MONITORING OF RUSSIA'S ECONOMIC OUTLOOK:

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

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1. LOW INFLATION ALLOWED THE RUSSIAN CENTRAL BANK TO LEAVE THE KEY RATE UNCHANGED, BUT INFLATIONARY PRESSURE WILL GROW

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Analysts' consensus-forecast and the financial market's expectations were in line with the Central Bank of Russia's decision of April 28, 2023 to leave the key rate unchanged at the level of 7.5% annually. However, the message about the further direction of the monetary policy has become tougher as compared with the previous press-release, reflecting the higher inflationary pressure. Based on results of April 2023, the annual inflation rate (over the past 12 months) slowed down to 2.3% with the level of consumer prices increasing by 0.38% in April which is equal to 3.4% year-on-year with seasonal adjustment. In March-April, a higher inflationary pressure remained in services and started to grow in non-food products. From June, annual inflation will speed up and amount, by our estimates, to about 6% annually.

Moderate growth in prices and a decline in households' inflationary expectations which were equal to 10.4%[1] justified the Russian Central Bank's decision of April 28 to leave the key rate unchanged at the level of 7.5% annually.

At the same time, the Russian Central Bank has sent a somewhat stronger message about the dynamics of the key rate as compared with the previous press-release, noting that amid a growing inflationary pressure it will assess the feasibility of increasing the rate at its next meetings.

In its updated mid-term forecast, the Central Bank of Russia raised by 1.5 p.p. the expectations regarding GDP growth rates in 2023. The current forecast is in the range of 0.5–2%, which is close to the updated April forecast of the RF Ministry of Economic Development (1.2%). The GDP growth rates forecast was revised upwards on the basis of an improvement in the outlook for households' consumption (the Russian Central Bank expects this indicator's active recovery to 3.5–5.5% in 2023 after a fall of 1.4% in 2022) and gross capital formation (the outlook was revised upwards straight by 4.5 p.p. and suggests growth in the range of 0.0–3.0%) by means of investment projects of large companies with state participation. The outlook for exports and imports was revised downward by 3.0 p.p. and 4.0 p.p., respectively. The Russian Central Bank expects a 10% growth in imports (after a 15% decrease at the end of 2022) and the ongoing fall of 2.5–5.5% in exports (after a 14.2% decrease in 2022).

The inflation outlook for the end of 2023 is reduced by 0.5 p.p. to 4.5–6.5% on the back of lower inflation in March-April (as compared with the February outlook) and a longer disinflationary impact of one-off factors: a good yield in 2022 and a decline in the propensity to consume owing to growth in uncertainties and consumers' ongoing adaptation to changes in available imported durable goods. The Russian Central Bank notes that in Q2 2023 annual inflation

1 URL: https://www.cbr.ru/Collection/Collection/File/43911/Infl_exp_23-04.pdf

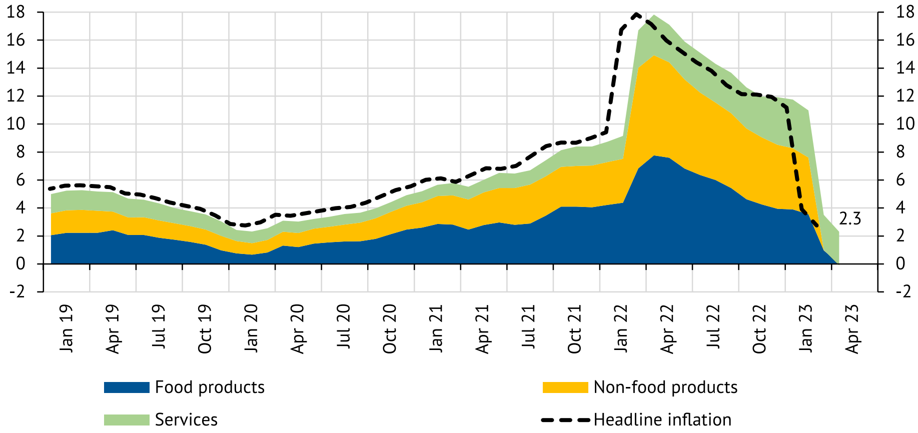

Fig. 1. Individual components' contribution to annual inflation, p.p.

Source: Rosstat.

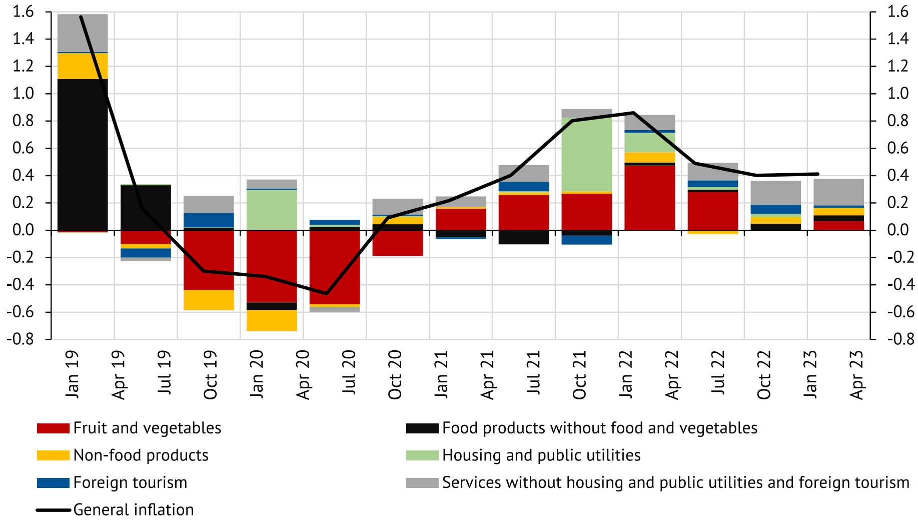

Fig. 2. Individual components' contribution to monthly inflation, p.p.

Source: Rosstat, own calculations.

(over the past 12 months) will reach its minimum and start growing gradually as the index of low values of price increases of summer 2022 is withdrawn from calculation and inflationary pressure increases on the part of recovered consumer demand.[1]

Also, the Russian Central Bank revised upwards the outlook for the monetary sector's growth rates in 2023 (money supply and loans) owing to the improvement in expected GDP dynamics in 2023 and the actual data of Q1 2023. The expected money supply growth rates in 2023 are higher than those of lending which situation can be explained by the expansionary fiscal policy and the state budget growing deficit. The federal budget deficit kept increasing in April and amounted, by the RF Ministry of Finance's estimates, to Rb3.4 trillion in January-April[2], an increase of Rb0.5 trillion as compared with the 2023 target value. At the same time, at the end of April the federal budget deficit over the rolling year

1 URL: https://cbr.ru/Collection/Collection/File/43959/2023_02_ddcp.pdf
2 URL: https://minfin.gov.ru/ru/press-center/?id_4=38473-predvaritelnaya_otsenka_ispolneniya_federalnogo_byudzheta_za_yanvar-aprel_2023_goda

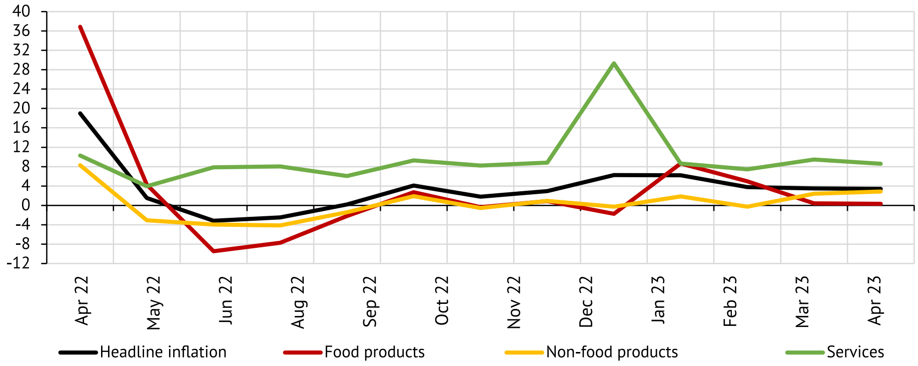

Fig. 3. Headline inflation dynamics and its main components, % SAAR

Source: Rosstat, own calculations

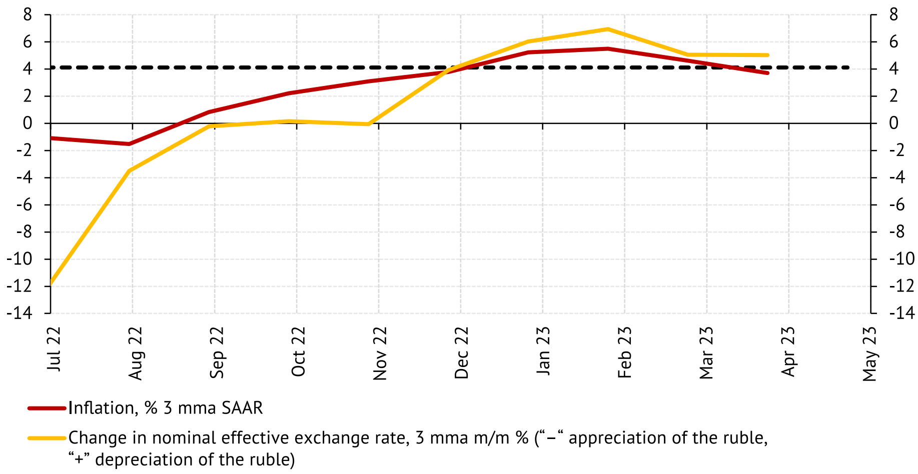

Fig. 4. Core inflation and the RUR/US Dollar exchange rate dynamics, m/m %

Source: Rosstat, the Central Bank of Russia.

is estimated at Rb7.9 trillion or 5% of GDP. The expansionary fiscal policy is still a major pro-inflationary factor in the medium-term.

Based on the April 2023 results, inflation in Russia decreased over 12 months to 2.3% (*Fig. 1*). As high values of the monthly inflation rate of March-April 2022, when prices for food products and non-food products were appreciating at a high rate, were excluded from calculation, only services with their catching-up price-rises made a positive contribution to annual inflation based on results of April. Over the past 12 months, non-food products saw deflation of -0.3%, food products demonstrated near-zero momentum of prices, while services appreciated by 9.4% year-on-year and accounted for the entire annual growth in consumer basket prices in April (*Fig. 1*).

In April, consumer prices increased by 0.38% with appreciation of the consumer basket (as in March) driven mainly by a rise in prices for services cleared from housing and public utilities and foreign tourism (+0.19 p.p.) (*Fig. 2*). A pick-up in prices for fruits and vegetables boosted the April inflation by 0.07 p.p.

After seasonal adjustment,[1] consumer inflation in April is estimated at 0.28% month-on-month or 3.4% year-on-year[2] (SAAR), which is close to the values of February and March (*Fig. 3*).

1 Inflation seasonal adjustment was carried out in the R program with the use of a seasonal package.
2 Monthly inflation raised to the power of 12.

Inflation components include, among other things, the acceleration of growth in prices for non-food products in March-April, probably, on the back of depreciation of the ruble early in 2023. However, non-food inflation year-on-year has remained below 4% (since May 2022) which can be substantiated by restrained consumer demand evidenced in a considerable decrease in the volume of retail trade in non-food products: -10.6% at the end of Q1 2023.[1]

Dynamics of year-on-year prices for services has remained at the level of over 4% since June 2022 and fluctuated at the level of around 8% month-on-month SAAR, except for December 2022 when indexation of prices for housing and public utilities services was done. This can be explained by the fact that growth rates of prices for services in March-April 2022 lagged behind from those of prices for goods, thus making relative prices return from the mid-2022 to the levels seen before February 2022, as well as the ongoing revival of demand in the services sector after a dramatic fall during the coronavirus pandemic.

In April, a three-month rolling average of the year-on-year inflation (3 mma SAAR) declined below 4% (after surpassing this level in January-March) and was equal to 3.6%. In March-April, the ruble kept depreciating: it fell against the key trade partners' currencies by 3.3% and 6.7% in March and April, respectively, (*Fig. 4*) on the back of a decrease in export revenues caused by sanctions imposed on Russian energy exports and amid the ongoing recovery of imports. Though in the first half of May the ruble appreciated to the levels relevant to the beginning of April, the pass-through of the exchange rate into prices remains a pro-inflationary factor in the forthcoming months.

By Rostat's estimates, in the first decade of May consumer prices increased by 0.05%[2], that is, close to the growth trajectory of consumer prices over the relevant period of the previous year. Most likely, year-on-year inflation based on results of May will amount to 2.3–2.4%, while from June it starts to speed up gradually. According to our model prediction,[3] quarterly seasonally adjusted year-on-year inflation will amount to 6.8% and 6.5% in Q3 and Q4 2023, respectively. This quarterly inflation outlook is in harmony with the acceleration of annual inflation to 5.3% and 6.1% at the end of September and year-end, respectively, while the average inflation rate is equal to 5.8% in 2023.

The main drivers speeding up the rate of inflation will be the pass-through effect of exchange-rate to prices along with a gradual closure of a negative output gap on the back of recovery of overall demand owing to households' spending of their savings and growth in government expenditures.

1 URL: https://rosstat.gov.ru/storage/mediabank/ind_03-2023.xlsx
2 URL: https://rosstat.gov.ru/storage/mediabank/72_12-05-2023.html
3 For more details on the model, see: Yu.N. Perevyshin. The Short-Term Inflation Forecasting in the Russian Economy // The Economic Policy. 2022. Vol. 17. No. 5. pp. 1–18.

2. INDUSTRIAL PRODUCTION DYNAMICS IN Q1 2023

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Despite the implications of anti-Russian sanctions, Q1 2023 saw slow growth in industrial production dynamics. The drivers of positive trends in the economy are the building sector and manufacturing industries whose products are aimed at meeting domestic demand or used as intermediate for the needs of the state defense order and building projects, including the development of railway and maritime infrastructure.

To provide accurate interpretation of trends in individual industries we decompose their output into calendar, seasonal, non-recurrent and trend components[1]; the interpretation of the latter is of particular interest. Experts at the Gaidar Institute cleared seasonal and calendar components from a number of manufacturing industries' indices for 2003–2021 and singled out the trend component[2] based on statistics published by Rosstat on output indices in industrial sectors of the economy.

The resulting series for the industrial production index as a whole are presented in *Fig. 1*. Shown in *Fig. 2* is the result for aggregate indices of the extractive and manufacturing sectors and production and distribution of electricity, gas and water. The results for the decomposition of other series are presented in *Table 1*.

In Q1 2023, the trend component of the industrial production index demonstrated slow growth driven mainly by extractive industries and manufacturing. The sector of production and distribution of electricity, gas and water was shrinking slowly.

In January-February 2023, oil production was falling (-2.6% on January-February 2022). This trend will continue owing to Russia's decision to cut voluntarily oil production by 500,000 barrels per day (without gas condensate taken

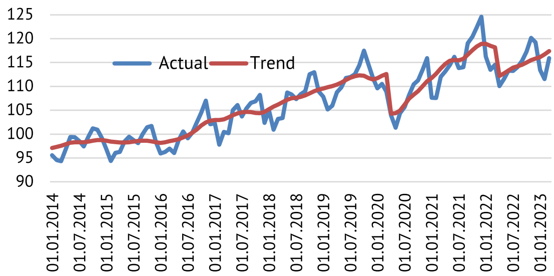

Fig. 1. Production indices' dynamics across sectors, 2014–2023 (actual data and trend component), % change relative to the 2016 annual average value

Source: Rosstat, own calculations.

1 "Trend component" is a well-established term in the literature; however, it is noteworthy that this component is not a "trend" in a strict sense and is used in econometrics for analyzing time series: in this particular case, it is the remainder after the time series have been cleared from calendar, seasonal and non-recurrent components. It is incorrect to use the "trend component" for forecasting time series: for most industrial production indices it is time-varying in levels (and time-invariant in differences), but can be used for interpreting short-term dynamics and for comparison with events that have taken place.

2 The trend component was determined using the Demetra package with the X12-ARIMA procedure.

into account) from March till the end of 2023.[1] Considering the fact that the average February level of oil production is taken as a reference point for reduction, the daily volume of oil production may decrease to 9.7 mn barrels, but the reduction cannot be traced because the statistics on oil and gas production is excluded from the monthly report on industrial production dynamics till April 1, 2024.[2]

Q1 2023 saw the ongoing negative gas production dynamics in Russia on the back of the same factors, such as a decrease in exports because of sanctions and restrained domestic demand. Re-orientation of export coal supplies from Russia to countries of the Asian Pacific Region is a long-term project. Production of coal kept falling early in 2023 owing to transport infrastructure bottlenecks.

Based on Q1 2023 results, the manufacturing sector's trend component picked up. Positive dynamics was evident in production of fabricated metal products, except for machinery and equipment; manufacturing of computers and electronic and optical equipment; manufacturing of electrical equipment; manufacturing of other transport vehicles. This trend can be substantiated by substitution of foreign-made goods for Russian manufacturers' products because of sanctions imposed on technologies, suspension of direct imports of some goods and growing demand for the sector's products which are intermediate for the needs of the state defense order and building projects, including the development of railway and maritime infrastructure.

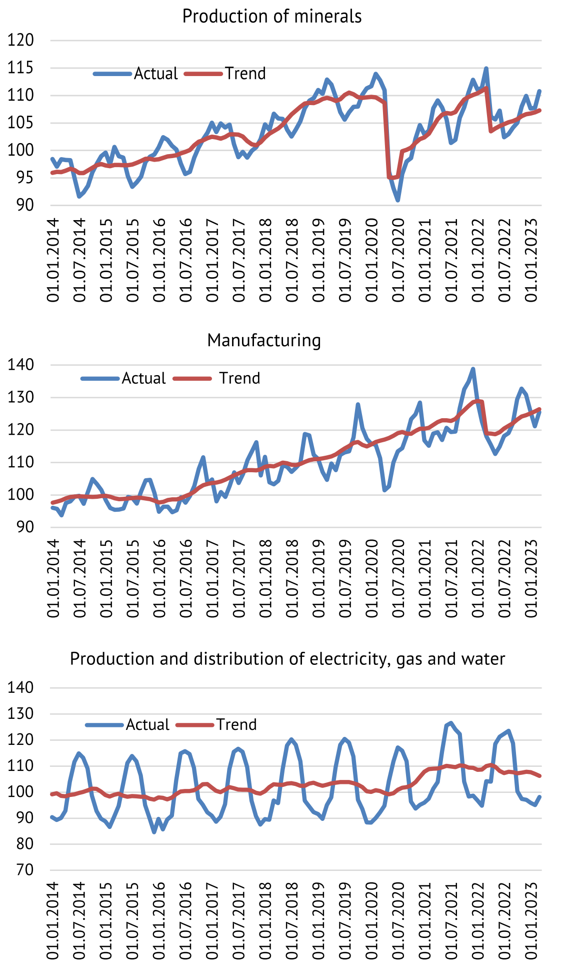

Fig. 2. Production indices' dynamics across sectors, 2014–2023 (actual data and trend component), % change relative to the 2016 annual average value

Source: Rosstat, own calculations.

In Q1 2023, growth drivers in other sectors remained the same: in commerce it was the replacement of US and European producers' goods in the non-food segment with products of Russian, Turkish and Chinese brands; in the building sector it was the repair and building of infrastructure in new territories and implementation of projects on development of transport infrastructure. Cargo turnover growth is justified by an increase in production capacity of Russian seaports and import substitution, as well as the re-orientation of cargo flows from Europe to Turkey, Arab countries and Africa.

The analysis shows that:

1 The reduction in oil production volumes was agreed on at the meeting of the OPEC+ member countries with the average February 2023 level of oil production taken as a reference point: the 48th Meeting of the Joint Ministerial Monitoring Committee // OPEC. April 03, 2023. URL: https://www.opec.org/opec_web/en/press_room/7120.htm

2 On industrial production in Q1 2023 // Rosstat. April 26, 2023. URL: https://rosstat.gov.ru/storage/mediabank/63_26-04-2023.html. Instructions No. 1074-r of April 26, 2023 of the Government of the Russian Federation // Official internet website of legal information. April 26, 2023. URL: http://publication.pravo.gov.ru/Document/View/0001202304280072?index=0&rangeSize=1

2. Industrial Production Dynamics in Q1 2023

Table 1

Output index change across economic sectors, %

Name of sector	Share in industrial production index, %	March 2023/ March 2022	March 2023/ December 2022	Change over past months
Industrial production index		99.3	101.4	Slow growth
Extraction of minerals	34.5	96.4	100.7	Slow growth
Manufacturing, including:	54.9	106.3	101.5	Slow growth
Production of food products, including beverages and tobacco	16.3	112.0	103.0	Growth
Textile and garment industry	1.1	106.4	100.9	Slow growth
Manufacturing of leather, articles thereof and footwear	0.3	106.2	104.1	Growth
Wood processing and woodware manufacturing	2.0	86.9	103.2	Growth
Pulp-and-paper industry	3.4	75.1	93.6	Decline
Production of charred coal and petrochemicals	17.3	103.4	101.0	Slow growth
Chemical industry	7.6	104.8	102.3	Growth
Manufacturing of rubber and plastic articles	2.1	100.0	102.3	Growth
Manufacturing of other nonmetallic mineral products	4.0	98.0	104.5	Growth
Metallurgy and manufacturing of ready-made fabricated metal products	17.4	130.0	109.1	Growth
Manufacturing of machinery and equipment	7.0	91.4	99.4	Slow decline
Manufacturing of electrical, electronic and optical equipment	6.3	105.9	104.4	Growth
Manufacturing of transport vehicles and equipment	6.8	110.6	105.1	Growth
Other industries	2.4	97.6	101.6	Growth
Electricity, gas and water supply	13.5	96.6	98.5	Slow decline
Wholesale trade		89.4	105.4	Slow growth
Retail trade		93.7	103.3	Growth
Cargo turnover		97.8	100.9	Slow growth
Building		107.7	101.9	Growth
Agriculture		103.9	100.8	Slow growth
Volumes of fee-based services to households		104.3	101.5	Slow decline

Source: Rosstat, own calculations.

- despite the implications of anti-Russian sanctions (growth in logistics costs, search for new suppliers and buyers, an increase in insurance premium, disruptions in deliveries, development of parallel imports chains, a longer period of delivery, lack of alternatives in case of replacement of foreign components and other), industrial production dynamics demonstrated slow growth in Q1 2023;
- with the cessation of publication by Rosstat of the data on oil production in its monthly reports, forecasting and analysis of the economic situation becomes more complicated and this may affect the level of uncertainty which economic agents encounter;
- in Q1 2023, the drivers of positive trends in the economy are the building sector and manufacturing industries whose products are aimed at meeting domestic demand (the food industry, the textile and garment industry and the furniture industry) or used as intermediate for the needs of the state defense order and building projects, including the development of the railway and maritime infrastructure.

3. CORPORATE LENDING IN JANUARY-APRIL 2023

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Early in 2023, growth rate of bank corporate lending portfolio was at the end of the previous year, when the acceleration was recorded in this segment of the credit market. An important role in maintaining credit activity was played by such factors as the stability of the Russian economy amid sanctions pressure; intensification of enterprises' activities in the field of import substitution, parallel imports and other activities related to overcoming the anti-Russian sanctions; refinancing of loans provided to Russian enterprises by banks of unfriendly countries, in the domestic market; as well as support measures by the government and the Central Bank of the Russian Federation aimed at implementing programs to stimulate preferential lending to small and medium-sized businesses.

The aggregate loan debt of corporate borrowers[1] to Russian banks as of May 1, 2023 reached Rb63.1 trillion. Growth of the corporate loan portfolio in the first four months of 2023 amounted to Rb3.2 trillion or 6.8%. A year earlier, the corporate credit portfolio of Russian banks in the same period increased by Rb0.6 trillion or 1.2% (a slight increase was due to the financial crisis caused by the aggravation of the geopolitical conflict).

However, the volume of loans in Q1 of this year amounted to Rb15.1 trillion, which is 11.6% less than in the first three months of the previous year (Rb17.1 trillion) and the reduction is almost entirely due to foreign currency loans, i.e. a drop of 78.0% (Rb0.8 trillion vs Rb3.9 trillion in 2022), while the ruble segment showed slight growth by 7.3%. Thus, the devaluation of the loan portfolio continues: Russian banks reduce lending in dollars and euros while growth of lending in currencies of friendly countries is not yet widespread due to high risks. On the whole, the foreign currency predominance of corporate loans during the year dropped from 21.2% to 16.5%.

The level of overdue debt has dropped to 4.8%, or 1.1 p.p. over the figure recorded on April 1, 2022. The dynamics of this index proves some improvement in the quality of the banking loan portfolio, however, this situation is largely due to the easing on the part of the RF Central Bank, in particular, permission allowing for the non-reporting of deteriorating loan quality, if the borrower faces problems resulted from restrictions associated with sanctions.

Given the stabilization of the economic situation and restoration of the sector's profitability, credit institutions now have a sufficient margin of financial stability, therefore, the Bank of Russia has decided not to extend the easing, which is scheduled to expire in H1 2023.

1 There are loans to non-financial and financial organizations, as well as individual entrepreneurs.

3. Corporate lending in January-April 2023

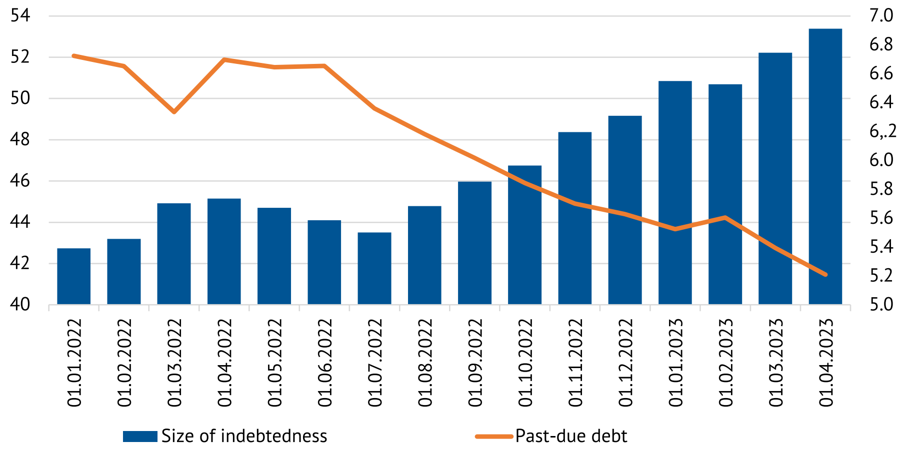

Fig. 1. Dynamics of corporate lending and outstanding debt in 2022–2023

Source: own calculations according to the Bank of Russia: "Information about allocated and attracted funds" /URL: https://www.cbr.ru/statistics/bank_sector/sors

At the end of H1, the deferral will expire and will not be extended for the forming of reserves for potential losses on loans, other assets and contingent liabilities of credit nature of legal entities. The prolongation of the measure is inexpedient in view of the provided long-term allowances for capital adequacy. To prevent the accumulation of systemic risks, banks must record and recognize the already realized losses.[1]

Certain longer-term strategic anti-crisis solutions will be permanently integrated into the regulation. In particular, it is planned to abolish the reduction of the Basel Capital Adequacy Ratios (down to zero in 2023). This norm will be stipulated in the Instructions No.199-I (the changes will take effect before July 1, 2023.) It is assumed that by 2028 banks will gradually restore markups to target values. Therefore, banks will benefit from indulgencies for a long time to come.

The sectoral structure of corporate loans has not experienced any essential modification compared to the previous year. The leaders by volume of debt as of April 1, 2023 are manufacturing enterprises (Rb13.5 trillion or 28.2% of the total debt of enterprises), financial and insurance companies (Rb8.6 trillion or 17.9%) and wholesale and retail trade companies (Rb5.7 trillion or 12.0%).

By volume of loans in Q1 of this year, the leaders are enterprises engaged in financial and insurance activities (Rb4.4 trillion or 29.2% of the total amount of loans), wholesale and retail trade (Rb3.6 trillion or 23.6%) and manufacturing businesses (Rb2.6 trillion or 17.1%).

Dynamics of interest rates is stable; after the key rate was set at 7.5% (September 16, 2022), it has not changed significantly remaining at 8-9% for both short-term and long-term loans.

The SME loan portfolio is growing faster than the portfolio of loans to large businesses. As a result, the share of SMEs in the corporate loan portfolio currently amounts to about 19%. This situation is partly due to the sanctions pressure on large Russian businesses and banks began to interact more actively with SMEs. At the same time, the state support of small and medium business is essential.

In 2023 small and medium-sized businesses will continue to receive concessional loans for investment purposes at 2.5 and 4% per annum under the

1 URL: https://www.garant.ru/hotlaw/federal/1626294/

program "1764." It is implemented under the national project "Small and Medium Entrepreneurship", as well as the program PSK Bank of Russia and JSC Corporation SME.[1]

The volume of the program of preferential investment lending for 2023 has been doubled compared to the previous year, reaching Rb100 bn. The list of industries whose enterprises can benefit from loans has also been expanded.

The Bank of Russia has developed the SME support road map for 2023–2024.[2] The road map was developed in consideration of proposals received from business representatives and the Central Bank plans to discuss new initiatives for its improvement.

The main purpose of the set of proposed measures is to increase the availability of credit (including investment) to small and medium-sized enterprises. In particular, proposals have been developed that will reduce bank costs when granting loans by reducing risk ratios on loans secured by the SME Corporation. There are also measures proposed for the classification of loans, expanding the use of factoring transactions in the interaction between banks and SMEs. Another important area of stimulating lending to SMEs is the expansion of concessional funding, including targeted funding for manufacturing and high-tech industries.

The document also provides for the expansion of opportunities for using digital services, identification/authentication of SME representatives using the Unified Biometric System when obtaining funding. The regulator intends to provide SMEs with access to the "Know Your Client" platform to verify counterparties. A special area of activity is to reduce the transaction costs of businesses by accepting payments through the rapid payment system (RPS).

This year, growth rate of bank lending to large corporations will still lag behind lending to SMEs, which is due to the low level of investment activity of large companies in connection with the expected decline in exports due to the closure of Western markets and the need to refocus on new sales channels, which do not yet fully compensate for the sanctions losses. The growth of credit demand may be influenced by the implementation of new large infrastructure projects involving the state. Another growth factor may be the need to refinance bond loans, but it is more likely that companies will try to do without bank lending using the opportunities of the stock market.

At present, risks of a global recession, falling world prices for energy resources and continuing geopolitical uncertainty are still quite high. The nature of these risks does not imply their minimization in the near future and, therefore, full stabilization of the macroeconomic situation and reduction of the key rate should not be expected soon. It is not unlikely that banks and their clients will have to adapt to conditions of rising rates, when the RF Central Bank will stimulate lending by new incentive programs and regulatory relief.

Stimulation of corporate lending growth will remain one of the priority tasks of the Bank of Russia, however, a rapid increase in the loan portfolio not supported by the expansion of production capabilities of enterprises can lead to the accumulation of imbalances in the credit market, which will be manifested in accelerating inflation, falling rates of economic growth and real incomes of households. Therefore, the power of the financial market should be used in a balanced way, taking into account all the various factors of developing current economic situation.

1 The Bank of Russia PSK is the Bank of Russia lending incentive program; JSC "Corporation "SME" – the federal corporation to support small and medium-sized businesses..
2 URL: https://www.cbr.ru/Content/Document/File/144001/Road_Map_development_2023-24.pdf