

Elvira Nabiullina: Current economic environment and monetary policy in Russia

Statement by Ms Elvira Nabiullina, Governor of the Bank of Russia, at the State Duma of the Russian Federation on the Bank of Russia Annual Report for 2014, Moscow, 16 June 2015.

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Good afternoon, distinguished colleagues!

While introducing the Bank of Russia Annual Report, I will give a brief overview of our activities such as monetary policy, banking and financial market regulation and supervision, and the national payment system.

Before passing on to the report, I would like to briefly describe the current economic situation, the environment, in which we implement our policy. The last year was a troubled one, oil price fall and financial sanctions emerged as serious challenges to the Russian economy.

The economy has slowed while decline in investments became manifest in the period of high oil prices and rather low interests rates. This determined the specifics of the current situation – unfavourable developments in external conditions overlapped structural economic slowdown. The situation was especially challenging as the economic downturn coincided with high inflation.

Currently, we have managed to curb inflation. According to our forecast, an economic growth (quarter-on-quarter) is expected to resume later this year. Certainly, a lot will depend on the efficiency of the joint efforts of the Government and the Central Bank.

The observed improvement and financial stabilisation must be supported by structural changes. They are indispensable for a sustainable economic growth. These include a better business climate and higher labour productivity. I think that infrastructure is also a crucial factor.

Last year we had to react quickly to changes in external conditions. Meanwhile, we did not abandon our strategic objectives, we still adhere to inflation targeting that allows us to control inflation and ensure its gradual reduction.

Early last year, the Central Bank actively intervened in the FX market to ease the market response to the Crimea developments and to support the ruble exchange rate. In 2014, we implement interventions in the amount of about US\$80 billion. At the same time, we were preparing for a floating exchange rate regime. We planned to have completed the transition by late 2014. During the year, the Bank of Russia took consecutive decisions thus gradually moving to the floating exchange rate.

The policy to support the ruble through interventions was sound until two important events took place last autumn. The first one was the issuance of large-scale financial sanctions, and the second one was the decline in oil prices that began in summer and accelerated dramatically following the November decision of OPEC to maintain the volumes of oil production.

Then we decided to accelerate the transition to the floating exchange rate. Looking behind, I would like to confirm once again that our country needed the transition to the floating exchange rate and it was a timely decision. It was the introduction of the floating exchange rate that quickly normalised the financial situation and saved us gold and foreign currency reserves. Different solutions were unlikely to stabilise the financial system.

The impact of external factors moved inflation up to 11.4% in 2014. Unfortunately, it turned out to exceed the level we had expected.

According to our estimates, sanctions and external trade restrictions account for one-third of the surfeit of inflation over the 5% target level, and ruble depreciation accounts for two-thirds. These are one-off factors and now we can see the inflation going down. It responds to the set of measures taken by the Bank of Russia to stabilise the situation.

Let me remind you of these measures. These are both the transition to the floating exchange rate, and the unpopular but absolutely needed decision to raise the key rate. I would like to emphasise that as soon as the situation began to stabilise we started to gradually reduce the key rate. We have already cut it four times as we realise its importance for the economy and lending.

The Bank of Russia introduced non-conventional refinancing instruments and started to lend foreign currency. This allowed us to pass the spikes in external debt repayments relatively easily this year amid restricted access to foreign markets.

We worked with exporters to ensure that our major suppliers of foreign currency sell it evenly.

Meanwhile, the stabilisation of the financial system in January should not be tied to the oil price growth alone. Certainly this process was supported by the oil price growth. Against this backdrop the ruble started to appreciate and the situation even allowed us to start replenishing our gold and foreign currency reserves.

Now I will give you the details of our monetary policy in 2014.

We have decided to grant the access to the main refinancing instruments to a wider range of banks (the so-called 3rd tier banks) and promptly extend the Lombard List. In making the Lombard List we abandoned the exclusive reliance on the international ratings agencies in order to reduce the dependence on them and make our own asset estimation.

We are developing special purpose instruments to compensate for the so-called market failures and support lending in certain areas amid low availability of loans, high interest rates, and lack of long-term money.

I am talking about four instruments – support of investment projects, small and medium-sized enterprises, military mortgages and non-commodity exports. The total of 290 billion rubles is currently allocated for these instruments.

The special purpose instruments will be limited in volume in order to avoid distortions in monetary policy mechanisms. However, since we have introduced these instruments, they must prove effective. Currently, our main objective is to increase their efficiency.

To summarise the results of the monetary policy we implemented last year, I would like to emphasise that, first, we acted in strict compliance with the functions assigned by the Constitution and the Central Bank Law, second, in the challenging conditions we tried to be flexible and to apply non-standard approaches, yet using only market mechanisms.

How do we see our objectives in the current conditions? Our priority task remains unchanged– it is the price stability. Despite a leap in inflation last year and earlier this year, our medium-term inflation target is still 4%. We estimate it to be achievable. Another important task is to maintain financial stability amid current turbulence. And third, we ultimately aspire to creating balanced macroeconomic conditions to put the economy on the track of sustainable economic growth.

We will have to tackle these issues in challenging external conditions. The pace of the global economic growth will not be high; other countries' monetary policy will keep influencing the Russian economy; the oil market is likely to remain unstable. Therefore, the economy will have to adjust to the new realities when both oil prices and exchange rates fluctuate both upwards and downwards.

A few words on the banking industry. Economic developments of the last year could not help but impact banks. Generally, all the economic indicators showed quite good dynamics last

year – assets and lending were on the rise. Profits, though 40% lower than in 2013, were non-negligible at the level of 600 billion rubles. However, the situation certainly began to change. We can see slower lending rates. In some months of the year we have registered losses in the banking system as a whole. Profits in January-May this year amounted to nine billion rubles. Lending to the economy shrank by 3% in the first five months (by 1.5% adjusted for foreign currency revaluation). Meanwhile, capital grew by 1.2%. It is important since capital growth is a key condition for increasing lending to the economy.

The trend towards deposit outflow and dollarisation has been reversed (currently, we can see their inflow).

Mortgage lending was supported by measures taken by the government. Currently, we can see this market recovering. According to our estimates, this trend will persist and residential construction will support the economy. It is the engine for many other sectors.

Our banking system is generally stable and banks – also supported by the government – meet the emerging challenges.

To allow banks to adjust to the new environment and support the banking system in the most challenging period, we temporarily eased the regulation. Our task was far from allowing banks to disguise their problems, we rather aim at mitigating the impact of external factors and enabling banks to adjust to the new environment.

Currently, we are gradually abandoning the anti-recessionary regulation regime. Following the discussion with the banking community, we decided to gradually reverse these measures.

Undoubtedly, decisions on additional capitalisation of the banking system played a positive role. I would like to thank the State Duma for this decision.

The Government and the Bank of Russia are unanimous that funds allocated for additional capitalisation of banks should be spent on expanding lending to real sectors of the economy rather than patching up the loopholes in banks' capital (they are not aimed at supporting owners).

To our regret, interest rates on bank loans have grown and accessibility of loans for the economy slumped. However, we can see that in recent months banks have followed the reduction of the key rate and above all the mitigation of inflation risks and gradually cut their loan rates.

Furthermore, difficulties in the economy and finance are not a reason for curtailing the policy of banking sector resolution. Besides, we consider it necessary to enhance banking supervision.

In 2014, banking licences were revoked from 86 credit institutions and earlier in 2015 from another 30, mostly due to the violation of banking laws, suspicious transactions, accumulated financial problems, and non-disclosure of real financial standing through misreporting.

The supervisory objective for the near future is to identify banks' problems as soon as possible. This will allow us to protect the stability of both the financial system and banks' creditors.

As for suspicious transactions, the number of banks servicing the shadow economy is constantly declining: according to our estimates, currently there are about 20 of them, and when we started their number approximated 150. The volume of overseas money diversion and cash withdrawal through the banking system has declined. We make use of the powers conferred on us under the amendments to the law approved by the parliament. I would like to express special gratitude to you for that.

We progressively stamp out suspicious transactions from the banking sector. Our current objective is to introduce end-to-end supervision over both credit institutions and non-bank

organisations through implementing our functions of a megaregulator in order to prevent the spillover of suspicious transactions from the banking to the non-banking sector.

The last year was important as the first full year in our capacity of megaregulator. We completed the transition period nine months earlier than expected. Along with internal restructuring at the Bank of Russia, we kept working on legislative initiatives. We continue developing financial market infrastructure by creating new and improving existing instruments. High-quality improvements in the system of financial market regulation and supervision are impossible without legislative amendments.

Non-governmental pension funds had to be incorporated and join the guarantee system. We inspected non-governmental pension funds before their accession to the guarantee system. As a result, 26 funds joined the system. The supervision obliged many funds to improve the quality of their assets and to make the ownership transparent, so that the guarantee system incorporated only resilient funds capable of ensuring safety of pension savings. We will further monitor and supervise these funds very closely.

Some words about insurance. We applied new laws on compulsory motor third party liability insurance (OSAGO) and raised the tariffs. The decision is not very popular, but it is necessary to ensure the economic efficiency of OSAGO. At the same time, we are looking for new growth areas together with the market. In particular, this is about developing life and medical insurance.

We also had to take supervisory measures. As a recent example licence of a major market participant was restricted for two weeks. Certainly, the licence restriction of such a large player was an outstanding event for the market. As a regulator we realised the importance of such a step, but we consider it necessary for the benefit of consumers to implement all the available measures to restore order and eliminate unlawful practices such as imposing services, non-applying bonus-malus ratio, etc.

We have established a consumer right protection service, and we pay special attention to processing claims. We will try to make the process of lodging claims convenient for citizens and will try to respond to claims in an efficient manner. One of our important objectives is to work out a concept of financial literacy. We also consider accessibility of financial services to be an important condition for proper functioning of the financial market.

Another field of our concern is the development of the national payment system. In less than a year after the decision was taken, a processing and clearing centre was created and inter-Russian transactions of international payment systems were transferred there. Currently, we are actively developing our own payment card.

In conclusion I would like to say that the integration of Crimea into the Russian financial and payment system became an important part of our job last year. We implemented accelerated transfer of settlements from hryvnias into rubles. Initially, in compliance with the law, we had to complete this process by 1 January 2015, but it became evident that such a long period of circulation of two currencies is unreasonable. As a result the transition was implemented in two months.

As many as 530 branches of Russian banks have been opened on the territory of Crimea and are ready to offer their customers a complete range of services. Cash circulation has been arranged and the necessary amount of coins and banknotes has been delivered.

A few words about internal changes in the Bank of Russia. In 2014, the organisational structure of the Bank of Russia underwent serious changes aimed at increasing our efficiency and optimising the workforce.

The improvement of the Bank of Russia territorial structure initiated in 2014 was completed in January 2015.

As many as 79 main branches and national banks were transformed into seven main branches with subordinated divisions. Due to the accession of the Republic of Crimea and

the federal city of Sevastopol to the Russian Federation, in 2014 a Division for the Republic of Crimea and a Division for the City of Sevastopol were established.

Resulting from the structural optimisation held in 2014, the Bank of Russia cut 3,500 jobs or 5.3% and its workforce amounted to 61,800 employees as of early 2015. I would like to note that the number of employees was reduced, while the Bank of Russia obtained vast powers as a megaregulator. However, we will continue reducing the workforce.

In conclusion I would like to say that the Bank of Russia faces challenging tasks in a challenging period in the country's history. We completely assume our responsibility. I am convinced that there are all the prerequisites to put the economy on the track of sustainable growth while ensuring the necessary macroeconomic and financial stability in joining our efforts.

Thank you very much for your attention.