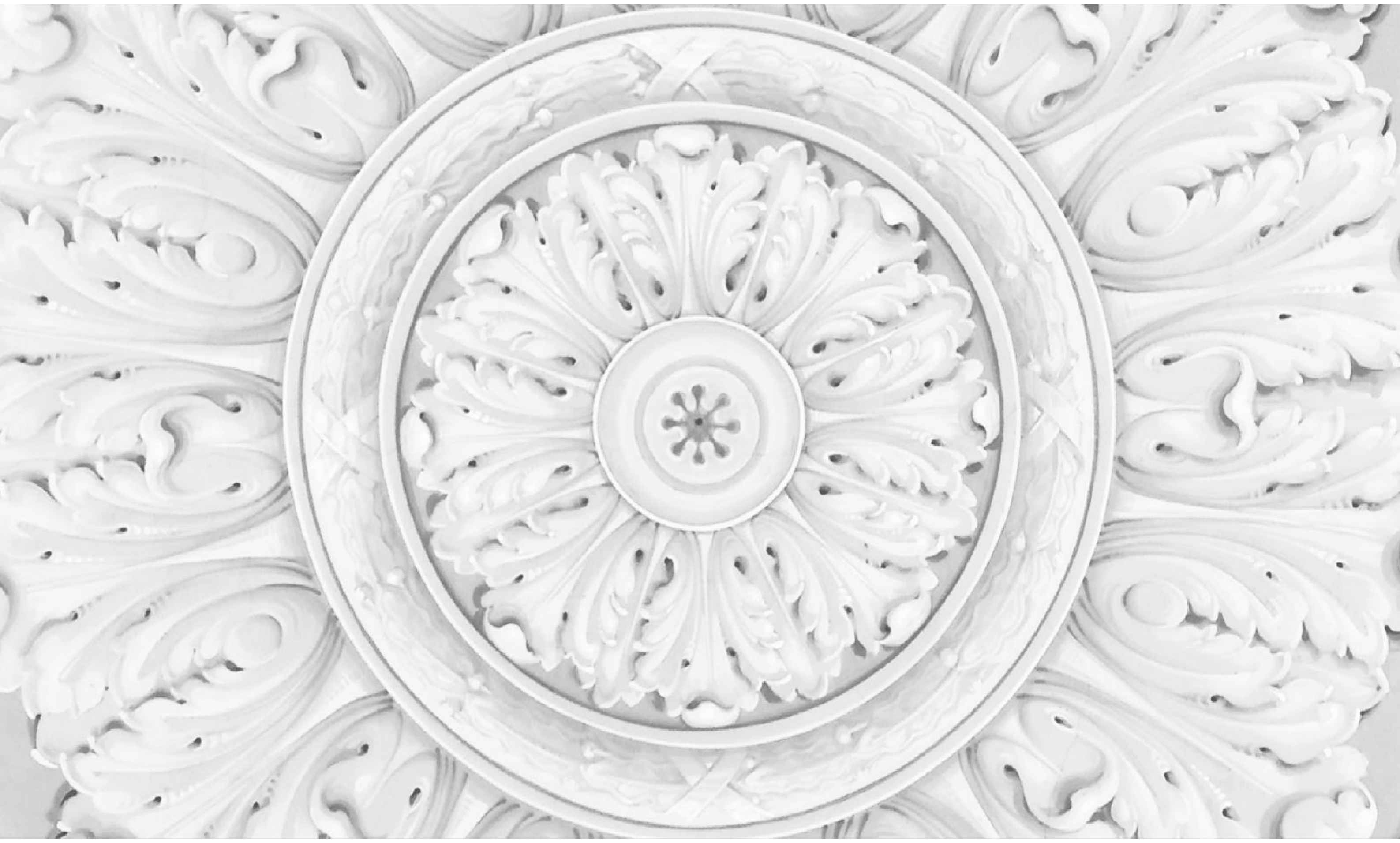
Bank of Russia
The Central Bank of the Russian Federation



TALKING TRENDS

Macroeconomics and markets

March 2018

No. 2 (22)

The bulletin is based on data as of 07.03.2018.
The views expressed in the bulletin
are solely those of the authors and do not necessarily reflect the official position of the Bank of Russia.

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

CONTENTS

Executive summary

1. Monthly summary

- February and early March saw inflation stabilise at a low level, driven, among other things, by temporary factors. Short-term inflation risks are down. Annual inflation is expected to stay below 4% in 2018 and keep close to this reading throughout 2019. Economic activity keeps expanding. The growth slowdown in late 2017 gave way to acceleration in early 2018. Overall, the economy is gaining traction on a slow but sustainable growth path. The current balance of risks enables a speedier shift from the current moderately tight to neutral monetary policy - which may be complete before the end of this year.
    - The February 2018 inflation reading remained at 2.2%. Growth rates of the most stable consumer price components held low, showing that short-term risks of inflation accelerating above 4% abated. Key medium-term proinflationary risks remain in place. Among them are possible drastic changes in consumer behaviour, accelerating growth in consumer lending, volatile and elevated inflation expectations and the state of the labour market. The Bank of Russia's policy fosters reduced inflation risks and the anchoring of inflation at a level close to 4% over the forecast horizon.
    - Economic growth accelerated aggressively in January, driven, among other things, by one-time tailwinds in the industrial sector, which is likely to fade away in the months to come. This should slow the economic growth pace to the potential level of roughly 1.5% a year.
    - Short-term risks to the stability of Russian financial markets held low in spite of increased volatility. The risks are kept low by the sustainable growth of the global economy, ongoing risk appetite on financial markets and oil prices. However, trade warfare is threatening economic growth and stability of financial markets worldwide.

2. Outlook

- High PMI indices in most major economies point to good prospects for further sustainable growth of the global economy in the near future.
- Our leading GDP growth indicator rose in February. This is indicative of a positive short-term outlook for the Russian economy.

1. Monthly summary

1.1. Inflation

The February 2018 inflation reading remained at 2.2%. This was assisted by, among other things, temporary factors. Short-term inflation risks were down vs January. Inflation together with its stable components remains low against the BoR target.

At the same time, consumer prices, loans and deposits, as well as macroeconomic indicators have yet to fully respond to recent monetary policy decisions. This factor and a complete transition to neutral monetary policy, alongside the dying-out of temporary tailwinds, are set to gradually move inflation closer to 4% in 2019.

Mid-term inflation risks remain in place. Among key risks are a potentially rapid switch to a consumer behaviour pattern, to the detriment of savings, accelerated consumer lending, elevated and unsteady inflation expectations of both businesses and households, and possible skill shortages in the labour market.

1.1.1. Inflation holds below target

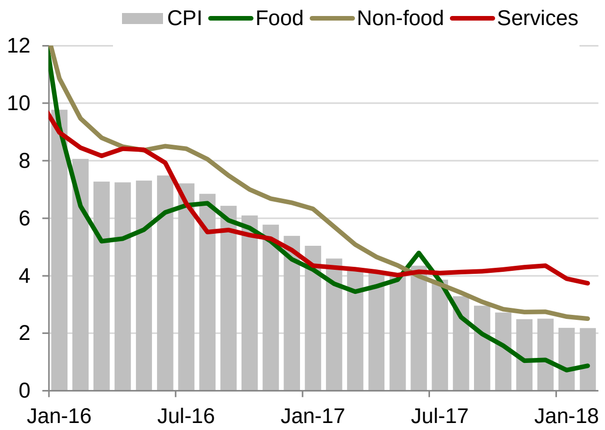
- Inflation hit a fresh low in February at 2.18%. Consumer prices went up 0.21% MoM in the month, which we estimate is consistent with a seasonally adjusted 0.08% MoM growth (and 1.0% on annual terms - which is estimated cumulative growth for the reporting period and 11 months ahead, providing that February's monthly growth paces prove sustainable).
- Food inflation accelerated on the back of vegetables and fruit prices. However, annual price growth paces of non-food goods and services continued to decline.
- Modified core inflation indicators resumed their downward trend, a sign of inflationary pressure remaining steadily below 4%.

In February, Rosstat recorded inflation at 2.18%, virtually unchanged from January (Figure 1). This shows that the gap is no longer narrowing despite inflation remaining below the target level of 4%.

The accelerated food price growth was set off by slower rising prices of non-food goods and services. Their performance was greatly influenced by one-off factors of a mixed nature.

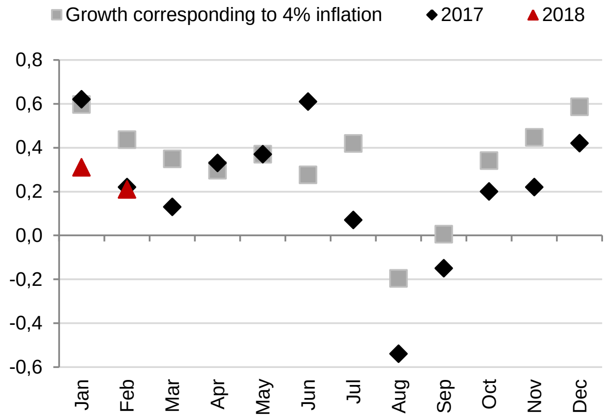
Inflation in the food market gathered pace to 0.87% YoY on 0.72% YoY in January as fruit and vegetable prices expanded 2.37% YoY in February, following 0.11% YoY fall in January. Annual food price growth, stripping out fruit and vegetables, continued to decline at 0.67% YoY vs 0.79% YoY in January.

Figure 1. Inflation and its components, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 2. Price growth, % MoM



Sources: Rosstat, R&F Department calculations.

The reverse trend in prices for fruit and vegetables is triggered by the past year's low base effect: last February, prices for fruit and vegetables grew a lot slower than they did this February (0.6% MoM vs 3.1% MoM respectively), partly as a result of exchange rate developments. This year's smaller crops, e.g. potatoes, also make the difference. As an example, according to Rosstat, gross potato output was lower 4.9% in 2017 following a decreased harvested acreage. Gross output of vegetables was meanwhile slightly higher than last year, rising 0.3%.

In the non-food market, inflation was down to 2.51% YoY on 2.58% YoY. Oil products led the slowdown of prices in the sector (from 6.86% YoY to 6.28% YoY), which comes as the result of oil price changes.

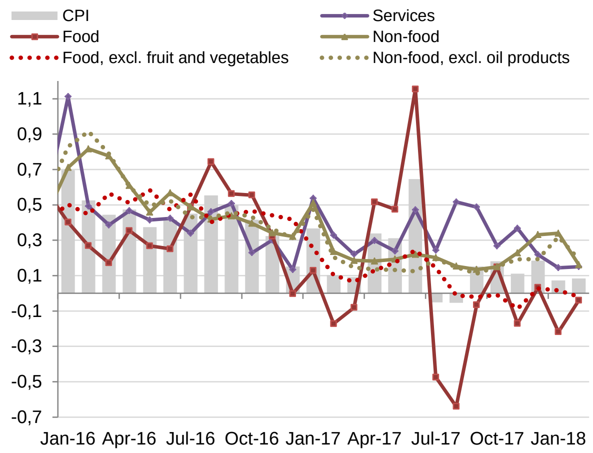
In the service sector, annual price growth have continued to decline for the second consecutive month. Similar to January, this was mainly driven by changes in passenger transportation tariffs. However, unlike in January (when the decline occurred thanks to the smaller than expected indexation of regulated tarrifs) the February slowdown is explained by the dynamic of railway fares per se. The 7.82% YoY decline in railway fares is probably a result of changes to the CPI calculation methodology. The statutory methodology for statistical monitoring of consumer prices[1] provides for statistical records to be made between the 21st and the 25th day of a reporting month. According to Russian Railways[2], the February 2018 fare review was implemented between 22 and 26 February, and so was it in February 2017. Rosstat registered higher fares in February 2017 as long as the CPI for passenger railway transportation totalled 108.9% MoM. This February's increase must have escaped Rosstat, with the CPI for passenger railway transportation at 100.6% MoM. This is how the high base of the past year came about, resulting in the overestimated measure for lower passenger railway transportation fares.

February saw consumer prices rising 0.21% MoM, which is in line with the past February level securing 4% annualised inflation (Figure 2). Seasonally adjusted, our

[1] Approved as per Rosstat Order No.734 dated 30 December 2014.
[2] JSC Russian Railways, Сезонные изменения тарифов (Seasonal changes in fares).

measure for consumer price growth is level with January at 0.08% MoM (1.0% on annual terms) (Figure 3).

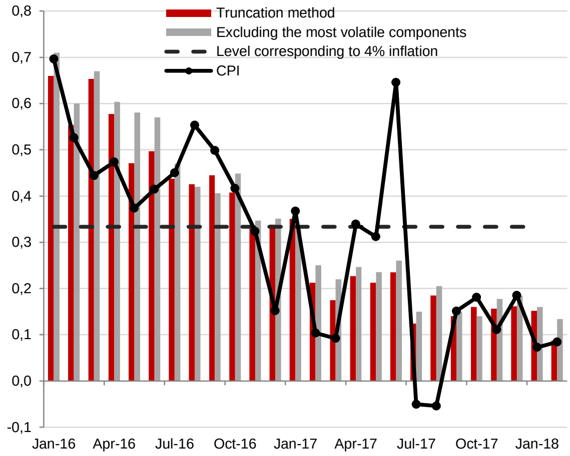
Figure 3. Seasonally adjusted price growth, % MoM



Sources: Rosstat, R&F Department calculations.

The February estimate is preliminary.

Figure 4. Modified indicators of core inflation, % MoM



Sources: Rosstat, R&F Department calculations.

In the course of the month, food prices changed little if at all; however, they remain highly prone to volatility[3]. Non-food prices slowed down to 0.16% MoM, which is related to a number of factors beyond oil product prices. Non-food products posted slower annualised price growth than the 4% increase in January. Prices for services remained almost unchanged as they climbed 0.15% MoM.

Inflationary pressure is still below a level consistent with 4% annualised inflation. This is evidenced by modified indicators of core inflation[4], which declined in February, following a slow growth period (Figure 4). Importantly, they are impacted by temporary factors albeit to a lesser degree compared to headline inflation. This leads us to conclude that core inflation indicators are considered somewhat undervalued.

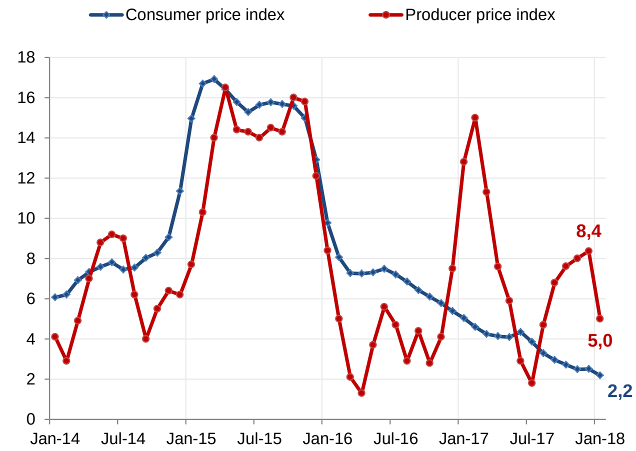
1.1.2. Producer prices slow down

- According to Rosstat's data, producer prices saw a sharp slowdown in January as their growth totalled 5.0% YoY (Figure 5).
- This slowdown found its way across most sectors, with the strongest decline registered in crude and gas production, as well as in coke and oil products, coming primarily as a result of the effect of a high base seen early last year.

[3] Here and elsewhere, including the seasonal factor impact.
[4] For more details see: Implications of underlying inflation readings for Russia. 2015. No. 4. March.

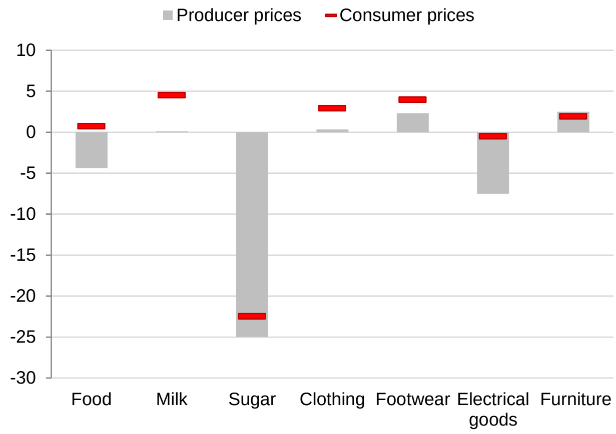
- Producer price inflation continues to hold above consumer inflation; nonetheless, producer price growth across most consumer products is still lower than consumer price growth (Figure 6).
- This signals that the recovery of retail margins that emerged in 2017 is continued after the 2015-2016 contraction. Our estimates suggest retail margins have yet to reach their pre-crisis levels; it is highly likely that margins will continue to grow as consumer demand recovers.

Figure 5. Producer price and consumer price index, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 6. Consumer price growth, some products, January, % YoY

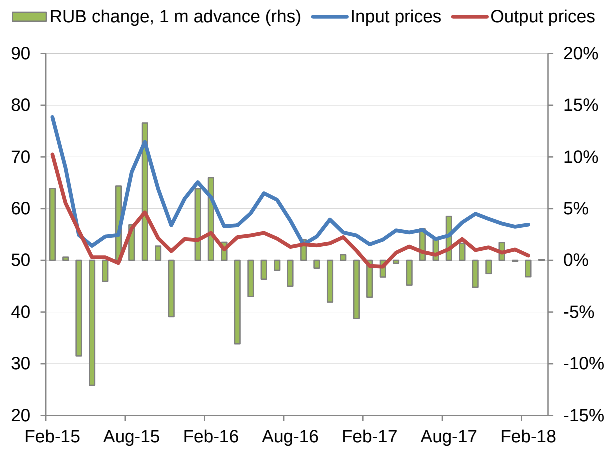


Sources: Rosstat, R&F Department calculations.

1.1.3. PMI price indexes: inflation pressure remains low

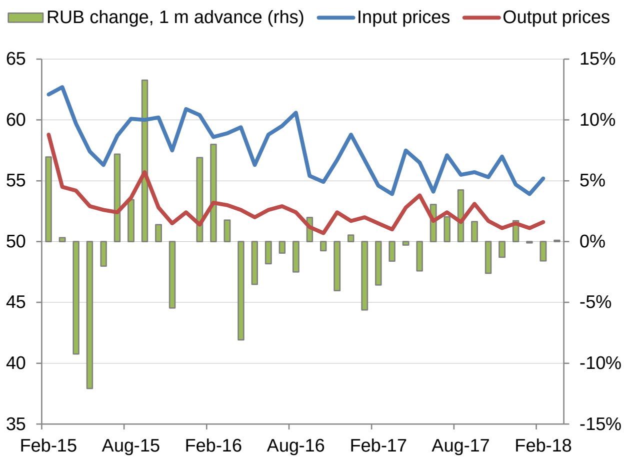
- Inflation pressure in the economy remains low. The manufacturing sector's index of output prices went down in February. It went up in the service sector but kept its overall low readings. (Figure 7, Figure 8).
- The input price indexes edged higher, mainly on the back of rising global commodity prices. However, companies are unable to fully translate their growing costs into consumer prices in the context of tighter competition and scarce demand in individual sectors.

Figure 7. PMI price indexes in the manufacturing sector, pp



Sources: Rosstat, R&F Department calculations.

Figure 8. PMI price indexes in the service sector, pp



Sources: Rosstat, R&F Department calculations.

1.2. Economic performance

The Russian economy had a good start to 2018. The acceleration was helped by one-off temporary tailwinds - which also partially offset the slowdown late last year. Current macroeconomic indicators and survey data suggest economic expansion continued in the first half of 2018. Moving forward, growth will be supported by higher domestic demand as real wages increase and the global economy turns in healthy growth.

1.2.1. Industrial production in January: sharply accelerated growth

- The production sector was back in positive territory in January, growing 2.4% MoM (seasonally adjusted) and 2.9% YoY, according to Rosstat.
- The checking impact from the OPEC+ on the oil sector is ebbing away; growth found its way back into the manufacturing industry.
- This suggests the manufacturing downfall of late last year was temporary, with the January growth paces offsetting it. This downfall was in part due to the specifics of statistical accounting of outputs in several sectors.

The production sector made a strong start to the year. Rosstat estimates the economy expanded 2.4% MoM[5] and 2.9% YoY - back to the dynamic 2017 H1 readings. Both calendar and weather effects came as a neutral backdrop for year-on-year comparison. The production sector turned in data consistent with the upbeat PMI index in the year start (Figure 9).

[5] Here and elsewhere, seasonally adjusted unless otherwise indicated.

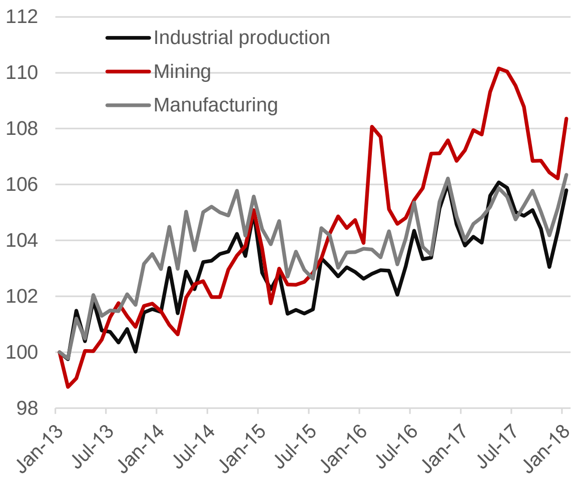
The R&F Department estimates suggest 1.4% MoM growth following 1.2% MoM in December - a sign of, beyond a reversing negative trend of the second half of 2017, accelerated growth in industrial output. Better industrial data were reported across the board (Figure 9).

Mining and quarrying expanded 2% MoM and 1.1% YoY, supported by rising coal outputs (+1.2% YoY). Interestingly, the average oil output stabilised at 10.95 million barrels a day. This is still below the level of the same month last year, when Russia was only at an early stage of its production contraction programme to comply with the OPEC+ deal. However, the negative impact of this factor is beginning to dwindle. January saw a 1% YoY output contraction after -2.3% YoY in December 2017. As the high base effect dies out, the OPEC+ deal compliance factor is set to stop its negative influence on mining and industrial output data this spring.

The manufacturing sector grew 0.7% MoM and 4.7% YoY. It follows from a product breakdown of the index that high growth was recorded in chemicals, the light manufacturing and the production of vehicles (cars +32% YoY, buses +10% YoY).

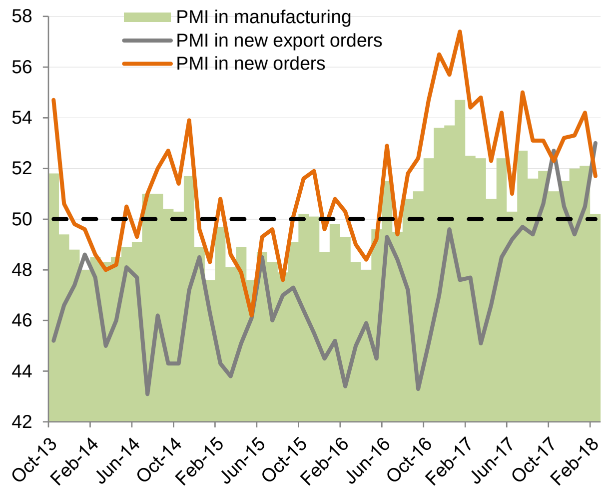
Given that both PMI and CCI are high enough, growth in the production sector is expected to continue in the near future. The annualised production data are also expected to gain additional support from the extra working day in February.

Figure 9. Sectoral performance (index, January 2013 = 100)



Source: Rosstat, R&F Department calculations.

Figure 10. PMIs in the manufacturing sector



Source: IHS Markit.

1.2.2. PMI in February: short-term economic outlook improves

- The composite PMI went up to 55.2 points in February, marking the 25th month of consecutive growth.
- The manufacturing sector's PMI edged lower but remained in growth territory. The slowdown comes as a result of weaker domestic orders, in part related to disrupted seasonal patterns for this indicator.
- Despite slower growth in outputs, expectations for 12 months ahead continued to improve. It therefore seems highly probable that the manufacturing sector will be back on a higher growth track in the next few months.
- The economy is seeing a continued switch to export-oriented growth as external demand is rising and domestic demand is slowing down.
- PMI in the service sector was up to 56.5 points, indicative of an incipient economic rebound. Growth was recorded across all categories. The *expectations* indicator is the only exception. However, it is still at its highest level since 2012.

The February PMI results are indicative of the overall Russian economy. First, following January's dramatic upturn, economic growth slowed down. Growth is nevertheless continued at lower but more sustainable rates, with strongly growing optimism in expectations. Second, the economy is continuing to switch to export-oriented growth as external demand is rising and domestic demand is slowing down. It is notable that demand originating from Asia and Middle East is rising fastest. Third, with competition becoming stronger and demand still limited, companies of the sector are forced to keep output prices in check, notwithstanding heightened wage growth. This accords with low producer price growth in the manufacturing sector (Rosstat). Rising costs and lower volumes of backlogs of work, in turn, act as efficiency drivers for companies, making them cut costs and optimise headcounts. Redundancies result in employees securing jobs in other sectors or exiting the labour market altogether.

The PMI IHS Markit index for the manufacturing sector moved lower to 50.2 points against 52.1 seen in January. The aggregate index was mainly lower on the back of declining Output and New Orders subindeces. These went down from 54 to 52 points in the month but didn't exit growth territory (>50). Respondents note that industrial output in February was mainly supported by new orders, especially export orders. The New Export Orders subindex hit 53 points, the highest reading since November 2011, which comes as a reflection of an improving global economy and its impact on Russian industrial data.

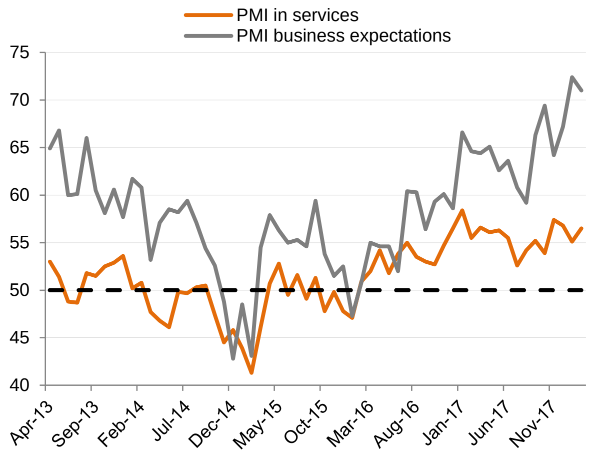
In the months to come, PMI may come back to its higher readings, given respondents' positive sentiment. The Future Output subindex, indicative of expectations for 12 months ahead, continued to grow. The index has held above 69 points, a reading above the past year's average (63.8 points). Respondents cite strong growth in the global economy and their own forays into new markets as factors behind their high expectations.

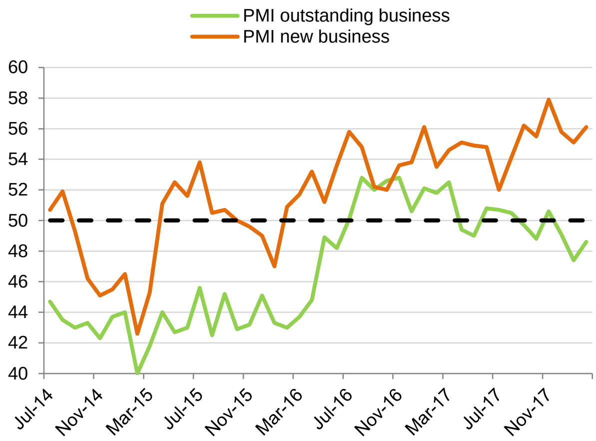
A noticeable decline in February's PMI for the manufacturing sector may to a great extent be caused by the technical factor - the disruptions in seasonal patterns which led to a different outcome adjustment result. In this way, given the actual balance of respondents' positive replies to questions on production outputs in February, it is possible that January's overestimated[6] seasonally adjusted estimates led to the high base of February.

The PMI IHS Markit index for the service sector grew robustly to 56.5 points against 55.1 seen in January. Growth was recorded almost across all subcategories: both new orders and employment data were positive; both indexes held close to 55 points. Respondents cite rising customer demand as a key reason for improved sentiment. More so, growth in both new and current customers' orders is reported: 33% of respondents note growing numbers of orders from new customers.

The Expectations for 12 months ahead subindex edged down, but has been above 70 points for the second consecutive month. This subindex hit this reading for the first time since 2012, which is why we are treating this as a very good signal for economic growth this year. Outstanding business is the only category where PMI is below 50 points. Having said this, there are signs of some growth emerging here, too: last month the index went up by 1.2 points to reach 48.6.

Figure 11. PMI in the service sector





Source: IHS Markit.

[6] The Demand and Output indexes, which cumulatively account for 55% of the manufacturing PMI, reached local maximums in January.

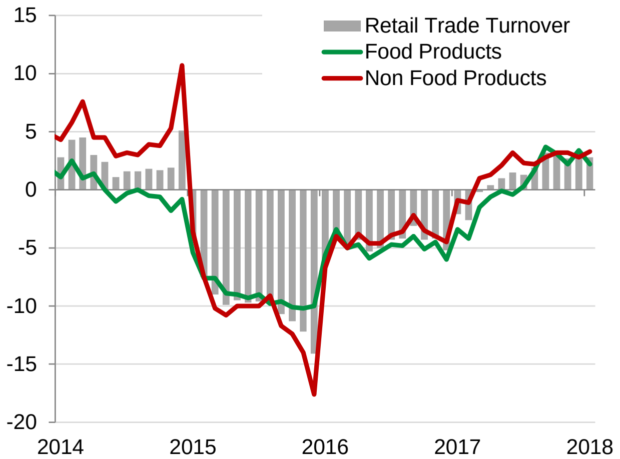
1.2.3. Consumer demand expands further in January

- High real wage increase and the ongoing acceleration of consumer lending growth underpin rising consumer demand.
- The annual growth of retail trade turnover slowed somewhat in January, whereas monthly growth adjusted for seasonality and calendar effects accelerated to 0.7% MoM, mostly due to non-food sales.
- Survey data suggest that consumers believe the current period to be more favourable for large purchases than previous years. This allows to expect that demand will continue to grow in 2018.

Having started in 2017, the recovery of consumer demand continued into 2018, supported by rising wages and expanding consumer lending.

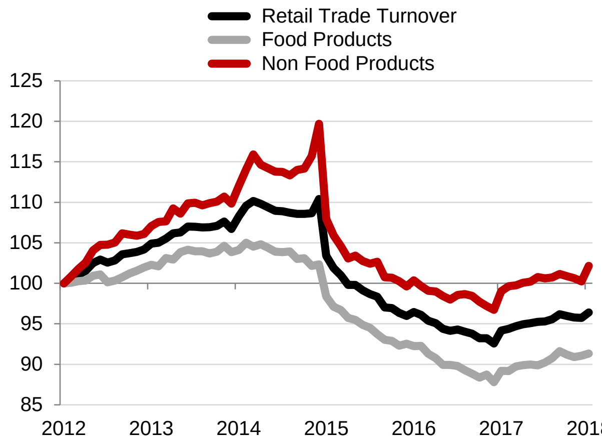
Retail sales increased by 2.8% YoY in January after 3.1% YoY in December (Figure 12). In January, growth slowed down in food sales but accelerated in the non-food segment. The latter is in line with other released statistics, such as the accelerated growth of light vehicle output.

Figure 12. Food, non-food and total retail sales, % YoY



Sources: Rosstat, R&F Department calculations.

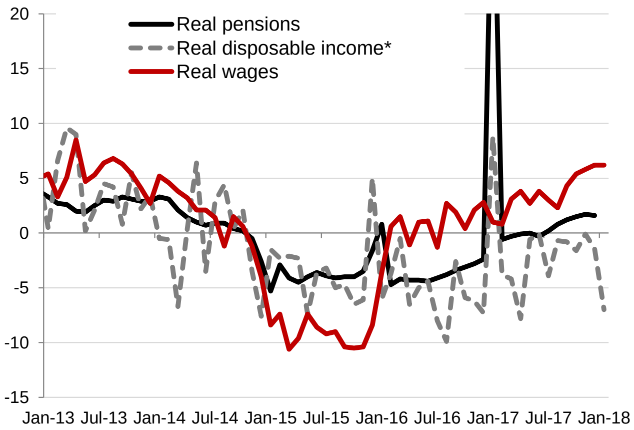
Figure 13. Retail sales, % (January 2012 = 100%, seasonally adjusted)



Sources: Rosstat, R&F Department calculations.

According to our estimates, monthly growth of retail sales accelerated to 0.7% MoM in January (adjusted for seasonality and calendar effects) (Figure 13). The acceleration was primarily triggered by the shift in non-food sales. The contraction of non-food sales, seen in the last three months of 2017, was followed by 1.9% MoM growth in January. Food sales kept growing steadily for the second month in a row (0.2-0.3% MoM).

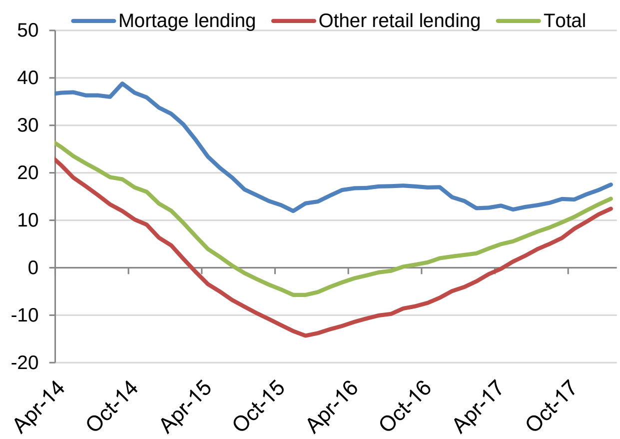
Figure 14. Real income of households, % YoY



Source: Rosstat, R&F Department calculations.

**Calculated using the old methodology, with a one-time payment in January 2017 factored in.*

Figure 15. Ruble household loans, % YoY

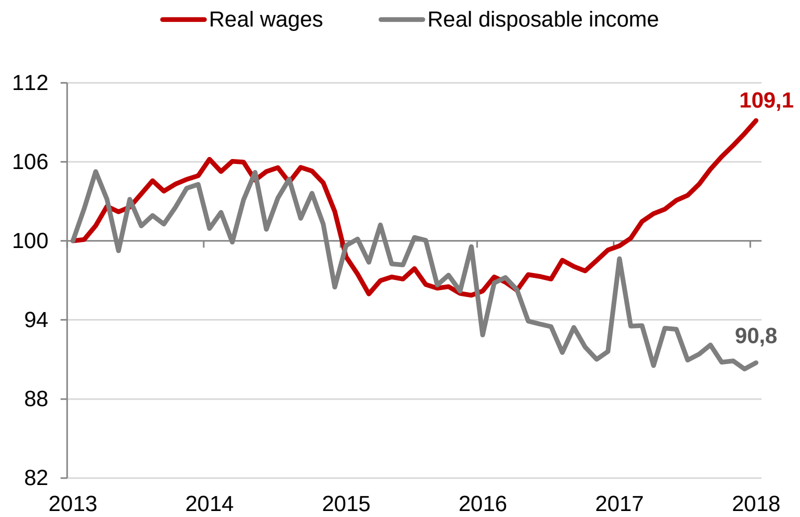


Sources: Bank of Russia, R&F Department calculations.

Consumer demand is recovering along with the growth of real wages. January's real wage growth was flat against the December readings at 6.2% YoY (Figure 14). Sales, and non-food sales in particular, were also driven by expanding consumer lending (Figure 15).

Real disposable household income dropped by 7% YoY in January due to the base effect triggered by the one-time pension payment last January. The R&F Department believes that the application of the currently used calculation technique for this indicator brings objective difficulties in factoring in certain components of households' savings and spending. As a result, the dynamics of real disposable household income is slightly underestimated. This partially explains the observed growingdiscrepancy between the dynamics of real wages and real disposable income (Figure 16).

Figure 16. Real accrued wages and real disposable income*, % (January 2013 = 100%, seasonally adjusted)

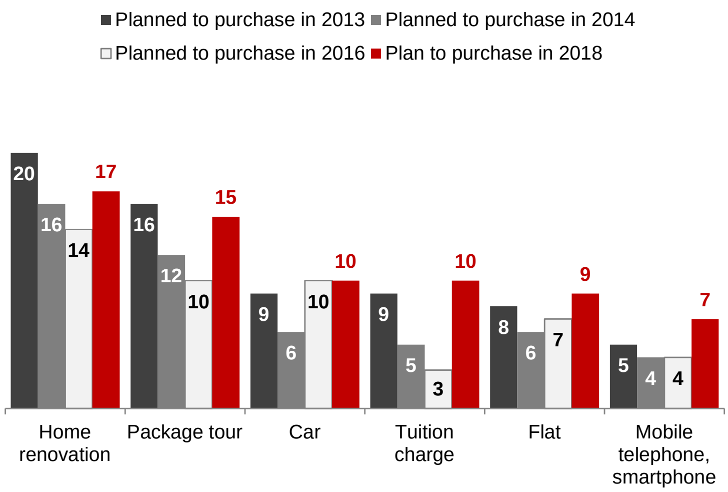


The estimation takes into account the one-time pension payment of 5 thousand rubles made in January 2017.

Sources: Rosstat, R&F Department calculations.

Growing demand comes along with improving consumer sentiment. This is suggested by survey data, in particular the VCIOM-conducted survey[7] on households' consumption possibilities. They suggest that one in ten respondents intends to buy a car or a flat in 2018 (Figure 17). The expected spending is most often associated with home renovation (17%). These are all signs that households can see the economy improving compared with the recession period and consider this point in time to be more favourable for large spending than previous years.

Figure 17. Consumer plans of households



Source: Russian Public Opinion Research Centre (VCIOM).

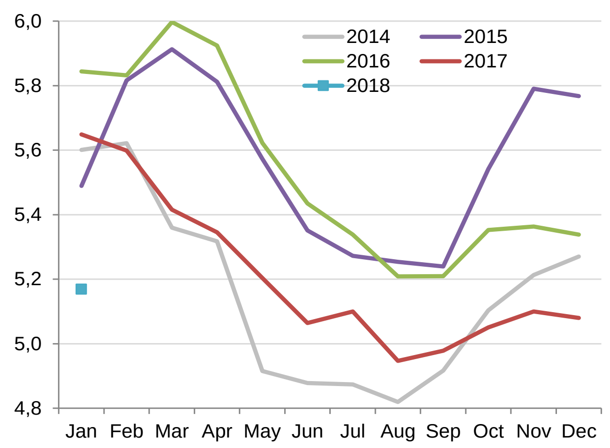
[7] VCIOM press release No. 3583 «Потребительские планы 2018». 16.02.2018.

1.2.4. Inflation risks from the labour market side swell

- Unemployment rate fell somewhat below our estimate of its natural level, pointing to slightly increasing tension in the labour market.
- Nominal wage growth in the private sector may slow as wage increases are curtailed because companies adjust to low inflation.
- This will be facilitated by the link between the rate of indexation and the past year's inflation recorded in collective employment agreements, as well as sluggish growth in demand for output that limits financial capacity for wage increase.
- However, the falling labour supply may bring a faster wage increase and risks of higher inflationary pressure as unemployment hits a new low. This effect may be offset by growing labour productivity which requires higher fixed capital investment.

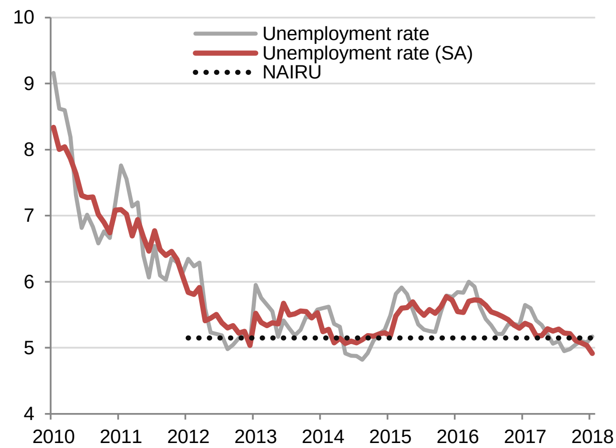
Unemployment data suggest that the risks of an increase in inflationary pressure are on the rise, with January's reading at 5.2% (Figure 18). The seasonally adjusted jobless rate dropped to an all-time low 4.95%[8], somewhat below the R&F Department's estimate of natural unemployment (Figure 19). Shrinking labour supply[9] threatens to accelerate nominal wage growth and, subsequently, bring up inflationary pressure.

Figure 18. Unemployment, %



Sources: Rosstat, R&F Department calculations.

Figure 19. Unemployment and its natural rate, %



Sources: Rosstat, R&F Department calculations.

The current nominal wage growth remains relatively high. Preliminary estimates suggest that in January it stood at 8.5% YoY, while in real terms it was 6.2% YoY. Rosstat revised upwards the December estimate of nominal and real wage growth to

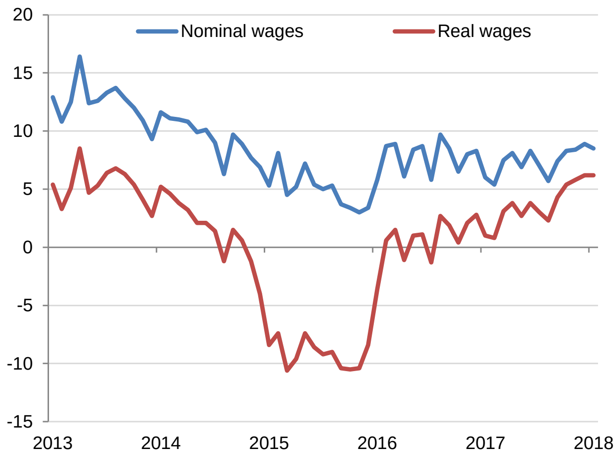
[8] A modest change in the calculation technique was among technical factors behind the decline: starting from 2018, Rosstat took to release numbers of unemployed aged more than 15; this translated, among other things, to rising labour force participation. Previously, Rosstat released data for the unemployed aged 15-72.

[9] The jobless rate dropped by 8.7% YoY in January.

8.9% and 6.2% YoY respectively (initial estimates stood at 7.2% and 4.6% YoY, Figure 20). As companies adapt to low inflation and moderate rate of growth in demand for output, wage increase in the private sector is most likely to slow, unless the ongoing decline in unemployment and increasing labour force shortage force companies to raise marginal labour costs at the expense of profits[10].

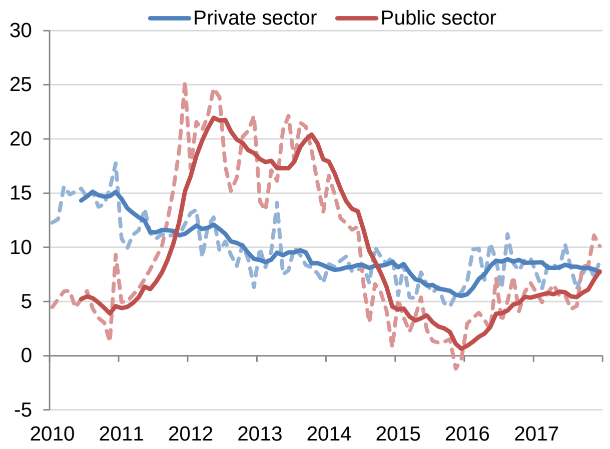
Overall real wage increase outpaced labour productivity growth in 2017. The average monthly nominal wage added 7.3% YoY while real wages rose by 3.5% YoY. Nominal wages increased by 7.9% YoY in the private sector and 6.4% YoY in the public sector[11]. In the second half of last year, the growth rate of public sector wages caught up with the private sector readings, in sign of delivery on the May presidential decrees (Figure 21). In 2018, wages are set to post higher growth in the public sector than in the private sector, driven by the indexation of civil servants' salaries untouched by the May decrees and further implementation of these decrees.

Figure 20. Nominal and real wages, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 21. Private and public sector wages, % YoY



Sources: Rosstat, R&F Department calculations.

1.2.5. Retail and corporate lending growth steps up

- The banking sector's financial standing and quality of the loan portfolio improved in 2017 (factoring out banks under financial resolution).
- In recent months, corporate and retail lending showed a dynamic growth. Accelerated growth in corporate lending is mostly registered in the top 30 banks.

[10] Russia, as well as many other countries, may have seen a decline in the unemployment elasticity of wages and prices (a flatter Phillips curve). The reasons behind this are both global and local in nature. Their analysis falls outside the scope of this report. Nevertheless, importantly, unemployment's further downward deviation from the natural rate enhances the odds of accelerating wage growth and surging prices.

[11] Filled vacancies were used as weights.

- The recovery of bank lending is a healthy development in the wake of macroeconomic stabilisation and monetary policy normalisation.
- However, a considerable acceleration in unsecured and high-risk lending called for macroprudential measures to prevent financial stability risks in these market segments, as well as to mitigate of mid-term inflation risks.

In early 2018, lending continued to expand. Its growth rate accelerated further in both retail and corporate lending, adjusted for FX revaluation and seasonality (Figure 22). Meanwhile, the annualised growth of retail lending reached 18%. The observed upward swing of the credit cycle is a healthy development in the wake of macroeconomic stabilisation and monetary policy normalisation.

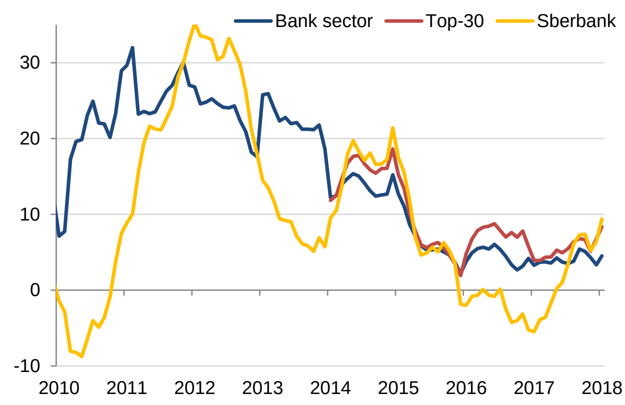
However, this process is associated with risks. The aggressive growth in retail lending currently fails to enhance inflationary pressure in the consumer market. Nevertheless, we may see such developments in the future, particularly if retail lending growth accelerates further. Furthermore, a much faster growth in unsecured and high risk lending may bring financial stability risks in these market segments (Figure 24). In order to mitigate these risks, in 2018 the Bank of Russia applied macroprudential regulation of undersecured mortgage loans and unsecured consumer loans.

The top 30 banks are responsible for the accelerated growth in corporate lending (Figure 23). Notably, the acceleration in the annual growth of corporate lending results not only from the low base effect of last year. Last December and in January 2018, monthly growth in this group of banks also exceeded the banking sector's aggregate readings.

Figure 22. Lending (adjusted for seasonality and FX revaluation), % MoM

Source: R&F Department calculations.

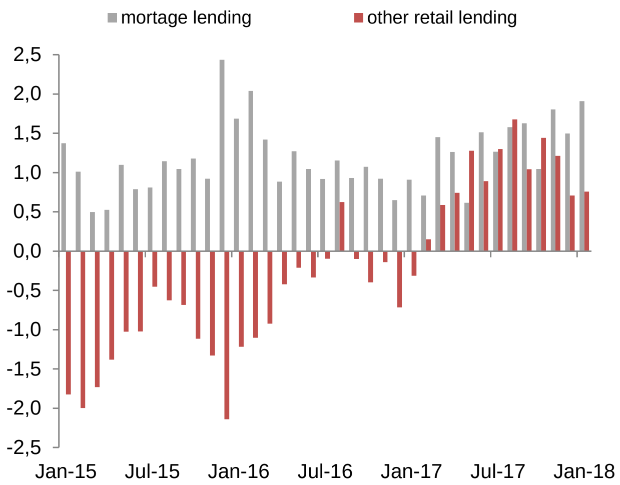
Figure 23. Annual growth of ruble corporate loan portfolio, % YoY



Source: Bank of Russia.

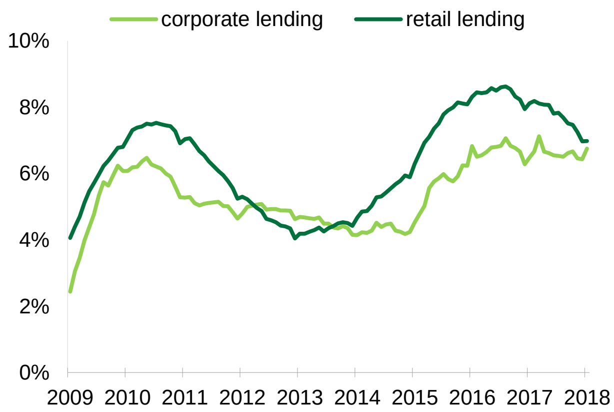
In 2017, the quality of banks' loan portfolio improved. The proportion of overdue loans in retail loan portfolio dropped from 7.9% to 7.0% (Figure 25). The banking system's corporate loan portfolio saw a slight increase in the share of overdue loans from 6.3% to 6.4%. However, if we factor out banks under financial resolution (both under the new BSCF framework, and through the use of the DIA funds and Bank of Russia loans), we will see that the proportion of overdue loans to non-financial organisations decreased from 5.4% to 4.6% in 2017.

Figure 24. Ruble mortgage and consumer lending, % MoM (seasonally adjusted)



Source: R&F Department calculations.

Figure 25. Overdue loans, %



Source: Bank of Russia calculations.

The lower 2017 profits compared with the 2016 readings resulted from a one-time creation of additional loss provisions for toxic assets of banks under financial resolution. Consequently, the return on assets and capital in the overall banking sector remained below the 2012-2013 readings. On the mid-term horizon, the creation of additional provisions may challenge banks with a high level of toxic assets.

Another challenge posed by banks was a decline in net interest margin to 3.9% in 2017. Net interest margin is also likely to remain under pressure in the years to come due to the following factors:

• The achievement and maintenance of sustainably low inflation provide for lower interest margin readings as the premium for high inflation is factored out. This premium was needed to offset the inflationary growth of banking costs. The shrinkage of the net interest margin because of this factor is offset by cost stabilisation and does not affect banks' financial stability.

• As deposit interest rates approach the inflation target, the interest rate elasticity of deposits (mostly household deposits) is likely to increase due to a falling overall propensity to save and households' appetite to more risky financial assets. In this context, the completion of monetary policy normalisation will exert a stronger impact on interest rates on loans than those on deposits, thus reducing net interest margin.

To successfully respond to this challenge, banks will have to increase non-interest income and cut expenses.

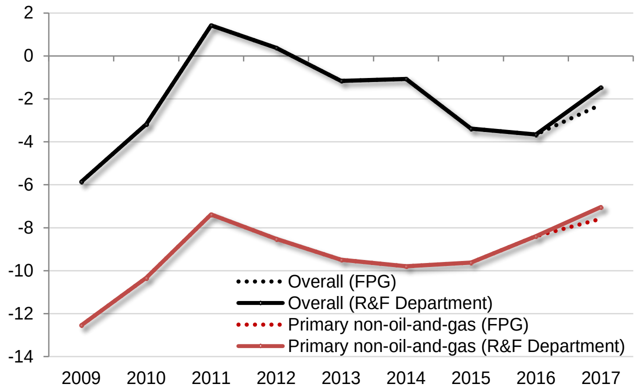
1.2.6. 2018 may see a budget surplus

- In 2017, budget deficit decreased by 2.2 pp to 1.5% of GDP, pointing to a considerable fiscal consolidation and improvement in fiscal sustainability.
- Revenues rose by 1.3 pp of GDP (adjusted for a one-off proceed from Rosneft privatisation in 2016), with oil-and-gas revenue adding 0.8 pp and non-oil-and-gas revenue - 0.5 pp, of which 0.2 pp came from better tax administration.
- Expenditures (adjusted for one-off early loan repayments by the military-industrial complex in 2016) decreased by 0.8 pp of GDP with a shift in the expenditure structure towards economic items (in the functional classification), and subsidies to businesses and capital investment (in the economic classification).
- Improvements in the structure of expenditures and tax administration, the effect of fiscal rule and the indirect effect of higher certainty over the long-term stability of public finance eased the negative effect of the budget consolidation on GDP growth in 2017. The most considerable constraint was registered in the fourth quarter due to the shifted seasonality of expenditures.
- In 2018, we expect that the budget will shift towards a surplus, and the National Wealth Fund and the aggregate public debt will resume growth relative to GDP.
- Estimates suggest that starting from 2019, once the consolidation is completed, the budget will stop constraining GDP growth. That said, structural changes and higher effectiveness of budget expenditures will potentially be able to accelerate economic growth.

Balance. As of end-2017 the Russian general government deficit totalled 1.5% of GDP, 2.2 pp lower than in 2016 and 0.8 pp lower than predicted in the Fiscal Policy Guidelines for 2018-2020 (hereinafter referred to as the FPG). As a result, the deficit met our expectations[12]. (Figure 26). There was a considerable fiscal consolidation and improvement in fiscal sustainability.

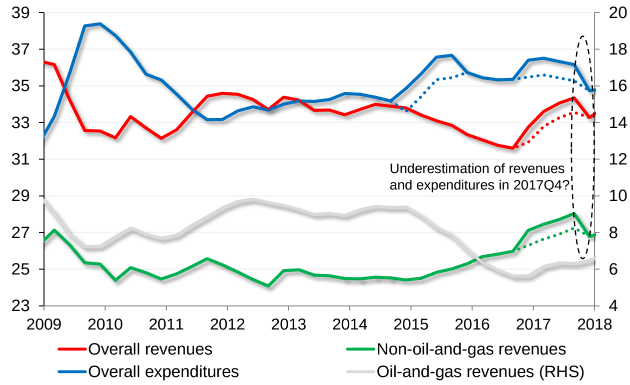
[12] See Section 1.2.8. 'Fiscal consolidation undertaken ahead of schedule', Talking Trends, December 2017 (No. 8).

Figure 26. General government overall and non-oil-and-gas primary balance, % of GDP



Sources: Federal Treasury, Russia's Finance Ministry, Rosstat, R&F Department calculations.

Figure 27. Key general government fiscal indicators (% of GDP, four-quarter moving average)



Sources: Russia's Finance Ministry, Federal Treasury, Rosstat, R&F Department calculations.

** Dashed line shows estimates adjusted for large one-off factors: bank recapitalisation in 2014 Q4, expenses on early loan repayment by the military-industrial complex and Rosneft privatisation in 2016 Q4.*

Revenues. Both revenue and expenditure items contributed to deficit reduction. Revenues rose by 0.5 pp of GDP compared with the 2016 readings, or by 1.3 pp of GDP, adjusted for a one-off proceed from Rosneft privatisation in 2016 Q4 (Figure 27). As many as 0.8 pp of GDP accounted for oil-and-gas revenues thanks to the increase in Urals crude prices of 27% YoY in US dollar terms and 12% YoY in ruble terms. Another 0.5 pp came from the increase in non-oil-and-gas revenues, including, as our estimates suggest, a 0.2 pp rise in tax collection rate (0.8 pp of GDP in 2014-2017).

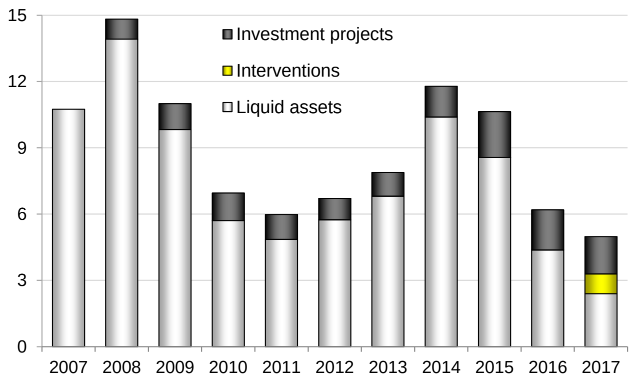
Expenditures. Expenditures fell by 1.7 pp of GDP compared with the 2016 readings or by 0.8 pp of GDP, adjusted for one-off early loan repayments by the military-industrial complex in 2016 Q4 (Figure 27). Functionally, the expenditure structure saw an increase in economic spending (0.4 pp of GDP), and a shrinkage in military (0.5 pp of GDP, adjusted for one-off payments in 2016) and social spending (0.6 pp of GDP) due to healthcare expenditure. Economically, the expenditure structure registered a considerable growth in subsidies to businesses (+13% YoY) and capital investment (+7% YoY), while the consolidation occurred through smaller purchases of goods and services (-13% YoY).

May readings update. The healthcare expenditure cut in 2017 (-10%) came unexpected, as did the small increase in social contributions to the budget (3% YoY, with labour costs adding 7% YoY and personal income tax 8% YoY). We expect these figures to be revised upward (by approx. 0.6 pp of GDP) in May when an updated budget assessment is to be released as complete reporting data come in. This approach has recently become standard practice. In 2015 and 2016, the update totalled 0.5 pp of GDP with the value of budget deficit unchanged.

Sovereign funds and public debt. In 2017, as many as 1.62 trillion rubles were used from sovereign funds to finance the budget deficit under the fiscal consolidation. The Reserve Fund was abolished, while the liquid part of the National Wealth Fund (NWF) totalled 2.4% of GDP (in old format without interventions) (Figure 28). The Finance Ministry's foreign exchange interventions under the budget rule totalled 0.9% of GDP (0.83 trillion rubles). Investment projects received little financing from NWF funds, and as of the year-end the NWF's non-liquid part totalled 1.7% of GDP.

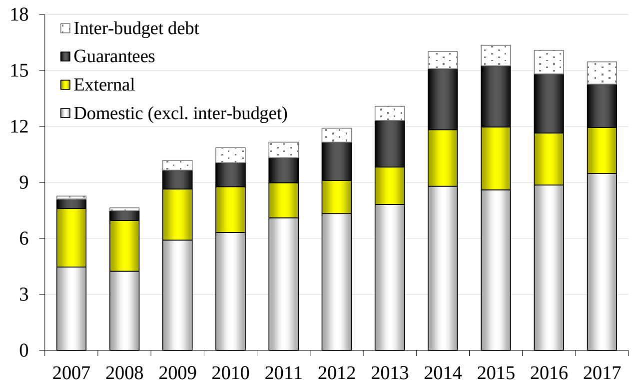
The general government debt dropped by 0.55 pp of GDP to 14.3% of GDP in 2017 (Figure 29). Its movements are attributed to the shrinkage in public guarantees of 0.85 pp of GDP. The debt structure (with guarantees factored out) saw a decline in foreign exchange loans, following net debt redemption and FX revaluation (of 0.15 pp of GDP respectively) while outstanding national currency loans added 0.55 pp of GDP as federal level loans expanded. This points to the improvement in regional budgets and the development of the national debt market.

Figure 28. Sovereign funds, % of GDP



Sources: Russia's Finance Ministry, Rosstat, R&F Department calculations.

Figure 29. General government debt, % of GDP



Sources: Russia's Finance Ministry, Rosstat, R&F Department calculations.

Impact on GDP growth. The decline in expenditures relative to GDP might have constrained GDP growth. Meanwhile, the shift in expenditures towards economic expenses with a relatively high fiscal multiplier, and lower federal expenditures with a negative multiplier, as estimated by Ivanova, Kamenskikh (2011)[13], boosted economic growth. The increase in revenues in 2017 and the lag effect of previous years may also have had a negative effect on GDP growth. Having said that, it is supposed to have been mitigated by the budget rule and better tax collection, which boosted competitiveness and economic effectiveness. Furthermore, the indirect positive effect of the fiscal consolidation should play a positive role by enhancing economic agents' confidence in the stability of public finance in the long run.

The most significant negative effect must have fallen on the fourth quarter, whereas the least constraining effect was registered in the first quarter. This is primarily explained by the shift in budget spending seasonality: the first quarter outpacing spending was

[13] Ivanova N., Kamenskih M. (2011). Efficiency of government spending in Russia // Economic policy, No. 1, pp. 176-192 (In Russian).

offset by lower spending in the fourth quarter, with neutral year-on-year performance in the second and the third quarters. This is overall in line with GDP growth dynamics.

2018-2020 forecast. Our estimates suggest that the budget balance will enter positive territory in 2018 but may be back in the red zone in 2019-2020 as oil-and-gas revenues is set to drop (consistent with the oil price downturn predicted in the Bank of Russia's baseline scenario) at the rate outpacing expenditures (under the fiscal consolidation).

The NWF has been on the rise since 2018, following the Finance Ministry's interventions under the budget rule updated this year (Figure 28). Meanwhile, the NWF in old format (without interventions) is poised to shrink in 2018 because of budget deficit financing under the ongoing fiscal consolidation. The general government debt will increase in 2018-2020 due to the direct effect of the budget rule (expenditures include, among other things, interest expenses funded with new loans), its indirect effect (as oil prices increase, sovereign fund savings are accumulated at an outpacing rate due to the outpacing growth in borrowing), and the expected resumption of regional debt growth.

The budget may have an insignificant negative effect on GDP growth in 2018 due to the ongoing fiscal consolidation and the lagged effect of the past years' consolidation.

Estimates suggest that starting from 2019, once the consolidation is completed, the budget will stop constraining GDP growth. That said, structural changes and higher effectiveness of budget expenditures may help accelerate economic growth.