Bank of Russia

No 6

TALKING TRENDS
Economy and markets
Research and Forecasting Department Bulletin

CONTENTS

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The views and recommendations expressed in the bulletin do not necessarily reflect the official position of the Bank of Russia.
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EXECUTIVE SUMMARY

MONTHLY SUMMARY

- July–August recorded some signs of a decrease in persistent inflationary pressure in the consumer market, but it nonetheless remains elevated. Households' and businesses' inflation expectations lowered somewhat, while still staying high, which causes the risks of stronger secondary proinflationary effects from price growth. Credit activity still continues to expand quickly. Higher interest rates on bank deposits have not yet influenced trends in the household deposit market as this change takes some time. Driven by soaring demand for labour, the growth rate of nominal wages sped up to double digits. This upward trend significantly supports the expansion of domestic demand and is a source of proinflationary risks as the response of products and services supply to higher demand is not sufficiently fast. The monetary policy pursued is weakening the impact of steady price growth factors. However, given the current situation, the influence of these factors will be waning gradually, thus limiting the deceleration of annual inflation.
  - In July – the first half of August, fruit and vegetable prices decreased considerably as compared to the levels typical of this season. During this period, the weekly growth of consumer prices (seasonally adjusted) slowed down substantially, although temporarily. After the effect of the reduction in fruit and vegetable prices was exhausted, the growth of consumer prices has probably sped up again to nearly 6% in annualised terms. In these conditions, annual inflation will reverse, slowing down to 4%, after the disinflationary effect of the earlier key rate increases on steady price growth components becomes stronger, and this will take some time.
  - According to surveys, economic activity started to trend downwards in July–August, declining closer to its potential growth rate. This was associated with both the remaining disruptions in raw materials and components supplies and a certain reduction in demand due to the depleting potential of the recovery growth in increasingly more industries and the negative response of demand to higher prices. Nonetheless, companies are still positive about the prospects of further demand and output growth. Their optimism is supported by the continuing upward trend in corporate and retail lending.
  - The Russian equity market hit its new highs in July–August. The bond market recorded a drastic decline in the slope of the yield curve. Moreover, yields on long-term bonds decreased amid a rise in market participants' expectations regarding the return of inflation to the target in the medium term. Hence, the monetary policy pursued promotes the stability of long-term interest rates in the economy.

IN FOCUS. Structural shifts in the labour market bring about proinflationary risks

- The pandemic and its aftermath have significantly altered the structure of the demand for labour. These shifts, coupled with the slow adjustment of supply in the labour market, have increased the natural rate of unemployment. This is evidenced by, among other things, the surge in the demand for labour and intensified inflationary pressure, even though unemployment has not fully returned to the pre-pandemic rate.
- One of the most important indicators of the labour market is the dynamics of wages. By the end of the first half of the year, the growth of nominal wages reached double digits. The highest rates were demonstrated by the industries facing a considerable rise in the demand for labour and higher competition for workers among employers.
- If the labour market maintains this trend in the next few quarters, the structural changes in the demand for labour may well support the generally faster growth of wages in the economy. Higher employment rates and wages in the leading industries will boost competition in the labour market and the growth of wages in other sectors as well. Moreover, wages may even rise faster than labour productivity. This might hinder the decrease in inflationary pressure.

1. Inflation

Monthly seasonally adjusted consumer price growth slowed in July–August. This was largely owed to the impact of one-off disinflationary factors in the fruit and vegetable and tourist services markets. That said, the key indicators of *persistent* inflationary processes, such as monthly indicators of core inflation and median price rises, as well as trend inflation, still suggest that the consumer sector continues to see significant inflationary pressure, which has so far declined only marginally.

Double-digit wage growth outpacing a labour productivity rise due to the shortage of labour in the face of demand expansion, as well as a fast pace of consumer lending growth, may restrain disinflationary trends and inflationary pressure's return to normal in the Russian economy. A record high level of job vacancies in the economy amid a rising financial result makes employers go along with accelerated wage growth relative to a productivity rise with workers and businesses' elevated inflation expectations contributing to it. Structural changes in the labour market are boosting a wage growth trend in the economy, producing a workforce shortage, driven by inter-industry competition for labour. The recovery of migrant workers' inflows may partially relieve the labour market situation.

The substantially elevated level of household and business inflation expectations may also contain the slowdown of a rise in the persistent indicators of inflationary processes and annual inflation. Among other things, elevated inflation expectations increase economic agents' propensity to consume, especially durable goods, their willingness to buy goods and services at rising prices, revise producer and retail prices more frequently, invest their savings in high-risk financial instruments, etc. In a situation of the elevated inflation expectations, households may view even the recent hikes in bank deposit rates as inadequate for maintaining the purchasing power of their savings. This is taken into account in conducting monetary policy.

According to our estimates, the disinflationary effects of the key rate raise will be gradually mounting as the signal is transmitted via the interest rate, loan-deposit, and other channels of the transmission mechanism. This will help inflation slow to 4.0%–4.5% in 2022 in Russia.

1.1. Inflationary pressure remains elevated but is declining somewhat

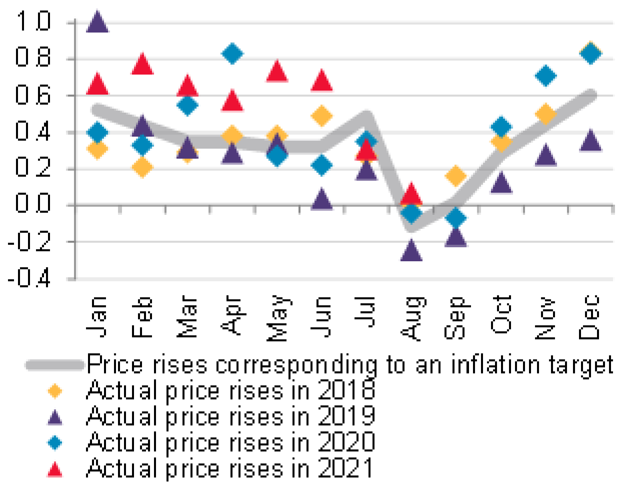
- Inflationary pressure adjusted for temporary and one-off factors declined somewhat in July–August but is still far above the 4% level. An elevated rate of price rises continues in many consumer basket components.
- That said, headline inflation was affected by various temporary and one-off factors. Overall, their impact was disinflationary in July, including due to the reversal of some components which drove headline inflation higher in the previous months. Thanks to this, month-on-month price rises for the first time in 2021 came in below a path corresponding to an inflation rate of 4%.

- Real time data indicates that the impact of these factors was no longer evident in the second half of August, therefore, seasonally adjusted month-on-month price growth will again exceed the 4% level in annualised terms.
- Monetary policy decisions being taken will help inflationary pressure decline gradually, bringing annual inflation down from the current 6.5% to 4.0%–4.5% in 2022 and keeping it close to the 4% level subsequently.

July saw *month-on-month price rises*[1] slow to 0.31% from 0.69% in June, coming in at a path corresponding to an inflation rate of 4% (Figure 1). *Annual inflation* slowed somewhat to 6.46% (Figure 2). The rate of *seasonally adjusted* consumer price rises declined to 2.39% MoM SAAR[2] (Figure 3). The key contribution to the price rise slowdown came from a deeper than usual seasonal drop of fruit and vegetable prices (Figure 4). Price rises were further contained by a slide in the prices of some unregulated services (hotel and tourism services). Non-food goods price rises, however, continued to gain momentum in both month-on month and year-on-year terms.

Seasonally adjusted consumer price rises in the *food segment* decelerated to 1.78% MoM SAAR in July (Figure 3), almost entirely due to a faster than seasonally normal decrease in fruit and vegetable prices on the back of a strong harvest (Figure 4). These price movements were generally expected, given faster price rises in the previous months, which provided an additional potential for a subsequent price decline, which was fairly sharp. Fruit and vegetable prices will likely be closer to the seasonal norm in August–September, no longer restraining overall price movements.

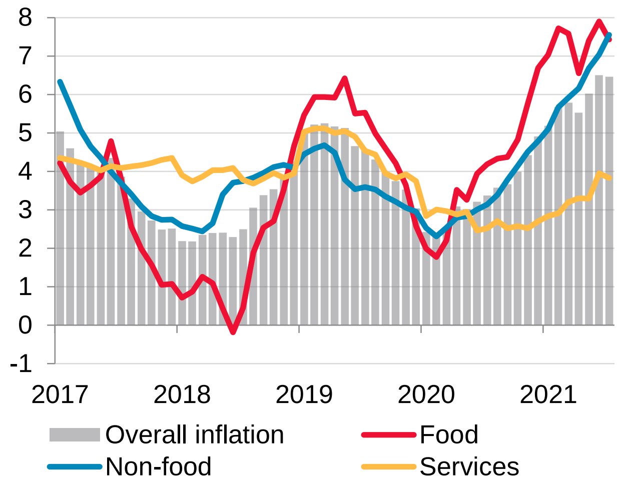
Figure 1. Price rises corresponding to an inflation rate of 4%, % MoM



Note: August 2021 figure is a preliminary estimate based on weekly data.

Source: Rosstat, R&F Department estimates.

Figure 2. Inflation and its components, % YoY

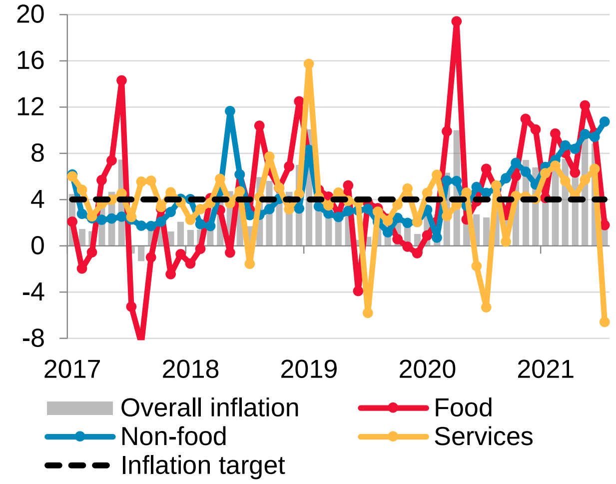


Source: Rosstat.

[1] Before seasonal adjustment.

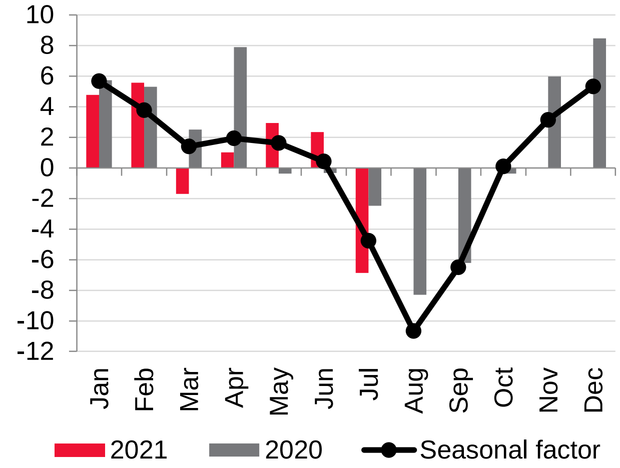
[2] SAAR – Seasonally adjusted annualised rate).

Figure 3. Seasonally adjusted inflation, % MoM SAAR



Source: Rosstat, R&F Department estimates.

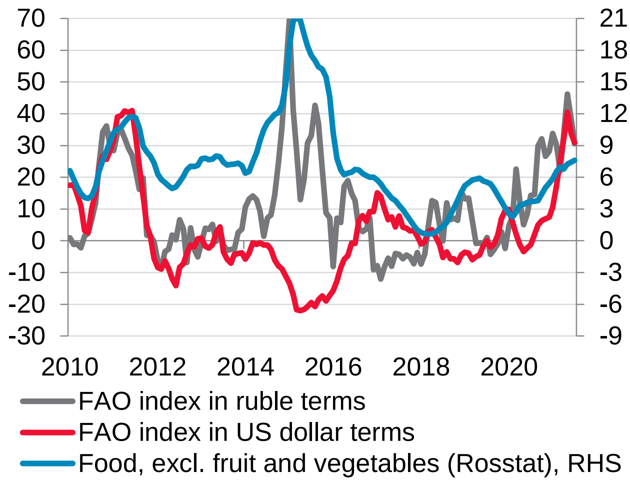
Figure 4. Fruit and vegetables prices, MoM



Source: Rosstat, R&F Department estimates.

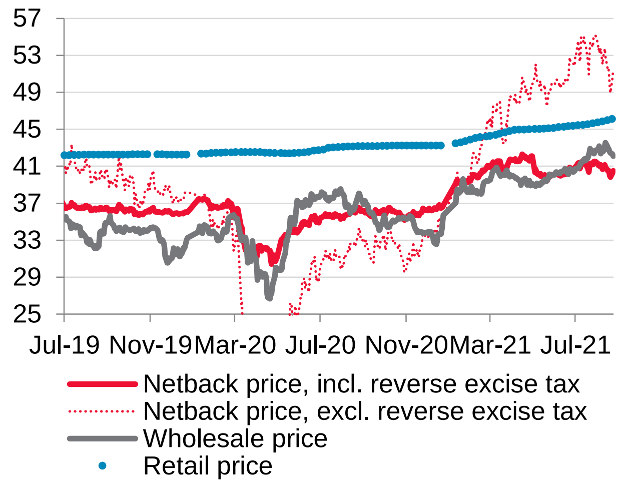
An elevated rate of price rises continues for many food products, but average price increases in the food segment, net of fruit and vegetables, slowed slightly relative to June: food price inflation (exclusive of fruit and vegetables) came in at 6.66% MoM SAAR after 7.59% MoM SAAR in June. Given a gradual easing of pressure on domestic prices from external markets (the FAO Food Price declining for the second consecutive month, Figure 5), one can expect this segment's price rises to slow gradually in the next few months.

Figure 5. World and domestic food prices, % YoY



Source: FAO, Rosstat, R&F Department estimates.

Figure 6. AI-92 petrol price, rub/litre



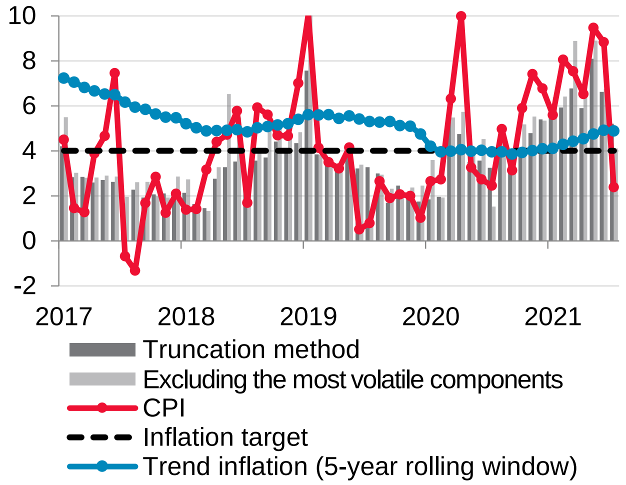
Source: Rosstat, St. Petersburg International Commodity Exchange, R&F Department estimates.

Inflationary pressure has continued to mount in the *non-food segment,* driven by a consumer activity rise amid elevated household inflation expectations and lending expansion, coupled with an increased rate of tradables' cost and price rises. A seasonally adjusted rise in the prices of non-food goods accelerated to 10.72% MoM SAAR in July (Figure 3). Price growth, elevated relative to 4% in annualised terms, continued in many categories, accelerating notably in petrol, passenger cars, television and radio goods, as well as electrical goods. Car price movements continue to be driven by microchip shortages and supply problems amid a concurrent rise in demand for these components. The prices of construction materials are affected by a similar picture in the lumber market. Rises in petrol prices have accelerated as relevant world prices have increased in recent months. The effect of the damper mechanism to a great extent contains the impact of rising world prices on domestic prices (Figure 6). A world price decline at the start of August, will, however, likely help stabilise petrol and diesel prices.

The *services sector* saw prices fall 6.59% MoM SAAR (Figure 3), driven chiefly by seasonally adjusted price movements in the housing and communal sector (whose prices were indexed less than 4%) and hotel services. After June's rise in foreign tourism services prices on the back of opening borders with Turkey, prices dropped in July, providing further contribution to the overall services price changes. Price rises in other categories of market services (personal and health care services, etc.) remain elevated.

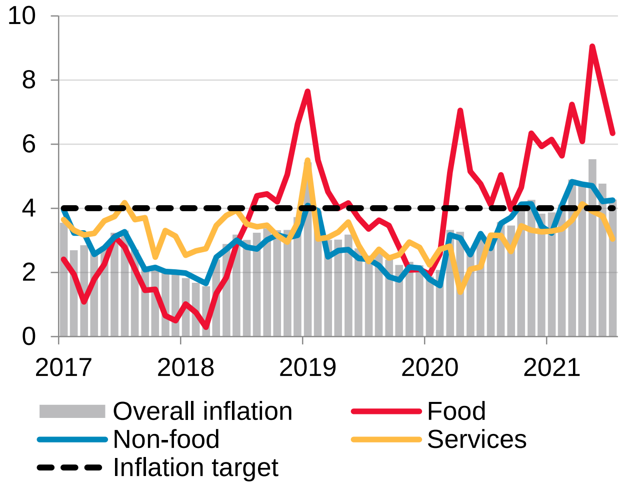
The analytical indicators of price movements in the most stable inflation components suggest some easing of inflationary pressure in the consumer market (Figure 7, Figure 8). Their estimates declined in June–July from their peak in May, but remained elevated relative to an inflation rate of 4%. July saw the mean modified core inflation indicator at 4.7% in annualised terms. The trend inflation estimate inched down to 4.88%. The median price growth in maximally disaggregated CPI components[3] also slowed to an average of 4.3%. Although inflationary pressure has slid from its peak readings, it remains elevated relative to the Bank of Russia's target. The departure of the one-off factors which caused a sharp slowdown of price rises in July will likely make headline inflation rise back above a trajectory corresponding to an inflation rate of 4% in the months to come.

Figure 7. Modified core inflation indicators and trend inflation estimates, % in annual terms



Source: Rosstat, R&F Department estimates.

Figure 8. Median distribution estimated on disaggregated components, % MoM SAAR



Source: Rosstat, R&F Department estimates.

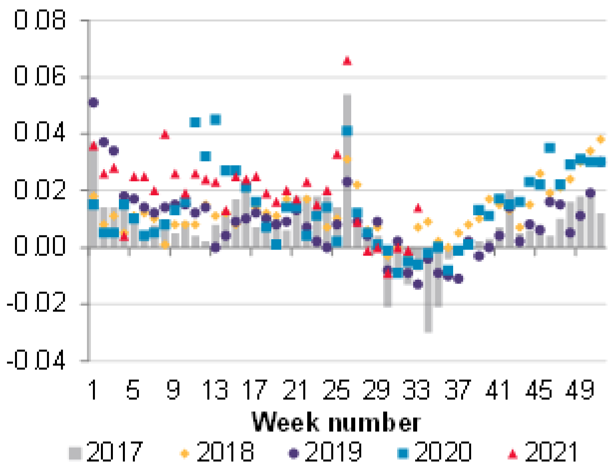
Real-time Rosstat data indicates that seasonally adjusted price growth will accelerate in August, given the weakening of one-off and temporary factors' impact which brought about a sharp slowdown in July. Prices have risen 0.07%[4] since the start of the month, above a

[3] 556 components in the 2021 basket.
[4] By 23 August.

trajectory corresponding to an annualised inflation rate of 4% and the level of the same period of previous years (Figure 9, Figure 1). The four-week moving average price of a week's basket exclusive of fruit and vegetables and regulated services prices along with the distribution median remains above an annualised rate of 4% (Figure 10). The key driver is the *non-food goods segment* with its continued accelerated hikes in the prices of cars, electrical goods, and petrol. A temporary impulse of price growth in August also made itself felt in the wearing apparel and footwear segment on the back of a seasonal rise in demand for goods bought ahead of the school year, boosted further by allowances paid to families with children. Price movements remain mixed in the *food segment*. While most food categories see a gradual slowdown of price hikes, price rises accelerated in meat products, whose share in the consumer basket is fairly large, underpinning overall price growth.

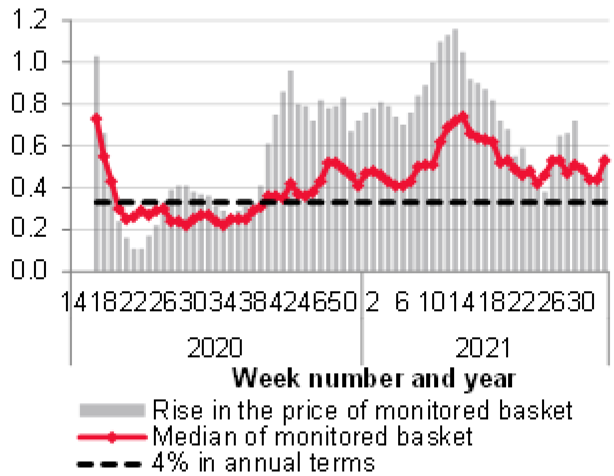
Gradual easing of inflationary pressure will continue as the effects of monetary policy decisions become evident. This will help inflation decelerate to 4.0%–4.5% in 2022 and subsequently stabilise close to the 4% level.

Figure 9. Average daily price rises, %



Source: Rosstat, R&F Department estimates.

Figure 10. 4-weeks rolling pace of the basket price increase and median distribution of weekly price rises[5], %



Source: Rosstat, R&F Department estimates.

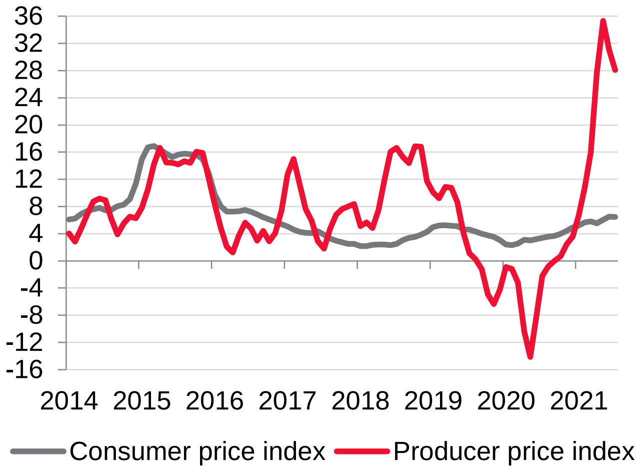
1.2. Producer price pressure on consumer prices eases slightly

- Annual rises in the producer prices of industrial goods slowed in July to 28.1% from 31.0% in June (Figure 11). Beginning from the second quarter of 2020, the low base resulting from a drop in the prices of commodities, chiefly oil, gradually started to exit the calculation of annual price indexes. The contribution of commodity prices to annual producer price growth is gradually diminishing (Figure 12).

[5] The calculation is based on an enlarged list of goods and services (excluding fruit and vegetables and regulated services prices). Earlier, Rosstat registered 64 items of goods and services on a weekly basis. As of April 2020, the list of items monitored on a daily basis was expanded to 100 categories, and to 106 categories as of January 2021. As of July 2021, Rosstat stopped monitoring some items on a weekly basis, replacing them by construction materials and trips to Turkey.

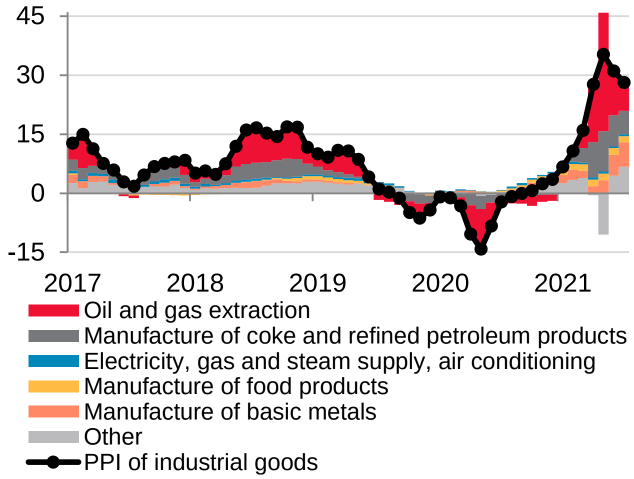
- Producer price movements are mixed in other industries. Extensive growth of domestic prices is continuing in the manufacture of basic metals, following in the footsteps of metal product and iron ore prices in global markets. That said, iron ore prices are stabilising in external markets, which may produce some easing of price pressure in the domestic metals sector in the months to come. The manufacture of food products saw price rises slow to 15.4% YoY in July from 16.7% YoY a month earlier.
- The acceleration of PPI growth rise is continuing in some “heavy” non-food segment components. Despite the likely passing of a local peak (Figure 13), the pace of a slowdown in the rises of the producer prices of consumer goods will likely be moderate, given the continuing impact of supply-side pro-inflationary factors.

Figure 11. Consumer and producer price movements, % YoY



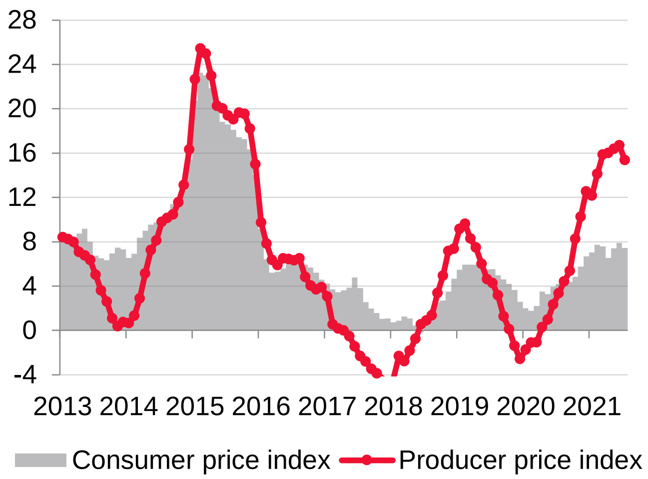
Source: Rosstat.

Figure 12. Input of top 5 industries to producer price growth, % YoY



Source: Rosstat, R&F Department estimates.

Figure 13. Consumer and producer prices of food products, % YoY



Note: Under the Rosstat methodology, producer price movements are calculated net of VAT. Hence the impact of the January 2019 VAT hike on producer prices is not factored in.

Source: Rosstat, R&F Department estimates.

2. Economic activity

Real-time and leading indicators of economic activity suggest that the Russian economy's growth continued in July–August albeit at a somewhat slower pace.

It is important to note that the causes of growth slowdown are found on the demand-side and supply-side alike. Amid the recent price rises, producers and households' willingness to buy goods at higher prices has declined. Business surveys also indicate contraction in export orders, which may stem from rising coronavirus contagions across the globe, especially in the Asian region. Also, the continuing shortage of some components and supplies, as well as the lengthening times of their delivery have made part of Russian producers cut production despite the existing demand for their products (for example, passenger cars).

The labour market is suffering a shortage of the increasing number of qualifications. Although the actual seasonally adjusted unemployment rate was still 0.4 pp above the pre-coronavirus level in July, the pace of nominal wage growth sharply accelerated at a double-digit rate in the second quarter, triggering an acceleration of real wage growth even amid elevated inflation. Overall, this indicates that the current unemployment rate is below the natural level, characterising a situation of sustainable economic growth with inflation at the target, while the natural unemployment rate itself has risen compared with the pre-coronavirus level.

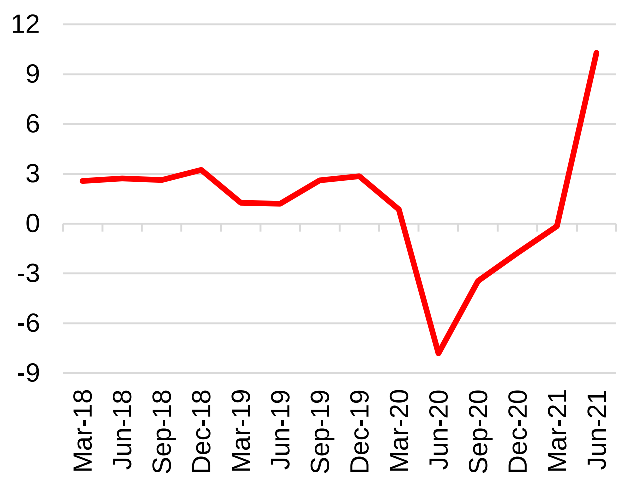
Although wage growth is led by industries benefitting from the ongoing structural and cyclical change in the economy, i.e. the IT sector, health service and construction, acceleration of this growth has affected practically all industries due to the strengthening of competition for labour amid elevated demand. In this situation, a slowdown of demand growth in the economy should cool the labour market somewhat, providing its greater stability while reducing its pro-inflationary effect.

2.1. Economic growth slowdown to more stable levels in 2021 Q3

- According to a preliminary Rosstat estimate, GDP expanded 10.3% YoY in the second quarter after a 0.7% YoY decline in the first quarter (Figure 14). According to our estimates, this corresponds to a 0.8% QoQ rise in seasonally adjusted terms (SA) for the first half of the year after a 1.0% QoQ SA expansion in the fourth quarter of 2020. Various real-time indicators suggest economic growth slowdown to more sustainable levels after going through the most extensive recovery phase in the previous quarters.
- Survey-based indicators signaled a likely slowdown in the manufacturing sector's output and new orders expansion in July. This was borne out by industrial output statistics: manufacturing output has stabilised on a slightly higher than the pre-coronavirus level in recent months. The recovery-induced expansion to the pre-coronavirus trend in industries meeting consumer and investment demand is over. Manufacturing output performance will in the coming months be increasingly driven by the potential growth rate to the extent allowed by resource constraints (in particular, the availability of labour resources). Mining and quarrying growth will in the months to come be secured by oil extraction expansion under the new provisions of the OPEC+ deal.

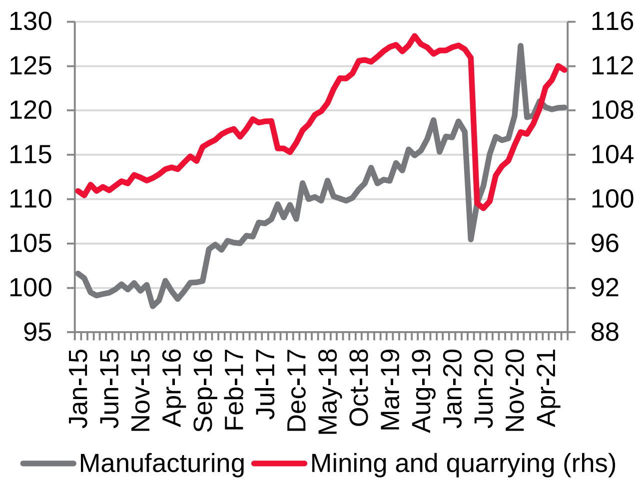
- That said, production activity expansion amid rising demand continues to be contained by worldwide supply chain disruptions. This is evidenced by the performance of both Russian and global PMI sub-indexes signalling further lengthening of delivery times due to the shortage of components and logistics problems.[6] A graphic example of the negative impact of supply disruptions is provided by the car market. July's drop in new car sales in both year-on-year and month-on-month terms was prompted by a shortage of cars, which producers are unable to deliver because of the shortage of components:[7] many car-making factories in Russia and abroad have to shut down their assembly lines.
- Unlike the production sector, business activity expansion in the services sector continued in July (as evidenced by survey-based indicators) but was slower than the average growth pace in the first half of the year.
- Individual industries' financial flows also indicate that activity growth continues at a slower pace than in the second quarter (Figure 16). Growth is driven by industries meeting external and intermediate demand. The latter is helped primarily by mining and quarrying output expansion and a rise in world commodity prices. In the group of industries meeting domestic consumer and investment demand, financial flows showed a slight downward deviation in July from the level of the previous quarter, indicating, above all, the completion of recovery-induced growth and the uncertainty of business activity prospects amid the continuing epidemic risks.
- The news flow weakened somewhat in August: the news-based index declined to 1.0 points from 1.2 points for July. Still, it remains close to its highest reading over the entire history of observation (since 2004).

Figure 14. GDP growth, % YoY



Source: Rosstat.

Figure 15. Indexes of mining and quarrying and manufacturing (2014 = 100)

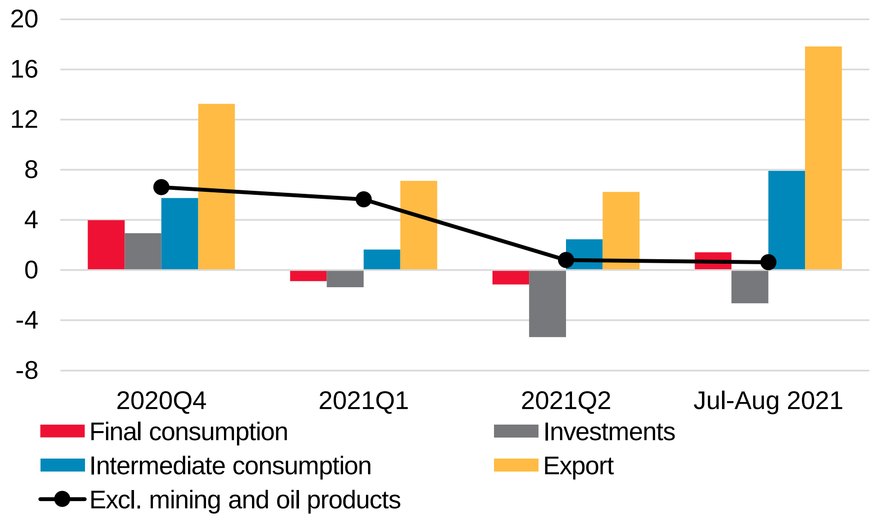


Source: Rosstat, R&F Department estimates

[6] Suppliers' Delivery Times Index.

[7] In addition to the problem with electronic chips, an Avtodom expert points out those with many other components // Komersant Daily, No.125 of 20.07.2021.

Figure 16. Incoming financial flows by industry groups, % of the preceding quarter level



Source: Rosstat, R&F Department estimates.

2.2. Further consumer demand expansion

- Despite the epidemic situation's worsening, household income and lending expansion helped sustainable consumption growth continue in June. Public food services were the only industry posting a sales decline – due to restrictions imposed on restaurants. Real-time indicators point to continued sustainable growth of consumer activity, which was further buoyed in August by allowances for school-aged children.
- The pandemic risks are still restraining the recovery of household spending on paid services. At the same time, we expect the coming months to see the reallocation of part of spending from non-food goods to FMCG, given their rising prices, and the recovering services sector.
- A continued rise in economic activity and household income will help maintain confident consumption growth going forward. A certain lending activity decline on the back of monetary policy tightening and macroprudential measures will prompt a gradual slowdown of final consumption growth to more sustainable levels. This will also be driven by fiscal policy coming back to normal.

Despite the epidemic situation's worsening, sustainable growth of consumer demand continued in June. Retail sales expansion accelerated from 0.3% MoM SA to 0.4% MoM SA (Figure 17). Household consumption of paid services resumed its growth to come in at 0.2% MoM SA after 0.0% MoM SA in May.[8] The rise is fuelled by both the recovery of income[9] and an elevated pace of consumer lending expansion continuing throughout the second quarter.

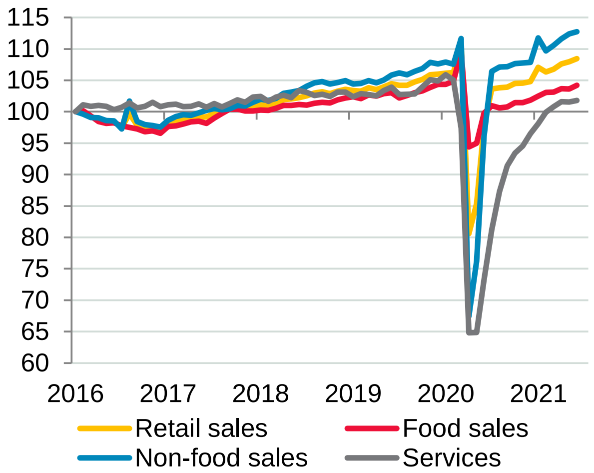
[8] The estimate of the industry's sales in January–May 2021 increased following an additional estimate of paid household services based on data from administrative sources (the Federal Tax Service) from self-employed people's income).

[9] Real disposable income rose 6.8% YoY in the second quarter of 2021.

Given the start of the vacation period, the hot weather, and a large number of workers' shift to work from home, people spent more time in the countryside in June. This prompted a rise in food sales (0.5% MoM SA growth in June after a 1.6% MoM SA fall 0.0% MoM SA in May), but hurt public food services' sales (down 1.6% MoM SA in June after a 0.7% MoM SA decline in May), which were also affected by the tightening of coronavirus-related restrictions. That said, the consumption of *services* so far lags far behind the 2019 levels, suggesting a potential for the continuation of recovery in this segment. Many services sector enterprises succeeded in adjusting their business models to the new conditions during the pandemic. But despite this, the continuing elevated uncertainty over how the epidemic will unfold, coupled with possible persistent changes in the consumption structure versus the pre-coronavirus situation, will, to a certain extent contain, the above process.

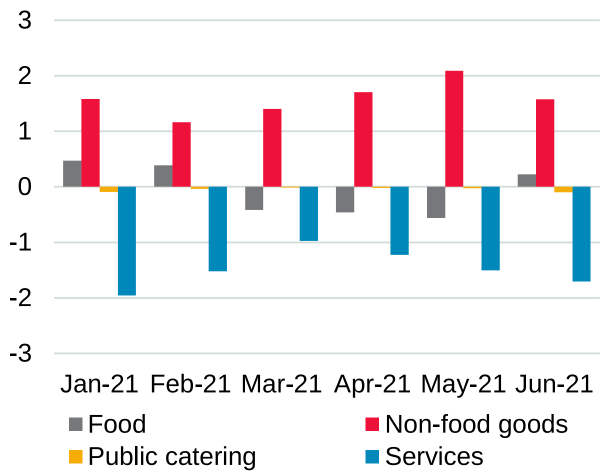
Non-food retail sales continued to expand but at a slower rate than in the previous month, posting a 0.3% MoM SA increase in June after a 0.7% MoM SA rise in May. We believe that the scale of a shift towards *non-food goods* which underlay the departure from the pre-coronavirus consumption model throughout most of the second quarter has reached its local peak (Figure 18). Increasing inflation expectations along with the relatively low cost of debt encouraged households to take loans and expand the consumption of durable goods. According to real-time data, households' perceptions of whether it is a good time for major purchases have notably worsened recently: the relevant index hit an all-time low in July (Figure 21).

Figure 17. Retail and services sector's sales (January 2016 = 100%, seasonally adjusted), %



Sources: Rosstat, R&F Department estimates.

Figure 18. Change in the share of expenditure by key household spending category compared with 2019, pp

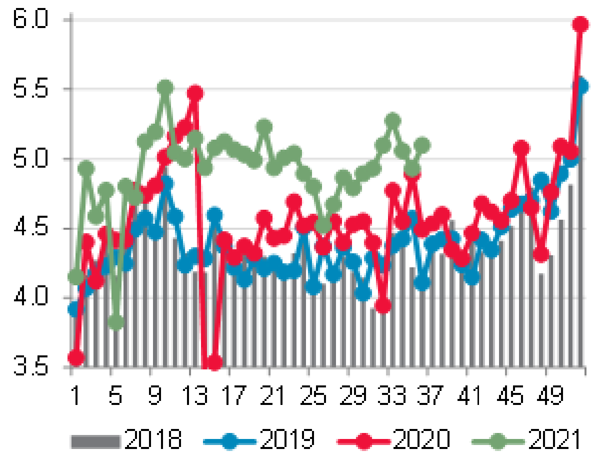


Sources: Rosstat, R&F Department estimates.

One can conclude from the above that the coming months will likely see the emergence of a trend towards reallocating part of spending from non-food goods to FMCG continuing to rise in price and the recovering services sector.

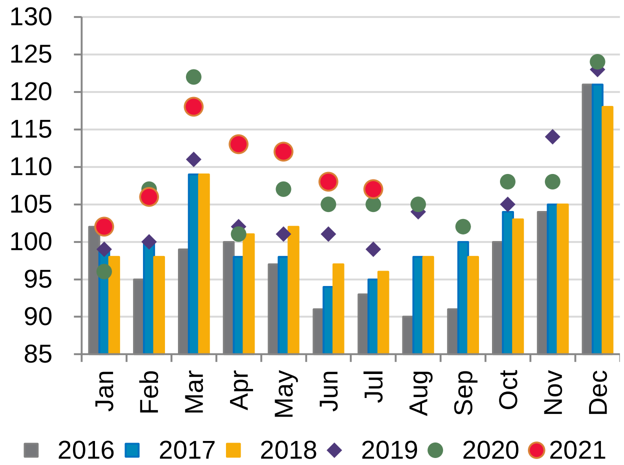
One-off payments to pensioners, as well as military and law enforcement personnel for a total of 500 billion rubles will additionally support consumer demand at the end of the third quarter – the beginning of the fourth quarter. They, however, will only have a one-off and minor impact on inflation. The funding of expenditure comes from extra non-oil and gas revenue under the fiscal rule. The budget's ability to meet this spending is generally taken into account in making monetary policy decisions and drawing up the Bank of Russia forecast.

Figure 19. Nominal weekly household everyday expenditure, thousand rubles



Source: Romir.

Figure 20. Real everyday expenditure, % of 2012 level



Source: Romir.

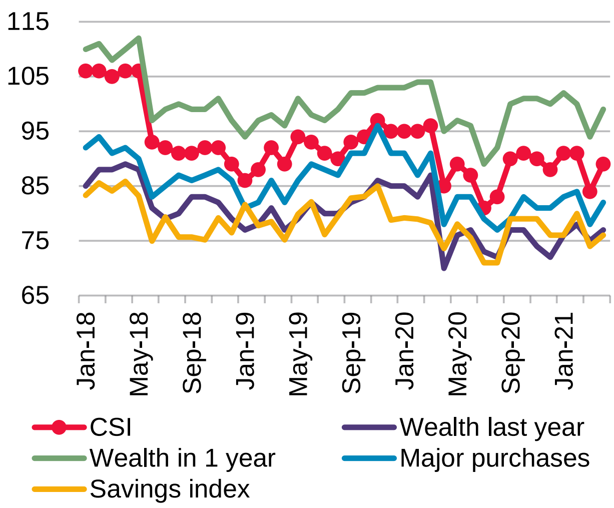
The real-time indicators of consumer activity bear out that the current episode of the epidemic situation's worsening does not have a significant negative effect on consumption. Except for a short period at the start of July, annual expenditure growth has steadily exceeded the inflation level over the past six weeks, accelerating further at the start of August as one-off allowances for school-aged children were paid. July saw this month's record high level of spending on FMCG (Figure 20), moreover, unlike June, real annual growth of spending was posted in an overwhelming majority of consumer categories. The spending structure is, to a great extent, driven by the onset of the vacation period, featuring a typical rise in spending on food, fuel, hotels, and Duty Free and a decline in spending on services. What is more, spending on hotels in Russia and abroad gives reason to assume that roughly one third of tourists' pre-coronavirus spending outside Russia steadily changed into domestic spending.

The continued economic activity and household spending growth will, in our view, help maintain sustainable consumption expansion going forward. With the difficult epidemic situation persisting across the globe, the prospect of large-scale border opening and the outflow of part of domestic demand to foreign countries is growing more distant.

That said, the second half of the year is expected to see a gradual slowdown of final consumption growth to more sustainable levels. This will be driven by lending activity growth weakening which started in the second half of the year, given monetary policy tightening and the impact of macroprudential measures aimed at curtailing banks' incentives to expand high-risk lending. This will also result from fiscal policy's return to normal. A more moderate pace of consumption growth is also evidenced by July's car sales, down 6.5% YoY, and a slowdown of expansion in imports from other than former USSR countries,[10] (up 16.0 in July compared with the same period of 2019 after a rise of 28.3% in June).

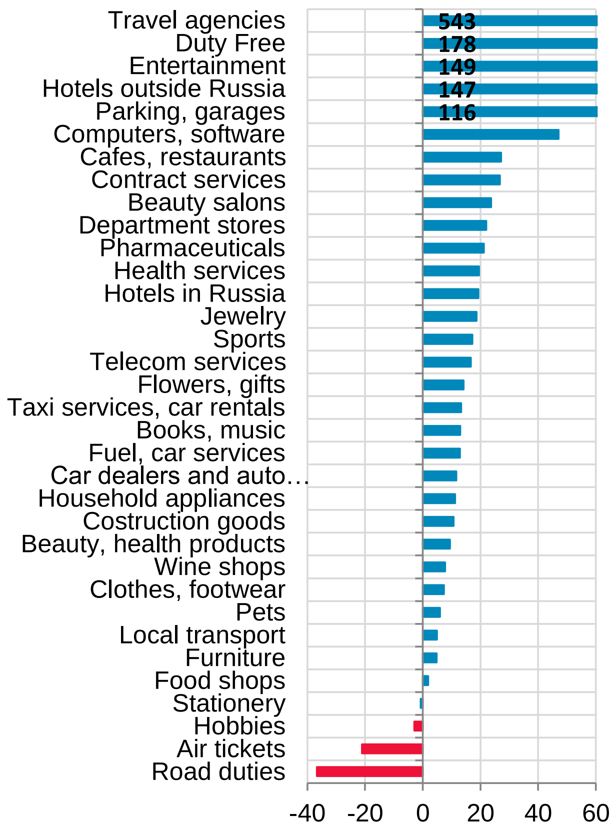
[10] A slowdown was posted in categories of consumer demand, such as wearing apparel, cosmetic products, alcohol, and food products.

Figure 21. Household consumer sentiment index and its components, pp.



Source: Bank of Russia.

Figure 22. Change in nominal spending on goods and services in July, % YoY



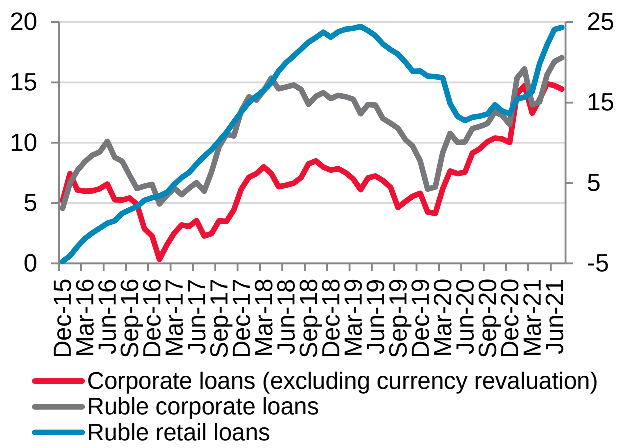
Source: SberIndex.

2.3. July sees some growth slowdown in key lending segments

- Seasonally adjusted growth in key lending segments slowed in July, staying, however, on elevated levels. Some cooling was driven by changed parameters of subsidised mortgage lending, macroprudential and monetary policy decisions, and a rise in uncertainty caused by the epidemic situation's worsening.
- Having contracted for the previous two months, household funds in banks expanded in July, which may have stemmed from a rise in the attractiveness of deposits on the back of deposit rate hikes.
- July saw banks' net profit rising far above the levels of July 2019 and 2010 thanks to interest and fee and commission income. The high level of profit and capital will help banks expand lending, but its growth is expected to slow to more sustainable levels, given the impact of monetary policy's return to normal and macroprudential policy measures.

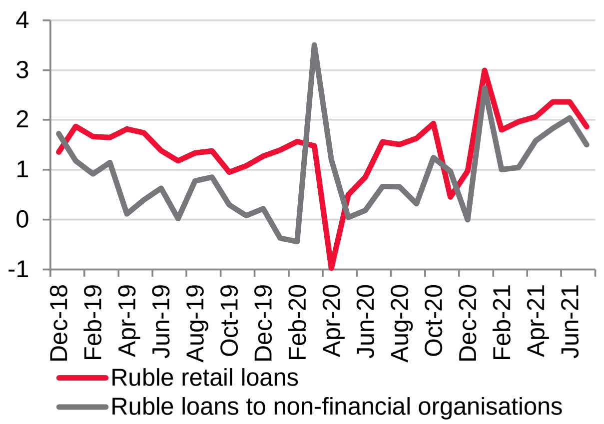
Retail lending growth slowed to 1.9% MoM SA in July from 2.4% MoM SA in June (Figure 24). This stems from several causes. A change in the parameters of the subsidised lending programme, in particular, cuts to subsidised loan limits in large cities, and a rise in loan rates played an important role. As a result, July's loan issuance contracted substantially compared with June (Figure 26), falling 20.5% for the overall ruble portfolio and almost halving for loans secured by shared equity agreements. Accordingly, ruble mortgage loan portfolio growth slowed from 2.5% MoM NSA to 1.7% MoM NSA,[11] and from 4.3% MoM NSA to 1.0% MoM NSA for loans secured by shared equity agreements. A raise of the highest interest rate under the subsidised mortgage lending programme from 6% to 7% has not so far fully translated into the movements of weighted average interest rate on loans (Figure 25): the rate on loans issued under the shared equity agreements increased 0.6 pp. One explanation we can offer is that the size of the interest rate subsidy provided to banks under the subsidised lending programmes rose together with a key rate increase. An interest rate cut under the family mortgage loan programme may have also played a role. The rate on all other mortgage loans, however, rose by up to 0.1 pp, according to our estimate: rates on unsubsidised mortgage loans look are set based on long-term OFZ yields, which have remained all but unchanged.

Figure 23. Banks' credit growth % YoY



Source: Bank of Russia

Figure 24. Banks' ruble credit growth, % MoM SA

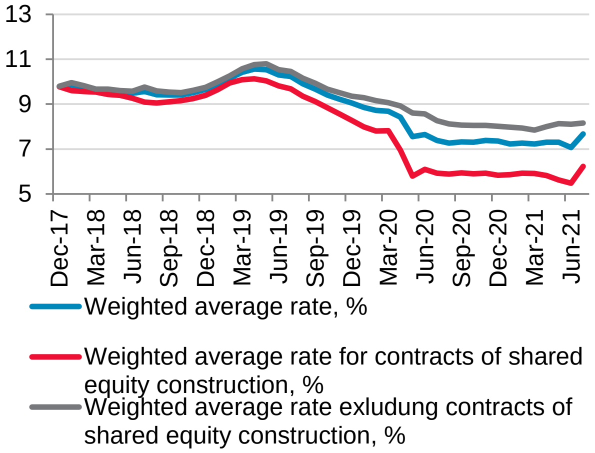


Source: Bank of Russia

Unsecured loan growth slowed to 1.4% MoM SA, dragged down by macroprudential measures and monetary policy tightening, but remained elevated relative to previous years (Figure 27). Auto lending also showed an expansion slowdown to 1.1% MoM SA. Together with recent key interest rate hikes, a raise of add-ons to risk weights for unsecured loans sent loan interest rates higher: rates on consumer loans rose 1.5–2 pp on average over one month.

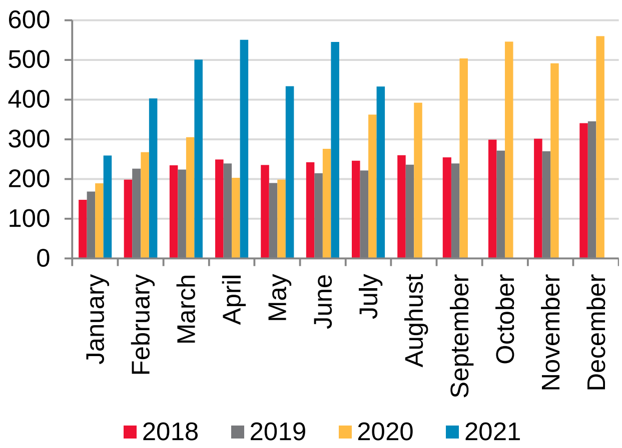
[11] Including mortgage-backed securities. NSA – non-seasonally adjusted.

Figure 25. Interest rates in mortgage loan market, %



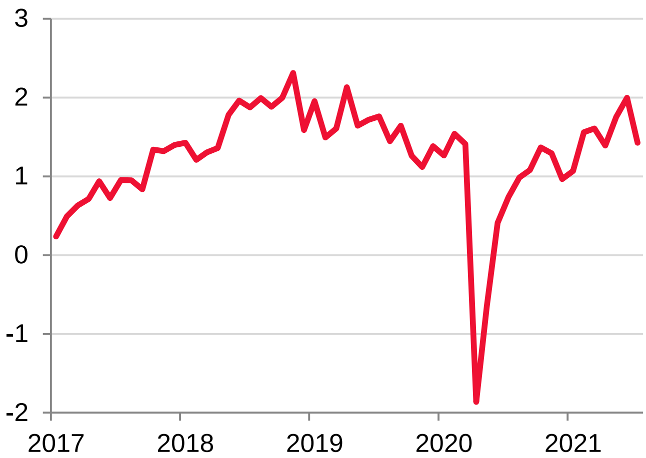
Source: Bank of Russia.

Figure 26. Total of new mortgage loans issued, billion rubles



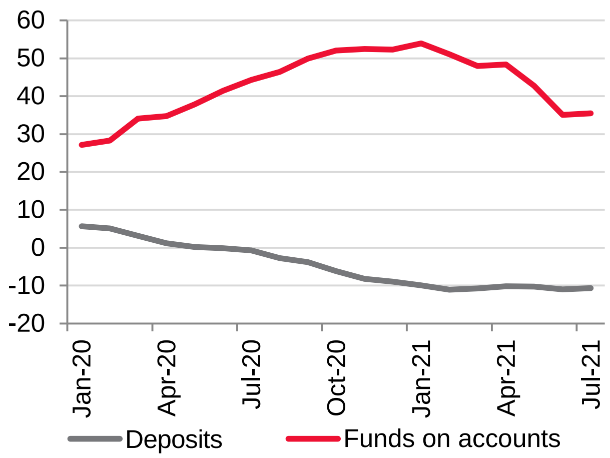
Source: Bank of Russia

Figure 27. Rise in unsecured consumer lending, % MoM SA



Source: Bank of Russia.

Figure 28. Household funds growth, % YoY



Source: Bank of Russia.

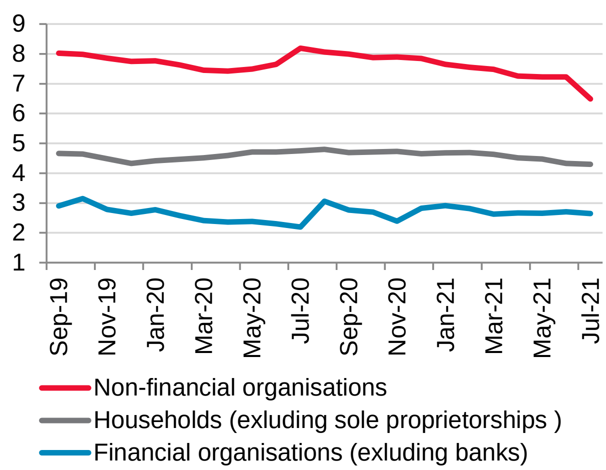
Some rise in interest rates on loans, including on mortgage loans, may continue in the months to come. Coupled with an elevated level of political uncertainty and possible tightening of banks' lending policies in the face of recent macroprudential measures, this may slow retail lending expansion.

Growth in loans to non-financial organisations also slowed to 1.5% MoM SA from 2.0% MoM SA. This may be driven by business activity deterioration in manufacturing and growth slowdown in services, as well as an increasing level of uncertainty due to the epidemic situation's worsening. Lending to sole proprietorships also suffered a decline in the pace of expansion to 1.9% MoM SA in July from 2.6% MoM SA in June. It is noteworthy that the portfolio of loans to non-financial organisations and sole proprietorships suffered a short-term loan expansion slowdown. One explanation we can offer is that funds earmarked by the RF government for subsidies under the programme of subsidised lending to small and medium-sized enterprises (SME) have come to an end. As of 26 July 2021, the Bank of Russia established a new rule for setting an interest rate as part of a procedure for supporting SME lending (offering a 1.5 pp lower interest rate than the key rate). Ruble lending to financial organisations rose 1.3% MoM SA after a 0.3% MoM SA decline a month earlier.[12] This may stem from an increasing role of factoring in financing SMEs.

The overall quality of loan claims continues to improve. Indeed, the share of overdue loans in claims on non-financial organisations and sole proprietorships slid from 7.2% to 6.5% and to 2.6% in claims on financial organisations, remaining practically unchanged at 4.3% in claims on households (Figure 29). The share of problem and bad loans in the retail portfolio stabilised, continuing to decline in the corporate loan portfolio (Figure 30). The loan portfolio quality improvement is largely owed to the continuing elevated pace of bank lending expansion, with the share of overdue loans continuing to contract in a large volume of newly issued loans as a result.

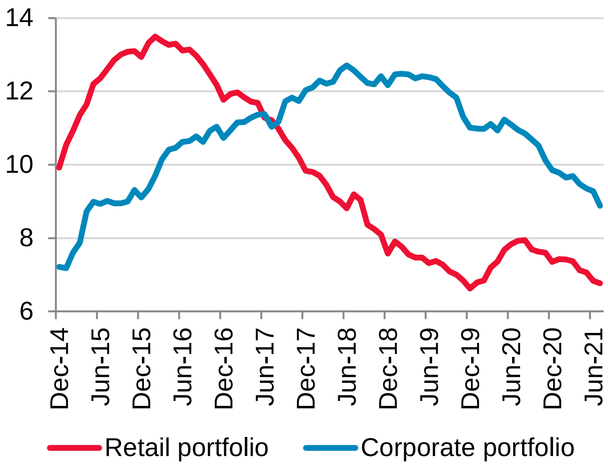
Household funds in banks added 0.7% MoM SA in July after a contraction over the previous two months, possibly driven by the improving attractiveness of deposits thanks to a gradual rise in deposit rates (Figure 28). That said, net inflows of household funds to financial market instruments stayed on an average level of the second quarter, according to our estimate. Growth in corporate customers' funds accelerated to 0.4% MoM SA, according to our estimate.

Figure 29. Share of overdue loans, %



Source: Bank of Russia.

Figure 30. Share of problem and bad loans, %

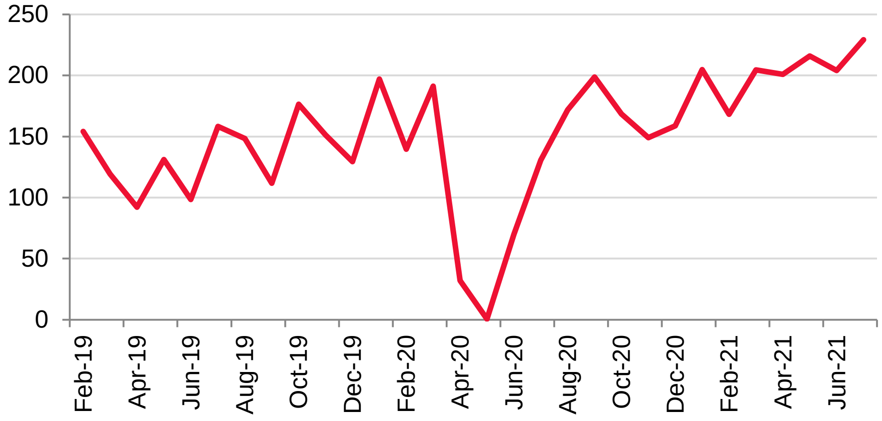


Source: Bank of Russia.

The banking sector's profit totalled 229 billion rubles in July, rising far above the July 2019 and 2020 levels. The key drivers of profit growth were net interest income (NII) and net fee and commission income (NFCI). Whereas the NII expansion arises primarily from loan portfolio growth, the NFCI rise is owed to bank card and acquiring commissions. The high level of profit and capital helps banks continue to expand lending. We believe the Bank of Russia's increase of the key interest raise during 2021 in response to the rising pro-inflationary risks will gradually slow lending growth further to more sustainable levels.

[12] May saw a decline in ruble loan issuance in the sectors of insurance and auxiliary activities in financial services. The issuance rebounded in June, which may have affected portfolio growth in July.

Figure 31. Net profit of banking sector, billion rubles



Source: Bank of Russia.

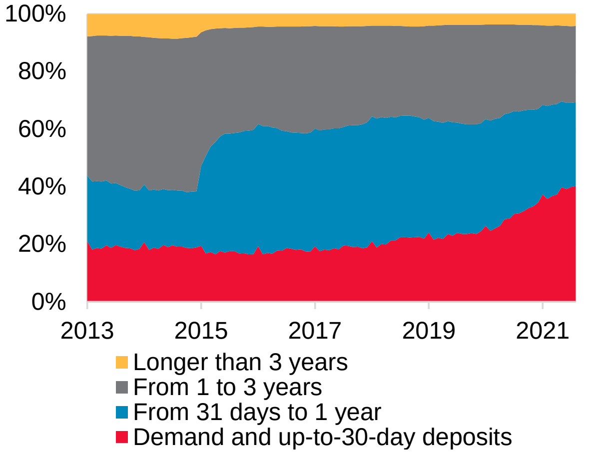
CHANGES IN HOUSEHOLD FUNDS ON BANK ACCOUNTS

Bank deposits is a major instrument through which the interest rate channel of monetary policy transmission affects inflation. Changes in household funds at banks and their term structure reflect household preferences in choosing between consumption and savings. Monetary policy easing in 2020 provoked significant changes in the structure and distribution of household funds, in particular, boosting funds in current accounts and simultaneously reducing time deposits (Figure 33). As a result, household funds on bank accounts became more short-term, i.e., more readily available for spending on goods and services. Meanwhile, the pace of growth in overall household funds at banks (including foreign currency deposits and accounts) slowed drastically (Figure 34). This trend reflects both consumer activity expansion and a rise in the attractiveness of alternative investments, above all, financial market instruments and real property.

Ruble interest rates on household deposits have started rising gradually on the back of key interest rate increases in the past months of 2021 (Figure 35, Figure 36), but this have not yet had a major effect on household deposit activity. There have emerged the first signs of household ruble funds' term structure stabilisation and a minor reversal of their changes. Still, it is too early to claim that we have seen a full-scale reversal which, via changes in the deposit market, would signal the effect of recent monetary policy decisions on households' choices between consumption and savings.

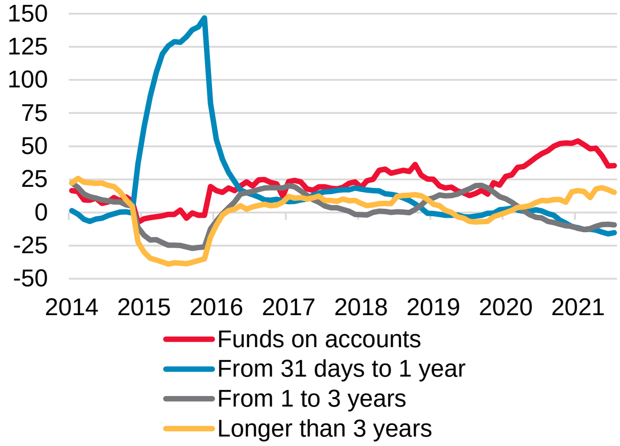
This may stem from several causes. *First*, interest rates on household deposits have not yet fully reflected the key interest rate increase, which is especially true of up-to-one-year deposits (Figure 35). *Second,* the attractiveness of alternative investments is still strong. *Third,* the current level of interest rates on deposits (even after they have fully taken account of the key interest rate increase to 6.5%) may fail to offer stronger incentives to savings due to elevated inflation expectations, which are still encouraging households to make their choice in favour of consumption and investments in riskier assets. Monetary policy decisions are taking this into account.

Figure 32. Structure of household ruble funds on bank accounts



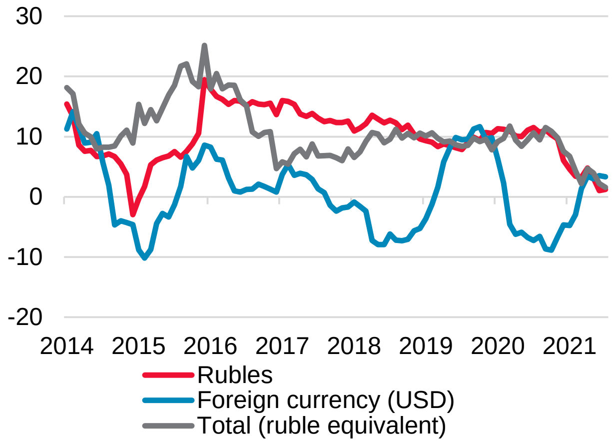
Source: Bank of Russia.

Figure 33. Changes in household ruble funds on bank accounts, % YoY



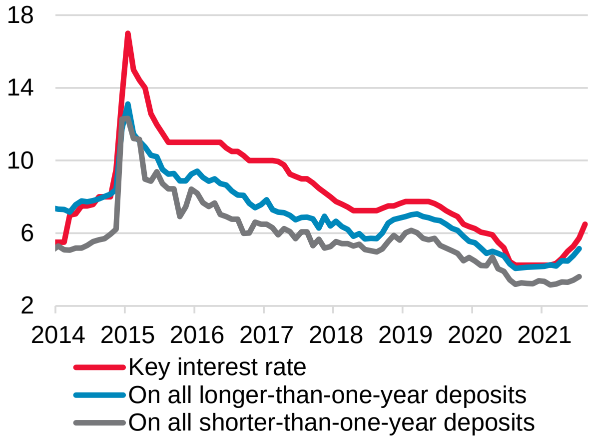
Source: Bank of Russia.

Figure 34. Overall household accounts at banks, % YoY



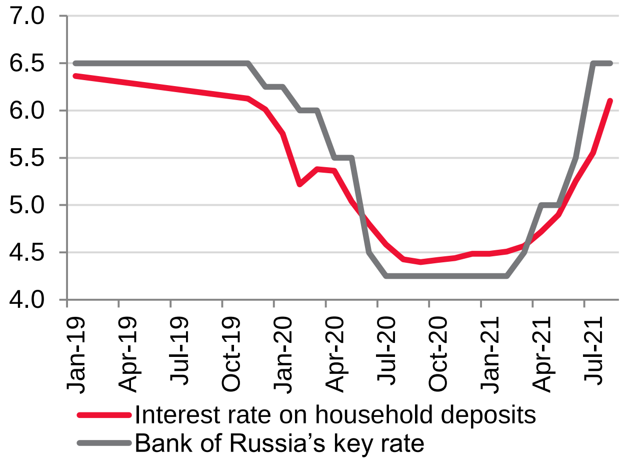
Source: Bank of Russia.

Figure 35. Interest rates on household deposits and key interest rate, %



Source: Bank of Russia.

Figure 36. The highest interest rate in top 10 banks and the key interest rate, %



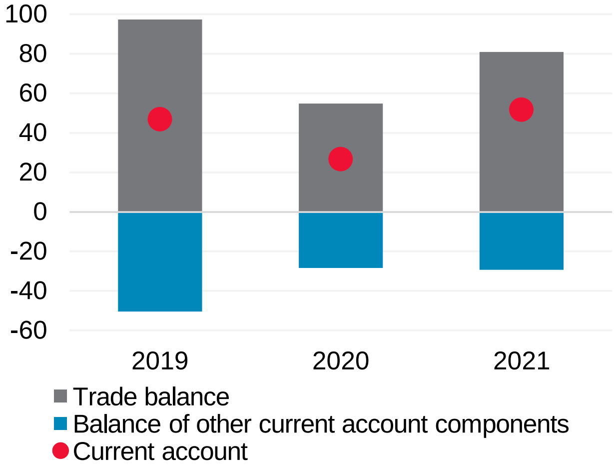
Source: Bank of Russia.

2.4. Minor weakening of foreign trade growth in July

- The current account surplus in January–July 2021 exceeded the levels of the same period of 2019 and 2020: the trade balance is expanding gradually as exports are rising, while the services deficit remains small.
- Merchandise export and import growth relative to the 2019 level lost momentum in July after its June's peak. Export growth stems chiefly from a rise in world commodity prices and the easing of the terms and conditions of the OPEC+ deal.
- Merchandise import expansion is still accompanied by confident growth in all investment categories. We expect growth in the import of goods to slow going forward as demand shifts towards the import of services and the Russian economy's growth rate declines to more sustainable levels now that the recovery-induced growth phase is over.

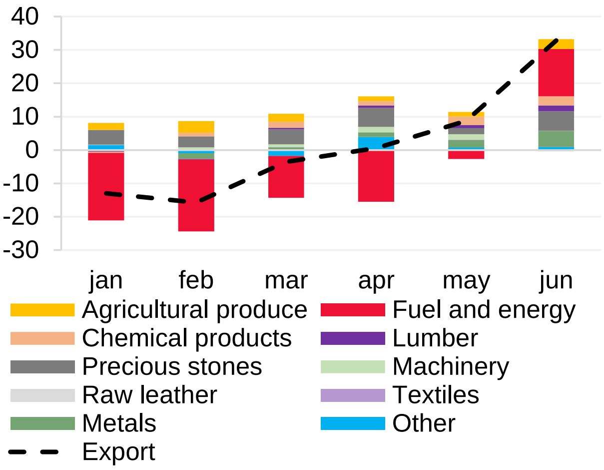
According to a preliminary estimate, the current account surplus reached USD 51.7 billion in January–July 2021, rising above the levels of the same periods of 2019 and 2020 (USD 47.5 billion and USD 26.5 billion, respectively). The current account surplus expansion relative to 2020 was fuelled by a trade surplus increase thanks to a faster rise in the export of goods by value than that in imports, up 35.0% YoY and 29.6%, respectively, whereas the aggregate deficit of the other current account components changed insignificantly compared with last year. The trade surplus exceeded the 2019 level for the second consecutive month, which, together with the continuing restrictions on international travel, ensures a stronger current account deficit than before the coronavirus crisis (Figure 37).

Figure 37. Key current account components in January–July, USD billion



Source: Bank of Russia, R&F Department estimates.

Figure 38. Export growth decomposition by major category, 2021 as a percentage of relevant month of 2029



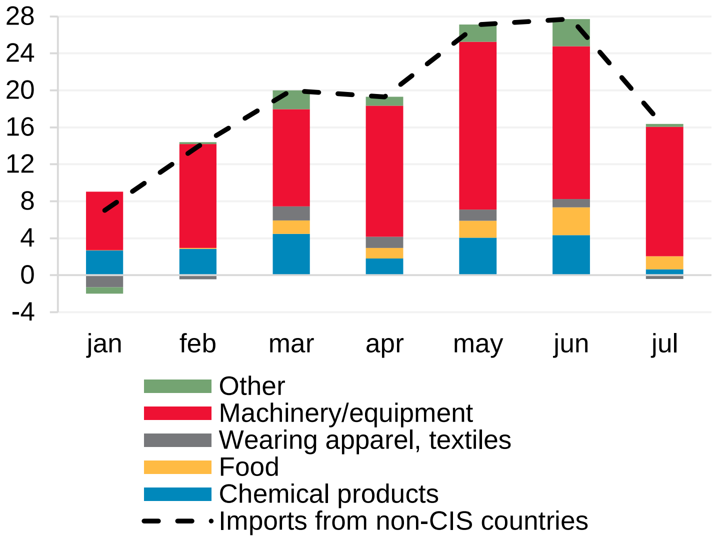
Source: Federal Customs Service, R&F Department estimates.

Merchandise exports remained elevated relative to the pre-coronavirus level, reflecting a rise in the world prices of oil, metals, and other goods, as well as an export increase in natural terms, thanks to, among other things, oil extraction growth under the OPEC+ agreement (Figure 37, Figure 38).

Import growth slowed in July relative to the same period of 2019 (Figure 39). The key contribution to import expansion continues to come from machinery and equipment. A rise in this category of imports, however, started to slow as the import of surface transport vehicles by value contracted, dragged down by constrains arising from a fall in global production due to the shortage of electronic components. Investment imports (mechanical and electrical equipment, as well as air transport) continue to increase steadily. According to our expectations, the raise of the key interest rate by the Bank of Russia in the past months of this year in response to rising pro-inflationary risks will bring the pace of consumer and investment activity (and, accordingly, imports) down to more sustainable levels going forward.

The analysis of foreign trade structure by country in the first half of the year indicates that a trend towards the reorientation of trade towards China and other non-EU countries has taken root as a result of the pandemic. Indeed, the trade structure by country, which has not changed much since last year, shows a sustainable shift towards China (its share in the trade turnover rose from 16.0% in the first half of 2019 to 18.1% in 2020 and 17.9% in 2021) at the expense of the EU countries' share,[13] which fell from 42.2% to 35.3% and 35.7% in 2020 and 2021, respectively. This arose in part from the impact of the pandemic, but we expect the trade turnover to continue shifting towards the Asian region in the long term.

Figure 39. Decomposition of growth in imports from non-CIS countries by major category, 2021 as a percentage of the same month of 2019*



** Imports are adjusted for deliveries of vessels under the temporary import scheme.*

Source: Federal Customs Service, R&F Department estimates.

[13] According to an R&F Department estimate, about 1.3-1.8 pp of the decline may be owed to the UK's exit from the EU.

The surplus of the private sector's financial transactions for July came in about twice as large as in July 2020. Unlike last year, when the balance resulted chiefly from a decline in other sectors' foreign liabilities coupled with a concurrent contraction in their foreign assets, the crucial factor of the 2021 developments is the private sector's expansion of foreign assets along with a much more moderate contraction in liabilities to non-residents. This trend of the private sector's transaction indirectly indicates the diminishing of risks to the refinancing of foreign liabilities and, therefore, a greater stability of the overall balance of payments.

Non-residents start to buy government bonds massively in July, moreover, their activity was also seen in the new issues market after a pause caused by the imposition of sanctions on the OFZ market. Net inflows of non-residents' funds to the OFZ securities totalled USD 2.2 billion, substantially compensating outflows recorded from the start of the year, with the share of non-residents in the government bond market rising to 20.0% as of the start of August versus 19.0% in June.

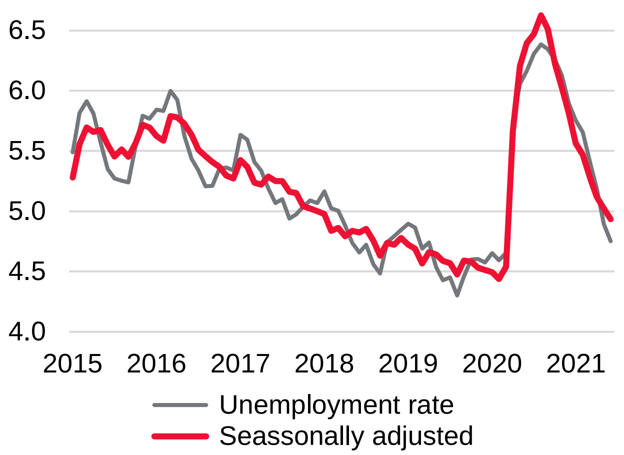
International reserves added USD 9.3 billion to reach USD 601.0 billion, resulting, above all, from the Bank of Russia's foreign currency transactions under the fiscal rule and a partial rebound of prices in the gold market. With the oil price staying far above the level stipulated by the fiscal rule and oil extraction concurrently rising under the OPEC+ agreement, the trend towards further expansion of international reserves is set to continue. The reserves will also increase following a receipt from the IMF of USD 17.5 billion as part of a new SDR issue allocation among the Fund's member-countries.

IN FOCUS. Structural shifts in labour market give rise to pro-inflationary risks

- Changes in the qualitative structure of labour demand caused by the pandemic and its consequences amid the slow adjustment of supply in the labour market have sent the natural unemployment rate higher. This is evidenced by, among other things, a dramatic rise in labour demand and inflationary pressure even as unemployment has not yet fully returned to the pre-coronavirus level.
- One of the most important labour market indications is wage trends. Nominal wage growth reached double digits at the end of the first half of the year, led by the sectors showing a dramatic rise in labour demand and a stronger employers' competition for workforce.
- If labour supply growth and skill mix adjustment remains restricted in the coming quarters, then structural changes in labour demand may well keep wage growth elevated. An employment and wage rise in the leader sectors will boost competition in the labour market, spurring wage growth at a faster pace than that of labour productivity in other industries as well. This may contain an inflationary pressure decline.

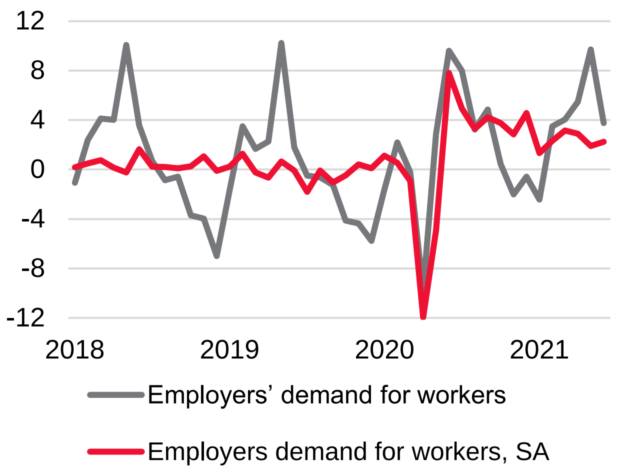
Labour market recovery continued in the second quarter of 2021. While labour force growth was minor at 0.3 QoQ (0.9% YoY), the unemployment headcount under the ILO definition dropped 16.7% YoY in the second quarter. As a result, the unemployment rate declined to 4.9% SA in June 2021, so far remaining somewhat above the pre-coronavirus minimum of the start of 2020 (Figure 40).

Figure 40. Unemployment rate, %



Source: Rosstat, R&F Department estimates.

Figure 41. Employers' demand for workers, % MoM



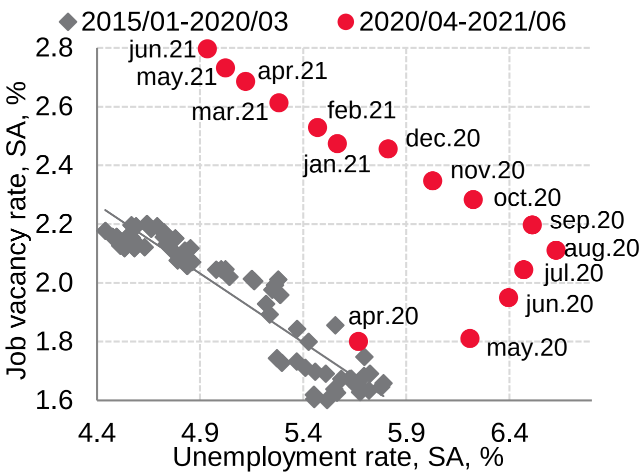
Source: Rosstat, R&F Department estimates.

An unemployment rate decline is occurring amid elevated labour demand. According to Rosstat data and our estimates, employers' demand for workers (the number of vacancies) is growing 2-3% a month in seasonally adjusted terms in 2021 (Figure 41) and has already risen far above the pre-coronavirus level, in the second quarter of 2021 the employers' demand for workers was 22.8% higher relative to the same period of 2019. The unemployment rate stood at 4.6% in seasonally adjusted terms at that time.

All this suggests significant structural changes in the labour market, in particular a rise in the natural unemployment rate. For example, the Beveridge curve showing the relationship between the unemployment and job vacancy rate shifted outwards in the second half of 2020 – the first half of 2021 (Figure 66). This shift has showed to be persistent, suggesting the structural nature of factors which caused it. Changes in the qualitative structure of labour demand (from the perspective of skills and competencies) caused by the pandemic and its consequences are occurring amid a slow adjustment of labour supply (because retraining and acquisition of new knowledge and skills are required). Therefore, the same level of employers' demand for workers currently is associated with a higher unemployment rate.

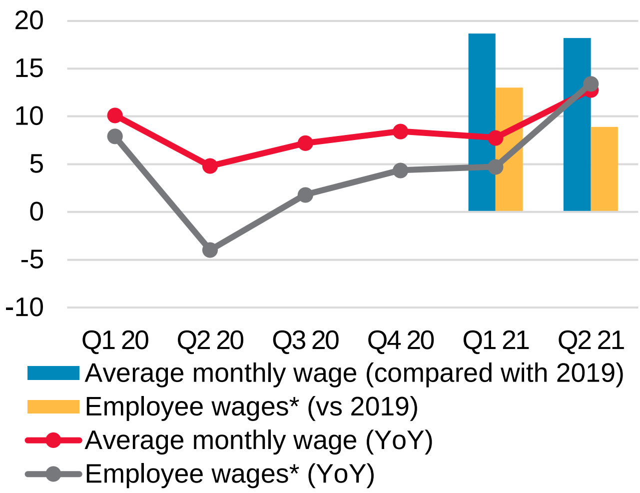
In some industries, structural shifts of labour demand and supply are especially salient. In particular, industries which need low-skilled workers are facing a significant shortage of workforce. A rise in demand for workers in sectors, such as construction, restaurants and hotels amid the recovery of business activity is confronted with competition from sectors which have benefitted from the pandemic (delivery services, online trade). The situation is further aggravated by a fall in the supply of low-skilled labour due to the outflow of migrant workers and still closed borders.

Figure 42. Beveridge curve



Source: Rosstat, R&F Department estimates.

Figure 43. Nominal wages, %



** Obtained from balance of household spending and income. Uses the estimate of all labour income, including wages of employees hired by individuals and sole proprietorships, wages of foreigners and others.*

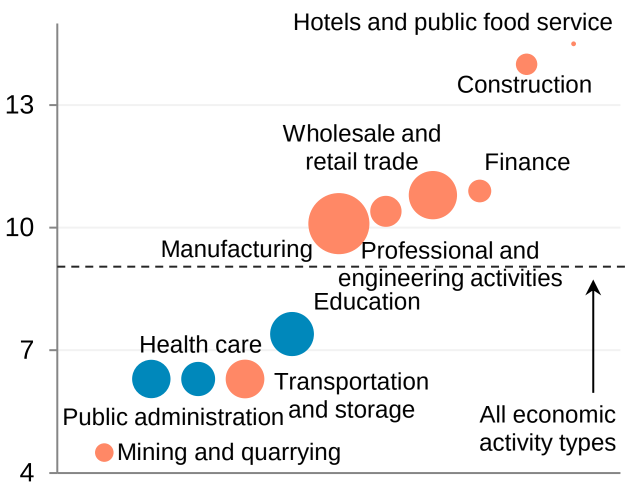
Source: Rosstat, R&F Department estimates.

Another consequence of a significant change in the labour market situation is an inflationary pressure rise in the second half of 2020 – the first half of 2021, with the unemployment rate remaining elevated versus the pre-coronavirus level. In terms of the Phillips curve, this means that the *natural* unemployment rate increased in that period, while the *actual* level is now below it, creating pressure on wages. As a result, the annual nominal wage growth stood at double-digits (Figure 43). That said, wage growth accumulated relative to the same period of 2019 exceeded inflation over the period significantly.

Comparison of job vacancy changes and those in CVs in professional fields with the 2019 situation[14] identified a group of industries in which job vacancy growth was stronger than average, while an increase in CV numbers was below average (Figure 46). It was the sectors with the strongest employers' competition for labour (Figure 47) that were among wage growth leaders (Figure 44, Figure 45).

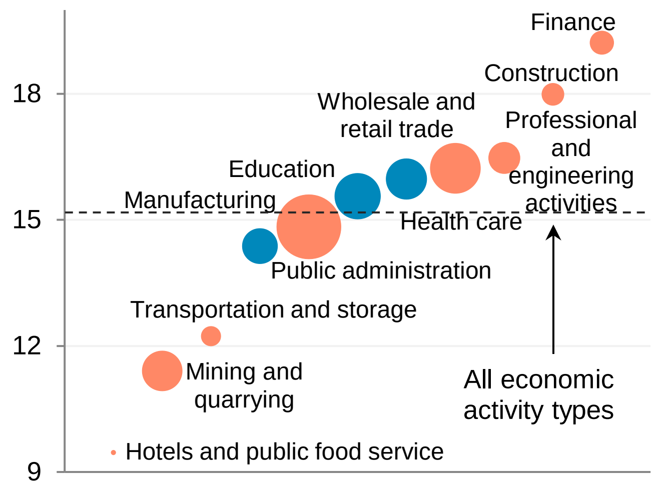
Pro-inflationary risks generated by the labour market are very visible. Labour demand changes over 2020–2021 are largely structural and sustainable in nature. If an adjustment of the labor supply to these changes is slow, then the *natural* (equilibrium) unemployment rate will remain elevated relative to the pre-coronavirus levels, supporting fast wage growth. This may keep inflation expectations persistently elevated, prompting a steady rise in inflationary pressure. The need to bring inflation back to the target if these risks are realised, may require a tighter monetary policy. That said, a return to the labour market of migrant workers who have left during the pandemic could help stabilise the situation and overcome part of the risks.

Figure 44. Wages by economic activity type in January–May 2021, % YoY



Source: Rosstat.

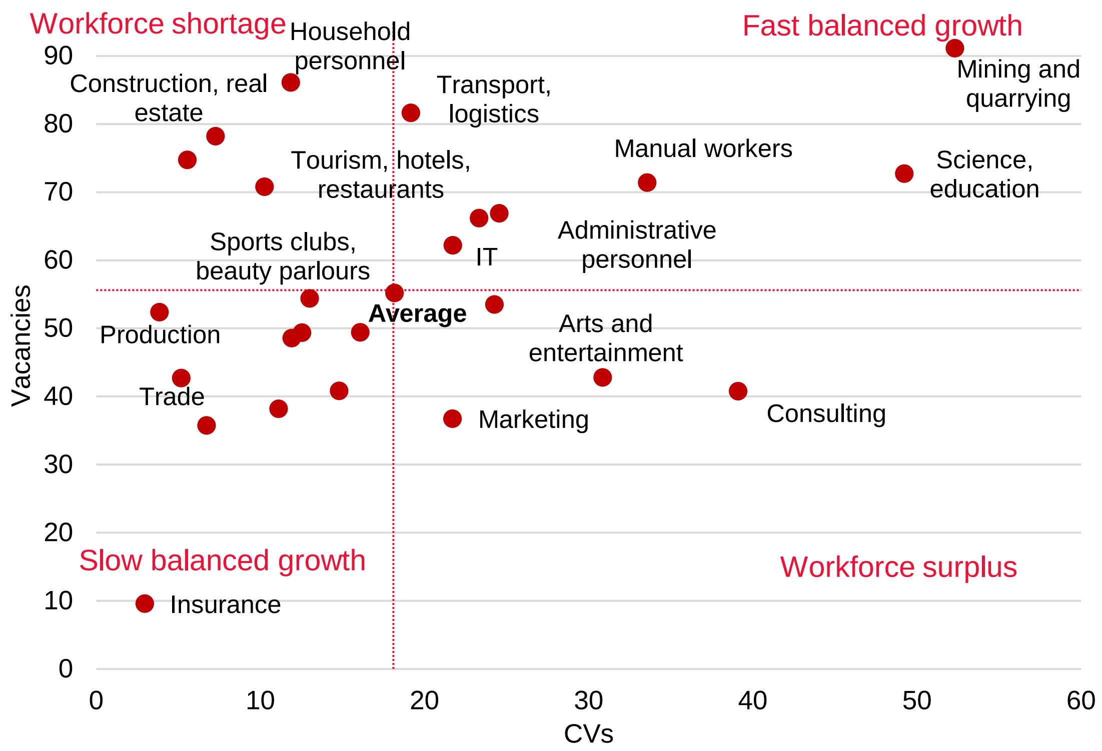
Figure 45. Wages by economic activity type in January–May 2021 compared with January–May 2019, %



Source: Rosstat, R&F Department estimates.

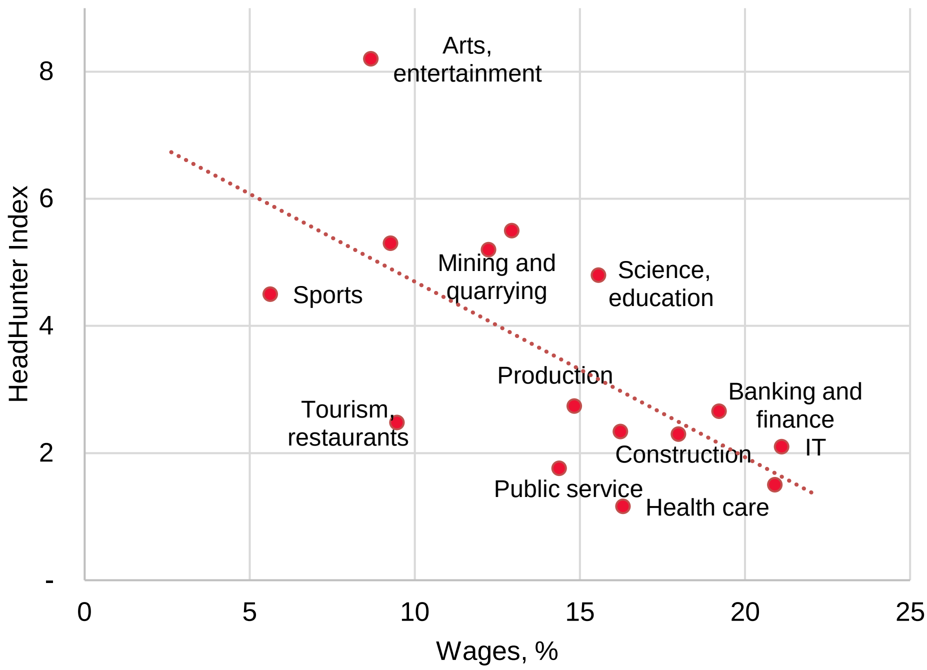
[14] In order to eliminate the impact of the episode of a deep economic activity downturn in the first half of 2020.

Figure 46. Change in job vacancy to CVs ratio in the first half of 2021 relative to the first half of 2019, %



Source: hh.ru, R&F Department estimates.

Figure 47. HeadHunter index ratio to wage changes by activity type in January–May 2021* relative to 2019, %



** The HeadHunter Index shows the ratio of the number of active CVs to the number of vacancies. The lower the value, the stronger employers' competition for workers.*

Source: hh.ru, Rosstat, R&F Department estimates.

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