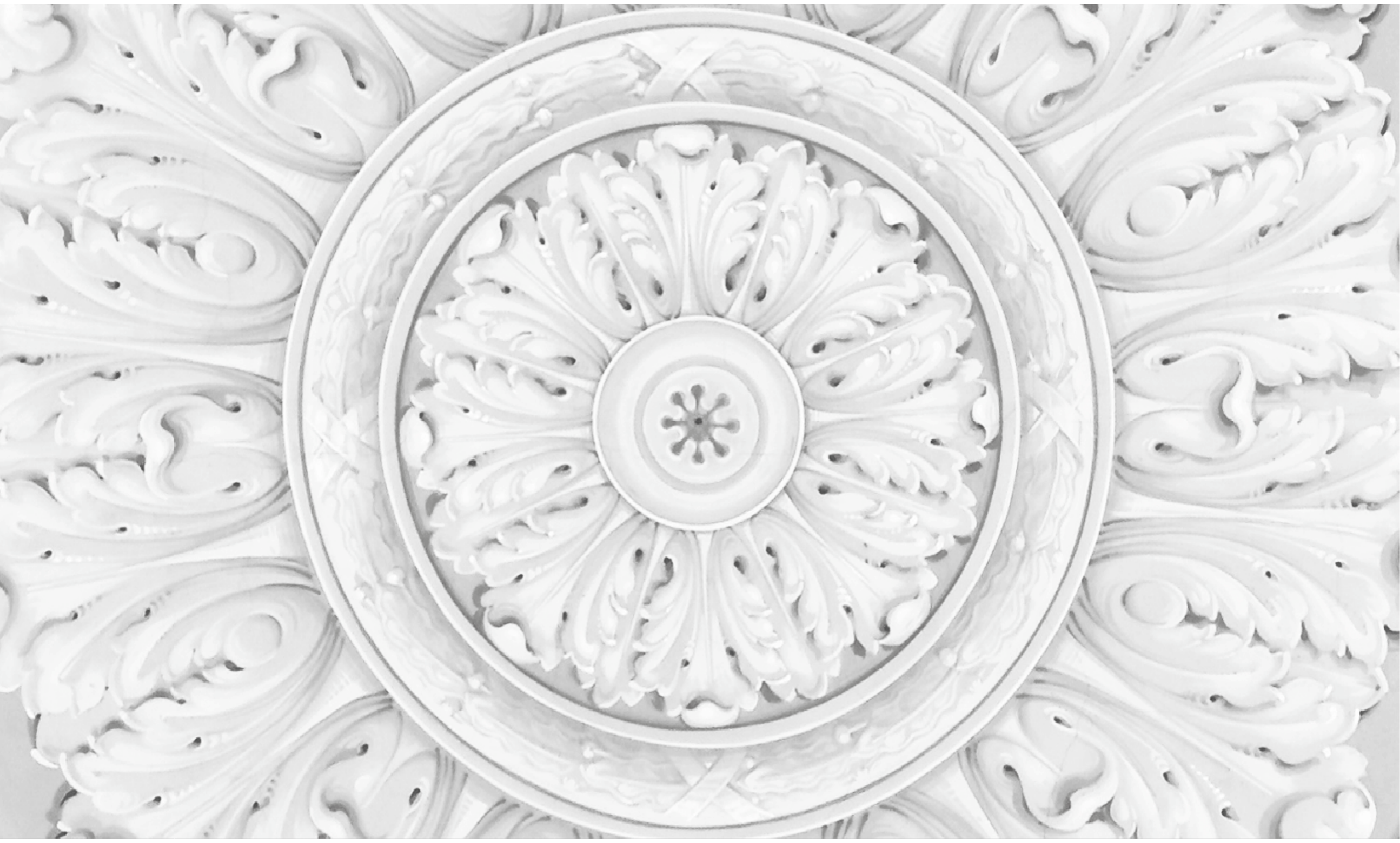
Bank of Russia

The Central Bank of the Russian Federation



Talking Trends

Macroeconomics and Markets

May 2017

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

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

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- Inflation has come down close to 4.0% YoY due to favorable external and financial conditions along with Bank of Russia's moderately tight monetary policy. Economy has returned to moderate, but sustainable growth. Current balance of risks suggests for further gradual cut of Bank of Russia's key rate.
  - As a result of temporary shifts in food price seasonality, seasonally adjusted annualized inflation in April slightly exceeded the 4%-target level. Our preliminary estimates also show that the same result will, in effect, hold in May. The adverse effects on harvest resulting from the relatively cold spring in Russia will lead to temporary rise in inflationary pressures from the supply side in the upcoming months. Another important risk of inflation for the rest of 2017 comes from revival of domestic demand. On the whole this brings about risks for maintaining inflation around target in the medium-term perspective.
  - Economy's current transition to slow but sustainable growth is accompanied by clear revival in both consumption and investment activity. Reduction of overall macroeconomic uncertainty, which partially occurred due to Bank of Russia's moderately tight monetary policy, played a key role in facilitating Russian economy's adjustment to structural shifts.
  - Current situation on the financial markets remains positive for financial stability and achieving inflation target in Russia.

2. Outlook

- Inflation expectations among the population and professional analysts have reached record lows in May. This reflects growing credibility of Bank of Russia's monetary policy.
- Real GDP growth may stabilize around 0.5% QoQ SA if moderately favorable external conditions persist.

3. In focus. Sustainability of fixed capital investment

- The process of Russian economy's adjustment to structural shifts is close to completion and points to positive perspectives for reviving growth in fixed capital investment.
- However, the task of promoting higher growth rates in the economy requires primarily high-quality investments and, hence, cannot be completed within a short time perspective.
- Bank of Russia's moderately tight monetary policy is likely to serve as one of the factors behind current rebound in investment growth, mainly via the reduction of uncertainty about the state of the economy.

1. Monthly summary

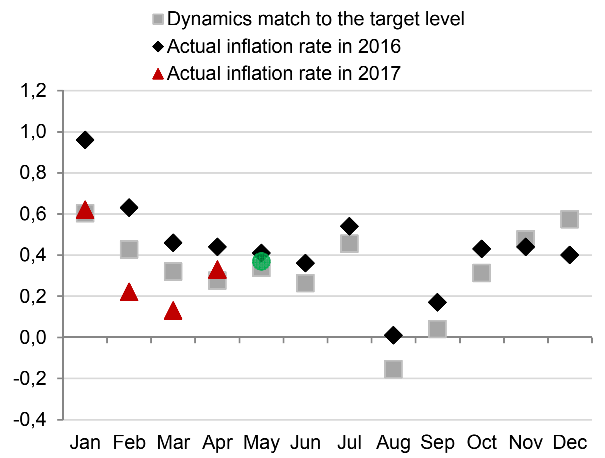
1.1. Inflation

1.1.1. Inflation has come down close to 4% YoY

- CPI growth rates in YoY terms came close to 4.0% in April. This is explained by both Bank of Russia's monetary policy, as well as by an ongoing disinflationary effect from Ruble appreciation from the beginning of 2017. The latter factor is likely to be observed throughout the first half of 2017.
- However, seasonally adjusted growth rates in April amounted to 0.35% MoM, which is higher than the 4% target level in annual terms. This is mainly explained by price growth under fruit&vegetable category, as well as some services.
- Recent pattern of core inflation, which generally assumes adjustment for temporary factors in inflation dynamics, also advocates for a slight rise in inflationary pressures.
- This year's relatively cold spring is likely to lead to adverse harvest issues, which implies temporary rise of inflation in 2017Q3.
- Seasonally adjusted annualized inflation in May 2017 may slightly exceed the 4% margin again.

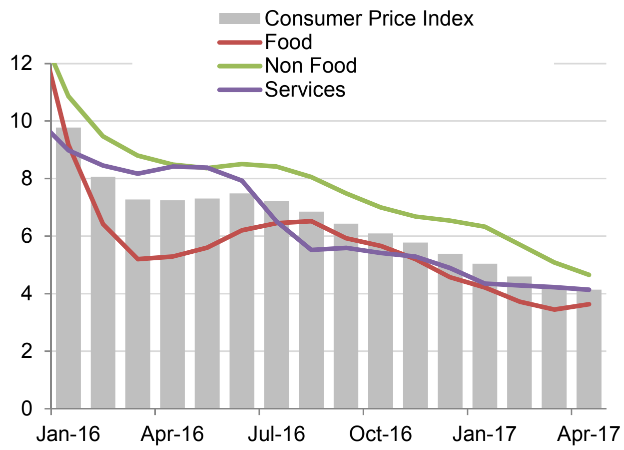
Consumer inflation reached 0.33% NSA in April, according to Rosstat. Our estimates show that in seasonally adjusted annualized terms this is slightly above the 4% margin (Figure 1).

Figure 1. Actual monthly inflation and monthly 4% target bands, %MoM NSA



Sources: Rosstat, R&F Department calculations.

Figure 2. Consumer inflation across different components, % YoY



Sources: Rosstat, R&F Department calculations.

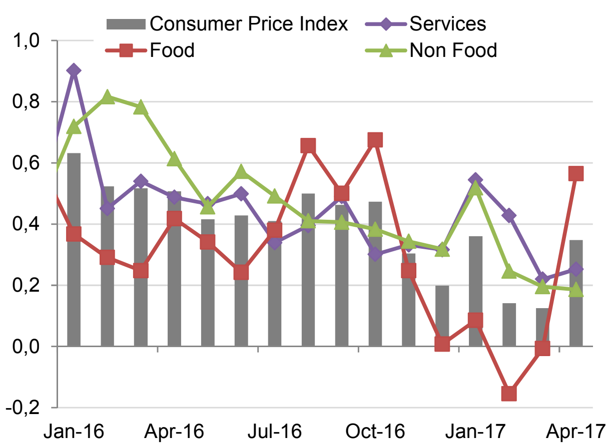
Just like in April 2016, monthly consumer price growth turned out to be smaller as compared to the preliminary estimate implied by Rosstat's flash weekly data. This is directly connected to methodological issues with respect to Rosstat's subsequent evaluation of price growth among items from the CPI basket, the statistics for which is not observed on a weekly basis.

The sharpest price growth in April was demonstrated by food items (up to 0.6% MoM from 0.14% in March). At the same time, non-food CPI growth declined from 0.22% MoM in March from 0.17% MoM in April. Price growth among services accelerated to 0.16% MoM from 0.0% MoM in March.

As a result, inflation declined to 4.14% YoY in April (Figure 2). However, in seasonally adjusted terms it increased to 0.35% MoM, up from 0.13% MoM in March, when prices had been largely driven by temporary disinflationary factors (Figure 3). The top contribution to price growth in April from the upside came from prices for fruits and vegetables, which increased by 3.9% in seasonally adjusted terms.

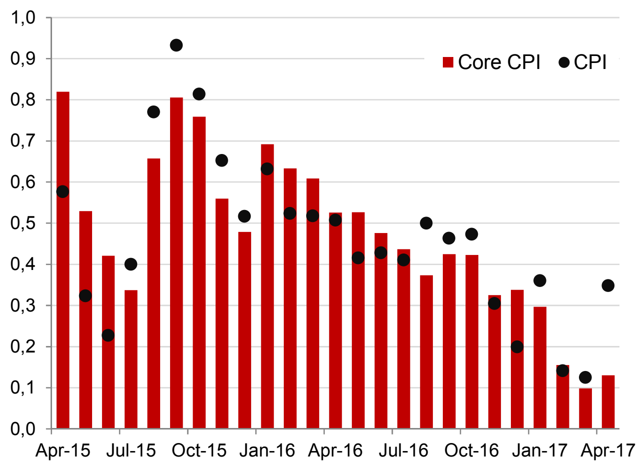
As for the non-food items, the respective price growth remained steady at around 0.2% MoM SA, which is well below the 4% level in annual terms. In our opinion, such moderate dynamics of the latter CPI component, which is traditionally characterized by smaller volatility, subtly reflects the disinflationary effect from Bank of Russia's monetary policy. On top of that, recent steady reduction of price growth among non-food items confirms positive disinflationary effect from Ruble appreciation. Our econometric estimates show that the magnitude of response of prices corresponds to the second or third month after the exchange rate shock. Hence Ruble appreciation at the end of 2017Q1 and in April 2017 are likely to produce further disinflationary effect throughout the first half of 2017 as a whole.

Figure 3. CPI growth rate, % MoM SA



Sources: Rosstat, R&F Department calculations.

Figure 4. Core CPI, %MoM SA



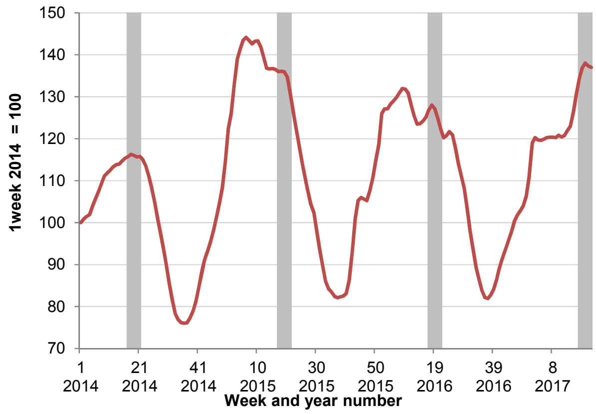
Sources: Rosstat, R&F Department calculations.

Inflation for services grew to 0.25% MoM SA in April from 0.22% MoM SA in March. This is mainly explained by an increase in prices for passenger transport services and communication services. Since services can be generally characterized as a component of the CPI basket which is relatively less sensitive to exchange rate shocks, the dynamics outlined above suggest for a slight increase in inflationary pressures that is not driven by temporary factors. The latter conclusion is also confirmed by data on core inflation for April, which grew to 0.13% MoM, up from 0.10% MoM in March (Figure 4). The main contribution to this growth came from food items, in particular sugar, meat, milk and dairy products.

Rosstat's preliminary estimates also show that from May 1st to May 29th accumulated CPI growth amounted to 0.29% MoM. Our preliminary estimate based on this figure is 0.35-0.40% MoM SA, which is slightly above the 4% margin in annual terms. Further revision of these assessments will be made as soon as monthly figures for CPI components are released by Rosstat.

The last two weeks of May saw a return of prices for vegetable&fruit to normal seasonality (Figure 5). This presumably indicates that temporary price growth related to shifts in seasonality resulting from prolonged disinflationary effect of last year's good harvest, which was observed earlier this spring, may have come to an end.

Figure 5. Weely price growth for vegetable&fruit, %



Sources: Rosstat, R&F Department calculations.

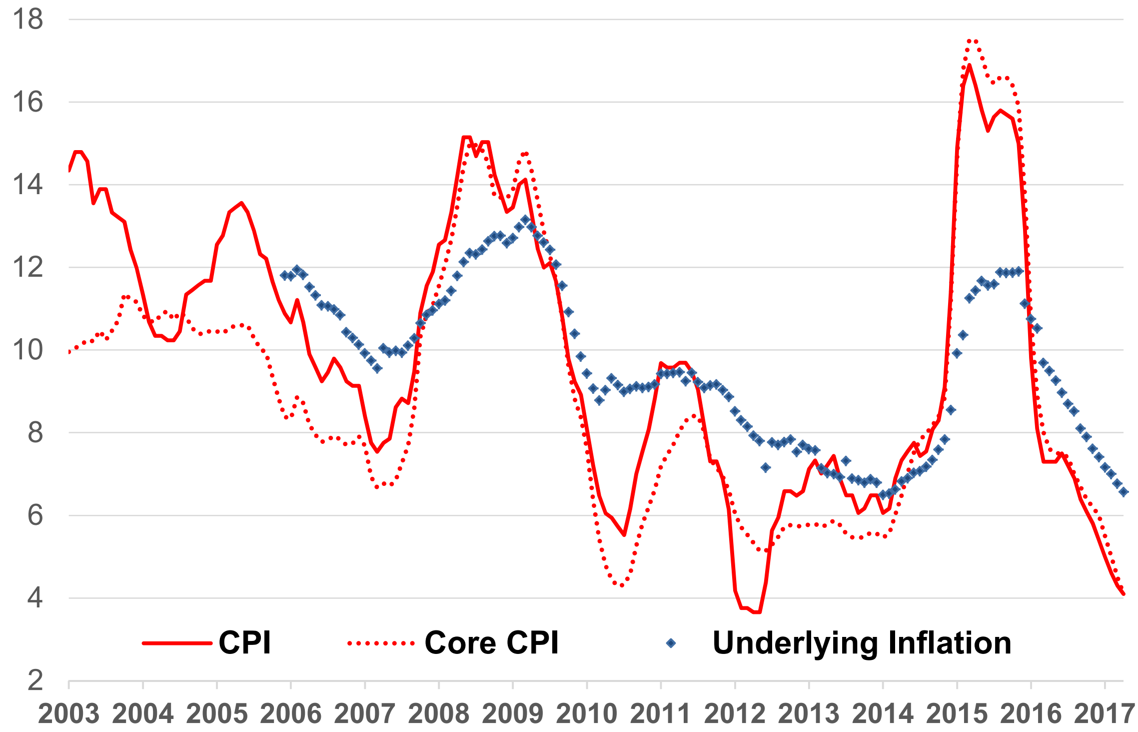
Grey areas correspond to May of each calendar year.

However, cold weather and ground frost throughout this year's spring brings about additional risks from the supply-side. The destruction of plants and trees along with postponed planting most likely signals a relatively late and less abundant arrival of future harvests to consumers. According to Rosstat, area of crop has declined by about 19% in YoY terms as of May 1st 2017. This temporary factor may lead to seasonally adjusted inflation being above 4% in annual terms throughout next several months and, especially, 2017Q3.

1.1.2. Underlying inflation shows moderate reduction and signals medium-term upside risks

- Trend inflation in April 2017 is estimated at 6.6% YoY, down from 6.7% YoY in March.
- Trend inflation continues to decline quite moderately due to dissimilar contributions of items from the CPI basket to disinflation.
- We expect further slow reduction in trend inflation throughout the rest of 2017.
- Risks of exceeding the 4% inflation target in 2017 have recently declined. Nevertheless, relatively high levels of trend inflation point to medium term risks to price growth.

Figure 6. CPI, core CPI and historical estimates for underlying inflation, % YoY



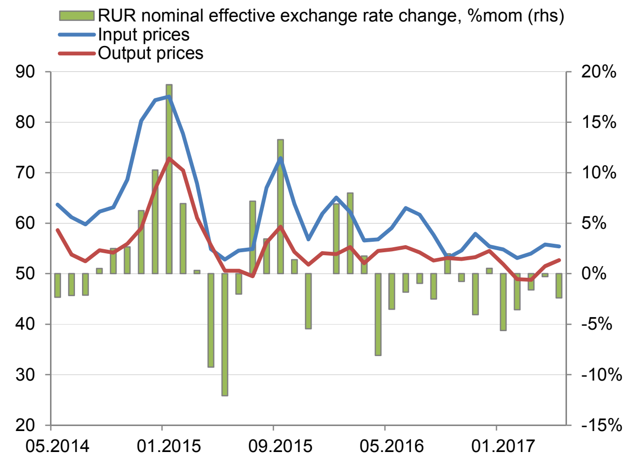
Sources: Rosstat, R&F Department calculations.

1.1.3. PMI data on input and output prices: higher producers' costs are actively passed down to consumers

- In April in May PMIs on input and output prices signaled growing inflationary pressures.
- This is primarily observed in the services sector, which is at the same time relatively less sensitive to exchange rate movements as compared to manufacturing (Figure 7, Figure 8).

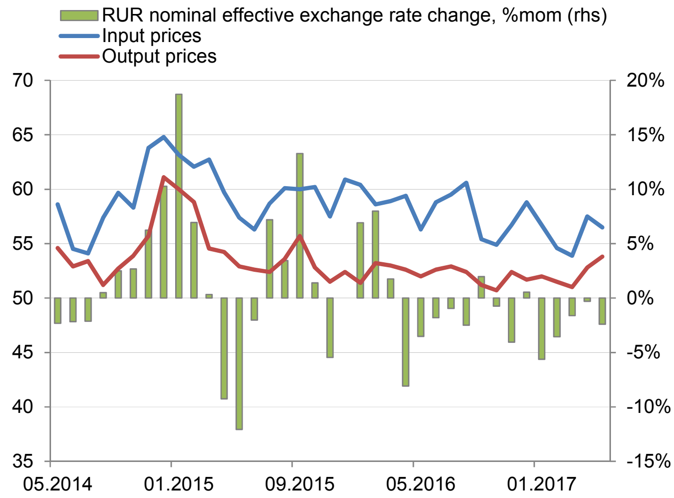
- We believe that recovery in consumer demand allows companies to more actively pass growing costs of production down to consumers.
- CPI growth is likely to rise in the upcoming months given the exhaustion of temporary disinflationary factors.

Figure 7. Selected PMIs in manufacturing sector, pp.



Source: Bloomberg Finance L.P.

Figure 8. Selected PMIs in services sector, pp.



Source: Bloomberg Finance L.P.

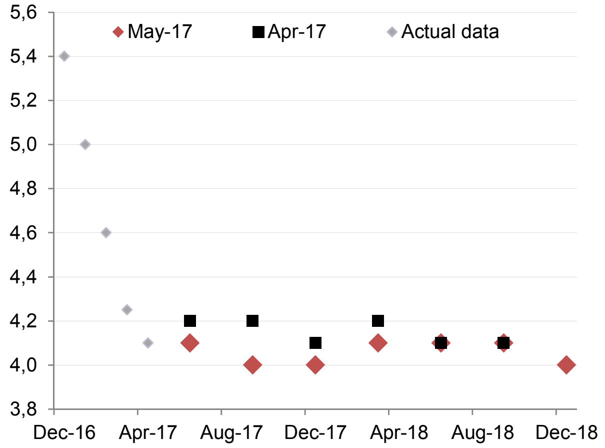
1.1.4. Bloomberg analysts' consensus forecast: inflation expectations have reached the target

- Analysts' expectations for inflation as of the end of 2017 have moved down to their target level for the first time. Importantly, price growth expected as of the end of 2018 has totalled 4%.
- This is a sign of growing credibility in the current monetary policy conducted by the Bank of Russia.
- Analysts' expectations as regards future key rate movements were revised and anticipate a faster pace of reduction in the next one to two quarters; the anticipated rate as of mid-2018 was practically unchanged.

A Bloomberg survey in May found the consensus forecast for inflation as of late 2017 edging lower to hit the BoR target for the first time (Figure 9). The spread of estimates remains invariably wide (between 3.6% and 5%). The consensus forecast for 2018 inflation was unveiled for the first time, with the median value at 4%.

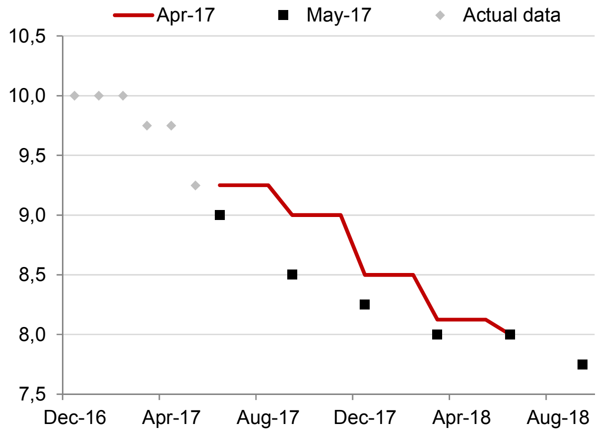
The projected performance of the BoR key rate was substantially revised (Figure 10) to show its faster downward movement in the months ahead. At the same time, the key rate expected for one year ahead changed little, if at all. Apparently, the Bank of Russia's decision to reduce its key rate by 50 bp to 9.25% was essentially behind the change in such forecasts.

Figure 9. Analysts' expectations for inflation, % YoY



Source: Bloomberg Finance L.P.

Figure 10. Analysts' expectations for the BoR key rate, % per annum



Source: Bloomberg Finance L.P.

The fact that expectations hit the target for the end of 2018 points to a marked growth in analysts' confidence in the BoR monetary policy stance. This confidence comes with the understanding that mid-term monetary conditions have to remain moderately tight to enable the economy to reach a sustainable path of approximately 4% price growth, which is reflected in the forecasts for the BoR rate change on the one-year horizon.

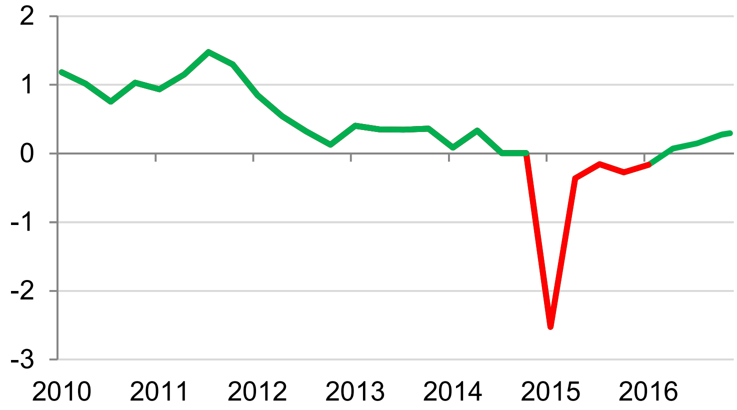
1.2. Economic performance

The economy hit a positive growth path early in the year, which is confirmed by both short-term business outlook including survey data and Q1 GDP data released by Rosstat. Industrial output growth remained positive and is increasingly more uniform across various sectors. Notable improvements are observed in consumer activity; the outlook for forthcoming improvement in investment activity remains positive. Although the economy has been gaining some support from the external conditions, moderately favourable early in the year, the key enabler for its recovery was the gradually completed adjustment to the recent structural change. Lower uncertainty alongside progressively declining inflation and inflation expectations were also of relevance.

1.2.1. Economic growth has been accelerating

- Rosstat's preliminary estimate points to a 0.5 % YoY GDP growth in 2017Q1.
- According to our estimates, this implies a seasonally adjusted growth of 0.3% QoQ in 2017Q1 (Figure 11).

Figure 11. GDP in constant prices, % QoQ sa



Sources: Bloomberg, Bank of Russia calculations.

- Fixed capital investment in 2017Q1 was slightly above expectations, demonstrating a solid 2.3% YoY growth.

1.2.2. April sees a robust growth in industrial output

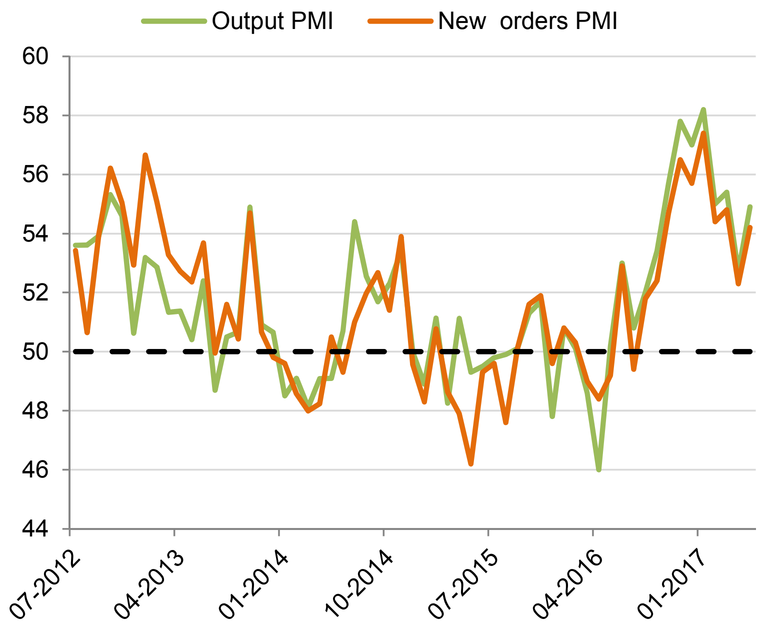
- In April, industrial output was up 0.8% MoM and 2.3%YoY, in defiance of the negative calendar effect.
- Growth was noted across all industrial subsectors, supported by the cold weather and the extra demand for gas exports.
- Manufacturing PMI suggests that the current paces of industrial expansion are likely to stabilise in the future.

According to Rosstat, industrial output in April grew 0.8% MoM and 2.3% YoY. With April one working day shorter that the April of the past year and two working days shorter than March 2017, expectations for growth paces are fairly high. R&F Department estimates find April's output, seasonal and calendar factor adjusted, to have grown 0.7% MoM. However, given the very limited series of observation based on the new methodology, these estimates should be treated with caution. The wagging tail problem may be responsible for a revision in these estimates as new data come in subsequently.

Fairly promising data follow from the sectoral breakdown: mounting outputs are observed across all industrial subsectors. The mining industry comes as a growth driver with its 1.7% MoM[1] and 4.2% YoY expansion, largely thanks to a 10.1% YoY rise in gas production, on the back of rising demand from European consumers. The latter is driven by the colder weather conditions and dwindling intra-EU production. Strong growth in the economic activity ‘electricity, gas and steam supply; air conditioning’ was supported by cold weather in April across Russia.[2] According to R&F Department estimates, the manufacturing sector’s output was up 0.7% MoM. The product breakdown is indicative of accelerated paces of growth in the production of chemicals, rubber and plastics, pharmaceuticals and healthcare products, computers, electronic and optical products. The food industry also extends its moderate growth.

Industrial output grew robustly in April, posting data consistent with multi-year highs the PMI index registered in 2017 Q1 (Figure 12). Mounting domestic orders, as well as better expectations of manufacturers themselves as regards volumes of output anticipated for the next 12 months, in the context of rebounding demand, suggest strong chances the current growth paces of the manufacturing sector will hold.

Figure 12. Manufacturing PMI index, pp



Source: Bloomberg Finance L.P.

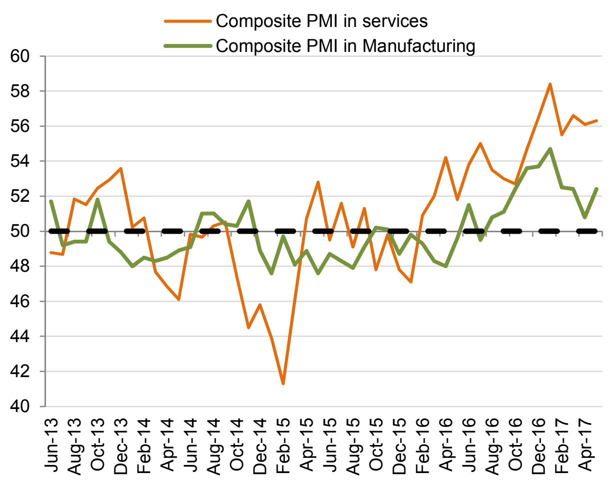
[1] Here and elsewhere according to R&F Department's seasonally and calendar effect adjusted estimates.
[2] According to the System Operator of the Unified Power System’s data, lower by 2.2ºC compared to 2016.

1.2.3. PMIs: consumer and export demand support economic growth

- The composite PMI for April suggests that the Russian economy continues to post buoyant growth, supported by consumer and export demand.
- This is suggestive of a further expansion in economic activity in the Russian economy's private sector in the next few months.
- The service sector continued to show healthy expansion, despite the slightly decreased PMI.
- The April slowdown in the manufacturing sector proved to be temporary. In May, growth was found to be accelerating, led by the investment goods production subsector.

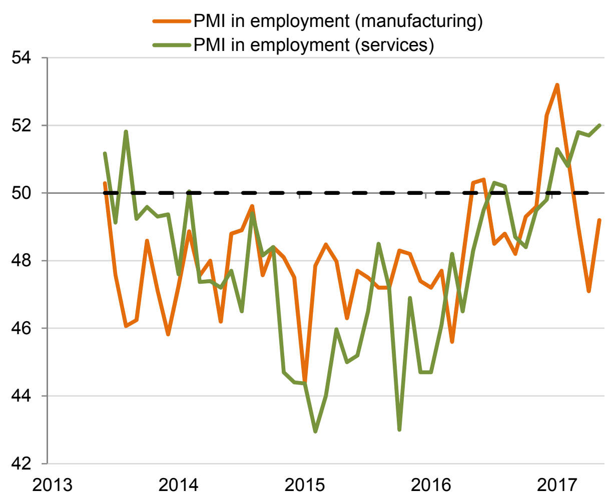
As follows from business activity PMIs, the Russian economy continued to turn in solid growth in April The composite PMI, albeit slightly down (from 56.3 to 55.3 pp), was above the average for the period under study, and well above the 50 pp mark that separates growth from contraction. The service sector came to be a substantial contributor to growth, while growth was slower in manufacturing.

Figure 13. PMIs, pp



Source: Bloomberg Finance L.P.

Figure 14. Employment PMI, pp



Source: Bloomberg Finance L.P.

Manufacturing PMI was up in May to 52.4 pp, following a contraction to 50.8 pp seen in April (Figure 13). Slower growth in April is explained by the way new order and output performed - where growth rates fell to an eight-month low. However, as early as May, both orders and output posted quicker paces of growth. The production of consumer goods and services has been showing solid rates of expansion, on the back of rising exports and outrunning growth in overall demand. Manufacturers of consumer goods note a rise in new orders including export ones, as well as continued increase in outputs of goods in process. Demand growing faster than production is further evidenced by the ongoing decline in finished goods inventories (May's PMI totalled 47.4 pp). Negative trends found their way in the production of investment good in April; nonetheless, as early as May this sector emerged as a growth driver in terms of outputs.

Services PMI in April edged downwards (from 56.6 pp to 56.1 pp) but was still above the average for the period under study, which suggests a substantial improvement in market conditions of the subsector. Growth is supported by stronger domestic and external demand, which works to shore up corporate optimism and incentivise increase in employment (Figure 14).

As a result, overall employment was still rising. This suggests that a further reduction in unemployment rate, seasonally adjusted, is in store, together with mounting labour shortages in the job market. The latter factor may well trigger expedited growth of wages, especially across most sought-after and highly-qualified positions.

Given the ongoing recovery in consumer demand, business activity of the Russian economy's private sector is poised to demonstrate continued healthy growth.

1.2.4. Retail sales hit zero point

- Annual growth rates of retail sales in April reached zero as they were out of negative territory for the first time since December 2014.
- April's retail sales, seasonally and calendar effect adjusted, were level with March.
- The period saw improvements in households' attitude towards major purchases and loans as real wages continued to grow, in a trend which is set to support a further increase in retail sales.

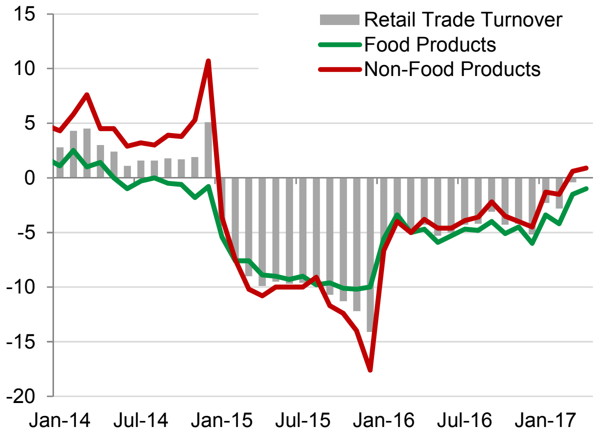
According to Rosstat data, volumes of retail sales for April 2017 were unchanged from the same period last year (Figure 15). Retail sales, following their uninterrupted slump since early 2015, stopped to decline for the first time. In this way, contraction in retail sales in March was 0.4% in annual terms, after a 2.8% drop seen in February.

In April, the non-food segment posted growth of 0.9% YoY for a second month in a row (after 0.6% YoY seen in March). At the same time, contraction in food sales persists, although its pace has diminished: 1.0% YoY (after 1.5% YoY in March).

We estimate that retail sales, seasonally and calendar effect adjusted, were level with March (Figure 16). Seasonally adjusted sales of non-food products edged up 0.05% MoM, while those of food products went down 0.05% MoM. Following a sharp uptick in sales in the early days of the month, retail sales changed little, if at all. Nonetheless, should this trend hold, the growing low base effect is set to entail a sustainable improvement in retail sales data in annual terms. This effect is likely to be especially noticeable in the second half of the year.

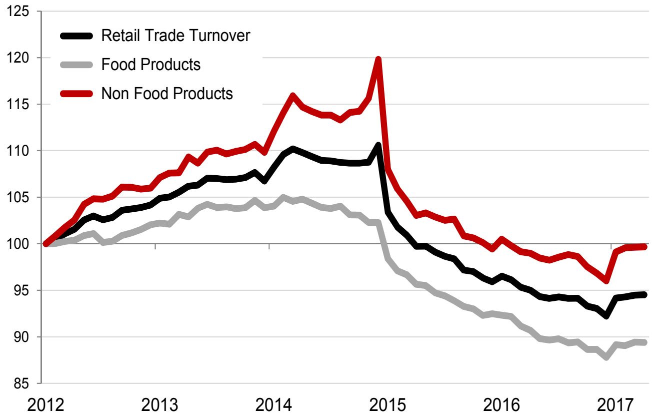
According to data from Global Blue, a major global VAT refund operator, Russian travellers' expenses abroad rose by more than 40% YoY in early 2017 (Figure 18). This is aligned with Rosstat's data on the proportion of income spent on products abroad relative to last year. Most growth in outbound tourism is explained by a strengthened ruble and the partial shift in traffic away from domestic destinations; yet, the better consumer sentiment was of no less importance.

Figure 15. Food, non-food and total retail sales, % YoY



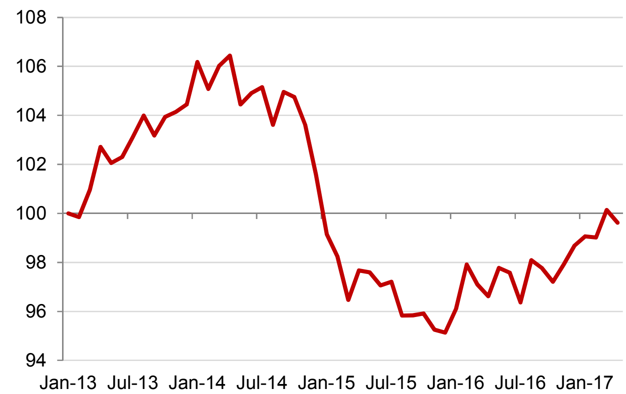
Sources: Rosstat, R&F Department calculations.

Figure 16. Retail sales (January 2012 = 100%, seasonally adjusted), %



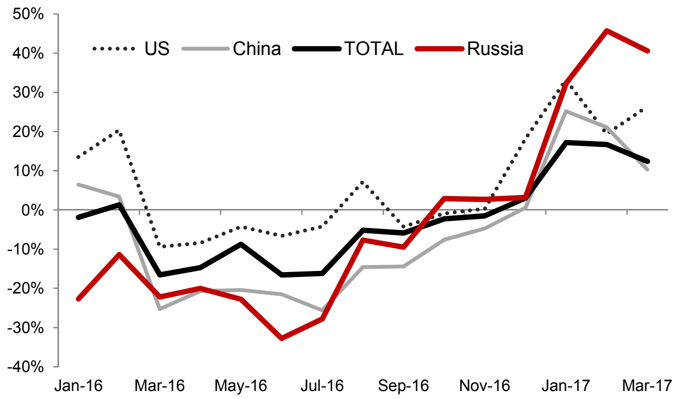
Sources: Rosstat, R&F Department calculations.

Figure 17. Real accrued wages (January 2013 = 100), seasonally adjusted



Sources: Rosstat, R&F Department calculations.

Figure 18. Growth in tourist expenses by country of origin, % YoY



Source: Global Blue.

Positive non-food sales data are consistent with findings derived from consumer sentiment surveys, conducted by inFOM[3], which suggest households' attitude towards major purchases is on the mend (Figure 19). More frequently mentioned are purchases of household appliances which saw a decline in prices on the back of the past few months' strengthening in the ruble.

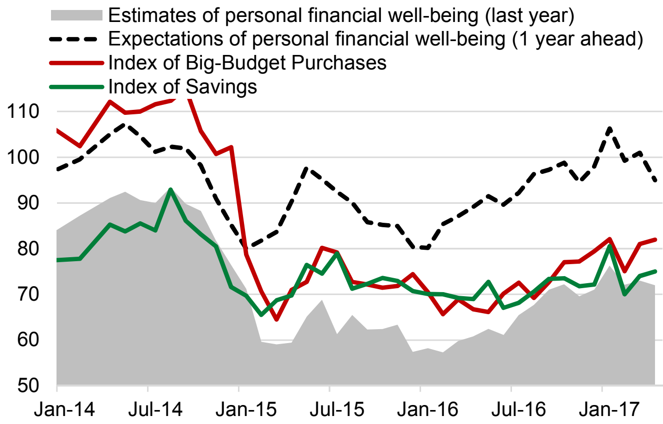
Similar tendencies are confirmed by a survey conducted by the Russian Public Opinion Research Centre (VCIOM). According to its April survey,[4] the share of respondents who believe the current time is appropriate for big-budget purchases went

[3] 'Inflation expectations and consumer sentiment'. No. 4. April 2017.
[4] VCIOM Press release.

up to 24% (on 22% in March); the numbers of those thinking otherwise slumped to 58% (65% in March). In another sign of rebounding consumer activity, attitude towards raising of credit saw an improvement: between March and April, the credit confidence index[5] edged up to 25 pp. (in comparison to 23 pp in March), which is a fresh annual high.

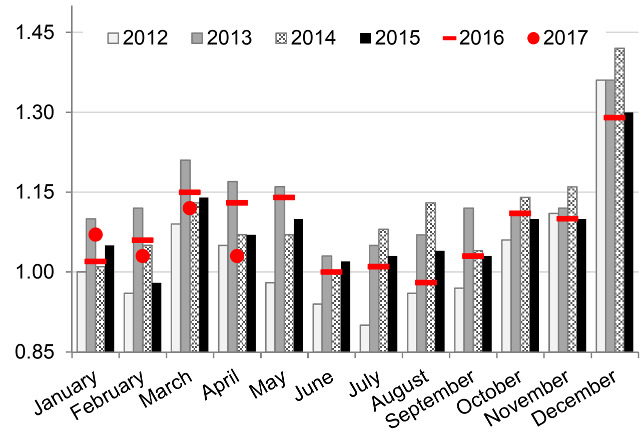
According to Romir, a pollster, real expenses of households contracted in April by as much as 6.8% on March and fell to their lowest level in five years (Figure 20). This is not to say, however, that Romir's data are in contradiction with consumer sentiment surveys and trends in retail sales. Romir's calculations are based only on every day products. They exclude big-budget purchases, of which growth was an important contributor to retail sales, which improved over the last few months.

Figure 19. Consumer sentiment index and its components, pp



Source: InFOM.

Figure 20. Consumer spending (every day products) (January 2012 = 100%), %



Source: Romir Scan Panel.

Considering the continued gradual recovery in real wages (Figure 17) and improvements in households' attitude to major purchases and loans, monthly growth in retail sales, seasonally adjusted, may be expected, as well as faster annual growth rates. Having said that, the upward trend is on course to transform into only a moderate recovery in retail sales for the total year.

1.2.5. The savings ratio is lower as households' saving-oriented model remains

- The savings ratio in 2017 Q1 went down to 7.8% from 8.7% seen in 2016 Q1.
- Its monthly movements retrace the 'typical' 2012 performance with its prevailing consumption-focused behaviour pattern.

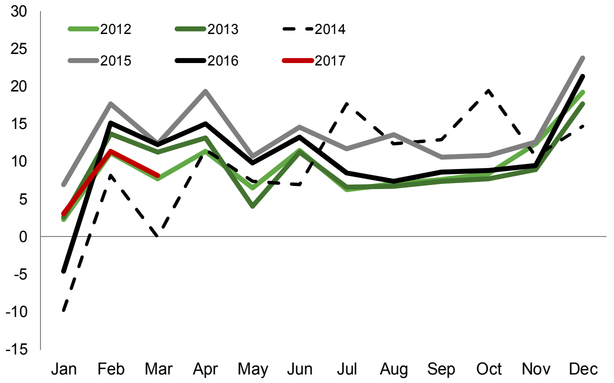
[5] The credit confidence index is built on responses to the question *'Do you believe now is the right time to take on a loan, don't you?'* The response *'It appears right rather than bad'* gets the index 0.9, the response *'It appears bad rather than right'* – 0.1, *'Cannot say'* – 0.5. The higher the index, the more favourable the Russians believe the current time is to raising of credit.

- Steadily high evaluations for personal financial standing and better attitude of consumers towards budget purchases, both observed in April, may well lead to the pre-crisis values of the savings ratio becoming entrenched.
- This suggests that the saving-focused behaviour of most population may prove sustainable.

The savings ratio in March, as follows from Rosstat's data, saw a seasonal downward blip to 8.2% from 11.4% in February (updated data). Seasonally adjusted data meanwhile suggest expansion in the savings ratio (8.5–8.9% for February and 9.2–9.3% for March).

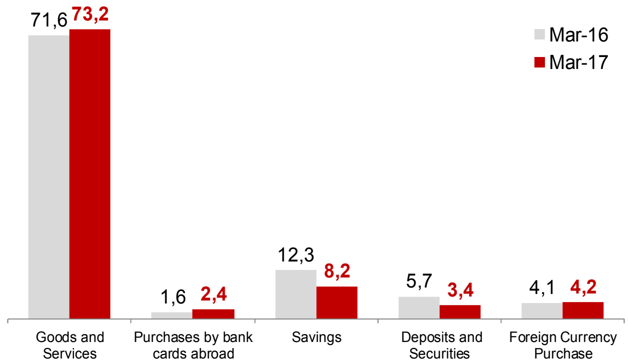
The overall proportion of income saved appears to be close to a 'typical' 2012 level, rather than to last year's, as it reflects the recovery in consumer activity and the shrinking propensity to save (Figure 21).[6]

Figure 21. Share of savings in households' monetary income, %



Sources: Rosstat, R&F Department calculations.

Figure 22. Change in households' spending pattern, % to monetary income



Sources: Rosstat, R&F Department calculations.

The proportion of income saved was down on March last year as households' monetary incomes rose 2.1% YoY. All other components of household spending rose at the expense of the savings ratio. In this way, growth was observed in the shares of income spent on goods and services, costs of banking card transactions abroad, regulatory charges and foreign currency purchases (Figure 22).

The growing share of income spent on goods and services abroad comes a result of rising outbound tourism, which is confirmed by 2017 Q1 international flights data. These costs are essentially household spending.

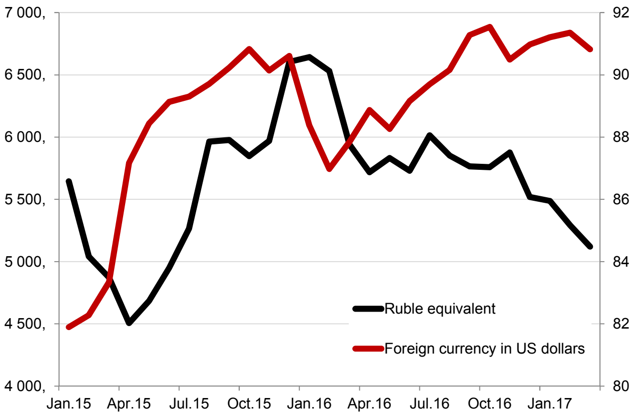
The slight upward movement in the proportion of income, compared to last year, spent on foreign currency purchases appears to be the result of both savings or foreign currency purchased for foreign travel. The period meanwhile saw a contraction in

[6] The revised 2016 statistical data show but insignificant change in the savings ratio for the year (down from 11.3% to 11.2%).

households' foreign currency deposits expressed in dollars. A stronger ruble triggered a further reduction in the ruble equivalent to foreign currency deposits (Figure 23).

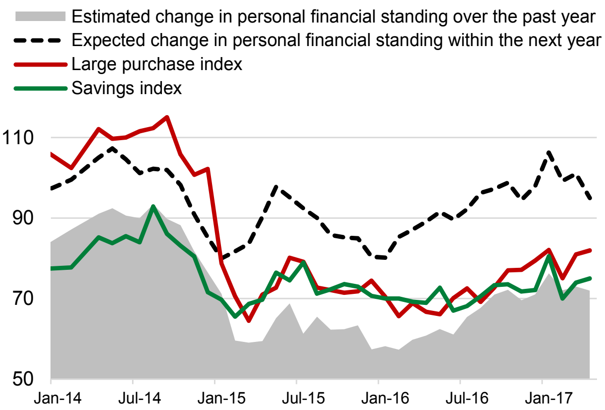
The shrinking savings ratio that continued into March (compared to March last year) was accompanied by mixed data on consumer expectations. According to an inFOM-conducted survey,[7] consumer sentiment in April[8] slightly deteriorated (Figure 24). Respondents' evaluations of their current financial standing were steady, with most referring to their material status in the past year as unchanged.

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



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

Figure 24. Index of big-budget purchases, savings and personal financial standing assessment, points



Source: inFOM survey.

The survey data suggest an ongoing stabilisation in saving-focused behaviour. In this way, the number of those polled who would save up if they had some extra money is still above the number of those inclined to spend (54% against 42% in April), with a wider gap compared to the past month (53% vers. 43% in March). Beyond that, the period saw a rise in the proportion of respondents who actually managed to save over the past month, to 29% from 26%. From a formal perspective though, these data are misaligned with the observed shrinking savings ratio.

It is possible that the share of the population that had the opportunity to save saw a shift in spending most of its income to consumption of goods and services. At the same time, the outnumbered proportion of the population that had no savings used the opportunity to partially redirect their income towards saving. In this scenario, the savings ratio is decreasing as the overall saving-oriented behaviour remains in place.

Better attitude towards big-budget purchases and saving, coupled with a steadily lower proportion of responses confirming substantially deteriorated financial standing, compared to the 2016 average, provide evidence to the continued stabilisation in consumer sentiment. They are also indicative of potential growth in both consumer spending and the shares of the population having the opportunity to save.

[7] 'Inflation expectations and consumer sentiment'. No 4. April 2017.
[8] Period of survey: 4–11 April 2017.

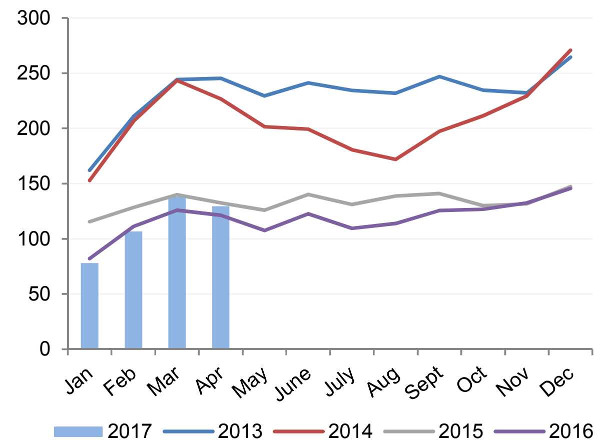
1.2.6. New car sales: the March performance looks set to take hold

- New car sales in April 2017, seasonally adjusted, edged down (-0.1% MoM) but retained a positive lead over the 2016 performance, on track to repeat the 2015 path.
- These robust new car sales data come as another important indicator bearing out the rebounding consumer demand.
- The government-backed favourable credit facilities, if extended into 2017, are poised to buttress the recovery in private consumer demand for new cars.

Sales of new cars have been above the level they registered last year for two consecutive months. According to the Association of European Businesses (AEB), there were 6.9% YoY more light cars sold in April 2017 (Figure 25). Provided that these moderate recovery rates endure, the sector's performance will not be short of analysts' various expectations for a 4% to 11% rise in sales.

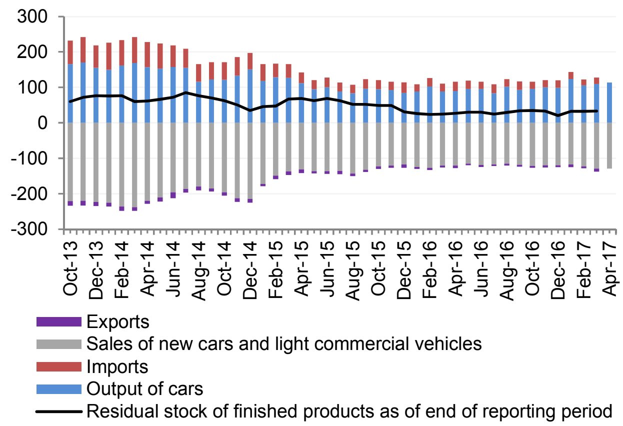
The rebounding demand for new cars observed between the end of the March quarter and the start of the June quarter may be attributed to the fiscal year end with the associated bonus payouts. Seasonal and calendar effect adjustments result in the March volume of sales growing 5.6% MoM, and a slight dip in April (-0.1% MoM) (Figure 26).

Figure 25. New car and light commercial vehicle sales, thousand pieces



Sources: AEB, R&F Department calculations.

Figure 26. Demand (-) and supply (+) components in the Russian auto market, seasonally adjusted, thousand pieces



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

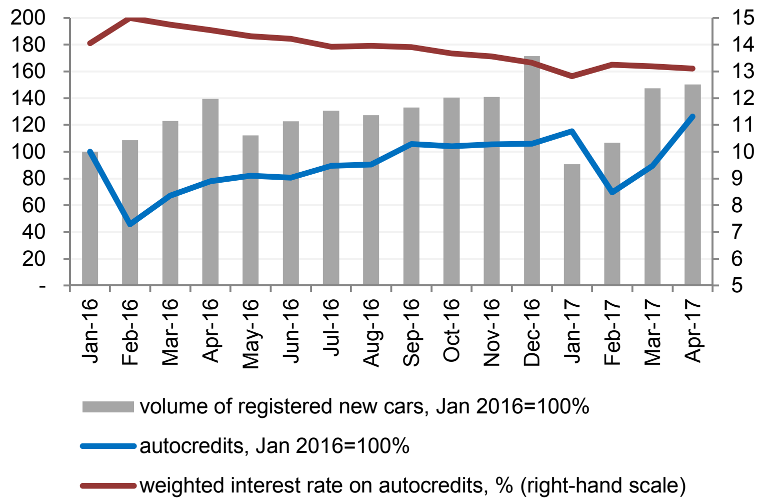
The data enable us to suggest that the strong March data are set to become sustainable, so we are likely to see monthly car sales moving to hit a higher target consistent with the 2015 trajectory - considered as a reference indicator for this year's sale.

New car outputs, following a minor drop in February, have again put in a 3.8% MoM growth, seasonally and calendar effect adjusted. These mixed data may bear out the manufacturers' ongoing efforts to adjust to the emerging demand in the context of a forthcoming recovery in the auto market.

Previously, we spoke on risks related to recovery in the market as are linked to the uncertain effectiveness of new governmental programmes to support the auto industry. The government decided to extend its concessional lending program into 2017, with several changes. These involved the increased maximum car price to partially offset the previous periods' uptick in auto prices and to include several new car makes into the programme. The updated programme however excludes premium car makes as it targets the mass market as a key market growth driver. Additional concessional lending to support the car market is due to amount to approximately 10 billion rubles. According to the RF Ministry of Industry and Trade (Minpromtorg), the programme is expected to generate sales of as many as 350 thousand cars. Considering Minpromtorg's forecast for a 7% market growth, this number will equal to approximately 30% of 2017 sales.

According to Autostat, a research company, of total 2016 car sales (including those sold with concession lending) approx. 40% were sold on credit. Car sales involving loans continued to expand into the first quarter of this year, accounting for 45% of total sales (vers. 38% in 2016 Q1). Economists attribute this expansion in the number of cars sold on credit to the effect of the government support programme. R&F Department analysts believe that the impact of this concessional lending is yet to run its course, and the link between the number of cars sold and the volume of loans extended is set to remain in the future (Figure 27). The Government's decision to extend the programme is expected to be of great importance in the anticipated market recovery in 2017.

Figure 27. Growth rates of car loans extended to individuals (January 2016=100%) and average car loan interest rate, %



Sources: Autostat Info, Bank of Russia.

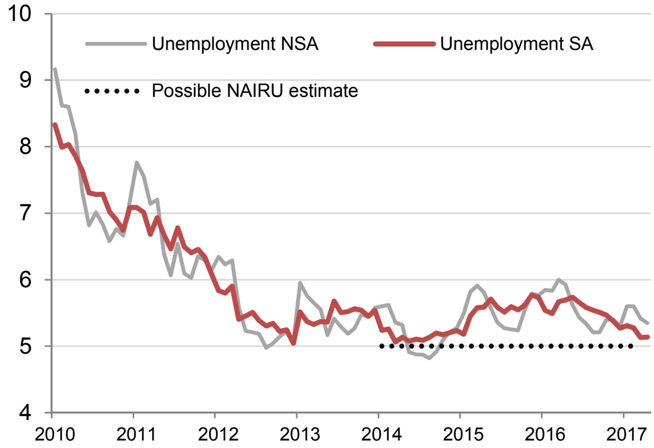
Annualised 2017 Q1 imports were lower 15.3% YoY. The negative imports data are mainly due to the continued localisation processes. These developments include the recent decision taken by KIA to stop car supplies into Russia as it explained that all car models were now assembled domestically. Exports have been on the rise since the start of the year; however, they remain lower than the 2013–2014 average: the expansion for the period between January and March totalled 28%, mainly on the back of non-CIS destinations (up 2.5 times). This period saw sales of Lada to EU countries rise 63.1% YoY (Germany, Hungary and Bulgaria).

1.2.7. Unemployment stays low as economic activity goes down

- Seasonally adjusted unemployment rate hardly changed in April, holding at a low level.
- Labour force participation is declining progressively; this is most likely explained by demographic factors.
- The employment structure is shifting towards shrinkage in the number of employees in large and medium-sized enterprises and a growing payroll of small businesses, as well as employment by sole proprietors and individuals.

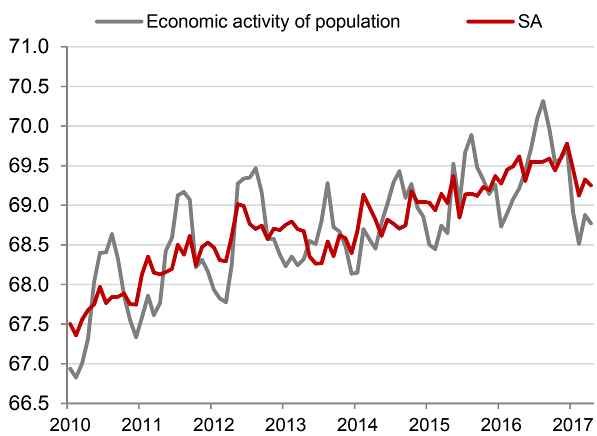
Joblessness dropped to 5.3% in April (it stood at 5.4% in March). Seasonally unadjusted, this indicator remained almost unchanged (Figure 28). Labour force participation continued to go down to 69.25%[9] in April after a spike last December (Figure 29). A drop in seasonally adjusted unemployment to 5.1%, which we consider to be close to the natural rate, signals that there is no output gap in the economy. In terms of monetary policy, such developments do not call for additional policy easing to back up economic growth, enabling the Bank of Russia to focus on the delivery on the inflation target.

Figure 28. Unemployment, %



Sources: Rosstat, R&F Department calculations.

Figure 29. Labour force participation, %



Sources: Rosstat, R&F Department calculations.

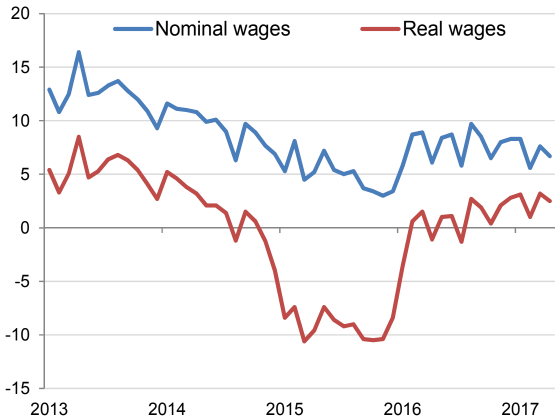
The seasonally adjusted number of the employed and unemployed shows considerable volatility. Therefore, we used year-on-year data to analyse the

[9] Seasonally adjusted.

developments in the labour market. April saw an accelerated shrinkage in economically active population from 0.3% to 0.7% YoY, whereas the number of those employed remained almost unchanged compared with last April's readings. Accordingly, jobless numbers dropped by 10%, being a key factor behind the decrease in labour force participation (0.4 pp as against the April 2016 readings). Information about labour force participation by age is currently unavailable but the drop in labour force participation is likely to have stemmed from demographic changes and lowering employment in older-age groups.

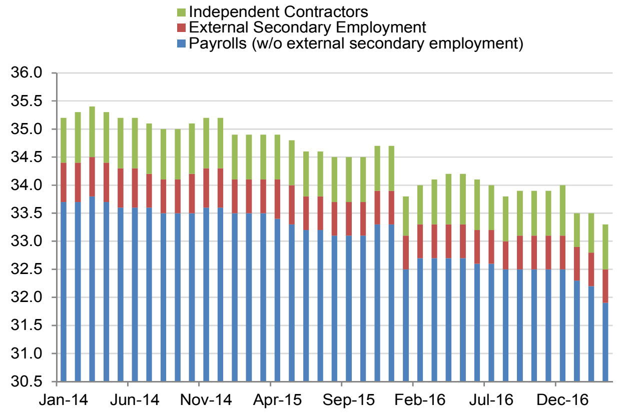
As the number of the employed remains relatively stable, the employment structure changes depending on the size of business. In March, full-time equivalent (FTE) positions in organisations other than small businesses totalled 33.3 million, the lowest on record (Figure 31). It may result from the shrinking number of large and medium-sized enterprises: a 30% contraction since 2010. Labour freed up from large and medium-sized enterprises moved either to small and micro-organisations or switched to self-employment.

Figure 30. Nominal and real wages, % YoY



Source: Rosstat.

Figure 31. FTEs in organisations, million people



Source: Rosstat.

The shift in the employment structure towards small businesses may have an adverse effect on the representation of nominal wages which are calculated by Rosstat on the basis of reports from large and medium-sized businesses. We can find a confirmation of this assumption if we compare an average salary in large and medium-sized enterprises with Rosstat's wage estimates based on the calculations supplemented with data on wages of those employed by sole proprietors and individuals. In the first quarter, the former stood at 36,664 rubles whereas the latter was 32,594 rubles or 11.1% lower. Moreover, growth in the expanded wage indicator is likely to have been lower.[10] It may explain a more constrained increase in household money income compared with growth in nominal wages.

[10] The expanded wage indicator grew 6.4% YoY in 2016 whereas the indicator calculated for large and medium-sized businesses added 7.8% YoY.

In April, annualised growth in nominal wages fell from 7.6% to 6.7% (Figure 30). Lower growth in nominal wages also affected real wages where the growth rate dropped from 3.2% to 2.5% YoY. At the industry level, the lowest growth was registered in public administration (2.4%), because wages of public sector employees were not indexed. The highest wage growth was registered in agriculture (10.3%), manufacturing (9.9%) and construction (9.6%), i.e. sectors with below-average wages. The average wage growth in sectors with below-average wages stood at 8.5% (6.5% for sectors with higher wages). It suggests that the gap between wages is narrowing across sectors.

1.3. Global economy, financial and commodity markets

1.3.1. Global economy: the US monetary authorities are gearing up for the next tightening

- Leading foreign central banks left the key parameters of their monetary policies unchanged at their meetings held in April and May.
- However, the market is preparing for a June rate hike by the US Fed and likely policy tightening in the UK.
- The April statistics highlight a domestic demand-driven slowdown in the Chinese economic growth.

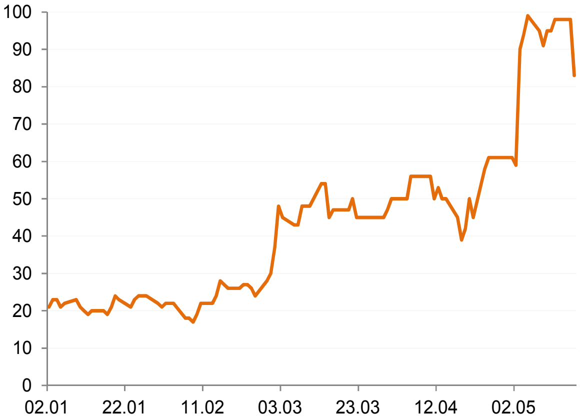
USA: the market is preparing for a June hike in the federal funds rate

The US Fed expectedly maintained its key rate at the meeting on 2-3 May. The regulator described the slowdown in GDP growth in 2015 Q1 as temporary and caused by slack consumer demand which may well rebound as early as this quarter. According to the regulator, as monetary policy gradually normalises, the economy will continue to grow moderately, the situation in the labour market will improve and inflation will stabilise at 2%.

The tonality of the regulator’s press release does not rule out a rate hike at the pivotal meeting in June. At the moment, its probability consistently exceeds 80% (Figure 32). The US Fed’s meeting in May boosted confidence in rate increase (to almost 100%) which was, however, undermined by the release of weak inflation data. In April, headline inflation stood at 0.2% MoM or 2.2% YoY, the lowest since 2017. The core CPI was at its lowest since October 2015, standing at 0.1% MoM or 1.9% YoY. Significantly, the rate hike in June may well prove to be the only revision throughout 2017. The market estimates the possibility of a double increase projected in the Fed’s current forecasts at roughly 30% (Figure 33).

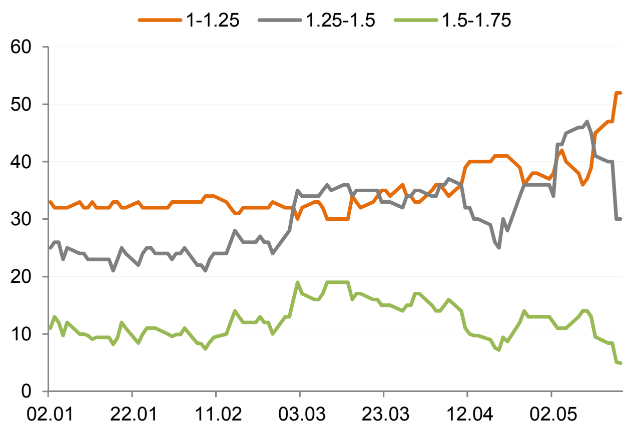
In April, US non-farm payrolls added 211 thousand jobs instead of 190 thousand forecast earlier. Job creation dispelled doubts about the slack March data (+79 thousand), which was attributed to the weather factor. Unemployment dropped to 4.4%, well below the Fed's estimate of the natural jobless rate (4.7%). The U6 unemployment rate fell from 8.9% to 8.6%, persisting at above the pre-crisis readings. The 0.3% MoM increase in hourly earnings added to the upbeat sentiment.

Figure 32. Prospects of the federal funds rate hike to 1.0-1.25% at the US Fed's June meeting



Source: Bloomberg Finance L.P.

Figure 33. Federal funds rate by end-2017



Source: Bloomberg Finance L.P.

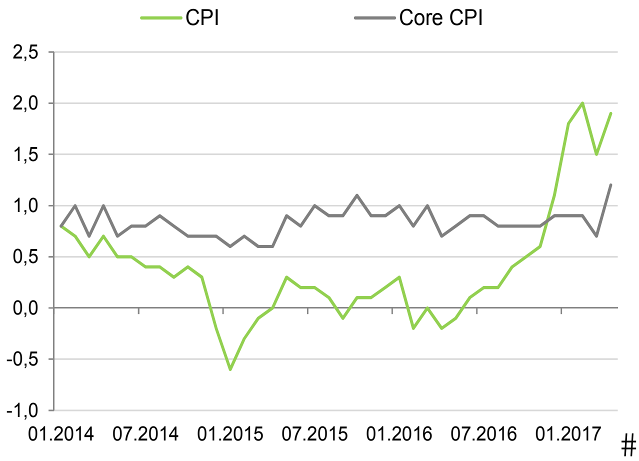
Eurozone: the ECB is to stick to its policy stance in the near future

The ECB's Governing Council left the parameters of its monetary policy unchanged at the meeting on 27 April. In its statement, the ECB confirmed that it 'continues to expect the key ECB interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of the net asset purchases'. Many expected that the ECB would abandon the forward guidance regarding the key rate cut in the evidence of growing economic activity in the Eurozone. Moreover, Mario Draghi admitted that risks surrounding the economic growth outlook moved towards a more balanced configuration. At the same time, the ECB President still tried to persuade the market not to expect a U-turn in the ECB's policy in the near future as inflation pressure is yet to build up.

Flash estimates of April inflation pointed to a temporary nature of the abrupt slowdown in price growth seen in March due to later Easter celebrations this year (in April vers. March in 2016). In April, the CPI grew by 1.9% YoY (1.5% YoY in March) while the core CPI accelerated to 1.2% YoY, the highest reading since June 2013 (Figure 34). The data were released the day after the meeting but they are unlikely to affect the ECB's stance on its monetary policy. Whereas March inflation underestimated real inflationary pressure in the economy, April inflation seems to overestimate it. Annualised inflation is very likely to have held close to 1.0%, considerably undershooting the ECB's target.

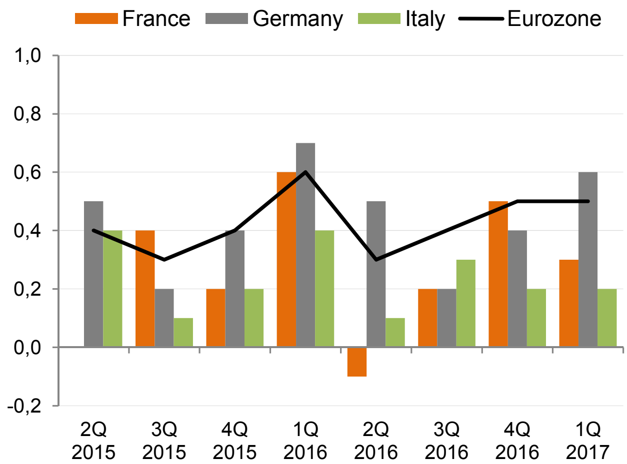
The Eurozone's GDP growth in the first quarter of 2017 remained at the level registered in the fourth quarter of 2016 (0.5% QoQ), though some leading indicators suggested that growth might have increased slightly (Figure 35). Nevertheless, April's growth in the composite PMI to 56.8 pp, a six-year high, as well as business and consumer sentiment data (ESI) fits in with a 0.6-0.7% QoQ economic growth in the second quarter of 2017.

Figure 34. Inflation in the Eurozone, % YoY



Source: Bloomberg Finance L.P.

Figure 35. GDP in the Eurozone, % QoQ



Source: Bloomberg Finance L.P.

Japan: will the temporary outperforming GDP growth ensure the 2% inflation?

At its meeting on 26-27 April, the Bank of Japan left key parameters of its monetary policy unchanged. The minor revisions applied only to the macroeconomic forecast – the regulator became more sanguine about economic growth in 2017-2018. Furthermore, the released statement described the economy with the term *expansion* (instead of *recovery*) for the first time after the 2008 crisis. The BoJ also published its first forecasts for fiscal 2019 (Figure 32).

Outperforming GDP growth[11] will be driven by effective external demand and fiscal stimulus connected with preparations for the 2020 Olympics. The economy will slow down to its potential growth rates in fiscal 2019. However, the regulator believes that this period will be sufficient for inflation to hit the target. Importantly, the core CPI shrank by 0.3 pp YoY in March 2017 after a 0.1% YoY decrease in February 2017. That said, the economy grew 0.5% QoQ or 2.2% in the annualised terms in the first quarter of 2017, overshooting the potential growth rates.

[11] The regulator revised its estimates of potential growth rates from 0-0.5% YoY to 0.5-1% YoY in April 2017.

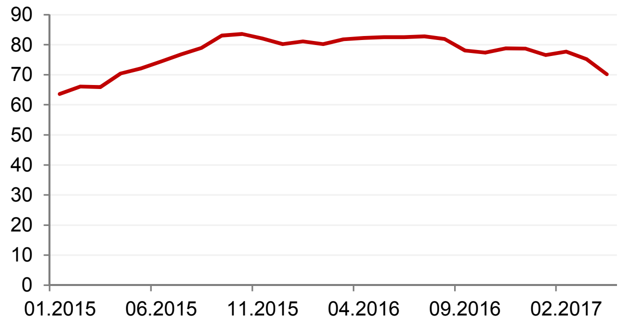
Figure 36. BoJ macroeconomic forecast

	fiscal 2017		fiscal 2018		fiscal 2019
	apr.17	jan.17	apr.17	jan.17	apr.17
GDP	1,6	1,5	1,3	1,1	0,7
Inflation	1,4	1,5	1,7	1,7	1,9*

Source: Bank of Japan.

** Net of the increase in sales tax to 10% in October 2019.*

Figure 37. Expansion of sovereign bond portfolio, trillion yen/year



Source: Japan Macro Advisors.

At the press conference in the follow-up to the meeting, Haruhiko Kuroda answered questions about the BoJ's strategy for abandoning QE. Such interest was partially explained by a shrinkage in the value of bonds in the central bank's balance sheet below the projected 80 trillion yen annual pace of expansion (Figure 33). Though the current policy of setting the target for government bond yields at zero makes fixing the rate of expansion of the central bank's balance sheet redundant, markets see its abandoning or deviation as policy tightening. The BoJ governor claimed that it would be premature to speak about abandoning ultra-loose policy. Such speculations would be reasonable when inflation hits 2%.

UK: monetary policy can be normalised faster than the market expects

The Bank of England kept its policy parameters unchanged at the meeting on 11 May. Similar to the previous meeting, one committee member voted for a rate hike. The committee still risks facing more disagreement if inflation accelerates more considerably than expected by the BoE in 2017 (see below).

The Bank of England also updated its macroeconomic forecasts based on a smooth Brexit (Figure 32). The released 2020 Q2 inflation forecast suggests that the regulator expects inflation to be overshooting the target during the whole forecast period. Nevertheless, such overshot is a downright result of depreciation of the pound. The Bank of England believes it unreasonable to use monetary policy measures to offset it because of the high cost for the economic growth and income. Meanwhile, Mark Carney said at the press conference that monetary policy might be tightened faster than the market expected if the economic developments were in line with the forecasts (Figure 33).

It is noteworthy that the economy performed worse than expected in the first quarter of 2017. GDP added only 0.3% QoQ after 0.7% QoQ seen in the fourth quarter of 2016 and given the expectations of a 0.5% QoQ increase. The slowdown stems primarily from the weakening of consumer demand triggered by a drop in real wages. In addition, March registered a 0.5% MoM drop in industrial production, primarily manufacturing (-0.6%

MoM) and construction (-0.7% MoM). Nevertheless, PMI and some other leading indicators suggest that the economy may accelerate slightly as early as the second quarter of 2017.

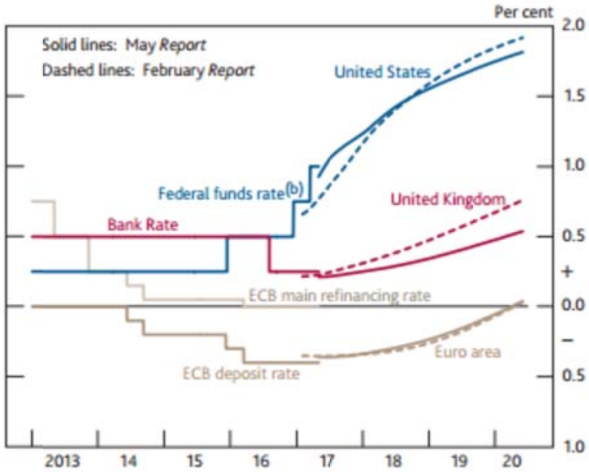
Figure 38. BoE macroeconomic forecast

		GDP, % yoy	CPI*, % yoy	Unemployment*, %
2017	May 17	1,9	2,7	4,7
	Febr.17	2	2,4	4,9
2018	May 17	1,7	2,6	4,7
	Febr.17	1,6	2,8	5,0
2019	May 17	1,8	2,2	4,6
	Febr.17	1,7	2,5	4,9
2020	May 17		2,3	4,5

Source: Bank of England.

** As of the end of the second quarter.*

Figure 39. Expected path of monetary policy normalisation

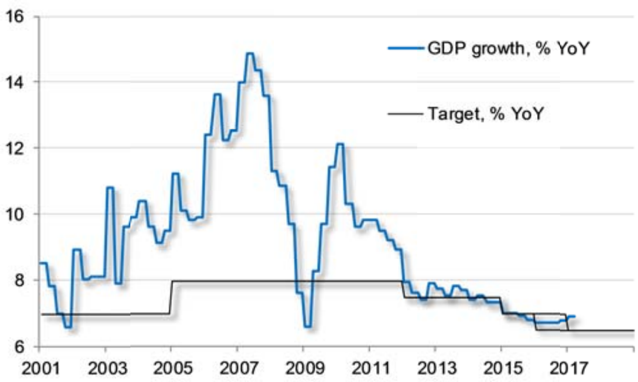


Source: Bank of England.

China: economic growth is slowing down

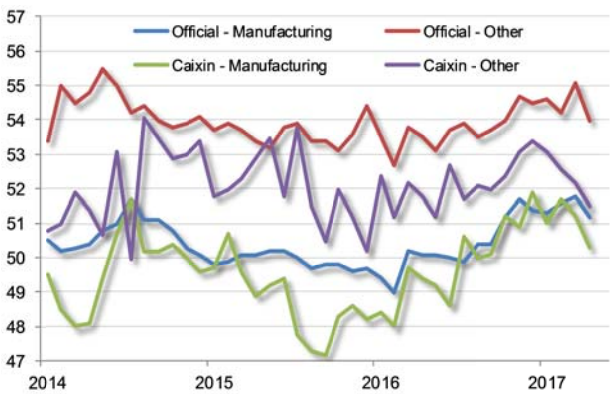
The Chinese economy closed the first quarter in a buoyant mood. Strong macrostatistics in March pushed Q1 GDP growth up to 6.9% YoY. This exceeded the 2016 Q4 readings (6.8% YoY), analysts' expectations and the official target (Figure 40). One of the factors behind the high growth was considerable increase in budget expenditure (22.0% YoY). It resulted in the first budget deficit (0.9% of GDP) in Q1 since 1995.

Figure 40. China's GDP growth targets and official statistics



Source: Bloomberg Finance L.P.

Figure 41. China's PMI



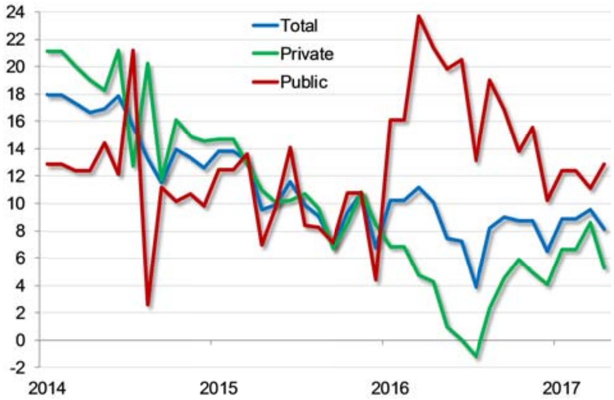
Source: Bloomberg Finance L.P.

However, the second quarter started with a slowdown: April's macroeconomic data proved to be worse than expected and undershot the previous months' readings. All PMI indicators dropped considerably. Aggregate orders largely shrank due to the domestic demand (Figure 41). Growth in industrial production slowed to 6.5% YoY, after 7.6% YoY seen in March due to production of key consumer goods (Figure 42). Retail sales growth pace also declined to 10.7% YoY. Growth in fixed capital investment slowed down (Figure 43).

Figure 42. Industrial production, retail sales and Bloomberg monthly estimate of Chinese GDP

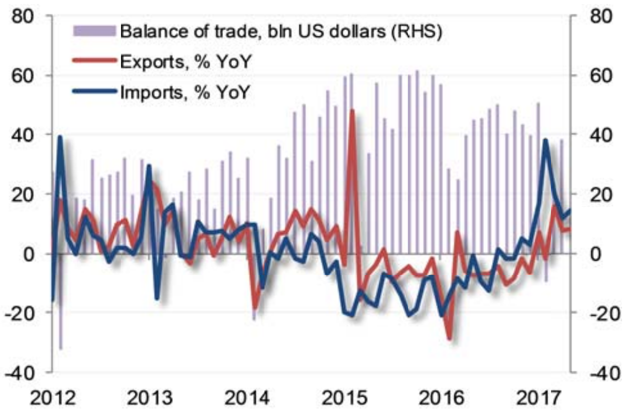
Source: Bloomberg Finance L.P.

Figure 43. Fixed capital investment in China



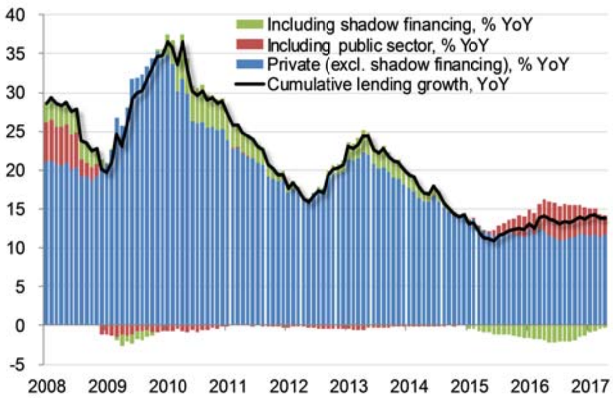
Sources: CEIC, R&F Department calculations.

Figure 44. China's foreign trade



Source: Bloomberg Finance L.P.

Figure 45. Lending in China



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

Foreign trade statistics were another indicator of slowing domestic demand (Figure 44): growth in imports in value terms[12] slowed to 18.6% YoY (26.3% YoY in March, 34.1% YoY in January-February). It is partially explained by a slight decrease in import prices. However growth in physical volumes of key imports also turned out lower than in previous months.

Domestic demand is also considerably slowed down by a decline in budgetary support: in April, growth in expenditures slowed to 3.8% YoY. Meanwhile, the People's Bank of China keeps tightening its monetary policy. However, its impact on the lending

[12] In renminbi.

growth rate in China is restrained because of the ongoing recovery in shadow financing, among other things (Figure 45).

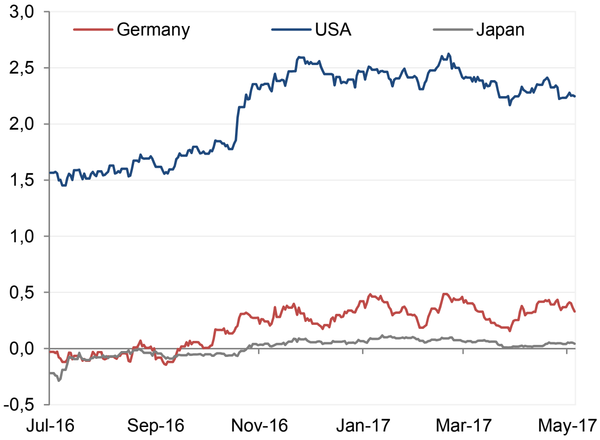
1.3.2. Volatility of global markets is at its lowest

- The US dollar returned to the level last seen in November as expectations were fading that Donald Trump would be fast to launch stimulus.
- Volatility indicators dropped to a low unseen since late 2006.
- The response of Russian markets to the rate cut by the Bank of Russia was restrained but predictable. Overall, the local bond market stabilised after a buoyant growth in March and April.
- Money market forward rates are based on the assumption that the Bank of Russia's rates will be reduced by 1 pp in the next three to six months.

Global markets

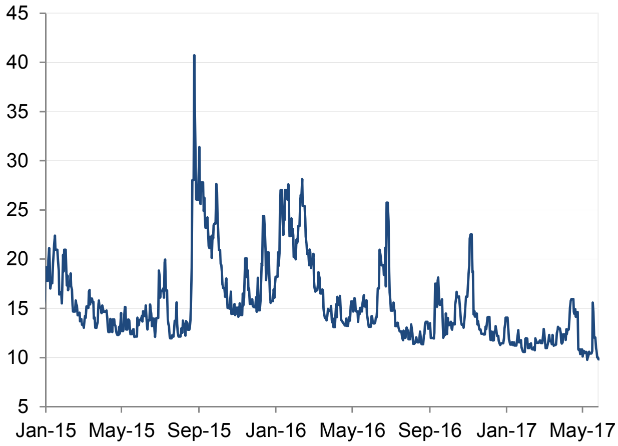
In May, the exchange rate of the US dollar continued to depreciate, most pronouncedly against emerging market currencies. This was largely caused by a revised outlook for fast reforms and the launch of stimulus projected by Donald Trump (Figure 49). As a result, the US dollar index (DXY) dropped to the level seen before the November elections in the US. Volatility surged in the middle of May because of growing tensions between the US president and the Congress (Figure 47). However, such response proved short-lived and the volatility index (VIX) dropped back to its lowest since late 2006 by the end of the month.

Figure 46. 10-year bond yields of advanced economies, %



Source: Bloomberg Finance L.P.

Figure 47. Volatility index (VIX)

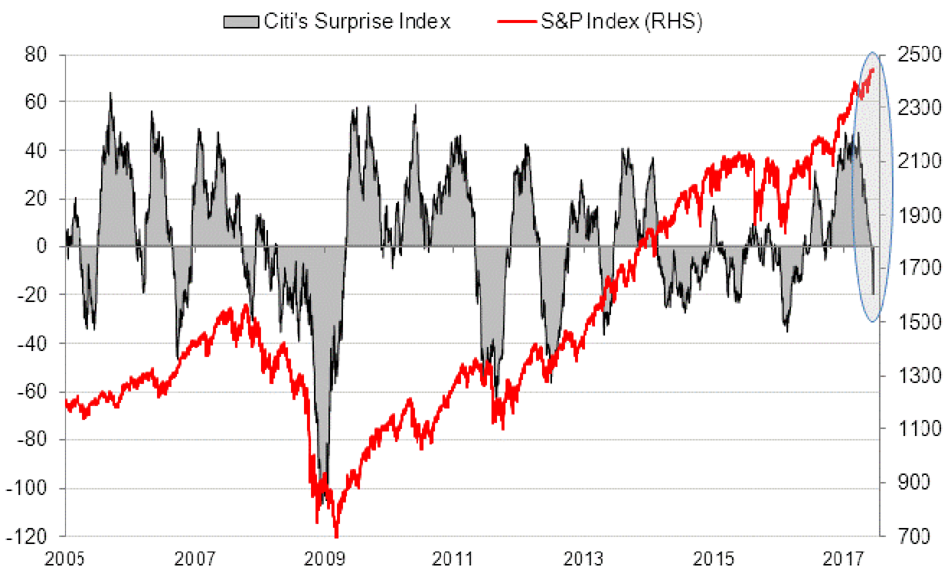


Source: Bloomberg Finance L.P.

Stock indices hit their historical records in May in defiance of growing expectations of normalisation in the US monetary policy, the economy's approaching to its potential level, and abating expectations concerning the scale and pace of stimulus launch by the new US president. For example, the S&P 500 index is set to grow for the seventh month in a row. Having said that, the performance of the index has been deviating from micro surprise indices in emerging economies in the past couple of months (Figure 48). Such deviations are, certainly, not unusual and do not always lead to an adjustment or a downturn in the stock market. However, such risks, capable of spurring volatility growth in global markets, should not be ignored.

Short-term spikes in volatility and growing political risks in some countries (both advanced and emerging economies) failed to interrupt a nearly-six-month investment inflow to the funds focused on emerging markets (Figure 50). In the first five months of 2017, cash inflow to emerging market funds exceeded $60 billion, with bond funds enjoying a slightly higher investment. Russia-focused funds received $4.5 billion, of which two thirds were invested in the bond market. Emerging market assets continue to enjoy buoyant demand from investors despite the expected normalisation of the US monetary policy. *On the one hand*, this helps mitigate negative effects of recurrent volatility surges in global markets. *On the other hand*, there is a place for volatility growth in domestic markets if capital flows start to reverse.

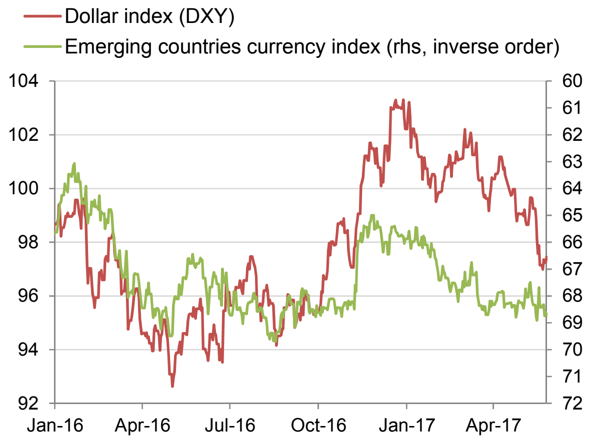
Figure 48. S&P 500 and Citi's Surprise Index



Source: Bloomberg Finance L.P.

Global markets failed to give a pronounced response as Moody's revised China's rating downwards. Chinese local stock and bond markets first sank but rebounded by the end of the week. Late May saw quite pronounced appreciation of the Chinese renminbi against the US dollar. Many market participants attribute it to the PBC's interventions and the announced introduction of countercyclical component in the renminbi fixing mechanism which may add to the measures to check downward pressure on the renminbi.

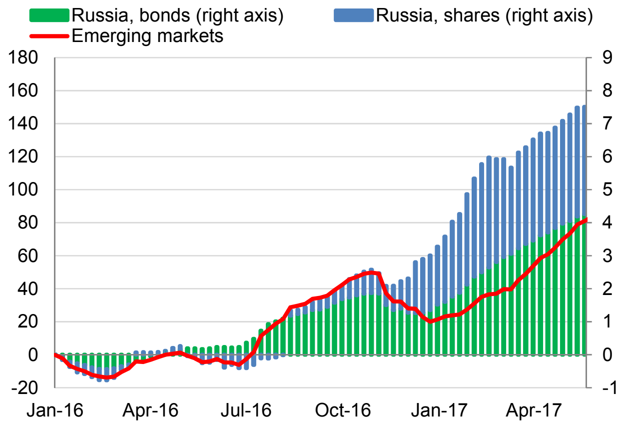
Figure 49. Foreign exchange rates



Source: Bloomberg Finance L.P.

** Growth means appreciation of the US dollar against other currencies.*

Figure 50. Cash inflow to investment funds, accrued since early 2016, billion US dollars



Source: EPFR.

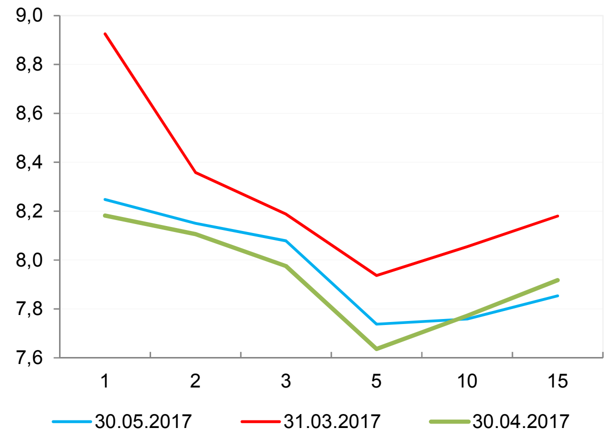
Russian markets

Forecasts by most market participants failed to predict that the Bank of Russia would cut its key rate by 50 bp at the end of April after it had reduced it by only 25 bp at its March meeting. A Bloomberg-conducted consensus survey of bank analysts suggested that the key rate would be reduced by only 25 bp to 9.5% in April. The response of the financial market to such rate cut was overall restrained but predictable. The ruble’s exchange rate grew by less than 1% against the US dollar within an hour after the decision was announced to subsequently adjust downwards. The stock market experienced a similar movement whereas the debt market responded positively. Yield on medium- and long-term OFZ (maturity of 5-15 years) dropped by 8-13 bp. The most pronounced decline was in the yields of 10-year OFZs mostly held by non-residents. At the short end (up to two years) rates changed immaterially during the day.

In May, 5-year OFZ yields rose slightly whereas yields of longer maturity bonds declined. The yield curve remains unconventional (Figure 51). That said, in the middle of May yields of Russian government bonds hit a low unseen since the second half of 2013. Yields of corporate bonds stabilised in May after a considerable drop in March and April (Figure 52).

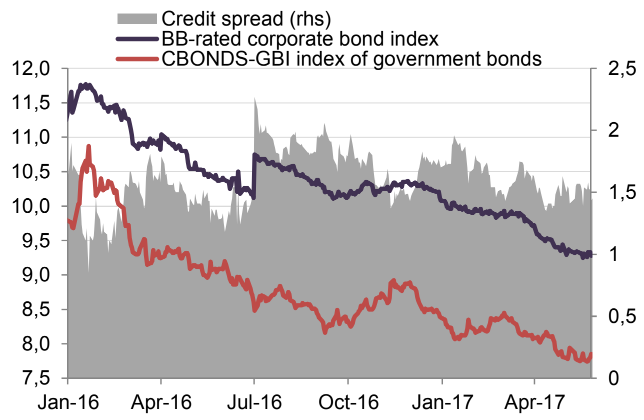
Money market forward rates show interesting dynamics (Figure 51). The negative spread between FRA 3X6 and 3M Mosprime expanded to 1 pp. It means that markets expect the Bank of Russia to cut its rates by 1 pp within the next three to six months, earlier than projected by financial analysts in the May consensus forecast.

Figure 51. OFZ yield curve, %



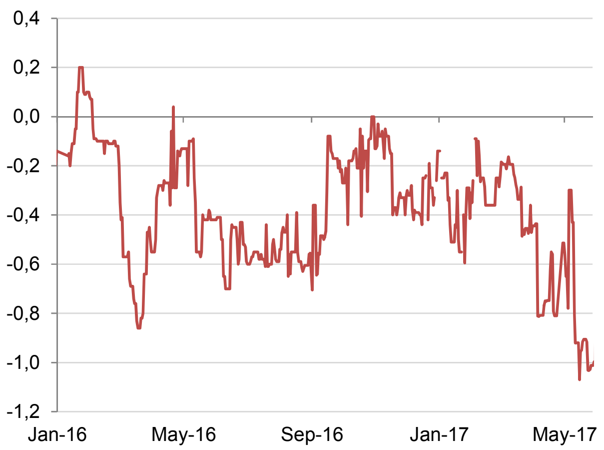
Source: Moscow Exchange.

Figure 52. Ruble bond yields, %



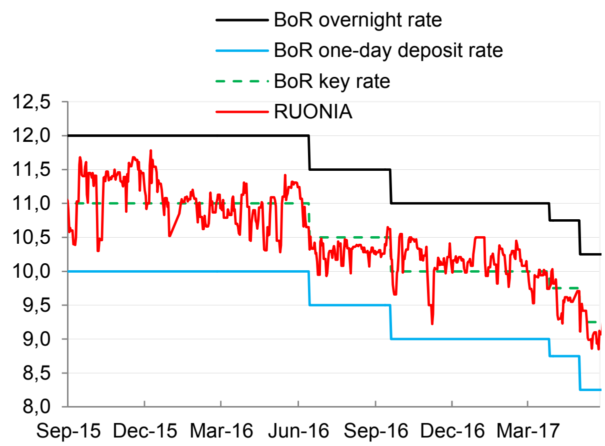
Source: Cbonds.

Figure 53. FRA3X6 and 3M Mosprime spread, % p.a.



Source: Bloomberg Finance L.P.

Figure 54. BoR interest rate corridor and short-term interbank lending rate, % p.a.



Sources: Bank of Russia, Bloomberg Finance L.P.

1.3.3. Commodity markets: oil prices fell despite the extended agreement to cut production

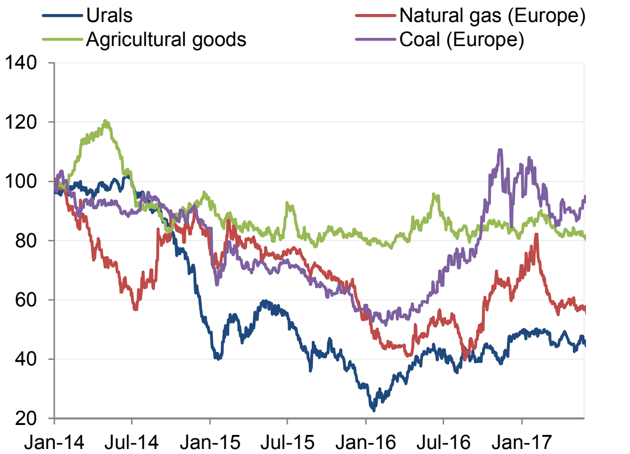
- Oil exporting countries continued to improve compliance with the production cut agreement and extended it until 1 April 2018…
- …However, oil prices dropped as investors are concerned that the agreement is not efficient enough and a new price war may be unleashed when it expires.
- Leading international organisations worsened their estimates of the fossil fuel market but the International Energy Agency still expects inventories to shrink considerably in the forthcoming months…

- …However, this is not yet confirmed by the US high-frequency data because of the ongoing increase in net oil imports despite the seasonality.
- After a surge seen in March and April, oil production in the US keeps growing though at a slower pace…
- … and the inflow of labour to service companies may boost shale oil production as suspended wells could be put on stream.

In April and May prices of most commodities and metals dropped (Figure 55 and Figure 56). Oil prices shrank by up to 5% and the Bloomberg Commodity Index fell by 3%.

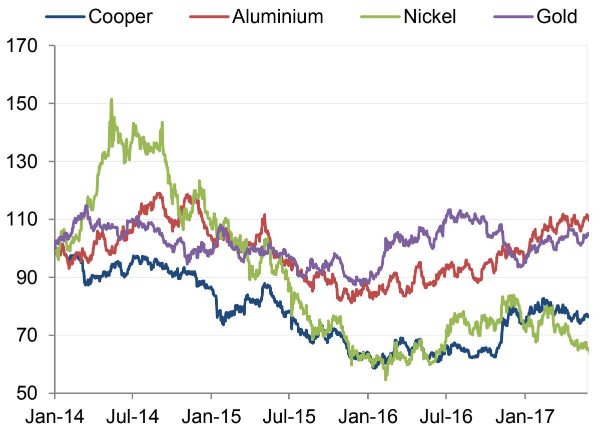
Oil exporting countries extended the agreement to cut oil production for another nine months until 1 April 2018. Bloomberg estimates based on data of the US Energy Information Administration (EIA) suggest that this period should be sufficient to deliver on the agreement objective of bringing oil inventories of OECD countries to their five-year average (Figure 59). Estimates by Goldman Sachs also suggest that the objective is achievable even if the exporters slightly violate their quotas.

Figure 55. Commodity prices (January 2014 = 100)



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

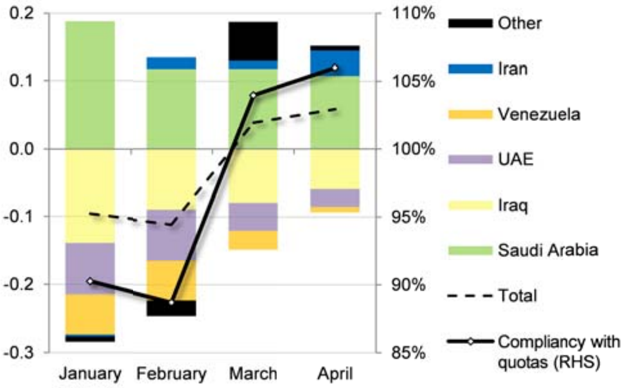
Figure 56. Metal prices (January 2014 = 100)



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

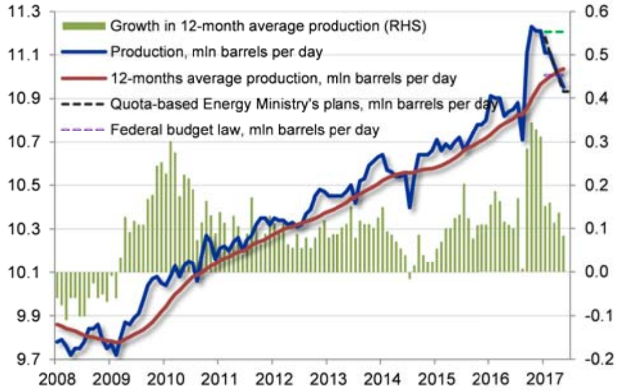
However, the announcement of this decision pushed the price of oil downwards as investors had expected more resolute steps. The agreement was merely tightened by the accession of Equatorial Guinea, a new OPEC member. This 'dwarf' oil producer (with its output of 0.3 million barrels a day) has a minimum contribution to efficiency of the agreement. Investors reasonably fear that the agreement's efficiency will be further undermined as exports shrink less against lower output and shale oil production expands.

Figure 57. OPEC[13] countries' deviation from their quotas ('+' stands for output cut in excess of requirements) (million barrels a day)



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

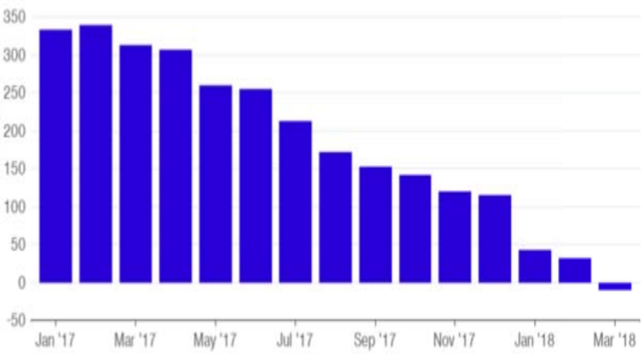
Figure 58. Oil production in Russia



Sources: Bloomberg Finance L.P., Russian Ministry of Energy, R&F Department calculations.

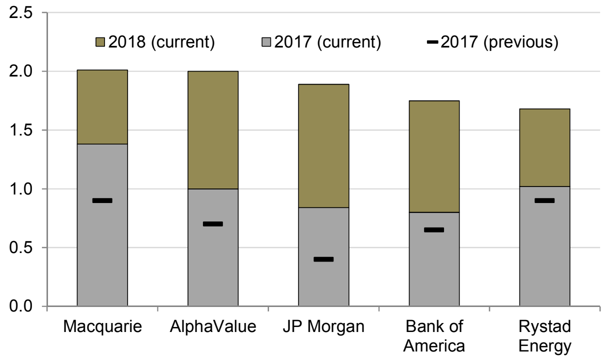
Bloomberg data suggest that OPEC members enhanced their compliance with the quotas to 106% in April (Figure 57). By the month-end, Russia cut its production to 0.3 million barrels a day compared with October 2016 (Figure 58). At the same time, the comparison of different estimates[14] allows us to conclude that by May daily output shrinkage of 1.6 million barrels a day by the member countries was offset by about 30% by the increase in exports through inventory sales by Saudi Arabia and Iran, and by 35% by extended production in the US (against the start of the year). Bloomberg-provided analysts' estimates suggest that the ongoing increase in shale oil production in the US may reduce the agreement's efficiency by another 20-50% throughout the year (Figure 60). Recovering oil production in Libya and Nigeria is likely to exert additional pressure.

Figure 59. Oil inventories in OECD countries in excess of their 5-year value as the agreement to cut oil production remains effective, million barrels



Source: Bloomberg Finance L.P.

Figure 60. Forecasts of shale oil production in the US, December-on-December, million barrels a day



Source: Bloomberg Finance L.P.

Moreover, investors gave a negative response to the exporters' failure to outline their plans beyond the first quarter of 2018. We believe that it was done intentionally in

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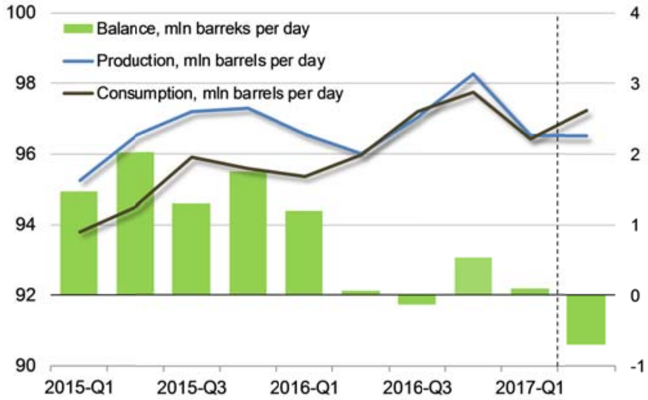
[13] Data for countries covered by quotas (excluding Libya and Nigeria).
[14] Bloomberg Finance L.P., EIA, Energy Aspects and JODI.

large part. Such uncertainty allows avoiding the situation when the futures curve switches to a contango shape.[15] This should hamper the expansion of activity of shale companies and hedging growth.

We suppose that the agreement was extended on the current conditions in order to target an excessively high oil price — the above-average price that makes shale oil production in the US profitable (roughly $50 a barrel[16]) — and it will boost production beyond 2017. Nigeria's oil minister Emmanuel Ibe Kachikwu and Russia's energy minister Alexander Novak indirectly confirmed that the agreement was aimed at targeting the price of oil at $50-60 a barrel. Investors are concerned about a new price war and a possible drop in oil prices to $30 a barrel as they expect the production of shale oil to be expanded and assume that traditional oil producers will not accept the loss of a market share, given the developments of the past years.

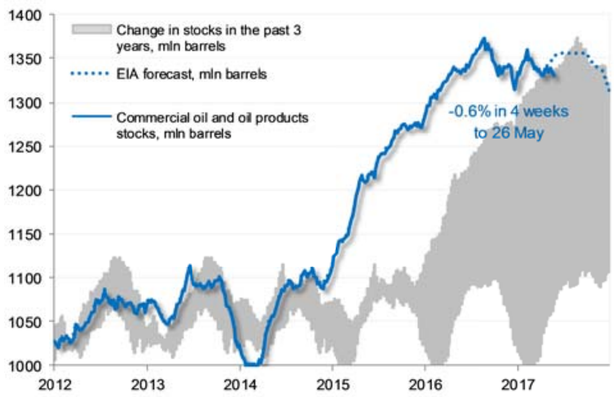
We expect that after the first quarter of 2018 traditional oil exporting countries — exposed to the risk of a new oil glut and, subsequently, a new surge in inventory accumulation – will enter into another agreement on softer terms compared with the effective one. This can help anchor the Urals crude price at $45-50 a barrel.

Figure 61. IEA estimates of key indicators of liquid fuel market



Source: IEA.

Figure 62. US commercial oil and oil product stocks



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

Key international organisations (the International Energy Agency (IEA), OPEC and the US Energy Information Administration) revised their estimates of the situation in the liquid fuel market downwards in their monthly reports in May. The reporting months of 2017 still register a relatively weak demand, especially in India and the US. The forecast for the rest of 2017 (and 2018 by the EIA) provides for an upward revision of production of, primarily, shale oil, compared with consumption (Figure 61). That said, the IEA believes that the market is attaining equilibrium and inventories will shrink considerably in the upcoming months.

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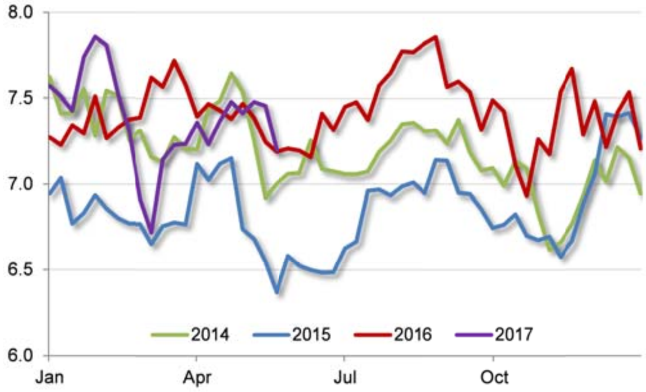
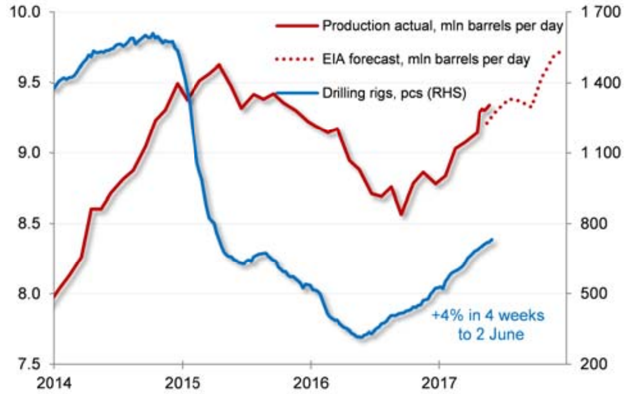
[15] The futures price is higher each month than in the previous month.
[16] See Section 1.3.3. 'Commodity markets: how sustainable is the growth in shale oil output?', Talking Trends, April 2017 (No. 3 (15)).

Figure 63. 4-week average volume of net oil imports in the US, million barrels a day



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

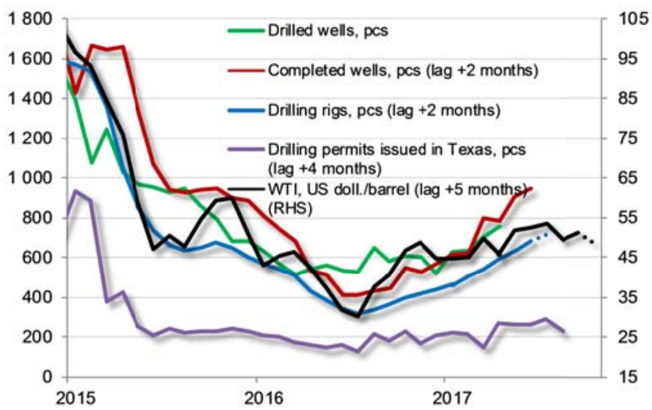
Figure 64. Oil production and number of operational drilling rigs in the US



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

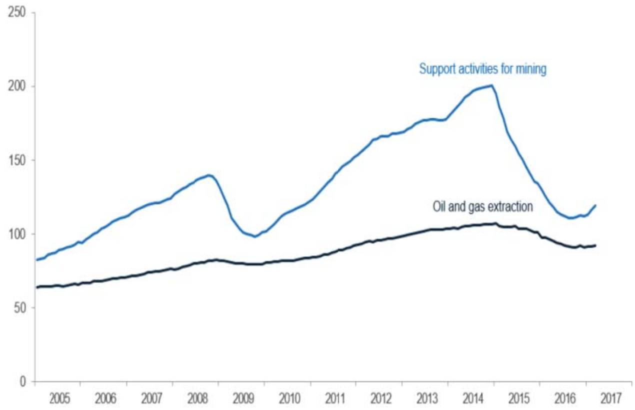
However, high-frequency data on the US oil sector still point to an oil glut. Total commercial oil and oil product inventories hardly shrank in the US in the period between April and May (Figure 62). Net oil imports to the US has been growing, reaching its highest level in the past years in May and failing to decline in line with seasonality (Figure 63).

Figure 65. Key indicators of the US shale industry with estimated lags in WTI prices[17]



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

Figure 66. Employment in production and service oil and gas companies in Texas (USA), thousands people, seasonally adjusted



Source: Dallas Fed.

Having surged, as we expected, in March and early April,[18] oil production in the US keeps growing, though at a much slower pace (Figure 64). Growth in the number of drilling rigs is also decelerating but remains significant. Having said that, the industry's output has been below the potential level for several months: starting from March, the number of wells put in operation has been inferior to the number of those drilled two months earlier (Figure 65). Bloomberg Markets points to a considerable deficit of service crews putting wells in operation. It results in a growing number of drilled but uncompleted

[17] Ibid (lag estimates).
[18] See Section 1.3.3. 'Commodity markets: risks that oil glut will persist remain elevated' Talking Trends, February 2017 (No. 1 (13)).

wells. This is confirmed by the employment statistics from oil and gas companies of Texas, the key oil region in the US (Figure 66). However, we assume that since oil exporting countries extended the production cut agreement for a relatively long period and seek to anchor relatively high oil prices close to the current level, the inflow of labour to shale service companies will increase (return of the old and hiring new service crews). This may allow producers to cut their costs (insufficient competition between rig crews pushed prices for their services upwards) and foster further increase in oil production.

2. Outlook: leading indicators

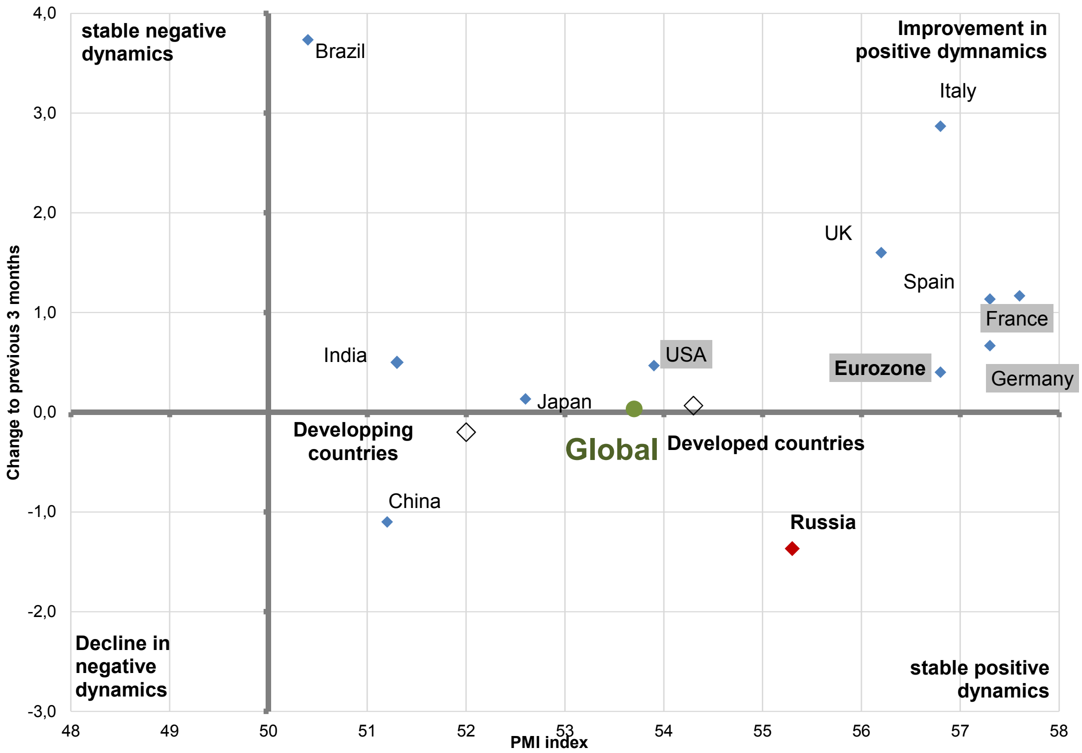
2.1. Global leading indicators

2.1.1. Global PMIs: stabilisation in global economic growth

The most recent PMI figures (Figure 67) are indicative of a stabilisation in global economic growth and, in particular, an optimistic global growth outlook for major advanced economies. Global PMI for April 2017 at 53.7 pp was unchanged from March. This steadiness in the overall indicator shows up faster growth in business activity in the US, the Eurozone and the UK, while slowdown is being recorded in Japan and several major developing markets. It is also of interest that the period between April and May saw Brazil return to growth territory, after 25 months of worsening in its economic conditions.

The divergence between data in the advanced economies was drawing to a close. The composite PMI index rose across the US, the Eurozone, and the UK, signalling a stronger outlook for faster growth in advanced economies in 2017 Q2.

Figure 67. Composite PMI for April and change on the February to April average



Sources: IHS Markit, Bloomberg Finance L.P.

The Eurozone's composite index was up from 56.4 to 56.8 pp, a six-year high. The material improvement in market conditions was shown by both the manufacturing sector and services and came with a nearly record expansion in employment in the past 10 years. Corporate optimism is supported by robust figures for new orders, including export data. Beyond that, businesses continued to note growing inflationary pressures weighing on input prices as it was showing up in output prices, a key factor to consider for the Eurozone.

PMI in the US climbed to 53.2 pp from to 53 pp as it suggested a halt in economic activity slowdown observed over the last six months. However, 2017 Q1 indicator was below average.

2.2. What do Russian leading indicators suggest?

2.2.1. GDP nowcast and forecast: the outlook for faster growth remains

- Our recent GDP nowcast for 2017Q2 is *0.5% QoQ* SA, which is slightly above the April reading.
- The forecast for 2017Q3 is *+0.5% QoQ SA and +0.4 – 0.5%* QoQ SA for 2017 Q4 (seasonally adjusted).
- Our calculations find quarterly GDP growth rates to have further room for improvement, which is mainly aligned with positive readings of several key leading indicators alongside the continued moderately favourable external environment.

	May 2017	April 2017
	% QoQ SA	% QoQ SA
2017 Q2	0.5	0.5-0.6
2017 Q3	0.5	0.5
2017 Q4	0.4-0.5	–

3. In focus. Sustainability of fixed capital investment

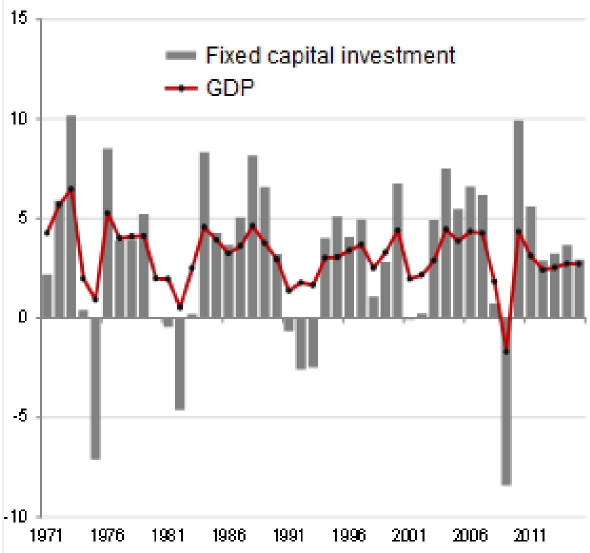
- Payments of external corporate debt peaked in 2014-2015 and are now mostly behind, leading to new investment resources being released in the economy.
- As the Russian economy is going through the final stages of its adjustment to structural change, the tradable sector's competitiveness remains in place, in a sign of solid prospects for growth in production, exports and fixed capital investment.
- Considering that the Russian economy may have closed in on its potential targets, growth acceleration is impossible without, primarily, high quality investment, which takes time to attract.
- The Bank of Russia's moderately tight monetary policy does not impede a recovery in fixed capital investment; rather, the regulator's policy promotes such recovery as its credibility with market players is growing stronger.
- The potential efforts to spur investment activity through a drastically loosened monetary policy stance would certainly fail to give rise to sustainable and long-term economic growth. The key downsides of such measures, if enacted, would include growing risks of financial bubbles spreading across financial markets, a shift in resource allocation towards inefficient sectors, as well as persistently higher rates of inflation and inflation expectations.

In recent years, the rates of global investment expansion have been below the historical average, essentially matching global economic growth (Figure 68). Many multinational corporations have faced growing political risks and uncertainty, which forced them to postpone and even cancel new project investment. The 2014 slump in oil and other commodity prices triggered a decline in investment across the extractive industry.

Nonetheless, more recently, signs of a rebound have emerged in investment activity (Figure 69). These are to a large degree due to the low base effect of the last few years, as well as equipment upgrade pressures, rather than plans for new business development. The other factor that could have indirectly led to faster investment growth is growing amounts of borrowings on global debt markets amid expectations for higher interest rates in the US and globally. In recent years, corporate borrowers preferred to direct borrowings towards repurchase of their own stock or to fund mergers and acquisitions; however, it seems highly probable at this point in time that some of such funds were also allocated to expand investment.

The movements in fixed capital investment in Russia are in many ways tracking the global trend; the drivers of these two are however different.

Figure 68. Global GDP growth and fixed capital investment, % YoY



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Source: World Bank.

Figure 69. Global investment activity

#

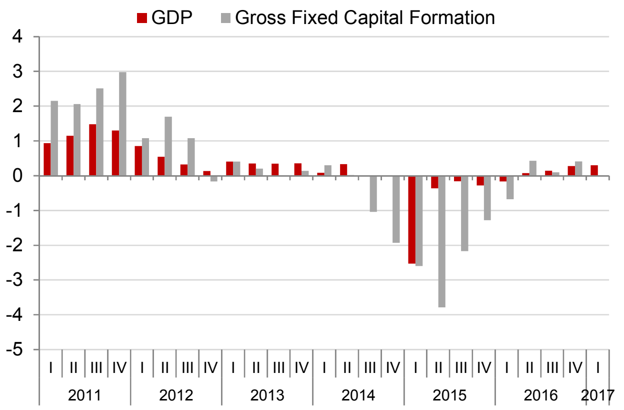
Sources: The Economist, JP Morgan.

The drop in investment came as a major factor behind a slump in Russia's GDP in 2015; importantly, investment slowdown dates back to 2013 - that is, a time span before the oil price slump. Nonetheless, investment activity has been bouncing back since the start of 2016Q2 (Figure 70), with its performance however yet remaining to show up in what could be a solid and sustainable trend. The 2014–2016 low base effect when the aggregate volume of investment fell 12.2% from a 2013 peak level, appear to rise expectations for stronger investment growth to occur this year. That said, the projected rebound is likely to take the so-called slow L-trajectory and will fail to reach the 2013 peak rates over the next few years. This expected rebound is held back by the persistent structural problems which hamper broad-based economic growth no less than investment recovery itself.

Rather mixed data are observed across investment types. Investment into machinery and equipment comes as a key recovery driver, whereas investment into construction extends its decline (Figure 71).

Increased investment into machinery and equipment occurs on the back of an expansion in domestic production as much as on the back of mounting imports (Figure 72). A recovery in this type of investment tends to emerge sooner thanks to its selective character. Companies may invest into only partial upgrades of obsolete equipment and technology, which involves a speedier decision-making process compared to the large-scale character of construction.

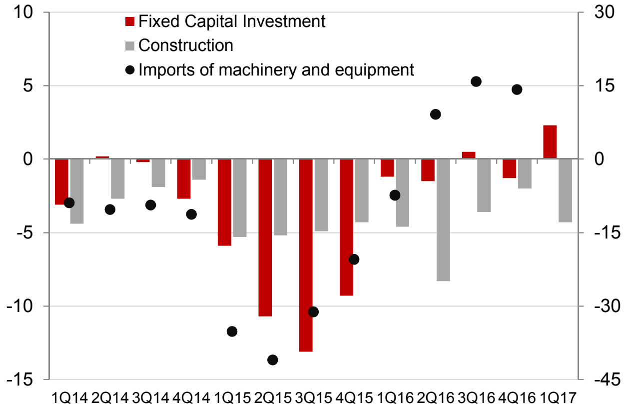
Figure 70. Investment* and GDP growth, % QoQ, seasonally adjusted



Sources: Rosstat, R&F Department calculations.

**SNA methodology-based investment estimates are currently unavailable in the absence of GDP data based on the expenditures approach.*

Figure 71. Fixed capital investment and adjacent indicators, % YoY



Sources: Rosstat, CEIC.

Construction is more inertial as a type of investment, which is explained by longer decision-making and pre-launch processes. Beyond that, new construction is usually intended as either new projects or project upgrades and involves larger-scale expansion of production in comparison with investment into machinery and equipment. As a non-tradable sector, construction apparently ‘fell prey’ to the structural change in the economy, triggered by the drastic change in foreign trade conditions. The recent months saw, however, a stabilisation with signs of a slight growth in this type of investment activity. According to Rosstat’s preliminary estimate, 2017 Q1 data showed a 2.3% YoY rise in fixed capital investment, which was apparently the key contributor to the 0.5% GDP growth (see also Subsection 1.2.1. ‘Economic growth has been accelerating’).

Figure 72. Imports of machinery and equipment (monthly 2007 average =100)

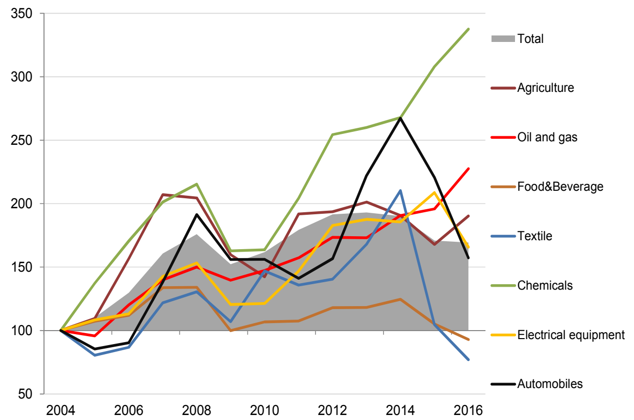
Source: Center for Macroeconomic Analysis and Short-term Forecasting

Figure 73. Production and net imports of construction materials (monthly 2007 average=100)

Source: Center for Macroeconomic Analysis and Short-term Forecasting

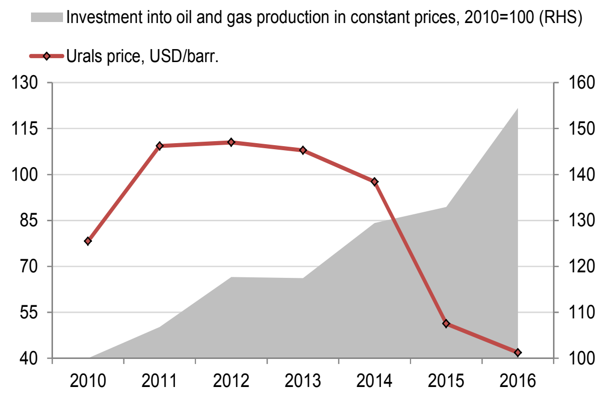
Current investment data varies substantially across sectors, in contrast to the 2009-2010 situation (Figure 74), a time when the recovery that followed the 2009 drop was fairly even across sectors. The current data put in a variety of trends: growing chemicals and agriculture come with drops in a number of sectors including the auto industry and textiles. These developments in fixed capital investment seen in the past 2-3 years are indicative of the ongoing structural change in the economy as it is undergoing adjustment to a lower long-term price level.

Figure 74. Investment by economic activity 2004 index = 100



Source: Center for Macroeconomic Analysis and Short-term Forecasting

Figure 75. Investment into oil and gas production



Source: Center for Macroeconomic Analysis and Short-term Forecasting

Of particular interest is the performance of oil and gas investment that has seen uninterrupted growth since 2010. This growth even accelerated in 2016, notwithstanding the lower oil prices (Figure 75). In a remarkable development, production drilling in 2016 expanded 12.1%. Oil companies were able to capitalise on a weaker ruble setting off their losses on lower oil, hence the continued pickup in sectoral investment.

It should also be noted that several major projects in oil and gas made particular difference to the positive movements in investment data. Arctic zone investment in 2016 totalled 10% of domestic fixed capital investment. Most of this investment was made in Yamalo-Nenets Autonomous District where new large-scale oil and gas projects are being launched, as well as a LNG terminal construction project.

What are the key factors behind the current investment activity in the Russian economy? In the aftermath of the oil price slump and the imposition of financial and economic sanctions in the second half of 2014, as well as amid growing concerns about world economic prospects, increasing uncertainty was one of systemic factors behind the downturn in the Russian economy that was especially pronounced in 2015. However, as the economy was adjusting to the structural changes, lowering uncertainty became one of the main factors bringing the Russian economy on the path of slow but sustainable growth.

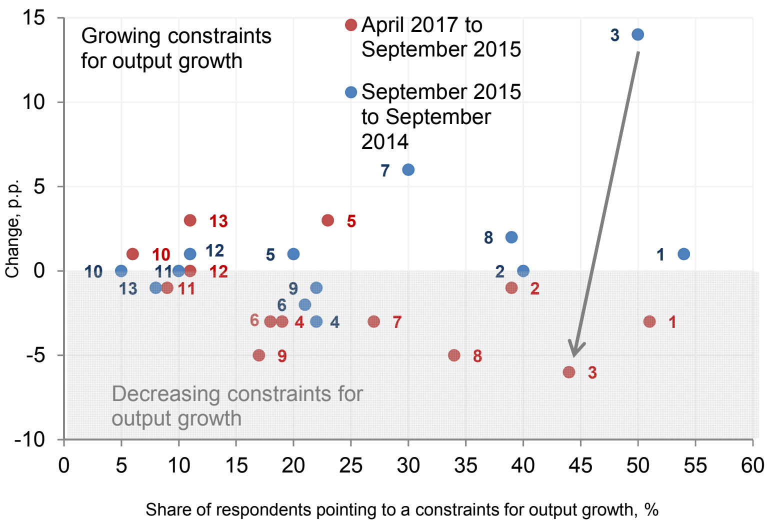
Why is uncertainty crucial for investment? Companies are less inclined to invest amid growing uncertainty over future demand. In such case the rate on loans does not limit investment which is non-existent due to companies' low demand for investment, rather than expensive funding.

A number of empirical research papers confirm the theory about a larger impact of uncertainty on investment activity in emerging markets where the economy is comparatively more sensitive to shocks and financial markets are less mature.[19] This is manifested in both deeper decline in the economy and its longer recovery.

The conclusion about the positive effect of lower uncertainty on economic performance is supported by Rosstat's monthly business activity surveys among organisations where manufacturers tell about factors constraining production growth (Figure 76). Whereas in the period between September 2014 and September 2015 the share of companies which pointed to repercussions of increased uncertainty grew by almost 15 pp, 18 months later, almost half of respondents dismissed uncertainty as a constraint of output growth. Meanwhile, despite the Bank of Russia's continued moderately tight monetary policy, the share of companies which consider the elevated cost of commercial lending to be a constraint dropped by almost 5 pp.

Thereby, moderately tight monetary policy and conservative fiscal policy reduced uncertainty, winning trust of economic agents and giving them confidence in the attainability of declared goals and targets. This effect proved stronger than the restraining influence of high real interest rates and allowed the Russian economy overall and fixed capital investment in particular to start recovering as soon as the second half of 2016.

Figure 76. Manufacturing output constraints



Demand constraints: 1 - insufficient demand in the domestic market; **5** - insufficient demand for a company's products in the foreign market; **6** - competitive imports. **Financial resource constraints: 2** - high taxes; **7** - high interest rate on commercial loans; **8** - funds shortage. **Labour constraints: 4** - skilled labour shortage. **Production capacity constraints: 9** - depreciation and lack of equipment; **11** - equipment shortage; **12** - primary product and material shortage. **Other factors: 3** - economic uncertainty; **10** - non-existent or incomplete regulations; **13** - no constraints.

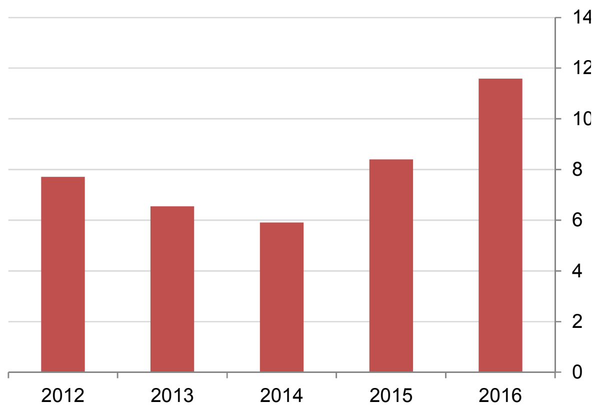
Sources: Rosstat, R&F Department calculations.

The fact that in Russia investment has always been financed from companies' own funds favours the assumption that moderately tight monetary policy is not the main

[19] See, e.g. *Bloom (2013)* with US-related annexes, the Bank of Chile's research (*The Impact of Uncertainty shocks in Emerging Economies, 2011*) with emerging market-related annexes and the European Commission's research (*European Commission Quarterly Report on Euro Area, 2013, Volume 12, Issue 2*).

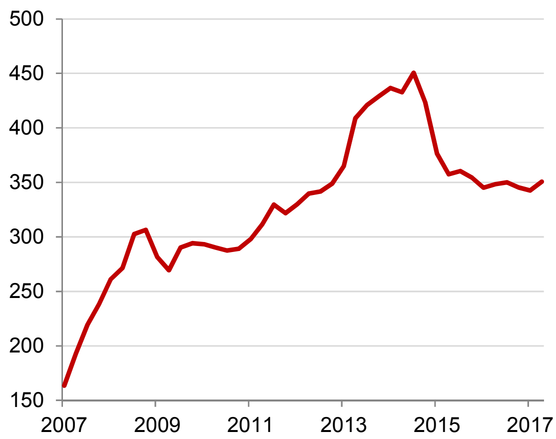
constraint for investment. Statistics show that corporate profits (net profit) almost doubled in 2015-2016 compared with 2014 readings.

Figure 77. Corporate net profit, trillion rubles



Source: Rosstat.

Figure 78. Foreign debt of other* Russian industries, billion US dollars



Source: Bank of Russia.

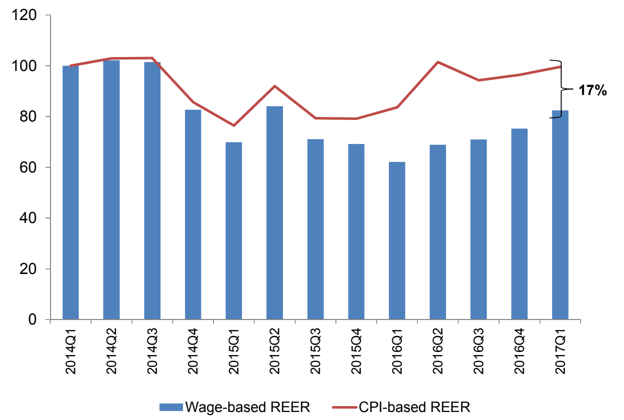
** Excluding banks, the central bank and general government.*

Thereby, investment resources are available and investment activity is constrained by other factors. Certainly, companies partially used their profits to repay foreign loans, limiting funds available for investing. However, the debt level has stabilised (Figure 78). Moreover, companies effectively refinance external debts in the domestic market, therefore this factor is unlikely to remain a constraint.

To foster further growth of the Russian economy and raise investment, its price competitiveness should be increased as the economy adjusts to the external shocks of the past years. This is supported by both the real effective exchange rate of the ruble, which is calculated as a difference in the cost of labour in Russia and its key external trade partners, and cross-country comparative analysis of nominal wages denominated in euro (Figure 79 and Figure 80). In particular, our estimates of the real exchange rate through wages in manufacturing show that there is a price competitiveness margin: CPI-based real exchange rate calculated on the basis of the Bank of Russia's official data is close to the level of mid-2014, and in terms of wages the real exchange rate only slightly exceeds the local minimum of early 2015.[20]

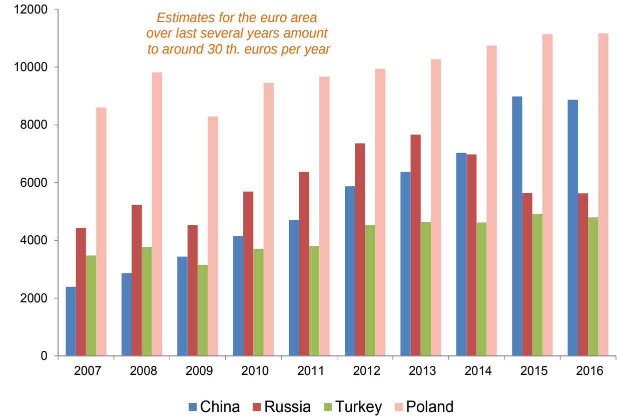
[20] A commonly known drawback of the standard calculation of real effective exchange rate through CPI is that it takes into account prices of both tradable and non-tradable goods. Therefore, the real exchange rate looked overrated in such a standard interpretation in the period of exchange rate shocks in late 2014, which also had its inflation fallouts materialised in early 2015.

Figure 79. CPI-based real effective exchange rate of the ruble against foreign currencies (Bank of Russia official data) and manufacturing wages (R&F Department estimates), 2014 Q1 = 100



Sources: Rosstat, Bank of Russia, CEIC, R&F Department estimates.

Figure 80. Average annual manufacturing wage, euro



Sources: Rosstat, CEIC, R&F Department calculations.

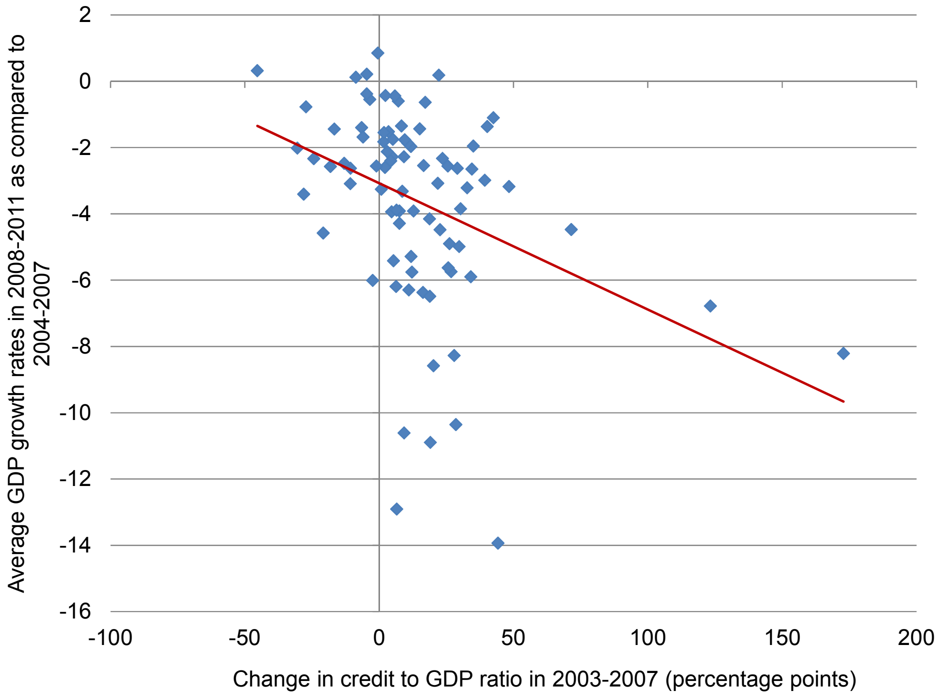
At the same time, it should be born in mind that these factors, though favouring investment, do not determine future investment dynamics. At the moment, investment growth is restricted by a number of structural challenges.

As for the most significant risks for further development of investment activity, it is worth mentioning that potential investment growth in Russia is currently restricted by different structural factors. For example, overregulation and risks that it may be revised either way discourage investment in many projects as they should bring high returns to offset these risks. A relatively low involvement of the Russian economy in global production chains may also be a constraint, because this issue calls for not only investment but also revision of customs procedures, tax laws, etc.

Current demographic trends in Russia point to considerable structural constraints on further growth in labour supply and provide clear evidence that the Russian economy cannot rely on the extensive growth model based on effective involvement of new labour force. Irrespectively of the above, the classical economic growth theory (in particular, the famous Solow growth model) sees return on investment and total factor productivity as main fallouts from overinvestment which results from the outrunning accumulation of some production factors compared with others. As a result, it seems unreasonable to take special measures to increase the share of investment in GDP, e.g. through heavy credit expansion, because this strategy will not have a steady positive effect on growth in the long run. In the case of the Russian economy, we consider it more important to increase investment in human capital (personnel training, education) which could lead to higher productivity of labour. Such investment is unlikely to require much finance but will take quite a long time to bring maximum return.

Overall, as aggregate demand declines not because of tighter monetary conditions in the economy but due to other fundamental factors, the attempts to encourage lending by monetary methods may bring about imbalances in financial markets (in the form of price bubbles or excessive pressure on the exchange rate). It is important to remember that monetary regulation measures cannot be effective in stimulating the real sector in the long term. Accelerated credit growth cannot be regarded as an enabler of sustainable economic growth. Lending activity is rather a driver of cyclical fluctuations (i.e. it stimulates growth during a prosperity phase and aggravates recession when the economy is in downturn). Thereby, fast credit growth in the pre-crisis period may be considered one of key determinants of depth of economic recession during and in the aftermath of the crisis (Figure 81).

Figure 81. Loan-to-GDP growth in 2004-2007 and average annual GDP growth in 2008-2011 compared with 2004-2007 in 83 advanced and emerging economies



Source: World Bank.

The above problem is significant in terms of sectoral imbalances in the economy. Financial booms caused by excessive stimulation of investment are connected with funding economic sectors marked by credit-supported higher prices and wages, rather than higher productivity of labour. As a result, the economy becomes more vulnerable to external shocks because of the debt load of less productive sectors caused by the inefficient allocation of resources. Thereby, high short-term growth will be transformed into a deep and long-lasing recession, as well as persistent growth of inflation and inflation expectations in the long run.

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