Elvira Nabiullina: Review of recent inflation developments in Russia and economic outlook

Statement by Ms Elvira Nabiullina, Governor of the Bank of Russia, in the follow-up to the Board of Directors meeting, Moscow, 14 December 2018.

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Today the Bank of Russia Board of Directors has decided to raise the key rate by 0.25 pp to 7.75% p.a. This move is aimed at limiting the scale of inflation risks in the coming year. I will subsequently elaborate on the rationale of this decision.

The second decision made today was to resume regular fiscal rule-based foreign currency purchases from 15 January. As we said earlier, the postponed purchases will be made gradually in the course of several years. We will decide on the fiscal rule-based foreign currency purchases postponed in 2018 in due course, after regular purchases are resumed. We have factored in this decision in our forecast.

Let me now proceed to give you the details of the key rate decision. Today's Board meeting took an in-depth look at the reasoning for both keeping the key rate unchanged and revising it upwards.

The main argument in favour of an unchanged key rate is the performance of the domestic demand. It is expanding moderately without posing any inflation risks. This primarily concerns consumption. In October, annual growth of retail sales came in at 1.9%. The heads of Bank of Russia regional branches, who contribute to the key rate decision, have also pointed to low demand and mixed consumption dynamics across regions. Annual wage growth has also slowed considerably after peaking early in the year.

The savings rate has been recovering in the recent months after a considerable drop in the second and third quarters. Household deposits resumed growth driven by interest rates attractive for depositors. In this context, strong growth in retail lending underpins consumer demand without posing inflation risks. The evolution of the household behaviour model meets our expectations.

However, more arguments call for a key rate hike.

What are these arguments? They are associated with both external and domestic factors.

External factors include, first, the state of the global economy as a whole and the situation in emerging markets. Certainly, global financial markets have been less volatile this quarter than they were in August and September. This is partially attributed to the revision of monetary policy projections by major central banks. The next year normalisation may prove slower than expected, thus mitigating the risk of capital outflow from emerging markets. However, it is important that the altered projections of policy revision by key central banks are associated with downgraded next year growth forecasts for major economies. Also, the current standstill in trade disputes may merely prove a temporary truce. These risks are quite tangible for emerging market economies.

Second, we have here the oil glut risk in 2019. This is partially associated with a downward revision of the global demand outlook. However, the main reason is an aggressive expansion of oil production in the US. In early December, OPEC and other oil exporters agreed to cut production in 2019. However, the developments of this year demonstrate that producers can rapidly ramp up shale oil production when prices are high.

Another considerable external factor is geopolitical risks affecting both Russia and other

countries and regions.

As far as internal factors are concerned, here we have persistent uncertainty over the price response to the VAT rate hike, the effect of this year's weakening in the ruble on inflation, and its effect on inflation expectations. It means that the uncertainty over price movements is associated with both an estimated direct effect of proinflationary factors and the scale of secondary effects dependent on inflation expectations.

Thus, our baseline scenario assumes that the VAT rise will contribute approx. 1 pp to inflation. However, the possible estimates of this contribution range between 0.6 and 1.5 pp.

The scale of secondary effects is still harder to estimate. Even a temporary acceleration of price growth raises inflation expectations of both households and businesses. We saw it from the surge in petrol prices registered in May-June this year. Petrol prices have been stable in the second half of the year. However, surveys suggest that Russians are highly concerned about the rise in petrol prices.

Inflation expectations remain unanchored. This means that they are highly likely to go up in response to price growth following the VAT rate hike. Therefore, we cannot consider the VAT rate revision as a purely one-off factor.

Elevated inflation expectations may change consumer behaviour and reduce the propensity to save. In these circumstances, firms will have an opportunity to raise retail prices even when the effect of one-off factors is exhausted. If this spiral is set off, inflationary pressure will rise and inflation may hold above the 4% target for a long period of time. This will require a considerable and enduring monetary policy tightening.

The task is to reduce as much as possible the risks of this scenario materialising. In addition, full-year inflation will total about 4% in 2018. This means that we are entering the new year without the inflation buffer we had and with a substantially upgraded inflation forecast for next year. This is why we are raising the key rate. At this moment in time, in the context of strengthened risks, it is crucial that we remain proactive. This approach reflects a key inflation targeting policy principle.

We look to the outrunning response of monetary policy to enable us to constrain the secondary effects and ensure inflation declines after its temporary rise. We admit that between March and April inflation could exceed 5.5% or even peak to 6%. Its acceleration in the first quarter of 2019 is set to precede its subsequent slowdown. Should we take action to curb the secondary effects, beginning from the second to third quarter of 2019, seasonally adjusted quarterly price growth will total 1 pp, that is, it will be consistent with 4% annualised inflation. The residual impact of the one-off factors on annual inflation is set to be entirely gone in one year's time – in the first quarter of 2020.

Now, I will say a few words about the economy and the forecast. Economic growth rates remain close to their potential levels. Unemployment is invariably low and close to its natural rate. Having said that, certain economic activity indicators continue to post a mixed performance.

The forecast remains essentially unchanged. Given the state of the global energy market over recent months, we have downgraded the oil price path somewhat in the baseline scenario. The assumption has been updated to reflect faster declining oil prices in the course of 2019 – based on the calculation that the average oil price will total $55 per barrel (from the previous estimate of $63 a barrel). Moving forward, the average price is set to remain at this level between 2020 and 2021. As before, our approach to oil price assumptions is conservative. The oil price volatility we saw in the fourth quarter (from $85 to $58 a barrel) is an indication of the validity of this approach.

The running fiscal rule will ensure that the impact of changing oil prices on economic growth

remains limited. We therefore leave our GDP growth forecast unchanged at 1.2-1.7% for 2019, admitting it may rise to 2-3% in 2021 as the Government implements its structural reforms.

Changing oil price assumptions have stronger implications for our estimated balance of payments. We now predict the current account balance to stand at $71 billion in 2019 (compared to $95 billion assumed in October). We have also made a slight downgrade in the financial account balance of the private sector – to $20 billion, in comparison to $25 billion assumed in October.

Many will ask why next year's financial account balance of the private sector will make up $20 billion, whereas it is predicted at $67 billion for this year.

Beyond the decline in oil prices, the reason for this is the decision to suspend and subsequently resume fiscal rule-based foreign currency purchases in the market. A positive current account balance is helped by either the buildup of national foreign currency reserves or capital outflow.

This is clearly seen from this year's movements in the balance of payments. In the first year-half, the current account totalled $49 billion, with foreign currency reserves at $31 billion and net capital outflow in the private sector at $13 billion. In the second half of the year, when we moved to suspend foreign currency purchases under the fiscal rule, this ratio reversed. With the current account running at $63 billion, we expect capital outflow to run at $54 billion and foreign currency reserves to expand by no more than $8 billion.

Capital outflow in the private sector is either repayment of external liabilities or accumulation of foreign assets including in the form of foreign exchange in foreign bank accounts. Hence, in the second half of the year, when the buildup of government reserves ground to a halt, a considerable part of export revenue, if unspent to reduce external debt, ultimately settled in bank accounts as extra foreign currency liquidity. Incidentally, this is why the response of the foreign exchange rate to the purchase suspension decision was fairly muted. The market essentially continued to expect their resumption and accumulated assets.

Next year, our baseline scenario provides for a return to the 2017–2018 situation, with a significant amount of oil revenues being used to rebuild international reserves and the private sector's capital outflow declining. Importantly, in this logic we do not foresee a strong response of either the current balance or the foreign currency exchange to resumed purchases.

To conclude, let me reiterate that the Bank of Russia will explore the need for further upgrades to the key rate, taking into account inflation and economic developments against the forecast, as well as the risks of external conditions and the response of financial markets.

In the current context it is crucial that our approach remains conservative as we assess risks and conduct monetary policy. Inflation stays close to 4%. More so, it has never climbed above this figure since the second half of 2017. Although the rise in inflation early next year is set to be driven by transient factors, considering the need to limit their negative effects and ensure a speedy return of inflation to 4%, it is critical that the response of monetary policy is well-timed. A consistently conservative monetary policy stance will enable us to curb both inflation risks and the response of inflation expectations. This will lay the groundwork for looser monetary policy by late 2019 – early 2020, if the situation unfolds consistent with our forecast.

Before I proceed to answer your questions, let me also inform you about the changes we want to introduce beginning in March 2019 as regards our communications related to key rate decisions. First, a key rate press release in the follow-up to our policy Board meeting will include a reforecast. Second, a monetary policy report will be published in a week after a Board meeting. These arrangements will serve to better reflect the logic of the already made decision.