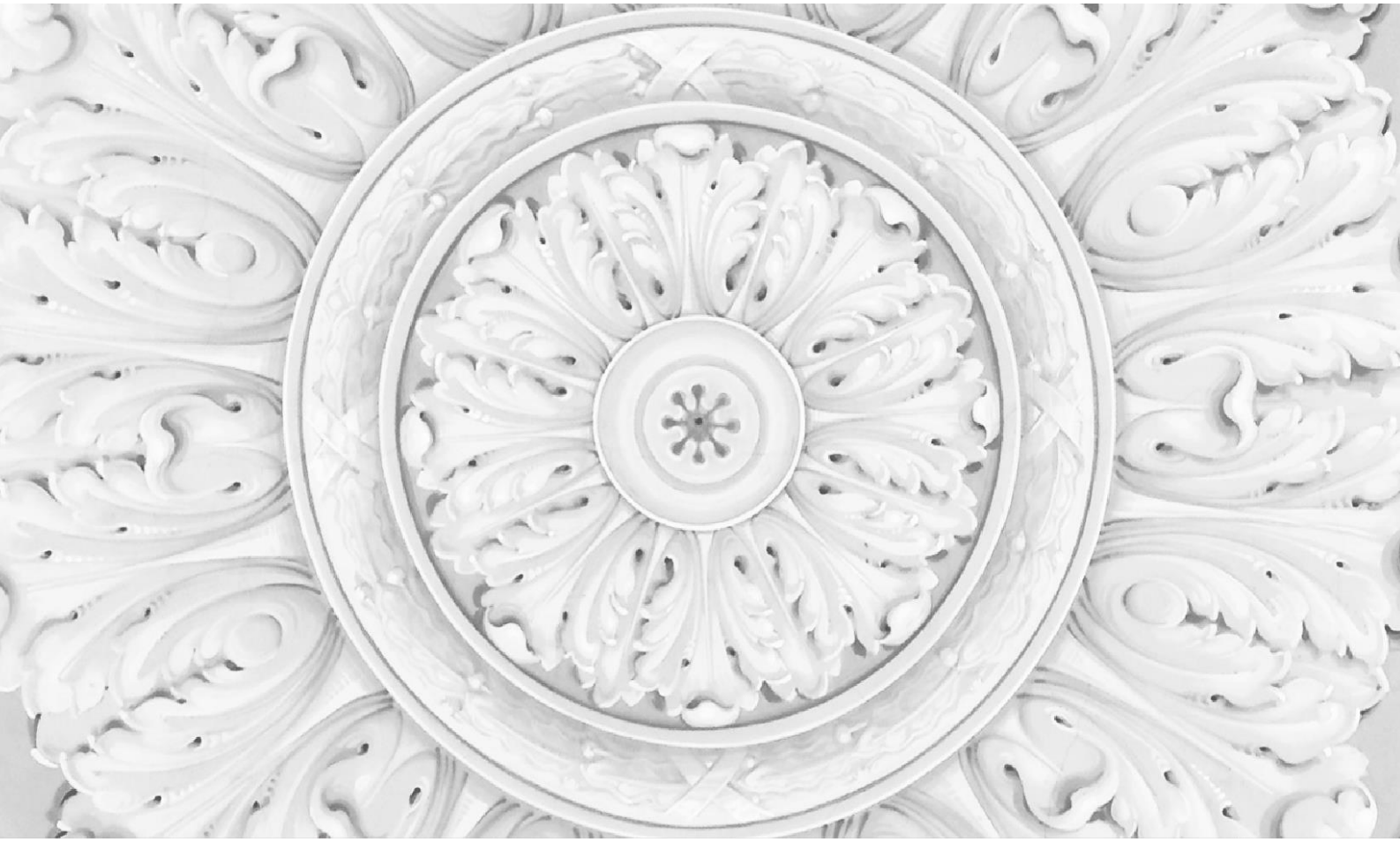
Bank of Russia

The Central Bank of the Russian Federation



TALKING TRENDS

Macroeconomics and Markets

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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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Summary

1. Monthly summary

- Between the second half of June and July, inflation dynamics remained within the bounds of the Bank of Russia's baseline scenario, while the prospects for positive quarterly economic growth rates due in 2016 H2 improved. The decline in oil prices is aligned with the baseline scenario assumptions.
    - **Inflation** remains on its downward path, thanks to, inter alia, the current monetary policy; however, it still holds steady above 7%. The risks that inflation may exceed the 4% target in 2017 are still in place owing to the stopped decline in inflation expectations, the uncertainty over specific budget dimensions and the negative pressure on consumer prices arising from potentially recovered consumption-oriented behaviour pattern. For these risks to go down, a higher saving ratio should be preserved and inflation expectations dragged down.
    - **Economic activity** in the second quarter grew somewhat as sectoral dynamics proved extremely uneven, reflecting the ongoing economic adjustment to the new environment. The economy is projected to hit a slow growth track in the next few months in the absence of new external shocks.
    - **Monetary conditions** were softening further on the back of the June rate cut and the ongoing switchover to structural liquidity surplus.

2. Outlook

- In the short term, Brexit has made little impact on the eurozone economy. Advanced economies continue to post sluggish growth. As before, the Bank of England, the ECB and the Bank of Japan are all expected to further soften their monetary policies.
- Russia's GDP indices suggest that the recession is behind, with the economy on track for slow growth. Model GDP estimate for Q3 was upgraded to 0.4% QoQ in July. The projection for Q4 is 0.5% QoQ.
- However, the unsteady survey indices seen over the recent months are evidence to the fact that a more confident industrial recovery is at risk.
- Although analysts continued to downgrade their consensus forecast for 2016 inflation as average expectations for the year 2017 edged up. This may have been the result of analysts expecting now a flatter line in the rate cut trajectory as compared to the June decision.

1. Monthly summary

1.1. Inflation remains on a downward track, with the risks of failure to meet the 4% inflation target for 2017 still in place

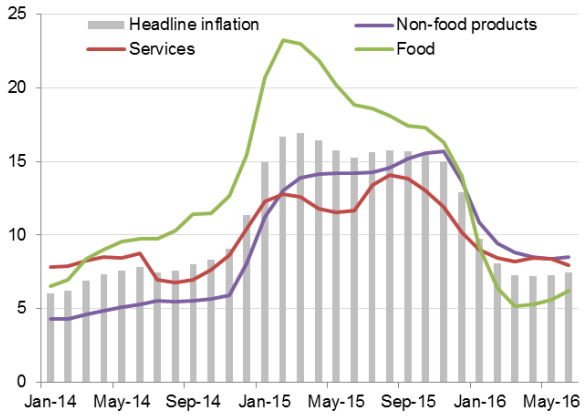
Inflation moved within the bounds of the Bank of Russia's baseline scenario, albeit showing less optimistic readings. Annual inflation has remained in the 7.1-7.5% range since March. The downward trend of inflation pressure and inflation expectations stalled. To ensure delivery of the inflation target, a further weakening in inflation pressure is required and inflation expectations should be dragged down.

1.1.1. The risks that inflation may entrench above 7% in August remain

- The high rate of consumer price growth, persisting over several weeks, may result in inflation entrenched above the 7% mark in August.
- The most prominent contribution to the acceleration of price growth comes from utilities, albeit still within the bounds of the initial forecast of 0.4-0.5 pp.
- The weak seasonal decline in fruit and vegetable prices, compared to standard seasonality, between July and August, remains an inflation risk.

The latest release of statistics indicates that inflation in June totalled 0.36%, a reading lower than in the preceding month. Annualised inflation accelerated from 7.3% to 7.5% (Figure 1). On an annualised basis, both types of inflation, food and non-food, were accelerating, while the deceleration of prices in the service sector was only partially setting off this movement.

Figure 1. Inflation component growth (%, YoY)



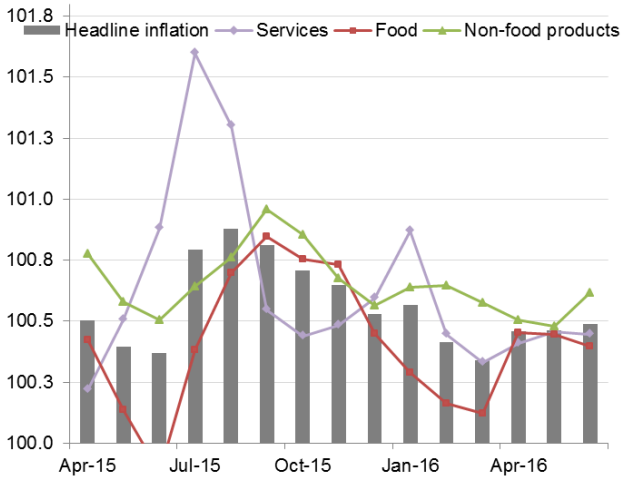
Sources: Rosstat, R&F calculations.

In June, the acceleration of annual price growth was majorly impacted by a speedup of food inflation to 6.2%, which has been on the rise for the past four months. Currently, YoY food inflation rates are affected by the low base effect, in the context of comparison to the plentiful past year and the recovering global food prices. The low base effect is the reason behind the non-food price acceleration (annualised, up to 8.5%), where comparison is made to the low price growth rates of June 2015 when a wave of price correction was seen in the aftermath of their excessive growth in 2015 Q1, which was triggered by the weaker ruble.

Seasonally adjusted month-on-month data suggest that inflation pressure is still in place. Seasonally adjusted inflation rose in June from 0.48% to 0.52% (Figure 2). This rise owes its existence mainly to an acceleration of non-food inflation. Importantly, the rise in non-food prices is not connected with a weaker ruble, as was the case in 2015 Q1. Conversely, the period between January 2016 and early June saw a strengthening in the national currency.

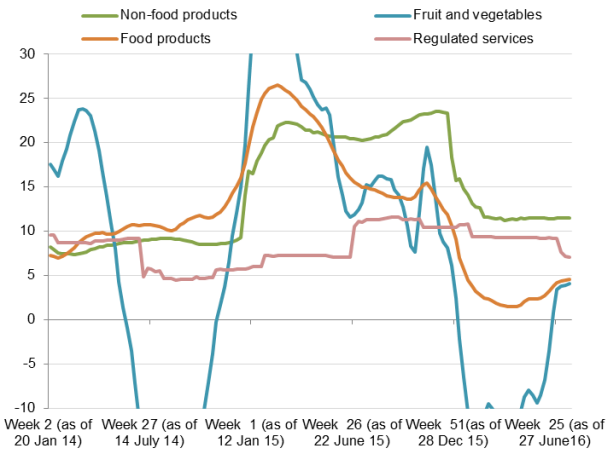
At the same time, there was no rise in inflation in the food market and services as it remained flat with May 2016. Having said this, no contraction of inflation was seen either, which is why it would be premature to conclude that the risks, especially those in the food sector, are on track to weaken.

Figure 2. Inflation component growth rates, seasonally adjusted (%)



Sources: Rosstat, R&F Department calculations.

Figure 3. Inflation component growth rates, on a weekly basis (% YoY)[1]



Sources: Rosstat, R&F Department calculations.

Although the planned 4% indexation was almost fully implemented in the first four days of June, utility rates were climbing throughout the whole month. Since the start of July[2] utility rates have been growing at the rate of 5.42%, contributing 0.31 pp to inflation month-to-date (as of 25 July). Prices for housing services are still

[1] The performance of these baskets is not aligned with annual growth rates for goods which are calculated on a monthly basis.
[2] As of 25 July.

rising. The utility sector contributed cumulatively 0.44 pp to the July inflation. While the upward utility price adjustment of July is the only one in the course of the year, prices in the utility sector tend to go on rising for the two post-adjustment months sequentially (albeit at a more modest rate) – which makes this a potentially impactful inflation component.

Overall, annualised price growth rates in the regulated services[3], monitored on a weekly basis, were down on the back of the low base effect (Figure 3). Once the utility sector's contribution to the July inflation is deducted and compared to the similar reading for last year, the contribution of the other components may prove to be the same at around 0.2%. Consequently, the rate of consumer price growth less utility rates this July was level with last year, in a sign that inflation pressure is still the case and inflation is showing no downward movement in the period under study.

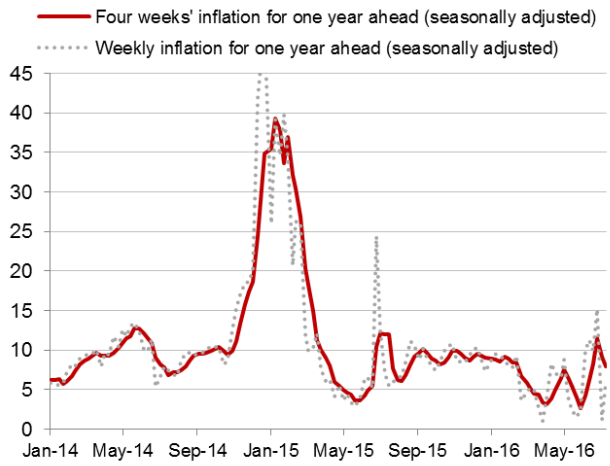
Inflation constraints include the moderately growing global food prices and a weak manifestation of the seasonal drop in fruit and vegetable prices. The insufficiently rapid, compared to the standard seasonality, drop in the prices of fruit and vegetables may well suggest changed temporal performance of price seasonality. This is an inflation risk of the second half of the year with the potential to keep inflation above the point of 7% in August. However, final conclusions could only be made once a set of data on prices is released in August, a time when the seasonal drop in fruit and vegetable prices tends to be most explicit.

Seasonally adjusted annualised (calculated for one year ahead based on the average daily rate for the reporting week) inflation was up at 10.3%. The substantial movements in this indicator, although failing to explicitly reflect the dynamics of inflation calculated for one year ahead, enable us to estimate the seasonally adjusted reading for the current week – which grew twofold. Seasonally adjusted four-week inflation (calculated for one year ahead), being a steadier indicator, rose from 7.9% to 8.0% (Figure 4).

The inflation accumulated since the start of the year once again put it off the track whereon it is supposed to be to enable delivery on the intermediate inflation rate of 5.5%[4] by this year-end and 4% for the end of 2017 (Figure 5). This widening deviation from the path diminishes the chances that the 2016 inflation target will be accomplished.

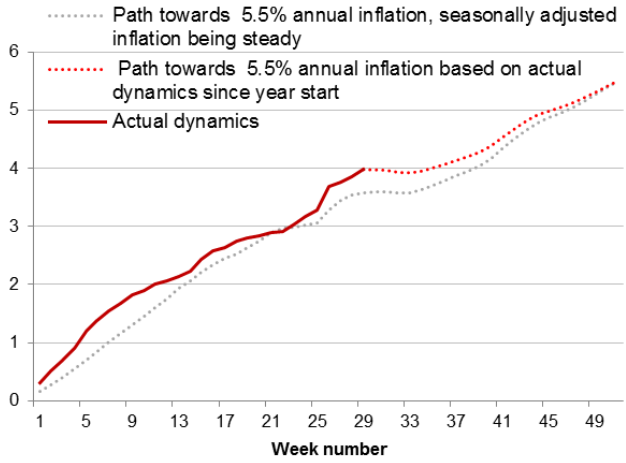
[3] This amount includes fare prices.
[4] The intermediate 5.5% rate is the interval mean of the BoR forecast for 2016 inflation under the baseline scenario (for more details, refer to Monetary Policy Report – No. 2 (14) • June 2016).

Figure 4. Seasonally adjusted weekly inflation calculated for one year ahead, %



Sources: Rosstat, R&F Department calculations.

Figure 5. Inflation accrued since start of the year (weekly data)



Sources: Rosstat, R&F Department calculations.

1.1.2. Growing agricultural outputs are projected to check the rise in food prices in the second half of the year

- Tentative estimates suggest that outputs of most agricultural products are set to grow in 2016
- The expanding agricultural production, together with the comparatively quiet price environment of the global market, brings but modest food inflation risks in 2016 H2.

Agricultural production in 2016 is on track for growth provided there are no unpleasant surprises coming from the weather conditions between August and September. R&F Department projects that key growth points in crop production will include grain, sunflower and sugar beet (Figure 6). The adverse weather conditions in several regions, seen in the first six month of the year, are likely to result in only immaterial drops in gross production of potatoes and vegetables, with their volumes still beating the average levels for many years. The steady advancement of the livestock sector is set to continue, majorly on the back of growing meat production in the sectors with sustainable trends towards import substitution and strengthening of Russian produce.

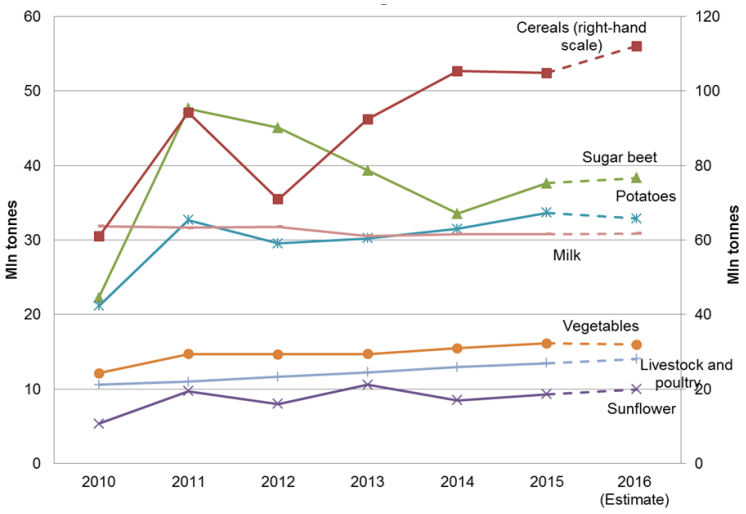
R&F Department estimates that on condition GDP structure stays at the level of 2015, the contribution of agriculture to 2016 GDP expansion may well be on the order of 0.3 pp.

According to the latest OECD/FAO forecasts (Figure 7), the period of high global food prices is over, while the probability of price fluctuations is still high. Following the sharp decline between 2014 and 2015, prices for individual products

(corn, sugar, vegetable oil, dried milk etc.) are expected to grow in the short term, but the prices will still be lower than the previous years' peak values.

The expected expansion in most agricultural product outputs in Russia, together with the comparatively quiet price environment in the global market, brings but modest food inflation risks in 2016 H2. It is only the potential growth of prices for potatoes in the end of the year that may trigger an inflation surge in the food market.

Figure 6. Agricultural production



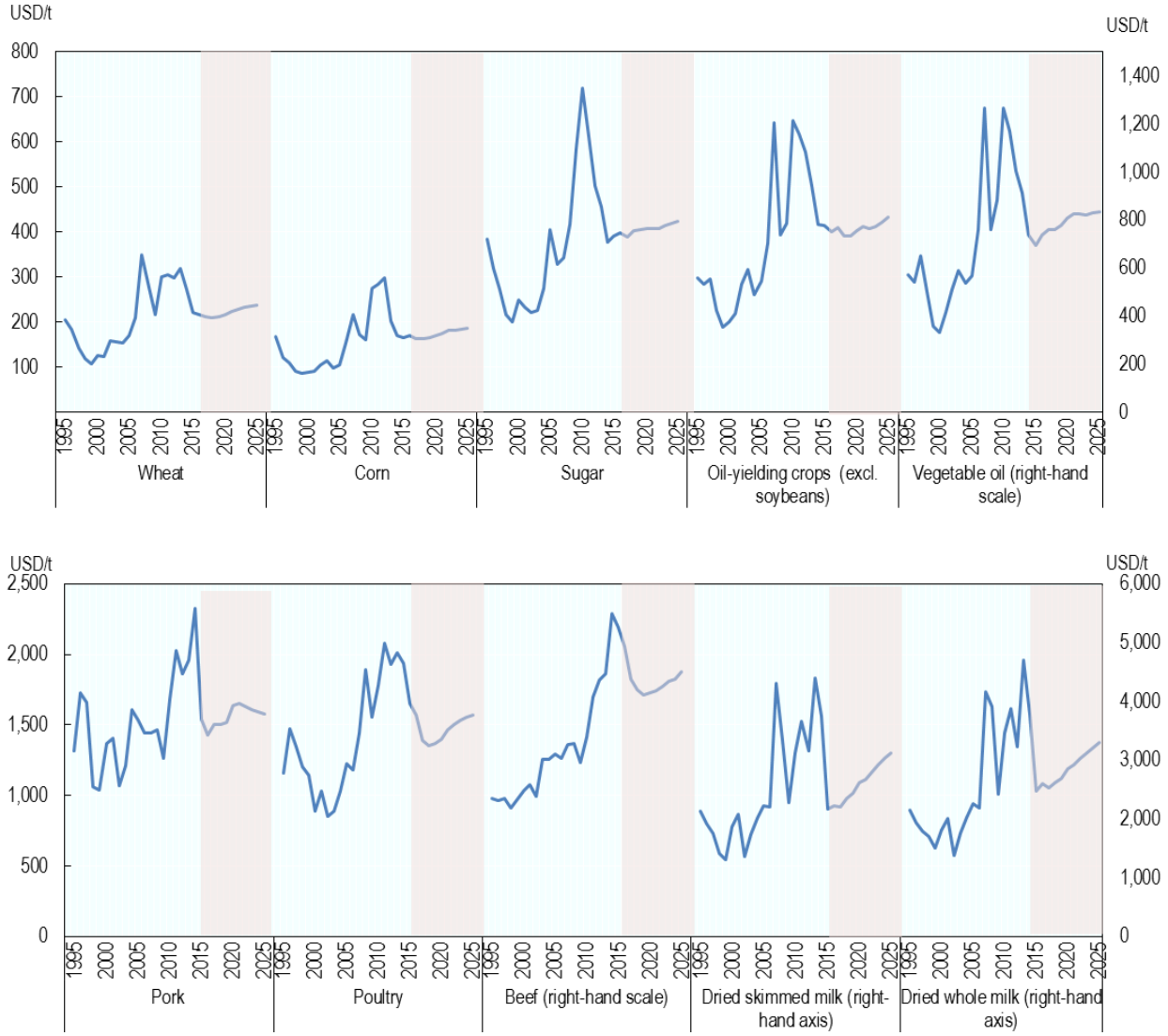
Source: Rosstat, R&F Department estimate.

Gross output of cereal and pulse crops, with their growing area expanding (1.3% on 2015) and good prospects for productivity, is expected to increase 7%-9%, in such a way posting a record figure and boosting supplies to foreign markets to their 20-year highs.

Oil-yielding crops are also expected to rise, helped by the capability to boost the exports of the raw produce and final products at a time the exchange rate differential is high, on the backdrop of a lower export duty effective from the end of 2015 (to meet Russia's WTO accession obligations). Gross crops of sunflower are estimated to beat the reading of 2015 by 6%-7%; the pace of growth in the output of sunflower oil is meanwhile expected to be low (2.0% for the whole year). This comes as a result of lower domestic consumption as vegetable oil production tends to be more reliant on cheaper tropical equivalents and the exports of sunflower seeds are growing in contrast to its domestic processing.

Despite the expansion (+8.6%) in sugar beet cultivated area, this year's crops are estimated to exceed that last year's by a mere 1.5%-2.0%. The recent rain, having caused the spread of sugar beet diseases, is certain to have negative repercussions for gross output of the plant and the production of beet sugar. The latter is set to rise to 5.3 million tonnes (+3.5% on 2015).

Figure 7. Forecast global food prices



Source: OECD/FAO (2016), OECD-FAO Agricultural Outlook 2016-2025, OECD Publishing, Paris.

R&F Department expects potato crops to decline (-2.2% on 2015), mainly attributable to excessive production fears (overproduction did occur in 2015) with the ensuing drop in prices, and the adverse weather. The volumes are still expected to be in excess of those seen in the previous years (except for the record crops in 2015), yet fully matching consumer demand. Bad weather may deteriorate product quality, impelling producers to sell most potatoes 'in the field', thereby boosting supply and causing a price drop at the time of harvesting, with less volumes of the product to be put in storage. In a scenario where demand for the product is stable, the balance would sell at high prices (including storage costs), provoking an inflation surge in the food market.

The crops of vegetables are expected to edge down, too (-1.0%-1.5%) following the contraction in cultivated areas and the adverse weather in the beginning of the summer. Protected ground vegetables are expected to post a growth estimated at 28.5% as of 27 July. This however is unlikely to make any major impact on overall figures as hothouse plants' share in the overall production is small (at about 9%).

In the livestock sector, key growth drivers are pig and poultry breeding. Buoyed by the demand from both consumers and the processing industry (seeking to find a cheaper alternative to meat), poultry is expected to grow by 6.0% in 2016, according to R&F estimates. The pace of growth is forecast to slow down compared to 2015, on market glut concerns. The pork market is on track to grow sustainably (growth is estimated at 4.5%-5.0%). This comes as a result of intensified production thanks to investment projects related to production upgrades and the launch of new capacity, as well as better export opportunities.

Importantly, the advancement of export is currently constrained by the problems connected with veterinary product certification and the negative epizootic situation in the industry, both leading to a strained market with fears of oversupply. Given the tight competition between poultry and pork producers, saturated markets and limited effective consumer demand, in 2016 no rise in prices on pork and poultry is in store.

The production of raw milk in 2016 is projected to remain low (0.2%), explained by the ongoing contraction in the cow population. Stagnated raw milk production undermines the output of dairy products, which is likely to post slower rates than in 2015. Key impediments to industrial advancement and import substitutions, on the background of the ongoing food embargo, include escalating milk production costs, low consumer demand and rising cheap exports from Belorussia.

1.1.3. Demand recovery for high price elasticity goods amplifies inflation risks

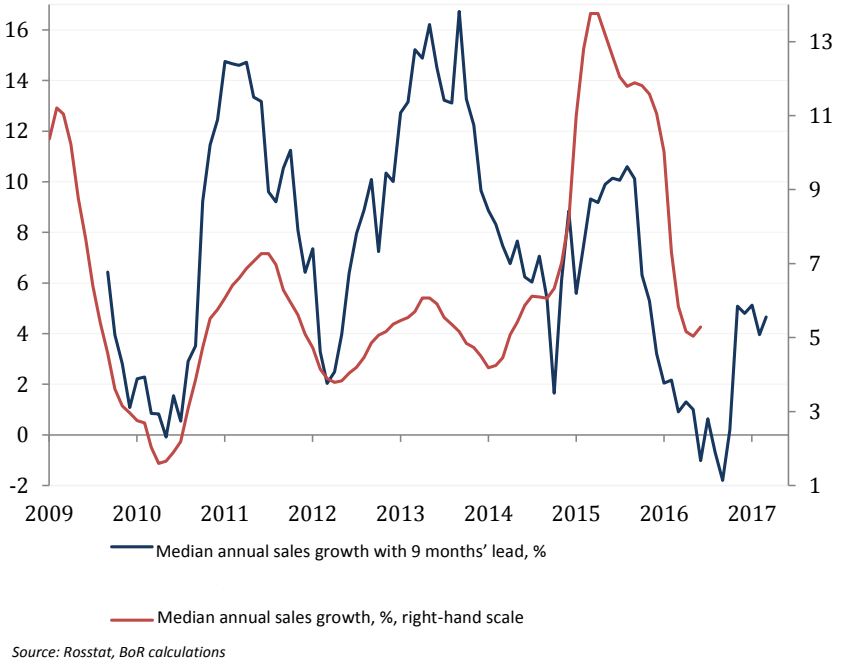
- The recovery in demand observed since January 2016 in certain product categories, where a change in demand precedes a change in their price, brings inflation risks in 2017.

Whenever inflation risks are discussed in the current situation, demand recovery is deemed a potential reason behind them. The conclusions of this nature are supported by aggregate macroeconomic statistics-enabled calculations. Further on in the paper we present calculations based on a disaggregation approach.

We have looked into the way physical retail volumes perform in 40 consumer spending components (based on Rosstat data on the performance of food and non-food product sales) together with the performance of prices in these components (based on Rosstat consumer price data).

Of the 40 product categories, the selection included those where a change in demand statistically precedes a change in prices, over a horizon of up to three quarters[5].

Figure 8. Median sales and subsequent median price change by product category, % p.a.



Sources: Rosstat, R&F Department calculations.

This group of products where a change in demand statistically precedes a change in prices (not vice versa) included milk, cheese, poultry, cereals, confectionery, construction materials, household furniture, telephones, gasoline and pharmaceuticals.

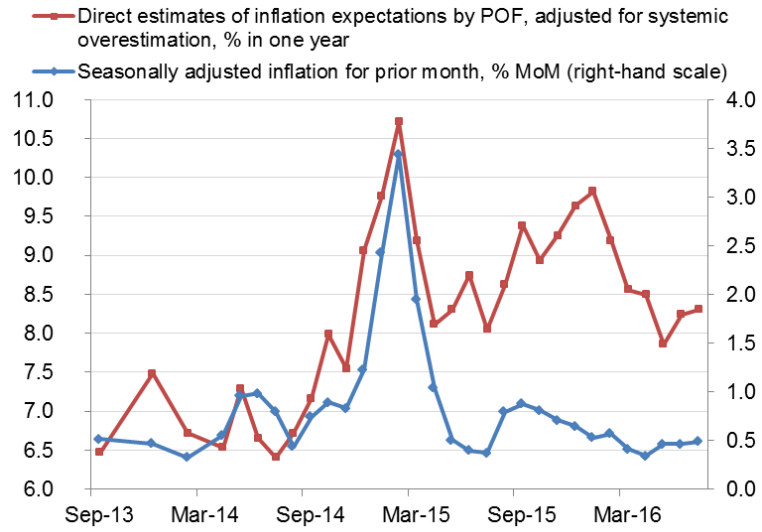
We calculated a median of the moving annual growth rates in retail trade volumes and the prices for these goods (Figure 8). The graph shoes how growing sales were overtaking prices with nine months' lag. The recovery in demand in this group since January 2016 involves potential inflation risks in 2017. These risks could be lowered if this rebounding demand was accompanied by a similarly rising supply of these products, backed by growing production volumes.

[5] The selection is for February 2008 – June 2016, data are seasonally adjusted.

1.1.4. Inflation expectations: there are risks that the current heightened price growth may settle

- In July, direct estimates of inflation expectations rose somewhat for a second straight month to 8.3% YoY, to defy households' estimates for the current inflation.
- Inflation expectations settled at a heightened level, which may hinder the efforts to slow down inflation in line with the projected trajectory whereon inflation is supposed to reach the target by late 2017.
- Hence the risk that inflation may harden at a point above the target.

Figure 9. Direct estimates for inflation expectations by POF, adjusted for systemic overestimation, % in one year

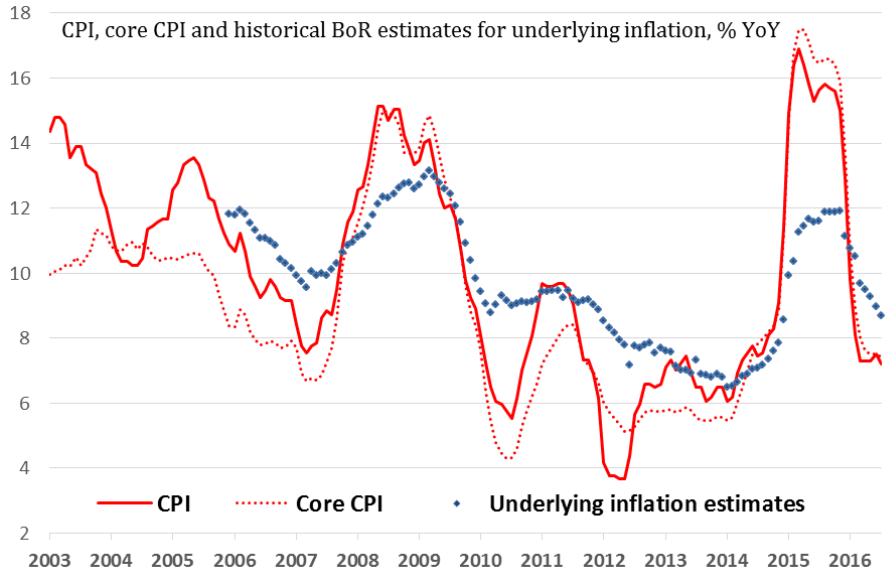


Source: inFOM, R&F Department calculations.

1.1.5. Underlying inflation is slowing down at a moderate pace

- June's estimates of annualised inflation are down to 9.0% from 9.3% in May, in a sign of abating inflation pressure (Figure 10).
- Provided that the current price trends and monetary aggregates hold, we expect a further gradual downgrade in estimates for underlying inflation.
- The risks that inflation may move away from target in late 2017 hold. Underlying inflation is still high and its downward movement is slow.

Figure 10. CPI, core CPI and historical estimates for underlying inflation, % YoY



Sources: Rosstat, R&F Department calculations.

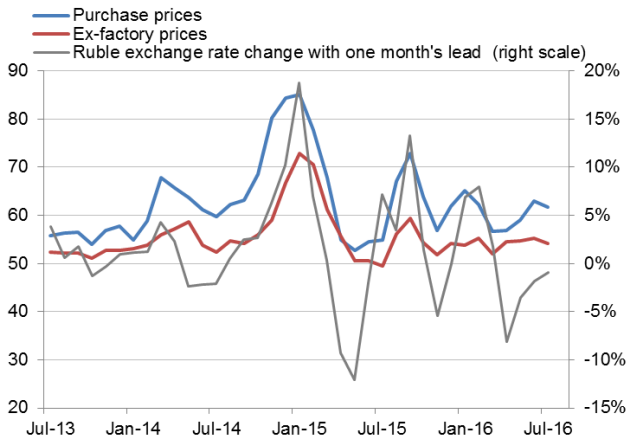
1.1.6. PMI input prices dynamics signals additional price pressures

- The June and July PMI data show that higher growth pace of input prices in manufacturing hold …
- …which, albeit leaving the output price index unaffected, does bring inflation risks.

As follows from the PMIs, the growth of input prices in the manufacturing sector, once accelerated to 63 points[6] between June and July, was somewhat down to 61.7 points. This value still suggests the pace of acceleration is heightened. While this upsurge is not projected to fully translate into ex-factory prices, the large difference between purchase and ex-factory prices signals the presence of inflation risks (Figure 11).

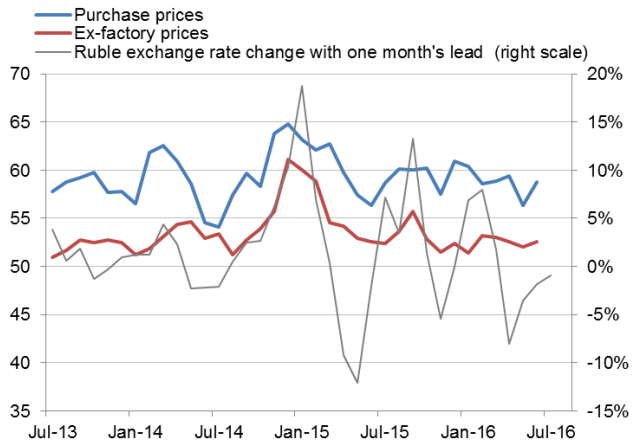
[6] To a maximum since January this year.

Figure 11. Manufacturing PMI price indices



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

Figure 12. Services PMI price indices



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

The service sector also saw an accelerated growth of costs. Respondents note that this growth was partially the result of the rise in the sector salaries. Nevertheless, the purchase price index in the service sector held below its January level, and its growth was only immaterially reflected on ex-factory prices (Figure 12).

In this way, there was no comparable growth in ex-factory prices to set off the rise in purchase as yet. The pass-through effect may be deferred. In this connection, short-term inflation risks appear elevated.

1.2. Expectations for a slow economic recovery to start in Q3 grew stronger

The current economic performance is showing an ongoing slow improvement, against the backdrop of mixed dynamics across sectors. The nascent recovery in inventories and the continued unsteady industrial growth are supposed to translate into more sustainable, albeit low, rates of economic advance.

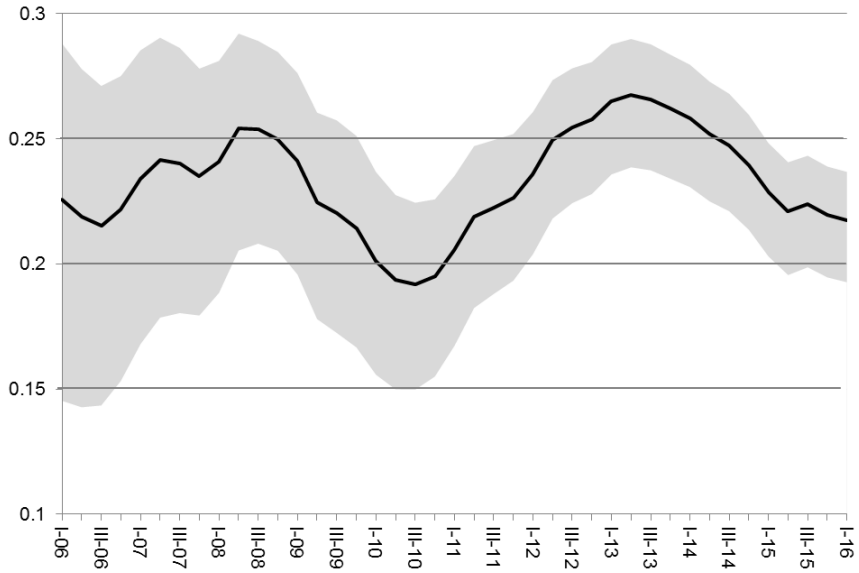
1.2.1. Q1 GDP: the strong performance of inventories comes as no surprise

The statistical data on the use of GDP in 2016 Q1 show that consumer and investment activity at the beginning of the year remained sluggish, substantially evidenced by monthly statistics. Of special interest is the more favourable performance of inventory holdings in comparison with many analysts' expectations.

Economic agents' demand for inventories is determined by a level where demand for products is met in the context of possible demand fluctuations. The existence of *a*

long-run equilibrium sales to inventories ratio could be assumed. The calculation of this ratio in an explicit form appears impossible. However, with some assumptions[7] it is feasible to estimate it as a first approximation.

Figure 13. Inventories to GDP ratio range (seasonally adjusted)



Sources: Rosstat, R&F Department calculations.

The current performance of the inventories to GDP ratio is overall a match to the 2008-2009 crisis fluctuations (Figure 13). Once the average level of inventory investment in 2011-2013 is considered to be equilibrium, the upsurge in inventory investment in the first quarter should be treated as nothing unexpected. Importantly, the equilibrium inventory to GDP ratio is subject to change, reflecting a changing economic structure, as well as the movements in real interest rates. Also, reduction in the inventories to GDP ratio may occur on the background of economic growth (as, for example, was the case in 2010).

1.2.2. Industrial performance: on track for a gradual recovery

- June's industrial output posted a slight pickup, which is consistent with the previously released positive survey data.

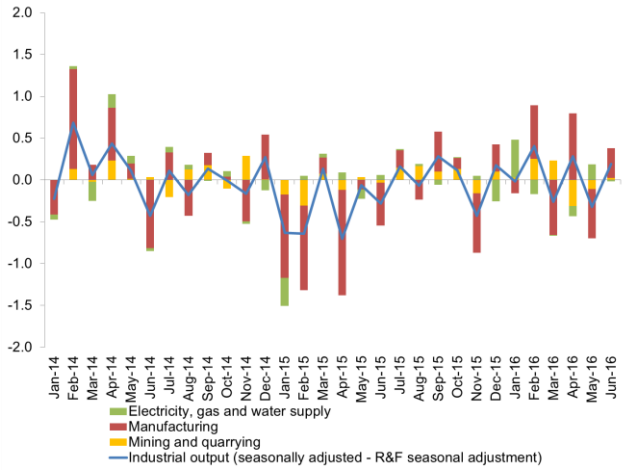
[7] We assume that the inventories to GDP ratio to have been 0.3 in the year 2000. For the confidence interval to be computed, we also calculate the movements of the ratio assuming the values are 0.05 and 0.5 in 2000. This range of values generally corresponds to the available estimates for this ratio for countries where such calculations can be made. Also, our calculations leave out inventory revaluation and depreciation.

- The pickup in the period under study came as a result of a higher manufacturing output.

The June industrial output data by Rosstat evidence a gradual recovery in economic activity. In annual terms, industrial output was growing at the pace of 1.7% YoY against 0.7% YoY in May 2016. The overall pickup was 0.4% YoY in 2016 H1.

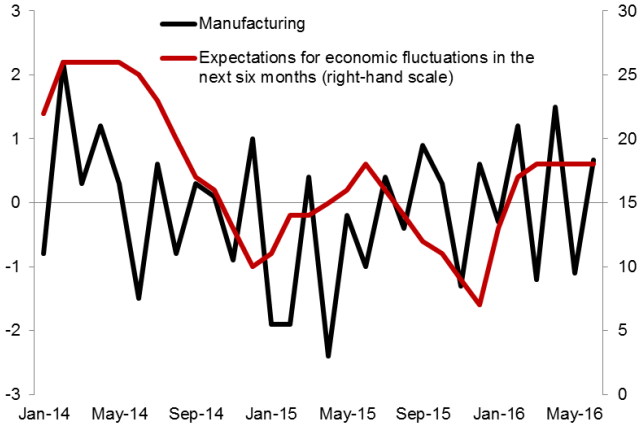
According to R&F Department estimates, seasonally adjusted industrial output was up 0.2% MoM in June (0.3% MoM, according to Rosstat), following the drop of 0.3% MoM seen in May (Rosstat and R&F estimates for May being identical).

Figure 14. individual components' contribution to the industrial production index, % MoM (seasonally adjusted)



Sources: Rosstat, R&F Department calculations.

Figure 15. Economic fluctuations in the next six months and the industrial production index in manufacturing, % MoM



Sources: Rosstat, R&F Department calculations.

In June, the indicator was growing on the back of the data in manufacturing sectors. This dynamism provides evidence to the rebound in economic activity evident from polling indicators. A positive signal also comes from the dominating number of producers expecting improvement in economic activity in the next six months

The performance in manufacturing made a substantial positive contribution to the seasonally adjusted industrial production index, with the contribution however of electric power, gas and water generation and distribution being negative in this month.

It should be noted that manufacturing output, a driver of the volatility seen in the previous months, is recovering gradually and appears on track to hit positive annual growth rates in 2016 Q2. R&F estimates for seasonally adjusted production in manufacturing grew 0.7% MoM in June.

With stabilisation in the manufacturing industry as a key prerequisite for overall industrial recovery, the latest data witness an ongoing stabilisation period. However, the volatility and multidirectional movements across branches may hold for the months to come, before a more confident recovery sets in.

1.2.3. Growing outputs in consumer and intermediate sectors

- Production is growing slower in consumer demand sectors.
- The rates of output growth in intermediate demand sectors are positive again, yet they are still characterised by marked volatility.
- Total output in investor demand sectors remains on a downward movement path.

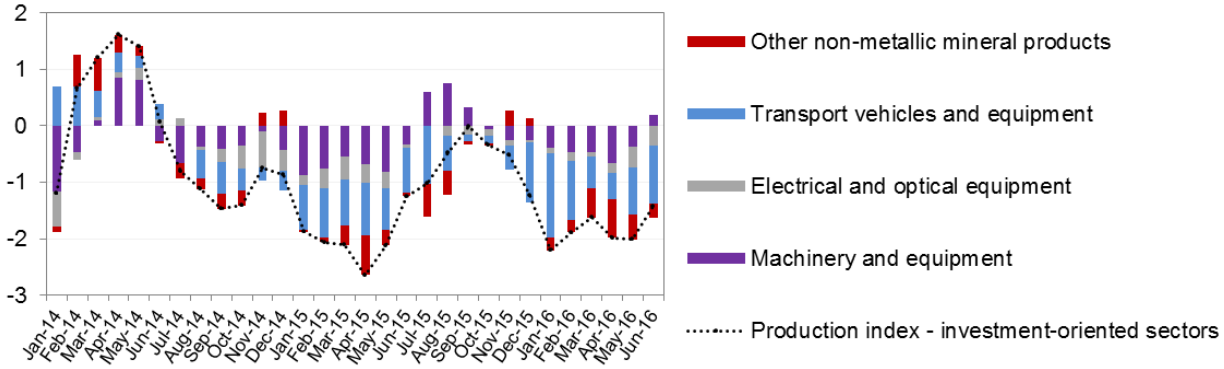
In June, the consumer demand group of industries (Figure 17) posted a slowdown in growth. It is connected with a renewed drop in the output of some durable consumer goods against unstable household income; on the other hand, household income levels show a gradual stabilisation. Food production is still a driver for positive data in the group of industries.

The intermediate demand-focused industries (Figure 18) posted positive level of production index yet again. Since the start of the year, chemicals have made a positive contribution to the index, which has been however declining in the past few months, as the other sectors of intermediate demand (in the first place, metallurgy and plastics / rubber) are showing volatile outputs.

Decline is ongoing in the group of investment demand industries. Positive dynamics of production index in these sectors come only from the two industries: machinery and equipment – with the signs of growth in production – and construction materials – where the paces of decline contracted (Figure 16). The other sectors' impact on production index was negative.

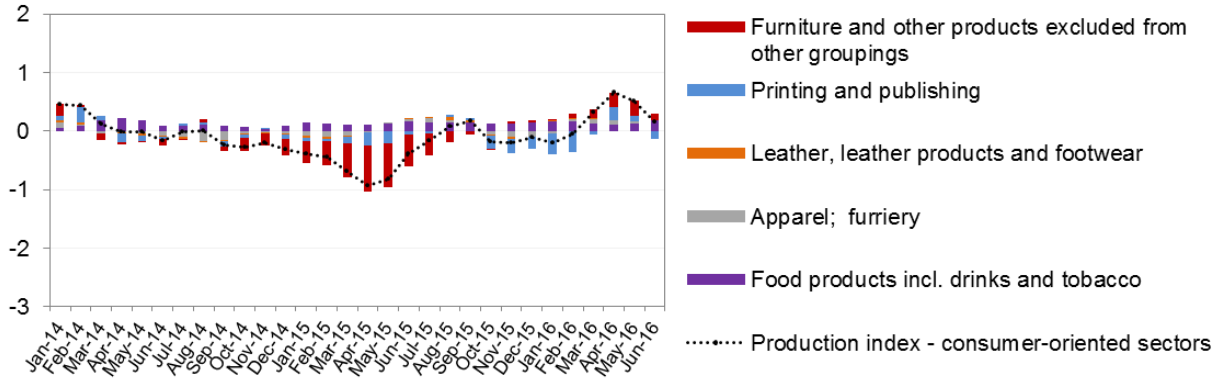
As outputs in the group of investment demand branches are dwindling on the background of continued relatively steady outputs in consumer and intermediate demand-focused sectors, there are gradual changes, moderately intensive and explicit, in the structure of manufacturing output (Figure 19, Figure 20).

Figure 16. Industrial production index in investment demand-oriented industries, (trend), % MoM



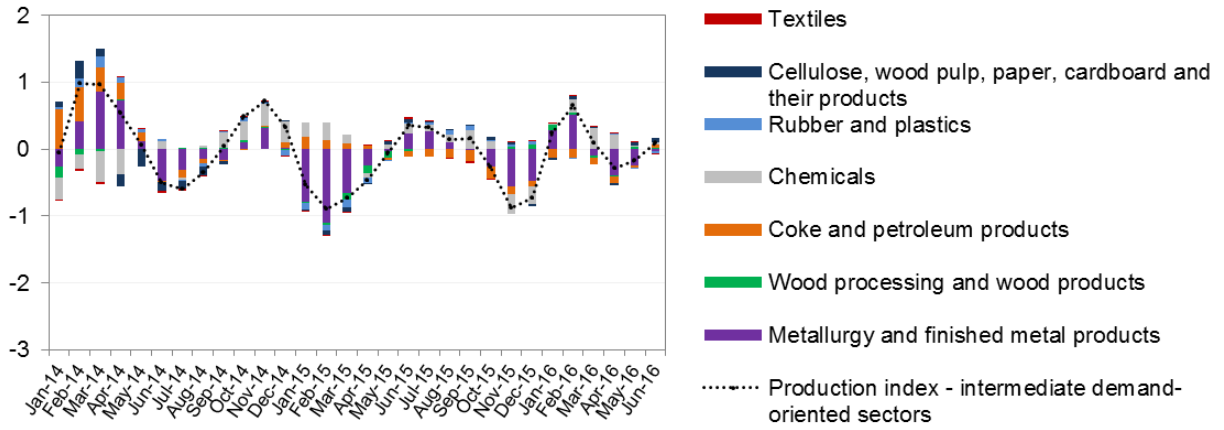
Sources: Rosstat, R&F Department calculations.

Figure 17. Production index in consumer demand-oriented industries (trend), % MoM



Sources: Rosstat, R&F Department calculations.

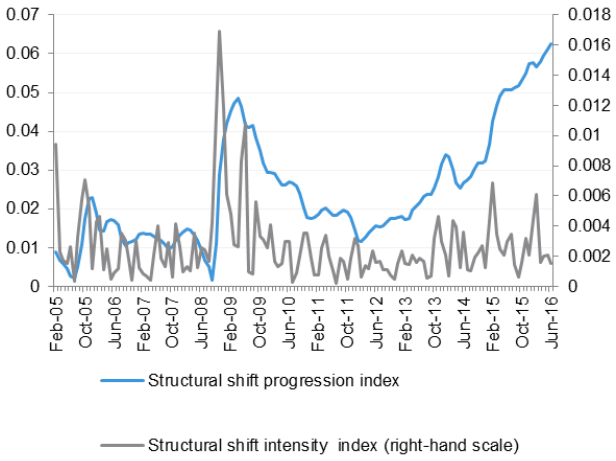
Figure 18. Production index in intermediate demand-oriented industries (trend), % MoM



Sources: Rosstat, R&F Department calculations.

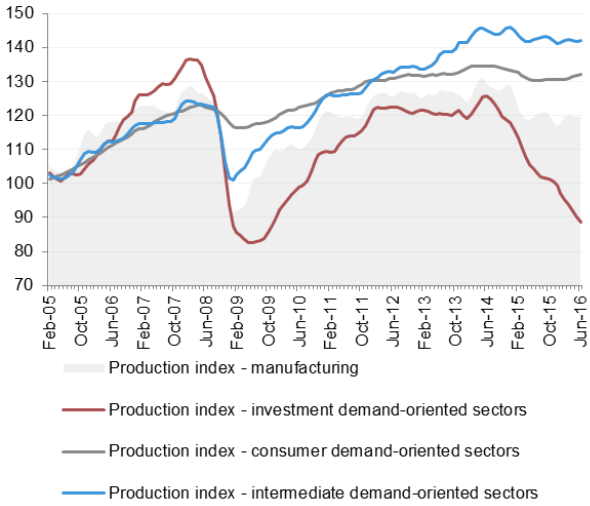
This direction of the change in the output structure, in the context of restricted use of imported technology, hinders the rollout of technical upgrades in the domestic economy – because investment demand sectors comprise businesses providing technology and product innovation to the other sectors (individual subsectors within the engineering industry, electronic and optical equipment).

Figure 19. Intensity and structural shift progression index across manufacturing sectors



Sources: Rosstat, R&F Department calculations.

Figure 20. Underlying component for production indices across manufacturing sectors, Jan 2005 = 100%



Sources: Rosstat, R&F Department calculations.

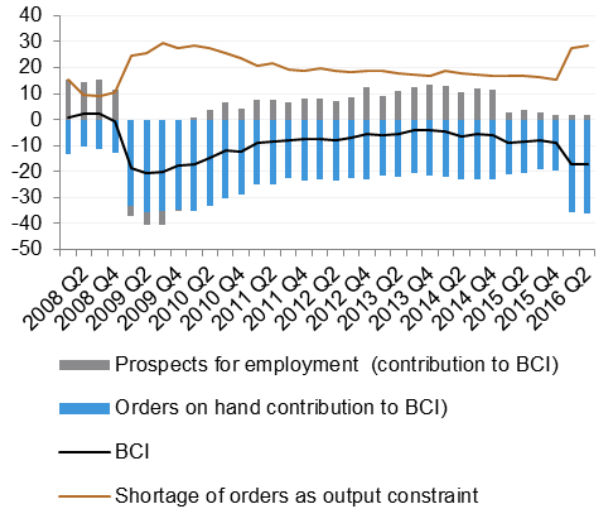
1.2.4. Business activity in construction is close to a ten-year low

- The business climate, having deteriorated in the second quarter, settled close to ten years' low as the amounts of state-funded construction fell amid feeble household and corporate demand.
- In a scenario where the nascent prerequisites for a rebound in consumer activity and investment demand take shape, business sentiment may be expected to improve gradually in the third quarter.

Since the beginning of 2016, Rosstat-conducted surveys of construction companies showed a sharp deterioration in business climate in construction. In the second quarter, the seasonally corrected business confidence index (BCI)[8] in the sector was continuing to decrease, having reached the lowest readings since 2009 Q3 (**Figure 21**). The key reason for such deterioration is the deepened lack of orders, which is limiting the volume of construction. Given the long financial cycle in construction, it is only now that industry participants fully feel the drop in total effective demand for construction services.

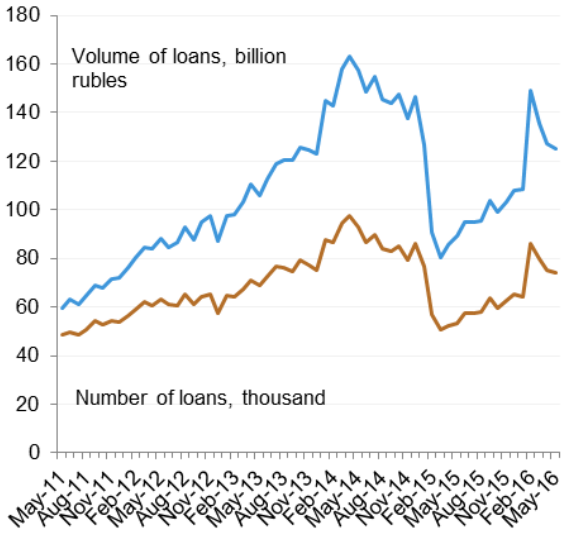
[8] The BCI in construction is calculated as an arithmetic mean of the balance of estimates for the product portfolio and the expected movements in employment in the next quarter against the current quarter (in %). The balance of estimates is a difference in the share of respondents whose estimates were 'above normal' and 'below normal' (in %).

Figure 21. Business confidence in construction (seasonally adjusted), %



Sources: Rosstat, R&F Department calculations.

Figure 22. Volumes of mortgage loans (seasonally adjusted)

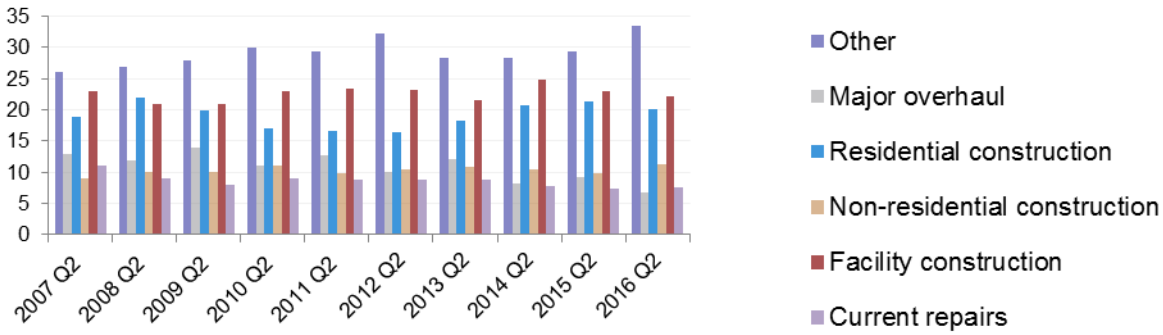


Sources: Bank of Russia, R&F Department calculations.

Residential building is a leader in the whole construction sector. The year 2016 sees a continued contraction in new builds, wholly driven by plummeting private housing construction as real household incomes are dwindling. According to the Agency for Housing Mortgage Lending, new builds over the four months fell by 27.1% on the same period last year. The trends also included an upsurge in block of flats (+20.7%). The resulting contribution of blocks of flats to the total amount of housing construction in Russia increased from 50% to 62%.

Following the sharp fall in the demand for housing mortgage loans of early 2015, the share of co-funded construction contracts with the use of borrowed funds and target loans in the total of registered co-funded construction contracts in 2016 Q1 reached a top figure (39%) for the period since 2010. The strong acceleration of the mortgage market, seen between January and February, came as a result of future demand having materialised on fears the soft mortgage lending terms may be cancelled. Between March and May, mortgage loans dropped both in number and amount but still remained above their top 2015 monthly marks.

Figure 23. Estimated volumes of construction by activity type[9], %



Sources: Rosstat, R&F Department calculations.

In the current development, however, the share of new house mortgage lending with subsidised interest rates in the total volume of mortgage loans is dwindling. This stood at 72% in May 2015, while May 2016 saw it drop to 32%. This trend owns its existence to, first, the ongoing downward movement in secondary housing and, second, less attractive loan terms (with fewer subsidies) as the difference in the terms of *subsidised* and *market-based* mortgage lending is shrinking. According to the Agency for Housing Mortgage Lending, the average mortgage loan rate in May was 12.99%. The number of co-funded construction contracts, a figure that could be viewed as a leading indicator for construction, was in 2016 Q1 above that of Q1 2015, having almost made it to the 2014 level. This will support the construction sector.

At the same time, the dwindling public demand for constriction services cannot but worsen the situation in the residential building sector. In 2016, the funding under the 'Housing' Federal Target Program (ФЦП «Жилище») dropped as much as 40.8% compared to 2015. As of 1 May 2016, a mere 4% of the planned 2016 volume were funded.

Low investment activity has negative repercussions for non-residential building. The low demand, from the side of the government and businesses, for construction services seen in the last ten years accounts for ten-year low readings of the share of capital overhauls in the total added value of construction companies (Figure 23).Provided that the emerging prerequisites for a rebound in consumer activity and investment demand secure a firm footing, a gradual recovery in the construction industry's business climate should be expected.

[9] This is estimated gross value added (GVA) percentage covering residential, commercial and engineering construction in the total GVA of construction companies, bases on the industrial business activity surveys.

1.2.5. Decline in consumer activity slows down as consumer expectations are stabilising

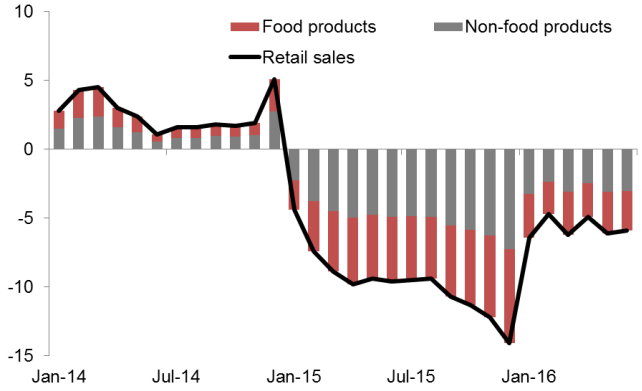
- In June, contraction of seasonally adjusted retail sales slowed down to 0.5% MoM, against 1.2% MoM in May.
- June's 1.4% annual growth rate of real wages, along with better consumer expectations, may help enhance consumer activity before the year is out.

According to Rosstat, retail sales in June were expanding at 0.6% MoM. R&F estimates show seasonally adjusted sales fell 0.5% MoM, following the contraction of 1.2% MoM in May.

Compared to the previous year, sales of both food and non-food products were continuing to shrink. However, as opposed to the previous month, the dynamic gap between the components is up. Food products shrank 5.7% YoY, while non-food items dropped 6.1% YoY (Figure 24). Also, the seasonally adjusted data show a more modest decrease in the sales of food products: 0.4% YoY against the drop of 0.6% in non-foods. May's stronger drop in the sales of food products is seen rather as an exception; the rates at which non-food sales have continued to outpace those of food products since February 2016.

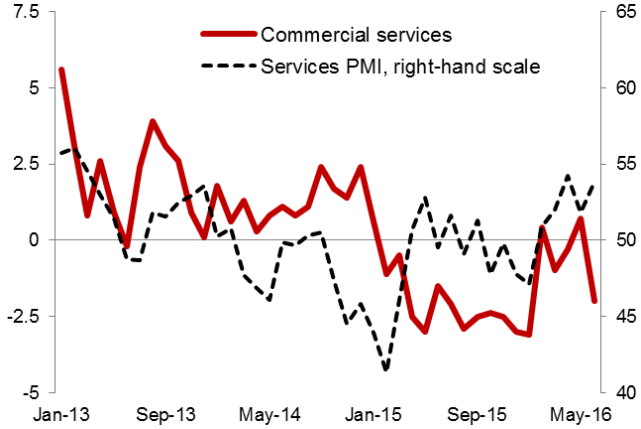
Commercial consumer services continue to show a volatile performance. As follows from updated Rosstat's data, consumer services appear more optimistic as positive annual growth rates were observed in both February and May; May's reading meanwhile was upgraded to 0.7% YoY from 0.2% YoY (Figure 25). Taking into account the fairly good dynamics of the PMI index and the business confidence index for services in the second quarter, the sector looks poised to show gradual positive annual growth rates. In 2016 H1, the contraction in commercial services totalled 0.9% YoY.

Figure 24. Share of food and non-food products in retail sales, % YoY



Sources: Rosstat, R&F Department calculations.

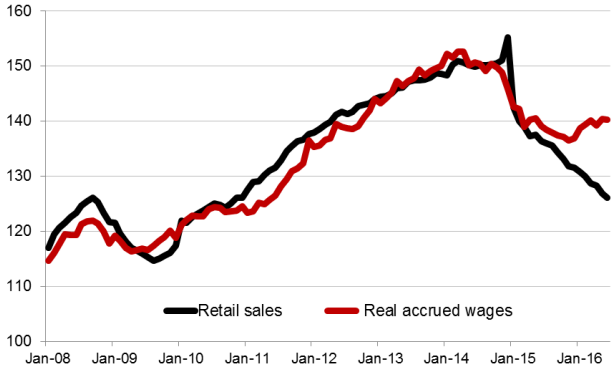
Figure 25. Commercial services (% YoY) and Services PMI



Sources: Rosstat, R&F Department calculations.

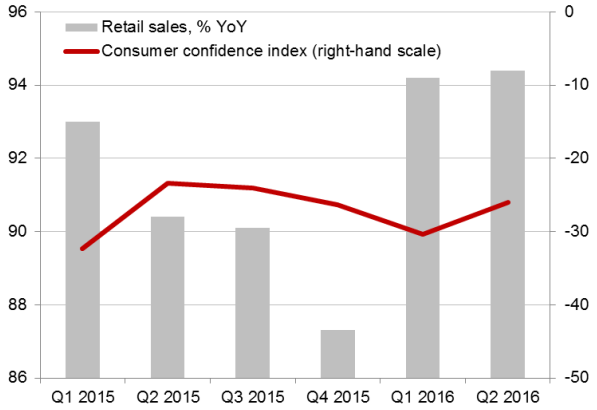
Despite the stubbornly weak retail sales data, rising real wages and steading consumer expectations suggest a potential rebound in consumer activity to come in the next few months.

Figure 26. Retail sales and real wages (Jan 2007 = 100%, seasonally adjusted)



Sources: Rosstat, R&F Department calculations.

Figure 27. Retail sales and consumer confidence index



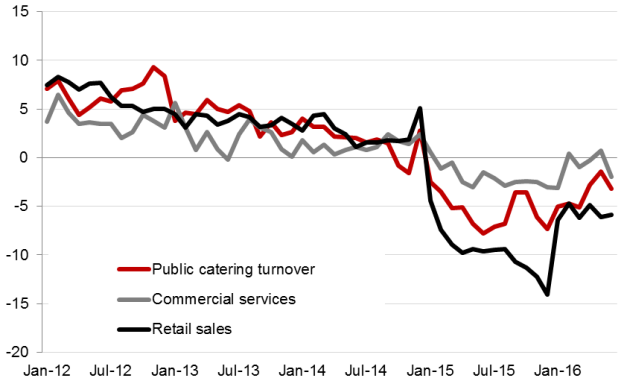
Sources: Rosstat, R&F Department calculations.

In June, seasonally adjusted real wages dropped 0.1% MoM, while the real disposable income grew 0.3% MoM after the slower drop seen between April and May. With seasonally adjusted data still rather volatile, their performance points to a gradual stabilisation in household income, which, in its turn, helps improve consumer expectations. In June, real salaries grew 1.4% YoY and hit zero of annualised growth for 2016 H1 (in 2015 H1, the contraction was 8.2% YoY). Their growth is grounded increasing nominal wages, which is a positive development (Figure 26).

The early signs of a recovery in wages have so far had only a minor impact on retail (Figure 26). This may partially be explained by the ongoing switchover to catering services, from household consumption-focused food shopping, as

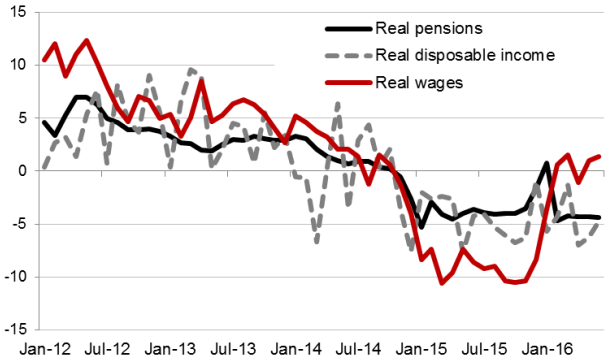
suggested by the more agile recovery of public catering (Figure 28). This may also result from the persisting propensity to save. Polling data show that the share of population who need to economise is still high.

Figure 28. Public catering, retail sales and commercial services, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 29. Real pensions, real disposable income and real wages, % YoY



Source: Rosstat.

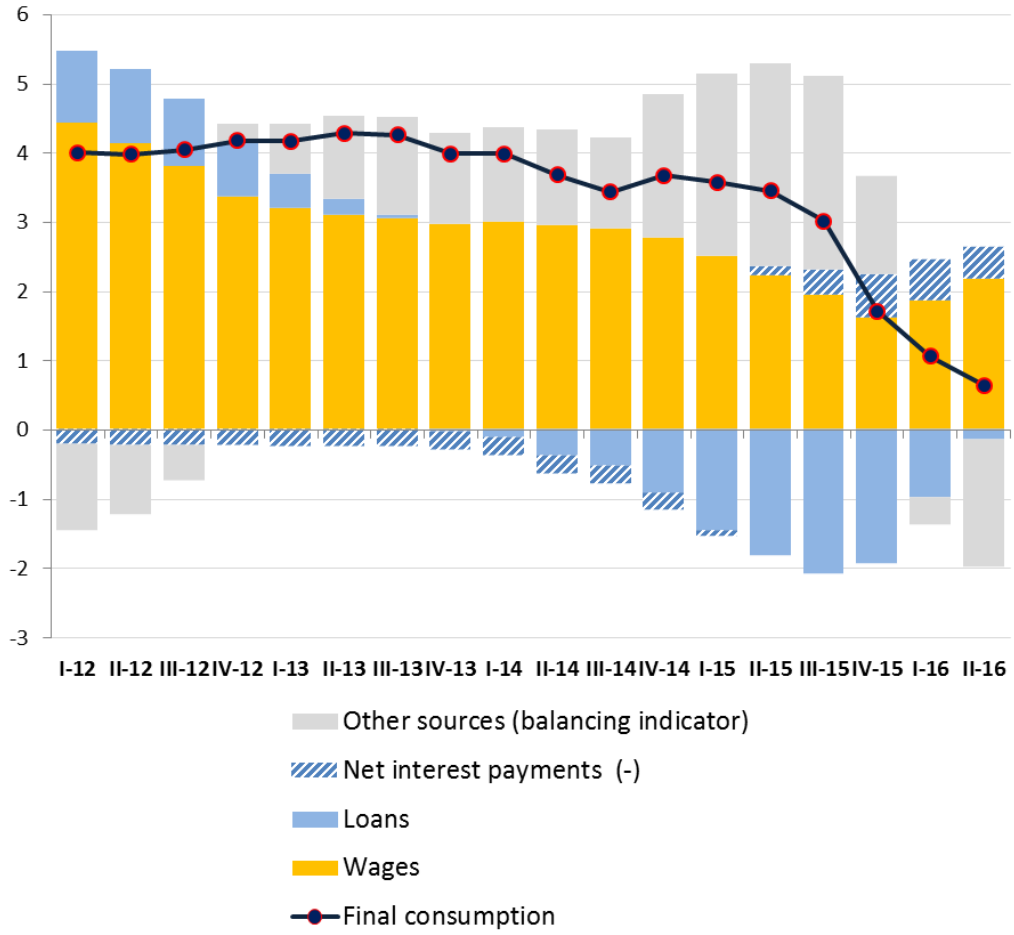
Also, June saw a decreased number of respondents who recognise the need to economise more[10]. June's saving ratio was still high (13.1% of monetary income), suggesting the lack of any clear improvements in the dynamics of retail, despite the recovery in wages. The fact that the saving ratio, in its turn, hold could be connected with a rising cross-sectoral wage differentiation. The available statistics indicate the outpacing growth of wages in high margin industries (mining, finance) with their employees' assumed stronger propensity to save, as opposed to other industries (see Figure 37 in 1.2.7).

The mixed readings from real wages and pension also matter as they dropped 4.4% YoY in June, which partially explains the drop in the sales of food products. However, the impact here is limited as the share of social payments in the total monetary income remains low (19.2% in the second quarter), with the dominance of labour compensation (65.6% in the second quarter).

It should be noted that, as follows from the decompositions of consumption by source of financing, the performance of wages and credit activity is no hindrance to retail expansion (Figure 30). Meanwhile, the advance of consumer lending remains fragile. The *wage rise to consumption pass-through* could be checked by a substantial rise in saving; however, the absence of any non-standard trends in household deposits suggests no firm conclusion as to the exact contribution of this factor.

[10] According to inFOM survey data, 66% of respondent in June recognised they economised on some products or services in the past three months. Expansion in economising was noted by 50% of respondents against 47% one month ago.

Figure 30. Household final consumption expenditure increment and its financing source*



**Excess in amount for the rolling year over the previous rolling year amount, ₽ trln.*

Sources: Rosstat, R&F Department calculations.

In the previous crisis, the period of mismatch between wages and retail sales was substantially shorter and the differential lower. This may be explained by the fact that in the aftermath of the 2008-2009 crisis, the quick rebound in oil prices enabled consumption-focused behaviour model to return, also helped by the outrunning indexation of pensions and salaries in the public sector. This is not the case now.

Moreover, the rise in income as follows from statistical data, has yet to translate into even planned spending. According to inFOM, in June and in May, as many as 50% of respondents in the past three months had to give up on their previously planned large expenses, while the share of those planning no big-budget purchases whatsoever increased to 31% from 21% in May. Consequently, provided that the tentative retail data are confirmed, it will be possible to speak on a longer lag in the reaction of consumer activity to income growth.

To a degree, the opportunity to save on durable goods was behind the buying in late 2014, when the consumption profile changed. Some purchases were made ahead of plans, while the frequency of upgrades could have been down.

Having said this, improved consumer expectations in 2016 Q2 are a positive signal in terms of future consumption (Figure 27). Moreover, although consumer sentiment and consumer expectation indices did drop in June below their May point (a top reading for the year), these indicators are still higher than those for the January to April 2016 period.

The strengthened big-budget purchase and present index, on the backdrop of improved consumer confidence, gives good reason to expect that the paces of 2016 H2 sales decline will continue to slow down.

1.2.6. Car market: stagnated demand for new cars amid growing demand for used cars

- June's uptick in sales replaced May's sales drop, which overall is indicative of stagnation in the last few months' demand for automobiles.
- The fact that new car orders have remained low over the last six months suggests that stagnation on a short-term horizon is set to continue.

According to the Association of European Businesses (AEB), the sales of new private vehicles and light commercial vehicles in June continued to repeat the dynamics of the same month in 2013. This suggests that the Russian automobile market, gradually adjusting to the drop in demand, is approaching a new equilibrium. Sales (seasonally adjusted) rose by 2% in June on May. However, the minor growth of sales in June comes after the May recession, which overall points to a stagnated market for the last few months.

Total number of future purchasing orders for new cars held at six month's low in May (**Figure 33**), suggesting protracted stagnation in the near future. The low current demand and the lack of expectations for its rapid recovery make producers compelled to keep inventories low. Output figures held relatively stable and within the range of insignificant fluctuations which enable manufacturers to sustain the effective level of inventories with limited volumes of sales.

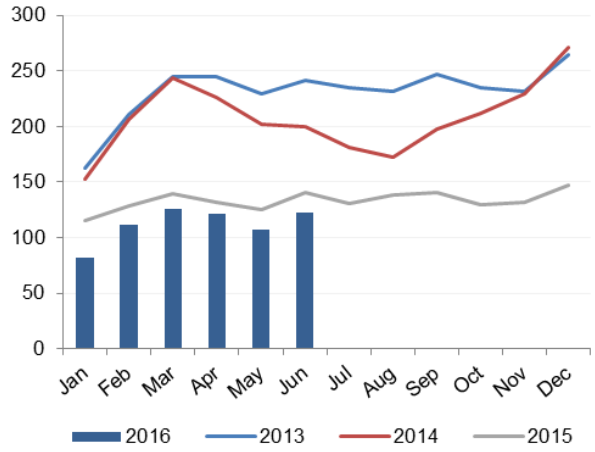
According to AEB forecasts, 2016 sales of new cars (including light commercial vehicles, or LCVs) are set to total 1.44 million pieces, 12.5% down on last year. According to Avtostat, an analytical agency, sales (excluding LCVs) are estimated to total 1.3 million pieces, which approximately corresponds to the 2015 level. Were the state market support programme for 2017 scaled back, the market would contract to as many as 1 million pieces – against 3.3 million of the total

Russian automotive industry's potential output, according to the Russian Automobile Dealer Association.

The car market sees the earlier trends being entrenched together with its structure change as it is adjusting to the current economic setup. In 2016 H1, compared to the same period last year, the major drops in the sales of new cars were seen in the mass market segment (15.4%) while the drop in the premium segment stood only at 8.3%. The premium segment is however likely to see a strengthened negative trend in the short term as market saturation is finding its way in the premium segment, too. This market segment may only get a boost from the drive to change cars in some two to three years.

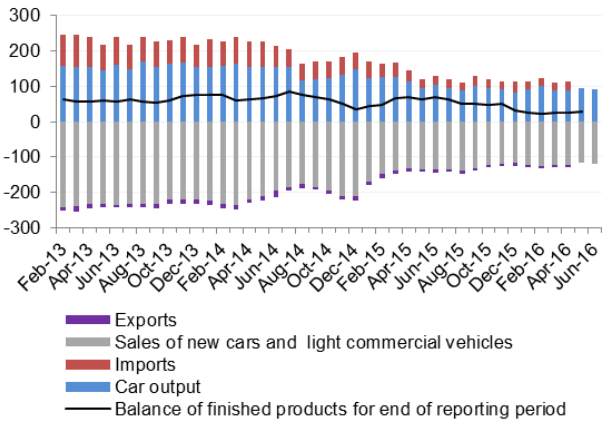
The market developments include the advancement of Chinese car makes in Russia (in this way, sales of Lifan grew in the first six months of 2016 by 63.3%). At the same time, some foreign brands with minor sales are leaving the market. Currently, the global automotive industry is on the rise, helping some foreign manufacturers tolerate their low Russian margins thanks to profit diversification across markets. This is why the Russian market looks promising, for the time being, to foreign car makers as they strive to carve out their niches. Tight competition is seen in the mass market segment where price considerations dominate over other competitive advantages including a car make or quality.

Figure 31. Sales of new private vehicles and new light commercial vehicles, thousand units



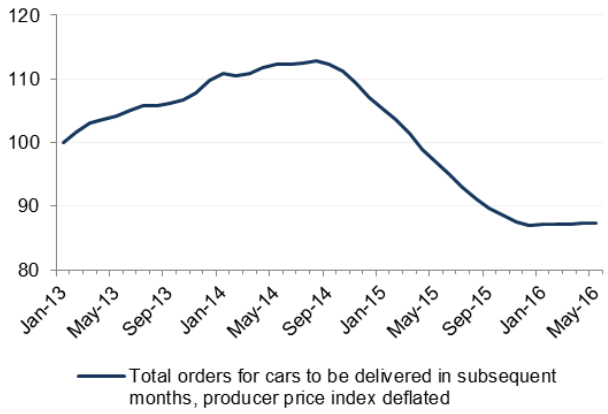
Sources: AEB, R&F Department calculations.

Figure 32. Demand (-) and supply components (+) on the RF car market, seasonally adjusted, thousand units



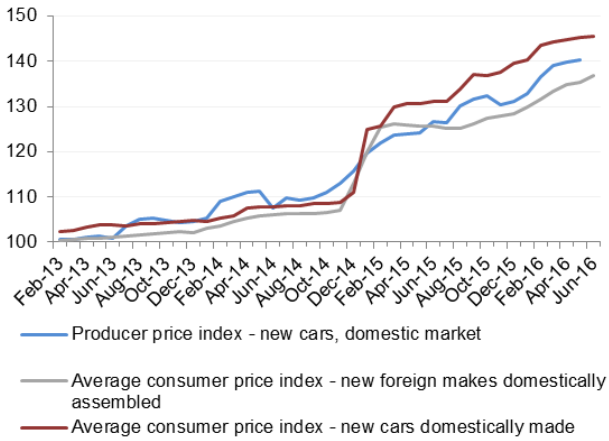
Sources: AEB, Rosstat, R&F Department calculations.

Figure 33. Total orders for new cars for future delivery (trend), Jan 2013 = 100%



Sources: Rosstat, R&F Department calculations.

Figure 34. Consumer and manufacturer prices for new cars, Jan 2013 = 100%



Sources: Rosstat, R&F Department calculations.

There is a shift in consumer demand towards used cars. In the first half of the year, this market registered an 11% growth on the same period of 2015. This trend should sooner or later be followed by a rise in the demand for new cars.

The global average for the share of used car sales in dealer chains is 25–30%, while that in Russia is a mere 8–9%[11]. The National Automobile Database, to be launched by the Russian Automobile Dealer Association, is thought to help promote a civilized market of used cars, in a move that would incentivise development of the segment.

1.2.7. Labour market: rising wages are set to help improve consumer activity

- The current performance of wages contributes to recovery in demand and improvement in consumer activity in the next few months.
- Outpacing rates of wage growth are observed in the tradable sector.
- Amid the current structural constraints in the labour market and the signs of prerequisites for rebound in economic activity due in the second year-half, the rate of unemployment in the coming months is likely to remain moderate or edge down (seasonally adjusted).

According to Rosstat, annualised nominal wages in June grew 9% a top gain since September 2014. With the annual acceleration of inflation factored in (7.5% in June against 7.3% in May), this essential increment becomes a key driver for real wages residing in positive territory for a second month sequentially. And, the fact

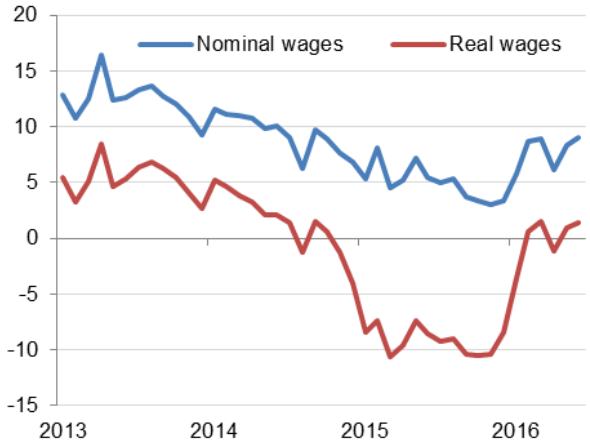
[11] The Russian Automobile Dealer Association data.

that income improved on the back of nominal wages may well be indicative of fundamental positive change in economic activity, reflecting better the increased effective demand as the population tends to react to nominal changes in income more rapidly.

Yet, the two months of statistics are not enough for firm conclusions. It is not impossible that Rosstat may revise its estimates yet again. This was the case in May when Rosstat upgraded its estimates by 2 pp on average on the original data.

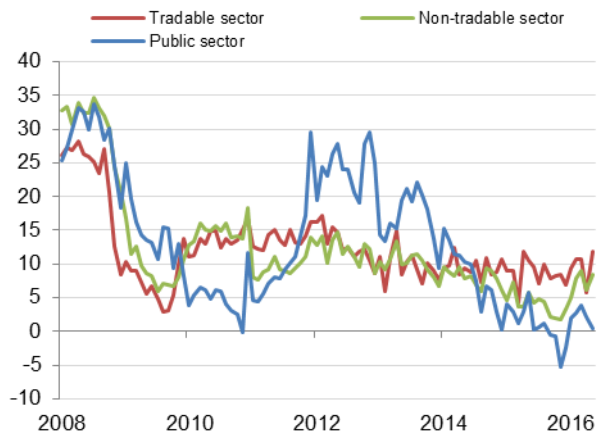
The May wage indices for core sectors of the economy against the same month of the previous year, gross value added weighed, remain mixed. The heterogeneous movements of salaries across sectors have been present since 2010. Whereas since the beginning of 2010 wages in the tradable and non-tradable sectors grew within the 5%-15% range YoY, those in the public sector had until 2014 occurred at outpacing rates (Figure 36), as a result of the one-off strong rise in servicemen's salaries as part of the armed force reform underway since 2011.

Figure 35. Performance of wages, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 36. Wage index by sector, % YoY



Sources: Rosstat, R&F Department calculations.

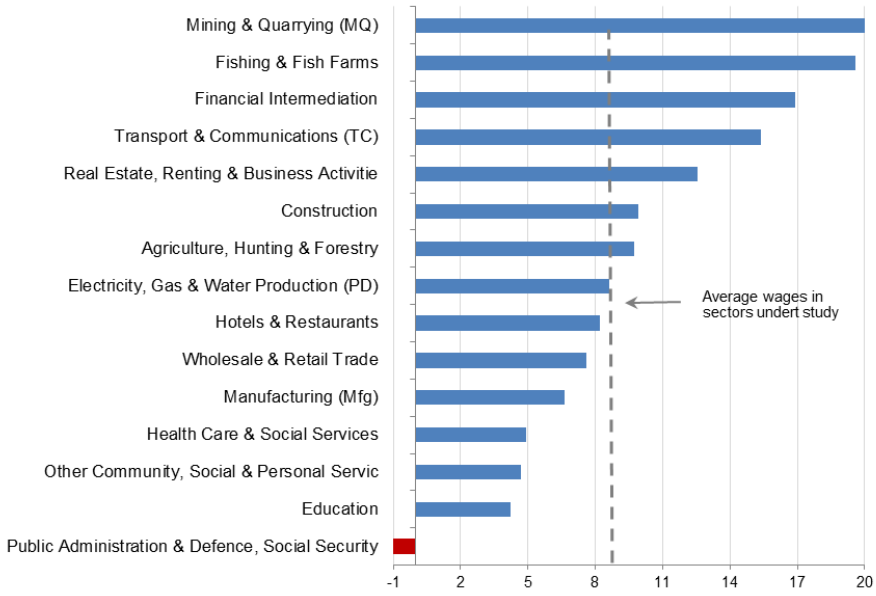
As the fiscal consolidation unfolds, 2015-2016 growth rates of salaries in the public sector are down strongly, as expected, leading to a widening gap with the tradable and non-tradable sectors' wages. Based on May's figures, the growth pace of salaries in the public sector slowed to 0.5% YoY, as a result of the indexation freeze of 2016. We have every reason to believe that this trend will hold in the months to come.

On the subject of the non-public sector, May's wages in the tradable sector were advancing at outrunning rates as compared to the tradable sector. Mining became a key wage growth driver in the sector, with nominal wages growing 20% YoY in the absence of any significant base effect (Figure 37). As a result, mining accounted for most wages in the tradable sector.

The industries in the non-tradable sector which posted the strongest wage growth include finance, transport, communications and real estate operations. This is noted however with the understanding that wage gains in these sectors are recovering after the rebound in economic activity, so the growth paces remain within the average range of the previous years. The same is true of wage growth rates in mining; being least susceptible to economic change, these are currently high.

In this way, *on the one hand*, there are signs of significant improvement in the overall wage trend. *On the other hand*, any fundamental positive change in its structure is still insignificant and unsteady. In the current setup, employers tend to rely on a strategy whereby staff reductions are minimised and cost savings are achieved through low indexation of salaries. The scenario is quite realistic in the context of the low growth rates of wages in the public sector as they are putting no pressure on wages in the private sector.

Figure 37. Nominal wage growth in May, % YoY



Sources: Rosstat, R&F Department calculations.

The current unemployment rate has been on a downward path since March when it hit a two and a half years' high of 6.0%. In June, unemployment totalled 5.4%, down 0.2% on the past month's reading.

Seasonal adjusted unemployment in June dipped slightly to 5.7%, as opposed to 5.8% in May (Figure 39).

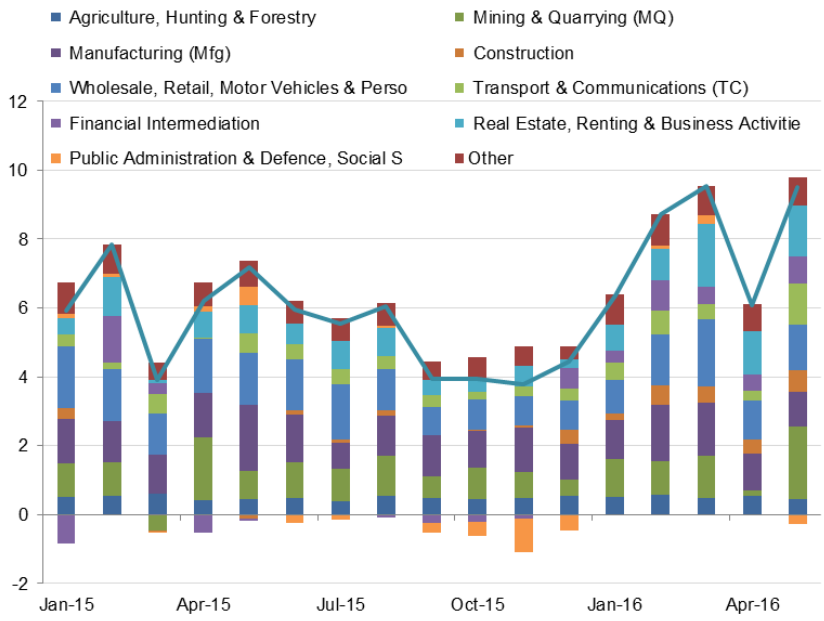
The lower unemployment owns its origin to both a reduction in the number of unemployed and a growing labour force (economically active population). The latter

is seen mainly in the 30-44 age group, not young people (the under 24 years age group) where unemployment stays on a upward path.

As for the pension and pre-retirement age groups, people aged 55–72 years are leaving the labour structure inactively. This is evidenced by the respective employment figures for economically active and inactive population, which are at their maximum and minimum, respectively (Figure 40).

In such a way, the senior generation still residing in the labour force is indeed putting pressure on youth unemployment (up to 24 years age group). In the first quarter, this unemployment, seasonally adjusted, was at its highest since 2010. The share of youth in the economically active population is low, this however fails to trigger any rise in the general unemployment rate.

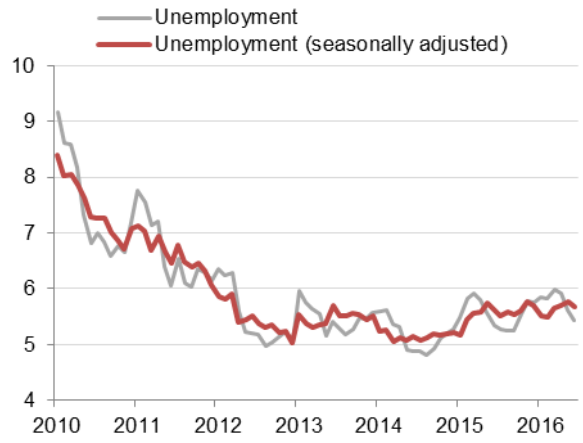
Figure 38. Nominal wage growth decomposed by industry, % YoY



Sources: Rosstat, R&F Department calculations.

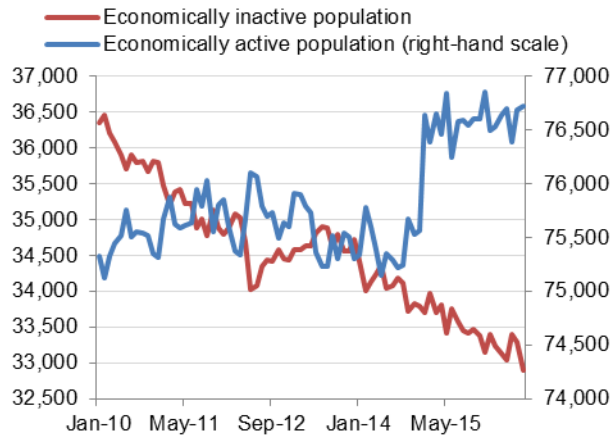
Given the ongoing impact from the structural factors helping check the growth of unemployment in a time of recession, as well as the emergence of prerequisites for economic recovery due in the second half-year, we see every reason for the moderately favourable indicators in the labour market to hold in the months ahead.

Figure 39. Unemployment, %



Sources: Rosstat, R&F Department calculations.

Figure 40. Dynamics of economically active and inactive population (seasonally adjusted), thousand people

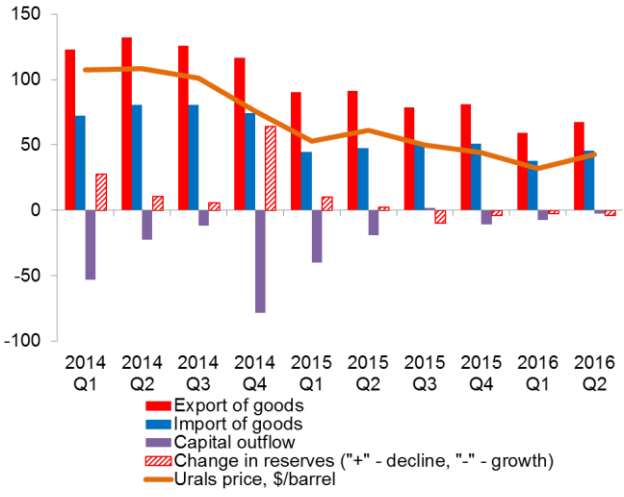


Sources: Rosstat, R&F Department calculations.

1.2.8. H1 balance of payments: a modest current account surplus lingers

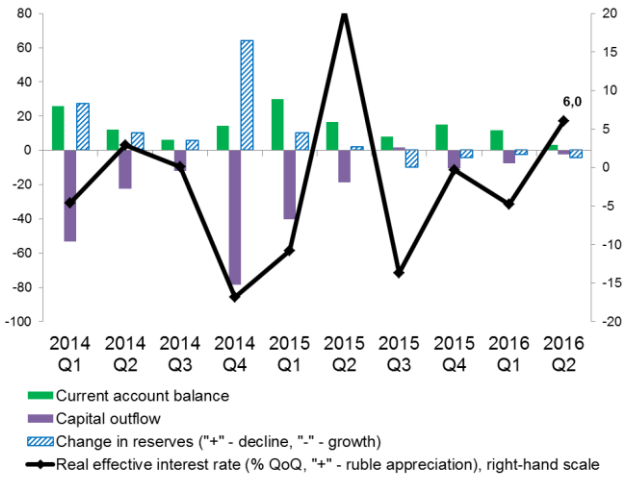
Provisional estimates of balance of payments dynamics in 2016 Q2 point to an on-going decline in the current account balance to $3.4 billion as compared to $16.5 last year.

Figure 41. Selected balance of payments components, $ billion



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

Figure 42. Selected balance of payments components, $ billion



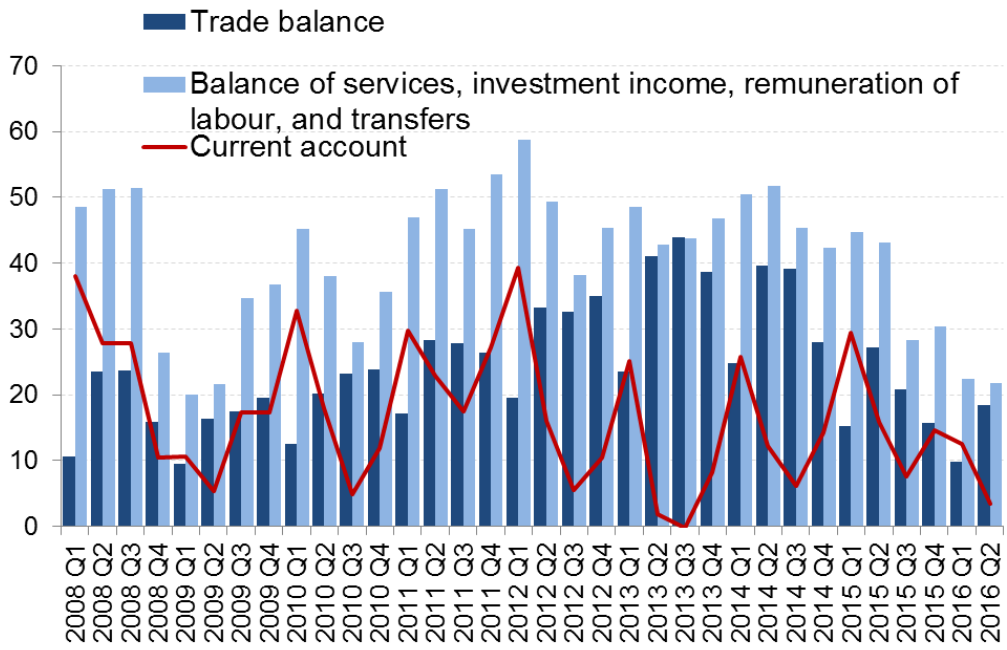
Sources: Bank of Russia, R&F Department estimates.

The published data proved to be inferior to our estimates (current account surplus of $6.5-7.0 billion) derived from the balance of payments model, based on the actual oil price dynamics, physical volumes and some other macroeconomic indicators we apply in our calculations.

Our assessment shows that R&F Department estimates do not match with the published provisional estimates of the balance of payments with regard to the current account in the balance of trade items. Thus, actual commodity exports fell short of our expectations given the actual oil prices in April-June. This can be explained by a lag in supply agreement execution coupled with a lagged effect of the negative oil shock early this year. However, that gives us hope for commodity exports recovery in future. At the same time, import dynamics exceeded our expectations even though the ruble appreciated and real household income stopped falling.

Capital outflow continued to show a downward trend: in April-June, net private capital outflow stood at only $2.4 billion. This favourable dynamics of net capital outflow result, primarily, from the last year peak in external debt repayments and the ongoing successful refinancing of foreign debt by the non-financial sector. In the second quarter, foreign borrowings of the non-financial sector exceeded its repayments (by $7.2 billion), though this estimate may change considerably after the cash flows recorded in the item 'errors and omissions' are adjusted (Figure 44).

Figure 43. Trade and non-trade balances, $ billion

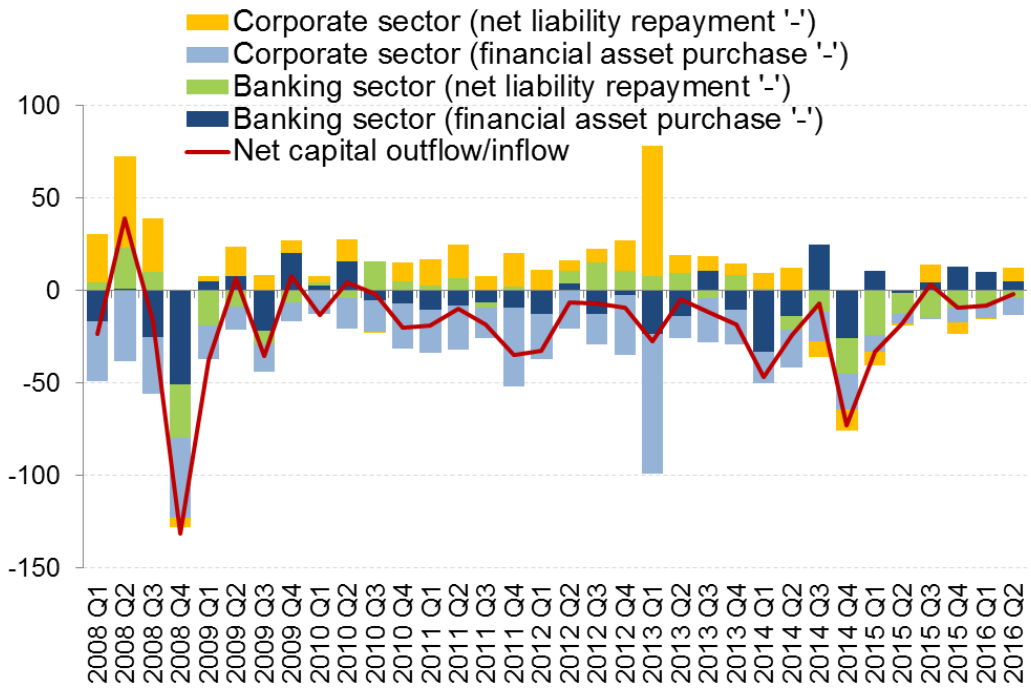


Sources: Bank of Russia, R&F Department calculations.

Banks' cutting of FX financial assets (by $4.7 billion) was another important positive factor in the dynamics of capital flows in the second quarter. This was mostly connected with the banks' repayments to the Bank of Russia under FX repos. Banks' repayments of foreign debts - the actual value of which is comparable to the estimates featured in the BoR schedule of external debt repayments - account for a relatively stable part of capital outflow in 2016.

We still assume that the modest current account surplus in 2016 will require a further shrinkage in the capital outflow, making the Russian currency more sensitive to shocks in global financial markets.

Figure 44. Capital account components, $ billion



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

Ruble stability amid oil price downturn: effects of capital inflow and anchored oil price expectations

In January-April the average exchange rate at given oil prices changed. The oil price growth could signal risk mitigation (at $40 a barrel the exchange rate was 65 rubles per US dollar vs. 75 rubles per US dollar at the beginning of the year). This trend persisted in July when at the same oil price the ruble was stronger than in June. Such shifts may result from investors' risk sentiment (capital inflow).

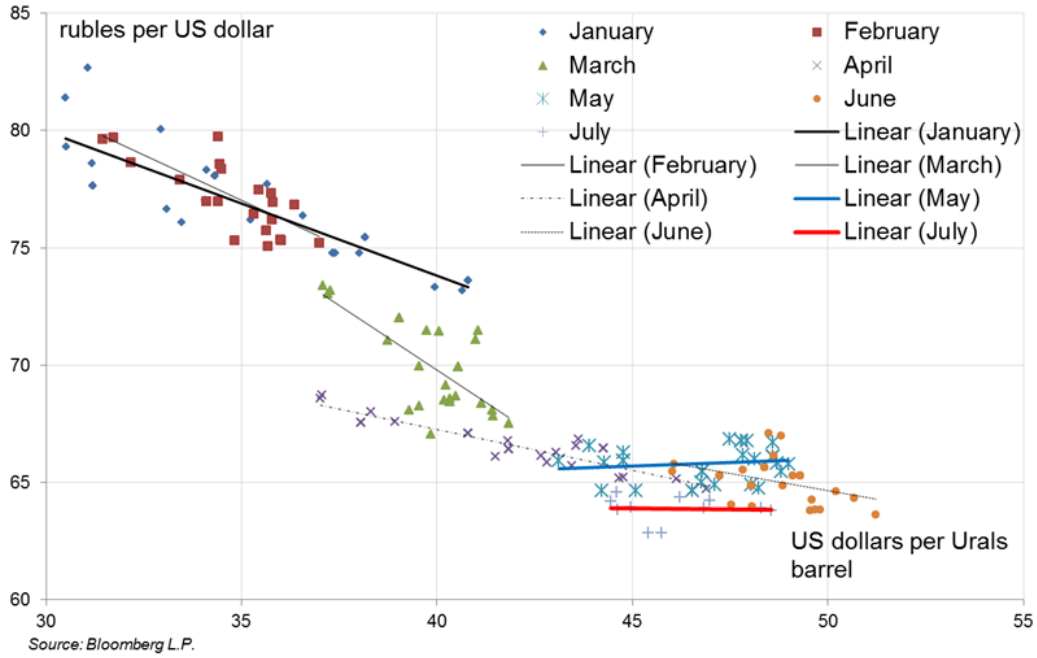
Since the beginning of July, the ruble has been showing the lowest oil price sensitivity. In March, when oil prices were up and global risks went down, the sensitivity was at its top reading for the year, triggering ruble appreciation. Since April, oil price elasticity of the ruble exchange rate has weakened. The downward trend persisted further and the exchange rate responded to large-scale oil price movements with only 3-4 ruble fluctuations. Such a low oil elasticity of the ruble may be explained as follows:

A) Market participants' confidence that the oil price has stabilised at the level of $45 a barrel. Therefore, even if oil prices fluctuate at around this level, there are no reasons to expect these deviations to be of a long-term nature (that would have

required the fundamental ruble exchange rate to be revaluated for this oil price). In other words, market participants consider oil price at $45-50 a barrel to have been equilibrium since April. They do not revaluate the ruble exchange rate if oil prices go up, considering the deviation of the oil price from the equilibrium to be temporary.

B) Sensitivity may be low amid high global risk (risk off) and high amid low risk level (risk on). If global risks drive investors off from a country, oil price fluctuations do not trigger capital inflow. Risk-on boosts oil price sensitivity, as oil starts to signal a relative risk of investments in Russian assets (as compared with other risk-on markets). However, in July the ruble's sensitivity to the oil price was very low amid a risk-on in the global market, which is in conflict with this assumption.

Figure 45. Ruble exchange rate and oil prices by month of 2016

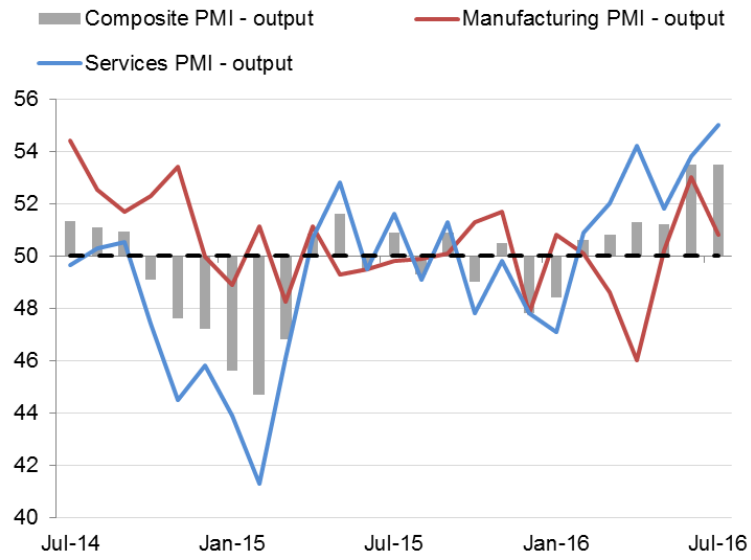


1.2.9. PMI indices: services grow faster as manufacturing shows a modest cooling

- Composite Russian PMI held at its February 2013 high: the considerable upturn in services offset the downturn in manufacturing.
- Slack demand and high capacity utilisation remain the key constraints of output growth in manufacturing as uncertainty loses its grip.
- Improvement in business sentiment to the level of early 2014 goes hand in hand with faster growth in services to the February 2013 high.
- July PMI data signal that economic activity is very likely to recover progressively in the months to come.

In July, composite PMI persisted at 53.5 points, the highest level since February 2013 (Figure 46) Meanwhile, business activity in manufacturing showed a slight decline while services demonstrated an accelerated growth.

Figure 46. Russian PMI - output, points

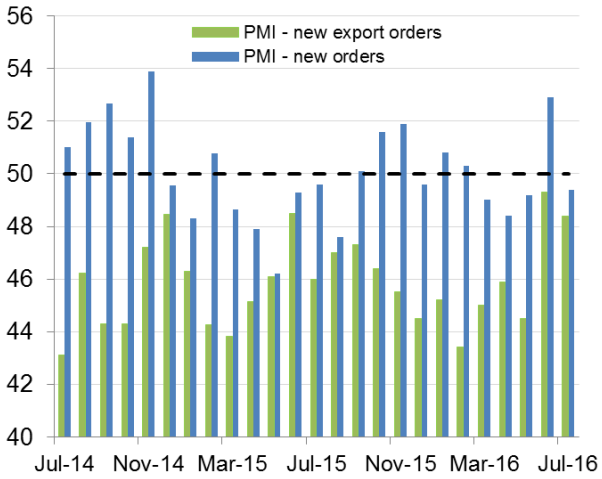


Source: Bloomberg Finance L.P.

Manufacturing PMI dropped from 51.5 in June to 49.5 in July, once again falling below the 50-point benchmark that distinguishes economic upturn from downturn. Business activity shrank due to a sluggish demand, both internal and external: new domestic orders resumed drifting down and new export orders suffered a more dramatic setback (Figure 47). Nevertheless, the drop in new orders was insignificant: the July downturn was less dramatic than monthly drops in March-May, and the decline in export orders was the lowest since June 2015 (bar the June 2016 data). Some companies attributed the drop in new orders to insufficient production capacities, which is partially confirmed by an increase in orders in progress, the first one since January 2013.

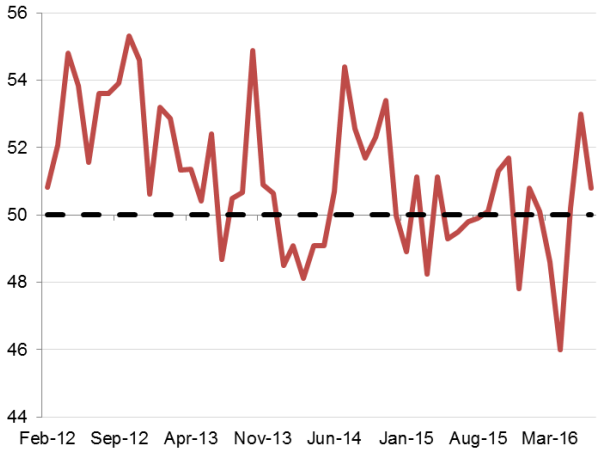
Despite the cutback in new orders, output continued to grow in the sector for the third month in a row, though at lower rates: output PMI dropped to 50.8 points against 53.0 points in June (Figure 48).

Figure 47. Manufacturing PMI - new orders



Source: Bloomberg Finance L.P.

Figure 48. Manufacturing PMI - output

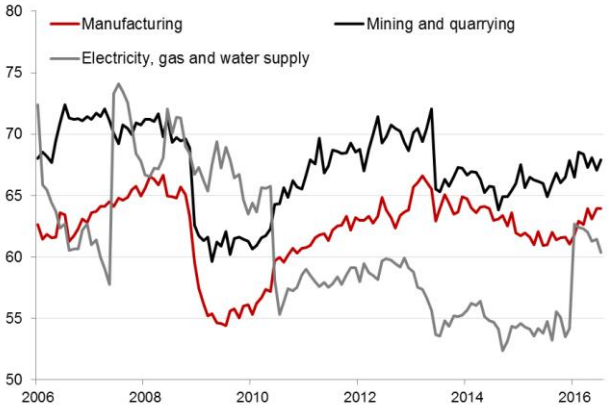


Source: Bloomberg Finance L.P.

Rosstat's monthly inspections of enterprises show that capacity utilisation, close to the local several-year high, persistently high uncertainty over the economic developments and low demand hold back growth in manufacturing (Figure 49, Figure 50). However, if no new external shocks emerge, uncertainty is expected to lose its grip in the months to come: the number of respondents considering this factor to be a constraint shrank in July to the lowest value since January 2016. Thereby, growth in manufacturing is likely to continue in the months to come.

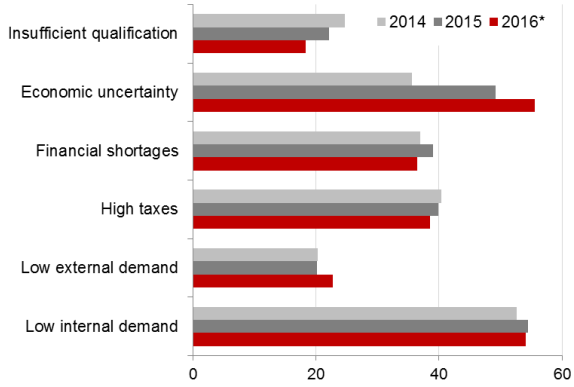
In July, services PMI hit its February 2013 high, growing to 55.0 points against 53.8 points in June. Business activity in services has been growing since February following a considerable increase in new orders to the highest level since January 2013 (Figure 51). It boosted employment in the sector for the first time since February 2014 (Figure 52). Although the rise was moderate, the indicator's entry into growth territory points to a better sentiment of service companies. This also boosted companies' sentiment with regard to the next year business activity to the highest level since February 2014. A switch of orders in progress from a 5.5-year decline to a symbolic growth (50.1 points) is a positive signal, along with employment growth.

Figure 49. Average capacity utilisation, % (seasonally adjusted)



Sources: Rosstat, R&F Department calculations.

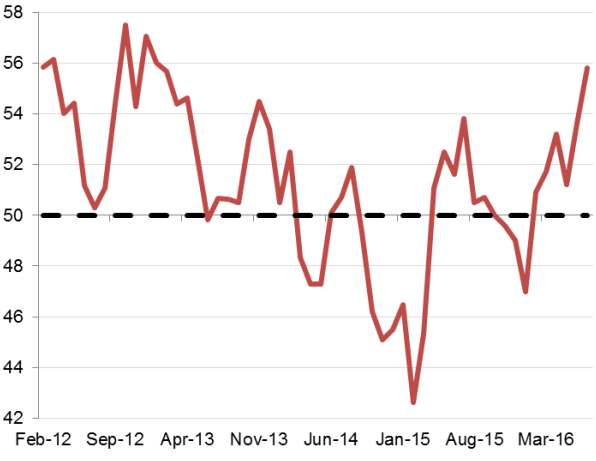
Figure 50. Manufacturing production constraints (% of respondents)



**2016 data is an average for January-July.*
Sources: Rosstat, R&F Department calculations.

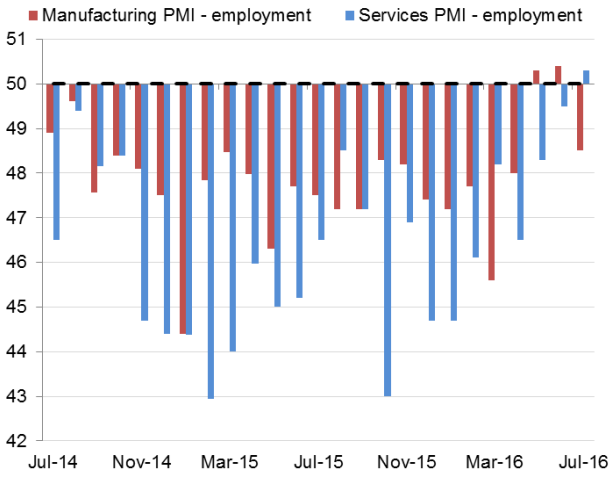
The overall PMI dynamics in July signal that gradual economic recovery is very likely to show up in the months to come. Having said that, deterioration in external environment that began in July may undermine expectations of economic agents, putting the economic dynamics at risk.

Figure 51. Russian services PMI - new orders, points



Source: Bloomberg Finance L.P.

Figure 52. PMI - employment, points



Source: Bloomberg Finance L.P.

1.3. Global economy, financial and commodity markets

1.3.1. Global economic growth remains sluggish

- Though buttressed by consumer demand, growth in advanced economies remained sluggish in the second quarter.
- Only one rate hike at most is expected from the Fed until the end of 2016.
- The government's accommodative measures anchored the economic growth in China at 6.7% YoY in the second quarter. In the second half of the year this effect can be exhausted.

USA

In June, non-farm payrolls grew by 287 thousand, outstripping the market consensus (180 thousand jobs). The newly published statistics showed that concerns over the US employment, expressed by some analysts following the poor statistics in the previous months, were premature. Yet, it is still early to make conclusions about sustainable employment recovery. When published, the statistics for July-August will clarify many issues regarding the current situation in the labour market.

The Fed's Federal Open Market Committee (FOMC) held the first meeting after the UK decided to leave the European Union. It expectedly retained the policy rate at 0.25-0.50%. The related press release mentioned considerable improvement in private consumption and labour market dynamics, though investment still shows modest dynamics. The Fed noted that short-term risks to the economic growth abated. It seems to refer to Brexit fallouts, which have not affected the US economy so far.

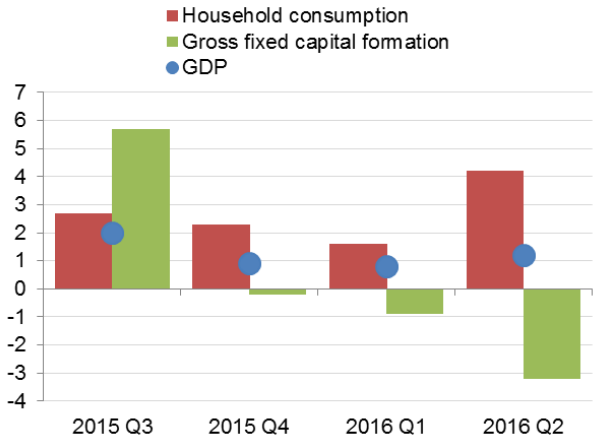
The first estimation of Q2 GDP growth confirmed the trend towards consumption and investment discrepancy. It grew by only 1.2%[12] Instead of the expected 2.5%. The Q1 data were revised downwards, from 1.1% to 0.8%. Household consumption expectedly made the most sizeable contribution to GDP dynamics in the second quarter; it grew by 4.2% YoY due to the increase in durable goods purchases of 8.4%. Investment dynamics made the main negative contribution. Gross capital formation dropped by 9.7% following the decline in inventories, while gross fixed capital formation fell by 3.2%[13] (Figure 53).

The considerable discrepancy between investment and private consumption is alarming. The accelerated drop in investment points to a rather pessimistic sentiment of the corporate sector. At some point it may reverse the positive trends in

[12] Seasonally adjusted QoQ growth in the annual terms.
[13] The maximum drop over the past 7 years.

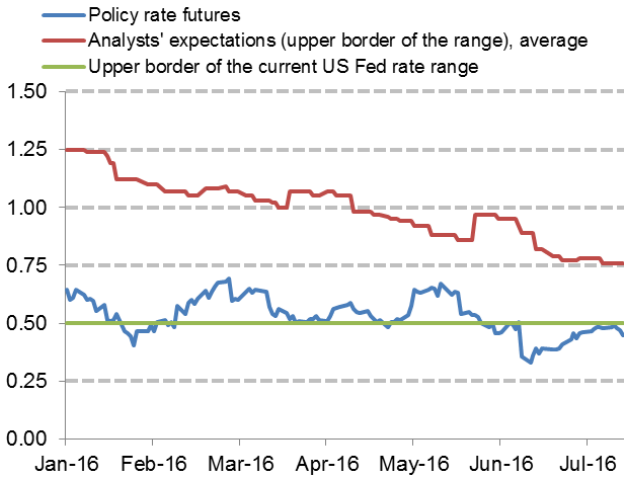
the labour market, consequently affecting consumption. Given these factors and the increasing uncertainty over the outcome of the presidential elections to be held in November, the Fed is very likely to abstain from raising the policy rate at the next meeting in September. It means that until the end of 2016 the Fed may revise the policy rate upwards only at its December meeting, that is currently in line with market expectations. Various indicators (Figure 54) predict a flat rate or just one hike until the year-end.

Figure 53. US GDP growth, seasonally adjusted, % QoQ in annual terms



Source: Bloomberg Finance L.P.

Figure 54. Fed rate expectations for end-2016

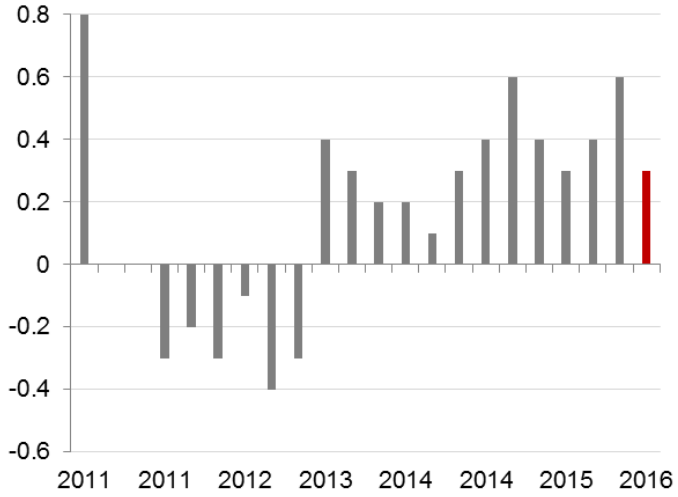


Source: Bloomberg Finance L.P.

Eurozone

At the meeting on 21 July, the Governing Council of the ECB decided to leave the parameters of the key operations unchanged. In his official statement in the follow-up to the decision Mario Draghi, President of the ECB, said that stagnation might strengthen if consumer inflation remained at about zero over the monetary policy impact horizon. Such an unequivocal statement proves that the European economy is far from a new round of monetary tightening. By now, the agenda is largely dominated by additional accommodative measures, in particular, adjustment of parameters of the quantitative easing programme (QE) with regard to both volumes and financial instruments to be purchased by the central bank from market participants.

Figure 55. Eurozone GDP growth, seasonally adjusted, % QoQ



Source: Bloomberg Finance L.P.

The first estimation of eurozone GDP suggests that its growth rates declined 0.3% in the second quarter after having accelerated to 0.6% in the first quarter (Figure 55). All major economies of the eurozone, including Germany and France, decelerated. Such economic dynamics are most likely to put further pressure on the ECB towards further monetary policy easing, even though the regulator constantly states that economic improvement depends not only on monetary policy.

Japan

The Bank of Japan's policy continues to raise questions with regards to its sustainability and largely contradicts market expectations. Last Friday, the Bank of Japan announced its decision, adopted by a majority vote (7 vs. 2), to leave the policy rate unchanged at -0.1%, to keep increasing the monetary base at an annual pace of ¥80 trillion, and to increase purchases of exchange-traded funds (ETF) from ¥3.3 trillion to ¥6 trillion.

In the run-up to the BoJ decision the volume of liquidity in the market declined. Given the sceptical statement about the prospects of helicopter money made earlier by Haruhiko Kuroda, BoJ Governor, the suggested expansion of accommodative measures disappointed the market. Intraday yen appreciation against the US dollar was close to 3% (the highest since end-2008) with a subsequent adjustment.

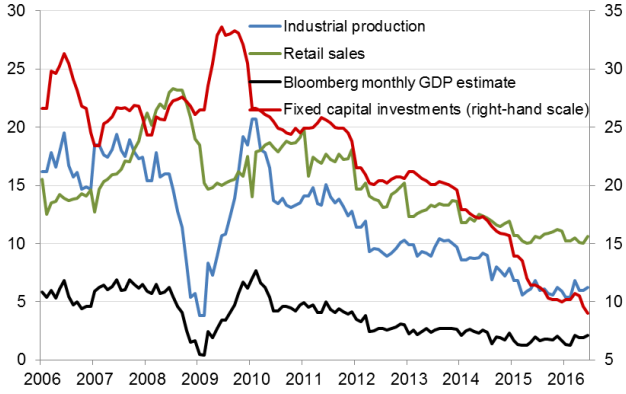
The press release published by the Bank of Japan in the follow-up to the meeting mentions 'considerable uncertainty' over the outlook for delivering on the 2% inflation target in view of the elevated volatility in global financial markets and the ongoing difficulties in major foreign economies. The document also announced the BoJ intention to conduct a comprehensive monitoring of economic activity and inflation under the QE with a negative interest rate. Such a narrative cannot bring market participants' uncertainty down. However, given that the BoJ balance sheet

has already been increased to 80% of GDP, the changes in the central bank's purchase practices and the efficiency of the accommodative measures become more relevant.

China

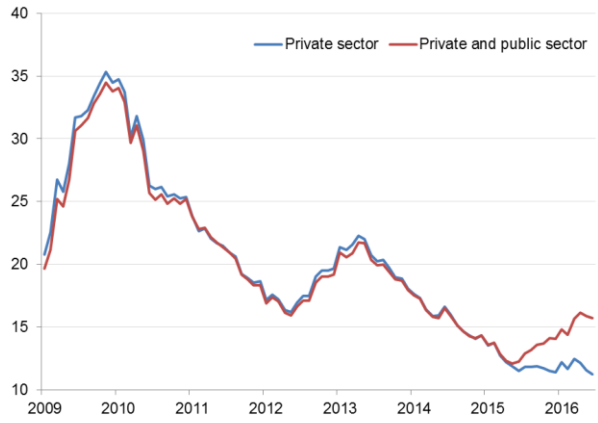
Chinese macroeconomic statistics in June proved to be slightly better than in May. Thus, industrial production grew by 6.2% YoY (in May, 6.0%), and retail sales were up by 10.6% (10.0%). Construction grew at an increased rate. Bloomberg revised its estimate of monthly GDP growth up to 7.1% YoY (6.9%). The official data suggest that in the second quarter the Chinese economy grew by 6.7% YoY, same as in the first quarter. It largely results from the government's stimulus measures.

Figure 56. GDP growth, industrial production, retail sales and investment in China, % YoY



Source: Bloomberg Finance L.P.

Figure 57. Debt financing in China, % YoY



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

At the same time, we can see a higher risk that the effect of these measures can soon be exhausted. In June, growth in debt financing of the private sector continued to go down to 11.3% YoY (11.6%). The ongoing active growth of public borrowing used to partially offset these dynamics, but after a spike in April it slowed to 15.7% YoY (15.9%). Investment activity faces similar difficulties: the ongoing decline in private investment is only partially offset by the public one. This resulted in a slowdown in growth of fixed capital investment in June to 9.0% YoY (9.6%).

On the whole, given an almost six-month lag between lending activity and economic growth, the threat of a downturn in the Chinese economy in 2016 is minimal, and in the third quarter it even can be expected to take an upward turn, as June data suggest. However, beyond 2016 we still can see the risks of the Chinese economy's slowing and the need of new accommodative measures, if the government seeks to underpin elevated economic growth rates.

1.2.3. Financial markets were too emotional in their first response to Brexit

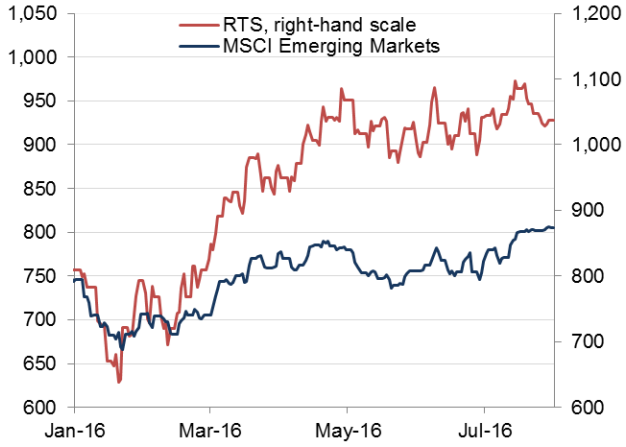
- In July, volatility of financial markets returned to the minimum level after an excessively emotional initial response to the Britain's decision to leave the EU.
- The increased prospects of major central banks' adherence to soft monetary policy dragged government bond yields of advanced economies to the floor.
- Against this backdrop, emerging markets offering relatively high yields see a dramatic capital inflow.
- Oil market deterioration pushed OFZ yields up and weakened the ruble.
- RUONIA remains below the BoR key rate despite a temporary liquidity outflow from banks in July.

Global markets

The month following the Brexit referendum showed that the first reaction of financial markets was too emotional. Throughout July, volatility in financial markets was going down to ultimately reach the historical lows (Figure 60). The decline was triggered, among other things, by growing expectations that major central banks would pursue a soft monetary policy for a longer period of time.

Government bond yields of advanced economies grew slightly in July, but lingered close to the floor (Figure 62). Expectations of a soft monetary policy and a drop in volatility boosted demand for risk assets. In particular, equity markets of both advanced and emerging economies grew (Figure 58, Figure 59).

Figure 58. RTS and MSCI EM

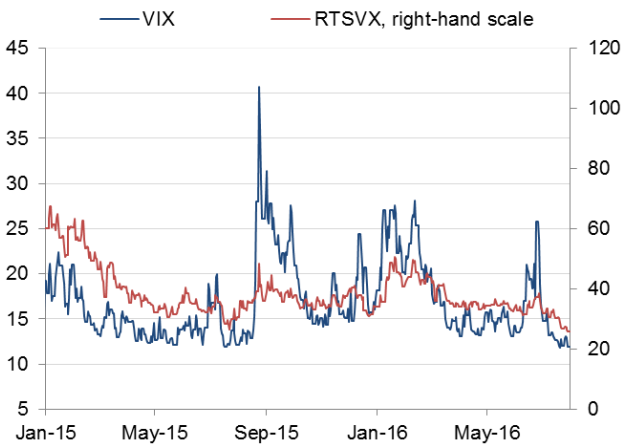


Source: Bloomberg Finance L.P.

Figure 59. S&P500 and Eurosotxx50

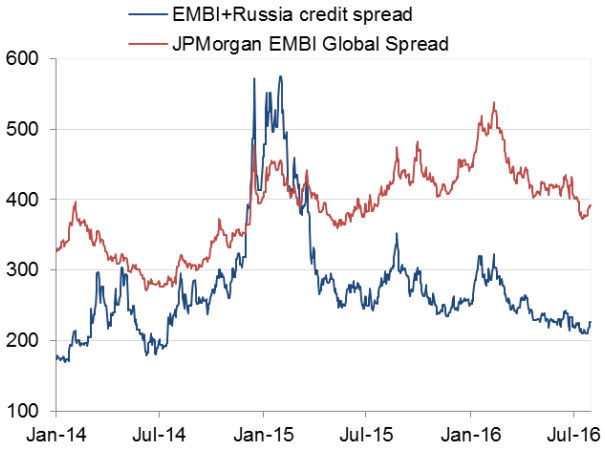
Source: Bloomberg Finance L.P.

Figure 60. VIX (S&P500) and PTC (RTSVX)



Source: Bloomberg Finance L.P.

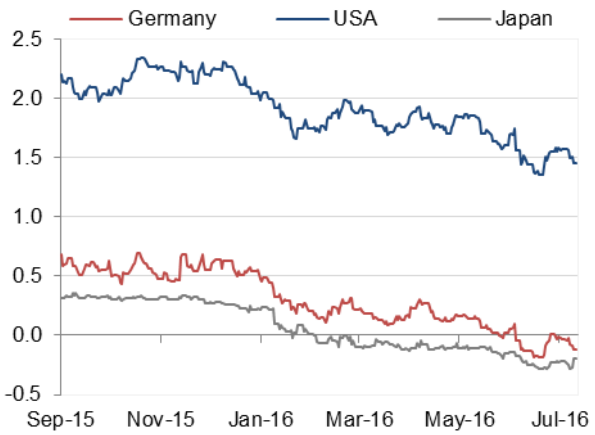
Figure 61. EMBI+Russia and JP Morgan EMBI Global



Source: Bloomberg Finance L.P.

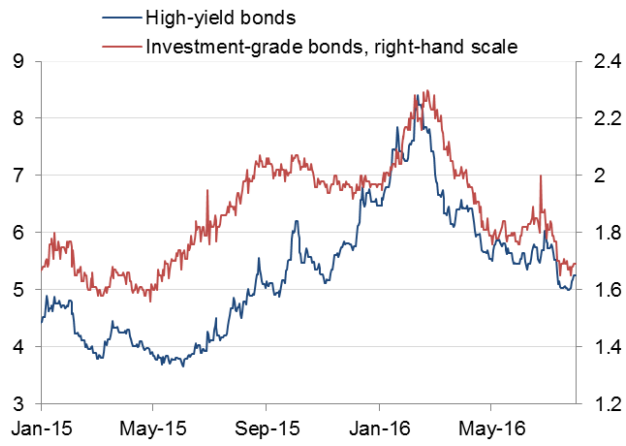
Emerging markets were among primary beneficiaries in this situation. July saw a dramatic inflow of funds to both equity and bond funds of emerging markets (Figure 65). Demand for the latter grew on the back of a general drop in the yields of risk-free instruments, which makes investors turn to higher-risk instruments with high yields. In July, national currency-denominated government bond yields of emerging markets hit the historical lows.

Figure 62. Yields on 10-year bonds of developed countries, %



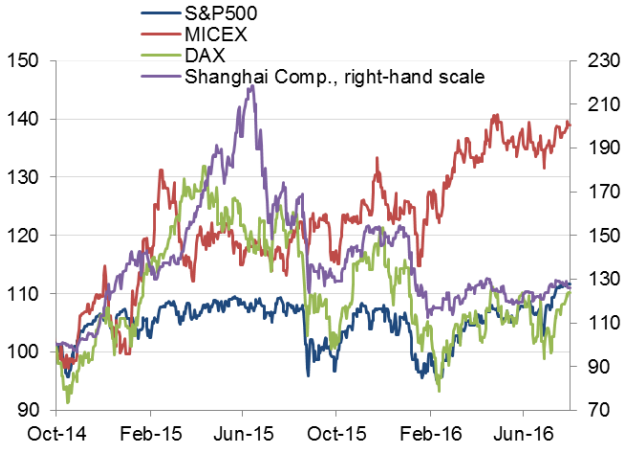
Source: Bloomberg Finance L.P.

Figure 63. Credit spread of corporate bonds of developed countries, %



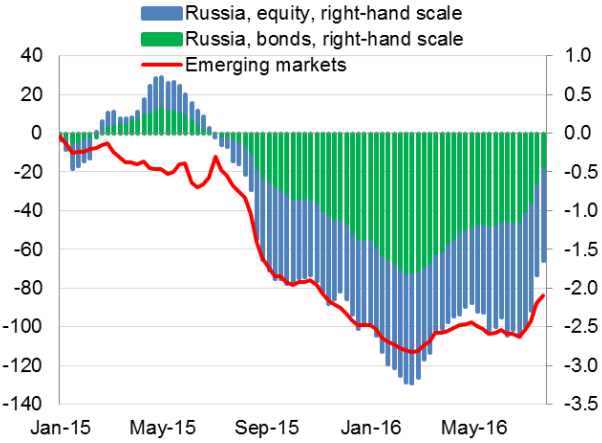
Source: Bloomberg Finance L.P.

Figure 64. Equity indices in local currencies (index, 1 January 2014 = 100)



Source: Bloomberg Finance L.P.

Figure 65. Cash flows into Russian and EM funds (accrued, '+' - inflow), $ billion



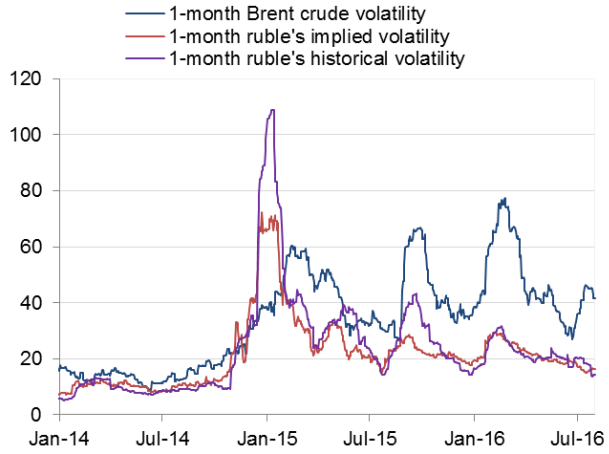
Sources: EPFR Global, Bloomberg Finance L.P.

Russian markets

External developments tuned the dynamics of the Russian financial market in July. The drop in oil prices was a negative factor that weakened the ruble against major global currencies, especially in the second half of the month. In the bond market, long-term government bond yields grew slightly by the month-end (Figure 67). The deterioration in the oil market could have resulted in a more considerable OFZ yield hike, but the moderately tight monetary policy of the Bank of Russia and capital inflow to securities markets of developing countries (including Russia), as seen in the latest EPFR statistics, dampened the oil price impact.

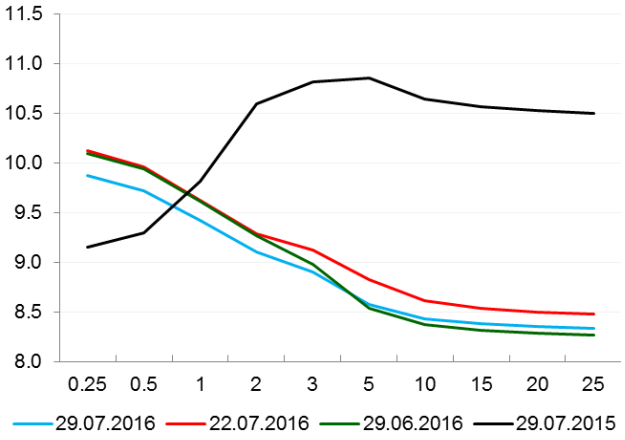
Corporate bond yields continued to decline despite the adjustment in the government bond market (Figure 69). Issuing activity of corporate borrowers went slightly down in July: according to Cbonds, primary placements in July stood at ₽128.8 billion against ₽160 billion in June. Nevertheless, net placements (including redemptions) remained in positive territory and amounted to ₽377 billion from the beginning of the year.

Figure 66. Implied and historical volatility of the ruble and oil prices



Source: Bloomberg Finance L.P.

Figure 67. GKO-OFZ yield curve, %

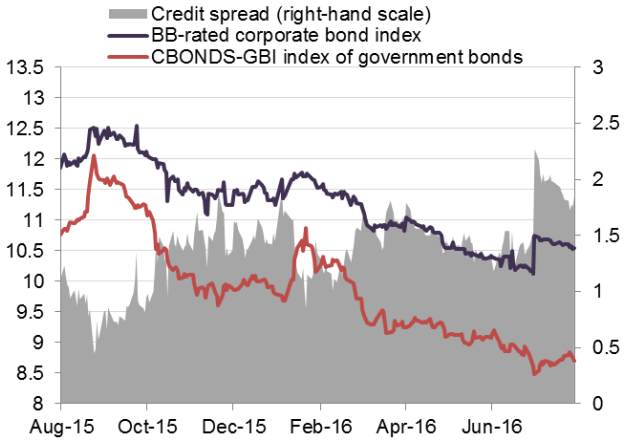


Source: Moscow Exchange.

Figure 68. FRA3X6 and 3M Mosprime spread, % p.a.

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

Figure 69. Ruble bond yield, %



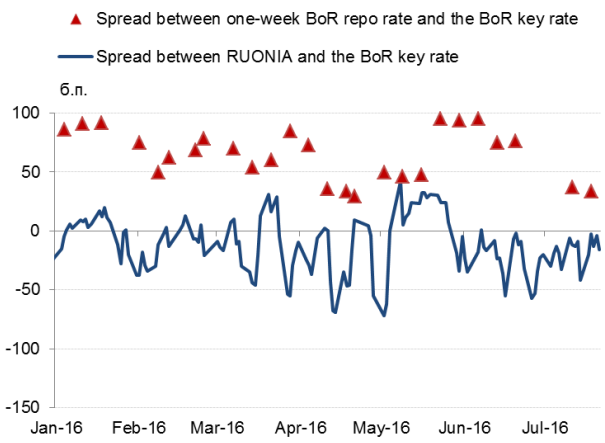
Source: Cbonds.

**Corporate bond index yield hike resulted from the revision of index calculation base on 1 June, rather than market dynamics.*

In July, changes in liquidity in the banking system as a whole were insignificant. Banks' net liquidity position with the Bank of Russia even declined slightly during the period under consideration (1-29 July) following net liquidity outflow registered in July, for the first time since the beginning of the year. This results mainly from withdrawal of funds to the accounts of the Federal Treasury to redeem banks' debts. At the same time, banks' debt to the Bank of Russia hardly changed, failing to offset this outflow. In July, cumulative net cash outflow from the banking sector amounted to ₽320 billion, it was financed from the previously accumulated funds on correspondent and deposit accounts with the Bank of Russia.

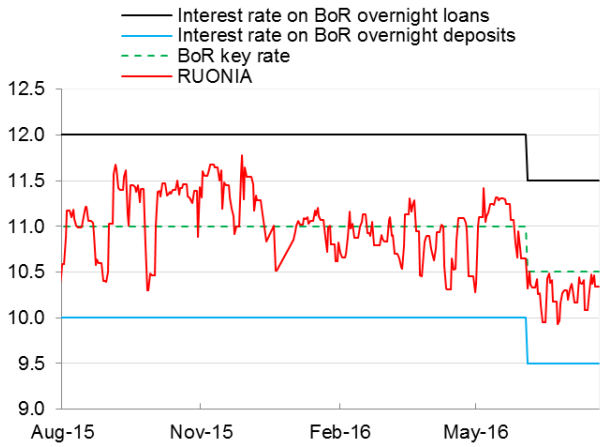
Meanwhile, short-term money market interest rates underreacted to these changes in liquidity. The spread between RUONIA and the BoR key rate remained negative throughout the month, including the period of large tax payments. On the whole, RUONIA has persisted below the BoR key rate since the beginning of June 2016.

Figure 70. Spread between RUONIA and one-week auction-based BoR repo rate to the BoR key rate, bp



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

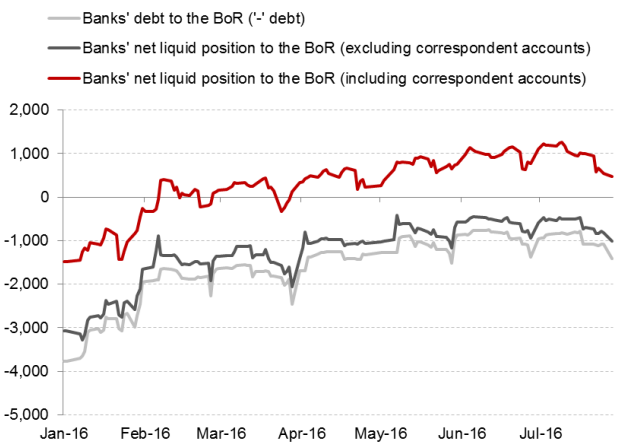
Figure 71. BoR interest rate corridor and short-term interbank lending rate, % p.a.



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

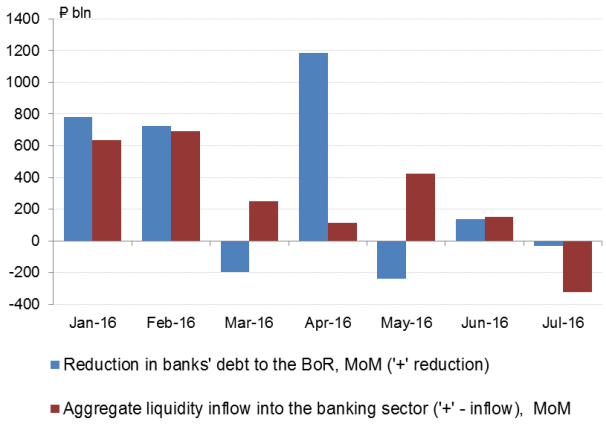
The persistence of short-term market rates in the lower range of the BoR interest rate corridor is very likely to result from changes in the structure of banking sector liquidity. The inflow of budgetary funds is concentrated in accounts of major banks, enabling them to promptly reach liquidity surplus, and seriously affects interest rates of these banks. Minor banks, still suffering from liquidity deficit, seemed to fare better in July than a month before as liquidity circulation in the banking system had improved. Against this backdrop the past weeks saw a considerable drop in the auction-based BoR repo rate and a decline in rates on interbank loans and interdealer repo to large banks.

Figure 72. Banks' net liquidity position to the BoR, ₽ billion



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

Figure 73. Reduction in banks' debt to the BoR and net liquidity inflow, ₽ billion



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

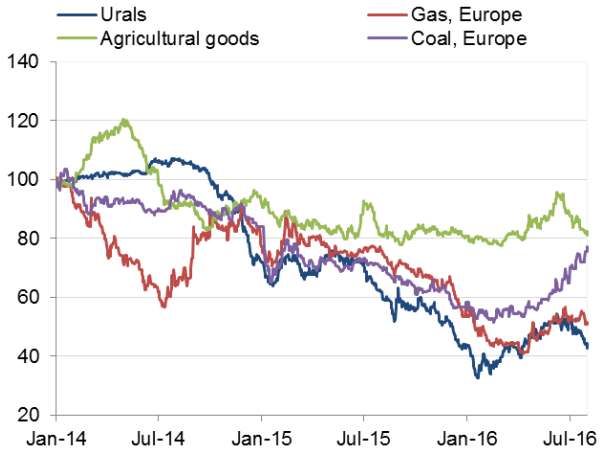
1.3.3. Commodity markets: oil market rebalancing postponed

- July was the worst month seen by the oil market since December 2015 as later-than-expected market rebalancing became evident.
- Global oil production grew considerably in June following, among other things, a decline in idle capacity. Having said that, the actual oil supply could have been even ampler due to Saudi Arabia's new strategy of selling out the accumulated inventories.
- The US started to step up production that may cut physical oil demand amid the upcoming refinery repairs and abundant stock of petrochemicals.
- Downward pressure on oil prices may persist in the months to come.

July saw mixed dynamics in commodity markets. Energy and agricultural products lost in value while metals perked up.

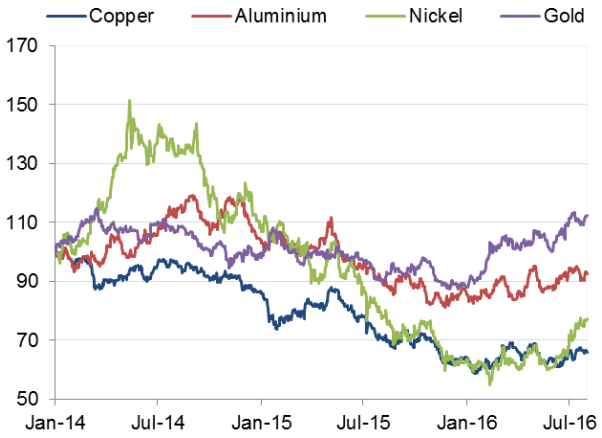
Evidence of suspended rebalancing of the oil market triggered price downturn. As a result, July turned out to be the worst month for the oil market since December 2015 with different crudes depreciating by 14-15%.

Figure 74. Commodity prices (January 2014 = 100)



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

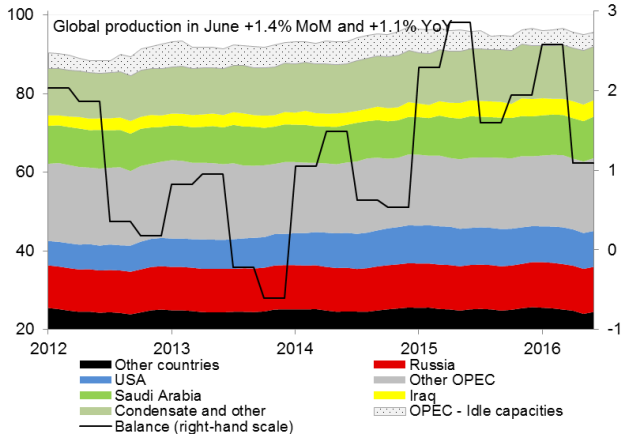
Figure 75. Metal prices (January 2014 = 100)



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

Bloomberg Finance L.P. pointed to a considerable growth in global oil production: idle capacities contracted and individual OPEC countries stepped up oil production in summer. Having said that, the actual oil supply in the market boomed due to the new strategy of Saudi Arabia that had been actively reducing its oil stocks since last year-end (Figure 77).

Figure 76. Production and balance in the oil market, million barrels/day



Sources: Bloomberg Finance L.P., OPEC.

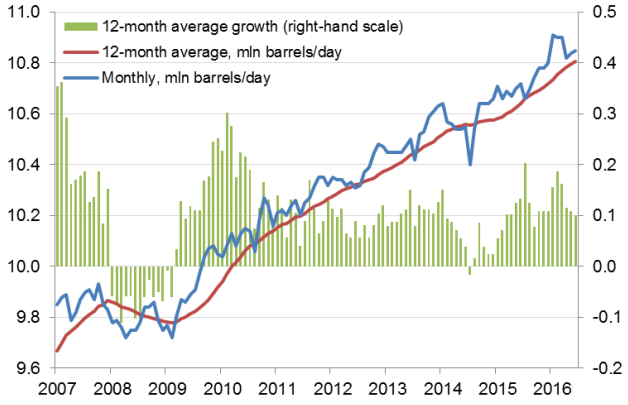
Figure 77. Oil inventories in Saudi Arabia, million barrels

Source: JODI.

This allows the country to fight for its market share while checking production growth that largely determines investors' sentiment. Our estimates based on JODI data suggest that in 2016 H1 this factor had the effect of additional production of 0.25 million barrels of oil a day. Meanwhile, sizeable reserve capacities will enable Saudi Arabia to replenish the stocks, if necessary. Oil stocks are also supposed to be shrinking in Iran, which was forced to accumulate them under sanctions, but this fact is not supported with accurate data.

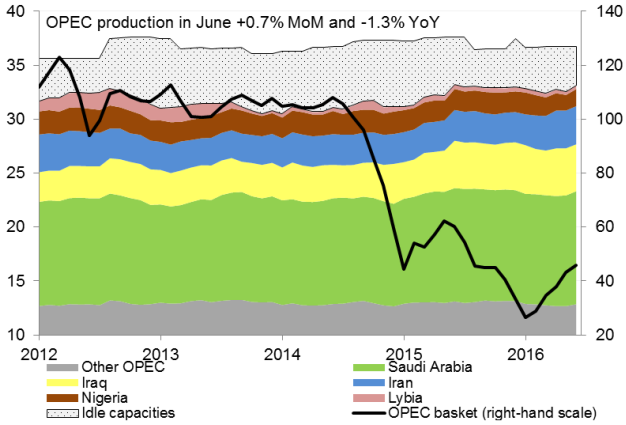
In June, oil production in OPEC countries put downward pressure on oil prices as Nigeria and Libya partially recovered production and most Gulf States increased production on the back of heavy usage of air conditioners in summer. At the same time, production has declined in Iraq for the second month in a row, with stagnation finding its way to Iran which is very likely to have reached its limit of pre-sanction production level. The overall production in OPEC grew by 0.7% MoM in June, but went down by 1.3% YoY (Figure 79). Temporary factors continue to influence the oil production forecast for OPEC.

Figure 78. Oil production in Russia



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

Figure 79. Oil production in OPEC countries



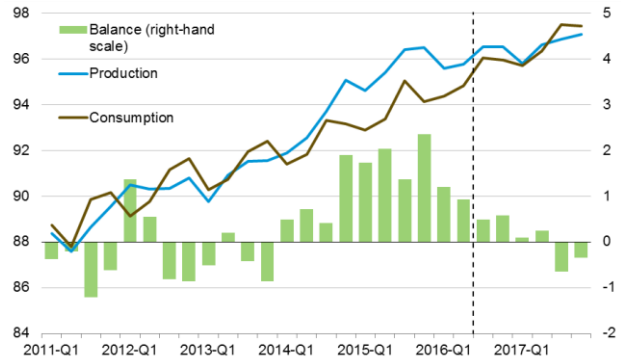
Source: Bloomberg Finance L.P.

Oil production in Russia persisted at the May level of 10.84 million barrels a day in June (Figure 78). Year-on-year production growth slowed while the 12-month average continued to go up. We still believe that international organisations, in particular the EIA, underestimate Russian oil production prospects.

Monthly reports of the US Energy Information Administration (EIA), the International Energy Agency (IEA) and OPEC were ambiguous. On the one hand, all of them mention that oil surplus shrank considerably in the second quarter thanks to, among other things, a regular upward revision of demand growth forecasts. On the other hand, this source is being exhausted or is already exhausted, while supply is more likely to expand thanks to progressively declining shortages, as seen in June. Through the end of the year, stocks are expected to continue to expand and hamper price growth.

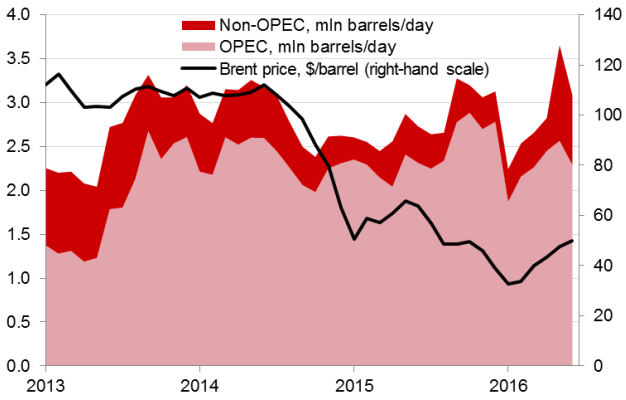
China is cutting demand for oil. In June, a considerable slowdown in strategic reserves accumulation added to the ongoing stagnation of domestic consumption. Our estimates suggest that this factor dragged the demand down from 1.1 million barrels a day in May to 0.6 million barrels a day in June (Figure 82, Figure 83). We still expect the first stage of strategic stock accumulation to be completed and the demand to go down further in the months to come.

Figure 80. Oil production in the US



Source: EIA.

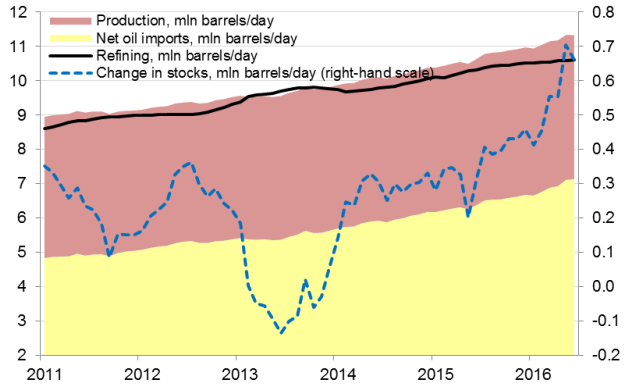
Figure 81. Idle oil production capacities and Brent crude price



Sources: EIA, Bloomberg Finance L.P.

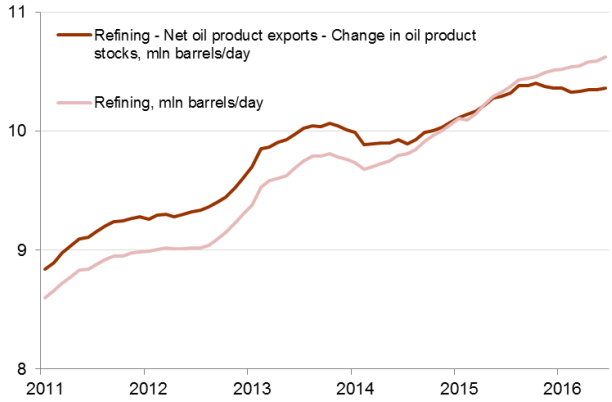
At the same time, China also continues to cut oil production as low-profit projects are curtailed (Figure 82). Production fell by 1.3% in June and 8.7% or 0.35 million barrels a day in the first six months, checking downward pressure on oil prices.

Figure 82. Production, net imports, processing and changes in oil stocks in China, 12-month average



Sources: EIA, R&F Department calculations.

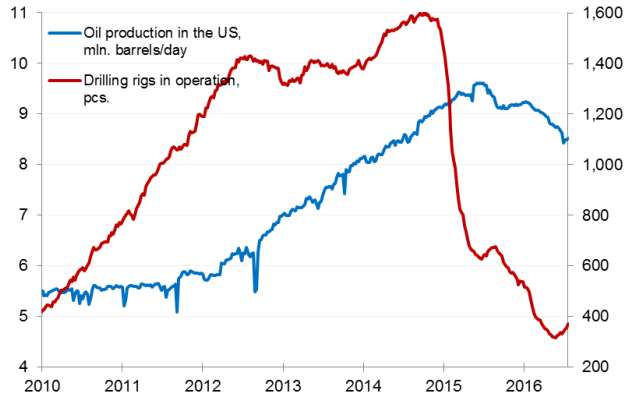
Figure 83. Oil processing and consumption in China, 12-month average



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

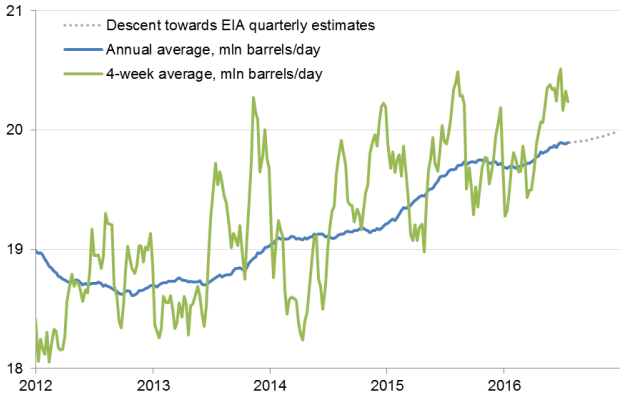
Statistics from the US were the major concern for market participants at the end of the month. July saw a non-typical increase in crude oil inventories and a seasonal growth in petrochemical stocks. A rapid accumulation of the latter puts pressure on oil prices. Current petrol stocks in the US exceed the last-year level by 11.8%. Refiners seem to have overestimated growth potential of demand for petrol during the holiday season, which resulted in excessive supply. The demand growth lags behind the earlier assumptions: average annual consumption of petrochemicals has been stagnating for more than a month. Oil production has been growing for the third week in a row following the increase in active drilling rigs late in May.

Figure 84. Oil production in the US



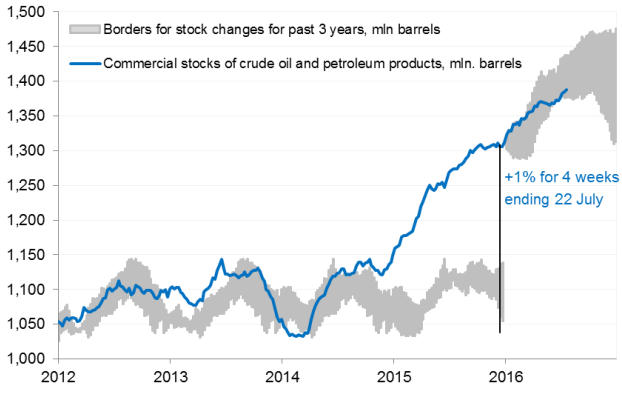
Sources: EIA, R&F Department calculations.

Figure 85. Oil product consumption in the US



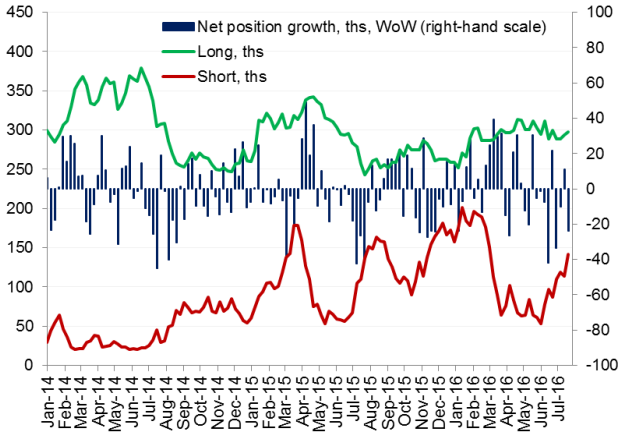
Sources: EIA, R&F Department calculations.

Figure 86. Total US commercial oil and oil product stocks



Sources: EIA, R&F Department calculations.

Figure 87. Open positions in futures oil market



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

In late summer - early autumn, US refineries usually idle some capacities for repairs and resetting for winter fuel production. Vast petrochemical stocks may cause earlier and longer shutdowns. That would reduce physical demand for oil and may result in accelerated growth of crude oil inventories on the back of resumed production takeoff. We believe that this factor will also exert pressure on oil prices.

According to CFTC, on 12-19 July the number of oil futures shorts at NYMEX exchange went up from 141.2 thousand to 113.5 thousand. Short positions have already increased 2.6-fold since the end of May. Meanwhile, the number of long positions did not change considerably during the same period. Further negative news may boost short open positions and uphold downward pressure on oil prices in the near future.

2. Outlook: leading indicators

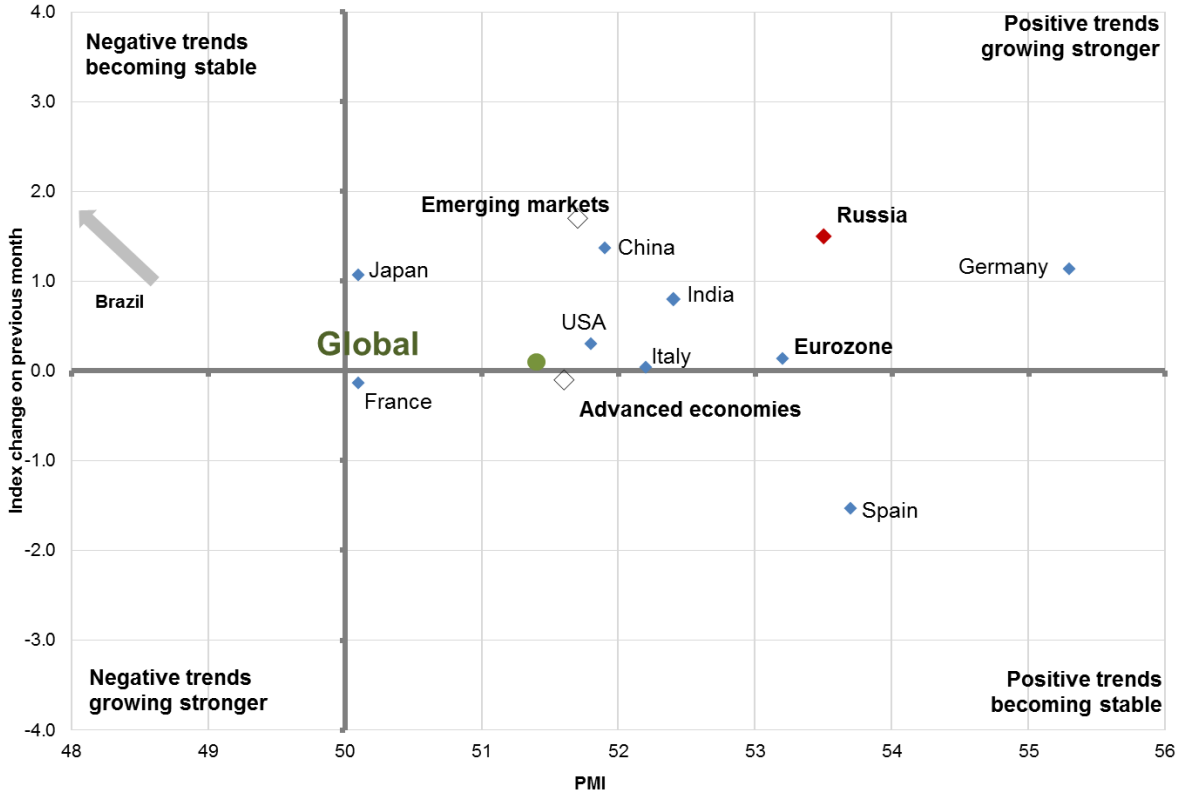
2.1. Global leading indicators

2.1.1. Short-term Brexit fallouts proved to be insignificant for the eurozone economy

The economic growth of advanced economies remains quite slack, as confirmed by the July data on the US and the eurozone Q2 GDP growth and composite PMI estimates. Indices of advanced economies hardly changed against the Q2 average, bar Germany, which showed a sizeable growth (Figure 88).

Having said that, PMI stabilisation in the European countries in the aftermath of Brexit can be considered as a positive signal. Eurozone countries are Britain's major economic partners, therefore lack of immediate response from the activity dynamics points to overestimated short-term risks of Brexit for the European economy.

Figure 88. Composite PMI in July and change against the average value in 2016 Q2



Source: IHS Markit.

2.2. What do Russian leading indicators suggest?

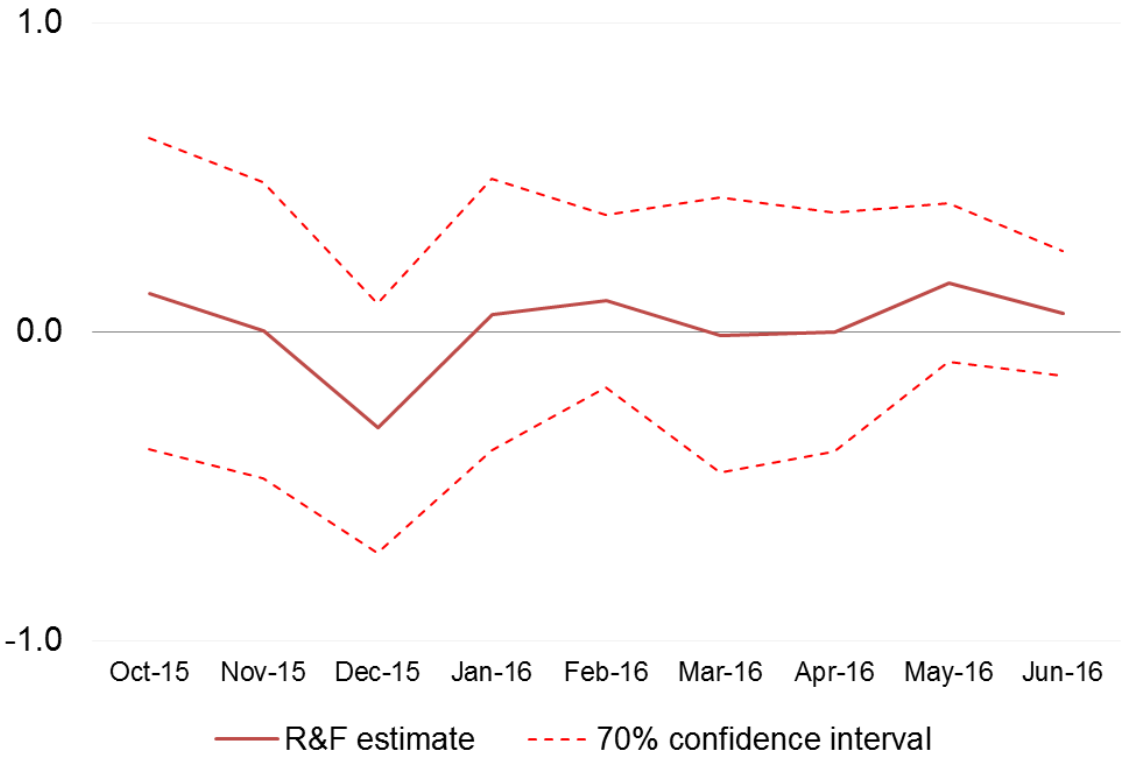
2.2.1. Index GDP assessment: the recession is over, slow economic growth is ahead

- The July index GDP assessment was revised upwards compared with the June estimates: the economy grew by 0.2-0.3% QoQ (seasonally adjusted) in April-June (Figure 89), while the previous estimates suggested stagnation.
- Model Q3 GDP estimate was revised upwards from 0.2% QoQ in June to 0.4% QoQ in July. The Q4 estimate stands at 0.5% QoQ, which is close to our last-month estimates.

	July 2016	June 2016
	% QoQ	% QoQ
2016 Q2	**0.2-0.3**	0.0-0.1
2016 Q3	**0.4**	0.2
2016 Q4	**0.5**	0.4-0.5

- We were mostly guided by positive manufacturing statistics in June when revising our estimates upwards.
- However, the revision was moderate because, we believe, the previously published leading indicators, which we also consider in our model estimates, largely reflect positive macroeconomic data for June.
- In our previous estimates we considered oil price growth to $50 a barrel in May to be a short-term one. Thereby, we expect that on the whole the current oil price downturn to $40 a barrel and its persistence at this level is in line with our earlier estimates of prospective economic activity.
- Significantly, fluctuations of short-term macroeconomic indicators were quite significant in the recent months. But we may improve our estimates if the future statistics register an emerging trend towards production recovery.

Figure 89. Estimate of GDP growth in 2016 Q2, % QoQ



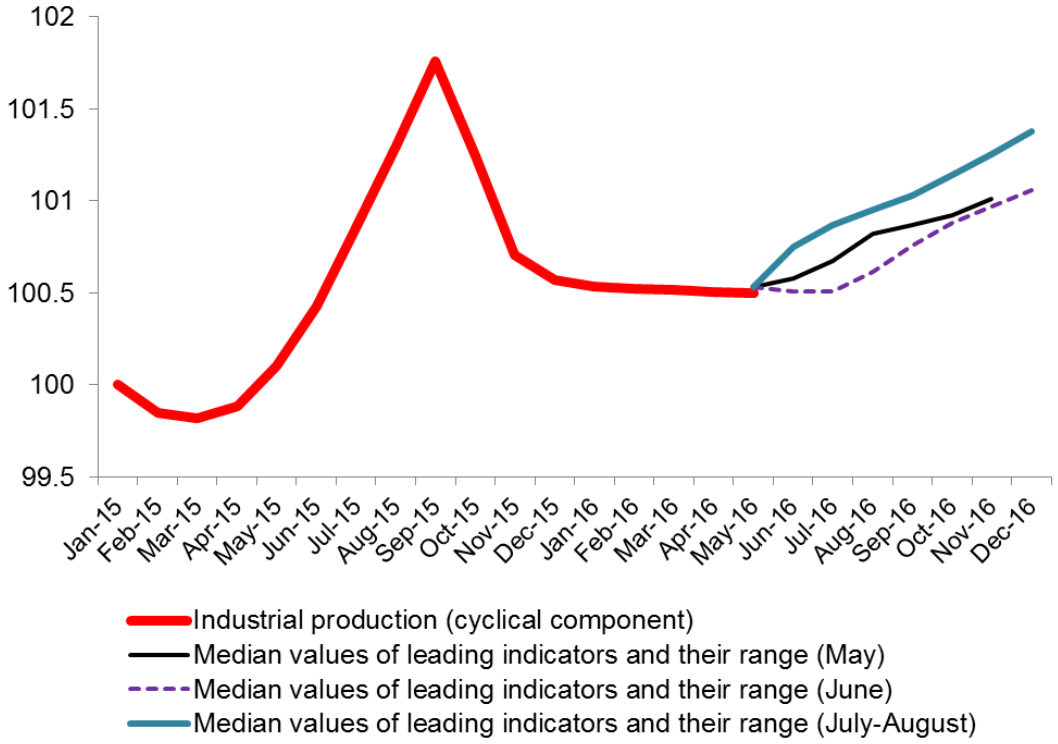
Sources: Rosstat, R&F Department calculations.

2.2.2. Composite leading business indicator: growth prospects improving

- The composite leading business indicator was revised upwards against the previous month (Figure 90).
- June data published by Rosstat (mostly positive manufacturing statistics) and July services PMI underpinned our expectations of economic recovery in the second half of the year.
- However, when interpreting these outcomes, the following factors should be taken into account: *a)* economic activity still varies across sectors; *b)* the current improvement in indicator assessments largely results from positive statistics on services PMI (in particular, HoReCa data, which are not very representative for assessing economic prospects as a whole), and *c)* monthly data used in index calculation is very volatile.
- The above factors allow to us argue that the composite leading business indicator based on the latest data may overestimate growth forecasts for the cyclical component of industrial production.

- We may subsequently revise our estimates downwards if the baseline scenario of the official BoR forecast (oil price drop to $40 a barrel) materialises. Having said that, it will not rule out prospects of economic growth in the months to come.

Figure 90. The cyclical component of industrial production (January 2015 = 100, seasonally adjusted) and leading business index



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

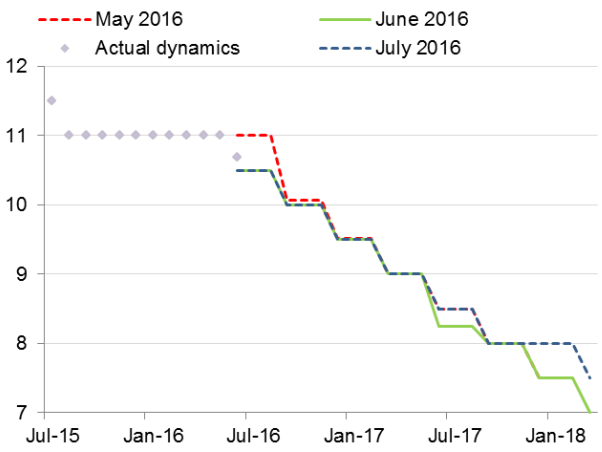
2.2.3. Consensus forecast for inflation in late 2017 is revised upwards, but remains close to the BoR target

- Professional analysts continued to revise their consensus forecast for inflation in 2016 downwards; their expectations for 2017 went slightly up.
- However, expectations for the end of 2017 remained unchanged and hold close to the BoR target.
- Upward revision of forecasts for the average annual price growth in 2017 may have triggered a modest upward revision of the key rate dynamics.

A survey, conducted by Bloomberg on 22-27 July, suggested that analysts continued to revise inflation expectations for 2016 from 6.5% to 6.3% (Figure 92). However, the forecast 2017 Q2 and Q3 price growth was revised slightly upwards. Nevertheless, inflation expectations for end-2017 remained unchanged at 4.7%. Compared to June, estimates vary less, though the span is rather wide - 3-6.7%.

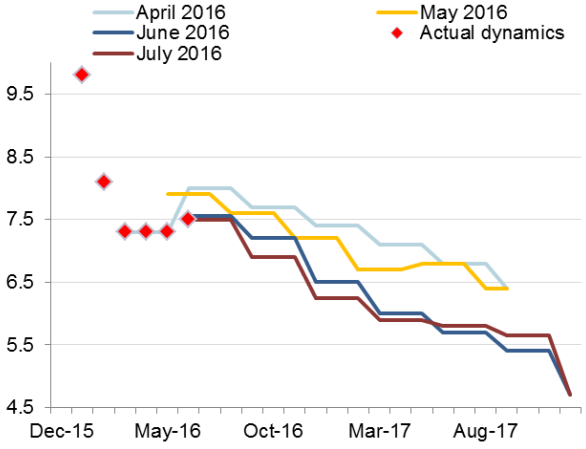
Expectations of the 2016 key rate dynamics remained unchanged. The median forecast still provides for two key rate cuts to 9.5% by the year-end (Figure 91). The prospective next year-end key rate was revised slightly upwards from 7.0% to 7.5%. This could be triggered by a modest growth in annual average inflation expectations in 2017 and the respective response of the Bank of Russia.

Figure 91. BoR key rate expectations of professional analysts



Source: Bloomberg Finance L.P.

Figure 92. Inflation expectations of professional analysts, % YoY



Source: Bloomberg Finance L.P.

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