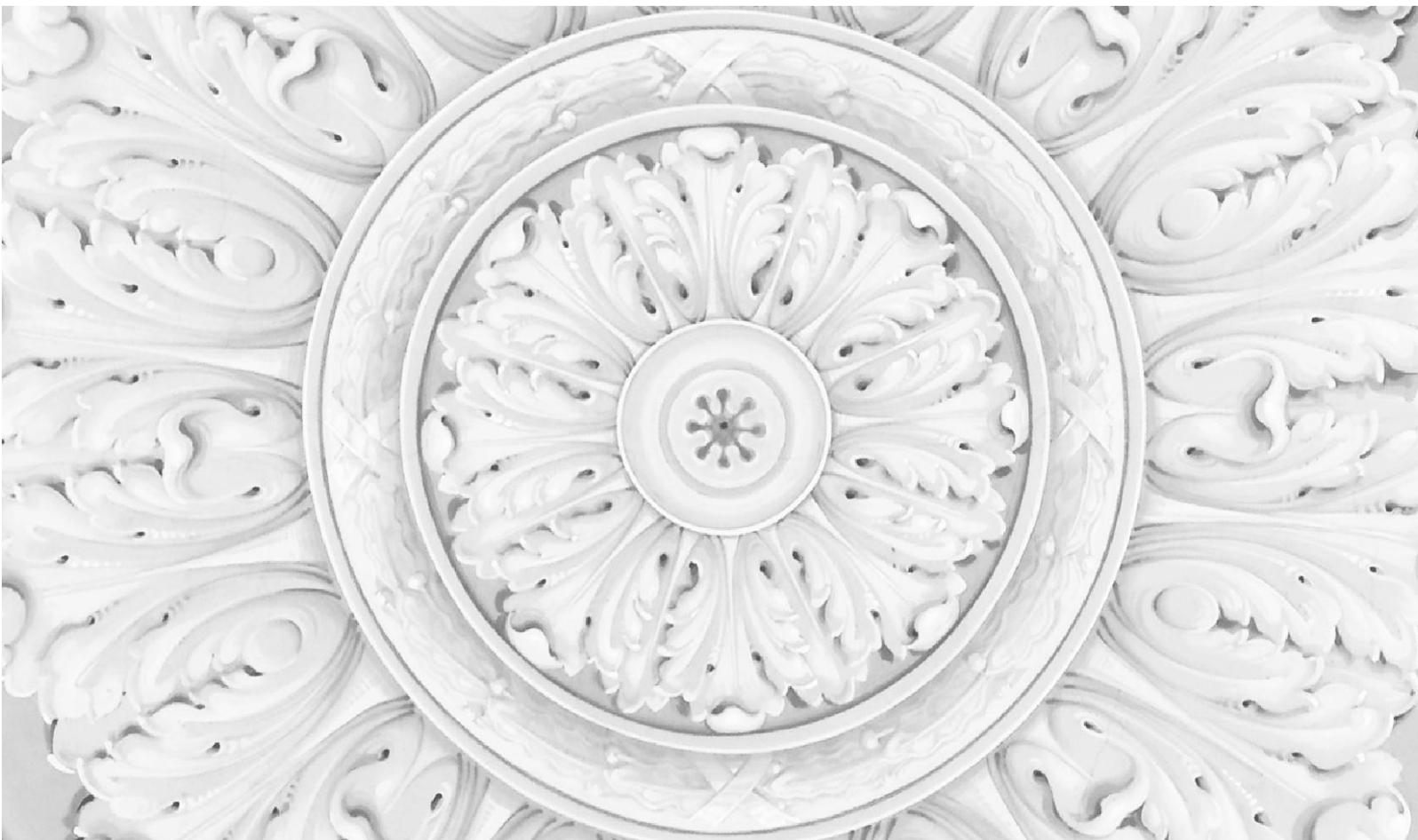




# Bank of Russia

The Central Bank of the Russian Federation



## TALKING TRENDS

Macroeconomics and markets  
November 2015

Research and Forecasting  
Department Bulletin

No. 2 / November 2015

*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*

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## Executive summary

### 1. Summary of the month

- November 2015 saw a further reduction in short-term financial risks, while inflationary risks were growing and the level of economic activity was stabilising.
- **Inflationary pressure remains high, and inflationary risks have grown.**
- The slowdown in the **Russian economy** stopped thanks to the ‘traded’ sectors; it may however resume, triggered by the drop in oil prices.
- Russia’s **overall financial stability risks have receded**, yet the current oil prices are substantially lower than those used in the Bank of Russia (BoR) baseline scenario.

### 2. Outlook

- Leading indicators of business activity suggest tentative signs of stabilising **economic developments in the world**, which helps alleviate concerns in financial markets over the consequences a Fed rate increase may have for the global economy.
- As before, leading indicators of Russian business activity do not yet promise a **resumption in economic growth until early 2016**.

### 3. In focus: public finance outlook

- In the years to come, budget revenues as a percentage of GDP are expected to continue to drop. Expenditure is projected to fall at an outrunning pace, driven by the need to cut back budget deficit. The underlying budget risks stem from the oil price remaining under \$50 a barrel, as well as the fact that the required scope of budget cutback will be challenging.

## 1. Summary of the month

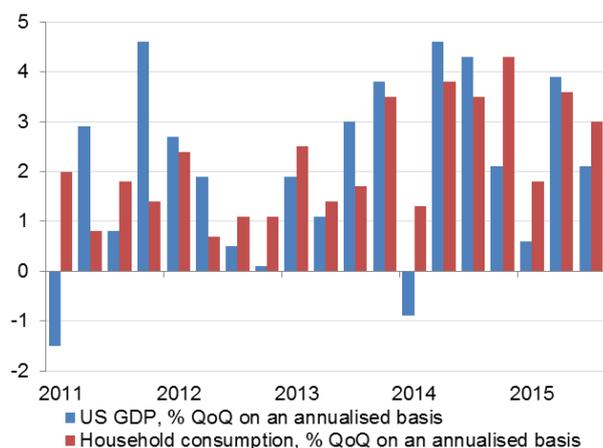
### 1.1. Global economy and financial and commodity markets

**1.1.1. In the US, the rates are expected to 'normalise' in December; the ECB is preparing to extend its monetary easing; the risks of a slowdown in growth of the Chinese economy remain**

#### USA

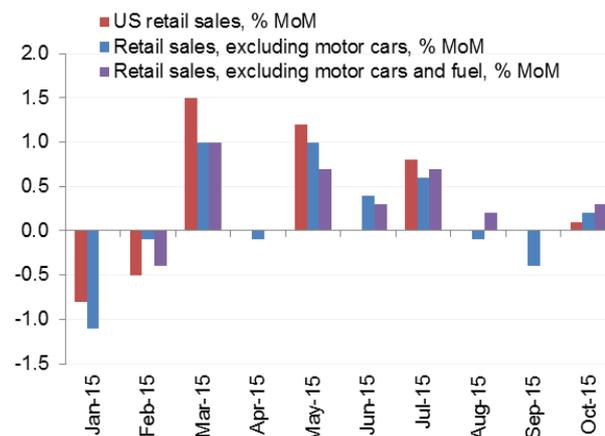
The US Fed's Federal Open Market Committee has left the rates unchanged, referring to a possible start in the stabilisation of the rates as early as December. In its minutes, the Committee mentions the ongoing economic rebound and job growth in the economy. According to the Committee, the inflation movements are on course to reach the long-term target of 2%. New to these minutes was the mentioning of a possible rate increase to be decided at the December meeting. This would be determined by less volatility in financial markets against the period of July to September, when the US Fed kept the rates. It was also noted that the rates would be increased at a quite moderate pace.

**Figure 1. US GDP, % QoQ on an annualised basis**



Source: Bloomberg

**Figure 2. US retail sales**



Source: Bloomberg

**US GDP growth in the third quarter slowed down to 2.1% QoQ against 3.9% QoQ on an annualised basis in the second quarter.**

This was driven by less inventory investment and a deteriorating external trade environment for exporting companies. At the same time, domestic consumption, albeit with a slower growth, remains a meaningful driver for economic activity (3.0% QoQ in the

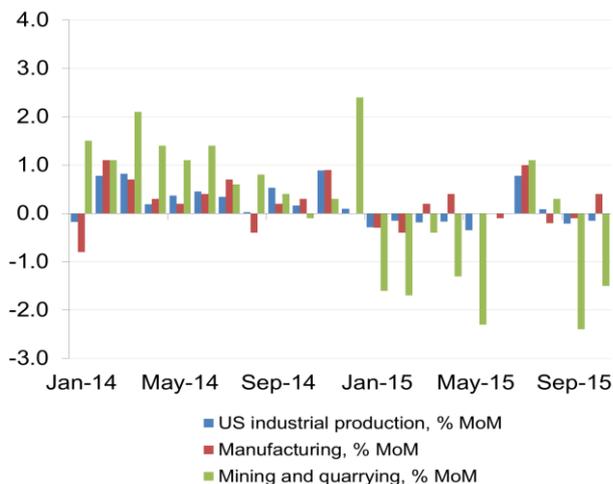
third quarter of 2015 against 3.6% QoQ in the second quarter of 2015), which is connected with dropping unemployment and reduced gasoline prices.

**Having said this, the survey data suggest a growing pressure on households. In the consumer sector, retail data proved disappointing to market participants.** Retail sales grew by 0.1% MoM, failing to meet the market expectations for a 0.3% growth pace, MoM. Consumer confidence index for November dropped to 90.4, a minimum recorded since September 2014. Americans are growing increasingly sceptical of both labour market prospects and a potential wage growth.

**US labour statistics for October proved very strong.** The data released on jobs added beat market expectations: the economy added 271,000 jobs against the expected 180,000, which was a maximum increase in 2015. Unemployment was down from 5.1% to 5.0%, close to what the US Fed considers natural (4.9%).

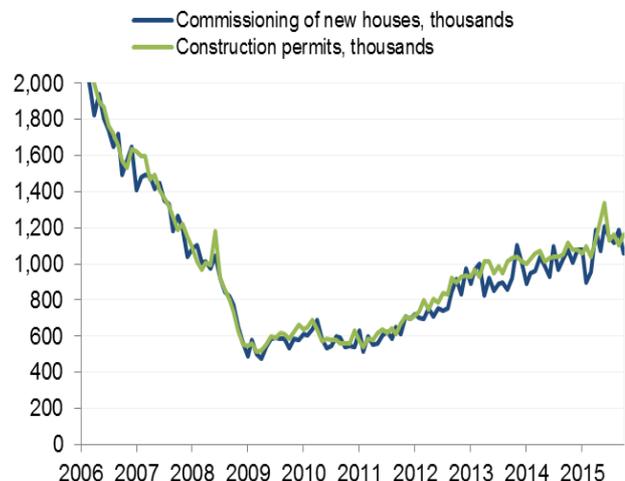
**October's industrial figures showed a variety of trends.** Industrial output was down 0.2% MoM (consensus forecast – +0.1% MoM), while the manufacturing sector grew by 0.4% MoM, above the expected 0.2% YoY. The key underperformers included mining and quarrying (-1.5% MoM) and electricity, gas and water supply (-2.5% MoM). Industrial capacity utilisation was somewhat down from 77.7% to 77.5%.

**Figure 3. US industrial production and its components**



Source: Bloomberg

**Figure 4. New builds and construction permits in the US**



Source: Bloomberg

**The housing market statistics expose a growth slowing to 1.06 million in October (on 1.19 million in September), which is the lowest reading for the period since March.** Construction permits, as proxy for housing delivery, rose by 4.1%, to 1.15 million. Although the new housing delivery rates were slow, NAHB survey data suggest fairly optimistic expectations with regard to the industrial situation.

**The US trade deficit in September dropped from \$48 billion to \$40.8 billion.** Exports in September rose to \$3 billion, while imports declined by \$4.2 billion on the back of ongoing reduction in oil imports. The trade deficit with China has grown over the last

month from \$35.6 billion to \$36.3 billion, owing to a strengthened dollar. This is expected, however, to support the Chinese economy.

## Eurozone

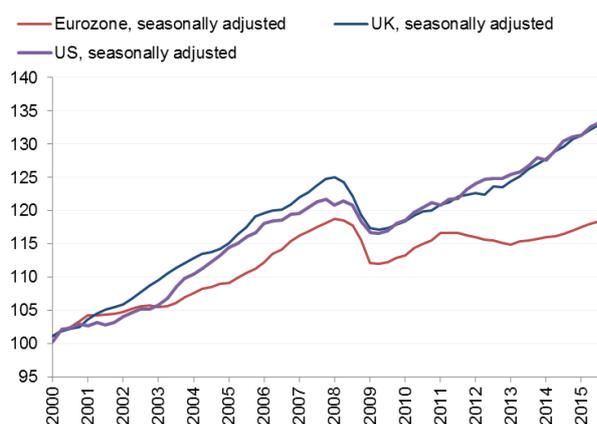
**The eurozone's Q3 economic expansion slowed down to 0.3% QoQ, worse than expected (0.4% QoQ).** Worse than expected were also the annual data with GDP growth totalling 1.6% YoY against 1.7% of expectations (YoY). Germany's GDP rose by 0.3%, following its 0.4% growth in the second quarter, Italy's GDP was up 0.2%, following its growth of 0.3% between April and June. At the same time, the growth of France's economy accelerated to 0.3%.

According to GDP data commentary by German, French and Italian national statistics agencies, domestic consumption continues to be the major contributor to the economic growth, which comes amid signs that expansion of foreign trade remains questionable.

The eurozone's consumer prices rose by 0.1% YoY in October, leaving negative territory wherein they have been since September 2015. More so, the core inflation index (non-food and non-fuel products), rising to the highest level since August 2013, totalled 1.1% YoY.

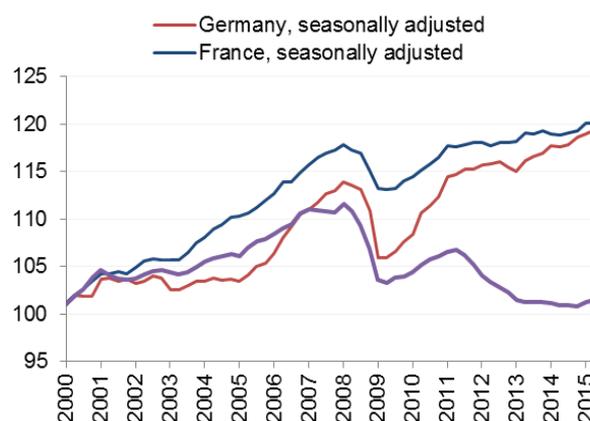
Despite the improving inflation dynamics, ECB president Mario Draghi announced that the current monetary policies were not sufficient for the ECB to deliver on its mid-term targets.

**Figure 5. Eurozone, US and UK GDP (1999 Q4 = 100)**



Source: Bloomberg

**Figure 6. Eurozone and EU major economies GDP (1999 Q4 = 100)**

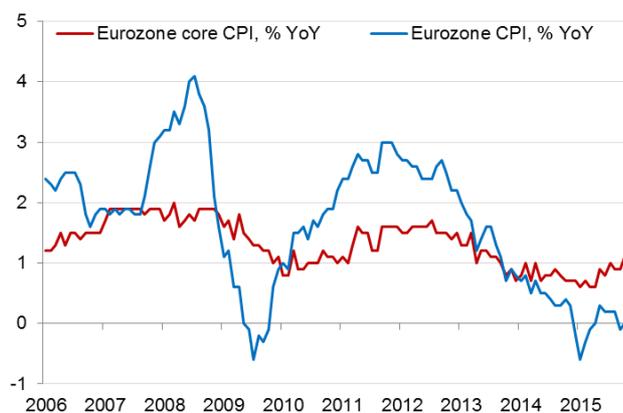


Source: Bloomberg

Although the eurozone's economic growth remains stable, the economy is still below its pre-crisis peak, which was passed in the US and the UK long ago. The recent data on economic growth and lower inflation point to the need for continued monetary easing by the ECB.

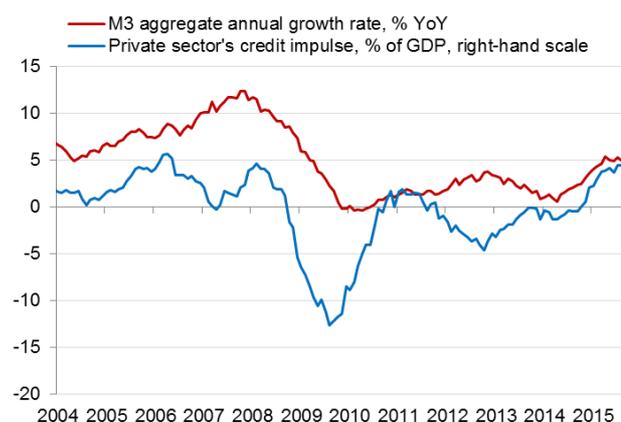
At the same time, it should be noted that no higher pace of growth in M3 money supply was recorded, and the growth remained flat at 4.9% YoY (against the expected 5.0% YoY). The reason for the money supply growth to become stable was a somewhat declining credit impulse. The lending increment in the private sector, albeit down to 3.7% of GDP in September on 4.5% of GDP in August, is still much stronger than a reading of three years ago, when it was below -4.5% of GDP (see Figure 8). The credit impulse was, in its turn, impacted by the lower lending in September of 0.7% YoY vs. 1% YoY in August.

**Figure 7. Eurozone consumer inflation**



Source: Bloomberg

**Figure 8. Eurozone's money supply growth and private sector's credit impulse**



Note. Credit impulse is understood to be an increment in lending increase/decrease divided by nominal GDP

Source: Bloomberg

Several ECB directors believe that these dynamics are still insufficient to enable the ECB to reach the forecast target of - 1.7% YoY by the end of 2017, and extra easing policies are necessary. The unemployment statistics were also better than expected. Unemployment fell to 10.8%, despite expectations for it to maintain at 11%.

## China

**China's** economic statistics for October suggest no turnaround in the downward trends. Consumer price growth in China continued to decline: 1.3% YoY against 1.6% YoY in September. This was mainly determined by the dynamics of food and non-food prices. Furthermore, the industrial sector showed continued deflationary trends. PPI totalled -5.9% YoY, unchanged from September. Annualised deflation in the industrial sector was largely due to the falling oil prices in the fourth quarter of last year. Prices are set to rebound as early as October, on the back of the low base effect.

**Figure 9. Inflation in consumer and industrial sectors in China, % YoY**



Source: Bloomberg

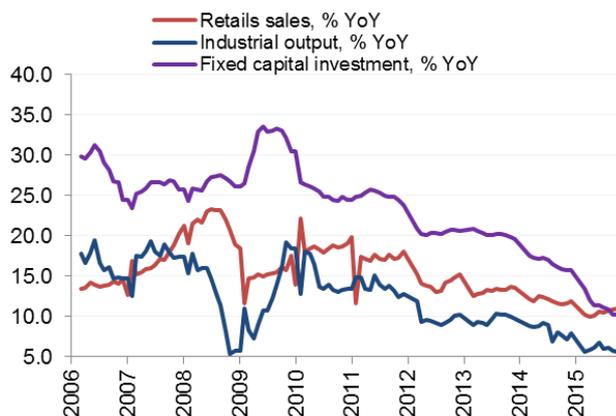
**Figure 10. Money supply and lending growth rates in China, % YoY**



Source: Bloomberg

Among the reasons behind the low inflation is a falling demand, reflected in the shrinkage of lending, which dropped to a fifteen-month low in October, despite the monetary and fiscal easing. It is also reflected in the slowing global growth, suggested by October's weak foreign trade data (the drop in exports amounted to 6.9% YoY vs. -3.2% YoY recorded in September).

**Figure 11. Retail sales and industrial output in China, % YoY**



Source: Bloomberg

**Figure 12. Chinese exports, imports and trade balance**



Source: Bloomberg

The October industrial output data also failed to oblige. The growth pace fell to 5.6% YoY in October from 5.7% YoY in September, against the expectations of 5.8% YoY. At the same time, retail sales accelerated slightly (to 11% YoY on 10.9% in September), while the growth rate of investment in fixed assets remained flat over the past 10 months at 10.2% YoY. Chinese industrial companies' profits continued to decline, with the fall

accelerating in October. The rate of decline increased from -0.1% YoY in September to -4.6% YoY in October.

### ***Japan***

**In Japan, the Board of Directors of the Bank of Japan (BoJ) concluded its two-day meeting with the decision to continue with its quantitative and qualitative monetary easing policy.** The BoJ also decided to go on with its asset purchase programme in the same scope. The decision was made contrary to the expectations that emerged in connection with the low inflation. The Bank of Japan substantiated its decision with the low energy prices, which, in their turn, impacted on forecast revisions. Under the current plans, it is expected that the 2% inflation target will be reached in the second half of 2017, although as recently as in the beginning of the year the BoJ expected the target to be hit in March 2016.

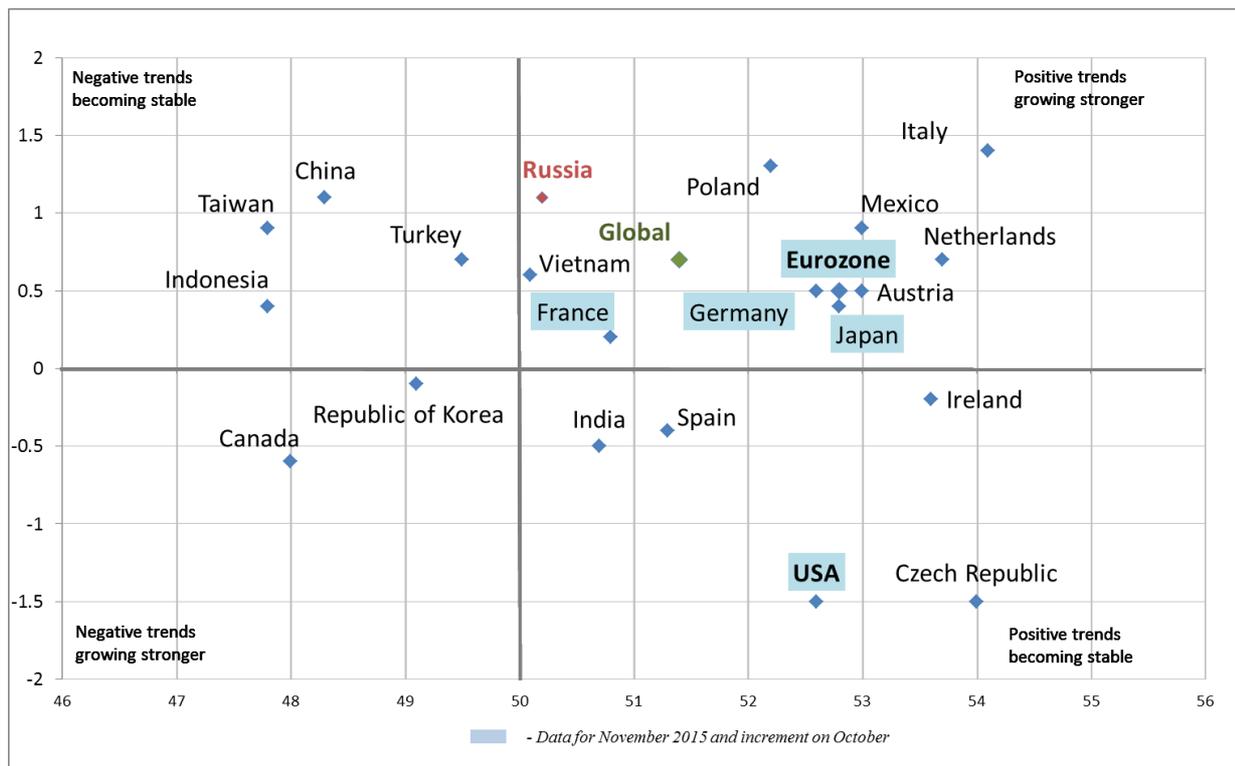
**Q3 GDP growth data support the need for a continuation of this policy.** In the third quarter, the Japanese economy shrank 0.2% QoQ, worse than expected (-0.1% QoQ). At the same time, the GDP deflator continued to grow and exceeded expectations, totalling 2.0% YoY against 1.5% YoY in the second quarter.

**September and October statistical data** for the Japanese economy were mixed. Retail sales in September, contrary to expectations, dropped by 0.2% YoY (on the forecast of -0.4% YoY), while August recorded the increase of 0.8% YoY. Similar dynamics were seen in household spending, which fell by 0.4% YoY against the expected growth of 1.1% YoY. The pace of growth in applications for housing construction was less than expected at 2.6% YoY compared to the consensus of 5.8% YoY and 8.8% YoY in August. At the same time, industrial production continued to decline, albeit better than expected (the actual reading was -0.9% YoY, against the expectations of -2.6% YoY).

### ***Readings of leading indicators***

Tentative PMI for the manufacturing industry point to the ongoing trend towards economic rebound in France, Germany and Japan. The US indicator value declined but remained within the growth zone (> 50). **China's Caixin PMI index in the manufacturing industry in China** in October, although still signalling a slowdown in the Chinese manufacturing sector, was better than expected and better than September at 48.3 against the expected 47.6. The service sector in China is gaining momentum: the index in October rose to 52.2 against 50.5 for September. This was the contributor to PMI rising from 48 to 49.9 points. The positive signal is the second consecutive surplus, beyond 50 points, of the 'orders' component in the official PMI index level.

Figure 13. PMI in manufacturing in October 2015 and increment on September



Sources: Markit Economics, Bloomberg

Global economy survey data available from analysts, according to Bloomberg, point to improved expectations with regard to the eurozone economies in 2016, while the expectations for the economies of Japan and the US deteriorated. The US economy is expected to expand 2.4% YoY in 2015 and 2.5% YoY in 2016 (August survey: 2.5% YoY in 2015 and 2.6% YoY in 2016). Forecasts on China's economy show a decrease in expectations against the previous month. The expectations for Q4 developments were revised from 6.9% down to 6.8% YoY. Expectations also deteriorated as regards the investment and the foreign trade sector. Anticipated export movement fell to -4% from -1% YoY in the fourth quarter, as did anticipated imports from -5.5% to -11.9% YoY.

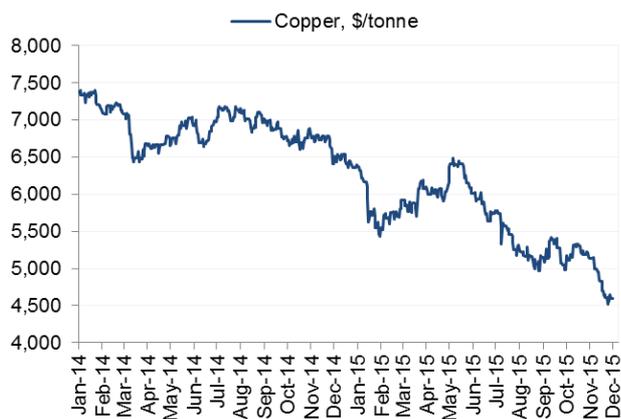
From the standpoint of expectations for monetary policy, the median analytical forecast for the Fed's key rate suggests its likely increase from 0.25% to 0.5% at the December meeting. At the same time, the euro area and the UK are projected to restrain from any rate hike in the final months of the year.

**Copper prices**, as global industrial bellwether, are in a bearish zone, reaching the lowest level since the 2009 crisis (Figure 14). The bearish trend in the copper and other metals markets is set to intensify.

**Summary surprise indicators** of macrodata for advanced and emerging economies show, according to Citi, a mixed trend. The ensuing synchronisation of indices around zero indicates a decline in both volatility and the *surprise effect* in macroeconomic data. The US and the whole of developed countries posted a worsening in the indicator, while

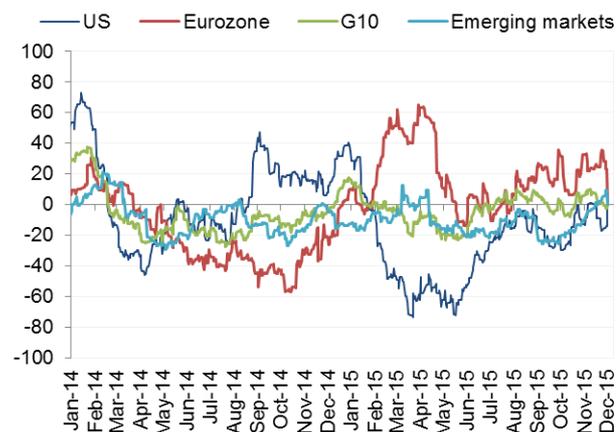
the releases of the eurozone and emerging market statistics were more often above expectations. The latter case is probably associated with the Chinese economic data.

Figure 14. Copper price, \$/tonne



Source: Bloomberg

Figure 15. Surprise indices in macrodata releases for US, eurozone and developed and emerging markets



Sources: Citi, Bloomberg

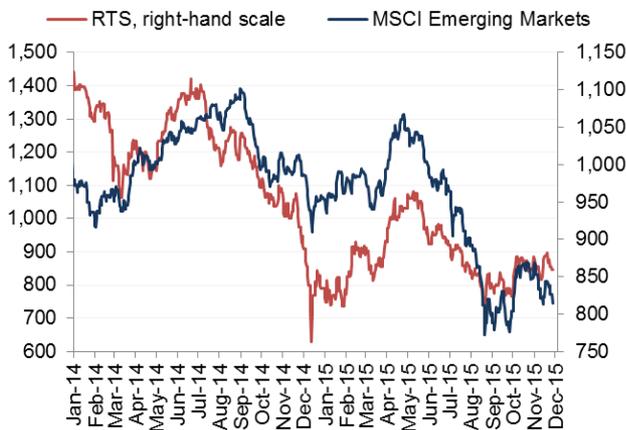
### 1.1.2. Financial markets: moderately negative on a fading global growth and Fed standpoint

By late November, the financial market situation was moderately negative on concerns over a slowdown in China. The US Fed assurances about the smoothness in the 'normalisation' of interest rates failed to reverse the trend.

In November, global financial markets showed a variety of trends, the negative one prevailing. The US and Asian stocks showed some positive movements, largely on expectations for a smooth growth in the US rates and recovery of the world's largest economy. Stock indices in the European countries closed the month in negative territory, mainly due to the weaker euro. The eurozone currency continued its weakening against the dollar, driven by the expected expansion of the easing policies of the ECB, unsatisfied with the current inflation dynamics in the eurozone.

In the past month, the dollar gained 4% on average against the currencies of emerging and developed markets. The strengthened dollar impacted also on the commodity markets, especially on oil quotes. Brent crude dropped over the month by 10%, copper and nickel fell 10-11% and platinum and palladium fell more than 15%.

**Figure 16. RTS and MSCI EM**



Source: Bloomberg

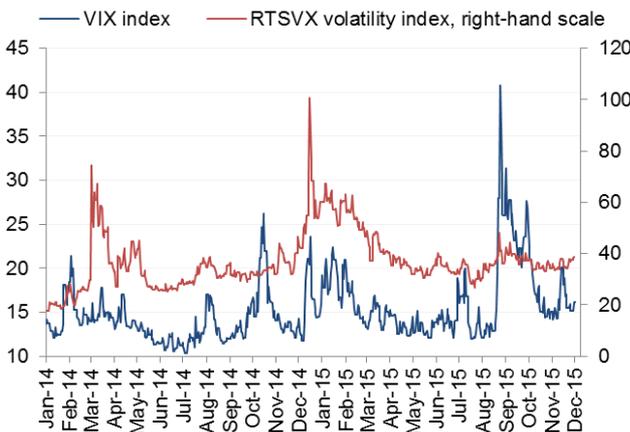
**Figure 17. S&P500 and Eurostoxx50**



Source: Bloomberg

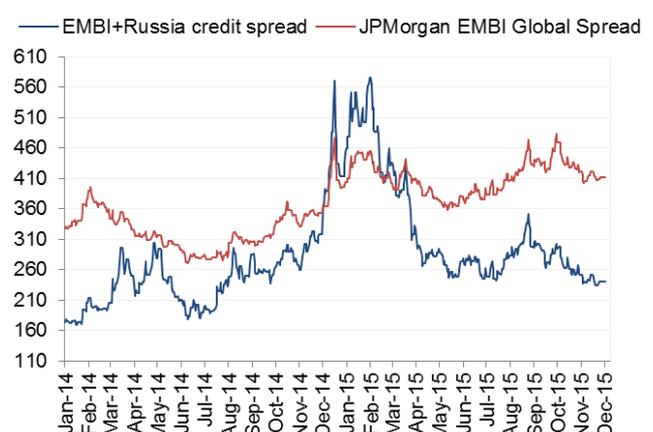
Contrary to the downward trend seen in several emerging markets and commodity markets, the Russian stock market posted strong growth on market expectations of tighter cooperation between Russia and the Western countries over Syria, as well as possible early lifting of the West-imposed sanctions. The Russian aircraft incident on the Syria-Turkey border led to a rising scepticism in regard to the NATO and Russia relations. The recent events were nonetheless not impactful on the RTS index path.

**Figure 18. VIX index (S&P500) and RTS volatility index (RTSVX)**



Source: Bloomberg

**Figure 19. EMBI+Russia and JP Morgan EMBI Global spreads**

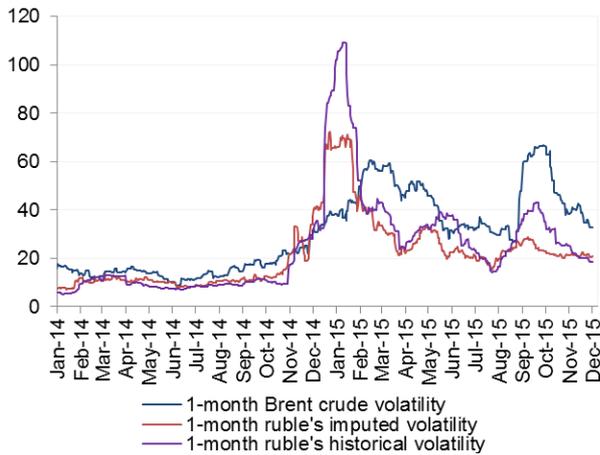


Source: Bloomberg

For the bond market, additional impact came from the Bank of Russia Board decision, in late October, to leave its interest rate unchanged. GKO-OFZ yield curve shifted down. The movement in the long part of the curve was especially strong, leading to a stronger invertedness of the curve. Credit spreads of the Russian bonds continued to decline in sync with that of developing countries.

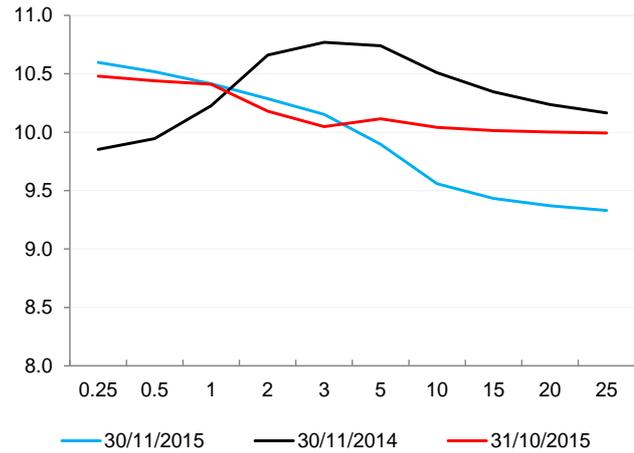
Volatility in financial markets exacerbated by mid-November, but subsided to the levels of late October by the end of the month. Expected ruble volatility remaining unchanged, the monthly realisation of oil and ruble volatility receded. Meanwhile, the annual ruble to oil correlation began to subside substantially, for the first time this year.

**Figure 20. Anticipated USD/RUB exchange rate volatility**



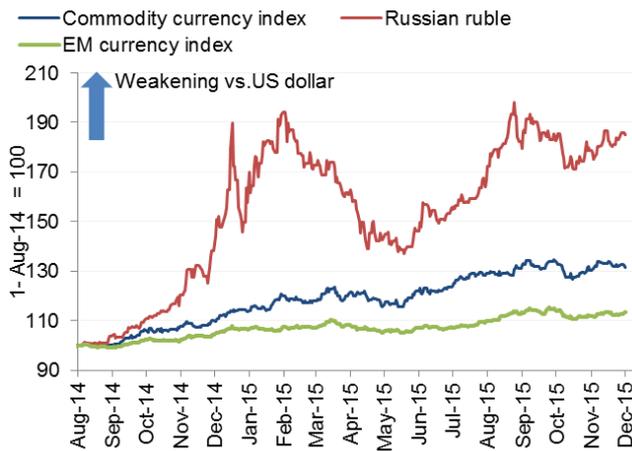
Source: Bloomberg

**Figure 21. GKO-OFZ yield curve, %**



Source: Moscow Exchange

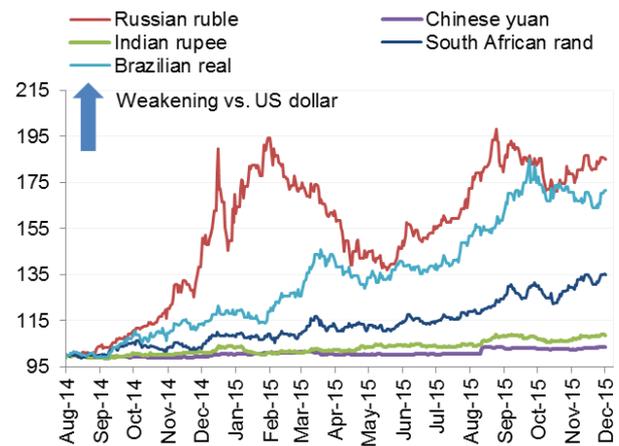
**Figure 22. Exchange rates of emerging economies, commodity currencies (1 August 2014 = 100)**



Commodity currencies: New Zealand dollar, Norwegian krone, Australian dollar.

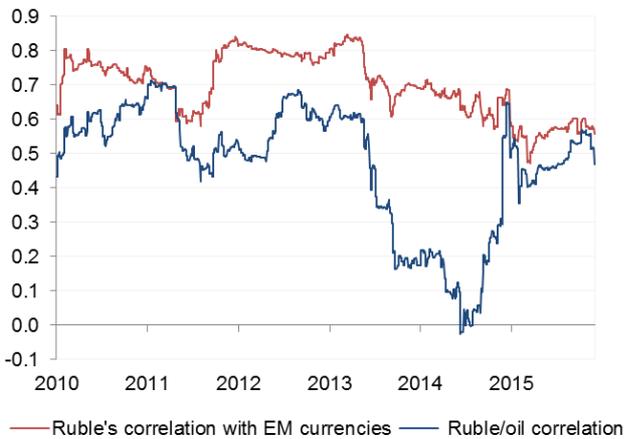
Source: Bloomberg

**Figure 23. BRICS exchange rates (1 August 2014 = 100)**



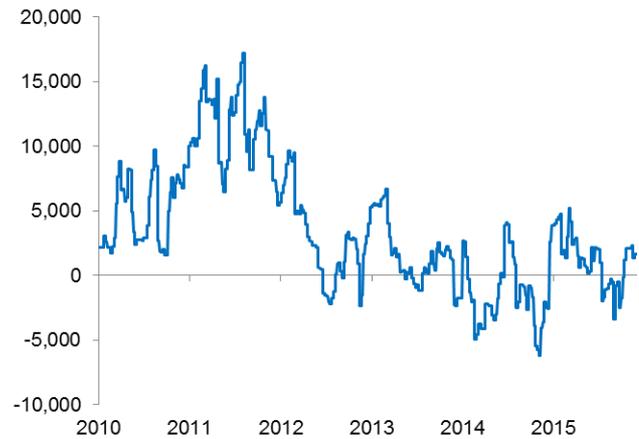
Source: Bloomberg

**Figure 24. Ruble's 12-month correlation with emerging economies' currencies and oil**



Source: Bloomberg

**Figure 25. Net short position for ruble futures**



Sources: Bloomberg, Bank of Russia calculations

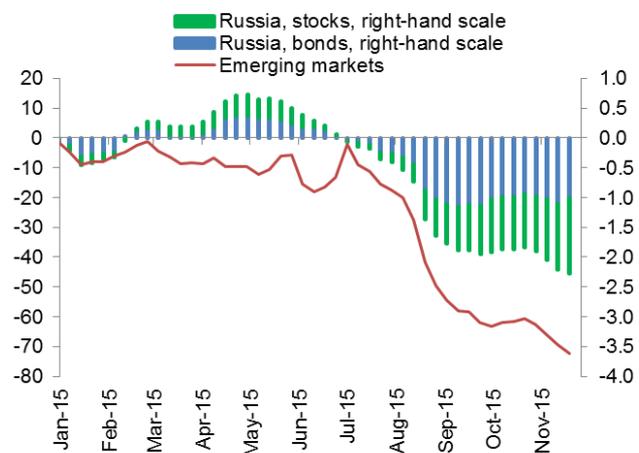
The data on cash inflows and outflows into/from the Russian and emerging countries' funds in November pointed to a reversal to outflow in November, repeating the September pattern. In four weeks from 29 October to 25 November, the outflow of Russian stocks and bonds totalled \$448 million, of which the greatest contribution came from debt instruments, while shares showed a significantly lower outflow (\$60 million, after the inflow of \$186 million in October and \$255 million in September). In general, the outflow of funds from emerging markets continued in November and amounted to \$11.7 billion, after the inflow of \$1.2 billion in October and the outflow of \$19.9 billion in September. The largest share in the outflow fell on shares (53%). In September, the proportion of shares was higher at 61%.

**Figure 26. Cash flows into Russian and EM funds (accrued, '+' – inflow), billions of US dollars**



Sources: EPFR Global, Bloomberg

**Figure 27. Cash flows into Russian and EM funds (accrued, '+' – inflow), billions of US dollars**



Sources: EPFR Global, Bloomberg

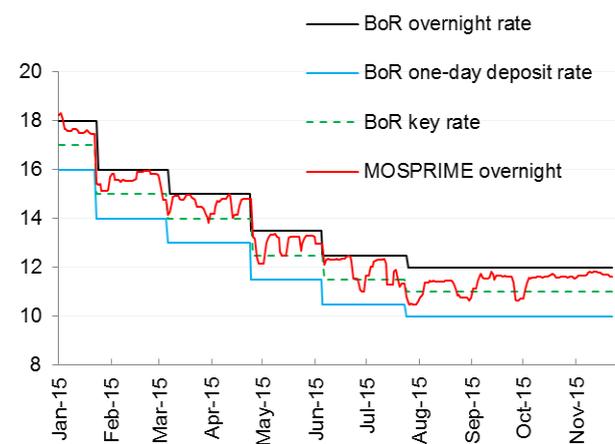
**Expectations over the risks related to liquidity and BoR monetary policy stabilised.** The FRA3x6 and 3M Mosprime spread fluctuated in November in the range of 0 - -100 bp (Figure 28), reflecting the market assessment of the Bank of Russia's monetary policy. Short-term rates in the interbank credit market throughout November lingered at the upper bound of the corridor (Figure 29).

**Figure 28. FRA3X6 and 3M Mosprime spread, % p.a.**



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

**Figure 29. BoR interest rate corridor and short-term interbank lending rate**



Sources: Bank of Russia, Bloomberg

### 1.1.3. Commodity markets: firm downward price movements

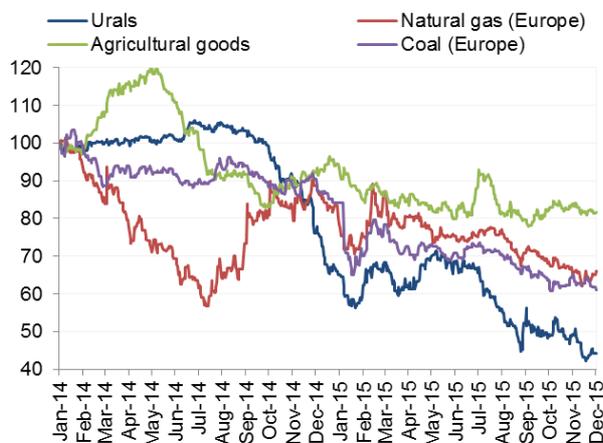
In November, the decline in prices for basic commodities and metals continued showing the necessity for a production restraint decision and also on the back of the strengthened US dollar. The data on mining and hydrocarbon reserves in the United States are still putting pressure on prices. OPEC countries maintained production, competing with Russia for the European market, and may well boost production even further in 2016. Prices may be impacted by the 4 December OPEC meeting results. The position that the supply factors are key to the downward trend is contested by the Bank of England, which is making the case for a softer policy.

In November, prices for basic commodities and metals showed a downward trend. They rebounded somewhat at the end of the month as a result of rising geopolitical risks related to the Syria attack on the Russian aircraft, but this appears to be temporary. The Bloomberg Commodities Index fell this month by 8% to its lowest level since 1999.

The oil price may linger below \$50 a barrel for a long time before it starts to recover. The Baltic Dry Index, which shows the demand for large-tonnage dry and liquid bulk shipping, fell on 20 November to an absolute all-time low.

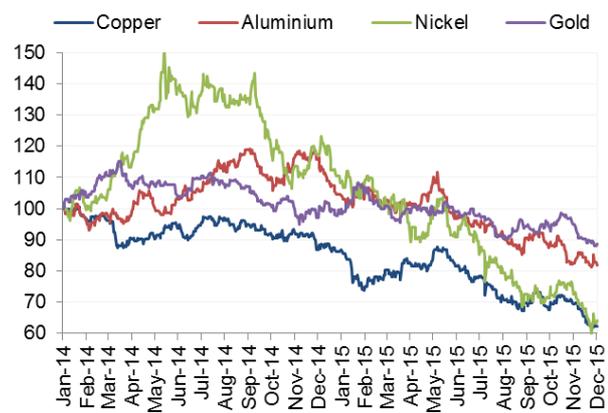
In most markets, investors view the current situation as overproduction and wait for production restraint decisions. The number of WTI crude contracts, with a marked negative trend, is five-year low. Investors are unsettled by the current dynamics in China's economy and the risks of its further slowing, particularly in connection with a sceptical perception of the authorities' easing policies and their efficacy. Significant pressure on prices comes from the US dollar strengthening on growing expectations for a Fed rate hike this December.

**Figure 30. Commodity prices (January 2014 = 100)**



Source: Bloomberg

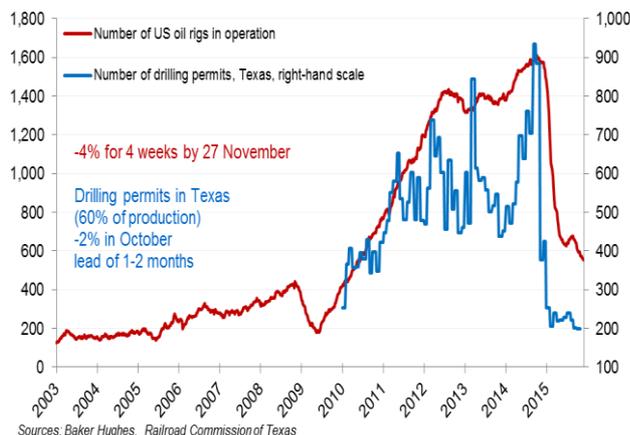
**Figure 31. Metal prices (January 2014 = 100)**



Source: Bloomberg

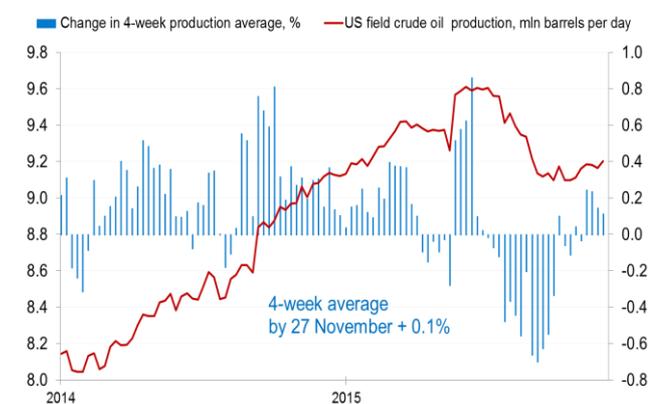
Hydrocarbon production and their inventories in the US remain high. Despite the declining numbers of field production permits and drilling rigs in operation (Figure 32), November output maintained at a steadily high level (Figure 33), and the commercial crude stockpiles are very close to the historical maximum of April 2015 (Figure 34).

**Figure 32. Number of oil rigs and drilling permits in Texas**



Sources: Baker Hughes, Railroad Commission of Texas

**Figure 33. US field crude oil production**



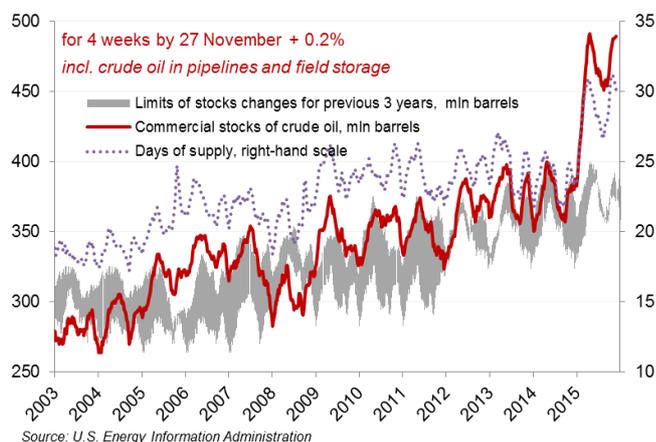
Source: U.S. Energy Information Administration

In its November bulletin, the International Energy Agency (IEA) upgraded its US oil production forecast for 2015 from 9.2 to 9.3 million barrels a day, in a sign that it expects the current production levels to maintain through the end of the year. The stable oil production in the US is driven by the shift of costs from development to production and the upstream operations in the best brownfields, as well as continued production efficiencies and price hedging by shale oil producers. According to Bloomberg, the hedged share of output in 2015 fell significantly against 2014, but such share remains high, up to 80%, in a number of companies, breaking the expectations for a quick US field production decline.

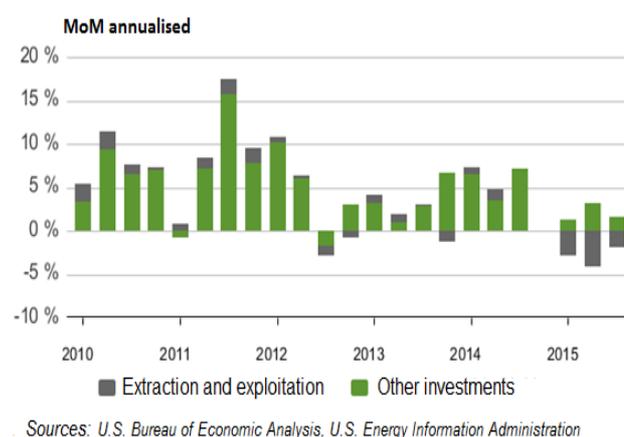
At the same time, the decline in US production in 2016 appears inevitable: the IEA forecast downgraded from 8.9 to 8.8 million barrels a day. Investment in the US oil sector in the third quarter of 2015 fell in real terms to its lowest level since 2009 (foreign investment change industries – Figure 35), major asset write-offs occurred for a fourth consecutive quarter, including brownfields, because of low field future productivity estimates.

The IEA suggests that the peak of global oil reserves fell on the second quarter of 2015 (2.0 million barrels a day). In 2016, the oil glut is on the course to shrink to 0.4 million barrels a day. Such estimate is broadly in line with the OPEC forecast presented in the November monthly bulletin (the OPEC forecast was unchanged vs. the previous month). The OPEC bulletin indicated that the oil price slump caused projects of 5 million barrels a day to be either deferred or cancelled.

**Figure 34. US commercial stocks of crude oil**



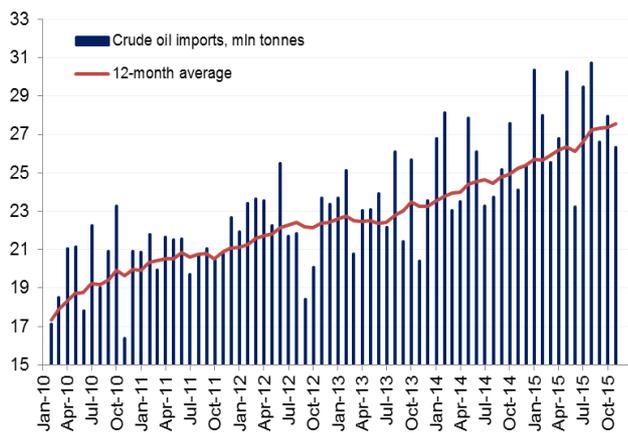
**Figure 35. Foreign investment in the US**



Amid the rising crude stockpiles, market participants have renewed fears about a possible exhaustion of the available crude storage capacity in the United States. According to our estimates based on IEA data on current crude storage capacities and stockpile dynamics, the US spare capacity is still about 35%, and the Christmas season (mid-December through early January), with its usually stronger road traffic, is set to lead to stock reduction.

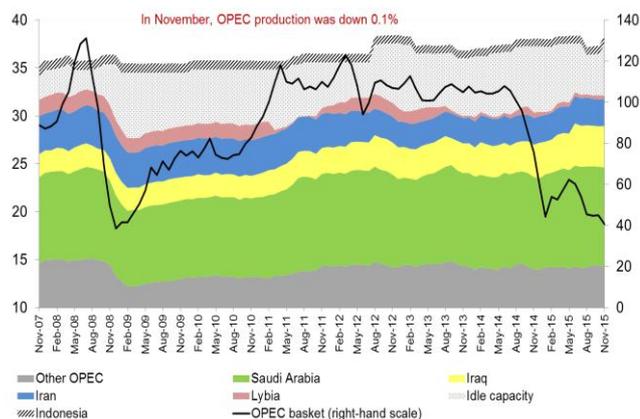
The factor on the demand side, which renders relative support to oil prices, is still data from the Asian region. The twelve-month average oil imports to China are growing, although their growth paces are shrinking (Figure 36). In October, according to Bloomberg, China has seen a significant decrease in stocks of oil products (to the mid-2014 level), while India posted a significant increase in their consumption.

**Figure 36. Crude oil imports to China**



Sources: U.S. CFTC, Bloomberg

**Figure 37. Crude oil production (mln barrels a day) and OPEC basket price, \$/barrel**



Sources: Bloomberg, OPEC

According to Bloomberg, OPEC in November reduced the volume of production insignificantly, and it remains well beyond the approved quota (Figure 37).

Libya intends to resume development of several oilfields with the production of 0.45 million barrels a day. According to The New York Times, Iraq, which ramped up production by 1 million barrels a day over the past year, is actively dumping to undermine Russia and Saudi Arabia as its rivals in the European market (the discount may total up to \$5 a barrel).

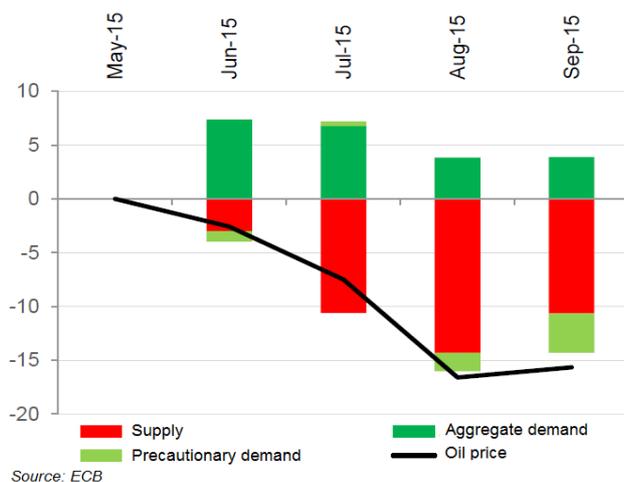
Competition for Russia is set to become even tighter once the lifting of sanctions materialises and Iran returns to its traditional market. The country looks to increase production by 1 million barrels a day. This jeopardises the national budget revenue.

The Russian government said that they were ready for an increase in discounts on Urals and would 'fight for their market in Europe'. Russia, in its turn, is ousting Saudi Arabia from the Chinese market. Russia was the number one oil exporter to China in May and September; Saudi Arabia regained the lead in October.

Venezuela's oil minister admitted that a decrease in oil prices to the level of \$25 a barrel is possible unless OPEC intervenes. Against this backdrop, Saudi Arabia, which suffers more than others from lower oil prices, as its riyal is pegged to the dollar, said that the country stands ready to discuss action aimed at stabilisation in oil prices jointly with other producers. However, the production restraint decision to be made at the forthcoming 4 December OPEC meeting seems unlikely.

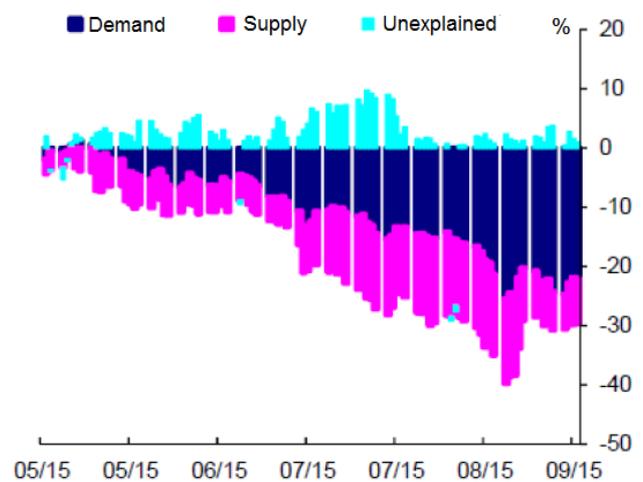
In Europe, the debate about the causes for the negative oil price dynamics is growing. The conventional standpoint that the demand factors (Figure 38) are dominant is questioned by the Bank of England (BoE) estimates contained in its November inflation report. These claim that for the last six months, about 2/3 of the oil price movements are explained by the demand factors including the expected weakening of economic growth (Figure 39), with an approximately equal contribution of factors over one year's horizon. The Bank of England suggests that this should be the argument for a relatively loose monetary policy as major central banks of the world make decisions on their rates.

**Figure 38. Downward oil price drivers decomposed, pp (accrued)**



Source: ECB  
 \* ECB calculations based on SVAR model  
 Source: ECB presentation by Peter Praet, 6 November 2015

**Figure 39. Downward oil price drivers decomposed by the Bank of England, pp (accrued)**



Sources: ECB presentation by Peter Praet, 6 November 2015, Bank of England  
 \* BoE calculations based on price comparisons across 200+ assets

## 1.2. Russia's economic development: stabilisation on the back of 'traded' sectors

### 1.2.1. Economic activity stabilised in the third quarter

Rosstat GDP data released on 12 November speak for **stabilisation in the Russian economy in the third quarter**, following four consecutive quarters of GDP decline. Rosstat estimates (first estimate) the drop in GDP to total 4.1% YoY in the third quarter, exceeding both market analysts' expectations (4.4% according to a Bloomberg survey) and the BoR Research and Forecasting Department (R&F) nowcasting model-based estimate (5.0%). According to R&F tentative calculations, which are based on Rosstat's first estimate of annual GDP growth in the last quarter, quarterly GDP growth in the third quarter was 0.1%, seasonally adjusted.

Our understanding is that Rosstat-highlighted stabilisation in economic activity may be related to, including other factors, **the possible onset of a recovery trend in inventories**. The inventories in 2015 largely surpassed GDP growth rates, which could be attributable to excessively low expectations of economic agents in the first half against the depth of the fall in aggregate demand. A more detailed explanations for the sources of GDP movements in the last quarter will be available once Rosstat releases its first estimates of GDP data (10-11 December) and GDP utilisation data (30-31 December) in the third quarter.

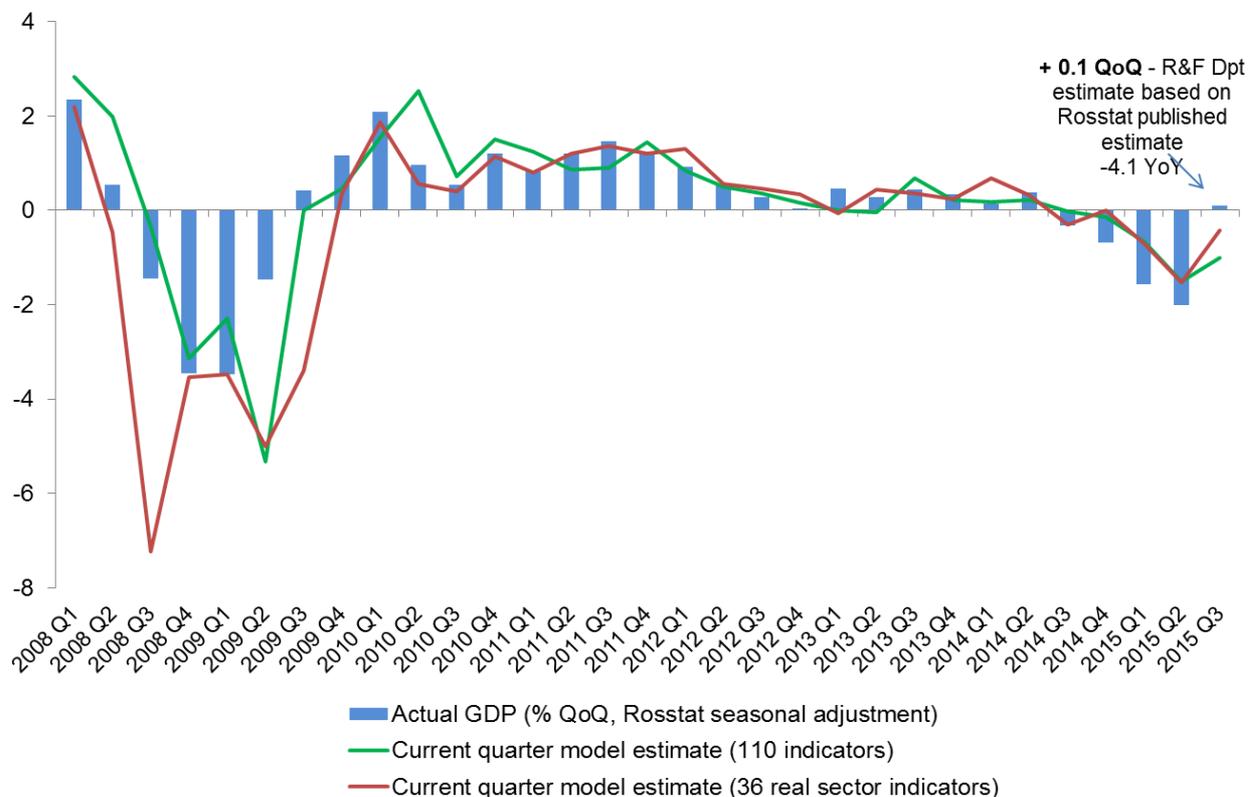
Rosstat data for Q3 GDP factored in, the probability has grown that **annual GDP readings will be better than expectations**. This may happen if eventually Rosstat GDP estimates for the third quarter see no substantial downward adjustments, and the economic activity for the October to December period remains steady or improves.

We believe that re-evaluation of the downturn in the Russian economy in the third quarter, according to our model calculations as compared to the official Rosstat estimate, may be explained as follows.

First, statistical methods are known for their poor capture of structural shifts in an economy, including growing employment in the shadow sector, which reflects overall **expansion of the shadow sector**. According to Rosstat, shadow employment increased from 18.9% of total employment in 2014 YoY to 21.3% in the first half of 2015. The nowcasting model-used indicator framework, as is the case of many other models, is focused on the 'formal' economy, which is why it underestimates the soothing influence of the shadow sector on GDP in the time of recession.

*Second*, the leading indicators in the nowcasting model have yet to justify their properties, indicating that a significant downturn continues into the third quarter. In this case we refer to survey data and business performance indicators in the financial sector, especially oil prices. This suggests either **diminishing predictive properties of leading indicators**, including due to possible adaptation of the Russian economy to low oil prices, or **an increase in the time lag for leading indicators to reflect their effect on GDP**.

**Figure 40. Actual Russian GDP growth rates in constant 2008 prices and short-term estimates for current growth rates based on R&F Department historical data model, % QoQ (seasonally adjusted)**



Sources: Rosstat, R&F Department calculations

However, the retrospective calculations made with the use of a dynamic factor model featuring a wide range of indicators (110 variables), as a basis for the Research and Forecasting Department to make short-term model estimates and GDP projections, indicate that the evaluation of the current quarter GDP based only on the real sector's variables (36 variables) was in some cases more accurate. This was also the case in determining turning points in business activity (Figure 40).

In such a way, the real sector performance pointed more accurately to a sharp slowdown in the economy in the acute phase of the global crisis of the second half of 2008, as well as to a more upbeat assessment of GDP dynamics in the previous quarter, which proved to be closer to the first Rosstat-published estimate. Having this in mind, the economic recovery in the second half of 2009 was, for example, accurately predicted through a wider range of variables, including surveys and financial performance. For the remainder of the periods, the predictive value of the models featuring a full set of explanatory variables and those including the only real sector indicators was about the same. This

supports the assumption that **the predictive power of the survey-based performance is quite unstable in time.**

### ***1.2.2. Business activity in manufacturing in November: weakly upward dynamics***

**The November survey of PMI in the manufacturing industry offered a mixed presentation.** The seasonally adjusted output of finished products continued to improve for a sixth consecutive month, reaching a year-high and settling steadily in positive growth territory. On the other hand, the sector continued to decline in employment and inventories of raw materials against the background of an accelerated fall in export demand. For now, it would be premature to conclude convincingly that the mid-term downward trend in manufacturing industries has stopped.

In our opinion, **a slow growth in manufacturing is highly likely to continue.** This is proved by the growing number of orders, which has accelerated in November (except for export orders, which have fallen to a seven-month low), against the backdrop of shrinking inventories, although at a lower pace. In addition, manufacturing is a **'tradable'** sector generally benefitting from a weaker ruble and falling imports. Manufacturing is unlikely to show any significant acceleration in growth in the next few months, with key deterrents including the ongoing decline in export demand and the Russian industry's slow adaptation to the new environment.

Compared to late 2014, the PMI readings for output and demand are lower for this year. Seasonally unadjusted values are below 50 points. This might suggest changed PMI seasonality, triggered by structural shifts in the economy. If this is the case, PMI may paint an overoptimistic picture of the real situation in manufacturing.

### ***1.2.3. Industrial output in October: a frail hope of recovery***

**The October industrial output statistics give some reasons to hope that the phase of a slow post-stagnation recovery is approaching.** The analysis of the trend component data<sup>1</sup> by industry group reveals a minor growth in October 2015 in investment and intermediate goods, which was still lower than in September. The output of consumer goods exposed a slight decline. However, the high volatility of short-term indicators, usually amplified in the periods of economic crises, calls for a cautious treatment of the monthly released indicators.

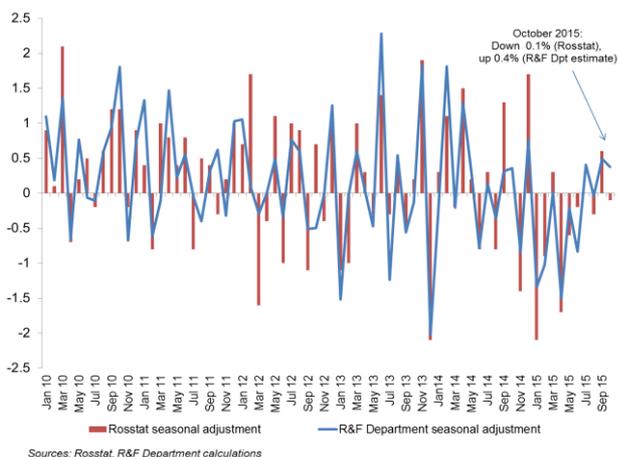
October's Industrial output data were somewhat worse than in September. Based on Rosstat-made seasonal adjustment, industrial output fell by 0.1% in monthly terms for October, although under R&F estimates the growth rate was 0.4%. In the past few months we have seen quite noticeable differences in the monthly estimates for growth in

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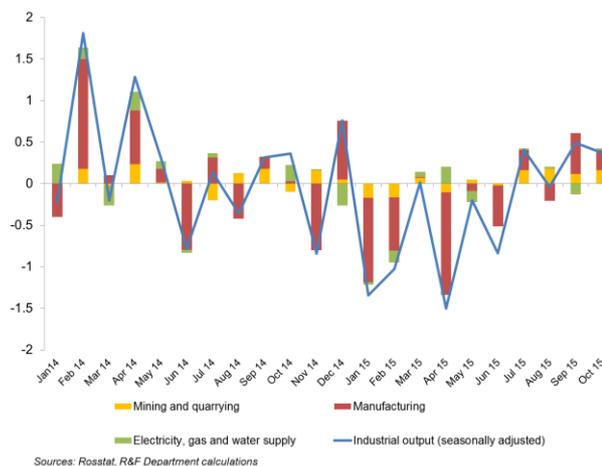
<sup>1</sup> The industrial output index by industry group is calculated on the basis of industrial output indices weighted by this industry's share in the 2010 value added structure.

quite a number of key short-term macroeconomic indicators; these were determined by various methods of seasonal adjustment, which also adds large uncertainty to the estimates (Figure 41).

**Figure 41. Industrial output, % MoM (seasonally adjusted)**



**Figure 42. Contribution of individual components to industrial output index, % MoM (seasonally adjusted)**



It is important to note that industrial output was growing in September largely thanks to the positive monthly dynamics in the manufacturing sector, which in its turn is explained, among other things, by the short-term support to the production of ‘tradable’ goods resulting from the weakening ruble in the third quarter. Although October industrial output data look somewhat more muted than those of the previous month, we expect a more convincing stabilisation in industrial activity on the way.

*First*, the manufacturing sector showed a positive trend for the second month in a row for the first time since 2014. *Second*, October’s growth in production, adjusted for seasonality, was observed, according to our estimates, across all major types of economic operations, while September’s indicators were multidirectional, showing a steady growth in the manufacturing sector against the backdrop of shrinking electricity, gas and water supply (Figure 42).

In terms of product categories, a small increase in the volume of **investment goods** in October occurred thanks to growth in individual types of machinery and equipment (mechanical equipment, machinery/equipment for agriculture and machines) and certain types of transport equipment (mainly ships, aircraft and spacecraft).

The critical factors of these dynamics include the decline, as follows from Rosstat data, in production companies’ residual stock for certain types of goods (machines, trucks) and the execution of the state defence orders, together with import substitution policies in the machine tool industry and agricultural machinery. Increased output of machinery and equipment was also due to the production of household appliances, which should normally be classed as consumer goods, but it is not possible for the lack of statistics on the share of gross value added of this product category in manufacturing.

The other components of the investment sector production index (other nonmetallic mineral products, electrical equipment) showed negative growth.

The electrical equipment industry's potential is currently unable to fully meet import substitution targets.

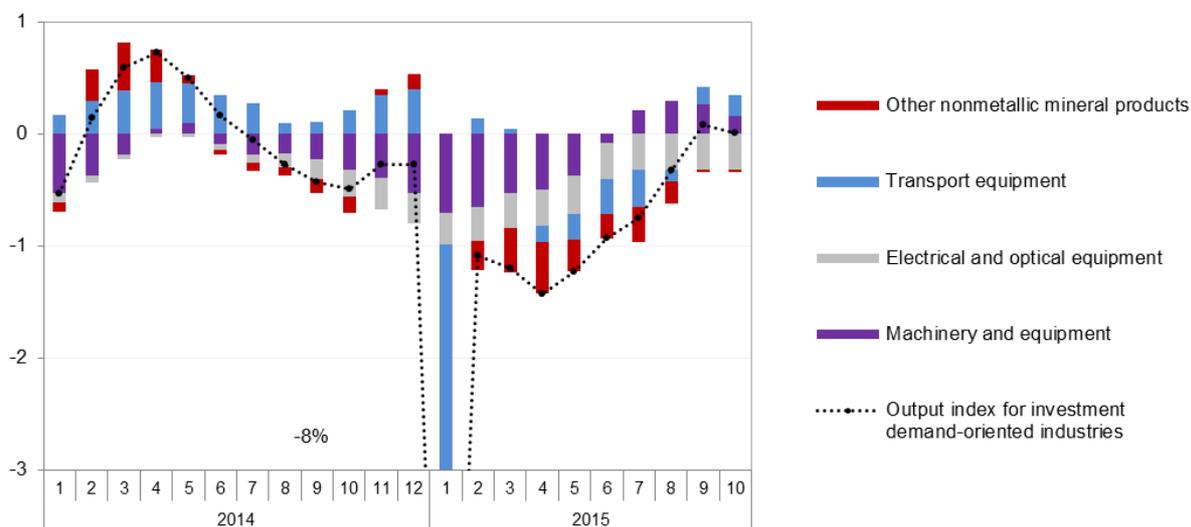
The production of other nonmetallic mineral products (construction materials) is adversely affected by the negative trends in construction as their underlying consuming sector.

The trend component of the output index for **consumer demand-oriented industries** moved into negative territory, a change following their residing in positive territory between June and September. This is due to the slowdown in the food industry output and the decline in the amounts of durable consumer goods (furniture, clothing and footwear).

**The intermediate demand-centred industries** retained chemicals as their key growth driver in October.

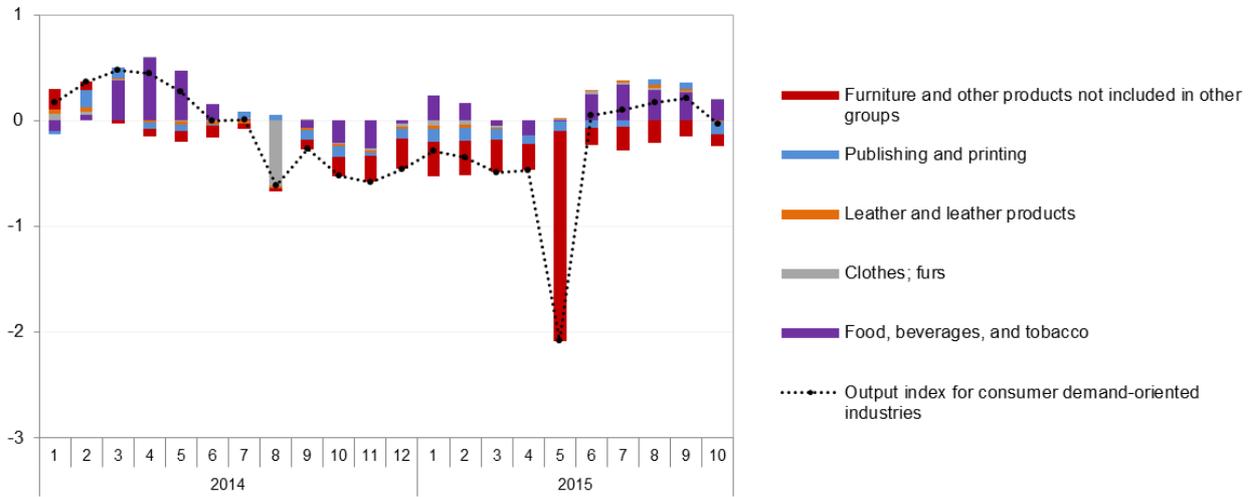
Yet, it was metallurgy that has been the key growth driver since early this year. The metallurgical industry is under pressure from low domestic demand in the construction sector and engineering enterprises. In October, both the volumes of metallurgical production and fabricated metal products declined, which made a negative contribution to the slowing trend component in the intermediate demand goods index.

**Figure 43. Output index for investment demand-oriented industries (trend component growth rate), % MoM**



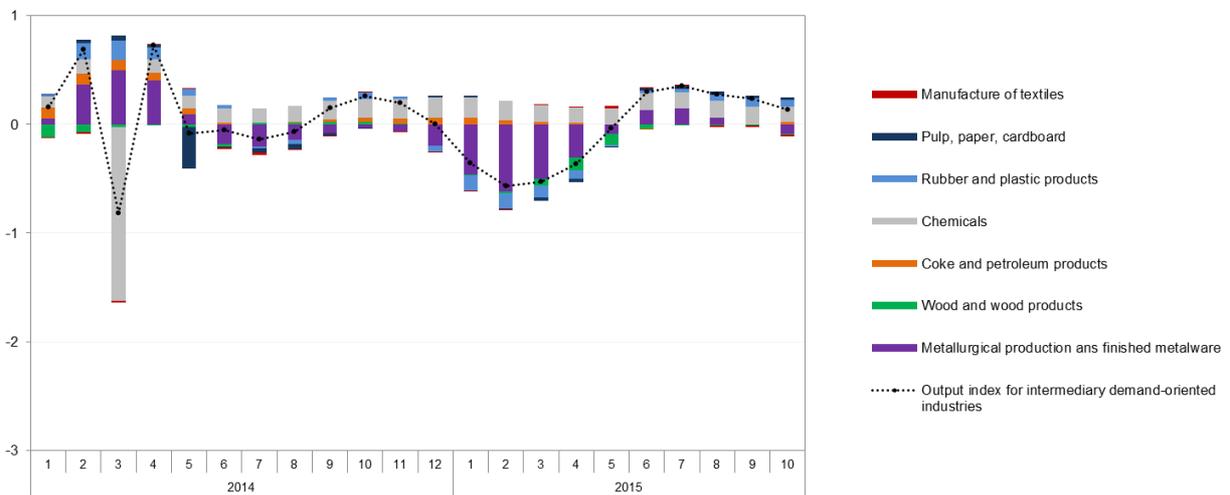
Sources: Rosstat, R&F Department calculations

**Figure 44. Output index for consumer demand-oriented industries (trend component growth rate), % MoM**



Sources: Rosstat, R&F Department calculations

**Figure 45. Output index for intermediary demand-oriented industries (trend component growth rate), % MoM**



Sources: Rosstat, R&F Department calculations

### 1.2.4. Decline in investment and consumption is ongoing

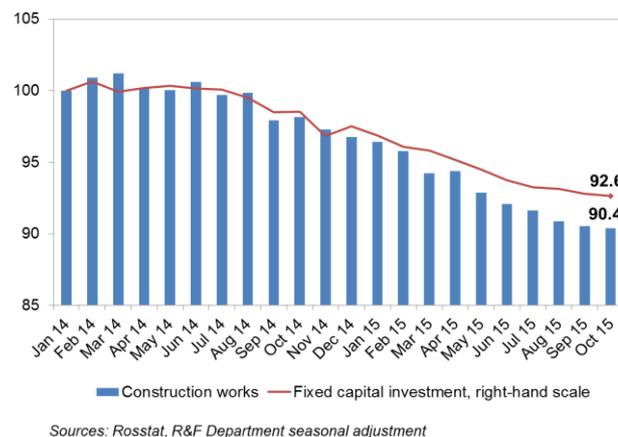
It would be premature to announce that the Russian economic downturn has passed its bottom – despite the slowing rates of decline in fixed capital investment.

The behaviour pattern of fixed capital investment in recent months has gradually stabilised over the last few months: seasonally adjusted reduction in investment in October totalled 0.2% against 0.4% in September.

**Figure 46. Cement production and fixed capital investment (January 2014 = 100, seasonally adjusted)**



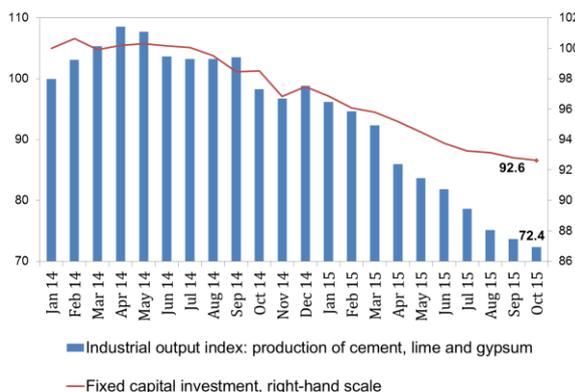
**Figure 47. Construction works and fixed capital investment (January 2014 = 100, seasonally adjusted)**



Business indicators in the construction and cement production sectors, which we consider as leading indicators for the pattern of investment, continued to decline slightly, albeit much slower than in the first half of the year (Figure 46 and Figure 47).

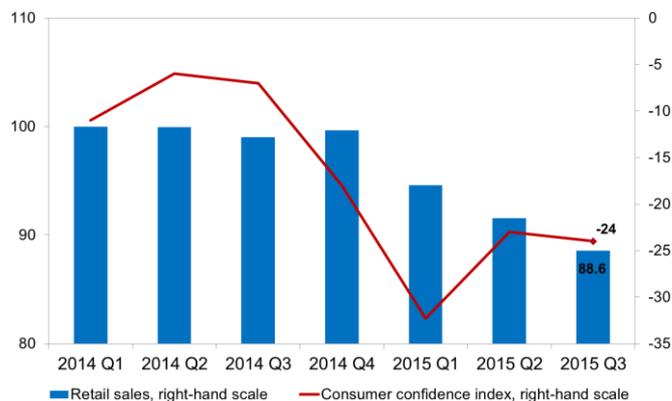
In October, contraction of consumer activity persisted. The low growth in real wages was among other factors driving a sustained fall in retail sales (Figure 48). Rosstat's assessment of consumer confidence index was slightly better than our tentative assessment based on the Ivanov index by Sberbank CIB, posting only a drop of one point against Q2. Moving forward, we expect stabilisation in consumer confidence index provided that financial markets maintain stability (Figure 49).

**Figure 48. Retail sales and real imputed wages (January 2014 = 100, seasonally adjusted)**



Sources: Rosstat, R&F Department seasonal adjustment

**Figure 49. Retail sales (January 2014 = 100) and Rosstat consumer confidence index<sup>2</sup>**



Sources: Rosstat, R&F Department seasonal adjustment

### 1.2.5. The car market: accelerated drop in sales in October, again

The AEB-published October data on new car sales (passengers cars and commercial vehicles) in the Russian Federation show an **accelerating annualised market decline**, owing to the high base effect of late 2014 (Figure 50), in line with the R&F predictions contained in one of its previous weekly newsletters. Sales fell by 38.5% against last year's October.

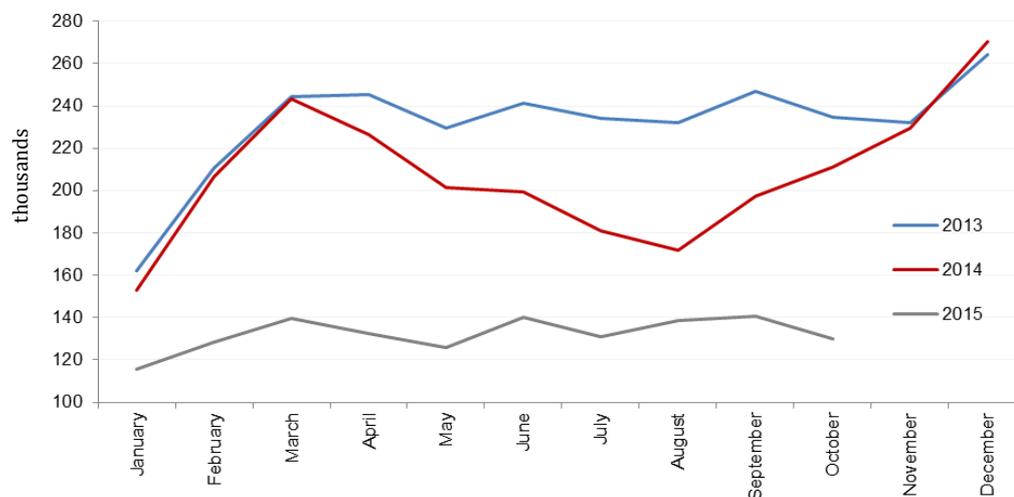
October also saw **demand contraction** as compared with the previous month (-7.3% seasonally adjusted, according to the R&F estimates). Most likely, this contraction resulted from a temporary increase in sales in August and September 2015, at the expense of future periods as we observed the double-dip ruble depreciation. In the first ten months of 2015, the new car market, including commercial vehicles, fell in terms of number by 33.6% YoY.

According to the R&F Department, **annualised sales of new cars are set to deteriorate through November and December**, reflecting both the high base effect and potential further contraction in domestic demand.

A 22.8% YoY contraction in the exports of passenger cars in the first eight months of 2015 provides evidence that **domestic producers missed** the opportunities, available from the weakening of the ruble, **to expand supplies to foreign markets** (Figure 51).

<sup>2</sup> In the R&F Department estimate of Rosstat's consumer confidence index for Q3, the data of the Ivanov index by Sberbank CIB were factored in; these exposed a ten-point decline in consumer confidence vs. Q2.

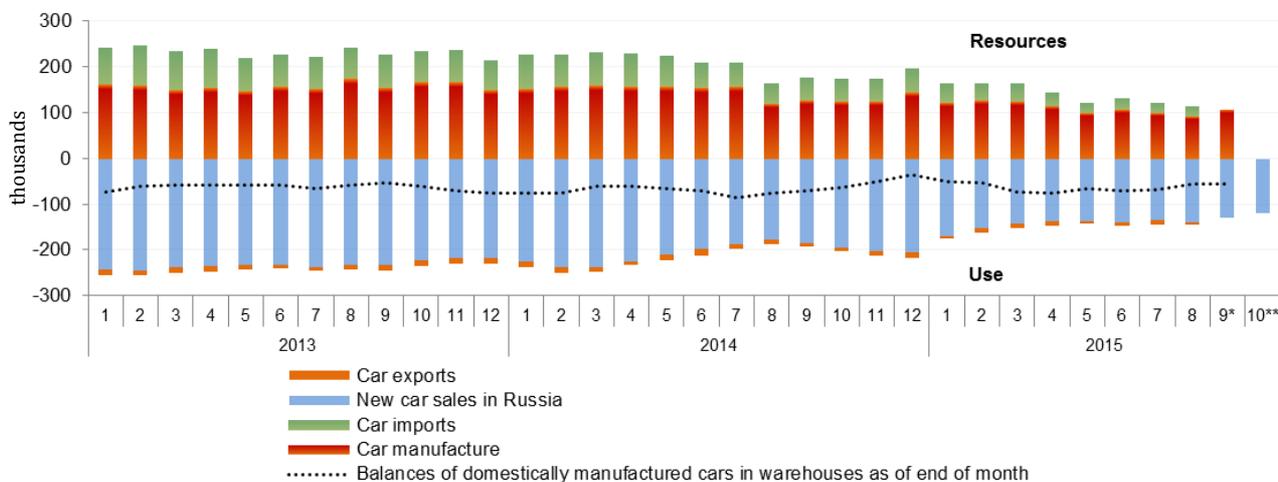
Figure 50. New car sales



Source: AEB

Supply is falling to match the pattern of demand, while the domestic production is declining at a rate slower than car imports: for the first eight months of 2015 the annualised number of manufactured passenger cars dropped by 28.3%. Imports in the same period contracted 52.7%. As a result, we observed **a growing contribution of domestic car assembly to the total supply in the domestic market, i.e. import substitution.**

The growing demand of August and September 2015 was met on the back of reduction in the residual stocks of cars of domestic production. At the end of September, stocks in the warehouses were below the average seen for the period since 2010.

**Figure 51. Car resources and use of cars in Russia (seasonally adjusted)**

\* September 2015 exports and imports are not released.

\*\* October 2015 statistics include only sales data statistics.

Sources: CEIC, R&F Department seasonal adjustment

### 1.2.6. Budget expenditures for the three quarters had a neutral impact on real GDP growth

**Non-interest budget expenditures peaked on 1 October 2015. For the three quarters, budget expenditures had a neutral impact on real GDP growth, while such impact should become negative in the fourth one. The improved evenness of spending occurred thanks to the dynamic advance payments for government procurement.**

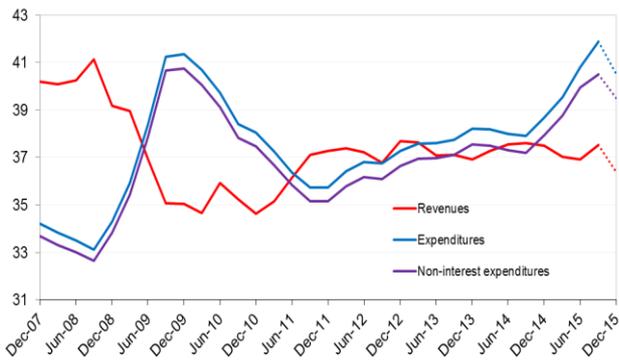
According to the Federal Treasury and the Economic Expert Group estimates for GDP, 12-month moving non-interest budget expenditures as of 1 October 2015 totalled 41% of GDP, exceeding the peak seen in the end of 2009 when large-scale anti-crisis measures were undertaken (Figure 52). By the year-end this indicator is expected to decline by 1.5 pp of GDP.

As of 1 October 2015, the evenness in budget expenditures remained higher than in previous years. For the January to September period, non-interest expenditures of the budget system totalled 37.2% of GDP, up 3.7 pp on the same period of 2014, which includes the estimated 1.0 pp achieved through enhanced evenness in expenditures.

According to the estimates based on the Federal Treasury data on economic classification of budget expenditure and Rosstat data on GDP by expenditure, in the first

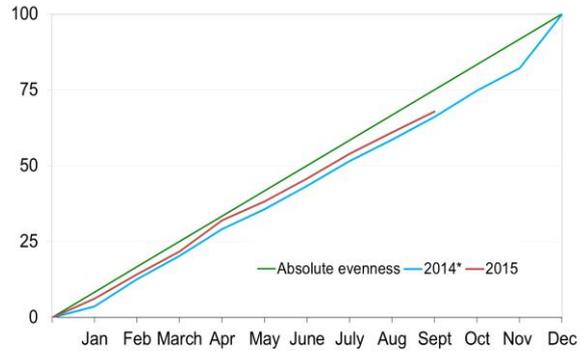
three quarters of 2015 the budget system expenditures had a neutral effect on real GDP growth. At the same time, we assume that enhanced evenness in government expenditures is connected with dynamic advance payments for publically procured goods and services, which is only partially transformed into actual growth of their production. In the fourth quarter of 2015, we can expect negative pressure from budget expenditures on real GDP growth.

**Figure 52. Budget revenue and expenditure (% of GDP, moving over 12 months)**



Sources: Russian Federal Treasury, Economic Expert Group of the RF Finance Ministry, R&F Department calculations  
 \* R&F Department forecast is shown in dotted line

**Figure 53. Evenness in budget expenditures (accrued, for the year)**



Sources: Russian Federal Treasury, Draft Budgetary Policy Guidelines for 2016-2018, R&F Department calculations  
 \* Excluding December's additional capital for the Deposit Insurance Agency

### 1.3. Inflation stays high, inflation risks go up

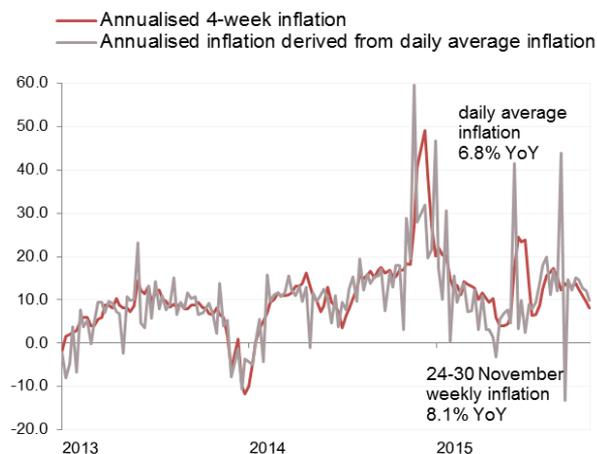
#### 1.3.1. Weekly consumer price growth has not yet slowed enough to reach the forecast downward inflation path

Weekly and average daily data-based current inflation indicators show a certain easing of inflation pressure. However, high inflation expectations and risks of geopolitical environment deterioration pave the way for persistently high inflation.

During the week from 24 November to 30 November 2015, consumer prices continued to slow. Consumer price growth stood at 0.1% WoW. Weekly and average daily data-based current indicators show an easing of inflation pressure. Daily average price growth declined to 0.022% from 1 November to 30 November 2015 (against 0.023% from 1 November to 23 November).

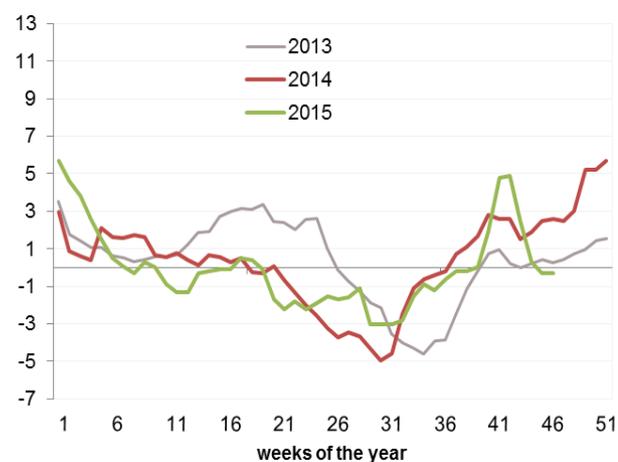
Seasonally adjusted annualised inflation (inflation calculated for a year ahead, proceeding from the average daily rate over the reporting week) was 9.9% YoY. Seasonally adjusted 4-week moving inflation went down to 8.1% (calculated for a year ahead), persisting at a high level (Figure 54).

**Figure 54. Weekly inflation based on prices for 64 goods and services, %**



Sources: Rosstat, R&F Department calculations

**Figure 55. Weekly price index for fruit and vegetables, % WoW**



Sources: Rosstat, R&F Department calculations

Weekly growth of consumer prices was 0.7% from the beginning of November (0.8% in October 2015). The main contributors to the weekly inflation hike were food products impacted by seasonal factors and higher cost of imports due to the ruble volatility. However, the contribution of fruit and vegetables to weekly inflation reduced sharply. It is likely to be indicative of accelerated inflation processes not related to seasonal factors. In order to reach the inflation target (4% YoY), the average monthly consumer price index should be 0.33% MoM.

As the 2015 seasonal profile of prices for fruit and vegetables shows, the price reduction cycle has shifted to earlier months as against 2013 data (Figure 55). Sizeable price

decrease in spring 2015 as against 2013 and 2014 was driven by domestic stock contraction and impact of the ruble appreciation on imported fruit and vegetables during that period. However, the bottom of the previous periods is not reached.

Import substitution returned the price dynamics for this group of goods to the trends seen in the autumn of 2013. Provided that there are no FX shocks, seasonal factor will determine the dynamics in December 2015. **Additional contribution of fruit and vegetables to the price growth is not expected to exceed 0.25 pp till the year-end.**

**The annual change in consumer price index by the year-end forecast by the Research and Forecasting Department remains unchanged (12.7% YoY).**

### ***1.3.2. Restriction of Turkish fruit and vegetable imports will step up inflation risks***

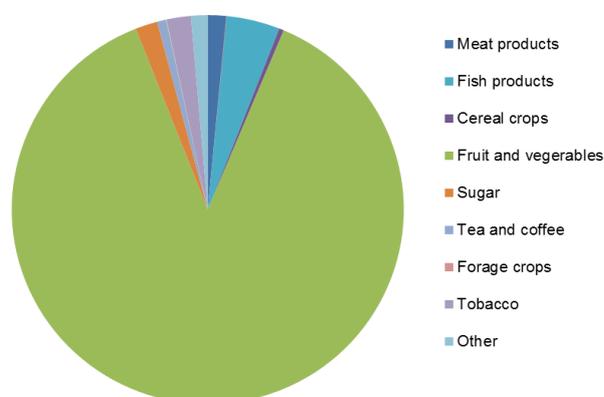
**Restriction of Turkish fruit and vegetable imports can trigger additional consumer price growth to 0.4 pp in 2015-2016. However, being a one-off price shock, the related price growth will not move inflation upwards in the medium term, unless inflation expectations deteriorate.**

According to 2014 data, fruit and vegetables have the highest weight in the structure of Turkish food exports (87.68% of the total food exports), followed by fish and fish by-products (4.40%), tobacco and tobacco products (2.01%), and sugar and confectionary (1.82%) (Figure 56). Restriction of food imports from Turkey challenges the Russian fruit and vegetable sector in the short term. Imports from Turkey currently account for about 5% of the total Russian home market of fruit and vegetables, while other food products have minor impact on the domestic food market (Figure 57). If price elasticity of goods supply stands at 1.3%<sup>3</sup>, the contraction in Turkish imports is expected to contribute to inflation up to 0.4 pp by late 2016. Tighter customs controls over all Turkish imports boost additional risks of price growth.

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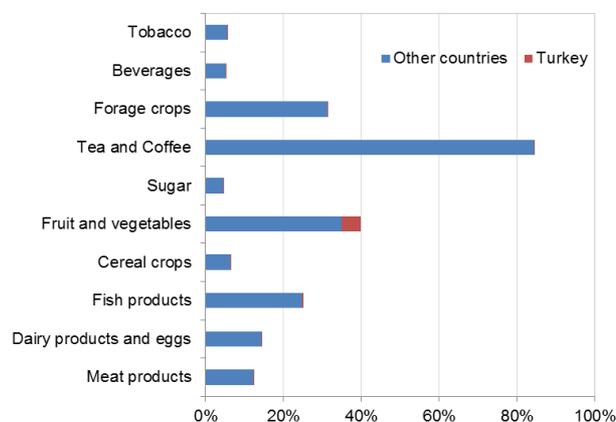
<sup>3</sup> The elasticity coefficient is based on the findings of Burggraf, Kuhn et al. (2015) Economic Growth and Nutrition Transition: an Empirical Analysis Comparing Demand Elasticities for Foods in China and Russia // Journal of Integrative Agriculture. Vol. 14 (6). Pp.1008–1022.

**Figure 56. Turkish food exports to Russia in 2014, %**



Sources: UNCTAD, R&F Department calculations

**Figure 57. Food imports in the total Russian market supply in 2014, %**



Sources: UNCTAD, R&F Department calculations

### 1.3.3. Pass-through effect on prices gained in momentum in 2014–2015

Following the decline in 2000-2008, the exchange rate pass-through effect on prices in emerging economies increased in 2014–2015. The pass-through effect in Russia is estimated at about 0.16 in 2014 – early 2015.

The exchange rate pass-through effect on the economy is an important parameter of the monetary policy when the share of imports in consumption is high. Nevertheless, it is difficult to correctly estimate the pass-through effect in Russia in 2015 because the period of the economy's functioning in the conditions of the floating exchange rate is not long enough.

For that reason, international organisations rarely include Russia in their panel models used to estimate the exchange rate pass-through effect and advise to look at similar transition economies. Estimates of the cumulative pass-through effect in these countries are given below (Table 1). The analysis of the listed empirical research papers allows to conclude on a weaker pass-through effect in emerging markets in 2000-2008 compared to 1970-1990 and a stronger pass-through effect in 2014-2015.

Econometric modelling shows that the exchange rate pass-through effect on consumer inflation is currently estimated at 0.16<sup>4</sup>. The pass-through effect lasts for about six months (Figure 58).

<sup>4</sup> The ruble exchange rate pass-through effect on the consumer price index was estimated through the time-varying parameter vector autoregression (TVP-VAR) to take account of structural changes in the economy and the transition to the floating exchange rate. Inflation, industrial production, average nominal USD/RUB exchange rate and the short-term interbank interest rate were used as key endogenous variables.

**Table 1. Pass-through effect in transition economies**

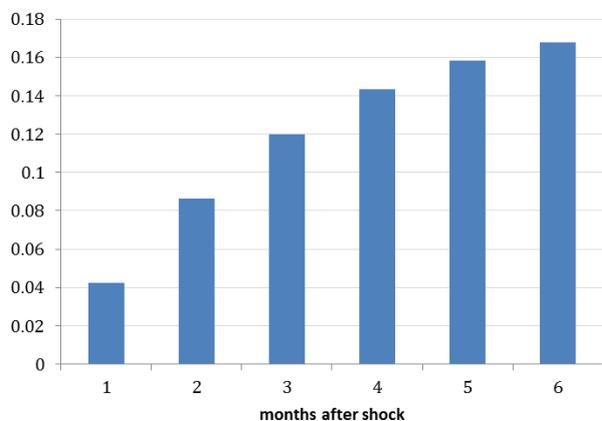
Model type	Period	Number of countries in the panel	Pass-through effect duration	Cumulative pass-through effect	Source
VAR	1975–2004	Separate equations for 12 countries	12 months	0.02–0.60 country specific	ECB (2007)
VAR	1990–2008	Separate equations for 14 countries	4 quarters	0.05–0.18 country specific	BIS (2008)
Phillips curve	2002–2014	Separate equations for 45 countries	4 quarters	0.01–0.34 country specific	WB (2015)
VAR	1980–2014	Panel of 28 countries	12 months	0.22 (0.4 without inflation targeting regime)	IMF (2015)

The ruble depreciation observed in December 2014 differs from regular exchange rate volatility seen as fluctuations around mid-term equilibrium triggered by temporal factors. Hypothetically, the equilibrium level shifted in December 2014. According to Devereux et al. (2003), in the competitive environment producers do not rush to change prices in response to the observed depreciation of the national currency as the exchange rate volatility grows; they are concerned about keeping the relative prices and the market share as before. Hypothetically, exchange rate movements do not prevent producers from adjusting their prices as they expect other producers to do so. As a result, the relative prices and the market share remain unchanged.

However, the pass-through effect increases. Estimates of the pass-through effects of large-scale depreciations (exchange rate movements) obtained in Burstein et al. (Large Devaluations and the Real Exchange rate, 2005) for depreciation in Argentina (2001), Brazil (1999) and Asian countries in 1997-1998 show that the pass-through effect of changes in the nominal exchange rate against the US dollar on consumer prices (two years after the exchange rate movement) was 0.36 for the average of eight episodes, greatly exceeding regular estimates. Unfortunately, econometric methods cannot identify an increase in the pass-through effect in Russia during 2015.

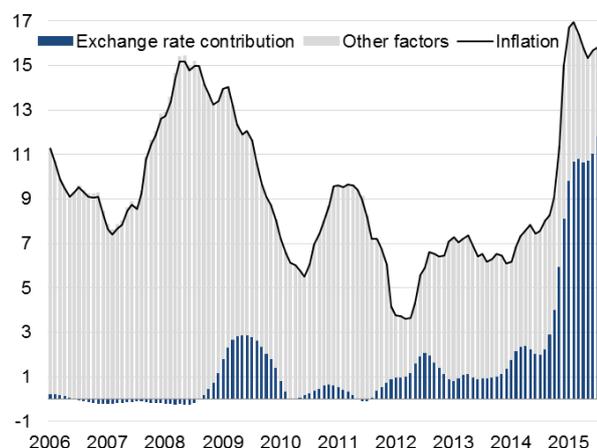
Decomposition of contribution of the ruble exchange rate to inflation in Russia is presented below (Figure 59).

**Figure 58. Cumulative response of consumer inflation to 1% shock of RUB/USD exchange rate, pp**



Sources: Rosstat, R&F Department calculations

**Figure 59. Contribution of change in USD/RUB exchange rate to CPI, pp**



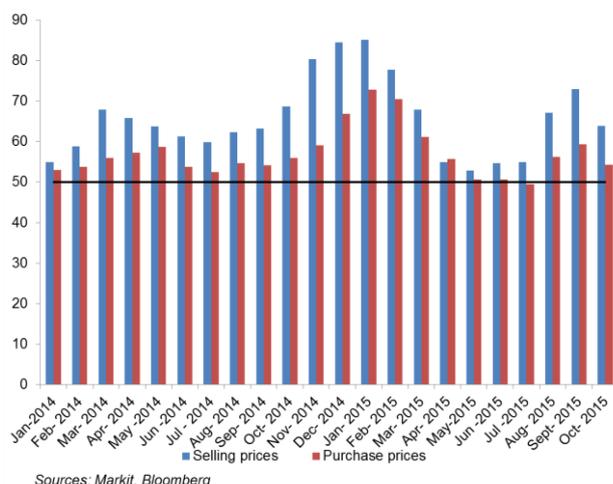
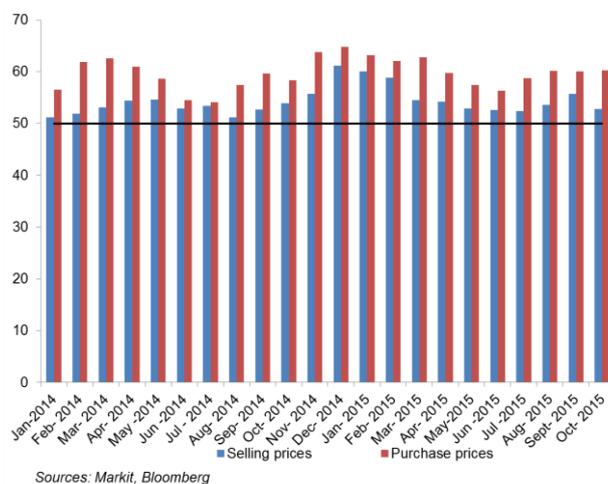
Sources: Rosstat, R&F Department calculations

### **1.3.4. Price components in manufacturing PMI: inflationary effect of exchange rate dynamics in Q3 is likely to be exhausted**

November dynamics of PMI price components showed persistent growth of purchasing and selling prices in manufacturing. However, fewer managers indicated price growth in the reporting month (strong reduction in the share of respondents indicating the price growth is registered in the category of purchasing prices, it is especially important for the future inflation dynamics).

Ruble depreciations in 2014 H2 and 2015 Q3 came with higher price fluctuations in manufacturing. This can be explained by manufacturers' higher share of imported raw materials and potential for extra charges for finished products in comparison with the more competitive service industry. The data show that the growth in selling prices for products of manufacturing industries during shocks in 2014 and 2015 exceeded that of purchasing prices considerably (Figure 60).

Services PMI price components show no similar trend: the dynamics of the share of managers communicating growth in selling prices largely corresponds to the share of respondents indicating higher purchasing prices (Figure 61).

**Figure 60. Price components of manufacturing PMIs****Figure 61. Price components of services PMIs**

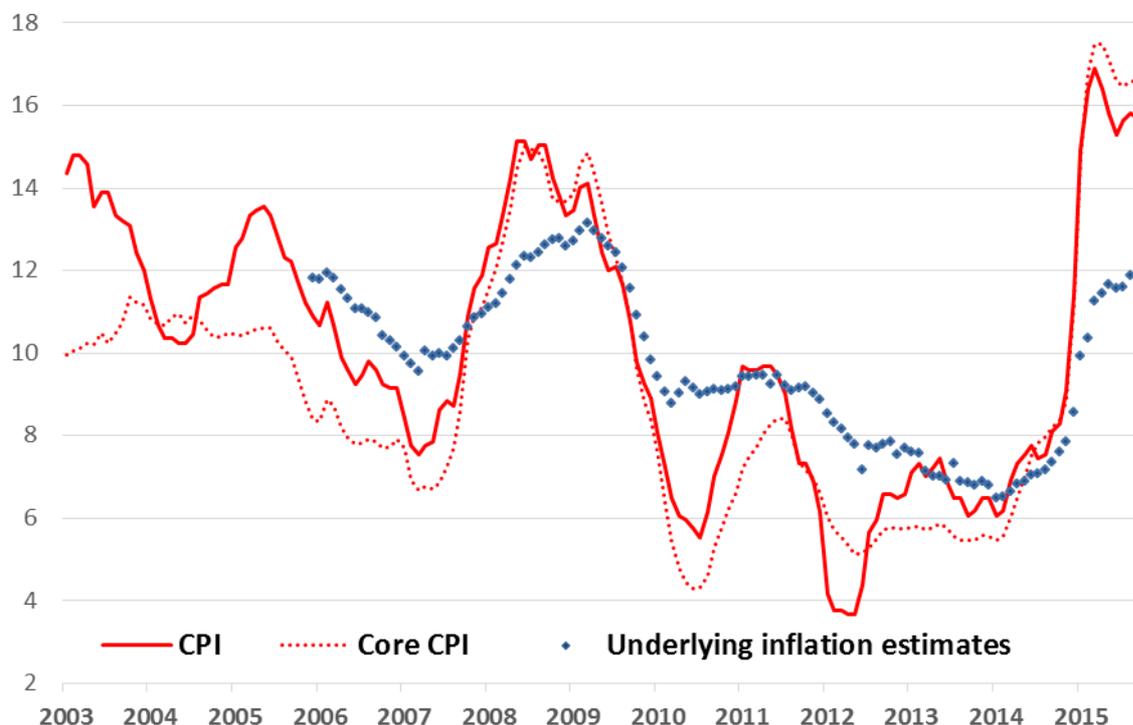
Although exchange rate shocks in late 2014 and mid-2015 were comparable in magnitude, PMI indices failed to reach previous-year levels during the last depreciation. We attribute it to the fact that considerable number of sellers adjusted prices for their products in late 2014 – early 2015 and did not raise them in 2015 Q3 (presumably due to the acceptable marginal charges).

It also should be noted, that in 2014-2015 local index maximums fell on the periods of dramatic ruble depreciation or the following month. This observation indirectly supports the hypothesis of short-term nature of the pass-through of the recent exchange rate shocks on prices and shows that inflation consequences of the summer ruble depreciation are likely to be exhausted. Thereby, provided that there are no considerable shocks in financial markets in November-December, no considerable inflation risks are forecast from the exchange rate dynamics side until the end of 2015.

### 1.3.5. Underlying inflation shows no signs of slowing

In October, the annual underlying inflation rate<sup>5</sup> remained at 11.9%. If the current trends in price and monetary aggregate dynamics persist, we expect that the underlying inflation estimates will gradually go down. Besides, **the underlying inflation staying at the high level which exceeds that of the key rate for a long time may result in persistently high inflation expectations.**

<sup>5</sup> The underlying inflation level is calculated as the median value of three estimates obtained from singling out an unobserved common component from a set of price indicators through dynamic factor models. The method for evaluating underlying inflation is described in the Bank of Russia's Working Paper Series: E. Deryugina, A. Ponomarenko, A. Sinyakov, K. Sorokin, Evaluating the Underlying Inflation Measures for Russia // Working Paper Series. 2015. No. 4.

**Figure 62. CPI, core CPI and Bank of Russia historical estimates of underlying inflation, % YoY**

Sources: Rosstat, Bank of Russia estimates

### 1.3.6. Producer prices resumed growth

#### Producer price dynamics pave the way for accelerated consumer price growth in late 2015.

In October, prices of producers of industrial goods grew by 1.8% MoM (1.1% MoM decline in September). The annual producer price growth went up from 12.7% YoY in September to 14.2% YoY in October this year.

The analysis of individual components of domestic industrial producer prices shows that **prices in mining and quarrying showed the most rapid growth in October 2015** (Figure 63). Prices in mining and quarrying grew by 17.1% YoY (6.5% MoM), in manufacturing – by 14.4% YoY (14.3% MoM), in electricity, gas and water supply – by 8.9% YoY (2.0% MoM).

The contribution of manufacturing industry to the annual producer price index during the said period stood at 9.7 pp (9.6 pp in September), mining and quarrying contributed 3.5 pp (2.1 pp in September), and electricity, gas and water supply contributed 1.1 pp (0.95 pp in September). As a result, contribution of all components to the annual producer inflation grew up compared to the previous month (Figure 64).

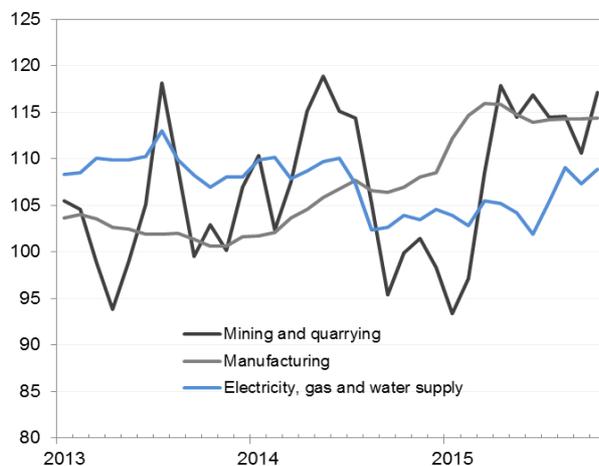
In October 2015, producer prices in mining and quarrying jumped compared to September 2015 due to the higher contribution of mining operations. Fossil fuel extraction

showed the highest growth of 7.0% MoM (16.0% YoY) mostly due to the 7.0% MoM (16.0% YoY) price growth in crude extraction and the 3.3% MoM (33% YoY) price growth in extraction of associated gas and metal ore. Higher production costs boosted prices in these sectors.

Prices for consumer (food industry, manufacture of textiles, leather and leather products and footwear production) and investment goods (construction materials, machinery and equipment, finished metalware, wood and wood products) determine the dynamics of manufacturing producer prices. Food industry contributed the most (2.4 pp) to the annual manufacturing producer price growth (Figure 65).

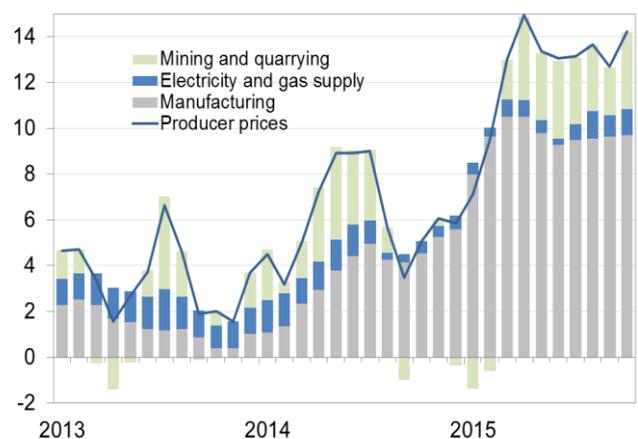
Food prices went up by 0.8% MoM (after 1.2% MoM in September 2015). Annual growth rates also grew to 18.3% YoY from 17.9% YoY in the previous month (Figure 68). Producer prices in light industry (manufacture of textiles and leather products) increased from 15.6% to 16.4% YoY in October 2015. Motor car producer prices were up from 18.9% YoY in September to 19.2% YoY in October 2015. Current trends in consumer goods sector pave the way for further growth of producer price index in November-December 2015 and higher non-food inflation.

**Figure 63. Producer prices in individual industries, % YoY**



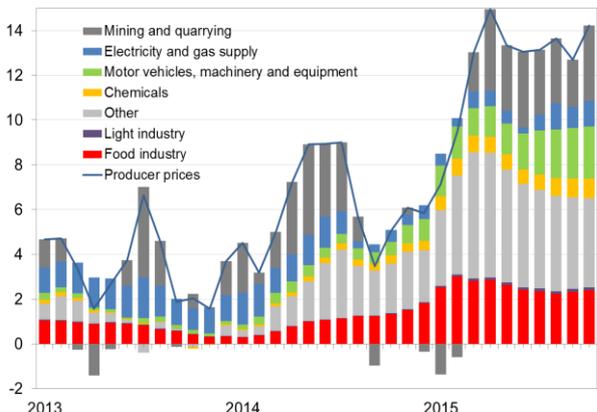
Sources: Rosstat, R&F Department calculations

**Figure 64. Contribution of individual industries to producer prices, % YoY**



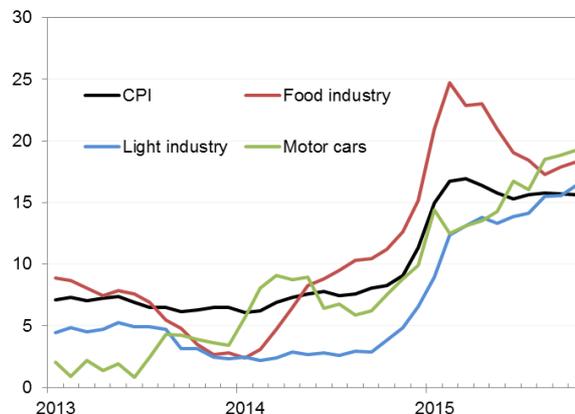
Sources: Rosstat, R&F Department calculations

**Figure 65. Contribution to producer prices by sector, % YoY**



Sources: Rosstat, R&F Department calculations

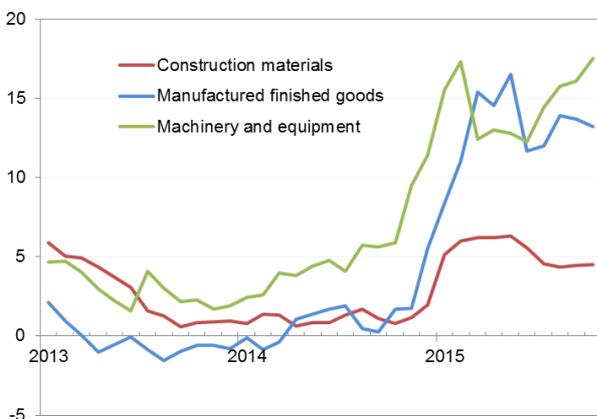
**Figure 66. Consumer goods producer prices, % YoY**



Sources: Rosstat, R&F Department calculations

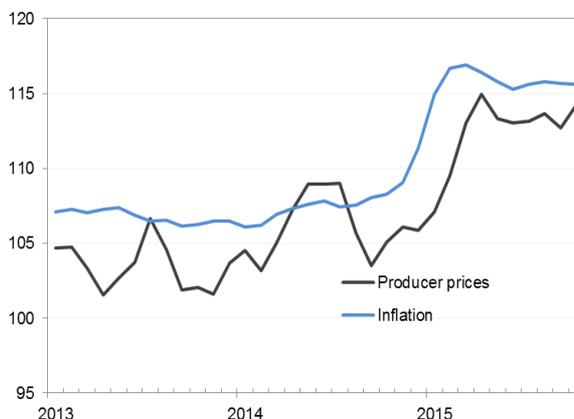
Investment goods producer prices showed varied dynamics in October 2015 (Figure 67). **In October, investment goods contributed 1.4 pp to the annual producer price growth.** In October, producer prices for construction materials were up by 4.5% YoY (-0.1% MoM), for finished metalware by 13.2% YoY (0.3% MoM), for machinery and equipment by 17.2% YoY (1.3% MoM). Low investment demand keeps the price growth in the sector persistently slow.

**Figure 67. Producer prices for individual investment goods, % YoY**



Sources: Rosstat, R&F Department calculations

**Figure 68. Consumer and producer price indices, % YoY**



Sources: Rosstat, R&F Department calculations

## 2. Outlook: leading indicators and forecasts

### 2.1. GDP nowcast: 2015 slump will be less deep than expected

**Current statistics show no considerable negative signals in dynamics of most indicators of the real sector and industrial production in particular.**

The GDP index estimate<sup>6</sup> for 2015 Q4 improved in October largely following better than modelled Rosstat estimate of GDP dynamics in Q3 (-4.1% YoY). With this assumption, we estimate the annualised seasonally adjusted GDP to total 0.2-0.5% QoQ in Q3. However, the model estimate signals a renewed GDP reduction of 4.3% YoY in Q4 and 0.6% QoQ in annual terms.

No considerable discrepancies were found between the short-term model estimate with complete set of explanatory indicators and the specification with real sector indicators within the current forecast iteration<sup>7</sup>.

Residential construction, retail trade turnover and Russian Economic Barometer diffusion indices made the maximum negative contribution to the GDP estimate for Q4. Risks of further deterioration in the model estimate of GDP growth in the current and two following quarters are set to increase with oil prices if they persist at the current level.

The model estimate of GDP growth in 2015 based on the first short-term estimate for Q4 stands at -3.9%, in line with the upper (better) bound of the Bank of Russia's current official forecast range. The model estimate for the moving year until 2016 Q2 stands at -3.1%. However, November and December statistics can further adjust these estimates.

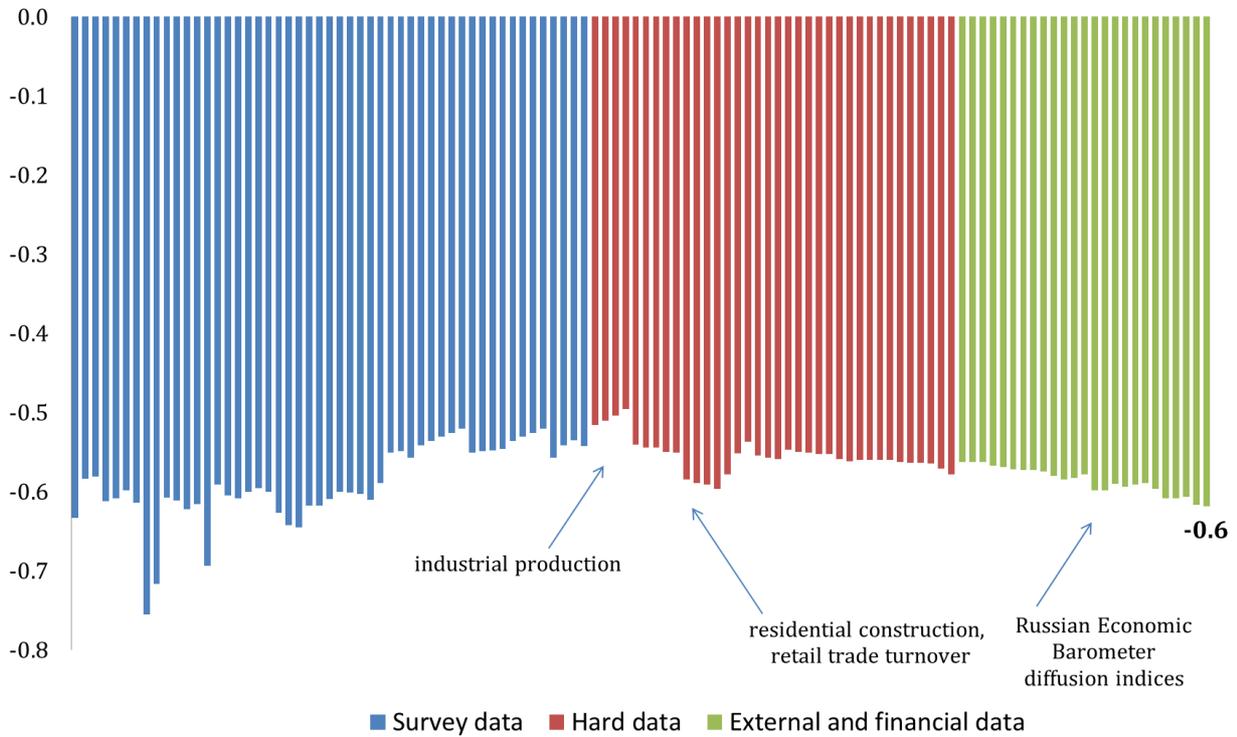
**Table 2. Index estimate of Russian GDP dynamics**

	<b>November</b>		<b>October</b>	
	<b>% QoQ,</b>	<b>% YoY</b>	<b>% QoQ,</b>	<b>% YoY</b>
	<b>annualised</b>		<b>annualised</b>	
2015 Q4	<b>-0.6</b>	<b>-4.3</b>	-0.9	-4.7
2016 Q1	<b>0.0</b>	<b>-2.3</b>	0.6	-3.4
2016 Q2	<b>0.5</b>	<b>0.0</b>	-	-

<sup>6</sup> GDP index estimate is based on Rosstat's data on social and economic situation in Russia in the corresponding month and other statistical, leading and financial data as of the calculation date and results from simulation of a dynamic factor model. These Research and Forecasting Department forecasts are based on model calculations only and their results do not represent the official Bank of Russia's forecast. The information set used for GDP index estimate includes 110 different time series divided into three groups: 1) survey data, 2) hard data, 3) external and financial data. The detailed methodology for the GDP index estimate is described in the Bank of Russia's Working Paper Series: A. Porshakov, E. Deryugina, A. Ponomarenko, A. Sinyakov // Nowcasting and Short-term Forecasting of Russian GDP with a Dynamic Factor Model // Working Paper Series. 2015. No. 2.

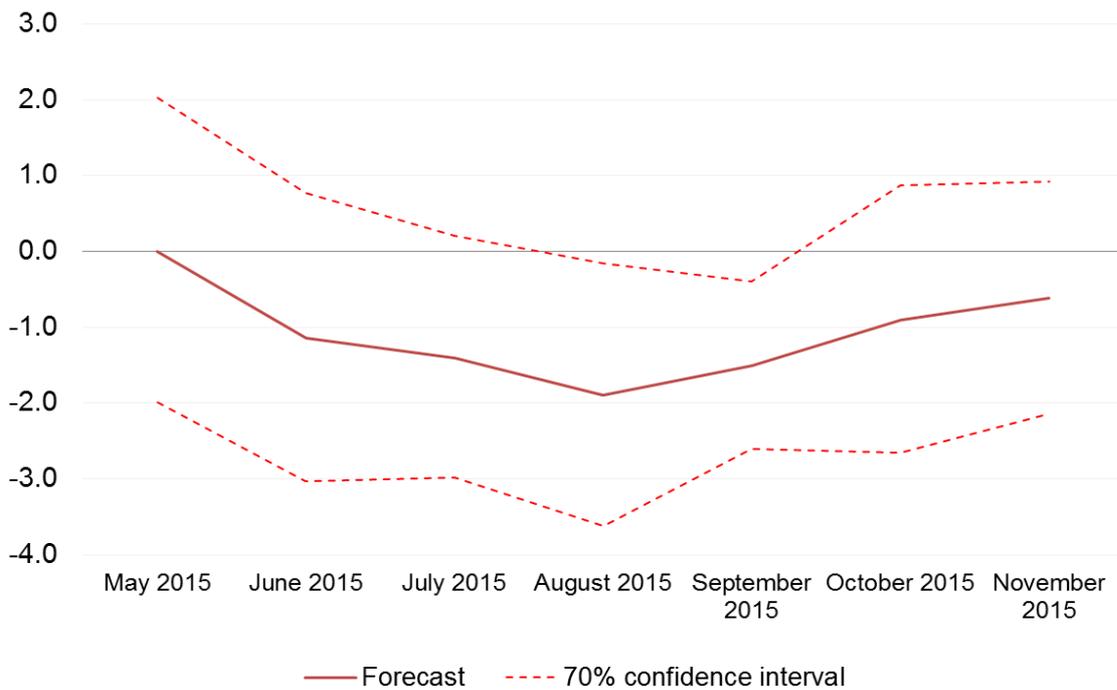
<sup>7</sup> Talking Trends. 2015. No. 1.

**Figure 69. Evolution of DFM-based GDP nowcast for 2015 Q4 (performed in September 2015), pp, annualised**



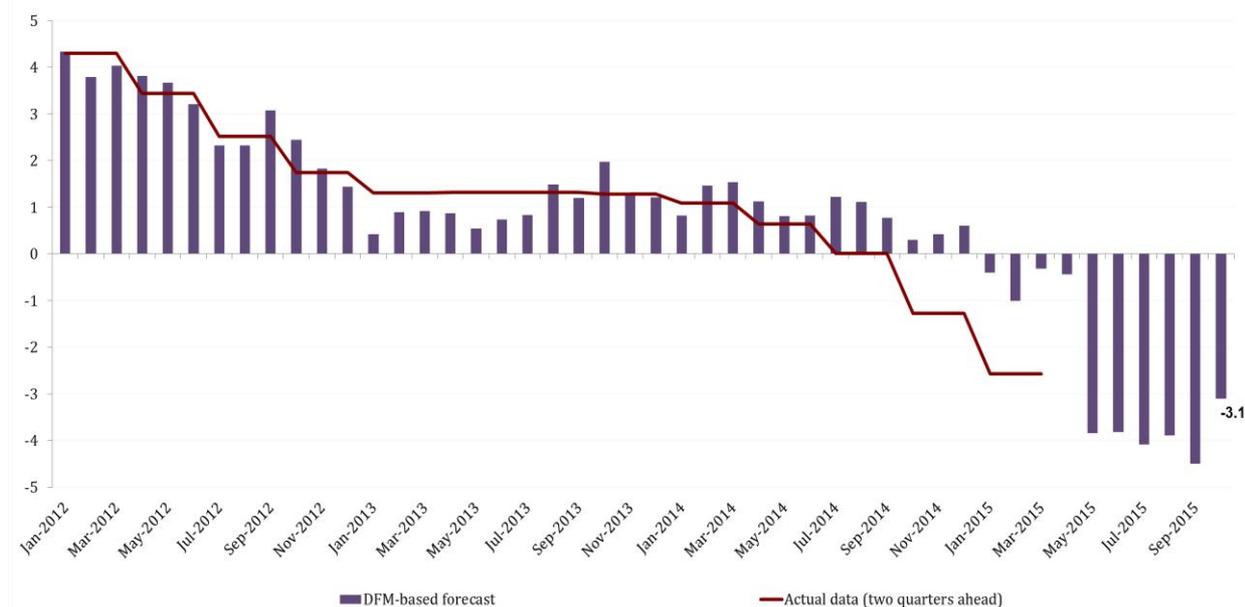
Sources: Rosstat, R&F Department calculations

**Figure 70. Forecast of annualised quarterly GDP growth in 2015 Q4**



Source: R&F Department calculations

**Figure 71. GDP nowcast and forecast for one and two quarters ahead, % over previous 'rolling year' (actual data on previous quarter + nowcast of current quarter + forecast for two quarters ahead)**



Sources: Rosstat, R&F Department calculations

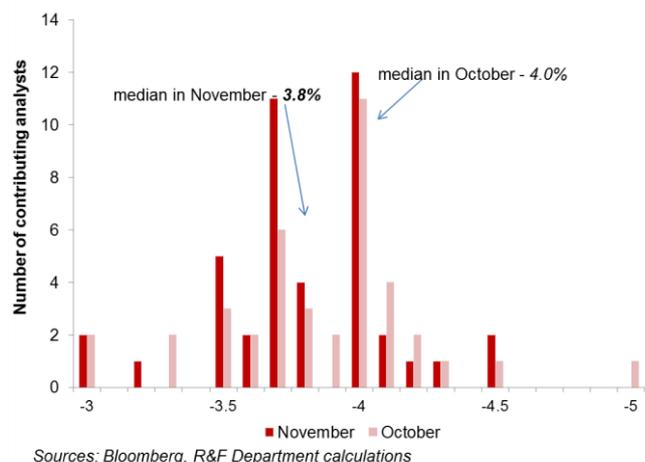
## 2.2. Current forecasts by financial analysts as market participants

### GDP

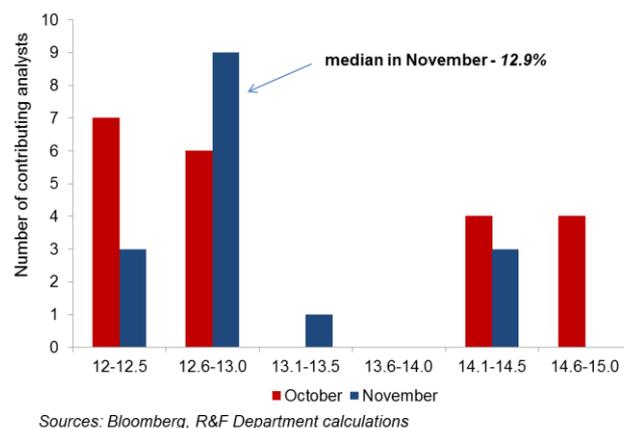
Bloomberg consensus forecast as of 27 November 2015 shows that most financial analysts expect the economy to slump by about 4.0% at the year-end. November median estimate of GDP growth in 2015 stood at -3.8% (against 4.0% a month earlier) (Figure 72). We believe that GDP forecast improvement was largely driven by the Rosstat's publication of preliminary GDP estimate for Q3, which overall exceeded market expectations. Under R&F estimates, seasonally adjusted GDP totalled 0.1% in Q3. The appropriate dynamics of economic activity in Q4 will enable a 3.8% GDP growth in 2015. Three respondents expect a slump of less than 3.5% in 2015, probable only in case the full-fledged economic recovery begins until the year-end.

Many respondents continue to forecast, as a month before, a slump of 4.0% as of the year-end. It is most likely to result from the fact that some analysts usually communicate rounded values rather than adjust their forecasts by percentage fractions. In such a way, these forecasts, given the currently published data, should be interpreted as neutral rather than pessimistic. In their turn, five respondents whose estimates for the year of 2015 are below 4%, still see the risks of GDP slowing in the current quarter.

**Figure 72. GDP growth forecasts by external analysts in 2015 (as % of 2014)**



**Figure 73. Consumer inflation forecasts by external analysts in 2015 (% YoY as of end 2015)**



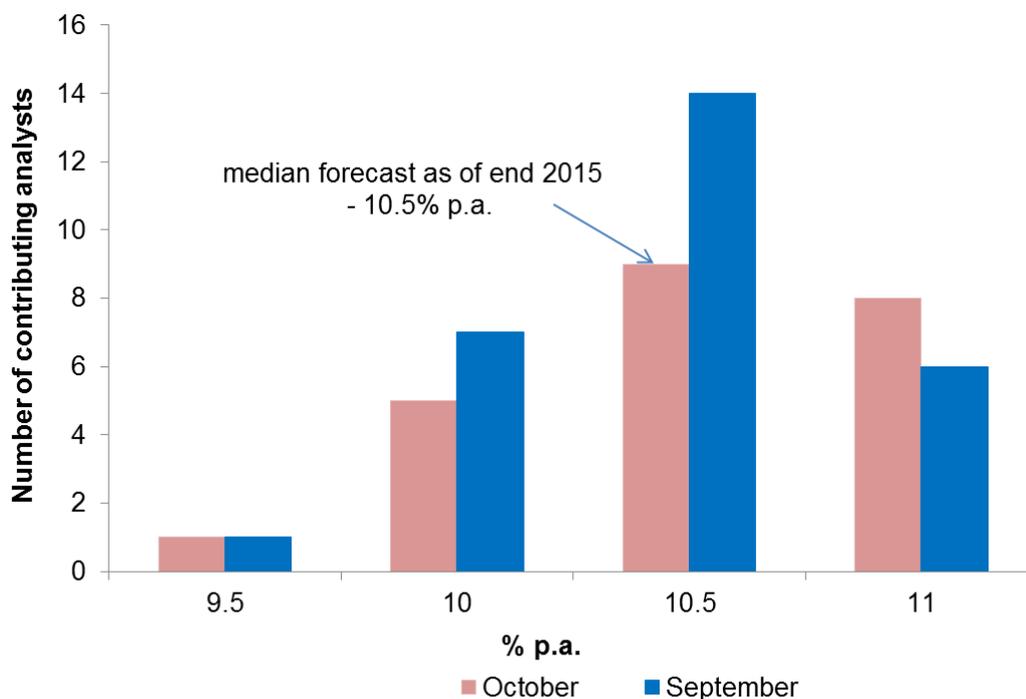
## Inflation

As of 27 November 2015, the median consumer inflation forecast for the end of 2015 is 12.9%, and that is above Bloomberg data in October (12.6%). Based on November's consumer price dynamics, the annual forecasts by most analysts remained within the 12.0%-13.0% range, though moving considerably upwards within this range (Figure 73). Consequently, analysts on average **revised inflation risks for the past month upwards**.

## Bank of Russia key rate (as of 2015 Q4 end)

In spite of the persisting risks of inflation expectations, most analysis see prerequisites for a 50 bp key rate cut to be decided at the Bank of Russia Board of Directors' meeting on 11 December 2015. However, the distribution of forecasts for the BoR key rate has become considerably more dense over the past month. It results primarily from the fact that the month-old Bloomberg survey preceded the Bank of Russia's decision on the key rate in late October and some experts expected the Bank of Russia to ease its monetary policy more actively until the end of the year.

Figure 74. Bank of Russia key rate forecasts by external analysts as of end 2015



Sources: Bloomberg, R&F Department calculations

## 2.3. Composite leading index

### Leading indicators show a smooth stabilisation

The **composite business activity index**, calculated by the principal component method for 30 leading indicators (including Rosstat data, PMI indices, Russian Economic Barometer diffusion indices), declined somewhat as of mid-November (

Figure 75). This decline was triggered by the current data for certain Russian Economic Barometer diffusion indices with regard to business activity and inventories, which weakened slightly over the past month. Our calculations show that manufacturing PMIs and services PMIs account for 65-70% of dynamics of the first key component of composite leading business indicators.

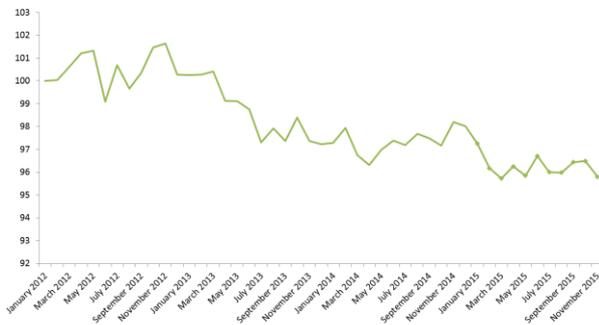
The **composite leading business indicator**<sup>8</sup> gives a clearer signal of industrial production recovery in 2016 Q1 (Figure 76) than the month before. The index forecasts that the output cyclical component will stay at around zero till the year-end. Meanwhile, in October the cyclical component of industrial production calculated on the basis of Rosstat data published on the reporting week declined somewhat. However, this decline was insignificant despite the substantial growth of the cyclical component in October, which, in

<sup>8</sup> Calculated by the Research and Forecasting Department on the basis of HSBC methodology for a wide range of short-term economic indicators (over 100 variables) through the turning point method. For details see Fenn D., Nerbrand F., Kasem S., Selvakumar Y. (2015) HSBC Leading Indicators. HSBC Global Research.

our opinion, could have been overestimated following the short-term surge in manufacturing seen in October. Consequently, we may have reassessed last month's magnitude of cyclical upswing to a lesser degree than was previously assumed.

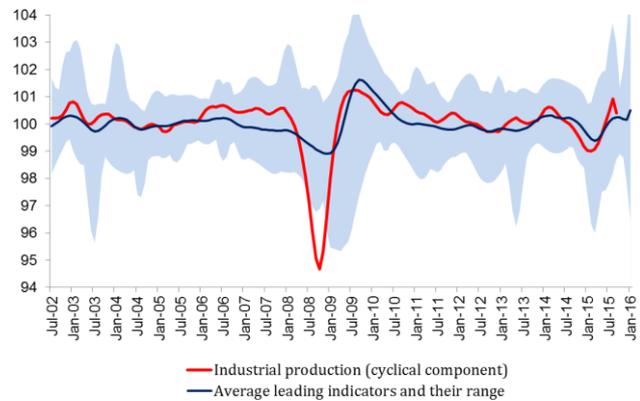
We are cautiously optimistic in our forecasts for future recovery of business activity as long as some indicators (primarily business activity indicators in manufacturing) can temporarily, during the Russian economic restructuring, lose their leading properties we have established based on historical data.

**Figure 75. First main component of leading business indicators (January 2012 = 100)**



Sources: Rosstat, Russian Economic Barometer, R&F Department calculations

**Figure 76. Cyclical component of industrial production (as % of previous month, seasonally adjusted) and leading business index: turning point method**



Sources: Rosstat, HSBC, Russian Economic Barometer, R&F Department calculations

### 3. In focus. Russian public finance forecast: budget expenditures must be cut in real terms

The baseline scenario-based forecast of key indicators of the budget system<sup>9</sup> shows that budget revenues will further decline as a percentage of GDP in the years to come. At the same time, outstripping expenditure cuts are required to reduce the budget deficit. The Reserve Fund and most of the National Wealth Fund will be used up by late 2018, and public debt will stabilise at 20% of GDP. Major budget risks arise from the oil price persisting below \$50 per barrel and the difficulty to reduce expenditure as required. Regional and local budgets can see sizable growth in receivables in the conditions of tight budget restrictions.

**Revenues.** Budget system revenues are expected to drop from 36.4% of GDP in 2015 to 34.2% in 2018 (Figure 77). It is triggered by lower oil and gas revenues resulting from the relatively stable ruble exchange rate and low oil prices applied in the calculations. Non-oil-and-gas revenues are very likely to dip as well due to the lower proceeds from non-tax components (lower income from sovereign fund placements following their shrinkage; lower proceeds from import duties due to the decreased import tariff, etc.). In comparison with the 2016 forecast by the Russian Ministry of Finance, our revenue estimates is somewhat higher due to the non-oil and gas component. It can be explained by the higher base of 2015 in our calculations. Oil-and-gas revenues are, on the contrary, lower, which probably results from the use of lower forecast oil price for the last months of 2015 and in 2016 Q1 in our calculations. Regional budget revenues are less exposed to the downside risk driven by economic reasons. High pressure on federal budget expenditures may result in higher centralisation of revenue sources.

**Deficit.** According to our estimates, the budget deficit will amount to 4.1% of GDP in 2015 and needs to be reduced considerably in the medium term to the level which will facilitate long-term fiscal sustainability, stabilise the public debt at the acceptable level, while ensuring certain financial reserves. Based on the Russian Ministry of Finance stand, the federal budget deficit needs to be reduced to 2% of GDP in 2017 and 1% of GDP in 2018, with consolidated budget deficit amounting to 2.7% and 1.5% of GDP respectively.

**Expenditures.** To reduce deficit, expenditure contraction should outstrip revenue decline: from 40.5% of GDP in 2015 to 35.7% of GDP in 2018 (that is equal to the level of expenditures in 2011 and exceeds that of 2007-2008 by 1.5 pp of GDP). Budget expenditures almost do not increase in nominal terms, and decline by 10% in 2018 against 2015 in real terms. The structure of budget expenditures will require a large-scale cost optimisation for final consumption (Figure 78). This will require lower labour costs resulting from job cuts in the public sector and moderate wage indexation, as well as a considerably more efficient public procurement of goods and services with lower funding.

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<sup>9</sup> The scenario provides for Urals crude prices to sustain at the level of \$50 per barrel from 2016 Q2, relative stability of the ruble exchange rate against the dual-currency basket, GDP contraction by 0.9% in 2016 and growth by 1.6-1.8% in 2017-2018, and gradual inflation reduction to 4% by late 2017.

Given the forecast parameters of the budget deficit, it is complicated to resume the formation of funded pension. At the same time, social welfare expenditures as a percentage of GDP will be preserved at 2015 level in 2018.

**Deficit financing sources.** According to our calculations, the Reserve Fund will be used up for budget deficit funding by mid-2017, after which the spending of the National Wealth Fund (NWF) resources will begin. As of the end of 2018, the NWF will amount to 2.5% of GDP, of which liquid funds will be 1% of GDP; other funds will be invested in (ongoing) projects directly or through Vnesheconombank (VEB) (Figure 79). The budget system debt will stabilise at about 20% of GDP, outstripping nominal GDP by its growth rate (Figure 80)<sup>10</sup>.

**Risks.** The persistence of Urals crude at well below \$50 a barrel poses the main risk for the revenue side of the budget in the presented calculations<sup>11</sup>. The major risk of the expenditure side is the difficulty to cut spending as required. Besides, the government may have to provide large-scale financial assistance to VEB to write off bad debts, which will add to the public debt and (or) shrink up the NWF. Sizeable tax increase and retirement age rise are unlikely before 2019. It seems inappropriate to use up NWF funds as it would deprive the government of reserves and reduce investment attractiveness of Russia and its government securities.

Additional borrowings are the main source of risk coverage. Sales of state-owned assets are seen as a reserve funding source, according to Anton Siluanov, the Russian Minister of Finance. Accounts receivables of regional and local budgets are likely to grow considerably amid tight budget restrictions exposing the budget system to another risk. The resumption of funded pension formation is complicated given the forecast budget deficit parameters and the risks.

**Fiscal policy cyclicity**<sup>12</sup>. According to our estimates, the primary non-oil-and-gas structural deficit will grow by 0.4 pp to 11.5% of GDP in 2015. Provided that the negative output gap expands, it will allow to determine the fiscal policy as countercyclical. The primary non-oil and gas structural deficit will gradually shrink in the years to come. Meanwhile, the fiscal policy will be of a procyclical nature in 2016 amid growing negative

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<sup>10</sup> Assessments of federal budget deficit financing sources (other than sovereign funds) are based on the Russian Ministry of Finance's materials adjusted as follows: annual external borrowings amount to \$1.5 billion, net domestic borrowings in 2017–2018 remain at 2016 level of 300 billion rubles, with the demand is mostly ensured by non-residents without considerable premiums at initial offering to reduce the effect of ousting private borrowings, net loans to regions are gradually cut from 210 billion rubles in 2015 to 100 billion rubles in 2018. Guarantees are supposed to be increased by the nominal GDP growth.

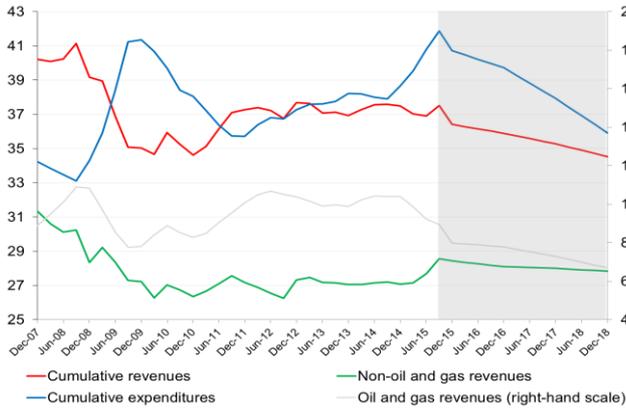
<sup>11</sup> According to our estimates, Urals price balancing the federal budget will stand at \$68–69 per barrel in 2015 and 2016, deficit reduction in the considered volume will ensure its cut to \$58 per barrel by 2018 (calculations are adjusted for oil price pass-through effect on the exchange rate).

<sup>12</sup> Countercyclical or stabilising fiscal policy requires tightening during economy overheating and easing amid recession. The dynamics of primary non-oil and gas structural deficit (cumulative deficit net of oil and gas revenues, net interest payments, one-off payments and revenues dependent on economic activity movements) determines fiscal policy tightness while output gap movements indicate the phase of the economic cycle. For details see Vlasov S. (2011) Russian fiscal framework: past, present and future. Do we need a change? // BOFIT Online. No. 5.

output gap (this is consistent with fiscal sustainability aspect), while turning countercyclical in 2017–2018 when the negative output gap is expected to be closed.

**Impact on the economic growth.** According to our calculations with the use of estimated fiscal multipliers for the Russian economy, the public finance sector will have a positive impact on the aggregate demand totalling 1 pp of GDP in 2015, close to zero in 2016 and negative at about -0.3 pp of GDP in 2017-2018.

**Figure 77. Key budget system indicators (as % of GDP, moving over 12 months)**



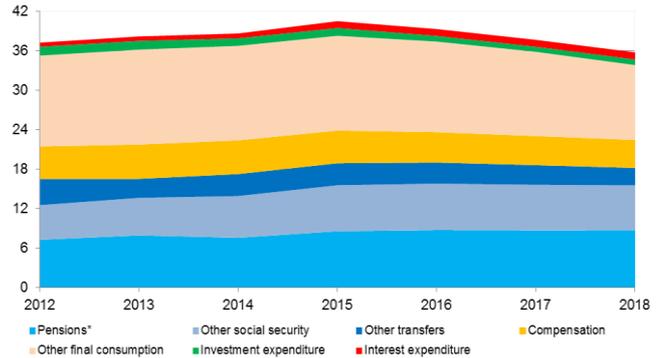
Sources: Russian Federal Treasury, Russian Ministry of Finance, Russian Ministry of Finance Economic Expert Group, R&F Department calculations

**Figure 79. Deficit funding from the Reserve Fund (RF) and the NWF (billions of rubles)**



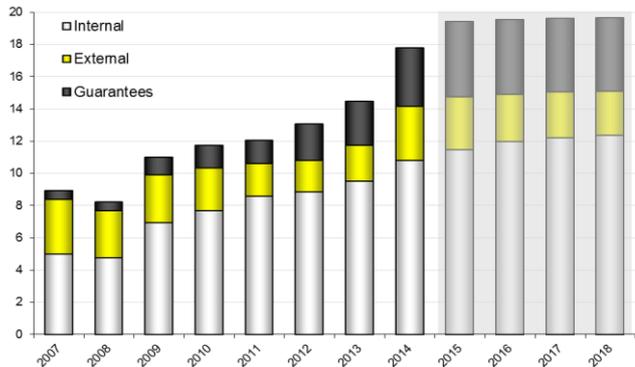
Sources: Russian Ministry of Finance, R&F Department calculations

**Figure 78. Budget system expenditures (% of GDP)**



Sources: Russian Federal Treasury, R&F Department calculations  
\* Funded pension pegging is assumed for the whole horizon.

**Figure 80. Budget system debt (% of GDP)**



Sources: Russian Ministry of Finance, R&F Department calculations

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