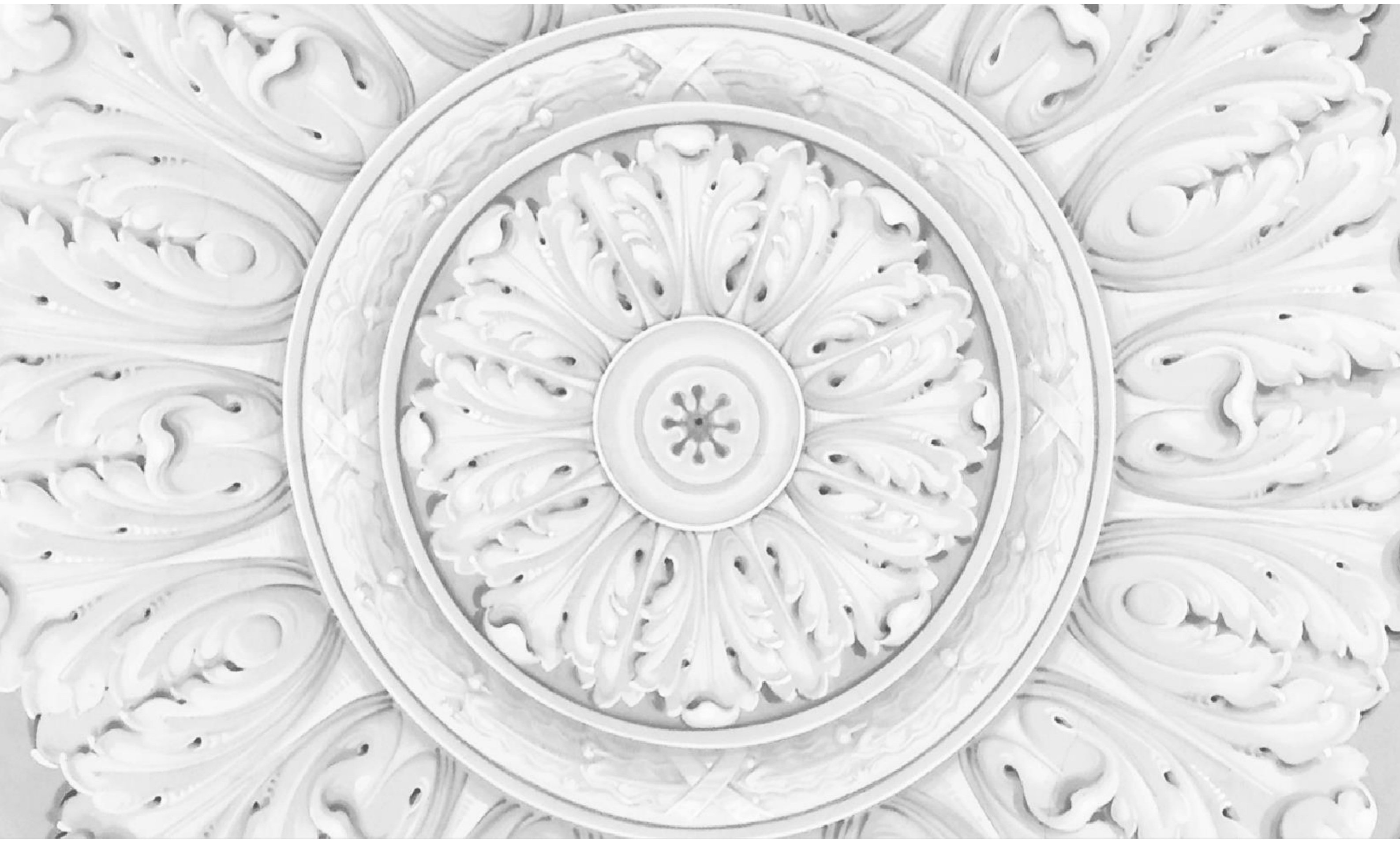
Bank of Russia

The Central Bank of the Russian Federation



TALKING TRENDS

Macroeconomics and markets

June 2018

Research and Forecasting Department Bulletin No. 4 (24)

The bulletin is based on data as of 25.05.2018.
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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Executive summary

1. Monthly summary

- Between April and May, annualised inflation held at a low level. However, the period saw an increase in inflationary pressures, mostly driven by temporary factors. Economic growth settled at a level close to its potential. The Russian financial market proved fairly resilient to the considerably deteriorated conditions in emerging markets.
    - Inflation in April stabilised at 2.4%; it is likely to accelerate somewhat in May, on the back of temporary factors including the weakening of the ruble and increased petrol prices. The stable components of inflation remain lower relative to the Bank of Russia target, with the gap recently becoming closer, however. At the same time, current price movements are still influenced by previous monetary policy decisions. The medium-term risks of inflation deviating from target remain dominant. These risks are connected with geopolitical factors, volatility surges in global financial markets, the transition to a consumption model to the detriment of savings, accelerated consumer lending, elevated and unsteady inflation expectations, the state of the labour market and the uncertainty over fiscal policy dimensions over the next few years. The Bank of Russia's policy fosters reduced inflation risks and the anchoring of inflation at a level close to 4% over the forecast horizon.
    - Economic growth in the first quarter rebounded to a level close its potential. The April volatility surge in financial markets and growing uncertainty have so far left economic developments unaffected. Consumer demand is still on the rise, gaining support from the ongoing expansion of consumer lending and sustainably high growth rates of real wages, with skills shortages widening. Based on current statistics and leading indicators, it seems probable that a slight acceleration in GDP growth is due in the second half of the year. Yet, this expansion is set to remain within the potentially possible growth rate.
    - Following the April volatility, Russian financial markets rebounded to normal levels. In this way, Russian markets were able to resist the elevated pressure emanating from stronger geopolitical tensions and overall deteriorated conditions in emerging market countries between late April and early May. Growing oil prices came as a key enabler.

2. Outlook

- Global economic growth still faces significant threats. US and eurozone growth rates are becoming increasingly divergent, while a volatility surge in emerging markets could slow down economies relative to the 2017 growth rates.

- The leading indicator for Russia's GDP suggests the Russian economy is poised for a slight growth acceleration through the year-end, which is set to remain close to its potential rate. Having said this, a temporary slowdown in annual growth rates is not ruled out, because of the past year's high base.

3. In focus. Agricultural market saturation: higher efficiency should support output growth

- In recent years, the reduction in food prices, which occurred mainly at the expense of previously built producer margins, contributed to tightened global competitiveness across individual product categories.
- This became a major factor driving sustainably low food inflation. However, moving forward, margins in agriculture may have reduced potential in terms of keeping prices down and limiting inflation risks.
- The task of securing steady competitive advantages with respect to fostering agrifood exports calls for continuing focusing on technological upgrades and higher efficiency of production.

1. Monthly summary

1.1. Inflation

Inflation was 2.4%YoY in April. At the same time, seasonally adjusted monthly price growth accelerated to a level where annualised inflation is slightly above 4%. This was largely driven by the response of prices to the weaker ruble. The stable components of inflation remain lower relative to the Bank of Russia target, with the gap in the April to May period becoming somewhat closer, however. At the same time, current price movements are still influenced by previous monetary policy decisions. Short-term inflation risks rose relative to the start of the year, on the back of the ongoing increase in real wages, which is above productivity growth rates, and growth in motor fuel amid mounting global oil prices. These factors will combine to help bring inflation close to 4% sooner than expected.

The rise in household inflation expectations was expected as they responded to a weaker ruble and growing motor fuel prices. There was a slight revision in financial analysts' inflation path estimate: inflation is now expected to return to 4% ahead of time.

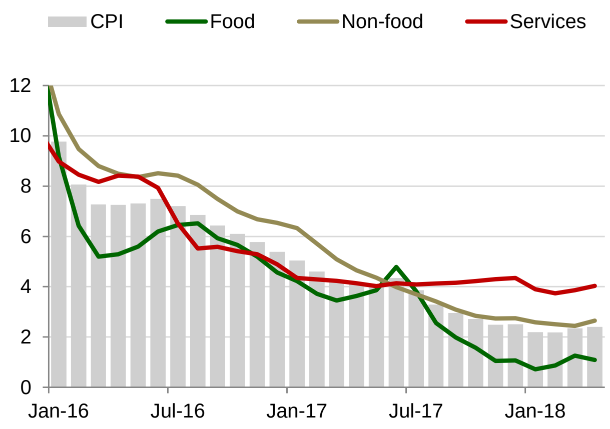
Mid-term proinflationary risks are invariably dominant over disinflation risks. Core risks include geopolitical factors, volatility surges in global financial markets, the transition to a consumption model to the detriment of the savings ratio, accelerated consumer lending, elevated and unsteady inflation expectations, labour market conditions and the uncertainty over fiscal policy dimensions.

1.1.1. Core inflation suggests inflationary pressure is rising

- Annual inflation in April was unchanged at 2.4%. Our estimates show seasonally adjusted consumer price growth accelerated to 0.36% MoM (4.4% on an annualised basis) vs 0.25% MoM seen in March.
- The preliminary estimate for the May growth is 0.4% MoM, or approx. 4.4% on an annualised basis (seasonally adjusted).
- The rise in the modified indicators of core inflation points to overall increase in inflationary pressure.
- The weaker ruble effect has so far translated into overseas travel costs. It will take several months to fully capture this effect across other segments.
- The decline in food inflation is driven by a slowdown in annualised growth pace of fruit and vegetable prices, likely to continue into May.
- There was an upward correction in both observed and expected inflation, which came as no surprise given the weaker ruble and growing petrol prices.

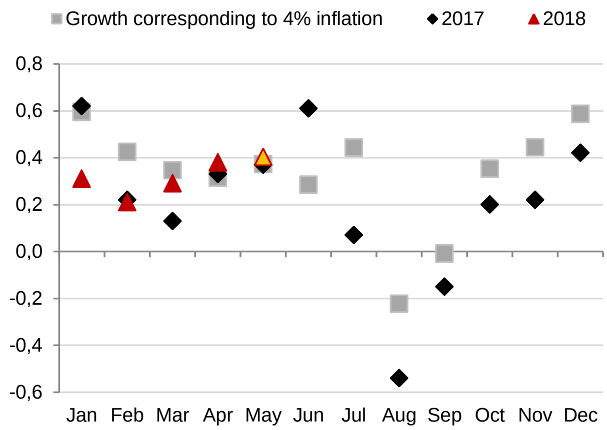
Annualised inflation in April was 2.40% YoY, against 2.35% YoY in March and 2.18% YoY in February (Figure 1). This sent the gap with the 4% target level contracting for the second consecutive month.

Figure 1. Inflation and its components, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 2. Price growth, % MoM



Sources: Rosstat, Bank of Russia calculations.

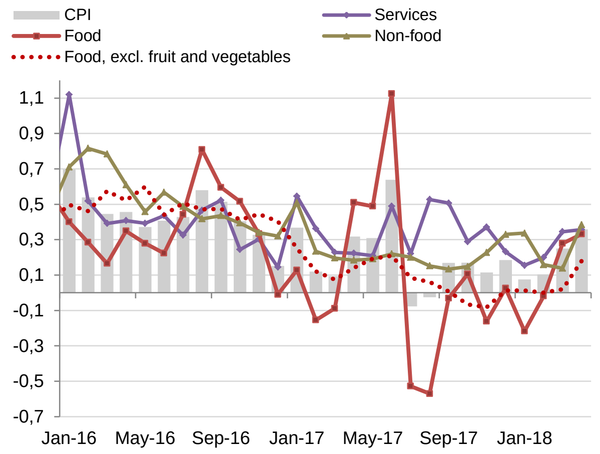
The May estimate is preliminary.

In the food market, inflation slowed down to 1.09% YoY on 1.26% YoY in March. This was mainly triggered by fruit and vegetable price movements. Slower annual price growth paces are attributable to the dying-out of the seasonal factor triggered by depleted stocks. Last year, the seasonal peak in prices occurred later than usual because of late arrival in the market of field vegetables, owing to adverse weather conditions.

Non-food inflation accelerated to 2.65% YoY from 2.44% YoY in March. Prior to that, except for a 0.01 pp symbolic acceleration in December 2017, non-food inflation had steadily declined since mid-2016. As regards the pass-through effect from a weaker ruble, its estimation could only be finalised in several months, given that the procurement of non-food products comes with rather lags. This April also saw communications from some auto makers and household appliance manufacturers about ruble devaluation-caused price reviews. These are reflected in the month's statistics: prices for light vehicles went up 0.5% MoM (after 0.2% MoM growth in March), while those for electrical goods rose 0.4% MoM (after zero growth in March). Importantly, the trends must have been brought about, beyond the weakening of the ruble, by gradually recovering consumer demand, which is confirmed by both retail sales data and a number of survey indicators.

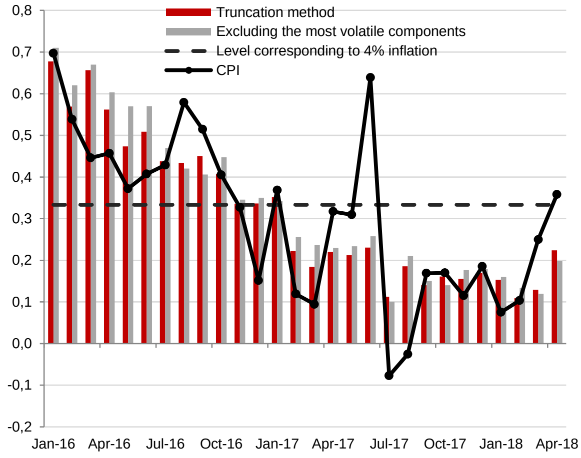
Prices for services accelerated to an annualised 4.03% YoY, after 3.86% YoY in March. Growth was mainly driven by the upward trend in outbound travel prices. The annual growth rates of non-regulated passenger transport services were up, too (airline service and intercity bus transportation). Annual growth rates across the remaining sectors were virtually unchanged.

Figure 3. Seasonally adjusted price growth, % MoM



Sources: Rosstat, Bank of Russia calculations.

Figure 4. Modified indicators of core inflation, % MoM



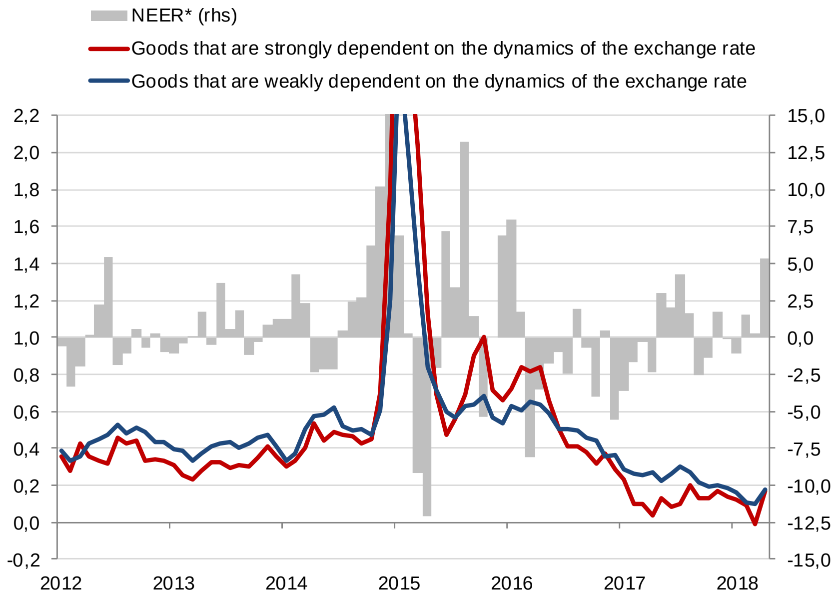
Sources: Rosstat, R&F Department calculations.

In April, consumer prices rose 0.38% MoM, which is a seasonally adjusted 0.36% MoM, or 4.4% in annual terms (Figure 3). Seasonally adjusted growth has accelerated for the second consecutive month. While in March this was mainly caused by growing prices for fruit and vegetables, April saw an increase in overall inflationary pressure. This is shown by the modified indicators of core inflation. They were up to 0.2% MoM in April, after 0.1% MoM in the February to March period (Figure 4). This reading is still below a level that corresponds to 4% inflation, the April uptick could mark a tipping point for the emergence of an upward inflation trend.

Overall growth in inflationary pressure, driven by, among other things, a weaker ruble, is also clear from the acceleration in price growth rates across products mainly independent of exchange rate movements[1] (Figure 5).

[1] Under study were CPI subcomponents of the respective disaggregation level except for fruit and vegetables and regulated rates.

Figure 5. Changes in median CPI values and ruble exchange rate*, % M/M (seasonally adjusted)



Sources: Rosstat, Bank of Russia calculations.

Plus stands for ruble depreciation against foreign currencies, minus stands for ruble strengthening against foreign currencies.

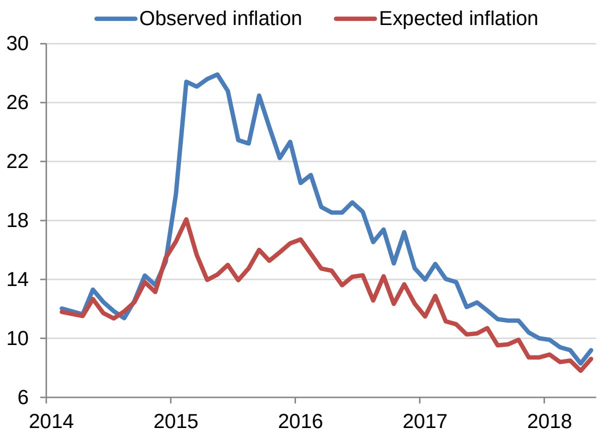
Household inflation expectations for one year ahead and observed inflation in May saw an upward correction vs the March level, which matched expectations in light of exchange rate volatility (Figure 6). Also, increased gasoline prices proved impactful: respondents cited this movement as the most noticeable price growth in the past month. As before, most respondents expect the current rate of inflation to be sustainable. The gap between observed and expected inflation has remained at an all-time low and near zero, in a sign that respondents do not expect a further inflation slowdown.

According to Rosstat, consumer prices between 22 and 28 May edged up 0.09% after 0.12% growth seen in the prior week. The preliminary growth estimate for May is 0.4% MoM (Figure 2), or approx. 4.4% on an annualised basis (seasonally adjusted).

Average fruit and vegetable prices changed little if at all, following their decline in the two preceding weeks (Figure 7). These data come as a result of a decline in prices for cucumbers and tomatoes, with muted growth in staple vegetables (comprising the so-called *borsch set*[2]).

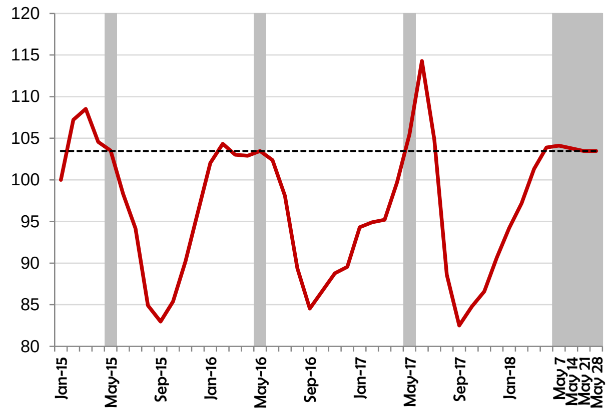
[2] The borsch set (otherwise, Russian staple vegetables) is understood to include potatoes, cabbage, onions and carrots.

Figure 6. Household inflation expectations, %



Source: inFOM.

Figure 7. Fruit and vegetable prices

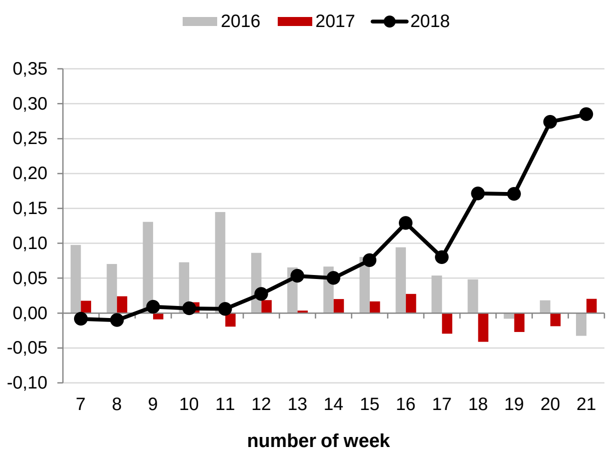


Sources: Rosstat, R&F Department calculations.

100 - January 2015. For the period before May 2018, monthly data, thereafter - weekly data.

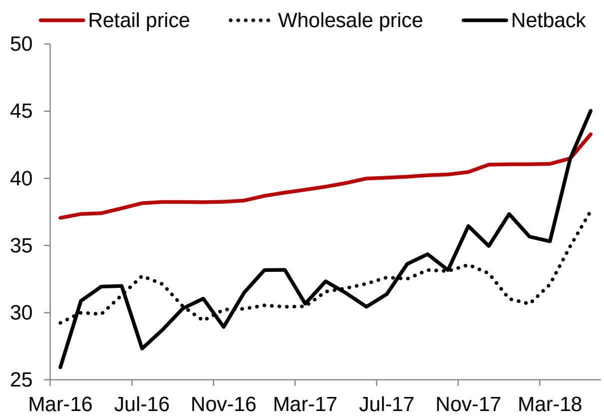
Growth rates in the consumer basket watched on a weekly basis, except for fruit and vegetables, accelerated (Figure 8). Prices of petrol and diesel fuel contribute significantly to this trend. Retail prices are catching up with wholesale prices that grew strongly on the back of a weaker ruble and growing global oil prices. The current retail price for oil products is lower than the export netback level[3] (Figure 9). This trend makes exports increasingly attractive, putting consumer prices under pressure.

Figure 8. Price growth in a weekly basket of goods and services (excluding fruit and vegetables), %



Sources: Rosstat, R&F Department calculations.

Figure 9. AI-95 petrol price, RUB/litre



Sources: SPIMEX, Rosstat, R&F Department calculations.

To reduce pressure on domestic prices, the government decided to reduce excise duties from 1 June 2018 by as much as 3,000 rubles a tonne for petrol and by 2,000

[3] The level of prices where margins of external and domestic supplies are equal, including export duties and transport costs.

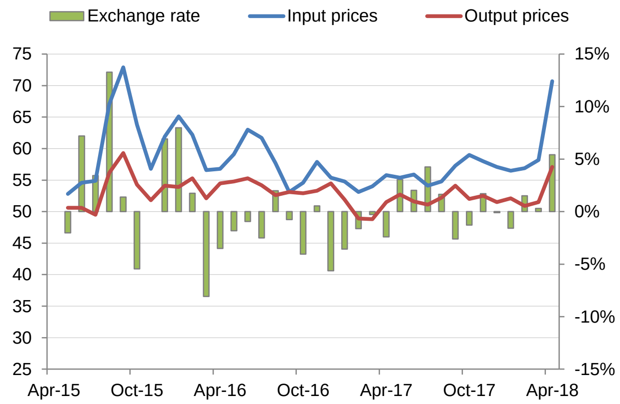
rubles a tonne for diesel fuel. Along with that, the July 2018 increase in excise duties approved last year (by 700 rubles) will be repealed. These measures are set to help slow down the growth of retail fuel prices.

On the one hand, the effect of the fiscal rule serves to counter the volatility of inflation by levelling out fluctuations in the ruble exchange rate. On the other hand, this effect is being partially undermined by growing volatility of domestic oil prices in rubles: changes in global prices are set off to a lesser degree by exchange rate movements.

1.2.2. PMI price indexes: a weaker ruble translates into price growth

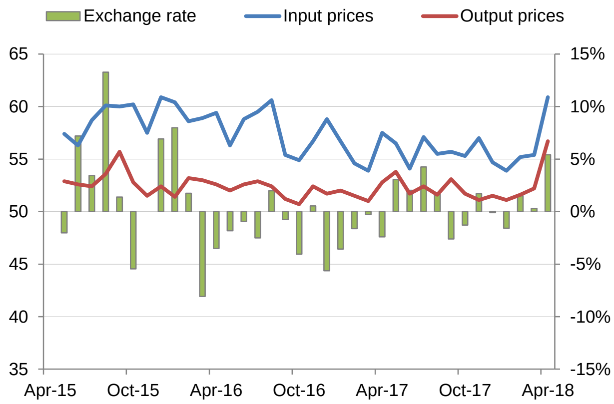
- The April weakening of the ruble triggered growth in the costs of imported raw material, with the entailing rise in the PMI procurement price indexes to local maximums.
- Responding to these developments, companies wasted no time passing on their rising costs to output prices. However, once the exchange rate has stabilised, price indexes are unlikely to remain high in May.
- We note that inflation risks from the labour market persist. The ruble weakening was not the only cost growth driver. Respondents cite growth in wages against the backdrop of an ongoing rise in employment in the service sector.

Figure 10. Manufacturing PMI price indexes, points



Source: IHS Markit.

Figure 11. Services PMI price indexes, points



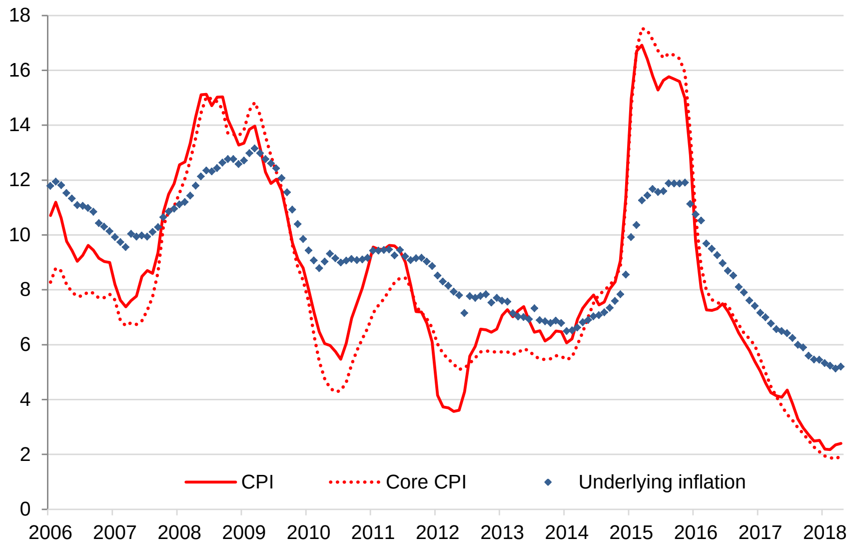
Source: IHS Markit.

1.1.3. Underlying inflation in April: the medium-term risks of inflation deviating from target remain dominant

- The annual paces of underlying inflation were in April 2018 estimated to be level with their February reading, at 5.2% after 5.1% in March. This is the first upgrade in the estimate since November 2015.

- This rise in underlying inflation must have been temporary, coming as a result of the indicator's relatively high sensitivity to changes in prices for oil / exchange rate-dependent products.
- The current underlying inflation estimate is seen as elevated because of heightened historical inflation rates, as well as the inertia of this indicator in terms of construction.
- Over a mid-term horizon, the risks of annual inflation moving upwards from 4% still prevail over those of its downward movement away from the target.

Figure 12. CPI, CCPI and historical estimates for underlying inflation, % YoY

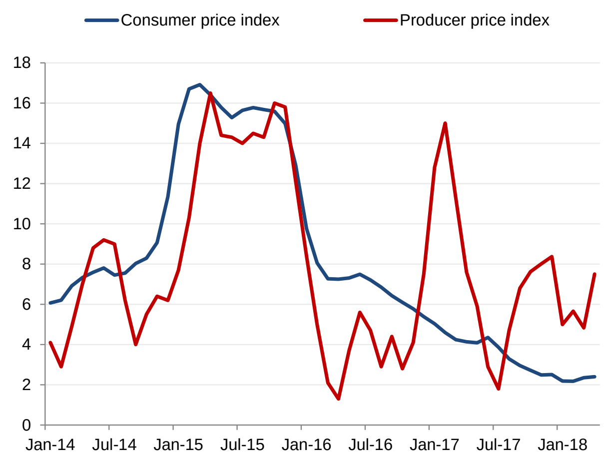


Sources: Rosstat, R&F Department calculations.

1.1.4. Producer prices grow at accelerated rates in April

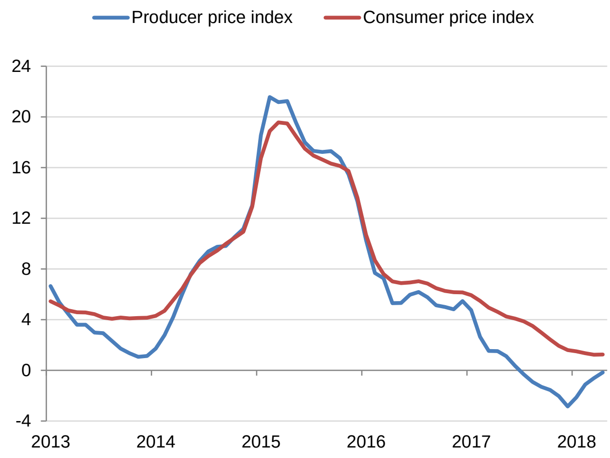
- According to Rosstat's data, producer prices grew at an annualised 7.5% in April vs 4.8% YoY in March (Figure 13).
- Annual growth rates of producer prices accelerated considerably in energy-related sectors (oil and natural gas production, oil products, metallurgy), which was driven by rising global oil prices as the ruble weakened. There was only immaterial change in producer prices across other sectors.
- Growth in prices in the oil products segment was checked by reduced petrol and diesel fuel excise duties.
- Producer prices for many consumer products are still growing at rates lower than those of consumer prices; the gap between the two is gradually closing, however (Figure 14).

Figure 13. Producer price and consumer price index, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 14. Price movements across individual products[4] in April, % YoY



Sources: Rosstat, R&F Department calculations.

1.2. Economic performance

Early this year, the Russian economy resumed growth at a rate close to its potential. Current macro indicators suggest the economy is poised for a slight growth acceleration in 2018 Q2-Q3. Nonetheless, a temporary slowdown in annual growth rates is not ruled out in the second quarter, because of the past year's high base. As before, this is driven by, among other things, consumer demand, against the backdrop of an ongoing decline in unemployment and rising real wages. The April ruble weakening and growing uncertainty have so far left economic developments largely unaffected.

1.2.1. GDP growth rates accelerate in the first quarter

- According to Rosstat's preliminary estimates, Q1 GDP grew 1.3% YoY (after its 0.9% YoY growth in 2017 Q4 [5]), which is only slightly less than the Research and Forecasting (R&F) Department estimate for the same period.
- This growth is consistent with changes in the output of core industries (Figure 15).

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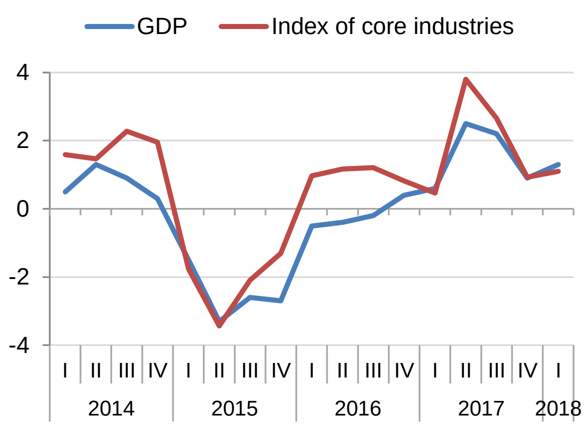
[4] The calculations are based on peer CPI and PPI products (meat products, fish products, oil and fats, dairy products, pasta, sugar, tea, coffee, clothing, knitted products, footwear, detergent and cleaning products, perfumes and cosmetics, consumer electronics and furniture). They account for 32% of the consumer basket.

[5] Based on the estimate as of 2 April.

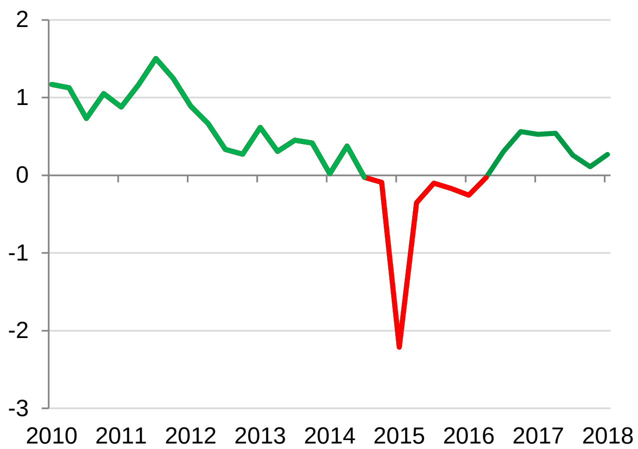
- Improvements are also seen after seasonal adjustments to QoQ growth rates: according to our estimates, GDP growth will accelerate to 0.3% QoQ in the first quarter, after 0.1% QoQ in 2017 Q1 (Figure 16). This result is fairly close to our seasonally adjusted GDP index growth estimate (0.35% QoQ SA).
- This seasonally adjusted GDP growth rate estimate is preliminary. In particular, it is based on the fact that Rosstat did not review GDP data retrospectively when making Q1 estimates.
- GDP growth acceleration is further evidenced by current basic macro indicators: improvement may have occurred on the back of a reduced negative contribution from net exports, with stabilisation in investment data.
- A batch of preliminary estimates shows that high growth rates hold in both investment and consumer imports in the period Q1 - early Q2, in a sign of encouraging developments in domestic demand.

Figure 15. Physical volumes of GDP and core industries' output index, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 16. GDP changes in constant prices (seasonally adjusted), % QoQ



Sources: Rosstat, Bank of Russia calculations.

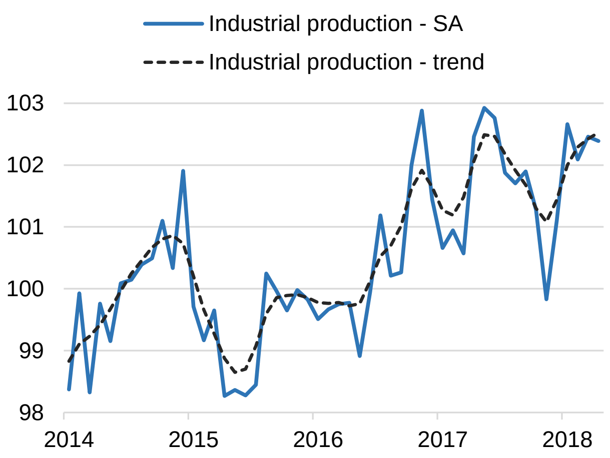
1.2.2. Industrial production in April: slowdown amid a negative environment

- According to Rosstat, industrial output in April grew at a seasonally adjusted 0.5% MoM, or 1.3% YoY. At the same time, R&F Department estimates show a marginal reduction of 0.1% MoM.
- Our estimates suggest a weakening in the trend component of industrial output (to 0.1% MoM), possibly, as a result of the negative impact from exchange rate volatility and April's overall pessimistic background.
- Slowdown is finding its way into both mining and the manufacturing sector.

Rosstat-recorded growth in industrial production index for April totalled 0.5% MoM (seasonally adjusted), or 1.3% YoY. Annual growth paces were lower than between January and March (+1.9% YoY), while in the first four months the index posted +1.8% YoY.

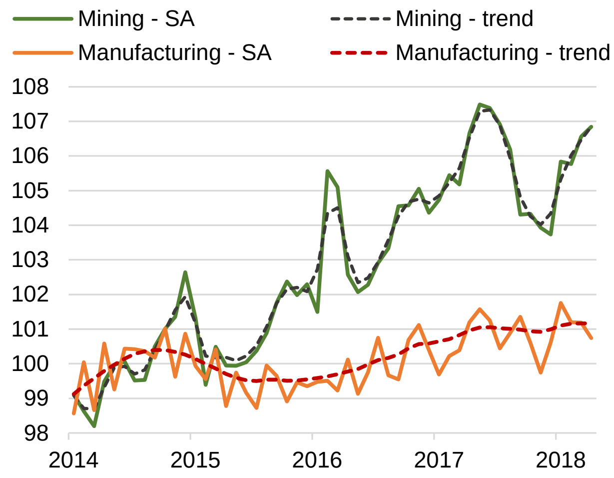
The R&F Department's estimates proved less positive: we record a 0.1% MoM marginal reduction (unchanged after seasonal adjustment, Figure 17). The manufacturing sector's impact was crucial to this reduction, with its 0.4% MoM decline in physical quantities (the R&F Department's estimate). At the same time, the mining sector's output rose 0.3% MoM, in defiance of April's negative news context. The alarming signal is slower growth in the trend component of the two key industrial production subsectors (Figure 18).

Figure 17. Industrial production index (2014 = 100%)



Sources: Rosstat, R&F Department calculations.

Figure 18. Changes in mining indicators. Mining sector's and manufacturing sector's outputs (2014 = 100%)



Sources: Rosstat, R&F Department calculations.

Although we do not report a slump in these industries, they are definitely growing at slower paces. The new US restrictions, alongside the weakening of the ruble that followed them, could have made a negative contribution to industrial output data. Nevertheless, there has yet been no meaningful reaction from the industrial sector overall; the fairly rapid stabilisation in financial markets and decreased volatility suggest that the current package of restrictions will make a limited impact on economic performance.

A weakened growth trend in the manufacturing sector is connected with the fact that positive output data in *growth driver industries* (the food industry, chemicals, the automotive industry, rubber and plastics) have been increasingly less steady in recent months. Also, the manufacturing sector's performance is still overall constrained by the negative trend in metallurgy and stagnation in oil processing.

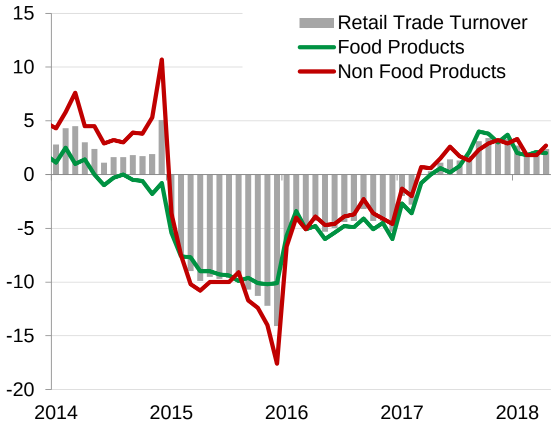
In May and June, annual industrial production growth rates and, therefore, GDP growth rates for the second quarter could slump, given the high base of the past year. Growth in industrial production picked up the pace to 5.6% in May 2017; therefore, the statistical effect could push annual data downwards in May-June this year.

1.2.3. Consumer demand grows strongly in April

- Retail sales grew at an accelerated 2.4% YoY after 2.0% YoY in March, against the backdrop of faster growing non-food sales. Seasonally and calendar effect adjusted, sales posted 0.3% MoM growth in April, unchanged from March.
- Retail sales gain support from rising real disposable household incomes and a speedier expansion in unsecured consumer lending.
- The current growth in consumer demand makes no constraining impact on inflation any longer, and its further acceleration is one of key inflation risks.

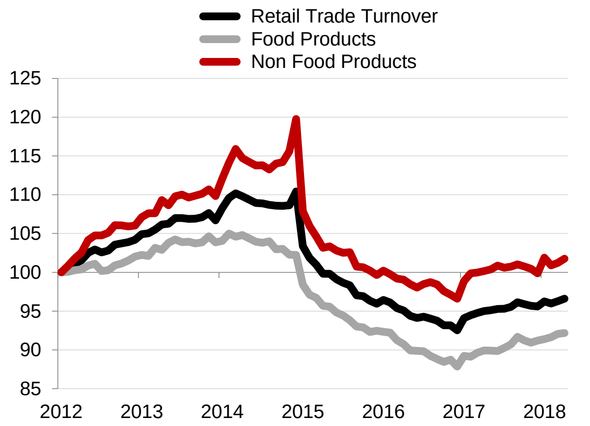
In April, retail sales accelerated to 2.4% YoY, on 2.0% YoY in March. Food sales saw their growth rates stabilise at 2.0% YoY, while non-food sales accelerated to 2.7% YoY after 1.8% YoY seen last month (Figure 19). According to our estimates, seasonally and calendar effect adjusted retail sales remained level with March at 0.3% MoM, or at an annualised 3.6% (Figure 20). Consumer spending in the March to April period was up on late 2017.

Figure 19. Food, non-food and total retail sales, % YoY



Sources: Rosstat, R&F Department calculations.

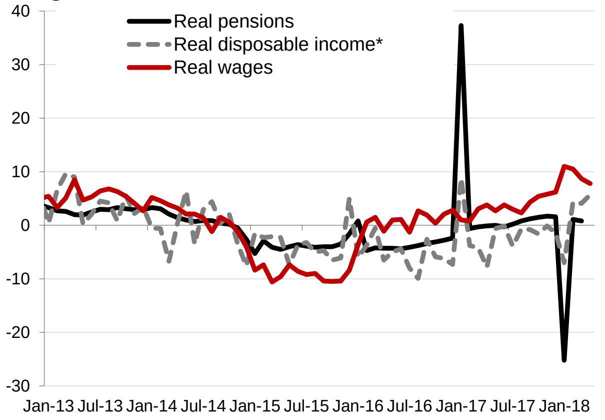
Figure 20. Retail sales, % (January 2012 = 100%, seasonally adjusted)



Sources: Rosstat, R&F Department calculations.

Retail sales are underpinned by rising real disposable household income that increased 5.7% YoY relative to the previous month's 4.1% YoY (Figure 21). Sales also gain support from expanding consumer lending (Figure 22).

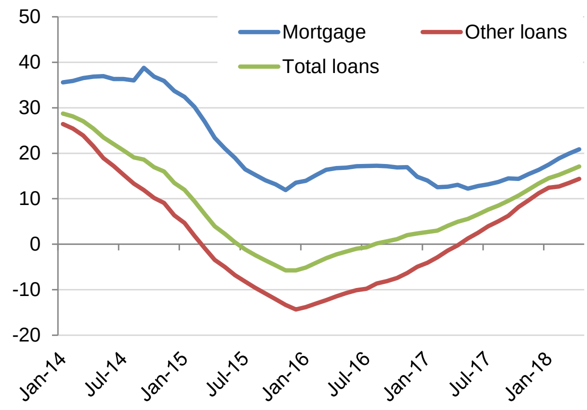
Figure 21. Real income of households, % YoY



Source: Rosstat, R&F Department calculations.

**Calculated using the old methodology, with a one-time payment in January 2017 factored in.*

Figure 22. Ruble household loans, % YoY

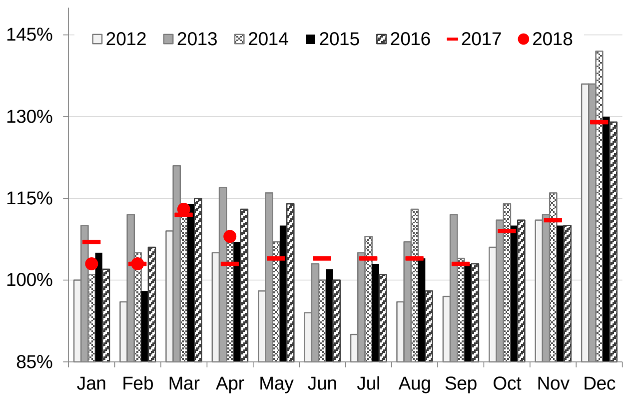


Sources: Bank of Russia, R&F Department calculations.

Growth in everyday spending is also confirmed by Romir Research Holding's data[6]. Real household spending in April 2018 was above April's readings seen in the previous three years (Figure 23).

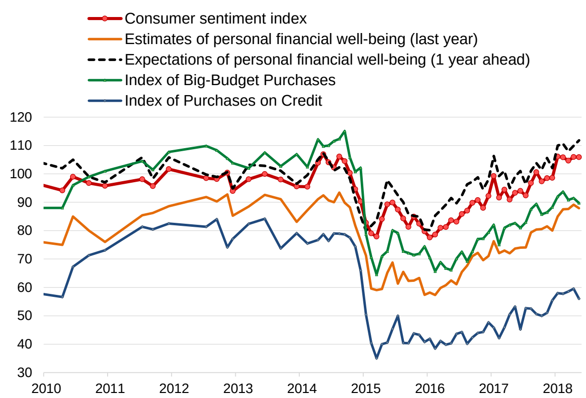
According to inFOM's monthly survey[7], overall consumer sentiment saw no material changes against April (Figure 24). Expectations as regards future incomes continued to gradually improve: the respective index was at a fresh high for the period since the first such survey (2010). At the same time, downgrades were reported in respondents' estimates of their current financial positions, as well as in perceptions of how opportune the current time is for large purchases. Continued positive consumer sentiment in general, increasing real incomes and the continued growth of retail lending will shore up expansion in consumer demand in the months ahead. Current consumer demand movements are not a limiting factor in price increase.

Figure 23. Change in real retail spending, % (January 2012 = 100%)



Source: Romir.

Figure 24. Consumer sentiment index and its components



Source: inFOM survey.

[6] Romir Research Holding. «Традиционная апрельская экономия». 10.05.2018.
[7] Based on real-time data for May.

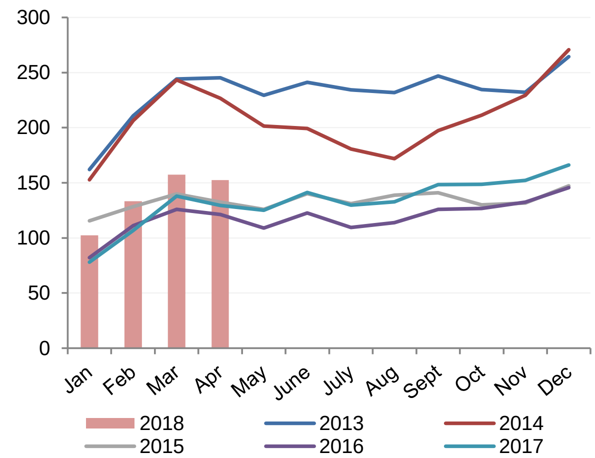
1.2.4. The car market continues to grow

- In April 2018, sales of new cars and light commercial vehicles edged up (+0.1% MoM).
- Car output in the first quarter of 2018 was up by almost 20% YoY.
- Imports in the January to March 2018 period were up 1.5 times on last year, while exports in the same period dropped 16% YoY.
- Amid a firming US dollar, consumer prices on new cars of foreign makes were up in April.

Data by the Association of European Businesses (AEB) suggest that new car and light commercial vehicle sales rose 17.7% YoY in April 2018 (Figure 25). This suggests a sustainable recovery in the market is continued. For the first four months, new car sales were up 20.5% compared to the same period last year.

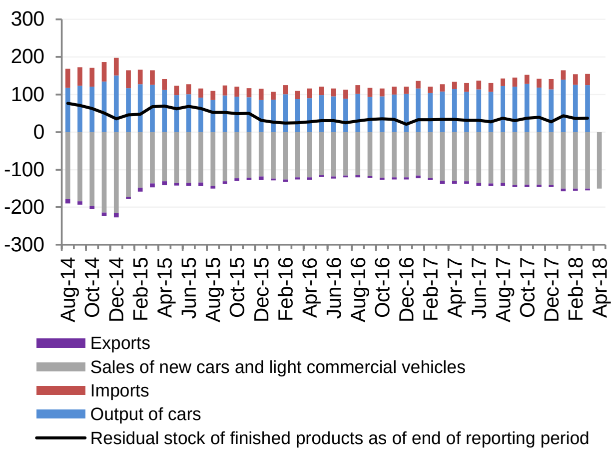
Meanwhile, market demand was only slightly up on March: once adjusted for seasonal and calendar effects, growth stands at 0.1% MoM [8](Figure 26). Market players note an increased interest from buyers in the face of April's ruble weakening. However, this had no implications for sales volumes.

Figure 25. New car and light commercial vehicle sales, thousand pieces



Sources: AEB, R&F Department calculations.

Figure 26. Demand (-) and supply (+) components in the Russian auto market, seasonally adjusted, thousand pieces



Sources: AEB, R&F Department calculations, Rosstat.

According to Rosstat, 2018 Q1 car sales were up 19.9% YoY, invariably a growth driver for the manufacturing sector. The Federal Customs Service reported a marked

[8]The above seasonal adjustment probably fails to fully capture changes in the nature of seasonality observed after 2013. The resulting estimates are probably somewhat undervalued.

continued rise in 2018 Q1 imports: imports in this period were up by almost 50% YoY. At the same time, new car exports fell by 16.2% YoY.

According to Rosstat, annualised consumer prices for new domestically manufactured cars and cars of foreign makes grew faster in April than the rate of inflation (3.31% and 3.77% vs 2.4% respectively). The noticeable growth in consumer prices for cars of foreign makes is related to this April's exchange rate fluctuations.

With the dollar strengthening in April, several manufacturers are planning to review their prices given the import component of their cost structures; however, this growth the manufacturers' representatives said would be minimal (1–2% according to AVTOVAZ).

The previous ruble weakening of late 2014 came with rapid growth in prices for new cars. This movement was partially explained, beyond price reviews triggered by rising production costs in foreign currency, by rapidly expanding demand at a time when the exchange rate was volatile and consumer uncertainty prevailed. We expect that this time the overall effect from changes in the dollar exchange rate on producer prices will be moderate.

1.2.5. Retail lending continues to grow at accelerated rates

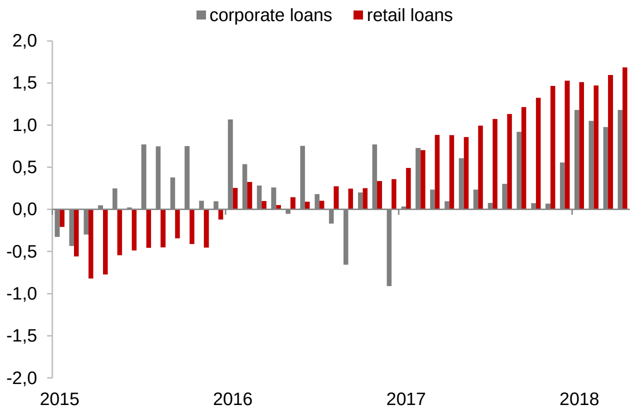
- Retail lending continues to grow at accelerated rates. Ruble loans to individuals grew at a local maximum of 1.7% MoM on the back of expansion in both housing mortgage and consumer lending.
- The corporate loan portfolio in rubles edged up 1.2% MoM, with a marked contraction of credit in foreign currency, in a sign of it being replaced by ruble loans.

Retail lending continued to boom in April. We estimate the ruble credit portfolio to have grown 1.7% MoM[9], to a fresh local maximum in the current growth phase (Figure 29). Growth accelerated somewhat across all segments of lending to individuals (Figure 28). The mortgage portfolio is rising at a 2% MoM rate, consumer lending is growing at 1.4% MoM - which is somewhat above the current wage growth rates (12.1% YoY from January through April). At the same time, given declining real interest rates, an accelerated expansion in lending is possible if debt load is unchanged or even shrinking (Figure 29).

Ruble loans to non-financial organisations in April continued to rise strongly (+1.2% MoM). At the same time, the month saw a considerable contraction in the foreign currency component (stripping out currency effects), in a sign that corporate loans in foreign currency are being replaced by those in rubles, as a result of, among other things, the Bank of Russia's prudential policies intended to curb foreign currency lending. Dollarisation of non-financial organisations' loans (adjusted for currency effects) continued to drop (Figure 30).

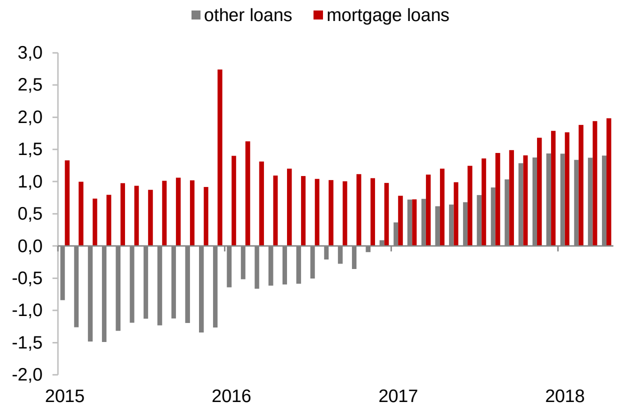
[9]Here and elsewhere, seasonally adjusted unless otherwise indicated.

Figure 27. Change in ruble loan portfolio, % MoM (seasonally adjusted)



Sources: Bank of Russia calculations.

Figure 28. Change in loan portfolio segments, % MoM (seasonally adjusted)



Sources: Bank of Russia calculations.

The share of overdue loans in April shrank from 6.7% to 6.4% in the retail portfolio and stayed at 6.9% in the corporate loan portfolio, mainly on the back of data by major banks undergoing financial resolution. Similar dynamics were registered in the aftermath of the 2009 crisis, when overdue retail loans also shrank faster and fell below overdue corporate loans.

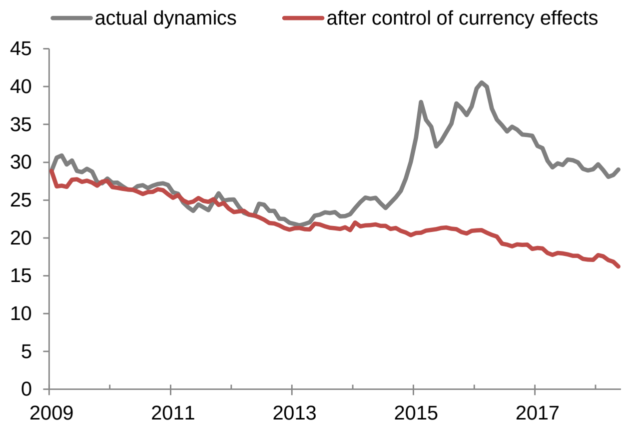
Figure 29. PTI at the average loan characteristics and income (annually in March)

	wage as of early 2014	average wages according to Rosstat
2014	14.8	14.1
2015	16.1	14.1
2016	14.8	12.5
2017	14.2	11.2
2018	13.5	9.8

Note: 3.5 years of maturity (the median of consumer loans based on the study *Sinyakov, Mamedli 'Consumer lending in Russia: prospects and risks based on household finance survey'*), the loan amount is 130 thousand rubles, the 2015 average (according to National Credit History Bureau data).

Sources: Bank of Russia calculations.

Figure 30. Dollarisation of loans to non-financial organisations, %



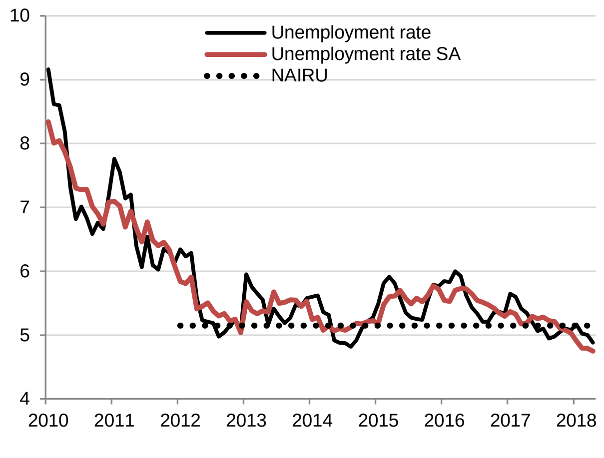
Sources: Bank of Russia calculations.

1.2.6. Unemployment hits a fresh low

- The unemployment rate continues to hit new lows, falling to 4.75% (seasonally adjusted) in April as the demand for labour rose.
- Still elevated, nominal wage growth slowed in March both in the private and public sectors.
- In March, nominal wages of employees covered by the presidential orders started to decline (-0.6% MoM); this may suggest that the sizeable wage increase in January and February partially resulted from the one-off payments.

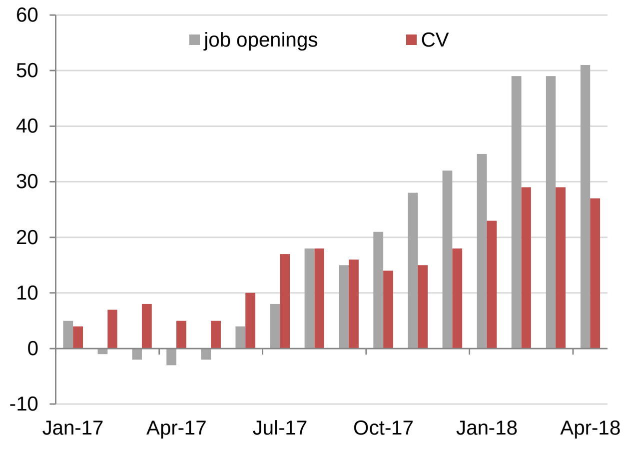
In April, unemployment stood at 4.9% vs 5.0% a month earlier. Seasonally adjusted, the indicator dropped from 4.80% to 4.75% (Figure 39). The unemployment rate is highly likely to remain low thanks to the demography[10] and the demand for labour that follows the economy's upward path. Data by HeadHunter suggest that the number of job openings is growing almost twice as fast as the number of CVs: 51% YoY vs 27% YoY (Figure 32). The ratio between CVs and job openings[11] on hh.ru went down to 6.2 in April 2018 from 7.4 in April 2017, with the decline observed in almost all professional areas. The increase in job openings was registered in all professional areas, signalling a rise in the demand for labour.

Figure 31. Unemployment and its natural rate, %



Sources: Rosstat, R&F Department calculations.

Figure 32. Monthly increase in job openings (May), % YoY



Sources: hh.ru.

As unemployment fell, wages continued to increase at a high pace. Rosstat's preliminary estimates suggest that nominal wages rose by 10.4% YoY and real wages added 7.8% YoY in April, showing slower growth than in March (Figure 33). Nominal and real wage growth projections for March were revised from 9.0% to 11.3% YoY and from

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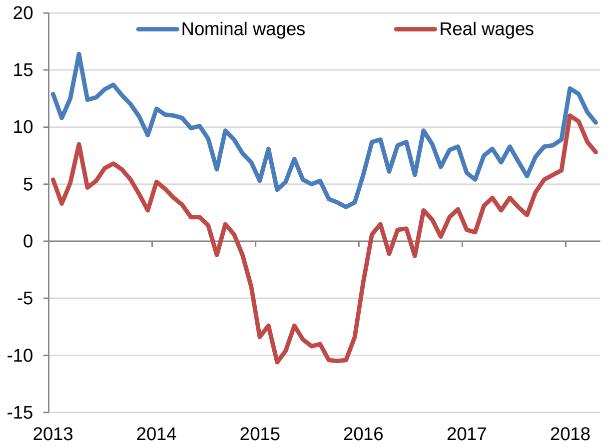
[10] The R&F Department estimates that in the next five years economically active population will shrink on average by 0.5 pp annually.

[11] The hh.index estimates skill shortage through the ratio between active CVs and job openings.

6.5% to 8.7% YoY respectively. In the past four months, Rosstat revised its preliminary estimates upwards, and therefore, the probability is high that wage growth in April will equal or exceed the March readings.

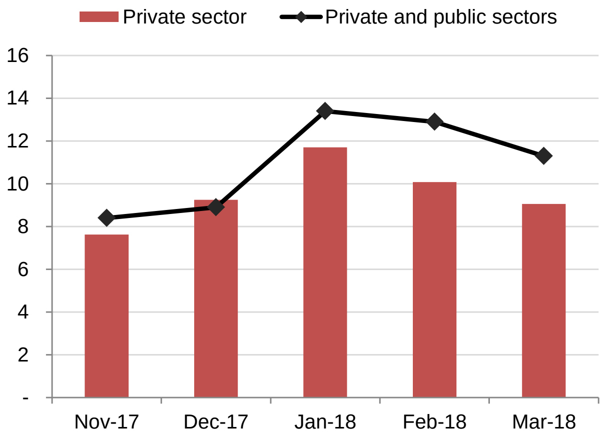
Despite the current slowdown, public sector wage growth remains high (Figure 34). The year-start surge was partially caused by the previous one-off payments; however, we estimate that the delivery on the 2012 May decrees and the indexation of other budget-financed wages will ensure above-average wage growth in the public sector.

Figure 33. Nominal and real wages, % YoY



Sources: Rosstat.

Figure 34. Nominal wages in public and private sectors, % YoY



Sources: Rosstat, R&F Department calculations.

Given the rising demand for labour and falling unemployment, we may conclude that private sector wage growth will remain high and will be one of inflation drivers. Having accelerated to almost 12% in January, nominal wage growth in the private sector is gradually going down, though staying close to 10% (Figure 34). In May, wage growth is poised to accelerate, as 1 May 2018 marked the next stage of minimal wage increase; according to R&F Department's estimates, this may add another 1.5 to 3.0 pp to the annual wage performance.

1.2.7. General government surplus is at its highest since 2012

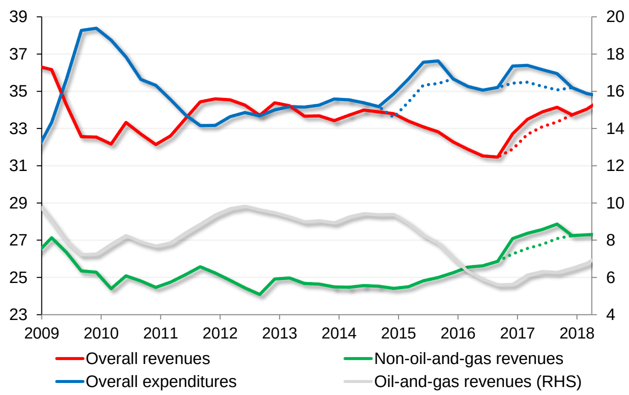
- In the first quarter of 2018, revenues increased by 1.3 pp of GDP, including a 1.1 pp hike in oil and gas revenue (following the surge in oil prices) and a 0.2 pp rise in non-oil and gas revenue on the back of higher labour tax revenues.
- Q1 expenditures dropped by 1.3 pp of GDP, including a 1.1 pp fall due to the high base effect (the one-off pension payment in January 2017) and a 0.3 pp drop triggered by shrinking capital investments.
- A surplus of 3.2% of GDP reduced the public debt to 13.9% of GDP and increased the National Wealth Fund to 5.7% of GDP in the first quarter of 2018. The effect of

the fiscal rule constrained domestic demand and prevented the economy from overheating that could have been triggered by rising oil prices. The base effect also was a constraint.

- The 2018 amendments to the federal budget law provide for an upward revision of non-oil and gas revenue and expenditure by 0.06 trillion rubles, oil and gas revenue and payments to the National Wealth Fund, by 1.76 trillion and 2.21 trillion rubles respectively. The 0.45 trillion ruble difference is supposed to be covered with additional loans and fund balances.

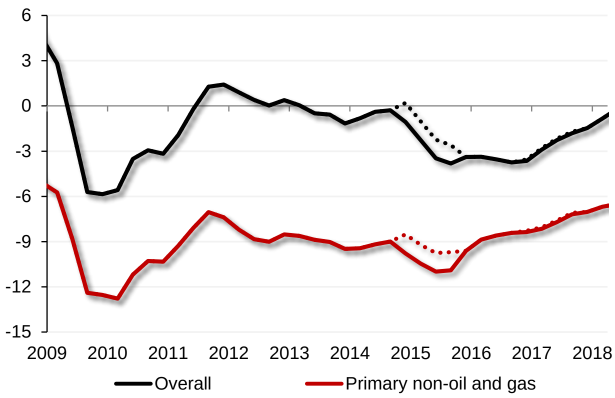
Revision of 2017 data. May expectedly saw a considerable upward revision of 2017 general government revenues (insurance and other payments to extra-budgetary funds) and expenditures (social payments) (by 0.45 pp of GDP), with the deficit remaining unchanged (-1.5% of GDP)[12] (Figure 35 and Figure 36). We also revised upwards the contribution of better tax collection to revenue growth in 2017 to 0.5 pp of GDP (1.3 pp in 2014-2017).

Figure 35. Key general government indicators (% of GDP, four-quarter moving average)



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

Figure 36. General government balance (% of GDP, four-quarter moving average)



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

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

2018 Q1 revenue. In the period between January and March 2018, general government revenue increased by 1.3 pp of GDP YoY.[13] As many as 1.1 pp accounted for oil and gas revenues thanks to the increase in Urals crude prices of 25% YoY in US dollar terms and 21% YoY in ruble terms (Figure 37) along with a 1% drop in oil production volume and exports. Growth by another 0.2 pp of GDP came from the increase in non-oil and gas revenue following outpacing growth of labour tax revenue (+0.6 pp of GDP) amid the comparable increase in labour remuneration (+13% YoY).

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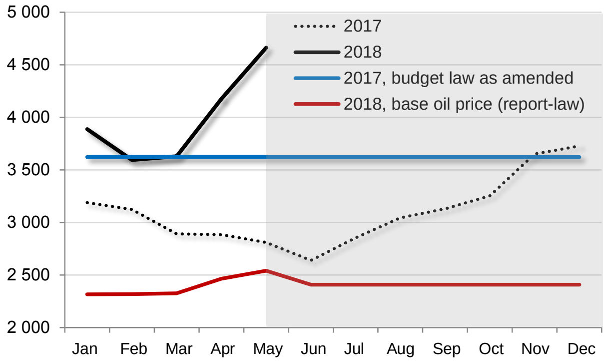
[12] See Subsection 1.2.6. '2018 may see a budget surplus' of the Talking Trends bulletin, March 2018 (No. 22).

[13] Here and elsewhere, the Russian Ministry of Finance's estimates of 2018 Q1 nominal GDP.

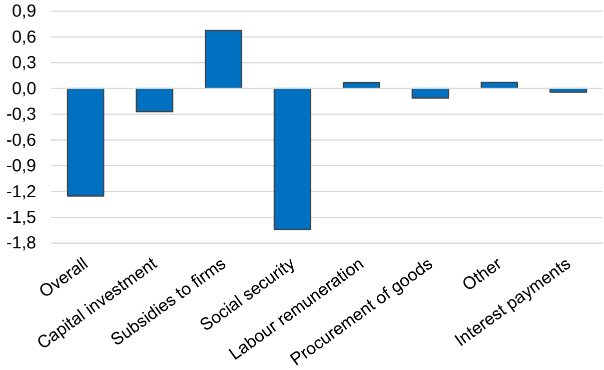
Expenditure. In the first quarter of 2018, general government expenditure dropped by 1.3 pp of GDP YoY or by 0.2 pp adjusted for the one-off pension payment in January 2017. Along with social payments, the expenditure structure registered a sizeable shrinkage of capital investments (-0.3 pp of GDP) (Figure 38). Expenditure for regions' debt servicing also fell (-0.05 pp of GDP).

Figure 37. Monthly ruble price of Urals per barrel in 2017-2018



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

Figure 38. Changes in general government expenditure in 2018 Q1, pp of GDP YoY



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

General government balance. The increase in revenue and the drop in expenditure closed the first quarter of 2018 with a surplus of 3.2% of GDP, 2.5 pp higher than in 2017 Q1 and the highest reading since 2012. This allowed public debt reduction and further cash accumulation in the National Wealth Fund.

Impact on GDP growth. The effect of the fiscal rule constrained domestic demand and prevented the economy from overheating on the back of rising oil prices. Additional impact was also exerted by the base effect (the one-off pension payment in January 2017).

The 2018 amendments to the federal budget law. On 22 May, the Government approved amendments to the 2018 budget law. The macroeconomic scenario forecast revised the Urals crude price upwards from $44 to $62 a barrel, the year-average US dollar exchange rate was revised downwards from 65 to 59 rubles per US dollar and inflation from 4.0% to 2.8%, with economic growth holding at 2.1%.

Revenue was revised upwards by 1.82 trillion rubles. Non-oil and gas revenue and expenditure increased by 0.06 trillion rubles. Oil and gas revenue was revised upwards by 1.76 trillion rubles and additional oil and gas revenue transferred to the National Wealth Fund - by 2.21 trillion rubles (the fiscal rule provides for an outpacing growth of extra oil and gas revenue along with oil price increase with this growth to be financed from additional funding sources). The difference will be offset by additional net domestic loans worth 0.22 trillion rubles (a total of 1.04 trillion rubles), the use of budget balances (of past periods) worth 0.18 trillion rubles and small foreign loans.

2. Outlook: leading indicators

2.2. What do Russian leading indicators suggest?

2.2.1. GDP index estimate revised upwards

- 2018 Q2 GDP growth projections stood at +0.4% QoQ SA as of end-May, exceeding the April estimates (+0.35% QoQ SA).
- The April short-term statistics released by Rosstat were in line with the 2018 Q2 GDP estimates of previous months.
- Model estimates suggest that GDP will grow by 0.4% QoQ SA in the third quarter and may hit 0.5% QoQ SA in the fourth quarter.
- The upward revision of projections for this and next quarters is largely attributed to oil price increase in May. Its impact on GDP growth in the second half of the year may be overestimated.

	May **% QoQ SA**	April % QoQ SA
2018 Q2	**0.4**	0.4
2018 Q3	**0.4**	0.3 - 0.4
2018 Q4	**0.4 - 0.5**	–

2.2.2. Bloomberg forecast: inflation expectations still anchored at 4%

- As analysts revise their expectations for the key rate in 2018 on the back of geopolitical risks, the Bank of Russia’s shift to neutral monetary policy in 2018 is not ruled out.
- The inflation consensus forecast hardly changed in April and May: CPI growth will range between 3% and 4% as of end-2018 and hold near 4% in 2019.
- The probability that price growth rates may faster approach 4% on the back of a weaker ruble and rising global oil prices poses no risks of inflation overshooting the target in 2018.

Analysts’ forecast for end-2018 inflation remained unchanged from March, holding at 3.6% YoY (Figure 39). Importantly, experts believe that consumer price growth will hit the path towards 4% annual inflation no sooner than the second half of this year. As the high and low base effects manifested themselves pronouncedly on the back of price fluctuations in 2017 caused by temporary factors, the 2018 Q2 consensus forecasts expectedly assume low inflation of no more than 2.5% YoY. It should gradually go up above 3.0% and 3.5 % in 2018 Q3 and Q4.

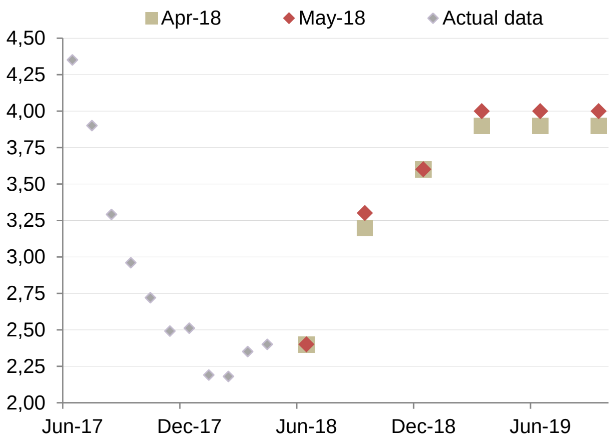
Our seasonally adjusted estimates suggest that this 2018 inflation path provides for short-term (monthly and quarterly) annualised CPI growth of 4.0% or higher. Nevertheless, these figures hardly reflect experts' assumptions that the risks of price growth deviation from the pace consistent with 4% annual inflation may materialise in the near future.

First, in the medium-term consensus forecast, inflation does not exceed 4% and even drops slightly below the target on the back of the past month's trends (as of end-April - 3.9% YoY). The possible proinflationary effect of the ruble's depreciation (at least given the symbolic revisions of consensus forecast against March) is yet to be factored in in respondents' short-term forecasts. Also, consensus forecasts do not predict that CPI growth may rise to 4% faster than previously expected.

Second, the analysis of consensus forecast should not underestimate evident technical factors, such as infrequent forecast revisions by some analysts, only partial consideration of real-time weekly CPI data by some experts, uncertainty over the year-on-year inflation estimates for each individual quarter due to the fluctuations of seasonal price components, etc.

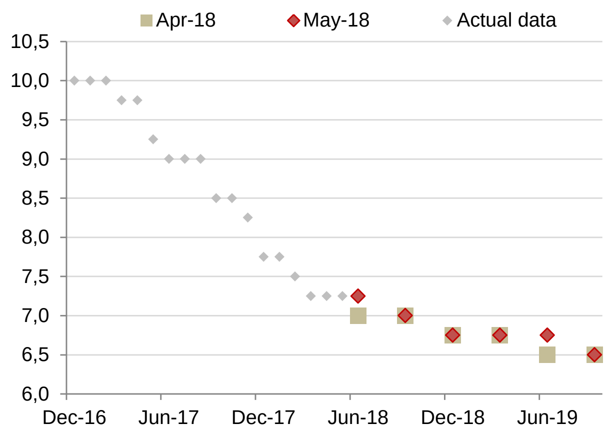
The new risks associated with the imposition of additional restrictions against some Russian companies in early April made experts revise their projections towards a more prudent monetary policy. The key rate dynamics were revised towards a 0.25 pp increase on the entire forecast horizon (Figure 40). The latter does not rule out the transition to a neutral monetary policy in 2018. The consensus forecast of the ultimate key rate reading still holds at 6.5% p.a.

Figure 39. Analysts' expectations for inflation, % YoY



Source: Bloomberg Finance L.P.

Figure 40. Analysts' expectations for the BoR key rate, % per annum



Source: Bloomberg Finance L.P.

3. In focus. Agricultural market saturation: higher efficiency should support output growth

- The food price drop of the past years, mostly driven by the previously accumulated producers' margin, boosted competitiveness of certain categories of Russian goods in the global market.
- This was the main factor behind the near-zero food inflation. However, falling profitability in the agricultural sector may disrupt low food inflation amid rising costs. This will bring headline inflation back to 4%.
- Many Russian food markets have come close to saturation, with some of them already witnessing a supply glut, whereas the competitiveness of Russian products (other than traditional agricultural exports) on the global market remains low or insufficiently stable.
- The task of securing steady competitive advantages with respect to fostering agrifood exports calls for continuing focusing on technological upgrades and higher efficiency of production.
- Exports form the basis of domestic production growth in the poultry, pork and sugar markets, which are running the risk of a supply glut and where prices have approached global readings.
- The strategy aimed at food self-sufficiency (dairy products, beef and greenhouse vegetables) is still associated with elevated household spending compared with consumption of similar imported products. Efficiency growth in these sectors needs a special focus.

By 2018, many Russian food markets, which used to depend on imports, had reached (or had almost reached) self-sufficiency, and some of them (poultry, pork and sugar markets) even face the risk of a glut. This was driven by the accelerated import substitution policy in food markets and favourable weather, which led to the high production growth rates in agriculture.

As restrictions were imposed to protect the market from imports, the rise in prices of domestic agricultural produce outpaced the increase in production costs in 2014-2015. Thereby, the relatively high domestic prices boosted profits of agricultural producers. Whereas in 2012-2014 agricultural profitability (factoring out subsidies) ranged between 5.2 and 6.3%, in 2015 this indicator reached 11.8%. The sector's profits rose by 20.3% with government subsidies factored in.[14]

However, in 2017, as the capabilities of import substitution were exhausted and agricultural production growth rates remained high amid restricted imports, the domestic market faced a supply glut in certain agrifood products. This exerted pressure on prices

[14] Data by the Russian Ministry of Agriculture.

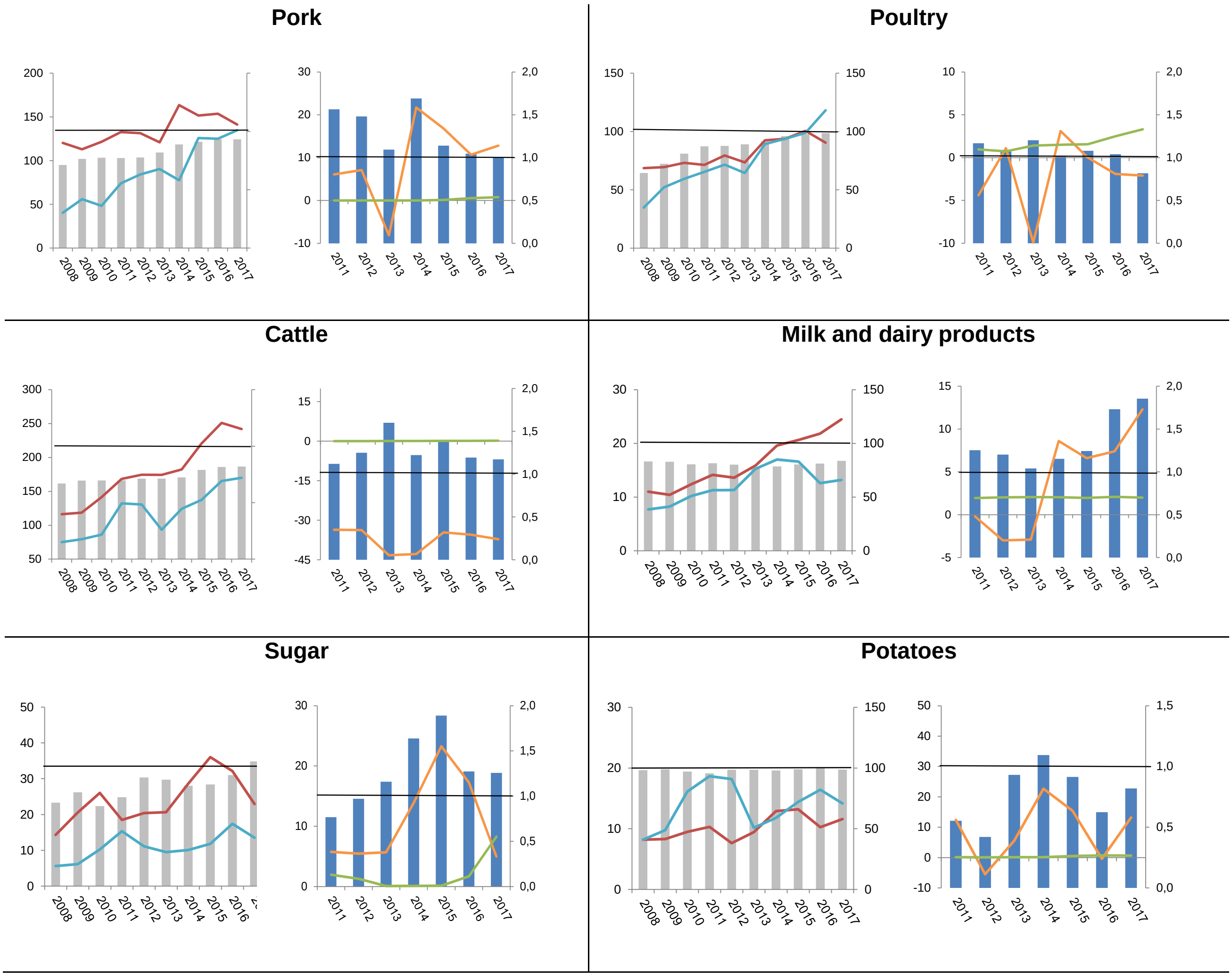
and caused a noticeable shrinkage of agricultural producers' profits (Figure 41). This factor played a key role in holding food inflation low during this period.

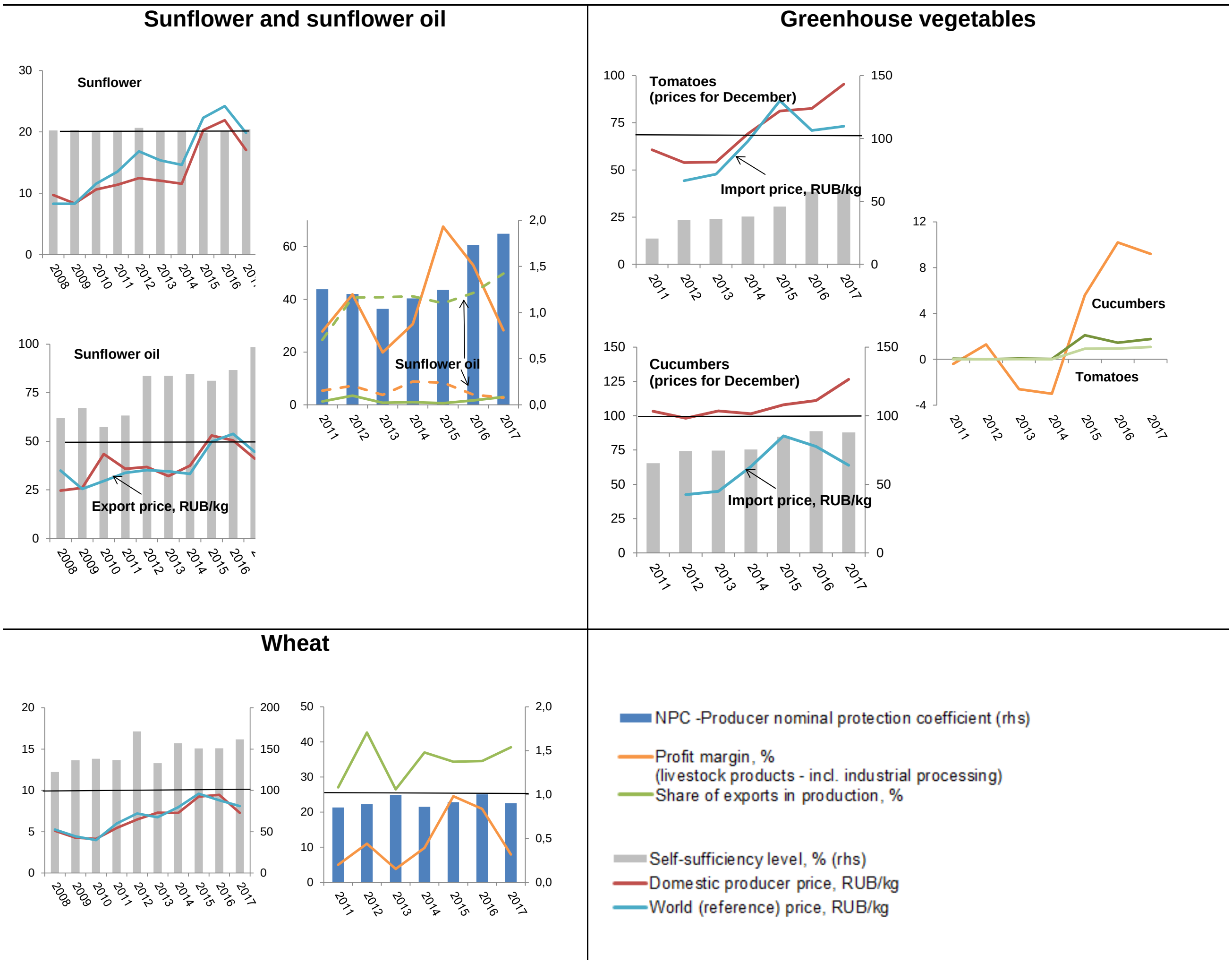
Further market saturation and export surpluses will continue to exert pressure on prices and create new price benchmarks in the agricultural sector, inevitably bringing domestic prices below the global market level (to export netback). Whereas certain sectors retain the potential for price reduction at the expense of producers' previously built margins, other sectors (poultry, pork and sugar production) have already exhausted their 'safety cushion' accumulated in 2014-2015 (Figure 41).

In this environment, businesses are losing stimulus to expand production. In saturated markets, producers may contain production growth to balance supply and demand and keep market prices and their profits at a more comfortable level.

Tougher competition will boost the trend towards the merger of leading enterprises (mostly vertically integrated companies) through market consolidation and acquisition of weak players. Accelerated market consolidation may give certain players more market power to shape prices. Coupled with recovering demand, this will accelerate food price growth.

Figure 41. Self-sufficiency and competitiveness of key agricultural products





Sources: Rosstat, Russian Ministry of Agriculture, Federal Customs Service, OECD, R&F Department calculations.

At the same time, there is a risk that the pressure of growing volumes of domestic produce on the market will hardly be offset by exports. This is partially associated with phytosanitary, administrative and logistic constraints; however, cost competitiveness of Russian products in global markets is of no less importance. This is typical of saturated market products, except for well-established exports (grain, sunflower and sunflower oil).

Competitiveness of the Russian agriculture is assessed through the OECD methodology based on the comparison of domestic and global (reference) prices and the calculation of the Producer Nominal Protection Coefficient (NPC).[15] Until 2017, this indicator stood above one for almost all main product categories, that is, prices of Russian food products exceeded global prices for such goods when the domestic market

[15] The Producer Nominal Protection Coefficient (NPC) is the ratio between domestic food prices and global (reference) prices. The NPC<1 means that agricultural producers offer their products at the price below the global market price and, thus, have competitive advantages over other countries; the NPC>1 means that global market prices is lower than domestic prices, that is Russian products are poor competitors in the global market.
The global (reference) price is the border price less delivery, processing and marketing costs, that is market profits. For exporting countries, the export border price is used as the global price and for importing countries the import border price is used. The domestic price is the average sale price of agricultural produce.

was open (Figure 41). In terms of competition with imports, this also means that the substitution of imports with more expensive domestic products leads to higher household food spending.

The OECD calculates consumer expenses for the support of agricultural producers with the use of Market Price Support (MPS), an indicator of the annual monetary value of gross transfers from consumers and taxpayers to agricultural producers arising from policy measures creating a gap between domestic producer prices and global (reference) prices. These calculations suggest that consumer expenses on the support of agricultural producers rose from 278.2 billion rubles in 2014 to 603.7 billion rubles in 2016 in current prices. Thereby, whereas each Russian used to overpay roughly 1,935 rubles a year for the consumption of more expensive domestic products, in 2016 this amount rose to 4,120.7 rubles per person.

As certain food markets were saturated, the decline of domestic prices in 2017-2018 helped increase competitive price advantages of Russian products. For the first time in the past ten years, poultry prices of Russian producers were lower than those of imported products, while prices for Russian pork only approached the global level (Figure 41). At the same time, greenhouse vegetables, sugar, dairy products and beef still cannot compete with imports on price.

Nevertheless, the rise in the global competitiveness of the Russian agrifood sector looks unstable as in most cases prices went down because a further margin reduction was impossible. Furthermore, some factors constrain the competitiveness of the agrifood sector in the short and long run. The World Bank's research[16] suggests that the main advantage of Russian businesses compared to competing western farms is the low cost of land (low land rent) and labour (low wage). That said, labour intensity per production unit is higher than in other countries. This suggests low productivity in Russian agriculture. As the economy develops, wages will go up. Growing cost of land and labour will reduce the competitiveness of Russian agricultural producers and call for higher productivity of physical labour. In the past years, the profitability of livestock farms was also driven by the relatively low prices of fodder, accounting for almost 70% of livestock product cost. However, fodder prices are largely affected by the weather.

The task of securing steady competitive advantages - to foster agrifood exports - call for a shift in agribusiness policy priorities away from the focus on self-sufficiency across all products to technological upgrades and higher efficiency of production. The World Bank's research describes three areas of the state policy's focus: spreading innovations and technologies for a larger-scale productivity growth in priority sectors, strengthening value chains and supporting human capital in agriculture through the development of institutional potential in agricultural sciences. Investments that used to target mainly production capacity building should now be focused on storage capacities, logistics and transportation.

[16] Russia: Policies for Agri-food Sector Competitiveness and Investment. World Bank, 2017.

The situation in agrifood markets varies, and their further development will depend on price competitiveness of domestic products, export development outlook and producers' ability to cut costs. In this context we may single out three groups of products.

– Highly competitive traditional exports: grain, oil-bearing crop and sunflower oil. Domestic production of these products has a potential for growth in the context of the expected rise in demand for these products in the global market once the low price period is over. In recent years of heavy grain and oil-bearing crops, producers were mainly challenged with the deficit of storage capacities and unfitness of transportation logistics for large exports.

– Products with saturated or almost saturated markets with unclear export outlook: pork, poultry, sugar and potatoes. The competitiveness of these products has approached their global equivalents. These sectors will depend on cost-cutting efficiency and the possibility of entering new export markets. The solution of export problems is the main driver for domestic production growth.

– Products with current low competitiveness with imports in open markets: dairy products, beef and greenhouse vegetables. Domestic prices of these products exceed global prices considerably. Should the self-sufficiency-focused policy hold, households will continue to spend more on consumption of such domestic products which are more expensive than their imported equivalents. Therefore, the focus in these sectors should be made on higher efficiency.

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