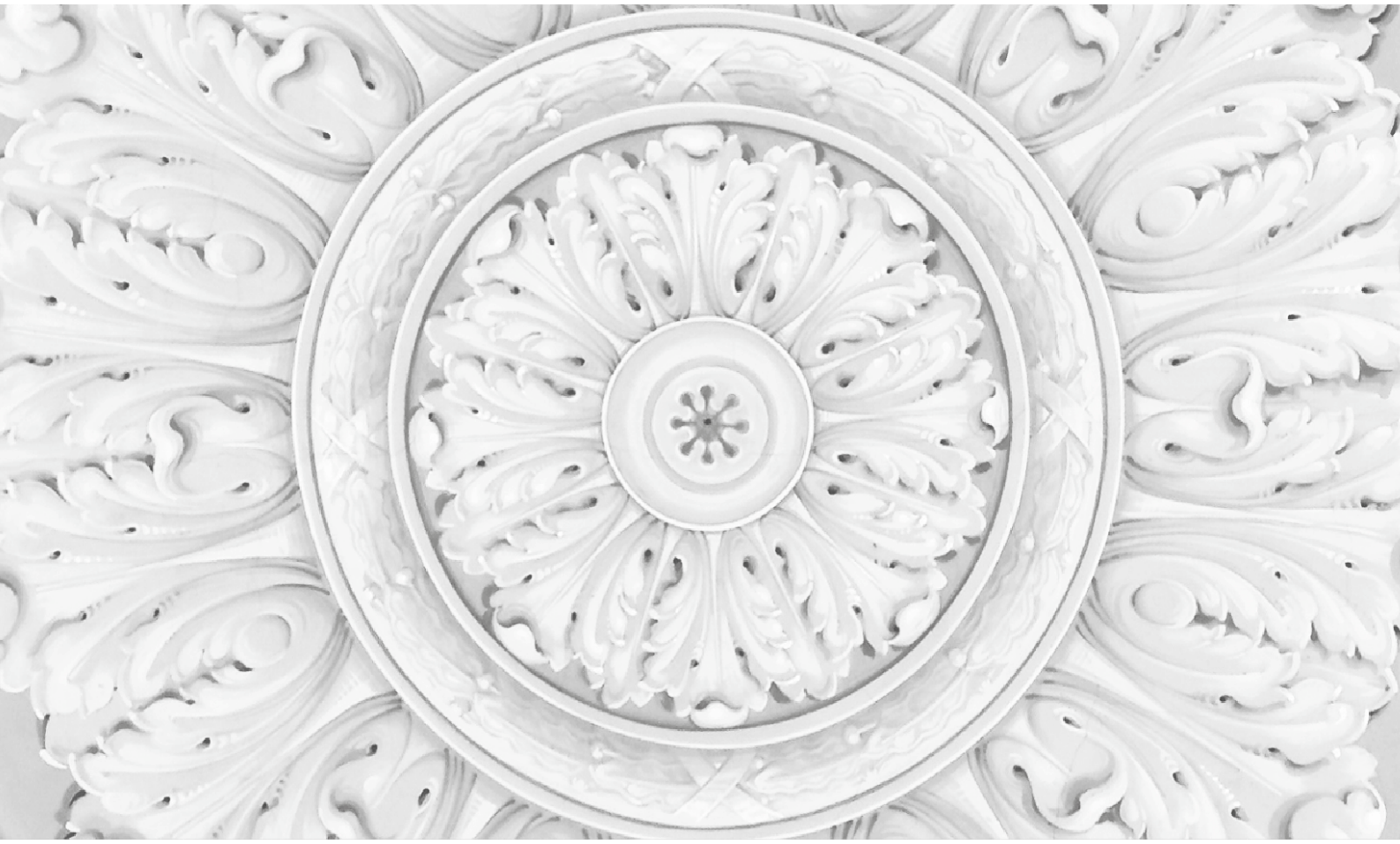
Bank of Russia

The Central Bank of the Russian Federation



TALKING TRENDS

Macroeconomics and markets

October 2015

Research and Forecasting Department Bulletin

No.1 / October 2015

CONTENTS

Introduction

The Bank of Russia introduces a series of regular publications which will appear in ‘Talking Trends’, its Research and Forecasting Department’s bulletin. These publications are intended to offer analytical insights into currently important trends in the movement of macroeconomic and financial indicators in Russia and globally, as well as Russian economic outlooks from the standpoint of these trends. The report findings are based on the evaluation of short-term statistics – which is essential in terms of real-time economic state monitoring and for the Bank of Russia’s decision-making with regard to monetary policy.

The report is addressed to vast audiences and may be of interest to the professional community and mass media; it may also be of general public interest.

To highlight the most prominent current trends, the bulletin includes ‘Summary of the month’, a special section which covers the past month’s short-term statistical data analysis for Russia and key foreign economies. The ‘Outlook’ section presents conclusions on the most probable, in the report authors’ view, macroeconomic dynamics in the short term, given the trends identified. ‘In focus’ is a special section featuring an assessment of selected currently important issues with an in-depth description of problems and methodological approaches.

The bulletin is posted in the subsection ‘Working Paper Series’ of ‘Information and Analytical Materials’ of the Bank of Russia website.

Findings and recommendations in ‘Talking Trends’ may be different from the official standpoint taken by the Bank of Russia.

Executive summary

1. Summary of the month

- October 2015 developments in the Russian and global economies point to a decline in the short-term external and internal financial risks. Elevated inflation risks persisted while economic activity showed signs of stabilisation in Russia. This suggests that inflation risks play a decisive role in monetary policy decisions by the Bank of Russia.

- Inflation risks and inflationary pressures stay high.

- The **Russian economy reveals signs of a fragile stabilisation.**

- The **overall financial stability risks have decreased**, yet the recently resumed decline in oil prices increases the probability of new risks emerging.

2. Outlook

- Leading indicators of business activity, actions and comments by major central banks speak for **a slowdown in global economic dynamics,** strengthening expectations of **easier monetary policies** and stimulating **risk appetite** in the short term.

- Leading business activity indicators in Russia do not promise **the resumption of economic growth until 2016.**

3. In focus: Russian import dynamics

- Since 2009, the Russian import dynamics have been mainly driven by the real exchange rate dynamics, while the long-term exchange rate elasticity of imports has increased. The elasticity decreased (most likely, temporarily) in 2014-2015 due to the non-macroeconomic shocks.

1. Summary of the month

1.1. Global economy and financial and commodity markets

1.1.1. The overall past month's global economic news exposed a deteriorating business activity and a growing deflationary pressure in key global economies

USA

The October **US** economic statistics have reinforced the concerns, which emerged in the financial markets between August and September, over the sensitivity of the US economy to the global financial volatility and a slowing growth in developing economies.

The October developments clearly suggest that the impact of net exports as a US economic growth driver has waned. The strong dollar, coupled with a high demand for American assets as triggered by risk aversion (risk-off), has spurred a further growth in foreign trade deficit.

The foreign trade deficit totalled $48.3 billion in August (against $41.8 billion for July). The rise in the deficit was caused by a $3.7 billion contraction in exports and a $2.8 billion growth in imports.

Imports to the US rose by 1% against the pre-crisis peak seen in the middle of 2008. Against this background, oil imports to the US in monetary terms declined substantially (Figure 1), in a sign that the growth in imports is reflective of the non-oil deficit in foreign trade (versus the peak seen in 2008). This may well be a sign of a solidly growing domestic demand in the US economy, but also of the strong dollar's negative pressure on foreign trade. Tellingly, trade deficit with China has risen from $30.3 billion in August 2014 to $35 billion in August 2015.

Figure 1

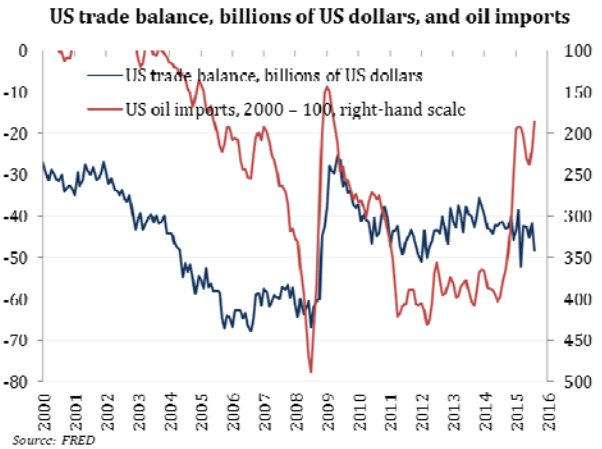
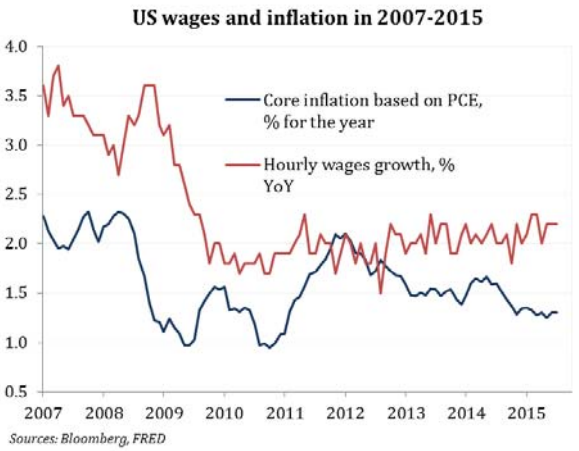


Figure 2



Consumer demand, a key growth driver for the US economy in the second quarter, grew at a slower pace in September.

US consumer dynamics have failed to oblige. US retail sales in September were expanding at a pace slower than expected: +0.1% MoM versus 0.2% MoM. The August expansion was revised downwards from +0.2% MoM to +0.0% MoM. Additional evidence to a weakening consumer demand came from the housing market. New-build sales in September declined by 11.5% MoM – well below market expectations. Existing home sales added 4.7% in September (above expectations), failing however to set off the August contraction (-5.0%, MoM). In a positive development, September's new-build housing counterbalanced the August contraction: +6,5% MoM, against the expected growth of 1.4% MoM and the August decline of 1.7% MoM. Real estate prices are showing a solid growth of around 5% (YoY).

US industrial output was down for a second month in a row, as seen from the September data, in line with market expectations. Orders for durable goods in September were down by 1.2% MoM, against the expected 1.5 MoM. The contraction in August was revised from 2% to 3% MoM.

Job statistics for September proved surprisingly lacklustre, putting the planned December rate rise under question. Job generation in the non-agricultural sectors, slowing down, was a lot worse than expectations: +142,000 against the healthy rates of 200,000, normally occurring in line with market expectations reflective of upward economic trends. The August gain was revised downwards from the initial number of 173,000 to 136,000. The July reading was also downgraded from 245,000 to 223,000. Most pressure on the slowdown in job generation came from the extraction sector.

Wage growth also slackened and failed to match expectations. Wages, viewed as an inflation driver, see no inclination for growth in line with the 2% inflation target in the mid-term, growing at 2.7%-3% a year (Figure 2). The average hours worked (labour utilisation) was also in decline and below expectations.

The economic activity index, so crucial an indicator for the Federal Reserve and a weighty argument, considering its decline in the US growth recovery cycle, for continuing with a softer policy, continued its downturn. It stood at 62.4% in September – a minimum seen since the late 1970s. Unemployment, the only indicator which remained unchanged and level with market expectations, totalled 5.1% in September, coming very close to the mark the Fed considers conventional (NAIRU).

US consumer and producer prices saw a variety of trends. Producers' prices on final products in September came under a deflationary pressure stronger than market expectations: -0.5% MoM against the expected 0.2% MoM. On a year-on-year basis, price deflation for producers' prices on final products was up from 0.8% to 1.1%. Consumer prices in September were down, level with expectations, by 0.2% MoM, with the core consumer price index, however, adding 0.2% MoM – against 0.1% MoM of

growth expectations. The resulting annual growth came close to the US Fed target: non-fuel and non-food prices grew by 1.9% in September YoY, while growth expectations were 1.8% MoM.

September's consumer confidence index in the USA beat expectations (103 against 101.5 in August). Yet, the US manufacturing sector came as an underperformer: 50.2 in September against the expected 50.6, recording a two-year low. The Bloomberg US macro surprise index was fairly stable throughout October, although increasing somewhat by the end of the month. This provides evidence to improvements in the US economic dynamics, better than financial analyst predictions (Figure 49).

Figure 3

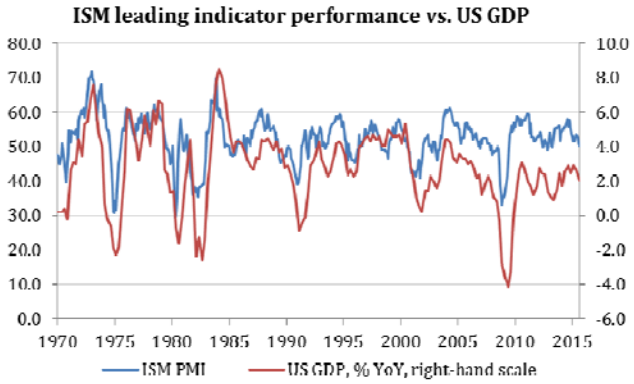
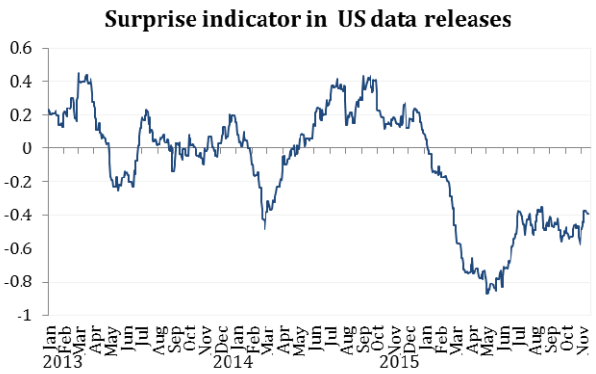


Figure 4



Source: Bloomberg

Eurozone and Japan

The **eurozone** business indicators worsened, and deflation in September persisted. Industrial output contracted in August which, however, was expected. Consumer prices in September were down by 0.1% YoY, as in the previous month. The core consumer price index is expanding by 0.9% YoY, in line with expectations.

The consolidated eurozone PMI for September fell short of expectations and August's readings: 53.6 against 53.9 (54.3 in August). The retail sector's PMI proved better than the August reading: 51.9 versus 51.4. As a result, the eurozone's internal demand is on a more sound footing compared to the export and China-focused manufacturing industry.

The monthly survey of eurozone's professional economists was updated in late October and showed to worsened eurozone GDP growth expectations for 2016 at 1.6% from 1.7% and less optimistic inflation forecasts of 1.1% from the target of 1.2%. The forecasted ECB rate remained unchanged over the whole forecast horizon: the first rise is expected in the middle of 2017. The eurozone consumer confidence index for October was lower than predictions: -7.7 points compared to -7.4 expected.

August's factory orders for capital goods in Japan's industrial sector were 5.7% MoM **lower,** on expectations of 2.3% MoM, in a sign of a weaker forthcoming investment.

Orders for German manufacturing goods in August declined by 1.8% MoM against the expected 0.5% MoM. This was also accompanied by a reduction in domestic orders.

Against this background, an easier ECB and BoJ policy is looking more plausible. In September, the eurozone was in deflationary territory, again. Consumer prices in both Japan and the euro area were down in September by 0.1% YoY – contrasted to the expected 0.0% YoY. Despite the central banks' assertions that the key force behind falling consumer prices is a lower cost of energy, their communications on expected return of CPI to the target may well be problematical in the current setup. In Japan, the poor manufacturing output statistics for August (+0.2% YoY and -0.5% MoM against market expectations of +1,8% YoY and +1.0% MoM), make a stronger case for the Bank of Japan to continue with its quantitative easing (QE) programme. This move would moderate the consequences of a global liquidity squeeze as prompted by the US Fed monetary normalisation.

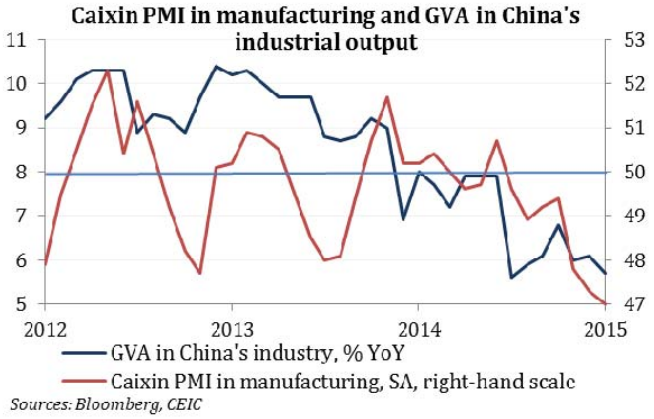
China

China's disappointing figures are becoming a new 'normality'. China's 2015 Q3 GDP only narrowly exceeded market expectations at +6.9% YoY (versus 6.8% YoY). The September output statistics show a further decline, with September's industrial output expanding by 5.7% YoY against the forecasted +6.0 YoY and August's 6.1% YoY. Fixed capital investment added 10.3% YoY in September against +10.9% YoY in August. September's leading PMI indicator turned out more pessimistic than the official statistical data. The service industry, however, looks to be on a stable expansion path in line with expectations (10.5% YoY). The recent slowdown in investment made Bloomberg downgrade China's GDP growth rate from 6.64% to 6.55%.

The composite Caixin PMI index was at historic low 48 points against 48.8 in August. The gap between the official industrial PMI index and the one calculated for a range of medium and small-sized businesses was up in September (Figure 5).

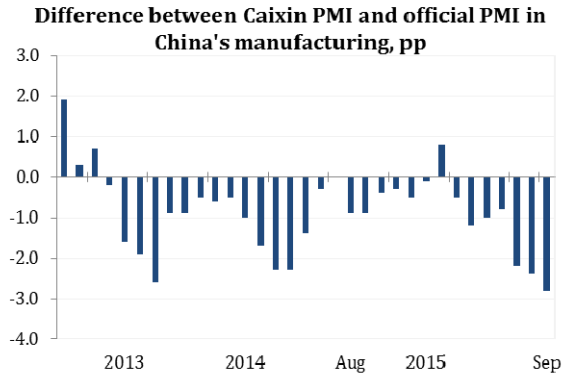
Given that large businesses would normally have access to government support, the official PMI index is not fully reflective of the pressure from structural drivers impacting on Chinese business, while the divergence may indirectly signal the amount of government support.

Figure 5



Sources: Bloomberg, CEIC

Figure 6



Sources: Bloomberg, CEIC

Profits in the Chinese manufacturing sector dipped by 8.8% YoY in August, following the drop of 2.9% YoY in July. Increment in profits totalled 5%.

In September, China saw a sharp 20.4% reduction in the imports of goods and services while the expected drop was 16% (all YoY). Nor did Chinese consumer price movements meet expectations, with the prices rising by 1.6% YoY in September against 1.8% YoY expected.

The new yuan-denominated loans are likely to support aggregate demand and/or financial market developments in the months to come. **Their volumes seen in September were better than expected** and better than the average for the period starting from mid-2014 (when the financial market was overheated)**.** The growth in new lending, prompted by the People's Bank of China's easing of monetary policy speaks for the fact that the Chinese regulator is currently fully in control, on the one hand. On the other hand, this is an indication of artificially sustained economic expansion through accumulation of imbalances (debt), which may well prompt the potential onset of a deep financial crisis and a hard landing of the Chinese economy.

Real estate prices in China remained on a downward path in September, in yet a smaller number of cities (58 of 70 surveyed against 61 of 70 for the previous month). New-build prices were rising in 39 cities, against 35 in the previous month.

Weaker business activity in China **strengthens the chance that the People's Bank of China will ease its monetary policy before the end of the year**. By doing so, it would seek to diminish the misalignment in dynamics of the yuan's real exchange rate as compared to other regional economies, as well as to decrease **the likelihood of another yuan weakening**. Effective 23 October, the People's Bank of China reduced its key (one-year) interest rate by 25 basis points to 4.35%, reducing the deposit rate by the same number to 1.5%.

The People's Bank of China rate decision was accompanied with an easing in required reserves requirements, injecting directly some 90 billion of liquidity (in the US dollar

terms). This rate downgrade was sixth in a row, from the time the rate was cut back from 6% in 2012. Even so, the People's Bank of China still **has abundant room for manoeuvre** as it continues with a further rate reduction in recognition of the current rates and the closed capital account (cf. the rate policy in the 1990s of the Bank of Japan, which, in five years, reduced its interest rate from 4.5% in 1991 to 0.5%).

As China pursues its structural transformation programme, fraught with inescapable slowdown in growth, this rate reduction may well be a contestable move. The industrial sector is however in the grip of deflation, while the paces of consumer price growth remain low (1.6% YoY in September) and are further slowing down.

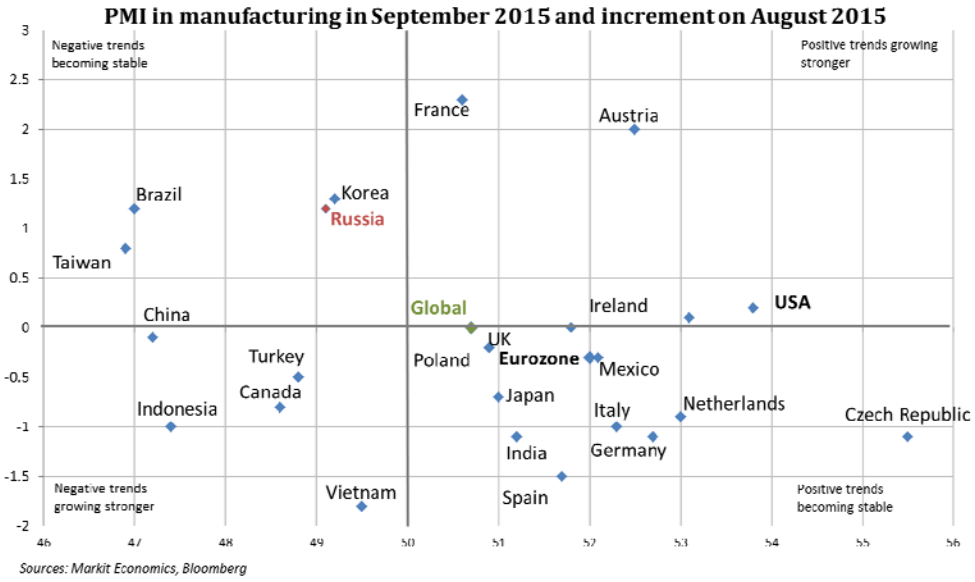
Furthermore, financial stability considerations could also be the rationale behind the People's Bank of China decision. Deflation in the manufacturing industry and the high accumulated debt lead to a heavier debt burden. In this setup, lower rates help decrease debt servicing costs. Having said this, the ongoing rate liberalisation, in progress since 2003, has made the rate irrelevant to market players, except for those in the construction sector and large state-owned companies as these are intended to benefit from an easier Bank policy.

Global economy

In last October's 'World Economic Outlook' report, the **IMF revised its global economic growth forecast for this year down** from 3.3% to 3.1%, which is below the 3.4% growth for 2014. Also, the **IMF** reduced its global economic growth forecast for 2016 from 3.8% to 3.6%. The Fund **warned of the growing risk of further economic slowdown in both developed and emerging economies**.

September's PMI survey findings for the manufacturing sector signal the risk of a deepening slowdown in Japan, the eurozone and, most importantly, China (Figure 7).

Figure 7



Sources: Markit Economics, Bloomberg

1.1.2. Financial markets: stabilisation succeeds a rally

Most October saw the global and Russian financial markets making a rally. However, the available macroeconomic and survey data suggested a slowdown in the global economy. This helped firm up market expectations that the US Fed rate hike cycle is unlikely to happen before next year, with the ECB and the BoJ embarking on a further set of quantitative easing. In the last ten days of the month, the financial markets stabilised.

The BoR decision to make a pause on any further change to its key rate was met with an overall modest reaction from Russian markets. The ruble exchange rate was down somewhat, reflecting, among other factors, the current oil price movements.

Market optimism, coupled with growing confidence that the Bank of Russia will seek to consistently drag down inflation by means of its moderately tight monetary policy, resulted in the federal government bonds (OFZ) **dropping their yields in the long end**. The ensuing OFZ yield curve took on a more inverted form.

Figure 8

Figure 9

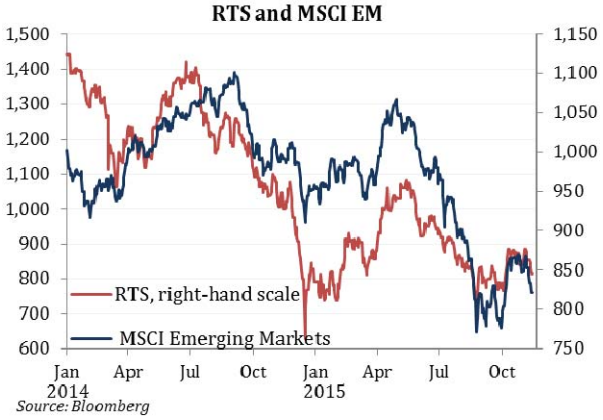
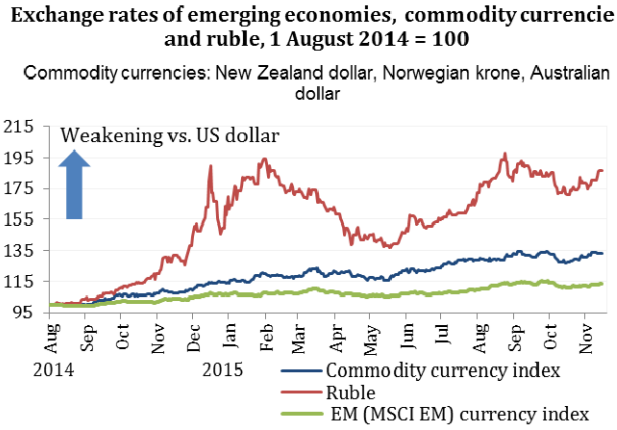


Figure 10

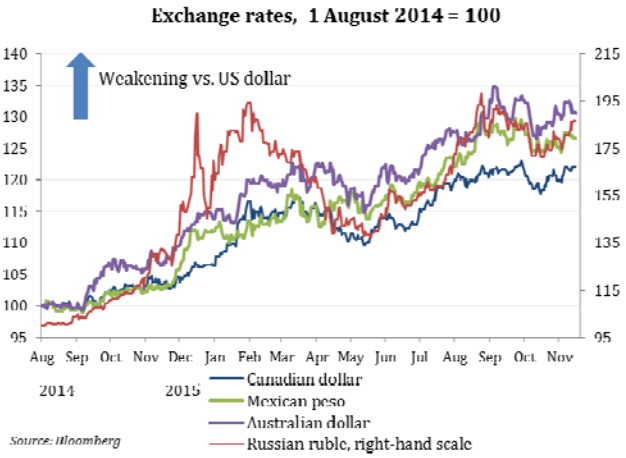
Figure 11

Figure 12



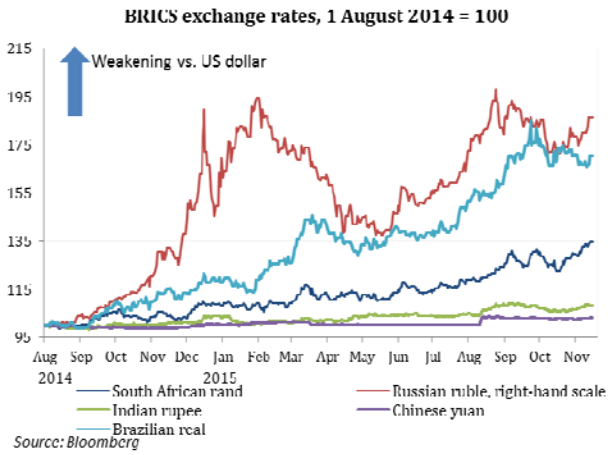
Sources: Bloomberg, Research and Forecasting Department calculations

Figure 13



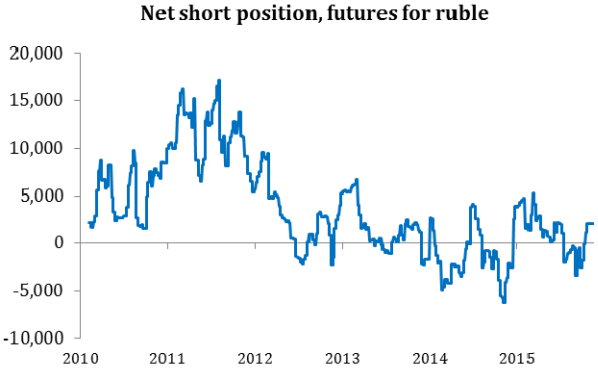
Source: Bloomberg

Figure 14



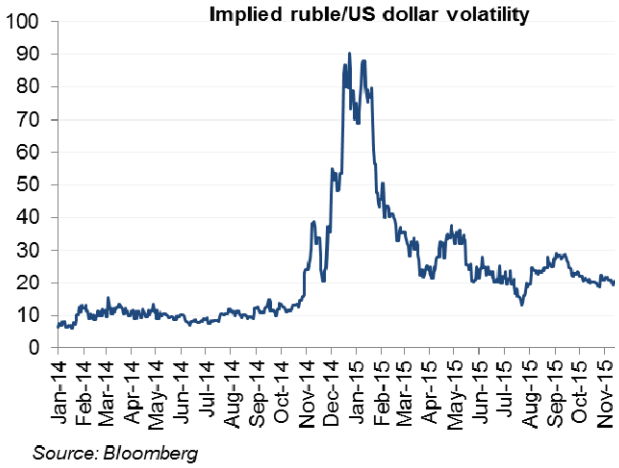
Source: Bloomberg

Figure 15



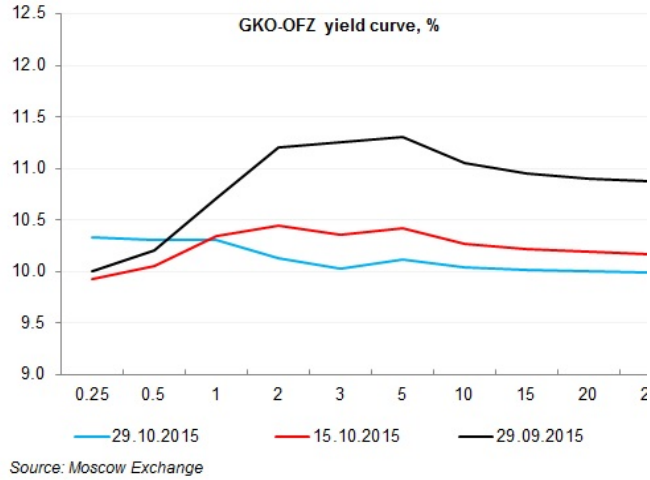
Sources: Bloomberg, Research and Forecasting Department calculations

Figure 16



Source: Bloomberg

Figure 17



Source: Moscow Exchange

October's statistical data on the pattern of cash flows into the Russian and emerging economies' funds suggest resumed **net inflows of portfolio investment into Russian securities over the past few weeks, with net inflows into emerging nations' equities**

and bonds mainly unchanged. Since early 2015, we have been seeing a net cash inflow into Russian portfolio against the backdrop of overall cash outflow from the developing economies (Figure 19).

This suggests that the current dynamics of Russian security investment are, in our understanding, of a corrective nature: we observe a gradual return of net inflow into Russian funds to the levels seen in the run-up to the ruble weakening and related shocks of July and August, as well as the ruble depreciation against the peak uncertainty seen in the end of 2014. We therefore expect the dynamics of Russian and emerging nation fund portfolio investment to become more co-directional already in the short term.

Figure 18

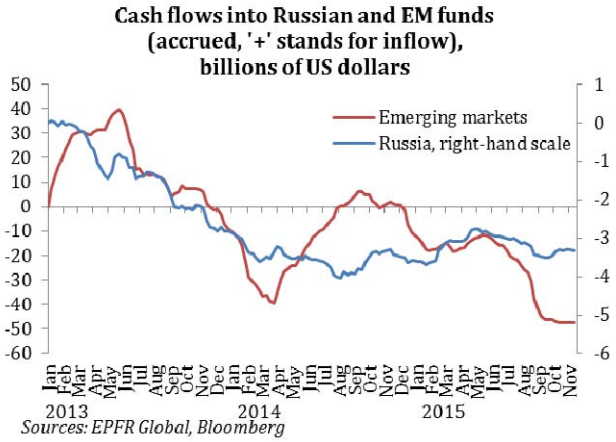
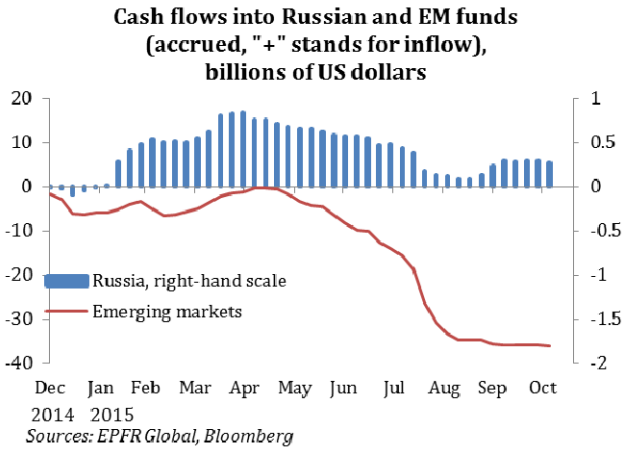
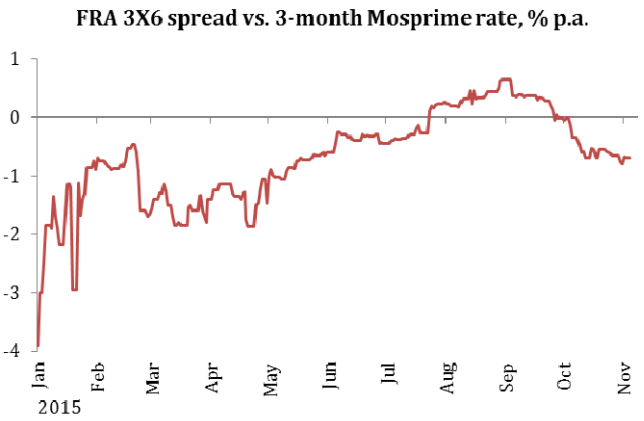


Figure 19



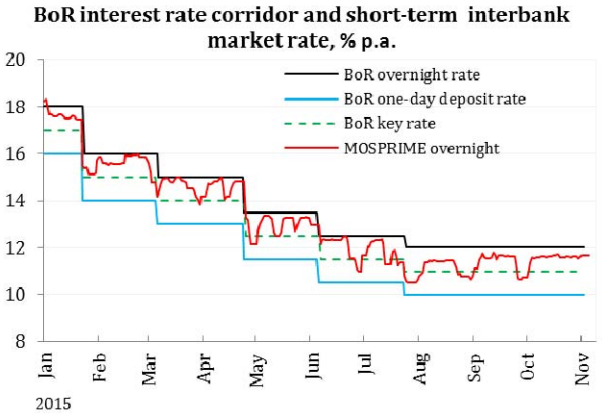
Stronger expectations for easing of the Bank of Russia's monetary policy. In the course of October, the FRA 3×6 and 3M Mosprime spread, reflective of market player expectations with regard to future interest rates, was declining gradually to return, in the middle of the month, into negative territory (Figure 20). We attribute this development to the normalisation of the global and Russian financial markets, which has been seen from after mid-September. The FRA 3×6 and 3M Mosprime spread made it into positive territory in the second half of July. This represents market players' reaction, in the third quarter, of additional inflationary risks related to the weakened ruble. To counter investor expectations, this made the chance of the Bank of Russia continuing with its monetary easing less strong. The spread's October contraction suggests declining liquidity risk expectations, in late 2015, and/or fading risks of a possible key rate upscale. Bearing this in mind, the said indicator is not reliable enough to allow clear-cut conclusions on market expectations for a monetary easing decision to be made at one of the forthcoming BoR Board meetings. FRA 3×6 stands out for its low liquidity, with its value changing in a wide range, subject to a provider.

Figure 20



Sources: Bank of Russia, Bloomberg, Research and Forecasting Department calculations

Figure 21



Sources: Bank of Russia, Bloomberg

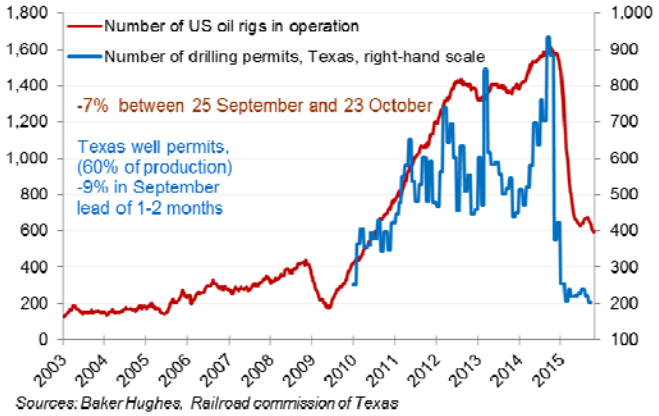
1.1.3. Commodity markets: still volatile

The oil market in October 2015 showed greater turbulence compared to September. Early in the month, crude prices hit $53 a barrel on the news of falling US production, a relative stabilisation in China's economy and expectations for OPEC production cutback. Yet, in the end of the month the negative trends prevailed under the growing concerns of the excess oil supply and in the absence of any signals that the global energy demand is on the mend. This was also triggered by the dollar's growth on expectations for the US Fed rate hike at the turn of the month. The unfolding developments included **a deepening discount of Urals against Brent**, probably as a result of stronger competition between oil exporters and more crude supplies to Europe originating from Saudi Arabia.

In its October report, OPEC reviewed its demand expectations upwards, on the back of revised growth forecasts in OECD countries. At the same time, it revised the **supply forecast downwards**, referring to greater contraction in US and Canada production. The latter is attributable to the high debt levels of oil production companies and higher debt servicing costs. While supply is still expected to be in excess of demand, on condition that current OPEC production levels remain unchanged, the odds are for the market to strike a balance by 2016 Q3. Iran is likely to contribute to this expansion, and we saw a reduction in underutilised OPEC capacities by a factor of 1.5 in 2015 Q3 against the first year-half.

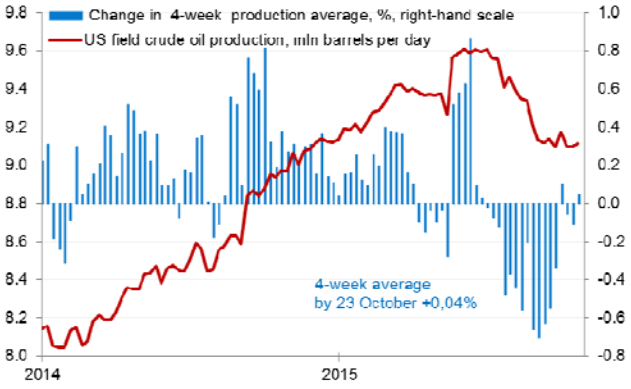
Against this backdrop, the meeting of oil producing countries' representatives ended inconclusively as regards potential production restrictions. **More so, as reported with reference to a Russia representative, the meeting agenda was even without this item**. In the meantime, the Gulf states, namely Saudi Arabia, Kuwait, Qatar and the UAE, are opposed to the idea of holding an oil producer summit with non-OPEC countries.

Figure 22
Number of US oil rigs and drilling permits in Texas



Sources: Baker Hughes, Railroad commission of Texas

Figure 23
US field crude oil production



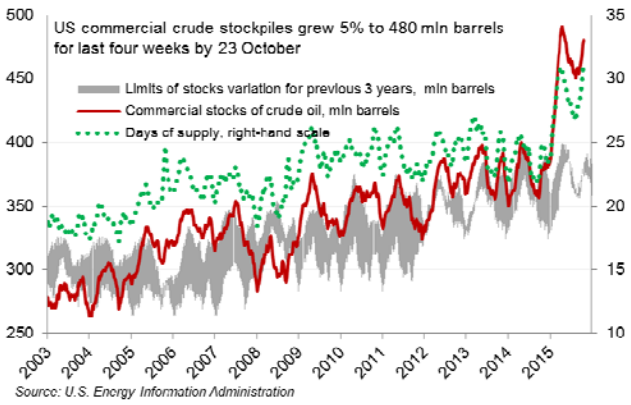
Source: U.S. Energy Information Administration

As reported by Baker Hughes of the US on 23 October, the number of well rigs in operation in the US fell back again, but only marginally. **The EIA data for the 25 September to 23 October period show that the US oil production remains flat,** while commercial crude stockpiles grew again meaningfully by more than 5%**.**

While the last few weeks' developments show to a rising oil glut in the market, generally speaking, such developments are in line with seasonality seen in previous years with respect to stockpiles, while sustained production is down to the shift in investment from oilfield development to production.

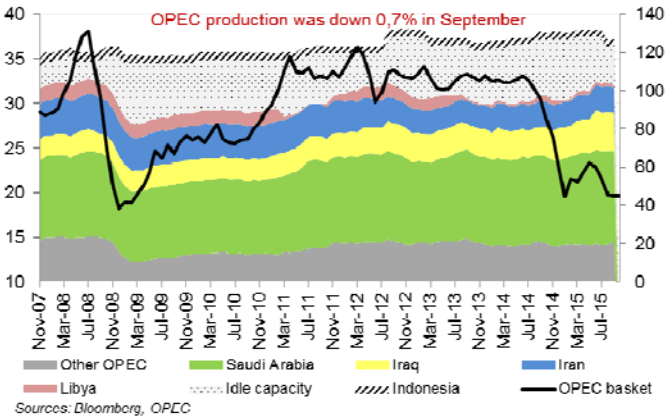
The forthcoming weeks are likely to bring more conclusive statistics, for the reason that seasonality suggests that crude stocks stop growing, or are growing only marginally, and production is set to become stabilised at a lower level.

Figure 24
US commercial stocks of crude oil



Source: U.S. Energy Information Administration

Figure 25
OPEC crude oil production



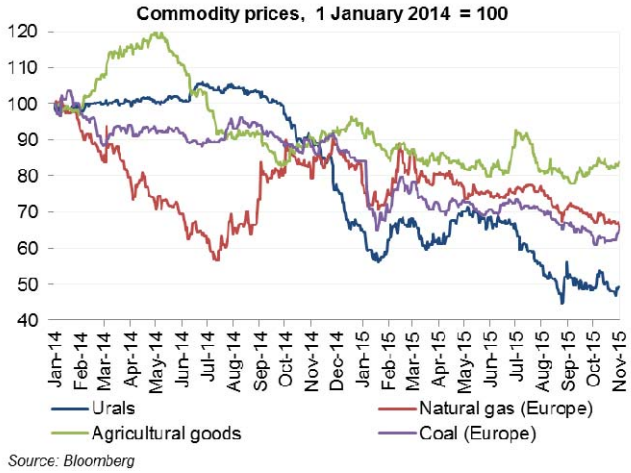
Sources: Bloomberg, OPEC

Oil supplies from Saudi Arabia to Europe are apparently exerting a negative drag on Urals. The discount on Urals CIF Rotterdam against Brent expanded to $3.35 a barrel, while normally it was never above $2 a barrel. This puts **added risks on the**

Russian exports and the balance of payments, and, most importantly, for the Russian state budget.

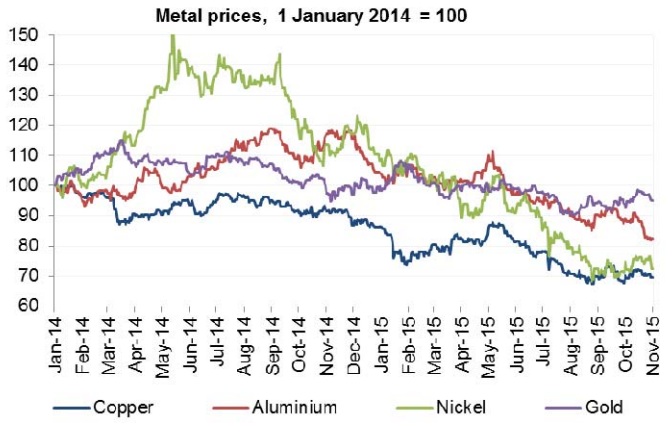
Other commodity markets in October were also on a downward path.

Figure 26
Commodity prices



Source: Bloomberg

Figure 27
Metal prices



Source: Bloomberg

1.2. Russia's economic developments: signs of stabilisation

1.2.1. Slowed contraction of industrial input in September stems from the positive dynamics in manufacturing

The available September statistics on industrial output can overall be viewed as fairly positive. According to Rosstat, seasonally adjusted industrial output for September rose by 0.6% (0.5% according to the BoR Research and Forecasting Department), totalling its maximum for the period since late 2014 (Figure 28). The manufacturing industries accounted for the reporting month's core industrial recovery, chalking up a 0.8% growth for September. This was a pivotal contribution to the composite industrial index given that production in manufacturing accounts for over 50% of its total. Having said this, the mining and quarrying sector, electricity, gas and water supply were not as good as in August, rising respectively by 0.3% and dipping by 1.1% in seasonally adjusted terms (Figure 29).

Figure 28
Industrial production, % MoM (seasonally adjusted)

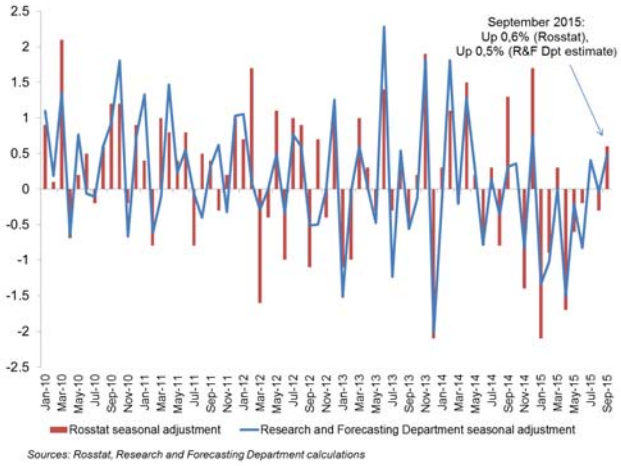
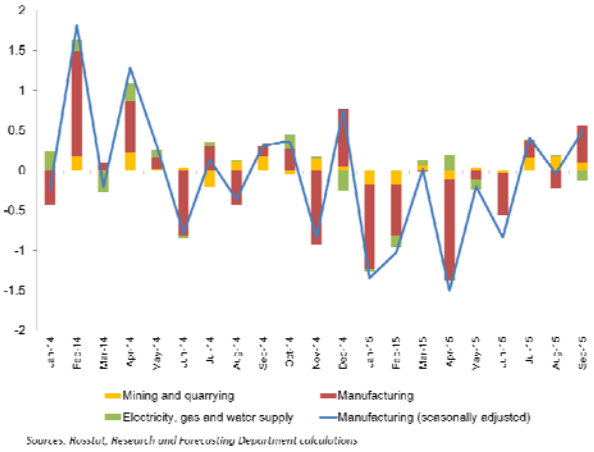


Figure 29
Contributions of individual components to industrial production index,% MoM (seasonally adjusted)



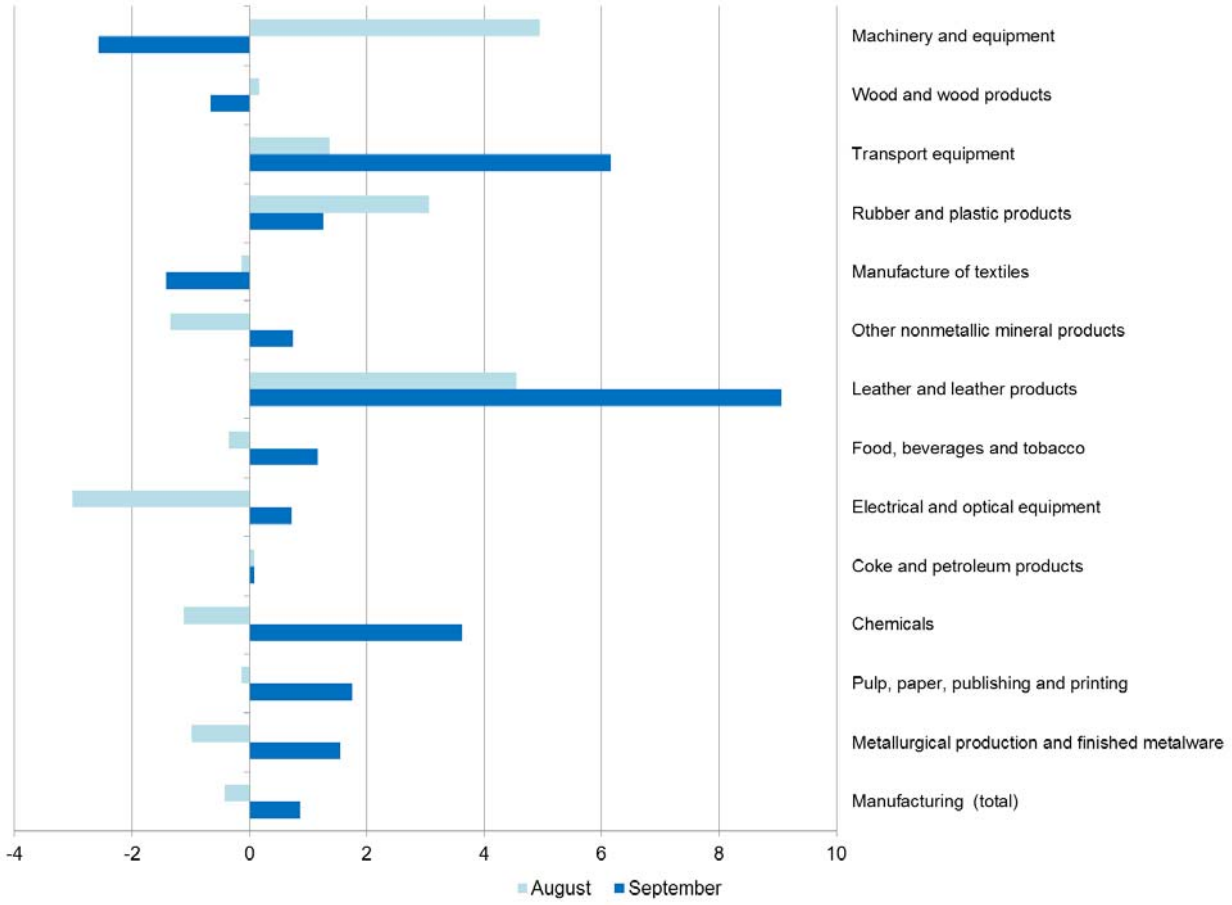
In the core types of manufacturing industries, the most positive changes against last month were seen in production of leather goods, transport and equipment, chemicals and metallurgy (Figure 30). Our estimates suggest a monthly growth in September in 9 out of 13 core manufacturing sectors considered, while that was recorded in only 4 back in August.

Industrial output data show a meaningful volatility of the last months even if adjusted for seasonality and calendar effects. The industrial output index in July was positive and close to the September figures, yet the subsequent August statistics failed to indicate any signs of an early economic recovery.

This probably makes premature any conclusions on the onset, in September, of some positive trends in the manufacturing industries. Production of leather goods and transport and equipment were the only two components of industrial production growing for two straight months, while there was a significant drop in manufacturing of machinery and equipment compared to August.

In our view, Rosstat's industrial statistics for October will be expected to provide a more solid basis for drawing conclusions on the outlook for future production recovery.

Figure 30
Industrial production growth in core manufacturing industries, September and August 2015, % MoM (seasonally adjusted)



Sources: Rosstat, Research and Forecasting Department seasonal adjustment

1.2.2. Russia's key industry index points to improved economic activities, with a slower slide in the manufacturing industries across most federal districts

The September key industry index (KII)[1] points to **an ongoing fading economic downturn** started in June, calculated on an annualised basis (Figure 31). The early signs of a slower downturn in the manufacturing industries, first seen in August, maintained in September (thanks to a month-on-month growth). Improved year-on-year KII trends occurred amid a slower downturn in construction, a rising agricultural output and minerals extraction as well as a rebound in cargo turnover.

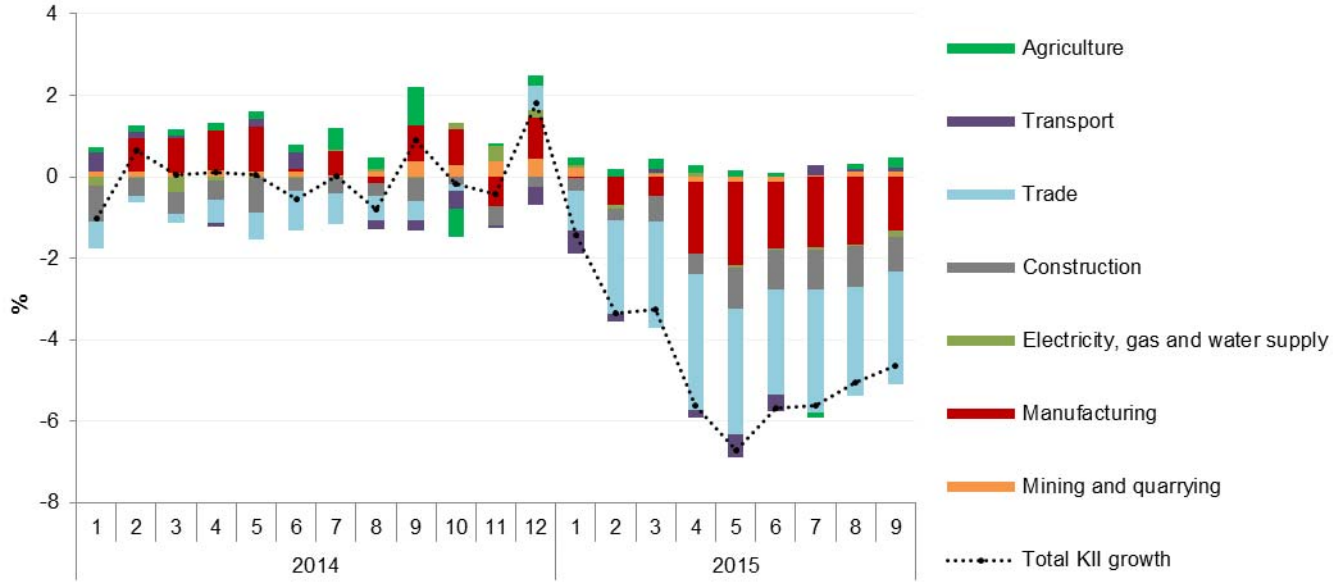
From the federal districts' perspective, KII trends are heterogeneous, in confirmation of varying degrees of a region's adaptation to new economic conditions related to its

[1] The key industry index (KII) was developed as a tool for real-time monitoring of the economic environment in Russia as whole and individual regions. KII is calculated as the aggregate of five industrial indicators, year-on-year (agricultural output; industrial output, volume of construction; volume of wholesale and retail sales, cargo turnover) with the weights corresponding to the industry's gross value added in 2013. Following unavailability of official data for agricultural output and cargo turnover by region, the KII for the federal districts was made for the remaining three indicators.

individual industrial profile (Figure 32). The last two months' sustainable economic recovery can only be seen in the Central, North Caucasian and Siberian Federal Districts. Tellingly, the common trend was that most federal districts with negative YoY growth rates in August showed a slowdown in the said activity, while the Central Federal District even posted a growth.

In our view, in the context of some slowdown in industrial output late last year, together with a discernible stabilisation in industrial production of the current year's fourth quarter, we can expect some further contraction in the manufacturing industries' negative contribution to the KII behaviour.

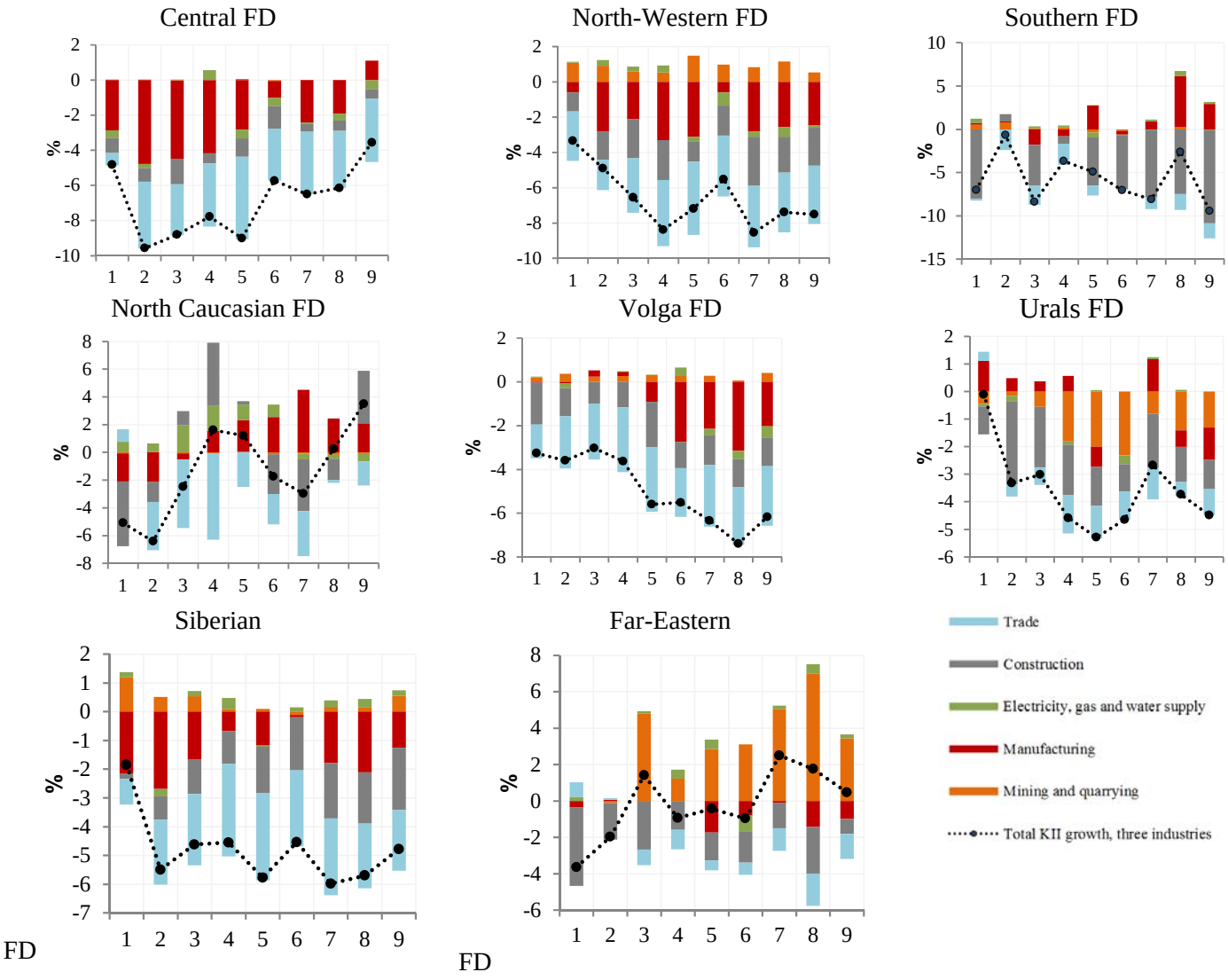
Figure 31
Industrial components' contribution to KII behaviour in Russia, % YoY



Sources: Rosstat, Research and Forecasting Department calculations

Figure 32

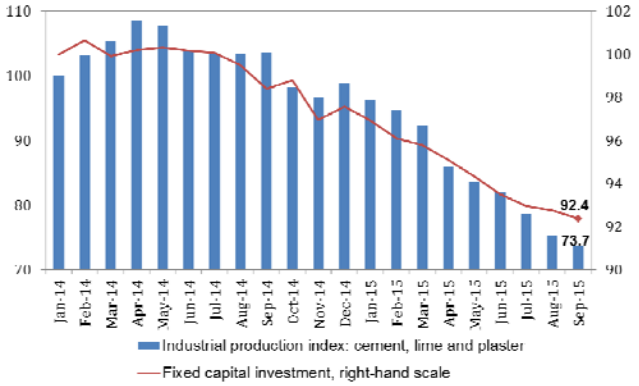
Industrial components' contribution to total KII growth by federal district, 2015, % YoY



1.2.3. Recovery in consumer and investment activity remains under question

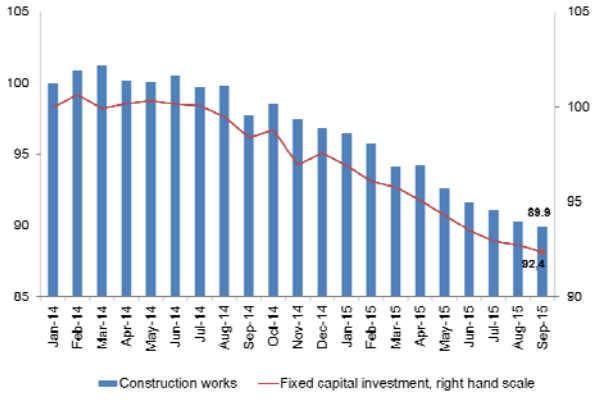
We believe that **investment activity has not yet reached its bottom** (Figure 33 and Figure 34). Construction works and cement production continued their decline in September. Our estimates suggest that a seasonally adjusted monthly change in fixed capital investment was negative at -0.4% MoM, as this does not provide evidence for recovery in investment activity.

Figure 33
Cement production and fixed capital investment (January 2014 = 100), seasonally adjusted



Sources: Rosstat, Research and Forecasting Department seasonal adjustment

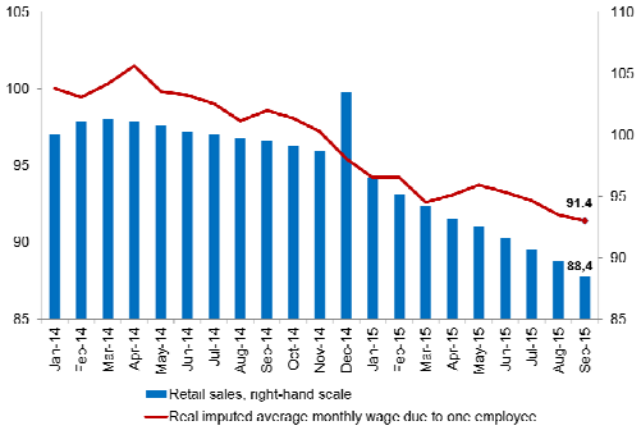
Figure 34
Construction works and fixed capital investment in 2014–2015 (January 2014 = 100), seasonally adjusted



Sources: Rosstat, Research and Forecasting Department seasonal adjustment

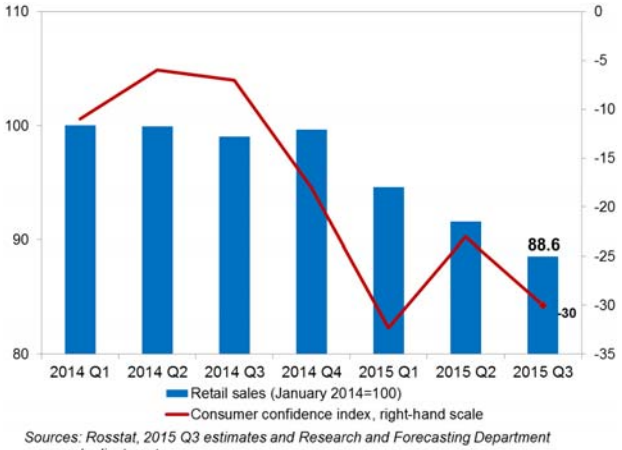
In September, **the decline in consumer activity continued**. Retail sales were further down, dragged down by the persisting drop in real wages started in mid-year 2014 (adjusted for a moderate growth in the periods of indexation of public sector wages) (Figure 35). Tentative estimates also suggest that consumer confidence for 2015 Q3 deteriorated (Figure 36). Our intuition is that this trend was triggered by the weakening of the ruble following the past quarter's plunge in oil prices. This is succeeded by the exchange rate stabilisation, which occurred in September and October and which is expected to affect consumer confidence positively. Nevertheless, we do not see fundamental reasons for an end in the current retail slump.

Figure 35
Retail sales and real wages (January 2014 = 100, seasonally adjusted)



Sources: Rosstat, Research and Forecasting Department seasonal adjustment

Figure 36
Retail sales and Rosstat consumer confidence index[2]



Sources: Rosstat, 2015 Q3 estimates and Research and Forecasting Department seasonal adjustment

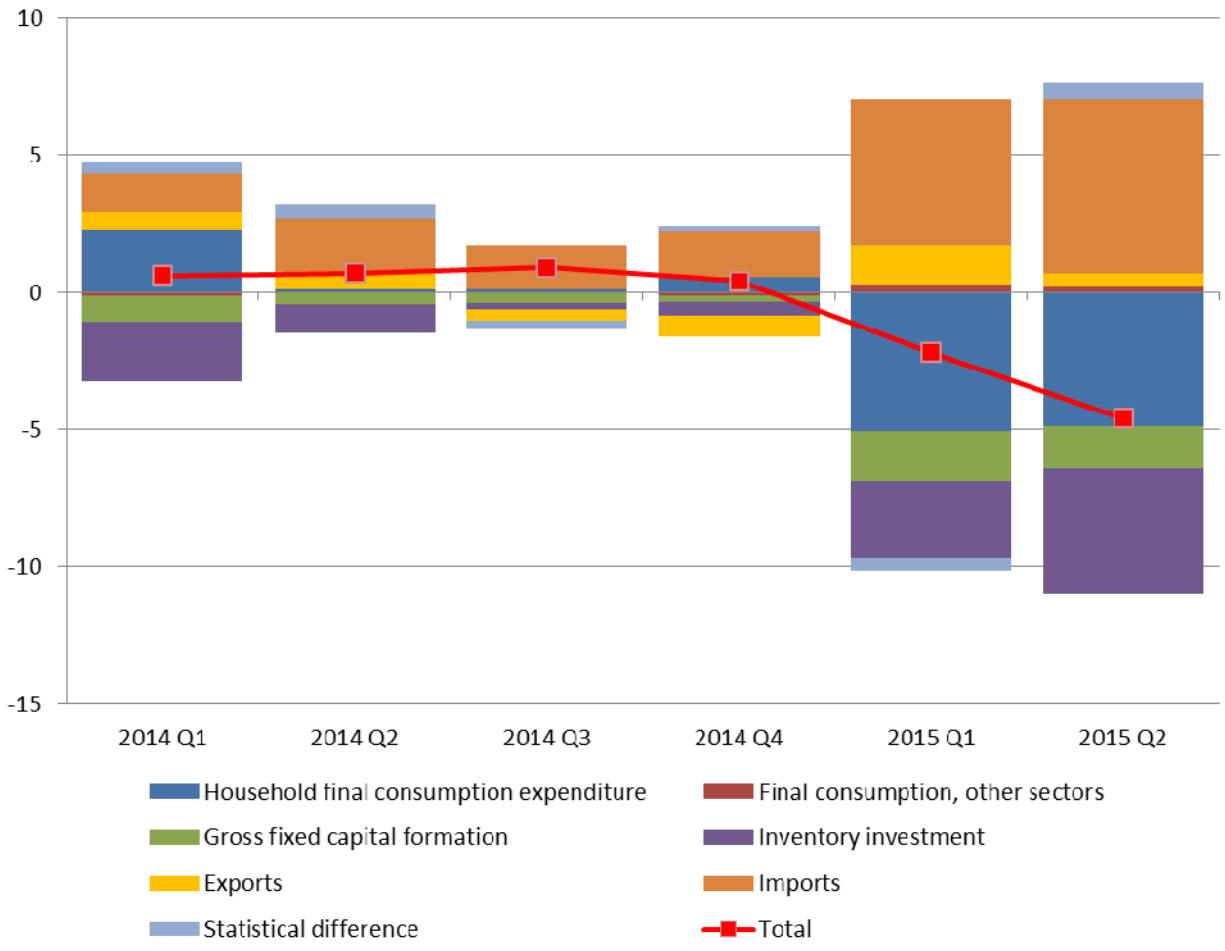
[2] Research and Forecasting Department's assessment of Rosstat's consumer confidence index for 2015 Q3 is based on data including the Ivanov Index by Sberbank CIB for 2015 Q3, showing a decline in consumer activity by 10 points against 2015 Q2.

1.2.4. 2015 Q2 GDP by expenditure: inventory valuation adjustment and imports as drivers of aggregate demand

Although import quantities saw a sharp and accelerated decline in the second quarter of 2015, they kept annualised GDP shrinkage within 4.6%, as Rosstat data imply (Figure 37). **However, the negative input of contracted inventories into the GDP behaviour has grown meaningfully**.

Expenditure on final consumption in the general government sector in the second quarter of 2015 was again showing neutral dynamics in real terms, despite the expedited, against last year, spending of budget funds. **This helps mitigate the risks of negative impact on 2015 Q4 GDP** from even budget spending of this year thanks to a high base effect. Even so, limitations in budget funding available to government contractors, may negatively influence the operations of such enterprises in 2015 Q4.

Figure 37
Contribution of individual expenditure components to Russian GDP behaviour (in constant prices, 2008), pp



Sources: Rosstat, Research and Forecasting Department calculations

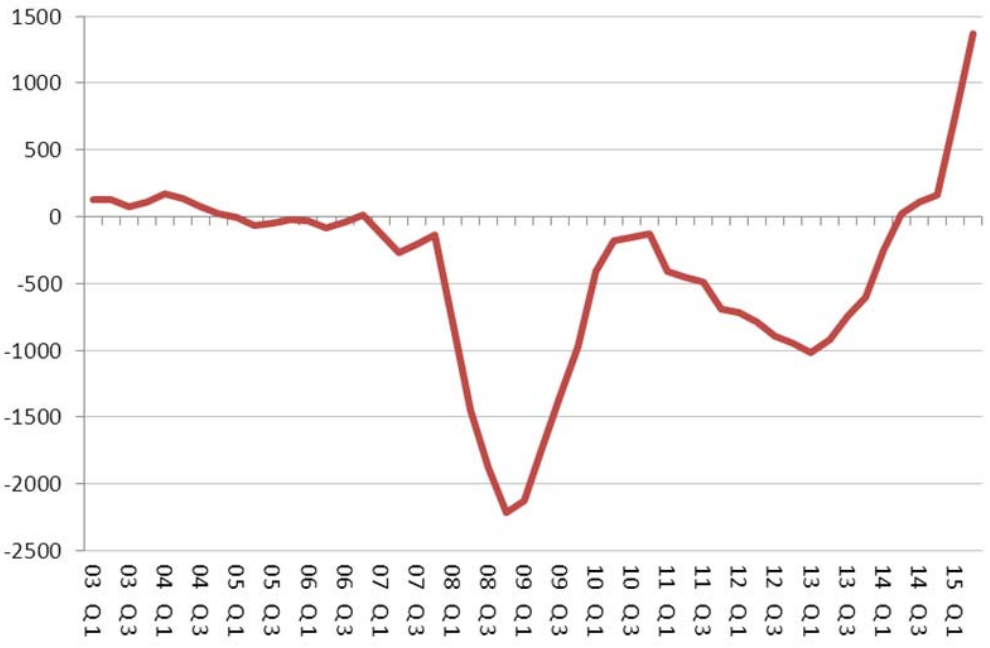
Our estimates suggest that the relative **inventory dynamics** in the first half of 2015 may indicate strongly overestimated expectations of economic operators regarding the depth of the current economic crisis. Also, it is possible that Rosstat exaggerates the real inventory drop, underestimating the drop in other GDP components (e.g. fixed capital investment) or overestimating the GDP size. In either case, **inventory movements are due to exert some positive influence on the GDP pattern in the nearest future**.

Inventory dynamics: underestimated expectations or a Rosstat mistake?

Economic operators' demand for inventory is determined by the level when demand for products is met in the conditions when it can fluctuate. One may assume that there exist a long-term equilibrium between the volume of sales and inventories. Such indicator cannot be calculated in an explicit form; yet, with certain assumptions, its changes may be approximated. Once assumed that the volume of sales correlates with the size of GDP, the difference between a GDP increment and inventories will be reflective of fluctuations in the sales to inventories ratio. If an equilibrium level of this ratio were constant, the cumulative gap between a GDP increment and inventory investment should be zero.

Until recently, inventory investment dynamics were in principle a match for these assumptions (Figure 38). For instance, the contraction in inventories seen between 2009 and 2010 and between 2013 and 2014 could be viewed as correction following their outrunning growth in previous periods. Yet, the scale of inventory contraction in 2015 is substantially in excess of the overall pace of GDP slowdown. Supposedly there must be several justifications for this phenomenon.

Figure 38
Cumulative deviation of seasonally adjusted GDP change from fluctuating inventories (2008 prices, billions of rubles)



Sources: Rosstat, Research and Forecasting Department calculations

Economic operators could expect a drop in demand more substantial than actual, given the 2008-2009 crisis scenario. Inventories could start to rebound at outperforming rates (compared to overall GDP) as soon as economic operators make certain that there was no substantial drop in demand and see early stabilisation in demand.

A return to the equilibrium could happen without build-up of inventories, should the drop in demand continue as a result of a deepening recession. Furthermore, the equilibrium of inventories my change, which, however, was not the case in the preceding decade, including the 2008-2009 crisis.

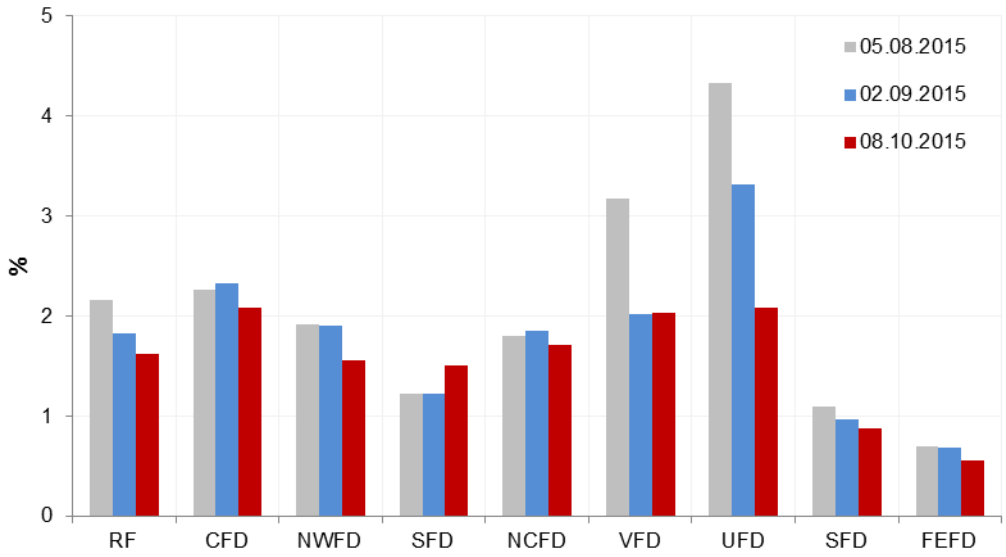
And finally, it could not be ruled out that Rosstat may overestimate the scale of inventory contraction, underestimating other GDP components (e.g. fixed capital investment) or overestimating the drop in GDP. The subsequent correction in GDP growth rates and structural components are assumed to provide a clear understanding.

In any case, any further contraction in inventories looks unlikely.

1.2.5. Labour market: underemployment on the decline

Labour market statistics in Russia suggest a drop in underemployment, impacted by both seasonality and the emerging stabilisation in economic activity. In the August to September 2015 period, Russia as a whole and individual regions saw underemployment contracting on a large scale. However, in the industrial regions, including Urals and Volga Federal Districts, the share of those employed short time (part-time work day or short week) in the average headcount is higher than the national average. This is explained by the high severance costs in the industrial sector.

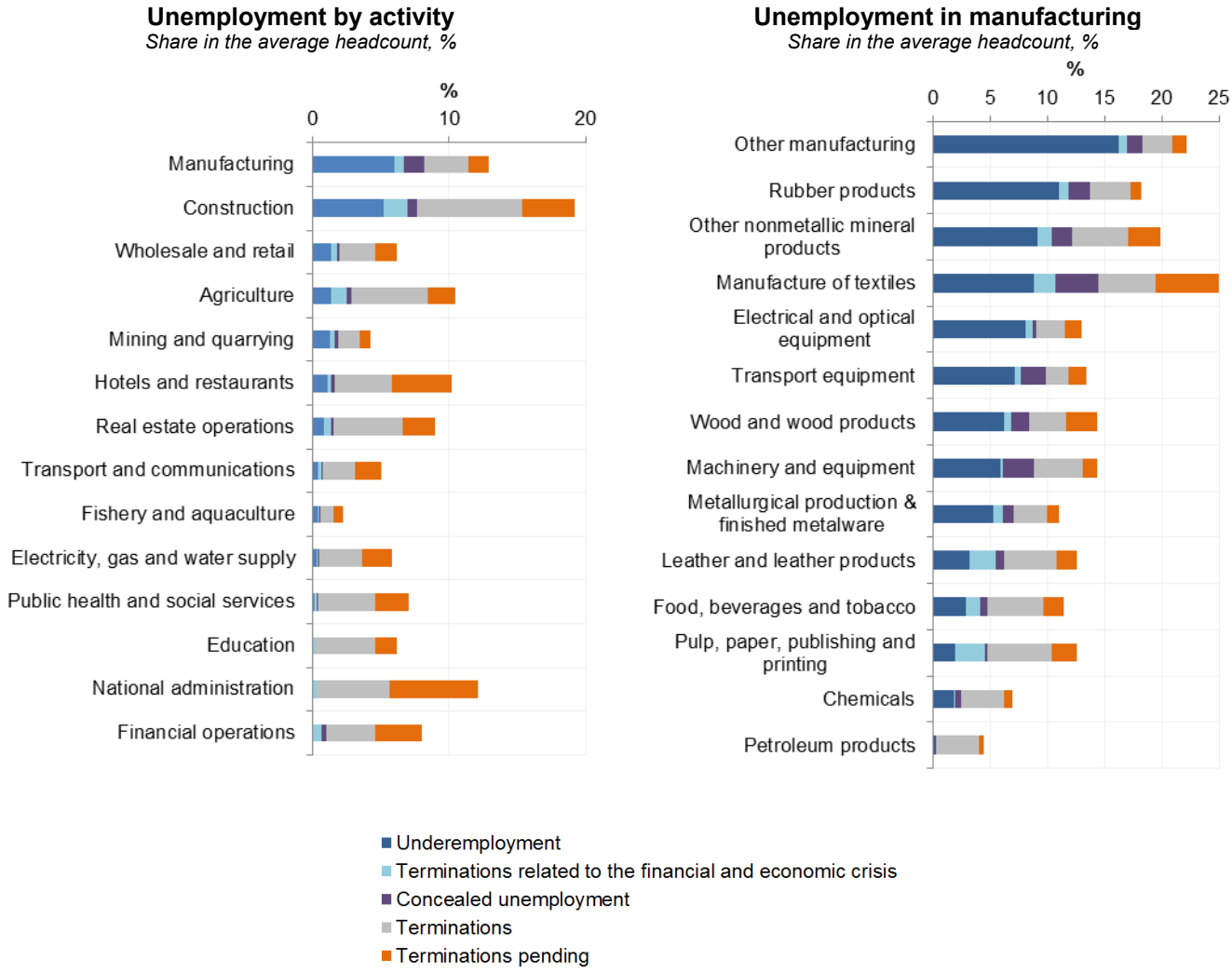
Figure 39
Share of underemployment in the average headcount, %



Source: RF Ministry of Labour and Social Protection

At the industry level, as of 8 October 2015, high underemployment was still recorded in manufacturing, construction and retail. This suggests that the ongoing adaptation across enterprises in most industries is mainly enabled through part-time employment and to a far lesser extent through concealed unemployment or employment termination related to the financial and economic crisis; such are the Russian labour market specifics.

Figure 40



Sources: RF Ministry of Labour and Social Protection, Research and Forecasting Department calculations

1.2.6. Structural changes in the oil sector exports

In 2015, **structural changes emerged in the exports of the oil sector**, with the exports of crude, for the first time over recent years, on the rise (+8% for the January to September period, YoY), with a concurrent drop in the exports of refined products (-19.6% for January to August, YoY). The ensuing effect was decreased oil refining (-1.9% for January to September, YoY), mainly residual fuel oil (-13.0%), a central export earner of recent years. Such changes were **the expected outcome of the *tax manoeuvre*** whereunder export duties on oil and refined products were reduced and the mineral extraction tax (MET) increased as a compensatory measure.

Figure 41
Crude: production, refining and export growth in 2011-2015, YoY, %

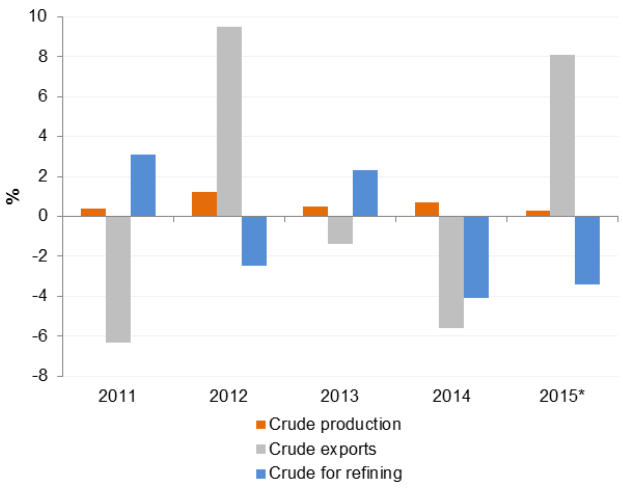
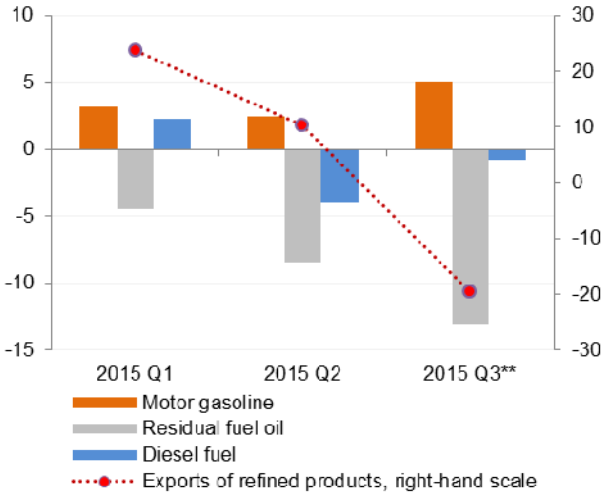


Figure 42
Refined products: production and export growth in 2015, YoY, %



** 9 months of 2015 to 9 months of 2014 ratio*
*** With September statistics unavailable, 2015 Q3 exports are calculated as the ratio of July-August 2015 to July-August 2014*
Sources: Rosstat, CEIC, Research and Forecasting Department calculations

Oil production is continuing to show positive dynamics (+0.3% YoY), for the first nine months of 2015, on the back of high investment in production in the previous years and because of the weaker ruble. While Russian companies' capital investment related to oilfield development and production in ruble terms continued to expand, their dollar equivalents shrank because of the depreciation. The ruble depreciation therefore helped as the industry was trying to soften the fallout from the oil price slump. A second mitigating effect came from the industrial tax system. Under the current taxation, the MET and export duties are pegged to Urals export price. As oil prices dropped, it was the federal budget that accounted for most shortfall, not the Russian oil companies.

Innovative tax regulations for the oil sector, together with the ruble exchange rate fluctuations, are exerting a negative influence on petrol prices in rubles. As Urals oil prices in dollars dropped by 44.4% between January and September 2015, the ruble petrol price equivalent for Russian consumers over the same period rose by 5.7%.

1.2.7. The car market: a new equilibrium at a lower level

The high base effect of late 2014 spells **a faster annualised downfall in the new car market** in the remainder of 2015. This will **most likely negatively affect all 2015 Q4 annualised retail sales trends**, and is thus a risk factor for GDP.

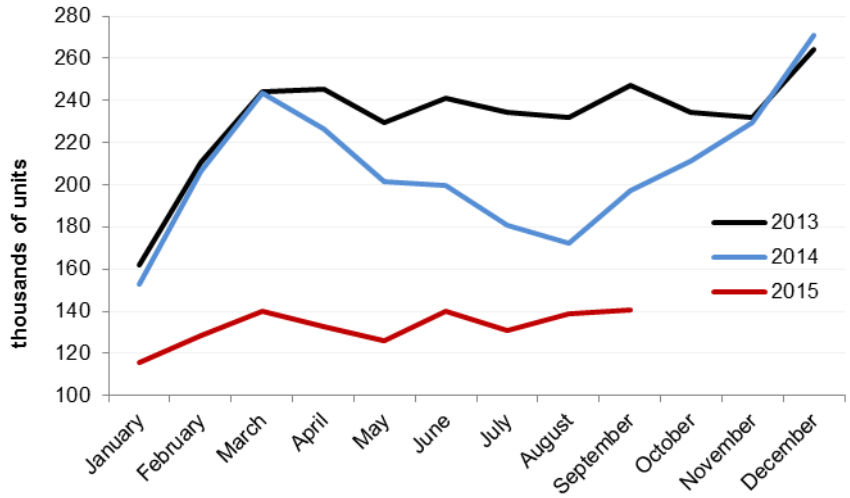
Sales of new cars have been falling at a sharply faster pace since September. The year-on-year pace of downfall reached 28.6% YoY, according to the Association of European Businesses (AEB). This faster annualised slump comes as a result of the dramatic market changes in the past year, when the crisis-affected market lost ground in the period starting in April, to regain some ground in the period starting in September, when the

demand was rebounding, spurred by the government support programme. The programme (concessional loans and leasing) was launched in the conditions of a swift fall in the value of the ruble.

2015 monthly sales data, which have no such sharp swings, look very much in line with the pre-crisis year of 2013 (Figure 43). The possible assumption therefore is that **the market saw a structural downward shift in car manufacturing and consumption with a new, lower, equilibrium** materialising. To an average customer, car affordability was down substantially due to growing prices, which followed the turbulent path of exchange rate, with real consumer incomes remaining almost flat. A lot fewer consumers are currently expected to trade in, which is set to boost the share of first car buys within a more affordable price range in the secondary market. The market growth outlook remains uncertain.

In the current settings of a turbulent exchange rate, local manufacturers' makes are gaining the lead. The recent years saw local manufacturers adding growth to their share annually. The trend became most discernible this year, when the highest rate was recorded: as many as 78.6% cars sold in the Russian market for the first nine months of 2015 were manufactured domestically, against 70.1% in the previous year. The number of locally assembled cars rose by almost 8% over the past year.

Figure 43
New car sales



Source: AEB

1.2.8. Low gross margin as structural problem

Gross margin in the Russian economy (including depreciation and mixed income) is one of the lowest in its peer group per capita income (Figure 44). **Russia's low gross margin points to the existing structural limitations to investment and economic growth determined by scarcity of domestic funds.**

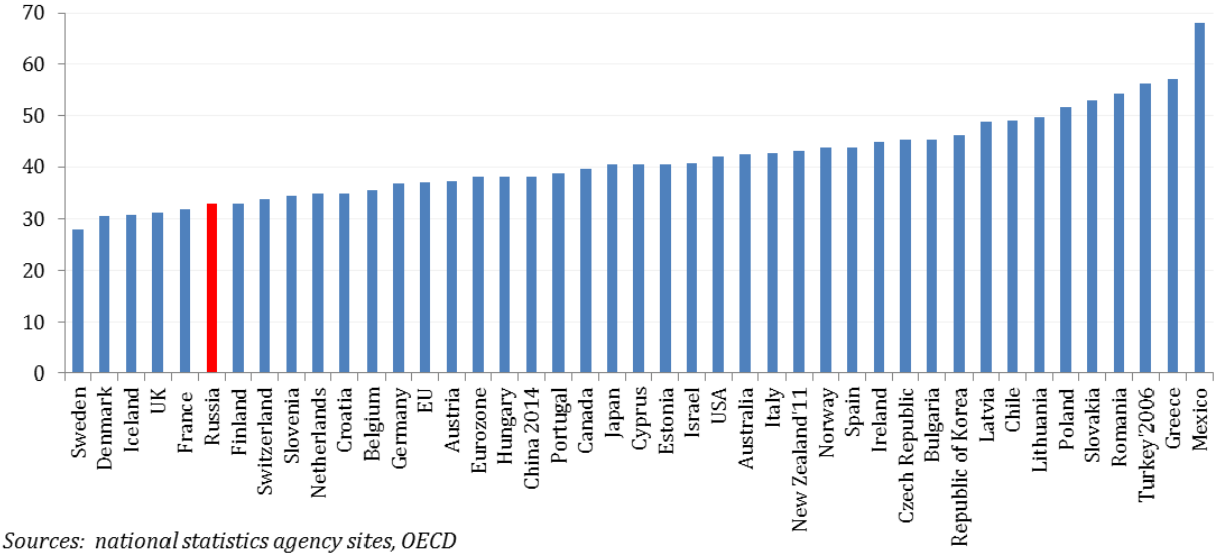
This underrun of the Russian economy, compared to the OECD group, is in no small measure a reflection of a **marginally low level of fixed capital consumption** (depreciation deductions) (Figure 45). The low fixed capital consumption, in its turn, is explained by the use of already depreciated fixed assets or restraints on accelerated depreciation.

The taxation system is also of essence here, since taxes on products and imports are not included in the amount of gross margin and mixed income. The high tax level countries, e.g. Sweden or Denmark, have the smallest share of margin in their GDP among all OECD economies. **The tilt towards broader taxation of capital** alongside with reduced taxation of labour is also partially accountable for the low gross margin in Russia's GDP.

And, finally, **the Russian specifics of imputed cost accounting are such that they could lead to an underestimated share of gross margin in GDP**. Rosstat does calculate the cost of households-provided rental services (imputed rent), yet in the absence of a mature methodology to appropriately evaluate the housing market, the amounts of rent in Russia may be underestimated.

Figure 44

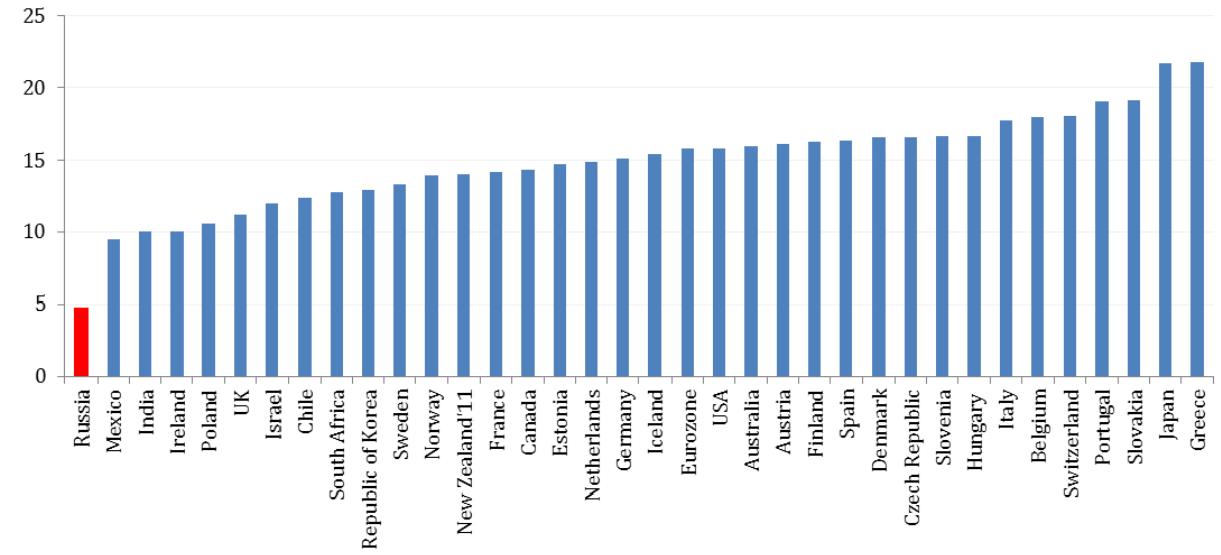
Gross margin and gross and mixed income according to SNA, % GDP, market prices , 2013



Sources: national statistics agency sites, OECD

Figure 45

Fixed capital consumption , SNA, % GDP, market prices, 2012



Sources: national statistics agency sites, OECD

1.3. Inflation stays high, elevated inflation risks persist

1.3.1. In October, inflation accelerated, reflective of increased inflationary pressure

Seasonally adjusted October inflation **accelerated following the surge in prices for fruit and vegetables beyond seasonal fluctuations and the persistent exchange rate pass-through effect on prices.** Even so, the annual inflation declined slightly from 15.7% YoY in September to 15.6% YoY in October 2015.

Provided that there are no new currency shocks on the way, the positive effect of the 2014 high base and the lower exchange rate pass-through effect pave the way for **disinflation to emerge by the year-end**. While assessing overall inflation risks as balanced, we leave the annual consumer price index forecast as of the year-end unchanged (12.7% YoY).

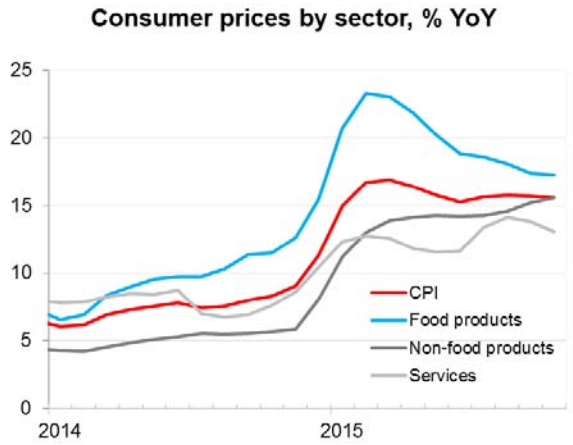
Food and non-food products showed the greatest acceleration in a monthly CPI growth. **Food** price growth **accelerated** from 0.4% MoM in September to 1.0% MoM in October 2015 (17.3% YoY), thereby contributing 0.33 pp to monthly inflation. The contribution of food products to inflation showed a stable downward trend due to lower consumer demand and a considerably dwindled effect of the food embargo. The segment of cheap *socially significant* food products showed the most sizable rise in prices (1.1%–10.6% MoM, depending on the product category). Fruit and vegetables showed a considerable price increase (2.9% MoM). The main reasons behind the price surge in this category of goods include the dependence on imported primary products and the exchange rate pass-through effect.

Prices for certain goods jumped due to the **seasonal factor,** which aggravated sharply as the share of imported products in the consumer basket reduced (vegetables, milk and dairy products).

Non-food price growth **slowed somewhat** from 1.1% MoM in September to 1.0% MoM in October this year (15.6% YoY). The contribution of non-food products to inflation totalled 0.37 pp. Such high contribution of non-food products results from the high dependence of this product category on the exchange rate dynamics for imports. Seasonal goods (footwear, clothes and fabric) and technical equipment (electric products and other household appliances, audio-visual goods), the cost of which largely depends on imports, tended to show a higher price growth.

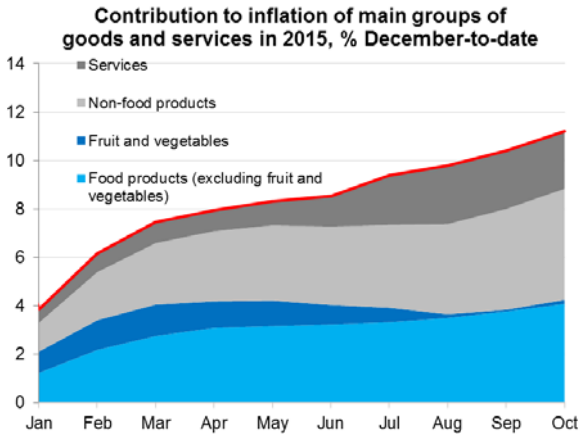
In October 2015, service prices were down by 0.1% MoM following the contraction in consumer demand. The annual service price growth was 13.1% YoY. A further shortage in consumer demand, likely to occur in 2015 Q4, may trigger an even slower growth in prices for commercial services.

Figure 46



Sources: Rosstat, Research and Forecasting Department calculations

Figure 47



Sources: Rosstat, Research and Forecasting Department calculations

The contribution of money supply to short-term consumer price dynamics **declines persistently.** Eventually, it should bring consumer inflation down to the 4% target.

Despite the exchange rate stabilisation observed from mid-September, **inflation expectations** remain relatively elevated (Figure 48, Figure 49). In our opinion, it may pose a risk of the actual inflation exceeding the BoR official forecast in both short and medium term.

Figure 48

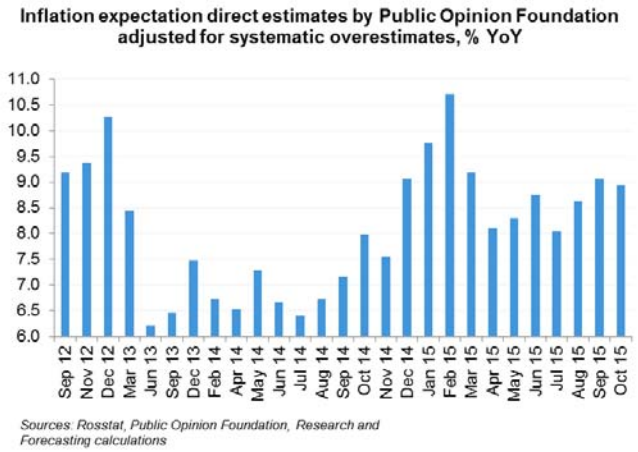
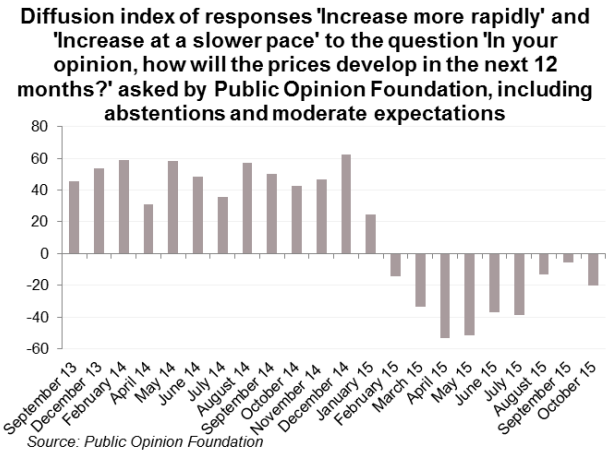


Figure 49



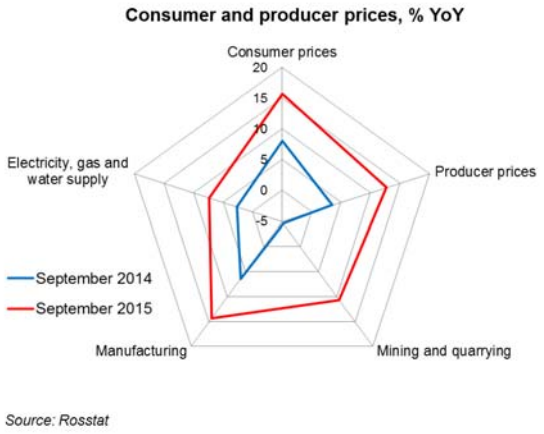
Nevertheless, consumer price growth slowed somewhat by the month-end. During the week from 27 October to 2 November 2015, the consumer price index rose by 0.2% week-on-week. **Seasonally adjusted annualised inflation** (inflation calculated for a year ahead, proceeding from the average daily rate over the reporting week) **went down** to 11.4% YoY. Seasonally adjusted sliding 4-week inflation was 13.1% (calculated for a year ahead), persisting at a high level. The main contributors to the increase in weekly inflation were food products with their high import component and fruit and vegetables.

1.3.2. Growth of producer prices for consumer goods brings additional inflation risks

The overall dynamics of producer prices put an upward pressure on **inflation** in late 2015.

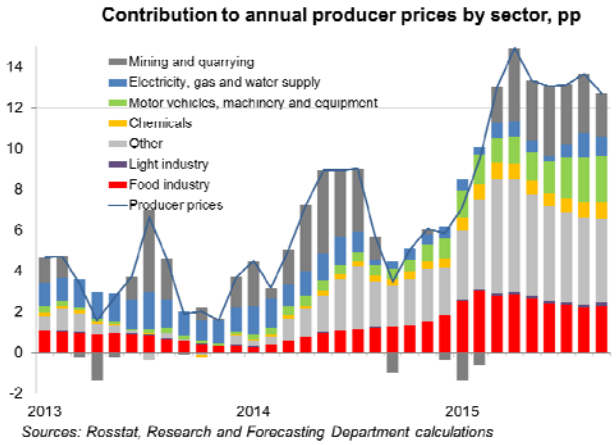
Manufacturing is the main contributor to the annual producer price growth. The contribution of manufacturing industries in producer price growth in September (12.7% YoY) stood at 9.6 pp; mining and quarrying contributed 2.1 pp, and electricity, gas and water supply contributed 1.0 pp.

Figure 50



Source: Rosstat

Figure 51



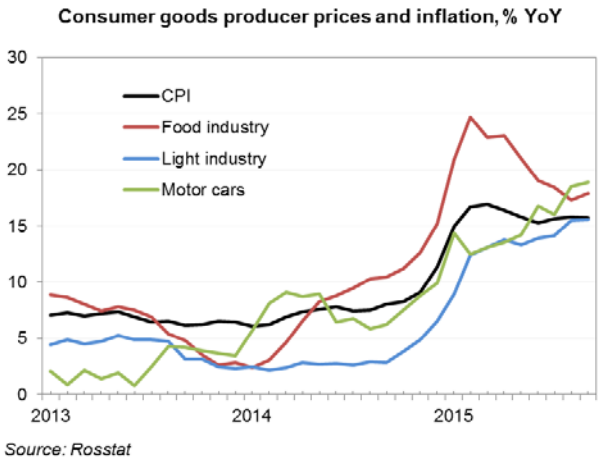
Sources: Rosstat, Research and Forecasting Department calculations

The food industry, in its turn, **was the greatest contributor to the annual growth of industrial producer prices** (2.3 pp). Annual growth in this sector accelerated to 17.9% YoY in September from 17.3% YoY a month earlier (Figure 50).

Prerequisites were created for a **further accelerated growth of producer price index** between October and November 2015. The high share of imports in production of consumer goods against the backdrop of a depreciated ruble in the June to August 2015 period turned out an important factor of price growth in the sector. The producer price index growth is additionally driven by the relatively stable households' demand for this category of goods (Figure 51).

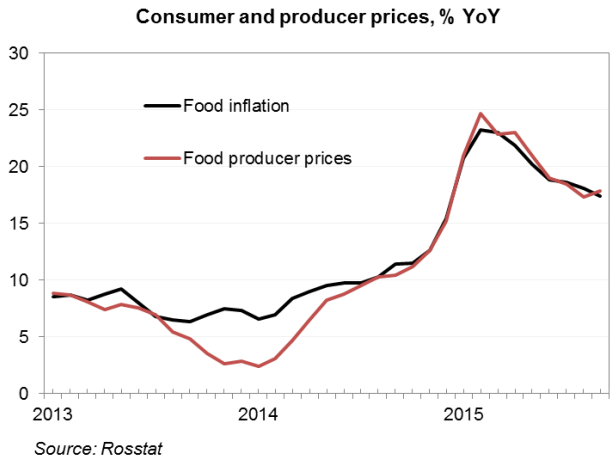
Accelerated growth of producer prices threatens consumer prices as any price growth in the food industry almost completely transforms into the growth of consumer inflation (the variables correlate at 0.98) (Figure 52 and Figure 53).

Figure 52



Source: Rosstat

Figure 53

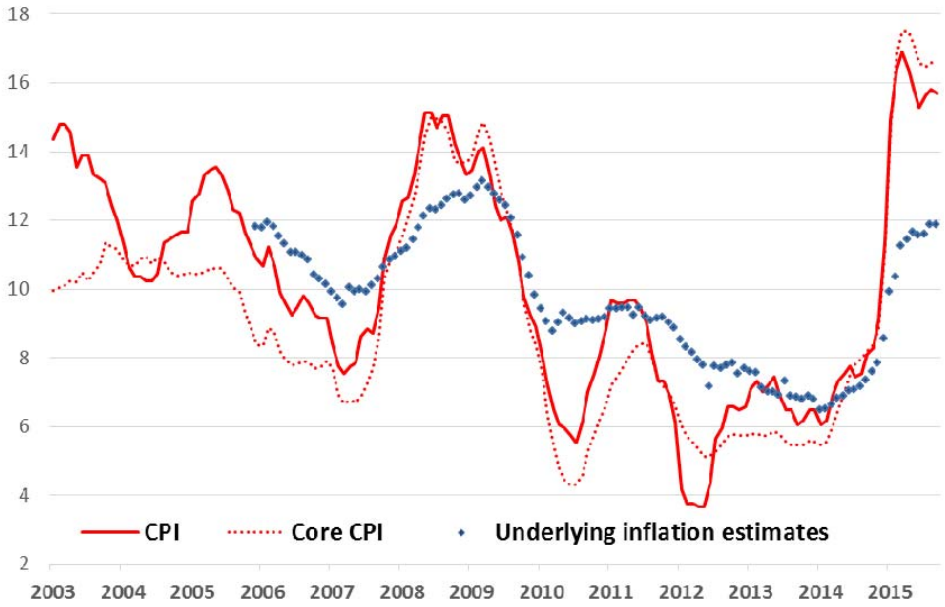


Source: Rosstat

1.3.3. Trend inflation: waiting for the local maximum to decline

In September, the annual *trend inflation* rate[3] **remained high at 11.9%**.
If the current trends in price and monetary aggregate dynamics persist, we **expect that the trend inflation estimated will gradually go down**.

Figure 54
CPI, core CPI and Bank of Russia historical estimates of trend inflation, %, YoY



Sources: Rosstat, Research and Forecasting Department calculations

[3]The trend 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 trend 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.

2. Outlook

2.1. Leading indicators and forecasts

2.1.1. GDP nowcast and forecast: macroindicators in line with expectations

In October, GDP index estimate [4] for 2015 Q3 remained almost unchanged compared to September estimates. The GDP is estimated to have fallen by 5.0% YoY and 4.0% QoQ in 2015 Q3, that is in line with our September expectations.

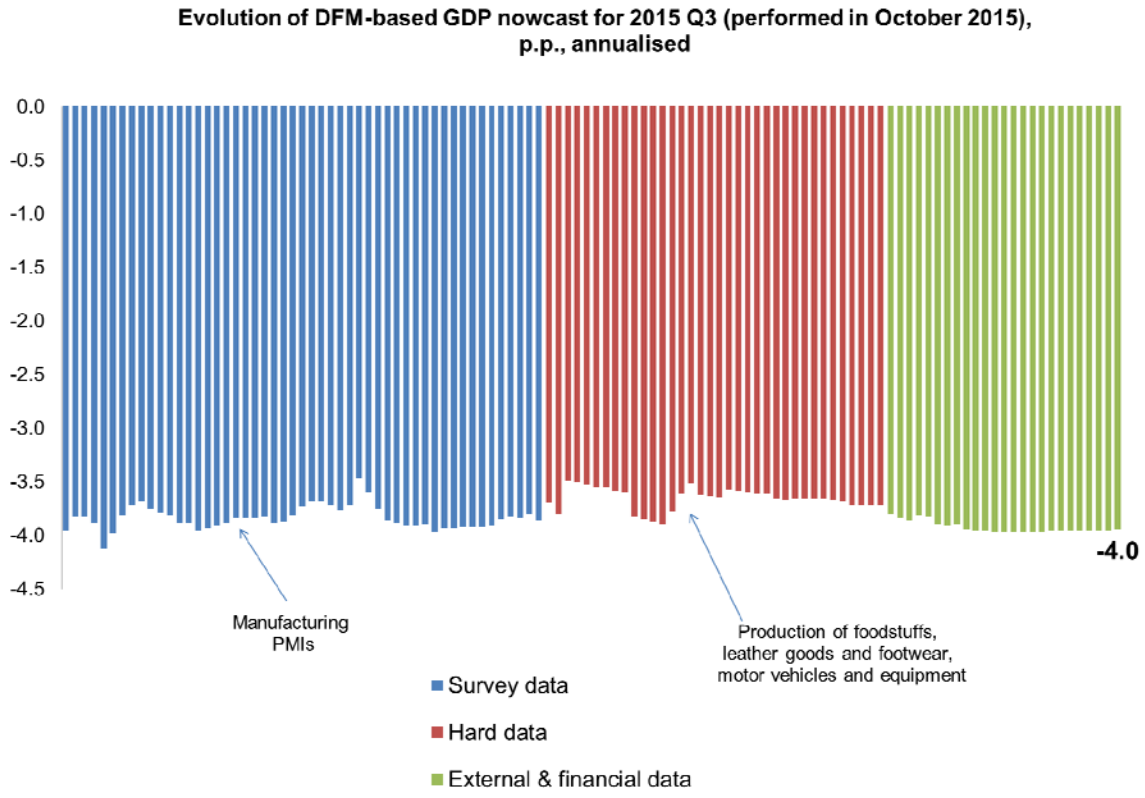
The current statistics show possible signs of revival in manufacturing industries; however, its stability is still questionable. September data on production of food, leather, leather goods and footwear, as well as motor vehicles and equipment, made a positive contribution to GDP estimates in 2015 Q3 (Figure 55).

Our **model-based GDP forecast for 2015 has slightly improved** to -4.2% (-4.3% in September), the forecast for the moving year until 2016 Q1 stands at -4.5% with -4.6% a month earlier (Figure 57). We still forecast that **economic growth will not resume until 2016 Q1 at the earliest**.

	October		September	
	% QoQ, annualised	**% YoY**	% QoQ, annualised	% YoY
2015 Q3	**-4.0**	**-5.0**	-4.1	-5.0
2015 Q4	**-0.9**	**-4.7**	-1.5	-4.9
2016 Q1	**0.6**	**-3.4**	0.3	-3.7

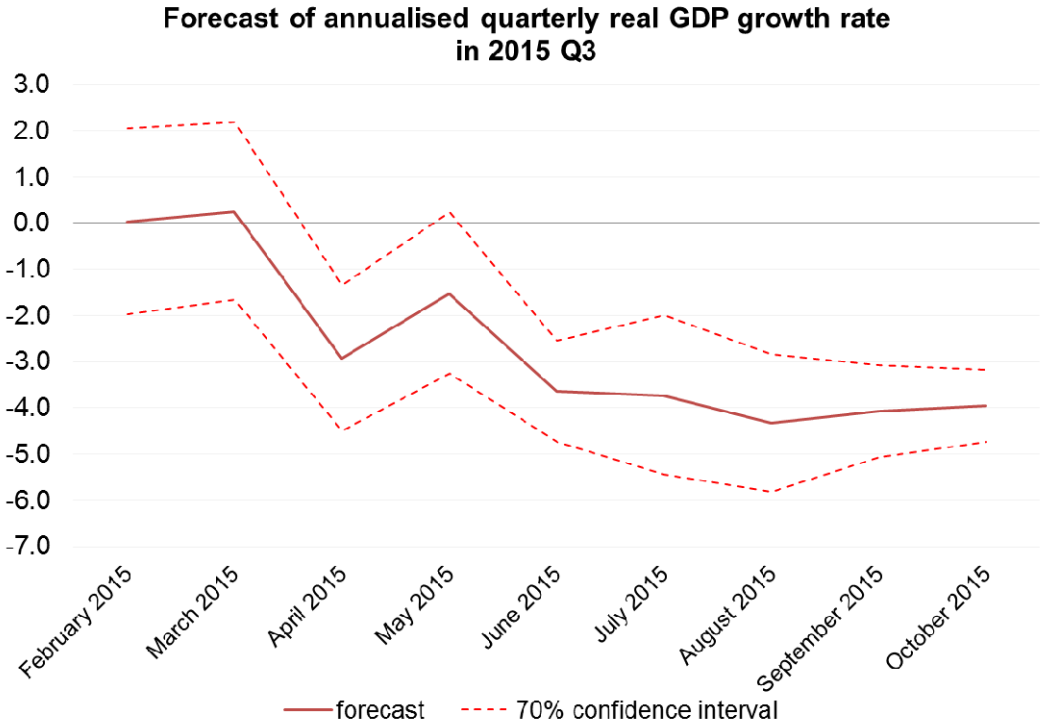
[4] GDP index estimate is based on Rosstat's data on social and economic situation in Russia in the corresponding month and other statistical, leading and financial data as of the calculation date and results from simulation of a dynamic factor model. These Research and Forecasting Department forecasts 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.

Figure 55



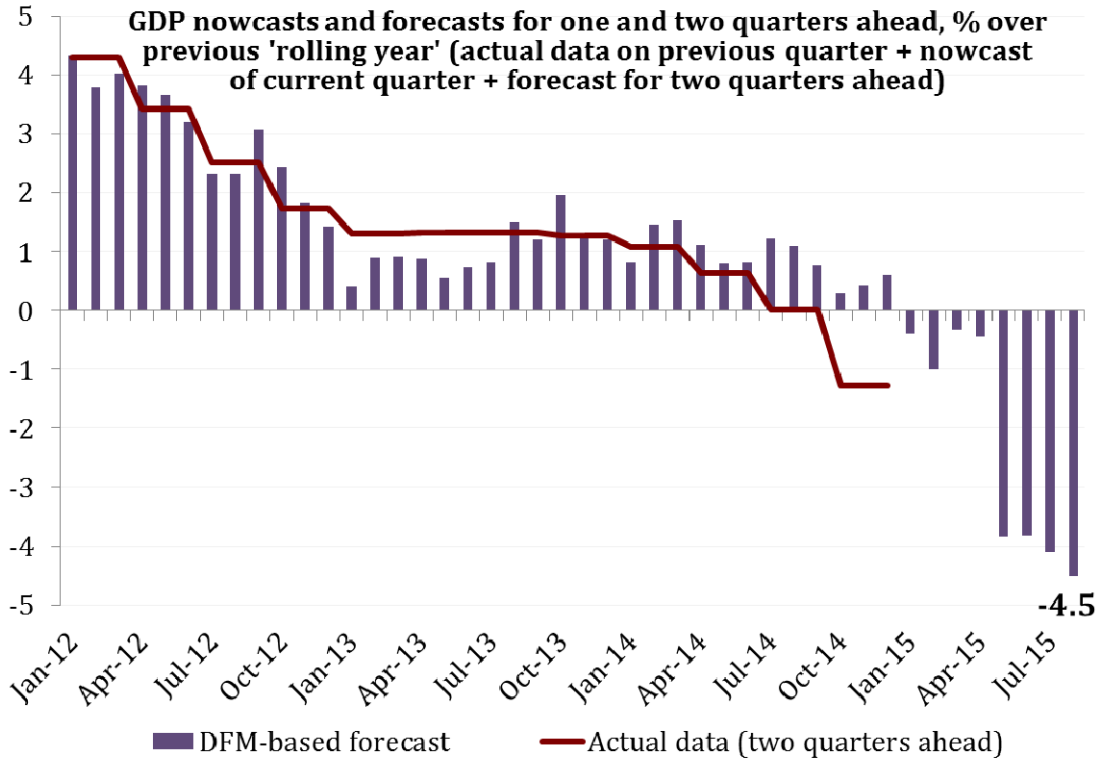
Sources: Rosstat, Research and Forecasting Department calculations

Figure 56



Source: Research and Forecasting Department calculations

Figure 57



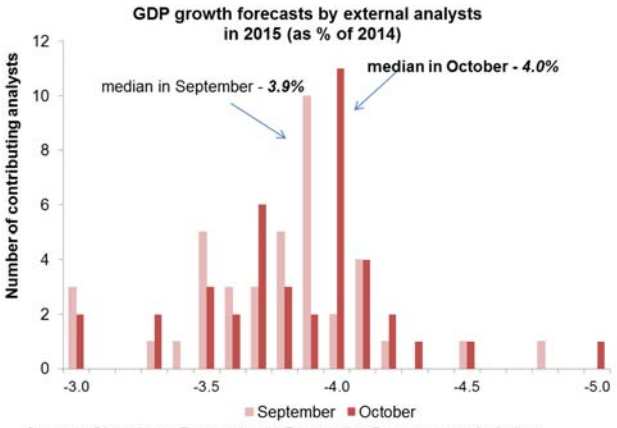
Sources: Rosstat, Research and Forecasting Department calculations

2.1.2. Current forecasts by market participants' financial analysts on main Russian macroindicators remain at the September level

GDP

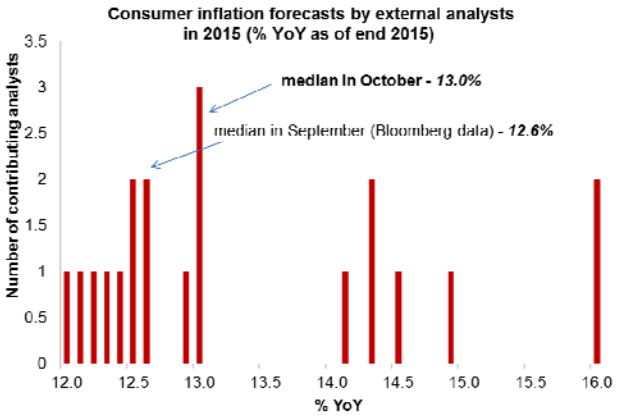
Bloomberg data on financial analysts' forecasts as of 29 October 2015 show that over the past month most experts made no considerable adjustments to their forecast of GDP growth in 2015. Thereby, analysts still do not see any prerequisites for the Russian economy to begin a full-fledged recovery until the end of this year. Our current estimate of the median forecast of GDP growth in 2015 based on Bloomberg analyst surveys stands at -4.0% (Figure 58), which approximately corresponds to zero GDP growth in 2015 Q4 (seasonally adjusted). In September, the median forecast by market participants stood at -3.9%, which differs insignificantly from the current median estimate.

Figure 58



Sources: Bloomberg, Research and Forecasting Department calculations

Figure 59



Sources: Bloomberg, Research and Forecasting Department calculations

Inflation

As of 29 October 2015, the median consumer inflation forecast for the end of 2015 is 13.0%, which is somewhat above the median forecast in September (12.6%). As a consequence, analysts on average overestimated inflation risks for the last month (Figure 59). It should be noted here that forecast discrepancies between the more optimistic analysis, on the one hand, and pessimistic ones, on the other hand, are quite tangible. Indeed, 7 out of 20 respondents of monthly Bloomberg surveys expect consumer inflation to be above 14.0% by the year-end. They are assumed to include the impact of exchange rate fluctuations on inflation in their forecasts. Nevertheless, other experts project inflation to range between 12.0% and 13.0% as of the year-end.

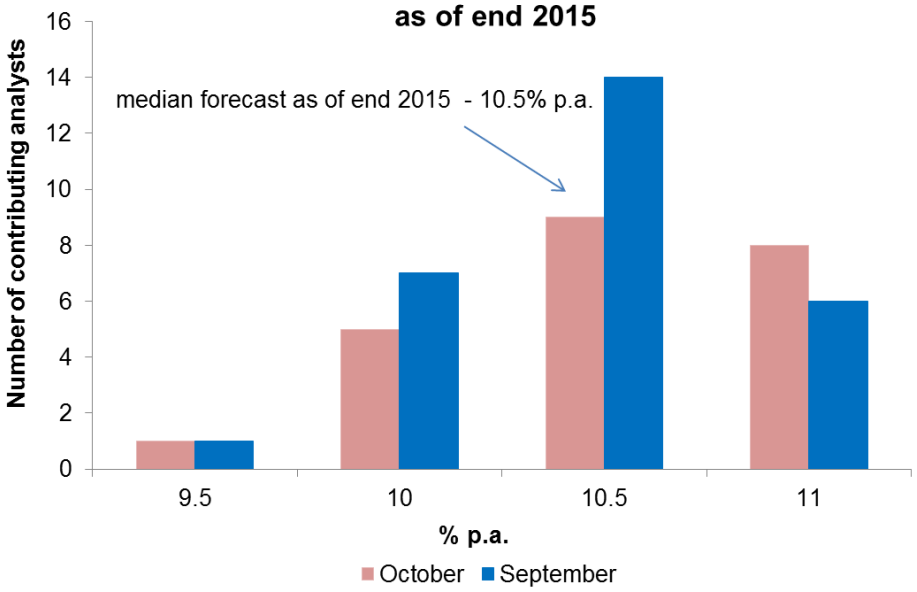
Bank of Russia key rate (as of 2015 Q4 end)

Over the recent months, external analysts revised their forecasts for the Bank of Russia monetary policy stance for the rest of the year due to inflation risks, which increased in

2015 Q3 and resulted mostly from the deteriorating external economic conditions and a depreciated ruble. However, in October, experts' expectations with regard to the Bank of Russia's monetary policy stabilised: as of 29 October 2015, most participants of Bloomberg surveys forecast that the Bank of Russia would cut its key rate by 50 bp before the year-end, and the median value is 10.5%, like in the previous month (Figure 60). Most experts are likely to view the current inflation risks as short-term.

Figure 60

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



Sources: Bloomberg, Research and Forecasting Department calculations

2.1.3. What do Russian leading indicators say?

Despite the improvement in leading indicators, they show that the economy is not expected to recover until the year-end.

The composite business index, calculated by the principal component method for 30 leading indicators (including Rosstat data, PMI indices, Russian Economic Barometer diffusion indices), did not change considerably in October against the September estimate (Figure 61). Manufacturing PMIs, on the one hand, and services PMIs, on the other hand, turned out to show largely mixed dynamics for October. It can be explained by the temporary positive impact of the ruble depreciation on production in the sector of marketable goods in 2015 Q3.

The composite leading business indicator[5] points to a possible stabilisation in the cyclical component of industrial production at around zero before the end of the year.

[5] 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*.

However, we estimate that it will not resume growth until 2016 Q1 (Figure 62). It results from the fact that the turning point method-based statistical analysis expectedly pointed to more significant forward-looking properties of manufacturing PMIs with regard to forecasting the cyclical component of industrial production for which the latest reporting data looked optimistic.

In addition, we assume that a full-fledged adjustment of business activity in services to more positive current production dynamics in manufacturing may fail due to the specifics of the Russian economic restructuring under way. Consequently, in the process of structural changes manufacturing PMIs may temporarily lose their leading indicator properties of the cyclical component in industrial production we have established based on historical data.

Importantly, the overall positive September production statistics were interpreted as considerable growth of its cyclical component within the statistical methodology applied to calculate the composite leading business indicator. However, this finding is hard to confirm at the intuitive level.

Figure 61

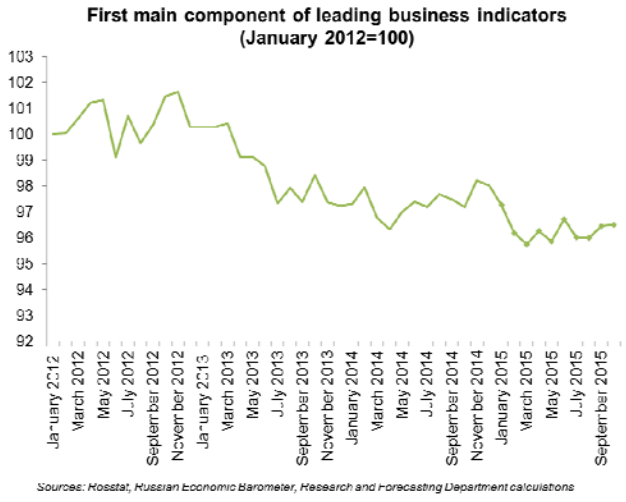
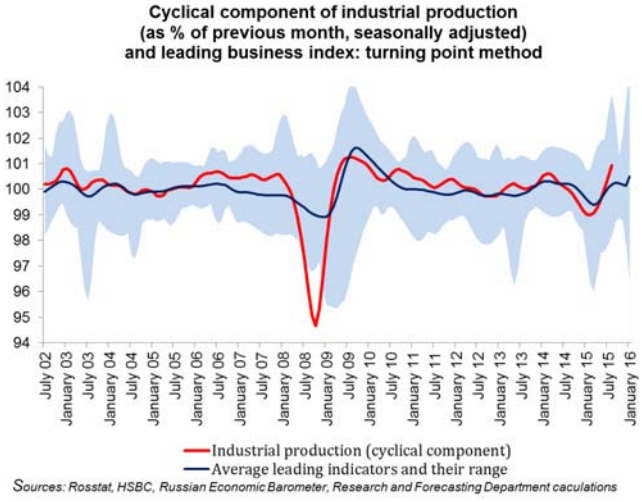


Figure 62



Composite leading business indicator in Russia

Identification and regular monitoring of leading indicators of business activity is a central bank's most important tool, indispensable for making well-timed decisions in monetary policy.

To develop such a tool for the Russian economy, we have tested an HSBC methodology for constructing a composite leading indicator[6].

Research and Forecasting team considered a set of 110 short-term macroeconomic indicators (of

[6] Fenn D., Nerbrand F., Kasem S., Selvakumar Y. (2015) HSBC Leading Indicators. HSBC Global Research.

which 80 are officially published with a lag of one month at most) as potential leading indicators for our short-term GDP estimates and forecasting[7]. The proposed transformation was applied to the indicators (at the levels and basis indices): the Hodrick-Prescott filter was applied to sequentially remove a long-term trend (parameter *λ = 133108*) and short-term fluctuations (parameter λ = 13.9). The relevant transformation of the industrial production index was used as a business cycle benchmark.

A 20% quantile (in this case, 21 indicators) with the best properties of the leading indicator for industrial production was extracted from the set of variables under consideration. This methodology is distinguished by the fact that only statistical methods are used to identify leading indicators, rather than expert judgments. Two alternative approaches – *a correlation method* and a *turning point method* – were applied as criteria for selection and consequent inclusion of indicators in the composite index.

Under the *correlation method,* we selected indicators which correlated the most with the business cycle indicator. Only the indicators where 3-6 month lagged values correlated the most were included in the index. By the *turning point method* we identified turning points in dynamics of the indicators using the Bry-Boschan algorithm. Thus, depending on each of the above-mentioned approaches the leading index included indicators where the lagged values were connected the most with the current industrial production dynamics and the indicators where the turning point preceded the turning points of the business cycle in one to two quarter horizon.

The statistical analysis of the historical data has shown that forward-looking properties are most typical of survey data (for correlation method – 17 out of 22 selected indicators, for the turning point method – 11 indicators) pointing to the prospects of the future output dynamics that corresponds to the economic intuition. Indicators selected for index construction are primarily PMIs for Russia (most of them refer to the manufacturing industry) and diffusion indices published by Russian Economic Barometer for production, employment and orders.

We have applied the turning point method featuring higher forecasting quality to make current forecasts of business activity in Russia.

Nevertheless, the current results of calculation of the composite leading indicator should be interpreted with caution. Growth in the composite leading indicator was observed after a prolonged recession when the dynamics of short-term monthly indicators are traditionally characterised by increased volatility. Additional statistics to be issued in the upcoming weeks will confirm or refute short-term positive trends which emerged in September.

[7] 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.

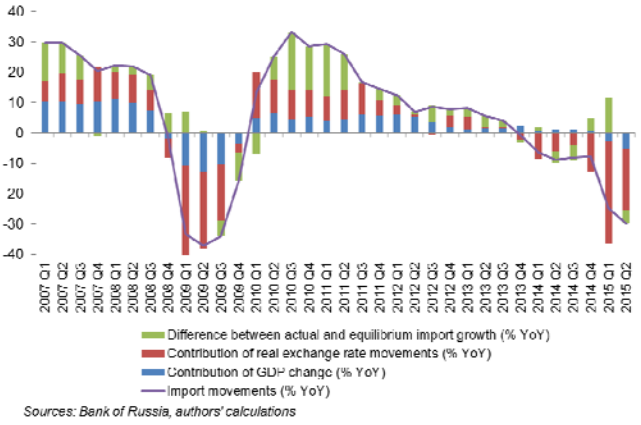
3. In focus

3.1. Exchange rate is the key factor in driving Russian import dynamics

Since 2009, Russian import dynamics have been mainly driven by the real exchange rate pattern, while the long-term exchange rate elasticity of imports has increased. The elasticity declined (most likely, temporarily) in 2014-2015 due to the non-macroeconomic shocks.

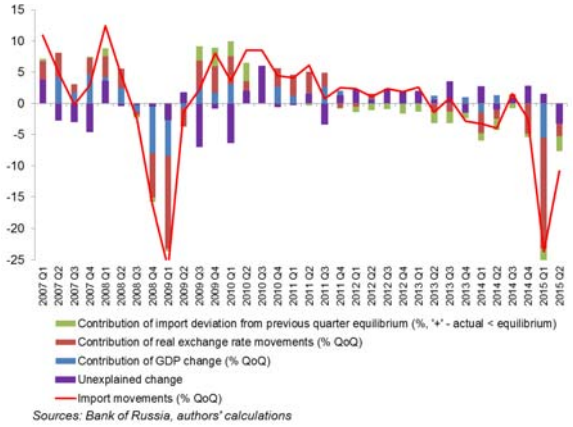
Factor analysis of Russian imports has shown that the real ruble depreciation in 2014 H2 – 2015 Q1 played the main role in the contraction of goods and services imports (Figure 63). The contribution of import factors was calculated based on the assessment of a long-term (equilibrium) ratio between the import quantities of goods and services, real GDP and the real exchange rate.

Figure 63
Factors of import quantities of goods and services, % YoY



Sources: Bank of Russia, authors' calculations

Figure 64
Factors of import quantities of goods and services, % QoQ



Sources: Bank of Russia, authors' calculations

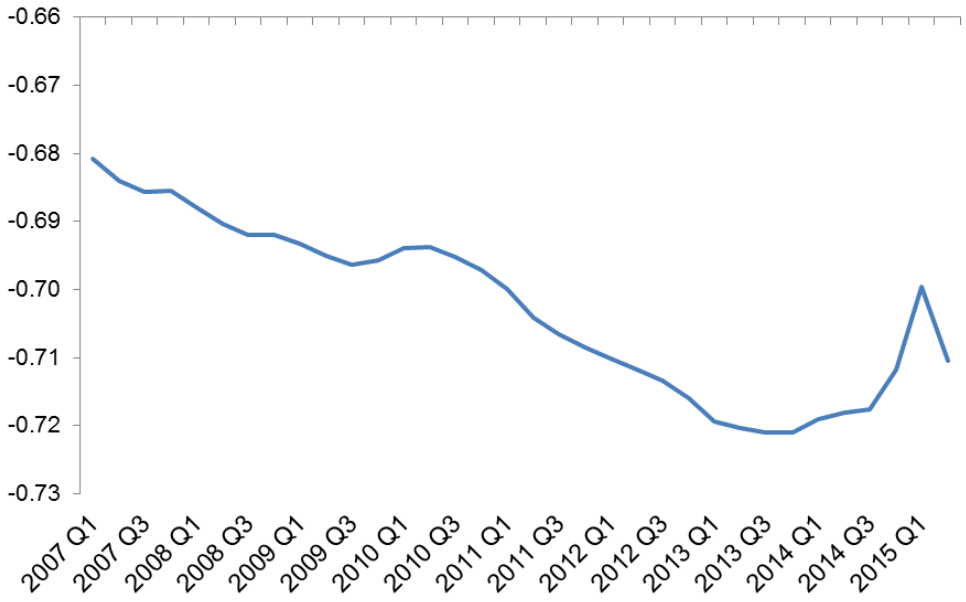
As a result of panel assessment for *1995 Q1 – 2015 Q2,* we have obtained long-term income and real exchange rate elasticity of demand for imports which ranged between [1.19–1.28] and [(-0.77) – (-0.70)] respectively. The calculations show that since 2009, import dynamics have been mainly driven by the real exchange rate developments.

The estimates of short-term dynamics of import quantities of goods and services also confirm the main role of the exchange rate in import evolution throughout 2014 Q4 – 2015 Q1 (Figure 64). Short-term real GDP and real exchange rate elasticity of imports ranges between [1.18–2.1] and [(-0.68) – (-0.53)][8]. According to our estimates, provided there are no unanticipated shocks, the adjustment of import deviation from the equilibrium takes about one year, which is in line with the IMF assessments of the global economy[9].

[8] A 1% growth in the real Russian GDP results in the average 1.6% increase in import quantities, while a 1% ruble appreciation triggers the average 0.6% growth in imports.
[9] World Economic Outlook. Chapter 3. 2015. October.

The long-term exchange rate elasticity of Russian imports had been growing slowly until mid-2014, as our calculations show (Figure 65). Afterwards, perhaps following the geopolitical and other non-macroeconomic shocks, the long-term elasticity of imports temporarily declined somewhat.

Figure 65
Recursive estimate of long-term real exchange rate elasticity of imports in Russia



Source: authors' calculations

The IMF[10] estimates of the exchange rate elasticity of trade flows tend to increase over time. This may result from liberalisation of trade flows and increased competition associated with globalisation of the world economy. The negative effect of globalisation on the exchange rate elasticity of trade flows due to the rise of global value added chains (disconnect puzzle) was not revealed.

[10] Ibid.

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