Bank of Russia

TALKING TRENDS
Economy and markets

Research and Forecasting Department Bulletin

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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

- Overall economic activity between July and August was marked by a certain rebound, with industries putting in a highly mixed and unsteady performance. Importantly, the economy has yet a long way to go as it adjusts to the new conditions. The effect of one-off disinflationary factors, primarily of the recent ruble strengthening, is running its course. This comes with a rise in consumer activity, fuelled by a rebound in consumer lending among other factors. An increasingly significant contribution to aggregate demand is made by fiscal spending. These trends are set to entail a gradual increase in inflationary pressures.
    - At this stage, there is a set of diverging factors at play that determine Russian economic performance. Among these are, first, an ongoing pause, after the February financial shock – before the economy starts to feel the core fallout from the deep decline in imports of intermediate and investment goods. Second, this is a window of opportunity for energy exports – before the EU enacts its restrictions. Third, this is the gradual adjustment of the worst hit industries (e.g. the automotive industry) through product line simplification. Fourth, this is growth in industries that are capable of delivering quick replacements of imports (e.g. the production of consumer goods) or those focused on government contracts.
    - The inflationary landscape is gradually changing. The recent strengthening in the ruble is still a source of disinflationary pressure in multiple market segments including the consumer one. However, the share of goods and services with current price growth rates above 4% has been steadily expanding since July. Concurrently, the share of goods and services with declining prices has been shrinking. These trends are likely to persist given the ongoing decline in the savings rate (including as a result of a rebound in consumer lending) and an increasingly expansionary nature of fiscal policy. Inflation is expected to return to 4% in 2024 under the influence of the monetary policy stance.
    - Russian ruble bonds have overall shown a stabilisation in yields. The risk and inflation premiums factored in the prices of medium- and long-term bonds speak to reduced sensitivity of their prices to key rate changes.

In focus: Assessing underlying inflationary pressure in current conditions

- The decline in the overall price level since May and the significant slowdown in annual inflation are largely the effects of one-off and transient factors. The drastic changes in price trends and the impactful disinflationary drivers in 2022 complicate an assessment of underlying inflationary pressure – the key factor to consider in monetary policy decisions.

- The measures that quantify core inflation, although less dependent on one-off and transient factors than general price trends, are not fully insured against their influence. For this reason, it is important to consider indirect estimates based on changes in other macroeconomic variables such as monetary aggregates, labour market indicators and others.
- The totality of indicators show that steady inflationary pressure is currently level with or above the Bank of Russia’s target. Having said that, medium-term inflation risks are tilted to the upside.

1. Inflation

Annual inflation is slowing, with the pace of seasonally adjusted price rises remaining close to zero. Actual and expected change in businesses' output prices, according to most of the survey data, suggests a subdued inflationary background at the moment. Annual inflation deceleration is set to continue in the coming months, given the exit from calculation of fast price growth rates at the end of last year. This is owed to strong *one-off* disinflationary factors, above all, ruble appreciation.

At the same time, a number of price indicators, portraying the most stable price movement trends (in particular, the median, trend inflation, the share of consumer basket components whose prices rise at a faster rate than 4% in annualised terms), as well as the persistence of increased household inflation expectations, point to some strengthening of inflationary pressure. This means that the *current* pace of seasonally adjusted consumer price rises will increase in the coming months. This stems, above all, from a gradual fading of the pass-through effect of ruble strengthening and the rebounding of consumer demand driven by the easing of lending terms and conditions and a decline in propensity to save.

1.1. First signs of rise in inflationary pressure

- Annual inflation slowed to 15.1% in July. The month-on-month price decline in seasonally adjusted terms continued: the prices of goods went down, whereas services prices remained elevated relative to the Bank of Russia target.
- The price decline in the goods market largely arises from one-off factors, including a "compensatory" adjustment after a price surge in March–April. This process receives a further impact from ruble strengthening seen since March, which restrains a rise in producer costs and the prices of imports, whose supply expanded after the mechanism of parallel imports had been introduced.
- At the same time, indicators portraying the most stable price movement processes suggest an elevated inflationary background. This is also evidenced by movements in the prices of some consumer basket components, in particular, those of free-market (unregulated) services.
- Weekly data suggest some strengthening of inflationary pressure in August, despite a decline in the overall consumer price index.
- Money supply growth acceleration against a background of lending recovery, coupled with budget impulse strengthening amid continued supply-side constraints, is a key pro-inflationary risk.

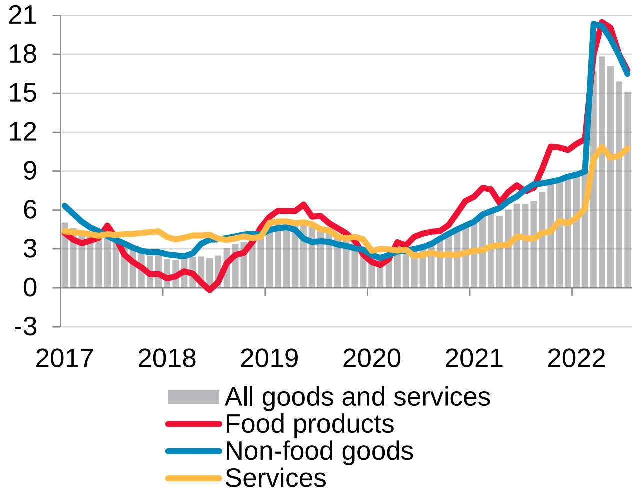
Annual inflation slowed to 15.1% in July from 15.9% in June (Table 1, Figure 1). Annual price growth continued to slow in the goods market but accelerated in the services sector. In-month-on-month terms, prices went down 3.2% SAAR (Figure 3).

Table 1. Inflation and its components

	July 2020	July 2021	Май 2022	June 2022	July 2022
% YoY					
All goods and services	**3.4**	**6.5**	**17.1**	**15.9**	**15.1**
Core inflation	**3.0**	**6.8**	**19.9**	**19.2**	**18.4**
Food	4.2	7.4	20.1	18.0	16.8
Non-food goods	3.1	7.6	19.2	17.9	16.5
Services	2.5	3.8	10.0	10.2	10.8
% MoM SAAR					
All goods and services	**5.2**	**5.2**	**2.0**	**-2.8**	**-3.2**
Core inflation	**5.7**	**8.9**	**4.0**	**2.8**	**1.1**
Food	9.5	4.5	8.3	-8.4	-8.1
– Net of fruit and vegetables	**4.8**	**6.9**	**16.1**	**4.9**	**-0.2**
Non-food goods	4.7	10.9	-0.7	-3.9	-4.1
– Net of refined petroleum products and tobacco	**3.5**	**10.5**	**-0.9**	**-4.7**	**-4.9**
Services	0.2	-1.0	-3.3	8.0	5.9
– Net of municipal and housing services	**2.1**	**-2.4**	**-7.5**	**10.2**	**4.7**

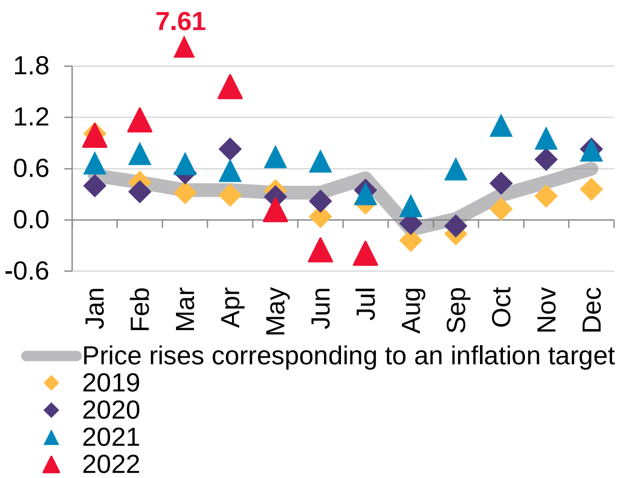
Sources: Rosstat, R&F Department estimates.

Figure 1. Inflation and its components, % YoY



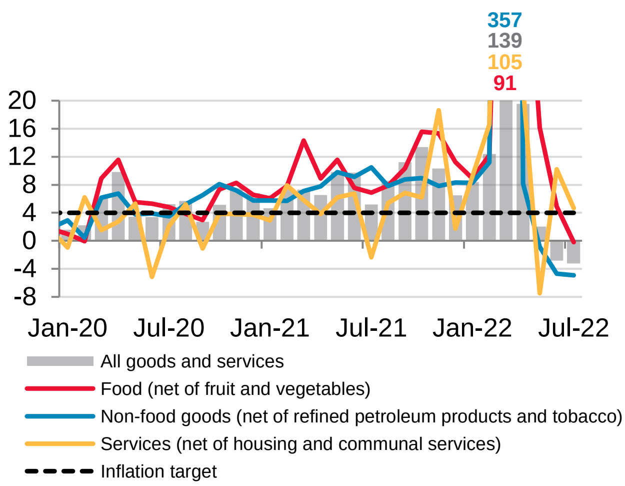
Source: Rosstat

Figure 2. Price rises corresponding to an inflation rate of 4%, % MoM



Source: Rosstat, R&F Department estimates.

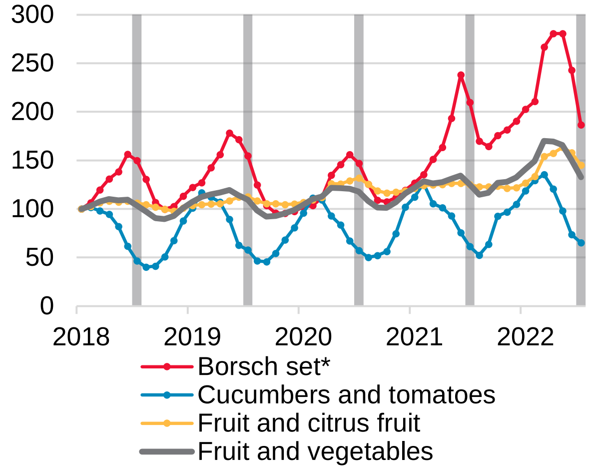
Figure 3. Seasonally adjusted price growth, % MoM SAAR



Sources: Rosstat, R&F Department estimates

Food prices continued to fall at a fast pace of 8.1% MoM SAAR after 8.4% MoM SAAR in June, driven chiefly by a faster than seasonally normal decline in fruit and vegetable prices, although its scale has decreased somewhat (Figure 4). The fruit and vegetable price slide has continued since April and has already offset a price increase in March (a fall of 18% in April–July compared with a rise of 13% MoM in March in seasonally adjusted terms).

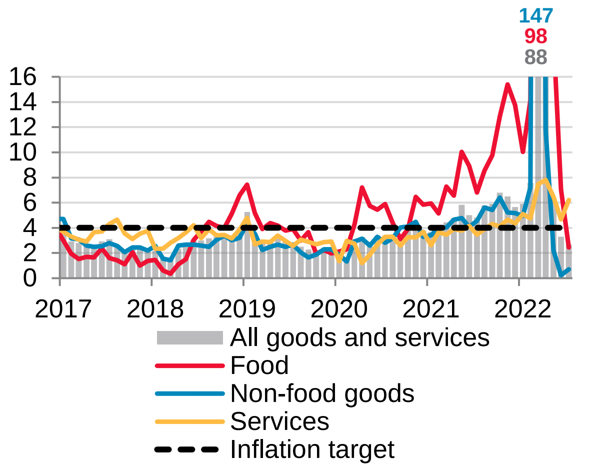
Figure 4. Fruit and vegetable price index, January 2018 = 100%



** Comprised of potatoes, cabbages, onions, beets, and carrots.*

Sources: Rosstat, R&F Department estimates.

Figure 5. Median distribution estimated on disaggregated components*, % MoM SAAR

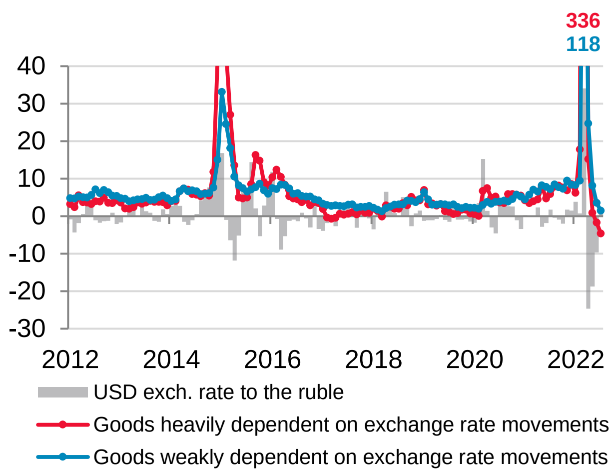


** 558 components in the 2022 basket.*

Source: Rosstat, R&F Department estimates.

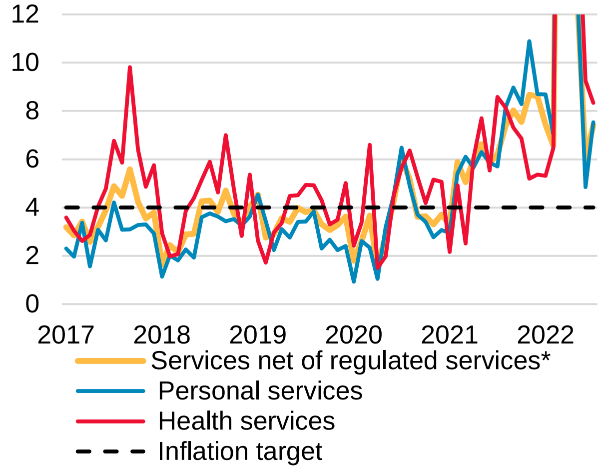
Net of fruit and vegetables, a food price descent came in at 0.2 MoM SAAR. This was owed to a price fall in some items which have a high share in the consumer basket composition (some meat products, sugar, tea, coffee, pasta, and grains) and a price rise slowdown across a wide range of food products. The distribution median calculated from disaggregated food product components dropped to 2.4% MoM SAAR from 7.0% MoM SAAR in June. This trend is largely helped by a stable domestic supply of food products and a likely fall or stabilisation of costs after their rise in Q2.

Figure 6. The US dollar exchange rate to the ruble (%) and median CPI, % MoM SAAR



Sources: Rosstat, R&F Department estimates.

Figure 7. Unregulated services prices, % MoM SAAR



** Net of housing and communal services, some transportation services and education, tourism, and banks.*

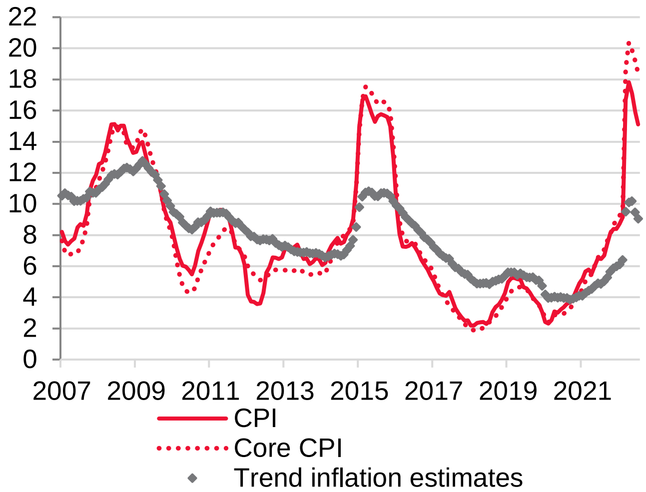
Sources: Rosstat, R&F Department estimates.

A price fall continued for the third consecutive month in the non-food segment to come in at 4.1% MoM SAAR, slightly accelerating from May. A price slide continued in goods heavily dependent on the exchange rate movements (Figure 6). The distribution median calculated from the disaggregated components of non-food goods remains close to zero (Figure 5). A factor restraining a price rise in this segment is supply expansion buoyed by logistics restructuring as part of producers' gradual adaptation to the new conditions, the organisation of deliveries under the parallel import scheme, as well as the launch of used equipment sales in certain marketplaces. The stocks of goods allowed to be imported under the parallel import scheme were replenished after their contraction in March–April (Figure 12).

The pace of month-on-month price rises in the services sector but remained increased at 5.9% MoM SAAR in July after 8.0% MoM SAAR in June. July traditionally sees the indexation of housing and municipal services prices. They rose 4.5% on average this time around, in line with the planned 2022 indexation (2.9%–6.5%, depending on the region).[1]

One measure of inflationary pressure in the consumer market, adjusted for the impact of one-off and temporary factors, is change in the prices of free-market (unregulated) services: these depend on the impact of one-off supply-side factors less to a lesser extent than goods and to a greater extent on wages and overall labour market situation. The pace of rises in the prices of unregulated services remained elevated in June–July at 6–8% MoM SAAR (Figure 7). The distribution median calculated from disaggregated services components remains at a roughly similar level (Figure 5).

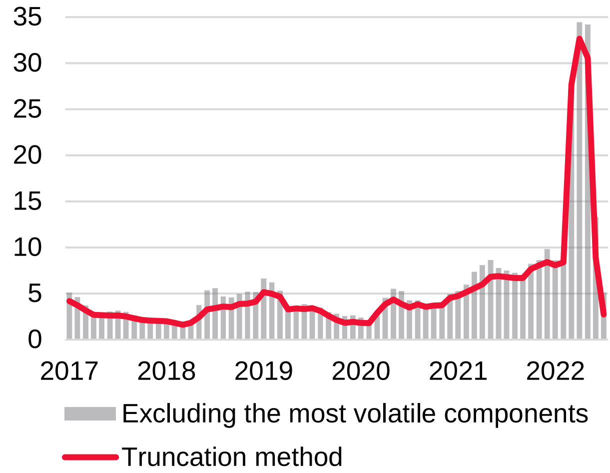
Figure 8. CPI, Core CPI and Bank of Russia historical estimates of trend inflation *, % YoY



** The indicator is computed on the 5-year moving average.*

Sources: Rosstat, R&F Department estimates.

Figure 9. Modified core inflation indicators, % 3M SAAR



Source: Rosstat, R&F Department estimates.

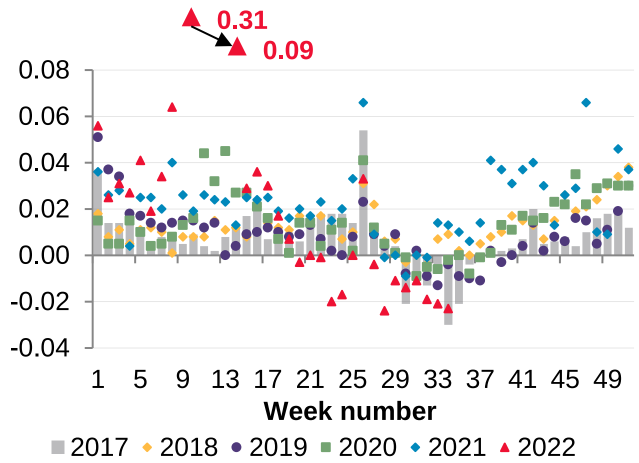
The trend inflation indicator also points to the continuation of elevated inflationary pressure at above 4%. Indeed, it stood at 9.1% in July and 9.5% in June (Figure 8). The mean of modified core inflation estimates declined to 3.9% in July from 11.1% 3M SAAR in June

[1] The scheduled range of increases in communal services prices will not have a significant effect on annual inflation.

(Figure 9). Price rises slow across a wide range of consumer goods and services, offsetting a sharp price increase acceleration in March. That said, the continuing gap between the overall price movements and the estimates of indicators portraying the most stable price movement processes suggests a significant impact of temporary and one-off disinflationary factors.

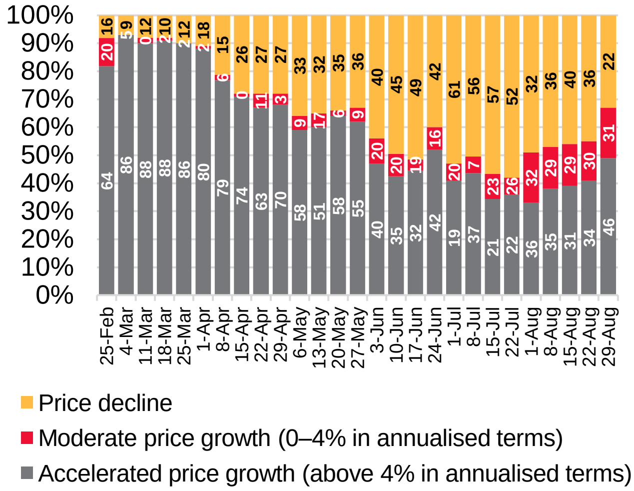
Weekly statistics indicate gradual mounting of inflationary pressure in August. The decline in the overall price level continued, but the array of goods and services whose prices rose at a rate above 4% in annualised terms[2] compared with July, while the number of items whose prices go down decreased (Figure 10, Figure 11). The fruit and vegetable price slide came close to the normal seasonal pattern. Nevertheless, August's annual inflation will slow due to the exit of the high base of 2021.

Figure 10. Average daily price growth, %



Sources: Rosstat, R&F Department estimates.

Figure 11. Distribution of price indices for categories of goods and services monitored on a weekly basis*



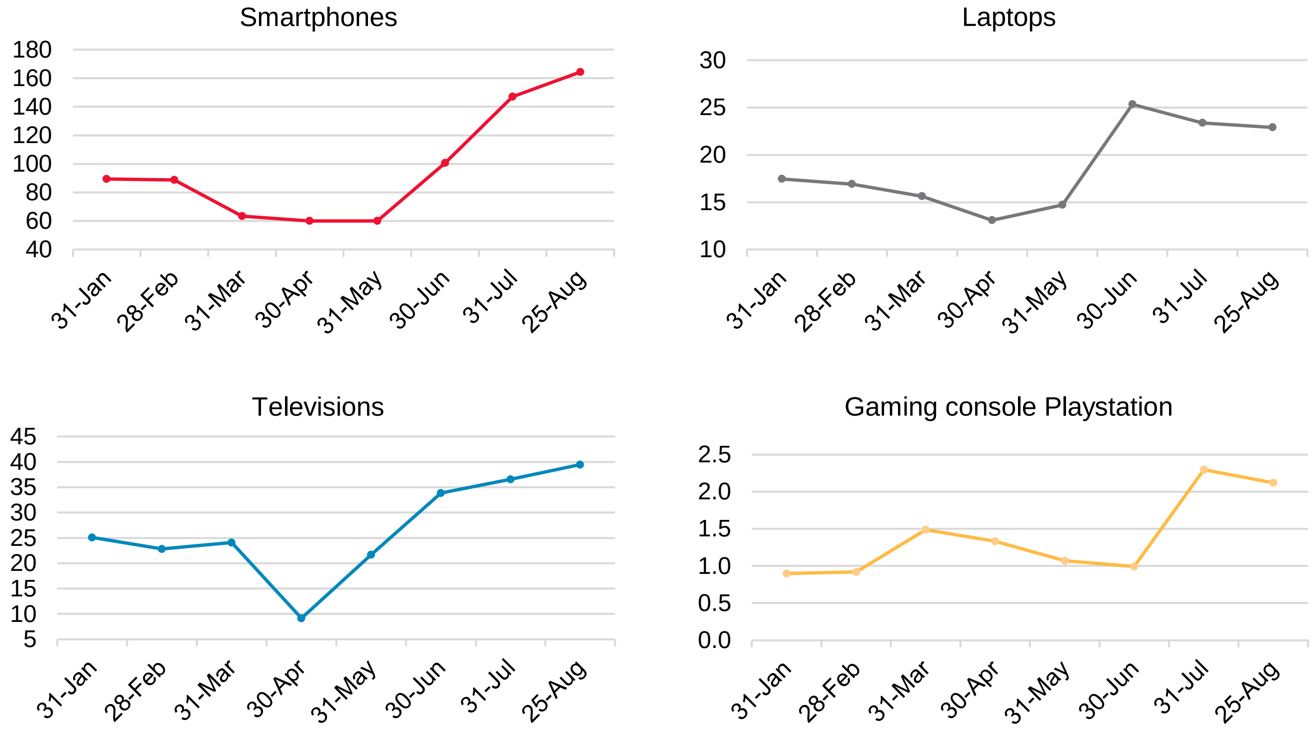
** Columns stand for the share of items (net of fruit and vegetables and regulated services, a total of 85 categories)). The numbers denote their weight in the weekly CPI estimate (net of fruit and vegetables, regulated services and the weight of the calculated addition to the estimate).*

Sources: Rosstat, R&F Department estimates.

The balance of medium-term risks still leans towards pro-inflationary factors. Money supply growth acceleration to the highest level since 2012 (19.3% YoY in July) as lending rebounds and the budget impulse strengthens, with supply-side constraints continuing, is a key factor of the price rise acceleration risk. The economy's restructuring and its adaptation to the new external conditions, including change in relative prices, requires time. The Bank of Russia takes this into account in conducting its monetary policy seeking to bring inflation back to the target. As a result, annual inflation will slow gradually, to 5-7% in 2023 and 4% in 2024.

[2] Net of fruit and vegetables and regulated services.

Figure 12. A total of balances of goods in the major marketplaces, pcs



Sources: Moneyplace analytical service, R&F Department estimates.

2. Economic activity

Business activity continues to vary across the economy and remains unsustainable due to high uncertainty. The simultaneous action of competing trends and factors may have different effects on individual businesses even within the same industry. Nevertheless, their combined action produced some business activity expansion in the Russian economy in July–August. Thus, economic downturn did not steepen.

It may well be this performance of the economy that have caused a wide divergence between negative assessment by enterprises and households of the current situation with demand, output, and income, on the one hand, and prevalent positive expectations for the future, on the other hand. These expectations in themselves help consumer and business confidence to rise. This is set to be reflected in consumers and businesses' behavior in the coming months, spurring demand.

At the same time, the supply of goods and services will likely contract, with the product mix shifting towards alternatives which were not represented or scarcely represented in the Russian market earlier. This process will be accompanied by the worsening of average quality characteristics of goods and services (consumer performance, a range of functions, durability, servicing support, etc.). Therefore, while the assortment of goods on sale will narrow, the overall contraction of output (in terms of pieces) will be less significant. As a result, output contraction will not be as deep as could be in case there were no alternative of a product mix change.

The import of intermediate and investment goods is recovering more slowly than consumer imports are. Further on, this will result in either extensive growth in domestic production of these goods (import substitution) or contraction in the output of goods whose production chains use these imports as inventories built up earlier are depleted. The second alternative is more likely on a short-term horizon. Some industries, however, have import substitution reserves available.

Earlier surveys of Russian industrial enterprises systematically showed an overall low level of competition, especially with imports, and the “local” nature of Russian businesses, their unpreparedness for expansion beyond their respective regions, let alone export markets. Moreover, an industry-specific analysis and surveys indicate that the swath of industry leaders which are, as a rule, engaged in foreign trade and implement long-term development strategies, is small. These structural specifics of the Russian economy have several important implications.

Firstly, operating in their niches, which do not overlap with imports, Russian producers can expand them. But this would only produce results provided that Russian customers and consumers would be willing to change their preferences and move into niches new to them.

Secondly, most industrial subsectors are in the short term incapable of a relatively massive import substitution in the literal sense of the word (analogues for the same products), or we would have seen competition with imports earlier. What counts is not only technologies but also the environment in which companies operate and strategies which they have developed, with the share of globally competitive industry leaders being small. Remarkably, a number of subindustries in manufacturing machinery and equipment, rubber and plastic products, as well as those engaged in the manufacture of wearing apparel, footwear, and chemical products represent an exception from this general rule. They compete with imports, which points to import substitution potential of these industries.

Thirdly, it is most likely that the part of imports which are not directly subject to sanctions but whose supplies face various financial and logistics constraints will to a great extent be replaced by imports from producers of other countries.

2.1. Structural transformation and monetary policy

The Russian economy has entered the period of structural transformation which will change not only the structure of the Russian economy but also the structure and geography of foreign trade, as well as the technological level and major macro proportions.[3] In this situation, a question arises of whether monetary policy can and should help structural transformation. This is feasible but only to the extent that this policy does not run counter to achieving its key goal of keeping inflation close to the target. In the opposite case, unanchoring of and a rise in inflation expectations along with persistent inflation acceleration would jeopardise structural transformation.

[3] Talking Trends. April 2022 (Subsection 2.1).

Monetary policy is in general neutral relative to potential GDP, i.e., it cannot have a sustainable effect on it. The use of monetary policy instruments is worthwhile when the economy grows below potential (loose monetary policy is required) or above potential (calls for tight monetary policy). Thereby the economy is maintained on a sustainable long-term growth path. This is a fundamental of the contemporary theoretical view on monetary policy.

At the same time, many studies find that potential economic growth slows under high inflation. Conversely, inflation targeting policy produces not only inflation deceleration but also stronger economic growth than alternative monetary policy regimes do. In other words, macroeconomic stabilisation and a better predictability of key macroeconomic parameters help long-term growth acceleration.

But would it be right to assume that in a shift from one equilibrium to another, from one economic structure to another, monetary policy would speed up transition, thereby ensuring the economy's faster move to a new long-term growth path? In theory, this is quite possible if inflation expectations are low and anchored. Then loose monetary policy bringing down the cost of money in the economy and stimulating borrowers and banks' risk appetite could speed up the implementation of investment projects enhancing production capacities in the economy's sectors which benefit from structural transformation. For example, import substituting enterprises could play this role if imports become virtually inaccessible. An inflation surge which loose monetary policy would then bring about would come to an end with a switch to neutral monetary policy if inflation expectations are anchored and there are no doubts about a central bank's ability and resolve to bring inflation back to the target. In the opposite case, i.e., if inflation expectations rise because they are not anchored, a switch to tight monetary policy would be required to bring inflation back to the target: should it fail to be done, high inflation would become persistent and eat up all of the additionally created economic growth potential. As a result, gains from the acceleration of transition to a new structure of the economy may fail to materialise.[4]

But should one fear tight monetary policy in the future if loose monetary policy produces tangible results here and now? Indeed, more projects would then be launched which are expected to secure sustainable returns in the future. An answer to this question largely depends on the specifics of a particular economy: institutional, infrastructure, financial, microeconomic, and industry-specific factors. Our analysis suggests that the combination of these factors in the Russian economy allows to expect a moderate response of production to monetary stimuli.

Firstly, despite a decline and partial anchoring thanks to inflation targeting policy, household and businesses' inflation expectations generally remain elevated and unanchored in Russia. This implies that after a possible period of loose monetary policy, bringing inflation down to the target would require a shift to tight monetary policy. In a situation of elevated inflation expectations, this period may be protracted, which would be accompanied by a loss of potential GDP.

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[4] Economists often operate with the concept of sacrifice ratio for these purposes – the loss of GDP potential per one percentage point of inflation slowdown towards the target under tight (out of necessity) monetary policy.

Secondly, the provision by banks of long-term loans for fixed investment requires a solid liabilities base, preferably time deposits, so that significant funding risks could be avoided. Currently, after a series of the key rate cuts and, accordingly, deposit rate decreases, a total of time deposits has stopped expanding and has stabilised. Should interest rates on deposits decline further, an outflow of deposits into shorter financial instruments and current accounts may emerge. This would increase funding risks for banks and even diminish their willingness to provide long-term loans.

Thirdly, market rates on long-term loans to a great extent depend on banks' transfer curve and returns desired by investors rather than the key rate as such. Returns are linked to the yields of OFZs of relevant maturities. These showed a weak response to the key rate cut in July. Should there be a shift to loose monetary policy, rates on long-term loans will remain all but unchanged (and may even rise). This means that this policy would to a greater extent stimulate consumer activity rather than investment. Therefore, its effect on the economy's potential would be minor.

Fourthly, structural transformation implies the expansion of production facilities in industry-specific niches which were previously occupied by imports or foreign companies localised in Russia. These niches are now being vacated. In the absence of competition, the recoupment of production under these projects raises no doubts: if there are no analogues the producer can easily cover the costs via the price. Therefore, the cost of servicing loans taken to finance investment is not a critical factor in making a decision to start production.

Fifthly, only a fraction of Russian companies in individual industries show high productivity and implement proactive strategies of long-term growth. The rest of companies operating in low competition environment are content with their current market share. Therefore, growth potential as part of structural transformation is now limited to a small share of companies. A significant macroeconomic effect of structural transformation is hardly possible without sharply increasing the number and share of highly productive companies.

Under these circumstances, one can claim that the use of monetary policy to speed up the Russian economy's structural transformation beyond inflation targeting may result in a situation where the costs of such policy to economic growth would be high and benefits insignificant. But, as previously, a decision to conduct loose or tight monetary policy should depend on whether inflation deviates downwards or upwards from the target on the forecasting horizon, adjusted for the risks factored in and the quality of forecasting models.

Global inflation acceleration may be persistent

During the acute phase of the pandemic, the majority of advanced and developing countries took unprecedented steps to support their economies, including monetary policy easing and asset purchase programmes, along with fiscal support. As a result, demand stimulation, with part of deliveries disruption problems remaining unresolved, brought about a significant price rise acceleration as early as 2021. Further impulse to inflation acceleration in 2022 came from the worsening of the global geopolitical situation, which pushed prices of metals, food, and energy sky-high.

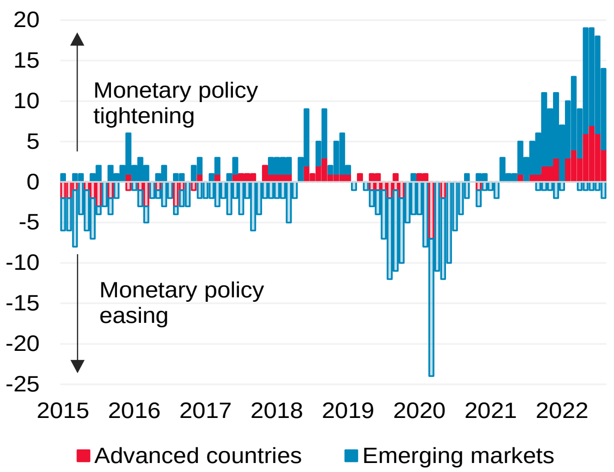
As a result, inflation hit many-year highs in the majority of advanced countries. Moreover, the elevated rate of price rises is becoming increasingly persistent in many countries. The mounting of inflationary pressure has spread to the services sector and may be further aggravated by rapid nominal wage growth in countries with strong labour market conditions. These persistent "second-order effects" carry risks of high inflation continuing for a long time as a result of weakened anchoring of inflation expectations. These effects have indeed become evident, in the U.S., among other countries.

Central banks of advanced countries underestimated these risks in 2021, regarding higher inflation as transient. As a result, these countries' monetary policy has to "catch up" with the inflationary trend: central banks of the major advanced countries have begun simultaneous and significant interest rate increases and the winding down of asset purchase programmes[5] (Figure13). That said, delays in and inadequate scale of monetary policy tightening may eventually perpetuate high inflation. In this event, the costs of bringing it back to the targets would be very high, since central banks would have to tighten policy more aggressively in order to cool the economy and resume anchoring inflation expectations.

Global inflation acceleration will have an effect on price movements in Russia, via, above all, import price rises. However, a sharp change in external conditions in 2022 has resulted in an import squeeze, which somewhat diminishes the effect of passing the global inflation rise through to domestic price movements. Domestic prices of some Russian exports have also become unfastened from world prices in the face of external restrictions associated with sanctions.

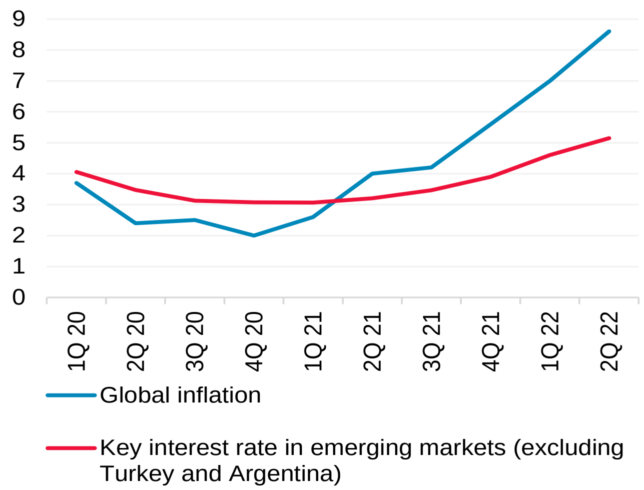
That said, the manner in which the external channel of the transmission mechanism operates has changed in the current situation. Capital controls imposed on nonresidents from unfriendly countries have significantly diminished Russian financial markets' sensitivity to global market conditions and monetary policy decisions of the major global central banks. Under these circumstances, in taking its monetary policy decisions, the Bank of Russia is looking to the global interest rates and financial market situation less than many other central banks of emerging markets. (Figure 14).

Figure 13. The number of central banks and their interest rate decisions, pcs



Source: IMF.

Figure 14. Global inflation and emerging markets' interest rates, %



Sources: BIS, IMF, R&F Department estimates.

[5] The first central bank of advanced countries to hike the interest rate, in the middle of 2021, was the Bank of England.

2.2. Domestic demand spurs economic activity

- Real-time statistics suggests that business activity contraction in Q2 was in general less severe[6] (Figure 16) than expected at the end of Q1 – the beginning of Q2, immediately after the change in external conditions. Moreover, business activity somewhat rebounded in July–August[7] (Figure 18). The recovery process, however, varies across the economy, with industries' reacting to structural transformation and external restrictions quite heterogeneously.
- Indeed, while the Bank of Russia's system posted a rise in incoming payments in July[8] (Figure 15), industries meeting external demand[9] and the manufacturing sector's segments critically dependent on imported components are showing negative performance.
- According to July's data, industrial output continued to expand for third month in a row (Figure 19), but as results significantly vary across individual industries, the sustainability of the current trend raises doubts. Growth/recovery is observed in industries which earlier encountered the shortage of imported components and raw materials and were able to at least partially address it, starting to manufacture less sophisticated products (for example, cars). Also, production is growing in sectors which, after various bans placed on their deliveries to traditional export markets, succeeded in partially redirecting their products to other countries. Nevertheless, output expansion in many major industries is contained by gradual depletion of imported raw materials and supplies and these industries' inability to promptly redirect their products from external markets now closed to them to other markets.[10]
- Domestic demand and improving expectations remain the drivers of business activity. The stable labour market situation and lending expansion at the start of Q3 kept supported the resiliency of household consumption (Figure 20). Going forward, however, the situation may deteriorate if tension rises in the labour market. Structural transformation will, on the one hand, result in layoffs at businesses that have until now been sticking to the 'wait-and-see approach', and on the other, lead to a rise in labour demand by industries experiencing an increase in demand for their products (Figure 25, Figure 26). Addressing these structural imbalances of demand and supply will require time, during which the unemployment level may go up from the current record low levels. Together with an increase in the number of migrant workers, this will likely exert downward pressure on real wages in a number of industries (Figure 23).

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[6] Based on R&F Department estimates, Russia's GDP contracted 5.6% QoQ SA.

[7] Electricity consumption adjusted for the average temperature has steadily exceeded the previous year's number by 2% since the middle of July.

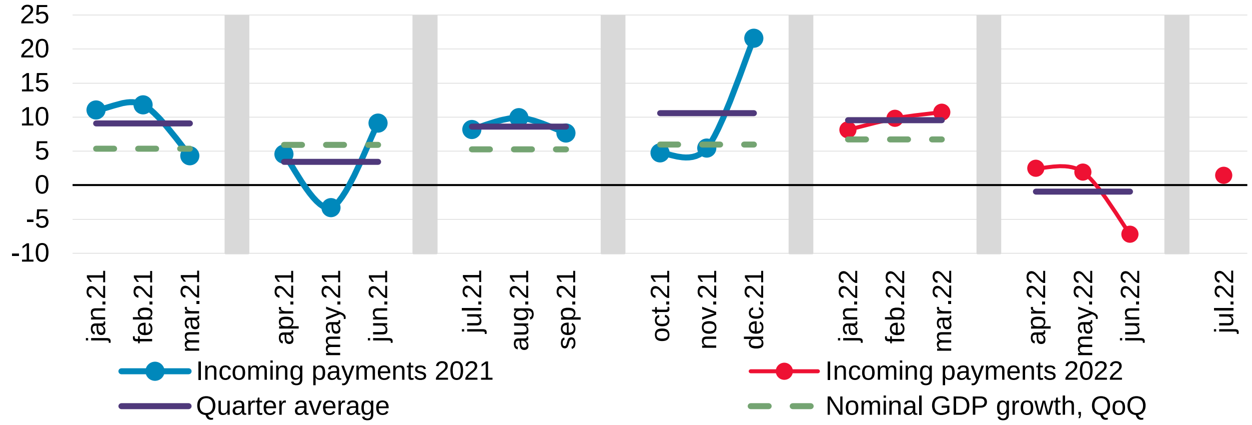
[8] 1.5% relative to the Q2 2022 average.

[9] Above all, the manufacture of basic metals, coal extraction, and manufacture of chemicals and chemical products. The indicators of crude oil and natural gas extraction were distorted due the massive transfer of budget funds under the reverse excise tax (damper) mechanism.

[10] The results of the Bank of Russia's monitoring of enterprises point to continuing disruptions in deliveries of imported equipment, spare parts, and components. That said, even an increase in inventories does not always indicate the absence of barriers to production. For example, if inventories expansion does not cover all items and has to be undertaken due to the shortage of some critically important items of raw materials and components, this growth will evidence the mounting of problems, including financial ones.

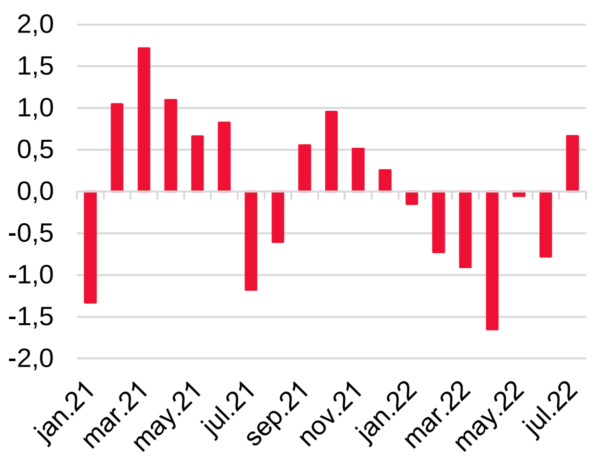
- At the same time, translation of Bank of Russia decisions into the economy and an improvement in Q3 of household perceptions regarding not only future but also current income (Figure 21) will likely bring down the savings ratio. Coupled with the ongoing recovery of retail lending, this will ramp up consumption. As parallel imports expand and new channels of Russian products sales are established the pace of output decline should slow in the second half of 2022. Successful build-up of new sales chains and companies' preparedness to expand production is evidenced by a rise in business confidence[11] testified by a variety of surveys and the accelerating pace of corporate lending growth.

Figure 15. Incoming payments growth[12] relative to the previous quarter's average weighted by the share of industries in gross value added, seasonally adjusted, %



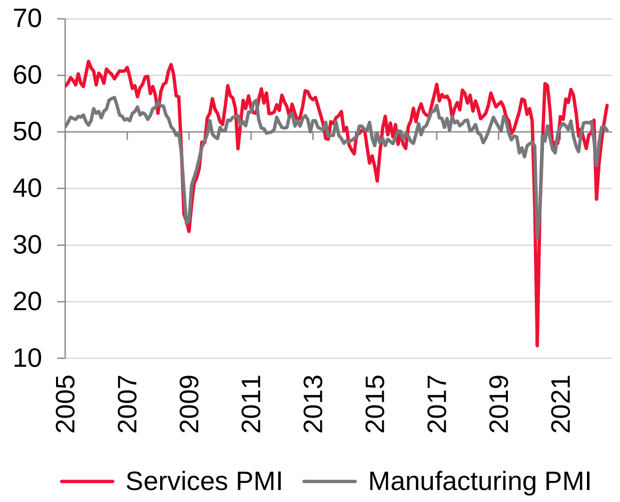
Sources: Bank of Russia, Monitoring individual industries' financial flows.

Figure 16. Output by core economic activity type, % MoM SA



Sources: Rosstat, R&F Department estimates.

Figure 17. Russia's Manufacturing and Services PMI, points

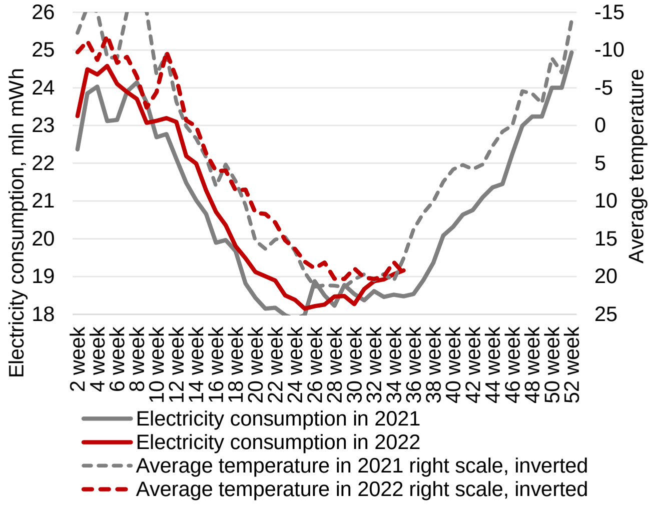


Source: S&P Global.

[11] Business activity expectations on a year's horizon in *manufacturing* reached the highest level since March 2022, in *services* – since October 2021.

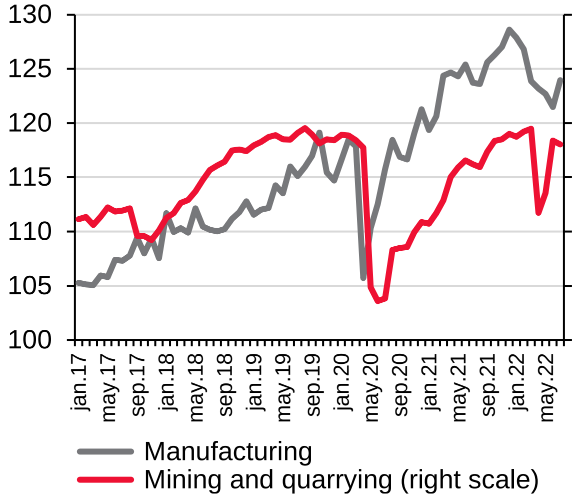
[12] The pace of growth means a percentage change in the required value: $g = \frac{(x_1 - x_0)}{x_0} * 100$.

Figure 18. Electricity consumption and average temperature in 2022 and 2021, mln mW*h (left scale), degrees (right scale)



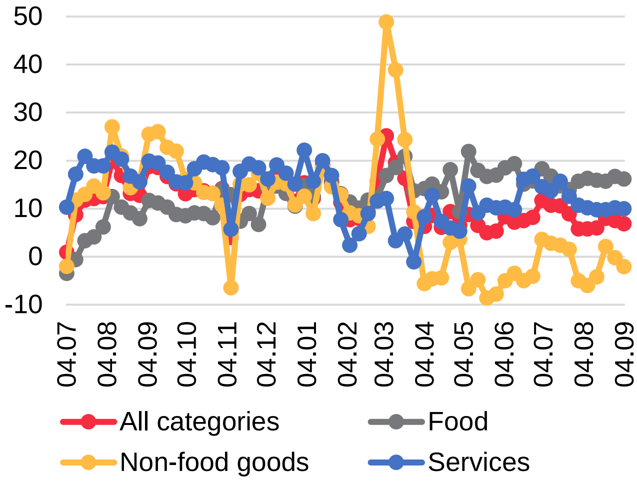
Sources: System operator of Unified Energy System, R&F Department estimates.

Figure 19. Mining and quarrying and manufacturing indices (2014 = 100)



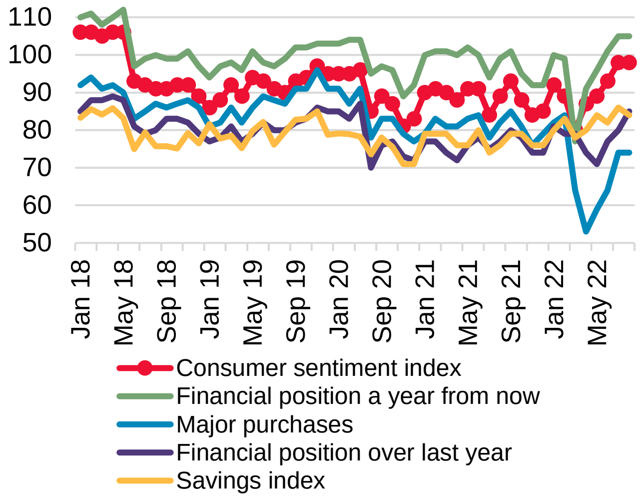
Sources: Rosstat, R&F Department estimates.

Figure 20. Nominal spending growth, % YoY



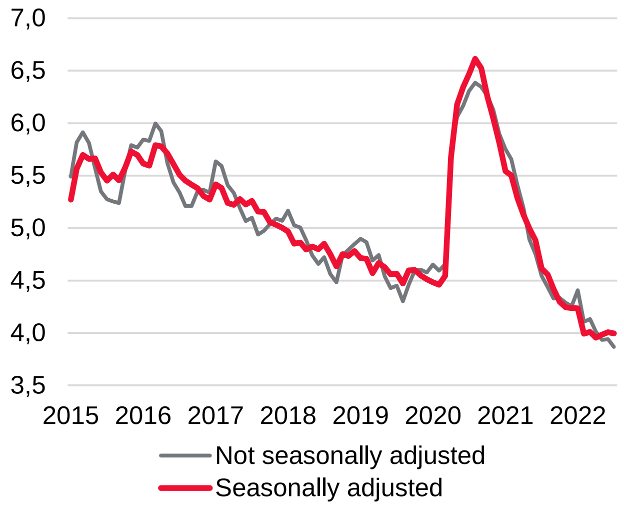
Source: SberIndex, R&F Department estimates.

Figure 21. Consumer and Financial sentiment index, points



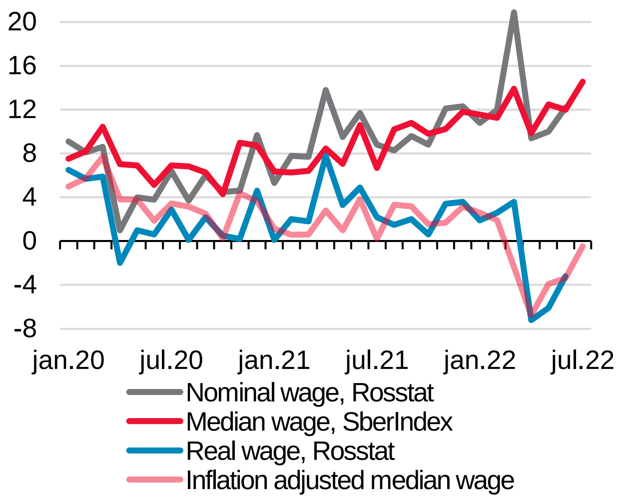
Source: InFOM.

Figure 22. Unemployment rate, %



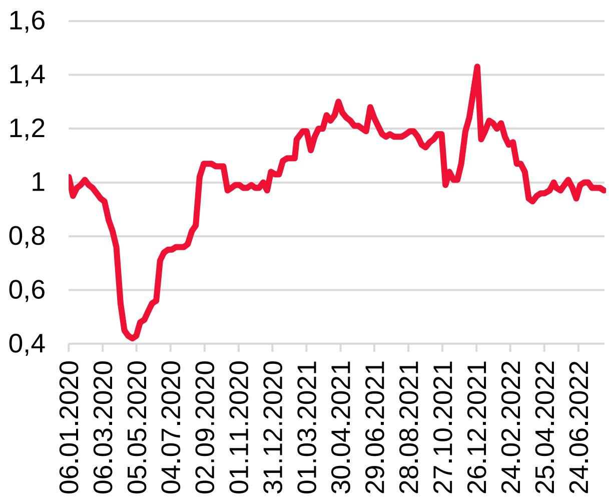
Sources: Rosstat, R&F Department estimates.

Figure 23. Nominal and real wage growth, % YoY



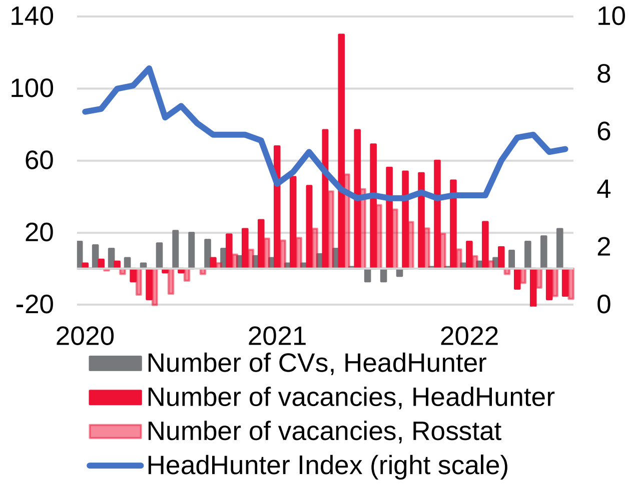
Sources: SberIndex, R&F Department estimates.

Figure 24. SuperJob Index[13]



Source: SuperJob.

Figure 25. CVs, vacancies (% YoY) and HeadHunter[14] index (points)



Sources: Rosstat, HeadHunter, R&F Department estimates.

2.3. Credit activity recovering

- The easing of the Bank of Russia's monetary policy and an uncertainty decline as the Russia's economy adapts to the changed external conditions provide incentives to credit activity expansion.
- Retail lending picked up in July, with ruble loan portfolio growth accelerating to 0.9% MoM SA from 0.1% MoM SA in June. The fast recovery of the retail lending segment (Figure 27) is driven by the cuts of interest rates on retail loans and some consumer sentiment

13 The SuperJob index reflects employers recruiting activity relative to the average 2017–2019 reading.

14 Shows the ratio of CVs to vacancies. The higher the reading the lower competition for employees.

improvement. Interest rates on mortgage loans came down the most tangibly thanks to subsidised loan programmes and joint efforts by developers and banks[15] (Figure 30). The mortgage lending segment saw a continued rise in ruble loan issuance in both new and secondary housing markets. As a result, seasonally adjusted growth in mortgage loan debt, based on our estimate, accelerated to 1.4% MoM SA in July from 1.0% MoM SA.[16]

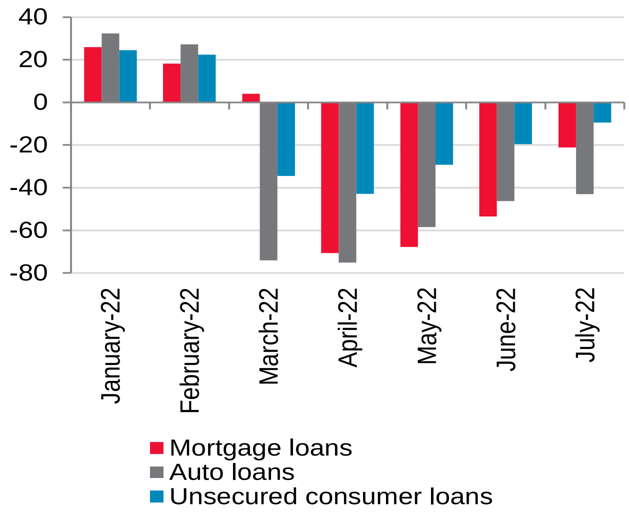
- The unsecured consumer loan segment posted minor portfolio expansion, its pace of growth edging up to 0.2% MoM SA from 0.1% MoM SA in June. The auto loan portfolio contraction slowed to 0.3% MoM SA from 0.7% MoM SA. New loan issuance in the unsecured consumer and auto loan segments is gradually recovering after a sharp dive at the start of Q2 but remains below the July 2021 level (Figure 26).
- Growth in ruble loans to nonfinancial organisations continued at double digits in annualised terms, slightly slowing compared with June, though, to 1.1.% MoM SA from 1.3% MoM SA[17] (Figure 28). The portfolio expansion is buttressed by interest rates cuts and some improvement in business expectations. According to bank surveys, the share of loans provided under subsidised programmes in total loan issuance is gradually declining, signalling that loan demand from nonfinancial organisations is rebounding, due to, among other things, possible replacement of foreign currency lending by ruble loans.
- That said, the term structure of the loan portfolio suggests that loans inreasingly tend to be taken to finance ongoing operations rather than investment. This indirectly supports the conclusion that investment demand changes only moderately, contained by the continuing uncertainty, including due to problems with imported equipment deliveries. (Figure 29).
- Loans to financial organisations expanded 3.5% MoM SA after a 1.2% MoM SA slide in June, providing indirect evidence that other financial market segments are starting to recover (Figure 28). Indeed, the leasing market has partially recovered from its previous decline thanks to new government contracts and a shift to equipment from friendly countries. Interest rate cuts have also given impetus to this market segment's growth.
- Growth in household ruble deposits slowed to 1.2% MoM SA from 1.4% MoM SA amid deposit rate cuts and some decline in household propensity to save. That said, compared with the spring, households showed a rising interest in long-term deposits, with demand for short-term deposits declining and current account balances growing. Amid interest rate cuts and expectations for this trend to continue, depositors regard long-term deposits as a way of fixing the rates still offered. At the same time, the narrowing of the gap between rates on short-term deposits and savings accounts causes an outflow of funds into savings accounts.
- Contraction in household foreign currency deposits accelerated to 3.5% MoM SA from 0.8% MoM SA. The deposit dedollarisation trend will likely continue as banks are

[15] Interest rate cuts as part of promotion events arranged by developers and banks is a hidden offer of a discount, with offer prices remaining intact. The developer assumes part of housing buyers' debt servicing expenses. The price of housing, however, is often higher as part of such promotion events compared with the regular price. In this case debt servicing costs are actually borne by the buyer, taking the form of payments of the principal.
[16] Adjusted for written off mortgage loans.
[17] Contraction in the portfolio of foreign currency loans to nonfinancial organisations accelerated to 2.4% MoM SA from a fall of 1.4% MoM SA.

deteriorating conditions offered for foreign currency accounts and deposits. Meanwhile, foreign currency balances on *broker* accounts showed growth, which may have also come to a halt in the last months of the summer because the terms and conditions of holding unfriendly countries' currencies have worsened. Given that households have become the largest net foreign currency buyers at the exchange, this may indicate expansion in households' foreign currency holdings.

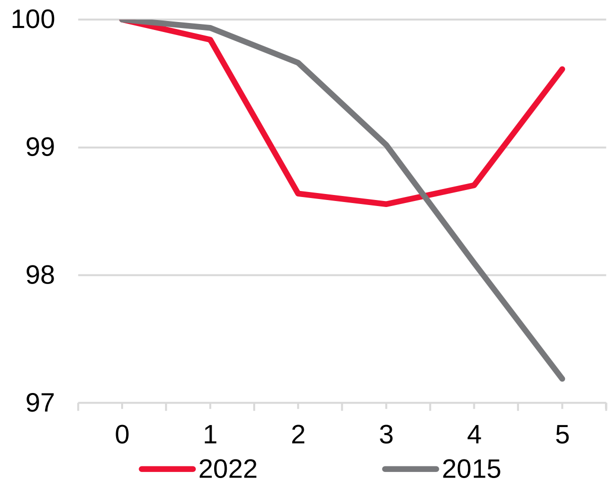
- Credit activity recovery is a key factor of accelerated money supply growth (to 19.3% YoY and 2.4% MoM SA in July, Figure 31), one of the leading indicators of inflation. Coupled with budget impulse strengthening amid continuing supply-side constraints, this creates risks of inflation acceleration above the Bank of Russia's target.

Figure 26. The dynamics of new loans issued, % YoY



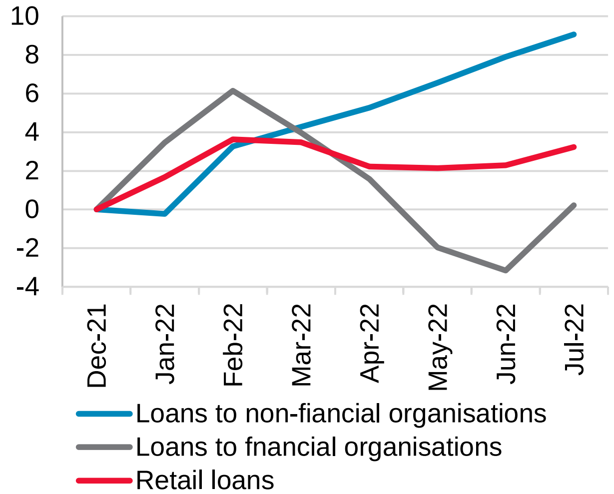
Sources: Bank of Russia, R&F Department estimates

Figure 27. Growth in household ruble loan debt in 2022 and 2015, portfolio change accumulated from the time of decline (month 0), %



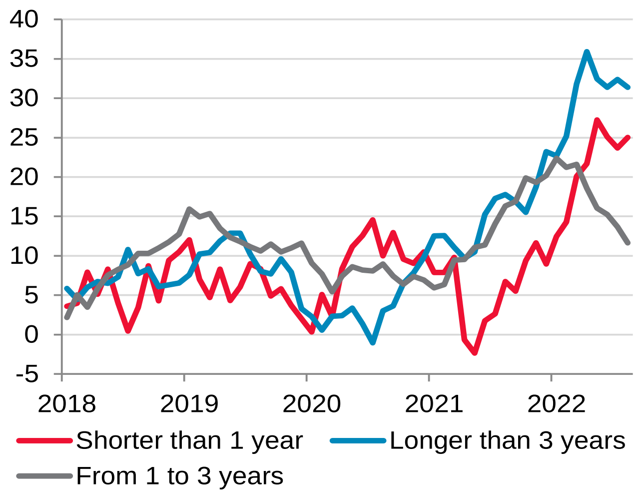
Sources: Bank of Russia, R&F Department estimates.

Figure 28. Ruble lending growth accumulated from the start of the year, % SA



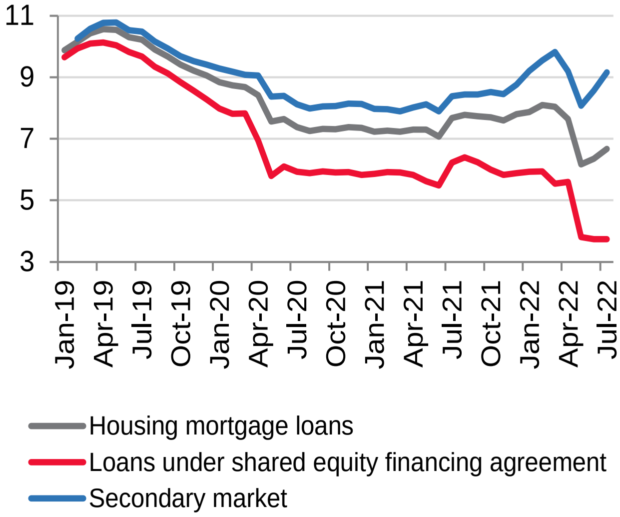
Sources: Bank of Russia, R&F Department estimates

Figure 29. Growth in loans to nonfinancial organisations and sole proprietorships by loan maturity, % YoY



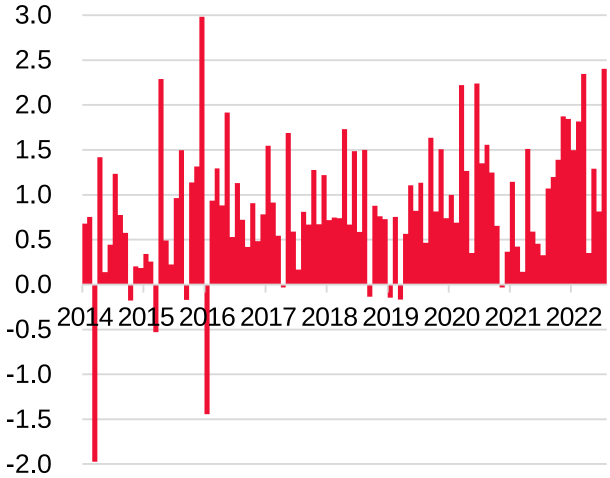
Sources: Bank of Russia, R&F Department estimates.

Figure 30. Mortgage loan rates, pp



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

Figure 31. Money supply M2, % MoM SA



Sources: Bank of Russia, R&F Department estimate.

In focus. Estimation of persistent inflationary pressure in current situation

- The overall price decline and significant slowdown of annual inflation are largely driven by one-off and temporary factors. Meanwhile, sharp price changes and a massive effect of these factors in 2022 make it difficult to estimate persistent inflationary pressure,[18] whereas this is the most important factor in taking monetary policy decisions.
- Various core inflation indicators depend on one-off and temporary factors less than on overall price movements but are not fully protected from their influence. In this situation, it is especially important to make use of indirect estimates based on the moves of other macroeconomic variables: monetary aggregates, the measures of the labour market condition, etc.
- An array of indicators suggests that persistent inflationary pressure is now on the level of the Bank of Russia's target or above it. That said, the medium-term risks lean towards pro-inflationary ones.

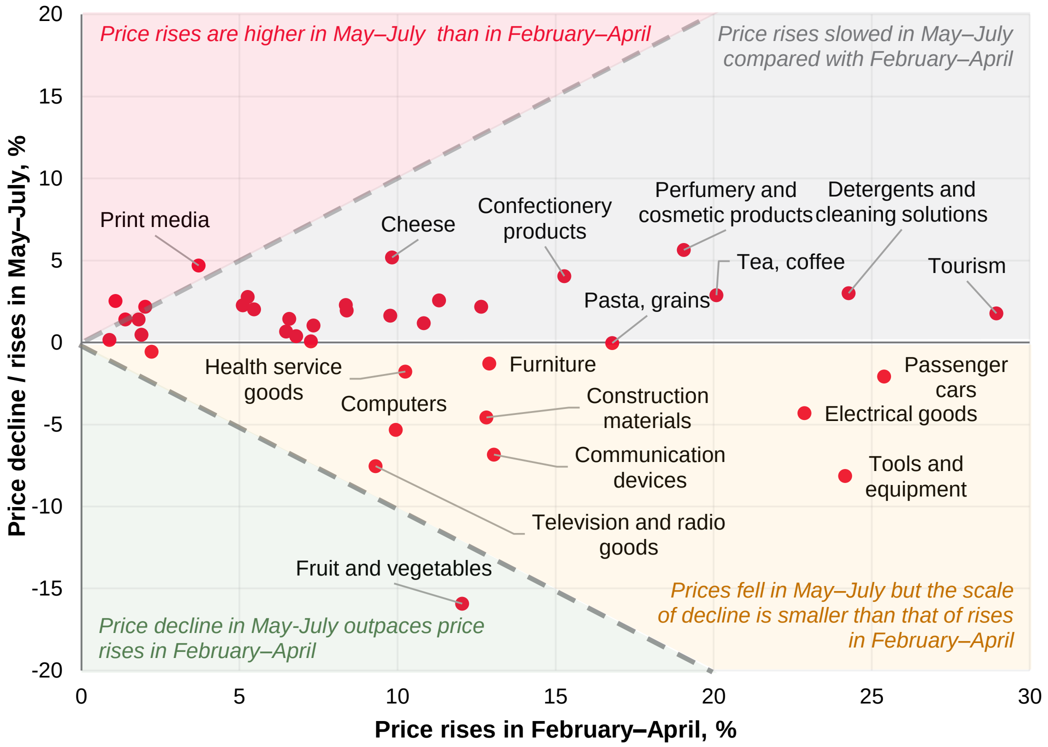
Consumer price movements have remained below the path corresponding to an inflation rate of 4% in recent months. This is owed to, above all, the impact of a number of temporary and one-off factors. The key contribution comes from the adjustment of prices for goods which soared in March–April on sharp ruble depreciation and panic buying of consumer goods. The subsequent ruble strengthening became one of the drivers of downward price reversal in the middle of Q2.

That said, the majority of goods and services only saw a slowdown of price rises in May–July after their sharp acceleration in February–April, while the decline in the overall price level was driven by a relatively small group of goods and services. It is noteworthy that the price fall in May–July was smaller in scale than their surge in March–April (Figure 32). One exception was a drop in fruit and vegetable prices, breaking the usual seasonal pattern.

One of the traditional temporary factors affecting price movements is the pass-through of exchange rate fluctuations. This year, they were very massive and swift in both directions. This makes it generally irrelevant to use econometric estimates obtained in quieter periods from the perspective of exchange rate volatility: the pass-through to prices amid strong exchange rate moves occurs more rapidly than usual and may rise in scale. We, therefore, computed changes in the modified core CPI excluding volatile components and making adjustments for the impact of the exchange rate, with the faster pass-through of the exchange rate to prices factored in (Figure 33). The indicator thus obtained has declined substantially in recent months but remains above the level corresponding to an annualised inflation rate of 4%. If the ruble exchange rate stabilises close to the current level, the disinflationary effect of the pass-through will be abating and may peter out by the end of the year. Then actual price moves will be determined by seasonally adjusted persistent inflationary pressure, which implies a significant strengthening of price movements.

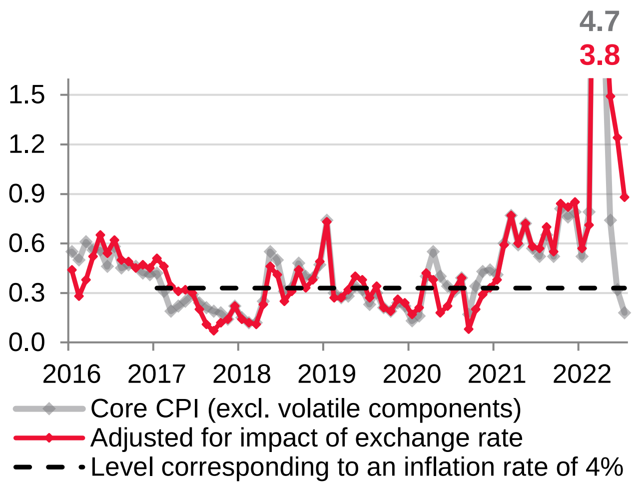
[18] Underlying inflation.

Figure 32. Price movements in categories included in the CPI, % SA



Sources: Rosstat, R&F Department estimates.

Figure 33. CPI excluding volatile components, % MoM SAAR



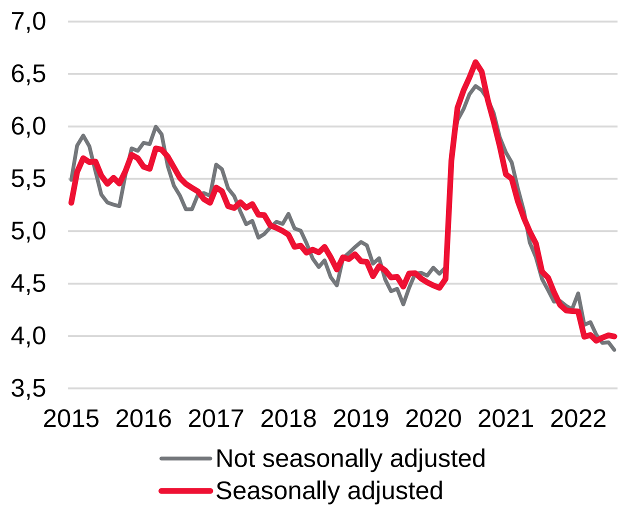
Sources: Rosstat, R&F Department estimates.

At the same time, significant price fluctuations driven by one-off and temporary factors make it difficult to estimate persistent inflationary pressure which the central bank has to respond to in taking monetary policy decisions. Indicators which we use (modified core inflation indicators, trend inflation estimates, etc.) are much less sensitive to the impact of one-off factors than the overall level price is but are not fully protected from it (Figure 9).

This situation requires looking at a wider range of indicators, including not only price variables but also other macroeconomic indicators reflecting changes in and the balance of demand and supply. Our analysis suggests that inflationary pressure adjusted for the impact of one-off and temporary factors is currently at or above the level of the Bank of Russia's inflation target. This, is in particular, evidenced by trend inflation indicators, the pace of price rises in unregulated consumer services, and the fact that half of the items making up the consumer basket rise in prices at a rate above 4% in annualised terms. Meanwhile, medium-term risks lean towards pro-inflationary factors:

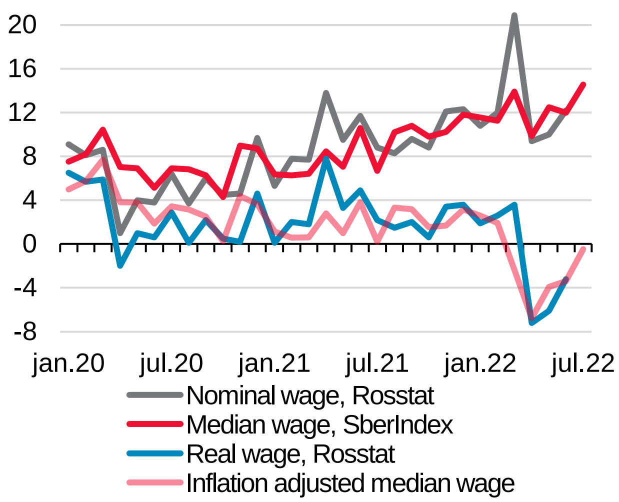
1) Consumer demand is gradually recovering (see Section 2.2 "Domestic demand spurs economic activity"). This is partly helped by a drop in the savings ratio as monetary policy eases. But the key support comes from the labour market. The unemployment rate is at an all-time low of 4.0% SA, indicating companies' willingness to retain personnel even amid the worsening external conditions. According to HeadHunter poll, 63% of companies have, in the face of the sanctions imposed on Russia, retained and 14% increased their personnel headcount. Moreover, the middle – end of the summer saw stepped up recruiting activity, which gives reason to believe that the economy is close to a situation of full employment. Against this background, we see gradual acceleration of nominal wages. Coupled with annual inflation deceleration, this process has made a real wage decline come to a halt. According to economic theory, in an environment of full employment, with no temporary factors and inflation expectations anchored, inflationary pressure should be close to the central bank's target. That said, August saw a rise in household inflation expectations, which in the current situation may, via various channels, ramp up inflationary pressure.

Figure 34. Unemployment rate, %



Sources: Rosstat, R&F Department estimates.

Figure 35. Nominal and real wage growth, % YoY

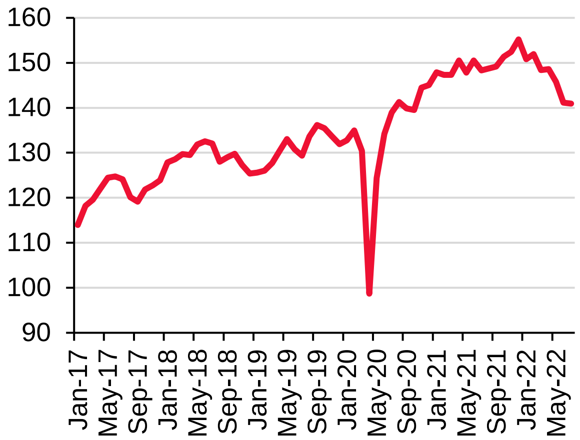


Sources: Rosstat, SberIndex.

2) Consumer demand recovery is occurring amid supply-side constraints, which may give a further boost to inflationary pressure. On the one hand, various indirect indicators suggest that the import of consumer goods has generally stabilised or is expanding, thanks to

among other things, the launch of the parallel import mechanism. On the other hand, domestic production of some categories of goods is so far contracting. This trend is, in particular, seen in the segment of durable consumer goods (Figure 36). The passenger car market stands apart: supply has started to recover thanks to the launch of production at part of manufacturing facilities but output is still far below the pre-crisis level.

Figure 36. Production of durable consumer goods*, January 2016=100%, seasonally adjusted

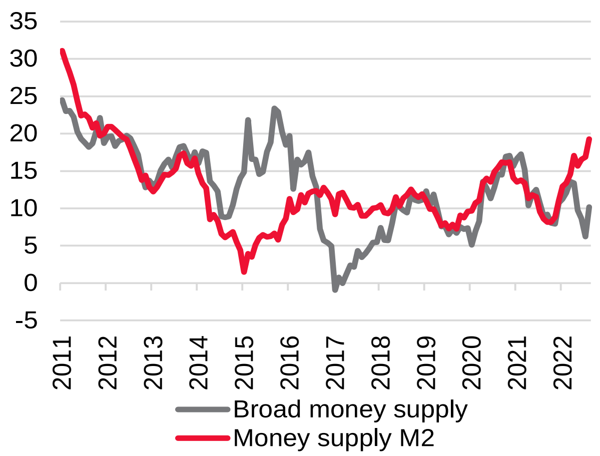


*Textiles, wearing apparel, leather products, printing, household appliances, furniture, other fabricated products.

Sources: Rosstat, R&F Department estimates.

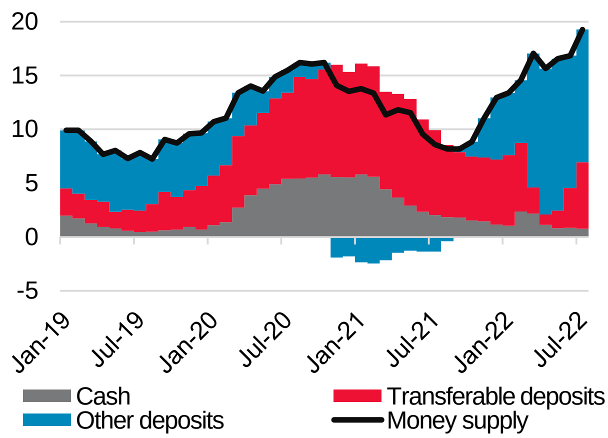
3) Monetary aggregates' performance looks pro-inflationary. July saw growth in ruble money supply M2 accelerate to almost 20%, the highest level since 2012, against a backdrop of credit activity rebounding, financing of the budget deficit financed with budget revenue balances, and investment of National Wealth Fund revenue. What is more, as deposit rates go down, the liquid part of money supply, transferable deposits, resumed its growth. With the economy expected to contract in 2022, double-digit expansion in ruble monetary aggregates signals risks of expansion in the monetary component of inflation. i.e., risks of persistent inflationary pressure mounting.

Figure 37. Monetary aggregate growth, % y-y



Source: Bank of Russia.

Figure 38. M2 growth structure, % YOY



Source: Bank of Russia.