Elvira Nabiullina: Recent Russian economic developments 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, 13 March 2015.

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Good afternoon! Today the Bank of Russia Board of Directors decided to reduce the key rate from 15.00% to 14% per annum. This decision takes into account the following main factors.

First, the latest data on the economic situation show that the balance of risks remains shifted towards the weakening of the economy rather than acceleration of inflation. January data and February leading indicators, primarily business sentiment indices, indicate that the economic situation continues to deteriorate and this trend may persist until 2016 Q1. Seasonally adjusted unemployment fell to 5.0%. It should be taken into consideration that the Russian labour market traditionally adjusts, at least at the first stage, through wage rates and part-time employment, whose dynamics is indicative of lower demand for labour. At the same time, shrinkage of consumer demand will have a downward pressure on inflation.

Second, monthly inflation slowed down considerably in February following the surge in late December-January. And weekly March data indicate that this process continues. The current high level of annual price growth is explained by the supply-side factors – decline in the ruble exchange rate and imposed trade restrictions. These are one-time factors, and in case there are no new considerable shocks their impact on monthly and quarterly inflation will decrease over the next months. The annual inflation, which to a large extend reflects past price dynamics, can keep rising up to the middle of the year. However, in a year, i.e. in March 2016, inflation will slow down to the level of about 9% amid the decrease in the monthly and quarterly price growth. While making the decisions regarding interest rates, we take into consideration not the current inflation that is essentially historical, and cannot be affected by our decision. We rely on inflation forecast.

Third, we forecast gradual decrease in inflation expectations. Surveys already show evident signs of such a decline. In case no new shocks occur, this process will persist facilitated by the slowdown in current inflation. Therefore, real interest rates which should be calculated with regard to the expected inflation will stay in the positive range providing for anti-inflationary nature of monetary policy.

Nevertheless, it is persistently high inflation expectations, as well as risks of the upward revision of tariffs of natural monopolies, fiscal policy easing, and possible accelerated growth of nominal wages that we consider to be the main risks for our policy and our inflation forecast.

I would like to note that, when taking the today's decision, the Board of Directors was guided by the goal to decrease inflation to 4% in 2017 and to further maintain it close to this level as it was stated in the Guidelines for the Single State Monetary Policy. We have repeatedly expressed our intention to reach this level step by step taking into account the economic conditions. The rate of inflation decrease will depend on further developments and changes in the economic situation. The attempt to reduce the inflation at any cost would obviously be a short-sighted strategy.

When taking a decision on the key rate we always consider the balance of risks of inflation acceleration and slowdown in economic growth. This balance changed considerably at the turn of 2014–2015.

For most of 2014 the balance of risks was shifted towards inflation acceleration. Economic slowdown was primarily of structural nature and did not have considerable impact on prices. Meanwhile, inflation expectations were growing.

The situation aggravated in 2014 Q4, because the fall in oil prices and the need to make large external debt payments amid almost inaccessible international capital markets led to considerable ruble depreciation. This in its turn resulted in higher inflation expectations. Demand of households and businesses for cash and non-cash foreign currency surged up. It threatened to heavily accelerate inflation and destabilise financial sector. It was important to bring these processes to a halt and we decided to raise the key rate dramatically to 17% p.a.

The rise of the key rate was followed by the increase in bank deposit rates that managed to stop the outflow of funds from ruble deposits and pegged down their dollarisation.

Our foreign currency REPO and lending operations also helped normalise the situation in the foreign exchange market. In December-January, we reduced rates on these instruments, introduced new types of operations, and increased the frequency and allotment amount of foreign currency provision. In late 2014, the allotment amount of foreign exchange liquidity provision was about 20 billion US dollars and currently exceeds 30 billion US dollars.

In January 2015, despite persistently low oil prices, complicated geopolitical situation, and Russia’s downgraded sovereign rating, the exchange rate volatility decreased and inflation expectations showed the first signs of stabilisation. This means that the result we expected when raising the key rate has been largely achieved. At the same time, the leading indicators started to show the beginning of considerable fall in aggregated demand and cyclical economic slowdown. Therefore, as opposed to 2014, the economic situation in 2015 started to exercise additional anti-inflationary pressure. This enabled the Bank of Russia to reduce the interest rates from 17% to 15 %.

The consequently published data for January 2015 confirmed out estimates. In January 2015, the economic activity started to slow down. Temporary surge in consumer demand in December 2014 changed into a drop. Decline in investments intensified. Both consumer and producer sentiments deteriorated. Inflation accelerated sharply, but this dynamics is largely explained by the accelerated pass-through effect of the exchange rate on prices. Therefore, monthly inflation started to decline in February.

We base our monetary policy decisions not only on the information about existing economic trends, but primarily on the forecasts of economic situation. Detailed and revised forecast will be published tonight as part of the Monetary Policy Report. In my speech today I would like to touch upon main elements of the forecast which are of key importance from the point of view of the decision we took today and for understanding the logic behind our future actions.

I will start from the assumptions. We assume the Urals crude price this year at around 50-55 US dollars per barrel. We have reasons to expect oil prices to rise to 70–75 US dollars per barrel by 2017, but nonetheless remain significantly below the levels observed during several past years.

We also assume that access of the Russian companies to the global capital markets will be restricted throughout whole forecast period.

A long period of relatively low oil prices will force Russian economy to adapt to the new conditions. As a result, GDP is expected to decrease by 3.5%-4% in 2015 and 1%-1.6% in 2016. Moreover, as I have already mentioned, the structural constraints of the economy will be supplemented by factors of cyclical nature.

Despite the drop in oil and other commodity prices, the net export will make a positive contribution to GDP dynamics due to the effects of the ruble depreciation on imports and Russian exporters’ competitiveness. However, net export dynamics will not be able to fully offset the reduction in consumer and investment activity during two coming years.

As in 2009, contraction in the domestic demand will primarily influence durable goods, including imports, and also some services sectors. It should be noted, that under existing circumstances, this effect will be reinforced by accumulated high consumer debt level of certain households.

Decline in investment activities is driven not only by reduced profits and lower accessibility of other financial resources, but primarily by high uncertainty with regard to future economic development. It is expected to be the highest in industries which have not benefited from the ruble depreciation and which suffer from increased debt burden.

For reference:

According to forecasts, household final consumption expenditure will fall by 5.5–5,7% and 1,5-2% in 2015 and 2016. Fixed capital investment will decrease by an estimated 10–12% and 0,5-1,5% respectively.

As for the labour market situation, we do not expect any considerable increase in the unemployment numbers in comparison with the existing level. This is due to both the demographic factors and the specifics of the Russian labour market which normally adjusts through changes in wages and partial employment, rather than by changes in the number of those employed.

For reference:

According to our estimates, the unemployment will not exceed 6.0%-6.2% in two coming years.

In comparison with December, we revised the balance of payment forecast. The expected fall in imports saw the most considerable change (almost by 30% in 2015 compared with 2014 instead of previous estimate of 10%). Therefore, the current account surplus estimate has been revised upward to 64 billion US dollars in 2015 and to 90 billion US dollars in 2016.

The current account surplus is comparable with our estimates of external debt payments in 2015. According to the data from transaction passports, the repayment value, including interest payments, is estimated at 120 billion US dollars this year. But, given the refinancing capacity of international markets, we estimate net external debt payments totaling 65 billion US dollars, that is twice as less as in last year. In effect, we have already passed the peak of external debt payments.

Residents can make payments either buy drawing down the buffer of their accumulated foreign exchange liquid assets or from current revenues from foreign trade. The Bank of Russia foreign liquidity refinancing instruments will make it possible to fund both external debt payments and cumulative capital outflow estimated as 100–110 billion US dollars without considerable impact on the ruble exchange rate. I would like to note, that this year peak debt servicing payments are due in February and March, and payments already effected did not have any significant impact on the ruble exchange rate.

Oil prices remain the main factor which can influence the ruble exchange rate dynamics. However, sustainable oil price reduction comparable to last year's patterns does not seem feasible. The oil market will remain volatile, with oil prices changing in both directions. Oil price fluctuations are followed by fluctuations in the ruble exchange rate. However, one-way change in the ruble exchange rate has stopped. This means that the exchange rate impact on the inflation will gradually wear out.

The restraining influence of low economic activity will begin to fully impact inflation dynamics in the second half of 2015. By this time, the effect of temporary factors, such as the depreciation of the ruble and foreign trade restrictions that have led to acceleration in consumer prices growth, will be exhausted. As we have already noted, inflation will reach its peak in 2015 Q2, and afterwards it is forecast to fall. In March 2016, inflation will approximate to 9% before falling down to 4% in the medium run.

Such inflation dynamics will be accompanied by economic recovery. The bottom of economic recession is expected in 2016 Q1, later on the economy will start growing on a quarterly basis. By that time the initial adjustment of the economy to the new environment will be over. Higher global oil prices, the economic recovery of trade partner countries, and the formation of new sources of financing will also contribute to this growth. In 2017, economic recovery is expected to exceed 6%.

We shall continue to regularly update our forecast by monitoring movements of a wide range of indicators taking into account not only annual inflation dynamics, but also quarterly, monthly and weekly ones. If new pro-inflationary factors do not appear and inflation decelerates according to our forecast, we shall continue cutting the key rate.

In conclusion, I'd like to note that although the current economic slowdown is of both structural and cyclical nature, structural factors and the need to create new growth sources still play a major role. This means that monetary policy measures are not sufficient to solve all the problems facing the economy. Special efforts are needed to promote new investments in the economy, improve business climate, increase the mobility of labour and its skills, enhance the efficiency of natural monopolies and government expenditure, improve state governance, and develop infrastructure and logistics. Only these efforts will ensure sustained long-term economic growth based on increasing productivity and economic structural changes.