Center
for Macroeconomic Research

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Established in 1841

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23.09.2009

Inflation in Russia: eight months results and 2009 year-end forecast

The global trend of falling inflation has reached Russia. The factor analysis reveals, that when compared to 2008, current year shows lower rate of consumer price inflation resulting from abating inflationary expectations, lower rate of inflation on the global scale and lower broad money growth at the end of 2008 - beginning of 2009.

Model inflation forecast made by the Center for Macroeconomic Research shows about 11% in 2009, whereas the actual inflation could be even lower. Provided the rouble exchange rate and oil prices remain stable, there should be an increased demand for money in Russia contributing to a moderate CPI growth, the trend which will be supported by a low level of aggregate demand.

January-August 2009 Inflation: factor analysis

At long last the global trend of inflation slow-down has come to Russia. In August and first weeks of September we enjoyed a zero consumer price growth bringing the year-to-date inflation down to 8.1% against 10.2% in January to mid-September, 2008. The Center for Macroeconomic Research (CMR) regression analysis (Annex: Table 1) reveals the latest inflationary effect of the most significant factors.

When comparing the current situation with that of 2008 (Annex: Table 2) one can make a conclusion that the **strongest factor** determining this year's lower consumer goods price growth is **decreasing inflationary expectations**. We assess that contribution of this factor to 8.1% inflation in Jan. to Aug. 2009 stands at **5.8 pp against 6.5 pp previous year**. Inflationary expectations began to abate noticeably in spring 2009 driven by crises-depressed consumption level and stabilized rouble exchange rate.

This year's inflation slow-down is also related to a decreasing broad money growth (M2X) evident since the middle of 2008 and getting more pronounced with the devaluation of the domestic currency at the end of 2008 - beginning of 2009. According to CMR the time lag of broad money growth impact on consumer prices makes 11 to 12 months. In the period from January to August 2008, annualized M2X growth averaged 35.2% against 45.3% for the same period of 2007. Thus, **in the 8 months of 2009 broad money growth contributed 0.3 pp against 0.7 pp in Jan. to Aug. of the previous year.**

Fig.1. Consumer price and producer price inflation, % y-o-y.

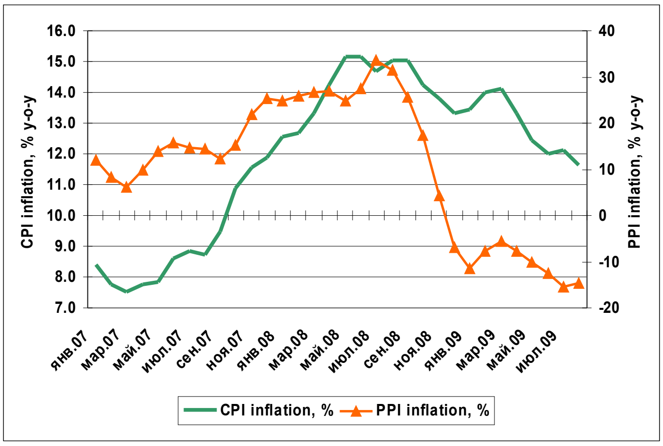
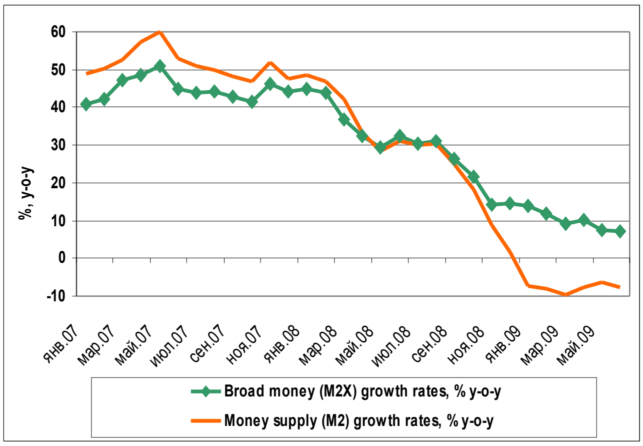


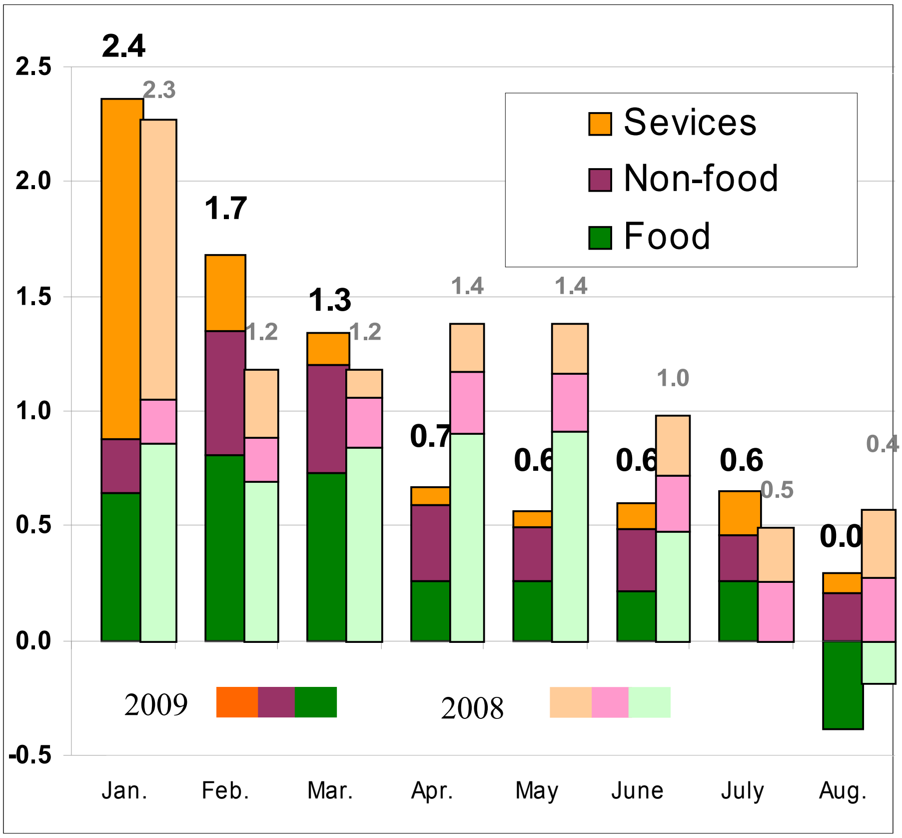
Fig.2. M2 and M2X aggregates growth rates, % y-o-y.



This year **decreasing producer prices** acted as another factor in the Russian economy **driving inflation down** under the impact of global economic crisis. Regression analysis shows a five-month lag between the producer prices change and their reflection in consumer prices. Since August 2008 to February 2009 producer price index decreased nearly by 24%. Thus, **in the 8 months of 2009 producer prices impact measured -1.0 pp against +0.5 pp in Jan. to Aug. of the previous year.**

Moreover, **in the Russian economy the fluctuation of food product prices** and aggregate CPI is dependent on the **global** growth of **food /agricultural commodities prices**. Change of the world prices for agricultural products feeds in the consumer price index with a 1 to 2 months lag. The recovery of soft commodity markets after a dramatic fall of prices in autumn of 2008 is much below the pre-crisis rates. From October 2008 to July 2009 Goldman Sachs food commodities price index (S&P GSCI Agriculture) grew by 5.2% against 22.7% for the relevant period of 2007-2008. Correspondingly, the contribution of **agricultural production prices in the global markets to inflation in Russia made 0.1 pp in eight months of 2009 against 0.5 pp in January to August of 2008.**

Fig. 3. Contribution to monthly inflation in Russia, 2008-2009.



A diminishing contribution of growing agricultural prices to the aggregate 2009 inflation rate is also confirmed by the analysis of the dynamics of CPI components (Fig. 3). **In January to August, 2009 food products price growth accounted for 2.8 pp of the aggregate 8.1% CPI growth** (compare with 4.7 pp contribution to overall 9.7% inflation in January to August, 2008). In the first eight months of 2009, the food product price index rose by 7.1% (against 8.6% in eight months of 2008).

At the same time, there were two factors - **early 2009 devaluation of rouble and growing federal budget spending – which exercised an upward pressure upon consumer price growth this year**. Statistics show, that from the beginning of 2009, after the rouble devaluation, the lag between the exchange rate movements and their reflection in the inflation rate changed. Before the scheduled devaluation in January, 2009, the lag between the movements in the rouble exchange rate and consumer price growth was about eight months. This year, after a significant depreciation of the rouble in January-February (23.6% against December and 36% against August, 2008), consumer prices including the prices of the imported goods, have reacted to the exchange rate movements with only a month lag. In this connection, rouble devaluation of January-February, 2009 has already had its full impact on inflation. Given FX stability, the lag between the exchange rate movements and their inflationary impact might increase again.

Fig.4. RUB/USD and RUB/bi-currency basket.

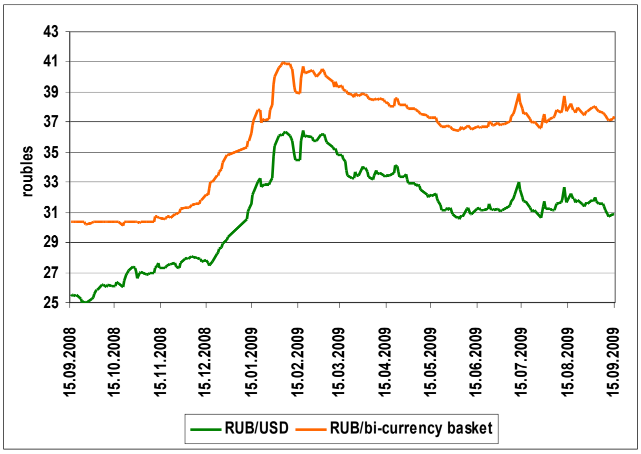
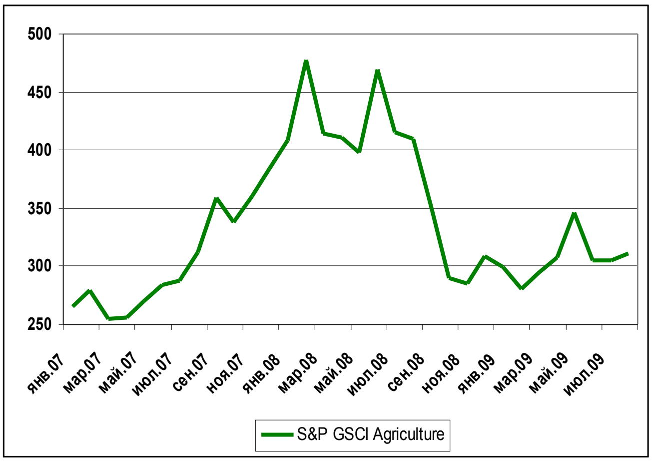


Fig.5. Agricultural products global price index S&P GSCI Agriculture**.**



In January to August 2009 depreciation of the rouble against the bi-currency basket contributed 1.1 pp to the cumulative growth of consumer prices. Depreciation had the greatest impact on non-food products, their prices growing by 7.6 % in eight months (5,8 % for the same period of 2008). **In 2009, the January to August growth of non-food product prices contributed 2.6 pp to the 8.1% growth of CPI** (against 2.0 pp contribution the overall inflation of 9.7 % in January to August, 2008).

In our opinion, the growing state budget expenditure is somewhat increasing its impact on the CPI growth as compared to the previous year. In January to August of 2009, non-interest budgetary expenditure made 22% of GDP against 14.8% in the same period of 2008 whereas the respective 2009 contribution of non-interest revenues to inflation made 0.2 pp against actually zero impact in the same period of 2008.

>Inflation forecast for 2009 year-end

Model estimates of CMR (see Annex) indicate that **considering the time lag of many factors there will be no substantial increase in prices until 2009 year-end.** Based on the most conservative assumptions on the rouble exchange rate against the bi-currency basket at 37.74 RUB, oil price at USD 65 to 70 per barrel and moderate growth of global agricultural production prices at 1.5% per month to the end of 2009, our model inflation forecast stands at 11%. Actual annual inflation might be even lower.

Provided the rouble exchange rate and oil prices remain stable, there should be an increased demand for money, which fell drastically in autumn of 2008; this will contribute to a low rate of CPI growth. The trend will be supported by a low aggregate demand. A different scenario of development is possible only in case of another panic in the currency market causing another fall in the demand for domestic currency.

In 2010, Russia may face changes like any other emerging market country. In the first half of the year the downward inflation trend will continue but should there be a global commodity price growth together with the monetary factors, it may bring about another spiral of inflation acting.

> Annex: inflation Model and 2009 year-end forecast for Russia

Inflation model

Table 1. Dependent variable: CPI growth per month, %

Variable	Coefficient	Lag in months
Constant	0.28	-
Inflation expectation / CPI growth (-1)	0.40	-
For January	1.38	-
For August	-0.39	-
Broad money (M2X) growth	0.01	-11
	0.02	-12
Producer Price Index growth	0.05	-5
RUB/bi-currency basket depreciation	0.06	-1
Global agricultural price growth	0.01	-1
	0.01	-2
Growth of non-interest expenditure in the federal budget (% of GDP)	0.04	-5

Forecast assumptions

- Maintaining the August level of RUB 37.74 against the bi-currency basket until the 2009 year-end
- Gradual growth of global food prices (S&P GSCI Agriculture): at 1.5% per month

Table 2. Factor analysis and CPI inflation forecast for 2009.

Factor	Jan.09	Feb.09	Mar.09	Apr.09	May.09	Jun.09	Jul.09	Aug.09	Jan.-Aug.08	Jan.-Aug.09	Sept.-Dec.08	Sept.-Dec.09	**2008**	**2009**
Seasonal components	1.4	0.0	0.0	0.0	0.0	0.0	0.0	-0.4	1.0	1.0	0.0	0.0	**1.0**	**1.0**
Inflationary expectations	0.6	1.2	1.0	0.8	0.6	0.5	0.5	0.5	6.5	5.8	2.3	1.8	**8.9**	**7.8**
Broad money (M2X) growth	0.0	0.1	0.0	0.0	0.1	0.0	0.0	0.0	0.7	0.3	0.5	0.1	**1.2**	**0.4**
Producer price growth	0.0	-0.2	-0.3	-0.4	-0.4	-0.2	0.2	0.1	0.5	-1.0	0.8	0.3	**1.4**	**-0.7**
Change of global agricultural prices	0.1	0.0	-0.1	0.0	0.1	0.2	-0.1	-0.1	0.5	0.1	-0.9	0.1	**-0.4**	**0.3**
Change of RUB/bi-currency basket rate	0.4	0.7	0.6	-0.1	-0.2	-0.2	-0.1	0.1	0.0	1.1	0.2	0.1	**0.2**	**1.2**
Non-interest budget expenditures, % of GDP	0.0	-0.1	0.1	0.1	0.4	-0.1	0.0	-0.3	0.0	0.2	0.0	0.05	**0.0**	**0.3**
Forecast*: CPI growth	**2.4**	**1.7**	**1.3**	**0.7**	**0.6**	**0.6**	**0.6**	**0.0**	**9.7**	**8.1**	**3.6**	**2.8**	**13.3**	**10.9**

***Forecast: September to December, 2009.**

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