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The views and recommendations expressed in the bulletin do not necessarily reflect the official position of the Bank of Russia.

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

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EXECUTIVE SUMMARY

MONTHLY SUMMARY

- Inflationary pressure adjusted for the impact of transient and one-off factors is in line with the inflation target. Meanwhile, loose monetary policy helps further the recovery of economic and consumer activity. This should prevent the impact of disinflationary factors from strengthening after the deferred demand effect has run its course, helping annual inflation come in at about 4% for next year, unless more shocks emerge.
 - We expect the second half of 2020 to see seasonally adjusted consumer price rises close to a level required for inflation to stabilise at the target. That said, August's ruble weakening may provide for accelerated price rises in goods enjoying stable demand. Annual inflation will come close to 4% in view of the slow price increases in the second half of last year.
 - The recovery of economic activity in Russia slowed in July–August as the effect of lifting the key coronavirus-related restrictions weakened, with caps on oil extraction under the OPEC+ agreement also playing a part. At the same time, consumer demand for *goods* all but recovered helped by deferred demand, the shifting of consumption from services to goods, and social payments from the budget. The process of investment demand recovery will be more protracted due to the continuing uncertainty over the spread of the pandemic in Russia and across the globe.
 - July–August saw the situation in the Russian financial market develop in a non-uniform fashion. The equity market was rising extensively, whereas the ruble weakened and bond yields and credit spreads increased. Overall, risks to the stability of Russia's financial markets and financial institutions rose somewhat compared with June.

IN FOCUS:

Budget deficit and debt burden expansion, the movements of key interest rates, as well as the current and expected inflation have a substantial effect on the change and pace of interest rate movements over various yield curves of government bonds. Moreover, change in long-term rates is driven not only by the strengthening or weakening of these factors' impact at any given moment but also by the long-term configuration of macroeconomic policy and, above all, the budget.

The extent of foreign investors' involvement in the market for government securities denominated in national currency also affects the shape of the yield curve.

The development of long-term institutional investors, the consideration of such investors' needs in deciding on bond terms and conditions (maturities, variable or fixed-rate coupons, etc.) for designing the strategy of lending from the market may partially compensate for a fall in demand from foreign investors and enhance the stability of the government bond market.

1. Inflation

August saw seasonally adjusted price rises slightly exceed the level corresponding to an inflation rate of 4% in annualised terms. That said, inflationary pressure adjusted for the impact of temporary and one-off factors is in line with the inflation target. In services, the recovery of demand as coronavirus-related restrictions were lifted accelerated price rises. The prices of non-food goods continued to increase at an accelerated pace, driven by the deferred demand effect, the pass-through of ruble weakening, and the overall recovery of economic and lending activity.

The risks of disinflationary pressure mounting declined thanks to, among other things, the current loose monetary policy and strengthening pro-inflationary factors, in particular, ruble depreciation. This should help inflation come close to 4% towards the end of 2020 and stay around 4% in 2021.

Demand will largely recover in the Russian economy in 2021–2022, requiring no further enhancement of fiscal support. Therefore, the forthcoming fiscal consolidation as part of the return to the parameters defined by the fiscal rule will not deflect inflation downwards from the current trend. The fiscal consolidation will only be disinflationary in relation to the 2020 budget which includes temporary measures to stimulate demand, most of which have been implemented by now.

Therefore, the fiscal consolidation will not be an obstacle to keeping inflation within 4% as part of the current monetary policy.

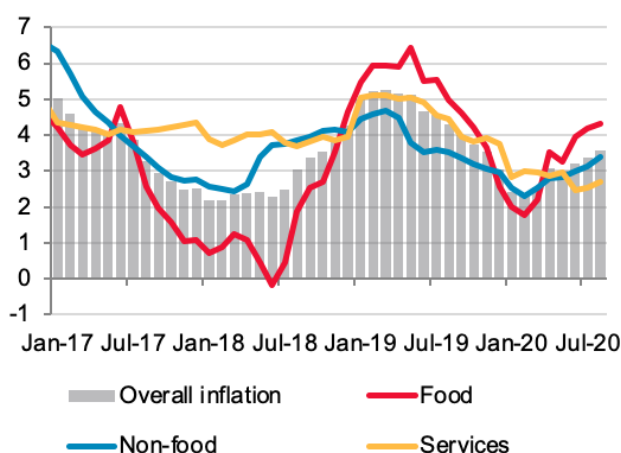
1.1. Inflationary pressure is in line with the inflation target

- Inflation accelerated to 3.58% YoY in August from 3.37% YoY in July. Seasonally adjusted consumer price inflation rose to 0.40% MoM after a temporary slowdown to 0.18% MoM in July, driven mostly by an incomplete indexation of housing and utility services prices.
- An acceleration in the seasonally adjusted monthly price increase in August was also driven by ruble weakening at the end of July – beginning of August. Although it was mounting somewhat in August, inflationary pressure in the consumer market is generally in line with an inflation rate of 4%: the mean modified indicator of core inflation stood at 4.16% SAAR in August after 3.68% SAAR in July.
- Price movements continue to be driven by a large number of oppositely directed one-off and more enduring factors. Overall, inflationary pressure adjusted for the impact of transient and one-off factors remains close to the target. The volatility of monthly price rises will likely remain high in the months ahead.
- Given the low base of the second half of last year, inflation will come in at about 4% at the end of 2020.

Prices declined 0.04% MoM in August after rising 0.35% MoM in July. Annual inflation continued to accelerate, coming in at 3.58% in August after 3.37% in July (Figure 1). Annual consumer price inflation was recorded in all three CPI components as the high readings of last year exited the calculation base.

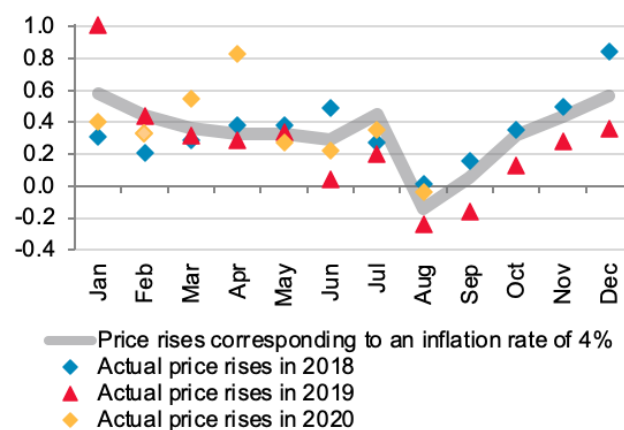
The monthly pace of consumer price rises in July was just below the path corresponding to an annualised inflation rate of 4% in July, while August, by contrast, saw it above this path. The seasonally adjusted consumer price increase stood at 4.9% SAAR¹ (0.40% MoM), in August, gaining pace from 2.2% SAAR (0.18% MoM) in July (Figure 3).

Figure 1. Inflation and its components, % YoY



Source: Rosstat.

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



Source: Rosstat, R&F Department estimates.

The seasonally adjusted rate of food price rises equalled 4.5% SAAR in August (0.37% MoM), down from 5.8% SAAR (0.47% MoM) in July. A price rise slowdown or a marginal price decline was seen in most food items. That said, some food categories, which were all but unaffected by coronavirus-related restrictions, saw an accelerated price increase (sugar along with fruit and vegetables).

The seasonally adjusted rate of price rises in non-food goods accelerated to 5.0% SAAR (0.40% MoM) in August after 4.5% SAAR (0.37% MoM) in July. After some slowdown or stabilisation of the pace of price increases for a wide range of goods in July, inflation notably gained pace in August for some items sensitive to exchange rate movements, such as passenger cars, electrical goods, and personal computers. This may be owed to the pro-inflationary effect of ruble depreciation in June–July.

The seasonally adjusted rate of services price increases stood at 5.3% SAAR (0.37% MoM) in August after a decline of 5.0% SAAR (0.43% MoM) in July. The indexation of housing and utilities services prices – by 4% under the original plan, was not implemented in full in July, thus bringing down the overall level of prices in seasonally adjusted terms. Housing and utilities services prices edged up 0.29% in August after a 2.15% rise in July. The effect of full indexation on the CPI is still likely to materialise in September: some regions

¹ SAAR – a seasonally adjusted annualised rate.

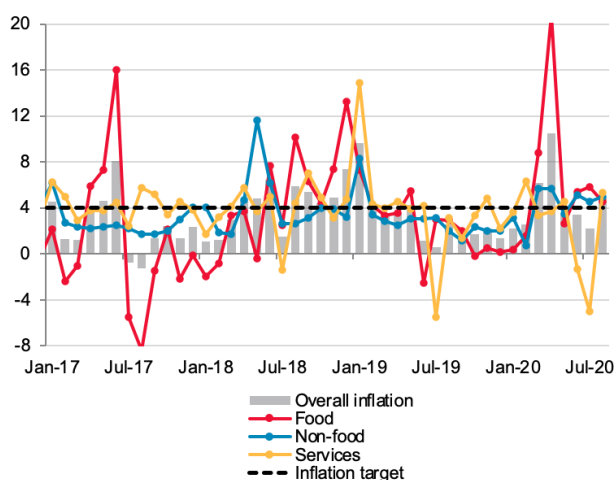
which previously postponed its implementation or increased these prices less than planned will index them in full.

Net of housing and utilities, services price rises accelerated to 4.3% SAAR (0.35% MoM) in August from 1.7% SAAR (0.14% MoM) in July): with coronavirus-related restrictions lifted in most regions, economic activity in preschool education services recovering gradually and deferred demand realised, July–August saw a seasonally adjusted price rise acceleration in personal services, the services of preschool education, cultural organisations, and passenger transport (exclusive of railways).

In some components, the volatility of price movements remains high. For instance, the prices of health resort services soared by 5.9% MoM SA in July, driven by a significant increase in domestic tourist travel flows in the summer vacation season when foreign countries were off limits. August, however, saw a slight correction, with these prices dropping 0.5% MoM SA.

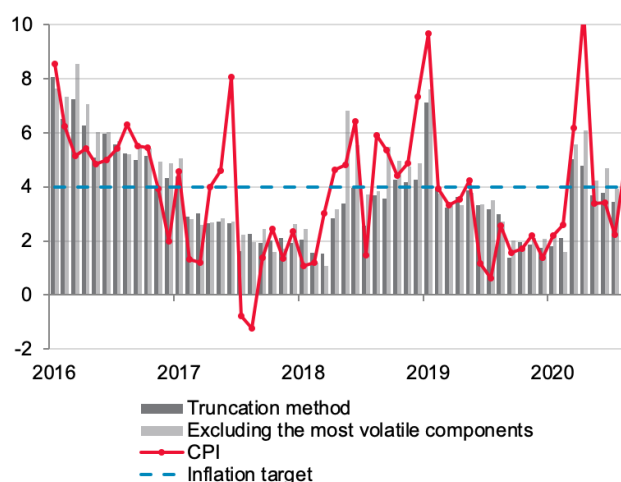
It should be specially noted that restrictions on the provision of some services types remain in place, and their prices are therefore not registered. This has made a certain contribution to the slow rise in services prices in recent months. The prices of foreign tourism services, for example, have not changed since April, while under the normal seasonal pattern, prices in this category climb about 4.5% in the April–August period. Technically, this brought down the prices of foreign tourism services in seasonally adjusted terms. But foreign tourism services prices decline in September–November as part of the seasonal cycle, hence the absence of price registration (and, accordingly, a zero price rise NSA) will accelerate a seasonally adjusted price hike. We estimate that this technical factor slowed the seasonally adjusted price increase by about 0.05–0.1% over the April–August period (an overall accumulated price rise within this time interval stood at 1.9% SA). Accordingly, price rises are set to accelerate at about the same pace in September–November.

Figure 3. Seasonally adjusted inflation, % SAAR



Source: Rosstat, R&F Department estimates.

Figure 4. Modified core inflation indicators, % SAAR



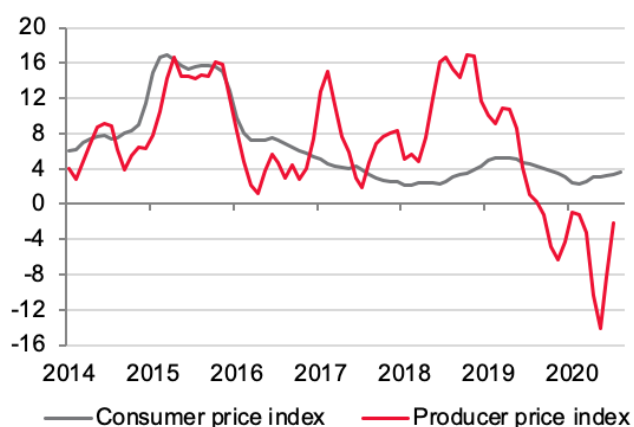
Source: Rosstat, R&F Department estimates.

The changes in modified core inflation indicators suggest that inflationary pressure adjusted for the impact of both pro-inflationary and disinflationary temporary effects corresponds to 4%. The mean reading of two modified core inflation indicators which are less sensitive to the impact of temporary factors stood at 4.16% SAAR in August, up from 3.68% SAAR in July and down from 4.25% SAAR in June.

1.2. Producer price decline slowing

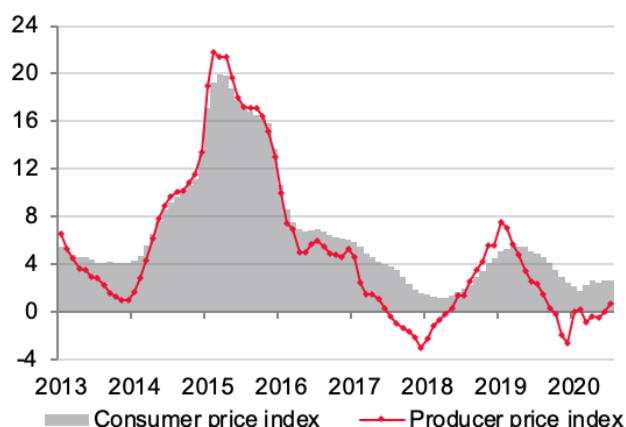
- A producer price decline stalled sharply to 2.2% YoY in July from 8.3% YoY in June and an even steeper drop in April–May, driven by a deep oil price fall in mining and quarrying on the back of the world oil price slump (Figure 5, Figure 7).
- Oil extraction and the manufacture of refined petroleum products still account for most of the slowdown in the overall PPI decline. That said, the pace of price decline in manufacturing has slowed over the last two months as producer costs climbed, driven by the rising prices of the imported raw materials and equipment.
- The producer prices of many consumer goods² went up 0.6% YoY in August after close-to-zero movements over the last few months (Figure 6). This may indicate the emergence of temporary pro-inflationary factors related to producer costs. Given weak demand, this should produce a moderate upward pressure on inflation, which is consistent with a gradual approach of inflation to 4% for the year.

Figure 5. Change in the producer price index and consumer price index, % YoY



Source: Rosstat.

Figure 6. Change in prices of some goods, % YoY

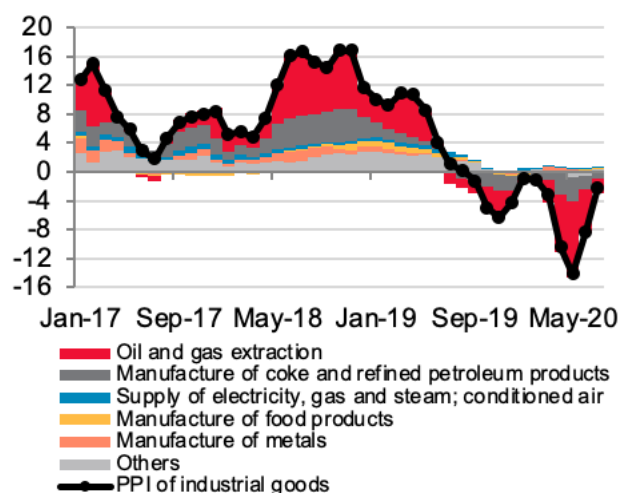


Source: Rosstat, R&F Department estimates.

Under Rosstat methodology, the calculation of the producer price indicator excludes VAT, and therefore, does not factor in the impact of the January 2019 VAT hike on producer prices.

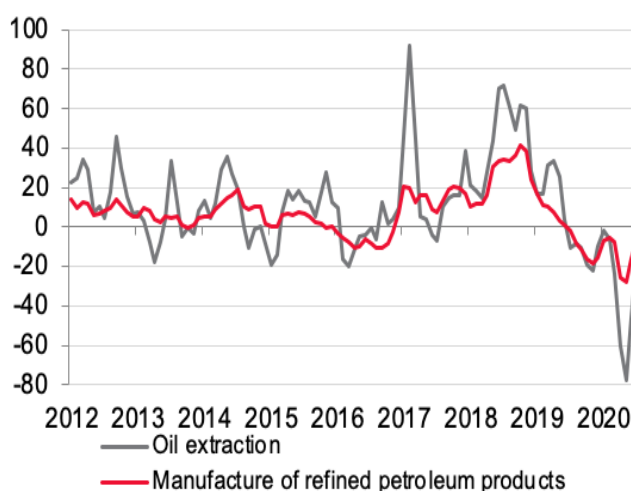
² The calculation used comparable goods in the CPI and PPI structure, such as meat products, fish products, butter and fats, dairy products, pasta, sugar, tea, coffee, clothing, footwear, detergents and cleaning solutions, perfumery and cosmetic products, household electronic appliances, and furniture. They account for about 30% of the consumer basket.

Figure 7. Input of top 5 industries to a rise in producer prices of industrial goods, % YoY



Source: Rosstat, R&F Department estimates.

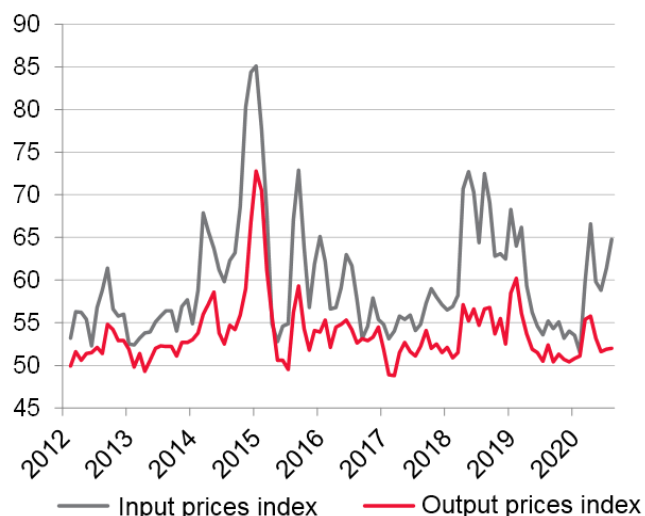
Figure 8. Producer price index in oil extraction and petroleum refining, % YoY



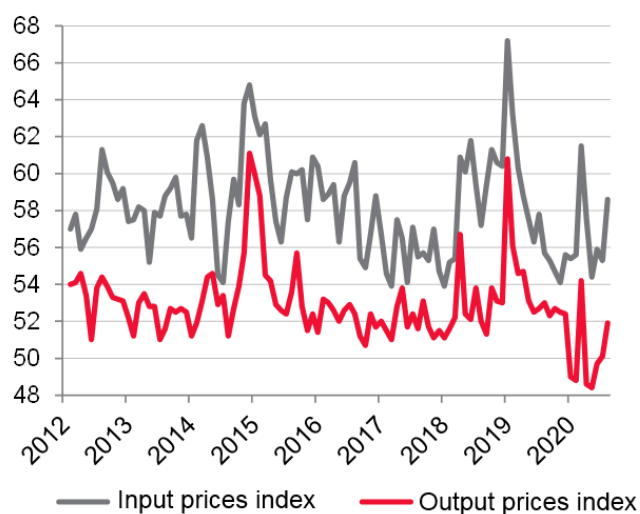
Source: Rosstat.

1.3. PMI price indexes in July–August: mounting inflationary pressure

- PMI price indexes also confirm a gradual mounting of inflationary pressure in manufacturing and services as economic activity recovered in July–August, although activity was in itself still below “pre-coronavirus” levels.
- The input price index in manufacturing climbed to 64.8 in August from 61.4 in July, coming in above the average level over the entire history of observations since 1997. Input price rise acceleration was also recorded in services, with the relevant index going up to 58.6 in August from 55.3 in July. One factor of August’s price rise acceleration was ruble weakening in July–August. The respondents, however, also report an overall increase in business costs as activity recovers.
- The recovery of demand has enabled the respondents to pass a part of the cost rises through to output prices. The relevant index inched up to 52.0 from 51.9 in July and 51.6 in June. The output price index in the services sector climbed to 51.9 in August from 50.1 in July B (the index stood below 50 in April–June signalling a price decline).

Figure 9. Change in PMI manufacturing indexes, pp

Source: IHS Markit.

Figure 10. Change in PMI services indexes, pp

Source: IHS Markit.

2. Economic performance

It appears from statistics and real-time data that the Russian economy continued to bridge the gap with the “pre-coronavirus” level of activity in August, albeit at a slower pace than in June–July. The most pronounced recovery was that of consumer demand for goods, which rose somewhat above the first quarter level in seasonally adjusted terms. In addition to the recovery of wages and income, the increase in consumer activity was helped by factors such as demand deferred on the back of restrictions put in place, the income support measures funded from the budget, and the shifting of demand from services to goods amid increased demand for domestic tourism services as people mostly had to spend their summer vacations in Russia. Demand may also have been buoyed by ruble weakening, which may have temporarily boosted demand for goods with a large share of imports in costs amid expectations of price hikes.

The phase of the Russian economy’s extensive recovery has come to an end, with its further recovery set to slow. Full recovery will be fairly long in coming especially in the services sector’s industries hardest hit by coronavirus-related restrictions, as well as in exporting and investment goods industries.

Structural changes in consumer behaviour and forms of doing business will cause some industries to suffer from lack of demand over an even longer horizon causing supply to contract as the least efficient companies go out of business. It is important that this process should not be distorted by government measures to support the economy.

The recovery process being non-uniform, most of the overall output gap in the economy is seen primarily in industries remote from consumer demand (for example, in the oil and gas and other industries meeting external demand). Due to this structural specificity of the

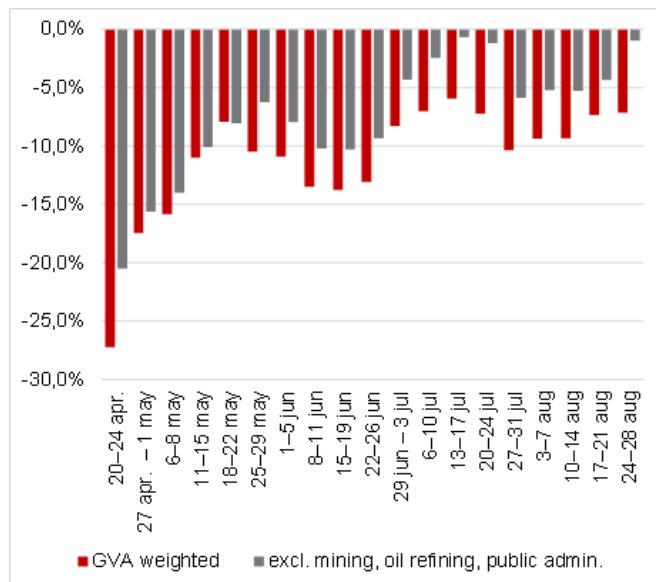
“coronavirus” crisis, disinflationary pressure is moderate in the consumer segment despite a large output gap.

2.1. Recovery of economic activity slackened in August

- August’s real-time indicators suggest that economic activity continues to recover but at a slower pace than in June-July, which becomes slower the closer it comes to the “pre-coronavirus” levels. Indeed, the mean deviation of GDP-weighted incoming financial flows from their “normal” level stood at -7.1% over the first four weeks of August (3–28 August), whereas it equalled -10.4% in July (6–31 July), and -13.1% in June (1-26 June). (Figure 11).
- Consumer demand (especially for goods) has shown the most significant growth in recent months. Various indicators suggest that it has come the closest to the “pre-coronavirus” level, even rising above it in some industries (Figure 12, Figure 13, Figure 14).
- In addition to some income rebound, the key drivers of a substantial consumption recovery were the realisation of deferred demand (despite an income decline, the savings ratio rose to 16.9% in Q2 2020 from 4.3% a year earlier as consumers were unable to spend money with restrictions in place), the budget-funded measures of income support and elevated demand for domestic tourism services, driven by, among other things, foreign countries being off limits.
- The aggregate change in several real-time indicators, however, suggests that consumption recovered at a slower rate in August than in June and July. Further on, the performance of consumer demand will increasingly depend on that of household, above all labour, income, which in turn depends on the pace of economic activity and employment recovery.
- Indirect indicators of business activity in manufacturing show that the recovery continued in August but was non-uniform. Electricity consumption, an indicator of business activity in power-intensive industries, in June stabilised at 96–97% of last year’s levels (Figure 15). On the other hand, the PMI index for manufacturing output climbed to 54.6 from 51.9 in July signalling an acceleration of recovery growth in the sector.
- External demand has shown some signs of improvement but is still far below the “pre-coronavirus” levels. For example, a decline in railway shipments slowed to 1.2% in August from 4.0% in July (Figure 16) helped most of all by oil and coal traffic. Russia’s oil extraction was scaled up under the OPEC+ deal in August thus improving oil traffic slightly, but the decline is still substantial at -12.3% YoY in August versus -17.8% YoY in July. The PMI sub-indexes for new export orders stayed below 50 in August.
- The recovery of investment demand remains volatile. The four-week rolling downward deviation of incoming financial flows from the “normal” level was increasing throughout

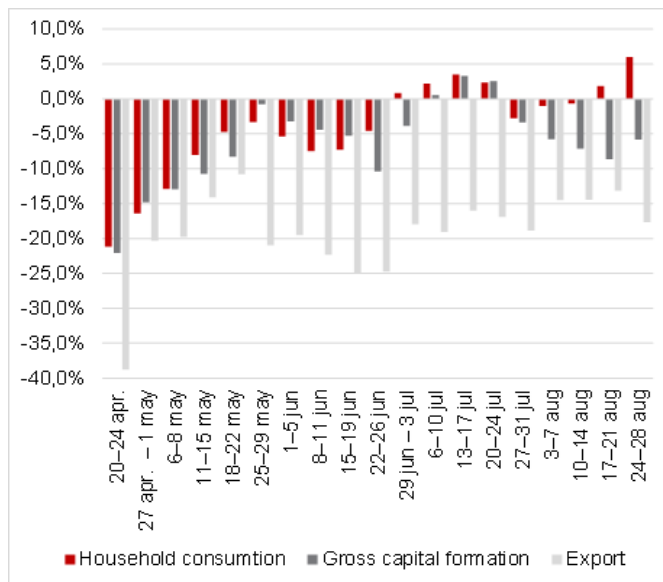
August but narrowed at the end of the month (Figure 12). Moreover, August saw a significant improvement in construction freight traffic (Figure 16), which remained in positive territory for as long as four months in succession.

Figure 1111. Four-week rolling average deviation of incoming payments from “normal” level



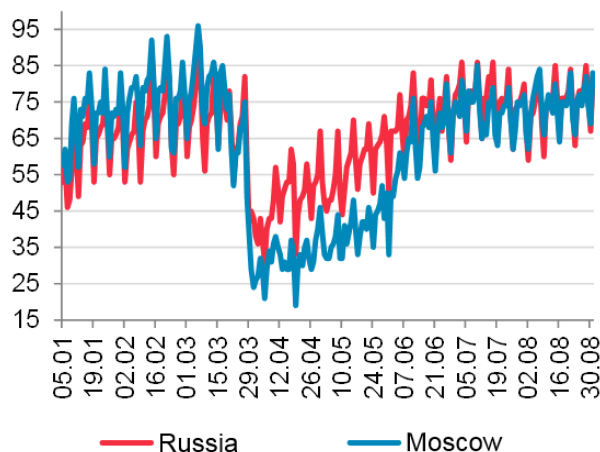
Source: Bank of Russia ([Monitoring of financial flows](#)).

Figure 12. Four-week rolling average of incoming payments from “normal” level by industry group



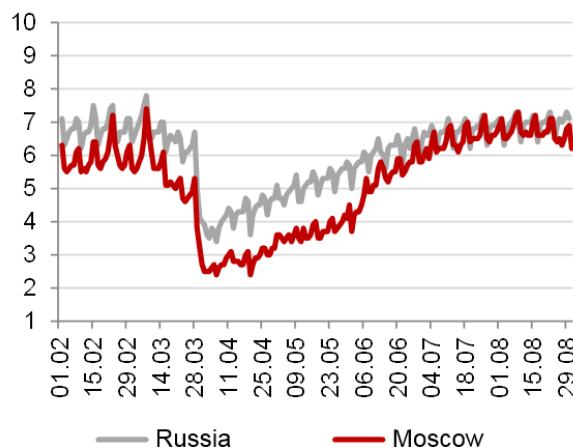
Source: Bank of Russia ([Monitoring of financial flows](#)).

Figure 13. Consumer activity Sberindex



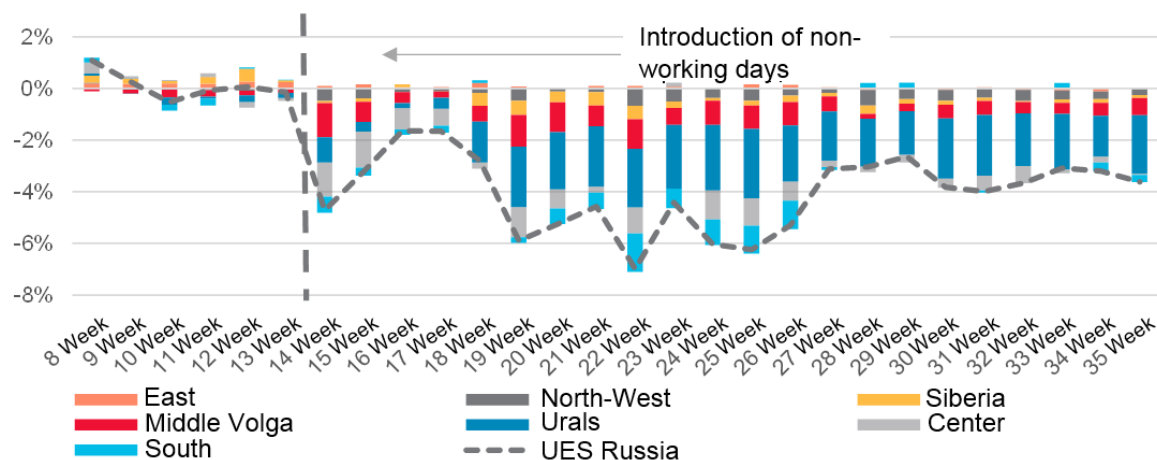
Source: Sberbank.

Figure 14. Consumer activity Tinkoff Corona Index



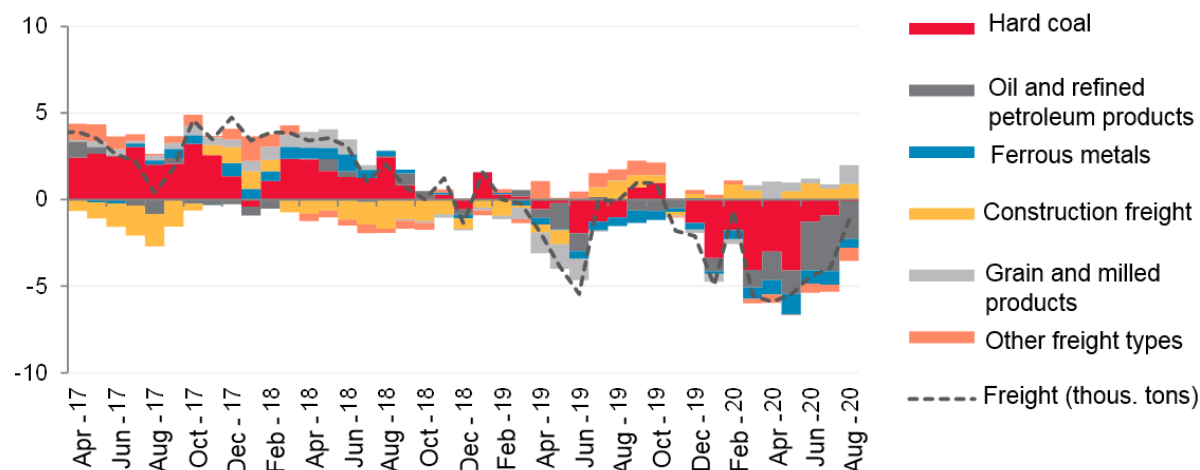
Source: Tinkoff Bank.

Figure 12. Contribution of regional energy systems to deviation of electricity consumption adjusted for temperature and calendar factors, % YoY



Source: System operator of United Energy System, R&F Department estimates.

Figure 16. Contributions of freight types to rail shipment growth, % YoY



Source: Russian Railways, Rosstat, R&F Department estimates.

2.2. Industrial output growth posted in July as oil extraction stabilised

- Industrial output continued to fall in June dragged down by mining and quarrying contraction. A slowdown in mining and quarrying downturn along with recovery acceleration in manufacturing helped industrial output move to an expansion of 0.9% MoM SA³ in July.
- Oil extraction, which was still declining in June, posted token growth of 0.5% MoM SA in July. However, a deferred negative effect on field services output caused a mining and quarrying output contraction of 0.9% MoM SA in July.

³ Here and further on in seasonally adjusted terms.

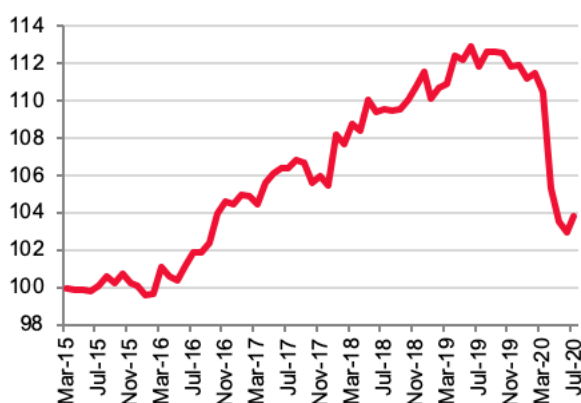
- Manufacturing recovery gave place to a minor output decline of 0.2% MoM SA in June. Growth resumed in July, reaching 2.1% MoM SA.
- Most industries hardest hit in April, saw growth easing in June–July after a fast rebound in May. A rapid output expansion in pharmaceuticals in April and in medical products in May–June was followed by a contraction in July.
- The improvement in manufacturing performance was chiefly fuelled by output growth in the intermediate goods industry and growth acceleration in the industry manufacturing investment goods.

A year-on-year fall in industrial output continued to slow in June and July (output contracted 9.4% YoY in June and 8% YoY in July. In monthly terms, after a decline of 0.6% MoM SA in June, recovery started in July with an output gain of 0.9% MoM SA (Figure 17).

Mining and quarrying maintained a negative trend in June and July. A year-on-year decline accelerated from 14.2% in June to 15.1% in July. By contrast, manufacturing continued to bridge the gap with last year's numbers as the fall slowed significantly from 7.2% YoY in May to 6.4% YoY in June and 3.3% YoY in July.

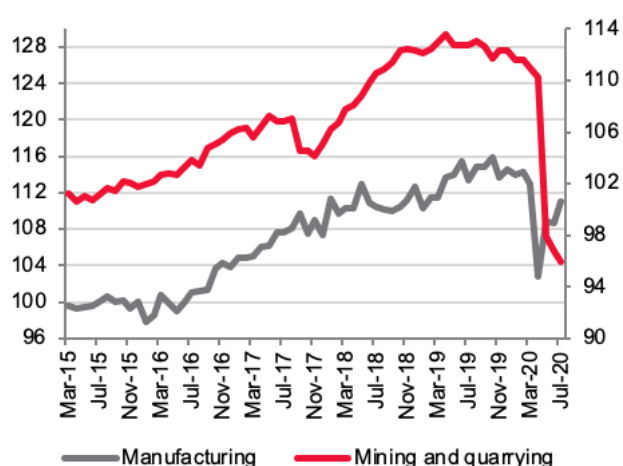
Compared with May, mining and quarrying output contracted 1.1% MoM SA in June, dragged down chiefly by a continued downward trend in crude oil and gas extraction as the OPEC+ agreement was implemented (Figure 18). The fall eased to 0.9% MoM SA in July. Oil extraction all but stabilised in July up 0.5% MoM SA. But the negative trends in the sector, however, started to affect the output of oil field services, which tumbled 9.4% MoM SA (Figure 20).

Figure 13. Change in industrial production index (2014 = 100)



Source: Rosstat, R&F Department estimates.

Figure 14. Change in mining and quarrying and manufacturing indexes (2014 = 100)



Source: Rosstat, R&F Department estimates.

The manufacturing sector saw a growth pause in June with its output sliding 0.2% MoM SA. This was, on the one hand, owed to a slowdown in the recovery of industries hit the hardest in April – those manufacturing both durable *consumer goods* and *investment goods*.

On the other hand, as oil extraction declined, there was a continued low output of refined petroleum products. Manufacturing returned to growth in July posting a 2.1% MoM SA output expansion thanks to an upward trend acceleration in the *intermediate* and *investment* goods industries.

The overall output of the group of industries manufacturing *durable consumer goods* made a positive contribution to manufacturing performance in June and July. The manufacture of motor vehicles continued to recover exceeding the March level (Figure 19). However, the industry's depressed financial flows, dragged down by the continued satisfaction of deferred demand, give reason to expect the persistence of the negative trend which emerged in the middle of last year.

An upward trend in other industries manufacturing *durable consumer goods* lost momentum in June–July. Explosive growth in the output of medical products posted in May and June came to a stop in July. The manufacture of household appliances reached the March level in June, stabilising in July.

FMCG industries which were hurt the least in April put a brake on manufacturing output in June and July. A downward trend which emerged as early as the start of the year continued in the manufacture of food products. The persisting low demand for grains put a downward pressure on this industry's output. The resumption of growth in the meat and dairy industry in July may signal a negative trend slowdown in the manufacture of food products in the months to come. May's growth slowdown in the manufacture of pharmaceutical products was followed by an output contraction in June, which continued into July.

Figure 15. Individual industries' contribution to manufacturing growth, % MoM

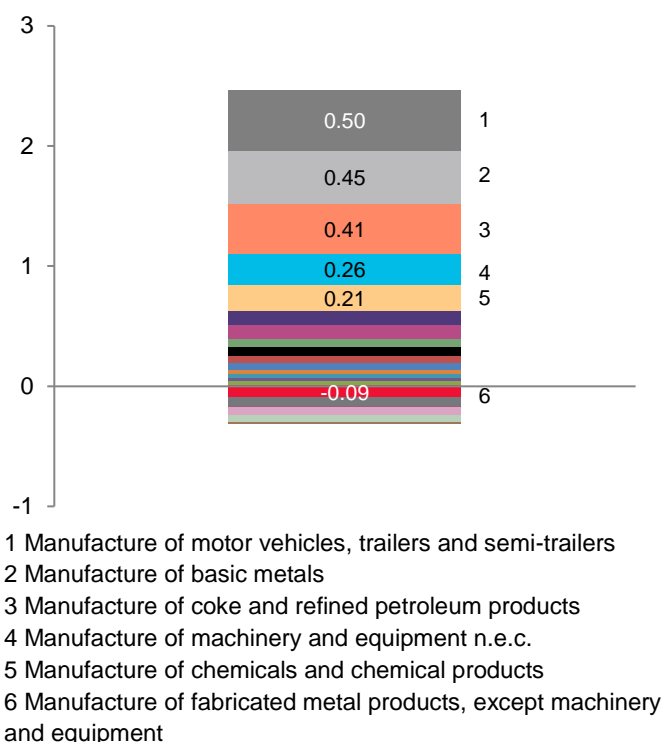
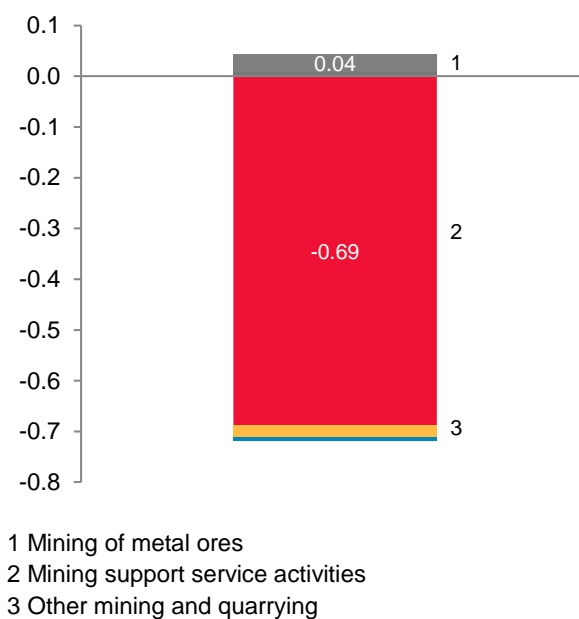


Figure 16. Individual industries' contribution to mining and quarrying growth, % MoM



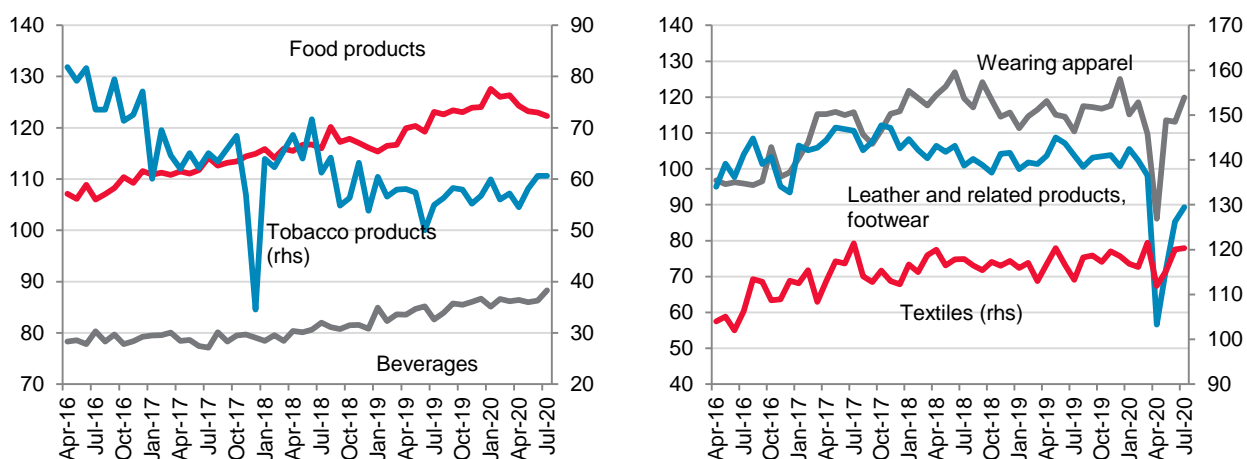
Source: Rosstat, R&F Department estimates.

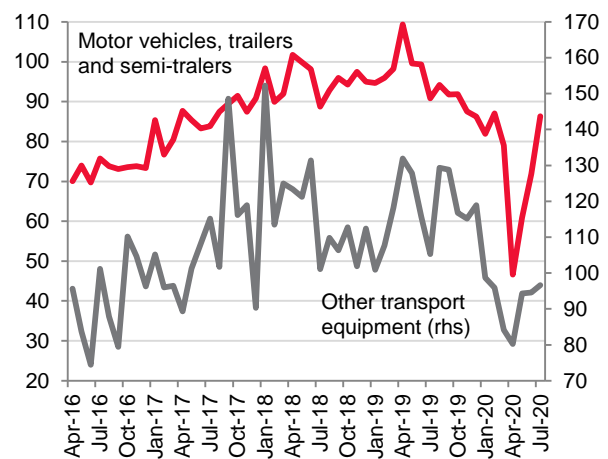
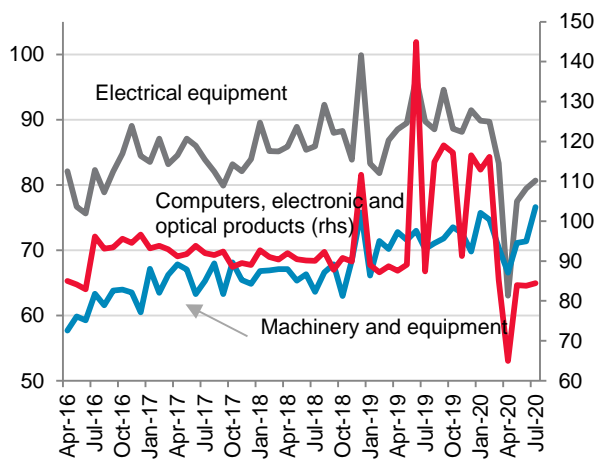
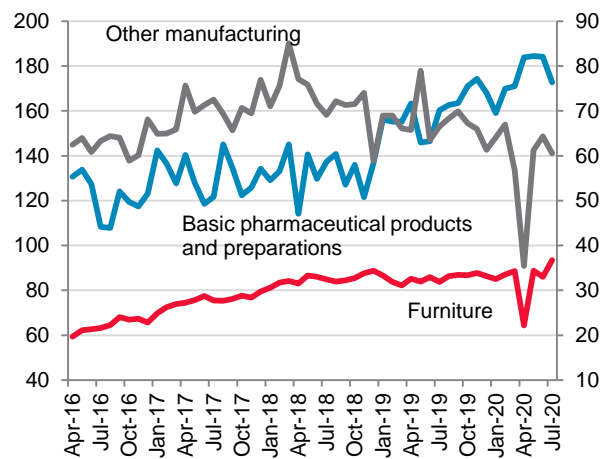
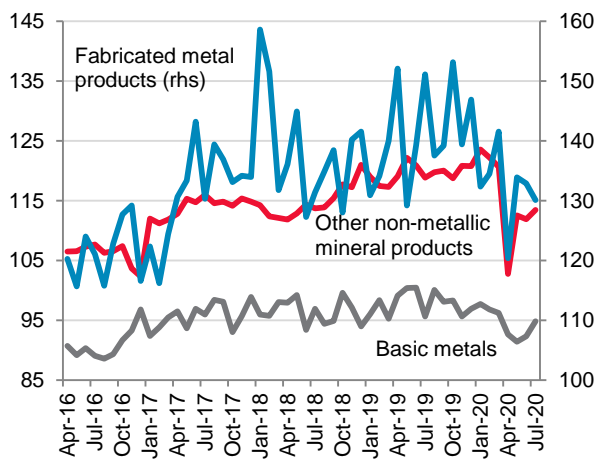
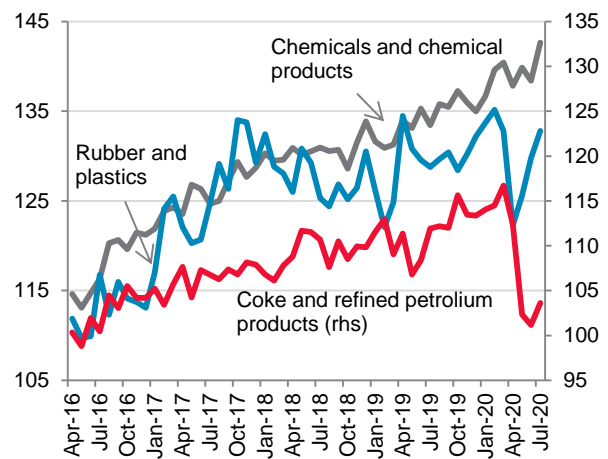
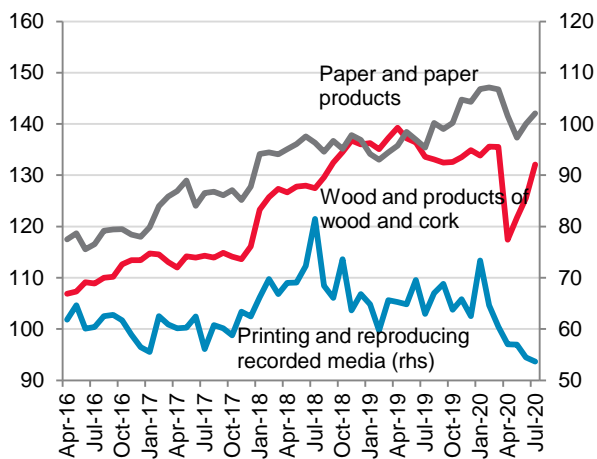
June saw a growth slowdown or even an output decline in industries manufacturing *investment goods*. All the industries of this group, however, posted an upturn in their performance already in July. The manufacture of machinery and equipment posted the strongest growth in July with its output rising above the March level. Other industries meeting *investment demand* showed a slower pace of recovery in July.

A continued output decline in the manufacture of refined petroleum products was still restraining growth in industries meeting *intermediate demand* in June. The recovery of this group of industries gained momentum because the biggest manufacturing industry moved to recovery after a three-month contraction. As early as June, its output trailed domestic demand, which was rising as coronavirus-related restrictions were [shifted to the domestic market](#). Despite the start of the recovery, the output of refined petroleum products was still far below the level of the start of the year.

The output of practically all other industries meeting *intermediate demand* (except for the manufacture of fabricated metal products) was no more than 5% below the March level. The key growth drivers in the basic metals industry were the manufacture of basic precious and other non-ferrous metals and nuclear fuel, along with the pipe and tube industry. The manufacture of basic iron and steel and ferro-alloys, however, maintained a downward trend in July despite a temporary upturn in June.

Figure 17. Manufacturing industries' output, December 2012 = 100%, seasonally adjusted





Source: Rosstat, R&F Department estimates.

2.3. Core industries continued to recover in July

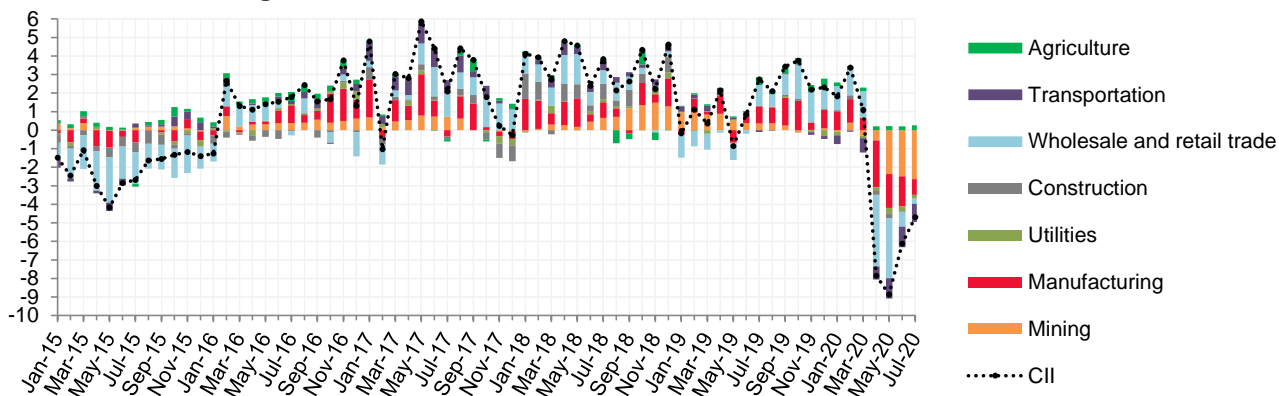
- A gradual recovery of core industries' output continued in July (core industries index, CII)⁴ (Figure 22). Having passed the trough of the decline at -8.9% YoY in April–May, the output performance started to improve, with the fall slowing to -6.5% YoY in June and -4.7% YoY in July.
- A significant core industries' output improvement in June as restrictions were gradually lifted and an increasingly large number of businesses resumed operations secured a milder than expected economic activity decline in the second quarter. Overall core industries' output lost 7.6% YoY in Q2 2020 (Figure 2), while GDP contracted 8.5% YoY according to a preliminary Rosstat estimate. The slowing output decline in the core industries in July gives reason to expect an improvement in GDP performance in the third quarter.
- Output remained below last year's level in almost all industries making up the CII in July. One exception was the agricultural sector, which maintains steady output growth.
- An agricultural output growth of 4.0% YoY in July after a 3.0% YoY gain in June was driven mainly by an earlier start of grain crop harvesting this year (threshed grain output rose 17.4% YoY by mid-August) and a stable increase in the output of meat (up 3.3% YoY) and dairy (+1.3% YoY) husbandry. According to expert projections, agricultural output will likely grow over 1% YoY for 2020.
- The heaviest negative input to the CII has come from a mining and quarrying plunge in recent months, down 15.1% YoY in July after a 14.2% YoY decline in June. This arises from compliance with the OPEC+ deal to cut oil production and weak demand for non-metallic minerals. Oil extraction was scaled up in August under the OPEC+ deal, therefore the negative effect of mining and quarrying and related industries' performance on core industries' output and GDP will be weakening.
- Manufacturing narrowed a gap with last year's output in July, down 3.3% YoY after a fall of 6.4% YoY in June. But individual industries' results are fairly mixed (see Section 2.2).
- The transportation industry's recovery was sluggish at -8.4% YoY in July after -9.3% YoY in June due to a fall in oil and gas extraction and a resulting decline in the pipeline industry's traffic, down 15.0% YoY in July after a 14.8% YoY in June. But the recovery of business activity in other sectors of industry has helped the fall in the rest of transport segments lose momentum.
- Trade recovery intensified in July. Retail sales contraction eased to 2.6% YoY after a 7.7% YoY fall in June thanks above all to an improvement in non-food sales, which lost 2.7% YoY after a 11.3% YoY slump in June. Food sales also showed a slowing decline (-

⁴ The core industries index (CII) is calculated by aggregating seven industry-specific indexes (agricultural production; mining and quarrying output; manufacturing output; freight traffic; wholesale and retail sales); and activities such as water supply, sewerage, waste management and remediation; as well as electricity, gas, steam and air conditioning supply; construction, with weights corresponding to the respective industry's share in Russia's gross value added in 2017.

2.2% YoY after -3.7% YoY in June). A positive trend in retail sales was reflected in wholesale sales, which narrowed a gap with last year to -0.6% from -1.4% in June.

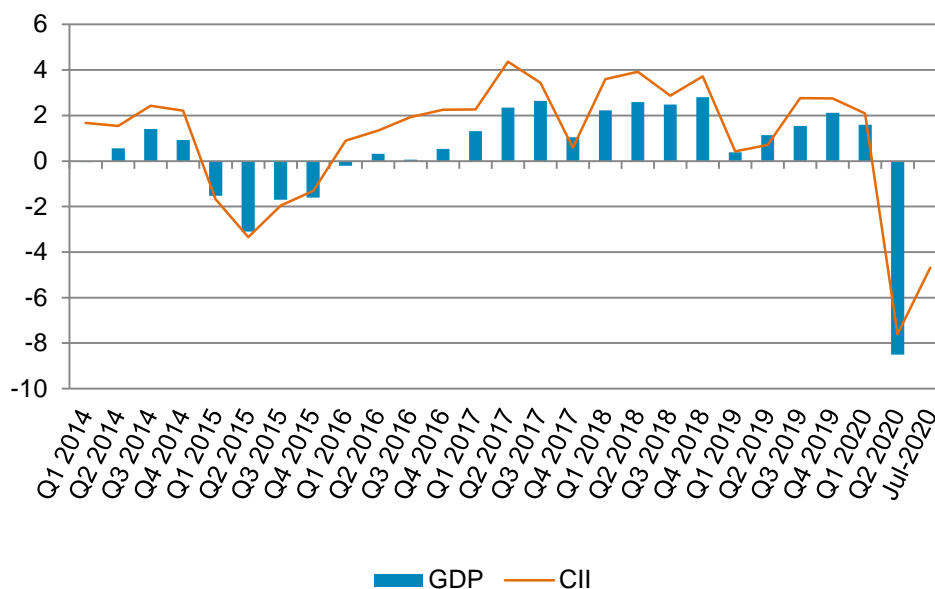
- After a business activity drop in the construction industry's organisations during the self-isolation period, construction output was close to last year's level for the second consecutive month, according to a Rosstat real-time estimate (a 0.2% YoY decline in June after a 0.1% YoY contraction in June).

Figure 18. Contribution of industries to the CII in 2014–2020, % YoY



Source: Rosstat, R&F Department estimates.

Figure 19. Quarterly index of GDP and CII in physical terms, % YoY



Source: Rosstat, R&F Department estimates.

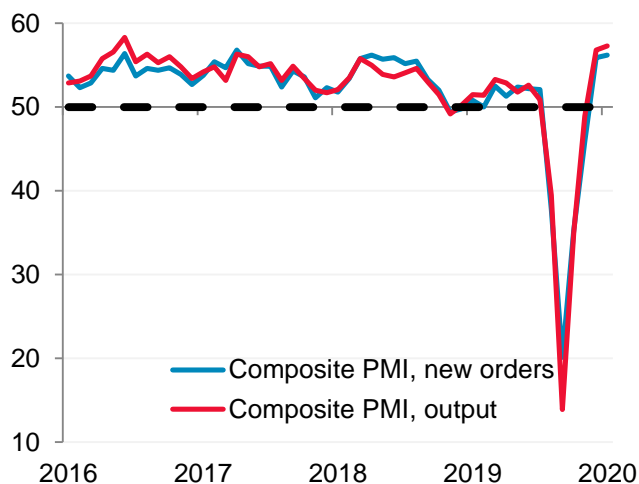
2.4. PMI indexes in July and August: strong activity growth, above all in services

- The PMI indexes in manufacturing and services changed their direction in July: manufacturing continued sliding, driven by weak demand, while services enjoyed a sharp rise in new orders. As early as August, however, manufacturing moved into positive territory, showing the strongest growth since April 2019. The positive performance in manufacturing and services alike pushed the overall index of business activity to the highest level since the start of 2017.
- A substantial rise in new orders in both sectors at last translated into employment, which stopped contracting after a six-month period of decline.
- Business expectations increased for two consecutive months in the Russian economy showing a high level of optimism.

The composite PMI for manufacturing sharply moved into positive territory in July, reaching 56.8 versus 48.9 in June, while August saw business activity rising further to 57.3, the highest level since the start of 2017 (Figure 24). The July gain in the index arose from a sharp business activity acceleration in services, while the positive performance of the overall index in August was helped by the index of manufacturing business activity making its way into positive territory. As production and new orders expanded, employment stabilised at 50 in the Russian economy after a six-month slide. The respondents reported an increase of optimism regarding future output in both July and August (65.4 and 65.5, respectively).

One should bear in mind that the PMI is a diffuse index showing the difference between the shares of respondents who witnessed growth or decline in output and/or demand for their products relative to the preceding month rather than the magnitude of change. Therefore, the reopening of the greater part of businesses in services after an all but full lockdown expectedly causes the relevant PMI indicators to rise.

Figure 20. Change in composite PMI indexes for Russia, pp

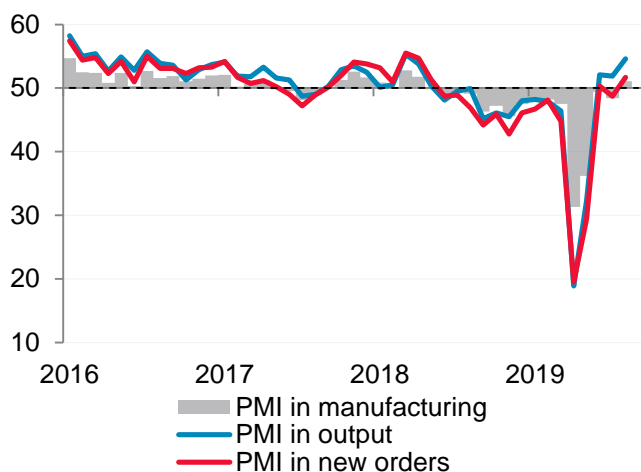


Source: IHS Markit.

The PMI index for manufacturing showed a steeper decline in business activity in July than a month earlier at 48.4 after 49.4 in June, but as early as August the index for the first time in more than a year moved above 50, a reading formally corresponding to a rise in activity, to reach 51.1 (Figure 25). This level is in fact not very high compared with other countries but is generally close to Russia's long-term average (since January 2000).

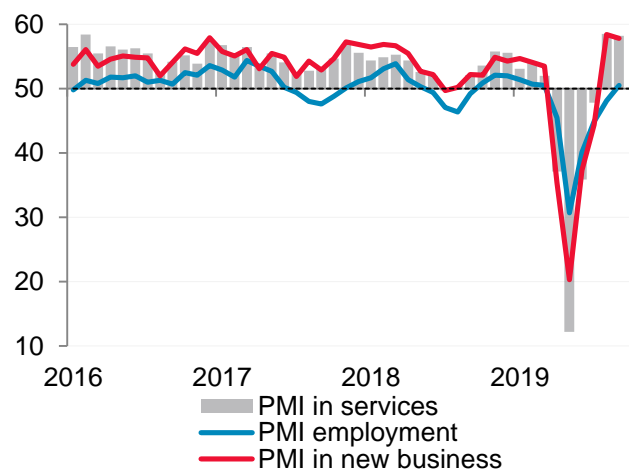
Business activity expansion in August arose from an acceleration in both output growth (54.6 after 51.9 in July, for the third consecutive month) and a resumption of a rise in new orders (51.7 versus 48.7 in July) as new customers were obtained and consumer demand strengthened. This performance was helped by a further easing of restrictions and a subsequent resumption of domestic customers' operations. External demand remains weak, but in August export orders contracted at the slowest pace since May 2019 (48.8 versus 48.5 in July).

Figure 21. Change in PMI manufacturing indexes, pp



Source: IHS Markit.

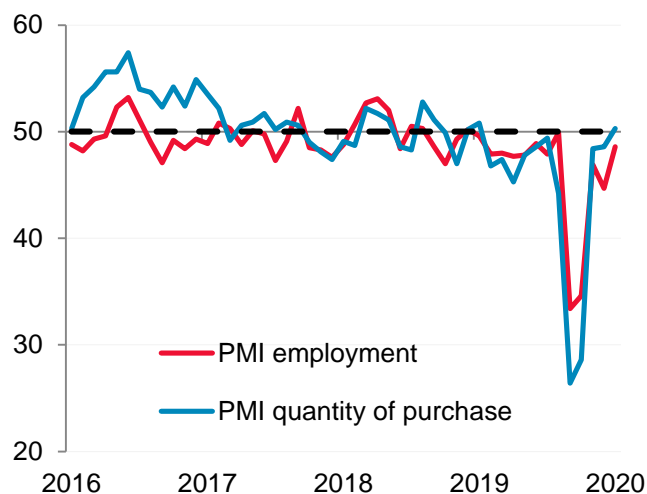
Figure 22. Change in PMI services indexes, pp



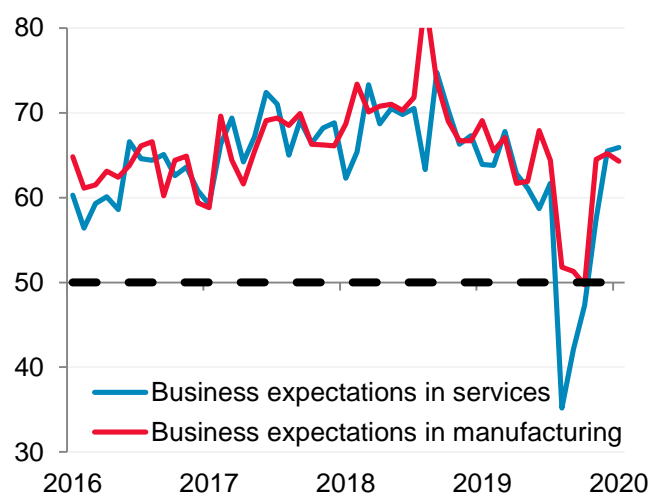
Source: IHS Markit.

Despite the growth, output and demand remain subdued. Therefore, the employment decline continued but at a much slower rate (from 44.7 to 48.6) (Figure 27). As business activity intensified and new orders flowed in, purchases of raw materials and supplies expanded, albeit insignificantly, for the first time in the last 12 months (50.3), even though purchasing activity was still dwindling notably as late as June. Change in the raw materials inventory, which contracted quite substantially (42.8), also indicates rising production needs.

Business expectations regarding future output slid somewhat after a six-month high in July, but the level of optimism remains steady (64.3 versus 65.2 in July) (Figure 28). Companies hope for a rise in demand and the economy's recovery.

Figure 23. Manufacturing PMI indexes for quantity of purchase and employment

Source: IHS Markit.

Figure 24. PMI for business expectations

Source: IHS Markit.

The services PMI showed an abrupt change in July, posting a 12-year high of 58.5. It did not change much in August (58.2) (Figure 26). The gain stemmed from a resumption in the operations of services suppliers and their customers as coronavirus-related restrictions were eased. New orders from domestic customers rose for the second month running (58.4 in July and 57.8 in August), but, as in manufacturing, external orders remained in negative territory. (43.8 in July and 48.3 in August).

The services sector's employment increased, albeit marginally (50.5) for the first time since February putting an end to a five-month period of an employment headcount decline in the sector. Meanwhile, the sub-index of incomplete orders rose to the highest level since November 2019 (remaining, however, below 50 at 48.2). Some respondents noted that the rise in new orders had led their companies to face capacity shortages. This kind of situation enables costs to be passed through to final prices more promptly and may, in the medium term, prompt companies to expand their capacities.

Business expectations posted a nine-month high of 65.5 in July, edging up further to 65.9 in August. The share of respondents expressing optimism about business conditions going forward equalled that in manufacturing, which did not see as steep a fall as in services (Figure 28).

2.5. Extensive retail sales recovery in July and August

- Retail sales for the most part recovered in July. While the June result was 7.7% YoY below last year's, July saw the gap shrink to -2.6% YoY. July was the first month when retailers faced no trading restrictions in most regions. This enabled deferred demand to be realised supported by social payments which started in June.

- The recovery of food retail sales seen in June continued in July but at a more moderate pace of 1% MoM SA, down from 5.7% MoM SA in June, helping to further reduce the share of food in total expenditure to 48.1% from a peak level of 57.6% in April.
- Non-food retail is still the key driver of retail sales expansion, but July saw the start of a gradual slowdown of demand expansion in most product categories (up 10.1% MoM SA in July after 26.0% MoM SA in June).
- Real-time data on household expenditure in August suggests that a consumer activity rise has slackened, which may have been owed to a gradual weakening of the deferred demand effect. As income and employment gradually recover, a demand upturn will ease in most product categories. Some improvements arising primarily from the resumption of business operations and people's more active travel will be registered in industries related to tourism, which previously lagged the overall rate of recovery.

According to Rosstat data, retail trade for the most part recovered to last year's levels narrowing the gap from -7.7% YoY in June to -2.6% YoY in July (Figure 29). July was the first month in which retailers operated with no restrictions in most regions, allowing pent-up demand to be realised, buoyed also by social payments which started in June. As a result, the recovery of non-food retail sales accelerated significantly with a 2.7% YoY decline coming close to that in food sales, down 2.2% YoY. In monthly terms, overall retail sales expanded 5.5% MoM SA⁵ after a 14.7% MoM gain in June, just below the "pre-coronavirus" levels.

In July, the recovery of food retail sales continued at a more moderate rate of 1.0% MoM after a gain of 5.7% MoM in June. This helped further reduce the share of food in total expenditure to 48.1% from a peak of 57.6% in April (Figure 32). Romir estimates show a similar picture: food expenditure stood at its usual levels for the second consecutive month, consumers have returned to purchasing food in standard quantities, and, as a result, the Food Index is stabilising at pre-crisis levels.⁶

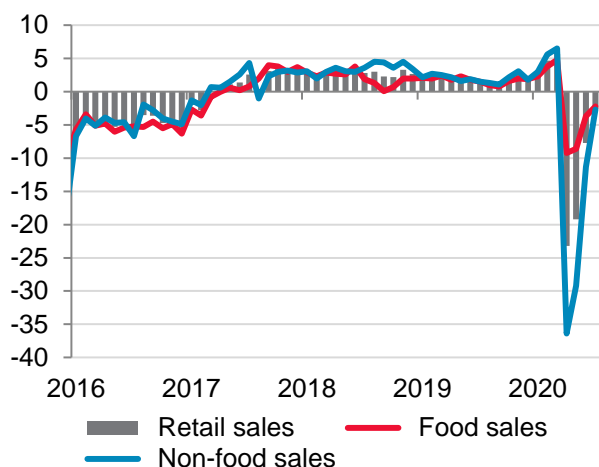
Non-food retail sales remain the key driver of sales expansion, but July saw a gradual slowdown of a rise in demand start in most non-food product categories (up 10.1% MoM in July after 26.0% MoM in June) (Figure 30). This impressive result stems, on the one hand, from deferred demand which arose in previous months on the back of lockdowns, and on the other hand, from expectations of price hikes due to ruble weakening and the measures of government support.

Based on the data from the Bank of Russia payment system, industries meeting consumer demand have in recent months shown one of the best results among composite indicators of industry groups. The incoming payments of the retail industry (OKVED2 47) stood far above the "normal" level in the first eight summer weeks (the mean upward weekly deviation equalled 19.75%). This performance continued to improve in August.

⁵ Here and further on, monthly growth rates are seasonally adjusted.

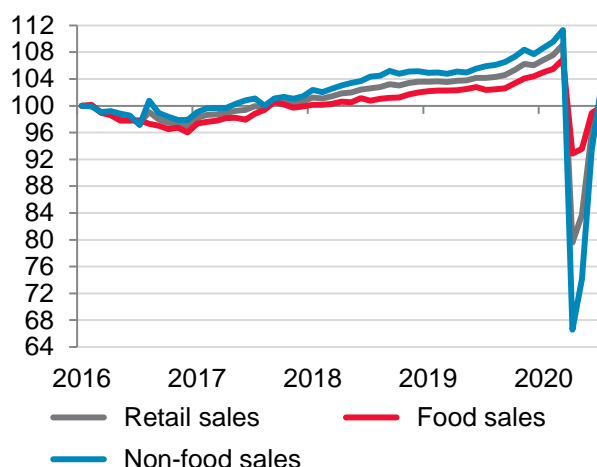
⁶ [Russian households continue to cut food expenditure](#) / Romir Research Holding Company. 20.08.2020.

Figure 25. Food and non-food retail sales and overall retail sales, % YoY



Source: Rosstat.

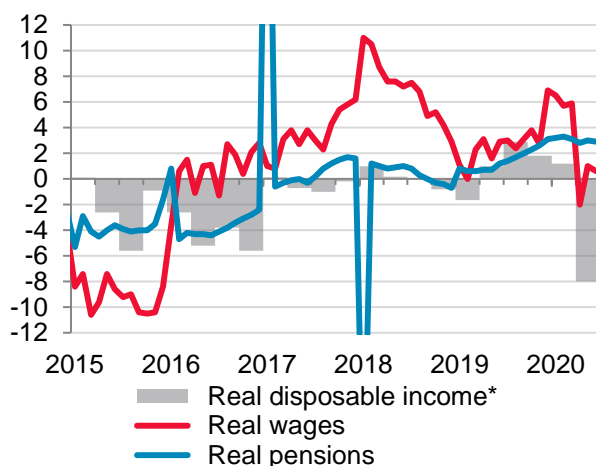
Figure 26. Retail sales (January 2016 = 100%, seasonally adjusted), %



Source: Rosstat, R&F Department estimates.

Banks all but recovered the pre-crisis rate of issuing credit cards and cash loans, which further supported the realisation of pent-up household demand for, above all, non-food goods and tourist services.

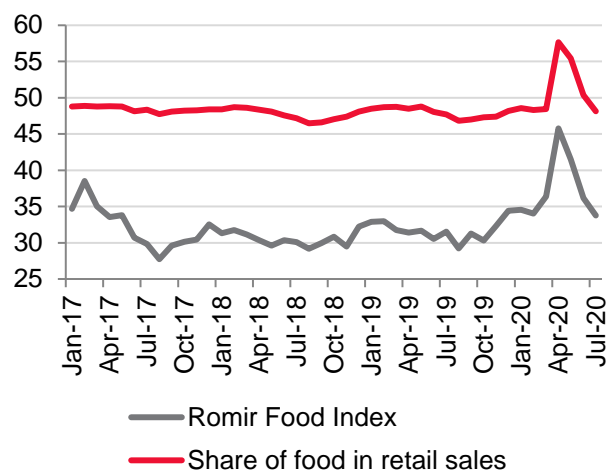
Figure 31. Real household income, % YoY



* Calculated based on a new methodology including a one-off payment in January 2017.

Source: Rosstat, R&F Department estimates.

Figure 32. Share of food in retail sales and Romir Food Index, %

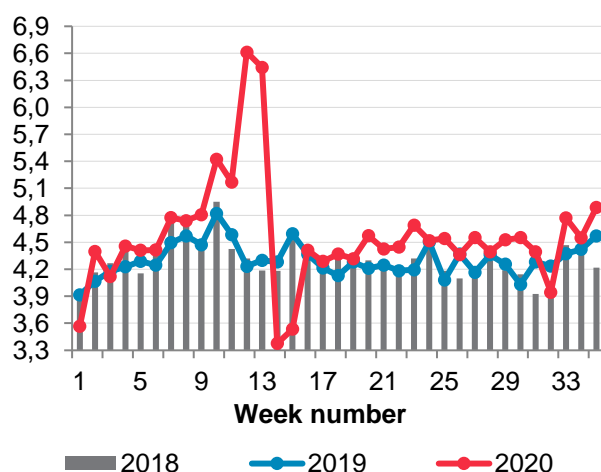


Source: Rosstat, Romir.

Real-time data on household expenditure in August indicates the continuation of the spending stabilisation trend after its spring peaks. Based on the First Fiscal Data Operator's index of retail business activity calculated as the difference between the current number of cheques with last year's average total, the deviation has remained stable at an average of

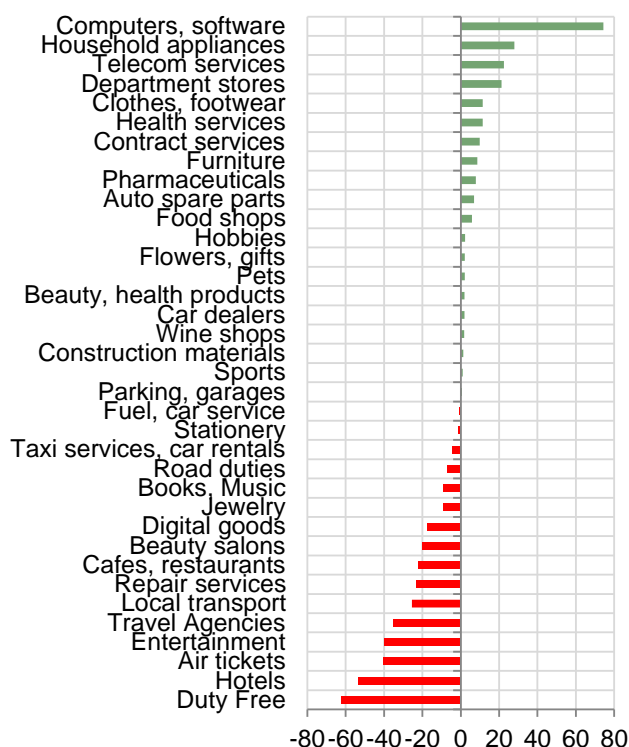
-0.08 in the past 12 weeks (a low of -0.45 was recorded in March). According to Romir⁷ data (Figure 33), the volatility of everyday household expenditure intensified over the first weeks of August, but its total came in above last year's level for the month. According to Sberbank estimates, an improvement in household expenditure on goods and services slackened. Consumer expenditure added 0.2% YoY in August after a drop of 0.7% YoY in July and a 5.8% YoY fall in June. Moreover, an expenditure increase eased in both food and non-food categories (up 5.6% YoY and 7.5% YoY, respectively in August versus a rise of 7.2% YoY and 9.1% YoY in July), while a contraction in expenditure on services slowed to 17.5% YoY in August from 21.6% YoY in July (Figure 34). Demand, therefore, hovered around the same level for the second month in succession, while its structure is gradually normalising: the share of services hardest hit from restrictions is rising.

Figure 27. Weekly nominal everyday household expenditure, thousand roubles



Source: Romir.

Figure 28. Change in real expenditure on goods and services in June, % YoY



Source: «SberData» Lab.

⁷ [Weekly household expenditure has contracted after a sharp rise](#) / Romir Research Holding Company. 25.08.2020

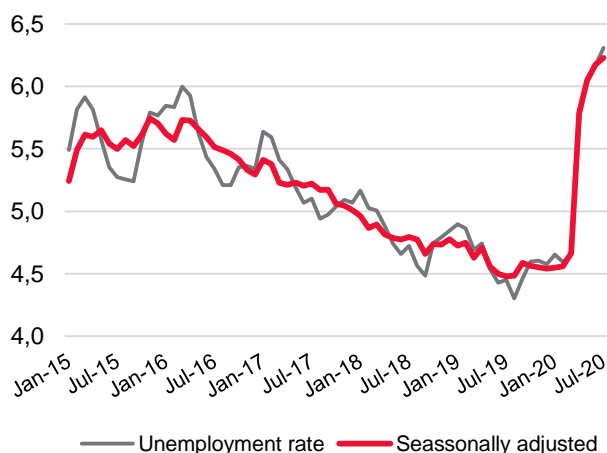
2.6. Labour market: unemployment rate gradually stabilising

- Unemployment has hit an eight-year high with its level stabilising.
- The June wage growth was buoyed by motivation payments in the health and public administration sectors.

The unemployment rate stood at 6.3% at the end of July, up marginally from 6.2% a month earlier. The unemployment headcount rose by 125 thousand to 4.7 million over the month. Seasonally adjusted, the unemployment rate stabilised at last month's level – 6.2% (Figure 35).

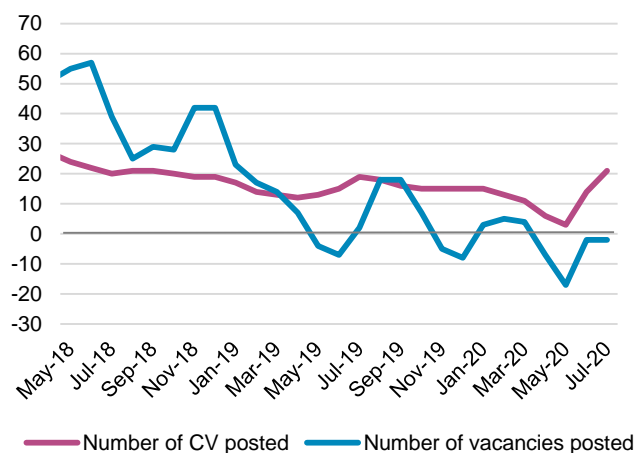
The number of registered unemployed increased 4.6 times YoY to 3.3 million in July. Increased unemployment benefits introduced as a household support measure are still motivating unemployed people to register at employment centres. Gradual abandonment of these measures will restrain a further rise in the number of officially registered unemployed and stabilisation of the unemployment rate.

Figure 29. Seasonally adjusted unemployment rate, %



Source: Rosstat, R&F Department estimates.

Figure 30. Number of vacancies and CV placed, % YoY

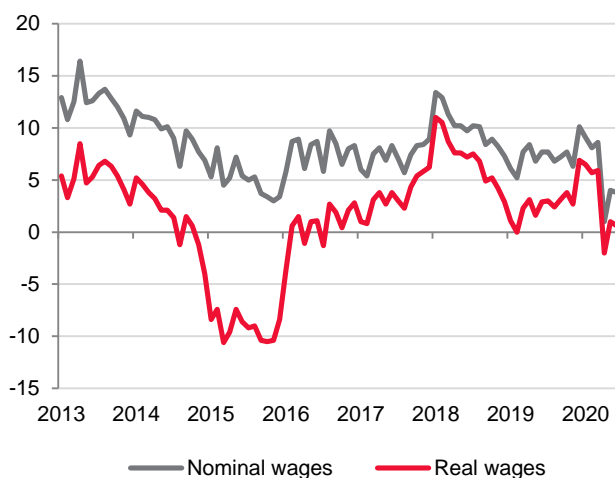


Source: Headhunter.

Data of job-search websites also evidences some stabilisation in the Russian labour market. Labour market demand also remained unchanged over the month, according to HeadHunter data. As in June, the number of vacancies decreased 2.0% YoY in July after a 17% YoY drop in May (Figure 36).

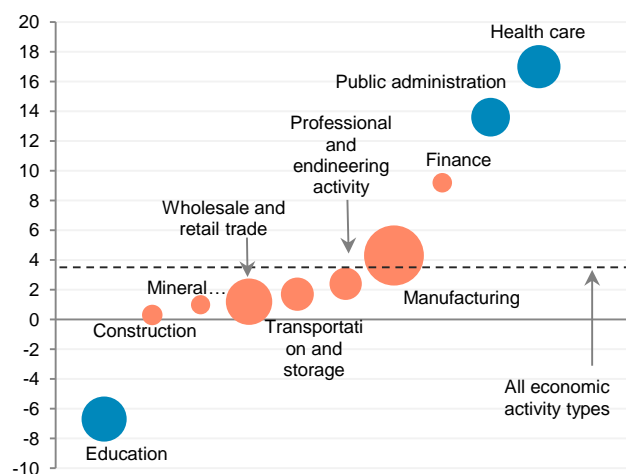
The key factor behind labour demand stabilisation is the lifting of restrictions in almost all activity types. An increase in the number of vacancies is recorded in all professional areas, with health care and public administration increasing new vacancies the fastest at 27% YoY and 323% YoY, respectively.

Figure 31. Wage growth rate, % YoY



Source: Rosstat.

Figure 32. Nominal wage growth by industry in June, % YoY



Source: Rosstat, R&F Department estimates.
The size of the circles corresponds to an activity type share in the payroll fund.

Real wages expanded 0.6% YoY in June, nominal wages added 3.8% YoY (Figure 37). Wage growth is shored up by motivation payments in the health sector, up 17.0% YoY, and public administration (a 13.6% YoY increase) (Figure 38). Private sector wages started to rebound gradually gaining 2.3% YoY in June after 0.5% YoY in nominal terms in May.

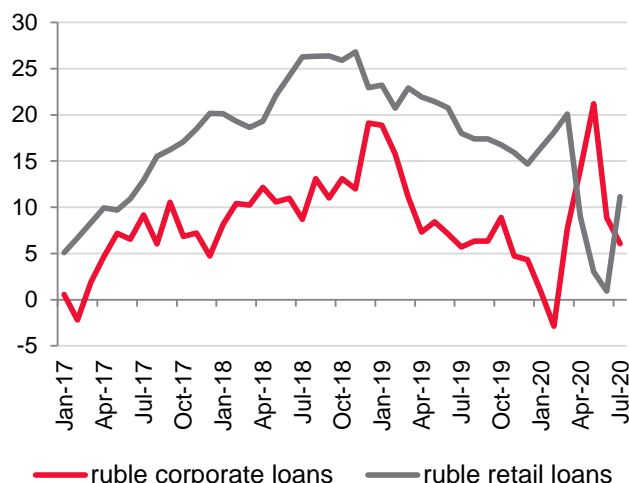
2.7. Banking sector in July: retail and corporate lending growth acceleration

- Retail lending growth acceleration continued in July fuelled, above all, by mortgage lending: the total of new mortgage loans exceeded last year's level by 63% YoY. Expansion also gained pace in unsecured consumer lending and auto loans.
- Retail lending will likely grow at a more moderate rate in the months ahead given that deferred loan demand has run its course, subsidised lending programmes have come to an end, and credit risks have risen as household income has dwindled.
- Corporate lending expansion⁸ has also gained momentum thanks, above all, to medium- and long-term loans (over 1 year), reflecting a gradual diminishment of companies' need for short-term financing as the economy recovers. The ongoing implementation of government programmes continues to support corporate lending.
- The share of nonperforming retail and corporate loans along with loan-loss provisions continued to rise in July. Nevertheless, the banking sector's profit notably increased month on month and year on year, providing a safety cushion to banks in the event of a further increase in lending risks.

⁸ In this case, corporate loans mean loans provided to nonfinancial organisations and sole proprietorships.

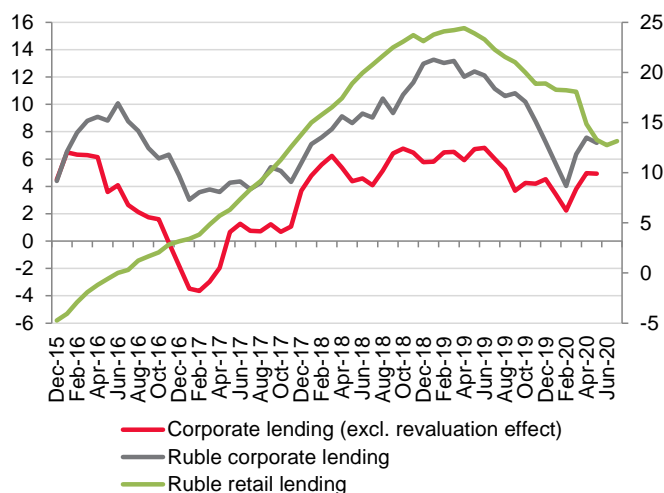
Seasonally adjusted retail lending growth accelerated to 1.4% MoM in July somewhat faster than at the start of the year and at a much faster rate than 0.2% MoM SA in May and 1.1% MoM SA in June (Figure 59). As a result, three-month annualised seasonally adjusted portfolio growth accelerated to 11.2% from 0.9% in June as the negative portfolio growth rate in April left the calculation base. The pace of year-on-year growth accelerated from 12.8% to 13.2% (Figure 60).

Figure 33. Credit dynamics, three-month annualised seasonally adjusted average, %



Source: Bank of Russia.

Figure 34. Credit portfolio growth, % YoY

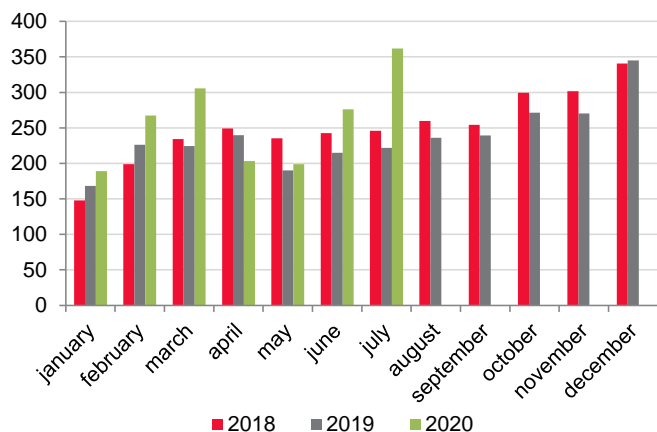


Source: Bank of Russia.

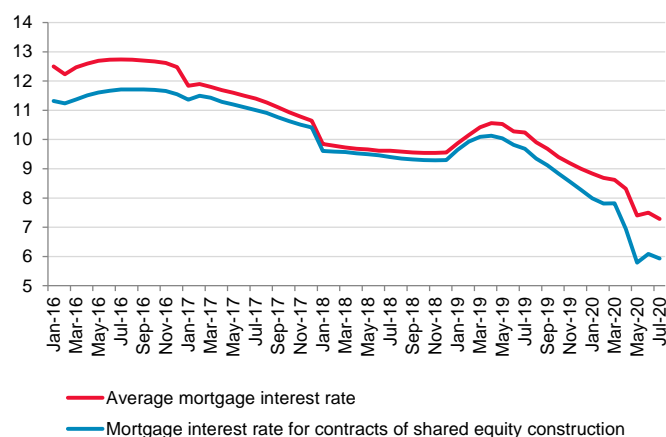
Acceleration of retail lending growth continues to be driven chiefly by mortgage lending. After a plunge in the number of new mortgage loans in April, May saw their recovery start. The provision of new loans expanded 45% year-on-year in terms of numbers and 63% by value in July 2020 (Figure 41). That said, about a third of loans provided are estimated to have been made possible by a subsidised mortgage lending programme. We note that the subsidised lending programme has increased the difference between interest rates in the new and secondary housing markets (Figure 42), shifting the demand structure towards newly constructed housing. The share of loans to buy new housing hit a high, exceeding 40% of the overall number of mortgage loans in June-July 2020.

Unsecured consumer lending and auto loans also posted growth acceleration in July to 0.5% MoM SA from 0.2% MoM SA and to 1.7% MoM SA from 1.4% MoM SA, respectively. Lending expansion is buoyed by interest rate cuts, government support programmes, and pent-up demand realisation. Indeed, according to [Association of European Businesses \(AEB\)](#) data, car sales returned to the “pre-coronavirus” level in July. The current recovery-generated growth is, however, so far not enough for these lending types to return to the pre-pandemic level⁹ (Figure 43). Also, banks’ risk appetite remains low. According to [National Bureau of Credit Histories](#) data, banks’ level of loan application approval is still decreased for most lending types (Figure 44). This is in part due to the widening range of applicants for, among other things, mortgage loans as the subsidised lending programme is implemented.

⁹ It was in part shored up by panic demand in March amid expectations of price hikes due to ruble weakening and problems with import deliveries on the back of the quarantine already imposed by some countries.

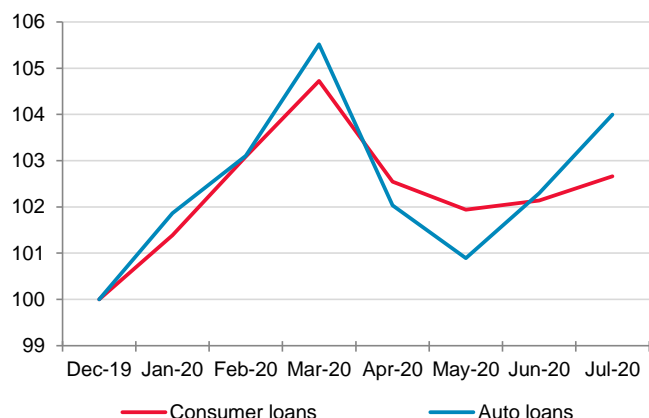
Figure 35. Dynamics of new mortgage loans, billion rubles.

Source: Bank of Russia.

Figure 36. Mortgage interest rate, %

Source: Bank of Russia.

Retail lending expansion is set to continue in the months ahead, but its growth rate may be more moderate. Amid declining household income and some increase in nonperforming loans, banks may start to assess new borrowers even more conservatively. On top of that, the subsidised mortgage lending programme, which is making a significant contribution to the ongoing lending growth is scheduled to be completed on 1 November.

Figure 37. Dynamics of unsecured consumer loans and mortgage loans, MoM, % (seasonally adjusted)

Source: Bank of Russia.

Figure 44. Approvals of retail loan applications, %

	Auto loans	Credit cards	Consumer loans	Mortgage	POS
March	37%	27%	30%	63%	26%
April	26%	22%	26%	58%	19%
May	28%	25%	31%	56%	21%
June	32%	26%	32%	53%	22%
July	31%	26%	31%	47%	23%

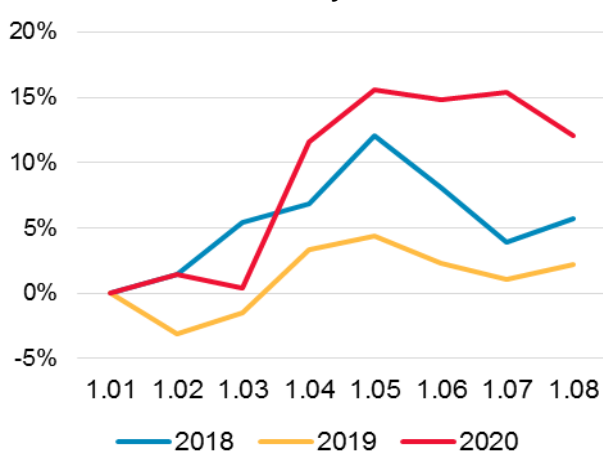
Source: National Bureau of Credit Histories.

Growth in ruble lending to nonfinancial organisations accelerated from 0.30% MoM SA to 0.65% MoM SA in July and to 7.5% YoY from 6.9% YoY in June. Three-month annualised seasonally adjusted growth equalled 6.08%. Ruble portfolio growth was driven by, above all, a rise in longer-than-one-year loans (Figure 45), with short-term lending (shorter-than-one-year loans) losing some momentum (Figure 46).

The recovery of economic activity seems to have prompted [a shortfall of companies' income to continue decreasing](#), reducing their need for short-term loans. Also, companies may have previously fully used credit lines opened by banks. As a result, a rise in the total of short-term loans, which lasted over the past months, came to a stop.

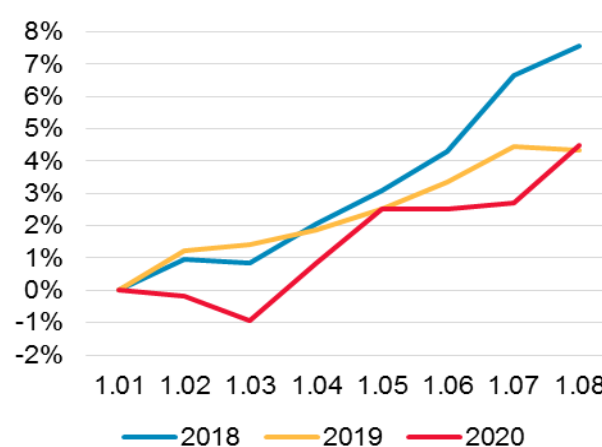
Lending to financial organisations (excluding credit institutions) also gained pace in July. Year-on-year ruble lending growth accelerated from 31.8% YoY to 36.2% YoY, with an expansion in the total amount of loans unadjusted for foreign exchange gain/loss edging up from 30.1% YoY to 31.9% YoY. As a result, growth in loans provided to financial and nonfinancial organisations accelerated from 7.4% YoY to 9% YoY in July unadjusted for foreign exchange gain/loss. Corporate lending growth continues to be shored up by government programmes¹⁰ – [a total of 104.9 billion rubles was provided under these programmes from 1 to 29 July.](#)¹¹ (124 billion rubles in June).

Figure 45. Shorter-than one-year loans to nonfinancial organisations, in rubles, % to the start of the year



Source: Bank of Russia.

Figure 46. Over-one-year loans to nonfinancial organisations, in rubles, % to the start of the year



Source: Bank of Russia.

Having accelerated by 1.4% MoM SA in June after 0.6% MoM in May, growth in household ruble deposits eased somewhat to 0.9% MoM SA in July, while their annualised growth rate stood at 12.0%. Household deposit expansion was chiefly driven by a rise in the shortest (and the most liquid) demand deposits maturing in 30 days. This can to a certain extent be explained by [households' preference of highly liquid savings](#) amid uncertainty. Some deposit growth easing can also be due to the peak of budget spending on social payments and wages being passed in June. Also, households have increasingly [preferred alternative methods of investing their funds](#) lately, because of, among other things, deposit rate cuts.

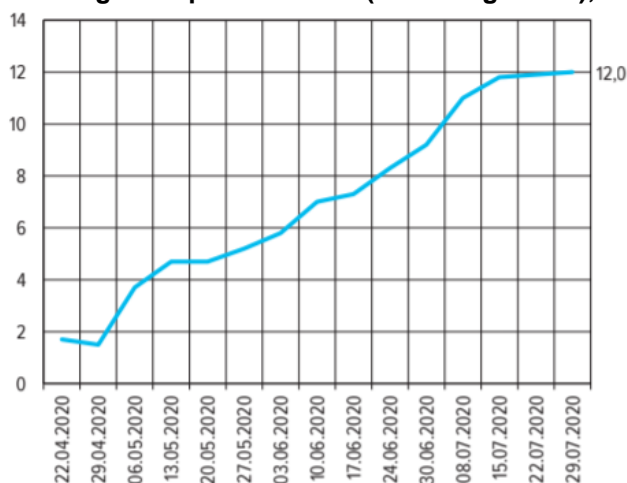
We note that amid a general interest rate decline in the economy, June–July saw rising loan restructuring demand from borrowers, fuelled by interest rate revisions in loan agreements with the largest borrowers. As a result, systemically important credit organisations restructured 12% of large companies' debt as of 29 July (Figure 47). Banks are now temporarily allowed to forego additional loan-loss provisions for the restructured loans. But banks have continued to expand provisions despite the regulatory easing granted to

¹⁰ Under RF government decrees No.442, 582, and 696.

¹¹ Exclusive of data for the programme Working Capital Loans under RF government decree No. 582 of 24.04.2020.

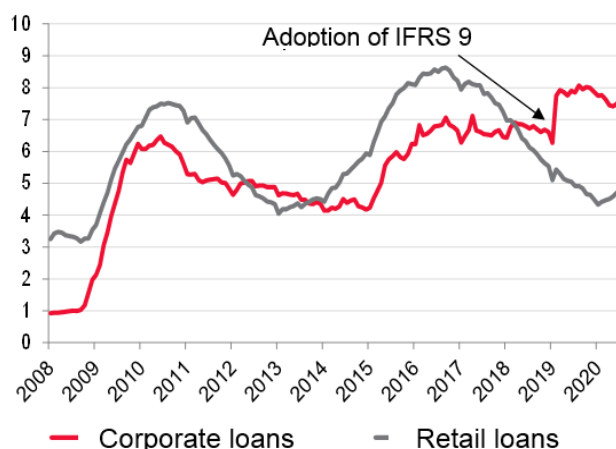
them. Loan-loss provisions were scaled up by 175 billion rubles in July (by 153 billion rubles in June and 106 billion rubles in May). This suggests expectations that some borrowers will see their financial position deteriorate going forward. That said, the share of nonperforming loans continues to rise gradually, reaching 4.8% for household loans and 8.2% for nonfinancial organisations in July (4.7% and 7.7%, respectively, in June). At the same time, [bank surveys](#) conducted at the start of August show the continuation of the trend towards a decline in the number of loan restructuring applications. As a result, further change in nonperforming loans will depend mainly on the credit quality of loans already restructured.

Figure 47. Share of restructured outstanding debt for large companies' loans (excluding SMEs), %



Source: Bank of Russia.

Figure 48. Share of nonperforming loans, %



Source: Bank of Russia.

The banking sector earned a profit of 188 billion rubles in July 2020, exceeding June and May levels of 79 billion rubles and 45 billion rubles, respectively, as well as that of July last year (173 billion rubles). Net income stood at 130 billion rubles. This provides a safety cushion for the banking sector in the event of further credit risk increases.

Thus, credit activity recovery and a significant improvement in banks' financial result are underway, thanks in part to government and Bank of Russia support measures. Risks to the banking sector, however, remain due to increased uncertainty over further spread of the pandemic and its effect on the economy. Another risk factor is that the economy's recovery is so far not sustainable.

First, these risks arise from a possibility that a second wave of coronavirus will emerge, with restrictions imposed again. Second, sources of lending growth based on deferred income realisation may peter out in the months to come, while the slow recovery of the economy and household income may boost credit risks, including for loans that have already been restructured.

The effect of this risk is contained by banks' current balanced policy: they are continuing to set aside additional loan-loss provisions despite regulatory easing and are very cautious in their lending, thoroughly assessing borrowers' risks.

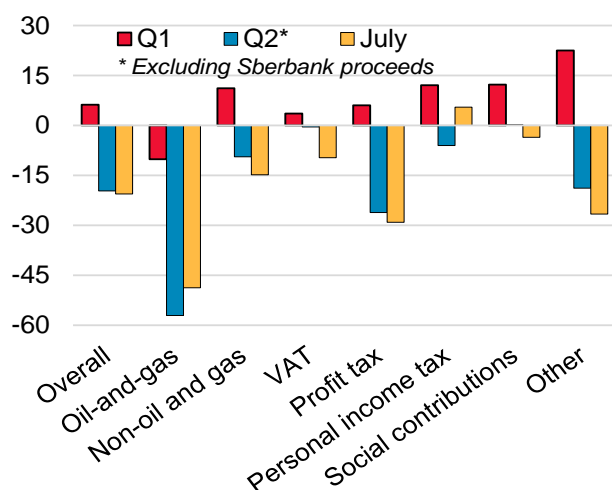
2.8. Budget spending growth lost momentum in July

- A decline in general government revenue accelerated to 20% YoY in real terms in July, dragged down by a fall in non-tax revenue, the resumption of a profit tax revenue contraction, and the materialisation of the effect of the pandemic on VAT revenue (this tax is paid with a one-quarter lag).
- Expenditure growth slowed to 19% YoY in real terms as the peak of social benefit and wage payments was passed. The easing of restrictions enabled capital expenditure growth to be scaled up.
- The 12-month rolling overall and non-oil and gas primary deficits continued to expand, mitigating the negative impact of the pandemic on GDP growth.

Revenue. According to RF Treasury data, a slump in the total *general government revenue* accelerated to 20% YoY in real terms¹² in July from 13% YoY in June (Figure 49). This stemmed from a drop in non-tax revenue, the resumption of a profit tax revenue decline, and a VAT revenue fall. VAT is paid with a one-quarter lag, and the July revenue therefore reflects an economic activity plunge in the second quarter: according to a preliminary Rosstat estimate, Q2 GDP dropped 8.5% YoY.

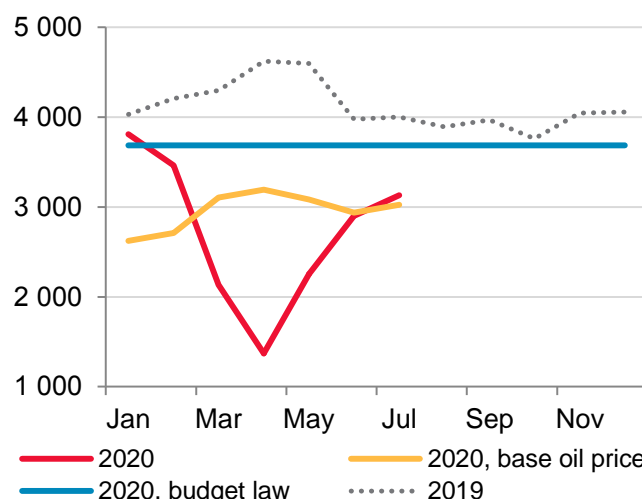
At the same time, personal income tax revenue expansion accelerated and an oil and gas revenue fall slowed to 48% YoY in real terms versus 67% YoY in June amid an oil price rebound and oil extraction stabilisation (Figure 50).

Figure 38. Change in general government revenue, in real terms, % YoY



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

Figure 39. Urals oil price, rubbles per barrel

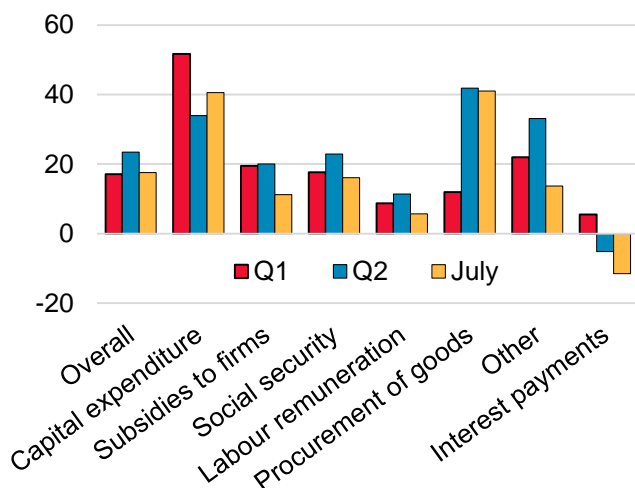


Source: Bank of Russia, RF Finance Ministry, R&F Department estimates.

¹² The proxy deflator we use is the average between the consumer price index and the producer price index. It equalled -5% YoY and 0% YoY in the second quarter and July, respectively.

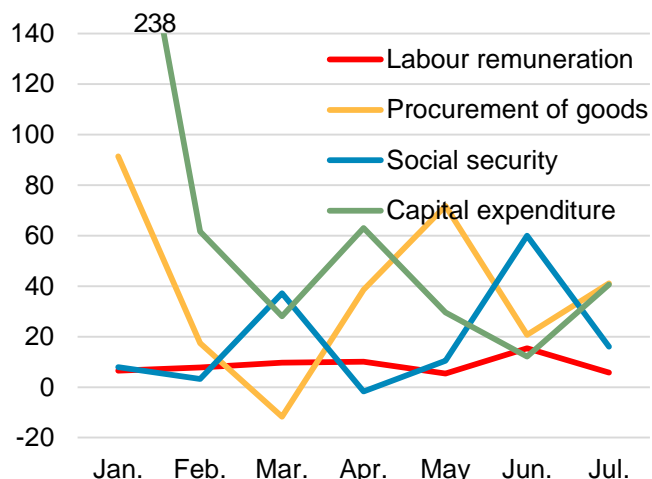
Expenditure. General government expenditure growth slowed to 19% YoY in real terms in July from 33% YoY in June (Figure 51). The peak of social benefit and wage payments was passed in June (Figure 52). The lifting of most of the quarantine restrictions enabled capital expenditure to be scaled up.

Figure 40. Change in general government expenditure, in real times, % YoY



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

Figure 41. Change in general government types of expenditure, in real times, % YoY



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

Budget balance and revenue sources. The 12-month rolling average general government revenue continued to decline as a percentage of GDP, with expenditure continuing to rise. (Figure 53). Accordingly, the 12-month rolling average total and non-oil and gas primary deficits expanded 3.5% and 8.5% of GDP, respectively, in July (excluding the proceeds from the sale of Sberbank shares) (Figure 54).

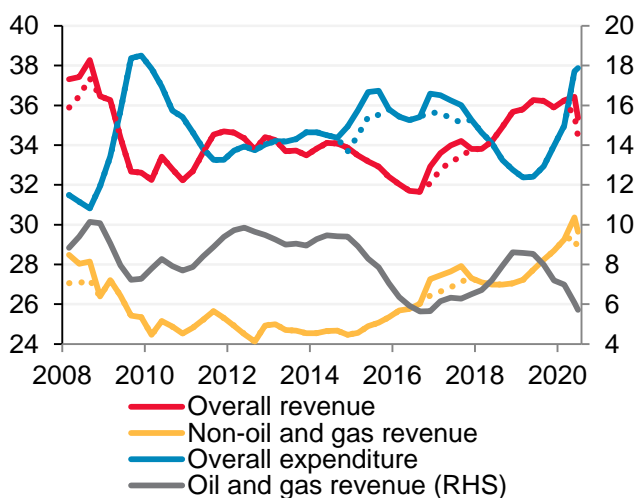
Domestic borrowings remain the key source of financing the budget deficit. Given a great need for raising finance¹³, yield premium went up in the secondary market. Also, to compensate for the shortfall of baseline oil and gas revenue,¹⁴ National Wealth Fund revenue continues to be used in compliance with the fiscal rule.

A rapid budget expenditure growth along with a concurrent reduction in the removal of private sector funds allows the negative effect of coronavirus-related restrictions on economic activity to be significantly mitigated as part of the current countercyclical policy.

¹³ The Q3 gross issuance plan equals 1.1 trillion rubles.

¹⁴ The expected positive value of extra oil and gas revenue in August is offset by the deviation of actual oil and gas revenue from the expected July total into negative territory.

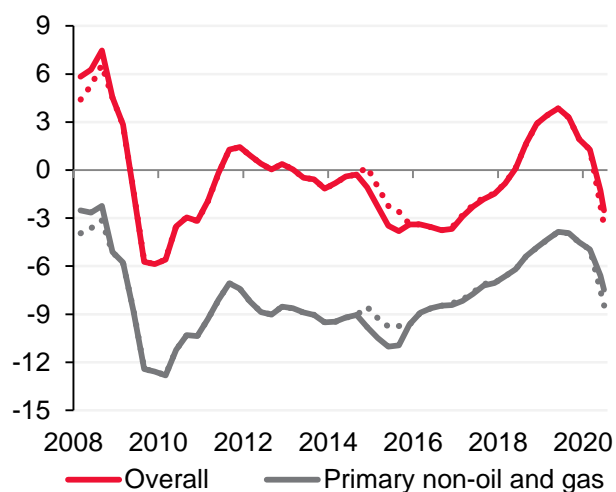
**Figure 42. Key indicators of general government
(% of GDP, 12-month rolling average)**



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

Note; dotted lines represent estimates, exclusive of major unconventional one-off factors: YUKOS debt payment in 2007, recapitalization of banks in 2014, expenditure for early repayment of defense sector loans and Rossneft privatization in 2016, proceeds from the sale of Sberbank shares in 2020.

**Figure 43. General government balance
(% of GDP, 12-month rolling average)**



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

IN FOCUS: what do yield curves of government bonds depend on?

- The high volatility of financial markets at the start of 2020, sparked by the rapid spread of the coronavirus, the subsequent borrowing expansion by governments, and loose monetary policy of global central banks, caused the yield curve slope of government bonds to steepen across the globe. But the extent of change in the slope varies across countries.
- A rise in the fiscal deficit and debt burden, the movements of key interest rates, and current and expected inflation have a substantial effect on the movements and pace of change in interest rates for various terms of the yield curve. Moreover, change in long-term interest rates is driven not only by the current strengthening of the impact of the above factors but also by the economic performance prior to the onset of a crisis. Indeed, in countries with a higher fiscal deficit, long-term yields normally rise higher, since accumulated fiscal problems make budget stabilisation more difficult.
- External factors may offset or, by contrast, exacerbate the impact of country-specific factors. Strong demand from foreign investors may limit a rise in the slope of the yield curve sparked by an increase in the fiscal deficit and debt burden. Au contraire, flight from risk assets seen in March 2020 may trigger a sharper fall in the price of local assets and a rise in long-term bond yields.
- Russia's low government debt to GDP, declining inflation and inflation expectations provided that the OFZ yield curve steepened to a lesser extent in Brazil, Indonesia, and South Africa. Despite Mexico's weaker financial indicators, the long term yields have risen less than that of Russia. We suppose that demand from foreign investors may have had a stronger impact on the yields of Mexico's long-term bonds compared with Russian instruments.
- Development of a domestic investor base with stable demand, addressing the needs of such investor groups by providing specific bond terms and conditions (for example, maturities, variable or fixed coupons, insurance against inflation, etc.) in designing market borrowing strategies may, to a certain extent, substitute for demand from foreign investors.

The rapid spread of the coronavirus has led financial authorities across the globe to develop and implement unprecedented stimulating measures in order to mitigate the economic and social implications of the pandemic.

According to OECD Sovereign Borrowing Outlook 2020,¹⁵ the governments of OECD member countries raised a record amount of debt in the market from January to May (Figure 1). Debt raised by the governments of 37 member countries totalled 11 trillion US dollars, up 70% from the average borrowing over the same periods in the past five years.

¹⁵ [OECD Sovereign Borrowing Outlook 2020](#).

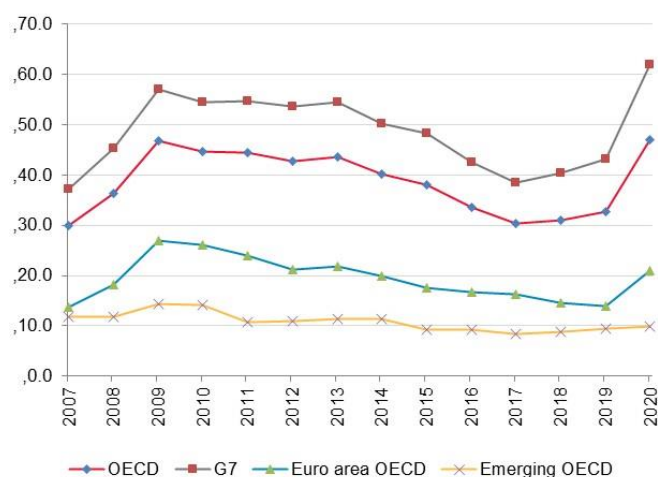
According to the OECD survey, the need for new borrowings will increase 30% compared with the “pre-coronavirus” estimates. That said, the rising debt burden coupled with a GDP slump arising from the COVID-19 implications may boost central governments gross borrowing needs by almost 14% of GDP (from 33% to 47% of GDP for OECD member countries). Note that this jump exceeds the rise during the 2008–2009 financial crisis.

The growing need for new debt in the first half of 2020 has made many countries adjust their borrowing strategies. Some countries expanded bond issuance along the entire yield curve, others focused on short-term instruments. A number of countries issued bonds of a certain maturity which had never been issued previously (for example, the U.S. issued a new twenty-year bond, Germany sold new seven- and 15-year papers).

Debt management offices (finance ministries and national treasuries) view short-term instruments as a reserve option which they can resort to in a situation of sudden market shocks (in other words, it is easier and less expensive to issue short-term coupon or discount bonds than longer-term instruments).

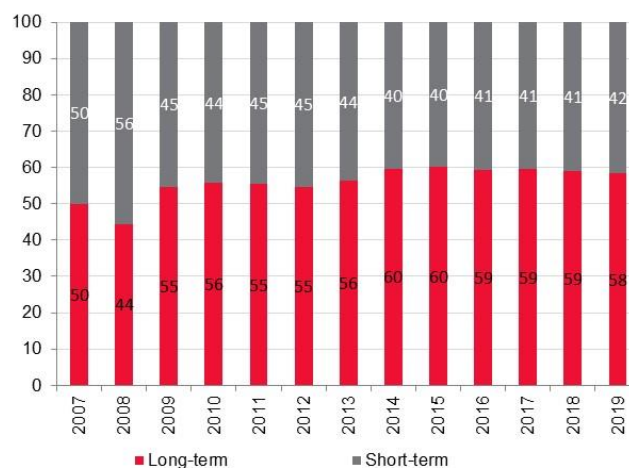
In fact, many countries, including the U.S., Germany, and France, temporarily boosted the issuance of treasury bills during the 2007–2009 global financial crisis. Subsequently, maturities of government debt gradually lengthened, allowing refinancing risk to be gradually reduced (Figure 2). The data of an OECD survey conducted in 2020 suggests that authorities issuing government securities are using a similar tactic even now. That said, the main factor determining the funding strategy is changing investor demand for instruments with various maturities and other terms and conditions (for example, a shift of interest towards variable coupon bonds, etc.).

Figure 55. Total borrowings / GDP by region, % of GDP



Source: [OECD Sovereign Borrowing Outlook 2020](#).

Figure 56. Shares of new short-term and long-term bond issues, %



Source: [OECD Sovereign Borrowing Outlook 2020](#).

Combination of monetary policy loosening in many countries along with growing future borrowing needs, the current borrowing expansion, change in investor preferences and general market sentiment have steepened the slope of the yield curves in major developed

countries and emerging markets: the difference between the yields of long-term and short-term government bonds has increased.

This trend has not left the Russian market unaffected. Below we dwell on factors changing the shape of yield curves in more detail, examining changes in the yield curves of emerging markets' government bonds.

I. Country-specific internal factors

Short-term and long-term interest rates are affected by a variety of factors affecting not only the movements but also the shape of the yield curve.

Short-term and long-term interest rates reflect the current direction of monetary policy: their level and movements depend on the key rate level and movements. However nominal long-term yields are to a greater extent determined by long-term inflation expectations, the extent to which they are anchored and sustainable (the credibility of the current monetary policy), inflationary risk (i.e., the risk that realised inflation will exceed that expected at the time of the bond purchase).

That said, short-term interest rates have an effect on the level of real medium- and long-term rates, but long-term rates are, as a rule, more sensitive than short-term ones to a rise in fiscal deficits and the total of government debt. An increase in risk premium is prompted by a potential rise in the probability of default and/or concerns about future government debt monetisation.

Expectations of a public expenditure increase as a rule push up the long-term government bonds' yields, which makes the shape of the curve more steep (i.e. where the curves are inverted, the shape tend to normal, while if the curve is originally flat, the difference between the yields of long-term and short-term instruments increases).

In 2010, the International Monetary Fund published the study [Fiscal Deficits, Public Debt, and Sovereign Bond Yields](#) analysing data from a sample of advanced and emerging market economies.

The IMF study isolated country-specific domestic and external factors affecting changes in and the shape of the slope of yield curves. Among domestic factors are named:

- Long-term yields usually increase more in countries with higher fiscal deficits: with accumulated fiscal problems, fiscal stabilisation after a still greater deficit expansion will be more difficult than in countries without such problems.
- A deficit expansion of 1% of GDP increases real long-term yields by 30 bp (a 20 bp rise in nominal yields) in countries with a high level of fiscal deficit and by 22 bp in countries with a low level of fiscal deficit.
- A public debt increase of 1% of GDP adds about 5 bp to long-term yields.
- A rise in inflation expectations (and, accordingly, expectations of a key rate increase) by 100 bp triggers an increase in long-term interest rates by 70 bp.

Inflation, meanwhile, has an additional impact on yields via a potential escalation of volatility, which may hamper the implementation of fiscal policy, causing a still greater fiscal deficit expansion.

- Yields in countries with a higher level of debt to GDP ratio are also more sensitive to a fiscal deficit expansion than countries with a low level of public debt. According to an IMF estimate, a debt to GDP ratio of 60% adds 6 bp to long-term interest rates in their response to a fiscal deficit expansion.

Given the current level of globalisation, including that of financial markets, the domestic factors cannot explain the extent to which the yield curves steepened in 2020.

II. External factors

External factors can exert a substantial pressure on the shape of the yield curve, weakening (or even offsetting) the impact of country-specific factors. The long period of low interest rates in the U.S. and Europe after the 2007–2009 financial crisis has shown that the yields of emerging markets' bonds are sensitive to a change in U.S. long-term rates even with the short-term rate remaining unchanged.

According to a study of the Bank for International Settlements¹⁶, a 100 bp yield rise in a U.S. Treasury Bond over the 2005–2015 period caused long-term rates in local currencies of eight emerging markets¹⁷ to increase by 50 bp.

Central banks' purchases of financial assets bring down long-term interest rates across the globe. Investors from advanced economies buy emerging markets' long-term assets, pushing down local long-term rates. Another effect of financial markets integration is the higher sensitivity of local long-term rates to changes in global markets' sentiment.

According to the IMF study (2010):

- Stronger foreign investment inflows (over 10% of GDP) limit rises in long-term yields because of a fiscal deficit expansion (when a fiscal deficit goes up by 1% of GDP on the back of foreign investment inflows a rise in yields slows by 5 bp compared with the baseline scenario).
- In the periods of high inflationary pressure and the worsening of the liquidity situation in global markets, a fiscal deficit has a substantial additional effect (of about 13 bp) on yield levels.
- In the periods of high volatility in stock markets (the high levels of the VIX index), markets show a more negative perception of a rise in extra public spending. An expansion in the fiscal deficit by 1% of GDP in these periods causes the yields of government bonds to go up 7 bp.

¹⁶ [BIS Working Paper Bond markets and monetary policy dilemmas for the emerging markets](#).

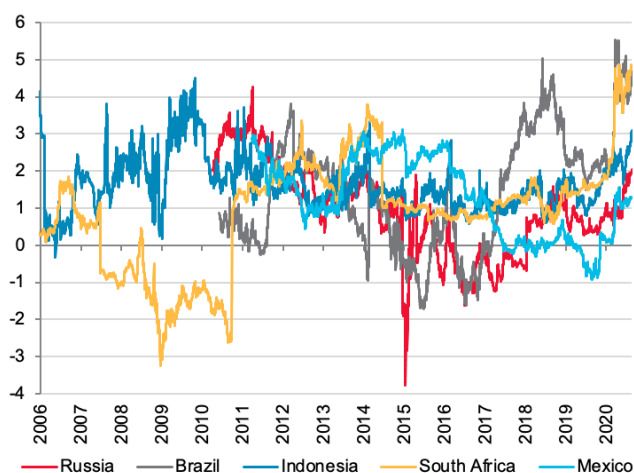
¹⁷ The study dealt with South Korea, Brazil, Malaysia, Mexico, Poland, South Africa, Thailand, and Turkey. A rise in short-term local rates by 100 bp was accompanied by a 20-25 bp increase of the long-term rate.

III. Yield curve steepening during the pandemic

Let us examine changes in the yield curves of five countries: Russia, Brazil, Mexico, Indonesia, and South Africa.

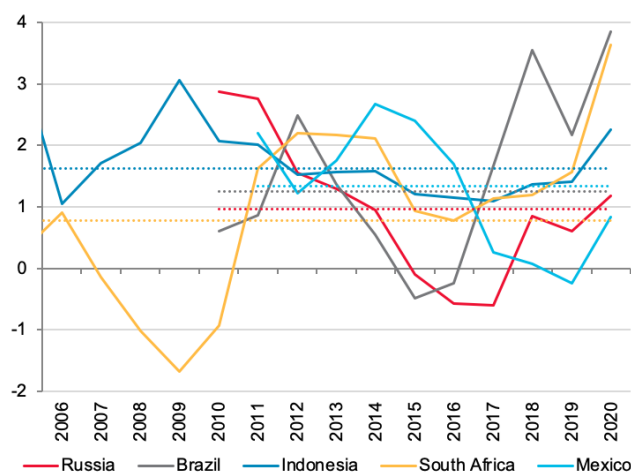
Among the five countries, yield curves in Brazil and South Africa were the steepest compared with Indonesia, Mexico, and Russia (Figure 57, Figure 58). The current difference between 10 years and 1 year OFZ yield is 2.1% compared with 1.45% in mid-June and 0.71% at the start of March). Mexico's yield curve is the flattest among the countries listed.

Figure 57. Yield spread of 10-year and 1-year (10Y - 1Y) government bonds, pp



Note: A 10Y-3Y spread for South Africa.
Source: Bloomberg Finance L.P.

Figure 58. Average annual yield spread of government bonds (10Y - 1Y), pp



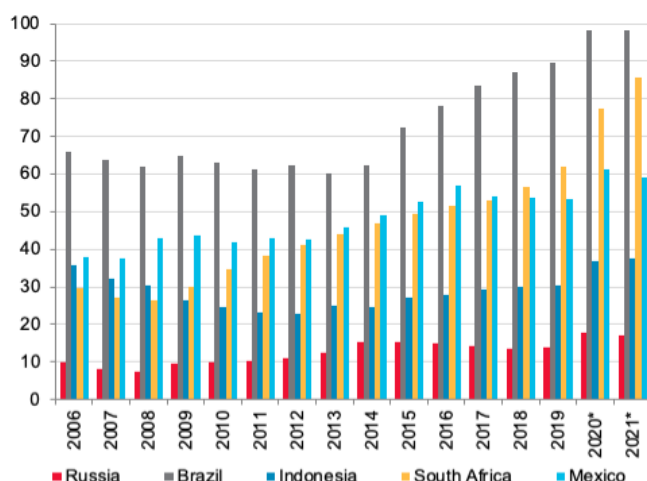
Note: the dotted line represents the average historical level of the spread. A 10Y-3Y spread for South Africa.
Source: Bloomberg Finance L.P.

The level of Russia's public debt to GDP was the lowest among the five countries (Figure 59). Meanwhile, total debt as a percentage of GDP in Brazil, Mexico, and South Africa was also far above that in Russia and Indonesia at the start of the pandemic (coming close to 90% in Brazil in 2019 and exceeding 60% in South Africa).

Inflation was relatively low in all five countries in question; key rates were going down in 2019 and continued to be cut thanks to the central banks' stimulating measures put in place with the advent of the crisis. The highest official inflation was posted in Mexico (3.62%). Also, Mexico has the highest key interest rate among the five countries (4.5%, Figure 63).

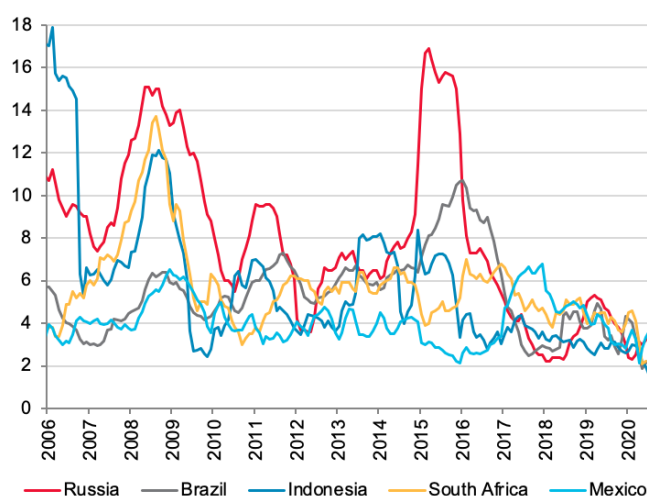
Inflation expectations put pressure on the yields of long-term government bonds since investors price in future inflation. Information about inflation expectations can be obtained through surveys and also (if there is a market for inflation-linked government bonds) by comparing the yields of inflation-linked and classical government bonds (for details of inflation-linked government securities and the calculation of the expected inflation rate, see the December 2019 issue of Talking Trends¹⁸).

¹⁸ [Talking Trends No.8 \(2019\)](#)

Figure 59. Total debt, % of GDP

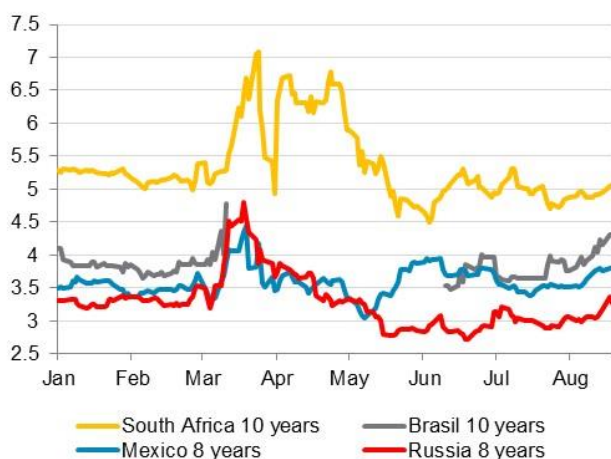
Note: *Forecast < April 2020.

Source: IMF Fiscal Monitor.

Figure 60. Inflation, % YoY

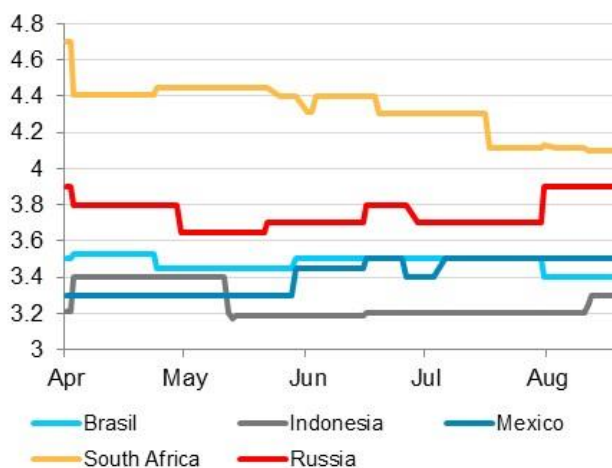
Source: Bloomberg Finance L.P.

After a jump in March posted in four of the five countries under consideration (there are no inflation-indexed government bonds in Indonesia), inflation expectations returned to their pre-crisis levels by the middle of the summer in South Africa and Russia (Figure 61). Long-term inflation expectations went down from their peaks of March 2020 in Mexico and Brazil but are still 0.3 pp and 0.5 pp, respectively, above their pre-crisis levels.

Figure 61. Implied annual inflation, %*

Note: Calculated as the yield difference between the inflation-indexed and conventional bond. The implied inflation index is used for Brazil, Mexico and South Africa. The index reading for Brazil is not available for the period from March to June 2020.

Source: Bloomberg Finance L.P.

Figure 62. Consensus forecast for annual inflation in 2022, %

Source: Bloomberg Finance L.P.

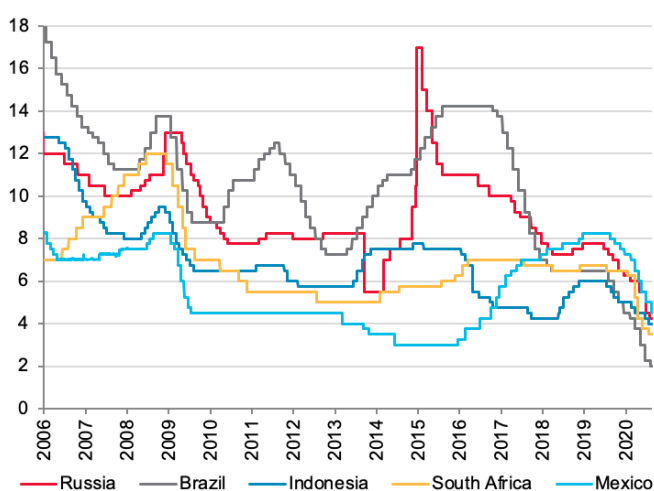
Analyst surveys, as a rule, provide information for a shorter period (for example, Bloomberg Finance F.P. analysts' consensus forecast is only available for 2022). This makes

it more difficult to use consensus forecasts for assessing the impact of inflation expectations on the trajectory of change (Figure 62).

Therefore, among the five countries in question, Russia has the strongest country-specific factors, which should provide a flatter slope of the OFZ yield curve than those of the other four countries. Indeed, the Russia's yield curve is flatter than that of Brazil, South Africa, and Indonesia. The yield curve of Mexico's bonds is, however, more flat than that of Russia's. Further on, we will compare the impact of external factors, dwelling in particular on the effect of external factors on yield movements in Russian and Mexican government bonds.

Flight to quality in Q1 2020 was triggered by the widening of these countries' yield spreads to U.S. treasuries, but a subsequent decline in risk-free rates and seeking additional yields brought the spread closer to the pre-crisis levels (Figure 64).

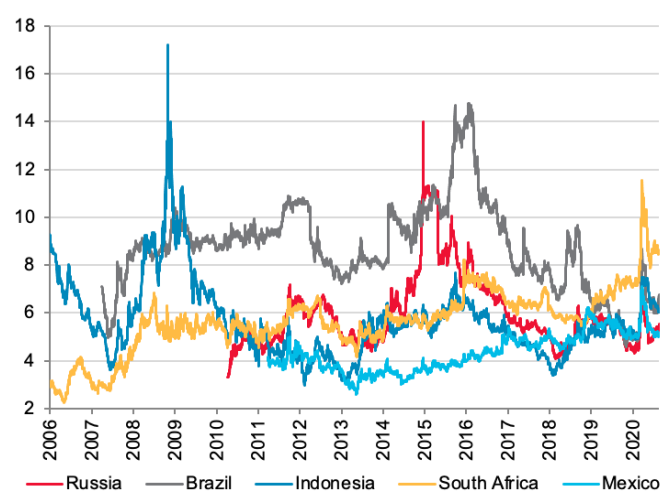
Figure 6344. Key interest rates, % p.a.



Note: Refinancing rate for Russia (before September 2013), Indonesia (before April 2016), and Mexico (before January 2008).

Source: Bloomberg Finance L.P.

Figure 64. Yield spread of 10-year government bonds to 10-year U.S. treasuries (10Y - 10Y UST), pp



Source: Bloomberg Finance L.P.

The decline in yield spreads of local bonds to U.S. treasuries was the largest in Mexico, Brazil, and Russia, with Mexican bonds showing the largest 204 bp contraction, while Russia's OFZ spread dwindled by 178 bp.

Strong demand from foreign investors (possibly fuelled by, among things, expectations of further monetary policy easing) prompted a faster decline in the long-term government bond yields in Mexico than that of Russia. As a result, the Mexican yield curve steepened less in spite of the country's weaker economic fundamentals (the debt burden, inflation, and inflation expectations).

Thus, the high level of government debt and inflation expectations represents a risk factor for the price of long-term assets. That said, demand from foreign investors may both offset the impact of weaker country-specific factors and, by contrast, amplify it if risk tolerance changes in global markets. It is therefore important to encourage the development of the long-term investor base with stable demand and address the interests of these investor groups (e.g., a floating or fixed coupon, etc.) in designing market borrowing strategies.

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