MONITORING OF RUSSIA'S ECONOMIC OUTLOOK:

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

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1. CRISIS 2020: IMPACTS AND RISKS FOR RUSSIAN PENSION SYSTEM

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Epidemiological crisis 2020 had a significant impact on multiple spheres of social and economic life, including Russian pension system. However, from perspective of pension recipients, this impact was minimum and associated only with lockdown measures, although the pension rate remained unchanged. Meanwhile, the reduction in payroll budget and decrease in premium rate for small and medium-sized business substantially increase the dependence of pension system on federal budget.

Measures taken worldwide to contain the coronavirus pandemic, reduction in oil prices coupled with the accumulated Russian institutional issues, have significantly affected many spheres of social and economic life and will continue to affect them in the following few years. Russian system of mandatory pension insurance (hereinafter, MPI system) is not an exception, though, probably, to a lesser extent.

The major direct negative factor for the pension system is the reduction of its income base, formed by insurance premiums charged on wages.

The incomes from insurance premiums (for 2020 it was envisaged in the amount of RUB 5.65 trillion) constitute about 75% of the costs for paying insurance pensions. The remaining 25% are secured by transfers from the federal budget to finance the MPI system (hereinafter referred to as transfers).

A reduction in incomes from insurance premiums will take place due to the following factors:

- a reduction in the payroll budget subject to insurance premiums charges (hereinafter - payroll);
- a decision to reduce the rate of insurance premiums for mandatory social insurance for small and medium-sized businesses (hereinafter - SMEs).

Estimates of impact on pension rates of non-working pensioners

In 2018, due to increase of the retirement age and aiming to secure growth of pensions in 2019–2024, the cost of one pension rate and fixed payments determining the scale of indexation of insurance premiums have been approved by law (*Table 1*).

Table 1

Scale of indexation of insurance premiums, %

2020	2021	2022	2023	2024
6.6	6.3	5.9	5.6	5.5

Relying on the available inflation forecasts for the period 2020–2024, which do not exceed 4%, the growth of pensions will outstrip inflation, and this growth will be significant. Therefore, there will be no need to further accelerate the indexation of pensions. Their pre-scheduled growth will ensure an increase in the real incomes of non-working pensioners.

Estimates of impact on the amount of transfers

The estimation covered the period of 2020–2024, while a separate model of the effect of a reduction in the payroll and a decline in the rate of insurance premiums for SMEs was developed.

Evidence of reducing payroll budget

Calculations were made based on the forecasted decline in GDP by 5% as of 2020 year- end under two scenarios of economic recovery after 2020:

- GDP growth will reach the previously planned level of 3.1–3.3% as from 2021;
- growth will be more moderate and will average about 1.5% over this period.

There is an assumption made in both scenarios that the share of the payroll budget in the GDP, subject to insurance premiums charges, remains constant over this period.

Table 2 shows the results of calculations.

Table 2

Forecasting the demand for additional transfers associated with reduction in payroll budget RUB billion

Dynamics of GDP growth, %		Demand for additional transfers					
2020	2021–2024	2020	2021	2022	2023	2024	Total 2020–2024
-5	3.1–3.3	375	410	438	463	496	2 182
	1.5	375	496	626	765	934	3 196

Source: own estimates.

The decrease in GDP and, accordingly, in the payroll budget by 5% in 2020 was driven by the need to increase transfers by 0.4% of GDP. In principle, the need for transfers will increase by 0.4% of GDP in the period of 2021–2024 (on average for one year) with economic growth of about 3% per year and 0.6% of GDP per year with an annual economic growth at 1.5%.[1]

Evidence of reducing the rate of insurance premiums for SMEs

As one of the anti-crisis measures, the decision was taken to reduce the rates of insurance premiums for SMEs from 30 to 15% from April 2020. The rate was reduced from 22 to 10% in relation to the part of payroll exceeding the minimum statutory monthly pay, specifically in terms of contributions to mandatory pension insurance. The new rate has been set for an indefinite period.

According to the Ministry of Finance,[2] this will result in reduction in the receipts of insurance premiums to the social insurance system in 2020 in the amount of RUB 285 billion (apparently, the estimation was made on the assumption that these types of businesses would work under crisis the same as without it).

1 The risk of significant growth in transfer in 2020–2024 has a reason that with raising of retirement age, the parameters of indexation of insurance pensions, in contrast to the previously existing procedure, have been established by law for 6 years at a time. Thus, as if a "loan was taken" at a fixed rate for a long period under rather high uncertainty. The risk of such an approach to the establishment of the indexation parameters of insurance pensions was highlighted in the work by Yuri.M. Gorlin, Viktor.Yu. Lyashok. "Raising the retirement age: the scenery after ...". M., 2019.

2 Ministry of Finance of the Russian Federation. URL: http://government.ru/news/39321/.

According to our estimates, the efficiency rate of insurance premiums to PFR for small and medium-sized businesses reduced from April 1 from 21.5–21.8% to 15.5–16% on the average stemming from the abovementioned decision, without reference to the impact of crisis. This is equivalent to reduction of PFR incomes from insurance premiums by 210–215 RUB billion comparable with the aforementioned estimates of the Ministry of Finance of Russia for all social extra-budgetary funds.

The need for additional value of transfers will increase in nominal terms in the following years in line with the growth of payroll budget (*Table 3*). In terms of GDP shares, this is equivalent to 0.2% in 2020 and 0.25% in 2021–2024.

Table 3

Forecasting the demand for additional transfers associated with reduction of insurance premiums rate, RUB billion

	2020	2021	2022	2023	2024	Total 2020–2024
Demand for additional transfers	213	304	325	343	367	1 551

Source: own estimates

Reduction in insurance premiums should be considered, first-and-foremost, as a support measure of small and medium-sized businesses.

Estimates of cumulative impacts on transfer

It is wrong to calculate the cumulative impacts of the aforementioned factors by summing up their individual estimates. The point is that the estimation of the impact of reducing the rate of insurance premiums was made based on the assumption that the crisis does not affect the activities of small and medium-sized businesses. Meanwhile, a decrease in the payroll budget resulted from crisis, will diminish the effect from lowering the rate of insurance premiums for SMEs.

Table 4 shows the forecast estimates of additional demand for transfers for the period until 2024, taking into account the integral effect of a reduction in the payroll budget and rates of insurance premiums for small and medium-sized businesses.

Table 4

Forecasting the demand for additional value of transfers in respect of cumulative impact on reduction of payroll budget and insurance premiums rate, RUB billion

Dynamics of GDP growth, %		Demand for additional transfers				
2020	2021–2024	2020	2021	2022	2023	2024
-5	3.1–3.3	495	571	610	644	690
	1.5	375	654	793	938	1 117

Source: own estimates.

Transfers will need to be increased by 0.5% of GDP with an annual economic growth of 3% and an average of 0.7% of GDP per year with an increase of 1.5% due to cumulative impact of both factors.

* * *

The estimates of the impact of consequences related to coronavirus crisis on the Russian system of mandatory pension insurance for the period 2020–2024 obtained upon results of the developed model, allow us to draw the following conclusions:

- in practice, the crisis will not have any negative impact on the rate of insurance pensions with their amount of indexation guaranteed by legislative solutions taken in 2018 in connection with raising of retirement age, and sufficiently exceed inflation, thereby, securing growth of real incomes of non-working pensioners;
- the decline in GDP and the resulting reduction in the receipts of insurance premiums for mandatory pension insurance (in the context of the statutory amounts of pensions indexation) necessitate an increase in budget transfers to MPI in 2020–2024, which may amount to 0.4–0.6% of GDP annually, depending on the rate of recovery growth;
- the decision taken to support small and medium-sized businesses to reduce their rate of insurance premiums will lead to a decrease in the incomes of the pension system resulting in the requirement to increase additional annual transfer by 0.2–0.25% of GDP. Consequently, dependence of the insurance pension system on budget transfers grows. Transfer in 2020 may increase up to 2.1%, in the period of 2021–2024; it will remain at this level with GDP growth of about 1.5% and will drop to 1.8% of GDP by 2024 under economic growth of 3%.

2. EXPORT ORIENTED AGRICULTURAL MODEL: PROS AND CONS

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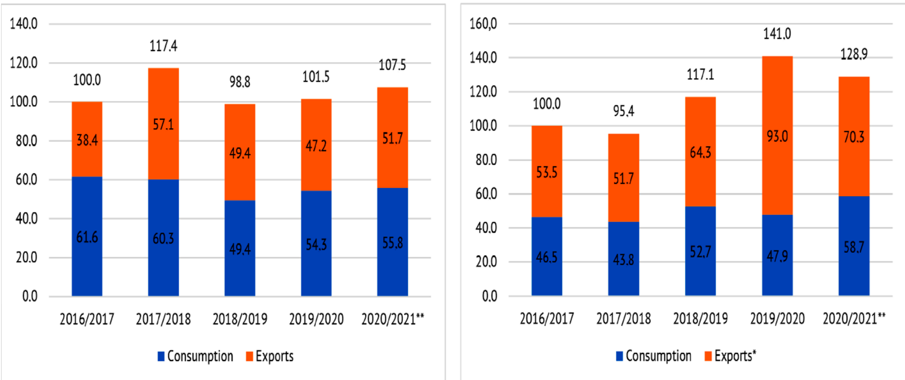
The 2020 harvest will help promoting export oriented agricultural development in Russia. That said, state priorities in regulation of export crops markets are shifting from supporting producers of agricultural products towards domestic consumers and agricultural processing which in future can lead to decrease in the volume of agricultural production.

On June 25, 2020, Dmitry Patrushev, Minister of Agriculture of the Russian Federation, speaking at the RF Government meeting announced a shift in the Russian AIC paradigm from import substitution to export oriented one.[1] Expected 2020 harvest will help promoting export potential across main crops that form one third of Russian agrarian exports – wheat and sunflower (*Fig. 1*).



* Including revaluation of vegetable oil exports.

** Forecast.

Fig. 1. Production and exports of wheat and sunflower in Russia in crop years 2016–2021 (%, production in crop year 2016/2017 = 100%)

Sources: own calculations on data released by FAS USDA, Ministry of Agriculture of Russia.

This year, production will exceed domestic requirements in wheat by around 2-fold, and sunflower – 2.5-fold. However, projection of the sunflower crop can be adjusted downwards in the wake of the losses sustained during the draught in the south of Russia.

Russia enters the new crop year 2020/2021 with significant changes implemented in the sphere of regulation of markets of export oriented agricultural products. Among such changes are actual rejection of purchasing and commodity interventions on the grain market; expansion and institutionalization of subsidizing of shipping agricultural products; planned setting up of the state intervention grain fund; planned rise in export duties or introduction of long-term embargo on export of sunflower seeds.

1 http://government.ru/news/39926/#patrushev.

Since enactment in 2006 of the federal law "On Development of Agriculture", purchasing and commodity interventions were to be the main instrument for ensuring protection of producers and consumers of grain under differently directed price fluctuations. The record of their implementation however making a certain contribution in stabilization of market oriented prices nevertheless did not ensure guarantees of grain sale and could not fully support the income level of producers which was one of the identified by the law objectives of regulation.

Actually, the tool of purchasing interventions on the grain market has not been in use since 2017, although formally it continued operating, minimum and maximum prices were annually approved and in 2019 a new procedure for their calculation was applied. Currently, one can acknowledge the tool to lose its regulatory function.

Firstly, from the demand point of view, there is no wish to apply this tool. Assessment of the purchases volume is a prerogative of the Ministry of Agriculture of Russia, However, its leaders consider interventions an ineffective tool for regulation.[1]

Secondly, from the point of view of support of the proposal, there are no resources for its effective use. The RF Government takes decisions, on the one hand, ensuring reduction in costs for maintenance of the intervention fund, but on the other hand, actually prohibiting the use of upper bound of price for grain in the course of stabilization. This is confirmed by the implementation of a compensation mechanism to the agent of a negative difference between the sales price and the purchasing price of grain[2] and practically total sale of grain from the intervention fund on exchange trading.[3]

Thirdly, actually, the procedure for replacing the tool has been defined. On the part of demand as an alternative to interventions should become subsidies for shipments of grain whose procedure of assessment was effective from June 2020,[4] and on the part of supply – the state intervention grain fund whose plans have been announced by the Government and the leadership of the Ministry of Agriculture of Russia.

The instrument for subsidizing expenses of shipments of grain between regions with surplus and shortage of the gran balance was launched from the end of 2017. Budget expenses on its operation were growing unevenly from Rb 1 billion in 2017 to planned Rb 2.6 billion in 2020–2022. The onset of the crop season 2020/2021 demonstrated on the whole the adequacy of the new procedure for determining the shipments volumes on the basis of regional balances of production and consumption of grain for the previous years and significance of the instrument for regional markets (*Fig. 2*). Before 1 September 2020, shipments of 1.8 million tons of grain was planned at the average shipment cost of Rb 855,000 per ton. At the end of August, the limit was used by 73.2%.

Success of subsidization of grain shipments against the buildup of the export potential does not brush off questions about its potential efficiency regarding the support of producers against the backdrop of unfavorable for them market environment. Firstly, subsidization boils down to the regions with stable grain surplus, however, marked decline in grain prices can happen in other regions where producers will also need support. Secondly, the use of subsidization is

1 URL: https://rns.online/consumer-market/Minselhoz-nazval-interventsii-na-rinke-zerna-perezhitkom-proshlogo-2020-02-18/.
2 Order of the Government of the Russian Federation dated 11.07.2020 No. 1030.
3 URL: https://www.specagro.ru/analytics/202008/ezhemesyachnyy-obzor-rynka-zernovykh-za-avgust-2020-g.
4 Order of the Ministry of Agriculture of the Russian Federation dated 01.06.2020 No. 300.

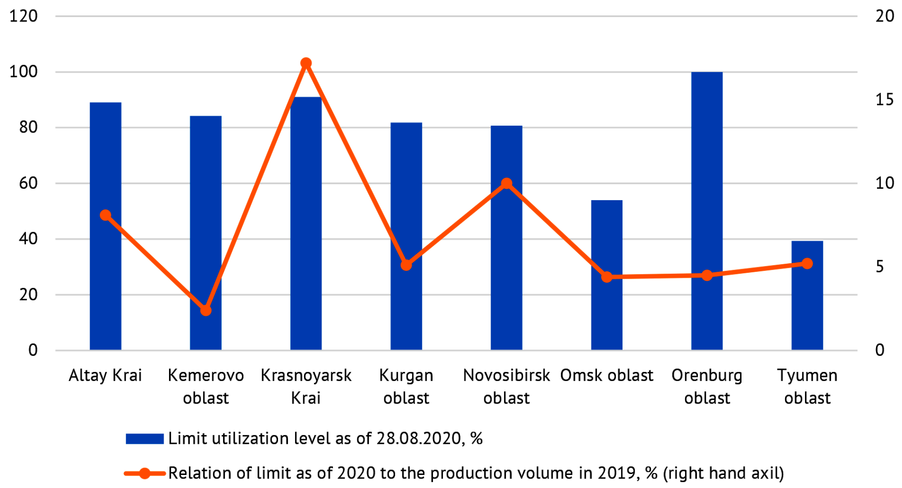


Fig. 2. Index of grain shipments at reduced tariffs in 2020[1]

based on the difference in grain prices between regions, however, regions-recipients can have prices that do not reimburse production costs of grain even taking into account subsidies.

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In this respect, the 2017 example is indicative when due to the record harvest the grain prices in Siberian regions dropped below cost of production and in the south and the center of Russia they dropped below the minimum set level. Consequently, according to the current rules for granting subsidies, their getting for purchased and shipped grain was not feasible.

Moreover, the procedure of subsidies calculation does not include the mechanism for their restrictions in case of high prices allowing the producers to obtain profits avoiding the use of the market regulation instruments linked to budget expenditures.

In our view, subsidization of shipments is an efficient instrument of state market regulation constrained by timing and regional frameworks. That said, the last condition is being observed – the program embraces 8 regions which produced in 2019 13.9% of wheat, barley, and corn in Russia then the five-year timeline of this program not associated with the market environment does not look justified.

As an alternative to the interventions in price regulation for consumers in the next crop season should become the state intervention grain fund envisaged, first of all, for leveling purchasing prices in the flour-milling industry.[2] According to our calculations, reserve grain store ensuring supplies at fixed prices in the

1 According to data released by Ministry of Agriculture of Russia: https://mcx.gov.ru/upload/medialibrary/ff4/28.08.2020.pdf.
2 URL: https://www.agroinvestor.ru/analytics/news/34210-vedomstva-prorabotayut-vozmozhnost-snizheniya-volatilnosti-tsen-na-zerno/. https://ria.ru/20200710/1574188812.html.

course of three months should be in the range of 1 million ton (in case of ensuring demand in bread production) to 3 million tons (to satisfy demand on the part of producers and population in flour) which on the whole coincides with the estimates of the Ministry of Agriculture of Russia. Annual expenses on its operation can amount to Rb 2.5 to 7.5 billion, respectively. Low elasticity of bread prices against grain prices (0.17 according to our estimates) justifies economic efficiency of the intervention fund on the back of significant fluctuations of grain prices. Fund's operational costs are compensated by financial losses of consumers from price growth on bread – in case of grain price growth by more than 15% in the course of 3 months and in case of fixed bread price growth by 2%. Additionally, socially motivated constraints in retail bread price growth – other economic conditions equal – already at grain price growth by over 8% will result in flour-milling industry losses, and under grain price growth by over 22% – even the baking industry.

Further, decline in the sunflower crop aggravates the discussion on the regulation of the distribution of its volume between processing (and subsequent export of oil) and shipment. There was a public discussion in August of the Government decree drafted by the Ministry of Economic Development[1] which envisages raising for the period from February 1, 2021 through August 31, 2021 sunflower export duty rate from 6.5% to 20%. Despite multiple expert remarks about the adverse effect of export duties growth on the sunflower producers,[2] the list of proposals on the draft decree lacked negative reviews; explanatory note features sufficient arguments justifying pros for export duty growth for fat and oil industry, however, there are no facts supporting total benefit from the regulation taking into consideration potential losses in agriculture. That said, export restrictions can be tightened: Oil-and Fat Union of Russia has submitted proposals on the implementation of the four-year ban on sunflower seeds export.[3]

Arguments of the representatives of the fat and oil industry about the benefit of effective from April through August of the current year of restrictions on sunflower seeds export outside of EAEU[4] for their producers on the back of domestic price growth looks debatable. For the period from mid-February (breakout of market pandemic-induced instability coupled with oil price drop, and volatility of the ruble rate instability) through early September 2020 sunflower prices in CFD went up by 17.1%, in SFD by 19.0%,[5] meanwhile in Eastern Europe – by 20.0%, in Southern Europe – by 26.2%[6] in ruble terms.

Shift in priorities in the market regulation towards domestic consumers and processing, lack of guarantees for producers and difficulty in long-term planning can in the future result in reduction in agricultural production.

1 URL: https://regulation.gov.ru/projects#npa=107082.
2 URL: https://www.kommersant.ru/doc/4165549, https://www.agroinvestor.ru/markets/news/33876-eksportnaya-poshlina-na-podsolnechnik-mozhet-vyrasti-do-20/, https://t.me/agro_nomika/419.
3 URL: https://www.vedomosti.ru/business/articles/2020/08/10/836327-eksport-podsolnechnika.
4 URL: https://www.mzhsr.ru/mneniya/mixail-malczev-lyuboe-regulirovanie-ryinka-vyigodno,-esli-pozvolyaet-razvivatsya-i-rossijskim-agrariyam,-i-maslozhirovoj-otrasli.
5 URL: https://www.apk-inform.com/ru/prices.
6 URL: https://ec.europa.eu/info/food-farming-fisheries/farming/facts-and-figures/markets/prices/price-monitoring-sector_en.

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In our view, improvement of the regulation mechanism is possible within the application of the following measures.

To integrate subsidization of grain shipments and operation of the state intervention grain fund in the mechanism of purchasing and commodity interventions envisaged by the law “On Development of Agricuture”, including:

- ensure purchases of grain on the back of significant reduction in domestic and global prices below the bottom line in order to support producers’ incomes;
- implement subsidization of shipments on the back of reduction in prices on grain below the bottom line in certain regions;
- ensure constant volume of the state intervention fund by way of competitive exchange purchases under favorable conditions, but not mandatory under price decline below bottom line;
- ensure sale of grain from the state intervention fund to the flow-milling and/or bakery industry with their pledge to stabilize production volume and price level;
- ensure grain sale from the state intervention fund on exchange trading amid price growth above the maximum level.

2. Apply estimates of redistribution of revenues between agricultural producers and processing industries in planning of measures aimed at achieving export objectives of AIC products, considering:

- effect from restrictions on sunflower seeds export on its prices on the domestic market;
- effect from the changes in sunflower prices on mid- and long-term dynamics of its production;
- change in revenues of sunflower producers due to possible change in prices and its production volumes.

3. BANK OF RUSSIA HAS TAKEN A BREAK IN MONETARY POLICY EASING

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The Bank of Russia Board of Directors meeting on 18 September 2020 left the key rate unchanged at 4.25% per annum thus putting on hold monetary policy easing taking place from the outbreak of the coronavirus pandemic. This decision was due to the effect of short-term proinflationary risks including weakening of the ruble, rapid revival of consumer demand, growth in inflationary expectations of the population and businesses. According to the Bank of Russia forecast annual inflation will hit 3.7–4.2% in 2020, 3.5–4.0% in 2020 and will stay close to 4% over the forecast horizon.

We recall that in the wake of 4 stages of the monetary policy easing implemented this year, onwards of February 7 when the key rate was reduced from 6.25% to 6% per annum, it hit the current level in late July. Stoppage of the monetary policy easing was due to the change in the balance of inflationary risks that happened in late summer – early autumn this year. Among the factors that contribute to the acceleration of inflation the key ones are the ruble's weakening, revival of the consumer demand, growth of the global prices on foods products and inflationary expectations of the population and businesses.

Inflation in Russia is on the rise reaching the target level. At August-end of 2020, the growth rate of consumer prices was zero meanwhile in August 2019 deflation was registered at -0.2%. Seasonal food inflation was the factor for slowing down in the CPI growth. Food price growth reported in August 2020 was negative and constituted -0.8% (-0.9% in August 2019). That said, the price growth of non-food products in August accelerated to 0.4% compared to 0.3% registered in July (0.2% in August 2019) which was due both to revival of consumer demand after the lockdown and weakening of the ruble. Price growth rate on services hitting 1% in July 2020 was owing to the indexation of housing and community amenities tariffs and in August stood at 0.4%, i.e. double that index in the last year (0.2% in August 2019).

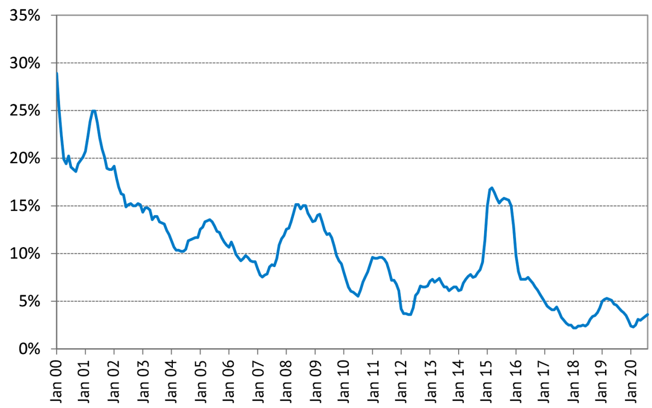

Fig. 1. Inflation for the previous 12 months, %

Source: Rosstat.

As a result, at August-end 2020, inflation in annual terms (over previous 12 months) hit 3.6% (in comparison with 3.4% in July) (*Fig. 1*). It should be noted that in the period from 1 through 14 September 2020 deflation was observed, prices decreased by 0.1% (-0.2% in September 2019) which was driven mainly by seasonal decline in prices on fruits and vegetables. Core inflation (exclusive of administrative and seasonal factors) in the course of June-August 2020 was constantly accelerating in annual terms (over recent 12 months) from 2.9% in June, to 3.0 and 3.1% in July and August respectively, which shows proinflationary risks.

According to the Bank of Russia estimates, inflation till the end of 2020 will be gradually on the rise and at the year-end will hit 3.7–4.2%. In our view, taking into account current inflation at 3.7% as of mid-September, inflation at 2020-end actually can exceed the target level of 4%.

One of the key factors of inflation acceleration is the weakening of the ruble against the dollar. For example, during July-August 2020 the ruble's exchange rate to the dollar dropped by 6.7% to Rb 74.6 to the dollar and over the first two weeks of September went down by another 0.7% to Rb 75.1 to the dollar (*Fig. 2*). The observed weakening of the ruble in the context of oil price growth (in July-August by 9.5% to 45.6 USD/bbl) was due to growing geopolitical risks, somewhat decline in attractiveness of Russian OFZ for non-residents in the wake of reduction in the key rate as well as decreased interest of investors in assets of developing countries against the backdrop of global uncertainty.

It should be noted that according to our estimates accounting Rb/USD rate[1] bearing in mind the oil price level, the interest rate differential in Russia and abroad, and the level of risk in the global economy in August stood around 70 Rb/USD. This shows a significant underestimation of the ruble, which is due to the outflow of capital from the RF driven, first of all, by geopolitical factors.

One more proinflationary factor is revival of consumer demand. Real wages in June-July 2020 were growing against the same period of the previous year: by 1% in June, 0.6% in July 2020 (1.6% in June 2019 to June 2018, 2.9% in July 2019 to July 2018). In June-July 2020 slowdown in growth of retail sales was observed which in annual terms constituted -7.7 and -2.6% respectively (-19.2% in May 2020 to May 2019).

Increase in the global food prices contributes to the acceleration of inflation in Russia. The index of food prices went up from 91.0% in May 2020 to 96.1% in August 2020. This owes to the revival of the global consumer demand as well as somewhat weakening of the dollar as a result of accommodative monetary measures put in place by the US FRS. Over June-August 2020, the world prices on dairy products moved up by 8.1%, grain – 1.2%, vegetable oil – 26.9%, and sugar – 19.6%.[2]

Inflationary expectations of the population and enterprises demonstrate increased risks of inflation acceleration. For example, findings of the survey conducted by "InFOM" demonstrate that median value of inflationary expectations for the next 12 months in August 2020 hit 8.8% meanwhile in March this year (last point before suspension of survey in personal interview mode) this index stood at 7.9%. The August balance of responses obtained from enterprises in the framework of "InFOM" survey following the July decline also rose which demonstrates growth in the expected price growth rate. At the same time, enterprises indicated increase in purchasing prices driven, first of all, by the weakening of the ruble.

1 Estimates were received on the basis of the model of nominal currency exchange rate that take into account such factors as oil price, differential of interest rates in Russia and abroad, index of volatility on financial markets Vix, as well as dummy variables on currency interventions by the Minfin (see in detail *Bozhechkova A.V., Sinelnikov-Murylev S.G., Trunin P.V.* Factors of the Russian ruble exchange rate dynamics in the 2000s and 2010s. Voprosy Ekonomiki. 2020. No. 8. P. 1–18).

2 Data released by the UN Food and Agriculture Organization.

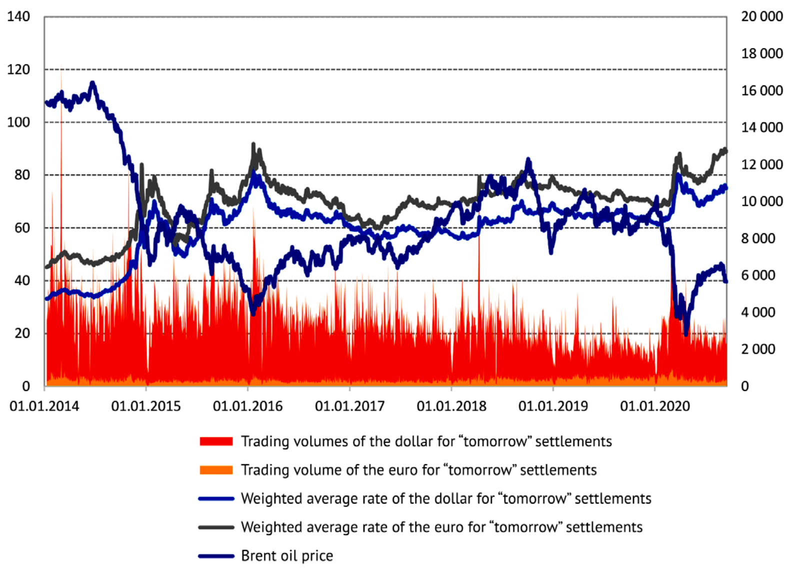

Fig. 2. Dynamics of dollar and euro rate against the ruble and Brent oil prices

Sources: Bank of Russia, Finam.

It should be noted that somewhat acceleration of inflation during last 3 years was observed in many developing countries. In the wake of pandemic central banks of the majority of countries time after time eased monetary policy trying to fuel economic activity. This being said, gradual revival of consumer demand produced an upward pressure on prices (*Fig. 3*).

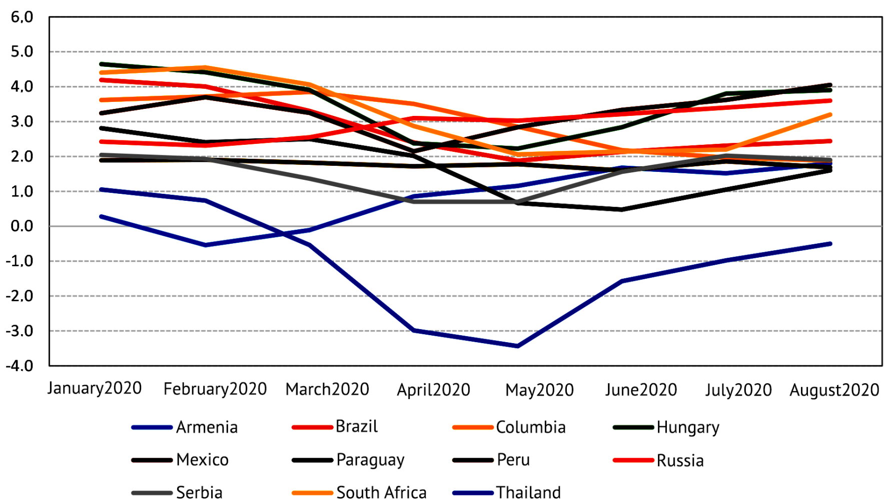

Fig. 3. Inflation in some developing countries (over previous 12 months, %)

Source: IMF.

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We believe that amidst risks of the acceleration of inflation and its rapid approach towards the target value the September stoppage of monetary policy easing implemented by the Bank of Russia seems justified. This being said, the possibility of further reduction in the Bank of Russia key rate will depend, first of all, on dynamics of inflation in the coming months, as well as changes in the ruble's rate in the context of growing geopolitical tension. However, in the event there are no new external proinflationary shocks, there is certain room for reduction in the key rate at the end of this year – early next one.

4. CORPORATE LENDING IN JANUARY-JULY 2020

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On the back of the implementation of containment measures due to the spread of the coronavirus infection, the Central Bank of Russia took a host of regulatory measures aimed at reducing banks' expenses on creation of loan loss provisions and stimulating soft lending. From the point of view of liquidity and capital provisions, the CB actions coupled with the banking system resilience allowed to avoid repetition of the credit shocks of 2008 and 2014 and ramp up volumes of corporate lending.

Activity pick-up on the corporate lending market amidst the pandemic is triggered by three main factors:

- Need to offset decline in cash flows and probable additional expenses of businesses in the wake of the business activity stagnation;
- Currency revaluation on the back of the ruble's depreciation;
- Comprehensive set of measures taken by the Central Bank aimed at the support of target corporate bank lending.

Corporate credit exposure before Russian banks during 7 months of 2020 went up by Rb 3.9 trillion (up by 9.6% of the volume of corporate bank loans as of the onset of year). Total debt of Russian enterprises before credit institutions as of August 1, 2020 amounted to Rb 37.9 trillion. Consequently, growth rates of corporate lending markedly exceed indexes of the last year. In 2019, corporate credit portfolio of Russian banks for the same period increased merely by Rb 0.45 trillion (or by 1.4%) to hit Rb 33.5 trillion.

The ruble segment's growth hit 7.7% (for the period from January to July 2019 the same index constituted 4.4%), and the currency part of the credit portfolio in ruble terms moved up by 18.8% (for the same period of 2019 decrease was registered at 11.1%). Without regard to the ruble's depreciation, currency lending practically stayed unchanged (slight decline by 0.3%), meanwhile last year the rates of contraction in the corporate lending portfolio in the currency segment were rather significant (9.5%).

It should be noted that such significant increment in corporate lending debt in large measure was due to the spike in March, when the credits portfolio increased by 6.1% (significant part of credit deals falls on the last week of March). In subsequent months as demand goes down for short-term financing, growth gave way to correction (*Fig. 1*). Growth resumption in corporate lending in July

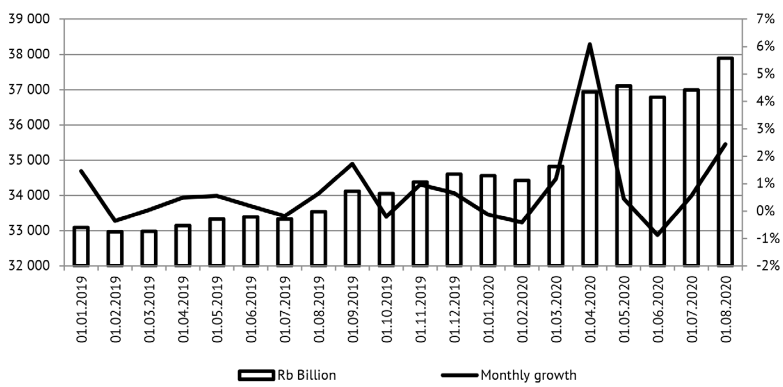

Fig. 1. Dynamics of corporate lending in 2019–2020

Source: statistical bulleting of Bank of Russia for 2020.

was due mainly to demand increase in mid- and long-term credits in the context of gradual economic revival.

The highest indexes of credit debt growth across industries according to OKVED-2 were noted in "Provision of services in extraction of mineral resources" (for 7 months of 2020 up by 257%), "Development of computer software, consulting services in this sphere and other related services (up by 86%), "Activity in the sphere of architecture and engineering and technical design; technical testing, research and analysis" (up by 52%). Dramatic drop in the volumes of lending was registered in "Provision of services in the sphere of liquidation of effects of pollution and other services tied to waste management (down by 53%), "Activity in the sphere of law and accounting (down by 41%)," "Functioning of libraries, archives, museums, and other cultural facilities" (down by 38%).

Short-term proinflationary risks at the onset of the pandemic did not affect the cost of lending in the ruble segment, an uptick was registered in April in the wake of self-isolation, but later in the course of stabilization of business's inflationary expectations, the interest rates went on declining. In the currency segment, interest rates were subject to fluctuations due to instability on the currency market (*Fig. 2*).

At the outset of the pandemic, the central bank developed measures of support of enterprises in potentially vulnerable industries, enterprises in healthcare industry, special attention was paid to small and medium-sized enterprises.

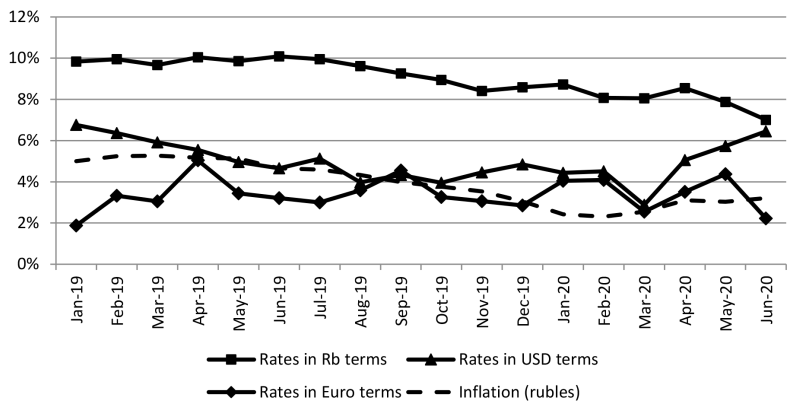

Fig. 2. Interest rates on the corporate lending market (from 6 months through 1 year)

Source: Banker's books according to form 101 (Ban of Russia website).

In March, with the onset of the implementation of lockdown measures, the Bank of Russia expanded the program of SME refinancing, setting a limit on the program at Rb 500 billion and cutting the interest rate from 6 to 4%, including allocation Rb 150 billion for lending SME in support of employment. Loans in the framework of this mechanism are originated for a period of 1 year at the interest rate of 4%. For the bank with high credit rating they originate unsecured loans.

As an additional support measure, the interest rate was cut within the already effective mechanism of refinancing on the surety of JSC "Corporation SME" from 6 to 4% and sectoral restrictions were lifted. That said, the interest rate for a borrower should not exceed 8.5%.

From April 27, 2020, the interest rate on loans originated by the Bank of Russia designed to support SME lending including urgent needs for keeping employment was reduced from 4 to 3.5% and from June 22, 2020 – to 2.5% annual.

The decision was taken on not worsening of the estimate of the financial situation of the borrow and/or debt service quality on credits restructured due to the pandemic (enterprises in the vulnerable industries). Subsequently, these regulatory easing were extended to the enterprises in all industries on condition that extended credits were classified not worse than in II quality category as of March 1, 2020. The banks are given the right to form reserves on corporate loans restructured prior to September 30, 2020on or before April 1, 2021.

As a result of measures implemented by the Central bank of Russia, many enterprises in vulnerable industries (for example, "Activity in the sphere of sport, recreation and entertainment", "Activity in provision of foodstuffs and beverages") received support in terms of soft-window facility and some them managed to ramp up borrowings compared to the pre-crisis period. However, enterprises in certain industries ("Activity of tourist agencies and other organizations providing services in the sphere of tourism", "Creative activity, activity in the sphere of arts and organization of entertainment") have experiences serious difficulties in significantly decreased borrowing volumes.

Another measure was the central bank's decision on the debt restructuring envisaging change of the currency from the foreign one to the national one in order to decrease debt burden of borrowers and minimization of the banks' currency risks.

The dynamics of interest rates of credit institutions (within provision of corporate loans) has undergone some changes mainly due to the decline in the interest rates. Despite the credit portfolio growth registered in H1 2020, obtained and earned interest on credits extended to non-state commercial organizations decreased by 11.6% and constituted Rb 993 billion (as of July 1, 2019 – Rb 1.12 trillion).

Interest yield from corporate lending is one of the main sources of income whereupon banks strive to offset the reduced interest margin by the cost of the commission income which demonstrated significant increase last year (by 72.1%). Nevertheless, in H1 2020, the commission income from loans granted to non-public organizations remained around the same level (decrease by 0.7%), moreover the ruble part of income went up by 6.1% meanwhile the currency one decreased by 51.5%.

Despite regular easing, banks continued ramp up reserves for possible losses on credits which demonstrates the deterioration on the financial situation of part of borrowers. However, the proportion of bad debts remained unchanged from the start of the year in the course under review: as of August 1, 2020, this index came to 7.1% (as of corresponding date of last year – 7.5%). However, the real level of the credit risk and the quality of the corporate credits portfolio can be judged solely after October 1, 2020 when the central bank's benefits on formation of reserves will terminate.

5. THE OIL MARKET IN MAY-AUGUST 2020

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Plunge in the oil prices seen in H1 2020, induced by the coronavirus infection was coupled with the lack of an agreement on the prolongation of OPEC+ deal. The latter has aggravated competition on the global oil market and led to a significant growth in commercial stocks of crude oil and oil products. The situation stabilized following the resumption on OPEC+ deal on cutting production coupled with the gradual easing of quarantine measures in a number of countries. Further dynamics in the oil industry will depend on compliance with the OPEC+ agreement and revival of demand.

In order to avoid further decline in crude oil prices a new OPEC+ deal was signed on April 12, 2020. According to the deal, in May-June 2020 the decline in oil production should hit 9.7 million barrels per day (mbpd) against the 2018 production level. For the next 6 months, reduction in the oil production was envisaged at 7.7 mbpd and then by 5.8 mbpd through April 2022.

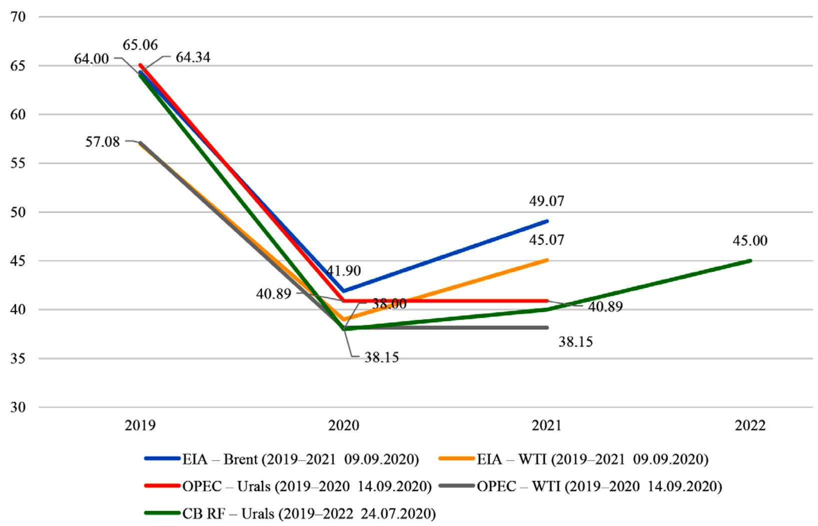
Second half of April was complicated for the oil industry given that renewed agreement has not resulted in price growth which was expected because production restriction came into force only from early May and many producers continued ramping up production and offer concessions fighting for the market share. One of the key factors exerting pressure on the oil quotations was tight storage capacities.

In May oil prices positively reacted to the reduction in production carried out by the members to the OPEC+ agreement. Total contraction hit 6.3 mbpd or 84% of the agreed amount. According to OPEC monthly oil market reports, Russia complies with the OPEC+ deal by 91% reducing its daily oil production by 2.27 mbpd down to 8.73 mbpd. According to data released by the Ministry of Energy of Russia, in May the level of the oil production came to 8.59 mbpd which corresponded to the deal by 96%. Differences in indexes are due to the methods of calculation.

At the OPEC+ meeting held in early June, a decision was taken to extend the cut in production by 9.7 mbpd through the end of July other terms of the deal remained the same. OPEC countries met the conditions of the deal by 112% mainly owing to the cut in production by Saudi Arabia by 1 mbpd, Kuwait – by 80,000 bpd, and UAE – by 100,000 bpd. Russia complied with the agreement by 93% in June, cutting its production by 2.34 mbpd down to 8.66 mbpd.

In July, the deal on the crude oil cut was totally accomplished by 97%. The reason for the production increase registered in July was stepping up of production in Saudi Arabia by 866,000 bpd on the back of the voluntary cut in production a month earlier by 1 mbpd. The OPEC monthly oil market report indicates that Russia cut production in July by 1.93 mbpd accounting for 88% of the stipulated indexes. Commencing with August 2020 through the end of the year, the production cut will decelerate to 7.7 mbpd. It should be noted that the renewed text of the OPEC+ agreement contains a compensation mechanism whereby countries that failed to meet fully their commitments must till the end of September compensate allowed overproduction of crude oil.

In H2 2020, key risks for the global oil market affecting the dynamics of prices of crude oil and petroleum products will be: feasibility of the "second wave" of coronavirus infection, increase in commercial stocks of oil on the back of the weak demand for fuel for automobiles and air traffic. Many international organizations include those risks in their oil price forecasts[1], but on the whole the latest forecasts look more optimistic than the May ones (in detail see *Fig. 1*).



Note. EIA – The US Energy Information Administration.
Fig. 1. Oil price forecasts, USD/bbl.

The US Energy Information Administration forecasts that high rates of decline in commercial crude oil stocks will contribute to the moderate price growth through the end of 2020 compared to the current prices. However, current high level of commercial stocks will ease any significant price increase. EIA forecasts that by the year-end Brent oil prices will go up to $45 per barrel, which is a little bit higher than the average price of August 2020. Depletion in global commercial stocks will continue affecting oil prices through the end of 2021 that according to IEA forecasts will average $49 per barrel in 2021.[2]

The Central Bank of Russia revised upwards their forecasts compared to the May average annual price of Urals oil in 2020 from $27 to $38 per barrel, in 2021 – from $35 to $40 per barrel. For 2022, projection on oil prices remained at $45 per barrel. It is presupposed that the key factor positively affecting the dynamics of crude oil quotations in H2 2020 will be cut in production.

Analysis of factors that affected dynamics of oil prices

Fig. 2 demonstrates oil price dynamics for Brent and Urals in 2020. At the onset of the year, the adverse influence was exerted by spread of the coronavirus

1 At the time of preparation of the article short- and med-term forecasts regarding global oil prices were updated, which do not surpass the period of 18 months, i.e. contain numerical index on oil prices in 2020 and in 2021. Publication of long-term forecasts for years 2022 and 2023 by the reviewed organizations was carried out prior to the events significantly affecting the dynamics of oil prices (January 2020), that is why those forecasts can be considered outdated.
2 Short-term energy outlook. Crude oil prices // EIA. 11.08.2020. URL: https://www.eia.gov/outlooks/steo/marketreview/crude.php.

infection in countries that are the principal consumers of crude oil, in particular, China; absence of an agreement on the extension of OPEC+ production cut deal, which led to the escalation of competition on the global oil market between Saudi Arabia and Russia; growth in the oil glut over the demand contraction as a result of the implementation of lockdown measures in the majority of countries worldwide, which in its turn, resulted in the shortage of capacities for commercial stocks.

The period after the renewal of OPEC+ agreement but before its actual coming into effect coincided with the strengthening of the lockdown measures worldwide.

Allowance increase on Urals oil in relation to Brent oil in March-April 2020 was on the back of scale-up in shipments from Russian ports due to the onset of the seasonal repairs on the Russian oil refineries and termination of OPEC+ deal as well as lack of agreements between Russian producers and Belorussia on the resumption of oil deliveries in April which additionally increase shipments from ports.

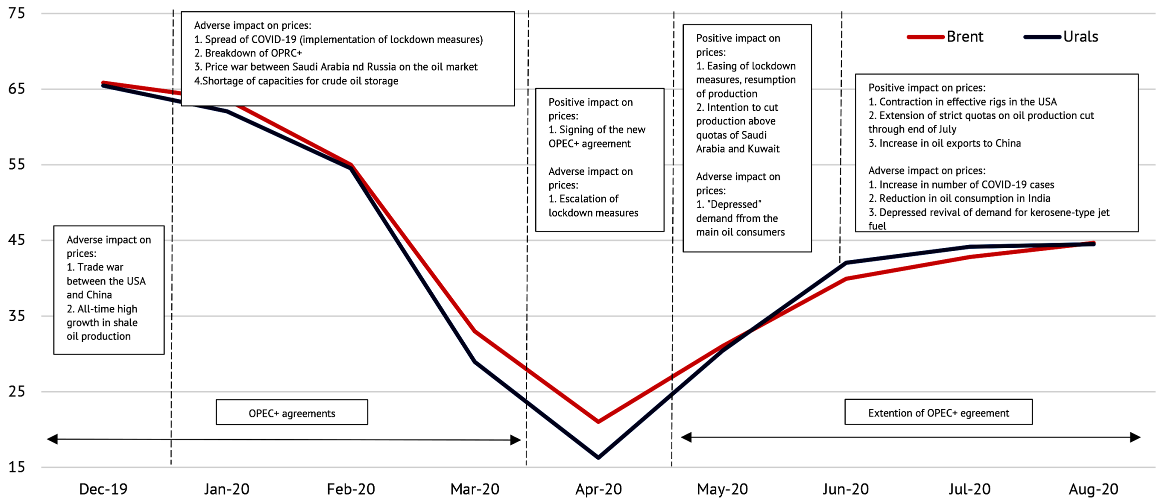


Fig. 2. Dynamics of oil prices, USD per barrel

Sources: the World Bank, Ministry of Economic Development of Russia (The Ministry of Economic Development of Russia makes an estimate of the average for the past month Urals oil price on the Mediterranean and Rotterdam oil markets with the use of data released by Argus Media (Russia) Limited.

Commencing from May, oil prices began going up owing to the real cut in the oil production by OPEC+ countries. This trend was retained in June due to additional contraction above quotas executed by Saudi Arabia and Kuwait. Easing of lockdown measures and resumption of production in a number of countries as another factor positively affecting the price dynamics in May-June. However, depressed demand and slow rates of contraction in stocks restricted this growth. Possible risks for the oil market can be: growth in the number of coronavirus infection cases registered in July-August 2020; reduction in OPEC+ quotas on the oil production cut from August 2020; full oil storage capacities (by over 60%).[1]

1 OPEC Monthly oil market report demonstrates that commercial stocks across OECD countries continue growing but at a slower pace (in some countries they decline, for example, in the USA). In June 2020, commercial stocks of crude oil and petroleum products in OECD countries surpassed average five-year indexes by 291 m barrels: growth to May 2020 amounted to 24 m

Russian crude oil market in May-August 2020

In the framework of OPEC+ agreement Russia undertook to cut oil production by 23% during May-June 2020, by 18% during July-December 2020, and by 14% from January 2021 of the benchmark production level of 11 mbpd. *Table 1* provides total production volumes by Russia by months 2020 as well as exports volumes, domestic supplies, oil and oil products transfer through sea ports.

Table 1

Dynamics of production, refining and exports of Russian oil industry

Index	January 2020	February 2020	March 2020	April 2020	May 2020	June 2020	July 2020
Production (with gas condensate), m t	47.7	44.7	47.8	46.4	39.7	38.2	39.6
To the corresponding month of 2019, %	-0.8	3.2	-0.1	1.0	-15.5	-16.4	-16.0
Exports, m t	21.3	20.8	21.4	22.2	18.5	18.1	17.2
To the corresponding month of 2019, %	-3.6	1.0	-6.0	-0.3	-13.0	-14.7	-25.2
Oil shipments for domestic refining, m t	25.1	23.8	25.5	22.5	21.9	20.1	22.5
To the corresponding month of 2019, %	-0.4	5.0	6.2	1.1	-4.2	-11.9	-11.7
Transshipment of liquid tank cargo in Russian ports, of which:	40.3	37.6	37.6	41.3	39.5	37.3	29.1
To the corresponding month of 2019, %	2.3	3.8	3.8	5.7	6.2	-4.1	-24.4
- crude oil	22.8	21.3	21.3	24.1	23.4	20.7	16.1
To the corresponding month of 2019, %	-5.0	-4.3	-4.3	8.3	4.5	-16.9	-32.9
- petroleum products	13.9	12.9	12.9	13.6	12.6	13.3	10.2
To the corresponding month of 2019, %	13.0	7.9	7.9	13.8	10.5	23.1	-10.5

Source: Ministry of Energy of Russia.

Potential further contraction in demand (in the event of "second wave" of pandemic) on Russia's oil market is contingent with serious risks. Despite the competitiveness of the Russian producers (both due to operational costs and features of tax regulation where risks of low oil prices are partly transferred to the budget) prolonged stay of the oil prices below $15 per barrel can lead to the majority of new projects to operate at a loss and effective projects will happen to be on the brink of profitability.[1] Rapid and large-scale contraction in production in the wake of low prices can lead to the revision of the investment programs (including financing of projects on hard-to-recover reserves, prospecting and development of new oilfields, technological re-equipment and modernization of oil refineries).

barrels against 82 m barrels in May to April 2020.In the USA commercial stocks of crude oil and petroleum products exceeded average five-year indexes by 161.4 m barrels in June 2020: contraction to May 2020 amounted to 9 m barrels. Dynamics of commercial stocks of crude oil and petroleum products was driven mainly by expectations of the future demand for fuel and energy resources, which depends on the feasibility of the "second wave" of coronavirus, restructuring of many production plants and events to remote mode, but not on the price growth and curtailment of oil production by OPEC+ agreement.

1 According to the MET calculation formula when oil price drops below $15 per barrel, the amount of MET is zero and the state stops receiving corresponding income.