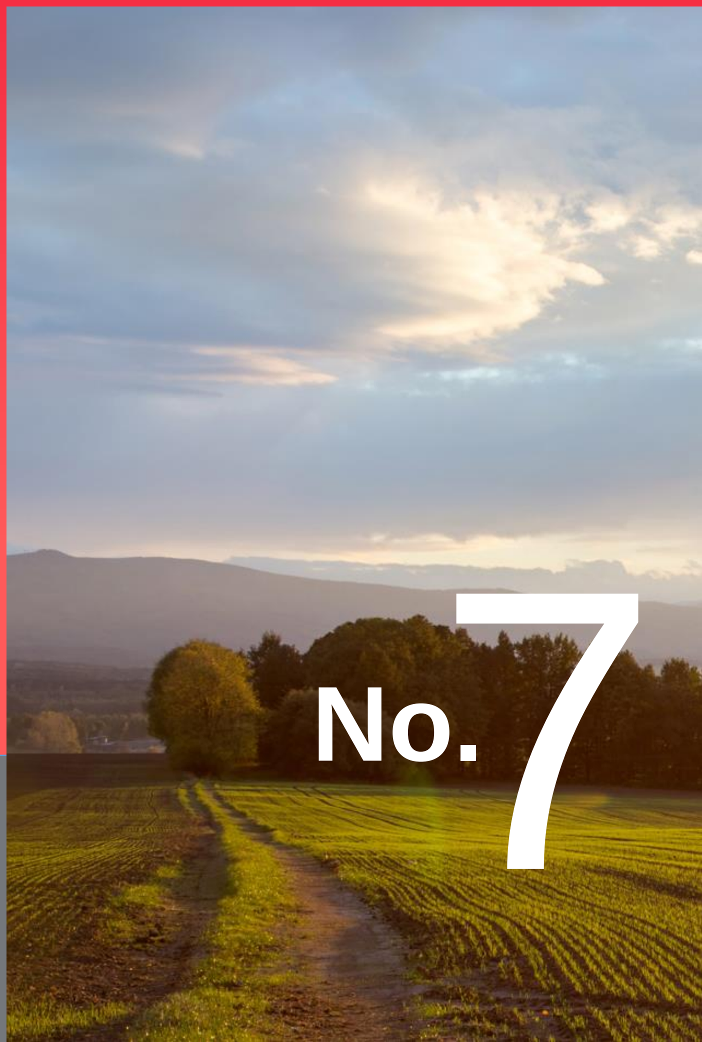
Bank of Russia



TALKING TRENDS
Economy and markets

Research and Forecasting Department Bulletin

OCTOBER 2021

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EXECUTIVE SUMMARY

MONTHLY SUMMARY

- Growth in the Russian economy slowed down between August and September on the back of several external and domestic factors unrelated to the Bank of Russia's monetary policy. The contribution of credit to expanding consumer and aggregate demand in the economy was invariably considerable. Strong financial results of the corporate sector alongside sustainably accelerated growth in wages suggest a promising outlook for economic growth and lending expansion moving forward. At the same time, weekly and monthly growth rates of seasonally adjusted consumer prices went up, while inflation topped 7%. The current monetary policy stance helps reduce the effects of sustainable price growth factors. Yet, the impact of these factors in current macroeconomic conditions is set to fade gradually given the elevated inflation expectations of households and businesses.
  - In the second half of August and September, a significant rise was recorded in weekly and monthly growth rates of consumer prices (adjusted for seasonal drops in fruit and vegetable prices). Although declining, inflation expectations of households and businesses remain high. Therefore, the risks are still in place that secondary inflation effects may strengthen on the back of rising prices.
  - In July-August, the Russian economy slowed down essentially on the back of pressure from external and domestic factors on the supply side. Intense supply chain bottlenecks, including due to coronavirus-linked restrictive measures, caused new delays in supplies. That had a negative effect on both the foreign trade sector and domestic manufacturers (in particular, car manufacturers). A decline in the harvest of several of crops due to weather conditions had negative repercussions for agriculture and agrifood companies. Furthermore, low unemployment, labour shortages caused by insufficient numbers of migrant workers and cross-sectoral labour outflows combine to constrain growth in construction, agriculture and several other industries.
  - Monetary conditions remain accommodative. Rapid expansion in credit activity is continuing, although some segments are showing signs of slower growth. Only signs of a nascent recovery in household deposits have emerged to date, in response to a rise in interest rates on bank deposits. In the context of outrunning paces of growth in labour demand, the rates of wage growth are invariably high. This is largely driven by expanding domestic demand against the background of a lagging expansion in the supply of goods and services.
  - In September, the Russian stock market rose to fresh all-time highs, raising public companies and investors' optimism. The debt market saw a rise in bond yields, in lockstep with other emerging market economies, coming as a sign of investors being prepared for the upcoming rollback of the Fed's quantitative easing.

IN FOCUS. Inflation risks from the labour market are moderate for the moment.

- The growth of real wages since early 2019 has exceeded the paces of labour productivity. However, companies had financial resources to raise wages: growing revenues and net financial results in the overall economy and in most industries were well above the growth of payroll budgets.
- The expected slowdown in price and demand growth is set to stabilise the labour market, limiting the associated inflation risks.
- However, the risks of steadily rising inflationary pressures from the labour market may still materialise if current labour shortages in some industries extend to a wider range of industries. Inflation risks are more likely to materialise against the background of elevated inflation expectations of households and businesses.

1. Inflation

Annual inflation was gaining momentum in the second half of August and in September, driven by the low base of the same period last year (which saw a slow pace of price rises) and mounting inflationary pressure in the consumer sector. The latter, in particular, takes the form of an elevated pace of consumer price rises relative to the usual seasonal pattern, including the indicators of stable price movements which are not liable to seasonal fluctuations. The examples of such indicators are median price rises, price growth (net of volatile components), and trend inflation.

An analysis suggests that the mounting inflationary pressure seems to be fuelled by a pass-through of rising wholesale prices of consumer goods to retail prices, with a gap between their comparative movements gradually closing. One-off pro-inflationary factors, including those in the fruit and vegetable and car markets, have also played a part.

Crucial to the further pace of inflation and monetary policy decisions are *the secondary effects* of price rises, i.e., the extent to which price growth affects inflation expectations and, via those, changes in economic agents' behaviour with respect to consumption, savings, borrowing, preparedness to reduce demand in response to price hikes, to demand that wages be indexed in order to "make up for price rises" or agree to meet these demands, and so on.

The transmission of recent monetary policy decisions has already made the Russian economy show signs of trends which help the secondary effects and inflationary pressure subside. Indeed, according to business surveys, the current input and output price growth is slowing. Household and business inflation expectations are gradually declining, growth in some retail lending segments is losing pace, a rise in household time deposits has emerged. These trends are not yet strong enough to cool the current consumer price rises significantly. It is therefore important that they develop further in the months to come.

It is also crucial that wage growth in the Russian economy meet the pace of labour productivity increase. The workforce shortages which many industries have suffered may result in an inflationary spiral: "price rises – wage growth – price rises", and so on. Still, the Russian economy's ongoing growth slowdown to a sustainable pace should relieve pressure on the labour market and ensure a balanced rise in output and wages alike.

We estimate that disinflationary trends and effects of the key rate hikes will gradually mount as the signal spreads through the interest rate, lending-deposit, and other channels of the transmission mechanism. This will help annual inflation slow in Russia to 4.0%–4.5% in 2022.

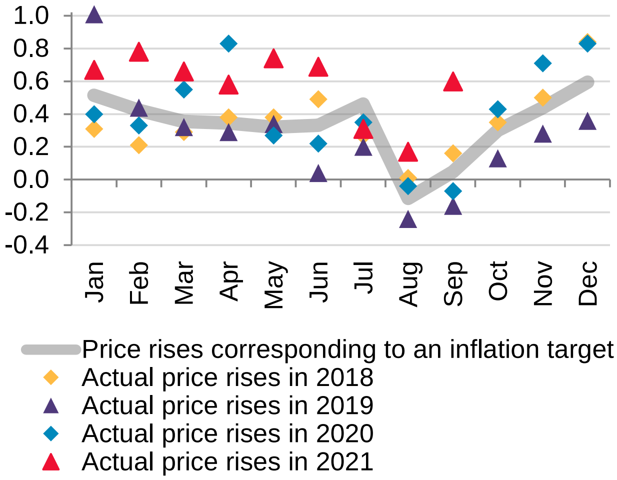
1.1. Inflationary pressure remains elevated

- Annual inflation accelerated to 7.40% in September, with seasonally adjusted monthly price growth going far above a level providing for the return of annual inflation to 4%.
- This was chiefly driven by the impact of some temporary pro-inflationary factors in the food segment, whereas the effect of enduring factors fails to subside, due to, among other things, a rise in producer costs.
- The monetary tightening has yet to affect the pace of price rises in full. We expect the development of disinflationary trends in the coming quarters to slow inflation to 4.0%–4.5% in 2022.

Consumer prices rose 0.60% MoM *in seasonally unadjusted terms* in September versus 0.17% MoM in August, notably faster than seasonally normal and far above a path corresponding to an inflation rate of 4% (Figure 1). After the low number of September last year had exited the calculation base, *annual inflation* hit a five-year high at 7.40% compared with 6.68% in August 2021 (Figure 2).

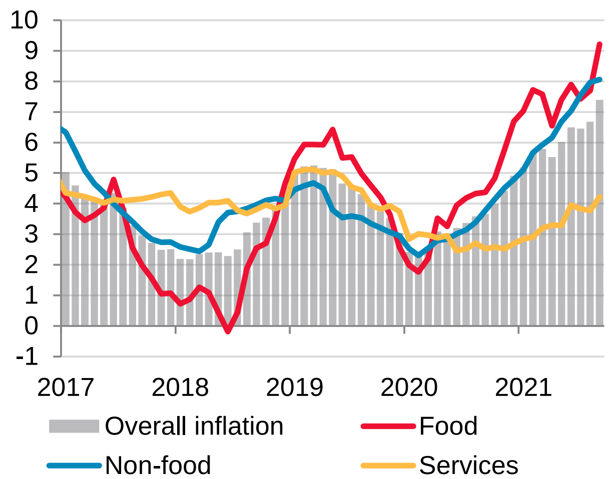
Seasonally adjusted consumer price inflation accelerated to 11.34% MoM SAAR in September,[1] rising notably above the numbers recorded in the previous months of this year (Figure 3). The seasonally adjusted price rise acceleration was chiefly driven by a much weaker fruit and vegetable price decline than seasonally normal on the back of harvest contraction. There was increasing pressure from producer costs in the food segment and continuing expansion of consumer demand, supported by one-off social payments and spurred by elevated inflation expectations.

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



Source: Rosstat, R&F Department estimates.

Figure 2. Inflation and its components, % YoY



Source: Rosstat.

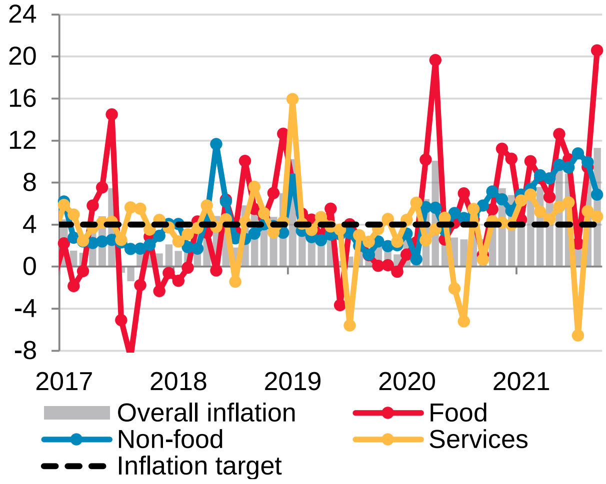
[1] SAAR – seasonally adjusted annualised rate.

Month-on-month seasonally adjusted consumer price growth *in the food segment* came in at 20.57% MoM SAAR (Figure 3). Food price movements were affected by both temporary and enduring factors. Fruit and vegetable price movements notably contributed to price rise acceleration. A decline in these prices was much weaker in September than what the seasonal pattern implies because of a drop in the harvest of some crops and a rise in the costs of fruit and vegetable transportation to the domestic markets.

Food price growth exclusive of fruit and vegetables also accelerated in September, helped by a pass-through to prices of rising producer costs of important categories accounting for hefty shares in the consumer basket: meat and meat products, dairy products, grain products, and eggs. Cost rises reported by producers earlier gradually translate into retail prices of products and will likely continue in the months to come.

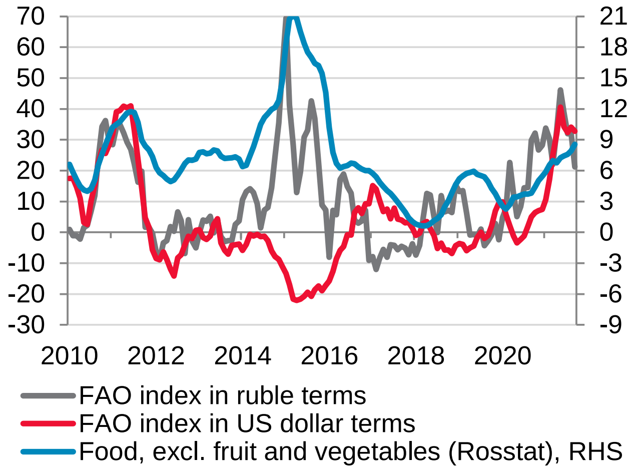
The situation in the global food markets so far continues to exert pressure on domestic prices, thus restraining the return of domestic food prices to normal. FAO data points to continued world food price growth across a wide range of goods in September (Figure 4).

Figure 3. Seasonally adjusted inflation, % MoM SAAR



Source: Rosstat, R&F Department estimates.

Figure 4. World and domestic food prices, % YoY



Source: FAO, R&F Department estimates.

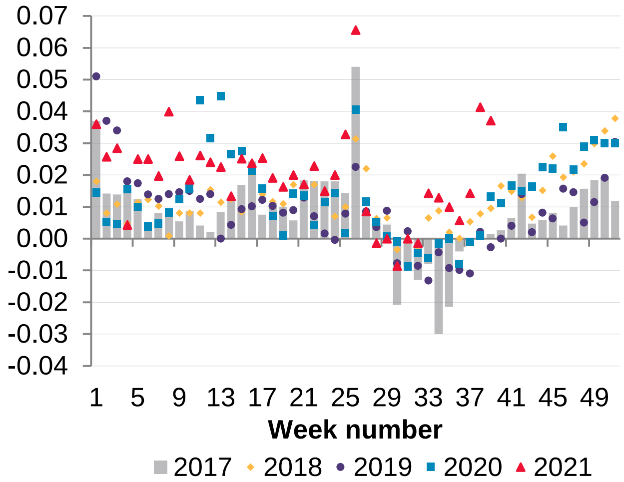
Inflationary pressure remains elevated in the *non-food segment.* Prices rose 6.85% MoM SAAR in September (Figure 3). Cost increases arising from supply-side constraints are promptly passed through to consumer prices, driven by consumer activity expansion as labour income increases and lending growth pace remains elevated.

Price movements remain mixed inside this category. With the world timber market situation returning to normal after explosive price growth which started as early as 2020, construction materials prices have begun to decline. But as demand expands, prices of wearing apparel, textiles, and footwear gave an extra impetus to non-food price rises in September. An increased pace of price hikes relative to 4% in annualised terms continues across a wide range of categories, such as passenger cars, television and radio goods, electrical goods, and furniture.

Prices rose 4.76% MoM SAAR *in the services sector* (Figure 3). A headline inflation rise was fuelled by an acceleration for the second consecutive month in the pace of price hikes for some market services (personal and health care) and a significant increase in the prices of education services at the start of the school year. At the same time, as the vacation season came to an end and seasonal demand weakened, the prices of passenger transport and domestic tourism services declined.

Real-time Rosstat data suggests that price growth remained elevated at the start of October. Prices went up 0.15% over the first four days of October. Average daily price rises continued to substantially exceed the numbers posted in the same weeks last year (Figure 5).

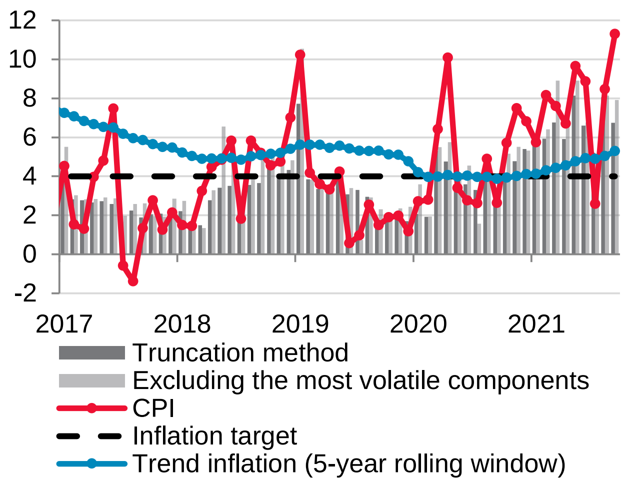
Figure 5. Average daily price growth, %



Source: Rosstat, R&F Department estimates.

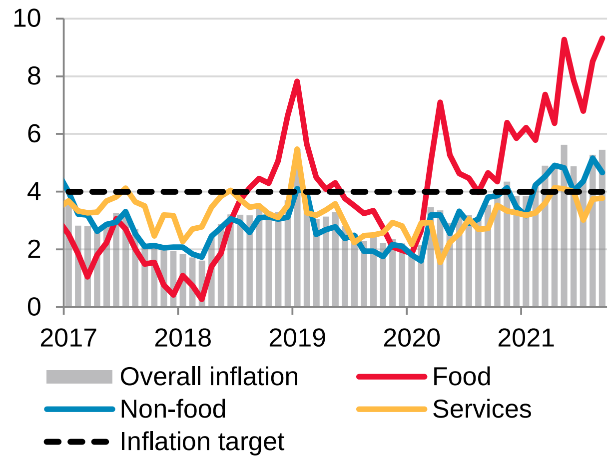
The analytical indicators of price movements (Figure 6, Figure 7) suggest that the contribution of the stable components to increased inflationary pressure remains significant. Trend inflation and median price growth continued to gain momentum in September. The mean reading of modified core inflation indicators, meanwhile, slid 0.8 pp compared with August but remained elevated at over 7% MoM SAAR.

Figure 6. Modified core inflation indicators and trend inflation estimates, % in annual terms



Source: Rosstat, R&F Department estimates.

Figure 7. Median distribution estimated on disaggregated components, % MoM SAAR



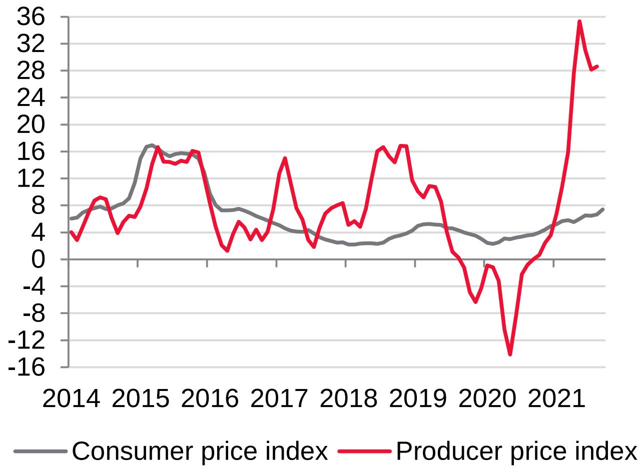
Source: Rosstat, R&F Department estimates.

Monetary policy tightening is just starting to show in household inflation expectations, savings activity, and lending performance. This does not so far have a significant effect on price movements, and a disinflationary trend has yet to develop as the effect of recent and future monetary policy decisions makes itself felt in full. This will provide for annual inflation slowdown to 4.0%–4.5% in 2022 in Russia.

1.2. Commodity price increase accelerates PPI growth

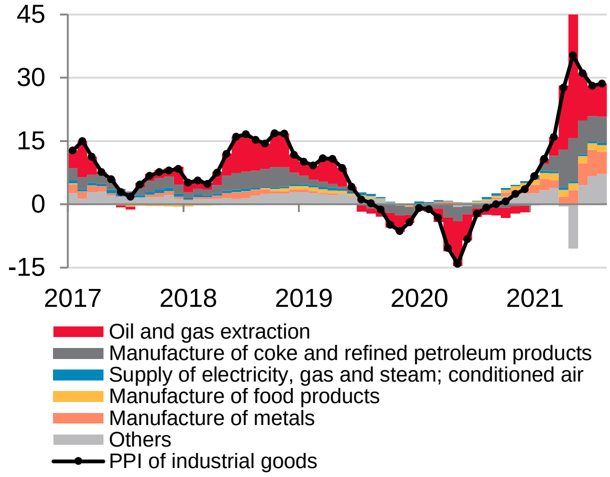
- Annual growth in producer prices of industrial goods accelerated to 28.6% YoY in August from 28.1% YoY in July (Figure 8). This acceleration is largely driven by the current commodity price movements coupled with the low base of 2020 (Figure 9).
- Inflationary pressure from producer prices in other industries shows signs of declining (except in the investment goods segment). But this decline is so far unsustainable and largely depends on price conditions in global commodity markets.
- A slowdown of the annual growth in the producer price index (PPI) in the manufacture of basic metals is owed to a drop in the prices of metal products and iron ore in the world market, driven, above all, by restrictions which Chinese authorities have imposed on the manufacture and export of steel. Russian authorities' imposition as of 1 August of export duties on metals, which has cooled domestic prices of raw materials for metal producers, has also played a part.
- Pressure from producer costs on consumer prices in the food segment is continuing. A rise in the PPI of food products has edged up further to 15.7% YoY in August from 15.4% YoY in July.
- An annual rise in the producer prices of consumer goods is likely to have passed its local peak (Figure 11) and is set to slow in the months to come. But given the continuing impact of supply-side pro-inflationary factors, the pace of the expected slowdown may prove to be moderate.
- That said, a substantial gap between the annual rate of annual price rises in consumer goods and that of their retail prices continues. This will hamper a slowdown in consumer price rises in the coming months.

Figure 8. Consumer and producer price movements, % YoY



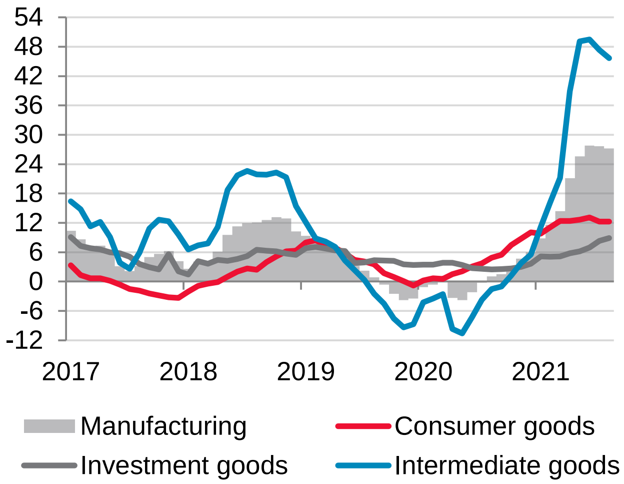
Source: Rosstat.

Figure 9. Input of top 5 industries to producer price growth, % YoY



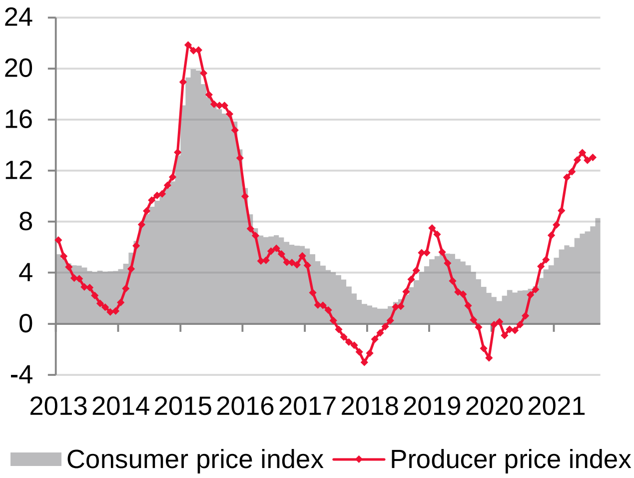
Source: Rosstat, R&F Department estimates

Figure 10. Producer prices by group of manufacturing industries, % YoY[2]



Source: Rosstat, R&F Department estimates.

Figure 11. Prices of some comparable goods in the CPI and PPI structure, % YoY [3]



Source: Rosstat, R&F Department estimates

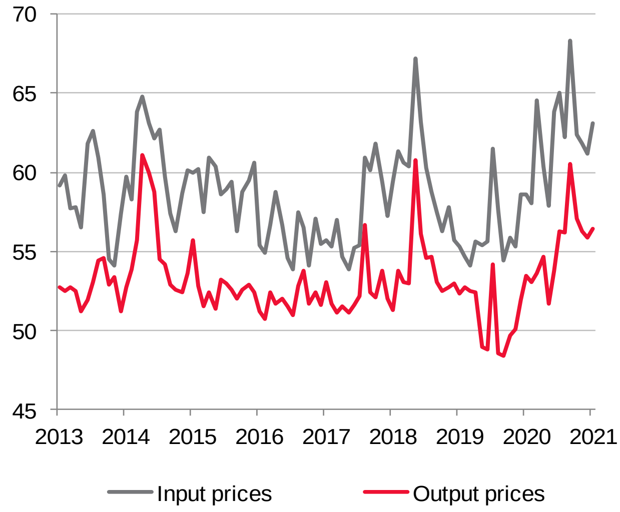
[2] The calculation of producer prices for groups of manufacturing industries producing consumer, investment and intermediate goods is carried out using the structure of weights for the calculation of the PPI of industrial goods in line with the Economic Activity Types under the OKVED 2 classification. The weights of consumer, investment and intermediate goods in the PPI of industrial goods for 2021 are 15.0%; 19.2%; and 33.2%, respectively.

[3] The calculation used comparable goods in the CPI and PPI structure, such as meat products, fish products, butter and fats, dairy products, pasta, sugar, coffee, wearing apparel, footwear, detergents and cleaning solutions, perfumery and cosmetic products, household electronic appliances, and furniture. They account for about 30% of the consumer basket. 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 accounted for.

1.3. Companies’ inflation expectations decrease but are still elevated

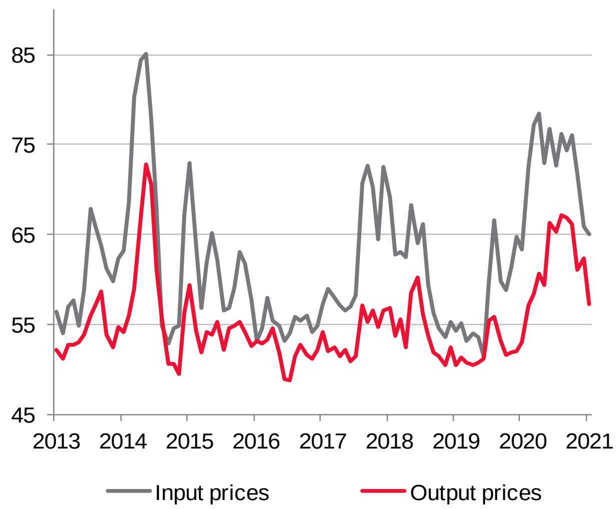
- Overall, price growth is gradually slowing in manufacturing industries but remains elevated, as suggested by Manufacturing PMI price indexes in September (Figure 13). The services sector indexes rose slightly as its activity recovered.
- Despite consumer price growth acceleration in September, business inflation expectations show the first signs of a reversal. September saw the balances of respondents’ perceptions regarding expected price hikes decline in business surveys from the Institute for Economic Policy (Figure 14) and the Bank of Russia (Figure 15). Still, companies’ inflation expectations so far remain elevated.
- Current monetary policy will, with lags inherent to it, slow a rise in final demand and prices, limiting the secondary effects of their elevated growth and bringing down inflation expectations.

Figure 12. Services PMI price indexes, points



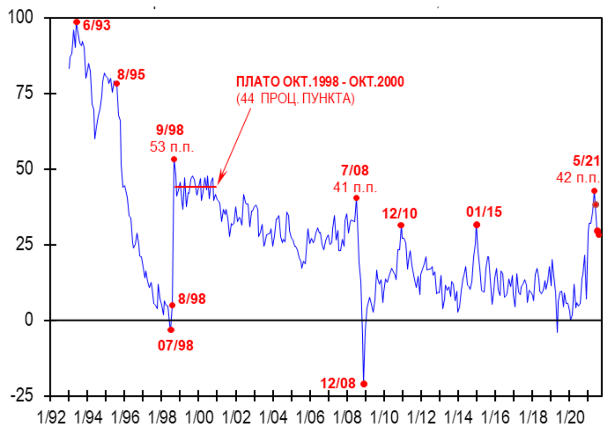
Source: IHS Markit.

Figure 13. Manufacturing PMI price indexes, points



Source: IHS Markit.

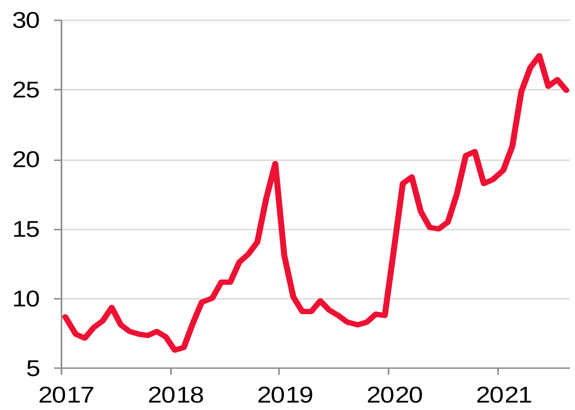
Figure 14. Seasonally adjusted balances of expected changes in output prices, 1993–2021



Oct 1998–Oct 2000 plateau (44 pp).

Source: Institute for Economic Policy.

Figure 15. Companies’ price expectations, three months ahead, balance of answers, %



Source: Bank of Russia.

2. Economic activity

Macroeconomic statistics, leading indicators of and survey data on economic activity in August–September were mixed and ambiguous. Still, put together, they give reason to claim that economic growth continued in Q3, albeit at a lower pace.

Indirect evidence of economic growth continuation, including in the short term, is provided by the high level of optimism in business respondents' perceptions. On top of that, the energy crisis in Europe and China has provided favourable conditions for the export of Russian energy products and power-intensive goods. Strong domestic demand is evidenced by a further rapid expansion in lending activity in both the retail and corporate segments, including SME.

Macroeconomic indicators vary widely across the economy's sectors, reflecting differences in their adjustment to the post-covid balance after the completion of the recovery phase of growth. These differences become all the more visible amid slower growth in the economy at large.

We also note the propagation of delivery disruptions restraining output, in particular of semiconductors and their components. These disruptions have already resulted in a substantial car and truck output contraction in August, despite the continuing strong demand.

In addition to external factors, growth slowdown is owed to the completion of the economic recovery phase. We note that for inflation to decelerate, the overheating of the economy should be avoided.

2.1. Demand growth slowdown and aggravation of supply-side problems

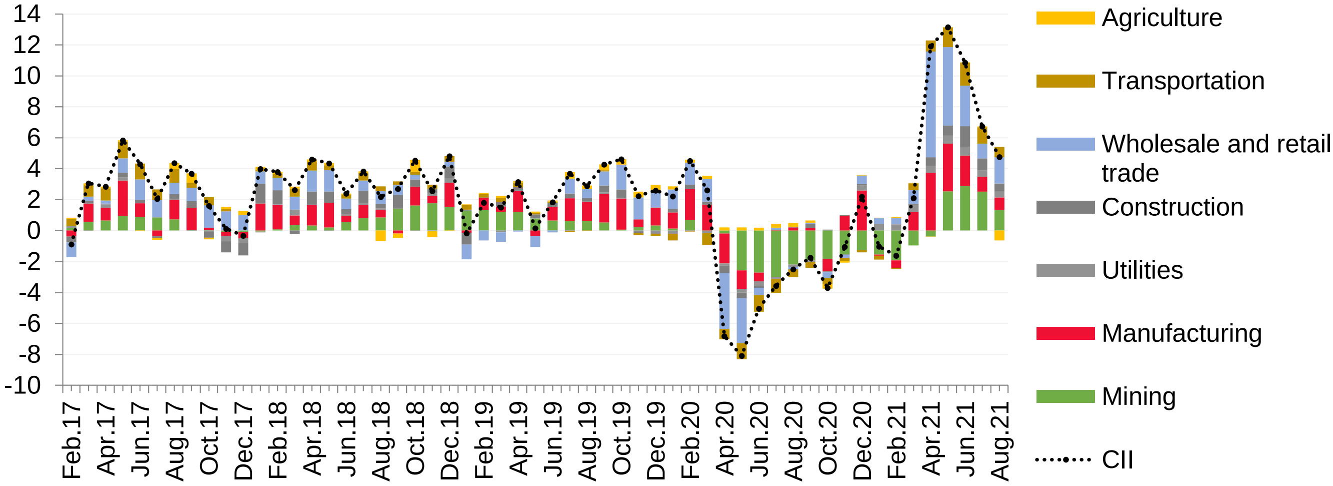
- Economic activity expansion slowed in Q3, with the components of aggregate demand showing mixed performance and supply-side one-off and enduring constraints increasing.
- Consumer demand was rising at an elevated pace throughout the quarter. The strengthening of monetary tightening effect will result in a gradual slowdown of consumer activity expansion.
- Q3 saw investment activity cooling after a sharp rise far above the pre-coronavirus level in Q2.

Q3 saw economic growth slow in both year-on-year and quarter-on quarter terms after the completion of the active recovery phase. This is evidenced by the July–August performance of the core industries index (Figure 16, Figure 17) and an array of changes in various real-time indicators for September.

Economic growth slowdown may prove to be more dramatic due, above all, to the impact of supply-side factors, both one-off and enduring ones. For example, mining and quarrying output declined in August on the back of temporary supply-side problems but is expected to rise in the coming months (see Subsection 2.2. "Temporary industrial output contraction"). The manufacturing output decline stemmed in large part from the shortage of car components. That said, the September PMI survey shows signs of minor growth in demand and output in manufacturing after its contraction in July–August. Business activity and demand moved to growth in the services sector (Figure 18).

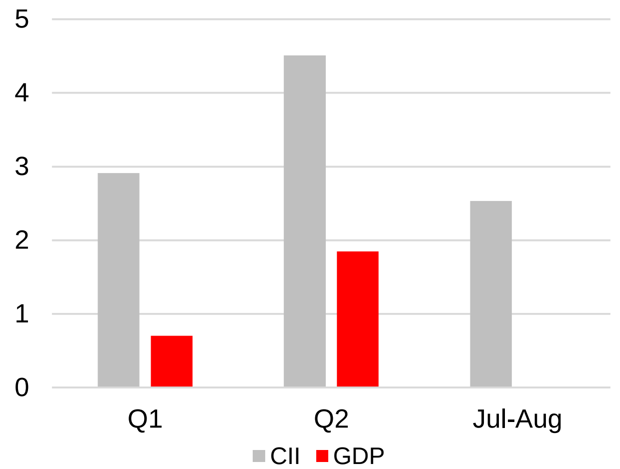
A severe fall in agricultural output due to a later than usual start of harvesting (which caused a seasonality shift in statistics) and a decline in grain and vegetable crop output were recorded in August. This may have been one factor behind acceleration in food price inflation in September.

Figure 16. Contribution of industries to the CII in 2017–2021, % YoY



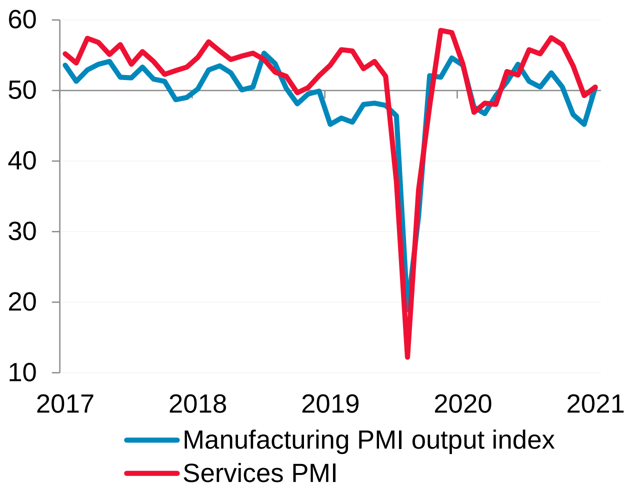
Source: Rosstat, R&F Department estimates.

Figure 17. Growth of GDP and CII in 2021 relative to 2019, %



Source: Rosstat.

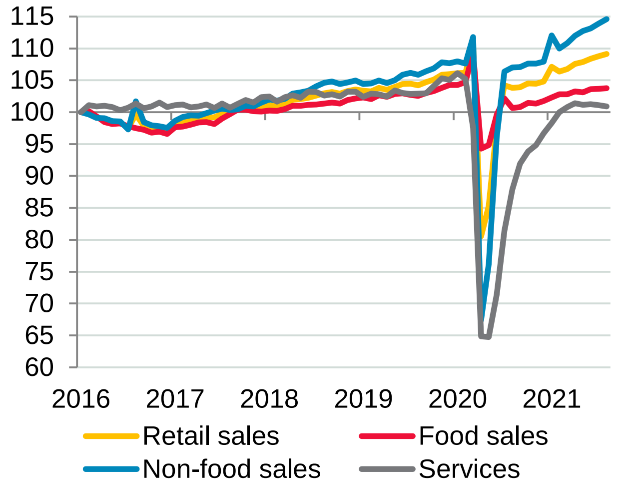
Figure 18. Russia PMI indices



Source: IHS Markit.

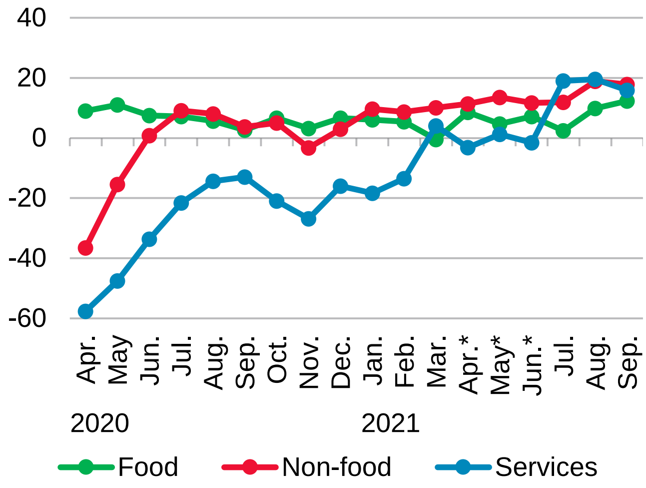
Consumer demand was expanding at an elevated pace throughout the quarter as household labour income rose (the unemployment rate all but hit the pre-pandemic level, the nominal wage growth came in at 14%–15% relative to the year 2019), and unsecured consumer lending gained momentum (see section 2.3 “Key lending segments show uneven performance in August”). Lump-sum social payments gave an additional, although minor, impetus to consumer demand in August and September. It appears that most of this extra income was used to buy goods, whose sales continued to rise at an elevated pace, whereas the paid services sector kept stagnating (Figure 19, Figure 20). We expect consumer demand growth to slow gradually as the effect of monetary policy decisions on the household savings and consumer activity strengthens.

Figure 19. Retail and services sector’s sales (January 2016 = 100%? Seasonally adjusted), %



Source: Rosstat, R&F Department estimates.

Figure 20. Change in nominal household expenditure by category, % YoY[4]



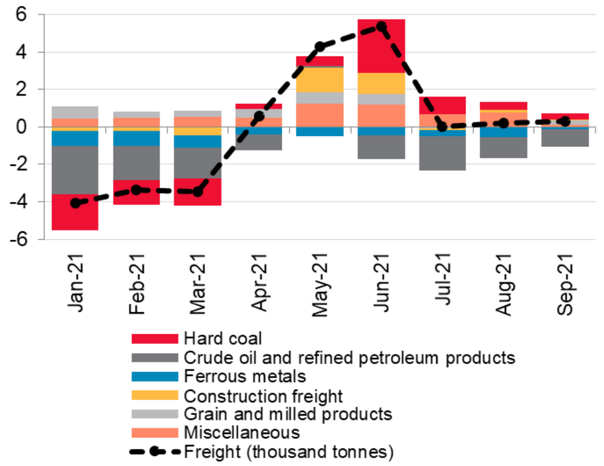
Source: SberIndex.

Investment growth also lost pace in Q3, having reached a high level in Q2 (gross capital formation exceeded the pre-coronavirus level of Q4 2019 by 9.2%), as suggested by changes in railway shipments, in particular, the stabilisation of construction materials freight traffic (Figure 21) and a decline in the Center for Macroeconomic Analysis and Short-Term Forecasting investment activity index. The cooling of investment is also evidenced by payments in industries meeting investment demand (Figure 22): a rise in outcoming payments slowed in Q3 after a sharp acceleration in Q2.

The newsflow became less positive in September: the news-based index slid to 0.9 from 1.0 in August. Nevertheless, the index reading remains close to its all-time high (observations since 2004), suggesting the continuation of economic growth.

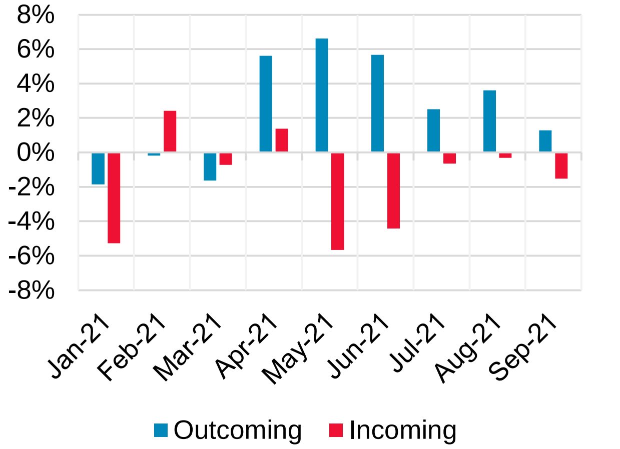
[4] The May–June growth figure is relative to the 01.02.2020–15.03.2020 average rather than a year-on-year increase. The September 2021 indicator uses data for the first four weeks of the month.

Figure 21. Railway shipments in 2021 relative to 2019, %



Sources: Rosstat, R&F Department estimates.

Figure 22. Financial flows in industries meeting investment demand relative to previous quarter's average



Source: Bank of Russia.

2.2. Temporary decline in industrial output

- Industrial output contracted in July–August, dragged down by, above all, supply-side problems caused by the global disruptions of some components' supply and shutdowns at some of oil and gas production facilities.
- The recovery of natural gas and condensate output after planned repair and maintenance at production facilities, along with a rise in extraction under the OPEC+ deal and an increase in coal demand will ensure output expansion, resulting in a turnaround of the mining and quarrying sector's output.
- Manufacturing industries which were less hurt by supply disruptions continue to expand output to meet a rise in demand. This is primarily the case in consumer industries.

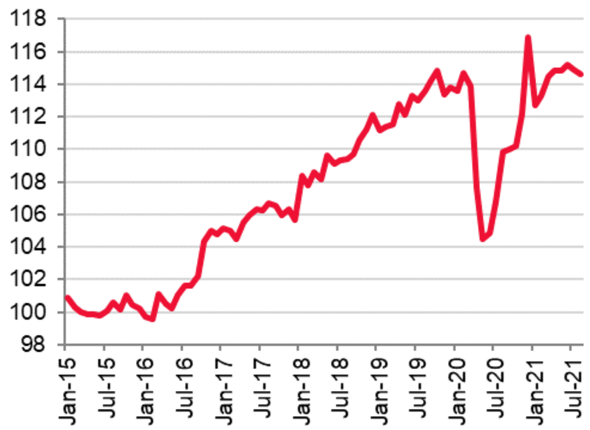
We estimate that industrial output edged down 0.3% MoM SA[5] in August 2021, remaining generally close to the pre-coronavirus level of February 2020 (Figure 23). Output performance continues to vary across groups of industries. Mining and quarrying output is still far below the pre-coronavirus level, with the recovery posted earlier having halted in the last two months. Manufacturing output rose above the pre-coronavirus numbers at the end of 2020 – the start of 2021, and has since hovered around the level thus reached.

The mining and quarrying output contraction slowed to -0.3% MoM SA in August compared with -0.6% a month earlier (Figure 24). The decline was posted in almost all industries. The largest negative contribution came from a temporary decline in crude oil and natural gas extraction and mining and quarrying services, dragged down by repair and

[5] Here and further on SA stands for seasonally adjusted.

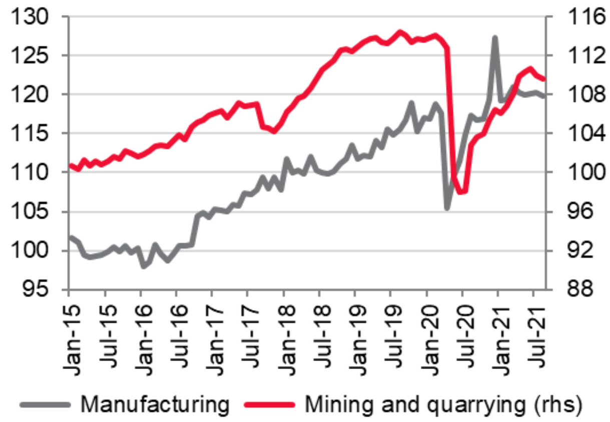
maintenance at LNG[6] plants and an accident at the Novy Urengoy condensate treatment facility. Mining and quarrying output is still far below the pre-coronavirus level at -3.8% SA in compliance with crude oil extraction limits under the OPEC+ deal. The July–August contraction is temporary, and the sector will return to recovery as the OPEC+ extraction caps are lifted in a planned manner. Also, a rise in extraction will be helped by expansion in external demand for coal both in Europe, due to the soaring gas prices, and in the Far East as China addresses the problem of the electricity shortage caused by, among other things, the country's coal underproduction.

Figure 23. Industrial production index (2014 = 100)



Sources: Rosstat, R&F Department estimates.

Figure 24. Indexes of mining and quarrying and manufacturing (2014 = 100)



Sources: Rosstat, R&F Department estimates.

Manufacturing output slid 0.4% MoM SA in August 2021 after two-month near-zero growth of 0.1% MoM SA (Figure 24).

The manufacturing output contraction stemmed from industries meeting investment demand. A fall in August arose from a 6.9% MoM SA drop in the manufacture of fabricated metal products after a jump in April–May 2021 (this industry's monthly performance is very volatile). This group of industries' output was hurt by the manufacture of electrical equipment (except for that of household appliances), down 8.3% MoM SA, the repair and installation of machinery and equipment (-2.5% MoM SA).

Consumer industries' output grew 0.8% MoM SA relative to June, helped most of all by the manufacture of basic pharmaceutical products and pharmaceutical preparations, up 7.6% MoM SA. The manufacture of food products recorded marginal growth of 0.2% MoM SA in August 2021, driven chiefly by the manufacture of vegetable and animal oils and fats, up 7.3% MoM SA, dairy products (a rise of 1.8% MoM SA), and ready-made animal fodder, up 3.4% MoM SA. The largest negative contribution came from the manufacture of other food products, which fell 6.8% MoM SA. An upward trend was also posted in the manufacture of tobacco products, textiles and in some other industries. A stronger output performance in consumer industries was prevented by a 14.7% MoM SA car production plunge stemming from the

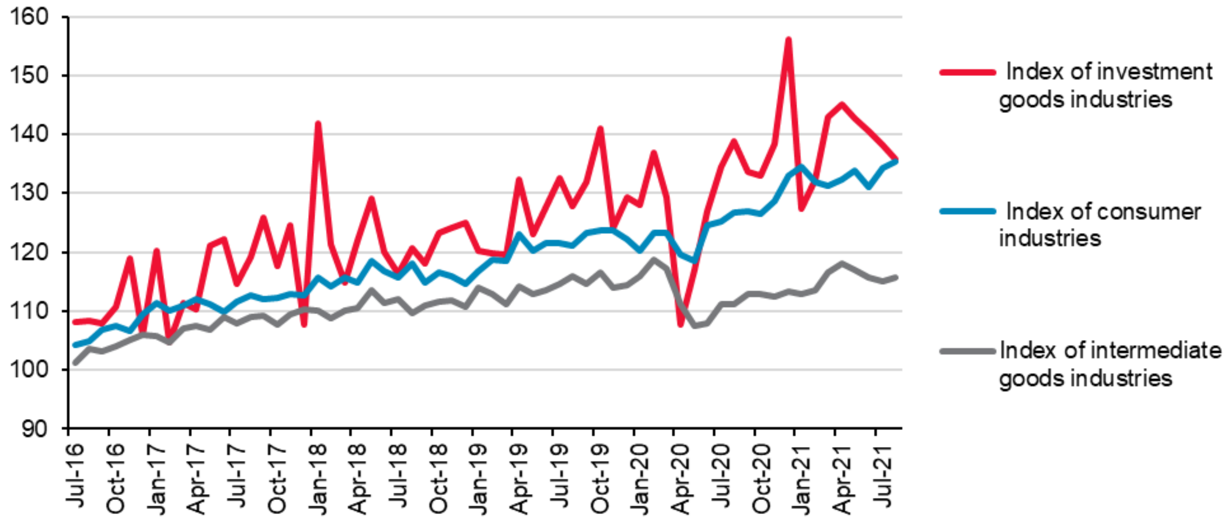
[6] https://www.interfax.ru/business/776026.

shortage of electronic components rather than demand-side problems. We estimate that a fall in the manufacture of motor vehicles, trailers and semi-trailers in August accounts for about 0.16 pp out of a 0.4 pp manufacturing output contraction in August.

Industries meeting intermediate demand enjoyed a minor output increase of 0.5% MoM SA thanks to the manufacture of coke and refined petroleum products, up 1.8% MoM SA. The key negative input was provided by a 1.9% MoM SA output decline in the manufacture of basic metals after a surge in July ahead of the imposition of export duties. This gives reason to count on this industry's output recovery in September–October.

Output contraction in industries which experienced it is generally one-off or stems from external factors. Industries which depend on domestic demand and do not encounter the problems of component shortages, continue to increase output at a comparatively fast pace.

Figure 25. Output in groups of manufacturing industries, January 2016=100%, seasonally adjusted



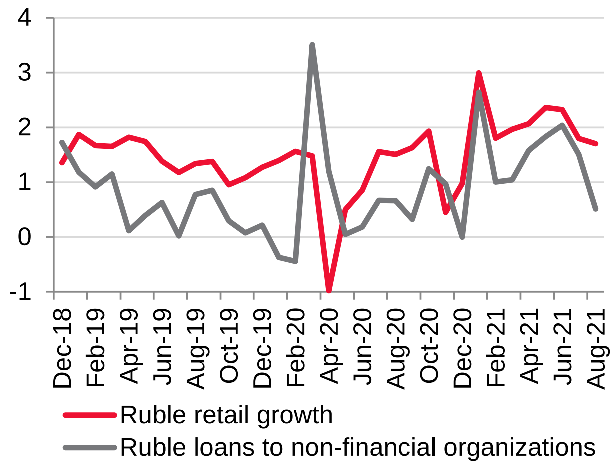
Sources: Rosstat, R&F Department estimates.

2.3. Growth pace varies across key lending segments in August

- Seasonally adjusted monthly expansion in the corporate and mortgage lending lost momentum in August. At the same time, unsecured consumer lending and auto lending continue to rise at an accelerated pace.
- The household deposit growth trend is gradually returning as interest rates on time deposits rise in the wake of monetary policy tightening by the Bank of Russia.
- Banks' net profit far exceeded the August 2019 and 2020 numbers. It continues to be fuelled chiefly by strong net interest income and net fee and commission income.
- The high level of profit and capital will help banks to further expand lending. But, given monetary policy tightening and recent macroprudential measures, its growth will likely continue to slow going forward.

Retail lending growth slowed marginally from 1.8% MoM SA to 1.7% MoM SA in August, remaining elevated (Figure 26). The growth slowdown was driven by the mortgage lending segment.[7] According to our estimate, growth in bank debt, including mortgage-backed securities (MBS), slowed to 1.4% MoM SA in August from 1.9% MoM SA owing to the toughening of subsidised lending conditions,[8] which is borne out by a decline in loan issuance at 7% under the subsidised lending programme (Figure 27). At the same time, key interest rate increases by the Bank of Russia and mortgage lending rate hikes (Figure 28) has so far failed to significantly lower mortgage lending attractiveness to borrowers. Therefore, further mortgage lending growth slowdown may fail to materialise in the short term.

Figure 26. Banks' ruble credit growth, % MoM SA



Source: Bank of Russia.

Figure 27. Mortgage ruble portfolio growth, including mortgage securities, % MoM SA

Source: Bank of Russia.

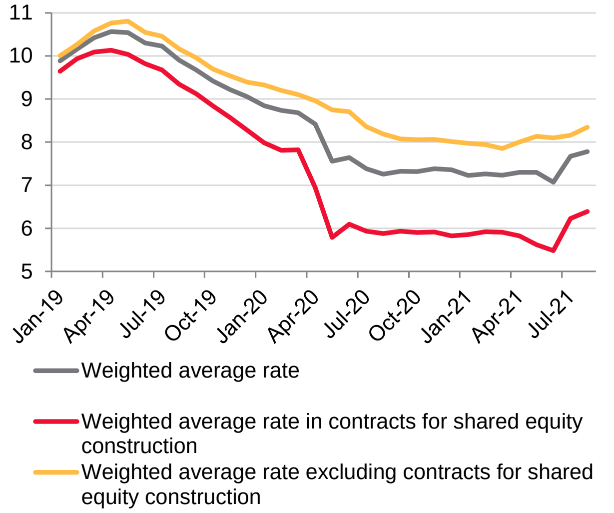
At the same time, unsecured consumer lending expansion accelerated somewhat to 1.6% MoM SA from 1.4% MoM SA (Figure 29). On the side of demand, this may stem from strong consumer activity against a backdrop of elevated inflation expectations as well as expectations for a rise in the cost of debt in the wake of the key rate increases by the Bank of Russia, while on the side of supply, this may be owed to high margins and attractiveness of this segment to banks. The structure of unsecured consumer lending sees a shift towards small loans, possibly due to banks' willingness to capture wider customer segments, attracting lower-income households.

Auto lending also showed growth acceleration to 2.0% MoM SA from 1.0% MoM SA in July. Moreover, National Bureau of Credit Histories data indicates a surge of demand for used cars, up 121.1%, on the back of the growing shortage of new cars.

[7] Mortgage lending portfolio in ruble terms.

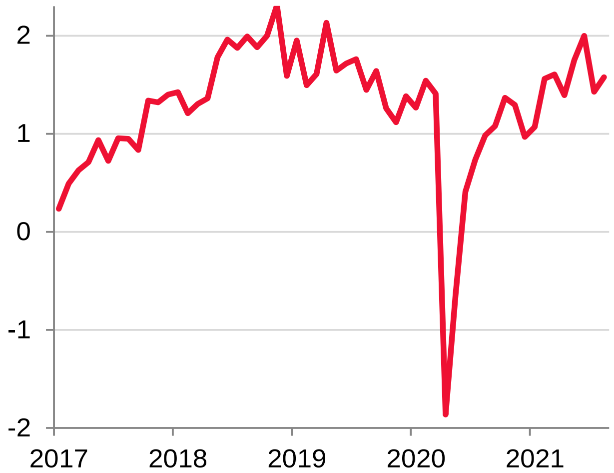
[8] An interest rate increase from 6.5% to 7% and the imposition of a 3-million-ruble loan limit for all regions as of July 2021.

Figure 28. Interest rate in mortgage loan market, %



Source: Bank of Russia.

Figure 29. Rise in unsecured consumer lending, % MoM SA

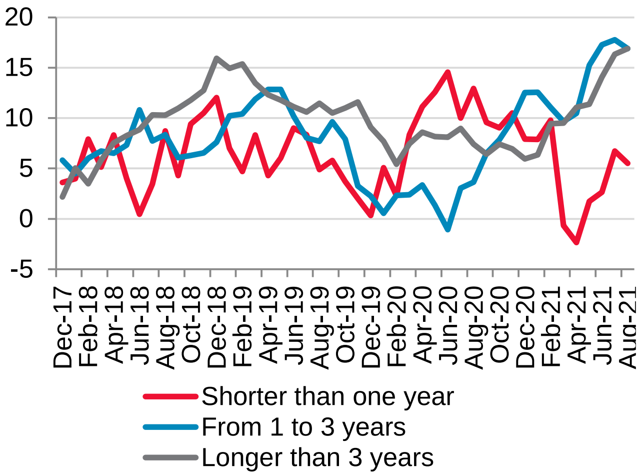


Source: Bank of Russia.

Growth in ruble loans to non-financial organisations slowed to 0.5% MoM SA from 1.5% MoM SA, a rise in loans to sole proprietorships stalled to 1.1.% MoM SA from 1.8% MoM SA. Lending to financial organisations contracted 1.2% MoM SA. Overall, this may reflect some worsening of economic conditions in August. Nevertheless, the fast pace of growth in long-term loans suggests that investment remains strong.

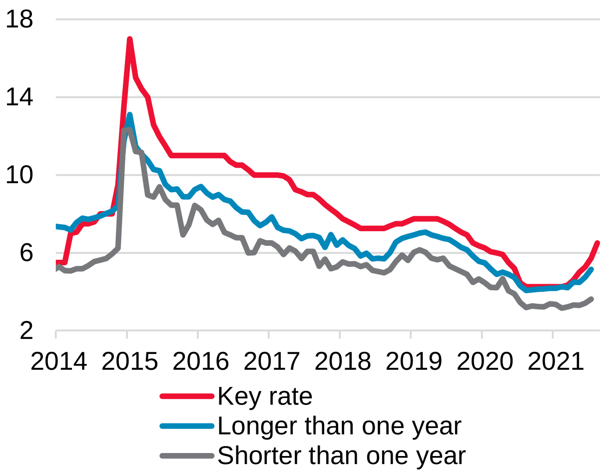
As in July, household funds in bank accounts and deposits expanded 0.7% MoM SA in August. This may arise from the continuing increase in interest rates (Figure 31), gradually improving the attractiveness of deposits (Figure 32), and partly from the recent payment of "school" benefits to families with children, part of which went to savings. Household preferences continue to shift towards time deposits, in particular, short- and medium-term ones.

Figure 30. Growth in ruble loans to non-financial organisations and sole proprietorhips, % YoY



Source: Bank of Russia.

Figure 31. Ruble interest rates on household deposits and the key interest rate, %

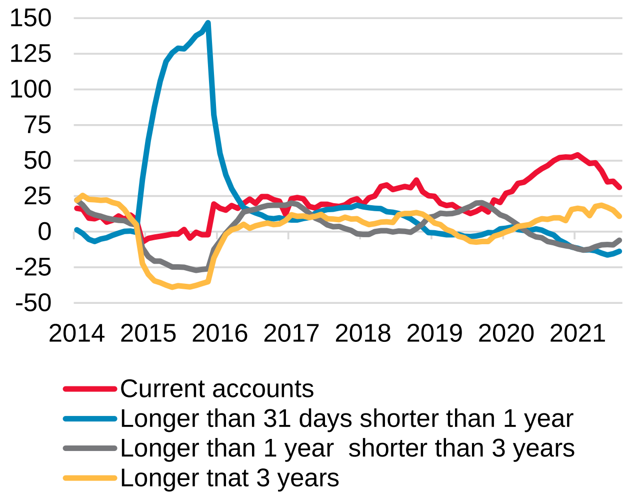


Source: Bank of Russia.

At the same time, we don't yet see a full-scale move towards time deposits, which would signal a massive impact of recent monetary policy decisions on households' choices between consumption and savings. Indeed, annual long-term deposit growth is slowing, driven by a still incomplete pass-through of key rate increases to deposit rates, as well as households' inflation expectations remaining high. Expansion in corporate customers' funds continues to accelerate, reflecting solid growth in companies' financial result this year.

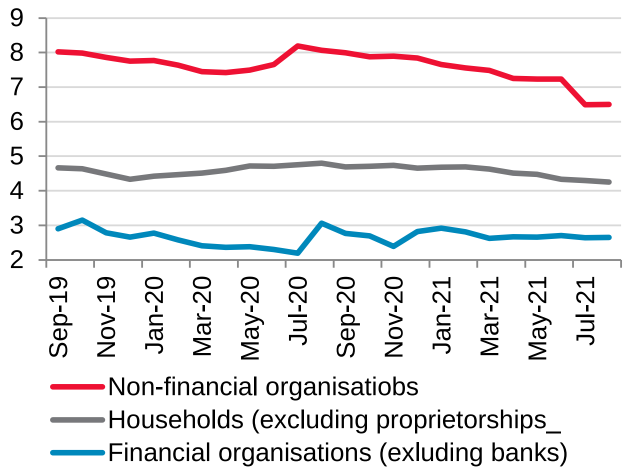
There is currently no loan quality deterioration. The share of overdue loans in loan claims remains all but unchanged (Figure 33), nor is there a significant rise in the share of problem loans (Figure 34).

Figure 32. Household funds growth, %YoY



Source: Bank of Russia.

Figure 33. Share of overdue loans



Source: Bank of Russia.

At 245 billion rubles, the banking sector's net profit notably exceeded the July level, as well as that of August 2019 and 2020 (Figure 35). The financial result continues to be buoyed by net fee and commission income and net interest income).

The coming quarters are expected to see a gradual slowdown in retail lending expansion on the back of ongoing macroprudential policy tightening in this segment, including decisions already taken and the Bank of Russia's announcement about a further increase in risk weight add-ons for unsecured loans to take effect as of 1 October 2021. The toughening of macroprudential requirements is expected to slow retail lending growth. These decisions, however, make themselves felt with a certain time lag. The banking sector's strong profits and satisfactory capital adequacy ratios, as well the sector's ability to adjust the structure of loan claims in favour of loans to which smaller risk weights apply allow banks to expand lending. As of 2022, the Bank of Russia may be granted a new instrument allowing excessive lending growth to be contained: the right to impose caps on some types of retail loans.[9]

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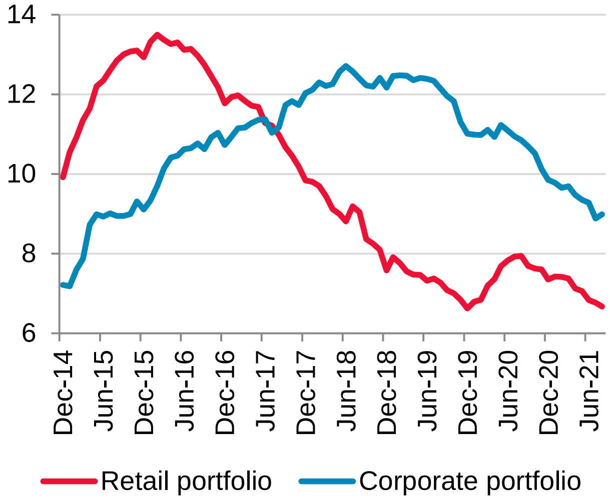
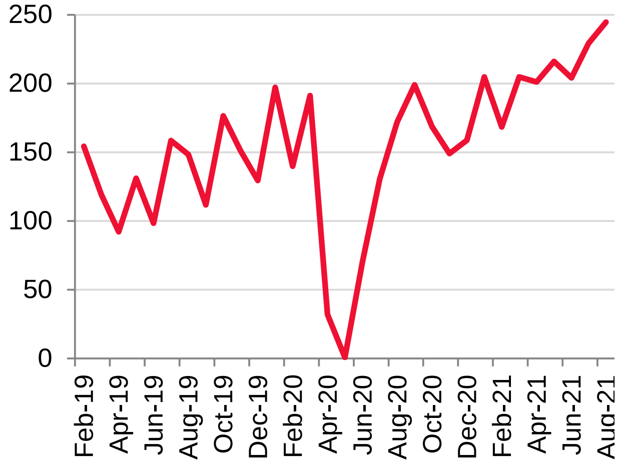
[9] The draft law is being considered by the State Duma.

Figure 34. Share of problem and bad loans, %



Source: Bank of Russia.

Figure 35. Net profit on banking sector, billion rubles



Source: Bank of Russia.

IN FOCUS. Pro-inflationary risks from labour market are so far moderate

- Real wage growth since the start of 2019 has outstripped a labour productivity rise. Companies, however, have had sufficient financial resources to raise wages: an increase in revenue and net financial result in the economy at large and most individual industries has outpaced payroll fund growth by far.
- The expected slowdown in price and demand growth across the Russian economy will stabilise labour market and limit the related pro-inflationary risks.
- However, the risks of a persisting increase in inflationary pressure arising from the labour market may still be realised, should the current workforce shortage in some industries spread to a broader range of industries. The likelihood of inflationary risk realisation is rising amid elevated household and business inflation expectations.

The coronavirus crisis has given rise to major structural changes in the labour market,[10] which are exerting persistent upward pressure on wages.

On the one hand, these changes have emerged on the side of labour demand due to strengthening competition among employers in a variety of industries (Figure 36). The competition for workers is driven by a fast rise in demand in goods and services market as well as changes in its structure after lifting of the pandemic-related restrictions at the start of 2021 amid an almost complete recovery of the employment headcount.[11] *On the other hand,* changes in supply, especially sizable outflows of migrant workers due to coronavirus-related restrictions, has played a significant part.

Real wage growth in H1 2021 stood at 6.4% relative to H1 2019.[12] GDP growth came in at just 1.3% over the same period (1.8% per employed person) (Figure 37). Thus, the real wage growth outstripped a rise in productivity, which is fraught with medium-term inflation implications. A rise in income supports demand expansion, which may be stronger than supply growth because of lagging labour productivity. This in turn gives companies an opportunity for more price hikes, generating the risks of persisting elevated inflationary pressure.

Despite the faster real wage growth than that of productivity in the economy at large, our analysis of unit labour costs suggests that medium-term pro-inflationary risks to the labour market can, in general, be viewed as moderate. Revenue expansion has allowed Russian companies to raise nominal wages without increasing unit labour costs[13] (Figure 38).

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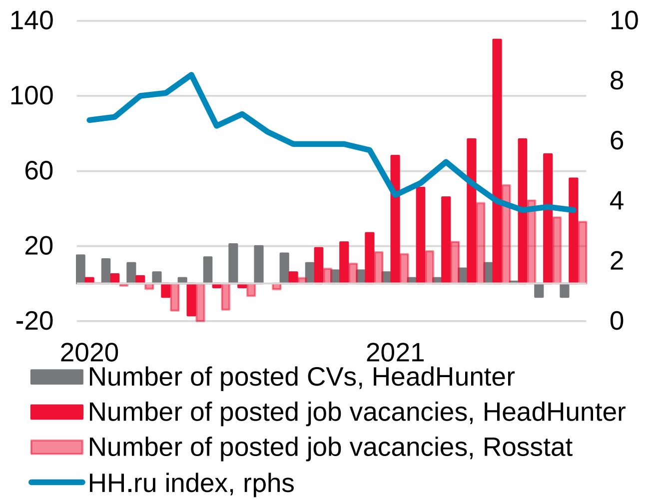
[10] IN FOCUS. Structural shifts in labour market give rise to pro-inflationary risks.

[11] The employment headcount in H1 2021 was 0.5% below the June 2019 level.

[12] Further on, the FOCUS section will analyse and describe changes in H1 2021 relative to H1 2019.

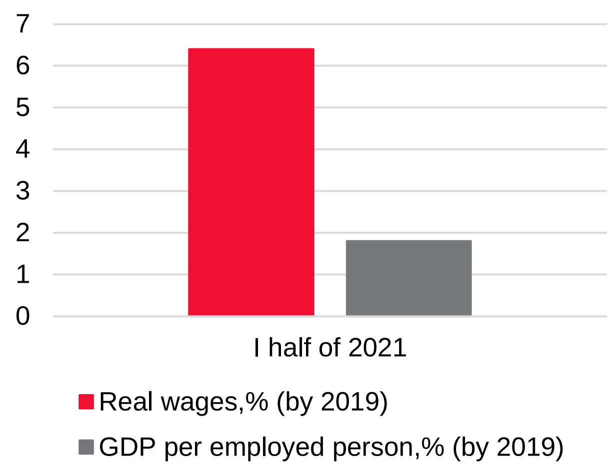
[13] This difference between changes in real and nominal wages and output is owed to the GDP deflator and consumer price inflation. The rate of price rises in the economy at large since 2019 has been higher than consumer price inflation due to faster price growth in other than consumer industries (above all, in industries meeting intermediate and external demand against a backdrop of export price rises).

Figure 36. CVs and job vacancies (% YoY), the HeadHunter index[14]



Sources: HH.ru, Rosstat.

Figure 37. Growth rate of GDP per employed person and that of real wages in H1 2021 relative to H1 2019



Source: Rosstat.

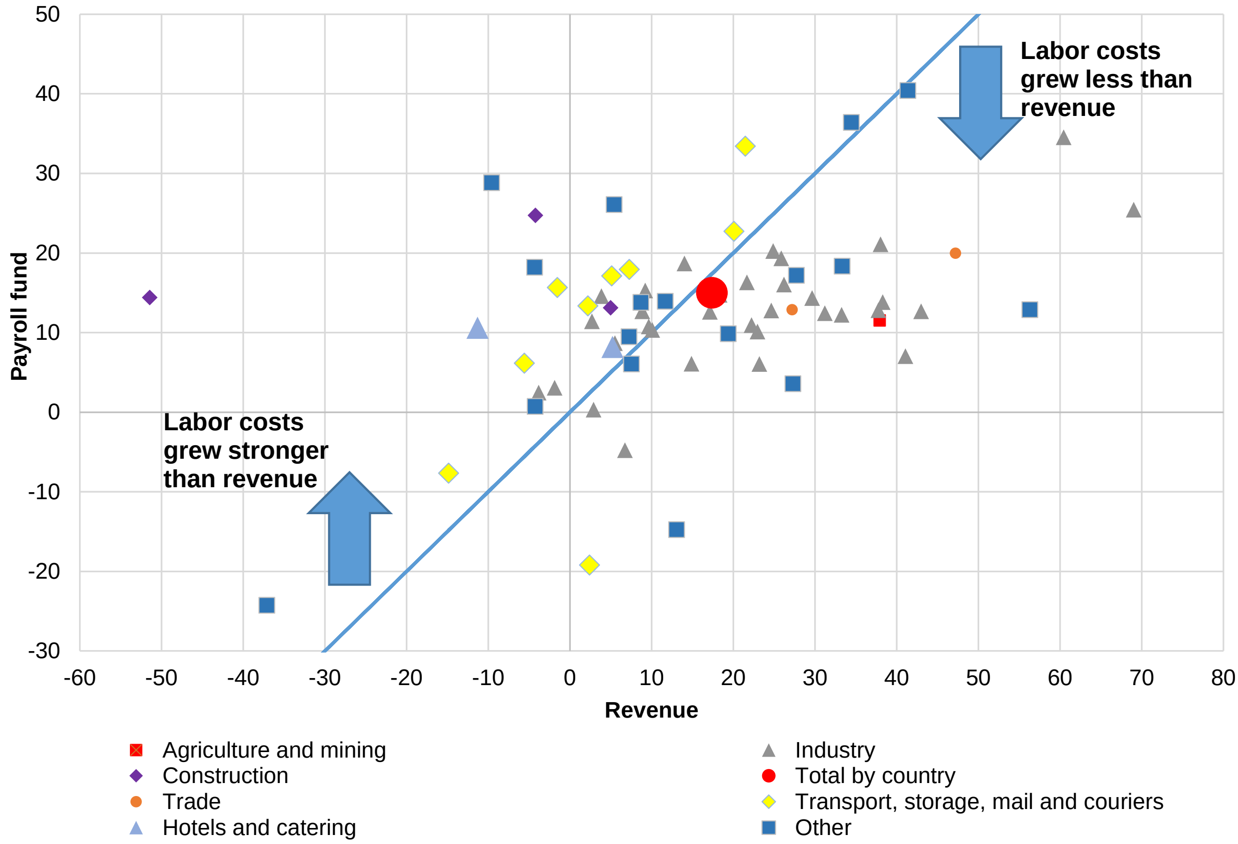
Changes in unit labour costs vary across industries. The hospitality and public food service, as well as construction, recreation and sports industries, which were hit the hardest by the pandemic, show notably faster growth in labour costs compared with revenue expansion. These are industries experiencing the most severe shortage of workforce due to a rise in demand in sectors which benefitted from the pandemic and limited labour supply. That said, revenue expansion outstripped both nominal and real wage growth in most industrial subsectors.

Thus, a large part of industries have had sufficient financial resources for raising wages to meet revenue and profit growth in the past two years. As price rises slowed, driven by the current monetary policy effect and the weakening of temporary supply-side pro-inflationary factors, including those arising from external markets, companies' ability to expand wages at a faster rate than that of productivity growth will decrease.

Nevertheless, inflation risks from the labour market remain. Industries, such as hotels, public food services, trade, and construction, are still experiencing a severe shortage of workforce and competition for workers among employers. This accounts for an accelerated rise in unit labour costs relative to the 2019 levels. The workforce shortage may become even more severe as economic activity rises further. As a result, pressure on wages and, accordingly, prices may spread to a wider range of industries, especially amid elevated household and business inflation expectations.

[14] The HeadHunter index shows the ratio of active CVs to job vacancies.

Figure 38. Changes in revenue and payroll fund by economic activity type, H1 2021 relative to H1 2019, %



Sources: Rosstat, R&F Department estimates.