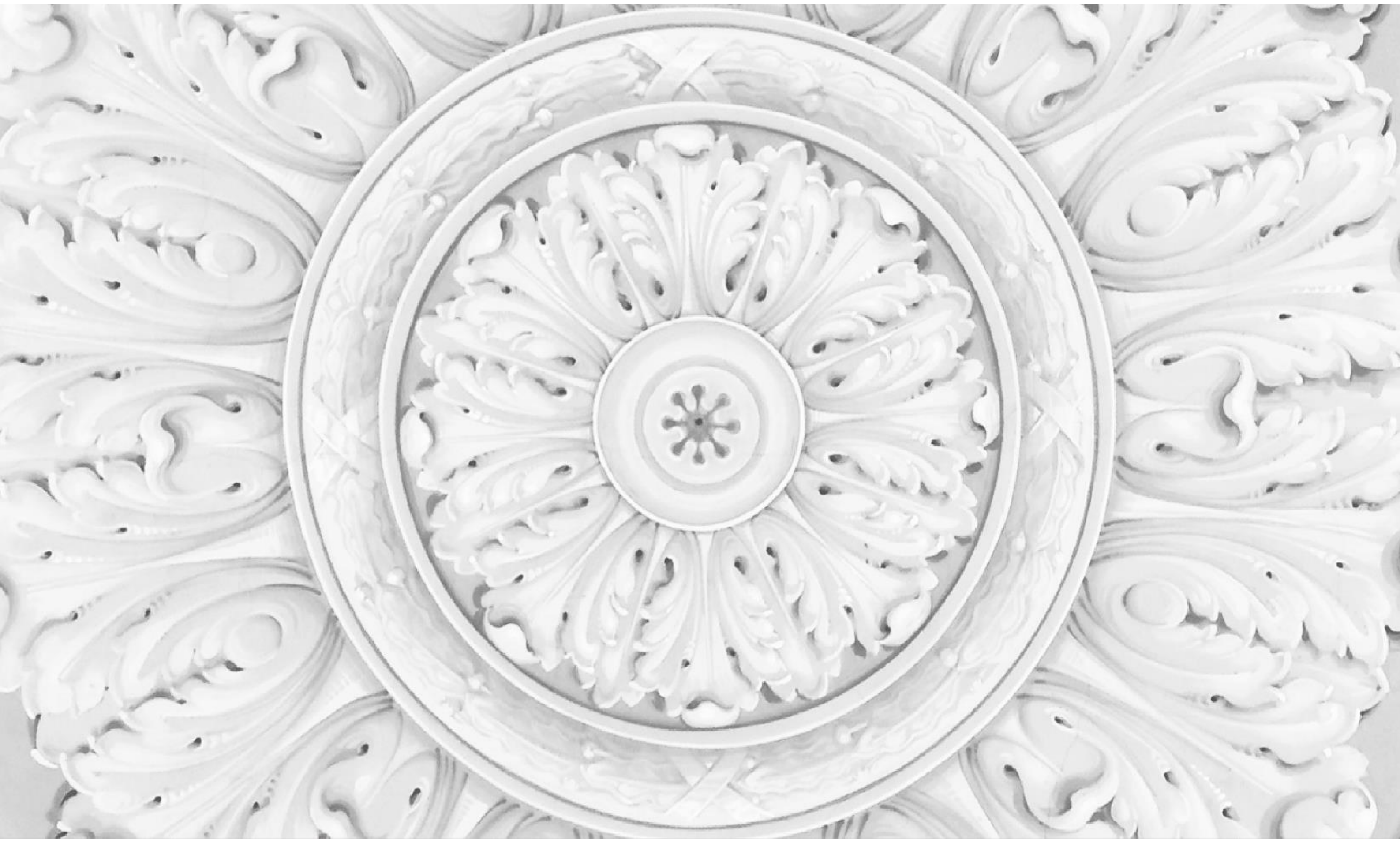

TALKING TRENDS

Macroeconomic dynamics and markets

November 2018

Research and
Forecasting Department
Bulletin № 8 (28)

The Bulletin is based on data as of 30.11.2018. The views expressed in the Bulletin are solely of the authors and do not necessarily reflect the official position of the Bank of Russia. Please send your comments and suggestions to

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CONTENTS

Executive summary

1. Monthly summary

- Annual inflation in October-November remained on track to reach the 4% level, mainly driven by proinflationary temporary factors. The monthly increase in seasonally adjusted consumer prices adjusted for the effect of one-off factors remains in line with the Bank of Russia's inflation target. The economy continued to grow at a pace close to potential in October, while the risks that it may slow down by the end of the year strengthened. Russian financial markets showed mixed dynamics in October–November, only slightly responding to the oil price drop.
    - Inflation is on track to reach 4% by the year end, driven by a number of one-off and enduring factors. Inflation is set to exceed 5% in 2019, driven by temporary factors, before returning to 4% in 2020. The medium-term risks of inflation deviating from the target still prevail. Bank of Russia policy helps reduce inflation risks and keep inflation close to the target.
    - Economic growth has in the last few months stayed at a level close to potential. However, the slowdown of the global economy, the oil price drop, and the forthcoming VAT hike signal a likely temporary deceleration of Russia's economic growth over the next two quarters. The ongoing consumer lending expansion supports consumer demand growth as real wage increase slows and unemployment remains sustainably low.
    - Volatility in the Russian financial market has generally declined after September's surge. Developments in emerging markets and fears of new U.S. sanctions dominate the Russian financial market.

2. Outlook

- Given the leading economic indicators, GDP growth is poised to come in at 1.6-1.7% for 2018. As the oil price dropped to almost USD55/bbl in November, seasonally adjusted quarterly economic growth will slow in early 2019 to 1% in annualized terms.
- Inflation expectations of financial analysts remain anchored at the Bank of Russia's inflation target: analysts expect inflation to return to 4% in 2020 after a temporary acceleration in 2019.

3. In focus. Rising uncertainty in the global economy yet again shows the advantages of economies without strong imbalances, the importance of buffers, and the central bank's ability to conduct independent anti-inflation policy

- The situation in the countries which suffered the steepest falls of financial markets in 2018 demonstrates the fallouts from negative external and internal shocks that an economy with accumulated imbalances and undermined confidence in government macroeconomic policy may face.
- The financial system stability problem may be aggravated by being entrained in a vicious circle. In these circumstances, the economy and financial markets become increasingly sensitive to authorities' potential mistakes in taking and communicating stabilisation measures and to institutional problems.
- One factor, which played a role in volatility amplification in some countries' markets, was the loss of market confidence in a central bank's ability to bring down inflation by taking relevant measures, because of, among other things, the apparent lack of a central bank's ability to implement independent disinflationary policy. And *vice versa,* the strongest resilience to external shocks was shown by countries whose monetary policies enjoyed strong confidence of the markets.

1. Monthly summary

1.1. Inflation

Annual inflation accelerated to 3.9% in November's last 10 days and is poised to reach a target of 4% by the year end. Short-term pro-inflationary risks remain elevated on the back of ruble weakening against the major currencies over 2018 and the forthcoming raise of the VAT base rate.

The ongoing return of inflation to the target is driven by a number of one-off and enduring factors. The former include the acceleration of food price rises from their extremely slow rate last year, the impact of ruble weakening on prices, and price hikes by some producers ahead of the forthcoming VAT base rate increase to 20%. Among the latter is some increase from last year's levels of the consumer price index's most stable components that are only weakly sensitive to transient factors.

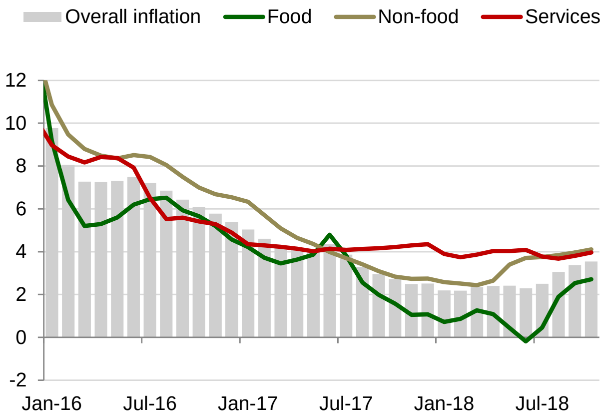
Medium-term pro-inflationary risks are prevailing over disinflationary ones. The key pro-inflationary risks include geopolitical factors and volatility surges in financial markets, the upward pressure of the accelerating consumer lending growth on prices, rising business and households' inflation expectations, and increasing workforce shortages in the labor market.

1.1.1. Inflationary pressure keeps mounting gradually

- Based on Rosstat data, consumer prices rose 0.35% MoM in October, with seasonal adjustment producing the same number, which is just above 4% in annualized terms.
- An increase in modified core inflation indicators accelerated, largely fueled by temporary factors. Still, the rate of the stable CPI components' acceleration continues approaching 4% gradually.
- The rate of services price rises remained stable while the goods market saw mixed price movements. As nonfood price rises accelerated, driven mainly by the deferred impact on prices of the recent ruble weakening spells, food price growth slowed.
- Household inflation expectations went up in November. Respondents remain extremely sensitive to meat and petrol price rises.

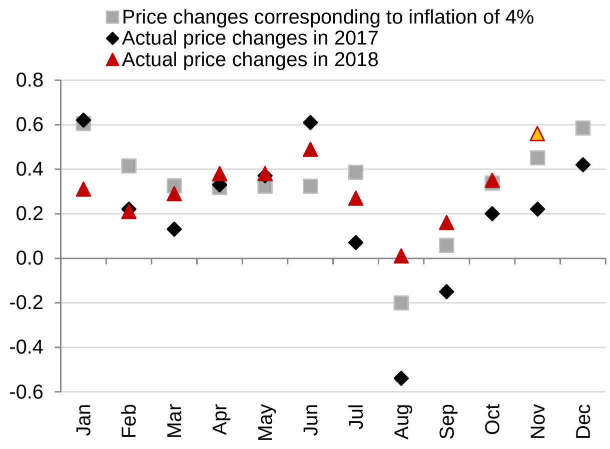
Based on Rosstat data, annual inflation expectedly accelerated in October to 3.5% from 3.4% in September (Figure 1), partly due to last year's low base. Consumer prices rose 0.35% MoM over October, coming back to the path which should keep inflation at 4% for the year, but inflation may well rise above this level in the months to come, affected by temporary factors. (Figure 2).

Figure 1. Inflation and its components, YoY %



Source: Rosstat, R&F Department estimates.

Figure 2. Price rises corresponding to an inflation rate of 4 percent, % MoM



Source: Rosstat, R&F Department estimates.

November data is a preliminary estimate based on weekly data.

The impact of the seasonal factor on the CPI is relatively minor in October: an estimate of seasonally adjusted consumer price inflation stood at 0.35% MoM, marginally down from 0.40% MoM in September (Figure 4). Three-month average inflation accelerated to 5.3% in annualized terms. Although the number has stayed above 4% for six months in succession, the share of goods and services whose price rises has not moved above this level remains significant at over 50%[1] (Figure 5).

As regards the key CPI components, seasonally adjusted price rises in services remained relatively stable, whereas the rates of price rises in food and nonfood goods went in opposite directions. Price rises in nonfood goods accelerated to 0.32% MoM in seasonally adjusted terms from 0.25% MoM in September, due primarily to the deferred impact of the April and August ruble weakening spells on prices. Oil product price increases accelerated to 0.41% MoM in October from 0.18% MoM in September. To stabilize motor fuel price rises, the government and the major oil companies have reached an agreement on oil product price regulation.

After the oil price drop, wholesale (commodity exchange) oil product prices climbed above the export parity level for the first time from mid-2017.[2] We estimate that the current domestic wholesale parity price corresponds to a Brent price of around USD70/bbl. If, after this drop, the world market price consolidates at a lower level, for example, at USD60/bbl, wholesale prices are bound to fall. Still, retail prices may stay on the current level if the suppliers seek to restore profit margins of oil product retail sales, which have fallen drastically this year on the back of measures to rein in price rises.

The fiscal rule mechanism envisages a codirectional movement of the world dollar-denominated and domestic ruble prices of oil and oil products in light of the dramatically

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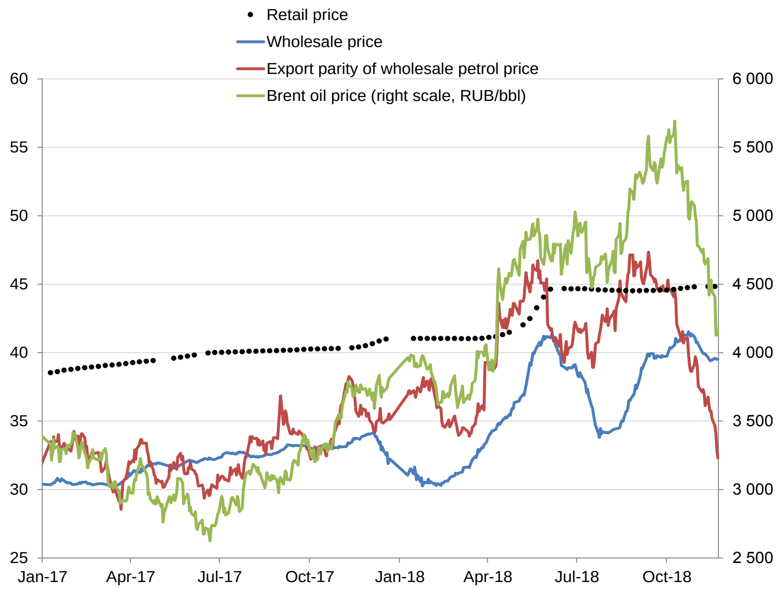
[1] Indicator calculation used 450 maximally disaggregated components included in CPI calculation. CPI calculation includes a total of 509 categories, but short series and regulated tariffs were excluded in constructing the distribution.

[2] Export parity is computed by the St. Petersburg International Mercantile Exchange.

weakening relationship between the ruble exchange rate and oil price movements in the absence of other external shocks. Prior to fiscal rule introduction, oil price movements were accompanied by comparable ruble exchange movements, stabilizing domestic ruble-denominated oil prices. With the fiscal rule in place, the exchange rate response is not as strong, hence the domestic ruble oil price may rise as the world oil price goes up and fall as it declines. In 2019, the reverse excise tax (damper) will be introduced as part of the tax maneuver. This will help weaken the response of domestic ruble-denominated oil product prices to changes in the world oil price.

Figure 3. AI-95 petrol price (ruble/liter) and oil price changes



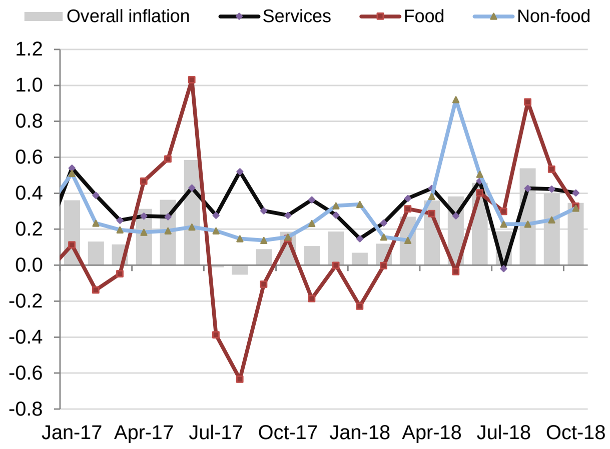
Source: St Petersburg International Mercantile Exchange, Bloomberg Finance L.P., CEIC, R&F Department estimates.

In the food market, consumer price rises slowed to 0.33% MoM in seasonally adjusted terms in October from 0.53% in September and 0.91% in August, with favorable price movements seen in goods which account for a large share in the consumer basket: meat, milk, and fruit and vegetables.

Fruit and vegetable prices went down in seasonally adjusted terms, moreover, the price decline accelerated compared with September (a decline of 1.8% MoM in October versus 0.5% in September). In year-on-year terms, fruit and vegetable prices fell 0.5%.

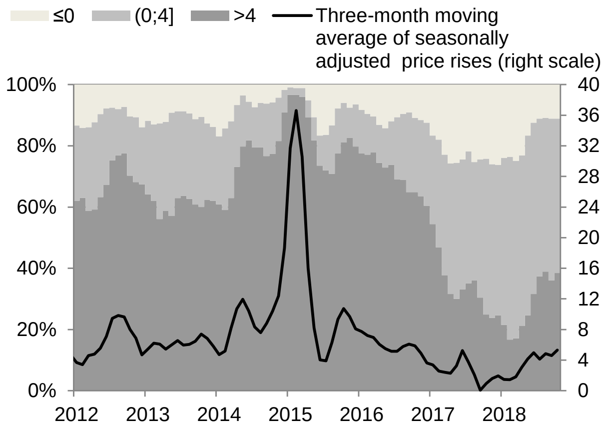
The key drivers of the fruit and vegetable price decline were cucumber and tomato prices. The rate of price rises in these items halved in October compared with last year. One explanation for the reduced volatility of price movements is the continuing expansion in greenhouse facilities. With normal seasonal trends, the fastest cucumber and tomato price rises are usually seen in October, followed by a gradual slowdown of price increases until January–February. Given the low level of prices for these items, a seasonal acceleration can be expected somewhat later. Still, we estimate that, given weekly statistics in November, cucumber and tomato price decline will equal 7–14% for the year, making a negative contribution of 0.1 pp to annual inflation.

Figure 4. Seasonally adjusted price rises, % MoM



Source: Rosstat, R&F Department estimates.

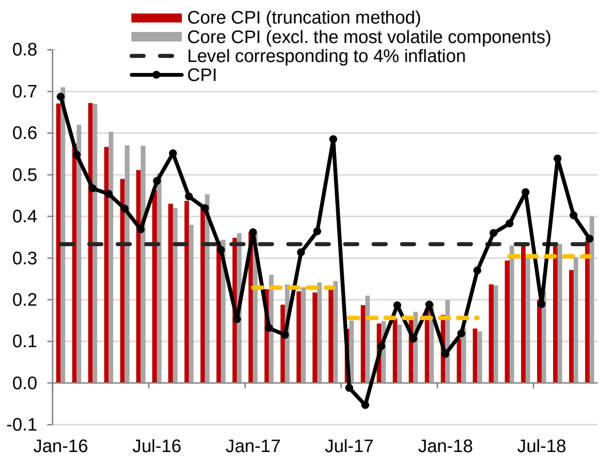
Figure 5. Distribution of three-month moving average of price rises in annualized terms, seasonally adjusted, %



Source: Rosstat, R&F Department estimates.

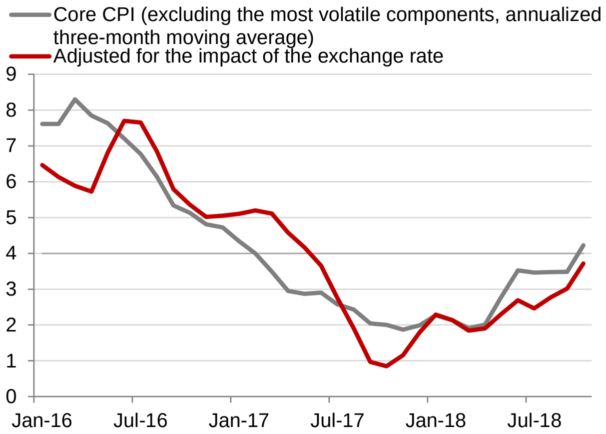
Despite the slowdown of monthly price rises in the food market and stabilization of services price growth, an increase in the modified core inflation indicators accelerated in October, moving above the 4% level for the first time since the beginning of 2017 (Figure 6). We have to admit that changes in the modified core inflation indicators presented are subject to the influence of temporary factors,[3] in particular exchange rate movements. Nevertheless, inflationary pressure on the most stable CPI components continues to mount, bringing them close to the level corresponding to an inflation rate of 4%. The average core inflation indicator[4] for August–September stood at 3.7% in annualized terms, up from 2% at the start of 2018 (Figure 4).

Figure 6. Modified core inflation indicators, % MoM



Source: Rosstat, R&F Department estimates.

Figure 7. Core inflation adjusted for the impact of exchange rate movements, %, seasonally adjusted

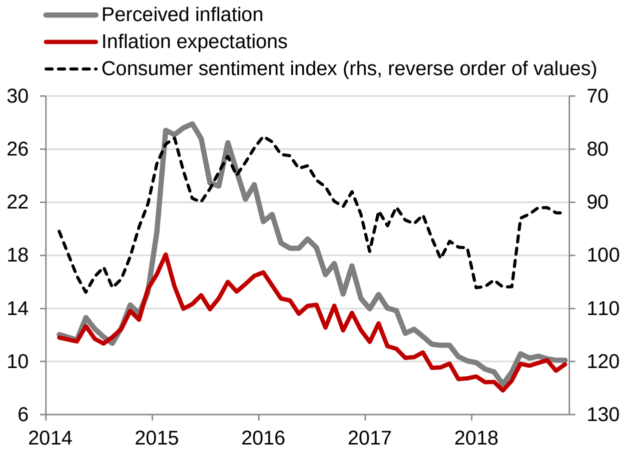


Source: Rosstat, Bank of Russia estimates.

[3] Although less than headline inflation.
[4] Calculated by the method of excluding the most volatile components.

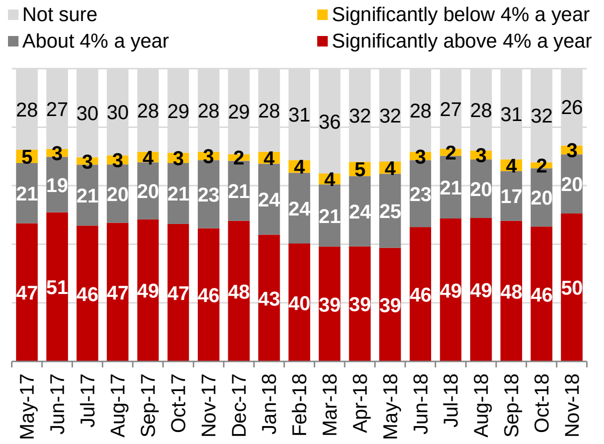
Based on Rosstat weekly data, consumer prices rose 0.5% over 26 days of November. A preliminary estimate for the full month of November puts inflation at 0.5–0.7% MoM, or 0.4–0.6% MoM in seasonally adjusted terms. This number implies annual inflation acceleration to 3.8%–4.0%. December's inflation may come in at just over 4% because of the low base of 2017, remaining within the range of the Bank of Russia official forecast.

Figure 8. Median estimates of perceived inflation and household inflation expectations



Source: inFOM.

Figure 9. Inflation expectations over a three-year horizon [5]



Source: inFOM.

Based on inFOM survey held on November 2–12, the assessment of household inflation expectations in one year's time rose to 9.8% from 9.3% in October (Figure 8). Meanwhile, the assessment of perceived inflation remained unchanged at 10.1%. The gap between perceived and expected inflation has stayed at a low level of less than 1 percentage point since March. This suggests that the respondents do not expect a notable inflation slowdown or acceleration from the current level in the months ahead.

As regards specific groups of goods, the respondents are still very sensitive to rises in meat and petrol prices. These items are still taking the lead among goods and services whose prices showed the most notable growth over the last month. Also, the respondents continued to cite petrol in their answers to the questions about the potential causes of price hikes in the near future.

Long-term inflation expectations followed in the footsteps of short-term ones. The share of respondents who believe that inflation will stand appreciably above 4% in three years' time reached 50%, the highest level since June 2017 (Figure 9). As a reminder, June 2017 saw a short-lived inflation surge, driven by temporary factors. This yet again supports the assumption that the share of respondents expecting inflation (often vague and uncertain in the eyes of respondents) to continue in three years' time is subject to

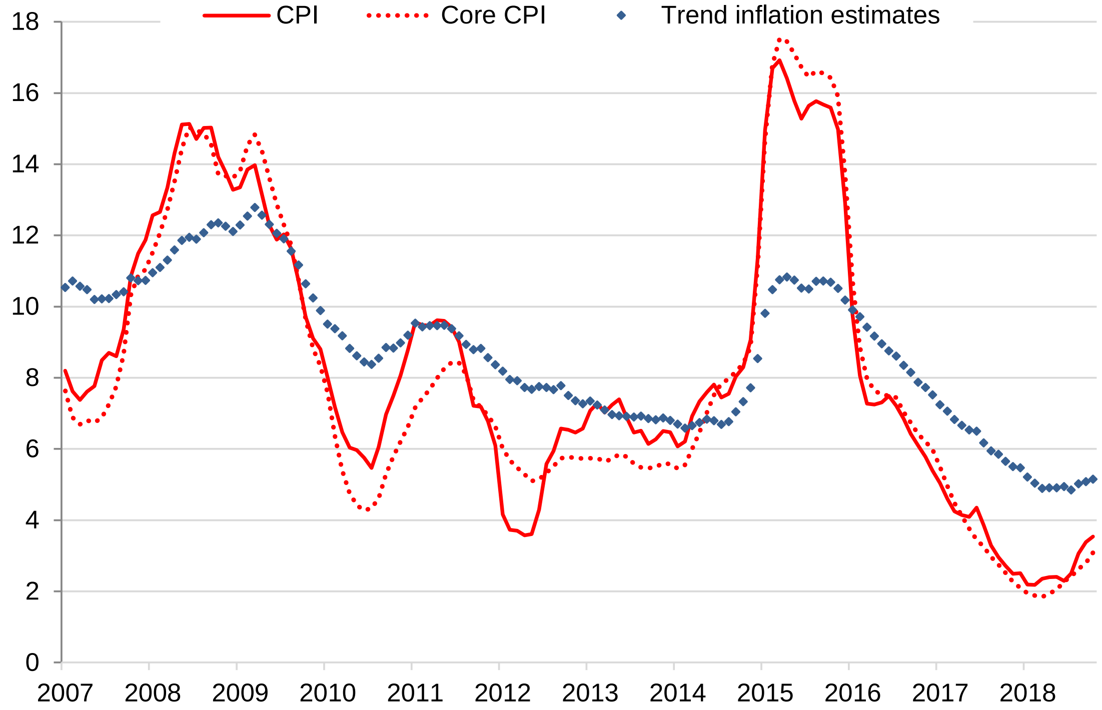
[5] Distribution of answers to the question: "Do you think annual inflation will be higher or lower than 4% in there years' time? Or will it stand at roughly 4% a year?"

dramatic fluctuations depending on short-term price movements, including changes in released price statistics. Still, long-term inflation expectations remain elevated compared with the start of 2018.

1.1.2. October's trend inflation: a slow rise

- The estimate of annual trend inflation went up to 5.15% in October 2018 from 5.08% in September and 5.02% in August.[6]
- The very slow rise in trend inflation indicates the continued stabilization of inflationary pressure among the most stable CPI components at a level of just over 4%.
- The very slow pace of trend inflation compared with a much more apreciable increase in the annual rate of consumer price rises suggests the prevalence of temporary factors of annual inflation acceleration.
- Over a medium-term horizon, the risks of annual inflation upward deviation from 4% are prevailing over the risks of its downward deviation.

Figure 10. CPI, Core CPI and Bank of Russia historical estimates of trend inflation, % annualized



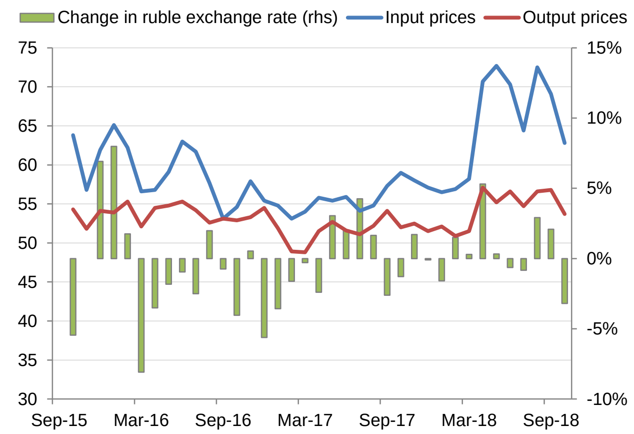
Source: Rosstat, Bank of Russia estimates

[6] In July 2018, the trend inflation numbers were revised following the adoption of a new methodology for seasonal adjustment of input price index series used in calculating the indicator. For details of seasonal adjustment of the CPI and its components, see Sapova et al (2018). [Review of Methodological Specifics of Consumer Price Index Seasonal Adjustment at the Bank of Russia, Bank of Russia]. Working Paper Series, №33, June 2018.

1.1.3. PMI price indexes: the pass-through effect gradually peters out in manufacturing and strengthens in services

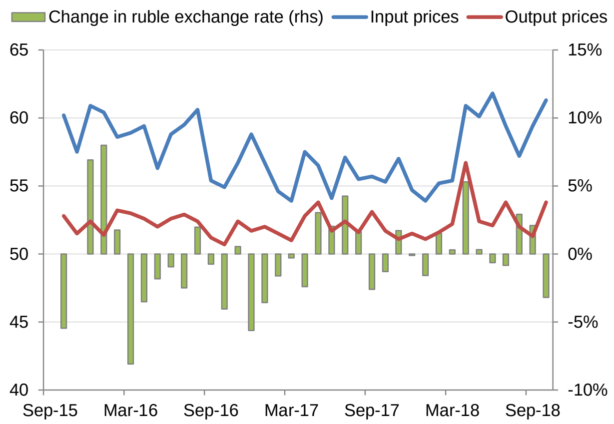
- The movements of PMI price indexes for manufacturing and services were again mixed but traded places: price rises slowed in manufacturing and gained pace in services.
- In manufacturing, the input price index is steadily losing momentum, with output prices following suit but less steadily. The pass-through from the exchange rate seems to be attenuating.
- The picture is quite the opposite in services: the indexes of input and output prices are at their four-month highs, with the latter exceeding its manufacturing counterpart. The pass-through effect of ruble weakening in August–September may well have made itself felt as late as October.

Figure 11. Manufacturing PMI price indexes, p.p.



Source: IHS Markit.

Figure 12. Services PMI price indexes, p.p.



Source: IHS Markit.

1.1.4. Producer prices rise faster than in 2015

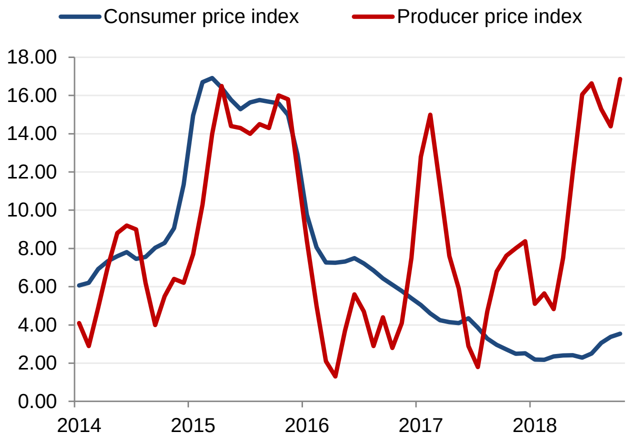
- Producer price rises accelerated to 16.9% in October after slowing for two months (Figure 13). This is the highest level over the entire observation period after switching to OKVED2[7] (The Russian National Classifier of Types of Economic Activity).
- Annual price rises gained the strongest momentum in the energy part of the extractive sector but the manufacturing sector also saw a minor acceleration in price hikes. The oil price drop in global markets will trigger a significant slowdown of producer price increases in the extractive sector as early as December.
- Producer price rises for the basket of representative consumer goods[8] are still outpacing consumer price increases, with the gap widening for the third consecutive

[7] From January 2013. A switch to OKVED2 took place in 2017 but Rosstat carried out retrospective estimation back to 2013.

month (Figure 14). Pressure from producer prices is paving the way for price rise acceleration in the consumer market.

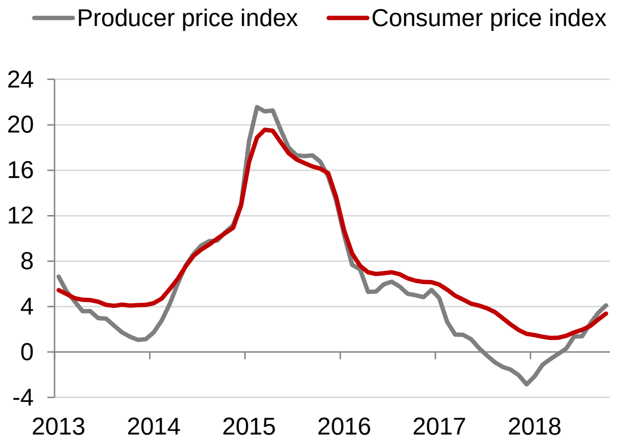
- Among items included in the calculation of the PPI index, the annual rate of sugar producers' price rises soared to 22.7% in October from 0.9% in September. Experts believe[9] that the sharp acceleration of sugar price rises stems from a dramatic increase in sugar beet input price growth.[10] Also, the market now sees a balance restored in the market: the October 2018 price is below the relevant 2015–2016 numbers.

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



Source: Rosstat, R&F Department estimates.

Figure 14. Price changes in some goods, % YoY



Source: Rosstat, R&F Department estimates.

[8] Goods included in both PPI and CPI calculation.
[9] Agroinvestor. *The Federal Antimonopoly Committee asks producers to account for sugar price rises. 13.11.2018.*
[10] Sugar beets price rise was fueled by the crop decline and seed price rises on the back of ruble weakening.

1.2. Economic performance

Russian economic growth is maintained at a level close to potential. Consumer demand remains a key engine of growth against a backdrop of continued fast expansion in consumer lending and real wage increases. At the same time, survey data and leading indicators along with the tax hikes, give reason to expect some slowdown of economic activity growth in the quarters to come. One should also bear in mind that some easing of the global economy's growth momentum in recent months will in the short term also likely hurt Russia's economic growth, which has lately enjoyed strong support from exports.

1.2.1. Harvest drop drags down third quarter economic growth

- According to preliminary Rosstat estimate, GDP growth slowed to 1.3% in the third YoY from 1.9% in the second quarter. A growth drop to 0.3% QoQ in seasonally adjusted terms from 0.5% QoQ in the second quarter suggests that it was not only the low base effect that drove the slowdown.
- A key contribution to GDP growth slowdown came from a reduction in the agricultural output owed to a fall in grain and other crops after last year's record levels. It was crop production that drove down the third quarter's index of core industries' performance, which is an accurate short-term indicator of GDP growth.
- Also, an impact on the third quarter result of possible revision by Rosstat of last year's GDP growth estimate for the third quarter cannot be ruled out.
- An improvement in key macro indicators and surveys in October give reason to expect annual GDP growth acceleration in the fourth quarter from the low base of last year's fourth quarter. The oil price drop and continuing negative expectations on fears of new sanctions may, however, weigh down on GDP growth acceleration.

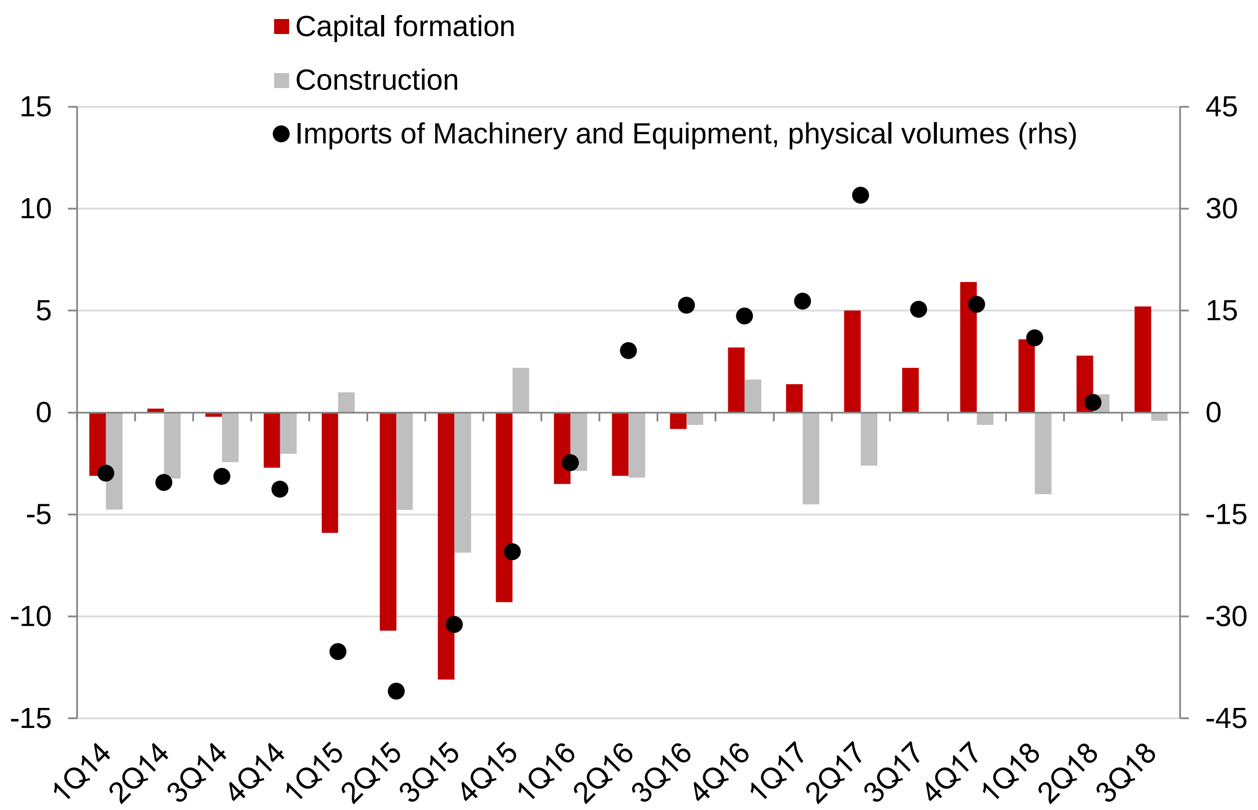
1.2.2. Fixed investment growth acceleration in the third quarter fails to match other investment activity numbers

- According to Rosstat data, fixed investment growth gained pace in the third quarter to reach 5.2% YoY, up from 3.2% YoY in the first half of 2018, while January–September saw and investment expansion of 4.1% YoY.
- An array of leading indicators, including those for business activity, investment goods imports, and construction, by contrast, showed a high likelihood of fixed investment growth losing steam in the third quarter.
- Even if the key driver of the slowdown, the poor showing of the agricultural sector, is taken into account, the preliminary third quarter GDP estimate, indicating that

economic growth slowed to 1.3% YoY from 1.9% YoY in the second quarter, suggests a lack of strong fixed investment growth.

- At the same time, an important negative contribution to the volatility of investment activity indicators has lately come from the oil and gas servicing sector, whereas other investment has shown a fairly stable performance. The third quarter data on investment structure supported the hypothesis that investment improvement is largely driven by investment recovery in the oil and gas sector after its fall in the second quarter.
- Although the major companies' did not show a pronounced production drilling upturn in the third quarter, improvements in the sector's other categories cannot not be ruled out. For example, there have been reports of increased orders for large-diameter pipes, which may produce a lagged positive effect on investment as they are put into operation.
- The current investment structure needs to be examined further. So far, there are not enough grounds to claim that a pronounced investment growth trend has emerged, given weak survey data and worsening GDP performance in the period concerned.

Figure 15. Fixed investment, construction, machinery and equipment imports in physical terms, % YoY



Source: Rosstat, Federal Customs Service, R&F Department estimates

1.2.3. October PMI: positive start of the quarter seen across the board

- Manufacturing PMI rose to 51.3. This is a good signal for fourth quarter economic performance.
- The key indexes of output, new orders, and employment posted a significant rise to 52.9, 52.0, and 52.7, respectively.
- The services PMI index reached the level of the last year end – 56.9, driven by demand and new orders growth. The rise in the services index was a good addition to the manufacturing PMI, bringing the composite PMI index to the end-of-2017 level.
- Judging by the employment PMI index, employment resumed growth in October after a period of decline, accompanied by an increase in new orders. The positive impact of demand on business activity is very much in evidence.
- Although the high PMI readings in October promise a higher quarterly growth rates in the fourth quarter, the business activity level will likely be subject to pressure from the oil price drop.

The fourth quarter was ushered in by positive data of manufacturing companies' surveys. This sector's PMI IHS Markit index for the first time since April rose above the 50 line, dividing business activity growth and its decline. The recovery of output and new orders subindexes has continued for the third month, with the respondents attributing the positive trend to an increase in orders from new customers and overall demand recovery after the summer months.

The employment subindex posted the fastest growth over the period, from 47.6 in July to 52.7 in October. Historically, this indicator has changed in parallel with output indicators, hence continued output expansion in the months to come may be accompanied by a rise in employment. Finally, the index of expectations over a one-year horizon stays appreciably above the average of the past 12 months at 70.1, which can also be regarded as a positive signal for the short-term economic forecast.

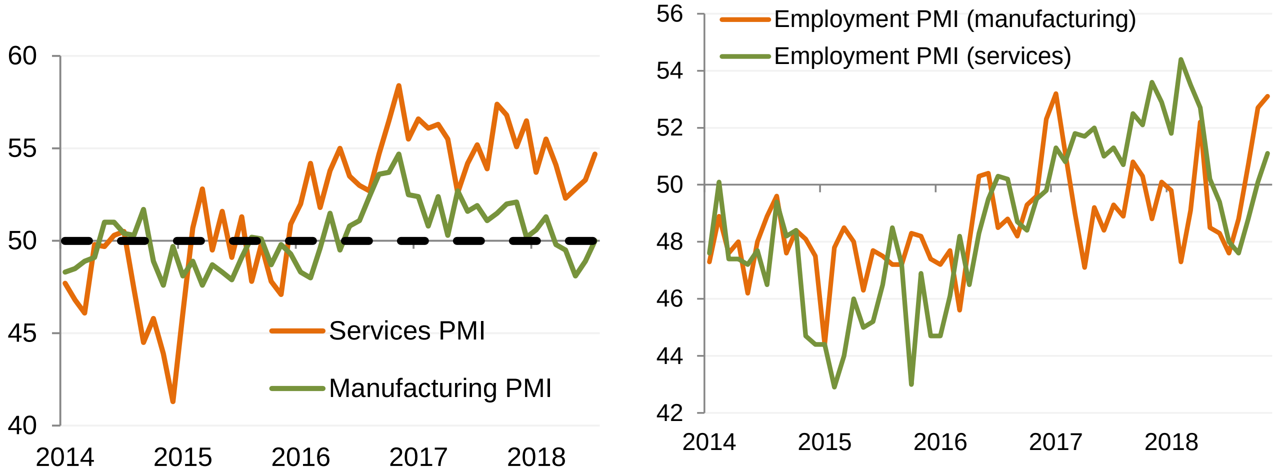
The manufacturing PMI November data indicate a continued acceleration in business activity expansion in the sector. The index climbed to 52.6, its highest reading since July 2017, as the statistics of new orders (including export ones), output, and employment kept improving. One can therefore expect actual data for November to also show an improvement in the manufacturing sector's performance.

The services sector got off to a very good start in the fourth quarter, with the sector's PMI rising to 56.9 from 54.7 in September. Coupled with the manufacturing sector's positive performance, this brought the composite PMI index to 55.8. These readings were last seen in November–December 2017. One, however, has to bear in mind that survey data improved as the oil price rose to USD80/bbl (the survey was held in mid-October, before the last oil price drop).

We note that the employment indicators changed from decline to growth simultaneously in the manufacturing and services sectors. Almost all the other PMI subindexes in both sectors stood above the 50 mark separating decline from growth. Most importantly, a rise in the employment index is accompanied by an increase in purchases of raw materials and supplies. Moreover, orders, both domestic and export ones, rose as the indicators of consumer demand and orders from new customers went up.

The entire set of these factors indicates that it was an upturn in demand that mainly accounted for the notable PMI rise in October. Expectations over a one-year horizon also bear this out: they are also staying at a many-year high of 73.3. Nevertheless, the oil price fall in the fourth quarter may drag down business activity towards the end of the quarter or at the start of 2019.

Figure 16. PMI indexes and subindexes for Russia



Source: IHS Markit.

1.2.4. A pause in manufacturing industries growth

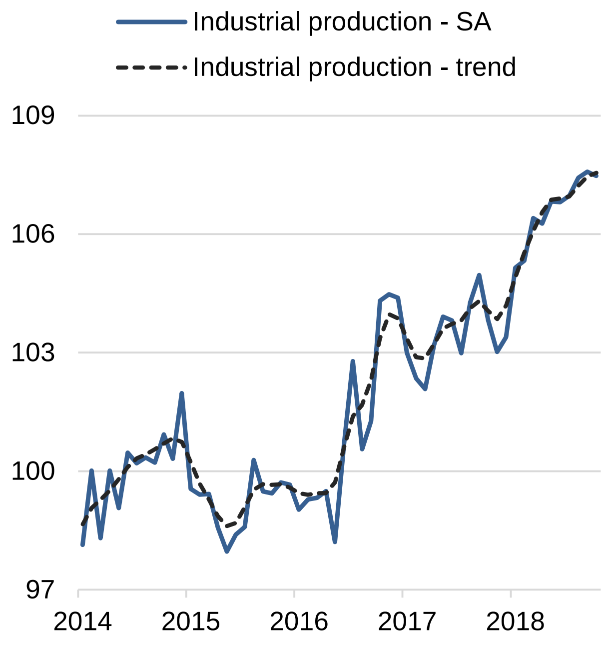
- Based on Rosstat estimates, industrial output expanded 0.3% MoM in seasonally adjusted terms in October 2018.
- Our estimates are more modest, suggesting that output was roughly unchanged from September. We note that the extractive sector's growth slowed from 0.5% MoM to 0.2% MoM, while manufacturing output stabilized, remaining on the August level.
- In individual manufacturing industries, output trends remain unstable and mixed: a recovery trend is continuing in metals, whereas positive trends which the machinery and oil refining industries saw in the summer, were again followed by a dramatic production downturn in October.

- Still, given the survey-based indicators (PMI) and our estimates of the output's trend component, we expect the manufacturing sector to see a revival of positive trends in the months ahead.

Rosstat estimates show the maintenance of moderate industrial output growth at 0.2–0.3% MoM in September–October (here and further in this subsection, MoM growth figures are seasonally adjusted). Research and Forecasting (R&F) Department estimates suggest that these months' output remained on the August level, i.e., stabilized marginally above the summer numbers. At the same time, output went up more than 3% in YoY terms.

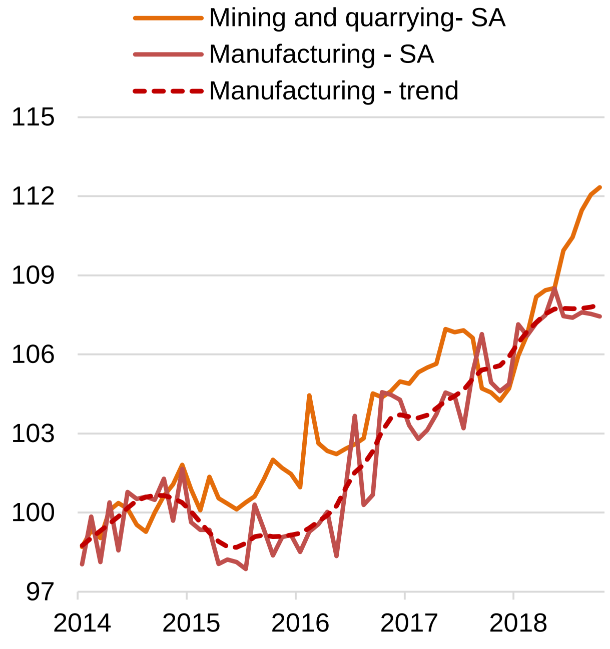
The extractive sector remains the key engine of growth: the average monthly rise in its output has stood at about 0.7% MoM since the beginning of the summer. This growth largely benefits from oil production expansion after its restricions under the OPEC+ agreements were lifted.

Figure 17. Industrial production index (2014 = 100)



Source: Rosstat, R&F Department estimates

Figure 18. Mining and quarrying and manufacturing production index (2014 = 100)



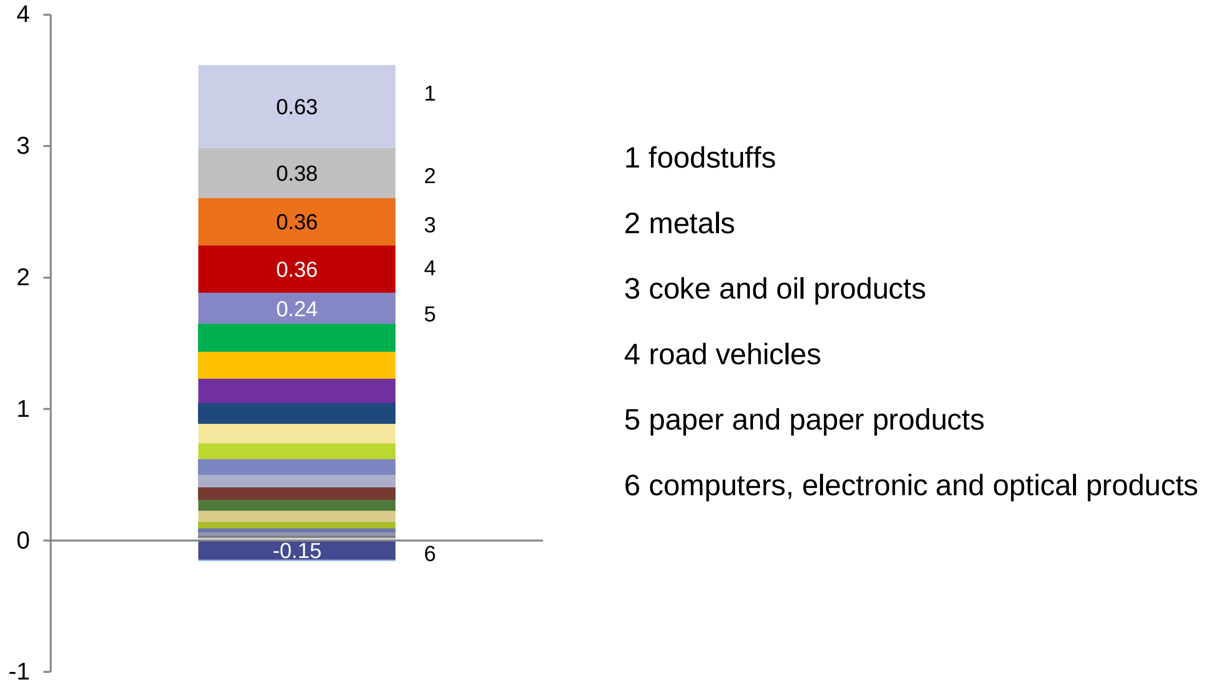
Source: Rosstat, R&F Department estimates

The extractive sector is so far outperforming manufacturing, which has shown near-zero seasonally adjusted growth for the second consecutive month. That said, growth numbers are still mixed and unstable across the sector's industries. The manufacturing sector's key industries (machinery and oil refining) made a substantial negative contribution to the sector's monthly output trends. Meanwhile the metals industry's recovery after its poor showing in the summer months, drove overall growth up to near-zero levels (-0.1

MoM in seasonally adjusted terms) (Figure 20). In YoY terms, almost all industries maintained growth in January–October (Figure 19).

Among industries meeting *investment demand*, production of other than road vehicles suffered the most significant downturn (-17% MoM). In particular, a negative trend in aircraft production (-20% MoM) was also accompanied by a dramatic drop in the production of railroad machinery and equipment (-17% MoM). But given the sustainable positive trend seen in the production of railroad machinery and equipment since 2016, a substantial negative contribution most probably came from one-off factors, whose impact is set to run its course in the months to come.[11]

Figure 19. Industry contribution to manufacturing production growth in Jan-Oct 2018, % y/y



Source: Rosstat, R&F Department estimates

The sustainable positive trend in the machinery and equipment production gave place to an output contraction of 9% MoM in October. It is so far too early to tell whether it is a trend reversal or a temporary correction. The negative trend in the output of construction materials which emerged in July 2018, continues (-3% MoM).

[11] Over the medium-term horizon, however, railroad machinery and equipment output will likely decline. Gazprombank's Center for Economic Forecasting expects rises in new wagon and carriage prices and operators' demand saturation to slow demand for rolling stock. The new wagon and carriage prices climbed 50% on average from 2016 to 2018, driven by steel price rises and increasing demand for wagons as programs to renovate the wagon fleet are implemented. In the next 3–4 year, the production of new wagons is expected to fall about 40% as the renovation of rolling stock is drawing to a close, freight turnover growth slows and the efficiency of managing the current fleet is enhanced by operators faced with rapid price rises.

Among industries meeting consumer demand, output expansion was recorded in the printing industry, production of beverages, the sector of other finished goods (thanks to jewelry production), and pharmaceuticals.

At the same time, the role of key consumer goods industries, which have lately provided support to the manufacturing sector, has declined. The food processing industry, which has seen a downward growth trend, posted a token rise of 0.04% MoM in October. This industry is adversely affected by a fall in the output of crops used in food processing. The stalled car sales expansion depresses the automotive industry's output. October saw a road vehicle production fall of 3% MoM.

The manufacturing sector received support primarily from industries meeting *intermediate demand* in October. An output growth rate of 17% MoM in the category "Production of key precious and other nonferrous metals, production of nuclear fuel" helped overall metals industry recovery to the level of May last year.

A moderate upward trend meanwhile continues in the iron and steel industry. The year 2018 was favorable for metal producers thanks to high world and hence domestic metal prices. Refinitiv's analysts estimate that hot- and cold-rolled plate prices rose 5% from the start of the year. As mentioned above with respect to the production of railroad machinery and equipment, this is putting upward pressure on related industries' costs. Severstal and WorldSteel forecasts expect steel production growth to weaken in 2019.

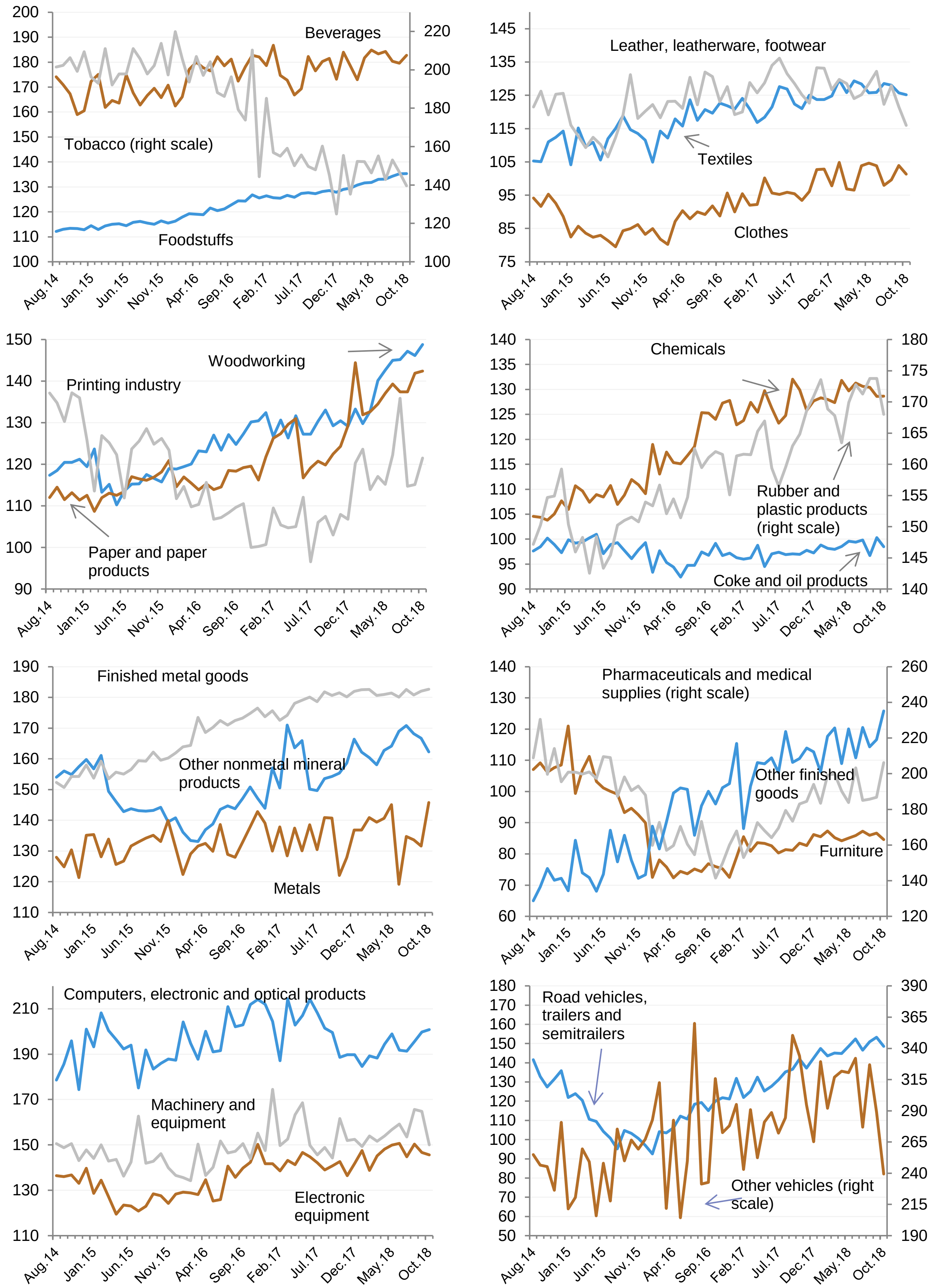
Woodworking and paper industries maintain positive trends, fueled by a favorable pricing environment and rising exports. Despite a relatively small share in the structure of manufacturing value added,[12] the paper industry's contribution to the sector's overall growth over the first 10 months of this year is comparable with that of oil refining[13] (Figure 19). The announced plans for the industry's capacity expansion should help further output growth.

A negative contribution to the industry's output came from a 2% MoM drop in oil refining and production of rubber and plastic products (-3% MoM). Aside from that, recent months have seen mixed trends in the chemicals industry, which used to be one of key drivers of overall manufacturing growth. Following a decline of 1% MoM in September, the output level was unchanged in October.

As mentioned above, the leading survey-based manufacturing PMI indicators have shown positive performance (see Subsection 1.2.3. *October PMI: positive start of the quarter seen across the board*). Coupled with the positive performance of industrial output's trend component (Figure 17), this bodes well for industrial output in the months ahead.

[12] Share in gross value added (GVA) is below 2% (based on 2010 data).
[13] Share in GVA is 17.2% (based on 2010 data).

Figure 20. Manufacturing industries' output, Jan. 2014=100%, seasonally adjusted



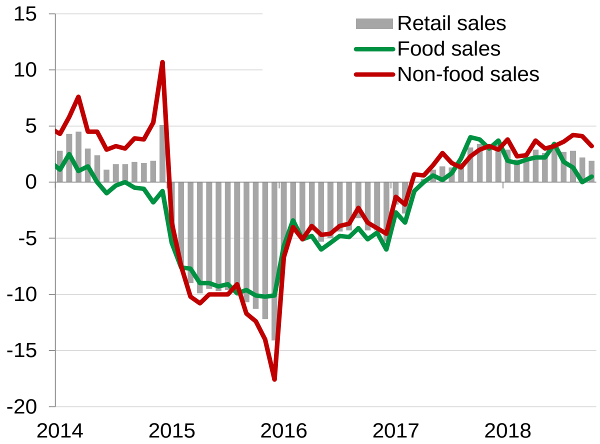
Source: Rosstat, R&F Department estimates

1.2.5. Nonfood retail sales expansion slows

- Retail sales expansion slowed to 1.9% YoY in October from 2.2% YoY in September due to weakening growth in nonfood retail sales. Adjusted for seasonal and calendar factors, retail sales remained unchanged after rising 0.1% MoM in September.
- Ruble depreciation in August – the first half of September may have boosted demand for nonfood goods, therefore the stabilization of the forex market situation brought about a minor sales slowdown in October.
- GfK estimates that in 2018 the market for fast moving consumer goods (FMCG), shrank for the first time in nominal terms, which may have stemmed from a dramatic slowdown in consumer price inflation at the start of the year and stepped up promo actions in the non-food FMCG segment.

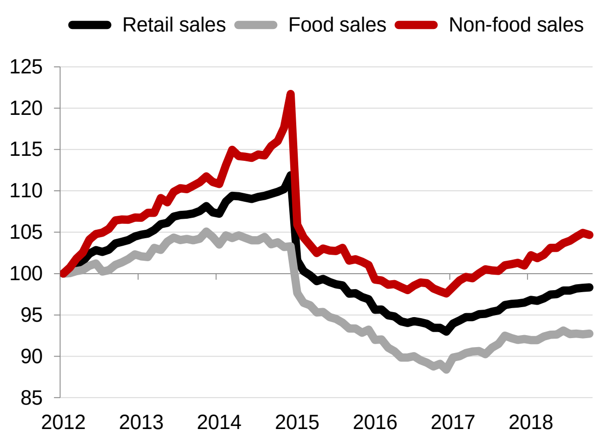
Based on Rosstat data, retail sales growth continued to soften in October, declining to 1.9% YoY from 2.2% YoY in September, the lowest level since August 2017 (Figure 21). Adjusted for seasonal and calendar factors, our estimate of retail sales, remained unchanged after rising 0.1% MoM in September (Figure 22).

Figure 21. Retail sales of food and non-food goods and overall retail sales, % YoY



Source: Rosstat, R&F Department estimates.

Figure 22. Retail sales, % (January 2012 = 100%, seasonally adjusted)



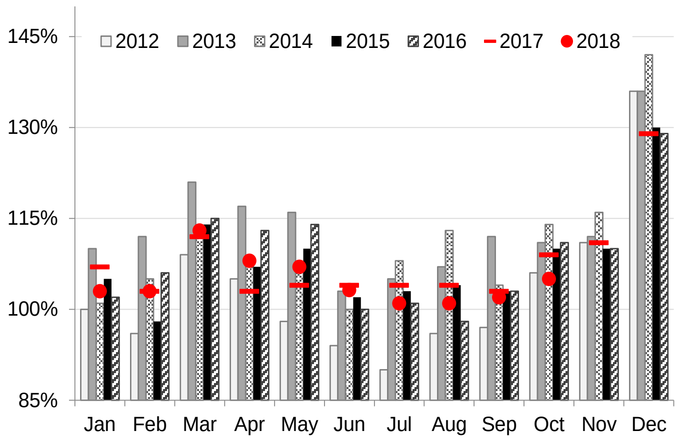
Source: Rosstat, R&F Department estimates.

October's slackening of retail sales growth was owed mainly to non-food sales. Sales growth rate in this segment fell to 3.2% YoY in October from 4.1% YoY in September. We estimate that seasonally adjusted non-food sales dropped 0.2% MoM after rising 0.4–0.5% MoM in August–September. Ruble weakening in August – the first half of September may have temporarily boosted demand for durable goods, hence October may have seen a minor easing of growth as the ruble stabilized. Consumers may have also deferred demand ahead of the pre-New-Year discounts and November's Black Friday bargain sales. The Association of Internet Trade companies (AKIT), the Russian Association of Electrotechnical Companies (RAEK), and the telecom company Beeline forecast a more massive action this year, with customers spending 57% more than in 2017.[14] This may have accelerated November retail sales growth by 0.7–0.8 pps.

Food sales expansion stood at 0.5% YoY, inching up from September's zero growth. Sales suffer from a temporary impact of smaller than last year's crop of field vegetables. Last year saw the opposite picture.

According to data from Romir[15] research holding company, October saw a seasonal rise in everyday household expenditure compared with September and the summer months of this year. The number came in below the levels of the same periods of previous six years but in the first half of the year it often exceeded the 2012–2014 indicators (Figure 23). Consequently, the above survey data should be treated with utmost caution. This picture may reflect not so much a consumption decline as the impact of various structural factors associated with, among other things, changes in the consumer behavior model, the specifics of goods categories used in Romir's survey, etc.

Figure 23. Real everyday household expenditure, % (January 2012 = 100%)



Source: Romir.

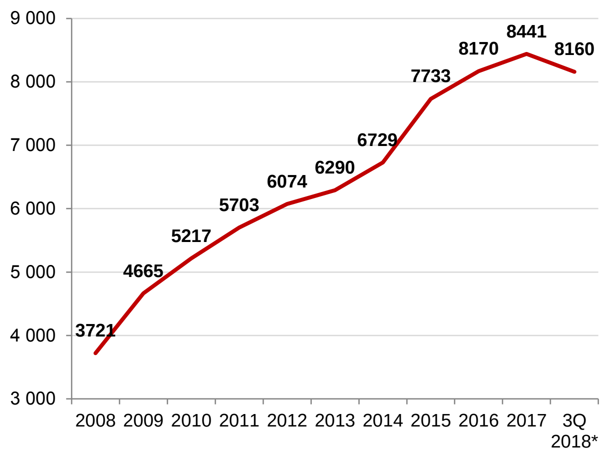
Negative trends in the fast moving consumer goods market[16] are reported by company GfK[17]. Its estimate suggests that the Russian FMCG market for the first time showed negative performance towards the end of the first half of 2018. Moreover, the decline gained momentum based on the third quarter data: accumulated FMCG sales from October 2017 through September 2018 fell 3.2% by value from a year ago (Figure 24). This may have resulted from a dramatic slowdown in consumer price inflation at the start of the year[18] and stepped up promo sales in the FMCG non-food segment.

[14] *Black Friday has bright prospects*. Kommersant newspaper. № 209. 14.11.2018.
[15] *Russians are looking for best prices*. Romir research holding company. 08.11.2018.
[16] The FMCG market includes foodstuffs, beverages, household chemicals, personal care items and cosmetics, baby food, pet feed, pharmaceuticals.
[17] *Growth problems in Russia's FMCG market*. GfK. 21.11.2018.
[18] Based on GfK estimate, foodstuffs account for almost 80% of the FMCG market.

Industry-specific research helps identify structural markets changes but does not always accurately evaluate overall dynamics of macro indicators. In particular, GfK estimates the total FMCG market at 8.2 trillion rubles over the period from the fourth quarter of 2017 to the third quarter of 2018 – much less than total food retail sales alone – 14.8 trillion rubles for the same period.

Based on inFOM[19] surveys, the Consumer Sentiment Index remains unchanged at 92 pps in November, as in mid-2017 (Figure 25). But the index components showed mixed performance: expectations regarding future income and respondents' assessment of whether time was good for major purchases improved, whereas their attitude to loans worsened, dropping to the November 2017 level. Notably, the above attitude to major purchases and consumer loans is roughly in line with the estimates of early 2015.

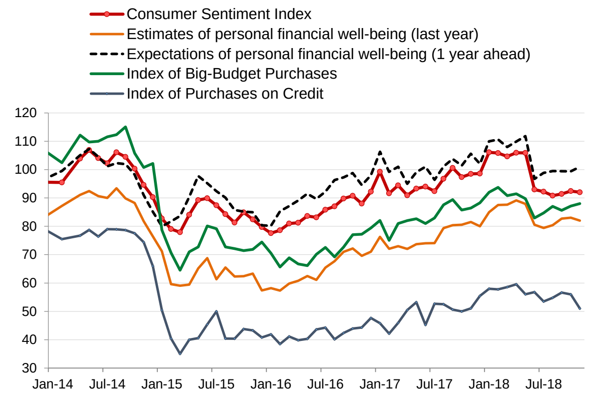
Figure 24. Sales in FMCG market, billion rubles



Source: GfK.

** Accumulated sales from 4Q 2017 to 3Q 2018*

Figure 25. Consumer Sentiment Index and its components



Source: inFOM survey.

The assessment of respondents' personal financial position also worsened, with the share of those who had to economize (up 2 pps) and do without earlier planned expenses (a gain of 9 pps) going up. Moreover, in November, respondents decided against major expenses on buying household appliances, a car, furniture, or renovating their apartments more often than in October.

1.2.6. Household savings rate continues to decline

- The savings rate continued falling in the third quarter as consumer lending growth accelerated and ruble deposit expansion slowed.
- A drop in household foreign currency deposits is partly due to their conversion to foreign currency cash, probably on fears of sanctions against some banks.

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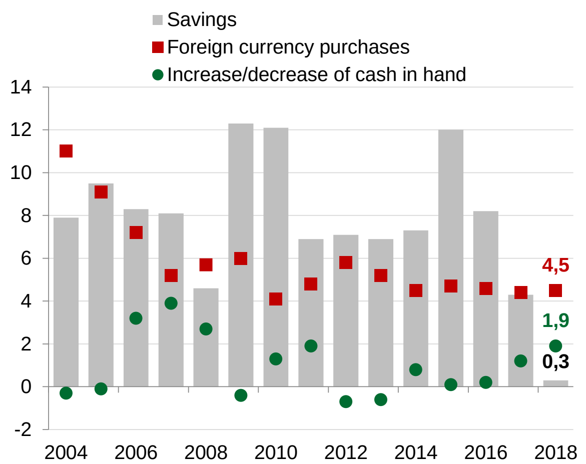
[19] November real-time data.

- The absence of spikes in the purchases of foreign currency cash, however, proves that households are generally responding to ruble exchange rate fluctuations more mildly and rationally.

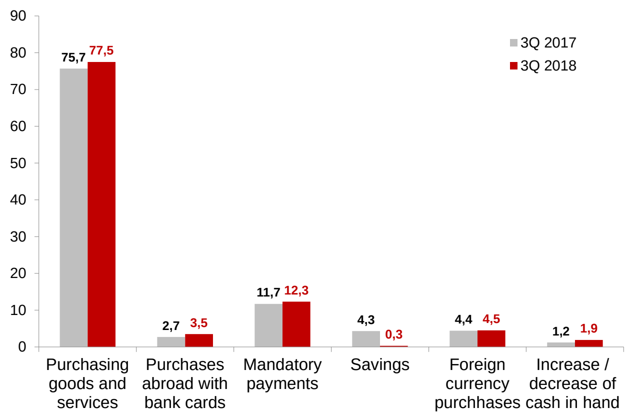
Rosstat estimates the savings rate at 0.3% in the third quarter, down from 6.5% in the second quarter.[20] That said, the share of income put aside as savings was the lowest in the third quarter since 2004 at the latest (Figure 26, Figure 27). The adjusted savings ratio[21] stood below the Rosstat estimate due to, among other things, a drop in foreign currency deposits (Figure 28).

Figure 26. Components of household income spending in the third quarter (%, seasonally unadjusted)



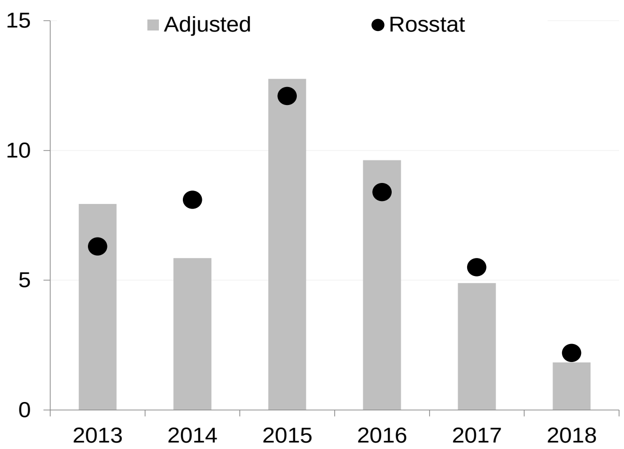
Source: Rosstat, R&F Department estimates.

Figure 27. Change in the structure of household income spending, % of income



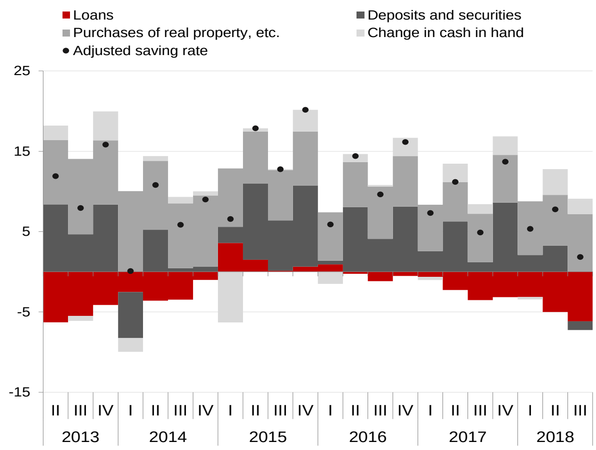
Source: Rosstat, R&F Department estimates.

Figure 28. Third quarter savings rate (%, cash in hand increase accounted for)



Source: Rosstat, R&F Department estimates.

Figure 29. Breakdown of the adjusted savings rate



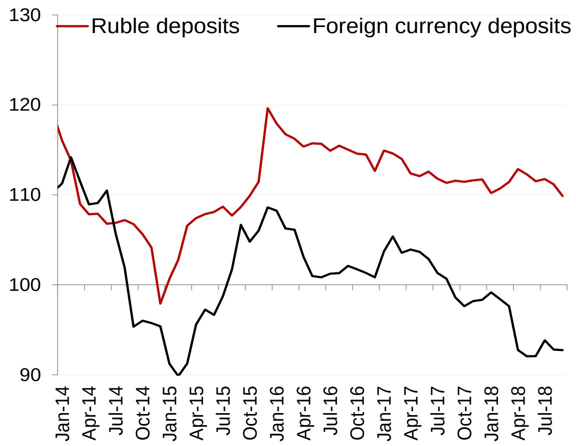
Source: Rosstat, R&F Department estimates.

[20] The second quarter data was revised down from 7.1% to 6.5%.
[21] Calculated by the Research and Forecasting Department. Includes changes in foreign currency deposits and ruble cash in hand, which are not deemed to be savings under Rosstat statistics.

The savings rate decline from the third quarter of 2017 is driven, first, by consumer (including mortgage) lending growth, whose negative contribution continues to rise (Figure 29), and second, by slowed ruble deposit expansion and contraction in foreign currency deposits (Figure 30). That said, cash in hand expanded substantially, while the share of income spent to buy foreign currency was all but unchanged.

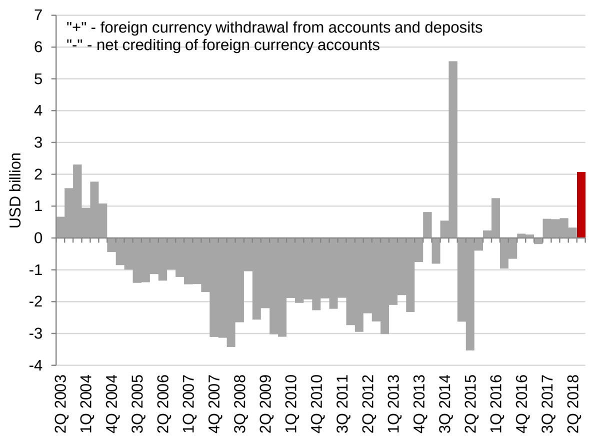
The accelerating decline in foreign currency deposits in the third quarter may have come from the news flow giving rise to fears of sanctions being imposed on state-owned banks. This may have made depositors withdraw their foreign currency savings from banks and convert them to foreign currency cash. This is borne out by data on the flow of foreign currency cash: this year saw the largest net withdrawal of foreign currency cash from bank accounts[22] in the third quarter since 2003 (excluding the 2014 developments) (Figure 31). We do not think that all of this foreign currency was withdrawn for spending in foreign travel. Meanwhile, the August–September ruble weakening spell did not spur additional demand for foreign currency purchases: the share of foreign currency purchases in household income remained virtually the same as in the relevant periods of 2014–2017 (Figure 32).

Figure 30. Ruble and foreign currency household deposits, % YoY



Source: Bank of Russia, R&F Department estimates.

Figure 31. Net withdrawal of foreign currency cash from foreign currency bank accounts

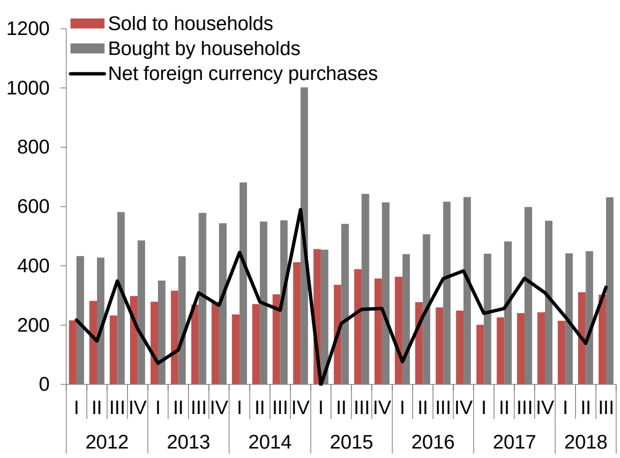


Source: Bank of Russia, R&F Department estimates.

The rise in foreign currency cash in hand, significant in terms of third-quarter figures, requires further analysis. Some banks' customers may have stepped up cash withdrawals not only from foreign currency-denominated but also from ruble accounts on fears of sanctions. Cash in circulation outside the banking system added more than 13% YoY in the third quarter, showing the highest expansion rate since mid-2102 (Figure 33). Should the news flow become more positive, the fourth quarter may see a lower cash-in-hand rise than seasonally normal.

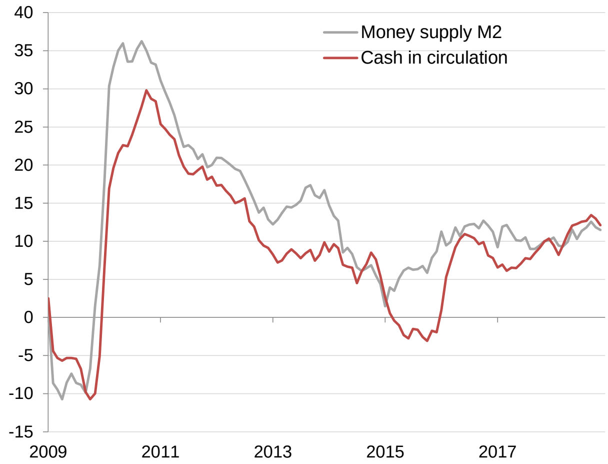
[22] The difference between foreign currency cash withdrawn by households from their foreign currency accounts and that paid into foreign currency accounts.

Figure 32. Purchase, sale and net household purchases of foreign currency (billion rubles)



Source: Rosstat, R&F Department estimates.

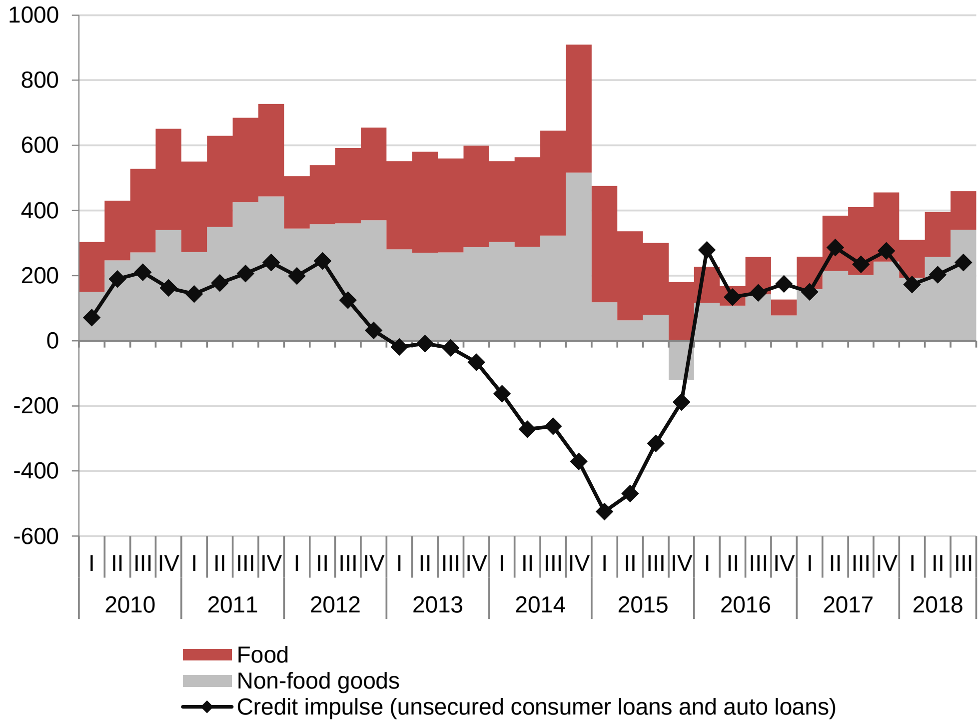
Figure 33. Money supply and cash increase, % YoY



Source: Rosstat, R&F Department estimates.

Our estimates suggest that consumer demand growth has been financed by, among other things, unsecured consumer lending and auto loans in the last three years (Figure 34). One cannot however claim that retail sales expansion is only due to unsecured lending acceleration. Inflationary risks from unsecured consumer lending remain moderate against a backdrop of modest household income performance.

Figure 34. Retail sales growth and the credit impulse, billion rubles, YoY



Source: Rosstat, R&F Department estimates.

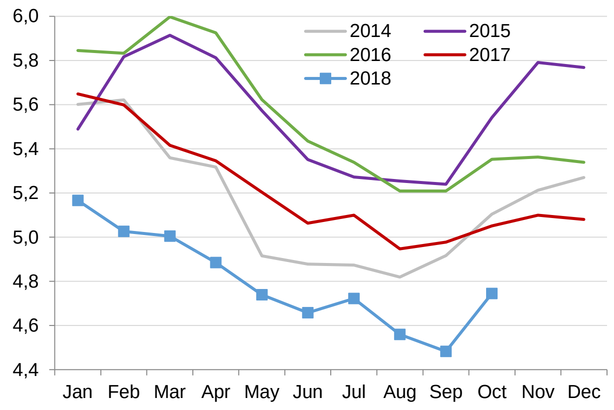
1.2.7. Unemployment rate is stable, wage growth weakens

- Seasonally adjusted unemployment rate keeps to the levels achieved at the start of the year.
- Wage growth slowed sharply in September–October compared with the summer months. The most dramatic growth deceleration was seen in the public sector. The growth weakening may continue in the fourth quarter given the high base of 2017 – the second half of last year saw accelerated wage indexation for public sector employees under the relevant presidential decree.
- Indirect measures of earned income outperform wage rises. For example, growth in personal income tax revenue has been gaining momentum in recent months.

Based on Rosstat data, the unemployment rate rose from 4.5% to 4.75% in October. The unemployment rise in October and the following months is a traditional, annual occurrence. This is the period when seasonal operations (agricultural, construction, and others) come to an end, and the number of people willing to resume employment after the summer period increases.

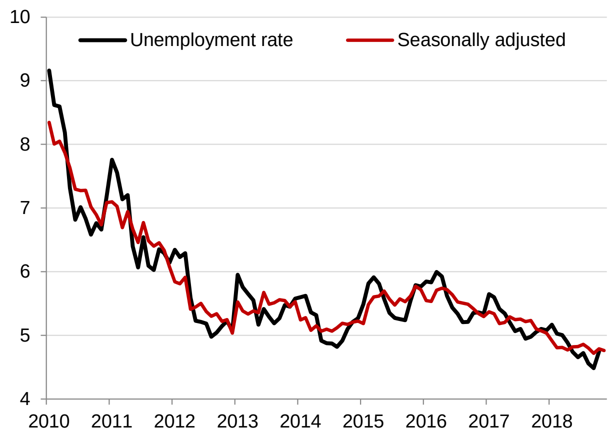
Adjusted for the seasonal component, the unemployment rate rose to 4.8% from 4.7%, generally staying on the level reached as early as the start of 2018. October's rise in unemployment was more significant than seasonally normal. This was owed to temporary factors rather than to worsening in the labor market situation. Most probably, the favorable weather conditions in September allowed seasonal summer employment to be retained and had a positive effect on the unemployment rate: the September indicator went down, uncharacteristically for the beginning of the autumn. A similar situation was seen in 2015 with its anomaly warm September. The unemployment rate also fell in September 2015, rising dramatically in October (Figure 36).

Figure 35. Unemployment rate by year, %



Source: Rosstat

Figure 36. Unemployment rate, %

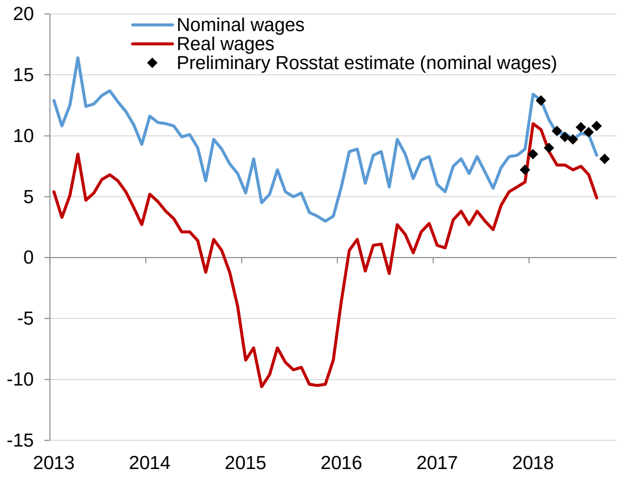


Source: Rosstat, R&F Department estimates.

According to Rosstat data, growth in nominal accrued wages slowed to 8.1% YoY, with real wages increasing 4.4% YoY. The initial September estimates were revised down to 8.4%YoY and 4.9%YoY from 10.8% and 7.2% respectively (Figure 37). Preliminary Rosstat estimates are fairly often revised after the actual data has been reported, hence the final October statistics may turn out to be different. For example, indirect wage measures have outperformed wage growth. The collection of personal income tax rather accurately reproduces wage changes, including changes in trends (although with a higher volatility). Unlike wage growth, a rise in personal income tax collection has accelerated in recent months.

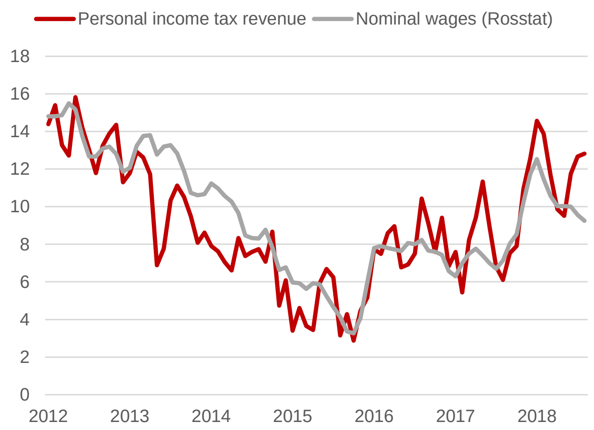
The public sector suffered the greatest wage rise decline. Public administration saw a growth rate of just 1.8% YoY after 8.5% YoY in August. September's wage increase practically halved in the education sector, owed to last year's high base: it was in September last year that wage acceleration started in this sector as part of implementing what is known as May's presidential decrees. Public sector employees' wage growth under the presidential decrees is set to continue in the fourth quarter, dragging down a rise in the economy's overall indicator.

Figure 37. Wage growth, % YoY



Source: Rosstat

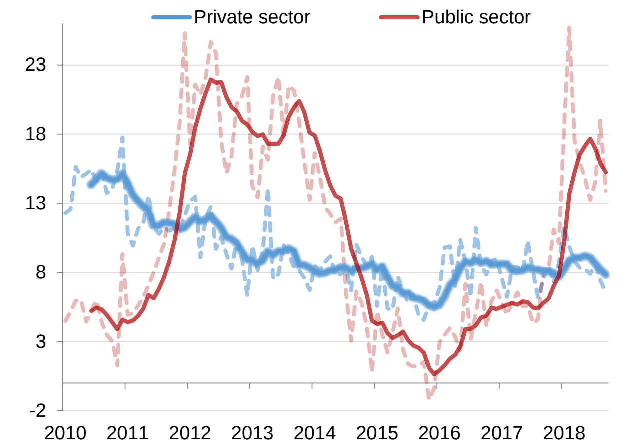
Figure 38. Growth in nominal wages and personal income tax collection, % YoY (3-month moving average)



Source: Rosstat, RF Treasury, R&F Department estimates

September's wage growth decline affected virtually all of the economy's industries, except for the financial and insurance sectors (Figure 40). The private sector saw wage growth slowing to the lowest level since August 2017. Amid the August–September rise in uncertainty, companies *may have played* with the variable components of employees' wages.

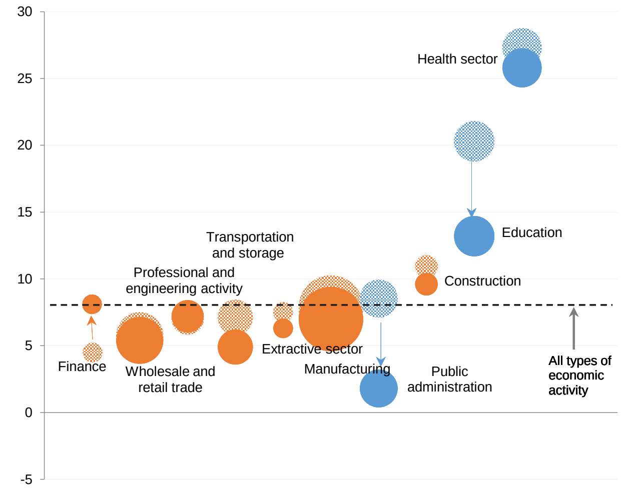
Figure 39. Nominal wage growth in the private and public sectors, % YoY



Dashed line – monthly wage growth in the relevant sector. Solid line – 6-month adjusted wage growth in the relevant sector.

Source: Rosstat, R&F Department estimates

Figure 40. Wage growth by sector in August and September, % YoY



Note: the circle size corresponds to the share of the economic activity type in the payroll fund.

Partially colored circle – August 2018. Fully colored circle – September 2018

Source: Rosstat, R&F Department estimates

1.2.8. The banking sector in September: downturn in mortgage lending expansion

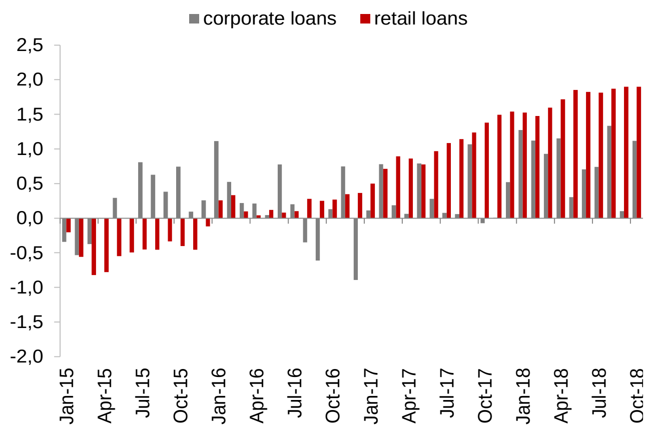
- Ruble lending maintains high growth rates in both retail and corporate segments.
- Seasonally adjusted mortgage lending expansion meanwhile decelerated and in annualized terms went under annual growth rate for the first time since mid-2017.
- Inflow of ruble household deposits resumed in October, thanks mainly to state-owned banks.
- Household foreign currency deposits continued to shrink in October in all of the main groups of banks.

Lending expansion remained strong in both the ruble segment of corporate loans and the retail portfolio (Figure 41). Retail lending increase is so far comparable with that in August–September at 1.9% MoM.[23] Although risk coefficients for consumer loans were raised as of September this year, unsecured consumer lending is still showing high and even accelerating growth rates Annualized. three-month average expansion accelerated from 23% to 23.8% in October, but mortgage lending expansion slowed to 1.6% MoM in

[23] Here and further in the section monthly growth estimates are seasonally adjusted unless otherwise specified.

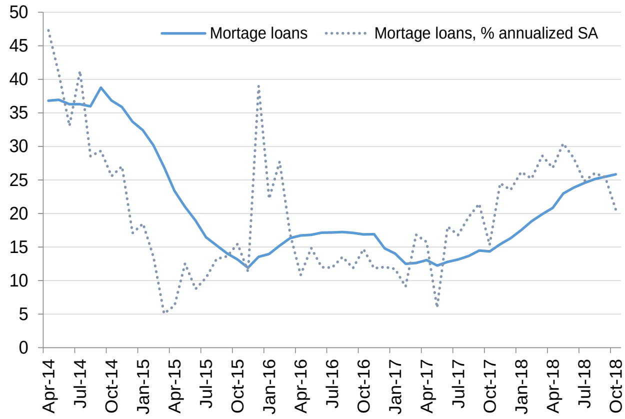
October from 1.9% MoM in September, while its annualized three-month average growth rate declined from 22.9% to 21.7%. This may result in a gradual slowdown of the mortgage lending rise in the next few months.

Figure 41. Ruble lending expansion, % MoM (seasonally adjusted)



Source: Bank of Russia estimates

Figure 42. Mortgage lending



Source: Bank of Russia estimates

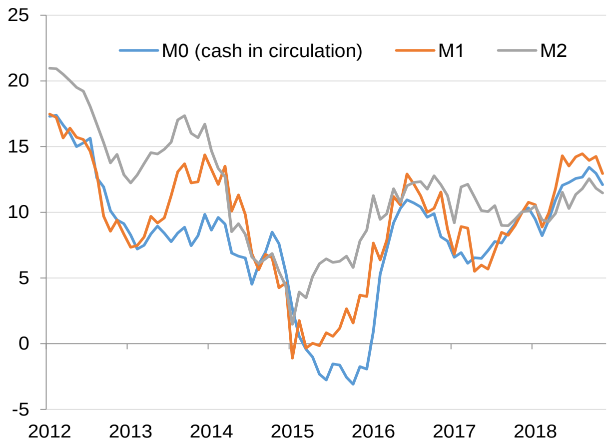
October's important trend was the recovery of retail ruble deposit expansion: their seasonally adjusted growth came in above the average levels of 2017 and the first half of 2018. This was largely brought about by state-owned banks raising interest rates on time deposits. The faster ruble deposits inflow to state-owned banks than their outflow from the rest of the banking sector was the main channel of cash rubles partial return to the banking system.

The expansion of transferable household deposits[24] has by far outpaced time deposits growth since early 2016 (Figure 44). Transferable deposits have been rising at a rate of 30% YoY and more since April this year, making the main contribution to the outpacing growth of the money aggregate M1 (Figure 43). It is noteworthy that it is the banking system in general rather than a few individual banks that shows accelerated increase in current accounts and demand deposits.

The rising household preferences of more liquid instruments may be due to a number of factors. First, rates on household time deposits hit all-time lows at roughly the same time. With programs of interest accrual on account balances widespread among commercial banks, the difference in rates may have been mostly insufficient to compensate for the loss of liquidity upon opening a time deposit. This situation has largely resulted from low inflation. Second, the sanctions rhetoric intensified in April 2018, which may have further boosted households' preference for liquid forms of holding money. In this context, the faster growth in household time deposits may indicate a diminishing impact of the sanctions factor and/or a sufficient rise in deposit rates to make up for the loss of liquidity.

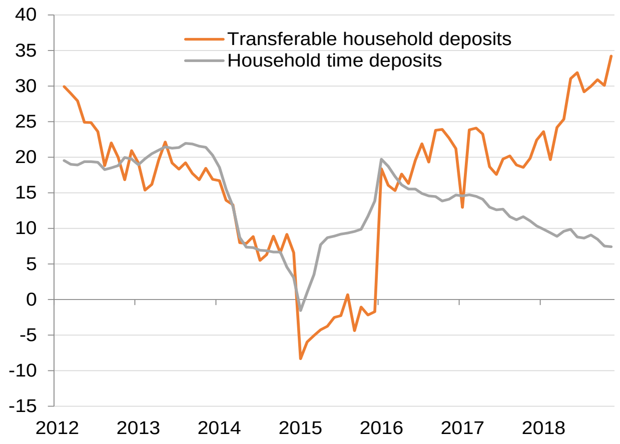
[24] Funds in transaction and current accounts and demand deposits.

Figure 43. Growth in money aggregates, % YoY



Source: Bank of Russia

Figure 44. Household deposits, % YoY



Source: Bank of Russia

The outflow of household foreign currency deposits continued in October, affecting all groups of banks, including partially foreign-owned ones, which took over some foreign currency deposits that fled state-owned banks. Notably, the outflows occurred amid hikes in rates on foreign currency deposits.

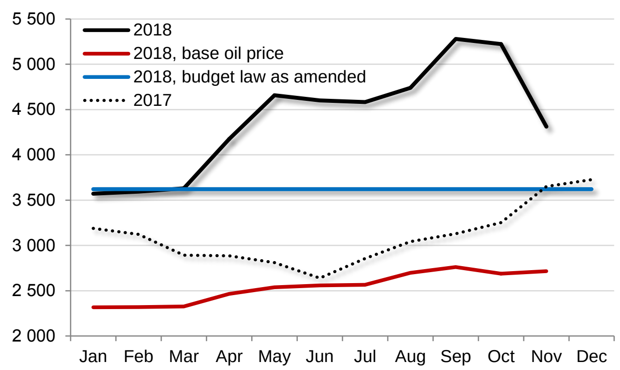
1.2.9. Account balances are a significant contingent finance source for the federal budget

- General government revenue rise accelerated to 4.4 pps of GDP YoY in the third quarter of 2018, with oil and gas revenue growth adding 3.2 pps of GDP YoY. Non-oil and gas revenue increase is partly owed to the continued tax collection growth.
- Expenditure dropped 1.4 pps of GDP YoY in the third quarter, with social services and capital expenditure accounting for most of the decline (down 0.6 pps and 0.4 pps of GDP, respectively). This may have had a temporary restraining effect on GDP growth.
- A surplus of 7.2% of GDP YoY in the third quarter, the largest since 2008, helped step up revenue accumulation in the National Wealth Fund.
- We expect budget revenue to GDP to start declining in 2019, driven by a faster oil and gas revenue contraction than a decline in other categories. With expenditure stable, total surplus and non-oil and gas deficit will shrink as a percentage of GDP. The National Wealth Fund's growth will outpace a public debt increase.
- Given the unfavorable conditions in the government debt market, there are risks that government bond issues will fail to be placed in full. But this will not affect the government's ability to finance its expenditure: federal budget account balances can be used as debt substitution. A total of 0.15–0.35 trillion rubles can be required for this purpose in 2018 and more in 2019. The substantial amount of account balances suggests the absence of risks to fiscal sustainability.

Revenue. General government revenue growth accelerated to 4.4 pps of GDP YoY in the third quarter (climbing 2.6 pps of GDP YoY in January–September).[25] The main contribution came from oil and gas revenue: up 3.2 pps of GDP YoY (a rise of 2.2 pps of GDP YoY over January–September). This was owed to an acceleration in Urals oil ruble price rise to 62% YoY (Figure 45), as well as that in extraction and export expansion. Non-oil and gas revenue climbed 1.2 pps of GDP YoY (up 0.4 pps of GDP YoY over January–September), with taxes on domestic production accounting for the major portion of the increase: profit tax provided a rise of 0.5 pps of GDP YoY, domestic VAT – 0.2 pps of GDP YoY. We believe that revenue is continuing to benefit from improved tax collection.

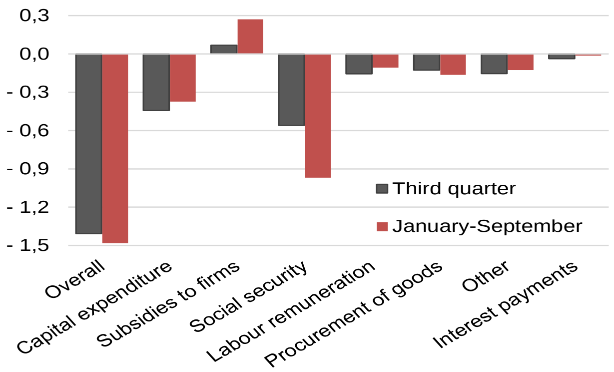
Expenditure. General government expenditure fell 1.4 pps of GDP YoY in the third quarter (dropping 1.5 pps of GDP YoY in January–September) (the first quarter saw a high base effect owed to the one-off pension payment in January 2017). The expenditure contraction stems mainly from the continued budget consolidation. Under the functional expenditure classification, the social and economic blocks accounted for the largest expenditure contraction in the third quarter – by 0.6 pps and 0.5 pps of GDP respectively, while under the economic classification it was driven by social services and capital expenditure (a decrease of 0.5 pps and 0.4 pps of GDP respectively). Debt servicing spending went down 0.04 pps of GDP YoY thanks to a fall in this expenditure on the regional level.

Figure 45. Urals monthly ruble price per bbl in 2017–2018



Source: Bank of Russia, RF Finance Ministry, R&F Department estimates.

Figure 46. Change in general government expenditure under economic classification in 2018, pps of GDP YoY

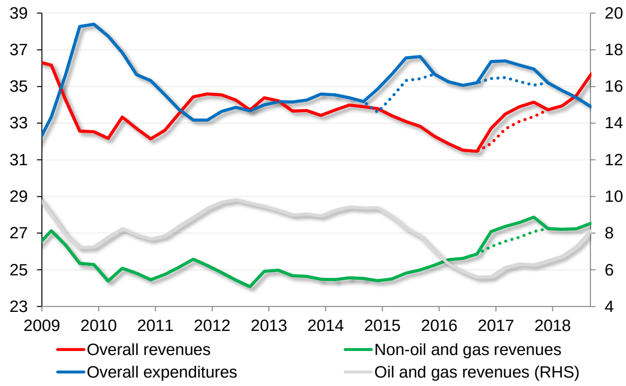


Source: RF Treasury, RF Finance Ministry, R&F Department estimates.

General government balance. The revenue expansion and expenditure contraction provided for the third quarter's largest surplus since 2008 – 7.2% of GDP. The four-quarter moving average surplus was at its highest for almost 10 years at 1.7% of GDP (Figure 47, Figure 48).

[25] Here and henceforth, RF Finance Ministry nominal GDP estimates for the second quarter of 2018 are used.

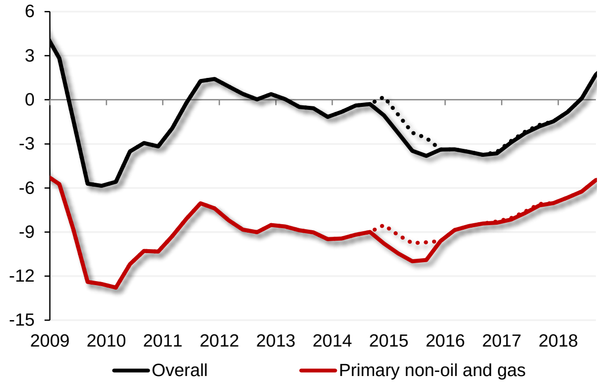
Figure 47. Key general government indicators, % of GDP, four-quarter moving average



Total revenue Total expenditure Non-oil and gas revenue Oil and gas revenue

Source: RF Finance Ministry, RF Treasury, Rosstat, R&F Department estimates.

Figure 48. General government balance, % of GDP, four-quarter moving average



Total Non-oil and gas primary

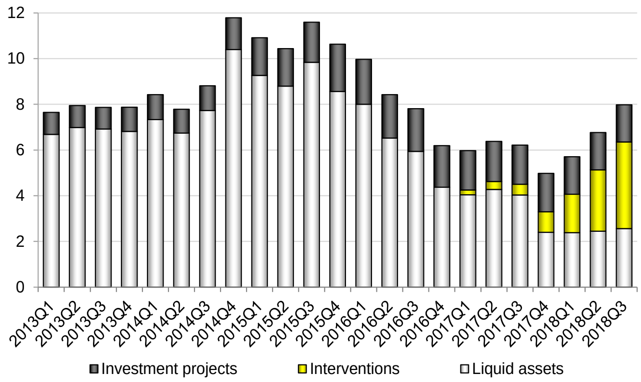
Source: RF Finance Ministry, RF Treasury, Rosstat, R&F Department estimates.

** Dashed line denotes estimates excluding major one-off factors: banks' recapitalization in 4Q 2014, expenditure for early re-payment of defense sector loans and Rosneft privatization in 4Q 2016.*

Sovereign funds and public debt. Acceleration in oil and gas revenue growth helped step up revenue accumulation in the National Wealth Fund (NWF). The transfer of extra oil and gas revenue to the Fund drove its potential size up 1.1 pps (Figure 49). The NWF amounted to 8.0% of GDP as of 01.10.2018, of which investment projects accounted for 1.6 pps, the liquid part accumulated before the fiscal rule was put in place – for 2.6 pps, the liquid part accumulated under the new fiscal rule – for 3.8 pps.

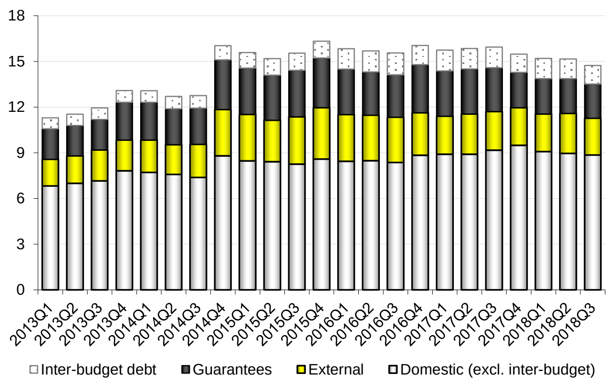
Total public debt net of the third quarter interbudget debt dwindled 0.4 pps of GDP to 14.7% of GDP. (Figure 50). Domestic and external debt declined 0.2 pps of GDP each. The amount of government guarantees continues to fall: after their extensive rise in the post-crisis period from 0.5% of GDP at end-2008 to 3.3% of GDP at end-2015 they dropped to 2.2% of GDP at the end of the third quarter of 2018 (a decrease of 0.05% of GDP over the third quarter).

Figure 49. Structure of sovereign funds (NWF as of 2018) % of GDP



Source: RF Finance Ministry, Rosstat, R&F Department estimates.

Figure 50. Structure of total general government debt, % of GDP



Source: RF Finance Ministry, Rosstat, R&F Department estimates.

Impact on GDP growth. The expenditure contraction and change in its structure towards categories with relatively low fiscal multipliers may have had a temporary negative effect on annual GDP growth in the third quarter of 2018. This was accompanied by a substantial revenue increase as part of the fiscal rule, which continues to help smooth out the short-term volatility of GDP and budget expenditure caused by oil price fluctuations. Predictable and stable performance of general government indicators promotes economic growth over the medium- and long-term horizons.

Forecast. We expect general government revenue to peak as a share of GDP in the fourth quarter of 2018 and subsequently decline, driven by oil and gas revenue contraction. With expenditure generally stable, this will cause a simultaneous reduction in total surplus and non-oil and gas deficit of general government.

The fiscal rule and a shift to accelerated revenue allocation for investment projects will push total public debt higher as a share of GDP, but this rise will be moderate thanks to regional budgets' enhancing stability.

Extra oil and gas revenue to be paid into the NWF will be compensated in the fourth quarter of 2018 by the planned use of NWF revenue accumulated before the fiscal rule came into effect. In years to come NWF revenue expansion will outpace a debt increase, reducing net debt as a share of GDP.

In the unfavorable environment, which has brought down the share of nonresidents in the OFZ market and made it difficult to place ruble- and foreign currency-denominated government bond issues, a need may arise for debt substitution, relying, above all, on the federal budget account balances deposited in the single RF Treasury account and with commercial banks.

These funds, held in both rubles and foreign currency, totaled 2.5 trillion rubles as of the start of 2018. In view of the risks that deficit financing sources will prove insufficient and the 2018 federal budget expenditure will be underexecuted, we expect the account balances of federal budget used as debt substitution to amount to 0.15–0.35 trillion rubles. The reliance on this source of deficit financing may increase in 2019. But given the substantial amount of the account balances, we do not see significant risks to the stability of public finances. Since the bulk of these funds (around two thirds) are deposited with commercial banks, this will not substantially affect the banking sector's liquidity.

2. Outlook: leading indicators

2.1. What do Russia's leading indicators suggest?

2.1.1. GDP nowcast for Russia: growth momentum eases, remaining close to potential

- The GDP nowcast for the fourth quarter indicates the Russian economy's slowdown in the second half of 2018. Growth is however sustainable at a rate close to potential.
- Our updated GDP nowcast for the fourth quarter of 2018 stood at +0,3% QoQ SA, unchanged from October's number.
- We estimate that GDP growth will come in at 1.6–1.7% for 2018.[26]
- During the first half of 2019, growth is expected to stabilize in the 0.2–0.3% range in quarter-on-quarter seasonally adjusted terms. The decrease in the range a estimates for two quarters ahead chiefly stems from a dramatic oil price drop in November. Moreover, the forthcoming VAT hike may slow growth further in the first quarter of 2019.

	November	October
	% QoQ SA	% QoQ SA
Q4 2018	**0.3**	0.3
Q1 2019	**0.25**	0.4
Q2 2019	**0.3**	–

[26] Index-based estimate is oriented to Rosstat's revised GDP estimates to be released in 2020 and in subsequent years.

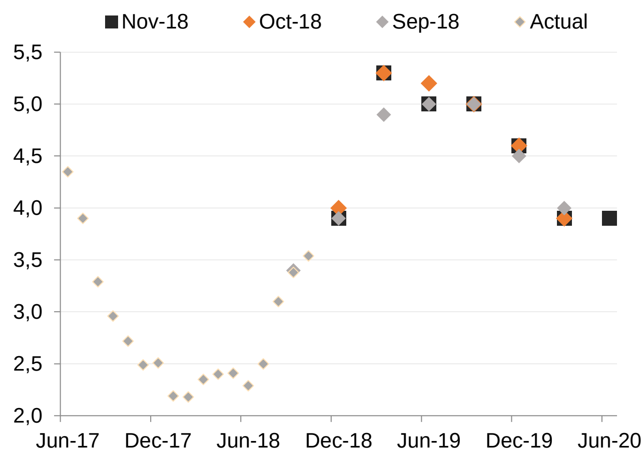
2.1.2. Blomberg consensus forecast: expectations of a key rate cut have been put on hold until 2020

- Bloomberg consensus forecast expects inflation to come in just below 4%, at 3.9%, for 2018. Inflation will expectedly accelerate in 2019 but will return to a Bank of Russia target of 4% as early as 2020.
- Reaching this inflation trajectory implies maintaining the Bank of Russia's current key rate until early 2020, while some analysts expect the key rate to be raised at the next meeting of the Bank of Russia board of directors on December 14.

A Bloomberg survey suggests that analysts' inflation expectations have gone down from 4.0% to 3.9% YoY for 2018 in the last month. This may have come from October's weaker-than-expected inflation acceleration, which was taken as a signal that ruble weakening in January–September had not brought about extra inflationary pressure. The consensus forecast of inflation at end-2019 stayed at 4.6% versus a Bank of Russia baseline forecast of 5.0–5.5%. Analysts expect inflation to return to 4% in 2020, in line with the Bank of Russia's forecast.

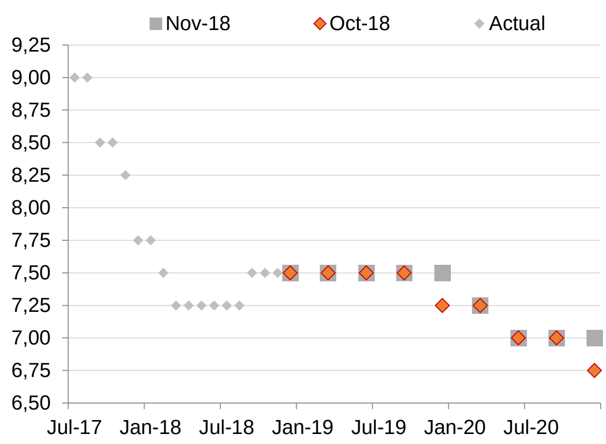
Expectations of the Bank of Russia cutting the key rate from the current 7.5% have now been extended to a later time. According to the consensus forecast, the key rate will stay on the current level throughout 2019, while its cuts and gradual decline to the neutral level will only begin in 2020.

Figure 51. Analysts' inflation expectations, % YoY



Source: Bloomberg Finance L.P.

Figure 52. Analysts' expectations regarding Bank of Russia key rate, % p.a.



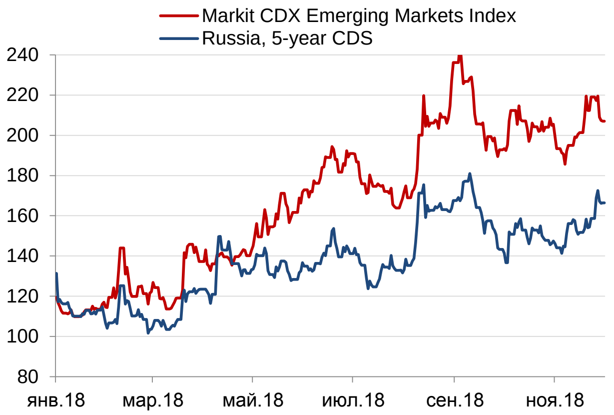
Source: Bloomberg Finance L.P.

3. In focus. Rising uncertainty in the global economy yet again shows the advantages of economies without severe imbalances, the importance of buffers, and a central bank's ability to conduct independent anti-inflationary policy

- The situation in countries where the steepest financial markets' fall was seen in 2018, vividly illustrates the consequences of negative external and domestic shocks that can be suffered by an economy with accumulated imbalances and undermined confidence in government macroeconomic policy.
- That said, the problem of financial system stability may be aggravated by an economy being entrained in a vicious circle. Under these circumstances, the economy and financial markets become increasingly sensitive to authorities' potential new mistakes in implementing and communicating stabilization measures, and to institutional problems.
- One factor which played a role in volatility amplification in some countries' markets was the loss of market confidence in a central bank's ability to bring down inflation by taking relevant measures, because of, among other things, the apparent lack of a central bank's ability to implement independent disinflationary policy. And vice versa, the strongest resilience to external shocks was shown by countries whose monetary policies enjoyed strong confidence of the markets.

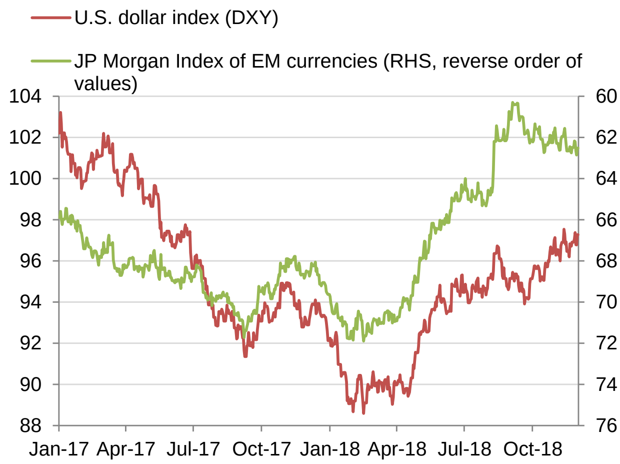
In 2018, emerging markets (EM) faced capital outflows as the U.S. Federal Reserve continued the normalization of its monetary policy, the global economy suffered growth weakening (on account of trade wars, among other things), and (geo)political uncertainty rose. The combination of these factors resulted in the negative performance of these countries' financial markets, with CDS-premia and government and corporate bond yields rising and national currencies weakening.

Figure 53. Emerging markets' CDS spreads



Source: Bloomberg Finance L.P.

Figure 54. Exchange rates of emerging market currencies and the U.S. dollar

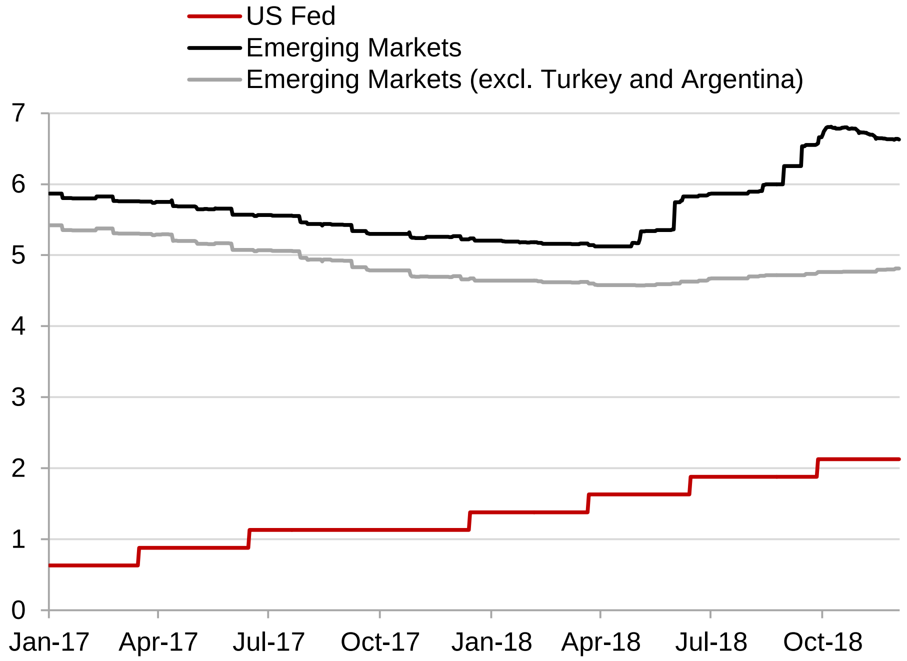


Source: Bloomberg Finance L.P.

In the face of external challenges, many EM central banks began to raise their key rates. Market indicator movements and degree of monetary policy response were uneven across countries. Where financial markets saw the highest volatility, a variety of related problems became evident, entailing the following consequences:

- accumulated external and domestic imbalances;
- low confidence in economic policy conducted;
- overdue and/or inadequate policy response, which may heighten financial market participants' sensitivity to all kinds of actions and mistakes, thus setting off the vicious circle mechanism;
- lack or curtailment of a central bank's independence in both statutory terms and in respect of making important practical decisions.

Figure 55. Central bank interest rates, % p.a.



Source: Bank for International Settlements, R&F Department estimates

Economy's imbalances

Key imbalances include external debt accumulated by emerging markets which suffer a current account deficit. Based on Bank of International Settlements (BIS) data, the external dollar-denominated debt of emerging markets' non-banking sector has doubled over the post-crisis decade.[27] As a result, hikes in interest rates on foreign currency debt may cause a number of negative consequences for emerging markets. Raising foreign currency rates drives debt servicing cost higher. The economic consequences of this will

[27] https://www.bis.org/speeches/sp180814.htm.

be the more serious, the larger is a mismatch between foreign liabilities and assets in both the banking system and the non-financial organizations and household sector.

Interest rate hikes in developed countries enhance the attractiveness of their assets. With rates remaining unchanged in emerging markets, this spurs capital outflows. As a result, even an equivalent rate hike by emerging markets' central banks sometimes fails to halt capital outflows to the required extent because a premium for the risk that investors in these countries' assets are willing to assume rises simultaneously. Hence financing the current account deficit on a previous scale becomes impossible – the economy encounters a national currency weakening. We note that domestic currency weakening amid increased debt and other vulnerabilities can have a mixed effect on an economy. National currency depreciation boosts foreign currency debt in terms of a domestic currency, heightening a country's debt burden and debt servicing costs.

In general, emerging markets have to a certain extent drawn lessons from the previous crises. Based on BIS data, the share of foreign currency in corporate debt has fallen in the last decade, countries have started to use macroprudential policy instruments more efficiently, destimulating financial institutions no longer have considerable uncovered foreign positions. Also, the share of short-term debt has dwindled.[28] Countries which have failed to follow these trends have proved the most vulnerable to financial shocks.

Low confidence in authorities' economic policy

Lack of confidence in authorities' economic policy sometimes causes the accumulation of the above imbalances. For example, persistent high inflation and inflation expectations with confidence in monetary policy lacking, boost demand for foreign assets from economic agents (companies and households), causing banks' foreign liabilities (foreign currency deposits) to expand and, accordingly, making banks which seek to avoid a mismatch in the currency beef up their foreign currency assets (loans).

Overdue and/or inadequate policy response

Lack or inadequacy of economic authorities' response to ongoing financial shocks may aggravate the impact of the shock, requiring a stronger response in the future.

For example, a central bank's inadequate response to inflation acceleration may weaken the domestic currency, especially amid a steady increase in capital outflows spurred by external factors, thereby accelerating inflation and heightening inflation expectations even further. This would in turn necessitate more resolute stabilization measures (more drastic rate hikes) in the future and increase the sensitivity of financial markets' performance to any statements and actions by a central bank. If a central bank has several times responded by an insufficient or overdue rate hike, the situation may escalate,

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28 https://www.societegenerale.com/sites/default/files/documents/Econote/EcoNote-Emerging-markets-external-debt-same-old-song.pdf.

threatening both price and financial stability. At some point, this would make a central bank raise interest rates much more drastically than currently expected in order to break the vicious circle and stabilize the situation. Meanwhile the rate would most likely be much higher than it would have been had the response been timely and preemptive.

Lack or curtailment of central bank independence

The inadequacy or lack of appropriate monetary policy response often results from a central bank not being *de jure or de facto* independent. Pressure from politicians and authorities whose interests may be confined to meeting short-term economic growth goals, curtail the ability of a central bank to respond to medium-term economic risks where monetary authorities lack independence. Instead of smoothing out cyclical fluctuations and ensuring price and financial stability, a central bank lacking independence may, on the contrary, trigger excess output and price fluctuations by pursuing a procyclical policy. Other things being equal, market confidence in a central bank's independence brings down a country risk premium and long-term interest rates. This boosts access to long domestic currency financing and helps reduce companies and households' foreign assets and liabilities.

A variety of empirical studies on panel data from a wide range of country groups also support the view that the more independent a central bank, the more successfully it maintains price stability. Moreover, its independence should be not only statutorily prion vided but also allow it a free hand in taking action which meets the interests of all economic agents and medium-term goals.

Monetary policy dependence on fiscal policy is a separate issue worth mentioning. The requirement to monetize a budget deficit largely undermines confidence in authorities' monetary and fiscal policy. The availability of "unlimited" finance source for the budget undermines motivation to support stability and fiscal discipline. Deficit monetization reduces monetary policy effectiveness on the operational level and limits an array of responses to inflationary shocks. This is yet again evidenced by a negative example of several emerging markets' operation in 2018.

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