Bank of Russia

TALKING TRENDS
Economy and markets

Research and Forecasting Department Bulletin

December 2022

CONTENTS

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

Monthly summary

- According to flash estimates, between mid-October and November, the Russian economy was able to overcome the short-term decline caused by partial mobilisation. The impact of the disinflationary effect on the consumer market was short-lived. However, over a one- to two-year horizon, workforce constraints are on course to hold back potential GDP growth, which, other things being equal, is to have a pro-inflation effect on the economy.
  - Economic activity has overall been steady following a strong decline in the second quarter. At the same time, data are invariably vastly mixed across sectors, in a sign of the ongoing structural shifts. Geopolitical and economic uncertainty constrains private investment and raises the share of government-supported projects. Overall, fixed capital investment is expected to slow down in 2023.
  - The lower growth rates of consumer prices, seasonally adjusted, conceal the effect of several diverging factors. On the one hand, prices for many goods and services including a certain foreign currency component are still on a downward trajectory. The high yield of many crops and the growth in production in livestock are both making a disinflationary impact. On the other hand, prices in foreign currency terms for many imported consumer products, especially of European origin, are up significantly. This comes as a result of sanctions, as well as of higher costs and more complex logistics, triggering a reduction in imports. Persistently high growth of prices in commercial services is in evidence, where prices last spring were unperturbed by the temporary sharp weakening of the ruble. As one-off disinflationary factors fade out, combined with the intensification of pro-inflation factors related to the labour market, a changing structure of the economy, and growing consumer confidence, fluctuations in inflation will emerge. The monetary policy stance aims to return inflation to 4% in 2024.
  - A slight decline was seen in yields on Russian ruble bonds in the context of abating investor concerns about the potential large-scale placements of fixed-yield OFZs by the Ministry of Finance.

In focus: Financing budget deficit through OFZs

- The transition to a fiscal rule in its updated version, according to a Ministry of Finance plan, involves a structurally higher level of federal budget expenditures relative to the previous version. OFZ placements will come as the main source to finance a budget deficit.
- The Ministry of Finance, back to the domestic debt market after a half-year break, ramped up placements in November mainly through floating-coupon securities (OFZ-PK). Their core buyers were banks that use OFZ-PK securities to improve liquidity indicators, as well as to reduce the sensitivity of their income to money market rates (interest risk).

- The banks boast massive technical capabilities to purchase OFZ-PK securities. Yet, the amount of financing available through this channel is limited. A substantial budget deficit adds to demand in the economy, thereby increasing pro-inflation risks. This factor should be addressed in monetary policy.

1. Inflation

The reduced pace of consumer price inflation continued in November despite a faster than seasonally normal price rises in some fruit and vegetable items. As a result, annual inflation slowed to 12.1%.

This was helped by a disinflationary post-mobilisation effect of a temporary drop in demand, which has all but dissipated by now. At the same time, one can expect inflationary pressure to mount, given the positive fiscal and credit impulses. As other countries' experience suggests, this effect can be offset through maintaining a high savings ratio. People now tend to save more, even though nominal and real wages are showing signs of growth acceleration. That said, the high savings ratio currently reflects the preference of liquidity, the need to build up a financial cushion (including in the form of cash), rather than a stronger attractiveness of savings in the form of bank deposits or other financial instruments (as was the case during the period of interest rates hikes in the spring). Therefore, the current high savings ratio is unsustainable and may quickly decline.

1.1. Inflationary background remains mild in October–November

- October consumer price growth continues but at a slower pace than in September. Inflationary pressure weakened, affected by a number temporary factors, including the impact of a record-high agricultural harvest and consumer activity decline at the start of the month amid rising uncertainty.
- The disinflationary effect of the weakening consumer demand had a stronger impact on price movements in non-food goods than in the food segment (including public food services).
- Weekly consumer price rises remained tempered in November. A number of key food categories saw a continued price decline throughout the month. That said, we view the decline in the prices of some non-food goods at the start of the month as temporary, associated mainly with a long sale period.
- Pro-inflationary risks prevail over a medium-term horizon. This is due to both continuing supply-side risks amid a possible return of the savings ratio to its normal levels after its significant rise in Q2–Q3 and the continuation of the fast wage growth outpacing a productivity increase.

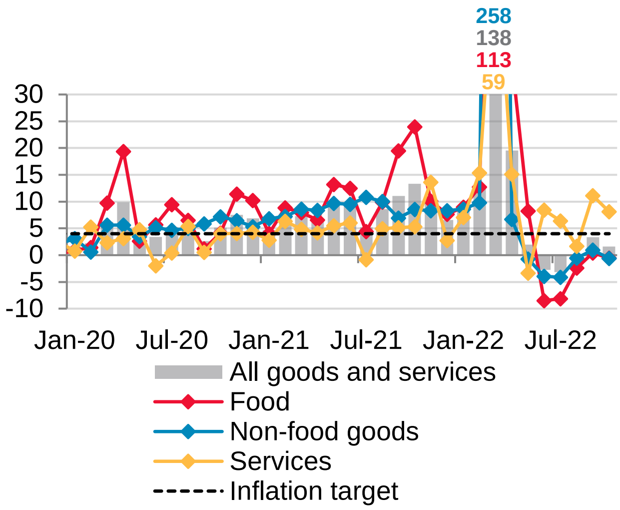
The seasonally adjusted pace of consumer price growth slowed to 1.6% MoM SAAR in October from 3.4% MoM SAAR in September (Table 1, Figure 2). The prices of goods resumed their slide, with consumer services price growth slowing but remaining fast. The month-on-month price rise slowdown accelerated an annual inflation decline to 12.6% from 13.7% in September (Figure 3).

Table 1. Inflation and its components

	Oct. 2020	Oct. 2021	Aug. 2022	Sept. 2022	Oct. 2022
% YoY					
All goods and services	**4.0**	**8.1**	**14.3**	**13.7**	**12.6**
Core inflation	**3.6**	**8.0**	**17.7**	**17.1**	**16.2**
Food	4.8	10.9	15.8	14.2	12.1
Non-food goods	4.2	8.2	15.5	14.9	14.1
Services	2.6	4.4	10.5	11.0	11.3
% MoM SAAR					
All goods and services	**5.1**	**13.3**	**-0.7**	**3.4**	**1.6**
Core inflation	**5.0**	**10.2**	**0.8**	**2.3**	**0.2**
Food	4.1	23.9	-2.4	0.4	-0.6
– net of fruit and vegetables	**7.5**	**15.8**	**-0.2**	**-0.2**	**-2.2**
Non-food goods	7.2	8.5	-0.6	0.9	-0.6
– net of refined petroleum products and tobacco	**8.1**	**9.0**	**-1.7**	**0.2**	**-1.4**
Services	4.0	5.3	1.7	11.1	8.1
– Net of housing and communal services	**3.9**	**6.1**	**0.1**	**15.1**	**10.5**

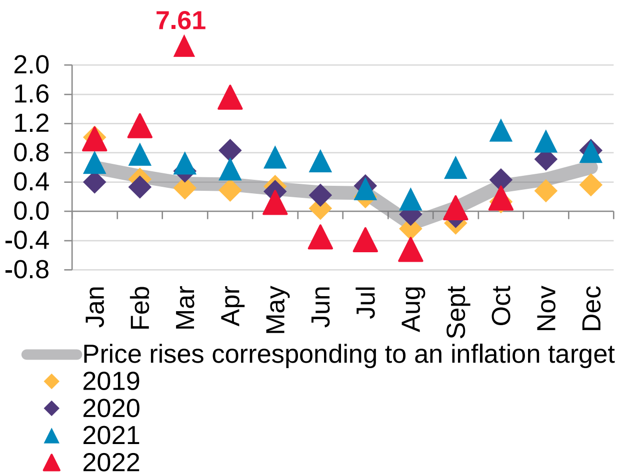
Sources: Rosstat, R&F Department estimates.

Figure 1. Seasonally adjusted price growth, % MoM SAAR



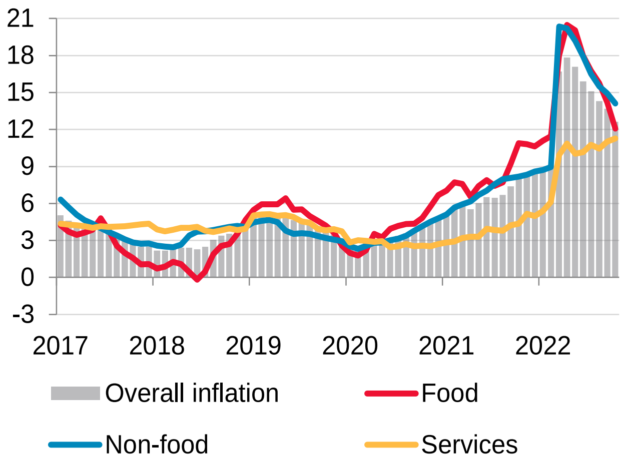
Sources: Rosstat, R&F Department estimates.

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



Sources: Rosstat, R&F Department estimates.

Figure 3. Inflation and its components, % YoY



Sources: Rosstat.

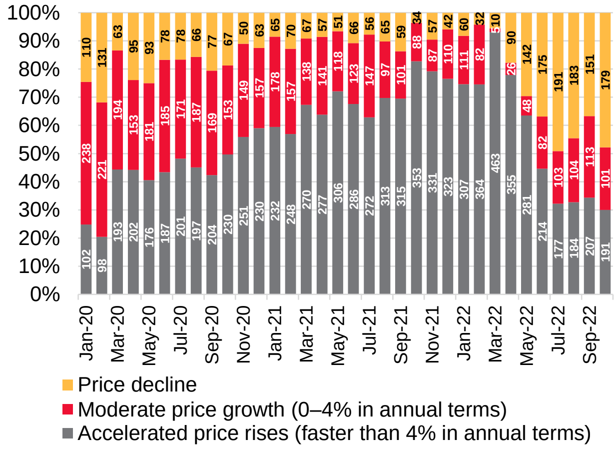
Food prices climbed 12.1% in October after 14.2% in September. Inflation in the food market came close to the level of the start of the year (it stood at 11.0%–11.5% YoY in January–February). Prices went down 0.6% MoM SAAR in October. A substantial positive contribution to the estimate came from a rise in fruit and vegetable prices by 1.2% MoM SA, compensating for the price decline in the summer months. Net of fruit and vegetables, food prices fell 2.2% MoM SAAR in September after a 0.2% MoM SAAR decline in August and September. The key factor restraining price movements in the key food groups, such as meat and dairy products, butter, and the products of grain processing, in recent months is domestic production expansion[1] amid limited export capability. Some export rebounding was posted at

[1] According to [Ministry of Agriculture data,] 155 million tons of grain crops in bunker weight was harvested as of 24 November versus 125.5 million tons as of a similar date last year). A rise was also posted in the output of other

the start of [Q3](), but its growth potential is limited, and the carryover of the key crops will be significant, bearing in mind the record-high harvest. This may restrain domestic food price rises, despite the agricultural [producer cost increases.]()

Annual inflation in non-food goods slowed to 14.1% in October from 14.9% in September. Their prices slid 0.6% MoM SAAR over October after a 0.9% MoM SAA rise in September. The key restraining effect was owed to a price growth slowdown / price decline in wearing apparel, footwear, household chemicals, personal hygiene products, electronic goods, and motor vehicles amid a temporary rise in uncertainty and consumer activity shrinkage. At the same time, overall inflationary pressure is somewhat higher in the non-food than in the food segment (although it holds below 4%) – the distribution median stood at 2.3% MoM SAAR in October after 2.5% MoM SAAR in September (Figure 5).

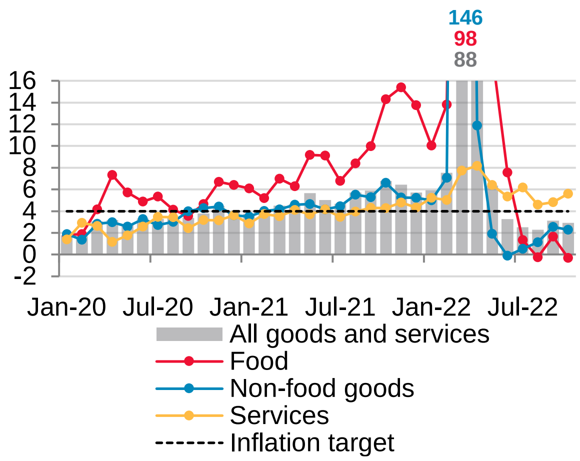
Figure 4. Total weight of goods and services (net of fruit and vegetables and regulated services) distributed based on seasonally adjusted pace of price rises, %



Note. The figures stand for the number of items.

Sources: Rosstat, R&F Department estimates.

Figure 5. Distribution medians calculated on disaggregated components*, % MoM SAAR



** 558 components in the 2022 basket.*

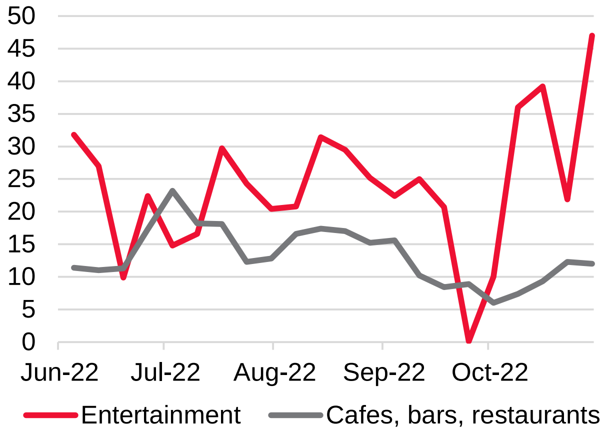
Sources: Rosstat, R&F Department estimates.

At the same time, the services sector registered annual price growth acceleration to 11.3% in October from 11.0% in September. In month-on-month terms, prices climbed 8.1% MoM SAAR versus 11.1% MoM SAAR in September. The overall inflationary background remains elevated relative to 4% in seasonally adjusted terms: the median of distribution among the most disaggregated services components rose to 5.6% MoM SAAR. There is no visible effect from the consumer activity's temporary decline on the components of unregulated (free market) services. Indeed, seasonally adjusted growth in personal services prices accelerated to 0.6% MoM in October from 0.5% MoM in September. Public food services, which fall under the category of food goods, posted a similar move. As uncertainty subsided, consumer activity started to pick up in the second half of October, with a rise in spending on leisure and entertainment, as well as visits to cafes and restaurants, accelerating (Figure 6). Meanwhile,

crops ([1](), [2](), [3](), [4]()) and in [animal husbandry](). The previous record-high grain crop harvest of 135.4 million tons was registered in 2017, which was a key beneficial factor of that period helping to keep up a moderate pace of consumer food price growth (below 4% SAAR) up until the end of the spring in 2018.

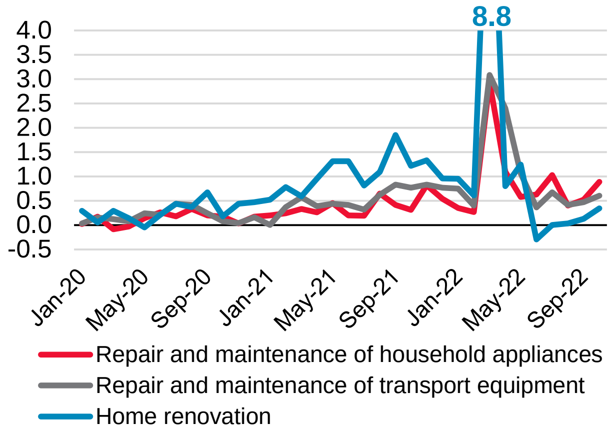
services price growth intensified in categories where labour shortages may have emerged (Figure 7).

Figure 6. Consumer spending, % YoY



Sources: SberIndex.

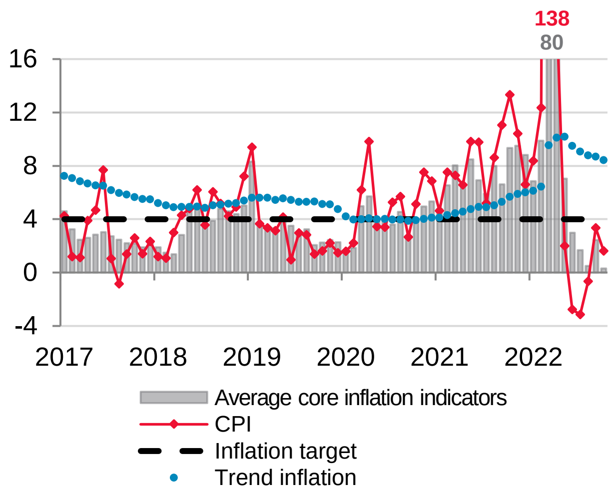
Figure 7. Seasonally adjusted rise in the prices of some personal services categories, % MoM



Sources: Rosstat, R&F Department estimates.

Trend inflation came in at 8.4% YoY in October, inching down from 8.7% YoY in September (Figure 8). Disinflationary factors which became evident in October and affected a wide range of consumer goods (the share of items whose prices went down notably increased – Figure 4), brought modified core inflation indicators back to a near-zero level. That said, the median of distribution among the most disaggregated consumer basket components remains in the range of 2–4% MoM SAAR for the sixth month in succession (Figure 5).

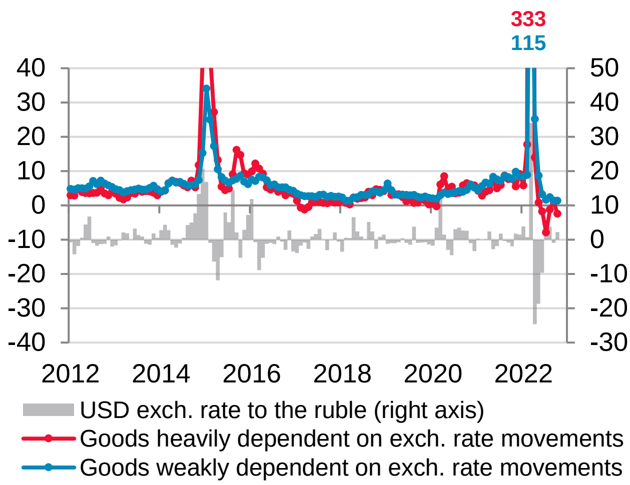
Figure 8. Modified core inflation indicators* and trend inflation estimates, % in annual terms



** Computed by the method of excluding the most volatile components and the truncation method.*

Sources: Rosstat, R&F Department estimates.

Figure 9. USD exchange rate to the ruble (%) and median CPI (%, MoM SAAR)



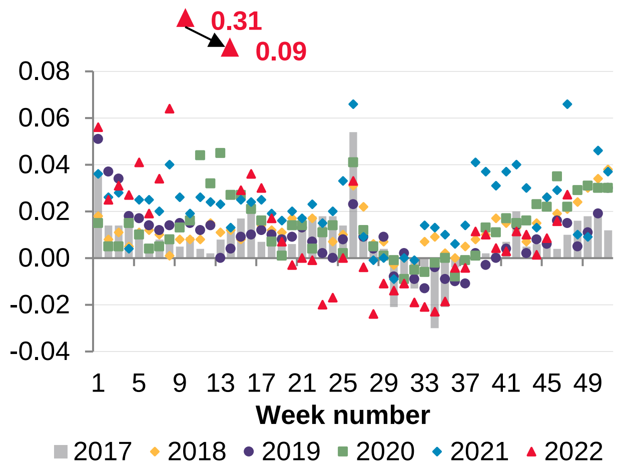
Sources: Bank of Russia, Rosstat, R&F Department estimates.

It is important to note that even the indicators of stable price movements such as the median, along with core inflation indicators reflect the effect of ruble appreciation's pass-through, amplified by an upward "overshoot" of prices in the spring of this year (Figure 9). We, therefore, believe that inflationary pressure in the consumer segment of the economy is higher than what can be assumed from these indicators. This is indirectly evidenced by an increased pace of rises in the prices of services, where the foreign exchange component of costs is traditionally smaller than in goods.

It appears from weekly data that consumer price movements remained tempered in November (Figure 10). The annual inflation estimate was down at 12.1% as of 28 November.

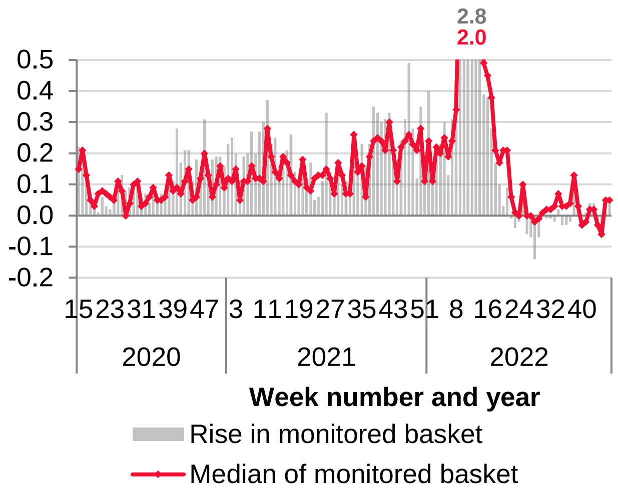
The prices of key food groups were declining throughout November, prolonging the October trend as supply expanded. A drop in the prices of many non-food goods (including wearing apparel, FMCG, and electronic goods) at the start of the month is likely owed to the temporary factor of season sales. The end of the month saw a notable contraction in the share and weight[2] of items showing a price decline, while the number of categories rising in prices at an accelerated pace increased, with the distribution median coming back to positive territory for the first time since end-October (Figure 11).

Figure 10. Average daily price growth, %



Sources: Rosstat, R&F Department estimates.

Figure 11. Pace of price increases and distribution median of weekly price rises, %



Note. The estimation is based on an enlarged list of goods and services net of fruit and vegetables and regulated services prices.

Sources: Rosstat, R&F Department estimates.

The easing of inflationary pressure which emerged in October–November is temporary in nature. The impact of some disinflationary factors (above all, of a record-high grain harvest and overall upward output trend in the agricultural sector) may prove to be longer than earlier assumed, but on a medium-turn horizon, both supply-side (continuing restrictions) and demand-side (the built-up savings overhang) pro-inflationary risks prevail.

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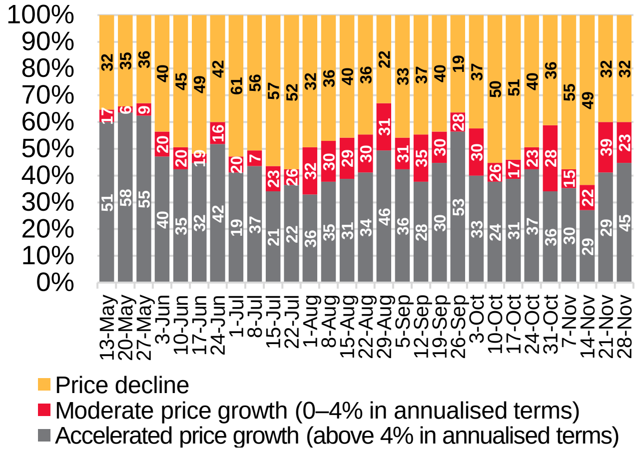
[2] Monitored on a weekly basis, net of fruit and vegetables and regulated services.

A further contribution to inflation will be provided by the move of housing and communal services price indexation from July 2023 to December 2022. The direct effect of this price hike on inflation in December this year is estimated at 0.6 pp. In addition, we will see indirect effects of it in 2023.[3]

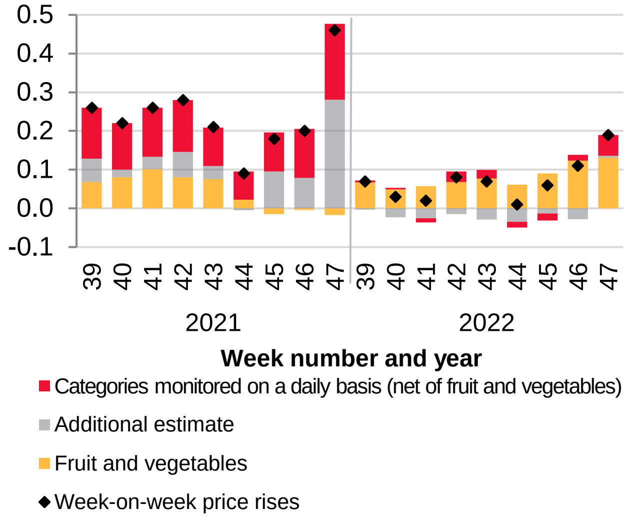
Figure12. Distribution of price indices for categories of goods and services monitored on a weekly basis, %



** 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.

Figure 13. Decomposition of week-on-week price rises, pp



Sources: Rosstat, R&F Department estimates.

2. Economic activity

Overall, the Russian economy returned to the stabilisation phase in November after a short-lived adverse reaction to a shock in October. This was in part helped by a government order expansion. The most notable of new economic shocks capable of triggering a sizable economic activity contraction in the coming months is a ban on the maritime export of Russian crude oil and refined petroleum products to Europe and the imposition of price caps on Russian crude oil.

In this context, one needs to distinguish between long-term and short-term effects of sanctions and other restrictions. Initially, they act as shocks – economic and/or financial ones, disrupting well-established business processes, supply and payment chains. This provokes a notable output contraction, especially where adequate inventories have failed to be built up.

[3] For more details, see Talking Trends of October 2022.

Upon subsequent adjustment and adaptation to shocks, new production, logistics, and financial chains are established, as well as chains allowing production to be maintained. This helps to partially smooth over the initial adverse effect. The stabilisation of the economic activity achieved in Russia suggests that these processes are going on extensively.

But restrictions also have a prolonged cumulative effect, steadily reducing the economy's potential with time by bringing down its productivity and efficiency. This is concerned mainly with the supply of high-tech intermediary and investment goods, as well as restrictions on exports. One should not, therefore, overestimate the role of reverse engineering and the parallel import of investment goods. They are, in effect, also adaptation, stabilisation mechanisms, only requiring more time. Growth and development potential achieved by employing these mechanisms is unlikely to be significant in the absence of tangible prospects for a large-scale entry to global markets of products manufactured in a situation of technological restrictions.

The recent shift of demand and supply balance in the labour market helps maintain unemployment at an all-time low and keep up fast wage growth, given a strong financial result achieved in many industries of the economy. This factor will help household consumption expansion in the coming quarters even if the high savings ratio persists.

Meanwhile, the net financial result has been decreasing in recent months, while the need for replacement investment in fixed assets will be gradually but steadily growing as the equipment is depreciated. That said, the productivity of replaced fixed assets will on average decline due to the employment of less sophisticated technologies. Over a horizon of several years, this will predetermine a structural shift of value added towards income from capital at the expense of income from labour. At the final stage of structural transformation, fixed investment will, as a result, grow faster than income from labour and household consumption against a background of a depressed pace of economic growth restrained by the technology level.

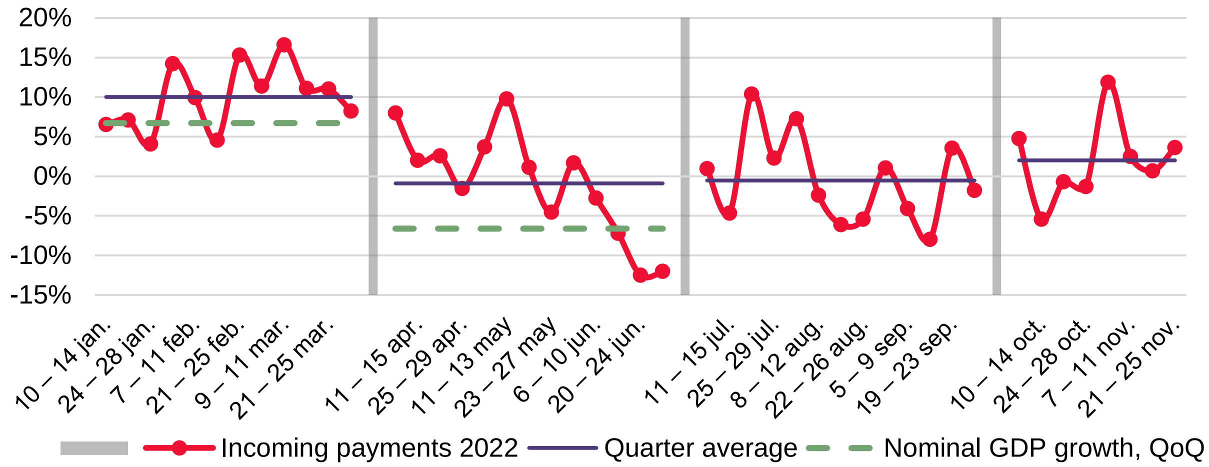
2.1. Economy faces new shocks

- A preliminary Rosstat estimate has confirmed that the economy stabilised in Q3 after its contraction in Q2, edging up 0.2% QoQ SA from -5.8% QoQ SA.[4] This was owed to addressing a part of logistics problems, redirection of export and import flows, a rise in demand for the products of some industries as the economy is restructured, helped by fiscal support and lending recovery against a background of monetary policy easing (Figure 15).
- Nevertheless, the results varied across the months of the quarter, while at the end of the quarter the economy faced new challenges and a rise in uncertainty. Part of this effect is temporary, all but dissipating in November, while part of it may be more enduring and structural in nature.

[4] An R&F Department estimate.

- The rise in uncertainty hurt mainly consumer activity. It temporarily declined at the end of September – the first half of October, to partially rebound subsequently (Figure 21).
- There have been signs that the demand and supply balance is shifting in the labour market. According to SberIndex real-time data, October saw median wage growth accelerating sharply (Figure 22), while the unemployment rate stayed at an all-time low (Figure 19) and vacancies in some industries were increasing at a faster pace (Figure 20). Labour income expansion may buttress a further consumer activity rise even if the savings ratio remains overly high (Figure 24, Figure 25).
- Industrial output stabilised in October (up 0.2% MoM SA) (Figure 17), after a two-month fall. This stemmed in part from production expansion in industries showing high output volatility (Figure 18).
- Leading survey indicators[5] and data from monitoring financial flows (Figure 14) suggest stabilisation of business conditions in industry and services alike after their October downturn (Figure 16). The PMI Composite Output Index stood at 50.0 in November, up from 45.8 in October (Figure 50). Meanwhile, as the adverse impact of factors, such as domestic demand and uncertainty, diminishes, difficulties on the side of external demand and labour shortages mount in a number of industries. Businesses' output expectations have not yet returned to their September level and remain mixed, showing worsening in mining and quarrying, construction, and the SME segment.

Figure 14. Incoming payments growth[6] relative to the previous quarter average weighted by industries' shares in gross value added, seasonally adjusted, %

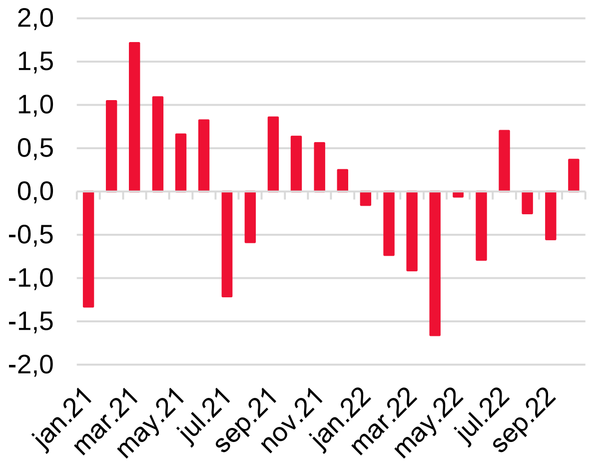


Sources: Bank of Russia, Monitoring of individual industries' financial flows.

[5] Institute for Economic Policy business surveys, the RSBI index of SME business activity.

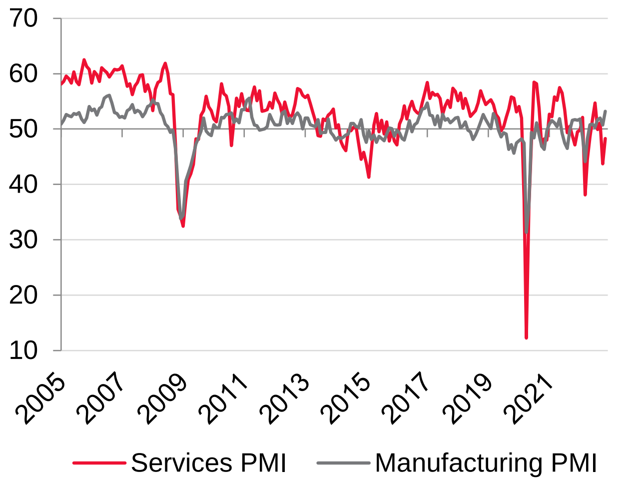
[6] Growth pace means a percentage change in the sought value: $g = \frac{(x_1 - x_0)}{x_0} * 100$.

Figure 15. Output in core economic activities, % MoM SA



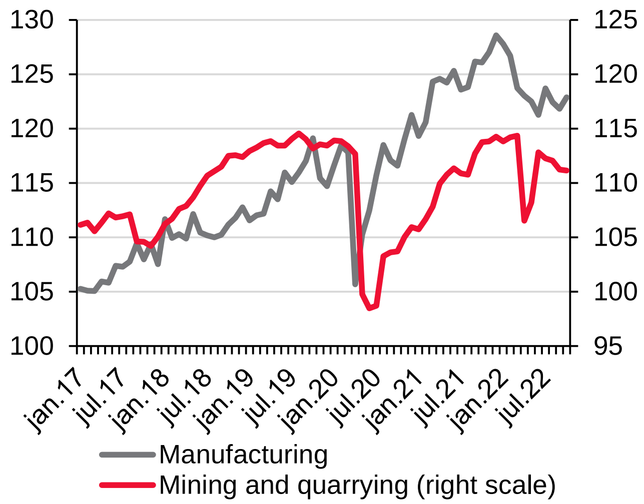
Sources: Rosstat, R&F Department estimates.

Figure 16. Russia's Manufacturing and Services PMI, points



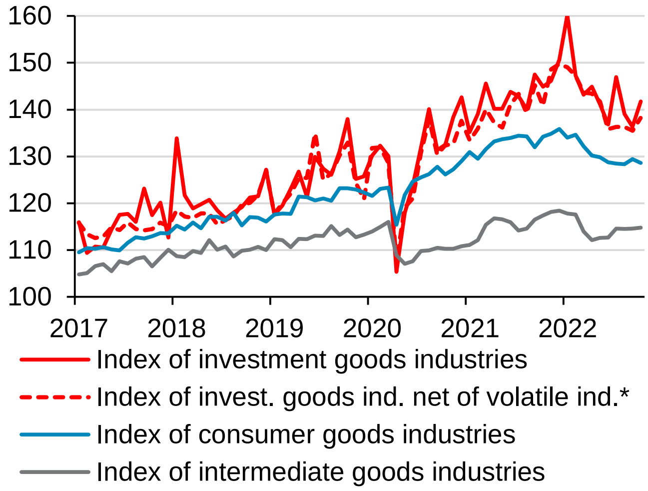
Source: S&P Global.

Figure 17. Mining and quarrying and manufacturing indices (2014 = 100)



Sources: Rosstat, R&F Department estimates.

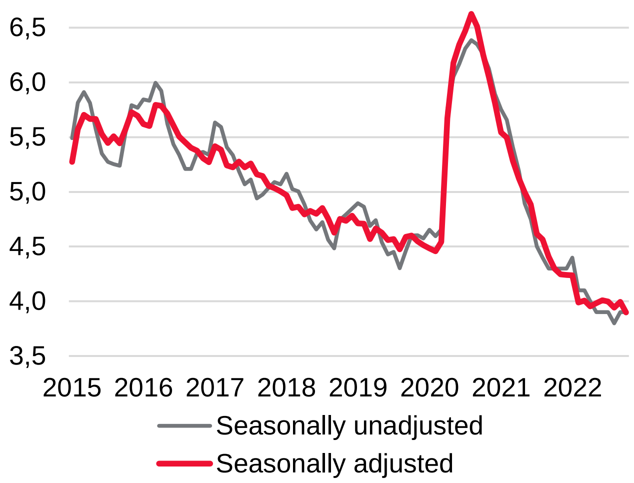
Figure 18. Output in groups of manufacturing industries, SA, 01.2016 = 100%



** Volatile industries mean the manufacture of fabricated metal products, except for machinery and equipment, and other transport equipment.*

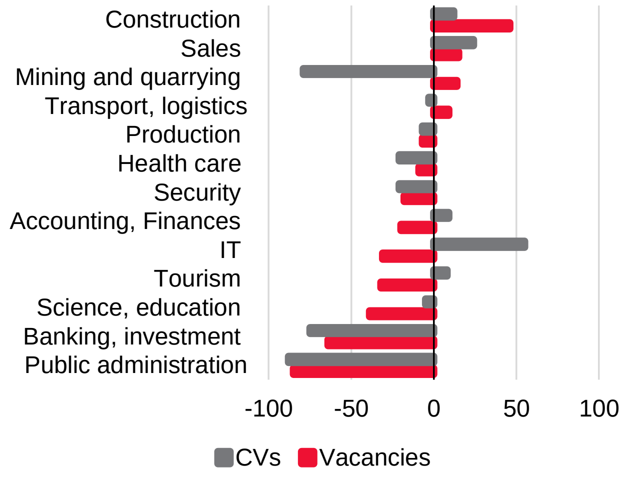
Sources: Rosstat, R&A Department estimates.

Figure 19. Unemployment rate, %



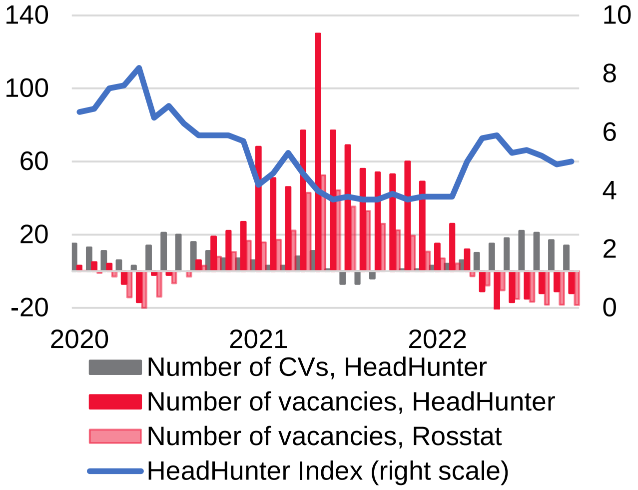
Sources: Rosstat, R&A Department estimates.

Figure 20. Vacancies and CVs in professional industries in October, % YoY



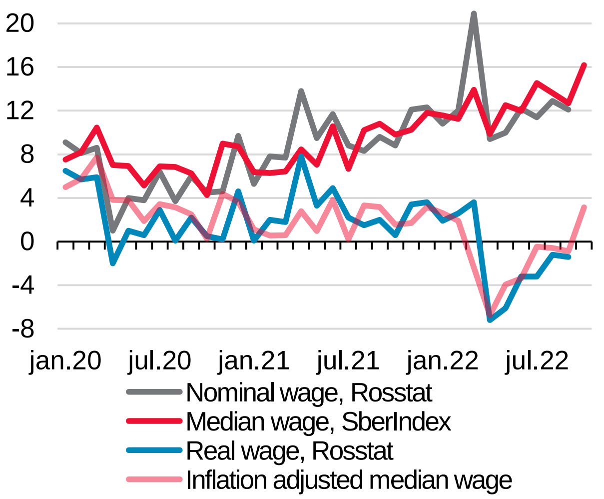
Source: HeadHunter.

Figure 21. CVs, vacancies (% YoY) and HeadHunter index[7] (points)



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

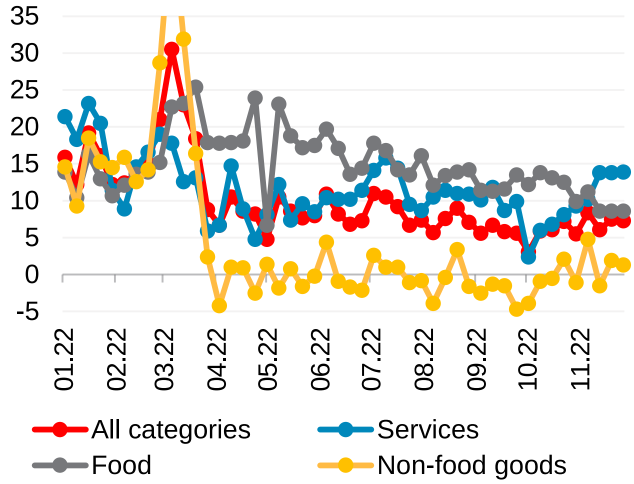
Figure 22. Nominal and real wage growth, % YoY



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

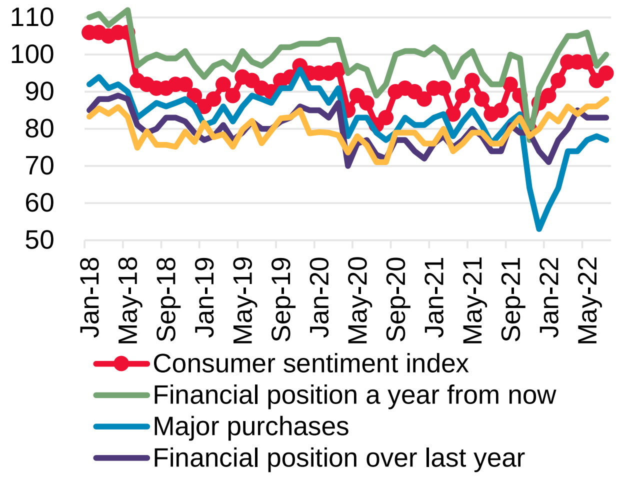
[7] Reflects the ratio of CVs to vacancies. The higher the number, the lower competition for employees.

Figure 23. Consumer goods and services nominal spending growth, % YoY[8]



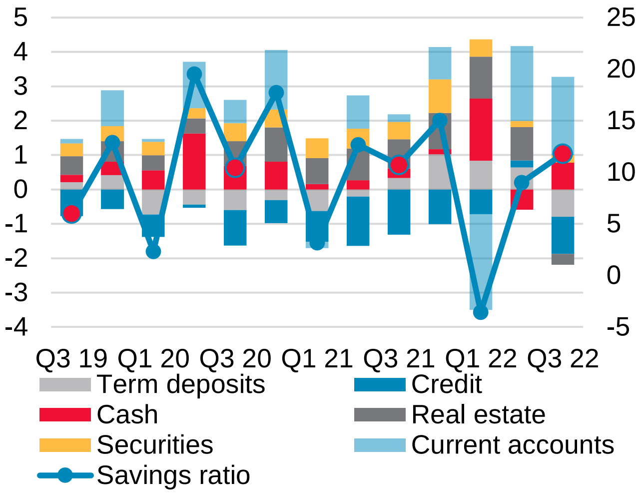
Source: SberIndex.

Figure 24. Consumer and financial sentiment indices, points



Source: inFOM.

Figure 25. Household savings: levels (trillion rubles) and savings ratio (right scale, %)



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

2.2. Retail lending cools in October

- A rise in uncertainty at the end of September temporarily brought down consumer activity, which in turn hit retail lending performance.
- Corporate lending, however, continued to expand at an accelerated pace, thanks to, among other things, extensive replacement of foreign currency lending by ruble loans.
- The shift of deposit structure towards short-term instruments coupled with an overall acceleration of monetary aggregate growth to the fastest pace since the adoption of inflation targeting policy suggests the mounting of pro-inflationary risks.

[8] Data for the week from 31.10 to 06.11.2022 versus the week prior to the lockdown, 22–28.10.2021.

According to an R&F Department estimate, growth in retail ruble lending slowed to 1.1% MoM SA in October from 1.3% MoM SA in September (Figure 26), having reached 6.9% SA from the start of the year. The slowdown was posted in the key retail lending segments: mortgage loan portfolio expansion slowed to 1.7% MoM SA from 2.1% MoM SA, consumer lending increase decelerated to 0.1% MoM SA from 0.3% MoM SA. The auto loan portfolio contracted 0.4% MoM SA after a fall 0.5 MoM SA a month earlier (Figure 28). Retail lending was hit by a rise in uncertainty at the end of September, which temporarily brought down consumer activity and lending in the first half of October.

Mortgage loan issuance shrank in October, dragged down by both a demand decline and the toughening of lending terms and conditions due to a rise in uncertainty (Figure 29). Total loans extended under shared equity agreements, primarily at a subsidised interest rate, decreased 10.5% YoY after their rise in recent months (Figure 27). A year-on-year loan issuance decrease in the secondary market accelerated to 10.4% YoY from 6.4% YoY. November's change in the number of loan applications indicated by DomKlik service data, suggests a possible rebounding of demand. That said, banks' more cautious approach to loan issuance may contain activity expansion in the mortgage loan segment. The performance of mortgage loan portfolio and housing prices in the coming months will depend on whether the subsidised seven-percent loan programme expiring at the end of 2022, will be extended.

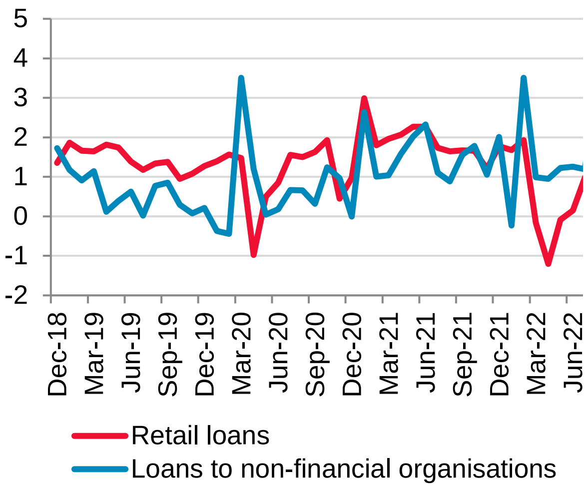
Growth in ruble loans to non-financial organisations remained strong at 3.6% MoM SA in October after 3.0% MoM SA in September[9] (growth from the start of the year came in at 23.3% SA). Ruble lending expansion is in part buoyed by portfolio dedollarisation, with total foreign currency loans declining 5.8% MoM SA. Subsidised lending is not the chief determinant of lending growth either. That said, corporate loan portfolio performance continues to vary across industries,[10] and so does change in business activity.

As interest rates rose somewhat, expansion in household ruble deposits accelerated in October to 0.9% MoM SA from 0.6% MoM SA a month earlier, with total growth from the start of the year standing at 7.1% SA. The deposit structure continued to shift towards short-term instruments. Year-on-year contraction in long- and medium-term deposits slowed, while expansion in deposits with maturities of up to 30 days and funds in accounts gained pace. Total household foreign currency deposits continued to shrink, down 6.0% after a slump of 10.4% MoM SA in September. This is partly due to a transfer of part of the funds to foreign countries (Figure 30).

Accelerated growth in ruble money supply has continued. It came in at 24% YoY for October, the highest level since the adoption of inflation targeting policy. The replacement of foreign currency lending by ruble loans also affects the currency structure of banks' liabilities (Figure 31). Indeed, growth in broad money supply was much slower at 10.8% YoY in October and 15.3% YoY after an adjustment for foreign exchange revaluation.

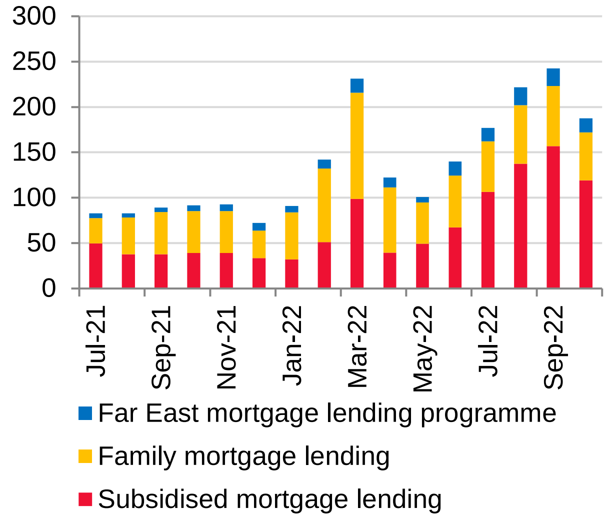
[9] The portfolio of loans to financial institutions added 1.2% MoM SA after a drop of 2.2% MoM SA in September.
[10] According to PMI indexes, October saw business activity improvement in manufacturing and contraction in services.

Figure 26. Banks' credit growth, % MoM SA



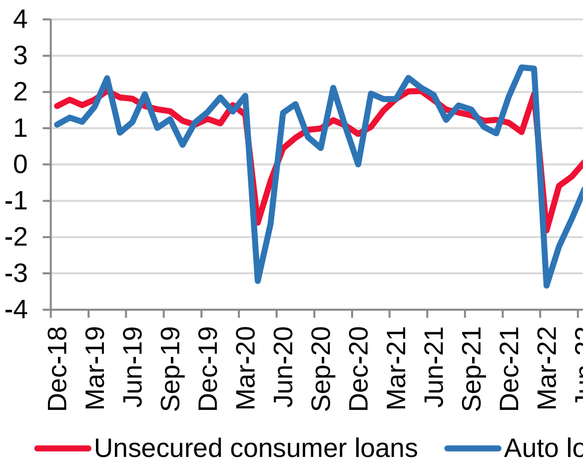
Sources: Bank of Russia, R&F Department estimates.

Figure 27. Loan issuance under subsidised mortgage loan programmes*, billion rubles



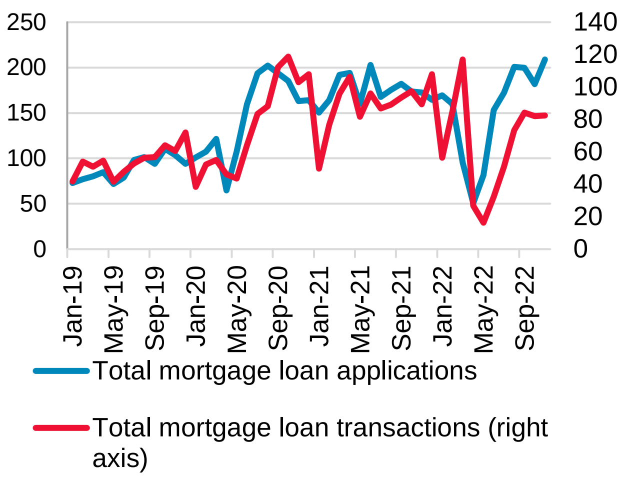
Sources: DOM RF, R&F Department estimates

Figure 28. Retail loans growth, % MoM SA



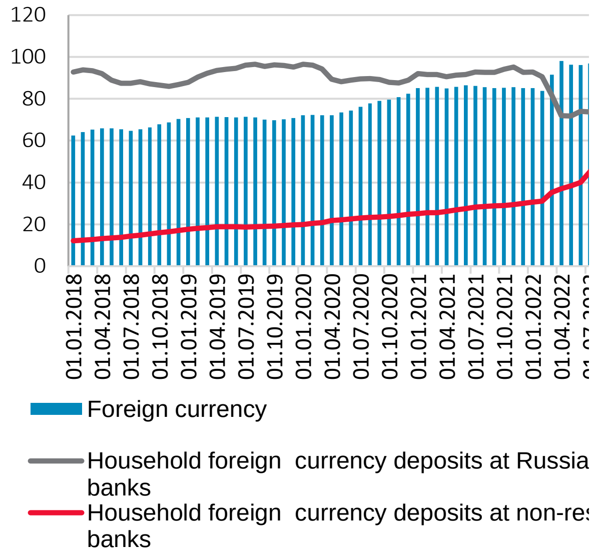
Sources: Bank of Russia, R&F Department estimates.

Figure 29. Number of mortgage loan applications and transactions, thousand



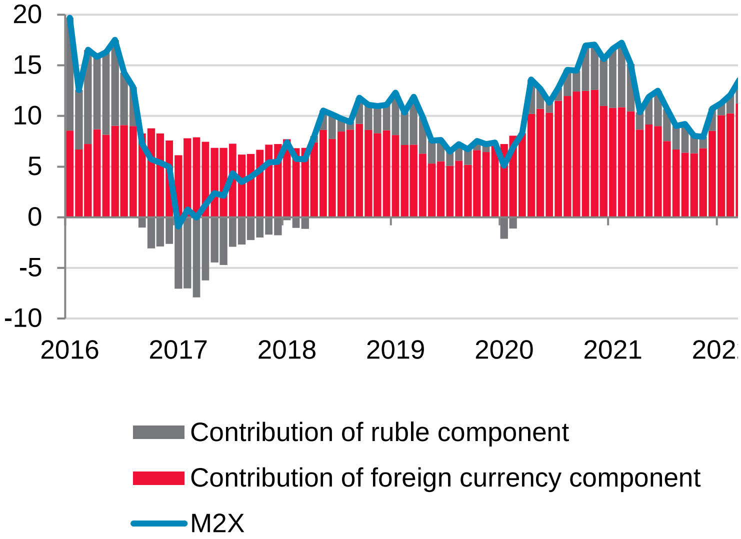
Sources: DomKlik, R&F Department estimates.

Figure 30. Foreign currency deposits and foreign currency cash, USD billion



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

Figure 31. Structure of growth in broad money supply M2X, %



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

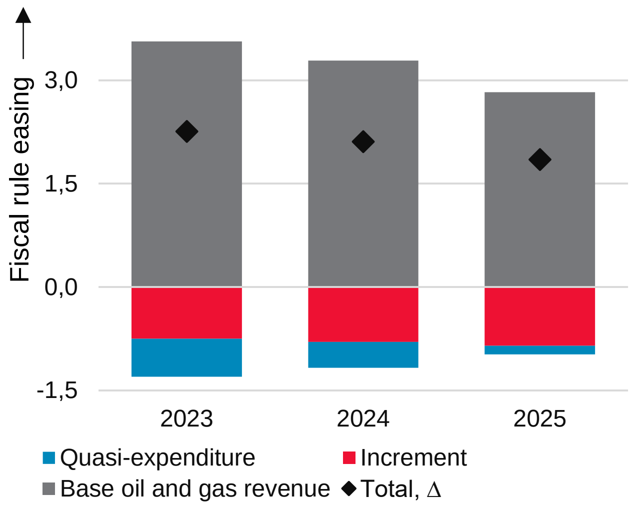
In focus. Financing budget deficit through OFZs

- Transition to a new version of the fiscal rule planned by Russia's Finance Ministry implies a structurally higher level of federal budget expenditure compared with the previous version of the rule. OFZ is set to be the key source of budget financing.
- The RF Finance Ministry returned to the domestic debt market after a half-a-year break and ramped up its debt issuance, relying mainly on floating coupon bonds (OFZ-PK). Banks have been the key bond buyers, since OFZ-PK securities help improve their liquidity position and reduce the sensitivity of their income to movements in money market rates (interest rate risk).
- Banks' technical capabilities to purchase OFZ-PK are substantial. Still, there are limits to the amount of financing through this channel. A significant budget deficit generates additional demand in the economy, which increases pro-inflationary risks. Monetary policy should take account of this.

The RF Finance Ministry's plans for gradually bringing fiscal policy back to normal involve a transition to a new version of the fiscal rule in 2025. It provides for easing the oil and gas part of the fiscal rule relative to its previous version by increasing the base oil and gas revenue and toughening the non-oil and gas part through a cut to the target level of the structural primary balance[11] of the federal budget and additional caps on the balance of intergovernmental and budget loans (Figure 32). Based on our estimate, this is to allow increasing expenditure in 2023–2025 by 2.8-3.6 trillion rubles annually relative to the previous structure of the fiscal rule. That said, the plan envisages a transition period in 2023–2024, during which expenditure is to exceed the fiscal rule projections by 2.9 trillion rubles and 1.6 trillion rubles, respectively. This reflects the need to provide additional fiscal support to the economy during the structural transformation period.

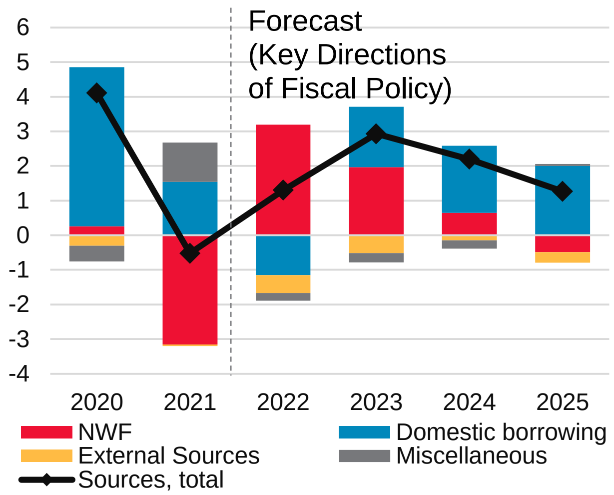
As a result, the budget deficit of 2.9 trillion rubles is expected in 2023, followed by a decrease to 1.3 trillion rubles by 2025 (Figure 33). National Wealth Fund (NWF) spending of 2.6 trillion rubles in 2023–2024 will come as an important source of budget deficit financing in the medium-term. A more extensive use of the NWF for this purpose would be unrealistic, because, given the planned investment of its liquid part (for a total of 3.5 trillion rubles over 2023–2025) it will have been almost completely drawn down by the end of the forecast horizon (to 65 billion rubles, bearing in mind the resumed inflow of additional oil and gas revenue).

Figure 32. Factors of difference in federal budget expenditures under the new and old fiscal rule versions, trillion rubles



Sources: RF Finance Ministry, R&F Department estimates.

Figure 33. Sources of financing federal budget deficit, trillion rubles



Source: RF Finance Ministry.

This year, OFZ issuance was suspended in February and resumed in September. The bulk of issuance took place in November (only one trial auction was held in September. OFZ for only 10 bln RUB were issued, with 227 billion rubles raised through two auctions held in October), whereas around 1.2 trillion rubles of bonds were sold in November.

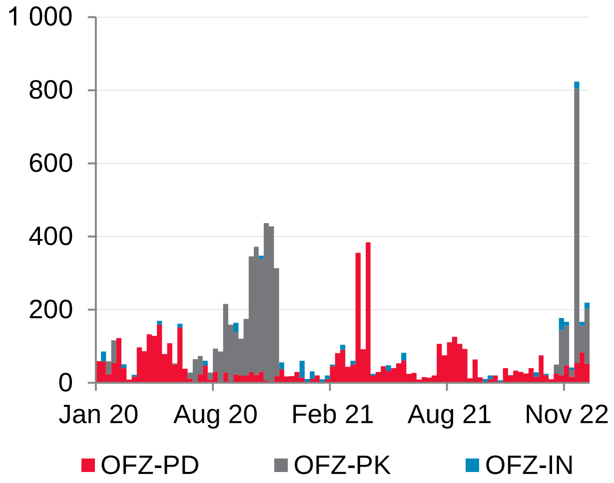
Debt issued totalled 1.44 trillion rubles, 77% of which were OFZ-PK (floaters), i.e., issues paying a coupon whose interest rate depends on the average RUONIA rate over the current coupon period with a seven-day time lag. The key buyers of these bonds are usually large banks (Figure 35).

[11] Difference between a sum of non-interest expenditure and quasi-expenditure transactions and a sum of non-oil and gas revenue and base oil and gas revenue.

Banks' technical capabilities to build up government debt on their balance sheets are substantial, as floating coupon OFZ bonds are considered as an attractive investment from the perspective of asset-liability management.

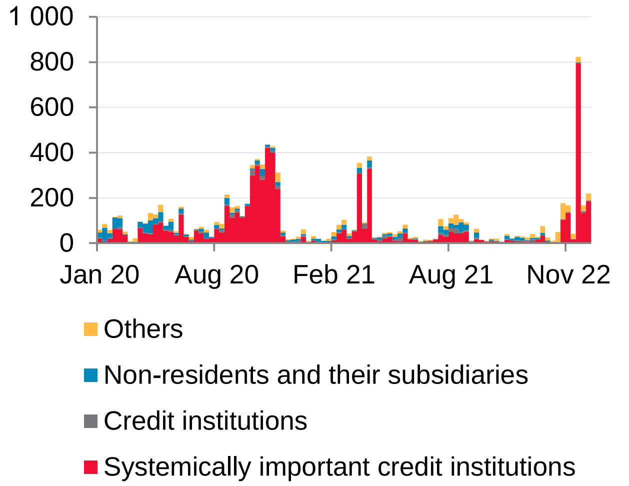
On the one hand, floaters help manage banks' interest rate risk, which reduces the sensitivity of their income to the movements of money market rates. Unlike classical fixed coupon OFZ-PD bonds, a rise in market rates does not result in a negative mark-to-market of OFZ-PK positions. However falling interest rates do not result in a positive mark-to-market. This is especially important in the absence of an efficient derivatives market and in the current situation banks are unable to manage interest rate risk using derivatives.[12]

Figure 34. OFZ issuance by bond type, billion rubles



Sources: Moscow Exchange, R&F Department estimates.

Figure 35. OFZ issuance by investor type, billion rubles



Sources: Moscow Exchange, R&F Department estimates.

On the other hand, the purchases of floaters are accounted for in calculating liquidity requirements. In addition, these assets do not create a load on capital (they have a zero weight in calculating capital adequacy ratios) and can be used as collateral in refinancing transactions.

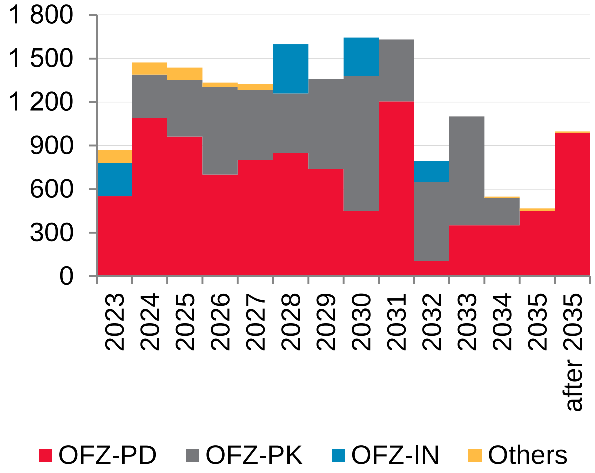
The current schedule of domestic government debt repayment allows the RF Finance Ministry to comfortably issue long-term (10-year and longer) securities with no risk to the stability of public finances (Figure 36). At the same time, the issuance of floaters would imply uncertainty regarding future coupon payments, and massive OFZ-PK issuance increases the overall sensitivity of budget expenditure to the economic cycle and changes in inflation.

Lack of spare cash in correspondent accounts may limit the potential amount of OFZ purchases by banks at new issue offerings. Banks can fill up the shortage of liquidity through repo transactions with the Bank of Russia. That said, liquidity shrinks after massive primary offering by The RF Finance Ministry (funds are debited from banks' correspondent accounts). Later, when Finance Ministry carries out its expenditures, money returns to the banking

[12] For example, interest rate swap transactions under which non-residents assumed the risk of change in market rates were extensively conducted prior to February 2022. For details of changes in the derivatives market, see The market of OTC derivative financial instruments.

system: budget expenses are credited to customers' accounts with credit institutions. Improved liquidity allows banks to gradually repay their repo debt.

Figure 36. OFZ bonds by time of redemption*, billion rubles



** The "Others" category includes OFZ-AD, OFZ-N, GSO-FPS, and GSO-PPS.*

Sources: RF Finance Ministry, R&F Department estimates.

Potential OFZ sales can be substantial. At the same time significant budget deficit generates additional demand in the economy, which amplifies pro-inflationary risks. Under its inflation targeting policy, the Bank of Russia should respond to these risks by monetary policy tightening in order to curb generation of additional demand through the private sector channel and to keep inflation close to the target. As a result, government demand will crowd out the private sector's demand. It is, therefore, important that the deficit be kept under control.

After the new version of the fiscal rule has reached its target parameters in 2025, it will curb inflationary risks from the budget, helping the stability of public finances. During the transition period fiscal policy effectiveness could be improved through measures to streamline budget expenditure (including quasi-expenditure in the form of NWF funds investment) and revenue.