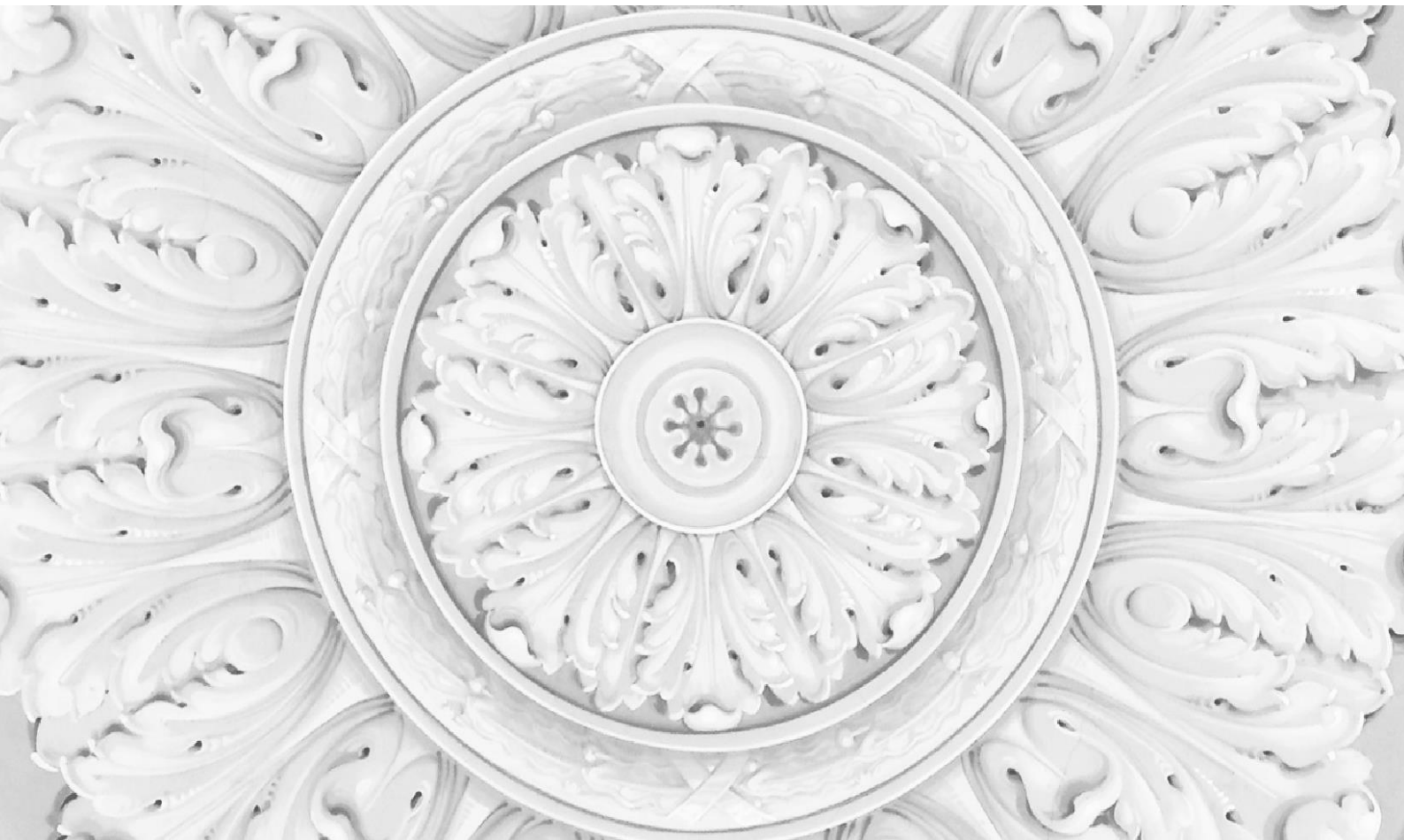




# Bank of Russia

The Central Bank of the Russian Federation



## TALKING TRENDS

Macroeconomics and Markets

May 2016

**Research and Forecasting  
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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](mailto:dip_bulletin@mail.cbr.ru).*

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## Executive summary

### 1. Monthly summary

- **April 2016** saw inflation stabilising, while the economy approached the point of recovery growth and stability risks for the Russian financial markets subsided.
  - **Inflation** is gradually settling down on the path towards its target level, thanks to the current monetary policy stance. However, the risks of inflation exceeding the 4% target in 2017 remain as inflation expectations are declining slowly and the trend towards wages acceleration may well hold. Annual inflation in April stopped its decline, and inflation pressure grew somewhat as the impact of temporary tailwinds weakened.
  - Economic activity in April was probably helped by the growing oil prices. We expect the economy to reach a slow growth path in the next few months in the absence of any new external shocks.
  - Softening in monetary conditions is ongoing, despite the worsened global financial market conditions.

### 2. Outlook

- With the signs of the US economic growth accelerating in early Q2, growth rates in other countries including China stabilising and financial conditions softer than early in the year, a Fed rate increase is now back again on its June meeting agenda. This move triggers the risks of capital outflow from risky asset markets including emerging economies and Russia.
- Short-term macroeconomic statistics and leading indicators suggest a growing probability for the economy to reach positive growth territory in the middle of the year.

### 3. In focus

- The industrial and agricultural surveys conducted by the Institute for Economic Policy and the BoR Research and Forecasting Department (R&F) show a large differential in the estimates of optimal ruble exchange rate, which exposes the benefits of a floating exchange rate for the economy to strike a balance of companies' interests.
- In addition, most respondents spoke in favour of a firm and sustainable exchange rate of the national currency, meaning there are no advantages of an ever weakening ruble to the economy.
- Respondents note that a strong ruble would enable industrial modernisation through purchase of imported equipment, cutting down production costs and boosting product competitiveness in external markets.

## 1. Summary

### **1.1. Inflation is gradually settling down on the path towards 4% for the end of 2017; however, the risks of inflation deviating from the target remain**

Consumer inflation is gradually settling on the path towards 6.5% for the year-end and 4% for the end of 2017. However, between late April and early May, the effect from temporary drivers, which were helping a faster-than-assumed decline in inflation, tapered off. As a result, inflation pressure was somewhat up, seasonality factored in, while annual inflation settled around 7.3% YoY. To put inflation on a firm course towards the target, a further weakening in inflationary pressure will be needed, together with lowered inflation expectations.

#### ***1.1.1. Inflation steadies after a substantial decline***

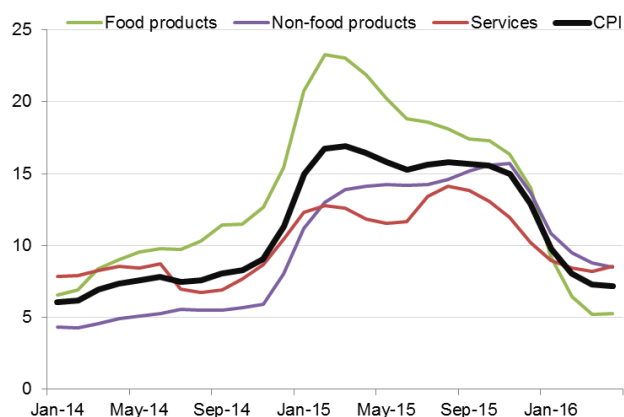
- Once down from 12.9% YoY in late 2015 to 7.3% YoY in March 2016, inflation settled down at this level.
- The favourable effect from declining prices on fruit and vegetables is wearing out. Their annualised prices look poised to accelerate, thereby adding some 0.3–0.5 pp to annual inflation...
- ...Nonetheless, the moderate indexation of regulated prices and rates is set to slow down annual inflation by 0.3–0.4 pp by the end of the year.
- Consequently, inflation is set to recede somewhat from the current figure by the end of the year.

The April inflation totalled 0.44% MoM (seasonally unadjusted). Annualised inflation was level with the March reading of 7.3% YoY. Food inflation was lower than headline and non-food inflation for a fourth consecutive month (Figure 1).

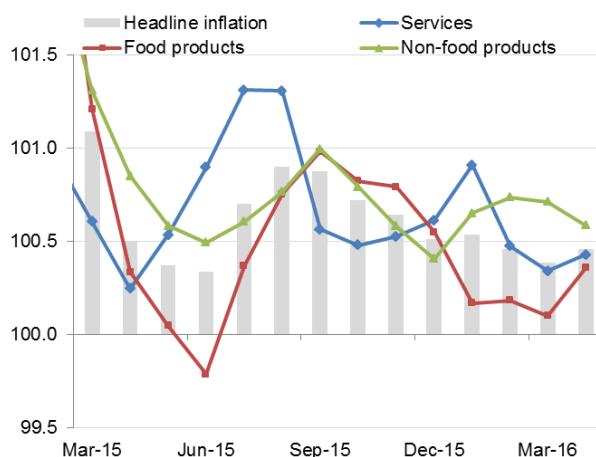
Seasonally adjusted prices were growing in April at a somewhat faster pace of 0.46% MoM, followed by 0.39% in March (Figure 2)<sup>1</sup>. Food price growth accelerated to reach 0.36%<sup>2</sup> vers. 0.10–0.18% in the period between January and March. This is majorly driven by the exhaustion of temporary tailwinds helping check inflation: the good crops of 2015 effect and globally declining food prices. Non-food inflation was down to 0.6% after growing 0.7% MoM in the first quarter, possibly influenced by a strengthened ruble. Inflation in the service sector edged up to 0.4% from 0.3% in March, driven by accelerated rates in the passenger transportation and health resort services sectors.

<sup>1</sup> We use the methodology of component-wise seasonal adjustment of consumer inflation as described in [Talking Trends No. 4](#). The methodology enables us to take into account change in seasonality of individual components (for example, the pass-through of indexation in the housing and utility sector from January to July), which is neglected in standard seasonal adjustment of consumer price index.

<sup>2</sup> Seasonally adjusted inflation indicators MoM are given.

**Figure 1. Core CPI components, % YoY**

Source: Rosstat.

**Figure 2. Core CPI components, % MoM, seasonally adjusted**

Sources: Rosstat, R&F Department calculations.

Food inflation is still checked by the behaviour of meat prices. Last time these were rising in April 2015, followed by twelve months of consecutive decline at the monthly average rate of 0.15%, triggered by tougher competition, as a result of expanding production of domestic poultry and pork.

A certain decline in annual inflation could be expected in the second half of the year, as regulated prices and rates in the housing and utility sector are going to be indexed. Our estimates suggest that the input of these regulated prices and rates totals roughly 1.2 pp. Assuming that the announced plans for rate indexation remain unchanged, for the year-end their input is estimated to drop to 0.85 pp.

A full-fledged seasonal price reduction is due between June and July, as new crops of fruit and vegetables enter the market. Nonetheless, the traditional summer drop in prices may well be less expressed than usual. This is explained by the smaller potential for reduction in the prices for fruit and vegetables, considering that their seasonal growth early in the year was slow<sup>3</sup>. We estimate this factor to add some 0.3%-0.5% to annual inflation.

The week of 11-16 May saw prices rising at the rate of 0.06%. Average daily price growth rate for this period was 0.01%, a minimum seen since August 2015. Fruit and vegetables were becoming cheaper for the first time since early April, contrary to the typical trends, and the prices within this product category showed mixed performance<sup>4</sup>.

The current behaviour of inflation since the start of the year has been close to the 2013 path, which enables inflation to reach 6.5% for the year-end (Figure 4). Prices were

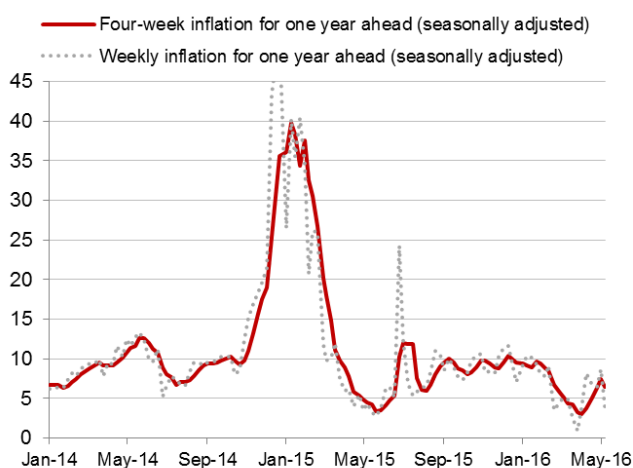
<sup>3</sup> Our estimates suggest that fruit and vegetable prices for the first three months fell 5.7%, seasonally adjusted, stabilising in April (up 0.2% MoM).

<sup>4</sup> Prices for cucumbers and tomatoes dropped; prices for open ground vegetables rose.

growing since early May by 0.24%, which raises the prospect of full-month annualised inflation totalling 7.3%. Seasonally adjusted four weeks' inflation (calculated twelve-month ahead) slowed down from 7.4% to 6.5% (Figure 3).

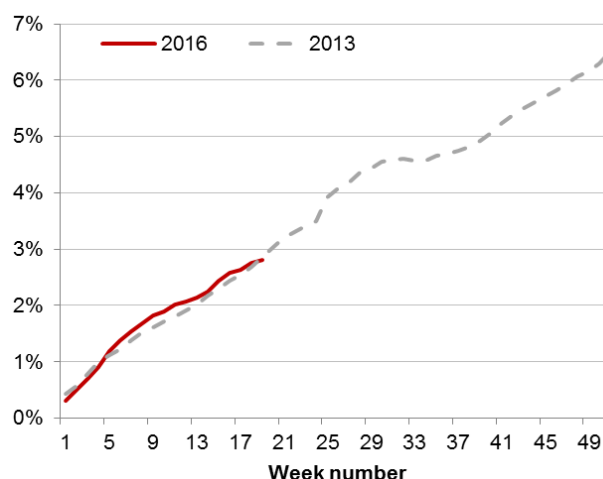
Between April and May, inflation showed fairly positive developments, resulting in no change in annual price growth rates, notwithstanding the past year's low base effect. However, the risks that annual inflation may be higher in the second half of 2016 remain, in the backdrop of high inflation expectations and accelerated wage growth. A correlation between the amount by which natural monopolies' rates are indexed and fiscal policy decisions and the inflation target would help drag down inflation risks.

**Figure 3. Seasonally adjusted weekly inflation calculated for one year ahead, %**



Sources: Rosstat, R&F Department calculations.

**Figure 4. Inflation accrued since the start of the year, 2013 and 2016 (weekly data)**



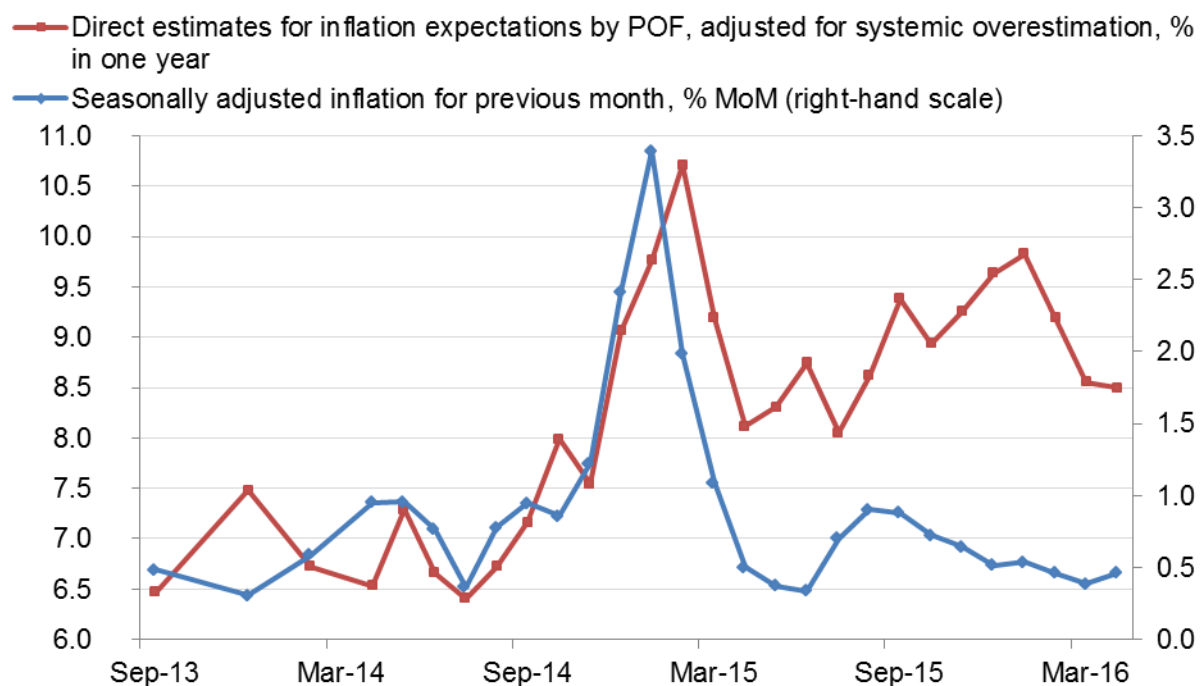
Sources: Rosstat, R&F Department calculations.

### **1.1.2. Inflation expectations in April: the decline stopped**

According to InFom-conducted April surveys, R&F adjusted for systematic overestimation, inflation expectations were only slightly down from 8.55% in March to 8.5% in April (Figure 5)<sup>5</sup>.

Inflation expectations remain stubbornly heightened, which is especially obvious when compared to the current inflation data. Importantly, with the comparable rate of price expansion, the expectations were a lot lower in 2013.

<sup>5</sup> Please refer to [Talking Trends No. 3, January 2016](#), subsection 1.3.2 'Inflation expectations continue growing in January', for the calculation methodology.

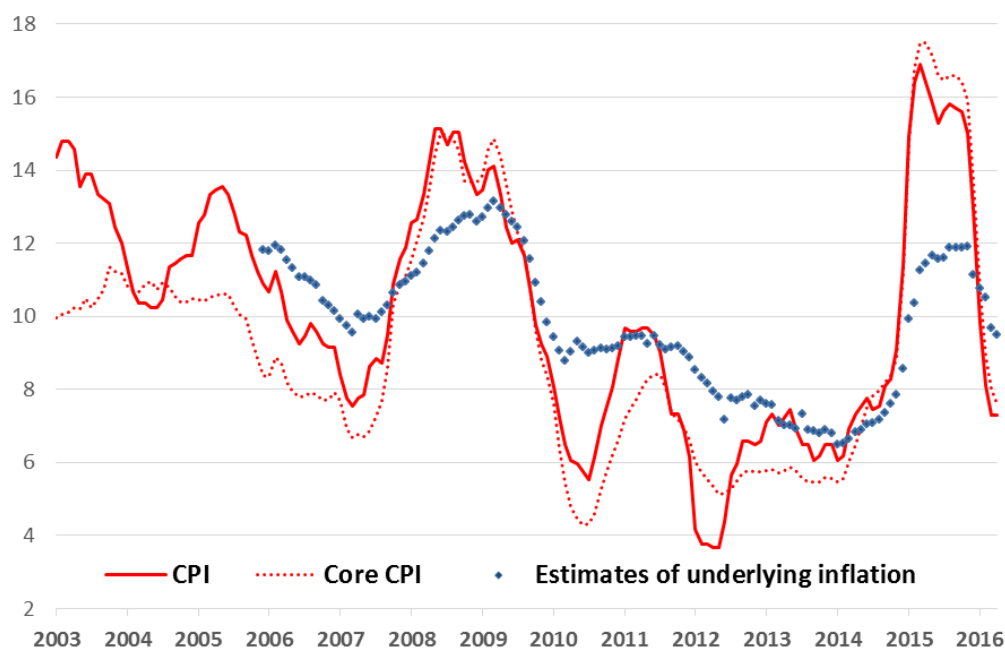
**Figure 5. Inflation expectations and actual inflation data**

Sources: Rosstat, inFOM LLC, R&F Department calculations.

### **1.1.3. Underlying inflation is gradually receding**

- Annual rates of underlying inflation in April are estimated to drop to 9.5% from the March reading of 9.7%.
- If the current trends in the performance of prices and monetary aggregates hold, we expect a progressive decrease in underlying inflation.



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

Sources: Rosstat, R&F Department calculations.

#### **1.1.4. The strengthening of the ruble is weakly reflected in the performance of ex-factory and purchase prices**

- The past April's strengthening of the ruble had only partial slowdown implications for product price dynamics in manufacturing...
- ... Which could be attributable to delayed pass-through effect on prices from the ruble weakening in early 2016.

Price pressure in manufacturing and in the service sector remains heightened (Figure 7 and Figure 8). The growth of ex-factory prices in manufacturing in April accelerated, in a sign that prices in the manufacturing sector are weakly responsive to the recent strengthening of the ruble. The current price readings in manufacturing PMIs are comparable to those observed in late 2015. The ruble then gained a mere 5.5%<sup>6</sup> against 11.6% seen between March and April. This price performance may well be evidence to producers checking in their growth at the time the ruble was weakening early in the year, hence the moderate response for the turnaround in the ruble dynamics.

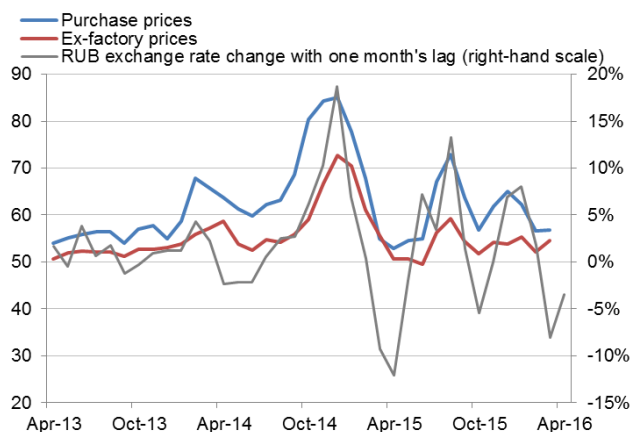
In the service sector, the trend towards accelerated growth in purchase prices has been observed for a second month in a row, while ex-factory prices showed a slight slowdown. Such divergence usually results in accelerated growth of the latter. The

<sup>6</sup> Calculated at nominal effective exchange rate.



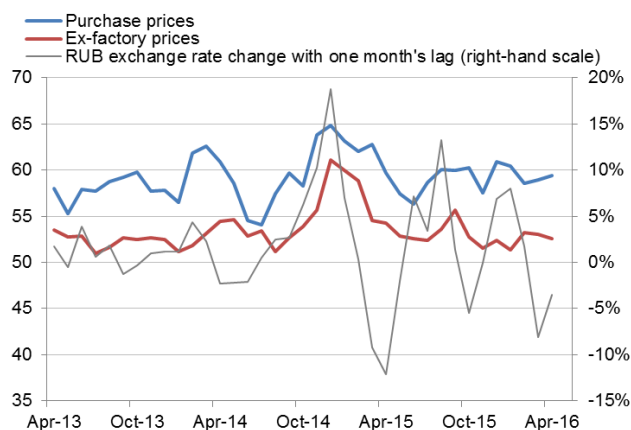
positive business activity of late may well help this trend. However, the recent ruble appreciation is set to stabilise price pressure.

**Figure 7. Price movements, Manufacturing PMI**



Sources: Rosstat, R&F Department calculations.

**Figure 8. Price movements, Services PMI**

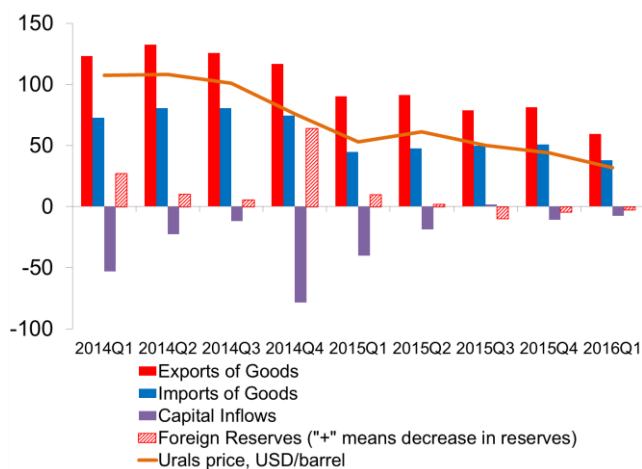


Sources: Rosstat, R&F Department calculations.

### **1.1.5. Balance of payments between January and April 2016: the decline in capital outflows continues**

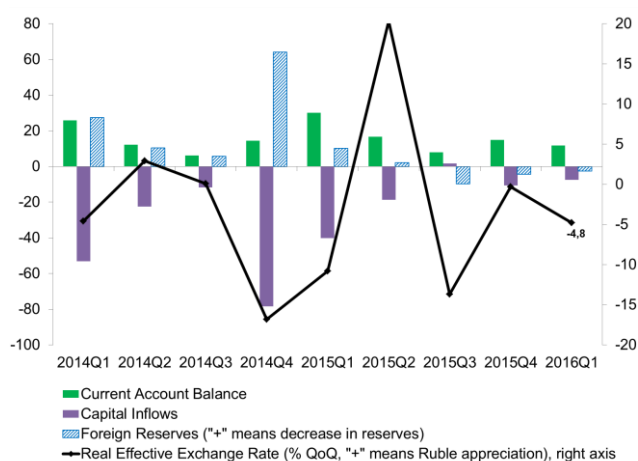
The balance of payments released for the period January through April 2016 suggested that current account surplus was down to \$16.3 billion, as a result of a weaker Urals that lost some \$8 a barrel averagely compared to 2015 Q4. Concurrently, imports performed fairly strongly, considering the stubbornly weak demand in the economy and the weaker ruble (Figure 9 and Figure 10).

**Figure 9. Key balance of payments components, billion USD**



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

**Figure 10. Key balance of payments components, billion USD**



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

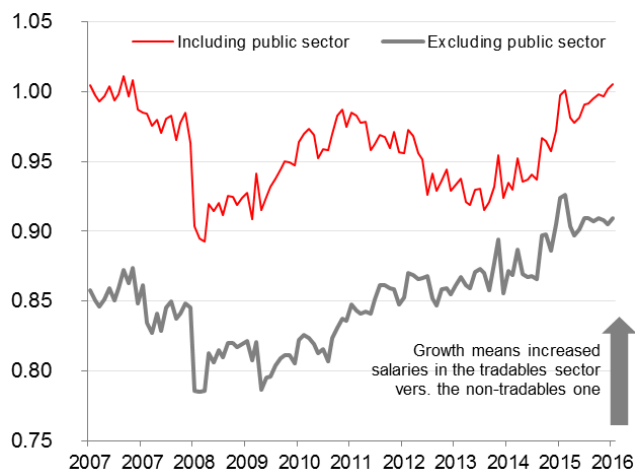
The private sector-conducted net capital outflows in the period between January and April were down to \$12.8 billion. Estimates suggest that Q1 capital outflows were mainly driven by contracting external liabilities of the private sector, banks in the first place. These developments had far weaker implications for companies still refinancing most of their external debt.

We think that the strengthening of the ruble may prove weak unless helped by a further growth in the price of crude as capital outflows persist. The current supply and demand balance in the oil market points to an ongoing high uncertainty with regard to the direction and the paces oil prices will be showing in the months ahead.

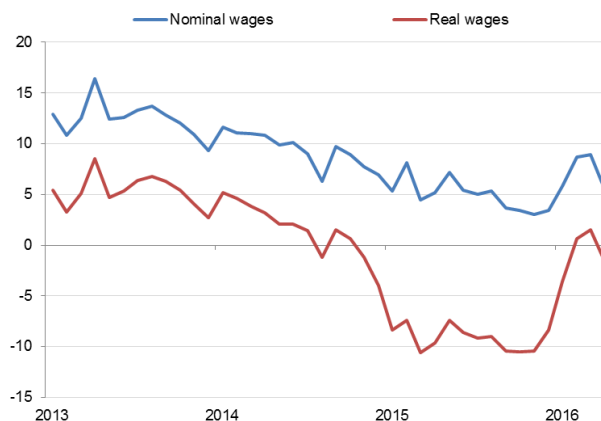
#### **1.1.6. Wage growth is slowing down; inflation risks remain**

- Wage growth in April slowed down compared to the first quarter; yet it would be premature to report that inflation risks are abating.
- The weak wage growth in the public sector helps support the trend towards change in relative labour compensation in the tradable and non-tradable sector, enabling to keep inflationary pressure in check.

Rosstat statistics on wage performance suggest that nominal wages decelerated to 5.4% YoY in April (Figure 12), following their acceleration in the first quarter to 7.7% YoY. Consequently, real wages were falling yet again, after posting, in February and March, growth for the first time since late 2014. Wage data for April are judgement-based and may well be reviewed subsequently, making premature any conclusion for a temporary acceleration of their growth in the first quarter.

**Figure 11. Wage ratio in the tradable to non-tradable sectors<sup>7</sup>**

Sources: Rosstat, R&F Department calculations.

**Figure 12. Wage performance, % YoY**

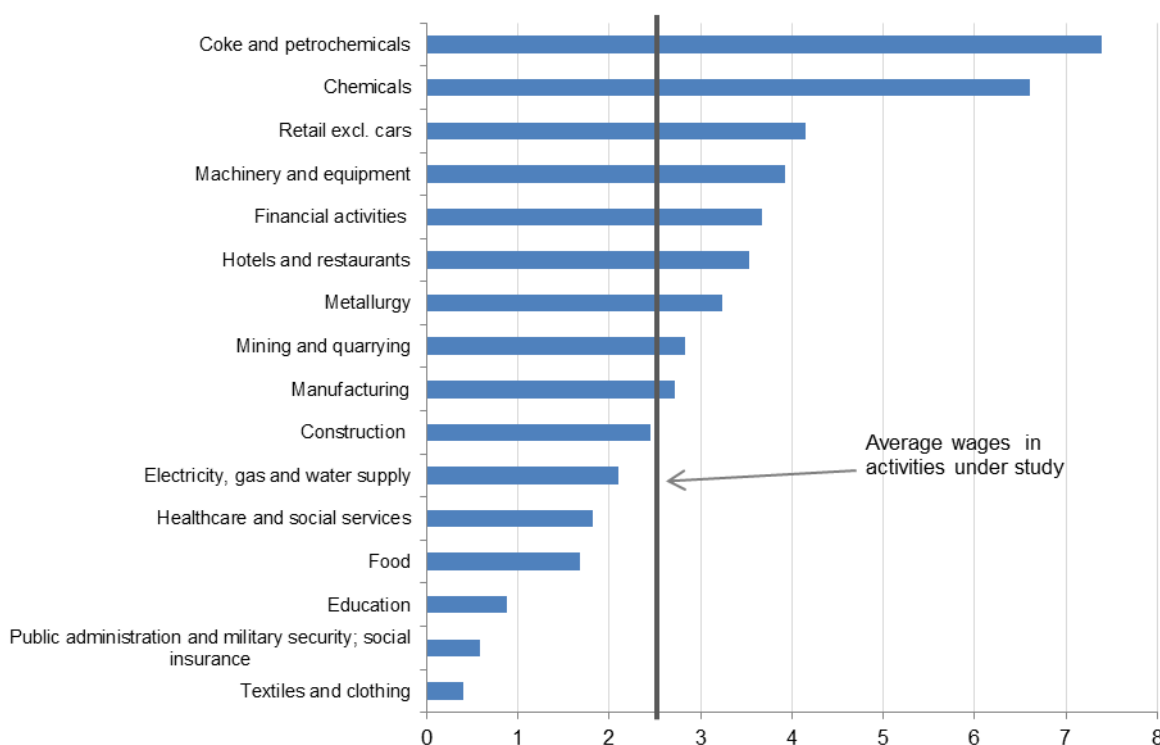
Source: Rosstat.

As seen from Q1 wage statistics by economic activity, the acceleration observed was heterogeneous in nature (Figure 13). The strongest growth was posted by chemicals and petrochemicals. Quite as a surprise came retail expansion, considering the continued fall in its turnover in real terms. Wages in the food and textile industry fared worse than average. On the one hand, this signals weaker pressure on ex-factory prices on the labour cost side in these sectors. On the other, this may well be explained by the inability to raise wages as profit margins are low – meaning that prices are set to rise at outstripping paces once the situation normalises.

Wage growth in the public sector still constrains labour compensation in the overall economy. Also, the low indexation of public sector salaries supports change in relative labour compensation in the tradable and non-tradable sectors (Figure 11). The tradables to non-tradables compensation ratio is back to 2007 levels. Once the public sector is taken out of calculations, this ratio becomes even higher than in 2007. This suggests that public sector salaries have been recently rising at outrunning paces (especially between 2011 and 2014), which is why the current course of fiscal policy, inasmuch as it seeks to constrain costs of labour, looks fairly sensible and helps check inflationary pressures. Should the stance change, inflation risks look set to amplify.

<sup>7</sup> Wages are seasonally adjusted.

**Figure 13. Nominal wage growth in 2016 Q1 vers. 2015 Q4, seasonally adjusted, % QoQ**



Sources: Rosstat, R&F Department calculations.

## 1.2. Structural shifts in the economy bring the moment of recovery growth closer

As industrial dynamics suggest, outputs look set to return to expansion territory shortly, in the absence of new shocks. On the back of a strengthened ruble, the non-tradable sector's prospects improved, while there are more signs of a slow recovery in the non-tradable one.

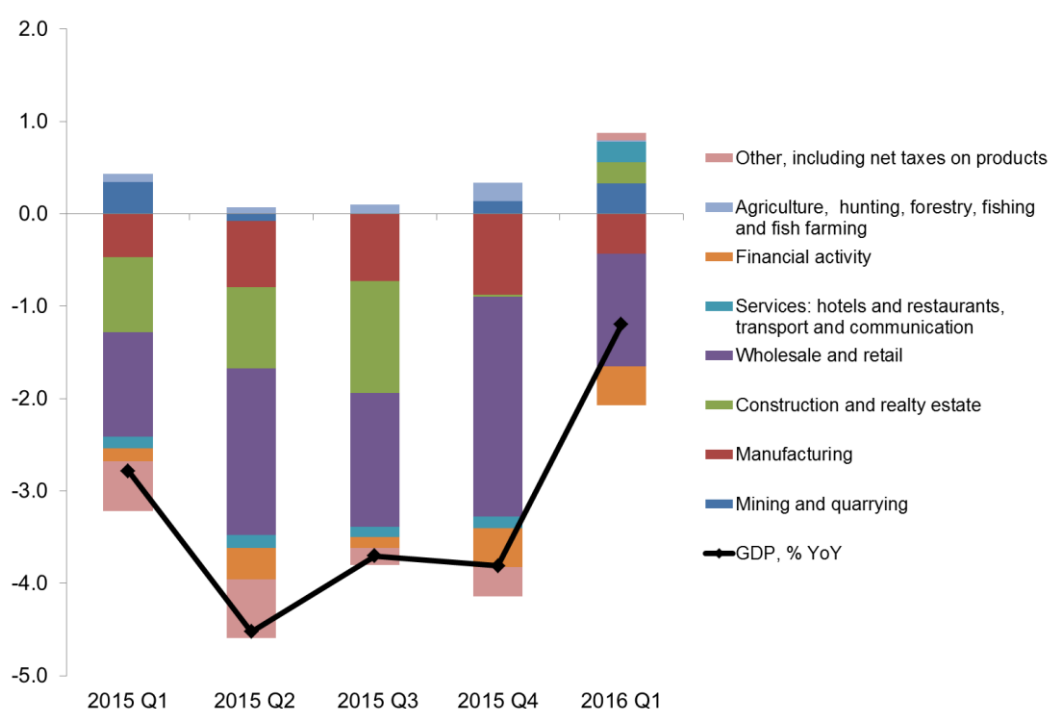
### 1.2.1. Q1 GDP: better than expected

- Tentative Rosstat estimate for 2016 GDP growth proved better than many analysts' expectations and our estimates.
- Short-term monthly statistics show that the current GDP dynamics are helped by the industries centred on domestic production and consumption.
- The latter come as precursors of positive trends in consumption and investment in Q1 GDP structure.
- Once the external backdrop stabilises, the economy is poised to show some growth as early as the current quarter.

Tentative Rosstat estimates suggest that 2016 Q1 posted a 1.2% YoY decline in GDP. This figure proved more optimistic compared to most analysts' expectations. As R&F Department estimates suggest, Rosstat's 1.2% annualised GDP decline lines up with a seasonally adjusted quarterly 0.1% GDP contraction.

Based on the analysis of individual short-term GDP components used to build the first Rosstat estimate for the first quarter, it is evident that the slowdown in GDP contraction, both annualised and for the reporting quarter, occurred on the back of improvements in most economic activities (Figure 14). The economy bottomed out and, barring new external shocks, has every chance to return to growth.

**Figure 14. Activity-based decomposition of annual GDP growth rates**



Importantly, the best output statistics came from domestic consumption-related activities. Wholesale and retail were the sectors that made the strongest impact on the slowdown of contraction. Although a meaningful role as regards this GDP component was also played by the base effect after the lacklustre start of 2015, the latest release of monthly statistical data suggests that turnover and consumer activity, albeit still low, are gradually bottoming out.

This is supported by the positive PMI data suggesting that the service sector fares well enough. This is mainly helped by tourism-related industries including those centred on foreign travellers.

Based on our assessment of the trend component, manufacturing, with its industries posting mixed output data, shows signs of growth emerging in consumer demand sectors (see also Section 1.2.3 'Outputs in consumer demand sectors register an upward trend in production').

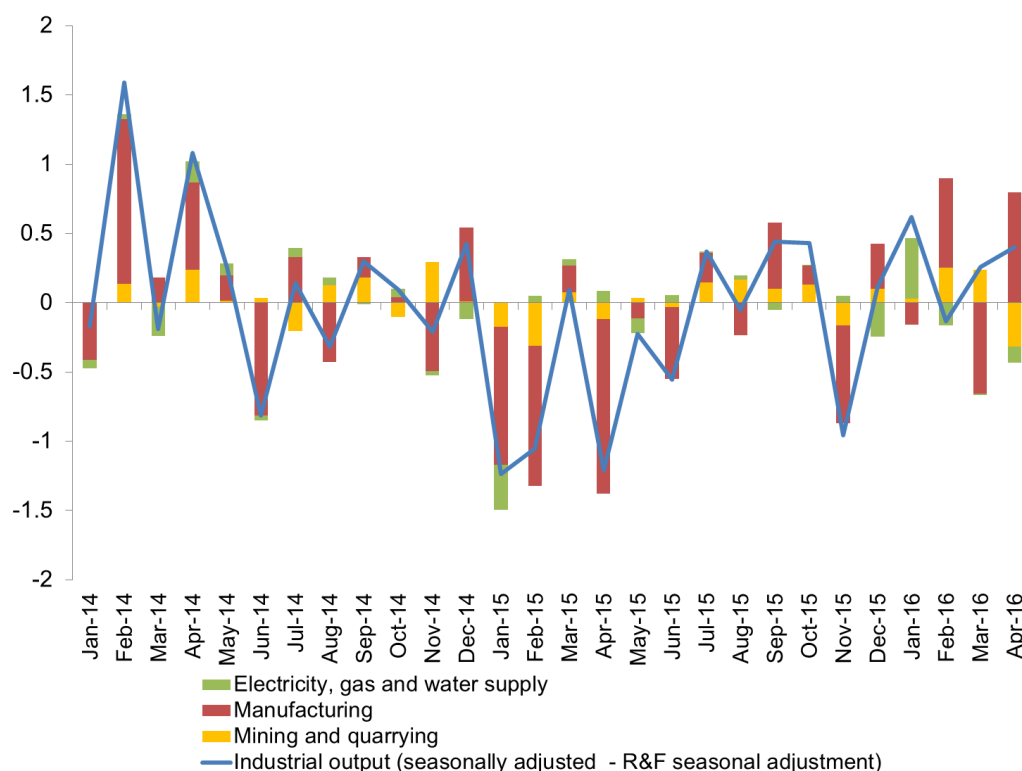
### 1.2.2. Industrial output in April suggests muted optimism

- Monthly industrial output data remain volatile enough to see the onset of a clearly positive trend.
- Manufacturing was probably helped by a growing oil prices, posting fairly strong data in April.
- Barring new external shocks, we expect manufacturing to gradually hit a slow growth path.

Rosstat's industrial output data for April indicated that recession is at an end and economic activity demonstrates nascent gradual recovery. According to Rosstat, seasonally adjusted industrial production in April was unchanged (+0.0% MoM). R&F Department estimates, with the seasonally adjusted growth of 0.4% MoM, are somewhat more positive.

However, given the turbulence of external conditions over the recent months and the structural change in the tradable and non-tradable sectors, the rebound in production remains extremely fragile, as indicated by multidirectional monthly output data in individual industries. Strong output fluctuations are also observed in core economic activities (Figure 15). The March mining growth of 0.7% (seasonally adjusted), mainly triggered by well performing oil and natural gas production, was followed by a 0.9% MoM contraction in April.

**Figure 15. Contribution of individual components to Industrial Production Index, % MoM (seasonally adjusted)**



Sources: Rosstat, R&F Department calculations.

The performance of manufacturing has been rather volatile since February. We partially attribute this to the leap year effect, which could have been underestimated in calculating seasonal adjustment. In such a way, the underestimated extra calendar day in February resulted in overestimated monthly rates of increment, which in its turn caused downward bias in the respective March estimate. Hence, the 1.5% MoM growth (seasonally adjusted) in manufacturing we recorded in April, signals more objectively resumed industrial growth. However, mature conclusions about the structure of the April growth in manufacturing can only be drawn once the analysis of outputs is made for individual industries.

It is still premature to speak on a sustainable economic recovery. Last month's support to manufacturing came from the rise in oil prices as seen between March and April. The current supply and demand balance is nonetheless indicative of the risks that crude prices might drop before long, rather than stay at current levels or even rise more.

Taking into account the traditional volatility of short-term macro statistics, as well as their high sensitivity to the external environment, we envisage that the key industrial production component will remain volatile in the next few months. Having said this, provided that there are no new shocks emerging from outside, the economy looks poised to hit a sustainable moderate growth over the next few months.

### ***1.2.3. Outputs in consumer demand sectors register an upward trend in production***

- In April 2016, consumer demand sectors started to show a trend towards growth.
- Aggregate output of investment demand sectors continued to decline, albeit with lower rates.
- Output in the group of intermediate demand sectors was changing over from growth to contraction.

Recovery in the production of investment products is checked by low investment activity (Figure 16). Outputs of construction materials, machinery and equipment still post negative trends. Improvements in the output of transport vehicles and equipment were behind a less pronounced contraction in the overall group of investment industries, seen since the start of the year. However, the break-point in negative developments in this group of industries is yet to come.

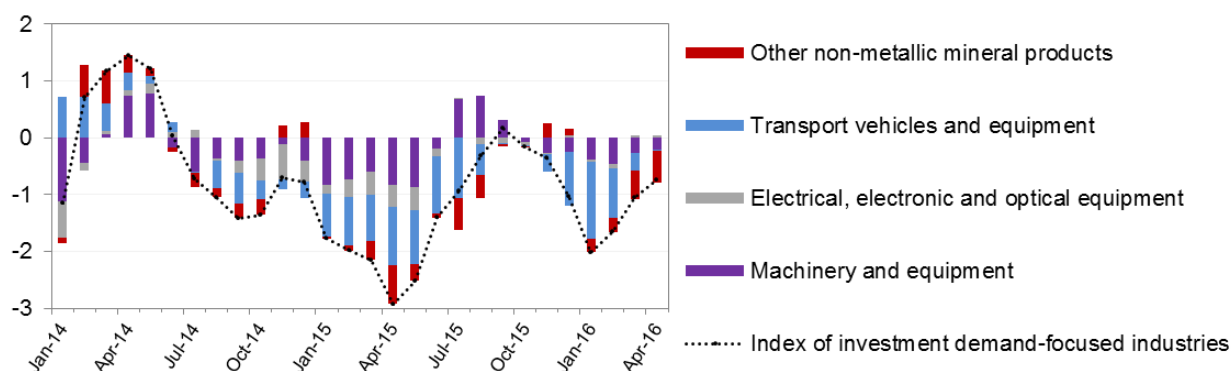
Selective import substitution, occurring in certain product categories, has so far had only limited implications for the output in investment industries. In the absence of opportunities for fast product diversification of exports, any potential, even short-term, export expansion with non-traditional, more high-tech Russia-made products is limited even with a weak ruble. Therefore, the group of investment industries could potentially improve its performance only if domestic investment demand recovers, helped by reduced macroeconomic uncertainty.



The upward trend in the group of consumer demand industries (Figure 17) was triggered by rising non-food outputs (furniture, clothing and footwear, printing and publishing products). This rise probably occurred on the back of the notable wage growth in 2016 Q1 and more active consumer lending. The outputs of these products are highly elastic in relation to household incomes. The positive impact of food production on the aggregate index of consumer industries has been shrinking, driven by, inter alia, a limited domestic market. The latter fact pushes the problem of foray into external markets even higher on the agenda.

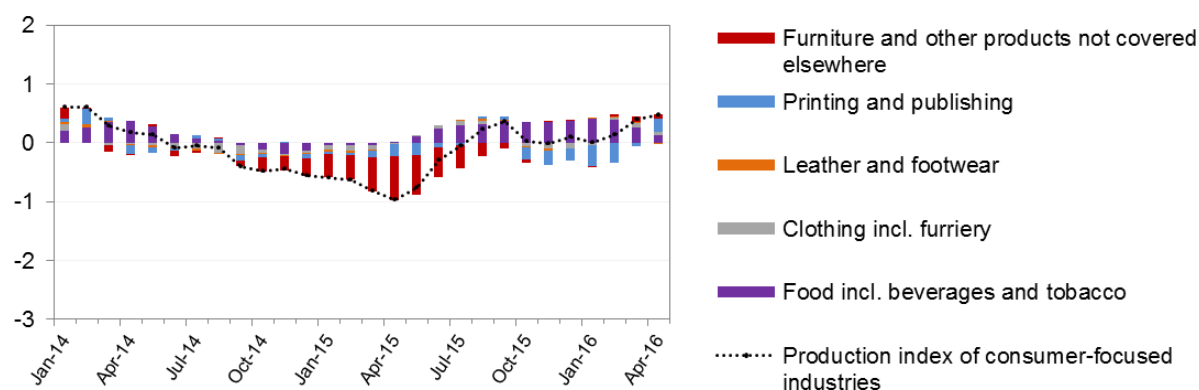
The production index dynamics in the group of intermediate demand industries is to a great extent affected by metallurgy (Figure 18), where volatility is strong. In April 2016, this index fell into negative territory yet again because the metallurgical industry contracted output. This may be explained by the continued output decline in mechanical engineering. Dwindled outputs of wood, coke and oil products, cellulose, wood pulp, paper and cardboard are also noted. The other industries in this cluster in April showed expanded production. Moving forward, any further increase in the production of intermediate products will be limited, influenced by low demand from consumer demand-focused industries and the lack of opportunities for substantial buildup of exports.

**Figure 16. Index of investment demand-focused manufacturing sectors (trend), MoM, %**

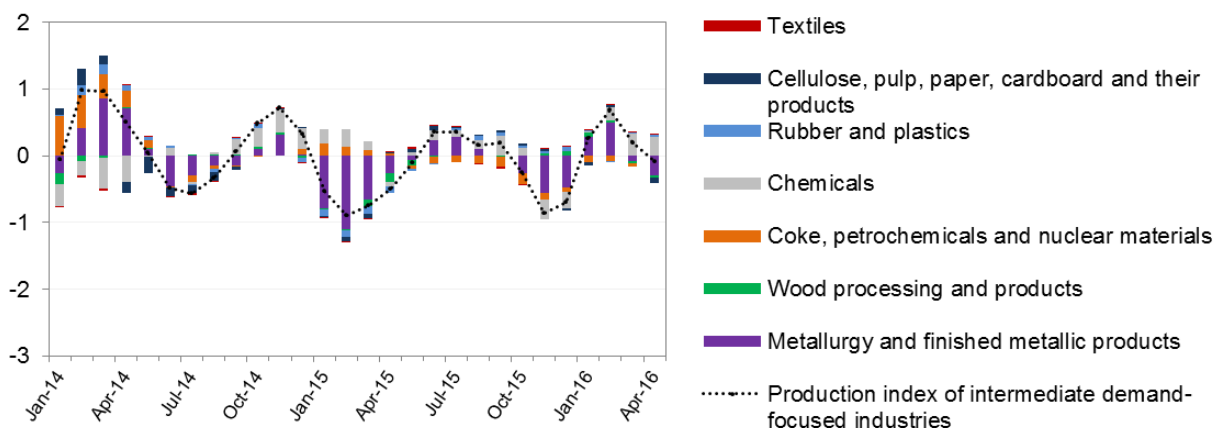


Sources: Rosstat, R&F Department calculations.

**Figure 17. Index of consumer demand-focused manufacturing sectors (trend), MoM, %**



Sources: Rosstat, R&F Department calculations.

**Figure 18. Index of intermediate demand-focused manufacturing sectors (trend), MoM, %**

Sources: Rosstat, R&F Department calculations.

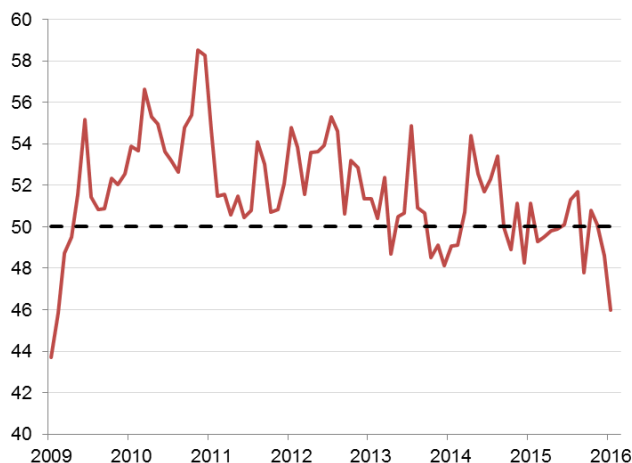
#### 1.2.4. Manufacturing PMI: close to local minimum values

- The April PMI data for the manufacturing sector proved notably worse than our expectations; however, there are no meaningful prerequisites for an economic downturn.
- The negative signals coming from short-term survey data may be overrated.
- In the absence of adverse external shocks, the manufacturing sector is poised for a moderate recovery.

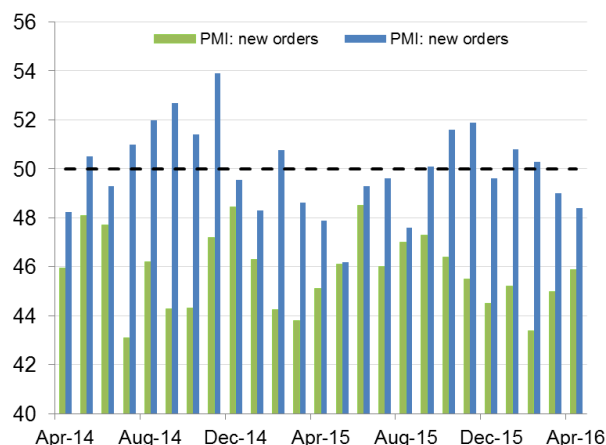
The five-month decline in manufacturing PMI persisted in April. The index dropped to 48 from the March reading of 48.3, having posted a minimal mark since August 2015 (Figure 19. Manufacturing PMI: output ).

It is worrisome that the contraction was mainly due to a lowering output index as the latter hit 46, a minimal reading since May 2009.

The downward trend of PMI was ongoing in new order intake, with some recovery in the amount of export orders (Figure 20). This suggests another trend of concern – the accelerated drop in domestic orders. Everything seems to suggest that the start of the first quarter could fail to match expectations.

**Figure 19. Manufacturing PMI: output**

Source: Bloomberg Finance L.P.

**Figure 20. Manufacturing PMI: new orders**

Source: Bloomberg Finance L.P.

It is important to note that falling manufacturing PMIs correlate to some extent with the negative performance of manufacturing sectors in March. The stronger ruble was hardly behind stalled manufacturing activity. *On the one hand*, potential further expansion in export sectors, on the back of the weaker ruble-induced price competitiveness, is currently limited. *On the other hand*, as the external economic conditions remain uncertain with the ensuing recurrent risks to financial stability, many producers view a strong ruble as a positive factor. This is evidenced by the short-term statistics (see Section 3 'In focus. Preferable ruble exchange rate varies across businesses: survey outcomes'). Furthermore, the April release of production statistics for the manufacturing sector disproves the assumption that a strong ruble is putting sustainable pressure on the manufacturing sector and constrains its output.

From this perspective, therefore, given the favourable oil price movements since early March and the signs of eased monetary policy despite the BoR key rate being left unchanged, we see no meaningful triggers in store for a double-dip recession. This observation gives reason to believe that this April's negative survey results could be explained by the traditional volatility in short-term indicators, a shift in seasonally adjusted estimates because of the leap year effect as well as other technical reasons.

The drop in manufacturing PMIs could be temporary because of the time lag between a turning point in financial conditions change and the time they begin to weigh in on economic indicators.

#### **1.2.5. Services PMI: business activity gains momentum**

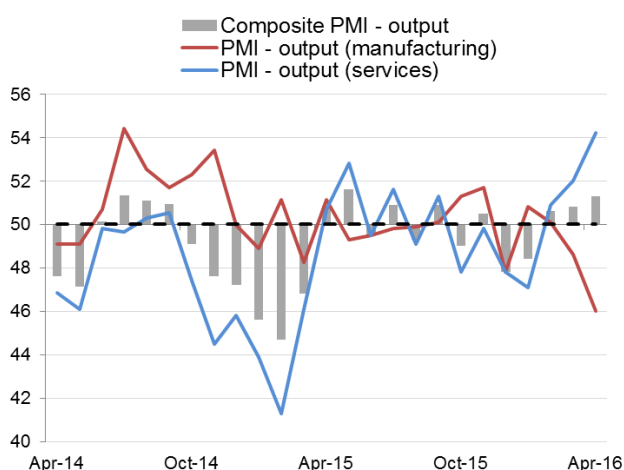
- Business activity in the service sector was at its highest level since early 2013.
- The growth may have been driven by expanding domestic and inbound tourism, and also probably buoyed by other sectors.

The April Services PMI was highest since March 2013 at 54.2, enabling the composite PMI to rise to 51.3 in the face of the continued PMI decline in the manufacturing sector (Figure 21). The Services PMI rose on the back of new orders which grew to 53.2 on 51.7 in March, as well as a slight improvement in incomplete orders where this indicator expanded to 44.8 in April from 43.7 seen in March.

Based on media reports, the best performers were hotels and restaurants. They are capitalising on the rise in domestic tourism and inflows of foreign travellers, helped by a weaker ruble. According to JLL estimates, Q1 hotel occupancy in Moscow, St. Petersburg and Sochi registered expansion against the same period in 2015 and 2014. Everything seems to suggest that the trend will continue into 2016 Q2 as the peak in the tourist season approaches.

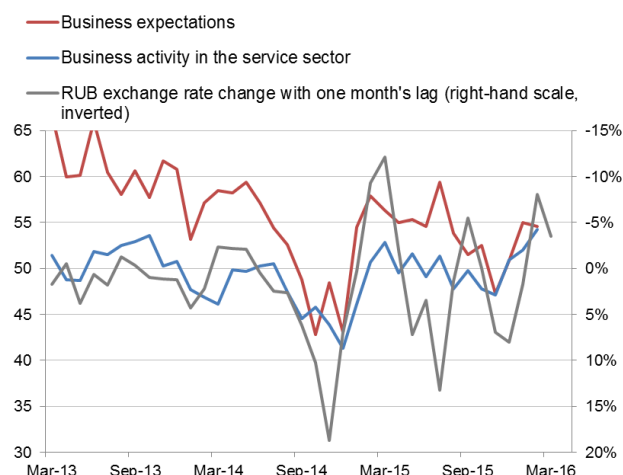
Having said this, this explosive growth can hardly be explained by developments in the sole service subsector. In all probability, revival is finding its way across most service subsectors. This may come as a result of a steadier foreign exchange market and a stronger ruble (Figure 22). Business players in Russia tend to equate the currency exchange fluctuations to the economic situation overall; in such a way, any strengthening in the Russian currency leads to both improved expectations and business activity expansion. From this perspective, it may well be expected that the subsequent performance of the service sector will be largely determined by what happens next in the oil market and, as a consequence, in the forex market. Were the risks of dropping oil prices materialise, PMIs are set to go down, too.

**Figure 21. PMIs: output**



Sources: Rosstat, R&F Department calculations.

**Figure 22. PMIs: business expectations in the service sector and for the ruble exchange rate**



Source: Rosstat, R&F Department calculations.

### 1.2.6. Unemployment is close to natural rates

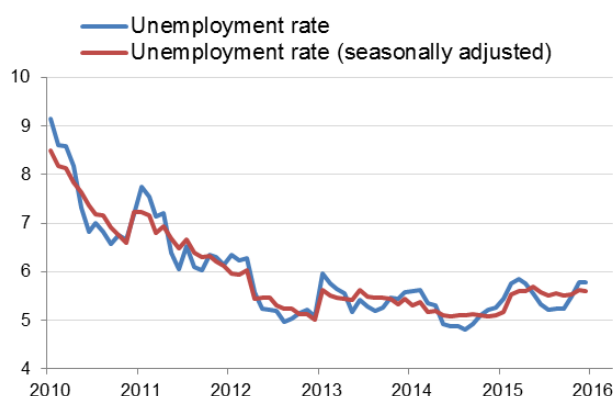
- Unemployment edged down in April to 5.9% from 6% in March, which is season-related in nature.
- Seasonally adjusted unemployment settled down at 5.7%, close to our estimated natural level of 5.5%.
- The fact that the labour market is close to full employment is an indirect sign of only a minor output gap.

The unemployment rate in April was down to 5.9% compared to 6.0% in March (Figure 23). Concurrently, the seasonally adjusted rate of unemployment held at 5.7%, suggesting the absence of any meaningful change in the labour market (Figure 24).

The current unemployment rate is close to its natural level (or NAIRU<sup>8</sup>), which we currently estimate to equal about 5.5%. The Russian economy is close to full employment, driven by currently shrinking numbers of the working-age population. This is the same reason why the natural unemployment level may continue to decline.

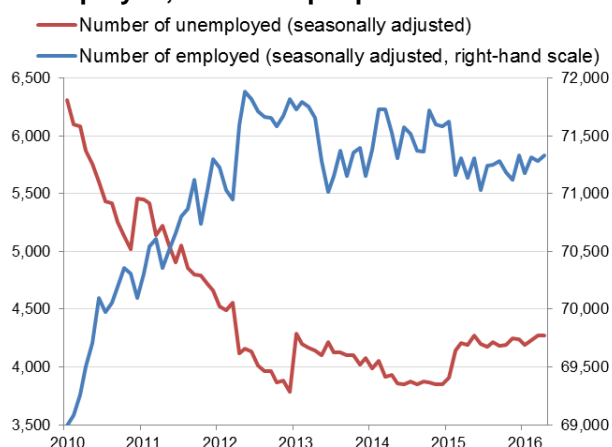
The fact that the labour market is close to full employment is an indirect sign of only a minor output gap. At times of improvement in economic indicators this may be accompanied by stronger inflationary pressure.

**Figure 23. Unemployment, %**



Sources: Rosstat, R&F Department calculations.

**Figure 24. Numbers of employed and unemployed, thousand people**



Source: Rosstat.

<sup>8</sup> Non-accelerating inflation rate of unemployment.

### **1.2.7. Fiscal policy: mixed impact on short-term and mid-term economic growth**

- Budget funds are being spent at faster rates, albeit still behind last year...
- ... Nonetheless, in consideration of the lower revenue, the public sector's effect on economic growth in the first and the second quarter is expected to be neutral.
- The sector's effect on economic growth is expected to be temporarily positive in the second half of the year because the revenue is lower than last year and budget spending is tilted more towards the second half of the year.
- Budget consolidation is needed to make economic growth more sustainable mid- and long-term.

Spending in the budget system in March accelerated against approved annual dimensions, exceeding a two-year path but still behind that of the past year (Figure 25). Healthcare and social spending<sup>9</sup> rose over the previous year, while defence spending declined. Non-interest nominal expenditures were down 3% YoY in the first quarter, which suggests negative effect on GDP from the public sector's final consumption. At the same time, the overall effect of the public sector on GDP may have been negligent due to the declining budget revenue, comparable to spending decrease (stronger *non-oil-and-gas* revenue was able to only partially offset the decline in *oil-and-gas* revenues)<sup>10</sup>.

In the second quarter, we foresee expedited spending of budget funds, while its impact on economic growth remains neutral. Budget funds are expected to be spent at moderate pace, constrained by a tightening in the policy of advance payments in public procurement. Non-interest expenditures could however remain level with last year in nominal terms. Short-term RF Treasury data for April show that non-interest expenditures of the federal budget were on the way towards cutting the gap against their relative performance in the past year, including on the back of further outrunning financing of national defence costs (Figure 26). We anticipate that nominal revenues will be level with last year: helped by the rebound in oil prices, the drop in oil-and-gas revenues is set to be smaller and could be set off by growing non-oil-and-gas revenues.

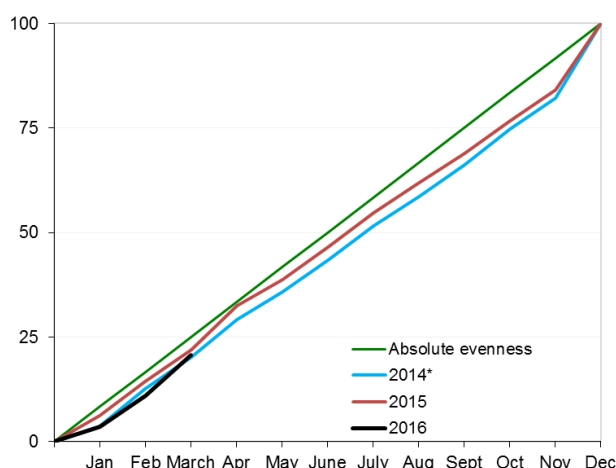
In the second half of the year, the government sector, including regional and municipal budgets and non-budget funds, could have a temporarily positively impact on GDP. Budget costs are expected to be at least 4% higher, and revenues lower than a year ago. At the same time, we note high uncertainty surrounding the budget system's revenues and expenditures. This relates to both external (oil price) and internal drivers (approval / disapproval of decisions affecting government revenue and expenditure).

<sup>9</sup> In both cases in the subsection, healthcare/social spending other than current costs of social services.

<sup>10</sup> Under our estimates, fiscal multipliers of the budget system revenue and expenditure are comparable in terms of value.

In 2016 overall, the budget-induced positive GDP performance could total up to 0.7 pp, at the expense of a drop in revenues and a growing budget deficit<sup>11</sup>. This is set to be a non-recurrent event though. Mid-term, the need to secure a balanced budget is most likely to give rise to temporary negative implications of the government sector's finance for GDP, before public finances reach stability leading and thereby expedite long-term economic growth.

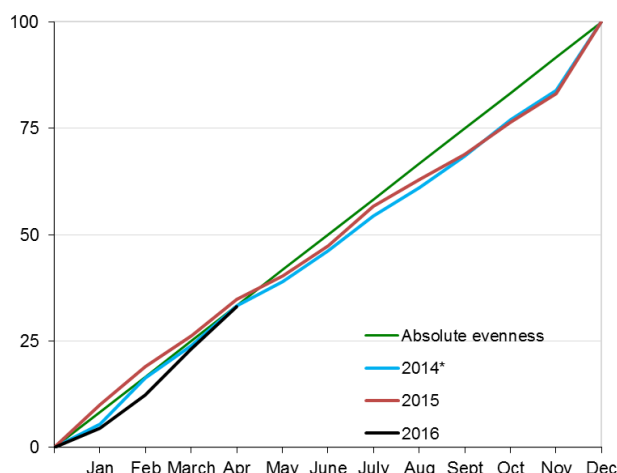
**Figure 25. Evenness in the spending of non-interest funds of the budget system (accrued within the year)**



\* Excluding the funds for capitalisation support of the Deposit Insurance Agency in December

Sources: RF Treasury, R&F Department calculations.

**Figure 26. Evenness in the spending of non-interest funds of the federal budget (accrued within the year)**



\* Excluding the funds for capitalisation support of the Deposit Insurance Agency in December

Sources: RF Treasury, R&F Department calculations.

### 1.3. Global economy, financial and commodity markets

#### 1.3.1. Rate hike is back on the Fed's agenda

- Economic activity started growing in the second quarter after having declined temporarily earlier this year.
- Improvements in the labour market and accelerated price growth enable the Fed to raise the rate at the June board meeting.
- The accommodative policy allows the Chinese authorities to avoid an economic downturn in the short term, but fails to respond to long-term challenges.

<sup>11</sup> Under average Urals oil price \$30 a barrel.



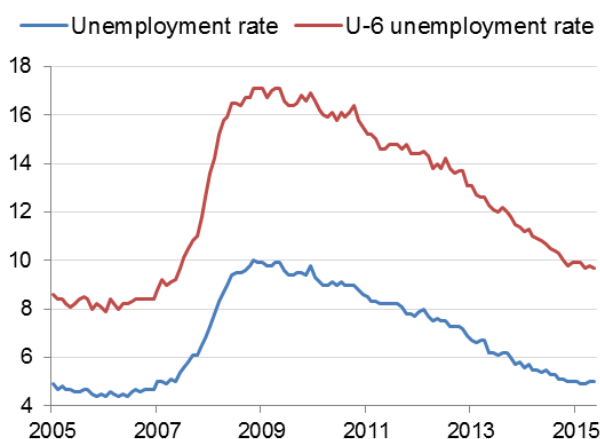
### ***USA: slower growth at the beginning of the year may be of temporary nature***

In the first quarter, the US showed a 0.5% GDP growth, the lowest since 2012 Q4. The indicator fell following a drop in investments (up to 86% in mining and quarrying) and a negative impact of net exports due to a strong US dollar. The May statistics signal that the start-year downturn may be of temporary nature.

In April 2016, the increase in US non-farm payrolls stood at 160 thousand instead of 200 thousand expected earlier. Nevertheless, this rise in jobs points to an improvement in the labour market. Unemployment rate has stabilised at 5%, close to the minimum level since 2007. Part-time employment dynamics are improving: U-6, an unemployment indicator, went down from 9.8% in March to 9.7% in April (Figure 27). Employer surveys held by NFIB and JOLT signal a growing number of open vacancies and difficulties in personnel search. These developments suggest that the wage growth is likely to accelerate in the months to come.

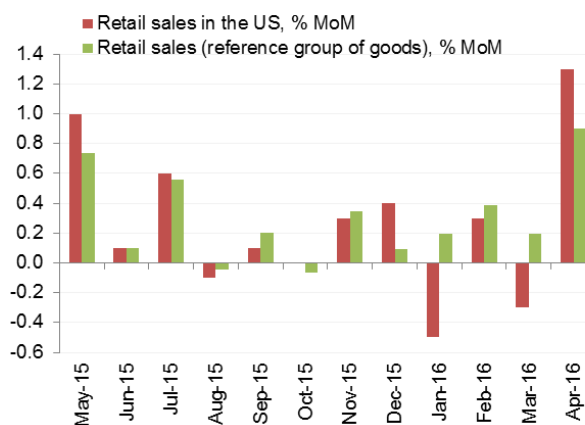
Other indicators also point to economic improvements in the US in April. Retail sales growth reached its maximum since March 2015 – 1.3% MoM, seasonally adjusted. The baseline indicators (adjusted for volatile components) rose by 0.9% MoM after having grown by the average of 0.3% MoM in 2016 Q1 and 0.2% MoM in 2015 as a whole (Figure 28). Better consumer sentiment could have spurred retail sales: the consumer confidence index, calculated by the University of Michigan, hit an 11-month high.

**Figure 27. Unemployment rate, %**



Source: Bloomberg Finance L.P.

**Figure 28. Retail sales, % MoM**



Source: Bloomberg Finance L.P.

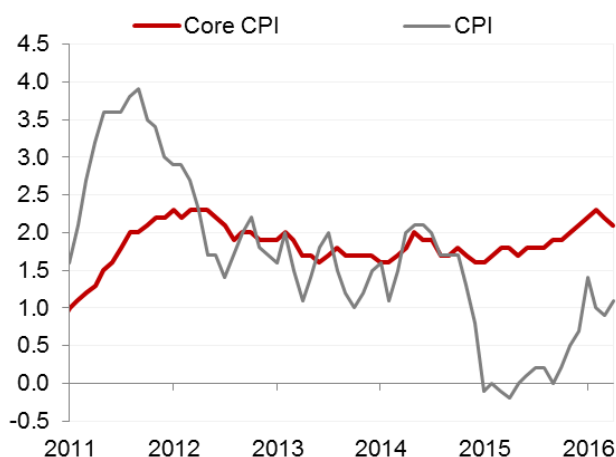
In April, monthly inflation in the US stood at 0.4%, the record readings since February 2013, following the petrol price growth. Oil market recovery made an 8.1% contribution to the fuel price growth. Annual headline inflation accelerated (to 1.1%) as the effect of the oil price drop was excluded from the calculation of annual inflation (Figure 29). The growth of the core CPI has slowed somewhat (2.1% YoY) but remains close to the Fed's inflation target (2%).

Gradual normalisation of inflation dynamics, along with the release of positive macrostatistics, and lower external economic risks considerably improve the prospects of a rate hike at the Fed's board meeting in June, as confirmed by the minutes of the Fed's board meeting in April. The discussion turned out more hawkish than at the previous meetings. Many Fed representatives voiced the opinion that the rate could be raised as early as June if the data point to an acceleration of economic growth after the downturn in the first quarter and further improvement in the labour market environment.

Market participants were quick enough to adjust their expectations to the Fed's tougher stance. In early May, the probability of a rate hike at the June board meeting stood at about 5%, jumping to 28% after the minutes were published (Figure 30). Along with recognising a real economic improvement, the Fed could have aimed at adjusting expectations of financial market participants. In recent weeks, market participants decreased their expectations as regards rate dynamics considerably; therefore the regulator's unexpected tough moves could have become a negative shock for them. Gradual adjustment of expectations allows soothing the effect of the Fed's actions on the market.

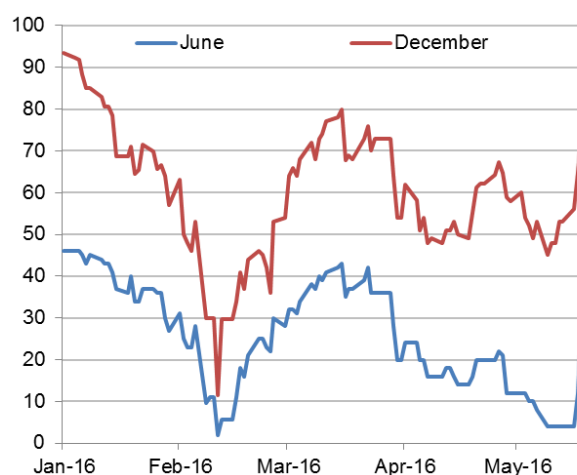
Even after a minor adjustment of expectations, markets still foresee only one rate hike till the year-end<sup>12</sup>. The Fed's intentions may turn out to be tougher, that is why its representatives are likely to go on with hawkish remarks.

**Figure 29. US inflation, % YoY**



Source: Bloomberg Finance L.P.

**Figure 30. probability of the Fed's rate hike from the current values at the board meeting in June and December, %<sup>13</sup>**



Source: Bloomberg Finance L.P.

<sup>12</sup> December Federal Funds futures contract stands at 0.625%, which is the medium of the 0.5–0.75% range and implies only one hike from the current 0.25–0.5%.

<sup>13</sup> Based on dynamics of Federal Funds futures contracts.

***Eurozone: the ECB may continue policy easing***

It came as no surprise that the ECB meeting left the current parameters of its monetary policy unchanged in April. The publication of technical details of the corporate sector purchase programme, to be launched in June, was a key development

Mario Draghi confirmed at the press conference that the ECB was very much concerned about the likely emergence of negative secondary effects for inflation dynamics if the price growth remained close to zero for too long. At the same time he mentioned that inflation was not expected to grow or approach the target level soon. The ECB President also said that the economic growth is slow but sustainable enough.

It is not ruled out that the ECB will take further steps towards monetary policy easing, either through rate cuts or by expanding monthly asset purchases or extending the purchase programme. However, the forthcoming ECB meetings are unlikely to see such moves as it takes time to assess the effect of the previous round of monetary policy easing.

***China: short-term slowdown risks are descending, while long-term ones are growing***

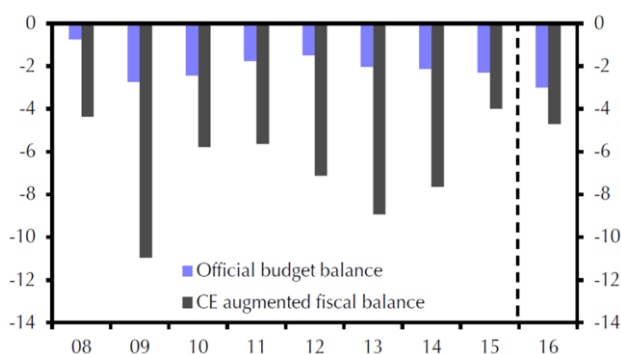
A considerable slowdown in China has been seen as a major risk to the global economy in 2016 since the start of the year. However, the growth rate remains within the Chinese authorities' target level<sup>14</sup>.

The Chinese economy is unlikely to slow in the quarters to come. The authorities' wider stimulus revived the economic growth in the first quarter. Active lending growth (Figure 33) and the fiscal policy easing as promised by the government (Figure 31 and Figure 32) are supposed to underpin the cyclical recovery of Chinese GDP growth in the short term. At the same time, long-term growth is persistently threatened. The Chinese year-on-year exports and imports dynamics (seasonally adjusted) remain in the negative territory. However, the bottom is supposed to have been reached early this year in terms of exports and late last year in terms of imports (Figure 32).

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<sup>14</sup> In the first quarter, Chinese GDP growth slowed to 6.7% YoY as against 6.8% in 2015 Q4. The decline was primarily seen in the service sector and is likely to be explained by the bubble observed in the stock market in 2015 H1.

**Figure 31. LGFV augmented fiscal balance, % of GDP**



Source: Capital Economics.

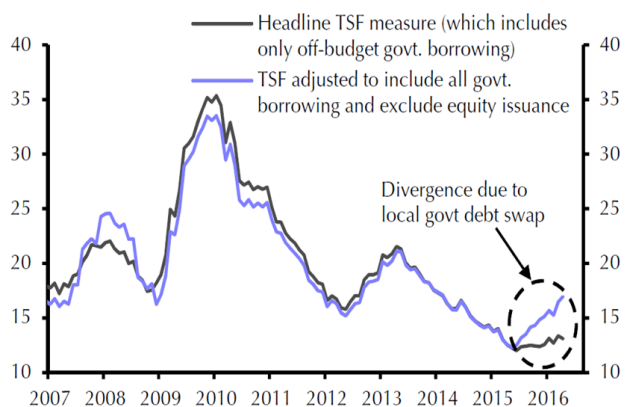
**Figure 32. Chinese exports and imports**



Source: Bloomberg Finance L.P.

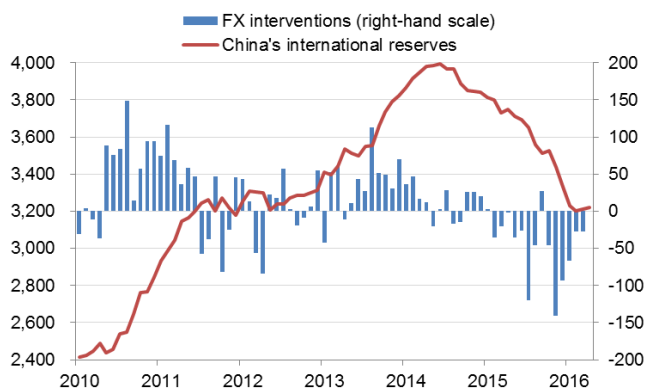
The April data of the People's Bank of China show that the total social financing slowed from 13.4% to 13.1% YoY. However, public borrowings continued to grow actively, mostly on the regional level, in particular for the purpose of refinancing debts passed to the regional authorities by local government financing vehicles (LGFVs). Capital Economics estimates that the total growth of financing, including the public sector, hit a 26-month high in April (Figure 33), and this trend will persist in the next few months. As the economic upturn lags behind the lending growth by about six months, relatively high GDP growth rates can be expected in China till the year-end.

**Figure 33. Lending growth in China, % YoY**



Source: Capital Economics.

**Figure 34. International reserves and FX interventions of the People's Bank of China (+/- – FX purchase/sale), \$ billion**



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

Dollar depreciation reduces needs for FX interventions. In April, the Chinese international reserves continued to grow slightly. According to our estimates, these dynamics are explained by the exchange rate revaluation as the People's Bank of China

persists with FX interventions (Figure 34). However, their amount declines following the US dollar depreciation against other currencies.

### ***Japan: efficiency of Abenomics is questioned***

The Bank of Japan disappointed market participants as it failed to take any steps at the board meeting on 28 April. The Bank of Japan was expected to respond to the yen appreciation that had cut down industrial activity and brought back deflation for the first time since 2013. However, the central bank halted further moves to assess the effect of the January decision on the rate cut (shift to the negative territory) on the economy.

### ***1.3.2. Financial markets: the Fed moderates risk appetite***

- The higher probability of the Fed's rate hike at the June board meeting moderated risk appetite in global markets.
- In April-May, monetary conditions in Russia continued to ease amid a rally in the corporate bond market and a decline in long-term rates.
- Banks reduce their debt to the Bank of Russia, keeping interbank rates in the lower range of the BoR interest rate corridor.

### **Global markets**

May saw a trend towards deterioration in the global financial markets after a slight improvement in April. The renewed expectations of the Fed's rate hike became a key factor of deterioration in the market conditions in the first half of May. Against this background markets of both risky (Figure 35 and Figure 36) and risk-free assets (Figure 37) showed negative dynamics.

**Figure 35. RTS and MSCI EM**



Source: Bloomberg Finance L.P.

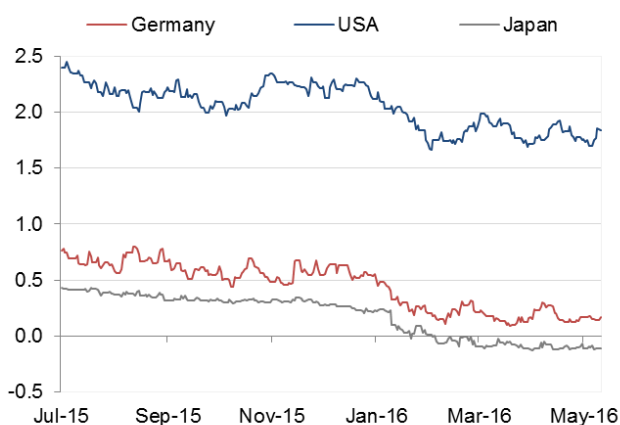
**Figure 36. S&P500 and Eurostoxx50**



Source: Bloomberg Finance L.P.

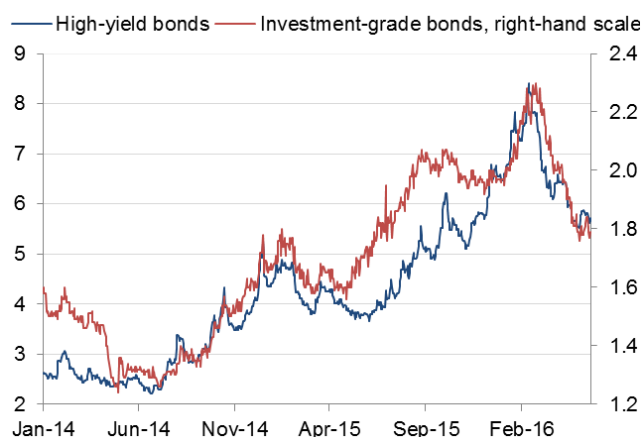
Despite the risk appetite decreased slightly in May, financial conditions in global markets are considerably milder now than early this year. Government bond yield in advanced economies (Figure 37) and credit spreads on corporate bonds (Figure 38) fell against the year-start levels. This should have a positive impact on the economic dynamics in developed countries and can allow the Fed to raise the rate at the forthcoming meetings.

**Figure 37. Yields on 10-year bonds of developed countries**



Source: Bloomberg Finance L.P.

**Figure 38. Credit spread of corporate bonds of developed countries**



Source: Bloomberg Finance L.P.

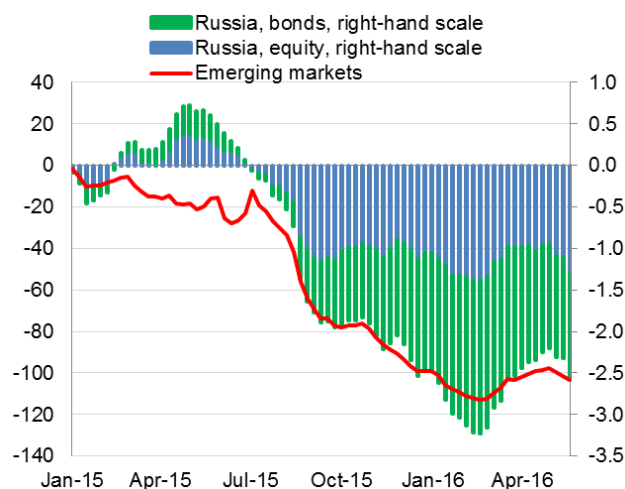
April saw further cash inflow into EM funds; however, a decline in risk appetite in May reversed this trend (Figure 40). Against this background, Russian funds look more confident, especially bond funds enjoying the inflow from early March. That makes the Russian market more stable.

**Figure 39. Equity indices in local currencies (index, 1 January 2014 = 100)**



Source: Bloomberg Finance L.P.

**Figure 40. Cash inflows to Russian and emerging market funds (accrued, '+' is inflow), \$ billion**



Sources: EPFR Global, Bloomberg Finance L.P.

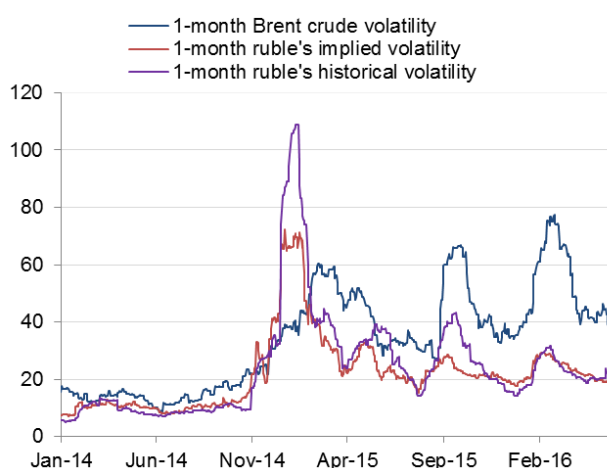
## Russian markets

The Russian financial market kept pace with the global trends. In April, all of its segments showed positive dynamics. The ruble appreciated following the persistent oil price growth and higher risk appetite in global markets, as signalled by high correlation with both the oil price and emerging market currencies (Figure 47). However, the ruble depreciated somewhat, along with other currencies, in May.

In mid-April, the Russian equity market reached the maximum intraday MICEX index (Figure 39) amid the expected growth of dividend payments by Russian state-owned corporations (up to 50% of profit under the IFRS). However, these expectations proved to be wrong, disabling the equity market to consolidate at a nearly record level.

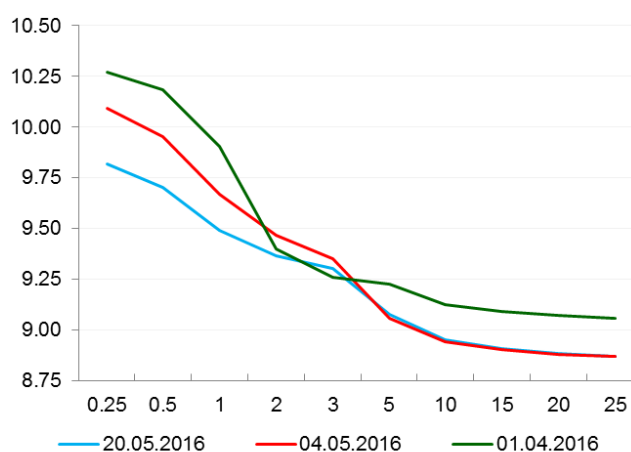
The OFZ yield curve sloped downwards as compared with early April (Figure 42). In addition, it became flatter in May following higher expectations of the key rate cut by the Bank of Russia at one of the coming board meetings and lower risk appetite. It is worth mentioning that the Russian government bond market proved to be more stable than those of other countries. In early May, the higher probability of the Fed's rate rise raised government bond yields of most emerging markets<sup>15</sup>. Meanwhile, OFZ yields at the long end remained unchanged for the same period and declined at the short end. Dynamics of other financial instruments points to the easing in monetary conditions, along with lower government bond yields (Figure 43).

**Figure 41. Imputed and historical volatility of the ruble and oil prices**



Source: Bloomberg Finance L.P.

**Figure 42. GKO-OFZ yield curve, %**

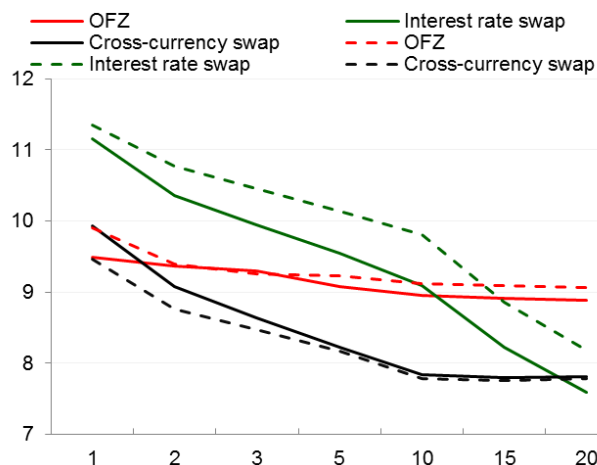


Source: Moscow Exchange.

<sup>15</sup> In local currency: Turkey, the UAE, Mexico, Brazil, Indonesia, Chile, etc.

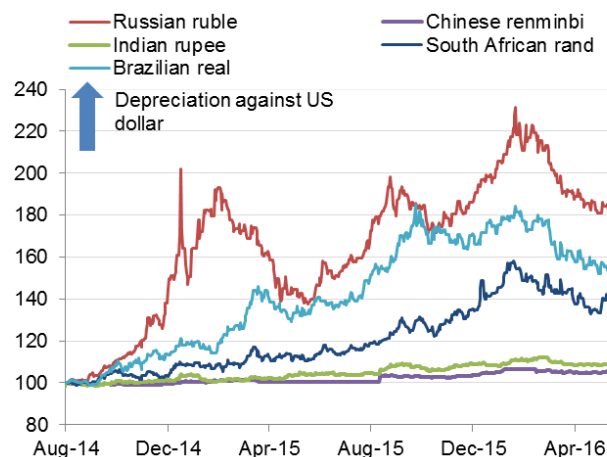


**Figure 43. Interest rates on different instruments as of 20 May 2016**



Source: Bloomberg Finance L.P.

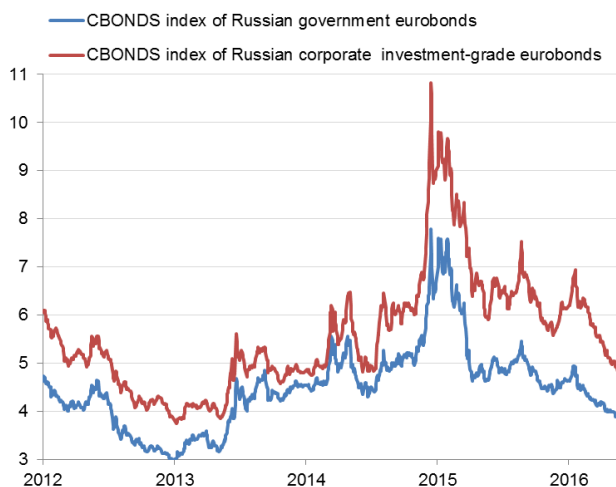
**Figure 44. BRICS exchange rates (1 August 2014 = 100)**



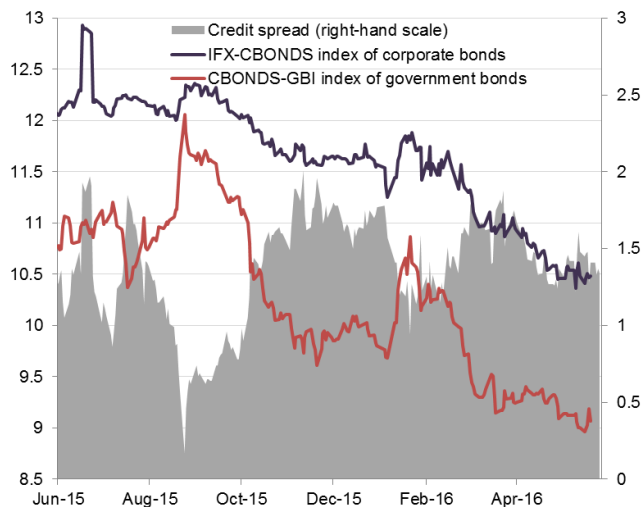
Source: Bloomberg Finance L.P.

Rally in the corporate bond market continued in April (Figure 46). Weighted average yield of the most liquid corporate bond index IFX-Cbonds fell below 10.5%. At the same time, offerings of new issues increased. According to Rusbonds estimates, companies placed bonds for about ₺316 billion in April. In May, borrowers took a pause and by 20 May held initial offerings for only ₺73 billion. Corporate bond yields ceased to decline and settled at 10.4-10.5%. Corporate bond yields may further decline considerably only if OFZ yields go down – credit spread between IFX-Cbonds, corporate bond indices, and Cbonds-GBI, a government bond index, stands at 1.34%<sup>16</sup>, which is close to its average value in 2012–2013.

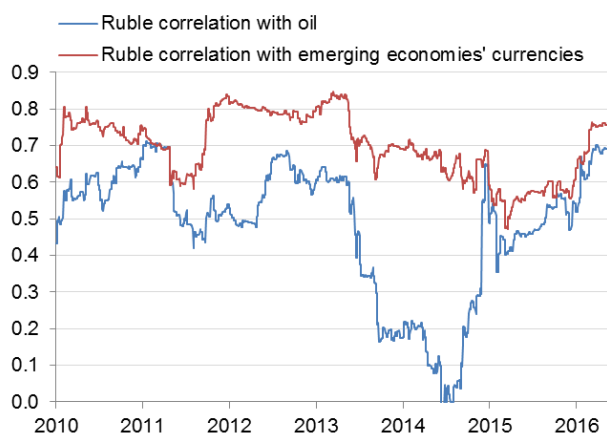
<sup>16</sup> As of 26 May 2016.

**Figure 45. Russian Eurobond yield, %**

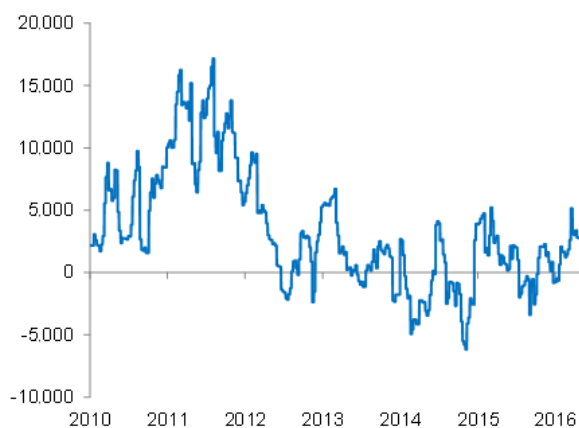
Source: Cbonds.

**Figure 46. Ruble bond yield, %**

Source: Cbonds.

**Figure 47. Ruble's 12-month correlation with emerging economies' currencies and oil**

Source: Bloomberg Finance L.P.

**Figure 48. Net position for ruble futures, number of contracts**

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

Interbank rates remained in the lower range of the BoR interest rate corridor most of April and in the first half of May (Figure 50). The exception was tax periods when interbank rates were slightly above the BoR key rate.

The situation with banking sector liquidity keeps improving. In this way, banks' debt on asset and guarantee-backed loans shrank to ₴575 billion by 20 May, the lowest since late 2013, while in the beginning of the year the debt stood at about ₴2 trillion. This process will continue, following liquidity inflow through the fiscal channel as a result of budget deficit financing from the Reserve Fund.

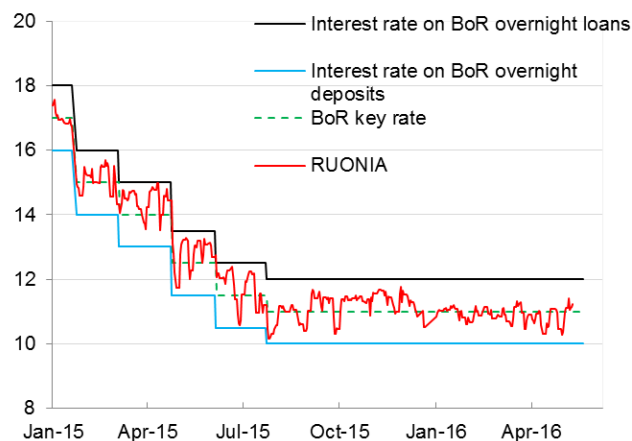
FRA3x6 and 3M Mosprime spread started shrinking in May (Figure 49). The outcome of the Bank of Russia board meeting in April enhanced market participants' expectations of the key rate cut at one of the coming meetings.

**Figure 49. FRA 3X6 and 3M Mosprime spread, % p.a.**



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

**Figure 50. BoR interest rate corridor and short-term interbank rate**



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

### **1.3.3. Commodity markets: how sustainable is the price growth?**

- In April-May, prices for most commodities and metals went up, but this growth is not backed by fundamental factors.
- Oil prices surged on the back of stronger demand and weaker supply, as well as expectations of market balancing in the second half of the year...
- ... However, further growth is restricted by the futures curve while temporary nature of key price growth factors may cause prices to skid.
- In the US, oil production goes down but it may fail to take a further tumble, needed to balance the oil market.
- China is faced up with the risk of oil production drop, while the growth of net imports reflects stock buildup amid stagnant consumption.

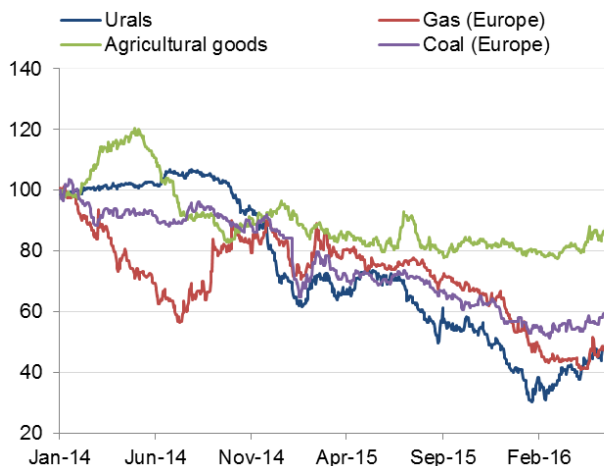
In April-May, prices for most commodities and metals went up amid the economic improvements (Figure 51 and Figure 52). The Bloomberg Commodity Index grew by 10%, the Baltic Dry Index, which shows demand for large cargo shipping by sea, leapt by 34%.

Prices for certain commodities and metals traded mostly in Chinese exchanges reflected increased speculative demand in April (these are primarily iron ore, steel and cotton). Measures taken by the exchange management, such as an increase in payment

for closing transactions and the introduction of intraday limits on transactions, have resulted in the ongoing price decrease.

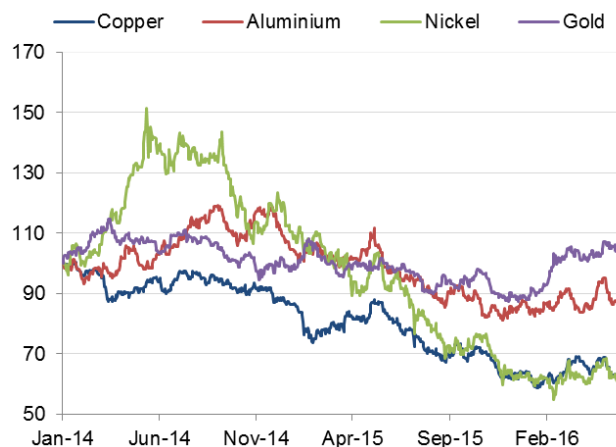
Prices for agricultural products rose by 7% on the back of energy price growth and El Niño climate phenomenon. The World Bank [estimates](#) elasticity of agricultural product prices relative to energy prices at 0.15-0.2, which is 4-5 times higher than in manufacturing. Prices are expected to reverse on the back of good harvest within the rest of the year.

**Figure 51. Commodity prices (January 2014 = 100)**



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

**Figure 52. Metal prices (January 2014 = 100)**



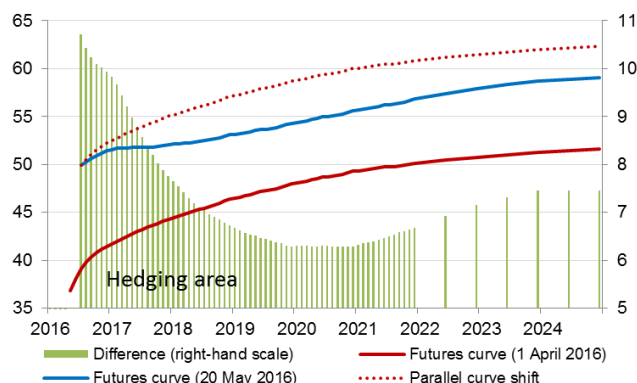
Sources: Bloomberg Finance L.P., R&F Department calculations.

Oil prices rose despite the failed Doha talks on output freeze. The Urals crude price surged by \$11 to \$48 per barrel amid higher demand growth, weaker supply growth and expectations for an earlier balancing of the oil market in the second half of this year.

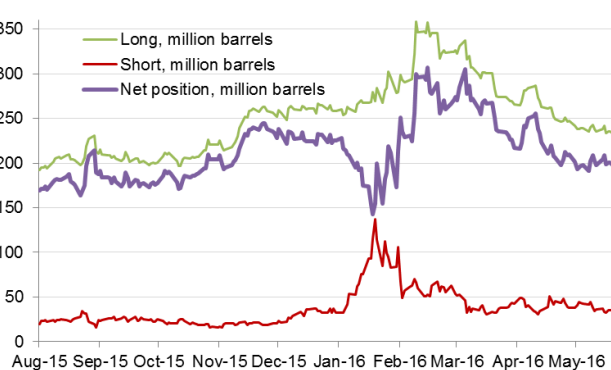
However, a further rise in oil prices is limited. The WTI futures curve preserves a contango shape<sup>17</sup>, but has almost flattened out on the 2017 segment following shale oil producers' active hedging (Figure 53)<sup>18</sup>. The short, speculative, end of the futures curve preserves selective activity of market participants. For instance, exchange-traded funds tend to shrink long positions (Figure 54).

<sup>17</sup> The futures price is higher each month than in the previous month.

<sup>18</sup> The short end of the curve shows the investors' activity, primarily hedge funds. The long end of the curve, where the hedging effect fades away, is not representative.

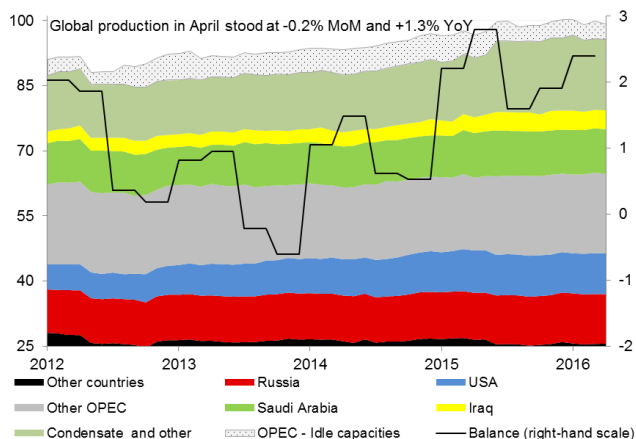
**Figure 53. WTI futures curve, \$/barrel**

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

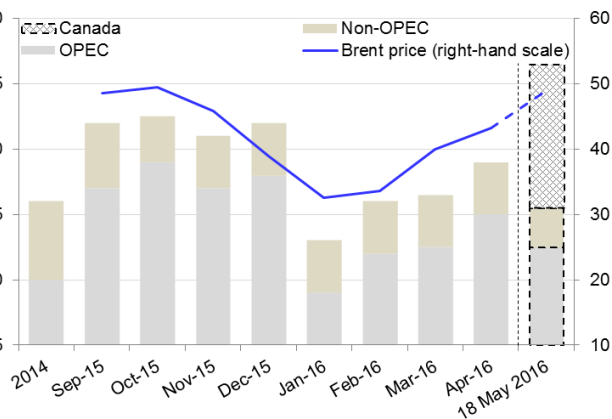
**Figure 54. Short and long positions in the oil market of exchange-traded funds**

Source: Bloomberg Finance L.P.

Moreover, the risks of oil price drop are on the rise. One of the key drivers of the price increase is a slowdown in supply growth due to unplanned production outages, despite oil supplies from Iran exceed expectations (Figure 55). These outages are growing, but have a temporary and uncertain nature. The minimum oil prices seen in January coincided with the minimum production outages over a long period of time (Figure 56). In the following months, the price growth was accompanied by problems in Nigeria and Iraq, considerable in scale and duration, and large-scale but short-term downturns in Kuwait and Canada (downturns in Canada still persist and underpin oil prices).

**Figure 55. Production and balance in the oil market, million barrels/day**

Sources: Bloomberg Finance L.P., Energy Intelligence Group, OPEC.

**Figure 56. Idle oil production capacities (million barrels/day) and Brent crude price (\$/barrel)**

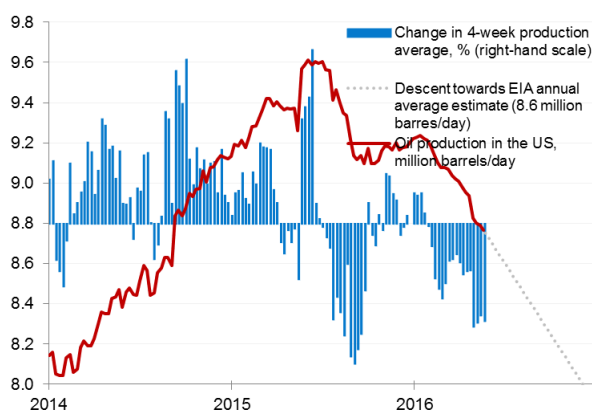
Sources: U.S. Energy Information Administration, Citi Research, R&F Department calculations.

In the US, oil production shrinks by a somewhat 0.3% per week (Figure 57). Commercial oil and oil product stocks are in line with seasonal trends, but their accumulation is considerably lower than the one seen in 2015 (Figure 58). It is largely

explained by an uprise in demand: oil product consumptions growth rate switched from negative early this year to positive (3.5% YoY on the average) in April-May.

However, in order to balance the oil market this year (given the assumption that temporary problems with production outages are solved) oil production in the US should decline further. At the same time, we estimate that current prices can stabilise production at the established level. The stalled shrinkage in the number of drilling rigs and an increase in the issuance of drilling permits in Texas, the key oil producing region in the US, in April underpin this assumption.

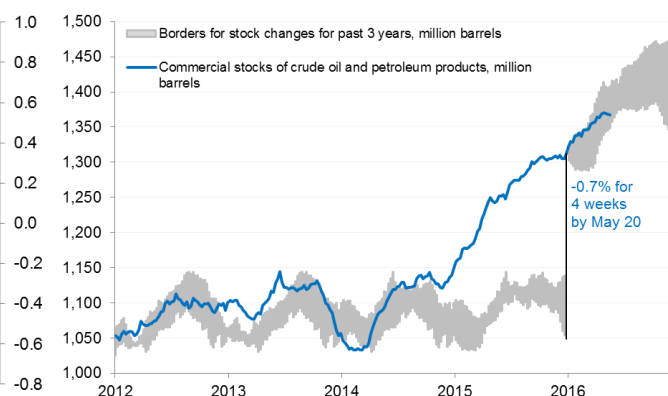
**Figure 57. Oil production in the US**



\* EIA – U.S. Energy Information Administration.

Sources: U.S. Energy Information Administration, R&F Department calculations.

**Figure 58. Commercial oil and oil product stocks in the US**



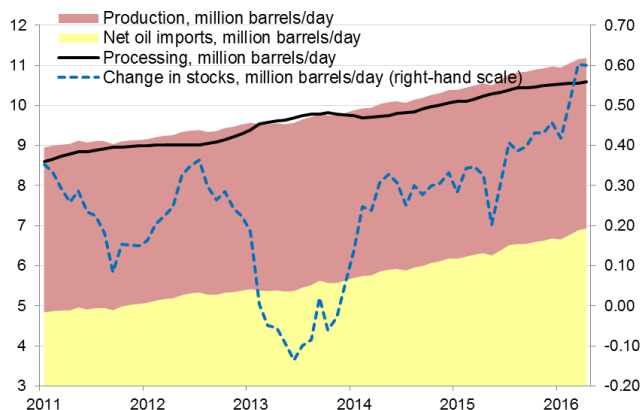
\* In 2016, borders come out of the actual value as of the beginning of the year.

Sources: U.S. Energy Information Administration, R&F Department calculations.

Oil production in China shows considerable negative dynamics, running the risk of a downward revision of the global supply forecast. In April, oil production in China fell by 5.6% or by 0.24 million barrels per day as against December. This is in line with the US production shrinkage.

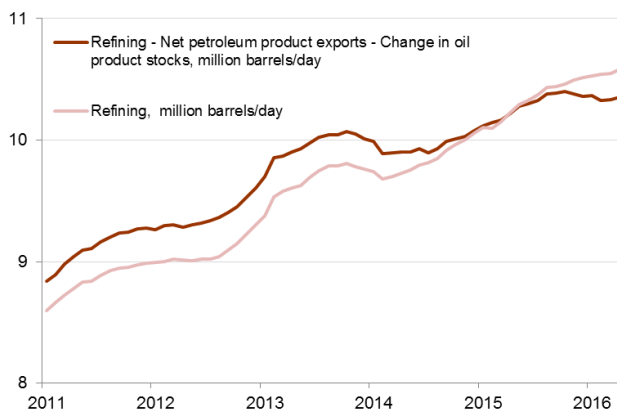
In April, China continued to increase oil imports; however, it still results in the growth in net exports of oil products and stocks with stagnant domestic consumption (Figure 59 and Figure 60). China's intention and capability to continue accumulating strategical stocks at high pace poses one of the main demand-side risks in the oil market.

**Figure 59. Production, net imports, processing and changes in oil stocks in China (12-month average)\***



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

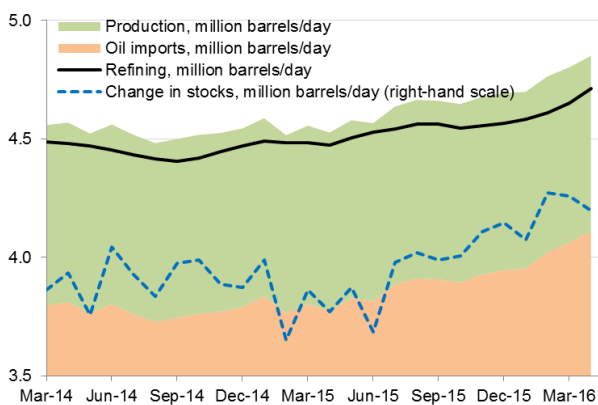
**Figure 60. Oil processing and domestic consumption in China (12-month average)\***



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

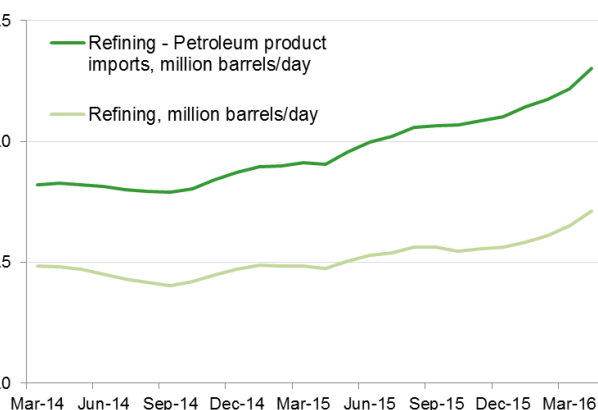
India also continues to actively build up oil and oil product imports amid persistently low domestic production: in April, the 12-month sliding value stood at +11.6% YoY and +1.5% MoM (Figure 61). Like in China, growing imports are partly used for strategic reserves, underpinning oil prices. But imports are mostly used for domestic consumption: according to our estimates, in April the 12-month sliding value grew by 1.6% MoM and 8.0% YoY (Figure 62). Granted the low number of cars per capita and active economic growth, the prospects of further consumption growth are tangible.

**Figure 61. Production, net imports, processing and changes in oil stocks in India (12-month average)**



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

**Figure 62. Oil processing and domestic consumption in India (12-month average)**



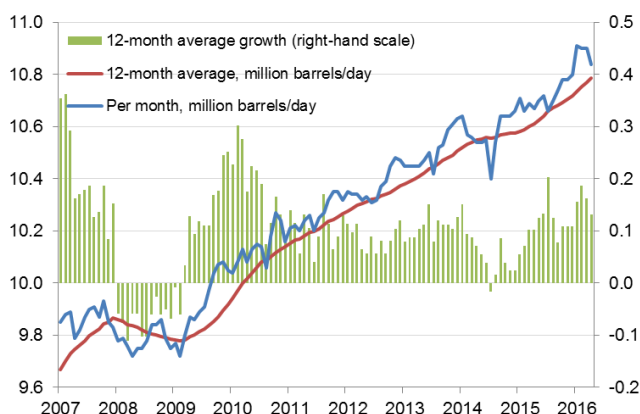
Sources: Bloomberg Finance L.P., R&F Department calculations.

In April, oil production in Russia fell as compared to March, but largely due to the seasonality. Meanwhile, the 12-month sliding value grew to 1.6% YoY (Figure 63). We expect this indicator to show moderate growth during the rest of the year.



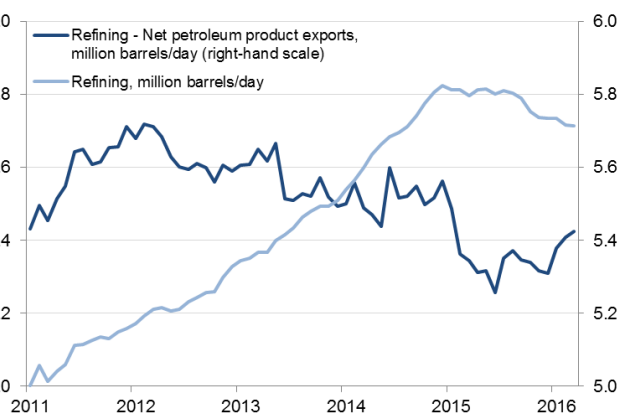
Domestic consumption continued to grow amid the ongoing shrinkage of oil processing in Russia in 2016: the 12-month average processing indicator less net oil product exports advanced by 0.6 MoM in March and by 5.0% against the local minimum in December last year (Figure 64). It exceeds expectations of market participants and may result in an upward revision of the global growth forecast.

**Figure 63. Oil production in Russia**



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

**Figure 64. Oil processing and domestic consumption in Russia (12-month average)**



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

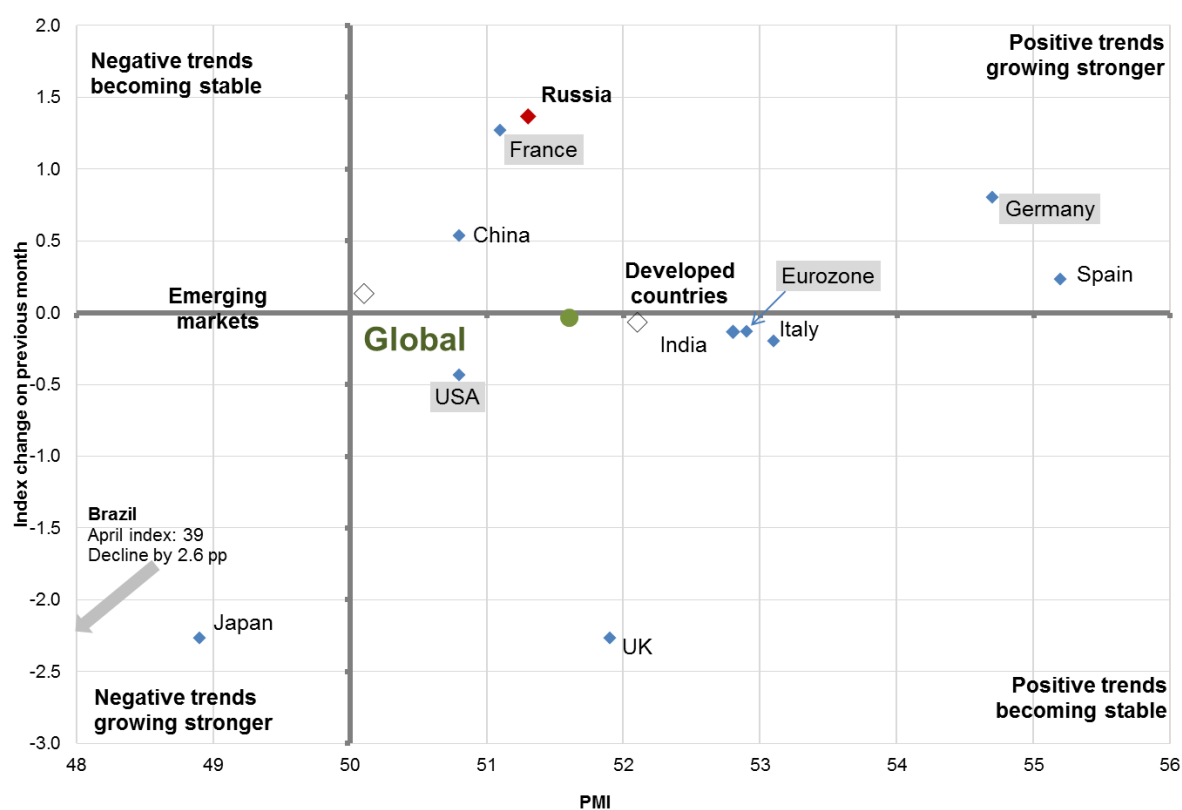
## 2. Outlook: leading indicators

### 2.1. Global leading indicators

#### 2.1.1. Global economic activity stabilises, but its sustainability is in question

Composite PMI indices point to stabilisation of economic activity in the beginning of the second quarter (Figure 65). Aggregate indices – global advanced and emerging economies – remained almost unchanged in April against the average value in the first quarter. However, the dynamics inside each group of countries are uneven. Improvement in developing countries is hampered by Brazil, while Japan and the UK hinder the development of advanced economies. Enhanced divergence between countries by growth points to accumulation of risks to sustainability of the global economic growth.

**Figure 65. Composite PMI indices in April and change against the average value in 2016 Q1**



Sources: Markit Economics. Highlighted in grey are preliminary May data and change against the average value in February-April.

**Copper prices**, as a global industry indicator, showed adjustive performance in May, tracking the commodities market (Figure 66). Stabilisation of Chinese economic growth have not led to considerable price growth for industrial metals yet. This may result from persistent excess of production volumes over demand level.

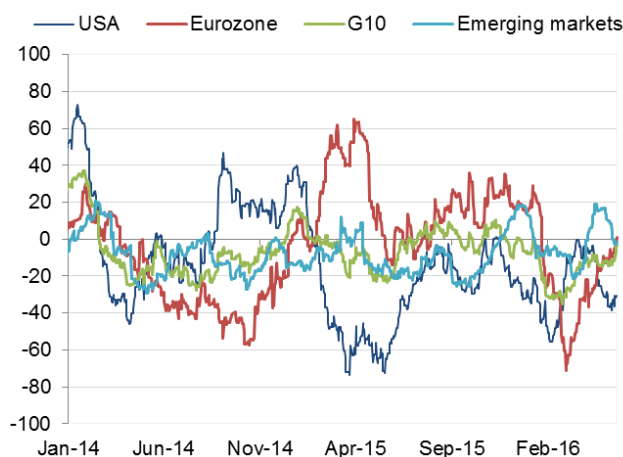
Composite Citi macro data indices show multidirectional dynamics (Figure 67). The Eurozone index recovers gradually, but it is more likely to result from the regular revision of expectations towards slower economic growth in Europe, rather than dramatic improvement. In the US, a U-turn is evident after the drop in 2016 Q1, as confirmed by outcoming data – in the second quarter, the economic activity rebounded after a slowdown in the first quarter.

**Figure 66. Copper price, \$/tonne**



Source: Bloomberg Finance L.P.

**Figure 67. Surprise indices in macro data releases for the US, Eurozone and advanced and emerging economies**



Sources: Citi, Bloomberg Finance L.P.

## 2.2. What do Russian leading indicators suggest?

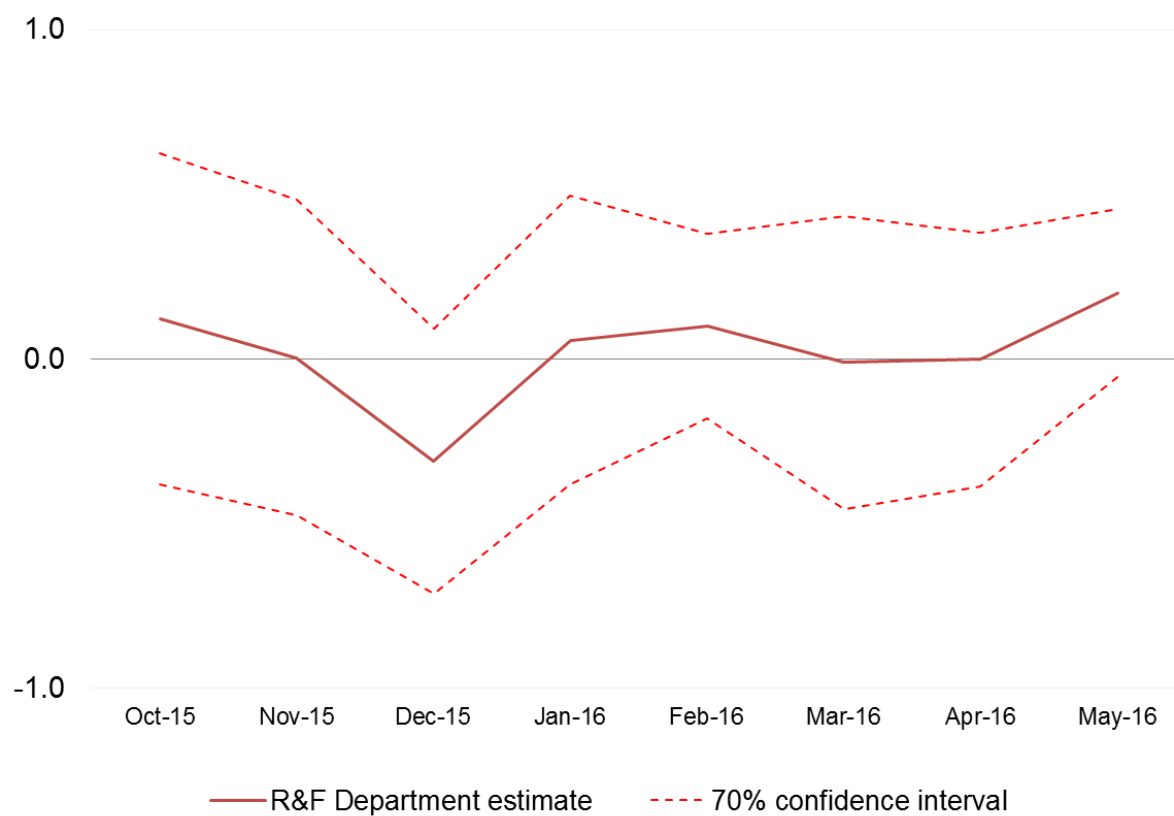
### 2.2.1. Index GDP assessment: prospects of prompt recovery are on the rise

- The May index GDP assessment suggests that signs of an economic recovery may be seen in 2016 Q2, though the growth will be small, about 0.2% QoQ (seasonally adjusted).
- GDP index estimates for the second half of the year have also improved: GDP is expected to grow by 0.3% QoQ in the third quarter and by 0.5% QoQ in the fourth quarter (seasonally adjusted).
- Our estimates improved against the April estimates, following mainly the favourable oil price dynamics and good manufacturing statistics for the last month.
- As we obtained monthly statistics for January-March, our index estimate of GDP growth in the first quarter changed insignificantly (Figure 68). This may point to a gradual stabilisation of the economic activity, which is a driver for economic growth recovery in the months to come.

- Nevertheless, we see the current growth indicators as unsustainable enough.

	May 2016	April 2016
	% QoQ	% QoQ
2016 Q2	0.1-0.2	0.0
2016 Q3	0.3	0.2-0.3
2016 Q4	0.5	-

Figure 68. Estimate of GDP growth in 2016 Q2, % QoQ

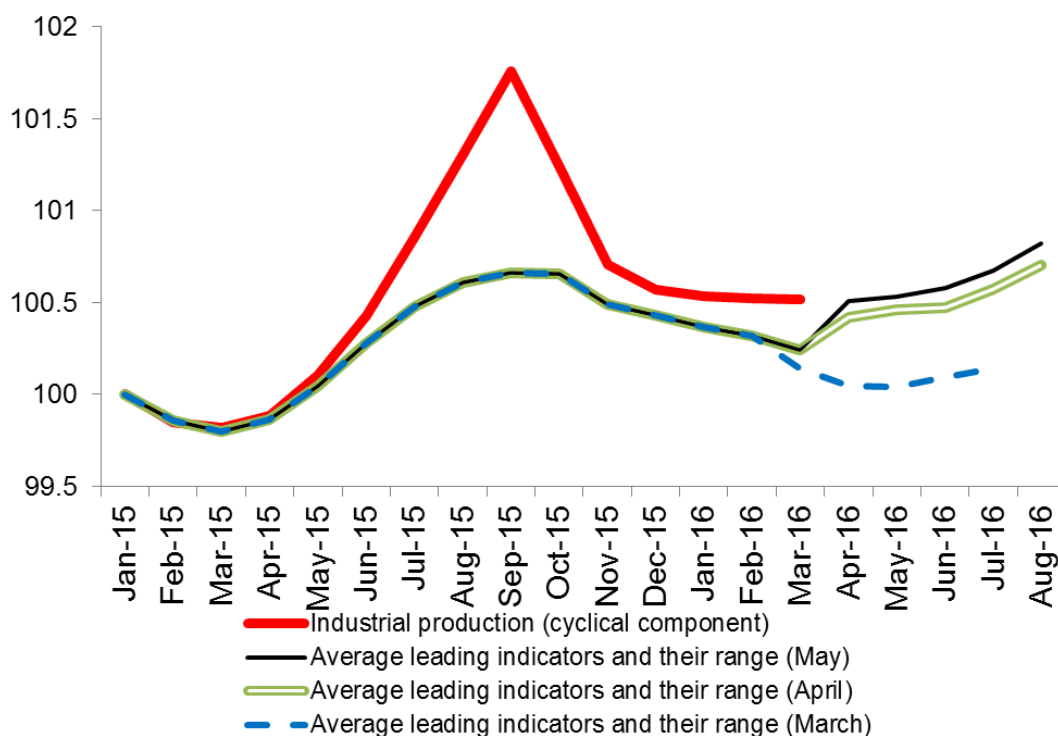


Sources: Rosstat, R&F Department calculations.

### 2.2.2. Composite leading business indicator improved

- April data on PMI indices (especially in services) contributed to further improvement of our estimate of the composite leading business indicator (Figure 69).
- Positive survey data are assumed to be based on managers' optimism, especially in the sectors which have profited from the weak ruble and import substitution of foreign services.
- We can see grounds for gradual recovery of economic growth in the months to come.
- However, poor manufacturing PMIs in April make us cautious about sustainability of the current positive estimates of the composite leading indicator, despite generally positive April statistics.

**Figure 69.**  
Cyclical component of industrial production (January 2015 = 100, seasonally adjusted)  
and leading business index



Sources: Rosstat, HSBC, Russian Economic Barometer, R&F Department calculations.

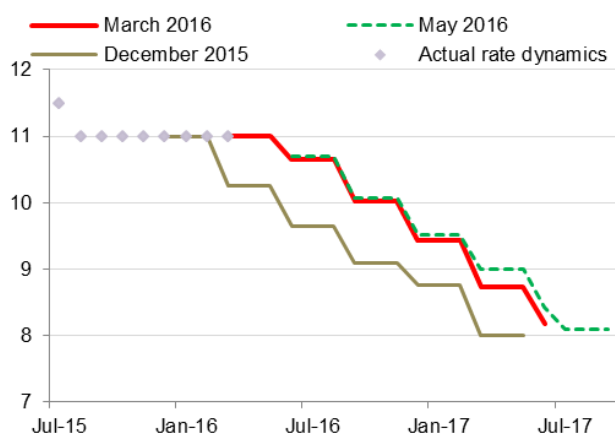
### 2.2.3. Inflation forecasts by professional analysis are revised downwards, but still far from the BoR target

Bloomberg published forecasts by professional analysts surveyed about the dynamics of key economic variables. Forecast for GDP dynamics in 2016 improved in May as compared with the survey held two months ago: a drop of 1.1% instead of 1.5% and recovery of the annual growth as early as 2016 Q4. At the same time, expected growth for 2017 fell from 1.2% to 1.0%.

Inflation expectations continued to decline in May, but analysts expect inflation to accelerate somewhat in 2017 Q2 (Figure 71). On the whole, market participants expect price growth to slow to 6.0% in 2017 and inflation in 2016 Q2-Q3 to accelerate less from the current 7.3% YoY. Moderately tough monetary policy pursued by the Bank of Russia may have become one of the key factors behind the drop in inflation expectations of the professional community.

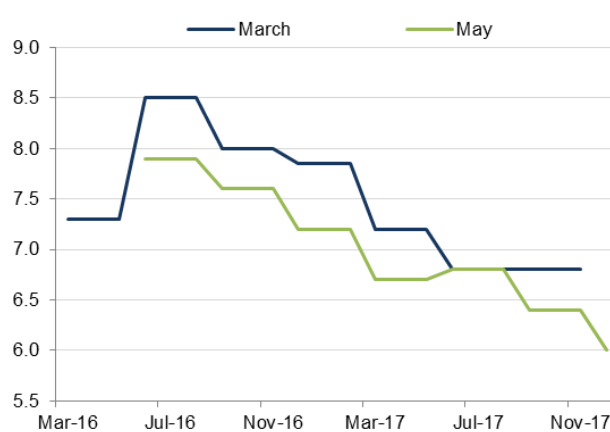
Expectations of lower price growth were accompanied by a minor upward revision of the key rate forecasts for 2017. It means that the market expects the Bank of Russia to tighten its monetary policy as compared to the one pursued in March (Figure 70). Nevertheless, the inflation analysts predict for 2017 will be above the BoR target. Elevated inflation expectations of not only professional community, but also other economic agents remain among the risks to achieving the inflation target in 2017. This may require the Bank of Russia to preserve moderately tough monetary conditions in future.

**Figure 70. Bank of Russia key rate expectations of professional analysts**



Source: Bloomberg Finance L.P.

**Figure 71. Inflation expectations of professional analysts, % YoY**



Source: Bloomberg Finance L.P.

### 3. In focus

#### ***Preferable ruble exchange rate varies across businesses: survey outcomes***

- The survey among industrial and agricultural enterprises conducted by the Gaidar Institute for Economic Policy and the Research and Forecasting Department showed that estimates of the optimal ruble exchange rate vary significantly; this suggests that the floating exchange rate is favourable for enterprises to balance their interests.
- Meanwhile, most respondents argued in favour of a strong and stable national currency signalling lack of economic advantages from persistent ruble depreciation.
- Respondents believe that a strong ruble would enable industrial upgrading through purchase of imported equipment, reduce production cost and boost product competitiveness in foreign markets.
- Entering new foreign markets and increasing exports require investments to establish new manufacturing facilities or improve quality of the current production. Only timber industry, metallurgy and mining see potential for expanding exports through ruble depreciation.
- Businesses are not interested in a weaker ruble to boost competitiveness with imports in the domestic market (except for leather and footwear industry).

In May, the BoR Research and Forecasting Department and the Gaidar Institute for Economic Policy (the Gaidar Institute) conducted surveys among industrial and agricultural companies to study businesses' involvement in certain ruble exchange rate movements within a broader analysis of currency risk distribution in the economy<sup>19</sup>. The survey showed that companies' preferences vary across sectors of the economy. Though most businesses argued in favour of ruble appreciation, a wide range of companies inclined to a weaker national currency. Such results expose benefits of a floating exchange rate as a means of balancing interests of different companies by market means.

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<sup>19</sup> Surveys were held from 11 till 20 May 2016 in two panels: 1) panel of industrial companies of the Laboratory of Conjunctural Surveys of the Gaidar Institute for Economic Policy (the Gaidar Institute); 2) panel of agricultural enterprises of the Sectoral and Regional Research Section of the BoR Research and Forecasting Department. Number of filled questionnaires in the panel of industrial companies is 263, in the panel of agricultural enterprises – 109, total of 372 questionnaires. Respondent industrial companies include 52% of exporters and 48% of non-exporters; agricultural companies include 14% of exporters and 86% of non-exporters.

The Bank of Russia appreciates the assistance in conducting the survey among agricultural companies provided by industrial associations of the agricultural sector: Russian Grain Union, Russian Potato Union, National Dairy Producers Union, National Vegetable Producers Union, National Pork Producers Union and Russian Poultry Union.

Companies' interest in ruble appreciation comes from their intention to upgrade production through imported equipment and (or) reduce production costs. It points to the persistent dependence of Russian companies from supplies of imported equipment, primary products and materials. Domestically produced equipment cannot substitute for the whole set of machinery and technological equipment in the short term. In some cases Russian equivalents of primary products, materials and equipment are either unavailable or fail to ensure adequate quality.

Significantly, high percentage of responses in favour of ruble appreciation for the purpose of industrial modernisation and reduction of production costs was typical not only of companies operating in the domestic market, but also of exporters. None of the respondents need ruble depreciation to start exporting its products; accordingly, further weakening of the ruble will not open new possibilities for non-exporters to enter foreign markets.

Thus, current depreciation of the national currency is insufficient for Russian companies to enter new markets or increase existing exports. This suggests that persistent weakening of the ruble is not advantageous to the economy.

Investments to launch a new production or improve the quality of current production are a must for expansion and diversification of Russian exports. Ruble stabilisation is important for production and investment planning in many companies.

The above-mentioned findings are backed up by the following outcomes. As many as 7% of the total number of respondents (or 18 companies) in the panel of industrial companies believe that ruble fluctuations do not have any impact on their business activity. Other respondents, who were not indifferent to ruble fluctuations, showed their interest in ruble depreciation (31% of companies, including 22% of exporters) and ruble appreciation (69% of companies, including 33% of exporters) (Figure 72).

In responses regarding their interest in ruble appreciation/depreciation, most companies (76%) showed high to moderate interest in ruble appreciation to modernise their business through imported equipment (Figure 73). As many as 61% of companies are interested in sizeable to moderate ruble appreciation to reduce production costs. And only 18% of respondents chose ruble appreciation to pay their debts in foreign currency. As many as 37% of companies need ruble depreciation to increase their competitiveness with imports in the domestic market, and 28% of respondents believe that a weaker ruble will allow them to boost imports of their products.

The survey revealed varying estimates of the optimal ruble exchange rate signaling the benefits of a floating exchange rate to strike a balance of companies' interests which may vary over time. In fact, the average optimal ruble exchange rate calculated based on responses of companies interested in ruble depreciation stood at ₴63.1 per US dollar, which is almost in line with the current exchange rate (Figure 74). Meanwhile, the average optimal ruble exchange rate in the subpanel of companies interested in ruble appreciation was ₴45.4 per US dollar. Induced ruble depreciation is unlikely to give



considerable advantages to the few interested companies, but may hinder production development of many Russian industrial and agricultural companies.

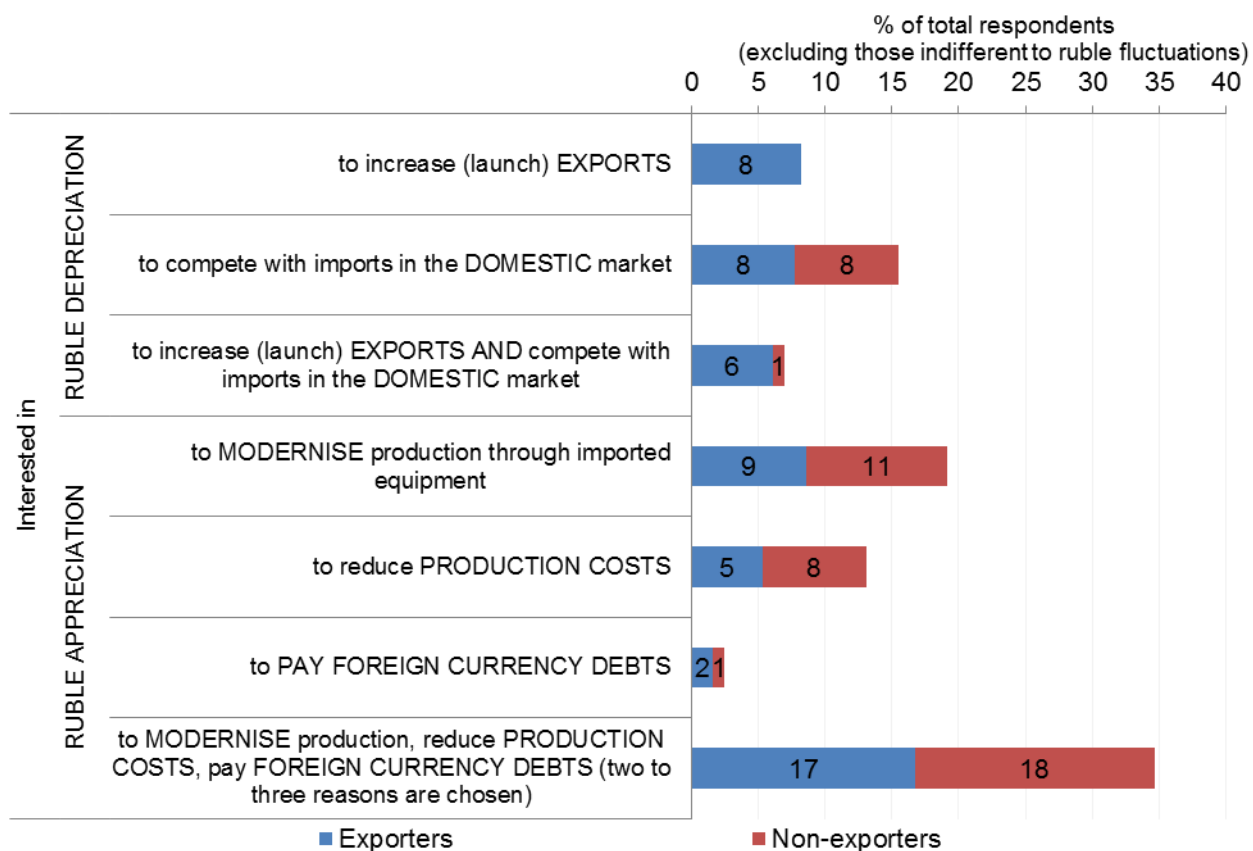
The distribution of responses by industry (Figure 75 and Figure 76) suggests that companies engaged in timber and woodwork (75% of respondents) and leather, leather products and footwear (67% of respondents) show high interest in ruble depreciation. Production of leather and leather goods is targeted mainly to the domestic market and the industry's key challenge is high competition with imported goods. Leather makers believe that further ruble depreciation could add advantages to domestic producers in competing with imports. In woodwork, represented exclusively by exporters, a focus on weaker ruble may be attributed to the possibility to set off the drop in prices for the industry's products in the global market and expand the developing timber exports. Depreciation of fixed assets in this industry is considerably lower than for an average manufacturer and the issue of modernisation is not so pressing.

Metallurgy and mining and quarrying (other than fossil fuel production) also had a relatively high percentage of responses in favour of ruble depreciation to ramp up exports. Some metallurgical and mining companies believe that the potential of export increase due to the ruble depreciation is not yet exhausted. However, the response distribution suggests that the issues of industrial modernisation and production cost cuts are of equal importance for these industries. Many iron and steel companies may be supposed to have been renovated and modernised in mid-2000s and not require investments for these purposes. At the same time, growth in the ruble value of their export prices due to a weaker ruble would allow them to improve their financial performance.

In most other industries more than half of respondents mentioned the need of a stronger ruble. The survey shows that it is most required in such sectors as energy, gas and water distribution (100% of respondents), coke and petroleum products (100% of respondents), food products (88% of respondents), pulp and paper (83% of respondents), motor vehicles and equipment (82% of respondents), and construction materials (80% of respondents). Significantly, these sectors include export-oriented industries which spoke in favour of ruble appreciation, as they consider modernisation and primary product and material cost cuts to be of primary importance.

In the panel of agricultural enterprises (Figure 77), 92% of respondents are interested in ruble appreciation. Among them, respondents see it as a requirement for production cost cut (62%), industrial modernisation (19%), and repayment of foreign currency debts (1%), another 10% chose several of the above reasons. Rising costs of mineral fertilizers, crop protectors, imported seeds and broods, and foreign veterinary drugs are the most challenging for agricultural companies. Only 3% of respondents believe that the ruble exchange rate has no effect on their business. Just 5% of respondents are interested in ruble depreciation to compete with imports. Thereby, no company in the panel, including 14% of exporters, said they needed a weaker ruble to expand exports or start exporting their products.

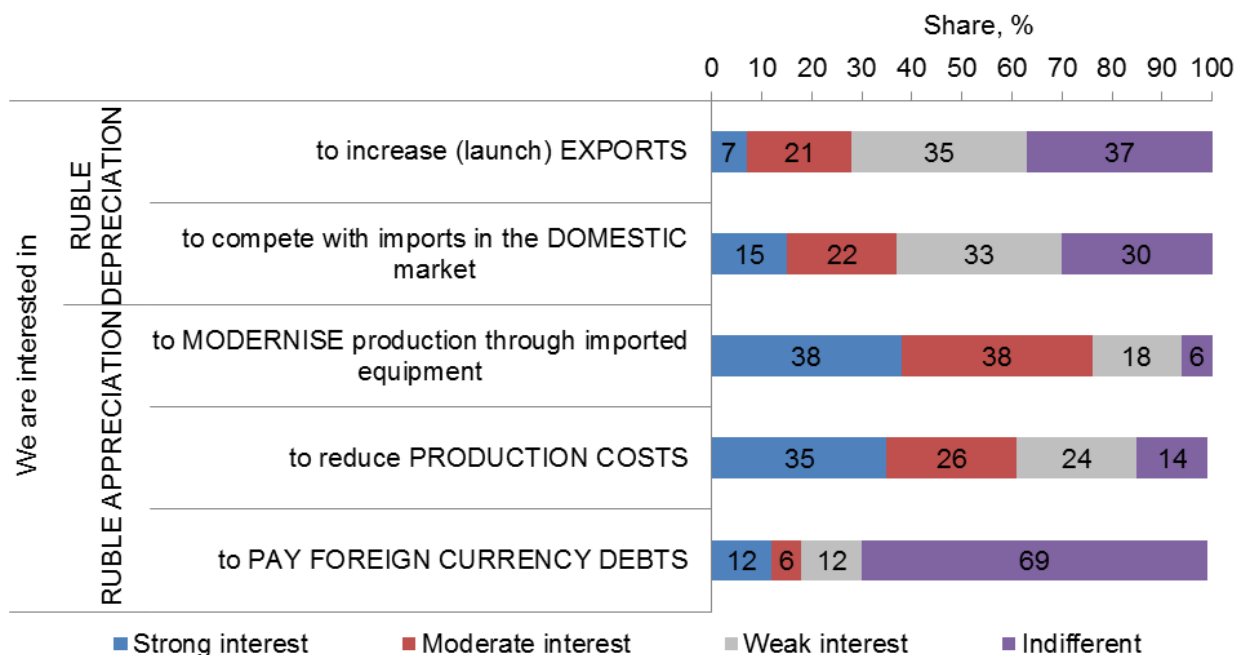
**Figure 72. Respondents by interest in ruble appreciation/depreciation for each of the five reasons (excluding those indifferent to exchange rate fluctuations), %\***



\* Interested in certain ruble exchange rate movements are companies which have shown considerable to moderate interest. Respondents were referred to those interested in ruble appreciation or depreciation for each reason proposed in the answer by the priority given by the respondent. Where priorities were equal, the ruble exchange rate considered to be optimal for the respondent's business was used to refer the respondent to those interested in ruble appreciation or depreciation.

Sources: Gaidar Institute survey, R&F Department calculations.

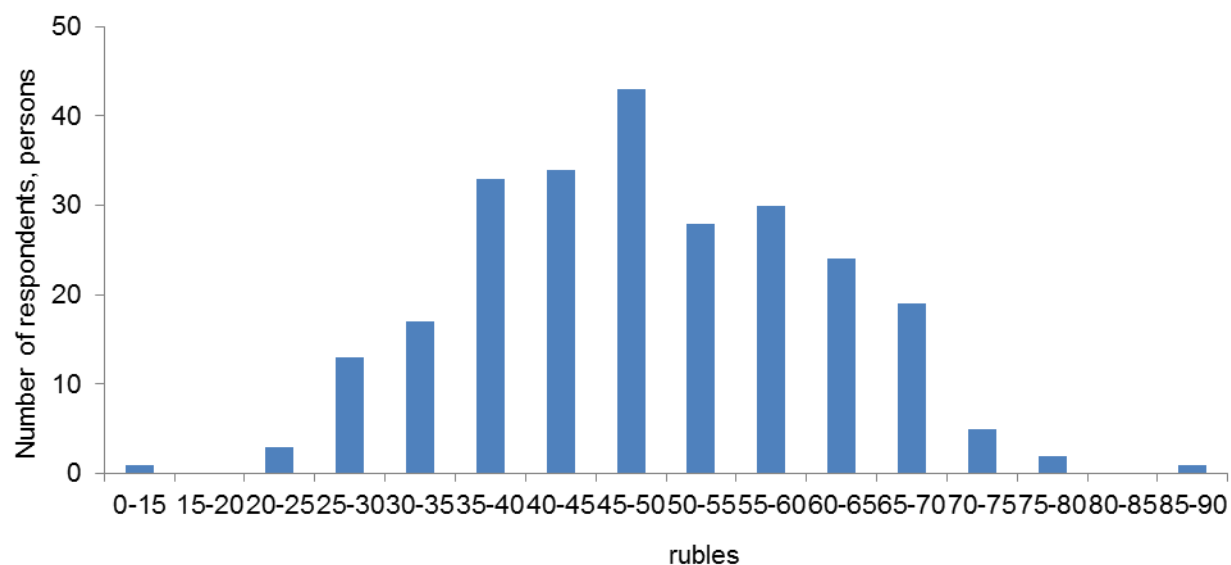
**Figure 73. Respondents by level of interest in ruble appreciation/depreciation for each of the five reasons\***



\* Respondents could choose the same level of interest in responses to two or more of the five questions.

Sources: Gaidar Institute survey, R&F Department calculations.

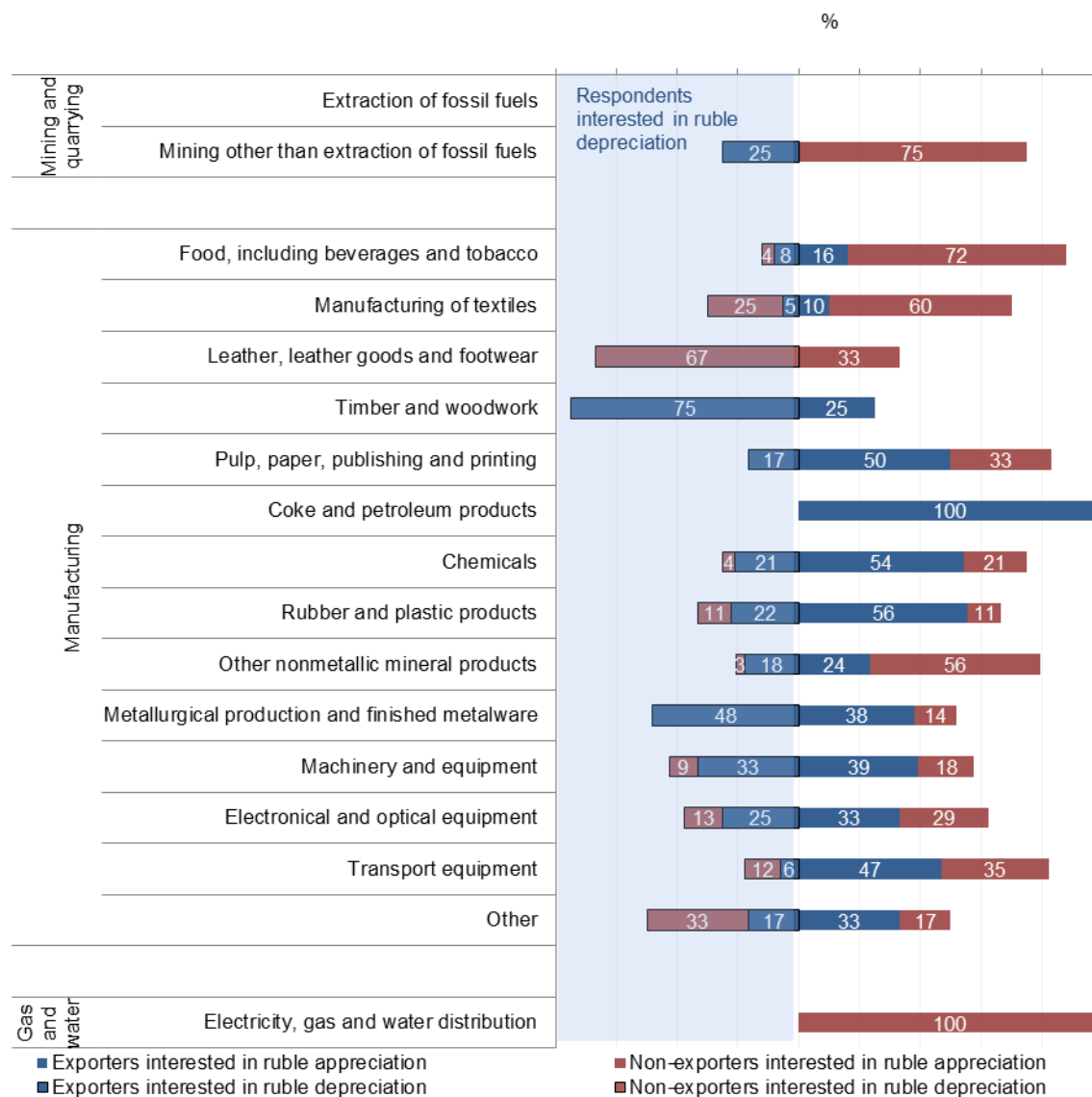
**Figure 74. Bar chart of responses to the question 'What RUB/USD exchange rate would be optimal for your company?'**\*



\* As many as 253 of 263 companies answered the question.

Sources: Gaidar Institute survey, R&F Department calculations.

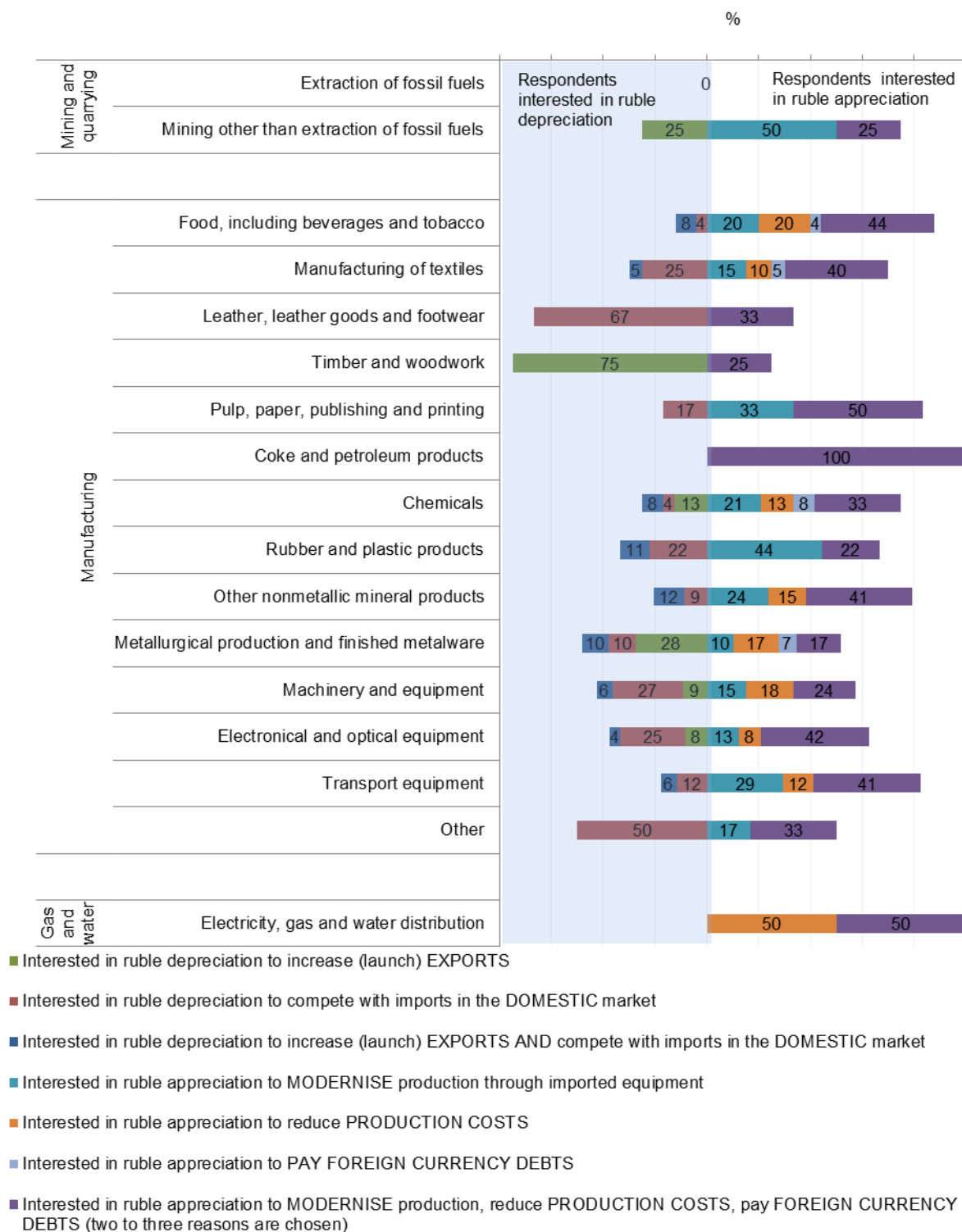
**Figure 75. Respondents in the panel of industrial companies by interest in ruble appreciation/depreciation (excluding those indifferent to exchange rate fluctuations), %\***



\* The graph does not feature 18 companies indifferent to exchange rate fluctuations.

Sources: Gaidar Institute survey, R&F Department calculations.

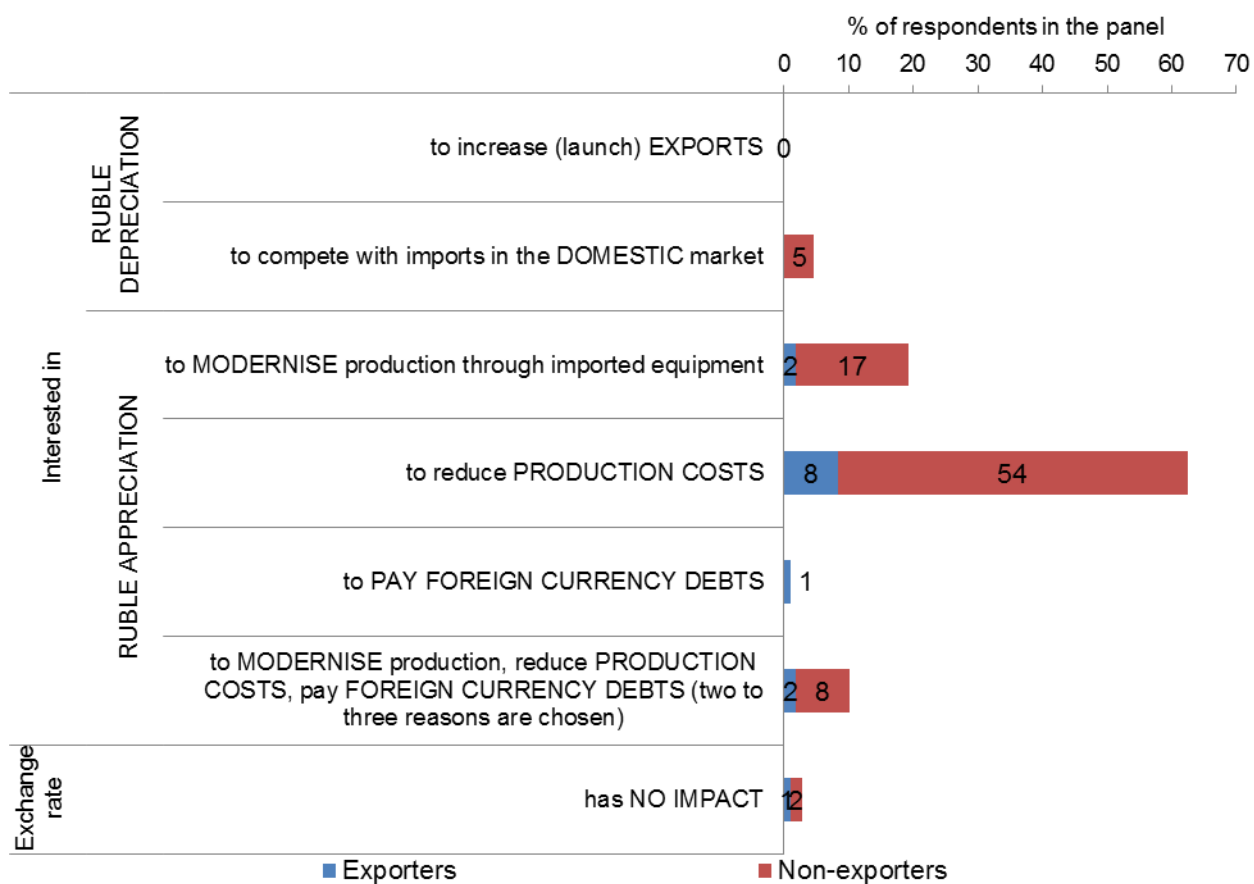
**Figure 76. Respondents in the panel of industrial companies by interest in ruble appreciation/depreciation for each of the five reasons (excluding those indifferent to exchange rate fluctuations), %\***



\* The graph does not feature 18 companies indifferent to exchange rate fluctuations.

Sources: Gaidar Institute survey, R&F Department calculations.

**Figure 77. Respondents in the panel of agricultural enterprises by interest in ruble appreciation/depreciation for each of the five reasons**



Sources: R&F Department survey, R&F Department calculations.

## Research and Forecasting Department

Alexander Morozov

*Director*

Dmitry Chernyadyev

Elena Deryugina

Ekaterina Ilicheva

Natalia Karlova

Dmitry Kreptsev

Alexey Ponomarenko

Alexey Porshakov

Sergey Seleznev

Andrey Sinyakov

Sergey Vlasov

Ksenia Yakovleva