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TALKING TRENDS
Economy and markets

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EXECUTIVE SUMMARY

1. Monthly summary

- As expected, annual inflation temporarily rose above 4% in December 2018 – January 2019, driven by one-off proinflationary factors. The monthly consumer price increase adjusted for seasonal and one-off factors is still in line with the Bank of Russia inflation target. Economic activity continued to expand, albeit at a somewhat slowed rate in recent months. Russia's financial markets were extensively recovering at the start of 2019, along with most other countries' markets, in response to the diminishing likelihood of monetary policy tightening by the Federal Reserve and ECB.
  - Fueled by the VAT hike and transient factors, inflation will likely accelerate further somewhat in the months to come before resuming its downward trend and returning to 4% in the first half of 2020. The medium-term risks of inflation upward deviation from the target are still prevalent. Bank of Russia policy helps bring down inflationary risks and maintain inflation at a level close to the target.
  - Economic growth has slowed somewhat in recent months weighed down by a number of transient factors, such as the global economy slowdown, the oil price fall and the VAT hike. The sluggish business activity performance will likely persist till the middle of the year. The continued consumer lending expansion is still supporting the consumer demand rise amid further deceleration of real wage growth and unemployment remaining consistently low.
  - The Russian financial markets' volatility generally declined after September's surge. Emerging market developments and the sanction risks remain the predominant factors behind the Russian financial market's performance.

2. Outlook

- One-off factors are set to slow GDP growth temporarily in 2019. Given the leading indicators of economic activity, this slowdown will be especially pronounced in the first half of the year.
- Analysts remain confident that inflation will go back down to 4% in 2020 after a short spike this year.

3. In focus. The 2018 results: did the Russian economy meet our expectations?

- Fueled by the rising oil prices and ruble weakening, inflation and economic growth came in higher for 2018 than we expected a year ago.

1. MONTHLY SUMMARY

1.1. Inflation

As expected, annual inflation temporarily rose to 5% at the start of February, driven mainly by one-off factors. That said, the impact of the VAT hike on January's price rises was moderate at about 0.3–0.4 pps, based on a preliminary estimate. The VAT increase will, however, continue to affect the rate of consumer price rises in the months ahead.

Short-term pro-inflationary risks have generally declined, remaining, however, elevated due to the still continuing pass-through to prices of ruble weakening against the major currencies and to the VAT base rate hike. The increase of the consumer price index's components that are only weakly sensitive to transient factors stabilized in December at a level corresponding to an inflation rate of 4%, suggesting a decline in short-term pro-inflationary risks.

Thanks to the weakening of short-term pro-inflationary risks, inflation will most likely stand close to the lower bound of the Bank of Russia's forecast range of 5.5%–6.0%.

But the continued recovery in the parity of relative prices after the slowed food price rises in 2018 suggests that the latter may rise faster than non-food prices further on in 2019.

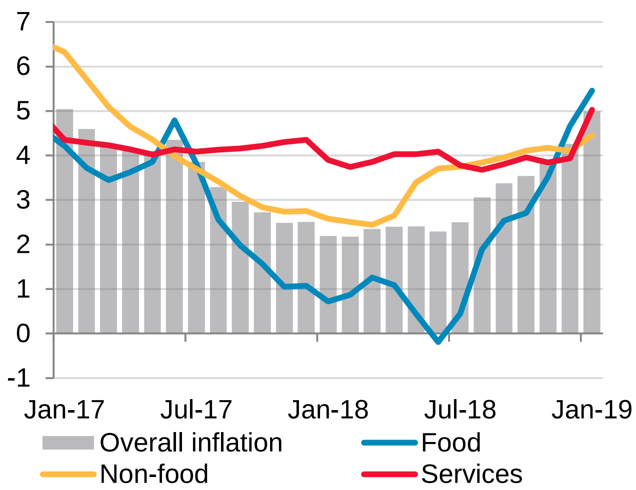
On the short-term horizon, pro-inflationary risks prevail over disinflationary ones. Among the key pro-inflationary risks are geopolitical factors and financial market volatility surges, the upward pressure on prices of the accelerating consumer lending growth, a rise in business and household inflation expectations, and the increasing workforce shortages in the labor market.

1.1.1. Effect of the VAT hike on prices is so far moderate

- Annual inflation temporarily rose to 5.0% in January from 4.3% in December. This was to be expected given the VAT hike and the low rate of food price rises in January last year compared with the usual seasonal trends.
- Consumer prices went up 1.0% MoM in January, or 0.8% MoM in seasonally adjusted terms, up from 0.6% MoM in December.
- Overall, the contribution of VAT to January's consumer price rises was moderate at about 0.3–0.4 pps. The major retail chains' desire to spread price hikes over time and make them less obvious in a situation of the slow consumer demand growth, seems to have held back a more extensive pass-through of the VAT hike to consumer price rises. On top of that, January's ruble strengthening generated downward pressure on the prices of some goods and services, partially offsetting the effect of the VAT increase.
- As inflation expectations rose, household consumer sentiment worsened. This may hamper growth in durable goods sales, restraining price rises in this category.

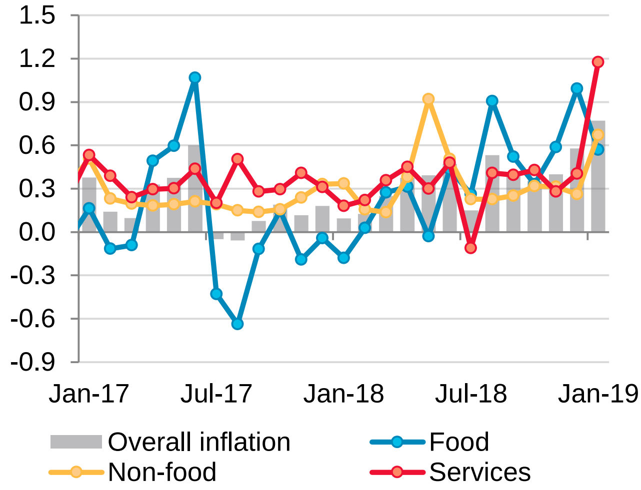
Inflation stood at 5.0% in January, up from 4.3% in December (Figure 1). The monthly price rises came in at 1.0% MoM, or 0.8% MoM in seasonally adjusted terms (Figure 2). Consumer price rise acceleration was expected given the VAT base rate increase from 18% to 20% as of January 1, 2019, and the low base of January last year (Figure 3).

Figure 1. Inflation and its components, % YoY



Source: Rosstat.

Figure 2. Seasonally adjusted price rises, % MoM



Source: Rosstat, Bank of Russia estimates.

The annual food price increase came in at 5.5% in January, climbing from 4.7% in December. Food price inflation acceleration was owed mainly to fruit and vegetable prices, which rose 7.3% in January versus 4.9% in December and 0.8% in November. January saw cucumber and tomato prices stop to decline in annualized terms on the back of the low base of January last year (Figure 4). Cucumber and tomato price movements are highly volatile but the expansion of production in greenhouse facilities should help gradually reduce this volatility. Based on the Agriculture Ministry's forecast, greenhouse vegetable crop will stand at 1.3 million tons for 2019, a 0.2 million ton increase from an all-time high of 2018.[1] According to the ministry's estimate, agreeing with that of the National Union of Fruit and Vegetable Producers, prices of greenhouse-grown vegetables will not rise above headline inflation in 2019.

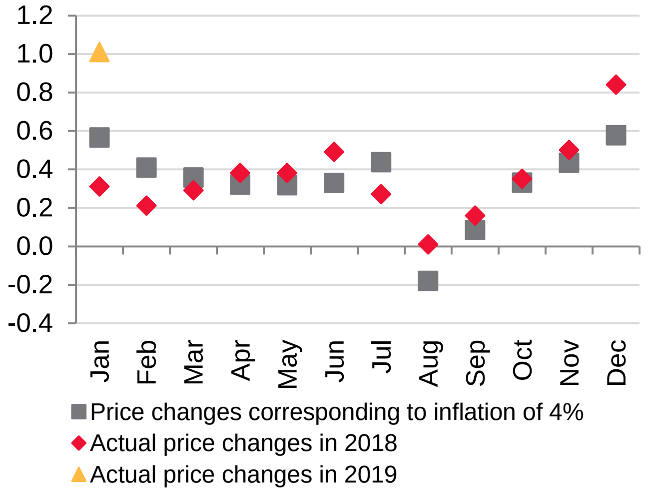
Exclusive of fruit and vegetables, food price rises accelerated to 5.2% YoY in January from 4.6% YoY in December. This reading stood above overall inflation for the second consecutive month. At the same time, inflationary pressure declined: the pace of price hikes slowed for eggs some meat and meat product categories, and bread.

The annualized rate of nonfood price rises accelerated marginally to 4.5% in January from 4.1% in December, with prices of some medication types showing an especially notable increase. In 2019, pharmaceutical prices are set to be adversely affected by the earlier ruble weakening, introduction of labeling, and higher electricity and logistical costs in the wake of the VAT hike. That said, prices of pharmaceuticals from the vital and essential drug list are

[1] Greenhouse vegetable crop is projected at 1.3 million tons for 2019 / The official Ministry of Agriculture website. 22.01.2019.

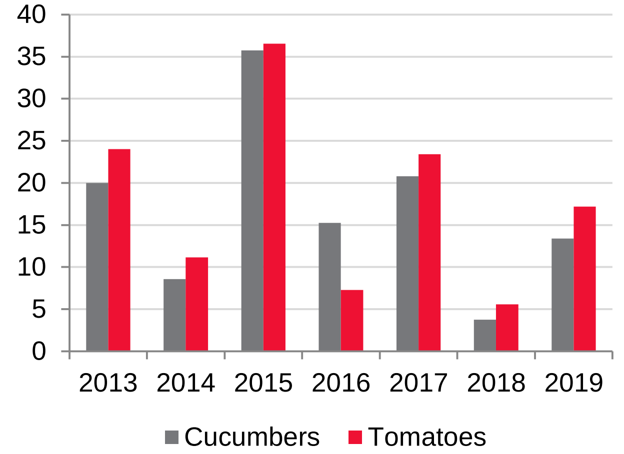
supposed to rein in inflation in the pharmaceuticals market, as they are subject to government regulation, with these drugs accounting for about half of medications sold in the Russian market.

Figure 3. Price rises corresponding to an inflation rate of 4 percent, % MoM



Source: Rosstat, R&F Department estimates.

Figure 4. Cucumber and tomato price rises in January, % MoM



Source: Rosstat.

With VAT raised, petrol prices rose 0.8% MoM, thus falling short of the 1.7% ceiling set in the agreement between the RF Government and oil companies. January's price hikes were restrained by the seasonal drop in demand and petrol glut in the domestic market, as petrol was no longer delivered to Kazakhstan and Belorussia, while major end users of petrol beefed up their inventories at the end of last year ahead of dramatic price hikes they expected in January.[2] Under the current oil prices, risks of dramatic acceleration of oil product price rises are viewed as insignificant.

January's ruble strengthening created downward pressure on some goods and services prices, partially compensating the VAT hike effect.

Services showed a notable acceleration of the annual rate of price rises, which went up to 5.0% in January from 3.9% in December. Among the services tracked by statistics, the housing and utilities sector was one of the hardest hit with prices rising 2.3% MoM there. Meanwhile prices of communal services covered by the plan for the first stage of indexation[3] rose 1.5%–1.9% MoM. Garbage collection prices outpaced the overall rate of indexation, rising 43.4% MoM and 52.3% YoY. The rates for garbage collection rose faster than the sector's other prices.[4] Exclusive of this category, prices of housing and communal services climbed 1.6% MoM in January. Given the weight of housing and utilities services in the bas-

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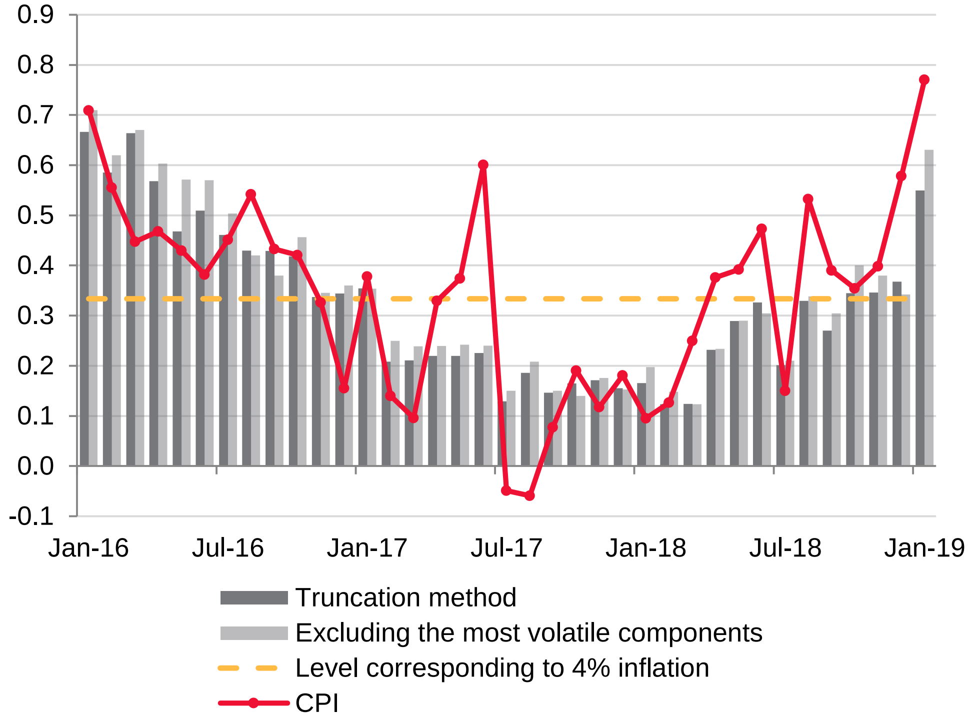
[2] Exchange petrol prices slumped 2–3% over one week // Interfax. 01.02.2019.
[3] In view of the VAT hike as of January 1, 2019, the government provided for a two-stage indexation of housing and utilities services prices in 2019 – by 1.7% as of January 1 (taking into account the effect of the VAT hike), and by further 2.4% as of July 1.
[4] Under the new rules for waste collection and disposal implemented in 69 regions as of January 1, the payment for the housing and utilities services includes the new item, *collection of communal waste,* which Rosstat included in the CPI calculation as of the start of 2019.

ket used for calculating the CPI in 2019, the contribution of garbage collection price rises to overall consumer price inflation totaled 0.07 pps in January.

Figure 5. Modified core inflation indicators, % MoM



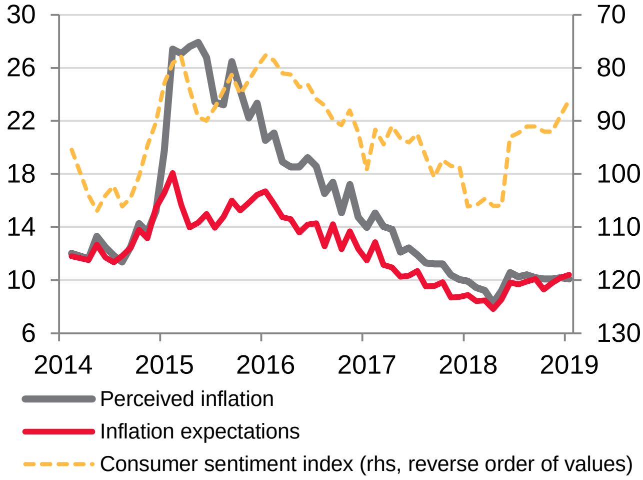
Source: Rosstat, R&F Department estimates.

Overall, the effect of the VAT hike on consumer price rises was moderate in January, as suggested by the restrained pace of price movements in nonfood goods and unregulated services subject to VAT at a base rate of 20%. The contribution of VAT to January's price rises can be preliminarily estimated at 0.3–0.4 pps. The less than full pass-through of the VAT increase to retail price rises likely stems from retailers' desire to smooth out the price jump, i.e., to spread it over time, making it less obvious to the consumers. Moreover, if the VAT hike has already been passed through to the input prices (see Subsection 1.1.3. PMI price indexes: the VAT hike temporarily accelerated price rises), then retailers are smoothing out the change in their prices at the expense of their margin.

It appears that the VAT pass-through to retail prices will take longer than previously expected, with its resulting contribution to inflation close to the lower bound of the earlier estimated 0.6%–1.5% range.

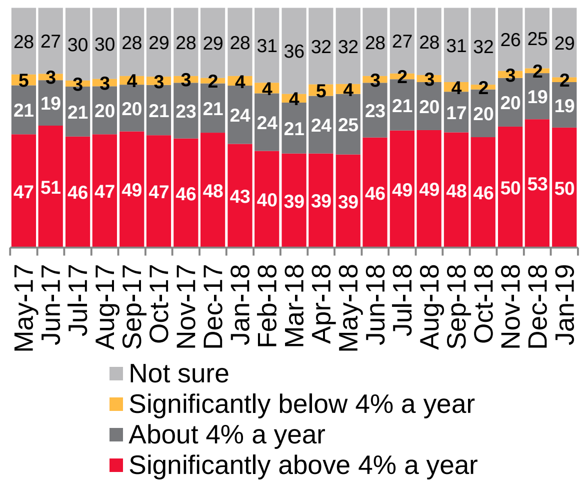
The estimates of core inflation modified indicators rose to 0.5%–0.6% MoM (Figure 5). The performance of these indicators is also affected by the VAT increase. In particular, it can give an approximate idea of a scale of the VAT pass-through to retail prices. Given the transient nature of the VAT hike effect on price rises, an increase in the modified core inflation indicators cannot, at this point, be interpreted as mounting of persistent inflationary pressure in the economy. At the same time, if these monthly indicators remain elevated in several months' time, this can suggest the presence of the persistent secondary effects of VAT in the consumer price performance.

Figure 6. Median estimates of perceived inflation and household inflation expectations, % YoY



Source: inFOM.

Figure 7. Inflation expectations over a three-year horizon[5]



Source: inFOM.

Based on the data of inFOM survey conducted on January 11–18, the estimate of household inflation expectations in one year's time marginally rose further to reach 10.4%. That said, the estimate of perceived inflation remained all but unchanged at 10.1% (Figure 6). Expected inflation therefore exceeded perceived inflation for the first time since the end of 2014. Previously, the respondents expected inflation to decline somewhat from its current level, whereas now they believe price rises will gain pace. The respondents still cite the VAT hike as one of the key factors behind future inflation. The occurrence of opinions that inflation accelerated on the back of rising petrol prices also increased in frequency.

As inflation expectations rose, household consumer sentiment worsened. This may hamper growth in durable goods sales, containing price rises in this category.

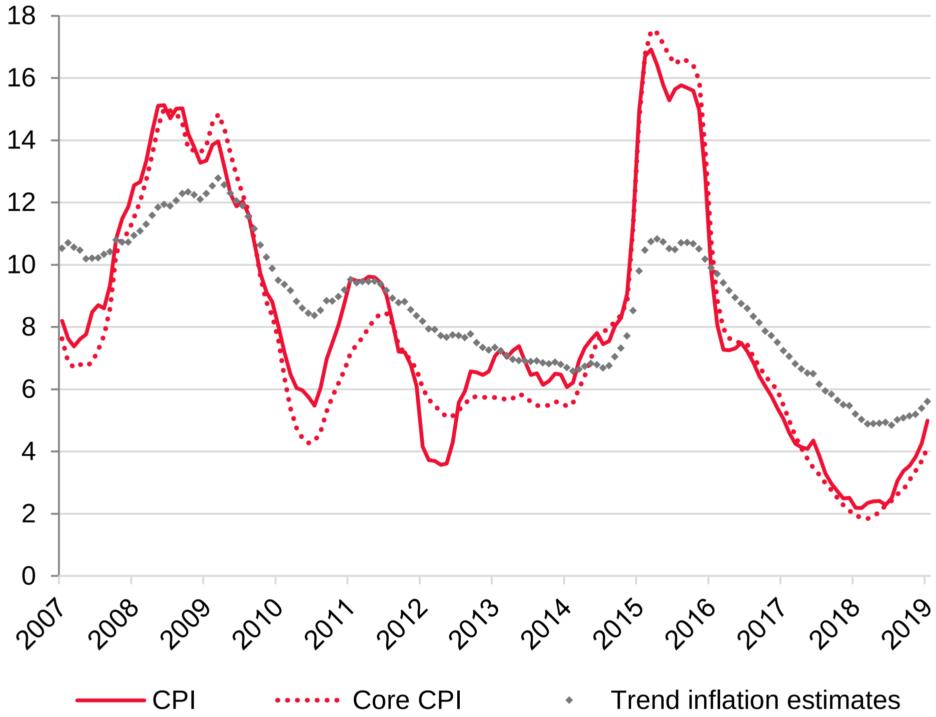
Despite the rise of short-term expectations, long-term inflation expectations declined somewhat relative to the December 2018 level (Figure 7). The share of respondents expecting inflation appreciably above 4% in the long term (in three years' time) dropped in January. This result can, *on the one hand,* be attributed to the remaining high sensitivity of household inflation expectations to transient factors. *On the other hand,* it may well be that respondents mostly report elevated long-term inflation expectations as price rises are accelerating notably, providing milder estimates after price increases have stabilized.

[5] Distribution of answers to the question "Do you think annual inflation will stand above or below 4% in three years' time? Or will it stand at about 4% annually?"

1.1.2. Trend inflation gained pace in January

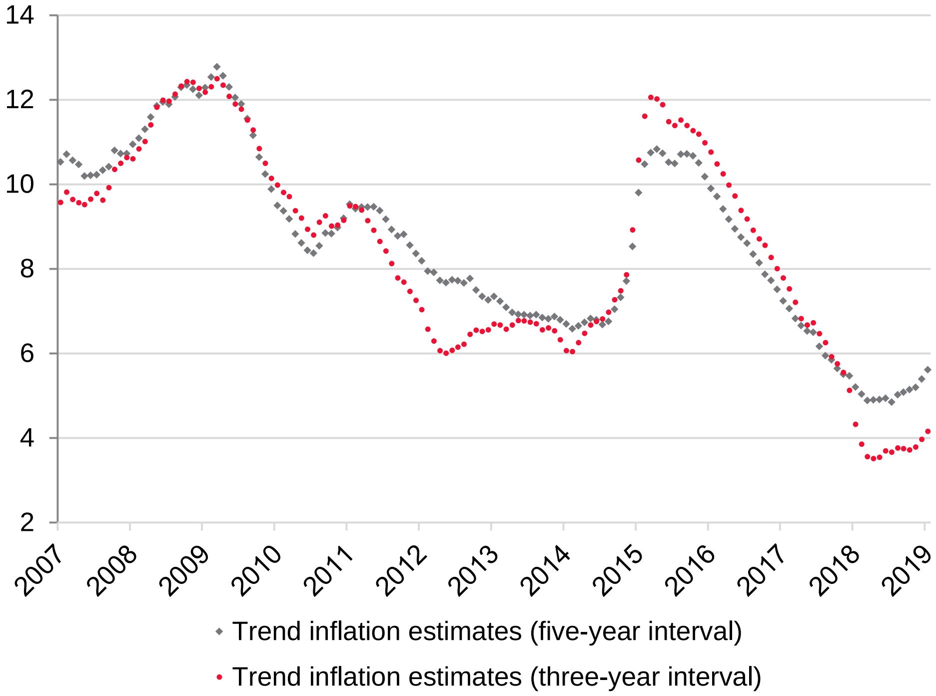
- The estimate of annual trend inflation went up to 5.61% in January 2019 from 5.40% in December 2018.
- The methodology of trend inflation calculation allows for an occasional response of the estimate to the temporary factors of price performance. These include, among other things, the VAT hike, which triggers price rises in goods and services used to calculate trend inflation. This circumstance in large part accounts for January's increase in the trend inflation estimate.
- The slower rate of trend inflation than the much faster pace of consumer price rises indicates the prevalence of temporary factors in annual inflation acceleration.
- The estimate of trend inflation over a shorter three-year interval stood at 4.16%, signaling that price rises in the most stable CPI components were close to the inflation target in January 2019.
- Trend inflation acceleration above 4% over a three-year observation window likely stems from the VAT increase. Trend inflation acceleration in January cannot therefore be interpreted as mounting of persistent inflationary pressure.

Figure 8. CPI, Core CPI and Bank of Russia historical estimates of trend inflation, % YoY



Source: Rosstat, R&F Department estimates.

Figure 9. Estimates of trend inflation calculated on a five- and three-year rolling period, % YoY

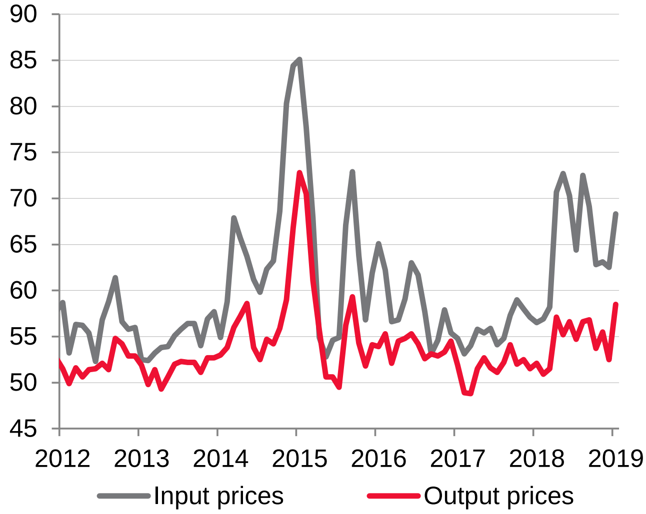


Source: Rosstat, R&F Department estimates.

1.1.3. PMI price indexes: the VAT increase temporarily accelerated price rises

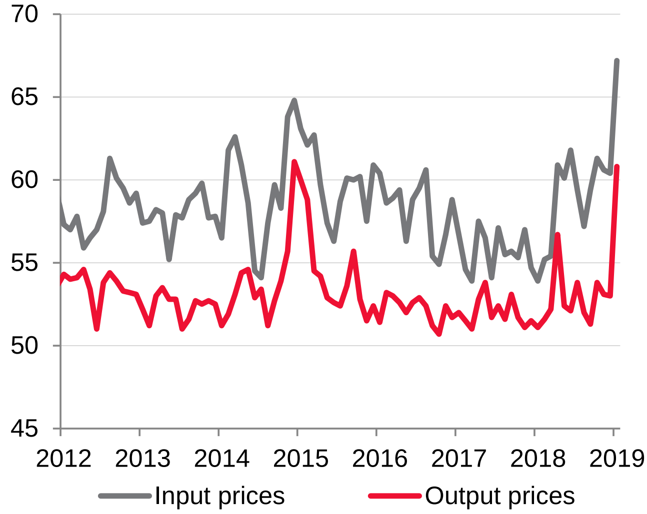
- The PMI output price index rose to the highest level since September 2015 in manufacturing, posting the highest reading since December 2014 in services. Respondents cite the VAT rate increase as the key trigger of price rises.
- Services saw the highest index of input prices since September 2008. In addition to the pass-through of the VAT hike, respondents cited fuel price rises and wage growth as the causes of cost increases.
- We view the price rise acceleration as a temporary development. A decline in the price indexes can be expected in the months to come unless new cost side shocks emerge.
- Our estimates point to the moderate effect of the VAT increase on retail prices in January. The major retail chains were able to temporarily sacrifice their margin by extending the period of retail price adjustment to the VAT hike. The contribution of the VAT rate change to inflation may show to be close to the lower bound of the initial estimate range but more extended over time.

Рисунок 10. Manufacturing PMI price indices



Source: IHS Markit.

Рисунок 11. Services PMI price indices



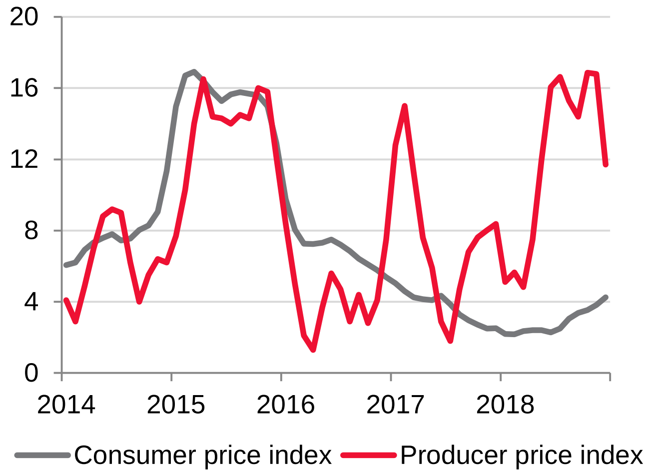
Source: IHS Markit.

1.1.4. Oil price drop expectedly slowed producer price rises in December

- Based on Rosstat data, the annual rate of producer price rises expectedly slowed to 11.7% in December from 16.8% in November (Figure 12). The key factor behind the price rise deceleration was producer price movements in the extractive sector.
- Crude oil and oil product prices dropped to 12.1% MoM and 9.7% MoM respectively over December, following a decline in world oil prices. Given the normal lag, we assume that the fall in the energy producer prices continued in January. We estimate that the retail oil product prices are now in line with the current world oil prices, hence the producer price drop will not have a significant effect on prices at petrol stations.
- Producer price rises for the basket of representative consumer goods[6] are still outpacing consumer price increases, but the gap narrowed in December (Figure 13). Producer price hikes slowed in meat processing and sugar production – these industries used to lead the acceleration of producer price rises.

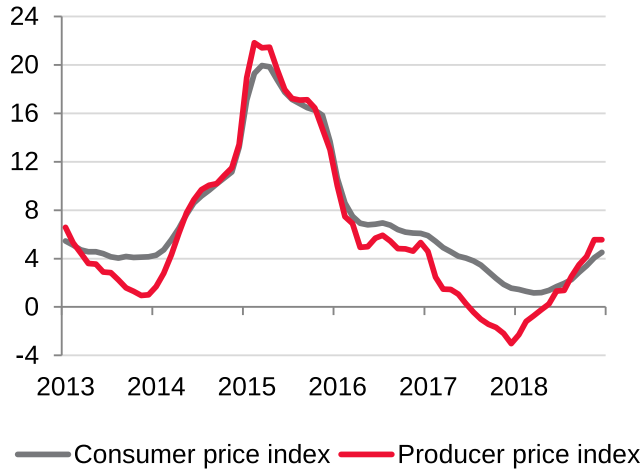
[6] Goods included in both PPI and CPI calculation.

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



Source: Rosstat.

Figure 13. Price changes in some goods[7], % YoY



Source: Rosstat, R&F Department estimates.

1.2. Economic performance

Russia's economic growth stalled somewhat at the end of 2018. Short-term negative factors, such as the easing of the global economy's growth momentum, the oil price fall, the VAT hike, and inflation acceleration, will likely slow growth for a while in the first half of 2019. With the negative factors running their course and budget spending stepped up in the second half of the year, economic growth will receive new impetus unless major new external shocks emerge.

1.2.1. Growth is viewed as close to potential in 2018

- Based on Rosstat's first estimate, GDP growth accelerated to 2.3% in 2018, largely helped by an upward revision of construction performance, which could have been technical in nature.
- We tend to believe that actual GDP growth could have been slower in 2018 and faster in 2016–2017 than current statistical estimates suggest. Indirect evidence of that is provided by a number of factors, such as the specifics of the stages of revision to and updating of statistics by Rosstat, the analysis of leading macroeconomic indicators and other measures of economic activity, as well as our model-based estimates.

[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, electronic household appliances, and furniture. They account for about 32% of the consumer basket.

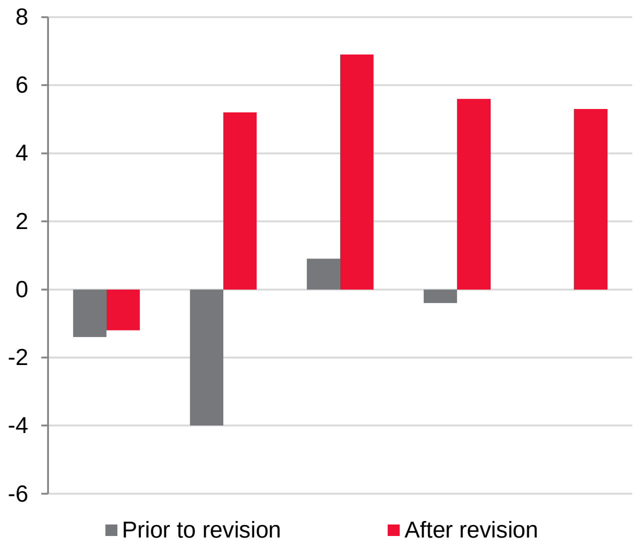
- In view of the uncertainty owed to the above factors, especially regarding subsequent revisions to the figures of GDP and its components, it would at this point be reasonable to estimate GDP growth in the range of 1.7%–2.3% for 2018.

Rosstat's first estimate puts GDP growth at 2.3% for 2018, up from 1.6% in 2017. This is the fastest growth rate since 2012.

According to the data on GDP components by use, the stronger goods and services exports in physical terms than in 2017 were able to compensate the weakening of investment and consumption accompanied by an import growth slowdown. Based on the structure of GDP by output under Rosstat's current statistics, GDP growth acceleration benefitted from an improvement in the performance of the extractive sector, wholesale and retail trade, transportation and storage, and construction.

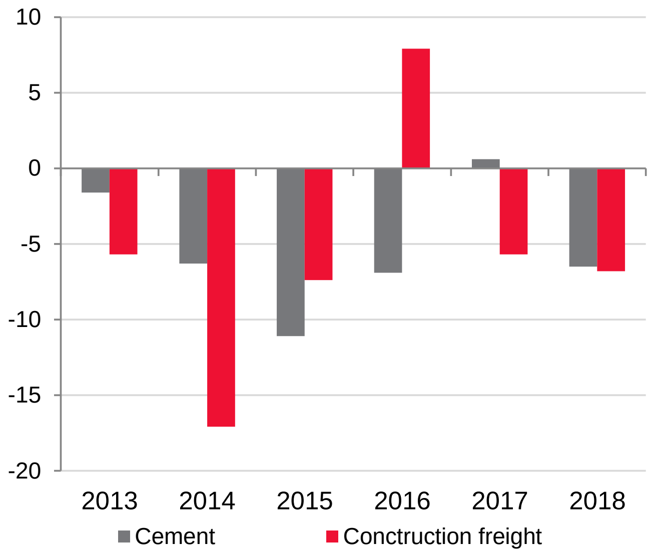
The last of the above sectors merits special attention. Construction's input to economic growth acceleration equaled 0.25 percentage points. Rosstat has substantially revised up construction output growth for 2018 (Figure 14). Prior to the revision, it was close to zero,[8] while the revised growth estimate stood at 5.3%. This growth number for construction works fails to correlate with indirect measures of business activity in construction. For instance, Russian Railways' data suggests that transportation of construction freight and cement by this company declined in 2018 (Figure 15). Rosstat's industrial output data posts a drop in the production of most of the major construction materials, bricks, cement, and concrete, in 2018. Moreover, while the volume of construction works declined in 2017, production of some construction materials showed a better performance than in 2018.

Figure 14. Construction works performed, % YoY



Source: Rosstat.

Figure 15. Transportation of some freight types by Russian Railways, % YoY



Source: Russian Railways.

[8] The report on Russia's January–November 2018 social and economic situation estimated growth at 0.5% YoY.

The revision to the construction performance numbers so far looks largely technical in nature and seems to have stemmed from getting access to more detailed reporting on some of major investment projects completed in 2018. Full reports with accurate data on the quantity of works performed are often submitted after the project has been completed (after its commissioning). If a major project has been constructed for several years, the quantity of works performed during this period may well have been underestimated in interim reporting. At the current estimation stage, the year 2018 may have accounted for a disproportionally large share of “new” works, boosting the growth number this much. The recalculated quantity of construction and installation operations may be subsequently spread more evenly over 2018 and previous years in which they were actually performed as part of major investment projects.

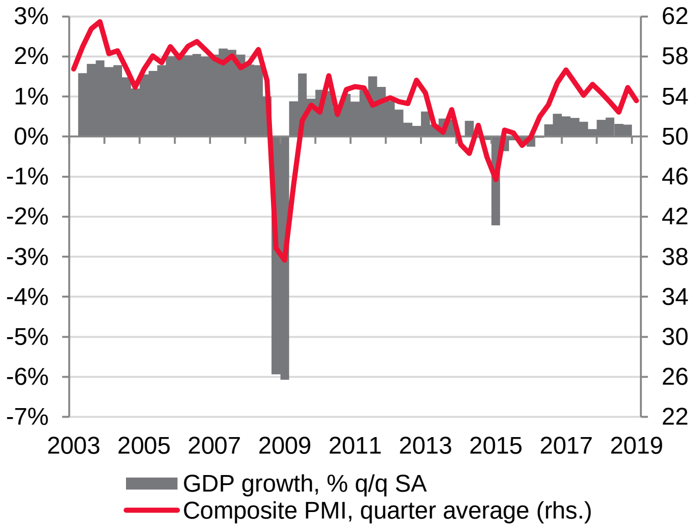
In that event, GDP growth in 2016 and 2017 should come in above and for 2018 below the current estimates. Indirect evidence of this is provided by a number of factors, such as the specifics of the stages of revision to and updating of statistics by Rosstat, the analysis of leading macroeconomic indicators and other measures of economic activity, as well as our model-based estimates.

First, the Research and Forecasting Department’s current quarterly estimates of seasonally adjusted GDP growth suggest that GDP growth slowed somewhat to 0.3% in the fourth quarter of 2018, implying a growth rate of 1.7% for the full year 2018 (see Section 2.1.1. Index-based GDP estimate for January: growth is set to slow somewhat in the first half of the year).

Second, the revision to the data on industry and other indicators has so far fully affected just the 2018 growth estimate, while the estimate for 2017 currently appears to fail to take account of all the subtleties of data revision. Hence the subsequent stages of statistical data updating will likely result in increasing the 2017 growth number, entailing an adjustment of the 2018 growth estimate as well.

Third, the performance of the composite PMI index, which is a credible indirect gauge of economic activity in Russia (Figure 16) and other countries, suggests that economic growth was slower in 2018 than in 2017. It is therefore quite possible that, following a sequence of estimate revisions, the final GDP growth numbers for 2017–2018 will be closer to the picture that has emerged from the performance of the PMI indexes lately.

Figure 16. Composite PMI and GDP growth (% q/q, SA)



Sources: Rosstat, IHS Markit, R&F Department calculation.

At the same time, without casting aside the above arguments for revising the 2016–2017 GDP growth estimates up and the 2018 numbers down, one cannot rule out that reasons for a revision in the opposite direction may emerge as new, updated statistics have become available.

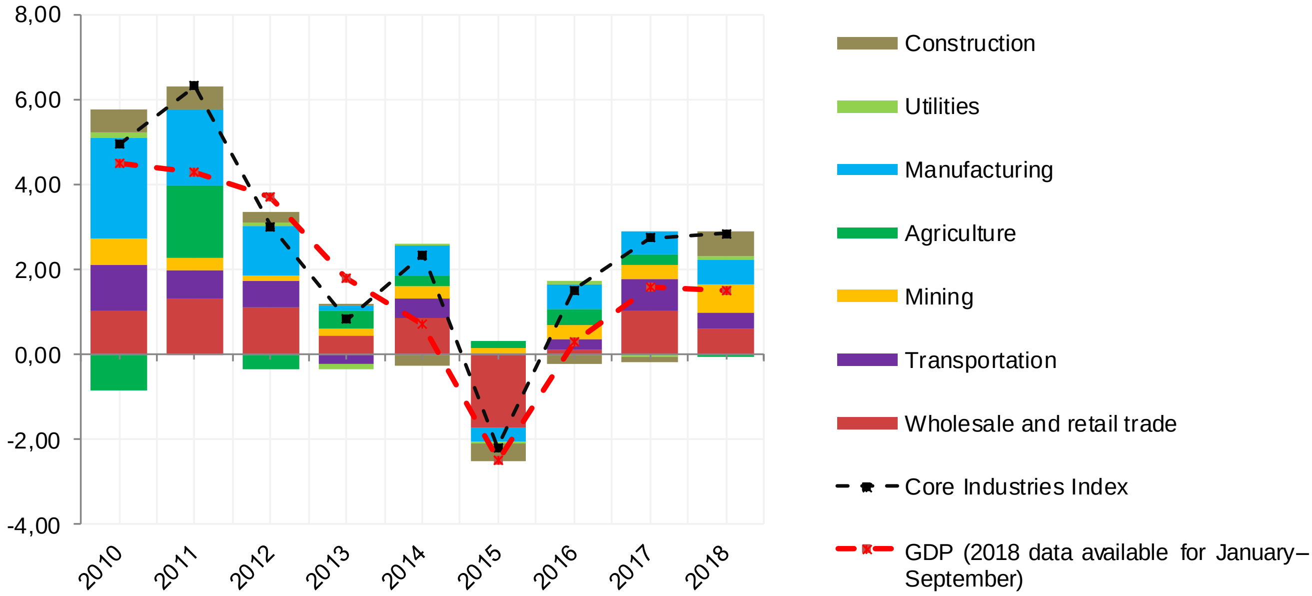
At this point, therefore, we estimate GDP growth for 2018 in the range of 1.7%–2.3%. This is generally in line with the current growth potential of the Russian economy. In this case, there is hardly any evidence of a significant positive output gap (a cumulative excess of the actual growth rate over potential, signaling an economy overheating).

1.2.2. Core industries' output growth in 2018 stayed on the 2017 level

- The index of core industries' output came in at 102.9% for 2018, close to the 2017 result.
- Growth was led by the extractive sector, manufacturing, trade, and construction.
- Negative growth numbers were only posted by agriculture, as output of some agricultural crops dropped.
- It seems that the results of data revision for construction works as part of major investment projects were primarily assigned to 2018. These numbers will likely be subsequently spread more evenly over the 2016–2018 period.

The index of core industries' output[9] came in at 102.9% for 2018, up from 102.7% for 2017. This provides indirect evidence that economic growth rates were roughly equal in both years (Figure 17).

Figure 17. Contribution of individual industries' contribution to the Core Industries Index in 2010–2018, % YoY



Source: Rosstat, R&F Department estimates.

All the core industries, except for agriculture, showed positive growth performance. The heftiest contribution came from the extractive sector, manufacturing, trade, and construction, with trade and transportation reducing their input to the index somewhat as their growth slowed.

Growth was led by industry in 2018. *The extractive sector* recorded the highest growth rate of 4.1%. *The manufacturing sector's output* rose 2.6% YoY. Power, gas and steam supply expanded 1.6% YoY, water supply and disposal posted a 2.0% growth.

Construction showed a substantial growth of 5.3% YoY in 2018 after a four-year slump. At the start of 2019, Rosstat provided revised 2016–2018 data for the construction industry, with the 2018 statistics affected the most. The construction growth rate in January–November 2018 was adjusted from 0.5% YoY to 5.7% YoY. According to Rosstat, the change followed revised reports by the contractors of Yamal LNG, Rosneft, Surgutneftegaz, and Gazprom. The main positive contribution to construction works was provided by industrial construction, while civil construction posted a decline of 4.9% YoY. The results of the substantial revision to the data on major investment projects have so far been fully assigned to 2018. The above adjustment will likely be subsequently spread more evenly over the 2016-2018, resulting in, among other things, a revision to GDP growth numbers for this period.

[9] The core industries index is calculated by aggregating seven industry indexes (agricultural output, the extractive sector, freight traffic, wholesale and retail sales, utilities, and construction) with weights in line with the share of a particular industry in Russia's gross value added in 2016.

Trade businesses reduced their contribution to the core industries' index in 2018 as wholesale trade growth slowed to 2.4% YoY from 5.7% YoY in 2017. Meanwhile, growth doubled to 2.6% YoY from 1.3% YoY a year earlier, driven mainly by a rise in nonfood sales to 3.4% YoY from 1.5% in 2017. Food sales also expanded, although more modestly, by 1.7% YoY versus 1.1% in 2017.

The transportation industry posted a growth rate of 2.9% YoY but, as the trade sector, lost some growth momentum compared with 2017, when it expanded 5.5% YoY. The main growth engines were the railway sector (up 4.2% YoY) and pipelines (a YoY rise of 2.0%). Growth was achieved due to, among other things, a rise in the transportation of extracted mineral and energy resources, accounting for 93% of overall traffic. Against the background of its more moderate performance in 2018 and a drop in water and air freight traffic overall freight traffic growth weakened.

The index of *agricultural output* ended the year in negative territory at -0.6% YoY for the first time since 2012, driven by a 16.7% YoY fall in grain crop production and a 20.6% YoY contraction in the sugar beet output, whereas both had posted record highs in the previous two years. Vegetable output also inched down by 0.1% YoY from the 2017 level due to a fall in field-grown vegetable crop production, while green-house vegetables showed a substantial output gain. Gross output of other crops also increased. The livestock sector's growth slowed marginally to 101.3% YoY from 102.6% YoY in 2017. Experts believe that the sector's performance is poised to improve in 2019. Weather conditions and the epizootic situation remain the key risks in agriculture.

1.2.3. Consistent industrial output growth supported by the extraction of mineral resources in 2018

- Industrial output growth stood at 2.9% in 2018, up from previous years' results.
- A significant contribution to growth came from the mining and quarrying with a gain of 4.1%. In 2019, the sector's performance will be tempered by the commitments to cut production under the December OPEC+ deal and the global economy's growth slowdown.
- The manufacturing sector's expansion in 2018 was comparable with the 2016 and 2017 growth rates at 2.6%, generally in line with Russia's economy's growth potential.
- Manufacturing saw accelerated growth in the first half of the year, hence growth weakening in the second half of 2018 can be viewed as a return to more sustainable growth rates.

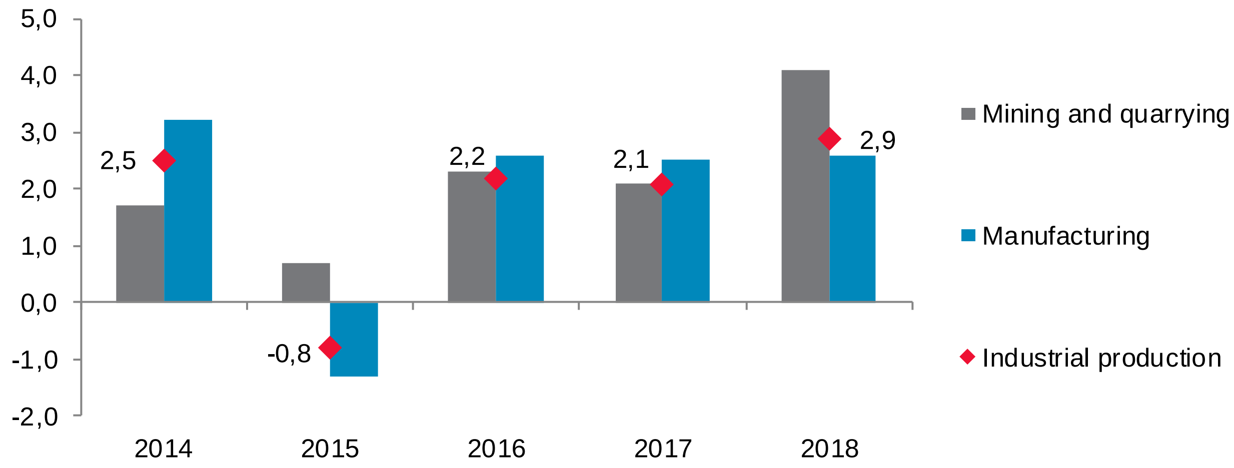
Industrial output expanded 2.9% YoY for 2018 (Figure 18), up from 2.1% in 2017.

A significant contribution to growth came from the mining and quarrying, whose output gained 4.1% YoY. Extraction growth acceleration in the second half of the year was helped by a rise in oil production under the OPEC+ agreement in June. As a result, Russia's oil production hit an all-time high in December. But a drop in mining of metal ores caused the mining and quarrying sector's output to fall 0.7% MoM in the last month of 2018 (here and further in seasonally adjusted terms). This agrees with the worsening of Rosstat's business confidence index by 0.7 pps (Figure 20).

A new OPEC+ agreement on oil production cuts was signed in December to take effect in January 2019. Russia is expected to gradually reduce oil production over the next few months, which is set to hurt seasonally adjusted monthly industrial output numbers in the first half of 2019.

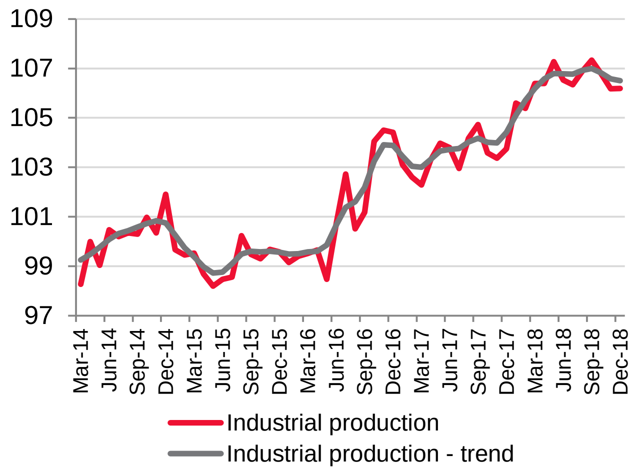
The manufacturing sector's expansion in 2018 was comparable with the 2016 and 2017 growth rates at 2.6%. The result was mostly achieved thanks to the sector's outstanding performance in the first half of the year, which saw a growth rate of 4% YoY (based on estimates taking account of data revision in May 2018).

Figure 18. Industrial production, manufacturing and mining and quarrying output growth, %



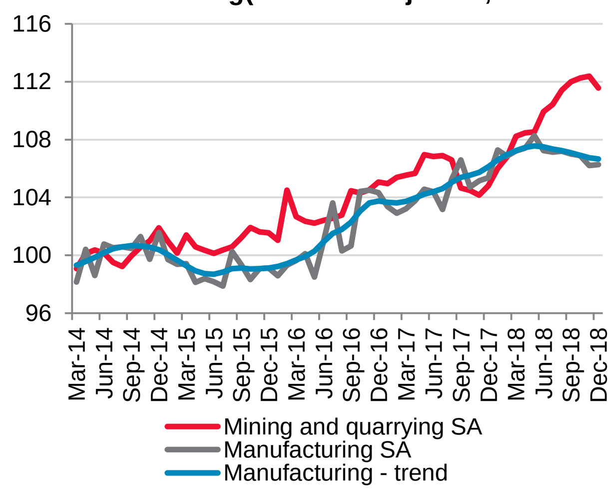
Source: Rosstat.

Figure 19. Industrial production (seasonal adjusted, 2014 = 100)



Source: Rosstat, R&F Department estimates.

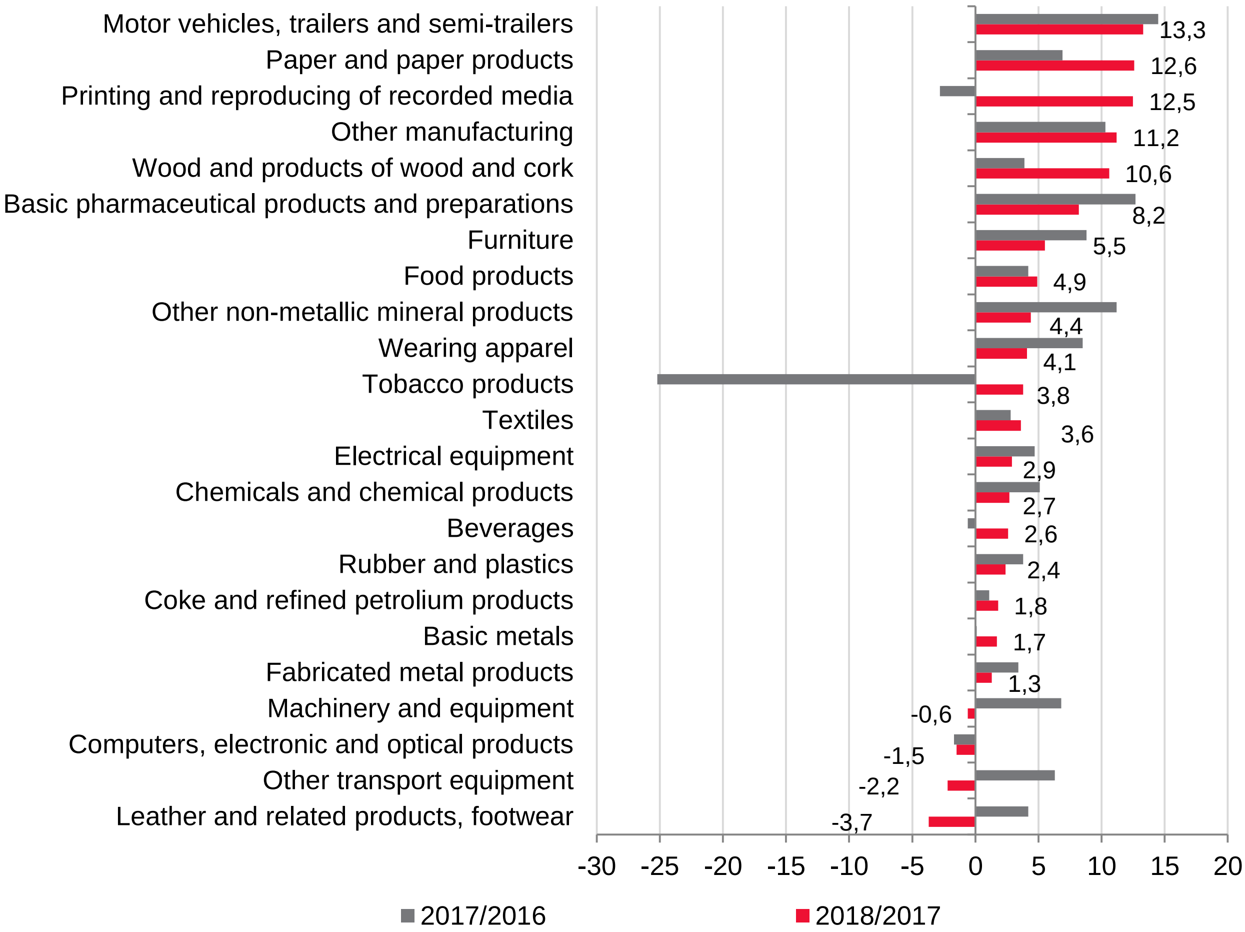
Figure 20. Production in mining and quarrying; in manufacturing(seasonal adjusted, 2014 = 100)



Source: Rosstat, R&F Department estimates.

In some of the sector's industries, steady positive trends continued till the year end. These were mostly industries meeting consumer demand, such as food products, which provided the largest input to the sector's positive performance (Figure 22), posting a 4.9% YoY gain (Figure 21), as well as pharmaceuticals (up 8.2% YoY) and production of other manufactured goods (an increase of 11.2% YoY). Among the leading contributors to aggregated growth was also the woodworking industry, which expanded 10.6% YoY. Its sustainable growth throughout the year was supported by external demand (timber and plywood exports added 6% YoY and 8% YoY, respectively, for the first 10 months of 2018.

Figure21. Output growth in manufacturing industries in 2018, % YoY



Source: Rosstat.

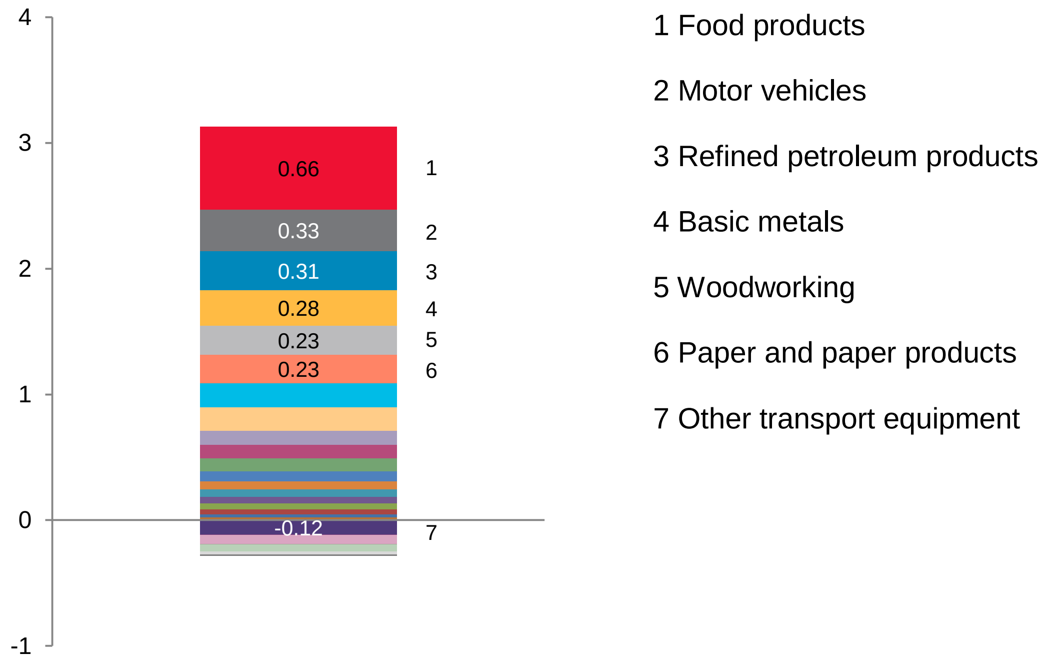
The second half of the year, however saw a reversal of the manufacturing sector's upward growth trend, driven by the worsening performance in a number of industries, meeting primarily intermediate and investment demand.

Growth came to a stop in the largest industry –refined petroleum. With the tax maneuver in place, uncertainty about the industry's future performance continues. Growth will highly likely be moderate: the expected oil production drop under the OPEC+ deal is set to affect oil refining output. Nonferrous metals production experienced dramatic ups and downs, hitting the entire metals industry and manufacturing as a whole. Growth also weakened in the chemicals industry (up 2.7% YoY), continuing to suffer from capacity shortages, and paper production, whose output expanded 12.6% YoY.

In some of the manufacturing sector's industries, such as non-metallic mineral products, textile and wearing apparel production, the second half of the year saw growth give place to a downturn. Most of the machinery producing industries posted an output drop for 2018, one of the major sources of which was other transport equipment, whose output was hurt by a drop in the production of aircraft and other equipment, not elsewhere classified. Rolling stock production recorded a dramatic fall in October–December, which, however, did not hurt the results for the year.

Growth was led by the motor vehicles industry, expanding its output 13.3% YoY in 2018. Its expansion is, however, expected to stall in 2019, given the projected fall in demand for new cars on the back of car price hikes driven by ruble depreciation and the VAT increase.

Figure 22. Industries' contribution to output growth in manufacturing, %



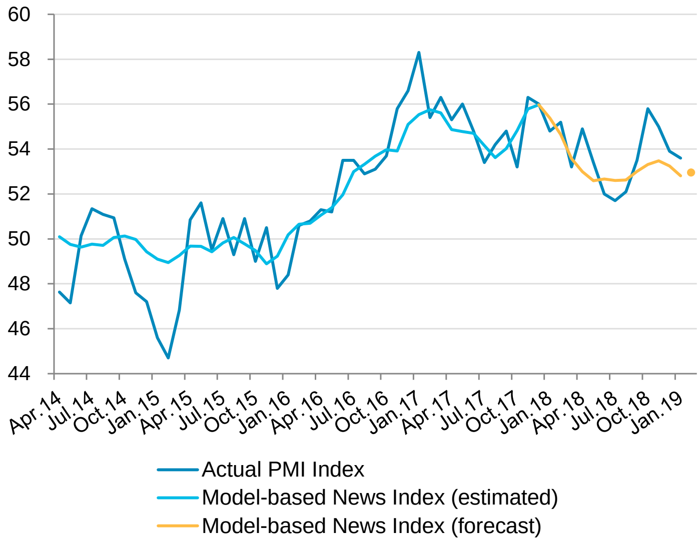
Source: Rosstat, R&F Department estimates.

1.2.4. PMI in January: growth softens in manufacturing and picks up in services

- The Composite PMI Index inched down in January, as evidenced also by the Research and Forecasting Department's News-based Business Activity Index (Figure 4), with the manufacturing and services indexes moving in opposite directions. (Figure 24).

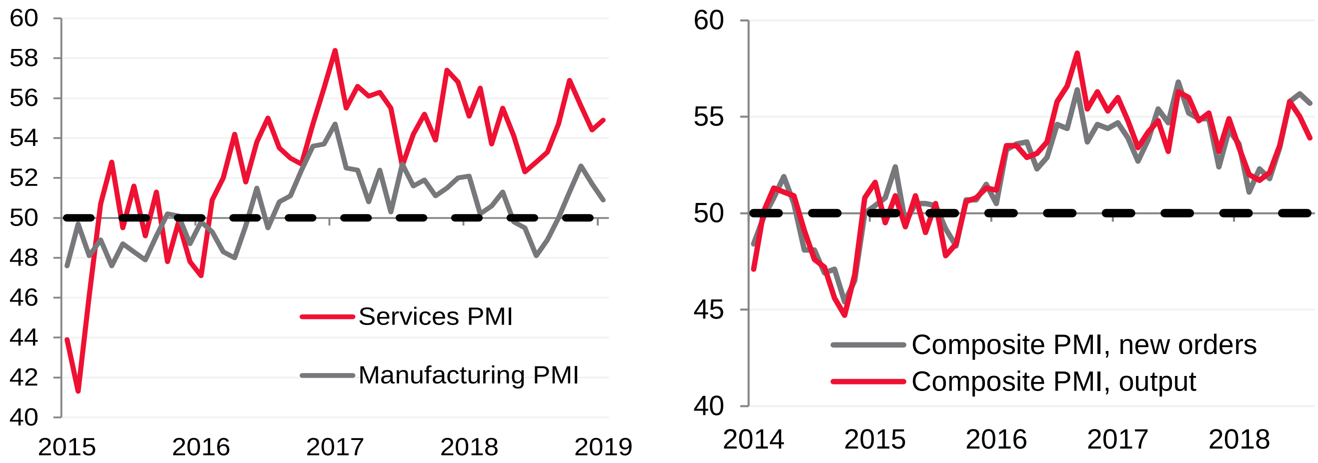
- The manufacturing sector's output did not change from December but the rise in new orders continued. Uncertainty regarding the VAT hike impact on demand affected companies' production plans for January. New orders expansion recorded by the surveys may spark an output growth resumption in February.
- The services sector, by contrast, posted growth acceleration after its marginal slackening at the end of 2018. New orders are steadily rising, with export orders supporting the trend.
- Survey data does not provide any evidence of a significant growth weakening at the start of the year.

Figure 23. Composite PMI Index and the News-based Index



Source: IHS Markit, R&F Department estimates.

Figure 24. Russia PMI indices



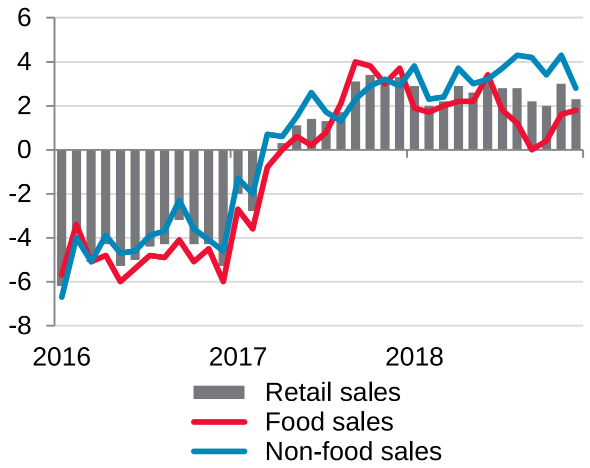
Source: IHS Markit.

1.2.5. Consumer demand rise slowed in December

- Retail sales expansion slowed to 2.3% YoY in December from 3.0% YoY in November on the back of non-food sales growth softening. Adjusted for seasonal and calendar factors, retail sales edged down by 0.1% MoM in December.
- Demand for non-food goods ahead of the VAT hike peaked in November, driving down December's traditional pre-New-Year sales surge. The slowdown of growth in demand for durable goods will likely continue in the first quarter of 2019.
- Consumer sentiment continued worsening in the fourth quarter of 2018, reaching the lowest level since 2016.

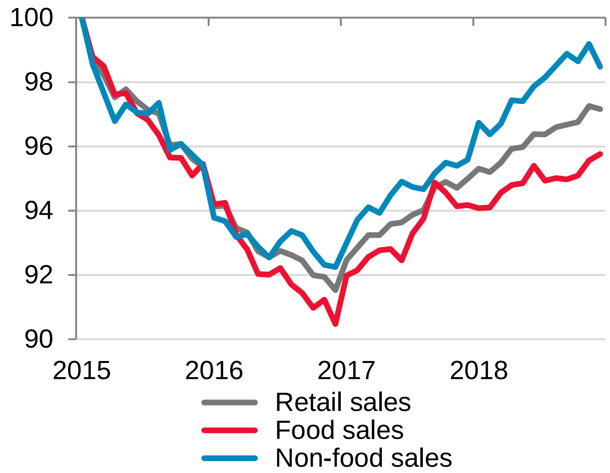
According to Rosstat data, retail sales expansion slowed to 2.3% YoY in December from 3.0% YoY in November, posting 2.6% YoY for 2018 (Figure 25). Based on our estimate, December's retail sales growth adjusted for seasonal and calendar factors edged down by 0.1% MoM after its substantial 0.6% MoM growth in November (Figure 26).

Figure 25. Retail sales of food and non-food goods and overall retail sales, % YoY



Source: Rosstat, R&F Department estimates.

Figure 26. Retail sales, % (January 2015 = 100%, seasonally adjusted)

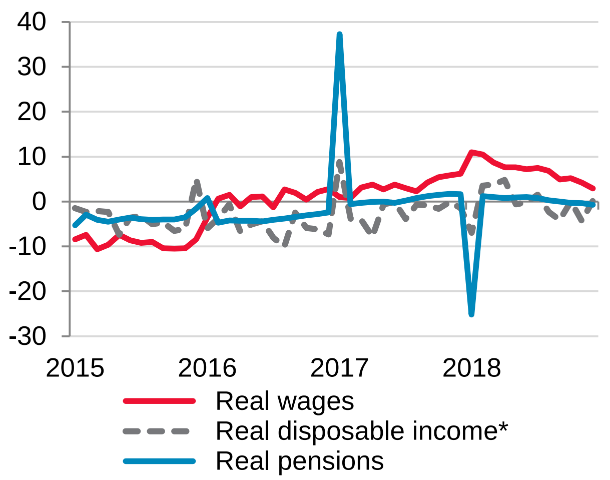


Source: Rosstat, R&F Department estimates.

Annual retail sales growth slowdown in December was driven mainly by non-food sales. Consumers have a boost to demand for durable goods in November ahead of the VAT hike, probably by making a part of their traditional pre-New-Year purchases in good time. This pushed non-food sales growth down to 2.8% YoY in December from 4.3% YoY in November.

Real wage growth continued weakening in December (Figure 27). With wage rise slowing, inflation accelerating and retail lending expansion slackening, household consumption growth momentum is expected to ease in 2019.

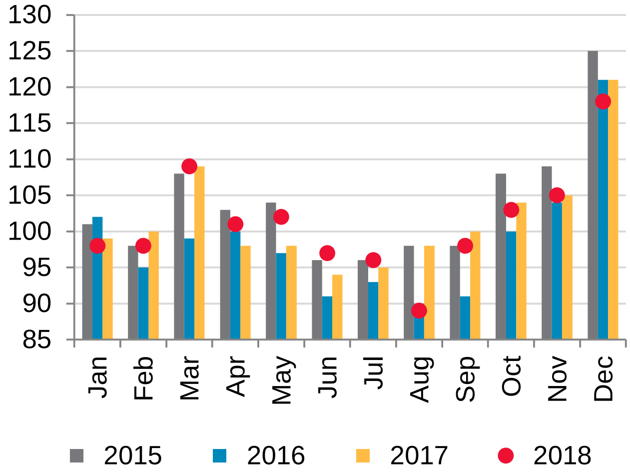
Figure 27. Real household income, % YoY



Source: Rosstat, R&F Department estimates.

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

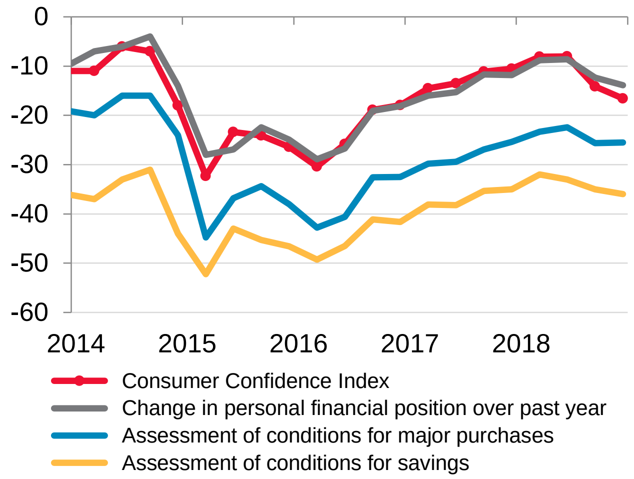
Figure 28. Real everyday household expenditure, % (Median 2012 = 100%)



Source: Romir.

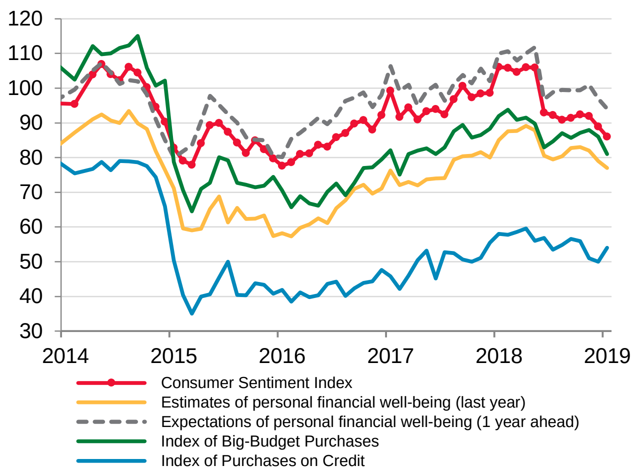
Data from Romir research holding company suggests a dramatic seasonal rise in everyday household expenditure in December, fueled by spending ahead of the New-Year holiday, especially on food (Figure 28). At the end of the year, however, the number came in below the levels of the same period of previous years.

Figure 29. Rosstat's Consumer Confidence Index and its components



Source: Rosstat, R&F Department estimates.

Figure 30. Consumer Sentiment Index and its components



Source: inFom.

Based on Rosstat survey, consumer confidence, continued worsening, with the fourth quarter of 2018 showing its lowest reading since the fourth quarter of 2016 (Figure 29). The consumer confidence index dropped 2.5 pps, driven down by the respondents' worsening assessment of their financial position and conditions for savings. Respondents' stance on making major purchases remained all but unchanged.

The downbeat consumer sentiment continued to worsen in January, as suggested by the data of inFOM[10] survey. (Figure 30). At the start of the year, the index of consumer sentiment fell to 86 pps, dragged down by respondents' worsening assessment of their current and future financial position and whether it was a good time for major purchases. The share of respondents whose financial position worsened or was expected to worsen in the future rose compared with December. This most often went along with the respondents deciding against major expenditures planned earlier. At the same time, respondents' stance on loans improved somewhat owed to the dwindling share of those who were not planning to borrow.

With inflation expectations rising and inflation accelerating, a dramatic improvement in consumer sentiment is hardly to be expected.

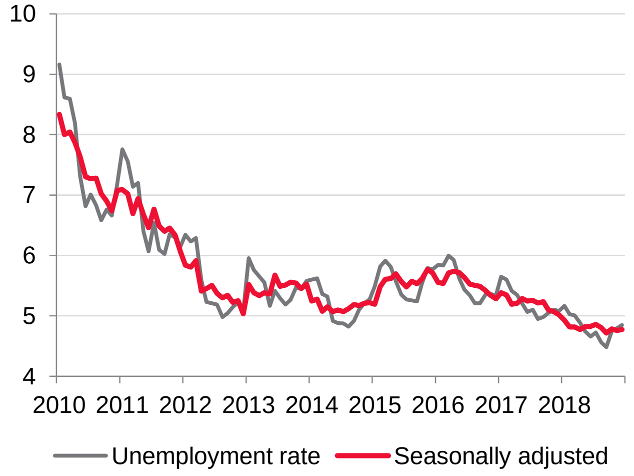
1.2.6. Real wage growth is set to lose momentum in the first quarter

- Real wage growth continued to lose momentum in December. Based on a preliminary estimate, nominal wages rose 6.9% YoY in December with real wages increasing 2.5% YoY, down from 8.2% YoY and 4.2% YoY, respectively, in November.
- Inflation acceleration and the adjournment of public sector wage indexation until October 1 may slow real wage growth further in the first quarter of 2019.
- According to Rosstat data, the rate of unemployment stood at 4.8% in December. In seasonally adjusted terms, unemployment kept to the 4.7%–4.8% level throughout 2018, matching the lower bound of the range of natural unemployment estimates.

The unemployment rate stood at a record low 4.8% in 2018. The seasonally adjusted unemployment rate remained close to 4.8% throughout the year, with a token rise from 4.77% to 4.79% in December (Figure 31).

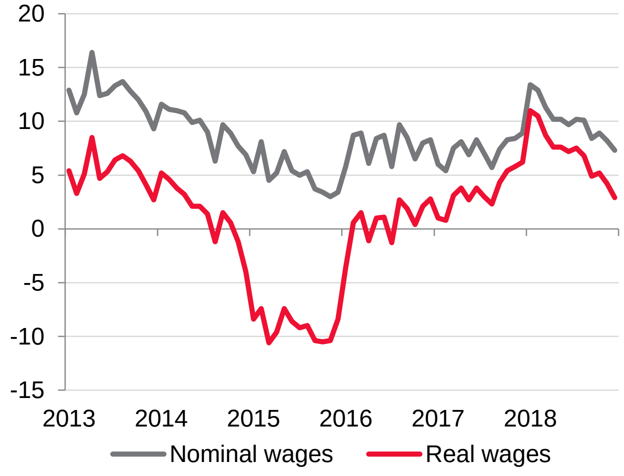
[10] See: Inflation expectations and consumer sentiment. №1. January 2019.

Figure 31. Unemployment rate, %



Source: Rosstat, R&F Department estimates.

Figure 32. Wage growth, % YoY

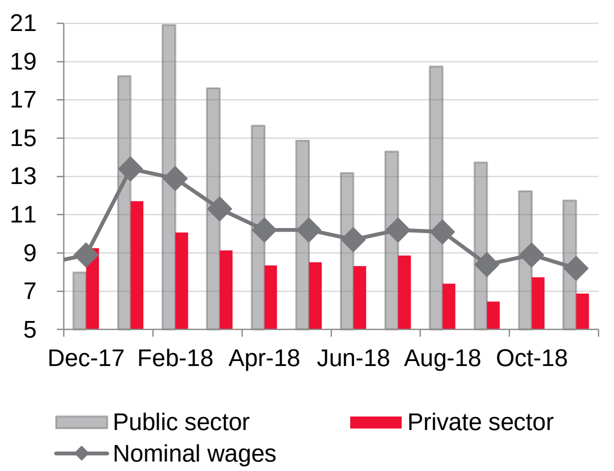


Source: Rosstat.

Rosstat estimated December's nominal wage rise at 6.9% YoY, down from 8.2% YoY[11] in the previous month, while real wage growth slowed even more, to 2.5% YoY from 4.2% YoY (Figure 32), driven by inflation acceleration in the last month of the year.

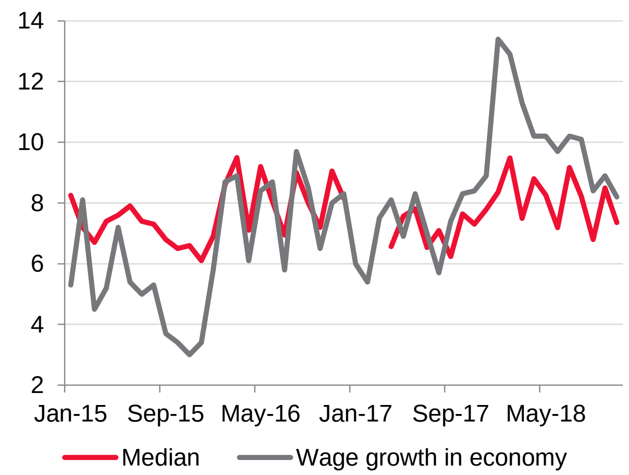
Public sector nominal wages increased 11.7% YoY in December versus 12.2% YoY in November. The slowdown was even more pronounced in the private sector: 6.9% YoY after 7.7% YoY a month earlier (Figure 33). Inflation acceleration and the adjournment of public sector wage indexation until October 1 may slow real wage growth further in the first quarter of 2019.

Figure 33. Rate of nominal wage growth in private and public sectors, % YoY



Source: Rosstat, R&F Department estimates.

Figure 34. Nominal wage growth in the economy and the median, % YoY



Source: Rosstat, R&F Department estimates.

[11] Rosstat has revised its estimates for November down by 0.4 pp.

The breakdown of median wage growth by economic activity type suggests that wage growth acceleration was at the start of last year concentrated in a small number of industries. The median hovered around an average 8% in 2018 (Figure 34), roughly in line with private sector wage growth.

1.2.7. The banking sector: retail lending expansion slowed in December

- December saw retail lending expansion soften in all major segments. This will likely translate into lending growth slowdown in 2019.
- Mortgage portfolio securitization had a significant effect on mortgage lending numbers at the end of 2018. Adjusted for the largest securitization transactions, mortgage lending expansion saw just a marginal slowdown at the end of 2018, continuing at a fast rate.
- The banking sector's net interest income declined in the fourth quarter of 2018 and will likely continue falling at the start of 2019.

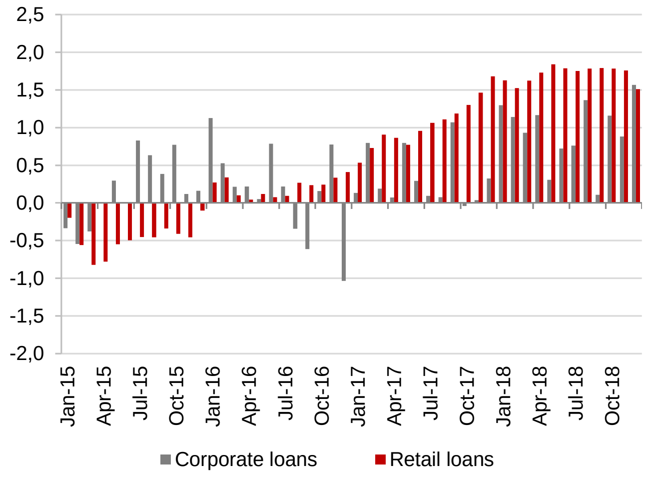
Ruble-denominated retail lending growth slowed to 1.5% MoM in December from 1.8% MoM in November in seasonally adjusted terms (Figure 35). Growth softening was seen in all the major lending segments. Mortgage lending expansion, for instance, slowed from 1.8% MoM to 0.6% MoM in December in seasonally adjusted terms (Figure 38). One can, however, claim that the rate of mortgage lending growth remained elevated.

First, its growth suffered a major hit from mortgage loan securitization. As a result of these transactions, loans covering the issuance of mortgage-backed securities (MBS) leave credit institutions' balance sheets, being replaced by MBS or receipts from their sales. Data on changes in outstanding debt on mortgage loan principals covering MBS for two largest 2018 transactions[12] enables the estimates of lending performance to be adjusted. It becomes clear that, exclusive of the securitization transactions, lending growth slowdown was not really significant. *Second,* November saw a local mortgage loan issuance boom which may have been fueled by expectations of further hikes in loan interest rates.

Unsecured consumer lending rise slowed to 1.84% MoM in December from 1.97% MoM in November but remained fairly robust with the three-month annualized average standing above 23%. (Figure 39). The likely interest rate hikes, macroprudential measures put in place, and some cooling of demand after the VAT increase may well temper unsecured consumer lending expansion. Still, macroprudential measures implemented last year have so far failed to produce a major effect on its growth rate.

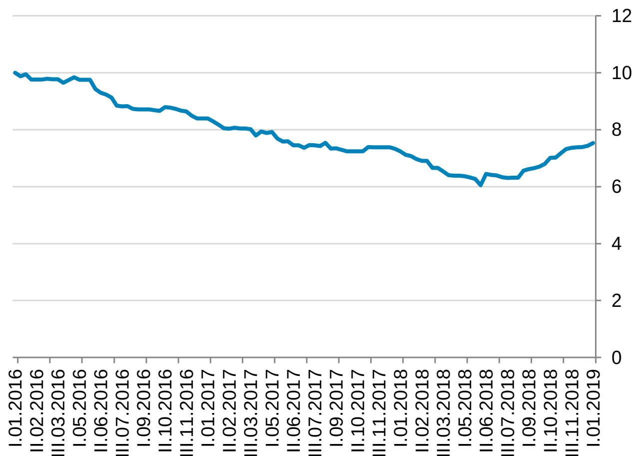
[12] 74.3 billion ruble MBS issue of 26.11.2018, government registration number 4-06-00307-R-002R, 46.1 billion ruble MBS issue of 21.12.2018, government registration number 4-08-00307-R-002R.

Figure 35. Ruble credit growth, % MoM (seasonally adjusted)



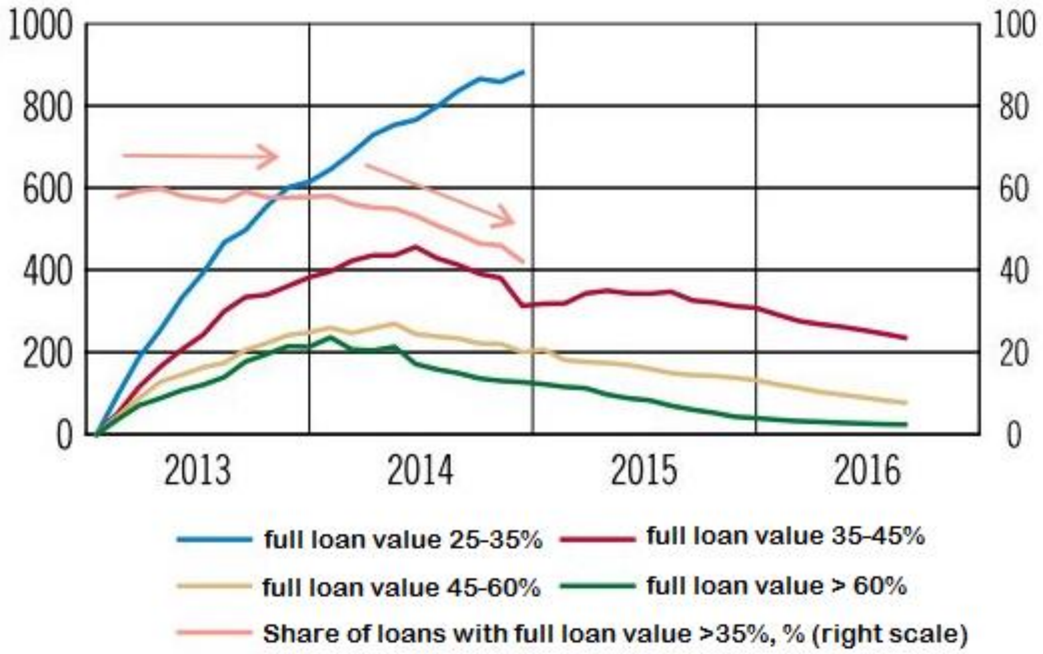
Source: Bank of Russia estimates.

Figure 36. Highest interest rates on household deposits in 10 largest (by deposits) banks, % p.a.



Source: Bank of Russia estimates.

Figure 37. Outstanding debt on unsecured consumer loans subject to raised risk coefficients, billion rubles

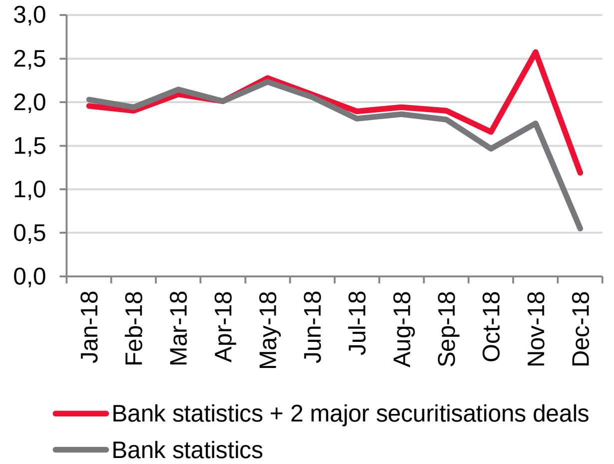


Source: Bank of Russia. “Financial stability review, second–third quarters of 2016”.

The previous instances of tightening macroprudential regulation for this lending segment (raising risk coefficients for high full value loans) suggest that the effect of such measures is extended over time. A downward trend for the share of high full value loans (above 35%), for example, only emerged 8–10 months after the effective date of raising the risk weights (Figure 37). The share of such loans remained almost unchanged over the first few months, suggesting a limited effect of macroprudential measures where the banking sector has sufficient capital.

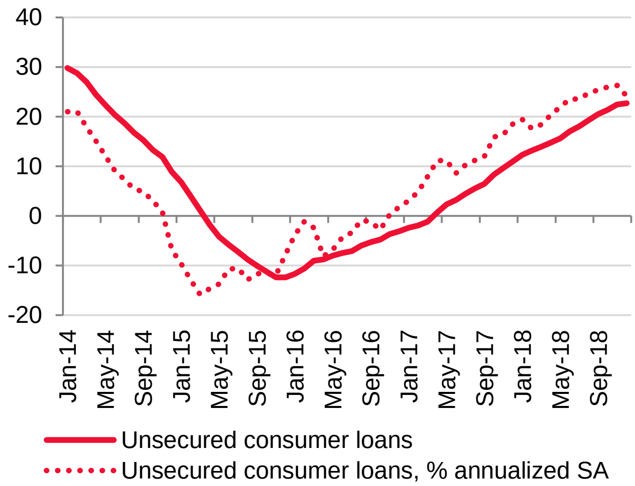
We note that growth in the issuance of auto loans also slowed to 1.1% MoM in December from 1.3% MoM a month earlier. Given the cooling of demand which made itself felt in the market as early as December and will likely continue in 2019, we expect further easing of growth in this market segment. On top of that, to buy a car (including in the secondary market) many borrowers prefer unsecured consumer loans to auto loans), hence slower car sales expansion will likely take its toll on unsecured consumer lending.

Figure 38. Ruble mortgage lending, % MoM (seasonally adjusted)



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

Figure 39. Unsecured consumer loans



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

The ruble-denominated corporate lending growth, by contrast, accelerated to 1.6% MoM in December from 0.9% MoM in November in seasonally adjusted terms based on Research and Forecasting Department estimate, posting the fastest portfolio expansion rate in the current growth phase (Figure 35).

Retail lending added 22.8% YoY for 2018,[13] while corporate lending expanded 5.8% YoY.[13] Both segments showed an appreciable growth acceleration compared with the 2017 level (up from 13.2% YoY[13] and 3.7% YoY,[13] respectively).

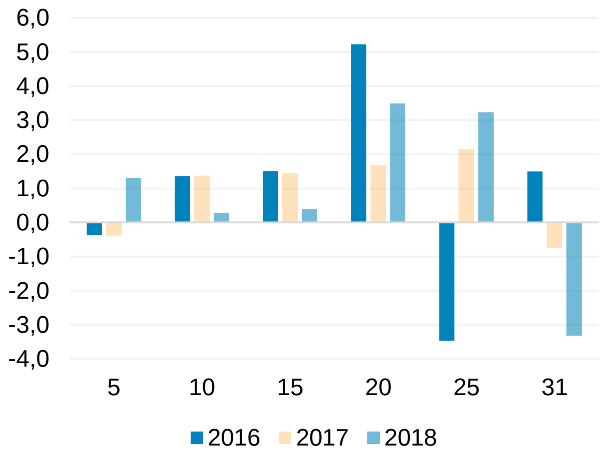
Household deposit growth in December almost fully compensated deposit outflows in August–October 2018. Total ruble deposits exceeded their level on August 1, 2018. Foreign currency deposits practically equaled their total amount as of that date. December's monthly inflow of funds to household and financial organizations' deposits suggests that this was owed primarily to the 13th month salary paid at the very end of December (Figure 40, Figure 41).

That said, the greater part of the increase (60%) in the December 25–31 period was concentrated in household current accounts and was somewhat more than in 2017 and much more than in 2016. Household deposit expansion typical of December may, therefore, be un-

[13] Adjusted for foreign exchange revaluation at credit institutions operating as of 01.01.2019 (including earlier reorganized banks).

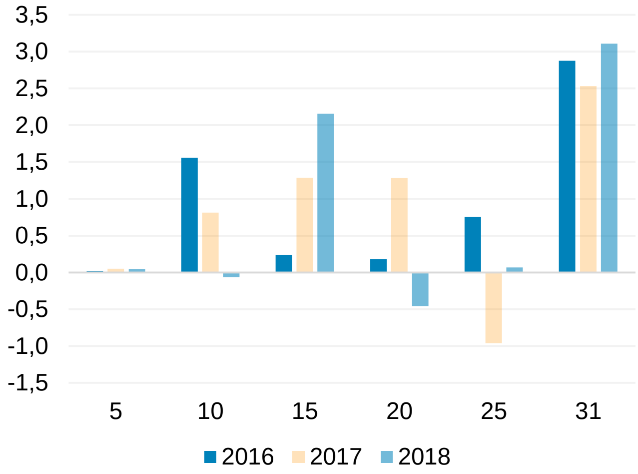
stable. Hikes in deposit interest rates may, however, diminish household preferences for the liquid forms of holding money (Figure 36), thus expanding time deposits.

Figure 40. December's ruble liabilities to households over three years, % to the previous date



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

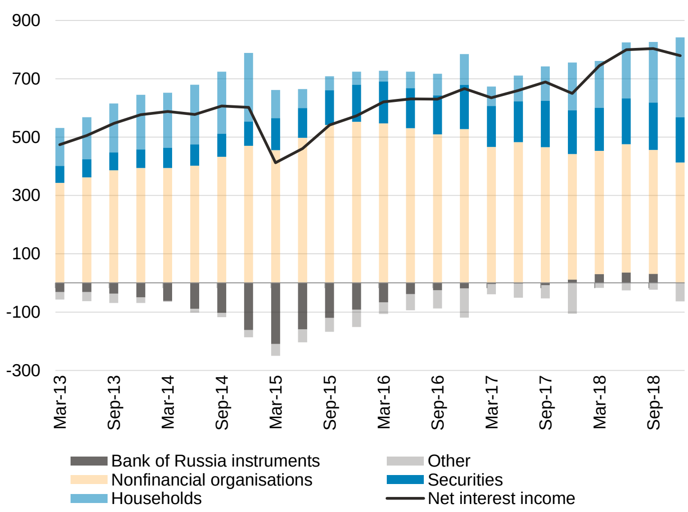
Figure 41. December's ruble liabilities to nonfinancial organizations, % to the previous date



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

The banking sector's net interest income dwindled in the fourth quarter of 2018 (Figure 42), dragged down primarily by a contraction in net interest income from transactions with nonfinancial organizations and the Bank of Russia. The latter was due to a drop in the banking system's deposits with the Bank if Russia as liquidity surplus decreased following a suspension of foreign currency purchases as part of the fiscal rule. Given the interest rate trend reversal, the maturity gap between the banking system's assets and liabilities, and the likely lending expansion slowdown, the interest income downward trend is highly likely to continue at the start of 2019.

Figure 42. Sources of net interest income, billion rubles



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

2. OUTLOOK: LEADING INDICATORS

2.1. What do Russia’s leading indicators suggest?

2.1.1. Index-based GDP estimate for January: economic growth is set to slow marginally in the first half of the year

- Based on statistics released in January, the estimate of GDP growth for the fourth quarter of 2018 stood at 0.3% QoQ in seasonally adjusted terms, little changed from December’s number.
- The projection of GDP growth for the first half of 2019 was in turn marginally revised down. Based on our latest estimates, quarterly growth is set to stabilize close to 0.2% QoQ in seasonally adjusted terms until the middle of the year.
- The VAT increase as of January 1, 2019, may be a further drag on growth in the first quarter of 2019. Still, our GDP growth estimates for the first half of 2019 do not look overstated on two grounds.
- *First,* our DFM model seems to have implicitly accounted for the hampering effect of fiscal measures on economic growth via the expectations of the VAT hike, which may have been reflected in a wide array of December macro statistics and some of the latest January data.
- *Second,* the likely failure to take full account of the impact of the VAT base rate increase is now being offset by what may be a somewhat elevated sensitivity of our GDP estimate to oil price movements and, as a consequence, by the estimate of the impact of oil price fall in November 2018 on economic growth. An explanation for the above elevated sensitivity is that the parametrization of the DFM model which our estimates are based on,[14] still relies to a large extent on the pre-fiscal rule period. The fiscal rule has diminished the Russian economy’s sensitivity to oil price changes.
- Hence short-term risks of a moderate GDP growth slowdown continue. Economic growth will likely accelerate later.

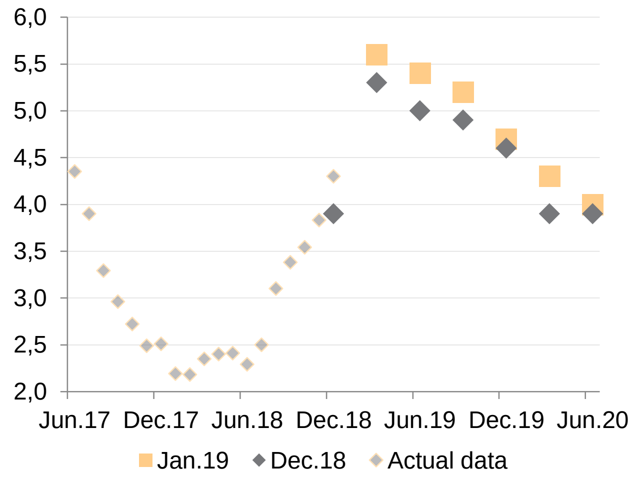
	January	December
	% QoQ SA	% QoQ SA
Q4 2018	**0.3**	0.3
Q1 2019	**0.2**	0.2
Q2 2019	**0.2**	0.3

[14] The model was estimated using a 7-year rolling window.

2.1.2. Analysts' inflation expectations remain anchored

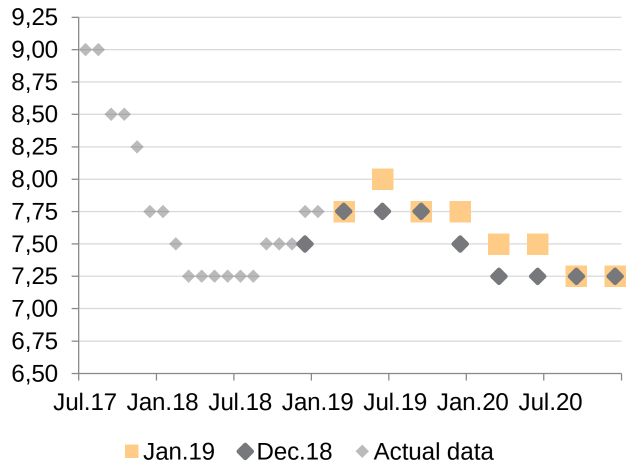
- Analysts surveyed by Bloomberg at the start of the year revised their inflation forecasts for the coming quarters up. The median inflation estimate for the first quarter of 2019 was revised from 5.3% YoY to 5.6% YoY. The subsequent quarters are projected to see gradual inflation deceleration, bringing it down to 4.7% YoY at the year end.
- The rise in the estimates seems to have stemmed from the analysts further factoring in the impact of the VAT increase and the faster food price growth. The revised forecasts expect inflation to decelerate to 4.0% YoY in June 2020. This indicates that financial analysts' expectations are anchored at the Bank of Russia 4% target.
- The consensus forecast assumes another Bank of Russia key rate hike in the second quarter of 2019 and its decrease to 7.25% by the start of the second half of 2020, slower than expected in December.

Figure 75. Analysts' inflation expectations, % YoY



Источник: Bloomberg Finance L.P.

Figure 76. Analysts' expectations regarding Bank of Russia key rate, % p.a.



Источник: Bloomberg Finance L.P.

3. The 2018 results: did the Russian economy meet our expectations?

- With higher oil prices and ruble weakening, inflation and economic growth in 2018 came in somewhat higher than we expected a year ago.
- Inflation was expected to stand at 3%–4% for 2018, but rose to 4.3% at the year end, driven by a number of primarily one-off factors. Adjusted for these factors, inflation would have stood within the projected range of 3%–4%. The most stable CPI components saw inflationary pressure at a level close to 4% at the end of 2018.
- At the start of 2018, the Bank of Russia expected its transition to neutral monetary policy to be completed by the end of 2018. But the changing external conditions and plans for tax policy changes slowed monetary policy normalization and made it necessary to tighten its monetary stance somewhat so as to curb secondary inflationary effects and stabilize annual inflation at about 4% over the forecast horizon.
- The economy was expected to stay on a steady growth path, consistent with potential, in 2018. But the first Rosstat estimate of GDP growth came in higher than expected. According to the data on GDP components by use, a stronger external demand and hence stronger goods and services exports in physical terms were able to compensate investment and consumption weakening.

Inflation

Inflation came in at 4.3% for 2018, above Bank of Russia baseline scenario forecast provided at the start of 2018. Inflation acceleration was driven by both domestic and external factors, with most of the producing only temporary inflationary effects.

Given inflation deceleration to 2.5% at the end of 2017, the inflation forecast published at the start of 2018 expected inflation to gradually accelerate to 3%–4%. Key temporary disinflationary effects keeping inflation below 4% included an agricultural produce glut in the domestic market, price regulation, better conditions in global commodity markets, and ruble exchange rate stabilization.

The effect of these temporary favorable factors was assumed to gradually run its course. This and possible realization of some inflationary risks were supposed to drive inflation back to 4%. Also, potential sources of inflationary pressure were taken into account. The following key risks were considered at the start of 2018:

1. Petering out of the impact of the record high output of many agricultural crops and the favorable exchange rate movements in 2017.
2. The oil price fall upon the expiration of the OPEC+ agreement and its possible effect on inflation via the foreign exchange channel.

3. Risks arising from wage and consumer demand growth acceleration. Sustainable wage growth amid limited supply in the labor market may drive a return to the consumption behavior model and faster price rises. A savings rate drop to the 2012–2013 level as consumer lending recovers.
4. Household inflation expectations, which, although declining, remained elevated and unanchored.

Moreover, we estimate that the overall pro-inflationary effect of the above factors in 2018 actually matched our initial forecast or even fell just short of it. At the same time, the forecasted inflation range change to 3.8%–4.2% from 3%–4% at the start of 2018 largely arose from a pass-through of ruble weakening to prices in April and August.

Our estimates suggest that, net of the new temporary factors which emerged after January–February 2018 and were not accounted for in the first version of the baseline 2018 forecast, actual annual inflation would have come in close to the middle of the forecast range of 3–4% for 2018.

The second quarter of 2018 ushered in inflation acceleration as the previous and a number of new risks were realized. Below are further risks which affected inflation after February 2018:

- The situation in the global economy as a whole and, specifically, the emerging markets. The key risks were the normalization of major central banks' monetary policy, trade tensions and their impact on the emerging markets, and macroeconomic imbalances in some countries.
- Escalation of geopolitical tensions, imposition of new sanctions on Russia in April 2018 and professional market participants' growing fears of further sanctions.
- A drastic drop in the pricing of Russian financial assets (the national currency, equities, ruble bonds) driven by the above factors, aggravation of risks to inflation and financial stability, the selloffs of securities by nonresidents, an expansion in the private sector's capital outflows, an upward reversal of loan and deposit rates in Russia's economy.
- A change in the household behavior model, associated with a dramatic fall in the savings ratio and rising demand for consumer loans as one of finance sources for deferred consumption.
- Accelerated oil product (primarily petrol) price rises.
- The announced VAT hike as of 2019 and direct and indirect inflationary effects arising from it, including the risks of the emergence of secondary effects associated with a steady rise in inflation expectations.

The adjustment of the initial inflation forecast was most of all affected by the escalation of rhetoric for sanctions against Russia amid the onset of steady capital outflows from emerging markets, with market participants' expectations worsening and risks to financial stability rising. The risks of an inflation expectations rise were further amplified by the news about the VAT hike as of 2019, but we view its effect on 2018 inflation as very moderate. The Bank of Russia measures to start raising the key interest rate in September and suspend foreign currency purchases on behalf of the Finance Ministry, aimed to suppress risks to financial stability and limit possible secondary effects of the VAT hike on inflation expectations.

At the start of 2018, the Bank of Russia expected to complete its transition to neutral monetary policy by the end of the year. April's ruble weakening amid geopolitical tensions along with the effect of the new fiscal package on the forecasts, slowed monetary policy normalization and made it necessary to tighten the regulator's monetary stance somewhat so as to curb secondary inflationary effects and stabilize annual inflation at about 4% over the forecast horizon.

A little later, external conditions worsened, developed markets saw rising yields, while emerging markets faced capital outflows, with volatility rising in Russia's domestic financial market. This was accompanied by further tightening of monetary stance, a rise in OFZ yields and interest rates in the deposit and loan market. To curb inflationary risks and keep up financial stability, a certain degree of tight monetary policy was maintained through raising the key interest rate and suspending foreign currency purchases on behalf of the Finance Ministry as part of the fiscal rule.

Temporary factors still account for most of the current inflation acceleration. Meanwhile, inflationary pressure in the most stable CPI components stood at a level close to 4% at the end of 2018.

The domestic financial market situation looked stabilized for 2018. The inflation trend remains fairly moderate and close to the lower bound of the trajectory which the Bank of Russia seeks to maintain, helped by some stabilization of external conditions and measures put in place by the Bank of Russia.

Uncertainty regarding further development of external conditions and the response of prices and inflation expectations to the VAT increase will remain in 2019, whereas Bank of Russia monetary policy will continue to bring down risks to financial stability,help the stabilization of inflation expectations and the return of inflation to 4% in 2020.

Economic growth

At the start of 2018, our forecast took account of the OPEC+ agreement to cut oil production and expected gradual acceleration of retail sales and consumption growth with investment rising moderately. Meanwhile, the economy was expected to stay on a steady growth path, consistent with potential.

The gradual increase in baseline assumptions regarding the oil price had just a minor effect on the forecasted GDP growth path throughout the year. This stemmed primarily from the economy's declining sensitivity to the oil price with the fiscal rule in place and financial stability maintained. We also bore in mind that as oil price rose in 2018, financial market participants' expectations plummeted on fears of new sanctions against Russia amid the overall capital outflow trend in emerging markets. The positive effect of the oil price rise on the Russian economy was therefore marginal. What is more, it was offset by the weakening (relative to the initial forecast) of investment and consumption as well as by rising inflationary risks.

Also, after new sanctions were imposed on Russia in April 2018, the new baseline forecast already took full account of the worsening market expectations. Even in the absence of these sanctions economic conditions remained under the pressure of rising geopolitical risks, the continuing capital outflow trend in emerging markets and worsening investor expectations. The estimates of the GDP components also changed considerably. The new assumptions gave rise to the expectations of lower investment and moderate consumption growth with a heftier input of net exports to GDP. At the same time, Rosstat's drastic increase of its industrial output growth estimates as part of its regular updating of statistics compensated a reduction in its estimates of the key GDP components.

The realization of external risks, including risk premium increases and capital outflows from emerging markets, as well as the escalation of the pro-sanction rhetoric, had a more significant effect on the forecast for inflation, the ruble exchange rate and monetary tightening than on that for GDP.

According to the data on GDP components by use, the stronger external demand and hence stronger goods and services exports in physical terms were able to compensate investment and consumption weakening, thus keeping the estimate of 2018 economic growth unchanged.

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