Bank of Russia

No. 2 (46)

TALKING TRENDS
Economy and markets

Research and Forecasting Department Bulletin

MARCH 2021

CONTENTS

The Research and Forecasting Department prepared this bulletin based on data as of 05.03.2021.
The views and recommendations expressed in the bulletin do not necessarily reflect the official position of the Bank of Russia.
Please send your comments and suggestions to dip1@cbr.ru.

Cover photo: shutterstock.com/FOTODOM
Address: 12 Neglinnaya Street, Moscow, 107016
Bank of Russia website: www.cbr.ru

EXECUTIVE SUMMARY

MONTHLY SUMMARY

- In January–February 2021, the Russian economy trended upwards while heterogeneity across industries remained high. Output in a range of industries exceeded pre-pandemic levels, while remaining considerably below these levels in other sectors. Accommodative monetary policy and fiscal measures continue to support economic activity and domestic demand. Lending has been expanding. The disinflationary impact of aggregate demand is weakening, while a range of industries are facing an acceleration of inflation due to higher demand. Nonetheless, anti-pandemic restrictions are still in place both in Russia and abroad. They are increasing logistics expenses and costs in general, among other things, pushing prices upwards in many countries. The overall effect of these factors and a range of one-off factors is currently the reason why the growth rate of consumer prices in Russia remains elevated. Moreover, these factors may delay the return of inflation to 4.0% until 2022.
    - In February, annual inflation rose close to its local peak and will decrease by the end of April owing to the low base effect. According to our estimates, inflationary pressure adjusted for temporary and one-off factors is currently slightly above 4.0%.
    - In January–February, economic activity was increasing (seasonally adjusted), supported by a fast recovery in export and intermediate goods industries. Consumer sectors demonstrated moderate growth. Power consumption exceeded the pre-pandemic level, which is evidence of the completed recovery process and a subsequent rise in the majority of energy-intensive industries, namely manufacturing.
    - Near-zero and negative interest rates in many countries, coupled with quantitative easing measures caused an increase in prices in the global commodity market and stock markets, including in Russia. This pushes up foreign-currency prices for Russian imports and exports. In addition, as investors demonstrated concerns about inflation acceleration, primarily in the USA and the euro area, this provoked a rise in long-term bond yields in these countries. Eventually, this also impacted bond yields in emerging market economies.

IN FOCUS. Short- and long-term consequences of grain damper

- In order to stabilise increased food prices, the Russian Government launches new regulation mechanisms, including in customs regulation. On 2 June 2021, the Government will introduce a variable export duty for grain crops equalling 70% of the difference between export and base prices. The funds to be received are planned to be allocated as subsidies proportionately to output amounts.
- The introduction of the variable duty will help stabilise domestic prices for grains and, accordingly, grain products over a short-term horizon. In the longer run, the efficiency of this damper will still depend on the distribution of collected export duties (this mechanism

has not yet been elaborated properly), the procedure for the base price indexation, and the timely adjustment of other parameters.

- If the mechanism for the distribution of the duties and the buffer is not adjusted appropriately, this will create risks of a negative impact on supply in the grain market. The materialisation of these risks may partially or fully eliminate the original stabilising effect on price movements.

1. Inflation

Annual inflation reached 5.7% in February, due to the continuing elevated pace of price rises in seasonally adjusted terms and the low base of February 2020. The leading indicators of inflation, including the producer prices of consumer goods and business survey data, suggest that an increased rate of seasonally adjusted month-on-month price rises will likely continue in the spring, driven by cost increases owing to, among other things, logistics and transportation disruptions. This has heightened the probability that inflation will come in close to the upper bound of a Bank of Russia forecast of 3.7–4.2% by the end of the year, with inflation returning to the 4.0% mark in 2022.

Still, the high rate of price rises at the end of March – April 2020, coupled with the diminishing effect of ruble weakening pass-through to prices, will slow annual inflation in April.

Further on in the year, consumer price inflation will be affected by mixed factors. In particular, the expected epidemic situation's return to normal on the back of mass vaccination will produce a recovery of demand for goods and services whose consumption was earlier limited. At the same time, demand for other goods and services, which earlier rose as they had to substitute for inaccessible goods and services, may weaken.

Also, some supply-side restrictions caused by coronavirus contagions, as well as work from home and migration, will be gradually eased. Fiscal policy's gradual return to normal is another factor which will contain price rises.

At the same time, export and import price hikes in foreign exchange terms is a factor driving domestic ruble prices higher.

As a result, the impacts of the above groups of factors will partially offset one another.

Finally, the maintenance of the current loose monetary policy will continue to perform its countercyclical function. This monetary policy, operating with a time lag, supports conditions for further strengthening of demand this year. However, as the economy returns to potential, the need for demand to be supported will be diminishing.

1.1. Pace of price rises remained elevated, accelerated further

- Inflation rose to 5.67% in February from 5.19% in January. Seasonally adjusted monthly price increases in January and February exceeded the level corresponding to an inflation rate of 4% in annualised terms. Moreover, February saw their pace accelerating.
- Price inertia will keep the pace of month-on-month price hikes elevated in March. Nevertheless, as the increased rate of price rises in March–April 2020 exits the calculation base, annual inflation will slow.
- Price moves continue to be affected by a large number of mixed factors at the start of the year. After the impact of short-term proinflationary factors has petered out, one can

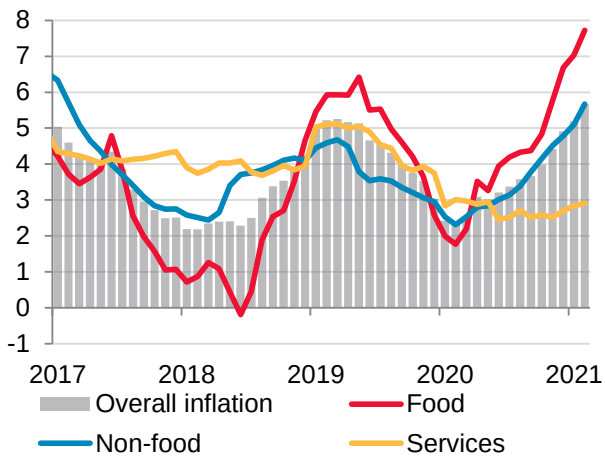
expect monthly price increases to gradually slow to a level close to 4% in annualised terms.

- Demand-side disinflationary risks are weakening as household income recovers. That said, enduring supply-side proinflationary factors driven by climbing producer costs are continuing to affect price movements. The impact of these factors may restrain inflation deceleration during 2021, delaying its return to 4.0% until 2022.

Inflation went up to 5.19% YoY in January from 4.91% YoY in December, with annual price growth accelerating in all of the consumer basket's key components (Figure 1). As in January, February's month-on-month price rise was still above a level corresponding to an inflation rate of 4% in annualised terms (Figure 2), driving annual inflation further up to 5.67%.

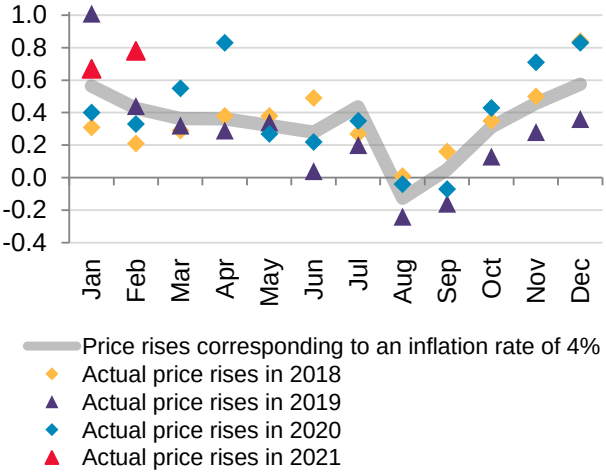
Annual inflation will likely reach a local maximum in mid-March,[1] to be followed by a decline as the elevated pace of price rises in March–April 2020 exits the calculation base and the effect of temporary proinflationary factors attenuates. At the same time, the continuing elevated pace of price hikes in the first quarter heightens the probability that inflation will come in close to the upper bound of a Bank of Russia forecast of 3.7%–4.2% by the end of the year.

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.

Month-on-month price growth accelerated to 7.77% MoM SAAR[2] in February from 5.79% MoM SAAR in January, remaining above 4% for the fifth consecutive month (Figure 3). As in the previous months, price movements were driven by a large number of both one-off and more enduring factors. In particular, January saw the impact of largely one-off proinflationary factors increasing in the non-food goods and services segments, with the structure of price rises changing somewhat in the food segment.

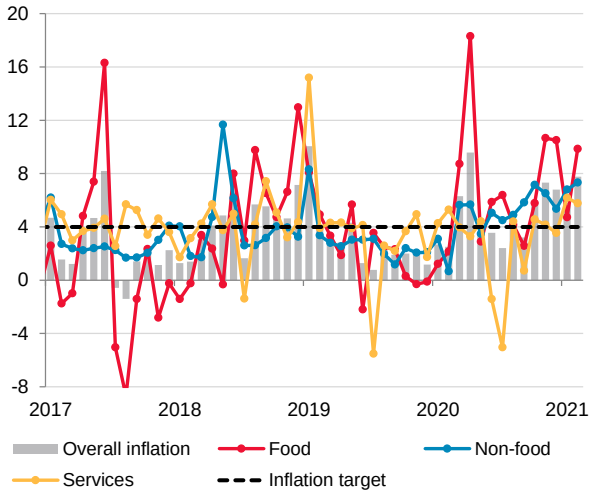
[1] Given the exit from the calculation base of slow month-on-month price growth in February.
[2] SAAR – seasonally adjusted annualised rate.

The monthly pace of consumer price rises in the *food segment* slowed significantly compared with the end of 2020, coming close to 4% SAAR in January–February (Figure 3). Government measures to rein in price rises in some socially sensitive FMCG brought to a halt sugar and sunflower seed oil price hikes (Figure 4).

The rate of price increases in flour, bread, bakery products, macaroni and cereal products remained elevated but was slowing. The ongoing decline in wholesale grain prices following the imposition of increased export duties on deliveries in excess of grain export quotas, may produce a further slowdown in processed grain product prices. As of June 2021, a grain (wheat, maize, and barley) damper mechanism will come into effect in Russia, seeking to make domestic grain prices less sensitive to world price rises (Figure 5).

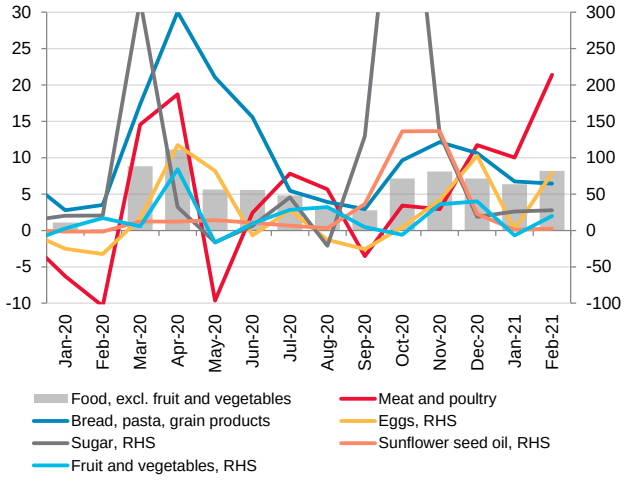
At the same time, we see some changes in the structure of some food categories' price growth in January–February: while price rises are slowing or coming to a halt in some goods which the leaders of elevated price growth at the end of 2020, the rate of price increases in some other goods (fish products, chicken meat, margarine, and tea) is accelerating.

Figure 3. Seasonally adjusted inflation, % MoM SAAR



Source: Rosstat, R&F Department estimates.

Figure 4. Seasonally adjusted inflation for some food goods, % MoM SAAR



Source: Rosstat, R&F Department estimates.

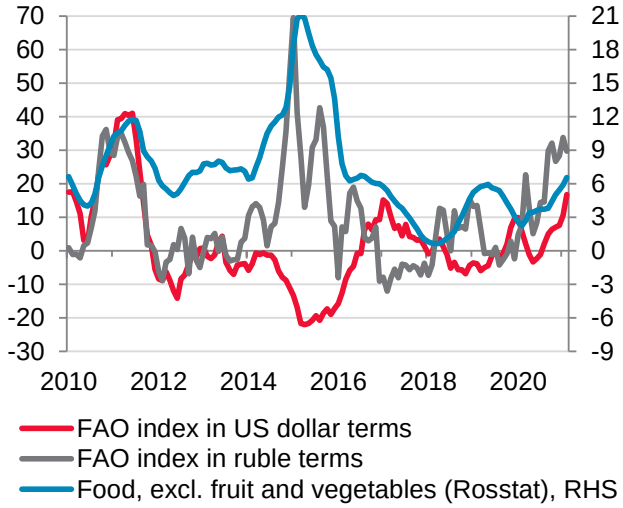
The pace of price hikes in *non-food goods* remained elevated at the start of the year, staying far above 4%.The key factor behind price growth is still the lagged effect of ruble weakening pass-through, which is, however, gradually attenuating. Non-food price rise acceleration in January–February also resulted from one-off factors.

For example, price rises at the start of the year were chiefly driven by price hikes in petrol, whose retail prices follow rises in wholesale prices on the back of annual indexation of damper mechanism parameters (Figure 6). The damper mechanism, meanwhile, provides that annual motor fuel price rises should not exceed the inflation target until 2024. We note that the RF Finance Ministry has agreed to index the damper mechanism parameters by 1% annually

starting 2024,[3] which, all other things being equal, should result in a structural slowdown of petrol price rises after 2024.

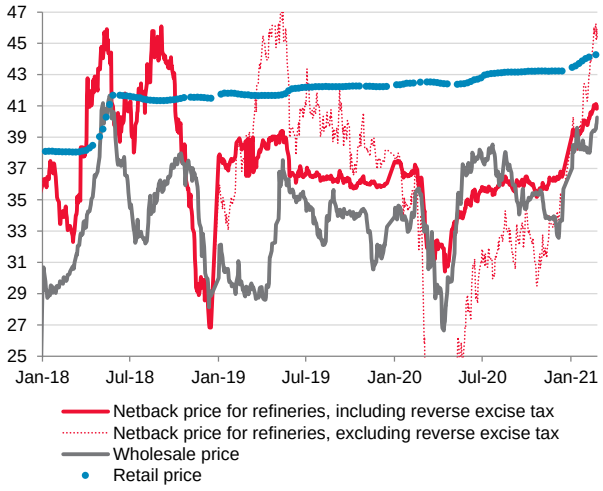
One-off elevated pressure on prices in the non-food segment was also exerted by a hike in tobacco product prices on the back of an excise tax increase. Television and radio goods, construction materials, and furniture also saw continued price rises. The pace of price hikes in goods highly sensitive to exchange rate movements (electrical goods and other household appliances, personal computers, tools and equipment, and passenger cars) slowed somewhat, possibly indicating that the effect of ruble weakening pass-through to prices is gradually attenuating.

Figure 5. World and domestic food prices, % YoY



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

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



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

The *services sector* posted a price rise acceleration in January, including under the pressure of administrative increases in housing services prices, which turned out to be temporary. The pace of services price rises remained elevated in February. A deferred price rise effect emerged at the start of the year as coronavirus-related restrictions began to ease in the regions on the back of the gradually improving epidemic situation. This buoyed demand for many market services – of hotels, culture and arts organisations and businesses offering guided tours. This is a temporary factor which may still contribute notably to price rises this year, including after the resumption of foreign tourism prices.[4]

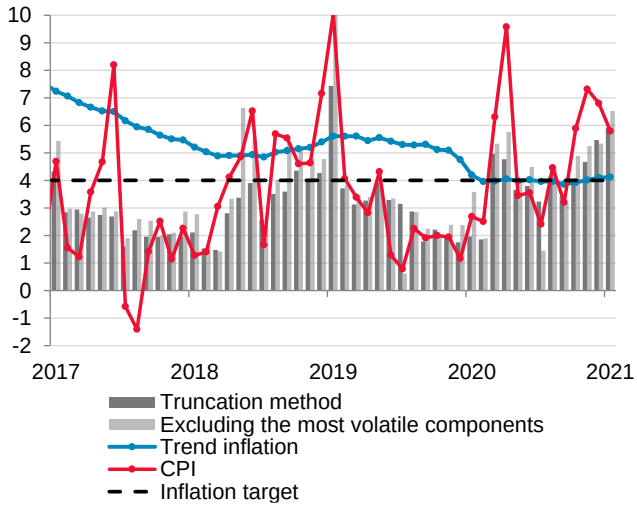
The mean modified core inflation indicator remained above 4% in January (Figure 7). The estimate of January's trend inflation also edged up to stand just above 4%.

[3] Finance Ministry agrees to adjust petrol price stabilisation mechanism / RBC / 19.02.2021.

[4] Inclusion by Rosstat of tourist travel to Turkey and the United Arab Emirates in the CPI as of 2021 can give a better insight into just monthly rather than annual movements of foreign tourism prices (due to the methodological specifics of calculation: no statistics were obtained in 2020 for the prices of tourist travel to Turkey and the UAE, therefore annual data on these items is restored using the prices of travel to other countries which were off limits for the greater part of 2020).

This indicates the continuation of enduring supply-side proinflationary factors (including structural ones). This risk common to many countries is examined in Talking Trends No. 6/October 2020.[5] There is a concurrent attenuation of generally disinflationary demand-side effect, since demand continues to recover, providing an additional contribution to price rises in some consumer market segments.

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



Source: Rosstat, R&F Department estimates.

1.2. Rise in producer costs boosted inflationary pressure

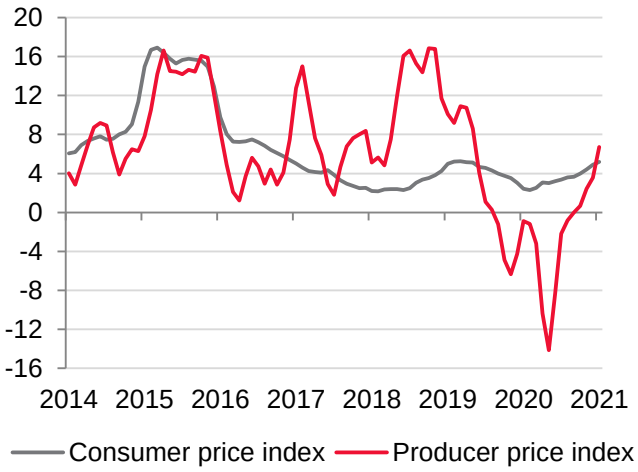
- A rise in producer prices of industrial goods accelerated to 6.7% YoY in January from 3.6% YoY in December (Figure 8). This stems from a continued increase in the pace of price hikes in manufacturing to 9.1% YoY in January from 6.0% YoY a month earlier (Figure 9). Mining and quarrying prices also started to rise after their protracted decline which began in July 2019.
- The dramatic acceleration of price rises in manufacturing is, above all, driven by prices of *intermediate goods,* with the pace of their growth surging to 10.5% YoY in January from 5.5% YoY in December (Figure 10). This group of goods is distinguished by an elevated rate of metal product price hikes. This is a direct result of world metal price rises, brought about by demand recovery as industrial output continues to expand vigorously in many countries.[6] An additional impetus to price hikes came from a renewed increase in the prices of coke and refined petroleum products driven by increasing world oil prices.
- Producer prices of *investment goods* also accelerated their ascent, which hovered around or below 4% in the last one and a half years. Price rises in these activity types gained

[5] See the *In Focus* section: Inflation in emerging market economies during the pandemic.
[6] Russia's energy companies are preoccupied with soaring metal prices / Interfax / 11.02.2021.

pace to reach 5.2% YoY in January versus 3.6% YoY in December. This may indicate a gradual rebound of investment demand as the economy recovers, which is borne out by investment goods imports (see Subsection 2.1).

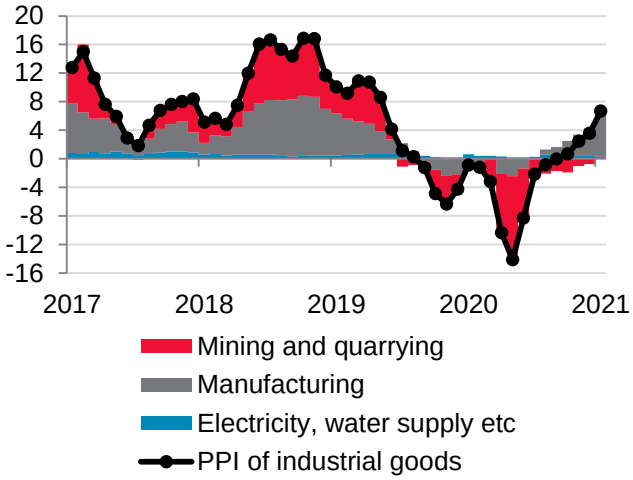
- The pace of rises in the producer prices of *consumer goods,*[7] meanwhile, accelerated just marginally, remaining fast at 10.2% YoY in January compared with 10.1% in December. The food product sector was still in the lead, maintaining double-digit price growth, little changed from December. A price rise slowdown in such categories as butter and sugar was offset by price growth acceleration in other food products.
- The pace of producer price hikes for the basket of some consumer goods[8] weighted based on the structure of household expenditure used in measuring the CPI accelerated to 8.3% YoY in January from 6.9% YoY in December (Figure 11), notably faster than consumer prices of comparable goods did, which explains the continuation of inflationary pressure in the consumer market at the start of the year.

Figure 8. Change in the producer price index and consumer price index, % YoY



Source: Rosstat.

Figure 9. Input of main industries to a rise in producer prices, % YoY

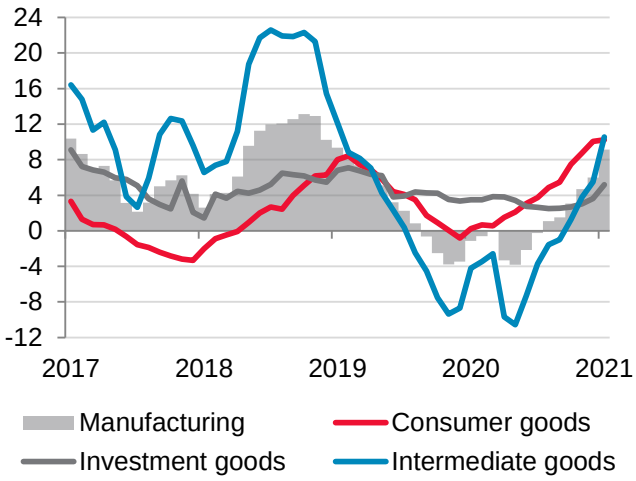


Source: Rosstat, R&F Department estimates.

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

[8] Unlike the above calculation, instead of aggregation based on activity types, we used aggregation of comparable goods in the CPI and PPI structure, such as meat products, fish products, butter and fats, dairy products, pasta, sugar, coffee, wearing apparel, footwear, detergents and cleaning solutions, perfumery and cosmetic products, household electronic appliances, and furniture. They account for 30% of the consumer basket.

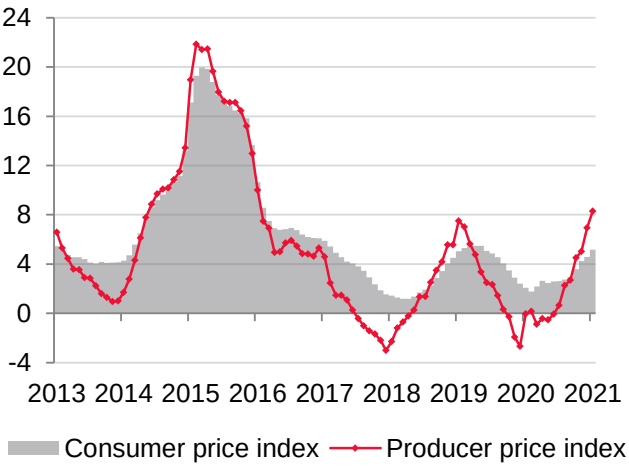
Figure 10. Producer prices for groups of manufacturing sector industries, % YoY



Note: The weights of consumer, investment, and intermediate goods in the CPI of industrial goods are 14.2%, 19.1%, and 30.5%, respectively

Sources: Rosstat, R&F Department estimates.

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



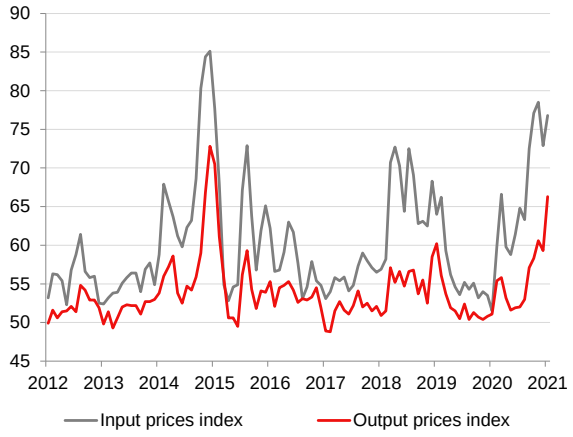
Note: Under Rosstat methodology, producer price movements are calculated net of VAT. Hence the effect of the VAT hike in January 2019 is not taken into account.

Sources: Rosstat, R&F Department estimates.

- The performance of PMI price indexes suggests that inflationary pressure remains elevated at the start of 2021: the recovery of economic activity encounters a number of supply-side constraints resulting in price rise acceleration. Inflationary pressure mounts in most of the largest countries, representing both advanced and emerging market economies. Price sub-indexes of the global PMI indexes hit longer than 10-year highs, with developed countries facing a greater increase in inflationary pressure.
- The output price index for Russia's manufacturing industries climbed to its highest level since the end of 2014 (Figure 12) and declined in services compared with December, remaining, however, above the level of the end of 2019 – start of 2020 (Figure 13). The key factor behind this is a rapid cost increase which companies are trying to partially pass on to output prices as demand for their products and services continues rising.
- Input price movements indicate growing costs. In the respondents' view, a rise in costs stems from, among other things, shortage of raw materials and climbing transportation costs. Price hikes by suppliers are owed to increasing demand for raw materials and supplies9 which is running into supply-side problems caused by restrictions put in place in many countries: the sub-index measuring supplier discipline[10] in manufacturing continues sliding. A dramatic rise in transportation costs stemming from the shortage of sea shipping containers has also started to be put through to prices. A gradual lifting of restrictions and epidemic situation improvement may increase the efficiency of logistics chains. However, uncertainty over the duration of the pandemic remains high, therefore the impact of supply-side shocks on prices may prove protracted.

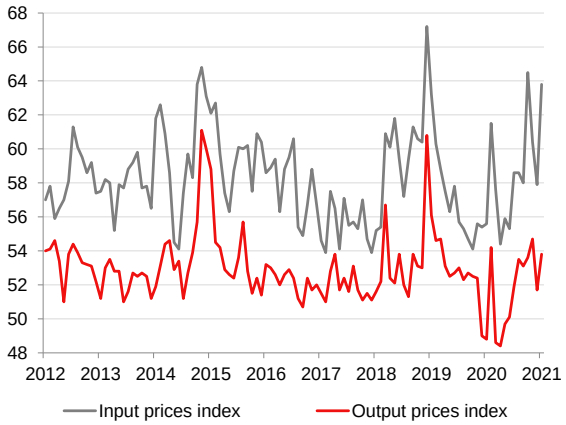
[9] The manufacturing purchasing index rose above the 50 mark for the first time since August.
[10] Suppliers' Delivery Times Index.

Figure 12. Change in PMI manufacturing indexes, pp



Source: IHS Markit.

Figure 13. Change in PMI services indexes, pp



Source: IHS Markit.

2. Economic activity

It appears from real-time data that the Russian economy was growing in January–February, beating expectations somewhat. An increasing number of industries, the power industry among them, reach or rise above the pre-coronavirus level. The higher level of electricity consumption than before the coronavirus crisis indicates the completion of the recovery process and further growth in most of the power-intensive industries (oil extraction is one important exception), in the manufacturing sector in particular.

Credit activity remained high in January–February, thanks to, among other things, loose monetary policy, regulatory easing, and government support measures. This continues to buoy domestic demand.

It is also important to note a recent resumption of consumer activity growth as household income recovers and retail lending enjoys a rapid expansion.

If the current trends continue, the need to support demand via loose monetary policy will be diminishing.

2.1. Manufacturing growth is close to pre-crisis trajectory

- Production activity showed signs of stabilisation in January after a major growth acceleration at the end of 2020. This conclusion agrees with January's business survey data and individual industries' financial flows.
- The current Rosstat estimates indicate an industrial output decline of 2.5% YoY and 1.0% MoM SA in January after a significant growth acceleration in December. This is, however, to a great extent owed to the traditional volatility of individual industries' monthly statistics.

The decline also arises in part from an upward revision to the December output data, producing a high base for comparison.

- Adjusted for one-off fluctuations of monthly data, manufacturing output stays on its medium-term (pre-coronavirus) path. This indirectly suggests that there is no output gap or loss of potential in this sector of the economy.

Industrial output declined 2.5% YoY in January after a 2.1% YoY rise in December. Adjusted for the calendar effect,[11] the industrial production fall in January came out less steep at -1.4% YoY. Our estimate based on the current data puts an industrial output decline at 1.0% MoM SA[12] (Figure 16).

The January estimate was affected by a significant upward revision to the December output, up 2.3 pp, especially for manufacturing industries, creating a high base for subsequent estimates. In line with its regular practice, Rosstat usually revises up data for the preceding month's output, based on the specifics[13] of obtaining data from the respondents.

Mining and quarrying output growth accelerated to 0.5% MoM SA in January versus a rise of 0.3% MoM SA in December 2020 (Figure 17). Oil extraction expanded 1.3% MoM in January in line with the OPEC+ agreement but remains 10.8% below last year's number. In year-on-year terms, mining and quarrying output contraction slowed to -7.1% YoY in January after the stabilisation of negative growth at the end of 2020 at -7.5% YoY in November and December each.

An estimate based on current Rosstat data indicates a manufacturing output contraction of 2.2% MoM SA in January after growth over the last three months of last year (up 2.3% MoM SA in November and December and 0.2% MoM in October 2020) (Figure 17). That said, the incoming financial flows of manufacturing industries (factoring in their weight in gross value added) rose 6.3% from the average fourth quarter level. Financial inflows expansion continued in February. In year-on-year terms, manufacturing output dropped 1.0% YoY in January after a 7.9% YoY increase a month earlier.

January's decline in total manufacturing output was mostly driven by production contraction in *investment goods* industries (Figure 17). This is, however, largely owed to the traditional volatility of monthly output statistics in some industries, primarily in the manufacture of other transport equipment, down 22.4% MoM SA in January and up 23.4% MoM SA in December. A likely output decline in this industry was suggested by individual industries' financial flows in January. At the same time, we see payments coming back to growth as early a February. Adjusted for idiosyncratic factors, investment goods industries show a gradual

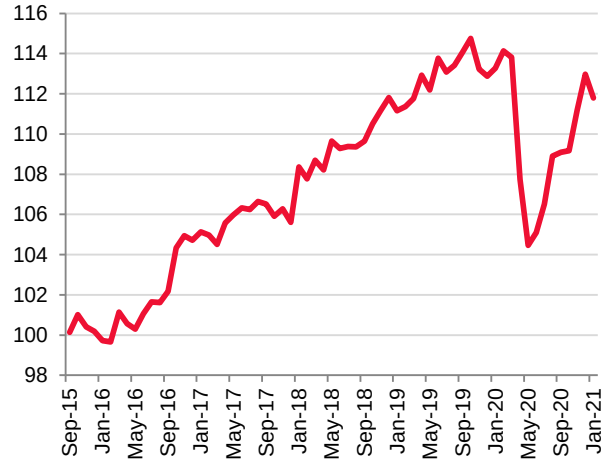
[11] There were two business days fewer in January 2021 than in January 2020.
[12] SA – seasonally adjusted.
[13] Businesses are required to submit their performance data on the fourth business day following a reporting month. As a result, in their current accounting, many producers state preliminary data which they subsequently update. Respondents tend to be pessimists rather than optimists and understate real-time output data more often. The need to revise data arises from the emergence of more relevant data on small businesses' s output because small businesses (excluding microbusinesses) are polled quarterly on a sample basis, while surveys of microbusinesses and sole proprietorships are conducted once a year.

recovery trend. A rise in investment demand is also evidenced by the import of investment goods[14] from other than former USSR countries, whose expansion in January we estimate at 7.5% YoY.

We, however, believe that, despite monetary easing, investment recovery will be generally moderate in 2021 because of uncertainty which will continue until herd immunity is achieved.

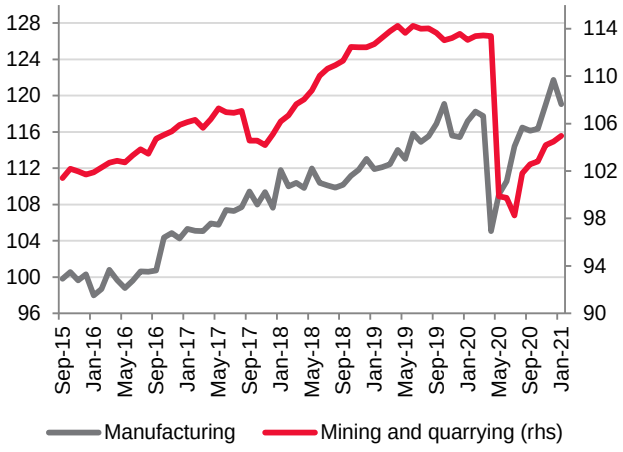
On an aggregate level, we see manufacturing output returning to the pre-coronavirus growth trajectory. This may indicate bridging of the greater part of the negative output gap even in the absence of a significant output potential loss in the manufacturing sector at large (Figure 17). However, output performance still varies widely across industries, suggesting, first, the restraining effect of persisting uncertainty over how long it will take the epidemic situation to come back to normal, and, second, protracted negative secondary effects of last year's restrictions which have hurt some industries. In particular, whereas output has already risen above the pre-coronavirus levels and pre-crisis growth trajectory in some industries (mostly manufacturing *consumer goods*, others (producing, above all, *investment goods)* have not yet brought their output back to the pre-crisis level.

Figure 14. Change in industrial production index (2014 = 100)



Source: Rosstat, R&F Department estimates.

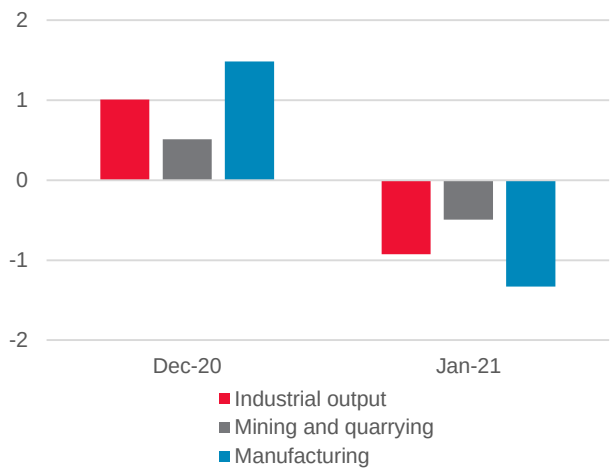
Figure 15. Change in mining and quarrying and manufacturing indexes (2014 = 100)



Source: Rosstat, R&F Department estimates.

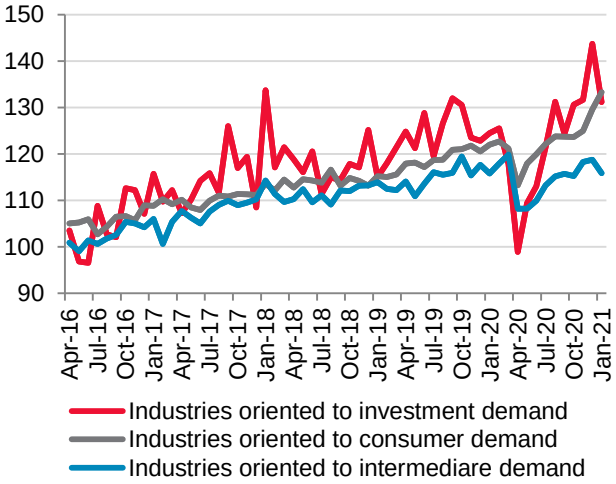
[14] We measure the import of investment goods as the difference between the total import of machinery and equipment and the import of land transport vehicles, with passenger cars sold to households (i.e., consumer goods) accounting for most of it.

Figure 16. Effect of industrial production index revision[15] in December, pp, MoM SA



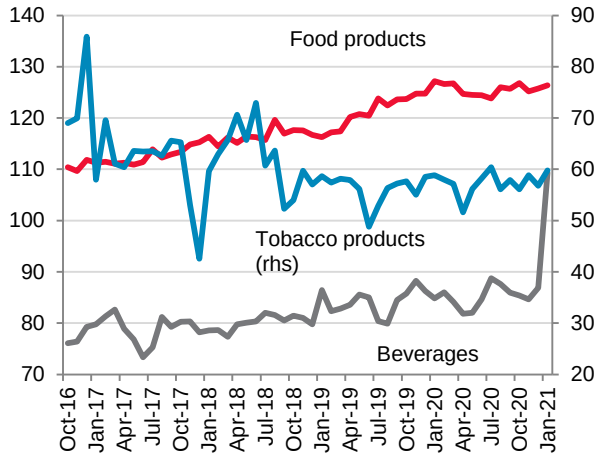
Source: Rosstat, R&F Department estimates.

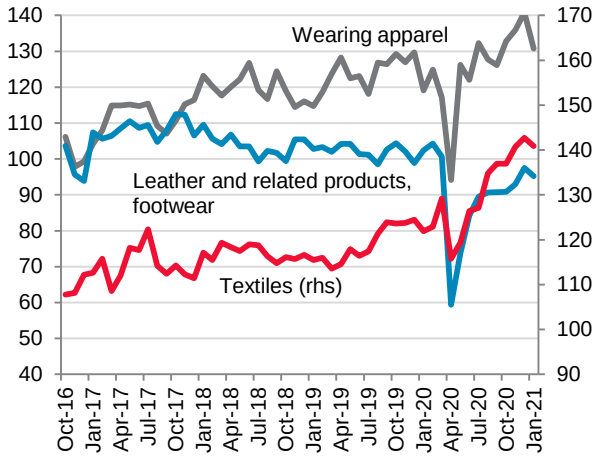
Figure 17. Manufacturing industries' output, Jan. 2016=100%, seasonally adjusted

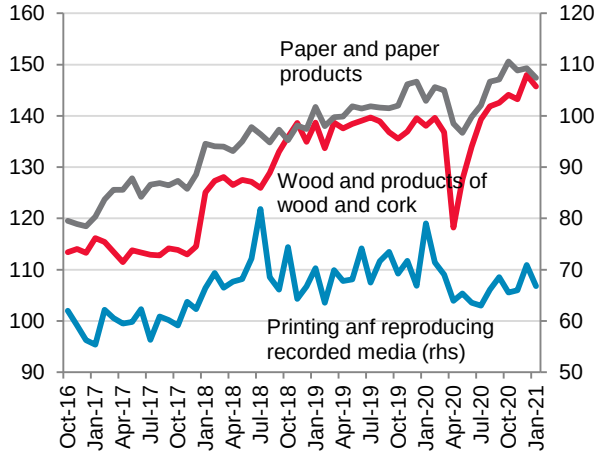


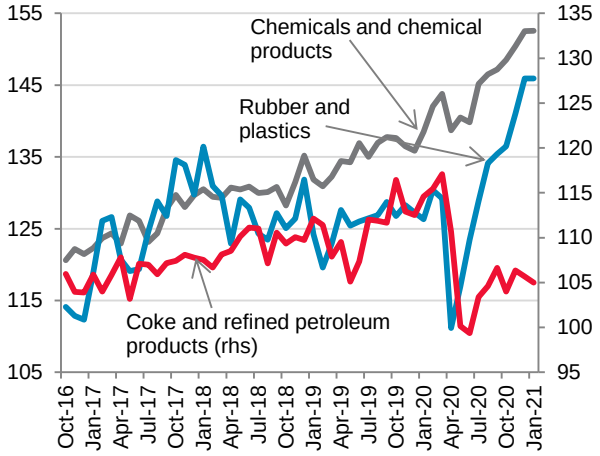
Source: Rosstat, R&F Department estimates.

Figure18. Manufacturing industries' output, December 2012 = 100%, seasonally adjusted

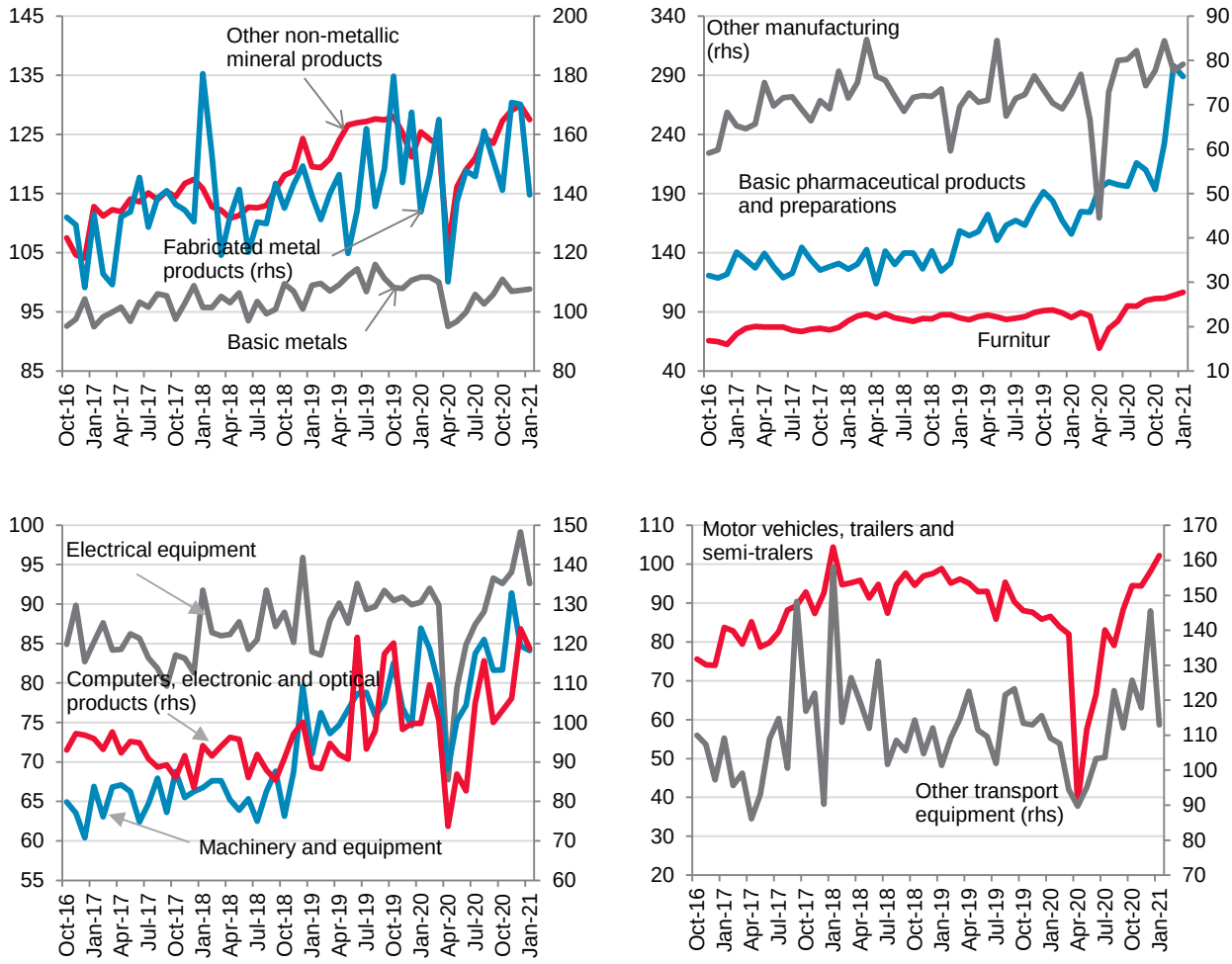








[15] The effect of revision means the difference between a rise in the industrial production index (in terms of pp MoM, SA) after Rosstat's revision to December 2020 data and before the revision to January 2021 data.



Source: Rosstat, R&F Department estimates.

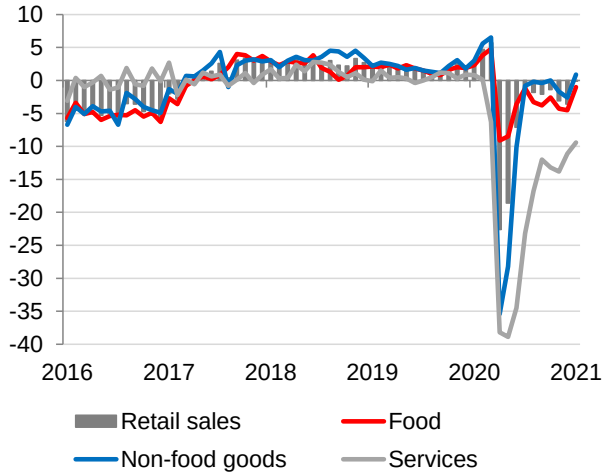
2.2. Household consumption of goods reached pre-crisis level

- Retail sales rose sharply by 3.8% MoM SA in January, almost reaching last year's levels.
- Whereas consumption of food and non-food goods has recovered to the pre-crisis levels, the services sector recovery is substantially restrained by structural changes in consumer preferences brought about by the crisis and continuing restrictions.
- A gradual improvement in the labour market situation, income (not only labour) expansion, and spending part of savings put by in 2020 amid high uncertainty and the impact of restrictions on current consumption, will provide a major support to consumption growth in 2021.

Consumer activity restrained by the epidemic situation's worsening in 2020 rose sharply in January, with retail sales growing 3.8% MoM SA versus 0.0% MoM SA in December and reached pre-coronavirus levels at -0.1% YoY after -3.6% YoY in December (Figure 19).

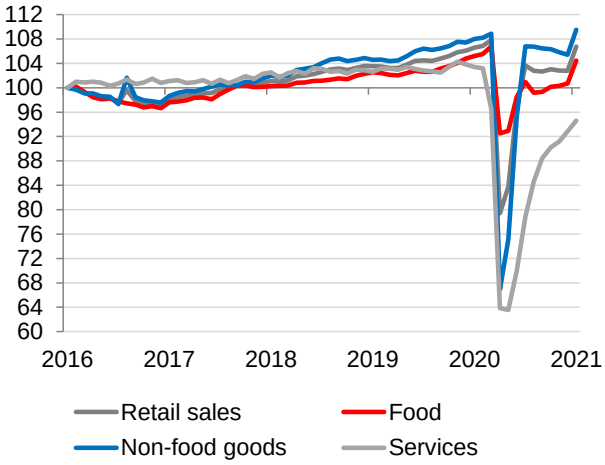
Normalization of the labour market situation, real wage growth, a generally more modest than expected economic downturn, and possible spending of savings put by in 2020 (an elevated savings ratio was posted in the Q2–Q4 quarters), allowed consumer confidence to improve, helping households return to their usual expenditure levels in product categories. January saw spending rise in all the segments, narrowing the gap with last year's level to 1.0% (up 3.7% MoM SA) in *food retail sales,* while spending on *non-food goods* came in 0.9% above the January 2020 figure (up 3.9% MoM SA) (Figure 20).

Figure 19. Services sector sales, retail sales of food and non-food goods, % YoY



Source: Rosstat.

Figure 20. Retail and services sector sales (January 2016 = 100%, seasonally adjusted), %



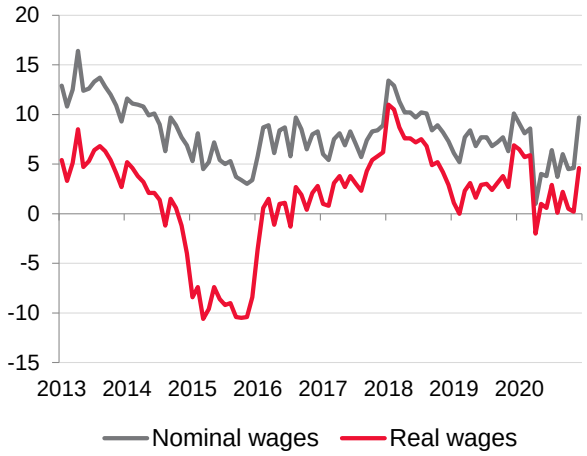
Source: Rosstat, R&F Department estimates.

Structural changes in consumer preferences brought about by the pandemic so far contain recovery in the public food and other personal services sectors. Indeed, as the epidemic situation improved and restrictions were partially lifted, the *services sector* recovery continued (up 1.9% MoM SA in January after a rise of 1.8% MoM SA in December), but a year-on-year plunge remains deep at -9.4% in January after an 11.1% fall in December.

Consumption recovery in January was buoyed by January's wage growth acceleration to 9.7% YoY for nominal and 4.6% YoY for real wages (Figure 21). We, however, believe that a large part of wage growth acceleration was owed to annual lump-sum payments, including the shift of bonus payments from the start of 2021 to the end of 2020 ahead of the personal income tax increase to 15%.[16] In particular, our analysis suggests that accelerated wage growth was recorded primarily in activity types which usually see a seasonal surge in payments between the end of the first quarter and the start of the second quarter. Thanks to this, private sector wage growth (9.5% YoY) reached the pre-pandemic level and was close to the pace of public sector wage expansion (10.4% YoY). Since the marginal consumption rate in relatively higher-income groups is much lower than in population at large, the impact of December's wage growth acceleration on consumption at the start of the year was likely more moderate.

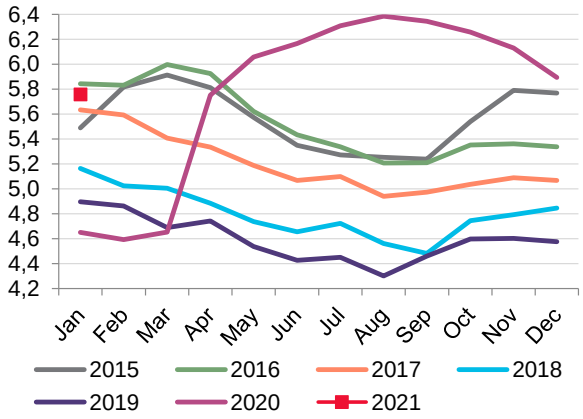
[16] For annual income exceeding 5 million rubles.

Figure 21. Wage growth rate, % YoY



Source: Rosstat.

Figure 22. Unemployment rate in 2015-2021, %



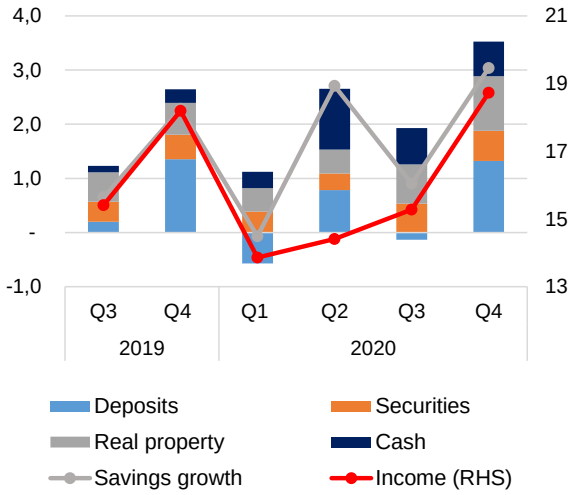
Source: Rosstat.

A continued improvement in the labour market situation has a greater effect on consumption recovery. The unemployment rate edged down to 5.8% in January from 5.9% in December (to 5.8% from 6.0% in seasonally adjusted terms) (Page 22). The unemployment decline was helped by and extensive recovery of labour demand. According to data from the HeadHunter website, January saw growth in demand for employees accelerate from 27% YoY to 68% YoY, whereas an increase in the number of CVs placed on the site continued slowing.

Meanwhile, labour supply remains depressed: the labour force participation rate in January 2021 was lower than a year earlier at 62.1% versus 62.7%. Barriers to the entry of migrant workers on account of closed borders also creates pressure in the labour market as economic activity recovers. Nevertheless, the unemployment rate will likely remain above the pre-coronavirus level. Part of the elevated unemployment rate may become persistent because of structural changes in the economy which affect the labour market. As a result, the natural unemployment rate may exceed the pre-crisis figure.

Another potential source of consumption expansion in 2021 is the spending of savings put by in 2020: the savings ratio was elevated in Q2–Q4 2020 (Figure 23). The savings partly resulted from the perceived need to put by funds in the face of increased economic uncertainty and, oftentimes, the impossibility to spend money because of restrictions imposed, for example, on services. With further recovery of economic activity and an income rise, households may bring down the savings ratio. This will support consumption growth, further diminishing the impact of disinflationary factors on consumer prices.

Figure 23. Savings expansion and household income, trillion rubles



Source: Rosstat, DOM.RF, R&F Department estimates.

2.3. Lending expansion acceleration at the start of the year

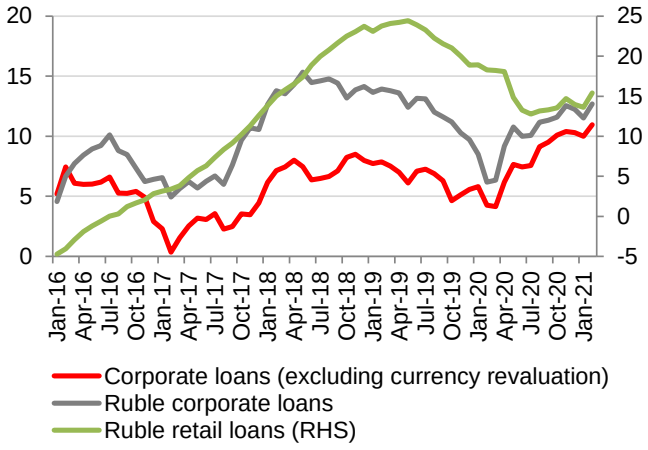
- Lending expansion was posted in all the segments at the start of the year, supporting the continuing recovery of economic activity.
- Despite banks' conservative policies regarding the issuance of new loans, monthly growth in unsecured consumer lending accelerated in January. Further lending growth in this segment should be helped by good prospects for further recovery of consumer activity as the epidemic situation improves.
- Sustainable expansion of medium- and long-term lending in the corporate segment is supported by companies' investment demand.
- The banking sector's profit rose above the pre-crisis level of January 2020. Banks' increasing profits and strong capitalisation also provide conditions for further lending growth.

Lending expansion continued at the start of 2021, supporting the recovery of economic activity. Retail ruble lending growth accelerated to 3.4% MoM SA. Growth is still driven by, above all, mortgage lending, which continues to be supported by low interest rates and subsidised loan programmes (Figure 26). Total mortgage loan issuance rose 37.4% YoY in January, with the secondary housing market accounting for a sizable part of growth: loan issuance for shared equity-financed housing increased less than for the overall portfolio (up 35.3% YoY). As a result, the ruble mortgage loan portfolio grew 21.8% YoY and 22.3% YoY with mortgage-backed securities included.

Portfolio growth accelerated in the unsecured consumer lending and auto loan segments, up 1.1% MoM SA and 1.2% MoM SA, respectively, compared with -0.4% MoM SA and 1.0%

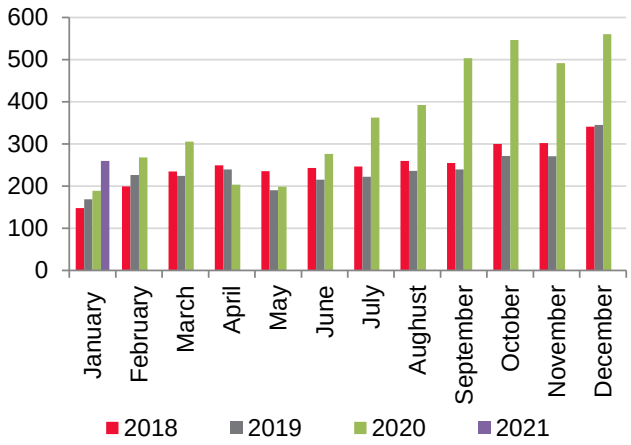
MoM SA in December 2020. Monthly growth in unsecured loans, however, remains slower than last year as banks maintain their conservative lending policies. According to National Bureau of Credit Histories data, the number of loans issued declined year on year, in particular in the credit card segment. An improvement in the epidemic situation will, however, enhance consumer activity further, including through growth acceleration in the consumer lending segment.

Figure 24. Banks' credit growth % YoY



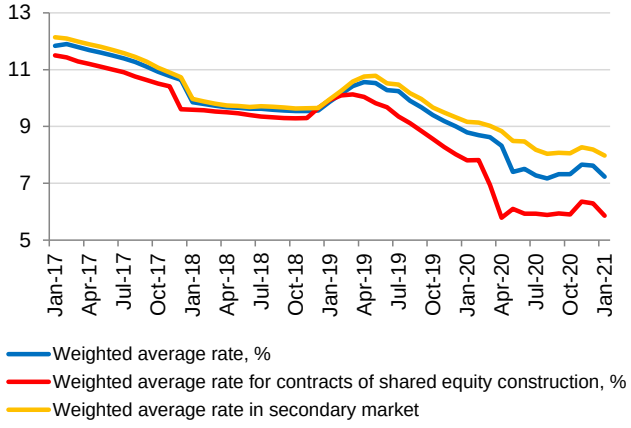
Source: Bank of Russia.

Figure 25. A total of new mortgage loans issued, billon rubles



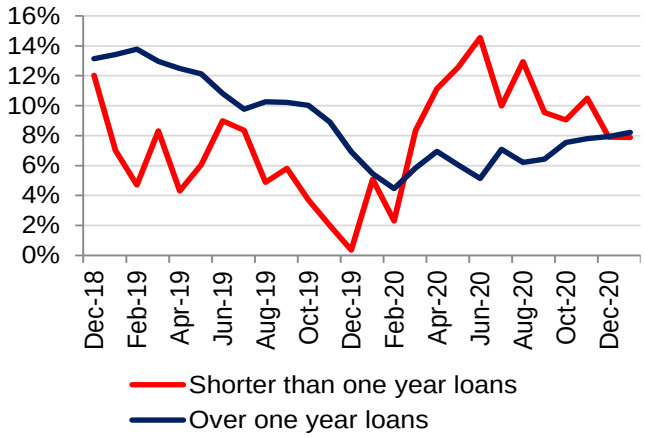
Source: Bank of Russia.

Figure 26. Interest rates in the mortgage loan market, %



Source: Bank of Russia.

Figure 27. Dynamics of loans for non-financial organization, % YoY



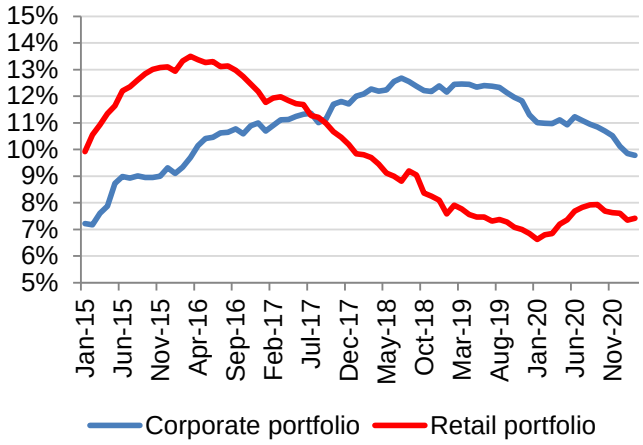
Source: Bank of Russia.

January 2021 saw ruble corporate lending expansion accelerating to 3.0% MoM SA for loans to non-financial organisations,[17] to 3.5% MoM SA for loans to financial organisations, with growth in lending to sole proprietorships standing at 1.1% MoM SA. Noteworthy is a sustainable expansion in long- and medium-term loans to non-financial organisations and sole proprietorships and a continued slowdown in the short-term loan segment (Figure 27).

[17] Excluding sole proprietorships.

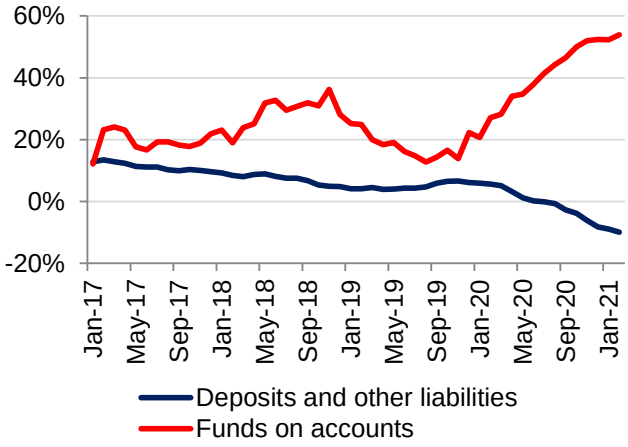
Sustainable growth in medium- and long-term lending buttresses the recovery of businesses' investment activity.

Figure 28. Share of non-performing and bad loans in claims on loans, %



Source: Bank of Russia.

Figure 29. Household funds at banks, YoY



Source: Bank of Russia.

Household ruble funds[18] contracted 0.1% MoM SA. The term structure of deposits, meanwhile, continues to change substantially, including under the influence of monetary easing: a significant rise in funds on accounts continues, with a total of time deposits shrinking (Figure 29).

The quality of claims on loans is improving: the share of overdue loans has contracted for retail and corporate portfolios alike, with the share of non-performing and bad loans[19] changing only marginally. Provisions set aside for loan claims increased in January, in part because regulatory easing is being gradually wound up for banks.

The banking sector earned a profit of 205 billion rubles[20] in January, a rise in both month-on-month and year-on-year terms. Banks' profit expansion and their strong capitalisation are conducive to further lending growth.

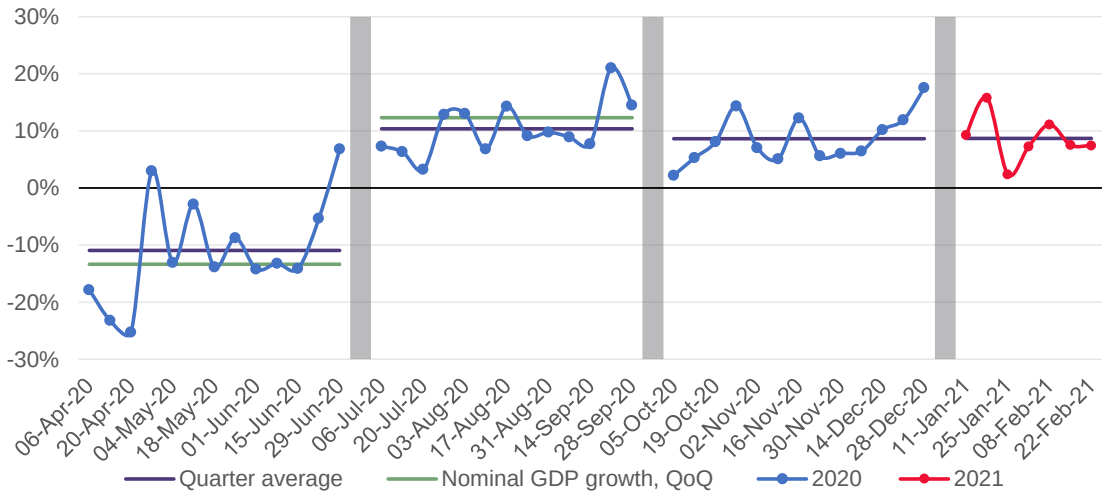
2.4. Leading indicators: economic growth continued in February

- Leading indicators suggest that economic growth continued in February. The average daily incoming payments settled via the Bank of Russia's payment system remain above the Q4 2020 level (Figure 30). Industries meeting domestic demand show the most sustainable performance of financial flows. This is, above all, true of industries oriented to consumer demand, which, it appears, is set to be the key driver of the economy's further recovery.

[18] Deposits and debt, as well as funds on accounts, excluding escrow accounts.
[19] Loans of the IV and V quality categories under banking accounting form 0409115.
[20] Profit after tax.

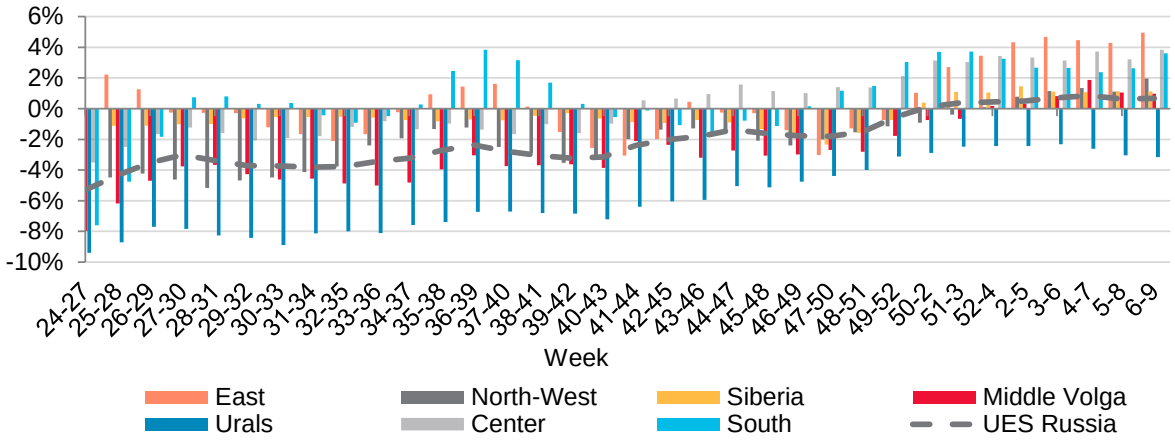
- Indeed, the continued recovery of consumer activity is borne out by a variety of real-time indicators. According to data from Romir, The First Operator of Fiscal Data, and SberIndex, nominal household expenditure consistently stood above last year's levels in February (Figure 32, Figure 33). That said, growth is, to a greater extent, concentrated in product categories, while the household consumption structure is not changing much. Impetus to further consumption structure change may come from a tangible decline in uncertainty over the emergence of new virus strains, along with mass vaccination success and the lifting of the greater part of restrictions in place.
- Production activity expansion in power-intensive industries, even exceeding the pre-coronavirus level in many of them, is evidenced by electricity consumption (Figure 31). Steady growth relative to the level of the start of 2020 is posted in all the power systems, except for the Urals IPS, where oil extraction cuts under the OPEC+ deal continue to take a toll on electricity consumption.
- The performance of PMI indexes in February also points to the economy's continued recovery. The manufacturing PMI climbed to 51.5 in February from 50.9 in January (the output sub-index went up to 53.7 from 51.2). The services index came in at 52.2 after 52.7 in January, holding above the 50 borderline mark which separates business activity expansion and its downturn.

Figure 30. Deviation of incoming payments from the previous quarter's average level, %



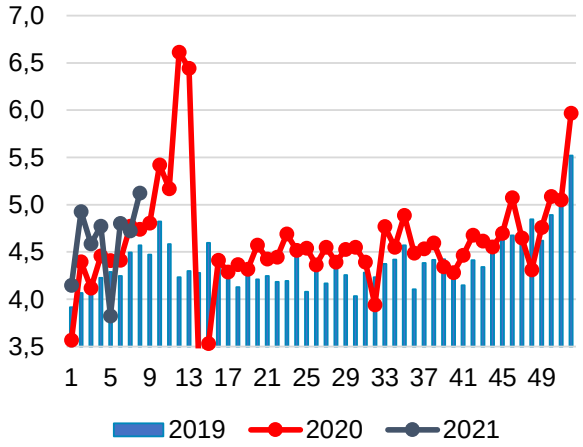
Source: Bank of Russia (Monitoring of individual industries' financial flows).

Figure 31. Electricity consumption growth rate, 4-weeks moving average adjusted for temperature and calendar factors, % YoY



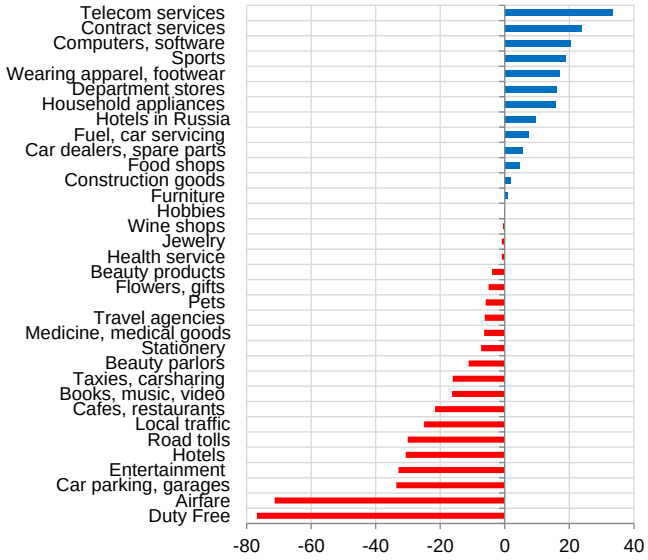
Source: System operator of United Energy System, R&F Department estimates.

Figure 32. Nominal everyday weekly household expenditure, thousand rubles



Source: Romir.

Figure 33. Change in spending on goods and services in February, % YoY



Source: SberIndex.

IN FOCUS. Short- and long-term implications of grain damper mechanism

- Seeking to stabilize rising food prices, the Russian Federation government is introducing new regulation mechanisms, including customs tariffs. A variable duty on the export of grain crops charged at the rate of 70% of difference between export and base prices will be imposed as of 2 June. Revenue from the duties are supposed to be reallocated as a subsidy in proportion to a producer's output.
- The introduction of the variable duty will help stabilize domestic grain prices and hence processed grain products prices over a short-term horizon. But the long-term effectiveness of the damper mechanism will depend on the mechanism of export tariff revenue reallocation (has yet to be developed), rules for indexing the base price and the dynamic setting of other parameters.
- Unless the duty revenue reallocation and buffer mechanism is designed and set, there are risks of a negative impact on supply in the grain segment. The realization of these risks may partially or totally eliminate the initial stabilizing effect on price movements.

Food price hikes triggered the imposition of various regulatory measures

Amid an extensive rise in the prices of a wide range of food products in the second half of 2020, the government put in place a number of price regulation measures. To stabilize domestic prices of grains (wheat, barley and maize), an export quota of 17.5 million tons has been imposed, effective from 15 February to 30 June 2021. Exports in excess of this quota will be subject to a prohibitive export tariff.[21] On top of this, an export duty was imposed on deliveries within the quota equaling 25 euro per ton for wheat in the period from 15 to 28 February, and raised to 50 euro per ton as of 1 March.

The provisional duties will give place to a permanent variable export duty mechanism, effective from 2 June 2021. Wheat exports will be subject to a duty charged at the rate of 70% of the difference between the export (contract) price and a base price of 200 US dollars (hereinafter referred to as a damper mechanism).[22] The size of the duty will be updated on a weekly basis and calculated as an arithmetic average of prices FOB[23] Novorossiysk sea port[24] over seven calendar days. The duty will not be charged if the export price stands below the base price.

Export duty revenue (possibly part of it) will be used to finance reimbursing grain producers' costs in the form of subsidies. Rules for revenue allocation have yet to be specified,

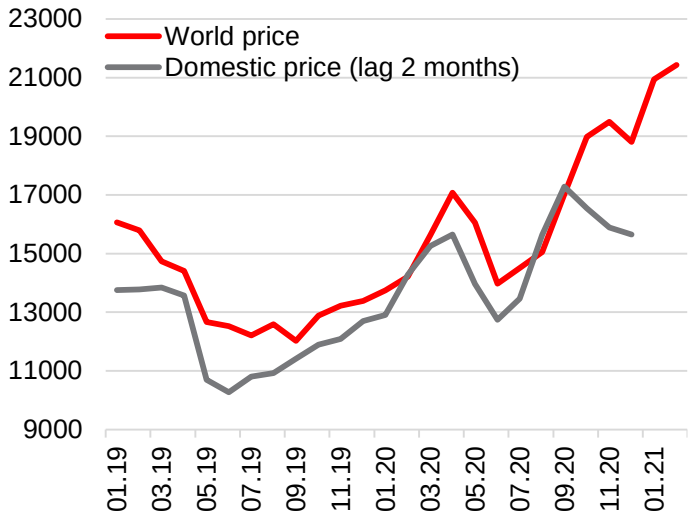
[21] 50% of the price of goods but no less than 100 euro per ton.
[22] For barley and maize, the base price was set at 185 US dollars per ton.
[23] Free on Board – terms of delivery under which the seller's obligations are deemed fulfilled as of the time when goods are loaded on board a ship.
[24] Commodity exchange registration of grain export contracts will be introduced as of 1 April. The RF Agriculture Ministry will calculate the size of the duty based on this information.

but the size of the subsidy is assumed to be set in proportion to a producer's output (or crop acreage).

In the absence of logistics and customs barriers to exports, world price[25] hikes generally translate into domestic price rises, ensuring price parity between deliveries by producers to domestic and external markets. Thus, along with ruble weakening, world price rises were a key factor behind domestic grain price hikes for most of 2020.

Russia's share in global grain exports is large enough (about 20%) for the introduction of domestic regulation to make itself felt in global markets. This is why discussions about prospects for the introduction of the damper mechanism and (to a lesser extent) export quota in Russia have, apart from standard demand-side and supply-side factors, triggered an additional increase in world wheat price rises. Thus, given the expected effect of damper mechanism and export quota introduction on grain exports, the domestic price[26] started to diverge from the world price at the end of last year (Figure 34).

Figure 34. Wheat price, rubles/ton



Source: Bloomberg Finance L.P.

Introduction of grain damper mechanism will limit short-term inflation risks…

Wheat and grain crops are an important component in the production cost structure of other foods, therefore changes in food price inflation. Change in grain prices directly affects production costs of items such as flour, bakery and pasta products, meat and poultry meat (via the cost of fodder for the last two items). Our estimates suggest that a 10% wheat price rise/fall produces an additional CPI rise/decline of about 0.1 pp, all other things being equal.[27] Based on this, we estimate the contribution of domestic grain price hikes in 2020 to overall price rises at 0.2–0.3 pp.

[25] Here and further on, the world price means an export price FOB Novorossiysk port.

[26] Here and further on, the domestic price of the IV class wheat in the Central Black Soil Region is used as a calculation basis

[27] The estimates are based on the share of grain in the production cost of these products. Only the direct effect of cost changes is estimated, all other things being equal.

The damper mechanism seeks to offset a significant part of the impact of world grain price rises on domestic prices. We have estimated the level of domestic wheat prices which would ensure an export parity price[28] under various world grain prices and ruble exchange rates to the dollar (Table 1). With the damper mechanism in place, the domestic parity price under the world price above USD 200 is much lower than with no export duty charged. This suggests that the damper mechanism can fairly efficiently smooth over the impact of world grain price rises on domestic prices. At an export price above USD 300 per ton, the difference between the parity price with the damper mechanism in place and without it can equal about 25%. Moreover, after the introduction of the damper mechanism, the parity price will only exceed the current domestic grain price if the world wheat price surges far above USD 300 or the ruble exchange rate falls dramatically. That said, the damper mechanism effect is asymmetric and a world price fall below the base level will fully translate into domestic price movements.

Table 1. Export parity for domestic wheat prices, rubles/ton

	US dollar/ruble exchange rate						
World price, USD	**60**	**64**	**66**	**70**	**74**	**76**	**80**
	No duty charged						
400	21 518	23 049	23 815	25 346	26 877	27 643	29 174
350	18 647	19 987	20 657	21 997	23 336	24 006	25 346
300	15 776	16 924	17 499	18 647	19 795	20 370	21 518
250	12 905	13 862	14 341	15 298	16 255	16 733	17 690
200	10 034	10 800	11 182	11 948	12 714	13 096	13 862
150	7 163	7 737	8 024	8 599	9 173	9 460	10 034
Export duty charged (grain damper mechanism)							
400	13 479	14 474	14 972	15 967	16 963	17 460	18 456
350	12 618	13 556	14 025	14 963	15 900	16 369	17 307
300	11 757	12 637	13 077	13 958	14 838	15 278	16 159
250	10 895	11 718	12 130	12 953	13 776	14 187	15 010
200	10 034	10 800	11 182	11 948	12 714	13 096	13 862
150	7 163	7 737	8 024	8 599	9 173	9 460	10 034

Source: Bloomberg Finance L.P., R&F estimates.

We note that the current domestic wheat price (just below 15 thousand rubles per ton[29]) already factors in an export duty of 50 euro per ton, in effect as of 1 March, and is generally close to an export price of USD 281 per ton.[30] The domestic price decline since the end of 2020 indicates a high probability of a rise slowdown and further stabilization of the consumer prices of processed grain products and meat. This should help a slowdown in the current overall price rises.

…but medium- and long-term implications for the economy and inflation require a comprehensive study

At the same time, medium- and long-term implications of damper mechanism introduction require a comprehensive assessment. In particular, we can identify several potential risk

[28] An export price less transportation costs and customs duty plus domestic VAT.
[29] As of 26.02.
[30] FOB Novorossiysk port, as of 26.02.

factors for grain market conditions which should be taken into account in the subsequent application of regulatory measures to be introduced.

First, it is important to ensure an efficient allocation of duty revenue to avoid risks of unreasonable support for loss-making businesses. If grain producers no longer have incentives to expanding grain output and investing in technology upgrading, this may have an adverse effect on Russian producers' competitive advantages in the global market.

Second, if the opportunity to earn higher profits when global market conditions are favorable is curtailed, it may become less attractive to grow grain crops. Russia's grain harvests have been strong in recent years, helped, in addition to acreage expansion and technology upgrading, by favorable weather conditions. But weather conditions may change, reducing output significantly. In the period of poor harvests, world prices usually rise, and with no permanent damper mechanism in place, this acts as a natural mechanism of compensation for a crop output contraction. Risks of a poor harvest can be compensated through a symmetric setup of the damper mechanism, as discussed below.

Third, the hypothetical medium- and long-term realization of the above risks may have an effect on markets for related food products. In particular, the tightening of grain market regulation may provide incentives for producers to move to product markets which are not yet subject to regulation. In the case of grain crops, this may motivate producers to shift crop rotation towards, for instance, less demanding oil-bearing crops, thereby engendering the risk of agricultural land degradation. On top of that, grain output contraction in Russia as a major exporter may spur a rise in world prices, putting upward pressure on the production costs of related foods products. Thus, the stabilizing impact of the damper mechanism on price movements may shed its effectiveness (in full or in part) in the longer term.

Fourth, as pointed out above, the current parameters of the grain damper mechanism allow limiting domestic price hikes when world prices rise, but do not limit a price decline if global price conditions worsen. All other things being equal, the asymmetric damper mechanism drives the balance of agricultural producers' risks and expected revenue/profits down. One solution which could balance the damper mechanism's effect on agricultural producers and grain processors/sellers' financial position is to make it *symmetric*, providing for a mechanism of a reverse export duty intended to operate when the price falls below the base level, in the same way as the oil damper mechanism operates. This would enable the volatility of domestic wheat prices to be additionally reduced (Figure 35), which would provide a compromise for all market participants along with a beneficial effect of bringing down the volatility of food price inflation and heightening its predictability.

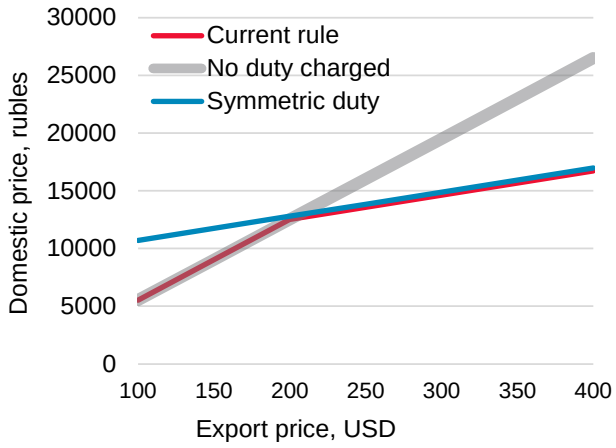
At the same time, it is not easy to design specific parameters of a symmetric damper mechanism operation. This approach would require a sort of accumulation fund to be set up to reserve revenue raised when grain prices were relatively high and reallocate it as subsidies in proportion to businesses' output, paying this money back to producers when market conditions worsen.

Also, if a symmetric damper mechanism is put in place, the choice of a base price becomes especially important. It should be chosen so as to make risks of a rise and decline in prices relative to it fairly symmetric. We believe that at USD 200 per ton, the current base price of wheat looks relatively unbalanced. Data going back to 2010 indicates that world prices fell

below USD 200 per ton for a relatively short time, deviating from this mark insignificantly (Figure 36). One solution would be to use a moving average over a relatively long period as a base price. Apart from that, it would be fair to index this price annually – for US inflation as an option. This would allow factoring in a gradual increase in producer costs incurred in purchasing imported raw materials and equipment.

One of the sources of short-term risks of damper mechanism introduction is the duration of export duty imposition. A weekly tariff change creates high uncertainty for producers, because many export contracts are signed for one- two months to come. In other words, at the time when a contract is signed, the exporter will not know the size of the duty to be paid at the time when the goods cross the border. This uncertainty would discourage producers/traders from dealing with grain crops. These risks could be eliminated by lengthening the period after which the duty is updated to the average time between the signing of an export contract and the delivery of goods under it.

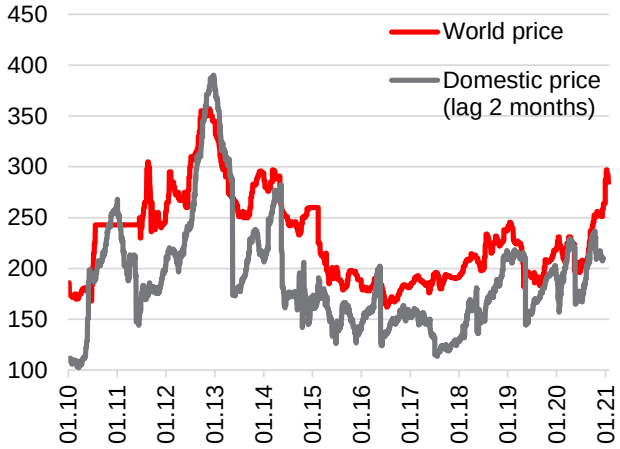
Figure 35. Wheat parity price, rubles per ton*



** At the 73 USD/ruble exchange rate.*

Source: Bloomberg Finance L.P., R&F Department estimates.

Figure 36. Daily wheat quotes, USD per ton



Source: Bloomberg Finance L.P.

Therefore, measures of customs regulation for grain crops can efficiently stabilize domestic grain prices and reduce their sensitivity to world price changes (their rises). This would help slow rises in consumer prices of processed grain and meat products, all other things being equal. The stabilizing effect of the damper mechanism may, however, be limited in time. Indeed, if producers no longer have incentives to output expansion and investment in technologies, there may emerge longer-term risks of decreasing competitiveness in global markets and generating upward pressure on food producer prices and headline inflation.

To neutralize the above risks, it is important, above all, to take steps to establish an efficient mechanism for reallocating the revenue from duties among efficient producers, having comprehensively analyzed the balance of external factors affecting the fluctuations of their expected revenue/profits and, ultimately, their output. Also, modifying the current version of the damper mechanism and making it symmetric by adding a reverse duty may reduce the volatility of domestic grain prices, limiting their upward and downward movements. This would make grain producers and domestic consumers' risks more balanced and bring down inflation volatility.