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The views and recommendations contained in this Bulletin do not necessarily reflect the official position of the Bank of Russia.

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EXECUTIVE SUMMARY

1. Monthly summary

- Annual inflation lost momentum in February as the effect of the VAT hike weakened and transient factors restraining price increases emerged. Monthly consumer price rises adjusted for seasonal and one-off factors are roughly in line with the Bank of Russia inflation target. Inflation expectations have started declining but remain elevated, signaling the continuation of medium-term pro-inflationary risks arising from the realization of secondary effects. Economic activity continued to expand at a somewhat slowed pace.
    - With the effect of the VAT increase extended over time and other temporary factors in evidence, inflation will likely accelerate somewhat in the coming weeks before starting to slow and going back down to 4% in the first half of 2020. Medium-term risks of inflation deviating upwards from the target are still prevailing. Bank of Russia brings down inflationary risks, maintaining inflation at a level close to the target.
    - Economic growth has somewhat eased in recent months, dragged down by a number of transient factors, such as the global economy's slowdown, the oil price fall, and the VAT hike. The sluggish pace of economic activity will likely continue until the middle of this year. This will in part stem from the high base owed to the specifics of construction statistics.
    - Russian financial market risks remained lower than in the fourth quarter of 2018, thanks to the generally favorable situation in global financial markets, including the oil market. The emerging market developments and sanction risks remain the predominant factors for the Russian financial market.

2. Outlook

The leading economic activity indicators signal that the Russian economy's growth is slower than potential in the first half of 2019. At the same time, it appears from the indicators that economic growth will gain pace in line with potential beginning the third quarter of 2019.

- Analysts have lowered their 2019 inflation forecast and are still confident that inflation will decelerate to 4% in 2020. The moderate rate of price increases at the start of the year has also affected analysts' key interest rate expectations: most of them are no longer expecting the rate to be raised.

1. MONTHLY SUMMARY

1.1. Inflation

Annual inflation had temporarily risen to 5.2% by March, driven primarily by one-off factors. The effect of VAT on consumer price increases remained moderate. At the same time, there emerged the effect of transient factors restraining price rises, such as ruble strengthening, motor fuel price stabilization and a fall in prices of some food items.

This brought down short-term pro-inflationary risks. The increase in the consumer price index's most stable components that are only weakly sensitive to temporary factors are in line with an inflation rate of 4%. Inflation may come in at 5.5% or just below this level in March–April.

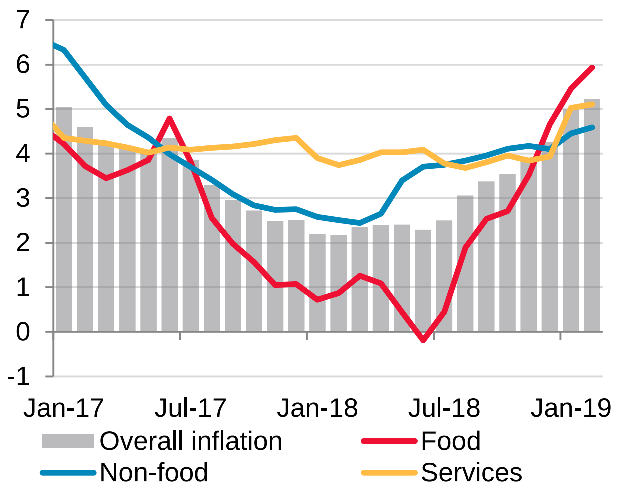
On the medium-term horizon, pro-inflationary risks prevail over disinflationary ones. Among the key pro-inflationary risks are geopolitical factors and volatility surges in financial markets, the upward pressure on prices of the accelerating consumer lending growth, secondary effects arising from higher business and household inflation expectations, increasing workforce shortages in the labor market, possible emergence of a positive output gap on the back of the fiscal maneuver.

1.1.1. One-off factors start restraining price rises

- Annual inflation rose to 5.22% in February from 4.99% in January. Inflation acceleration stems from the low rate of price rises at the start of 2018 and partly from the VAT hike as of January 1, 2019.
- Prices climbed 0.44% MoM in February, or 0.35% MoM in seasonally adjusted terms, down from 0.77% MoM in January, which is roughly equivalent to 4% in annualized terms.
- Stabilization of the pace of price rises in some food markets, the fall in oil product prices, and ruble stabilization are likely partially offsetting the effect of the VAT hike.
- The median household inflation expectations went down in February as perceived inflation rose. Household long-term inflation expectations also improved marginally.

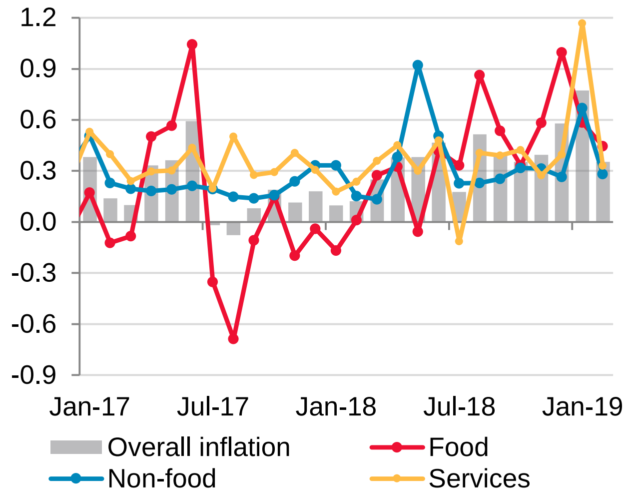
According to Rosstat data, inflation stood at 5.22% in February, accelerating from 4.99% in January (Figure 1). Price rise acceleration in annual terms was expected because of last year's low base: the consumer market saw reduced inflationary pressure at the start of 2018. Food price hikes were the fastest at 5.93% in February compared with 5.46% in January, in large part driven by fruit and vegetable price rise acceleration. The heftiest input to the increase in fruit and vegetable prices came from the "compensatory" tomato and cucumber price movements. Their prices rose more slowly than normal seasonal effects implied in the autumn of 2018. Inflation went up just marginally in the nonfood and services markets.

Figure 1. Inflation and its components, % YoY



Source: Rosstat.

Figure 2. Seasonally adjusted price rises, % MoM



Source: Rosstat, Bank of Russia estimates.

Consumer price rises stood at 0.44% MoM in February, or 0.35% MoM in seasonally adjusted terms (Figure 2). February's price movements were on a path suggesting an inflation rate of 4% (Figure 3). This, however, does not mean that the VAT hike had a zero effect on February's price rises. Price increases in detergents and cleaning solutions, perfumes and cosmetics, haberdashery items, furniture, electrical appliances, and construction materials stood in the range of 0.4%–0.7% MoM in seasonally adjusted terms, indicating that the effect of the VAT hike on prices had not petered out yet. The contribution of the tax rate increase is likely to have been offset by the restraining effect of other temporary factors.

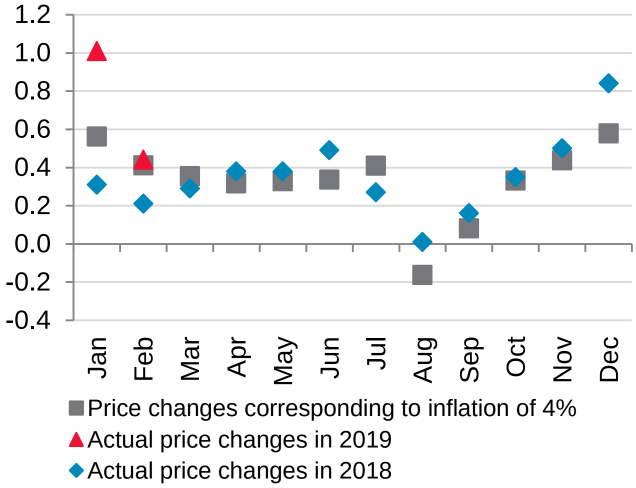
Price stabilization in some food markets had a disinflationary effect on consumer price movements in February. Meat and poultry prices declined 0.41% MoM in seasonally adjusted terms, chicken egg prices saw an even steeper drop of 2.17% MoM, while sugar price increases slowed. The price rise slowdown or decline in the prices of these food items seem to be an adjustment after a period of accelerated price rises in the second half of 2018. Regarding one-off effects in the food market, alcohol prices are noteworthy: they did not change in February after their 0.64% MoM rise in January, triggered by the VAT hike.

Ruble strengthening at the start of the year is another likely factor restraining consumer price rises. The CPI components highly sensitive to exchange rate movements include audio visual goods, whose prices dropped 0.78% MoM in February. Should the ruble exchange rate be stable further on, this will slow price rises in other nonfood goods. Other temporary favorable factors include a petrol price drop following in the footsteps of wholesale oil product prices.

Seasonally adjusted services price increases slowed to 0.33% MoM after a 1.17% MoM rise in January. This price performance suggests that the services market responded to the

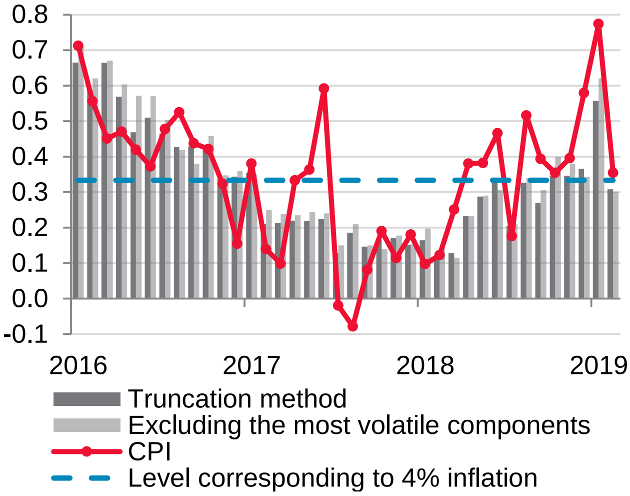
VAT increase much faster than the goods market: virtually all of the effect materialized in January.

Figure 3. Price rises corresponding to an inflation rate of 4 percent, % MoM



Source: Rosstat, R&F Department estimates.

Figure 4. Modified core inflation indicators, % MoM



Source: Rosstat, R&F Department estimates.

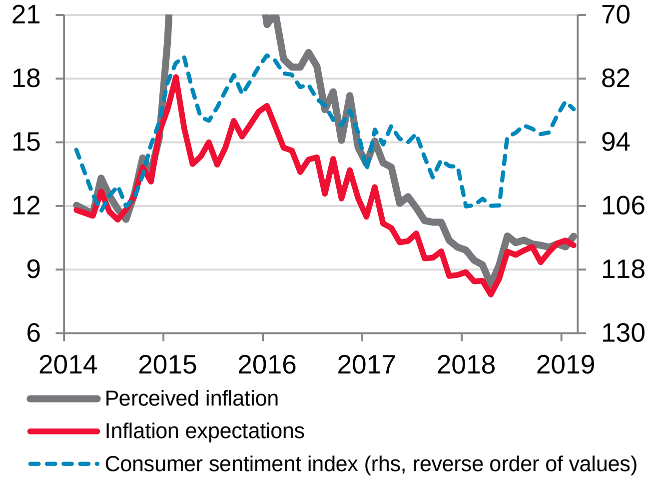
The estimates of modified core inflation indicators fell to 0.3% MoM in February after their one-off increase to 0.6% MoM in January (Figure 4), suggesting that the effect of the VAT hike largely materialized in January. That said, the drop of modified core inflation indicators below 4% in annualized terms further bears out the assumption about the relevance of temporary factors which restrained consumer prices in February.

Based on the data of inFOM survey conducted on February 4–14, household inflation expectations over a one-year horizon declined to 10.1%, down from 10.4% in January, after their rise in November–December, associated mainly with the VAT rate increase (Figure 5). By contrast, the perceived inflation estimate went up to 10.6% from 10.1% in January. The estimate of future inflation therefore again went below perceived inflation, meaning that the respondents expect inflation to decelerate from its current level going forward.

The VAT and petrol price cited as the factors behind price rises in the near future decreased in the frequency of occurrence. At the start of February, the respondents referred to the fast rate of price increases in housing and utilities services, food, and medications.

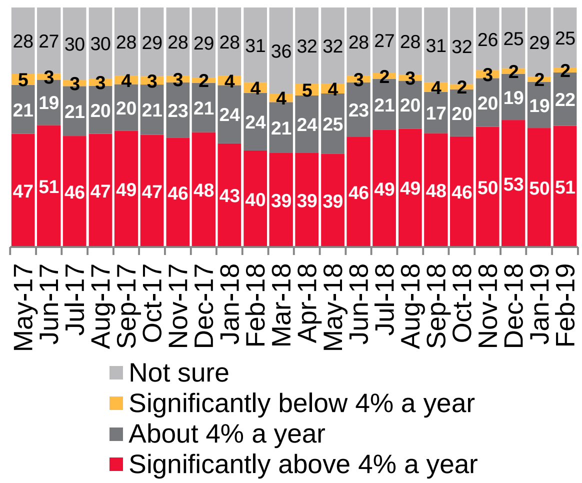
Long-term household inflation expectations declined marginally from their January level: the share of respondents who believe that annual price rises will stand at 4% in three years' time equaled 22%, its highest reading since June 2018. (Figure 6). Inflation expectations remain elevated relative to their level last year. This suggests the continuation of medium-term pro-inflationary risks arising from the secondary effects of the VAT increase and other one-off factors which pushed inflation expectations up in the second half of 2018. To contain them, a certain tightness of monetary stance is required.

Figure 5. Median estimates of perceived inflation and household inflation expectations, % YoY



Source: inFOM.

Figure 6. Inflation expectations over a three-year horizon[1]



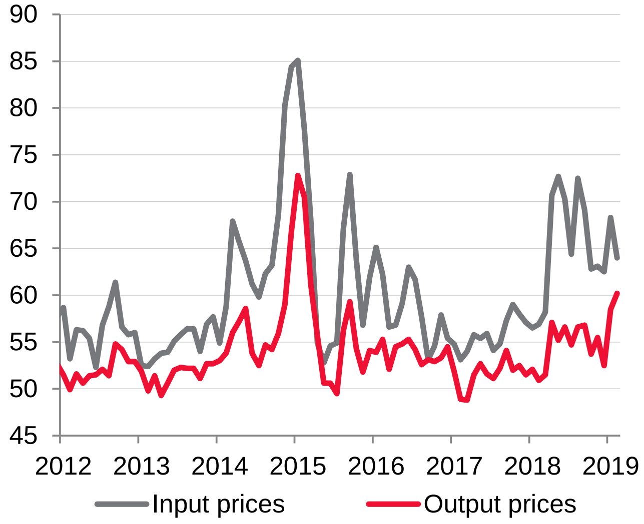
Source: inFOM.

1.1.2. PMI price indexes: the pass-through of the VAT hike to prices continues

- The performance of the PMI price indexes suggests that the pass-through of the VAT rate hike to producers' output prices is continuing in manufacturing and services.
- In manufacturing, the output price index posted its highest reading since March 2015. In services, the relevant index declined marginally but stayed on a level signaling elevated inflationary pressure.
- The current accelerated price increase is temporary. The price indexes are set to decline in the months ahead unless new cost-side shocks emerge.
- The pass-through of the VAT increase to producer prices so far does not have a significant impact on consumer prices. As we have noted previously, its eventual effect on inflation will be close to the lower bound of the initial estimate range and spread over time. Also, we cannot rule out that other one-off factors are now containing price rises, which can be viewed as a weak effect of VAT.

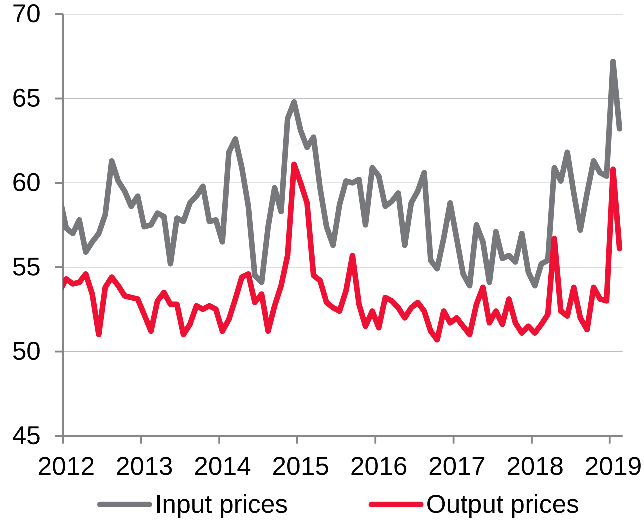
[1] Distribution of answers to the question "Do you think annual inflation will stand above or below 4% in three years' time? Or will it stand at about 4% annually?"

Figure 7. Manufacturing PMI price indices



Source: IHS Markit.

Figure 8. Services PMI price indices



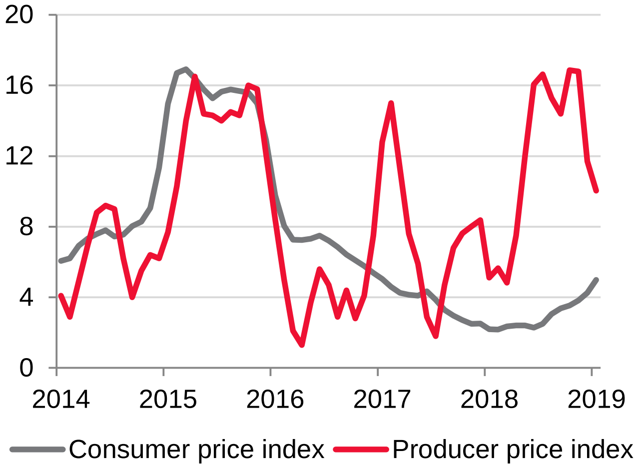
Source: IHS Markit.

1.1.3. Slowing rises in producer prices of consumer goods

- The annual rate of producer price increases stood at 9.5% in January, down from 11.7% in December and 16.8% in November (Figure 9). Among the key types of economic activity, a dramatic slowdown of price rises was recorded in the extraction of natural resources. The key factor behind this was the declining pace of domestic oil price rises, which shadowed world oil prices.
- Prices of some oil products fell notably over January. In particular, the petrol price dropped 19.1% MoM to the levels of February–March 2018, while the diesel price went down 9.2% MoM to roughly equal the September 2018 level. The seasonal drop in demand in the environment of a supply glut in the domestic market is having a restraining effect on oil product producer prices.
- The annual rate of producer price rises in consumer goods slowed 0.5 pps (Figure 10). Rosstat does not include VAT in its calculation of producer price changes. Accordingly, customers, who pay for manufactured products at a price including VAT, may have faced an additional 1.7 pps price increase[2] in January. The slowing pace of producer price rises provides a further argument that producers are sacrificing their profits to extend the period of final price adjustment to the VAT hike. A notable improvement in retailers' 2018 financial results suggests that they have sufficient reserves to afford this.

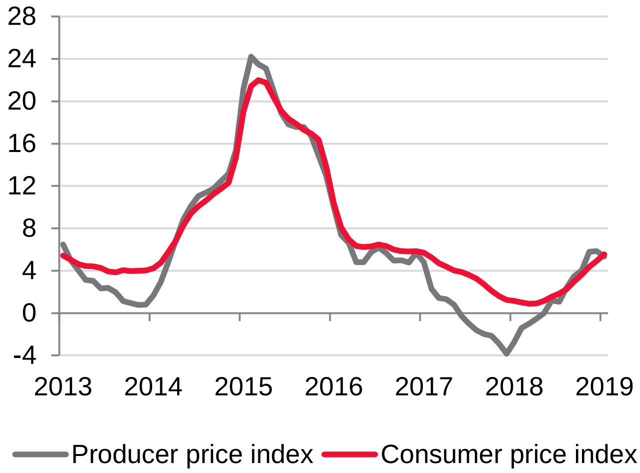
[2] The net effect of the VAT increase from 18% to 20% with the price net of VAT remaining the same.

Figure 9. Producer price and consumer price indexes, % YoY



Source: Rosstat.

Figure 10. Price changes in some goods , % YoY



Source: Rosstat, R&F Department estimates.

1.2. Economic performance

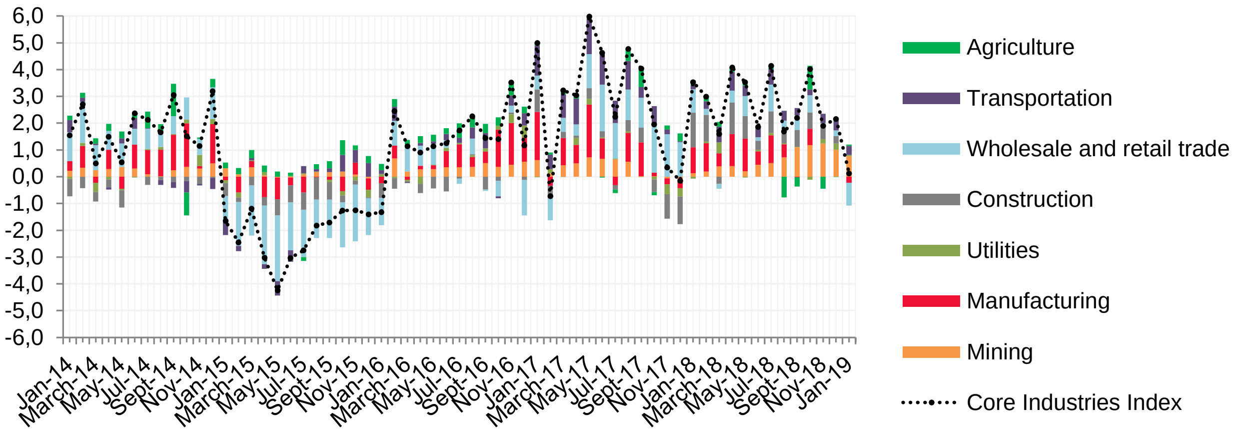
Russia's economic growth is continuing but at a rate below potential. Short-term negative factors, such as the global economy's slowdown, the VAT increase, and inflation acceleration, will likely keep growth sluggish in the first half of 2019. This will also be owed to the high base effect arising from the specifics of construction statistics. As the negative factors run their course and budget expenses are stepped up, economic growth will accelerate in the second half of the year, unless major new external shocks emerge.

1.2.1. The Core Industries Index slowed its climb in January

- The annual pace of the Core Industries' Output Index rise expectedly slowed to 0.1% in January from 2.2% in December due to the high base of 2018, the effect of the VAT increase, and implementation of the OPEC+ deal to cut oil production. The performance of the Core Industries Index suggests a high likelihood of annual GDP growth weakening in the first quarter.
- A negative contribution to the CII came from retail trade and manufacturing.
- Growth slowed in the extractive sector, retail, the construction and transportation industries.
- The agricultural sector for the first time in several months posted a minor output expansion, driven by livestock production.

The annual rise in the Core Industries' Output index[3] (CII) stalled to 100.1% from 102.2% a month earlier, posting the slowest growth rate since the end of 2017 (Figure 11). All the core industries except for agriculture showed a worse index performance, owed to, among other things, the high base of last year (in manufacturing and construction).

Figure 11. Contribution of industries to the Core Industries Output Index in 2014–2019, % YoY



Source: Rosstat, R&F Department estimates.

Trade made the largest negative input to the CII performance in January, due to a 6.2% YoY fall in wholesale trade. Wholesale trade is an intermediate link between the producers of goods and retailers/final consumers of goods, hence its performance is closely related to that of the above sectors. In January, wholesale trade was dragged down by a 1.0% YoY output drop in *manufacturing,* the weakening of growth in *the extractive sector* to 4.8% YoY from 6.3% YoY and retail sales to 1.6% YoY from 2.3%, respectively, in December 2018.

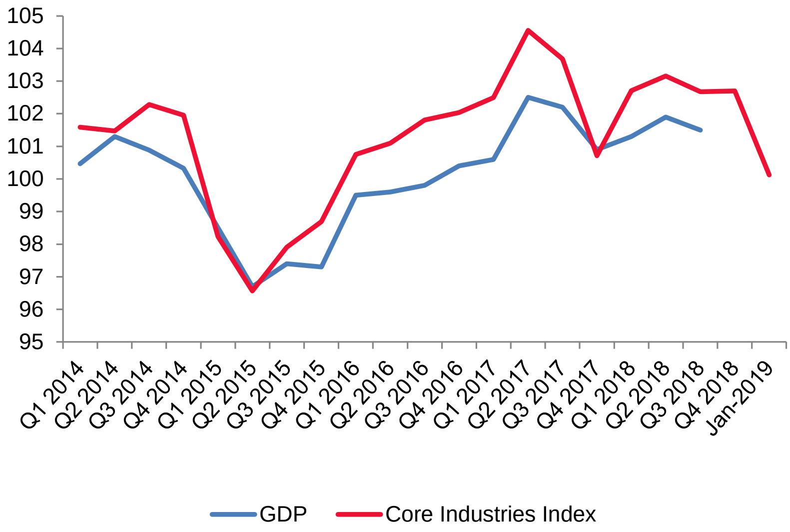
January's retail sales were adversely affected by a fall in demand for nonfood goods to 1.2% YoY from 2.3% YoY a month earlier, whereas food sales expansion, by contrast, posted a minor acceleration to 2.1% from 1.8% in December. Nonfood sales growth easing was driven by the VAT hike: demand for durable goods rose at an accelerated pace ahead of the tax rate increase from 18% to 20%.

Growth all but came to a stop in *the construction industry* in January, with construction works posting a token YoY increase of 0.1%. This stemmed from the high base of last year, which saw an output rise of 12.2% YoY in January.[4] The continued housing construction drop is also noteworthy. Housing delivery contracted 16.8% YoY in January, also driven by the high base of early 2018: Housing delivery expanded 19.6% YoY in the first quarter of 2018 but dropped 4.9% for the full year 2018. The pace of housing delivery at the start of a year is not indicative of full-year numbers, as the major proportion of housing is commissioned in the second half of the year.

[3] The Core Industries Index is calculated by aggregating seven industry indexes (agricultural output, the extractive sector, freight traffic, manufacturing output, wholesale and retail trade, utilities, and construction with weights corresponding to the share of particular industry in Russia's gross value added in 2016.

[4] Rosstat has revised construction output up, with the first quarter of 2018 accounting for most of the revision.

Figure 12. Quarterly index of GDP in physical terms and Core Industries Output Index, % YoY



Source: Rosstat, R&F Department estimates.

The transportation industry posted a marginal growth slowdown to 2.4% YoY in January from 3.2% YoY in December. Freight traffic expanded in all transport sectors, except for air cargo transport. Railways, as usual, accounted for the largest, 45%, share of freight traffic, which rose 2.3% YoY in this sector. The fastest growth rates were recorded in the haulage of coal (up 5.2% YoY), iron ore (a 7.5% YoY increase), timber freight (6.0% YoY), chemical and mineral fertilizers (2.0% YoY). Exports represented the bulk of freight traffic. Given a drop in export orders indicated by purchasing managers' surveys, growth in export freight traffic may weaken in the months ahead (see Subsection 1.2.3. February's PMI: activity stabilization in manufacturing, acceleration in services).

Agricultural output rose marginally by 0.7% YoY after falling for most of the second half of 2018. Livestock products account for the bulk of this sector's output in winter months: milk production, which expanded 2.0% YoY, was growth driver in January. The meat segment recorded an overall output drop of 0.4% YoY, driven by a poultry production contraction (by 3.8% YoY in agricultural organizations). The high market saturation in previous years had toughened competition, driving down businesses' profit margins. As a result, a number of major poultry factories reduced their output in 2018. This also affected egg output, which fell 0.4% YoY in January.

1.2.2. Oil production drop hampers industrial output growth

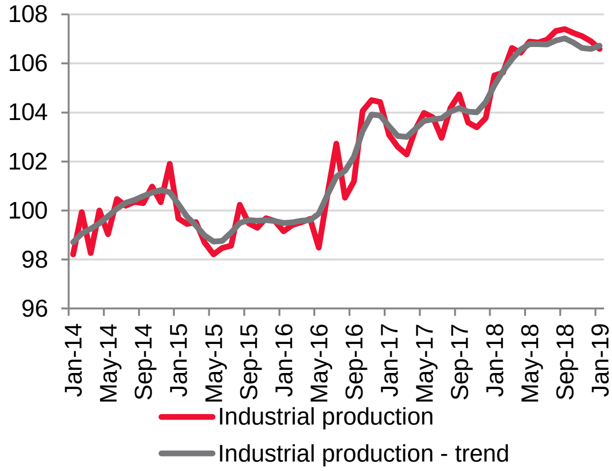
- Based on Rosstat estimates, industrial output growth slowed to 1.1% YoY from 2.0% YoY in December. Research and Forecasting Department estimates indicate an output contraction of 0.3% MoM in seasonally adjusted terms relative to December.
- The key factor behind January's industrial output drop was a 0.3% MoM fall in the production of natural resources on the back of the new OPEC+ agreement.

- The manufacturing sector recorded a seasonally adjusted output expansion of 0.1% MoM for the second consecutive month.
- The manufacturing sector's growth is restrained by output contraction in industries meeting investment demand. Exclusive of them, output growth accelerated from 0.1% MoM in December to 0.4% MoM in January in seasonally adjusted terms.
- The performance of industries meeting investment demand was most of all dragged down by air and spacecraft vehicle production, but the other industries also posted a notable output contraction.

Annual industrial output growth slowed to 1.1% YoY in January from 2.0% YoY in December, recording its slowest rate since December 2017. According to Research and Forecasting Department estimates, industrial output dropped 0.3% MoM relative to December 2018 in seasonally adjusted terms.

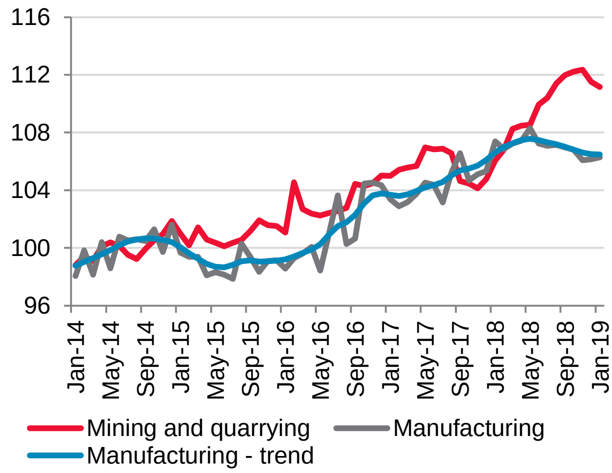
The key factor behind January's industrial output fall was a 0.3% MoM[5] drop in natural resources extraction. This was also reflected in a decline of annual expansion in mining and quarrying from 7.8% YoY in November to 4.8% YoY in January. Under the new OPEC+ agreement, Russia started to cut its oil production. We estimate that Russia's oil production is set to drop 2% from the October 2018 level. In January 2019, extraction fell 0.35% from the October level, suggesting that the extraction decline will continue in the coming months, hamper overall economic growth. We estimate that, given the share of extraction in Russia's value added, the implementation of the OPEC+ agreement may cause economic growth to slow 0.1–0.2 pps in the first half of 2019.

Figure 13. Industrial output index (seasonally adjusted, 2014 = 100)



Source: Rosstat: R&F Department estimates

Figure 14. Production in mining and quarrying; in manufacturing(seasonal adjusted, 2014 = 100)



Source: Rosstat: R&F Department estimates

The manufacturing sector showed signs of monthly output stabilization in seasonally adjusted terms. Following its drop in the autumn of 2018, the sector's output posted a minor

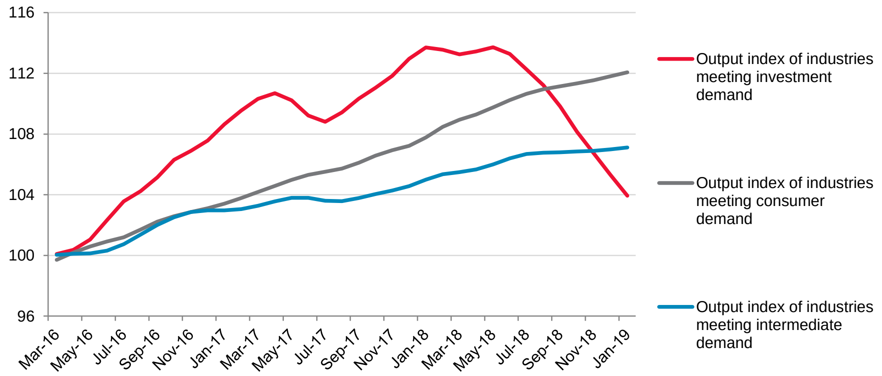
[5] Seasonally adjusted.

output expansion of 0.1% MoM. But in annual terms, manufacturing output dropped 1% YoY due to last year's high base.

The manufacturing sector's weak growth stems primarily from the continued negative trend in industries meeting investment demand (Figure 15). A notable output decline in industries meeting investment demand along with a fall in investment goods imports in the second half of 2018, provide indirect evidence of investment contraction.

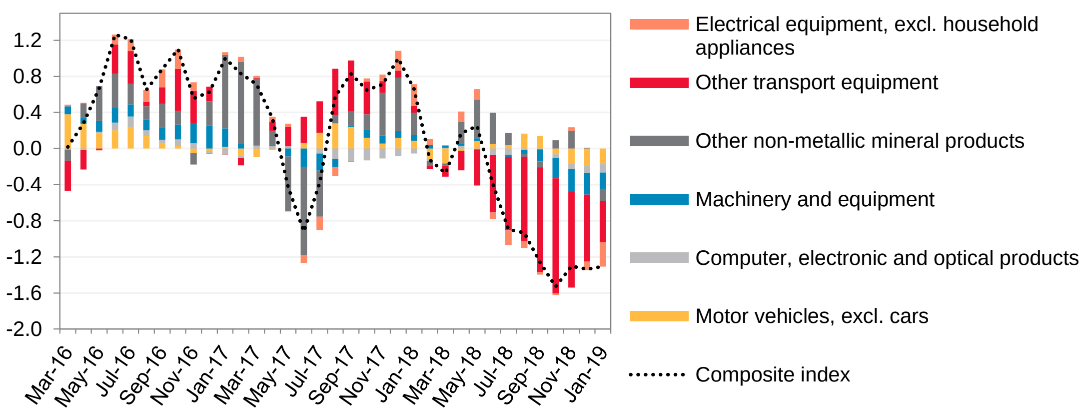
All industries meeting investment demand saw an output decline in January (Figure 16). As in the previous months, the largest negative contribution came from the production of other transport equipment (down 6% MoM), with the output of air and spacecraft vehicles plunging 75.4% YoY. Net of this segment's results, a fall in the production of investment goods was still substantial at -3.5% MoM. The production of electrical and electronic equipment also recorded a major output fall of 19% MoM and 13% MoM, respectively. Still, the decline in the manufacture of other transport equipment slowed in January, driven by the recovery of railway locomotives and rolling stock production (up 15% MoM) after its slump over the last months of 2018.

Figure 15. Trend component of output indexes for groups of manufacturing sector industries, January 2016=100%



Source: Rosstat, R&F Department estimates

Figure 16. Output index of manufacturing sector industries meeting investment demand (trend), % MoM



Calculation used weights based on gross value added of 2010
Source: Rosstat, R&D Department estimates

Manufacturing is still enjoying support from industries meeting consumer and intermediate demand. Its growth drivers are the manufacture of food products (up 0.2% MoM and pharmaceuticals (an increase of 3.3% MoM) driven by the expansion of production facilities.

Upwards trends are continuing in the woodworking and paper industries. The basic metals industry' overall output remains volatile but the production of steel and primary aluminum is enjoying an upward trend.

1.2.3. February's PMI: activity stabilizes in manufacturing, accelerates in services

- The Composite PMI Index edged up from 53.6 to 54.1 in February, signaling a minor business activity recovery compared with January. The R&F Department News-based Business Activity Index also showed an activity expansion, albeit more modest. (Figure 17).
- As in many countries, February saw mixed performance of indexes across sectors: growth weakened in manufacturing and gained momentum in services (Figure 18).

Figure 17. Composite PMI Index and the News-based Index

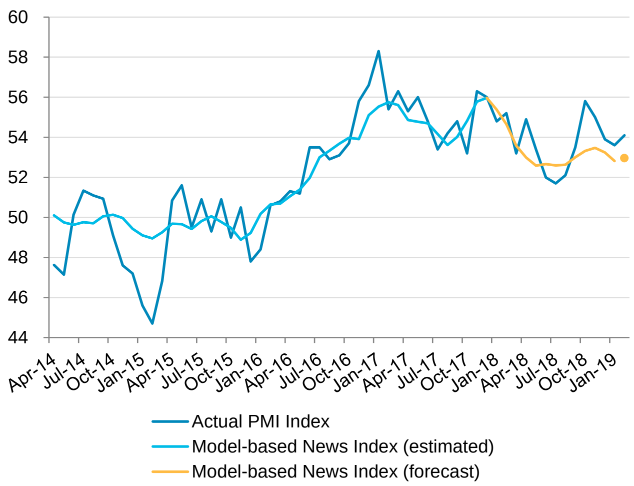
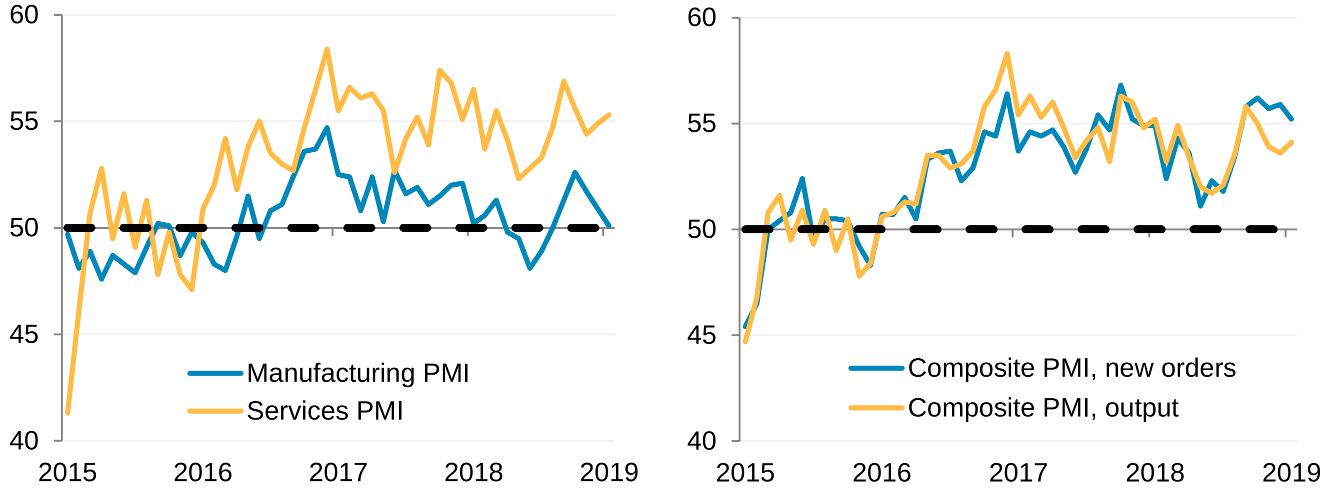


Figure 18. PMI indices



Source: IHS Markit, R&F Department estimates.

- February's output growth inched up in manufacturing, with the index rising from 50.1 to 50.5, while new orders expansion dropped notably from 53.2 to 51.0, the lowest reading of the index since September 2018.
- In addition to domestic demand weakening in manufacturing, the respondents indicated a drop in external demand for the second consecutive month: the Export Orders Index declined from 49 to 47.3 in January. This stems from the global economy's general slowdown: the Export Orders Subindex of the Global PMI Manufacturing is in negative territory (below 50) for sixth month running.
- In services, companies' business activities gained momentum in February, coming close to the levels of the start of last year. Unlike manufacturing, new orders growth has been stable over the last five months, staying above the average 2016–2018 level. Export orders expansion also continues, but at a slower pace, which, as in manufacturing, may be owed to the global economy's slowdown.
- The survey data indicates an improvement in output expectations, suggesting a transient nature of business activity slackening.

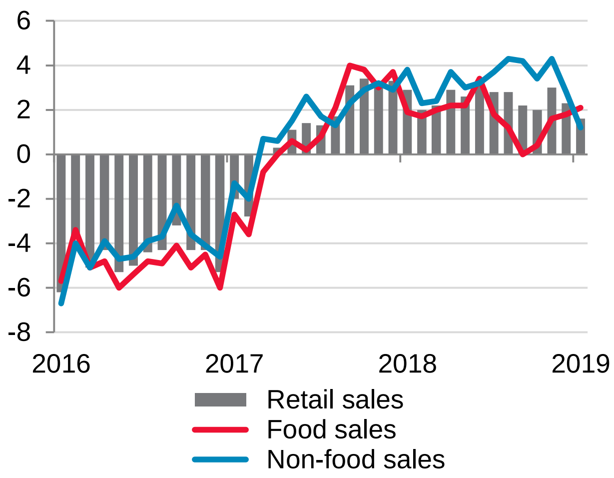
1.2.4. Non-food sales decline as food sales expand

- Annual retail sales growth continued softening in January, due to a slowed expansion in non-food sales. Food sales rise is meanwhile accelerating, despite outpacing food price growth.
- The monthly seasonally adjusted numbers show a decline in non-food sales and food sales growth. Overall retail sales meanwhile contract slowly.

- The slowing pace of wage growth and expected weakening of consumer lending expansion are set to hamper further retail sales rise.

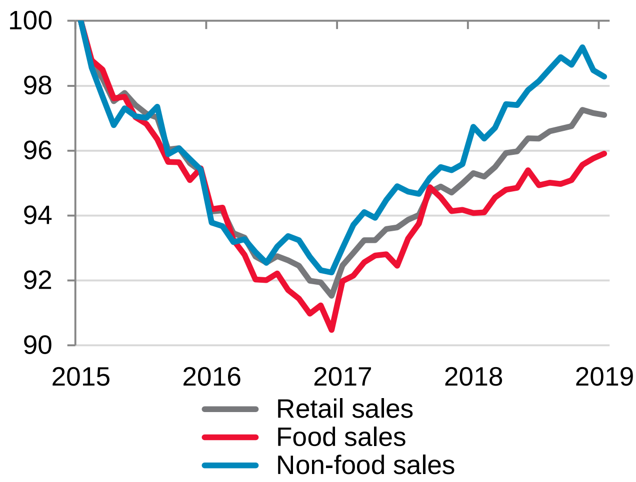
Based on Rosstat data, retail sales growth slowed to 1.6% YoY in January from 2.3% YoY in December, dropping to its lowest rate since August 2017 (Figure 19). Our estimate, adjusted for seasonal and calendar factors, suggests that retail sales contracted 0.1% MoM in both January and December (Figure 20).

Figure 19. Retail sales of food and non-food goods and overall retail sales, % YoY



Source: Rosstat.

Figure 20. Retail sales, % (January 2015 = 100%, seasonally adjusted)



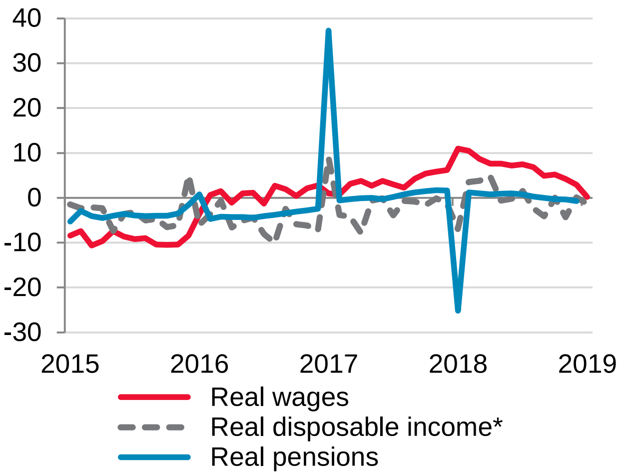
Source: Rosstat, R&F Department estimates.

Non-food sales dropped 0.2% MoM in January versus 0.7% MoM in December.[6] Annual growth slowed to 1.2% YoY from 2.8% in December. Food sales meanwhile grew 0.2% MoM in January, at the same rate in December. Their YoY expansion inched up to 2.1% from 1.8% in December. The past two months have seen a non-food sales decline and food sales growth, with the overall retail sales remaining practically unchanged (Figure 20). It is not unlikely that in the wake of a faster growth in the sales of durable goods with the VAT hike forthcoming and consumer lending expanding, households changed their consumption model slightly in favor of foodstuffs, cutting down on the purchases of non-food goods. That said, food price rises over the last several months were much steeper than those of non-food goods, so in nominal terms, the change in favor of food was even more notable.

Real wage growth all but came to a halt, standing at 0.2% YoY (Figure 21). The wage trend will likely continue worsening at the start of this year, restraining an overall rise in consumer demand. The expected weakening of consumer lending expansion may contain demand for non-food goods. The trend and structure of demand may hamper retailers' ability to pass the VAT hike through to final prices, especially those of goods featuring high elasticity of demand.

[6] Here and henceforth in this subsection, monthly growth rates are seasonally adjusted.

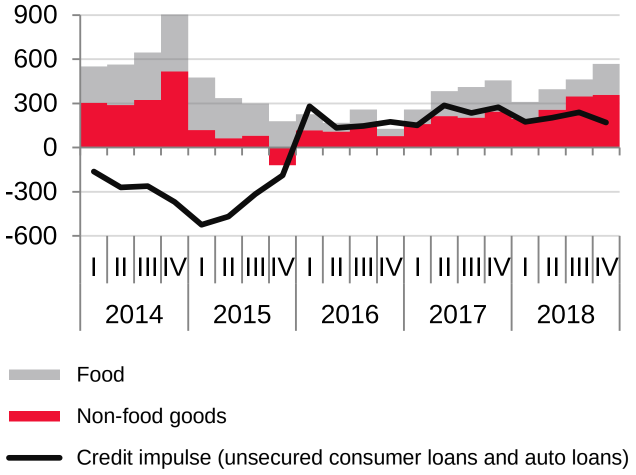
Figure 21. Real household income, % YoY



Source: Rosstat, R&F Department estimates.

** Computed under the previous methodology including the one-off payment in January 2017.*

Figure 22. Retail sales growth and the credit impulse, billion rubles, YoY



Source: Rosstat, R&F Department estimates.

Lending was an important source of financing consumption in the previous three years (Figure 22). The pace of retail lending growth will likely be slower in 2019 than in 2018, hence retail lending will no longer help consumption expansion, with retail sales growth losing momentum. The fact is that, other things being equal, consumption growth through lending only occurs if lending growth keeps accelerating (the positive credit impulse).[7] If lending growth stabilizes or slows, the contribution of lending to a consumption rise will be close to zero or even negative.

1.2.5. Nominal wage growth will marginally outpace inflation in 2019

- The seasonally adjusted unemployment rate estimate hit a low of 4.7% in January 2019.
- We estimate that a nominal public sector wage rise will stand at just 1.5% in 2019 because of the wage indexation deferral until the second half of the year. The overall real wage growth in Russia's economy may therefore come in just above zero in 2019.
- A near-zero real wage growth and the expected weakening of consumer lending expansion are set to restrain a consumer demand rise.

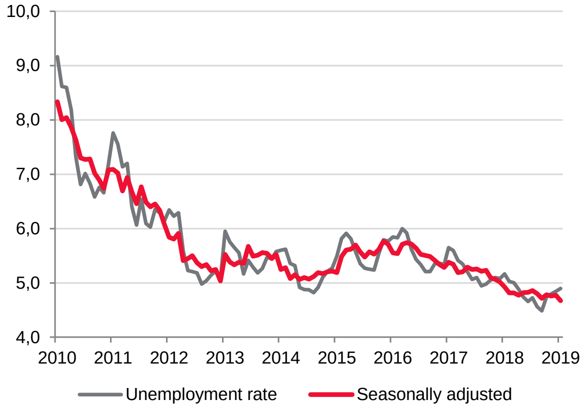
According to a Rosstat estimate, the unemployment rate rose to 4.9% in January 2019, driven by seasonal effects, after staying at 4.8% in the previous three months. Adjusted for

[7] The credit impulse is a change in lending expansion in absolute terms (the second-order derivative of lending dynamics).

the seasonal component, the unemployment rate hit a low of 4.67% in January versus 4.77% in December (Figure 23).

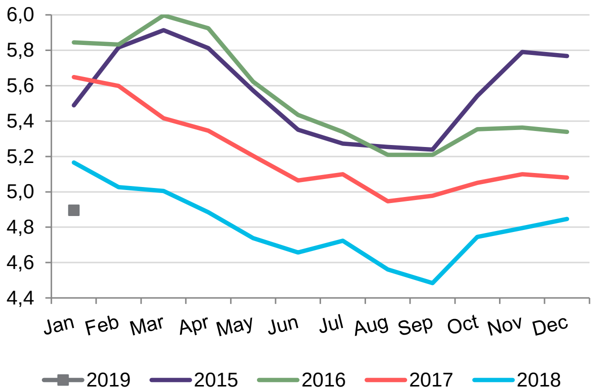
Both number of employed and unemployed people went down in January. The number of unemployed dropped to the lowest level of 3,531 thousand in seasonally adjusted terms, 103 thousand fewer than in the previous month. This trend signals a continued labor force contraction.

Figure 23. Unemployment rate, %



Source: Rosstat.

Figure 24. Unemployment rate over years, %



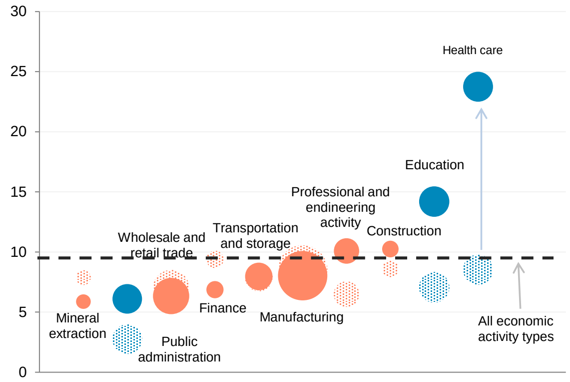
Source: Rosstat.

December 2018 wage growth has been revised up by 0.4% pps. Based on the updated estimate, nominal wages rose 7.3% YoY, while real wages increased 2.9% YoY in December last year. The average accrued monthly wages went up 9.9% over 2018. Public sector wages added 14.7%, wages in the private sector climbed 7.9%. The highest rate of wage growth was seen in health care in 2018 (Figure 25), wage hikes slowed in the extractive, financial and insurance sectors.

According to a preliminary estimate, nominal wages rose 5.2% YoY in January. Real wage increases slowed to 0.2% YoY, the lowest growth rate since 2016.

Public sector nominal wage growth will be close to zero over the first two quarters of 2019, as the indexation of public sector wages has been postponed until the second half of the year. Under the 2019–2021 federal budget, the salaries of doctors and other health care employees, school teachers and university faculty members, scientists, and cultural workers are planned to be raised on September 1, 2019, by an average of 6.1%. Other public sector employees' wages are to be raised by 4.3% on October 1, 2019. Given the planned indexation schedule and magnitude, we estimate public sector wage growth at 1.5% YoY for 2019.

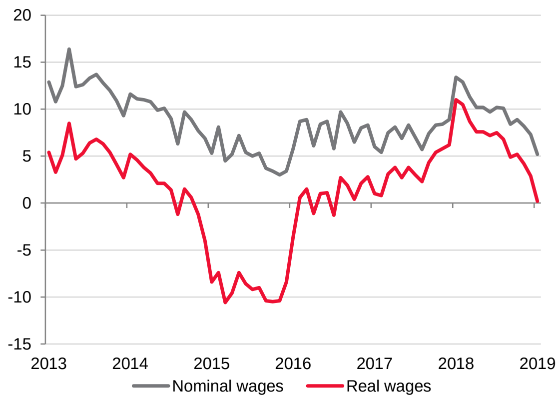
Figure 25. Nominal wage growth by industry, % YoY



Source: Rosstat.

Note: full filled circle – 2018, partially filled circle – 2017. Circle size corresponds to the share of the economic activity type in the total payroll fund

Figure 26. Wage growth rate, % YoY



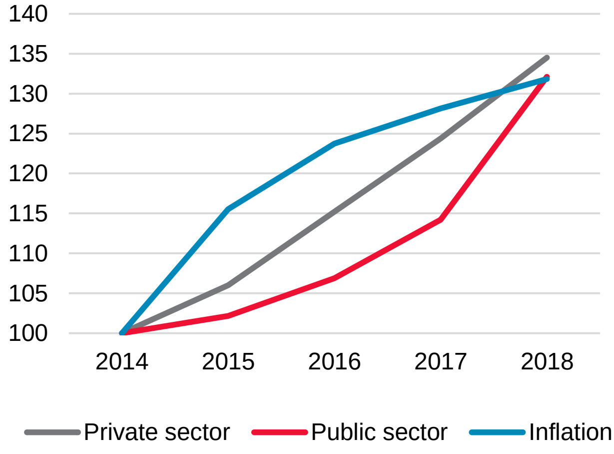
Source: Rosstat.

Private sector nominal wages rose at an annual rate of about 8% in 2017–2018, with average inflation standing at 3.6% in 2017 and 2.9% in 2018. Some companies' stated rationale for the accelerated wage indexation in the environment of low inflation was their willingness to make up for the real wage decline in 2015 and 2016 driven by inflation acceleration. Private sector's wage growth accumulated since 2014 "caught up with" the accumulated price rises (Figure 27). Given this circumstance, private sector wages may be indexed at a lower rate in 2019 than in 2017–2018.

Based on our estimate, private sector nominal wage growth stood just below 7% YoY[8] in January, which is comparable with the wage growth rate in the fourth quarter of 2018. Should private sector wage hikes continue at the same rate till the year end, overall growth[9] of accrued wages will stand at just about 5.5% in nominal terms and just above zero in real terms for the full-year 2019. The expected slowdown of consumer lending expansion and the low rate of real wage growth will restrain a consumer demand rise in 2019.

[8] Assuming a near-zero public sector wage growth in January.
[9] Including the public sector.

Figure 27. Nominal wage growth and inflation, %
(2014 = 100%)



Source: Rosstat, R&F Department estimates.

1.2.6. Retail lending expansion gradually loses momentum

- January 2019 saw retail lending growth decline from its record-high monthly rates of November–December 2018, adjusted for debt on loans covering mortgage-backed securities issuance.
- Retail lending slowdown is driven by mortgage and auto loans. Unsecured consumer loans so far do not show clear signs of monthly growth softening in seasonally adjusted terms.

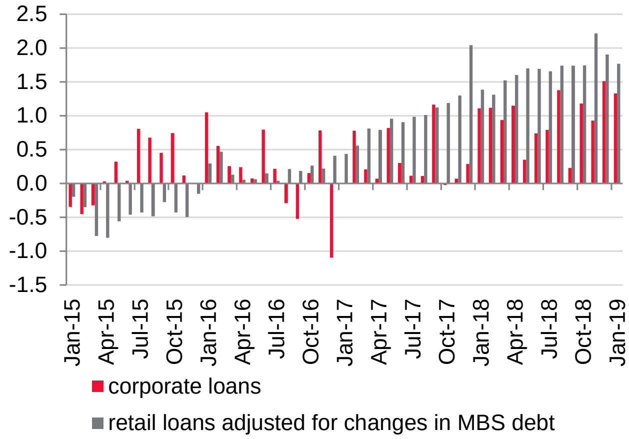
Ruble corporate loan lending growth slowed to 1.3% MoM in January from 1.5% MoM a month earlier[10] (Figure 28). Foreign currency corporate lending meanwhile continued to contract in January 2019. Corporate borrowers keep replacing foreign currency loans by ruble-denominated ones. Corporate lending numbers adjusted for seasonal factors and foreign exchange revaluation suggest a much more modest growth rate of 0.3% MoM. This roughly matches its average growth in 2018 and stands above the 2016–2017 level.

Retail ruble lending is exposed to heavy pressure from mortgage loan securitization transactions, which accounted for 6% of banks' mortgage loan portfolios at the end of 2018. Retail ruble loans suffered an especially heavy blow from major securitization transactions of mortgage lending leaders at the end of 2017 and 2018.[11] Data on changes in outstanding debt on mortgage loan principals covering mortgage-backed securities (MBS) suggests an

[10] Here and henceforth in Subsection 1.2.7. Retail lending expansion gradually loses momentum, monthly growth rates are seasonally adjusted unless otherwise stated.
[11] A 74.3 billion ruble MBS issue of 26.11.2018, government registration number 4-06-00307-R-002R; a 46.1 billion ruble MBS issue of 21.12.2018, government registration number 4-08-00307-R-002R; a 48.2 billion ruble MBS issue of 07.12.2017, government registration number 4-02-00307-R-002R.

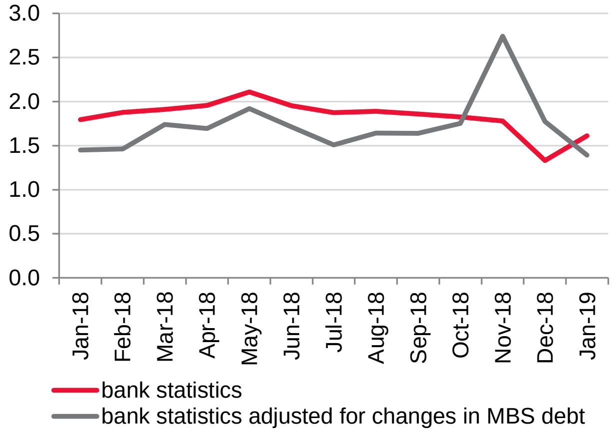
accelerated retail lending expansion in recent months (Figure 29). This may have stemmed from stepped up demand for loans in expectation of interest rate hikes. We note that January's lending expansion still outpaces average retail loan growth in 2018 somewhat, but it has been slowing in the last two months.

Figure 28. Ruble credit growth, % MoM (seasonally adjusted)



Source: Bank of Russia estimates.

Figure 29. Ruble mortgage lending, % MoM (seasonally adjusted)



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

The weakening of retail ruble lending growth was owed to a slowdown in mortgage lending expansion (to 1.4% from 1.8%, adjusted for changes in MBS debt) and auto loan growth deceleration (to 0.6% MoM from 1% MoM). We note that mortgage loans adjusted for debt on MBS showed slower growth rates throughout 2018 (excluding the months in which major securitization deals were carried out) than those based on an analysis of mortgage loan portfolios on banks' balance sheets. (Figure 29). This is due to accounting for refinanced loans. If a loan is refinanced and an old loan is repaid before maturity, MBS debt is reduced and a new loan emerges on a bank's balance sheet (a loan which covered MBS left a bank's balance sheet earlier). As a result, the rate of growth in outstanding household mortgage loans was lower than what followed from an analysis of bank statistics themselves.

Auto loan expansion slowdown was due to lower demand growth rates after the VAT increase, as well as the suspension of the subsidized government auto loan program supporting sales expansion in the automotive industry. The slowdown in this lending segment may become less dramatic after the resumption of the program as of March 1, 2019.

Unsecured loan expansion so far has not showed any major weakening, sticking to its December level but remaining below that of October–November. Still, we expect retail lending growth to slow further as consumer demand slackens, driven by the VAT rate increase, rising interest rates on some loan types and macroprudential measurers put in place by the Bank of Russia.

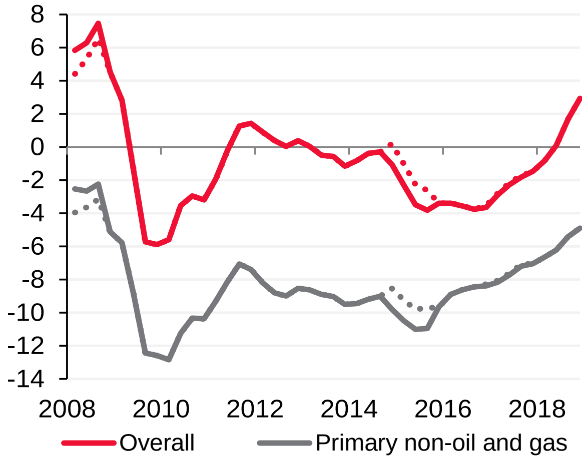
1.2.7. General government surplus hits a 10-year high

- The general government balance rose 4.4 pps in 2018 to reach 2.9% of GDP, the highest level since 2008. Russia's regions posted a budget surplus for the first time since 2012.
- Revenue to GDP added 2.3 pps, with oil and gas revenue climbing 2.2 pps and non-oil and gas revenue rising 0.1 pps. Without the continuing tax collection improvement, non-oil and gas revenue would have posted a decrease as a percentage of GDP in 2018.
- Expenditure rose 1.9 trillion rubles, while *expenditure to GDP* dropped 2.1 pps owing to budget consolidation. The contraction affected all expenditure areas.
- The solid surplus enabled the National Wealth Fund (NWF) to be expanded substantially and government debt to be reduced without relying on account balances. Net general government debt decreased 3.7 pps to 2.9% of GDP.
- The strong improvement in the general government balance contained GDP growth in 2018. This was partly due to budget consolidation and tax collection improvement, which ensured the sustainability of the general government balance. The main effect is owed to the fiscal rule smoothing out cyclical fluctuations of economic activity. Without the fiscal rule in place, the general government balance would have been much lower, resulting in a medium-term budget instability and overheating of the economy, fraught with a subsequent slump. The direct negative effect was partially offset by an indirect positive impact of improved expectations regarding the maintenance of macroeconomic stability on GDP growth.
- Large-scale national projects aiming to promote investment growth are to be launched in 2019. Since the financing of the projects as part of the fiscal maneuver will start towards the middle of the year, while the raised VAT rate came into effect in the first half of 2019, we expect a negative effect on GDP growth to emerge in the first half of 2019 and the effect below average for the full-year 2019. In subsequent years, the fiscal maneuver should have an increasingly positive effect on GDP growth.

Balance. Russia's general government balance came in at 2.9% of GDP for 2018**,** up 4.4 pps compared with 2017 (Figure 30). The change was about equally owed to revenue expansion and expenditure contraction in relation to GDP. The balance reached the highest level since 2008. Russia's regions posted a budget surplus for the first time since 2012, which resulted from both the underexecution of appropriated expenditure and higher than planned revenue. Regions rich in natural resources showed far better results than the others.

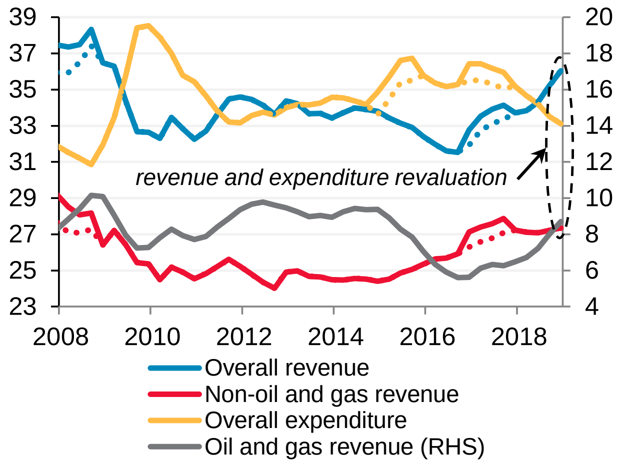
Revision in May 2019. The Russian Treasury will, as is customary, present a revised version of budgetary accounts in May. As in previous years, we expect both revenue and expenditure to be revised up substantially with the balance changed only marginally. The explanation is that data on employers' direct contributions to social insurance funds can be fully summed up only several months after the year end. We estimate that revenue and expenditure will increase by 0.4 pps of GDP. Further on in this Section, the data we provide takes into account our revaluation.

Figure 30. Overall and non-oil and gas general government primary balance, % of GDP



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

Figure 31. General government key indicators (% of GDP, 4-quarter moving averages)



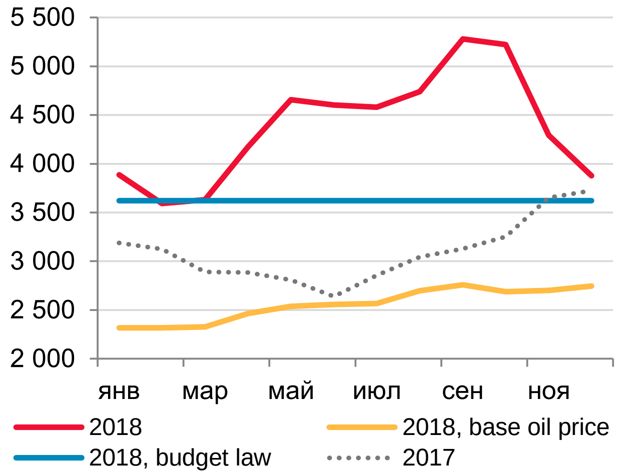
Source: Russian Treasury, RF Finance Ministry, Rosstat, R&F Department estimates.

** Dashed lines denote estimates excluding major one-off factors: revenues for YUKOS debt repayment in 2007, banks' recapitalization in 4Q 2014, expenditure for early repayment of defense sector loans and Rosneft privatization in 4Q 2016.*

Revenue. Revenue to GDP rose 2.3 pps to 36.0% in 2018 (Figure 31). Of this increase, oil and gas revenue accounted for 2.2 pps, thanks to a Urals oil price rise of 41% YoY in ruble and 31% YoY in dollar terms (Figure 32). The other 0.1 pps came from an increase in non-oil and gas revenue, with a profits tax revenue growth of 0.4 pps of GDP making a major contribution to it. We believe that this revenue growth and a rise in the VAT revenue are in part driven by a tax administration enhancement, which has provided an important support for the budget in recent years. Had tax collection not improved in recent years, non-oil and gas revenue would have shown a contraction as a percentage of GDP in 2018.

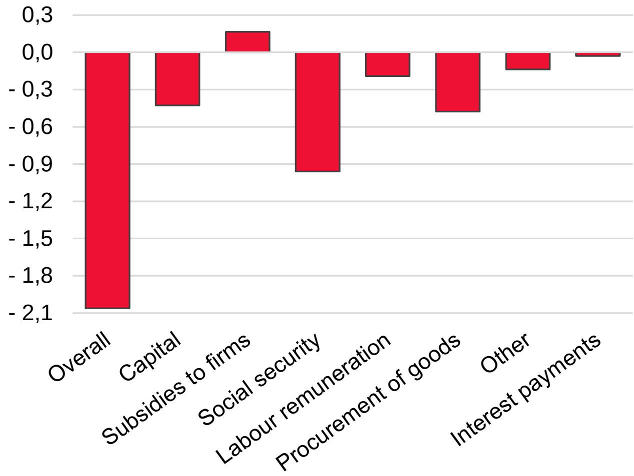
Expenditure. Expenditure climbed 1.9 trillion rubles relative to 2017, with *expenditure to GDP* decreasing 2.1 pps to 33.1% of GDP (Figure 31), driven by budget consolidation: i.e., bringing expenditure to a sustainable level. Based on functional classification, social spending went down 1.0 pps of GDP, defense and law enforcement expenditure contracted 0.5 pps of GDP, spending on the economy declined 0.4 pps of GDP. Under economic classification, purchases of goods and services were cut by 0.5 pps, capital expenditure decreased by 0.4 pps of GDP (Figure 33). Spending on government debt servicing decreased marginally as a percentage of GDP. The evenness of spending within 2018 all but matched that in 2017.

Figure 32. Monthly ruble price of Urals oil per bbl in 2017–2018



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

Figure 33. Change in general government expenditure under economic classification in 2018, pps of GDP, YoY



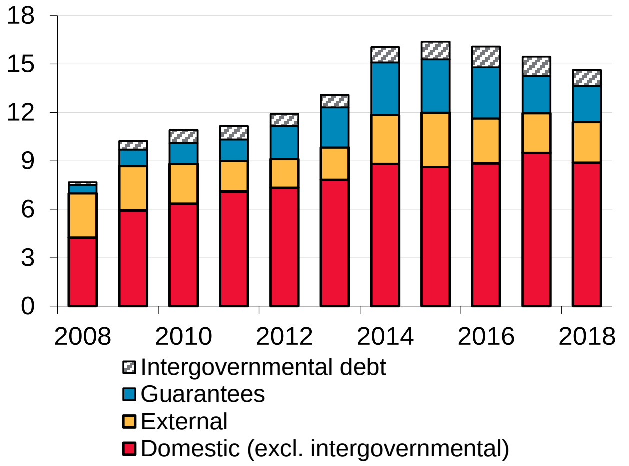
Source: Russian Treasury, RF Finance Ministry, Rosstat, R&F Department estimates.

Public debt, sovereign funds and account balances. Total government debt, excluding intergovernmental transfers, rose 0.3 pps to 13.6% of GDP in the fourth quarter of 2018. Of this increase, Russia’s regions accounted for 0.2 pps of GDP arising from replacing general government loans by bank loans. The other 0.1 pps came from the federal government, which issued 1 billion euros of seven-year bonds in November, thereby canceling out an internal debt reduction.

National Wealth Fund (NWF) remained unchanged at 7.9% of GDP in the fourth quarter: the use of 1.2 pps of GDP to finance the budget deficit under the old rules was compensated by a revenue increase under the new fiscal rule.

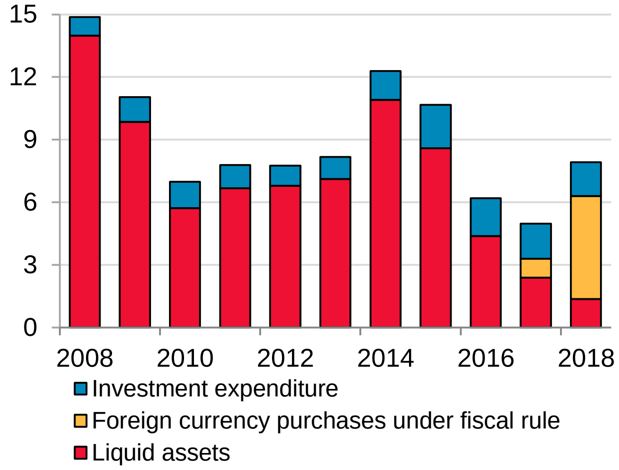
The strong surplus for the full-year 2018 helped enhance NWF revenue by 3.0 pps of GDP, reduce public debt by 0.6 pps of GDP (excluding intergovernmental transfers) without relying on budget account balances (which rose by 0.1 pps to 2.8% of GDP). General government net debt contracted 3.7 pps (adjusted for foreign exchange revaluation) to 2.9% of GDP as of 01.01.2019.

Figure 34. Structure of total general government debt, % of GDP



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

Figure 35. Structure of sovereign fundse, % of GDP



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

Effect on GDP growth. The strong budget revenue expansion along with expenditure, including capex, reduction were bound to have a significant negative effect on annual GDP growth in 2018. Estimates using fiscal multipliers indicate a negative effect of about 1.0–1.5 pps. The negative effect was in part driven by the budget consolidation and tax administration enhancement, which brought the general government deficit to a level ensuring a long-term fiscal sustainability. That said, the main effect is owed to the fiscal rule smoothing out cyclical fluctuations of economic activity. Without the fiscal rule in place, revenue expansion and expenditure reduction would have been much less significant, causing an additional temporary economic growth acceleration followed by a slump. The direct negative effect on GDP growth was partly offset by an indirect positive impact of improving expectations with regard to sustainable macroeconomic stability.

Forecast. Our baseline oil price scenario expects both the overall surplus and the non-oil and gas deficit of general government to decline in 2019. Ambitious national projects aiming to promote investment growth are to be launched in 2019. Project financing is planned to total 25.7 trillion rubles over the period until 2024 (20% of the average 2019–2024 GDP), of which 13.1 trillion rubles is to come from the federal budget, 4.9 trillion – from regional budgets, 0.1 trillion – from state extra-budgetary funds, with 7.5 billion rubles planned to be raised from private sources. On the federal level, extra expenditure will be financed through raising VAT and temporarily reducing the primary budget balance by 0.5 pps of GDP relative to the current fiscal rule. Based on our medium-term estimate, the fiscal maneuver will add about 0.2–0.3 pps to average annual GDP growth.[12] Since the financing of the projects as part of the fiscal maneuver will start towards the middle of the 2019, while taxation at the

[12] Estimates were made using fiscal multipliers without taking into account the effect on potential GDP growth and a possible additional effect in an event of improving the efficiency of using the funds (for example, through -high quality selection of investment projects), as well as VAT taxpayers' cutting costs and productivity improvement. For details, see Vlasov S. (2018). *Impact of the fiscal maneuver on GDP growth: estimation of short-term effects using fiscal multipliers.* Analytical note. Bank of Russia Research and Forecasting Department.

raised VAT rate is effective already in the first half of the year, we expect a negative effect on GDP growth to emerge in the first half of 2019 and the effect below average for the full-year 2019. In subsequent years, the fiscal maneuver should have an increasingly positive effect on GDP growth.[13] If, on the horizon of monetary policy planning, the fiscal maneuver fails to give a significant impetus to potential growth rates, then, other things being equal, there will emerge a minor positive output gap. The Bank of Russia should take that into account in its policy seeking to maintain inflation at a level close to the target.

[13] *Ibid.*

2. OUTLOOK: LEADING INDICATORS

2.1. What do Russia’s leading indicators suggest?

2.1.1. Russian GDP Nowcast: temporary weakening of economic growth

- Based on statistics released in February, the estimate of GDP growth in the first quarter of 2019 remains unchanged at 0.2% QoQ in seasonally adjusted terms.
- Our growth estimate for the second quarter of 2019 stands in the range of 0.2%–0.3% QoQ SA. Our first growth estimate for the third quarter of 2019 is 0.3% QoQ SA.
- The current estimates continue to suggest that there are factors for slowing economic growth in the first half of 2019. The slowdown will likely be short-lived, due to, among other things, the transient nature of the restraining effect of the VAT hike on economic growth. Further on, growth will likely continue at a higher pace in line with potential.

	February **% QoQ SA**	January % QoQ SA
Q1 2019	**0.2**	**0.2**
Q2 2019	**0.2–0.3**	**0.2**
Q3 2019	**0.3**	**–**

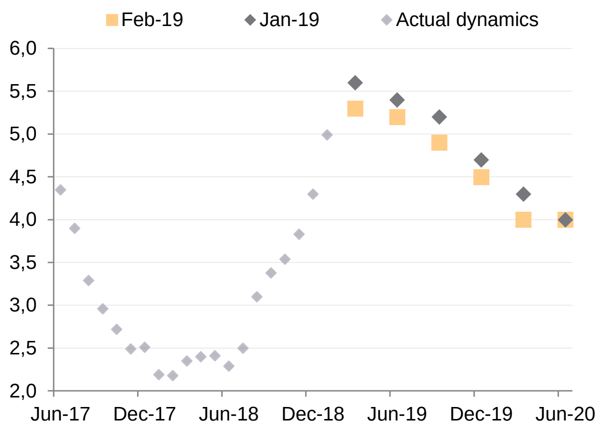
2.1.2. Analysts lower 2019 inflation expectations

- Analysts surveyed by Bloomberg in February believe that the risk of inflation further deviating upwards from the target is declining.
- The moderate price rises at the start of the year have also affected the key interest rate expectations: most financial analysts no longer expect it to be raised.

According to a monthly Bloomberg survey, the forecast of annual inflation in 2019 was revised down by 0.2–0.3 pps from its January reading (Figure 36). The adjustment was likely due to more moderate than expected price rises in January–February after the VAT increase. Analysts project inflation at 5.3% YoY for the first quarter of 2019, down from a January survey projection of 5.6% YoY. Inflation is expected to go back down to the 4% target in the first quarter of 2020.

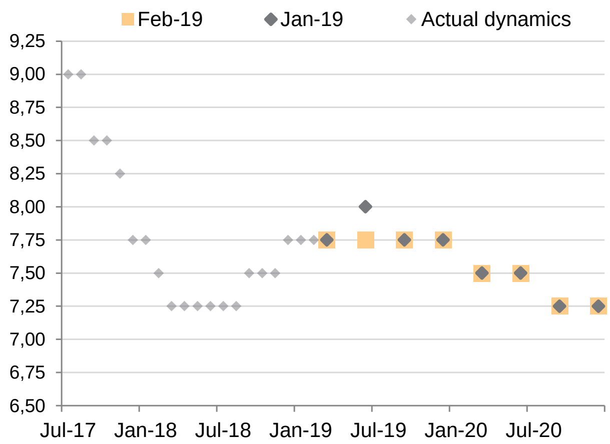
Given the more favorable inflation trend than earlier assumed, the overwhelming majority of analysts no longer expect the key interest rate to be raised, although the previous months' forecasts assumed another interest rate hike towards the end of the second quarter. (Figure 37). The survey data suggests that the key rate will stay at a current level of 7.75% to be cut by 0.25 pps at the start of 2020, provided inflation slowed to 4.0% YoY.

Figure 36. Analyst inflation expectations, % YoY



Source: Bloomberg Finance L.P.

Figure 37. Analyst expectations for Bank of Russia key rate, %



Source: Bloomberg Finance L.P.

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