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TALKING TRENDS
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EXECUTIVE SUMMARY

1. Monthly summary

- Annual inflation slowed to 4% in September. It will continue slowing to reach 3% in January, driven by disinflationary factors and no longer affected by the high base due to the VAT hike and the housing and utility price indexation in January 2019. Month-on-month price rises in the most stable components of the consumer basket also slowed, falling below the level corresponding to 4% in annualized terms. As a result of monetary policy decisions, whose effect is lagged, and stepped up budget spending, inflation is set to stop accelerating and to keep close to 4% as temporary factors recede. Meanwhile, still elevated and unanchored inflation expectations suggest the persistence of medium-term risks associated with this. Despite lending expansion, economic activity was generally subdued in the third quarter, mainly on the back of unfavourable external factors. At the same time, year-on-year GDP growth accelerated in the third quarter thanks to, among other things, an upturn in the agricultural sector. The next two quarters are expected to see some economic growth acceleration, helped by stepped up budget spending and generally favourable situation in the Russian financial market.
    - Consumer price movements, the current level of inflationary pressure in the economy and the prevalence of short-term disinflationary risks, suggest further inflation deceleration in the coming months. Inflation is set to return to 4% by the end of 2020 as economic activity picks up and transient disinflationary factors recede.
    - Russian economic growth accelerated year on year in the third quarter. Still, the pace of growth remains slow due to an export decline amid the global economic slowdown, unfavourable demographic trends, and the Russian economy's other structural and institutional problems. Budget expenditure and monetary easing should help an overall rise in demand in the economy, whereas inflation deceleration is set to support real household income growth and consumer demand.
    - A moderate risk appetite in global financial markets, with the Russian market among them, continues due to monetary easing by most major countries' central banks in the face of the rising risks to the global economy. At the same time, there is significant uncertainty over central banks' ability to prevent the global economy from slipping into a recession amid the continued trade tensions.

2. Outlook

- According to the index-based GDP estimate, Russia's economic growth will still be slower than potential before accelerating at the start of 2020.

3. In focus: agricultural output expansion has contributed to inflation deceleration

- The output of most agricultural products is set to exceed last year’s in 2019, hitting an all-time high for some of them. The expanding supply, world food price stabilisation and export growth constraints in a number of subsectors, are making a substantial contribution to the easing of inflation in the second half of the year.
- Confronted by rising costs against a backdrop of strong competition, many producers absorb them through reducing their profit margins. On the medium-term horizon, this may drive inefficient players out of the market and have an adverse effect on food prices due to reduced supply.

1. MONTHLY SUMMARY

1.1. Inflation

Annual inflation remains on the downtrend, with short-term disinflationary risks now prevailing over pro-inflationary ones following rouble appreciation and the successful completion of the crop harvesting season. As a result, annual consumer price inflation is set to decelerate in the coming months.

An analysis has shown that there is a large number of significant temporary factors behind the rapid easing of inflation. At the same time, September also saw a slowdown in the rise of prices which are not very volatile or sensitive to temporary factors. The pace of monthly rises in these prices declined below 4% in annualized terms. This suggests that signs of sustainability of disinflationary processes have emerged, which, all other things being equal, creates conditions for monetary easing.

The key rate cuts carried out this year and budget spending, which is being stepped up later than usual will, with a lag, gradually bring inflation back to 4% by the end of 2020. The continuing elevated inflation expectations may also become a factor of returning inflation to the target.

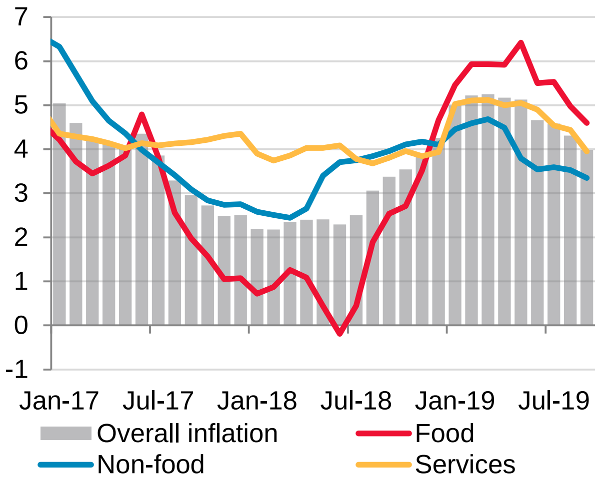
Over the medium-term horizon, pro-inflationary risks prevail over disinflationary ones. Among key pro-inflationary risks are geopolitical factors and volatility surges in financial markets, as well as uncertainty over fiscal policy. These one-off factors may, via possible secondary effects, fuelled by still elevated and unanchored business and household inflation expectations, drive inflationary pressure higher.

1.1.1. Inflationary pressure continued to ease in September

- Inflation slowed to 3.99% YoY in September from 4.31% YoY in August. Price rises decelerated in all of the three CPI key components.
- Prices declined 0.16% MoM in September, which, in annualised terms, is below the path leading to an inflation rate of 4%. Seasonally adjusted monthly inflation slowed to 0.18% MoM (or to 2.15% in annualized terms).
- Aggregate demand and inflation is, with a lag, tempered by later than seasonally normal budget spending in the first half of the year. The stepping up of expenditure in the second half of the year will likely drive inflationary pressure higher at the end of 2019 – start of 2020.
- The estimates of modified core inflation expectations declined, reflecting a decline in fundamental inflationary pressure. But the rate of this decline remains much more moderate than that of overall consumer price inflation.

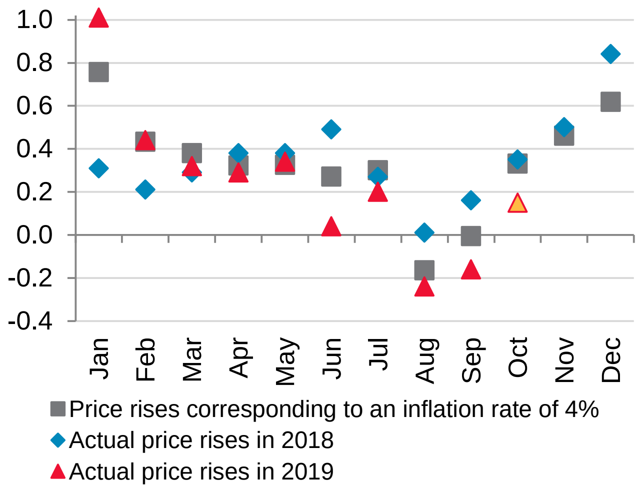
According to Rosstat data, consumer prices dropped 0.16% MoM in September, bringing inflation down to 3.99% YoY from 4.31% YoY in August (Figure 1). Consumer price inflation slowdown was posted in all the key segments.

Figure 1. Inflation and its components, % YoY



Source: Rosstat.

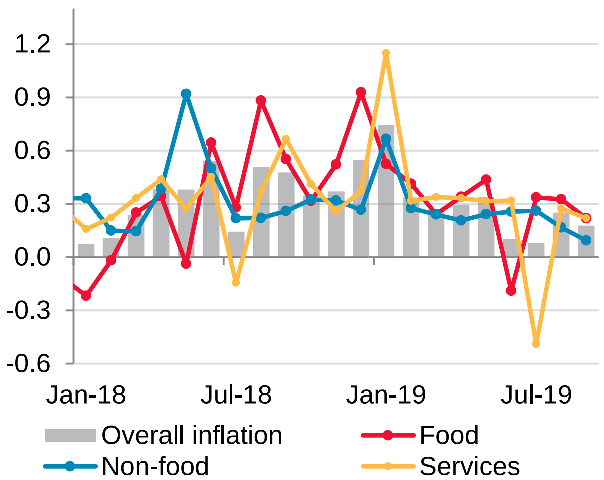
Figure 2. Price rises corresponding to an inflation rate of 4%*, % MoM



Source: Rosstat, R&F Department estimates.
**The October number is an initial estimate.*
The estimate takes account of splitting housing and utility services price indexation into two stages: in January and July.

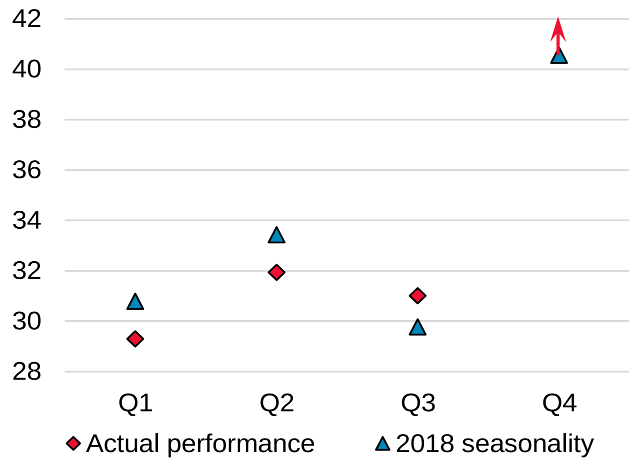
A gap with the path securing an inflation rate of 4% widened (Figure 2). Seasonally adjusted, prices rose 0.18% MoM in September, down from 0.25% MoM in August (Figure 3). Slowed consumer price inflation may be owed to tightening demand constraints, including temporary ones.

Figure 3. Seasonally adjusted price rises, % MoM



Source: Rosstat, Bank of Russia estimates.

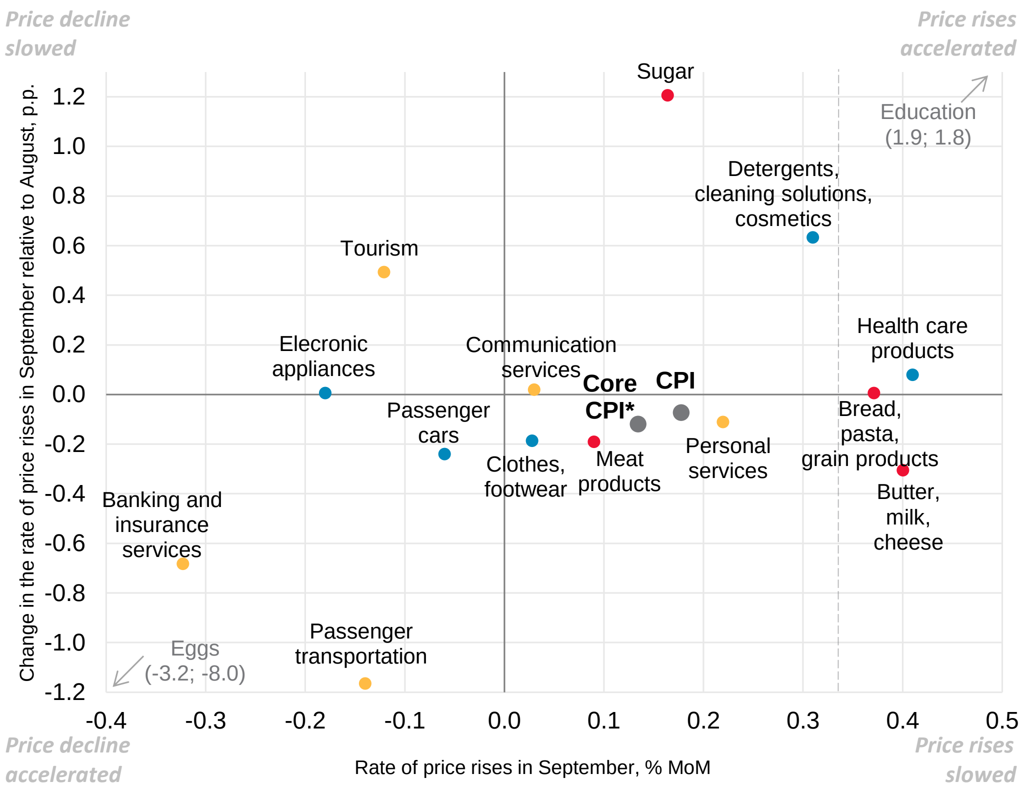
Figure 4. General government non-interest expenditure in 2019, by quarter, % of GDP



Source: RF Treasury, Rosstat, R&F Department estimates.
**Q3 – estimate, Q4 – forecast.*

In particular, aggregate demand and inflation may have been substantially tempered by budget expenditure lagging the normal seasonal pace. The first and second quarters saw non-interest spending of general government 1.5% of GDP below levels corresponding to the seasonal pace of spending in 2018 (Figure 4). Our estimates of the impact of the January 2017 one-off pension payment on inflation showed inflation elasticity with respect to budgetary transfers to households (as a percentage of GDP): 0.15–0.2 pp for the first quarter and 0.25–0.3 pp for the following quarter, with expenditure remaining elevated. Therefore, a budget expenditure underperformance of 1.5% of GDP for two consecutive quarters had a maximum restraining effect of 0.25–0.3 pp in the first quarter and 0.4–0.45 pp in the second quarter. But the actual impact on inflation in the first–second quarters of 2019 was probably much lower because spending was concentrated in items whose effect on inflation is smaller, lagged significantly and more extended over time. We also note that general government spending on non-interest items was given a notable boost, which will likely offset the budget's restraining impact on inflation in the second half of the year, exerting some inflationary pressure in late 2019 – early 2020.

Figure 5. Seasonally adjusted inflation in September and its change from August, % MoM



Source: Rosstat, R&F Department estimates.

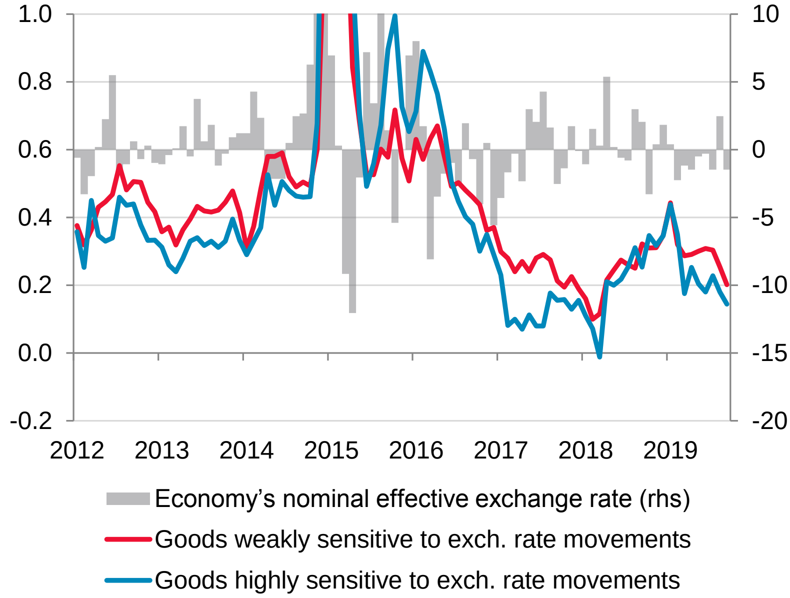
** Modified indicator of core inflation calculated by the truncation method.*

The dashed line indicates the level corresponding to inflation of 4%.

Non-food price inflation is estimated at 0.09% MoM SA, the lowest level over the entire period of observation (since 2002). Food and services prices went up 0.22% MoM SA.

The slowed rate of non-food price rises may be owed to the continued disinflationary impact of rouble appreciation in the first half of 2019. This is, in particular, suggested by the reduced median rate of price rises in goods heavily dependent on exchange rate movements (Figure 6).

Figure 6. Median price rises in goods and services heavily and weakly dependent on exchange rate movements



Source: Rosstat, R&F Department estimates.

** Plus stands for rouble depreciation against foreign currencies, Minus stands for rouble appreciation against foreign currencies.*

Among non-food goods, of special note is a slowdown in clothing and footwear price rises (Figure 5). *On the one hand,* this may be due to moderate exchange rate moves. There is a certain lag between signing import contracts and delivery of goods to the consumer market. Contracts for the delivery of clothes and footwear for autumn and winter may well have been signed based on the rouble exchange rate in the spring, i.e., the period of the most notable rouble strengthening.

On the other hand, the current slowdown in price rises may be owed to the methodological specifics of monitoring seasonal goods prices. Actual prices of autumn/winter clothing and footwear registered by Rosstat in September proved to be lower than estimates made in the summer months to be used as substitutes for the so far missing actual prices.[1] Indirect evidence of this is provided by a substantial decline in the seasonally adjusted rate of price rises in winter clothes, with price movements in summer and non-seasonal categories being relatively stable. The pattern of further price movements would allow more definitive conclusions to be drawn regarding the causes behind the current slowdown in price rises.

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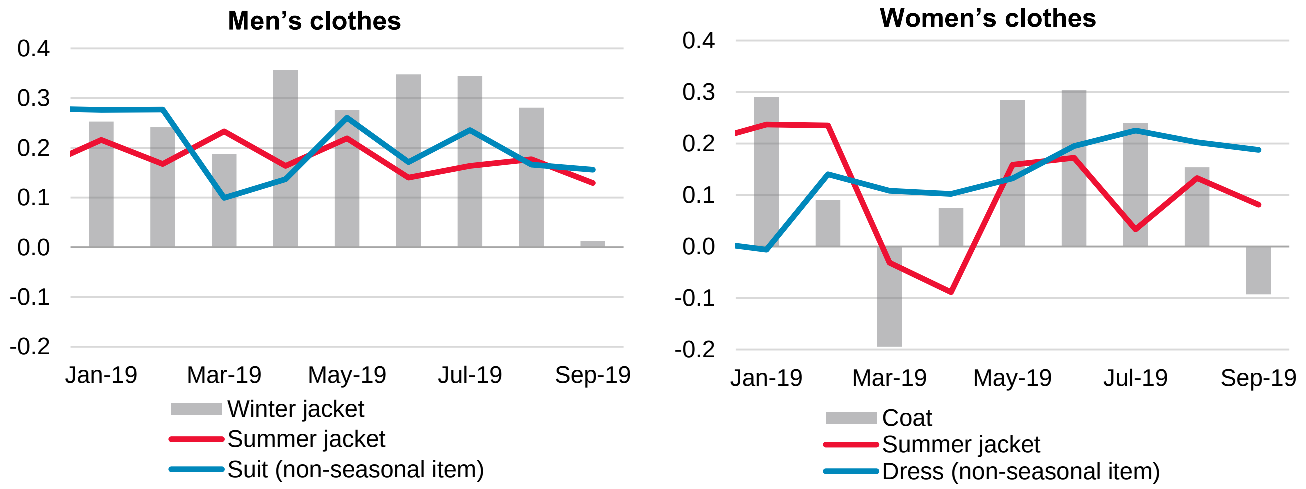
[1] This is a specific feature of estimating changes in prices of seasonal goods in an off-season period, when shops do not have them on their shelves. Rosstat assumes that their prices change in the same manner as those of goods intended for the current season. In the spring/summer season, for example, clothing shops (excluding specialized ones) do not carry winter clothes. In such seasons, Rosstat assumes that movements in winter clothing prices are similar to those for spring/autumn items.

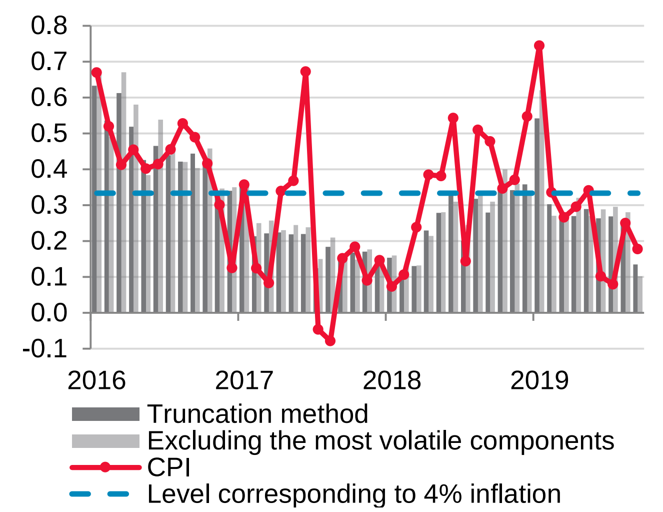
Figure 7. Seasonally adjusted price rises in individual clothing categories, % MoM



Source: Rosstat, R&F Department estimates.

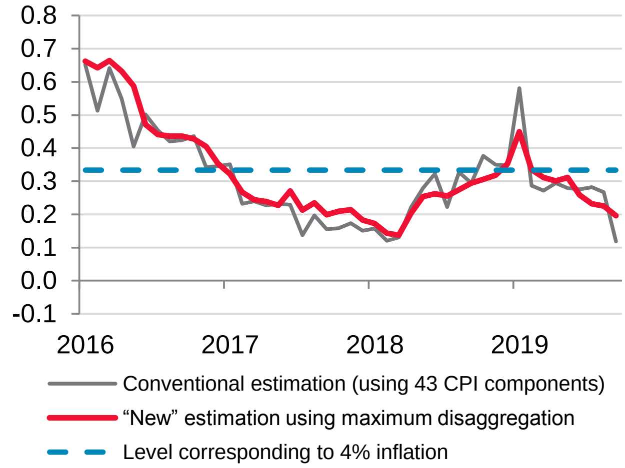
The estimates of modified core inflation indicators plunged below the headline CPI in September (Figure 8). The calculation of similar indicators on more deeply disaggregated data produced somewhat different results: the mean of the estimates stood at 0.20% in September, down from 0.22–0.23% in July–August (Figure 9). The minor decline in the estimates calculated on an enlarged sample compared with a much more notable drop in those produced by a conventional calculation suggests that September's sizable decline in modified core inflation indicators stems from the methodological specifics of constructing the indicators, which do not allow these to be fully adjusted for the impact of one-off/temporary factors.

Figure 8. Modified core inflation indicators, % MoM



Source: Rosstat, R&F Department estimates.

Figure 9. Estimates of modified core inflation estimates using different disaggregation depth, % м/м



Source: Rosstat, R&F Department estimates

Given the substantial disinflationary effect of temporary factors (including the slow pace of budget spending) coupled with the lagged impact of monetary policy decisions, the decline in fundamental inflationary pressure suggested by changes in modified core inflation indicators, may prove to be temporary. Moreover, it is important to note that the pace of this decline remains much more moderate than that of overall consumer price inflation.

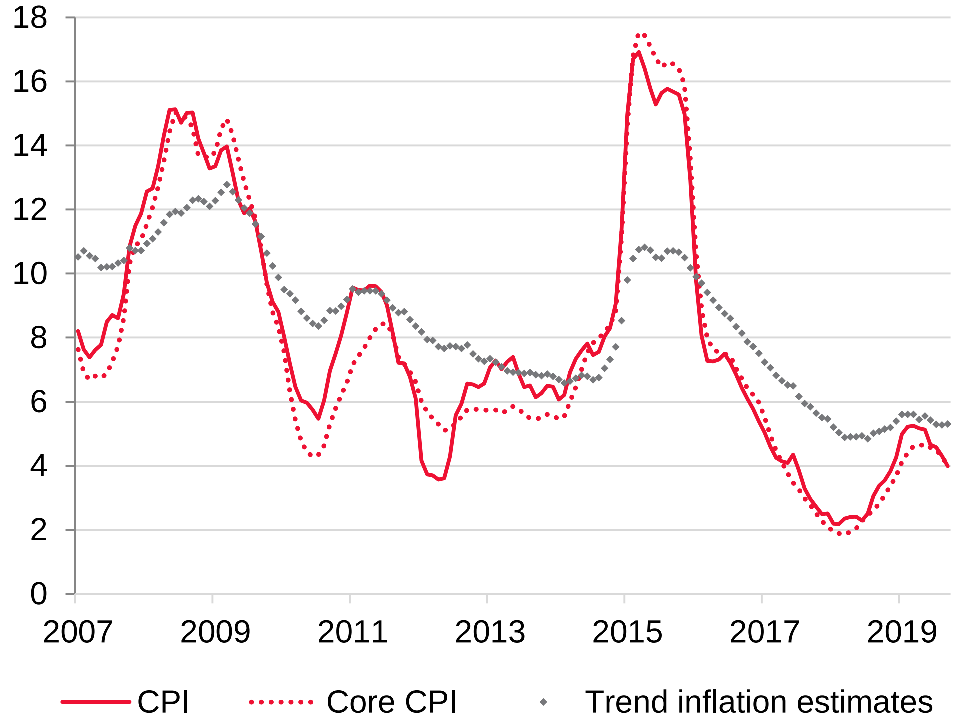
Consumer price movements remained moderate in October. According to real-time Rosstat data, consumer prices rose 0.13% for the October 1–21 period, much less than a year earlier (0.33%), thus reducing the moving average annual inflation estimate to 3.8%. Consumer price movements continue to be significantly restrained by the slow pace of food price rises.

Based on weekly data, we expect consumer price inflation to once again fall below the path corresponding to an inflation rate of 4% (Figure 2). Our preliminary estimate puts the October CPI reading at 0.1–0.2% MoM, with seasonally adjusted figure in roughly the same range and annual inflation at 3.7%–3.8%.

1.1.2. Widening gap between trend inflation estimates

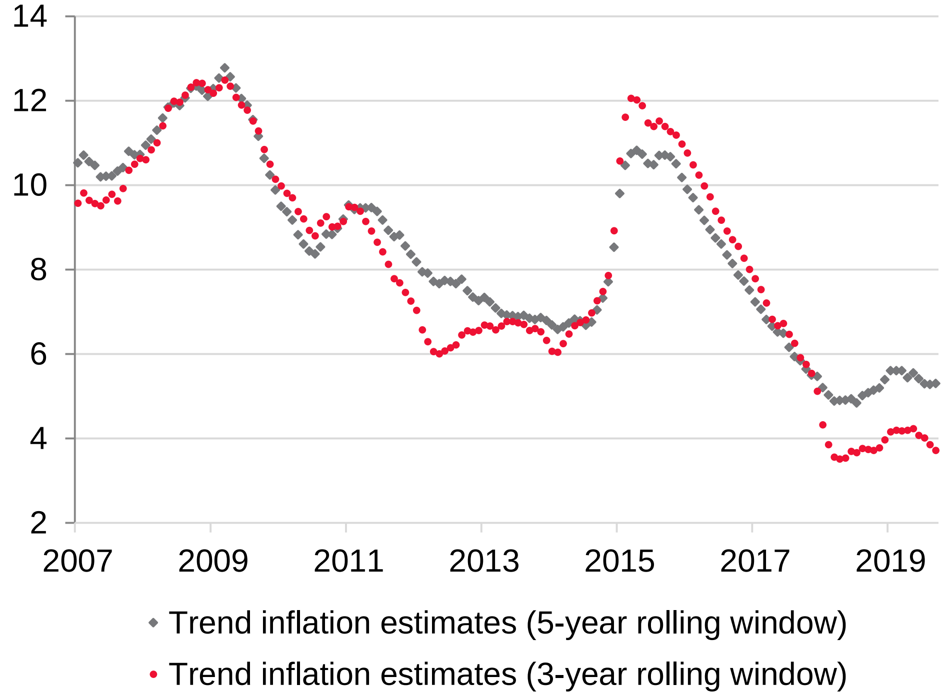
- The trend inflation estimate inched up to 5.30% in September 2019 from 5.28% in August (Figure 10). The marginal rise in the trend inflation estimate versus a notable drop in the headline inflation reading may suggest a hefty contribution of temporary factors to inflation deceleration in the consumer market.
- Meanwhile, a trend inflation estimate calculated on a shorter three-year interval continued declining to come in at 3.72% in September after 3.86% in August (Figure 11). The indicator calculated on the short interval is more sensitive to changes in current price movements, disinflationary at this point.
- The decline in trend inflation estimated on a three-year interval is also technical in nature, as it is owed to the elevated rate of price rises in 2016 leaving the calculation base. The year 2020 may be expected to see a similar “technical” decline in trend inflation estimates calculated on a five-year interval, because the calculation will shed the high inflation numbers of 2015.
- This “technical” trend inflation slowdown so far cannot be unambiguously interpreted as an alleviation of inflationary pressure. As the effect of the high statistical base of 2015–2016 recedes, trend inflation indicators will allow more definitive conclusions to be drawn regarding the inflation trend.

Figure 10. CPI, core CPI, and Bank of Russia historical estimates of trend inflation,[2] % YoY



Source: Rosstat, R&F Department estimates.

Figure 11. Trend inflation estimates constructed for 3- and 5-year rolling periods, % YoY



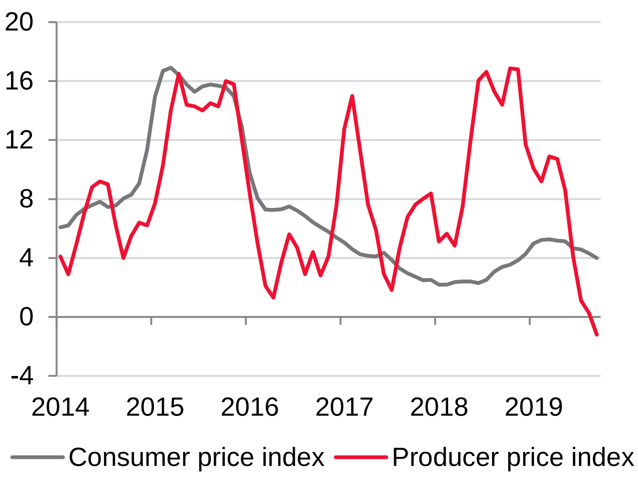
Source: Rosstat, R&F Department estimates.

[2] This trend inflation indicator is constructed over a rolling five-year period.

1.1.3. September's producer price decline

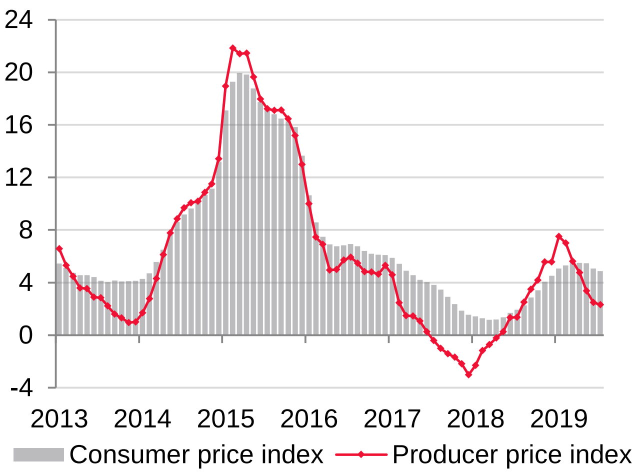
- Producer prices of industrial goods fell 1.22% YoY in September after their 0.27% YoY rise in August (Figure 12). The producer price decline was posted in both mining and quarrying and manufacturing.
- A substantial negative input to the overall indicator came from producer prices in fuel and energy industries (oil extraction and petroleum refining) on the back of a fall in the world oil prices.
- The pace of rises in producer prices of many consumer goods remains below the rate of consumer price inflation (Figure 13). This indicates the absence of producer price pressure on prices in the consumer market.

Figure 12. Change in the producer price index and consumer price index, % YoY



Source: Rosstat.

Figure 13. Change in prices of some goods,[3] % YoY



Source: Rosstat, R&F Department estimates.

Under Rosstat methodology, the calculation of the producer price indicator excludes VAT, and therefore, does not factor in the impact of the January 2019 VAT hike on producer prices.

1.2. Economic performance

Although having picked up somewhat versus the start of the year, Russia's economic growth remains slowed, according to estimates. The global economic slowdown continues to take a toll on Russian exports. As a result, economic growth will likely remain below potential despite the continuing positive credit impulse from lending expansion, which shores up domestic

[3] The calculation used comparable goods in the CPI and PPI structure, such as meat products, fish products, butter and fats, dairy products, pasta, sugar, tea, coffee, clothing, footwear, detergents and cleaning solutions, perfumes and cosmetics, household electronic appliances, and furniture. They account for 30% of the consumer basket.

demand. Gradually easing, monetary conditions are currently not hampering economic activity growth, to say the least.

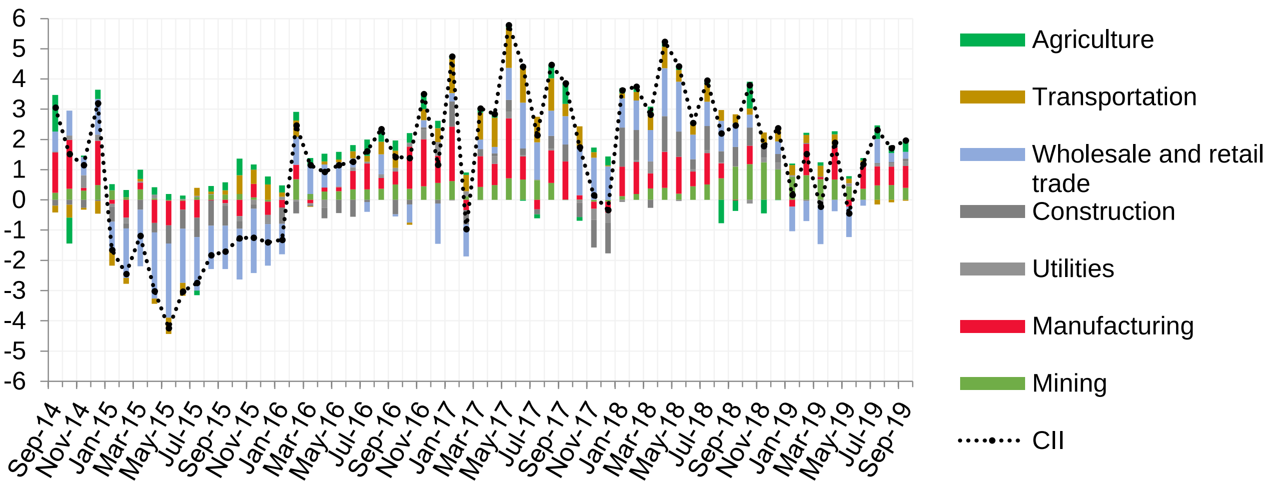
With budget spending being gradually stepped up and monetary conditions easing, Russia's economic growth will be given a boost in the quarters to come in the absence of significant external shocks, a further global economic slowdown among them.

1.2.1. Core industries' output growth gained momentum in September

- Core industries' output growth gained momentum year on year in September. As a result, the third-quarter core industries' index (CII)[4] stood significantly above its second-quarter reading, which will likely have a positive effect on GDP.
- This improvement was owed to practically all industries, except for mining and quarrying and retail trade.

Core industries' output growth accelerated to 2.0% YoY in September from 1.7% a month earlier (Figure 14). This enabled average core industries' output expansion for the third quarter to accelerate 2.0% YoY from 0.9% YoY in the second quarter (Figure 15). Given a close correlation between change in core industries' output and that in GDP, there is reason to expect annual GDP growth acceleration in the third quarter.

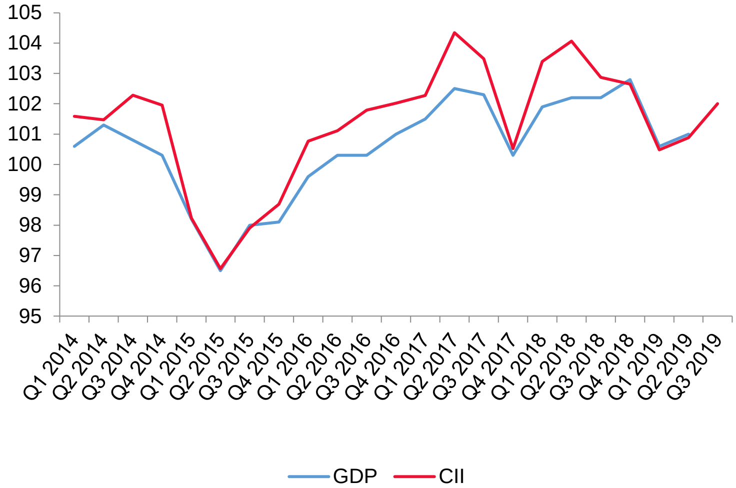
Figure 14. Contribution of industries to the CII in 2014–2019, % YoY



Source: Rosstat, R&F Department estimates.

[4] The core industries' index is calculated by aggregating seven industry-specific indexes (agricultural production; mining and quarrying; manufacturing output; freight traffic; wholesale and retail trade sales; and activities such as water supply; sewerage, waste management and remediation activities; as well as electricity, gas, steam and air conditioning supply; construction, with weights corresponding to the industry's share in Russia's gross value added in 2016.

Figure 15. Quarterly index of GDP and CII in physical terms, % YoY



Source: Rosstat, R&F Department estimates.

Output growth acceleration was fuelled by gains in practically all core industries, except for mining and quarrying and retail trade, both of which registered growth weakening. The fastest growth among core industries was recorded in *agriculture,* up 5.6% YoY, thanks to a stronger output of key crops than a year earlier: cereals and grain legumes posted a 8% YoY rise, sunflower seeds saw a 58% YoY increase, sugar beets were up 16%YoY. Livestock sector also showed strong growth, with meat production increasing 4.7% YoY and dairy production gaining 3.1% YoY.

The main positive input to trade performance in September came from the *wholesale segment,* up 4.6% YoY, helped by, among other things, expanding manufacturing output. *The retail segment* recorded a continued sales growth slowdown in September (a 0.7% YoY rise versus an expansion of 0.8% YoY in August).

September saw *construction* output increase somewhat to 0.8% YoY from 0.3% YoY in August, following a virtual lack of growth in the previous months of 2019. Positive trends which may help further growth in this industry are also evidenced by a Rosstat survey of construction companies. The survey conducted in the third quarter showed a business activity upturn in construction relative to the previous year, owing to, among other things, an orders portfolio expansion, a capacity utilization increase, and the physical volume of operations.

The *transportation industry* is suffering a continued output contraction, albeit at a slower pace of 0.2% YoY compared with a 0.6% drop in August. September figures were more significantly affected by a pipeline traffic fall of 0.4% YoY, whereas railway freight started to expand, posting a rise of 1.3% YoY in September after a 2.0% YoY decline in August. The pipeline transport seems to have shown worse performance than last year against a backdrop of slowed oil and gas extraction and a fall in petroleum product output.

1.2.2. Quarterly growth in industrial output slows somewhat

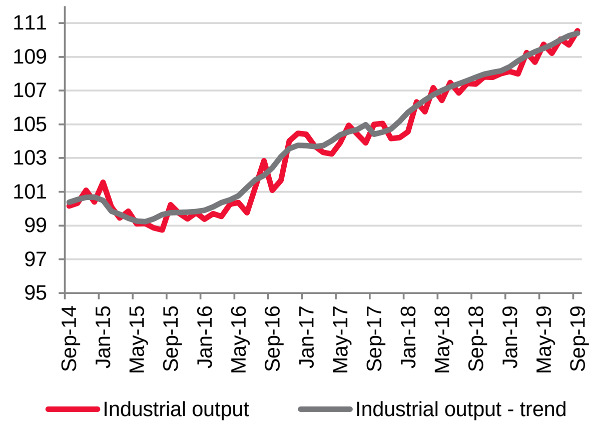
- Industrial output growth accelerated to 3.0% YoY in September, while slowing 0.2% MoM SA compared with August.
- Russia's oil production fell in September, although continuing to exceed the OPEC+ quota somewhat.
- Manufacturing output declined 0.4% MoM SA, driven by a contraction in major industries: manufacture of other transport equipment and petroleum refining. Despite a slowdown in the third quarter, driven by temporary factors, a clear positive performance trend is continuing.

September saw industrial output growth continue at a fast pace. Following a rise of 2.8% YoY in July and 2.9% YoY in August, output expanded 3.0% YoY in September and 2.7% YoY for the first nine months of 2019. Still, despite the year-on-year growth, industrial production fell 0.2% MoM SA in September, according to an R&F Department estimate (Figure 16). Overall, industrial output growth slowed to 0.45% QoQ SA, down from 1.0% QoQ SA in the second quarter.

September's industrial output decline relative to August was driven by a contraction in mining and quarrying as well as manufacturing. Mining and quarrying recorded an annual growth decline to 2.5% YoY, and a contraction of 0.2% MoM SA relative to August. Overall, the third quarter saw growth acceleration to 1.0% QoQ SA from 0.4% QoQ in the second quarter, fuelled mainly by an increase in oil and gas services output and extraction of other natural resources.

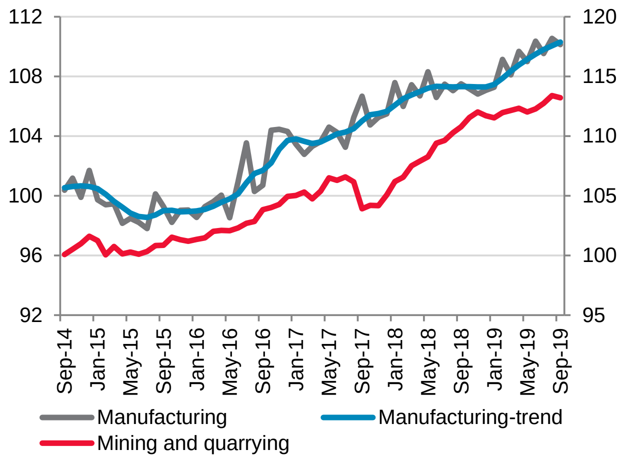
Daily oil production lost 0.4% in September, remaining above the level specified by the OPEC+ agreement. September's contraction in mining and quarrying was also driven by a sharp 9.1% MoM SA decline in the output of services provided in this industry. Overall, the industry is maintaining its upward trend. In the coming years, it is poised to see a faster overall growth rate than that in oil and gas production, as extraction becomes more complicated and intensive. A downward trend continues in metallic ores, whose extraction fell 2.3% MoM SA in September. With a gain of 0.9% MoM SA in September, coal production continued to rebound for the third consecutive month, reaching the level of December last year. The output expansion goes along with a positive export trend, although export shipments have not yet reached the level of the middle of last year, when coal export contraction started.

Figure 16. Change in industrial production index (2002 = 100)



Source: Rosstat, R&F Department estimates.

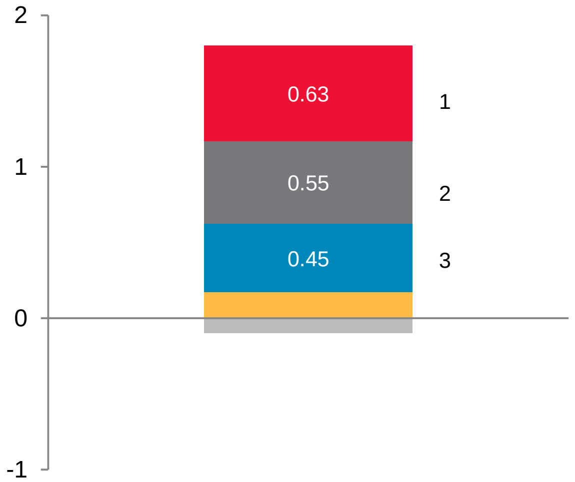
Figure 17. Change in mining and quarrying and manufacturing indexes (2002 = 100)



Source: Rosstat, R&F Department estimates.

Manufacturing's annual growth accelerated to 3.2% YoY in September (Figure 19), thanks to, among other things, the calendar factor.[5] Manufacturing output gained 2.2% YoY over the first 9 months of 2019. Despite the strong year-on-year growth, the sector expectedly posted an output decline of 0.4% MoM SA compared with August. Manufacturing performance is, as usual, volatile in monthly terms: growth is bound to be followed by a downturn, but a gradual upward trend continues. Manufacturing output expanded 0.3% QoQ SA for the third quarter of 2019, whereas the second quarter saw a production rise of 1.3% QoQ SA (the second quarter's strong growth was fuelled by, among other things, a surge in the manufacture of electronic appliances on the back of temporary factors).

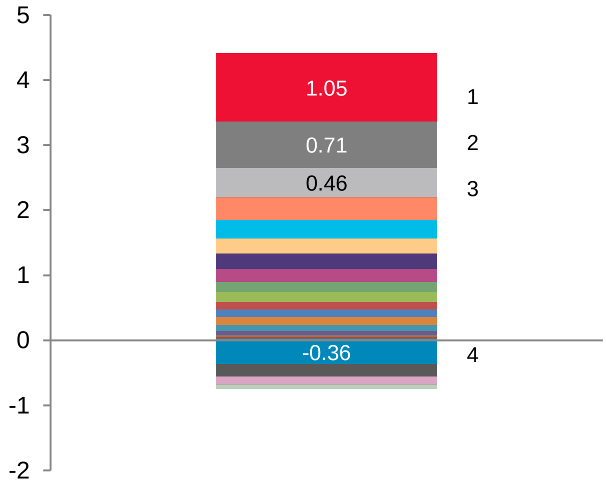
Figure 18. Individual industries' contribution to mining and quarrying growth in September 2019, % YoY



1 Other mining and quarrying
2 Mining support service activities
3 Extraction of crude petroleum and natural gas

Source: Rosstat, R&F Department estimates.

Figure 19. Individual industries' contribution to manufacturing growth in September 2019, % YoY



1 Computer, electronic and optical products
2 Food products
3 Fabricated metal products, except machinery and equipment
4 Machinery and equipment n.e.c.

[5] September 2019 had one working day more than September 2018.

September's key restraining factor was the volatile performance of the manufacture of other transport equipment, with its output plummeting 12% MoM SA in September). In year-on-year terms, this industry scaled down its adverse impact on manufacturing owing to the low base of 2018: September last year saw an even sharper output fall.

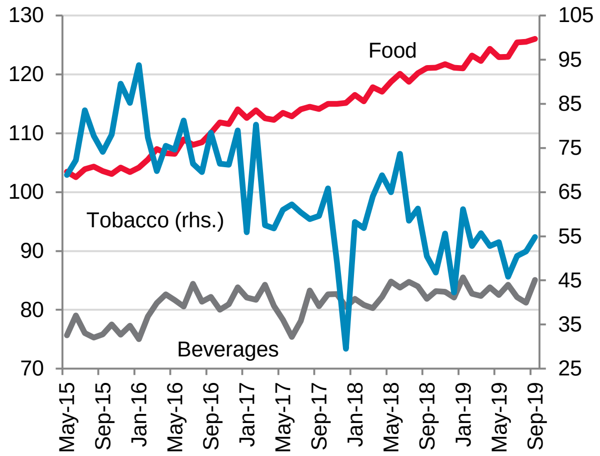
A negative input to manufacturing output also came from another major industry, the manufacture of refined petroleum products, which registered a 0.7% MoM fall for in September. Volatility is continuing in this sector, but its output is still exceeding the levels of the summer months, which saw problems with the Druzhba oil pipeline.

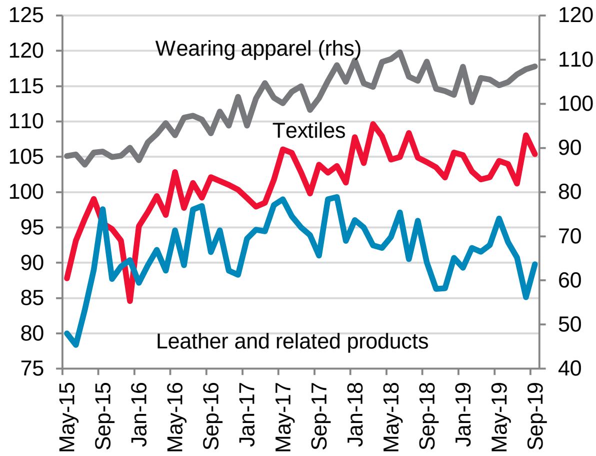
Among other industries meeting *intermediate demand,* the manufacture of chemicals and chemical products posted a contraction of 1.6% MoM SA, but it is maintaining its overall upward trend. Another major industry meeting intermediate demand, the manufacture of basic metals, saw an output gain of 0.8% MoM SA, driven by the production of precious and other non-ferrous metals and nuclear fuel. The iron and steel industry's downward trend continues amid unfavourable market conditions due to low demand outside China.

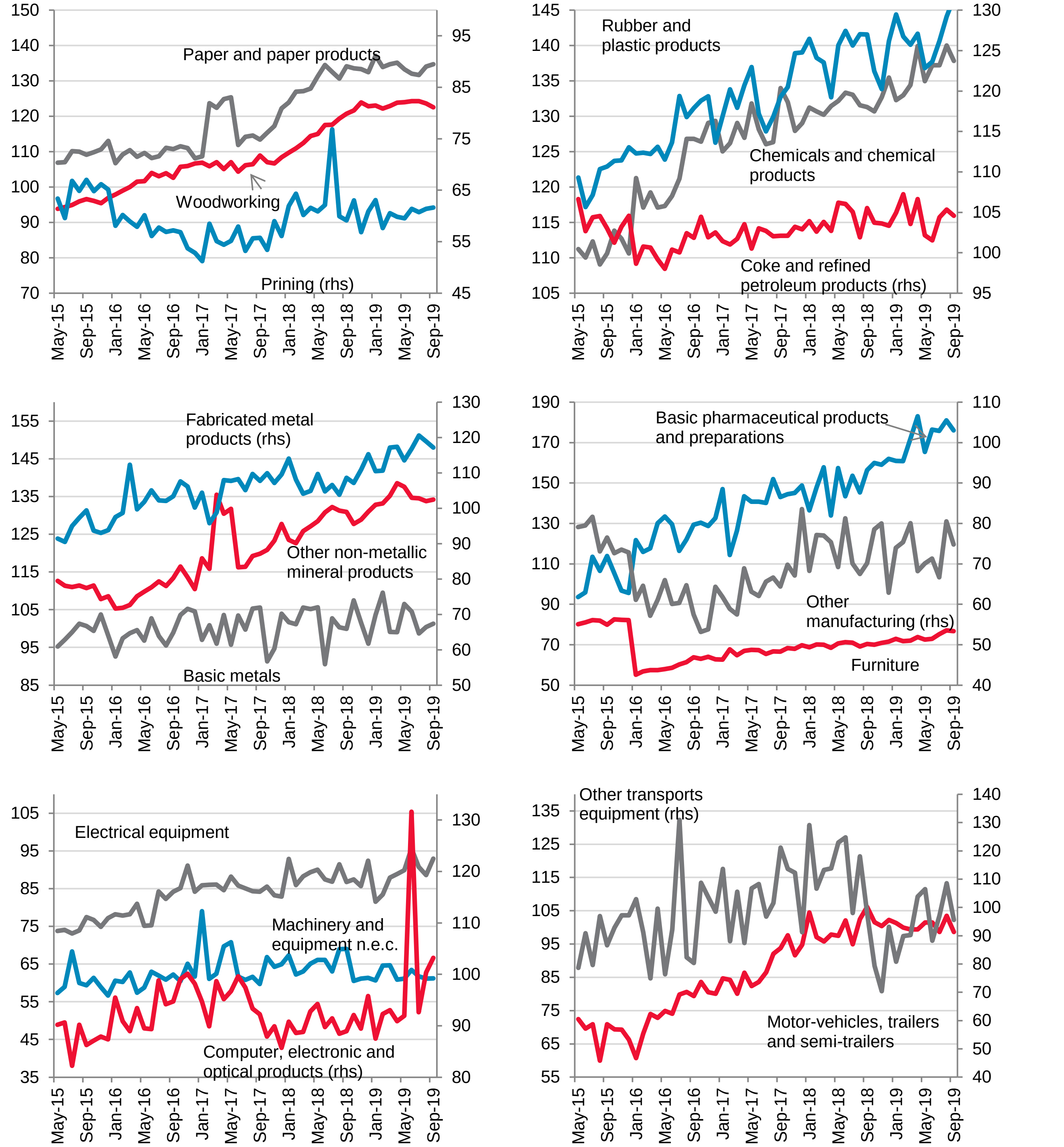
The output of major industries oriented to *consumer demand* – the manufacture of food products and manufacture of beverages, rose 0.4% MoM and 4.8%, in large part thanks to a strong harvest. Most other industries meeting consumer demand suffered an output decline in September.

Industries meeting *investment demand* enjoyed growth in September. Manufacture of construction materials stabilised after a three-month contraction, posting a marginal expansion of 0.3% MoM SA as rail shipments of construction materials jumped 7.6% YoY in September. Production of electronic and electrical equipment gained 2.8% MoM and 5.0% MoM SA, respectively, in September. The output of machinery and equipment remained all but unchanged from August, inching up a token 0.1% MoM. Last year saw an output surge, in August–September, therefore this industry's production plummeted 10.1% in September, driving down annual manufacturing output figures.

Figure 20. Manufacturing industries' output, December 2012=100%, seasonally adjusted







Source: Rosstat, R&F Department estimates.

1.2.3. Survey-based indicators: do they presage business activity growth or slowdown?

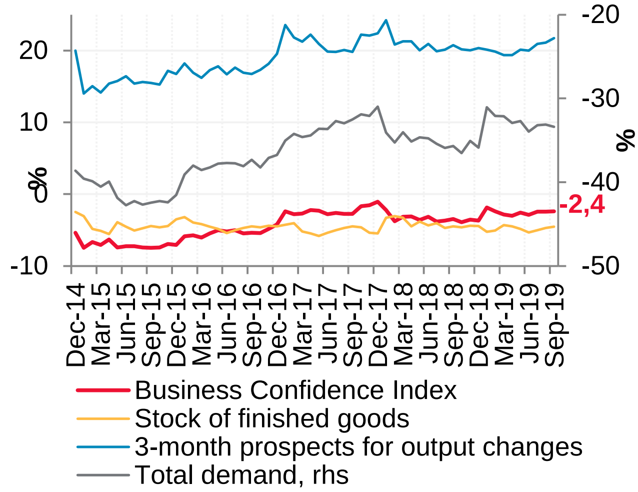
- Rosstat survey data (the business confidence index for manufacturing and mining and quarrying) does not show negative trends in business activity as reported by respondents, posting minor but, nevertheless, positive growth, thanks mainly to the favourable assessment of production outlook.

- Manufacturing and services PMI indexes showed mixed performance: a decline in manufacturing driven by a fall in output and new orders, and a confident rise in services against a backdrop of strengthening domestic demand.
- The differences in survey data are owed to the difference in the structure of samples and estimation methodologies. Against this background, it is, in our view, best to look to PMI data.
- The discrepancy between the weak survey data of the Manufacturing PMI and August's positive industrial output statistics from Rosstat points to the need for a balanced assessment of the situation.
- On the one hand, given the volatility inherent in monthly statistics, optimism regarding the situation in manufacturing looks premature. On the other hand, the drop in the composite manufacturing PMI below the borderline 50 mark may be technical in nature rather than presaging a future recession, which this particular balance of respondents' answers does not promise.
- It needs to be said, though, that, given the subdued output readings and weak investment trends, the negative survey data, and especially that for PMI investment sub-indexes, does signal risks of economic growth continuing below potential.

The business confidence index for manufacturing companies has not shown any meaningful changes since February. In September, the index added a negligible 0.04 pp relative to August (Figure 21). Based on Rosstat survey data, manufacturing companies' optimism regarding the output outlook continues to grow, although the assessment of current demand is not that upbeat.

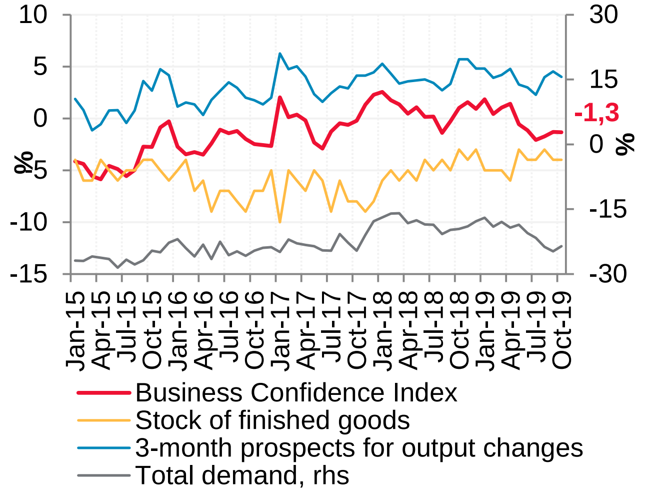
The business confidence index for mining and quarrying showed a rise in the sector's business activity (Figure 22): the index increased for two consecutive months (up 0.4 pp in seasonally adjusted terms in September). As in manufacturing, the survey data points to a fairly sustainable growth in optimism regarding output prospects, but the assessment of mining and quarrying companies' current demand is still weaker than that of manufacturing companies.

Figure 21. Business Confidence Index and its components for manufacturing companies (excl. small businesses), SA[6]



Source: Rosstat, R&F Department estimates.

Figure 22. Business Confidence Index and its components for mining and quarrying companies (excl. small businesses), SA



Source: Rosstat, R&F Department estimates.

In manufacturing industries, the assessment of key factors restraining output growth remained practically unchanged for quite a long period (Figure 23). Mining and quarrying sees a somewhat different situation: some important factors are strengthening their influence (Figure 24). Despite the key rate cut, an increasingly large part of companies cite high loan interest rates, while the number of firms claiming the lack of funds stands above their share last year.

Manufacturing IHS PMI dropped sharply to 46.3 in September from 49.1 in August. The last time the index was seen close to this level was during the 2009 crisis. The precipitous fall of the index was above all driven by an output contraction (the relevant PMI index plunged from 49.9 to 45.2). The respondents attribute the output fall to a contraction in new orders (The PMI index for orders declined from 46.9 to 44.2) on account of weak current demand and difficulties of finding new customers. Against a backdrop of bleak assessment of the current situation, manufacturers indicated declining expectations for output expansion over the next 12 months: the relevant index fell to the lowest level since the end of 2017.

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[6] Rosstat calculates the business confidence index (BCI) based on manufacturing and mining and quarrying companies' business activity surveys. The key index components are total demand for their products and stock of finished goods. The 3-month prospects for output changes are calculated as the difference between the shares of respondents reporting "an increase" and "a decrease" in the next three months (in percentage terms), The stock of finished goods is calculated as the difference between the shares of respondents referring to the number as "more than sufficient" and "insufficient" in the current month. Total demand is calculated as the difference between the shares of respondents reporting the number as "more than sufficient" and "insufficient" in the current month (%).

Figure 23. Factors, constraining manufacturing output growth, share of respondents %

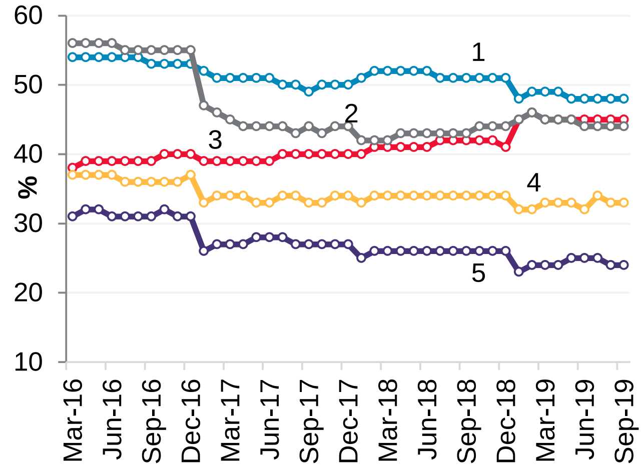
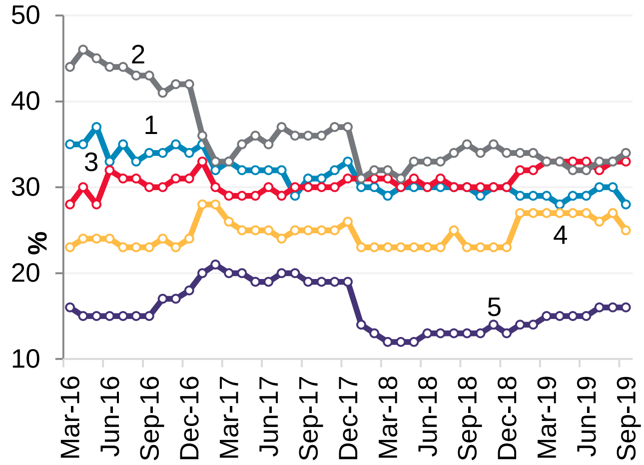


Figure 24. Factors, constraining growth in mining sector, share of respondents %



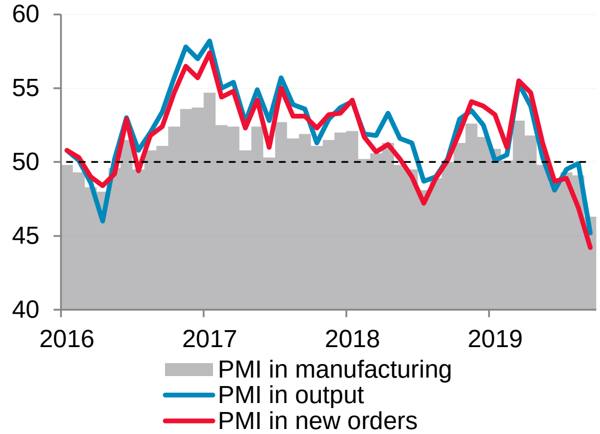
***Factors, constraining growth: 1** – inadequate domestic demand for company products; **2** – uncertainty of economic situation; **3** – heavy taxation; **4** – shortage of finance; **5** – high interest rates on commercial loans.*

Source: Rosstat, R&F Department estimates.

The performance of the services IHS PMI in September points to continued business activity expansion in the sector: the relevant index rose from 52.1 to 53.6 (Figure 26), driven by a gain in new orders (52.1). That said, external demand remains weak: new export orders rise at a slower pace than at the start of the year. As business activity picks up in the services sector, it sees employment expansion resume: respondents report an increase in the number of jobs for the first time since May (the employment index stood at 50.9 in September versus 49.2 in August). Despite the positive change in the assessment of the current situation, the sector's companies more moderately assess prospects of the economic situation in the future against a backdrop of difficult conditions for small and medium-sized businesses: the expectations index continued to slide – from 63.9 to a six-month low of 63.8.

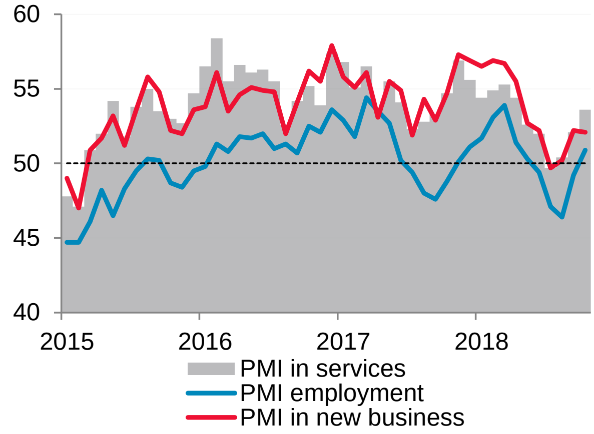
As the composite PMI components moved in opposite directions, its headline reading remained all but unchanged from the previous months at 51.4 versus 51.5 in the preceding month.

Figure 25. Change in PMI manufacturing indexes, pp



Source: IHS Markit.

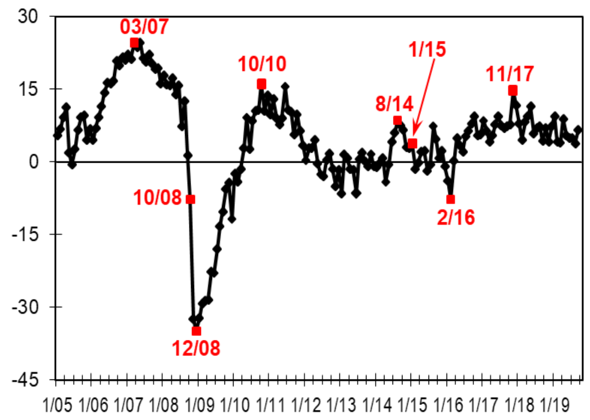
Figure 26. Change in PMI services indexes, pp



Source: IHS Markit.

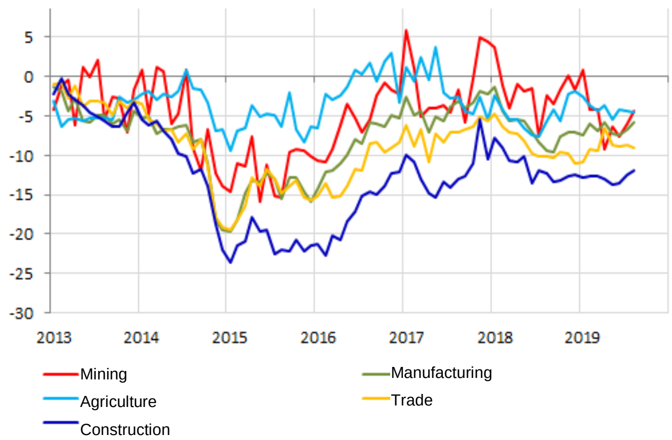
As one can see, data of various business surveys indicates practically opposite trends in the economy. In addition to the above indexes, notable are several more leading indicators (Figure 27, Figure 28). The leading indicators show mixed trends, since samples used in their calculation differ in size and structure, and methodologies employed in their construction are also vastly different.[7] In particular, Rosstat's manufacturing index showed no changes in September 2019, Institute for Economic Policy index and that of Bank of Russia (calculated by the Bank's Monetary Policy Department) pointed to manufacturing growth, while the PMI index for this sector declined notably. In situations of dramatic data changes it is important to understand whether this signals the forthcoming economic activity slowdown in any way. It needs to be said, however, that the level of leading indicators says nothing about the *degree* of the economy's downturn or growth.

Figure 27. Industrial Confidence Index, 2005-2019



Source: Institute for Economic Policy.

Figure 28. Dynamics of business conditions by main types of economic activities (balance of answers, %)



Source: Bank of Russia, Monetary Policy Department.

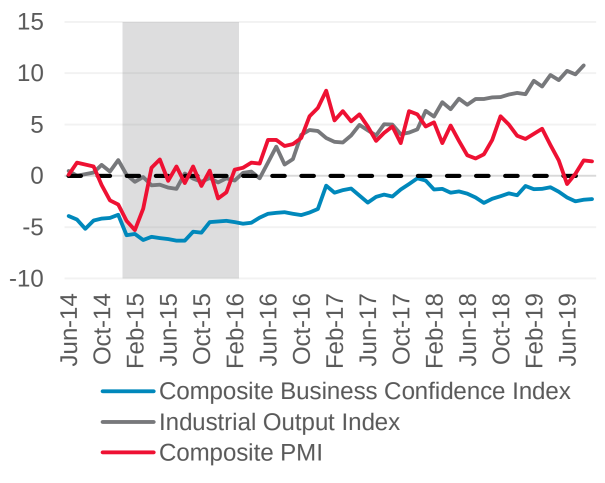
[7] PMI covers about 300 manufacturing companies, the Industrial Optimism Index (IOI) represents about 800 manufacturing and mining and quarrying businesses, Rosstat's Business Confidence Index accounts for over 3,000 industrial enterprises.

To understand the predictive power of indexes, we compare leading indicators with actual output figures (Figure 29). The composite PMI index showed, somewhat in advance, an economic slowdown in 2014, declining to 49.1 from 50.9, while the lowest reading of the index in that period stood at 44.7. The index stayed below the critical 50 mark for six months and then started rising. Rosstat's Composite Index of Business Confidence[8] pointed to a business activity decline practically simultaneously with Rosstat's industrial output index. The reading of this leading indicator came close to positive territory at the start of 2017, with no significant changes in its performance seen afterwards.

Comparison of these leading indicators and real-time statistics is not always relevant, because Rosstat's monthly output data is fairly volatile due to the specifics of companies' reporting and may be lagged. Leading indicators include components reflecting assessment by companies of demand and inventories in terms of "sufficient/insufficient" or "above normal/below normal" in current economic conditions. Even where actual output growth is in evidence, businesses may assess demand as still insufficient or below normal. In such cases, leading indicators and industrial output index may show different performance.

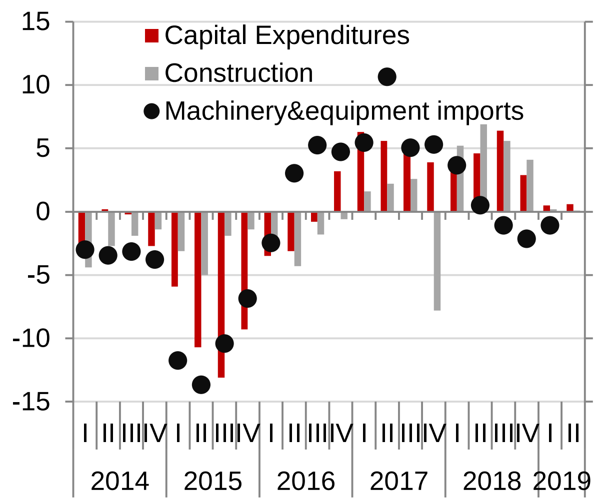
Business sentiment should not be completely ignored as the insignificance of leading indicators' fluctuations is estimated. Since the data of the real economy does not show significant growth, while investment and business expectations suggest negative trends (Figure 30), a decline in leading indicators may, after all, point to the risks of the Russian economy's slowdown in the coming months.

Figure 29. Composite Business Confidence Index, Composite PMI and Industrial Output Index



Source: Rosstat, IHS Markit, R&F Department estimates.

Figure 30. Growth in investment and its components, % YoY



Source: Rosstat, R&F Department estimates.

[8] The calculation of this index by the R&F Department is modeled on that of the composite PMI: three Industrial Confidence Indexes (those for manufacturing; mining and quarrying; and electricity, gas, steam supply) were weighted using weights from the GDP structure..

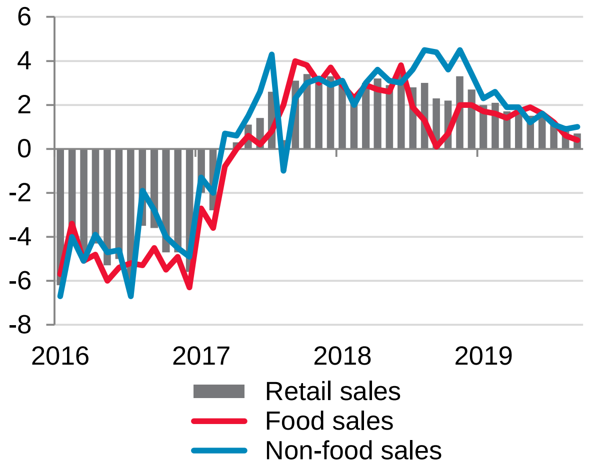
1.2.4. Household income growth picks up, consumption growth slows

- September saw annual retails sales growth continue to slow, dragged down by food sales most of all. Adjusted for the seasonal and calendar factors, retail sales edged up 0.1% MoM in September.
- Meanwhile, household income data indicates a significant improvement in real disposable income growth in the third quarter. Households may have changed their behaviour pattern somewhat, boosting their savings in the third quarter, which adversely affected consumption.
- Expansion in the share of promo sales took a plunge in the first half of 2019.
- Alternative indicators suggest a continued moderate rise in consumption. A consumer sentiment improvement may support this trend even in the face of the expected easing of consumer lending growth.

Rosstat data still indicates a weak retail sales growth. Retail sales expansion again slowed in September to hit the lowest level since mid-2017 at 0.7% YoY, down from 0.8% YoY in August (Figure 31). Retail sales are above all hurt by food sales growth slowdown continuing for the fourth consecutive months. Sales expansion in this category eased to 0.4% YoY in September, with non-food sales growth stabilizing at 1.0% YoY.

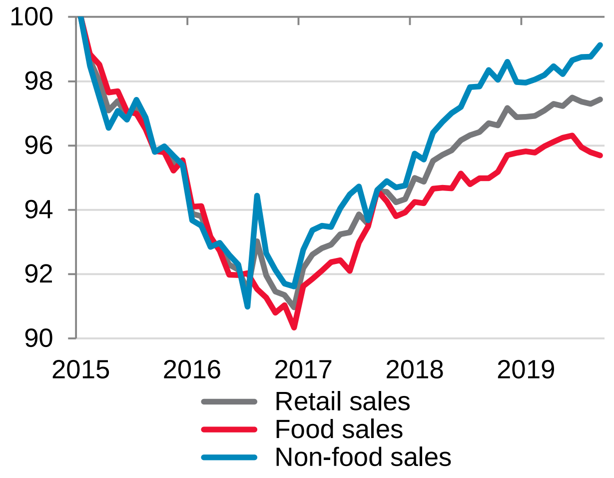
Seasonally adjusted monthly figures show a 0.1% MoM retail sales rise in September, with food sales inching down 0.1% MoM (Figure 32). That said, non-food sales went up 0.4% MoM in the first autumn month.

Figure 31. Change in retail sales of food and non-food goods and retail sales turnover, % YoY



Source: Rosstat.

Figure 32. Change in retail sales turnover, % (January 2015 = 100%, SA)

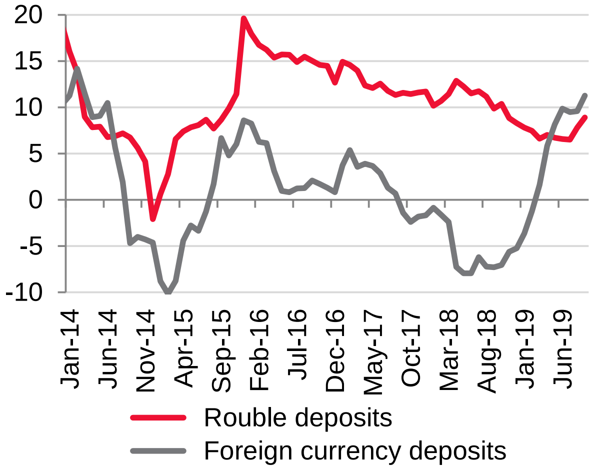


Source: Rosstat, R&F Department estimates.

Rosstat household income data shows a dramatic improvement in real disposable income performance in the third quarter. The indicator gained 3.0% YoY after a long decline

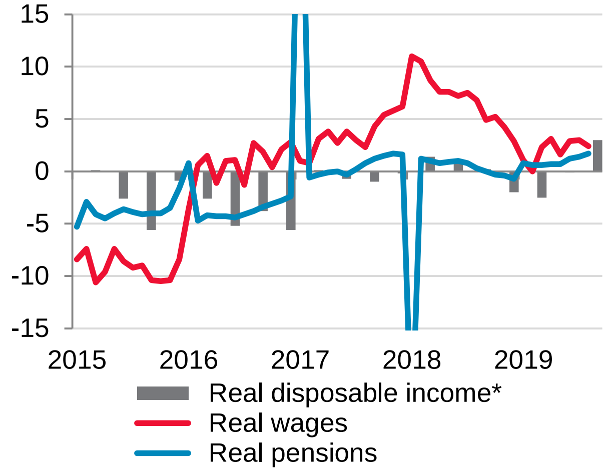
(Figure 34). Households seem to have boosted their savings in the third quarter, as suggested by foreign currency and rouble deposit growth from the low base of last year, which saw outflows of funds from foreign currency deposits (Figure 33). It is also not unlikely that households preferred to expand their deposits before returns contracted even further as the key interest rate declined.

Figure 33. Rouble and foreign currency deposits, % YoY



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

Figure 34. Change in real household income, % YoY



Source: Rosstat, R&F Department estimates.

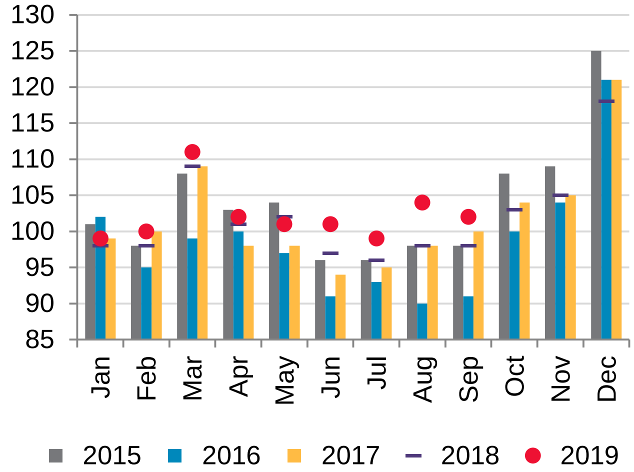
** Calculation based on the new methodology taking into account the one-off payment in January 2017.*

Romir research holding data[9] indicates some contraction in household FMCG expenditure after its jump in August ahead of the new school year (Figure 35). At the same time, this data continues to show that this year's real everyday household spending exceeds that in the same period of previous years.

Consumer sentiment continued to recover in the third quarter. According to a Rosstat survey, the consumer confidence index rose 2 pp compared with the second quarter, buoyed by an improvement in all of the index's components. (Figure 36).

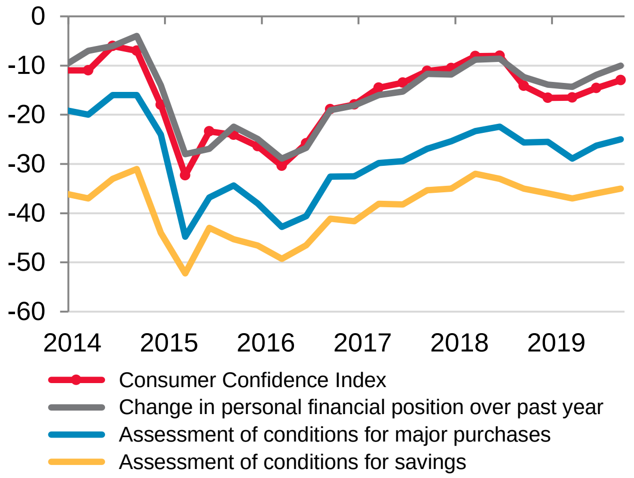
[9] Russian households' income has returned to April's level / Romir Research Holding Company. 11.10.2019.

Figure 35. Real everyday household expenditure, % (2012 median = 100%)



Source: Romir.

Figure 36. Rosstat Consumer Confidence Index and its components



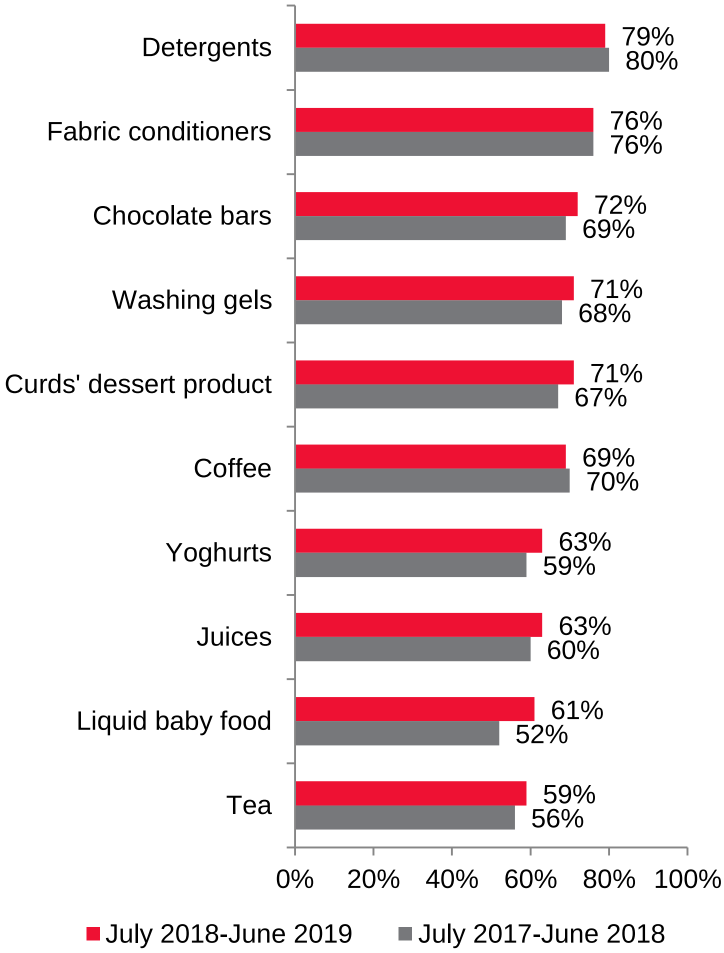
Source: Rosstat, R&F Department estimates.

Nielsen has reported the results of measuring promo sales of various FMCG categories. According to a Nielsen Promo Scantrack survey, the first half of 2019, promo sales growth slowed in both money and physical terms. The share of sales of all FMCG[10] categories stood at 53% (52% and 45% in the first half of 2018 and 2017, respectively). Growth also slowed dramatically in all of top-20 FMCG categories.

This is the case for both food and non-food segments (their shares of promo sales stood at 50% and 53%, respectively, in the first half of 2019). Detergents and conditioners remain the leaders in terms of their shares of promo sales (Figure 37). At the same time, the share of promo sales of most food categories shows growth.

[10] The FMCG market includes food products, beverages, home care chemicals, personal care items and cosmetics, baby food, pet food, and medications.

Figure 37. The share of promo actions in total sales of modern format shops , % (in money terms)



Source: Nielsen Promo Scantrack.

It is worth noting that the average discount remained fairly high in the first half of 2019. At 25%, it was practically unchanged compared with 2018. The slowdown in promo sales growth is set to bring about a more moderate rise in non-food sales. Given the newly emerged income growth and improving consumer sentiment amid consumer lending growth easing, a moderate consumer demand expansion can be expected to continue.

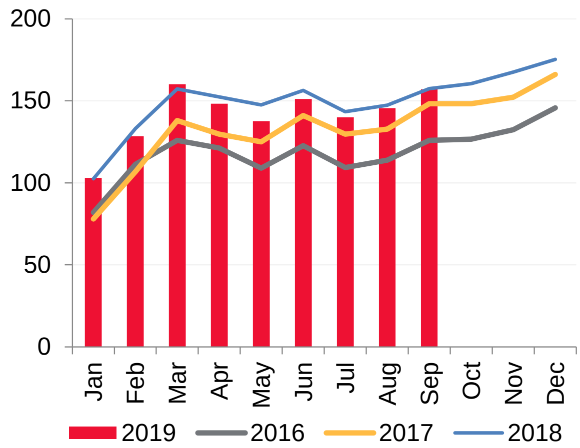
1.2.5. September's car market: sales remain stable

- According to Association of European Businesses (AEB) data, the sales of new passenger cars and light commercial vehicles remained almost unchanged from a year ago, declining 0.2% YoY (Figure 38).
- Demand for new cars fell 2.0% YoY for the first nine months of 2019. The sustainable weakly negative trend made the AEB downgrade its annual sales forecast for 2019 from 1.87 million to 1.76 million cars, down 2.3 YoY. There is, however uncertainty regarding a possible utilization fee hike as of January 1, 2020, and hence an increase in

payments to the budget as cars are imported. This may give a short boost to the sales of imported cars before the end of the year, to be offset by a subsequent fall.

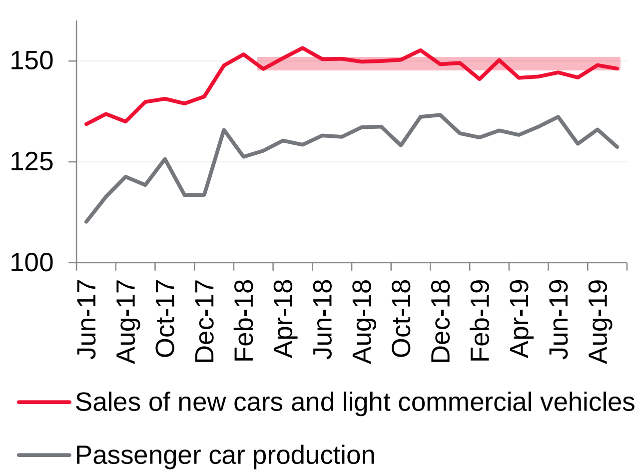
- Monthly sales figures remain volatile: seasonally adjusted, demand fell 0.6% MoM in September after a 2.2% MoM growth in August (Figure 39). The premium car segment accounting on average for 8–9% of total sales posted a slight rise of 0.6% MoM SA.
- Passenger car production declined again in September, down 3.2% MoM SA, Figure 39). Output moved to positive territory for the first 9 months of 2019, rising 1.0% YoY. But this is a much lower growth rate than 16.5% YoY a year earlier.
- Overall car exports show a steady positive trend. July saw exports rise at double digits in both monthly terms (up 10.9% MoM SA in July, figure 40) and year on year, growing 27.8% YoY for January–July. Exports declined slightly in August, returning to their June values. The share of exports in output expanded, coming in at an average 7.3% for the first eight months of 2019 versus 5.7% in 2018. But export deliveries are still relatively too modest to provide support to production in the face of domestic demand stabilization.
- The sizable year-on-year export growth in physical terms is fuelled by a rise in deliveries to a limited number of countries, mostly Belorussia and the Czech Republic, of car makes no longer manufactured in the Czech Republic from factories of one global car-making group. This development hardly supports claims of Russian car exports' emerging competitiveness.
- Following a steady import growth from the end of last year, the imports of transport equipment contracted 9% MoM SA in July. A reduction in car import tariff in September under agreements with the WTO, will likely help resume the positive import trend before the end of the year.
- Rises in consumer prices of new cars still far outpace inflation but are slowing gradually (especially in the foreign brand segment) (Figure 41).

Figure 38. Sales of new passenger cars and light commercial vehicles, thousand units



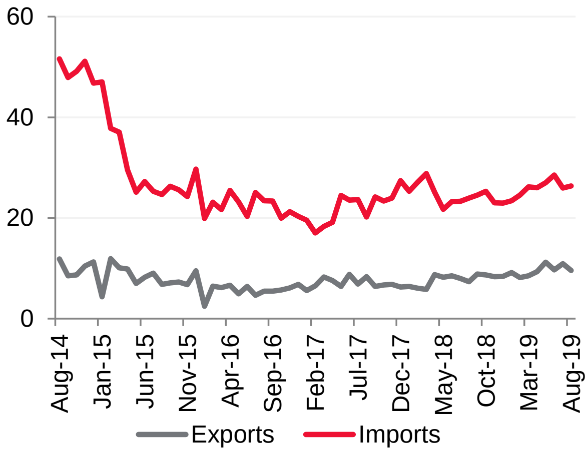
Source: AEB, R&F Department estimates.

Figure 39. Sales of passenger cars, seasonally adjusted, thousand units



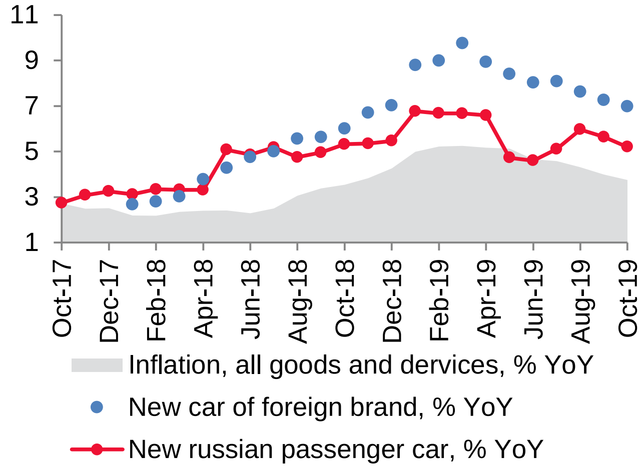
Source: AEB, R&F Department estimates.

Figure 40. New passenger car exports and imports, thousand units, SA



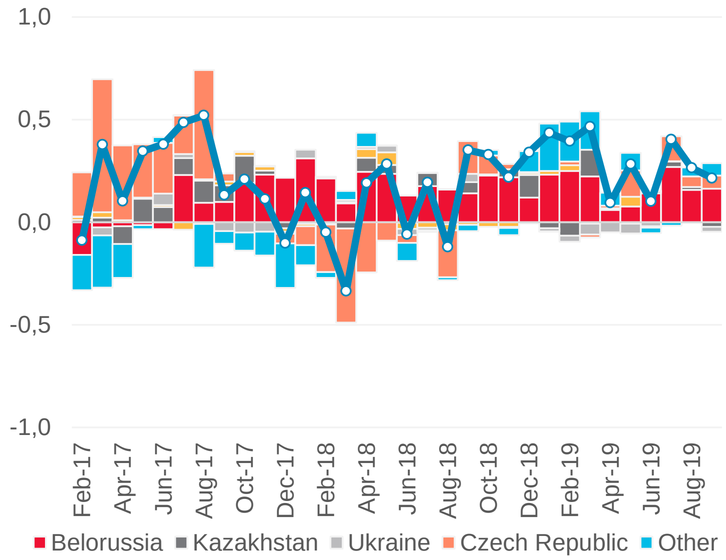
Sources: Federal Customs Service, R&F Department estimates.

Figure 41. Inflation rate and the pace of consumer price rises for new cars , YoY %



Source: AEB, R&F Department estimates.

Figure 42. Passenger car exports, YoY, %



Source: Federal Customs Service, R&F Department estimates.

1.2.6. Unemployment rate rises temporarily in September

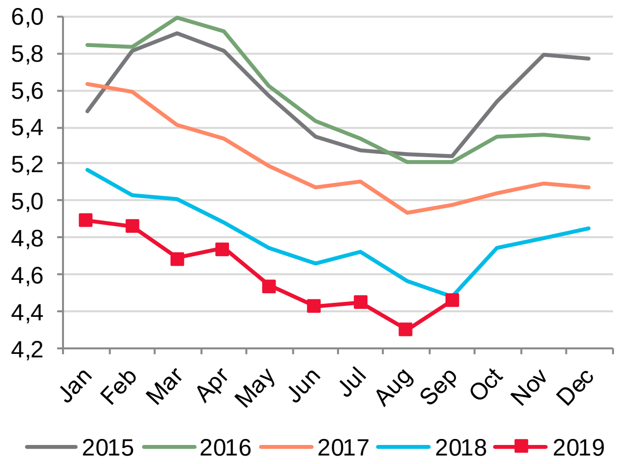
- September saw an unemployment rate rise uncharacteristic for this month, likely due to earlier than usual completion of farming operations.
- Wages rose at a slower pace than in July on the back of growth easing in the public sector[11].

According to Rosstat data, the rate of unemployment rose from last month's figure to reach last year's level of 4.5% (Figure 43). The unemployment rate also rose in seasonally

[11] Rosstat stopped releasing the initial estimate of the previous month's wages in October.

adjusted terms – from 4.57% to 4.65%. Unemployment data may be mixed in early autumn, because it substantially depends on seasonal operations. Autumn months, as a rule, see an employment decline in construction, agriculture, and partially in trade, thus triggering an increase in unemployment headcount. An earlier than seasonally normal unemployment rise in agriculture could have resulted from the earlier start of harvesting this year (in August). The unemployment increase is therefore temporary, caused by a shift of seasonal effects in time.

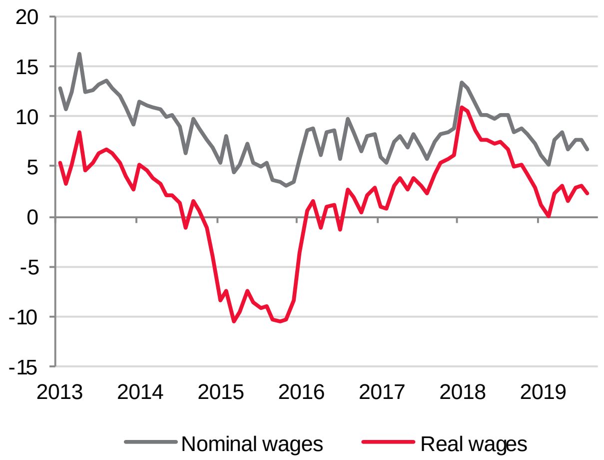
Figure 43. The unemployment rate by year, %



Source: Rosstat.

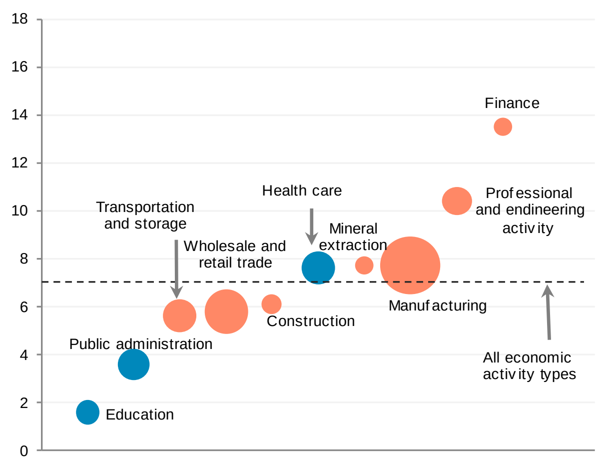
Wage growth equaled 6.8% YoY in August in nominal terms and 2.4% YoY in real terms (Figure 44). Public sector nominal wage rises slowed drastically from 7.9% YoY in July to 4.8% YoY in August. Wages edged up just 1.0% YoY in the education sector and by 3.6% YoY in the public administration sector. August is an unrepresentative month, because this is a summer vacation time for most of education sector employees, therefore, wage growth slowdown will likely be temporary.

Figure 44. Wage growth rate, % YoY



Source: Rosstat.

Figure 45. Nominal wage growth in August, % YoY



Source: Rosstat.
The circle size represents a share in the total payroll.

The pace of private sector wage growth was little changed at 7.4% YoY in August versus 7.6% YoY a month earlier. Private sector industries show a wide scatter of wage growth rates. The financial sector was, as previously, in the lead, enjoying wage growth of 13.5% YoY, whereas most other industries saw a wage increase of less than 8.0% YoY (Figure 45).

1.2.7. Q3 balance of payments: current account surplus shrinks, capital flows stabilise

- The current account surplus stood at 12.9 billion dollars, missing our expectations. This provides grounds for Bank of Russia forecast of annual current account surplus to be downgraded.
- There are several causes of the low current account surplus. In addition to a contraction in export proceeds due to falling oil prices, non-oil and gas exports were falling in January–August for a number of commodity items, while imports continued to rebound more extensively.
- Preliminary data suggests that the current account surplus will not be much stronger in the fourth quarter than in the third quarter, remaining under pressure from weak export performance (due to, among other things, falling global demand) and continued import growth.
- In financial transactions, the third quarter saw a near-zero financial account balance. The government sector posted continued, albeit marginal 1.1 billion dollar net inflows of nonresidents into OFZs after a surge to 10.5 billion dollars in the second quarter.

The current account surplus stood at 12.9 billion dollars in the third quarter of 2019, a marginal rise compared with the second quarter and a drop by half from a year earlier (27.4 billion dollars).

The current account surplus accumulated from the start of the year thus totaled 57.2 billion dollars. Preliminary estimates suggest that the fourth quarter current account surplus will not be much stronger than in the third quarter. Against this background, the full-year surplus will likely be closer to 4.2–4.5% of GDP (70–75 billion dollars) rather than about 4.8% of GDP, as the previous forecasts expected.

The weaker current account surplus stems from a number of factors. *First*, a trade surplus contraction driven by a fall in exports both by value on the back of unfavourable price movements, and in physical terms, under pressure from the global economic slowdown. *Second,* a larger deficit of other current account components, due above all to the services balance deficit.

Non-oil and gas exports fell 3% QoQ and 17.5% YoY to 55.7 billion dollars in the third quarter. According to Federal Customs Service data, oil exports gained 5.9% YoY in physical terms in August, which was all offset by an oil price drop. As a consequence, exports by value contracted 7.9% YoY. *Petroleum product exports plummeted 16.3%* YoY in August. Based on our estimates, total exports of mineral resources fell both by value and in physical terms in August 2019.

The latest data suggests that it is not only oil and gas exports that are shrinking. Based on our preliminary estimates, non-oil and gas exports continued to contract in physical terms in the third quarter of 2019, while rising 3.6% QoQ and 6.5%YoY by value (the difference, however, equals just 1.6 billion dollars QoQ and 2.8% billion dollars YoY in nominal terms.

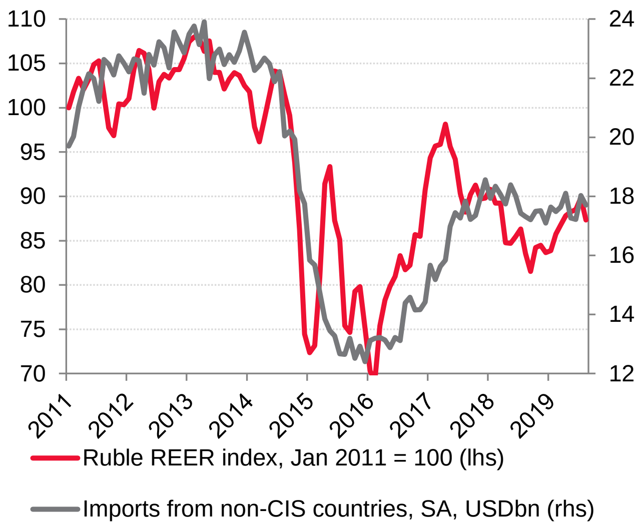
A year-on-year contraction in physical terms slows down in key export categories (largely owing to the base effect), while the pace of MoM growth declines in metals, with the situation in chemical products showing no improvement, to say the least.

Imports continued to expand in the third quarter, rising 5% QoQ and 3.5% YoY to 64.9 billion dollars. In particular, imports from other than former USSR countries added 5.3% YoY in September.[12] This positively affected overall import performance in the period from the start of the year: after a 2.6% YoY drop in the first half of 2019, imports are steadily growing in the second half of the year.

The downward trend recorded at the start of 2019 stemmed, on the one hand, from the high base of 2018, and on the other hand, from the deferred effect of real rouble depreciation against the currencies of Russia's key trading partners in 2018.

These factors are, however, now acting in the opposite direction: imports reacted to rouble depreciation in the first half of 2018, providing a low base for calculating its annual performance figures, whereas the latest rouble strengthening brings about gradual import strengthening in seasonally adjusted month-on-month terms.

Figure 46. Imports and rouble exchange rate

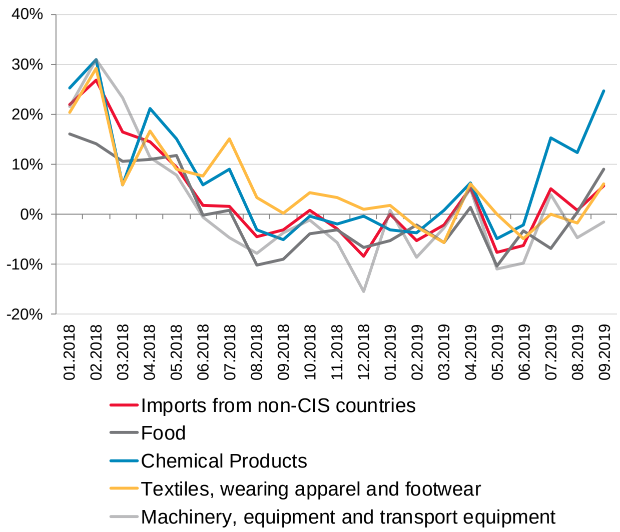


Source: CEIC.

[12] The latest data. Here and further on, September's import data covers imports from other than former USSR countries.

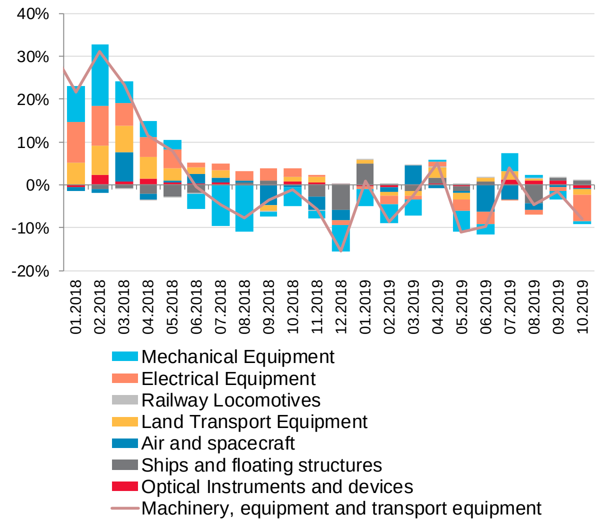
Overall import performance was in large part driven by a recovery in consumer imports. Food imports, for instance, gained 8.4% YoY in September. Clothing and footwear imports rose 6.9% YoY, whereas August's expansion was much more modest at 12.3% YoY in this category. The key growth driver in this category was an impressive 69% YoY rise in pharmaceutical imports in September. This explosive growth may have arisen from stepped up government purchases, and hence may prove to be a temporary development. Also notable is growth acceleration in perfumery products and cosmetics to 19.8% YoY and home care chemicals to 14.2% YoY in September 2019.

Figure 47. Import components growth from non-CIS countries, USD, YoY



Source: CEIC, Federal Customs Service, R&F Department estimates.

Figure 48. Decomposition by component of machinery and equipment imports by value, YoY



Source: CEIC, Federal Customs Service, R&F Department estimates.

While the consumer import trend is generally positive, imports of machinery and equipment (the key investment import category), by contrast, showed both a quarter-on-quarter and year-on-year decline (down 1.9% YoY) in September. This change was largely driven by a contraction in imports of mechanical equipment by 5.1% YoY and electrical equipment by 2.9% YoY.

Statistics therefore suggest continued pressure on the current account from a seasonally adjusted decline in exports and growth in imports, mainly of consumer items, in the fourth quarter of 2019.

As regards the third quarter financial account, the private sector's financial transactions suggest a zero balance in other sectors and the Russian banking sector's near-zero net lending of 1.5 billion dollars to the rest of the world. Banks reduced their foreign liabilities to nonresidents by 8.1 billion dollars, paring their foreign assets by 6.7 billion dollars. Since in the previous months banks were, by contrast, expanding their foreign assets, the change in the situation may well be owed to lesser net inflows of foreign currency to Russia as a whole, when the entire inflows as part of current account surplus were absorbed by international reserves growth of 15.9 billion dollars, mainly through purchasing foreign currency on behalf of the Finance Ministry under the fiscal rule.

1.2.8. Corporate and retail lending expansion remained on August level in September

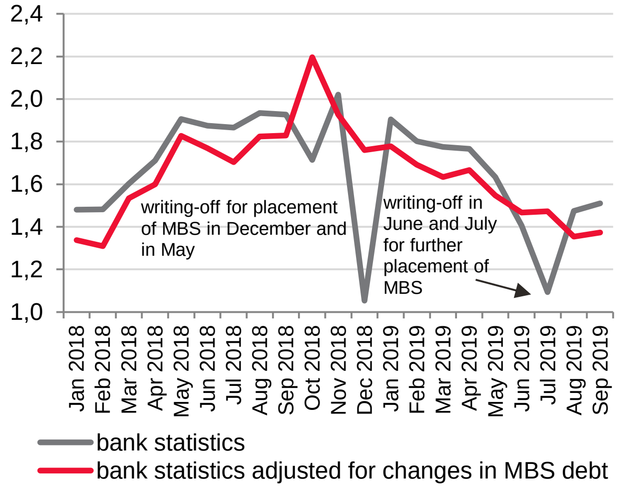
- Lending expansion stabilized in September: the rate of both retail and corporate rouble lending growth remained close to August levels.
- Seasonally adjusted monthly mortgage lending growth softened in September, with unsecured consumer lending expansion slightly accelerating.
- Unsecured consumer lending may start slowing due not only to Bank of Russia policy but also because of internal policies of banks themselves encountering the first signs of borrower quality worsening.
- Corporate lending continued to slow year on year owing to a notable contraction in the foreign currency part of the portfolio, down 13.1% YoY. Rouble corporate lending continues to expand at a rate close to levels estimated as sustainable in the long term.

Retail lending growth, inclusive of change in principal of loans providing collateral for mortgage-backed securities (MBS) and a write-down of a part of the banking sector's retail loan portfolio transferred to an SPV as collateral for the subsequent issuance of mortgage-backed securities, remained on August's level – just below 1.4% MoM in seasonally adjusted terms (Figure 49). The annual rate of retail lending expansion continued to slow, sliding to 20.9% YOY from 21.4% YoY[13] (Figure 50). Even if the current pace of seasonally adjusted month-on-month growth continues, the rate of retail portfolio expansion will fall below 20% before the end of the year. Meanwhile, seasonally adjusted annualized retail lending growth rate already stands at about 16% SAAR.[14]

The components of retail lending structure showed mixed trends. We estimate that the rate of mortgage lending growth inclusive of the principal of loans covering the issuance of mortgage-backed securities (MBS) and a write-down of a part of the banking sector's retail loan portfolio in June and July to provide collateral for future MBS issuance, continued its slow decline. Seasonally adjusted, its growth rate fell below 1.2% MoM (Figure 51).

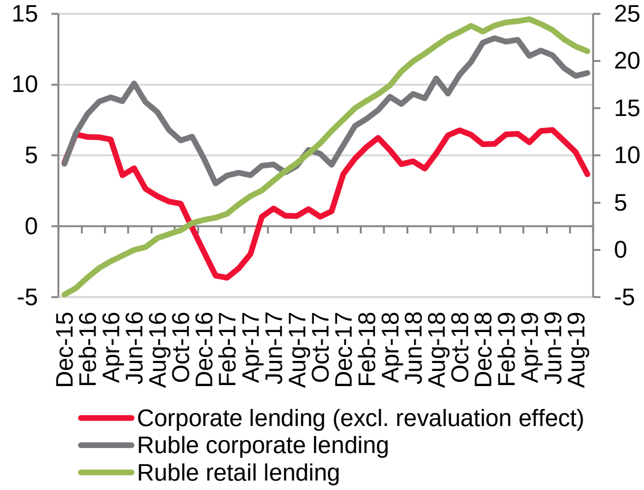
[13] Unless otherwise provided, here and further on, annual growth rates are specified for banks which were in operation as of the last reporting date.
[14] Seasonally adjusted monthly growth in annualized terms.

Figure 49. Retail lending growth, % MoM (seasonally adjusted)



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

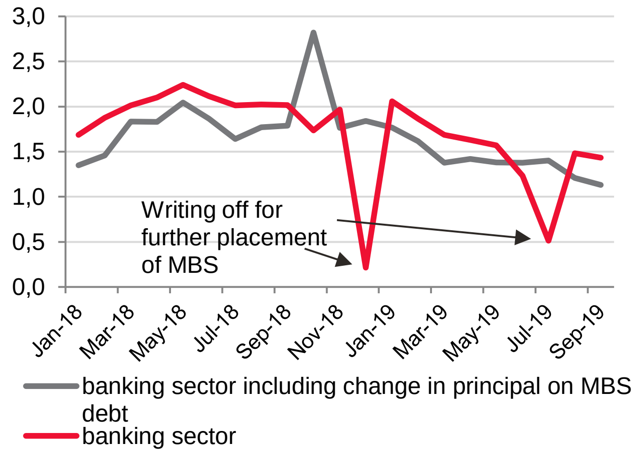
Figure 50. Annual rates of outstanding loand debt, % YoY



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

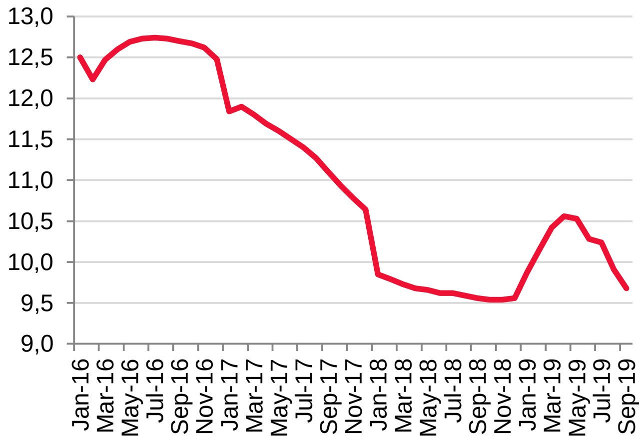
September saw the weighted average rate on issued mortgage loans almost returned to all-time lows recorded last year (Figure 52). The current monetary easing will likely trigger a further decline in mortgage loan rates, which will support demand for this lending type going forward.

Figure 51. Mortage lending growth, % MoM (seasonally adjusted)



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

Figure 52. Rate on mortgage loans provided %

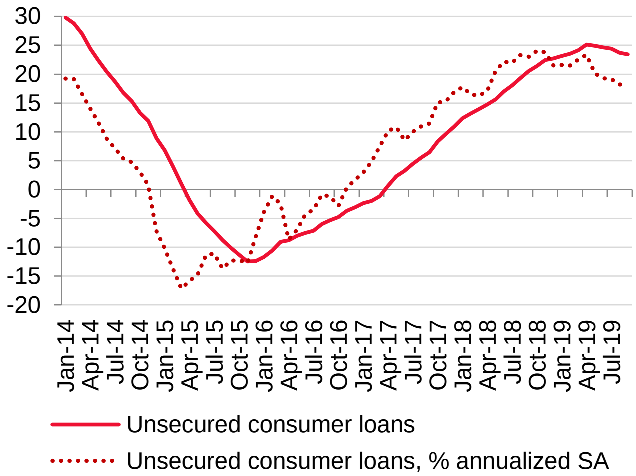


Source: Bank of Russia, R&F Department estimates.

Seasonally adjusted monthly growth in unsecured consumer lending gained some momentum in September (Figure 53). This is probably owed to loan issuance acceleration in the run-up to the introduction of add-ons to risk weights depending on the borrower's debt service to income ratio: banks showed elevated marketing activity in September. Meanwhile, the annual rate of unsecured consumer lending expansion continued to slow, falling to 23.5% from 23.8% in August 2019. Unsecured lending growth is set to gradually ease further in the fourth quarter.

The National Bureau of Credit Histories notes an increase in borrowers' debt service to income ratio for the second–third quarters of 2019 for the first time since early 2015[15] (Figure 54). Nevertheless, this ratio is, according to NBCH estimates, still far below maximum, while the share of borrowers with a higher-than 50% ratio continues to decline.[16] The increase in borrowers' debt burden therefore does not currently threaten financial stability, while the introduction of a new scale of add-ons to risk weights will limit the provision of loans to heavily indebted borrowers.

Figure 53. Unsecured consumer lending growth, %



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

Figure 54. Borrowers' debt ratios based on data from 4 thousand Russian lenders, %

Source: National Bureau of Credit Histories.

Still, more signals of some borrower quality deterioration are emerging. Based on their meetings with commercial banks, Fitch analysts,[17] for example, point out a more extensive use of long-term cash loans to refinance outstanding debts and banks' increasingly frequent reports of average customer profile worsening. On top of that, the Bank of Russia notes a slight increase in nonperforming loans in the latest loan generations. The change in the share of loans more than 30 days overdue shows that the risk level for loans provided in the first quarter of 2019 is somewhat higher than that for ones provided in 2017 and 2018. In the fifth month of life in the vintage, the share of NPL 30+ in 2019 vintages stood at 1.80% versus 1.54% and 1.60% in 2017 and 2018, respectively (Figure 55). Moreover, the credit quality of these vintages is much higher than in 2013–2015. Hence the cooling of consumer lending growth may arise from policies of risk management's internal policies at banks which receive first signals of borrower quality worsening.

[15] https://www.nbki.ru/company/news/?id=25850
[16] https://www.nbki.ru/company/news/?id=25628
[17] https://www.kommersant.ru/doc/4126422

Figure 55. NPL 30+ by vintage

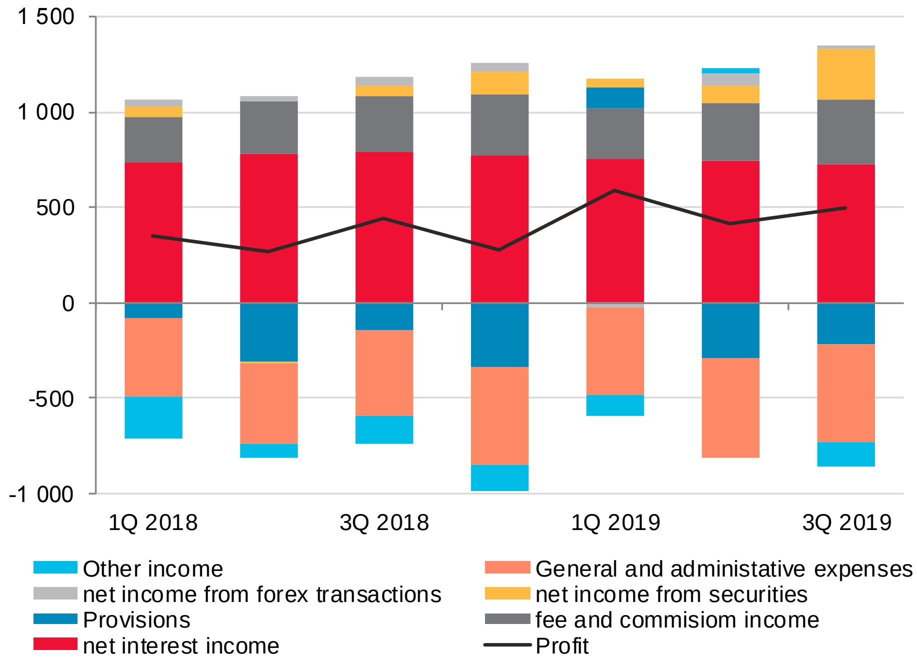
Source: Bank of Russia estimates based on National Bureau if Credit Histories data.

Rouble corporate lending added 0.7% MoM in September, posting marginally lower rates of portfolio growth than those in August and average portfolio growth rate in 2019. Annual ruble portfolio expansion meanwhile accelerated from 10.6% to 10.8% YoY. Growth in overall outstanding corporate debt, however, slowed, reflecting a contraction in the portfolio's foreign currency part. In annual terms, outstanding corporate foreign currency debt dwindled 13.1% YoY, dragging overall lending expansion down from 5.2% YoY to 3.7% YoY (Figure 50).

Despite the lending growth slowdown in the third quarter of 2019, the banking sector's profit totaled almost 500 billion roubles for the third quarter, up from about 420 billion roubles in the second quarter and 445 billion roubles a year earlier. Net interest income continued to slide, coming in at 724 billion roubles, a fall of 16 billion roubles from the second quarter of 2019 and 67 billion roubles from the same quarter of 2018, driven by interest expense growth, which outpaced a rise in the banking sector's interest income. Interest income and expense show an increase despite the starting cycle of interest rate cuts. This likely stems from a change in the banking sector's portfolio structure towards more expensive deposits and loans in the first half of 2019. Also, the weighted average interest rate on household and non-financial organizations' deposits in the first half of 2019 exceeded the level of the first half of 2018 by at least 0.5 pp. The lower net interest income than in the first–second quarters of 2019 may be partly due to some banks understating the full loan value in an attempt to avoid higher provisions, compensating this understatement by increasing fees and commissions. As such, fees and commissions income continued to rise notably, up 41 billion roubles from the second quarter of 2019 and 54 billion roubles from the third quarter of 2018. The resumed interest rate reduction may support the banking sector's income through a faster reduction in effective rates on deposits than that on loans.

Profit was also supported by a notable rise in income from securities transactions (up 169 billion rubles from the second quarter of 2019 and 205 billion roubles from a year earlier). That said, the banking sector continued to set aside additional provisions at a quarterly rate of 260 billion roubles. Unlike the first quarter, the adjusting entries failed to surpass this effect and to support profit. As a result, additional provisioning became a factor of profit shrinkage in the third quarter of 2019.

Figure 56. Factors of profit generation, 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: growth still below potential

- Our index-based estimate of third quarter GDP growth stood at 0.2% QoQ SA in October, down slightly from September. The fourth quarter estimate was also revised down, remaining below the potential growth rate of the Russian economy.
- Gradual GDP growth acceleration is expected in the first quarter of 2020. Meanwhile, the current index-based estimate for the coming quarters in this model specification does not factor in a possible additional impulse from stepping up budget spending, which started as early as the third quarter of 2019.
- The estimates of quarterly GDP growth below expect GDP growth for 2019 at about 0.8–1.0%, which lies within the range of the Bank of Russia forecast.

	October	September
	% QoQ SA	% QoQ SA
Q3 2019	**0.2**	0.2-0.3
Q4 2019	**0.2**	0.3
Q1 2020	**0.3**	0.4

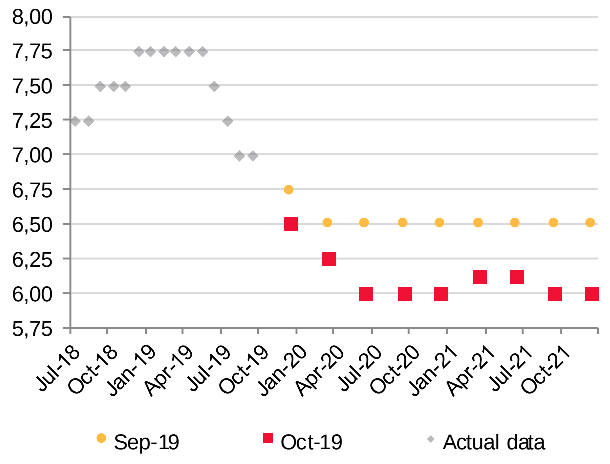
2.1.2. Analysts revise down their expectations for key rate trajectory

- Monetary policy signals from the Bank of Russia have made analysts revise down their key rate trajectory forecast.
- The level of the rate on the medium-term horizon, which in effect reflects analysts' idea of the rate's neutral level, was revised down from 6.5% to 6% as early as September.
- Analysts' medium-term inflation expectations remain anchored, despite their revisions to key rate trajectory expectations.

Bank of Russia officials' statements in October regarding the Bank's more resolute monetary policy measures amid inflation deceleration, have caused most analysts to revise down their forecasts for the key rate trajectory over the entire forecast period. According to a monthly Bloomberg forecast,[18] the key rate will be cut to 6.50% by the end of 2019 rather than to 6.75% as assumed a month earlier (Figure 57). This is what most of the analysts assume, but two of them believe that the Bank of Russia will act more resolutely to lower the rate to 6.00–6.25% (Figure 58). Since the Bank of Russia Board of Directors decided on cutting the rate by 50 bp to 6.5% on October 25, analyst year-end expectations may still be revised down.

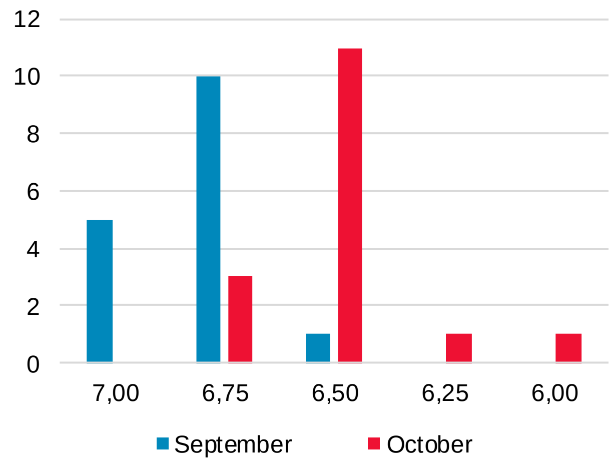
As regards a longer-term horizon, analysts believe the Bank of Russia will cut the key rate to 6.0% by mid-2020, finishing its monetary easing cycle there. As late as a month ago, the key rate was expected to stabilise at 6.5%. The analysts seemed to interpret the Bank of Russia signal as above all the reassessment of the key rate level which will enable inflationary pressure to stabilise at 4%. This corresponds to the lower bound of the Bank of Russia's current estimate range of the neutral rate level.

Figure 57. Analyst expectations for Bank of Russia key rate, % per annum



Source: Bloomberg Finance L.P.

Figure 58. Distribution of analyst expectations for Bank of Russia key rate at the year-end, persons

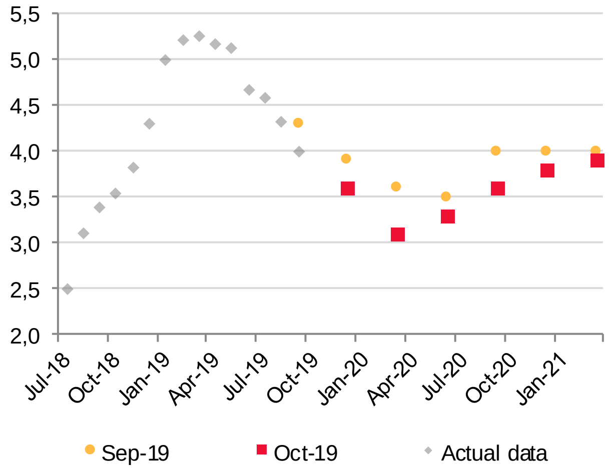


Source: Bloomberg Finance L.P.

Analysts' forecast for end-2019 inflation was revised down to 3.6% YoY, which lies within the 3.2–3.7% range of the Bank of Russia's updated forecast (Figure 59). Analysts' medium-term inflation expectations remain anchored, given their revision to the key rate trajectory expectations. The analysts surveyed by Bloomberg expect inflation to accelerate to 3.8% YoY in 2020, stabilizing at 4% in 2021.

[18] The survey was conducted from October 18 to 24, just before the Bank of Russia Board of Directors' key rate meeting.

Figure 59. Analyst inflation expectations, % YoY



Source: Bloomberg Finance L.P.

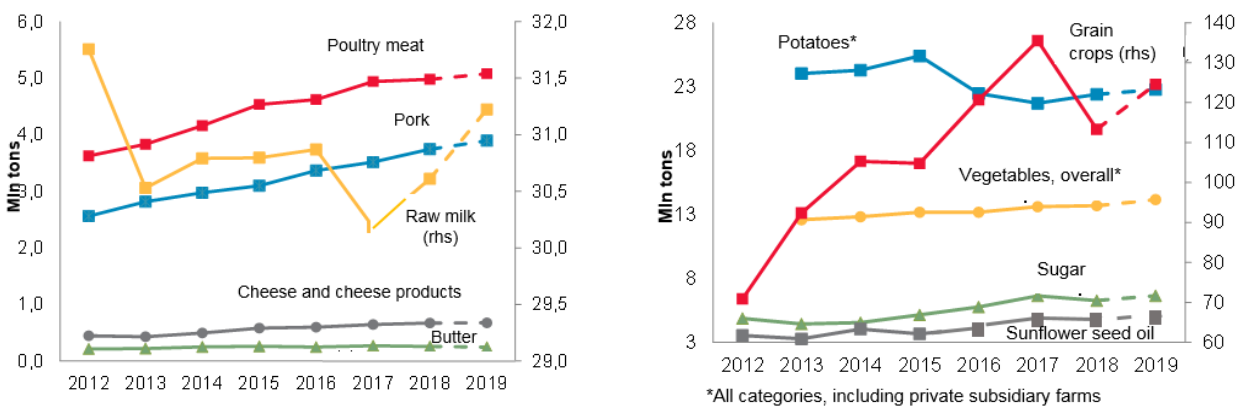
3. In focus: agricultural output expansion has contributed to inflation deceleration

- The situation in the agricultural produce market was one factor bringing down inflation in recent months.
- The output of most types of agricultural produce will exceed last year's in 2019, hitting all-time highs for some of them.
- Expanding supply, stabilisation of world food prices, and export growth constraints in some industries are set to rein in domestic price rises in most types of produce.
- Strong competition in some food markets will cause consumer prices to rise more slowly than costs at the expense of producers' margins.
- The disinflationary impact of the agricultural market situation may prove temporary, while pro-inflationary risks are very likely to materialize on the medium-term horizon. The margin decline will drive inefficient players out of some food markets, adversely affecting food price movements due to supply contraction.

The Bank of Russia's Research and Forecasting Department in October held a roundtable attended by representatives of the agroindustrial compex's industry unions and food market experts to discuss the current situation in the agricultural produce sector and expectations for it.

The output of most agricultural produce types is poised to outstrip last year's level in 2019. (Figure 60). Growth in the Russian produce supply in the domestic market and weak movements of world food prices will be the key factors restraining price rises in the main food categories before the end of 2019 and the first half of 2020. The sector's representatives view weak real household income growth as a demand constraint. Strong competition causes prices to rise at a slower pace than costs, restraining producers' margins. In some markets, this may drive inefficient companies out of business, boosting market concentration, which may in turn adversely affect food price movements in the medium turn.

Figure 60. Output of key produce types in agroindustrial complex



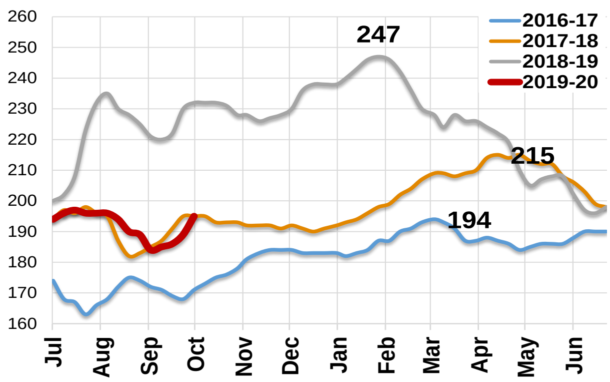
*All categories, including private subsidiary farms

Source: Rosstat, RF Ministry of Agriculture, Industry unions and food market experts' estimates

This year is expected to see an expansion in the output of grain and leguminous crops compared with 2018, up 5–7% YoY, with wheat output rising 4% YoY). Output growth was fuelled by favourable price movements in the last season, stable external and domestic demand, as well as good weather conditions. Moreover, grain market prices are likely to rise slightly in the coming months (Figure 61). Prices will be driven chiefly by global market conditions and a depletion of agricultural produce stocks, which started to decline as early as last season amid the poor harvest and an expansion in exports. That said, the price level is unlikely to reach last year's high levels, thus depressing producers' margins.

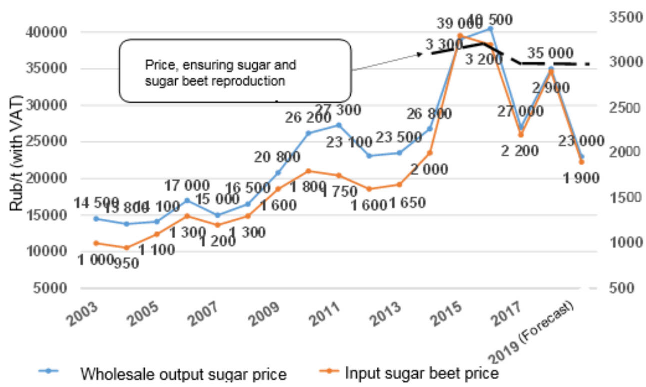
In *cereals*, prices are expected to stay within the range of five-year averages. Buckwheat may become an exception due to a projected 16.3% YoY output decline for 2019.

Figure 61. Russian wheat price, USD/ton, FOB



Source: ProZerno.

Figure 62. Sugar beet and sugar price



Source: Soyuzrossakhar.

The 2019 *oil crop* output may surpass the record level of 2018, thanks primarily to sunflower seed gross output, up 9–10% YoY. This will boost sunflower seed oil output, with its exports likely hitting a record high. The sunflower seed price is formed based on world prices via the export parity mechanism. World prices are exposed to pressure from the record high crop output in Russia and Ukraine but are unlikely to fall below last year's values. This will allow keeping producers' margin on last year's level.

Despite a crop acreage reduction, *sugar beet* output will expand about 14% YoY this year, driven by a significant rise in crop yields. Sugar production may grow 7–10% YoY as a result. A strong sugar output over the last three years has helped accumulate large stocks, and, given the continuing export constraints, this puts pressure on domestic prices. Sugar prices have hit a seven-year low this year (Figure 62). The current domestic price level amid rising costs brings down the industry's margins, which already makes producers plan reducing crop acreage in 2020 and drives some businesses out of the market.

Gross output of commercial *potatoes* is expected to surpass the 2018 level, helped by an increase in crop yields. That said, crop acreage continues to shrink as inefficient players pressured by the current low potato prices, exit the market because they are unable to compete with more efficient businesses which enjoy low costs thanks to modern produce growing and storage methods. Prices will stay close to last season' levels until the end of 2019 and in the first half of 2020. In the winter (February–March), the price level will depend on seasonal prices of imports, whose volume will not exceed that of last year.

In vegetables (field- and greenhouse-grown), a gross output expansion is expected for full-year 2019. As regards staple crops, a fall in *cabbage and onion* output is expected on the back of last years' low prices, which were one of the causes behind an acreage contraction. The reduction in these vegetables output will boost imports, possibly affecting prices. Meanwhile, this season's high prices will likely prompt producers to plan a crop acreage increase in 2020. The market for *carrots and beets* is expected to see an output rise, with the price situation remaining stable.

Cucumber and tomato output is set to continue growing this year. This year's price rises in this produce are driven by consumers' reorientation from imports to Russian vegetables (for example, from Turkish tomatoes to sweeter, Russian-produced cherry tomatoes. Also, retail chains' demand for Russian produce is rising, because it has a longer shelf life than imports. Given these trends and the commissioning of new capacities, output growth will continue next year. Moreover, stepped up government support[19] is expected to substantially cut production costs, favourably affecting consumer price movements.

Commercial *milk* production growth will accelerate for 2019, posting a rise of 2.5% YoY, fuelled by the commissioning of new modern milk production facilities and marketability improvement over the previous years. The favourable price conditions also provide support to milk producers. Demand from milk processing businesses rises, including for milk fat, due to producers' reorientation to dairy products free from milk fat substitutes.

Milk processing faces a different situation. Businesses rein in producer price rises by reducing their margins as costs increase in the face of, among other things, raw milk price rises and heavier regulatory pressure[20] amid weak consumer demand growth (including due to the need of selling a large share of products as part of retail chains' promo actions). As demand growth recovers, dairy product prices will likely rise at a rate outpacing cost increases for businesses' margins to be restored.

Aside from the above factors, product price rises are driven by an increase in milk powder price due to its insufficient domestic stocks owed to restrictions imposed on deliveries from other countries. Butter prices will also continue to rise because of inadequate domestic output and compensation for the shortages by imports.

In the *pork* market, the completion of projects started in 2017–2018 will enable pork production to be further expanded (up 4% YoY). The rising supply is affecting prices: the level of producer prices in 2019 will be the lowest in the last five years (Figure 63). These prices allow only about half of producers to cover their costs (these businesses include new or upgraded facilities with a completed investment phase). Given the current prices, about

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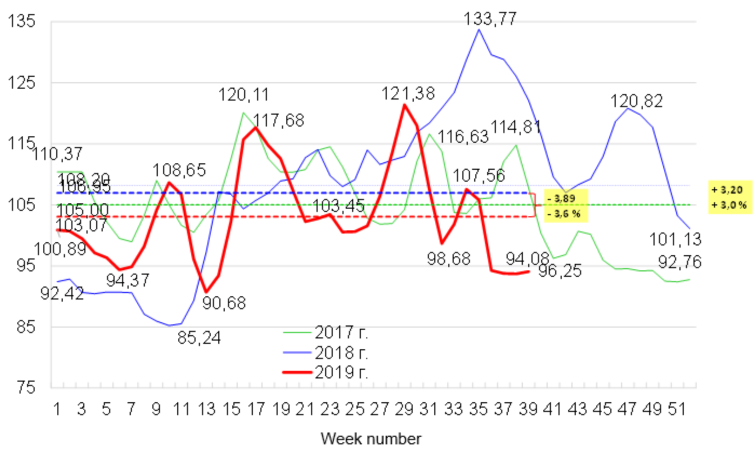
[19] The maturities of subsidized loans will increase from 8 to 12 years.
[20] Introduction of electronic veterinary certification, labeling, etc.

half of pig-breeding businesses risk sustaining operating losses. Investment attractiveness of new projects declines substantially in these circumstances, in effect blocking the entry of new players to the market. Pork exports are growing rapidly (up 20% YoY), but are so far mostly comprised of by-products and are insufficient to take the surplus pork off the domestic market. We, however, note a fairly strong export growth potential of Asian countries, above all that of China, where demand for animal proteins rises, while the country's domestic resources are insufficient to meet this demand. The Chinese market is, however, currently off limits to Russian pork.

Domestic competition is strengthening, driven by high market saturation, expectations for further output expansion and exports underperformance relative to output. In this situation, wholesale prices may remain under pressure in the coming years unless inefficient producers start exiting the market massively.

Figure 63. Prices of first and second category live pigs in the Central Federal Okrug, Rouble/kilo including VAT



Source: National Union of Pork Producers

Poultry meat output can grow 1.5–2.0% YoY for 2019. Further output growth will depend on the situation with exports because the domestic market is already saturated, prices, as well as margins, are at their lowest. Expansion in exports to China and Saudi Arabia is somewhat compensated by a contraction in exports to former USSR countries (to Ukraine on the back of import duties imposition, to Kazakhstan because of its own production development). By the end of the year, poultry meat prices are expected to fall below the levels of last year and the start of 2019. An additional factor restraining poultry prices is the pork market situation. For consumers, poultry meat and pork are interchangeable, therefore their prices are fairly closely correlated.

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