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Economy and markets

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EXECUTIVE SUMMARY

1. Monthly summary

- Annual inflation decelerated to 2.4% in January. The current price growth, adjusted for seasonal and other temporary factors, remains slowed. However, there are prerequisites for inflation gradually returning to the 4% target, in particular, a revival in economic activity, petering out of a number of temporary disinflationary factors, and the monetary policy decisions, which have a lagged effect. As a result of inflation holding on average close to the target for several years (an average of 3.7% in the past three years), price stability is maintained, helping reduce macroeconomic uncertainty, develop long-term planning in business decision-making and private investment, and maintain the purchasing power of household income. According to our estimates, Russia's economic growth will remain close to potential in the first half of 2020. This will be helped by a revival in consumer demand, a rise in public spending, monetary easing following the monetary policy decisions, and a generally favourable situation in the Russian financial market.

  - Inflation slowdown continues to be driven by temporary factors associated with the exclusion of the VAT increase and utility price indexation in January 2019 from the calculation of inflation, as well as with rouble appreciation, good harvest of most agricultural crops, and the abnormally warm winter in Central Russia. Monthly growth in the most stable components of the consumer basket is holding below the level corresponding to 4% in annualised terms. This also slows consumer price rises. That said, our estimates suggest that the months to come will see the emergence of a trend towards inflation returning to 3.5–4% by the end of 2020.
  - Russia's economic growth accelerated to potential in the second half of 2019 and, according to estimates, will continue on this pace in the first half of 2020. Domestic demand is gaining momentum thanks to the accumulation of inventories, the recovery of household consumer spending, and an accommodative fiscal policy since 2019 H2. The continuing positive credit impulse from corporate lending expansion is underpinning economic growth. The inflation slowdown helps a rise in real household income and consumer demand, offsetting a credit impulse decrease to zero in the consumer segment. Monetary easing boosts consumption and demand for mortgage loans and allows companies to raise finance in the bond market. Taken together, these factors offset the remaining negative effects of subdued global economic growth on Russian exports.
  - Risk appetite in global financial markets, including Russia, has declined due to the spread of the coronavirus, which may temporarily contain growth of the Chinese and global economy.

2. Outlook

The index-based GDP growth estimate improved again, pointing to Russia’s economic growth gradual acceleration to potential in 2019 Q4 – 2020 Q1.

1. MONTHLY SUMMARY

1.1. Inflation

Annual inflation remained on a downtrend in December–January, approaching a point of reversal. There are still a large number of important temporary factors behind the rapid easing of inflation. Short-term disinflationary risks are still prevailing over pro-inflationary ones amid rouble strengthening, a strong output of major agricultural crops and beneficial weather conditions.

A rise in prices which show low volatility and insensitivity to temporary factors remains below the level corresponding to an inflation rate of 4%. At the same time, prerequisites for inflation gradually returning to the target are taking shape. The recent key rate cuts along with the fiscal stimulus to be implemented in 2020 will, with a long lag, bring inflation back to 4% by the end of 2020. Short-term pro-inflationary risks associated with world food prices may also become factors of inflation returning to the target.

Among medium-term pro-inflationary risks are geopolitical factors and volatility surges in financial markets, as well as possible fluctuations of key public finance indicators. These temporary factors may, via possible secondary effects driven by still elevated and unanchored business and household inflation expectations, push up inflationary pressure.

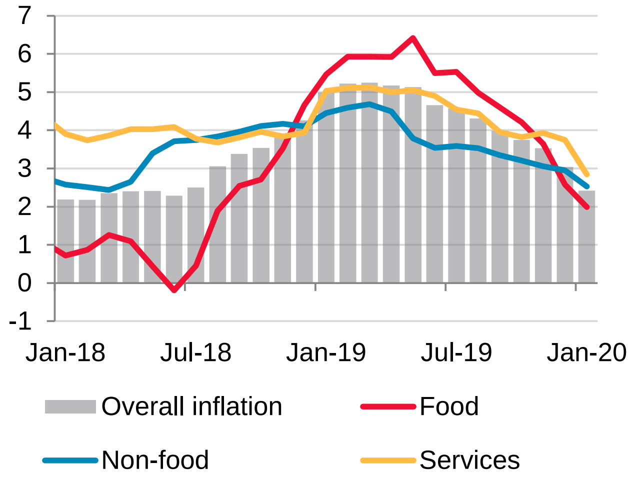
1.1.1. Price rises remain moderate at the start of 2020

- Price rises slowed to 3.0% towards the end of 2019, driven by both temporary factors (temporarily depressed government demand, a strong output of agricultural crops, production expansion in some food markets, rouble strengthening, a slow rise in petrol prices as part of adjustment to the damper mechanism) and more sustainable developments, such as an economic growth slowdown in the first half of the year, the alleviation of pressure on producer costs due to, among other things, external demand weakening in the face of global economic slowdown.
- An annual inflation easing continued in January, owing partly to the high base of the start of last year on the back of accelerated price rises driven by the VAT hike.
- The pace of monthly price rises was notably below the path corresponding to an inflation rate of 4% in December–January. Seasonally adjusted price growth accelerated to 0.2% MoM in January after a temporary slowdown to 0.1% MoM in December, returning to the August–November level.
- World food prices, which rose dramatically in the second half of the year, remain one potential factor of food price inflation acceleration in 2020.

- The estimates of modified core inflation indicators remained low at the September–November level. Adjusted for the impact of exchange rate movements, the mean of the estimates stood just above 2% in annualised terms.

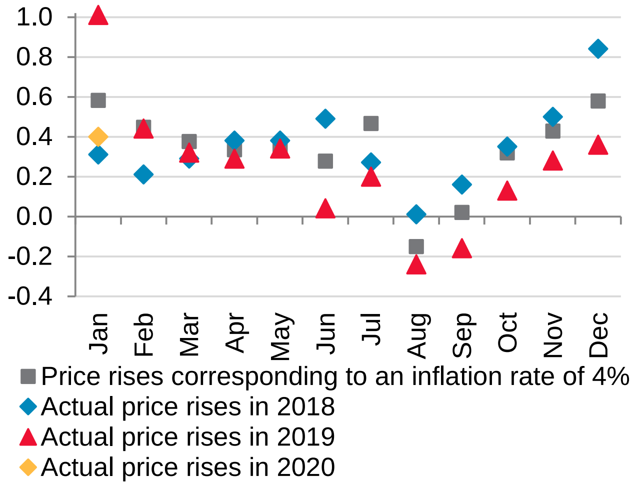
Annual inflation slowed to 2.42% in January from 3.04% in December and 3.53% in November (Figure 1). The annual inflation slowdown seen at the start of 2020 is owed to, among other things, the high base effect of last year on the back of accelerated price rises driven by the VAT hike.

Figure 1. Inflation and its components, % YoY



Source: Rosstat.

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



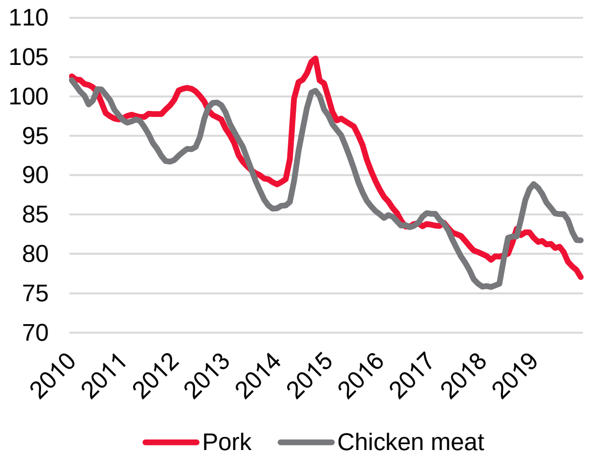
Source: Rosstat, R&F Department estimates.

Annual food price inflation slowed to 1.99% in January from 2.58% in December and 3.65% in November, owing in large part to fruit and vegetable price movements. Fruit and vegetable price rises were much more moderate in December–January than a year earlier, thanks to an output expansion in many agricultural crops. Annual price rises in the rest of food products also slowed to 2.54% in January from 3.11% in December and 3.74% in November. A substantial contribution to the annual food price inflation slowdown continues to come from falling prices of sugar, meat products, and chicken eggs.

Meat product prices were stable or declining for the greater part of 2019 after rising sharply in the second half of 2018, driven by a number of temporary factors (including through an increase of costs on the back of rouble weakening and outbreaks of cattle diseases). The end of 2019 saw relative pork prices dropping below the level of the start of 2018, i.e., the period preceding the price jump, while chicken meat prices have not yet reached this level, thus signalling that price movements in these products may continue to be moderate relative to the overall price rises in 2020.

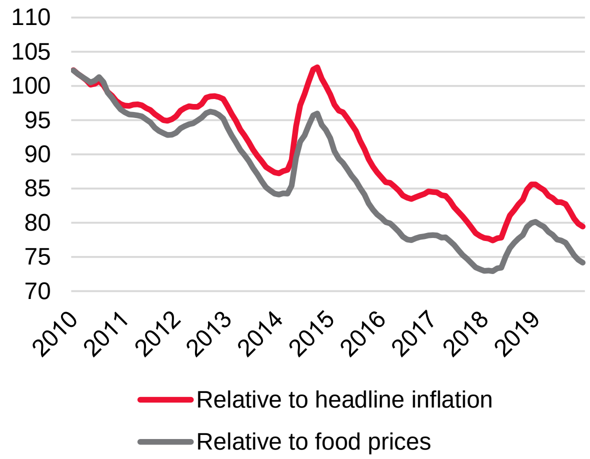
Relative pork and chicken meat prices have declined in the last several years, driven primarily by a significant and continuing expansion in domestic production, which all but fully substituted for imports. Meat demand, meanwhile, is already generally strong: Russia's meat consumption per capita is comparable with that in countries with a similar level of development and slightly below the OECD average. Given Russian producers' limited access to foreign markets, the expansion in domestic production exerts pressure on domestic prices, containing overall consumer price inflation.

Figure 3. Pork and chicken price movements relative to overall inflation, the 2010 average = 100%



Source: Rosstat, R&F Department estimates.

Figure 4. Relative pork and chicken price movements, the 2010 average = 100%



Source: Rosstat, R&F Department estimates.

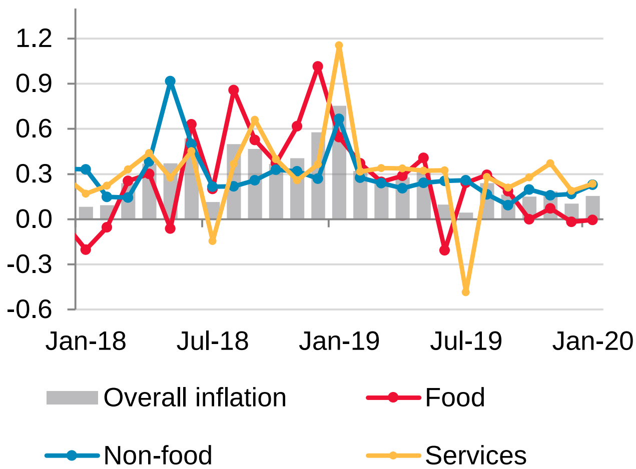
Annual price rises in nonfood goods and services remained stable in December, with non-food goods prices climbing 2.95% after their 3.06% increase in November, while services prices added 3.75% in December, down from 3.93% in November. Rouble appreciation was one of the key factors behind the non-food price slowdown in 2019. January saw annual inflation slow, as expected, with inflation standing at 2.53% in the market for non-food goods and 2.84% in the services market, chiefly because the high rate of price rises in January last year driven by the VAT hike left the calculation base.

Consumer prices were rising at a rate of 0.4% MoM in December–January (prior to seasonal adjustment), which is notably below the path corresponding an inflation rate of 4% (Figure 2). Seasonally adjusted, inflation came in at 0.18% MoM in January,[1] returning to the August–November level after a one-off 0.1% MoM drop in December (Figure 5). Trailing behind the 4% path is in large part owed to the slow pace of food price growth.

Seasonally adjusted food price inflation has hovered around zero for four months in succession. World price rise acceleration in recent months remains one of the key medium-term pro-inflationary risks for the food product sector (Figure 6). In the fourth quarter, for example, world food prices rose just over 7% in terms of US dollars, driven chiefly by butter, fats, and sugar prices. At the same time, rouble strengthening has partly offset the world price growth. If the rouble stabilises or weakens, the impact of world prices on domestic food prices will increase, which is especially true of categories whose share in foreign trade is relatively high (grains, fish products, dairy products, and butter).

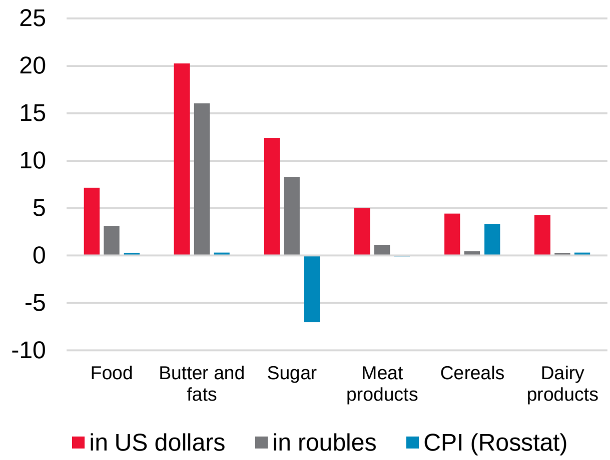
[1] Here and further on, seasonally adjusted estimates for January 2020 are preliminary.

Figure 5. Seasonally adjusted inflation, % MoM



Source: Rosstat, R&F Department estimates.

Figure 6. World and domestic food price growth in the fourth quarter of 2019, %, seasonally adjusted

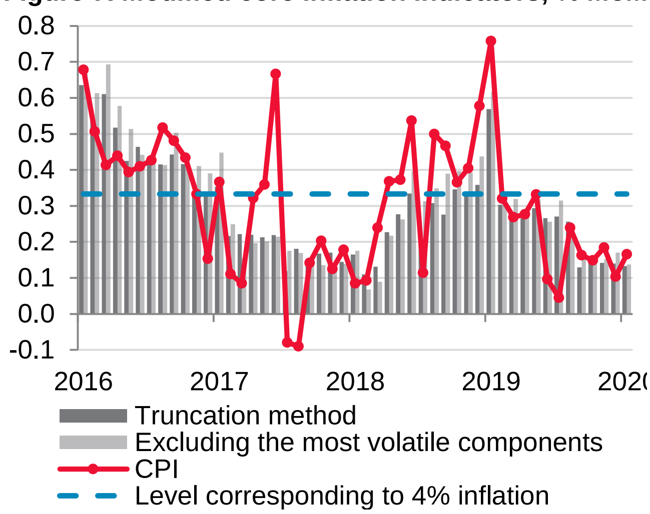


Source: FAO, Rosstat, R&F Department estimates.

Seasonally adjusted non-food price rises stayed at 0.2% MoM in the fourth quarter, accelerating slightly to 0.3% MoM in January. Seasonally adjusted services price growth eased to 0.2% MoM in December, but accelerated again to 0.36% MoM in January. However, January's non-food price rise acceleration cannot so far be interpreted as a signal of mounting inflationary pressure.

Modified core inflation indicators stayed low at the September–November level in December–January (Figure 7). The mean of December estimates stood at 0.16% MoM in December, coming in at 0.14% MoM in January, which corresponds to a price rise of just over 2% in annualised terms. Adjusted for the impact of exchange rate movements, this estimate stands slightly above 2% in annualised terms. Core inflation indicators are exposed to the influence of temporary disinflationary factors, albeit less than the headline inflation figure.

Figure 7. Modified core inflation indicators, % MoM

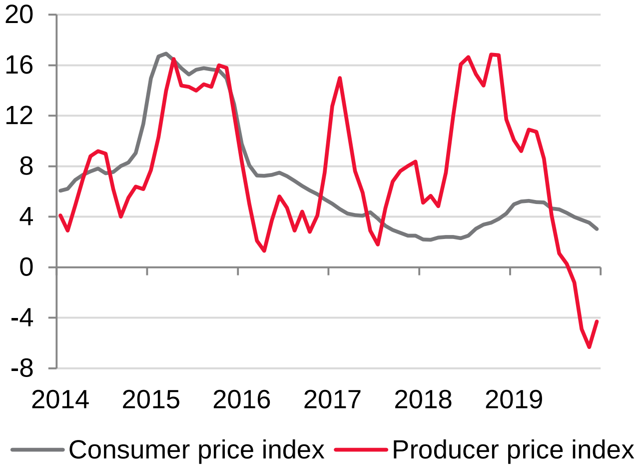


Source: Rosstat, R&F Department estimates.

1.1.2. Producer price movements still contain consumer price inflation

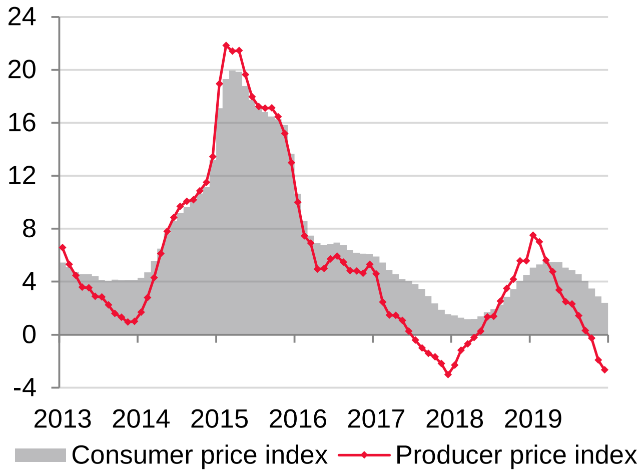
- According to Rosstat data, the annual rate of producer price inflation declined to 4.3% YoY in December from 6.3% YoY in November (Figure 8), helped most of all by the pace of producer price rises in mining and quarrying falling almost by half to -9.2% YoY from -16.2% YoY in November.
- Change in crude oil prices remains the key factor of producer price movements. Following world oil price growth late in 2019[2] domestic prices went up 3.3% MoM. That said, prices of key refined petroleum products continued to slide, with petrol price, for example, shedding 7.2% MoM.
- Producer prices of many consumer goods are continuing to decline. This is largely true of food prices. The overall performance of the indicator suggests the absence of pressure on consumer prices from producer prices.

Figure 8. Change in the producer price index and consumer price index, % YoY



Source: Rosstat.

Figure 9. 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.

[2] The Urals price added 10% in November–December compared with October.
[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, perfumery products and cosmetics, household electronic appliances, and furniture. They account for 30% of the consumer basket.

1.2. Economic performance

Russia's economic growth gained pace in the second half of 2019 to reach levels close to potential. Leading indicators suggest that this growth pace will be maintained at the start of 2020 and in the first half of the year, provided that the coronavirus epidemic recedes and other significant external shocks do not emerge.

Domestic consumer demand and investment helped by the implementation of the national projects still provide an engine of growth for the Russian economy. The positive credit impulse from corporate lending expansion also props up domestic demand. That said, in an environment of institutional and structural constraints, *investment* demand may show a weak response to monetary easing, limiting the effectiveness of the credit channel of the monetary policy transmission mechanism.

All in all, a domestic demand expansion in 2019 allowed offsetting a significant negative impact on Russia's GDP of sluggish global economic growth, causing export contraction. Stimulating fiscal policy and the recent monetary easing are set to support domestic demand in 2020.

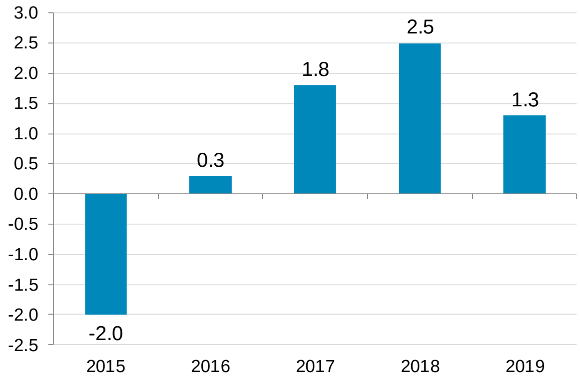
1.2.1. Weak external demand put a brake on Russia's 2019 economic growth

- GDP growth came in at 1.3% for 2019, matching the upper bound of the Bank of Russia December's forecast.
- Rosstat has revised the 2018 growth structure significantly, which has also affected the key components of GDP by end use in 2019.
- The key factor behind growth slowdown in 2019 was export contraction. That said, household consumption growth slowdown was offset by government consumption expansion gaining momentum due to the implementation of the national projects.
- External demand performance remains a key risk factor for Russia's economic growth at the start of 2020.

Rosstat released early in February its initial 2019 GDP estimate and updated GDP data for previous years. The most interesting of the new data are the composition of GDP by end use in 2019 and change in the GDP time series for previous years.

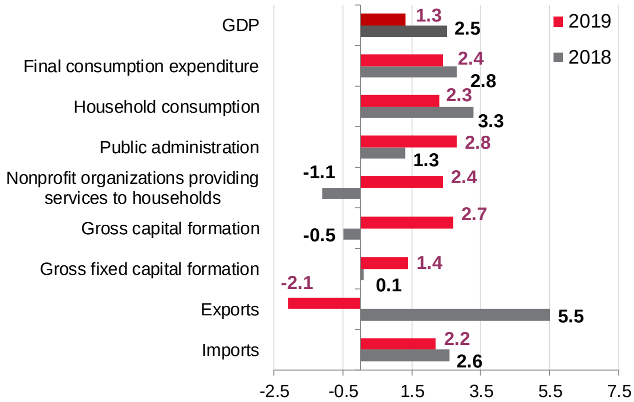
GDP growth came in at 1.3% for 2019, matching the upper bound of the 0.8–1.3% range provided by the Bank of Russia in its December's forecast. That said, Rosstat revised up the comparison base by upgrading its 2018 GDP growth estimate from 2.3% to 2.5%, which is supposed to have brought down the GDP growth estimate for 2019. This suggests that actual economic performance in 2019 was stronger than what could have been assumed from its real-time indicators.

Figure 10. GDP growth rate, % YoY



Source: Rosstat, R&F Department estimates.

Figure 11. Comparative performance components of GDP by end use in 2018 and 2019, growth, % YoY



Source: Rosstat, R&F Department estimates.

Key GDP growth drivers in 2019 were an acceleration in gross capital formation expansion from -0.5% to 2.7% and a public administration expenditure increase from 1.3% to 2.8%, with household consumption expansion growth slowing from 3.3% to 2.3% and export contracting 2.1%.

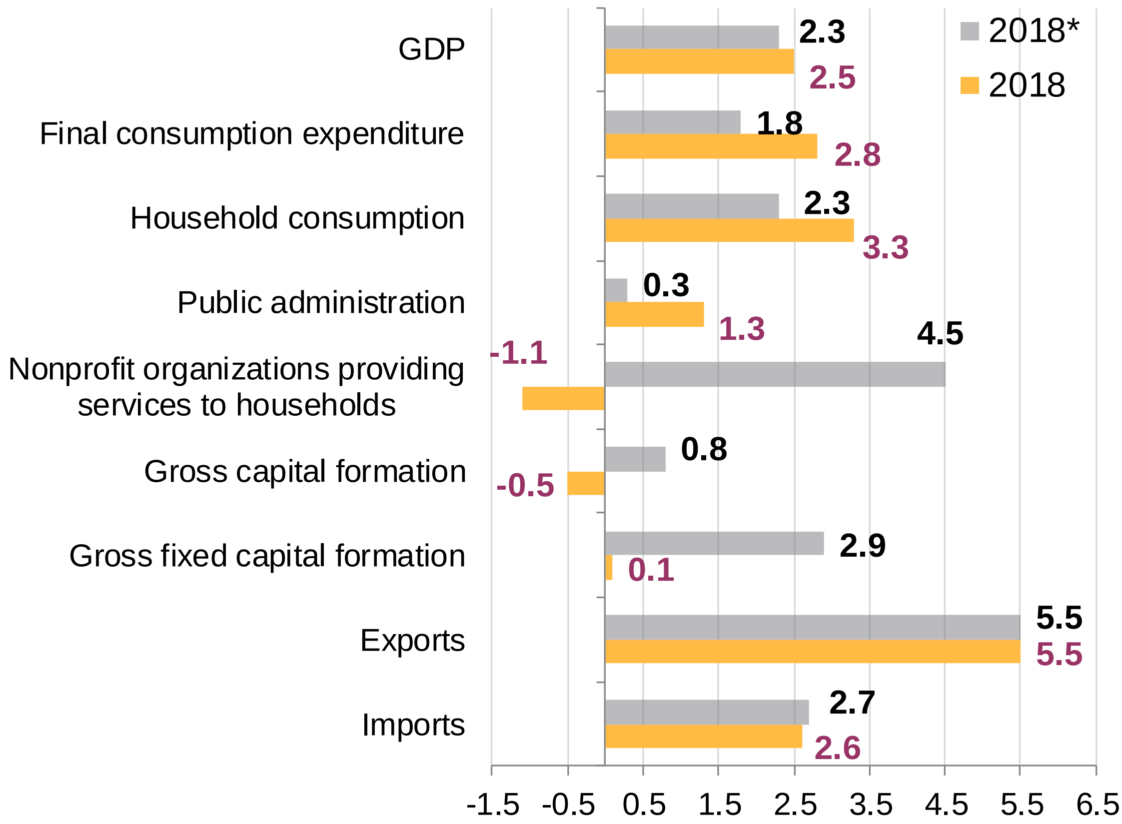
Of special note is change in the distribution of growth factors among GDP components relative to initial expectations. Rosstat has substantially revised the structure of GDP components in 2018, which has also changed the 2019 estimates.

As the revised data indicates, 2018 did not in fact see an upsurge in investment and consumption growth, while earlier estimates suggested that the above two factors accounted for most of GDP growth acceleration in 2018. The current estimate indicates a drop in gross capital formation by 0.5% instead of a rise suggested by an earlier estimate. This discrepancy with earlier initial estimates following their revision sent 2018 consumption growth indicators higher for both the private sector (to 3.3% from 2.3% earlier) and the public administration segment (to 1.3% from 0.3% earlier). Therefore, the strong positive impact on GDP, which was previously attributed to investment (largely in the construction industry) has now been redistributed among the key consumption components.

With the comparison base revised down, gross capital formation expansion in 2019 was quite significant at 2.7% versus a 0.5% drop in 2018. Real-time indicators imply a dramatic investment growth improvement in the fourth quarter. That said, a significant acceleration in gross accumulation expansion is assumed to be largely owed to inventories growth. Inventories made a key contribution to the gross accumulation improvement in 2019, since the pace of gross accumulation expansion was almost double the rate of gross capital formation growth (1.4%). A rise in the pace of inventories growth was recorded in the second half of the year, which simultaneously saw a faster import growth for both consumer and investment goods along with a boost in the production of investment goods. Rosstat reports that inventories growth came on the back of a work-in-progress expansion, which may have nothing to do with changes in domestic demand (for example, be owed to production suspension or production as part of major projects extended over time). Whatever are the factors behind this development, inventories figures are very volatile and subject to revisions as time passes, thus precluding straightforward explanations for the causes of this investment trend before revised data appears in April.

With average annual inflation gaining pace and real wage growth slowing, a rise in household consumption lost momentum in 2019. Overall, slowed household consumption growth was compensated by a doubled pace of public administration expenditure rise prompted by stepped up spending on urban improvement projects and the public road system as part of the national projects (even with some expenditure underperformance for the year).

Figure 12. Comparison of revised and earlier Rosstat estimates of components of GDP by end use in 2018, growth, % YoY



** Earlier Rosstat estimate for 2018 prior to updating in February 2020.*

Source: Rosstat, R&F Department estimates.

One of the key sources of Russia's slowed economic growth in 2019 was external demand. Real export contraction came in at 2.1% for the year against a backdrop of global economic slowdown. The implementation of the OPEC+ deal to cut oil production was another drag on exports. Real oil and refined petroleum product exports in 2019 remained unchanged from 2018, whereas 2018 saw a 2% rise in these exports. Imports were declining early in 2019 but started to grow in the second half of the year, fuelled both by some one-off factors and rouble appreciation along with the recovery of consumer and investment demand.

At the start of 2020, external demand remains a key risk for Russia's economic growth, due above all to the high uncertainty over the impact of the coronavirus outbreak on Chinese and global economic growth. The experience of the 2003 atypical pneumonia outbreak suggests that China's economic slowdown could be dramatic but fairly short-lived. The spread of the disease, which started late in 2002, had come to a stop by the summer of 2003. The current outbreak is larger in scale, and given that China's weight in the global economy has since grown, it may result in more dramatic implications on the global level. So far, we view a likely growth slowdown or an external demand drop in physical terms, for above all commodities, as the main channel of influence on the Russian economy. With the fiscal rule in place, the effect of the oil price decline to date so far looks minor.

Protracted operation disruptions in China's industrial centres may bring about production problems in other countries because of Chinese producers' extensive involvement in global value chains. While Russia's involvement in these chains is not very extensive, Russian producers may, as a result, face delays in the deliveries of machines and equipment, which would adversely affect investment.

1.2.2. Economic growth gained pace in the fourth quarter

- Core industries' output enjoyed support primarily from manufacturing in December 2019.
- Russia's retail, transportation industry, and agricultural sector suffered a slowdown.
- Core industries' output growth slowed for the year on the back of sluggish performance of all core industries, except for the agricultural sector.

Based on a preliminary estimate, a rise in core industries' output (the core industries index, CII[4]) gained pace to 2.9% YoY[5] in December 2019 after slowing to 2.2% YoY a month earlier (Figure 13). The fourth quarter average CII thus went up from the third quarter level in annual terms to reach 2.8 % YoY (Figure 14). This trend gives reason to expect the fourth quarter GDP to rise relative to the third quarter number: an initial Rosstat estimate of GDP growth of 1.3% YoY for 2019 corresponds to GDP growth acceleration to 1.9% YoY in the fourth quarter from 1.7% YoY in the third quarter.

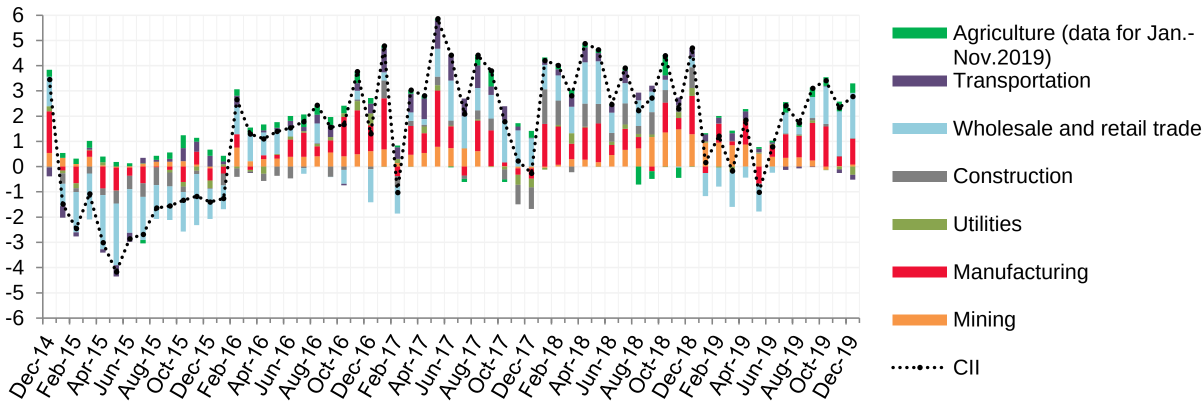
[4] The core industries' index (CII) is calculated by aggregating seven industry-specific indexes (agricultural production; mining and quarrying; manufacturing output; freight traffic; wholesale and retail sales; and activities such as water supply; sewerage, waste management and remediation; as well as electricity, gas, steam and air conditioning supply; as well as construction, with weights corresponding to the respective industry's share in Russia's gross value added in 2017.

[5] Rosstat has not yet released data on December's agricultural output. For the purposes of preliminary CII estimate output was taken as equal to the November value.

The CII performance improvement in December arose, above all, from a moderately favourable situation in manufacturing, as well as an output growth acceleration in mining and quarrying, construction, and wholesale trade, while retail and the transportation industry recorded a slowdown.

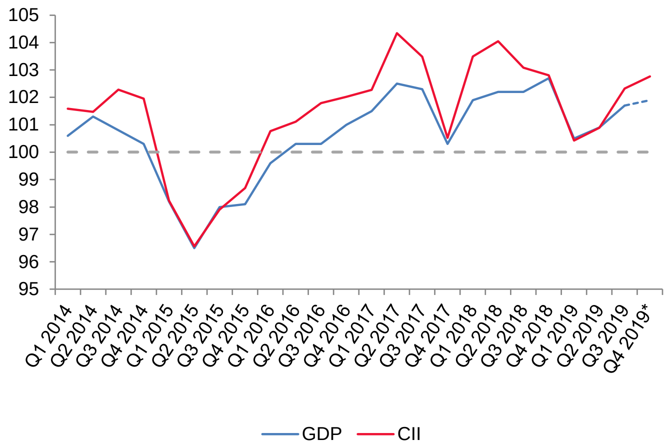
The pace of core industries' output growth for the full-year 2019 was slower at 2.0% YoY[6] than in 2018 (2.9% YoY). The modest performance of the index stemmed from the worsening situation in practically all core industries, except for the agricultural sector, which saw a strong harvest of most crops.

Figure 13. Contribution of industries to the CII in 2014–2019, % YoY



Source: Rosstat, R&F Department estimates.

Figure 14. Quarterly index of GDP* and CII in physical terms, % YoY



Source: Rosstat, R&F Department estimates.

** 4Q2019 growth – estimate based on whole year GDP growth of 1.3%.*

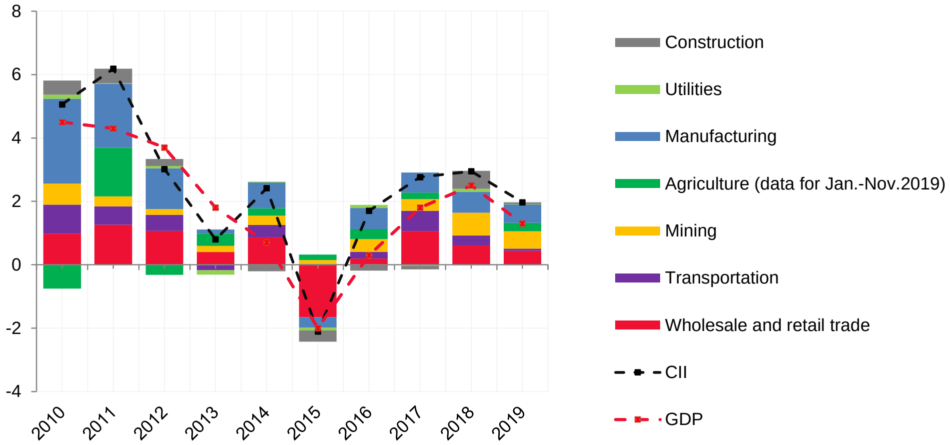
Manufacturing posted a minor output growth weakening to 2.3% for 2019 from 2.6% YoY in 2018. Key industries showed a growth slowdown in the manufacture of other transport equipment, machinery and equipment, motor vehicles, and textiles. At the same time, a

[6] Data on agricultural output for January–November 2019. Data on the agricultural output index for 2019 was to be published in the annual report "Russia's Social and Economic Situation" on 7 February 2019.

number of industries, such as the manufacture of food products, chemicals and chemical products, wood and products of wood, pharmaceutical products, fabricated metal products, computer, electronic and optical products, and others, made a notable positive contribution to manufacturing performance.

The *mining and quarrying* output expansion slowed to 3.1% YoY for 2019 from 4.1% YoY in 2018 on the back of modest coal, crude petroleum, and gas extraction numbers, especially at the end of the year.

Figure 15. Contribution of industries to the CII in 2014–2019, % YoY



Source: Rosstat, R&F Department estimates.

Given slack construction growth throughout the year, the industry posted a weak growth number of just 0.6% for 2019, notably down from the revised Rosstat figure for 2018 (+6.3% YoY). Note that Rosstat has conducted yet another revision to the 2018 data, updating the statistics for both individual months (for instance, revising up the December output indicator to 9.2% YoY from 2.6% YoY) and the full year (6.3% YoY, up from 5.3% YoY).

Change in wholesale and retail sales figures dragged down CII performance in *trade.* Despite the fast growth pace at the end of the year, wholesale sales expansion was weaker at 1.9% YoY in 2019 than in 2018, which saw a growth rate of 2.8% YoY. Retail sales also posted growth weakening to 1.6% YoY from 2.8% YoY in 2018 on the back of sluggish food and non-food goods sales.

A contraction in freight rail and pipeline traffic, which weighed down on the *transportation industry's* indicators in the second half of the year, took a toll on the industry's growth rate for the whole of 2019, down to 0.6% YoY from 2.7% YoY in 2018. Moreover, the worsening of indicators versus those of 2018 was recorded in every subsector of the transportation industry.

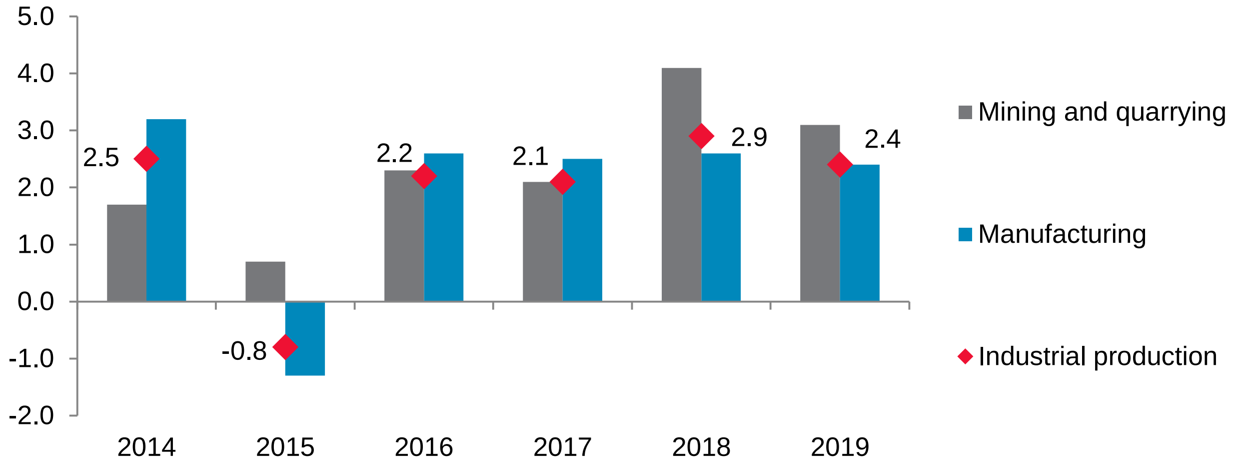
The *agricultural industry* enjoyed a notable output expansion of 4.1% YoY for January–November 2019 after a 0.2% decline for 2018. Most of the credit for this went to crop farming, which boasted a strong harvest of a number of crops. According to preliminary Rosstat data for 2019, grain output rose 6.5% YoY, sunflower seeds showed output growth of 18.4% YoY, sugar beets enjoyed a 20.7% YoY output expansion, vegetables saw an output increase of

2.5% YoY. Potatoes posted a 1.4% YoY output drop driven by a crop acreage reduction on the back of low production margins in recent years. Livestock farming suffered a growth slowdown in the meat segment to 1.9% YoY from 2.5% YoY in 2018, due to domestic market saturation against a backdrop of inadequate export development. The dairy segment enjoyed a 2.4% YoY output growth after a 1.4% YoY rise a year earlier thanks to favourable domestic market conditions in recent years.

1.2.3. Industrial output rise still outpaces GDP growth

- Industrial output growth came in at 2.4% for 2019, slowing slightly from 2018. Industrial output expansion still outstrips GDP growth, reflecting the continuing change in the economy's structure towards tradable industries after a fall in the real effective rouble exchange rate in 2014–2015.
- The easing of industrial output growth is driven by both external factors (oil extraction stabilisation under the OPEC+ agreement and an external demand decline on the back of global economic slowdown) and the internal economic environment (an overall slowdown in domestic demand growth stemming from, among other things, fiscal policy).
- Manufacturing's upward trend is in large part buoyed by the continued steady growth in some leader industries, such as pharmaceuticals, food and chemical products.

Figure 16. Annual growth rates of industrial production and its main components, %

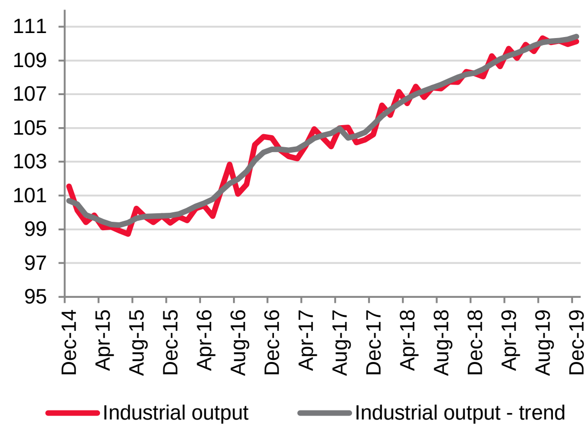


Source: Rosstat, R&F Department estimates.

Recent years' upward trend in industrial output continued in 2019, with industrial production rising 2.4% compared with 2018 (Figure 16). Industrial output expansion still outpaces GDP growth. This reflects a continuing change in the economic structure towards tradable industries after the 2014-2015 plunge in the real effective rouble exchange rate.

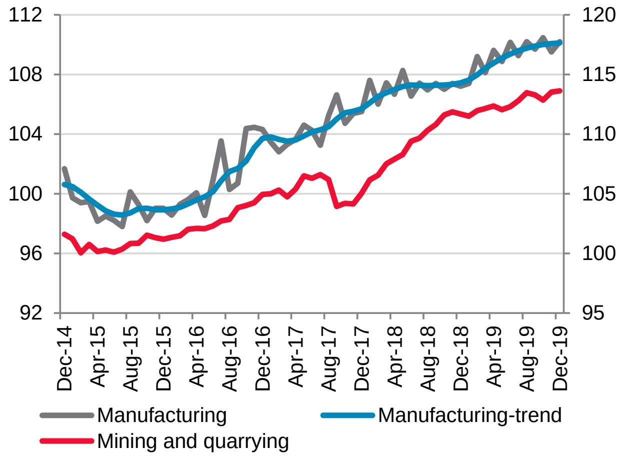
Mining and quarrying output growth came in at 3.1% for 2019, weakening from 4.1% for 2018. Growth slowdown was largely driven by oil extraction being restrained under the OPEC+ agreement. Also, a drop in the extraction of metal ores was recorded in the middle of the year. The negative trend in metal ore extraction persists as global steel demand is continuing to decline. Coal mining hit record highs after a marginal decline in the middle of the year.

Figure 17. Change in industrial production index (2002 = 100)



Source: Rosstat, R&F Department estimates.

Figure 18. Change in mining and quarrying and manufacturing indexes (2002 = 100)



Source: Rosstat, R&F Department estimates.

The pace of manufacturing output growth also slowed slightly to 2.3% for 2019. While growth came to almost a stop in the second half of 2018, the second half of 2019 saw an upward trend continue, albeit at a slightly slower rate.

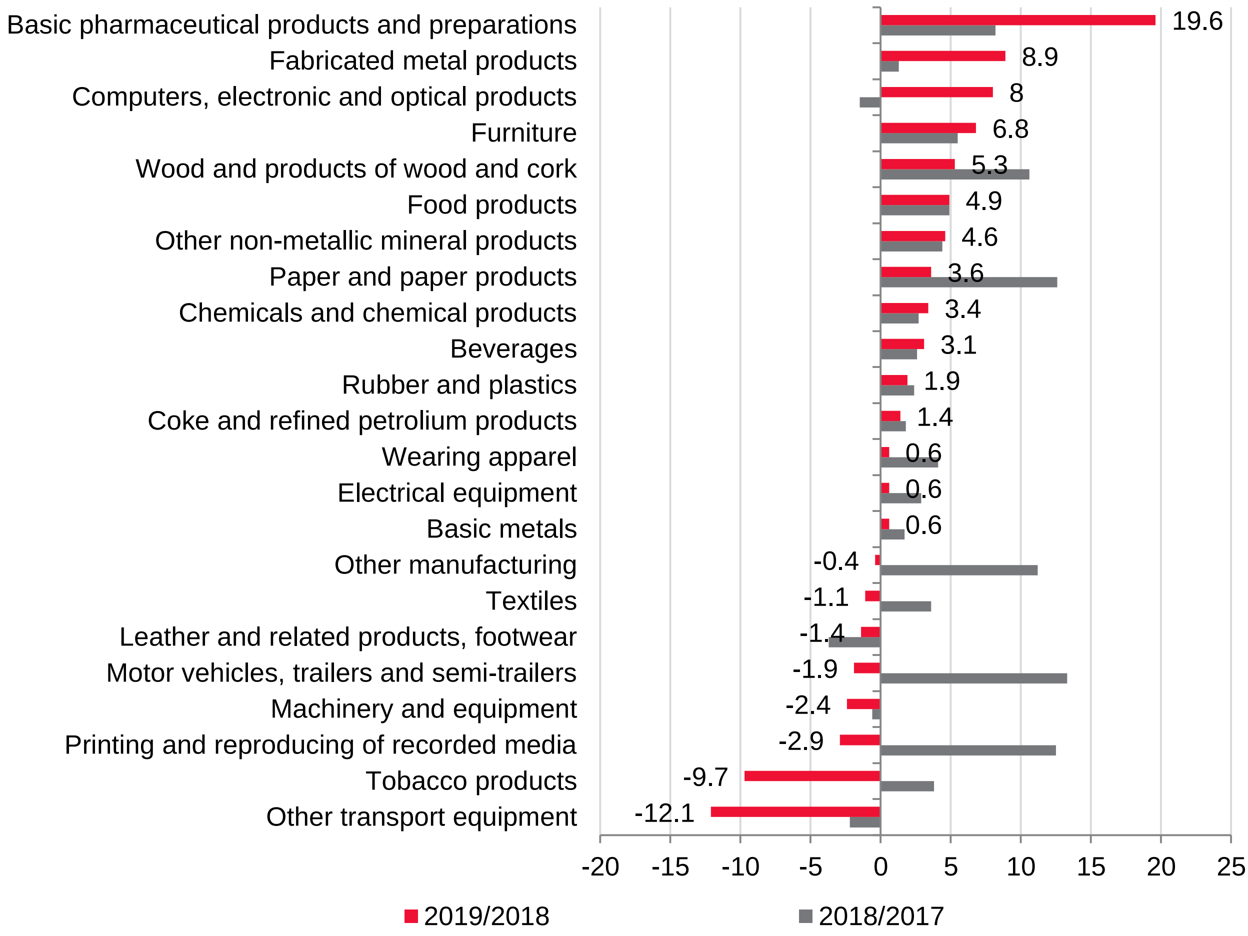
Most industries posted growth for 2019 (Figure 19). The manufacture of food and chemical products maintain a steady upward trend, expanding 4.9% and 3.4%, respectively, for 2019, with growth likely to continue in 2020. The manufacture of pharmaceutical products enjoyed a dramatic growth acceleration from 8.2% for 2018 to 19.6% for 2019. The manufacture of electronic products showed short-lived output jumps thanks to exports, with overall expansion coming in at 8% for the year.

The other industries mostly saw either a growth slowdown compared with 2018 or an output contraction (Figure 19). For example, the output of refined petroleum products, which has a substantial effect on overall manufacturing performance, expanded 1.5% for 2019, down from 1.9% a year earlier, on account of unscheduled repair and maintenance operations related to the suspension of export deliveries through the Druzhba oil pipeline.

A significant negative contribution to manufacturing performance in 2019 came from the manufacture of other transport equipment, which lost 12.1% for the year, dragged down primarily by the manufacture of air and spacecraft, shipbuilding and other equipment. After a very successful year for the manufacture of motor vehicles, which expanded 13.3% for 2018, its output growth slowed in 2019, with production starting to decline towards the year end.

The motor vehicle output contracted 1.9% for the year. Given the forecast for a fall in motor vehicle sales in 2020,[7] the negative production trend will likely persist.

Figure 19. Manufacturing industries annual growth rates, %



Source: Rosstat.

1.2.4. PMI indexes: economy maintains pace of growth achieved earlier

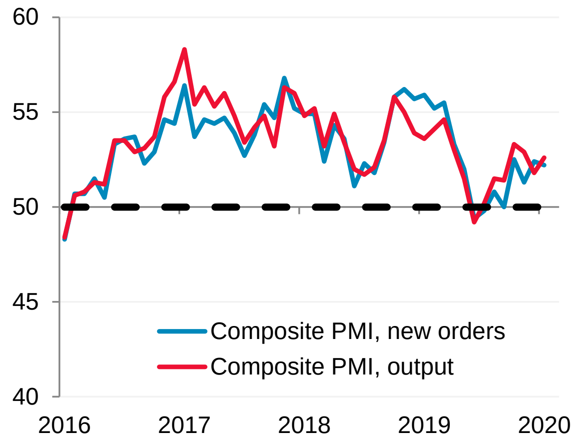
- The composite PMI for Russia rose to 52.6 in January, pointing to a marginal business activity acceleration at the start of the year. In February, economic growth may be adversely affected by the spread of the coronavirus in China, which may weigh on global economic growth.
- It appears from the PMI index that a business activity decline in manufacturing is continuing but at a slower pace than at the end of last year. Worth noting is a gradual rise in external demand in the consumer goods sector, suggesting Russian companies' success in tapping foreign markets.

[7] https://www.kommersant.ru/doc/4227622?from=vybor.

- Business activity growth in the services sector gained momentum in January as demand rose and new customers, including foreign ones, were obtained.

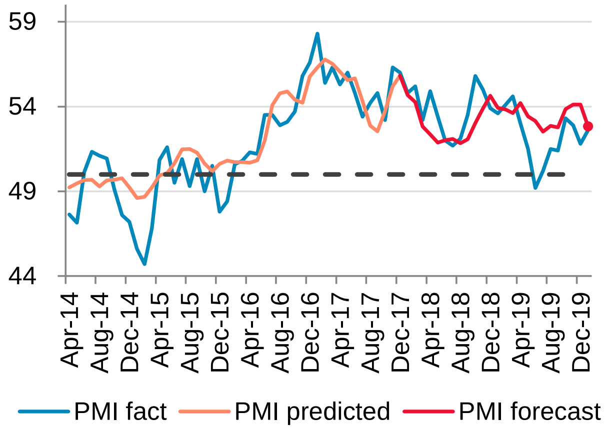
The composite PMI for output rose to 52.6 in January from 51.8 in December, fuelled by business activity expansion in services and a slowdown in manufacturing output contraction. The composite index value virtually matched that of the R&F Department's news-based business activity index in January, pointing to the maintenance of the Russian economy's growth rate at the start of the year (Figure 21). The situation may, however, worsen in February, since the coronavirus outbreak in China may take a heavy toll on global economic growth, affecting business activity in Russia.

Figure 20. Change in composite PMI indexes for Russia, pp



Source: IHS Markit.

Figure 21. Composite PMI and News-based business activity index, pp



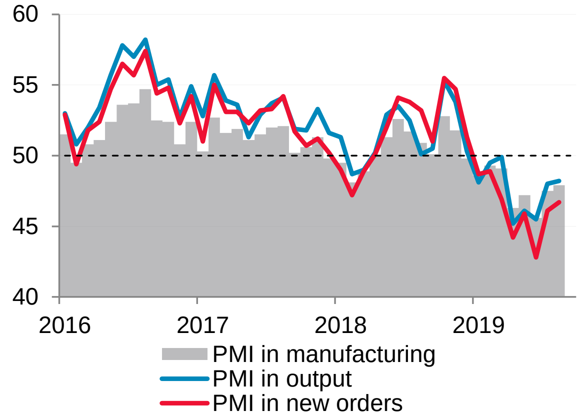
Source: IHS Markit, R&F Department estimates.

The manufacturing PMI suggests a gradual situation improvement in the sector. Its January reading rose above the December level to 47.9: business activity contraction continues but at a slower pace than at the end of last year (Figure 22). The current index reading is the highest since August 2019.

The output index edged up to 48.2 from 48.0, while the new orders index rose from 46.1 to 46.7. That said, producers again refer to weak demand and low purchasing power as factors behind business activity worsening in manufacturing. External demand continues to contract but at a slower pace. As at the end of 2019, consumer goods remained an exception: export orders for them were expanding, which may indicate gradually increasing access of Russian producers to foreign markets.

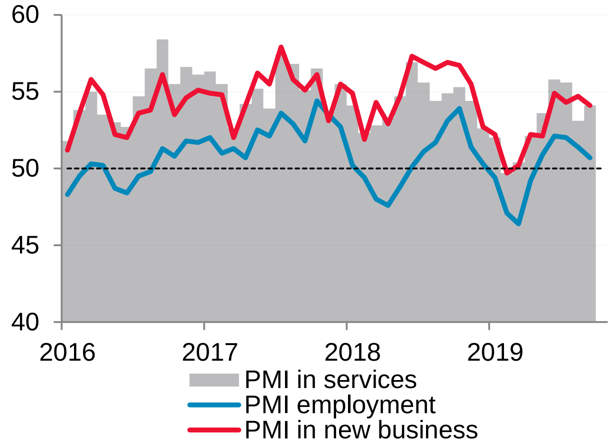
Reduced needs for personnel stemming from output contraction resulted in the continued decline in employment (48.9) and new orders (43.6). Despite the downbeat perceptions of the current situation in the sector, companies significantly upgraded their expectations for production prospects within the next 12 months: the index jumped from 61.9 to 67.9. The respondents reported plans for launching new product types and rising expectations for demand growth.

Figure 22. Change in PMI manufacturing indexes, pp



Source: IHS Markit.

Figure 23. Change in PMI services indexes, pp



Source: IHS Markit.

The services IHS PMI stood at 54.1, climbing above the December level, which suggests continued business activity expansion in the services sector (Figure 23). The respondents attribute business activity expansion to a demand enhancement and arrival of new customers. The new orders expansion continues, with a rise in export orders accelerating in January. Transportation and storage services saw the most extensive activity recovery. Business expectations of services sector companies for the next 12 months declined to 58.7 in January from 61.1 a month earlier on concerns over demand sustainability going forward.

1.2.5. Consumption growth accelerated in the fourth quarter

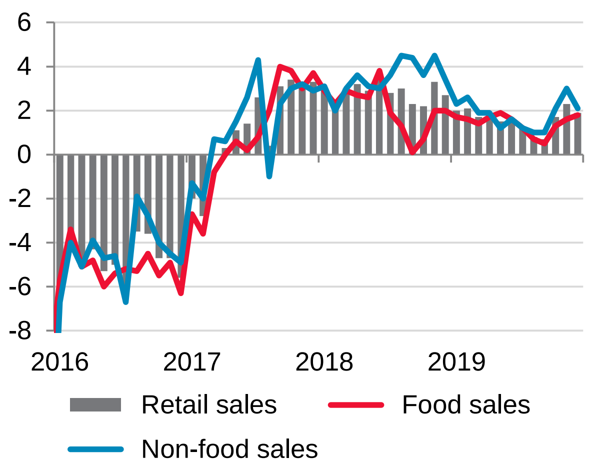
- Seasonally adjusted retail sales growth accelerated in the fourth quarter. This may indicate a rise in final household consumption growth at the end of the year, buttressing the Russian economy.
- Retail sales growth edged down in December after gaining pace in November, which may have in part been due to some redistribution of seasonal effects on the back of stepped up seasonal bargain sales in November.
- Consumption growth acceleration in the fourth quarter may have stemmed from an inflation slowdown amid a steady rise in key household income items in nominal terms. That said, the maintenance of the current pace of household income growth may spur inflation.
- The credit impulse from unsecured consumer lending turned negative in the fourth quarter, which did not have a significant effect on consumer demand as other finance sources grew, wages remaining the most important of them.

Retail sales growth eased to 1.9% YoY in December after a notable acceleration to 2.3% YoY in November (Figure 24). The sales numbers were dragged down by non-food sales, whose annual pace of growth slowed to 2.1% YoY from 3.0% YoY. Food sales continued to rebound, rising 1.8% YoY from 1.6% YoY.

December's slowdown in non-food sales may have stemmed from seasonal effects moving to November, which saw a certain demand shift on the back of earlier-than-usual pre-new-year spending boosted by stepped up bargain sales and discounts in that period. In fact, seasonally adjusted monthly data indicates a 0.6% MoM drop in non-food sales after their 0.8% MoM increase, whereas food sales inched up 0.2% MoM. Retail sales contracted 0.2% MoM SA in December after their strong growth by 0.7% MoM SA in November (Figure 25).

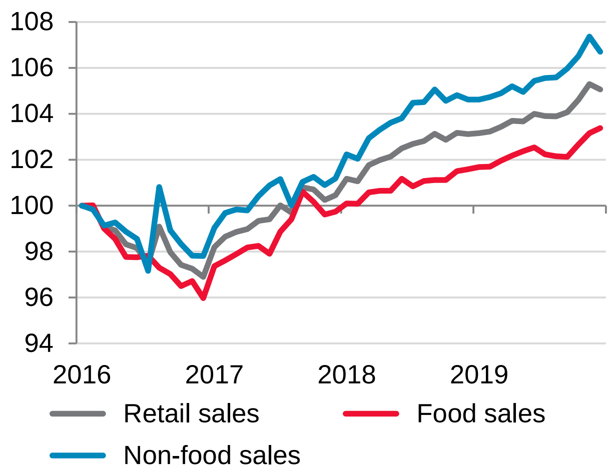
Based on our estimate, seasonally adjusted retail sales expansion accelerated to 0.99% QoQ in the fourth quarter from 0.16% QoQ (Figure 27). This may indicate an acceleration in final household consumption rise in the fourth quarter, which is set to have a positive effect on GDP growth.

Figure 24. Change in retail sales of food and non-food goods and retail sales turnover, % YoY



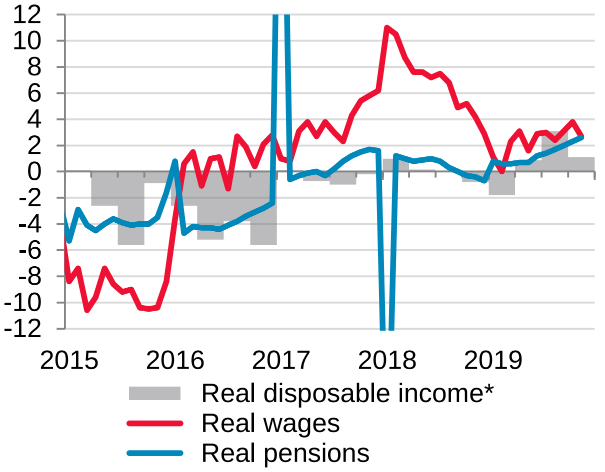
Source: Rosstat.

Figure 25. Change in retail sales turnover, % (January 2016 = 100%, SA)



Source: Rosstat, R&F Department estimates.

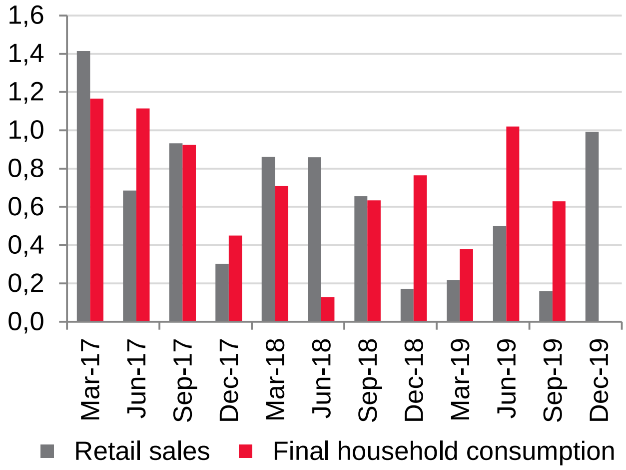
Figure 26. Change in real household income, % YoY



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

Source: Rosstat, R&F Department estimates.

Figure 27. Change in retail sales turnover and final household consumption, % QoQ SA



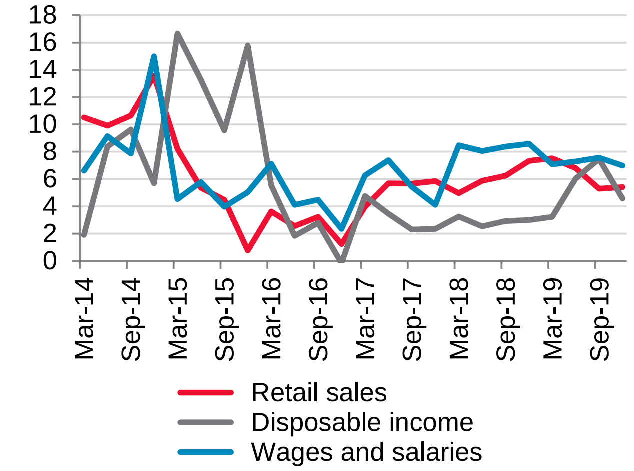
Source: Rosstat, R&F Department estimates.

Retail sales expansion slowdown to 1.6% YoY for 2019 from 2.8% in 2018 is in line with the pace of real wage growth, which stood at 2.5% YoY in January–November 2019, down from 8.5% YoY in 2018 (Figure 26). It is noteworthy that retail sales growth acceleration towards the end of 2019 was concurrent with inflation easing. Meanwhile, sales growth slowed in nominal terms towards the end of the year, whereas growth in employees' wages and salaries (the key source of household income) was stable in nominal terms[8] throughout the year (Figure 28). If the fourth quarter's consumer demand growth acceleration (in real terms) continues going forward, this may, with a lag, heighten inflationary pressure.

A decline in the pace of unsecured consumer lending expansion continued in December, with the credit impulse[9] turning negative in the fourth quarter of 2019 (Figure 29). This did not, however, dampen consumer demand. The key source of finance for consumption is still wages and salaries, whose growth rate was constant at 7.2% YoY. The fourth quarter saw a slowdown in the rise of such income items as social payments, income from property and other payments in cash. The third quarter's acceleration was in large part due to one-off factors (mostly social payments on account of emergency situations, as well as dividends). The share of income which went to savings in the fourth quarter was roughly unchanged from a year earlier but slightly declined for the year to 3.4% from 4.2% in 2018.

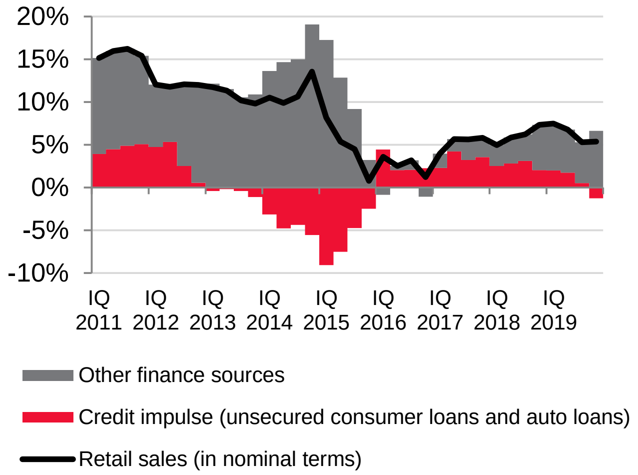
[8] Rosstat statistics from the balance of income, expenditure and savings.
[9] The credit impulse is a ratio of lending growth change in absolute terms to retail sales (the second-order derivative of lending changes).

Figure 28. Disposable income, wages and salaries, and retail sales in nominal terms, % YoY



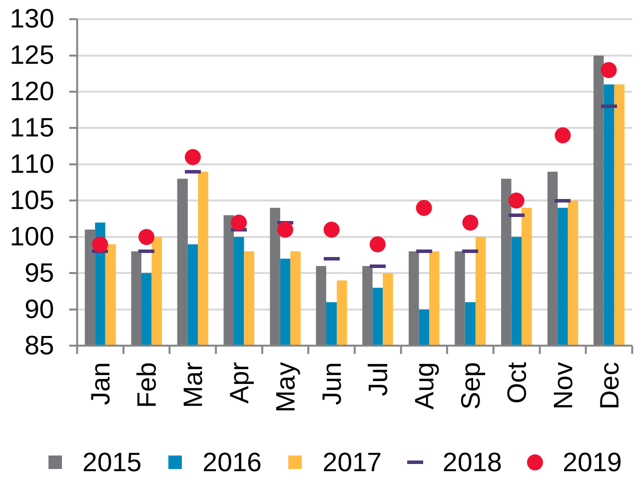
Source: Rosstat, R&F Department estimates.

Figure 29. Contribution of quarterly lending growth to retail sales expansion, % YoY



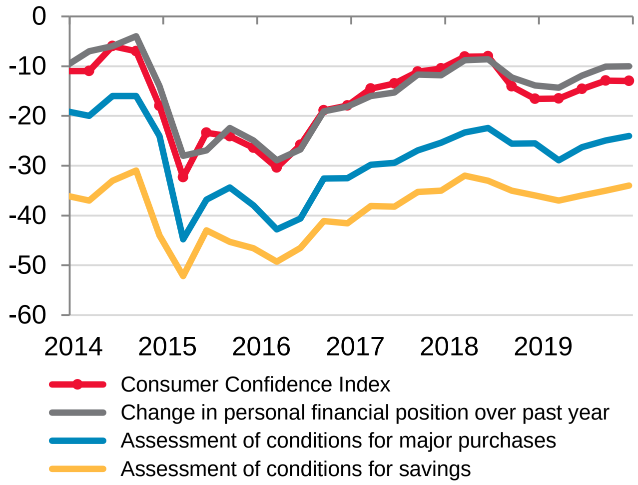
Sources: Rosstat, Bank of Russia, R&F Department estimates.

Figure 30. Real everyday household expenditure, % (2012 median = 100%)



Source: Romir.

Figure 31. Rosstat Consumer Confidence Index and its components



Source: Rosstat, R&F Department estimates.

Alternative indicators of consumption also point to a continued rise in consumer demand. Based on Romir research holding company data,[10] real everyday household expenditure continued to grow in December after its spike in November (Figure 30). December's indicator rose above the levels registered in the same period of previous years, coming close to a high of December 2015. Since Romir data only includes FMCG[11] expenditure, the daily spending figure may be not fully consistent with the retail sales

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[10] Russian households posted all-time expenditure highs in the run-up to New Year's / Romir research holding company. 24.01.2020.

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

slowdown in December. Still, it provides more evidence of household consumption recovery at the end of the year.

According to Rosstat surveys, the fourth quarter consumer confidence index was unchanged from the third quarter. The respondents showed some improvement in their perceptions regarding major purchases, which slowly recovered throughout 2019 after a slump at the start of the year stemming from the VAT hike. As inflation declines, survey data is expected to continue improving gradually, with household perceptions buoying consumption going forward.

1.2.6. Unemployment rate at an all-time low

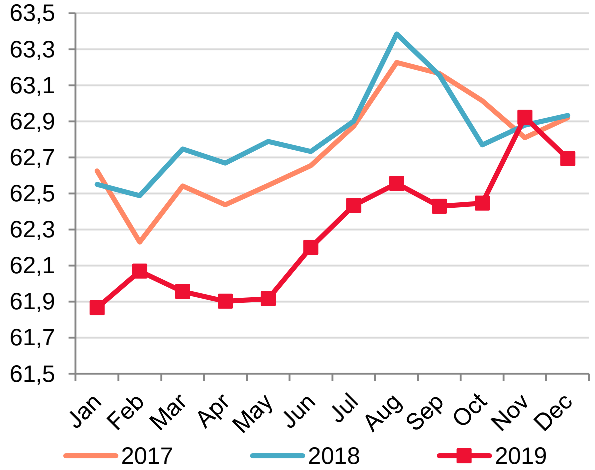
- The end of 2019 saw the labour force participation and employment rates return to the 2018 levels after their decline in the first half of the year, which was consistent with an overall rebound of business activity in the second half of 2019. As a result, the unemployment rate continues to slide, hitting all-time lows.
- The retirement age increase has started to affect the labour market: a decline in the number of economically active people in 2019 would have been more significant without this reform in place. Its impact on labour market indicators should rise in the years to come.
- All in all, the labour market situation so far does not create significant inflationary risks. The nominal wage growth was generally steady last year, while the inflation slowdown accelerated real wage growth.

The labour force participation rate[12] fell dramatically in the first half of 2019 compared with 2017–2018. The situation, however, changed in the second half of the year: the decline slowed and the proportion of economically active population returned to the levels of previous years (Figure 32), which is consistent with developments in the economy.

A gradual increase in the retirement age has started to affect the labour market situation. According to Russian Pension Fund data, 355 thousand fewer people retired in 2019 than would have done so if the retirement age had not been increased. This is comparable with the R&F Department's earlier estimates[13] (about 400 thousand in 2019). The overall effect on the numbers of economically active people was less significant, since many of those who could have retired, would have stayed on in the labour market anyway. The impact of pension reform is set to increase in the years to come, likely affecting the labour market (Figure 33). The impact of pension reform is indirectly evidenced by the labour force participation rate by age group.[14] Age groups of 55–59 and 60–69 years increased substantially in the third quarter of 2019 (Figure 34).

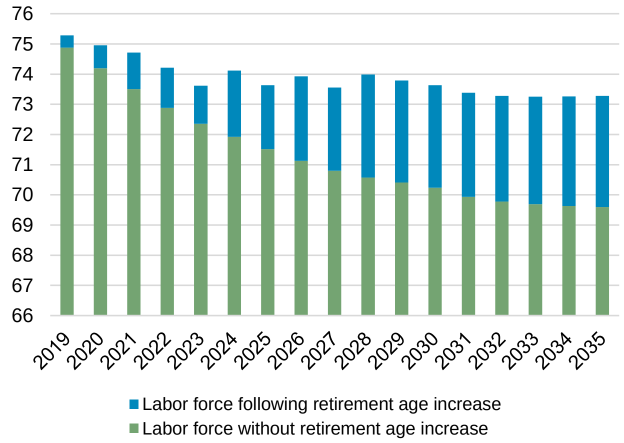
[12] Economically active population (employed and unemployed) as a percentage of working age population.
[13] The estimate is based on Rosstat mean demographic forecast.
[14] The fourth quarter data has yet to be released.

Figure 32. Economically active population, %



Source: Rosstat.

Figure 33. Labour force*, million

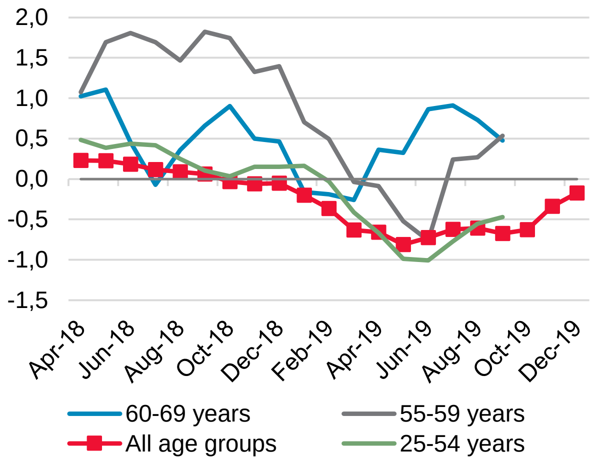


** Estimates based on Rosstat mean demographic forecast.*

Source: Rosstat, R&F Department estimates.

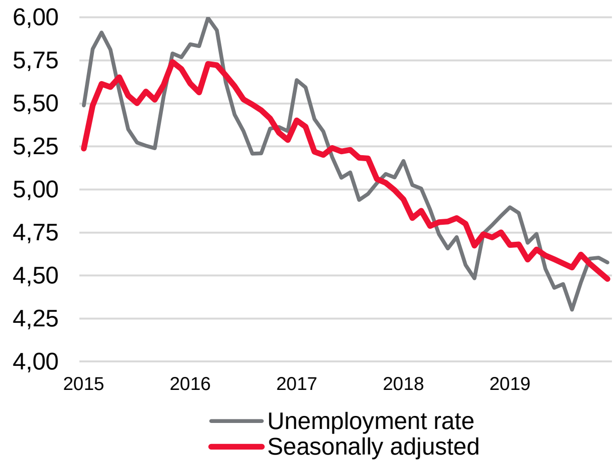
The employment rate recovered even faster than the labour force participation rate in the last months of 2019, bringing the unemployment rate down to an all-time low of 4.48% SA (4.6% NSA) in December.

Figure 34. Economically active population growth by age group, % YoY (three-month moving average)



Source: Rosstat, R&F Department estimates.

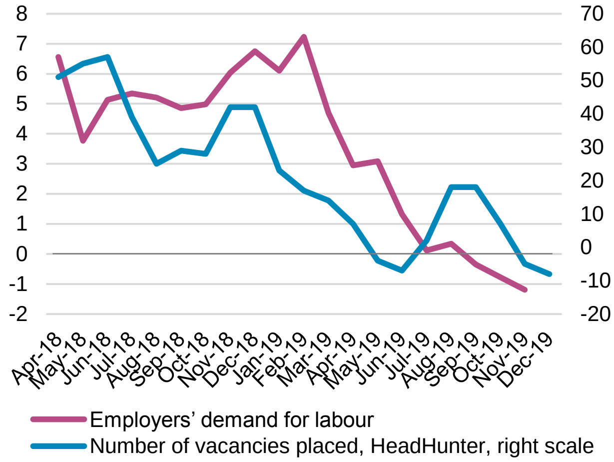
Figure 35. Unemployment rate, %



Source: Rosstat.

Some indicators, however, fail to show an improvement in the labour market situation towards the end of the year. According to data from the online job search service HeadHunter, employers' demand for labour dropped again at the end of the year after rising somewhat in August–October, while Rosstat data indicates that this occurred as early as September 2019 (Figure 36).

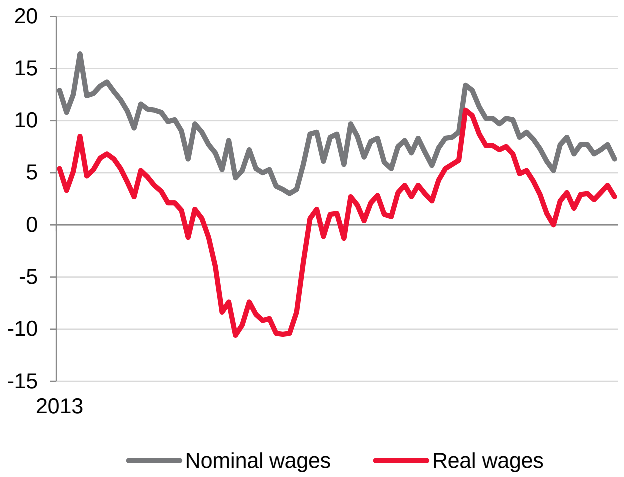
Figure 36. Employers' demand for labour, % YoY



Source: Rosstat, HeadHunter.

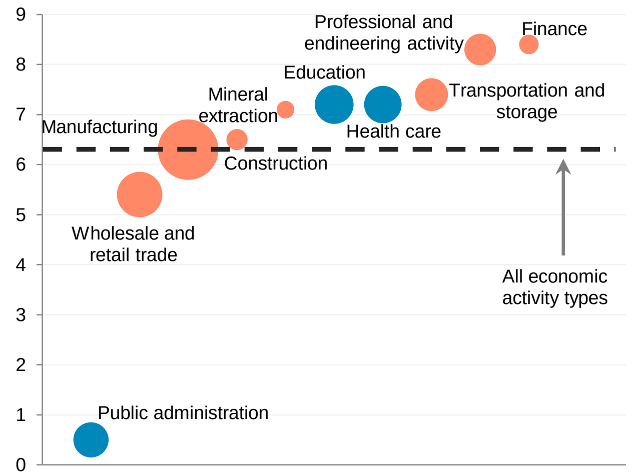
The demand to supply ratio in the labour market so far does not create significant pro-inflationary risks related to wage growth.

Figure 37. Wage growth, % YoY



Source: Rosstat.

Figure 38. Wage growth by economic activity type in November 2019, growth, % YoY



** The size of the circles corresponds to an activity type share in the payroll fund.*

Source: Rosstat.

The pace of real annual wage growth slowed to 2.7% YoY in November from 3.8% YoY in October (Figure 37). Nominal wage growth eased from 7.7% YoY in October to 6.3% YoY in November, with growth slackening to 6.7% YoY from 7.4% YoY in the private sector and to 5.1% YoY from 8.5% YoY in the government sector. Public administration salaries rose just 0.5% YoY in November, sharply down from 10.5% YoY in October (Figure 38). This high wage volatility in public administration is temporary: public sector wages were indexed by 4.3% in October, therefore November's growth slowdown may be owed to, for example, a shift in the time of bonus payments in that year.

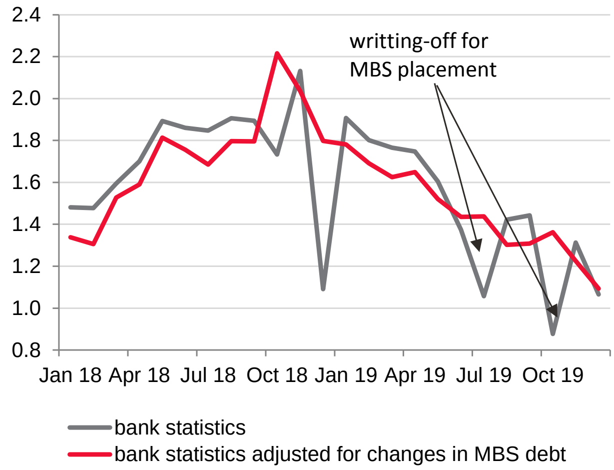
1.2.7. Key bank lending segments see some growth slowdown

- Retail lending expansion continued to weaken in December, with mortgage lending growth (adjusted for seasonal effects and debt on MBS principal) slackening to 0.8% MoM and unsecured consumer lending expansion inching up.
- December saw new mortgage loans exceed the 2018 level for the first time since February, likely signalling an upturn in demand for mortgage loan refinancing. The interest rate cuts and an expansion in the programme for lump-sum child-birth allowances (maternity capital) may boost demand for mortgage lending in 2020.
- Corporate lending growth weakened to 4.5% for 2019, largely driven by a change in companies' debt finance structure towards other segments: the issuance of rouble-denominated corporate bonds in the domestic debt market hit record highs in 2019, with the leasing market also showing extensive growth by 12% YoY for the first nine months of 2019.
- Household bank deposits went up 10.1% for 2019, exceeding the 2018 number (6.5% YoY). Retail deposit growth is also buoyed by households using escrow accounts, which added 0.5 pp to the growth figure.
- Banks earned a record high profit of over 2 trillion roubles for 2019. Among key growth factors are technical profit expansion following the sector's adoption of IFRS 9 reporting standards, the absence of losses as part of massive additional provisioning, and a rise in fees and commission income.

Retail lending[15] expansion continued to slow in December, coming in at 1% MoM in seasonally adjusted terms (Figure 39). A preliminary estimate of retail lending growth adjusted for debt on MBS principal[16] also indicates a continued lending growth softening. Retail lending rose 18.6%[17] for 2019, edging down from 22.8% for 2018.

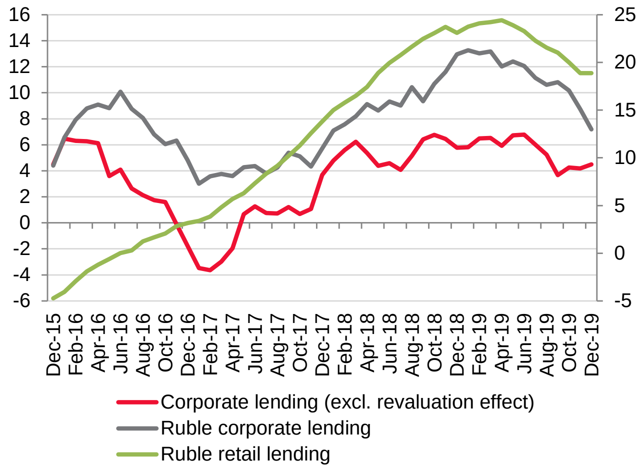
[15] Total retail loans.
[16] Mortgage-backed securities. December saw two MBS issues for a total of 120.5 billion roubles.
[17] Here and further on, annual growth rates are reported for banks operating as of the last reporting date, unless otherwise provided.

Figure 39. Retail lending growth, % m/m SA



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

Figure 40. Annual growth rates, y-o-y



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

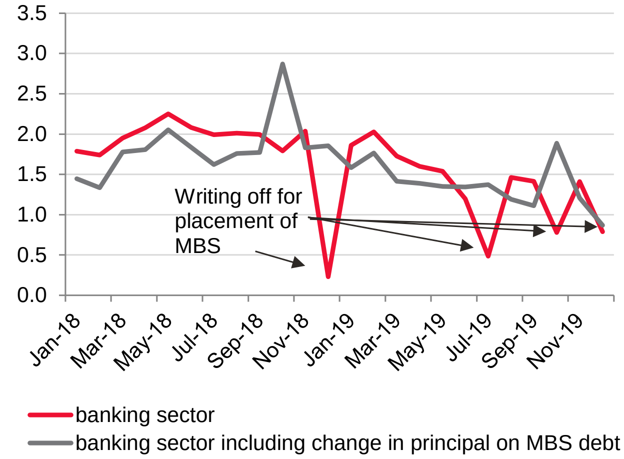
Mortgage lending growth adjusted for seasonal effects and MBS debt gained 0.8% м/м in December, thus continuing this segment's gradual slowdown from the start of the year. (Figure 41). Mortgage lending expansion slowed to 17.2%[18] for 2019 from 23.1% for 2018.[19]

It appears that a decline in interest rates on mortgage loans to an all-time low of 9% in December 2019 has already boosted demand for loan refinancing. A total of mortgage loans issued in December exceeded the December 2018 level. Given the slowed loan portfolio growth, this indicates a rise in loan refinancing (Figure 40). Loan refinancing does not increase outstanding debt, therefore extra demand and mortgage loan provision will not affect debt figures. At the same time, refinancing at lower interest rates enables borrowers' debt burden to be reduced, enhancing opportunities for consumption and lending growth. Mortgage loan rates may continue to decline at the start of 2020, providing support for this segment's expansion. Changes in rules for the provision of lump-sum child-birth allowances (maternity capital) announced recently may also improve demand for mortgage lending.

Unsecured consumer lending growth stood at 1.3% MoM SA in December, up from 1.2% MoM in November 2018. Three-month annualised portfolio expansion continues to weaken, coming in at 16.8% in December after 18.1% in November. December's minor growth acceleration may have stemmed from banks' successful adaptation to the requirement that borrowers' debt service to income ratio be measured, suggesting that this market segment's slowdown may be smooth in 2020.

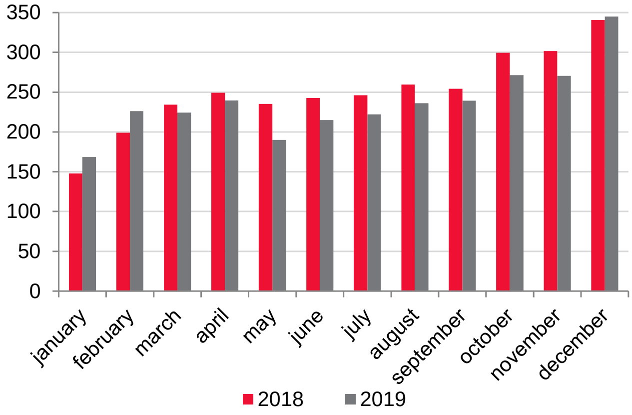
[18] In terms of roubles and foreign currency, including acquired claims.
[19] Based on our estimate, growth adjusted for MBS debt stood at 15.4% for 2019 after 23.6% for 2018.

Figure 41. Mortgage lending growth, % m/m SA



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

Figure 42. Volume of total of mortgage loans issued, bln rub.



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

Rouble corporate lending added just 0.4% MoM in seasonally adjusted terms in December. Rouble corporate lending grew at a slow pace for the whole of the fourth quarter of 2019, while three-month annualised growth suggests an expansion rate of 4%, appreciably slower than sustainable long-run growth for the sector. The corporate loan portfolio expansion slackened to 4.5% for 2019, down from 5.8% for 2018 (Figure 40), with the rouble portfolio adding 7.2% versus 13% for 2018. The foreign currency portfolio contracted 2.2% YoY compared with a drop of 11.1% for 2018, continuing the banking loan lending dedollarisation trend.

Corporate loan portfolio growth slowed as the issuance of rouble-denominated corporate debt securities (exclusive of the Central Bank and public agencies) in the domestic debt market posted record highs at 12.9 trillion roubles for 2019, up 12.8% YoY. A faster rise in returns on corporate debt towards the end of the year sparked large borrowers’ interest in this financing instrument, which was probably a key factor behind growth in bank loans to nonfinancial organizations (the fourth quarter accounted for about half of an annual rise in the total of nonfinancial sector bond issuance).

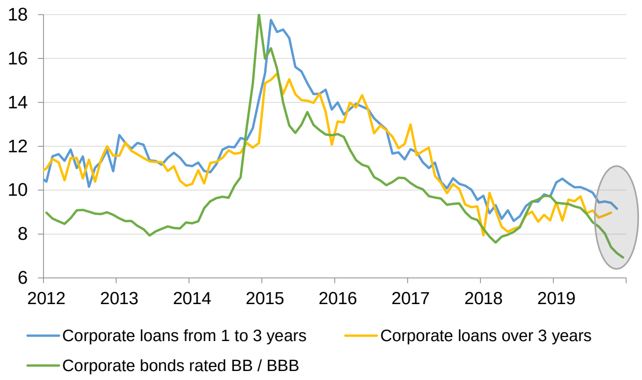
A part of corporate bonds thus issued were bought by banks. Their rouble corporate bond portfolio[20] gained 12.2% for 2019. As a result, the banking sector’s rouble-denominated claims on corporate borrowers[21] added 7.6% YoY. Also, the non-financial sector’s rouble-denominated debt (includes the banking sector and other residents’ claims) increased 9% for 2019, based on preliminary estimates (Figure 45).

One should also note the continuation of extensive growth in leasing, providing yet another alternative to corporate lending as a source of finance for upgrading fixed assets. According to Expert RA data, the leasing portfolio totalled 4.6 trillion roubles for the first 9 months of 2019, up 12% YoY (Figure 44), and is projected to expand 5–7% for the whole of 2019.

[20] Investments in other debt securities.
[21] Loans and debt securities.

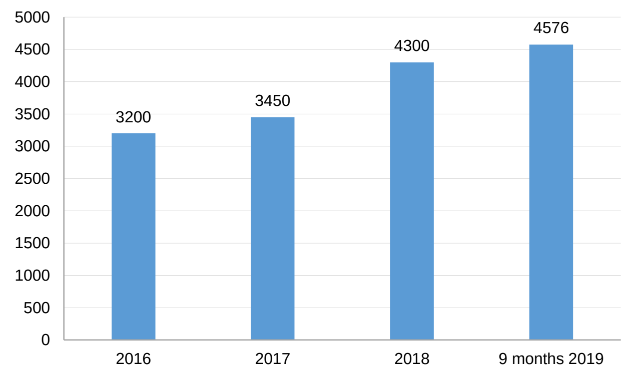
The slower bank lending growth in 2019 thus partially arose from a change in the structure of corporate debt financing towards other sources. That said, prospects for further debt financing growth depend not so much on monetary conditions as on the degree of uncertainty for businesses. Therefore, in an environment of institutional and structural constraints, investment demand weakly responds to monetary easing, thus tempering the effectiveness of the bank lending channel of the monetary policy transmission mechanism.

Figure 43. Interest rates on corporate loans and corporate bonds, %



Source: Bank of Russia, Cbonds.

Figure 44. Leasing portfolio, billion roubles



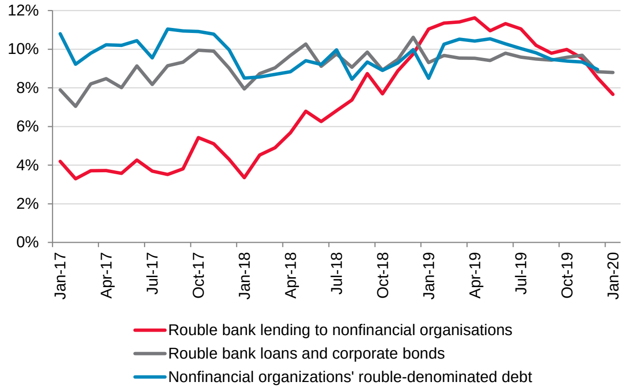
Source: Expert RA.

Lending growth easing during 2019 arose from a number of factors, such as enhanced attractiveness to borrowers of other financing instruments, thanks to, among other things, monetary easing; internal risk management policy at banks, since they receive the first signals of borrow quality worsening[22] (for example, the share of loan applications approved by banks in December dropped to the lowest level since 2017[23]); macroprudential policy, and a gradual toughening of add-ons to capital adequacy requirements. For example, a buffer for systemic importance was raised from 0.65 pp to 1 pp as of January 2020, with a capital conservation buffer going up from 2.25 pp to 2.5 pp. The banking system is, on the whole, strongly capitalised, and this toughening of requirements is unlikely to raise barriers to lending growth in 2020. However, some banks meeting capital adequacy requirements less comfortably may encounter constraints on further lending expansion.

December saw household rouble deposit expansion slow to 0.5% MoM in seasonally adjusted terms and to 0.3% MoM if adjusted for a rise in escrow accounts. The slowest pace of household deposit monthly growth in 2019 may stem from diminishing attractiveness of bank deposits versus alternative saving instruments, in particular the stock market. This trend may continue in the months ahead – the highest interest rates at top-10 banks dropped to 5.76% p.a. Household deposits rose 10.1% for 2019 after a 6.5% increase in 2018. We estimate that escrow accounts expansion contributed about 0.5 pp to this growth (Figure 46).

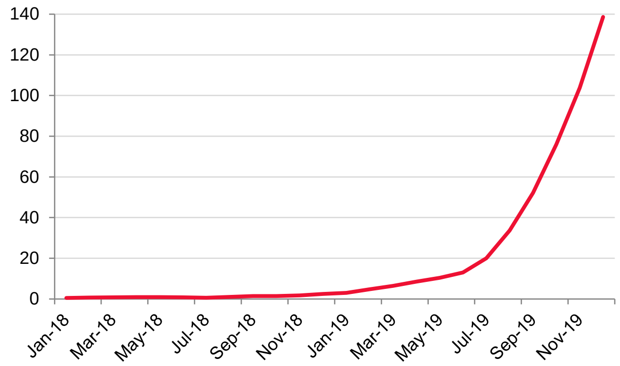
[22] For details see Section 1.2.8. “Corporate and retail lending expansion remained on the August level in September” in Talking Trends bulletin No. 7, September 2019.
[23] “Banks refused over 60% of loan applicants”.
https://www.rbc.ru/finances/14/01/2020/5e1c91b89a79476cad759d0b

Figure 45. Growth in rouble corporate banking lending, bonds, and non-financial sector's debt, % YoY



Source: Bank of Russia, Cbonds.

Figure 46. Household escrow accounts, billion roubles



Source: Bank of Russia.

The new financing scheme for housing construction is set to affect banking sector performance going forward. Aside from the immediate effect on household deposits, it is supposed to provide more impetus to nonfinancial sector lending. In addition to mortgage loans to be held in household escrow accounts, loans to developers will appear on banks' balance sheets. Under the earlier financing scheme, bank lending to developers was far from the key funding source for projects co-financed by developers and housing owners. The new scheme for financing of housing construction will likely result in a substantial change to the structure of banks' balance sheets in the years to come.

Banks earned a record high profit of 2.04 trillion roubles for 2019, more than one and a half times the level of the previous year (1.35 trillion roubles) in 2018 (Figure 47). A significant, albeit technical, input to the profit came from adjustments to provisions following the adoption of the IFRS 9 standards.[24] The revisions totalled 0.4 trillion roubles for 2019. Also, some of the banks under resolution posted a significant loss of about 0.5 trillion for 2018, on the back of one-off additional provisioning for old troubled assets, whereas the result these banks showed in 2019 was close to zero.

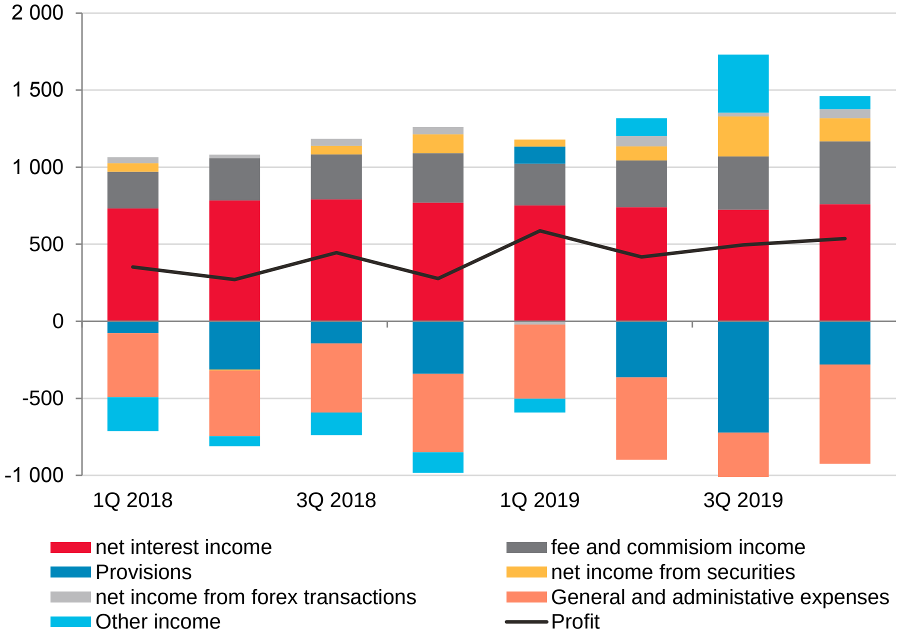
Net interest income (NII) and fees and commission income remained the key sources of the banking sector's profit. We note that the NII decline, which started late in 2018, came to a halt: NII totalled 761 billion roubles for the fourth quarter of 2019, a rise from 724 billion roubles in the third quarter. NII growth in the last quarter of the year stemmed from a faster contraction in banks' interest expenditure. The interest expenditure drop may continue on the back of recent monetary easing and a decline in bond yields, which, as a rule, translates into bank funding rates at a faster pace than into loan rates.

Fees and commission income growth continued, hitting an all-time high of 1.3 trillion roubles, up 18% YoY. This suggests that banks continue to explore and develop new

[24] Banks are required to report provisions set aside under prudential regulation but are allowed to carry out revisions to those according to their assessment under the IFRS 9 standards, with revision results referred to the profit of the current year.

products unrelated to interest income with the interest margin and nominal interest rate expected to decline as inflation slows.

Figure 47. Factors of profit generation, bln rub



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

1.2.8. Balance of payments in 2019: exports dwindle as imports expand

- The current account surplus came in at USD70.6 billion for 2019, much lower than initially expected. This stemmed from an extensive import recovery in the second half of 2019 and a more significant deficit in the balance of services (related to travel) and income from investments (a rise in payables) against a backdrop of rouble appreciation. The above factors completely offset a positive contribution to the current account of a larger income from non-oil and gas exports than initially projected.
- Exports contracted 6% for 2019 (a drop of 9% YoY in the fourth quarter). Import growth accelerated to 10% YoY in the fourth quarter of 2019 from 4% YoY a quarter earlier, providing for growth of 2.5% for the whole of 2019.
- The surplus of private sector financial transactions more than halved to USD26.7 billion from USD63 billion in 2018.
- This was driven primarily by banks repaying USD20.1 billion of foreign liabilities, whereas other sectors' contribution to net lending to the rest of the world was insignificant in 2019. A foreign direct investment (FDI) inflow of USD26.9 billion to the nonfinancial sector offset a rise in foreign assets.

- The FDI improvement may be owed to one-off deals to sell ownership stakes in Russian assets (the Arctic LNG 2 Project). The impact of major companies' intra-group transactions also remains important.
- Nonresidents' stepped up inflows to OFZs, with a peak of demand in the second quarter of 2019 (up USD10.5 billion) and a moderate expansion in the fourth quarter of 2019 (a rise of USD3.6 billion and a total increase of USD20.4 billion for the year), were helped by expectations for key interest rate cuts. Against this background, foreign exchange inflows to the public sector were comparable with the surplus of the private sector financial account.

The 2019 results showed that a trend towards a more significant than expected decline in current account surplus was taking shape. A commodities export contraction was driven by an external demand worsening. On top of that, import expansion is gaining momentum as the rouble and external demand strengthen and investment growth recovers.

The second half of 2019 saw a recovery in the imports of machinery and equipment, which is basis of investment imports and a leading indicator of a rise in investment. Imports remain strong even exclusive of a temporary factor, such as a jump in chemical products imports (thanks to pharmaceuticals). This suggests that the trend is sustainable.

We believe that the contraction in seasonally adjusted current account surplus will continue going forward, driven by the shrinking of trade surplus. In the medium term, exports by value will continue to dwindle as external demand weakens, whereas imports will be buoyed by real exchange rate strengthening and the recovery of imports.

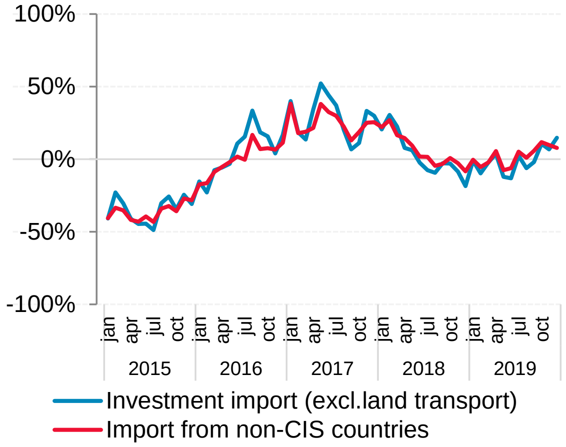
Changes in the key balance of payments components were mixed in 2019. Oil and gas exports contracted 9% YoY to USD238 billion, dragged down chiefly by the worsening external conditions. While crude oil exports rose 3.8% in physical terms in January–November, refined petroleum product exports fell 7%. Gas exports remained almost unchanged in physical terms in January–November 2019, thanks in large part to sharp export increases of 11% YoY in October and 6% YoY in November as European gas inventories were stocked up. Non-oil and gas exports beat expectations, showing just a token decline to USD180 billion from USD181 billion in 2018. Their share in exports went up to 43.1% from 41% in 2018. Meanwhile, the physical volume of metal exports contracted 10.4% YoY in January–November 2019. Non-oil and gas exports were buoyed mainly by chemical products, which rose 3.8% in physical terms in January–November, according to Federal Customs Service data.

As regards imports, they showed signs of a rise in the second half of 2012. Based on preliminary data, import growth accelerated to 4% in the third quarter and to 10% in the fourth quarter after falling 2.6% in the first half of 2019.

One growth factor was imports of chemical products, fuelled primarily by pharmaceuticals. However, after a jump in October–November 2019 (Figure 49), an expansion in pharmaceutical product imports weakened in December, as expected. This was owed to a postponement of mandatory labelling introduction from 1 January until 1 July

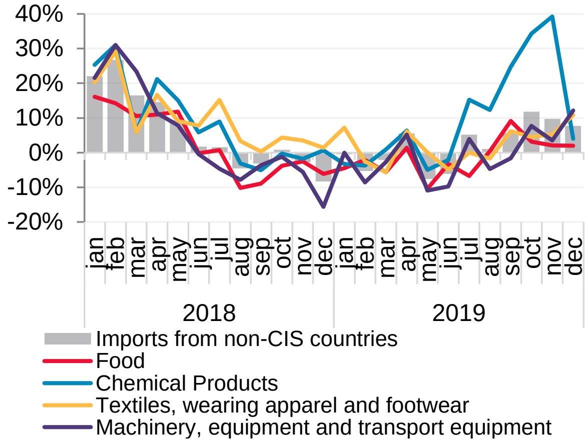
2020,[25] which allows medications produced or imported prior to this date to be sold without labelling until their expiration dates. However, as the start of mandatory labelling approaches, one cannot rule out a new wave of pharmaceutical import expansion in the first half of 2020. Another, no less important, factor supporting pharmaceutical imports in the medium term is the implementation of the federal project *Combatting Cancer* for which funding will be scaled up in 2020.[26]

Figure 48. Growth in imports from non-CIS countries and investment imports[27], USD, rate of growth, YoY



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

Figure 49. Growth in the components of imports from non-CIS countries, USD, rate of growth, YoY



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

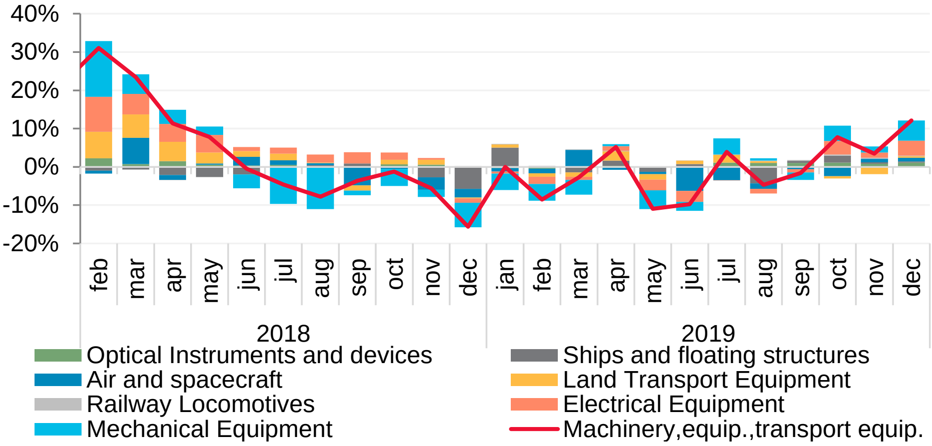
At the same time, the rest of key import categories maintained an upward trend in both investment and consumer imports, with machinery and equipment, as well as textiles, wearing apparel and footwear import expansion accelerating substantially.

[25] Federal Law No 462-FZ of 27.12.2019 On Amending the Federal Law *On the Circulation of Pharmaceutical Products;* Federal Law on Amending the Federal Law *On the Circulation of Pharmaceutical Products*

[26] The funding of the Combatting Cancer project for 2019–2022 is planned at 101;189;182, and 187 billion rubles a year, a significant part of which may finance the purchases of pharmaceuticals.

[27] Investment imports are calculated as the difference between total machinery and equipment imports and the import of overland transport equipment from other than former USSR countries.

Figure 50. Decomposition by component of machinery and equipment imports by value, YoY



Source: Federal customs service, R&F Department estimates.

Noteworthy among last year's important factors are a deficit increase in the balance of services and that in primary and secondary income at a faster pace than initially projected. A total of this deficit rose to -92 billion dollars from -81 billion dollars a year earlier, exerting a significant pressure on the current account surplus. Specifically, we saw a larger deficit in the balance of services (related to travel) and income from investments (due to growth in payables) than projected at -35 billion dollars versus -30 billion a year earlier. Recent years' trend suggests a high likelihood of this factor continuing to exert a negative pressure on the current account surplus going forward.

The non-residents' stepped up inflow to OFZs played an important role in financial account improvement. Non-residents' OFZ purchases in the secondary market expanded by USD20.4 billion, with the second quarter accounting for half of this sum (+USD10.5 billion). An inflow this large had a significant positive impact on the balance of payments as the weight of rouble appreciation, which provided additional support to imports, increased.

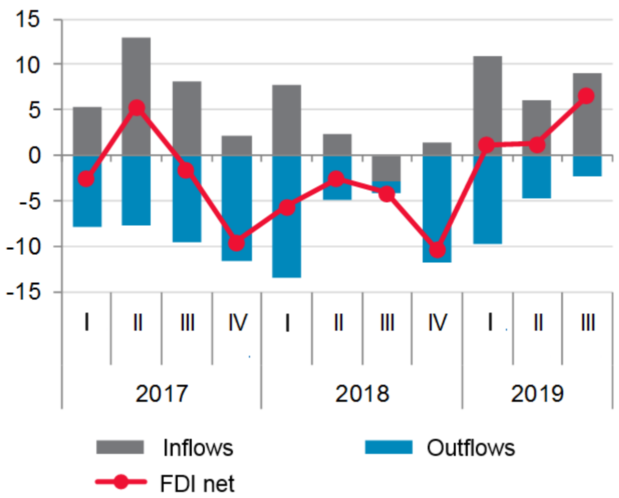
The surplus of private sector financial transactions was driven primarily by banks repaying USD20.1 billion of foreign liabilities, whereas the contribution of the other sectors to net lending to the rest of the world was insignificant for 2019. Meanwhile, unlike the previous year, 2019 saw a USD 26.9 billion inflow of foreign direct investment to the nonfinancial sector, which is, however, comparable with growth in foreign assets. We believe that the banking and corporate sectors may see these trends continue unless serious external shocks emerge.

Whether the significant inflow of foreign direct investment (FDI) seen recently is sustainable is an issue which merits special attention. The largest FDI inflows were recorded in the first and third quarters of 2019 at USD10.9 billion and USD9 billion, respectively. Net FDI inflows to Russia (accounting for FDI abroad) were also positive at USD9.1 billion in January–September 2019 in contrast to outflows in the same period a year earlier. While the share of reinvested earnings in total FDI remains constant, it is noteworthy that the role of investment in ownership capital and debt instruments was enhanced.

More detailed preliminary estimates for January–September and market data analysis give reason to assume that the improvement in the 2019 numbers was helped by PJSC NOVATEK's large-scale deals. NOVATEK's profit from the sale of 10-percent and 30-percent stakes in the Arctic LNG 2 project to foreign investors totalled 675 billion roubles; the deals were reported in March and July 2019 accounting, respectively,[28] i.e., for the first and third quarters 2019, which saw the bulk of FDI inflows.

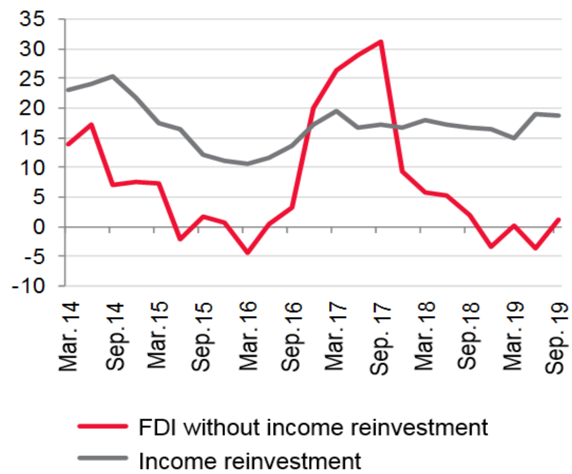
An examination of other FDI categories suggests a lack of improvement in this area as a whole – as such, the current FDI growth cannot be viewed as sustainable. What we see is an inflow related to one major project rather than a general trend. As regards the Arctic LNG 2 project plans, the likelihood of raising external foreign exchange finance for the project from foreign banks (the media refer to a total of up to 8 USD billion) may have a temporary positive effect on capital inflows in the medium term.

Figure 51. FDI inflows and outflows, billion US dollars



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

Figure 52. Balance of FDI inflows to Russia, by instrument, other sectors (four-quarter moving average)



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

Change in reserves stood at USD66.5 billion in 2019, driven mainly by foreign currency purchases for the Finance Ministry under the fiscal rule. A larger reserves growth in 2019, notwithstanding a lower average annual oil price, stemmed from the low base of the second half of 2018, which saw the Bank of Russia suspend, as of August 2018, foreign currency purchases in order to maintain financial stability and from subsequent foreign currency purchases deferred earlier.

In the medium term, we will likely see continued pressure for current account surplus narrowing from both external and internal factors, including the weakening of demand for Russian exports, the recovery of investment imports as the deferred budget spending

[28] PJSC NOVATEK accounting for the third quarter and nine months of 2019. http://www.novatek.ru/ru/press/releases/index.php?id_4=3523

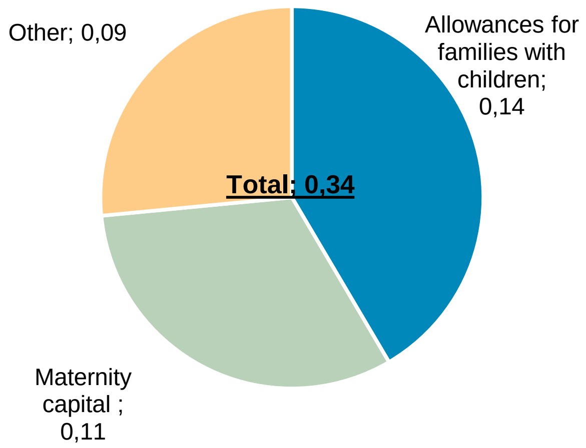
enhancement and government programmes are implemented, which may shift the key balance of payments components.

1.2.9. Inflationary effect of the new social package announced by the RF president will be minor

- The new social package announced by the Russian president as part of his address to the Federal Assembly is to cost 0.38 trillion roubles, or 0.34% of GDP in 2020.
- We estimate the contribution of the new measures to Russia's GDP growth in 2020 at 0.20–0.25 pp, its input to inflation – at 0.1 pp at the end of the year, and to real disposable income growth – at 0.45–0.55 pp.
- Subsequent years are expected to see accelerated growth in the cost of the new package, allowing of further macroeconomic effects.
- Actual macroeconomic effects will, however, likely be much weaker if financing comes primarily from reallocation of the funds rather than from budget surplus narrowing.

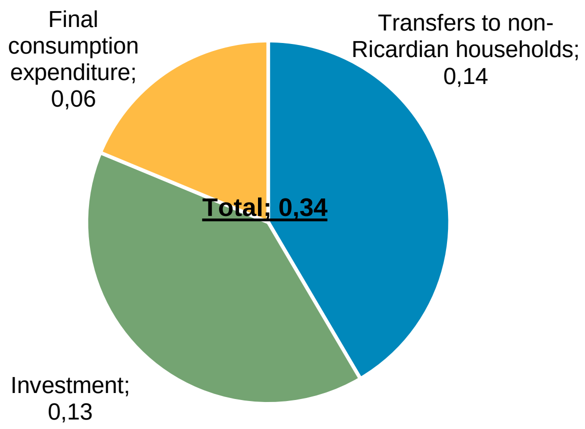
In his address to the Federal Assembly, the RF president Vladimir Putin proposed a new social package, providing such key measures as social support for families with children, first of all from low-income groups (benefits, lump-sum child-birth allowances (maternity capital)) and reimbursement to regions of two thirds of a revenue shortfall incurred by the investment tax credit. According to an RF Finance Ministry estimate, the cost of the package will come to 0.38 trillion roubles, or 0.34% of GDP (Figure 53) in 2020. In terms of economic classification, about 2/5 of funds, will, according to our estimate, be spent towards the cost of transfers to non-Ricardian households (households with a high propensity to consume) and investment, to which we assign the investment tax credit and the greater part of expenditure on maternity capital payment (about 90% of it is used to improve families' housing conditions). The other 1/5 will go towards spending on final consumption (Figure 54).

Figure 53. Extra budget expenditure by type of measures, % of GDP



Source: Media reports, R&F Department estimates.

Figure 54. Extra budget expenditure based on economic classification, % of GDP



Source: Media reports, R&F Department estimates.

According to our estimates based on fiscal multipliers for the economic classification of expenditure, the contribution of the social package to GDP growth will equal 0.20–0.25 pp of GDP in 2020.[29] Meanwhile, the effect on consumption will be more significant (the “flight” of funds via the import channel has a negative effect on fiscal multipliers).

We estimate the inflationary effect of the social package at about 0.1 pp at the end of 2020.[30]

According to our estimate, the direct effect of the social package on nominal disposable income will equal 0.55–0.65 pp in 2020, the impact on real disposable income will come in at 0.45–0.55 pp.[31]

In subsequent years, the cost of the new social package will likely rise at an accelerated pace, because a part of the measures will be financed starting from the end of 2020 onwards (for example, payment supplements for class masters and hot meals for elementary school children as of 01.09.2020). According to RF Finance Ministry estimates, expenditure will double to 0.78 trillion roubles in 2021, rising to 4.13 trillion roubles in 2020–2024. This allows additional macroeconomic effects from the new package to be expected in subsequent years.

Actual additional macroeconomic effects will, however, likely be much lower because what is most probably implied is not so much a budget deficit widening as revenue reallocation. If the fiscal rule is not adjusted, financing for 2020 will be feasible through either

[29] The lower bound estimate is based on the estimates of fiscal multipliers in Vlasov (2018). “Impact of the fiscal manoeuvre on GDP growth: estimation of short-term effects using fiscal multipliers”. // Analytical note of Bank of Russia Research and Forecasting Department, November. The upper bound estimate was obtained using an increased fiscal multiplier for transfers to non-Ricardian households, taking into account that transfers are to be allocated for the lowest-income families.

[30] The estimates were obtained using the R&F Department’s BVAR model by analogy with estimating the effect of the one-off lump-sum pension payment in January 2017. See Subsection 1.1.7. “The one-off supplementary pension payment will have but immaterial implications for inflation and economic growth” in Talking Trends No. 9, August 2016.

[31] The estimates account for allowances for households with children, expenditure for the maternity capital and pay supplements for class masters.

revenue expansion (a further tax administration improvement[32]) or expenditure reallocation. Preliminary Finance Ministry data suggests that non-oil and gas revenue for 2019 exceeded the budget law projections by 0.13 trillion rouble for the federal budget alone. The years 2021 and 2022 will also add provisionally approved federal budget expenditures of 0.5 trillion roubles and 1.1 trillion roubles. In any event, this reduces estimates presented above, while the final numbers will depend on the efficiency of revenue reallocation.

[32] According to our estimate, tax collection improvement increased general government revenue about 2 pp of GDP in the 2016–2019 period alone.

2. OUTLOOK: LEADING INDICATORS

2.1. What do Russia's leading indicators suggest?

2.1.1. Index-based GDP estimate: economic growth picking up gradually

- Our final index-based GDP estimate for the fourth quarter of 2019 stood at + 0.3–0.4% QoQ SA, up slightly from December's estimate. Based on the estimates using time series released by Rosstat, this corresponds to Russia's economic growth of 1.2% for the full-year 2019.
- The current estimates also suggest a likelihood of a moderate growth acceleration in the first half of 2020, bringing the growth rate fully in line with potential or even slightly exceeding it. Based on short-term data available as of the end of January, growth for the first quarter of 2019 is estimated at +0.4% QoQ SA, for the second quarter of 2019 – in the range of +0.4–0.5% SA.
- Our current short-term model-based projections so far rely on just scant real-time data for January available by now. They may therefore be adjusted further on as fresh statistics are released in the coming months.

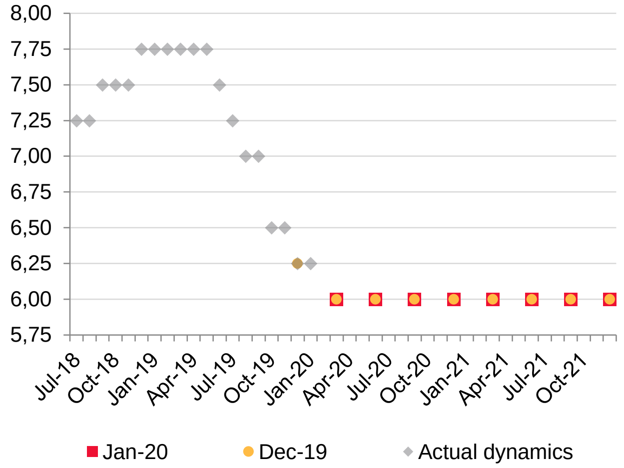
	January **% QoQ SA**	December % QoQ SA
Q4 2019	**0.3–0.4**	0.3
Q1 2020	**0.4**	0.3–0.4
Q2 2020	**0.4–0.5**	0.4

2.1.2. Bloomberg consensus forecast: analyst expectations remain anchored

- Expectations of analysts surveyed by Bloomberg in January remained all but unchanged. Analysts expect inflation to return to 4% and stabilise at that level in the middle of 2021. This suggests that their medium-term expectations remain anchored.
- According to the consensus, the Bank of Russia's key rate cuts in 2019 coupled with other factors will be sufficient for inflation to return to the target: the forecast assumed just one key rate downgrade by 25 bp of to 6% in the first quarter of 2020 and its stabilisation on this level until the end of 2021.

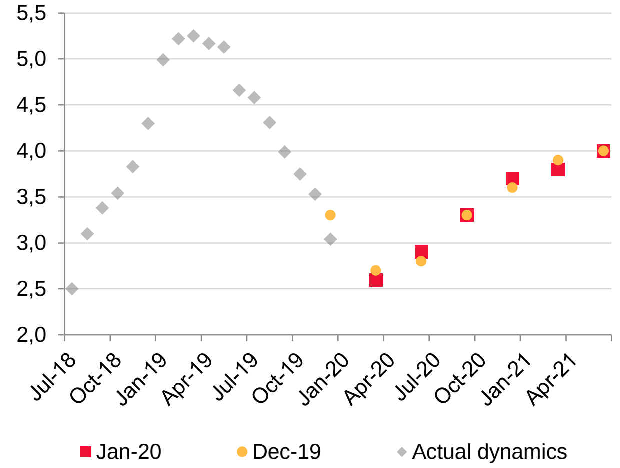
A Bloomberg poll conducted in January shows that financial analysts' inflation expectations remained virtually unchanged, assuming that inflation will accelerate to 3.7% and return to 4% by the middle of 2021 (Figure 55). It may well be that analysts have not fully factored in the effect of the new social package announced by the RF president in his address to the Federal Assembly or have estimated it as minor.

Figure 55. Analysts' expectations of Bank of Russia key rate path, %



Source: Bloomberg Finance L.P.

Figure 56. Analysts' expectations of inflation dynamics, % y/y



Source: Bloomberg Finance L.P.

The consensus forecast assumed a 0.25 bp key rate cut to 6.0% in the first quarter and its stabilisation at that level (as long as until the end of 2021) (Figure 56). Analysts' key rate expectations have remained unchanged since November. The range of forecasts for the end of 2020 is narrow at 5.5–6.0%.

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