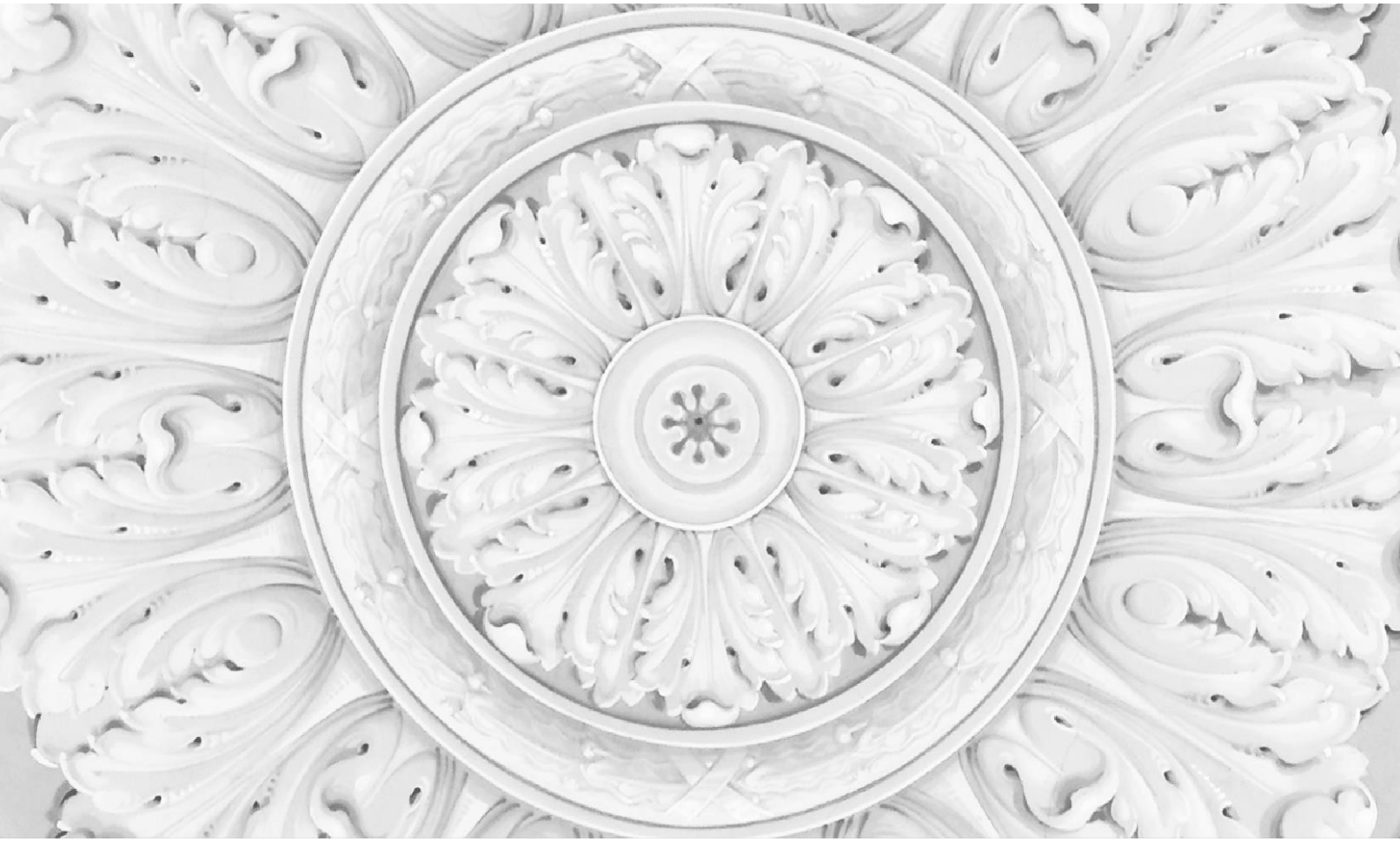
Bank of Russia

The Central Bank of the Russian Federation



TALKING TRENDS

Macroeconomics and markets

October 2018

Research and Forecasting Department

Bulletin № 7 (27)

The Bulletin is based on data as of 08.10.2018. 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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- Annual inflation continued moving to the Bank of Russia target in September, driven primarily by temporary pro-inflationary factors. Seasonally adjusted monthly consumer price rises are still somewhat above the level providing for an inflation rate of 4% for the year. Adjusted for one-off factors, however, inflation remains slowed relative to the Bank of Russia target. Economic growth continued at a rate close to potential, with risks of growth slowdown at the year end rising. 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 3.4% in September, consolidating its ascending trend. Price rises are expected to come close to the 4-percent target at the year end, driven by a number of enduring and one-off factors. Medium-term risks of inflation upward deviation from the target are still prevalent. Transient factors will therefore cause inflation to temporarily rise above 5% in 2019 before dropping back to 4% in 2020. Bank of Russia policy helps reduce inflation risks and keep inflation close to the regulator's target over a horizon of two-three years.
    - Russian and international business surveys are, however, still suggesting that the Russian and global economies may slow at the year end. Consumer demand is on the rise, fueled by the continued consumer lending expansion and the maintenance of fast real wage growth against a backdrop of mounting workforce shortages in the labor market.
    - Russian financial markets' volatility has risen above emerging markets' average level. Volatility was adversely affected by fears of the U.S. imposing new sanctions on Russia and contagion from Turkey and Argentina's financial markets.

2. Outlook

- September surveys indicated some growth deceleration in advanced economies and emerging markets as trade tensions between major countries continue.
- The leading indicator of Russia' GDP points to the Russian economy's growth in line with its potential and its likely marginal slowdown at the year end.

3. In focus. The impact of the retirement age increase on public finances and the labor market

- Having encountered demographic challenges, many countries have in the last decade decided on raising the retirement age.
- The rationale provided for raising the retirement age in Russia is Russian population's increased actual and expected healthy lifespan. This measure aims to stabilize the share of pensioners in Russia's overall population and the country's age dependency ratio.
- This decision seeks to slow labor force dwindling in the years to come, largely compensating the adverse effect of this factor on the potential growth rate of Russia's economy.
- The retirement age increase should allow accelerated indexing of the average pension benefit at a rate above inflation. Meanwhile public spending on pension payment will be gradually decreasing as a percentage of GDP, stabilizing after the transition period has come to an end.
- Public finances may see a revenue drop as a share of GDP in the decade to come, stemming from, among other things, a likely oil price fall. To maintain the long-term stability of public finances, expenditure will also likely have to be cut as a share of GDP. The reduction in the age dependency ratio thanks to the retirement age increase should help address this problem.

1. Monthly summary

1.1. Inflation

Annual inflation reached 3.4% in September, consolidating the trend towards returning to 4% by the year end. Short-term pro-inflationary risks remain elevated because of ruble depreciation against major currencies and the forthcoming raise of the VAT base rate.

Inflation is expected to reach 4% at the year end, driven by a number of enduring and 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 acceleration of price rises from their extremely slow rate last year, the effect of ruble depreciation on prices, and price hikes by some producers ahead of the VAT base rate increase to 20%.

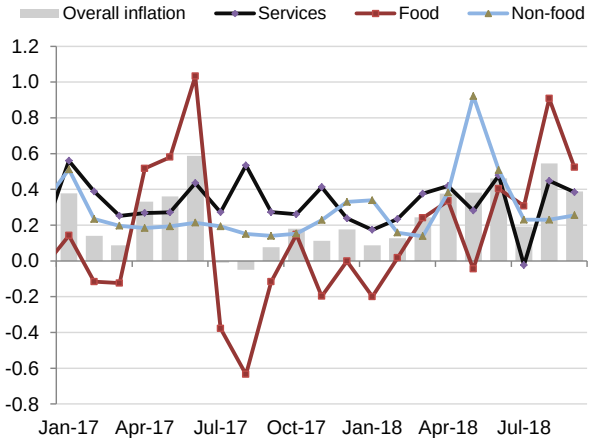
Medium-term pro-inflationary risks are prevailing over disinflationary ones. The key pro-inflationary risks include geopolitical factors and volatility surges in financial markets, the upward pressure of the accelerating consumer lending growth on prices, rising inflation expectations, and increasing workforce shortages in the labor market.

1.1.1. Inflation accelerates in September, approaching 4%

- Prices rose 0.16% MoM in September, or 0.39% MoM in seasonally adjusted terms. Three-month moving average seasonally adjusted price growth stood at 4.6% in annualized terms.
- Price rises adjusted for one-off factors are so far marginally below the level corresponding to an inflation rate of 4% for the year but are appreciably above the level seen at the start of 2018.
- Annual inflation accelerated to 3.38% in September, with its further acceleration likely in the months to come. Nevertheless, we still expect inflation to stand within the 3.8%–4.2% range at the end of 2018.

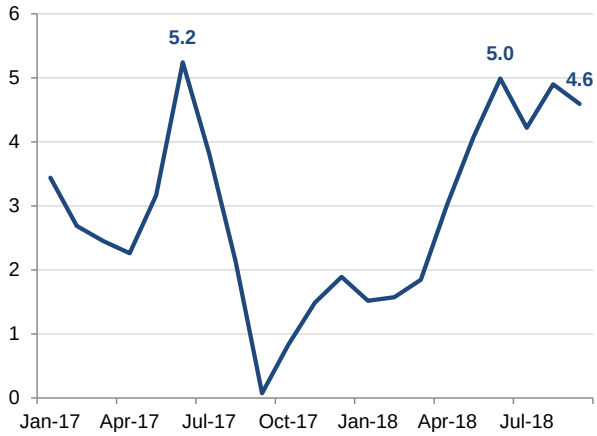
Consumer price inflation came in at 0.16% MoM in September. Seasonally adjusted, consumer price rises stood at 0.39% MoM, marginally below their August level of 0.54% MoM (Figure 1). Average seasonally adjusted price growth came in at 4.6% in annualized terms in July–September (Figure 2) and 5.7% in August–September.

Figure 1. Seasonally adjusted price rises, % MoM



Source: Rosstat, R&F Department estimates.

Figure 2. Three-month moving average seasonally adjusted price growth in annualized terms, %



Source: Rosstat, R&F Department estimates.

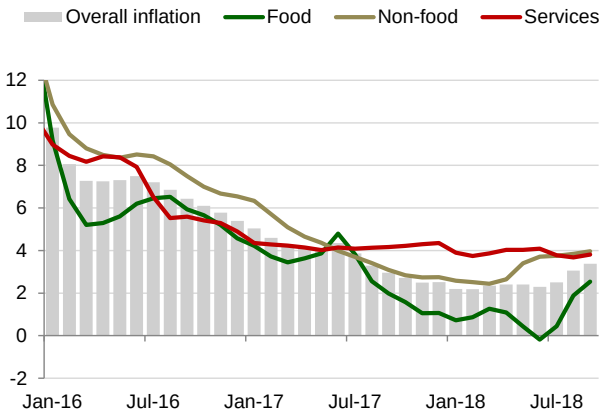
Annual inflation rose to 3.38% YoY in September from 3.06% in August (Figure 3). September's inflation acceleration was expected and owed to, among other things, the low base effect: the second half of last year saw inflation appreciably below the trajectory which would have kept the figure at 4% for the year, while this year price rises are seen somewhat above this level (Figure 4).

The risks of inflation coming in slightly above 4% for the year, within the projected 3.8%–4.2% range, persist as one-off pro-inflationary factors remain evident. That said, the preliminary estimates of price rises in the most stable CPI components (i.e., inflation adjusted for the impact of temporary factors) are much lower at 3.8% YoY. The impact of the recent ruble weakening bouts and retail price hikes ahead of the forthcoming VAT increase remain the key pro-inflationary factors. They may drive seasonally adjusted inflation to 1.2%–1.3% QoQ[1] in the fourth quarter. Given the price rises accumulated over January–September, this will cause inflation to move further to 4%. Nevertheless, we still expect inflation within the 3.8%–4.2% range at the end of 2018.

In the food market, inflation accelerated to 2.54% YoY in September from 1.89% YoY in August despite the stabilization of fruit and vegetable price rises. September's monthly price change equaled 0.52% MoM in seasonally adjusted terms. Although marginally below an August level of 0.91% MoM, inflation pressure remains generally elevated in the food market. Meat and meat product prices, for instance, continued climbing as supply contracted, driven by several factors (restrictions on exports from Brazil, exit of inefficient producers from the market, outbreaks of virus diseases). On top of that, ruble depreciation is sending agricultural producers' costs higher.

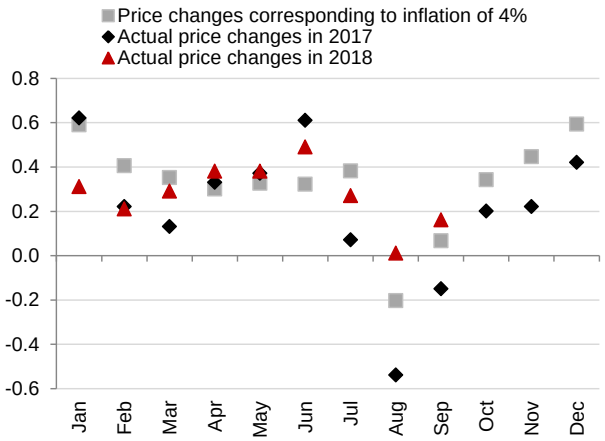
[1] Total contribution of one-off factors to the fourth quarter's consumer price rises is estimated at 0.4–0.5 pps (0.1–0.2 pps from the VAT increase and 0.3 pps from ruble weakening in August–September).

Figure 3. Inflation and its components, YoY %



Source: Rosstat, R&F Department estimates.

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



Source: Rosstat, R&F Department estimates.

Fruit and vegetable price movements stabilized in September after their temporary deviation from the normal seasonality in August on the back of delayed harvesting of field-grown vegetables. Seasonally adjusted, fruit and vegetable prices fell 0.48% MoM in September after a rise of 5.14% MoM in August.

We expect the acceleration of food price rises to remain the main driver of inflation acceleration in the months ahead (Figure 3). Meanwhile, price rises in nonfood goods and services are stable at 4% YoY. September saw the price pressure begin to mount in nonfood goods which are highly sensitive to exchange rate movements. Prices of electrical and household appliances went up 0.49% MoM (versus 0.2%–0.3% in May–August) although the retail chains claimed at the start of September that they intended to keep prices unchanged.[2] As the exchange rate pass-through to prices is lagged, price movements will continue to be affected by the recent ruble depreciation episodes in the months to come.

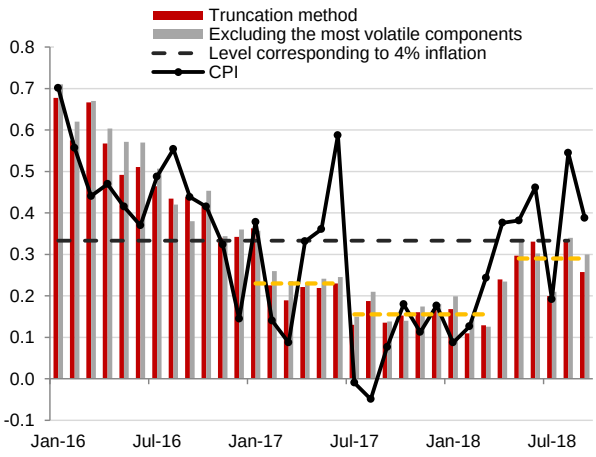
September's modified core inflation indicators slightly departed from the level corresponding to an inflation rate of 4% for the year after coming very close to it in August (Figure 5). Changes in modified core inflation indicators suggest that inflationary pressure rose notably in April–May (compared with the period of 2017 – early 2018) and has since remained elevated although somewhat volatile. The volatility of core inflation indicators stems from the effect of temporary factors on their changes, which is, however, weaker than the impact of temporary factors on headline inflation.

Adjusted for the impact of all one-off factors, price rises are still below the level providing for an inflation rate of 4% for the year. The median price rises in goods which are only weakly sensitive to exchange rate movements have stood at an average 3.4% in annualized terms in the last three months (Figure 6). The median of price rises in goods sensitive to exchange rate movements declined marginally in September from its August

[2] RBC. Pass-through effect: which prices will rise on the back of ruble weakening. 12.09.2018.

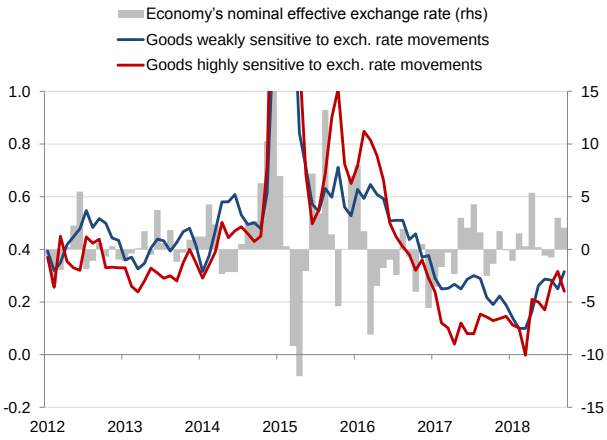
level, although remaining on the uptrend seen from April. It can be expected to continue in the months ahead, given ruble depreciation in August–September.

Figure 5. Modified indications of core inflation, % MoM



Source: Rosstat, R&F Department estimates.

Figure 6. Median price rises in goods differing in sensitivity to exchange rate movements, % MoM, seasonally adjusted



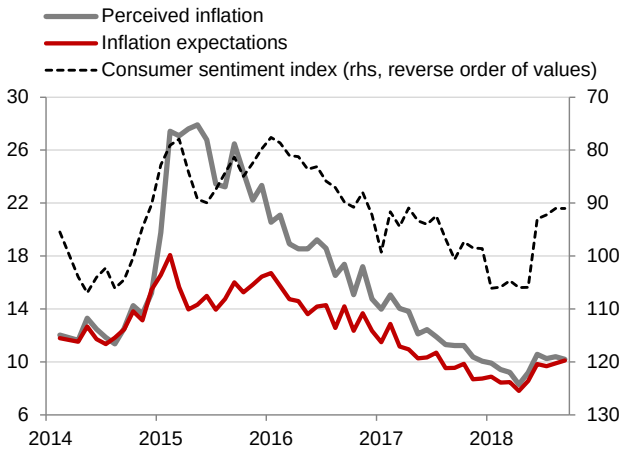
Source: Rosstat, R&F Department estimates.

** Plus means ruble depreciation against foreign currencies, minus means its appreciation against foreign currencies.*

Household inflation expectations rose to 10.1% in September, the highest level since July last year (Figure 7). The gap between perceived and expected inflation shrank to 0.1 percentage points.

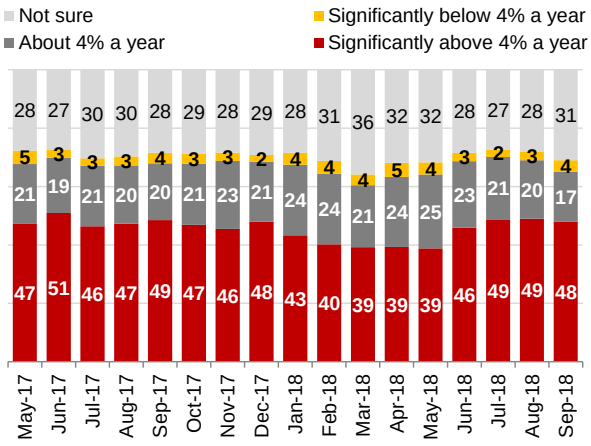
Inflation expectations went up as the number of respondents citing a steep rise in meat and poultry prices increased (to 41% in September from 39% in August). This factor will continue to push inflation expectations higher because consumers react fairly strongly to changes in prices of staple goods. One example of this is that, despite the relatively stable oil product prices in recent months, the share of respondents citing a dramatic rise in petrol prices remained quite significant at 36% versus 40% in August.

Figure 7. Median estimates of perceived inflation and household inflation expectations



Source: inFOM.

Figure 8. Inflation expectations over a three-year horizon [3]



Source: inFOM.

Respondents continue to cite ruble depreciation and the VAT hike as some of the causes of future inflation. These factors and the news flow they are generating spark the risks of a further rise in inflation expectations in the months ahead. For example, the share of respondents who believed that the ruble exchange rate would fall against the dollar in a year's time stood at 50% in September. At the same time, the share of those who assumed that the ruble exchange rate would remain unchanged declined, while the share of respondents who were not sure increased. Thus, respondents who earlier believed that the ruble exchange rate was stable started to have doubts in September.

Answers to the question about whether inflation will meet the 4% target in the long-term also showed rising uncertainty: the share of those who were not sure what to answer increased, while the share of respondents who believed prices would climb notably higher than stated by the authorities remained unchanged (Figure 8). However, this kind of change in the distribution of answers to inFOM's relevant question is fairly typical during ruble weakening bouts (a similar picture was, for example, seen in April–May of 2018).

1.1.2. Trend inflation in September: medium-term risks of inflation rising above 4% persist

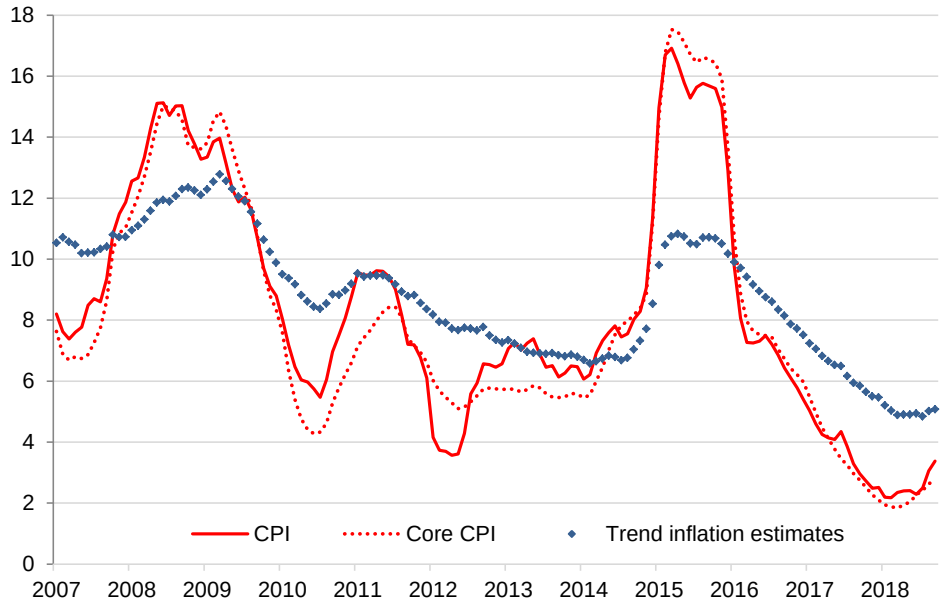
- The annual trend inflation estimate inched up to 5.08% in September 2018 from 5.02%[4] in August.

[3] Distribution of answers to the question "Do you think annual inflation will be higher or lower than 4% in three years' time? Or will it stand at about 4%?"

[4] In July 2018, the trend inflation numbers were revised following the adoption of a new methodology for seasonal adjustment of input price index series used in calculating the indicator. For details of seasonal adjustment of the CPI and

- Trend inflation stabilization in recent months seems to indicate that inflationary pressure in some of the most stable CPI components is stabilizing somewhat above the 4% level.
- Over a medium-term horizon, the risks of annual inflation upward deviation from 4% are prevailing over the risks of its downward deviation.

Figure 9. CPI, Core CPI and Bank of Russia historical estimates of trend inflation, % annually



Source: Rosstat, R&F Department estimates.

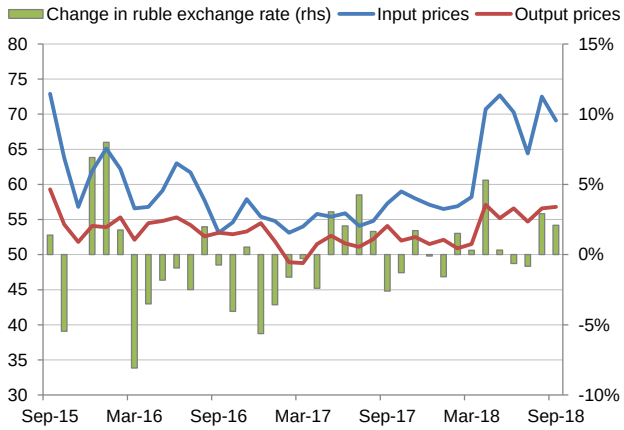
1.1.3. PMI price indexes: output prices are more sensitive to cost increases in manufacturing than in services

- September saw PMI IHS Markit price indexes for manufacturing and services move in opposite directions. The manufacturing sector's price indexes remain elevated, while the services sector's output price index hit an eight-month low, even though respondents are reporting cost increases on the back of ruble weakening.
- The movement of the price indices in opposite directions suggests that the current price rise acceleration is fueled mainly by one-off factors: manufacturing sector prices are more sensitive to exchange rate movements than prices in the services sector.
- The decline of the output price index for the services sector to its lowest level since January suggests that inflationary pressure adjusted for one-off factors has so far

its components, see Sapova et al (2018). Review of Methodological Specifics of Consumer Price Index Seasonal Adjustment at the Bank of Russia, Bank of Russia. Working Paper Series, №33, June 2018.

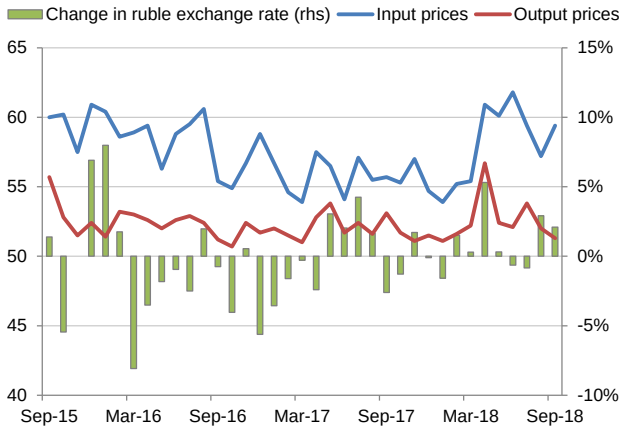
failed to reach the level exceeding an inflation rate of 4% YoY. Therefore, the secondary effects of ruble weakening on prices are so far mild.

Figure 10. Manufacturing PMI price indexes



Source: IHS Markit.

Figure 11. Services PMI price indexes



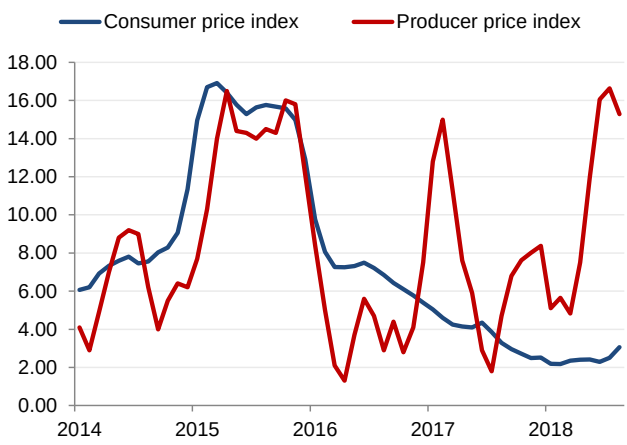
Source: IHS Markit.

1.1.4. Producer price inflation decelerates

- Acceleration of annual producer price inflation stopped in August, with producer prices rising 15.3% YoY versus 16.6% YoY in July (Figure 12). This was largely helped by the stabilization of the rate of domestic oil and oil product price rises following the slowdown of oil price hikes in the world market (Figure 13).
- Producer price increases measured using the basket of representative goods[5] for the first time since late 2015 outpaced consumer price rises, albeit by just 0.2 pps (Figure 14). This suggests the mounting of inflationary pressure in the consumer market in the months ahead.
- The meat processing industry sees a steady price rise acceleration (Figure 15), fueled mainly by wholesale price increases on the back of supply contraction. To support demand, retail chains won't meet producers' requests to raise meat product prices sharply. This depresses meat product suppliers' profit margins but industry experts believe that this is still more worthwhile for them than non-performance of contracts with retail chains.

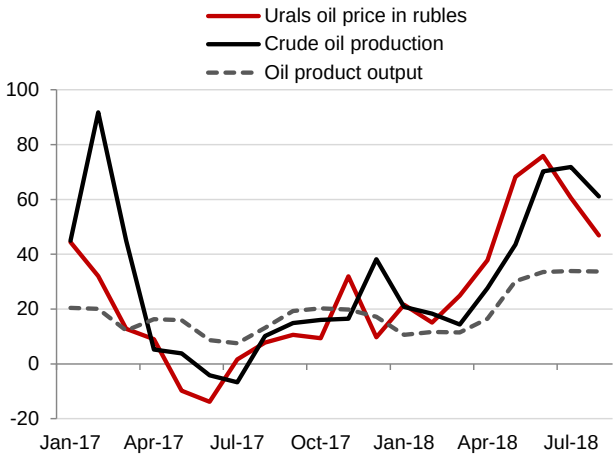
[5] Goods included in both PPI and CPI calculation.

Figure 12. Producer price and consumer price indexes, % YoY



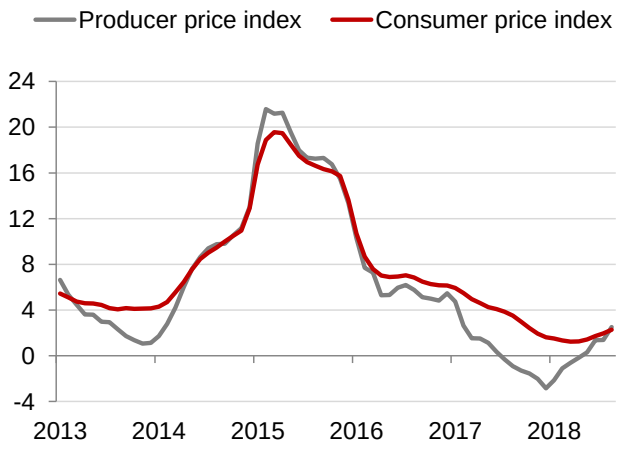
Source: Rosstat, R&F Department estimates.

Figure 13. Producer price index for oil and oil products. Urals oil price in rubles, % YoY



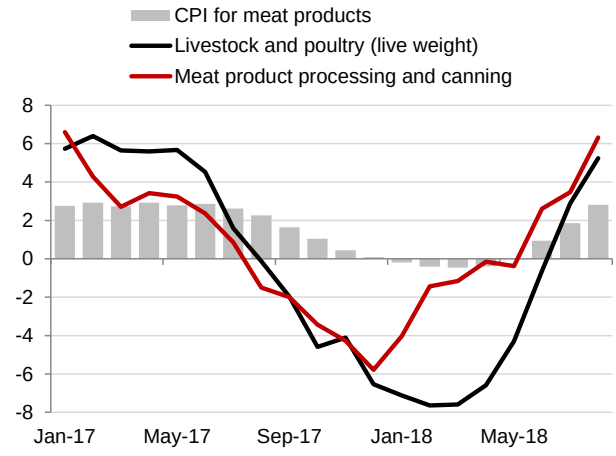
Source: Rosstat, R&F Department estimates.

Figure 14. Price changes in some goods,[6] % YoY



Source: Rosstat, R&F Department estimates.

Figure 15. Changes in consumer and producer prices of meat product producers, % YoY



Source: Rosstat, R&F Department estimates.

[6] 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 about 32% of the consumer basket.

1.2. Economic performance

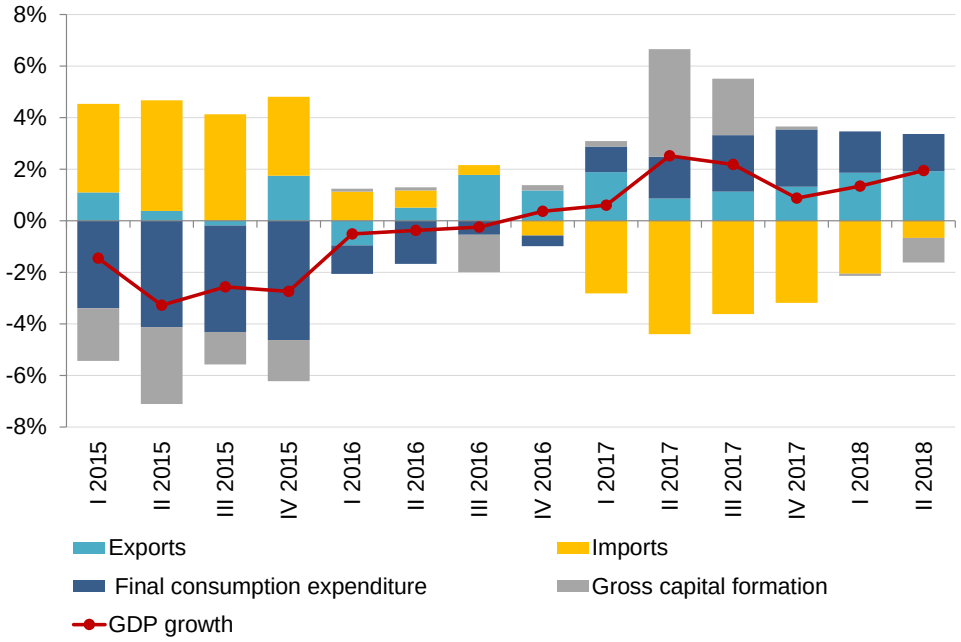
Russian economic growth is maintained at a level close to potential. Consumer demand remains a key engine of growth against a backdrop of unemployment rate stabilization at low levels, real wage growth and continued fast expansion in consumer lending. At the same time, survey data and leading indicators give reason to expect some slowdown of economic activity growth in the quarters to come. One should also bear in mind that some easing of the global economy's growth momentum in recent months will in the short term also likely hurt Russia's economic growth, which has lately enjoyed strong support from exports.

1.2.1. The second-quarter performance of GDP by end use points to the risks of some growth weakening towards the end of the year

- Rosstat confirmed its GDP growth estimate for the second quarter of 2018 at 1.9% YoY. Our updated estimate puts seasonally adjusted quarterly GDP growth at 0.5% QoQ, up from 0.4% QoQ in the first quarter.
- Quarterly GDP growth therefore accelerated in the second quarter, with the revised estimate suggesting that the actual GDP growth numbers beat initial expectations, if only by 0.1 pps.
- GDP growth acceleration benefitted from stronger net export numbers along with import correction. Given the emerging signs of a short-term growth slowdown in the global economy, export expansion will likely diminish its support for Russia's GDP performance. The third quarter may become an exception, with oil production and exports rising as the OPEC+ June agreements were implemented.
- That said, investment performance has worsened, while consumption was all but unchanged. Investment growth slowed not only year on year (down to 1.0% YoY from 1.8% YoY in the first quarter of 2018) but also quarter on quarter: second quarter investment even dropped marginally by 0.1% QoQ in seasonally adjusted terms after a token growth of 0.2% QoQ in the first quarter.
- The second quarter saw a dramatic YoY drop of inventory accumulation. As a result, this component brought about negative growth of gross capital formation in the second quarter and made a significant negative contribution to YoY GDP growth.
- A reduction in the output of the main agricultural crops this year caused a YoY crop production decline in the third quarter. This will take its toll on food production in the second half of the year, weighing down on overall economic growth to a certain extent.
- Given the high likelihood of gradual export slowdown, the weakening of investment expansion along with the stabilization of household consumption growth rate (see also Subsection 1.2.4.) points to the risks of GDP growth softening in the fourth

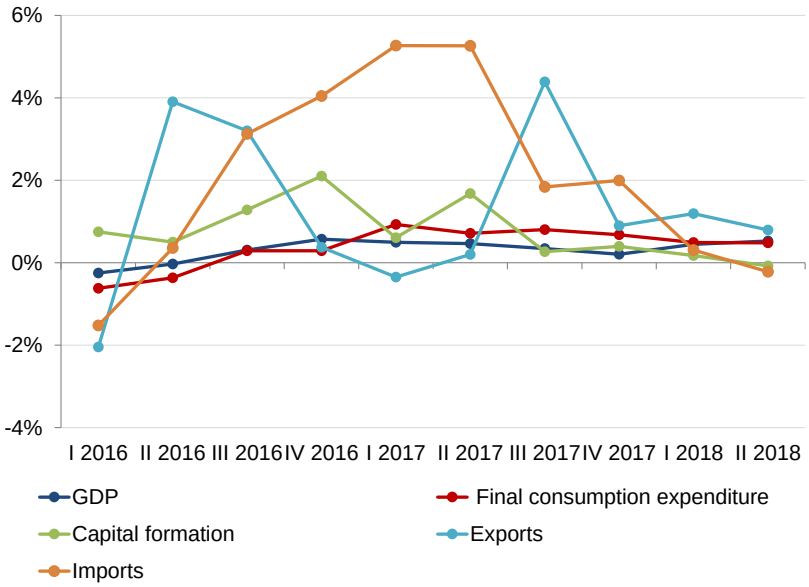
quarter. Also, the VAT hike is set to make a temporary negative contribution to economic performance in the first quarter of 2019.

Figure 16. Key components' contribution to GDP growth, pps YoY



Source: Rosstat, R&F Department estimates.

Figure 17. Growth in key GDP components, % QoQ, seasonally adjusted



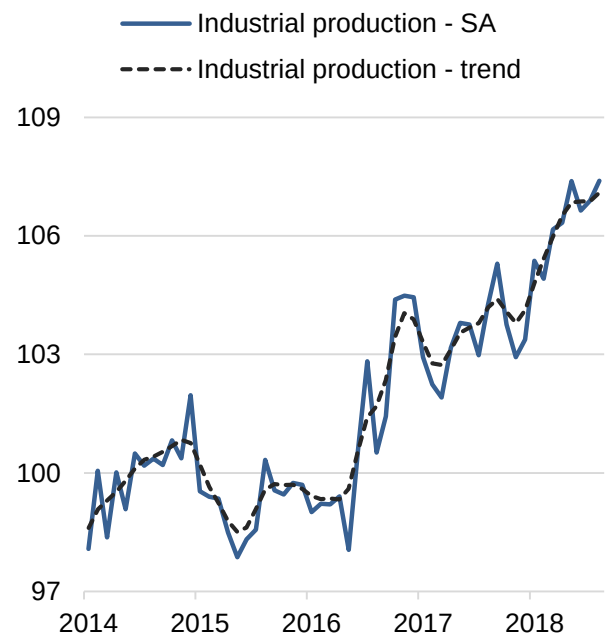
Source: Rosstat, R&F Department estimates.

1.2.2. The extractive sector led industrial output growth in the summer months

- Rosstat estimated seasonally adjusted industrial output growth at 0.3% MoM in August 2018. Research and Forecasting Department estimates August's growth rate at 0.5% MoM in seasonally adjusted terms. Overall industrial output, including the extractive and manufacturing sectors, remain on the growth path (Figures 17 and 18).
- Industry saw a change of growth leaders as of the early summer: the extractive sector's acceleration partially compensated for a slowdown in manufacturing.
- The manufacturing sector posted a growth of 0.2% MoM in seasonally adjusted terms [7] after some slackening in June–July.
- The manufacturing sector's growth was led by the machinery industries, especially motor and other vehicle production (up 7.5% MoM and 16.2% MoM respectively).
- The automotive industry expanded its output after the summer corporate vacations, responding to the upturn of consumer demand ahead of the expected car price hikes. For their part, government support programs continue to positively affect railway machinery production development.
- Food production growth (+1.2% MoM SA) continues to make a positive contribution to manufacturing sector performance.
- Sustainable growth was recorded in the woodworking industry (up 1.3% MoM, SA), the pulp and paper production (an increase of 0.2 MoM, SA), as well as the rubber and plastics industry (a gain of 1.6% MoM, SA). The positive performance of these industries is driven by steady demand from external and domestic markets along with export support measures provided by the government.
- Among August's negative factors were output contraction in major manufacturing industries: production of chemicals (down 0.2% MoM, SA), coke and refined petroleum products (a decline of 3,3% MoM, SA) and basic metals (a drop of 1,6% MoM, SA). The basic metals industry's results continue to be negatively affected by the faltering performance of nonferrous metals and nuclear fuel production.

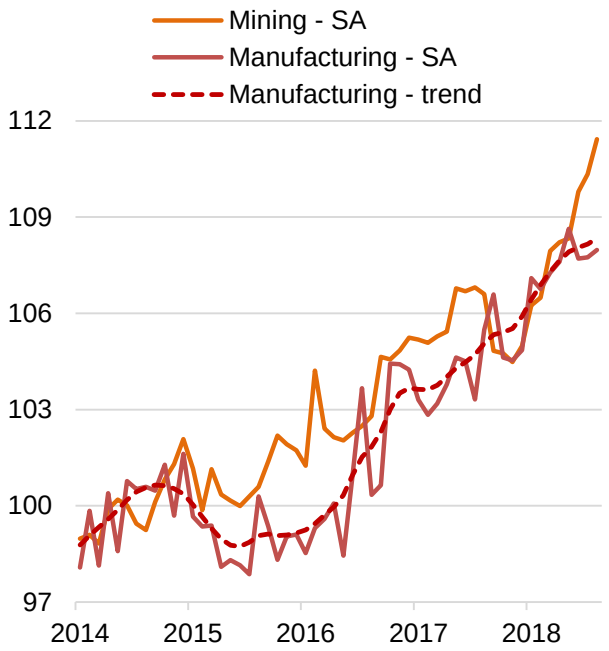
[7] Hereinafter R&F Department's seasonally adjusted estimates.

Figure 18. Industrial output index (2014 = 100)



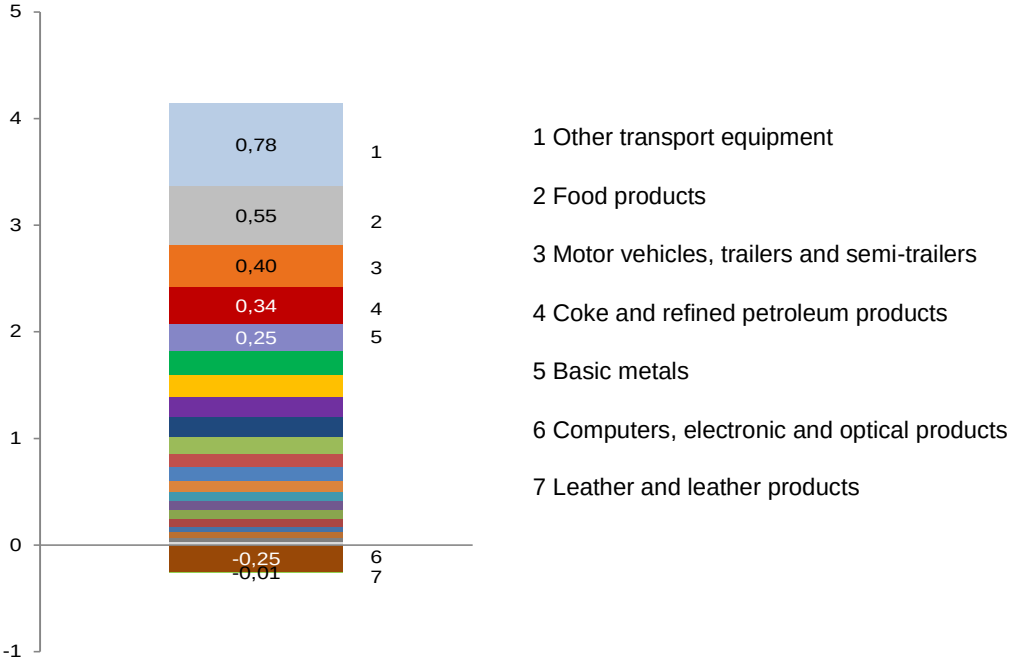
Source: Rosstat, R&F Department estimates.

Figure 19. Extractive sector and manufacturing output indexes (2014 = 100)



Source: Rosstat, R&F Department estimates.

Figure 20. Contribution of some industries to manufacturing output growth in January–August 2018, % YoY

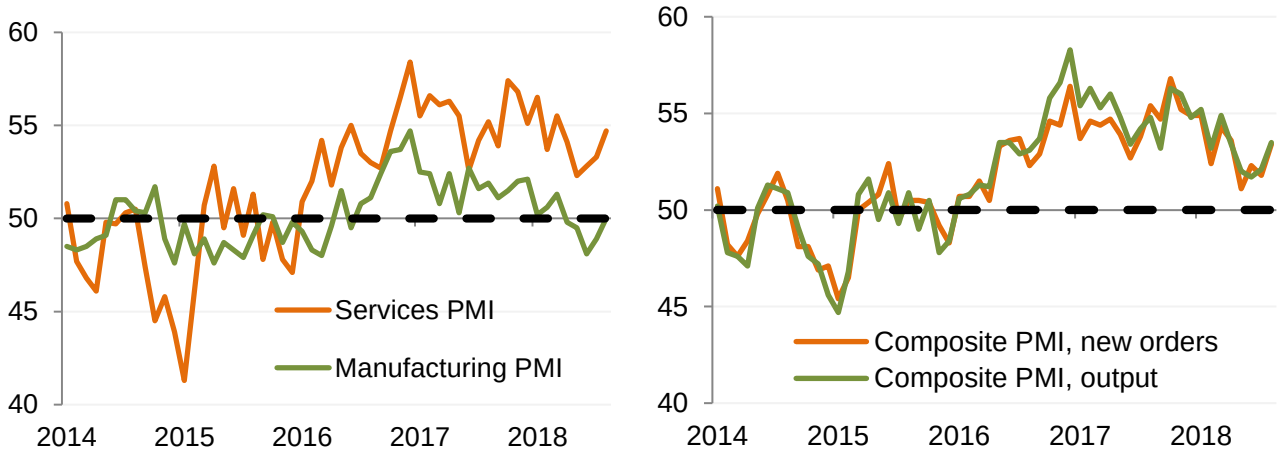


1.2.3. PMI indexes in September: marginal growth acceleration

- The performance of the PMI indexes signals some economic growth acceleration after its summer halt.
- The Services PMI Index returned to its average reading of the first half of the year, when economic growth was on the level of potential.
- The Manufacturing PMI Index left negative territory as output and new orders increased. Ruble weakening helped accelerate export order growth, which may, however, prove temporary because of the global economy's slowdown.

The latest data suggest that a marginal business activity drop in manufacturing in June–July was a temporary phenomenon. The results of the past three quarters of the year indicate the maintenance of moderate positive trends in the Russian economy.

Figure 21. PMI indexes and subindexes for Russia



Source: IHS Markit

The PMI IHS Markit for manufacturing returned to 50. A decline in output [8] and new orders came to a stop. Respondents attribute this positive performance to an increase in orders from new customers. New export orders posted an especially sizable increase, from 51 to 53.1: the upturn of demand from foreign customers may be partly owed to the recent ruble depreciation. That said, export orders in emerging markets have on average contracted as the signs of short-term growth slowdown in the global economy became evident. If this growth decline continues, the favorable effect of ruble depreciation on export orders may prove short-lived. Finally, the one-year business expectations index hit an all-time high of 73.4.

The Services PMI Index rose to 54.7 in September, suggesting the services sector's growth acceleration to the average level of the first half of the year (54.5). An increase in

[8] The relevant indexes at levels below 50.

new orders was posted in all of the five sectors and was especially pronounced in information and communications. Negative signals came from yet another employment decline (48.8) and some worsening of expectations (65.4).

1.2.4. Sales of non-food goods rise as retail lending expansion continues

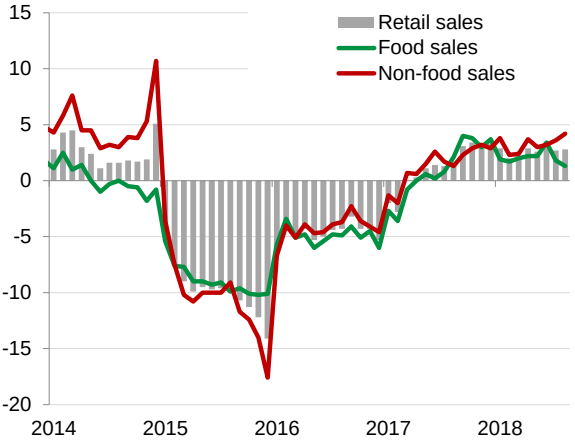
- Annual retail sales growth rate stood at 2.8% YoY in August, up from 2.7% YoY in July. Adjusted for seasonal and calendar factors, retail sales went up 0.3% MoM in August.
- The slowdown in food sales growth continued, driven partly by a tourist flow decline in July–August. We, however, believe that this may also reflect the acceleration of food price rises.
- Acceleration of non-food sales growth continued, supported by a rapid consumer lending expansion.

Retail sales added 2.7% YoY in January–August,[9] with August sales increasing 2.8% YoY, up marginally from 2.7% YoY in July (Figure 22). In the food segment, sales growth momentum continued easing to reach 1.3% YoY versus 1.8% YoY in July and 3.4% YoY in June. One can assume that the slowdown in food sales growth represents a correction following the end of the World Cup in mid-July. At the same time, inflationary pressure remains elevated in the food market. This has already started translating into household inflation expectations and may have affected consumer behavior. In the non-food segment, retail sales expansion again accelerated to reach 4.2% YoY in August, up from 3.6% YoY in July.

We estimate that, having taken a break in July, retail sales growth adjusted for seasonal and calendar factors resumed in August to reach 0.3% MoM (Figure 23). As regards food sales, after their appreciable 0.5% MoM drop in July, they stood at zero in August. Non-food retail sales growth returned to a June level of 0.5% MoM after a slight weakening to 0.3% MoM in July.

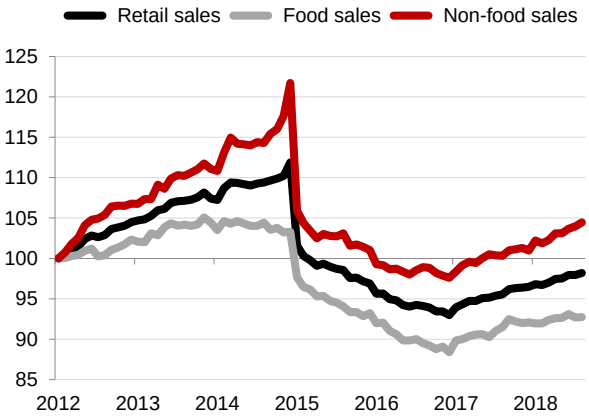
[9] Rosstat revised April–July data, as respondents provided more accurate information than previously reported.

Figure 22. Retail sales of food and nonfood goods and overall retail sales, % YoY



Source: Rosstat, R&F Department estimates.

Figure 23. Retail sales, % (January 2012 = 100%, seasonally adjusted)



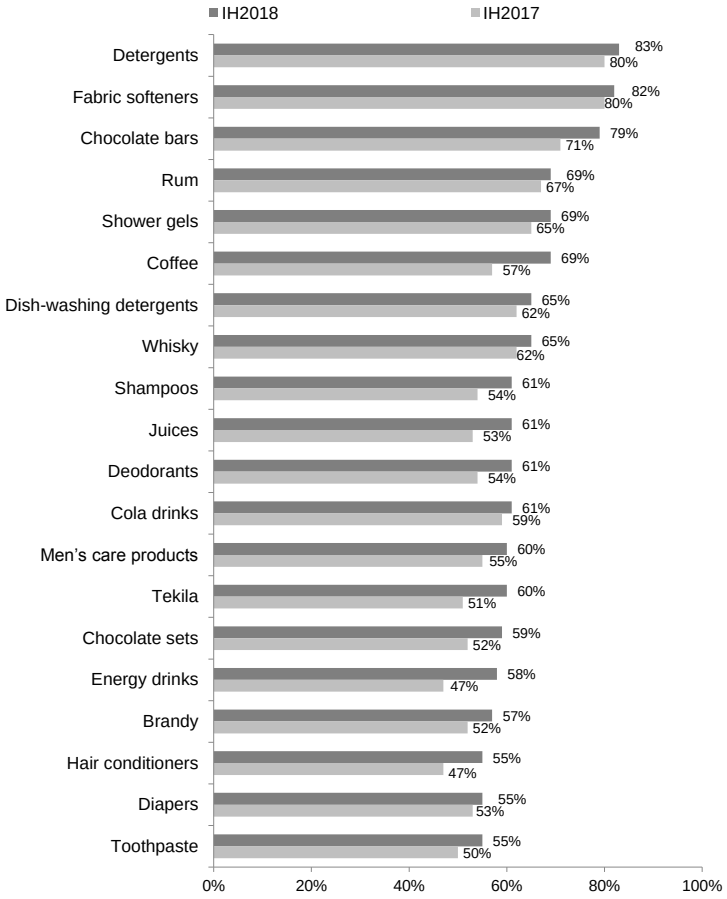
Source: Rosstat, R&F Department estimates.

In recent years, non-food sales growth has been additionally supported by discounts and shops' promo actions. Based on *Nielsen Promo Pressure* research data, discounts in the non-food category increased to 30% in the first half of 2018 from 27% a year earlier,[10] with the number of non-food items thus sold remaining unchanged. Non-food goods also continued to account for the largest share of sales as part of promo actions in total retail sales in the first half of 2018 (Figure 24).

In general, the number of items sold at a discount per modern format shop continued to rise, going up from 10 in the first half of 2016 to 14 in the first half of 2018, driven by an increase in the number of food items (from 13 to 17). Based on the above research data, the share of promotion sales continued to rise in physical terms in the first half of 2018 compared with 2017, reaching 64%, up from 58% and 53% in the first half of 2017 and 2016, respectively. The weighted average discount for food and non-food goods in the first half of 2018, however, remained unchanged from last year at 23%, whereas in 2016 it was estimated at 20%. The maintenance of the average discount at a fairly high level amid the positive profit performance in the retail sales sector may be owed to the specific features of commodity items and categories, as well as promo action types: for example, price reductions may result from purchasing a large number of goods, thereby increasing sales of a particular category of goods in physical terms. The above results may also be distorted because prices for many goods can be initially set at a higher level to allow subsequent discounts.

[10] Nielsen Promo Pressure.

Figure 24. Percentage of promo action sales in modern format shops' total sales of item categories in the first half of 2017 – 2018 (in physical terms)



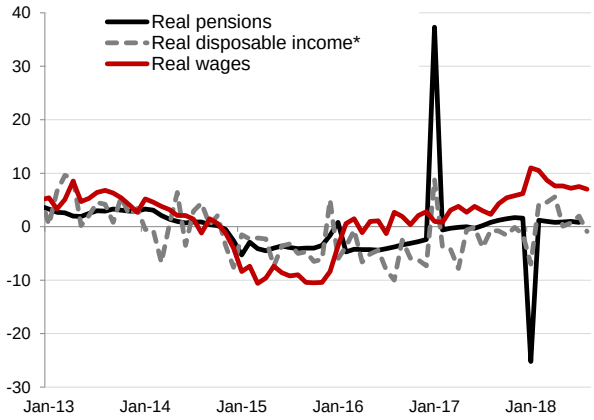
Source: Nielsen Promo Pressure.

Based on Association of Internet Trade Companies (AKIT) data[11], the forecast of transborder trade growth was revised upwards from 470 billion rubles to 750 billion rubles on the back of a significant increase in purchases at foreign online shops in the first half of 2018. The transborder segment is poised to double this year compared with 2017. Given the rising risks of local companies being pushed out of the Russian market, the threshold sum exempt from duties is planned to be lowered for purchases at foreign online shops as of next year. The imposition of a 20% duty on all of these goods is also being discussed. These measures will support domestic online shops, as they bear higher costs than foreign online companies.

Many experts believe that the impact of such a rapid transborder trade expansion on conventional trade can be both positive and negative. On the one hand, competition promotes online trade market development on the other hand, Russian companies are losing their market share.

[11] RBC. Russians have already spent over $5 billion in foreign online shops. 04.10.2018.

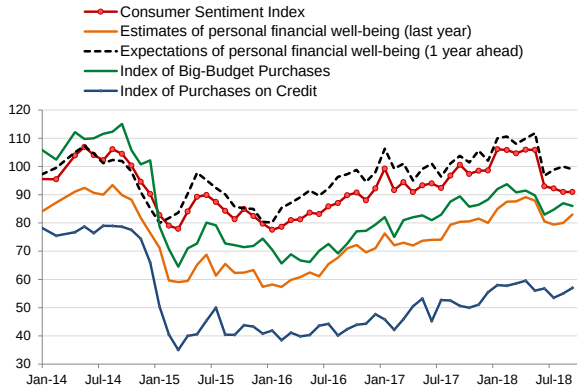
Figure 25. Real household income, % YoY



Source: Rosstat, R&F Department estimates.

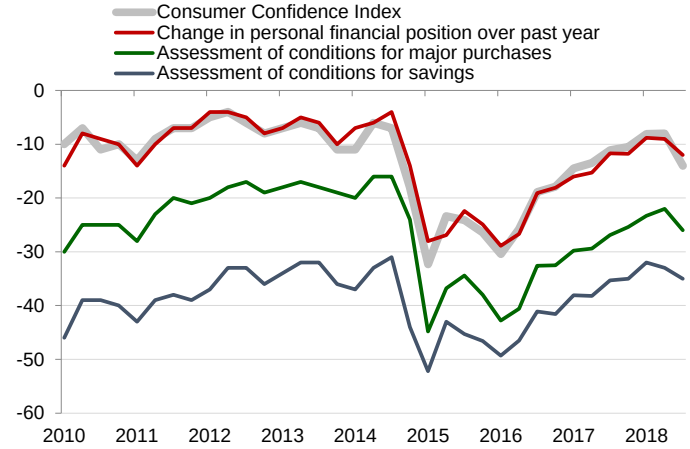
** Computed under the previous methodology including the one-off payment in January 2017*

Figure 26. Consumer Sentiment Index and its components



Source: inFom.

Figure 27. Rosstat's Consumer Confidence Index and its components



Source: Rosstat, R&F Department estimates.

Non-food retail sales growth is gaining momentum, supported primarily by the continued retail lending expansion as real disposable income stagnates (down 0.9% YoY in August, Figure 25). Based on National Credit History Bureau data, the average size of consumer loans issued in January–August rose almost 30% from the same period of last year. Meanwhile, the number of loans issued over the same period fell 0.9%.[12] Lending growth in 2018 has therefore been driven by increasing loan sums rather than by a rise in the number of borrowers, with banks stepping up lending to borrowers with a good credit history (see also Subsection 1.2.7.).

[12] The National Credit History Bureau. The number of consumer loans has been declining in 2018, with loan sums increasing. 14.09.2018.

Retail lending performance agrees with survey data. Based on inFOM data, the share of respondents who believed that it was a good time to make purchases on credit went up in September compared with both August 2018 and September 2017 (Figure 26). The pattern of answers about whether it was a good time to make major purchases remained practically unchanged. Although the share of respondents who answered in the affirmative declined slightly, the majority of them (59%) said they had spent large sums on such purchases during the year. As regards consumer expectations in general, the respondents' assessment of their financial position were unchanged, with their expectations for the future improving marginally.

Rosstat's sample survey of household consumer expectations showed that the consumer confidence index declined 6 percentage points in the third quarter compared with the previous quarter (Figure 27).

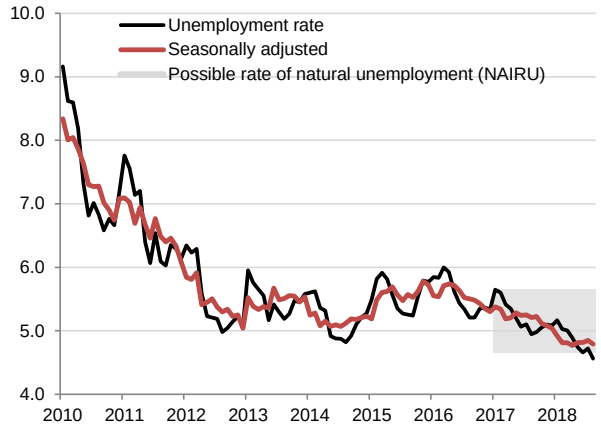
1.2.5. The labor market. Unemployment stabilizes on a low level

- The seasonally adjusted unemployment rate is still at a low of 4.8% thanks to a decline in the unemployment headcount.
- The second quarter's enlarged unemployment indicators were all but unchanged in seasonally adjusted terms from the first quarter.

Based on Rosstat data, 3.5 million people aged 15 years and older were classified as unemployed in August. The unemployment rate dropped to 4.6% from 4.7% in July, the seasonally adjusted indicator also went down to 4.8% from 4.86% in the previous month (Figure 28). The unemployment rate keeps close to the lower bound of our estimate of the natural unemployment rate, accounting for workforce shortages in the labor market.

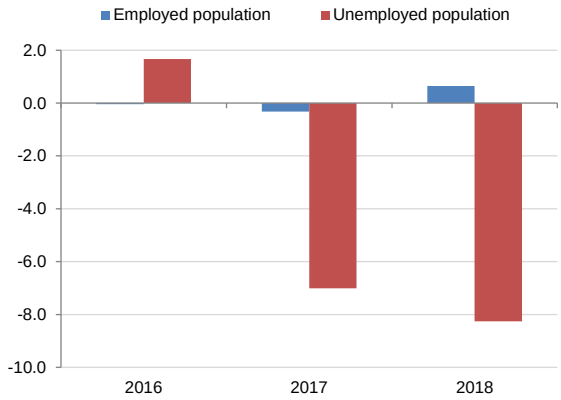
The unemployment rate is declining thanks to a decrease in the unemployment headcount, which fell more than 8% YoY from the beginning of the year (Figure 29). The employment headcount added about 1% YoY from the start of the year.

Figure 28. Unemployment and its natural rate, %



Source: Rosstat, R&F Department estimates.

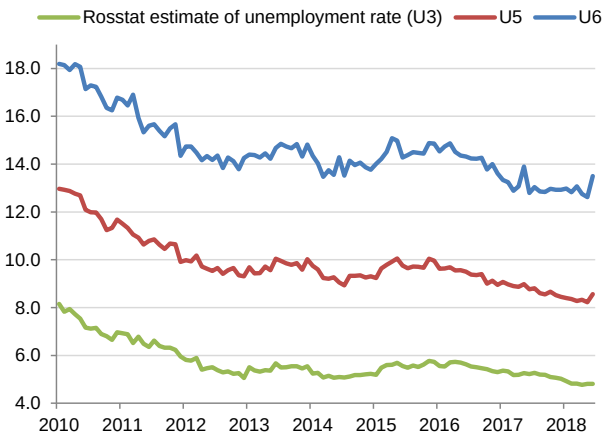
Figure 29. Change in the rate of employed and unemployed population increase in January–August, YoY



Source: Rosstat, R&F Department estimates.

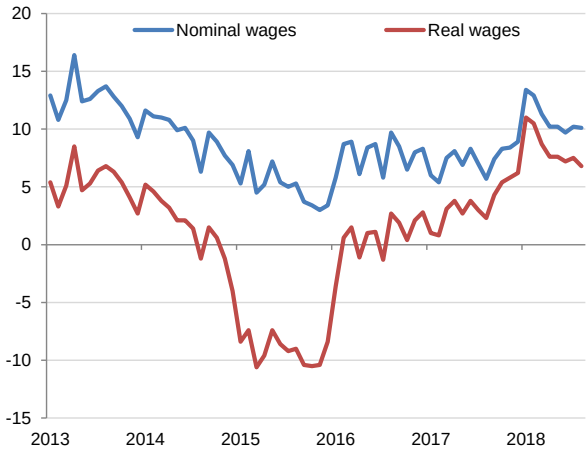
The second quarter's enlarged unemployment indicators, U5 and U6,[13] were all but unchanged from the first quarter in seasonally adjusted terms (Figure 30). June's increase in these indicators seems to be temporary, judging by unemployment rate stability in July–August.

Figure 30. Enlarged unemployment indicators (seasonally adjusted), %



Source: Rosstat, R&F Department estimates.

Figure 31. Real and nominal wage growth, % YoY

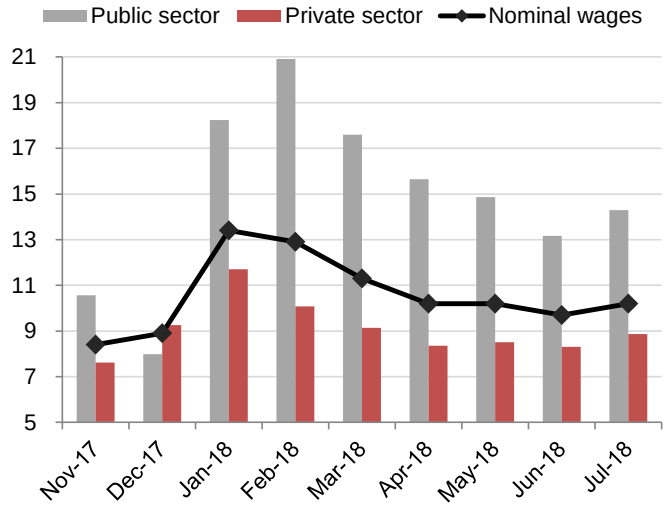


Source: Rosstat, R&F Department estimates.

[13] U3 – the official rate of unemployment;
U5 – U3 + economically inactive people who are not seeking work but are available for it;
U6 – U5 + people employed less than 30 hours a week.

Public sector wage growth accelerated to 14.3% YoY[14] in July (education and health service taking the lead), but given last year's low base, one can expect growth to slow further on. Private sector wage increases gained momentum to reach 8.9% YoY (Figure 32).

Figure 32. Rate of nominal wage growth in private and public sectors, % YoY



Source: Rosstat, R&F Department estimates.

1.2.6. The banking sector in August – an expansion in ruble lending to the economy is at its highest

- Retail and corporate lending growth reached its highest level in the current credit cycle phase but was far from growth rates seen during the 2011–2012 lending boom.
- Retail ruble and dollar deposits contracted in August owing to among other things, seasonal factors.
- Banking sector profit remained solid in August despite the rising OFZ yields.

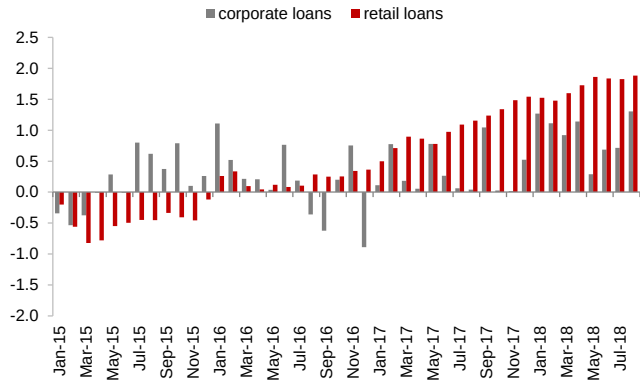
Ruble lending growth in both retail and corporate segments reached its highest level in the current credit cycle phase (Figure 33). All lending segments in the retail loan portfolio saw growth acceleration. The mortgage loan portfolio added 2% MoM[15] versus 1.9% in July, auto loans gained 1.5% MoM, up from 1.1% MoM a month earlier, unsecured consumer loans rose 1.9% MoM, an increase from 1.8% MoM for the previous month.

[14] In calculating private and public sector wages, their shares in the payroll fund were used as weights.
[15] Here and further on in the Subsection, in seasonally adjusted terms unless stated otherwise.

National Credit History Bureau data[16] indicates that the unsecured consumer loan portfolio increase stems from loan sum expansion, whereas the number of loans issued is not rising. In January–August 2018, for instance, 9.9 million loans were issued (down 0.9% YoY) for a total of 1.75 trillion rubles (up 27.7% YoY). That said, the average loan size increased as loan maturities lengthened, making debt servicing easier for borrowers (3.83 years in the second quarter of 2018 versus 3.38 years a year earlier).

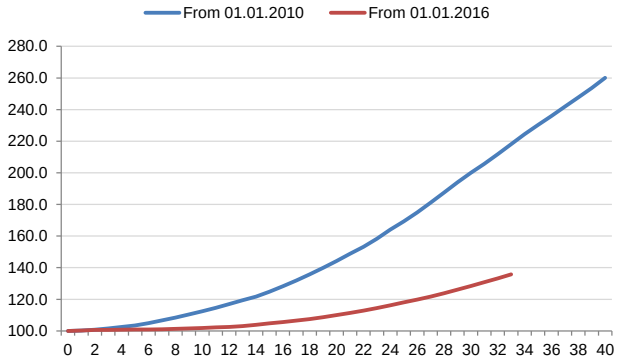
In general, prudent lending policy continues in the unsecured consumer lending segment. Based on National Credit History Bureau data, banks are extensively providing loans to household borrowers boasting a good credit history and higher income levels. The situation in this segment is radically different from banks' behavior regarding mortgage lending, which, according to the National Credit History Bureau, posts growth in both the number and size of loans, with the proportion of approved mortgage loan applications also rising. Due to banks' more prudent consumer lending policy, the retail segment's growth rates are far from those seen during the 2011–2012 lending boom, when a package of prudential measures had to be put in place so as to prevent a bubble buildup in the consumer lending market (Figure 34).

Figure 33. Ruble lending expansion, YoY (seasonally adjusted)



Source: Bank of Russia estimates.

Figure 34. Monthly accumulated retail lending growth (seasonally adjusted)



Note: The first month of retail loan portfolio growth was taken as Month 0.

Source: Bank of Russia estimates.

Raised risk coefficients for consumer loans which came into effect as of September 1, 2018, along with measures to limit mortgage lending risks already in place, may temper retail lending growth in the fourth quarter of 2018.

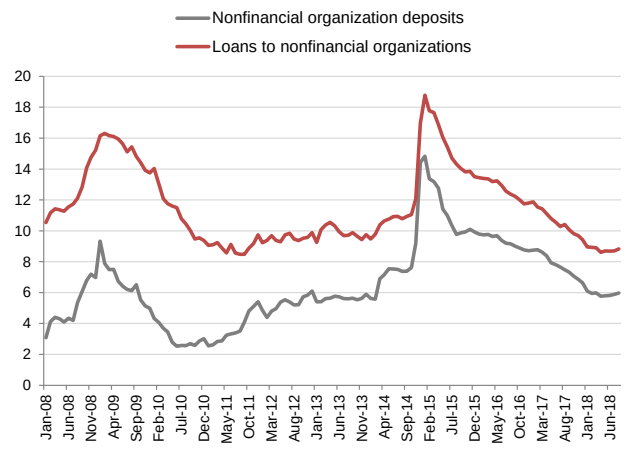
We also expect to see a more moderate corporate lending expansion on the back of the hike in the interest rate on ruble corporate loans which already took place in July–August and may still be further undertaken (Figure 35). Interest rates were raised follow-

[16] Based on data from by 4,100 providing reports to the National Credit History Bureau.

ing an upward shift in the transfer curve based on which banks set loan and deposit rates. The curve shift was in turn driven by rising OFZ yields.

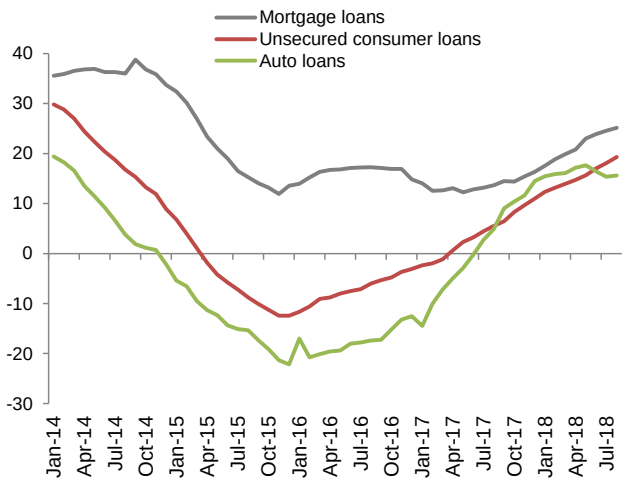
August also saw a household deposit contraction in ruble and dollar terms (adjusted for their revaluation in terms of foreign exchange). At the same time, nonfinancial organizations' ruble deposits gained 4.6% MoM in August.

Figure 35. Weighted average interest rates in Russia, % p.a.



Source: Bank of Russia estimates.

Figure 36. Growth in retail loan portfolio components



Source: Bank of Russia estimates.

Banking sector profit totaled 1.068 trillion rubles in January–September. Exclusive of banks undergoing financial resolution, the sector's profit came in at 1.3 trillion rubles. The main factor behind the losses at banks undergoing financial recovery is setting aside additional provisions.

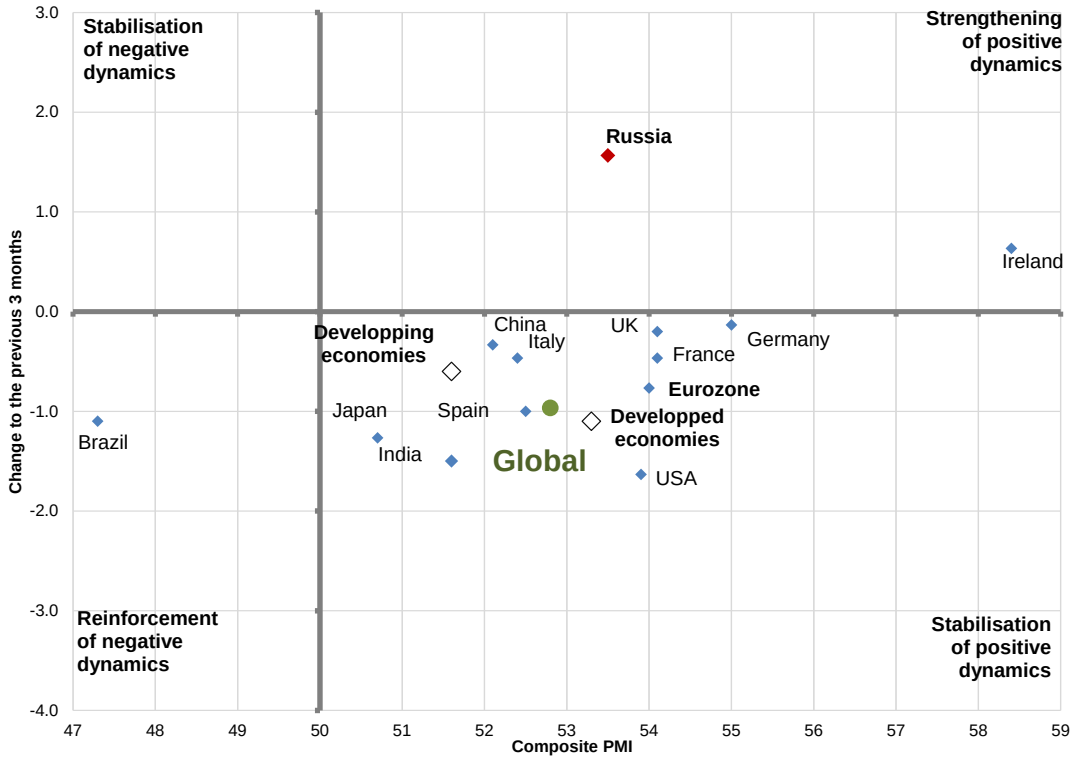
2. Outlook: leading indicators

2.1. Global leading indicators

2.1.1. Global economic growth weakened in the third quarter

The Composite Global PMI Index continued declining in September, hitting a two-year low of 52.8, down from 53.4 in August. This signals the continued slowdown of the global economy's growth, which the absolute majority of major countries, except for Russia, experienced in September.

Figure 37. September's Composite PMI and its change versus the June to August average



Sources: IHS Markit, Bloomberg Finance L.P.

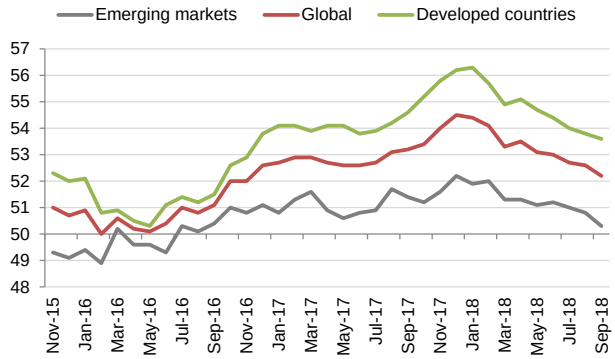
The Global Manufacturing PMI dropped to 52.2, its lowest reading since late 2016 (Figure 38). Emerging markets, which seem to have been more sensitive to the rising global trade restrictions, account for a large part of the slowdown: the emerging markets' overall export orders sub-index has stayed in negative territory (below 50) for the sixth consecutive month. Among developed countries, the U.S. sees a steady acceleration in manufacturing output growth, fueled by the continued effect of fiscal measures which is pushing domestic demand up, but developed countries' overall industrial output growth is also steadily slowing. This divergence in industrial output performance between the U.S. and the rest of the world is unlikely to last long.

The Services PMI index has also been on the downtrend in recent months, driven mainly by developed countries (Figure 39).

It seems that global growth easing recorded by short-term statistics may also take its toll on the rate of Russia's economic expansion, because exports were a key Russian GDP growth driver in the first half of the year.

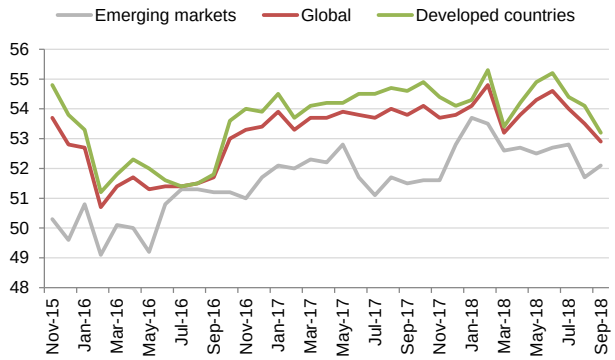
In its forecast published in October's World Economic Outlook, the IMF expects the global economy's growth to stabilize on last year's level at 3.7% in 2018–2019. Many countries have reached or approached the full employment level but their growth has become less balanced. The realization of a number of risks has caused the IMF to revise its April's projections 0.2 pps down and to expect the global economy's growth stabilization instead of acceleration. At the same time, the IMF continues to note current risks to the global economy – those of trade policy and capital outflows from emerging markets as well as risks associated with the high levels of corporate and sovereign debt. Nevertheless, global economic growth still looks steady.

Figure 38. Global Manufacturing PMI indexes



Sources: IHS Markit, Bloomberg Finance L.P.

Figure 39. Global Services PMI indexes



Sources: IHS Markit, Bloomberg Finance L.P.

2.2. What do Russia's leading indicators suggest?

2.2.1. Index-based GDP estimate: sustainable growth continues, in line with expectations

- The current GDP estimate and short-term forecasts indicate that Russia's economic growth is close to potential.
- The index-based estimate of GDP growth for the third quarter of 2018 stood at +0.4 QoQ SA in September, unchanged from August's estimate.

- A drop in the output of agricultural crop due to a less abundant harvest this year may, however, result in a slower economic growth for the third quarter than our estimates project.
- Short-terms forecasts for the end of 2018 and the beginning of 2019 point to a possible minor slowdown in quarterly GDP growth at the end of 2018 – the beginning of 2019. Based on our model estimates, this stems from a relatively weak survey data for the manufacturing sector seen in recent months.
- Our additional calculations, the above estimate, and short-term forecasts indicate a likely Russian GDP growth of about 1.7%–1.8% for 2018.[17]

	September	August
	% QoQ, SA	% QoQ, SA
Q3 2018	**0.4**	0.4
Q4 2018	**0.35**	0.35
Q1 2019	**0.3**	0.35

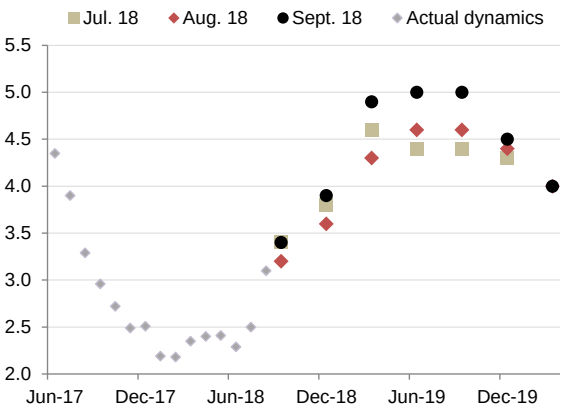
2.2.2. Analysts' inflation expectations are anchored at 4%

- Market analysts' inflations forecasts for the period until the end of 2020 reflect their strong confidence in Bank of Russia monetary policy and suggest that experts' medium-term inflation expectations are anchored at 4%.
- Analysts expect end-2018 inflation to stand at 3.9% and to accelerate to 4.5%–5.0% for 2019, given that the transient pro-inflationary effect of the VAT raise and ruble weakening will also make itself felt beyond 2018 (Figure 40). This is below Bank of Russia official forecast, projecting inflation in the 5.0%–5.5% range at end-2019.
- At the same time, uncertainty as to the magnitude of the effect of temporary factors on price rises till the year end predetermined the wide scatter of even conservative short-term inflation forecasts for the end of this year: they vary in the range from 3.8% to 4.1%, practically in line with the range of Bank of Russia official forecast under the baseline scenario (3.8%–4.2%).
- The consensus inflation forecast for 2010 equals 4%. Analysts expect the effects of ruble weakening and the VAT raise on the current price performance to attenuate and the CPI to return to the path providing for an annual inflation rate of 4%. This suggests that inflation expectations are anchored at the level of Bank of Russia inflation target.

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

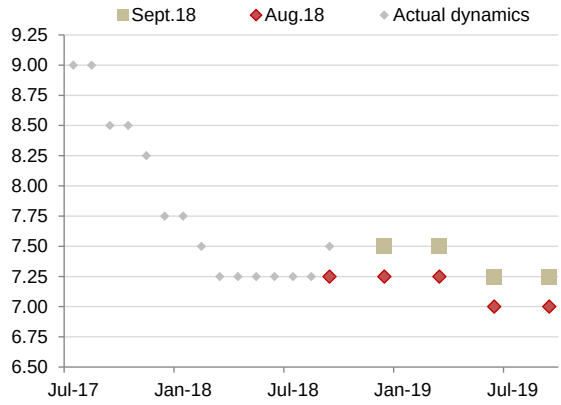
- We believe that the analysis of consensus forecasts should focus not so much on the extent of the revision (and, for example, its subsequent comparison with the Bank of Russia forecast) as on the overall direction of change in the median inflation forecast on a qualitative level – especially in relation to the 4% target. The rationale for this is that many analysts update their public forecasts less than regularly.
- The end-September consensus forecast assumes the key interest rate will be maintained at 7.50% p.a. through the first half of 2019 (Figure 41).

Figure 40. Analyst inflation expectations, % YoY



Source: Bloomberg Finance L.P.

Figure 41. Analyst expectations for Bank of Russia key rate, %



Source: Bloomberg Finance L.P.

3. In focus. Impact of the retirement age increase on public finances and the labor market

- Having encountered demographic challenges, many countries have in the last decade decided on raising the retirement age.
- The rationale provided for raising the retirement age in Russia as of 2019 is Russian population's increased actual and expected healthy lifespan. This measure aims to stabilize the share of pensioners in Russia's overall population and the country's age dependency ratio.
- This decision should slow labor force reduction in the years to come, largely compensating the adverse effect of this factor on the potential growth rate of Russia's economy. At the same time, a change in the age structure of Russia's labor force towards older generations will diminish the positive effect of the retirement age increase on the potential GDP level.
- The retirement age increase will allow accelerated indexing of the average pension benefit at a rate above inflation. Meanwhile public spending on pension payment will be gradually decreasing as a percentage of GDP, stabilizing after the transition period has come to an end. A higher demographic scenario will require larger public spending on pension payments.
- Public finances may see a revenue drop as a share of GDP in the decade to come, driven by, among other things, a likely oil price fall. To maintain the long-term fiscal sustainability, expenditure will also likely have to be cut as a share of GDP. The reduction in the age dependency ratio thanks to the retirement age increase should help address this problem.

Retirement age increase. Having encountered demographic challenges, a large number of countries have in recent decades decided to increase the retirement age. About half of OECD countries are currently in the process of raising the retirement age (Figure 42, Figure 43).[18] Unlike other countries, Russia has not yet done so.

In 2017, the increase of Russian civil servants' retirement age started, at a rate of half a year annually. But as the share of these employees in Russia' total employment headcount is just 3%, this measure will only have a minor effect on the labor market and the budget.

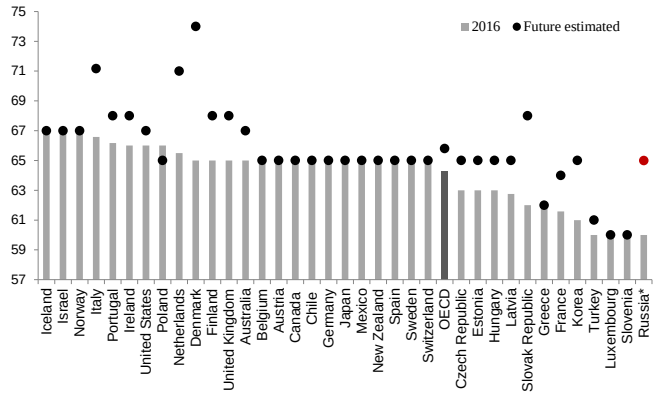
As of 2019, the annual retirement age increase will be extended to Russia's entire population. The retirement age will be gradually raised by 5 years to 65 and 60 years for men and women respectively. That said, after this measure has been implemented, Russian women's average life expectancy after retirement will be on a par with that in OECD

[18] For details of pension reforms in OECD countries, including the retirement age increase, see, for instance, in OECD (2017). Pensions at a Glance 2017: OECD and G20 Indicators. *OECD Publishing.* Paris.

countries, where the average retirement age is higher than in Russia.[19] Moreover, Russia will still be one of very few countries retaining a sizable gap between women and men's retirement age (Figure 42, Figure 43).

The transition period for the retirement age increase will last until 2028 and two years less for civil servants. People of the first two ages affected by reform (men born in 1959–1960 and women born in 1964–1965) will be entitled to retire half a year earlier than provided by new legislation. Our estimates assume that everyone entitled to that will start receiving pension benefits.

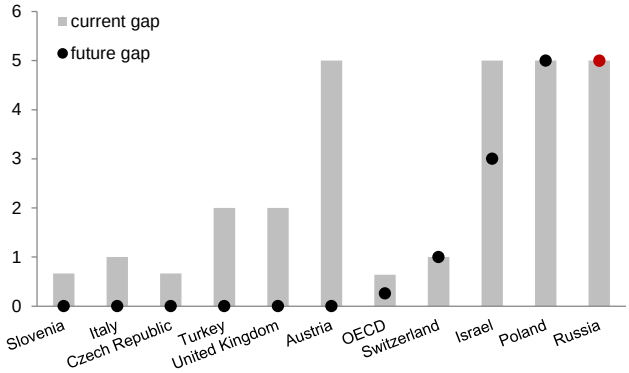
Figure 42. Current and expected calculated retirement age for men*, years



** Expected minimal retirement age for a man who entered the labor market at the age of 20 in 2016 and expecting to receive a full pension benefit.[20] A standard retirement age is indicated for Russia.*

Source: OECD (2017)[21], Rosstat.

Figure 43. Current and future gap between men and women's retirement age, years



Source: OECD (2017), Rosstat.

With the start of the retirement age increase, a simultaneous shift to retirement pension indexing at a faster than inflation rate is expected to start, i.e., the pension purchasing power will be rising. Pension benefits are expected to increase at an average rate of 1,000 rubes a year.[22]

Our estimation assumes that the current share of employed old age pension recipients and duration of their employment after reaching the retirement age are close to the levels of early 2016: 39.9% and 5 years, respectively.[23] In subsequent years, the share of

[19] For details, see Yefremov (2018). Why should the retirement age be equalized rather than raised. *Vedomosti,* July 31.

[20] The calculated retirement age takes into account country-specific features of pension systems, for example, the linking of the retirement age to life expectancy, as well as requirements for the employment length, and is based on OECD forecasts for these indicators. In Luxembourg and Slovenia, for example, people are eligible for retirement at the age of 60 subject to the condition of paying social contributions for 40 years, otherwise, the retirement age is 65 years. In Turkey, the retirement age takes into account the minimum employment length with social payments, otherwise, the expected retirement age is 65 years.

[21] OECD (2017). Pensions at a Glance 2017: OECD and G20 Indicators.*OECD Publishing.* Paris.

[22] See, for instance, Regnum. Pensions will rise at double the rate of inflation in 2019. August 29, 2018.

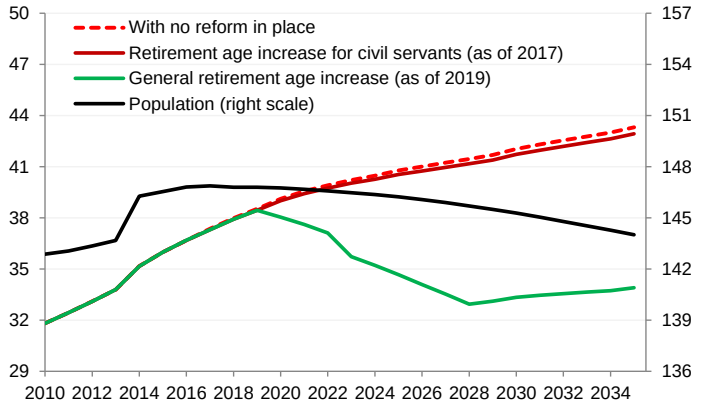
[23] According to Rosstat data, from 2001, the share of employed pension recipients gradually rose 21 pps to 36% in 2015.

employed pension recipients will be shrinking as they are increasingly included in the working age group.

Demographic scenarios. Rosstat updated its demographic forecast until 2035 in October, revising its population growth projection down from the previous, February 2018, version of the forecast, due to a fall in the number of people under the working age outpacing the dynamics in other categories because of a birth rate decline.

Under the *medium* scenario, population decreases at an accelerating pace from 2018, dropping by 2.9 million in 2018–2035 (Figure 44). Without a retirement age increase in place, the number of people of the retirement age steadily grows, with the next three years accounting for the largest increase: 1.7 million out of a 5.6 million growth over 2018–2035. The old age dependency ratio (for people above the working age)[24] increases over the entire forecast horizon, and the total age dependency ratio[25] stabilizes starting from 2025, driven by a drop in the number of people under the working age.

Figure 44. Total and retirement age population under medium demographic scenario, million



Source: Rosstat, R&F Department estimates.

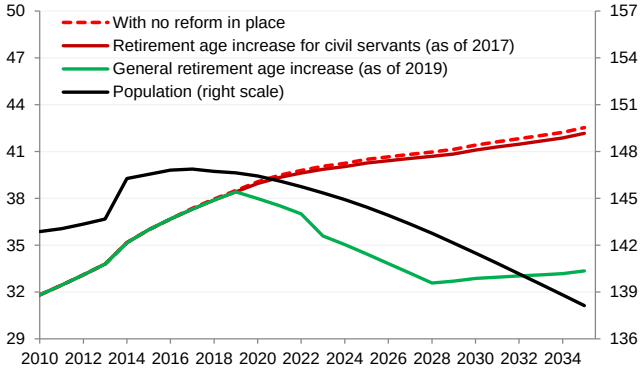
Estimates suggest that the retirement age increase helps reduce the number of people above the working age by 3.4 million in 2018–2035 and avoid a rise in the age dependency ratio. In 2035, there are 2.6 people of working age for one retired person, while under the scenario excluding the retirement age increase, this ratio would stand at 1.8. The number of retired people will decline until 2028, resuming its rise in subsequent years. As a result, the old age dependency ratio will return to the 2013 level by the end of the forecast horizon.

To analyze demographic risks, we also consider *high* and *low* scenarios. Under the *low* scenario, population is 4.1% smaller in 2035 than under the *medium* scenario (Figure 45). The *low* scenario comes up with a smaller size of all population groups, which most of all affects population under the working age, and least of all – the number of retired

[24] The ratio of the population older than the working age to the working age population.
[25] The ratio of the sum of the population older than the working age and the population younger than the working age to the working age population.

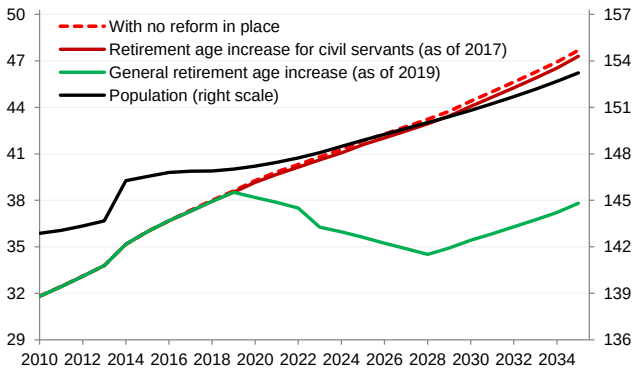
people, whose share in total population is smaller than under the medium scenario. The *high* scenario, by contrast, shows consistent population growth over the entire forecast horizon: an increase of 4.3% from 2017 to 2035 and a 6.4% rise compared with population at the end of forecast horizon under the *medium* scenario (Figure 46).

Figure 45. Total and retirement age population under low demographic scenario, million



Source: Rosstat, R&F Department estimates.

Figure 46. Total and retirement age population under high demographic scenario, million



Source: Rosstat, R&F Department estimates.

Other scenario alternatives and premises. In addition to the three demographic scenarios, we consider two scenarios of Russia's long-term economic growth: growth at a rate of 1.5% – without structural reforms, and growth above 3% over the time span until 2035 – if structural reforms accelerating Russia's potential economic growth are implemented. Based on all the estimates, a real wage rise lags real economic growth somewhat with inflation stable at 4%.

In addition to a retirement wage increase, we assumed as a baseline premise that the income replacement ratio[26] is maintained unchanged at 35% – the 2017 level.[27] For comparison, we also carry out estimates for an alternative with no retirement age increase and with pension indexing for inflation. Under the former alternative, the rates of retired and employed people's wealth growth are on average comparable, while in the latter case, the pension purchasing power does not weaken but retired people's wealth growth on average lags that of employed population. Recent years have mostly seen the latter alternative realized, but the retirement age increase should allow a shift to the former alternative.

[26] The ratio of the average retirement pension to the economy's average wage.
[27] The maintenance of the income replacement ratio is comparable with a planned annual pension increase of 1 thousand rubles under the scenario of economic growth at a rate above 3%. In 2018, the income replacement ratio declines somewhat, as wages rise at a faster rate.

Spending on retirement pension payment is calculated from the following formula:

$$PEx_t = PEx_{t-1}\left(1 + indexation\left(1 - ratio_{wp}\right)\right)\frac{N_t^{pens}}{N_{t-1}^{pens}}, \quad (1)$$

where PEx_t is spending on retirement pension payment in year t;

$indexation$ is the rate of pension indexing in year t;

$ratio_{wp}$ is the share of employed pensioners in year t;

$\frac{N_t^{pens}}{N_{t-1}^{pens}}$ is an increase in the number of people above the retirement age.

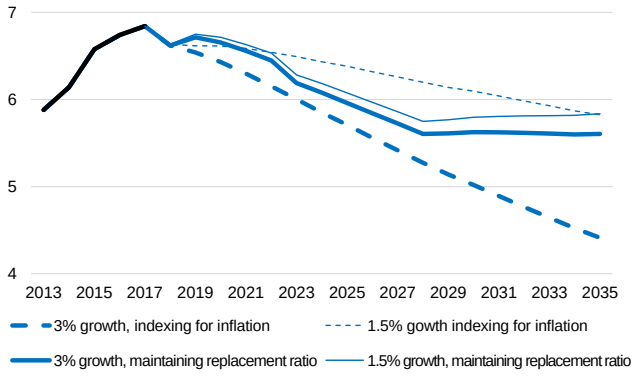
Scenario forecast of public spending on retirement pension payment. Retirement pension payments have in recent years grown as a share of both GDP and total general government expenditure to reach 6.85% of GDP and 19.5% respectively in 2017 (6.65% of GDP and 18.9% net of the one-off January payment) (Figure 47). The number of pension recipients has increased rapidly since the early 2010s, at an average annual rate of 0.8 million. Accordingly, spending on pension payment has been rising at a fast pace.

While providing for real average pension growth, the retirement age increase will allow pension spending reduction as a share of GDP, to be followed by its stabilization after 2028 under the *medium* and *low* demographic scenarios[28] (Figure 47, Figure 48). If the economy grows at a faster rate, an additional moderate pension spending reduction as a share of GDP or an additional pension increase are possible. A shift from the higher to the lower scenario increases public spending. But this should also involve an additional rise in budget revenue.

The retirement age increase will not help save budget revenue. By the end of the forecast horizon, public spending as a share of GDP under the scenarios with a retirement age increase along with the maintenance of the income replacement ratio (solid lines), does not exceed comparable indicators under scenarios with no retirement age increase and with pension indexing only for inflation (dashed lines) (Figure 47, Figure 48). Moreover, a faster pension spending growth is expected in the medium term until 2022 as a result of accelerated pension indexing starting as early as 2019.

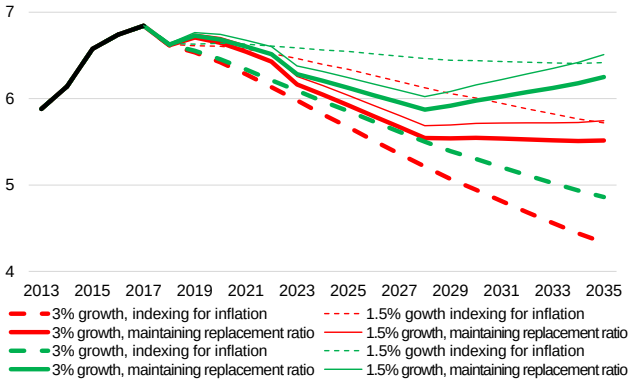
[28] The high scenario sees a resumption of growth in pension payment expenditure as a share of GDP.

Figure 47. Scenario forecast for public spending on retirement pension payment under the medium demographic scenario, % of GDP



Source: The Federal Treasury, Rosstat, Ministry of Economic Development of the Russian Federation, R&F Department estimates.

Figure 48. Scenario forecast for public spending on retirement pension payment under the low and high demographic scenarios, % of GDP



Source: The Federal Treasury, Rosstat, Ministry of Economic Development of the Russian Federation, R&F Department estimates.

Solid lines – scenarios with the retirement age increase, dashed lines – scenarios without the retirement age increase. Red lines – low demographic scenario, green lines –high scenario, Blue lines – medium scenario.

Public finances may see a revenue drop as a share of GDP in the decade to come, driven by, among other things, an expected oil price fall. In its long-term fiscal forecast, Russia's Finance Ministry expects an appreciable cut in general government expenditure as a share of GDP on the back of oil and gas revenue contraction,[29] with non-oil and gas revenue performance remaining neutral.[30] To maintain the long-term fiscal sustainability, expenditure will also likely have to be cut as a share of GDP. The reduction in the age dependency ratio thanks to the retirement age increase should help address this problem.

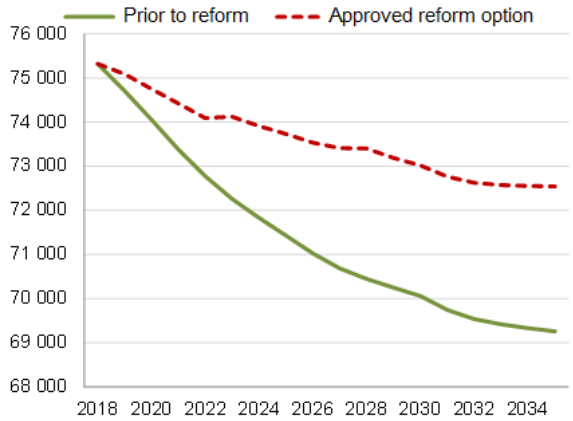
Impact on the labor market. The retirement age increase will have a positive effect on the labor market. Our estimates suggest that the stepwise retirement age increase to 65 years of age for men and 60 years for women will help slow the labor force reduction in the next 10–15 years[31] (Figure 49). The labor force participation rate will decline at an average pace of 0.3% in the next 5 years (until 2024) versus 0.8% under the scenario with no pension reform, and 0.2% in the next 10 years (2025–2034) versus 0.3% (Figure 50).

[29] Indicators affecting the absolute value of oil and gas revenue (oil and gas prices, oil, gas, and oil product production and exports, as well as the ruble exchange rate to the dollar) are expected to rise at a lower rate than GDP or even to decline from the current levels.

[30] Fiscal rule will only partially mitigate the pass-through of revenue to expenditure.

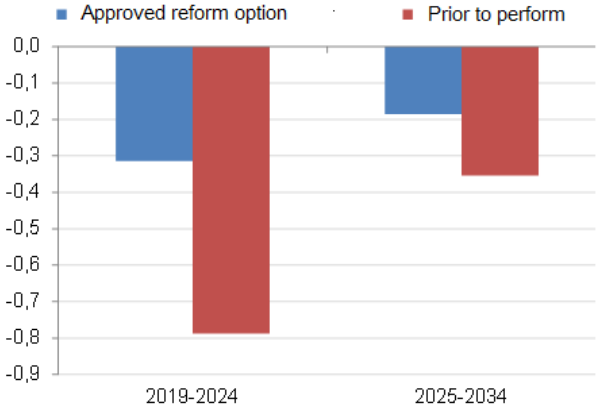
[31] All estimates presented in this subsection were carried out based on Rosstat's medium demographic scenario until 2035. Out estimation assumed that in 2028 the labor force participation rate for men aged 60–65 years will become equal to that of men aged 55–59 years in 2017, while for women aged 55–59 years this indicator will become equal to that for women aged 50–54 years in 2017.

Figure 49. Labor force estimate, Thousand



Source: Rosstat, R&F Department estimates.

Figure 50. Average annual labor force reduction, %

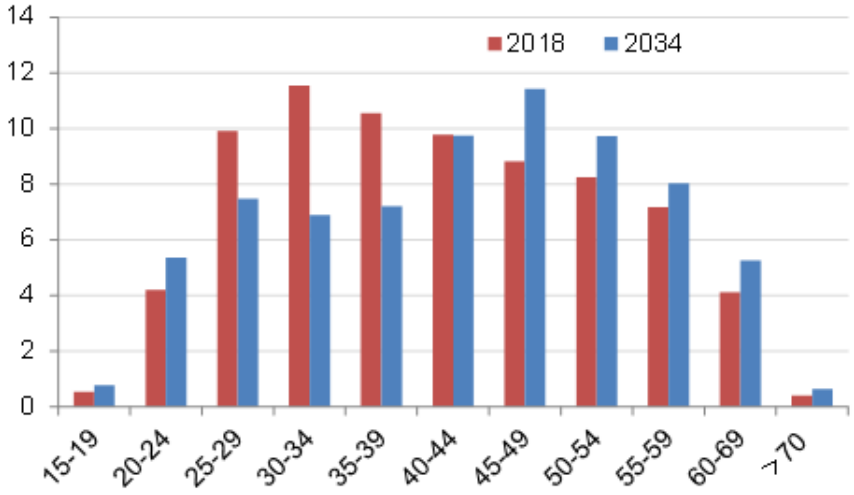


Source: Rosstat, R&F Department estimates.

The upward shift of population trajectory should bring about a comparable rise in the Russian economy's potential output, driven by a larger labor force. Still, the structural shift in the labor market will to a certain extent temper the positive effect of pension reform on potential output in Russia. The natural shift of labor force age structure towards older generations due to the current demographic situation will be amplified by the increased participation of people aged 55–65 in the labor market following the retirement age increase. As a result, the average labor force age will increase from 41.5 to 43.5 years, with the median age rising from 40 to 44 years.

The labor force ageing implies new challenges for the labor market and economic policy. The planned increase in education spending should target not only the younger generation for financing their primary, secondary and higher education but also people of middle and older ages to ensure their retraining and skill upgrading for them to better adapt to possible changes in demand from companies in the labor market. With the average age of labor market participants rising, measures to improve health service quality also remain an important factor of maintaining a high level of the labor force participation rate.

Figure 51. Labor force structure by age group in 2018 and 2034, million



Source: Rosstat, R&F Department estimates.

Also, the retirement age increase will boost the employment of women aged 55-59 years and men aged 60–64 years. Retired, they now often perform important social functions in their families, bringing up their grandchildren and taking care of disabled family members, etc. It is therefore important to take steps for the government and the private sector, including non-profit organizations, to provide such services: increase the capacity of day-care facilities, ensure flexible working hours for young mothers, enhance nursing services, etc.

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