Bank of Russia

The Central Bank of the Russian Federation

Companies look ahead to 2018 with conservative optimism: survey results

Research and Forecasting Department

Analytical Note

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In 2017 the Research and Forecasting Department conducted a survey of 236 industrial and agricultural producers*.*[1] *The survey results were rather optimistic.*

Broadly, the following conclusions can be drawn:

- *Business is gradually adapting to low inflation and is lowering its inflation expectations. The median expectation is as little as 5%. It is of particular note that many companies believe their prices will drop faster than inflation.*
- *Most companies (66%) believe that production growth will continue and therefore 45% of them are planning to invest. That said, companies are focused on expenses and cost reduction. 44% do not envisage an increase in the cost of their products in 2018.*
- *At the same time, most companies (72%) are planning to raise wages, and 35% are set to hire new staff.*

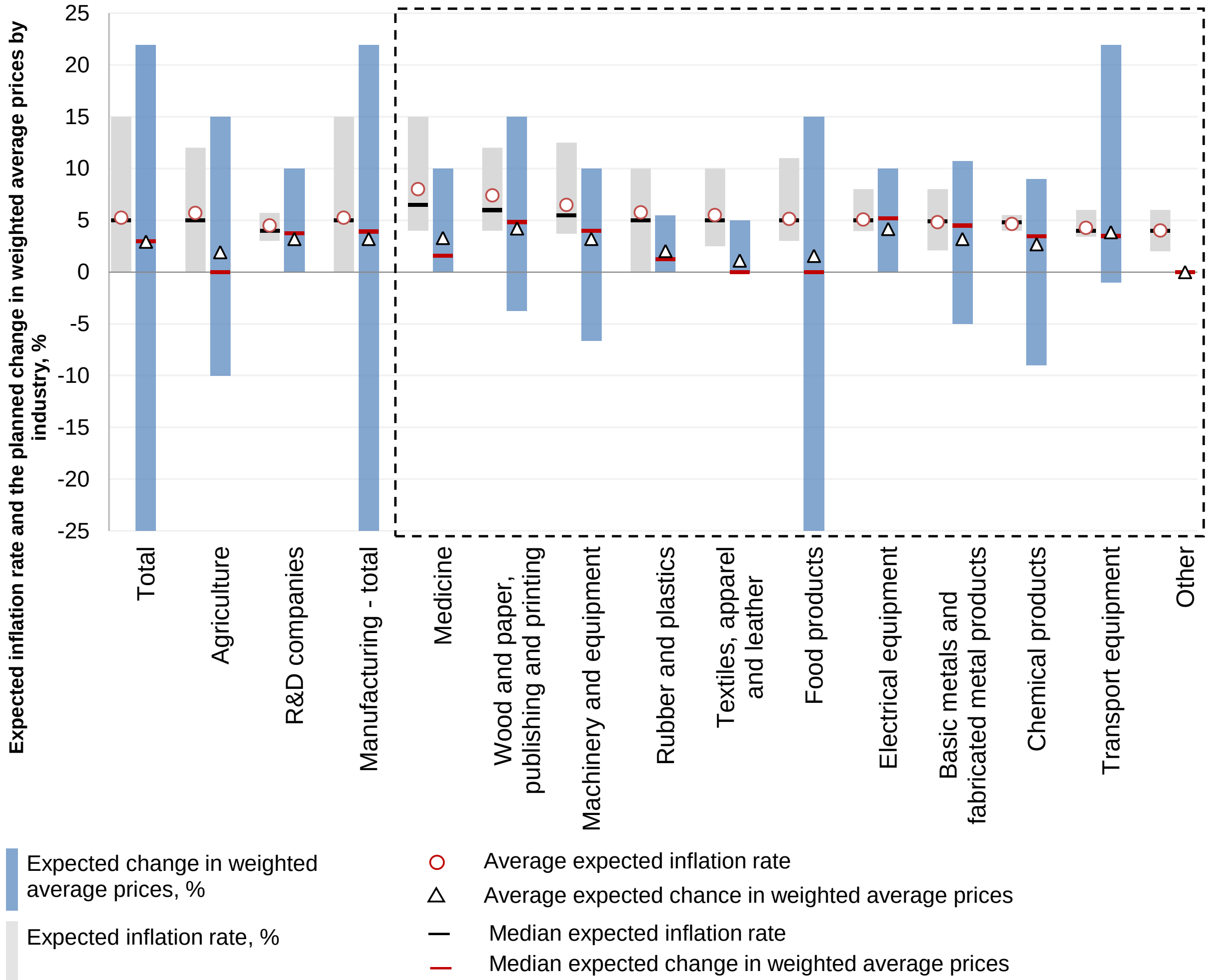
[1] Those surveyed included 34 agricultural companies, 178 companies working in various areas of the manufacturing industry, and 24 research and development companies producing engineering products. The sample description is given in the appendix.

1. Inflation expectations and pricing strategy

The companies' inflation expectations are close to the Bank of Russia's target. The sample's median expected inflation rate in 2018 stood at 5% (Figure 1). The survey showed that 31% of respondents expect inflation between 3 and 4%; 32% estimate it will be between 4 and 5%; 16% are planning their production levels based on inflation between 5 and 6% (Figure 2). Only 16% believe that inflation will exceed 6% next year.

In general, producers are geared towards conservative pricing strategies. The median forecasted planned growth of weighted average[2] prices for products was 3%, which is lower than the median expected inflation rate (Figure 1). 61% of the surveyed companies believe the prices of their products will increase less than their inflation expectations (Figure 3). However, 23% of companies believe the rise in prices in 2018 will exceed their inflation expectations, with most companies stating they will be between 3 and 6% (Figure 4).

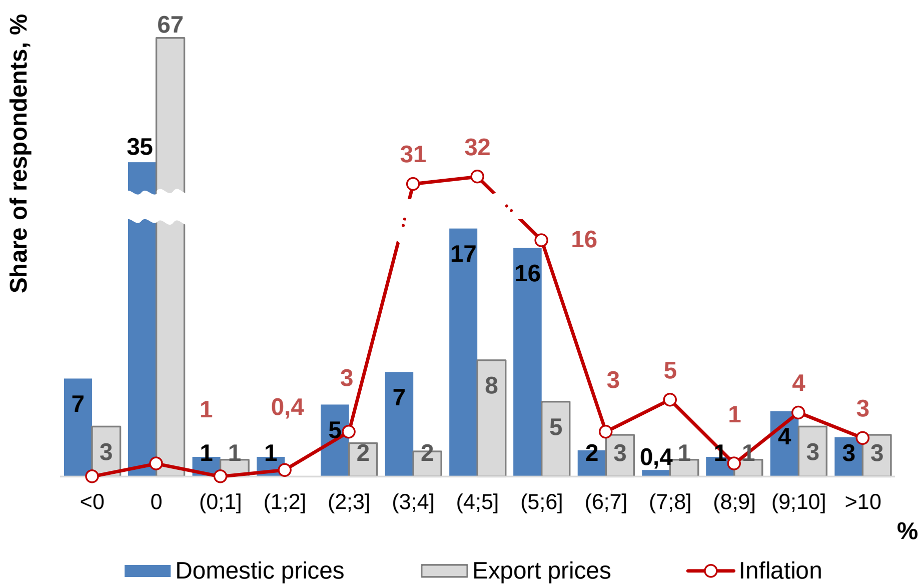
Figure 1. Expected inflation rate and the planned change in weighted average prices by industry



Source: Bank of Russia survey.

[2] Weighted average prices are the sum of domestic and export prices, weighted according to the proportion of the company's supply to the domestic and foreign market.

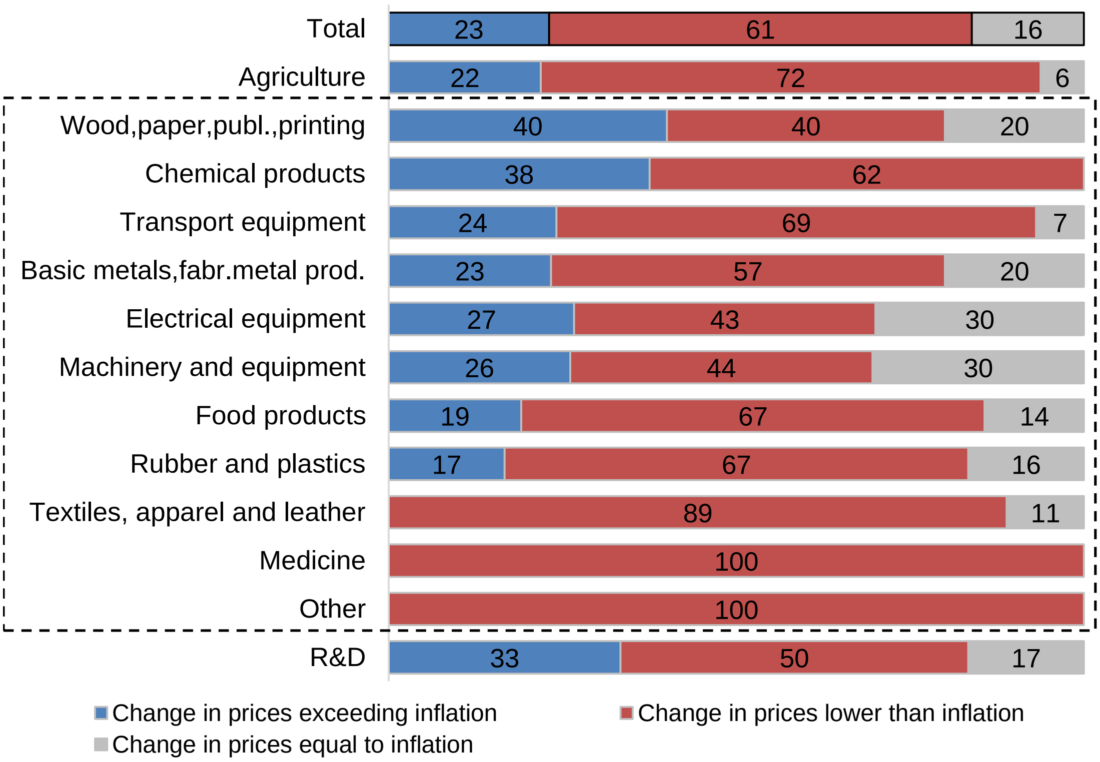
Figure 2. Breakdown of respondents by expected inflation rate and planned changes in domestic and export prices



Source: Bank of Russia survey.

Limited demand is holding prices back on the domestic market. Approximately 1/3 of the companies surveyed (35%) are not planning to adjust the domestic prices of their products, while 47% envisage an increase of no more than 6%. Only about 10% of the companies forecast higher domestic price growth rates (Figure 2).

Figure 3. Breakdown of companies in terms of the interrelation of changes in weighted average prices and inflation expectations (share of respondents, %)



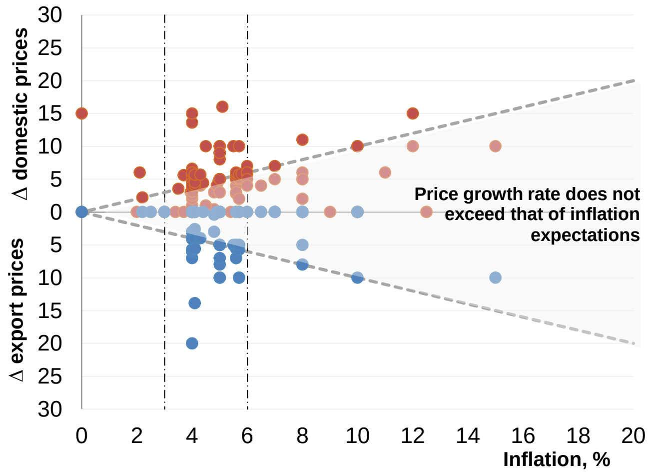
Source: Bank of Russia survey.

The companies' pricing strategies for their exported goods are even more conservative, which can be explained by their aim of remaining competitive on foreign markets.

About 2/3 (67%) of exporters suggest that the average export prices *in rubles* for their products will remain the same as in 2017; 29% of exporters plan to raise prices of products for export with 18% of these respondents envisaging a rise of no more than 6%, and the remaining 11% projecting over 6% (Figure 2). The survey results also show that companies selling their products both on the Russian and foreign markets are raising domestic prices at a faster pace than export prices (Figure 5).

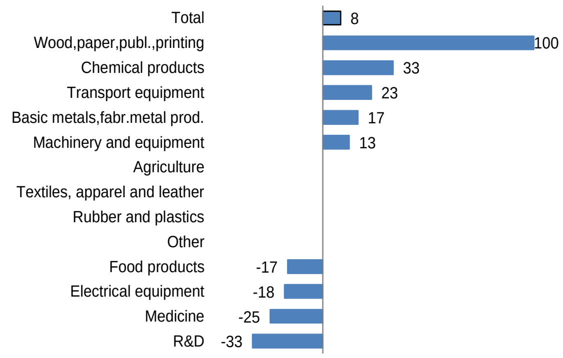
This may be evidence of the fact that by forcing themselves to limit any increase in export prices, companies are increasingly compensating for the growth in costs with their prices for products sold on the domestic market.

Figure 4. The interrelation of growth rates in domestic and export prices and expected inflation (%)



Source: Bank of Russia survey.

Figure 5. Changes in domestic and export prices (balance of responses, %[3])



Source: Bank of Russia survey.

By industry, the spread of estimated inflation rate is lower than the spread of expected price changes. As a result, in some industries there is a significant positive gap between the companies' inflation expectations and their plans to change the prices of their products (Figure 1).

This effect can be seen in such sectors as medicine, rubber and plastic production, the textiles, apparel and leather, food industries, agriculture. These industries produce with a focus on consumer demand. They are expected to see less intensive price increases compared to other industries. In agriculture and the food industry, the saturation of individual food markets may be a key factor that will keep price increases in check. Prices for some types of medicines are state-regulated, which limits their increase.

[3] Here and hereafter: the balance of responses is calculated as the share of companies that indicated that the growth rate of domestic prices exceeded that of export prices minus the share of companies that mentioned that the growth rate of domestic prices was less than that of export prices.

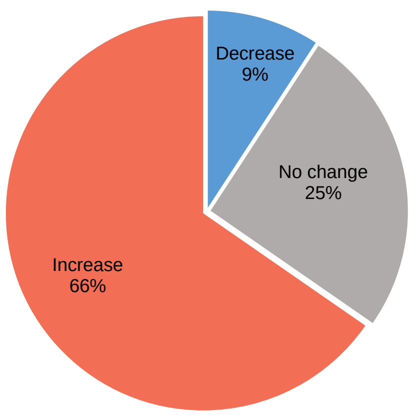
Textiles, apparel and leather is facing strong price competition with imported goods, which have recently begun to recover.

2. Production and export plans

Economic growth had a positive impact on the companies' production plans, bolstering their expectations for a further increase in domestic and foreign demand. About 66% of the companies are planning to expand production (Figure 6). 25% of respondents plan to keep production volumes at the same level as in 2017. The largest share of companies with plans to increase production are in the chemical industry (medicine, chemical products, rubber and plastics production) (Figure 7). The balance of responses in terms of change in production in these sectors is high (83.3-100 pp).

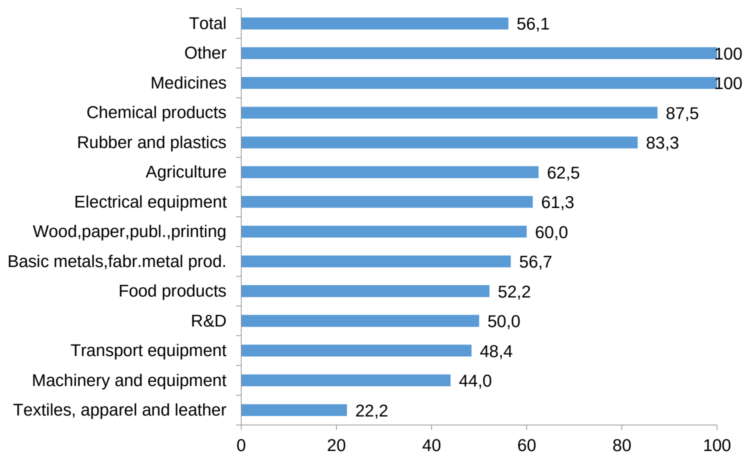
Only 9% of the companies are expecting a decrease in production: most of them are producers in the machinery (transport equipment, machinery and equipment, and electrical equipment), basic metals and fabricated metal products. According to the survey, these companies mainly focus on supplying the domestic market with their products and operate at low or negative profitability.

Figure 6. Companies' plans to change production levels in 2018 (share of respondents, %)



Source: Bank of Russia survey.

Figure 7. Companies' plans to change production levels in 2018 (balance of responses, %)

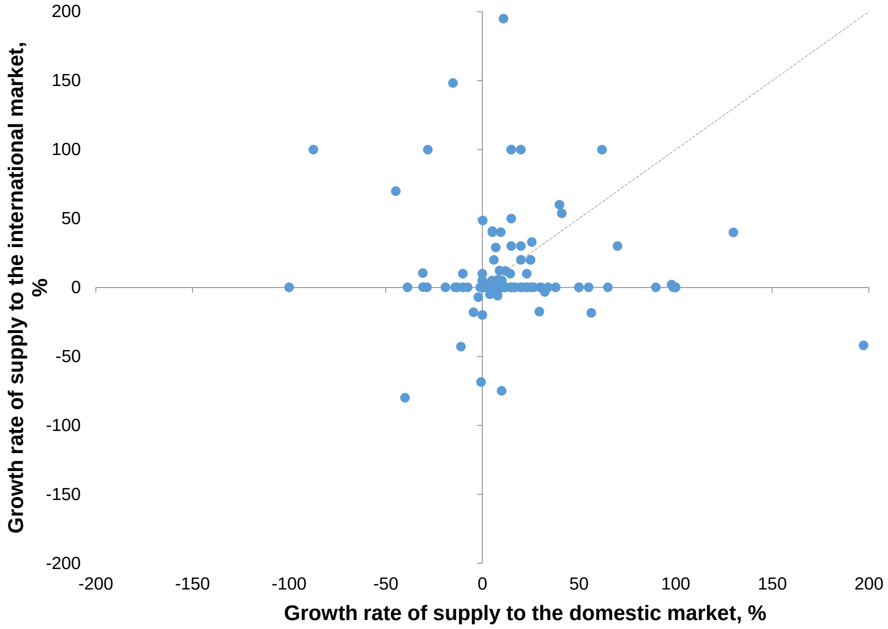


Source: Bank of Russia survey.

Most export-oriented companies are reporting higher growth rates in their deliveries abroad than that of sales on the domestic market. That is, their main aim is strengthening their presence on the global markets. This is their main incentive to increase production (Figure 8).

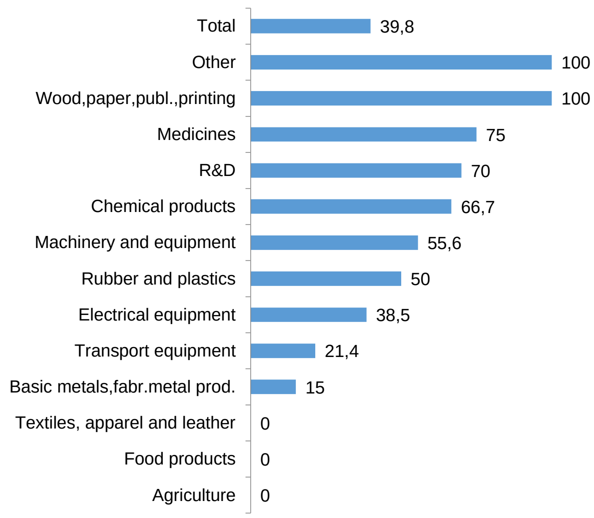
The industries with the highest number of exporters planning to up their supply to the international market include: wood processing, chemical (chemical products, pharmaceuticals), and some machinery production carried out by research and development companies (Figure 9). As with the increase in exports, chemical companies are more focused on growing domestic demand than the companies in other industries (Figure 10).

Figure 8. The interrelation of the growth rate of supply to the domestic and international markets



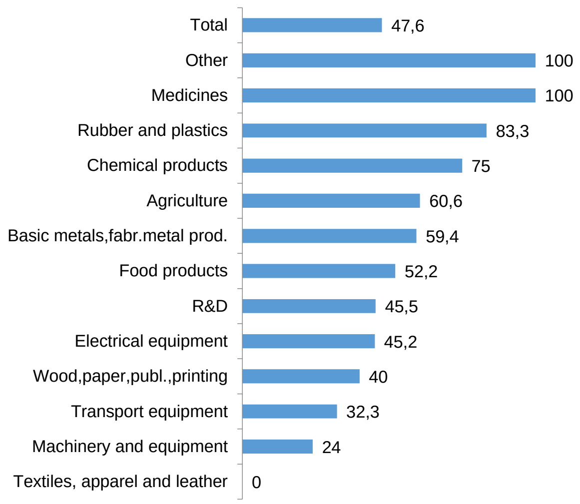
Source: Bank of Russia survey.

Figure 9. Expected change in supply to the international market (balance of responses, %)



Source: Bank of Russia survey.

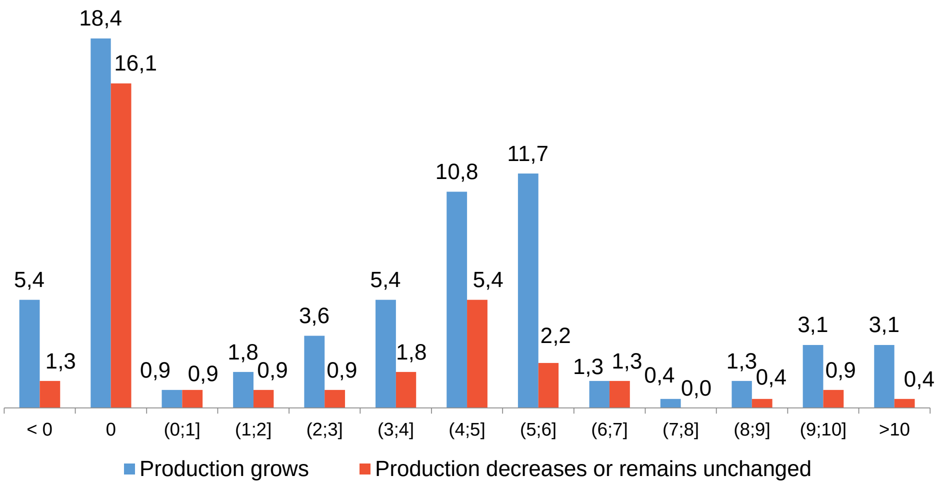
Figure 10. Expected change in supply to the domestic market (balance of responses, %)



Source: Bank of Russia survey.

It is important to note that companies that expect to increase production in 2018 have a greater tendency to increase their selling prices compared with those that plan to reduce or maintain production levels. This suggests that producers are reasonably optimistic about the future demand for their products. If the growth in selling prices has a negative impact on demand and it thus proves to be lower than expected, it will result in the risk of overestimated production plans.

Figure 11. Expected change in prices of companies' products and production plans (share of respondents, %)

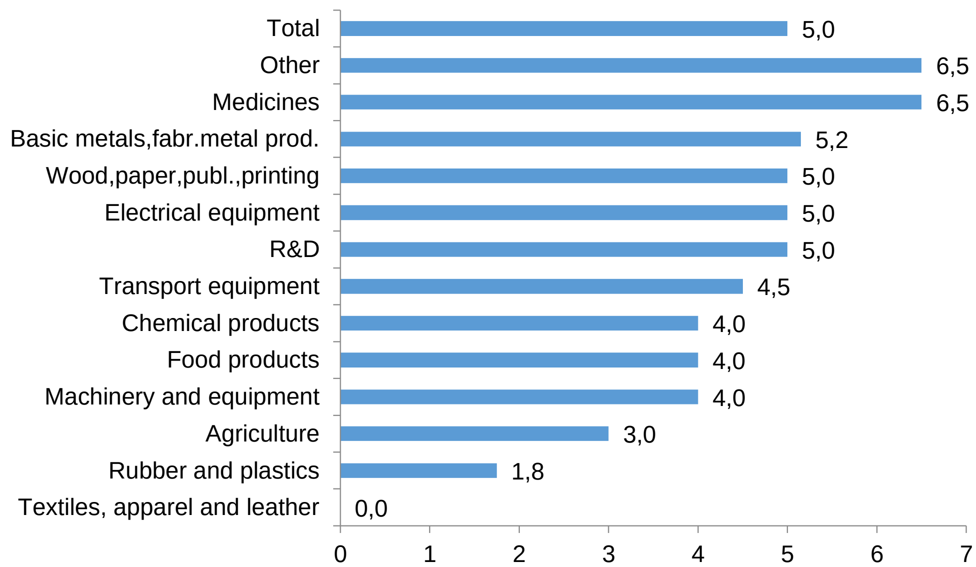


Source: Bank of Russia survey.

3. Wages and employment

The survey revealed the median estimated wage growth rate in 2018 is 5%, which is in line with the companies' median inflation expectations (5%) (Figure 12).

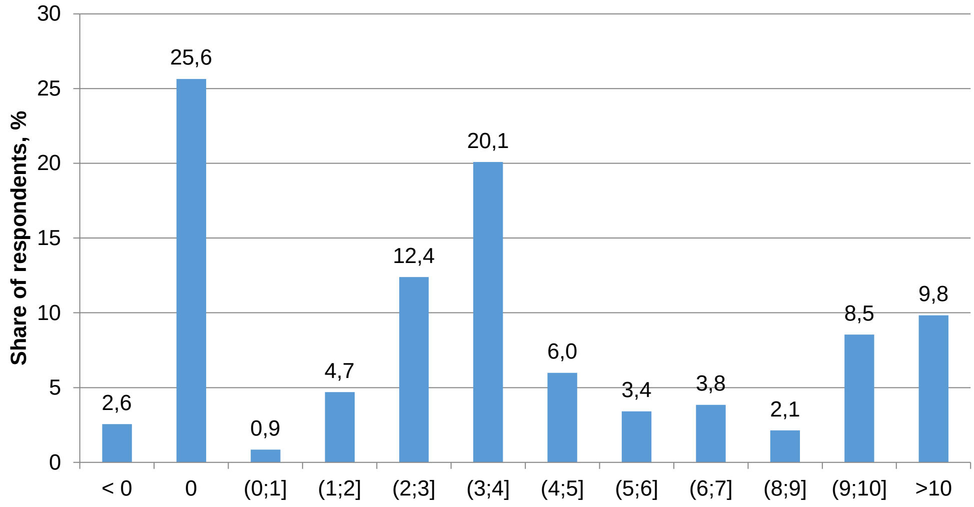
Figure 12. Median estimated wage growth rate in 2018 by industry (%)



Source: Bank of Russia survey.

A clear majority of respondents (71.8%) reported that wages would increase this year. Of this group, 38.1% stated the increase would be no more than 4%, 33.7% see the rise in wages exceeding 4%. However, 25.6% have no plans to change wages (Figure 13).

Figure 13. Breakdown of companies by wage growth rate (%)

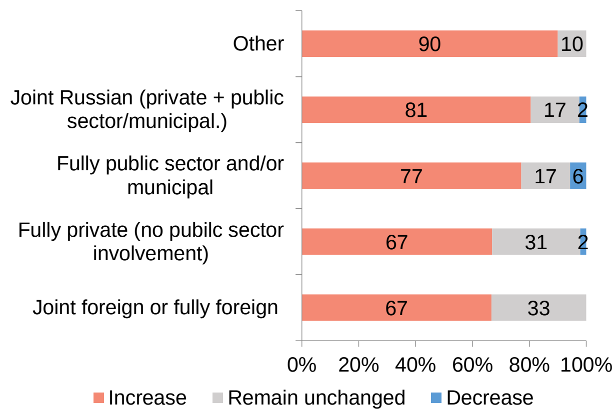


Source: Bank of Russia survey.

Public sector companies are more focused on raising wages (Figure 14). Large organisations (with a workforce of over 250 people) also experience increases in the cost of labour, where the positive effect of large-scale production reduces the costs per manufactured unit (Figure 15).

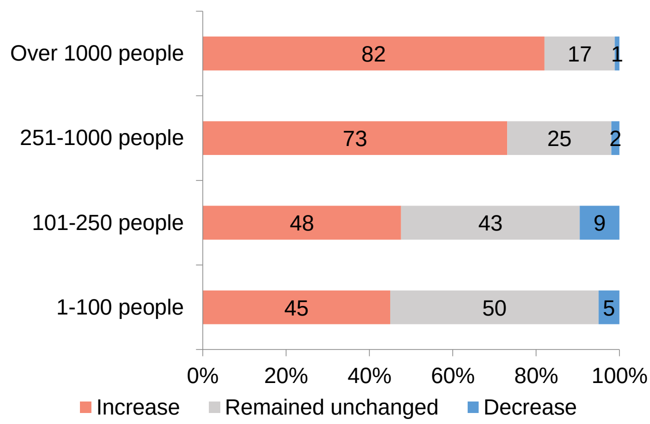
The expected inflation rate influences the producers' decisions concerning employee wages. Most companies state wage growth is lower than their estimates of the future inflation rate: 48% index wages below inflation, 13% adjust wages in line with their inflation expectations. 39% of companies say their increase in labour costs exceeds their inflation expectations (Figure 16).

Figure 14. Changes in wagesby types of ownership (share of respondents, %)



Source: Bank of Russia survey.

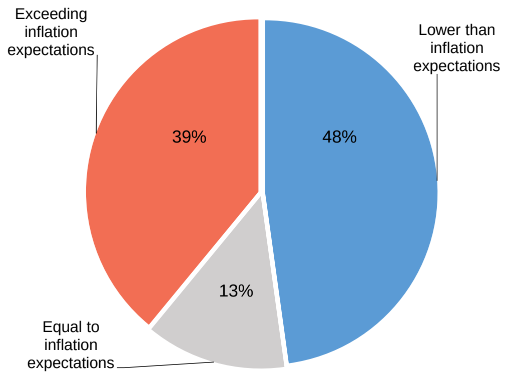
Figure 15. Changes in wages by company size (share of respondents, %)



Source: Bank of Russia survey.

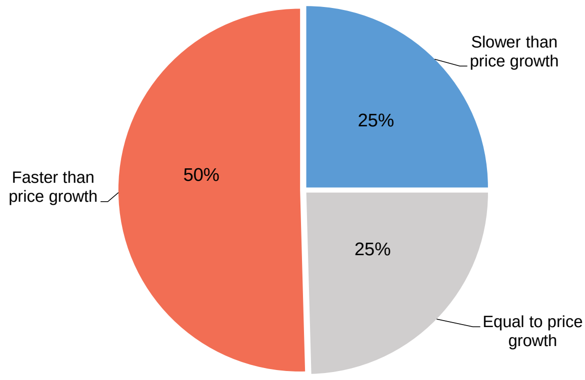
50% of respondents that raise wages said that their wage growth will exceed the growth rate of prices for their products (Figure 17). On the one hand, raising prices slower than wages curtails inflationary pressure due to the partial compensation for wage increases with a rise in selling prices. On the other hand, increasing wages can lead to inflation risks linked to an excessive increase in consumer activity, which is not underpinned by an increase in labour productivity.

Figure 16. Average expected growth rate of wages relative to companies' inflation expectations (share of respondents, %)



Source: Bank of Russia survey.

Figure 17. Average expected growth rate of wages relative to the average expected growth rate of product prices (share of respondents, %)



Source: Bank of Russia survey.

One of the possible reasons wages are increasing faster than selling prices is linked to the labour supply and demand imbalance by economic sector. In response to positive production plans and/or continuing shortage of qualified staff, about a third of the respondents (35%) intend to hire new employees this year (Figure 18). 22% of the companies said they envisage reducing their workforce, while 43% have no plans to changes their number of employees.

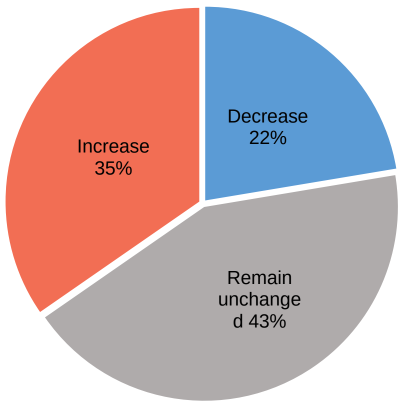
The survey does not allow us to draw conclusions about the correlation of the companies' labour productivity dynamics with that of wages. However, indirect estimates of labour productivity show that some companies are concerned about its increase.

23.2% of producers have plans to expand production while making no changes to their current workforce, 16.7% plan to reduce staff numbers while maintaining or increasing production (Figure 20). The first case demonstrates that these companies have sufficient human resources, which can be fully engaged amid increased economic activity. The second case indicates that these companies plan to optimise their workforce. However, both scenarios involve an increase in labour productivity.

HR policy varies greatly across different industries (Figure 19). The following industries are those with the largest share of companies envisaging a reduction in workforce: textiles, apparel and leather, food and machinery (transport equipment production, electrical equipment, mechanical engineering products manufactured by research and development companies). Companies in these industries plan a slight increase in production. The textiles, apparel and leather, and food industries meanwhile see relatively low wage growth as this happens.

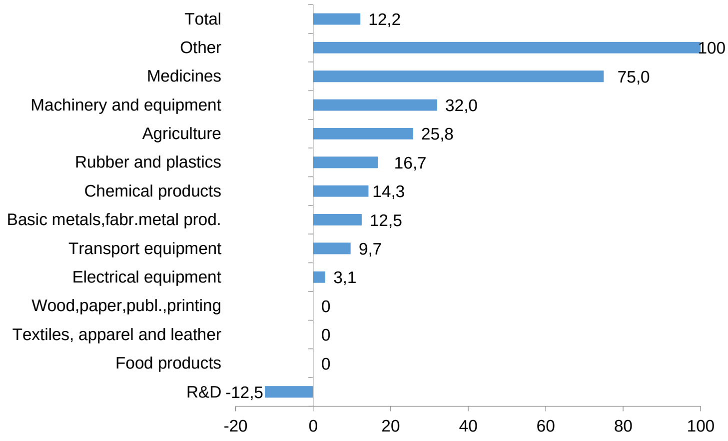
The majority of chemical producers (chemical, rubber and plastic, and pharmaceutical production) report that they have plans to increase production and thus it demonstrates a more marked tendency towards increasing the number of employees compared to other industries.

Figure 18. The breakdown of the expected change in number of employees (share of respondents, %)



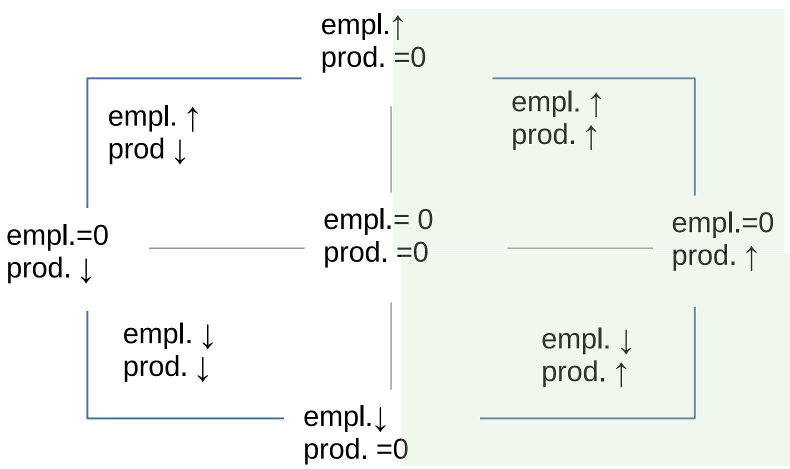
Source: Bank of Russia survey.

Figure 19. The balance of responses of the expected change in number of employees (balance of responses, %)



Source: Bank of Russia survey.

Figure 20. The interrelation of changes in number of employees and production (for companies reporting that wages will grow or not change – 97.4% of respondents)



Source: Bank of Russia survey.

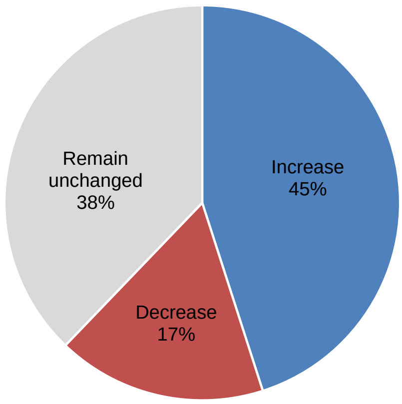
4. Investment plans

The companies' investment plans for 2018 will continue to recover on the back of improved market conditions and planned production growth. Most companies have no plans to reduce fixed investments: 45% of the companies are going to raise investments, while 38% state they will not change (Figure 21). Only 17% of respondents said they plan to reduce them this year. Generally speaking, this indicates that companies have a positive outlook and that the negative impact of economic uncertainty has been reduced. Relatively low inflation expectations also have a positive impact on the companies' investment plans.

The average expected change in fixed investments made by exporting companies is much higher than that of non-exporters (35% vs. 19%) (Figure 22). These companies are creating production facilities for new, more competitive products for the global market.

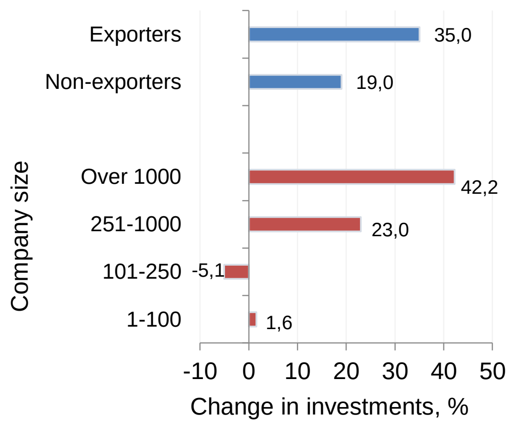
Notable, large-scale companies with more than 1,000 employees are raising their investments in 2018 to the greatest extent with their investment costs rising on average by 42.2% (Figure 22). Smaller companies are planning significantly lower investment growth or even envisaging a decrease.

Figure 21. Companies' plans to change fixed investments (share of respondents, %)



Source: Bank of Russia survey.

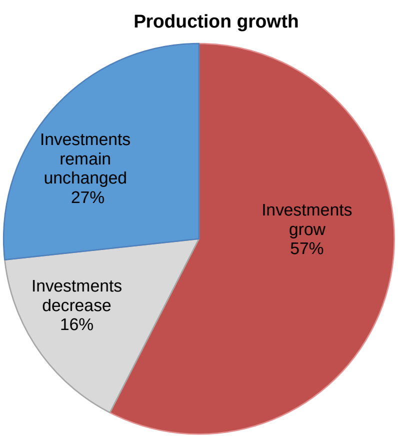
Figure 22. The average change in fixed investments (%)

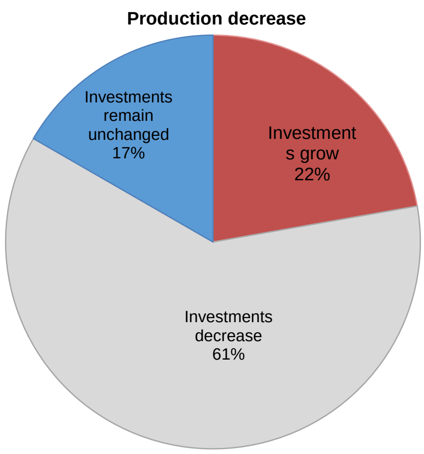


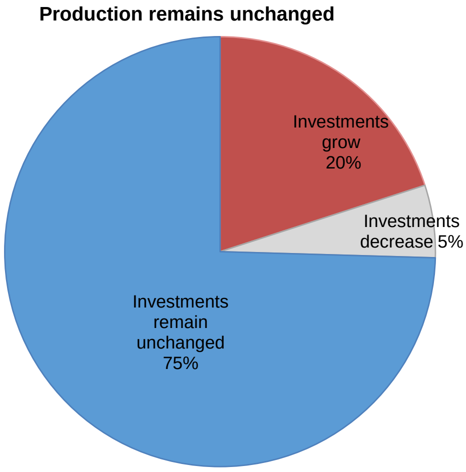
Source: Bank of Russia survey.

It can be seen that investment plans depend on the planned production dynamics. The majority of companies expecting production growth this year (57%) are also planning to increase investment (Figure 23). If companies start to decrease production, 61% of respondents states this will lead to a reduction in fixed investments. 75% of companies that do not intend to change production levels in 2018 will maintain their current investment levels.

Figure 23. Companies' plans to change the investments depending on production dynamics







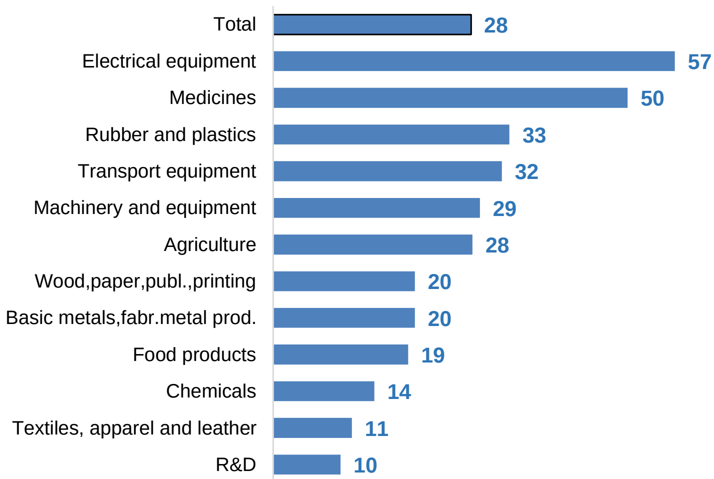
Source: Bank of Russia survey.

The balance of responses on the expected change in fixed investments is positive across all sectors. This means that a greater number of companies stated they plan to increase investment than those planning to decrease (Figure 24).

However, there is a significant difference in investment activity in 2018 by industry. In general, the industries with high value added demonstrate the highest level of investment optimism, which may indicate further signs of sustainable economic growth.

The producers demonstrating the clearest intention to raise investments are in the following sectors: electrical equipment, medicines, and rubber and plastic products. They are also set to increase production volumes. The transport equipment, machinery and equipment production sectors are reporting relative optimism towards investments on the back of conservative production plans. These investments are possible to be long-term and aimed at building facilities in order to ensure future growth or replacing outdated fixed assets.

Figure 24. Planned changes in fixed investments (balance of responses, %)



Source: Bank of Russia survey.

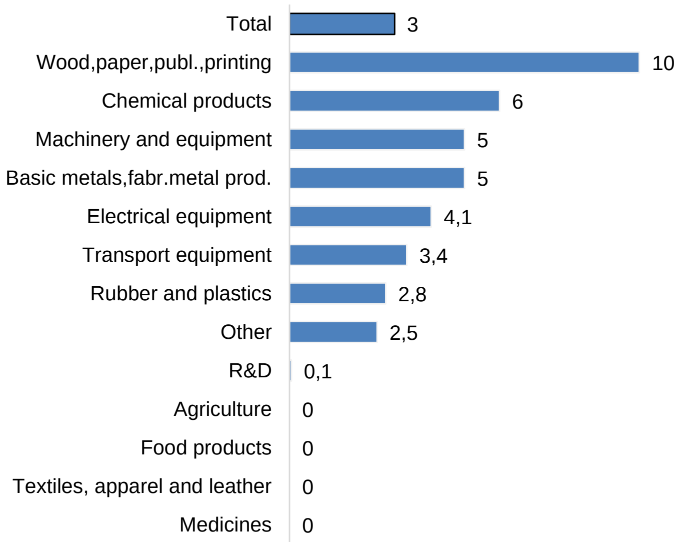
5. The cost and profitability of production

In 2018, the majority of companies note a stable or even improving financial situation. However, the financial indicators vary by industry.

The respondents estimate the median growth rate of costs per unit produced this year at 3%, which is in line with the median growth rate of selling prices (3%) and is lower than the average inflation rate that companies used when drawing up their business plans (Figure 25).

More than half of the companies surveyed (55.8%) expect an increase in the cost of production in 2018. Of this group, 28.3% envisage an increase not exceeding 5%, while 27.5% believe it will undergo more significant growth (Figure 26). About a third (31.9%) of respondents base their production plans on expectation that costs will remain unchanged, while 12.3% assume they will drop.

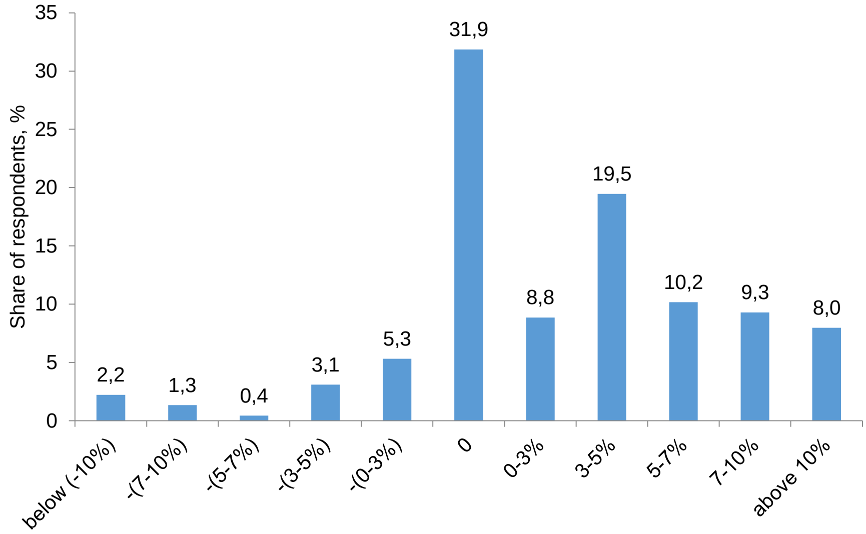
Figure 25. The median expected changes in costs per unit produced by industry



Source: Bank of Russia survey.

As we have already noted, companies use growth in labour productivity as factors behind maintaining or reducing production costs. This includes optimising the number of employees and improving the skills of their staff by reducing a lack of qualified staff. Optimising business processes by modernising and introducing new technologies also reduces costs, which is evidenced by companies' positive investment plans.

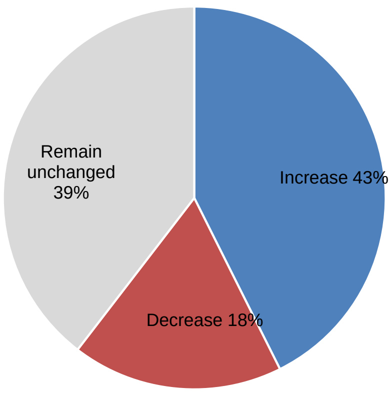
Figure 26. Breakdown of companies by expected growth rate of costs per unit produced (%)



Source: Bank of Russia survey.

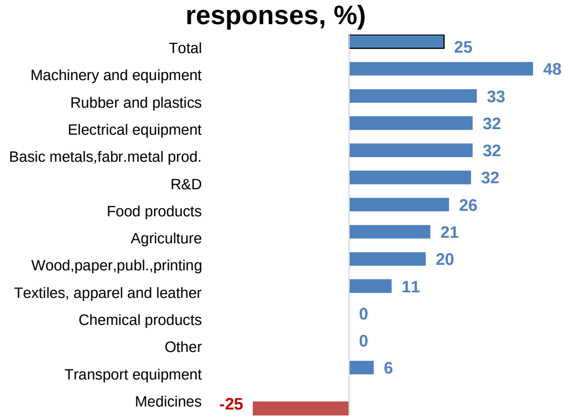
Estimates of expected changes in profitability are relatively optimistic: 82% of respondents expect the profitability in 2018 either remains unchanged (39%) or increase (43%) (Figure 27).

Figure 27. Expectations of changes in profitability of production (share of respondents, %)



Source: Bank of Russia survey.

Figure 28. Expectations of changes in profitability of production (balance of responses, %)



Source: Bank of Russia survey.

Companies are planning to maintain profitability by optimising costs (44.2% of the companies have no plans to increase production costs in 2018). Alternatively, should production costs increase (as the remaining 55.8% envisage), profitability will be maintained by compensating for these increases by fully or partially transferring the load to prices. For example, in response to rising costs per unit produced, the majority of companies (73%) said their profitability will not decrease (Figure 29). This is mainly because companies compensate for increased costs by fully or partially pass-through of their costs to the prices. 72% of respondents acknowledged this.

Assessments carried out by the companies of the average cost dynamics in 2018 vary significantly by industry. The wood and paper production, chemical, basic metals and machinery (particularly machinery, equipment and electrical equipment production) industries can expect a significant increase in the average cost per unit produced exceeding inflation target (4%) (Figure 25). Notably, these companies anticipate a greater increase in weighted average prices in 2018 (Figure 1). Therefore, these companies are planning to transfer the costs increase to their prices.

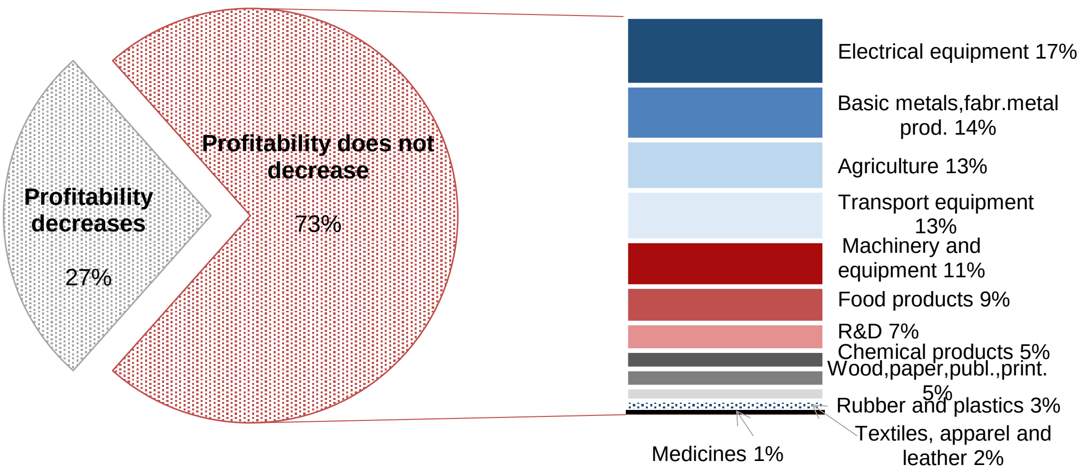
However, in machinery and basic metals, the anticipated rise in costs does not exceed expected price growth (Figure 25, Figure 1), and an increase in production costs does not lead to a decrease in profitability (Figure 29). A significant share of the companies in these industries expect a rise in profitability by fully compensating for costs with prices (Figure 28).

In 2017, Russian basic metals producers had the record levels of profitability thanks to high export and domestic prices. It stands to reason that companies are looking to maintain the same high level of profitability this year. Many machinery companies are working under government contracts that stipulate that pricing is carried out based on regulated contract prices. This policy leads to a delayed price increase in response to inflation and prior cost increases.

Therefore, the relatively high price increase expected in 2018 in the machinery may lag behind. Often, this increase includes a price premium – insurance against potential future shocks – allowing companies to maintain a higher level of profitability.

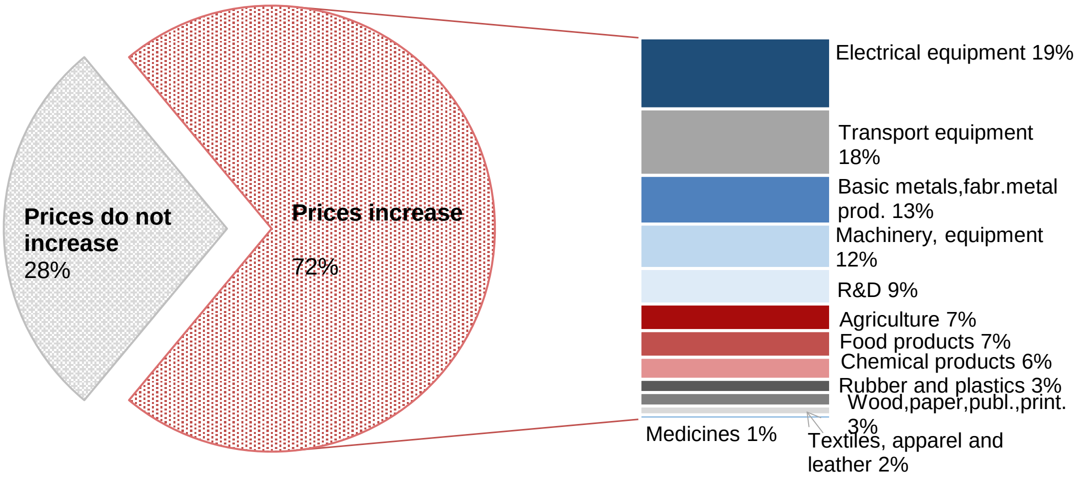
Figure 29. Companies' reaction to growth in costs per unit produced[4]

A. Companies' expected changes in profitability, planned growth in costs



[4] Growth in costs was mentioned by 56% of respondents from the total sample.

B. Expected changes in prices of companies' main product, planned growth in costs



Source: Bank of Russia survey.

In the wood and paper production and chemical industries, the estimated increase in costs in 2018 exceeds the expected rise in the producers' prices. This means that there may only be a partial effect of compensating for costs with prices in these industries. The key factors holding these companies back from increasing prices for their products in these industries may be the fact that they are export-oriented and therefore strive to stay competitive on the world market. As a result, a large share of companies in these sectors are expecting a decrease in the profitability of production in 2018.

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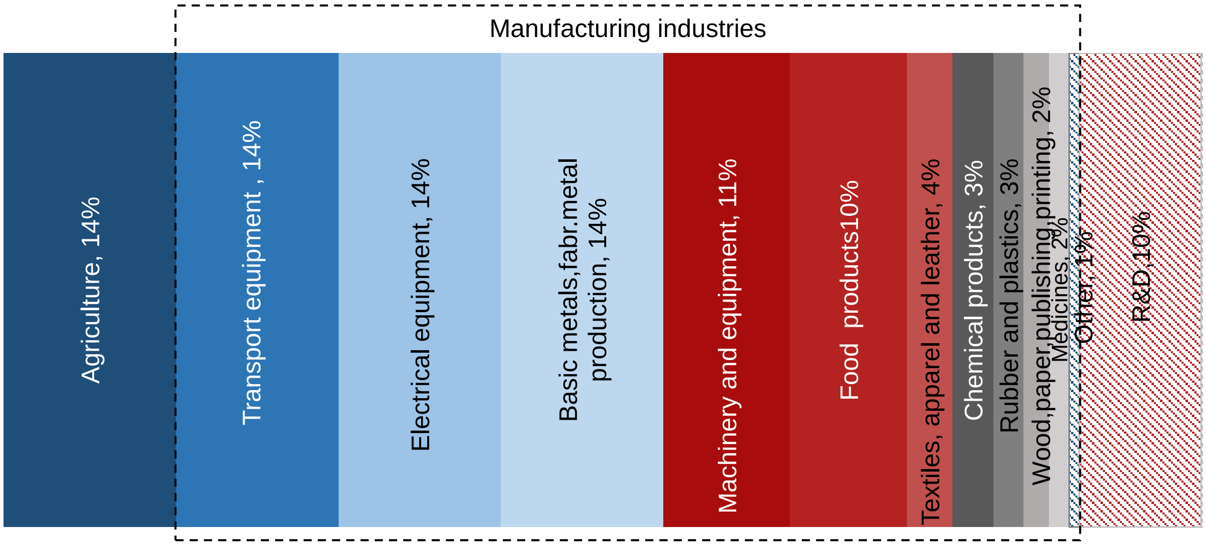
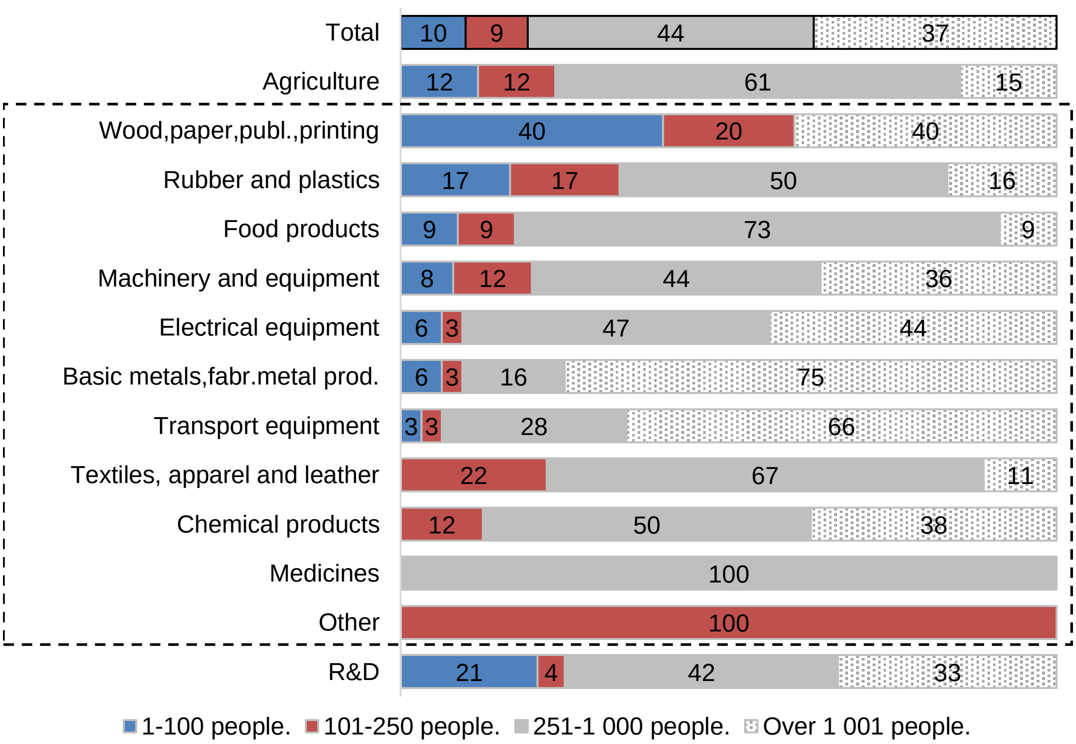
Appendix

Figure A. Breakdown of the sample by industry



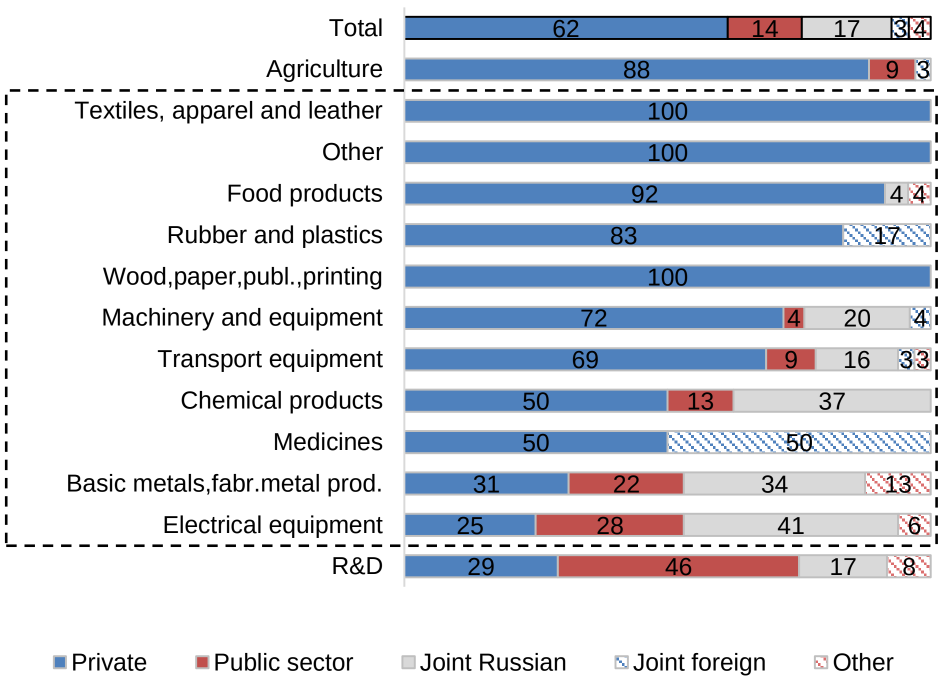
Source: Bank of Russia survey.

Figure B. Breakdown of the sample by company size



Source: Bank of Russia survey.

Figure C. Breakdown of the sample by type of ownership



Source: Bank of Russia survey.