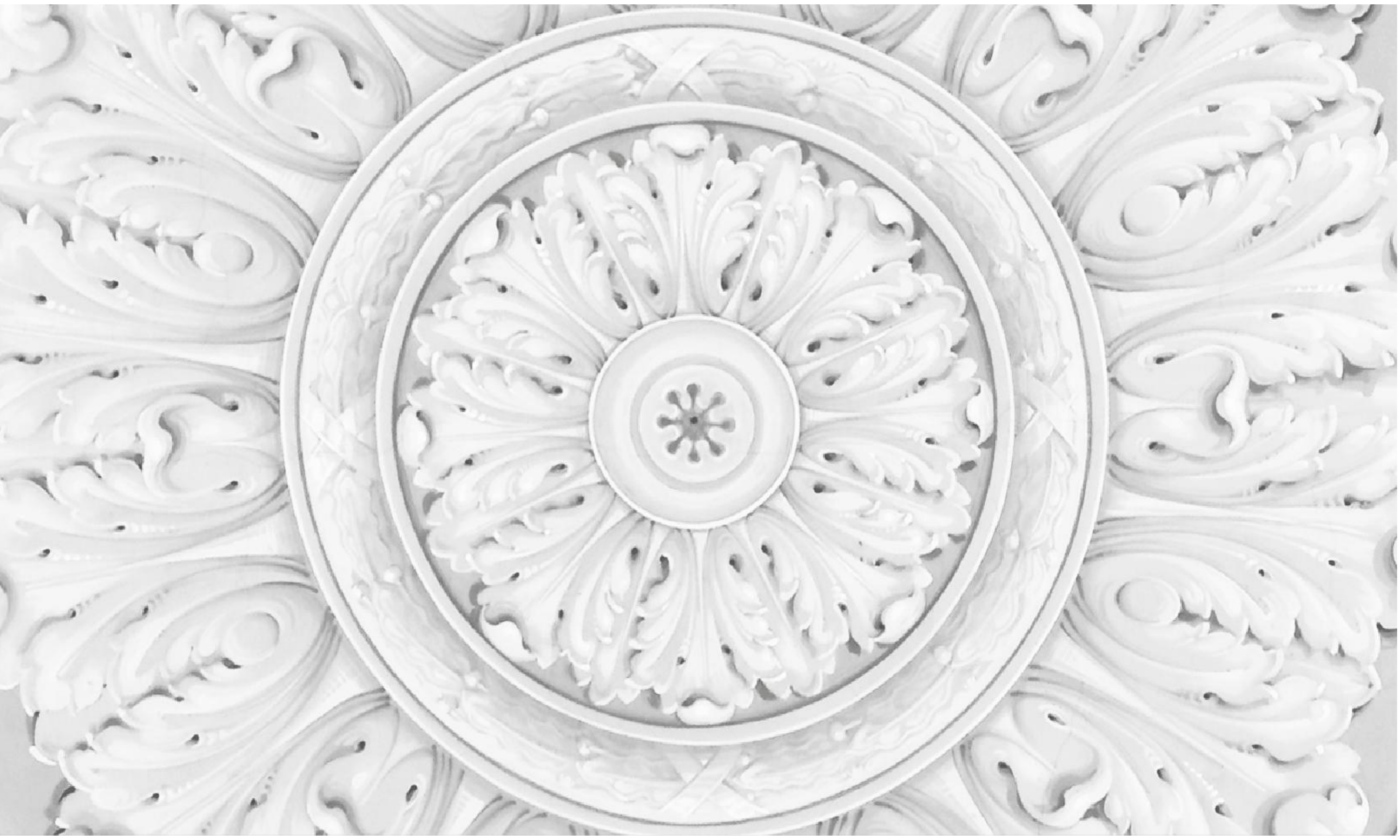
Bank of Russia

The Central Bank of the Russian Federation



TALKING TRENDS

Macroeconomics and markets

March 2017

Research and Forecasting Department Bulletin

No. 2 (14)

The views and recommendations expressed in the Bulletin are solely those of the authors and do not necessarily reflect the official position of the Bank of Russia.

Please send your comments and suggestions to dip_bulletin@mail.cbr.ru

CONTENTS

Executive summary

1. Monthly summary

- Inflation has been decreasing at a slightly faster pace as compared to the Bank of Russia's recent forecasts given the temporary favourable external and financial conditions, alongside the moderately tight monetary policy. Economic activity retained sustainable positive dynamics, with the trend towards recovery strengthening. The current set of risks in the economy makes the case for a highly cautious easing of monetary policy which should overall remain moderately tight.
  - Deviation of inflation from the forecast target path considerably decreased in February, raising the probability of reaching the 4% target for headline inflation by the end of 2017. The latter was a consequence of the moderately tight monetary policy, combined with the appreciation of the ruble. Nevertheless, if inflation expectations remain high and wage growth rates exceed growth rates of labour productivity, additional risks to the target for inflation may emerge.
  - Economic activity is currently characterised by a strengthening in recent positive trends, which may potentially beat the Bank of Russia's expectations. Signs of revival are observed with respect to both consumption and investment demand. The moderately tight monetary policy ensures decreased macroeconomic uncertainty, having thereby a positive effect on economic growth.
  - The moderately tight monetary conditions levelled risks to inflation connected with the Finance Ministry's purchases of foreign currency in the FX market.

2. Outlook

- Our recent model estimates of GDP for 2017 Q1 and 2017 Q2 have been substantially revised upwards, indicating better short-term prospects for economic growth.
- Financial analysts' forecasts of inflation for the end of 2017 have approached the target level, which points to higher confidence about the possibility to reach the target for inflation.
- Leading indicators continue to point to robust growth of the US economy and some positive signs with respect to business activity in the eurozone.

3. In focus. On speculative inflows and the role of foreign investors in the recent appreciation of the ruble

The recent ruble appreciation is mainly explained by the high supply of foreign currency on the market provided by exporters, on the background of seasonally low demand for foreign currency from importers. The inflows of funds from foreign investors explain the ruble appreciation to a lesser extent.

1. Monthly summary

1.1. Inflation

In February, inflation slowdown was faster than expected, on the background of the moderately tight monetary policy stance and a stronger ruble. The deviation from the target path shortened substantially, with chances now stronger that the 4% inflation target will be delivered by late 2017. Analysts' expectations for price growth have by late 2017 moved close to the inflation target, in a sign that the economy is on track to approach this target. That said, households' inflation expectations remain persistently high, while the current growth in wages outruns labour productivity. In this context, additional risks may emerge that jeopardise the chances for delivery on the inflation target once the temporary economic tailwinds have expired and the economy moves to reach a surer footing with steady growth. In such a way, the current balance of inflation risks makes the case for a very gradual loosening in monetary policy, which should overall remain moderately tight.

1.1.1. In February inflation continued to slow down, on track to reach the target

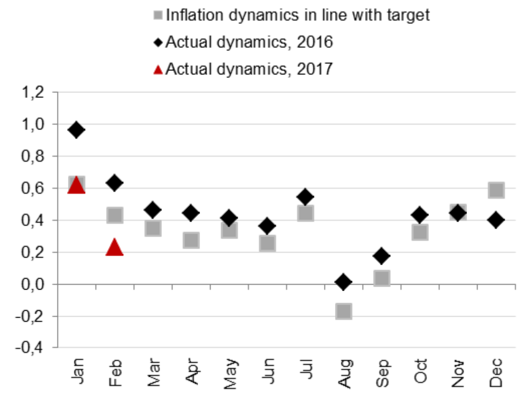
According to Rosstat, prices over the course of 27 days of February climbed 0.2%, way below the level of the target path of inflation[1] (Figure 1). It may well be that weekly price growth estimates underrate the real movements, resulting in higher price growth rates in February[2]. However, the February growth of prices will, in all probability, be at record lows. The annual growth of prices based on weekly CPI estimates was down to 4.5–4.6% from 5.0% seen in January.

The month's second week saw an average daily price increment dwindle to almost zero (Figure 2). Such low growth rates were last seen between August and September last year; once these data are seen between late summer and early September, they are seasonal in nature, whereas zero-like price growth rates are atypical of February and have never been observed before.

Consumer prices are checked by, alongside the Bank of Russia's moderately tight monetary policy stance, a set of economic tailwinds including a strengthening in the ruble and last year's heavy crops. This translates clearly into fruit and vegetable prices posting growth slower than would be expected based on seasonality (Figure 3). Fruit and vegetables, with their short supply cycles, tend to respond quicker to any strengthening in the national currency, compared to other product categories.

[1] This is aligned with seasonally adjusted price growth of 0.1-0.15% MoM.
[2] Ruble exchange rate movements are a factor Rosstat takes into account for its weekly CPI calculations. Still open is the issue of the scale and the speed with which a faster strengthening in the ruble translates into product prices Rosstat monitors only on a monthly basis.

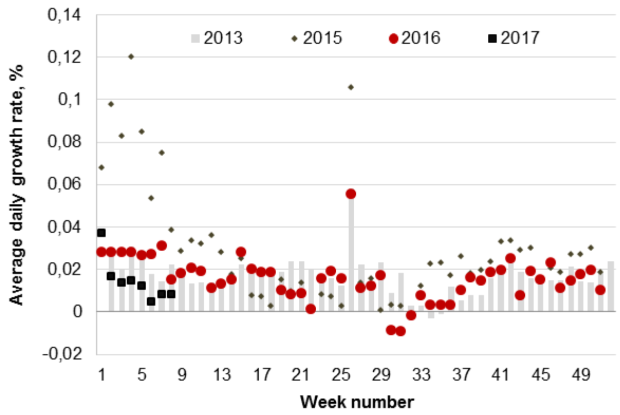
Figure 1. Monthly price growth: target vs. actual, %



** February 2017 reading is an estimate.*

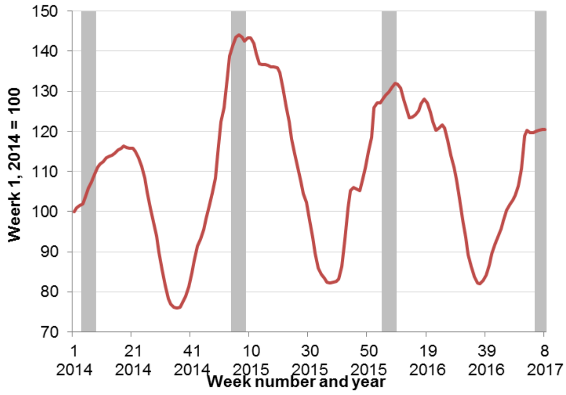
Sources: Rosstat, R&F Department calculations.

Figure 2. Average daily growth rate, %



Sources: Rosstat, R&F Department calculations.

Figure 3. Weekly fruit and vegetable price index[3]



** Grey-highlighted are Februaries.*

Sources: Rosstat, R&F Department calculations.

Figure 4. Households' inflation expectations (median estimates), %

Source: inFOM.

Despite the observed slowdown in growth seen in February, inflation expectations have so far remained unsteady. Median estimates for inflation and anticipated price growth within the next twelve months were upgraded, following the decline over the course of two preceding months (Figure 4). Ultimately, they were at the highest point since November 2016. This can be hardly explained by any seasonal factors, considering that fares and rates for regulated services were mainly upgraded in January and prices for fruit and vegetables grew but moderately. Having said all that, inflation expectations overall continue to trend downwards (Figure 4).

The behaviour of inflation expectations serves to reconfirm the strong impact of tailwinds on slower rising prices. Their stabilisation at the current level or slow decline

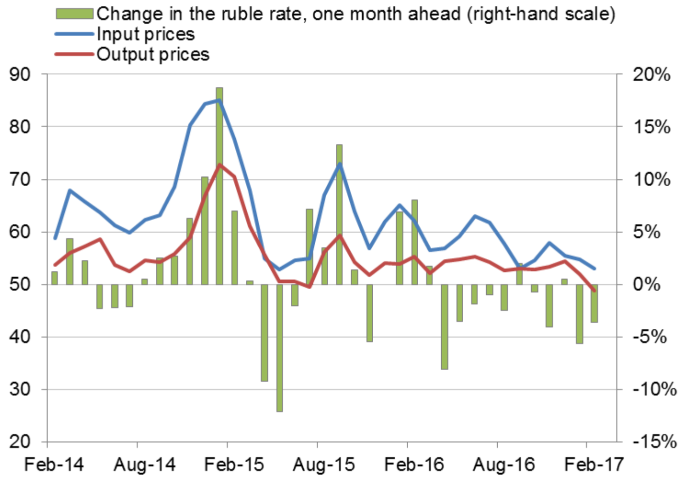
[3] Largely vegetables and potatoes.

points to the potential risks of expedited growth in prices – which may emerge once the temporary tailwinds have run their course.

1.1.2. PMI price indexes: lower output prices in the manufacturing sector

- The manufacturer's price index in the sector was below 50 points, for the first time since July 2015, signalling a drop in ex-factory prices (Figure 5).
- The The recent months' strengthening in the ruble was a key driver responsible for weaker pressure on ex-factory and cost prices. A stronger ruble helped bring down the costs related to the imported component, so selling prices can be reduced in a way that does not negatively affect margins.
- As the performance of PMI price reconfirms, the slowdown in inflation is partially caused by temporarily favourable factors. Once they have expired, inflationary pressure in the economy is set to amplify, to be countered by the moderately tight monetary policy.

Figure 5. PMI price indexes in the manufacturing sector, points



Source: Bloomberg Finance L.P.

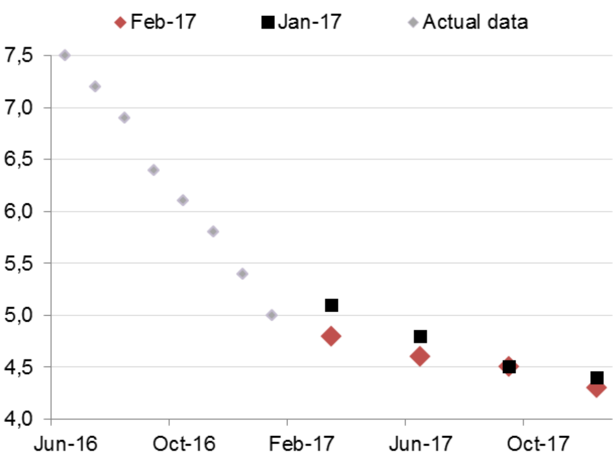
1.1.3. Analysts' expectations for inflation are increasingly aligned with the Bank of Russia's target

- The consensus forecast for inflation was down to 4.3% as of late 2017. This is explained by the more favourable-than-expected inflation dynamics in the first quarter, as well as expectations for the Bank of Russia to keep its moderately tight monetary policy.

- Considering persistent inflation risks and the regulator's rhetoric, under analysts' consensus forecast, a smoother path for the key rate is envisaged, to reach 8.5% by late 2017 against 8.0% suggested by the January survey.

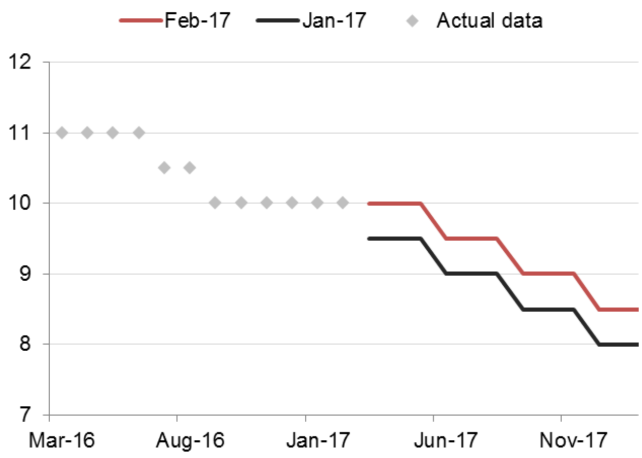
The change in expectations as regards the anticipated path of the BoR key rate and the faster than expected inflation slowdown in the first quarter (under 5% YoY as of mid-February) led to market participants downgrading their quarterly inflation forecasts. That said, the review in H2 forecasts came to be less noticeable as anticipated annual inflation fell only 0.1 pp to total 4.3%. The consensus forecast was nevertheless yet more aligned with the Bank of Russia's target level (Figure 6).

Figure 6. Analysts' inflation expectations, % YoY



Source: Bloomberg Finance L.P.

Figure 7. Analysts' expectations for the BoR key rate,%



Source: Bloomberg Finance L.P.

Analysts in a Bloomberg survey reviewed upwards their forecasts as regards the future Bank of Russia's key rate movements, for the first time since September last year. According to the consensus estimate, the key rate is set to decrease to 8.5% against 8.0% recorded in the preceding survey (Figure 7).

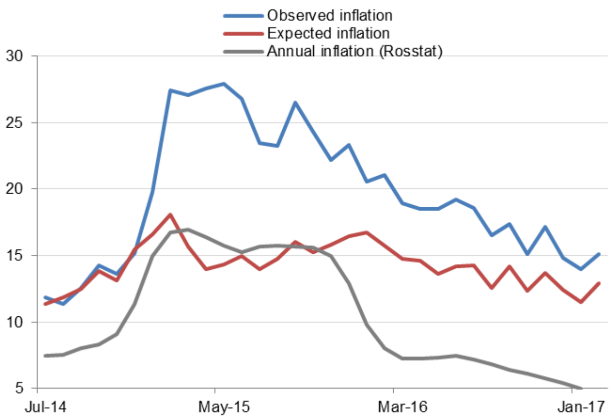
1.1.4. Inflation observed in low-income population groups as a driver for elevated inflation expectations

- The inflation dynamics we calculate *on a consumer basket for low-income layers of population basis* have recently become highly sensitive to exchange rate movements – as contrasted with overall consumer basket inflation.

- In a time of currency exchange shocks, 'inflation for the poor' climbs higher than overall consumer inflation, triggering additional growth in inflation expectations among people with low incomes.
- This may obstruct a downward trend in inflation expectations as inflation slows down.

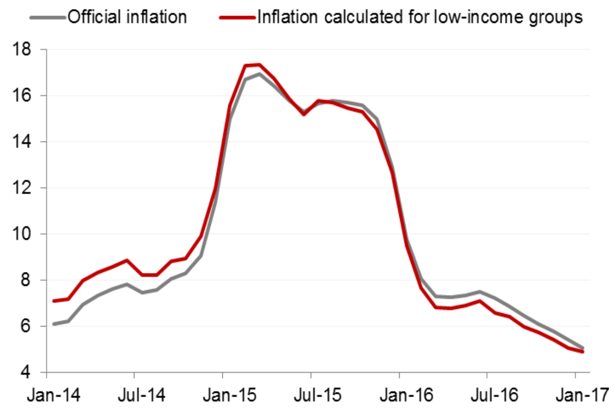
According to an inFOM[4] survey, inflation expectations of households remain persistently elevated (Figure 8). The fact that estimates for anticipated inflation are markedly above the officially released data on price growth is attributed to the differences in various income groups' consumer spending structures, as well as the different compositions of individual consumer baskets Rosstat uses to calculate CPI. In this way, the share of the relatively low-income population's consumption of industrial bread, fruit and vegetable products, clothing and footwear, medical products and utilities is way above its weight in CPI structure.

Figure 8. Annual inflation estimates, median values, % YoY



Sources: InFOM, Rosstat

Figure 9. Overall vs. low-income CPI movements, % YoY



Sources: Rosstat, R&F Department calculations.

The growth in prices as calculated based on the structure of consumption in low-income population groups was in 2014 and in the first half of 2015 higher than inflation as per CPI-based inflation estimates (Figure 9). This is explained by the strong contribution to inflation from products which have a lot of weight in low-income population's consumption structure (e.g., fruit and vegetables and medical goods).

The year 2016 saw a reverse correlation (lower rates of price growth for low-income consumers), stemming from the high 2015 base effect. CPI inflation and annual inflation as computed for low-income population was in early 2017 almost at the same level. Having said that, the stronger price shock that fell to this population group,

[4] 'Inflation expectations and consumer sentiment', No.1, January 2017

compared to the overall shock between 2014 and 2015, may at the present time curb the downward movement in inflation expectations in low-income segments.

1.2. Economic activity

Both macroeconomic statistics and polling data indicate a strengthened trend towards economic recovery. A rebound is finding its way both in consumer and investment demand, buoyed by a rise in oil prices, a stronger ruble, growing salaries and a decreased savings ratio. The current moderately tight monetary policy pursued by the Bank of Russia has favourable bearings on economic growth, helping reduce macroeconomic uncertainty.

1.2.1. Industrial production: growth continued into January

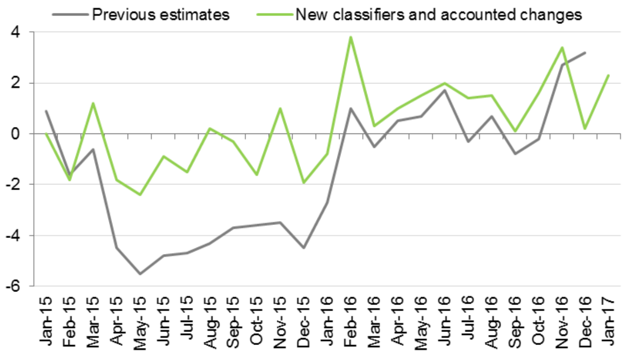
- New Rosstat estimates suggest that the industrial slump in 2015-2016 proved less severe than previously estimated and the economy has by now left all of it behind in 2016.
- Rosstat estimates increasingly match the performance of leading indicators including those based on polling data.
- The industrial production posted a robust start to the year 2017.
- Yet, the industry is poised for a ‘statistical time-out’ in February, on the back of the leap 2016 year effect.

According to Rosstat data, the production sector continued robust growth in the start of 2017. Outputs grew 0.8% MoM (seasonally and calendar factor adjusted) and 2.3% YoY.

The release contains a retrospective revision of 2015-2016 data, with a fairly substantial magnitude (Figure 10). The new estimates recognise that the industrial recession of 2015 turned out to be slighter (-0.8% YoY instead of -3.4% according to the original estimates) and the economy is thought to have overcome it fully in 2016 (+1.3% YoY instead of +1.1% in the original estimate). The most evident revision is seen in the manufacturing sector data (Figure 11), where output contracted in 2015 by a mere 1.3% YoY[5], followed by a slim recovery in 2016 (+0.5% YoY)[6] [7].

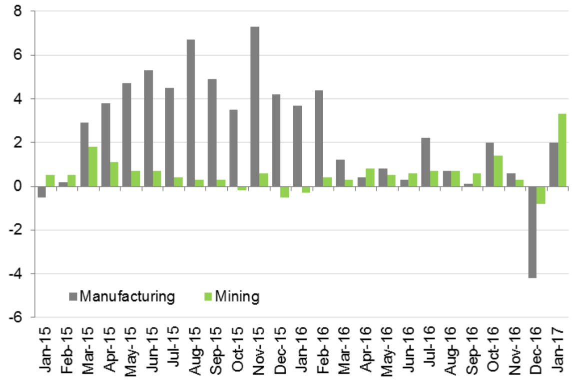
[5] -5.4% YoY by the original estimate.
[6] +0.1% YoY by the original estimate.

Figure 10. Annual industrial growth rates: original and reviewed data, % YoY



Source: Rosstat.

Figure 11. Magnitude of revision in annual growth rates, pp.



Source: Rosstat.

The industrial production index estimates as per the new qualifiers are only available for the period of last three years and only in the aggregated form (industrial production index). While it takes at least 5-7 years of observation to identify a firm seasonal pattern, the required minimum for seasonal adjustment of monthly data is three years. Our estimates suggest that the industry turned in a seasonally adjusted 0.4% MoM growth and a 1.3% MoM seasonally and calendar adjusted growth in January. As follows from the dynamics of annual growth rates, industrial growth was shored up by mining and manufacturing.

Let us note that the revised industrial production data are becoming increasingly aligned with polling data and estimates for economic growth by CMASF and Moscow's Higher School of Economics. Despite a reduction in the PMI index in the manufacturing industry in February from 54.7 to 52.5 pp, business activity in the sector posted rates above its historical average and was mainly unperturbed by a stronger ruble. Taken into account the upbeat behaviour of the PMI index and the Gaidar Institute's ad-hoc enterprise polls, the trend towards recovery in industrial growth looks set to continue. It must be kept in mind however that annual growth rates for February are in for a sharp short fall due to the 2016 leap year effect.

[7] The revision of 2015-2016 industrial production data occurred on the back of two factors. First, Rosstat switched over to new qualifiers by types of economic activity (OKVED2) and that by production (OKPD2) which necessitated the retrospective revision to ensure data comparability. According to the new classification, there are four sectors in the industry. *The production and distribution of electric power, gas and water sector* is now split into two ones: *electricity, gas and steam supply and air conditioning* and *water supply and disposal*, *waste disposal and recycling and clean-up*. Additionally, some changes were made to the accounting of some components of manufacturing and mining. As a result, the new qualifiers partially changed the relative shares of sectors. Secondly, Rosstat took into account all the changes respondents made to the earlier provided data. By CMASF (Centre for Macroeconomic Analysis and Short-term Forecasting) estimates, three quarters of the revision magnitude as regards the industry came as a result of fine-tuning in the classification of earlier provided data: enterprises tend to fail to account for their production in accordance with the new classification codes.

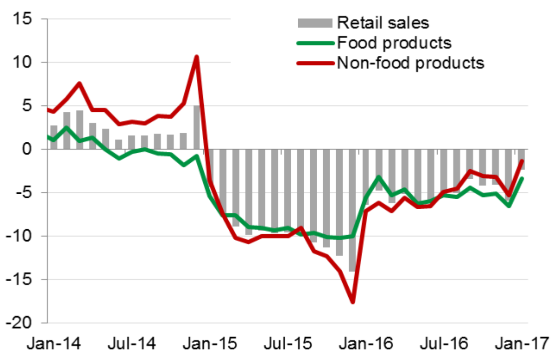
1.2.2. Recovery in consumption on the back of better consumer sentiment

- January's traditional decline in sales, which follows a December uptick, was at six years' low. The resulting annualised rates of contraction in retail sales slowed down considerably.
- Alternative estimates and indirect indicators suggest that the population's consumption is growing as its financial standing is improving on the back of, among other things, slower inflation.
- The impact from the one-off payment to pensioners on retail turnover was but limited. The effect is due to be reflected fully in the performance of consumption and savings in the next few months.

According to Rosstat data, annual rates of retail sales contraction in January slowed down to 2.3% YoY. This saw an outrunning rate of contraction of food sales, compared to the nonfood segment (-3.3% YoY against-1.3% YoY) (Figure 12).

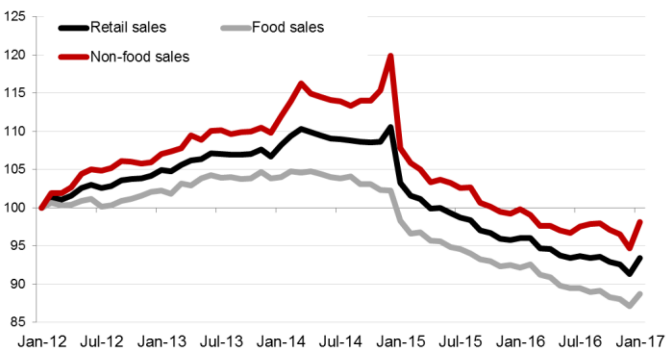
According to the Research and Forecasting Department, seasonally adjusted retail sales increased in January by as much as 2.3% MoM, after a 1.4% MoM drop in December. These comparable growth rates were last observed was December 2014 (Figure 13). Core contribution to the improved dynamics came from sales in the nonfood segment with its growth rates of 3.6% MoM (-1.9% MoM in December). Food sales show a less optimistic picture, with their January increment in sales having totalled 1.8% MoM (-1.0% MoM in December).

Figure 12. Retail sales, % YoY



Sources: Rosstat, R&F Department calculations.

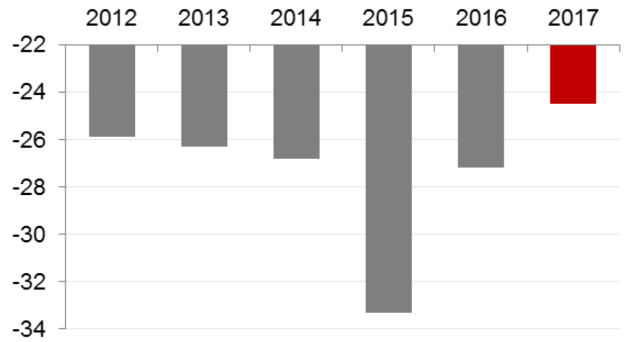
Figure 13. Retail sales and their components (%, January 2012 = 100%, seasonally adjusted)



Sources: Rosstat, R&F Department calculations.

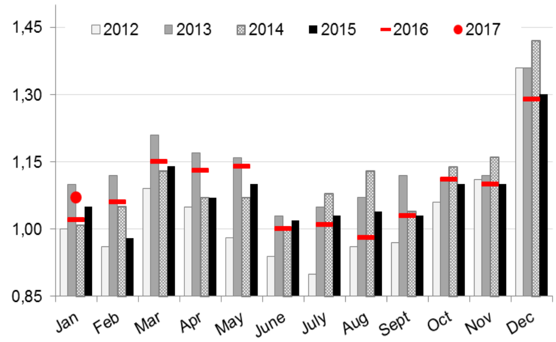
Retail sales in January are traditionally lower than in December. This seasonality is due to the fact that following the upsurge in sales in the New Year / Christmas period, consumers will return to their habitual spending patterns. That said, the contraction of January 2017 was a six years' low, which found its way in seasonally adjusted data (Figure 14). A possible explanation of this trend could be 'seasonal trend evolution', which began to emerge late last year. The traditional pre-Christmas uptick in retail sales was in December lowest for the past eight years. In this way, consumption over the last two months was more even: lower spending in December was also followed by lower reduction in January. This is confirmed once January and November sales are compared. This year, this difference was at its lowest level in several years.

Figure 14. January retail sales in recent years, % MoM (seasonality unadjusted)



Sources: Rosstat, R&F Department calculations.

Figure 15. Real retail spending (%, January 2012 = 100%)



Source: Romir Scan Panel.

An improved consumer market, suggested by Rosstat's January data, is confirmed by a set of alternative indicators representative of the population's consumer behaviour. In this way, according to Romir[8,] a pollster, consumer demand in January was a record high for the past four years[9] (Figure 15).

January saw a rise in the population's demand for services. Preliminary data suggest that the volume of commercial services was up 2.2% YoY, following its immaterial drop of 0.1% YoY in December (Figure 16). The November data were also upgraded: instead of 0.1% YoY growth, the increase in the volume of commercial services totalled 1.8% YoY. Seasonally adjusted data show a 0.6% MoM growth (after a reduction of 0.2% of MoM in December).

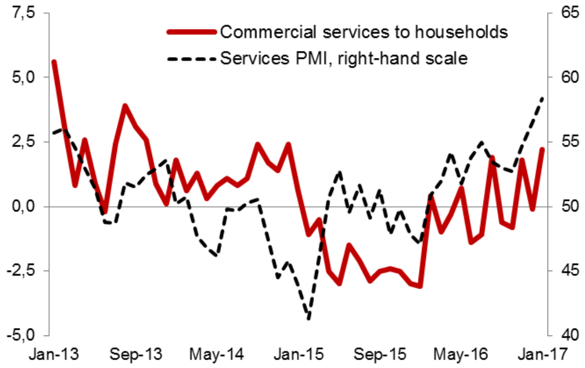
Retail volumes may have been helped by the one-off payment to pensioners, in the amount of 5 thousand rubles. With data for January still unavailable, it is difficult to gauge this effect, both as regards the average pension and the population's spending pattern. The one-off pension payment totalled roughly 10.1% of the overall retail sales in January[10]. The nominal increase in retail sales in January 2017 compared to January 2016 was a mere third of this amount.

Therefore, even if we attributed the total growth in retail sales in January to the spending of the pension payment, most of this money remained unspent. Importantly, this payment was implemented between 13 and 28 January 2017 even to pensioners who

[8] See Romir's research paper («Аппетитный январь», 09.02.2017).
[9] On the same periods of the past years.
[10] Based on open sources, the amount spent was 221.7 billion rubles.

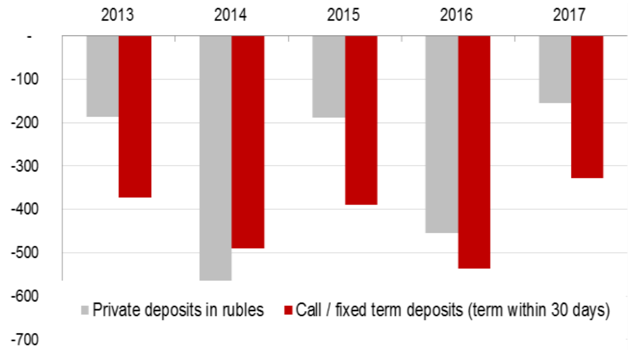
usually receive their pensions in the first days of a month[11]. The one-off rise in incomes occurred in the second half of the month and may not have fully translated into increased spending as pensioners may have kept these amounts on their accounts. This may serve as a partial explanation of the less-than-usual drop in cash on bank accounts (Figure 17).

Figure 16. Commercial services (% YoY) and services PMI



Sources: Rosstat, Bloomberg Finance L.P., R&F Department calculations.

Figure 17. Change in the volume of all and short-term ruble deposits for January, billion rubles[12]



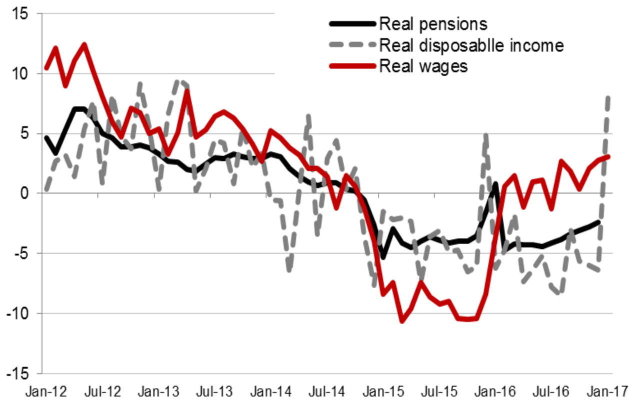
Source: Bank of Russia.

In this way, this pension payment is likely to have implications both for retail sales and savings in the months ahead. At the same time, a more moderate drop in nonfood sales and rising consumer activity on an annual basis seen largely in average and high incomes serves to explain that slower rates of decline in sales in January are not attributed only to this one-off payment to pensioners[13].

The overall economic upturn, suggested by lower inflation, a steadier labour market and an ongoing recovery in real incomes, translated into the current evaluations of consumer sentiment (Figure 18). According to InFOM[14], consumer sentiment index was up 7 pp in January, having reached the October 2014 level. The improvement was seen in the assessment of both financial standing for the past year and expectations for a change to come in the next twelve months. Furthermore, the slower growth of prices for many durable goods led to a hike in the number of consumers who believe the current time to be favourable for major purchases (Figure 19). This is consistent with the dynamics of nonfood sales in January.

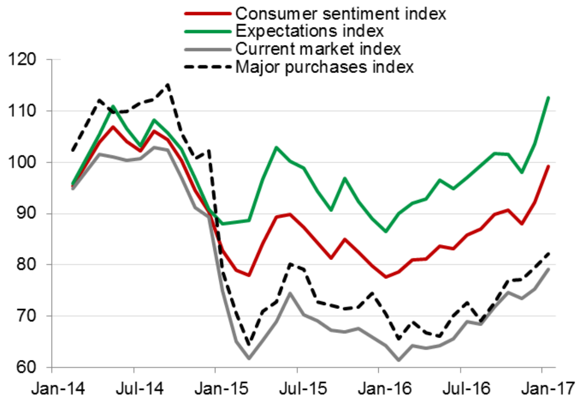
[11] According to the RF Pension Fund data.
[12] Including saving certificate, change from 01.02 through 01.01 of the relevant year.
[13] See Romir's research paper («Аппетитный январь», 09.02.2017).
[14] 'Inflation expectations and consumer sentiment' No.1 January 2017 («Инфляционные ожидания и потребительские настроения населения», №1, январь, 2017 год).

Figure 18. Real income of households, %



Source: Rosstat.

Figure 19. CPI and its components, points



Source: inFOM.

1.2.3. Lower savings ratio in 2016

- December saw a seasonal rise in the household savings ratio, which however was still lower than its December 2015 reading.
- In 2016, the savings ratio came in close to its pre-crisis 2012-2013 values.

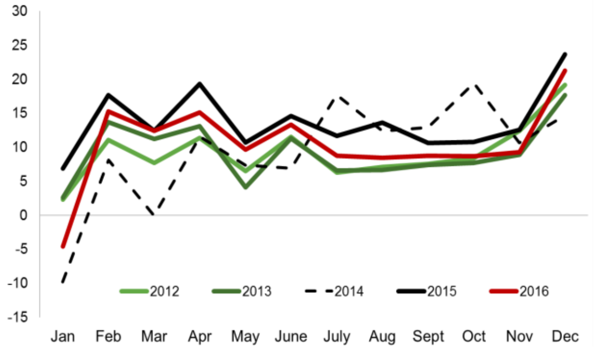
Rosstat data suggest that December 2016 saw a seasonal rise in the savings ratio to 21.3%, mainly on the back of growing income from deposits and securities, in comparison with November (Figure 20).

Data on the average savings ratio, with income dynamics taken into account, are indicative of an ongoing alignment with the 2012-2013 level: the 2016 savings ratio surpassed those years' readings but dropped compared to 2015 (Figure 21). The saving rate also saw a decline once we take into account the increment in households' cash on hand, foreign currency deposits and purchases of foreign currency. Moreover, the savings ratio including foreign currency deposits saw a steep decline in 2016 in comparison with 2015[15]. However, the reduction in the share of savings was to a certain degree set off by households' cash on hand.

With the emerging recovery of households' real income, these savings ratio movements may point to a gradual stabilisation in households' propensity to save.

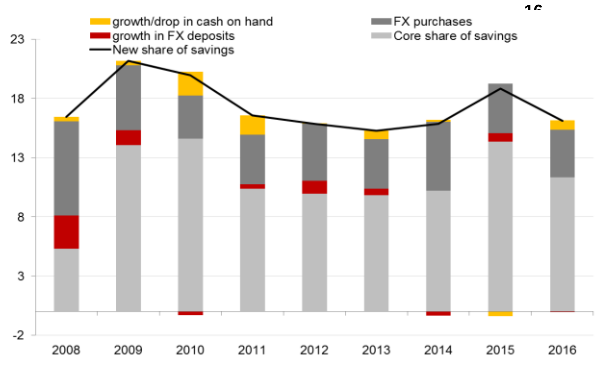
[15] The increase in households' FX deposits, cash on hand and purchase of foreign currency is calculated relative to the monetary income.

Figure 20. Savings ratio in households' incomes, %



Sources: Rosstat, R&F Department calculations.

Figure 21. Income-weighted share of savings as change in cash on hand, foreign currency deposits and purchases[16]



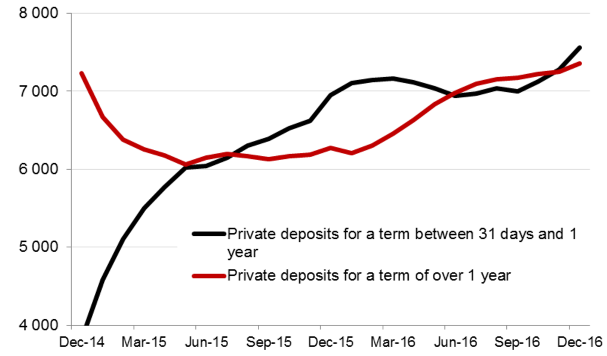
Sources: Rosstat, Bank of Russia, R&F Department calculations

The distribution structure of cash income in December saw but a marginal change against the previous year. The drop in the share of savings in income came with a rise in the share of income intended for purchases of goods and services (from 56.7% to 58.6%), including purchases of goods and services with the use of bank cards abroad (from 1.0% to 1.6% in December 2016) and also statutory payments. The share of income spent on foreign currency purchases in December was unchanged against December last year at 3%. Given the dropping share of income intended for purchases of foreign currency, we see a continued redistribution between households' deposits and savings in cash.

Furthermore, according to Rosstat, households' monetary income was almost the same against December last year (-0.4% YoY); taking into account a stronger ruble, it is possible to speak about some growth in household spending on foreign currency purchases in the equivalent to forex amount. It should be noted, however, that Rosstat's structure of income spending does not include foreign currency purchases in savings, with a separate line assigned to this amount, so only deposits in rubles, not in foreign currency, are treated as savings.

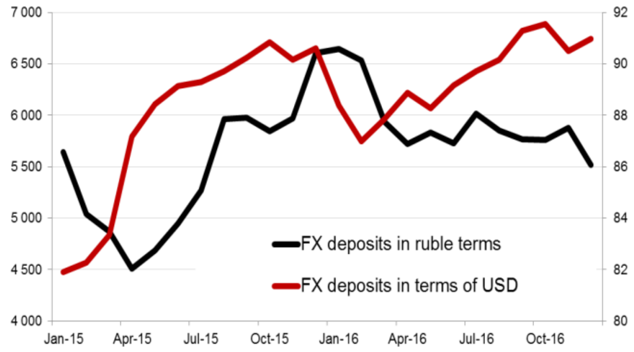
[16] Changes in foreign currency deposits were calculated based *the Banking System Review* data ('Обзор банковской системы').

Figure 22. Household ruble deposits, billion[17]



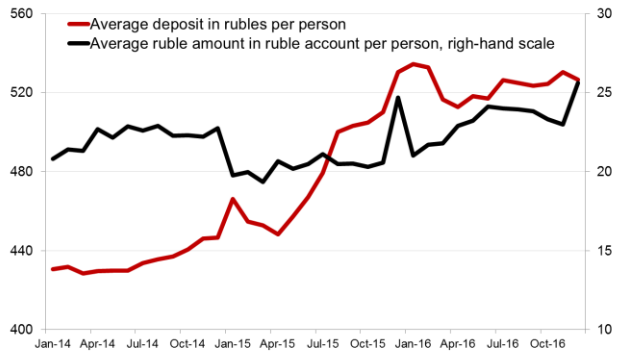
Sources: Bank of Russia, R&F Department calculations.

Figure 23. Household deposits in foreign currency expressed in rubles (billion) and US dollars (billion, right-hand scale)



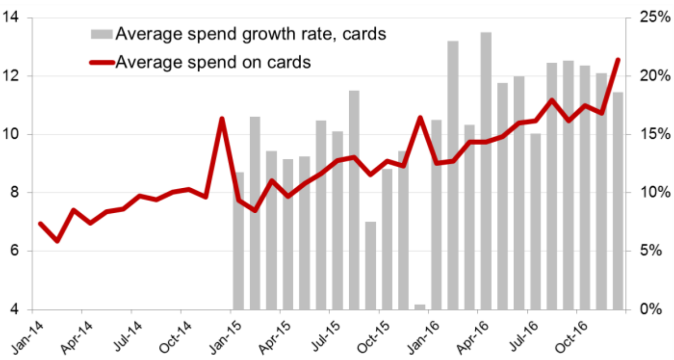
Sources: Bank of Russia, R&F Department calculations.

Figure 24. Average holder's deposits / cash on current accounts, thousand rubles[18]



Sources: Sberbank's open data, R&F Department calculations.

Figure 25. Average spend on cards (thousand rubles) and their growth rates (% YoY)[19]



Sources: Sberbank's open data, R&F Department calculations.

Ruble deposits in 2016 saw an outrunning growth in deposits for a term of over one year (Figure 22). Foreign currency deposits in the course of the year were virtually unchanged on last year, thanks to some growth that set off the contraction early in the year (Figure 23). The rise in 2016 Q3 and Q4 was largely dictated by advancing foreign currency deposits for the term of up to 30 days.

Against the backdrop of a potential rebound in lending, we can expect a further drop in the savings ratio on the back of higher loan debt. Improved consumer expectations will also spur a downward trend in the savings ratio, helping lower buffer savings.

---

[17] Movements in ruble and foreign currency deposits, including saving certificate, exclude deposits for a term less than 30 days.
[18] The ratio of balance of deposits and saving certificates to the number of unique clients as of end of period (excluding deposits in the amount of under □1,000) and the ratio of current and card account balance to the number of unique clients at year-end).
[19] The ratio of debit transactions on card accounts to the number of clients in a period. This includes POS and ATM debit transactions and web-payments.

The rebound in household incomes will continue to facilitate accumulation of savings in the case of those who previously had no cash to save. In such a way, we saw a rise in the average share of those who would save rather than spend (including on current goods and services) their extra cash, should it become available in 2016[20]. This rise continued into January 2017. The evidence to gradually recovering household incomes is twofold. First, this is an upward trend in the average amount of deposits and funds on current account per person. Second, we observe increased spending on bank cards, in a sign that demand is improving (Figure 24 and Figure 25).

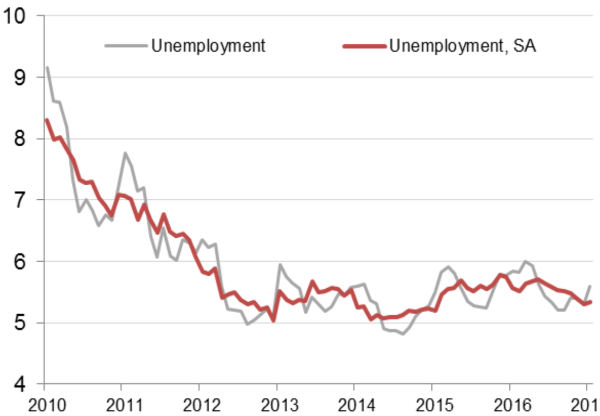
1.2.4. Expedited growth in real wages as unemployment steadies

January's labour market stabilised as the improvement on 2016 H2 takes hold.

Annual wage growth rates in real terms were above 3% as those of nominal wages remained unchanged on the backdrop of a steep decline in price growth.

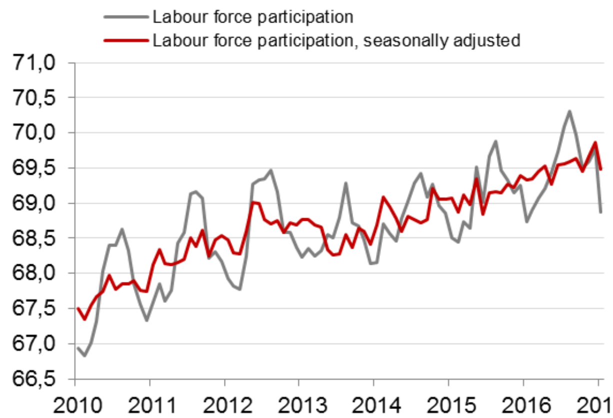
The extended indicator average nominal wages in 2016, which includes those employed by private entrepreneurs and individuals, rose less than average wages of corporate sector employees, which suggests lower rates of wage growth in the informal sector.

Figure 26. Unemployment, %



Sources: Rosstat, R&F Department calculations.

Figure 27. Labour force participation, %



Source: Rosstat.

The labour market was mainly unchanged and is overall a lot better than in the first half of the past year. Although the level of unemployment in January rose to 5.6% on 5.3% in December, this was due to the headwinds of a seasonal nature. Once seasonally adjusted, this indicator grew but marginally 0.05% to 5.35% (Figure 26).

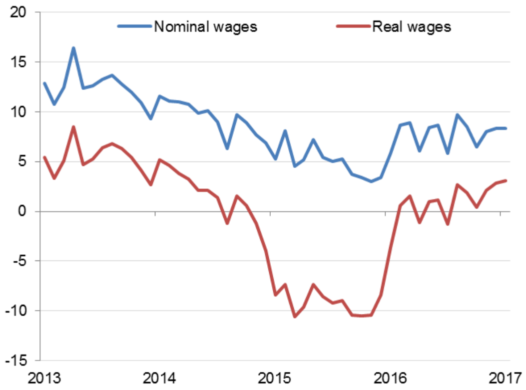
Households' economic activity, seasonally adjusted, dropped somewhat, with the upward trend however still holding (Figure 27). The number of employed in January grew in absolute numbers by as many as 296 thousand (+0.4%) against January 2016, while

[20] Based on inFOM's survey (excluding those undecided).

the number of unemployed fell by 140 thousand (-3.2%). As a result, the numbers of unemployed dropped by 156 thousand (-0.5%).

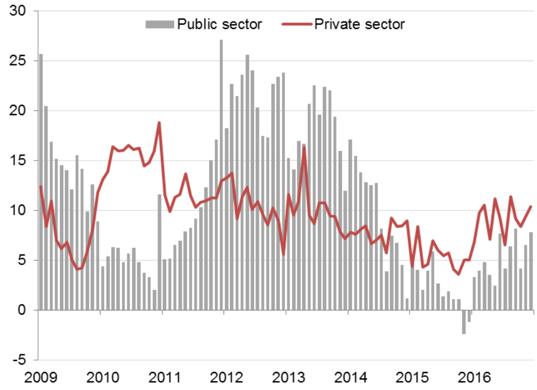
The fact that positive dynamics in the labour market are taking hold is evidenced by the current trends in wages. According to Rosstat's preliminary estimates, the growth of nominal wages in January was 8.3%, while real wages grew at the rate of 3.1%, helped by slower inflation (Figure 28). These trends are confirmed by Sberbank's data which point to 8.6% of YoY growth in wages of the bank's clients in January.

Figure 28. Nominal and real wage growth rates, % YoY



Sources: Rosstat.

Figure 29. Wage growth rates, % YoY



Sources: Rosstat, R&F Department calculations.

Throughout 2016, the average nominal monthly wages in the corporate sector grew 7.8%. Aiming to provide an assessment of how the President's May decrees are implemented, Rosstat publishes a modified average wage indicator which now includes, beyond corporate sector employees, both people employed by private entrepreneurs and individuals. This indicator posted in 2016 a more moderate growth of 6.4%. This suggests that the informal sector wages were growing at a slower pace than those in the formal sector, resulting in more moderate consumer growth in the course of 2016.

The wage data by economic activity types released for December (Figure 29) suggest that the earlier trends persist. Wages in the private sector of the economy are still growing faster than those in the public sector, having reached double-digit values. At the same time, the gap in the dynamics of wages across sectors remains high enough.

Should the private sector continue to turn in double-digit wage growth which outruns productivity growth, inflation risks will emerge. Going forward, these have to be taken onto account in monitory policy.

1.2.5. Imports are recovering as the ruble is strengthening

- Growth in imports is increasingly more homogeneous, in a sign that overall economic improvement is in place.

- The contribution of investment products to growth in overall imports is sustainably above 50%; it supports expectations for positive developments in fixed capital investment in the first quarter of this year.
- Growing consumer imports signal a recovery in households' consumer activity.

According to preliminary FCS data, non-CIS imports in January 2017 posted accelerated annual growth rates to 36.4% from 11.1% seen in December 2016. Improved consumer expectations and business activity indicators, as well as a stronger effective ruble exchange rate, have a positive bearing on imports.

The strongest contribution to gains in non-CIS imports both in terms of paces of recovery and in terms of demand for external purchases comes from machinery and equipment. The contribution of this category to growth rates of imports is more than 50%. Improvement is steadiest in imports of mechanical and electrical equipment. Other subcategories within imports of machinery and equipment remain volatile.

The chemical sector is the second largest contribution to imports. Seasonally adjusted, a marked improvement is seen in imports of rubber, polymers, detergents and cleaning products, and medical supplies. Improvement is also finding its way in imports of clothes, textiles and footwear. The greatest growth is observed in imports of footwear, both on a monthly basis and annualised. These are import categories most responsive to expectations for future demand and fluctuations in the real ruble exchange rate. In this way, these indicators becoming stronger are probably indicative of overall economic improvement. A less robust growth is seen in the food industry, with its key import categories still showing mixed data, which may be down to a certain rise in domestic production as well as the continued effect of Russian counter-sanctions.

Although January data on imports are overall not representative due to seasonal specifics, they suggest that the trend towards an outrunning recovery in imports vers. exports is still in play. The continued advancement in imports of investment products will enable positive expectations as regards investment in this year's first quarter; while burgeoning consumer imports may well suggest a long-awaited recovery in consumer demand on the back of overall economic improvement.

1.3. Global economy, financial and commodity markets

1.3.1. Global economy: the US Fed's hawkish mood

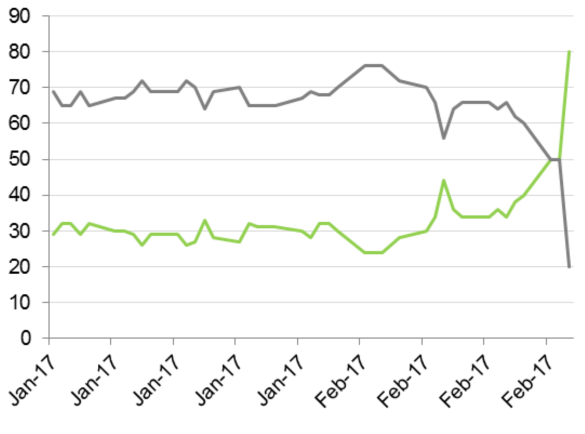
- The hawkish narrative of the US Fed's governors together with the plans to boost defence spending translated into higher probability of the federal funds rate's hike as soon as the March meeting.

- Inflation acceleration in the eurozone is temporary in nature and insufficient to exert high inflationary pressure. However, it is sufficient to check consumption and boost economic growth this year.
- Rising inflation in China comes with advancing shadow financing and tighter monetary policy.

USA: the US Fed remains hawkish

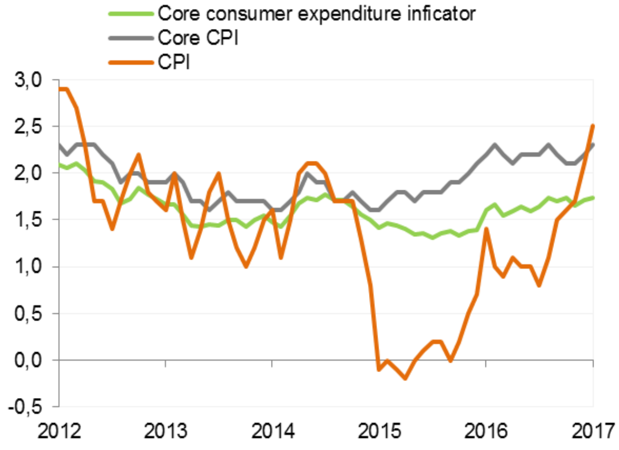
Last month's statements by Janet Yellen and other governors of the US Fed, as well as the minutes of the Fed's meeting of 1 February were outright hawkish. Everything seems to suggest that the regulator underestimated the probability of a rate hike at the forthcoming meetings and tried to convince market participants of its determination to further normalise monetary policy. Looking back, the market expected two rate hikes in 2017, while the US Fed's governors forecasted three upward revisions. The situation changed considerably as Donald Trump revealed his plans to scale up defence expenditures by $54 billion. If approved by the US Congress, the increase in the defence budget will be comparable with that in the periods of military campaigns in Afghanistan and Iraq. Taken together, these developments made the market reassess the possibility of a rate hike as soon as March. The prospects of an upward rate revision are far beyond 50% (Figure 30). Nevertheless, most analysts still expect only two rate hikes in 2017, though there are a bit more of those who predict a faster policy normalisation.

Figure 30. Prospects of the US Fed's decision due in March, %



Source: Bloomberg Finance L.P.

Figure 31. Inflation indicators, %



Source: Bloomberg Finance L.P.

Donald Trump was expected to reveal more of his fiscal plans in the address to the US Congress on 28 February. However, Mr Trump focused exclusively on infrastructural issues, saying that he was going to spend on infrastructure $1 trillion of public and private investment in the next decade. The president made another promise to cut taxes, without going into technicalities. Apparently, the details of the tax reform will be revealed later. The budget for the 2018 fiscal year is now being drafted. It provides for an increase in the defence expenditures of $54 billion as compared with the effective rule for their reduction under the budget cut approved by Barack Obama. Lifting the cap on military spending should be approved by the Democrats, which is unlikely – given that additional defence funding cuts other budget items. As the Republicans do not have a 60% majority in the Senate to approve the draft budget, the additional fiscal initiatives are supposed to be proposed in special acts which need to be approved by a simple majority. However, only one such initiative a year can be proposed. In 2017, the Republicans will use this opportunity to reform the national healthcare.

Thereby, the tax reform is likely to be postponed for one year. Large-scale infrastructure investment and the increase in defence expenditure will need to be approved by both houses of the Congress. The recent statements failed to shed light on the terms and scale of Donald Trump’s fiscal initiatives. Therefore, the ongoing monetary policy is determined by the nature of the statistics. As the US Fed has repeatedly stated, it is going to tighten its policy if the key inflation and labour market indicators meet expectations. The labour market continued to signal aggressive growth in January (adding 227 thousand new jobs), while inflation accelerated to 0.6% MoM or 2.5% YoY, a five-year high, on the back of higher petrol prices (Figure 31).

The February statistics on the deflator for personal consumption expenditure, the US Fed’s key inflation indicator, and the labour market will be released by the next meeting of the US Fed’s Federal Open Market Committee (14–15 March). Other macroeconomic statistics released in February also pointed to the aggressive growth of the US economy. According to the New York Fed’s calculations, annual US GDP growth is currently estimated at 3.1%. We believe that the US Fed’s policy decisions at the March meeting will be determined by the nature of labour market statistics, mostly wage growth data. It is one of the few indicators which underperform in terms of sufficient inflationary pressure to be created.

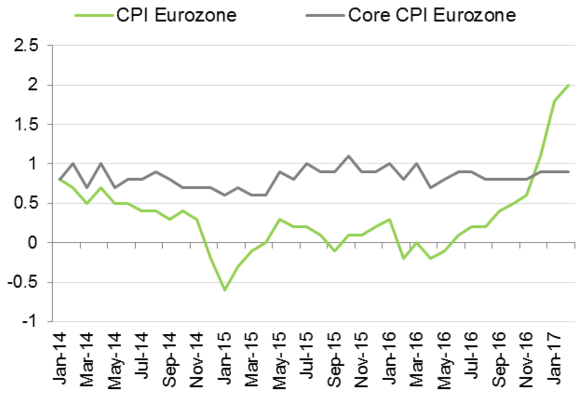
Eurozone: the acceleration of inflation is temporary in nature

The released verbatim report of the January ECB meeting confirmed that the regulator did not see any signs of growing inflationary pressure, though inflation accelerated close to the target level (Figure 32). Core inflation, which does not show any signs of acceleration, underpins this conclusion. Growth of headline inflation is apparently temporary in nature and results mainly from the energy component.

Having said that, the members of the Governing Council agreed that the ECB’s loose monetary policy mitigated risks to economic growth and falling inflationary pressure. Nevertheless, the ECB is ready to extend its quantitative easing programme if the situation deteriorates. The verbatim report of the January meeting showed that the current programme would remain in place at least until the end of the year. That said, the ECB may take a looser stance to allow short-term deviations from the country-based bond purchase. It may taper spreads between Italian, Spanish and French bonds and the German bonds, which have grown since the beginning of the year (Figure 33).

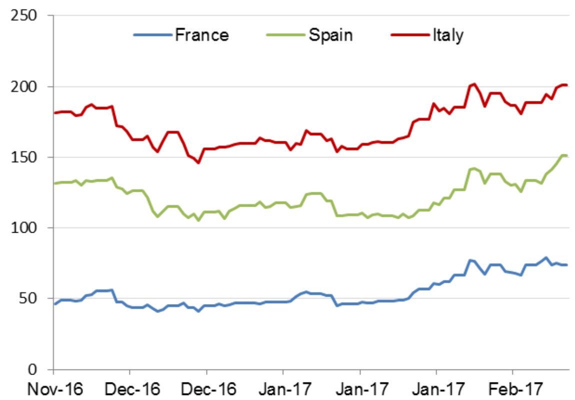
The eurozone's economic growth in 2016 Q4 fell short of the initially released estimates. GDP went up 0.4% QoQ against the 2016 Q3 readings and is unlikely to pick up in 2017. Consumer demand will be checked by temporarily accelerated inflation and growing uncertainty due to the problems accumulated on the fringes of the eurozone and the upcoming elections in some core countries.

Figure 32. Eurozone's consumer price indices



Source: Bloomberg Finance L.P.

Figure 33. Spread between 10-year sovereign bond yields and the German benchmark



Source: Bloomberg Finance L.P.

Industrial production contracted 1.6% MoM in December, falling 3.1% MoM in Germany, 0.9% MoM in France and 0.5% MoM in Spain. However, leading PMIs and EC indices point to a temporary nature of the negative trend. Robust external demand should back up industrial performance.

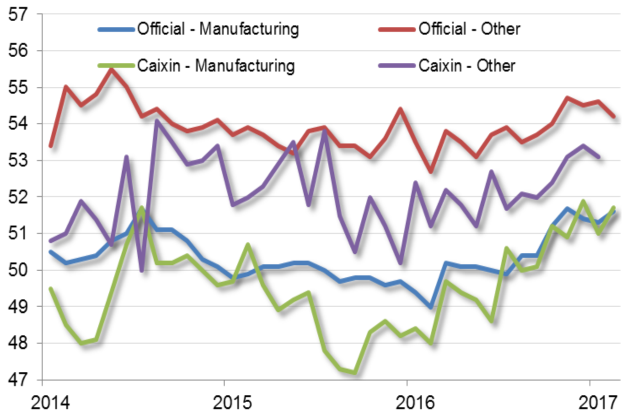
China: inflation is accelerating and shadow financing is gaining ground

The official and Caixin PMI held relatively high in the early months of the year (Figure 34). We can see export orders going up as the global economy is set to grow.

The January foreign trade data suggest that both commodity exports and imports grew considerably (7.9% YoY and 16.7% YoY, respectively) (Figure 35). It may be attributed to seasonality, mainly the shift of the Chinese New Year to January. Meanwhile, Capital Economics' adjustment for seasonality suggests that the positive trend also results from growth in both internal and external demand. Given the improved short-term prospects for global economic growth (see Section 2.1.1. Global PMI: business activity keeps growing steadily), exports may be supposed to become an important driver of the Chinese economy in 2017.

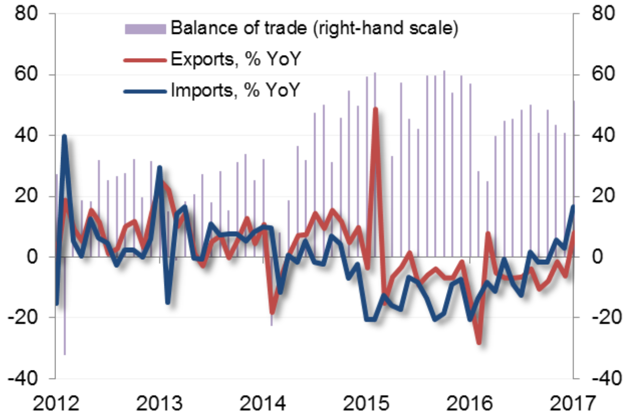
In January, China saw accelerated growth in consumer (to 2.5% YoY against 2.1% YoY in December) and producer prices (to 6.9% YoY against 5.5% YoY in December) (Figure 36). Apart from the recovering commodity prices, the shift of the Chinese New Year was an important driver of consumer inflation that suggests that inflation may slow down in February. However, core inflation continued to grow to the five-year high of 2.2% YoY (1.9% YoY in December).

Figure 34. Official and Caixin PMI in manufacturing and other sectors, points



Source: Bloomberg Finance L.P.

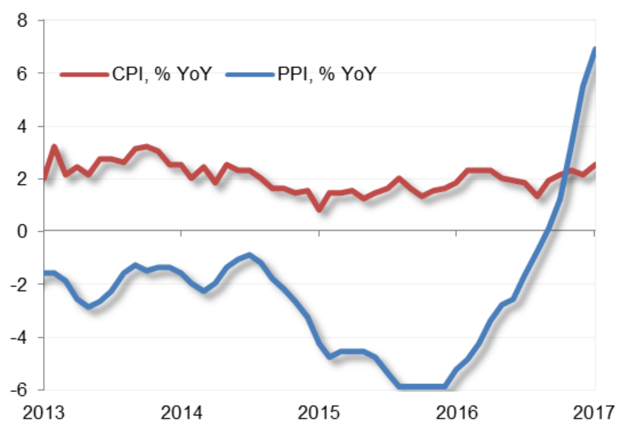
Figure 35. Growth in commodity exports and imports and China's balance of trade (billion US dollars)



Source: Bloomberg Finance L.P.

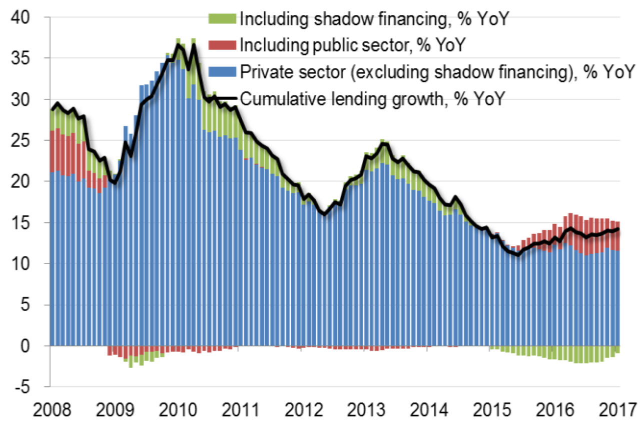
Inflation growth is accompanied with sustainably high lending to the economy. The ongoing decline in lending to private and public sectors is offset by expanding shadow financing, which conventionally steps up during the downward swing of a lending cycle (Figure 37).

Figure 36. Consumer and producer price indices in China



Source: Bloomberg Finance L.P.

Figure 37. Lending growth in China

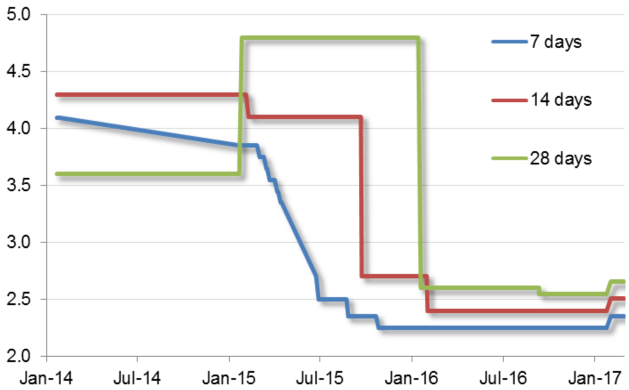


Sources: Bloomberg Finance L.P., CEIC, R&F Department calculations.

Natixis estimates that entrusted loans[21] grew 20% YoY in January. The key net borrowers are developers, whereas net lenders are companies engaged in excess capacity sectors such as coal and metal mining. The latter's limited profits from the main activity make them seek profits in other areas. In addition, a Financial Times-conducted research has shown that shadow financing is an important source of mortgage lending in the periods when its conditions are tightened. The government's measures suggest that growth of shadow financing may slow down.

The People's Bank of China (PBC) continued to revise interest rates upwards. Having increased rates on the medium-term loan facility (MLF), it raised rates on standing lending facility (SLF) and open market operations (OMO) (Figure 38). We believe that the PBC will continue to raise its rates[22] to keep inflation, capital outflow, renminbi exchange rate and financial market risks in check. At the same time it will avoid new market turbulence and ease additional negative impact on economic growth.

Figure 38. PBC's reverse repo rates, %



Source: Bloomberg Finance L.P.

Figure 39. PBC's international reserves and FX interventions

Sources: Bloomberg Finance L.P., R&F Department calculations.

China's international reserves fell below $3 trillion (Figure 39). The moderate dynamics are explained by a considerable positive exchange rate revaluation. At the same time, our estimates suggest that the PBC's measures to prevent financial market turmoil in the first half of the month stepped up its FX interventions to their highest since February 2016. A Financial Times-conducted survey showed that economic agents in China expect the renminbi to depreciate; they are more attentive to the RMB/USD than RMB/currency basket exchange rate, seeking to save mostly in foreign currency.

[21] Direct financing of one corporation by another through a credit institution that bears no risks but obtains a commission as an intermediary.
[22] Significantly, unlike most national banks the PBC usually changes liquidity volumes and instruments' maturity rather than revises its policy rate (the PBC is establishing its interest rate corridor) to steer money market rates.

1.3.2. Financial markets: equity markets set new records

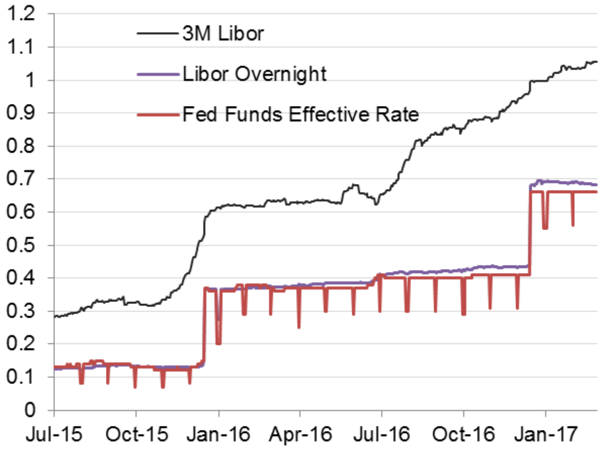
- Risk appetite grew as sovereign bond yields of advanced economies went down.
- Market indicators suggest that two to three rate hikes by the US Fed are expected till the end of 2017, with the first one due in mid-March.
- Moody's, a rating agency, upgraded its outlook on Russia's sovereign rating from negative to stable. In their price calculations, markets had long expected rating agencies to act more positively,
- February turned out to be the worst month for the Russian equity market since late 2014, due to the sinking optimism about the prospects for easing of international sanctions.

Global markets

Global markets faced quite a strange situation in February. On the one hand, stock indices were on the rise, especially in developed countries, signalling growth in risk appetite. On the other hand, sovereign bond yields of advanced economies went slightly down, which is untypical of periods of higher interest in risk assets.

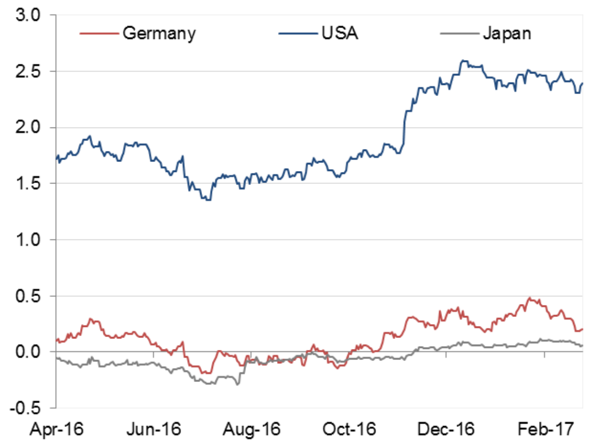
The US stock indices repeatedly hit their historical highs in February as positive macroeconomic data were released and Donald Trump promised to dramatically change the corporate tax system.

Figure 40. US dollar LIBOR rate, %



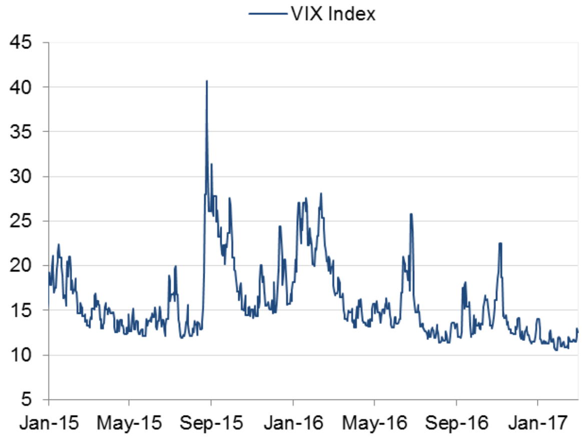
Source: Bloomberg Finance L.P.

Figure 41. 10-year bond yields of advanced economies, %



Source: Bloomberg Finance L.P.

Figure 42. VIX index (S&P500)



Source: Bloomberg Finance L.P.

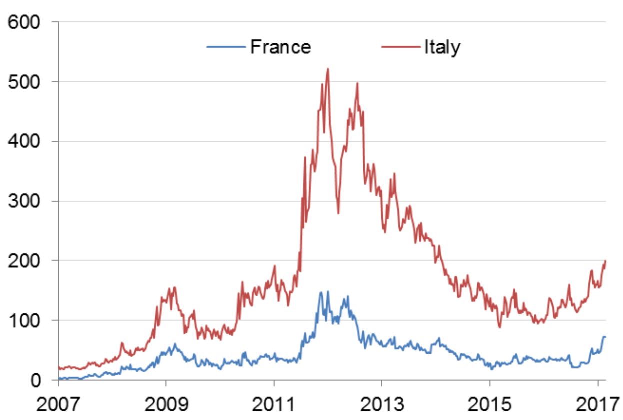
Figure 43. Stock indices in local currency, 1 January 2016 = 100

Source: Bloomberg Finance L.P.

The probability of the US Fed's rate hike as soon as March exceeded 80% late in February, after a number of statements by the regulator's representatives, whereas it hardly reached 40% before that. The dynamics of federal funds rate futures suggest that the market expects two to three rate hikes till the end of 2017.

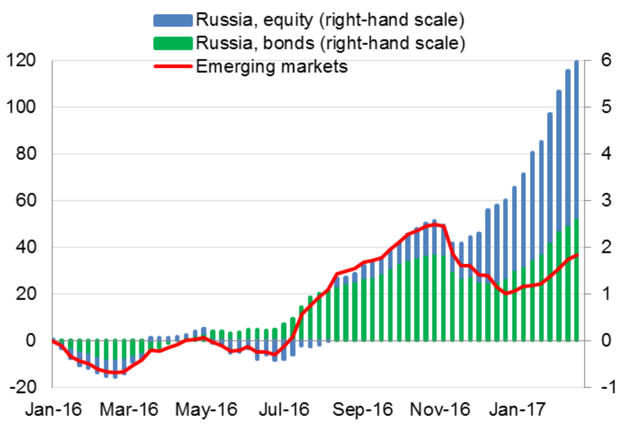
Spreads between the bond yields of the eurozone's core and fringe countries continued to grow in European sovereign bond markets. Growing uncertainty over the outcome of the presidential elections in France and a new round of political crisis in Italy, in particular, boosted demand for protective German, Austrian and Dutch bonds, increasing the spread between sovereign bond yields of these countries and those in the fringes of the eurozone (Figure 41). Such developments may drag down the efficiency of the ECB's quantitative easing programme, because the widening spreads of benchmark yields may be translated into corporate bond yields and higher lending rates in these countries.

Figure 44. Yield spread to German 10-year sovereign bonds



Source: Bloomberg Finance L.P.

Figure 45. Cash inflow to investment funds, accrued since early 2016, billion US dollars

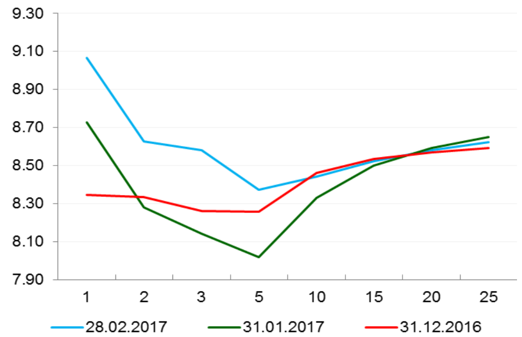


Source: Bloomberg Finance L.P.

Russian markets

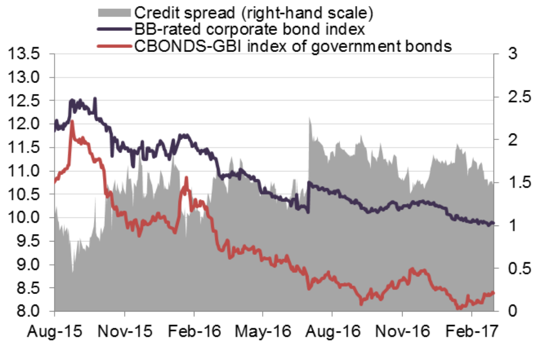
The Russian equity market had its worst month since December 2014 (Figure 43). The sizeable adjustment resulted mainly from the revised outlook on the pace and scale of lifting or easing of western economic sanctions, as well as stagnant oil prices, which were the main driver of equity market growth in the previous months.

Figure 46. OFZ yield curve, %



Source: Moscow Exchange.

Figure 47. Ruble bond fields, %



Source: Cbonds.

The bond market also saw an adjustment: monthly OFZ yields picked up (Figure 46), especially on the short and medium end, despite the ongoing cash inflow to Russian bond funds (Figure 45). As a result, the OFZ yield curve inverted. Growing yield on the short and medium end reflected slightly revised expectations of the Bank of Russia's key rate movements in the bond market. It also implicitly suggests that February did not see any considerable OFZ purchases in carry trade transactions.

The FX market gave a smooth response to the announcement and launch of the Finance Ministry-conducted currency purchases under a transitional budget rule – the ruble did not show any speculative short-term fluctuations towards depreciation (for details see Section 3. In focus. On speculative inflows and the role of foreign investors in the recent appreciation of the ruble).

Moody's, a rating agency, upgraded Russia's sovereign rating from negative to stable, as it was guided the fiscal consolidation programme and stabilising economic activity. The rating has been held at Ba1, one notch below the investment grade. Such news may back up short-term demand for Russian assets, but it is noteworthy that markets have long allowed for more positive rating revisions by agencies when calculating the prices. Earlier this year, Russian five-year CDS-premium returned to the pre-sanction levels of the period between late 2013 and early 2014, which correspond to higher credit ratings.

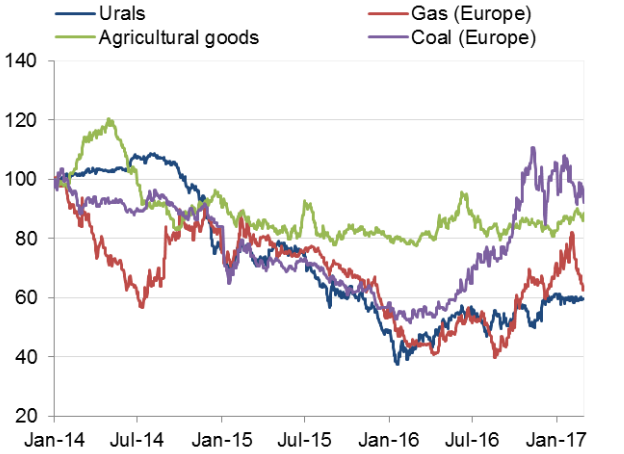
1.3.3. Commodity markets: sustainable stabilisation

- The high adherence to oil production quotas and the upward revision of demand growth forecast improved international organisations' assessment of the pace towards the equilibrium in the liquid fuel market and further growth of investors' bullish sentiment.

- Both demand- and supply-side risks persist. Having said that, we expect moderately high growth in shale oil production due to the cyclical growth of cost and OPEC's adequate informational policy.

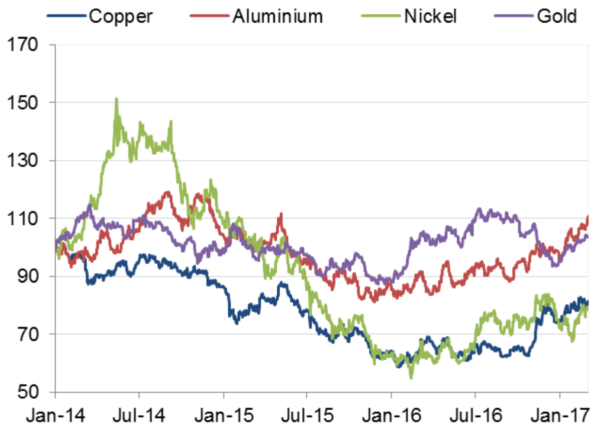
Commodity and metal prices showed mixed dynamics in February, whereas oil prices grew by roughly 1% as the market is expected to reach the equilibrium soon (Figure 48 and Figure 49). The Bloomberg Commodity Index went slightly down, but given the adjustment for a stronger US dollar, commodity prices added roughly 1%.

Figure 48. Commodity prices (January 2014 = 100)



Sources: Bloomberg Finance L.P., R&F Department calculations.

Figure 49. Metal prices (January 2014 = 100)



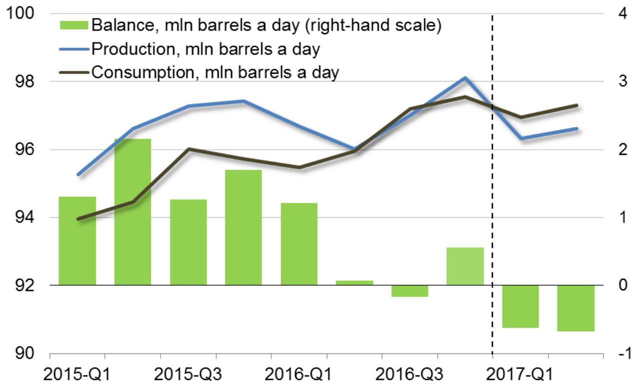
Sources: Bloomberg Finance L.P., R&F Department calculations.

Leading international organisations – the International Energy Agency (IEA), the US Energy Information Administration (EIA) and OPEC – improved their assessment of the pace towards the equilibrium in the liquid fuel market in their February reports (Figure 50 and Figure 51). It results from oil exporters' high compliance with the established quotas (about 90%), and an upward revision of demand growth forecast, primarily due to the relatively cold weather. The IEA pointed to the shrinking oil stocks in OECD countries and expects this process to accelerate in 2017 (Figure 52). At the same time, for the stocks to correspond to the five-year average, quotas need to be observed throughout 2017.

The expected balancing of the oil market boosts investors' bullish sentiment: WTI long and net positions continued to hit their historical highs (Figure 53).

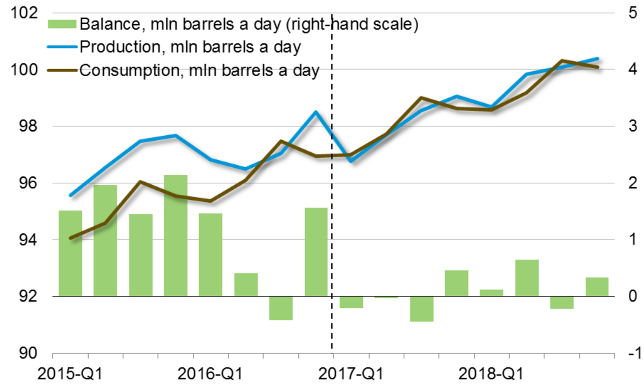
Meanwhile, both demand- and supply-side risks persist. Oil product consumption in the US was unstable as of the beginning of the year and below the EIA forecast (Figure 54), while oil processing capacity utilisation is below the level typical of this season. January data on oil and oil product imports to India were also slack dragging the indicator's 12-month average down for the first time in almost two years (Figure 55).

Figure 50. IEA estimates of key indicators of liquid fuel market



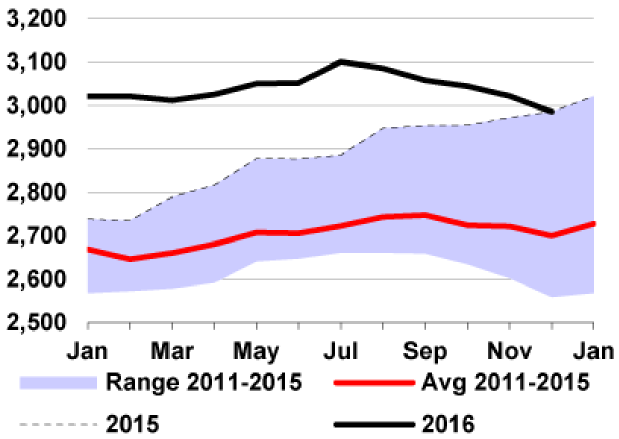
Source: IEA.

Figure 51. EIA estimates of key indicators of liquid fuel market



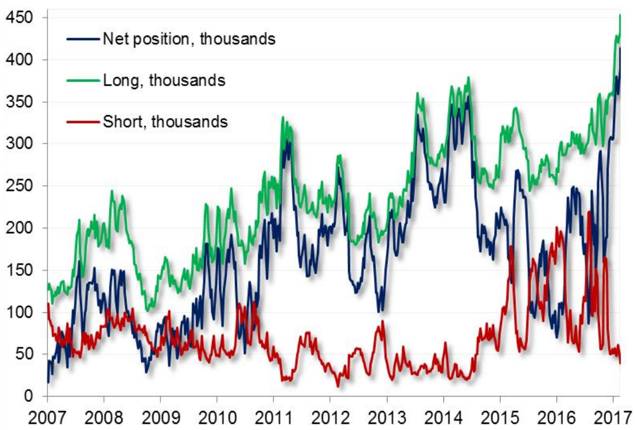
Source: EIA.

Figure 52. OECD commercial oil stocks, mln barrels



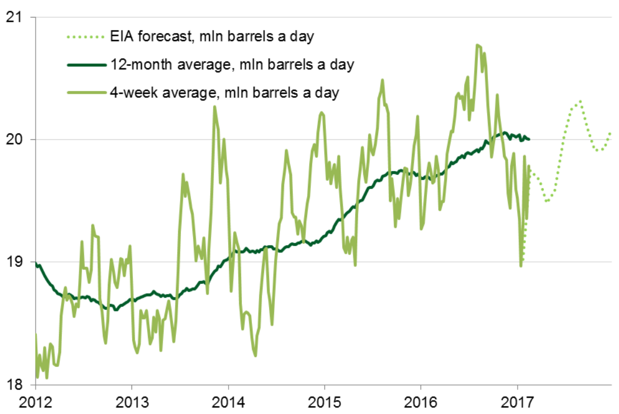
Source: IEA.

Figure 53. WTI futures and options



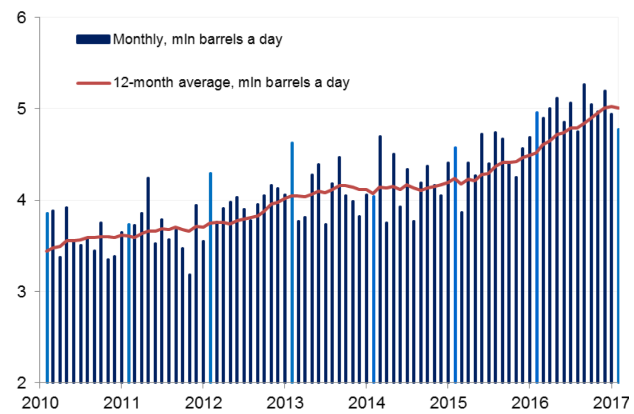
Source: Bloomberg Finance L.P.

Figure 54. Oil product consumption in the US



Sources: Bloomberg Finance L.P., R&F Department calculations.

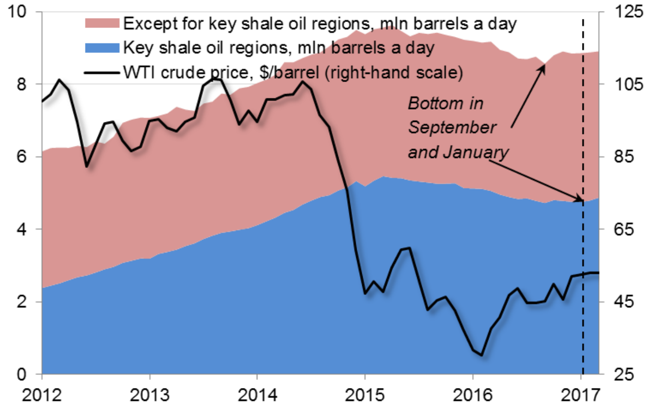
Figure 55. Cumulative oil and oil product imports to India



Sources: Bloomberg Finance L.P., R&F Department calculations.

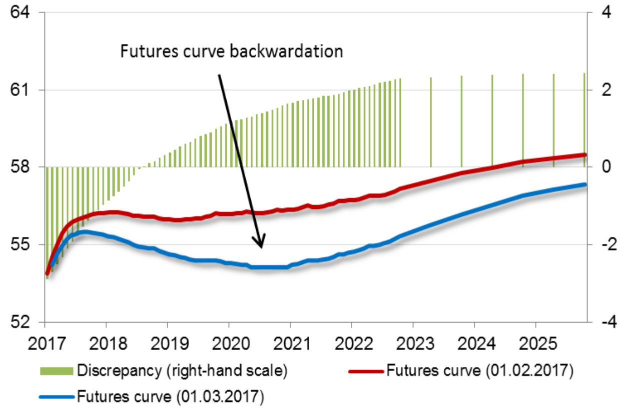
The expectations of faster oil production recovery in Libya exert supply-side pressure on oil prices. The government reported that they had passed the level of 0.7 million barrels a day and expected to reach 1.2 million barrels a day by August (this level was expected to be achieved by the year-end[23]) and 1.7 million barrels a day by March 2018. It will reduce the quotas' efficiency.

Figure 56. Shale and conventional oil production in the US



Sources: EIA, R&F Department calculations.

Figure 57. WTI futures curve, US dollars



Source: Bloomberg Finance L.P.

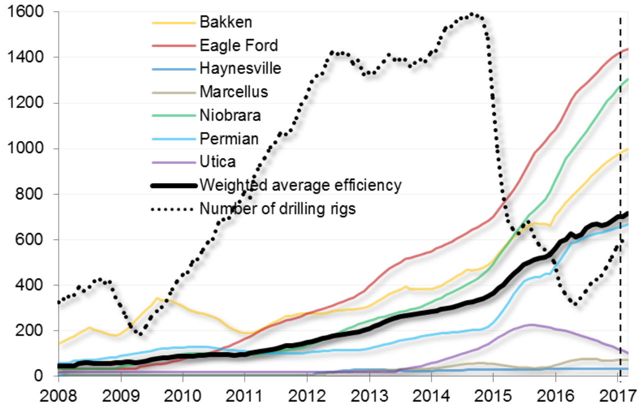
The expansion of shale oil production poses the main risk to the balancing of the oil market and stock cutting to the level compatible with the 'normal market'. Shale oil production, which the EIA estimates to have passed the bottom in January (Figure 56), will continue to grow and exert pressure on oil prices. In particular, it may reverse them downwards (Figure 57). However, given the current movements of leading indicators, we expect shale oil production in 2017 to be moderately high.

The EIA's data suggest that the growing drilling activity of shale oil producers will come with higher production efficiency. The EIA has already revised the historical data on production efficiency upwards (Figure 58). In addition, we have registered that new wells (drilled two month earlier, with due account taken for the lags in the activity) were put in operation in January. It signals that production is being backed up by putting suspended rigs back in operation (Figure 59). These dynamics may hold in the months to come and bolster production growth.

Nevertheless, the number of drilling permits issued in Texas declined month-on-month in January, despite the ongoing growth in oil prices (Figure 59). We believe that it confirms the data of the US Fed's poll conducted in Dallas that many shale oil producers are not willing to step up production amid the uncertainty over the oil exporters' adherence to the established quotas[24]. In the months to come, possible shale oil production may be checked by OPEC's adequate informational policy, which will bring more incertitude in possible extension of quotas through the second half of 2017.

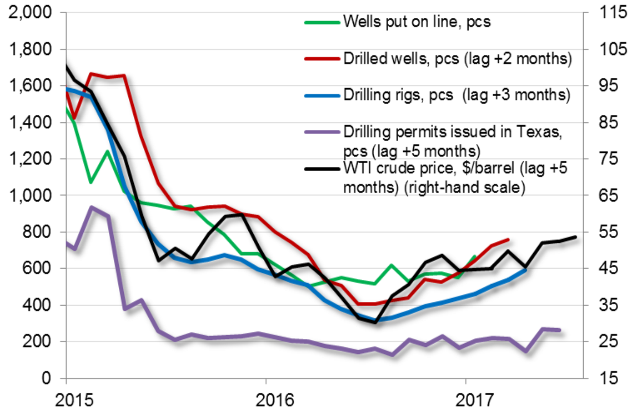
[23] See 'Talking Trends', No. 1 (13) February 2017, Sub-section 1.3.3. Commodity markets: risks that oil glut will persist remain elevated.
[24] Ibid.

Figure 58. Drilling rigs (pcs) and efficiency of shale oil production in the US (barrels per rig)



Sources: Bloomberg Finance L.P., EIA, R&F Department calculation.

Figure 59. Lags in response of shale oil producers to oil price movements[25]



Sources: Bloomberg Finance L.P., EIA, Railroad Comission of Texas, R&F Department calculation.

In addition, the rising cost of rig hands is an important constraint for shale oil production growth. This cyclical factor, which used to reduce the production cost as oil prices went down, is reversing and, according to CNBC, has already become critical for some producers. Lilis Energy's drilling costs have grown more than 15% and hydraulic fraction costs (the key stage of putting a well in operation) have been up 45% over the past two months.

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[25] See 'Talking Trends', No. 1 (13) February 2017, Sub-section 1.3.3. Commodity markets: risks that oil glut will persist remain elevated.

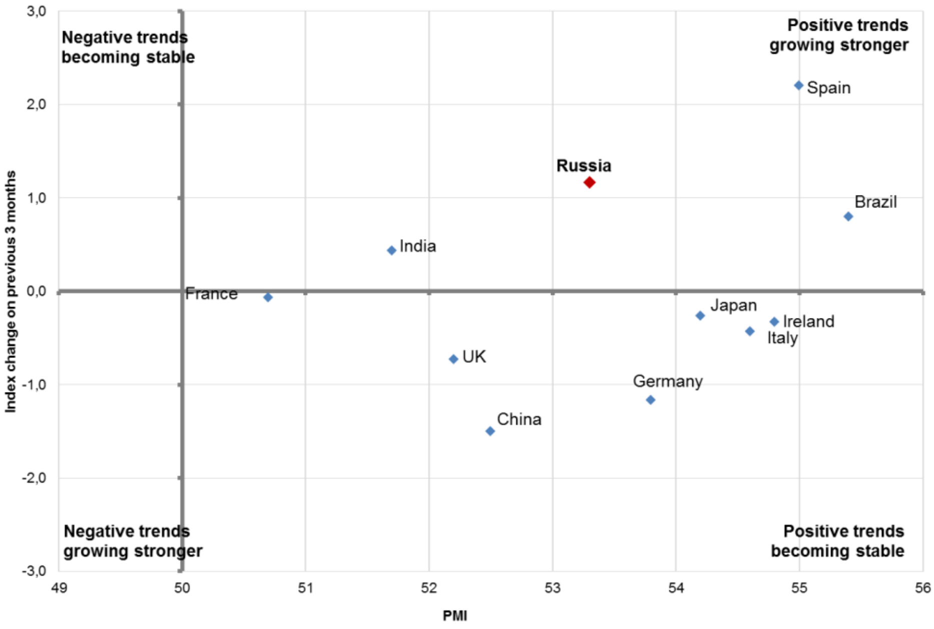
2. Outlook: leading indicators

2.1. Global leading indicators

2.1.1. Global PMI: business activity keeps growing steadily

- Manufacturing PMI in February suggests that the sector's business activity is growing sustainably in most advanced and emerging market economies (Figure 60).
- The eurozone and Japan have registered accelerated growth in business activity to many-year highs to 53.3 points (over 35 months) and 55.4 points (over 70 months), respectively. Companies' business expectations continue to improve amid sustainably high growth in new orders. In the eurozone, input prices trigger inflationary pressure which companies seek to translate to consumers. Japanese companies are yet to adopt this practice.
- Slowing growth in Britain (from 55.7 to 54.6 points) is not yet a reason for concern as the index holds above the long-term average. Furthermore, business sentiment continued to improve and the impact of pound depreciation on prices abated.
- The US manufacturing sector registered a slight slowdown in business activity growth (from 55.0 to 54.2 points) following a slow growth in new export orders only partially offset by domestic demand. The data for the period between January and February promise the soundest quarterly performance in the sector over the past two years.

Figure 60. Manufacturing PMI in February



Sources: IHS Markit, Bloomberg Finance L.P.

2.2. What do Russian leading indicators suggest?

2.2.1. Improvement in GDP growth prospects continues

- 2017 Q1 GDP nowcast was revised upwards to *0.6% QoQ* (seasonally adjusted) from 0.4% QoQ last month.
- The updated 2017 Q2 estimate stands at *+0.8% QoQ* (seasonally adjusted)[26] [27].
- If moderately favourable external conditions hold, chances are high that we will further revise our short-term model estimates and GDP forecasts upwards.
- The current estimates are largely based on the performance of leading business indicators (primarily, PMI indices) and may be updated as new short-term statistics are released and monthly industrial production data are revised retrospectively.

	February 2017	January 2017
	% QoQ SA	% QoQ SA
2017 Q1	0.6	0.4
2017 Q2	0.8	0.5-0.6

[26] Given the incomparability of some recent monthly industrial production data, we temporarily excluded individual non-financial indicators of the real sector from our model estimates.
[27] 2017 Q2 GDP estimate assumes that Urals is roughly $50 a barrel.

3. In focus. On speculative inflows and the role of foreign investors in the recent appreciation of the ruble

- Seasonality of the balance of payments favoured the appreciation of the ruble, especially as oil prices went up in late 2016.
- Cash inflow to Russian financial markets from non-residents since the beginning of the year resulted largely from the cash inflow to emerging markets' investment funds as a whole, rather than Russian domestic factors.
- The appeal of ruble-denominated carry trade transactions may be overestimated because the difference between interest rates in Russia and abroad is set off by the risks related to relatively higher volatility of the exchange rate.
- The main reason behind the ruble's strengthening was higher foreign currency sales by exporters amid seasonal decline in importers' demand for foreign currency. Cash inflow from non-residents also strengthened the ruble, but played a subordinate role.

The Russian ruble firmed against the US dollar by 3.1% in February, whereas oil prices hardly changed over the month. The ruble strengthened in defiance of the Finance Ministry-conducted currency purchases under a transitional budget rule. Despite the widespread expectations the Finance Ministry's daily purchases of foreign currency failed to weaken the ruble. Many professional market participants tend to attribute the ruble's appreciation in February to a large cash inflow from non-residents under carry trade transactions[28], due to, among other things, the appeal of the ruble that has remained high as the Bank of Russia decided to maintain the key rate at 10% in early February. We tried to analyse the role of non-residents and carry trade transactions in the ruble's strengthening and the impact of internal and external conditions.

First, we should say that the first quarter is traditionally the most favourable for the ruble because of the seasonal increase in the balance of trade and Russia's current account (CA) surplus. Revenues from energy exports are high at the beginning of the year, whereas imports contract considerably – it results in growing balance of trade and CA surplus. In addition, foreign debt servicing and repayments are traditionally low in the first quarter. It cuts the demand for foreign currency and adds to the CA balance (Figure 61).

Thereby, the supply of foreign currency from exporters often exceeds the demand from importers and borrowers with FX-denominated liabilities early in the year. This creates opportunities for the ruble's strengthening, which often takes place. Over the past 15 years the ruble saw 10 appreciations against the US dollar in the first quarter; in February and March only, there were 11 appreciations (Figure 62).

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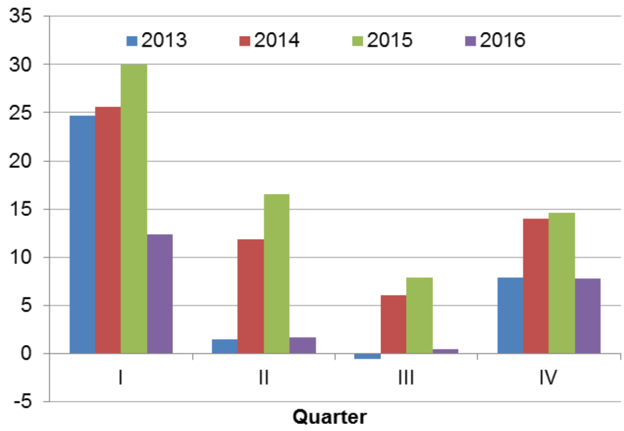
[28] Allow gaining profits from the difference in interest rates across currencies.

It is also noteworthy that this year’s impact of seasonal fluctuations of the current account on the ruble was enhanced by operations related to the large privatisation deal with foreign investors made in December 2016.

Figure 61. Current account balance, billion US dollars



Source: Bank of Russia.

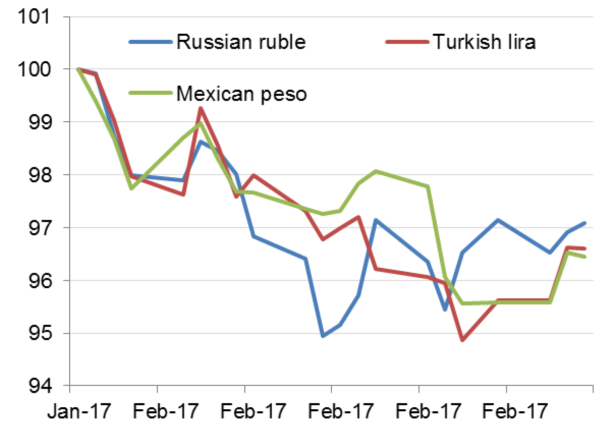
Figure 62. Ruble’s monthly dynamics (growth means appreciation)

Source: Bloomberg Finance L.P.

The ruble was clearly among the fastest growing currencies, but currencies of many other emerging market economies (EME) showed a similar or even better result. For example, the Mexican peso and the Turkish lira outpaced the ruble in their strengthening against the US dollar in February (Figure 63). The appreciation of many EME currencies signals investors’ positive sentiment towards this group of countries. Cash inflows from investors to EME funds also prop up this conclusion – a positive trend has been in place since the beginning of the year and cash inflows to Russian equities and bonds are in line with it (Figure 64). It is not the ruble’s appeal, but the general cash inflow to EMEs that drives the inflow of non-residents’ funds to Russian assets.

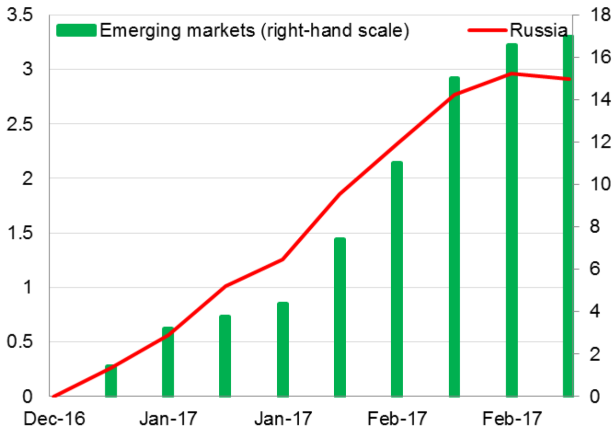
Large funds, which focus on all the emerging markets or certain regions, usually allocate funds to assets of different countries automatically depending on the index benchmark share. Depending on the managers’ short- and medium-term outlook for certain markets, there may be deviations from these shares (usually, minor ones). Accordingly, cash inflows to large EME funds automatically increase investments in the markets of individual countries.

Figure 63. Emerging market currencies against the US dollar, index



Sources: Rosstat, R&F Department calculations.

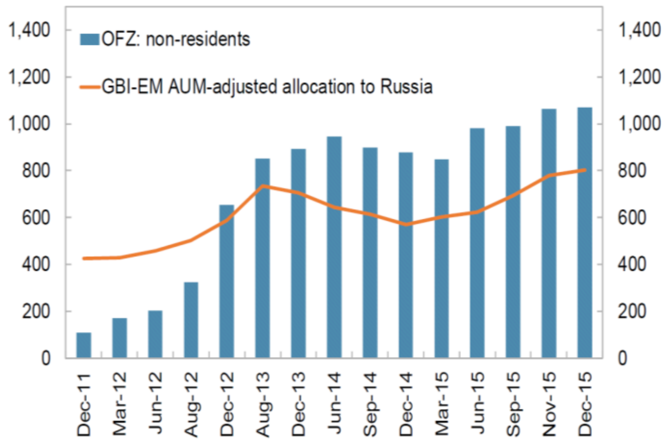
Figure 64. Cash inflow to investment funds, accrued year-to-date, billion US dollars



Source: EPFR.

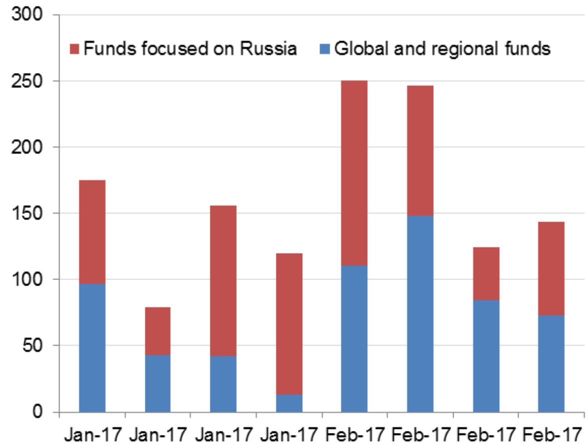
The above trend clearly manifested itself in 2013–2015 in the OFZ market (Figure 65). Most investments of non-residents were bought under the placement of global funds' portfolios in Russian assets after market liberalisation (access through Euroclear)[29]. It is important that, though the value of investment changed over time (went up or down), this process ran quite smoothly due to the above specifics of funds' investing. Therefore, they hardly should be considered venturers with 'hot money'.

Figure 65. Non-resident holdings of OFZ and their sources



Source: International Monetary Fund.

Figure 66. Investment in Russian bonds by fund, billion US dollars



Source: EPFR.

EPFR's statistics suggest that more than half of investment in Russian bond funds this February were made by global and regional investment funds (Figure 66). It confirms

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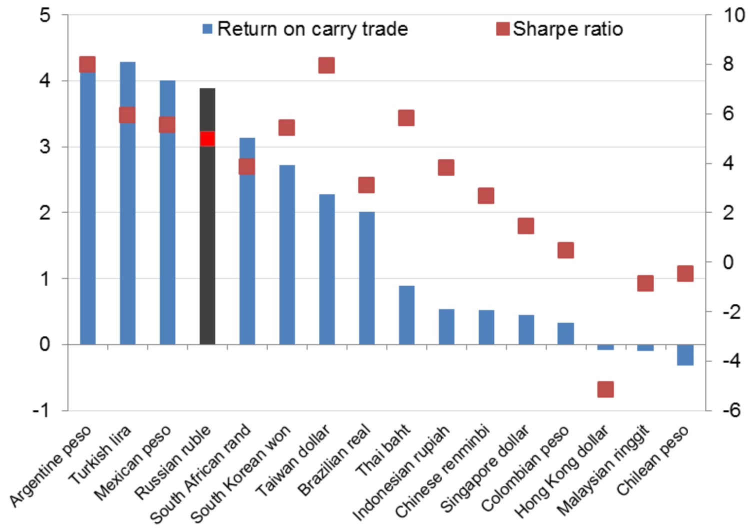
[29] Investors switched from indirect OFZ holding through financial derivatives (TRS and CLN) to the direct one. For details, see Yinqiu Lu and Dmitry Yakovlev. [Exploring the Role of Foreign Investors in Russia's Local Currency Government Bond (OFZ) Market. Series: Working Paper No. 17/28]().

the assumption that the increase in the inflow of funds from foreign portfolio investors to Russia results mainly from the upbeat sentiment in global financial markets.

Figure 67. Returns on carry trade transactions in different currencies in February, %



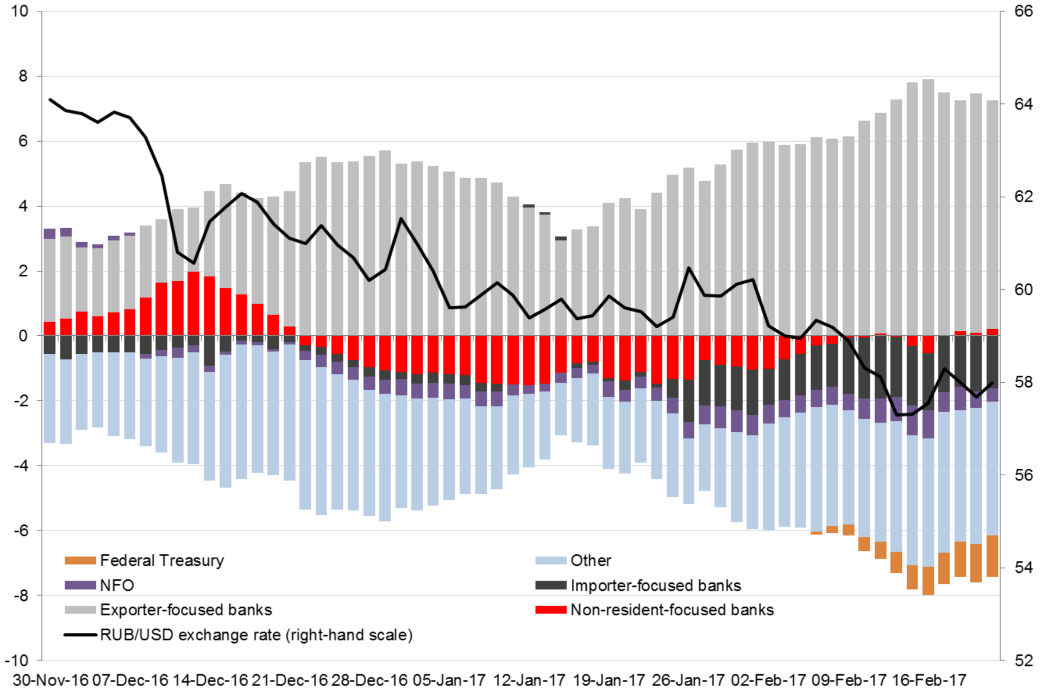
Source: Bloomberg Finance L.P.

Many experts opine that the Bank of Russia's current monetary policy makes the ruble one of the most attractive instruments for carry trade transactions. Is it really so? We would like to point out that high interest rates are not the only factor making carry trade transactions appealing. In February, the ruble was among the leaders in returns on carry trade transactions[30] (Figure 67). They were largely attributed to the currency's strengthening rather than the difference in the exchange rates. However, it may be quite risky to stake on the exchange rate dynamics in such operations. This assumption is backed up by the Sharpe ratio[31]. Many currencies offering lower returns in February than the Russian ruble had a considerably higher Sharpe ratio. It results primarily from lower volatility (both realised and implied) of the exchange rate. The latter means that despite quite high interest rates of ruble assets, the risk of the exchange rate change (volatility) that is higher against many other currencies makes the ruble less appealing in terms of carry trade transactions.

Banks usually make transactions in the FX market at the requests and orders of their customers – exporters, importers, non-residents, etc. Consequently, the analysis of banks' activity in the FX market may shed light on how the operations made by groups of their customers affect the exchange rate (Figure 68). February saw a considerable increase in net sales of foreign currency by exporters, whereas importers' purchases of foreign currency were stable. It is in line with the concept of seasonality of the balance of trade and current account.

[30] The currency's appreciation and difference in local and base (the US dollar) currency rates. Bloomberg calculations.
[31] The ratio measures the return on an operation adjusted for its risks. In this case risk is measured by the exchange rate volatility.

Figure 68. Net position in the FX spot market over the rolling month[32] ('+' – net currency sales, '-' - net currency purchase), billion US dollars



Source: Bank of Russia.

Thereby, growing sales of foreign currency by exporters were the main driver of the ruble's appreciation in February. Banks, which service non-residents, also made their contribution because they shifted from the category of net currency buyers to a neutral position (purchases almost equalled sales). However, the change of their net position was less considerable as compared with exporters. Consequently, the growing inflow of foreign currency (or rather termination of its outflow) from non-residents was just one of the reasons for the ruble's appreciation in February, and a secondary one.

We may conclude that the role of the speculative foreign capital inflow in the recent ruble strengthening is overstated. The main reason behind the increased capital inflow lies with the improved sentiment in global financial markets.

[32] This range is used to smooth away seasonality inside the month associated with tax payments.

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