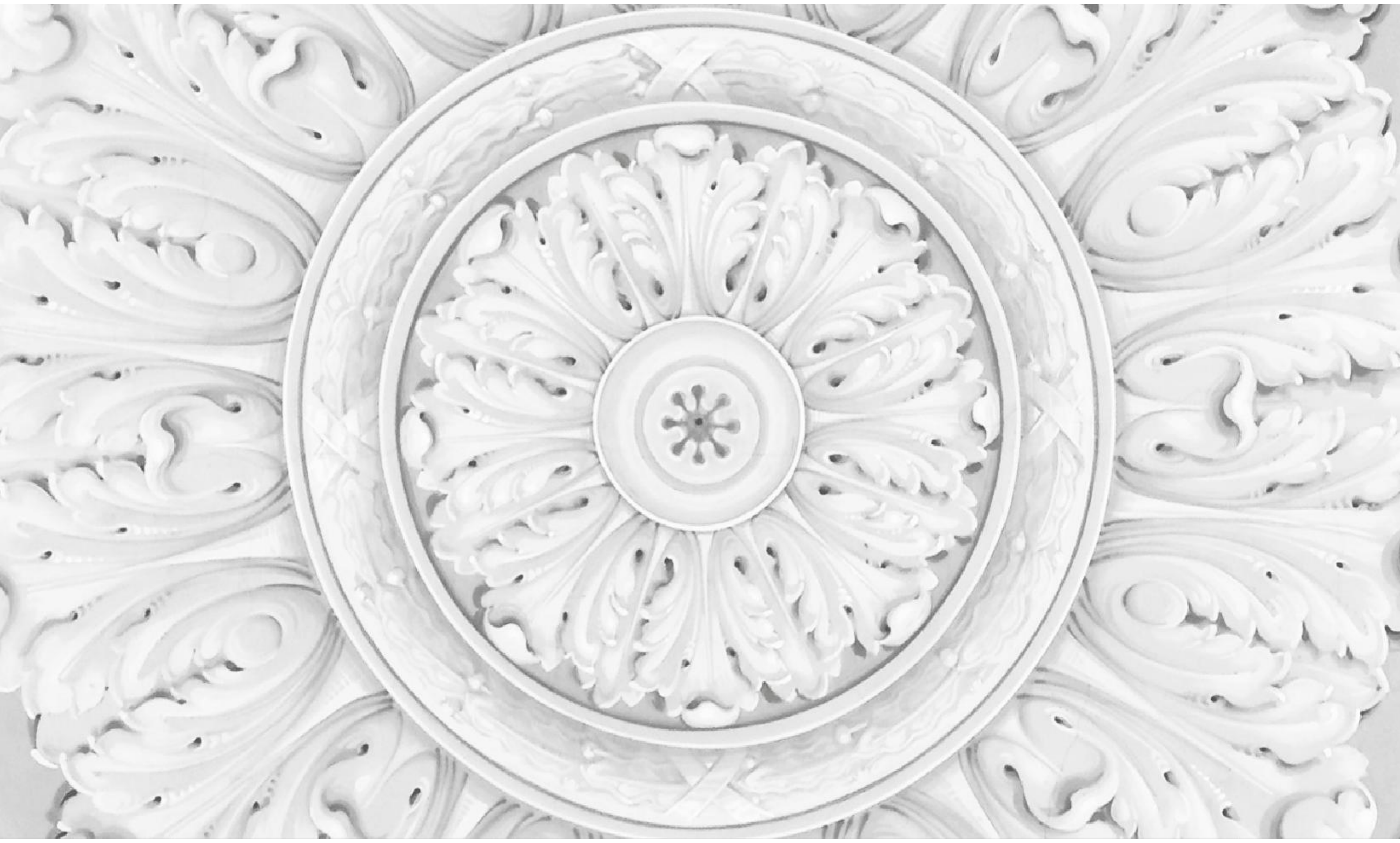
Bank of Russia

The Central Bank of the Russian Federation



TALKING TRENDS

Macroeconomics and markets

December 2017

Research and Forecasting Department Bulletin No. 8 (20)

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

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

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1. Monthly summary

- In the October to November period, inflation slowed to a fresh low, further driving down household inflation expectations. Based on analysis of inflation factors and their temporal variations, expectations are reasonably high that some acceleration in consumer prices is possible compared to their current reading, a steady 4% rate of inflation in 2018–2019 priced in. Economic expansion continues as it gains traction on a slow but sustainable trajectory. The balance of risks speaks well for a gradual shift from moderately tight to neutral monetary policy.
  - In October and November, inflation slowed to less than 3% on the back of the cumulative effect of temporary tailwinds and a moderately tight monetary policy. Risks that inflation may overshoot 4% in the medium term, albeit lower, still remain. These risks are primarily associated with real wage growth at a pace outperforming growth in productivity. The Bank of Russia's policy fosters reduced inflation risks and inflation becoming anchored at a level close to 4% over the forecast horizon.
  - Short-term economic activity readings and survey indicators suggest the economy is set to post sustainable albeit low economic growth rates in the second half of 2017 and the first half of 2018. Retail sales and consumer lending are gaining pace as real wage growth is accelerating.
  - Risks to the stability of financial markets remain moderate; they are not a substantial impediment to both successful inflation targeting or a gradual shift to neutral monetary policy. The Russian market remains broadly resilient to short-term movements in the external environment, global market fluctuations and global political risks.

2. Outlook

- Short-term model estimates suggest that economic growth is likely to be near or slightly above the potential in the forthcoming quarters.

3. In focus. Ruble performance in November. Depreciation despite high oil prices

- The ruble exchange rate weakened in the first half of November in spite of rising oil prices.
- This was caused by the overall performance of emerging markets: they have lost their appeal to investors as risk appetite declined.
- The weakening could also have been driven by the announcement of new budget rule parameters for 2018 and possible restrictions on Russian debt purchases.

1. Monthly summary

1.1. Inflation

Inflation slowed down between October and November and totalled less than 3%, driven by temporary tailwinds (growing global oil prices, record harvest across a number of agricultural crops combined with this year's extended effects from a stronger ruble) and moderately tight monetary policy stance. Household inflation expectations were also at an all-time low, as was underlying inflation. Core inflation readings stabilised at low levels. The OPEC+ deal extension helped reduce the risks of any substantial drop in the price of crude in 2018.

The deal also laid further groundwork for consumer price growth stabilising at a fairly low level close to 4%, which paves the way for a phased transition to neutral monetary policy.

The risks that inflation may overshoot 4% in the medium term declined but remain in place. Amid low unemployment and still elevated inflation expectations, they may materialise if the pace of wage growth exceeds growth in labour productivity.

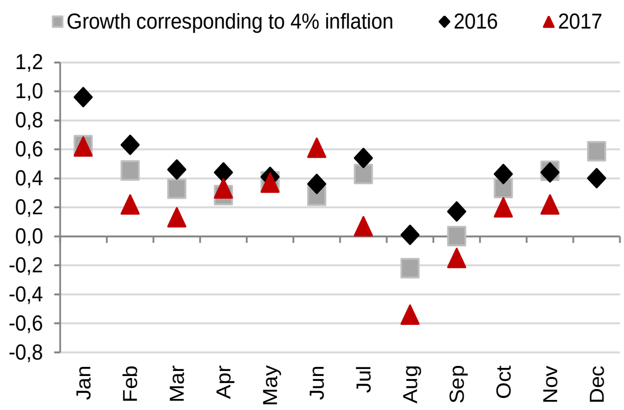
1.1.1. Inflation reduction is driven by a number of factors

- Consumer inflation in November decreased to 2.5% YoY.
- Inflation is currently constrained by temporary tailwinds together with the moderately tight monetary policy.
- The effects of a lower interest rate on the economy are not expected to materialise until next year. In this context, the consistent yet phased reduction of the Bank of Russia key rate will help avoid the risks of excessive price pressures in the second half of 2018.
- The median estimate of household inflation expectations for twelve months ahead was at its all-time low following two months of consecutive growth.

According to Rosstat data released late 5 December, November's price growth stood at roughly 0.22% MoM, holding below the reading consistent with the 4% inflation. Annualised inflation dropped to 2.5% in November from 2.7% registered in October (Figure 1). The impact of a fluctuating exchange rate on inflation remains substantial and drives its slowdown. In the October-November period, inflation, adjusted for intra-year stronger ruble effects, is expected to total 3.4–3.7%. Beyond currency exchange fluctuations, inflation is further constrained by the record harvest of a number of agricultural crops. The resulting inflation - adjusted for short-term effects is estimated to stand at slightly less than 4%. Seasonally adjusted growth rates slowed down to 0.1% MoM on 0.2% MoM in October (Figure 3).

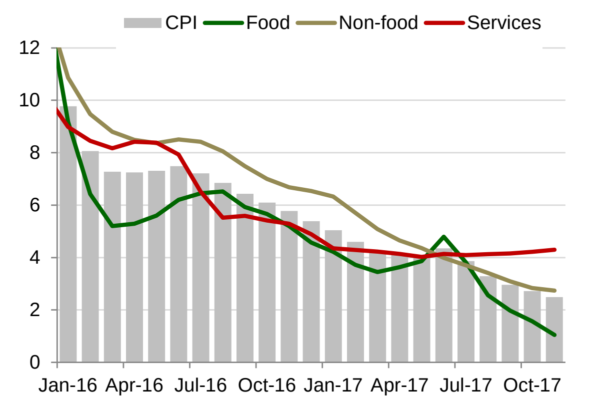
Estimates suggest that consumer prices increased by 0.1% in the period between 28 November and 4 December, with considerable acceleration in the average daily price growth. This is partially the case of the seasonal acceleration in fruit and vegetable price growth. However, accelerated price growth was also registered in many other weakly consumed products.

Figure 1. Price growth, % MoM



Sources: Rosstat, R&F Department calculations.

Figure 2. Inflation and its components, % YoY



Sources: Rosstat, R&F Department calculations.

Food prices resumed their downward trend in November (seasonally adjusted). Unlike before, this year it was driven not only by fruit and vegetable prices brought by good harvest. The increase in non-food prices accelerated for the first time in several months to 0.23% MoM after 0.15% MoM in October. The low price growth across several categories could be explained by the fact that the ruble was at its local maximum in mid-spring – the time seasonal procurement decisions were made (on fall/winter products, e.g. footwear and clothes). Considering that this effect is gradually fading, conditions are still in place for a further accelerated growth in non-food goods prices. Services prices showed the highest growth rate, with price growth accelerating in November to 0.33% MoM after 0.28% MoM in October.

This November's modified indicators of core inflation[1] grew virtually at the same pace as seen in October (Figure 4). It can be said they started to stabilise from mid-July (stripping out their August's temporary uptick) at 0.15%[2] MoM, following 0.20–0.25% MoM growth between February and June,. Comment is necessary on the temporary factors of a stronger ruble and good crops which affect the indicators of modified inflation, albeit to a lesser extent than those of headline inflation.

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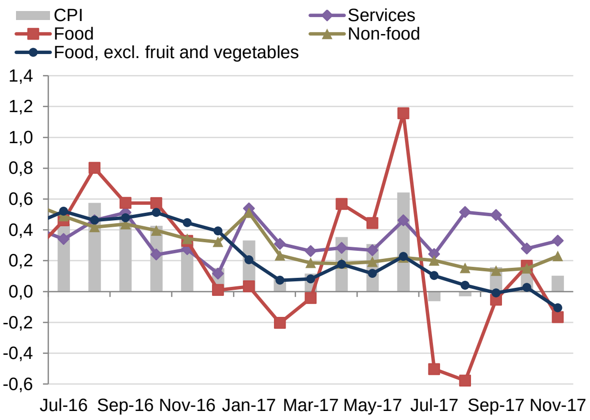
[1] The truncation method suggests a slight acceleration in price growth, whereas it is clear, once the most volatile components are excluded, that we are dealing with deceleration. Ultimately, this is a case of stabilisation close to the above reading.

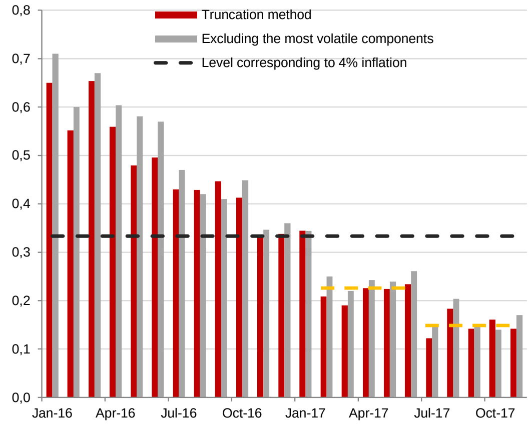
Figure 3. Seasonally adjusted price growth, % MoM



Sources: Rosstat, R&F Department calculations.

The November 2017 estimate is preliminary.

Figure 4. Core inflation estimate %, MoM, based on seasonally adjusted data



Sources: Rosstat, R&F Department calculations.

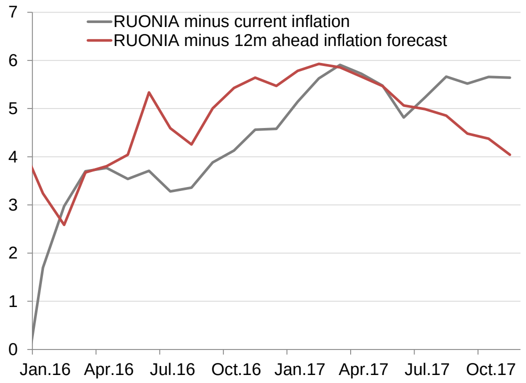
Current inflation dynamics have triggered a rise in the real interest rate, if calculated as the key rate deducted by the current inflation reading, because inflation declined faster than interest rates (Figure 5, grey line).

However, the real interest rate calculated based on *expected* inflation (in line with the conventional approach assuming that this particular measure influences market players' decisions) shrank by almost 2 pp. – from approximately 6 to 4%[3]. With the impact of transmission mechanism taking effect with time lags, the effect of this reduction will not materialise until next year.

Therefore, the expected expiry of the temporary tailwinds alongside a certain reduction in real interest rates in the course of 2017 are set to send price growth rates higher next year, all other things being equal. Yet inflation will stay close to 4%.

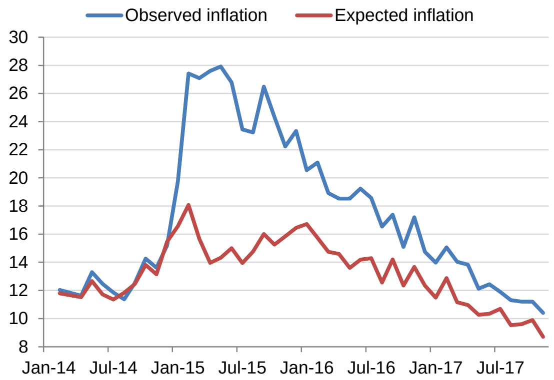
[3] Calculations are based on the Bloomberg inflation forecast for 12 months ahead.

Figure 5. Real interest rates, %



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

Figure 6. Household inflation expectations, %



Source: inFOM.

Polls suggest the economy is seeing a gradual decline in household inflation expectations. Based on an inFOM consumer survey, November's median estimate of household inflation expectations for the next 12 months were down to 8.7%, a fresh all-time low (Figure 6). Most respondents expect price growth rates to remain the same. The estimate for observed inflation was downgraded to 10.4%. As before, most respondents view the current price growth as muted. However, as follows from VCIOM (the Russian Public Opinion Research Centre) poll findings[4], households still expect price growth to continue in the face of currently low inflation. However, the estimate for anticipated price growth declined relative to last year.

1.1.2. Acceleration in producer prices hasn't translated into consumer prices so far

- Producer prices are currently growing at faster paces than consumer inflation, mainly thanks to the strong increase in producer prices in mining, oil products and metallurgy, which are all tracking the global trends.
- From a statistical standpoint, the producer price index cannot be viewed as a precursor of acceleration in consumer prices; however, in the current context of accelerated price growth rates in the oil products sector, given that high oil prices are holding, this index could add further inflationary pressure in 2018.
- Producer prices rising at an accelerated pace could sustain elevated inflation expectations in the industrial sector, shoring up demand for borrowings while the BoR key rate is at this reading.

[4] ВЦИОМ Пресс-выпуск №3514. (VCIOM, Press release 3514) 15.11.2017. The poll took place between 30 October and 1 November 2017.

This October saw annual producer price growth rates reaching 7.62% as they outran the pace of consumer price growth (2.72% in October) for the third consecutive month (Figure 7). Producer prices registered outrunning growth paces in mining (+14.0% YoY). In the manufacturing sector, producer prices were rising fastest in the production of coke and oil products (+20.8% YoY) and in the metallurgical sector (+11.7% YoY), coming as a result of the global expansion of oil and metal prices.

As regards consumer goods, the paces of producer price growth broadly remain below those of consumer prices, in a sign that prices are under no further pressure from producers (Figure 8).

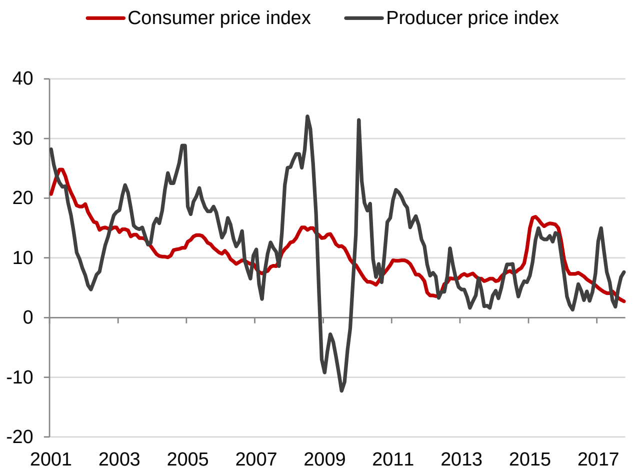
A rising producer price index is not an automatic trigger of consumer inflation, with its performance being much more volatile relative to the consumer price index[5]. For example, the February upsurge of 15% YoY in producer prices failed to accelerate consumer inflation. Based on statistical causation tests for the past 17 years, there is no direct impact of the producer price index on that of consumer prices and vice versa. The key reason, as we see it, is the different component structure of the two indexes.

Insights into individual product categories could provide more evidence of inflation risks or their absence. As an example, producer and consumer prices for oil products are both rising at a rate well above inflation. Assuming global oil prices hold at $60 a barrel or higher, an outrunning growth of fuel prices could start to put pressure on costs in the economy and further exacerbate overall inflation pressure. Furthermore, the fuel excise duty review as early as 2018 could add another 0.24 pp to consumer inflation - more than the initially proposed 4% indexation of excise duty commensurate with inflation.

Proceeding from the current growth paces of consumer prices, many experts consider the BoR real interest rate to be high (2.4% as of late November against the key rate 8.25%). However, the high pace of producer price growth – 7.6% YoY (with strong differentiation across industries) – could sustain elevated inflation expectationsin the industrial sector, thereby shoring up demand for borrowings. This spells the need for an appropriate monetary policy stance that would not hold back demand for loans in the industrial sector.

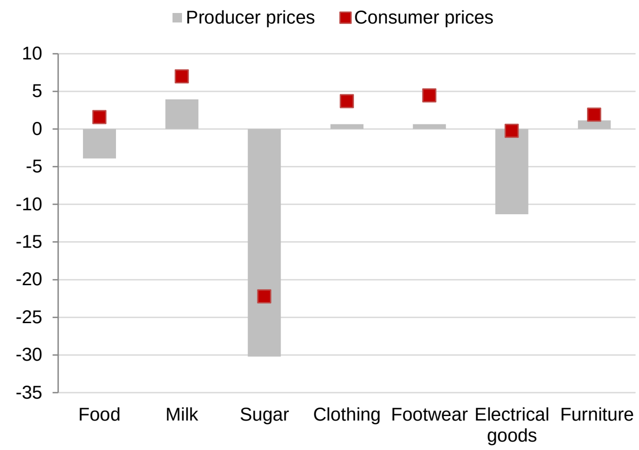
[5] The standard variation in annual growth paces of producer prices since 2000 has been two times the deviation in consumer prices.

Figure 7. Producer price and consumer price index, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 8. Price movements across individual products in October, % YoY

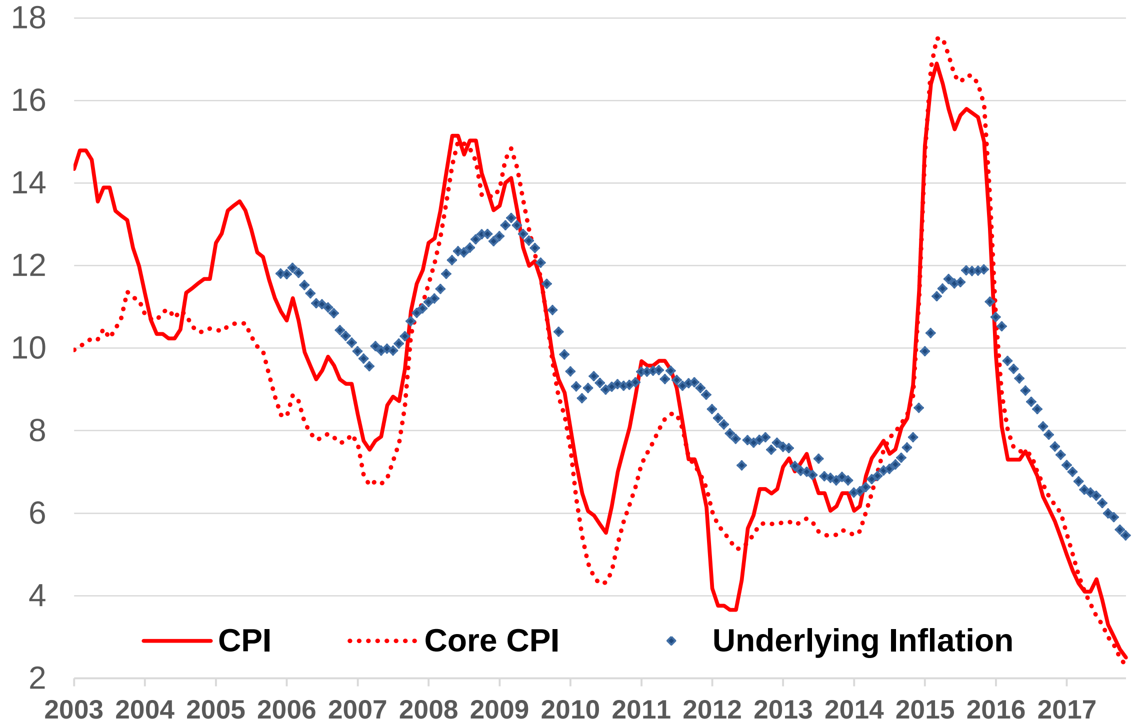


Sources: Rosstat, R&F Department calculations.

1.1.3. Underlying inflation is declining

- The annual rate of underlying inflation in October 2017 was revised downwards to 5.6% from 5.9% in September, reflecting a further easing in mid-term inflationary pressures (Figure 9).

Figure 9. CPI, core CPI and historical estimates for underlying inflation, % YoY



Sources: Rosstat, R&F Department calculations.

- Despite the sustainable slowdown in underlying inflation, its current estimate is still viewed as elevated, which is attributed to heightened historical inflation rates, as well as the inertia of this indicator from its building perspective.
- Our estimates suggest that the decline in underlying inflation, barring pro-inflation shocks, is on track to continue.

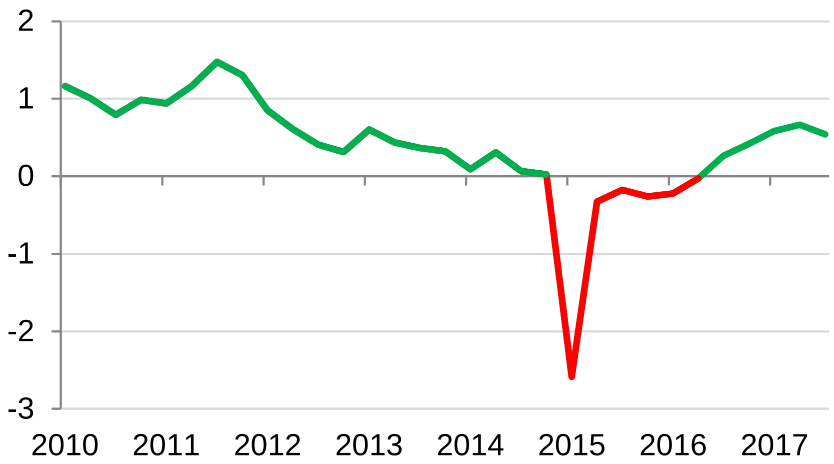
1.2. Economic performance

Short-term economic indicators and survey data point to sustainable economic expansion at a steady pace consistent with its current potential. Unemployment edged down to a level we view as natural and the one that maintains sustainable economic growth without accelerated inflation. The October slowdown in industrial expansion is short-lived and comes mainly as a result of the OPEC+ deal alongside the warm weather factor. Leading indicators suggest continued expansion in the manufacturing sector and in the overall economy in the fourth quarter of 2017 and in the first half of 2018.

1.2.1. GDP growth in 2017Q3 matches potential rates

- According to Rosstat's preliminary estimates, Q3 GDP growth stood at 1.8% YoY, having slowed down after 2.5% YoY in the second quarter.
- Our estimates suggest the above GDP growth is corresponding to seasonally adjusted quarterly growth paces of 0.5% in the third quarter of 2017 (Figure 10).
- This is in line with the current potential growth of the Russian economy or slightly above it.
- The seasonally adjusted GDP growth rates estimates are preliminary. These estimates assume no retrospective review in Rosstat Q3 data and the indicator stands at 1.8% YoY.

Figure 10. GDP in constant prices (seasonally adjusted), % QoQ



Sources: Rosstat, Bank of Russia calculations.

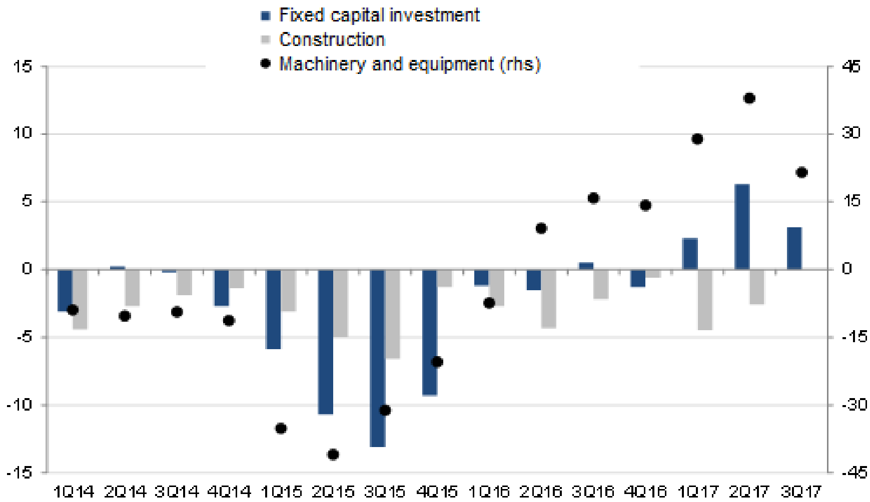
1.2.2. Investment in fixed capital is slower as large-scale projects are nearing completion

- Small enterprise investment is invariably the leading contributor, notwithstanding a certain slowdown in growth rates.
- The weaker investment data are mainly driven by the slower machinery and equipment procurement undertaken by major enterprises.
- Conversely, residential and non-residential construction is on the mend.

According to updated Rosstat data, fixed capital investment growth in the third quarter of 2017 slowed down to 3.1% YoY against 6.3% YoY in the second quarter of 2017. This slower fixed capital investment on an annual basis was stronger than expected.

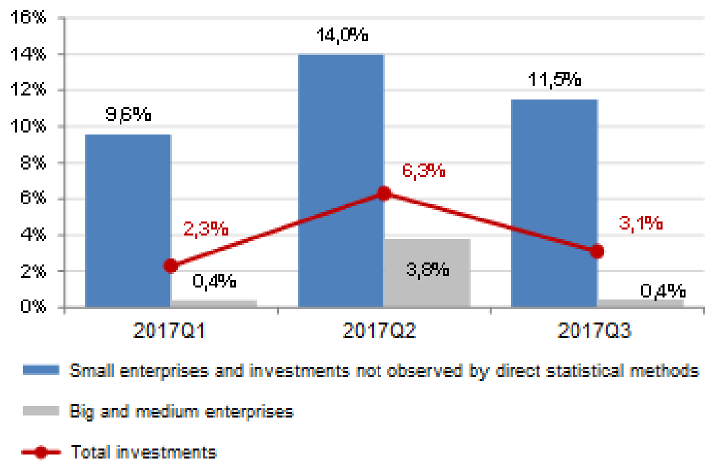
Importantly, based on recent estimates, assuming the overall pace of fixed investment growth for the first nine months of 2017 at 4.2% YoY, major and medium enterprises report a mere 1.3% YoY. Consequently, small enterprise investment as well as investment unobserved by statistical methods make a key contribution to the current growth. New statistics are further testament to the fact that small enterprises are emerging as a key investment driver. There was only a slight contraction of small enterprise investment growth in the third quarter from 14% to 11.5% YoY[6]. The fact that most growth was observed in small enterprises shows signs of the onset of a very important trend: growth is increasingly driven by fundamental factors, and it is also becoming increasingly broad-based, expanding beyond major projects.

Figure 11. Fixed capital investment, construction and machinery and equipment exports, growth rates YoY



Sources: Rosstat, R&F Department calculations.

Figure 12. Core components of fixed capital investment, % YoY

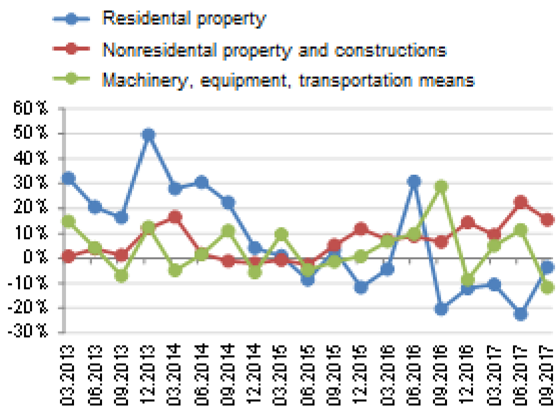


Sources: Rosstat, R&F Department calculations.

[6] The contribution of investment directly uncaptured by statistical methods is not viewed as prevalent.

As follows from analysis of major and small enterprise investment (accounting for roughly 70% of total capital investment)[7], the weaker data in this type of investment were recorded against the background of lower growth in investment into machinery and equipment (approximately 40% of aggregate capital investment). Importantly, it is procurement of machinery and equipment that has been an investment growth driver since the start of the year. Meanwhile, the third quarter saw continued improvements in the other important investment categories, namely, non-residential and residential construction (>40% of all investment).

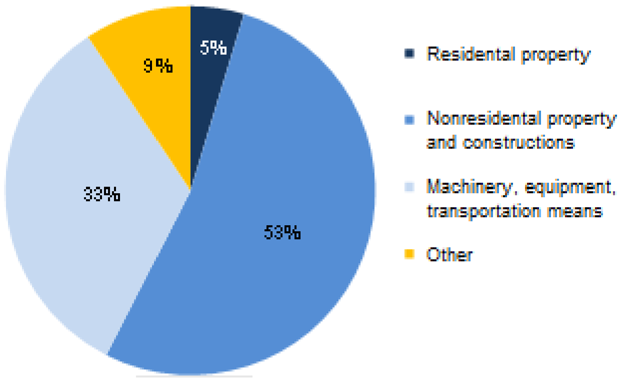
Figure 13. Core investment components: major and medium enterprises*, % YoY



** approx.70% of total fixed capital investment*

Sources: Rosstat, R&F Department calculations.

Figure 14. Investment composition: major and medium enterprises*, % YoY for the first nine months of 2017



Sources: Rosstat, R&F Department calculations.

1.2.3. Industrial output: the OPEC+ deal pushes manufacturing output down

- Seasonally adjusted industrial output was down in October by 0.1% MoM, according to Rosstat, and 0.7% MoM, according to the R&F Department estimates.
- Industrial output declined mainly on the back of the manufacturing sector's data. Among key reasons behind this is the impact of compliance with the OPEC+ deal to cut the output of crude oil on refiningand other cross-sectors, while at the same time rebalancing exports towards more crude oil.
- With business expectations in the industrial sector still sanguine, the industrial sector looks on track to resume expansion.

According to Rosstat, industrial output in October continued to decline. The decline, adjusted for seasonal and calendar effects, totalled 0.1% MoM. On an annualised basis,

[7] Excluding small enterprises and the amount of investment uncaptured by statistical methods.

industrial output was unchanged (after +0.9% YoY in September) despite the positive contribution of the calendar effect which was expected to support continuous production[8].

Having offered a fairly conservative estimates of industrial output performance between June and September, R&F Department's October reading suggested a deeper decline of 0.7% MoM[9]. In particular, it follows from these estimates that the increment in output generated between January and May was mainly lost in the months that followed (Figure 15).

The core reason behind negative industrial output dynamics, beyond the expected drop in the output of mining, was a drop in manufacturing output of 0.7% MoM[10] (slowdown to +0.1% YoY from +1.1% YoY in September) following the two months of robust growth there.

Based on product breakdown, manufacturing outputs were under pressure from the impact of compliance with the OPEC+ deal to cut oil production. The volume of primary crude oil refining and the output of core oil products in October both saw a decline because of last year's high base effect (Figure 16). Furthermore, the trend of exports being rebalanced towards crude oil remains, making a further negative contribution to oil product outputs. The effect from the OPEC+ deal extended to cross-sectors. For example, negative growth in metallurgy could have been driven in part by slower demand for pipes used in oil production.

The relatively warm weather in October[11] made a negative contribution to industrial outputs, pushing down the outputs of electrical power, gas and steam.

Preliminary data[12] suggest that the outputs of consumer and investment products showed only immaterial slowdown in growth. In this way, the reasons for decreased industrial outputs are mainly technical (implementation of the OPEC+ deal and its implications for the allied sectors), coupled with natural factors (warm weather).

The warm weather, which continued into the first two weeks of November[13], oil outputs and outputs in the allied sectors are on course to put further pressure on industrial expansion in November and, consequently, on GDP growth in the fourth quarter. That said, the overall negative October data are misaligned with the performance of PMI indexes - which showed a *slower growth* rather than a *drop* in outputs. The positive expectations in the industrial sector, confirmed by several polls, suggest that it is reasonable to expect a rebound in industrial growth in the next months (adjusted for the adverse effects stated above).

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[8] There were 22 working days in October compared to 21 in October 2016.

[9] However, considering the extremely limited series of observations based on the new methodology, the current seasonally estimated calculations should be interpreted with caution. Central to this caution is the wagging tail problem: as new data come in subsequently, these estimates can be revised.

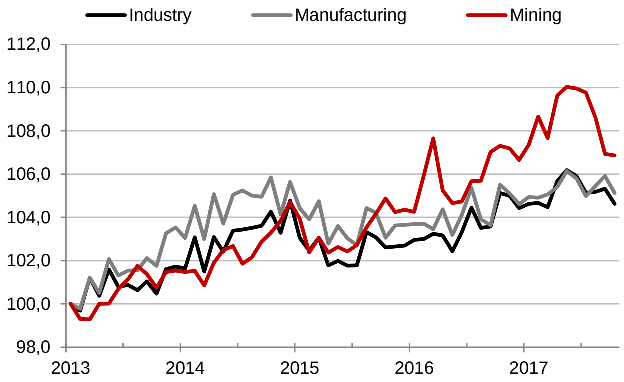
[10] Adjusted for seasonal and calendar factor effects.

[11] 3.6ºC in October 2017 compared to 1.9ºC in October 2016.

[12] Estimates are expected to be finalised following the release of the report on Russia's social and economic situation for the January-October 2017 period.

[13] -0.8ºC between 1 and 17 November 2017 against -6.8ºC between 1 and 17 November in 2016.

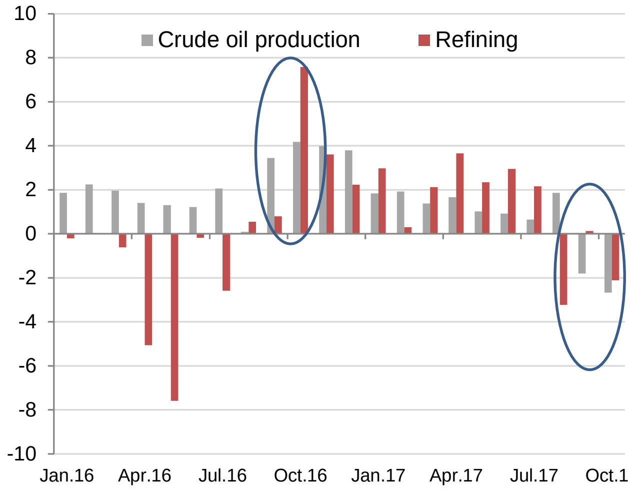
Figure 15. Industrial production* (January 2013 = 100)



* seasonally and calendar effect adjusted.

Sources: Rosstat, Bank of Russia calculations.

Figure 16. Oil production and refining in Russia, % YoY



Source: RF Ministry of Energy (Minenergo of Russia).

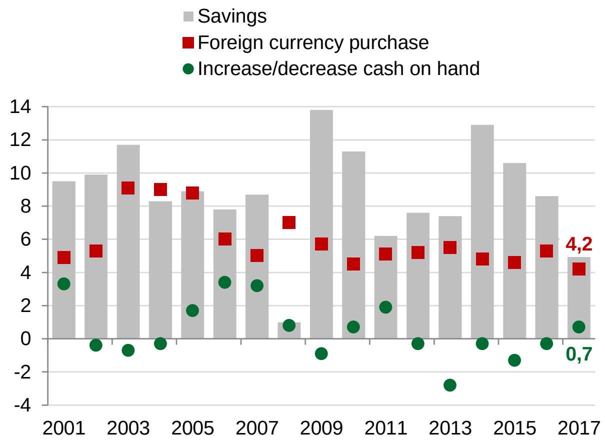
1.2.4. The savings ratio is down, driven by a recovery in lending

- According to Rosstat, the savings ratio in September was 5.5%, which is below the reading of the same period of the past year and more of a match for 2011-2013.
- Expansion in lending remains among the underlying causes of the declining savings ratio.
- Stronger consumer activity is evidenced by polling data: households tend to save less as consumer lending is expanding.

According to Rosstat, September's saving ratio at 5.5% on 4.1% in August[14] was more aligned to the September 2011–2013 readings than to the past year's (Figure 17). Due to the decline in the savings ratio compared to last year increased the share of monetary income spent on products and services including the use of banking cards overseas and on statutory payments and contributions. Also, unlike the year prior, currency in hand is up

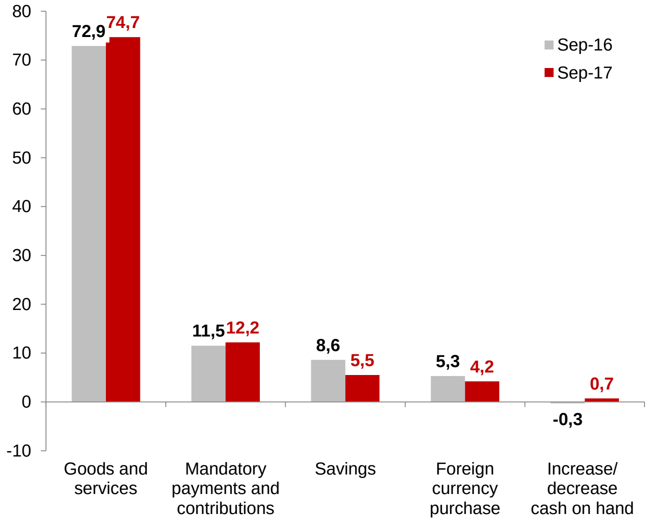
[14] The January-August 2017 data were revised.

Figure 17. Spending patterns in monetary income, August 2017 (%, seasonally adjusted)



Source: Rosstat, R&F Department calculations.

Figure 18. Changes in the spending structure of monetary income, % to monetary income



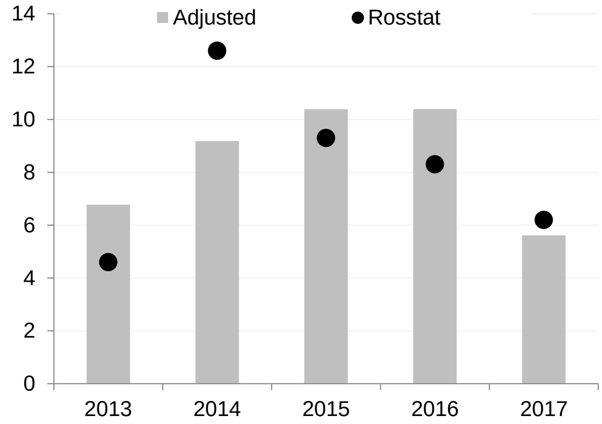
Source: Rosstat, R&F Department calculations.

Once foreign currency deposits and loans are included, the savings ratio becomes lower than Rosstat's reading - due to the decline in foreign currency deposits (Figure 19)[15]. The lower savings ratio against previous years comes as a result of a rebound in lending with its negative implications for the savings ratio, as well as slower growth of deposits (Figure 20). It is also possible that immediate assessment of the savings ratio is somewhat undervalued due to the consumers' increasing use of alternative forms of savings (including individual investment accounts and profit sharing certificates) - and there is a delay in their accounting.

Household net purchases of foreign currency in September went down against the previous month. Demand for foreign currency was declining in part on the back of the tourist season drawing to a close. Nonetheless, the share of foreign currency purchases in monetary income was slightly down against the previous year. This can be partially attributed to the increased amounts of consumer spending (on goods and services) (Figure 21).

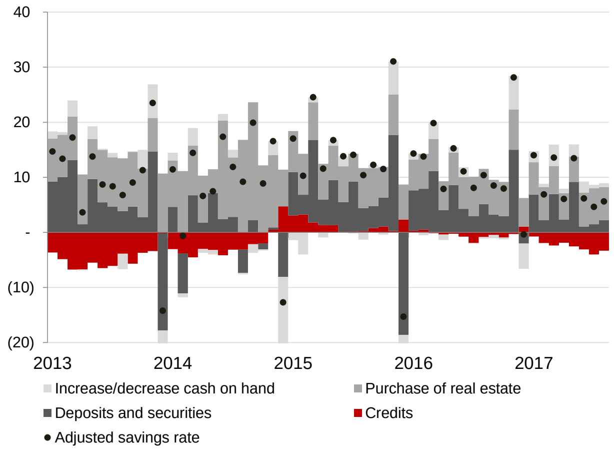
[15] Rosstat's savings ratio also took into account movements in cash in hand.

Figure 19. Savings ratio in September (%, including cash in hand)



Sources: Rosstat, R&F Department calculations.

Figure 20. Adjusted savings ratio breakdown



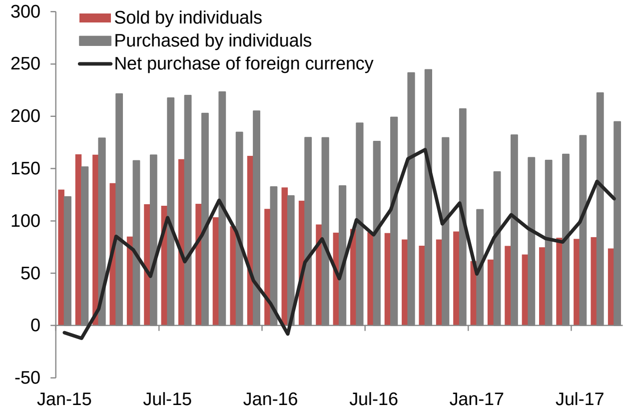
Sources: Rosstat, R&F Department calculations.

With Rosstat currently refining the methodology for calculating household monetary income and spending, which may entail a revision of statistical data, alternative indicators should also be used to enable a more precise understanding of consumer behaviour patterns. According to inFOM's October survey[16], October's consumer sentiment slightly deteriorated against September, which was triggered by lower expectations including those pertaining to future financial standing (Figure 22). In this manner, the assessment of future financial standing was down by 3 pp on the back of a growing proportion of respondents who expect their financial standing to deteriorate in the next 12 months. Still, most respondents expect no changes to their financial standing in the next 12 months. The current assessment of financial standing remained unchanged overall.

The population's attitude to saving in October also deteriorated. Although the proportion of respondents who were able to save was unchanged from September, it is still at its lowest level since early 2016. Moreover, the proportion of individuals without savings was also up in the September to October period. However, considering the decline in the share of those, having to economise over the past three months, it is reasonable to assume that households tended to spend cash on goods and services rather than on accumulating savings. Overall, given the trend towards a decline in the estimates of how this period favours saving, as well as the fact that the proportion of respondents with a loan has been growing, it can be said that household purchasing activity is rising. In light of this, October's consumer sentiment could lead to the savings ratio stabilising at a level lower than the one a year ago, due to the more muted growth in deposits and a rebound in lending.

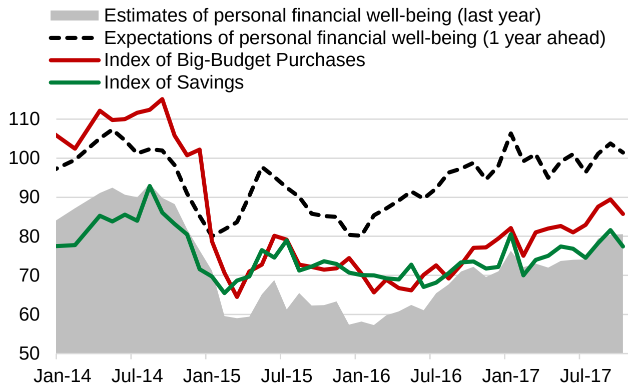
[16] See 'Inflation expectations and consumer sentiment'. 2017. No. 10 (October).

Figure 21. Purchases, sales and net purchases of foreign currency by households (billion rubles)



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

Figure 22. Index of large purchases, savings and personal financial standing assessment / expectations, pp



Source: inFOM survey.

1.2.5. Consumer demand keeps recovering

- Retail sales grew by 3.0% YoY in October following a 3.1% YoY growth in September.
- September's high comparative base as a result, among other things, in the delayed harvesting of fruit and vegetables, decreased retail sales in October by 0.35% MoM, adjusted for seasonal and calendar effects.
- Real wage growth, a lending revival and optimistic consumer sentiment will continue to boost consumer demand.

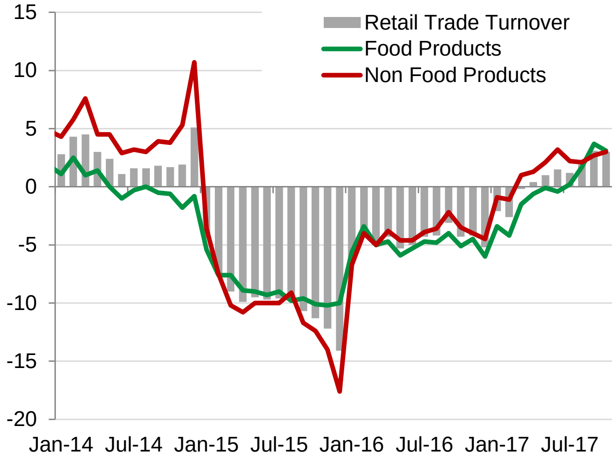
Rosstat data suggest that retail sales grew by 3.0% YoY in October after a 3.1% YoY increase in September: the highest reading since December 2014. The recovery of turnover is backed up by real wage growth that stood at 4.3% YoY in October after 4.4% YoY a month earlier.

Food sales continue to increase faster than non-food turnover, though the gap in growth rates shrank compared with the previous month. Food sales grew by 3.1% YoY while non-food turnover accelerated from 2.7% YoY to 3.0% YoY.

According to our estimates, seasonally and calendar effect adjusted retail sales dropped by 0.35% MoM after having increased by 0.6% MoM in September (Figure 24). Meanwhile, the reporting month registered a shrinkage in both food and non-food sales by 0.56% MoM and 0.4% MoM[17] respectively. The decline may have resulted from large purchases of food products in September due to a delayed harvesting of fruit and vegetables this year, and smoother dynamics of non-food purchases during the year (as evidenced by a faster annualised growth of non-food sales).

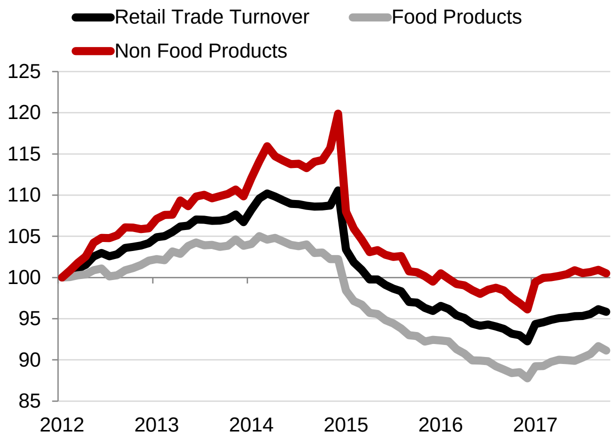
[17] The dynamics of individual indicators may differ from the overall dynamics.

Figure 23. Food, non-food and total retail sales, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 24. Retail trade turnover (%, January 2012 = 100%, seasonally adjusted)



Sources: Rosstat, R&F Department calculations.

Data by Romir[18], a research holding company, suggest that household real consumer spending increased by 5.5% in October compared with September. This is partially attributed to a halt in the seasonal price drop for some fruit and vegetables. However, last month's increase in spending on non-food products (from 50% to 53%) allows us to conclude that they most likely accounted for the additional spending. Real expenses fell by 2.1% YoY after having grown by 0.3% YoY in September. As regards consumer spending of individual income groups, it should be noted that consumers in the middle income group increased their expenses by 2.5% over the year, considerably more than other income groups.

An inFOM survey[19] suggests that household consumer sentiment slightly deteriorated in October compared with September. October estimates of the current and future financial standing hardly changed (Figure 27). At the same time, as early as November respondents improved their perception of developments in their financial standing over the past year and expect it to pick up in future.[20] The proportion of respondents whose financial standing deteriorated over the past year shrank further to reach 30% in November.

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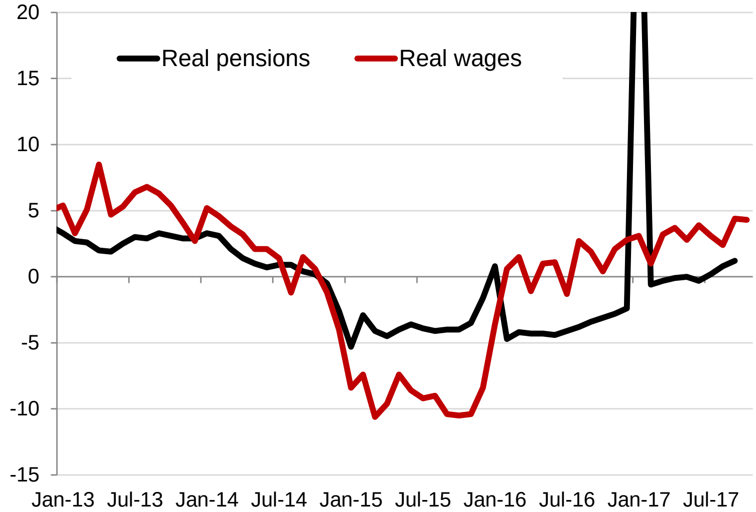
[18] Romir Research Holding «Пошли в расход». 08.11.2017.
[19] 'Inflation expectations and consumer sentiment'. No. 10. October 2017
[20] Real-time data for November.

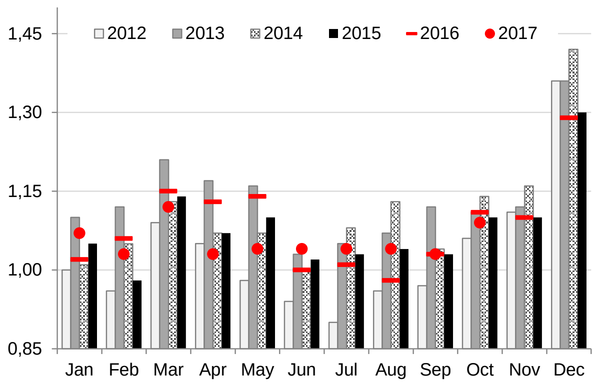
Figure 25. Real income of households, % YoY



Sources: Rosstat, R&F Department calculations.

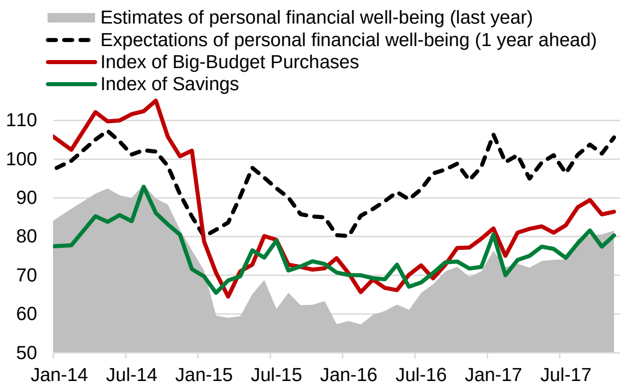
Households' sentiment attitudes to large purchases slightly deteriorated in October after having grown for the three previous months, but has remained above the year-start reading. The proportion of those who would choose to spend their discretionary income on expensive goods increased as the proportion of those who would choose to save shrank. In November, respondents' attitude towards large purchases remained virtually unchanged. Overall, given the trend towards a decline in the estimates of how this period favours saving, as well as the fact that the proportion of respondents who have taken a loan has been growing, it can be said that household purchasing activity is set to rise.

Figure 26. Real consumer spending (January 2012 = 100%)



Source: Romir Research Holding.

Figure 27. Consumer sentiment index and its components, pp



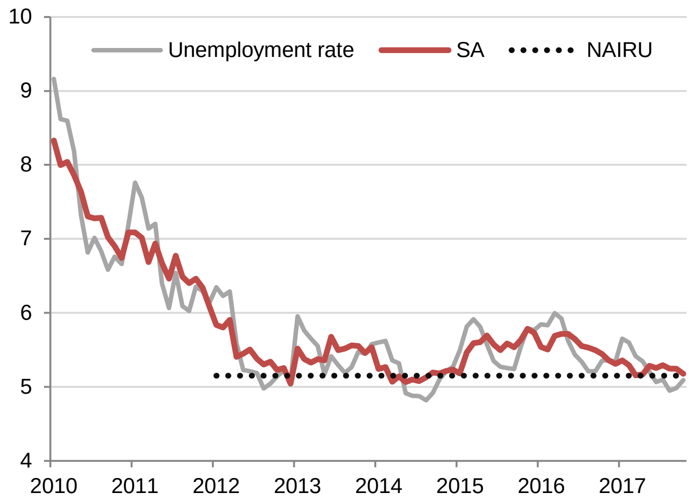
Source: inFOM, R&F Department calculations.

1.2.6. Unemployment remains low, real wages grow faster

- In October, seasonally adjusted unemployment rate declined slightly, staying close to the natural level.
- The annual increase in nominal wages was revised upwards by almost 2 pp in September exerting a positive effect on real wage growth.
- The fulfilment of the May presidential decrees will support wage growth throughout 2018.

Unemployment has been sustainably low throughout this year. In October, it increased to 5.1% following 5.0% in September, while the seasonally adjusted indicator dropped slightly from 5.24% in September to 5.18% (Figure 28).

Figure 28. Unemployment, %



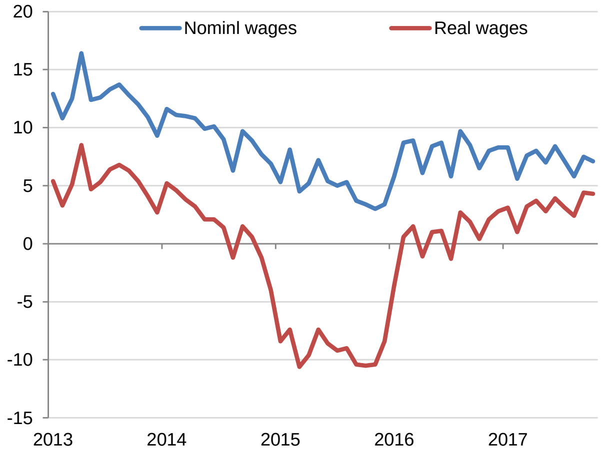
Sources: Rosstat, R&F Department calculations.

As expected, Rosstat revised nominal wage growth in September upwards, from 5.6% to 7.5% YoY. The revision had a positive effect on the annualised real wage growth that ultimately came to 4.4% YoY.

According to preliminary estimates, nominal wage rose by 7.1% YoY in October (Figure 29). Nominal wage growth has held at 7-8% YoY on average for almost two years. However, real wage rose by 4.3% YoY. The recent acceleration in real wage growth is explained by the ongoing inflation slowdown driven by temporary factors. Factored out, they would hold real wage growth at roughly 3% YoY. Thereby, low inflation increased incomes’ purchasing power.

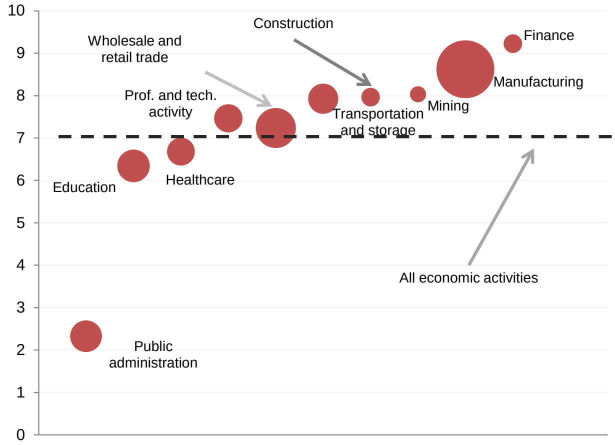
Wages by economic activity remain unchanged (Figure 30). The expected fulfilment of the May presidential decrees is posed to keep overall wage growth elevated throughout 2018.

Figure 29. Nominal and real wage growth rates, % YoY



Source: Rosstat.

Figure 30. Nominal wage growth by sectors in January-September, % YoY



Sources: Rosstat, R&F Department calculations.

The area of the circles is proportional to the activity's share in total payroll.

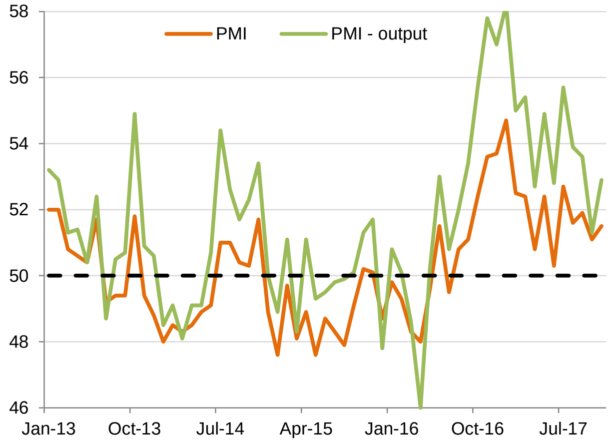
1.2.7 The November PMI index pointed to stabilised growth in manufacturing

- In November, manufacturing PMI increased to 51.5 pp, an all-time average.
- At the same time, companies' business sentiment declined and they resumed job cuts.
- PMI movements suggest that growth rates have stabilised at more moderate levels. However, oil price growth above $60 a barrel may result in another modest surge in business activity growth.

In November, manufacturing PMI went up from 51.1 pp to 51.5 pp, pointing to an accelerated expansion in the sector's business activity compared with October (Figure 31). However, the index has held near the all-time average for the fourth month in a row. This may suggest that the sector has achieved moderate but sustainable growth. This may keep the volatility of the integral index low in the months to come.

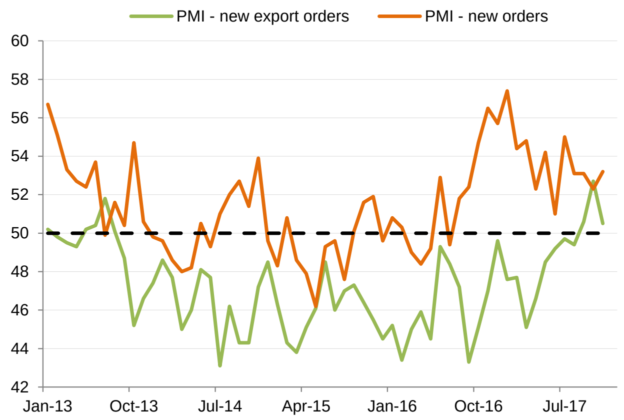
PMI growth in November was triggered by the improved dynamics of new orders which showed the highest growth since July 2017. New export orders grew as well but at a lower rate than in October (Figure 32). Production volume PMI also exceeded its October reading (Figure 31). Furthermore, quantity of purchases resumed growth while stocks of finished goods shrank at the highest rate registered since January 2016. This indicates that growth in demand is outpacing that of production.

Figure 31. Manufacturing PMI indices, pp



Source: Bloomberg Finance L.P.

Figure 32. Components of manufacturing PMI by orders, pp

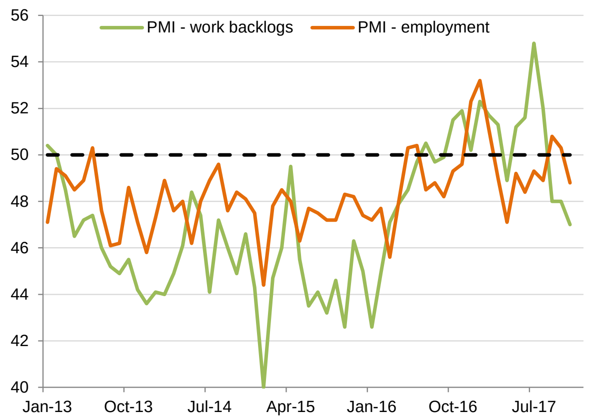


Source: Bloomberg Finance L.P.

Nevertheless, these factors together proved insufficient to sustain businesses' elevated optimism. The business expectations index was down again, dropping below its all-time average in November. Work in progress shrank at the highest rate registered over 21 months. In addition, firms cut jobs, interrupting the trend toward job growth that had started in August (Figure 33). Apparently, manufacturing companies believe that low growth rates the sector has experienced over the past months will persist. Therefore, companies may be guided by such expectations in their job cuts. This may suggest that labour market risks coming from the manufacturing industry are abating.

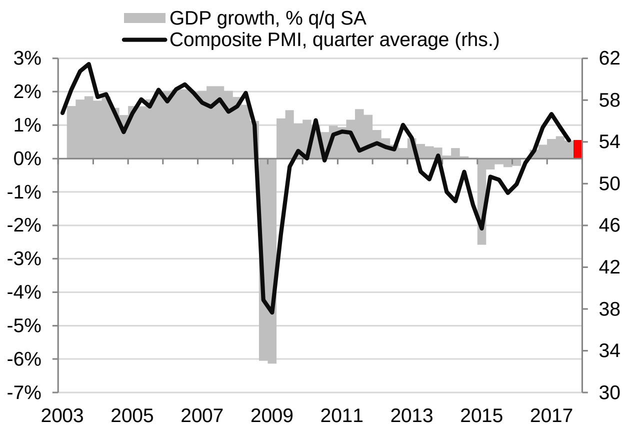
Overall, the fourth quarter is still characterised by a low but apparently more resilient growth in this sector's output. This is in line with a gradual slowdown in economic growth to the potential growth rates (Figure 34). Meanwhile, oil price growth above $60 a barrel may result in another modest surge in growth acceleration. This is indirectly confirmed by our upward revision of the index estimate of 2017 Q4 economic growth to 0.6% QoQ (for details see Sub-section 2.2.1. GDP nowcast revised upward in November').

Figure 33. Manufacturing PMI indices, pp



Source: Bloomberg Finance L.P.

Figure 34. GDP and composite PMI index



Source: Bloomberg Finance L.P., Rosstat, Bank of Russia calculations.

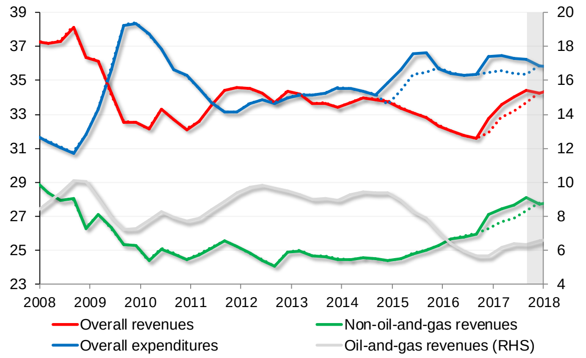
1.2.8. Fiscal consolidation undertaken ahead of schedule

- As of the end of the first three quarters of 2017, budget revenue went up by 2.4 pp of GDP YoY; this includes a 1.4 pp increase in non-oil and gas revenue. This results from improvements in tax collection from domestic manufacturers. As of the year-end, this surplus will shrink but remain considerable.
- Overall, budget expenditure is repeating 2016 seasonality while its structure is shifting from military to economic and social items, and from final consumption expenditure to transfers and capital investment.
- As of end-2017, budget deficit will come to roughly 1.5% of GDP, 2 pp lower than in 2016 and 0.7 pp below the Finance Ministry's plan for 2017. In 2017, the benchmark deficit for 2018 will be achieved.

Russian budget revenue surged in 2017 (Figure 35). In the first three quarters, revenue increased to 33.7% of GDP or by 2.4 pp of GDP YoY[21], including oil and gas (1.0 pp) and non-oil and gas revenue (1.4 pp). The former results from the increase in oil prices (Figure 36): the positive effect of the OPEC+ production cut deal largely offset revenue uncollected because of production and export cuts. The latter comes from rising tax revenue from domestic production. This may be primarily explained by improvements in tax collection (the increase in non-tax payments and tax revenue from imports largely matches GDP growth).

In the 2017Q3, non-oil and gas revenue increased by 1.6 pp of GDP YoY whereas oil and gas revenue dropped by 0.1 pp of GDP YoY.

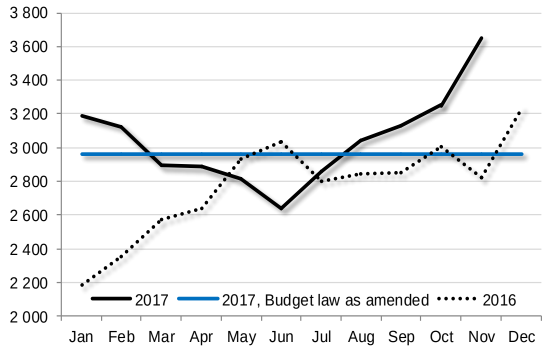
Figure 35. Russia's key budget system indicators (% of GDP, four-quarter moving average)



Sources: Russia's Finance Ministry, Federal Treasury, Rosstat, R&F Department calculations.

** Dashed line shows estimates with large one-time factors factored out: bank recapitalisation in 2014 Q4, expenses on loan repayment before maturity by the military-industrial complex and Rosneft privatisation in 2016 Q4.*

Figure 36. Monthly ruble price of Urals per barrel in 2016-2017



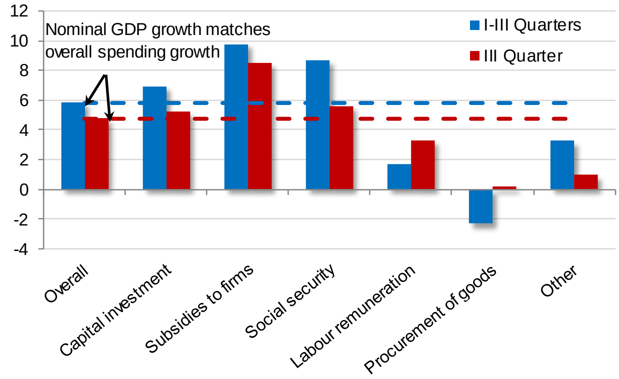
Sources: Bank of Russia, Russia's Finance Ministry, R&F Department calculations

[21] 2017 Q3 data use preliminary GDP estimates of Russia's Finance Ministry.

The high base of non-oil and gas revenue will start to play a role in the fourth quarter due to the effect of Rosneft privatisation.[22] Change in oil and gas revenue relative to GDP may also stay insignificant. However, budget revenue will retain a high growth rate as of the end of 2017. Our estimates suggest that it will come to 1.4 pp of GDP YoY (Figure 35), exceeding the predictions made in the Guidelines for Fiscal, Tax and Customs and Tariff Policy for 2018-2020 (Fiscal Policy Guidelines) by almost 1 pp of GDP.

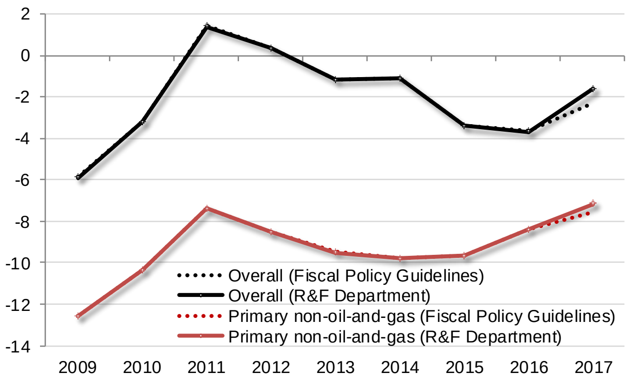
The Fiscal Policy Guidelines provide for a 1.2 pp of GDP lower budget expenditure in 2017 than in 2016. However, after deduction of loan repayment before maturity by the military-industrial complex in 2016 Q4,[23] it is equal (Figure 35). 2017 saw outpacing expenditure in the first quarter that was offset in the second quarter; subsequently, spending seasonality matched that of 2016 (Figure 37). By functional classification the expenditure structure shifts from military to economic and social spending. By economic classification expenditure shifts from final consumption expenditure (procurement of goods and services, labour remuneration and most other expenses) to transfers (to businesses and households) and capital investment (Figure 37).

Figure 37. Budget expenditure growth by economic classification, % YoY



Sources: Federal Treasury, R&F Department calculations.

Figure 38. Cumulative and non-oil and gas primary balance of the budget system, % of GDP



Sources: Federal Treasury, Russia's Finance Ministry, Rosstat, R&F Department calculations.

According to our estimates, budget deficit is set to decrease considerably as of end-2017 against the previous year, and will stand at roughly 1.5% of GDP: this reading may be slightly higher if we assume that allocated funds are spent in full and slightly lower they are spent only partially, as usually done (Figure 38). This is not only 2 pp less than in 2016 but also roughly 0.7 pp below the predictions made in the latest Fiscal Policy Guidelines due to the Russian Finance Ministry's conservative revenue estimates. Therefore, as early as end-2017 the benchmark budget deficit for 2018 will has been achieved (1.5% of GDP). This suggests that budget consolidation is being conducted ahead of schedule.

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[22] Revenue from Rosneft privatisation accounted for almost 3 pp of GDP in 2016 Q4.
[23] Expenses on early loan repayment by the military-industrial complex accounted for slightly less than 3 pp of GDP in 2016 Q4.

2. Outlook: leading indicators

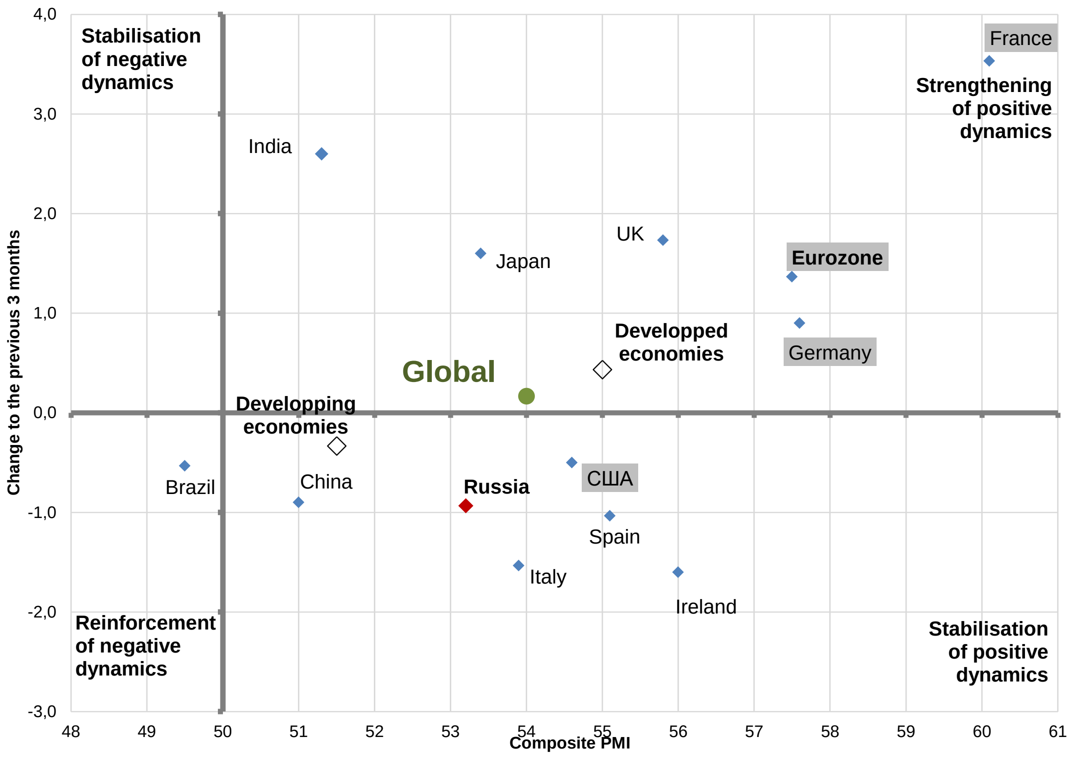
2.1. Global leading indicators

2.1.1. Euro zone's PMI unexpectedly hit multi-year high

Preliminary data for November PMI indices suggest mixed dynamics in business activity acceleration in major advanced economies. Nevertheless, the economies of the US and the euro zone retain a stable growth pace (Figure 39, highlighted in grey).

In November, the composite PMI of the US dropped from 55.2 to 54.6 pp, a four-month low. In spite of the slowdown in the composite index, the flow of new orders remained strong (above average in the first half of 2017). In addition, companies noted that input and output prices increased at a rate outpacing that observed in the past three years. Employment also expanded sustainably adding 200 thousand new jobs per month. Thereby, the economy is improving despite a certain slowdown in business activity. This is beneficial to the US Fed and favours the expected December rate hike.

Figure 39. Composite PMI for November and change to the August to October average



Sources: IHS Markit, Bloomberg Finance L.P.

The euro zone's composite PMI picked up after last month's slowdown and impressively rose to 57.5 pp (a 6.5-year high) in November. The economy registered a surge in production and new orders, especially in the manufacturing industry where PMI reached 60 pp, the highest reading since April 2000. Production capacity shortage comes along with a 17-year high rise in employment and accelerated growth in labour remuneration. That said, inflationary pressure continued to increase at the highest pace registered since 2011. All the above suggest a positive and stable year-end in the euro zone.

2.2 What do Russian leading indicators suggest?

2.2.1. GDP nowcast revised upward in November

- As of 20 November, 2017Q4 GDP nowcast[24] ranged between 0.5% and 0.6% QoQ SA. This is slightly above the October estimate (0.5% QoQ SA).
- Worse-than-expected October data for industrial production were offset by positive effect of the increase in oil prices.
- The 2018Q1 estimate has been revised upwards to +0.6% QoQ SA (vs. +0.5% QoQ SA in late October).
- The preliminary 2018Q2 GDP estimate stands at +0.5% QoQ SA. However, it may be adjusted considerably as new data comes in.
- We believe that the above model estimates are optimistic enough as our dynamic factor model currently assumes Urals price standing at roughly $60 per barrel until mid-2018.
- The above estimates allow us to expect GDP to grow by roughly 2% as of end-2017.[25]

	November 2017	October 2017
	% QoQ SA	% QoQ SA
2017 Q4	**0.5-0.6**	0.5
2018 Q1	**0.6**	0.5
2018 Q2	**0.5**	-

[24] The GDP index estimate is based on Rosstat data on the social and economic situation in Russia for the month and other statistical, leading and financial data as of the calculation date; it is built on dynamic factor modelling. These R&F Department forecasts are based on model calculations, and their results do not represent the official forecast of the Bank of Russia. The data set used for the GDP index estimate include 110 different time series divided into three groups: 1) survey data, 2) hard data, 3) external and financial data. The detailed methodology for the GDP index estimate is described in the Bank of Russia's Working Paper Series: A. Porshakov, E. Deryugina, A. Ponomarenko, A.Sinyakov 'Nowcasting and Short-term Forecasting of Russian GDP with a Dynamic Factor Model' // Working Paper Series. 2015. No. 2).

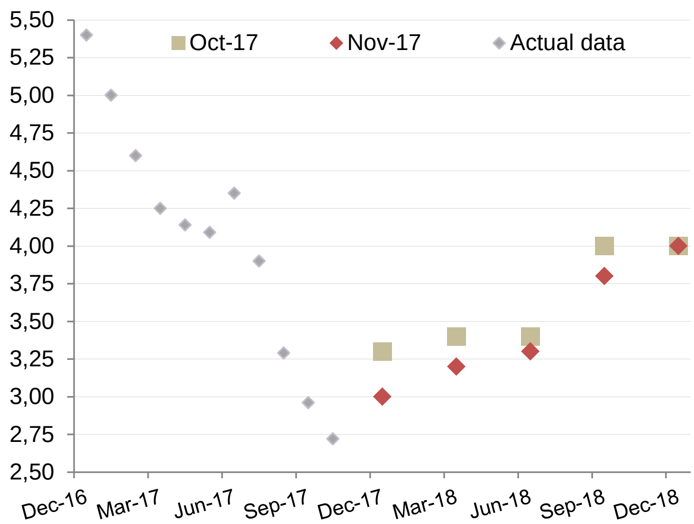
[25] Our estimate is based on the final rather than preliminary estimates of GDP growth made by Rosstat.

2.2.2. Inflation expectations of professional market participants remain anchored at the target

- Analysts polled by Bloomberg in November revised downwards their price growth estimates for this year, bringing them to an all-time low.
- However, respondents kept their inflation expectations at 4% YoY for end-2018. This points to their anchoring and confidence in the Bank of Russia's inflation targeting policy.

A Bloomberg survey suggests that inflation expectations of professional market participants went down in November to a fresh historical low. This may be largely caused by actual inflation that dropped to 2.7% YoY in October. According to the agency, the median inflation forecast for this year-end decreased from 3.3% to 3.0% (Figure 40). This is still above the estimated inflation range we expect in end-2017 (2.5-2.7%). This is most likely explained by a purely technical factor - real-time weekly Rosstat estimates rarely force certain experts to make formal revisions of their short-term forecast. The inflation consensus-forecast for the first three quarters of next year was also revised downwards. Significantly, the estimate for end-2018 remained unchanged: analysts remain convinced that inflation will hold at 4% YoY.

Figure 40. Analysts' expectations for inflation, % YoY



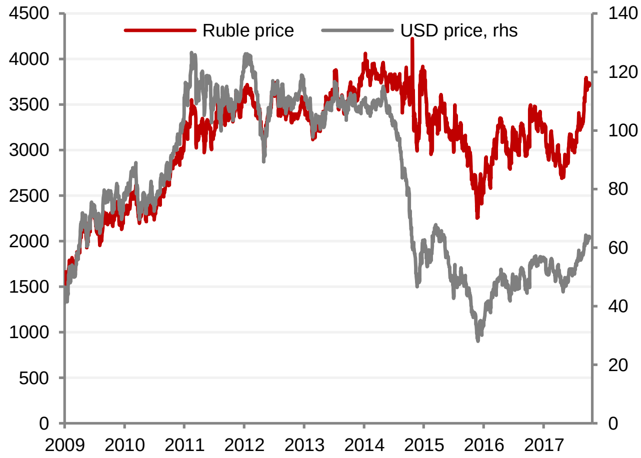
Sources: Bloomberg Finance L.P.

3. In focus. Ruble performance in November. Depreciation despite high oil prices

- The ruble exchange rate weakened in the first half of November in spite of rising oil prices.
- This was caused by the overall performance of emerging markets: they have lost their appeal to investors as they reduced their risk appetite.
- The weakening could also be driven by the announcement of new budget rule parameters for 2018 and possible restrictions on Russian debt purchases.

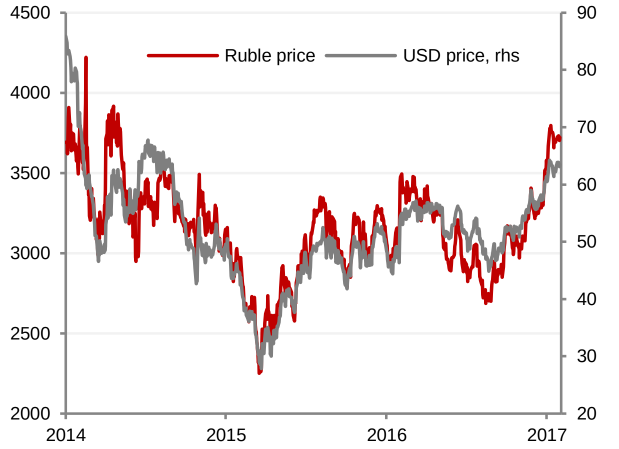
In the period between October and November, the price of Brent crude overpassed $60 a barrel for the first time since late 2014. However, the ruble exchange rate hardly responded to this price increase and even declined in early November. This brought the ruble price of oil above □3500 a barrel (Figure 41 and Figure 42). What are the reasons behind that?

Figure 41. Brent crude price in USD and RUB per barrel in 2009-2017



Source: Bloomberg Finance L.P.

Figure 42. Brent crude price in USD and RUB per barrel in 2014-2017



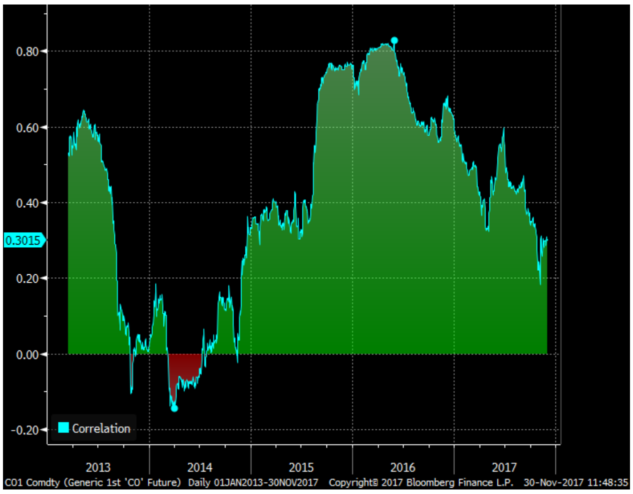
Source: Bloomberg Finance L.P.

First, the decline in the ruble exchange rate's sensitivity to oil price movements is a relatively stable trend that has been registered since mid-2016. In recent weeks, the correlation between them has dropped to the lowest level since late 2014 and is likely to decline further in the near future as correlation is calculated for a 90-day period[27] (Figure 43). The Finance Ministry's operations to buy foreign currency under the budget rule are supposed to reduce the ruble's sensitivity to oil price movements. However, actual data have yet to confirm this. The modified version of the budget rule effective from 2018 should make the ruble even less dependent on oil price movements.

[27] We would like to remind that in 2014 the geopolitics-related financial shock affected the ruble exchange rate alongside the oil shock.

Second, the ruble price of oil correlates well with its dollar price (Figure 43). When oil prices are high, the ruble price of a barrel of oil is still higher because the elasticity of the ruble exchange rate stands considerably below 1 when oil prices fluctuate.

Figure 43. Correlation between RUB/USD exchange rate and oil price (90-day)



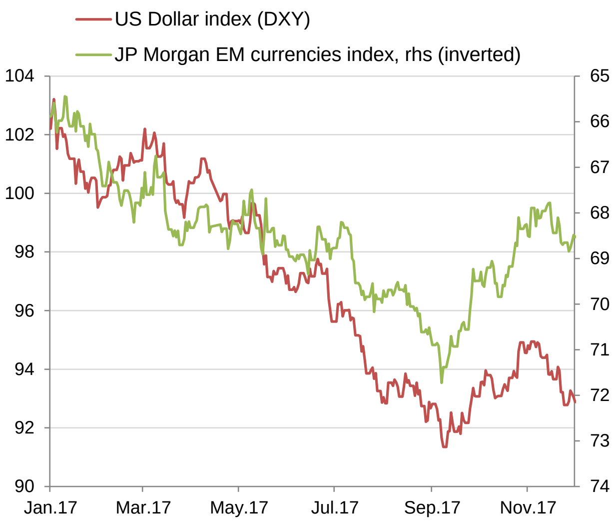
Source: Bloomberg Finance L.P.

Why did the ruble depreciate in the first half of November though oil prices maintained a slight upward trend?

We believe that this is largely associated with **the adjustment in global financial markets** caused by a decline in risk appetite. The US dollar started to regain its position against the currencies of both advanced and emerging market economies (EME) in early September (Figure 44). By the beginning of November, the EME currency index dropped by 4.5% against the US dollar, while that of advanced economies showed a 3.5% decline. Currencies of some countries depreciated against the US dollar by 7-11% over the course of less than two months[28] (Figure 45). The decrease of the ruble exchange rate proved more moderate than on average in EMEs and advanced economies due to the increase in oil prices by almost 11%.

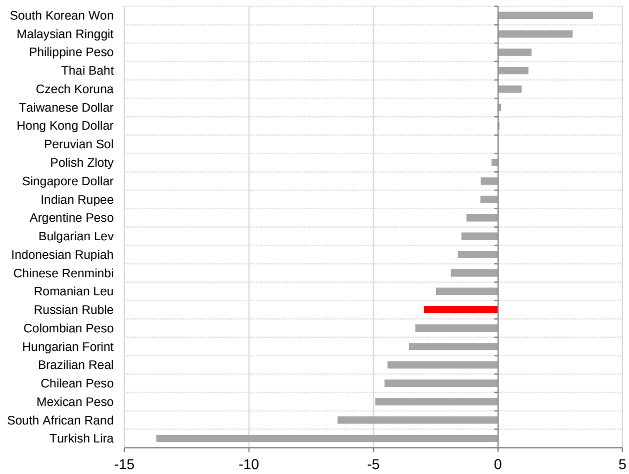
[28] The dynamics of nominal effective exchange rates were more favourable because the US dollar appreciated against almost all global currencies.

Figure 44. Exchange rates



Source: Bloomberg Finance L.P.

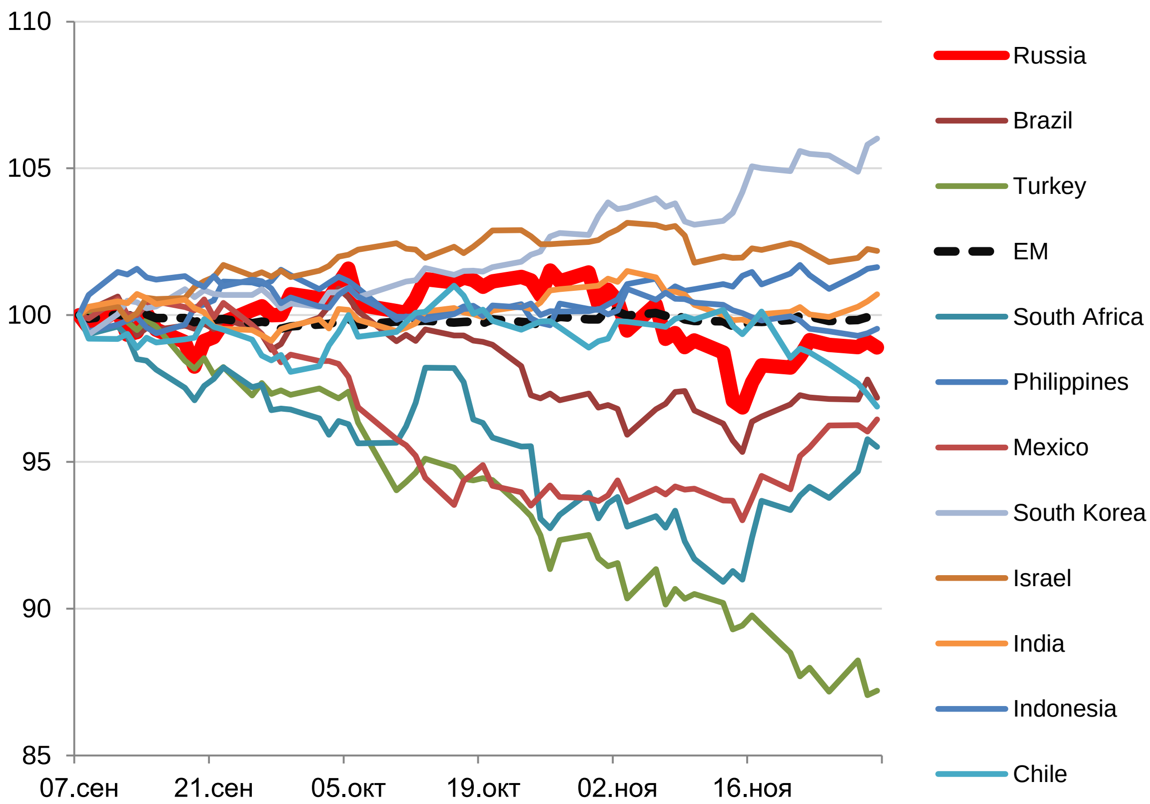
Figure 45. Exchange rates of EME currencies against the US dollar from 7 September* till 30 November



Source: Bloomberg Finance L.P.

**The beginning of the reverse dynamics of the US dollar exchange rate against all global currencies.*

Figure 46. Nominal effective exchange rates of EME currencies (index, 100 = 1 September 2017)

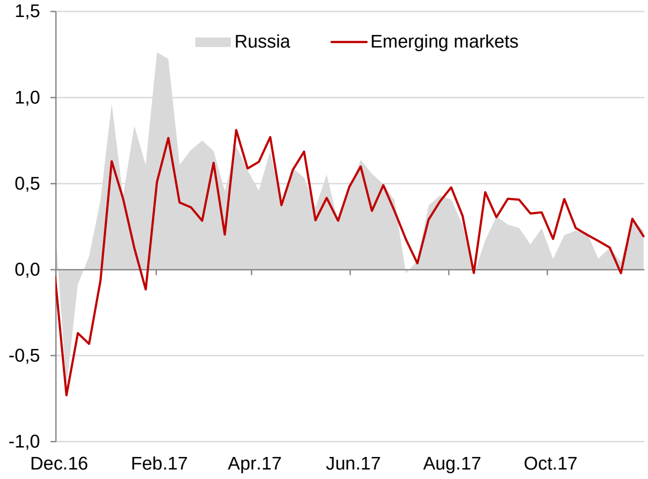


Sources: Bloomberg Finance L.P., J.P. Morgan.

We believe that alongside the global financial markets, the ruble was also slightly influenced by the following factors:

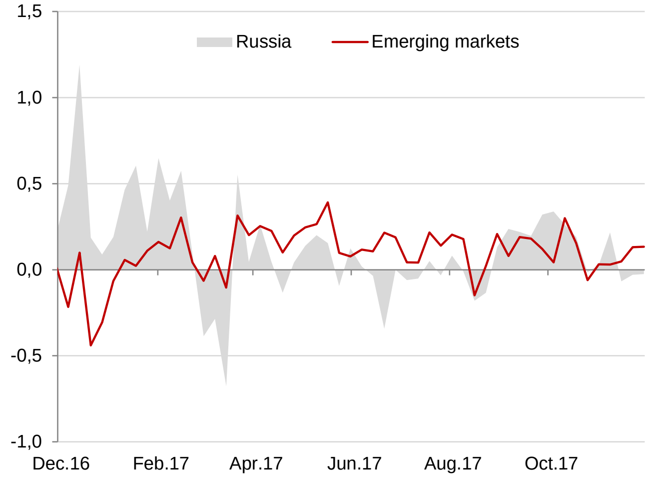
1) The reaction of market participants to **the announcement of new sanctions** by the US. The increase in exporters' supply of foreign currency due to rising oil prices in late October was offset by an elevated demand for foreign currency among non-residents. The EPFR data confirm that cash inflow in both Russian bond and equity funds terminated at that period (Figure 47 and Figure 48).

Figure 47. Weekly cash inflow/outflow to/from bond funds (% of the cost of assets)



Source: EPFR.

Figure 48. Weekly cash inflow/outflow to/from equity funds (% of the cost of assets)



Source: EPFR.

2) Another negative effect on the ruble was caused by investors who factored in **the new parameters of the budget rule** in their expectations of exchange rate movements. All else being equal, the new version of the rule provides for larger foreign currency purchases by the Finance Ministry compared with the effective rule and a weaker ruble at the same oil price. Overall, the budget rule will increase volatility in the ruble price of oil as the ruble exchange rate will offset changes in dollar prices to a lesser extent.

3) Furthermore, on 3 November the Finance Ministry announced that it would **increase foreign currency purchases** by a factor of 1.6 in the next four weeks (to 126 billion for the period) under the effective budget rule. This exceeded the market's expectations considerably and might have been one of the factors behind the ruble depreciation.

The relative weakness of the ruble proved temporary, and in the second half of November it started to regain its position as global investors showed a renewed interest in emerging market assets.

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