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EXECUTIVE SUMMARY

1. Monthly summary

- Annual inflation passed its peak as the effect of the VAT hike attenuated and one-off factors containing price rises strengthened. The monthly consumer price increase adjusted for seasonal and one-off factors is in line with the Bank of Russia's inflation target. Inflation expectations are declining, remaining elevated and unanchored, which signals the continuation of related medium-term pro-inflationary risks. Economic activity continued to expand at a somewhat slower pace.
 - Consumer price movements and the current level of inflationary pressure in the economy suggests an increasing likelihood of inflation slowing to 4% in the first quarter of 2020, helped by transient disinflationary factors, in particular ruble strengthening. Short-term pro-inflationary risks (including those associated with VAT) declined. The preemptive raise of the key interest rate in the second half of 2018 accomplished its mission in full. At the same time, medium-term risks of inflation upward deviation from the target are still predominant.
 - Economic growth eased somewhat in the first quarter, driven by some transient factors, including the global economy slowdown, the oil price fall late in 2018, and the VAT hike. This was also prompted by the high base effect arising from the specifics of reporting value added statistics in the construction industry. At the same time, the economic situation showed signs of improvement, thanks to, among other things, the oil price rise amid the favorable market situation and ruble strengthening.
 - Russian financial market risks remained lower than in the fourth quarter 2018, supported by the generally favorable situation in global financial markets and the rising oil prices. Emerging market developments and risks associated with the sanctions against Russia remain the predominant factors for the Russian financial market.

2. Outlook

- The leading indicators of business activity signal that Russia's economic growth was below potential in the first quarter of 2019. Still, it appears from the indicators that economic growth will pick up to reach potential as early as the second quarter of 2019.
- Analysts have upgraded their inflation forecasts, bringing them close to the Bank of Russia projections, and are still confident that inflation will decelerate to 4% in 2020. Expectations for a key interest rate cut in 2019 have started gaining strength.

1. MONTHLY SUMMARY

1.1. INFLATION

Annual inflation passed its peak on a lower level than expected, helped by the strengthening effect of transient factors restraining price rises, such as ruble appreciation and the diesel price decline. The impact of VAT on consumer price inflation no longer makes itself felt in statistics, suggesting, among other things, that no significant indirect effects have emerged.

This brought down short-term pro-inflationary risks. The pace of increase in the most stable components of the consumer price index that are only weakly sensitive to temporary factors was in line with an inflation rate of 4%. The months to come are expected to see inflation gradually decelerating to come down to 4% in the first quarter of 2020.

Pro-inflationary risks prevail over disinflationary ones on the medium-term horizon. Among the key pro-inflationary risks are geopolitical factors and volatility surges in financial markets, the upward pressure of the accelerating consumer lending expansion on prices, secondary effects associated with rising business and household inflation expectations, and increasing workforce shortages in the labor market.

1.1.1. One-off disinflationary factors restrain price rises

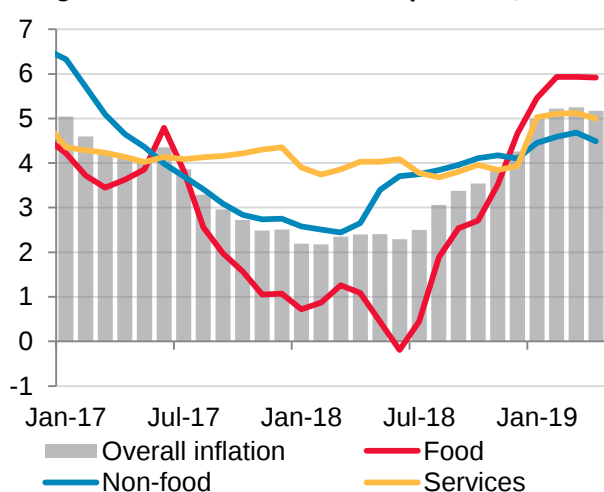
- Inflation peaked at 5.25% in March, slowing to 5.2% in April. That said, monthly seasonally adjusted price rises kept close to the path securing an inflation rate of 4% for the third consecutive month.
- Price movements are sensitive to both pro-inflationary and disinflationary factors. These generally offset one another, hence inflationary pressure adjusted for their effect is also close to the level corresponding to an inflation rate of 4%.
- The concurrent action of oppositely directed factors, however, makes it difficult to assess the true level of inflationary pressure.

Inflation accelerated to 5.25% in March from 5.22% in February (Figure 1). The annual food and services price inflation stabilized, while the acceleration was brought about by a minor nonfood price increase. After peaking in March, inflation went down to 5.2% in April as nonfood and services price rises slowed.

In monthly terms, consumer prices rose 0.32% MoM in March and 0.3% MoM in April (Figure 2). The monthly price increases kept very close to the path corresponding to an inflation rate of 4% for the third consecutive month (Figure 3). That said, our preliminary estimates suggest that price movements, including a pass-through of the VAT hike to prices, are contained by a number of one-off disinflationary factors.

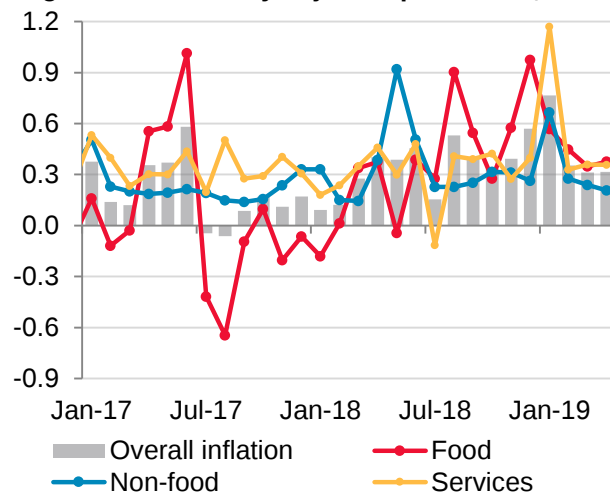
The food market saw seasonally adjusted price rises slow to 0.34–0.36% MoM in March–April from 0.42% MoM in February and a peak of 1.0% MoM in December last year. Fruit and vegetable prices are still making a substantial contribution to price fluctuations in the entire food segment: the seasonally adjusted rate of food and vegetable price increases declined to 0.4% MoM in March from 1.5% MoM in February, accelerating to 0.8% MoM in April. Net of fruit and vegetables, food prices rose at a slowed pace of 0.3% MoM in seasonally adjusted terms for the third consecutive month after their fast increases in the second half of 2018. Price movements are, however, mixed in the food segment. On the one hand, the group of items which made a hefty contribution to price rise acceleration in the second half of 2018 (meat and poultry, chicken eggs) showed a drastic price rise slowdown or a price decline. On the other hand, consumer prices of bread, cereals, and pasta are going up at a somewhat elevated rate, reflecting grain price rises which occurred as early as 2018.

Figure 1. Inflation and its components, % YoY



Source: Rosstat.

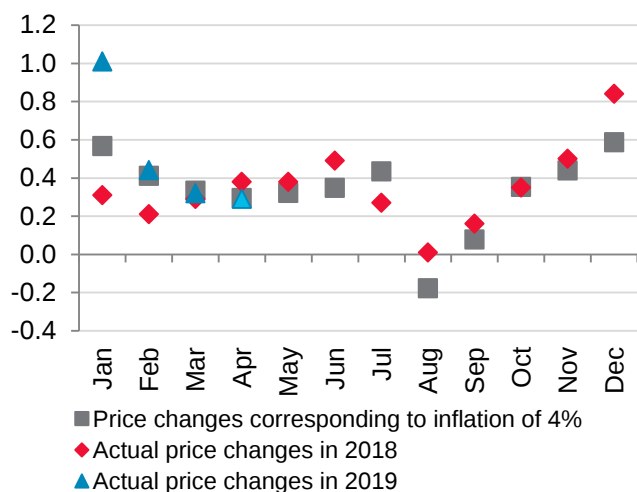
Figure 2. Seasonally adjusted price rises, % MoM



Source: Rosstat, Bank of Russia estimates.

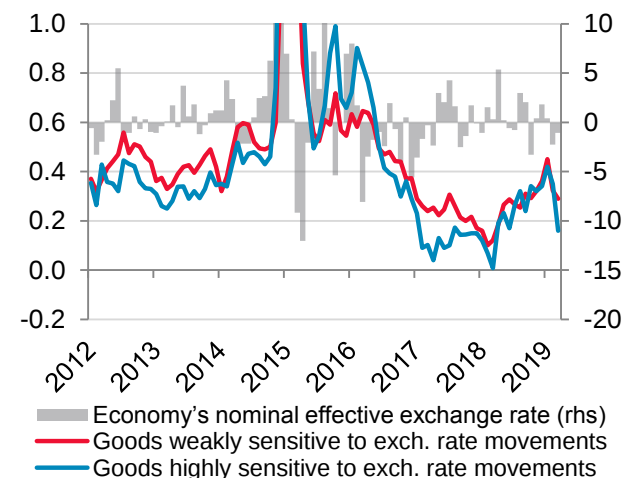
Nonfood price inflation slowed for the third consecutive month – to 0.22% in April and 0.24% in March from 0.27% MoM in February and 0.66% in January. Oil product prices continued to decline, while the extension of the agreement between oil companies and the government minimizes the risks of their increases at least until the end of the second quarter. Many items sensitive to exchange rate fluctuations showed slower price movements in March than in February. The fast decline in the median of price rises for the group of items closely correlated with the exchange rate provides indirect evidence of the impact of exchange rate movements (Figure 4).

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



Source: Rosstat, R&F Department estimates.

Figure 4. Median price rises in goods differing in sensitivity to exchange rate movements, % MoM, seasonally adjusted



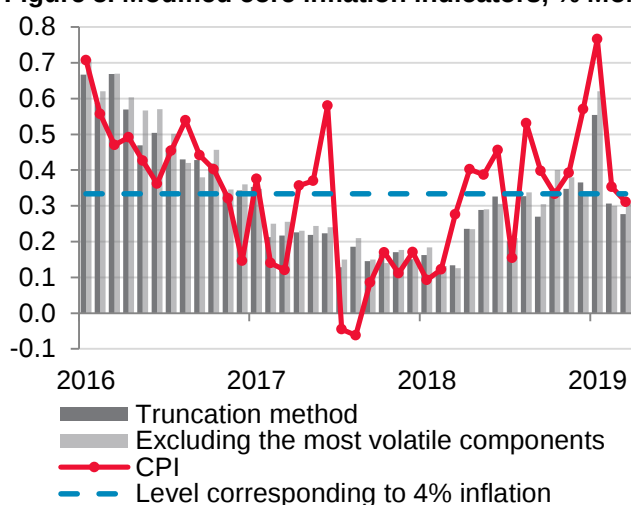
Source: Rosstat, R&F Department estimates.

Seasonally adjusted services price rises remain close to the level providing for an inflation rate of 4%. Prices of some services components are also affected by one-off factors. For example, prices of foreign tourism services, which promptly respond to exchange rate movements, stay on their February level (in seasonally adjusted terms) and dropped 0.3% from the start of the year.

The price rise deceleration in March also had an effect on the modified indicators of core inflation¹ (Figure 5), although these are less sensitive to various one-off factors. Overall, after January's spike triggered by the VAT hike, inflationary pressure is close to a level of 4% in annualized terms.

At this point, inflation is affected by a number of one-off factors driving it both downwards (ruble strengthening since the start of 2019, the diesel price decline, stabilization in some food markets) and upwards (accelerated price rises in some groups of food items, the residual impact of the VAT hike). This makes it difficult to assess the level of inflationary pressure and to identify the effects of one-off factors in the current price movements.

¹ At the time of bulletin preparation Rosstat had not yet released all data required to estimate April's changes in modified core inflation indicators.

Figure 5. Modified core inflation indicators, % MoM

Source: Rosstat, R&F Department estimates.

Assessment of the direct effect of the VAT increase on consumer inflation

To assess the direct effect of the VAT increase on inflation, we consider individual price indexes for goods and services included in the CPI calculation and subject to VAT at 20%. To eliminate possible distortions of estimation results, the preliminary stage excluded the following high-volatility or regulated components: housing and utility services, some passenger transport services, fruit and vegetables, oil products and tobacco products. The weight of the other categories, mostly nonfood goods, equaled approximately half of the consumer basket used to calculate the CPI in 2019.

Decomposition of the price growth rate suggests that the largest contribution to the acceleration of consumer price rises triggered by tax changes came, as expected, from nonfood prices (Figure 6), given that most nonfood goods included in the calculation of the CPI are subject to VAT at the basic rate. The impact of food items was also sizable, while the contribution of services prices was, by contrast, marginal.

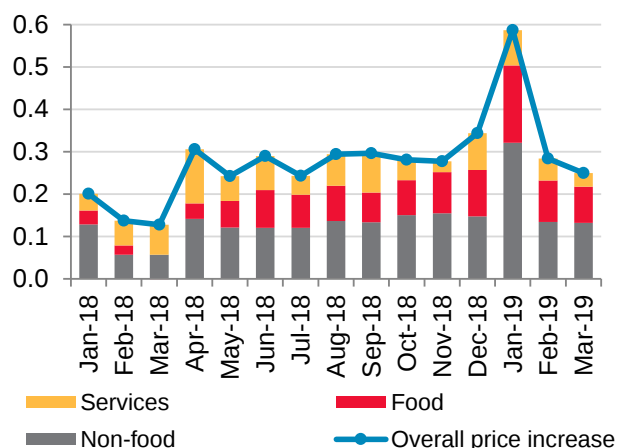
To decompose the factors of price changes into one-off and permanent ones more formally, an indicator was computed representing the most stable component of consumer price dynamics. In constructing this indicator, we relied on an algorithm used on a monthly basis for computing our trend inflation estimates,² but, instead of the entire consumer basket, we only used its part liable to VAT at the basic rate.

Taking the deviation of the above basket's price increase upwards from the trend component as an effect of the VAT hike (Figure 7) produces a minor reading of 0.3–0.4 pps for the basket of goods and services subject to VAT at the basic rate, which corresponds to a 0.15–0.2 pp input to inflation. It can be seen that January accounted for almost all of the effect, while a price increase in the basket of goods subject to VAT at 20% came in below

² 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

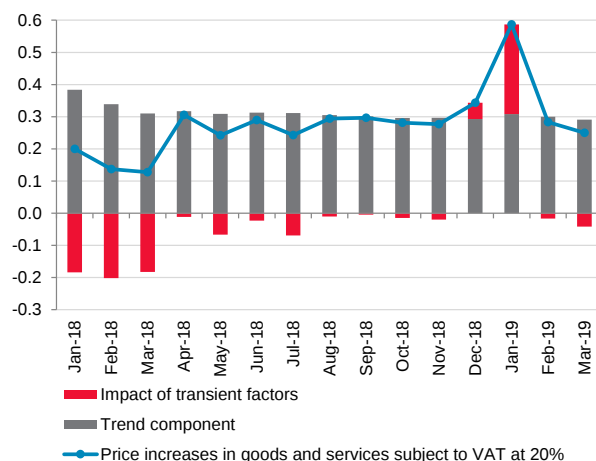
trend inflation in February–March. This, however, does not mean that the VAT hike did not affect consumer price changes in February–March. The effect of the VAT increase was highly likely offset by temporary factors restraining consumer price rises, in particular, by ruble strengthening.

Figure 6. Price rises in the basket of goods subject to VAT at 20%, seasonally adjusted, % MoM



Source: Rosstat, R&F Department estimates.

Figure 7. Decomposition of price rises in goods and services subject to VAT at 20%, by factor impact, % MoM



Source: Rosstat, R&F Department estimates.

Price changes in oil products merit a separate discussion. The agreement between the government and oil companies signed as early as 2018, allowed the latter to raise retail prices by 1.7% in January in order to compensate the VAT rate hike, and to hike them further by no more than 0.33%. Petrol and diesel prices actually went up 0.6% in January, but this does not imply that the VAT increase was not fully passed through to prices. January's slower oil product price increase than what could have been expected stemmed from a producer price drop of 9.3% MoM. In estimating the VAT hike effect on inflation, we will assume that it was passed through to retail oil product prices in full.

By adding the result thus obtained to the contribution of oil product and tobacco product prices which was earlier intentionally excluded from the computation, we come up with an estimate of 0.3–0.4 percentage points. It is noteworthy that we do not factor in the impact of January's house and utility services price indexation (it would have added just over 0.2 pps to the estimate). Housing and utility price indexation for the full year 2019 will be close to the Bank of Russia's inflation target: the housing and utility services price increase was divided into two stages, the first providing for a 1.7% hike in January and the second for a 2.4% raise in July, in order to cushion the impact of the VAT hike on the housing and utility companies' financials for the first half of the year.

The above estimation may at first sight suggest that the effect of the VAT increase on inflation for the first three months of 2019 came in below the lower bound of the Bank of Russia's initial range of estimates. But we offer a different interpretation of this result. First of all, what looks like a zero effect of the VAT increase in February–March was owed to the counteraction of transient factors slowing price rises: primarily ruble strengthening, which,

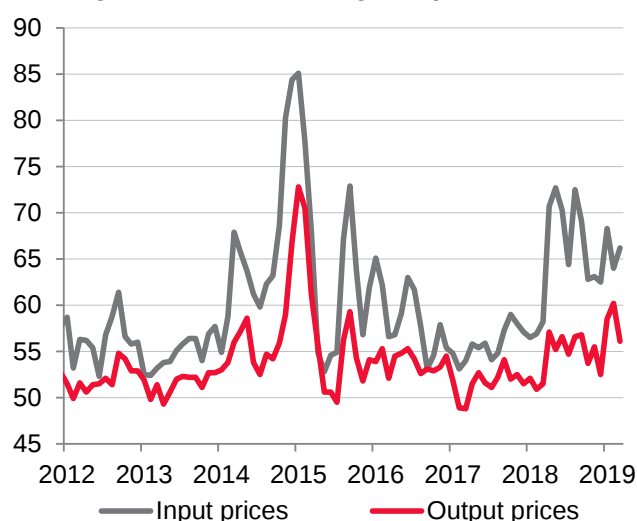
based on our estimate, diminished price rises in goods and services subject to VAT at a basic rate by 0.1–0.2 percentage points over the last two months. Also, the results we have obtained may be marginally underestimated owing to the lagged response of the trend component of inflation. Net of all the transient factors, inflationary pressure may currently stand just below 0.3% after all (Figure 7). Taking account of these effects, we estimate that the impact of the VAT hike on inflation is closer to the lower bound of the Bank of Russia's initial estimates (0.6 pps).

Importantly, what at first sight looks like a minor direct effect of the VAT hike on inflation, as well as slower than expected price rises in the first – second quarters, scale down secondary effects on inflation via lower inflation expectations and a more gradual cost increase for producers of goods subject to tax at a reduced or zero rate.

1.1.2. PMI price indexes: the pass-through of the VAT to prices slowly diminishes

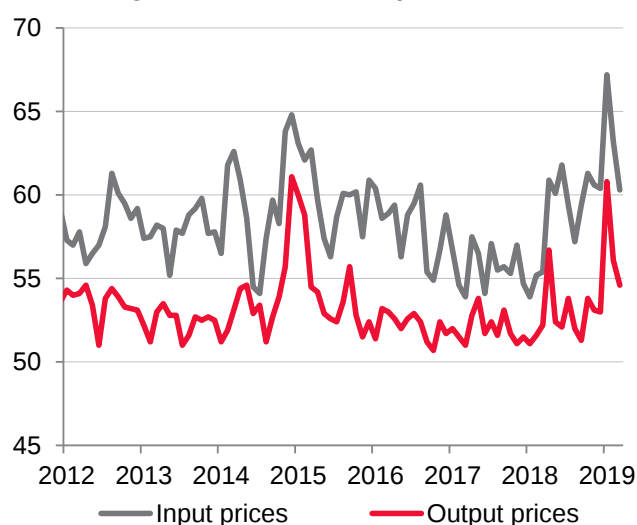
- PMI price indexes suggest that price rises slowed somewhat in March while elevated price pressure was still in evidence.
- Respondents still refer to the pass-through of the VAT hike as one of the factors behind price rises, but the diminishing price indexes (except for the input price index in manufacturing) suggest that this effect is gradually subsiding.
- In the services sector, respondents cite wage growth aiming to retain skilled labor as one of the factors behind the rising costs.

Figure 8. Manufacturing PMI price indices



Source: IHS Markit.

Figure 9. Services PMI price indices

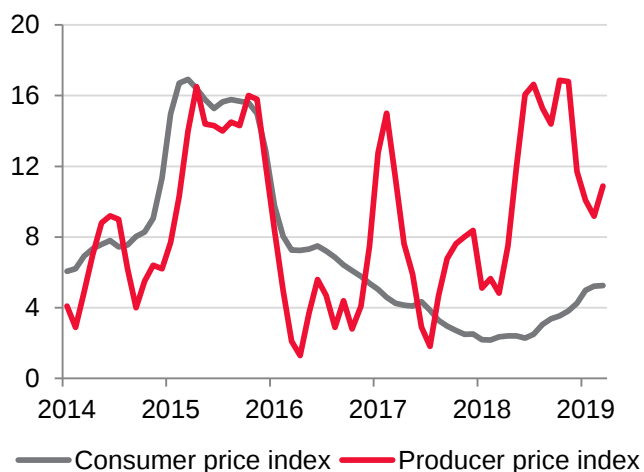


Source: IHS Markit.

1.1.3. Producer price inflation in consumer goods slows down

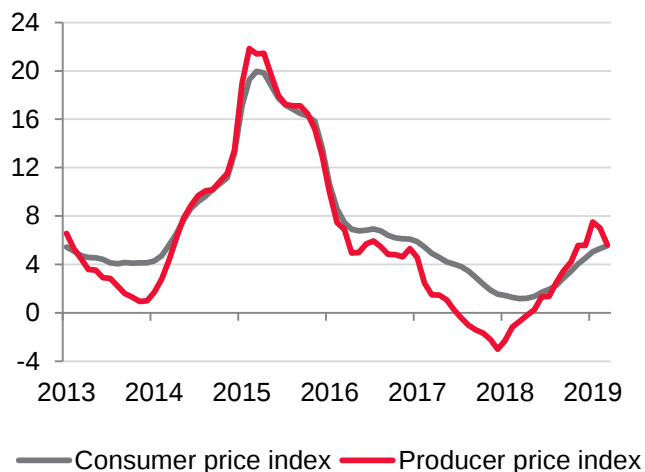
- The annual rate of producer price inflation stood at 10.9% in March versus 9.2% in February³ (Figure 10).
- But the annual rate of producer price rises in manufacturing went down to 7.4% in March from 8.0% in February. Producer price rises in consumer goods also posted a slowdown (Figure 11). Among categories included in the calculation of the index, meat processing and sugar production saw the most notable deceleration in price hikes, suggesting that producer price pressure on the consumer market is gradually subsiding in these industries.
- Among the key types of economic activity, mining and quarrying showed a dramatic price rise acceleration of 24.4% in March from 15.0% in February, driven chiefly by domestic crude oil prices, whose annual rate of increase accelerated to 29.3% in March from 14.3% in February. In monthly terms, the crude oil price climbed 5.5% MoM, up from 2.8% MoM in February, which was expected, given the world oil price hikes. Oil product prices meanwhile continued to decline, with petrol price dropping 4.0% MoM and diesel price losing 0.8% MoM.

Figure 10. Producer price and consumer price indexes, % YoY



Source: Rosstat.

Figure 11. Price changes in some goods⁴, % YoY



Source: Rosstat, R&F Department estimates.

³ Rosstat has revised January and February PPI estimates.

⁴ The calculation used comparable goods in the CPI and PPI structure: meat and fish products, butter and fats, dairy products, pasta, sugar, tea, coffee, clothes, footwear, detergents and cleaning solutions, perfumes and cosmetics, electronic household appliances, and furniture. They account for over 30% of the consumer basket.

1.2. Economic performance

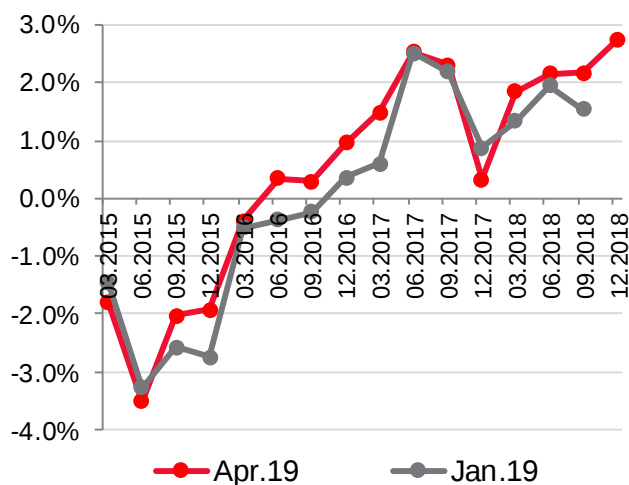
Russia's economic growth stalled somewhat temporarily in the first quarter of 2019. Short-term negative factors, such as the easing of the global economy's growth momentum, the VAT hike, and inflation acceleration will likely maintain growth below potential in the first half of 2019. This will also be prompted by the high-base effect stemming from the specifics of data reporting in construction. With the negative factors running their course and budget spending stepped up towards the middle of the year, economic growth is poised to accelerate unless new major external shocks emerge.

1.2.1. Inventories flow pushed GDP growth up in 2018Q4

- Rosstat has confirmed GDP growth at 2.3% for 2018. Quarterly GDP data since 2014 has been revised substantially.
- The structure of 2018 GDP components by end use have been affected materially.
- An upward revision to the estimate of expansion in inventories was the key cause of the stronger than expected GDP growth in 2018.
- The positive input of consumption and net exports was, however, not much different from the earlier estimates.
- We believe that growth in inventories did not show a more substantial decline due to the effect of ruble depreciation and the effect of additional demand from major projects running its course.

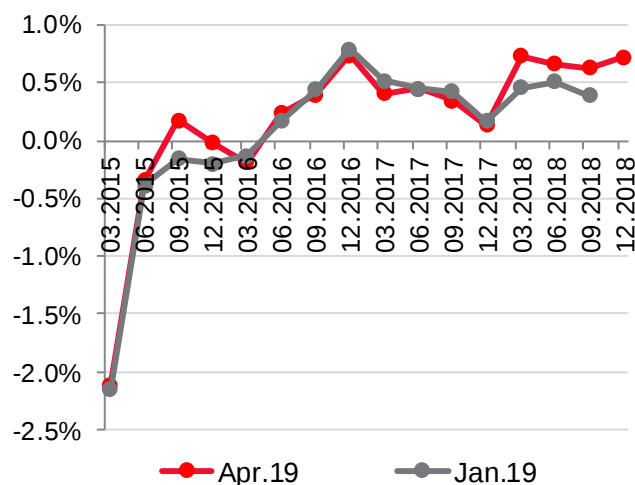
At the start of April, Rosstat released revised annual and quarterly 2014–2018 data. The most interesting news – aside from the revised retrospective data, including that on the components of quarterly GDP – is that the 2018 GDP growth estimate has been confirmed at 2.3% and a breakdown of last year's GDP by end use has been provided.

Figure 12. GDP dynamics in January vs. April 2019, % YoY



Source: Rosstat, R&F Department estimates.

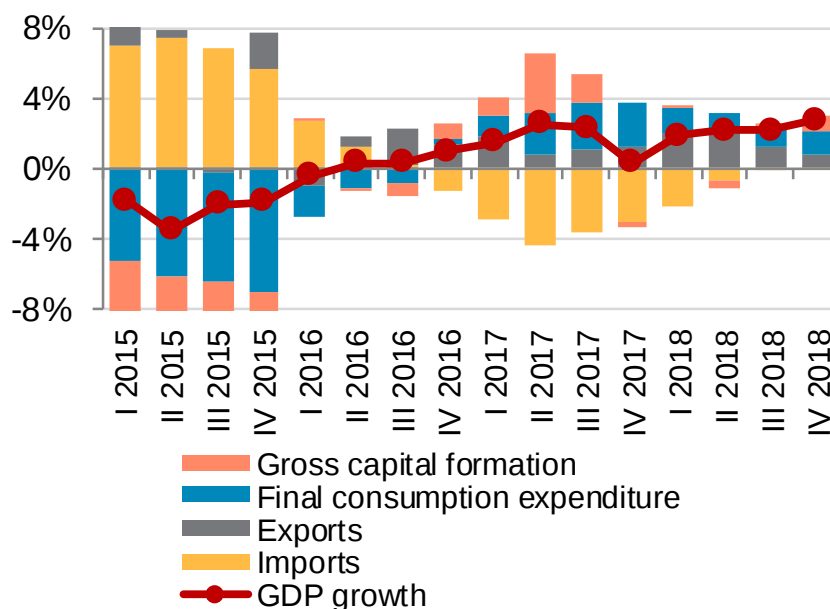
Figure 13. GDP dynamics in January vs. April 2019, % QoQ SA



Source: Rosstat, R&F Department estimates.

Based on the new data, a stronger 2018 growth than thought earlier (Research and Forecasting Department estimate stood at 1.6%–1.7% in December) was chiefly fueled by a stronger gross capital formation, whereas the data on the other components is generally in line with the preliminary numbers. For example, the largest positive income to GDP growth expectedly came from household consumption and net exports.

Figure 14. Decomposition of GDP, contribution to annual growth, pps



Source: Rosstat, R&F Department estimates.

The final numbers of household consumption showing growth slowdown in the first half of 2018 and some acceleration towards the end of the year (2.2% YoY versus 3.2% YoY in 2017) are generally in line with the leading indicators of private consumption. Household consumption was supported by a savings ratio decline, due to, among other things,

consumer lending expansion. Meanwhile, the contribution of household consumption to GDP generally weakened in proportion to the current balance of income.

The fast pace of export growth in physical terms resulted from oil production expansion as restrictions under the OPEC+ agreement were eased. Fuel and energy exports added 6.4% in real terms,⁵ practically in line with an overall goods and services export growth of 6.3% for 2018. Export growth was also supported by the non-oil and gas sector. Metal exports, for instance, climbed 8.5% YoY in physical terms, that of chemicals industry products increased 3.5% YoY. Agricultural produce exports posted a significant acceleration of 19.2% YoY in physical terms. In particular, fresh meat and wheat exports showed an impressive rise of 65.5% YoY and 33% YoY, respectively.

The rate of import growth, however, slowed more than initially expected towards the year end. First, imports weakened more than one could have assumed based on the response to ruble exchange rate movements. Second, investment goods imports worsened drastically, largely in line with fixed investment growth slowdown at the end of the year. Both the former and the latter may well have resulted from the positive effect of major investment projects petering out, and it is not unlikely that import performance will remain quite modest until new government investment is stepped up.

Based on the updated statistics, both the fixed investment level and the inventories growth rate rose dramatically in 2018. The input of fixed investment to 2018 economic growth, however, did not change very much given the revision to the 2017 base. The updated construction data drove both 2018 and 2017 data up, changed the structure of quarterly GDP estimates but did not raise full-year estimates significantly. The effect of inventories accumulation, however, exceeded earlier estimates.⁶ The performance of this indicator is very volatile and is not always correlated with that of other GDP components, making it difficult to interpret its changes. One explanation is that that inventories are often accounted for as a residual component. We tend to attribute the increasing input of this component' to GDP growth in the fourth quarter (approximately 0.8 pps of 2.8%) to output growing faster than demand, above all investment demand. This may become one of the factors of GDP growth weakening in the first quarter of 2019.

Does the choice of the key GDP calculation method affect the magnitude of revisions after the release of preliminary estimates?

The contemporary practice of drawing up a system of national accounts generally uses three GDP calculation methods allowing various components of the aggregated indicator to be analyzed.

GDP measured by the output method (as the difference between the overall output of goods and services in the economy and intermediate consumption plus net taxes (i.e., less subsidies) on production) is the most informative from the perspective of understanding the

⁵ Here and henceforth according to Federal Customs Service quarterly data: the relevant period of 2017 = 100%, at average annual prices for 2017.

⁶ The overall inventories growth was, however, expectedly lower than in 2017.

contribution of the economy's individual industries to GDP. This method allows tracking industry-specific changes, especially in the long run. The disadvantage of the method is that it is uninformative as regards the structure of GDP expenditure. The method became widely used in the US and Canada in the 1930s based on Simon Kuznets's studies.

GDP measured by the end-use method is a sum of expenditure on the final consumption of goods and services, gross capital formation, and net export of goods and services. This method therefore allows presenting a structure of GDP by expenditure, giving an insight into the key expenditure components, which is important for understanding the dynamics of economic cycles. Also, the input of foreign trade to the GDP structure is dealt with separately. The method came into wide use after WWII (under the influence of J.M Keynes's research).

GDP calculated based on the sources of income, reflects primary income earned by units directly engaged in production, as well as by public agencies and non-profit organizations providing services to households. Under the standard approach, gross profit (i.e., corporations' primary income) is measured based on total GDP by output less compensations to employees (primary household income) and taxes on production (primary income of public agencies). In other words, in practice, this method is used for estimating the structure of GDP formation from the perspective of factor incomes rather than for measuring total GDP. Also, this method does not provide for estimating GDP in real terms.

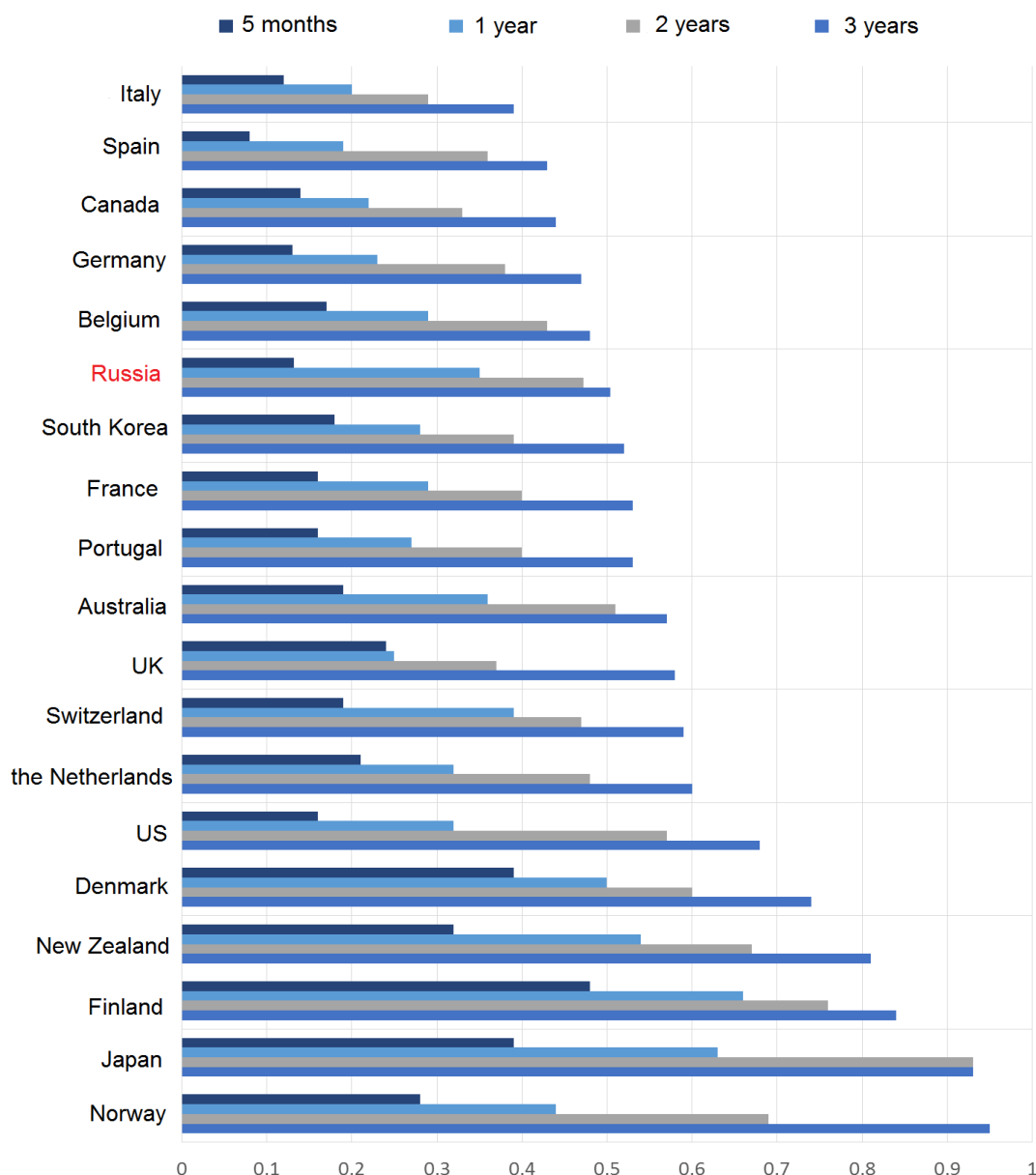
In the 1940s–1960s, most countries using SNA measured GDP by the end-use method. But beginning from the 1970s, the output method became widespread. Currently, a SNA views a complementary set of indicators under all the three concepts of GDP formation as the only possible approach, and statistical agencies seek to calculate GDP and its components using all the alternatives.

In doing so, one of GDP estimates can be regarded as the principal one, and a discrepancy between the principal and alternative estimates can be published under the title Statistical Discrepancy. The choice of the principal method, as a rule, depends on the quality of source data used for calculating GDP by this method. Russia (along with most of the CIS countries) for example, uses the output method as the principal one in view of the historically weaker development of household surveys, with its enterprise statistics fairly advanced. At the same time, many foreign countries refer to the end-use method as the formally principal one in preparing their statistics.

It should be mentioned that in reality a distinction between the principal and alternative methods of measuring GDP is largely nominal, because both calculation methods are anyway used for cross-checking and reciprocal balancing. In particular, there is no reason to believe that a significant discrepancy between the 2018 annual GDP estimate and preliminary quarterly data released during 2018 is due to using the output method for calculating GDP. The key source of uncertainty was in this case the emergence of the final estimate of companies' gross capital formation expenditure, which brought about revisions to the output of relevant supplier industries and changes in the numbers of gross capital formation (one component of GDP by end use).

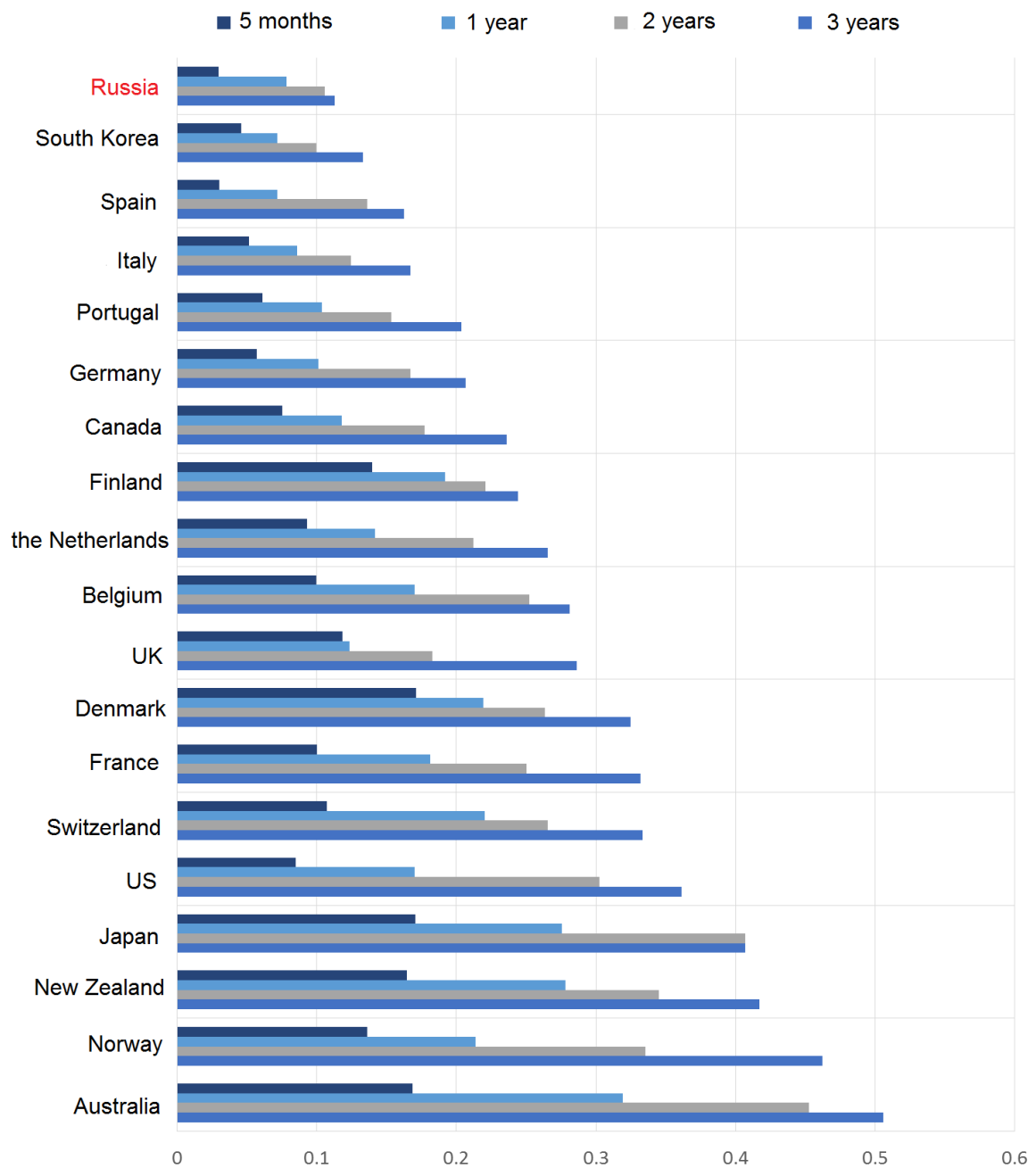
We also note that a 0.5 pp revision to annual GDP growth numbers (this is the expected magnitude of revisions to the 2018 quarterly dynamics) is essentially in line with the average value of final revisions in both Russian and international practice (Figure 15). Also, given, the relatively higher volatility of Russia's GDP growth, this scale of revisions cannot be viewed as unusual (Figure 16).

Figure 15. Average revisions to GDP growth rates (QoQ in the previous year) over various time horizons (in absolute terms, pps)



Source: OECD Statistics Brief No. 22 (July 2015), Rosstat.

Figure 16. Average revisions to GDP growth rates (QoQ in the previous year) over various time horizons (relative to standard deviation of GDP growth rates)



Source: OECD Statistics Brief No. 22 (July 2015), Rosstat.

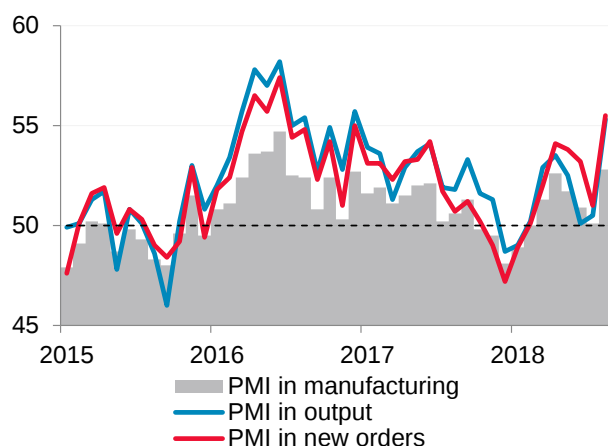
1.2.2. March PMI: business activity upturn in manufacturing, moderate optimism in services

- Manufacturing gained pace in the first quarter: the PMI Index rose to 52.8.
- The services PMI, however, fell to 54.4, posting the lowest reading since December 2018.
- The composite PMI performance signals an acceleration in overall business activity growth versus February to the highest readings since November 2018. Meanwhile, the R&F Department's [News-based Business Activity Index](#) has remained unchanged in recent months, suggesting the stabilization of economic growth rates.

The March data on the Manufacturing PMI Index points to a business activity increase from 50.1 to 52.8 from September's relatively weak estimates (Figure 17). This sector's upturn is above all fueled by a notable acceleration in domestic demand, producing a strong rise in the Manufacturing Output Index from 50.5 to 55.3 and the New Orders Index from 51.0 to 55.5. That said, the survey data did not show a significant acceleration in employment growth, which, in the respondents' view, stems from companies' rising productivity.

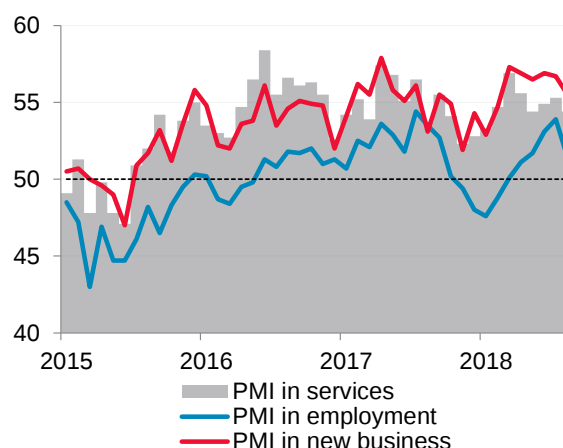
Extremely positive assessment of current output helped manufacturing output forecasts climb impressively from 71.8 to 83.5, the highest reading over the entire observation period starting in April 2012. This bodes well for a short-term forecast of this sector's business activity.

Figure 17. Russia PMI index in manufacturing



Source: IHS Markit.

Figure 18. Russia PMI Index in services



Source: IHS Markit.

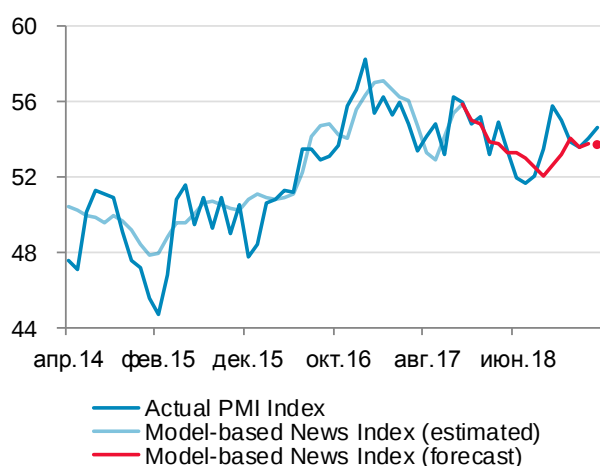
March saw the services PMI fall from 55.3 to 54.4, the lowest level since December 2018 (Figure 18), caused primarily by a slowdown in new orders increase and competition strengthening in the sector. New orders growth weakened, declining to a six-month low of 55.5 but still staying above the average 2016–2018 level. The continuing positive trend is supported by a sizable rise in demand from foreign customers: export orders showed the fastest growth rates since September 2014. The number of backlog orders continued to

decline (46.0) thanks to companies' improving efficiency. But a less upbeat sentiment regarding future business development (63.3) was reflected in the sector's employment growth weakening, with the relevant index falling to 51.4, the lowest reading since November 2018.

The Composite PMI Output Index climbed from 54.1 to 54.6 in March (Figure 20), fueled by growth gaining pace in manufacturing. Growth acceleration was not even hampered by an export orders decline in manufacturing. They continued to fall for the third consecutive month, possibly dragged down by a further worsening in the euro area's economic situation.

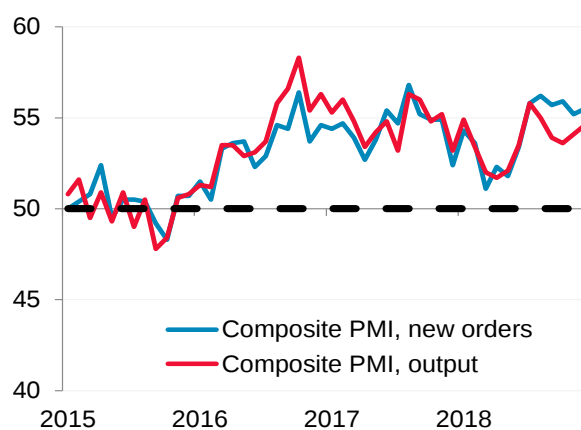
With the PMI numbers showing continued business activity acceleration, the R&F Department's [News-based Business Activity Index](#) has held on to about the same level over the last three months, suggesting the stabilization of economic growth rates (Figure 19).

Figure 19. Composite PMI Index and the News-based Index



Source: IHS Markit, R&F Department estimates.

Figure 20. Composite PMI Index



Source: IHS Markit.

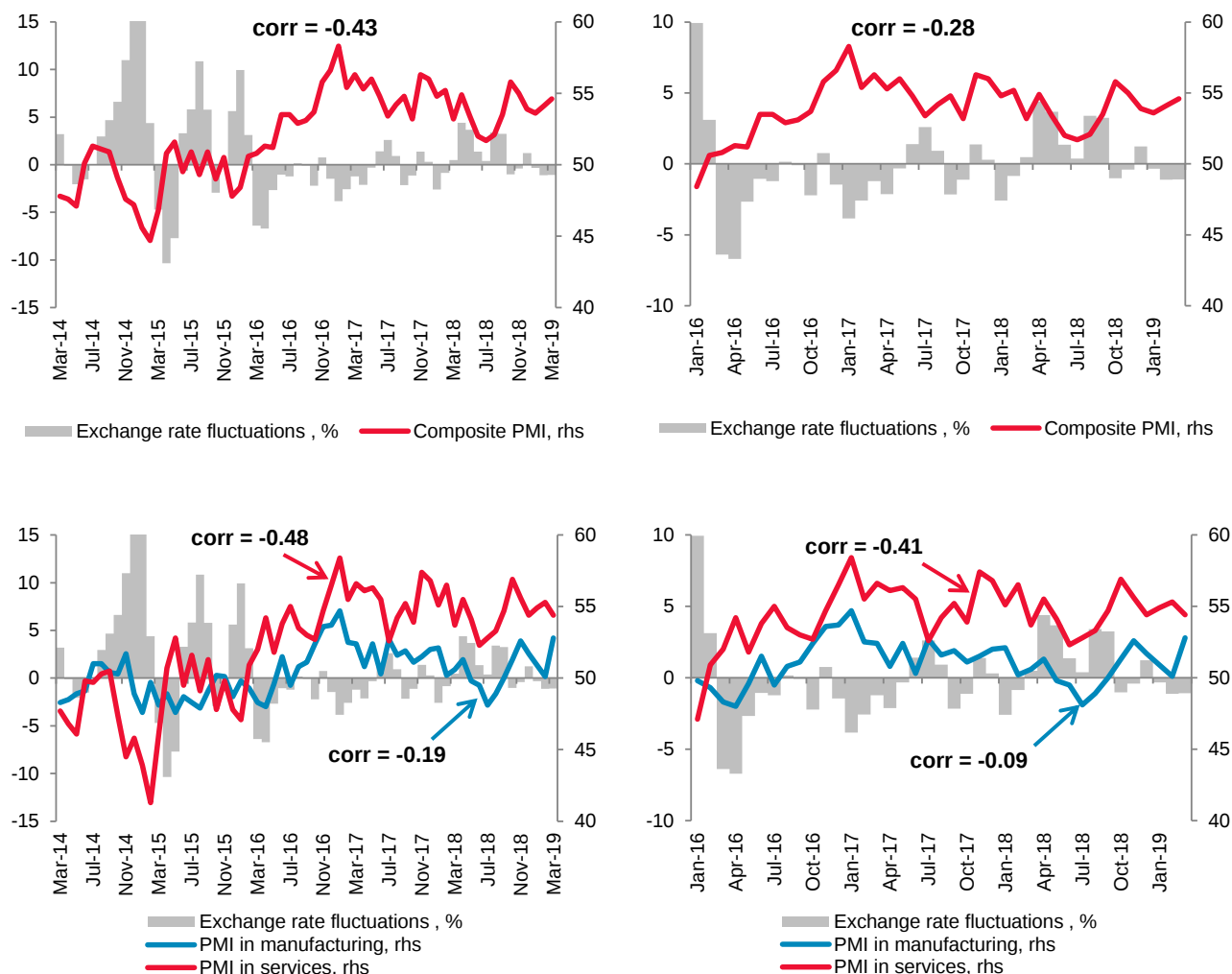
What does the performance of leading business activity indexes reflect?

Notable fluctuations in monthly survey data regarding the assessment of the current business activity and its prospects give rise to a hypothesis that survey-based leading indicators may from time to time show an excessive sensitivity to changes in macroeconomic variables or be strongly affected by a news flow. This may mean that changes in the respondents' assessment of their companies' business activity often have nothing to do with whether there are any fundamental reasons for output growth acceleration or slowdown.

We analyzed, as first approximation, to what extent companies' assessment of their business activity can vary from month to month for relatively less fundamental reasons. To do so, we used ruble exchange rate movements as an example. The exchange rate was chosen as a benchmark indicator because public can easily observe it and, as such, it can largely be regarded as a key factor for the tone of the news flow. The diagrams below present the

performance of PMI indexes based on HIS Markit data and the fluctuations of the ruble exchange rate against the US dollar as a ratio of the current month's exchange rate to the average exchange rate for the last three months (a rise means ruble weakening).

Figure 21. Performance of and ruble exchange rate against the US dollar



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

Correlation coefficients obtained show an inverse relationship between the leading indicators and ruble exchange rate movements (the greater ruble weakening, the steeper the decline in the survey-based business activity indicator, all other things being equal). We, however, note the following empirical patterns.

First, we can see that these relationships are not equally strong for manufacturing and services companies. The services PMI shows a much closer correlation with the ruble exchange rate than the other series under consideration.

Second, the relatively higher correlation coefficients obtained largely stem from the episodes of significant ruble weakening (e.g., at the end of 2014) amid a drastic worsening in the external economic conditions. In this environment, ruble weakening and the decline in

PMI indexes were concurrent with each other with no clear signs of causality between them. The last conclusion is to a greater extent true when applied to an analysis of the performance of the composite and manufacturing PMI indexes. Here we see a notable decline in the correlation coefficients the sample size and starting it from the beginning of 2016⁷. At the same time, the exclusion of the period of drastic changes in external conditions did not have a significant effect on results for services sector companies. In this context, we can assume that a certain property has been found relevant to the series of the leading indicator of the services sector's business activity, but this has yet to be examined more closely and verified.

The above simple analysis suggests a cautious conclusion that the share of the exchange rate is somewhat overrated in explaining the composite PMI performance, which may sometimes distort respondents' assessment. It may well be that this distortion does not occur systematically. Rather, this may be true of the periods when exchange rate fluctuations rise above a certain threshold.

Exchange rate movements probably do play an important role in respondents' answers. But, *first*, this effect is in reality less straightforward than a simple negative correlation (companies differ in the scale of foreign component purchases or exports, so they may differ in assessing the exchange rate level and its fluctuations comfortable for them⁷). *Second*, a substantial proportion of changes in business sentiment indexes is likely associated with other factors, those related to industry-specific changes.

Completely eliminating the influence of the exchange rate or other macro variables on the indexes in question is quite problematic. So one should interpret the fluctuations of business activity assessment which coincide with exchange rate movements with caution, since this does not necessarily reflect fundamental changes in the situation with production within industries.

Table 1. Coefficients of correlation between changes in ruble exchange rate and leading indicators

Time span	Manufacturing PMI	Services PMI	Composite PMI
January 2014 – March 2019	-0.19	-0.48	-0.43
January 2016 – March 2019	-0.09	-0.41	-0.28

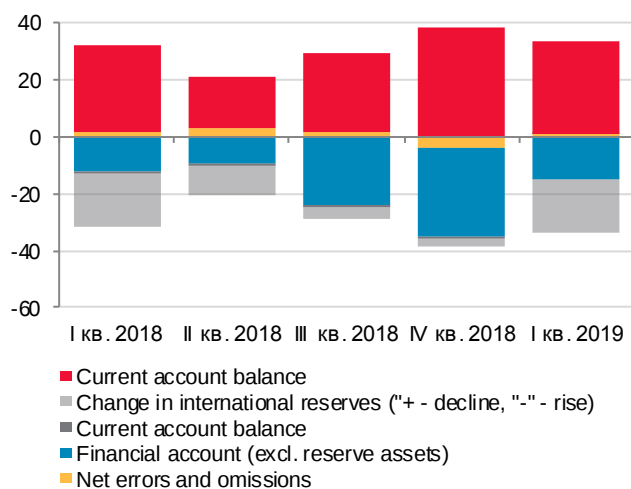
1.2.3. First quarter balance of payments: a strong current account surplus and the return of nonresidents

- A strong current account surplus of 32.8 billion dollars in the first quarter of 2019 benefitted from export stabilization with imports continuing to show a marginal decline and the balance registering a small deficit (Figure 22, Figure 23).

⁷ See also Section "In Focus. Companies need different exchange rates: survey results". [Talking Trends No 6, May 2016](#).

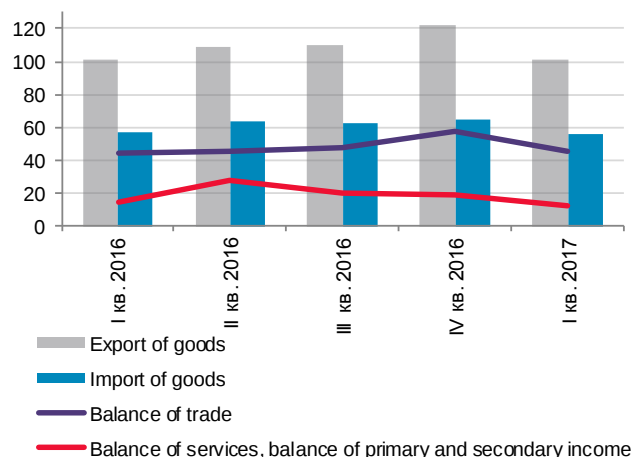
- Exports gave up 0.5% YoY and 11.8% QoQ, mainly dragged lower by an export contraction of 1.1% YoY in the oil and gas sector. This contraction largely stemmed from changes in the prices of natural resources, whereas in physical terms oil and gas exports seem to have fallen only marginally YoY.
- Non-oil and gas exports changed marginally in both value (a rise of 0.5% YoY) and physical terms. Its steep QoQ decline of 24.2% may be due to a considerable negative contribution of grain exports, whereas other key components of non-oil and gas exports did not show a QoQ weakening.
- An import contraction slowed somewhat to -2.6% YoY in the first quarter of 2019 from -3.6% YoY in the fourth quarter of 2018. But this improvement varied across sectors. On the one hand, a decline in the import of machinery and equipment slowed, on the other hand, a fall in mechanical equipment imports is continuing at a rate close to the average values of the fourth quarter of 2019. Moreover, the import of electronic equipment and vehicles declined further, the rate food import decline remained roughly the same, while clothes and footwear import fall was steeper than in the fourth quarter of 2019.
- The financial account deficit increased marginally to -15 billion dollars in the first quarter of 2019 from -12.4 billion dollars a year earlier. What is more, this result was posted in spite of a significant rise in the deficit of the private sector's financial transactions to -25.2 billion dollars versus -16.1 billion dollars in the first quarter of 2018.
- This became possible due to a strong inflow of nonresidents' funds to the OFZ market (up 5.3 billion dollars after an outflow of 5.8 billion dollars in 2018), and a successful placement of government Eurobonds (a 2.7 billion dollar increase in nonresidents' holdings).
- Banks accounted for the larger part of net private sector capital outflows (-15.7 billion dollars), whereas net outflows from other sectors were smaller at -9.4 billion dollars. The smaller outflows from the corporate sector than those in 2018 stemmed from two factors: 1) a substantial direct investment inflow of 11.5 billion dollars with the acquisition of foreign financial assets far below this level; a relatively modest net repayment of external debt (a total of just -3.3 billion dollars for "loans" and "other liabilities" versus -6.4 billion dollars in the first quarter of 2018).
- As regards the banking sector, a sizable external debt repayment of 5.5 billion dollars by banks went in parallel with a notable expansion in their foreign assets (up 10.3 billion dollars).
- The comparative oil price and exchange rate movements in 2018 and 2019 give reason to expect a further improvement in quarterly and annual import numbers in the second quarter along with a quarterly export growth in terms of value.

Figure 22. Key components of the RF balance of payments, USD billion, QoQ



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

Figure 23. Key components of the RF current account balance, USD billion, QoQ



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

1.2.4. Manufacturing moved on to growth in the first quarter

- Industrial output growth slowed to 1.2% YoY in March after accelerating to 4.1% in February. Despite dramatic output fluctuations from month to month, the situation is generally favorable in industry: industrial output gained 0.5% QoQ⁸ relative to the fourth quarter of 2018.
- Expansion in natural gas and non-ferrous metal ores extraction brought about an overall growth in the mining and quarrying industry's output, restrained somewhat by the oil production cut as part of the OPEC+ agreement.
- Manufacturing showed signs of a trend reversal in the first quarter: having stagnated in the second half of 2018, output rose 0.8% QoQ. Industries meeting consumer and intermediate demand continue to grow. The trend remains negative in industries meeting investment demand, dragged down by the production of other than motor vehicles. Exclusive of this sector, industries producing investment goods also posted growth.

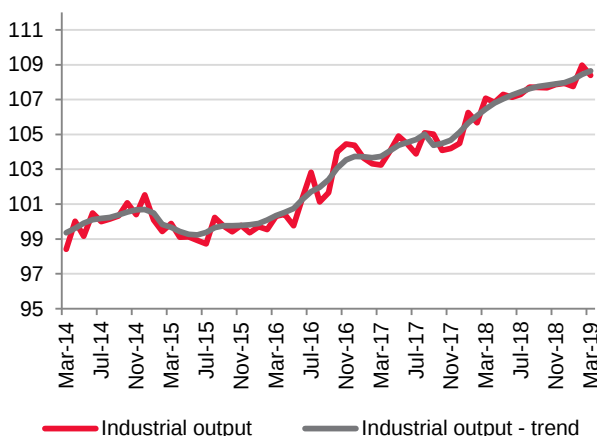
Industrial output expansion stalled to 1.2% YoY in March following a dramatic growth of 4.1 YoY in February, helped by temporary factors. Industrial output climbed 2.1% YoY in the first quarter of 2019. Based on an R&F Department estimate, industrial output fell 0.5% MoM in seasonally adjusted terms in March relative to the previous month (Figure 24), which was to be expected after a 1.1% increase in February. Overall, industrial output rose 0.5% QoQ in the first quarter compared with the fourth quarter of 2018.

The quarrying and mining sector saw growth easing to 4.3% YoY in March from 5.1% YoY in February, while the first quarter's number stood at 4.7% YoY. The sector's

⁸ Here and further on, all numbers, except for annual (YoY) indicators, are seasonally adjusted.

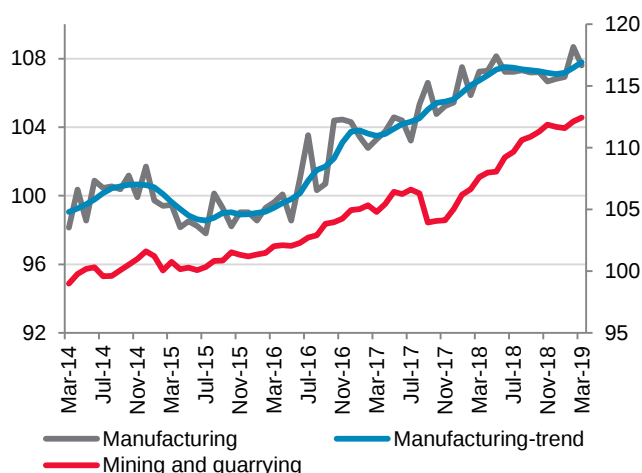
performance was restrained by the oil production cut under the OPEC+ agreement. At the same time, a rise in the extraction of other natural resources (natural gas and non-ferrous metal ores) produced a seasonally adjusted output growth of 0.4% QoQ in the mining and quarrying sector (Figure 24).

Figure 24. Industrial production (2014 = 100)



Source: Rosstat, R&F Department estimates.

Figure 25. Production in mining and quarrying; in manufacturing (2014 = 100)



Source: Rosstat, R&F Department estimates.

The manufacturing growth rate declined to 0.3% YoY in March from 4.6% YoY in February, coming in at 1.3% YoY for the first quarter. In monthly terms, the manufacturing sector's output lost 1.0% MoM, partially offsetting a dramatic 1.6% MoM increase in February. Manufacturing output fluctuations from month to month are traditionally very pronounced due to output performance in some of individual industries. One can get a clearer idea of the manufacturing sector's condition from the performance of its trend component, which showed signs of a turnaround in the first quarter (Figure 25): output added 0.8% QoQ⁹ after stagnating throughout the second half of 2018.

Growth rates vary across groups of manufacturing industries (Figure 26). The food product industry remains a growth driver, maintaining a positive trend despite a fall in March following a spike in February.

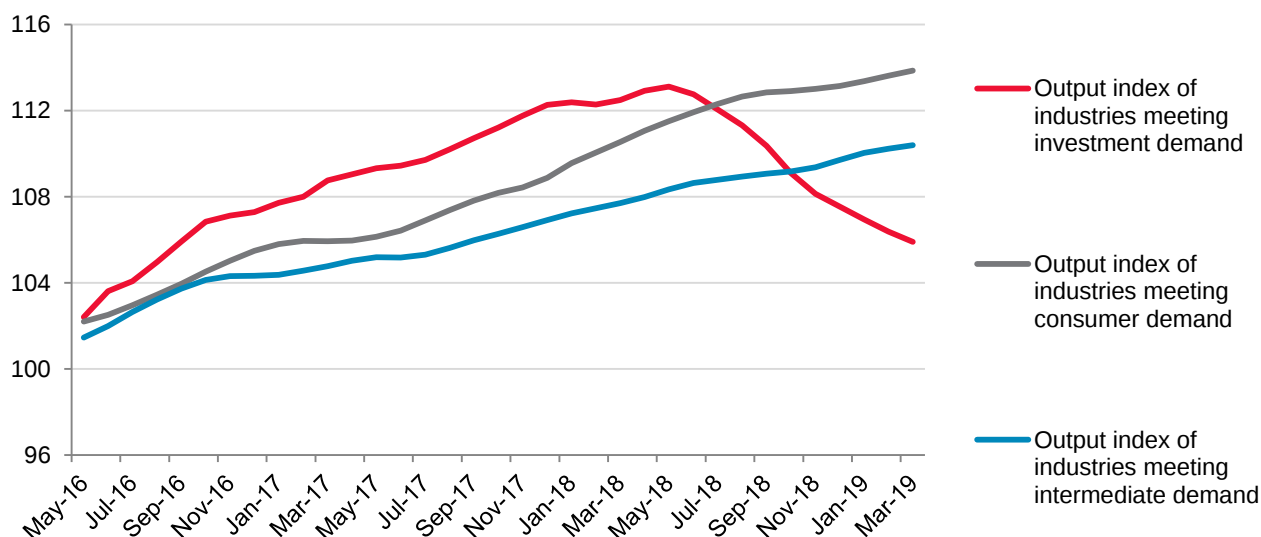
Industries meeting intermediate demand were the main factor behind a drop in the manufacturing sector's output in March. Still, these industries maintain an overall positive trend, despite temporary fluctuations in oil refining, which, prior to March, posted an anomalous growth rate in February, and continuing volatility in the metals sector (driven mainly by non-ferrous metals and nuclear materials).

Trend growth in industries meeting investment demand remains negative, driven above all by a contraction in the manufacture of other transport equipment. A government procurement decline seems to be the main factor behind this trend in this industry. Exclusive of other transport equipment, the investment goods sector has shown positive growth rates

⁹ Seasonally adjusted.

since as early as the end of 2018, largely aided by an improvement in the manufacture of construction materials (concrete, cement and plaster products, as well as refractory items). This suggests an upturn in the construction sector.

Figure 26. Trend component of output indexes for groups of manufacturing sector industries, January 2016 = 100%)



Source: Rosstat, R&F Department estimates.

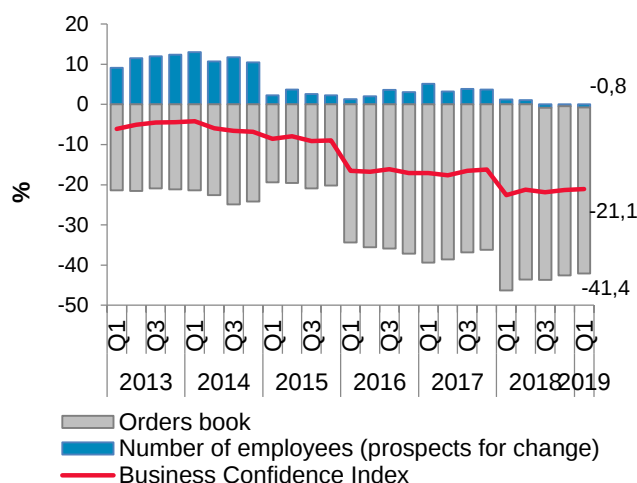
1.2.5. Business activity slowly recovers in construction

- The Business Confidence Index (BCI) in construction added 0.2 pps in the first quarter relative to the previous period.
- Assessment of the orders books continues to improve, with a decline in the assessment of key performance measures (output in physical terms and capacity utilization) slowing.
- At the same time, the measures of the companies' financial position (equity finance and profits) worsened drastically.
- Companies cite a significant tax liability increase versus the first quarter of last year, a further rise in financing constraints, and high prices of supplies, structures and products.
- Based on Rosstat data, construction operations added 0.2% YoY in the first quarter of 2019, while housing delivery dropped 5.6% YoY. The rate of housing delivery is, however, not really indicative of future full-year results. The greater part of housing is delivered in the second half of a year due to business cycle specifics in the sector.

Construction companies' business activity continued its slow recovery in the first quarter of 2019, gaining 0.2 pps QoQ. (Figure 27). The Business Confidence Index (BCI)¹⁰ climbed to -21.1% over the period.

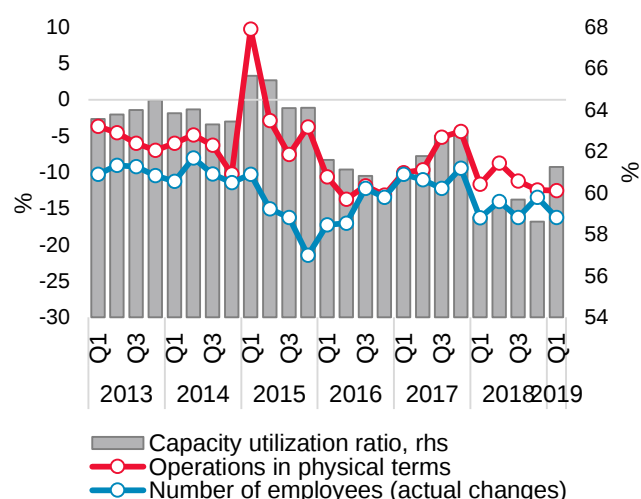
The change in the BCI reading was fueled by an improving assessment of the construction orders books, up 0.8 pps QoQ, suggesting a continued slowdown in a decline of demand for construction companies' services. The balance of answers about plans for changing employment numbers in the industry, nevertheless, remains negative at -0.8% in seasonally adjusted terms, while its decline by 0.4 pps QoQ made a negative contribution to the index reading. It may well be that, given the still weak recovery trend, construction companies are not yet prepared to hire new personnel.

Figure 27. Change in BCI and its components for construction companies, seasonally adjusted



Source: Rosstat, R&D Department estimates.

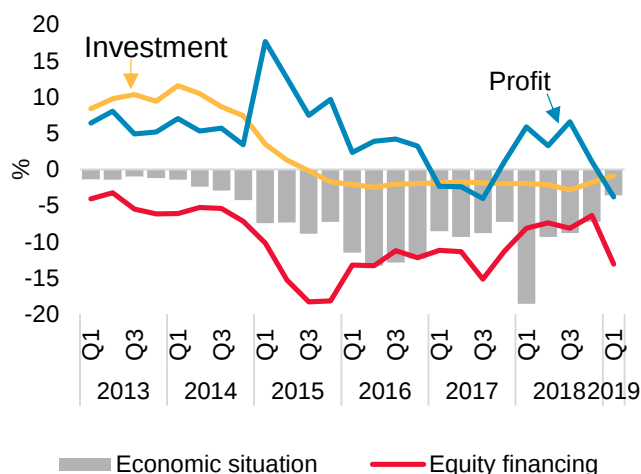
Figure 28. Assessment of construction companies' operating activities, seasonally adjusted



Source: Rosstat, R&D Department estimates.

The assessment of key operating indicators continues to worsen but more slowly than in 2018 (Figure 28). The balance of answers regarding changes in the quantity of operations in physical terms fell 0.1 pps QoQ (versus a decline of 1.6 pp QoQ in the previous period) to -12.5%. The sector's employment optimization is continuing (the seasonally adjusted assessment balance stands at -16.3%). At the same time, construction industry companies report a capacity utilization rise of 2.6 pps QoQ to 61.3%, the highest level since the start of 2018. The capacity utilization increase amid the continued fall in the quantity of operations may signal capacity retirement.

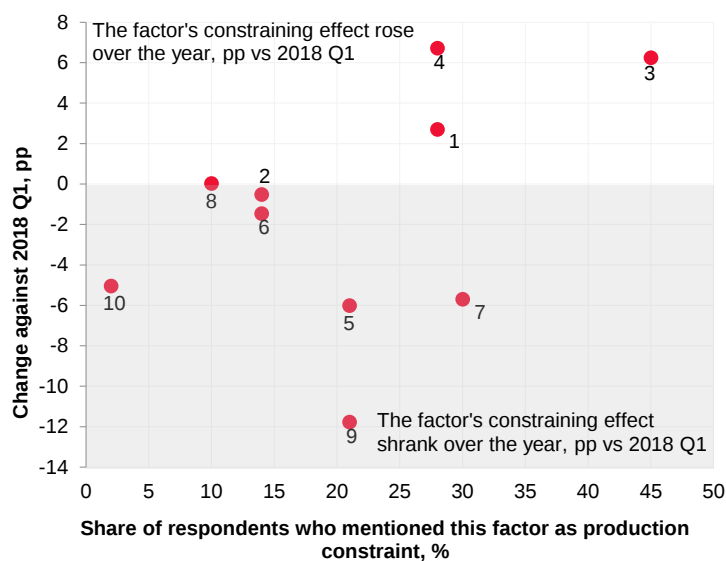
¹⁰ The Business Confidence Index for construction is calculated as an arithmetic average of assessment balances for orders portfolio and the expected change in employment numbers in the next quarter relative to the current quarter (in percentage terms).

Figure 29. Assessment of construction companies' financial position, seasonally adjusted

Source: Rosstat, R&F Department estimates.

The assessment of construction companies' financial position worsened in the first quarter of 2019 (Figure 29). The improving assessment of equity financing and profits in 2018 amid the worsening assessment of operating activities indicates that last year's value added rise in the construction industry came from getting payment upon commissioning construction projects, which also included compensation for operations performed in the previous years.

The balance of economic situation assessment hit a four-year high of +3.7 pps, remaining, nevertheless, negative at -3.6%, while the balance of investment assessment improved by 1 pp QoQ, reaching the highest level since the fourth quarter of 2015.

Figure 30. Key constraints on business activity in construction

1. High cost of supplies, structures, and products.
2. High interest rates on bank loans.
3. High tax rates.
4. Finance shortage.
5. Competition from other construction companies.
6. Severe weather conditions.
7. Shortage of orders.
8. Shortage of skilled labor.
9. Customers' inability to pay.
10. Shortage and wear of construction machinery and mechanisms.

Source: Rosstat, R&F Department estimates.

The constraining impact of the finance shortage and high tax rates significantly increased by 7 pps YoY and 6 pps YoY, respectively, in the first quarter of 2019 from a year earlier (Figure 30).

Some increase in the constraining effect of the high cost of supplies, structures and products is also notable at +3 pps YoY.

At the same time, construction companies report a considerable decline in the significance of such factors as customers' inability to pay (-12 pps YoY), the shortage of orders (-6 pps YoY), competition from other construction companies (-6 pps YoY), as well as the shortage and wear of construction machinery and mechanisms (-5 pps YoY).

The high tax rates reported by 45% of respondents, the shortage of orders (30%), the shortage of finance (28%) and the high cost of supplies, structures and products (28%) remain the most substantial constraints on construction companies' operations. The least important constraint is, in the respondents' view, the shortage and wear of construction machinery and mechanisms (2%).

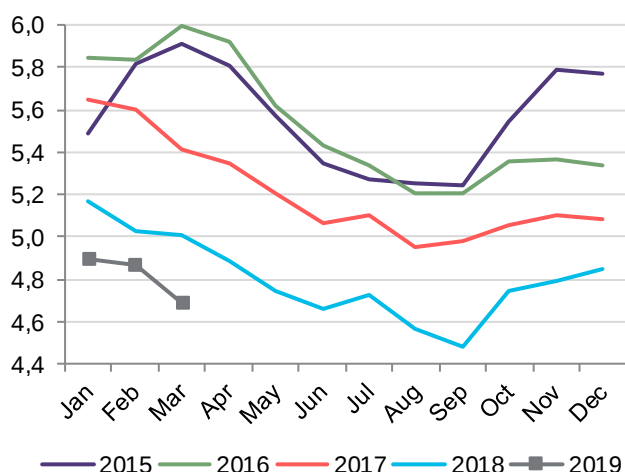
1.2.6. The unemployment rate hits new lows

- The rate of unemployment continues to hit new all-time lows, largely helped by demographic factors.
- Real wages did not change in YoY terms in February and March, owing to the nominal wage growth slowdown concurrent with inflation acceleration. A rise in most of private sector companies' wages outpaces the country's average.

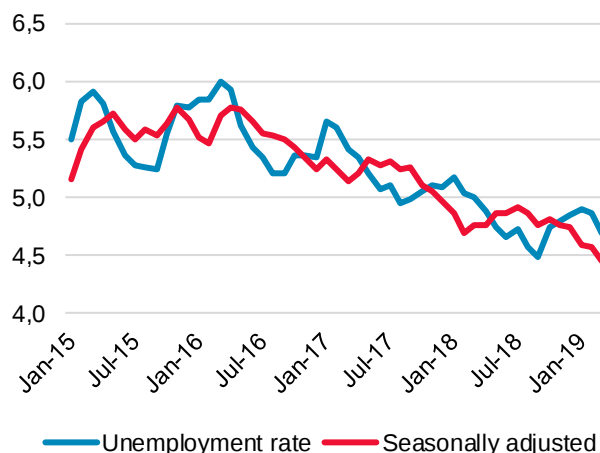
According to Rosstat data, the rate of unemployment fell to 4.7% in March. This decline is seasonal and is in line with changes seen over the last two years (Figure 31). We estimate that the seasonally adjusted unemployment rate continued to decline, posting the lowest reading over the entire history of observations (Figure 32).

The fall in the unemployment rate is concurrent with a decline in the labor force participation rate, which, based on our estimate, stood at 62.0% in March versus 62.7% a year earlier. Overall, the labor force headcount dropped by about 0.9 million in the first quarter of 2019 from the first quarter of 2018, of which a reduction in the employed accounted for 0.65 million and a fall in the unemployed for 0.25 million. This pattern is in our view largely governed by demographic trends. The faster pace of employment reduction in absolute terms suggests that after quitting their jobs people tend to be deemed economically inactive rather than unemployed, which is typical of retiring employees.¹¹

¹¹ The publication "Labor force surveys as of the first quarter of 2019" scheduled for the end of May will give a better insight into the demographic structure of labor force trends.

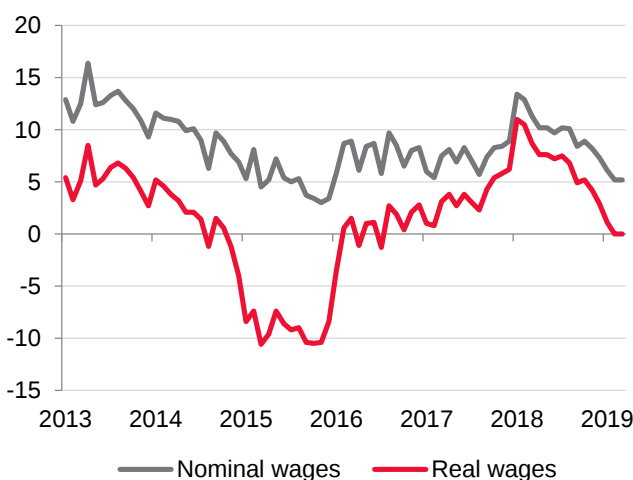
Figure 31. The unemployment rate by year, %

Source: Rosstat.

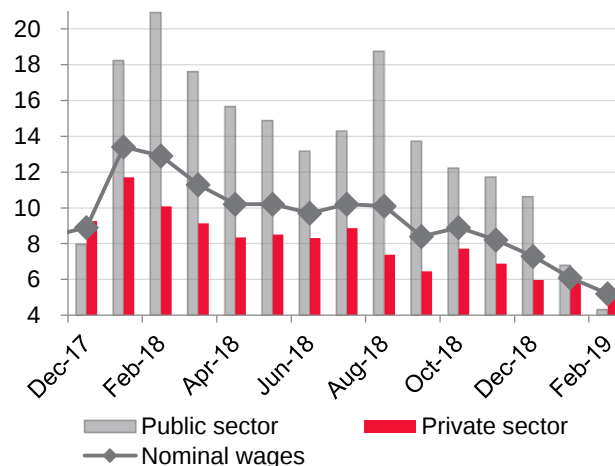
Figure 32. The unemployment rate, %

Source: Rosstat, R&F Department estimates.

Nominal wage growth in March remained unchanged from February at 5.2% YoY, based on a Rosstat estimate. As a result, real wages did not increase in YoY terms in February and March (Figure 33).

Figure 33. Wage growth rate, % YoY

Source: Rosstat.

Figure 34. Rate of nominal wage growth in private and public sectors, % YoY

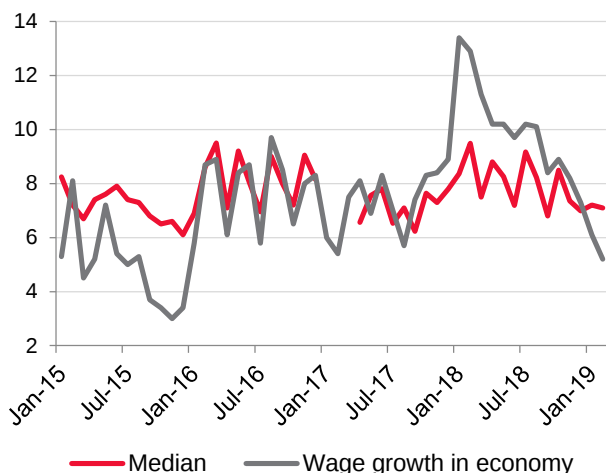
Source: Rosstat, R&F Department estimates.

Nominal wage growth slowed in both the private and public sector, with the latter posting a much steeper decline. We estimate that public sector wages rose 4.3% YoY in February after 6.8% YoY, while private sector wages went up 5.5% YoY versus 5.9% (Figure 34). The dramatic public sector wage growth deceleration was expected and may last up until the start of the fourth quarter of 2019, when the wages of public sector employees are to be indexed.

We note that while the weighted average wage increase in the economy has lost momentum, the median growth rate across types of economic activity has stayed at 7% YoY

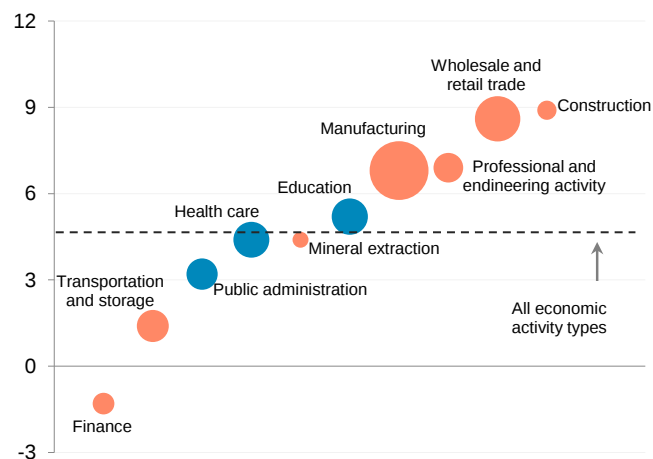
since the end of last year (Figure 35). This indicates that wage growth slowdown has arisen from trends in several major industries (based on the payroll fund). Wage growth, however, remains above average and is still positive in real terms in most private sector industries (Figure 36, Figure 37). This is, for example, true of manufacturing and trade, where employed population is the highest.

Figure 35. Nominal wage growth in the economy and the median, % YoY



Source: Rosstat, R&F Department estimates.

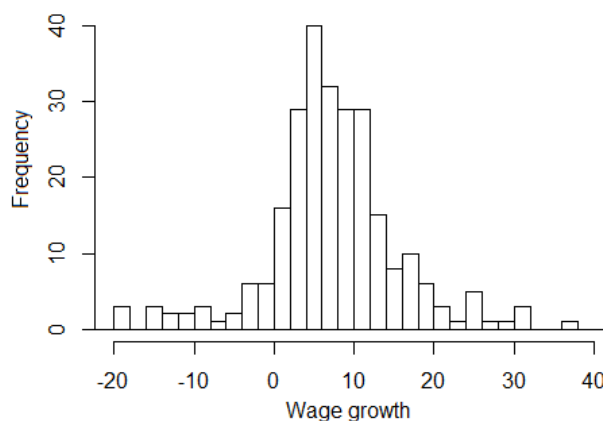
Figure 36. Wage growth by industry, %



Source: Rosstat, R&F Department estimates.

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

Figure 37. Wage growth distribution by type of economic activity



Source: Rosstat, R&F Department estimates.

1.2.7. Retail sales expansion weakened in March

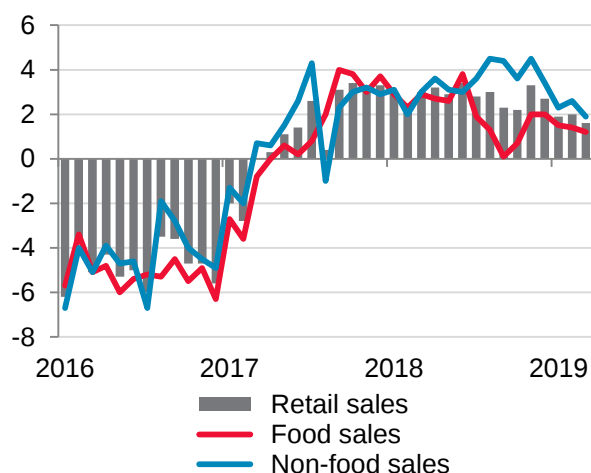
- Annual retail sales growth softened in March, largely driven by nonfood sales. Meanwhile updated statistics of food sales indicate growth weakening for the third consecutive month.
- Monthly seasonally adjusted data, however, shows expansion in both nonfood and food sales. Retail sales went up 0.2% MoM in seasonally adjusted terms.
- The weak wage growth will weigh on household consumption.
- Consumer sentiment was still more downbeat in the first quarter than a year earlier.

Rosstat has updated retail sales data for 2016–2018. The rate of annual retail sales decline in 2016 was revised up to -4.8% YoY from -4.6% YoY, while the rate of sales growth in 2017 and 2018 improved to 1.3% YoY and 2.8% YoY, respectively, compared with earlier estimates of 1.2% YoY and 2.6% YoY.

Based on the revised Rosstat data, retail sales growth slowed to 1.6% YoY in March from 2.0% YoY in February, meeting analyst expectations. Retail sales expanded 1.8% YoY in the first quarter of 2019. The annual growth rate softened in both food and nonfood sales. The former slowed for the third consecutive month, declining to 1.2% YoY in March from 1.4% YoY in February. The latter weakened to 1.9% YoY from 2.6% YoY (Figure 38).

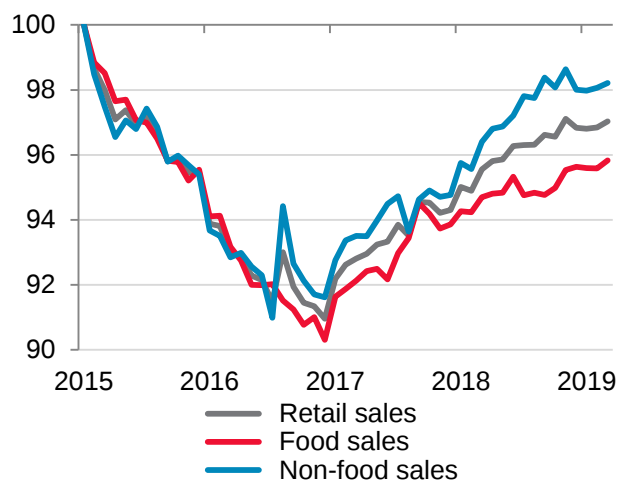
This decline in annual growth rates stems from the high base, because, adjusted for seasonal and calendar factors, retail sales added 0.2% MoM¹² (Figure 39). Moreover, March saw both food and nonfood sales expand 0.3% MoM and 0.1% MoM respectively.

Figure 38. Retail sales of food and non-food goods and overall retail sales, % YoY



Source: Rosstat.

Figure 39. Retail sales, % (January 2015 = 100%, seasonally adjusted)



Source: Rosstat, R&F Department estimates.

¹² Prior to the data revisions by Rosstat, the monthly growth rate stood at 0.2% MoM in February, but after the revisions it equaled 0.0% MoM. March probably accounted for all of this growth.

The weak real wage growth may continue in the months to come, depressing household consumption (Figure 40, for details see Section 1.2.6. “The unemployment rate hits new lows”).

Figure 40. Real household income, % YoY

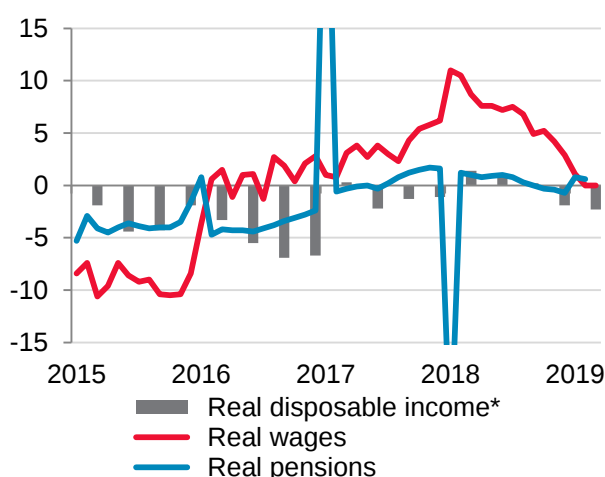
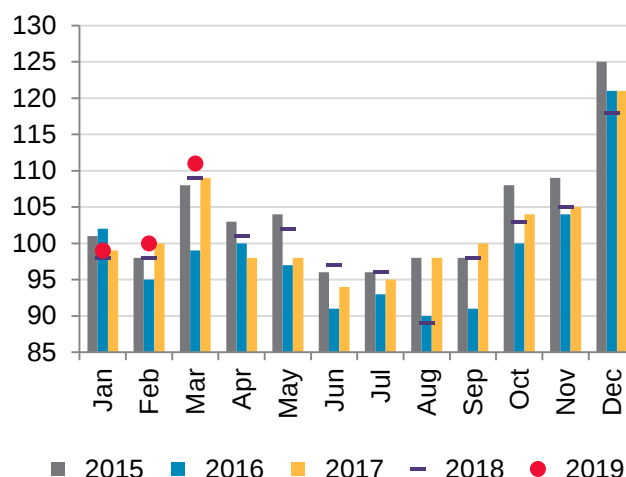


Figure 41. Real everyday household expenditure, % (Median 2012 = 100%)



Source: Rosstat, R&F Department estimates.

Source: Romir.

* Computed under the previous methodology including the one-off payment in January 2017. Data has been recounted since 2018.

Romir Research Holding Company data¹³ indicates seasonal expansion in everyday household spending in March compared with February, which is traditionally associated with the first spring-time holiday on March 8. We also note the continuing expenditure increase stemming from the VAT hike (Figure 41). March this year saw the fastest rate of expenditure increase with the exception of its December highs. It is, however, important to bear in mind that Romir's number does not fully reflect consumer demand changes, for example, because it does not include spending on major purchases.

The results of the GfK consumer panel¹⁴ show weak sales growth in the FMCG market. The sales in this market¹⁵ gained 2% YoY in terms of value over the period from March 2018 to February 2019 compared with the same period a year earlier. One possible explanation for this low growth rate is that households tend to follow more rational principles of consumer behavior, keeping track of promo actions and discounts and refraining from hoarding FMCG items. Households' willingness to save time by not preparing food at home may also count: practically half of the respondents visit bakery or confectionary shops at least once a month or more often, a fourth of them frequent fast food restaurants and cafes, and one fifth use

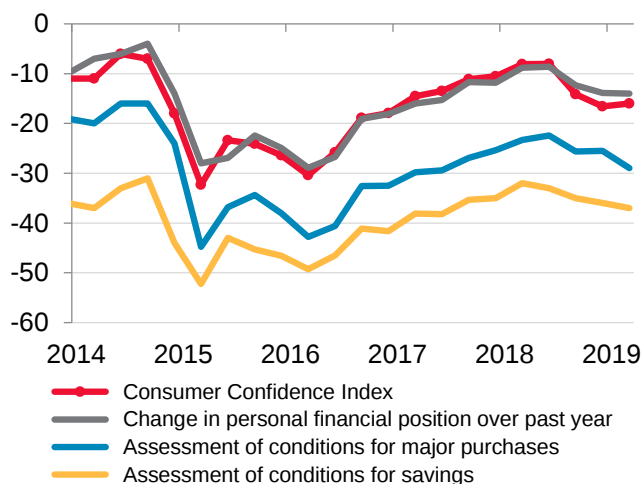
¹³ Romir Research Holding Company. [“Expenditure posted a record-high growth in March”](#). 10.04.2019.

¹⁴ GfK. [“Russia's FMCG trends”](#). 03.04.2019.

¹⁵ The FMCG market includes food, beverages, household chemicals, personal care and cosmetic items, baby food, pet food, and medications.

food delivery services. This may bring about a contraction of the share of expenditure in the retail segment in favor of the food service industry.

Figure 42. Rosstat's Consumer Confidence Index and its components



Source: Rosstat, R&F Department estimates.

Rosstat survey data shows that the first quarter's Consumer Confidence Index remained unchanged from the previous quarter (Figure 42). There were no significant changes in the index components, except for the respondents' worsening sentiment as regards major purchases. This measure went down 3.5 pps from that of the fourth quarter of 2018. This may have stemmed from gradual price rises at the start of 2019 on the back of the VAT increase.

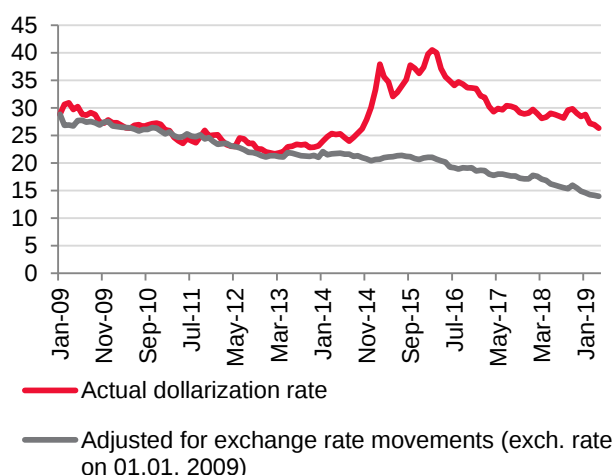
1.2.8. Unsecured consumer lending growth accelerates further

- Ruble household and corporate lending continues to expand at a fast pace.
- The retail lending segment saw a minor slowdown in the loan portfolio growth compared with the second and thirdquarters of 2018, driven by mortgage lending. Unsecured consumer lending showed the fastest growth rates in the current phase of portfolio expansion.
- Lending expansion was accompanied by a rise in household deposits and those of the Federal Treasury and the Russian regions' budgets. Corporate customers preferred more liquid forms of holding money in transactional accounts in March.
- The release of provisions set aside earlier and the resulting adjustments became the factors of the banking sector's higher profit in the first quarter of 2019.

The current loan portfolio data suggests that growth in lending to nonfinancial organizations slowed in March owed to a contraction in the foreign currency component of

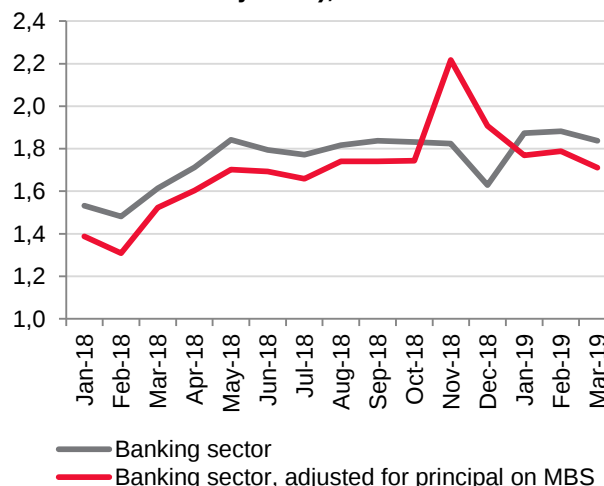
the portfolio (the foreign currency part of the portfolio fell by 0.4% MoM in that month). Ruble corporate lending maintains growth¹⁶ at a rate close to a last year's average of about 1%. As a result, the dollarization of loans to nonfinancial organizations continues to decline (Figure 43).

Figure 43. Dollarization of corporate lending, %



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

Figure 44. Ruble lending growth (seasonally adjusted), % MoM



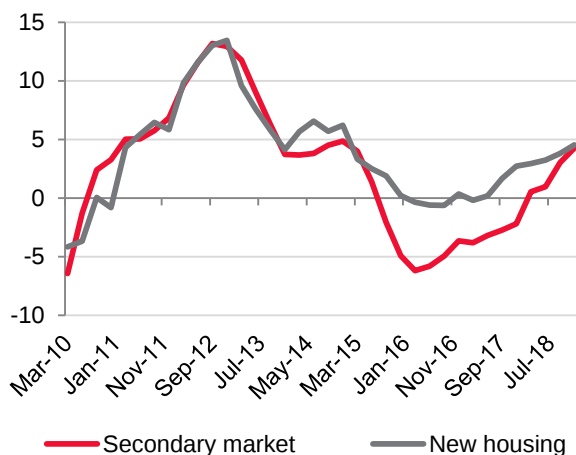
Source: Bank of Russia, R&F Department estimates.

Household lending continues to enjoy high growth rates in banking sector statistics, indicating just a marginal portfolio expansion slowdown in March (Figure 44). Factoring in changes in the principal on MBS, one can claim that portfolio growth gradually weakens, returning to the 2Q–3Q 2018 levels, which is still somewhat above 20% in annualized terms.

Mortgage loan portfolio expansion eased somewhat in March. Statistics covering only the banking sector indicate that mortgage loan growth rate reached the average level of the second half of 2017, falling below 20% in annualized terms. With changes in the principal on mortgage-backed securities (MBS) factored in, March growth rates suggest a more notable portfolio expansion slowdown (Figure 47). Some cooling of mortgage lending was likely owed to a drop in demand driven by the rising interest rates: the weighted average rate climbed to 10.4% in March from 9.5 %–9.6% in November–December 2018 as a number of the major market players hiked rates on new loans notably. An increase in risk coefficients for loans with a low down payment also likely hampered the mortgage lending rise. We note that prices resumed growth in both the new and secondary housing market (Figure 58). Moreover, the current data for Moscow indicates that housing prices continued to rise in the first quarter of 2019 (Figure 59).

¹⁶ Here and further on in the section, estimates are seasonally adjusted unless otherwise stated.

Figure 45. Prices of mass market housing in Russia, % YoY



Source: Rosstat.

Figure 46. Moscow housing prices, rubles per sq. meter



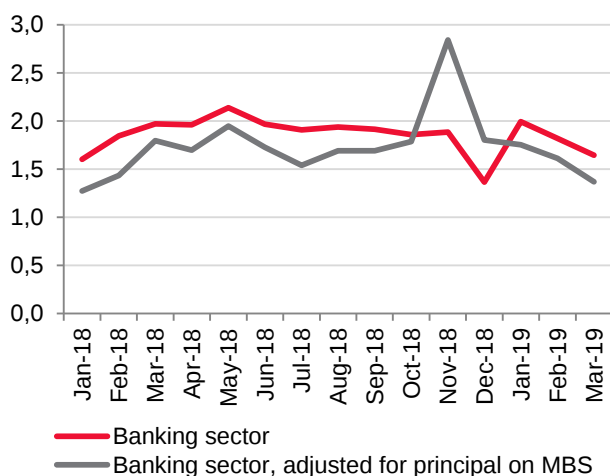
Source: www.irm.ru.

The rate of unsecured consumer lending growth, by contrast, reached 2% MoM in March, the highest growth number in the current phase of portfolio expansion. Two credit history bureaus differing in the composition of creditors providing their data, report a rise in this segment, due to a loan size increase.¹⁷ The increase in the average unsecured consumer loan size may signal a change in the structure of purchases funded via this loan type. This may well mean a rise in the share of these loans used to finance repairs in newly acquired apartments (mainly bought in the new housing market) and to buy furniture or cars, although such loans are not issued as auto loans. An increase as of April 1 of risk coefficients for unsecured consumer loans for calculating capital adequacy ratios, may have made some banks boost the provision of such loans at the end of the first quarter.

March also saw auto loans posting growth acceleration to levels just above the average portfolio expansion rate in 2018. This coincided with a resumption in government programs to support auto loans, which buttressed demand and triggered a rise in car sales (up 1.8% YoY in March). But the amount of government support was reduced relative to last year, which may temper this loan segment growth further on.

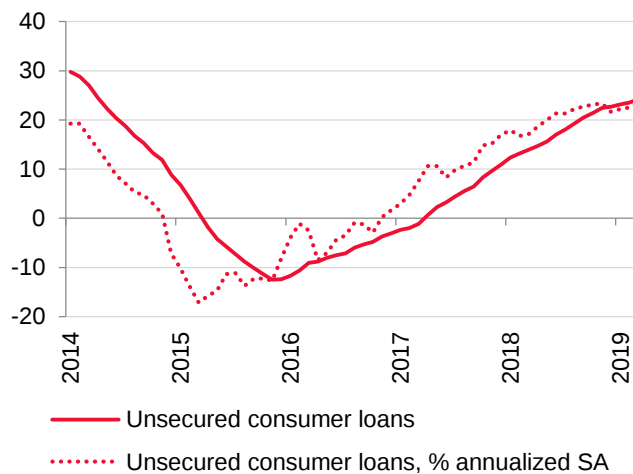
¹⁷ See the National Credit History Bureau: The average consumer loan size rose 24.3% to 170.3 thousand rubles in the first quarter of 2019 (<https://www.nbki.ru/company/news/?id=23715>); Borrowers took 1.97 trillion rubles of loans in the first quarter of 2019. (<https://bki-okb.ru/press/news/v-i-kv-2019-g-zaemshchiki-vzyali-kreditov-na-197-trln-rub>).

Figure 47. Ruble mortgage lending, % MoM (seasonally adjusted)



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

Figure 48. Unsecured consumer loans, %



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

A household deposit rise slowed from 1.1% MoM to 0.6% MoM in March, dragged down by a slower ruble deposit expansion. Legal entities deposit growth,¹⁸ however, continues to outpace the household deposit increase, at least in the ruble segment. This growth rate was chiefly owed to deposits and other accounts of the Federal Treasury and those of regional budgets and off-budgetary funds. The significant rise in the amount of funds placed with banks may stem from a budget surplus and raising debt in the OFZ market faster than planned in the first quarter (over 500 billion rubles against 450 billion rubles planned) (Figure 49). Nonfinancial organizations preferred a more liquid form of holding money in March, expanding funds in transactional and other accounts by 2.2% MoM.

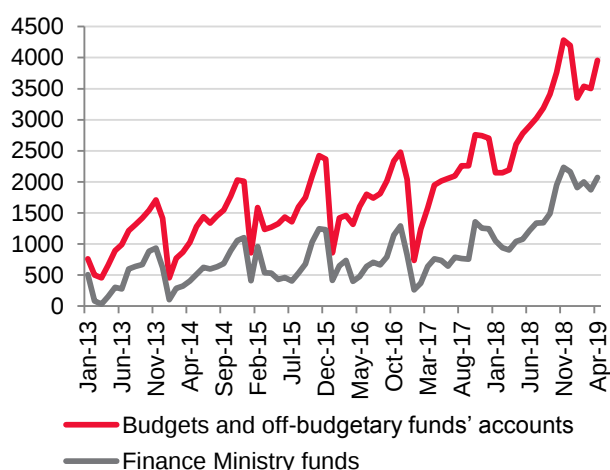
The adoption of IFRS 9 as of January 1, 2019, continues to affect the banking sector's profit, the levels of bad debts and provisions. The banking sector's profit totaled over 585 billion rubles in the first quarter, far exceeding the result posted a year earlier (353 billion rubles). At the same time, the corporate portfolio's NPLs rose by more than 530 billion rubles (1.6% of the corporate loan portfolio) in the first quarter of 2019, while the retail loan portfolio saw bad debts increasing by 38 billion rubles (0.2% of the retail loan portfolio). This largely arose from moving NPLs and overdue receivables incurred from acquired claims to the appropriate accounts. Hence the dramatic bad debt increase is largely technical in nature and does not suggest that loan portfolio quality has really worsened this much. On the other hand, the adoption of IFRS 9 means that banks are supposed to measure some assets at fair value and to release provisions set aside earlier. This contributed the most to a downward adjustment of almost 850 billion rubles to loan loss provisions in the first quarter of 2019.

Credit institutions could make adjusting entries by allocating income from reducing provisions to either the current financial result or the results of previous years. As shown in the profit and loss statement, about 110 billion rubles out of the total profit growth in the first

¹⁸ The analytical indicator "Deposits and other funds from legal entities" includes deposits and other funds placed by the Federal Treasury, regional budgets and off-budgetary funds.

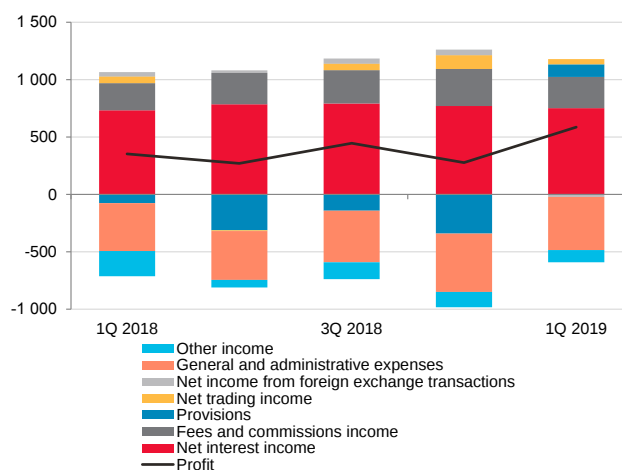
quarter of 2019 was made possible by a reduction in provisions through adjustments (Figure 50). It should be noted that had there been no adjustments, additional provisioning (provision growth) would have amounted to about 240 billion rubles. Net interest income, which is the key factor of the banking sector profit, declined compared with the third and fourth quarters of 2018. But the deposit rate decline which started towards the end of the first quarter of 2019 may put a brake on this trend further on.

Figure 49. Ruble funds from budgets and the Finance Ministry in bank accounts (without seasonal adjustment), billion rubles



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

Figure 50. Factors of the banking sector's profit, billion rubles



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

2. OUTLOOK: LEADING INDICATORS

2.1. What do Russia's leading indicators suggest?

2.1.1. GDP nowcast: economic growth slows down temporarily

- Based on statistics as of April 18, GDP growth estimate for the first quarter of 2019 posted a small decline to 0.2%–0.3% QoQ in seasonally adjusted terms. We note that estimates made as early as the fourth quarter of 2018 also provided indications of growth deceleration at the start of 2019.
- Prospects for growth acceleration have, however, improved: starting from 2018Q2 the growth rate is expected to stand at about 0.4% QoQ in seasonally adjusted terms, reaching potential.
- Monthly fluctuations of individual macroeconomic indicators' performance are restraining the volatility of the index-based GDP estimate obtained using our DFM model. An explanation for this is that changes in high-frequency time series across a wide spectrum of macro indicators used to obtain current estimates and a short-term GDP forecast on a quarterly basis, are, according to the conventional approach, smoothed via quarterly transformations.¹⁹

	April % QoQ SA	March % QoQ SA
Q1 2019	0.2 – 0.3	0.3
Q2 2019	0.4	0.3
Q3 2019	0.4	0.4

2.1.2. Bloomberg consensus forecast: analysts respond to Bank of Russia's forward guidance

- The Bank of Russia milder rhetoric regarding monetary policy had an effect on analysts' March forecast for the key interest rate. The signal sent following April's Board of Directors meeting has yet to be reflected in the consensus forecast.

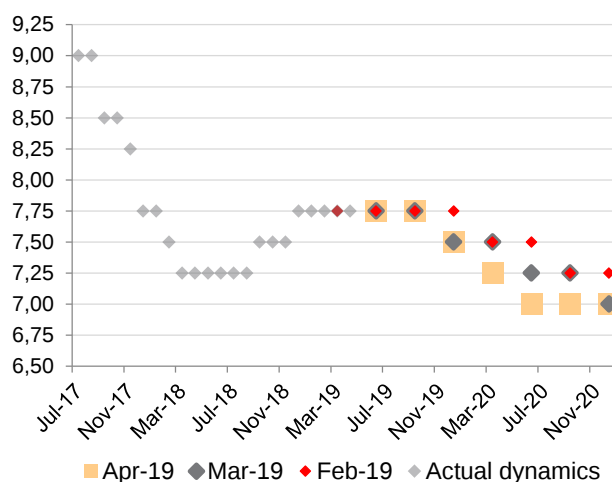
¹⁹ See also: *Short-term estimation and forecasting of Russia's GDP using a dynamic factor model*. A. Porshakov, E. Deryugina, A. Ponomarenko, A. Sinyakov. The Bank of Russia, Working Paper Series, 2015, No 2.

- Analysts medium-term inflation expectations remain anchored at the Bank of Russia's target.

Based on a monthly Bloomberg survey,²⁰ analyst expectations for the key rate at the end of 2019 have not changed (Figure 84). The survey was conducted on April 19–25, **just ahead** of the Board of Directors interest rate meeting, so it failed to take into account the Bank of Russia's signal that the rate could be cut as early as the second or third quarter of 2019. The April survey, however, already factors in the signal from the March Board meeting that the rate could start going down in 2019. The key rate forecast was revised compared with the February one, now expecting the rate to be brought down towards the end of 2019 (Figure 84). The further rate movement is also assumed to be very smooth: analysts expect the Bank of Russia to remain cautious in taking decisions on key rate cuts. Most of the respondents expect the rate to be lowered to 7% per annum (this is in line with the upper bound of neutral rate estimates) by mid-2020.

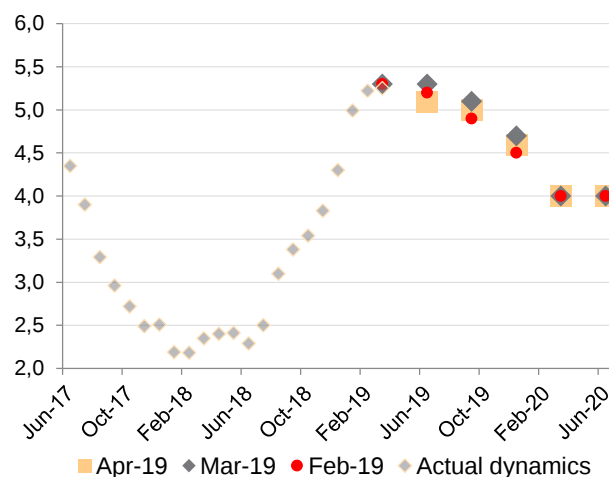
Annual inflation forecasts have not changed much over the last two months (Figure 85). Analysts agree that the current inflation acceleration is temporary and annual price increases are past their peak. Inflation is expected to come back down to the 4% target in the first half of 2020, in line with the Bank of Russia forecast. Analysts' medium-term expectations (beyond the horizon of one-off effects) remain anchored at 4%.

Figure 84. Analysts' expectations regarding Bank of Russia key rate, % p.a.



Source: Bloomberg Finance L.P.

Figure 85. Analysts' inflation expectations, % YoY



Source: Bloomberg Finance L.P.

²⁰ The survey involved 36 analysts.

3. IN FOCUS. Declining inflows of foreign direct investment

- According to preliminary data, the inflows of foreign direct investment (FDI) to Russia contracted to 0.5% of GDP (8.8 billion dollars) from 1.8% of GDP (28.6 billion dollars) over the previous 5 years.
- Russia's net FDI balance (taking account of Russia's FDI abroad) remained negative at 1.4% of GDP (-23.1 billion dollars) in 2018, broadly the same as the recent years' average. Meanwhile, this balance contraction at least by half from levels seen prior to 2013 indicates a downward trend, including that in FDI from Russia.
- Other emerging markets have also seen a downward FDI inflow trend in recent years. But the relative level of FDI inflows to Russia has in recent years lagged the emerging market average (2% in 2015–2017).²¹
- The FDI structure has experienced a substantial reduction in the share of investment in debt securities and ownership stakes, whereas the share of reinvested earnings has stayed at the previous years' level. This trend may indicate the scaling down of return to Russia of funds taken out to offshore jurisdictions.²²
- Investment in tradable sectors, mining and quarrying and manufacturing, which are the principal investment objects, has diminished to a lesser extent (possibly because of earnings reinvestment), while nontradable sectors have posted a steep investment fall.²³ This agrees with the economy's restructuring as it adapts to the lower oil price.²⁴
- The contracting FDI in Russian debt securities and ownership stakes is a constraint on an improvement in economic growth potential.
- The first quarter of 2019 saw an unusual spike in FDI in other sectors, up 11.5 billion dollars after a 1.4 billion dollar increase in the fourth quarter of 2018. But this spike partly came from some intragroup transactions between large companies. Net of these, FDI in Russia did not rise much compared with the previous quarters.

As evidenced by the experience of European countries featuring a medium level of economic development (Ireland and some Eastern European countries), significant inflows of foreign direct investment are a key engine in the period of accelerated economic growth.²⁵

²¹ The calculation includes Argentina, Brazil, Mexico, and Turkey. The 2018 data is not available.

²² Earlier, a fairly significant outflow of funds to foreign countries was concurrent with comparable inflows to Russia, which is largely explained by offshore SPV transactions. This had a minimal effect on Russia's FDI balance but produced quite significant FDI inflows to Russia. What is seen now is a fall in FDI inflows to Russia in parallel with a minor contraction of outflows to foreign countries. Changes in FDI territorial distribution indicate the same trend. For example, FDI inflows from offshore zones (primarily from Cyprus) are weakening the most.

²³ See Appendix for the classification of FDI to tradable and nontradable sectors.

²⁴ The average oil price fell to 54 USD/bbl in 2015–2018 from about 102 USD/bbl in 2010–2014.

²⁵ Ireland's gross FDI inflows equaled about 17% of GDP in 2013–2014, with GDP growing 1.1% and 8.5% respectively, Poland posted a local gross FDI inflow maximum of 5% of GDP, with GDP rising 5.1%–6.8% in 2006–2008. The Czech Republic's local gross FDI inflows stood at 5.9% of GDP in 2005–2007, GDP went up 6.3% on average over the same period.

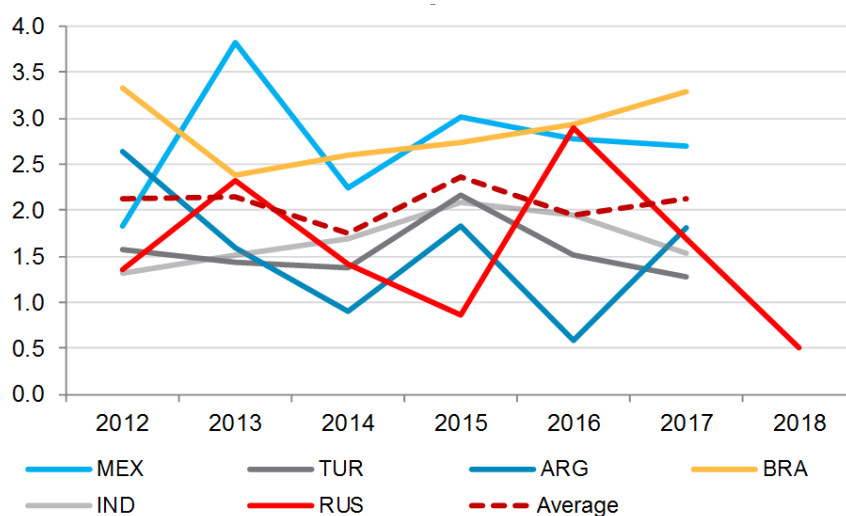
They enable such countries to drastically reduce the economic development gap with developed countries.

Apart from its direct contribution to economic growth, FDI plays an important role in the transfer of technology and management techniques which are then replicated by other companies, including from other industries, producing a synergy between economic growth and FDI.

Foreign direct investment inflows to Russia continued to contract in 2018. Based on preliminary data, they dropped more than three times to 8.8 billion dollars (0.5% of GDP) from 28.6 billion dollars a year earlier.²⁶ This is the lowest FDI inflow level in the last 10 years. Net FDI outflows (FDI inflows to Russia less FDI from Russia in foreign countries) continue, standing at 23.1 billion dollars (1.4% of GDP) versus outflows of 8.2 billion dollars in 2017, which is, however, much less than prior to 2013.

Other emerging markets also show a generally downward FDI inflow trend, but FDI inflows to Russia have in recent years lagged these countries' average with 0.5% of GDP in 2018 and 1.8% of GDP in 2015–2017 against 2% of GDP in 2015–2017 for emerging markets.

Figure 86. Comparative FDI inflow data, % of GDP



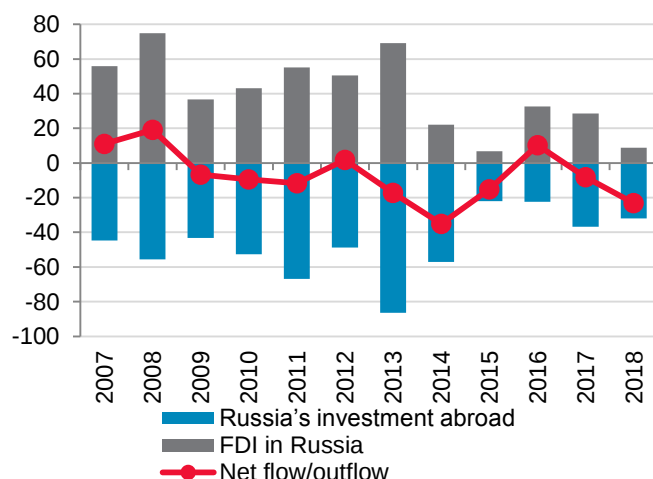
Sources: UNCTAD, World Bank.

Investment in the nonbanking sector continues to account for the greater part of FDI contraction in Russia, whereas investment in the banking sector is usually insignificant. The nonbanking sector showed the most dramatic FDI inflow decline (Figure 88). The same is true of the negative balance of net FDI inflow to Russia, which expanded to -24.3 billion dollars for the corporate sector in 2018 versus -8.8 billion dollars in 2017. Foreign direct investment in “other sectors” traditionally represents the largest share of total FDI in Russia. But with a fairly steep fall in total FDI in Russia, the share of investment in the nonfinancial

²⁶ Taking account of negative balance for the item “FDI in Russia in the third quarter of 2018”.

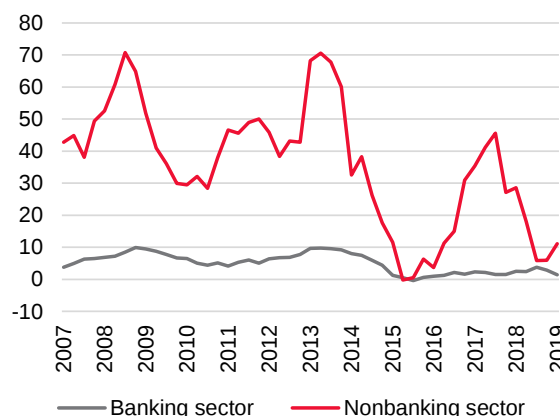
sector dropped from 90% to 67%. FDI inflows to the banking sector meanwhile remain insignificant but offset Russia's FDI in foreign countries.

Figure 87. FDI in Russia and Russia's FDI abroad, USD billion



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

Figure 88. Balance of FDI in Russia by institutional sector (rolling four-quarter total), USD billion



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

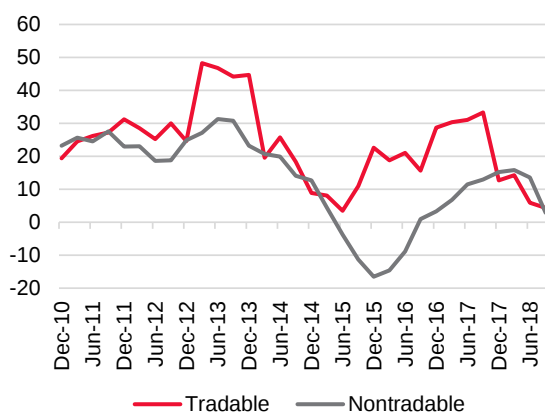
From the perspective of FDI analysis by economic activity type, FDI inflows to tradable sectors enjoy a higher stability and smaller contraction than those in nontradable sectors.²⁷ Investment in nontradable sectors plunged in 2018 after its recovery in 2016 – the first half of 2017. These developments are in line with the fall in the oil price which has almost halved to an average of USD 54 per barrel in 2015–2018 from USD 102 per barrel in 2010–2014, as well as a worsening real income performance. Against this background, the FDI contraction in nontradable sectors may result from the economy's restructuring in response to the lower oil price.

Data for January–September 2018 (the latest figures available) suggests that tradable sectors accounted for practically all of FDI inflows to Russia (Figure 90).²⁸ The positive FDI performance in the tradable goods sector was fueled mainly by mining and quarrying. Moreover, FDI numbers improved significantly in the second and third quarters of 2018. The positive FDI performance in these sectors may well stem from the steady level of earnings reinvestment in the FDI structure in Russia.

²⁷ See Appendix for FDI classification by sector (tradable and nontradable).

²⁸ According to preliminary quarterly data on total FDI investment inflows to Russia for 2018 and, specifically, updated statistics for the third quarter of 2018, a contraction in FDI in other sectors was less pronounced, followed by an FDI rise in the fourth quarter.

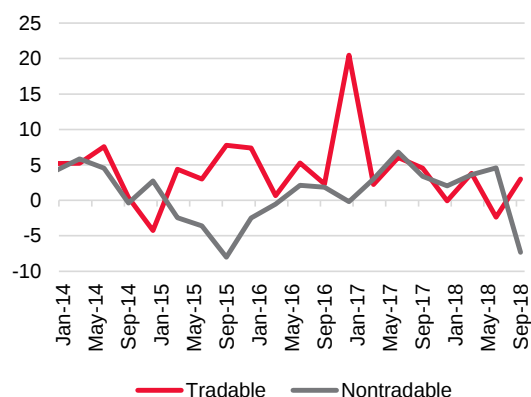
Figure 89. FDI in Russia by sector* (rolling four-quarter average), USD billion



* Excluding data that was not distributed by sector

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

Figure 90. FDI in Russia by sector* (rolling four-quarter average), USD billion, QoQ

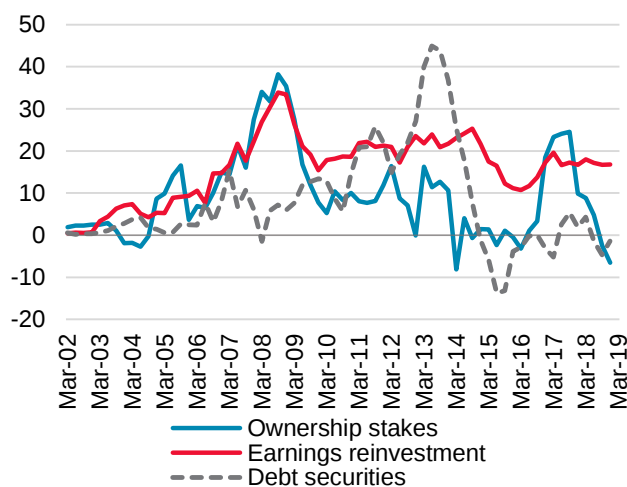


* 2017 spike from Rosneft's transaction

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

Earnings reinvestment in other (nonbanking) sectors in 2018 remained on practically the same level as in 2017. In other words, direct investors do not take out profits via dividend payments but continue to invest funds in companies' development (Figure 91). This item is the most stable and on average predominant in the structure of FDI in Russia. Meanwhile, foreign direct investment in the form of ownership stakes fell dramatically, with investment in debt securities failing to recover. While the former of these two components is fairly volatile, weak investment in debt securities has only been seen in the last two years. (Figure 91).

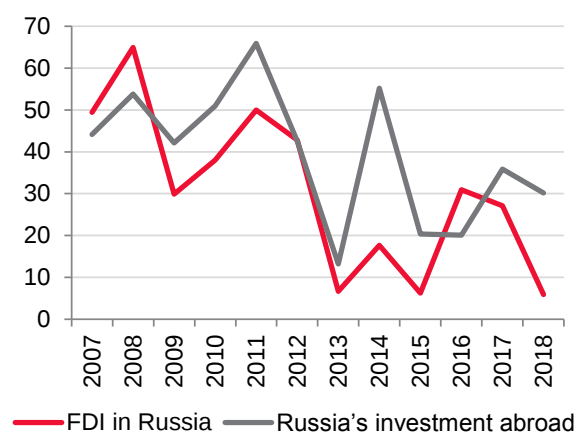
Figure 91. Balance of FDI in Russia by instrument, other sectors (four-quarter rolling total)



Excluding data that was not distributed by sector

Source: Bank of Russia, D&F Department estimates

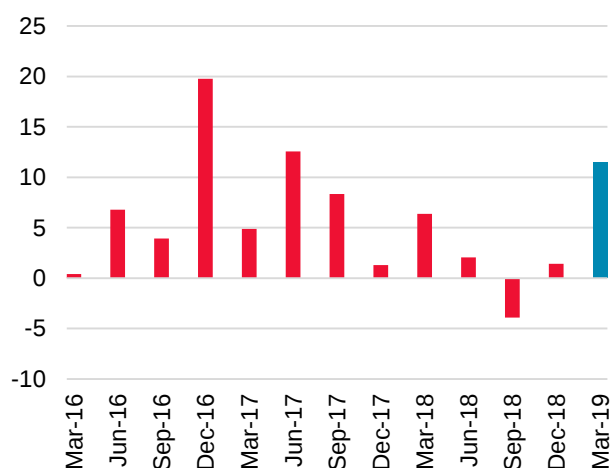
Figure 92. Comparative data on FDI investment in Russia and Russia's investment abroad, USD billion, annual figures



It is noteworthy that a relationship between FDI inflows and outflows has substantially weakened in other sectors after 2012. Earlier, FDI inflows to Russia was concurrent with outflows (expanding investment both in and from Russia without affecting the balance), which may have arisen from intragroup transactions and those with offshore entities. Now we see a downward trend in FDI inflows to Russia, with Russia's FDI abroad stabilizing (Figure 92).

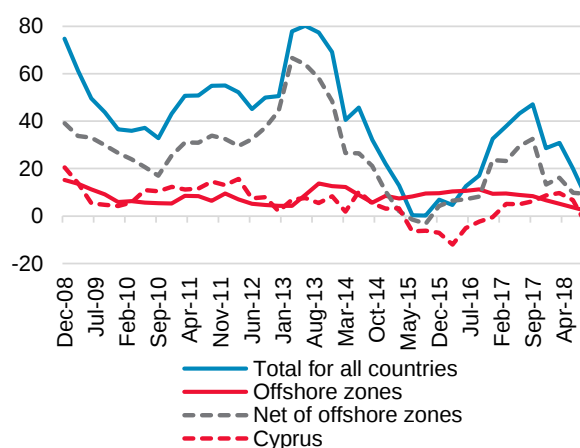
According to FDI breakdown by investor country, investment net of investment inflows from key offshore zones fell the least in January–September 2018²⁹ (Figure 94). Investment from Cyprus suffered the largest contraction. Net investment inflows from Cyprus to Russia were negative at -7.9 billion dollars in the third quarter, providing the key contribution to the negative balance of FDI in Russia in that period.³⁰ Investment inflows from other traditional offshore zones are also declining, but to a lesser extent, and this investment has become generally insignificant in recent years. Other countries showed a moderate inflow of direct investment to Russia in both the third quarter and from the start of the year.

Figure 93. FDI in other sectors USD billion, QoQ



Source: Bank of Russia, R&F Department estimates

Figure 94. FDI in Russia: geographical distribution (four-quarter rolling total)³¹



Offshore zones – the Bahamas, Bermudas, the British Virgin Islands, the Cayman Islands, Panama

The first preliminary estimates of FDI in Russia for the first quarter of 2019 (from balance of payments data) indicate that FDI in other sectors rose to 11.5 billion dollars, up from 1.4 billion dollars in the fourth quarter of 2018 and 6.4 billion dollars in the same period of 2017 (Figure 93). This improvement partly arose from the recovery of investment in debt securities. But since a considerable share of this investment had to do with some intragroup transactions between large companies, it is too early to claim that it is a sustainable FDI recovery in these sectors.

²⁹ The latest data available.

³⁰ This estimate may well be revised down further on because the updated estimates of overall FDI investment inflows to Russia suggest a much less drastic FDI fall.

³¹ The total for all countries includes investment that is not distributed by country and investment by international organizations and institutions.

Adjusted for the above effect, FDI increased just marginally compared with recent months in the first quarter. Moreover, almost all FDI types showed varying degrees of deterioration in the third and fourth quarters. Overall, this period's FDI in Russia was lower than recent years' quarterly averages.

The weakening of FDI inflows to Russia is in line with FDI performance in other emerging markets. However, recent years' FDI inflows to Russia in percentage terms have remained somewhat lower than these countries' average. A contraction in FDI inflows to Russia in the form of investment in debt securities and ownership stakes is a constraint on an improvement in economic growth potential.

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