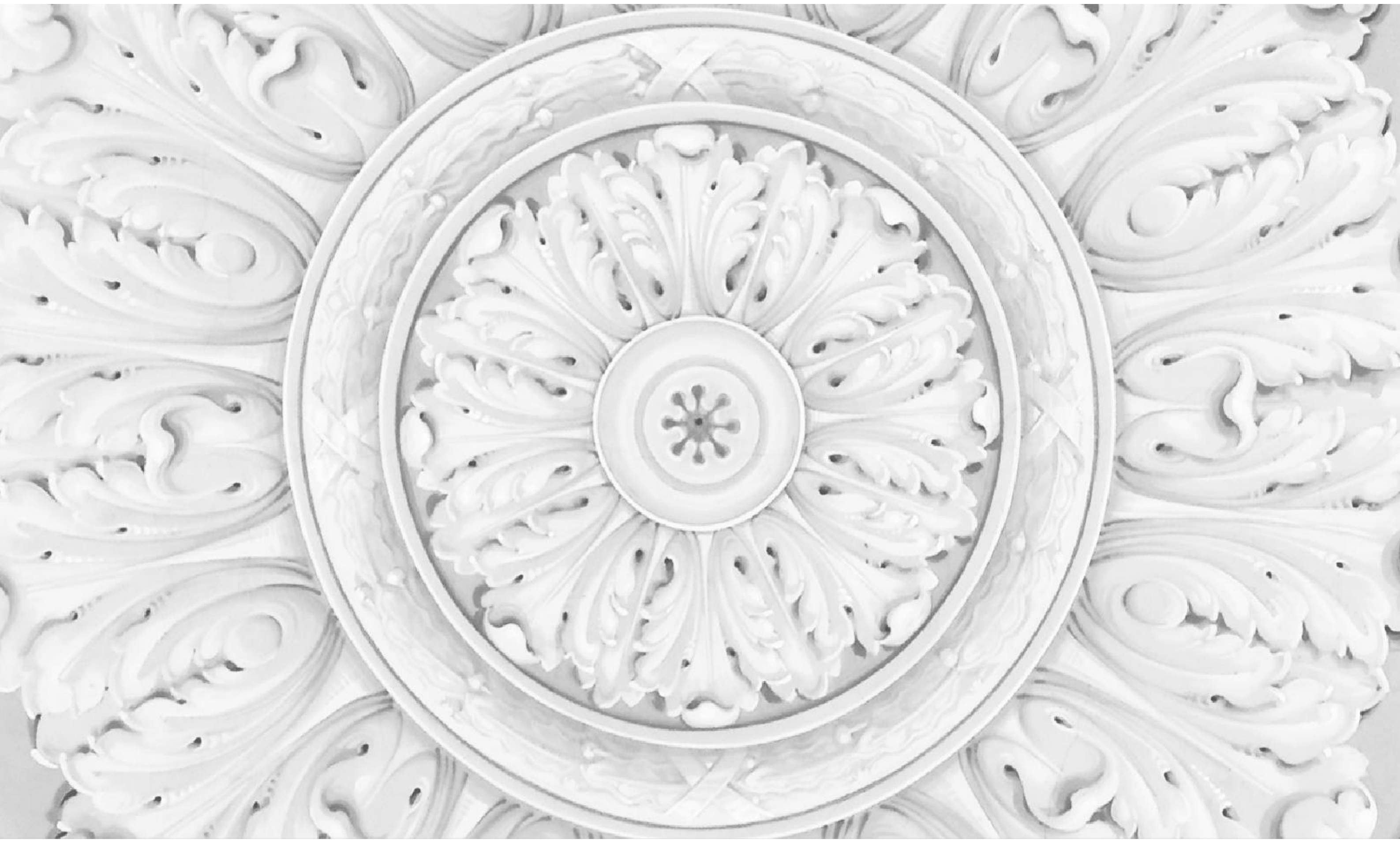
Bank of Russia

The Central Bank of the Russian Federation



TALKING TRENDS

Macroeconomics and Markets
October 2016

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The views expressed in the Bulletin are solely those of the authors and do not necessarily reflect the official position of the Bank of Russia.

Please send your comments and suggestions to dip_bulletin@mail.cbr.ru

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Executive summary

1. Monthly summary

- October 2016 saw inflation dynamics remaining within the bounds of the Bank of Russia's baseline scenario, with overall favourable financial conditions. Tentative estimates suggest a growth in the economy, albeit with mixed economic data across sectors.
  - Inflation remained on a downward path, driven by a number of factors including the current monetary policy. However, the deceleration of prices, partially triggered by the impact from temporary factors, is insufficient to predict with confidence that the 4% inflation target will be delivered in 2017. The substantially inertial inflation expectations of both households and businesses, the uncertainty over the mid-term budget configuration, coupled with the risk that the consumer-oriented behaviour model may return, are still there, constraining the downward movement of inflationary pressure. The current moderately tight monetary policy is nevertheless set to further drive down inflationary pressure in the months ahead.
  - The economic environment is increasingly on the mend as we see a rise in real wages, retail sales and imports of investment gods. Having said that, the economic performance in a number of sectors remains negative, reflecting the ongoing structural adjustment to low oil prices. The economy is on the way to a slow growth path.
  - The monetary conditions, being overall tight, are set to continue to soften, as regards both the level of interest rates and non-price lending terms. At the same time, financial markets saw risk premium and yields rising.

2. Outlook

- The current index GDP estimate invariably suggests fragile positive growth in the past quarter.
- Inflation expectations are set to become anchored at the required revel on the back of the growing credibility of the Bank of Russia's moderately tight monetary policy as shown by financial analysts.
- The improvement in global leading business indicators seen in October may prove to be temporary.

3. In focus

- Seasonally adjusted rates of consumer price growth are down to 5% on an annual basis; however this drop owes its existence to the temporary favourable factors.
- For the inflation target to be reached by late 2017, it is critical to ensure that seasonally adjusted monthly price growth slows down to 0.33% by no later than early 2017, which is set to be helped by the Bank of Russia's moderately tight monetary policy stance.

1. Summary

1.1. Inflation

The current inflation dynamics are aligned with the baseline scenario in the Bank of Russia's forecast for 2016 (5.5-6.0%), with the level of actual oil prices somewhat higher than expectations and some favourable impact from other temporary factors. Barring new price shocks in the months ahead, year-end price growth is set to be close to the lower bound. Inflation expectations are trending down albeit still heightened. This suggests that the risks of the failure to deliver on the 2017 target for inflation are still in place.

1.1.1. Inflation is moving closer to its optimal path

- Seasonally adjusted consumer prices grew 0.4–0.5% in October.
- The good crops, together with a stronger ruble, are still positive drivers as regards inflation; yet, these are partially set off by the rise in global milk prices and recovering meat prices.
- The movements in unregulated services (as an indicator of general price pressure) are an approximate match to 5% inflation, slightly above the Bank of Russia's target.

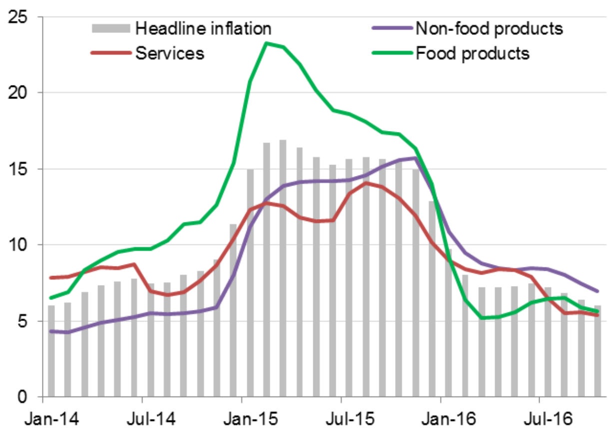
The growth in consumer prices in October totalled 0.4% MoM, which was substantially below the previously released estimate based on weekly data (slightly above 0.5%). This trend has been in progression for the second month in a row: back in September the finalised inflation indicator was also 0.1% below the weekly data-based estimate.

This may be the result of the ongoing decline in relative prices for services, which the selection (used to calculate the weekly consumer price index, CPI) fails to fully reflect, leading to this overestimation in Rosstat's weekly estimates of price growth. Consequently, we see some loss in the informative value of weekly data and rapid data analysis becomes more complicated.

Price growth accrued to date is 4.5%; annual inflation is down to 6.1% from 6.4%. The past year's high base effect helps drag down annual inflation across all three CPI components including food products, non-foods and services (Figure 1).

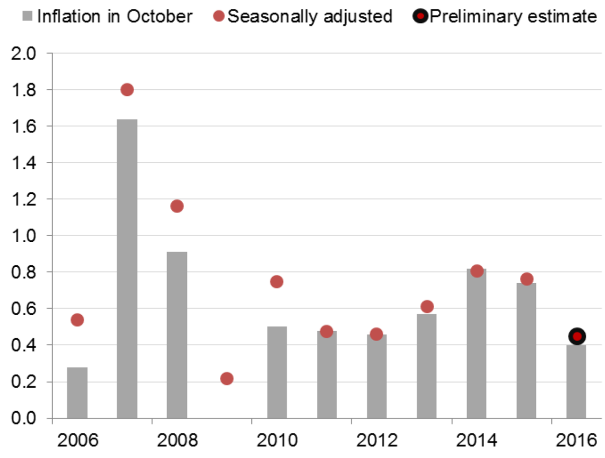
Over the last five years, the seasonal factor in October's price dynamics was small, which is why seasonally adjusted inflation was almost no different to the actual one. This finding is confirmed by our tentative estimates for October inflation once it is seasonally adjusted (0.4–0.5% MoM) (Figure 2).

Figure 1. Inflation dynamics, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 2. Inflation in October, % MoM



Sources: Rosstat, R&F Department calculations.

Food prices grew 0.8% MoM (excluding fruit and vegetables – 0.6% MoM), compared to 1% (0.8%) in the previous year. On the one hand, good crops are still putting downward pressure on the prices of such products as sugar and cereals. On the other hand, we see accelerated growth in prices for products which were previously acting as deterrents to inflation, e.g. meat.

Meanwhile, rising global prices trigger growth in prices for dairy produce and vegetable oil (1.7% and 4.2% MoM, respectively). In the non-food segment, rates of growth are approximately level with last month, mainly thanks to favourable exchange rate developments.

Prices for services were down 0.3% MoM in October, which is explained by the impact from the seasonal factor in passenger transport and health resort services, as well as the drop in prices for outbound travel on the back of a strengthening ruble. Annual price growth rates in services have held at the level of 5.4–5.6% for three consecutive months; excluding the regulated services (utilities and public transport) these stand at 4.9–5.1%.

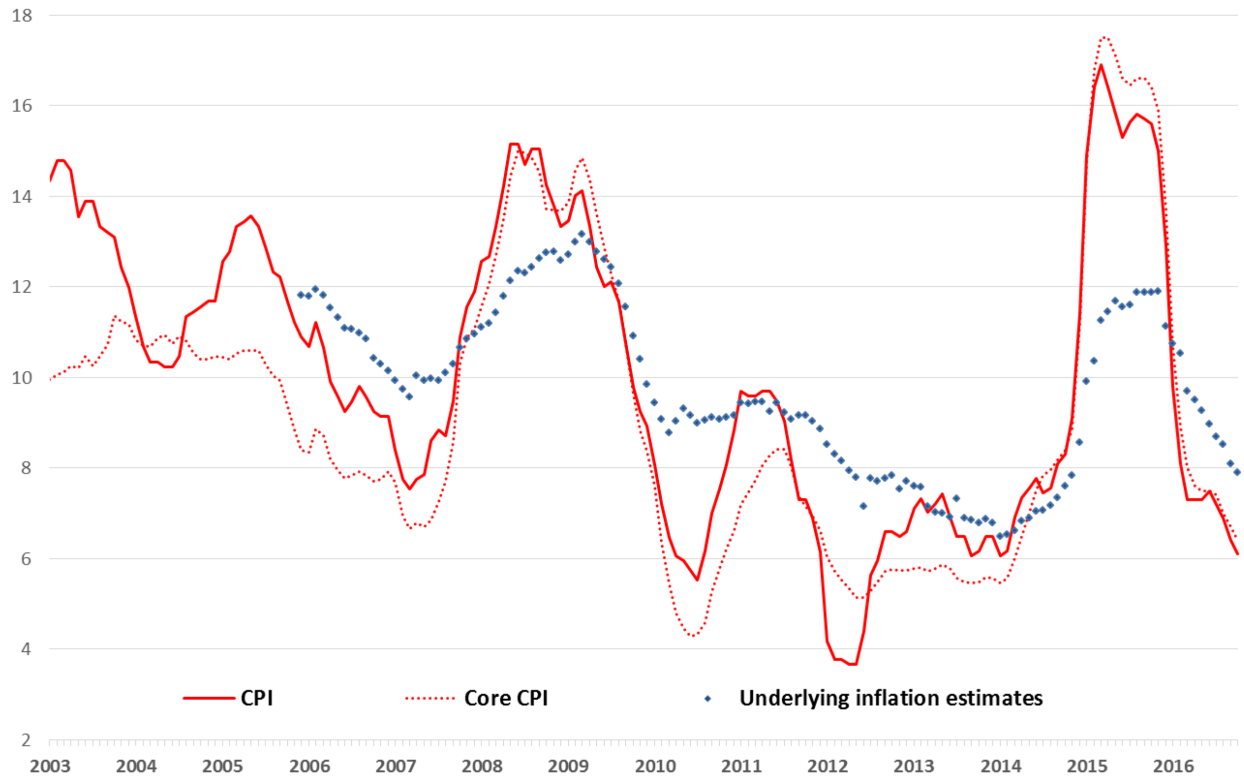
Prices for unregulated services are known for their low pass-through effect, in comparison with food and non-food products[1], as well as for being independent of temporary factors (e.g. crops and global prices). They are therefore good to be used in calculating current inflation estimates adjusted for temporary factors. Our calculations suggest that seasonally adjusted increase in prices of services (excluding those for the regulated sector) totalled 0.4–0.45% for October, which corresponds to annual inflation of 4.8–5.4%. In this way, our rough calculations show that inflation is moving downwards progressively to reach a point close to the target. However, the risks that temporarily favourable factors are set to expire shortly spell the need for continued moderately tight monetary policy.

[1] Excluding services related to outbound travel.

1.1.2. Underlying inflation in October: the downward trend holds

- Annualised rates of underlying inflation in October were downgraded to 7.9% from 8.1% seen in September, reflecting weaker inflationary pressure.
- Provided that the current trends in prices and monetary aggregates hold, a further downgrade in estimates for underlying inflation is expected
- The risks that inflation may diverge from the late 2017 target are still in place.

Figure 3. CPI, core CPI and historical BoR estimates for underlying inflation, % p.a.



Sources: Rosstat, R&F Department calculations.

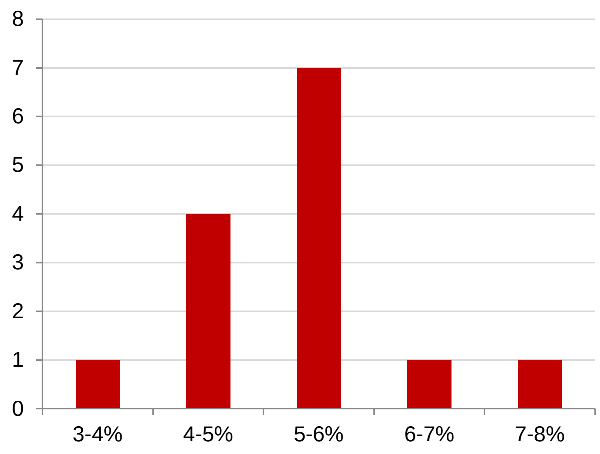
1.1.3. Average daily inflation expectations of big business are close to those of the Bank of Russia

- Most major Russian companies' CFOs polled are confident that the inflation targets will eventually be delivered, but not before 2018 and 2019.

- Expectations for 2017 business performance are consistent with slow GDP growth projections

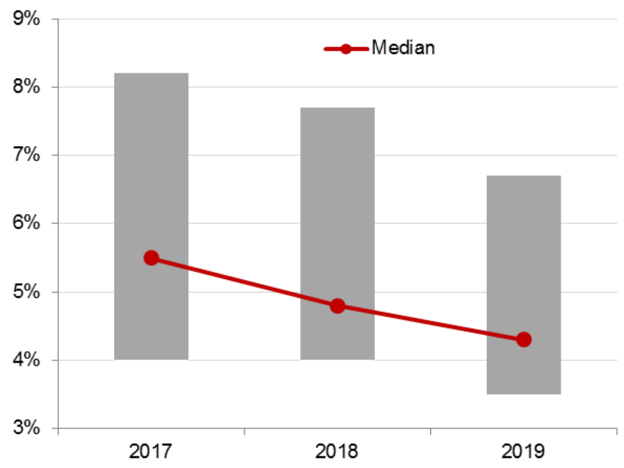
Below are the findings made on the basis of a poll of chief financial officers of major Russian companies, conducted jointly with the Bank of Russia. Some companies report heightened inflation expectations for the next three years. The poll covered 14 major companies operating in the following industries: oil and gas, metallurgy, transport, communications and the power sector. This sample, albeit biased from the standpoint of the overall economic structure, is useful in understanding the sentiment and expectations of big business. Half the companies expect annual inflation for 2017 to be in the range of 5-6% (Figure 4). Those believing that the Bank of Russia' target is accomplishable are few. The reasons cited are a standard set of risks: potential weakening in the ruble, the uncertainty over budget dimensions, growing costs / utility rates, a recovery in consumer demand and heightened inflation expectations.

Figure 4. Expectations of major businesses' CFOs for 2017 inflation



Source: R&F Department calculations.

Figure 5. Business planning assumptions for 2017-2019 inflation



Source: R&F Department calculations.

Longer-term expectations for price growth are a lot closer to the Bank of Russia's target (Figure 5). In 2018 business plans, inflation above 5% is assumed in only three corporations, with four of them using the Bank of Russia's target for guidance. The fact that most major Russia companies use in their mid-term calculations an inflation indicator close to the target indicates growing business confidence in the current inflation targeting policy, adding to its chances for success.

Most corporations (8 of 14) expect that the output in 2017 is likely to be level with the previous year; one company envisages contraction and the rest expect a rise. Investment activity suggested similar attitudes, with half the companies planning to maintain the current level of investment, four companies planning to expand and three intend to cut.

Corporate expectations as regards the actual performance in 2017 are overall consistent with our estimates for insignificant GDP growth.

1.1.4. Inflation risks persist on the back of a better labour market, unbalanced against a rebound in business activity

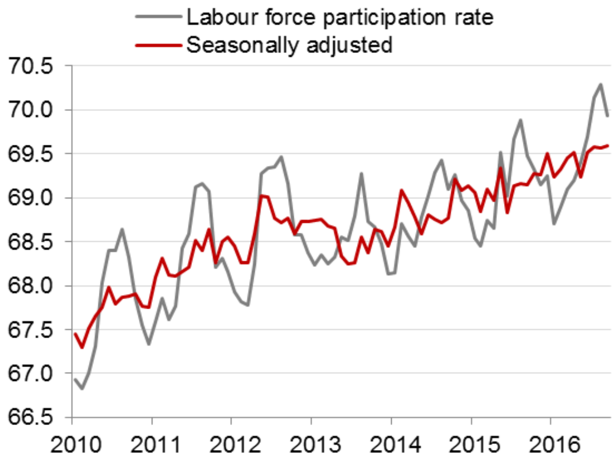
- The labour market sees continued improvement as the rate of unemployment is falling and activity rates are up.
- At the same time, accelerated growth in wages and rising employment in the conditions of low business activity are fraught with risks to sustainability of inflation reduction.
- These risks are partially set off by the mixed nature of wage growth.

Seasonally adjusted unemployment rate was slightly down in September and totalled 5.5% (Figure 6). The positive developments here come with a rise in both labour force[2] and the rate of involvement[3] (Figure 7). Overall, the situation in the labour market remains on the mend, which, coupled with accelerated growth in nominal wages, brings risks to inflation targeting.

Figure 6. Unemployment rate, %

Sources: Rosstat, R&F Department calculations.

Figure 7. Economically active population, %



Sources: Rosstat, R&F Department calculations.

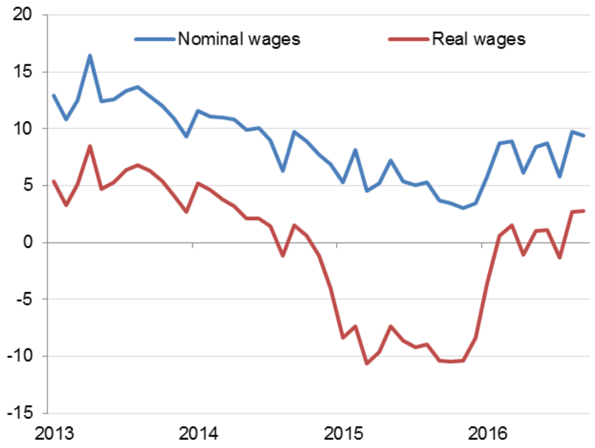
According to Rosstat's assessment, annualised nominal wages in September grew 9.4% (Figure 8). The material rise in nominal wages and slower inflation had a positive impact on real wages, which grew 2.8% - a top reading since April 2014. Upgrades were also

[2] A rise of 167 thousand people by September 2015.
[3] A substitute of the indicator 'labor force participation' – labour force in % of population aged 15-72.

made to estimates for growth of nominal wages in August as they were increased from 5.8% to 9.7% YoY.

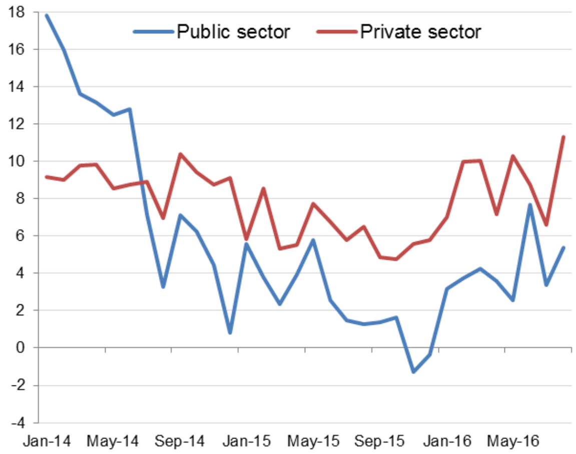
Wages in the non-public sector continued to grow at outrunning rates as compared to those in the public sector[4] (Figure 9). Key growth drivers in the tradable sector included mining and fishery, with financial operations leading in the non-tradable sector.

Figure 8. Wage development, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 9. Wage index across sectors, % YoY



Sources: Rosstat, R&F Department calculations.

The most substantial wage growth in September, for the year to date, was in industries with highest wage levels, with an immaterial increment in those with low wages was. This strengthening income differentiation across population groups could prove a deterrent to rising consumer prices.

1.1.5. PMIs are indicative of moderate inflationary pressure

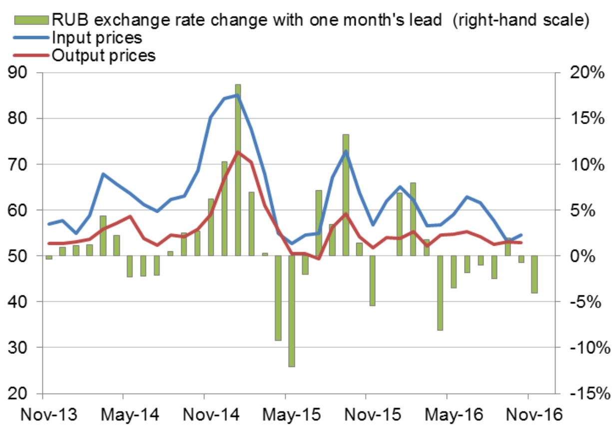
- PMIs suggest a gradual decline in inflationary pressure in both manufacturing and services.
- The growth of output prices in services was at its lowest point since May 2010.
- A steadier ruble may have been behind the slower price growth.

The behaviour of PMI points to a gradual decline in inflationary pressure in the economy, especially in services where the index of output prices was down to 50.7, the lowest value since May 2010 (Figure 10, Figure 11). The manufacturing sector also saw some deceleration in the rise of output prices.

[4] For August. Rosstat data on wages are released with a month's lag.

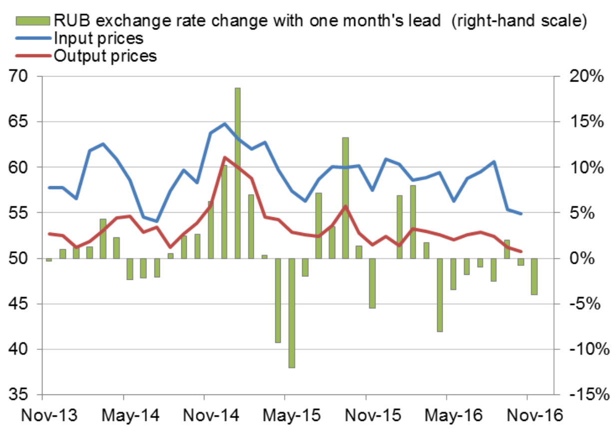
The steadier ruble exchange rate seen over the last few months may well have been behind this slowdown in price growth. This is seen, first and foremost, from movements in the input price index, with purchase prices being the most sensitive to fluctuations in the exchange rate. They are known for their quick reaction to a changing exchange rate, which subsequently translates into ultimate prices. The impact from this temporal factor, however, may prove short-lived, especially if the recent drop in the price of crude, together with the weakening of the ruble, continues.

Figure 10. PMI, manufacturing



Sources: IHS Markit, Bank of Russia.

Figure 11. PMI, services



Sources: IHS Markit, Bank of Russia.

1.2. Economic performance

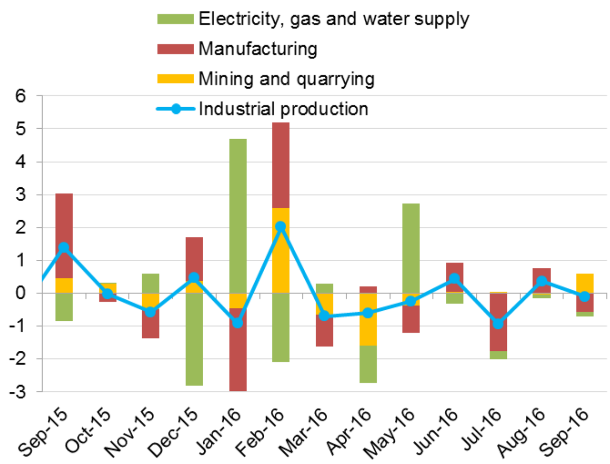
Short-term business activity indicators in October were on the mend, boosting expectations for economic growth in the fourth quarter, driven by a number of factors including a recovery in investment activity. We note a rise in real wages and consumer demand, as follows from both Q3 sales and the drop in the savings ratio. Structural constraints in a number of key industries remain, as the economy is still struggling to exit stagnation.

1.2.1. Although stagnation in the sector continues, manufacturing PMI climbs to a four-year high

- Industrial production saw a 0.1% MoM contraction (as seen from the R&F Department's seasonal adjustment), triggered by the decline in manufacturing.
- Manufacturing PMI in October, 52.4 points, was at its four-year high.
- The unprecedented growth of new orders and procurement strengthen expectations for sustainable expansion in manufacturing to resume.

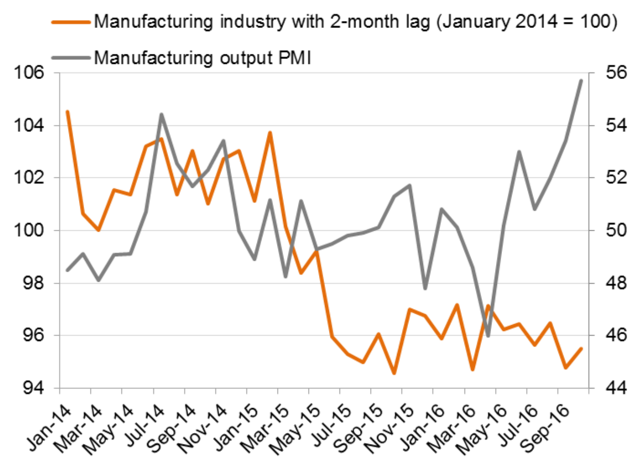
The industrial sector's performance remains extremely volatile (Figure 12). According to Rosstat data, industrial production in September shrank 0.3% MoM and 0.8% YoY, almost fully eroding the August growth (+0.5% MoM). The actual estimate proved a lot worse than analysts' expectations (+0.4% YoY). Q3 industrial output dropped 0.7% QoQ.

Figure 12. Individual industries' contribution to monthly industrial growth, % MoM (seasonally adjusted)



Sources: Rosstat, R&F Department calculations.

Figure 13. Industrial outputs and their components in composite PMI (seasonally adjusted)



Sources: Rosstat, Bloomberg Finance L.P., R&F Department calculations.

Our estimates also bear out the negative dynamics of September's industrial production. The drop in the manufacturing sector proved strong enough to wipe out the whole growth in mining, where daily oil outputs were at new record levels (11.085 million barrels a day). Support to the mining industry came from the noticeable growth in the outputs of coal (+3.9% YoY), ore (+2.2% YoY) and gas (+6.5% YoY). The output in electric power, gas and water production and distribution posted a slight contraction of 0.1% MoM.

The manufacturing industry is continuing to seesaw. The impressive growth in August output gave way, yet again, to a drop in in September. This type of volatility, as we have cited for three quarters, hampers identification of true seasonality, complicating the analysis of industrial performance. Overall manufacturing outputs remain at last year's levels, suggesting that stagnation is ongoing. This behaviour pattern is contrary to the changes in the production component of manufacturing PMI (Figure 13), where growth rates in October reached the highest mark for over five years. Such many months' highs were seen in new orders from the domestic market, as well as in the volume of outstanding orders, and came with fairly strong rates of growth in procurement.

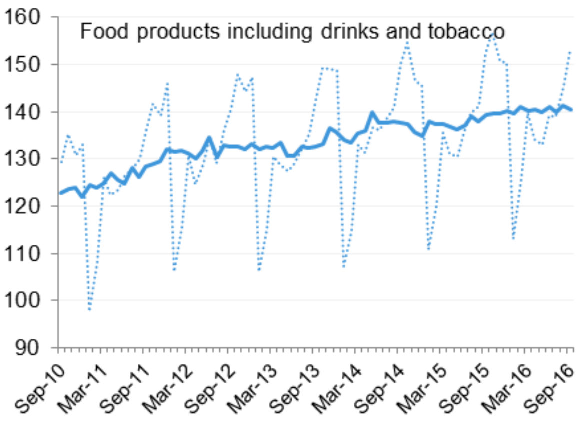
Moving forward, PMI may fail to be so optimistic. In previous years, new domestic orders within the year tended to fall on October, thereby to a great degree defining intra-annual output movements and PMI changes. Moreover, according to Rosstat's surveys, the month's business confidence index failed to beat its July reading, while future output and order portfolio estimates were even worse than September. It is therefore a sure bet that PMI in the next few months will appear below its October reading. Nevertheless, the above-mentioned peak values for incomplete orders and procurement, as well as the decline in stocks of finished goods, in progress for two and a half years, coupled with the emerging rebound in consumer demand, are set to provide support to business activity growth in the sector. In the next few months, PMI is unlikely to hit a point anywhere below 50 points, which supports expectations for output growth in manufacturing.

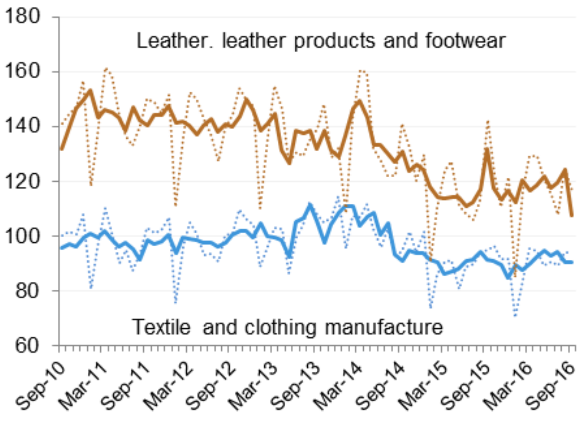
1.2.2. Manufacturing: outputs are down in most sectors

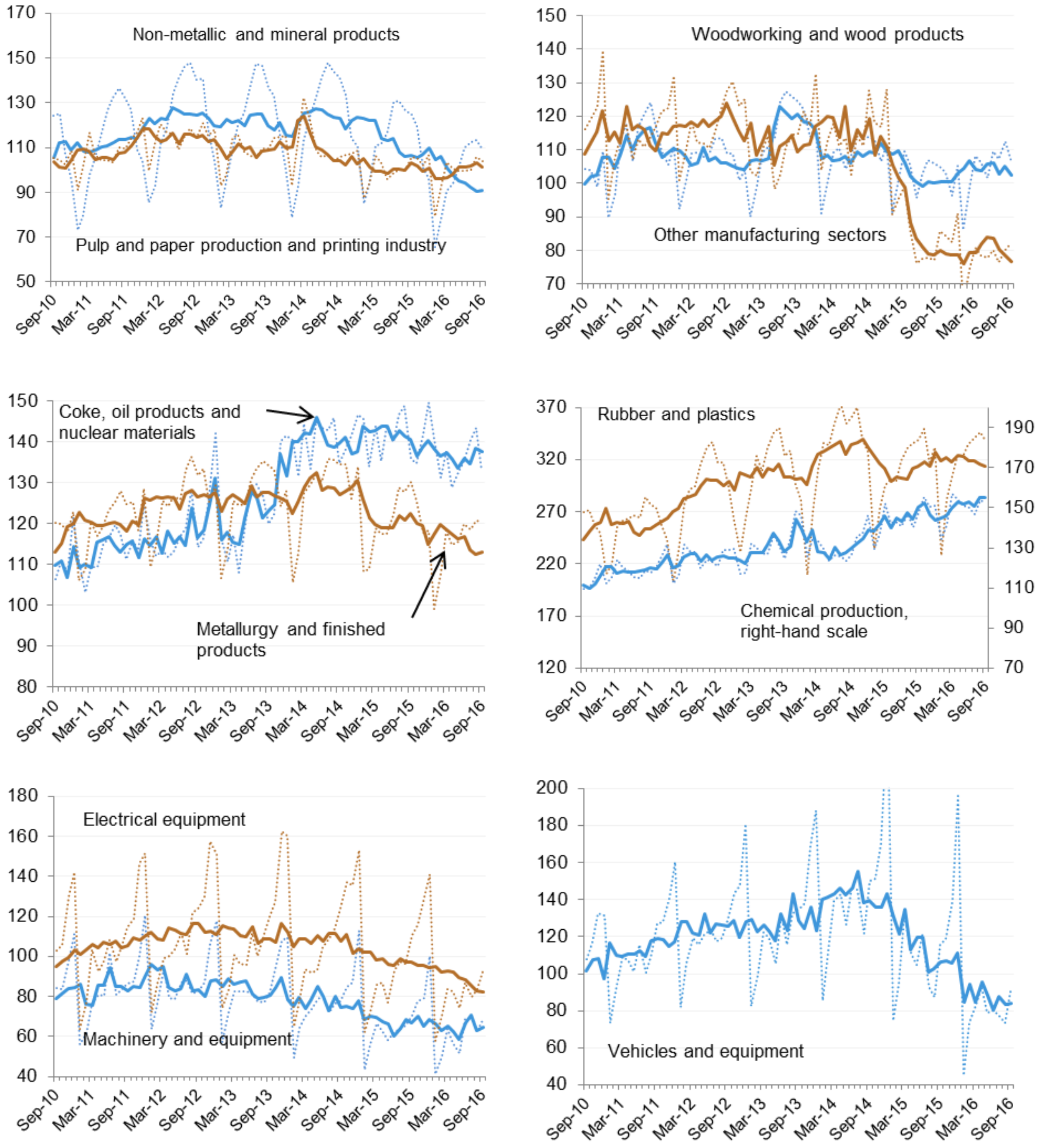
- Unchanged from the previous month, growth in the food industry and chemicals is decelerating.
- On this background, the rates of decline are trending down in investment demand sectors.
- Outputs contracted in most other industries including where growth was reported in the previous months.

Outputs are declining in most manufacturing sectors in September, in a sign to continued stagnation. Outputs in the industries which are drivers (the food industry and chemicals) either slid somewhat or settled, while retaining the trend towards growth, albeit at slower rates. Investment demand sectors report a slight improvement, which is persistently weak. Beyond metallurgy, growth was slower across all sectors in September, explained by both fragile and unsteady investment and consumer activity.

Figure 14. Outputs in manufacturing sectors, January 2005=100%







** Dotted lines are used for actual data in the graphs; bold lines are used for seasonally adjusted data*

Sources: Rosstat, R&F Department calculations.

Outputs of food and tobacco products fell but insignificantly in September. In general, the industry retains a positive trend; however, its long-term growth is slowing down, triggered by market saturation for some commodity groups against the population's low purchasing power.

Outputs in textiles and the clothing industry in September were almost level with August, seasonally adjusted. Growth in this industry, with its high import substitution potential, is held back by the shortage of high quality raw materials of domestic production amid high prices for imported raw material, the lack of modern equipment in the industry and the high share of counterfeits.

The leather and leather / footwear sector, which has been trending upwards since the start of the year, saw a sharp drop in the output. The high share of small enterprises and the operating shadow business appear to be constraints on industrial performance. Importantly, in the past year the industry's positions were fairly strong, with development underpinned by low dependence on imports of raw materials. A weaker ruble led to increased costs of imports and boosted demand for domestically made footwear, helping in the advance of exports.

Low purchasing power was responsible for the ongoing decline in the production of durable goods including jewellery and furniture[5].

Outputs are still quite unsteady in the woodworking industry, with import substitution advancing in individual segments (wood boards) as the negative trend persists in the production of timber. Yet, the September drop in production of wood boards drags down the overall output, which fell 2.4% MoM, seasonally adjusted.

The growth in the output of pulp-and-paper and printed products, which has progressed for half a year, gave way to a drop in September, as a result of contraction in paper and cardboard products.

The output of the chemical industry in September was almost level with August, taking seasonal adjusted. In general, the positive trend in the sector is still in place; however, a further increase in production is held back by the limits in planned production capacities. The additional incentives to new investment projects in the industry will include extension of government support to the chemical industry, which relates to its broader subsectoral application and increase in the value of projects that can qualify[6].

The production of rubber and plastics in September showed improvement albeit within the bounds of a downward trend, which resulted from more dynamic import substitution processes in the production of tyres for agricultural machines and vehicles.

The noticeable growth in the August output of coke and oil products were followed by a 0.5% MoM drop, seasonally adjusted. The so-called 'tax manoeuvre' is expected to continue to have negative implications for the sector's performance.

In September, the decline in the output of metallurgical products, observed since February 2016, came to a stand. Once the US-introduced anti-dumping duties for cold worked rolled products were lifted, metallurgy output remained mainly unaffected, with the US-bound share in all exports totalling less than 1%, according to the RF Federal Customs Service. It is premature to discuss a recovery in the industry still struggling to overcome the negative trend.

The drop in the production of non-metallic mineral products also came to a stop. This is related to insignificantly increased turnouts of cement, lime and plaster.

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[5] Other activities in OKVED (Russian Industry Classification System).
[6] RF Government Resolution No. 545, dated 15 June 2016.

The long-term negative trend is entrenched in the electrical equipment sector. There was a 2.5% MoM increase in the number of machinery and equipment, seasonally adjusted. It is explained by the continued positive trend in the production of tractors which grew 12% MoM in September, seasonally adjusted. Overall output of agricultural machinery, after the summer surge, fell 12% MoM, seasonally adjusted. More dynamism was seen in the production of household appliances (a rise of 5% MoM, seasonally adjusted), connected with a rebound in consumer demand for household appliances and expansion in consumer lending.

Transport mechanical engineering in September posted a steady turnout compared to its August indicators; however, it would be premature to conclude that the industry has overcome the long-term downward trend. Amid this continued negative trend in the automobile subsector, the outputs of other vehicles rose (3.4% MoM, seasonally adjusted). The high outputs of freight cars also held, following the marked growth of 16% in August. This comes as evidence to the efficiency of the state car-building support package launched in July[7].

1.2.3. Consumer activity rebounds on the back of a recovery in demand for non-food products

- In September, retail sales saw annual rates of decline slowing down to 3.6%YoY, beating expectations.
- Seasonally adjusted sales increased 0.2% MoM.
- The recovery in retail sales of non-food products is invariably stronger than that in the food sector.
- Moving forward, a rising income of the population, coupled with better consumer expectations, is set to help in the recovery of sales and commercial services.

According to Rosstat data, retail turnover fell 1.4% MoM in September. R&F Department estimates show that seasonally adjusted turnover rose 0.2% MoM after a 0.3% MoM drop in August. Annualised sales growth rate came in above potential GDP growth estimates[8], which suggests potential pro-inflationary effect of the emerging recovery in sales. More so, assessments of retail sales growth rates based on seasonally adjusted data probably underestimate the *actual* growth (see the box ‘The specifics of seasonal adjustment for retail sales estimates’).

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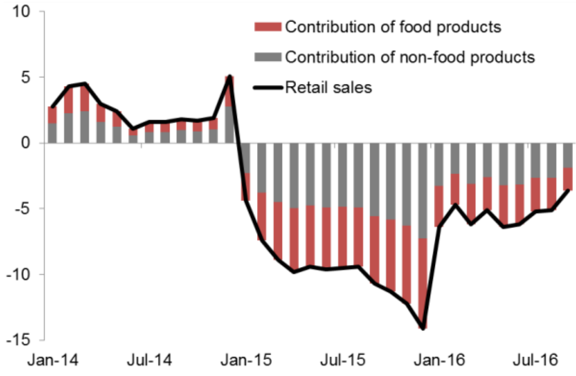
[7] See ‘Talking Trends’ 2016. 22–28 August No. 44, Section 1.2.1 ‘Manufacturing: shrinking growth in driver industries comes with the emergence of new growth points’.

[8] Based on assumed potential GDP growth in 2017 of 1.5% YoY. For more details, see:. А. Синяков, А. Ройтман, С. Селезнев. Динамика потенциального ВВП России после нефтяного шока: роль сильного изменения относительных цен и структурных жесткостей, *Серия докладов об экономических исследованиях в Банке России*, Август 2015 г., No. 6 (Bank of Russia Economic Research Papers, August 2015)

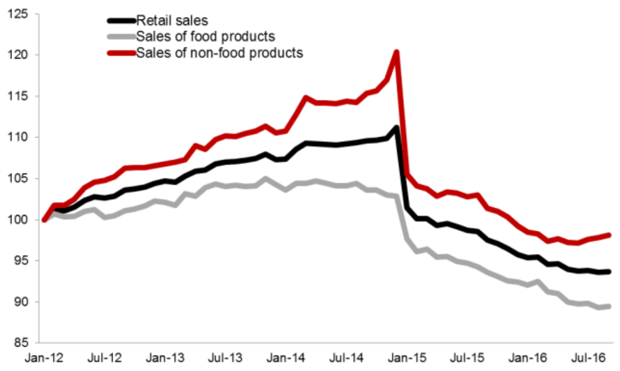
Annual growth rates suggest that the rates of decline (3.6% YoY from 5.1% YoY) decelerated in August. Rates of decline in September slowed both in food and non-food products, with the latter posting more intense deceleration: -2.8% YoY against -4.4% YoY (Figure 15). The seasonally adjusted data also continue to indicate a more dynamic recovery in the sales of non-foods (Figure 16).

Figure 15. Contribution of food and non-food products to retail sales, %, YoY



Sources: Rosstat, R&F Department calculations.

Figure 16. Retail sales and their components (%, Jan 2012 = 100%, seasonally adjusted)



Sources: Rosstat, R&F Department calculations.

Once the September rates of growth in sales of non-food products in real terms are analysed in more detail, recovery is seen across most product categories[9]. In this way, outerwear, computers and television sets, mobile phones, washing machines and automobiles posted substantially higher rates of growth compared to the corresponding categories over the last seven years (Figure 17). Along with the income effect, strengthened demand for non-foods can be explained by the redistribution of money initially saved for major purchases to buy products in other categories.

Consequently, the way individual retail sales components perform suggests a gradual ongoing recovery in demand in some categories, with potential recovery in others.

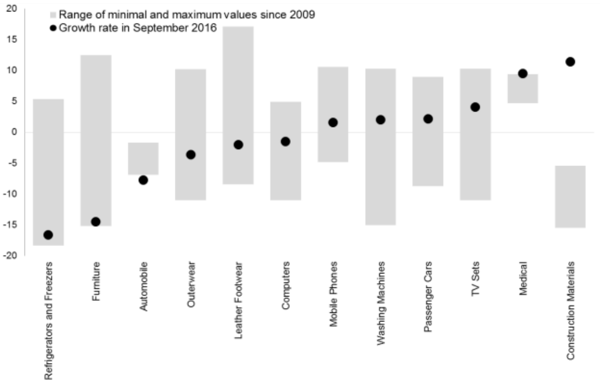
Taking into account that a number of categories posted minimal growth rates in 2015, it is not ruled out that partially this demand is a consequence of deferred consumption[10]. What may have been the case here is a change in the seasonal component, which is why the comparison with the historical paces of growth in September could distort the measurement of current demand in the respective category. In this way, it could be relevant to look into accumulated growth rates. The latter points to rising demand for

[9] September saw better consumer sentiment as regards major purchases, as well as a growing share of nonfoods in retail sales. Therefore, it is especially interesting to look into this category. Considering that the seasonal component in the sales estimate may potentially be unsteady, rates of sales growth were compared across core nonfood categories based on 2009 data without seasonal adjustment. The scope of the analysis included product categories with available data retail sales in real terms starting from 2009.

[10] The rates of growth in 2015 were at their lowest points in outerwear, leather footwear, computers, mobile phones, television sets, furniture, construction materials and automobiles.

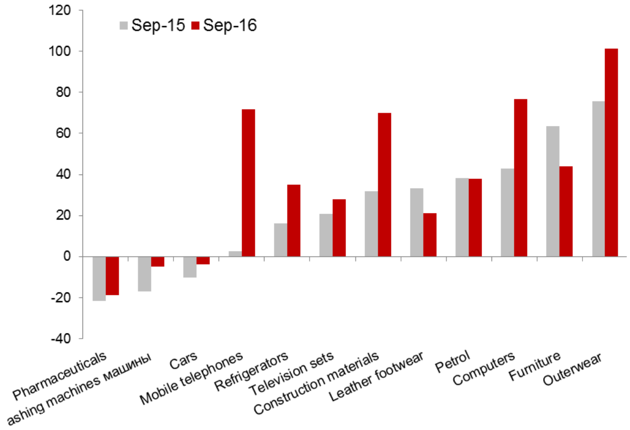
mobile phones, construction materials and computers, with the rising volumes of pharmaceuticals, washing machines and automobiles so far unable to set off the preceding decline in sales.

Figure 17. Rates of retail sales growth in real terms and data range since 2009, % (seasonally unadjusted)



Sources: Bloomberg Finance L.P., Rosstat, R&F Department calculations

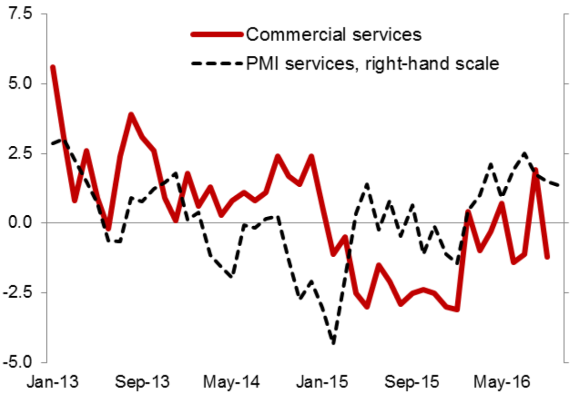
Figure 18. Retail sales index growth rates (Sept 2010 = 100%, seasonally adjusted)



Sources: Rosstat, R&F Department calculations.

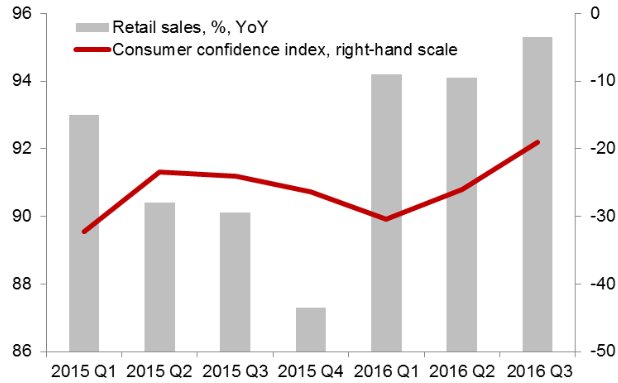
Demand for commercial services also continues to recover, albeit the dynamics here remain volatile. Although annual rates of decline in 2016 slowed down, they have yet to reach steadily positive levels (Figure 19). Nevertheless, the volume of commercial services remains on a recovery path (-0.6% YoY in the January to September period). With the fairly steady Services PMI readings factored in, a recovery is set to continue in the sector.

Figure 19. Performance of commercial services (%, YoY) and services PMI



Sources: Bloomberg Finance L.P., Rosstat, R&F Department calculations

Figure 20. Retail sales and consumer confidence index



Sources: Rosstat, R&F Department calculations.

The rebound in domestic demand occurred on the background of rising real wages (2.8% YoY) and significant deceleration in the drop of real disposable income (-2.8% YoY, on -

8.2% YoY in August). As a result, the gap between retail sales and real wages was beginning to decline.

The recovering real income of the population and improving consumer expectations suggest that there is potential for further recovery of consumer activity in the next few months (Figure 20).

Specifics of seasonal adjustment in estimating retail sales

The current seasonal adjustment techniques (e.g. TRAMO/SEATS and X-13-ARIMA) tend to be sensitive enough when statistical data are revised, new observations are added and initial model specifications / parameters are set[11].

As follows from the results of seasonal adjustments of retail sales (based on TRAMO/SEATS) available from time series of various lengths (from January 2002 through December 2015 and from January 2002 through September 2016), additions of new observations lead to revaluated parameters in the seasonal adjustment model. Also, parameters will be changed under the influence from monthly rates of retail growth, which are unsteady for various years (Figure 21). Although general seasonal trends are unchanged, the range of seasonal fluctuations varies from year to year. Therefore, the seasonally adjusted rate of retail growth for September 2016 as calculated using the December 2015 data-based model is 0.9% MoM. However, if the parameters of the model are measured based on the data through September 2016, the growth will total 0.2% MoM.

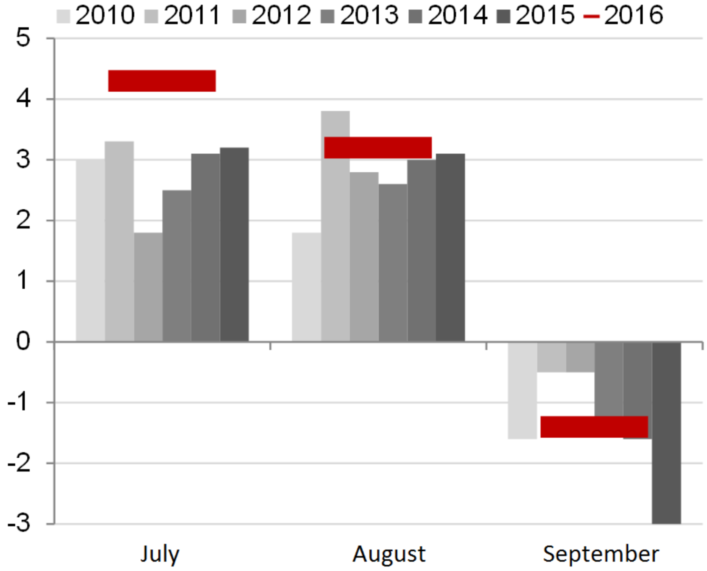
The variability of seasonal adjustments, close to the right-hand margin, which may change as the latest month data come in, is now referred to as a 'wagging-tail problem'[12].

According the ECB seasonal adjustment guidebook, 'the optimal frequency of review of the seasonal models' is one time a year (on condition that the time series is longer than seven years)[13]. This implies that the model, the filters and the calendar regression variables are estimated each time new data come out. This approach enables a substantial reduction in the variability of estimates as new observations are added.

This leads us to conclude that the resulting seasonally adjusted reading for retail sales growth of 0.2% MoM is an underestimate, caused by the volatile nature of a seasonal estimate as explained above.

[11] Bulletin 'Talking Trends' No.10 Section 1.2.1 'New seasonality' in manufacturing'.
[12] Бессонов В.А., Петроневич А.В. «Сезонная корректировка как источник ложных сигналов» - Экономический журнал ВШЭ, №4 (2013).
[13] European Central Bank. Seasonal Adjustment (2009).

Figure 21. Monthly retail sales growth rates, % (seasonally unadjusted)



1.2.4. Savings ratio is going down as consumer sentiment is on the mend

- September's savings ratio was markedly down on the previous month, leaving the gap with the previous year unchanged
- This drop in savings ratio is due to the seasonal factor, which suggests that a change in the current savings-oriented consumer behaviour is so far unlikely.
- Savings ratio for September approached 2012-2013 indicators.
- As consumers are increasingly more inclined towards major purchases, the savings ratio is headed for a further decline.

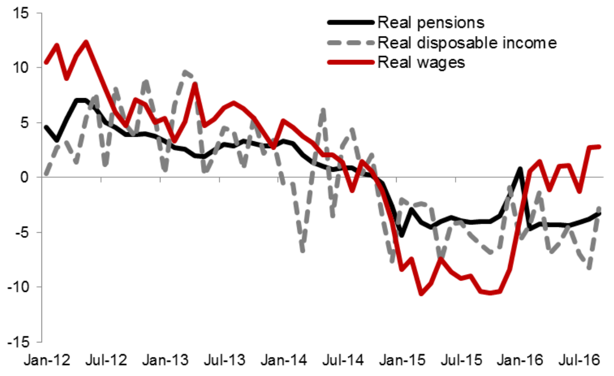
According to Rosstat, in September the share of income earmarked for saving was 7.4% on 8.5% in August (updated data).

This low level of savings is explained by some factors beyond seasonal fluctuations: seasonally adjusted data also suggest somewhat reduced savings ratio as compared with last month[14]. Nevertheless, it should be noted that this drop is not a regular seasonal occurrence. Except for the 2008 crisis, September savings ratios were falling in 2004-2006 and in 2010-2015. Shrinking incomes of the population is no explanation, either, as the latest data suggest a recovery in household earnings and a slower decline in the purchasing power of pensions (Figure 22).

[14] Seasonally adjusted savings ratio was 10.1% in august and 10% in September.

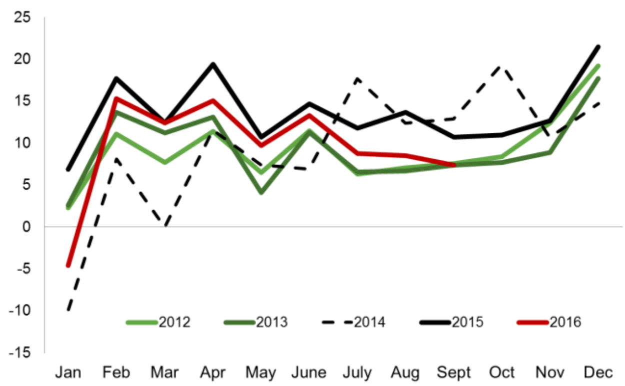
The downward trend of the indicator is exposed by a dwindling share of income for saving and the downgrade of the past month's reading (from 8.6% to 8.5%). The September savings ratio was equal to the September 2012-2013 readings, which was lower than last year (Figure 23)[15].

Figure 22. Real income of the population, YoY, %



Sources: Rosstat, R&F Department calculations.

Figure 23. Savings ratio in household incomes, %



Sources: Rosstat, R&F Department calculations.

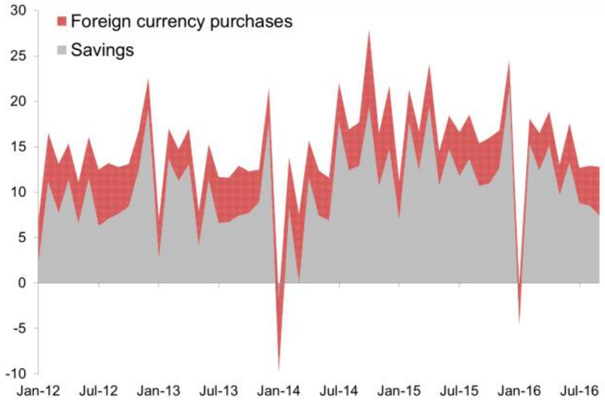
Income distribution was virtually unchanged from last year. The decline in savings ratio was accompanied with a growing share of income meant for purchase of foreign currency and slower reduction in the amounts of foreign cash on hand, while the budgets to buy goods and services were growing but insubstantially. The savings ratio, including the share of income reserved for purchase of foreign currency, is also lower than last year and similar to values seen between 2012 and 2013 (Figure 24). We expect that barring external shocks, savings ratio is set to be lower than last year, approaching the pre-crisis readings (Figure 25). This trend is set to continue to support the emerging recovery in retail sales and services.

As September's inFOM polls show, the share of population who have no savings whatsoever edged up in this month and remained unchanged in October (62%). These movements may have been connected with the spending of money saved for future trips and planned purchases. More so, the previous years also saw this share rise.

Polling data highlight the persistence of a saving-oriented consumer behaviour model with the dominating households' intent to additionally save up. Also, households' attitude towards major purchases is still on the mend.

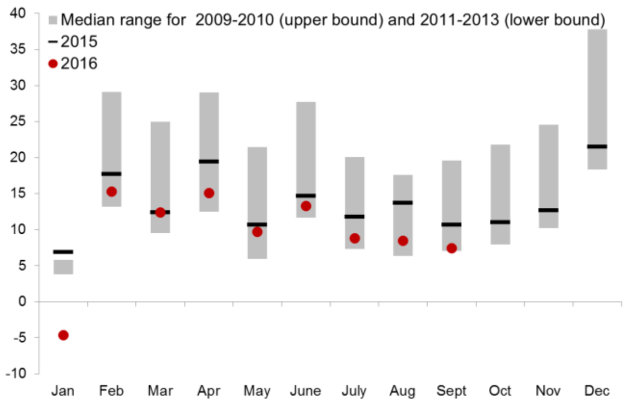
[15] Average savings ratio for the period between January and September 2000, except for years of crisis (2008-2010, 2015) totalled 9.2%. Excluding the year 2000 with its rather low savings ratio the average value is 9.6%. This figure for 2016 is 9.54%.

Figure 24. Changing shares of savings ratio and purchases of foreign currency in household incomes, %



Sources: Rosstat, R&F Department calculations.

Figure 25. Savings ratio in household incomes and the historical data range, %



Sources: Rosstat, R&F Department calculations.

In this way, the share of respondents who would save additional money if they had it, rose in September to an all-time high of 52% and was invariably high in October. This came with a rise in the share of those who consider that the time is right to save. October also saw this share at a high level, once the reading of 20% had been recorded in September, the highest point since August 2014. However, the balance of responses remains in negative territory.

At the same time, the share of respondents in October who believe the current time is appropriate for major purchases was at its highest reading since December 2014[16]. The growth of this share in September is consistent with decelerated decline in retail sales of non-food products. Taking into account increased frequency of responses in support of credit purchase, a further recovery in sales of non-foods may well encourage growth in consumer lending (Figure 26).

Therefore, polling data suggest an ongoing improvement in the attitude towards major purchases, as well as an increasingly more optimistic view of respondents' personal financial standing for the past year (Figure 27). Indirect evidence to improvements in financial standing of the population in October also comes from a growing share of respondents who were spared the need to economise, over the last three months, on any goods or services. Plus, October saw continued growth in the share of people who are confident in the future of their earned incomes[17].

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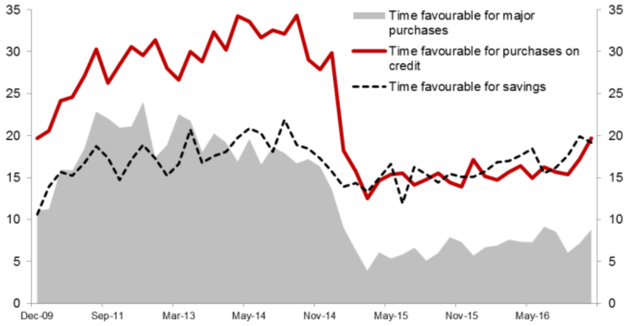
[16] However, the balance of responses remains in negative territory.

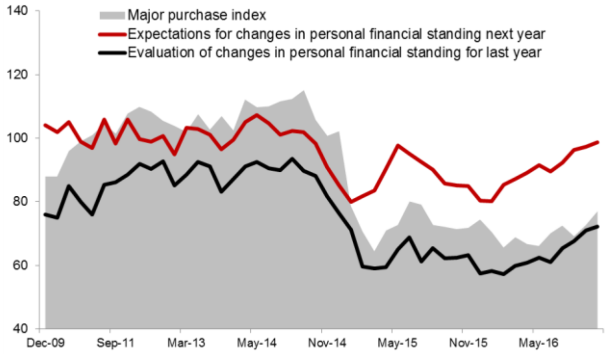
[17] According to inFOM poll, the share of respondents in October who said that their wages were unlikely to drop in the nearest future is up to 53% (from 47% in September); the share of those thinking they were unlikely to be made redundant in the coming 2-3 months was up to 63% *(from 56% in September).

Figure 26. View of the current time as favourable for savings, major purchases and credit purchases, % of all respondents



Sources: InFOM poll, R&F Department calculations.

Figure 27. Index of major purchases, estimates and expectations for change in financial standing, points



Source: InFOM poll.

Considering improved consumer expectations with regard to changes to personal financial standing for the next year, a further recovery in domestic demand may be in store and the share of the population with the capability to save is likely to rise. Yet, we expect savings ratio to settle at points lower than last year, which is driven by declining paces of accumulated precautionary saving and partially spending of accumulated savings.

1.2.5. Consumer confidence index continues to grow amid stronger consumer expectations

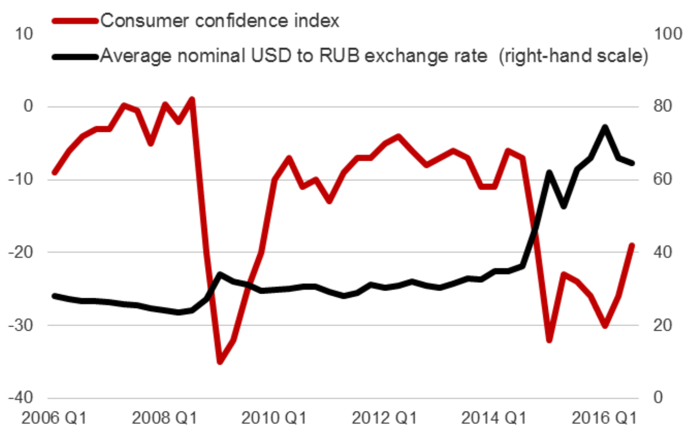
- In the third quarter, consumer confidence index was 7 pp up against the previous quarter.
- The bulk of the rise was noted in the level of evaluations of economic changes.
- Improved evaluations of personal financial standing and a better environment for major purchases provide good reason to expect continued recovery in consumer demand.

In the third quarter, Rosstat's consumer confidence index rose 7 pp to (-19) pp. Its pace of growth was up against last quarter and came with a rise in all its components.

Consumers' evaluations of recent economic changes were much higher (+11 pp). The other noticeable change was in evaluations of personal financial standing (+8 pp) and the timing for major purchases (+8 pp) as there was also growth in the index of conditions favourable to saving (+5 pp).

Improved consumer expectations can be attributable to the summer stabilisation in the ruble exchange rate (Figure 22). At the same time, the fact that all index components were up, as well as better consumer confidence across age groups, signal a recovery in consumer demand. A similar recovery in consumer demand was seen in 2009, which provides good reason to believe that in the absence of external shocks this trend towards growth is set to continue into the fourth quarter.

Figure 28. Consumer confidence index and ruble exchange rate movements



Source: Rosstat, BoR, Research and Forecasting Department.

1.2.6. New cars: a short-lived rise in production and sales

- The drop in demand for cars for the first nine months and a downgrade in the Association of European Business (AEB) forecast for 2016 provide evidence that stagnation in the automobile industry is ongoing.
- The rise in the August turnout of cars is connected to production launch of new auto models, at some plants, and is no evidence to a clear trend.
- The September growth in sales, compared to the previous month, is also temporary and comes as a result of uncertainty over government support of the car market planned for the next year.

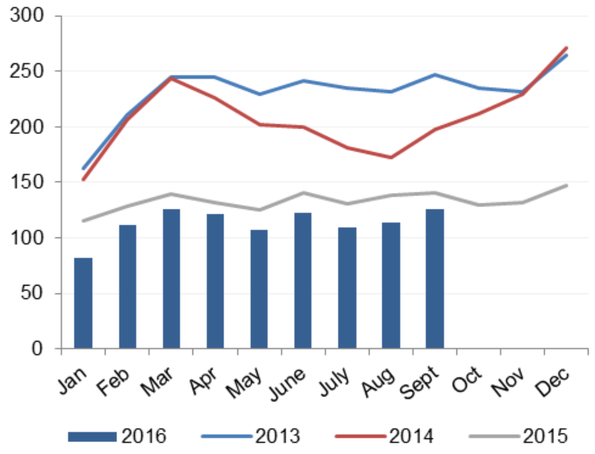
Most of the year saw output and demand in the automobile industry stabilise, which is a fairly acceptable performance for this cyclical industry most severely hit by the recession. Yet, in a low oil price environment, the industry is unlikely to hit a growth path before 2017.

Demand for new cars in September 2016 remained negative against last year. According to the Association of European Business data, sales of new cars and light commercial vehicles (LCV) fell 10.9% YoY (Figure 29). Physical volumes of sales in September, seasonally and calendar effect adjusted, rose 2.5% on last month (Figure 30). Growth in monthly sales occurred last time in June this year.

This minor rise in demand may be linked to the uncertainty over prospects for government support programmes for the industry in 2017. Specifically, this is due to potential termination of the car allowance rebate system (CARS) enabling buyers to use discounts on new cars as old cars are disposed / used for trade-in. This is the most popular programme with consumers[18].

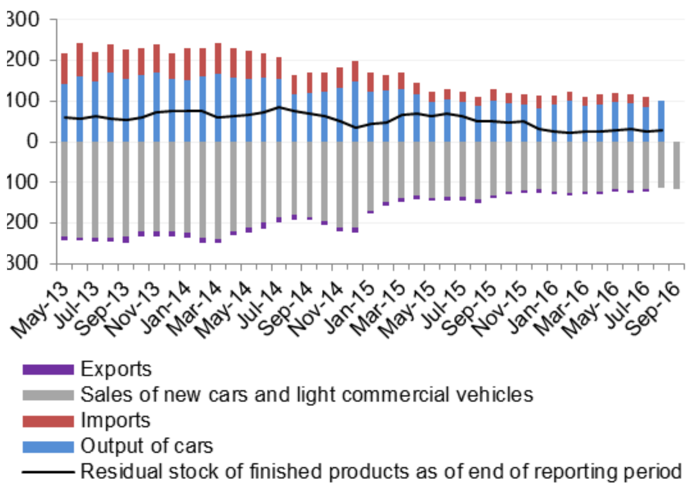
On the one hand, the potential rollback of state support programmes may encourage customers to make purchases before the year is out, which would support the market. On the other hand, a further decline in the LCV market should be expected, triggered by the pre-term expiry within the year of the subsidised leasing programme, which helped sales of commercial vehicles. By September, the federal budget limit for the programme had exhausted.

Figure 29. Sales of new cars and light commercial vehicles, thousand pcs.



Sources: AEB, R&F Department calculations.

Figure 30. Demand (-) and supply (+) components in Russian car market, thousand pcs. (seasonally adjusted)



Sources: AEB, R&F Department calculations.

Overall AEB forecasts for 2016 were revised downwards on expectations for year-end sales to drop 10.3%, with a 4.7% fall expected in the beginning of the year. Even this estimate looks too optimistic as the nine months' sales fell 14.5% YoY.

Shrinking demand for new cars reflects on the financial state of corporations within the sector. Research and Forecasting Department profitability calculations for 2016 H1 were (-3.80%), with production profitability in the corresponding period of the past year standing at 1.08%. The turnout of cars for the eight months dropped 15.9% YoY.

The August output totalled 87.3 thousand cars, which is, according to our estimates, 34.0% up on the corresponding period of the past year (under Rosstat calculations, this is

[18] Total incentivising programmes ('the fleet upgrade programme', preferential auto loans and preferential leasing), according to the RF Industry and Trade Ministry (Minpromtorg), in the nine months of 2016 covered approximately half the total car sales (including LCVs). The state support in 2015 had a smaller effect and stimulated, for the same period, 36% of the total demand (expressed in sales). The greatest support to demand came from the so-called 'fleet upgrade programme'.

up 41.6%). The difference in calculations is due to Rosstat's downwardly revised August 2015 data, which brought about overestimation in the actual pace of growth in the automobile industry. The rise in the turnout of cars, following a consecutive drop over the previous three months, is probably temporary and due to new car launches in St. Petersburg plants.

As the market is declining, deferred demand for cars is continuing to rise so that potential improvement in the economic situation may result in a sharp yet short-lived rise in sales that would also come with price growth.

1.2.7. Balance of payments: current account decline is set off by reduced capital outflows

- Current account surplus is declining as imports and non-trade balance are recovering.
- Net capital outflows are down due to banks' shrinking forex assets, explained by several factors including payments of debt to the Bank of Russia.
- Once the total of this debt is settled, other things being equal, capital inflows through this channel are set to contract sharply.

Recent data show that current account surplus, following a sharp decline in the second quarter, was roughly at the same level in the third quarter at $1.9 billion (after $1.5 billion in the second quarter and 12.2 billion in the first quarter). Considering that the contraction in current account was largely set off by reduced capital outflows, the ruble exchange rate performed somewhat better than expected.

Importantly, the core reason behind the low current account surplus over the last months is a dynamic recovery of imports, while exports are overall staying within the expected bounds[19]. Q3 paces of growth entered positive territory, amounting to 4% YoY following a 4.9% YoY drop in the second quarter and 20.4% YoY in the first quarter of 2016. This trend is most likely to result in a mere 2% reduction in annual imports.

The recovery in imports seen over the last few months is mainly due to substantial procurements of mechanical engineering, driven by a number of factors including the Yamal LNG[20] project procurement. Yet, the share of the latter in the total growth of mechanical engineering imports is not dominant, which in reality means that investment imports are recovering. The trend is still there after seasonal adjustment. Additional pressure on current account surplus is coming from the rising deficit of non-trade balance[21].

Capital outflows in the private sector in the third quarter were slightly up on the second quarter at $2.6 billion; yet it was much lower than in the first quarter ($8 billion). Year-to-

[19] (-9.6)% YoY in Q3 against (-25.5)% YoY in Q2 в. Specifically, the decline in exports in September was only 4.8% YoY after (-7,2)% YoY in August.
[20] Procurement of LNG plant modules.
[21] Primarily, the balance of services driven by more intense travel.

date capital outflows in the private sector totalled $9.7 billion. Capital outflows are invariably affected by the reduction in banks' liabilities to non-residents (payments of external debt), which in the third quarter was $7.5 billion (the same between January and September 2016 года – 19.7 billion). Updated data suggest that growing financial assets of corporations are increasingly a driver of equal force for capital outflows. In the third quarter, foreign assets were up by $3.2 billion, which is still less than their growth in the second quarter (almost $7 billion). For the total nine months of 2016, this factor was responsible for as much as $17.7 billion of capital outflows.

Outflows are offset mainly by banks' shrinking forex assets: a drop of $9 billion in 2016 Q3 and $23.3 billion in the first nine months of 2016.

However, once banks have settled this debt under Bank of Russia forex transactions in full, other things being equal, capital outflows under this channel are set to decline sharply.

1.3. Global economy, financial and commodity markets

1.3.1. Fed draws closer to raising rates

- At their meetings in October-November, the Fed and ECB kept the key monetary policy parameters on hold. In December, the Fed is expected to raise the federal funds rate and the ECB is set to expand its QE policy.
- The United Kingdom is engulfed by the problems around Brexit.
- China's GDP showed stable growth in Q3 and a sharp downturn in economic activity growth till the end of 2016 is unlikely.
- Commodity price recovery made China PPI return to the black which may have a favourable impact on the financial indicators of industrial enterprises.

The US Fed is on the verge of resuming its monetary policy tightening as is shown by the moderately positive macroeconomic statistics and the press release published following the November meeting of the Federal Open Market Committee. Other leading central banks of the developed countries, on the contrary, took a respite from conducting their monetary policies or are preparing to continue QE programmes. The United Kingdom considers Brexit options. The accommodative measures taken by Chinese authorities at the beginning of the year are likely to continue having a favourable impact on the economy's dynamics in the next one or two quarters, following which a slowdown may resume.

USA: heading for December rate hike

US GDP statistics in Q3 turned out to be rather positive. A QoQ growth of 2.9%[22] was the maximum one over the past two years and also turned out to be better than the Bloomberg consensus (2.5% QoQ) and the GDPNow model forecast of FRB of Atlanta (2.1% QoQ). Short-term data largely point to the recovery of investments in inventories amid the moderately favourable consumption stabilisation (growth of 2.1% QoQ).

Despite the fact that the US Fed concentrates largely on monitoring data on employment and inflation, statistics on industry and orders for durables published over the past month also turn out to be a convincing argument for the rate rise expected by the markets. However, the November meeting of the FOMC left the federal funds rate intact. The press release published following the meeting duplicated in many aspects the Committee's September assessments: risks seem balanced, while arguments in favour of raising rates increased. Despite the positive statistics, the uncertainty about the outcome of presidential election in the US prevented the rate from rising. Therefore, all the factors are currently indicative of the December rate hike.

Eurozone in anticipation of QE programme extension

According to preliminary estimates, eurozone GDP in Q3 grew by 0.3% QoQ[23], which fully coincided with the consensus forecast and economic growth rates in Q2 (Figure 31). Growth remains moderate and, proceeding from the breakdown by component published so far only in France, apparently reflects consumption stagnation. The first surveys point to a probable slight acceleration of economic growth in Q4. If in Q4 GDP growth reaches 0.4% QoQ, its annual growth will total 1.6% YoY, which corresponds to the ECB forecast announced in September. Therefore, the probable slight acceleration of economic growth in Q4 should not result in the QE programme tapering.

Inflation accelerated to 0.5% YoY in October amid the reduced negative contribution of energy component (0.4% YoY in September). Core inflation, which excludes the volatile components of food and fuel, remained at 0.8% YoY pointing once again to the lack of inflationary pressure in the eurozone (Figure 32).

At its October meeting the ECB Governing Council decided to leave all its main operation parameters unchanged. Also unchanged was the press release, according to which the key ECB interest rates will remain at present or lower levels for an extended period of time, and well past the horizon of the asset purchase programme. The programme will continue to function until members of the Council see the steady signs of inflation acceleration towards the target.

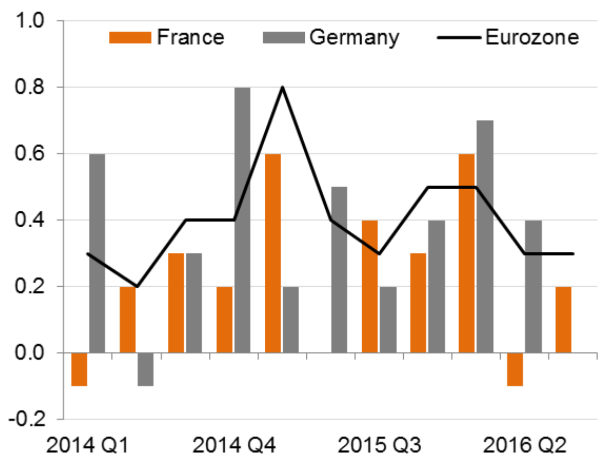
At a press conference following the meeting Mario Draghi promised to ensure a smooth exit from the asset purchase programme. Along with the assurances that the ECB has not yet discussed the QE tapering mechanism, the programme extension in March 2017 is highly probable. Mr. Draghi also confirmed that in December the ECB committees

[22] Seasonally adjusted on an annual basis.
[23] Seasonally adjusted.

would carry out the respective analysis and the Governing Council would ponder on possible settlement of the asset shortage problem meeting the requirements of the QE programme. The press conference as a whole provided little information, since Mario Draghi refrained from any promises and hints of the ECB's further actions.

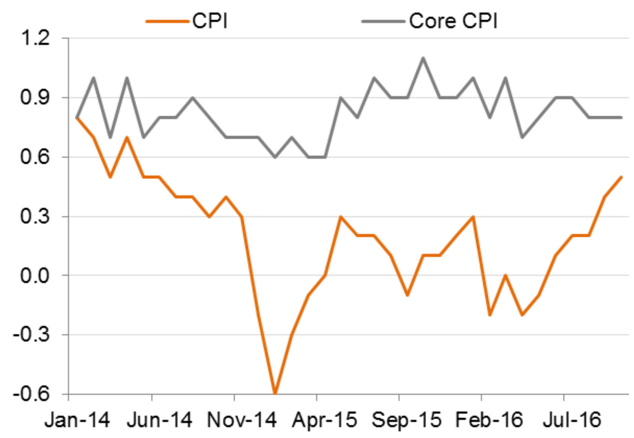
The next meeting of the Governing Council scheduled for 8 December 2016 is likely to be more informative. The meeting is expected to extend the QE programme from March 2017 for another six months. The volume of asset purchases is likely to remain at the current level, i.e., €80 billion a month. Moreover, to settle the bond shortage problem the ECB may abandon the lower bond yield benchmark currently pegged to the ECB deposit rate (-0.4%). A number of bonds cannot join the QE programme, primarily those of Germany, because of this limit.

Figure 31. Quarterly rates of economic growth, %



Source: Bloomberg Finance L. P.

Figure 32. Inflation in eurozone, % YoY



Source: Bloomberg Finance L. P.

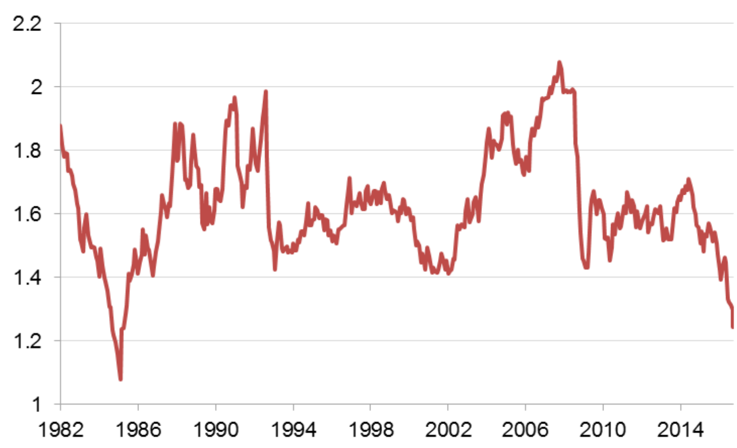
United Kingdom: hard Brexit prospects

In early October, Theresa May, the British Prime Minister, outlined the government position with regard to Brexit prospects. Firstly, the procedure for leaving the EU should be launched by March 2017. The country will then have only two years to coordinate the EU exit and parameters of relationships with EU countries after the breakup. Secondly, the government is set up for hard Brexit. The most critical outcome of the EU exit should be the UK's full independence and exit from the jurisdiction of the European Court of Justice. Such sovereignty means abandoning the single market and a loss of privileges of the financial and a number of other sectors of the economy. A major outcome of the independence thus gained will be, first of all, the opportunity to control migration.

However, in early November, London Supreme Court made a ruling that the government cannot launch the EU exit without the Parliament's consent. The government is set to appeal against this ruling, that's why the uncertainty with regard to Brexit may remain for a few months.

Hard Brexit prospects and the uncertainty about the agreement's parameters will hamper investment activity and economic growth in the UK. In its October WEO the IMF downgraded the forecast of the UK's growth in 2017 by another 0.2 pp to 1.1% (from 1.8% YoY in 2016 and 2.2% YoY in 2015). The Bank of England is slightly more optimistic in its expectations: it predicts growth of 1.4% YoY in 2017 and 1.5% YoY in 2018. The national currency depreciation entails inflation risks. The pound sterling has lost about 20% of its value against the US dollar since the beginning of summer (Figure 33). According to Bank of England forecasts, this will prompt inflation acceleration to 2.7% in 2017–2018. Against this backdrop the Bank of England kept its key rate on hold at its early November meeting.

Figure 33. Pound exchange rate against US dollar, $/£



Source: Bloomberg Finance L.P.

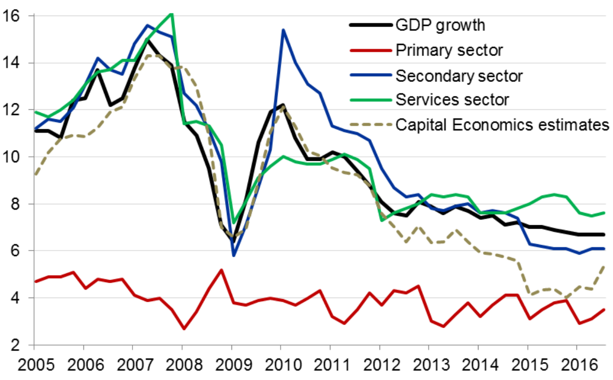
China: GDP quarterly growth froze at 6.7% YoY

China's GDP growth rates remain stable for the third quarter in a row, at 6.7% YoY. Nevertheless, the primary and secondary sectors see a slight growth acceleration. Many analysts, for example Capital Economics, continue showing their distrust in the official statistics pointing to lower economic growth and, at the same time, noting the signs of recovery in the past few quarters (Figure 34).

The monthly dynamics of macroindicators in China remain stable and a new economic downturn until the year's end is unlikely. In September, for the first time since October 2014, both official and Caixin PMIs exceeded 50.0 points and continued growing in October. Retail sales in September showed the maximum growth in 2016, 10.7% YoY. Industrial output growth slowed somewhat to 6.1% YoY.

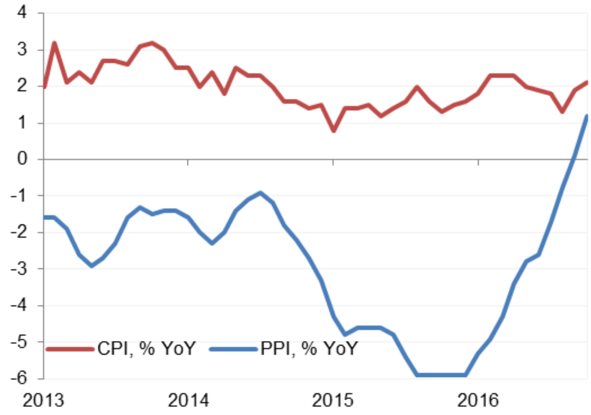
Following the July's 'bottom' (witnessing floods) fixed capital investment growth continued to recover in September owing to private investments in manufacturing and real estate. Debt financing dynamics stabilised. However, the increased growth rates of these indicators should not be expected to remain longer than one or two quarters and will fall as the effect of stimulative measures runs out.

Figure 34. Growth in GDP and its components, % YoY



Sources: Bloomberg Finance L.P., Capital Economics.

Figure 35. Consumer and producer price indices, % YoY



Source: Bloomberg Finance L.P.

The consumer price index went up to 1.9% YoY in September due to the accelerated growth in food prices (Figure 35). Non-food inflation turned out to be the maximum one over the past two years largely due to the resumed growth in fuel prices for the first time since mid-2014.

For the first time since early 2012, the producer price index returned to the black due to the accelerated growth in oil prices in September, 0.1% YoY (Figure 35). The low base to compare commodity prices should contribute to further PPI growth in the next few months. The end of period of low producer prices may have a favourable impact on the financial indicators of industrial enterprises, which will be conducive to certain credit risk mitigation, especially in the former loss-making industries.

1.3.2. Global markets in anticipation of Fed December rate hike

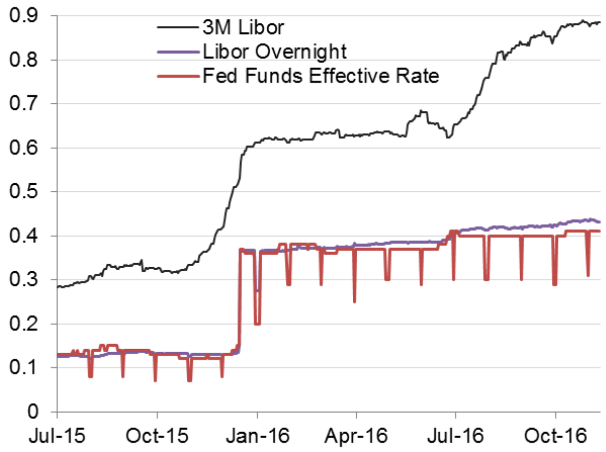
- US Treasury bond yields rose against the backdrop of greater confidence that the Fed would raise the federal funds rate.
- The continued sale of bonds in the global market may have an adverse impact on financial stability.
- OFZ yield curve became less inverted due to growing yields of long-term bonds.
- Short-term money market rates slightly deviate from the Bank of Russia key rate and volatility is determined by the transition period from structural liquidity deficit to its surplus.

Global markets

In the past month, the global financial markets were excited over the coming Fed rate rise, the uncertainty about the outcome of presidential election in the US, and fears that the central banks of the developed countries (not only the US Fed) would taper their stimulative measures.

US macroeconomic statistics and the press release published following the Fed's meeting in early November add to the possibility of raising the federal funds rate in December. Therefore, US dollar LIBOR rates (Figure 36) and US Treasury bond yields (Figure 40) kept on growing. October and early November also saw yield growth in the government bond markets of other developed countries. This resulted from fears that the ECB is set to shortly taper its QE programme. We do not consider this scenario to be realistic, however, the situation that has shaped in the bond markets over the past month allows us to assess the possible scope of implications from such central bank actions.

Figure 36. US dollar LIBOR, %



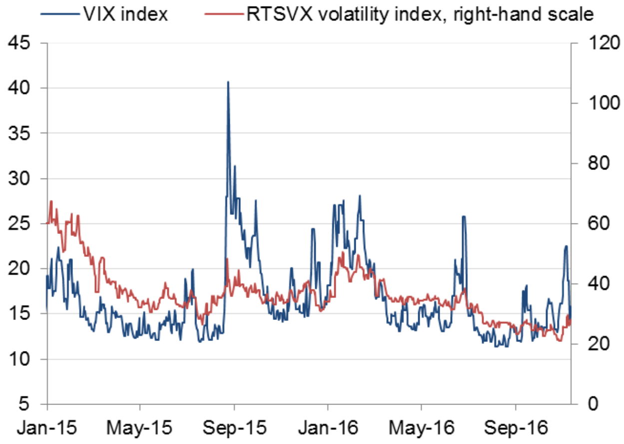
Source: Bloomberg Finance L.P.

Figure 37. S&P500 and EuroStoxx 50

Source: Bloomberg Finance L.P.

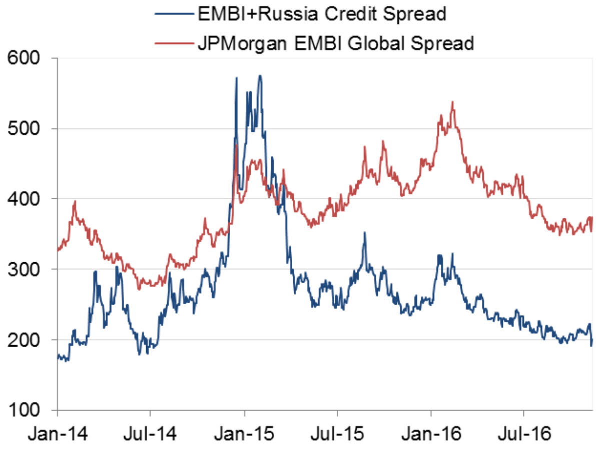
The continued growth in basic yields may have an adverse impact on the market dynamics and financial stability. The reduction in yields of government bonds of the developed countries to the minimum (and even negative) values stimulated investors to give preference to longer-duration instruments and more risky segments to gain profit. The longer is the bond maturity, the more variable is its price given the comparable change in yields. Respectively, when yields grow, prices of long-term instruments go down faster, which may provoke a chain reaction, if investors start to lock in the already gained profits or try to minimise losses.

Figure 38. VIX index (S&P500) and RTS volatility index (RTSVX)



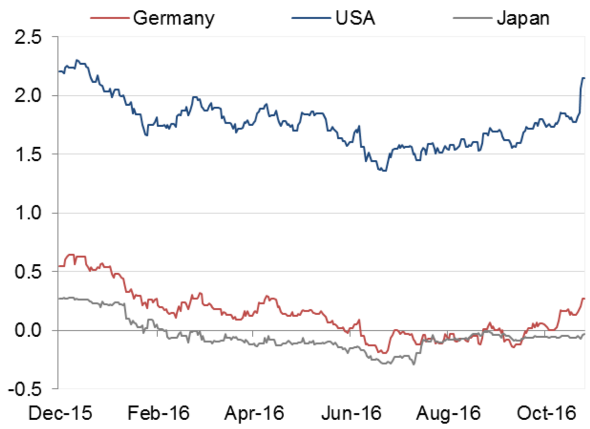
Source: Bloomberg Finance L.P.

Figure 39. EMBI+Russia and JP Morgan EMBI Global spreads



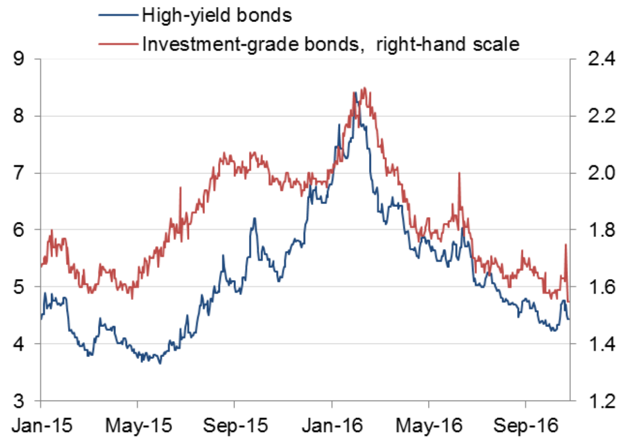
Source: Bloomberg Finance L.P.

Figure 40. Yields of 10-year bonds of developed countries, %



Source: Bloomberg Finance L.P.

Figure 41. Credit spread of corporate bonds of developed countries, %



Source: Bloomberg Finance L.P.

As investors flow into more risky segments, credit spreads decline, thus allowing them to obtain extra yields with respect to risk-free assets. Over the past few months, credit spreads approached their minimums (Figure 39, Figure 41). So far, the sale in government bond markets did not result in spread expansion. However, if it continues, the fall in risky segments of the bond market may proceed at an accelerating pace. From the viewpoint of risks for emerging market economies (EMEs), this U-turn may signify the beginning of the portfolio investment outflow.

Russian markets

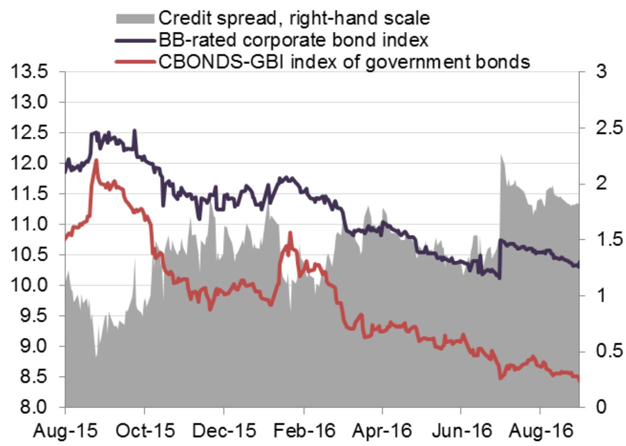
The market response to the Bank of Russia's decision to keep the key rate on hold at 10% was neutral. The decision was expectable on a whole, while the opinions of market players with regard to toughening or mitigating the press-release rhetoric divided pretty equally. It should be noted that the spread between the forward on 3-month Mosprime rate and the rate proper was close to zero for the first time over the past few months

(Figure 42). This means that the market is waiting for the key rate to go down no earlier than the middle of the first quarter of 2017, trusting to Bank of Russia statements.

Figure 42. FRA3X6 and 3M Mosprime spread, % p.a.

Sources: Bloomberg Finance L.P., R&F Department calculations.

Figure 43. Ruble bond yields, %



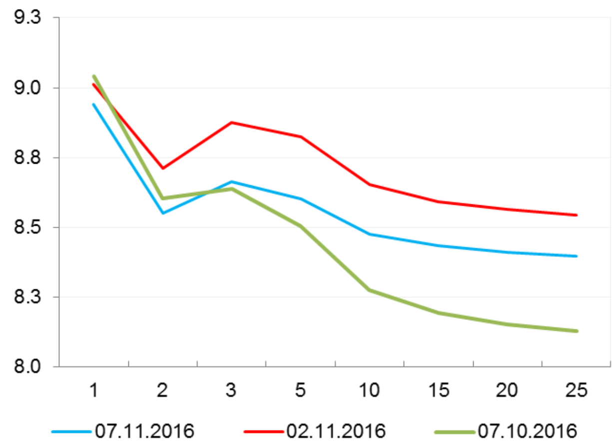
Source: Cbonds.

The Russian bond market was under the influence of global trends. The Eurobond market saw yields grow following the increase in basic yields and the decrease in oil prices in late October – early November (Figure 44). Nevertheless, many private companies managed to place Eurobonds on favourable terms. Over the past month, OFZ yields grew significantly following the yields of government bonds of other EMEs (Figure 45). The yields of long-term securities grew faster, which made the yield curve of Russian government bonds less inverted.

Figure 44. Russian Eurobond yields, %

Source: Cbonds.

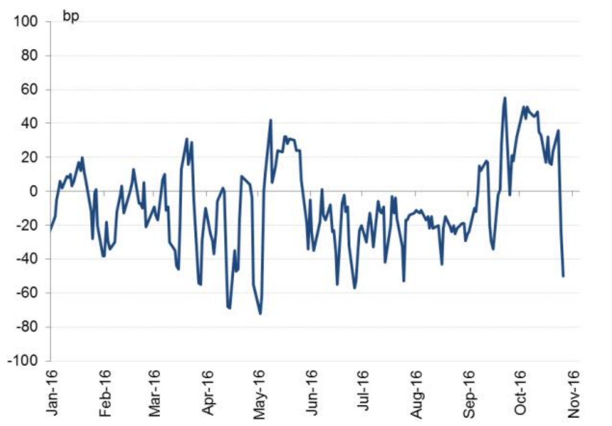
Figure 45. OFZ yield curve, %



Source: Moscow Exchange.

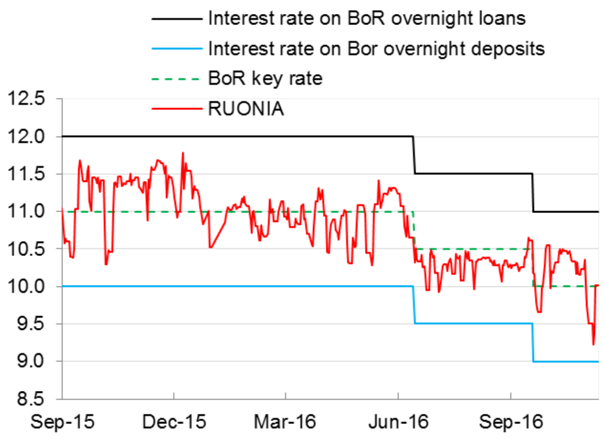
In October, money market ruble liquidity did not undergo serious changes, although the situation was unstable during the month: both considerable inflow and outflow of funds were observed (Figure 48). From 7 October to 7 November, the balances of correspondent accounts and deposits with the Bank of Russia were practically unchanged standing at ₽2.4 trillion. However, the liquidity structure shifted towards growing reserves in deposits with the Bank of Russia (growth of ₽150 billion)[24] resulted from the regulator's expansion of the respective limits. Such liquidity reallocation contains money market short-term rates and mitigates the impact of the transition of major banking sector participants to liquidity surplus.

Figure 46. RUONIA and BoR key rate spread, bp



Sources: Bank of Russia, R&F Department calculations.

Figure 47. BoR interest rate corridor and short-term interbank lending rate, % p.a.

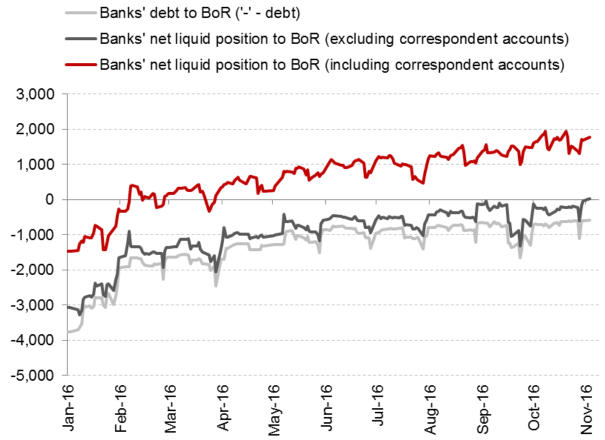


Sources: Bank of Russia, Bloomberg Finance L.P.

The total liquidity inflow of ₽146 billion into the banking sector observed during this period was spent by banks practically in full to redeem repo debt to the Bank of Russia. That is why the liquidity inflow should not have an additional positive effect on rates. October would see a liquidity outflow, but for the amount of ₽330 billion raised by certain banks as part of operation with the Russian Treasury.

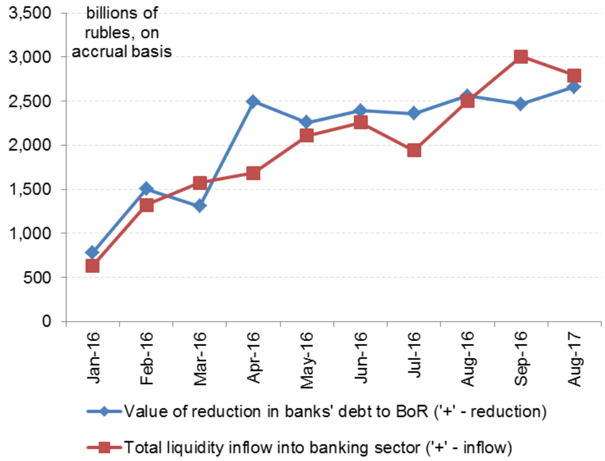
[24] From 7 October to 7 November 2016.

Figure 48. Banks' net liquid position to BoR, billions of rubles



Sources: Bank of Russia, R&F Department calculations.

Figure 49. Reduction in banks' debt to BoR and net liquidity inflow



Sources: Bank of Russia, R&F Department calculations.

A sharp reduction in money market short-term rates in early November 2016 to the levels below the Bank of Russia key rate[25] is temporary and largely caused by the changed liquidity circulation across the banking system[26] and temporary delays in absorbing spurious liquidity surges. Usually the impact of such one-off factors is of short duration and is smoothed over the horizon of several weeks due to the Bank of Russia instruments to provide and absorb liquidity. Money market short-term rates as a whole remain close to the Bank of Russia key rate and their average deviations from the key rate fluctuate within a narrow range of +/ 60 bp.

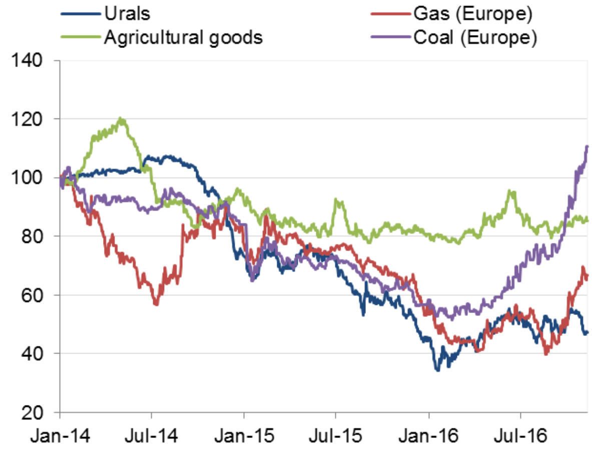
1.3.3. Commodity markets: agreement to reduce oil production unlikely

- The frictions between the OPEC countries and oil production growth there made it difficult to implement the agreement to reduce oil production and cut oil prices.
- US shale industry shows signs of recovery with companies undergoing bankruptcy procedures providing great support to the industry.
- Oil demand growth forecast continues to deteriorate despite the invigorating growth in consumption in the US and India and the accumulation of strategic reserves in China.

[25] Down to 9.5% on average.
[26] For example, changes in the volume of FX swaps or launch by VTB Bank PJSC of one-day bonds placed with banks.

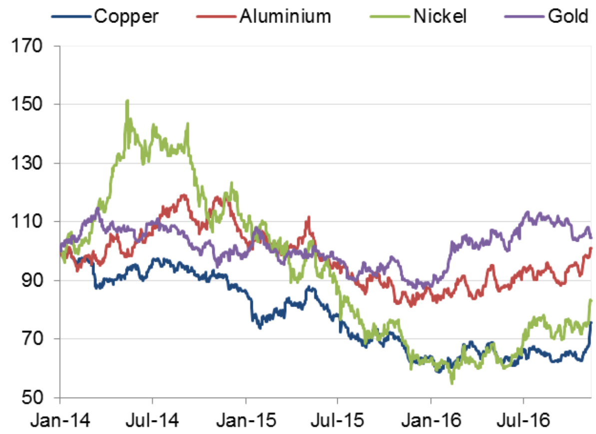
In October, commodity prices showed mixed dynamics. Bloomberg Commodity Index declined slightly, but increased adjusted for the appreciated exchange rate of the US dollar.

Figure 50. Commodity prices (January 2014 = 100)



Sources: Bloomberg Finance L.P., R&F Department calculations.

Figure 51. Metal prices (January 2014 = 100)



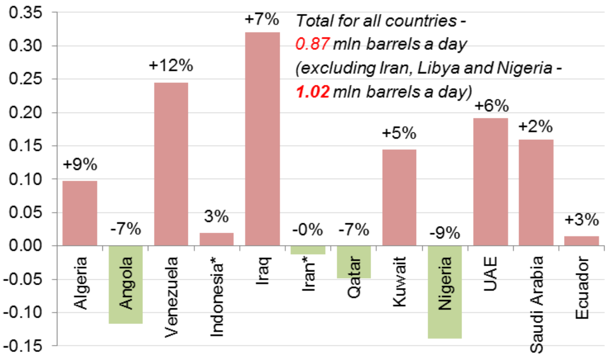
Sources: Bloomberg Finance L.P., R&F Department calculations.

In October, oil prices were elevated on the back of meetings and statements by representatives of the OPEC countries and countries outside of the cartel to implement the agreement on oil production reduction. However, in early November prices practically returned to their late September level, when the OPEC announced its intention to cut production to 32.5–33.0 million barrels per day.

A number of factors stand for lower possibility of the agreement to reduce oil production. In its October report the OPEC disclosed information about the oil production ratios in its member countries based on the assessments of the countries proper and on secondary sources used by the OPEC as the official ones (Figure 52). Almost all countries state a material understatement of their own production, which totalled in September (with due account of opposite deviations) 0.9 million barrels per day, and excluding Iran, Libya and Nigeria, which are not subject to the production reduction quotas, 1.0 million barrels per day. This deviation exceeds the respective figures of 2014–2015 three to four times. This adds to our assumption that the majority of countries try to narrow their participation in the agreement to reduce production by verbal support and, moreover, gives rise to many-times increase in the assessment of oil surpluses in the market.

The OPEC also continues renewing a record of oil production. According to Bloomberg, in October oil production grew by 0.5% MoM and 2.8% YoY (Figure 53). The cessation of deliveries from a large oilfield in Angola (0.2 million barrels per day) was offset by the recovery of production in Libya, Nigeria and Iran, which together added to the supply 0.4 million barrels per day. According to Bloomberg, oil production in these countries continues to grow in November. Thus, the Minister of Oil in Nigeria stated the recovery of oil production in early November to the January level, which exceeds the October figure by 0.4 million barrels per day. Proceeding from the current dynamics, the OPEC countries will have to reduce production by 1.5–2.0 million barrels to implement the September agreement. A large number of factors are indicative that the agreement's implementation will shift to Saudi Arabia and other rich countries, which hardly meets their interests. The Vienna meeting held on 28–29 October to discuss the specific steps to reduce oil production yielded no results.

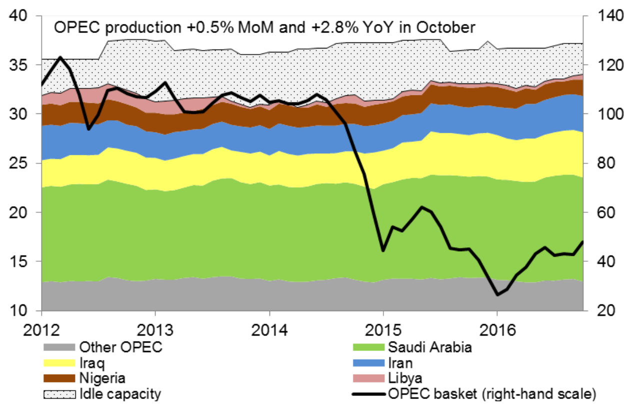
Figure 52. Difference between oil production in OPEC in September 2016 according to countries' estimates and OPEC official data (mln barrels per day) and their shares in official production volumes, %



** Data for August 2016.*

Sources: OPEC, R&F Department calculations.

Figure 53. Crude oil production (mln barrels per day)* and OPEC basket price, $/barrel



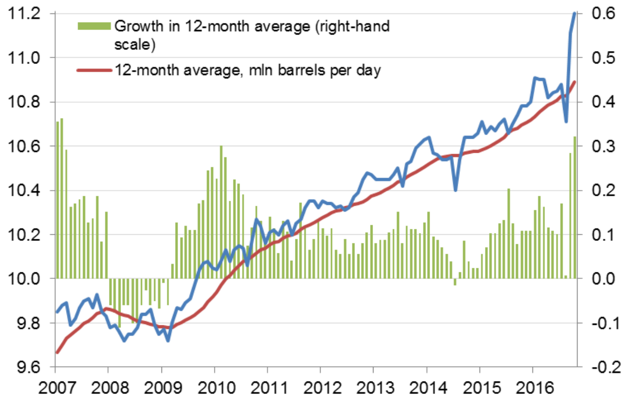
** For comparison's sake, data include oil production in Indonesia before December 2015 and in Gabon before July 2016.*

Sources: Bloomberg Finance L.P., R&F Department calculations.

In October, Russia also renewed its oil production record increasing it by 0.8% MoM and 3.9% YoY (Figure 54).

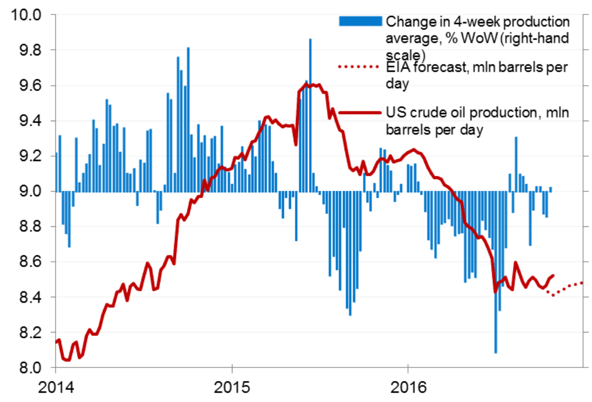
Having passed the bottom in August, US oil production continues to grow exceeding the US Energy Information Administration (EIA) expectations (Figure 55). The Wall Street Journal reported that companies undergoing bankruptcy procedures made a great contribution to oil production: their production indicators remained almost unchanged as compared to the level before the initiation of bankruptcy proceedings. A large number of such companies have recently terminated bankruptcy procedures and step up their activities.

Figure 54. Oil production in Russia



Sources: Bloomberg Finance L.P., R&F Department calculations.

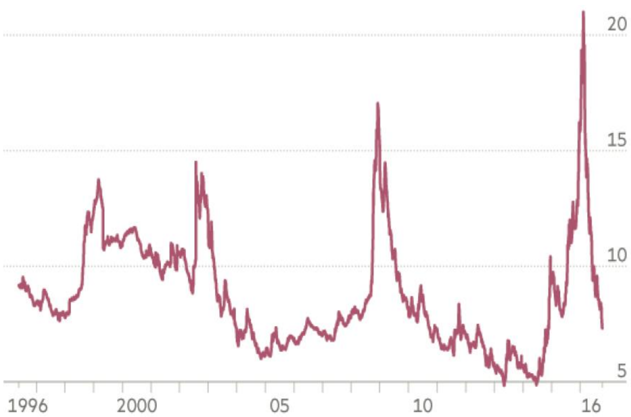
Figure 55. Oil production in US



Sources: EIA, R&F Department calculations.

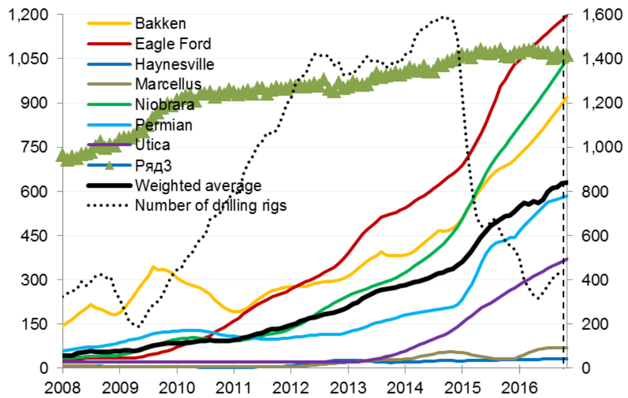
In its October report the EIA noted the improved financial position of the US oil-producing companies and capital expenditure growth in 2016 Q3. This happened for the first time since 2014 Q2. The Financial Times reported on the largest IPO ever since 2014 of the US Extraction Oil & Gas company and on IPO preparation by other companies. According to Bank of America Merrill Lynch estimates, the yields of high-risk bonds of the US oil sector dropped to the 2014 level (about 7%) from over 20% in early 2016 (Figure 56). The number of drilling rigs in operation and their efficiency keep on growing (Figure 57).

Figure 56. Yields of high-risk bonds of US oil sector, %



Sources: Financial Times, Bank of America Merrill Lynch.

Figure 57. Number of drilling rigs and average efficiency of production in US shale oilfields, barrels per day

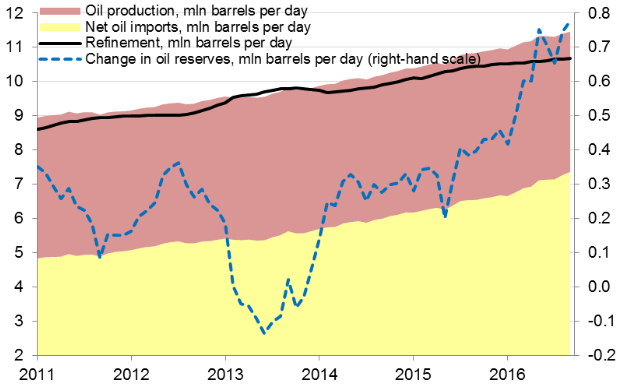


Sources: EIA, R&F Department calculations.

China continues to be the country providing supply-side support to oil prices. In January-September, oil production fell by 0.5 million barrels per day, or by 12%. According to Sanford C. Bernstein (Hong Kong) estimates, to stabilise oil production in China oil prices should be at $50 per barrel, while production growth is possible with prices standing at about $60 per barrel.

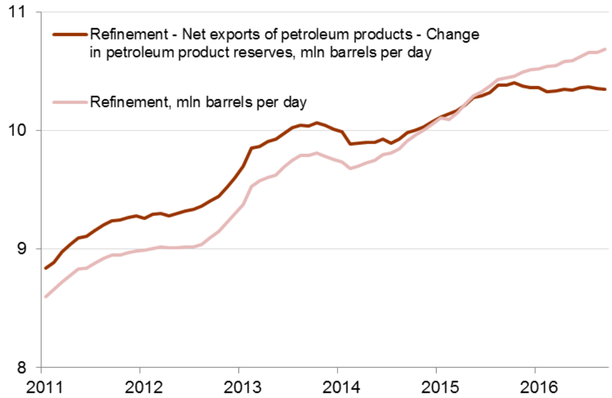
Petroleum product consumption is on the rise in the US and India, but global demand growth as a whole continues to slow down. In their October reports the International Energy Agency and the EIA revised the global demand forecast downwards and again postponed the oil market balancing. China continues to step up net oil imports, but still for the purposes of offsetting own production reduction, increasing net exports of petroleum products, and accumulating strategic reserves (Figure 58) amid consumption stagnation (Figure 59).

Figure 58. Oil production, net imports, refinement and change in oil reserves in China, 12-month averages



Source: Bloomberg Finance L.P., R&F Department calculations.

Figure 59. Oil refinement and consumption in China, 12-month averages



Sources: Bloomberg Finance L.P., Xinhua News Agency,R&F Department calculations.

2. Outlook: leading indicators

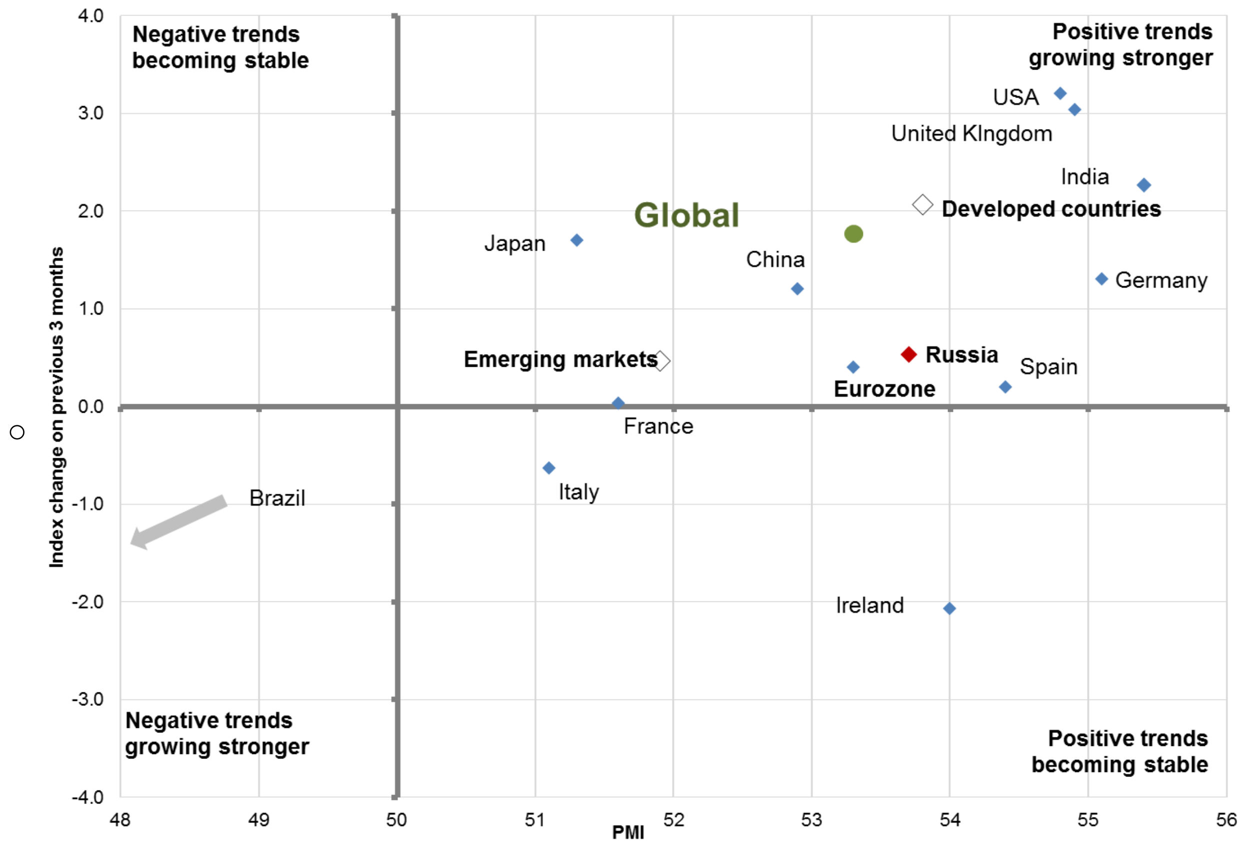
2.1. Global leading indicators

2.1.1. PMIs suggest a good beginning of Q4 for global economy

- The beginning of Q4 turns out to be a success from the viewpoint of the global economy's dynamics. Improvements are registered in both developed countries and EMEs.
- PMIs reached their two-year high against the backdrop of oil price growth. Acceleration may turn out to be temporary.

Judging by PMI dynamics, the beginning of Q4 turned out to be a success for the global economy (Figure 60). The aggregate output index reached its one-year high, with PMI in the manufacturing sector climbing to the maximum since July 2014, and that in the services sector – since November 2015.

Figure 60. Aggregate PMI in October and change against Q3 average



Sources: IHS Markit, R&F Department calculations.

The situation in developed countries has improved considerably, while the acceleration of growth in EMEs is contained by the resumed downturn in activity in Brazil. Improved information about the new order index is also worth noting. PMIs are expected to remain unchanged till the end of the year.

An accelerated growth in input and output prices is important in terms of monetary policy. Both price indices reached their two-year highs. Input price growth can be explained by a considerable increase in oil prices in October as compared with September on the back of hopes that the bargain between the OPEC and other countries to reduce oil production would be implemented. The price downturn, which has begun in late October following the uncertainty about the agreement reached in Algeria, may be conducive to relieving the pressure on price indices in November.

2.2. What do Russian leading indicators suggest?

2.2.1. GDP index assessment still indicative of growth

- GDP index assessment in Q3 continues to be indicative of positive dynamics (Figure 61).
- The assessment went down slightly to 0.1% QoQ, seasonally adjusted, as compared with September. The review value is within the standard error of our model calculations.

	October 2016	September 2016
	% QoQ	% QoQ
2016 Q3	**0.1**	**0.1–0.2**
2016 Q4	**0.2–0.3**	**0.3**
2017 Q1	**0.3**	**0.3**

Estimated values take into account the provisional Rosstat estimate for Q2 GDP at the level of -0.6% YoY.

- A downturn in GDP assessments in Q3 for three months in a row testifies to the fact that the real sector statistics in July-September as a whole turned out to be worse than expected.

• Assessments for the next two quarters suggest that positive GDP dynamics should remain intact and strengthen. The current assessment stands at 0.2–0.3% QoQ for 2016 Q4 and 0.3% QoQ for 2017 Q1, seasonally adjusted.

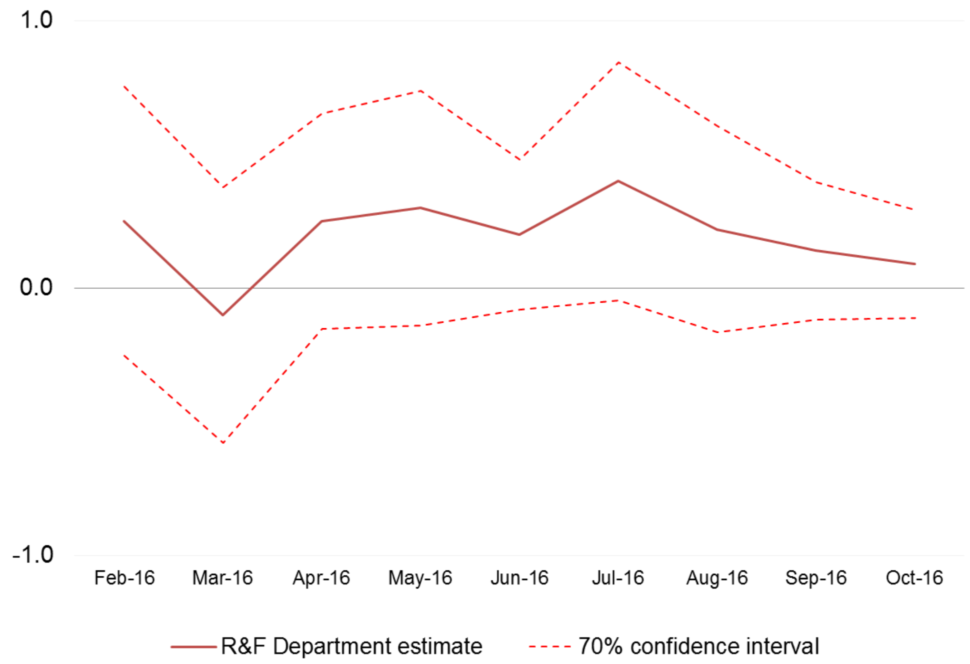
• These assessments are based on the average Urals crude prices in the next six months at about $45 per barrel, which exceeds the figure envisaged in the Bank of Russia's baseline scenario …

• …however, as calculations show, the exclusion of the oil price indicator from calculations reduces the assessment of GDP growth in Q3 by a mere 0.02 pp. This means that practically all the influence on GDP from oil prices is reflected in other explaining indicators.

• Therefore, volatility of oil price growth observed over the past month had a little impact on our model GDP estimates.

• GDP index assessment in future quarters may change drastically as new statistical data on short-term macroeconomic indicators are published.

Figure 61. Estimate of GDP growth in 2016 Q3, % QoQ



Sources: Rosstat, R&F Department calculations.

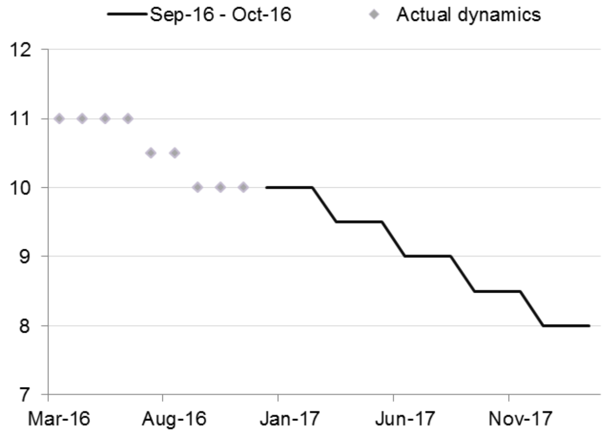
2.2.2. Inflation expectations of financial analysts approach Bank of Russia's target

• Analysts' confidence in the current Bank of Russia monetary policy increased…

- … triggering a significant decrease in inflation expectations, which approached the Bank of Russia's target for late 2017.
- The moderately tight monetary policy makes it possible to anchor expectations at the required level.

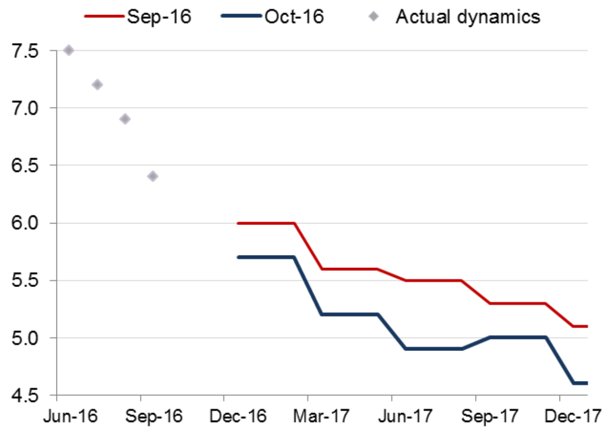
According to a Bloomberg survey of financial analysts published in October, this year median inflation estimation went down to 5.7% from 6.0% a month earlier (Figure 63). This reflects positive dynamics of the past few weeks, which have been under the favourable influence of various temporary factors. The review of expectations for late 2017 from 5.1% to 4.6% is more significant in terms of Bank of Russia policy. Inflation expectations of market participants for late 2017 came close to the target, although they still continue to be above 4%. Analysts kept their expectations of the key rate dynamics at the previous month's level (Figure 62).

Figure 62. Analysts' expectations of BoR key rate



Source: Bloomberg Finance L.P.

Figure 63. Analysts' expectations of inflation, % YoY



Source: Bloomberg Finance L.P.

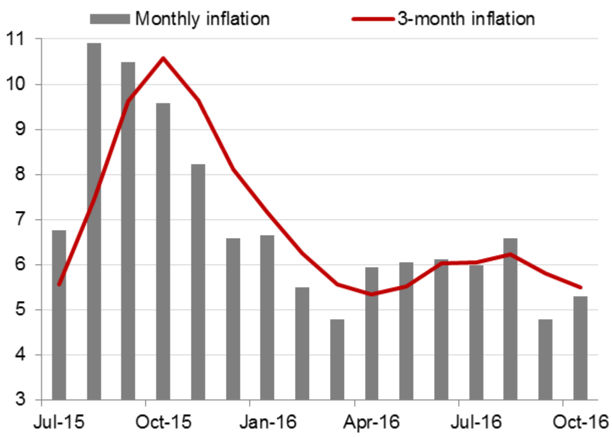
October assessments show that the overwhelming majority of analysts trust in the moderately tight monetary policy pursued by the Bank of Russia. The increased confidence of financial analysts will be conducive to further inflation reduction. That is why it is extremely important to prevent inflation expectations from growing in the future. One of the instruments to anchor inflation expectations at a low level is to maintain the moderately tight monetary policy with the real rate being above the neutral level.

3. In focus. On impact of temporary favourable factors on consumer prices

- Seasonally adjusted consumer price growth decreased to 5% year-on-year in the past few months…
- …however, the decrease was largely caused by temporary favourable factors. Without their impact the inflationary pressure would have corresponded to the annual price growth of 6.0–6.5%.
- In order to convincingly achieve the inflation target by late 2017, seasonally adjusted monthly price growth might need to slow down in November-December…
- …on the back of the Bank of Russia's moderately tight monetary policy.

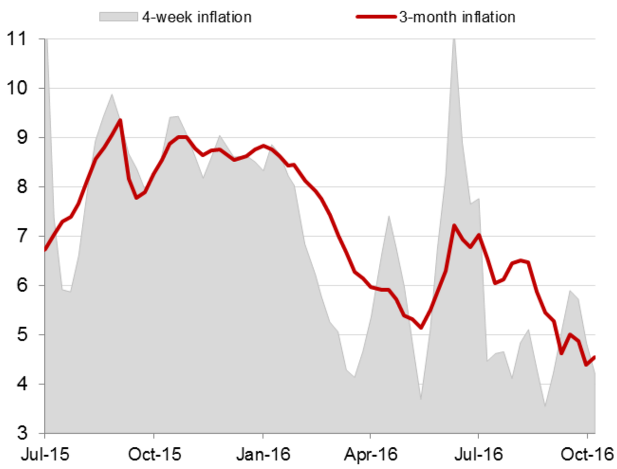
The past months saw annual inflation slowing: to 6.1% in October from 7.5% in early summer. The slowing is due to the overall relief of inflationary pressure in the economy, apart from the previous year's high base effect. This is demonstrated by the dynamics of our estimates of seasonally adjusted inflation, which are made on the basis of both monthly (Figure 64) and weekly data (Figure 65). In September and October[27], seasonally adjusted price growth was below its summer rate and corresponded to annual inflation of about 5%. Such inflation dynamics look favourable from the viewpoint of achieving the 4% target in late 2017.

Figure 64. Annual inflation, seasonally adjusted (monthly data)



Sources: Rosstat, R&F Department calculations. October estimates are preliminary.

Figure 65. Annual inflation, seasonally adjusted (weekly data)



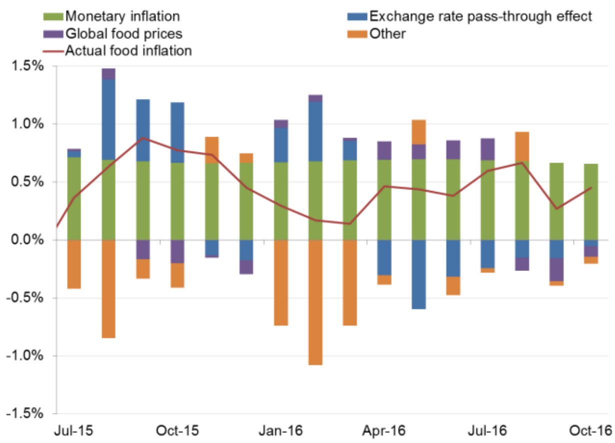
Sources: Rosstat, R&F Department calculations.

[27] Preliminary estimate.

If at the beginning of 2017 seasonally adjusted monthly growth in consumer prices remains above 4% for a year ahead, the achievement of inflation target in late 2017 will require slower seasonally adjusted monthly price growth for a year ahead below 4% in the course of next year. Strong intrayear fluctuations of inflationary pressure and inflation indicators going down far below 4% are undesirable, since the monetary policy objective is to ensure stable price growth close to the target. There are only two months left till the end of 2016. That is why inflation trends over this period will largely determine the inflation path in 2017.

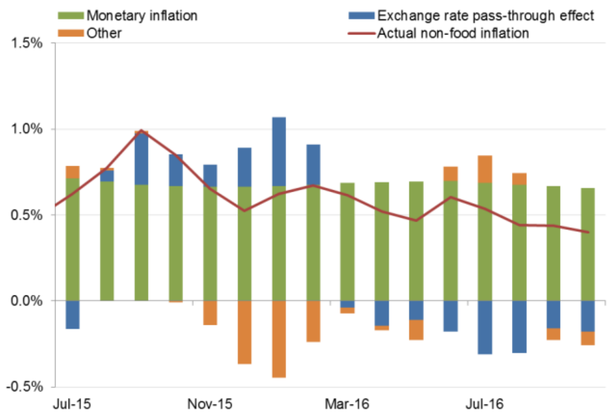
The favourable price dynamics observed in the past few months are likely to underestimate the inflationary pressure in the consumer market due to temporary factors. Such factors include ruble appreciation, a good harvest in Russia and the world, as well as the resumed decline in global food prices.

Figure 66. Food inflation decomposition, % MoM seasonally adjusted



Sources: Rosstat, R&F Department calculations. October estimates are preliminary.

Figure 67. Non-food inflation decomposition, % MoM seasonally adjusted



Sources: Rosstat, R&F Department calculations. October estimates are preliminary.

In order to assess the degree of influence of the aforementioned temporary factors we conducted decomposition[28] of food and non-food inflation into monetary component, exchange rate component, and global food prices component (Figure 66 and Figure 67). The results obtained confirm that the pass-through effect of the exchange rate appreciation and also a downturn in global food prices impacted the recent slowdown in price growth. According to our estimates, the contribution made by these factors to headline inflation slowing totalled 0.10–0.15 pp a month on average. This means that without their impact seasonally adjusted inflation would have been higher in the past two to three months and corresponded to annualised growth rates of 6.0–6.5%[29].

[28] For inflation decomposition methodology, see Section 1.1.2 of the Talking Trends Bulletin No. 5/March 2016).

[29] Price growth rates for a year ahead calculated based on seasonally adjusted monthly growth rates (annualised growth rates).

Therefore, we can conclude that inflationary pressure (adjusted for temporary factors) still remains elevated against the target one, while inflation is moving down along the more sloped path. Nevertheless, the consistent moderately tight monetary policy pursued by the Bank of Russia should result in the easing of inflationary pressure.

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