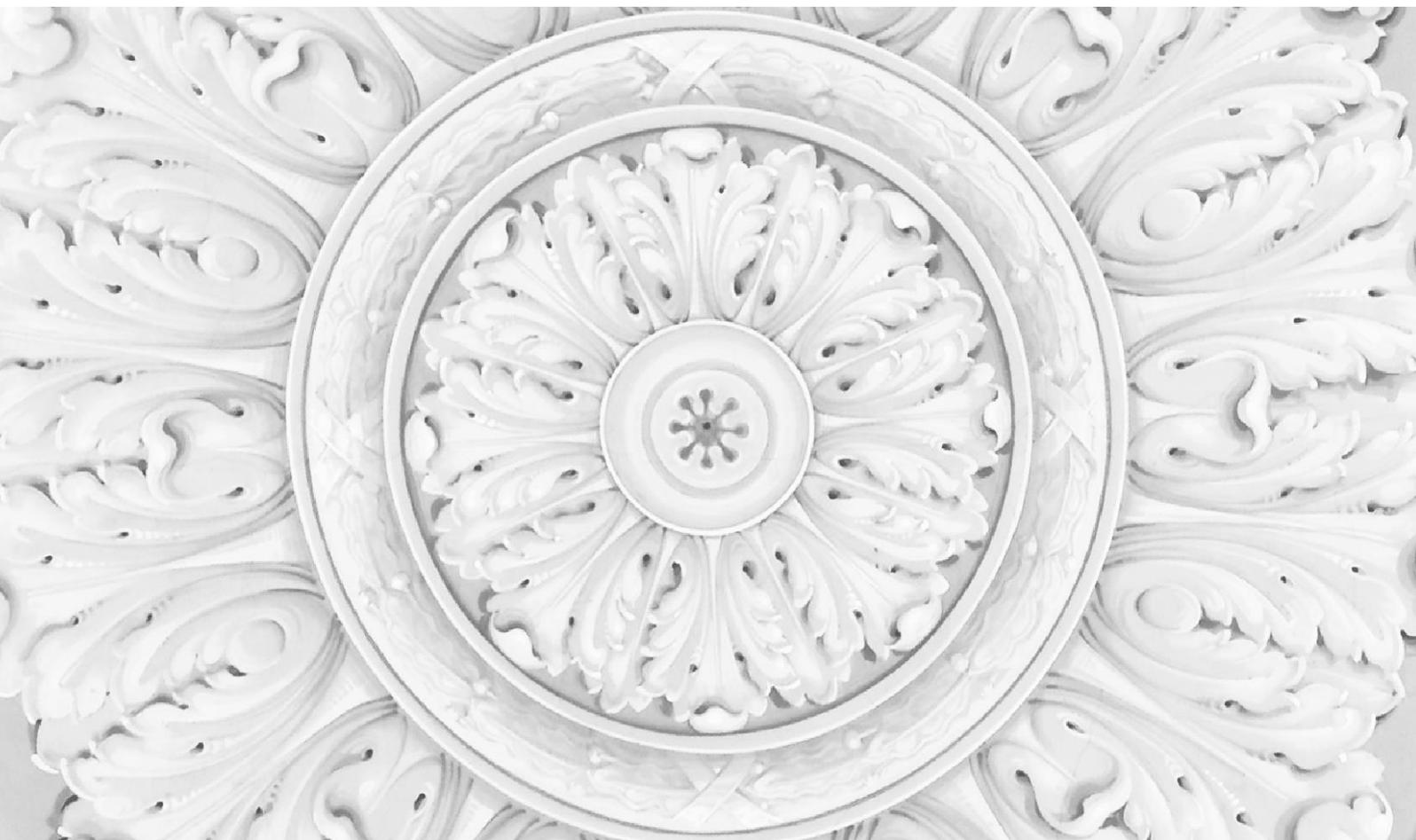




# Bank of Russia

The Central Bank of the Russian Federation



## TALKING TRENDS

Macroeconomics and Markets

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No. 7

*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](mailto:dip_bulletin@mail.cbr.ru).*

## CONTENTS

<b>Summary</b>	<b>3</b>
<b>1. Summary</b>	<b>4</b>
<b>1.1. Inflation stays on the path to its target level of 4% for 2017; however, the risks of inflation deviating from target remain</b>	<b>4</b>
1.1.1. Inflation between May and June flattens out on the target path; however, food inflation begins to accelerate	4
1.1.2. Inflation expectations, although abating in May, remain heightened	6
1.1.3. The decline in underlying inflation has been slow	7
1.1.4. PMI price indicators: relative prices in services are down	8
1.1.5. After a slowdown between April and May, nominal wage growth may accelerate as the economy picks up	9
<b>1.2. Although the economy is in stagnation, expectations for growth in the third quarter grow stronger</b>	<b>10</b>
1.2.1. Q1 GDP: the bottom is passed	10
1.2.2. Consumer activities: weak performance on the backdrop of better consumer expectations	11
1.2.3. Industrial outputs are still unsteady	13
1.2.4. Volatile outputs in individual industries are behind the unsteady performance in manufacturing	15
1.2.5. Demand for new cars in May resumed its decline after the previous months of stabilisation	17
1.2.6. Unemployment is on track to become steady	19
1.2.7. Part-time and informal employment in Q1: low risks of unemployment	20
1.2.8. With most impact on economic growth from the budget side ahead, its impact on liquidity has passed	22
<b>1.3. Global economy, financial and commodity markets</b>	<b>24</b>
1.3.1. Brexit may trigger a new surge of monetary policy easing in advanced economies	24
1.3.2. Brexit came as a surprise for financial markets	28
1.3.3. Commodity markets: Brexit sets growing prices to fall	35
<b>2. Outlook: leading indicators</b>	<b>40</b>
<b>2.1. Global leading indicators</b>	<b>40</b>
2.1.1. Sustainability of global economic growth is still in question	40
<b>2.2. What do Russian leading indicators suggest?</b>	<b>41</b>
2.2.1. Index GDP assessment: economic recovery is still slow	41
2.2.2. Composite leading business indicator: Q3 growth prospects still in place	42
2.2.3. Analysts' inflation expectations tumbled	43
<b>3. In focus</b>	<b>45</b>

## Summary

### 1. Monthly summary

- The period between May and mid-June 2016 saw inflation flatten out as the economy was even more close to the point of recovery growth. The intention of the UK to exit the European Union (Brexit) has so far had limited impact on Russian markets.
  - **Inflation** stays on the path to its target level, thanks to, inter alia, the current monetary policy. However, the risks of inflation exceeding the 4% target in 2017 remain, as inflation expectations are declining slowly and the uncertainty surrounding the budget and the performance of wages remains in place. With the temporary tailwinds having run their course, the growth of food prices accelerated and is very likely to continue into the next few months.
  - Economic activity in May was helped by growing oil and the continued adjustment of the economy to new conditions. As before, we expect the economy to reach a slow growth path in the next few months, barring any new external shocks.
  - There was a further softening in monetary conditions. As a result of Brexit, Russian financial markets are running the risk of stronger volatility.

### 2. Outlook

- Brexit has led to higher risks to economic growth in the UK, the EU and across the globe. These risks may well become the reason for BoE, ECB and BoJ to further soften their monetary policies. The probability of a next quarter interest rate rise from the Fed has grown weaker.
- For emerging economies, the stronger volatility in the global financial markets with risk aversion is set to constrain the central banks' capability to soften their monetary policies in the near future.
- The Russian short-term macroeconomic statistics, together with leading indicators, reinforce our projections for economic growth to hit positive territory in the middle of the year.

### 3. In focus

- Further potential diversification of Russian exports looks limited.
- In the long term, export-focused sectors are likely to feel the need for extra long-term investment to upgrade production facilities.

## 1. Summary

### **1.1. Inflation stays on the path to its target level of 4% for 2017; however, the risks of inflation deviating from target remain**

Consumer inflation remains on the path to reach 4% for the end of 2017. That being said, inflation pressure is still heightened, with no more downward movement. To be confident that the inflation target will be met, a further weakening of inflation pressure will be required, as well as reduction in inflation expectations.

#### ***1.1.1. Inflation between May and June flattens out on the target path; however, food inflation begins to accelerate***

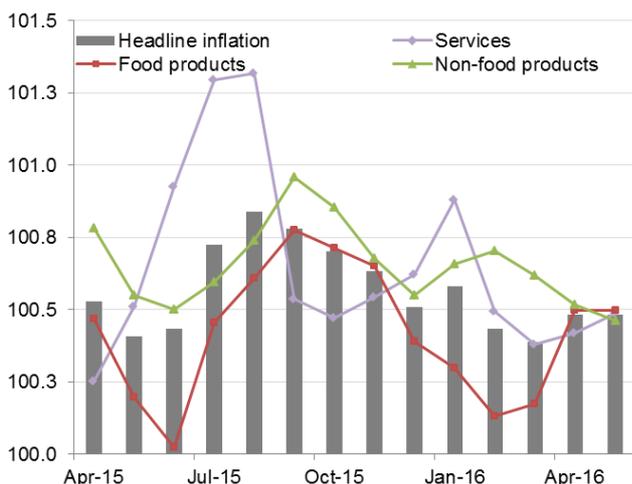
- May saw inflation flatten; however, accelerated food inflation and slower non-food inflation were seen.
- Inflation is currently on track to total 5.5% by the end of 2016 and 4.0% by the end of 2017.
- Food inflation has been accelerating since mid-April, and the risks this trend will persist in the second half of the year remain strong, with global prices on the rise and bad weather affecting the south of Russia.

Prices were 0.41% MoM higher in May (in April – 0.44% MoM). Seasonally adjusted, the growth totalled 0.45–0.5%, repeating the April readings (Figure 1). Annual inflation remained at 7.3% for a third month in a row. Also, May recorded a slightly accelerated growth in food prices against a symbolic drop in non-food inflation and steadier prices in services (Figure 2).

While seasonally adjusted acceleration of prices remains level with April, their structure is continuing to change. Seasonally adjusted price growth in the non-food sector continued to decline. We attribute this to the favourable performance of the ruble exchange rate. Food prices have been accelerating for a second consecutive month at 0.5% MoM, in a sign that the impact from tailwinds of both dropping global food prices and a bumper crop in 2015 has run its course.

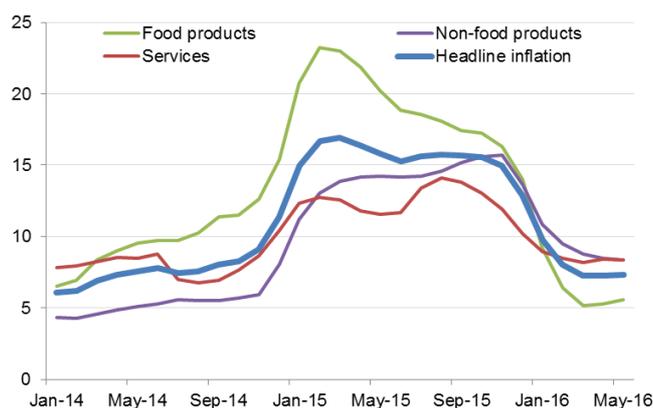
June saw prices for fruit and vegetables starting to grow. The annual growth rates of the fruit and vegetable product basket, watched on a weekly basis, exceeded point zero for the first time since late 2015 (Figure 3). The trend to price acceleration in the watched basket holds. Prices for fruit and vegetable are very likely to go on growing until August-September.

**Figure 1. Core CPI components, % MoM, seasonally adjusted**



Sources: Rosstat, R&F calculations.

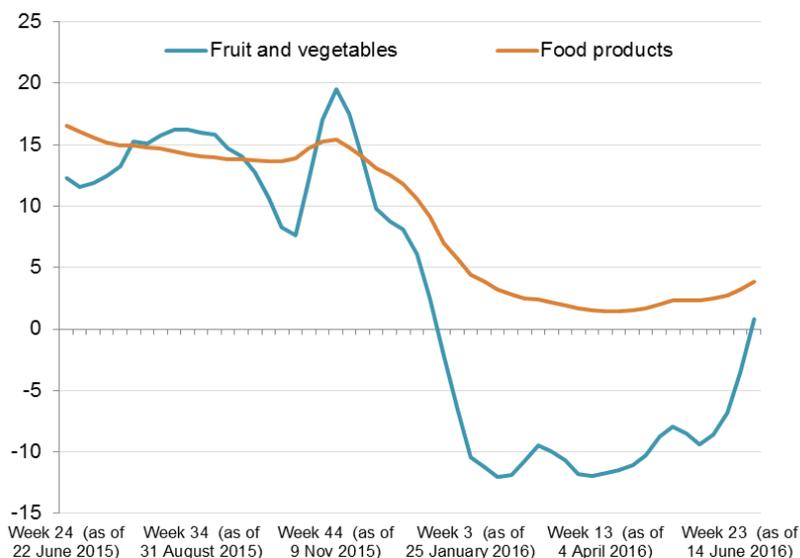
**Figure 2. Core CPI components, % YoY**



Sources: Rosstat, R&F calculations.

Food inflation in the next few months is also set to accelerate. Global food prices grew continuously from November 2015<sup>1</sup>; key agricultural regions in the south of Russia were affected in early June by abnormally rainy weather, which could trigger some loss in crops.

**Figure 3. Growth rates: food and fruit and vegetables baskets, on a weekly basis, % YoY<sup>2</sup>**



Sources: Rosstat, R&F calculations.

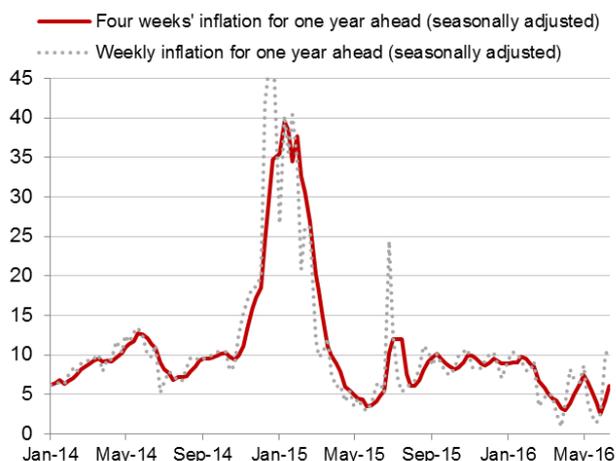
Price acceleration was registered in June, with seasonality factored in. There was a rise in seasonally adjusted annualised inflation (as calculated for one year ahead based on the average daily rate for a reporting week). It equalled to 11.2% by the end of the week ending 20 June. The last time such rates were registered was the beginning of July of the past year, caused by the indexation of prices, and, before that – only in March 2015. The more stable indicator of seasonally adjusted four-week inflation

<sup>1</sup> The IMF-calculated food price index rose 14.2% between November 2015 and May 2016.

<sup>2</sup> The performance of these baskets is no match to annual rates of product price growth, which are calculated on a monthly basis.

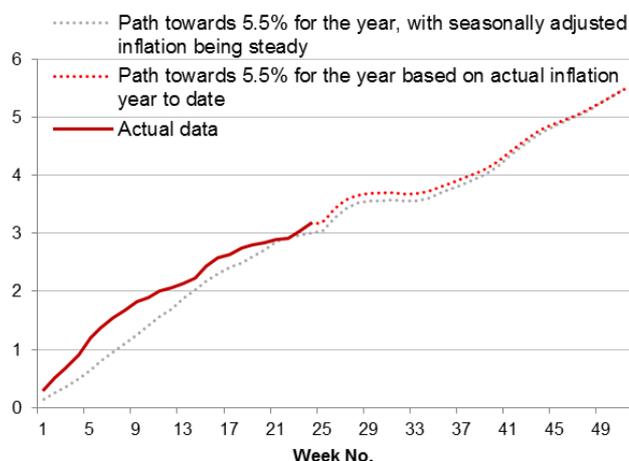
(calculated for one year ahead) continued to grow to reach 6.1% (Figure 4). Should the current growth rate of prices persist through the end of June, seasonally adjusted inflation could be over 0.5% MoM.

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



Sources: Rosstat, R&F calculations.

**Figure 5. Year-to-date inflation (weekly data)**



Sources: Rosstat, R&F calculations.

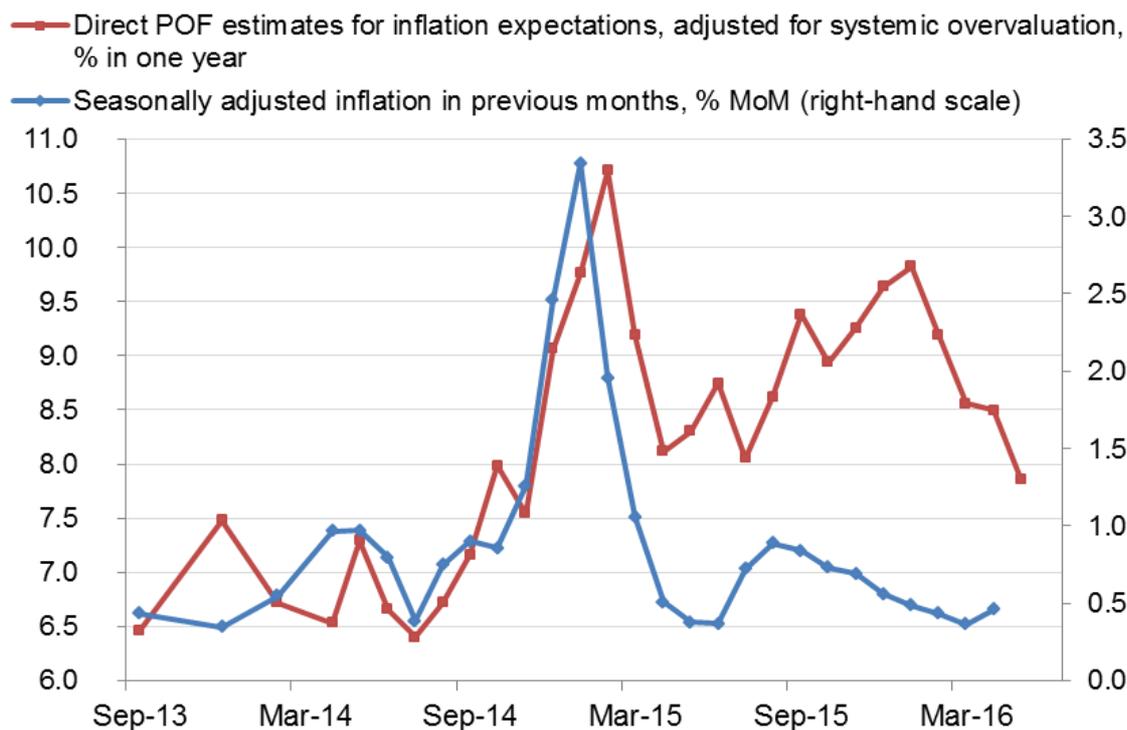
Updated calculations suggest that for inflation to be on track for the target level by the end of 2017 without monetary policy ‘over-tightening’, annual inflation should be dragged to 5.0–5.5% by the end of 2016. The performance of inflation accumulated since the start of the year shows that inflation is indeed close the trajectory whereon it is to reach 5.5% by the end of the year (Figure 5).

Our estimates show that sliding annualised seasonally adjusted inflation for the last three months has been within the above range for 2016. The current focus of the Bank of Russia’s monetary policy strives to deliver on the 4.0% target by early 2017 for annualised seasonally adjusted quarterly inflation, barring any negative change in the external environment in the months to come. Respectively, thanks the rates of price growth remaining within the specified range, the Bank of Russia’s target for inflation for the next year will be achievable. This supports the case for the Bank of Russia to hold its moderately tough monetary policy, taking into account the above strong risks of inflation accelerating in the second six months.

### **1.1.2. Inflation expectations, although abating in May, remain heightened**

According to inFOM’s April polls, R&D-adjusted for systematic overvaluation, inflation expectations decreased from 8.5% in April to 7.9% in May (Figure 6)<sup>3</sup>. Expectations reached a minimum seen since 2014 but remain elevated versus their historical readings, the current inflation pattern and the Bank of Russia target. High inflation expectations bring the risks of inflation declining at a slower pace than is needed to deliver on the 4% target. This consideration makes a powerful case for maintaining the moderately tough monetary policy.

<sup>3</sup> For calculation methodology, see Section 1.3.2 ‘Inflation expectations continue growing in January’ of ‘Talking Trends’ [Bulletin](#) No.3 (January 2016).

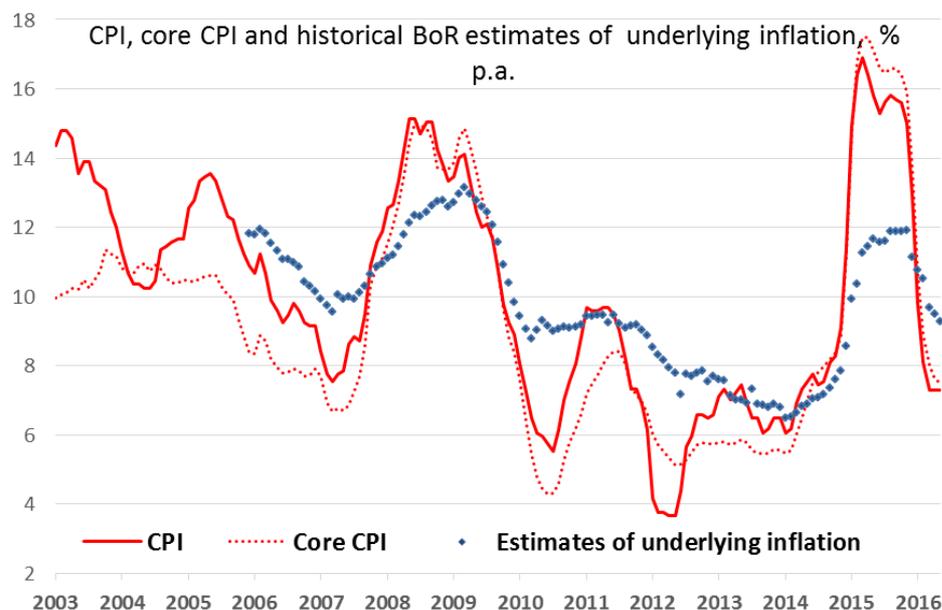
**Figure 6. Inflation expectations and actual inflation data**

Sources: Rosstat, LLC inFOM, R&F calculations.

### 1.1.3. The decline in underlying inflation has been slow

- The estimate for annual rates of underlying inflation in May was revised lower to 9.3% from 9.5% in April, which is reflective of weakened inflation pressure (Figure 7).
- Provided the current economic trends and monetary aggregates hold, we expect a further downgrade in estimates for underlying inflation.
- The risks of inflation deviating from target by the end of 2017 are still in place, with underlying inflation still high and declining slowly.

**Figure 7. CPI, core CPI and historical estimates for underlying inflation, % YoY**



Sources: Rosstat, R&F calculations.

#### **1.1.4. PMI price indicators: relative prices in services are down**

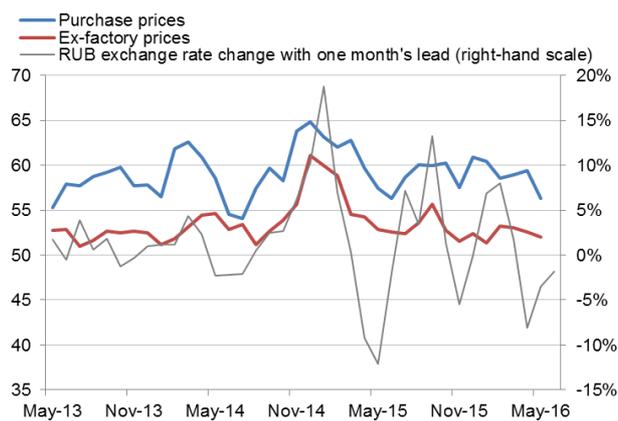
- The rates of purchase and ex-factory prices in the manufacturing sector remain elevated, and the trend towards their further slowdown has yet to emerge.
- In the service sector, the disinflation trend persists, which is probably reflective of the ongoing downward movement in this sector's relative prices as opposed to the tradables sector.

The manufacturing sector in May chalked up stronger inflation pressure (Figure 8). As the ruble was switching to post-strengthening stability in its exchange rate, purchase prices were showing a noticeable acceleration, reflecting negatively on purchase prices. Overall, the rates of purchase and ex-factory prices remain accelerated, and the trend towards its further slowdown remains to be seen.

To counter the trend, services indicated a slowdown in both purchase and ex-factory prices (Figure 9). The companies in the polls noted that competition, including in price, prevents them from fully converting higher purchase prices into retail prices. The service sector retains a disinflationary trend, in a sign that decline in the sector's relative prices is ongoing, as opposed to tradables which include manufacturing.

**Figure 8. Price movements, Manufacturing PMI**

Sources: Markit Economics, BoR, R&F calculations.

**Figure 9. Price movements, Services PMI**

Sources: Markit Economics, BoR, R&F calculations.

### **1.1.5. After a slowdown between April and May, nominal wage growth may accelerate as the economy picks up**

- Growth rates of wages between April and May settled at a lower level against the first quarter.
- Slowly growing wages in the public sector still keep in check the overall expansion of labour remuneration, decreasing inflation pressure.
- Yet, the expected economic rebound could trigger a more rapid rise in nominal salaries, as well as a return to consumption-focused behaviour model,
- ...resulting in higher inflation pressure in the economy.

Rosstat reviewed its April estimate for nominal wages upwards from 5.4 to 6.1% YoY. Tentatively, in May their rates accelerated to 6.2% YoY (Figure 10). Nevertheless, the slower, against the first quarter, growth in nominal salaries led to real wages re-entering negative growth territory: -1.1% in April and -1.0% in May. Most likely, the considerable acceleration of wage rates in the first quarter was temporary, and growth rates stabilised at lower levels, somewhat mitigating the risks of inflation acceleration. As an indirect sign of the temporary nature of this wage acceleration, the continued contraction in retail sales was irresponsive to the growth of real wages between February and March.

The April deceleration of salaries found its way across all industries<sup>4</sup> (Figure 11). The public sector salaries are still there to check the overall labour remuneration, helping drag down the overall inflation pressure. Were the current public sector salaries a match to those in the non-tradables sector, wages in the economy would be growing at rates 0.8–1.0% higher.

<sup>4</sup> Rosstat-published wage statistics are released with a large lag. The May data are not expected before July.

The strong acceleration in the growth of salaries in the first quarter was in all probability temporary, somewhat helping mitigate the risk of faster inflation. The ongoing decline in retail sales, with a stabilisation seen in real wages, suggests that households maintain a saving model in their behaviour, cutting down their bank debt, among other saving-focused actions.

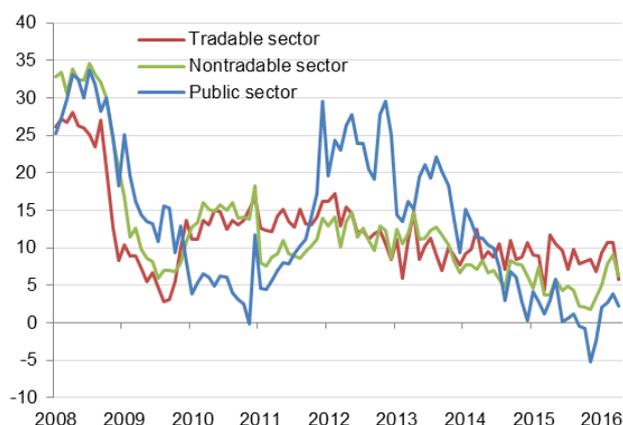
The incipient economic stabilisation with the expected resumption of economic growth could trigger a more rapid nominal wage acceleration, with the consumption-focused model re-emerging. This could lead to higher proinflationary pressures in the economy.

**Figure 10. Wage performance, % YoY**



Source: Rosstat.

**Figure 11. Nominal wage performance by sector, % YoY**



Sources: Rosstat, R&F calculations.

## 1.2. Although the economy is in stagnation, expectations for growth in the third quarter grow stronger

As microeconomic fundamentals show, consumption and investment stood a good chance of expanding in the final months of the year – despite the currently persisting slump in household consumption. This would be helped by recovering oil prices and a strongly performing exchange rate of the ruble.

### 1.2.1. Q1 GDP: the bottom is passed

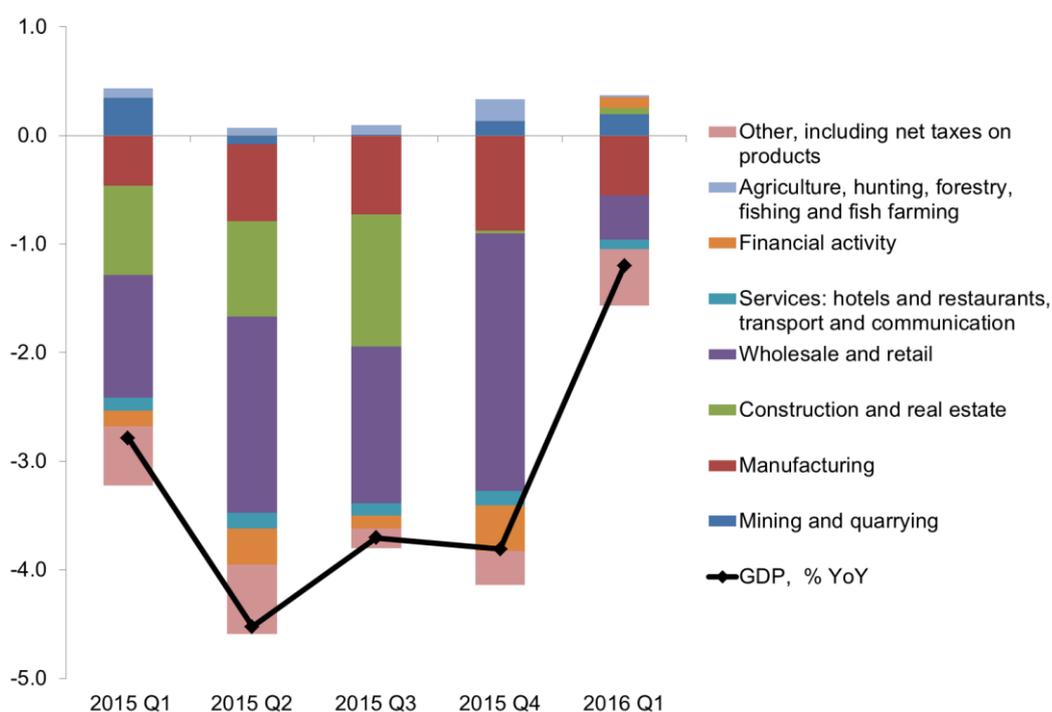
- Q1 GDP production data enable a positive assessment of potential changes in consumption and investment in 2016.
- Most probably, the economy has by now passed the bottom of the downturn, despite the fact that some GDP components are still unstable.
- The recovery in banks' interest rate margins and stronger profits were behind the value added in the financial operations.

In April, the first Rosstat assessment of Q1 2016 GDP came to show a 1.2% YoY drop. Rosstat's data on production GDP components confirm that the greatest improvement is shown in activities related to domestic consumption.

A significant contribution to the drop in annual rates of recession was being made by wholesale and retail and also by construction (Figure 12). However, in the case of wholesale and retail, this is mainly down to the low base effect, triggered by a sharp slump at the beginning of 2015. Quarterly wholesale and retail data show a stabilisation in economic activity, rather than a resuming economic growth. Most likely, the bottom point of recession is behind as the economy is yet to hit a steady recovery path.

It should be noted that our one month-old expectations for a fairly strong growth in the hotel and restaurant business failed to oblige fully. These were based on short-term monthly poll data<sup>5</sup>. The contribution of the manufacturing and agricultural sectors to GDP was also somewhat worse than expected.

**Figure 12. Activity-based decomposition of GDP growth rates, % YoY**



Sources: Rosstat, R&F calculations.

The growth in value added in the financial activities is noticeable, supported by the recovery in banks' interest rate margins and better profits.

### **1.2.2. Consumer activities: weak performance on the backdrop of better consumer expectations**

- In May, seasonally adjusted retail turnover dropped 1.2% MoM, from the reduction of 0.4% MoM in April.

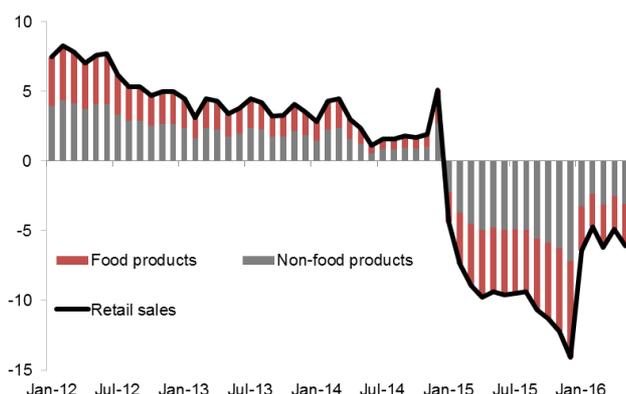
<sup>5</sup> See Section 1.2.1 'Q1 GDP: better than expected' of 'Talking Trends' [Bulletin](#) No. 6 (May 2016).

- However, the way real wages and incomes were performing, with improved consumer expectations, speaks for the probability that economic growth is set to resume before the end of the year.
- The potential growth recovery is likely to pave the way for a more sustainable growth in the manufacturing sector which serves consumer demand.

According to Rosstat, the annualised shrinkage in retail sales since January 2015 continued into May to reach 6.1% YoY. R&F estimates the volumes of seasonally adjusted retail sales to drop 1.2% MoM on April.

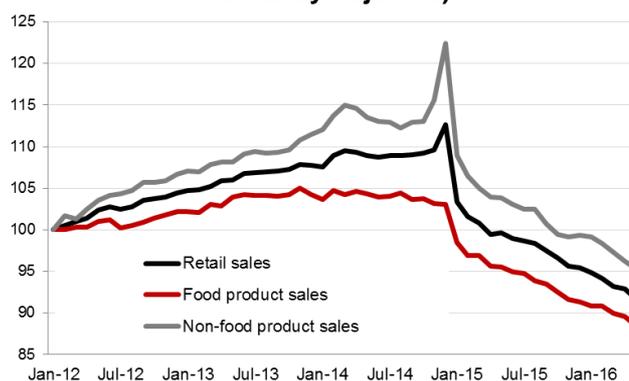
Both food and non-food products were affected in equal measure: -6.0% YoY and -6.2% YoY, respectively (Figure 13). However, as the indicator accumulations since 2012 show, non-food sales saw a more modest contraction, caused by faster expansion between 2012 and 2014 and the hike in sales seen in late 2014 inflicted by the dramatic drop in the ruble exchange rate (Figure 14). The more sustainable sales pattern of non-food sales in 2014 may well have been attributable to household spending of both ruble and forex savings to buy durable goods, while the developments that followed may have been the result of growth in sales of individual non-food products.

**Figure 13. Food and non-food products in retail sales, % YoY**



Sources: Rosstat, R&F calculations.

**Figure 14. Retail sales, food and non-food products (January 2012 = 100%, seasonally adjusted)**



Sources: Rosstat, R&F calculations.

Although the current data on retail remain weak, there are a number of positive signals to indicate a potential rebound in consumer activity in the next few months.

These signals include a gradual recovery in real household income. The May data on real wages and real disposable income, adjusted for the seasonal component, were practically unchanged in comparison with April (0.01 and 0.33% MoM, respectively). The seasonally adjusted data indicate the lack of any pronounced trend since the beginning of the year. The performance of real salaries in annual terms also testifies to a gradual stabilisation. In May, the drop in real salaries totalled 1% YoY on the April shrinkage of 1.1% YoY and the positive growth rates seen in February and March. As a result, in five months' time this indicator dropped only 0.8% YoY.

The current retail turnover and services data are in many ways dictated by the low purchasing power of the population. Real salaries fail to surpass those of the past years (Figure 15). With the period when real wages were dropping substantially over, their performance remains rather volatile and steady rates of positive growth remain to be seen. The nascent income recovery remains to weigh in on retail turnovers as the

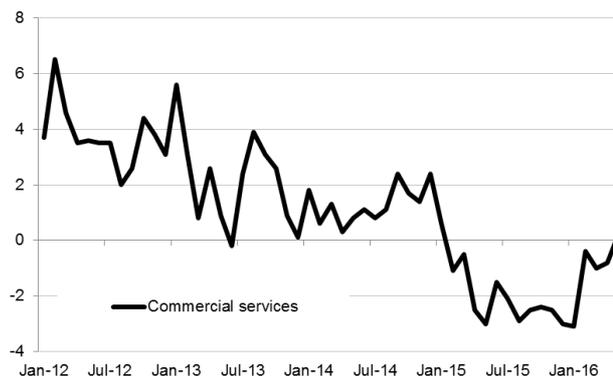
population keeps its inclination to save when it comes to certain product types. This can also be the result of the high saving rate.

**Figure 15. Retail sales and real wages (January 2007 = 100%, seasonally adjusted)**



Sources: Rosstat, R&F calculations.

**Figure 16. Commercial services (% YoY)**



Sources: Rosstat, R&F calculations.

Another optimistic signal came from the positive growth rate of commercial services to the population in May (0.2% YoY), for the first time since January 2015, which tallies with PMI data for services (Figure 16). Nevertheless, any reliable findings in favour of the rebound in the demand for services could only be made once data on commercial services by sector are released.

It is also worth noting some improvement in consumer expectations as to future income. In May, larger was the share of those expecting their family's financial well-being to improve in the next year, topping a maximum for the last year – the reading of May of last year<sup>6</sup>. More so, the share of consumers forced to save was considerably lower in comparison with last month at 62% against 67% recorded a month ago<sup>7</sup>.

Therefore, despite the ongoing shrinkage in retail turnover numbers, the gradual recovery in real household income over the past months, as well as improved consumer expectations, allows to expect the rates of retail turnover contraction to drop and reach a path of positive monthly growth rates by the end of the year.

### 1.2.3. Industrial outputs are still unsteady

- In May, industrial production contracted 0.3% MoM, seasonally adjusted, following a rise of 0.3% MoM in April.
- The negative contribution to the industrial output data came from manufacturing and mining operations.
- This unsteady performance is likely to remain in the months to come before growth in industrial production is expected to recover slowly.

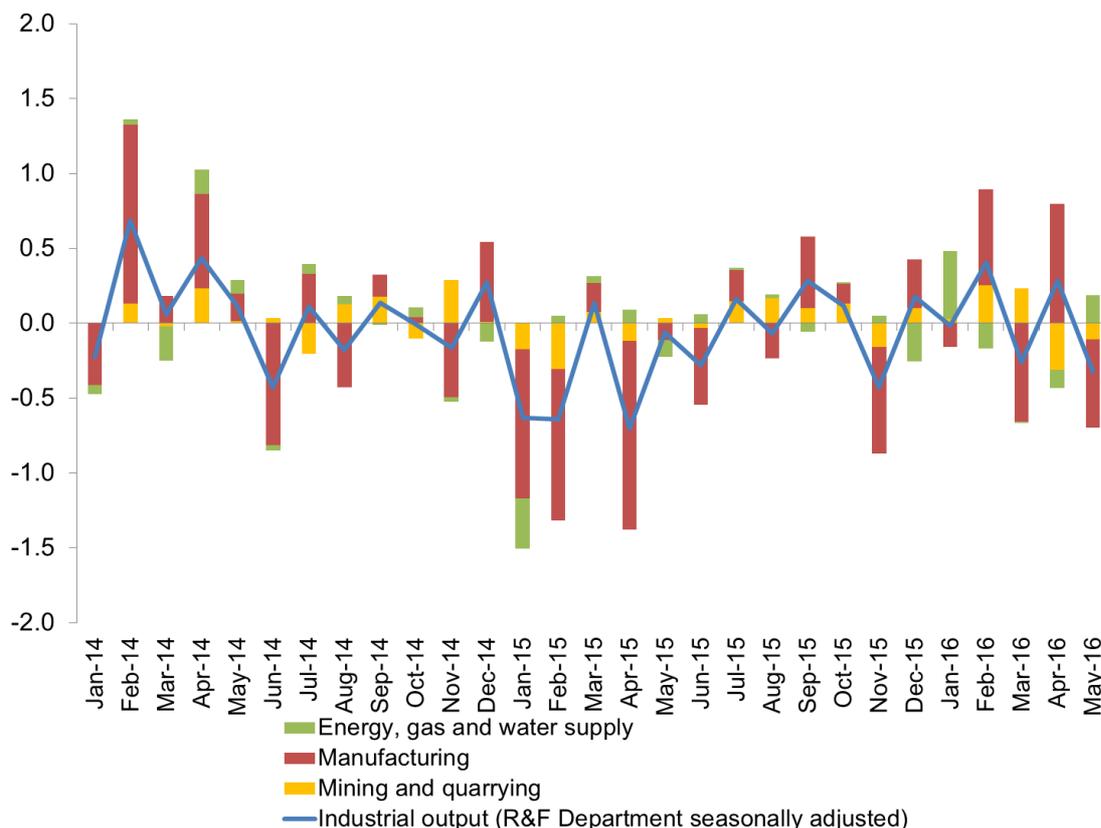
<sup>6</sup> According to inFOM's survey in May

<sup>7</sup> According to inFOM's survey in May, 62% of those polled admitted the need to economise when paying for a product or a service over the past three months. This number dropped against last month but is still high.

Rosstat's industrial output data for May support the gradual rebound trend that emerged one month ago. Industrial production grew 0.7% YoY, resulting in a slight growth (0.1% YoY) for the first five months of the current year.

However, according to Rosstat and R&F estimates, seasonally adjusted industrial production saw a 0.3% MoM contraction in May. R&F estimates that this contraction occurred in May on the April growth of 0.3% MoM (seasonally adjusted).

**Figure 17. Contribution of individual components to Industrial Production Index, % MoM (seasonally adjusted)**



Sources: Rosstat, R&F calculations.

The fragile nature of industrial output recovery is suggested by the sectoral performance. Shrinking outputs in the manufacturing sectors were key negative contributors, with mining also in decline (Figure 17). This saw electricity, gas and water production and distribution edging up in May.

Seasonally adjusted industrial production remains rather volatile, with a pronounced trend towards recovery remaining to emerge. Meanwhile, the key triggers of volatility are still manufacturing sectors. A stabilisation in manufacturing would be key to a start in the process of industrial recovery in general.

It should be noted that seasonally adjusted industrial outputs in the manufacturing industries have been showing alternate positive and negative values for a seventh month in a row. This suggests the existence in the manufacturing sector of product groups with a 1.5-2 months' production cycle, resulting in 'floating' seasonality that standard statistical methods are unable to capture.

It is possible to speak on a continued stabilisation in mining operations, despite the May drop in industrial production. The length of this stabilisation with near-zero growth rates fluctuations is strongly influenced by external factors. The volatility observed may well

persist in the next few months before the industry starts to demonstrate a steady recovery.

#### ***1.2.4. Volatile outputs in individual industries are behind the unsteady performance in manufacturing***

- The manufacturing sector's shaky performance, with the lack of pronounced trends, is due to volatility of output data in individual sectors. This supports the conclusion that the structural change being observed in manufacturing have yet to become systemic in nature.
- May saw some growth only in industries accounting for 10% of the manufacturing sector's gross value added (GVA): wood-working, wood-pulp and paper industry, leather and footwear industry, textile and apparel industry and others)
- Looking forward, economic activity may benefit from a decline in economic uncertainty expected in the months to come; however, the current demand level is insufficient for the improvements in individual sectors to transform into a steady industrial growth.

R&F estimates that the manufacturing industry in May was hit by a recession after its April growth and, as a result, extreme instability was seen in monthly data on physical output volumes, adjusted for seasonal and calendar factors. The fluctuations observed in volumes were caused by the volatile output in major industries and the unstable nature of development in the growth-driving industries (food and chemicals) where growth made way to decline.

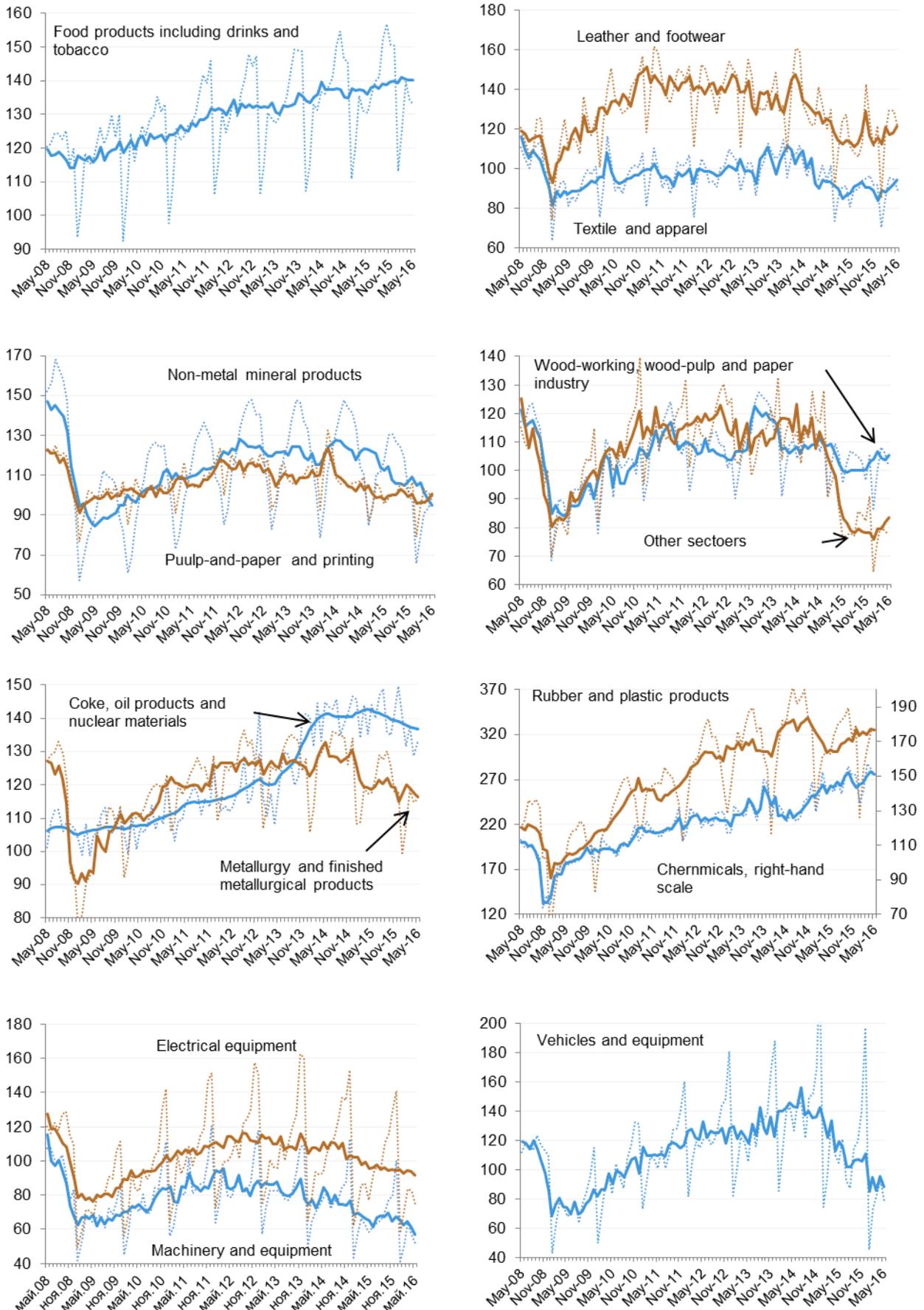
The sectors accountable for most GVA in the manufacturing industry have for the last several months dragged it down. In particular, in May outputs were still declining in the food industry, metallurgy, production of coke and oil products (Figure 18). The manufacturing sector remains heavily affected by investment demand industries. There was accelerated drag in the production of construction materials, machinery and equipment and electric equipment. Production of vehicles and equipment left the territory of recession and are on track for a stagnation mode with some tactical fluctuations. In chemicals, the four months of consecutive growth gave place to decline; these saw output expansion between March and April mainly on the back of the boom in pharmaceuticals, which slowed down in May. Output of rubber and plastic products also registered a slump following a rise in April.

The volume of output continued to rise only in industries which account for about 10% of the manufacturing sector's GVA: these included woodworking, pulp-and-paper, leather and footwear, textile and apparel and others.

In the next months, economic activity in the manufacturing industry could be encouraged by the cessation of negative pressure related to economic uncertainty (Figure 19).

Nevertheless, as situational polls of enterprises show, the current demand is insufficient for the slight improvement seen in several sectors to develop into strong growth.

Figure 18. Manufacturing sector outputs, January 2005 = 100%



\* Dotted lines are used for actuals; full lines are used for seasonally adjusted data.

Sources: Rosstat, R&F calculations.

**Figure 19. Share of manufacturing enterprises which referred to economic uncertainty as an output constraint<sup>8</sup>**



Sources: Rosstat, R&F calculations.

### **1.2.5. Demand for new cars in May resumed its decline after the previous months of stabilisation**

- The equilibrium point, which the car market seemed to have reached in the preceding months, proved shaky. In May, demand (seasonally adjusted) was falling again. The Russian car output is showing only minor fluctuations, matching the demand.
- Exports and imports shrank to their lows, making no material impact on the supply and demand balance.
- The Russian market is losing its appeal to foreign car makers as global major car markets are continuing to grow and the prospects for demand recovery in Russia remain vague.
- The resumed slump in demand for new cars helped constrain prices in this product category.

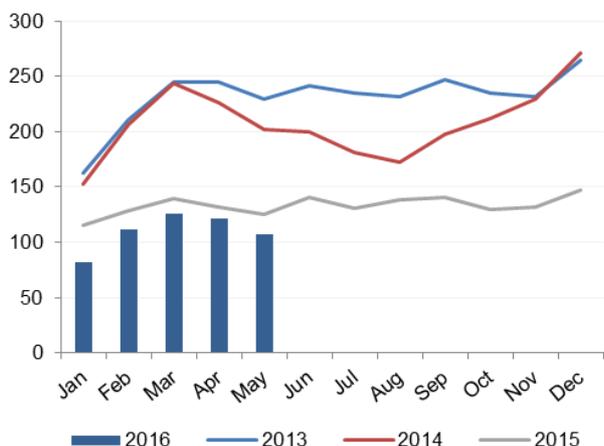
The Russian car market resumed its search for a new balance in May, after the previous months of temporary stabilisation. Consumers, with their real incomes shrinking, are forced to refrain from purchasing non-essentials. In May, known to be an adverse month because of seasonality, sales of new automobiles and commercial light cars were at their lows since the start of 2010 to total 107.7 thousand pieces. This is evidenced by the Association of European Businesses (AEB) data. Even after seasonal and calendar adjustments, physical volumes of sales showed a decrease of 6.2% against April, with the annualised decrease in sales accelerating again as they dropped 14.5% on the May 2015 reading.

The output of cars, according to Rosstat data, having risen 6.2% on April, was 4.1% higher than in the same period last year. Exports of cars fail to show any inclination to growth. The Russian automotive industry is in search of new sales markets; its exports total less than 10% of the total volume of production. The imports, which at the beginning of the year dropped to all-time lows, remain relatively steady.

<sup>8</sup> According to Rosstat's monthly survey of business activity in manufacturing enterprises.

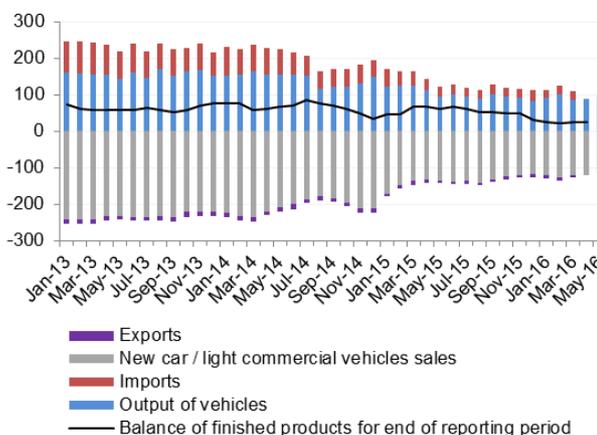
With the current demand still low and no prospects for its revival in the next few months, producers maintain steadily low levels of stocks as of the beginning of the year. Total amounts of purchase orders for new cars in the future periods of the current year also saw a stabilisation, following a dramatic collapse in 2015, and remain 12% lower than 2013 orders.

**Figure 20. New car / light commercial vehicle sales, thousand pieces**



Sources: AEB, R&F calculations.

**Figure 21. Demand (-) and supply (+) components in the car market in Russia, thousand pieces, seasonally adjusted**

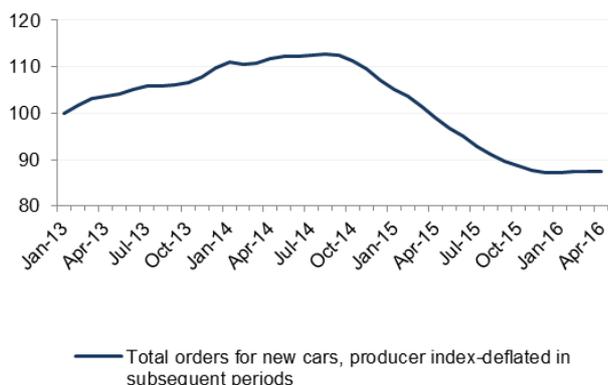


Sources: AEB u Rosstat, R&F calculations.

The Russian market retains its strategic importance for many foreign car makers. However, as the prospects for recovery in demand in Russia remain blurred and sales in major global car markets are expanding, Russia is losing its appeal to foreign car groups.

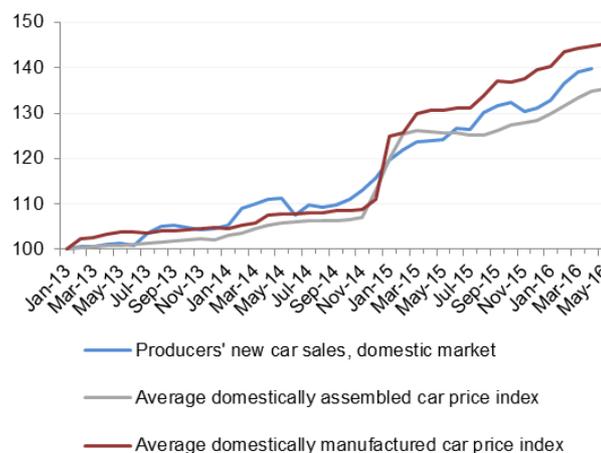
China retains its number one position in car sales: as many as 2,107 thousand automobiles and light commercial cars were sold here in May (20 times more than in Russia). According to forecasts of the China Association of Automobile Manufacturers (CAAM), the national market grew 6% in 2016. In this way, as the population was continuing to migrate to large cities, the city authorities are pursuing the policies of limited new car registration as they attempt to address the issues of environmental protection and heavy traffic. These policies could encourage some Chinese car makers to make a foray into the Russian market, where sales of Chinese brands for the five months of the current year grew 9% on the same period in 2015.

**Figure 22. Total new car orders in the months ahead (trend), January 2013 = 100**



Sources: Rosstat, R&F calculations.

**Figure 23. Retail and manufacturer prices for new cars, January 2013 = 100**



Sources: Rosstat, R&F calculations.

For individual foreign brands, the post-crisis Russian market remains rather narrow with unclear perspectives for expansion. For example, in May Volkswagen sold 149.3 thousand cars in EU countries, in China – 311.6 thousand, and in Russia – only 5.6 thousand cars. Renault chalked up 102.0 thousand cars of its EU sales and only 8.9 thousand cars sold in Russia. Ford sold 87.8 thousand and 3.5 thousand pieces, respectively<sup>9</sup>. In the current situation, for foreign direct investment-backed projects to advance, servicing only the domestic market is not enough. These projects should target production in Russia and servicing foreign markets.

The resumed decline in demand for new cars was acting as a constraint for prices in this product group, which were rising regardless (Figure 23).

### 1.2.6. Unemployment is on track to become steady

- The current rate of unemployment is still fluctuating around its 2015 levels.
- Neither the risks of substantial rise in unemployment nor those of its decline are strong as a result of demographic factors and other Russian labour market specifics.

Unemployment fell from 5.9% in April to 5.6% in May. The seasonally adjusted level of unemployment grew slightly from 5.7% to 5.75% (Figure 24). The number of employed in May 2016 was 488 thousand less than in May 2015. This decrease is caused by the past year's high base effect<sup>10</sup> and should therefore be interpreted as no sign of a deteriorating labour market.

Overall, it is possible to speak on the unemployment rate settling around the current level, with no substantial risks of growth or prospects for decline. The Russian labour

<sup>9</sup> According to Avtostat, an analytical services agency.

<sup>10</sup> May 2015 recorded a material growth in the number of employed (seasonally adjusted), which proved temporary.

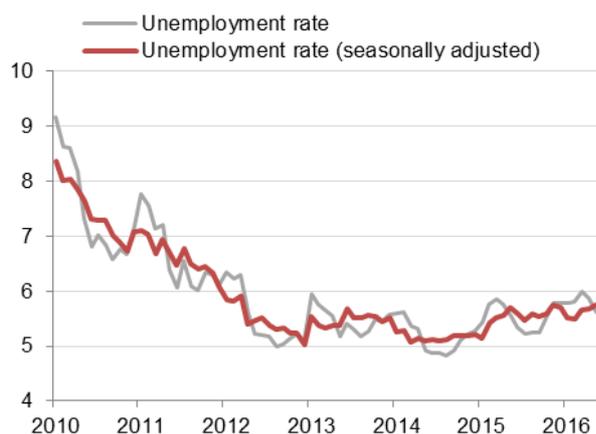
market specifics are such that they allow no expectations for a marked decrease in unemployment even as the economy resumes recovery. This is well illustrated by a Beveridge curve<sup>11</sup> for the past 2.5 years in comparison with 2010-2013 (Figure 25).

In theory, the curve shifting closer to the origin of coordinates should imply a better performing labour market. One and the same unemployment rate there corresponds to the lower number of open vacancies, pointing to higher efficiency of recruitment processes and the fact that candidates become more qualified for employer requirements. However, in the last three years the Russian labour market performance is unlikely to have caused a sharp shift in the curve. In our opinion, such a shift can be the result of the following Russian labour market specifics:

- Deteriorating demographics, leading to a decline in the natural unemployment level.
- Weaker unemployment elasticity against economic performance. For a number of reasons, employers would keep from firing staff, introducing shorter hours or cutting back on their salaries (refraining from indexation etc.).

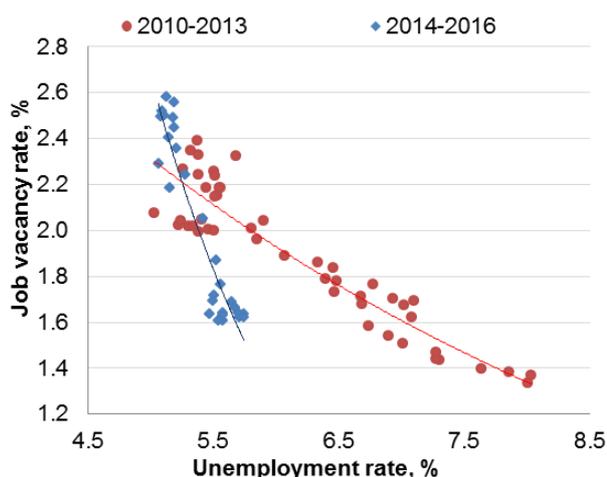
We therefore believe that the transition of the economy to recovery growth will lead to no considerable contraction in unemployment as the labour market is most likely to adjust through cutting back on part-time employment and wage change.

**Figure 24. Unemployment rate, %**



Sources: Rosstat, R&F calculations.

**Figure 25. Beveridge curve**



Sources: Rosstat, R&F calculations. Seasonally adjusted.

### **1.2.7. Part-time and informal employment in Q1: low risks of unemployment**

- Part-time employment indicators suggest a certain worsening in the labour market in the first quarter...
- ... which is offset by growing employment in the informal sector.

<sup>11</sup> The Beveridge curve, developed by William Beveridge (1879-1963) is a graphical representation of the negative relationship between unemployment and the job vacancy rate (the number of unfilled jobs as reported to the public employment services). The position on the curve indicates a fluctuating demand for labour: as economic growth drops, the number of unfilled jobs grows, together with the rate of unemployment, and vice versa. A parallel shift in the curve speaks for structural shifts in both the labour market and the economy.

- The share of employed population in the total working-age population is still on the rise, in a sign of low rates of unemployment.

Based on Rosstat's labour assessment results for 2016 Q1, part-time and informal employment data can be generated: U5 and U6<sup>12</sup> (Figure 26). For the first three months of 2016, the U5 indicator stabilised at the level of 9.6%, having decreased 0.2% from 2015 Q4. This movement was caused by the drop in the number of economically inactive population which is ready to start working. The wider U6 indicator fell in the beginning of the year to 14.6%, growing by March to almost the November 2015 reading<sup>13</sup>. Our estimates suggest that the number of part-time employees rose to a maximum since June 2014<sup>14</sup>.

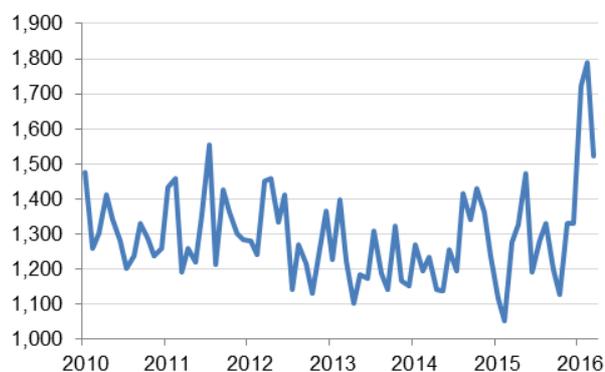
Employment in the informal sector is on the rise, too, mainly on the back of those whose occupation in the sector is supplementary (Figure 27).

**Figure 26. Unemployment including part-time employment and willingness to find a job, %**



Sources: Rosstat, R&F calculations.

**Figure 27. Informal sector employees with supplementary jobs (seasonally adjusted), thousand people**



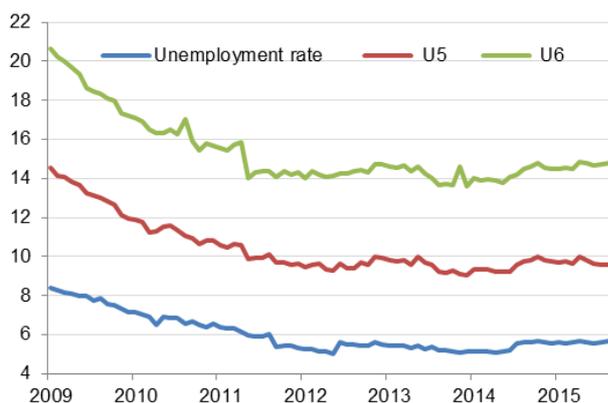
Sources: Rosstat, R&F calculations.

<sup>12</sup> This classification is used by the Bureau of Labor Statistics to calculate a variety of unemployment indicators. These calculations are based on quarterly statistical releases. U5, on top of the number of unemployed, includes the share of economically inactive population which is at the moment in no search for a job or, despite unclear prospects for employment, is willing to start working. U6 includes U5 and part-time employees (less than 30 hours a week).

<sup>13</sup> The top reading for 2015.

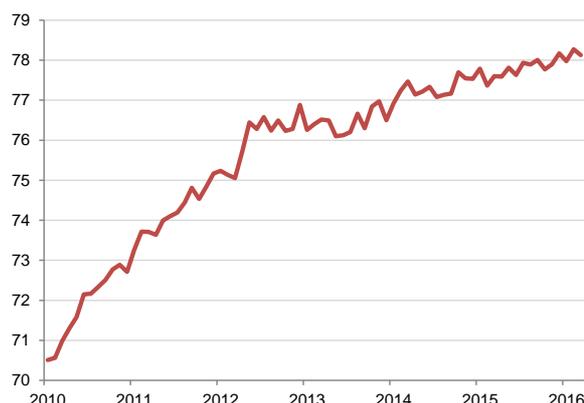
<sup>14</sup> Seasonally adjusted.

**Figure 28. Unemployment indicators, %, seasonally adjusted**



Sources: Rosstat, R&F calculations.

**Figure 29. Total employed, including the informal sector, of the working-age population, %**



Sources: Rosstat, R&F calculations.

The movements of part-time employment indicators suggest a minor deterioration in the labour market in the first quarter, led by a growing number of those employed half-time. That being said, the trend towards growth in the total number of working-age population is ongoing (Figure 29). The demographic situation is set to worsen, which is why we consider the risks of rising unemployment at this moment to be low.

### **1.2.8. With most impact on economic growth from the budget side ahead, its impact on liquidity has passed**

- The federal budget funds were spent in a *catch-up* manner, as the rates of spending were still behind those in 2015 and 2014.
- The estimate for positive impact from the public management sector on economic growth in 2016 is revised downwards to 0.5 pp owing to stronger revenues.
- The budget showed most of positive impact on liquidity in the period between January and April. The budget system may well add another 0.5 trillion rubles of liquidity in the final months of the year, which is to lead to a further bank segmentation by liquidity.

According to tentative data, May was a second month in a row when the federal budget funds were spent in the so-called catch-up mode. That being said, this speed in 2016 is still behind both 2015 and 2014. In the period between January and May 2016, the spending of own non-interest rate funds<sup>15</sup> totalled 38.3% against 40.3% in 2015 and 38.9% in 2014 (Figure 30). The spending speed in other budgets in January-April was also inferior to 2015.

As before, we expect the public management sector to have neutral implications for economic growth in 2016 Q2, given that expedited expenditure will be set off by an increase in revenues, first of all thanks to rebounding oil prices including in ruble-denominated (Figure 31)<sup>16</sup>. In the second half of the year, primarily in the fourth

<sup>15</sup> Costs where general interest rates and inter-budget payments are excluded.

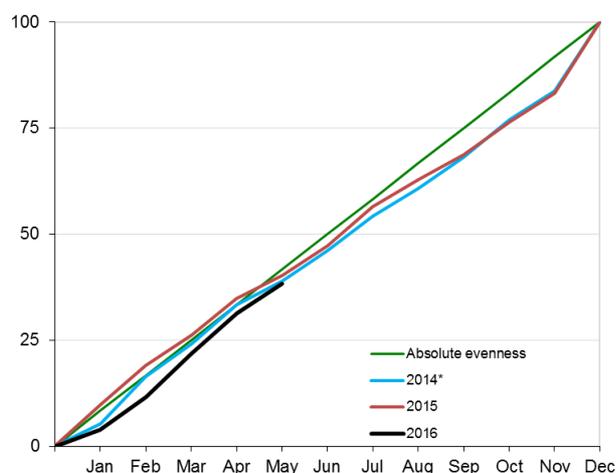
<sup>16</sup> Hereinafter – excluding the impact from the National Wealth Fund investment, considering the heightened uncertainty as to the time for this money to enter into the real economy.

quarter, the influence on economic growth is to become positive; this will see our estimate for the total 2016 impact downgraded to 0.5 pp because of increased revenues<sup>17</sup>.

At the same time, we do not expect in the remaining months of the year any considerable pressure from the budget on banking liquidity, assuming that the bulk of this pressure came in the first four months<sup>18</sup>. And, because of the specifics of the Russian banking system, that resulted in bank segmentation: the largest banks responsible for essential budget flows are either already or on the point of showing surplus, while the overall banking system in general still operates with liquidity deficit.

According to our estimates, the baseline May-December 2016 scenario provides for budget deficit of ₺3 trillion. Of this amount, ₺1 trillion could be made up by market loans and privatisation, which are still negative<sup>19</sup>. Between January and April, there were as much as ₺1 trillion of net placements of temporarily free funds of federal and regional authorities as bank deposits and repo operations. These funds are supposed to come back until the end of the year. And, considering that regional authorities, in line with budget planning, are going to partially cover the deficit from the balance of funds for the previous periods, we expect net reduction of commercial banks' liabilities to public authorities in the remaining months to equal to ₺1.3 trillion. The ensuing impact from the budget on liquidity in the remaining months of the year, the external sector operations factored in, may well total about ₺0.5 trillion<sup>20</sup>.

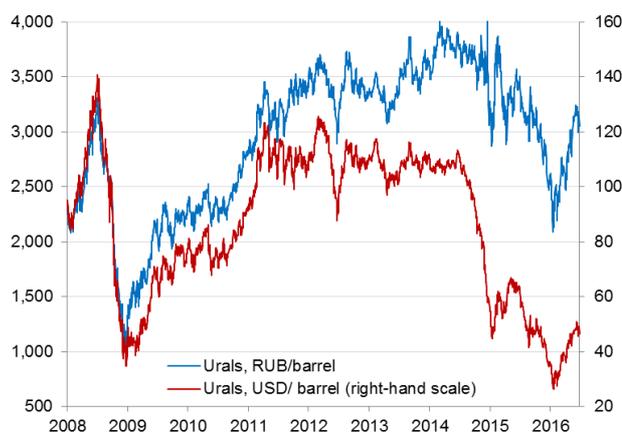
**Figure 30. Evenness in the spending of non-interest funds of the federal budget (excluding inter-budget transfers), accrued within the year**



\* Excluding funds for the Deposit Insurance Agency capital top-up in December.

Sources: RF Treasury, R&F calculations.

**Figure 31. Ruble and US dollar Urals price**



Source: Bloomberg Finance L.P.

Structurally, the money market developments are expected to be different from the situation in the first months of the year. A further inflow of budget funds is likely to spur

<sup>17</sup> In the baseline scenario, average Urals for 2016 is upgraded to \$38 a barrel.

<sup>18</sup> In particular, under our estimates, in 2015 the balance of conversion funds in accounts was used, with the spare money of the Reserve Fund.

<sup>19</sup> We assume that the great demand for OFZ (federal loan bonds) from commercial organisations and non-residents will help increase net federal budget loans in 2016 approximately twofold from the legislated amount of ₺300 billion. For January-May 2016, net loans totalled ₺0.15 trillion with the Bank of Russia sale of ₺0.12 trillion of its federal loan bond portfolio.

<sup>20</sup> Additionally, the National Wealth Fund investment may enter into the banking system in 2016; we estimate this money to total on the order of ₺0.1–0.2 trillion.

segmentation in the banking system and a rise in surplus liquidity for major banks, thereby making a marked impact on the interest rates in the money market.

### **1.3. Global economy, financial and commodity markets**

Global financial markets were agitated by the eventual victory of Brexiteers, although the referendum was widely expected to have the opposite outcome. However, its long-term repercussions for the British, EU and global economy are more significant.

#### ***1.3.1. Brexit may trigger a new surge of monetary policy easing in advanced economies***

- Higher risks following the vote for Britain's exit from the European Union may well become the reason for the Bank of England, the ECB and the Bank of Japan to further ease their monetary policies. The probability of a next quarter interest rate hike from the Fed has grown weaker.
- The US Fed revised the rate forecasts down. The estimates of a long-term real rate went down to 1%, signaling a modest prospective growth in the US.
- China is gradually depleting the effect of monetary stimulus as the authorities are pushed to choose between the launch of new programmes and control over credit institutions.

#### **Brexit: uncertainty is to restrain global economic growth**

The unexpected outcome of the referendum on Britain's exit from the European Union shocked financial markets and resulted in risk aversion. It will push monetary authorities of developed countries to prevent further worsening of financial conditions against the backdrop of slow economic growth and low inflationary pressure.

Brexit's economic spillovers are important for both the ongoing developments and long-term growth rates. In the current situation it is important with regard to the effect of uncertainty on economic agents' conduct: primarily businesses and their investment activity and secondly consumers. For instance, the uncertainty over the definite launch of Britain's exit from the EU, that is to take two years, may result in suspension of many investment projects, especially UK-related ones.

Conditions of Britain's exit from the EU and agreements the country would have with the union bring even more uncertainty. Will the single market remain? To what extent laws and general regulation will change? The answers to these questions will shape the potential economic growth of the UK and the EU.

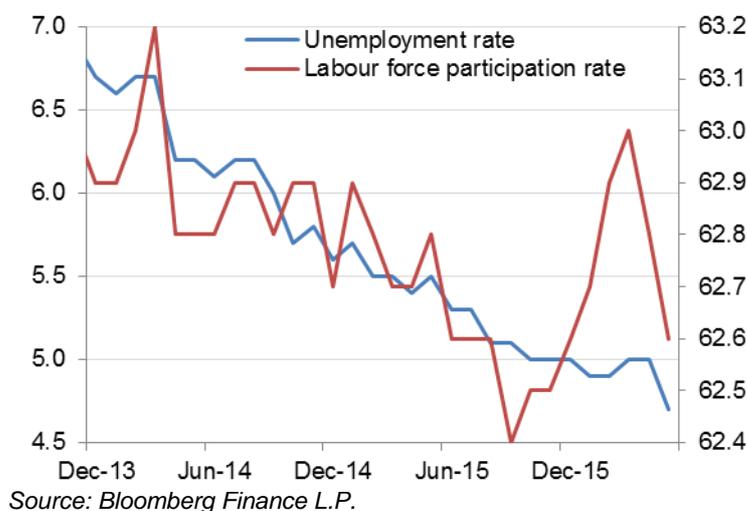
Another important risk factor is a possible domino effect. Britain's decision to leave the European Union may set off a chain reaction and ultimately boost anti-globalisation movements in other EU member-states and in the world as a whole.

Given the current developments, the Bank of England, the ECB and the Bank of Japan may be expected to ease their monetary policies and the US Fed is likely to suspend its monetary policy normalisation.

### USA: the Fed softens its rate forecasts

The release of labour market statistics in May cut off a stream of positive US economic data. Although a slowdown in jobs growth did not come as a surprise following a strike of Verizon staff, the ultimate figures turned out to be much worse and cannot be explained by the strike effect only. Non-agricultural sector added only about 38 thousand jobs, the lowest since September 2010.

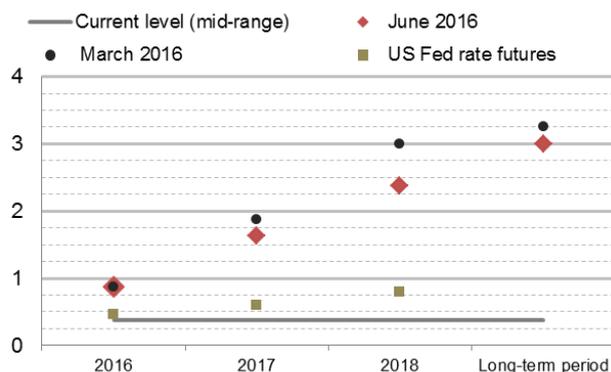
Figure 32. US unemployment, %



It is currently hard to determine whether the May deterioration is of a temporary or permanent nature. The overall Q2 data point to an acceleration of economic growth due to a higher consumer demand and a more likely pickup in the price growth. The US Fed's meeting, held on 14-15 June, delivered an unexpected outcome. The Fed's decision to keep the rate on hold was predictable, given the release of disappointing labour market statistics in May and higher Brexit risks.

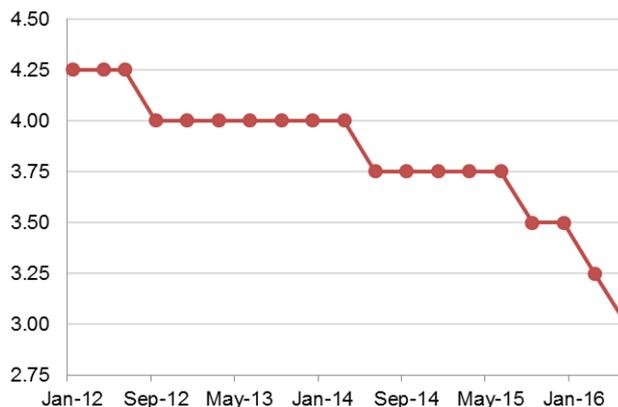
The Fed's considerable revision of the rate dynamics forecasts came all of a sudden. The median forecast, providing for two rate hikes in 2016, remained unchanged, but the balance of estimates shifted towards a softer monetary policy. Median estimates of the rate dynamics in 2017 and 2018 were downgraded (Figure 33). Meanwhile, GDP and inflation forecasts were left almost unchanged. A decline in expectations of the Fed's policy normalisation and inflation dynamics signal a shift in the Fed's vision of the US economic prospects in the long run. This is clear from the Fed's long-term rate forecast dynamics (Figure 34).

Figure 33. US Fed's forecast dynamics



Sources: US Federal Reserve, Bloomberg Finance L.P.

Figure 34. US Fed's long-term rate forecast



Source: US Federal Reserve.

In June, the forecast was revised down to 3%, provided that inflation stands at 2% this implies a 1% real interest rate. As recently as one to two years ago, the neutral real interest rate was estimated at 1.75-2%. As Janet Yellen puts it, aging population and low labour productivity growth are the key reason why the current estimate of the long-term equilibrium rate is considerably below the historical levels. Significantly, all else being equal, a decline in estimates of the Fed's long-term neutral real rate will drag the estimates of the Bank of Russia's neutral real rate down. Brexit was one of the Fed's risk factors. Its materialisation makes a rate hike less probable in the coming quarter. Higher volatility in financial markets and uncertainty over long-term Brexit implications disable a smooth rate hike in the near future.

### Eurozone: the ECB takes a break to assess implications of its March decisions

At the meeting early in June (2 June 2016), the ECB expectedly left all monetary policy parameters unchanged. The ECB continues to give effect to sub-standard accommodative measures<sup>21</sup> announced at the March meeting, and therefore does not take any additional steps.

The ECB revised the 2016 GDP growth forecast slightly upwards (from 1.4% to 1.6%) following good performance in the first quarter. Inflation forecast was nominally revised from 0.1% YoY to 0.2% YoY. Mario Draghi said at the press conference that the prolonged dramatically low inflation in the euro area had not resulted so far in negative secondary effects on inflation expectations and inflation.

<sup>21</sup> On 8 June, a corporate bond-buying programme is to be launched, and on 22 June, the first auction under a new programme of targeted longer-term refinancing operations (TLTRO) is to be held.

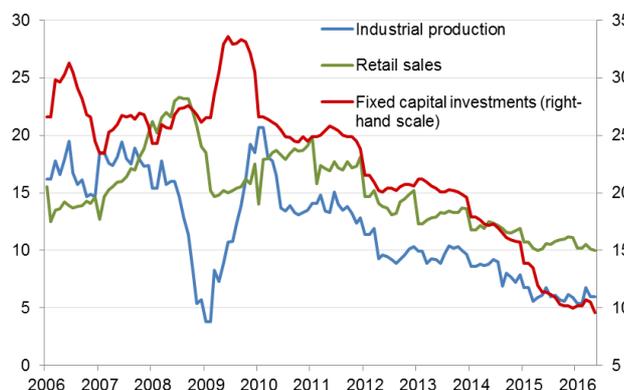
## China: as stimulus effect abates authorities face a tough choice

In May, industrial production continued to grow by 6.0% YoY, though manufacturing started to decline in annual terms. Retail sales growth slowed slightly to 10.0% YoY (Figure 35). Construction activity dropped, but remains elevated. Imports showed the same level as a year earlier (in US dollar terms they stood at -0.4% YoY after -10.9% YoY in April). It generally points to an economic stabilisation. According to Bloomberg, monthly estimates of China's economic growth in May remained at the April level (6.9% YoY). It largely results from the authorities' stimulus efforts.

However, loan and investment dynamics suggest that the effect of these measures is likely to abate soon. In May, the private sector saw a further decline in debt financing from 12.1% to 11.5% YoY (Figure 36). The ongoing active borrowing through the issue of municipal bonds under the debt portfolio optimisation programme allowed smoothing of these dynamics but failed to avoid a slowdown against the April local high. Fixed capital investment growth also showed negative dynamics (9.6% against 10.5% YoY in April): on the back of persistently high growth in public investments, private investments continued to fall (Figure 35). Having said that, the efficiency of public investments seems to go down following their shift to less economically developed regions with lower return on capital.

Thereby, the Chinese authorities may soon face a tough decision regarding new stimulus efforts. They lead to credit risk growth, but are deemed necessary if the authorities still prioritise sustaining the economic growth at the target level. As inflation shows no signs of acceleration (2.0% YoY in May), the Chinese authorities may continue to introduce economic stimulus.

**Figure 35. Industrial production, retail sales and investments in China, % YoY**



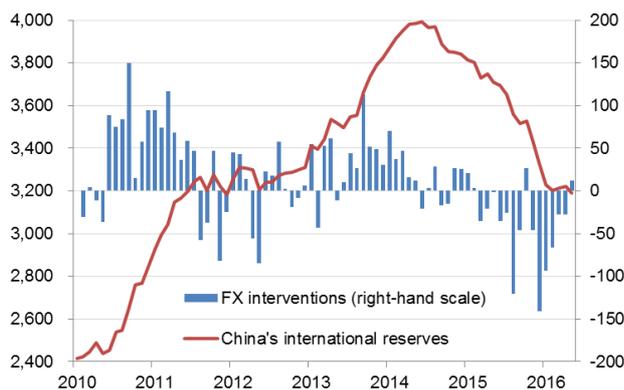
Source: Bloomberg Finance L.P.

**Figure 36. Growth of debt financing in China, % YoY**



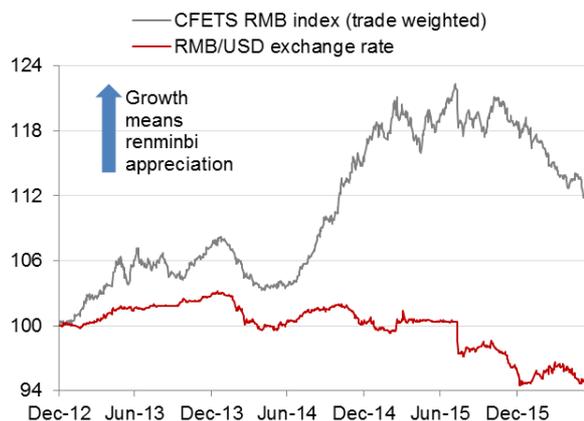
Sources: Bloomberg Finance L.P., CEIC, R&F Department calculations.

**Figure 37. Chinese gold and currency reserves and PBC interventions, \$ billion**



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

**Figure 38. CNY/USD and CNY/currency basket exchange rate**



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

In May, Chinese gold and currency reserves shrank by \$28 billion to \$3,192 billion following currency revaluation amid a drop in FX interventions by the People's Bank of China (Figure 37). An increase in placement of foreign currency bonds by Chinese issuers partially eased pressure on the renminbi<sup>22</sup>. The renminbi depreciated against the US dollar, but strengthened against the currency basket (Figure 38). June saw further renminbi weakening against the US dollar and renewed depreciation against the currency basket.

### 1.3.2. Brexit came as a surprise for financial markets

- Excessively optimistic attitude in the run-up to the British referendum doomed a surge in volatility in the follow-up to its decision to leave the EU.
- Increased volatility and risk aversion in global financial markets will hinder emerging market central banks' capabilities to ease their monetary policies in the short run.
- The Russian market looks confident against other countries, although there is a high risk of volatility growth underpinning the pursuit of moderately tight monetary policy.
- The balance of factors affecting short-term money market rates continues to shift towards monetary policy easing.

## Global markets

The victory of Brexit supporters shocked financial markets. The pound lost more than 10% against the US dollar; other developed market currencies (except for the Japanese yen) also depreciated against the US dollar. Risky asset markets crashed

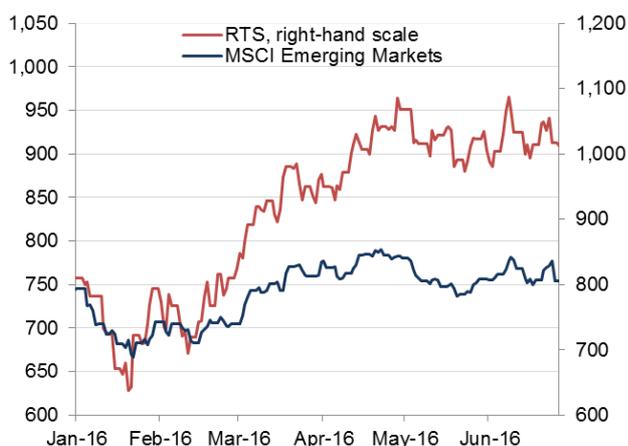
<sup>22</sup> According to the Financial Times, in May Chinese companies placed external bonds for about \$19.2 billion.

(Figure 40) and volatility surged (Figure 41) in the follow-up to the referendum. The markets responded in such a tough manner following the excessive optimism take-off in the run-up to the referendum. Market participants believed that Britain would vote Remain, triggering growth in risky assets the day before. As the outcome fell short of expectations, volatility surged and risky assets dropped.

Overall in the past month, advanced economies' government bond yields fell considerably amid growing demand for safe assets and continued to hit historical lows (Figure 43). The next spiral in the government bond rally points to the market participants' expectation of monetary policy easing by central banks of developed countries.

The volatility growth has already hit some emerging markets. For instance, the Mexican peso hit the all-time low against the US dollar, falling by almost 5% the day after the referendum. The Mexican authorities responded to the national currency depreciation and uncertainty growth immediately. Despite Brexit was not supposed to affect Mexico directly, the authorities announced a \$1.6 billion budget cut to enhance the government's and the economy's financial position. Moreover, there is a higher probability of a preemptive rate hike by the Bank of Mexico from 3.75% to 4.0% at the meeting on 30 June. The case of the Bank of Mexico shows that central banks of developing countries will be limited in their capabilities to ease monetary policies on the back of risk aversion and volatility growth.

**Figure 39. RTS and MSCI EM**



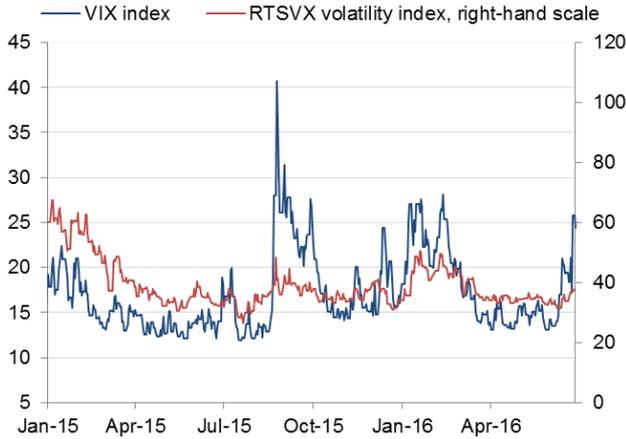
Source: Bloomberg Finance L.P.

**Figure 40. S&P500 and Eurostoxx50**



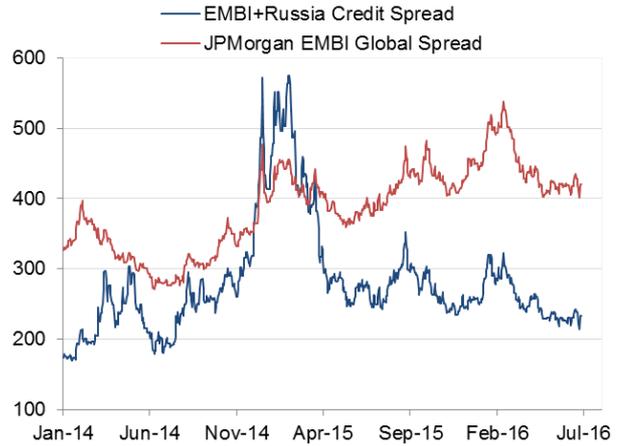
Source: Bloomberg Finance L.P.

**Figure 41. VIX (S&P500) and PTC (RTSVX) volatility index**



Source: Bloomberg Finance L.P.

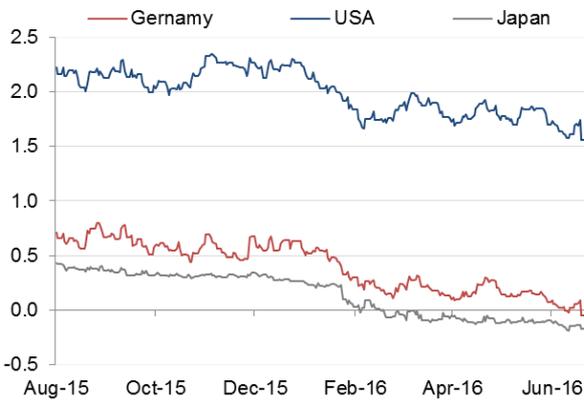
**Figure 42. EMBI+Russia and JP Morgan EMBI Global spreads**



Source: Bloomberg Finance L.P.

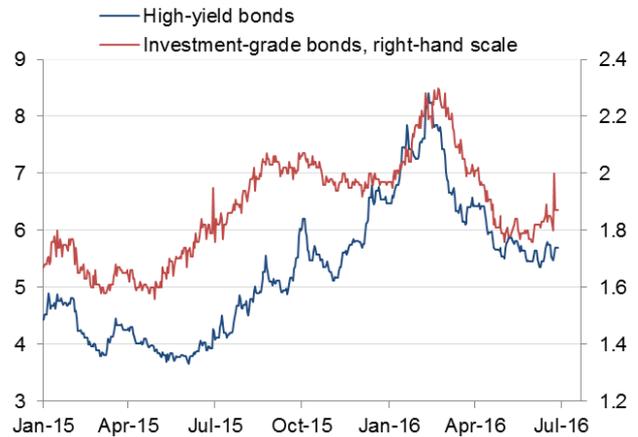
In June, the previously observed inflow into emerging market funds reversed (Figure 46): an outflow from equity funds offset a modest inflow into bond funds. Russian funds showed a similar trend. Lower risk appetite on the back of the unexpected outcome of the referendum is likely to result in capital outflow from emerging markets.

**Figure 43. Yields on 10-year bonds of developed countries, %**



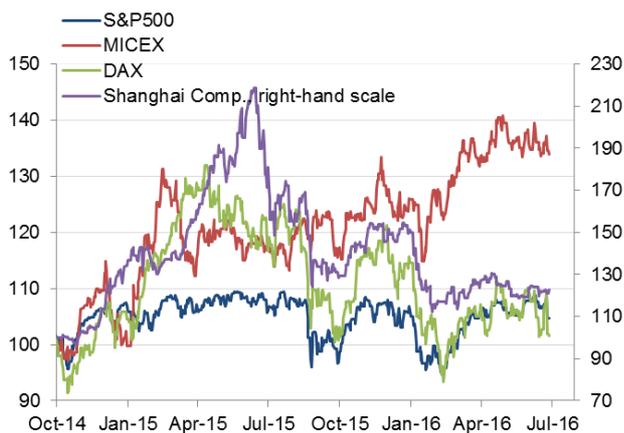
Source: Bloomberg Finance L.P.

**Figure 44. Credit spread of corporate bonds of developed countries, %**



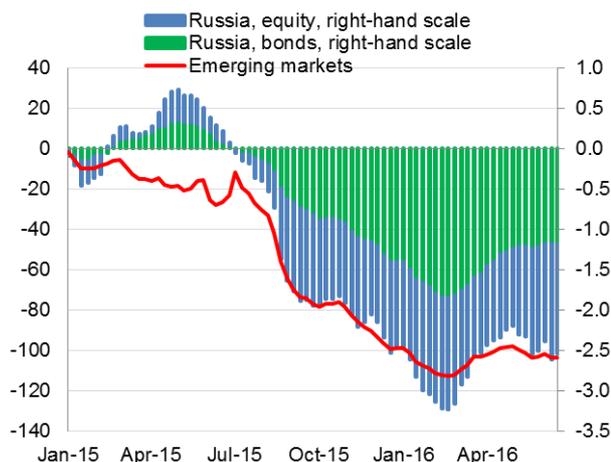
Source: Bloomberg Finance L.P.

**Figure 45. Equity indices in local currencies (index, 1 January 2014 = 100)**



Source: Bloomberg Finance L.P.

**Figure 46. Cash inflows into Russian and emerging market funds (accrued, '+' is inflow), \$ billion**

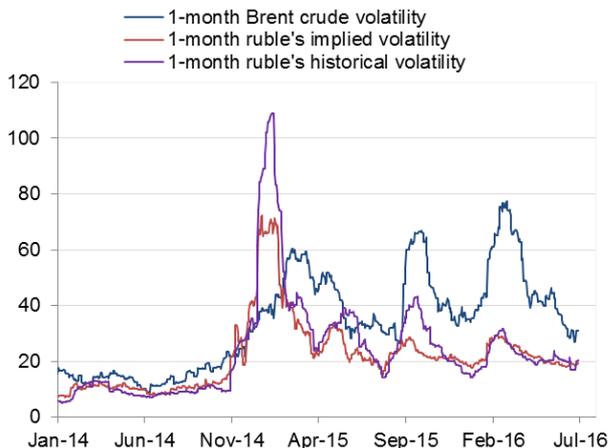


Sources: EPFR Global, Bloomberg Finance L.P.

**Russian markets**

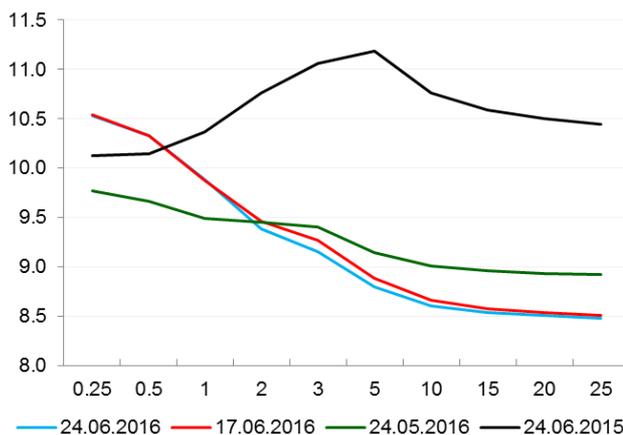
Russian financial markets responded to Brexit moderately compared to other emerging markets. The ruble depreciated against the US dollar as oil price dropped, but partially recovered by the end of the day after the voting. The OFZ market first showed a price drop and a yield growth, but both rebounded shortly. The Russian equity market declined but the drop was incomparable with that seen in advanced economies.

**Figure 47. Imputed and historical volatility of the ruble and oil prices**



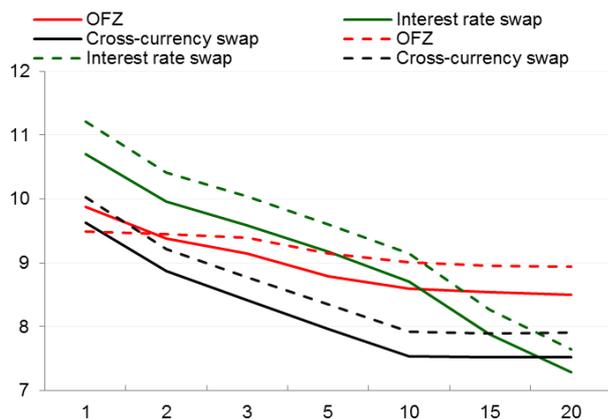
Source: Bloomberg Finance L.P.

**Figure 48. GKO-OFZ yield curve, %**



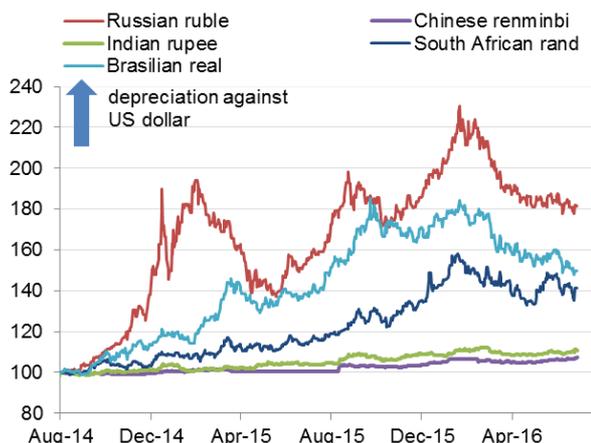
Source: Moscow Exchange.

**Figure 49. Interest rates on different instruments as of 24 June 2016**



Solid lines – values as of 24 June 2016, dotted lines – values as of 24 May 2016.  
Source: Bloomberg Finance L.P.

**Figure 50. BRICS exchange rates (1 August 2014 = 100)**

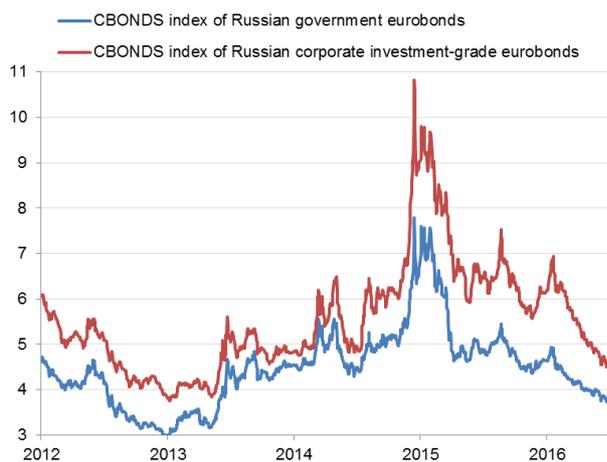


Source: Bloomberg Finance L.P.

In June, both corporate and government bond markets continued to grow. Lower yields were observed in the Eurobond segment (Figure 51) and in the ruble bond market (Figure 52). The market responded positively to the Bank of Russia’s decision to cut the key rate to 10.5% triggering a further inversion of OFZ yield curve (Figure 48). Yields of long-term financial instruments (Figure 49) were down by about 0.5% over the month.

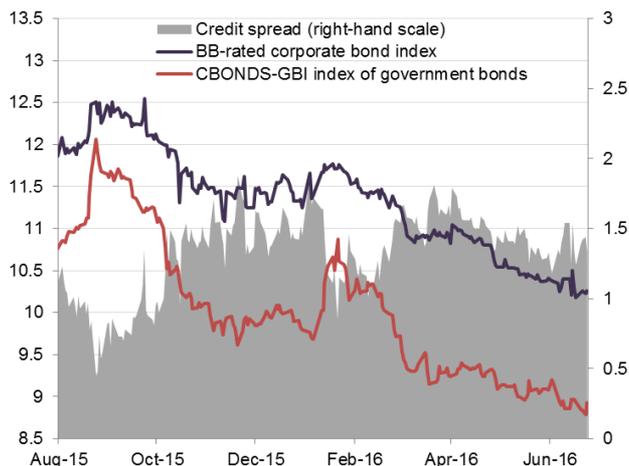
The relative sustainability of the Russian market may result from the macroeconomic policy considered to be correct by market participants. Nevertheless, the volatility in global markets is running the risk of growing further. In this environment, the need for a moderately tight monetary policy persists.

**Figure 51. Russian Eurobond yield, %**



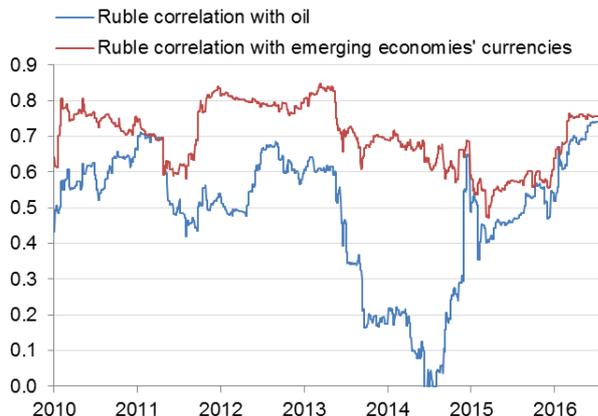
Source: Cbonds.

**Figure 52. Ruble bond yield, %**



Source: Cbonds.

**Figure 53. Ruble’s 12-month correlation with emerging economies’ currencies and oil**



Source: Bloomberg Finance L.P.

**Figure 54. FRA 3X6 and 3M Mosprime spread, % p.a.**

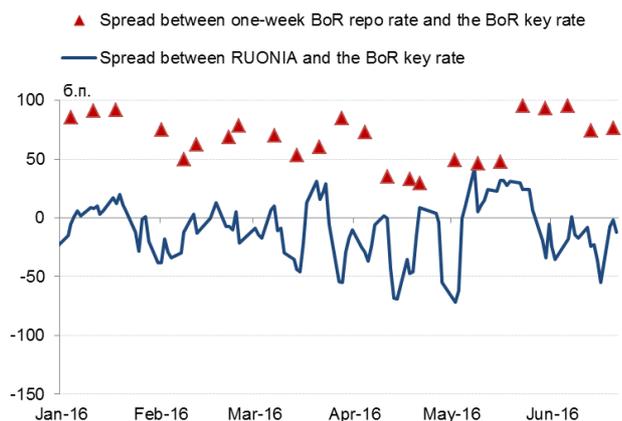


Sources: Bank of Russia, Bloomberg Finance L.P., R&F Department calculations.

In the past month, the environment in the money market improved and the equilibrium of liquidity factors shifted towards a slight decrease in the interbank market rates. Now, liquidity inflow offsets banks’ total debt repayments to the Bank of Russia. This allows banks to accumulate surplus funds on correspondent accounts with the Bank of Russia, which they do not intend to transfer into BoR deposits.

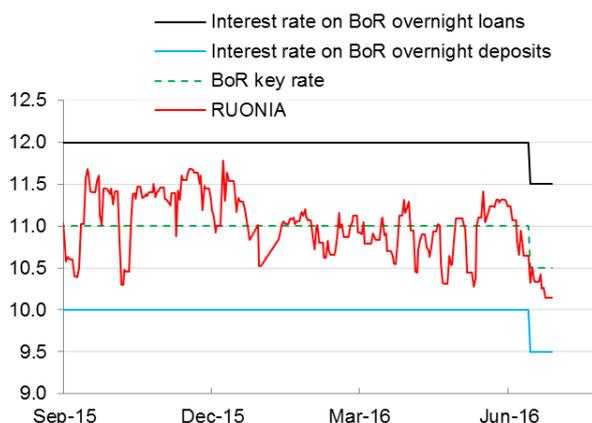
Net liquid position of banks to the Bank of Russia grew by ₴446 billion in the period under consideration (24 May – 24 June), as banks redeemed considerable debt to the public sector (₴195 billion) and increased correspondent accounts and deposits with the Bank of Russia (by ₴251 billion).

**Figure 55. Spread between RUONIA and one-week auction-based BoR repo rate to the BoR key rate, bp**



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

**Figure 56. BoR interest rate corridor and short-term interbank rate**



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

Despite that, spread between RUONIA and the BoR key rate has not always been negative. Thus, late in May, rates were affected by a considerable reduction of one-week repo limits by the Bank of Russia (Figure 55). Limits were partially restored

afterwards on the back of higher demand for BoR repos from smaller banks. In June, RUONIA fell below the BoR key rate: the trend towards a persistently small negative spread between short-term market ruble rates and the BoR key rate is still in place

The Bank of Russia's decision to reduce the key rate by 50 bp to 10.5% from 14 June was the key determinant of the money market. However, the response of market participants was moderate as the rate cut has already been included in quotations.

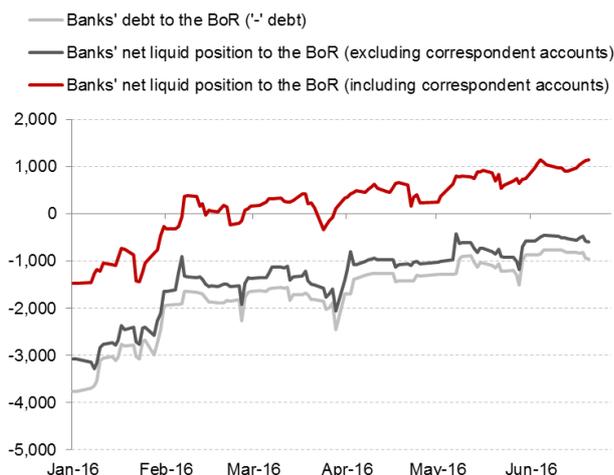
The ongoing inflow of funds from the Federal Treasury's accounts improved the situation with liquidity while other liquidity factors had a minimal impact on rates. Given the increased deficit of the consolidated budget and the operations of the Ministry of Finance with the banking sector (deposit auctions and OFZ repos), the banking system received almost ₹500 billion over the month. Nevertheless, like in June, almost all the budget funds will be used to repay debts to the Bank of Russia (₹953 billion as of 24 June) in the near future, curbing the downward pressure on rates from the budget for a certain period.

In addition, the intensity of budget fund inflow is expected to weaken in the second half of the year, as the principal amount of the budget deficit covered by the Reserve Fund of the Russian Federation and liquidity allocated by the Federal Treasury was used in the first four months of the year.

Though correspondent accounts and deposits with the Bank of Russia have grown insignificantly so far, money market segmentation will progress in the near future even if liquidity inflow from the budget is less sizeable. The concentration of budget fund inflow on major banks' accounts creates liquidity surplus in these banks faster than in other credit institutions of the banking sector.

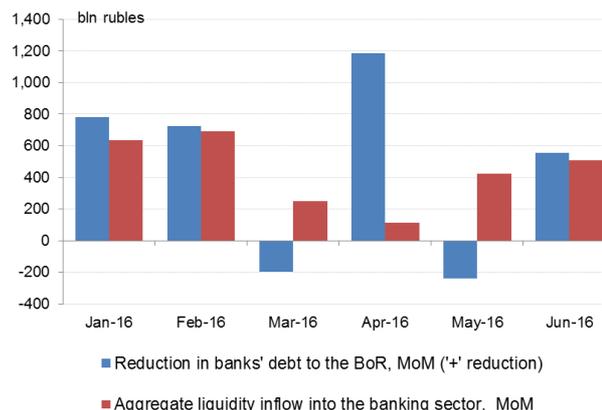
Meanwhile, major banks still experience liquidity deficit. Therefore, last month some banks showed an increased demand for more expensive fixed-rate BoR repos. The number of large Top-20 banks experiencing a liquidity surplus is likely to grow soon, as some of them already have minimum debt to the Bank of Russia. Such developments may result in a stable shift of short-term rates to the lower range of the Bank of Russia interest rate corridor, driving monetary easing.

**Figure 57. Banks' net liquid position to the BoR<sup>23</sup>, ₪ billion**



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

**Figure 58. Reduction in banks' debt to the BoR and net liquidity inflow, ₪ billion**



Sources: Bank of Russia, Bloomberg Finance L.P., R&F Department calculations. June data are calculated for 1-24 June.

### 1.3.3. Commodity markets: Brexit set growing prices to fall

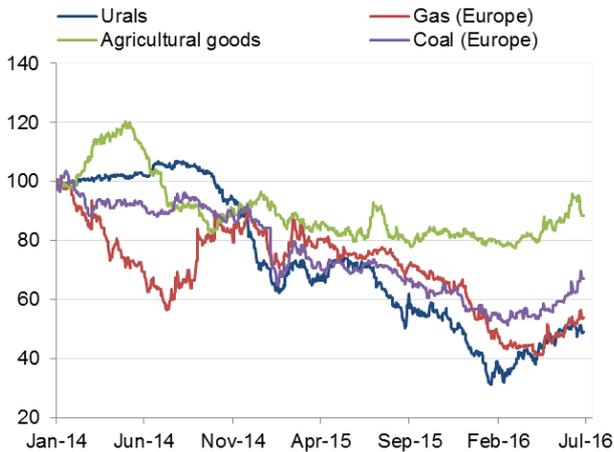
- Starting from the end of May, commodity and metal prices grew for the most of the period to skid in the follow-up to the British referendum.
- Oil price dynamics are still largely determined by temporary factors giving rise to uncertainty.
- The US data underpinned oil price growth in the first half of June and exerted downward pressure on prices in the second half.
- China continued to accumulate strategic oil stocks amid stagnant oil product consumption.
- Oil product consumption grew slower in India, was on the rise in Russia and declined in Japan.

Starting from the end of May, commodity and metal prices grew, in some cases following the oil price increase in the previous months. At the end of last week, Brexit and the ensuing higher risk aversion triggered a considerable price drop (Figure 59 and Figure 60). The Bloomberg Commodity Index grew by 2%, the Baltic Dry Index, which shows demand for large cargo shipping by sea, was up by 0.5%.

<sup>23</sup> Banks' net liquidity position to the Bank of Russia (excluding correspondent accounts) = deposits with the Bank of Russia – banks' debt to the Bank of Russia.

Banks' net liquidity position to the Bank of Russia (including correspondent accounts) = banks' correspondent accounts and deposits with the Bank of Russia - banks' debt to the Bank of Russia.

**Figure 59. Commodity prices, January 2014 = 100**



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

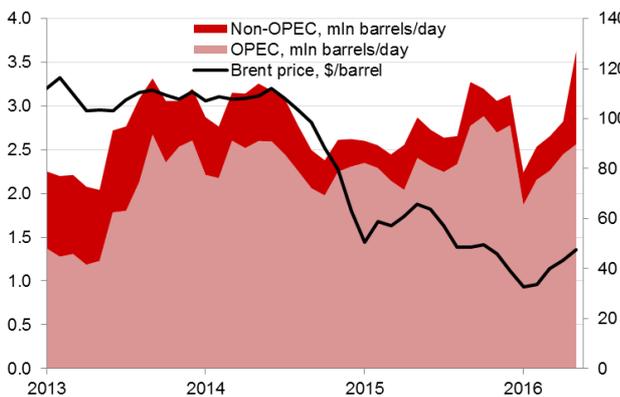
**Figure 60. Metal prices, January 2014 = 100**



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

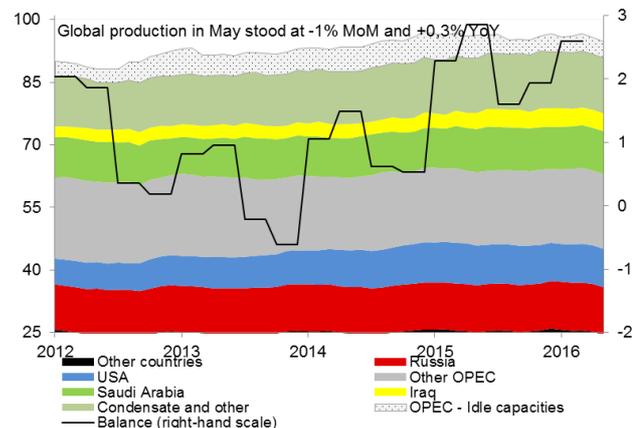
Oil price dynamics are largely determined by supply outages, and the oil production forecast (mostly in OPEC) is characterised by elevated uncertainty. In May, idle capacity growth reached a long-time high (Figure 61), resulting in a 1% MoM drop in global liquid fuel production with a minimum year-on-year growth (Figure 62). In the first half of June, a worsened environment in Nigeria, where production dropped to a 30-year low following the guerilla attacks, boosted a further oil price growth. Production recovery in Canada exerted a downward pressure on prices. The oil price drop below \$50 a barrel in the second half of June returned the WTI futures curve in contango<sup>24</sup>.

**Figure 61. Idle oil production capacities and Brent crude price**



Source: EIA.

**Figure 62. Production and balance in the oil market, million barrels/day**



Sources: Bloomberg Finance L.P., Energy Intelligence Group, OPEC.

We expect the US Energy Information Administration (EIA)<sup>25</sup> to upgrade its oil production [forecast](#) and to revise its oil consumption forecast downwards. Oil

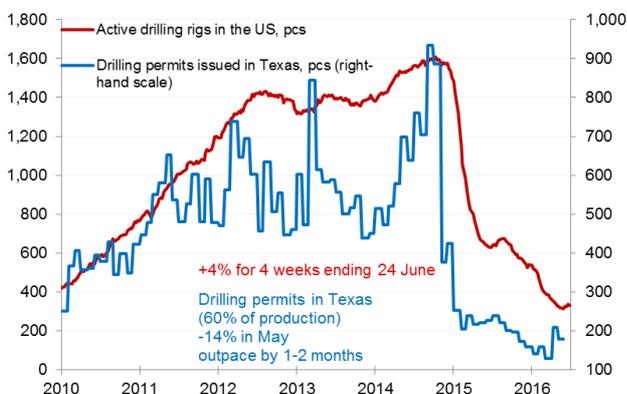
<sup>24</sup> The futures price is higher each month than in the previous month.

<sup>25</sup> Hereinafter, to analyse demand and supply-side risks in certain countries we use the available, updated and comprehensive EIA forecast data.

production declines in line with the EIA forecast for this year (Figure 64). However, oil price fluctuations near \$50 a barrel resulted in a growing number of active drilling rigs (Figure 63) and a rebounding risk of production growth. Together with the WTI futures curve, this indicates that the price level of \$50-55 a barrel can be comfortable for shale oil producers. Thereby, the probability of price increase above this level is limited, among other things, by stacked wells which are being placed on stream, as the Financial Times reports. Rystad Energy reports that 90% of these wells are profitable if oil price is \$50 a barrel. Citigroup estimates that they may increase production by up to one million barrels in the second half of the year.

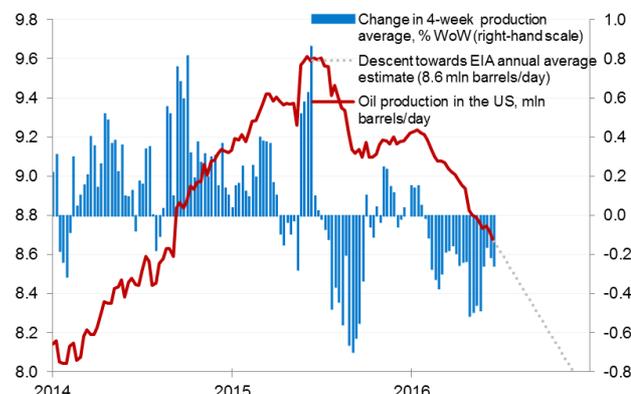
Oil product consumption in the US is growing, but the growth rate has declined in the recent weeks lagging behind the EIA-predicted dynamics (Figure 65). Aggregate commercial oil and oil product stocks resumed growth, offsetting the May drop (Figure 66).

**Figure 63. Active drilling rigs in the US and drilling permits issued in Texas**



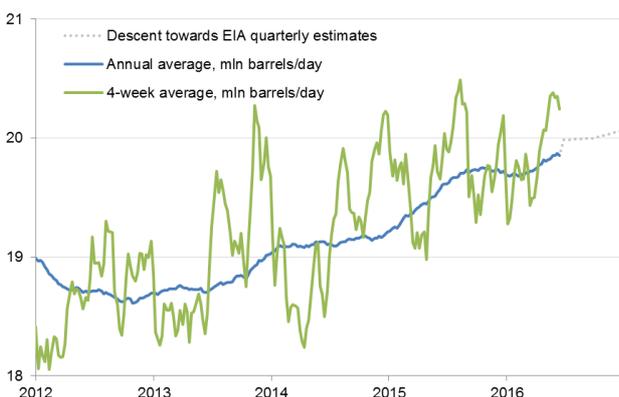
Sources: EIA, Railroad Commission of Texas.

**Figure 64. Oil production in the US**



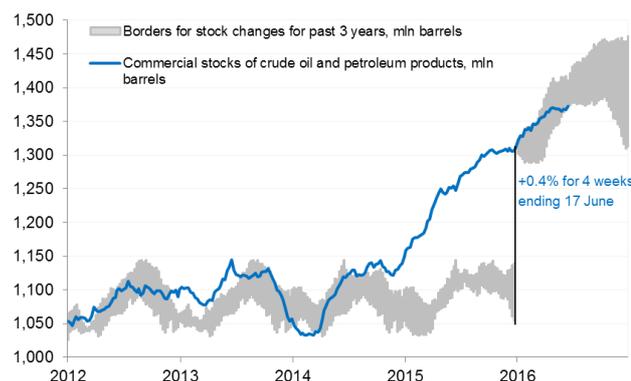
Sources: EIA, R&F Department calculations.

**Figure 65. Oil product consumption in the US**



Sources: EIA, R&F Department calculations.

**Figure 66. Commercial oil and oil product stocks in the US**



\* In 2016, borders come out of the actual value as of the beginning of the year.

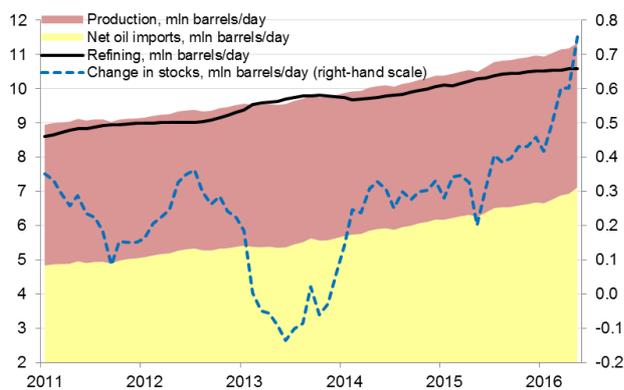
Sources: EIA, R&F Department calculations.

In China we still observe considerable risks of downward revision of the oil demand forecast. China continues to increase net imports of oil and oil products, showing a 37% YoY growth in May (Figure 67). However, this is explained by the low base in May

2015, when, according to our estimates, a considerable share of strategic reserves was used for domestic consumption. In May 2016, China continued to accumulate strategic reserves: the 12-month average of strategic reserve replenishment grew to 0.8 million barrels (against 0.65 million barrels in April). Consumption continued to stagnate (Figure 68).

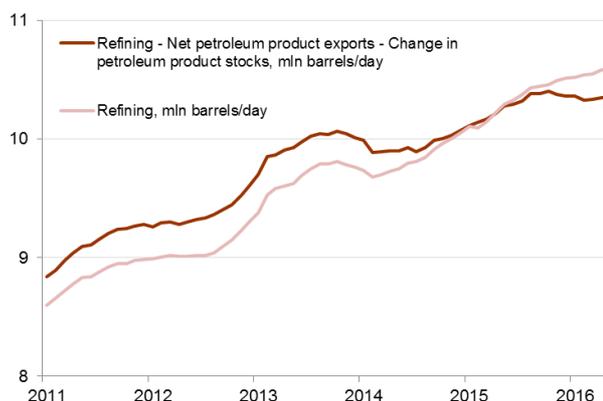
In June, the forecasted oil product consumption in India was revised upwards on the back of rapid dynamics in January-April, which buttressed oil prices considerably. In May, 12-month average oil import and consumption figures grew modestly against the April data in line with the EIA forecast (Figure 69).

**Figure 67. Production, net imports, processing and changes in oil stocks in China (12-month average)**



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

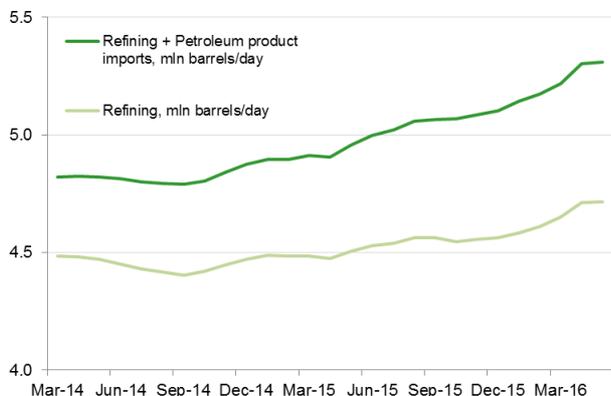
**Figure 68. Oil processing and domestic consumption in China (12-month average)**



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

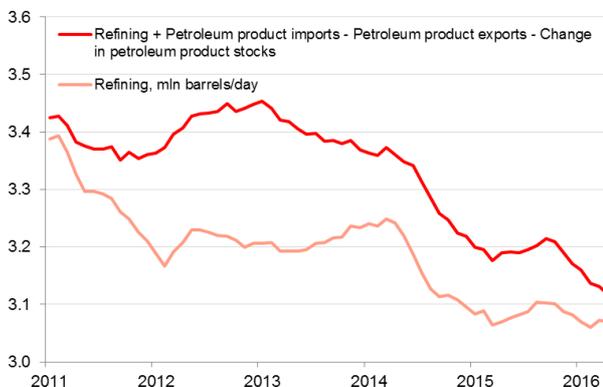
Japan shows modest risk of cutting its oil consumption forecast. April saw a drop in oil consumption amid stable imports (Figure 70). This trend manifests itself on the back of slack economic growth and higher energy efficiency. Oil processing companies have to build up exports and improve efficiency through mergers.

**Figure 69. Oil processing and consumption in India (12-month average)**



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

**Figure 70. Oil processing and consumption in Japan (12-month average)**

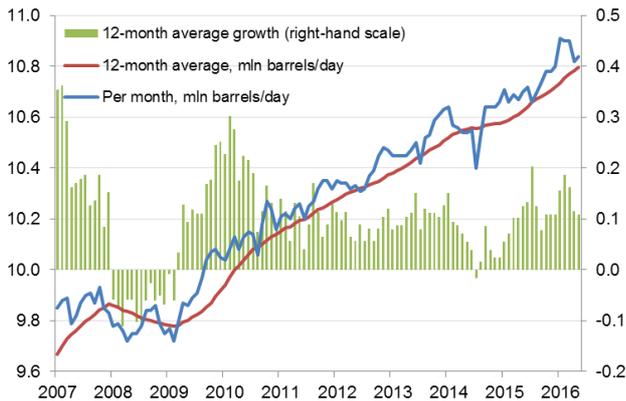


Sources: Bloomberg Finance L.P., R&F Department calculations.

In Russia we can see risks of upward revision of the EIA forecast for both oil production and consumption. In May, oil production grew slightly (MoM) as well as the 12-month average (Figure 71). At the same time, year-on-year production growth continued to slow to 1.2% in May from 2.3% in February. We assume that this indicator will cease to decline in the months to come.

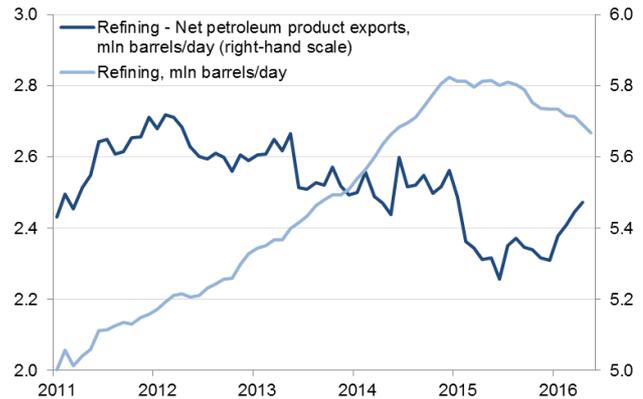
In April, oil processing continued to contract and export structure shifted from oil products to crude oil. Meanwhile, we estimate domestic oil consumption to have continued to grow (Figure 72).

**Figure 71. Oil production in Russia**



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

**Figure 72. Oil processing and domestic consumption in Russia (12-month average)**



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

## 2. Outlook: leading indicators

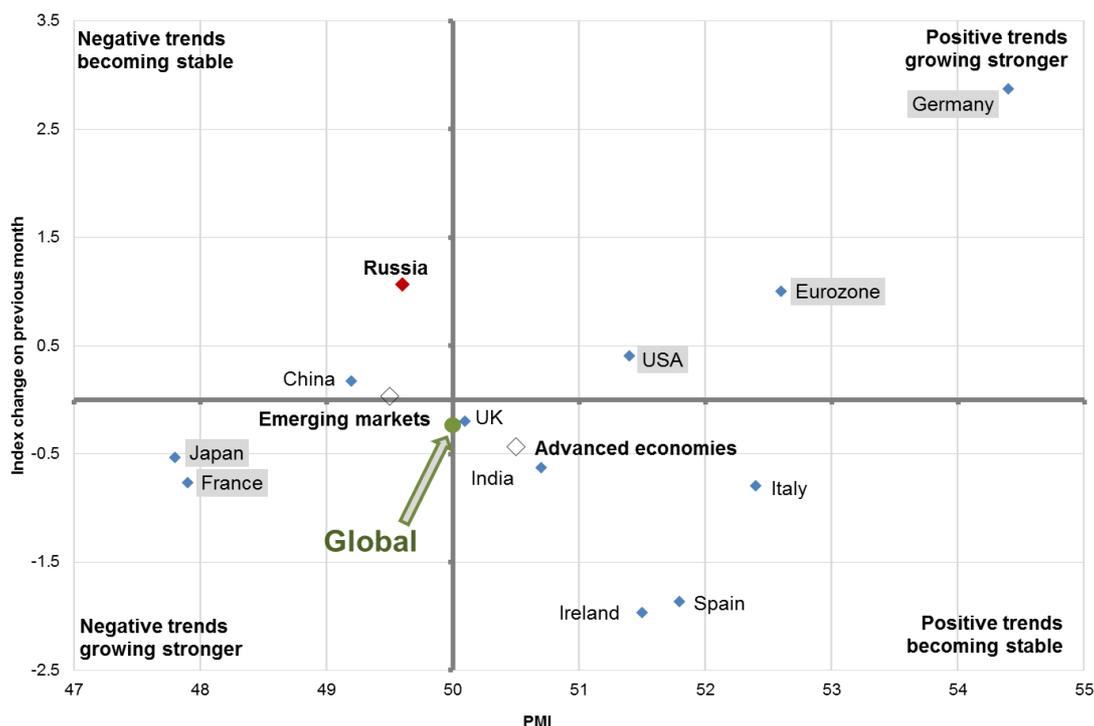
### 2.1. Global leading indicators

#### 2.1.1. Sustainability of global economic growth is still in question

The preliminary estimate of manufacturing PMI in June persistently points to considerable variations in economic dynamics of different countries (Figure 73). The total of the euro area showed some improvement that is likely to be driven by a faster growth in Germany, but restrained by negative dynamics in France. However, the eurozone's composite PMI turned out to be considerably worse following a drop in services PMI to an 18-month low.

The economic dynamics in both services and manufacturing may deteriorate in the months to come. A surge in volatility in financial markets following the British referendum may have a negative impact on the economic activity. In addition, uncertainty over the terms of Brexit and its long-term implications for both Britain and the EU and the global economy will affect consumers' and businesses' expectations.

**Figure 73. Manufacturing PMI indices in May and change against the average value in February-April**



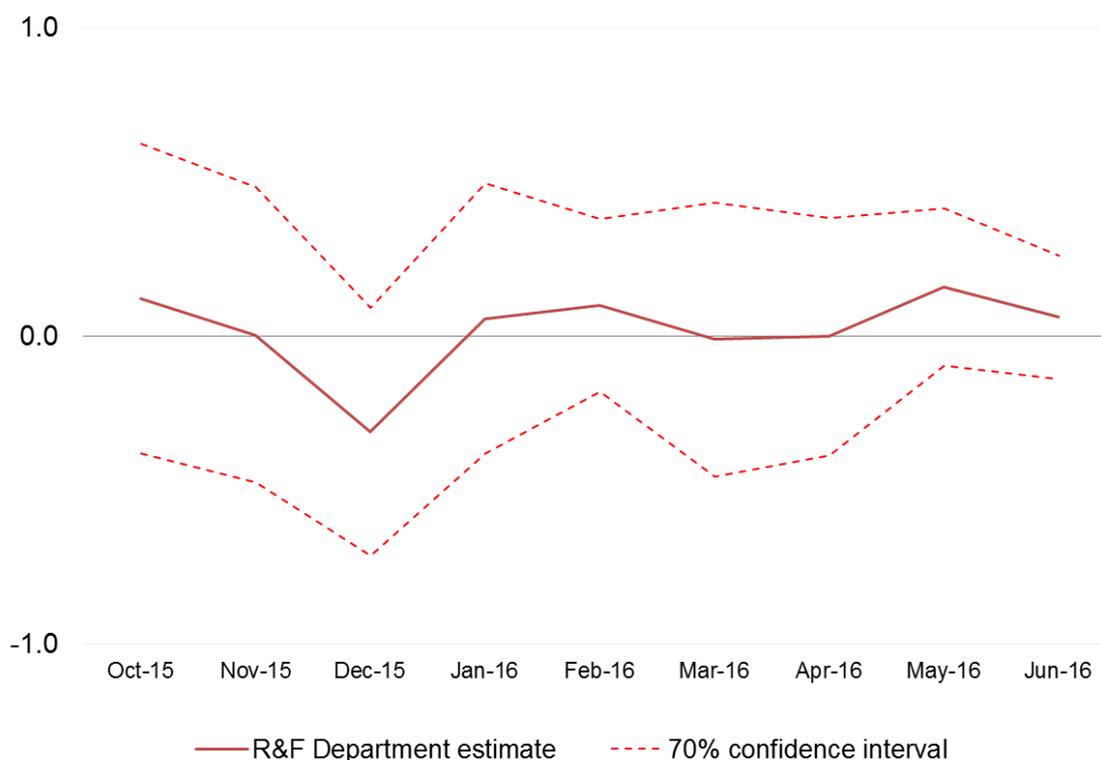
Sources: Markit Economics, R&F Department calculations. Highlighted in grey are preliminary June data and change against the average value in March-May.

## 2.2. What do Russian leading indicators suggest?

### 2.2.1. Index GDP assessment: economic recovery is still slow

- The June index GDP assessment suggests that the economy is close to stagnation in the second quarter (0.0-0.1% seasonally adjusted), but the bottom is already passed.
- GDP index estimates for the second half of the year were revised slightly down against the last month estimates: GDP is expected to grow by 0.2% QoQ in the third quarter and by 0.4-0.5% QoQ in the fourth quarter (seasonally adjusted).
- Our GDP estimates deteriorated slightly against the previous month estimates following the weak manufacturing statistics in May.
- Though certain indicators show positive gleams, sustainable economic recovery is still in question.
- Should oil prices anchor near \$50 a barrel within the next two months, our H2 growth estimates may be improved considerably.

	June 2016	May 2016
	% QoQ	% QoQ
2016 Q2	<b>0.0–0.1</b>	<b>0.1–0.2</b>
2016 Q3	<b>0.2</b>	<b>0.3</b>
2016 Q4	<b>0.4–0.5</b>	<b>0.5</b>

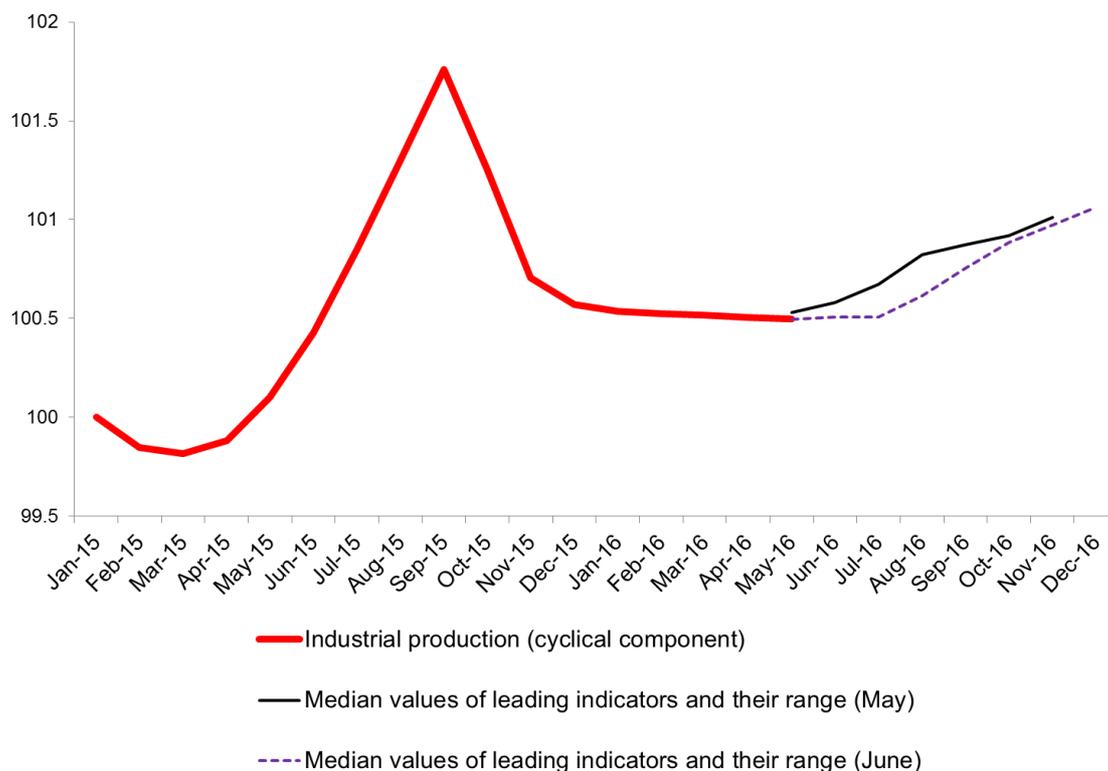
**Figure 74. Estimate of GDP growth in 2016 Q2, % QoQ**

Sources: Rosstat, R&F Department calculations.

### **2.2.2. Composite leading business indicator: Q3 growth prospects still in place**

- Month-on-month estimate of the composite leading business indicator remained almost unchanged: we expect modest but sustainable growth of the cyclical component of industrial production by the end of the third quarter (Figure 75).
- Rosstat data for manufacturing output in May underpinned sluggish April statistics for manufacturing PMI which are estimated to outpace the industrial production cycle by 1-3 months.
- As a result, we barely revised our estimates in the follow-up to the release of the Rosstat data.
- June PMI may impact substantially on further estimates of the composite leading business indicator.

**Figure 75. 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. Analysts' inflation expectations tumbled

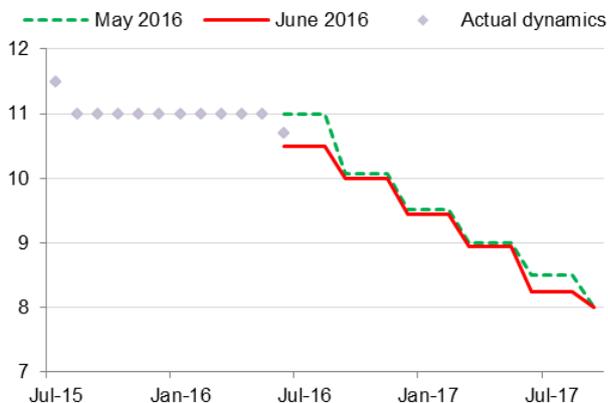
- Analysts' inflation expectations tumbled in June.
- The forecast for the end of 2017 is approaching the Bank of Russia's target.
- Expectations of the key rate dynamics remained almost the same. Market participants expect the Bank of Russia to pursue a moderately tight monetary policy.

Bloomberg's survey of professional analysts points to a decline in inflation expectations in June. The May survey suggested that the forecast for the end of 2016 was down from 7.2% to 6.5% (Figure 77), while 2017 estimates changed more dramatically. The median forecast predicts that by the end of 2017 inflation will drop to 4.7%, bringing it closer to the Bank of Russia's target.

The key rate forecast for the end of 2016 remained unchanged as compared to the previous month and stood at 9.5% (Figure 76). Lower inflation expectations along with

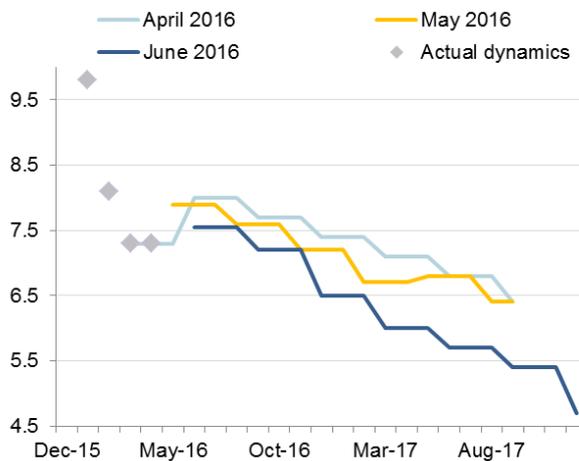
steady key rate estimates suggest that market participants expect the Bank of Russia to stick to a moderately tight monetary policy.

**Figure 76. BoR key rate expectations of professional analysts**



Source: Bloomberg Finance L.P.

**Figure 77. Inflation expectations of professional analysts, % YoY**



Source: Bloomberg Finance L.P.

### 3. In focus

#### ***Diversification of Russian exports***

- Low export diversification is typical of the Russian market: only 10% of the total exports enjoy comparative advantages<sup>26</sup>.
- Most of them are commodities or intermediate goods. Their production provides for limited cross-sectoral relations, hampering comparative advantages from spreading to a wider range of goods and sectors and impairs exports of technically sophisticated products.
- In this environment, diversification of Russian exports with new goods requires investments in upgrading production capacities and establishing new production facilities, which is a long-term objective.
- In the medium run, exports can be expanded through higher competitiveness of current Russian exports where comparative advantages are not yet achieved.

Ruble depreciation has paved the way for Russia to expand non-commodity exports, while previously high commodity prices fueled dependence of exports on fossil fuels. Has it helped adjust the structure of Russian exports and decrease their dependence on volatile commodity markets? What are the prospects of Russian non-commodity producers for pumping up exports and entering new markets? How quickly can they be realised and under what circumstances? Experts discuss these issues in one form or another<sup>27</sup>. This research analyses structural changes of exports in 2014–2015 and tries to assess prospects of diversification of Russian exports based on the ongoing comparative advantages.

The drop in global prices for main Russian exports brought down the value of Russian exports by 31% in US dollar terms in 2015. However, a weaker ruble allowed exporters to encourage international sales and build up physical volumes of commodity exports on the back of low export prices (Figure 78). In 2015, we also saw a surge in untypical Russian exports. However, as these goods make a small share of the total exports, no

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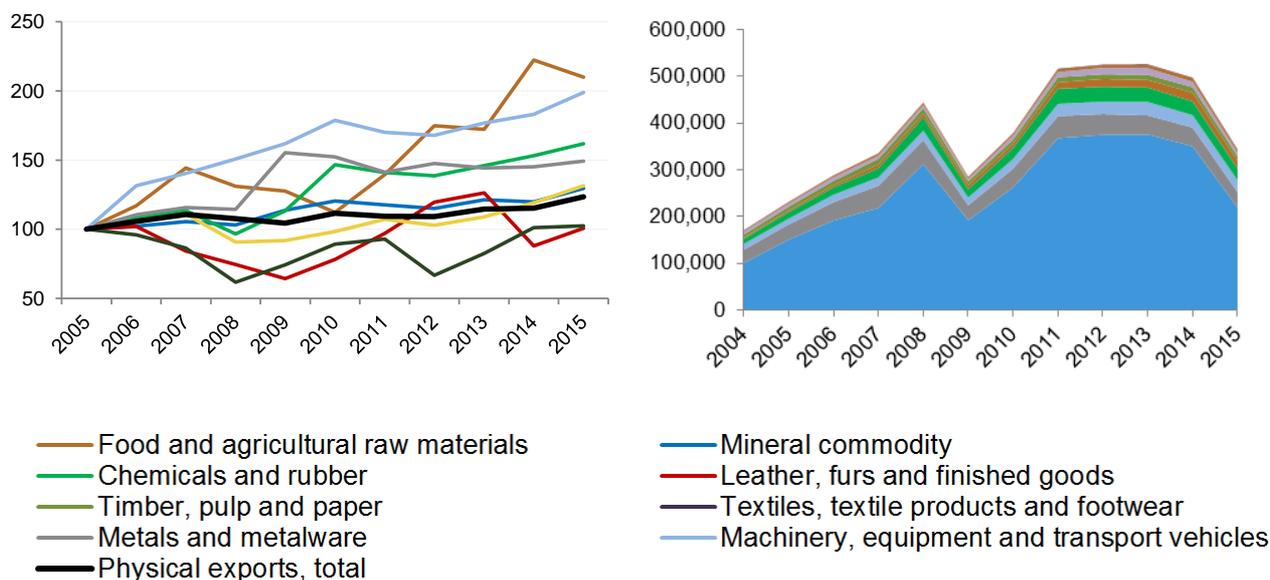
<sup>26</sup> The comparative advantage principle has it that countries specialise in goods they can produce at lower relative costs compared to other countries. Ricardo's theory suggests that comparative advantage comes from countries' difference in technological development, or rather difference in production factor development. According to the Heckscher-Ohlin factor proportions theory, comparative advantages come from differences in availability of production factors in a country and proportions in which they are used in manufacturing of various goods. A *concept of revealed comparative advantage* is the most popular method of gauging comparative advantages. It is based on the assumption that if a country has a comparative advantage in producing particular goods, it will be manifested in the country's export specialisation in these goods, i.e. comparative advantage manifests itself in the country's trade structure. Given the barriers for free international trade, the country's comparative advantages may fail to manifest themselves in full in the foreign trade structure. In this respect, the concept of revealed comparative advantage cannot be regarded as a sufficient instrument for predicting changes in the country's export and import structure. However, this article does not study forecasting of such changes.

<sup>27</sup> World Bank Group. Russian Economic Report, No. 35, April 2016: The Long Journey to Recovery. World Bank, Washington DC.

Н. Волчкова. Перспективы экспортной диверсификации: голландская болезнь или провалы экономической политики? Материалы круглого стола «Семь тощих лет: российская экономика на пороге структурных изменений»/ под ред. К. Рогова. – Москва: Фонд «Либеральная Миссия», 2016.

considerable structural changes in physical exports followed (at least with regard to goods within commodity nomenclature of foreign economic activity (CN FEA)).

**Figure 78. Russian physical exports and export value by product group**  
Physical exports, 2005 = 100%      Export value, \$ million



Sources: Federal Customs Service, R&F Department calculations.

A weak ruble promoted cost competitiveness of Russian companies. However, this is insufficient to expand Russia's export nomenclature and transform the country's export structure. Russian exports need to be diversified in terms of goods and markets.

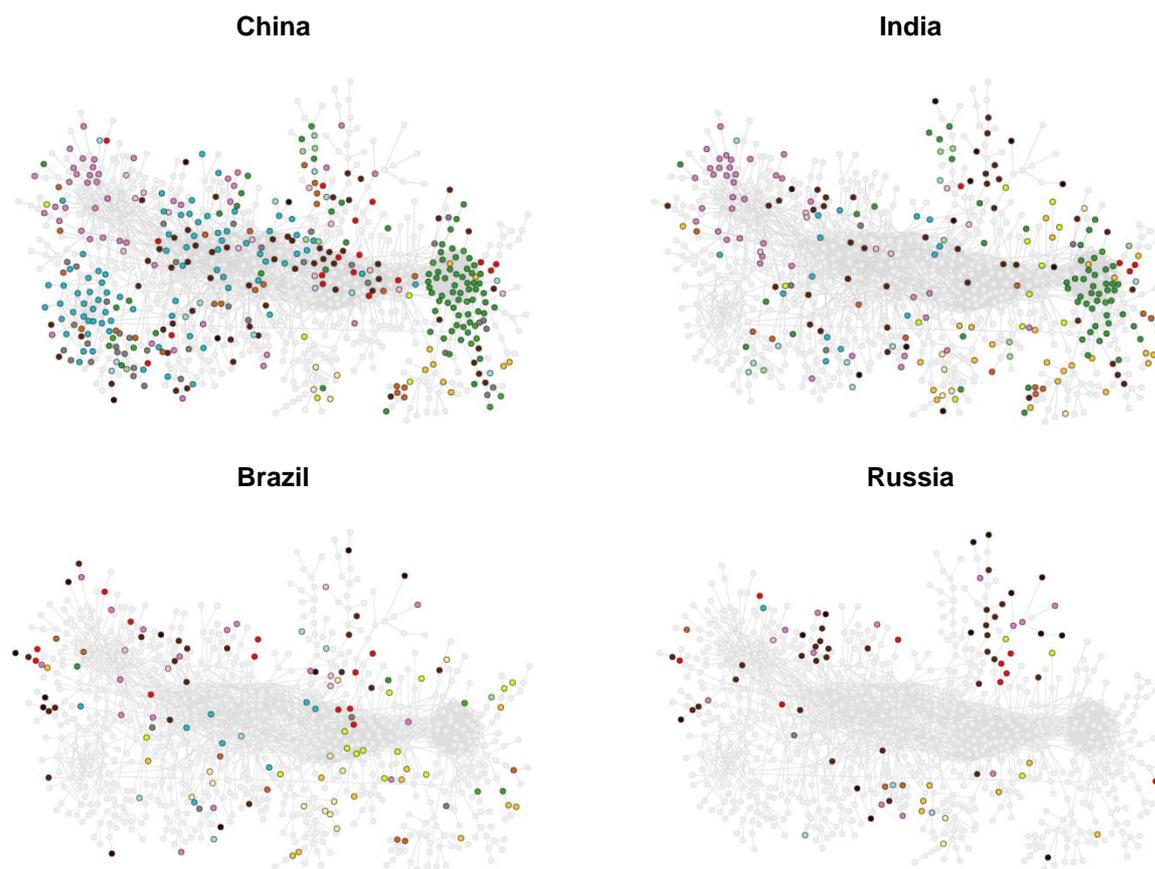
Product diversification of Russian exports lags considerably behind that of leading emerging markets within BRICS which have seriously gained in importance in the global trade in the recent years.

This thesis is supported by Figure 79 illustrating a product space model or a set of ties between goods in BRIC members: Russia, China, India and Brazil<sup>28</sup>. Points in the graph denote product space in accordance with the four-digit code of an international foreign economic activity classification (Harmonized System 2012). Grey lines stand for merchandise proximity, i.e. if a country enjoys the production capacity<sup>29</sup> to efficiently produce an article of trade, it is capable of using this potential to produce other similar goods.

<sup>28</sup> The model is introduced by R. Hausmann, B. Klinger 'Structural Transformation and Patterns of Comparative Advantage in the Product Space' (2006).

<sup>29</sup> Production capacity means specific production factors for each type of products, such as knowledge, physical assets, intermediate goods, labour force training requirements, infrastructure, property rights, regulations and other public benefits.

**Figure 79. Goods of revealed comparative advantage in the product space of BRIC countries, 2014**

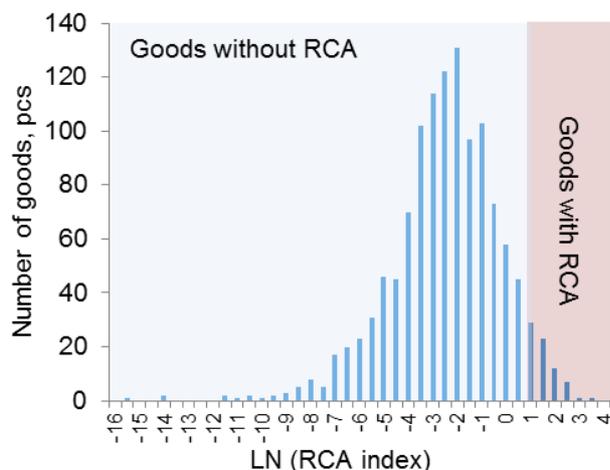


Source: Comtrade.

Structural diversification of exports is easier when moving to the 'neighbouring' products. In this case, export expansion requires only adjustment of the available capacity. Thereby, merchandise exported by the country (the country's export basket) largely determines the possibility of future structural diversification of exports. Countries with exports within a highly dense product space enjoy considerable capabilities of export diversification. Export of goods lying on the fringe of the product space signals low export diversification capacity.

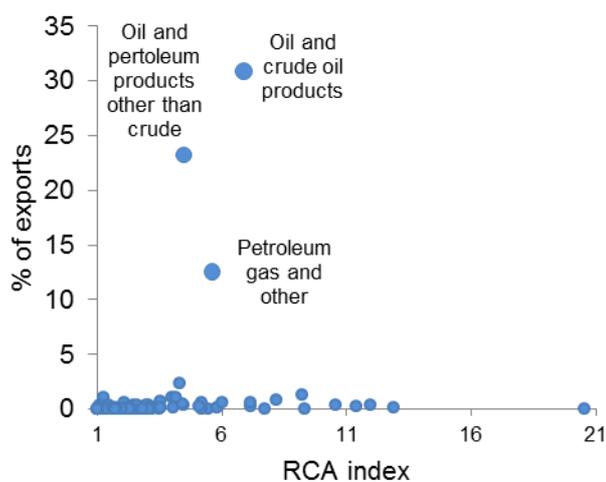
Heavy points in Figure 81 correspond to export commodities with *revealed comparative advantages* (RCA), i.e. make up the country's export basket. Fewer heavy points in Russia suggest low product diversification of exports compared to three other countries. All Russian export goods with comparative advantages fell outside the dense grey cloud where export diversification capacity is the highest one. This is due to the fact that in foreign trade Russia usually has comparative advantages in goods the production of which provides for weak cross-sectoral relations, hampering comparative advantages from spreading to a wider range of sectors.

**Figure 80. RCA index logarithm distribution for Russian exports by four-digit commodity nomenclature of foreign economic activity, 2014**



Sources: Comtrade, R&F Department calculations.

**Figure 81. RCA goods by four-digit commodity nomenclature of foreign economic activity and their share and Russian export value, 2014**



Sources: Comtrade, R&F Department calculations.

Russia's comparative advantages are shifted towards commodities and intermediate goods. According to our calculations, out of more than 1200 goods (by four-digit commodity nomenclature of foreign economic activity) Russia exported in 2014, only 117 goods (i.e. about 10%) enjoyed comparative advantage. They had RCA<sup>30</sup> index above 1. Most of these goods are commodities and intermediate goods. These 117 goods accounted for 97% of export value, with fossil fuels accounting for 80% (Figure 80 and Figure 81). Russia had no comparative advantage (in terms of the established international labour distribution) in other export goods (about 1000 goods in 2014), and they accounted for only 3% of exports.

Thereby, Russian exports have low diversification capacity. In the current environment, diversification of export goods enjoying comparative advantages would be very challenging even with a weak ruble. In order to diversify exports, the nomenclature of export goods with comparative advantage shall be expanded with new, more technically sophisticated goods with high added value, and higher competitiveness of currently exported goods in which Russian has no comparative advantage.

The first issue can be solved only in the long term, as it requires investments in upgrading effective production capacities, launching new production facilities and introducing advanced technologies.

The second objective can be met in the medium run through aligning quality standards with international standard frameworks, holding international talks to bring Russian products to new markets, drafting a strategy for promoting domestic (mostly branded) goods in foreign markets, and expanding public support of exports.

<sup>30</sup> The most wide-spread index used to reveal comparative trade advantage of certain goods is Balassa index. It is calculated as a ratio of the product's weight in the country's exports and its weight in the global exports. If Balassa index is higher than 1, the country reveals comparative advantage in the product in the global market. For details see Balassa B. 'Trade Liberalization and Revealed Comparative Advantage' // Manchester School of Economic and Social Studies, Vol. 33 (1965).

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