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 June 2019.

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Today, the Bank of Russia has decided to cut its key rate to 7.50 % per annum.

We also revised our end-2019 inflation forecast downwards by 0.5 pp, to 4.2-4.7%.

Should our baseline forecast materialise, we hold open the possibility of a further rate cut at one of the upcoming Board meetings. We assume that we may shift to neutral monetary policy before mid-2020.

I will now highlight the factors we considered while making today's decision.

First. There is a stable trend towards inflation slowdown. It is attributed to the Bank of Russia's key rate decisions including the preemptive hike in the second half of last year. We passed the inflation peak of 5.3%, slightly lower than we expected, in March. Inflation slowing down from this lower peak is overall in line with our forecast. In the February-May period, prices rose by approximately 0.3-0.4% a month, seasonally adjusted. That means that the monthly growth pace has returned to the lowest readings since last August and stands near 4% in annual terms. Annual inflation fell to 5.1% in May, and came in at 5% precisely as at the beginning of this week. This dynamics is attributed to the following factors.

The effect of the VAT increase on inflation has run its course.

The ruble's strengthening since the beginning of the year made an additional contribution to inflation slowdown. Higher oil prices and overall favourable conditions in financial markets helped. International investors' interest in Russian assets recovered, which was the most distinctive in the OFZ market.

The agreements on retail fuel prices between the Russian Government and oil majors are continuing to play a significant role. Consumer petrol prices rose in May by 2.8% year on year, and their growth is likely to be moderate in the near future. That said, the new regulation in this market, in particular, the offsetting mechanisms (including reverse excise duties), is rather complicated. Currently, it is hard to accurately estimate its medium-term economic effectiveness, especially for scenarios providing for tangible oil price fluctuations.

Moderate domestic demand is also curbing inflation.

This calls for a deeper insight into the economy. This is the *second* most important factor that we took into account. Economic growth in the first half of the year has been lower than expected. We predicted that business activity might slow down somewhat at the beginning of the year on the back of the following factors: the VAT hike, a likely slowdown in growth of the global economy and demand for Russian goods and services, and the implementation period of the major national projects scheduled for the second half of the year. Some of these factors had a stronger effect than expected. In particular, budget expenditure dynamics.

We will be able to take a deeper insight into the economic growth slowdown after detailed GDP statistics are released. However, the 2018 data released in April and preliminary Q1 2019 estimates allow us to update our GDP forecast for this year. In particular, the revision is associated with lower export growth rates and a tempered outlook for growth in the global economy and external demand. We have left the forecast for consumer and investment demand unchanged in view of the expected rise in public expenses in the second half of the year. As a result, we have updated the 2019 economic growth forecast from 1.2-1.7% to 1-1.5%.

Third. Proinflationary risks have declined over a one-year horizon. First, we no longer expect any deferred effects of the VAT hike. Second, the US Fed consistently eased it rhetoric since the year start amid the expected slowdown of global economic growth. All else being equal, this constrains the risks of considerable capital outflow from emerging markets.

In March-April, we noticed that the risks of accelerated growth in prices of certain food products diminished. Overall, they remain moderate, though current food inflation was somewhat higher in May than in the previous three months, seasonally adjusted.

Moving forward, we expect that record crop areas, early spring, and overall favourable weather will bring a good harvest of vegetables, grains and other crops. Domestic and global grain prices have been down since the beginning of the year. This contains proinflationary risks for food products.

As regards monthly growth in prices of non-food goods and services, it held close to or below 4% in annual terms in March-May.

Fourth. We factored in that inflation expectations of households and businesses remain elevated against both the inflation target and the minimum levels reached in the opening months of 2018. Inflation expectations show mixed dynamics. Business price expectations continued to decline in April-May. Inflation expectations of households came in at 9.3-9.4% during this period. However, we expect that inflation decline to 4% will bring down inflation expectations of households and businesses.

Analysts' expectations remain anchored at the inflation target of close to 4%.

Fifth. Monetary conditions are softening. This is driven by changing expectations of domestic and external financial market players. First, this is enabled by revised expectations as to the path of the Bank of Russia key rate; second, by an adjustment in expectations and yields in the external financial market against the background of changes in major central banks' rhetoric – which I have mentioned. OFZ yields are declining in this environment, enabling a potential reduction in deposit and lending rates. Between April and May, a number of major banks revised downwards their interest rates on several deposit products; interest rates on mortgage loans were also beginning to trend down. Today's decision to cut the key rate alongside the signal we have sent out will work to solidify these trends.

Medium-term outlook. The outcome of OPEC+ negotiations remains uncertain. We look to further concerted actions by deal parties to warrant smooth oil price dynamics over the forecast horizon. Based on their actual movements since the year start, we have upgraded the average annual Urals crude price in our baseline scenario from $60 to $65 per barrel in 2019 and from $55 to $60 per barrel in 2020. We retain our conservative assumptions for 2021 whereby the oil price is expected to reach $55 per barrel.

Key balance of payments figures in the baseline scenario have also been adjusted to oil price movements and the expected dynamics of the global economy. This year's current account balance is estimated to total $98 billion (approx. 6% of GDP) and drop subsequently to $50 billion (approx. 3% of GDP) in 2021. This is attributed to downward oil price trends and expanding imports as economic growth accelerates.

The private sector's financial account balance in 2019 is set to amount to approx. $50 billion (3% of GDP). Financial transactions of private sector balance already reached $35 billion in the first five months of the year. We expect it to drop substantially in the second half of the year compared to both the past year's last six months and the first six months of this year. The main reasons behind this outlook are as follows. First, it comes as a reflection of the seasonality which is typical of balance of payments figures. Second, we look to normalisation in the accumulation of foreign assets, which has quickened considerably since the middle of the past year in the context of strengthened external, including geopolitical risks.

Our medium-term economic growth outlook is essentially the same. 1-1.5% GDP growth in the current year is expected to accelerate gradually to 2-3% in 2021. Having said that, our forecast will largely depend on the timeframes and successful implementation of the national projects along with other fiscal policy decisions.

Discussions are currently underway about possible options of spending the liquid part of the National Wealth Fund in excess of the 7% of GDP cap. As we look into such options, it is imperative that we remember the key objective of the fiscal rule, which is to reduce the reliance of the economy, of the real exchange rate and of public finances on a volatile energy price environment so that they all become stabilised in a state equivalent to the oil price cut-off. We have largely delivered on this objective, with the impact of oil price fluctuations on the Russian economy having considerably weakened. Current suggestions are essentially focused on changes to the rule. They could result in either direct or indirect change in the cut-off price, entailing a strengthening of the real ruble exchange rate and undermining competitiveness of our products. Alternatively, the stabilising mechanism of the fiscal rule could be undermined, yet again adding to the vulnerability of the Russian economy to fluctuations in external environment.

More so, the 7% of GDP cap was set a long time ago; yet another review is needed to establish whether this volume of liquid assets is adequate to resist to sharp and lengthy change in external conditions.

As we review these and similar suggestions, we urge to fully consider the benefit and loss balance driven by change in macroeconomic conditions which may be tangible enough.

Approaches to fiscal and structural policies will have a significant impact on both our forecast and estimates of the balance of risks for inflation. This will in turn determine the monetary policy path.