# MONITORING OF RUSSIA'S ECONOMIC OUTLOOK:

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

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# MAIN TRENDS AND CONCLUSIONS

## V.Gurevich

After the unexpected outcome of the recent round of talks between the OPEC members in Algeria, the market was left with the slim hope that the soap opera titled 'Finally Getting an Oil Production Freeze Deal' was approaching a constructive ending. For the first time in eight years, it was announced that the oil cartel members were prepared for an oil production freeze, or even for a crude output cut. The actually proposed reduction rate is, however, meager enough – by 0.5–0.7m barrels per day (fires in Canada or blasts in Nigeria removed much bigger quantities of crude oil from the market). However, what is most important for brokers and traders, this would-be deal is a symbol of the OPEC's negotiability. After all, the market loves to trade in symbols.

Their negotiability will be able to translate into an actual deal only at their new meeting on the last day of autumn, where the oil production quotas are to be set. And should the new quotas indeed be determined for a period of as yet unknown duration, we will be given opportunities to make our judgment concerning the level of their artistic performance when oil producers begin to accuse one another of exceeding their quotas, while Saudi Arabia, having assumed the oil output reduction burden, begins to move its now idle production capacities (the world's biggest) into various directions. Russia, while being left with a free choice of either joining or to separating itself from the deal, has already announced that it will make no cuts, and that a production freeze, if any, can only be possible at the level of its record high output rate that tops 11m barrels. Even more importantly, several hundred shale producers from Texas and North Dakota, who are the principal market disturbers on the supply side, were absent from the negotiating table. So, the most likely scenario is that under which the per barrel price of oil, in response to every news coming from the market, will be moving up or down by $3–5, for an indefinitely short time.

Russia is currently trying to provide an affirmative answer to the question as to whether there is 'life after oil' (at $ 100). Although any answer can be obtained only at the price of some sacrifice, indeed not anything can be sacrificed – at least under the present circumstances.

The resort fee and the higher oil extraction levy seem to be the only items that Russia's head of state had agreed to pick from the versatile 'tax menu' offered to him prior to the presidential election. However, so far nobody can be certain even about this. Instead, it became obvious that the RF Ministry of Finance's fiscal initiatives – which could be described as deliberate and ruthless – were visibly transforming into an irreversible, tsunami-like wave. However, the 'tax wave' had receded just before it hit the shore. Nevertheless, it should be borne in mind that there still exists an infinite variety of taxes, excises, duties, levies, tariffs, fees (and even fines) – both in lexical and fiscal terms.

Without going into too much (as yet unknown) detail, we may, nevertheless, conclude as follows: if the decision to leave the existing taxes intact for the next two or so years is final, and the desire 'not to eat up' the reserve funds is strong, then continual expenditure cuts must go hand in hand with significantly increased borrowing.

Understandably, in view of the current situation, foreign loans are going to be on a much more modest scale than those made on the domestic market. Nevertheless, the recent decision to top up Russia's sovereign Eurobond issue (to the modest value of $ 1.25bn) appeared to be a comfortable solution in conditions of high demand and low yield (actually lower than that of the previous issue). The fact that Russia could rely on Euroclear servicing has also played its role. This positive trend also involves the recent decision, made by S&P, to upgrade Russia's rating; however, the market is unlikely to be seriously affected by this, because it currently treats Russian securities as those with investment grade credit rating – that is, higher than the rating agencies do. Still, the RF Ministry of Finance is not going to walk too deep into the unexpectedly warm water, as this country's forex revenue is unlikely to begin to grow – something that cannot be said about geopolitical risks.

By way of expanding on the water metaphor, we may say that the domestic body of water is shallower and colder, and the loans offered there are more expensive. But it is our own body of water, and so the state is more willing to enter it and to expand its activities. Of course, it is not going to replace private lenders, but this is not the biggest risk – what indeed is risky is whether the state can become aware of the limitations to its activity before it is too late, and whether it will be able to stop in time. At present, the plans of the RF Ministry of Finance for the next two or three years appear to be impressive, but not overwhelmingly so. Meanwhile, the future buyers of government bonds will be offered a handsome security – something that can hardly be refused by any potential creditor, even the Bank of Russia.

Our experts have prepared a forecast of how the macroeconomic situation in Russia is going to develop over the next two-to-three-year period. According to their estimates, in mid-2016 the economy is to pass the lowest point of the crisis, and then in 2017–2018 almost every main development index will begin to display growth, and this will happen even if the external situation remains disadvantageous. The forecast is geared to two scenarios: a basic (or conservative) and a favorable one. The difference between the two depends, quite naturally, on the price of Urals. The first scenario is 'conservative' because over the entire three-year period (2016–2018) the oil price index is not expected to rise above $ 40; and the second one is 'favorable' because it is oriented to the average annual price being $ 42 in 2016, $ 50 in 2017, and $ 60 in 2018. At the same time, both scenarios envisage that the economic sanctions against Russia and Russia's retaliatory sanctions will not be abolished.

If the year-end GDP index for 2016 is expected to decline by 0.7–0.8%, in 2017 it is expected to display growth by 0.5–0,9%, and in 2018 – by 1.5–1.9%. The inflation target somewhat deviates from the RF Central Bank's year-end target for 2017 (4%): in 2016 it is expected to amount to 6.3%, in 2017 (depending on the scenario) – to 5.3–5.7%, and in 2018 – to 4.8–5.1%, in response to the predicted demand growth.

The forecast's authors believe that both scenarios are indicative of a sufficiently successful adaptation of the economy to the existing shocks. A reversal of the downward movement within only two years (2015–2016) in face of a persistently unfavorable external situation and the world economy's unstable growth appears to be a good result. So, they predict that the Russian economy may enter a new growth trajectory with an annual growth rate of up to 3–4%. However, for this scenario to become a reality, it will be necessary to improve the business climate, implement structural reform, bring down the inflation rate, and achieve stabilization in the budgetary system.

If we choose to speak of a consistently declining inflation, the Bank of Russia appears to be quite consistent in setting its key rate. Its September plunge by 0.5 pp. to 10% was accompanied by a rather tough comment on the part of the Bank of Russia that any further monetary policy easing could be possible no earlier than Q1–Q2 2017. In view of the fact that both the inflation index and inflation expectations are declining faster than predicted, such an approach has inevitably caused criticism. Nevertheless, our experts think that the Bank of Russia's decision was motivated by the necessity to strengthen the downward movement of the inflation rate.

On one hand, they consider the inflation acceleration risks associated with the forex market's behavior to be low. On the other, the possibility of new external shocks cannot be ruled out, which is also true of the revival of consumer demand with its upward pressure on prices. Another risk factor is the accelerated growth rate of M2 (in response to spending the Reserve Fund and reviving lending activity). While over the period of January–July 2015 that index never rose above 6%, over the same period of this year its growth rate was almost twice as high. Overall, according to our experts, the Bank of Russia will have to achieve the tricky goal of properly balancing its inflation target against its suppressive effect on the economic activity.

As far as the banking system regulation is concerned, the Bank of Russia is also forced to maintain some sort of tricky balance. On one hand, it has to deal with the (current) surplus liquidity, while on the other maintain a proper capital adequacy ratio, asset quality, and financial result across the system – that is, its performance and viability.

As noted by our experts, by the end of summer 2016, the volume of bad assets in the banking system had continued to be on the rise, albeit at a much slower pace. For this reason, banks cut their deductions to reserves against potential losses. As a result, their profits over January–August 2016 rose to Rb 532bn, or sevenfold on the same period of last year.

So, what exactly the movement pattern of bad debt is like? By the beginning of autumn, outstanding consumer debt had increased by Rb 66bn, while its growth over the same period of last year was much more impressive – by Rb 208bn. As a result, the share of outstanding consumer debt currently amounts to 9%. In the corporate sector, bad debt rose by Rb 141bn (vs. its last year's index of Rb 514bn), while its share in overall corporate debt is 6.6%. Meanwhile, asset quality varies broadly between different groups of banks (big state-owned banks; foreign banks; big private banks; small banks; and medium-sized banks). The best credit portfolio quality (with the least share of outstanding debt) is displayed by Sberbank.

On the whole, however, experts believe that the bad debt issue has remained unresolved. During the previous crisis (in 2008–2010), no systemic measures were implemented in order to deal with it. So, until the economy begins to display sustainable growth (without which no lending and bank asset growth can be possible), bad debt will continue to be a serious burden for banks and an obstacle to their development.

# 1. REVERSING THE SLUMP. MACROECONOMIC FORECAST FOR 2016–2018

**V.Averkiev, S.Drobyshevsky, M.Turuntseva, M.Khromov**

*According to our forecast, the period 2017–2018 will see renewed growth of practically every main socioeconomic activity index, even under the scenario geared to a persistently unfavorable external situation. The economy will be able to show only weak growth at a rate of 2% в per annum. Inflationary and budgetary risks will persist. Sustainable growth can only be achievable if a consistent and predictable economic policy is implemented in order to improve the domestic business and investment climate, carry on structural reform, and eliminate the macroeconomic destabilization risks.*

As shown by the period-end results for Q2 2016, a significant number of socioeconomic indices were still displaying a negative movement pattern by comparison with Q2 2015; nevertheless, their rates of decline had become slower.

**The lowest point has been passed**

In Q2 2016, the rate of GDP decline amounted to 0.6% (relative to Q2 2015); investment in fixed assets dropped by 3.9%, retail turnover – by 5.6%. Meanwhile, the industrial production index (IPI) increased by 1.0% on the same period of 2015. The agricultural sector continued to display growth (at a rate of 2.5%, as a year earlier); besides, since early 2016, freight turnover had also increased (+1.0% in Q2).

The volume of foreign trade continued to slide. Thus, in Q2 2016, exports and imports in US dollar terms dropped by 23.5% and 9.8% respectively on Q2 2015.

Over the course of Q2 2016, the consumer price index was moving slightly above its last year's level – it increased by 1.2% (vs. by 1% in Q2 2015). Correspondingly, in Q2, the average interest rate on ruble-denominated loans stood at 12.9% per annum in nominal terms, or 5.1% in real terms. The monetary base over that quarter slightly contracted to Rb 10.8 trillion, while ruble money supply (M2) increased to Rb 36.5 trillion due to an increase of the money multiplier from 3.2 to 3.4.

In Q2 2016 , the average nominal ruble-to-USD exchange rate stood at Rb 65.9, thus having gained 11.7%. The real effective exchange rate of the ruble over Q2 2016 gained 11.3% on Q1 2016.

So, the movement patterns displayed over the course of Q2 by the major macroeconomic indicators confirmed our prediction[1] that in mid-2016, the Russian economy would pass through the lowest point of the current crisis (if no new negative shocks occurred in the nearest future). At the same time, at present there are no indications that a sustainable growth trajectory may indeed establish itself, and low economic activity can be expected to persist at least for the next few months.

1 *V. Averkiev, S. Drobyshevsky, M. Turuntseva, M. Khromov.* Macroeconomic Forecast for 2016–2018: The Economy is Passing Through the Lowest Point of the Current Crisis. Russian Economic Developments, 2016, No. 7, pp. 3–9.

**Two scenarios**

When assessing the development prospects for the Russian economy over the period until 2018, we considered two possible scenarios. We expect that under each of these scenarios, the year-end results of 2016 will indivate a further shrinkage of the Russian economy and a decline in the major macroeconomic indicators in real terms. Later on, in 2017–2018, the Russian economy can be expected to gain a positive growth rate, even if the external situation should follow the conservative pattern of development. Besides, both scenarios rule out the possibility that the economic and financial sanctions introduced against Russia and Russia's retaliatory sanctions against the USA and the EU can be abolished before 2018.

Under the basic scenario, it is expected that, in 2016–2018, the average annual price of Urals crude oil will amount to $40 per barrel[1]. At that price level, it would be unrealistic to hope that the Russian economy may indeed face a significant improvement of its foreign trade conditions.

Under the second (optimistic) scenario it is expected that, by the end of 2016, the price of Urals crude oil will amount to $42 per barrel, and then it will further rise to $50 per barrel in 2017 and to $60 per barrel in 2018. The average nominal ruble-to-USD exchange rate under the basic scenario will be Rb 67.5 in 2016, Rb 65.3 in 2017, and Rb 64.9 in 2018. Under the optimistic scenario, the average nominal ruble-to-USD exchange rate over the period 2016–2018 will amount to Rb 67.1, Rb 60.8, and Rb 57.3 respectively. Thus, the real effective exchange rate of the ruble in 2016 will increase by 7.2% under the basic scenario, and by 8.7% under the optimistic one. Thereafter it will continue to be on the rise under both scenarios: at an approximate rate of 3.5% per annum under the basic scenario, and by 7% per annum under the optimistic one.

We expect that the year-end results of 2016 will demonstrate a plunge of GDP by 0.7–0.8% in real terms. In 2017, the decline will give way to growth of 0.5% to 0.9%, and in 2018 – 1.5% to 1.9%.

The movement pattern of the industrial production index will give more reason for optimism, and this will be made evident already by the year-end results of 2016 – its decline will halt (100% on 2015). We expect that in 2017 and 2018, the IPI will display growth by 1.1% and 1.8% respectively under the basic scenario, and by 1.4% and 2.0% respectively under the optimistic one.

Similar behavior patterns will also be displayed by the other economic activity indicators. In 2016, investment in fixed assets will drop in real terms by 2.2–2.3%, retail turnover by 4.9–5%, and real disposable income by 3.8–3.9%. For 2017, it is forecasted that retail turnover will follow a rickety trajectory (somewhere between 0.3% and +0.1%), alongside growth of investment (by 1.5–1.7%) and real disposable income (by 0.6–0.8%). In 2018, growth will be demonstrated by all these indicators: investment will increase by 0.6–0.8%, retail turnover by 0.9–1.4%, and real disposable money income by 1.9–2.4%.

Inflation (measured as CPI) in 2016 (vs. 2017/2018) will amount to 6.3% (vs. 5.7%/5.1%) respectively under the basic scenario, and to 5.9% (5.3%/4.8%) under the optimistic one. Over the period 2017/2018, the growth rate of CPI will continue to slide under the two scenarios: to 5.3–5.7% and to 4.8–5.1% respectively. So, according to our estimates, by 2017 inflation may remain at

1 We treat this scenario as a basic one, for a possible comparison with the forecast worked out by the RF Government.

a level approximately 1 pp. above the RF Central Bank's inflation target due to eased constraints on the demand-side.

Under the basic scenario, the forecasted exports of goods will amount, in 2016, to $271.9bn, and imports to $184.8bn; thereafter, in 2017 (2018), these two indicators will display some growth – to $281.7bn ($288.1bn) and $205.1bn ($216.9bn) respectively. Under the optimistic scenario, exports and imports will demonstrate a somewhat similar movement pattern: $276.9bn and $185.7bn in 2016, followed by more robust growth to $313.7bn ($350.5bn) in 2017 and to $216.4bn ($244.8bn) in 2018 respectively. Thus, a positive current account balance will be observed throughout the entire three-year period under both scenarios.

The existence of factors like persisting inflation risks (CPI above its target value), federal budget deficit and a slow financial recovery pace reported by businesses may confirm our assumption that interest rates will remain rather high. Thus, in particular, the RF Central Bank will follow a cautious approach to its policy of reducing the key rate. Under the basic scenario, the nominal interest rate on the ruble-denominated loans is forecasted to be at an average level of 12.2% per annum in 2016 (vs. the real interest rate of 4.9% per annum); 10.5% per annum in 2017 (vs. the real interest rate of 4.3% per annum); and 9.5% per annum in 2018 (vs. the real interest rate of 4% per annum). Under the optimistic scenario, the nominal interest rate in 2016, 2017 and 2018 will be at 12.1%, 10.2% and 9.1% per annum respectively (vs. the real interest rate of 4.9%, 4.5% and 4% per annum respectively).

Nevertheless, as can be seen from the estimates cited above, nominal interest rates in 2018 will plunge to their level typical of the period 2011–2012 (approx. 9.0% per annum), when the lending sector was recovering after the 2008–2009 crisis. However, due to the declining inflation in real terms, the interest rates will remain at their current high level.

The Bank of Russia's tough monetary policy, the low demand for bank loans in the real sector and a slow recovery of real disposable personal income will translate into a moderate growth of money aggregates. Thus, in particular, the monetary base's growth rate will amount to 10.2–10.9% in 2016, to approximately 6.6% in 2017, and to approximately 6.0% in 2018. Money supply (M2) will increase by 7.6–8.2% in 2016, by approximately 9% in 2017, and by approximately 11% in 2018. The main source of money supply growth in 2016, similarly to 2015, will remain the Reserve Fund. In 2017–2018, as it is spent up, we expect that the Bank of Russia will again start to refinance the banking sector at an increasing rate by conducting operations in the secondary market for government securities, thus covering budget deficit by way of domestic borrowing.

**Adaptation to external conditions and economic growth**

Overall, both scenario point to the economy's successful adaptation to the shocks produced by plunging oil prices, economic sanctions and the cyclical decline trend. The reversal of the downward trend within a two-year period (2015–2016) in face of a continually unfavorable external situation (under the basic scenario) and the global economy's slow growth at an unstable rate appears to be a good result. Judging by these developments, we may assume that the Russian economy may indeed enter a new growth trajectory at an annual rate of up to 3–4%. However, for such a scenario to become reality, it will be necessary to improve the business climate, implement structural reform, consistently reduce inflation and achieve stabilization in the budgetary system.

*Table*

MAIN SOCIOECONOMIC DEVELOPMENT PROJECTIONS

| Basic scenario | 2016 | | | | | 2017 | | | | | 2018 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Year-end | Q1 | Q2 | Q3 | Q4 | Year-end | Year-end |
| | actual | actual | estimated | forecasted | forecasted | forecasted | forecasted | forecasted | forecasted | forecasted | forecasted |
| **Urals, USD per barrel** | **32.6** | **44.4** | **44.0** | **39.0** | **40.0** | **40.0** | **40.0** | **40.0** | **40.0** | **40.0** | **40.0** |
| **GDP** | | | | | | | | | | | |
| bn Rb | 18 561 | 19 832 | 22 370 | 23 384 | 84 147 | 19 491 | 21 260 | 23 649 | 24 784 | 89 184 | 94 094 |
| physical volume index, as % of corresponding period of previous year | 98.8 | 99.4 | 99.2 | 99.3 | 99.2 | 99.9 | 101.2 | 100.5 | 100.4 | 100.5 | 101.5 |
| deflator | 103.1 | 104.8 | 105.9 | 106.9 | 105.0 | 105.1 | 105.9 | 105.2 | 105.6 | 105.4 | 104.0 |
| **Industrial production index** | | | | | | | | | | | |
| as % of corresponding period of previous year | 99.4 | 101.0 | 100.0 | 99.4 | 100.0 | 100.4 | 102.5 | 100.7 | 100.7 | 101.1 | 101.8 |
| **Investment in fixed assets** | | | | | | | | | | | |
| physical volume index | 95.2 | 96.1 | 99.5 | 99.8 | 97.7 | 100.9 | 102.2 | 102.1 | 100.8 | 101.5 | 101.6 |
| **Retail turnover** | | | | | | | | | | | |
| as % of corresponding period of previous year | 94.2 | 94.4 | 95.4 | 96.0 | 95.0 | 98.7 | 99.5 | 100.0 | 100.5 | 99.7 | 100.9 |
| **Real disposable money income** | | | | | | | | | | | |
| as % of corresponding period of previous year | 96.3 | 94.0 | 96.2 | 98.0 | 96.1 | 99.1 | 100.3 | 101.0 | 101.9 | 100.6 | 101.9 |
| **Exports** | | | | | | | | | | | |
| bn USD | 68.8 | 79.9 | 82.1 | 85.7 | 316.5 | 75.3 | 80.8 | 80.7 | 85.1 | 321.9 | 327.2 |
| Including | | | | | | | | | | | |
| Exports of goods | 59.3 | 67.2 | 70.6 | 74.8 | 271.9 | 66.6 | 70.2 | 69.9 | 74.9 | 281.7 | 288.1 |
| oil and gas exports | 31.5 | 36.3 | 36.8 | 36.6 | 141.2 | 34.3 | 33.6 | 32.4 | 34.6 | 134.9 | 130.8 |
| other exports | 27.8 | 30.9 | 33.8 | 38.2 | 130.8 | 32.3 | 36.7 | 37.5 | 40.3 | 146.8 | 157.3 |
| Exports of services | 9.5 | 12.7 | 11.5 | 10.9 | 44.6 | 8.7 | 10.6 | 10.8 | 10.2 | 40.3 | 39.1 |
| **Imports** | | | | | | | | | | | |
| bn USD | 52.1 | 63.3 | 71.9 | 72.3 | 259.6 | 59.8 | 66.6 | 75.2 | 77.2 | 278.9 | 292.4 |
| Including | | | | | | | | | | | |
| Imports of goods | 37.8 | 45.5 | 49.5 | 51.9 | 184.8 | 44.8 | 49.0 | 54.4 | 56.9 | 205.1 | 216.9 |
| Imports of services | 14.3 | 17.8 | 22.4 | 20.4 | 74.8 | 15.0 | 17.6 | 20.9 | 20.3 | 73.8 | 75.5 |

| Basic scenario | 2016 | | | | | 2017 | | | | | 2018 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Year-end | Q1 | Q2 | Q3 | Q4 | Year-end | Year-end |
| | actual | actual | estimated | forecasted | forecasted | forecasted | forecasted | forecasted | forecasted | forecasted | forecasted |
| **CPI** | | | | | | | | | | | |
| as % of previous period | 102.1 | 101.2 | 101.1 | 101.8 | 106.3 | 101.9 | 101.1 | 101.1 | 101.6 | 105.7 | 105.1 |
| **Average interest rate on ruble-denominated loans over given period, as % per annum** | | | | | | | | | | | |
| real | 5.7 | 5.1 | 4.3 | 4.4 | 4.9 | 4.3 | 4.5 | 4.1 | 4.4 | 4.3 | 4.0 |
| nominal | 13.3 | 12.9 | 11.4 | 11.0 | 12.2 | 10.7 | 10.7 | 10.2 | 10.3 | 10.5 | 9.5 |
| **Ruble-to-USD exchange rate** | | | | | | | | | | | |
| average nominal, for period | 74.6 | 65.9 | 64.6 | 65.0 | 67.5 | 65.5 | 65.3 | 65.1 | 65.4 | 65.3 | 64.9 |
| **Ruble's real effective exchange rate** | | | | | | | | | | | |
| period-end value, as % of previous period-end value | -8.3 | 11.3 | 3.1 | 1.9 | 7.2 | 0.7 | 0.9 | 0.8 | 0.8 | 3.3 | 3.7 |
| **Money base** | | | | | | | | | | | |
| trillion Rb | 11.0 | 10.8 | 10.9 | 12.2 | 12.2 | 11.5 | 11.6 | 11.7 | 13.0 | 13.0 | 13.9 |
| **Money supply (M2)** | | | | | | | | | | | |
| period-end value, trillion Rb | 35.4 | 36.5 | 36.6 | 38.5 | 38.5 | 38.9 | 38.7 | 39.5 | 42.2 | 42.2 | 47.2 |
| growth, as % of previous period | -1.0 | 3.0 | 0.4 | 5.2 | 7.6 | 0.8 | -0.5 | 2.0 | 6.9 | 9.4 | 11.9 |
| **Industrial production index** | | | | | | | | | | | |
| as % of corresponding period of previous year | 99.4 | 101.0 | 100.0 | 99.4 | 100.0 | 100.4 | 102.5 | 100.7 | 100.7 | 101.1 | 101.8 |
| **Unemployment** | | | | | | | | | | | |
| % of total labor force | 5.9 | 5.7 | 5.2 | 5.6 | 5.6 | 5.7 | 5.2 | 4.8 | 5.2 | 5.2 | 4.8 |

| **Optimistic scenario** | 2016 | | | | | 2017 | | | | | 2018 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Year-end | Q1 | Q2 | Q3 | Q4 | Year-end | Year-end |
| | actual | actual | estimated | forecasted | forecasted | forecasted | forecasted | forecasted | forecasted | forecasted | forecasted |
| **Urals, USD per barrel** | **32.6** | **44.4** | **44.0** | **47.0** | **42.0** | **50.0** | **50.0** | **50.0** | **50.0** | **50.0** | **60.0** |
| **GDP** | | | | | | | | | | | |
| bn Rb | 18 561 | 19 832 | 22 370 | 23 650 | 84 413 | 19 663 | 21 358 | 23 766 | 24 765 | 89 552 | 95 695 |
| physical volume index, as % of corresponding period of previous year | 98.8 | 99.4 | 99.2 | 99.6 | 99.3 | 100.4 | 101.9 | 100.7 | 100.6 | 100.9 | 101.9 |

| Optimistic scenario | 2016 | | | | | 2017 | | | | | 2018 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Year-end | Q1 | Q2 | Q3 | Q4 | Year-end | Year-end |
| | actual | actual | estimated | forecasted | forecasted | forecasted | forecasted | forecasted | forecasted | forecasted | forecasted |
| deflator | 103.1 | 104.5 | 105.9 | 107.9 | 105.2 | 105.5 | 105.6 | 105.5 | 104.1 | 105.2 | 104.9 |
| **Industrial production index** | | | | | | | | | | | |
| as % of corresponding period of previous year | 99.4 | 1010 | 100.0 | 99.6 | 100.0 | 100.8 | 103.5 | 100.7 | 100.8 | 101.4 | 102.0 |
| **Investment in fixed assets** | | | | | | | | | | | |
| physical volume index | 95.2 | 96.1 | 99.5 | 100.0 | 97.8 | 101.2 | 102.3 | 102.3 | 101.2 | 101.7 | 102.3 |
| **Retail turnover** | | | | | | | | | | | |
| as % of corresponding period of previous year | 94.2 | 94.4 | 95.4 | 96.5 | 95.1 | 99.0 | 100.0 | 100.5 | 100.9 | 100.1 | 101.4 |
| **Real disposable money income** | | | | | | | | | | | |
| as % of corresponding period of previous year | 96.3 | 94.0 | 96.2 | 98.3 | 96.2 | 99.5 | 100.5 | 101.2 | 102.0 | 100.8 | 102.4 |
| **Exports** | | | | | | | | | | | |
| bn USD | 68.8 | 79.9 | 82.1 | 91.0 | 321.8 | 83.6 | 89.6 | 89.7 | 93.7 | 356.6 | 395.4 |
| Including | | | | | | | | | | | |
| Exports of goods | 59.3 | 67.2 | 70.6 | 79.8 | 276.9 | 74.3 | 78.4 | 78.3 | 82.8 | 313.7 | 350.5 |
| oil and gas exports | 31.5 | 36.3 | 36.8 | 41.6 | 146.2 | 42.0 | 41.7 | 40.7 | 42.4 | 166.8 | 192.9 |
| other exports | 27.8 | 30.9 | 33.8 | 38.2 | 130.8 | 32.3 | 36.7 | 37.5 | 40.4 | 146.9 | 157.6 |
| Exports of services | 9.5 | 12.7 | 11.5 | 11.2 | 44.9 | 9.3 | 11.2 | 11.5 | 11.0 | 42.9 | 44.9 |
| **Imports** | | | | | | | | | | | |
| bn USD | 52.1 | 63.3 | 71.9 | 73.4 | 260.7 | 61.4 | 69.2 | 79.5 | 82.3 | 292.4 | 326.6 |
| Including | | | | | | | | | | | |
| Imports of goods | 37.8 | 45.5 | 49.5 | 52.9 | 185.7 | 46.2 | 51.2 | 58.0 | 61.1 | 216.4 | 244.8 |
| Imports of services | 14.3 | 17.8 | 22.4 | 20.6 | 75.0 | 15.2 | 18.1 | 21.5 | 21.2 | 76.0 | 81.8 |
| **CPI** | | | | | | | | | | | |
| as % of previous period | 102.1 | 101.2 | 101.1 | 101.4 | 105.9 | 101.8 | 101.2 | 101.1 | 101.1 | 105.3 | 104.8 |
| **Average interest rate on ruble-denominated loans over given period, as % per annum** | | | | | | | | | | | |
| real | 5.7 | 5.1 | 4.3 | 4.6 | 4.9 | 4.9 | 4.7 | 4.0 | 4.3 | 4.5 | 4.0 |
| nominal | 13.3 | 12.9 | 11.4 | 10.8 | 12.1 | 10.7 | 10.6 | 9.9 | 9.8 | 10.2 | 9.1 |

| Optimistic scenario | 2016 | | | | | 2017 | | | | | 2018 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Year-end | Q1 | Q2 | Q3 | Q4 | Year-end | Year-end |
| | actual | actual | estimated | forecasted | forecasted | forecasted | forecasted | forecasted | forecasted | forecasted | forecasted |
| **Ruble-to-USD exchange rate** | | | | | | | | | | | |
| average nominal, for period | 74.6 | 65.9 | 64.6 | 63.3 | 67.1 | 61.6 | 60.8 | 60.3 | 60.5 | 60.8 | 57.3 |
| **Ruble's real effective exchange rate** | | | | | | | | | | | |
| period-end value, as % of previous period-end value | -8.3 | 11.3 | 3.1 | 3.3 | 8.7 | 3.0 | 1.8 | 1.2 | 0.5 | 6.6 | 7.6 |
| **Money base** | | | | | | | | | | | |
| trillion Rb | 11.0 | 10.8 | 10.9 | 12.2 | 12.2 | 11.5 | 11.6 | 11.7 | 13.0 | 13.0 | 13.9 |
| **Money supply (M2)** | | | | | | | | | | | |
| period-end value, trillion Rb | 35.4 | 36.5 | 36.6 | 38.8 | 38.8 | 39.0 | 38.8 | 39.4 | 42.2 | 42.2 | 46.7 |
| growth, as % of previous period | -1.0 | 3.0 | 0.4 | 5.7 | 8.2 | 0.6 | -0.5 | 1.7 | 6.9 | 8.9 | 10.7 |
| **IPI** | | | | | | | | | | | |
| as % of corresponding period of previous year | 99.4 | 101.0 | 100.0 | 99.6 | 100.0 | 100.8 | 103.5 | 100.7 | 100.8 | 101.4 | 102.0 |
| **Unemployment** | | | | | | | | | | | |
| % of total labor force | 5.9 | 5.7 | 5.2 | 5.5 | 5.6 | 5.6 | 5.1 | 4.8 | 5.2 | 5.1 | 4.7 |

# 2. RATES, RISKS AND M2: FACTORS AFFECTING THE RATE OF INFLATION

**A. Bozhechkova, P. Trunin**

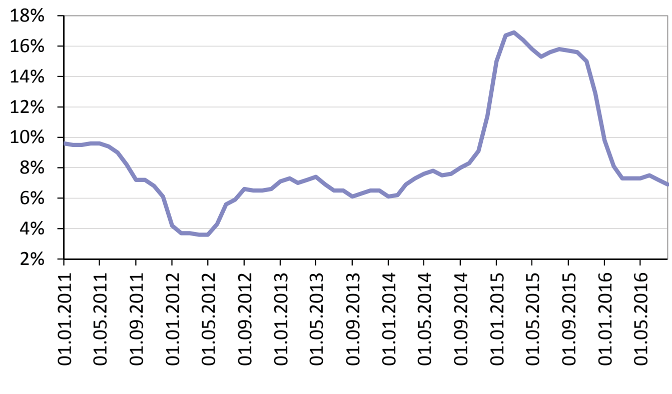
*In September, the Central Bank of Russia made a decision to cut the key rate by 0.5 p.p. to 10%. The intention of the Central Bank of Russia to stick to a moderately tough monetary policy is justified by the need to consolidate the trend towards sustained reduction of the rate of inflation.*

Taking into account the continued slowdown of the rate of inflation, reduction of economic agents' inflationary expectations, as well as the ongoing stagnation, in September the Central Bank of Russia cut the key rate by 0.5% to 10%. In August and early in September 2016 consumer prices remained on average unchanged. It is to be noted that in the past 12 months the accumulated inflation indicator fell from 7.2% in July to 6.9% in August which value is equal to the level of March 2014 (*Fig. 1)*. Slowdown of the rate of inflation was contributed to by a seasonal factor, low aggregate demand, as well as appreciation of the ruble.

Also, in August the level of households' inflationary expectations decreased considerably. According to the estimates published by the Central Bank of Russia, the median value of the expected rate of inflation for a year ahead fell by 1.7 p.p. and amounted to 12.6%, which is the minimum value of that indicator since October 2014.

In August, the core inflation[1] amounted to 0.4%, having increased by 0.1 p.p. as compared to the previous period. It is to be noted that within that month it exceeded by 0.4 p.p. the rate of growth of the consumer price index which means that upward pressure on prices was put on by factors which are mainly of administrative and seasonal nature.

In August, consumer goods depreciated by 0.6%, mainly, due to a seasonal reduction of prices on fruit and vegetable products. On the contrary, growth rates of prices on non-food products increased to 0.4%. As a result, the contribution of the group of non-food products to the dynamics of the consumer price index (CPI) tuned out to be the highest one as compared to that of other components and amounted to 45.1%. In August, prices and tariffs on paid services to households rose by 0.4%. The highest contribution into appreciation of services in August was made by seasonal growth – which took place despite appreciation of the ruble – in prices on foreign tourism services.




*Source*: The Rosstat.

*Fig. 1. Growth rates of CPI in 2011–2016, % a year*

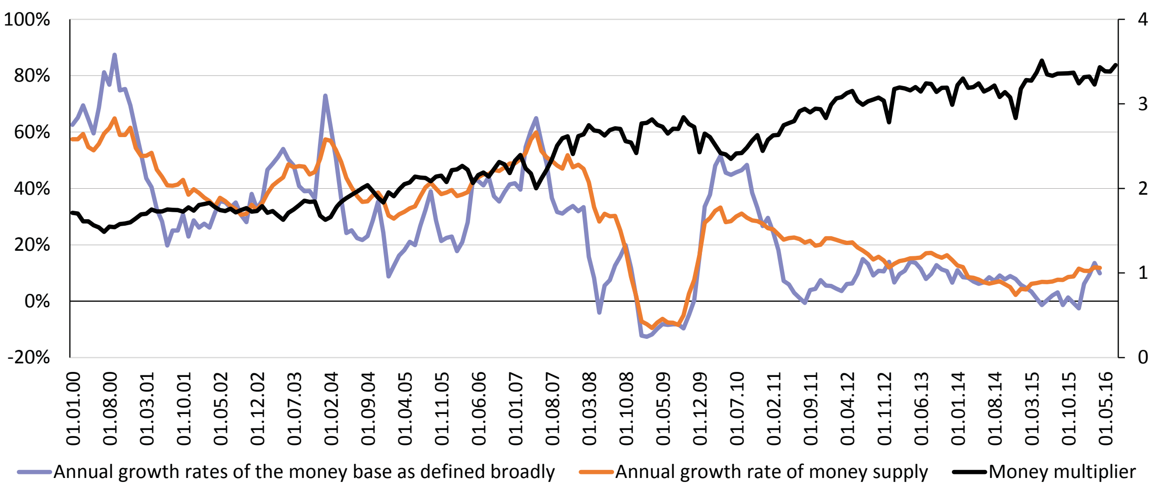
1 The baseline index of consumer prices shows the level of the rate of inflation on the consumer market with exclusion of seasonal (prices on fruit and vegetable products) and administrative (tariffs on regulated types of services and other) factors which are calculated by the Rosstat of the Russian Federation, as well.

A possible renewal of the aggregate demand which with all other conditions being equal may lead to upward pressure on consumer good prices is still a source of inflation risks. In particular, both in Q1 and Q2 2016 nominal wages rose by 7.7% as compared to the same period of 2015, having continued their growth in July 2016 (7.8% against July 2015). In September–December 2015, that index grew on average by 3.4% year-on-year. Due to slowdown of the rate of inflation in Q2 2016 (for the first time since Q3 2014) positive growth rates – 0.3% on the same period of 2015 -- of real accrued wages were observed.

In 2016, an additional source of risk of inflation rate growth is a speed-up of M2 money supply growth rates justified both by an increase in the money base as the Reserve Fund's sources for budget deficit financing were spent and renewal of the lending activity. In January–July 2016, M2 growth rates amounted on average to 11.7%, while during the same period of 2015 they did not exceed 6.0% (*Fig. 2*).

Money base growth at the expense of spending of the Reserve Fund's sources exceeds reduction thereof which factor can be explained by a decrease of the banking sector's debt to the Central Bank of Russia, as well as holding of depositary auctions by the latter. Due to the above, in Q1 and Q2 2016 despite the fact that the key interest rate remained unchanged till mid-June interest rate cuts were observed. In particular, interest rates on deposits to individual for a one-year term fell from 8.53% per annum in January to 7.2% per annum in June 2016. As an additional measure to prevent expansion of the money base, in September 2016 the Central Bank of Russia made a decision to issue bonds for the terms of three, six and 12 months with a three-month coupon.

Risks of a speed-up of inflation rate growth due to the exchange rate dynamics are not high. So, in August the ruble appreciated by 1.1% to Rb 65.3 per $1, while early in September, by another 1.2% to Rb 64.4 per $1. Strengthening of the ruble is justified by appreciation of oil prices which in August amounted to 1.3% (up to $47.3 a barrel). In addition to the above, the ruble was underpinned by depositary operations carried out by the Central Bank of




*Source:* The Central Bank of Russia.

*Fig. 2. Dynamics of money aggregates and money multipliers in 2000–2016*

Russia in August and aimed at withdrawal of funds received by the banking sector through a budget channel.

Among the factors which may contribute to depreciation of the ruble, one can point out the uncertainty related to the dynamics of oil prices (including that justified by economic problems faced by China), possible toughening of the US Federal Reserve's monetary policy and dramatic growth in Russia's budget deficit.

So, despite some stabilization in the economy the Central Bank of Russia still has to take into account both domestic and external factors which affect economic agents' inflation expectations and prevent reduction of the key rate this year. It is to be noted that as the rate of inflation and inflation expectations are reduced with the key rate remaining unchanged the monetary policy is getting tougher. So, in the next six months the Central Bank of Russia will have to look for a delicate equilibrium, that is, to secure inflation targets (that will become a significant result of the monetary policy) and prevent its policy from producing an adverse effect on economic activities.

## 3. Dynamics of bad debts: has peak been reached?

A.Vedev, M.Khromov

*The growth of bad assets in the banking sector slowed down significantly in 2016. This has resulted in a decrease of reserves increment against potential losses on loans and other assets and was the principal factor for restoring banking profit in 2016.*

By the end of summer 2016, the volume of bad assets in the banking system had continued to be on the rise both in nominal and in percentage ratio to the overall volume, albeit at a much slower pace. If we take the overall assessment of bad assets across all types of assets as a total volume of generated reserves against potential losses then its ratio to the total volume of assets for 1 January through 1 September 2016 went up by 0.8 p.p. from 6.5% to 7.3%. For the same period 2015, the increment constituted 1.2 p.p. from 5.2% to 6.4%. To be noted, the maximum of this ratio which was observed in 2010 (7.5%) has not been reached yet, however the proper volume of reserves has already grown 2.5-fold against 2010 (Rb 5.8 trillion against Rb 2.3 trillion).

Increment of the nominal volume of generated reserves against potential losses in 2016 has turned out to be nearly 2.5 times less than during the corresponding period of 2015 (Rb 397bn against Rb 939bn). Close dynamics of the share of reserves in bank assets is explained by the fact that the nominal amount of assets for the first eight months of 2016 moved down by 4.0%, meanwhile a year earlier bank assets went up by 1.0%.

In certain segments of the credit market, the situation with bad debts is like this.

**Retail segment**

The retail segment of the credit market faced specific indicators, which characterize the quality of loans exceeded maximums of 2009–2010 already last year. The share of outstanding consumer debt by 2015-end hit 8.4% and by 1 September 2016 went up by another 0.6 p.p. to 9.0%. In 2010 maximum totaled to 7.7%.

The volume of the outstanding consumer debt increased in January–August 2016 by Rb 66bn, while its growth over the same period of last year was Rb 208bn. Additional factor for the past due debt growth is the ongoing reduction of the nominal volume of consumer debt on bank credits. As of 1 September 2016, consumer debt before banks fell by 0.4% against 1 January 2016.

The volume of generated reserves against potential losses on consumer credits has gone up over 8 months of 2016 by Rb 26bn (2.1%), which is significantly slower than a year earlier (Rb 162bn and 15.3% over the corresponding period of 2015). The ratio of generated reserves against potential losses on consumer loans and the volume of consumer debt on bank loans hit 11.5%, having grown by 0.3 p.p. compared to the turn of the year. In 2010, this indicator's maximum reached 10.9% (*Fig. 1*)

**Corporate sector**

From the point of view of bad debt, corporate loans do not exceed previous maximum. During eight months of 2016, the volume of past due corporate debt has moved up by Rb 141bn (7.9%), which is 3.6-fold less than a year earlier (Rb 514bn or 48%). Its share in overall volume of corporate loans has gone up by 0.6 p.p. from the turn of 2016 and hit 6.6% as of 1 September 2016, which corresponds its maximum posted in 2010.

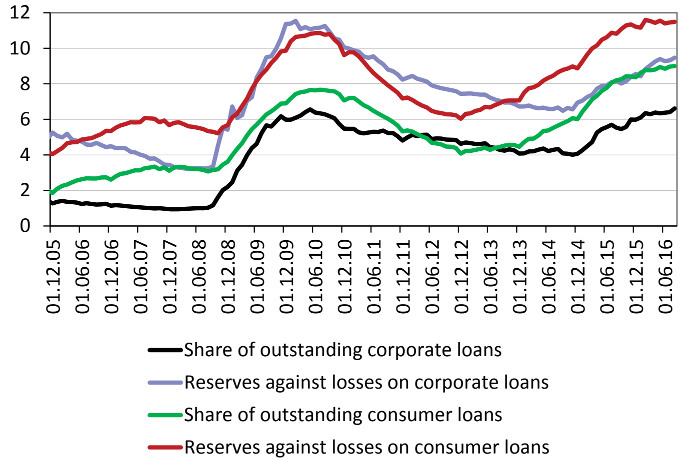



*Fig. 1. Indicators of bank loans quality, %*

The increment of the reserve volume against potential losses on corporate loans fell by 2.5-fold in comparison with the same period of 2015 (Rb 201bn against Rb 507bn). The ratio of reserves to the amount of the corporate credit portfolio has gone up to 9.5%, which is noticeably below the level posted in 2010 (11.5%).

**Quality of assets**

Thus, during 8 months of 2016, the trend to deterioration of bank asset quality remains. However, unmasking of bad assets has been going much slower this year compared to 2015. Relative level of bad assets has exceeded the maximum of 2009–-2010 solely in the retail segment of the credit market. On the whole, the share of bad assets is still lower.

Regarding certain groups of banks, the best asset quality remains in Sberbank and banks owned by non-residents. As of 1 September 2016, the share of reserves against potential losses across all types of assets to total assets constituted 5.3% in Sberbank, and 5.5% in foreign banks. In major banks[1] asset quality related to this definition (7.2%) nearly equals an average level across the banking system as a whole (7.3%).

However, Bank of Moscow influences most on this group indicators. Since 2011, Bank of Moscow is subject to bank resolution regime. This bank holds mainly loss assets (following transfer of part of business to the parent bank in May 2016). As of 1 September 2016, the ratio of reserves against potential losses to total assets for Bank of Moscow constitutes 47%. Without Bank of Moscow, asset quality (5.8%) of major state banks is close to leaders.

The worst asset quality indicators are posted by private banks. Plus, in the group of large banks[2] the share of bad assets (9.5%) is higher than in small and medium banks (8.7%).

In certain segments of the credit market Sberbank is the leader regarding credit portfolio quality. At the same time, foreign banks preserve high asset quality solely on the corporate segment of the credit market. In the retail segment owing to certain banks specializing on consumer lending total quality of consumer loans are lower than in the banking sector as a whole. The same

1 Banks of VTB group (VTB, VTB24, and Bank of Moscow), RSHB, GPB.

2 Banks part of 30 largest on assets volume, along with state banks and banks owned by non-residents.

picture is characteristic for large private banks, which are outsiders in retail credit portfolio quality owing to certain banks focused on the consumer loans market where the share of arrears exceed 40%. In the corporate lending, on the contrary, the worst situation regarding the quality of loans is being observed in small and medium banks, which is explained probably by a lack of access for these banks to lending to the most reliable borrowers from among large businesses.

*Table 1*

INDICATORS OF ASSET QUALITY OF AS OF 1.09.2016, %

| | Ratio of total reserves against potential losses to total assets | Share of past due debts on retail loan | Share of past due debts on corporate loans |
|---|---|---|---|
| Banking system | 7.3 | 9.0 | 6.6 |
| Sberbank | 5.3 | 4.7 | 3.4 |
| Large state banks | 7.2 | 7.8 | 7.1 |
| Banks owned by non-residents | 5.5 | 10.6 | 4.3 |
| Large private banks | 9.5 | 17.2 | 7.0 |
| Small and medium banks | 8.7 | 13.7 | 11.8 |

Slowdown of bad debts growth has affected the banking profit. In 2016, banks significantly reduced deductions to reserves against specified deposit liabilities, which resulted in growth of a positive performance outcome. For example, over 8 months of 2016, banking profit constituted Rb 532bn, which is seven times higher performance result for the same period of 2015. In 2016, return on assets has moved up to 1.0% in annual terms (0.2% a year earlier).

Such sharp increase of profit in comparison with the previous year is due more likely to the base effect – sharp decline of the last year than a final recovery of profitability in the banking activity. The record volume of profit was generated during the first eight months of 2012 when banks earned Rb 678bn and return on assets (ROA) came to 2.4% in annual terms.

The most notable contribution to an increase in the profit volume of the banking sector was due to a reduction of deductions to reserves against potential losses from loans and other assets. Moreover, profit has gone up from regular banking transactions minus operations with reserves and revaluation (*Table 2*).

*Table 2*

MAIN FACTORS OF BANKING SECTOR PROFIT IN 2015–2016, RB BN

| | 2015 | | 2016 |
|---|---|---|---|
| | January–August | Total for year | January–August |
| Bank profit before taxes | 76 | 192 | 532 |
| Growth of reserves against potential losses | 939 | 1352 | 397 |
| Profit from revaluation of foreign currency accounts | 288 | 430 | 17 |
| Profit minus operations with reserves and revaluation | 727 | 1114 | 912 |

Despite such positive effect for the current performance result of the banking sector, the bad debt issue still remains unresolved. During the previous crisis (in 2008-2010), no systemic measures were implemented aimed at dealing with it. It resulted in the fact the nominal volume of generated reserves against potential losses has not been decreasing. Improvement of relative indicators of bank asset quality was owing to exclusively recovery of the banking sector growth and the new (current) crisis commenced from inferior positions than the previous one. Repetition of the same situation means that until the economy begins to display sustainable growth (without which no lending and bank asset growth can be possible), bad debt will continue to be a serious burden for banks and pose an obstacle to their development.

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