Elvira Nabiullina: The Russian economic situation and Bank of Russia's forecast

Statement by Ms Elvira Nabiullina, Governor of the Bank of Russia, in follow-up of Board of Directors meeting, Moscow, 11 December 2014.

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Good afternoon! Today the Bank of Russia Board of Directors has decided to raise the key rate to 10.5% per annum.

In the recent months, domestic inflation accelerated significantly and inflation expectations increased. According to our estimates, annual inflation will approximate 10% in 2014. The acceleration of inflation results from both the impact of the external trade restrictions and specific factors in the food market (which will add about 2.3 pp to the total inflation at year-end), and considerable ruble depreciation (that will contribute 2.6 pp). According to the Bank of Russia estimates, the impact of these factors will persist in 2015 Q1 resulting in stable increased inflation expectations and spreading inflationary pressure to the markets of goods and services not directly related to imports and sanctions.

Meanwhile, the direct impact of ruble depreciation is time-limited and, according to our estimates, may be largely exhausted during the next six-month period. Tighter monetary policy of the Bank of Russia will contribute to limiting secondary effects, cooling inflation expectations and slowing price growth.

Should inflation risks aggravate, the Bank of Russia is ready to further raise the key rate in order to prevent acceleration of inflation and loss of control over it. Monetary policy easing can be considered when inflation and inflation expectations show a stable downward trend.

Before moving to the forecast our decision is based on I would like to touch upon the current situation.

Russian economic situation

The recent months saw considerable changes in the global economy, primarily in the global commodity market, which have a direct impact on the Russian economy.

Urals crude price fell by over 40% as against the highest price in June. Some other Russian export commodities have also experienced price decrease. Oil price dynamics have become one of the main reasons of ruble depreciation.

Discussions of multiple interconnections between the foreign exchange rate and oil prices have currently become a popular trend which should not be taken literally. There should be understanding that it is not the only factor of exchange rate fluctuations. They are also caused by the situation in the Russian and global economy, domestic and foreign financial markets, and by the expectations of the economic agents. In particular, the ruble exchange rate was affected by the restricted access of Russian companies and banks to external markets raising concerns regarding the upcoming external debt payments.

However, the impact of the external factors on the economic situation should not be considered unidirectional. External trade restrictions and ruble exchange rate dynamics have enhanced the competitiveness of Russian exports and boosted import substitution. The recent months see accelerated annual growth rates of industrial production (almost two-fold in September-October as against 1.5% in the first six months of the year) and improved sentiment of manufacturers. Net export contribution to GDP growth increased.

Nevertheless, amid high uncertainty this output growth is not yet accompanied with investment increase. Consumer demand also weakens due to the slowdown in annual growth of real income of households which has contracted to 0.5%. As a result, procurement manager sentiment index in the service sector deteriorates.

The situation in the labour market remains unchanged, seasonally adjusted unemployment rate stayed at 5.2% in October. Broad set of labour market indicators, including the number of working hours, number and length of unpaid vacations, and others do not bear evidence of considerable concealed unemployment. According to our estimates the labour productivity growth slowed down to 0.7% in January-October this year with persistent gap between the growth of wages and labour productivity signaling of slow pace of economic restructuring.

These factors affected GDP dynamics. Our estimate of the GDP growth in 2014 has been slightly raised to 0.6%.

Due to the transition to the floating exchange rate, the foreign exchange market absorbs external shocks preserving relative stability of other segments of the financial market. For comparison, during the global crisis of 2008, the volatility of the money market rates exceeded the current values ten-fold. The banking sector continues stable servicing and funding of the economy. During the previous 11 months, loans to non-financial organisations grew by 12% and loans to households by 12.7% (adjusted for currency revaluation).

The financial system gradually adjusts to inflation targeting and floating exchange rate. Time lag of the reaction of the banking sector to the change of the Bank of Russia key rate remains large though, according to our estimates, gradually shrinking. This refers to deposit rates as well. As lags shrink, the effectiveness of the interest rate channel of the Bank of Russia monetary transmission mechanism will improve.

As for the foreign exchange transmission channel, its impact is complicated due to the high volatility in the foreign exchange market which resulted, inter alia, from the restricted access of Russian banks and companies to external markets. In order to normalise the situation with foreign exchange liquidity, the Bank of Russia has introduced reverse transactions to provide it. Interest rates on these transactions have been decreased to the level of LIBOR rates plus 0.5 pp. The volume of foreign exchange liquidity provision is determined by the demand estimates based on the balance of payments forecast. The next one-year repo auction of 15 December will accept Eurobonds and provide for the possibility of early deal termination by borrowers.

In the near future the Bank of Russia also intends to consider the introduction of foreign exchange lending secured by non-marketable assets. Foreign exchange loans, extended by banks to companies with stable income in foreign currency, are supposed to be eligible as collateral.

Bank of Russia forecast

The current situation requires updating the forecasts and adjusting the policy to ensure financial and price stability enabling the economy to adjust to the new conditions and start developing as quickly as possible.

The "Guidelines for the Single State Monetary Policy in 2015 and for 2016 and 2017" stipulate that the removal of sanctions and trade restrictions results in certain inflation decrease and moderate acceleration of economic growth. We take this possibility into account but base our policy decisions on the forecasts providing for long-term sanctions.

The baseline forecast the Bank of Russia currently applies in the decision-making approximates scenario IIIb published in the aforementioned document.

We expect average oil prices to be $80 per barrel during the next three years. This average price results from consensus forecast of the leading analysts.

In the scenario under consideration the current account surplus remains on the acceptable level of $56 billion in 2015. In 2016 and 2017, no significant changes in the current account balance are expected either.

The development of import substitution will boost domestic production. The service sector will see similar trend. Conditions for diversification of the economy will be established. Contribution of net exports to GDP will be positive.

According to the Bank of Russia estimates, in these conditions economic growth rates will remain close to zero in 2015–2016, however in 2017, when import substitution and increase in non-commodity exports become more apparent, we expect GDP to grow up to 1–1.2%. Higher growth rates in the next three years require structural reforms, primarily measures aimed at real improvement of business climate and higher labour productivity.

The inflation level is currently affected by the actual ruble depreciation and the imposed import restrictions but, according to our estimates, these factors will contribute to inflation increase only till late 2015 Q1, afterwards, the inflation will start declining. By late 2015, inflation will fall to 8%. Inflation is forecast to slow down to the target of 4% by late 2017. These dynamics are largely connected with the increased inflation expectations. In this regard, the Bank of Russia intends to conduct its monetary policy to prevent further aggravation of inflation and inflation expectations.

As I have mentioned, under the baseline forecast the current account surplus will amount to $56 billion in 2015 which is below the possible capital outflow we estimate to reach up to $120 billion next year.

Next year the volume of external debt payments will also approximate to $120 billion, of which banking sector debt payments will amount to $42 billion, including interest payments. Non-financial sector debt payments are estimated to be $77 billion, including interest payments.

We have made special calculations based on the reporting data received from banks and the survey of 40 largest companies. According to our estimates based on these data, more than 10% of these payments refer to intergroup transactions. Another 20% can be refunded in the international markets. At least 15% can be redeemed through the partial use of cushion of liquid foreign exchange assets accumulated by banks and state-owned companies. The remaining 55% of debts subject to redemption which make about $65 billion can be covered from the current account balance and reduction of international reserves.

According to our calculations, operations to close the gap of the balance of payments will require about $70 billion next year. The Bank of Russia will carry out transactions aimed at maintaining stability of the balance of payments, i.e. the financial stability, in the stipulated volumes. We believe that the international reserves are sufficient to carry out foreign exchange transactions in such volume. Meanwhile, in the next three years, the reserves level will be significantly above the generally accepted adequacy indicators. There definitely will be no deficit of foreign exchange liquidity given these parameters of the balance of payments and the volume of our operations.

We indent to conduct the aforementioned FX repos, extend foreign currency loans and carry out occasional direct FX buy/sell transactions, inter alia, to accumulate and use Government reserve funds.

It should be noted that under this scenario the ruble should appreciate considerably next year due to both the compensation of the currently observed exchange rate overshoot or, in other words, excessive depreciation, and the oil price growth stipulated by the scenario. Let me remind you that according to the scenario oil price will be $80.

This is our baseline scenario. At the same time we are aware of the pessimistic sentiments in the market due to the dynamics of oil contract quotations observed over the last months. Therefore, alongside with the baseline forecast, we have worked out an alternative scenario which we consider to be unlikely to develop and which provides for oil price fall to $60 per barrel from early 2015 and during the whole three-year period.

In this case Russian economy will require more profound adjustment to the new conditions in 2015–2016. In this scenario, the current account surplus will amount to approximately $40 billion in 2015. It will further increase due to the slight rise of non-oil and gas exports and decline of imports.

Economic growth rates will depend on the pace of import substitution. Slow development of import-substituting production in 2015–2016 may result in “mild” recession. Nevertheless, output and employment decrease will be considerably less than in 2008–2009. In this scenario we expect economic recovery growth to over 5% in 2017.

Under this scenario, in 2015, inflation acceleration may be higher than in the baseline scenario due to the lower ruble appreciation during the year which is also expected due to the compensation of the exchange rate overshoot. During the following two years, due to the deeper output gap inflation will decrease even faster than stipulated in the baseline scenario reaching the target of 4% before late 2017. Meanwhile, the monetary policy will be aimed at stabilisation of inflation expectations, prevention of inflation spiral and its gradual decrease due to the prospects of economic growth. It is also possible that under this scenario we will be able to ease our policy even earlier.

As the capital outflow during this period will mainly result from external debt payments, in this scenario we estimate the total capital outflow to be at the same level as in the baseline scenario. Under this scenario we are ready to allocate about $85 billion for FX transactions in order to stabilise the balance of payments that is also acceptable from the foreign exchange reserve adequacy point of view. It should be noted that the reserve level will be restored following the economy adjustment to the new conditions as we intend to conduct mainly reverse transactions.

The Bank of Russia will undertake operations in the foreign exchange market based on the balance of payments forecast and the estimation of balances of banks and companies taking into account the structure, terms and nature of corporate debt. I would like to emphasise that we carry out these transactions in order to prevent situations when excessive exchange rate volatility and its considerable deviation from fundamental levels create financial stability risks and result in higher depreciation and inflation expectations. In particular, now that risks arising from the ruble exchange rate dynamics have aggravated, the Bank of Russia came up with interventions in the foreign exchange market.

Of course, we will also consider the impact of operations in the foreign exchange market on the ruble liquidity and ease the negative effect of growing structural deficit on the credit institutions’ balance sheets. Besides, we are especially concerned about the collateral adequacy and will take further measures to decrease pressure on market-traded bonds through providing liquidity against other types of assets. Amid the increased volatility of the foreign exchange market, the Bank of Russia will stick to the conservative approach to the assessment of banking sector demand for liquidity. Meanwhile, the volume of ruble liquidity provision will be sufficient for the banking system to function properly and the money market rates to remain within the interest rate corridor bounds. The Bank of Russia will also continue to permanently monitor the situation in all the segments of the financial market and is ready to take the required measures to ensure its stable functioning. It is crucial for normal functioning of the economy and successful implementation of all macroeconomic policy measures.

Currently the Russian economy faces both external and internal challenges. The uncertainty over further developments is really high and the sensitivity of the economy and especially the financial markets to various developments increases, at some point the reaction can be excessive. In these conditions the Bank of Russia is ready to be flexible and take unconventional decisions in meeting strategic objectives of ensuring financial and price stability.