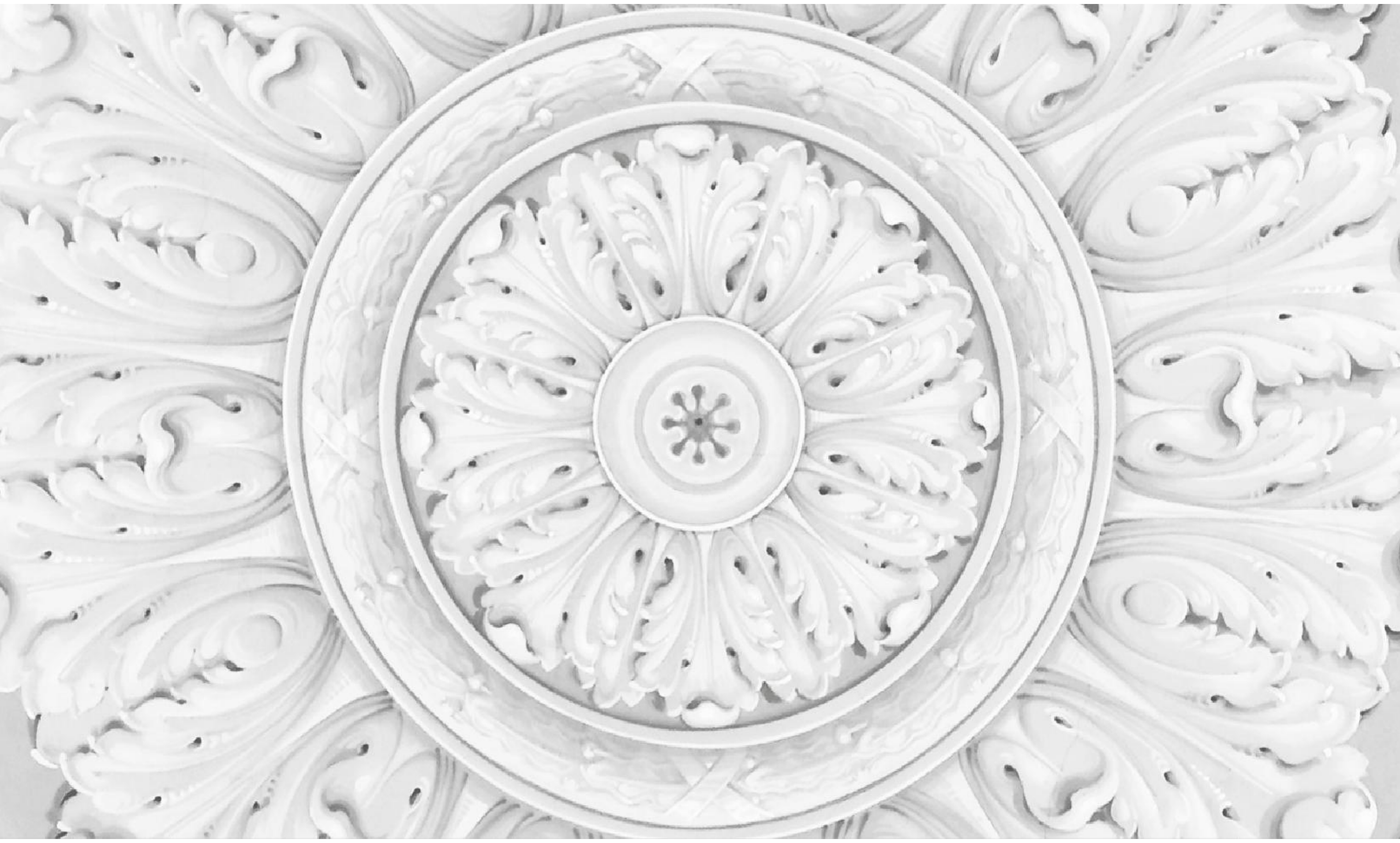
Bank of Russia

The Central Bank of the Russian Federation



TALKING TRENDS

Macroeconomics and markets

April 2018

Research and Forecasting Department Bulletin No. 3 (23)

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

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

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1. Monthly summary

- Between March and early April, inflation was unchanged and low. The trend towards its return to 4% is not expected to emerge before the second half of the year, notwithstanding a rise in short-term inflation risks. Having said that, economic activity continued to expand. Overall, the economy is gaining traction on a slow but sustainable growth path. The surge in geopolitical strains has been no threat to the stability of financial markets, although it has indeed led to a surge in volatility.
    - Temporary factors account for the March acceleration in inflation to 2.4%. The steadiest components of consumer prices retained low growth rates. At the same time, the short-term risks of inflation accelerating to a point above 4% are slightly up on the back of an accelerated wage growth pace and a weaker ruble in April. Key medium-term proinflationary risks remain in place. Among them are possible drastic changes in consumer behaviour, accelerating growth in consumer lending, unstable and elevated inflation expectations, the state of the labour market and risks related to external factors, alongside the uncertainty of fiscal policy dimensions after 2018. 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.
    - The economy in March expectedly slowed down slightly to a level consistent with its potential (approximately 1.5% a year). There was concurrent growth in the uncertainly over short-term economic performance. These developments come on the back of mixed factors: on the one hand, there is growth in geopolitical tensions; on the other hand, oil prices are rising. In defiance of this environment, economic expansion is progressing at paces that are close to potential.
    - Russian financial markets saw a strong rise in volatility in early April, driven by the impact of geopolitical factors. However, this volatility does not pose a threat to macroeconomic stability.

2. Outlook

- The slide in most major economies' PMIs from local maximums suggests mounting risks to global economic growth and financial markets will emerge in the near future.
- The leading GDP growth indicator is still indicative of a positive short-term outlook for the Russian economy.

3. In focus. Retail expansion: key trends and outlook

- Consumers' recently acquired habit of doing shopping when goods are on promotions alongside their preference for private labels are expected to constrain growth in consumer prices.
- Consumer prices are further pressured by dynamically expanding e-commerce, especially cross-border web stores.
- Strengthening market consolidation processes will possibly help individual players boost their market positions and trigger a certain acceleration in consumer price growth, going forward.

1. Monthly summary

1.1. Inflation

In March, inflation slightly accelerated to 2.4%. This acceleration was expected given that the stocks of vegetables including potatoes depleted earlier than last year. Having said this, the stable components of inflation remain low relative to the Bank of Russia's target. Short-term inflation risks were up on February on the back of exchange rate movements and accelerated wage growth paces which are unsupported by productivity growth.

Consumer prices, loans and deposits, as well as macroeconomic indicators have yet to fully respond to recent monetary policy decisions. This factor and a gradual transition to neutral monetary policy alongside the dying-out of temporary tailwinds are set to gradually move inflation closer to 4% in 2018 and sustain it at this level in subsequent years.

Mid-term proinflationary risks are dominant. Key risks include a potentially rapid switch to a consumer behaviour pattern, to the detriment of savings, and accelerated consumer lending, elevated and unsteady inflation expectations, possible skill shortages in the labour market and the uncertainty over fiscal policy dimensions in the next few years. An increasingly volatile currency market, impacted on by geopolitical factors, could add to proinflationary risks.

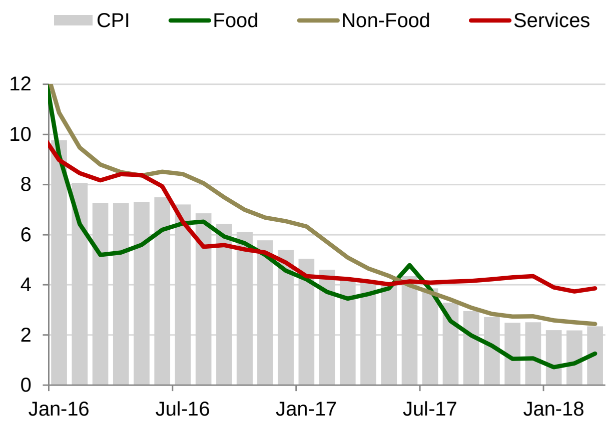
1.1.1. Inflation accelerates but remains low

- Annual inflation was up to 2.35% in March on 2.18% in February against the backdrop of accelerated growth in fruit and vegetable prices. We estimate seasonally adjusted consumer price growth at 0.23% MoM (2.8% on an annualised basis) vs 0.07-0.10% MoM seen in the January to February period.
- Modified core inflation indicators suggest inflationary pressure remains low.
- The emerging reverse trend in global food prices may potentially lead to a gradual rise in domestic food prices that have registered near-zero growth for the fourth month in a row[1].

Inflation accelerated to 2.35% YoY in March from 2.18% YoY in February (Figure 1).

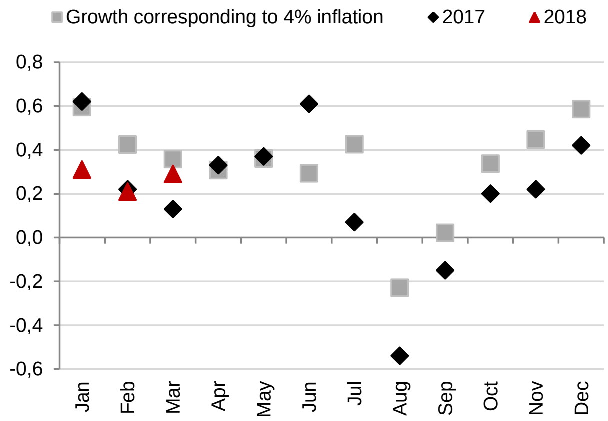
[1] Seasonally adjusted growth excluding fruit and vegetables.

Figure 1. Inflation and its components, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 2. Price growth, % MoM



Sources: Rosstat, Bank of Russia calculations.

Food inflation totalled 1.26% YoY; it has been growing for the second month in a row, mainly thanks to fruit and vegetable prices. In this way, March saw a 6.39% YoY rise in food and vegetable prices, vs 2.37% YoY seen in February. This is mainly driven by the performance of crop stocks, which depleted sooner than last year.

Annual food price growth, stripping out fruit and vegetables, continued to decline and totalled 0.6% YoY in March vs 0.7% YoY in February. The pace of this decline is however dropping (thanks to prices for eggs and sugar that are falling at gradually slower paces), suggesting a reverse trend is possible in the months to come.

In the non-food market, inflation was down to 2.44% YoY on 2.51% YoY in February. Consistent with prior months, the strongest decline was seen in oil products (from 6.28% YoY to 5.73% YoY). Annual growth paces remain steady enough across other non-food goods prices.

Services prices accelerated to 3.86% YoY, following a slowdown between January and February. This was mainly driven by the expected dying-out of the one-time impact from railway fares, attributable to the Rosstat-specific methodology for price capture[2].

Consumer price growth in March was 0.29% MoM and above the past year (Figure 2). There was a noticeable reduction of a gap with the path securing 4% annual inflation. However, this was virtually caused by nothing else but growing fruit and vegetable prices.

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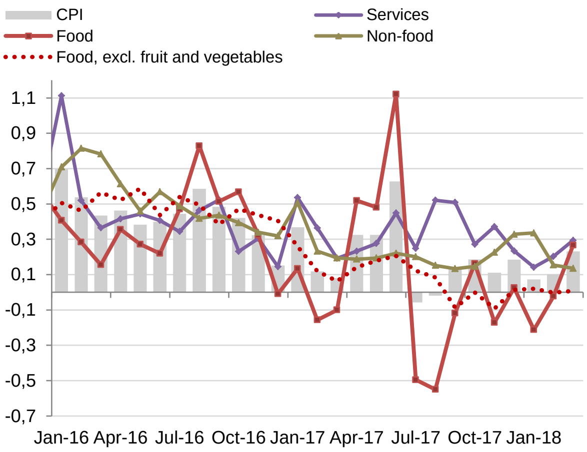
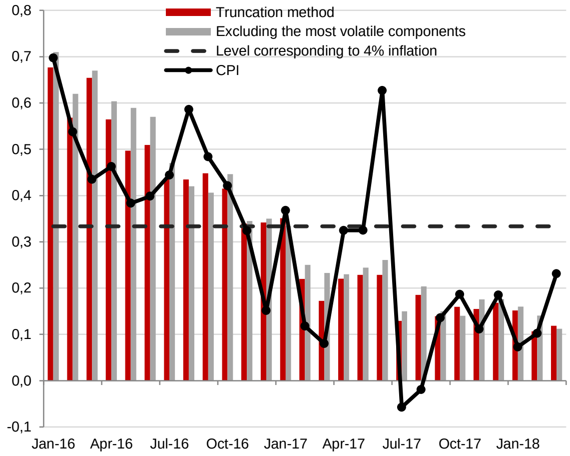
[2] The 7.82% YoY decline in railway fares in February is probably a result of changes to the CPI calculation methodology. The statutory methodology for statistical monitoring of consumer prices provides for statistical records to be made between the 21st and the 25th day of a reporting month. According to Russian Railways, 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 the February reduction of passenger railway transportation fares.

Figure 3. Seasonally adjusted price growth, % MoM



Sources: Rosstat, Bank of Russia calculations.

Figure 4. Modified indicators of core inflation, % MoM



Sources: Rosstat, R&F Department calculations.

Seasonally adjusted consumer price growth accelerated to 0.23% MoM (2.8% on an annualised basis) vs 0.07-0.10% MoM seen in the January to February period (Figure 3).

The month saw 0.27% growth in food prices[3]; however total growth remains zero if fruit and vegetable prices are not included. Prices for non-food goods remained steady and climbed 0.14% MoM. Prices for services quickened their growth pace to 0.29% MoM.

Inflationary pressure is still below a level consistent with 4% annualised inflation. This is evidenced by modified core inflation indicators that were unchanged in March from February (Figure 4). Importantly, they are impacted by temporary factors albeit to a lesser degree compared to headline inflation. This leads us to conclude that current core inflation indicators are considered somewhat undervalued.

The emerging global growth in food prices is poised to push up domestic prices given their strong correlation (Figure 5). According to the UN Food and Agriculture Organization (FAO), the food price index has been growing for the second month in a row, mainly on the back of rising prices for cereals and dairy produce.

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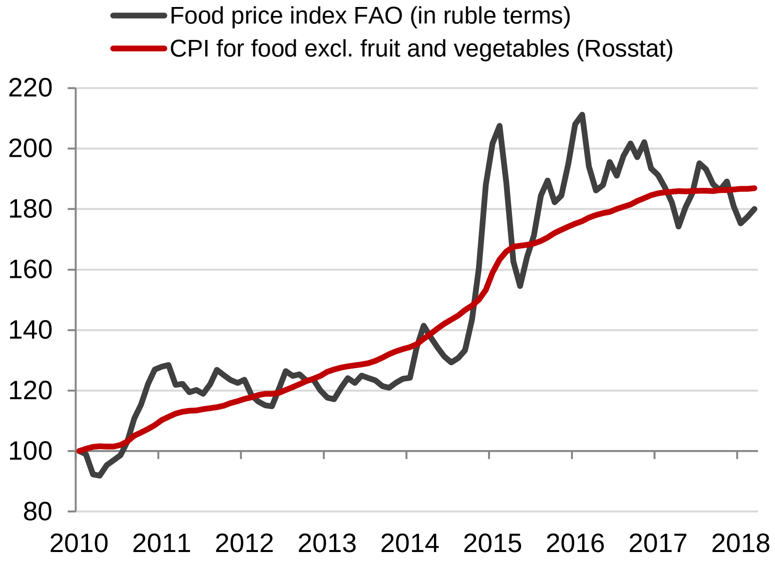
[3] Here and elsewhere, seasonally adjusted.

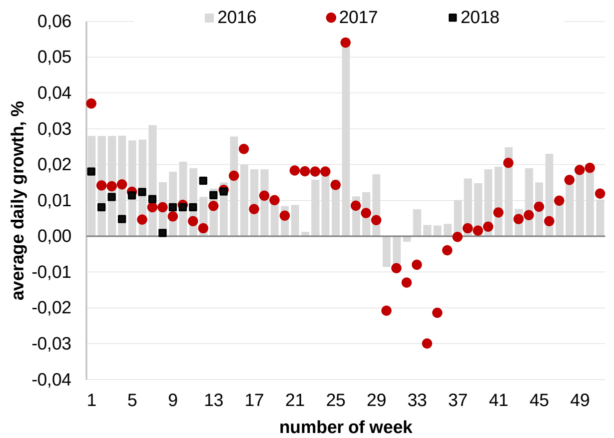
Figure 5. Global and domestic prices for food products, %, January 2010 = 100%



Sources: Rosstat, FAO, R&F Department calculations.

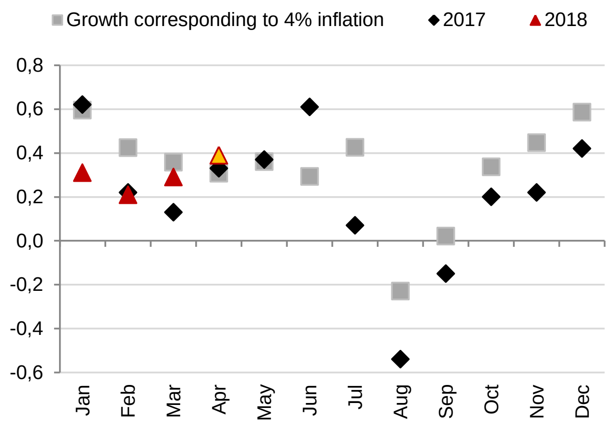
According to Rosstat, consumer prices went up 0.09% between 3 and 9 April. Average daily growth paces were level with the corresponding week of the past year (Figure 6). The current inflation rate is estimated to total 2.36% (2.35% in March).

Figure 6. Average daily price growth, %



Sources: Rosstat, R&F Department calculations.

Figure 7. Price growth, % MoM



Sources: Rosstat, R&F Department calculations.

The April estimate is preliminary.

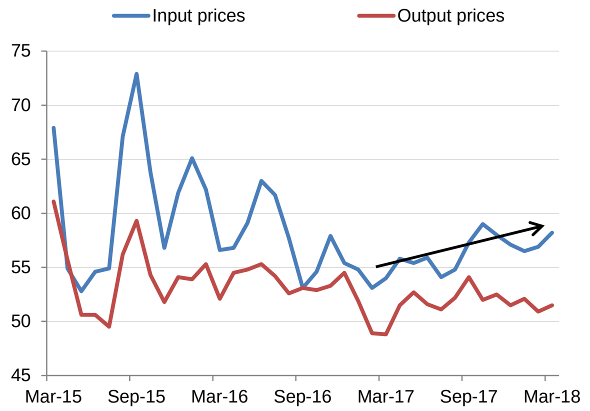
The preliminary estimate of consumer growth is estimated to total 0.4% MoM in April, based on current weekly data, which is consistent with last April (Figure 7). The impact of the seasonal factor on consumer prices is relatively modest, which is why the seasonally adjusted estimate is 0.4% MoM.

How strongly the expanded sanctions will impact on inflation will depend on how long the weakening of the ruble lasts and at which level it will subsequently settle. Our estimates show a 5-10% weakening adds 0.05-0.1 pp to inflation for a half-a-year to one-year period. Also, the exchange rate settling at a new lower level would affect food sooner than non-food prices, particularly fruit and vegetable prices. The first reason for this is seasonal growth in the proportion of fruit and vegetable imports between late spring and early summer. Secondly, there are longer lags in the procurement of non-food products.

1.1.2. PMI price indexes: growth is gradually accelerating

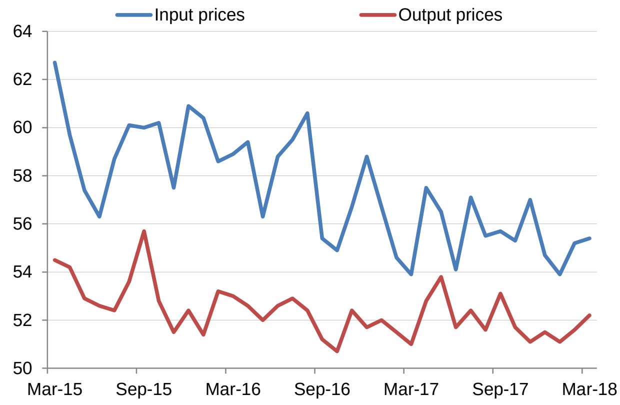
- Services PMIs have been growing for the second month in a row, pointing to slightly increased inflationary pressure.
- The stronger demand enabled companies to pass wage growth and utility costs to final consumers.
- The input price index for the manufacturing sector has been on an upward trajectory since 2017 Q2. For the time being, companies have been passing on growing costs to consumers fairly cautiously, which constrains output prices.
- However, a continued upward trend in the input price index is set to translate into accelerated growth in output prices.

Figure 8. Manufacturing PMI price indexes



Sources: IHS Markit.

Figure 9. Services PMI price indexes



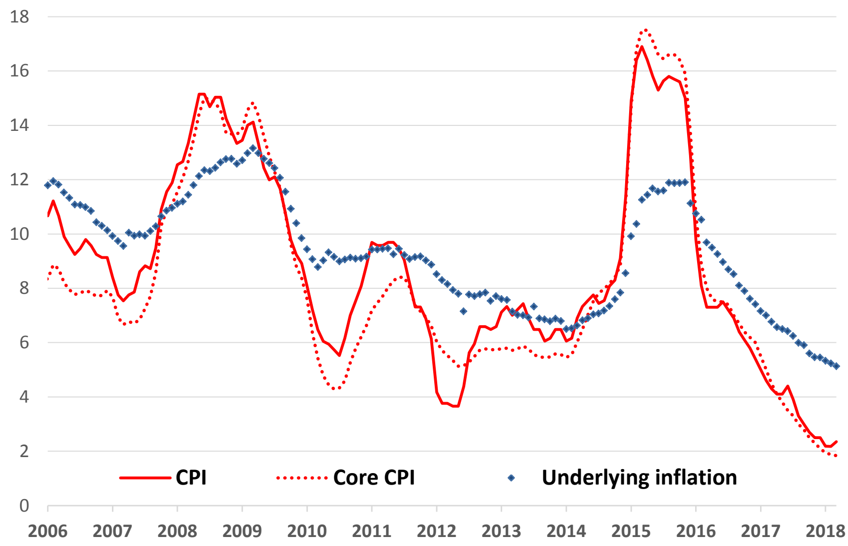
Sources: IHS Markit.

1.1.3. Underlying inflation in March

- In March 2018, the estimate of underlying inflation declined to 5.1% from 5.2% in February.
- A fairly sustainable slowdown in underlying inflation being evident, its current estimate is still viewed as elevated, which is attributed to heightened historical inflation rates, as well as the inertia of this indicator in terms of its construction.

- Over a mid-term horizon, the risks of annual inflation moving upwards from 4% still prevail over the risks of its downward movement away from the target.

Figure 10. CPI, CCPI and historical estimates for underlying inflation, % YoY



Sources: Rosstat, R&F Department calculations.

1.2. Economic performance

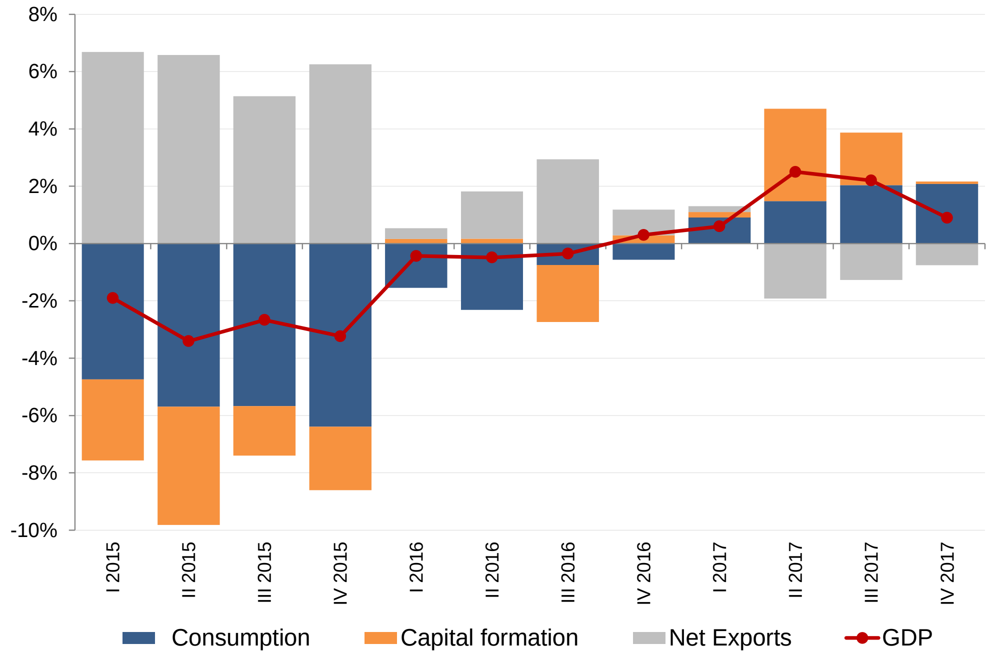
The Russian economy had a good start to 2018. The acceleration was helped by one-off temporary tailwinds - which also partially offset the slowdown late last year. Current macroeconomic indicators and survey data suggest economic expansion continued in the first half of 2018. Moving forward, growth will be supported by higher domestic demand as real wages increase and the global economy grows. However, there is stronger uncertainty over short-term GDP trends, driven by a variety of mixed external factors.

1.2.1. 2017 GDP: growth slows down temporarily in the second half

- As follows from a preliminary estimate for 2017 Q4 GDP growth, there was a substantial slowdown in both annualised GDP and quarterly seasonally adjusted data.
- Behind this is inventory, a volatile component that is difficult to measure.
- Against this backdrop, expansion in domestic demand has been sustainable and consistent with GDP, totalling 1.5% in 2018.

In April, Rosstat issued its updated GDP growth estimates including updates on 2015 and 2016, as well as the first preliminary estimate for 2017 Q4 GDP. Our primary focus is on quarterly estimates.

Figure 11. Contribution of core components to GDP growth, on a year-on-year basis, pp

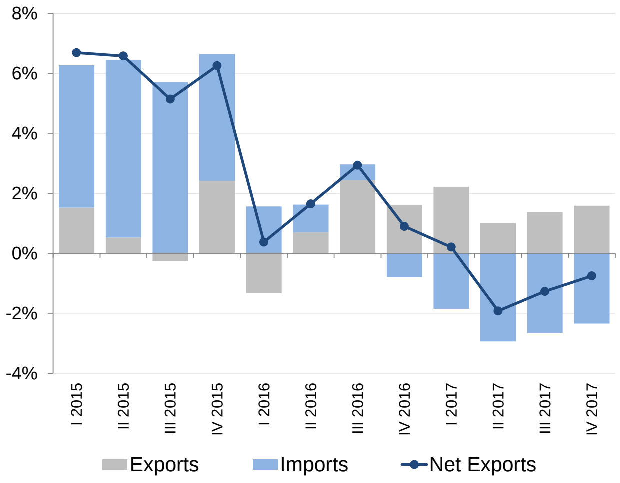


Source: Rosstat, R&F Department calculations.

In the fourth quarter of 2017, annualised economic growth slowed down considerably, totalling 0.9% YoY vs 2.2% YoY in the third quarter. The estimate for the third quarter was substantially upgraded (+0.4 pp on 1.8% YoY previously), which highlights an even more pronounced drop in the fourth quarter. The current shrinkage is seemingly based on the preliminary nature of Q4 GDP estimates. However, there was also a strong downward revision of the R&F Department's seasonally adjusted Q2 estimates, updated based on new statistics. Having said this, our understanding is that it would be incorrect to read recent data as a quality change for the worse in economic activity.

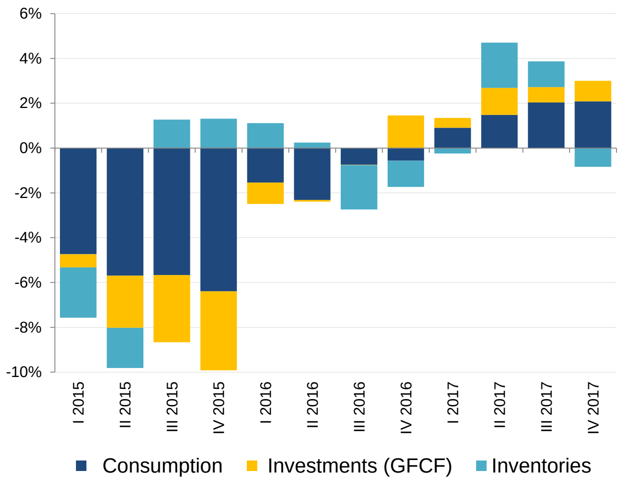
Current data show both YoY and QoQ GDP slowdown in the fourth quarter occurred mainly on the back of poorer gross fixed capital formation, specifically, on the back of the negative contribution of inventories. Their decline in late 2017 proved stronger than traditional seasonal trends for the fourth quarter suggested. However, inventories are known as the most volatile GDP component, normally revised each time an overall GDP estimate is updated.

Figure 12. Net export components and their contribution to annual growth rates, pp



Sources: Rosstat, R&F Department calculations.

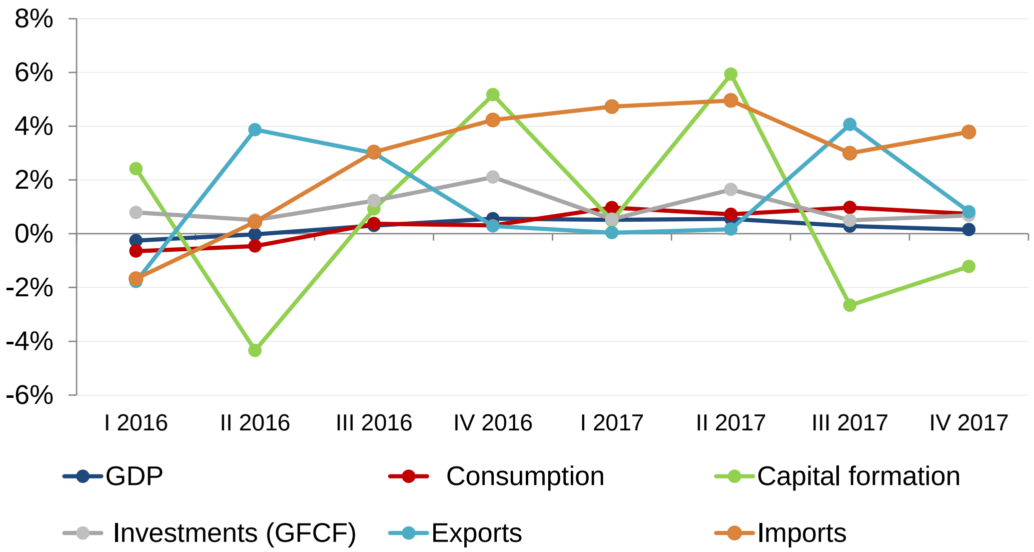
Figure 13. Investment and consumption, and their contribution to annual growth, pp



Sources: Rosstat, R&F Department calculations.

At the same time, gross fixed capital formation in the fourth quarter IV, even when annualised, showed only a slightly worse performance (slowdown to 3.4% YoY against 4.0% QoQ in Q3), while quarter-on-quarter seasonally adjusted growth even picked up its pace (from 0.5% QoQ to 0.7% QoQ). The same is true of final consumption expenditure which, viewed on an annual basis, saw stabilisation (3.3% against 3.2% YoY in Q3), with only a slight quarter-on-quarter deceleration (0.7% vs 1.2% QoQ respectively). This leads us to conclude that domestic demand remained fairly strong in the period. Naturally, this was accompanied by slightly accelerated imports, while volumes of exports continued to show favourable developments as key export commodities sustained on a positive path.

Figure 14. Core GDP components, % QoQ, seasonally adjusted



Source: Rosstat, R&F Department calculations.

Based on a review of GDP data for the total 2017 vs preliminary February 2018 statistics, the following changes should be noted. The GDP structure by expenditure highlights a slight upward adjustment in the growth of imports, which is viewed as natural given Rosstat's upward revision of the contribution of final consumption expenditure to annual GDP growth. Importantly, the correction changed Rosstat's previously published contribution of public expenditure turned positive but dropped relative to 2016. As a matter of fact, in Rosstat's new version, the total contribution of fixed capital formation to GDP growth in 2017 even edged down. The upward revision of the gross fixed capital formation estimate was set off by a downgrade in the estimate of inventories.

As shown by a more detailed study of recent macroeconomic statistics, preliminary GDP estimates (for more details, see Subsection 2.2.2. GDP growth projections: fluctuations in short-term statistics do not impede sustainable growth) and leading indicators, there was no essential deterioration in GDP data. Also, Rosstat's updated GDP structure suggests stabilised domestic demand.

1.2.2. Industrial output in February: a slight drop as the moderately positive trend holds

- The swings in production are overwhelmingly attributable to the natural volatility of short-term statistical indicators.
- This suggests that slow economic growth, close to its potential, is ongoing.
- Industrial output growth slowed down to 1.5% YoY, while the manufacturing sector reported 1.9% YoY growth.
- Several estimates suggest that once statistical and temporal factors are excluded, there emerges continued growth in industrial production, following a short-lived drop in late 2017.

Rosstat estimates captured the following decline in February’s industrial production index: -1.3% MoM. Also, growth paces vs last February are positive: +1.5% YoY. In particular, positive trends sustain in the mining (+0.3% YoY) and the manufacturing sector (+1.9% YoY), as well as electricity, gas and steam supply (+1.8% YoY) and water supply (+1.4% YoY), that is especially evident following their contraction in January.

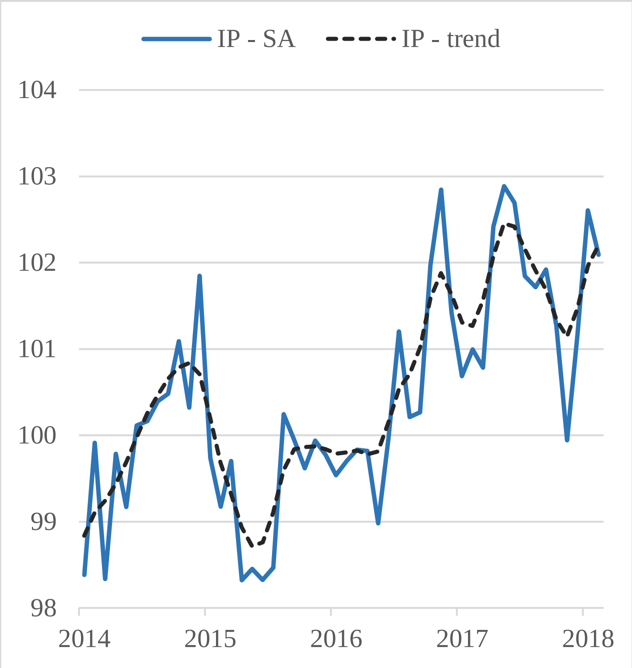
Seasonally adjusted R&F Department estimates showcase a much more modest drop in industrial production of 0.5% MoM. Our calculations also show the manufacturing sector reported a contraction of 0.5% MoM SA. At the same time, the mining sector's output was level with January; electricity, gas and steam supply and water supply were up 1.5-2% MoM SA.

We cannot read this drop as any reason for a reverse in the current trend. Based on R&F Department trend estimation[4], the industrial production index has been positive for three consecutive months (Figure 15), with the February growth totalling +0.2% MoM. More so, net positive growth rates are seen across all subindexes, and the positive trend in the manufacturing sector has maintained since mid-2015 (Figure 16). Respondents for the industrial sector's February PMI also noted muted growth expansion (51.9), with the New Orders category gaining the best score (51.7).

This modest growth is further confirmed by the Centre for Macroeconomic Analysis and Short-term Forecasting data: they record +0.2% MoM growth in the seasonally adjusted indicator. Their product breakdown singles out gas production (+2.3% MoM), supported by the cold weather conditions, and the motor industry (+1.1% MoM), where a gradual recovery follows the 2015 shrinkage.

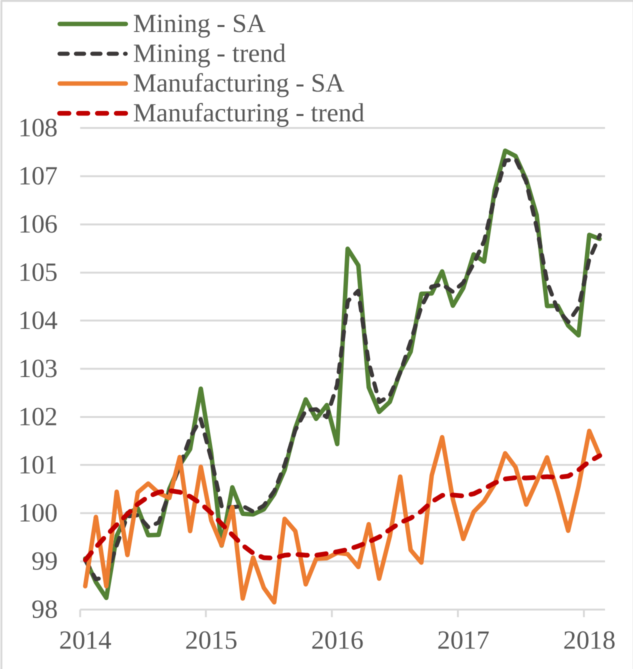
These data in their entirety suggest that the February drop is within the range of regular industrial production index swings. Therefore, the upward trend, backed up by positive producer and buyer sentiment in early 2018, is highly likely to sustain in the months to come, as the 2018 economic growth is set to total 1.5-2.0%, a pace consistent with its potential.

Figure 15. Industrial production index (2014 = 100)



Sources: Rosstat, R&F Department calculations.

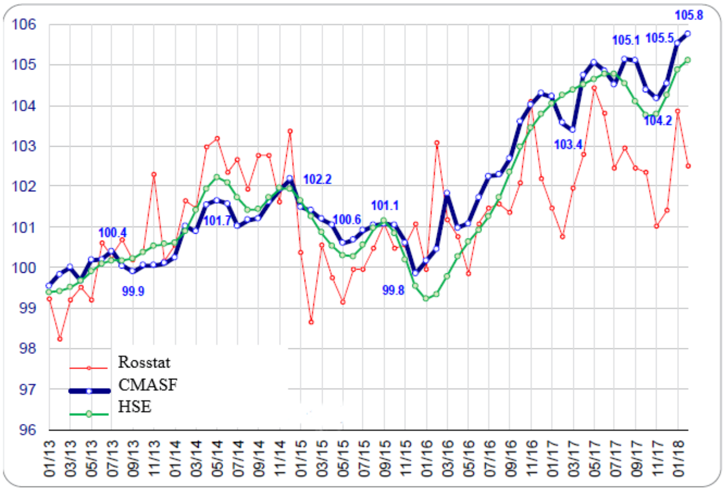
Figure 16. Mining output and manufacturing sector output indexes (2014 = 100)



Sources: Rosstat, R&F Department calculations.

[4] Obtained in the course of the TRAMO/SEATS procedure for seasonal adjustment.

Figure 17. Industrial output (seasonally adjusted, 2013 = 100)



Sources: Centre for Macroeconomic Analysis and Short-term Forecasting (CMASF)

1.2.3. Composite PMI: economic growth slows down in Russia and globally

- The composite PMI fell to 53.2 points. This slowdown coincided with global trends.
- All services subindexes except that for price movements registered a slowdown. The Expectations subindex slid strongest, driven by growth in uncertainty.
- The manufacturing PMI edged higher in March to 50.6 from 50.2 points seen in February.
- The production index, following its January surge, stabilised at the point slightly below 52 points, which attests that the manufacturing sector grew slower than its 2017 average pace.

The composite PMI IHS Markit Russia index hit 53.2 points, fully obliging the R&F Department's news index estimate[5]. The services PMI in March (53.7 points) highlights continued sectoral growth albeit at lower paces than seen in the January to February period (55.8 points – Figure 18). The downward movement of Russia's PMIs was concurrent with a global economic slowdown that emerged in March.

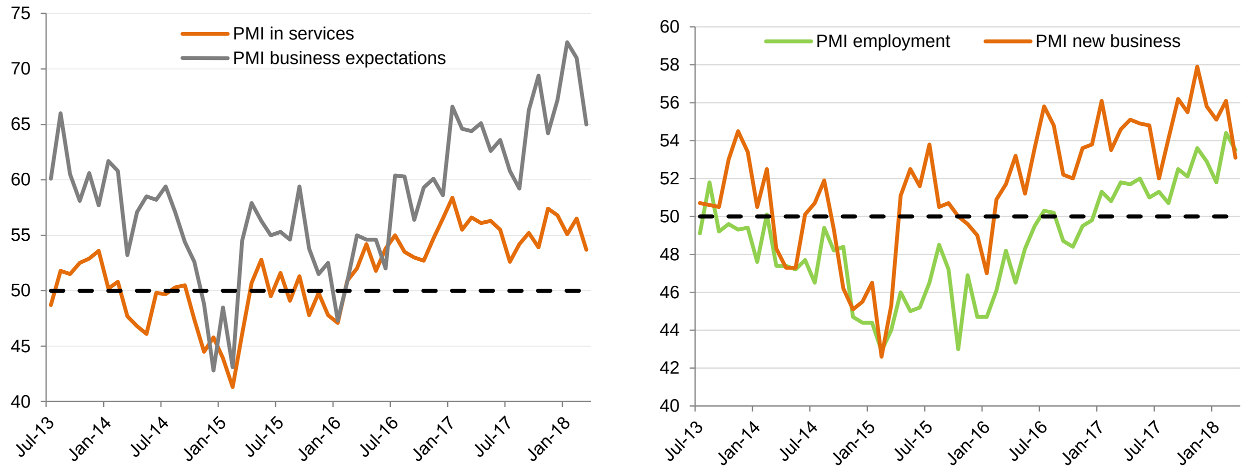
A detailed breakdown bears out that all PMI subindexes moved downwards in March. The New Orders and Employment subindexes retained their positive trends; however they both came back to 53 from 55 points seen in February. Roughly 20% respondents cite growth in new orders; 15% report a drop. Based on responses, employment drivers include expansion in the number of orders from both new and current clients.

[5] http://cbr.ru/Content/Document/File/27714/wp_25.pdf

The decline in the *Expectations over a 12 Month Horizon* subindex was strongest, having revisited the level of early this year. Some respondents reported doubt as to how sustainable the current agility of demand would be. This was likely caused by rising uncertainty, both domestically and around the globe. Having said this, expectations remain at a fairly high level, suggesting economic expansion is highly likely to continue at current levels.

The IHS Markit PMI index for the manufacturing sector in March moved higher to 50.6 points from 50.2 points seen in February. This growth owes its origin to improved jobs data (49.1 vs 47.3) and purchases of intermediate goods (49.1 vs 46.3): although the two subindexes are still below 50, their rates of decline in March were down substantially. Key components in the composite manufacturing PMI, Output, and New Orders remain in growth territory (>50), for all their modest decline over the past month.

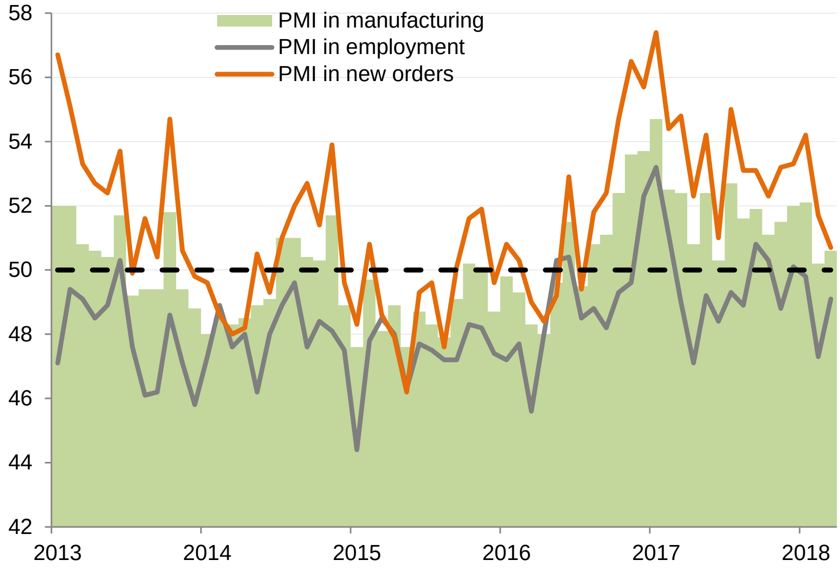
Figure 18. Services PMI



Source: IHS Markit.

Respondents note that industrial production continued to grow in March on the back of recovering consumer demand. Respondents of IHS Markit's survey also cite growth in new clients' orders, with some 15% of them recognising growing export orders. The forecast for the next 12 months was downgraded slightly: the Future Output subindex held around 69 throughout the course of the first quarter, with more than 40% companies expecting growth in demand over one year horizon. Some respondents cite the fragile nature of recovery in demand as a constraint on further expansion in the production of goods.

Figure 19. Manufacturing PMI, points



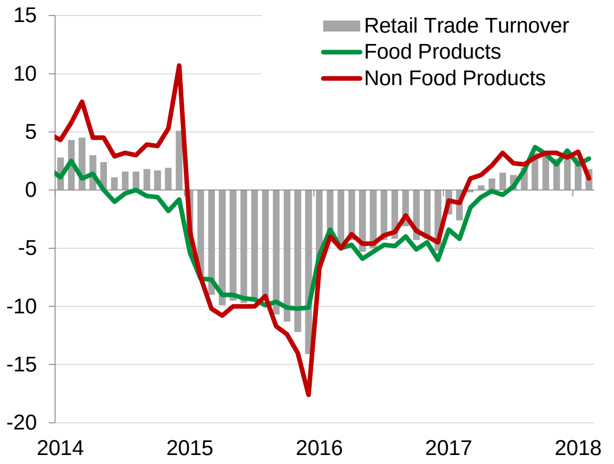
Source: IHS Markit.

1.2.4. Retail slowdown in February is temporary

- This February saw annualised growth slowdown to 1.8% YoY after 2.8% YoY in January, on the back of movements in non-food goods.
- Seasonally and calendar effect adjusted, retail sales in February dropped to 0.3% MoM.
- Accelerating wage growth, ongoing expansion in retail lending alongside sustainably sanguine consumer sentiment are set to help quicken the pace of retail growth in the months to come.

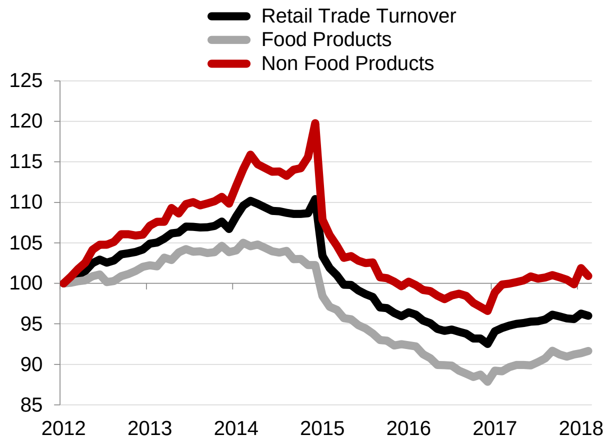
According to Rosstat, retail growth slowed down to 1.8% YoY in February after 2.8% YoY in January, on the back of movements in non-food sales: 1.0% YoY in February after 3.3% YoY in January (Figure 20). Food sales growth accelerated to 2.7% YoY in February on 2.2% YoY in January.

Figure 20. Food, non-food and total retail sales, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 21. Retail sales, % (January 2012 = 100%, seasonally adjusted)

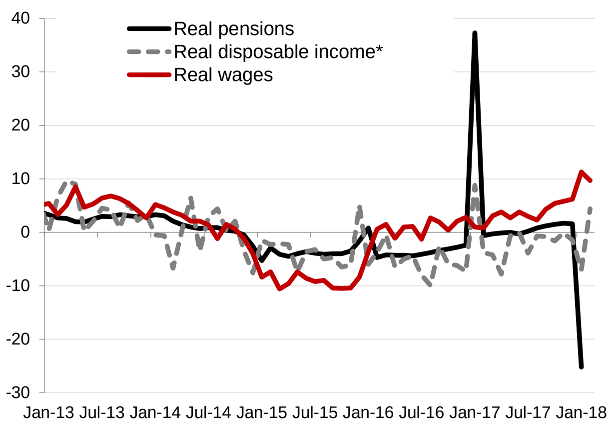


Sources: Rosstat, R&F Department calculations.

According to our estimates, seasonally and calendar effect adjusted retail sales dropped to 0.3% MoM after 0.7% MoM growth in January (Figure 21). In February, dropping sales of non-food goods were recorded, a trend that persisted for the last three months of 2017, with the current month's rate of decline rising to 1.0% MoM. Food sales kept growing steadily for the third month in a row at 0.2-0.3% MoM.

February 2018 also saw a slight deceleration in real wage growth to 9.7% YoY, after its acceleration to 11.3% YoY in January[6], driven by the indexation of public sector employees' salaries (Figure 22). Real disposable household income was also up 4.4% YoY. Growth in both income and wages contributed to a rise in ruble deposits (Figure 23). The January outflows of deposits were thereby offset by this month's inflows.

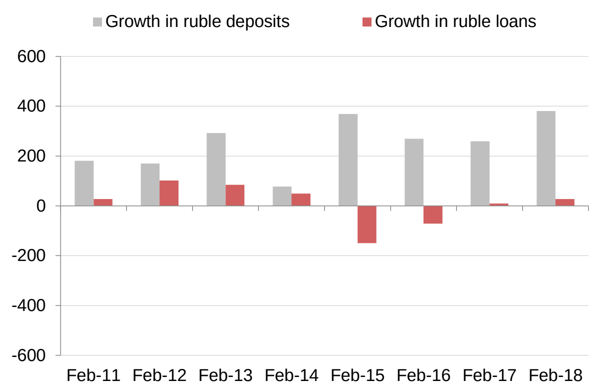
Figure 22. Real income of households, % YoY



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

Source: Rosstat, R&F Department calculations.

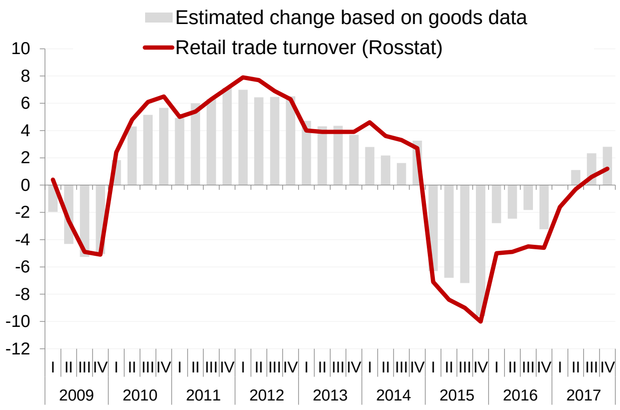
Figure 23. Growth in ruble deposits and loans (billion rubles)



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

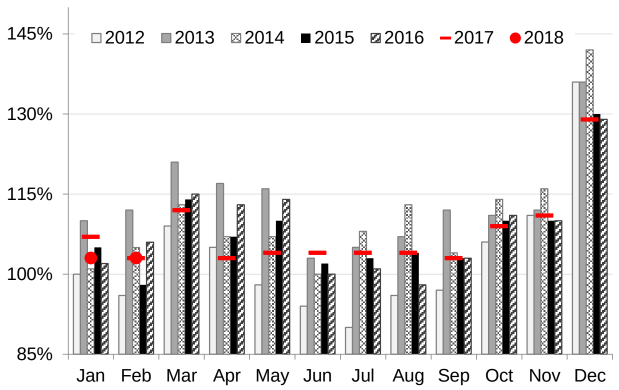
[6] Rosstat revised the January indicator from 6.2% to 11.3%.

Figure 24. Retail sales, change in % from year-start, on corresponding period of previous year



Source: Rosstat, R&F Department calculations.

Figure 25. Real every-day spending, % (January 2012 = 100%)



Source: Romir.

The past year's retail sales calculated on the basis of changes in individual product categories[7] proved sustainably more optimistic than Rosstat's official estimate. According to Rosstat, retail sales were up 1.2% in 2017; however, once sales data on individual product categories are looked into, sales grew by 2.8% YoY (Figure 24).

According to Romir[8] (Figure 25), real consumer spending, after a substantial drop in January, was virtually unchanged in the current month and remained level with last year.

The income-based breakdown of consumer spending shows that low income consumers increased their spending by as much as 5.2%, while average and high income consumers cut down their spending by 1.8% and 1.3% respectively. This is an indirect sign of these categories of consumers increasingly migrating to web stores.

Household sentiment is invariably positive (Figure 26). This is suggested by an inFOM survey[9]. This March saw the positive trend in evaluations of current financial standing remain in place, with next year expectations unchanged thanks to a receding proportion of respondents whose financial standing deteriorated or who expect it to deteriorate in the future. Households' attitudes to large purchases and savings saw a slight deterioration after the improvement of the past four months. There was a rise in the proportion of respondents who intend to make large purchases in the next three months.

Given the sustainably positive trend in consumer sentiment, it is highly likely that the current consumption contraction is short-lived and retail sales will improve.

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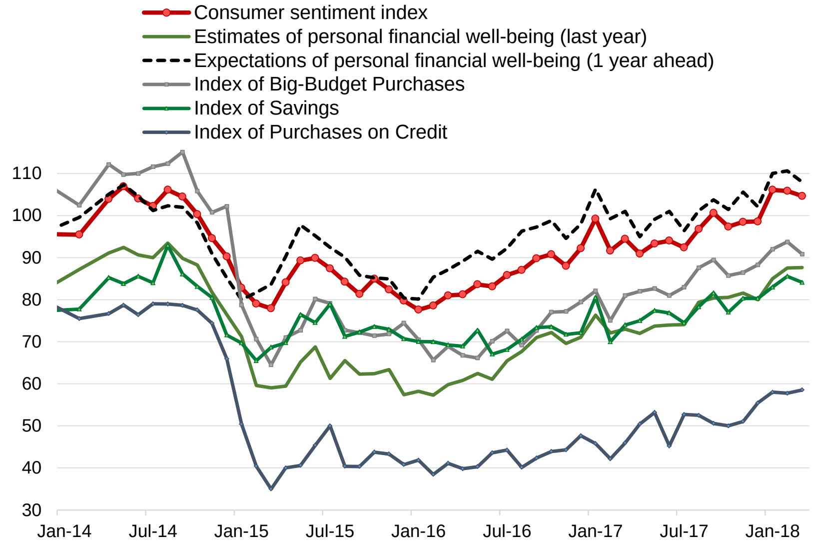
[7] The index is the weighted average of core food and non-food products accounting for about 72% of total retail sales. The conclusions are based on the commodity composition of the year that precedes the accounting year.
For details, see Talking Trends. No. 1. February 2017. Section 3. 'In focus. Consumption: evidence for decline or growth?'.
[8] Romir Research Holding. «Потребительские расходы без сюрпризов». 13.03.2018.
[9] Based on real-time data for March.

Figure 26. Consumer sentiment index and its components



Source: inFOM survey.

1.2.5. Inflation risks from the labour market side are on the rise

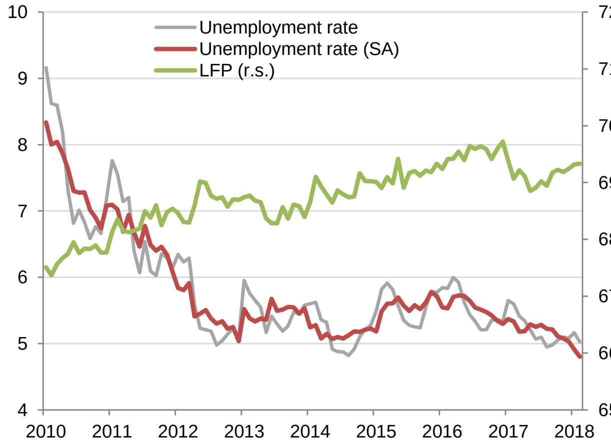
- In February, unemployment, at a seasonally adjusted 4.8%, hit a new all-time low, which is indicative of growing pressure on the private sector's wages.
- The annual growth pace of nominal wages in January was revised upwards by 5 pp, essentially driven by public sector and oil sector data.
- The growth of nominal wages may exceed 10% for 2018, thereby bringing about conditions for accelerated inflation.

Unemployment rate was 5.0% in February vs 5.2% in January. In the first two months of the current year, unemployment rates are approximately 0.5 pp lower than in the corresponding period of the past year. A seasonally adjusted unemployment rate hit a new historical low of 4.8%, reflecting the overall decline in the number of available labour resources (Figure 27).

Beginning from 2018, Rosstat changes the methodology[10] for calculating this indicator, with so far little implications for its performance, though (Figure 28). The 2017 and 2018 methodology collation makes it clear that unemployment rate remained virtually unchanged. This suggests fundamental rather than technical factors are behind the decline in unemployment.

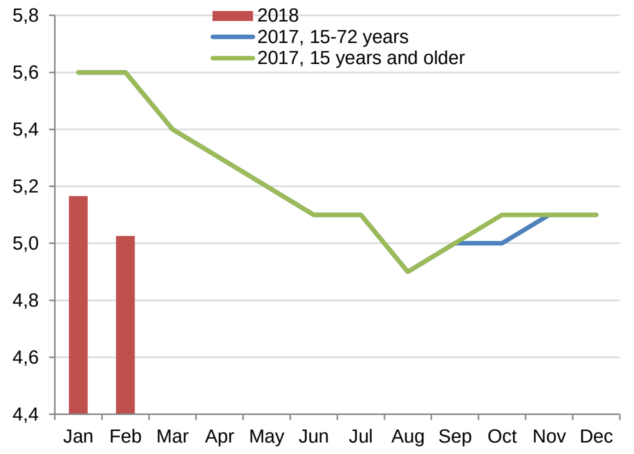
[10] According to Rosstat, since 2018, economically active population has included people aged 15 and older; previously, people aged 15-72 were included.

Figure 27. Unemployment rate and labour force participation, %



Sources: Rosstat, R&F Department calculations.

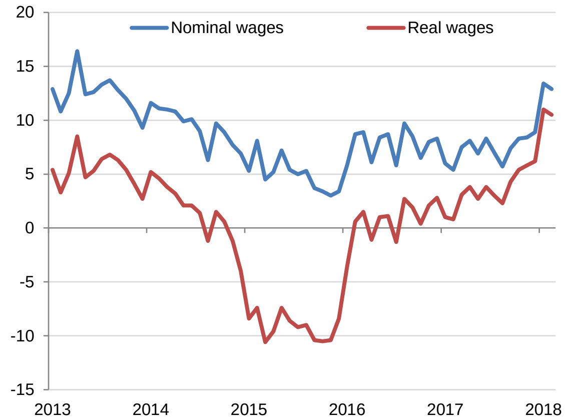
Figure 28. Unemployment rate in 2017 and 2018, %



Sources: Rosstat.

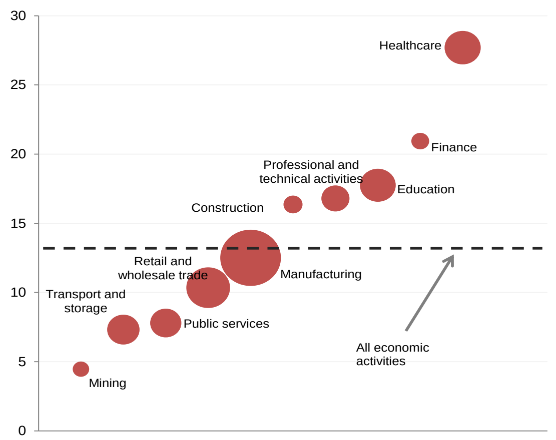
Nominal wages in January were expectedly revised upwards at once by an increment of 5 pp from 8.5% to 13.7% YoY (Figure 29). The revision sent growth in real wages up to as much as 11.3% YoY. Preliminary February's estimates suggest growth in both nominal and real wages slowed down somewhat relative to January to 12.1% and 9.7% YoY respectively.

Figure 29. Growth rates: nominal and real wages, % YoY



Sources: Rosstat.

Figure 30. Growth of nominal wages by economic activity in January 2018, % YoY

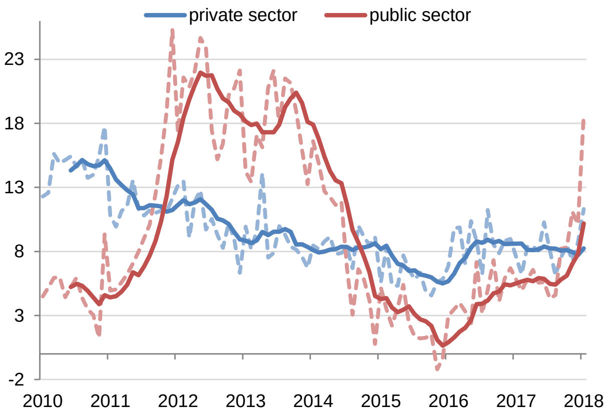


Sources: Rosstat, R&F Department calculations.

**The area of circles is reflective of the activity's share in total payroll*

The strong upward revision in nominal wage growth is mainly connected with the public sector where an indexation occurred in salaries of employees covered by the presidential orders and the planned indexation took place (Figure 30 and Figure 31). We estimate that the growth of public sector employees' wages in 2018 may total on the order of 13-15% YoY, while the 2019 growth is set to decline consistent with inflation (4%) barring any other salary reviews.

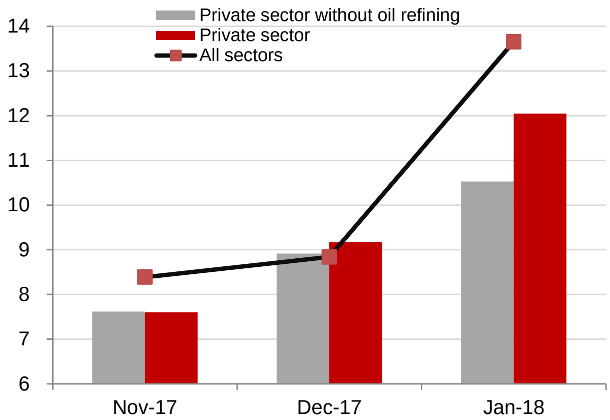
Figure 31. Nominal wage growth in the private and public sector, % YoY



Sources: Rosstat, R&F Department calculations.

**The dotted line stands for monthly YoY growth, the solid line stands for the rolling average for 6 months.*

Figure 32. Nominal wage growth in the private sector including and excluding oil refining, % YoY



Sources: Rosstat, R&F Department calculations.

Wage growth is accelerating in the private sector, probably driven by a shrinking labour force available and tighter competition for competent employees in individual sectors (see also Subsection 1.2.6. Unemployment declines on the back of cyclical growth in labour demand). In January, nominal wage growth in the private sector accelerated to 12.0% from 9.0% YoY in December 2017. The key contributor to the private sector's wages was the oil industry where wages rose 2.2 times relative to 2017 (Figure 33)[11]. However, the private sector posted a double-digit wage growth even stripping out the oil refining sector (Figure 32). The manufacturing sector, the largest by headcount, showed 12.5% YoY nominal wage growth.

[11] The stunning wage growth in the oil refining sector is probably due to the deferral of fringe benefits (bonuses) until the start of the year. Overall wages in this economic activity are characterised by high volatility probably attributable to uneven payouts of variable components of compensation within a year.

Figure 33. Nominal wage growth in the manufacturing sector, % YoY

	Jan-2018	4Q2017	Difference
Manufacturing	**12,5**	**8,4**	**4,1**
Petroleum Coke & Refined Petroleum Products	*120,0*	*11,0*	*109,0*
Chemicals	14,1	8,7	5,4
Beverages	8,8	4,7	4,1
Others	12,4	9,0	3,4
Other Non Metallic Mineral Products	10,9	81,0	2,8
Clothing	14,5	12,2	2,3
Computers, Electronic & Optical Equipment	8,4	6,1	2,3
Machinery & Equipment	10,4	8,9	1,5
Basic Metals	7,9	6,8	1,1
Electrical Equipment	9,0	8,3	0,7
Leather, Leather Products	9,2	9,0	0,2
Other Transportation	7,3	7,1	0,2
Tobacco	3,5	3,3	0,2
Publishing & Printing	12,3	13,0	-0,7
Food Products	6,6	7,4	-0,8
Fabricated Metal Products	7,5	8,4	-0,9
Furniture	7,6	9,0	-1,4
Vehicles & Trailers	12,9	14,5	-1,6
Rubber & Plastic Products	8,4	10,2	-1,8
Wood & Wood Products	2,6	5,5	-2,9
Textile & Textile Products	6,7	10,6	-3,9
Medicines	3,7	8,3	-4,6
Pulp, Paper	-0,2	8,4	-8,6

Sources: Rosstat, R&F Department calculations.

Accelerated wage growth was driven, among other things, by a rise in the minimum monthly wage, from 7.8 thousand to 9.5 thousand rubles. We estimate[12] that the direct impact of an increase in the minimum monthly wage added 0.4-0.5 pp to the January growth in wages. The rise across all pay grades that are close to the minimum monthly wage could have added between 0.4 and 1.1 pp. The increased minimum monthly wage contributed to wage growth acceleration between 0.8 and 1.6 pp in total. The planned increase in the minimum monthly wage to 11.1 thousand rubles, due on 1 May, is set to add to wage growth a further 1.5-2.9 pp. All other things being equal, the increased minimum monthly wage at year-end will push up wages by 2.3-4.5%.

The realisation of inflation risks from the labour market side, which are persistently high, is not the case now. A drastic downturn in unemployment rate could support the paces of wage growth that the private sector has recently attained. Overall nominal wage growth this year may well exceed 10%, contributing to growth in real disposable household income (+4.4% YoY in February).

[12] It is envisaged that the increased minimum wage will not lead to shady schemes in labour compensation.

1.2.6. Unemployment declines on the back of cyclical growth in labour demand

- The extended unemployment indicators declined in the course of 2017 at a quicker pace than the standard U3 indicator, which suggests an ongoing shift in the labour market's balance to a labour shortage.
- Unemployment reduction is mostly driven by growing demand for labour, while changes in the age structure can account for a mere 0.1 of the 0.4 pp reduction in unemployment in 2017.

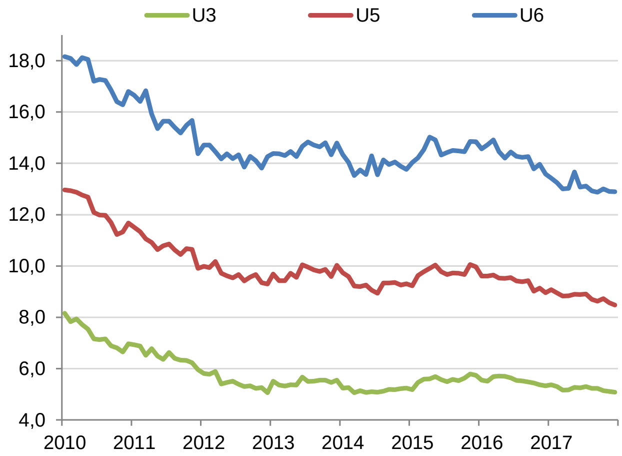
The extended unemployment indicators point to an ongoing shift in the labour market's balance to a labour shortage. They are declining at a faster pace that the standard unemployment rate (U3) calculated by Rosstat.

The U6[13] indicator, which includes workers with a work week under 30 hours, went down in 2017 to 12.9% from 13.4% in 2016 (Figure 34). Therefore, companies have increasingly scarce resources to expand production without additional jobs. Another indicator exposing reduced underutilisation of labour resources is the potential work force, which is included into the extended unemployment indicator U5[14]. It fell from 9.0 to 8.5%. All the three indicators are at their all-time lows.

The direct impact from the changing age structure on reduction in unemployment appears moderate. Our estimates show this explains a mere 0.1 of the 0.4 pp reduction in unemployment in 2017 vs 2016 (Figure 35). Among other factors dragging down unemployment is cyclical growth in labour demand. Corporate demand for manpower reported to state employment offices is recovering quickly, following a sharp decline between late 2014 – early 2015 (Figure 35). HeadHunter’s data also confirm that demand for job force is growing quickly: between January and March, growth in vacancies totalled 44.0% YoY[15].

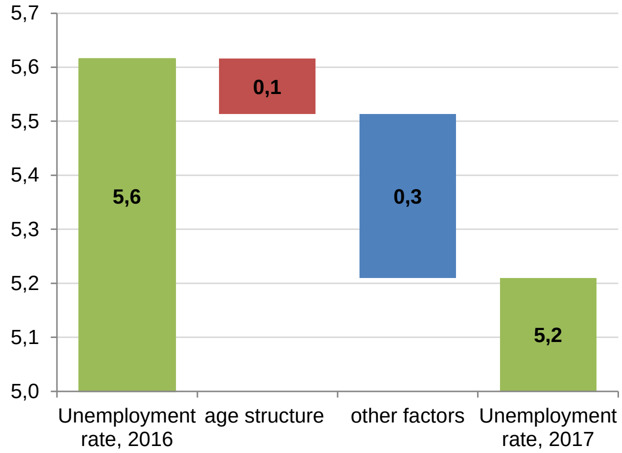
[13] Includes the number of unemployed; economically inactive population that is not seeking employment but is willing to take on a job; and those employed for less than 30 hours a week.
[14] Includes the number of unemployed and economically inactive population that is not seeking employment but is willing to take on a job.
[15] https://stats.hh.ru

Figure 34. Extended unemployment indicators (seasonally adjusted), %



Sources: Rosstat, R&F Department calculations.

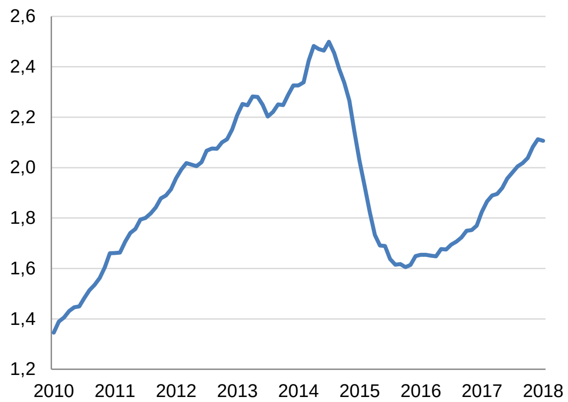
Figure 35. Factors driving lower 2017 unemployment* vs 2016, %



Sources: Rosstat, R&F Department calculations.

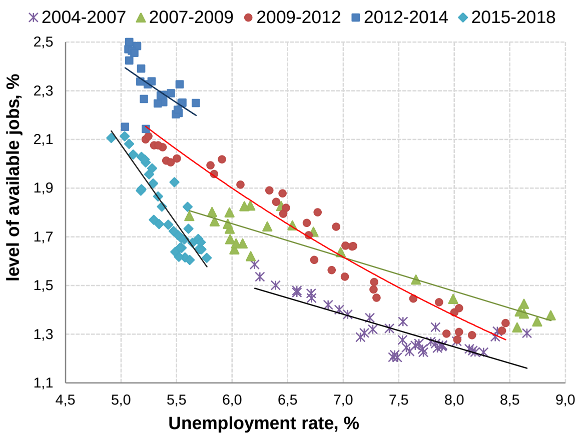
** Unemployment indicators are calculated for those aged 15-59 following changes to the calculation methodology covering older age groups.*

Figure 36. Corporate demand for manpower reported to state employment offices, thousand employees



Sources: Rosstat.

Figure 37. The Beveridge curve



Sources: Rosstat, R&F Department calculations.

The Beveridge curve is a graphical representation of the relationship between demand for labour and unemployment rate[16] (Figure 37). Overall unemployment trends in 2015-2017 are mainly explained by cyclical factors, that is, decreased / increased demand for labour. However, it is interesting to note that those years saw a significant

---

[16] A graphical representation of the relationship between unemployment and the job vacancy rate. The curve was named after the British economist William Beveridge (1879-1963). A division into years is based on statistical tests for structural gaps in a linear regression, and is in our view a fairly good representation of crucial labour market changes. A movement along the curve usually denotes a change in unemployment rate caused by cyclical factors, while a shift in the curve signals the presence of structural factors. The latter factors include, among other things, demographic factors and changes in the levels of frictional and structural unemployment.

shift leftwards in the curve relative to prior years, suggesting the natural rates of unemployment may have declined.

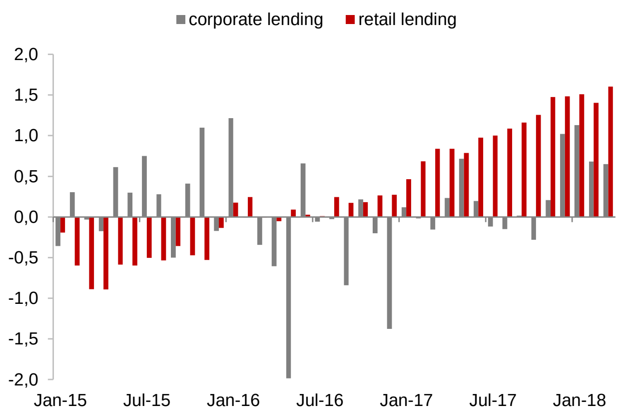
1.2.8. Q1 growth in lending to the economy hit the high of this phase of economic growth

- In the first quarter, growth in lending to the economy hit the highest reading at this stage of economic recovery.
- Mortgage lending showed the highest growth rate, while consumer and corporate lending also demonstrated sustainable growth.
- Overdue loans increased to 6.9% in the corporate loan portfolio and dropped to 6.7% in the retail loan portfolio in the first quarter.

Growth in lending to the economy proved the most significant at the current stage of economic growth in 2018 Q1. According to our estimates, annualised three-month growth in lending[17] to the economy exceeded 12% in the first quarter.

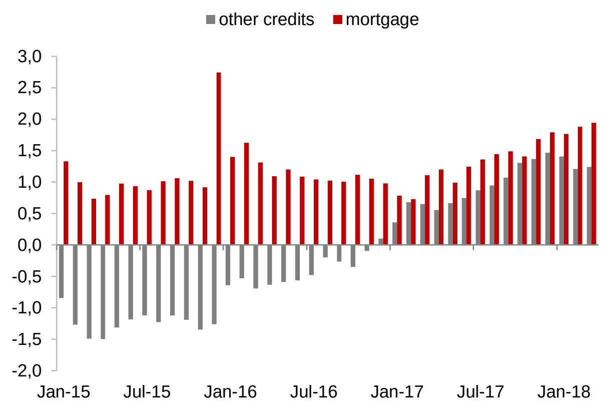
Growth in the *corporate* loan portfolio (adjusted for seasonality and foreign exchange revaluation) slowed in March compared to previous months (Figure 38). This was triggered both by the shrinking corporate FX loan portfolio and slower growth[18] of ruble lending. Nevertheless, growth rates remain considerably high, exceeding the average monthly growth - in 2015-2017. That said, the revival is largely driven by short-term lending (Figure 41).

Figure 38. Lending, % MoM (seasonally and FX revaluation adjusted)



Source: Bank of Russia calculations.

Figure 39. Ruble retail lending and its main components, % MoM (seasonally adjusted)



Source: Bank of Russia calculations.

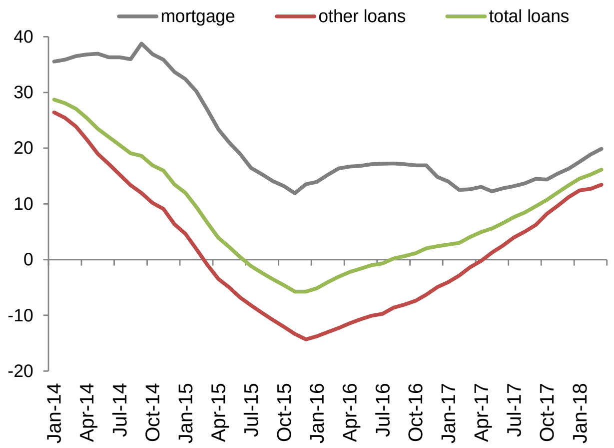
[17] Adjusted for seasonality and foreign exchange revaluation
[18] Seasonally adjusted.

Growth in *retail* lending accelerated to hit the high of this recovery stage (Figure 38). Growth in the retail loan portfolio is backed up by mortgage lending that keeps expanding at a high pace even as the Bank of Russia takes macroprudential measures to limit high-risk mortgage lending (Figure 39 and Figure 40). Growth in retail loans other than mortgages has been slowing for the second consecutive month and approaching wage growth rates.

In March, overdue loans in the corporate loan portfolio remained at 6.9%, higher than those in the retail loan portfolio which dropped from 6.9% to 6.7%. Similar dynamics were registered in the aftermath of the 2009 crisis, when overdue retail loans also shrank faster and fell below overdue corporate loans.

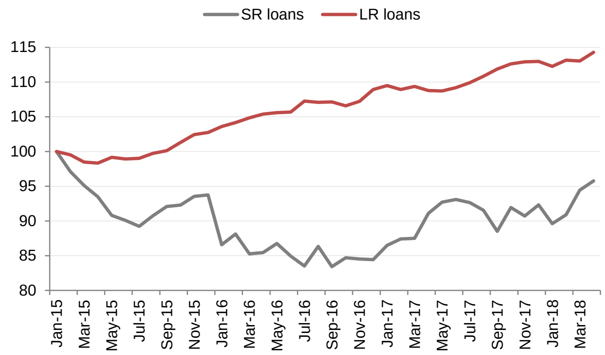
Notably, loan loss provisions increased by 2.2% QoQ in the first quarter. The banking sector profit totalled 352 billion rubles, exceeding last year's readings. This points to an increase in the sources of bank capital growth.

Figure 40. Retail lending, % YoY



Source: Bank of Russia calculations.

Figure 41. Ruble loans to non-financial organisations (January 2015=100), %



Source: Bank of Russia calculations.

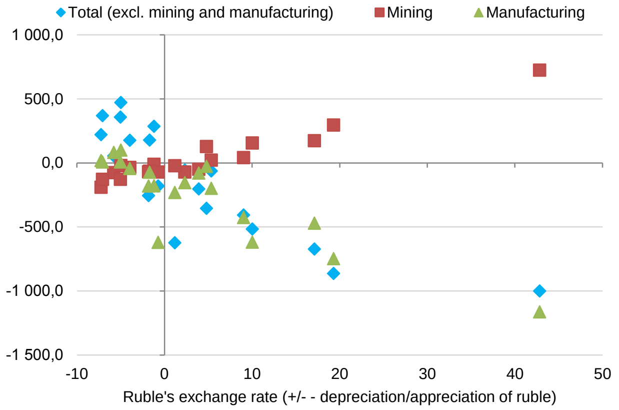
1.2.9. Organisations posted poorer net financial results despite higher sales profits

- The 8.5% YoY decline of net financial result is largely associated with losses from non-sale operations.
- Sales profits increased by 6.7% YoY in 2017, making the decline in operational efficiency less considerable.
- Food producers cut production costs to offset falling proceeds.

- Greater production efficiency helps agricultural producers retain high profitability despite the price downturn. This structural factor may keep food inflation low in the future.

According to Rosstat, companies' 2017 net financial result[19] totalled 10.3 trillion rubles, 8.5% less than a year earlier. Importantly, a lower financial result has so far failed to restrict investment. Fixed capital investment increased by 4.4% YoY in 2017.

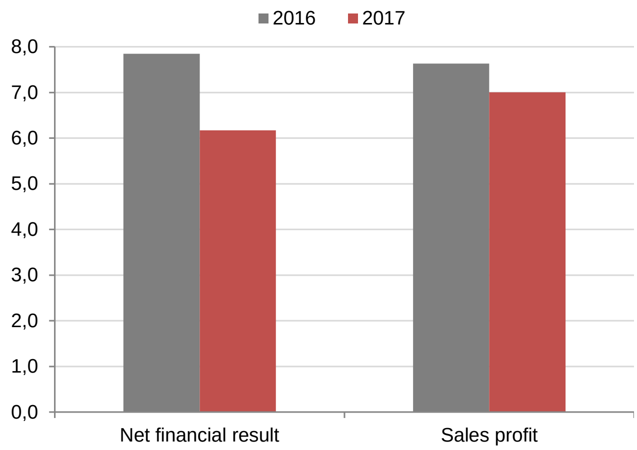
Figure 42. Non-sales operation balance (billion rubles) and RUB/USD exchange rate (% QoQ)



** Breakdown through 2016 was based on the OKVED classifier; the OKVED-2 classifier has been applied since 2017. Quarterly data since 2013 Q1.*

Source: Rosstat, Bank of Russia calculations.

Figure 43. Economic margins*, %



** Note: The margin was calculated as the ratio between net profit or sales profit to proceeds.*

Source: Rosstat, Bank of Russia calculations.

The main reason behind the drop was 'other' net income and expenses. In 2017, organisations registered losses in this item whereas a year earlier it brought additional profit (Figure 44). Losses from non-sales operations were not attributed to the negative FX revaluation following the ruble's appreciation in 2017. Moreover, they were mostly registered in the manufacturing sector that historically suffers losses due to a weaker ruble (Figure 42). Given the lower volatility of the ruble exchange rate, the FX revaluation factor is likely to play a less significant role in shaping net financial result in the future.

Sales profits, factoring out the performance on non-sale operations, grew by 6.7% YoY as of the year end. Mining and quarrying and manufacturing made the most considerable contribution to growth (+2 pp and +1.8 pp). Coal production (a 6.4% YoY increase in 2017) and oil and gas production, that gained from the oil price growth, contributed to improved performance in the mining and quarrying sector. Production of motor vehicles and other vehicles were the leaders among manufacturing industries.

Nevertheless, the 2017 growth in sales profits lagged slightly behind the production cost dynamics, resulting in lower performance in 2017 (Figure 43). However, the decline

[19] Excluding SME, banks, insurance and budget-financed organisations.

in margin was largely associated with losses from non-sales operations, and the drop in operational efficiency was less significant.

Figure 44. Financial result factors, billion rubles

	Jan. - Sept. 2016	Jan. - Dec. 2016	Jan. - Sept. 2017	Jan. - Dec. 2017	YoY growth for 9 months	YoY growth for 12 months
Sales revenue	98744	143797	117375	167253	18,9	16,3
Production costs	80444	117820	98212	140178	22,1	19,0
Gross profit (losses)	18300	25977	19163	27075	4,7	4,2
Administration expenses	10680	15004	11260	15364	5,4	2,4
Sales profit	7619	10973	7903	11711	3,7	6,7
Balance of other incomes and expenses	480	312	-517	-1391		
Net financial result	8099	11285	7386	10321	-8,8	-8,5
Profit of profit-making organisations	9249	12919	8680	12276	-6,1	-5,0
Losses of oss-makers	1149	1634	1295	1956	12,7	19,7

Source: Rosstat, EMISS, Bank of Russia calculations.

Figure 45. Key margin indicators*, OKVED-based breakdown, %

	2016		2017	
	Net financial result	Sales profit	Net financial result	Sales profit
Total	7,8	7,6	6,2	7,0
Agriculture	16,4	17,0	12,5	14,8
Mining	19,1	21,8	19,5	20,5
Manufacturing	9,4	10,6	8,0	10,3
Energy supply	7,2	6,8	6,3	7,7
Water supply	1,8	3,0	2,6	3,5
Construction	2,6	4,5	2,7	6,7
Trade	6,4	4,7	4,8	4,4
Transport and storage	10,2	8,7	9,1	8,9
Hotels and Restaurants	3,7	4,9	4,2	6,5
Information and communication	11,0	11,6	12,8	12,4
Finance	1,1	0,9	0,4	0,4
Real estate	19,8	14,1	10,5	13,4
Scientific activitires	16,0	9,9	7,6	10,9
Administative activities	5,2	9,8	6,5	10,9
Government management	54,6	7,9	40,2	1,6
Education	5,4	5,6	5,6	4,8
Public health	6,6	9,6	7,1	9,4
Sport and culture	13,4	-4,5	0,3	1,2
Others	3,1	5,2	4,1	4,6

** Note: Here, the margin was calculated as the ratio between net profit or sales profit to proceeds.*

Source: Rosstat, EMISS, Bank of Russia calculations.

Financial position of food producers is worth a special mention. Low food inflation reduced their proceeds, which was offset by higher operational efficiency. As a result, their operating margin increased from 7.5% to 7.8% in 2017 (Figure 45).

Return on sales in the agricultural sector dropped considerably (Figure 46); the dynamics inside the sector varied. Profitability in crop production showed a strong decline amid a price downturn. However, the 2016 profitability proved much higher than in previous years, and in 2017 it returned to the average readings.

Nevertheless, agricultural profitability remains considerably higher than the economy's average. This ensures a leeway in the rate and scale of the cost pass-through into prices of agricultural produce, thus, limiting inflation risks. The high margins of agricultural producers amid falling prices for their products (-8.1% YoY in February 2018) point to the important role of higher efficiency, as a structural factor, in keeping food inflation low. This factor is very likely to continue to keep food price growth rates low, while monetary policy tightness (or softness) will have a minor effect on food inflation.

Figure 46. Profitability indicators in agriculture, %

	Net financial result		Sales profit			
	2016	2017	2014	2015	2016	2017
Agriculture	16,4	12,5			17,0	14,8
Annual crops	22,7	12,6			24,3	15,8
Cereal crops	21,6	12,7			24,3	16,0
leguminous crops	20,7	13,0			26,8	20,1
Oil seeds	28,2	22,4			32,1	24,1
Vegetables, tuber crops, roots	25,2	10,7			23,0	13,3
Vegetables	15,9	11,3			12,9	14,7
Potato	14,0	4,9			-1,7	-11,9
Sugar beet	33,8	10,3			31,7	12,8
Plantation crop	25,5	10,7			22,8	14,0
Transpla	7,0	-3,7			15,3	10,4
Animal Breeding	9,3	9,1			9,6	11,2
Cattle breeding	13,3	12,2			8,9	9,6
Pigs	12,0	16,4			16,4	21,0
Poultry	4,1	3,2			7,2	7,1
Hunting	-4,3	-33,9			-17,5	-86,8
Forestry	10,4	-0,4			7,3	5,1
Fishery	35,5	33,1			37,3	33,3

**Note: Here, the margin was calculated as the ratio between net profit or sales profit to proceeds.*

Source: Rosstat, Bank of Russia calculations.

1.3. Global economy, financial and commodity markets

1.3.1. New restrictions put Russian financial markets under pressure

- Increasing geopolitical tensions have put Russian financial markets under pressure. Having said that, markets needed no additional efforts from the Bank of Russia to effectively manage external shocks; this is indicative of their maturity.
- Russian risk premium has added almost 50 bp over the month. Should this change be sustainable, the key rate corresponding to neutral monetary policy is set to go up.
- Higher risks to the global economy caused by growing protectionism affect global financial markets' performance.

- The growth of the USD Libor rate has recently outpaced other market rates. However, these developments are highly likely to prove temporary and do not point to growing credit risks on the international interbank market.

Global markets

Reciprocal duties imposed by the US and China, and higher geopolitical risks associated with the situation in the Middle East determined the performance of global financial markets in the past month. In this environment stock markets hit the lows registered during the February correction and closed the quarter with falling asset prices for the first time since early 2016.

Overall emerging market currencies weakened over the past month, however, countries showed mixed dynamics. The worst performance was registered among the currencies of the countries that suffered from growing domestic political uncertainty or an external shock.

Volatility in global markets remained elevated compared with the 2017 readings, supporting demand for haven assets. Growing uncertainty worldwide is unlikely to allow volatility indicators to return to record lows in the near future.

Yield margins on US and EU government bonds widened to hit fresh highs. In the US, an upward pressure on yields is exerted by the normalisation prospects of the Fed's policy under the new Chair and the forecast growth in bond issue following the tax reform that increases budget deficit. The ECB continues quantitative easing, scales back its asset purchase programme only gradually and is unlikely to rush into rate hikes.

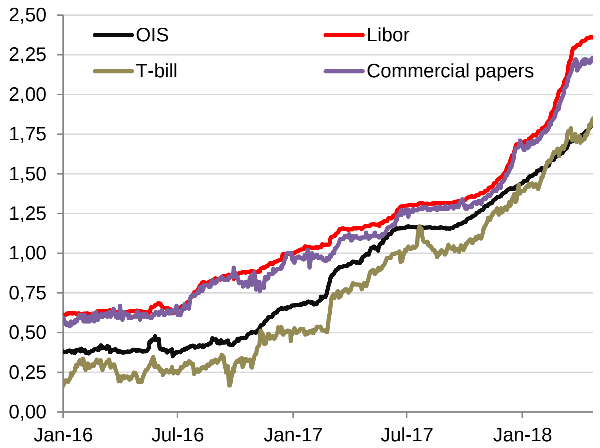
Libor rate growth

The 3-month Libor exceeded 2.25%, (Figure 47) recently outpacing basic rates in its rise. The Libor-OIS spread[20] approached 60 bp, the highest reading since 2009 (Figure 48). The spread expansion may be attributed to two components:

- The expanding yield spread between US Treasury bonds and OIS, triggered by the growing issue of government bonds (Figure 48, T-bill – OIS).
- The increasing credit spread between commercial papers (CP) and the US Treasury bond yield (Figure 48, Commercial papers – T-bill). This was caused, among other things, by the repatriation of corporate profits to the US under the tax reform. Funds on accounts outside the US were invested, among other things, in the CP market, whereas parent companies had to apply for additional bank loans or place debt securities to fund their operations or corporate actions such as buyback or mergers and acquisitions. Now that account balances outside the US are declining, the demand for CP is falling. Meanwhile, firms may use the repatriated funds to redeem previous debts and avoid returning to the CP market, temporarily maintaining the credit spread elevated.

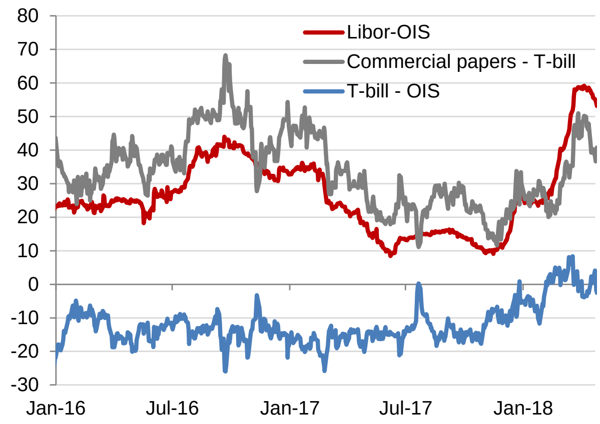
[20]An Overnight Indexed Swap is a rate on the fixed leg of the interest rate swap whose floating leg is the effective federal funds rate.

Figure 47. 3-month US dollar rates, %



Source: Bloomberg Finance L.P.

Figure 48. 3-month US dollar rate spreads, bp



Source: Bloomberg Finance L.P.

The second component is the key driver of Libor-OIS spread expansion not associated with fundamental deterioration of commercial paper issuers' credit quality or credit risk growth in the interbank market. The credit spread expansion is highly likely to be temporary as was the case in 2016, when the reform of US money market funds resulted in falling demand for commercial papers and credit spread expansion to 65 bp. However, other market actors were quick to use the arbitration and the spread bounced back to 20-30 bp by mid-2017 (Figure 48).

Russian markets

Geopolitical tensions and new sanctions put pressure on Russian financial markets. As a result, the ruble became an outsider emerging market currency, Russian risk premium and bond yields went up, while equity prices dropped over the past month.

This brought the yield curves of OFZ and other interest-bearing instruments back to the readings registered in late 2017 and set off the effect of monetary easing of the first three months of this year. Russian CDS risk premium has added almost 50 bp over the month. Should this change prove permanent, the potential for the further Bank of Russia key rate cut to the neutral level will diminish.

The abrupt ruble depreciation pushed up both its realised and implied volatility indicators. Notwithstanding this surge, the ruble remains considerably less volatile than in early 2015 due to both the current macroeconomic policy and the stable oil market.

The deviation of the RUONIA rate from the Bank of Russia key rate hardly changed in the past month, holding at 25 bp an average. The Bank of Russia takes this into account in its monetary policy and key rate decisions.

2. Outlook: leading indicators

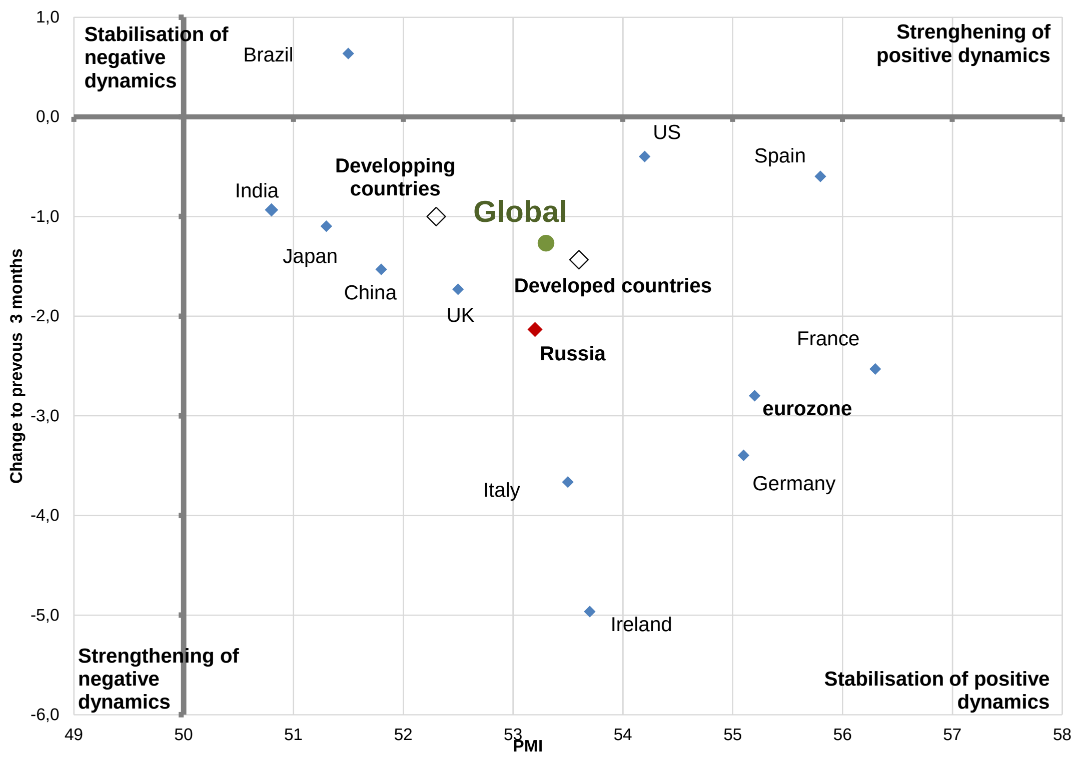
2.1. Global leading indicators

2.1.1. Global PMI fell to a 16-month low

The March PMI suggests that business activity is slowing in most advanced and emerging market economies (Figure 49). In this environment the global PMI dropped to a 16-month low in March. This reflects the slowdown to an 8-month low in manufacturing industries and to a 1.5-year low in services.

Though global economic growth rates remain high, global financial markets may face serious negative consequences because of a further slowdown in economic growth due to, among other things, the external trade restrictions and the threats of their imposition.

Figure 49. Composite PMI for March and change to the December to February average



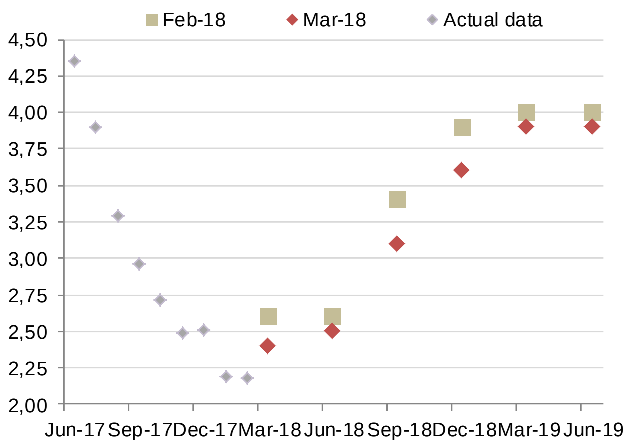
Sources: IHS Markit, Bloomberg Finance L.P.

2.2. What do Russian leading indicators suggest?

2.2.1. Analysts revised again the expected end-2018 inflation downwards

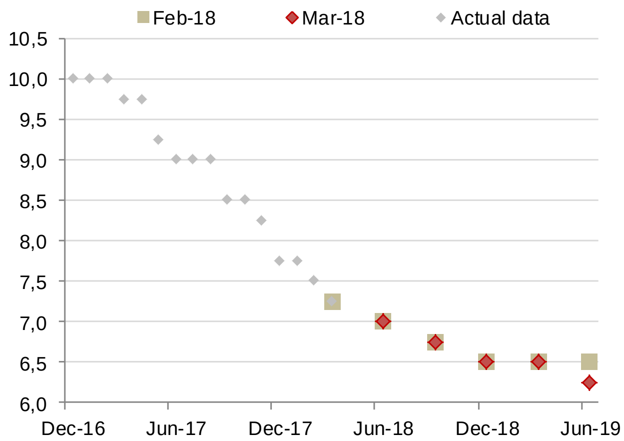
- According to a Bloomberg survey held late in March, analysts' inflation expectations declined compared to February over the entire forecast horizon.
- The 2018 path was revised considerably downwards (from 3.9% to 3.6% as of the year end) after the actual dynamics of the first three month were factored in (Figure 50).
- Analysts' expectations for the key rate were adjusted slightly down only outside 2018 (Figure 51). The key rate is still expected to be reduced to 6.5% by the end of this year with further insignificant cuts to follow in 2019.

Figure 50. Analysts' expectations for inflation, % YoY



Sources: Bloomberg Finance L.P.

Figure 51. Analysts' expectations for the BoR key rate, % p.a.



Sources: Bloomberg Finance L.P.

2.2.2. GDP growth projections: fluctuations in short-term statistics do not impede sustainable growth

- The 2018 Q1 GDP nowcast was slightly revised downwards to +0.4% (QoQ, seasonally adjusted) in March from +0.5% QoQ seen in February[21].
- Model estimates suggest that Q2-Q3 GDP growth also stood at roughly 0.4% (QoQ, seasonally adjusted).
- Thereby, despite the traditional fluctuations of monthly data, short-term statistics suggest that the economy is growing at the estimated potential (1.5% a year).

[21] These projections may be adjusted as new statistics are released.

- Our 2018 GDP model estimates do not factor in possible fallouts from budgetary, geopolitical and other factors (e.g., the OPEC+ deal) on GDP growth. This may serve as a ground for their further downward revision as new statistics are released during the year.

	March	February
	% QoQ SA	% QoQ SA
2018 Q1	**0.4**	0.5
2018 Q2	**0.4**	0.4 - 0.5
2018 Q3	**0.4**	0.4

3. In focus. Retail expansion: key trends and outlook

- Consumers' recently acquired habit of doing shopping when goods are on promotions alongside their preference for private labels are expected to constrain growth in consumer prices.
- Another factor curbing consumer price growth is dynamically expanding e-commerce, especially cross-border web stores.
- Consumer price growth is also constrained by a stronger market consolidation and tougher competition between major retail chains.
- Having said that, market consolidation may enhance the market power of individual actors triggering a faster increase in consumer prices.
- High regulatory pressure on trade may also cause proinflationary effects. It increases commercial organisations' costs which are likely to be translated in retail prices as demand recovers.
- Amid restricted purchasing power, low inflation and growing competition, retailers try to enhance efficiency and cut costs through own production, direct imports, shared storage facilities, wholesale trade and e-commerce.

This March, the Bank of Russia held a round table meeting with representatives of retail chains and retailers associations. The meeting discussed retail sale dynamics, the effect of inflation slowdown on trade financial indicators, changes in consumer behaviour, the impact of e-commerce, tougher competition between chains and cost cuts in retail. The discussion allows revealing the following trends in retail trade and forecasting its 2018 development.

Consumer demand remains highly sensitive to price fluctuations despite rising consumer activity

2015-2016 registered a decline in physical retail trade turnover. In late 2017, consumer demand started to recover in both food and non-food segments. Analysts expect this recovery to have the pace of 2-3% a year and to last for roughly two to three years. Having said that, the market's further development will differ from that before the crisis. This results from changes in consumer behaviour and tougher competition, which call for cost-cutting in retail and higher efficiency.

In 2017, drivers of consumer demand recovery may include the downturn in prices of certain socially important foods, the increase in the number of goods retail chains offer on promotions, and growing consumer lending.

An INFOLine research shows that discount sales of alcohol, coffee, home care products and perfumes exceed 50%. Overall, promotional sales account for more than 20% of sales in retail chains. Thrifty consumer behaviour is expected to hold throughout

2018. More than 30% of consumers choose goods on promotions, cheaper brands and less expensive products.[22]

Importantly, goods sold on less-than-one-week promotions are factored out of consumer price index calculation. Therefore, the statistics are highly likely to underestimate real retail sales, but overestimate the level and movements in prices of such goods.

Consumer price growth will be inhibited by consumers' ongoing appetite for promotions and private label goods, which ensure good value for money.

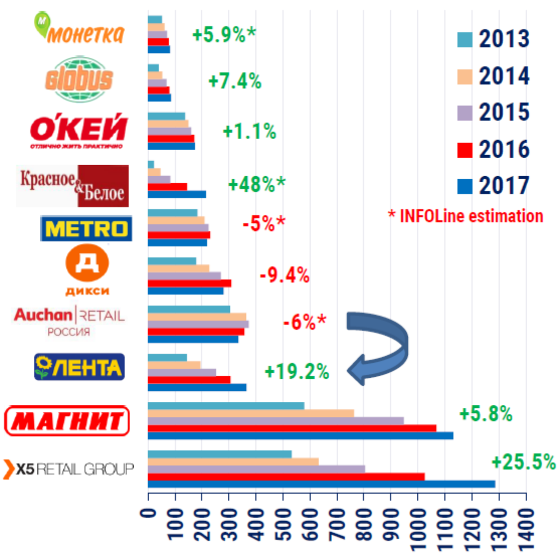
Market consolidation accelerates

In 2008, the retail market shifted from growth to saturation and the development of up-to-date forms of retail trade. Starting from 2014, the market started consolidating under financial dominance of certain companies. The consolidation is set to continue in the sector in 2018 and to see tougher competition between major retail chains, retail chain mergers and the ousting of less efficient regional retailers.

Whereas in 2015, top-700 food retailers accounted for a half of the retail food market, in 2017 their share increased to 57%. Top-10 retailers by proceeds accounted for 30% of the market.[23]

Meanwhile, chains' growth rate differentiation is increasing, with market leaders strengthening their positions (Figure 52). As of the end of last year, X5 Retail Group became the country's largest food retailer for the first time since 2013. Smaller chains post slower growth, while some of them demonstrated negative dynamics as of the year-end.

Figure 52. Top-10 FMCG chains by proceed, billion rubles excl. VAT

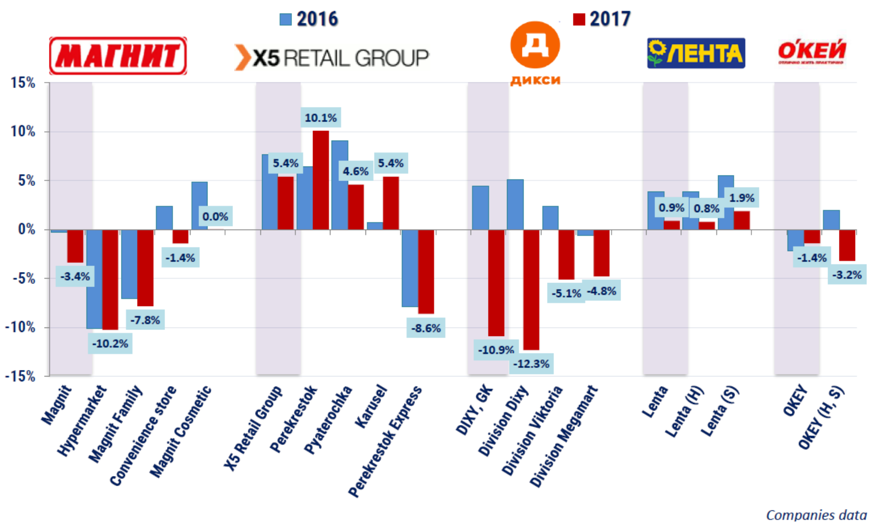


Source: INFOLine.

[22] Data by INFOLine agency.
[23] Data by INFOLine agency.

Having said that, retail chains expanded due to new store openings. Food retailers added 2-2.5 million sq.m. to their sales premises annually over the past four years. At the same time, chains' like-for-like sales (LFL[24]) showed poor performance compared to 2016 readings (new stores factored out) (Figure 53).

Figure 53. LFL revenue growth in retail chains



Source: INFOLine.

Retail chains curb retail price growth, but market consolidation may accelerate it in the future

Consumers' thrift, low inflation and tougher competition constrain the potential consumer price growth in the near future.

That said, retail chains' policies aimed at curbing prices and increasing promotional sales affect retail chains' margins.

As demand recovers, accelerated market consolidation, that will enhance certain actors' pricing power, may result in faster growth of consumer prices, especially in non-food retail.

Higher business performance is on the agenda

In the future, we may see a new stage in retail development where further market consolidation will be driven by companies' technological superiority and intensive trade growth factors come to the fore. Advantage will be gained by major retailers who control the whole supply chain (production, direct imports, private labels), efficiently store goods, develop other sales channels (wholesale, e-commerce), use IT capabilities, and can cooperate with state authorities directly as state regulation is tightening.

Private labels allow retailers to be more flexible about their margins and pricing. Thrifty consumption, as the main focus of demand, has been on the rise in recent years.

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[24] LFL is the analysis of comparable sales (factoring out the units unavailable in one of the periods).

Retail chains are set to launch or purchase food production and agricultural companies as private labels account for a larger share of purchases.

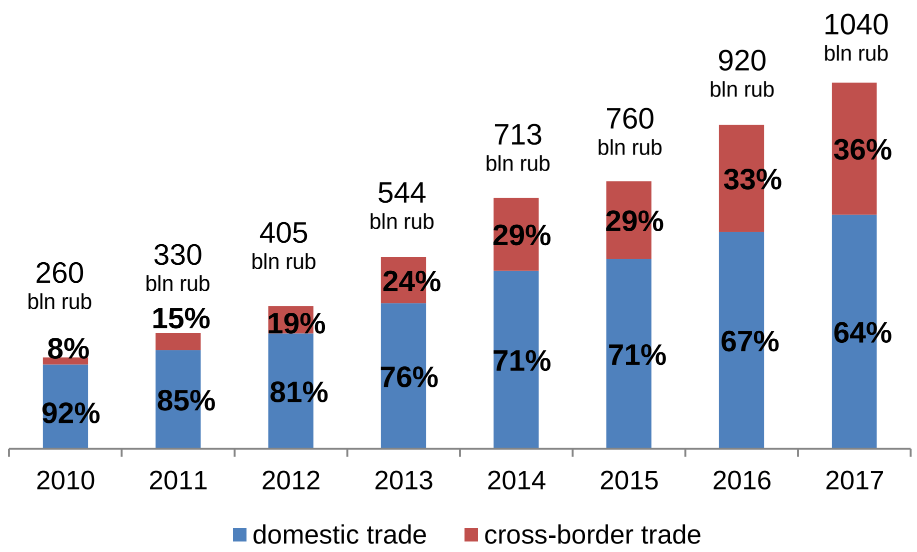
The trend towards wholesale development has come to the fore. Magnit has launched wholesale stores Magnit-Opt, Metro is developing its franchise network Fasol, and Lenta is launching B2B programmes.

E-commerce is on the rise

The AITC data suggest that the Russian e-commerce market expanded by 13% in 2017; this figure is lower compared to the 2016 reading (21%). However, analysts estimate that this year the e-commerce market will grow by another 20% to 1,250 billion rubles. Despite the high growth rates, e-commerce only accounts for roughly 3% of the total retail trade turnover and affects it insignificantly.

Cross-border trade makes a large contribution to e-commerce (+24% in 2017), while online sales in the domestic market demonstrate slower growth (+8% in the same period) (Figure 54).

Figure 54. Russian e-commerce market



Source: AITC.

Thereby, foreign online retailers and shopping sites are expanding. Cross-border trade accounted for 36% of all purchases made online in 2017. Regulatory deficiencies burden foreign companies with lower costs associated with import VAT and customs duties, certification and consumer protection than Russian market players. As a result, such businesses earn much higher profits. This forces Russian online retailers to move their trade infrastructure outside Russia. They build logistic hubs in the border area and ship from these hubs without customs clearance.

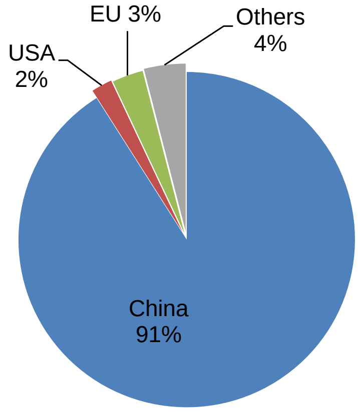
This calls for the need to make the terms of trade equal for Russian and foreign e-retailers. Importantly, such regulatory alignment is highly likely to bring up prices in online and offline stores.

Household appliances and consumer electronics, as well as clothes and footwear are the categories that accounted for the major share of online purchases in 2017 (35% and 27% on the local market, 33% and 38% on the cross-border market respectively).

The rise in online food sales is an evident 2018 trend. A greater number of food retailers go online. Non-food e-retailers are also intending to sell food. Moreover, online sales of medicines and alcohol may become a promising sector of e-commerce (if regulatory restrictions are lifted). The respective regulations are being developed.

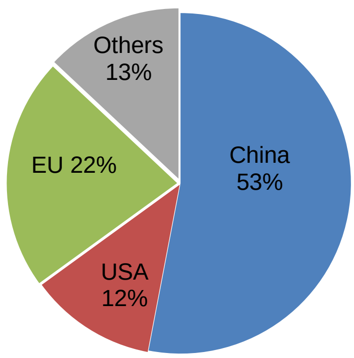
Most orders made in online stores are shipped from China (91%) (Figure 55). Countrywise, China accounts for 53%, the EU for 22% and the US for 12% of Russian spending (Figure 56). The cost of purchases is usually below 22 euros (61.4% of all foreign transactions) or ranges between 22 and 50 euros (22.2% of transactions).

Figure 55. Shipments by country of origin



Source: AITC:

Figure 56. Russian spending in foreign online stores by country



Source: AITC:

Despite e-commerce accounting for a small share of retail sales, its development has already created a competitive environment for traditional forms of trade, holding consumer price growth in check (primarily non-food prices). Russian consumers' growing demand is easily absorbed by foreign and Russian online stores. This does not trigger any increase in their prices because the volume of the Russian market is small relative to the supply of goods. Offline trade has to catch up with e-commerce. Therefore, we can expect this effect to further constrain growth in consumer prices in Russia.

Rosstat's retail trade statistics factor out sales of goods shipped to Russia by foreign online stores. This results in somewhat understated statistics on retail trade turnover.

A high regulatory burden puts pressure on retail chains' profit margins

Market participants note that the declining profits result from a high regulatory burden in the trade sector (the introduction of online cash desks, the USAIS and Mercury systems, technical regulation developments, etc.)

An important issue is the high cost of merchant acquiring that takes up to 3% of the price and often eats up the retailer's profit from the transaction. Card payments in the consumer market have been adding 5% annually over the past three years and account for almost 30-40% of total payments depending of the retail chain’s specialisation. The respective increase in the cost of merchant acquiring services reduces profit margins of trade companies.

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