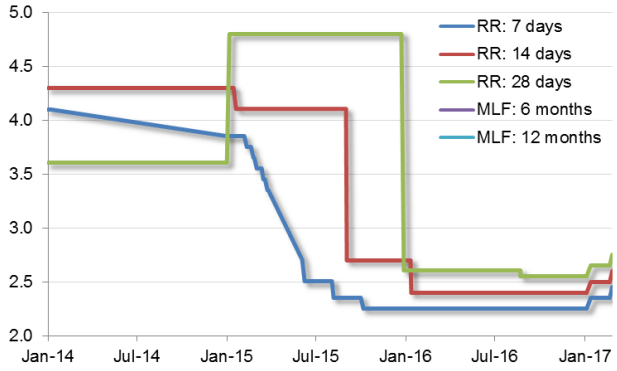
People's Bank of China continued with its monetary policy tightening. In March, in addition to the already familiar reduction in liquidity provision volumes[25] and the shift towards tools with longer maturity, the bank resumed raising interest rates. Rates for core liquidity facilities were upgraded by 0.1–0.2 pp. (Figure 59), including the de facto bank rate (for 7 days' reverse repo).

[25] The key tool to regulate interest rates in the economy, which makes the People's Bank of China (PBC) different from most other central banks.

The PBC press release cites, among other things, the risks of rising inflation, the risks of growing debt load in the economy, an overheated housing market as factors making it raise the rates; however the fundamental reason is control over the yuan exchange rate and capital outflow - triggered by the US Fed rate hike. This is aligned to the task of sustaining the yuan's position in the global payment system, which is a priority item on the PBC's agenda.

Considering that the risks of economic slowdown are receding, the PBC may well continue to increase interest rates for its credit facilities. This is indicated by, inter alia, by Shibor interbank rates: the three months' rate has easily added over 1 pp in the period since the start of the year, and counting.

Figure 59. PBC rates for repo operations (RR) and mid-term liquidity facilities (MLF), %



Sources: CEIC, MNI.

Figure 60. PBC's international reserves and FX interventions

Sources: Bloomberg Finance L.P., R&F Department calculations.

In February, capital inflow recovered and the PBC resumed its foreign currency purchases. To defy analyst's forecasts, the PBC's forex reserves were once again over $3 trillion. Our estimates suggest the negative exchange rate revaluation lead to the PBC's foreign exchange interventions becoming positive (Figure 60). According to Capital Economics, capital inflow was recorded for the first time in three years. This comes as a result of the favourable economic situation brought about by, among other things, a steadier yuan exchange rate combined with the policy makers' efforts to control capital flows.

1.3.2. A rally in emerging markets

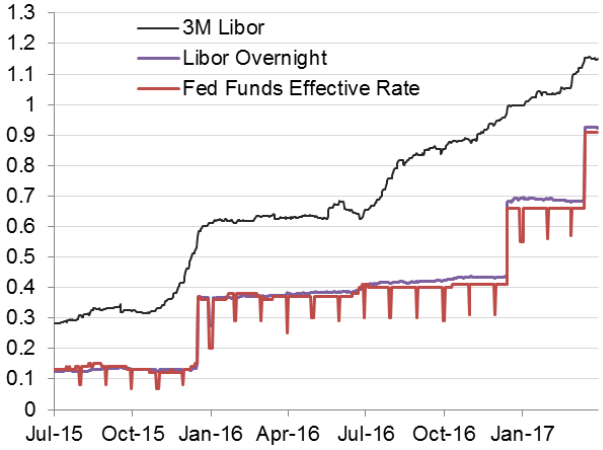
- In the lead to its policy meeting, the US Fed was using verbal interventions to successfully adjust market expectations; it increased the key rate to 0.75–1.0% p.a., a decision that came as no surprise.
- The Fed's unchanged guidance as to the number of forthcoming rate rises before the year-end combined with the growing probability of the ECB rate hike to weaken the US dollar.

- With S&P having upgraded Russia' ranking, the country looks poised to come back to the group of investment-grade status countries.
- The Bank of Russia's decision to reduce its key rate triggered a slight drop in OFZ yield. The ruble strengthened in response, which may have been caused by expectations for a more moderate interest rate reduction as the new 25 bp step of reduction implies.

Global markets

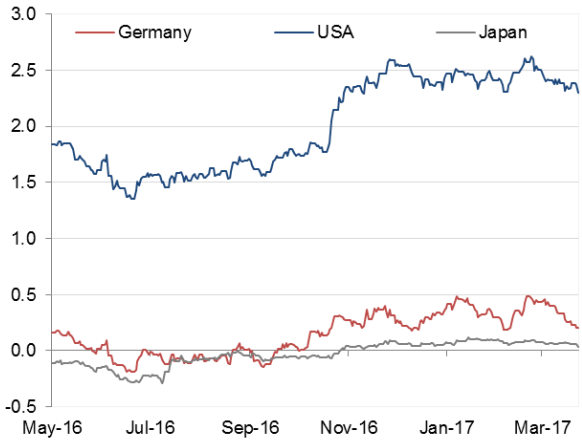
The US Fed meeting shaped all financial markets' movements in the months. Between late February and early March, several Fed representatives spoke out in a fairly tough manner, which leads to growing confidence of market players in a rate hike no later than March. This sent the US dollar higher against core currencies of both advanced and emerging economies.

Figure 61. US dollar LIBOR, %



Source: Bloomberg Finance L.P.

Figure 62. 10-year bond yields of advanced economies, %



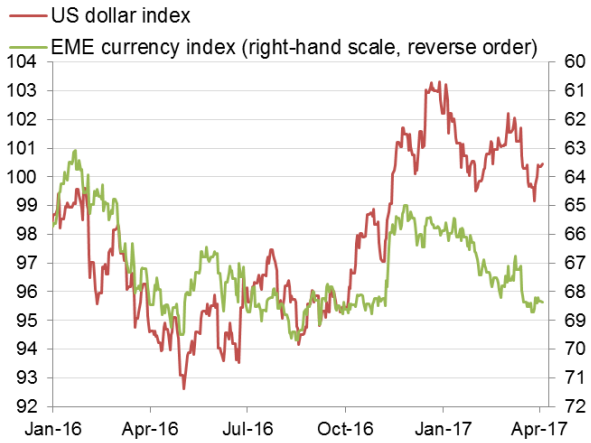
Source: Bloomberg Finance L.P.

Ultimately, the rate upgrade decision was made (Figure 61), but the Fed's expectations for interest rate movements through the end of the year were unchanged. Many market participants feared that the regulator might review its projections and implement four rate hikes instead of three. This triggered a lot of excitement on the markets, mainly, forex (Figure 63) and bond markets (Figure 62). This pushed the US dollar downwards by late March against core global currencies of both advanced and emerging countries. The movement was also helped by the ECB March meeting, with its outcomes boosting expectations for an increase in the ECB rate by the end of this year.

March was overall very favourable to emerging markets' assets. Virtually all core emerging market countries' currencies grew against the US dollar, with government bonds denominated in national currencies trending downwards. This was in no small measure helped by the continued capital inflow (Figure 64) fully offsetting the previous outflow which followed the US presidential election of November 2016.

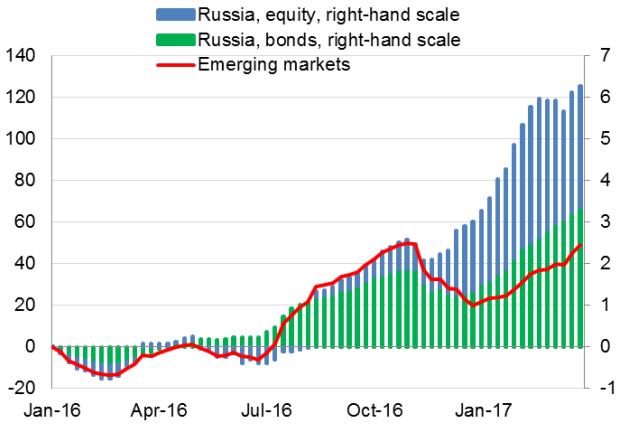
The rally in the US stock market, also buoyed by expectations for the new US president's swift action to follow through on his promises, ground to a halt as soon as it became clear that Donald Trump failed to win legislative support needed to repeal Obamacare.

Figure 63. Foreign exchange rates



Source: Bloomberg Finance L.P.

Figure 64. Cash inflow to investment funds, accrued since early 2016, billion US dollars USA



Source: Bloomberg Finance L.P.

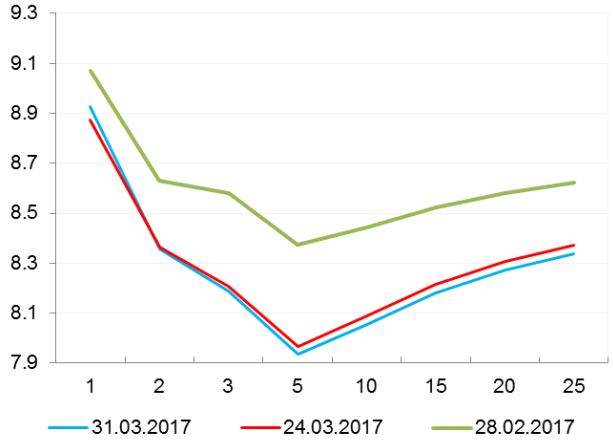
Russian markets

The Russian stock market's reaction to the Bank of Russia's decision to reduce its key rate by 25 bp was a concurrent rise in the ruble exchange rate and the bond market. The new 25 bp step of reduction is set to make the potential rate path smoother and could have triggered the short-lived demand for the Russian currency.

The drop in OFZ yield along the whole curve in March totalled 30–40 bp, a result comparable with government bond yield movements in Mexico, Poland, Peru and other emerging economies. Capital inflows into Russian funds, in progression since the start of the year is aligned with the general trend of emerging markets, enabling an upward trend of the bond markets.

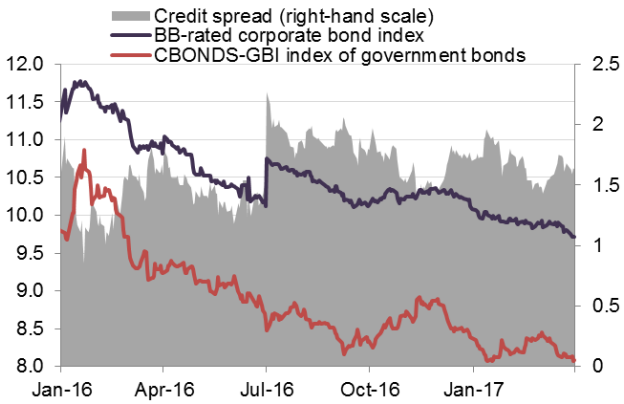
In a key development, S&P moved to upgrade its outlook for Russia to 'positive'. Back in September, the outlook was upgraded from 'negative' to 'neutral'. S&P ranking for Russia is one notch below investment grade. This positive outlook bodes well for a potential upgrade from BB+ to BBB-, which would restore Russia to an investment-grade ranking, as also suggested by the current investment grade ranking by Fitch. This action by Fitch may open up the Russian market to yet another category of investors whose investment is limited to investment-grade assets only. This may generate, all other things being equal, an additional inflow of portfolio investment in the bond market.

Figure 65. OFZ yield curve, %



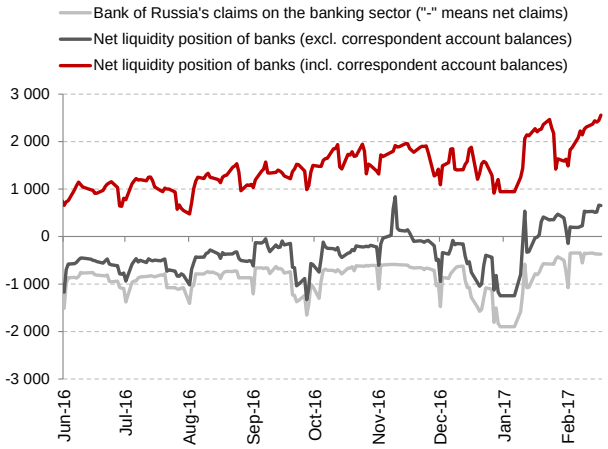
Source: Moscow Exchange.

Figure 66. Ruble bond yields, %



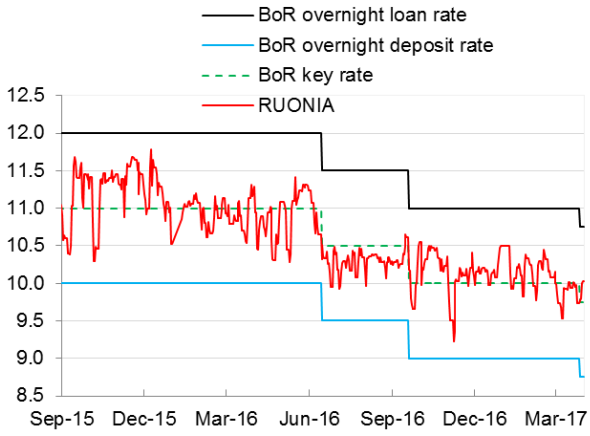
Source: Cbonds.

Figure 67. Banks' net liquidity positions to the BoR, billion rubles



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

Figure 68. BoR interest rate corridor and short-term interbank lending rate, % p.a.



Sources: Bank of Russia, Bloomberg Finance L.P.

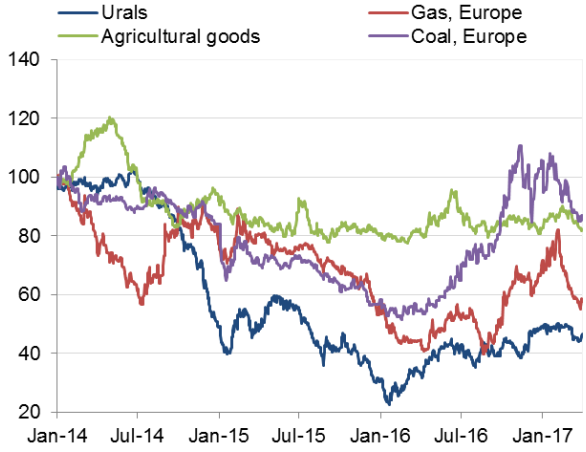
1.3.3. Commodity markets: how sustainable is the growth in shale oil output?

- The drop of crude prices in March comes as a result of the resumed growth in US oil stockpiles, mainly on the back of higher imports.
- Saudi Arabia and Iran are actively selling their oil stock, with the impact which is equal to the across-the-board OPEC reduction, in line with quotas, in January output from 90% to 45%.
- In the last 9 months, the US Energy Information Administration revised its forecast for daily oil output in the country up by more than 1 million barrels a day. We see a further outlook upgrade potential,

- as well as headwinds for the currently high paces output growth to sustain for long, considering the cyclical nature of the cutoff price growth.
- Shale oil production in core US oilfields is commercially feasible if WTI averages about $50 a barrel, while the price should hit $55-60 for substantial expansion in production to be profitable.
- A recovery in oil prices is likely to be checked by the expected substantial surge in the output of traditional oilfields, mainly in the Middle East.

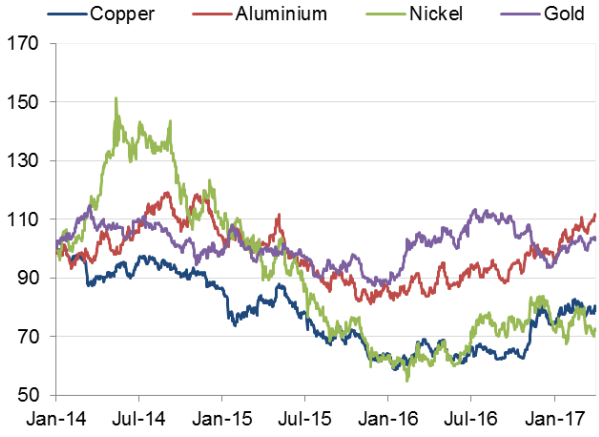
In the course of March, prices of most commodities including metals, declined; oil prices also declined by as much as 5% (Figure 69, Figure 70). The Bloomberg Commodity Index lost 3%.

Figure 69. Commodity prices (January 2014 = 100)



Sources: Bloomberg Finance L.P., R&F Department calculations.

Figure 70. Metal prices (January 2014 = 100)



Sources: Bloomberg Finance L.P., R&F Department calculations.

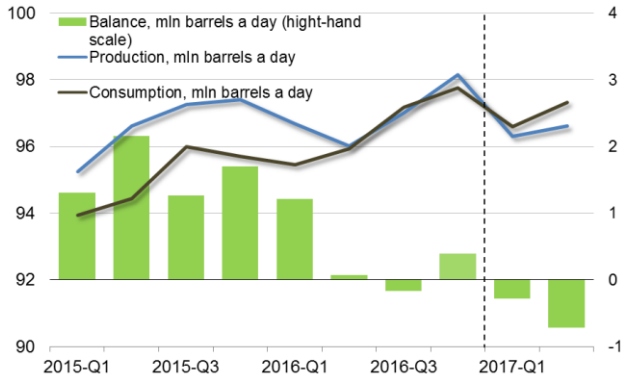
The International Energy Agency (IEA) and the US Energy Information Administration (EIA) in their March reports downgraded projected demand and supply in the liquid fuel market. The IEA projected that the deficit in the fists half of 2017 would drop 0.1 million to 0.5 million barrels a day as it noted weak growth in the first quarter and material growth in the stock of OECD countries in January (Figure 71). At the same time, in an effort to check a bearish attitude, the agency suggested that investors arm themselves with patience.

Oil prices are pressured by a continued growth in crude stockpiles in the US (Figure 72). Large volumes of imports are understood to be the underlying cause: having bottomed out at a local minimum in mid-February, imports resumed growth (Figure 73).

This is probably explained by the actions by Saudi Arabia and Iran. *On the one hand,* these countries are leaders by output cuts as they maintain their production below

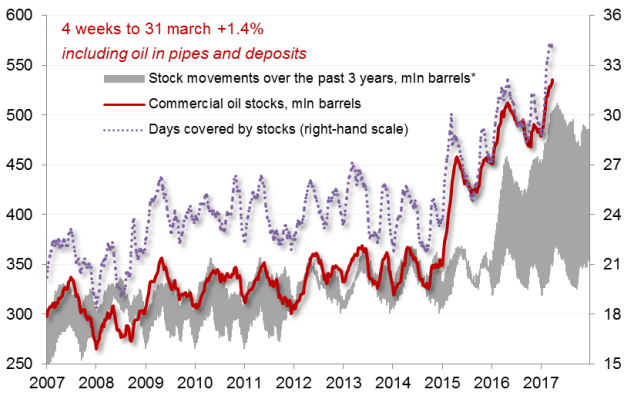
a point per quota (Figure 74). As suggested by Bloomberg-based estimates, OPEC countries were 90%[26] compliant with their quotas in March.

Figure 71. IEA estimates of key indicators of liquid fuel market



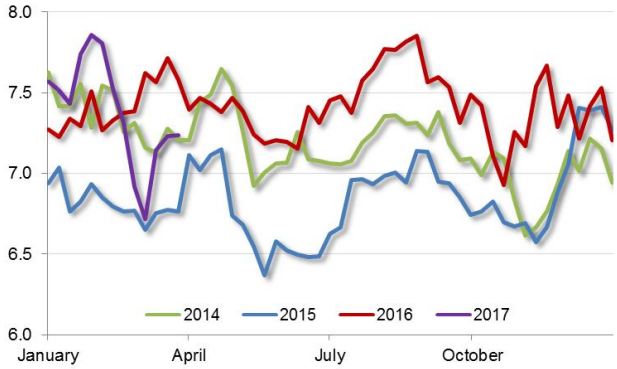
Source: IEA.

Figure 72. Commercial oil stockpiles in the US



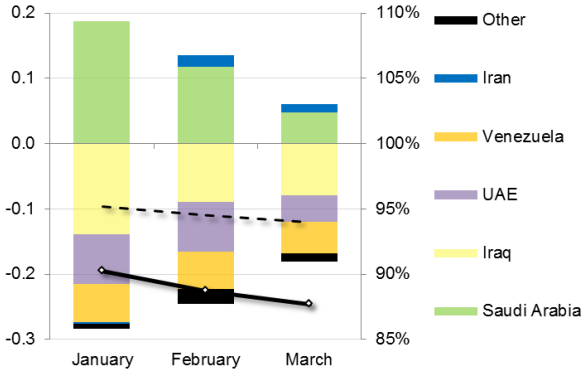
Sources: Bloomberg Finance L.P., R&F Department calculations.

Figure 73. 4-week average volume of net oil imports in the US, million barrels a day



Sources: Bloomberg Finance L.P., R&F Department calculations.

Figure 74. OPEC[27] countries' deviation from their quotas ('+' stands for output cut in excess of requirements) (million barrels a day)



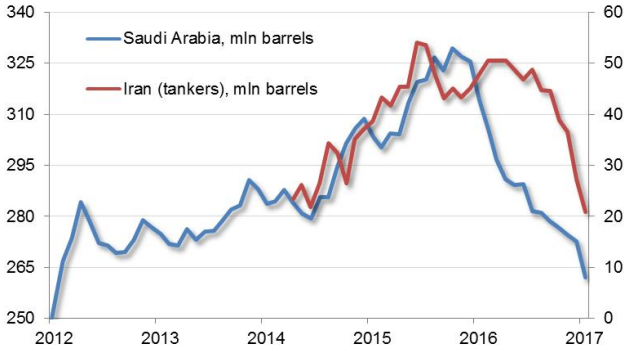
Sources: Bloomberg Finance L.P., R&F Department calculations.

On the other hand, Saudi Arabia, as JODI data suggest, and Iran, according to Bloomberg, are cutting their stockpiles aggressively. In this way, since early 2016, the average contribution of this factor from these two to a growing global supply totalled 0.22 million barrels a day, while in January 2017 it climbed to 0.55 million barrels a day (Figure 75). Taking into account these two factors (production and stockpiles) combined, the degree of OPEC compliance with the cut deal in January is down from 90% to 45%[28]. Moving forward, such actions could prove a major predicament to global stock-cutting efforts and add pressure on oil prices.

[26] In March, this degree of compliance, including Libya and Nigeria to which quotas do not apply, went up to 86% (vers. 73% and 66% in January February accordingly) owing to additional supply problems.
[27] Data for countries covered by quotas (excluding Libya and Nigeria).
[28] According to JODI, oil stockpiles in other OPEC countries posted weak growth in January.

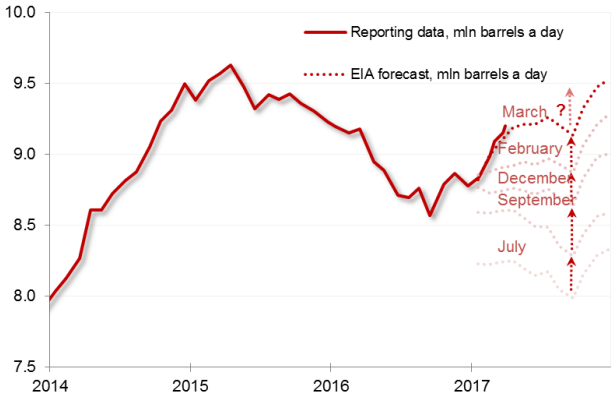
In March, Russia cut its production by 0.06 million barrels a day, in full compliance with the commitment to deliver a cut of 0.3 million barrels a day in line with the quota. It is expected that this amount will be delivered in the second half of April.

Figure 75. Oil stockpiles in Saudi Arabia and Iran (in tankers), million barrels



Sources: Bloomberg Finance L.P., JODI.

Figure 76. Actual US production and EIA forecasts for 2017



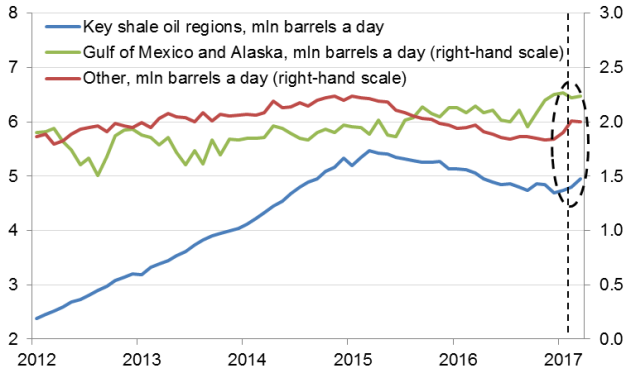
Sources: Bloomberg Finance L.P., EIA, R&F Department calculation.

Oil prices are still under pressure from US production growing, based on weekly data, by 0.38 million barrels a day. Once compared, it follows from EIA forecasts that the future US production trajectory, based on the past nine months for 2017, is up by more than 1 million a day, and we see its further growth potential (Figure 76).

At the same time we see, as before, that sustainably high growth paces of production in the long-term are questioned, as are the nature and sustainability of this recent short-term growth. The field-type breakdown of production reveals that the bulk of the growth fell on oil fields that the EIA classifies as neither core traditional (the Gulf of Mexico, Alaska) no shale production regions, with details on them being scarce (Figure 77). The high correlation with oil output in key shale production areas gives reason to suggest that the bulk of this output is generated by shale oil. It is not ruled out that output is growing on the back of an accelerated producer reaction to the oil price surge in late September (a lag of less than five months) or the rollout of field projects formerly on hold. These sharp movements, in contrast with the core shale deposits, are however raising questions as to their nature and sustainability.

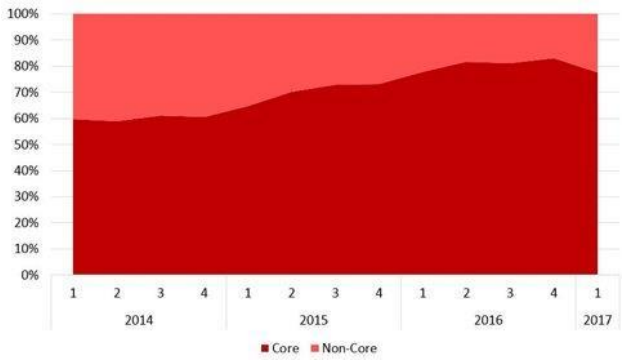
Also, according to EIA data, February's output was increasingly buoyed by stacked rigs as the majority of them are located in Eagle Ford and Niobrara where efficiency is high. This support may either hold or grow, and is volatile.

Figure 77. US oil production by filed type, million barrels a day



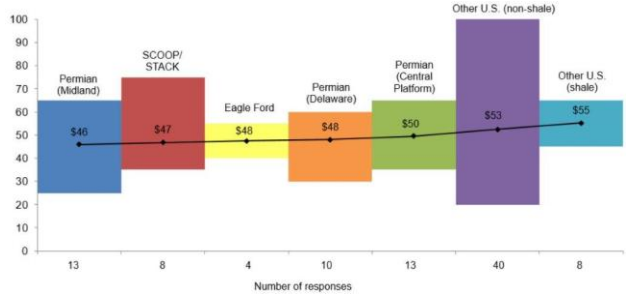
Sources: EIA, R&F Department calculations.

Figure 78. The share of the best and other shale deposits in the total amount of oil fields in Permain's producing oil fields



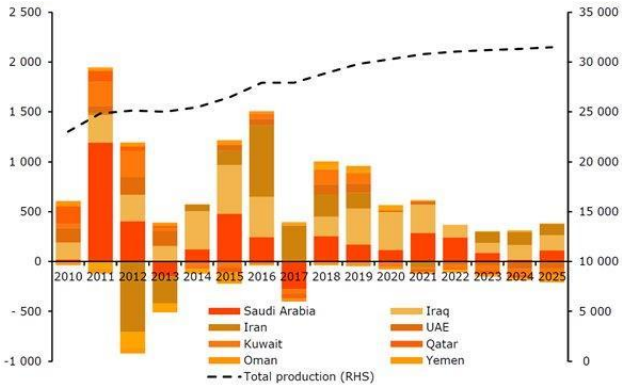
Source: Rystad Energy.

Figure 79. WTI crude (range and average) to enable production efficiency in US regions, according to companies' estimates, USD/barrel



Source: Federal Reserve Bank of Dallas

Figure 80. Growth forecasts by Rystad Energy in Middle East countries, thousand barrels a day



Source: Rystad Energy.

Also, we expect growth in pressure on efficiency and margins from the side of cyclical factors, which were instrumental in the reduction of the cutoff price in the last few years. In this way, Rystad Energy estimates based on Permian show that since 2017 Q1 (after growth in 2014-2016) the share of the best oilfields (50% of best efficiency oil fields) in the total producing fields was beginning to decline (Figure 78). It can be expected that this trend will hold in future.

Dallas Fed 2017 Q1 energy report shows that shale production companies continued to expand their business operations in the 11th Federal Reserve district[29] across the whole set of indicators including capital costs, with service providers showing outrunning paces. This is an indication of a substantial share of additional revenue from higher oil prices being allocated to service companies. Production companies polled by the Dallas Fed expect costs related to drilling and putting oilfield into operation to rise 8-9%.

[29] This is made up of US core oil producing regions accounting for up to 70% of total shale production in the US.

Companies polled cite also a wide spread in WTI price values providing for production efficiency, with the average cost effective WTI being $50 a barrel (Figure 79). It is therefore logical to assume that substantial growth in the US output can only be possible with WTI between $55 and $60 a barrel. This is consistent with both Wood Mackenzie and IEA estimates, as well as with a target WTI reading for OPEC, which held in the market in February.

Nevertheless, we believe that a 2017-2019 recovery is going to be checked by the high potential growth of production in conventional oilfields. Rystad Energy projects that between 2018 and 2019, Middle East countries are going to annually raise production by as much as 1 million barrels a day (Figure 80) as the many fields explored in the last two decades have the cutoff price below $40 a barrel. Combined with the expected output growth elsewhere (including Russia), this is set to offset the international agencies-forecast rise in demand (1.5 million barrels a day).

2. Outlook: leading indicators

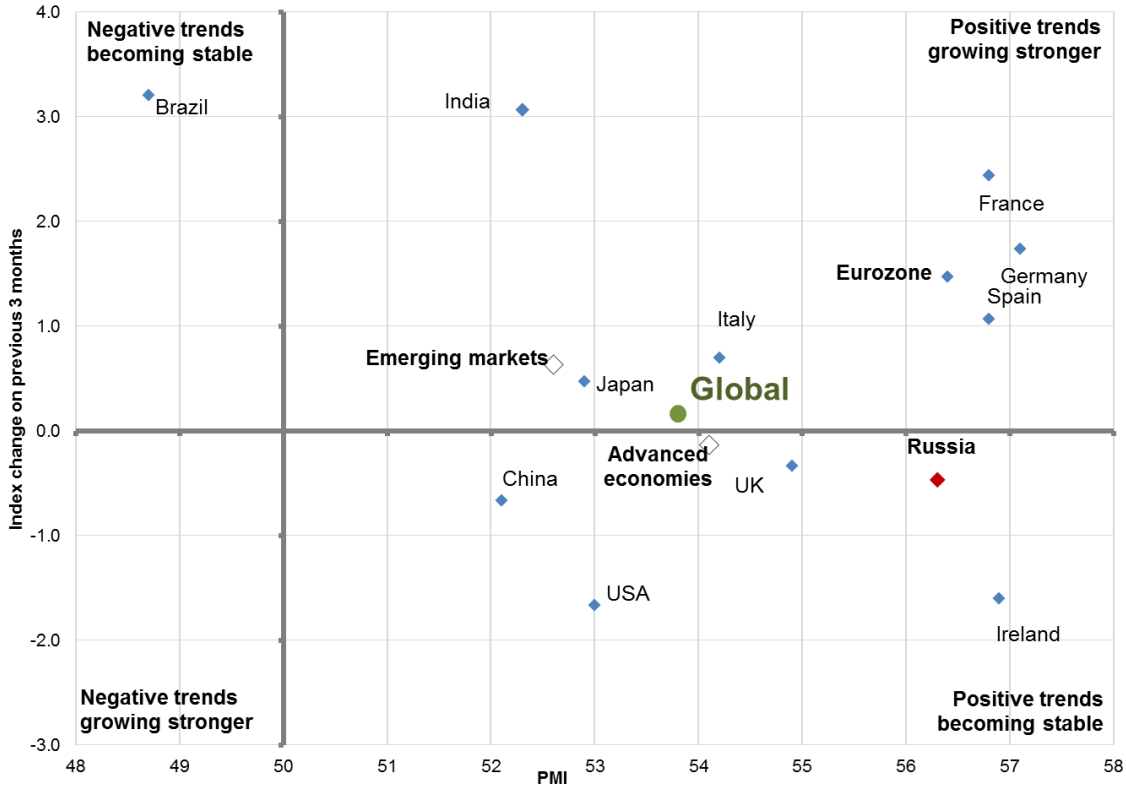
2.1. Global leading indicators

2.1.1. Global PMIs: accelerated growth in emerging markets as advanced economies post mixed data

Composite PMI data for March 2017 (Figure 81) suggest a slight acceleration in global economic growth, which occurs on the back of improvements in emerging market economies.

Across advanced economies, performance was mixed and diverged vastly: the period saw the private sector accelerate in the eurozone and slow in the US. The composite eurozone index was up from 56 to 56.6 pp, its highest level in 71 months. Economic conditions improved substantially in both the manufacturing sector and services and came with employment growing at a ten-year high pace. Companies' optimism gains further support from the bright data on new orders. Also, corporations noted, as before, growing inflationary pressure in input prices; this is said to be translating into output prices, a critical development for the euro zone.

Figure 81. Composite PMI for March and its change against the December-February average



Sources: IHS Markit, Bloomberg Finance L.P.

US PMI was down from 54.1 to 53 pp, which is a half-year low. Slowdown in growth was seen across manufacturing industries and the services sector, and was essentially

the outcome of a less optimistic picture of factory orders and a shrinking backlog in services. Having said that, March even saw some growth in companies' optimism, which offers hope that the current growth slowdown is temporary.

2.2. What do Russian leading indicators suggest?

2.2.1. The outlook for GDP growth remains solid

- 2017 Q1 index GDP estimate was slightly revised downwards to 0.5% QoQ (seasonally adjusted) from 0.6% QoQ seen in February.
- The March estimate for 2017 Q2 is +0.6% QoQ, and that for 2017 Q3 is +0.6% QoQ (seasonally adjusted).
- The slight downgrade in our estimates is not connected with February's macroeconomic statistics; the latter cannot be seen as weak taking into account the calendar factor adjustment.
- It appears that previous model estimates may have overvalued GDP movements in the nearest quarters, impacted by optimistic leading indicators, and are currently seeing a correction towards more realistic values as new statistical data come in.
- According to the model estimates under review, GDP growth is projected to total 2.0% for 2017.
- The calculations being reported are in rough agreement with the average oil price standing at $50-51 a barrel in 2017.
- 2017 model estimates present much uncertainty and subject to correction as new nowcasting data are out.

	March 2017	February 2017
	% QoQ SA	% QoQ SA
2017 Q1	0.5	0.6
2017 Q2	0.6	0.8
2017 Q3	0.6	-

3. In focus.

Low food inflation factor and their sustainability

- The most significant contribution to the slowdown in inflation in Russia is made by stabilisation in prices for agricultural products.
- This stabilisation comes on the backdrop of favourable weather conditions and a propitious global market and is helped by
- the disinflationary effect of import substitution.
- However, the technological backwardness of the sector and its heavy reliance on intermediate imports of technical supplies combine to limit the industry's potential competitive edge as they also work to maintain the industry's dependence on the exchange rate.
- The observed slowdown in food inflation may fail to be sustainable.

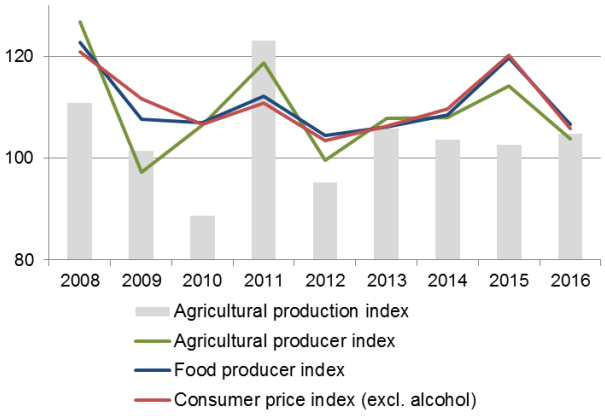
In 2016, CPI for food products (excluding alcoholic beverages) was down to 104.3%, which was a record mark in the period since 2011 (Figure 82). The most significant contribution to the slowdown in inflation in Russia is made by stabilisation in prices for agricultural products on the background of mounting outputs, a trend sustainable since 2013. At the same time, prices in the manufacturing and retail sectors have been growing at outrunning paces.

In 2016, growth in prices for agricultural products was checked by the impact from short-term factors. These included favourable weather conditions, domestic economic environment and a propitious global market. Of the long-term factors, positive impact on price stabilisation was coming from growing competitiveness of food products and declining imports.

Moderate paces of growth in agricultural prices were determined by growing outputs. In the past two years, agricultural production was growing mainly on the back of plant production, where strong crop volumes were helped by *favourable weather conditions* (Figure 83).

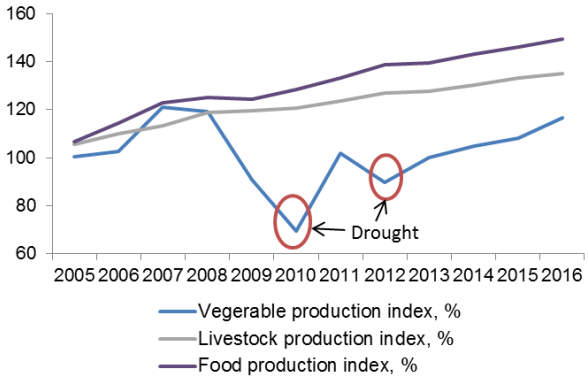
The recent years' negative global market environment was also instrumental in maintaining domestic prices at lower levels. The second half of 2016 saw signs of nascent growth in prices for individual products. According to FAO/OECD forecasts, this trend is likely to hold in the course of 2017, albeit with only a limited impact on food inflation in Russia (for the most part through higher dairy prices).

Figure 82. Agricultural outputs, producer prices and consumer prices, %



Source: Rosstat.

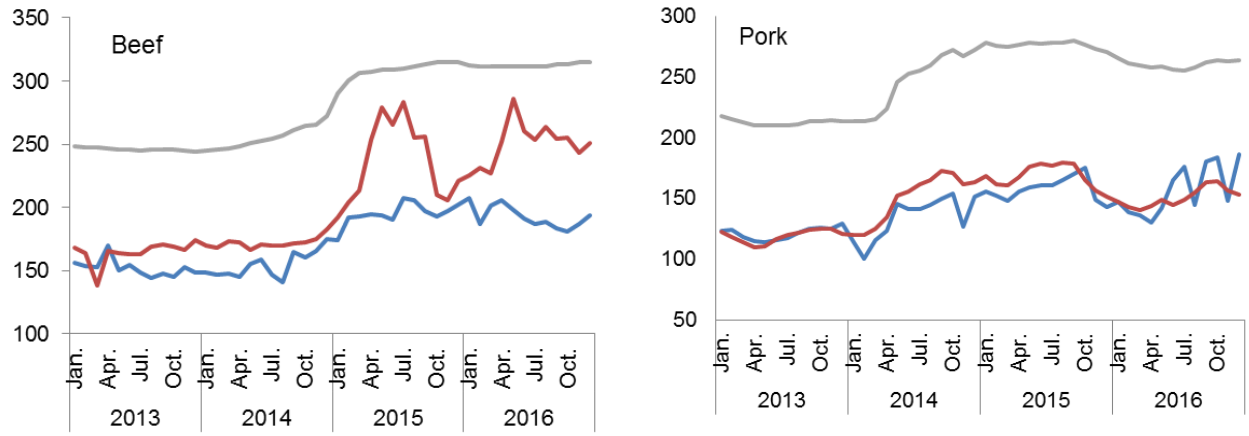
Figure 83. Agricultural and food industry outputs

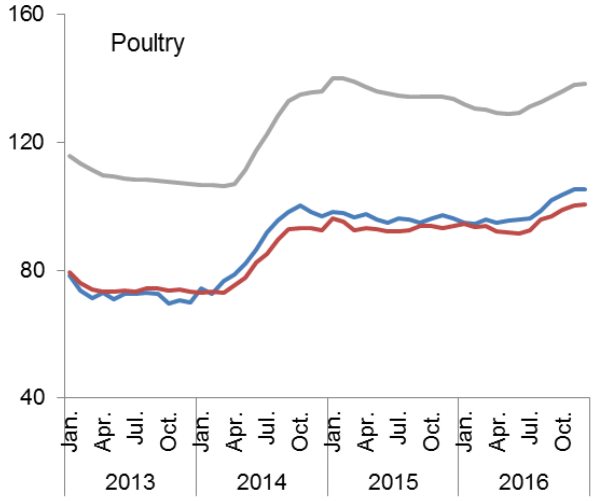


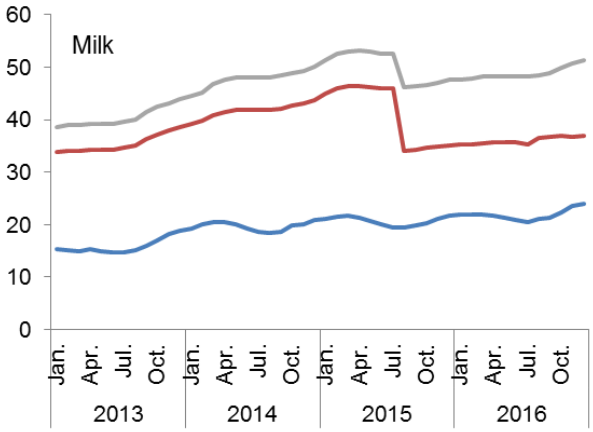
Source: Rosstat.

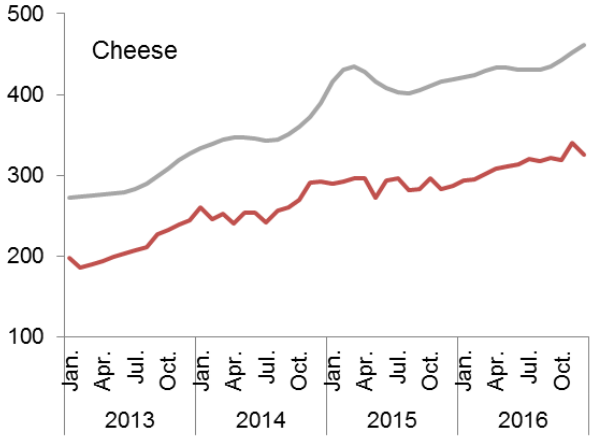
One of key factors slowing down growth in the 2016 food price index was the price correction that followed a leap in prices in the aftermath of the *counter-sanctions* and the *weakening of the ruble* (Figure 84). With restrictions imposed on imports in 2015, producers capitalised on the situation and raised their prices. In doing so, they sought to set off costs growing as a result of imported components becoming more expensive (as the ruble weakened), as well as to fatten profits. However, the limited consumer demand of 2016 acted as a deterrent to price growth driven by raising costs, undermining corporations' financial resilience. Moving forwards, we are going to see that agricultural production's high margins as a counter-price buffer in an environment of limited household income are going to be less relevant. Therefore, we expect this price disparity, caused by the downward price correction in 2016, to even out gradually in the course of the year.

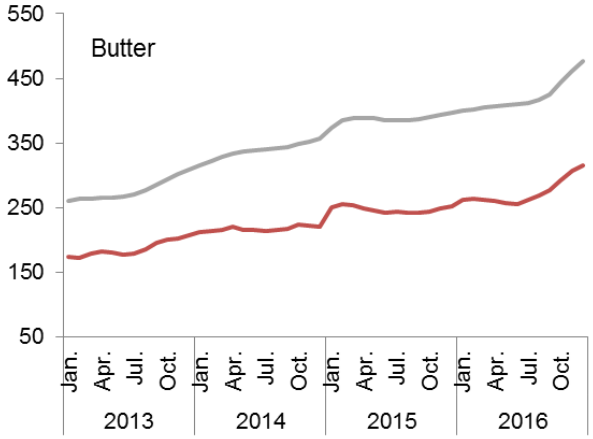
Figure 84. Agricultural producer, processor and consumer prices (seasonally unadjusted), rubles/kg

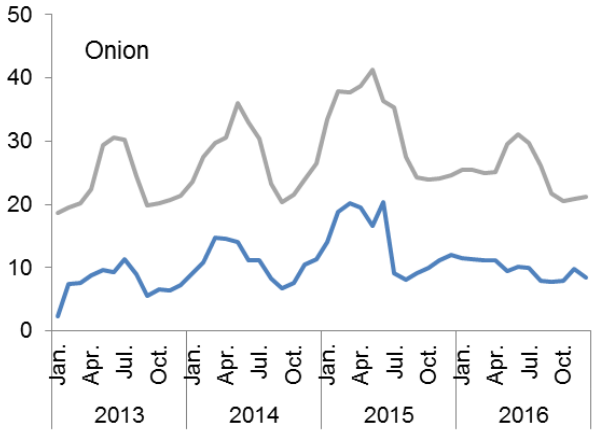


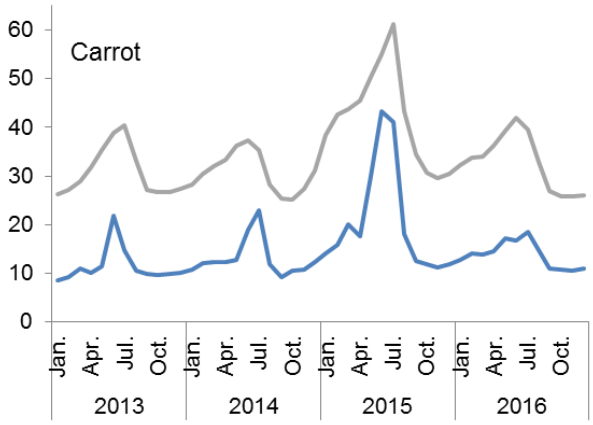

Poultry
160
120
80
40
Jan. Apr. Jul. Oct.
2013
2014
2015
2016

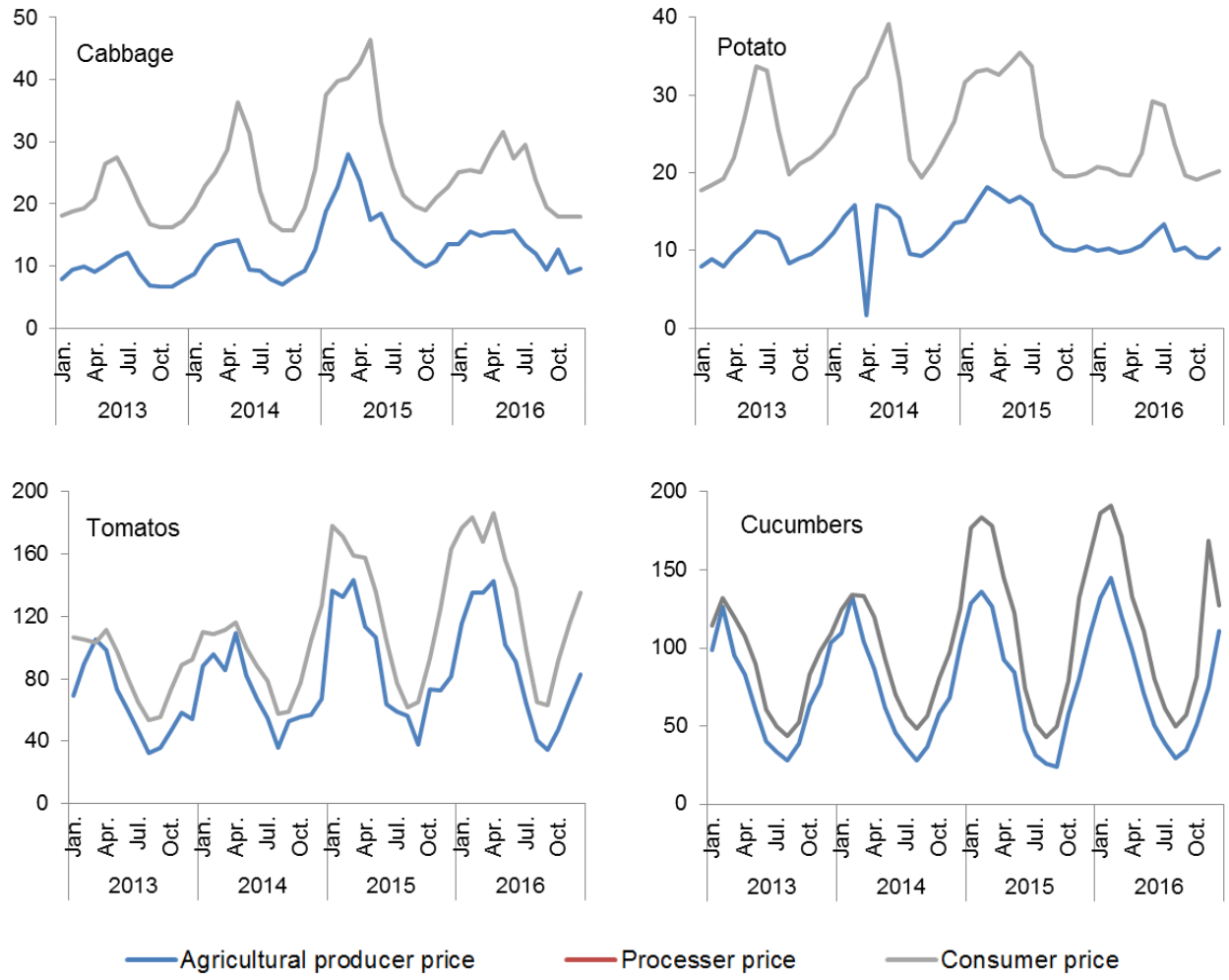

Milk
60
50
40
30
20
10
0
Jan. Apr. Jul. Oct.
2013
2014
2015
2016


Cheese
500
400
300
200
100
Jan. Apr. Jul. Oct.
2013
2014
2015
2016


Butter
550
450
350
250
150
50
Jan. Apr. Jul. Oct.
2013
2014
2015
2016

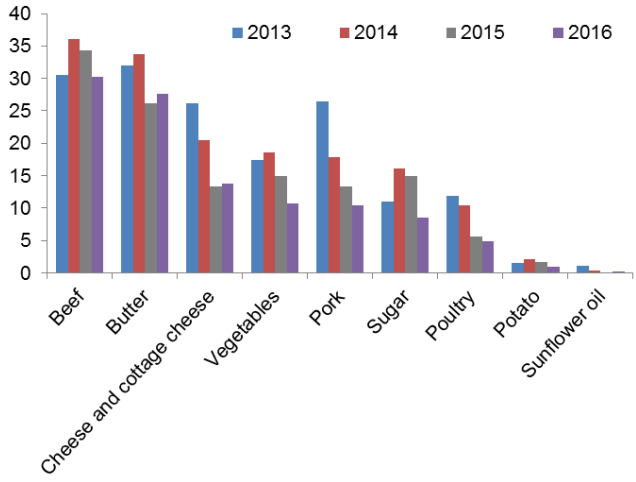

Onion
50
40
30
20
10
0
Jan. Apr. Jul. Oct.
2013
2014
2015
2016


Carrot
60
50
40
30
20
10
0
Jan. Apr. Jul. Oct.
2013
2014
2015
2016



Source: Rosstat.

Figure 85. Imports' share in visible consumption, %



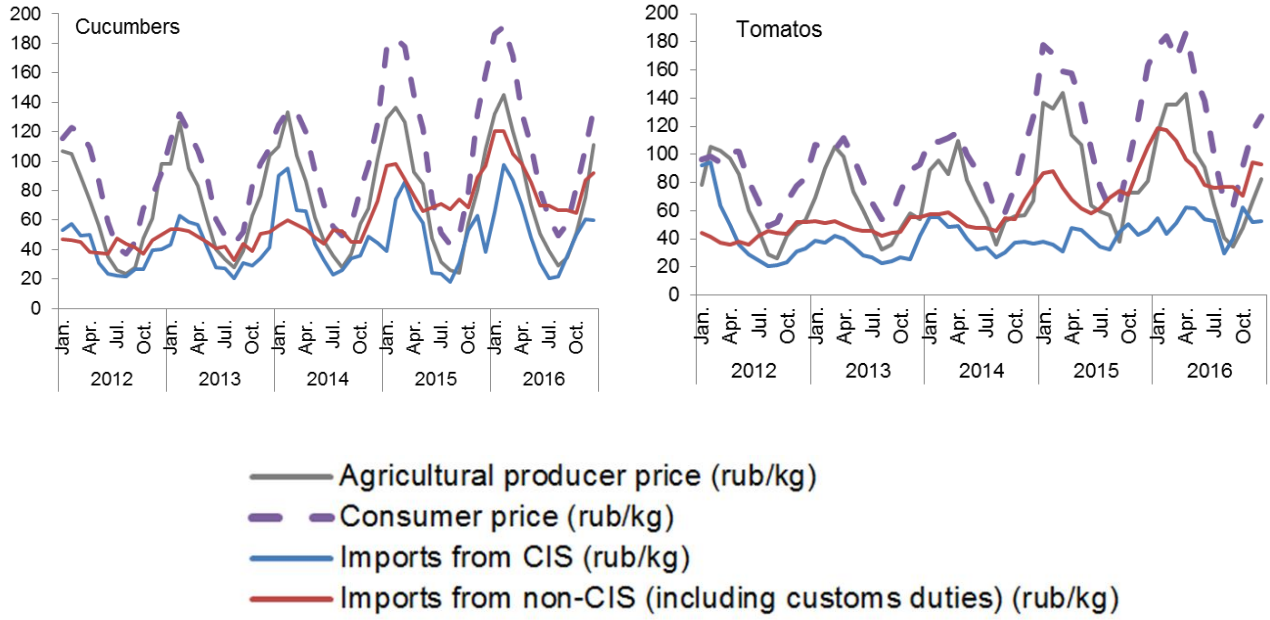
Sources: Rosstat, R&F Department calculations.

With governmental support of the agricultural sector being enacted, the imposed food embargo helped the processes of import substitution in the sector. In 2015–2016, the share of imports of most products was dwindling, suggesting a downward trend (

Figure 85), with positive implications for price stabilisation. However, the potential production capacities are limited in some product categories (several dairy products, greenhouse vegetables) and will not be enough to fully substitute imports (Figure 86).

As domestic agricultural production is growing, with import substitution gaining momentum, some food markets have edged close to full self-production (port, poultry) (Figure 87). Scarce exports of this produce have triggered the risk of market oversaturation, which weigh in on food inflation, dragging it downwards throughout 2016. This factor will continue to be impactful in 2017.

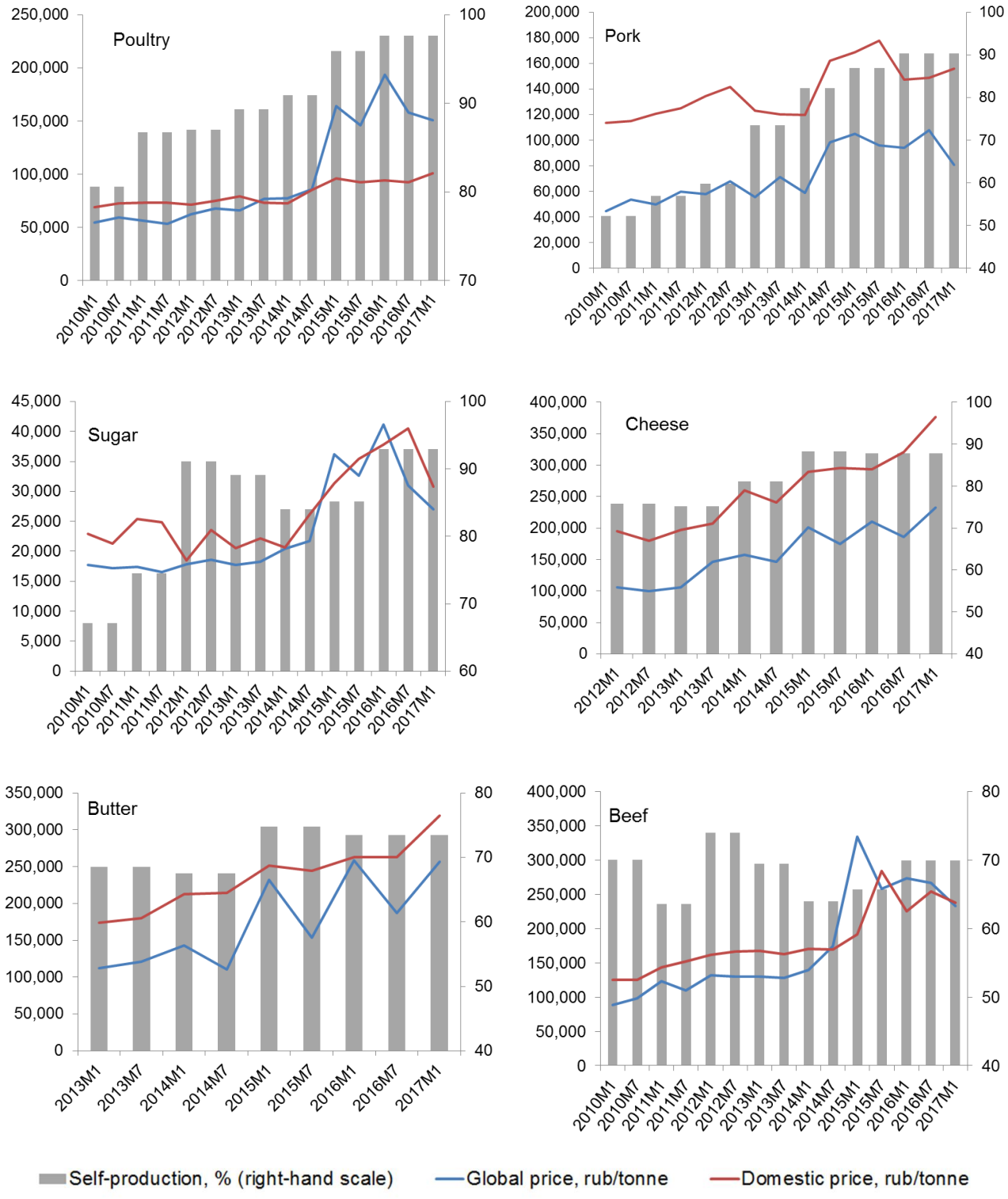
Figure 86. Tomatoes and cucumbers: domestic and global prices



Sources: Rosstat, Federal Customs Service, R&F Department calculations.

The underdeveloped infrastructure and logistics of food markets lead to high input costs. The new logistics centres, constructed in line with the government's agricultural sector support programme, helped extend storage life of vegetables to moderate seasonal price swings in open ground vegetables (potatoes, onions, cabbage, carrots) (Figure 84).

Figure 87. Domestic and global prices. Self-production



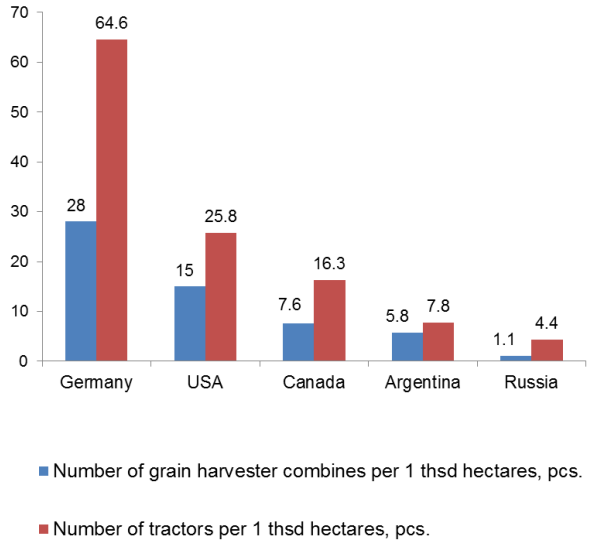
Sources: Rosstat, Federal Customs Service, IMF, Global Dairy Trade, R&F Department calculations

In prior years, agricultural outputs had been growing extensively, with livestock and gross crops rising; at the same time, production efficiency had been growing slowly. As a result, the industry is technically and technologically underdeveloped.

The low paces of technical and technological upgrades finding their way into the agricultural sector are working against a potential boost in competitiveness and reduce the sector' resilience to climate and weather conditions - which may result in price fluctuations in the agricultural market. On top of that, the still heavy reliance of the sector on imports of equipment, plant protection tools and equipment, seeds and young breeders entails a strong impact from the exchange rate on volumes of production.

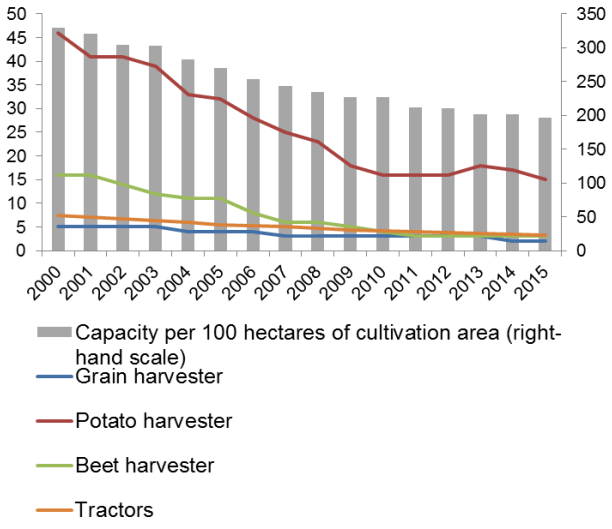
The technological backwardness is explained by a high percentage of obsolete equipment in operation and the continued contraction of the agricultural equipment fleet. The latter is technologically much behind that in advanced economies (Figure 88, Figure 89). The sector's reliance on some types of foreign equipment is explained by the fact that their Russia-made substitutes are either non-existent or technologically inferior to Western models. In plant production, this reliance has been declining slowly as a result of the government's support of farming equipment manufacturers.

Figure 88. Provision of producers from different countries with agricultural equipment (as of 2015)



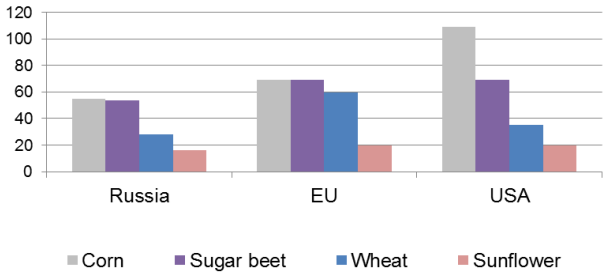
Source: Rostselmash.

Figure 89. Provision with agricultural equipment (units per 1,000 crop hectares) and energy capacity



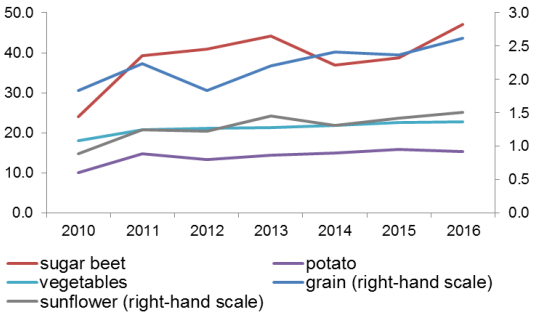
Source: Rosstat.

Figure 90. Core crop yields: Russia, the EU and the US(as of 2016)
hundred kilograms per hectare



Sources: FAO–OECD, Rostselmash.

Figure 91. Crop yield in Russia, 2016, tonnes per hectare



Sources: Rosstat.

Crop productivity increasing technologies (soil improvement, application of mineral fertilisers, use of high-yield seeds, etc.) are rolled out at slower paces in comparison with leading agricultural economies (Figure 90) due to various reasons (high prices on mineral fertilisers, reliance on imports of seeds, etc.). Nevertheless, crop yields are gradually rising in the sectors which supply produce competitive in domestic and external markets (cereal crops, oil crops, sugar beet) (Figure 91).

In livestock farming, provender milling and genetic technologies are central to boosting outputs. Although the recent years saw considerable progress in the efforts to reduce reliance on imports of mixed feed, imports of young breeders account for a high share.

This suggests that the current slowdown in food price growth may prove to be unsustainable. In 2017, a key risk leading to heightened inflationary pressure from the food products side may come from the expiry of recent factors dragging down food inflation, which have been essentially short-lived in nature. At the same time, the structural transformation in the sector, which is meant to boost production efficiency and make a long-term impact on prices, has yet to deliver any prominent outcomes.

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