

Russia Economic Review

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Inflation fell below 5½% at the end of 2016, and has a good chance of falling further to 4% this year. And positive GDP growth returned in November.

- Inflation in December fell to 5.4%Y/Y – the lowest level since mid-2012. Core inflation came in at 6.0%Y/Y.
- Seasonally adjusted GDP growth returned to positive territory in November for the first time in two years and the Russian Ministry of Economic Development upwardly revised its forecast for 2016 as a whole to -0.5%.
- December's PMIs were at the highest in more than four years, with the manufacturing PMI at 53.7, services at 56.5 and composite index at 56.6 amid increasing orders and stabilizing labour market.
- The Reserve Fund in December fell to \$16bn, half the level of the previous month as the Government used its funds to finance the widening budget deficit. The Wellbeing Fund was untouched throughout 2016 with a balance of \$71.9bn on 1 January, up slightly over the year mainly amid currency revaluations.

Inflation fell to 5.4%Y/Y at the end of the year – the lowest inflation rate since 2012

On 3 January, the British magazine "The Banker" announced its Central Bankers of the Year with the Governor of Russia's Central bank (CBR) Elvira Nabiullina awarded the Banker of the Year in Europe. And there appear good reasons for that award. Indeed, the inflation rate in December fell to 5.4%Y/Y – the lowest level of inflation since 2012 and less than 2ppts above lowest rate since the collapse of Soviet Union (when there was no officially admitted inflation). And prospects of achieving the CBR's inflation target this year look bright, as inflation expectations are also decreasing. Monthly headline inflation came in at 0.4%M/M, while monthly core CPI was of 0.3%M/M (6.0%Y/Y).

In detail, food prices rose by 4.6%Y/Y (0.6%M/M), with prices of food excluding fruit and vegetables increasing by 6.0%Y/Y(0.6%M/M) and non-food prices up by 6.5%Y/Y(0.3%M/M). Services prices increased by 4.9%Y/Y (0.3%M/M). And while bringing inflation towards the lowest level in decades has made a positive contribution to stabilising the domestic economy and increases the attractiveness of Russia as a place for investments compared to the period of double-digit inflation and financial instability, the more than 400bps gap between the CBR's key interest rate and the headline inflation rate seems to be too wide for an economy struggling to achieve a robust and sustainable pace of growth.

According to the latest comments made by Governor Nabiullina, the CBR will cut the key rate gradually this year from the current level of 10%. And should inflation decrease to the CBR's inflation target of 4% and stabilize at that level, the key rate will be cut to around 6.5%-7.0%. Considering the above view, we think that the probability that Central bank will re-start monetary easing by cutting rates in the first quarter is fairly high.

Positive economic growth returned in November and the forecast for 2016 was revised to the upside

Economic growth in Q316 came in at -0.4%Y/Y and was in line with the Bloomberg consensus expectation. Over the first three quarters of 2016 GDP decreased by 0.7%Y/Y. And while the quarterly growth rate remained negative, the third quarter saw the smallest decline since GDP started to fall in Q115 (-2.8%Y/Y). According to the Ministry of Economic Development (MED)'s estimate, seasonally adjusted growth in November returned to positive territory at 0.1%M/M and 0.5%Y/Y, with the forecast of full-year GDP growth for 2016 revised up from -0.6% to -0.5%. But while the upward trend in industrial production which re-emerged in the second half of 2016 and continuing growth in agriculture are among the main factors behind the promising dynamics of GDP, retail sales remain weak.

Industrial production in November increased by 2.7%Y/Y, the highest rate in two years. But retail sales remained weak, decreasing by 4.1%Y/Y, although the car sales data in that month provided a cause for cautious optimism. Indeed, car sales in November rose by 0.6%Y/Y – the first increase in two years. Among the brands which saw double-digit growth were traditionally best-selling domestic brands such as Lada (up by 18%Y/Y). But as always in a very Russian way, luxury overseas car brands also performed well (Lexus' sales up by 22%Y/Y, Porsche's up by 29%Y/Y).



December's PMIs came out at their highest levels for the last few years

At the end of 2016, economic sentiment improved markedly compared to a year earlier and the first half of 2016. Indeed the manufacturing PMI in December came out at the highest level in 69 months at 53.7 compared to 48.7 a year ago (48.7 in December 2015 and 48.8 in pre-crisis December of 2013). The average for the manufacturing PMI in 2016 was 50.6 compared to 48.7 in 2015 and 49.6 in 2014. Behind the improving main index was an increasing output PMI, which rose above the long-run average with particular uplift in production of investments goods. Employment grew at the fastest pace in more than 5 years and, while export-oriented orders declined in December, the scale of decline was the smallest in more than 3 years.

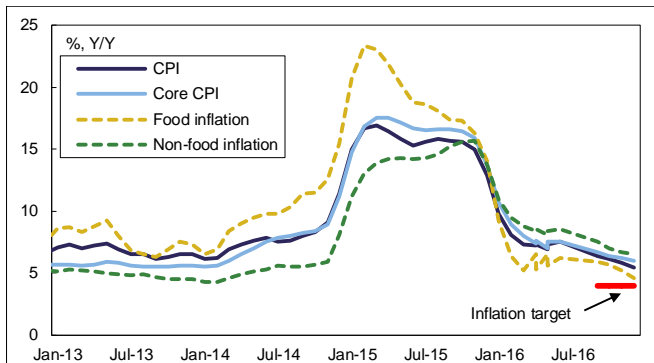
December's services PMI came out at 56.5, markedly higher compared to 47.8 a year ago and indeed represented the highest in four years to leave the composite index at its highest in 50 months amid growth of new orders and a stable labour market.

Reserve Fund halved in December. Wellbeing Fund kept untouched

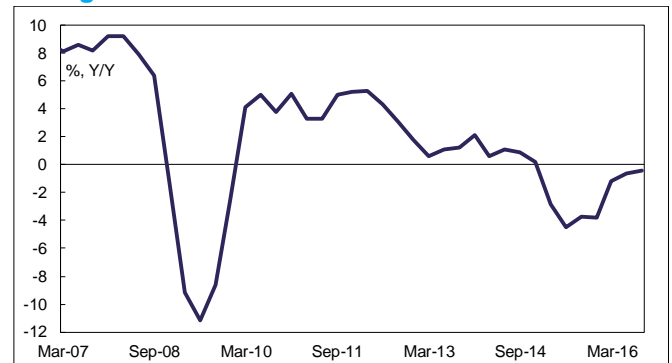
The balance of the Reserve Fund as of 1 January 2017 was \$16.03bn, down by 68%Y/Y in dollar terms. Not surprisingly, the biggest decrease in the Fund was seen in December when the balance diminished by almost 50%M/M as the funds were used to cover the fiscal deficit, which has widened from 3% of GDP as was expected under the assumption that oil prices stayed at \$50pbl in 2016, to 3.7%-3.8% of GDP, not least because the average price for Russian oil (Urals) in 2016, according to the Ministry of Finance (MOF) latest release, was \$42pbl.

The balance of the Wellbeing Fund, the other sovereign fund which was set up to help Russian pension system and which is able to invest in infrastructure projects, remained stable in 2016. But if oil prices fall again, there is the possibility that the Reserve Fund will be used up in 2017 and in that event, the possibility that the Wellbeing fund would be partly used to support fiscal expenditure. On 1 January, the Wellbeing Fund's balance was \$71.9bn, up slightly (by 0.25%Y/Y) in 2016 mainly thanks to currency revaluations.

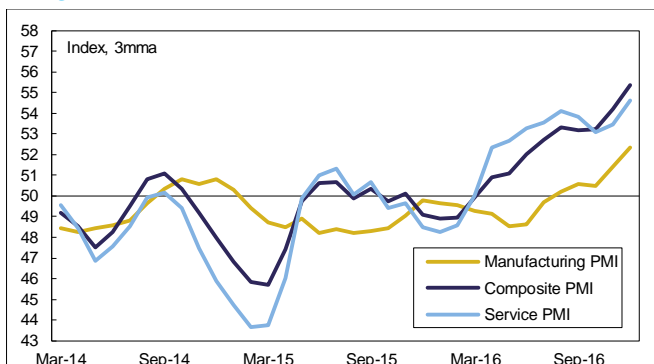
Inflation



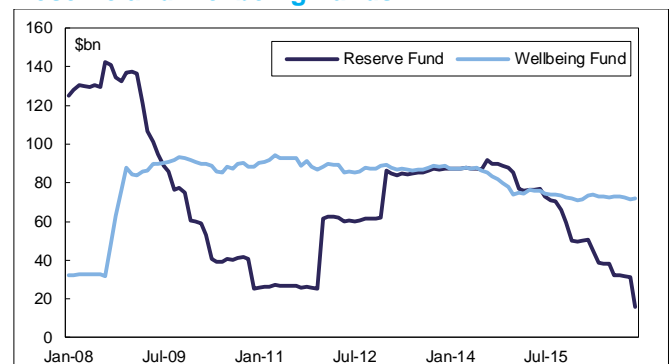
GDP growth



PMIs



Reserve and Wellbeing Funds



Economic Research

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