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TALKING TRENDS
Economy and Markets

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CONTENTS

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EXECUTIVE SUMMARY

1. Monthly summary

- Annual inflation expectedly slowed in August, mainly on the back of temporary disinflationary factors, and already keeps close to 4%. That said, inflationary pressure, defined as monthly growth in prices for the most stable consumer basket components, is holding near the target level. This predetermines the anchoring of inflation close to 4%. Inflation expectations have stabilised, remaining, however, elevated and unanchored, which suggests the persistence of the related medium-term pro-inflationary risks. Despite a steady expansion in lending, economic activity in July-August was overall low, largely due to unfavourable external economic factors. Nevertheless, economic growth is expected to accelerate somewhat before the end of the year, helped by the expected reduction in budget expenditure underperformance, monetary easing, and overall favourable financial markets.
    - Consumer price movements and the current level of inflationary pressure in the economy suggest that inflation will stabilise close to 4% going forward. Although short-term disinflationary and pro-inflationary risks have balanced out, the risks of inflation deviating upwards from the target still prevail in the medium term.
    - Economic activity indicators suggest that Russia’s economic growth accelerated somewhat year on year in the third quarter. However, growth remains slow as exports decline and domestic demand weakens amid the global economic slowdown, unfavourable demographic trends, and other structural and institutional problems in the Russian economy. In the second half of the year, budget expenditure and monetary easing will help an overall increase in demand in the economy, while a slowdown in inflation will underpin consumer demand.
    - As the US Fed and the ECB are willing to loosen their monetary policy in the face of rising risks for the global economy, moderate risk appetite remains in global financial markets, the Russian market among them. At the same time, there is growing uncertainty about the ability of central banks to prevent the global economy from sliding into recession amid the ongoing trade disputes.

2. Outlook

- According to GDP growth projections, Russian economic growth will accelerate somewhat in the second half of the year, remaining, however, below potential.

1. MONTHLY SUMMARY

1.1. Inflation

Annual inflation remains on the downtrend. Short-term disinflationary and inflationary risks have balanced out as some inflationary risks emerged on the back of rouble weakening in August. As a result, annual consumer price inflation will stabilise at about 4% going forward, given the recent monetary policy decisions.

Rises in the consumer price index most stable components which are only weakly sensitive to the impact of temporary factors are staying at a level corresponding to an inflation rate of 4% amid subdued economic activity and monetary conditions that have yet to fully reflect monetary policy loosening by the Bank of Russia. Coupled with the lagged response of elevated inflation expectations, this suggests that the short-term neutral interest rate may currently exceed the long-term one. This uncertainty in a situation of interest rates entering their neutral range requires the central bank to act cautiously while closely monitoring possible changes in the balance of risks related to price movements.

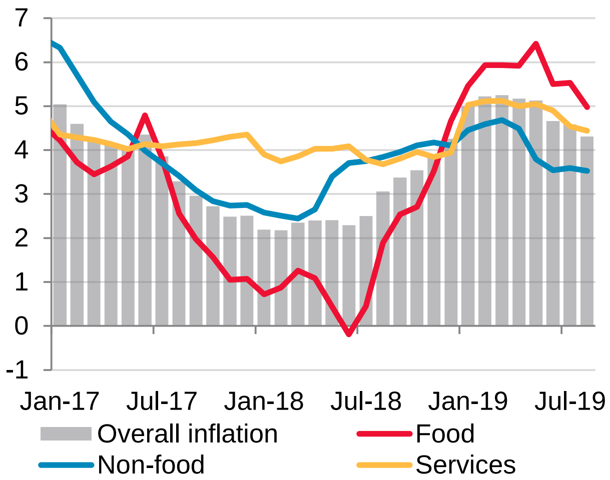
On the medium-term horizon, pro-inflationary risks prevail over disinflationary ones. Among the key pro-inflationary risks are geopolitical factors and volatility surges in financial markets, the uncertainty regarding fiscal policy, potential secondary effects arising from elevated and unanchored inflation expectations by businesses and households, as well as workforce shortages in the labour market.

1.1.1. Inflationary pressure stayed close to 4% in August

- Inflation expectedly slowed to 4.31% YoY in August from 4.58% YoY in July. All of the three key CPI components showed price rise deceleration, but the main inflation restraining effect came from slowed food and vegetable price rises.
- In monthly terms, prices went down 0.24% MoM in August. Seasonally adjusted, inflation accelerated to 0.26% MoM, coming close to a path providing for an inflation rate of 4% in annualized terms.
- The estimates of modified core inflation indicators remained all but unchanged relative to July, standing just below the level corresponding to an inflation rate of 4% due to the disinflationary impact of rouble strengthening in the first half of the year.
- At the same time, adjusted for the effect of the exchange rate and other transient factors, inflation pressure stays close to 4%. This implies inflation stabilisation at around 4% under the current monetary conditions which emerged after the effects of disinflationary and pro-inflationary factors have petered out.
- In months to come, August's rouble weakening will largely neutralize the effect of its strengthening in the first half of the year on inflation for the full-year 2019.

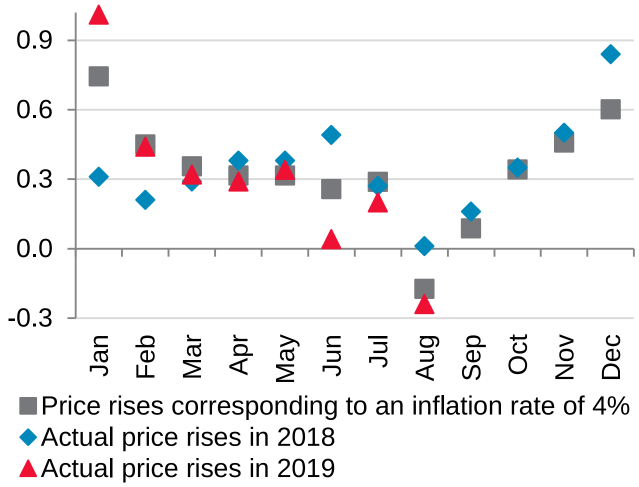
Annual inflation continued to slow, going down to 4.31% in August from 4.58% in July (Figure 1). The key inflation restraining effect came from food price movements: food price inflation slowed from 5.53% in July to 4.98% in August. The market for nonfood goods and services posted a modest inflation deceleration to 3.53% and 4.44%, respectively, from 3.59% and 4.54% in July.

Figure 1. Inflation and its components, % YoY



Source: Rosstat.

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



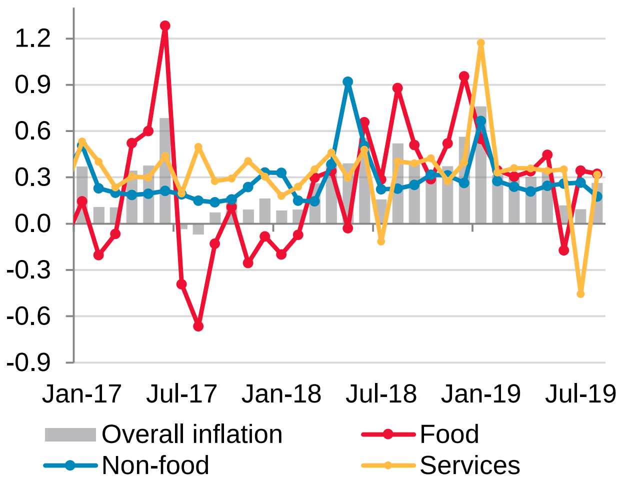
Source: Rosstat, R&F Department estimates.
**The August number is an initial estimate.*
The estimate takes account of splitting housing and utility services price indexation into two stages: in January and July.

The monthly consumer price movements came close to the path ensuring an inflation rate of 4% (Figure 2). August, for example, saw prices go down 0.24%, or 0.26% in seasonally adjusted terms. The rate of food price inflation remained all but unchanged from July at 0.32% MoM SA. Nonfood price rises slowed to 0.18% MoM SA. After July's one-off drop largely owed to technical aspects of accounting for the seasonal factor in the housing and utilities prices,[1] services price rises returned to their February–June range, posting an increase of 0.32% MoM SA.

Fruit and vegetable prices were the key factor behind the food price inflation deceleration. A dramatic slowdown in fruit and vegetable price rises from 5.43% YoY in July to 1.28% YoY in August was owed to the high base of August 2018, when prices were declining at a slower rate than seasonally normal (Figure 4). This year, prices fell 10.1% MoM, which is closer to the usual seasonal rate of decline. Meanwhile, weekly Rosstat estimates indicated a much more drastic 12% fruit and vegetable price drop in August, but the movements of prices for goods which are not monitored on a weekly basis (mostly imported fruit and citrus) compensated for the accelerated vegetable price decline.

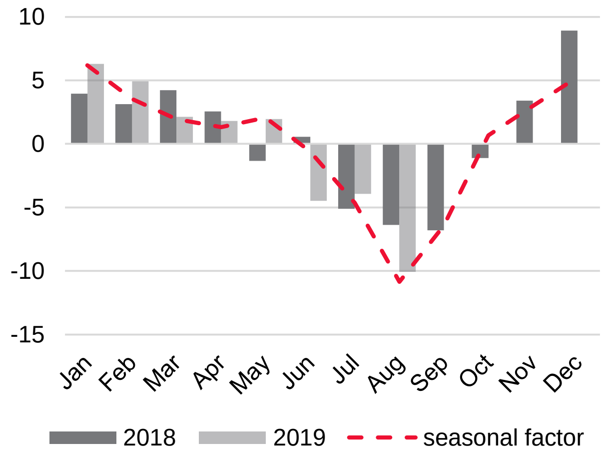
[1] Since this sector is regulated, a peculiar seasonal adjustment method is used for it. The seasonal factor for July this year assumed a 4% price rise. But given the VAT hike, housing and utilities prices were indexed in two stages this year, so July saw a smaller price rise than what was assumed as a seasonal factor.

Figure 3. Seasonally adjusted price rises, % MoM



Source: Rosstat, Bank of Russia estimates.

Figure 4. Fruit and vegetable price rises, % MoM



Source: Rosstat, R&F Department estimates.

Exclusive of fruit and vegetables, annual food price inflation edged down to 5.39% YoY in August from 5.52% YoY in July. Noteworthy are movements in sugar prices which posted a change from a 0.17% YoY rise in July to a 2.21% YoY fall in August. Sugar prices plunged 14.1%, or 6.6% in seasonally adjusted terms from the start of the year. Industry experts[2] believe that the key factor behind the continued sugar price decline is a supply glut that has emerged in the global market over the last two years. Given the expected strong output this year,[3] the price decline will likely continue.

The annual rate of meat and poultry price rises went down for the third consecutive month. As the high prices seen at the end of last year exit the calculation, the annual rate of meat and poultry price rises will continue to decline.

We distinguish chicken eggs among food items which showed a notable price rise acceleration. Since the Russian Poultry Union reported the absence of factors for rises in the consumer prices of chicken eggs[4] and high volatility of this item's prices, the current price rise acceleration will likely be short-lived.

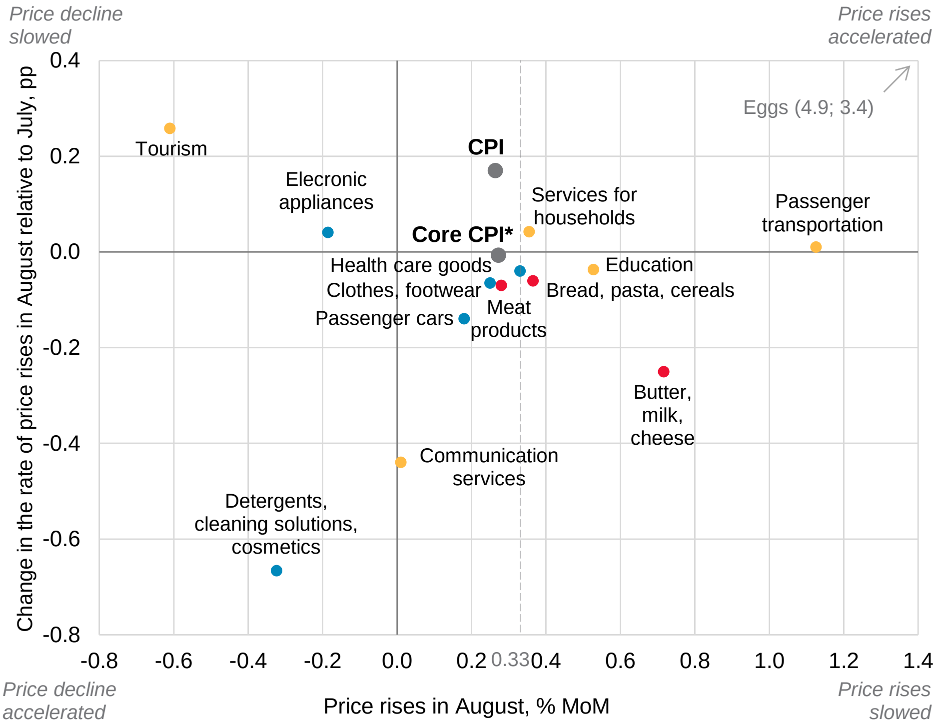
Inflation in the market for nonfood goods is staying below 4%. Seasonally adjusted price rises in most of the key nonfood items slowed in August (Figure 5) as a result of the continued pass-through of rouble strengthening to prices, which was seen up until the start of August. Rouble appreciation also continued to affect price movements in some services. For example, prices of foreign tourism services declined almost 1% in seasonally adjusted terms over this month.

The median of distribution of price rises in goods heavily dependent on exchange rate movements stays depressed (Figure 6), which also suggests the continuing effect of rouble appreciation in the first half of the year on consumer price trends. While August's rouble

[2] Agroinvestor. "Sugar glut in the market will continue to put pressure on prices". 03.09.2019.
[3] According to the International Sugar Organization's forecast, sugar production is set to stand at 6.5 million tons in the 2019–2020 season, up from 5.9 million tons in the 2018–2019 season.
[4] РИА Новости. «Росптицесоюз не видит предпосылок для роста цен на яйца». 08.08.2019.

weakening has yet to have a notable effect on prices, the months to come will likely see it largely offset the impact of rouble strengthening in the first half of the year.

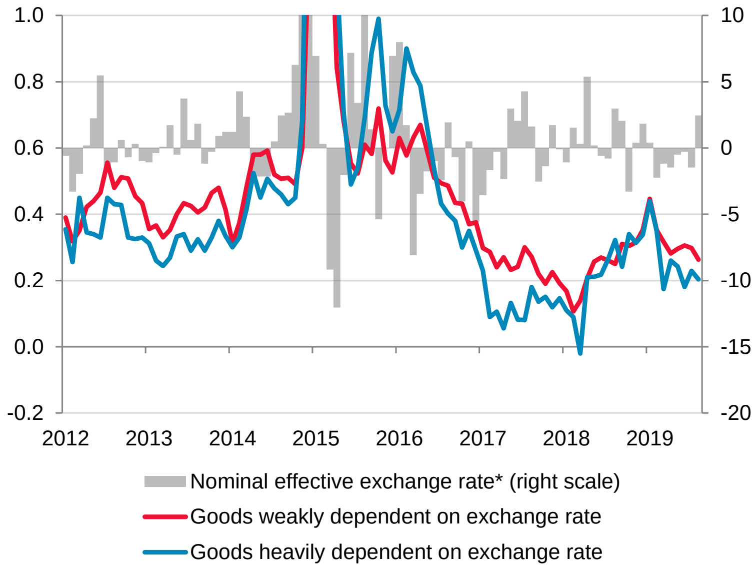
Figure 5. Seasonally adjusted inflation in August and its change from June, % MoM



Source: Rosstat, R&F Department estimates.

** Modified indicator of core inflation calculated by the truncation method.*

Figure 6. Median price rises in goods and services heavily and weakly dependent on exchange rate movements

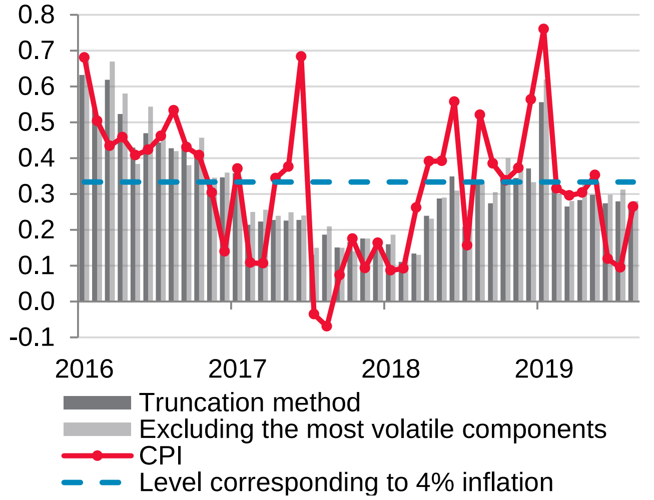


Source: Rosstat, R&F Department estimates.

** Plus stands for rouble depreciation against foreign currencies, Minus stands for rouble appreciation against foreign currencies.*

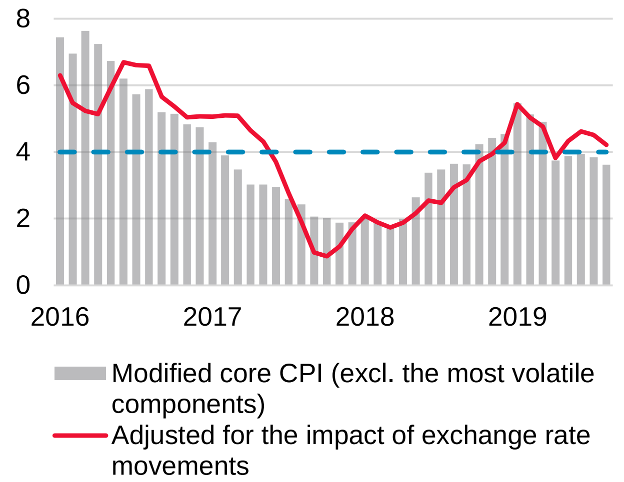
The mean of estimates of modified core inflation indicators inched down to 0.28% MoM in August from 0.30% MoM in July (Figure 7). The estimates of the indicators lie below the level corresponding to 4% because they are exposed to the impact of transient factors, although to a lesser degree than the headline CPI. The estimates adjusted for the impact of exchange rate movements suggest the stabilisation of inflationary pressure on a level close to 4% (Figure 8).

Figure 7. Modified core inflation indicators, % MoM



Source: Rosstat, R&F Department estimates.

Figure 8. Modified core inflation indicator, %, three-month moving average in annual terms



Source: Rosstat, R&F Department estimates.

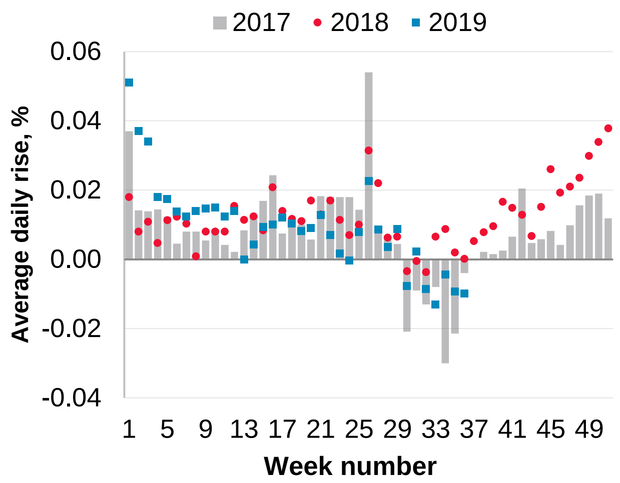
Consumer prices continued sliding down at the start of September. The average daily rate of price changes remained negative, while it was positive a year earlier (Figure 9). This means that annual moving average inflation deceleration is continuing.

The difference between the current and last year's inflation levels is owed mainly to price movements in categories monitored on a weekly basis: the price of the monitored basket (excluding fruit and vegetables) rose much less than a year ago (Figure 10). This is also a likely explanation for the difference between the levels of Rosstat's evaluations of price growth among categories which are not monitored on a weekly basis: the indicator is constructed based on the monitored basket.

Fruit and vegetable prices went down 2.7% over the week from September 3 to 9. The comparable week of last year posted a little faster 2.9% rate of decline in fruit and vegetable prices. It is noteworthy that cucumber prices started rising earlier than usual, following a sizeable drop in the previous months. This may be a harbinger of earlier than usual price rises in other types of fruit and vegetables on the back of an earlier harvesting peak this year.

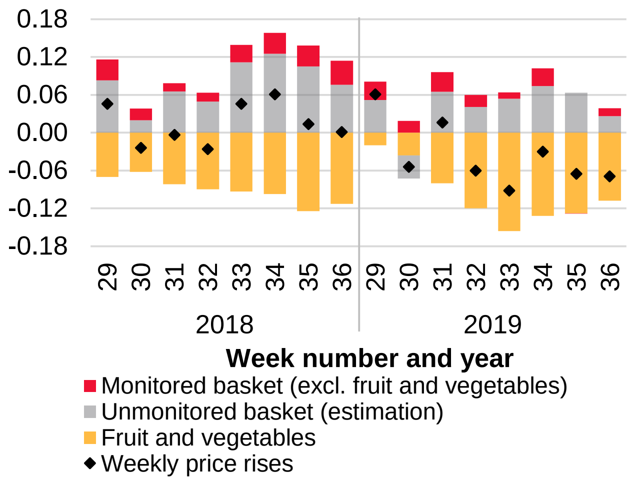
Based on this factor, an initial estimate of price increases for the full month stands at 0.1% MoM, which, depending on the second decimal place, corresponds to an inflation rate of 4.2–4.3% and a seasonally adjusted price rise in the range of 0.3–0.4% MoM.

Figure 9. Daily average rate of price rises, %



Source: Rosstat, R&F Department estimates.

Figure 10. Decomposition of weekly inflation rates, pps



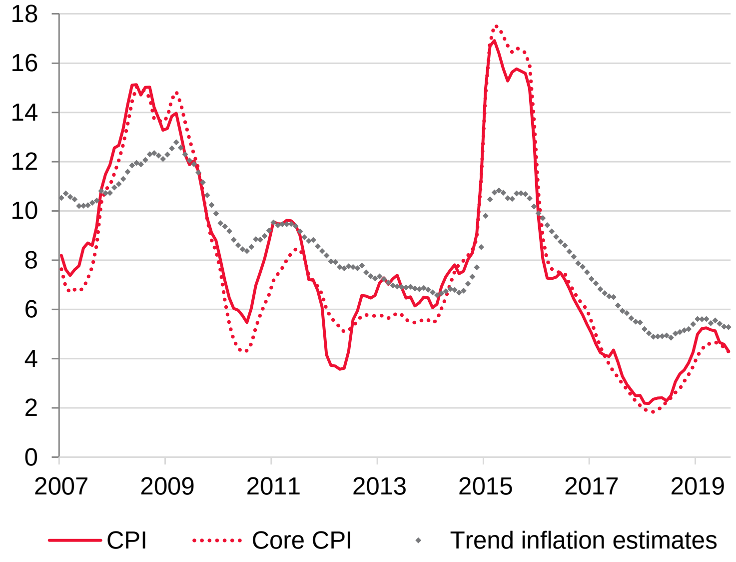
Source: Rosstat, R&F Department estimates.

1.1.2. Trend inflation deceleration in August 2019

- The estimate of trend inflation[5] inched down to 5.28% in August 2019 from 5.30% in July (Figure 11). The trend inflation estimate calculated for a shorter three-year time span declined to 3.86% in August from 4.02% in July (Figure 12).
- A marginal drop in trend inflation estimates compared with a more notable decline in the annual rate of consumer price rises suggests the prevalence of transient factors in inflation deceleration.
- Overall, changes in the trend inflation estimates imply that inflationary pressure continues on a level close to the inflation target.
- Pro-inflationary risks are so far predominant on a medium-term horizon despite the above drop in the trend inflation estimates.

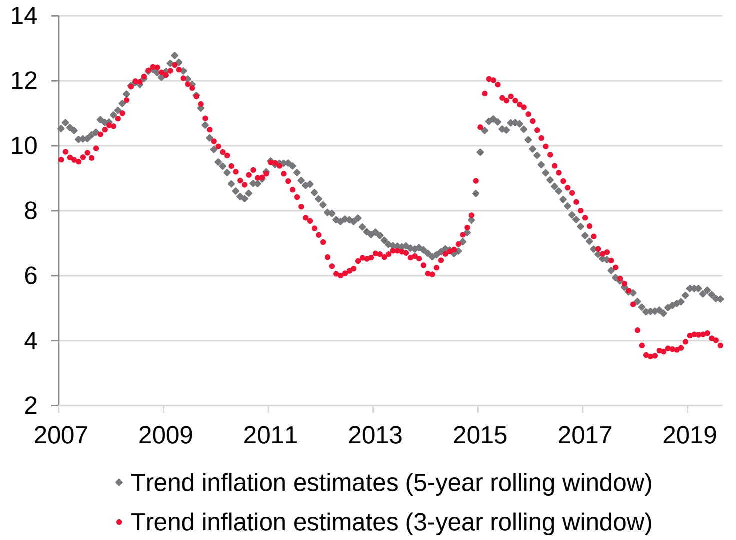
[5] The methodology of estimating trend inflation was described in the Bank of Russia Paper: Deryugina E, Ponomarenko A., Sinyakov A, Sorokin K. Estimating properties of trend inflation indicators for Russia. // Bank of Russia Working Paper Series. March 2015, No 4, and the analytical note from the Research and Forecasting Department: Measuring Domestically Generated inflation. May 2016, No 2.

Figure 11. CPI, core CPI, and Bank of Russia historical estimates of trend inflation,[6] % YoY



Source: Rosstat, R&F Department estimates.

Figure 12. Trend inflation estimates constructed for 3- and 5-year rolling periods, % YoY



Source: Rosstat, R&F Department estimates

[6] This trend inflation indicator is constructed over a rolling five-year period.

1.2. Economic performance

The Russian economy's growth remains subdued, although it has picked up somewhat versus the start of the year. The global economy's slowdown is taking an increasingly heavy toll on Russian exports, keeping Russia's economic growth below potential despite a substantial positive credit impulse from corporate and household lending expansion which is propping up demand in the economy. Therefore, monetary conditions do not currently hamper economic activity growth, to say the least.

With budget spending expected to be stepped up, Russian economic growth is poised to accelerate in the absence of significant external shocks, the global economy's further slowdown among them.

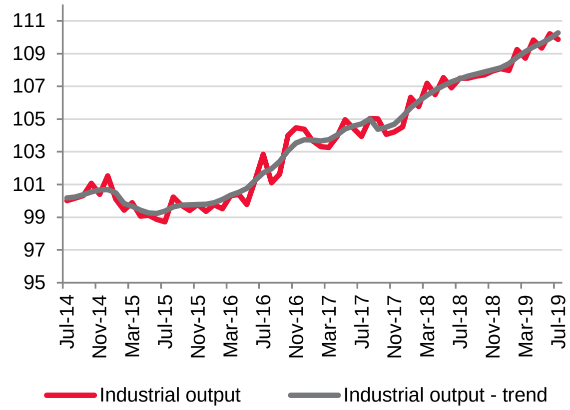
1.2.1. Positive trend continues in industrial production

- Industrial output growth eased in July 2.8% YoY as manufacturing's output expansion weakened to 2.8% YoY from 3.4% YoY in June.
- Despite the stable oil production, the overall mining and quarrying output remains in positive trajectory thanks to the nonferrous metals, non-metallic minerals and related services.
- Although volatile, a gradual growth trend continues in manufacturing. July saw manufacturing output decline 0.8% MoM SA, chiefly because the electronic industry's output returned to its usual level after a spike in the preceding month.
- Exports remain in negative territory with mineral fuel and ferrous metal deliveries taking most of the blame. While decline of mineral fuel deliveries is mostly concentrated in EU countries, fall of ferrous metals is dispersed among almost all destinations.

The annual rate of industrial output growth came in at 2.8% YoY in July, down from 3.3% YoY in June. In monthly terms, industrial output lost 0.4% MoM SA relative to June, based on an R&F Department estimate (Figure 13).

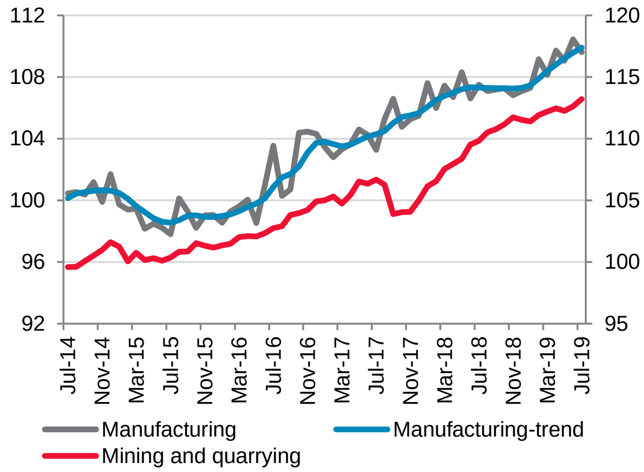
Mining and quarrying is retaining an upward growth trend. July saw growth accelerate to 3.0% YoY from 2.3% YoY in June. In monthly terms, mining and quarrying rose 0.5% MoM SA (Figure 14), with oil production slightly below the level of quotas under the OPEC+ agreement. In year-on-year terms, oil production lost 0.6%. The fast rate of growth in the mining and quarrying sector is fuelled by a rapid expansion in the extraction of other natural resources, such as nonferrous metals (up 3.1% YoY), and non-metallic minerals (a 15.7% YoY rise). A positive input also comes from the related servicing businesses (an increase of 16.7% YoY).

Figure 13. Change in industrial production index (2002 = 100)



Source: Rosstat, R&F Department estimates.

Figure 14. Change in mining and quarrying and manufacturing indexes (2002 = 100)



Source: Rosstat, R&F Department estimates.

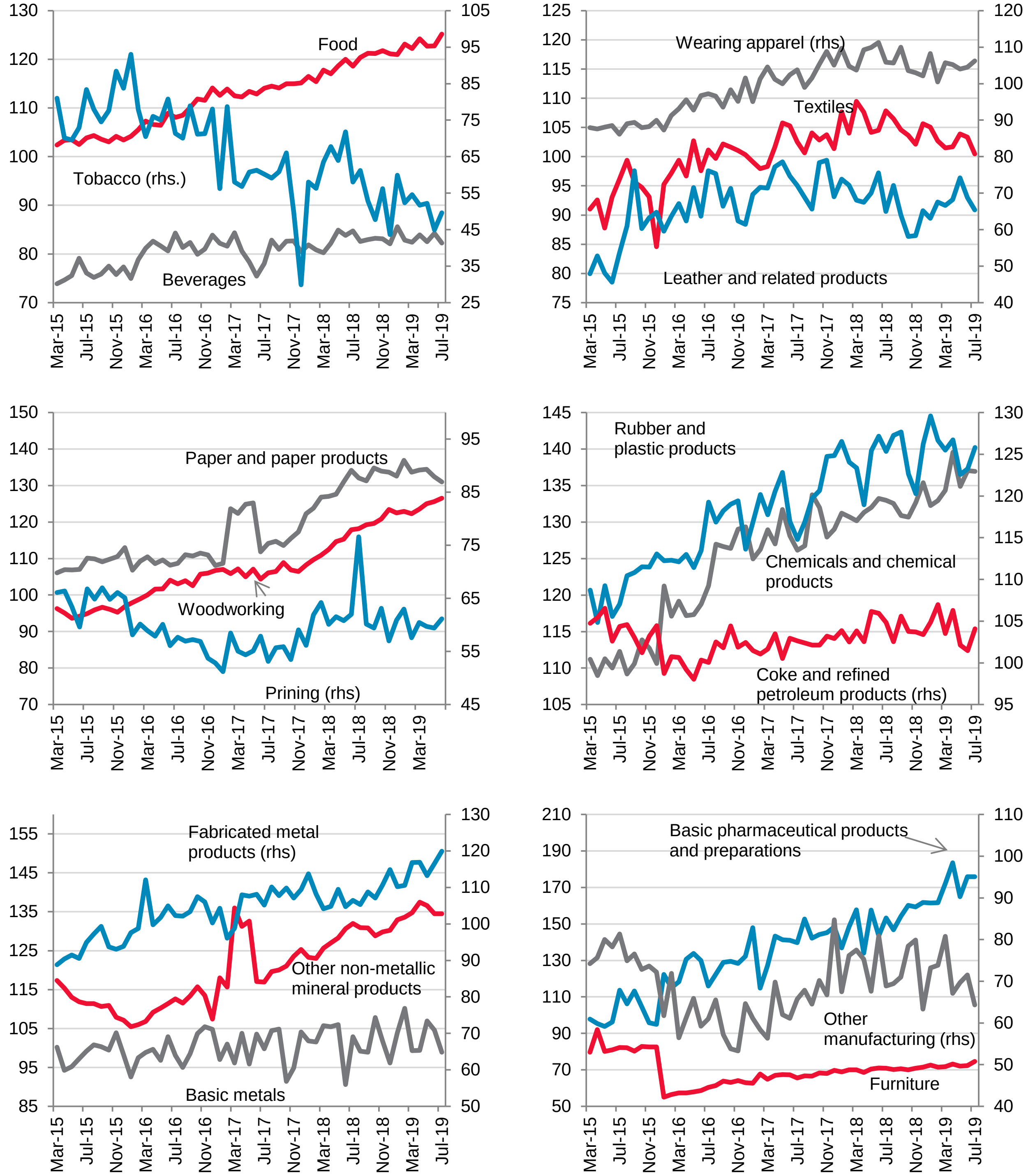
Output remains volatile in manufacturing. A seasonally adjusted output fall in July was largely driven by the manufacture of electronic products returning to normal after soaring in June. Still, manufacturing is maintaining its upward trend. In July, it was supported by a moderate growth in the major industries rather than by a local production spike in just one of them.

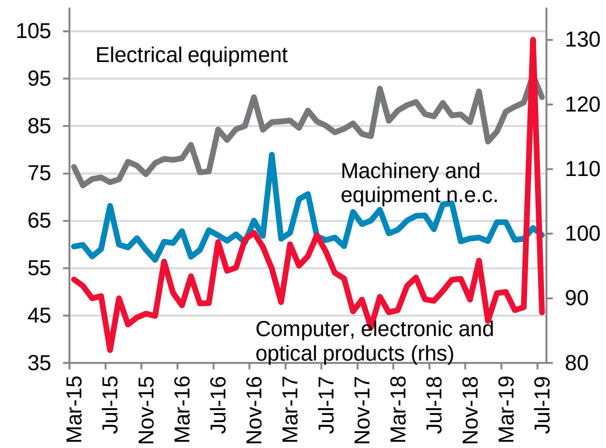
The manufacture of food products resumed growth in July, posting an expansion of 2.0% MoM SA thanks to an increase in meat and fish output. Another major industry, manufacture of refined petroleum, also showed a significant output rise of 2.6% MoM SA in July. Production seems to have started returning to previous levels after falling in the preceding months. The manufacture of other transport equipment added 8.5% MoM SA in July, thereby bringing this industry back to the recovery path. Output is, however, staying below last year's levels.

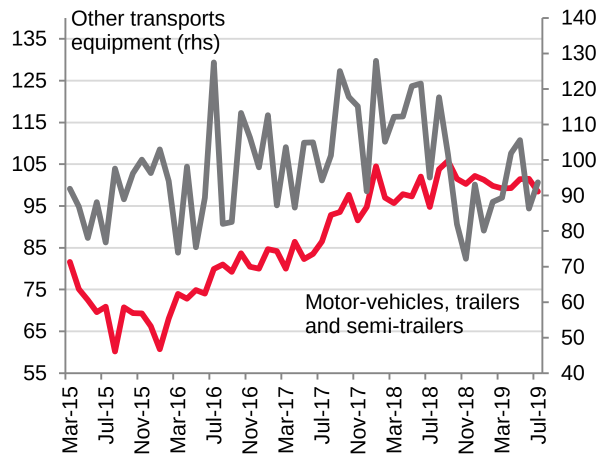
The output of the iron and steel industry climbed 2.0% MoM SA in July. This was, however, overridden by a fall of 10% MoM SA in the manufacture of basic precious and other nonferrous metals and nuclear fuel. Overall, the metals industry recorded a 5.5% MoM output fall in July. This industry made a hefty contribution to the negative trend in manufacturing, which was exacerbated by an output drop in the electronic industry.

Most industries manufacturing durable consumer goods are retaining negative trends. This is also true of the textile, clothing and footwear industry and other manufacturing. The performance of industries manufacturing consumer goods is also dragged down by a drop in the manufacture of motor vehicles (down 3.0% MoM SA).

Figure 15. Manufacturing industries' output, December 2012=100%, seasonally adjusted







Source: Rosstat, R&F Department estimates.

Figure 16. Countries' inputs to export growth, first half of the year, % YoY

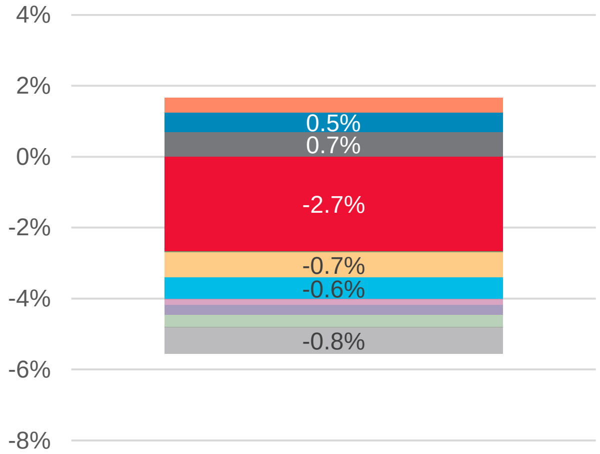


Figure 17. Countries's inputs to mineral fuel export growth, first half of the year, % YoY

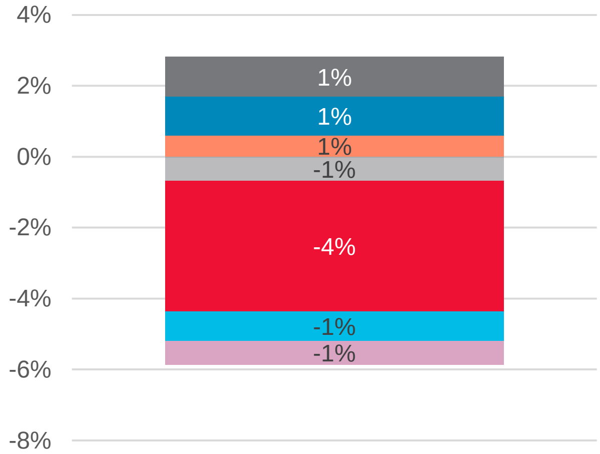
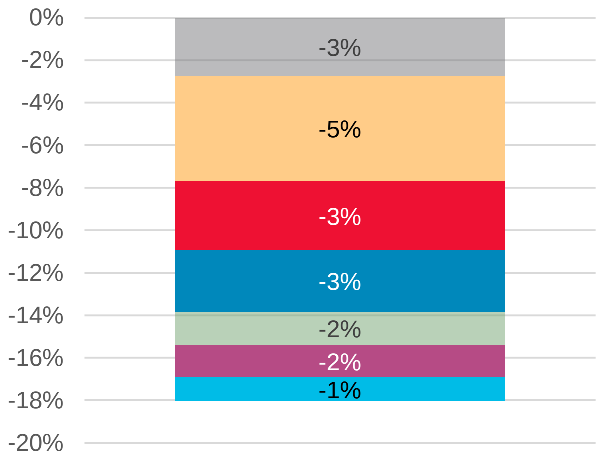


Figure 18. Countries' inputs to ferrous metal export growth, first half of the year, % YoY



Source: Rosstat, R&F Department estimates.

Industrial output is adversely affected by a fall in exports. The first half of the year saw 3.6% less exports by value than a year earlier. Exports also suffered a 2.4% YoY decline in physical terms.[7] The main negative contribution came from a drop in deliveries of mineral fuel and ferrous metals. Most countries' exports remained the same as last year. Deliveries to China (Russia's second largest trading partner) were also all but unchanged. The overall export numbers were hardest hit by a 6% YoY fall in exports (by value) to the EU in the first half of this year (Figure 16).

The European Union accounts for most of the contraction in mineral fuel exports in both nominal and real terms. This may stem from transient factors.

Ferrous metal exports fell 18% YoY by value in the first half of the year. The contraction affected all major types of exported products. We note that, unlike mineral fuel deliveries, this contraction was distributed among most geographical areas, with exports to Turkey (down 30% YoY), the EU (a 12% YoY fall), and the US (a drop of 36% YoY) bearing the brunt of contraction.

1.2.2. IHS PMI indexes: business activity picks up in services as manufacturing faces external demand weakening

- The performance of the composite PMI index points to a marginal economic growth acceleration in August, driven by activity enhancement in services. The estimate of the R&F Department's news-based index also showed a rise in the composite PMI index
- Business activity weakening in manufacturing stems from an accelerating decline in new orders. The global economy's slowdown seems to contribute the most to it: a drop in export orders was the steepest since September 2016.

The August reading of the manufacturing IHS PMI index shows a continued business activity decline in Russian manufacturing industries: the index dropped to 49.1 in the last summer month from 49.3 in July (Figure 19). The Center for Macroeconomic Analysis and Short-term Forecasting estimates that, given sample errors, the true survey-based PMI value lies in a confidence interval of 46.5–51.7.[8] Therefore, one so far cannot claim with certainty that there is a pronounced negative trend in business activity. For example, manufacturing PMI for output rose to 49.9, thus formally indicating output stabilisation in the sector after its decline in June–July.

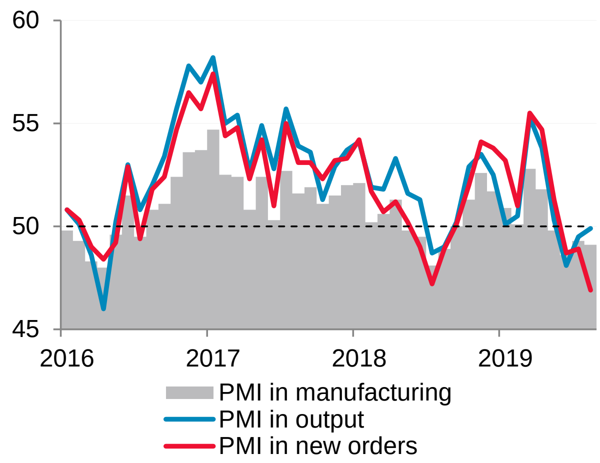
The fall in the headline index stems from a decline in new orders, fraught with an output weakening. The relevant index dropped from 48.9 to 46.9. The respondents refer to a loss of key customers and demand slackening as the main factors behind the new orders contraction. The new orders decline was likely driven by a continued growth slowdown in

[7] According to data on the export of major goods, which account for 70% of total exports by value.
[8] The Center for Macroeconomic Analysis and Short-term Forecasting. "Indirect assessment of business activity in manufacturing in July".

global trade: the export orders index plunged from 48.3 to 44.8, its lowest level since September 2016.

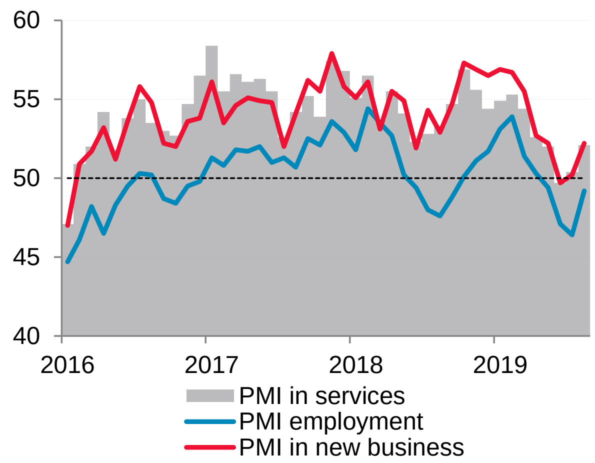
Despite the negative trends in the above indexes, manufacturing companies are reporting the highest degree of optimism (69.1) since March this year regarding their output prospects.

Figure 19. Change in PMI manufacturing indexes, pp



Source: IHS Markit.

Figure 20. Change in PMI services indexes, pp



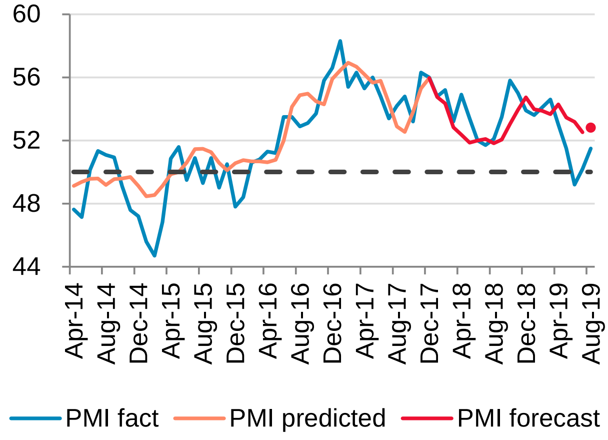
Source: IHS Markit.

The services PMI and its components, by contrast, improved, suggesting a rise in the sector's business activity: the relevant PMI index climbed from 50.4 to 52.1 (Figure 20). Growth was fuelled by an increase in orders from both domestic and foreign customers. The respondents' positive assessment of demand, was not, however matched with that of employment growth (companies continue to cut jobs, albeit at a slower rate: the employment index stood at 49.2 in August, up from 46.4 in July. In addition, unlike the manufacturing sector, services companies are concerned about the economy's prospects: the expectation index dropped to its lowest readings since March this year.

August's composite PMI index for output came in at 51.5 in August, once again going above a "borderline" reading of 50 which separates growth from decline (Figure 21). The composite index is a weighted average of manufacturing and services' output indexes. It broke through into positive territory thanks to a substantial new orders expansion in services, whose weight in GDP is much heavier than those in manufacturing. Services companies also played a crucial role in forming an overall level of expectations in the economy: moderately downbeat regarding prospects for economic growth (the relevant index at 65.3, the lowest since September 2018).

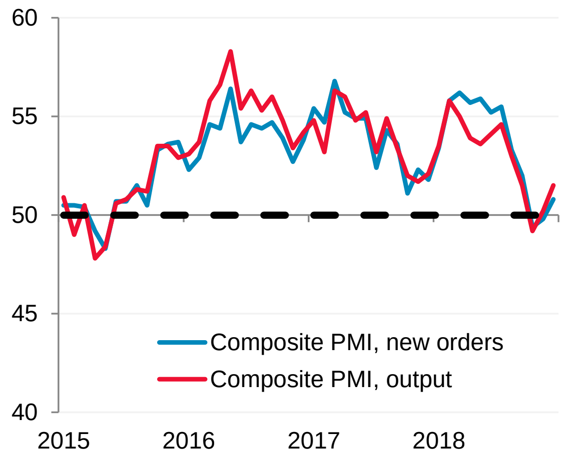
The current composite PMI trends are in line with the R&F Department's [News-based business activity index,] which rose in August (Figure 21).

Figure 21. Composite PMI and News-based business activity index, pp



Source: IHS Markit, R&F Department estimates.

Figure 22. Change in composite PMI indexes for Russia, pp



Source: IHS Markit.

1.2.3. Marginal slowdown in consumption growth

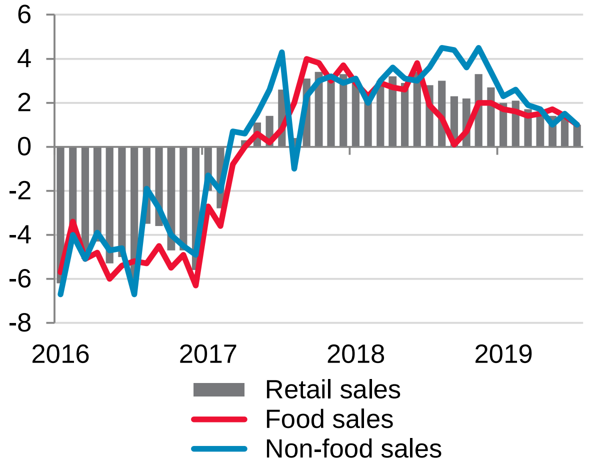
- July saw the annual rate of retail sales growth slow in both the food and non-food segments.
- Real wage growth acceleration failed to provide a strong support for consumer demand, since it was concentrated in just one industry. Stabilisation in consumer lending growth also has an effect on consumption.

Retail sales growth eased to 1.0% YoY in July from 1.4% YoY in June (Figure 23). Both food and non-food retail sales posted growth slowdown to 0.1% YoY each. Retail sales growth softening may have stemmed from a summertime rise in foreign travel. The Tour Operators Association, for example, indicates an expansion in sales and demand for mass market foreign destinations, expecting a further rise in foreign travel after the summer travel season is over.[9] One can therefore assume that an increase in foreign travel from Russia may have restrained domestic consumption somewhat. Based on preliminary estimates, a foreign travel growth of 5–10% in July may have cut 0.1–0.2% off annual retail sales growth.

Monthly seasonally adjusted data indicates a 0.1% MoM retail sales contraction in July, with food sales dropping 0.4% MoM and non-food sales showing a marginal gain of 0.1% MoM.

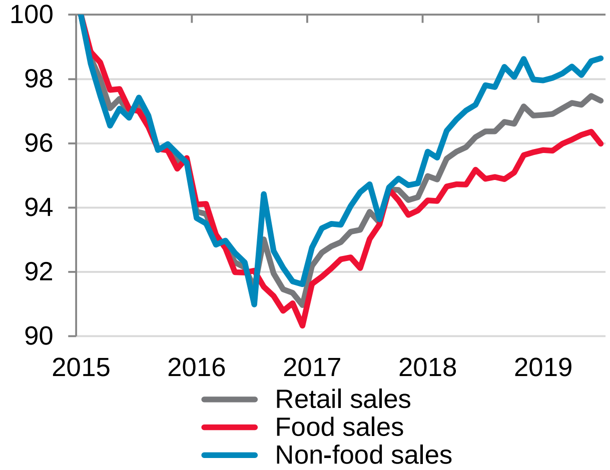
[9] Travel companies' sales expansion relative to 2018 is estimated in the range from 5% to 20%, depending on a country, while growth in foreign travel from Russia came in at 6.67% in the first half of the year (9.1% in 2018). The Tourist Operators Association: the tourist operator market shows stability this summer / TOA. 14.08.2019. Foreign travel from Russia rose 6.67% in the first half of the year / TOA. 12.08.2019.

Figure 23. Change in retail sales of food and non-food goods and retail sales turnover, % YoY



Source: Rosstat.

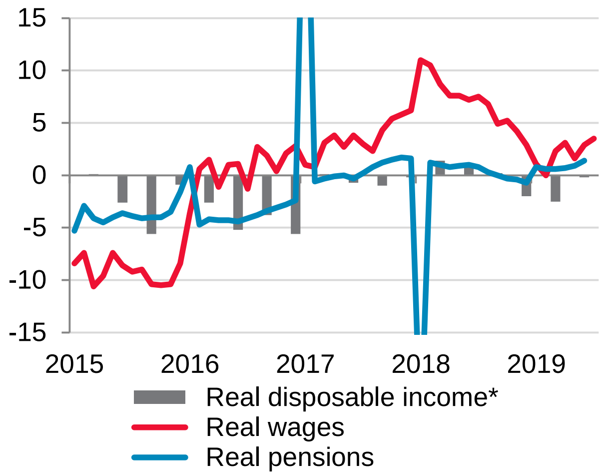
Figure 24. Change in retail sales turnover, % (January 2015 = 100%, SA)



Source: Rosstat, R&F Department calculations.

Real wage expansion continued to accelerate in July as inflation slowed (Figure 25). This, however, failed to provide strong support to consumer demand: the acceleration was local in nature and confined to just one industry (see Subsection 1.2.2.). Retail lending growth stabilisation is also restraining growth in demand for non-food goods. At the same time, real everyday household expenditure figures (survey data from Romir research holding company,[10] Figure 26) points to the reorientation of demand to this spending category.

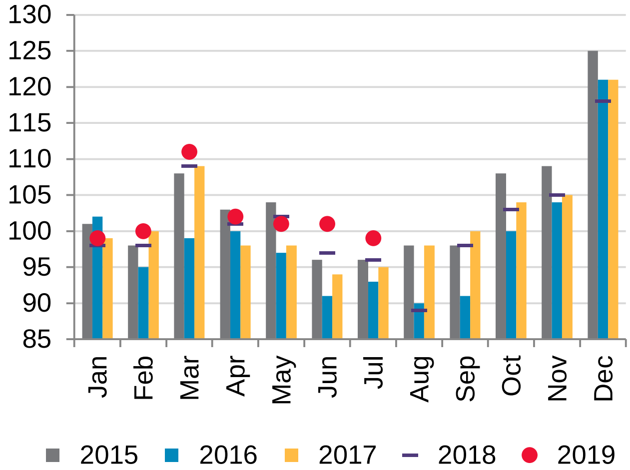
Figure 25. Change in real household income, % YoY



Source: Rosstat, R&F Department calculations.

** Calculation based on the new methodology taking into account the one-off payment in January 2017.*

Figure 26. Real everyday household expenditure, % (2012 median = 100%)



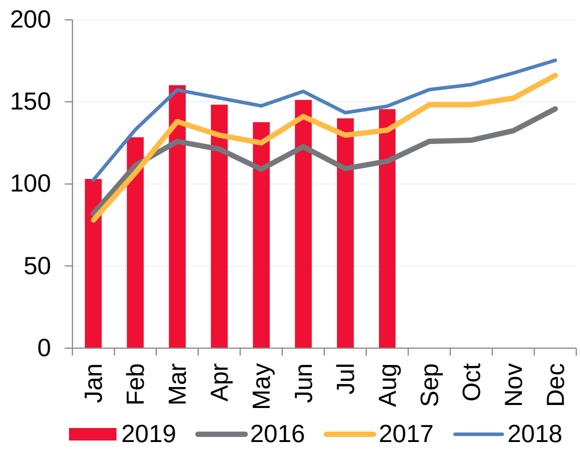
Source: Romir.

[10] Seasonal reduction in consumer activity / Romir research holding company. 08.08.2019.

1.2.4. Stabilisation of new passenger car market

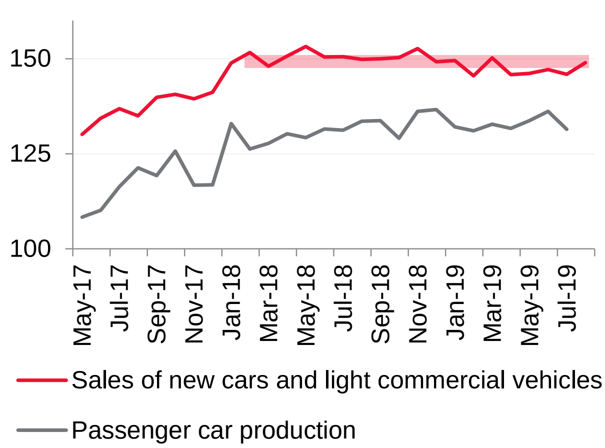
- Based on Association of European Businesses data, August sales of new passenger cars and light commercial vehicles remained 1.3% YoY lower than a year earlier (Figure 27). Demand for cars fell 2.3% YoY for eight months of 2019.
- Nevertheless, the market situation has now generally stabilised. Seasonally adjusted monthly numbers (Figure 28) indicate a 2.2% MoM SA rise in demand after a drop of 0.7% MoM SA in July.
- The sales level may vary substantially from month to month, but it has long enough hovered around the same level. From calculating the average monthly sales over the period from January 2018 to present and estimating the confidence intervals of this average value, one can see that, sales fluctuations (SA) in most cases lie within the confidence intervals (Figure 28, the red area, the level of significance is 5%). One cannot therefore claim with certainty that there is a pronounced negative trend in the automotive sector. Sales have hit a plateau and are staying far above the levels of 2016–2017, when the market was recovering after the 2014–2015 shock.
- Sales are also affected by exchange rate movements (because of a high share of imported components in car prices). The average 12-month rouble exchange rate to the dollar was falling from the second quarter of 2018 to the first quarter of 2019, hurting annual sales figures with an about one-quarter lag. The stabilisation of the average 12-month exchange rate as of the second quarter of 2019 currently helps car market stabilisation.
- Auto loans and government support provide another factor of market growth. According to National Bureau of Credit Histories data, July 2019 saw a record high total of auto loans: 69.5 billion roubles versus 51.8 billion roubles in July 2018. This growth can in part arise from additional financing by the government of subsidized auto loan programmes.
- Passenger car production declined 3.8% MoM in July (Figure 28), taking a heavy toll on the overall output of goods meeting consumer demand. The numbers were also negative for the first seven months of this year, with the industry posting a 1.8% YoY production fall, whereas a year earlier it recorded an output rise of 19% YoY.

Figure 27. Sales of new passenger and light commercial vehicles, thousand units



Source: AEB, R&F Department calculations.

Figure 28. Sales and production of passenger cars, SA, thousand units



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

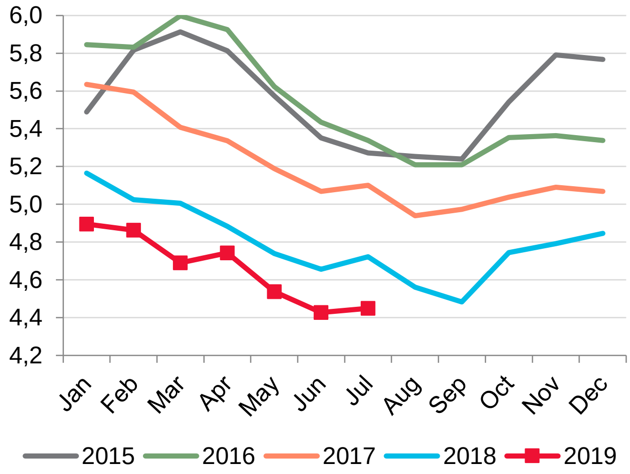
1.2.5. Labour market indicators suggest the economy's slowdown

- The seasonally adjusted unemployment rate keeps close to all-time lows.
- Labour demand expansion is slowing this year, reflecting subdued economic performance.
- Acceleration of nominal wage growth is concentrated in just a few industries, so far failing to spread to the entire economy.

According to Rosstat data, the unemployment rate edged up from 4.4% in June to 4.5% in July (Figure 29). Seasonally adjusted, the rate of unemployment also went up slightly from 4.60% to 4.66% in July but is staying close to all-time lows.

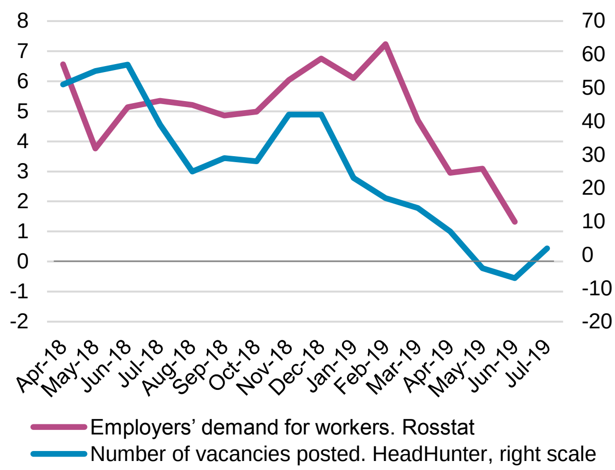
The unfavourable economic situation continues to affect changes in the labourforce, driving it down. It dropped 0.9% YoY (0.67 million) in July, with the number of economically inactive population rising 1.1% YoY (0.48 million). Moreover, along with a fall in supply in the labour market, signs are emerging of slowed demand growth this year. Vacancies offered by the employment service showed the slowest rise over the last several years in June: employers' demand for workers increased just 1.1% YoY. Another indicator, the number of vacancies posted on the HeadHunter web portal, also shows slower growth than in the previous years (Figure 30).

Figure 29. The unemployment rate by year, %



Source: Rosstat.

Figure 30. Employers' demand for workers based on Rosstat and HeadHunter data, YoY %



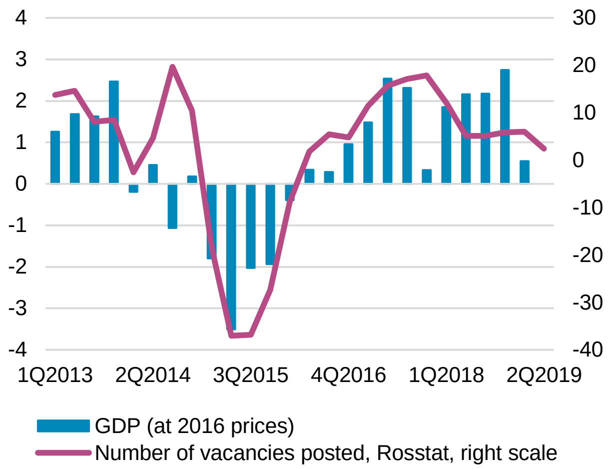
Source: Rosstat, HeadHunter.

The slackening vacancies rise reflects economic growth slowdown in the first half of 2019. The change in employers' demand for workers is closely correlated with the GDP growth rate (Figure 31).

Based on preliminary Rosstat data, real wage growth accelerated to 3.5% YoY in July from 2.9% YoY in June. The real wage rise was driven by both nominal wage increases and inflation deceleration.

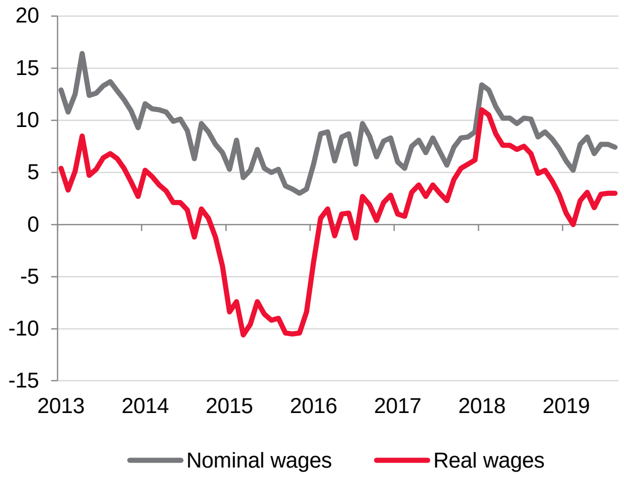
June's nominal wage growth was revised up in June from 7.1% YoY to 7.7% YoY, with a real wage increase revised up from 2.3% YoY to 2.9% YoY. Wage growth acceleration was posted in the private sector (from 6.5% YoY to 7.7% YoY), whereas the growth rate remained unchanged at 7.7% YoY in the government sector.

Figure 31. Employers' demand for workers and GDP growth, % YoY



Source: Rosstat.

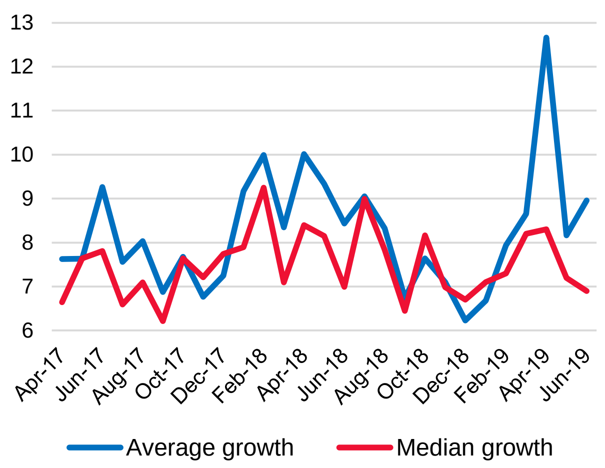
Figure 32. Wage growth rate, % YoY



Source: Rosstat.

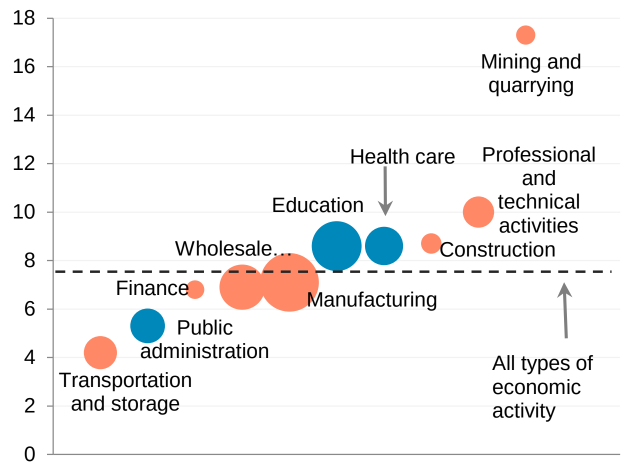
The average wage growth in the private sector is above that of the median rate, suggesting that just a small number of industries enjoy wage growth acceleration, whereas the overall growth rate was rather on a downtrend in the last two months. (Figure 33). For example, the only major industry of the private sector which recorded a double-digit nominal wage rise in June was mining and quarrying (up17.3 % YoY, Figure 34). Among subindustries we note extraction of crude petroleum and natural gas, where wages more than tripled in Moscow, and other mining and quarrying (wages quadrupled over June in the Magadan region). This growth rate is not typical of mining and quarrying: this industry usually sees the fastest wage rise in April–May, followed by a growth slowdown. In this particular case, the fast wage rise likely stems from a one-off factor: a shift of various kinds of bonus payments from April–May to June.

Figure 33. Average and median nominal wage growth in private sector, % YoY



Source: Rosstat.

Figure 34. Nominal wage growth by industry in June, % YoY



Source: Rosstat.

The circle size represents a share in the total payroll

1.2.6. With exports declining, import recovery boosts inflationary risks

- Imports from other than former USSR countries expanded 2.9% YoY in July–August following a 2.8% YoY contraction in the first half of the year. Rouble strengthening and the low base of the second half of the year may buttress imports in the months to come.
- Investment and intermediate goods were the drivers of import expansion. The recovery of investment goods imports should have a positive effect on the economy's overall investment rate in the second half of the year.
- Import growth and export downturn amid the global slowdown bring down the current account surplus. This aggravates the risks of higher ruble exchange rate volatility stemming from its rising sensitivity to capital flows.

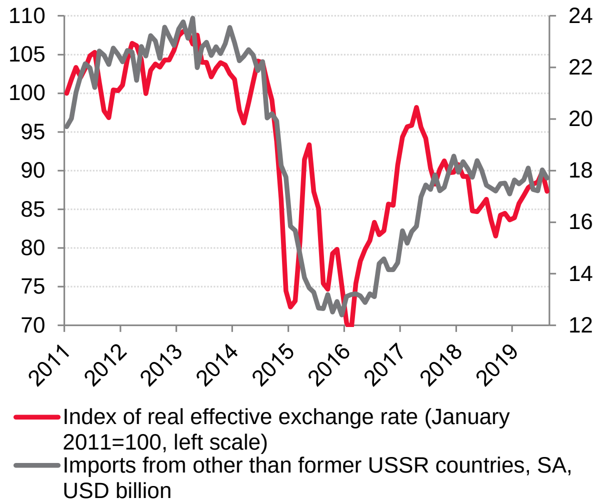
Imports from other than former USSR countries rose 2.9% YoY in July–August. This had a positive effect on the overall import figures for the period from the start of the year: a 2.7% YoY decline recorded for the first quarter of 2019 slowed dramatically. The results of the first eight months of the year suggest a much less pronounced import contraction – by just 1.3% YoY based on estimates. The negative trend seen at the start of 2019 arose, on the one hand, from the high base of 2018, and, on the other hand, from the lagged effect of rouble depreciation against the currencies of Russia's key trading partners for 2018.

But now these factors will likely start acting in the opposite direction: in the second half of 2018, imports responded to rouble depreciation, thus providing a low base for calculating the annual numbers, whereas rouble appreciation in 2019 is producing a gradual import rise in seasonally adjusted monthly terms in the second half of 2019. Rouble weakening in August, may, however, temper this rebound somewhat.

We estimate that in seasonally adjusted terms imports exceeded their average level of the second half of 2018 – the first half за 2019, remaining, however, below the local peaks of the second half of 2017 – the first half of 2018.

The overall import strengthening was fuelled by a gradual recovery in investment imports, such as machinery and equipment along with transport equipment, which lost 0.6% YoY in July–August. The fall was much more severe at 3.7% YoY and 5.4% YoY in the first and second quarters, respectively. A year-on-year import strengthening was posted in all major components: the import of mechanical equipment as well as optical and electrical equipment. The rebound of investment goods imports should give a boost to overall investment in the second half of the year.

Figure 35. Imports and rouble exchange rate



Source: CEIC

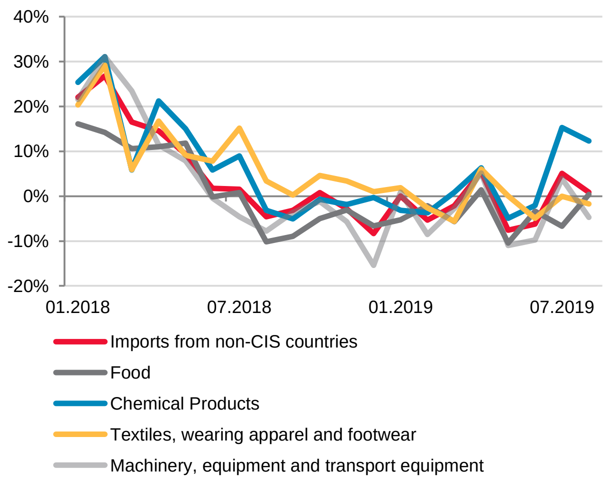
A contraction in food imports from other than former USSR countries in July–August was comparable with that in the first half of the year. A positive turnaround of the trend is now unlikely given the continuing restrictions on food imports from some countries and competition from domestic producers which has been strengthening in recent years. The trend of textile, wearing apparel and footwear imports also remained unchanged from that of the first half of the year, consumer demand growth being moderate.

We note a significant growth acceleration in the import of chemical industry products, which expanded 13.8% YoY after a 1.0% drop in the first half of the year. Growth was led by pharmaceutical imports, which recorded an explosive rise of 30% YoY. This was probably owed to an increase in government purchases and may prove to be short-lived.

Bank of Russia estimates also indicate services import strengthening to 5.8% YoY versus 0.8% YoY and a 2.3% YoY contraction in the first quarter. Travel contributed the most to this improvement, evidencing foreign travel expansion this year.

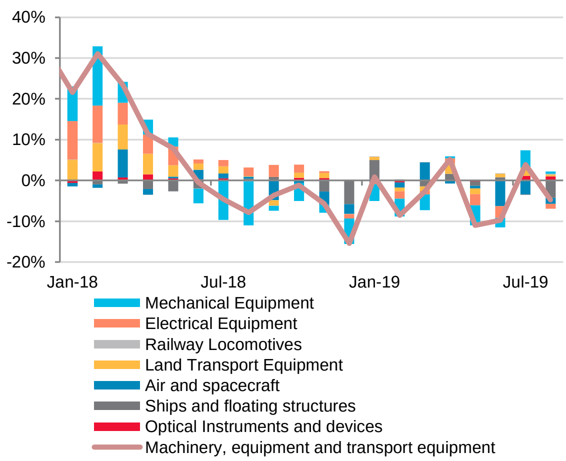
Based on a Bank of Russia estimate, the current account surplus stood at 8.6 billion US dollars in July–August, having narrowed almost by half from +16.5 billion US dollars. A minor rebound of imports and export weakening amid falling oil prices and an overall decline in oil and gas exports in physical terms and some of major items of non-oil and gas exports on the back of the global economic slowdown are conducive to a further contraction in the balance of trade and current account surplus (in seasonally adjusted terms). With the current account surplus narrowing, the rouble exchange rate volatility may increase due to its rising sensitivity to capital flows.

Figure 36. Growth in the components of imports from other than former USSR countries, USD, rate of growth, YoY



Source: CEIC, Federal Customs Service, R&F Department estimates.

Figure 37. Decomposition by component of machinery and equipment imports by value, YoY



Source: CEIC, Federal Customs Service, R&F Department estimates.

1.2.7. Weakening of retail lending growth

- The annual rate of corporate lending growth slowed in August but its seasonally adjusted monthly expansion gained momentum.
- Retail lending expansion was restrained by another transfer of a part of mortgage loan portfolio to an SPV for the purpose of the subsequent issuance of mortgage-backed securities in June and July.
- Data adjusted for mortgage-backed securities debt and the transfer of loans to an SPV indicates continued weakening of retail lending growth in August compared with its dynamic rise at the start of the year. That said, retail lending growth stays in the 15–20% seasonnaly adusted annualized rate range.
- September may well see temporary acceleration in unsecured consumer lending expansion in the run-up to the introduction from October 1 of increased risk ratio buffers to new unsecured consumer loans depending on household borrowers' debt burden. Also, lending demand may be supported by declining loan rates in the months ahead.

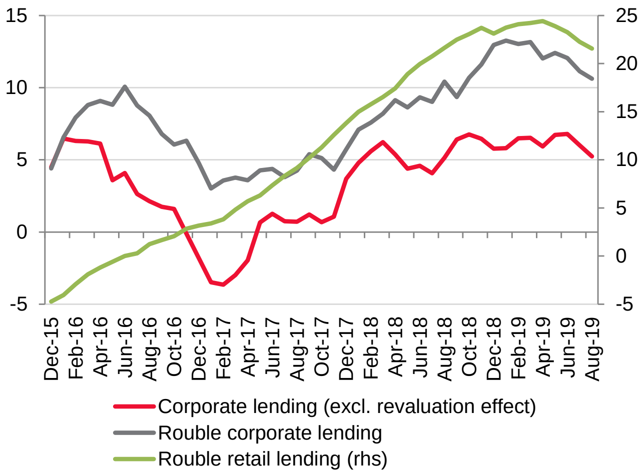
Annual lending growth lost momentum at the start of the third quarter of 2019. Both corporate and retail loan portfolio expansion suffered a downward reversal (Figure 38). Still, the loan rate decline which has resumed lately may support lending growth in the months to come.

The annual rate of growth in outstanding corporate loan debt slowed from 6.8% YoY in June to 5.2% YoY in August,[11] with the rate of expansion in the rouble part of the portfolio dropping from 12.1% YoY in June to 10.6% YoY in August. In seasonally adjusted terms, however, a rouble corporate lending rise accelerated to 0.8% MoM from 0.3% MoM in July. Corporate loan dedollarisation is continuing since forex debt is contracting.

According to banking sector statistics, retail lending growth has varied from 1.1% MoM to 1.5% MoM in seasonally adjusted terms over recent months. This data does not however take into account the transfer of a part of the banking sector's loan portfolio to an SPV as collateral for the future MBS issues in June and July. Given this development, an analysis of retail lending growth based just on banking sector statistics may be misleading.

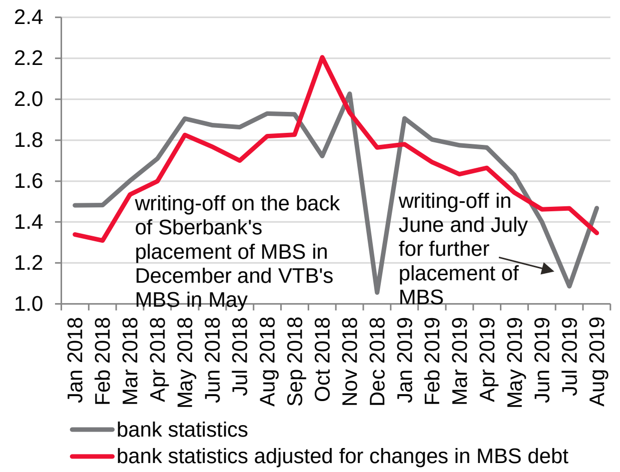
Growth data adjusted for dynamics of outstanding debt on loans providing collateral for mortgage-backed securities and the above write-down of the portion of the retail loan portfolio, suggests the stabilisation of seasonally adjusted retail lending expansion at around 1.5% MoM in June–July and a minor slowdown to 1.3% MoM in August (Figure 39). Gradual cooling of retail lending after its dramatic rise in 2018 is therefore continuing. In annualized terms, seasonally adjusted growth is staying in the 15–20% range. The Bank of Russia wants sustainable growth of loans The macroprudential measures which it uses restrain growth in the most risky segments but do not hamper meeting loan demand from reliable borrowers.

Figure 38. Annual rate of outstanding loan debt, % YoY



Source: Bank of Russia, R&F Department estimates

Figure 39. Retail lending growth, % MoM (seasonally adjusted)

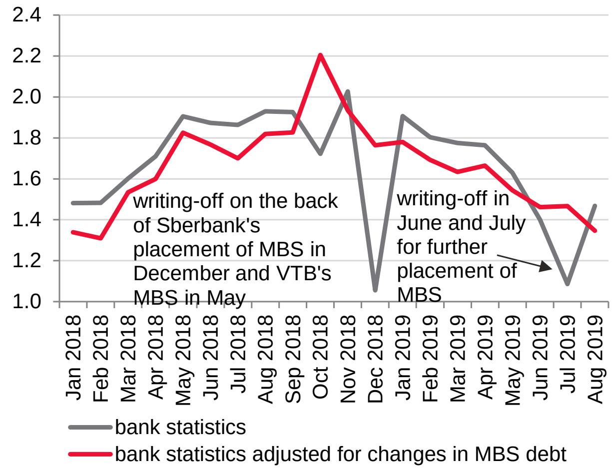


Source: Bank of Russia, R&F Department estimates

[11] Excluding the revaluation effect, for banks which were in operation as of the last reporting date.

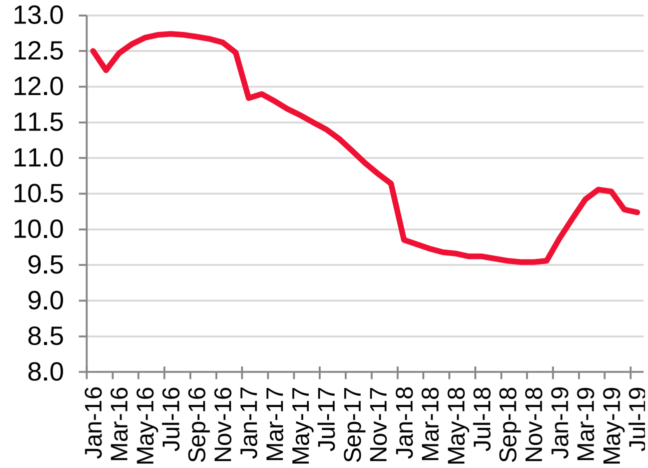
Mortgage lending growth adjusted for the write-down of the portfolio by one of the banks and dynamics of debt on loans providing collateral for MBS stood at around 1.4% MoM in March–July. Growth slowed marginally in August (Figure 40). The annual rate of mortgage loan portfolio expansion was the highest at 25.4% for 2018 and has been slowing gradually to reach 19.4% YoY in August 2019 (20.0% YoY adjusted for the written down portfolio). But the decline in mortgage loan rates which has started lately may support growth in the months to come (Figure 41).

Figure 40. Mortgage lending growth, % MoM (seasonally adjusted)



Source: Bank of Russia, R&D Department estimates

Figure 41. Rate on mortgage loans provided, %



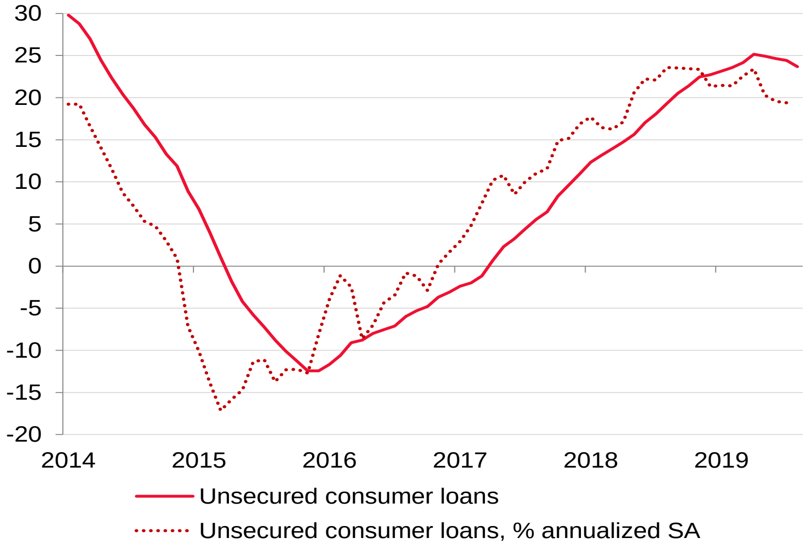
Source: Bank of Russia, R&D Department estimates

Auto loans posted growth acceleration to 2.0% MoM in July, likely driven by the resumption of subsidized auto loan programmes. Growth slowed to 1.5% MoM in August. Given that the subsidized loan limits were quickly used up at the start of the year, a resumption of these programmes may have resulted in a rapid rise in demand. When additional funds come to an end, however, a new growth slowdown is quite possible.

Unsecured consumer lending also shows some growth softening compared with the start of the year and its stabilisation at 1.5–1.7% MoM in May–August (Figure 42), which is still close to 20% in annualized terms. Though the issuance of large loans has increased. Based on National Bureau of Credit Histories data, the share of larger than 500 thousand ruble loans issued in the first half of 2019 stood at 55.1%, up 4.1 pp on the same period of last year.[12]

[12] Based on National Bureau of Credit Histories data, there has been a contraction in the share of "smaller than 100 thousand rouble" loans", and those "from 100 thousand to 300 thousand roubles" in total consumer loans issued. See https://www.nbki.ru/company/news/?id=25410

Figure 42. Unsecured consumer lending growth, %



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

The wide use of large-sum loans suggests that the current lending growth cannot be explained just by a rise in demand for loans taken to meet households' everyday needs. This is also corroborated by credit bureaus whose data indicates that banks maintain a selective approach to household borrowers, providing loans to customers with a good credit history and higher income levels. Moreover, according to Sberbank data,[13] the most popular purposes of spending borrowed funds within several months after taking loans are housing renovations and furniture purchases, which is likely due to mortgage lending growth. Given some slowdown in this growth, demand for consumer loans associated with mortgage lending (housing renovations, furniture purchases, etc.) may also slow, albeit with a lag. At the same time, lending growth may well accelerate in September: banks may boost the provision of new loans in the run-up to the introduction from October 1 of the increased risk ratio buffers to new unsecured consumer loans depending on individual households' debt burden.

[13] https://www.vedomosti.ru/finance/articles/2019/08/14/808795-sberbank

2. OUTLOOK: LEADING INDICATORS

2.1. What do Russia's leading indicators suggest?

2.1.1. GDP nowcast: economic growth stays below potential in 2019Q3

- Based on statistics released by August 30, the estimate of the third quarter GDP growth was revised down to 0.2% QoQ SA. Therefore, growth so far remains below potential.
- Gradual GDP growth acceleration is expected at the start of 2020. Meanwhile, the current index-based estimate for the third and fourth quarters in this model specification does not factor in a possible additional impulse from stepping up budget spending.
- The estimates of quarterly GDP growth below expect GDP growth for 2019 at about 1.0%.

	August **% QoQ SA**	July % QoQ SA
Q3 2019	**0.2**	0.3
Q4 2019	**0.2**	0.3
Q1 2020	**0.3–0.4**	

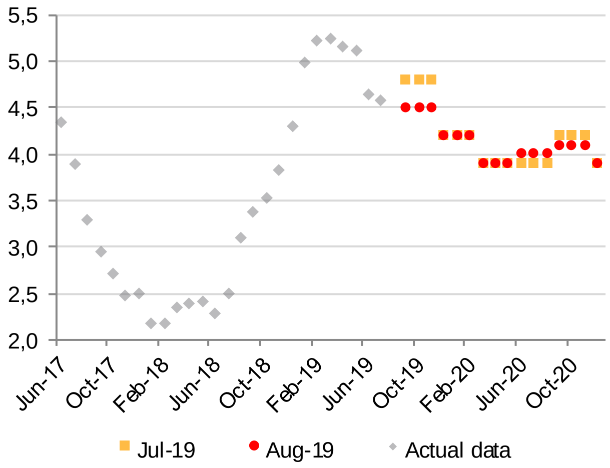
2.1.2. Analysts' inflation expectations remain anchored

- Analysts' short-term inflation expectations have declined somewhat in the wake of actual price movements in recent months. That said, medium-term expectations remain anchored at the Bank of Russia's 4% target.
- Key rate expectations were revised down in August surveys following signal from the Bank of Russia's Board meeting in July. Most analysts now expect the key rate to be cut to 6.50% p.a. in mid-2020.

Analysts' inflation expectations have expectedly continued to decline. Their estimates assume that inflation will slow to 4.5% in the third quarter and continue decelerating gradually to reach 4.2% YoY by the end of the year (Figure 43). Analysts' medium-term inflation expectations remain anchored at 4.0% YoY.

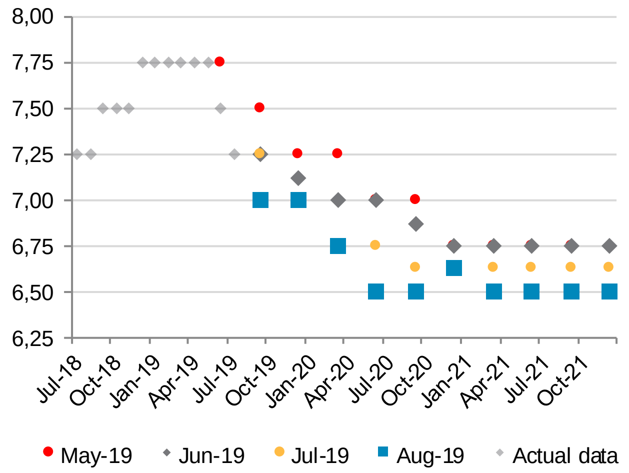
Key rate expectations were revised down on the entire time horizon following the Bank of Russia's July decision and a signal that a further rate cut was possible in July (Figure 44). We do not believe that the Bank of Russia Board decision of September 6 to cut the key rate to 7% p.a. and the subsequent official comments will significantly affect analysts' medium-term key rate expectations in the course of the forthcoming September surveys

Figure 43. Analyst inflation expectations, % YoY



Source: Bloomberg Finance L.P.

Figure 44. Analyst expectations for Bank of Russia key rate, % per annum



Source: Bloomberg Finance L.P.

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