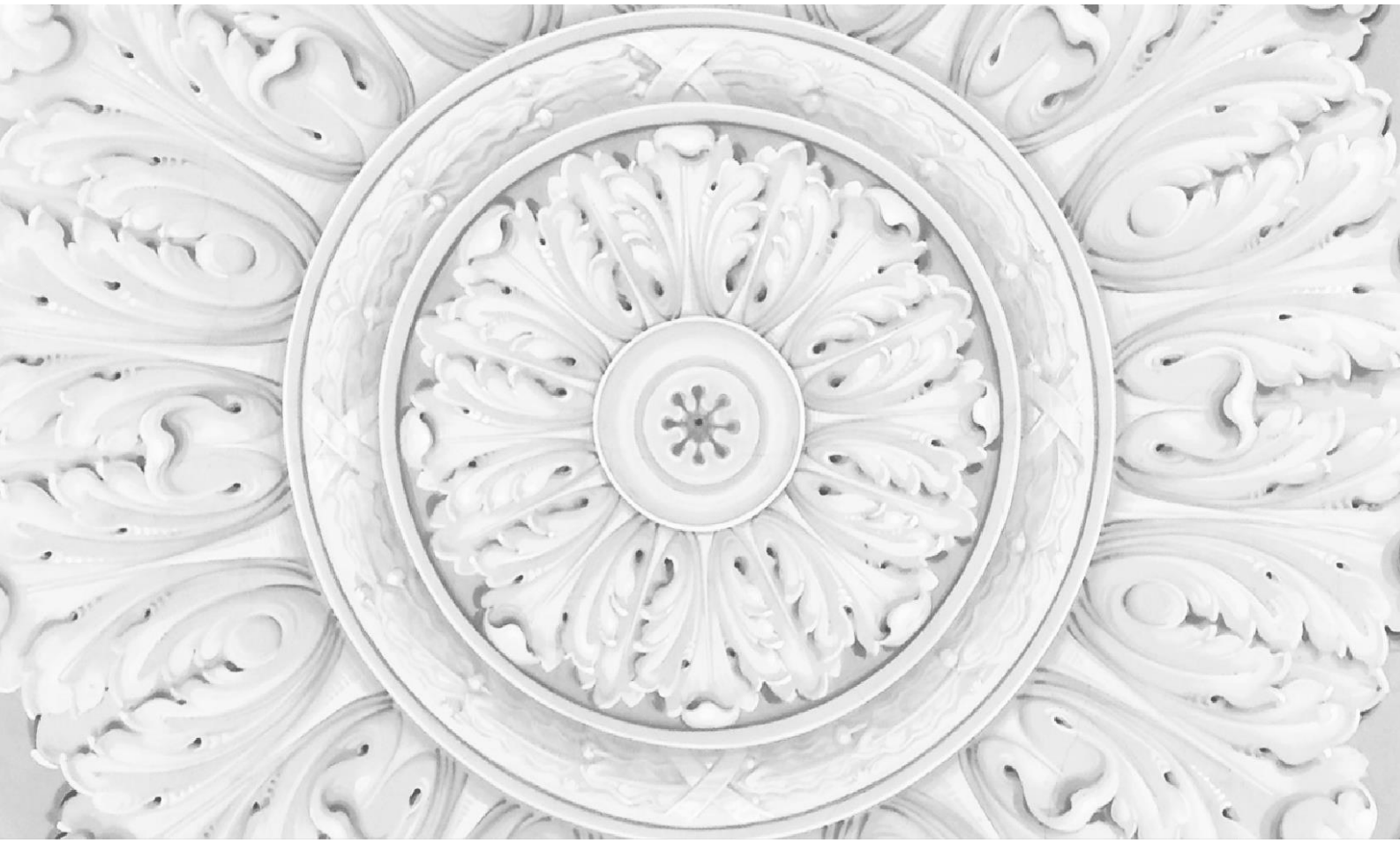
Bank of Russia

The Central Bank of the Russian Federation



TALKING TRENDS

Macroeconomics and markets

July 2018

Research and Forecasting Department Bulletin No. 5 (25)

The bulletin is based on data as of 6 July 2018
(the Global Economy section is based on data as of 29 June 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.
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CONTENTS

Executive summary

1. Monthly summary

- Annual inflation in June remained low. However, three months' rolling seasonally adjusted inflation accelerated, largely on the back of temporary factors. The economy continued to grow at a level close to potential; at the same time, some signs emerged of slower growth rates. The overall Russian financial market proved fairly resilient to the ongoing deterioration in emerging markets.
    - Inflation in June declined to 2.3%, thanks to short-term effects. Inflation is on track to return to previous months' readings. Modified core inflation indicators remain lower relative to the Bank of Russia target, with the gap having recently become smaller, however. The medium-term risks of inflation deviating upwards from 4% remain dominant. In particular, it seems highly probable that the envisaged VAT base rate increase to 20% will trigger a temporary acceleration in inflation to a level above 4% in the course of 2019. These medium-term risks are connected with geopolitical factors, volatility surges in global financial markets, monetary policy normalisation in advanced economies, the transition to a consumption model to the detriment of savings, accelerated consumer lending, elevated and unsteady inflation expectations, the condition of the labour market and the uncertainty over fiscal policy dimensions. 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 in the last few months held at a level close to its potential. Having said that, survey data suggest there are individual signs of a slowdown emerging; its causes and sustainability have yet to be determined. At the same time, consumer demand is still on the rise, gaining support from the ongoing expansion of consumer lending and sustainably high growth rates of real wages, with skills shortages widening.
    - Russian financial markets continue to show low volatility against other emerging market economies, defying the continued overall deteriorations in conditions and rising yields of ruble financial instruments. This is driven by macroeconomic stability resulting from low inflation, the fiscal rule, a current account surplus alongside high oil prices.

2. Outlook

- Global economic growth faces significant threats, for all its robust growth in late Q2. The group of developing markets comes under the spotlight because of their growth slowdown. It may well be the case that negative developments in these countries' financial markets are increasingly feeding into overall economic trends.
- The leading indicator for Russia's GDP suggests the Russian economy is posting growth close to its potential rate. Taking this into account, 2018 GDP growth is set to be close to the upper bound of the interval in the BoR official forecast (1.5–2.0%).

These estimates do not reflect the recent poll data suggesting the emergence of a slowdown of which causes and sustainability have yet to be determined. The leading indicator could be revised downwards moving forward.

3. In focus. What constrains productivity growth?

- Total factor productivity (TFP) has since 2008 been growing thanks to a small group of leaders – predominantly major companies. At the same time, the least productive companies are seeing contraction in terms of the scale of operations but – despite the logic of ‘creative destruction’ are neither exiting the market nor undertaking a restructuring procedure.
- This results in lower TFP rates across the overall economy, freezing production factors in inefficient enterprises.
- The task of boosting total factor productivity growth rates spells the need to create conditions for inefficient businesses to exit the market or undertake restructuring, to promote high performance medium and small enterprises, their transition into the major companies category, as well as to reduce barriers to new businesses entering the market.

1. Monthly summary

1.1. Inflation

Inflation in June temporarily moved down to 2.3% YoY. However, it is expected to come back to previous months' levels as early as July. Modified core inflation indicators remain lower relative to the Bank of Russia target, with the gap having recently become far smaller, however, in a sign of stronger inflationary pressure. Short-term proinflationary risks went up on the expected VAT rise starting from 2019 – this is likely to push inflation closer to 4% in the course of this year.

Household inflation expectations continued to negatively respond to the prior periods' weakening of the ruble, rising motor fuel prices and the announced VAT rise.

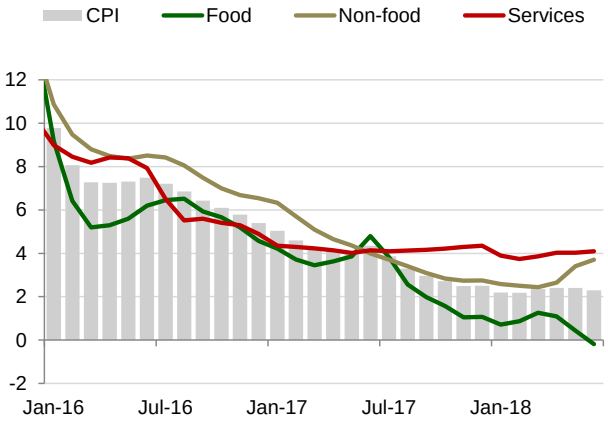
Mid-term proinflationary risks are slightly up; they are still dominant over disinflation risks. Core risks include geopolitical factors, volatility surges in financial markets, the transition to a consumption model to the detriment of the savings ratio, accelerated consumer lending, elevated and unsteady inflation expectations, labour market conditions and the uncertainty over fiscal policy parameters.

1.1.1. Inflation temporarily slows down in June

- Annual inflation moved down to reach 2.29% in June on 2.41% in May, because of the high base effect. It is expected to return in July to the April-May readings.
- Seasonally adjusted consumer price growth accelerated to 0.49% MoM on 0.37% MoM seen in May. Three months' rolling seasonally adjusted price growth went up 5.0% in annual terms – driven however in the main by temporary factors.
- Modified core inflation indicators remain somewhat lower relative to the Bank of Russia target, with the Q2 gap however at its lowest since early 2017.
- Household inflation expectations continued on an upward path in June, responding to rising petroleum prices and the announced VAT rise.
- Household inflation expectations growing in the long term might necessitate a delayed transition to neutral monetary policy.

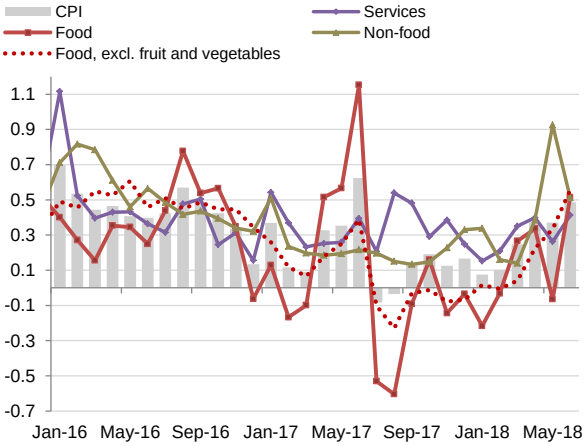
June saw annual inflation slow down to 2.29% (on 2.4% YoY in May) (Figure 1). The gap with the 4% target was up for the first time in three months. Having said that, inflation is on track to return to the 2.4% level, helped by the mixed nature of base effects in the period.

Figure 1. Inflation and its components, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 2. Seasonally adjusted price growth, % MoM



Sources: Rosstat, Bank of Russia calculations.

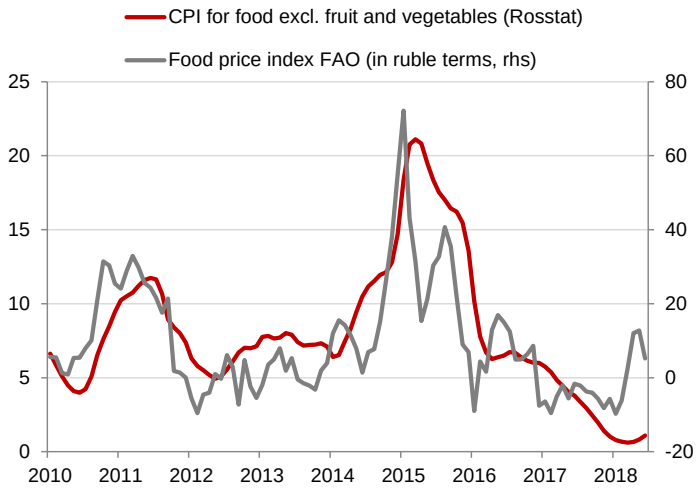
The June slowdown in inflation owes its origin mainly to trends in fruit and vegetable prices. Fruit and vegetable prices were declining faster at 9.81% YoY after 2.84% YoY in May, resulting from last year's high base effect. The then unfavourable weather conditions sent price growth rates higher than regular seasonal trends; growth peaked in June.

Annual food price growth, stripping out fruit and vegetables, accelerated again (1.13% YoY in June, 0.82% YoY in May). As the temporary factors (surplus offer in several markets) had run their course, this growth may be accelerated[1] by rising global prices that are in strong correlation with domestic prices (Figure 3).

The annual growth rate of non-food prices in June quickened to 3.71% YoY (on 3.40% YoY in May). Their performance tracked the rise in retail prices for oil products, which continued until the first week of June. It was triggered by growing oil prices as the ruble weakened, resulting in a sharply increased export parity price for oil and oil products. Another important factor contributing to the rise in fuel prices was the 1 January excise duty increase. All this led to a decline in domestic stocks, putting domestic wholesale and retail prices under strong pressure The subsequent government moves to stabilise domestic fuel prices helped drive their weekly growth rates lower to almost zero.

[1] For the period since January the FAO Food Price Index has grown 3.1%, and the ruble index went up 15.0%.

Figure 3. Global and domestic prices, % YoY



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

Inflation accelerated slightly in services to reach 4.09% YoY after it had settled at 4.03% YoY in the course of the two prior months.

We estimate seasonally adjusted consumer price growth to quicken in June to 0.49% MoM (on 0.37% MoM in May). Annualised seasonally adjusted consumer price growth picked up the pace to 6%, with three months' rolling growth having quickened to 5.0%. This acceleration is however grounded in the effect of temporary factors (rising oil and oil product prices and a weaker ruble). The indicators are poised to come back to 4% in the second six months of the year.

The acceleration in food price growth was to a great degree the result of movements in prices for chicken, with growth registered in wholesale chicken broiler prices[2]. Experts highlight the impact of the exchange rate fluctuations as a trigger: costs of poultry production are to a great degree dependent on the prices of imported components in forage. The RF Agriculture Ministry data suggest[3] poultry output has grown by almost 4% since the start of the year on the same period last year. Given this output growth, the strong acceleration in chicken price growth is likely to be short-lived. The still existing risks of further growth in poultry prices are associated with bird flu outbreaks in several Russian regions. Experts however view this as a standard situation for this time of year.

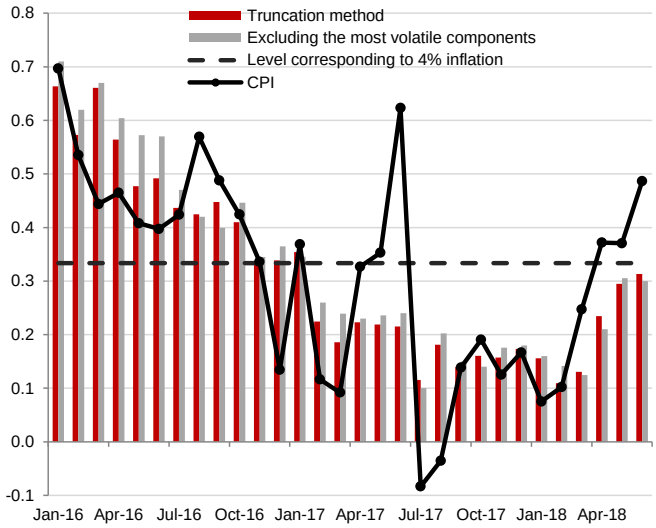
June saw acceleration in consumer price growth paces in the services sector. This was driven by the planned upgrade of passenger railway fares, among other things. Consumer prices also quickened in the hotel industry, most likely, as a result of the FIFA World Cup; the blip should be short-lived.

A certain strengthening in Q2 inflationary pressures, unrelated to temporary factors, is signalled by a stabilisation in modified indicators of core inflation (Figure 4). In the May

[2] Агроинвестор «Мясо бройлера начало дорожать» (Agroinvestor. 'Broiler chicken prices are rising'). 10.06.2018.
[3] Agriculture Ministry press release. 21.06.2018.

to June period, they reached their highest reading since early 2017 of 0.3% MoM (3.6–3.8% in annual terms). Although temporary factors including the ruble exchange rate weigh in on their performance, the scale of this impact is far weaker compared to the impact on headline inflation.

Figure 4. Modified indicators of core inflation, % MoM



Sources: Rosstat, R&F Department calculations.

According to Rosstat's immediate estimate, consumer prices went up 0.3% between 1 and 9 July. Utility rates are traditionally indexed in July. Based on past years' developments, a majority of regions will see the rate reviews implemented through the end of July, with a small proportion of this revision to be postponed until August.

We can therefore expect the residual growth of utility rates to continue in the weeks ahead. This will likely see annual rate growth changing immaterially vs June, given that the indexation of core rates is still linked to 4%.

Household inflation expectations in June rose again, coming back to the late 2017 levels – in defiance of the observed low price growth in consumer goods and services. The median estimate for inflation expected in 12 months was up straight to 9.8% (vs 8.6% in May), with the estimate for observed inflation also upgraded to 10.6% from 9.2% (Figure 5).

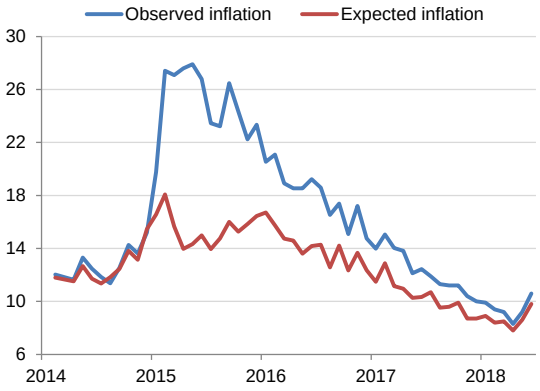
The proportion of respondents thinking inflation will be substantially above 4% rose to 46% from the low levels seen between March and May (Figure 6). As follows from respondents' answers, growth in petroleum prices came as the key driver for inflation expectations. Although no meaningful changes were registered in motor fuel prices in June (+0.8% since the start of the month) after their fast growth between April and May, many respondents expect price to rise as producers will pass their rising costs on to product prices. The announced VAT rise from 18% to 20% may well be a further driver for inflation expectations. This, rather than the more expensive petrol, is probably the key reason behind rising household inflation expectations over a three-year horizon. However, this factor has yet to take its toll on the outcomes of the poll that took place

between 8 and 18 June, whereas the government plan to raise VAT was not made public until 14 June.

The impact of petrol prices on inflation expectations is a sign of them remaining unanchored and highly sensitive to price movements across individual goods and services.

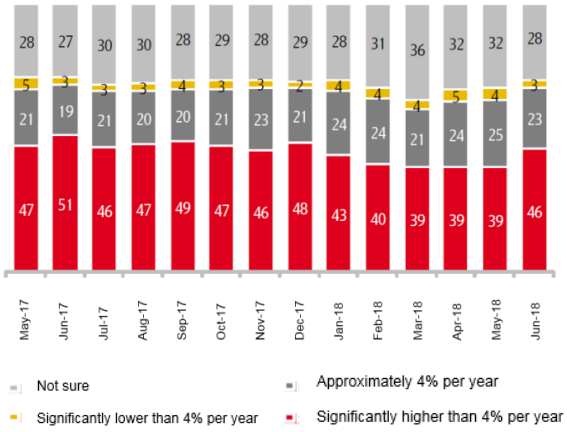
From a monetary policy perspective, the big focus is growth in long-term inflation expectations. Household inflation expectations growing in the long term might necessitate a delayed transition to neutral monetary policy.

Figure 5. Median estimates for observed and expected inflation



Source: InFOM.

Figure 6. Inflation rate expected in three years

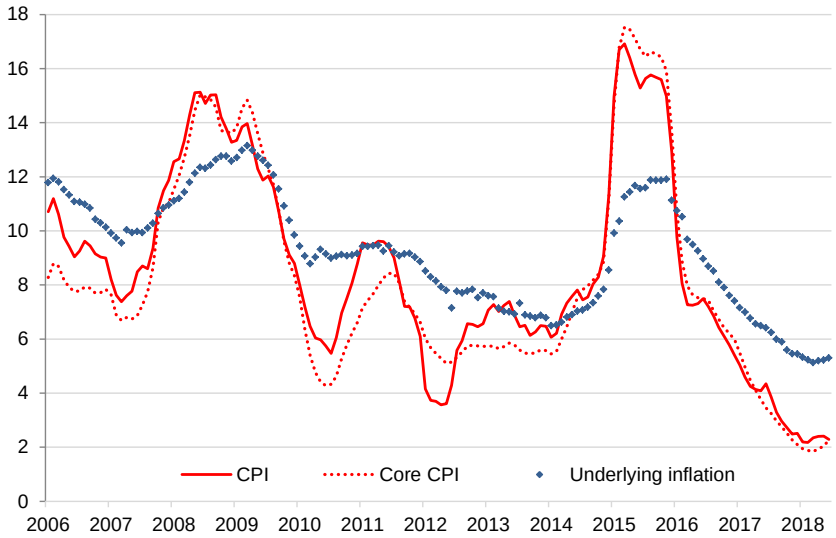


Source: InFOM.

1.1.2. Underlying inflation in May is still above 5%

- Annual rates of underlying inflation in May 2018 are estimated at 5.2% and level with April.
- For all the inertia of underlying inflation in terms of construction, its less pronounced slowdown reflects gradually mounting inflationary pressures among the relatively steadier CPI components.
- 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 7. CPI, CCPI and historical estimates for underlying inflation, % YoY

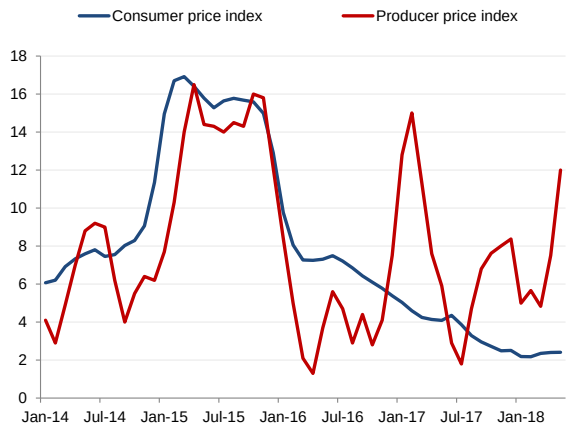


Sources: Rosstat, R&F Department calculations.

1.1.3. Oil prices expectedly accelerated producer price growth in May

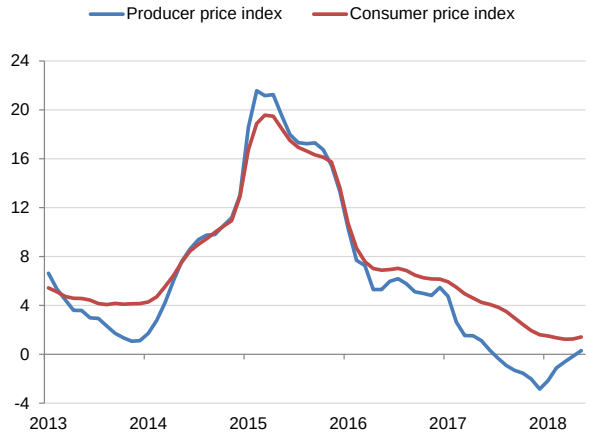
- According to Rosstat, annual price growth in May expectedly picked up the pace against the backdrop of higher oil prices and totalled 12.0% YoY (7.5% YoY in April) (Figure 8).
- Crude prices gained 11.7% MoM. In the manufacturing sector, there was a rise in prices for individual oil products. Specifically, petroleum prices gained 18.7% MoM. Growth in energy-related sectors was mainly caused by global oil price movements. In this way, Urals rose almost 9% in May.
- Producer prices for oil products are set to decline in June thanks to the government measures to stabilise the domestic energy market. Of these, the key move is the reduction of excise duties on petrol and diesel fuel starting from 1 June.
- Producer prices for many consumer products are still growing at the rates lower than those of consumer prices; the gap between the two continues to close, however (Figure 9). This factor constrains the potential slowdown in prices for consumer products.

Figure 8. Producer price and consumer price index, % YoY



Sources: Rosstat, R&F Department calculations.

Figure 9. Price movements across individual products[4] in April, % YoY



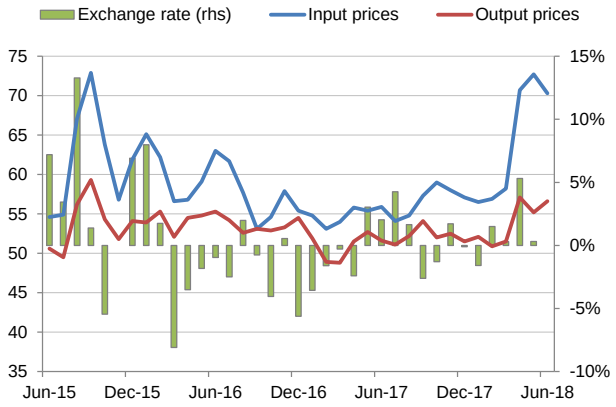
Sources: Rosstat, R&F Department calculations.

1.1.4. PMI price indexes: a weaker ruble and growing oil prices triggered a temporary acceleration in price growth

- The PMI input price indexes in the manufacturing sector and services have held at higher levels for the third consecutive month, owing to the weakening of the ruble and rising oil prices.
- Faster growing costs force companies in the manufacturing sector to raise their output prices quicker than companies in the services sector – despite the slower rising demand for their products compared to the services sector.
- A poll in the April through May period showed respondents in the services sector citing growing wages as a factor driving up costs. There was no mention of this factor in June however, in a sign that employment may have stopped growing.

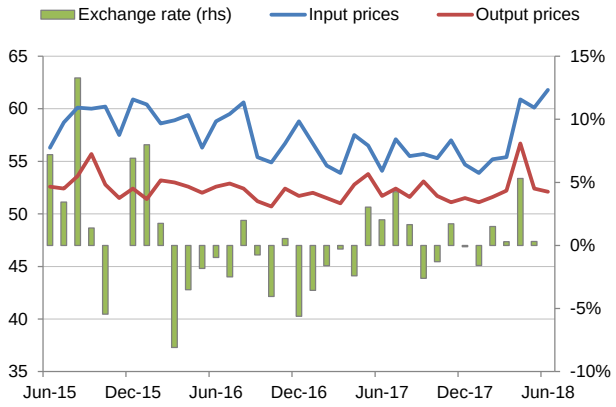
[4] The calculations are based on peer CPI and PPI products (meat products, fish products, oil and fats, dairy products, pasta, sugar, tea, coffee, clothing, knitted products, footwear, detergent and cleaning products, perfumes and cosmetics, consumer electronics and furniture). They account for 32% of the consumer basket.

Figure 10. Manufacturing PMI price indexes, points



Source: IHS Markit.

Figure 11. Services PMI price indexes, points



Source: IHS Markit.

1.2. Economic performance

The Russian economy continues to grow at a level close to potential. As before, this is driven by, among other things, consumer demand, against the backdrop of an ongoing decline in unemployment and rising real wages. Some signs of economic slowdown following from polls are not yet conclusive. They can reflect either the economy's temporary response to short-lived factors or an upward trend, especially if the same developments occur in the global economy.

1.2.1. Industrial data revisions will improve 2016-2018 GDP estimates

- According to a new Rosstat estimate, 2017 industrial output grew 2.1% – compared to the previous 1% YoY. The upgrade is explained by the arrival of updated statistical data based on qualifiers by types of economic activity (OKVED2) and those by production (OKPD2).
- The January through May period also turned in sanguine data: +3.7% YoY, which is still consistent with moderately growing GDP.
- Most upgrades were made in the investment industries group – because of heavy vehicles (railway, water-borne and air-borne transportation) and construction materials.
- In consumer sectors, the food industry's performance strengthened; however, slower growth was reported in outputs of light cars.
- Among key changes was the revised trend, from negative to positive, for the non-ferrous metals industry's output, previously a key negative contributor to the manufacturing sector's data.

Rosstat revised industrial output indexes for 2016-2018 to take account of updated data based on the OKVED2 and OKPD2 methodologies. The new figures are more precise estimates for companies' outputs: the statistical body cites the fact that respondents are rather pessimistic in real-time statistics – hence the positive impact of the updates on the aggregate index. In its note Rosstat also suggests that low frequency specific to small enterprises' data has not enabled the agency to capture promptly developments in this sector. This move took 2017 industrial output up 2.1% on the previously reported 1% YoY, mainly as a result of revised output in the manufacturing sector.

Our estimates suggest[5] data correction could lead to revised 2016 GDP data from -0.2% to 0%, and 2017 GDP from 1.5% to 1.8%. We highlighted the high probability of an upward revision of 2017 gross output early in the year[6], based on our alternative GDP estimates.

Figure 12. Industrial production index (2014 = 100)

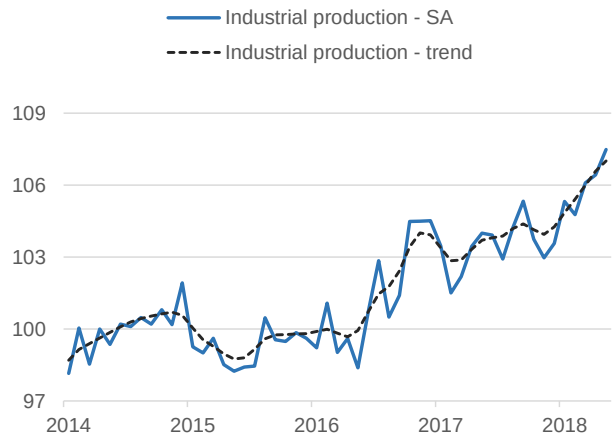
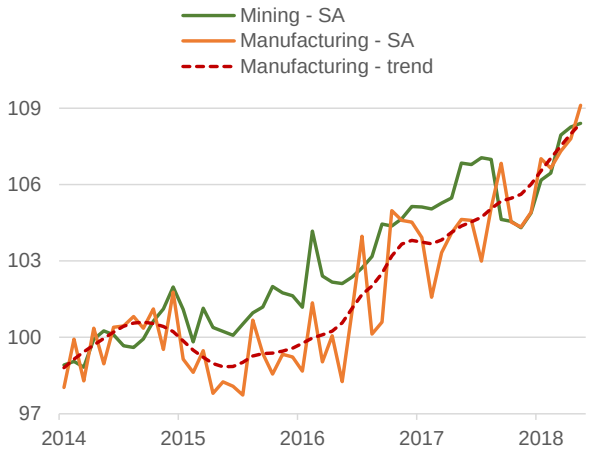


Figure 13. Mining output and manufacturing sector output indexes (2014 = 100)

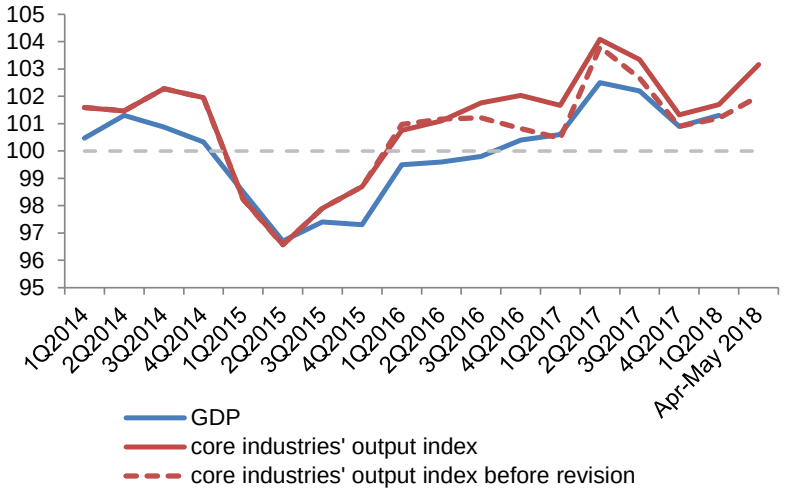


Sources: Rosstat, R&F Department calculations.

Industrial production growth for the first months of 2018 was also revised upwards by approximately 1.5 percentage points. This took industrial production growth since the start of the year to 3.7% YoY. From all appearances, Rosstat's first 2018 Q1 GDP estimate (+1.3% YoY) does not take into account the revised industrial data; chances are high that it will also be upgraded moving forward. This is what the upgraded estimate for the output of core industries also suggests (Figure 14). Acceleration in GDP growth in annual terms in the second quarter may also be expected.

[5] Based on gross value added across economic sectors for 2016–2017.
[6] See Subsection 1.2.1. 'The 2017 GDP growth estimate of 1.5% is most likely to be revised upwards', Talking Trends, February 2018 (No. 1).

Figure 14. Physical volumes of GDP and core industries' output index, % YoY

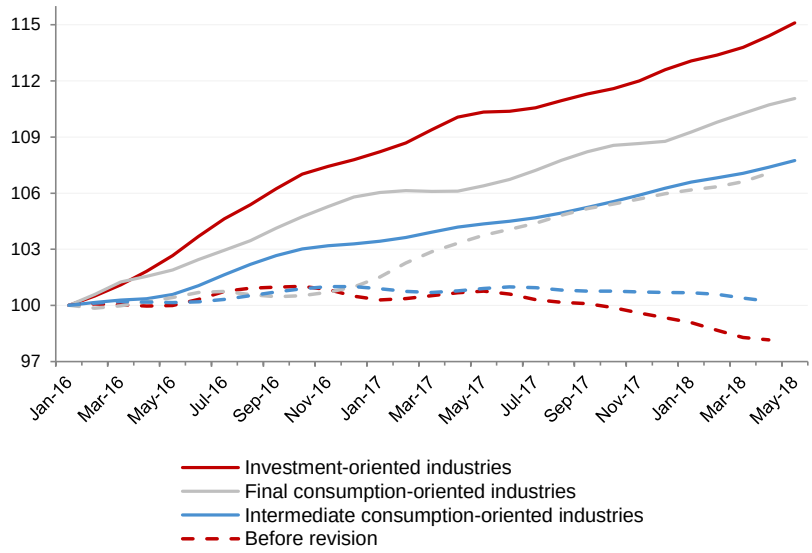


Sources: Rosstat, R&F Department calculations.

The industrial data revision of this magnitude is not surprising. The Centre for Macroeconomic Analysis and Short-term Forecasting (CMASF) reports that the 2006 industrial production index was adjusted from 103.9% to 106.3% – upwards of the current revision. The revision was necessary: the expert community view data quality as questionable, with a number of organisations (CMASF, Higher School of Economics) unveiling alternative estimates in the course of the year. The latter proved fairly close to Rosstat's new data.

According to Rosstat's revised data, in recent years the manufacturing sector grew at more robust paces than previously estimated. Growth in 2016 totalled 2.6% instead of 0.5%, and 2.5% instead of 0.2%.in 2017. From January to May 2018, the manufacturing sector's output was above the same period last year by 4.4%.

Figure 15. Trend component of output across manufacturing industry groups, January 2016 = 100%



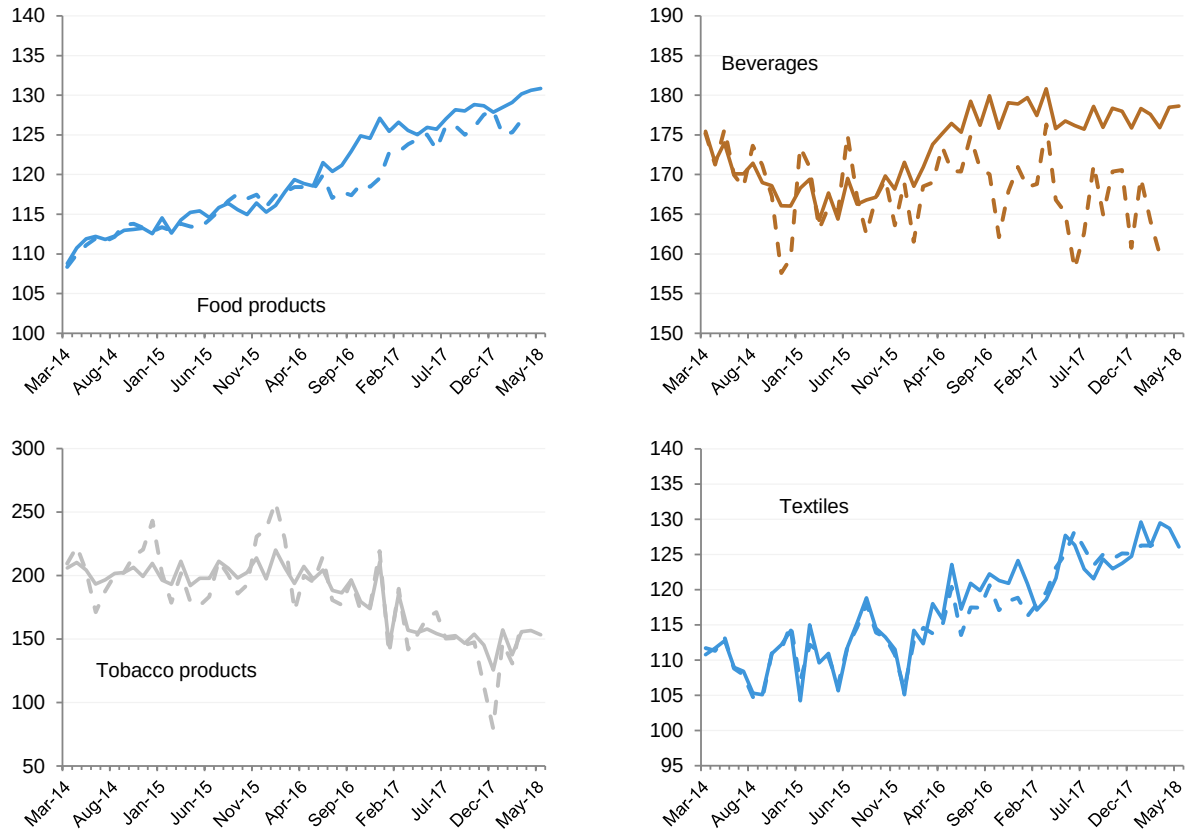
Sources: Rosstat, R&F Department calculations.

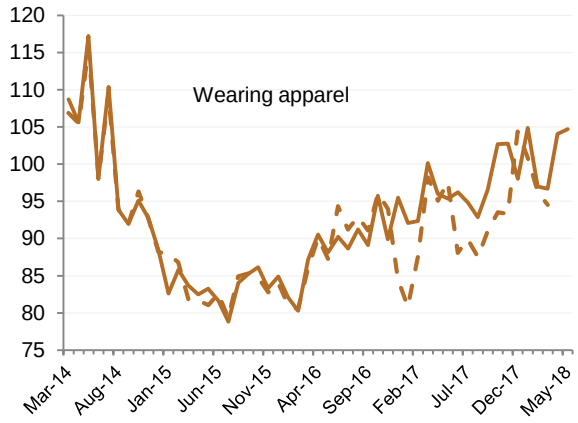
The most substantial revisions were made in the investment demand industries that previously posted declines in outputs because of negative data in defence order-focused operations, as well as in construction material production. Once the data were updated, the output index in this industry group shows steady growth (Figure 15). The key contributor to growth is the *other transport vehicles* sector (Figure 16) with long production cycles, which complicated real-time accounting. Drastic upgrades were also made in construction materials. It is conceivable that official data on construction volumes are also likely to be revised (their latest revision occurred in October 2017).

In the consumer industry group, food production solidified its positions following the revision – as a growth driver in the manufacturing sector. Pharmaceuticals show a slowdown in their fast growth. Also, the output of light vehicles has been stagnant over the past four months.

According to the updated statistics in intermediate demand-focused industries, the previously moderate output data gave way to a sustainable growth path. A key factor driving the manufacturing sector down, before the revision, was contraction in metallurgy outputs in the activity titled 'production of core precious metals and other non-ferrous metals, nuclear fuel production'. The updated statistical data reveal growth in this segment. Post-revision data of the pipe industry look more solid, too. In this way, metallurgy, previously a negative contributor to the performance of intermediate industries, is increasingly a growth driver in manufacturing.

Figure 16. Manufacturing data revisions per sector, seasonally adjusted, January 2014 = 100%




Wearing apparel
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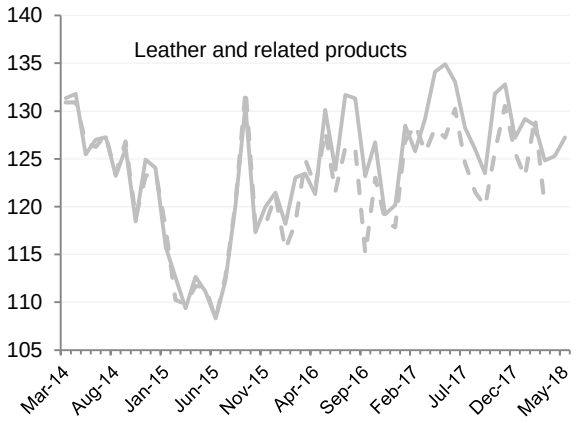
Leather and related products
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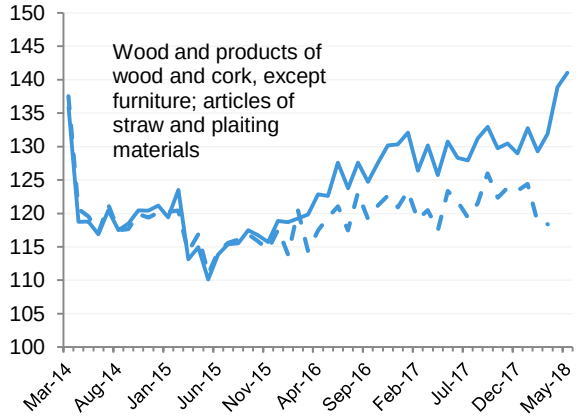
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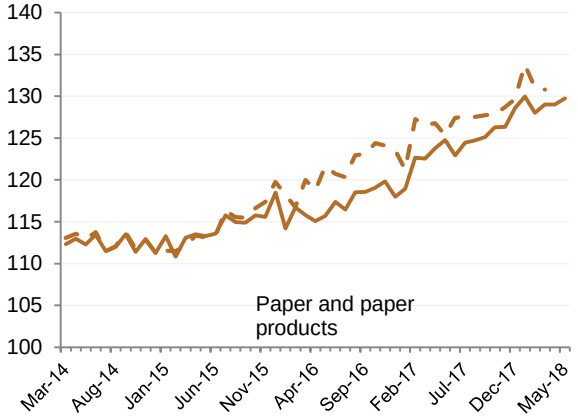
Paper and paper products
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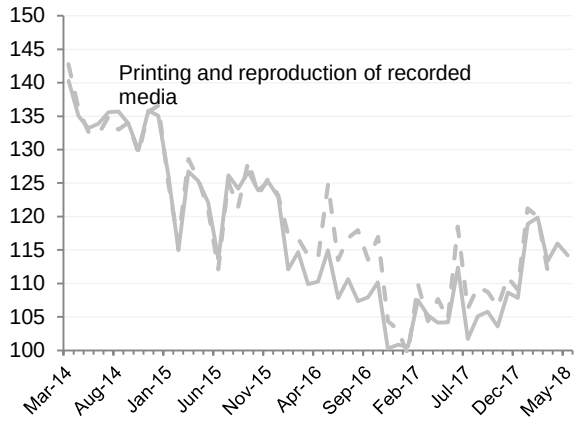
Printing and reproduction of recorded media
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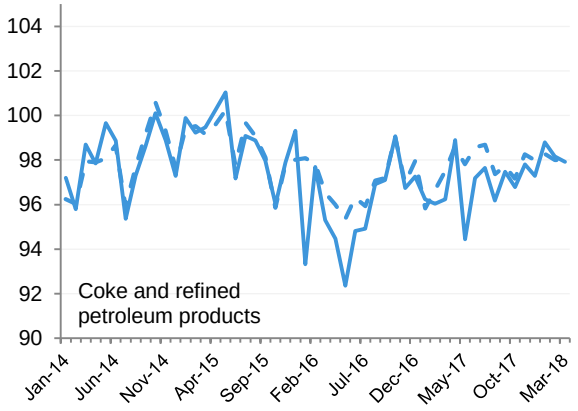
Coke and refined petroleum products
104
102
100
98
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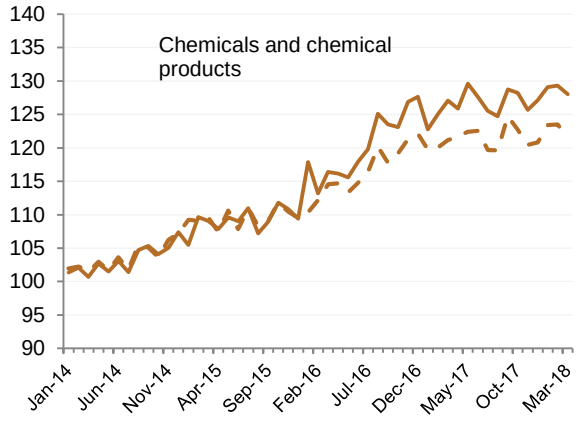
Chemicals and chemical products
140
135
130
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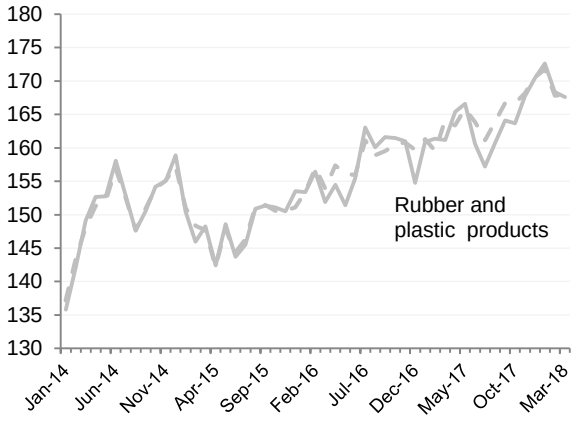
Rubber and plastic products
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175
170
165
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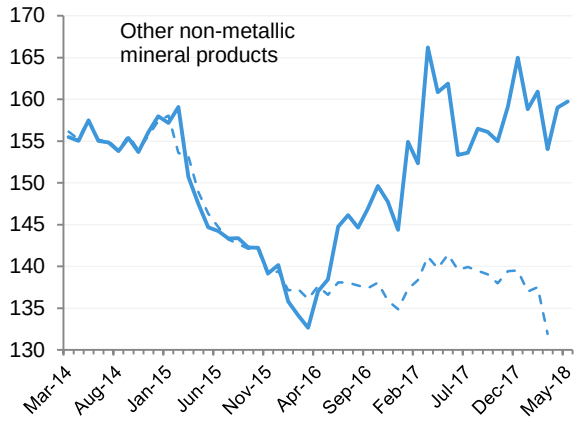
Other non-metallic mineral products
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165
160
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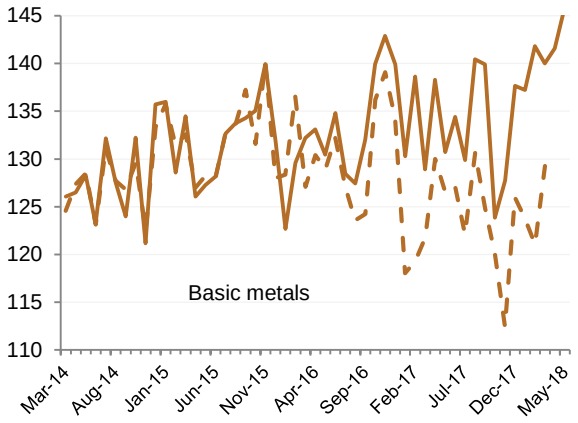
Basic metals
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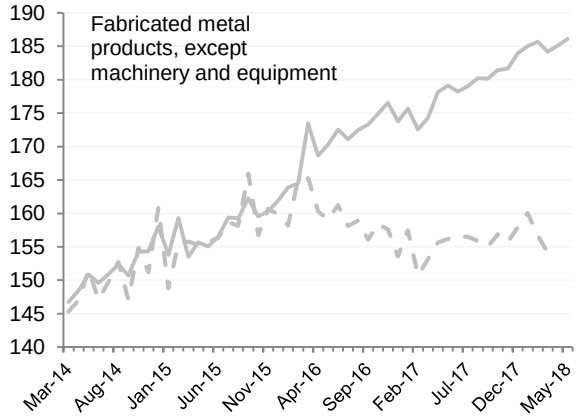
Fabricated metal products, except machinery and equipment
190
185
180
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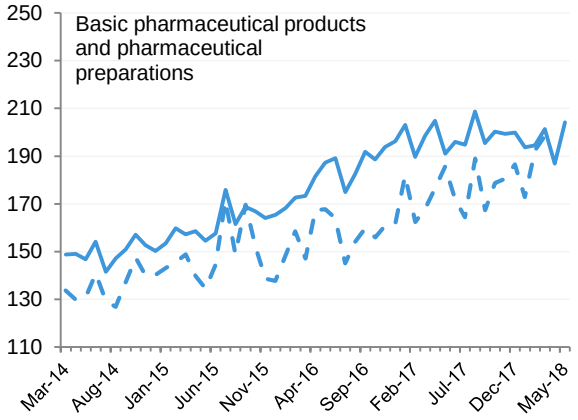
Basic pharmaceutical products and pharmaceutical preparations
250
230
210
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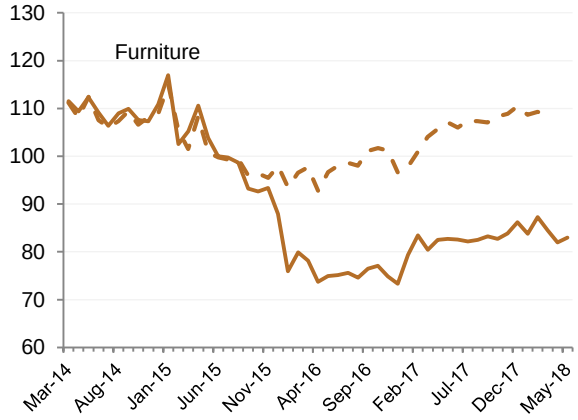
Furniture
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120
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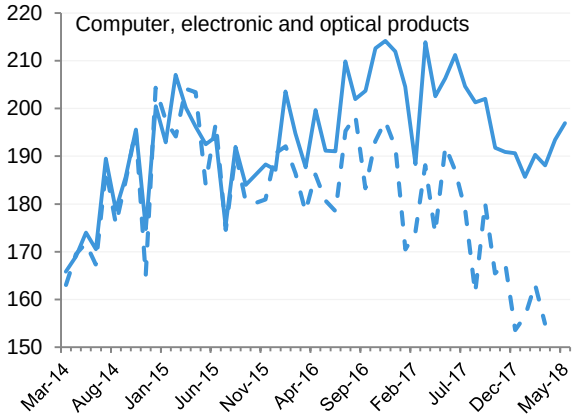
Computer, electronic and optical products
220
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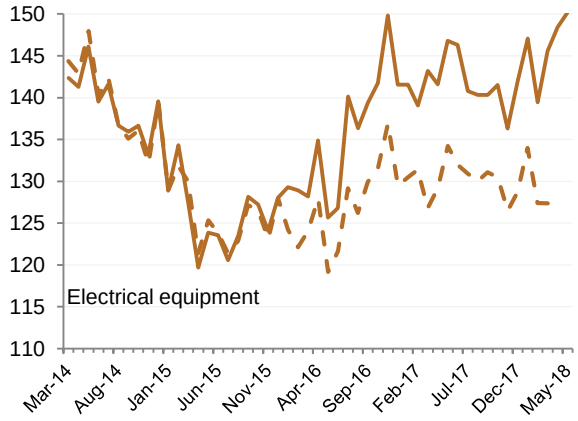
Electrical equipment
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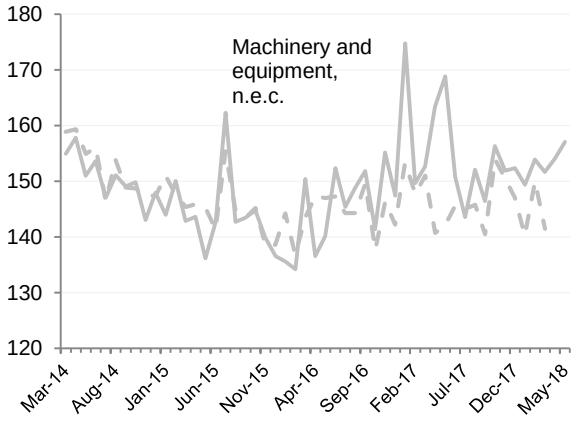
Machinery and equipment, n.e.c.
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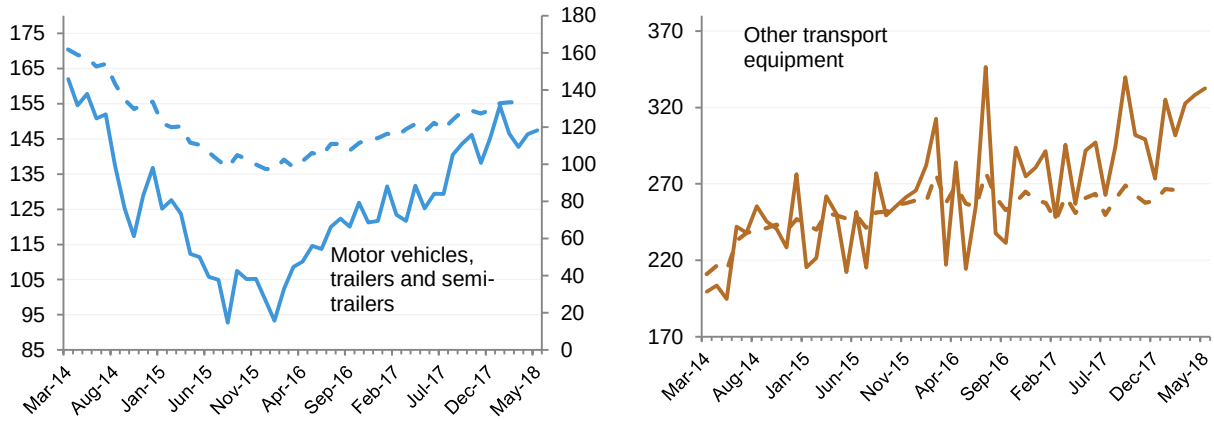


Sources: Rosstat, R&F Department calculations.

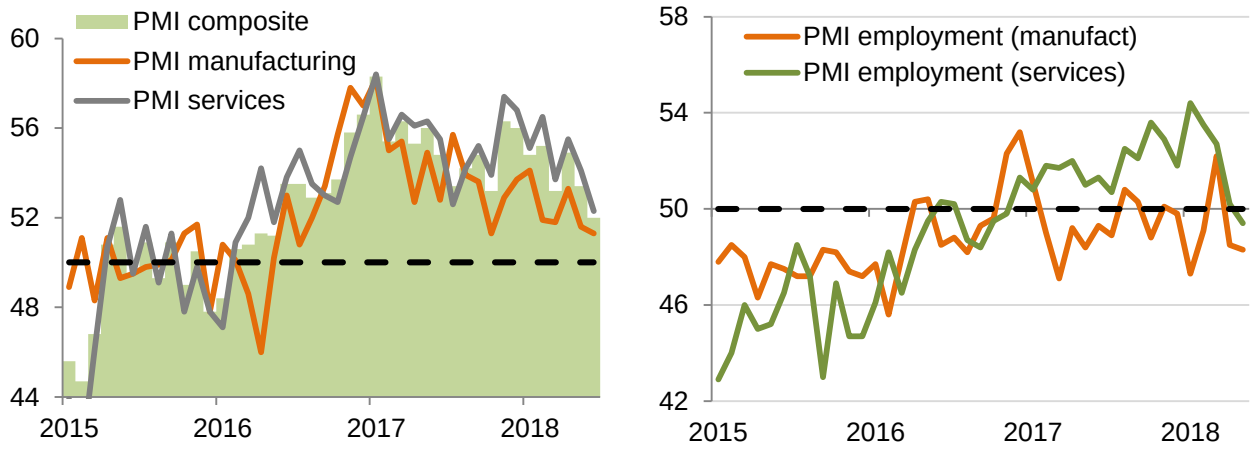
1.2.2. June PMI: business activity slows down

- The manufacturing PMI in June went down to 49.5; yet, the measure for output growth remained in positive territory. Respondents cite considerably increased costs, but their positive thinking over a one-year horizon is unchanged.
- The services PMI in June dropped to 52.3, which came as a key factor driving the aggregate PMI to 52.0. A decline was noted across all PMI subindexes except for expectations that kept their high reading.

The IHS Markit PMI index for the manufacturing sector in June moved lower to 49.5 points against 49.8 seen in May. This pushed the mean Q2 value to a level slightly above 50 points, which separates growth from contraction. Key drags on the deteriorating June index were the subindexes Stocks of Orders, Employment, Delivery Times and New Orders which collectively account for 75% of the aggregate indicator. Russia's values of the first two subindexes are below 50; the following two subindexes did not drop below 50 points until May, whereas the decline in New Orders (accounting for 30% in the index) came as an unpleasant surprise.

At the same time, the second-weightiest PMI subindex for manufacturing (Output) remains in growth territory (>50), with its growth however lower than early in the year. Ultimately, the picture is quite mixed: the lagging Employment indicator and the leading New Orders indicator both point to slowdown, while Output suggests moderate growth.

Figure 17. PMI index:

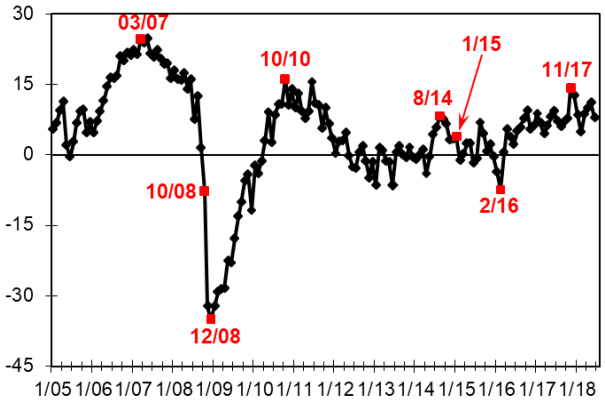


Source: IHS Markit.

These mixed movements are probably connected with exchange rate trends and regulatory factors. Indeed, in May respondents noted the strong growth in input prices (the Prices subindex reached 71.2 in Q2 vs 57.2 in Q1) was in many ways a result of exchange rate movements. In turn, more expensive raw material and intermediate goods negatively affect employment data (respondents noted headcount reduction) and output (rising costs are not fully passed on to consumers). Combined with sustainably positive expectations for one year ahead, this suggests that we are seeing another round of industrial adjustment to changing external environment rather than the likelihood of decline in this sector. Specifically, this explanation is consistent with the CMASF's relevant indirect estimates for industrial output in June. These record growth both in energy consumption changes and railway shipments.

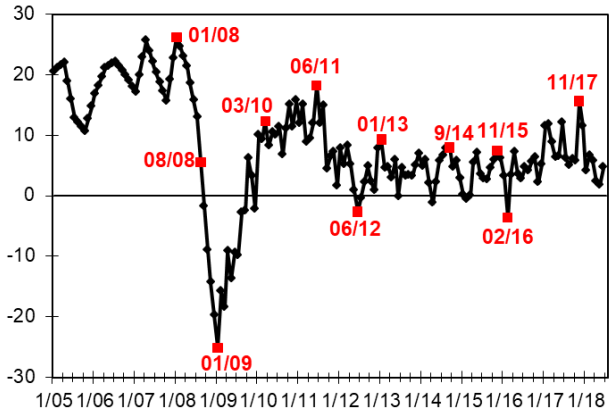
Furthermore, this explanation is consistent with a poll by a survey by the Gaidar Institute for Economic Policy. The industrial confidence index in June edged slightly down, after three months' growth; however, it retained its position within the range of data since 2017. The key reason for the negative outlook in June was a noticeable deterioration in corporate satisfaction with demand (from 64% to 56%) as a result of soft sales. At the same time, the industrial outlook index improved in June, which comes as a result of sanguine corporate expectations for demand and output alongside their intention to boost headcounts in the face of rising oil product prices and the expected tax increase.

Figure 18. Industrial confidence index



Source: IEP.

Figure 19. Industrial outlook index



Source: IEP.

The IHS Markit PMI for services in June (52.3) suggested sustainable growth in the sector albeit slower than in the first quarter of this year (55.1). Four out of five service sectors posted growth, with contraction finding its way only in consumer services. Some respondents attribute expansion to new clients; others refer to market uncertainty as a constraint on business development. The employment index dropped below 50 points for the first time since late 2016. The contraction was moderate (49.4), with the consumer services sector strongest affected.

Contraction in consumer services may well be related to consumer response to the VAT change and pension reform announcements: the consumer sentiment index by inFOM in June also declined after it stabilised at the level of 2014 H1.

The total PMI index went down from 53.4 to 52.0, in a sign of a certain economic slowdown in June. It may well be connected with one-off factors: the negative news context due to changes in administrative and tax regulation, tighter security arrangements at some companies – because of the World Cup – or a mere statistical error against the backdrop of low economic growth.

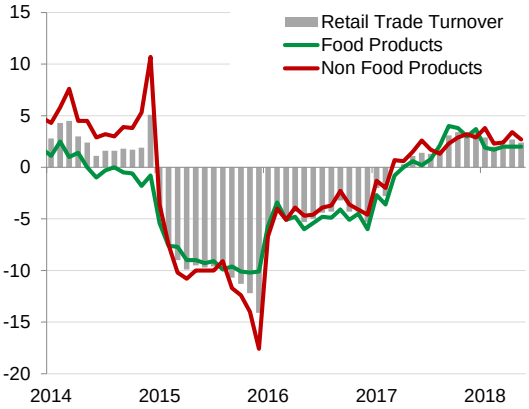
1.2.3. Growth in retail trade turnover slowed in May

- This May saw annualised growth in trade turnover slow down to 2.4% YoY (2.7% YoY in April), on the back of movements in non-food goods.
- Seasonally and calendar effect adjusted, sales posted 0.1% MoM growth in May (0.4% MoM in April).
- Growth in retail lending and real wages continues to underpin consumer demand.
- Households' consumer expectations deteriorated in June on the back of a hike in petrol prices seen in May and concerns over the Russian government's plans to revise the VAT rate.

According to Rosstat data, growth in retail trade turnover slowed down to 2.4% YoY in May (2.7% YoY in April), on the back of movements in non-food goods (Figure 20). Rosstat revised the January to April retail trade data upwards as respondents updated their submissions. Growth in non-food sales slowed to 2.7% YoY in May vs 3.4% YoY registered last month (revised from 2.7%), whereas food sales continued to grow at the sustainable pace of 2.0% YoY for the third straight month.

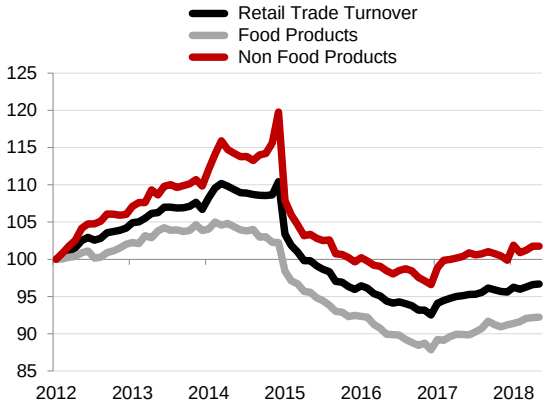
According to our estimates, monthly growth of retail sales slowed to 0.1% MoM vs 0.4% MoM registered in April (adjusted for seasonality and calendar effects) (Figure 21). May saw growth in non-food sales slow to 0.0% MoM (0.7% MoM in April), whereas food sales remained at the April level of 0.1%. The ruble's weakening in early April might have triggered growth in demand for non-food goods in April which gave way to stabilisation in May.

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



Sources: Rosstat, R&F Department calculations.

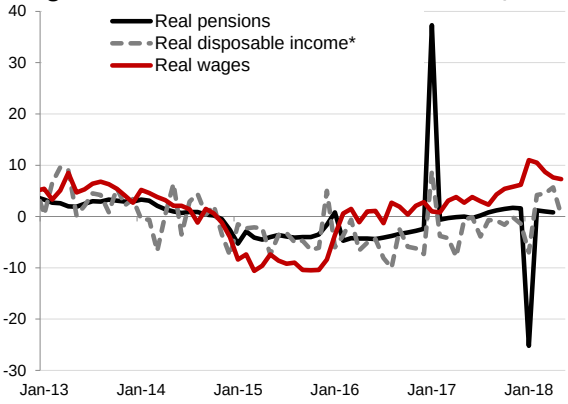
Figure 21. Retail sales, % (January 2012 = 100%, seasonally adjusted)



Sources: Rosstat, R&F Department calculations.

Retail sales are supported by the ongoing rise in retail lending (Figure 23) and a steady positive trend in real wages (Figure 22).

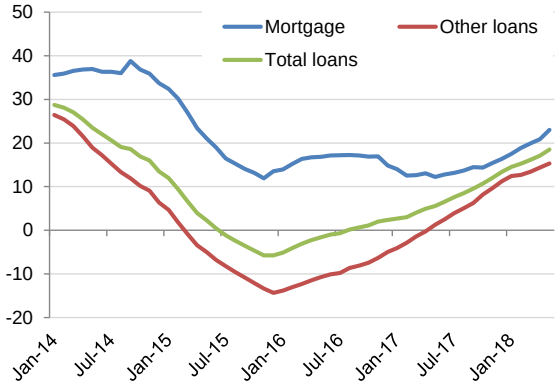
Figure 22. Real income of households, % YoY



Sources: Rosstat, R&F Department calculations.

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

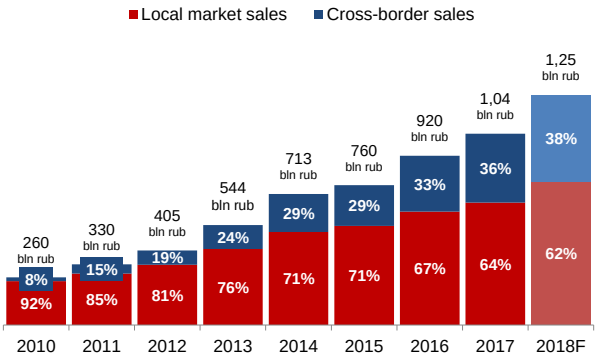
Figure 23. Ruble household loans, % YoY



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

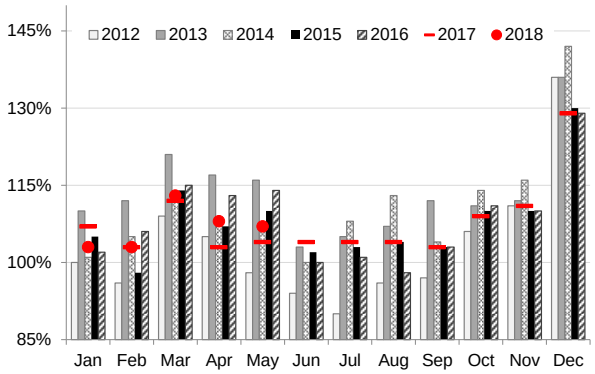
According to the AITC[7], cross-border sales are still ahead of local market sales (Figure 24). However, growth in cross-border sales registered a slowdown to 24% in 2017 (37% in 2016). The AITC's preliminary data predict that the cross-border segment will add 26% in 2018. The difficulties related to Rosstat's recording of such sales lead to possible undervaluation of non-food sales.

Figure 24. Russian e-commerce market



Source: AITC.

Figure 25. Change in real retail spending, % (January 2012 = 100%)



Source: Romir.

Romir Research Holding's data[8] point to a certain contraction in household spending in May backed by falling fruit and vegetable prices (by 4.7% MoM, seasonally adjusted) and lower daily expenses compared with the 2016, 2015 and 2013 readings (Figure 25). Households' real consumer spending however increased by 2.9% compared with last year readings. In terms of consumption behaviour in certain income groups, low-income consumers cut their annual expenses by 7% in May, whereas high- and medium-income consumers increased their spending by 2% and 9.2% respectively.

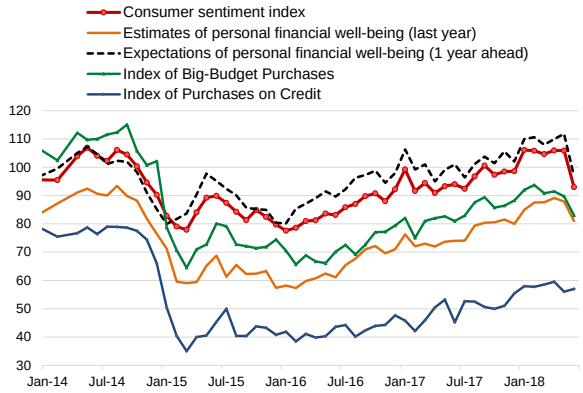
Also, Romir Research Holding reports a more rational consumption behaviour and notes that the proportion of households which had to save continued to contract to 76% this year (82% a year earlier).[9] At the same time the saving strategy of those who had to save changed: the year saw a decline in the proportion of those who sought discounts and promotions (from 36% to 33%) and chose cheaper brands (from 31% to 27%). An insignificant increase was registered in the proportion of those who tried to go shopping less frequently (from 17% to 18%) and made shopping lists (from 28% to 29%).

According to an inFOM-conducted monthly survey,[10] consumer sentiment in June deteriorated (Figure 26). After a relatively steady performance since the beginning of 2018, the consumer sentiment index and in early 2018, the ICS and expectations of future income moved to negative territory (below 100 points) and decreased by 13 and 15 points respectively contracting by 13 and 15 points respectively. The estimates of the

[7] The Russian Association of Internet Trade Companies (AITC): «Оборот российского рынка интернет-ритейла превысил 1 трлн рублей». 05.04.2018.
[8] Romir Research Holding. «Сезонная экономия началась». 07.06.2018
[9] Romir Research Holding. «Рациональная стратегия экономии побеждает». 24.05.2018.
[10] Based on real-time data for June.

current financial standing and the favourability of the current situation for high-value purchases lost 7 points.

Figure 26. Consumer sentiment index and its components



Source: inFOM survey.

Consumer sentiment deteriorated in June on the back of a hike in petrol prices seen in May and concerns over the VAT rate increase. This is suggested by the FOMnibus survey.[11] According to inFOM data, 87% of Russian respondents said that rising petrol prices affected their everyday life (50% of them noted that 'all prices were rising'[12]). More than half of respondents (57%) believe that higher VAT will have a negative effect on their financial standing and a third (34%) notes a negative effect on the economy.[13] Households' response may slow down consumption growth in June. However, the ongoing growth of retail lending and real wages points to the opposite or suggests that the slowdown will prove short-lived.

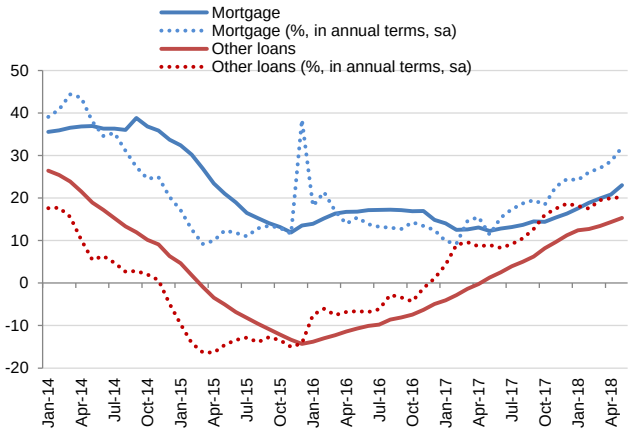
1.2.4. Retail lending continues to accelerate

- The retail lending continues to boom. In May, annualised seasonally-smoothed rates of mortgage growth exceeded 30% YoY and that of unsecured consumer loans – 20% YoY.
- The restructuring of asset portfolios of banks undergoing financial resolution with the participation of the BSCF sharply slowed growth in lending to non-financial organisations.
- The banking sector remains profitable (banks under financial resolution factored out).

[11] The survey of Russians aged 18+. 10 and 24 June 2018. 53 Russian regions, 104 settlements, 1500 respondents. Statistical error is below 3.6%.
[12] InFOM. «Рост цен на бензин: реакция граждан». 15.06.2018.
[13] InFOM. «О повышении НДС». 02.07.2018.

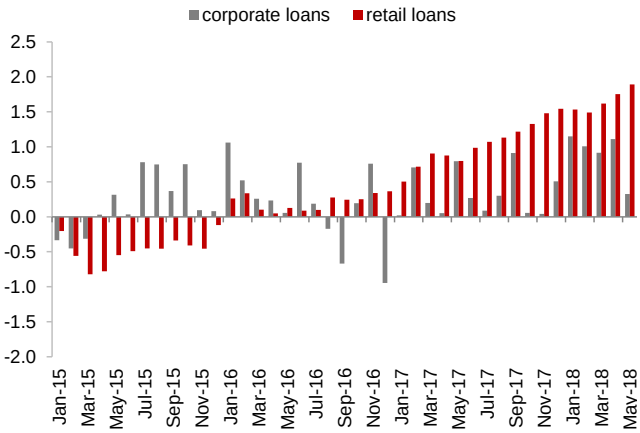
The retail lending continues to boom. Growth rates in mortgage (+2.3% MoM[14], 23% YoY) and unsecured consumer lending (+1.5% MoM, 15.3% YoY) hit new highs in May in this phase of economic growth (Figure 27). Accelerated growth is registered in all bank groups other than banks under resolution.

Figure 27. Annualised seasonally-smoothed monthly growth rates



Source: Bank of Russia calculations.

Figure 28. Lending to households and non-financial organisations, % MoM



Source: Bank of Russia calculations.

Growth in ruble corporate lending slowed in May to 0.3% MoM (5.7% YoY) after the average 1% MoM seen from January to April 2018 (Figure 28). Slowing growth is a one-off effect largely associated with the restructuring of asset portfolios of banks undergoing financial resolution with the participation of the BSCF. Both retail and corporate lending markets may see banks under financial resolution step up their operations as they finish cleaning up their balance sheets. This may spur competition in the market and further accelerate growth in lending to the economy.

Banks undergoing financial resolution were also responsible for a formal shrinkage of banking sector profits in May from 537 billion to 527 billion rubles. The banking sector (with banks under financial resolution factored out) continued to generate profits.

1.2.5. Unemployment stabilises close to the lowest readings

- In May, seasonally adjusted unemployment remained at the previous month level of 4.8%.
- Real wage growth slowed down in May by 0.3 pp to 7.3% YoY, but may be revised upwards by Rosstat.

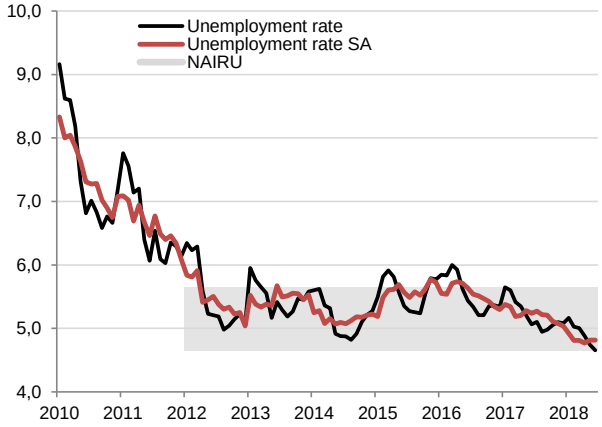
The unemployment rate fell to 4.7% in May vs 4.9% in April because of the seasonal increase in employment in services and agriculture. The seasonally adjusted

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

indicator remained at 4.8% holding at the lower bound of the non-accelerating inflation rate of unemployment (NAIRU) (Figure 29).

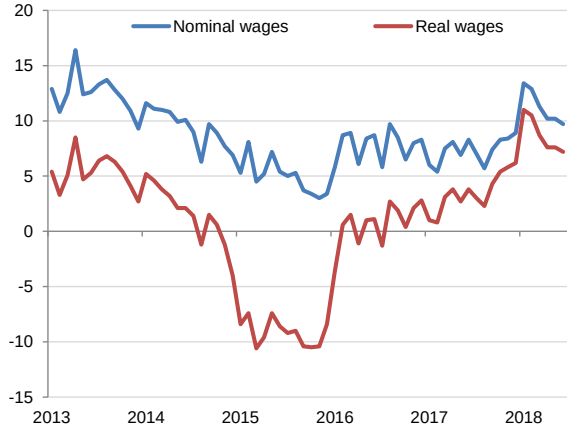
Nominal and real wage growth slowed in May to 9.9% and 7.3% YoY (Figure 30). In April, nominal and real wage growth was revised downwards by 0.2 pp to 10.2% and 7.6% YoY respectively. The May estimate is preliminary and highly likely to be revised upwards by Rosstat due to the minimum wage increase early in the month.

Figure 29. Unemployment, %



Sources: Rosstat, R&F Department calculations.

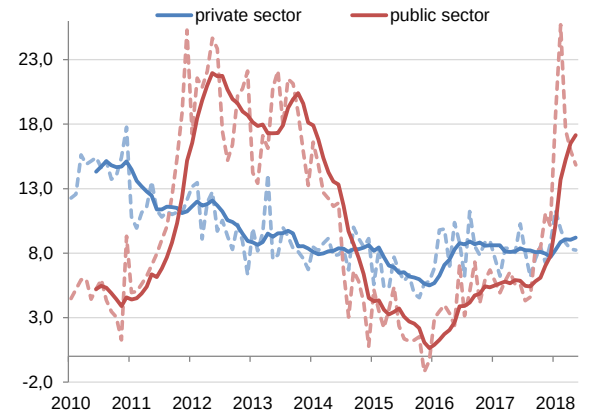
Figure 30. Nominal and real wage growth rates, % YoY



Sources: Rosstat, R&F Department calculations.

Wages in the public sector continue to rise at double-digit rates on the back of May decrees implementation (Figure 31). Healthcare remains the main driver (26.2% YoY in April). However, the growth pace slowed down: in March, wages in healthcare grew by 30.0% (Figure 32).

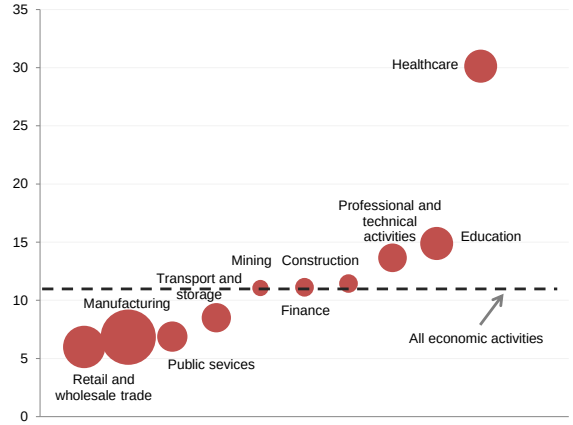
Figure 31. Wage growth in the private and public sector, % YoY



Sources: Rosstat, R&F Department calculations.

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

Figure 32. Wage growth in the private and public sector in March, % YoY



Sources: Rosstat, R&F Department calculations.

The area of the circles is proportional to the activity's share in total payroll.

1.2.6. Macroeconomic effects of the proposed fiscal measures

- The increase of the VAT base rate from 18% to 20% may add 0.8-1.25 pp to consumer price growth (taking into account the moderate secondary effect). Central banks are usually attentive to secondary effects in their monetary policy.
- The VAT rise and the increase of the primary budget deficit by approx. 0.5 pp of GDP, with the potential automatic increase in expenses factored in, may add a total of approx. 5 pp of GDP to the budget in 2019-2024.
- The impact of fiscal measures on GDP growth, including the potential one, will depend on the efficiency of fund spending on the implementation of new May decrees.

The increase of the VAT base rate and a certain easing of the fiscal rule will allow funding most additional budget expenditures in infrastructure, healthcare, education and other sectors mentioned in the new presidential May decrees (8 trillion rubles in six years).

I. The increase of the VAT base rate from 18% to 20%

1. Effect on inflation

We estimate that approx. 68% of the consumer basket cost is taxed at the VAT base rate (18%) (the 2018 structure). *The maximum direct one-off effect on inflation from the increase of the VAT base rate by 2 pp with a complete pass-through to consumer prices totals 1.16 pp.* As producers transfer the tax burden to consumers only partially by reducing their profits, *we estimate that the direct effect on inflation will total 0.8-0.95 pp.* We expect that *the effect will largely manifest itself within the first two quarters following the VAT rise:* after the VAT cut in Russia in 2004 and the sale tax hike in Japan in 2014, the effect manifested itself within the first quarter. *Prices may grow by tenths of percentage point in the month preceding the VAT hike.* In Germany and Japan, producers raised prices before the increase of consumer tax. Russian consumers may also shift their purchases to the end of 2018; this is mostly relevant for durable goods.

At the same time, *secondary effects on inflation may emerge.* They are associated with growing inflation expectations and certain inertia in the price dynamics. The occurrence and scale of secondary effects depend on the Bank of Russia's policy related to the outpacing effect on inflation expectations. Thereby, the effect on inflation may total 0.8-1.25 pp.

The Central Bank's response to changes in the tax burden depends on the anchoring of inflation expectations and the scale of secondary effects. The experience of other central banks, which faced a VAT rise, shows that monetary policy not always responded to tax hikes and the associated one-off price leap (Felcser, 2013[15]). In the

[15] Felcser D. (2013). How should the central bank react to the VAT increase? // *MNB Bulletin*, January 2013.

Czech Republic, where the inflation target was reached before the tax increase, the regulator considered secondary effects to be immaterial and did not respond to them. National banks of other countries (UK, Poland and Romania) considered secondary effects to be a factor in favour of a tighter monetary policy. In Russia, inflation expectations are unanchored and secondary effects are highly likely to manifest themselves. Therefore, the Bank of Russia cited the tax increase among the important reasons to keep the key rate unchanged.

2. Effect on the budget balance

The VAT demonstrates high collectability comparable with other countries' readings, according to the Ministry of Finance's estimates. According to our estimates, if we assume that collectability holds at the 2017 level, the upward revision of the core rate from 18% to 20% will increase budget revenues by 0.55-0.6 trillion rubles or 0.55% of GDP in 2019.

However, as inflation accelerates on the back of the VAT increase, *budget expenditure may automatically start to grow* because of higher costs (public procurement) and additional indexation (social security and labour remuneration). Our estimates suggest that expenditures *may rise by a total of 0.25-0.3 trillion rubles or 0.25% of GDP.*

Thereby, the cumulative effect on the budget balance may total 0.55-0.25=0.3% of GDP.

3. Effect on GDP growth

According to our estimates, the fiscal multiplier of consolidated income of the Russian economy is 0.75.[16] The estimates of multipliers of income components for advanced economies suggest that the consumption tax multiplier (by GDP growth) is one of the highest and the effect is relatively quickly transferred to GDP growth.[17] We assume that the consumption tax multiplier for the Russian economy may total 0.9-1.0 (a 0.9-1.0 pp decline in GDP when taxes are raised by 1 pp of GDP). Thereby, *the direct negative effect of the 2 pp increase in the VAT base rate may total approx. 0.5 pp of GDP.* However, *given the offsetting increase in expenditures* (including the potential automatic growth in budget expenditures) *the cumulative effect on GDP may prove positive.*

II. The temporary increase in the primary deficit under the fiscal rule from 0 to approx. 0.5% of GDP and the respective increase in expenditures

1. Effect on inflation

[16] S. Vlasov, E. Deryugina (2018). Fiscal multipliers in Russia // *Working Paper Series*, No. 28.
[17] Coenen G., Kilponen J., Trabandt M. (2010). When does fiscal stimulus work? // *ECB Research Bulletin*, No. 10.

The effect on inflation will depend on a number of factors, including the expenditures structure. According to our estimates, *inflation will accelerate insignificantly by 0.1 pp*.[18]

2. Effect on the budget balance

A temporary increase in the primary budget deficit from 0 to approx. 0.5% of GDP will allow raising expenditures by approx. 0.5% of GDP (approx. 0.59 trillion rubles). This measure will call for raising a similar volume of additional funding, presumably by borrowing in the domestic market.

Similar to the VAT increase, automatic growth of expenditures may have an inflationary effect. However, in this case we estimate that it will be weak.

3. Effect on GDP growth

According to our estimates, the fiscal multiplier of consolidated expenditures of the Russian economy is 0.28.[19] *The increase in expenses as their current structure remains unchanged may raise GDP by approx. 0.15 pp. However, the real effect should prove several times higher*, given the fund allocation for production expenditures (infrastructure projects) which have a considerably higher multiplier.[20] This should increase the potential economic growth rate, among other things. Meanwhile, the potential economic growth rate may increase only in several years, given the deferred effect of potential economic growth of such expenditures: investments initially trigger growth in demand and only at the final stage boost production capacity.

[18] See Section 1.1.2. 'Additional pension payment poses minor inflation risks' of the talking Trends bulletin for 22-28 August 2016 (No. 44). The estimates are based on a BVAR model, a modification of the model described in Deryugina E., Ponomarenko A. (2015). Accounting for Post-Crisis Macroeconomic Developments in Russia: A Large Bayesian Vector Autoregression Model Approach, Emerging Markets Finance and Trade, vol. 51(6), pp. 1261–1275, with addition of fiscal variables.
[19] S. Vlasov, E. Deryugina (2018). Fiscal multipliers in Russia // *Working Paper Series*, No. 28.
[20] See A. Kudrin, A. Knobel (2017). Fiscal policy as a source of economic growth // *Voprosy Ekonomiki*, No. 10.

2. Outlook: leading indicators

2.1. Global leading indicators

2.1.1. The global economy closed the second quarter on an upbeat note but the achieved growth rates are in question

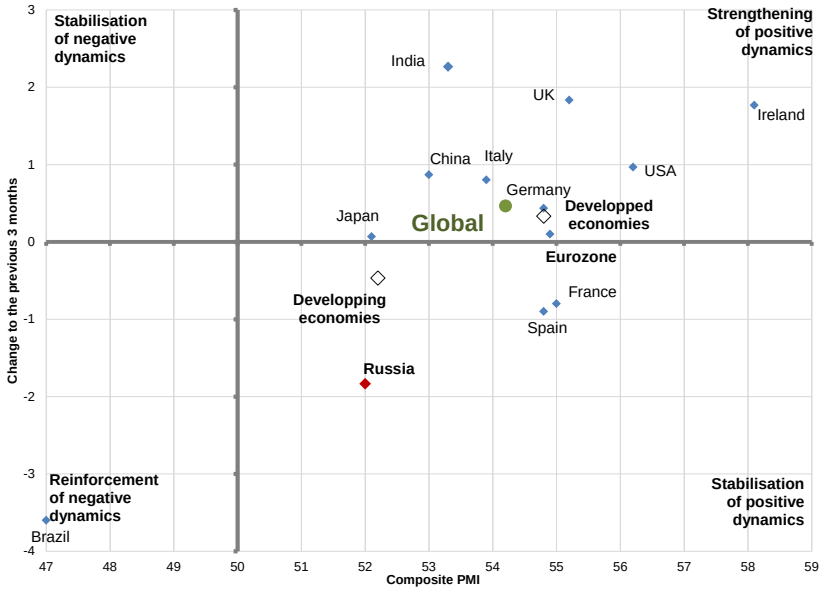
The PMI index in June 2018 points to a confident closure of 2018 Q2 by the US economy and a certain acceleration in the eurozone, but it remains in question whether these achievements will hold (Figure 33).

In June, the US composite PMI index dropped from 56.6 to 56.2 pp pointing to a confident closure of the second quarter. The PMI index suggests that the US economy performed at its three-year best during this quarter. 2018 Q2 GDP growth is set to exceed not only the 2018 Q1 readings but also the 3% level. Growth comes along with a steadily expanding employment and rising inflationary pressure driven by a strong demand. However, business expectations dropped to the three-month low and growth of new orders has been slowing for the second month in a row. This may suggest slower growth in the months to come.

The eurozone's composite PMI index rose from 54.1 to 54.9 pp, only partially offsetting the drop against the late 2017 - early 2018 levels. Having said that, growth was observed only in the services sector (from 53.8 to 55.2 pp) whereas the manufacturing PMI index fell from 55.5 to 54.9 pp. Positive news came from a climbing inflationary pressure manifested not only in price growth (largely related to higher prices of oil and raw materials) but also in wages due to the tighter conditions in the labour market of a number of regions of the single-currency union. Like in the US, business optimism in the eurozone abated while the production output index exceeded new orders. This may point to a temporary nature of the current index growth.

The group of developing markets comes under the spotlight because of their growth slowdown. It may well be the case that negative developments in these countries' financial markets are increasingly feeding into overall economic trends.

Figure 33. Composite PMI for June and change to the March to May average



Sources: IHS Markit, Bloomberg Finance L.P.

2.2. What do Russian leading indicators suggest?

2.2.1. GDP estimate in June: growth at the potential level

- The 2018 Q2 GDP estimate as of 20 June stood at +0.4% QoQ SA remaining at the May level.
- Short-term Q3-Q4 forecasts also remained largely unchanged suggesting growth of 0.4% and 0.5% QoQ SA respectively.
- Our estimates and short-term predictions suggest that GDP growth as of end-2018 may be close to the upper bound of the Bank of Russia's official forecast (1.5-2.0%).[21]
- These estimates are based on the average Urals crude price of $71 per barrel in 2018, which is somewhat higher than the assumptions made in the Bank of Russia's baseline and unchanged-oil-price scenarios ($67 and $69 per barrel respectively).

	% QoQ SA	% QoQ SA
2018 Q2	**0.4**	0.4
2018 Q3	**0.4**	0.4
2018 Q4	**0.5**	0.4-0.5

[21] The index estimate is based on Rosstat's updated 2018 GDP estimates to be released in 2020 and later.

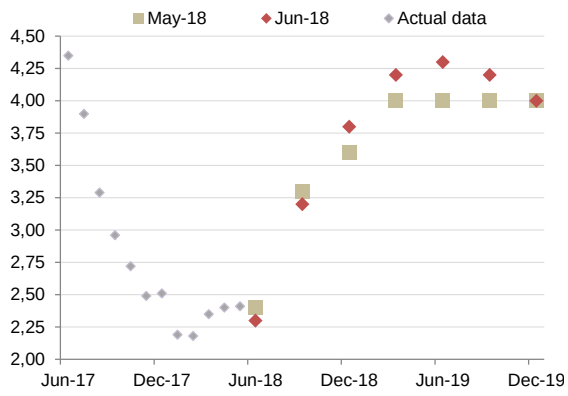
2.2.2. Analysts revised their expectations for inflation and the key rate upwards

- Analysts revised their forecast for inflation upwards on the back of the VAT increase early next year. Inflation is forecast to bounce back to 4% and stabilise further as early as end-2019.
- The Bank of Russia's signal of a possible delay in the shift to a neutral policy stance to 2019 adjusted the expectations for the key rate upwards. Analysts no longer expect key rate cuts this year.

According to June's Bloomberg survey, financial analysts revised their end-2018 inflation estimates upwards from 3.6% to 3.8% YoY. The 2019 median inflation estimate was revised towards growth. In the first quarter of next year, analysts expect inflation to stand at 4.2% YoY compared with 4.0% YoY forecast in May. In mid-2019, annual consumer price growth is expected to accelerate to 4.3% to consequently slow down to the 4.0% target by the year-end. The upward trend in the inflation path in late 2018 and early 2019 is associated with the planned VAT increase from 1 January 2019. From all appearances, analysts expect that the effect of the VAT increase will in part manifest itself as early as end-2018 bringing annual inflation back to 4% by end-2019.

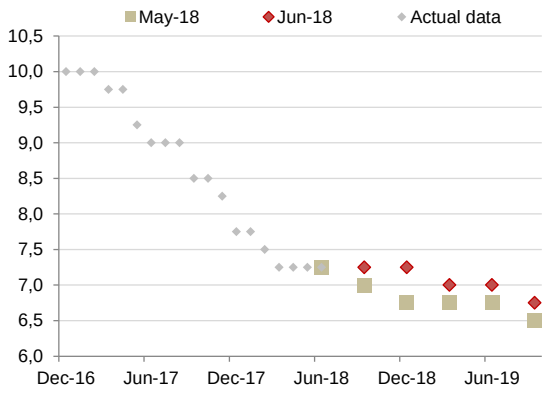
The expectations for the key rate were revised upwards in June following the Bank of Russia Board of Directors' meeting. The median forecast predicts that the key rate will be kept at 7.25% all through 2018 and resume its downward movement only at the beginning of next year. Analysts took literally the signal of a possible delay in the shift towards neutral monetary policy until 2019. They expect the key rate to be reduced to 6.75% by end-2019. That said, with next year-end projections varying from 6.5% to 7.0%, financial analysts believe that the neutral key rate lies closer to the upper bound of the Bank of Russia's estimate range (6-7%).

Figure 34. Analysts' expectations for inflation, % YoY



Source: Bloomberg Finance L.P.

Figure 35. Analysts' expectations for the Bank of Russia key rate, %



Source: Bloomberg Finance L.P.

3. In focus. What constrains productivity growth?

- After the 2008 crisis TFP growth was mainly driven by a small group of leaders, mostly large enterprises. This is a world-wide phenomenon.
- The peculiarity of Russia is that laggard firms are shrinking in size, but do not exit the market, continuing to use production factors inefficiently ...
- ... which leads to a decrease in the average TFP growth rates in the economy and freezes the inefficient use of factors.
- Economic policy enhancing TFP growth should focus on creating conditions for faster exit of inefficient companies and reducing barriers to the entry for new companies.

Addressing the goal of sustainable growth acceleration is essentially tantamount to boosting productivity growth through the progress of technology, thus fastening the pace of total factor productivity (TFP) rise.[22] This observation also holds good for Russia. Extensive growth through labor force expansion[23] is impossible because of demographic factors. Growth can, to a certain extent, be accelerated through implementing the presidential decree on bringing fixed investment up to 25% of GDP. If implemented efficiently, this should secure the modernization of the economy's capital, resulting in overall productivity growth. Growth acceleration may however prove only temporary, lasting no longer than the period of accelerated investment growth, should investment turn out to be ineffective and nonproductive. On top of that, the positive effect of investment in infrastructure and human capital may be significantly lagged in time.

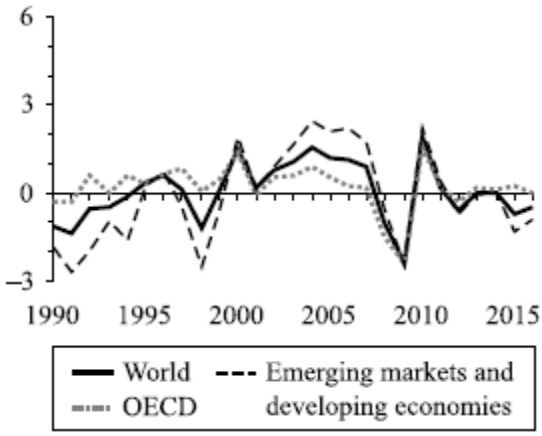
Research[24] suggests that the Russian economy's slowdown after the 2008–2009 crisis was brought about by slowed TFP growth, in line with the trends, seen in developed economies during the same period (Figure 36, Figure 37). Some studies, however, provide evidence that the TFP growth decline trend emerged even before 2008. The question then arises about the extent to which the Russian economy's growth through the progress of technology is hampered by constraints on the reallocation of resources from less efficient to more efficient firms within industries as well as that among industries. An answer to this question would help to make up a more clearly formulated list of measures to address the growth acceleration goal more efficiently.

[22] Total factor productivity growth (TFP) is defined as output growth of production which is seen over a certain period and cannot be attributed to growth due to an expansion in the use of production factors (labour and capital) in the same period.
[23] The so-called demographic dividend.
[24] See, for example, Voskoboynikov, I. B. (2017) 'Sources of Long Run Growth of the Russian Economy before and after the Global Financial Crisis', Russian Journal of Economics 3 (2017), pp. 348–365.

Figure 36. TFP dynamics in Russia (KLEMS)

Source: Voskoboynikov (2017).

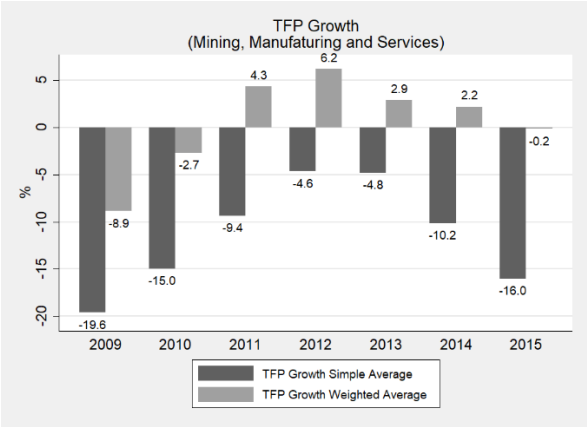
Figure 37. TFP dynamics



Source: Voskoboynikov (2017).

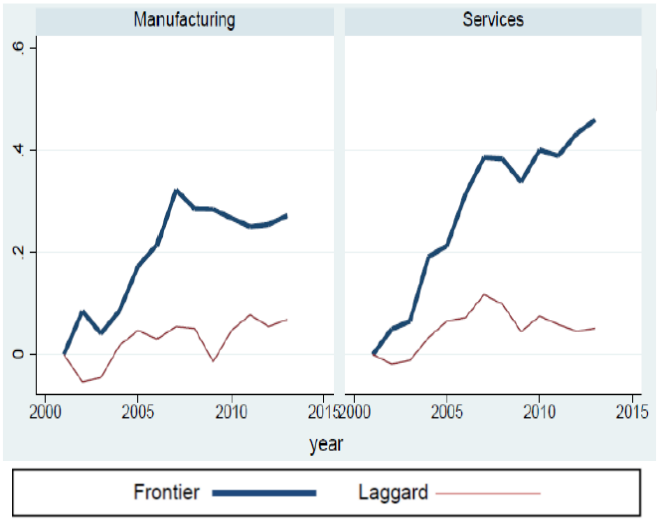
Firm-level estimates confirm the trends evidenced by aggregated data. Estimates by Bessonova (2018)[25] using Russian data suggest that firms' 2009–2015 average TFP growth was negative, whereas the weighted average[26] growth was positive in 2011–2014, appreciably surpassing the former number (Figure 38). The OECD[27] countries also showed the overall downward TFP growth trend in the manufacturing and services sectors in the post-crisis period (Figure 39).

Figure 38.



Source: Bessonova (2018).

Figure 39.



Source: Andrews et al. (2016).

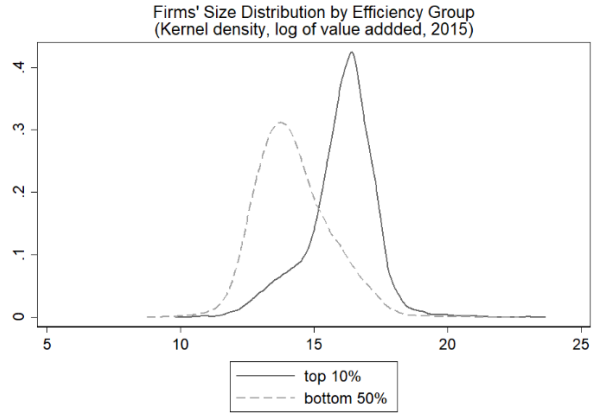
[25] For Russia, see Bessonova E. (2018), "Analysis of Russian firms' TFP growth in 2009—2015", Voprosy Ekonomiki, No 7, pp. 96—118. In print. (In Russian). In this article, the TFP growth rate was calculated using translog production function estimates.

[26] By firms' value added.

[27] For OECD countries, see Andrews, D., C. Criscuolo and P. Gal (2016), "The Best versus the Rest: The Global Productivity Slowdown, Divergence across Firms and the Role of Public Policy", OECD Productivity Working Papers, No. 5, OECD Publishing, Paris, https://doi.org/10.1787/63629cc9-en.

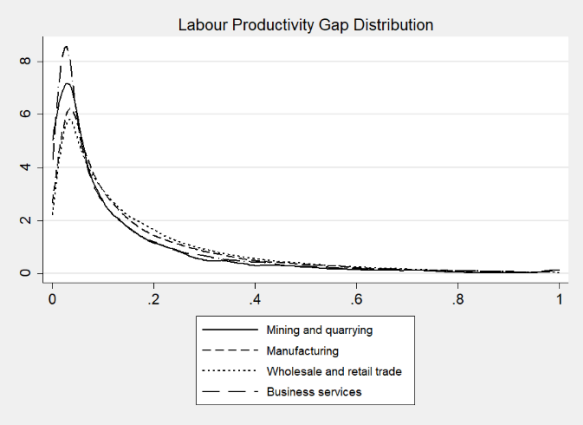
This TFP performance and its variation in the Russian economy show that firms are widely different as regards the TFP level and its growth rates, large enterprises largely being the most efficient[28] (Figure 40). Our estimates also suggest that firms' distribution by productivity is extremely non-uniform. A large proportion of firms show productivity levels that are 10–20 times lower than the highest in their respective industries (Figure 41).

Figure 40.



Source: R&F Department calculations based on RUSLANA database.

Figure 41.



Source: R&F Department calculations based on RUSLANA database.

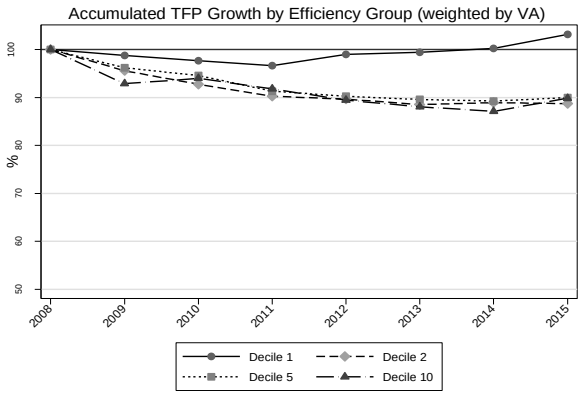
We have assessed TFP growth in relation to individual firms' distance from the technological frontier.[29] A breakdown by decile shows that the first decile of growth leaders accounts for all of TFP growth in the economy.[30] That said, the gap between the leaders and firms from the second decile is very wide, while the TPF performance in all the other deciles is generally similar (Figure 42). This kind of TFP performance is not specific to Russia, in other countries, it is also the most efficient firms that show a significant productivity growth, with 5% and 2% of some industries' best firms in a number of countries sometimes posting higher growth rates than the best 10% do (Figure 44).

[28] The efficiency of an enterprise is calculated as the ratio between its productivity and the maximum productivity in the industry.

[29] The analysis was conducted using a stochastic frontier analysis based on the Russian companies' accounting data taken from the RUSLANA database for the period from 2008 to 2015.

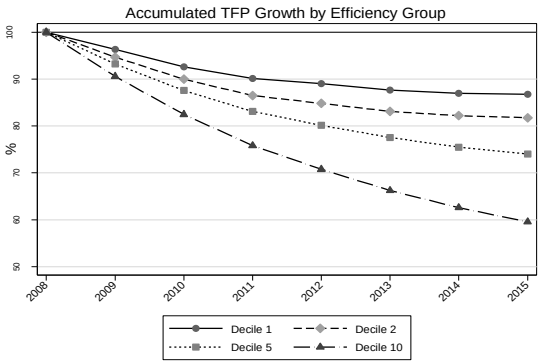
[30] Decile 1 includes the most efficient enterprises. Decile 10 includes the least efficient enterprises.

Figure 42. Accumulated weighted average TFP growth by deciles (efficiency-based)



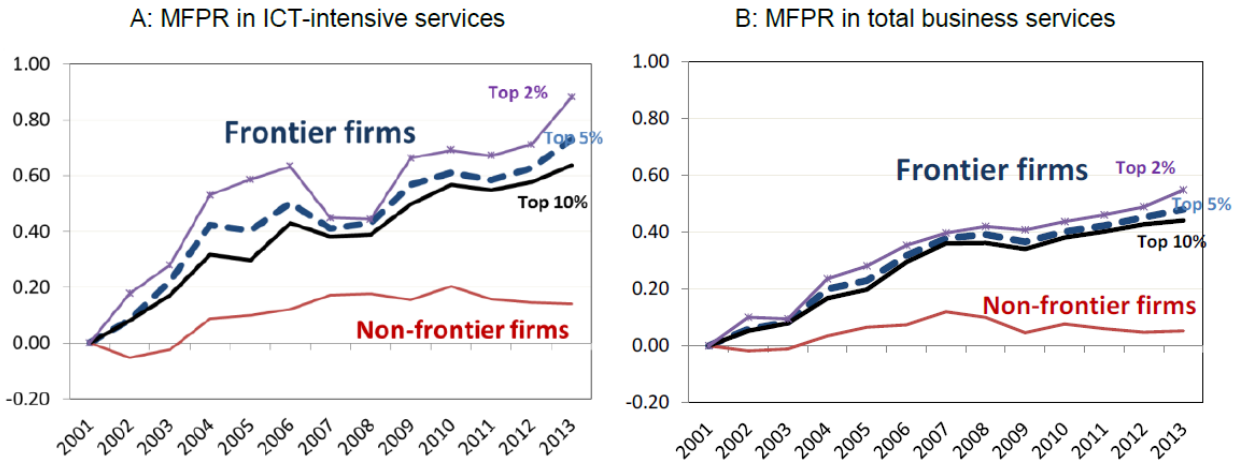
Source: R&F Department calculations based on RUSLANA database.

Figure 43. Accumulated average TFP growth by deciles[31] (efficiency-based)



Source: R&F Department calculations based on RUSLANA database.

Figure 44. TFP growth in OECD countries



Source: Andrews et al. (2016)

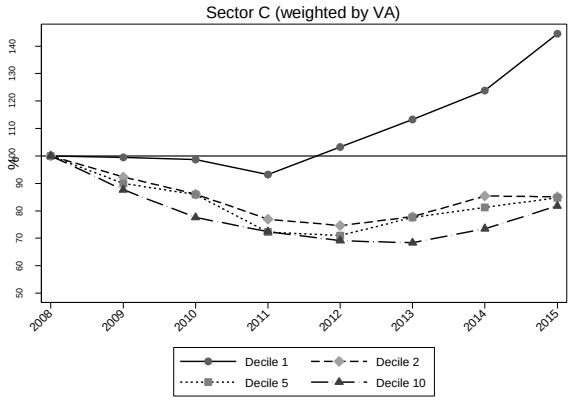
The accumulated weighted average TFP growth performance is similar to that of the most efficient firms' accumulated growth. At the same time, average (nonweighted) accumulated TFP growth rates are closer to those of laggards. This suggests that the most efficient firms expand their output, increasing their market share with time. The least efficient firms shrink in size but, contrary to the logic of "creative destruction", do not exit the market, nor do they restructure. This brings down average TFP growth rates in the economy and freezes production factors at inefficient firms. At the same time, in some sectors, the TFP performance of the leaders' group and the catching-up firms (the second decile) may be different from that of the economy as a whole. Where an individual industry shows TFP growth, it is clearly seen in the most efficient firms group. Meanwhile, the catching-up group may show an entirely different performance: lagging, stagnation, or catching-up development (Figure 45, Figure 46). The initial efficiency gap between the

[31] Decile 1 includes the most efficient enterprises. Decile 10 includes the least efficient enterprises.

leaders and all other firms is extremely wide, so even if we see the catching-up TFP growth in the second decile, it will not necessarily bring these firms to the leaders' level of efficiency in the near future.

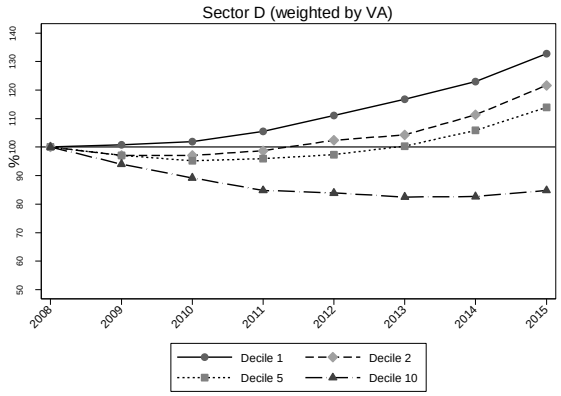
In the extractive sector, the gap in the TFP performance between the leaders and other firms is the widest for all economic activity types (Figure 45). Therefore, high TFP growth rates of the most efficient firms do not have a significant effect on this sector's average TFP growth. In the manufacturing sector (Figure 46), the number of enterprises showing TFP growth is much larger and the gap in the growth rates between the leaders and deciles from two to five is relatively narrow. Meanwhile, in the laggards group, the accumulated TFP growth performance does not point to a mass exit of inefficient companies from industry markets or their restructuring either during the 2008-2009 crisis or in the post-crisis period.

Figure 45. TFP dynamics by deciles in mining and quarrying



Source: R&F Department calculations based on RUSLANA database.

Figure 46. TFP dynamics by deciles in manufacturing



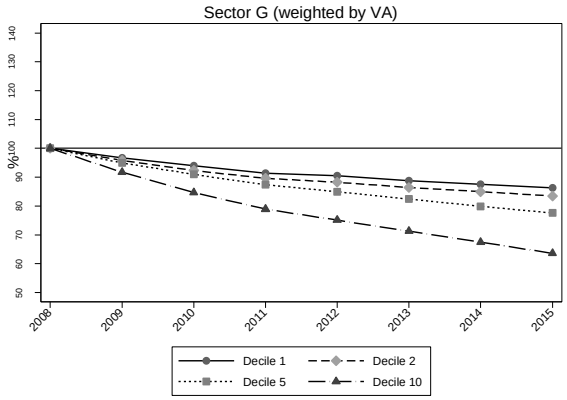
Source: R&F Department calculations based on RUSLANA database.

In the services sector, TFP growth pattern in the most efficient firms and laggards is different from that in the industrial sector (Figure 47 and Figure 48). On the one hand, in the services sector, laggard firms show a substantial TFP drop comparable to that in the industrial sector. On the other hand, the most efficient firms of the services sector do not post TFP growth, which is, by contrast, clearly pronounced in industry. The productivity of the most efficient firms drops dramatically after 2008 and either stagnates (at 90–95% of the pre-crisis level) or keeps declining over the whole period concerned. Therefore, the accumulated gap between the TFP levels of services sector firms in 2008–2015 emerges due to the post-crisis productivity drop in laggard firms rather than due to the most efficient companies' growth.

The leaders' stagnating growth rates in the services sector and steady growth in industry may be owed to the production function specification and the specifics the estimation period that includes two occurrences of turbulence: in 2008–2009 and 2014–2015. Ruble depreciation at the end of the period in question brought about a change in relative prices in favour of the economy's tradable sectors (industry) and situation

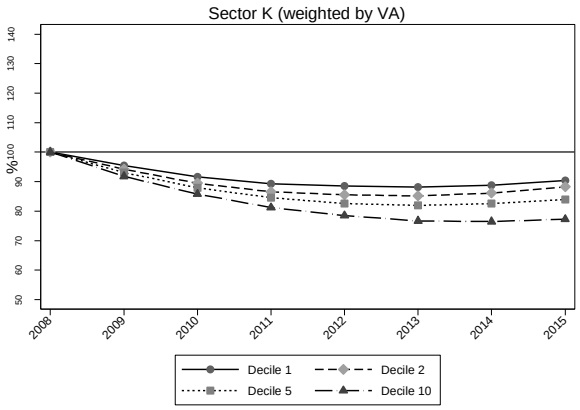
worsening in the non-tradable ones (services). Firms fail to promptly react to substantial changes in price conditions, especially with regard to their capital stock. For this reason, the last two years in the sample can be nonrepresentative in terms of the productivity performance in both the services sector and industry.

Figure 47. TFP dynamics by deciles in wholesale and retail trade



Source: R&F Department calculations based on RUSLANA database.

Figure 48. TFP dynamics by deciles in real estate operations, leasing and service provision



Source: R&F Department calculations based on RUSLANA database.

Therefore, our analysis shows that the productivity growth only occurred thanks to a small group of the most efficient firms. Less efficient companies did not adopt the experience of the leaders, and, as a result, the average TFP growth in both the economy as a whole and individual industries was slow. Although inefficient companies lose their market share to their more efficient competitors, a large proportion of them prefer to stay in the market and do not innovate. This keeps production factors (labour, capital) in small inefficient firms constraining industry-wide productivity growth.

In order to address the goal of accelerating TFP productivity growth, it is necessary to concentrate on creating conditions for inefficient companies' prompter exit from the market or their restructuring. Measures to achieve this may include simplification of the bankruptcy procedure, shifting the accent of government support from troubled to growing enterprises (e.g., through proactive export support), developing programmes for retraining or reemployment of personnel leaving such inefficient companies. To boost competition in the existing markets it is necessary to lower administrative barriers to new companies' entry to the markets and for the expansion of efficient small and medium-sized enterprises, and create conditions for promoting foreign direct investments. Cost cutting is one way of improving efficiency and productivity. It is therefore important that the government take over a part of this work by removing many unjustified regulatory and administrative barriers that cost Russian companies so dearly.

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