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, 11 June 2021.

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Today, we have decided to raise the key rate by 50 basis points to 5.50% per annum.

As inflationary pressure has notably strengthened, we need to ensure price stability consistently and actively. We see the necessity of further increases in the key rate at upcoming meetings.

Let me dwell on the factors behind the today's decision.

First. The Russian economy will return to its pre-crisis level during this quarter. Its H1 growth exceeds the pace we factored in in the April forecast. Leaving out restrictions on oil production and international passenger travel, it is clear that the output in most key industries has not only bounced back to the end-2019 level but outstripped it. Russia is among the group of countries that will be the first to reach the pre-pandemic level of output.

It is typical of the current situation in many sectors of the economy that growth in demand is outpacing the potential to expand supply. Companies need time to roll out new capacities, and also hire and train staff.

Demand is growing both domestically and abroad. The activation of external demand is underpinned by a faster-than-previously-anticipated rebound in the global economy and trade. The main reasons are abating epidemic risks, given vaccination rates, and extremely loose monetary and fiscal policies in major economies.

The aggregate demand is also affected by the elevated growth rates of raw materials and component inventories. Firstly, companies make up for the drop in inventories incurred during the pandemic and as a result of disrupted logistical chains. Secondly, in light of the last year's experience companies are seeking to accumulate more inventories to insure against possible disruptions in supplies, as well as further price increases. These processes concern a broad range of production chains rather than a narrow group of goods.

The structure of demand is also changing, as a result of changes in people's way of life due to the pandemic. Neither the sustainability nor the duration of this process is clear so far. Yet, it evidently creates bottlenecks on the supply side. For instance, massive work and study from home spurred a sharp increase in the need for telecommunications followed by a considerable increase in the demand for microchips. Online orders require much more packaging materials. A pick up in demand for real estate is in part associated with the desire to reach comfortable conditions for working from home. Wishing to support their economies, many countries are expanding infrastructure projects; all this also influences the increase in demand for construction materials and metals.

It is still difficult for businesses to assess which part of the elevated demand is temporary and which — sustainable. They need time to make decisions about investing in new production facilities. Moreover, these decisions may be postponed given the large-scale changes concerning the regulation of greenhouse gas emissions and corporate taxation. These transformations can significantly change the economic situation in many industries and the return on investment in them. Such uncertainty is able of decelerating capacity expansion globally. In these conditions, the aggregate supply will be less elastic, responding less flexibly to the pick up in demand even over the mid-term horizon, compared to previous years.

Coupled with the accommodative monetary policy and fiscal policy of major economies, all these factors strengthen the risk that the acceleration of inflation both in this country and in the majority of other countries is of a more sustainable nature than perceived at first glance.

In the Russian economy, demand is growing energetically and sustainably. This is especially noticeable in the non-food segment. People continue to actively buy household appliances, construction materials, and furniture. The change in car sales is a clear manifestation of the pick up in domestic demand. In recent months, their sales have exceeded the 2018 level, which was a record high compared to 2014. The sales of apartments have increased considerably. To finance these large purchases, people use their savings, including money saved due to restrictions on foreign tourism, and take out more loans. In the services sector, the recovery has not yet completed mainly due to remaining anti-pandemic restrictions.

The demand for labour is bouncing back, with some industries noting a certain deficit of labour force. This is associated both with borders closed for labour migrants and with the expansion of several industries' need to hire more staff than before the pandemic. The annual growth of nominal wages remains within the range of recent years.

Accommodative monetary policy was required to ensure a faster return of demand to its pre-pandemic level and to restore output. Once recovery is completed, supply cannot keep pace with further fast expansion in demand. Therefore, accommodative monetary policy would continue to step up inflation rather than expand output.

This brings us directly to the second factor underlying our today's decision. Inflation becomes a growing concern. In May, annual price growth rates reached 6%, considerably exceeding the target level. The current inflationary pressure has intensified. The average three-month (from March to May) seasonally adjusted price growth peaked up to a maximum since January 2016. Similar trends are observed for other indicators of price dynamics under our consideration.

It does not seem correct to attribute this elevated price growth exclusively to the impact of transitory supply-side factors, in particular, global price movements. Let me remind you that this explanation was the main one when prices picked up in Q4 last year. At that moment, doubts indeed persisted as to the sustainable nature of demand recovery given the ongoing pandemic. Nonetheless, even then we aired fears that the rise in inflation expectations driven by these external shocks might transform one-off proinflationary factors into sustainable ones. We may see now that in recent months the proinflationary impact of demand has become prevailing.

The fundamental difference of the so-called 'cost inflation' from 'demand inflation' is how it influences the physical volumes of consumption. In case of 'cost inflation', that is, supply shock, prices are growing, but consumers have to buy less in response. Businesses can only partially translate their costs into prices, as demand is limited. Whereas, if both prices and sales volumes grow, and this is exactly what we are seeing now across quite a few market segments, it means that the expansion in demand is by far exceeding the impact of supply-side factors. Therefore, it means that we are facing 'demand inflation'.

Finally, elevated inflation expectations do make a considerable contribution to inflation. In anticipation of price increases, consumers are ready to start buying earlier than they previously planned. Thus, given the unanchored expectations even transitory price spikes may become more sustainable.

Why is the acceleration of inflation posing a threat? It is more difficult for companies to stick to their business plans, predict financial flows, and hedge against volatility. It is the most vulnerable citizens that are hardest hit by inflation. Low-income families spend increasingly more funds on essential goods. High inflation boosts inequality, lowers social security, and undermines the financial standing of most families. That is why our main task is to stabilise price growth as soon as possible by curbing inflation expectations and not allowing inflationary spiral to exacerbate.

According to our estimates, annual inflation is expected to be higher than we forecast in April but lower than its current level. Due to the high base effect in the first half of this year annual inflation will return to the target only in the second half next year.

Third. Monetary conditions remain accommodative. Interest rates on loans and deposits are low as compared to current and expected inflation. Our decisions to raise the key rate in March and April have not yet been fully reflected in banks' interest rates.

Banks' lending and deposit rates are closely connected with yields on government bonds, OFZs. OFZs are risk-free ruble assets for banks and the pricing of all other ruble products of banks is pegged to them. OFZ yields with various maturities change together with the key rate, though to a different extent.

The key rate impacts to the most extent the yields on short-term OFZs, with maturities of up to two-three years. These yields have increased significantly over the past two months. They will impact the cost of short-term loans and also deposit rates, which have already started rising.

Meanwhile, yields on long-term OFZs are largely determined by long-term inflation expectations, the assessment of the macroeconomic policy stability, and external environment. The cost of long-term financing of investment projects as well as mortgage loan rates depend precisely on the yields on long-term OFZs. Pursuing monetary policy to stabilise inflation and raising the key rate to achieve this, the Bank of Russia curbs growth in long-term interest rates in the economy. This quarter experience is a good illustration of the above. Despite the increase in the key rate on three occasions since last March for a total of 125 basis points, the yields of long-term OFZs are currently on the same level as in late March.

As far as the pace of lending growth is concerned, it remains high both in corporate and particularly retail segments. Thus, mortgages are rising by more than 25% year-on-year. In addition, retail loans are heating consumer demand. We are also concerned by the fact that lending is growing due to loans to borrowers with a high debt burden. Therefore, we resume pre-pandemic macroprudential add-ons on unsecured loans from 1 July and on mortgage loans with a low down payment and a high debt-to-income ratio of borrowers — from August. The Bank of Russia will stand ready to further increase macroprudential add-ons to prevent the accumulation of systemic risks and to ensure financial stability.

Since our meeting in April, the balance of risks has tilted even more towards proinflationary risks.

Elevated inflation expectations as a response to high inflation and low interest rates still pose a major risk. With fears of future price growth, people tend to spend more today and save less for tomorrow. This makes prices grow even more rapidly.

Disinflationary risks look weaker. They are connected with, firstly, a faster reopening of borders. In this case, domestic demand may partly shift to imports of tourism services, easing domestic demand-side pressure on prices. Secondly, if the pandemic deteriorates, depending on the pace of vaccination and the spread of new coronavirus strains, the global economy will grow much more slowly. Thirdly, a bumper harvest may cause inflation to slow down.

As far as monetary policy prospects are concerned, we are prepared to step up actions needed to bring inflation back to the target. As I have already mentioned, the Board of Directors sees the necessity of further increases in the key rate at upcoming meetings. We will determine the scope and pace of increasing the key rate based on our assessment of the level of sustained inflationary pressure, the timeframe for inflation expectations stabilisation, as well as the forecast of further movements of aggregate demand and supply. Our monetary policy will ensure annual inflation to return to the near 4% target in the second half of 2022.

Thank you for your attention!