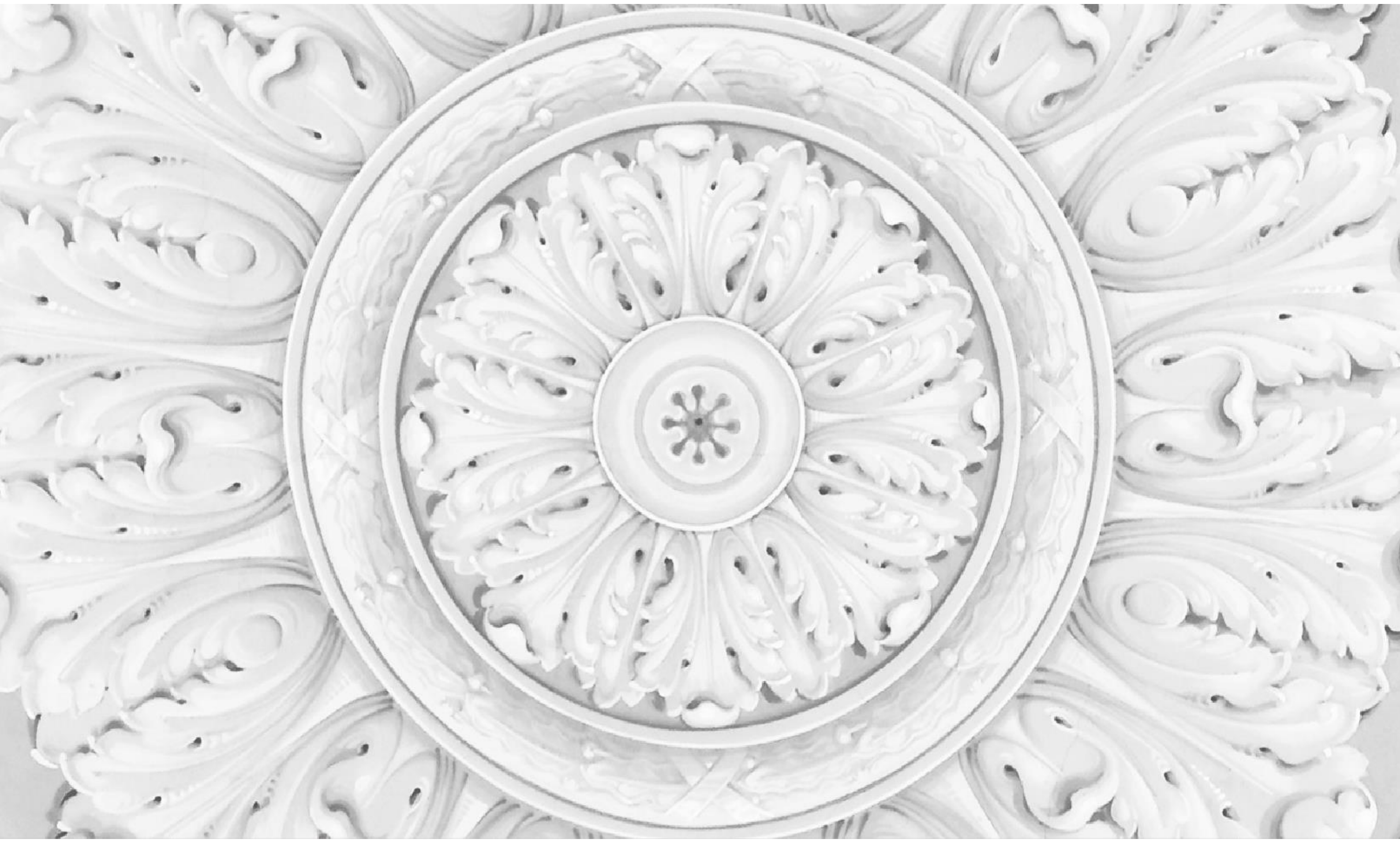
Bank of Russia

The Central Bank of the Russian Federation



TALKING TRENDS

Macroeconomics and markets

September 2018

Research and

Forecasting Department

Bulletin № 6 (26)

The Bulletin is based on data as of 31 August 2018. 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

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Executive summary

1. Monthly summary

- Annual inflation began to return to the Bank of Russia target in July–August. Monthly consumer price rises accelerated in seasonally adjusted terms from the slowed rate of the start of the year. Still, adjusted for one-off factors, price rises remained slowed. Economic growth continued at a rate close to potential, with some signs of growth deceleration persisting. Russian financial markets' performance deteriorated amid overall capital outflows from the emerging markets and increasing risks of the U.S. toughening its financial restrictions.
    - Inflation climbed to 3.1% in August, consolidating its ascending trend. Inflation is expected to come close to the 4-percent target at the year end, driven by a number of enduring and transient (temporary) factors. Medium-term risks of inflation upward deviation from the target are still prevalent. Transient factors will therefore cause inflation to temporarily rise above 4% in 2019 before dropping back to this level in 2020. Bank of Russia policy helps to reduce inflation risks and keep inflation close to the target over a horizon of several years.
    - Economic growth has in recent months remained in line with the economy's potential. Business surveys are, however, still indicating the emergence of some growth deceleration signs. Meanwhile, consumer demand is still on the rise, fueled by the continued consumer lending expansion and the maintenance of fast real wage growth against a backdrop of increasing workforce shortages in the labor market.
    - Russian financial markets' volatility has increased to become comparable with that in other emerging markets. Volatility was adversely affected by contagion from Turkey and Argentina's markets as well as U.S. plans to impose new sanctions on Russia. Interest rate movements in the Russian money market suggest that markets are expecting the Bank of Russia to raise its key rate in response to the rising inflation risks.

2. Outlook

- Risks to global economic growth have been aggravated by continued trade tensions among the major countries. Growth slowdown in a group of emerging economies, in particular China, remains a noteworthy development.
- The leading indicator of Russia' GDP points to the Russian economy's growth in line with its potential. This should result in a 1.5%–2.0% GDP growth in 2018.

1. Monthly summary

1.1. Inflation

Annual inflation reached 3.1% in August, consolidating the trend towards returning to 4% by the year end. Short-term pro-inflationary risks have been exacerbated by U.S. dollar strengthening against most other currencies, including the ruble.

The year end is expected to see inflation coming close to 4%, driven by a number of enduring and transient (one-off) factors. Among the former is some increase from last year's levels of the consumer price index most stable components that are only weakly sensitive to transient factors. The latter are the normalization of food price movements (change from deflation to moderate inflation), the effect of ruble depreciation on prices, and price hikes by some producers ahead of the VAT base rate increase to 20%.

Medium-term pro-inflationary risks are prevailing over disinflationary ones. The key pro-inflationary risks include geopolitical factors and volatility surges in financial markets, the shift to the consumption behavior model, with savings ratio declining and consumer lending growth accelerating, elevated and unstable inflation expectations, and the labor market situation.

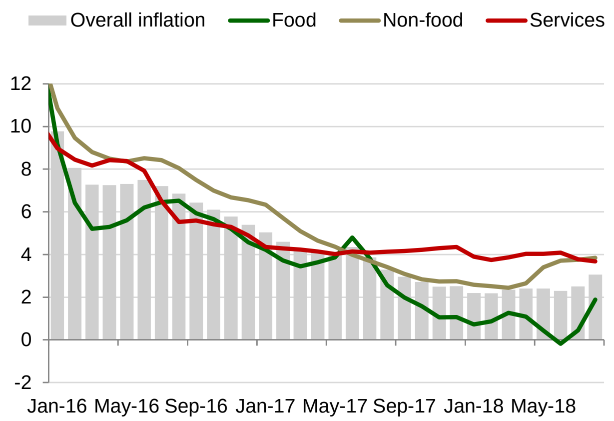
1.1.1. August's inflation accelerated more than expected

- After the expected acceleration to 2.5% YoY in July, inflation continued climbing in August, to reach 3.1% YoY, higher than expected. Seasonally adjusted consumer price rises accelerated to 0.5% MoM after a temporary slowdown to 0.16% in July.
- August's price change was much stronger than what would have provided for an inflation rate of 4% for the year. As a result, three-month rolling seasonally adjusted inflation went up to 4.8% YoY.
- The key contribution to the higher seasonally adjusted rate of monthly inflation comes from the normalization of food price movements. The steep rise in meat and meat product prices is temporary; after an adjustment to the new equilibrium, the rate of price rises will become more moderate.
- Household inflation expectations over a horizon of one and three years stabilized in August, but the risk of their further increase is still high.

Annual inflation rose to 2.50% YoY in July from 2.29% in June (Figure 1). July's inflation acceleration was expected and driven mostly by food prices, which resumed their rise after the first YoY decline in June over the entire history of observations. The services market saw inflation slow to 3.8% YoY from 4.1% YoY in June.

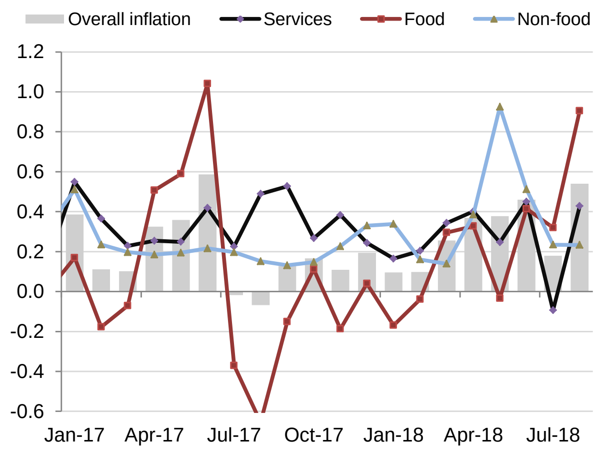
Seasonally adjusted, consumer price rises slowed to 0.16% MoM in July versus 0.5% MoM in June (Figure 2). This price deceleration was seen in each of the three key components of the consumer price index and owed to the impact of some temporary factors petering out and certain specifics of seasonal adjustment of price movements in regulated services. Seasonally adjusted, three-month rolling average inflation rate slowed to 4.1% in July from 4.9% in June versus 1.6% in the first quarter.

Figure 1. Inflation and its components, YoY %



Source: Rosstat.

Figure 2. Seasonally adjusted price rises, % MoM



Source: Rosstat, Bank of Russia estimates.

August data is preliminary.

Food price rises decelerated to 0.3% MoM from 0.5% MoM on the back of price rise slowdown in chicken eggs, sugar, and fruit and vegetables. Although slowed, food price rises are still faster in seasonally adjusted terms than last year's, which will contribute to a gradual acceleration in food price inflation towards the year end. The risks of domestic grain prices remain elevated, primarily due to movements in world grain prices and the ongoing ruble depreciation.

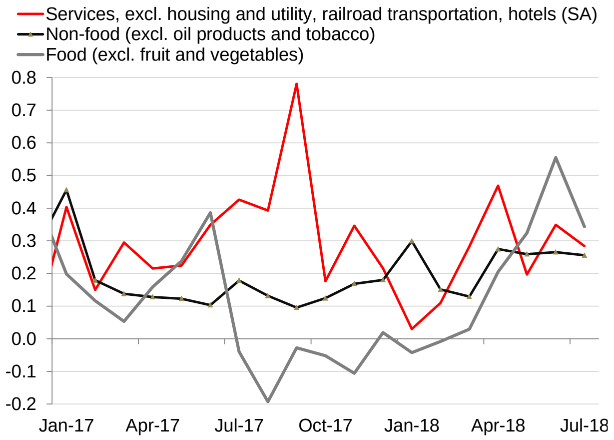
In non-food goods, price rises slowed to 0.2% MoM in July from 0.5% in June. This was mainly driven by marginal, 0.1% MoM, cuts in oil product prices, after their substantial increase in April–June. The excise tax cuts and agreements reached between the Russian Federation government and oil companies to scale up oil product sales on the commodity exchange stabilized oil product prices. Exclusive of oil products and tobacco, the rate of non-food price rises stood at 0.26% – 0.27% MoM (3.2% YoY) for the fourth consecutive month.

Services prices went down 0.16% MoM in July, partly due to correction in prices of certain services.

But the key contribution to the drop in services prices (in seasonally adjusted terms) came from the prices of housing and utility services. As this sector is subject to regulation, a special seasonal adjustment method is used for it.[1] Utility services prices were indexed by 3.95%, within the expected range. But changes in housing services rates are not regulated as strictly. In July, for example, they were indexed by just 1.3%, leading the above seasonal adjustment method[2] to indicate a price decline of 0.63% MoM in housing and utility services in July after a 0.38% rise MoM in June. Further changes in this component depend on the rate of price indexing in housing services. Exclusive of changes in regulated prices and services prices driven by the World Cup,[3] the seasonally adjusted rise in services prices remains close to 0.3% MoM.

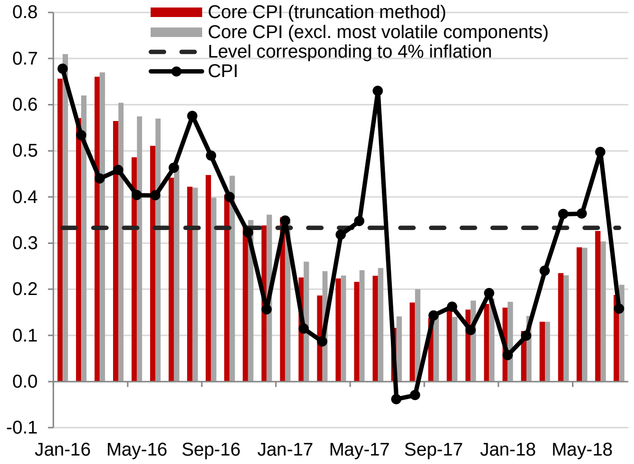
The deceleration of seasonally adjusted price rises in the main categories drove modified core inflation estimates down to roughly 0.2% MoM (Figure 4). Still, changes in modified core inflation indicators are affected by temporary factors which pushed the number lower. Their impact is, however, much smaller than their effect on headline inflation.

Figure 3. Seasonally adjusted price rises in goods and services, % MoM



Source: Rosstat, R&F Department estimates.

Figure 4. Modified indications of core inflation, % MoM



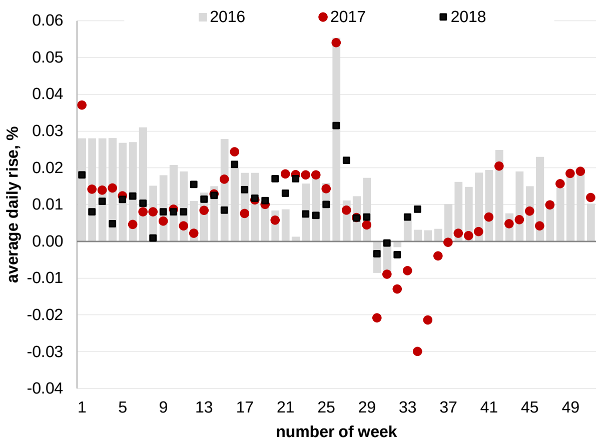
Source: Rosstat, R&F Department estimates.

The median rises in goods and services prices (Figure 7) which are not sensitive to significant changes in individual components' movements, indicate that July's inflationary pressure stayed at the same level as in May–June. This suggests an inflation rate of about 3% for the year. July saw an unexpected median price rise acceleration in goods sensitive to exchange rate movements (although our estimates suggest that the contribution of April's ruble depreciation to inflation is gradually weakening). If a new spell of ruble depreciation in August persists, it may spur additional acceleration of price rises in this group of goods and headline inflation towards the year end.

[1] See Sapova et al (2018). Review of Methodological Specifics of Consumer Price Index Seasonal Adjustment in the Bank of Russia, Bank of Russia Working Paper Series, №33, June 2018.
[2] Estimates of seasonally adjusted price rises assume price indexing of housing and utility services by 4% for the year.
[3] Hotels, taxi services, domestic tourism, restaurants.

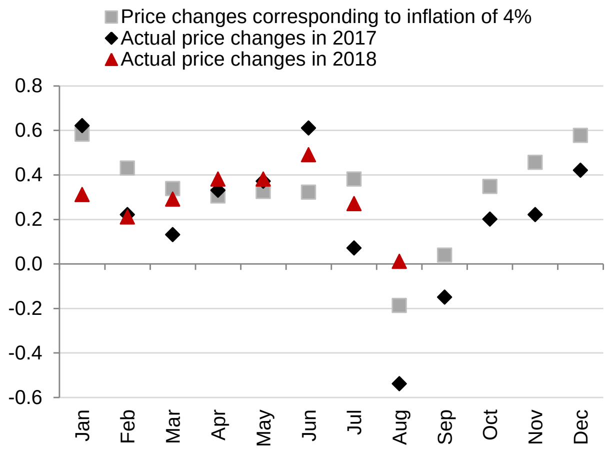
The average daily rate of price rises is staying above the 2017 level (Figure 5), and the end of August saw inflation rate above that of 2016. Prices started dropping at the beginning of August, but there was a turnaround of this trend in the last two weeks of the month, despite the continuing seasonal decline in prices of fruits and vegetables. As a result, the overall price level did not change in August. This is above an indicator of -0.2% for August which would enable the 4% target to be achieved for the year (Figure 6). The inflation rate came in at 3.1% YoY, with seasonally adjusted price rises accelerating to 0.5% MoM.

Figure 5. Average daily price rises, %



Source: Rosstat, R&F Department estimates.

Figure 6. Price rises corresponding to an inflation rate of 4 percent, % MoM



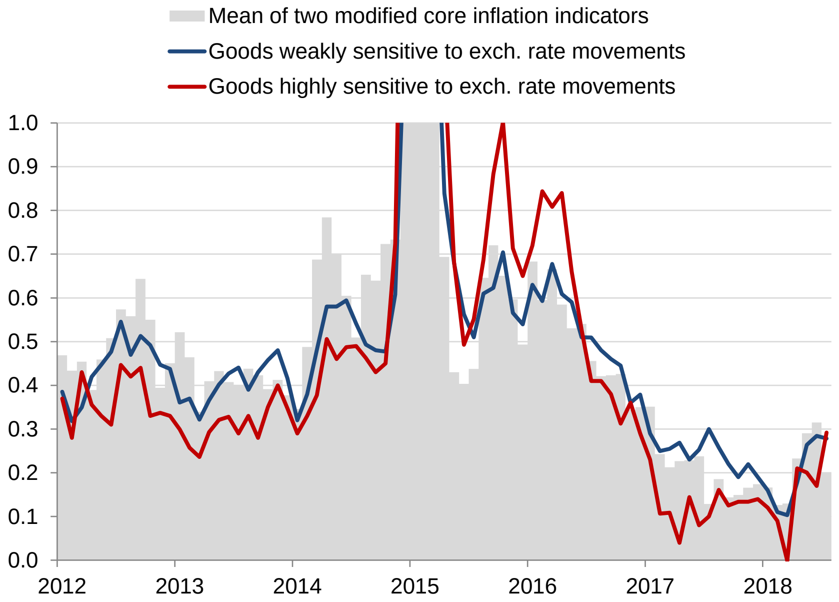
Source: Rosstat, R&F DEPARTMENT estmates.

August’s acceleration of seasonally adjusted inflation rate was fueled mainly by the adjustment of food prices, specifically, those for meat and meat products. After a decline in meat prices seen throughout 2017 and in early 2018, we are now witnessing their appreciable increase stemming chiefly from a gradual contraction in excess supply concurrent with rising production costs owed to ruble weakening. A ban on the export of meat from Brazil, previously a major supplier of meat products to the Russian market, is also playing a certain role. In the case of pork, a rise in wholesale prices in July–August is also fueled by outbreaks of diseases cutting down the livestock. Since all these factors are temporary in nature, price rises can be expected to subside to moderate levels going forward.

Nevertheless, annual inflation will keep accelerating in the months to come, driven by the pass-through to prices of ruble weakening and the low base effects: in the second half of last year, inflation stayed far below the trajectory securing a rate of 4% for the year (Figure 6).

If, in the four remaining months of 2018, price movements keep to the path providing for an inflation rate of 4%, price rises will not exceed 4% for the year. Still, the risks of inflation coming in marginally above 4% for the year have slightly risen on the back of ruble weakening in August.

Figure 7. Median price rises in goods differing in sensitivity to exchange rate movements, % MoM, SA



Source: Rosstat, R&F Department estimates.

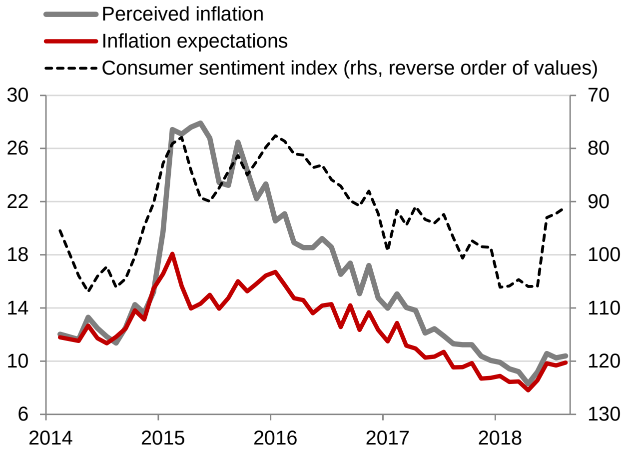
100 – January 2015. Monthly data – until July 2018, further on – weakly data.

August's household inflation expectations and estimates of perceived inflation remained practically unchanged from July, stabilizing at about 10%, with the number of respondents who cite a substantial rise in petrol prices continuing to fall (Figure 8). The gap between perceived and expected inflation is still small.

In August, the respondents cited a steep rise in meat and poultry prices. Price hikes for these staple goods may push inflation expectations up going forward. The share of respondents who believe that the ruble will fall against the dollar in a year's time continued increasing in August to reach 50%, up from 44% in July. Ruble weakening has yet to take a major toll on inflation expectations, since the survey was conducted on August 6–13 (part of respondents were surveyed before the exchange rate movement which started on August 8).

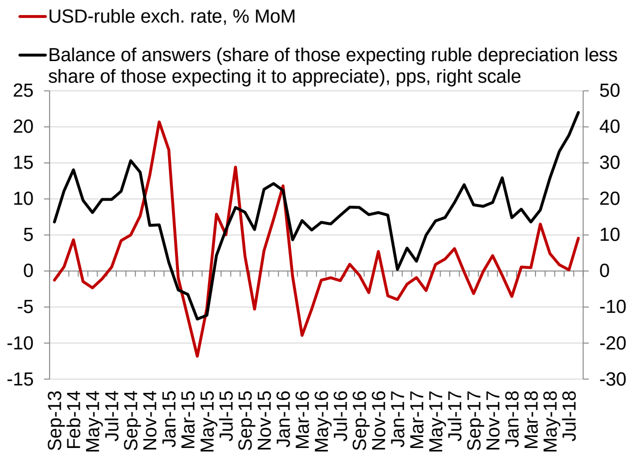
It is also noteworthy that the respondents did not regard the VAT hike as major news. That said, inflation expectations may go up if the share of responents taking note of this factor starts rising. The share of respondents expecting major price rises among those who took note of the VAT hikes stood at 23% versus 16% in the overall sample.

Figure 8. Median estimates of perceived inflation and household inflation expectations



Source: inFOM.

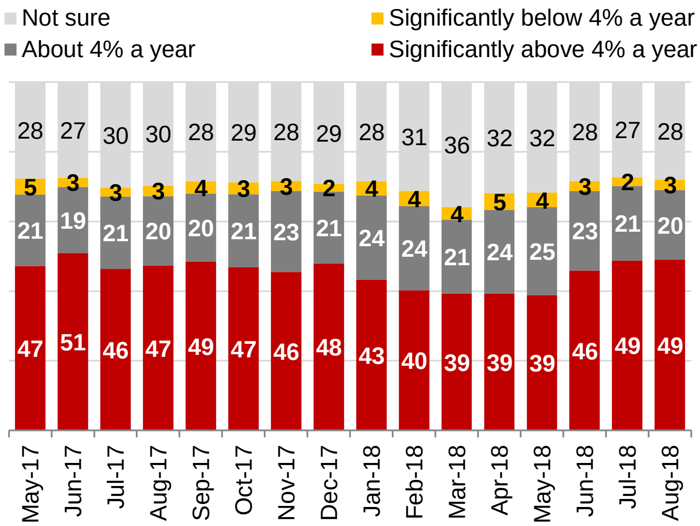
Figure 9. Household expectations of ruble exchange rate movements



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

August saw long-term household expectations stabilizing at last year's level, following short-term expectations. Practically half of respondents (49%) continue to believe that inflation will be appreciably higher than 4% in three years' time (Figure 10).

Figure 10. Inflation expectations over a three-year horizon[4]



Source*: inFOM.*

1.1.2. Trend inflation stabilizes

- Trend inflation numbers were revised in July, following the adoption of a new methodology of seasonal adjustment of the price index input series[5] (Figure 12).The es-

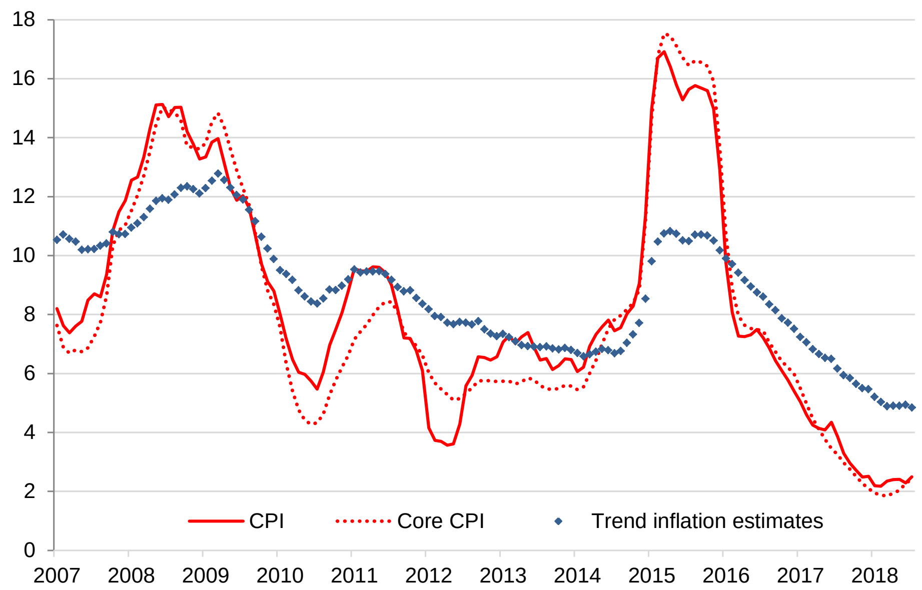
[4] Distribution of answers to the question "Do you think price rises will be above or below 4% a year in three years' time? Or will they post about 4% a year?"

[5] For details of seasonal adjustment of the CPI and its components see Sapova et al (2018). Review of Methodological Specifics of Consumer Price Index Seasonal Adjustment in the Bank of Russia, Bank of Russia Working Paper Series, №33, June 2018.

timate of annual trend inflation dropped to 4.85% in July 2018 from 4.90% in June (Figure 11).

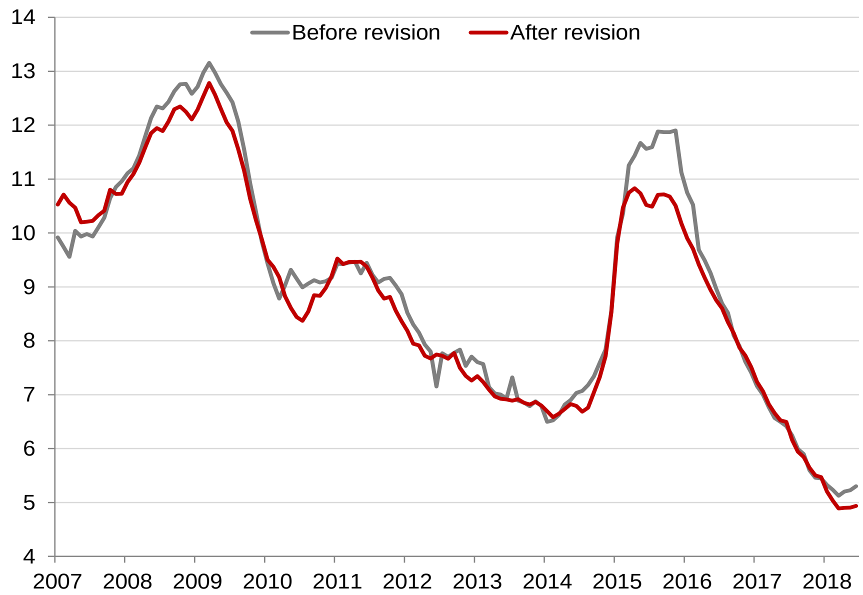
- The cessation of a significant decline in trend inflation estimates since March 2018 may suggest inflationary pressure stabilization just above 4% in the most stable CPI components.
- Over a medium-term horizon, the risks of annual inflation upward deviation from 4% are prevailing over risks of its downward deviation.

Figure 11. CPI, Core CPI and Bank of Russia historical estimates of trend inflation, % annually



Source: Rosstat, R&F Department estimates.

Figure 12. Trend inflation estimates before and after revision

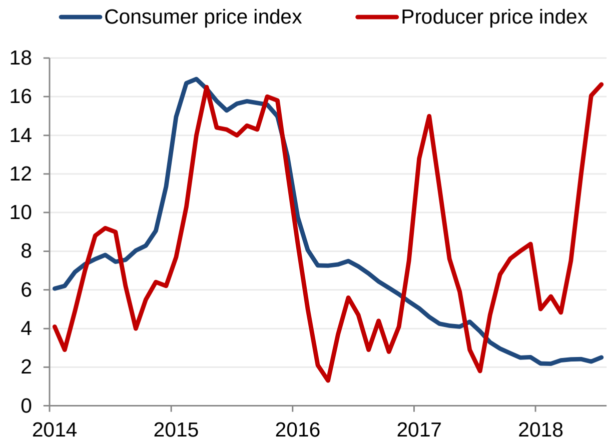


Source: Rosstat, R&F Department estimates.

1.1.3. Producer price inflation is on the rise

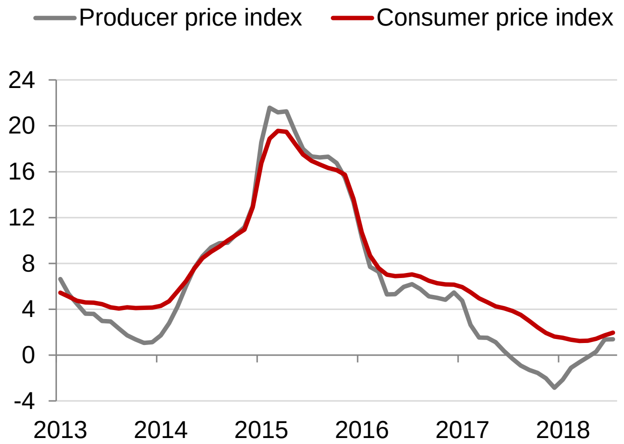
- According to Rosstat data, July saw producer price rises continue accelerating to reach 16.6% YoY, up from 16.1% YoY in June (Figure 13). Changes in oil and oil product prices accounted for most of this acceleration, but other categories also showed a rise in inflationary pressure.
- The gap between the rates of producer and consumer price increases based on the basket of representative goods[6] widened slightly (Figure 14), driven by the former's stabilization and the latter's acceleration. Gradual inflationary pressure elevation in the consumer market will continue in the months to come.

Figure 13. Producer and consumer price indices, % YoY



Source: Rosstat, R&F Department estimates.

Figure 14. Price changes for some goods[7], % YoY



Source: Rosstat, R&F Department estimates.

1.1.4. PMI price indices: inflationary pressure remains elevated

- PMI *input* price indices for the manufacturing and services sectors declined marginally in July but remain elevated because of ruble weakening and wage growth.
- Firms continue to pass their rising costs through to *output* prices. As a result, *output* price indices are also staying above the 2017 levels.
- The activity recovery in the services sector has led *output* price rises to accelerate. Wage growth has again started to appear in the surveys as one of the factors behind the elevation of upward pressure on output prices.

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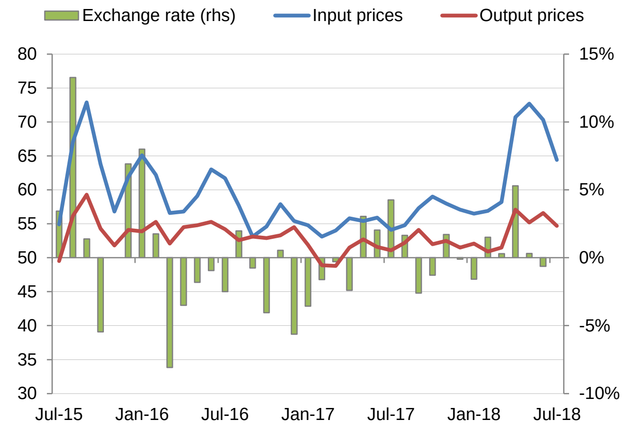
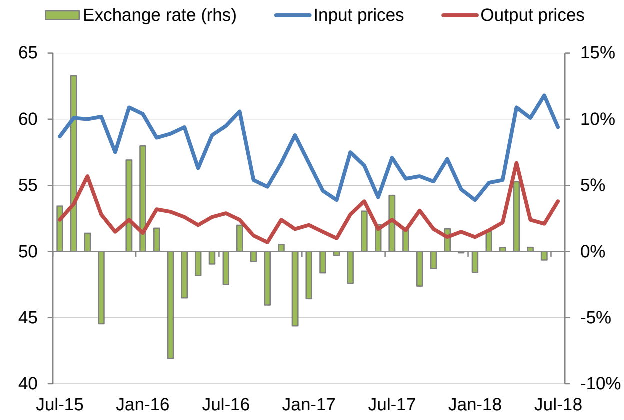
[6] Goods included in both PPI and CPI calculation.
[7] The calculation used comparable goods in the PPI and CPI structure: meat and fish products, butter, fats and oils, dairy products, pasta, sugar, tea, coffee, clothes, knitwear, footwear, detergents and cleaning solutions, perfumes and cosmetics, household electronic appliances, and furniture. They account for 32% of the consumer basket.

Figure 15. Manufacturing PMI price indices



Source: IHS Markit

Figure 16. Services PMI price indices



Source: IHS Markit.

1.2. Economic performance

Russian economic growth is maintained at a level close to potential. Consumer demand remains a key engine of growth against a backdrop of unemployment stabilization at low levels, real wage growth and continued fast expansion in consumer lending. Some of the remaining signs of business activity slowdown found in survey data have not so far formed a trend. However, growth slowdown in European countries, China, and Turkey may also adversely affect Russia's economic growth.

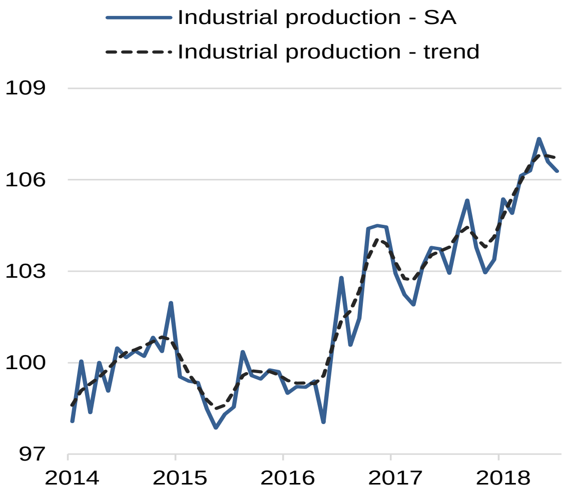
1.2.1. Industrial output growth accelerated in July

- July's deterioration in the performance of leading indicators did not make its way into the industrial output figures. According to Rosstat and Bank of Russia' Research and Forecasting Department estimates, July's industrial output grew 0.3% MoM in seasonally adjusted terms.
- The manufacturing sector's output expanded 0.1% MoM after its July's drop of 0.7% MoM in seasonally adjusted terms.
- Growth continued in the extractive sector, driven by oil production expansion owing to the implementation of OPEC+ June 2018 decision.

Industrial output growth accelerated to 3.9% YoY, up from 2.2% YoY in June, helped by the calendar effect: July 2018 had one day more than July 2017. Rosstat estimates registered a minor rise in July's industrial output index, up 0.3% MoM, adjusted for seasonal and calendar effects[8], in line with Research and Forecasting Department estimates. A deterioration in the performance of the leading (in particular, PMI IHS Markit) so far has not so made its way to the industrial output statistics (*see subsection 1.2.2. Business surveys may signal growth slowdown*).

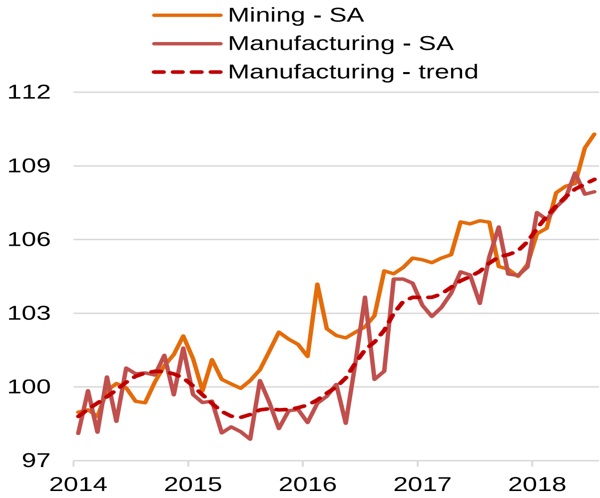
The manufacturing sector is maintaining its fast growth rates (above 4% YoY). After suffering a dramatic drop of 0.7% MoM in June, the sector's output failed to regain the lost ground in July, rising just 0.1% MoM. Manufacturing enjoyed support from the non-ferrous metals industry, which bounced back after a disastrous June, expanding its output by 11.5% MoM. A positive contribution also came from oil refining with its growth of 0.5% MoM thanks to a rise in petrol output production, likely driven by the government measures to halt a surge in petrol prices and boost fuel sales in the domestic market.

Figure 17. Industrial output index (2014 = 100)



Source: Rosstat, R&F Department estimates.

Figure 18. Mineral extraction and manufacturing indices (2014 = 100)



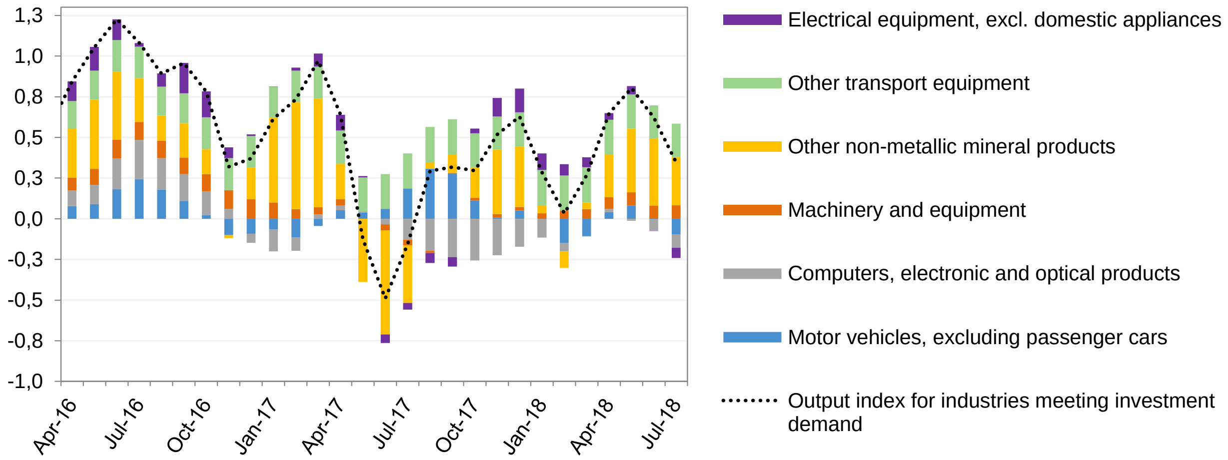
Source: Rosstat, R&F Department estimates.

Manufacturing output expansion was hampered by a virtual lack of growth in the food-processing industry (+0.1% MoM). Ruble depreciation in the spring was followed by a drop in the output of products depending on imports (cacao, chocolate, tea, coffee, spices). On top of that, a negative trend persists in the production of vegetable oils and butter due to the accumulation of these products' excess stock. Among negative factors were also a decline in motor vehicle production, which fell 3.7% MoM on the back of slowing demand (car sales dropped 1% MoM in June–July) and corporate vacations in the automotive industry along with an output contraction in other transport equipment (down by 13.7% MoM), primarily air and spacecraft.

The extractive sector's output expanded 0.5% MoM versus 1.4% MoM in June.[9] In particular, crude oil production rose on the back of June's OPEC+ agreement providing for a 1 million bbl/day production increase from May.

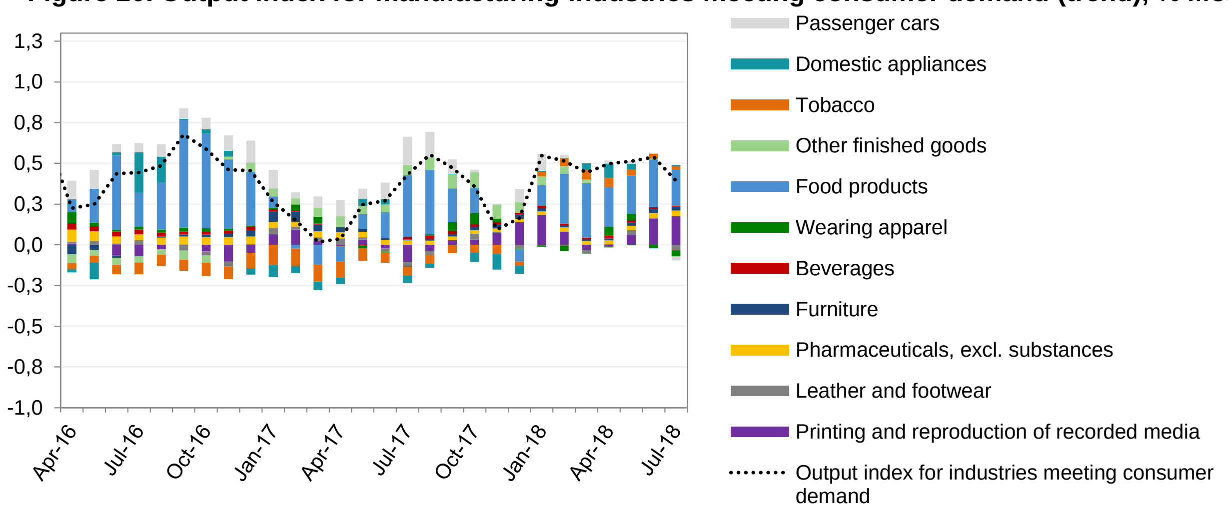
[8] Hereinafter – MoM, seasonally adjusted.
[9] R&F Department estimate (seasonally adjusted).

Figure 19. Output index for manufacturing industries meeting investment demand (trend), % MoM



Source: Rosstat, R&F Department estimates.

Figure 20. Output index for manufacturing industries meeting consumer demand (trend), % MoM



Source: Rosstat, R&F Department estimates.

1.2.2. Business surveys signal possible growth slowdown

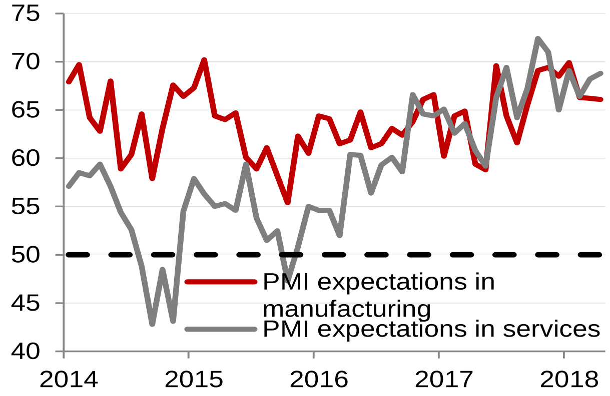
- July's PMI indices suggest a minor growth acceleration in the services sector and an output decline, probably temporary, in the manufacturing sector.
- Rosstat business survey data registers a business activity deterioration in the manufacturing and extractive sectors. Both sectors report a diminishing impact of high interest rates on loans, with the impact of taxation heightening.
- According to Institute for Economic Policy August's business survey, companies are satisfied with their current sales despite a fall in demand.

The IHS Markit PMI index for the manufacturing sector fell to 48.1 in July from 49.5 in June. July saw a data deterioration across the board. All the subindices, except for the price and business expectations, dropped below 50. The output index declined below 50 for the first time since April 2016, signaling an output fall in July.

Industrial output fell against a backdrop of further deterioration in new orders, which declined for the second consecutive month. The export orders index stood below 50 for the first time in 2018, reflecting a deterioration in the global economy's performance: a number of countries[10] saw their export orders indices below 50, as Russia did. The wave of trade restrictions along with prospects for their extension seem to have started taking a toll on global trade.

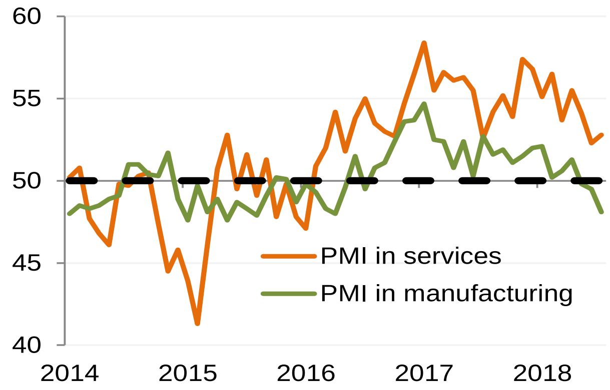
The services sector's growth marginally accelerated after its slowdown in June. The services PMI IHS Markit rose from 52.3 to 52.8 in July, but that was not enough to stop the headline PMI index from falling to 51.7 (Figure 22).

Figure 21. PMI expectation indices



Source: IHS Markit.

Figure 22. PMI IHS Markit indices



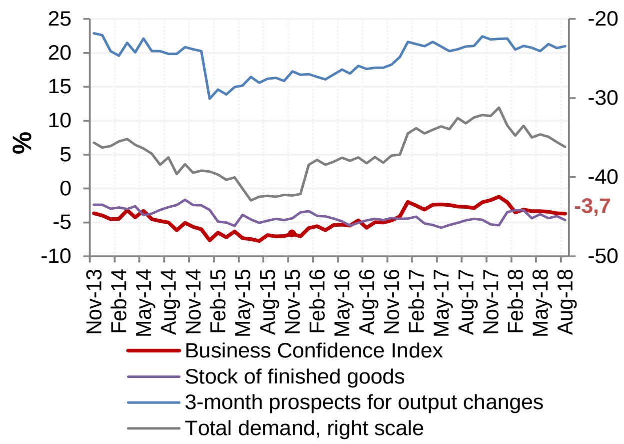
Source: IHS Markit.

According to Rosstat August's surveys, manufacturing sector companies lowered their demand estimates, keeping output and stock estimates practically unchanged. As a result, the business confidence index for manufacturing posted a minor decline (Figure 23). The high interest rate on commercial loans was the only factor in the manufacturing sector whose negative effect on output growth diminished over the past year (Figure 25). The increasing impact of other constraining factors may suggest the consolidation of a downward trend in business confidence for the manufacturing sector, owing to, among other things, a deterioration in external conditions.

In the extractive sector, the main components of the business confidence index (BCI) continued their downward trend, despite output expansion seen in June–July (Figure 24). Both manufacturing and extractive sector companies refer to inadequate, including external, demand and the uncertainty of the economic situation as the main constraints on output expansion. Both sectors report the strengthening impact of heavy taxation and workforce shortages (Figure 26). The latter is consistent with the unemployment lows and provides indirect evidence that the economy is close to its potential level.

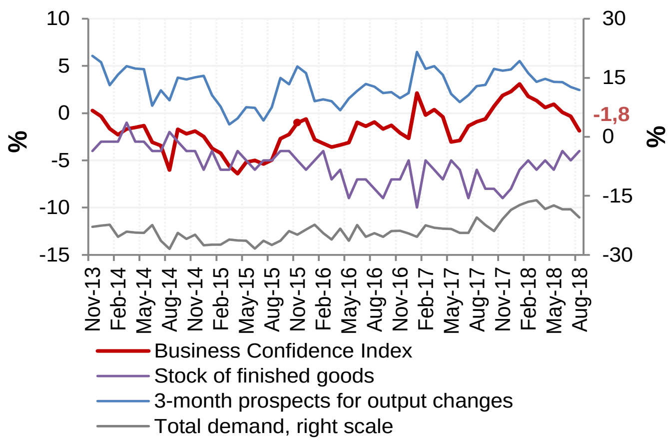
[10] U.S. China, France, Indonesia, Brazil, Austria.

Figure 23. Business Confidence Index and its components for manufacturing companies (excluding small enterprises), SA[11]



Source: Rosstat, R&F Department estimates.

Figure 24. Business Confidence Index and its components for extractive sector companies (excluding small enterprises), SA



Source: Rosstat, R&F Department estimates.

Figure 25. Factors constraining manufacturing output growth in August 2018 versus August 2017

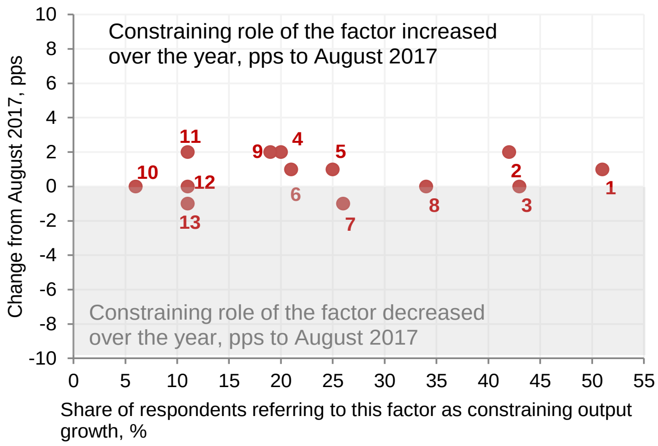
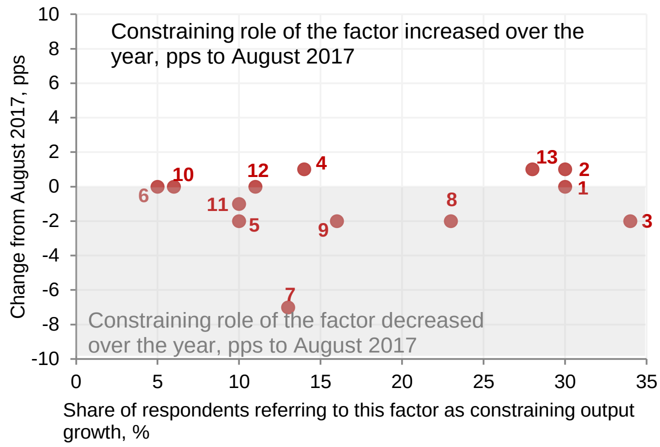


Figure 26. Factors constraining extractive sector output growth in August 2018 versus August 2017



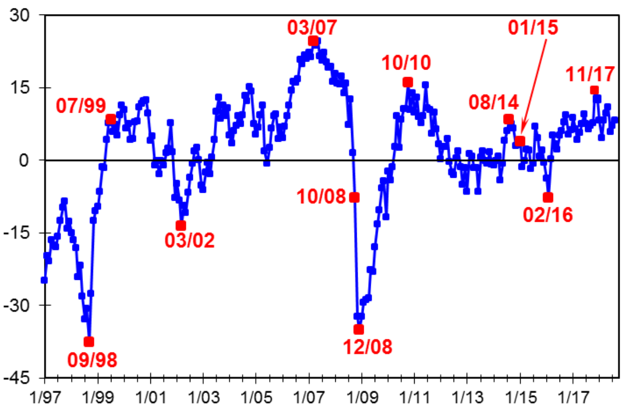
Factors constraining demand: 1 – inadequate domestic demand for company products; **5** – inadequate external demand for company products; **6** – competition from imports. **Factors constraining financial resources: 2** – heavy taxation; **7** – high interest rates on commercial loans; **8** – shortage of finance. **Factors limiting labor resources: 4** – shortage of skilled labor. **Factors constraining production development: 9** – worn out facilities and lack of machinery; **11** – lack of machinery; **12** – Lack of raw materials and supplies. **Other factors: 3** – uncertainty of economic situation; **10** – lack or inadequacy of regulatory and legal framework; **13** – no constraints.

Source: Rosstat, R&F Department estimates.

[11] Rosstat calculates the consumer confidence Index based on business activity surveys of manufacturing and extractive sector companies data. The main components of the index are total demand, three-month prospects for output changes and the stock of finished goods. The three-month prospects for output changes are measured as the share of respondents expecting the number to increase less the share of those expecting it to decrease in the next three months (in percentage terms). The stock of finished goods is calculated as the share of respondents reporting a “more than sufficient” stock less the share of those reporting an “inadequate” stock in the current month (in percentage terms). Total demand is estimated as the share of respondents reporting a “more than sufficient” number less the share of those estimating demand as inadequate (in percentage terms).

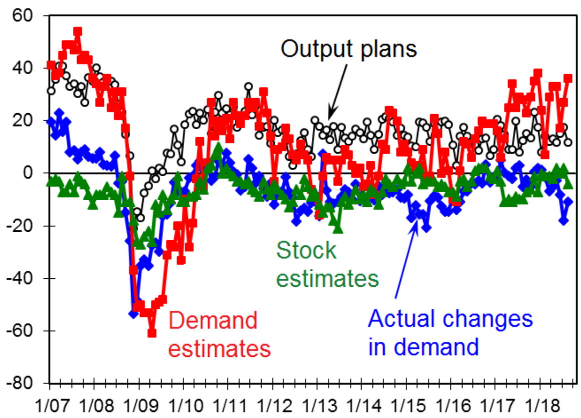
The Gaidar Institute for Economic Policy's Industrial Confidence Index inched up in August after its two-month decline (Figure 27). The positive performance of the index was driven by a certain improvement in sales after their worsening in June–July. Based on companies' estimates, demand is currently continuing to shrink but less drastically (Figure 28).

Figure 27. Industrial Confidence Index, 1997–2018



Source: Institute for Economic Policy.

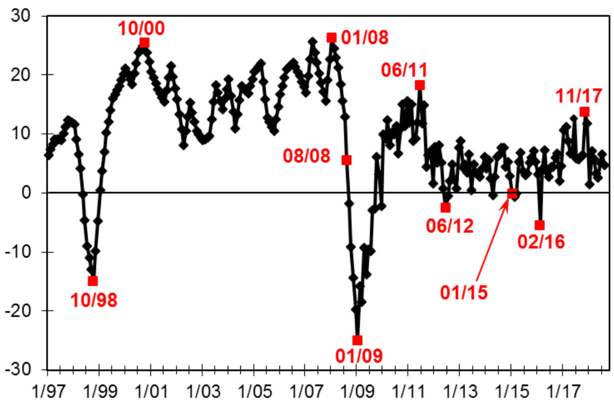
Figure 28. Components of Industrial Confidence Index (balances and difference)



Source: Institute for Economic Policy.

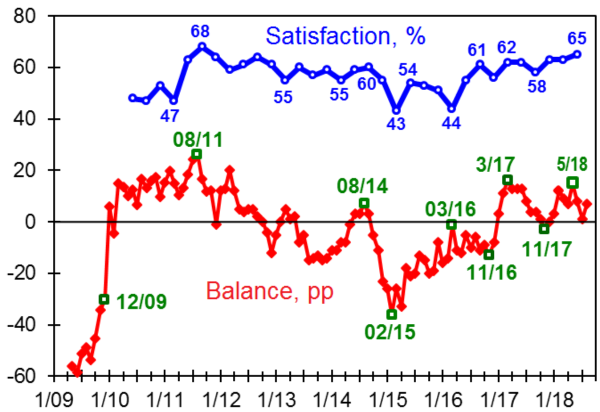
Meanwhile, the number of companies estimating their sales as stronger than normal was at its highest in recent years (64%). It seems that companies' demand expectations in the preceding month were understated versus their actual business conditions. Moreover, it suggests that companies have adapted to the volatile demand dynamics.

Figure 29. Industrial Outlook Index, 1997–2018



Source: Institute for Economic Policy.

Figure 30. Balance of expected capital expenditure changes and level of satisfaction with its actual amount



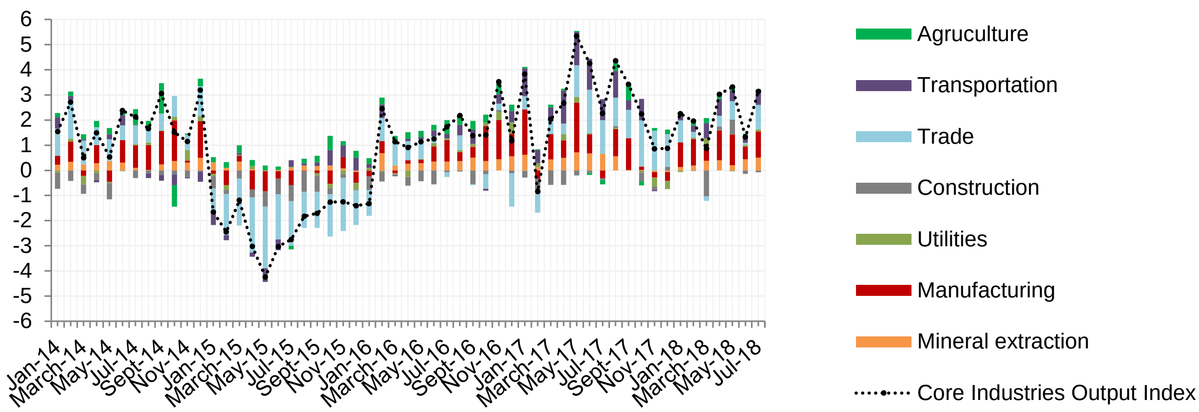
Source: Institute for Economic Policy.

The Industrial Outlook Index posted a marginal drop in August, remaining, however, within the range of its fluctuations over 2011–2016 (Figure 29). After the slackening of companies' investment plans, their minor growth was seen in that month (Figure 30). At the same time, the share of companies satisfied with their capital expenditure in the current environment of weak demand, increased to 65%, practically its highest value since 2011. Hence an appreciable investment growth in industry is unlikely in the immediate future.

1.2.3. The Core Industries Output Index climbed higher in July

- The Core Industries Output Index rose substantially by 3.1% YoY in July 2018 versus 1.3% YoY a month earlier.
- This positive performance benefitted from an improvement in practically all industries and last year's low base.
- The largest contributors to the index were manufacturing, which expanded its output 4.6% YoY, and trade, gaining 4.7% YoY and 2.4% YoY respectively in its wholesale and retail segments.
- Output growth was also seen in mineral extraction (+3.2% YoY) and transportation services (+4.0% YoY).
- Construction continues to show negative growth for the third consecutive month, registering a decline of 0.7% YoY for July. This is mainly owed to July's 8.1% YoY fall in housing commissioning.
- The Core Industries Output Index will likely post a more moderate YoY change in August–September given its high values in August–September 2017. The third quarter's index may decline from its second quarter's reading. Given a close correlation between the Core Industries Output Index and GDP, it can be assumed that GDP growth will stand just below 1.8% YoY for the third quarter[12] (Figure 32).

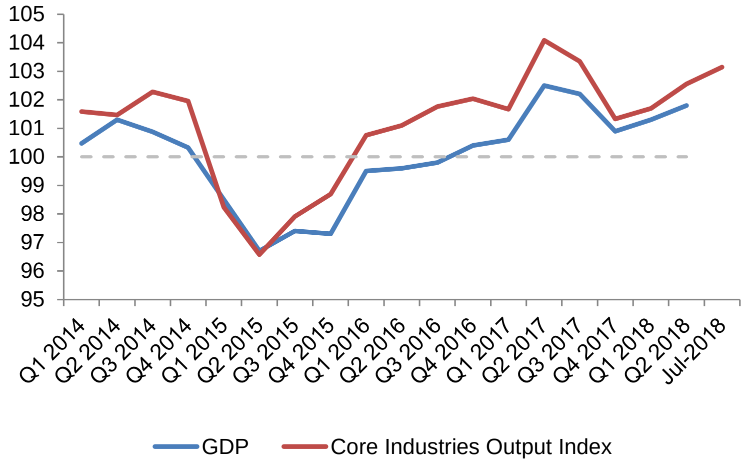
Figure 31. Contribution of industries to the Core Industries Output Index in 2014–2018 годах, % YoY



Source: Rosstat, R&F Department estimates.

[12] Preliminary estimate of Q2 GDP growth.

Figure 32. Quarterly index of GDP in physical terms and Core Industries Output Index, % YoY



Source: Rosstat, R&F Department estimates.

1.2.4. Retail sales resumed their consistent expansion

- Retail sales growth slowed to 2.5% YoY in July after its temporary acceleration to 3.0% YoY in June. Adjusted for seasonal and calendar factors, retail sales remained unchanged after their June's expansion of 0.4% MoM.
- Sales growth acceleration in non-food goods indicates the continuing consumer demand growth fueled by wage increases and consumer lending expansion.

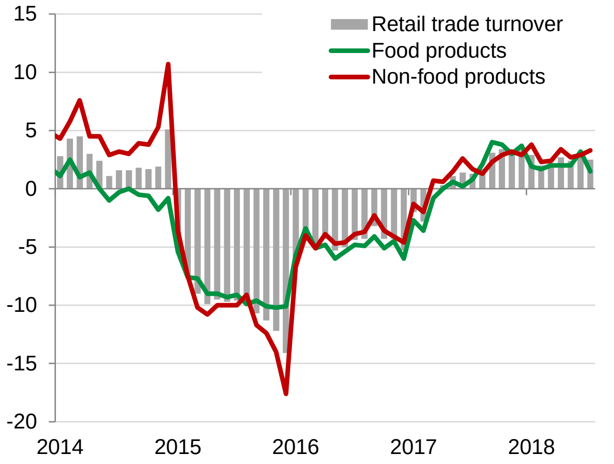
According to Rosstat data, retail sales growth slowed to 2.5% YoY in July from 3.0% YoY in June (Figure 33). The growth slowdown, quite naturally, stemmed from the conclusion of the World Cup and a gradual decrease in the number of tourists in the first half of July versus the second half of June.[13]

This factor brought about a food sales growth slowdown to 1.5% from 3.2% in June. Food sales expansion was fairly steady at no more than 2.0% YoY from the start of 2018, so June's growth acceleration was temporary. Sales increase in the non-food segment accelerated to 3.3% YoY from 2.9% YoY in June.

Adjusted for seasonal and calendar factors, the monthly rate of retail sales increase declined to 0.0% MoM from 0.4% MoM in June (Figure 34). Food sales fell 0.4% MoM in July after their 0.5% MoM rise in June. Sales growth in non-food goods slackened to 0.3% MoM from 0.5% MoM in June.

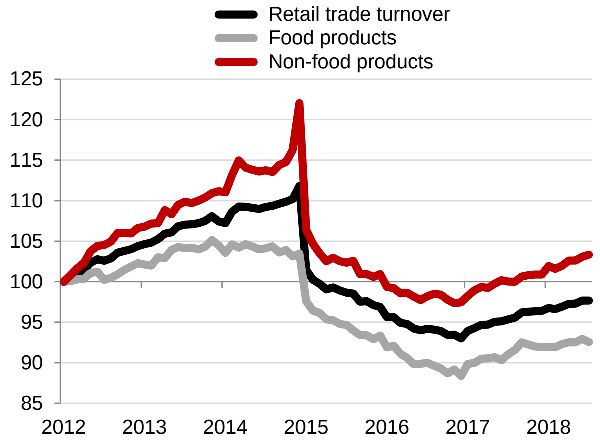
[13] June saw the group stage of the World Cup in which all of 32 teams were represented. The play-off round took place in July, with the number of participants, and, accordingly, tourists, decreasing.

Figure 33. Food, non-food and total retail sales, % YoY



Source: Rosstat, R&G Department estimates.

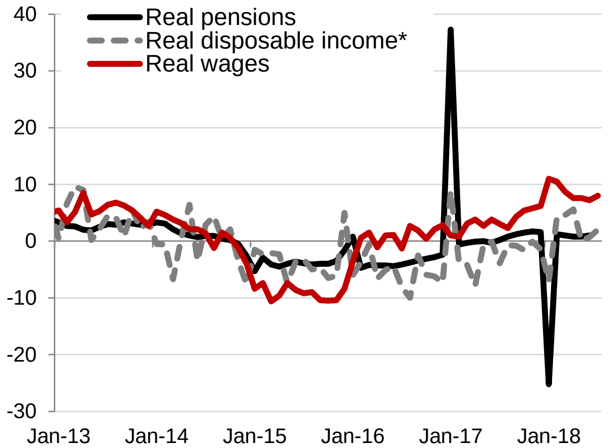
Figure 34. Retail sales, % (January 2012 = 100%), seasonally adjusted



Source: Rosstat, R&F Department estimates.

Real wage growth continues to support rising consumer demand (Figure 35), also helped by the continuing retail lending expansion. It is important to note that banks are providing loans to the increasingly large number of reliable borrowers, as evidenced by the National Credit History Bureau statistics,[14] which show a substantial rise in the average size of consumer loans issued (Figure 36). All this should support growth in the sales of non-food goods.

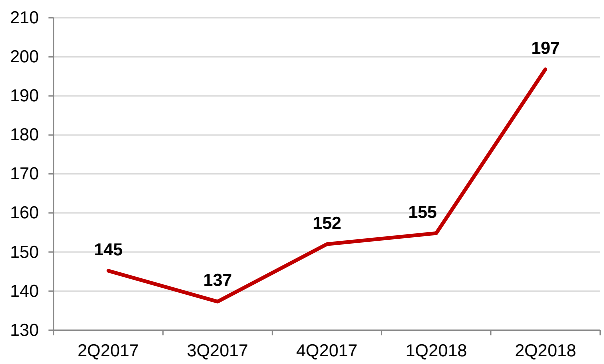
Figure 35. Real household income, % YoY



Source: Rosstat, R&F Department estimates.

** Computed under the previous methodology including the one-off payment in January 2017.*

Figure 36. Average size of consumer loans issued, thousand rubles



Source: National Credit History Bureau.

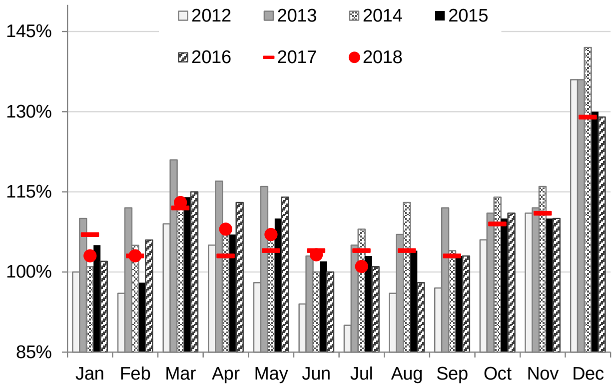
Romir Research Holding[15] July data confirms a certain contraction in households' everyday food expenditure and an increase in spending on non-food goods from their June levels. Real consumer spending stands at the 2016 level, slightly down from the

[14] The National Credit History Bureau. The average size of consumer loans issued came close to 200 thousand rubles in the second quarter of 2018. 15.08.2018.

[15] Romir Research Holding. Russian households reduced their food expenditure appreciably in June. 21.08.2018.

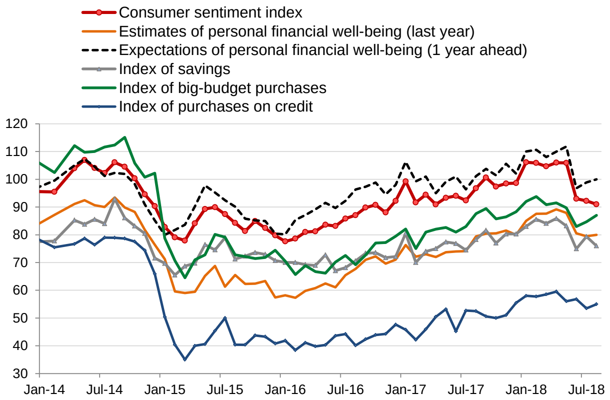
numbers of the same periods prior to 2018 (Figure 37). Looking at the consumer behavior of individual income groups, we note that the middle-income group reduced their expenditures the most, by 2.6%, followed by the high income group with a smaller cut of 1.3%, while the low income group, by contrast, showed a spending increase of 3.9%.

Figure 37. Real everyday household spending, % (January 2012 года = 100%)



Source: Romir Research Holding.

Figure 38. Consumer sentiment Index and its components



Source: inFOM.

The data of inFOM[16] monthly survey suggest that consumer sentiment changed only marginally in August versus July (Figure 38). The consumer sentiment index continued its gradual decline. At the same time, there was some improvement in all individual components of the index, except for household attitude to savings. This may signal a certain stabilization of consumer expectations in the months ahead.

1.2.5. The new car market in July: growth slowed expectedly

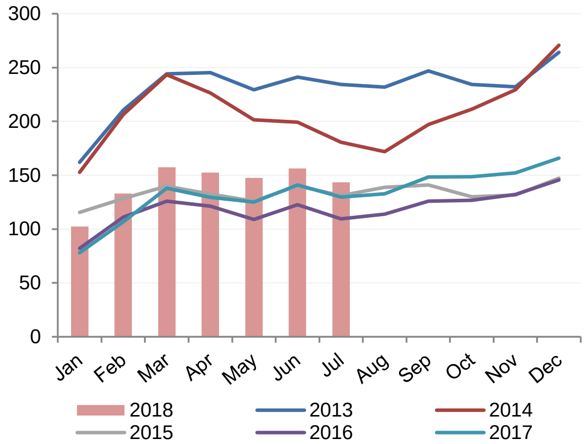
- New car sales growth continued slowing against last year's high base, posting 10.6% YoY in July 2018.
- Compared with the previous month, car sales showed a small decline of 1% MoM in seasonally adjusted terms.
- Passenger car output expanded 19.1% YoY in the first half of 2018, with foreign car brands accounting for a large part of the production increase.
- Deferred demand of previous years which has not yet to be fully met, along with the expectations of further price rises on the back of VAT hikes and ruble depreciation, as well as the extension of subsidized car loan programs may spur market growth acceleration towards the year end.

[16] Based on August operating data.

According to Association of European Businesses data, the sales of cars and light commercial vehicles rose 10.6% YoY in July 2018 (Figure 39). Growth slowdown in the second half of 2018 occurred against the high base of last year, as July 2017 saw the largest market gains. Overall, new car sales added 17.1% YoY in January–July 2018.

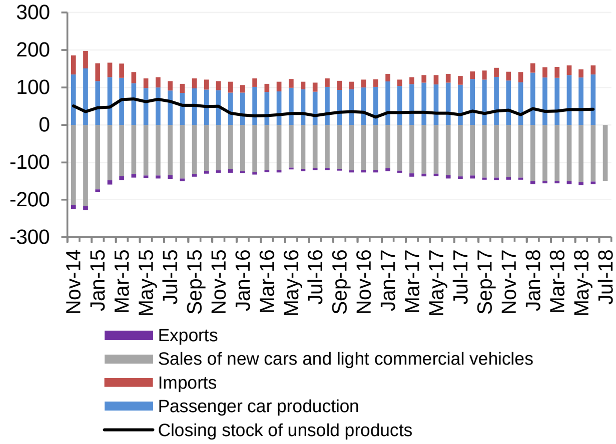
Adjusted for seasonal and calendar effects, demand has looked volatile since the start of 2018 (Figure 40), gaining slightly in some months and giving up these gains in the following months. In July, sales fell 1% MoM (June also saw a sales drop of 1.1% MoM).

Figure 39. Sales of new cars and light commercial vehicles, thousand units



Source: AEB, R&F Department estimates.

Figure 1. Demand (-) and supply (+) components in Russia's auto market, seasonally adjusted, thousand units

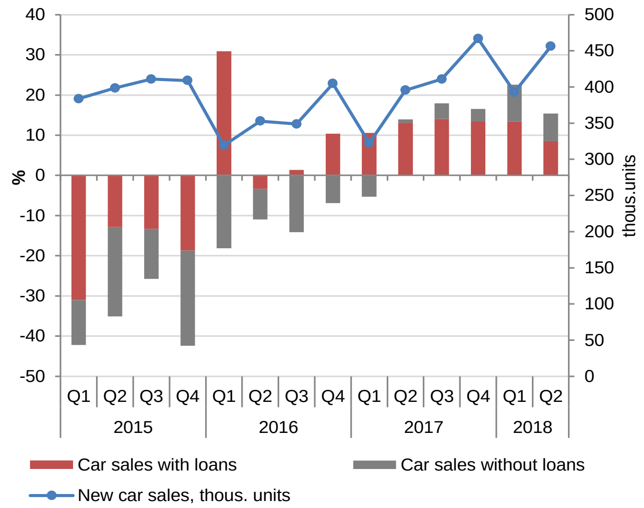


Source: AEB, F&R estimates, Rosstat

The stalled demand growth translates into the car production dynamics. According to Rosstat data, passenger car production expanded 19.1% YoY in January–June 2018. Growth continues to be driven by foreign car brands. Based on data from analytical company ASM-Holding, production rose 18.8% YoY in this category over the first half of this year, while foreign brands accounted for 74% of the total car output. Employees of some car-making companies took corporate vacations in July, which affected that month's output.

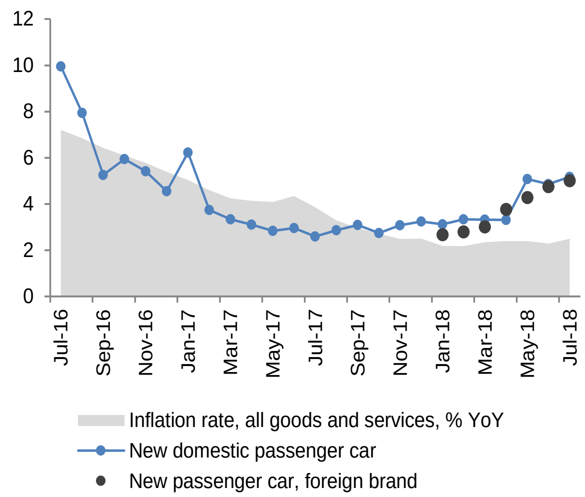
The availability of car loans continues to be an important component of demand. According to National Credit History Bureau data, the share of cars purchased with auto loans (with or without government support) continues to rise. In the second quarter of 2018, it stood at 49.1%, up from 48.1% a year earlier. It should also be noted that the last quarter's number of auto loans exceeded that of the same period of the "pre-crisis" year 2014 (208 thousand and 205 thousand respectively). But the decomposition of sales growth shows that car purchases with and without auto loans are making roughly equal contributions to sales expansion, in stark contrast to the market situation last year (Figure 41).

Figure 41. Decomposition of new car sales growth, % YoY[17]



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

Figure 42. Inflation rate and new car consumer price rises, % YoY



Source: Rosstat, R&F Department estimates

According to Rosstat data, price rises for new domestic and new foreign car makes continued to accelerate in July, outpacing overall YoY inflation (5.18% and 5.01% versus 2.5% respectively (Figure 42). The VAT base rate hike from 18% to 20% carries risks of further car price rises, which will likely be realized in 2019.

Despite the current sales growth slowdown, there are factors that can support the market in the months to come. First, experts point out that deferred demand of previous years still holds as a reason for changing a car (as suggested by growing sales of cars purchased without loans). Second, in July, the government announced its decision to extend the subsidized car loan program ("My First Car" and "Family Car") to 2018–2020.[18] Third, the VAT hike may spur demand towards the year end, ahead of the forthcoming price rise in line with the new tax rate. Fourth, August's ruble weakening may spark demand, as, for example, was the case in the second half of 2014.

1.2.6. Unemployment remains extremely low

- Seasonally adjusted unemployment rate inched up in July, as the employment growth slowed drastically year on year. This may stem from a drop in demand for casual labor in agriculture.
- Based on a preliminary estimate, real wages growth accelerated to 8.0% YoY in July from 7.2% YoY in June, despite inflation acceleration.

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[17] The share of loans provided for buying a new car is somewhat lower because there is no data breakdown by new and used car.

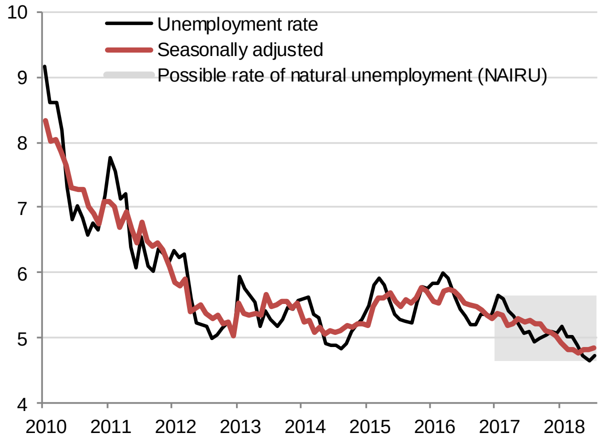
[18] http://government.ru/docs/33417/. Customers will be provided a 10% discount for a down payment on an auto loan, with Russia's Far East residents offered a 25%-discount so as to make Russian-produced cars more affordable and attractive to them.

- The public employees' wages raised under the presidential decrees increased 13% QoQ in the second quarter. This is however far below the usual seasonal growth, bearing out the view that wage raises at the start of the year were partly driven by one-off payments.

According to Rosstat data, the unemployment rate stood at 4.7% in July. Seasonally adjusted, this reading rose slightly to 4.86% from 4.83% a month earlier (Figure 43). A marginal increase in the seasonally adjusted unemployment rate was fueled by an unemployment headcount rise of 17.5 thousand (up 0.5% MoM in seasonally adjusted terms), and an employment headcount reduction of 192.5 thousand (down 0.3% MoM in seasonally adjusted terms). This may stem from a fall in demand for casual labor in agriculture and construction.

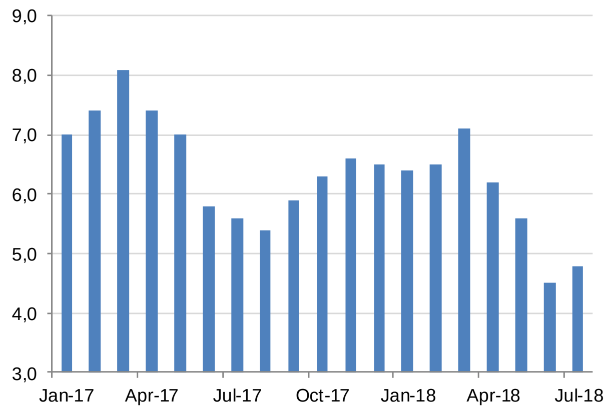
Despite a minor rise in the unemployment rate, the labor market situation did not change much, as evidenced by, among other things, HeadHunter data. The hh.Index gauging the job vacancy to unemployed ratio measured as the ratio of vacancies to the number of applicants, stays at a record-low level (Figure 44).

Figure 43. Unemployment and its natural rate, %



Source: Rosstat, R&F Department estimates.

Figure 44. hh.index

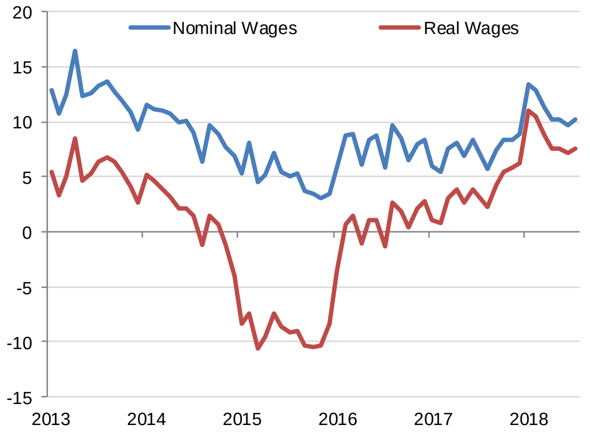


Source: HeadHunter.

Nominal wage growth accelerated to 10.7% YoY in July from 9.7% YoY in June. Real wage growth was also gaining momentum to reach 8% YoY, up from 7.2% in June (Figure 45), despite annual inflation acceleration in July.

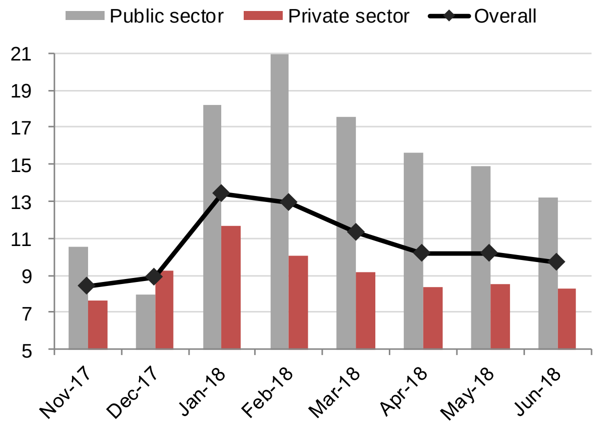
Nominal wages in the public sector keep increasing at double digits (up 13.2% YoY in June), but their growth is slowing. Private sector wages showed an unfaltering rise of 8.0% for the third consecutive month. Public sector wage growth slowdown versus it stabilization in the private sector suggests that the labor market is generating lower inflationary risks than thought previously. Still, the labor market is one of the sources of medium-term inflationary risks because wage rises outpace productivity improvement.

Figure 45. Wage growth rate, % YoY



Source: Rosstat.

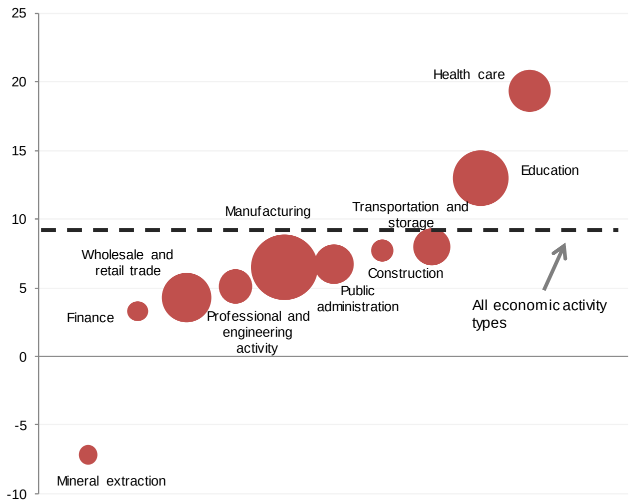
Figure 46. Rate of nominal wage growth in private and public sectors, % YoY



Source: Rosstat, R&F Department estimates.

Public sector industries remain wage growth leaders, with health care posting a rise of 19.4% YoY and wages in education increasing 13.0% YoY (Figure 47).

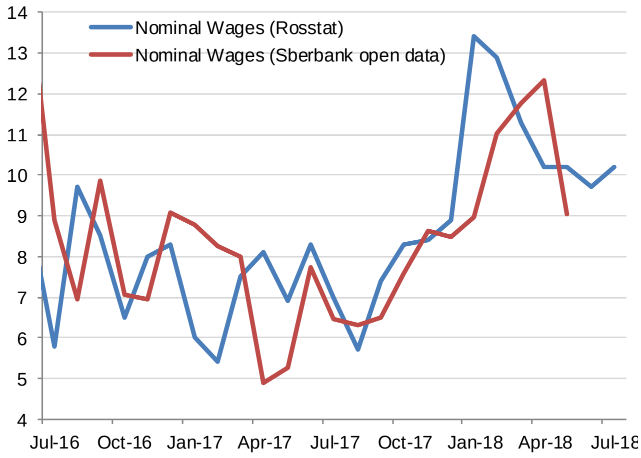
Figure 47. Nominal wage growth in June 2018 by industry, % YoY



Source: Rosstat, R&F Department estimates.
Note: Circle size corresponds to the share of the economic activity type in the total payroll fund.

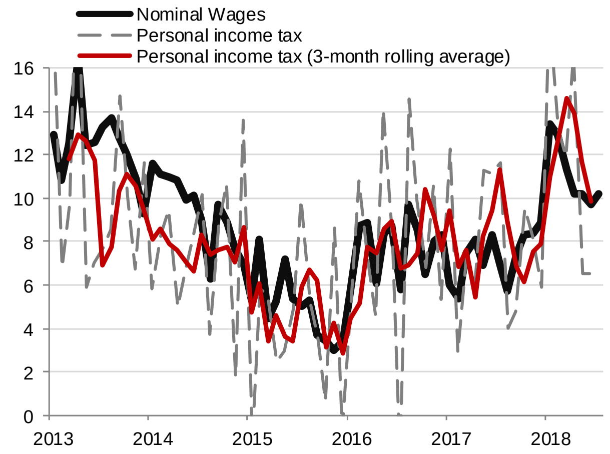
Sberbank Open Data on wages actually paid into the accounts of the bank's customers confirm the upward trend of real wage growth in 2018. It correlates well with Rosstat's official value of average accrued salaries in organizations (Figure 48). Changes in the collection of budget revenue from personal income tax, a large proportion of which is imposed on wage and salary income, also suggest wage growth acceleration (Figure 49).

Figure 48. Wage growth, % YoY[19]



Source: Rosstat, Sberbank Open Data.

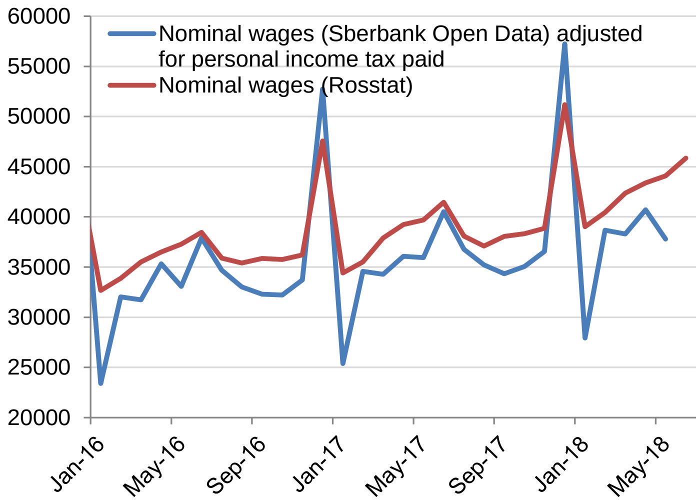
Figure 49. Growth in wages and personal income tax, % YoY



Source: Rosstat, RF Finance Ministry.

Although the wage growth trend is in both cases similar, Sberbank's figure is lower (Figure 50), possibly due to its wider coverage of wage earners. Rosstat's number is calculated based on large and medium-sized enterprises' reporting and is subsequently adjusted to take account of the entire range of organizations. Sberbank takes account of all wage earners, regardless of the legal form of business. This may explain the above difference in wage levels. This hypothesis is indirectly borne out by changes in a broader measure of average accrued monthly wages of personnel employed by organizations, sole proprietorships and individuals, which is also calculated by Rosstat. This value is lower than those of both the average accrued monthly salaries in organizations and wages computed based on Sberbank Open Data.

Figure 50. Nominal wages



Source: Rosstat, Sberbank Open Data.

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19 Wage growth based on Sberbank Open Data is calculated as a rise in a two-month average value. Many companies pay the main part of salaries at the start of a month following the reporting month. Accordingly, a part of salaries accrued for, e.g., May is only entered in statistics of actually paid salaries in June.

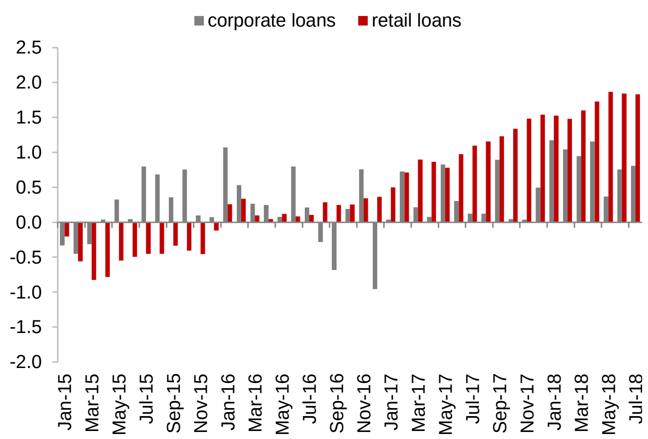
Both of the above wage measures may overstate the actual wage growth numbers to a certain extent in view of the ongoing movement of grey businesses into the white zone. The shift to official wage payment should send the figure of average payable monthly wages higher in statistical terms, boosting revenue from personal income tax collection, while the net sum actually paid to an employee may remain unchanged.

1.2.7. Retail lending keeps up steady growth

- Retail lending remains the key driver of banks' loan portfolio expansion.
- Seasonally adjusted retail lending growth may decelerate towards the year end, since risk coefficients for consumer loans were raised as of September 1. Year-on-year growth of unsecured consumer loans will, however, continue accelerating from the slow rate of last year (the low base effect).
- The banking sector profit fell below last year's on the back of additional loan loss provisions at banks undergoing recovery. Exclusive of these banks, profit rose year on year.

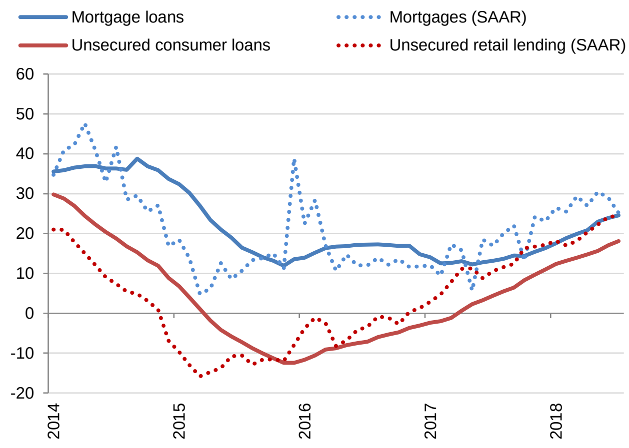
Consumer lending remains the main driver of banks' ruble loan portfolio growth. Retail ruble lending growth rate has in recent months stabilized at 1.8% MoM (Figure 51). As regards individual segments of retail lending, July saw a minor slowdown of mortgage loan expansion to 1.9% MoM (a seasonally adjusted annual growth rate of 25%) and stabilization of unsecured consumer loan growth at 1.8% MoM (24% YoY).

Figure 51. Ruble lending expansion, % YoY (seasonally adjusted)



Source: Bank of Russia estimates.

Figure 52. Retail lending, % YoY



Source: Bank of Russia estimates.

A rise in risk coefficients for consumer loans as of September 1, 2018, along with measures to limit mortgage segment risks already in place, will likely cause seasonally adjusted retail lending growth to cool marginally in the second half of 2018. This may in turn have a moderate effect on consumer demand growth. Still, the annual rate of loan portfolio expansion will continue to rise with last year's much lower numbers exiting the calculation base: monthly growth rates were much lower in that period.

Banking sector profit totaled 775.7 billion for January–June. Exclusive of banks undergoing financial recovery, the sector's profit reached 1 trillion rubles, a gain of about 18% from January–July last year. The main factor behind the loss posted by banks undergoing financial recovery was setting aside additional loan loss provisions which has in recent months outpaced provision expansion in other credit institutions.

1.2.8. Fiscal alternatives in 2018: how is extra non-oil and gas revenue to be used?

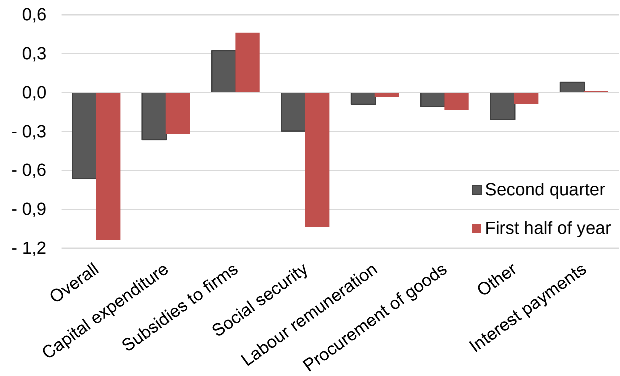
- General government revenue rose 3.0 pps of GDP YoY in the second quarter of 2018, with oil and gas revenue adding 2.3 pps. Non-oil and gas revenue gain is partly due to tax collection improvement.
- Expenditure went down 0.7 pps of GDP YoY in the second quarter. The items accounting for the main portion of the decrease were spending on the economy – under the functional expenditure classification (a decline of 0.5 pps of GDP), and capital expenditure – under the economic classification (a fall of 0.4 pps of GDP). The effect of fiscal consolidation was alleviated by an improvement in the evenness of spending distribution.
- A surplus of 3.3% of GDP helped step up revenue accumulation in the National Welfare Fund (NWF). The effect of the fiscal rule constrained domestic demand, preventing economy overheating on the back of the rising oil price.
- NWF growth will continue at a slowing pace until the year end, while the performance of other fiscal indicators will depend on federal and regional authorities' decisions regarding extra non-energy revenue: using it to scale down borrowing would relieve pressure on the OFZ market and diminish the potential effect of crowding out private borrowing, while spending these funds may accelerate growth of the economy beyond its potential level and heighten inflationary pressure.

Revenue. General government revenue to GDP added 2.0 pps YoY in the first half of 2018, increasing 3.0 pps of GDP YoY in the second quarter.[20] Oil and gas revenue rose 2.3 pps of GDP thanks to a Urals oil price rise of 49% YoY in dollar terms and 61% YoY in ruble terms. Non-oil and gas revenue to GDP gained 0.7 pps of GDP driven roughly equally by taxes on imports and those on domestic production. It seems that tax collection improvement also continues to positively affect the revenue: an increase in revenue from individual taxes is outpacing an expansion in their respective tax bases.

[20] Hereinafter, RF Finance Ministry estimate of Q1 2018 nominal GDP is used.

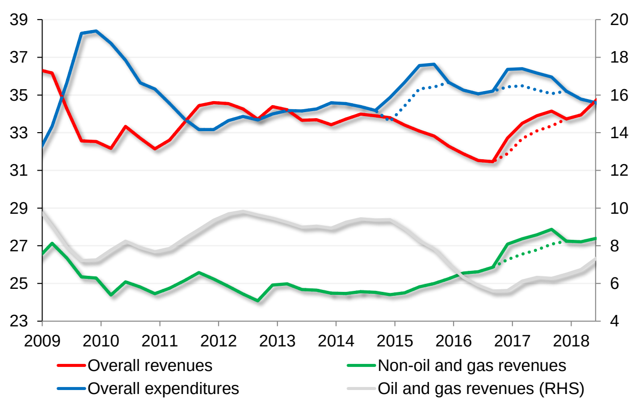
Expenditure. Expenditure declined 1.1 pps of GDP YoY in the first half of 2017 and 0.7 pps YoY in the second quarter (the first quarter saw a high base effect owed to the one-off pension payment in January 2017). Expenditure contraction is driven by the continuing fiscal consolidation. That said, an improvement in the evenness of spending distribution within a year alleviated the effect of this decline: the share of the general government non-interest expenditure stood at 46.9% in the first half of the year versus 43.8% in the same period last year[21] (25.2 and 23.4% respectively in the second quarter). The items accounting for the largest part of the expenditure decrease were spending on the economy – under the functional expenditure classification (a decline of 0.5 pps of GDP), and capital expenditure – under the economic classification (a fall of 0.4 pps of GDP) (Figure 53). Interest expenditure rose 0.1 pps of GDP on the federal level, falling 0.05 pps of GDP on the regional level.

Figure 53. Budget spending change in 2018 under economic classification, pps of GDP YoY



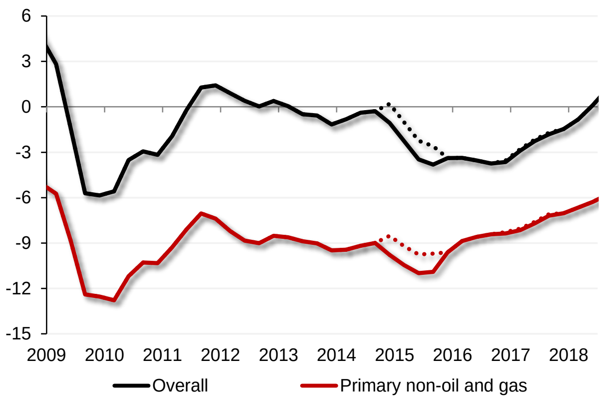
Source: RF Treasury, RF Finance Ministry, расчеты R&F Department estimates.

Figure 54. General government key indicators, % of GDP (four-quarter rolling numbers)



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

Figure 55. General government balance, % of GDP, (four-quarter rolling numbers)



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

** The dashed line shows estimates exclusive of major one-off factors: recapitalization of banks in the fourth quarter of 2014, expenditure on early repayment of defense sector loans, and Rosneft privatization in the fourth quarter of 2016.*

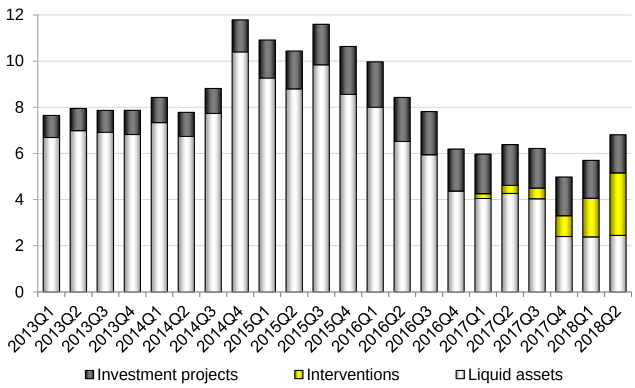
[21] Net of the one-off pension payment in January 2017; 44.5% with this payment included.

Budget balance. The revenue expansion and expenditure reduction helped post a budget surplus of 3.3% of GDP for the first half and second quarter of 2018. Moreover, a four-quarter surplus was seen for the first time since 2013 (Figure 55).

The National Wealth Fund (NWF) and government debt. Acceleration in oil and gas revenue growth helped step up NWF accumulation. Foreign currency interventions under the fiscal rule totaled 0.95 trillion rubles in the second quarter, which was expected to bring the NWF to 6.8% of GDP as of 1.07.2018, of which investment projects accounted for 1.6 pps, the liquid part accumulated prior to 2017 – for 2.5 pps, and the liquid part accumulated under the new fiscal rule – for 2.7 pps (the 2017 portion was paid into NWF in June) (Figure 56).

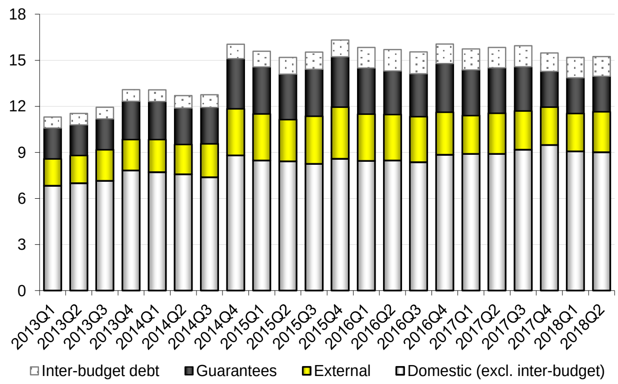
General government debt increased marginally for the second quarter of 2018 on the back of debt revaluation in terms of foreign currency (Figure 57).

Figure 56. Structure of sovereign funds (from 2018 – NWF), % of GDP



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

Figure 57. Structure of general government debt, % of GDP



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

Impact on GDP growth. The sizable budget revenue increase and the appreciable expenditure contraction, primarily in the economic block with a relatively high fiscal multiplier, may have adversely affected annual GDP growth in the second quarter of 2018. This, however, was largely due to the effect of fiscal rule implementation, smoothing out cyclical fluctuations of economic performance. With no fiscal rule in place, oil price rises would have triggered economy overheating beyond its potential level. This would have given rise to additional inflationary pressure, calling for a monetary policy response.

Outlook for 2018. NWF expansion is expected to continue in the second half of 2018, but at a slowing pace: its portion provided by foreign currency interventions may continue to grow at a quarterly rate of about 1 pp of GDP, but the remaining liquid part will be partly spent to finance seasonally large expenditure.

The performance of other key indicators will depend on decisions regarding extra non-oil and gas revenue expected on both the federal and regional levels. Should it be decided to use this revenue to scale down borrowing and beef up the budget surplus, then total public debt will stay at roughly the current level as a percentage of GDP.

Should the extra revenue be spent, public debt will rise. The former scenario would relieve pressure on the OFZ market against amid the worsening global market conditions and risks of financial restrictions escalation by the U.S. This may also alleviate the effect of crowding out private borrowings in the current situation should the Russian Finance Ministry opt for implementing the 2018 borrowing program in full. Spending escalation under the latter scenario may cause GDP to rise about its potential level, heightening the risks of inflation acceleration above 4% for 2018.

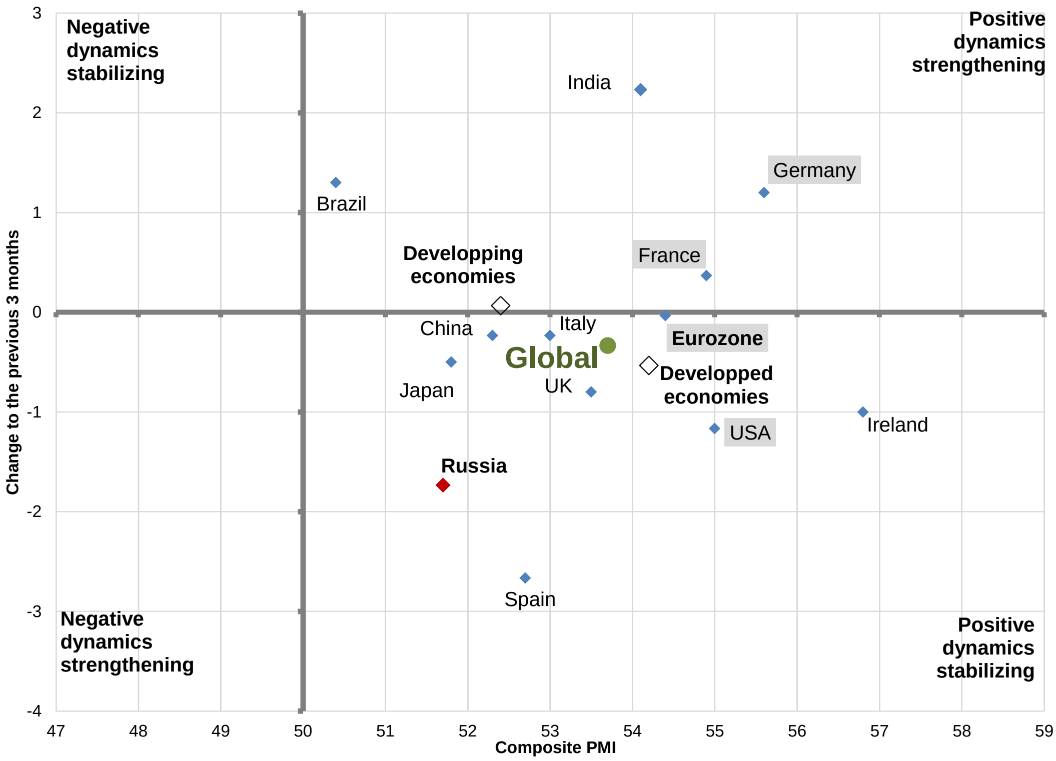
2. Outlook: leading indicators

2.1. Global leading indicators

2.1.1. The global economy will lose growth momentum in the third quarter

The performance of the composite PMI indices points to a minor QoQ growth slowdown in the global economy at the beginning of the third quarter, led by developed countries (Figure 90).

Figure 90. July's Composite PMI* and its change versus average Q2 reading



Source: IHS Markit, Bloomberg Finance L.P.
**Grey highlights indicate preliminary August estimates and their change from the average May–June level.*

Based on a preliminary estimate, the composite IHS Markit U.S. dropped to 55.0 in August from 55.7 in July (the second quarter average stood at 55.9). IHS Markit estimates that the August index corresponds to a U.S. economy growth of 2.5% YoY. U.S. economy growth is expectedly slowing after its acceleration to 4.1% in the second quarter in annualized terms as the effect of fiscal stimulus peters out, US dollar strengthens and monetary policy is gradually tightened. This year's first fall in the new orders index, which is a leading indicator of output growth, suggests further growth softening.

A preliminary estimate of the Eurozone composite PMI index posted a token rise to 54.4 from 54.3 in July, but came in below an average second quarter reading of 54.7. One can say that the Eurozone's economy growth generally stabilized at 0.4% QoQ in the third quarter after a fairly sharp slowdown at the start of the year. European economic performance is dragged down by the weakening growth of the global economy and trade: the new orders index was the lowest in the last two years. The risks of further growth easing are highlighted by a drop in the expectations index which hit a 23-month low and was especially weak in manufacturing, where it was the lowest in almost three years.

2.2. What do Russia's leading indicators suggest?

2.2.1. Russian GDP nowcast in August: growth close to potential

- The current GDP estimate and short-term forecasts indicate that Russia's economic growth is close to potential.
- The GDP nowcast for the third quarter of 2018 stood at +0.4 QoQ SA in August, down marginally from the preceding month's reading.
- Short-terms forecasts for the end of 2018 and the beginning of 2019 also remain stable. Their minor decline stems from a deterioration in some of survey data (primarily PMI indices) and does not signal the emergence of a pronounced downward growth trend.
- Our additional calculations, the above estimate and short-term forecasts indicate a likely Russian GDP growth of about 1.7%–1.8% for 2018.[22]

	August % QoQ SA	July % QoQSA
Q3 2018	**0.4**	**0.4 – 0.5**
Q4 2018	**0.35**	**0.4**
Q1 2019	**0.35**	**–**

2.2.2. Analysts' inflation expectations remain anchored at 4%

- Analysts have revised their inflation forecasts for end-2018 marginally down, still expecting price rise acceleration above 4% in 2019. Nevertheless, inflation is expected to go back down to 4% as early as the beginning of 2020.
- The consensus forecast for the key rate remained unchanged in July–August after the Board of Directors raised it in June. The median consensus forecast sees its re-

[22] The index-based estimate is oriented to Rosstat revised 2018 Growth estimates to be released in 2020 and onwards.

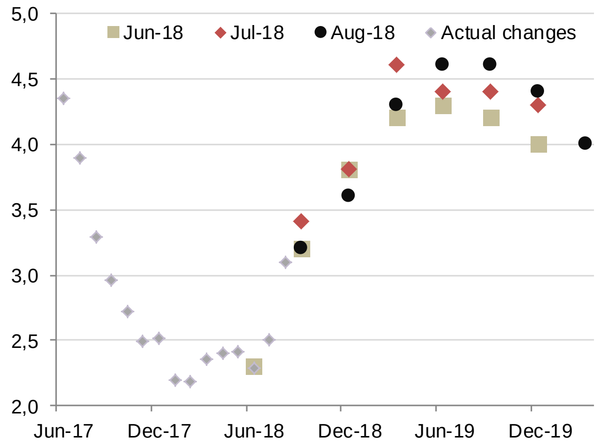
tention on the current level till end-2018. Some analysts, are, however, currently expecting the rate to be raised.

Blomberg consensus forecasts for inflation based on surveys of financial analysts changed significantly compared with June (Figure 91). Despite some price rise acceleration in August, inflation expectations for the year end declined to 3.6% from 3.8%. That said, analysts expect inflation to peak at 4.6% in the second or third quarter of 2019 following the VAT increase. Still, inflation is expected to return to 4% as early as the beginning of 2020, in line with dynamics forecast by the Bank of Russia.

The key rate expectations did not change much from the end of June. The median reading of the Bloomberg survey for the end of 2018 stays at 7.25%, which analysts expect to subsequently decline gradually to reach 6.75% at the end of 2019. Some analysts expect the key rate to be raised towards the end of 2018, probably in light of the volatility rise in emerging markets.

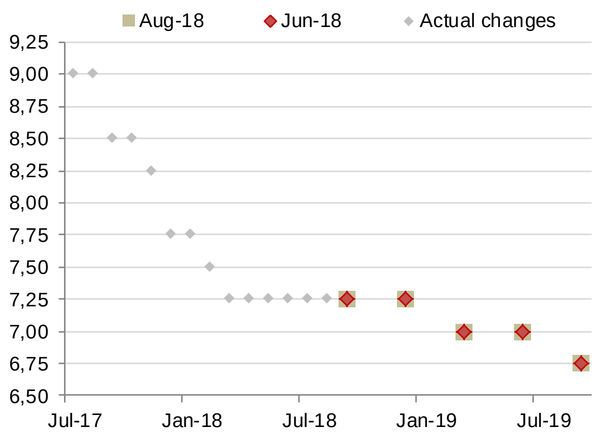
It seems that the August developments in the markets and the inflation performance haven't yet to be reflected in the consensus forecasts. Bloomberg collects analysts' forecasts on a monthly basis but analysts do not always promptly take account of the latest developments in their forecasts, especially during the summer vacation season. The September forecasts will provide a more comprehensive picture of analysts' expectations regarding changes in the trajectory of economic and financial indicators.

Figure 91. Analyst inflation expectations, % YoY



Source: Bloomberg Finance L.P.

Figure 92. Analyst expectations for Bank of Russia key rate, %



Source: Bloomberg Finance L.P.

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