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, 22 March 2019.

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Today, the Bank of Russia Board of Directors decided to keep the key rate at 7.75% p.a.

We have every reason to believe that the decisions to raise the key rate made last year are most likely to be sufficient to bring annual inflation back to the near 4% target in the first half of 2020. Some indicators have performed better than we expected in December: foreign financial and commodity markets have stabilised, the VAT pass-through to prices is quite moderate, and inflation expectations have turned to decline. In these circumstances, inflation stands somewhat below our December forecast, while short-term proinflationary risks have softened.

Given these trends, we expect end-2019 inflation to come in at a lower level of 4.7-5.2% instead of the 5-5.5% range forecast earlier.

Let me set out in further detail the factors that were central to our decision.

First, as I have mentioned, annual inflation in January-February proved somewhat lower than we expected at the end of last year, In February, it came in at 5.2%. Monthly price growth rates have already been going down. Annual inflation will pass its peak in March-April on the back of the base effect. Our updated estimates suggest that at its highest point inflation may surge to approx. 5.5%. You will recall that in December we did not rule out that inflation might considerably exceed this level.

There are several reasons for such inflation dynamics.

First of all, the contribution of the VAT hike to annual inflation currently stands at approx. 0.6-0.7 pp, which is close to the lower bound of our expectations. According to our estimates, the VAT pass-through to prices has already largely materialised. This is suggested by the analysis of prices of goods and services for which the VAT was raised. These are mostly non-food goods and services. Annual price growth in most of them has accelerated only moderately. In monthly terms, it returned in February to the growth pace seen in September-December last year (seasonally adjusted); however, it still holds somewhat above 4% in annual terms. Weekly inflation estimates suggest similar developments. After a surge in the first two weeks of this year, they have dropped in recent weeks, though holding somewhat above the path that corresponds to our inflation target. Moreover, we do not rule out that the deferred effects of the VAT hike may manifest themselves in the months to come. It is also of note that in February, both monthly core inflation and most other indicators adjusted for volatile components and seasonality exceeded 4% in annual terms.

There is evidence that risks that prices of certain food products may grow at an elevated pace have decreased. In February, a decline was registered in prices of a number of products which had made a considerable contribution to acceleration of food inflation. Furthermore, both domestic and external prices of main crops stopped growing in recent months. Current harvest expectations for this year are favourable, which also limits risks in this part.

Petrol and diesel prices were comparatively stable in December-February, and even drifted down slightly in February. This constrained inflation acceleration. Furthermore, the ruble appreciated in the opening months of the year; this had a favourable effect on prices and inflation expectations.

Inflation expectations is the second factor we closely monitor. We had concerns about their possible response to inflation acceleration. Expectations of professional analysts remain anchored. Analysts understand the temporary nature of this year's inflation acceleration associated with one-off factors, in particular, the VAT. Therefore, as the Bank of Russia, they forecast a moderate increase in inflation in 2019 and expect inflation to come in at 4% from next year onwards.

Households and businesses responded to inflation acceleration more pronouncedly. Expectations of households rose from a historic low of 7.8% seen last April to 10.4% in January, that is returned to their mid-2017 readings. Businesses' price expectations also jumped considerably. However, household inflation expectations dropped to 9.1% as early as March. Price expectations of businesses also declined. However, they both remain elevated. It is of special note that inflation expectations of households and businesses demonstrated last year that they remained unanchored. They follow current changes in prices, primarily petrol and food prices, and ruble exchange rate fluctuations.

The third important factor we took into account is consumer demand. Lending underpins consumption but slowing wage growth constrains a rise in demand. Consumption growth slowed down after a short-term acceleration in November, which was likely associated with preemptive purchases of non-food goods in the run-up to the VAT hike. We can see it from retail sales figures. The rise in consumer activity does not exert pressure on prices. This, among other things, is an important reason of a moderate VAT pass-through to prices.

The fourth factor is external conditions. A number of changes which only started to emerge in December, intensified at the beginning of this year. The US Fed and the European Central Bank eased their rhetoric as regards the monetary policy outlook. Improvements were seen in markets' expectations regarding the negotiations of international trade restrictions. These factors supported emerging market currencies and reduced their risk premiums. We may say that external risks declined in this part. At the same time, geopolitical risks remain in place.

Oil prices in the first quarter were higher than projected in the baseline scenario. However, risks are high that oil production will exceed consumption this year.

Finally, overall monetary conditions have changed little if at all since the start of the year. Deposit rates have edged higher, while loan rates have stabilised. OFZ yields dipped on the back of improving conditions in global financial markets, as well as a result of reviewed expectations of market participants as to the future key rate path. These OFZ yield movements, while working to constrain the potential of loan and deposit rate growth, are laying the groundwork for their subsequent decrease.

With due account for the totality of factors I have mentioned, we have downgraded our inflation forecast for the end of this year to 4.7-5.2%. At this point in time, it is with a certain degree of confidence that we can say: provided that the situation unfolds according to our baseline scenario, the preventive steps we have made so far to increase the key rate last year are most likely to be sufficient to ensure annual inflation returns to 4% in the first half of 2020.

I will now proceed to speak on the risks, as usual. Despite the reduction in short-term risks, the overall balance of medium-term risks remains tilted towards proinflationary ones. As before, we should approach the assessment of external conditions with great caution. The risks related to geopolitical factors remain high. We continue to observe manifold sources of uncertainly in the global economic outlook. Investor sentiment is subject to rapid change in this environment, which is set to impact on OFZ yields and the exchange rate. Certainly, elevated and unanchored inflation expectations, as I have said, also remain a material risk.

Moreover, it is premature at this stage to make a precise estimate for the ultimate impact of the VAT increase on prices and inflation expectations. At the present time, producers and retailers are essentially compromising part of their margins to ensure customer retention. The muted demand and competition for market share both work to prevent them quickly passing the tax change on to higher prices. This is why they proceed on a piecemeal basis, each time they are able to do so. Moreover, there are still stocks built up before the VAT hike. As contracts are renewed, goods taxable at the new rate will come into the market. Taking into account these factors, we do not rule out that the VAT change pass-through to prices could be protracted. Having said this, our baseline scenario suggests that the VAT pass-through to consumer prices is mostly complete.

As regards the main changes to our medium-term forecast, beginning from today, it will be published as part of the key rate press release. You have had the opportunity to read it.

The principal change in the forecast is a downward revision of inflation projections for this year. Furthermore, we have refined the average level of oil prices for this year based on their actual movements at the start of the year. The baseline scenario has been revised upwards from $55 to $60 a barrel; the high oil price scenario has been revised downwards from $75 to $70. Our oil price forecast for 2020–2021 remains unchanged. These adjustments have made no major impact on expected economic growth indicators in the context of the operating fiscal rule.

Finalised data suggest GDP growth was 2.3% last year, above our expectations. Our estimates suggest that the accomplishment of major investment projects emerged as key enablers of this growth. With due regard for this, we, first, reconfirm our assessment of the nature of economic growth: the economy is close to its potential; its expansion does not create additional proinflationary pressure. Second, we keep our GDP growth estimate in the baseline scenario at 1.2-1.7% for this year. The growth rates will accelerate to 1.8-2.3% in 2020 and 2-3% in 2021 as the positive effect of national projects and structural reforms provided that these deliver.

The oil price adjustments in the forecast carry implications for balance of payments indicators. In the baseline scenario, the forecast current account balance for this year has been upgraded from $71 billion to $88 billion, chiefly on the back of a higher value of oil and gas exports. The balance of the financial account of the private sector has also been raised from with $20 billion to $35 billion. This is based on the actual data for the first two months of the year along with greater opportunities for the buildup of foreign assets given the higher export revenues. Over a medium-term horizon, balance of payments trends remain unchanged.

This year’s revision of the estimate for foreign currency reserves from $52 billion to $59 billion comes a result of higher foreign currency purchase volumes based on the fiscal rule in the context of higher oil prices.

In conclusion, I would like to make the following comment. Should the situation unfold according to our baseline forecast, we hold open the prospect of a key rate reduction somewhat sooner than we assumed back in December last year. We do not rule out that this may occur in 2019. The Bank of Russia will make its key rate decisions, as it always does, taking into account inflation and economic dynamics against the forecast as well as risks posed by external conditions and the reaction of financial markets.