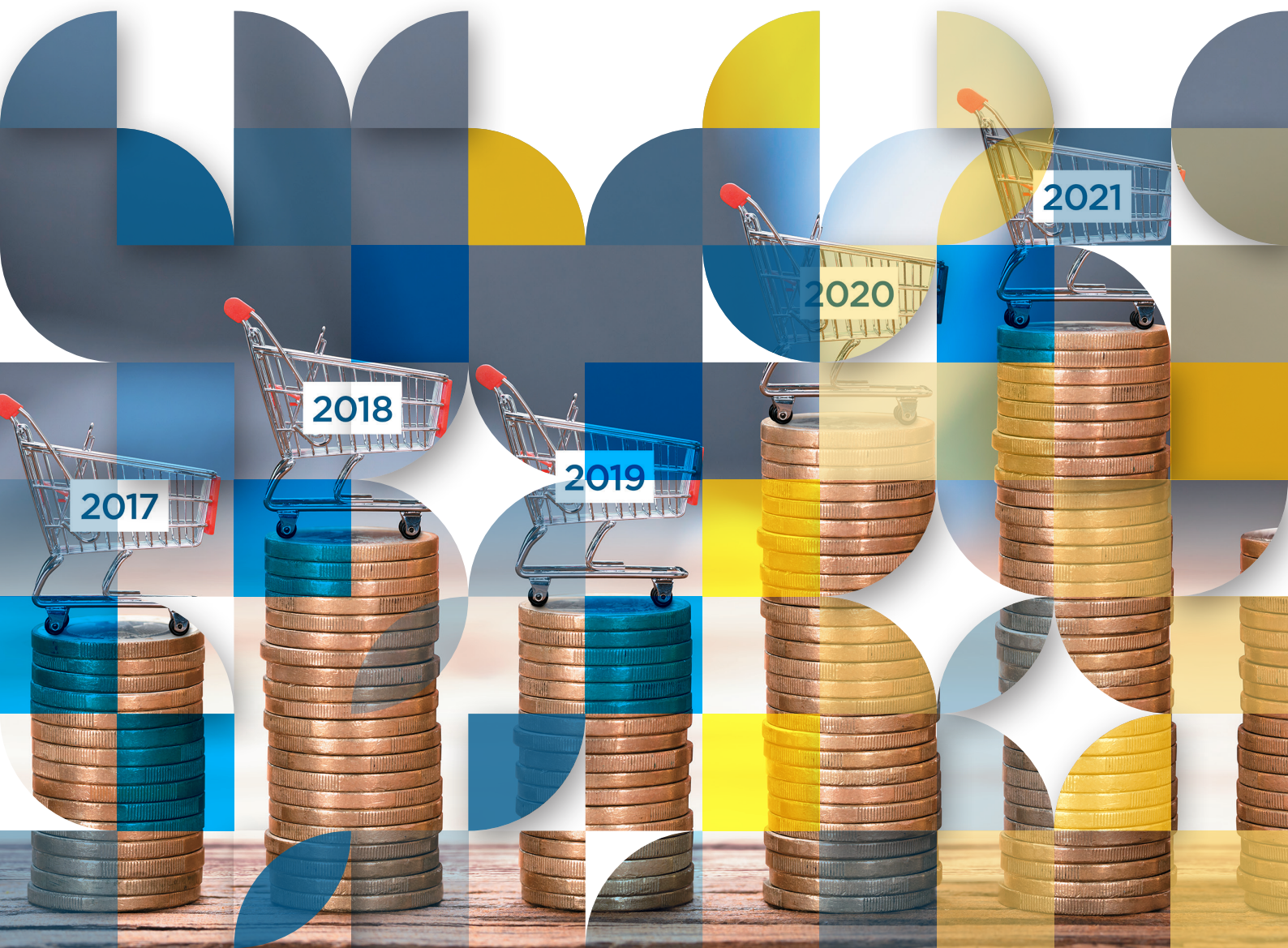


MACROECONOMIC FORECAST

The Return of Inflation:
For How Long and Should
We Fear It?

June 2021



EDB MACROECONOMIC FORECAST

THE RETURN OF INFLATION: FOR HOW LONG AND SHOULD WE FEAR IT?

JUNE 2021

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Centre for Country Analysis
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The document contains a detailed description of the current domestic and external macroeconomic conditions, and a consistent set of forecasts. The analysis covers existing mutual links among six economies (Armenia, Belarus, Kazakhstan, Kyrgyzstan, Russia, and Tajikistan) and their key trading partners. Macroeconomic projections are developed by the EDB using the integrated modelling system (IMS) underpinned by a multi-country dynamic stochastic general equilibrium model. Additional information on that system is presented in a joint EDB and EEC report ([EDB, 2016](#)).

Keywords: economic growth, forecast, GDP, inflation, exchange rate, demand, monetary policy, budget, interest rate, investments.

JEL: E17, F15, F31, H62, O11.

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SUMMARY

The global economy is in an upswing. The global aggregate PMI in May reached a 15-year high of 58.4 points. Business activity is rising in almost all major economies, with the U.S. showing the strongest momentum. The service sector is playing an increasingly important role in the global economic recovery. Activity in the tourism and leisure sector increased in April for the first time since January 2020, and in May, it grew at the fastest rate ever observed over the period. Industry is also maintaining its growth momentum. Large-scale fiscal and monetary stimuli reinforce a strong global economic recovery, foremost in developed countries.

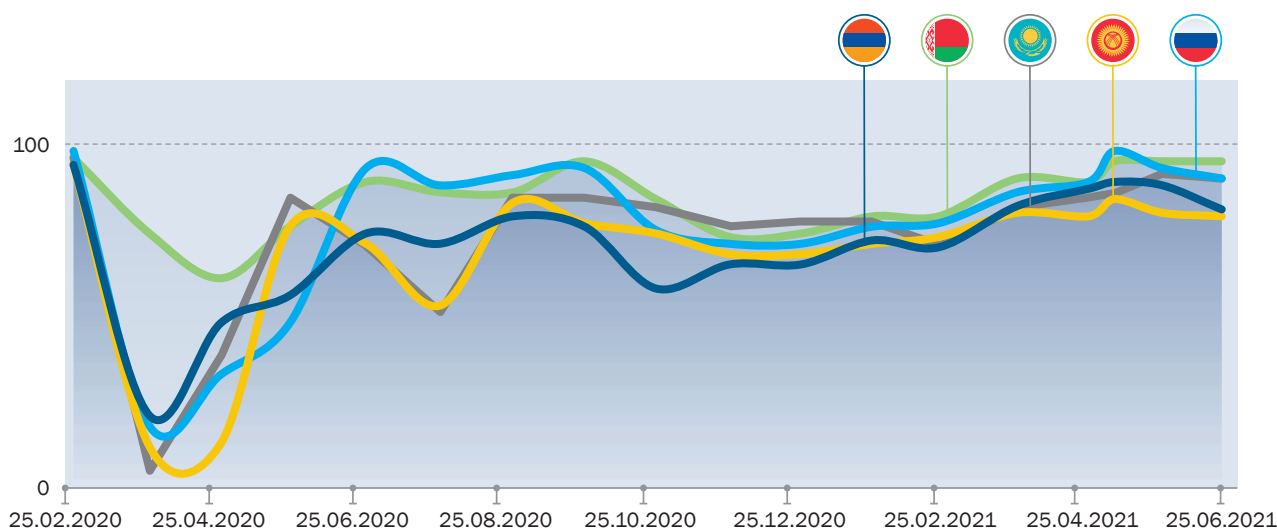
The EDB operating region was not immune to global trends in the first half of this year, as business activity recovered rapidly (Figure 1). The economies of Russia and Kazakhstan, according to the EDB estimates, were already reaching the pre-pandemic level by the end of 2Q 2021. That was possible largely due to government support measures and the marked easing of fiscal and monetary policy last year. Kyrgyzstan's economy will achieve positive growth early in the second half of the year. A strong trend is seen in Armenia and Tajikistan, where GDP could grow by around 4.0% and more than 7.5% YoY, respectively, over the six-month period. The exports of the Bank's member states in the first half of the year were substantially supported by stronger global economic activity and soaring prices for key export commodities. It is thanks to the increasing external demand that Belarus's GDP growth is expected to be around 3% YoY for January–June. The easing of restrictive measures as a result of an improved epidemiological situation attributed greatly to the increase in business activity in the region.

Figure 1. Economic Recovery in EDB Member States

A) Real GDP (4Q 2019 = 100%, seasonally adjusted)

	IV.19	I.20	II.20	III.20	IV.20	I.21	II.21
Aggregate GDP	100	100	92	95	98	99	100
 Armenia	100	100	85	91	91	97	97
 Belarus	100	99	97	99	100	100	102
 Kazakhstan	100	100	93	95	98	98	100
 Kyrgyzstan	100	98	89	92	86	88	93
 Russia	100	100	92	95	98	99	100
 Tajikistan	100	100	102	103	105	107	109

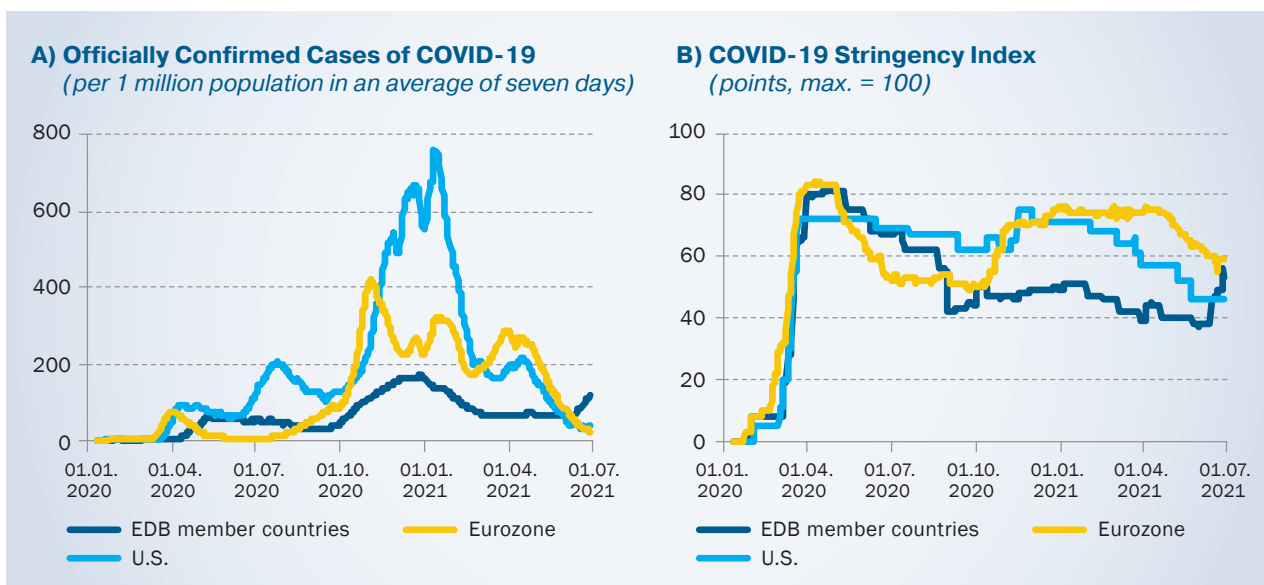
B) Activity on the Streets of the Largest Cities (Maximum daily level in February–March 2020 = 100%)

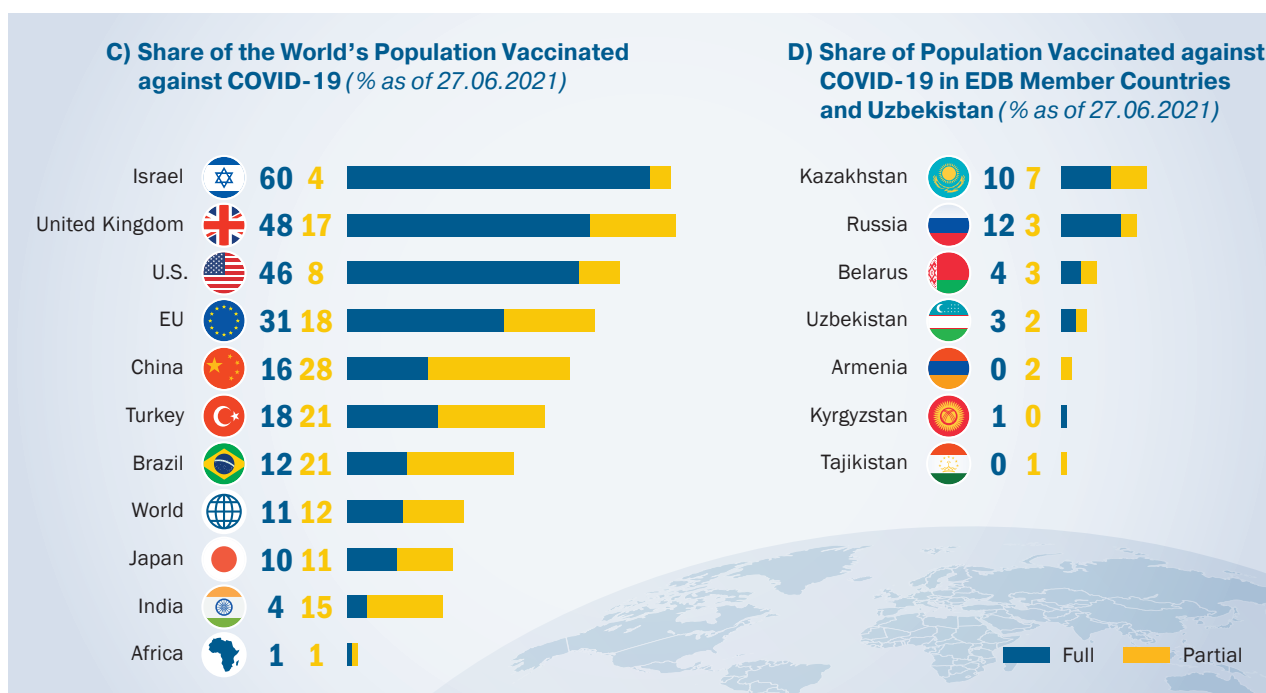


Sources: Yandex, national agencies, EDB calculations.

The global incidence of coronavirus is gradually declining and restrictive measures are being relaxed (Figures 2.A and 2.B). The situation in the EDB member states evolved within this trend in the first half of the year, which is broadly in line with the assumptions of our [previous forecast](#). In Russia and Kyrgyzstan, however, there was an increase in reported cases of COVID-19 in June. The immunisation campaign, which has begun in the Bank's member states, may help reduce the rate of infection further during the year. However, vaccination rates in the region are still moderate (Figures 2.C and 2.D). According to our baseline scenario, we expect vaccination rates to increase and the rate of spread of coronavirus in the region to slow down, but the risk of new upsurges of the disease persist.

Figure 2. Pandemic Progress and Intensity of Anti-Epidemic Measures





Note: Figure 2.C shows data for China as of 10 June; and for the UK, as of 26 June. Figure 2.D shows data for Armenia as of 6 June; for Belarus, as of 13 June; for Uzbekistan, as of 15 June; for Tajikistan, as of 20 June; and for Kyrgyzstan, as of 23 June.

Sources: Oxford University, Johns Hopkins University, Our World in Data (Mathieu et al., 2021), EDB calculations.

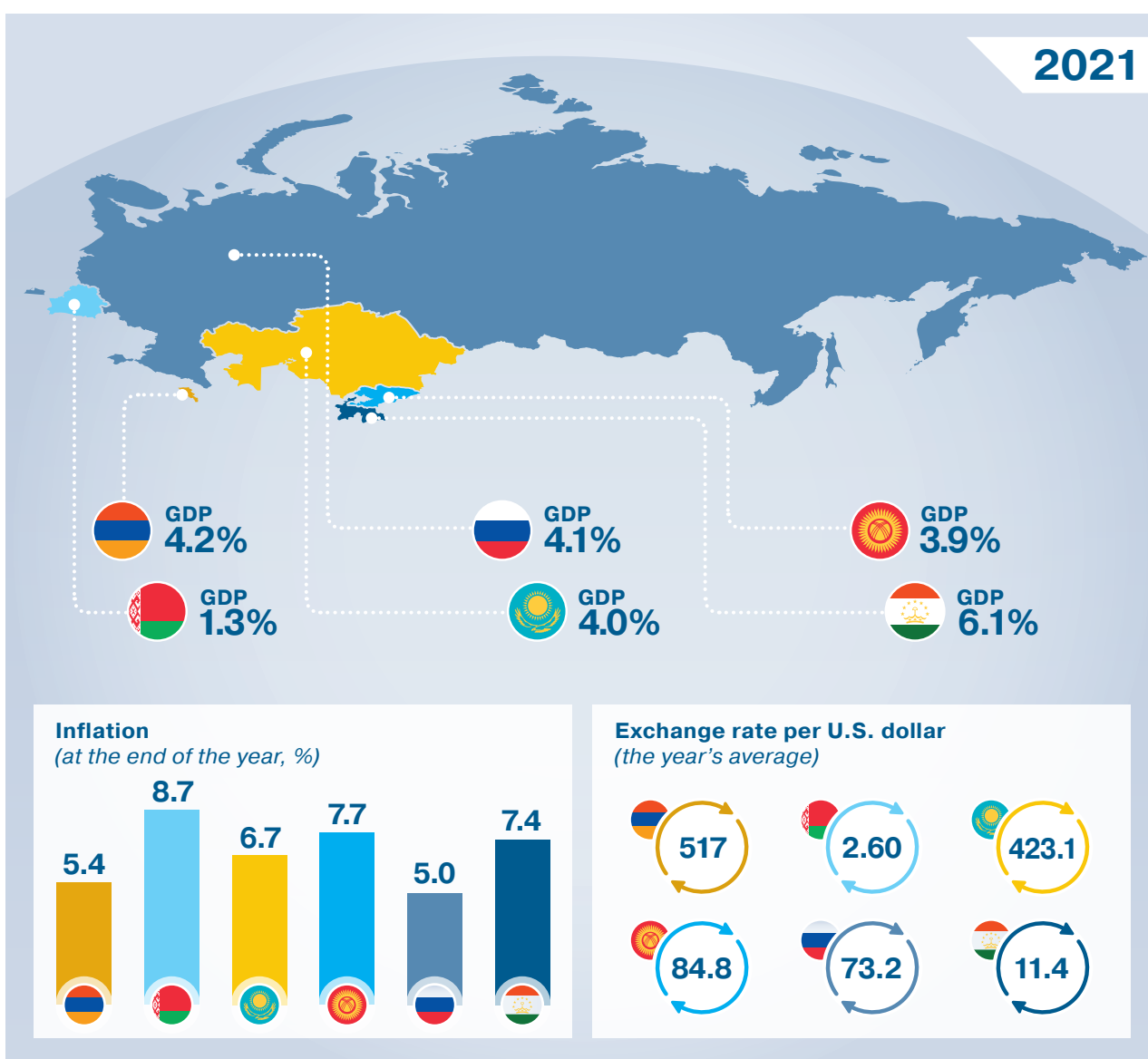
The economies of the EDB operating region's key trading partners this year will register their fastest growth in a decade as they recover from the pandemic-caused downturn. We project China's GDP to increase by 8.5% this year. We assume that China's business dynamics will stabilise near their potential growth rate from the second half of 2021 after a surge in the second half of 2020 and early 2021. A strong recovery is expected in the Eurozone, with its GDP likely to add 4.3% in 2021 and 4.7% in 2022. In the U.S., the baseline scenario expects the economy to grow by 6.5% this year and 3.9% next year. As early as 3Q 2021, the U.S. economy may be overheating due to massive budget and cash injections. The U.S. expects a positive output gap throughout the projection horizon of 2021–2023. However, the baseline scenario assumes that the Fed's policy remains soft this year and that a cautious rate hike will start from late 2022–early 2023. The 2021 Urals oil price projection has been raised from USD 55 to USD 64 per barrel amid a strong global economic recovery and growing market optimism. In 2022–2023, oil prices are expected to range between USD 60 and USD 65 per barrel.

The 2021 projection for aggregate GDP growth of EDB member states is raised by 0.7 p.p. to 4% due to strong support from the global economy. The revision is attributable to an improved GDP growth estimate for Russia this year, from 3.3% to 4.1%. We *forecasted* a strong recovery in Russian economic activity, but the reality of the first half of the year has exceeded expectations. Higher oil prices will add an additional 0.3 p.p. to Russia's GDP growth, and higher budget revenues are likely to result in additional support for business activity on the spending side. The EDB's *GDP growth forecasts* for Armenia and Belarus have also been raised to 4.2% and 1.3% in 2021, respectively. The stronger economic recovery of Russia, a key trading partner of Armenia and Belarus, has boosted the exports of these countries. At the same time, consumer and investment activity in Armenia and Belarus are

expected to be moderate. However, Belarus is projected to see a slowdown in economic growth in the second half of the year due to the introduction of restrictive measures by the U.S., EU, and UK.

The EDB maintains its projection for Kazakhstan’s economy to grow by 4% in 2021. Fiscal policy and a comfortable oil price level will continue to support economic activity in Kazakhstan. However, the more protracted effect of restrictive measures largely offsets the positive impact of the external environment. The EDB’s growth forecasts for Kyrgyzstan and Tajikistan for 2021 are also maintained at 3.9% and 6.1%, respectively. We expect that the faster-than-projected recovery of the Russian economy may not have a significant effect on the growth of the Kyrgyz and Tajik economies this year, as restrictions on cross-border labour migration are set to linger.

Figure 3. Forecast of Economic Growth in EDB Member Countries



Source: EDB calculations.

Most countries in the region are expected to achieve sustainable economic growth in the medium term. However, the growth dynamics may be varied in 2022. In Russia, active economic recovery will end in 2021. GDP growth will then slow down to its potential growth rate as monetary and fiscal stimulus eases. In the baseline scenario, the EDB projects that the Russian economy will grow by 2.2% in 2022. In Kazakhstan, we expect economic activity to rise by 4.4% in 2022, which will become possible once sanitary restrictions in the country are lifted. GDP growth is also projected to accelerate in Kyrgyzstan next year, to 5.2%, thanks to an expected increase in gold production and higher remittances. Armenia and Tajikistan are expected to perform strongly in 2022, at 4.7 and 7.8% growth, respectively. Business activity in these countries will also be supported by an influx of remittances as a result of the restrictive measures being lifted. The Belarusian economic dynamics remain highly uncertain. In the baseline scenario, the EDB projects Belarus's GDP in 2022 to remain at the same level as in 2021. We expect the economy to adjust to the U.S., EU, and UK restrictive measures gradually, with their effects likely to limit GDP growth in the Republic in 2022. If, however, the Belarusian economy adapts quickly to the imposed restrictions, the country's GDP could grow by up to 1% in 2022.

The rapid recovery of the global economy, fuelled by cheap money from developed country central banks and budgetary injections, is driving asset prices up massively. Industrial metals are far ahead, gaining more than 60% in May to pre-pandemic levels. Food prices rose by more than 30%, and building materials by more than 10% during this period. Oil is trading above USD 70 a barrel in June; such a high price was last recorded in spring 2019. Temporary factors, such as pandemic-induced disruptions in production chains, also contribute to this situation. All of this translates into rising prices almost all over the world. For example, inflation in the U.S. surged in May to the highest since August 2008 and amounted to 5% YoY, and in the Eurozone, to 2% YoY. In China, producer prices rose by 9% YoY in May, the highest since September 2008.

Inflation in the EDB member states is moving in line with the global trend, with the regional average rising to 6.6% YoY in May from 5.6% in December 2020. The inflation path in the Bank's member countries is broadly in line with the [previous EDB projection](#), but the effect of inflationary factors has been stronger than expected. The price rises in the region are now largely imported. They are due to higher commodity prices and the weakening of national currencies during the previous year. With continued global constraints and rapidly increasing demand, delivery times are often longer and the choice of suppliers and components is shrinking. As a result, business costs are rising at the highest rate in recent years, and demand-side pressures on prices are becoming increasingly persistent in most states in the region. In the current conditions, central/national banks in the region have reduced their monetary stimulus to economies. The refinancing rate in Belarus has risen by 0.75 p.p. to 8.5% YTD; in Armenia and Tajikistan, by 1.25 p.p. to 6.5% and 12.0%, respectively; in Kyrgyzstan, the policy rate has increased by 1.5 p.p. to 6.5%; the Bank of Russia has increased its key rate by 1.25 p.p. to 5.5%.

Many inflationary factors are temporary, but it takes time to neutralise them. With the pandemic waning, the recovery of production chains will be on track, thus relieving pressure on business costs. As before, we expect metal, food, and oil price increases to slow down by the end of the year as the active phase of the Chinese economic recovery is completed. As a result, consumer inflation in the Bank's operating region is projected to fall to an average of 5.6% by the end of 2021. In Armenia, we expect inflation of 5.4% at the end of the year; in Belarus, 8.7%; in Kazakhstan, 6.7%; in Kyrgyzstan, 7.7%;

in Russia, 5%; and in Tajikistan, 7.4%. In 2022, the EDB's baseline scenario projects an easing of demand-side inflationary pressures and the recovery of production chains. As a result, the regional average inflation rate could fall to 4.1% by the end of 2022.

In the baseline scenario, the EDB expects a gradual transition to neutral monetary conditions in most member states over the medium term. At present, the scale of the monetary stimulus varies widely across the region. In Russia, the key rate, even though it has risen to 5.5% since the start of the year, remains a stimulus for economic activity. We acknowledge that it might rise to 6–6.5% to keep the economy from overheating. In the medium term, we see an optimal key rate of 5.5% with a projected slowdown in inflation. In Kazakhstan, we assess monetary conditions as close to neutral and believe that keeping the base rate at 9% this year will balance inflationary risks and risks to economic growth. Going forward, we expect a gradual rate cut as inflation decreases. We believe the same pertains to Tajikistan. In Armenia and Kyrgyzstan, the effort to introduce a neutral monetary policy could lead to a slight increase in key rates in 2022–2023. In Belarus, the baseline scenario assumes that a tight monetary policy will remain in place in 2021–2023 due to increased risks to the exchange rate of the national currency and inflation. We should note that, in general, the EDB's forecast assumes a gradual convergence of inflation and interest rates in its member states, as integration processes in the region deepen.

Oil prices will continue to support the currencies of EDB member states in 2021. In 2Q 2021, the currencies of most countries in the region strengthened against the dollar. Exchange rates were buoyed by higher global prices for key export commodities (primarily oil and metals) and stronger external demand. The Russian rouble received additional support from the Central Bank's key rate hike and some easing of geopolitical risks. The undervaluation of the national currencies of the Bank's member states against the dollar has declined, and there is limited room for further appreciation. As oil prices are expected to remain at a level comfortable for the countries of the region, it will bolster their currencies in 2021–2022. The average exchange rate of the Russian rouble to the dollar in 2021 is projected to be around 73.2; in 2022, around 71.8; for the Kazakh tenge against the dollar, 423 and 428, respectively.

The return of global inflation poses significant risks to the economic development forecast for the Bank's member states. Accelerating price rises and a strong global economic recovery raise the probability of rapid withdrawal of monetary stimuli. This is of particular importance to the U.S., whose economy could be overheated as early as 3Q 2021. With inflation persisting near 5% in the U.S. this summer, the Fed might tighten its rhetoric significantly as early as August–September 2021. This will increase capital outflows from emerging markets, amplifying their government bond yields, weakening national currencies, and raising domestic interest rates.

The EDB risk scenario assumes a tightening of the Fed's rhetoric this year, the start of tapering of quantitative easing in late 2021 or early 2022, and a gradual Fed rate hike from autumn 2022 to around 2% by the end of 2023. That would tend to strengthen the dollar, and global GDP growth could slow down by 0.3 p.p. in 2022–2023 compared to the baseline scenario. U.S. inflation in the risk scenario is projected to average 2.7% in 2022 and 1.9% in 2023. Oil prices may fall slightly but will remain close to USD 60 a barrel. Meanwhile, gold could fall to USD 1,500 per ounce in 2023, 10% lower than in the EDB's baseline scenario.

Should the risk scenario translate into reality, pressure on the exchange rates of EDB member states is projected to intensify. The annual average exchange rate of the Russian rouble against the dollar in the risk scenario is projected to be 1.8% weaker in 2021 than the EDB's baseline forecast, almost 5% weaker in 2022, and 6% weaker in 2023. The currencies of the other member states could also weaken against the dollar in the risk scenario. Their value is projected to be on average 0.3% lower in 2021 than in the baseline scenario, 2.5% lower in 2022, and about 4% lower in 2023. A weakening of national currencies would accelerate inflation in the EDB member states. Its average level by the end of 2021 could reach 5.9% in the risk scenario, which is 0.3 p.p. above the average in the baseline scenario. Accelerating inflation could result in higher key interest rates: in Russia, such a scenario envisages the key rate increasing to 6.5–7% in 2021 and remaining around these levels for most of 2022. The rate hikes will ensure that inflation in the EDB member states in 2022–2023 stays close to the EDB's baseline levels. However, this will lead to a loss of economic growth, which could amount to about 0.1 p.p. overall for the region in 2021–2022 and about 0.3 p.p. in 2023. The small magnitude of the GDP loss is due to the fact that the positive effect of weaker national currencies on non-commodity exports, along with import substitution, will partly offset the contractionary effect of higher interest rates.

The return of global inflation poses significant risks, but we cannot overlook the uncertainty of the pandemic's evolution. The vaccination campaign is supposed to mitigate the threats to the global economy; however, it has developed very unevenly so far, with emerging economies lagging far behind. It remains unclear how much impact the secondary effects of the pandemic, such as the large amount of accumulated debt, both public and corporate, will have on business activity. In the event of a rapid tightening of monetary policy in developed countries, there is a good chance that there might be global issues with refinancing and debt accumulation between 2023 and 2024. Economies, including those of the Bank's member states, have adapted to operating in a difficult environment, which is a plus; therefore, should the epidemiological situation worsen, the [loss of economic growth](#) will be limited, and growth will remain positive in the medium term worldwide and in most countries of the EDB operating region.

Back to the future? Return to the “old reality” inflation

Recovery in the world and in Bank member states is well underway. We had previously projected strong recovery growth this year, but reality so far exceeds even our expectations. We have raised our forecast for the region's aggregate GDP growth by 0.7 p.p. to 4% at the end of 2021.

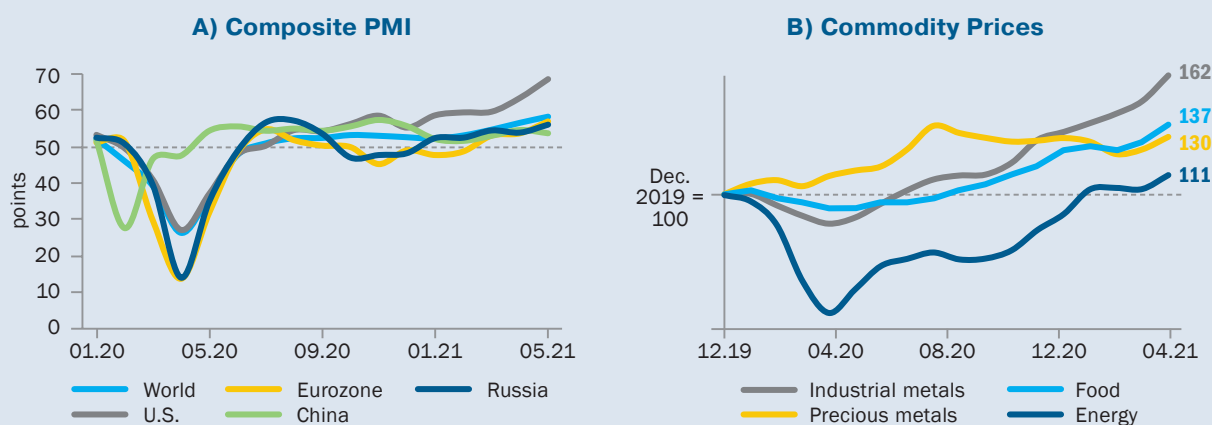
A boom in commodity prices is the driver behind improving growth estimates. Thanks to higher-than-expected oil prices in March, the Russian economy could gain around 0.3 p.p. of additional GDP growth this year. However, the commodity boom has a downside: a global spike in inflation. A topic that has been almost forgotten for decades has not only made its way onto the agenda of central banks worldwide, but has also posed the toughest challenge to monetary policy.

We believe that the relative importance of the fundamental and temporary factors that led to the inflation spike is key when it comes to assessing the risks of high inflation.

We think that it is mostly temporary factors that are driving inflation at the moment. Pandemic-induced disruptions to production chains and a strong global economic recovery are leading to widespread asset inflation. Industrial metals are far ahead, gaining more than 60% in price over pre-pandemic levels. Food prices rose by more than 30%, and building materials and energy, by more than 10%. Rising commodity prices, logistics challenges, and a reduced choice of suppliers have driven up costs in industry. For example, PMI indicators have been showing a continuous increase in costs since last summer, and the rate is now the fastest since August 2008. Due to a strong recovery in global demand, stimulated by cash injections in developed countries, increased costs are affecting consumer prices. As a result, consumer price rises accelerated at the start of 2Q 2021 in both developed and emerging economies.

The ultra-soft monetary policy of the world's biggest central banks and significant budgetary injections are obviously the fundamental factors. They certainly support economies weakened by the pandemic, but they also result in massive increases in asset values, which translate into higher consumer prices. Central banks therefore now face a difficult dilemma: to limit stimuli in order to curb price increases, which risks slowing the recovery of business activity, or to continue to fuel their economies, which could further accelerate inflation.

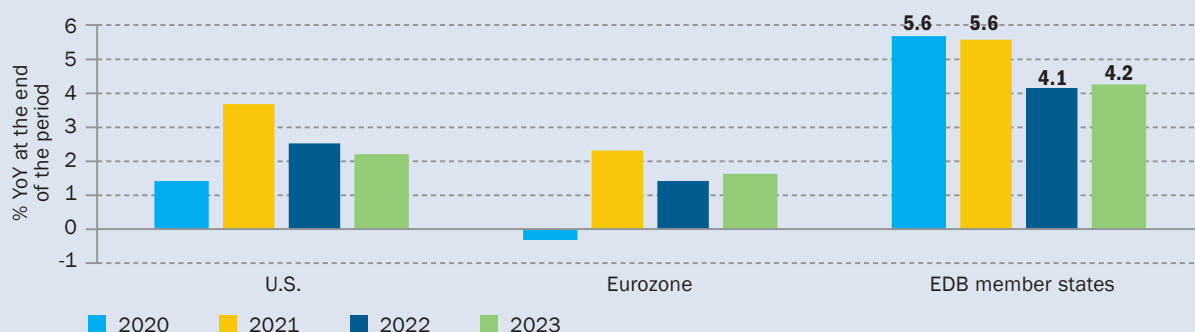
Figure 4. Global Business Activity and Commodity Prices



Sources: IHS Markit, World Bank, EDB calculations.

As already noted, we believe that the current inflationary factors will grow neutral. With the pandemic waning, the recovery of production chains will be on track, thus relieving pressure on business costs. Rises in food, metal, and energy prices will slow down by the end of the year as the major economies, especially China, complete the active recovery phase. As a result, consumer inflation will also slow down, although it will remain slightly above the targets. We expect it to average around 5.6% in the EDB member states for the year and 3.5–4% in the U.S. As the recovery period ends and the pandemic subsides, inflationary pressures will ease considerably, and we would not be surprised, for example, to see inflation in Russia drop closer to 3% next year. The U.S. stands out since the country's inflation is likely to remain above the levels of the past decade, i.e., close to 2.5% in the coming years.

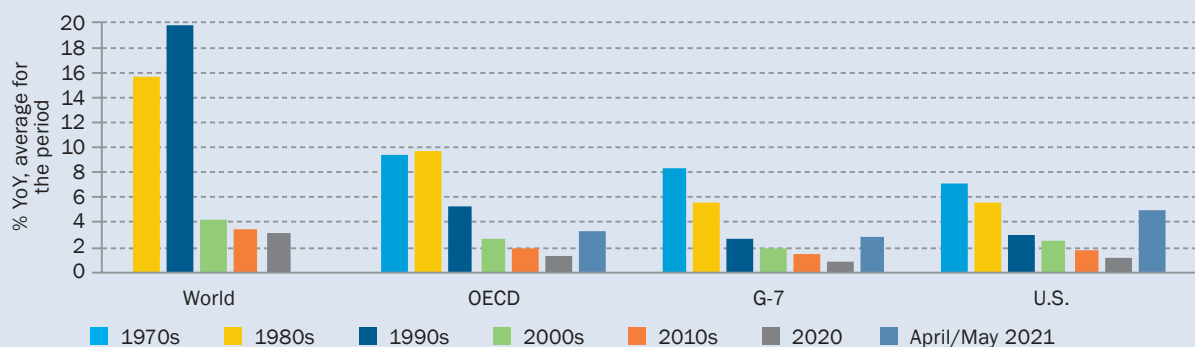
Figure 5. EDB Inflation Forecast (baseline scenario)



Sources: national agencies, EDB calculations.

We can thus say that we do not share alarmist views about the coming quarters and even years. But we also see room for a persistent increase in the average inflation rate in the 2020s. It is realistic to assume that inflation in developed countries will be steadily higher than in the 2010s; not the 0–2% to which the market became accustomed in the 2010s, but perhaps 2–4%. This was considered a standard before the global financial crisis. Such persistent inflation rates do not constitute a structural problem for the global economy; however, they will now require quite a substantial adjustment of the financial sector (loans, deposits) and the real sector (pricing strategies, risk hedging, etc.).

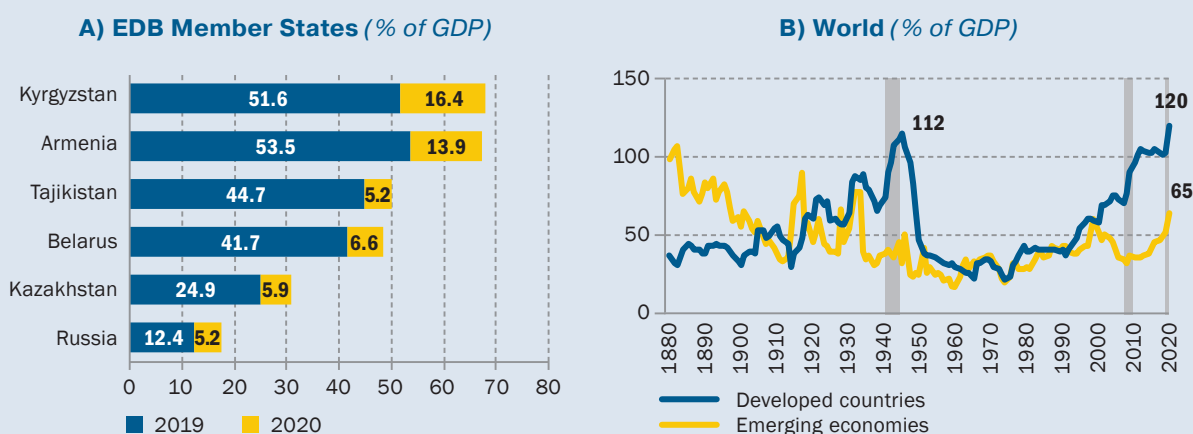
Figure 6. Inflation Averages Over the Last 50 Years: Return to the “Old Reality” of Persistently Higher Inflation?



Sources: IMF, OECD, EDB calculations.

Could the ultra-soft monetary policies of developed countries, for example, give rise to stagflationary risks in the longer term? We believe it is not likely to happen globally, but for individual countries, countries with high levels of sovereign and private external debt (especially if the debt is denominated in foreign currencies), this is likely to be the case in the 2020s. Of course, Russia and Kazakhstan, with their comfortably low levels of external debt, are outside the risk zone.

Figure 7. Public Debt in the World and in EDB Member States



Sources: Ministries of Finance of the EDB member states, IMF, EFSD calculations.

The surge in debt burden is clearly a major challenge for many countries. In developed countries, public debt increased on average by 16 p.p. in 2020, reaching 120% of GDP. In middle-income countries, it increased by 10 p.p. to 64% of GDP. The fourth wave of debt accumulation had commenced even before the pandemic. The previous three waves (1970–1980, 1990–2000, and 2007–2009) invariably ended in crisis. Despite the favourable environment of low interest rates, economic growth and investment are weaker this time around. With rising inflation risks, monetary policy in developed countries will likely begin to normalise. This would pose significant risks for emerging markets with high levels of foreign currency debt. It will therefore be critical for the global economy that central banks abandon the super-soft policies carefully, but also in a timely and unhindered manner.

*Evgeny Vinokurov,
EDB and EFSD Chief Economist*

EDB MEMBER STATES

Key Macroeconomic Indicators (baseline scenario)

Indicator	2019	2020	2021F	2022F	2023F
EDB Member States					
Aggregate real GDP, % YoY	2.3	-2.9	4.0	2.4	2.7
Republic of Armenia					
GDP in constant prices, % YoY	7.6	-7.4	4.2	4.7	4.7
Inflation (end of period), % YoY	0.7	3.7	5.4	3.5	4.5
Interbank rate (the year's average), %	5.8	4.8	6.2	7.1	7.2
Exchange rate of national currency to U.S. dollar (the year's average)	480	489	517	506	499
Republic of Belarus					
GDP in constant prices, % YoY	1.4	-0.9	1.3	0.0	1.6
Inflation (end of period), % YoY	4.7	7.4	8.7	6.1	4.6
Interbank rate (the year's average), %	10.1	7.8	9.1	9.3	8.5
Exchange rate of national currency to U.S. dollar (the year's average)	2.09	2.43	2.60	2.73	2.81
Republic of Kazakhstan					
GDP in constant prices, % YoY	4.5	-2.6	4.0	4.4	5.0
Inflation (end of period), % YoY	5.4	7.5	6.7	5.7	4.8
TONIA rate (the year's average), %	8.4	9.0	8.5	7.9	7.5
Exchange rate of national currency to U.S. dollar (the year's average)	382.8	413.0	423.1	427.7	436.5
Kyrgyz Republic					
GDP in constant prices, % YoY	4.6	-8.6	3.9	5.2	3.2
Inflation (end of period), % YoY	3.1	9.7	7.7	4.4	5.4
7-day Repo rate (the year's average), %	3.0	3.6	5.1	6.4	7.6
Exchange rate of national currency to U.S. dollar (the year's average)	69.8	77.3	84.8	85.3	86.2
Russian Federation					
GDP in constant prices, % YoY	2.0	-3.0	4.1	2.2	2.4
Inflation (end of period), % YoY	3.0	4.9	5.0	3.7	4.0
MIACR rate (the year's average), %	7.2	4.9	5.2	5.8	5.4
Exchange rate of national currency to U.S. dollar (the year's average)	64.7	71.9	73.2	71.8	73.2
Republic of Tajikistan					
GDP in constant prices, % YoY	7.4	4.5	6.1	7.8	7.3
Inflation (end of period), % YoY	8.0	9.4	7.4	5.7	6.1
Refinancing rate (the year's average), %	13.8	11.5	11.7	10.1	10.0
Exchange rate of national currency to U.S. dollar (the year's average)	9.5	10.3	11.4	11.8	12.2

Sources: national agencies of the EDB member countries, EDB calculations.