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## INTRODUCTION

*The Bank of Russia's monetary policy is aimed at maintaining price stability in the Russian economy. Keeping inflation sustainably low is of paramount importance to public welfare, favourable business environment, higher accessibility of long-term financial resources and confidence in the national currency.*

*Setting a quantitative inflation target near 4% and inflation steadily anchored at a sustainably low level significantly raise the certainty of economic conditions for all economic agents and ease financial and investment planning, as well as decision-making on saving and borrowings.*

*In the Monetary Policy Guidelines for 2020-2022, the Bank of Russia's strategic document, the regulator explains goals, key principles and approached towards the conduct of monetary policy, and presents medium-term macroeconomic forecast scenarios.*

*Alongside the consistency of goals and principles and the continuity of approaches, the central bank's consistent and timely measures aimed at the delivery on the inflation target are key to households' and businesses' trust in monetary policy and the near 4% inflation target.*

*Inflation has been at its all-time lows in recent years in Russia; however, economic participants' inflation expectations remain elevated, with credibility in the target and monetary policy measures remaining yet to be fully built. Only sustainably low inflation close to 4% can emerge as a reliable benchmark.*

*In this context, the Bank of Russia's preventive action made the difference back in 2018, when the decisions were made to raise the key rate in response to a host of proinflationary factors. This helped check their influence on inflation, and – after short-term growth in consumer prices – ensured steady deceleration in their growth so that in the middle of this year it was possible to switch to the key rate cutting policy. Annual inflation moved close to 4% by autumn 2019; the Bank of Russia forecasts that it is to reside close to 4%. The Bank of Russia will make every effort to anchor annual inflation to the target. Alongside key rate decisions, the Bank of Russia's communication policy is a core monetary policy tool. It makes a tangible impact, helping shape both interest rates in the financial market and inflation expectations.*

*At the same time, the Bank of Russia is focused on the factors which will have a significant influence on the development of the Russian economy and inflation dynamics over the forecast horizon. External factors include world economic growth prospects which have deteriorated considerably amid a rise in trade tensions and other geopolitical factors in 2019. Internal factors include approaches to the pursuit of fiscal policy, including the use of liquid assets of the National Wealth Fund exceeding 7% of GDP. That said, the pace and structure of economic growth over a three-year horizon and the nature of the impact of economic dynamics on inflation will largely depend on the implementation of national projects and the effects of other structural measures. The Bank of Russia includes other*

*internal and external factors in the calculation of its baseline scenario, the assessment of related risks, and the elaboration of supplementary scenarios.*

*When articulating its medium-term view, the Bank of Russia also takes into account the fact that economic development and a rise in the efficiency of the monetary policy transmission mechanism will be fostered by the Bank of Russia’s measures to develop the financial market, enhance the accessibility of financial resources, instruments and services, and maintain overall stability of the financial sector.*

*In the years to come, a steady rise in the Russian economic growth pace driven by internal development sources, is only possible if all public authorities work together, the private and public sectors join their efforts at all levels, and the business climate, of which price stability is an integral element, improves.*

# 1. MONETARY POLICY GOALS, PRINCIPLES AND TOOLS

## CONTRIBUTION OF MONETARY POLICY TO ECONOMIC DEVELOPMENT

**The main goal of monetary policy is to support price stability, that is, sustainably low inflation. Low inflation ensures a stable purchasing power of the national currency. Price stability is an important element of an environment that is favourable for living and doing business.**

**Low and predictable inflation protects income and savings in the national currency.** Price stability protects wages, pensions and other income, as well as national currency-denominated savings of households and businesses from unpredictable depreciation. This allows households to, among other things, maintain the living standards and plan spending, including long-term, with a greater confidence.

**Price stability is paramount for social stability.** Low-income households are the main beneficiaries of low and steady inflation. Such families choose inexpensive staple goods and cannot switch to their cheaper substitutes if prices rise considerably. High inflation forces them to reduce consumption to the detriment of their quality of life. All else being equal, high inflation causes income differentiation and aggravates social inequality. Low inflation is, therefore, an important prerequisite for social stability.<sup>1</sup>

**Low and sustainable inflation is also favourable for businesses. It makes debt financing more affordable for companies.** High inflation and/or significant price volatility are a risk source for economic

agents, including banks. When inflation rises, the cost of bank liabilities grows faster than the return on bank assets. In this environment, banks have to raise the cost of borrowing or reduce the maturity of loans to mitigate risks.<sup>2</sup> In contrast, low and steady inflation brings down the inflation premium included in banks' interest rates and allows lenders to expand the supply of long-term loans. This creates favourable conditions for businesses to borrow. Not only Russian banks, but also domestic investors (individuals and firms) and foreign investors are more inclined to lend in countries with a predictable economic environment of which sustainably low inflation is an integral part.

**Price stability also simplifies financial and investment planning for businesses.** Low inflation lays the groundwork for investment growth and, consequently, sustainable and balanced economic growth. Thereby, monetary policy contributes to the common goal of current economic policy aimed at speeding up economic growth through a rise in investments.

**Boosting confidence in the national currency, low and stable inflation paves the way for a smaller share of foreign currency in assets and liabilities in the economy. This, in turn, decreases the influence of external conditions on the economy.**

**Public opinion polls and company surveys also suggest that low and stable inflation is an important part of an environment which is favourable for living and doing business.** According to surveys, households and corporates cite inflation as one of the problems deteriorating living

<sup>1</sup> For details of the effect of inflation on social inequality, refer to Appendix 3 of the Monetary Policy Guidelines for 2018–2020.

<sup>2</sup> As a result of high and volatile inflation of the early 2000s, short-term loans (for up to one year) accounted for more than 50% of banks' corporate loan portfolio. Currently, the figure holds within 20%.

conditions and the business environment and impairing the competitiveness of Russian goods.

Monetary policy lays the groundwork for economic development; however, it cannot be a source of a sustainable rise in economic potential. In the long term, the main factors determining the outlook for economic growth include developments in labour and capital productivity and an innovation pace. The central bank cannot impact the efficiency of production factors and the introduction of technologies through its monetary policy tools. In its efforts to underpin price stability, the central bank influences domestic demand and, consequently, the use of production factors. Thereby, monetary policy impacts the deviations of the economic growth rate from the potential, rather than the economic potential itself.

Given the above, any efforts to boost economic growth in Russia through monetary policy measures by means of an unreasonable key rate cut would lead to large-scale negative consequences in current conditions. In the short term, an unreasonable reduction of the key rate would stimulate accelerated lending growth and raise investment and consumer demand. In addition, such growth can have inflation implications as it will outpace potential production capacity expansion. This is associated with the fact that this period of time gives no opportunity to substantially raise production because the economy is close to its potential. When companies register a rise in demand, they will compete for the labour force and raise wages. This will also expand consumer demand. Meanwhile, many industries will need time to increase fixed assets through the implementation of investment projects. As a result, the rise in domestic demand, coupled with the lack of internal opportunities to satisfy it, will considerably accelerate inflation in two ways.

First, as wages and loans increase demand amid an insufficient supply of domestically-produced goods, their prices will go up. Second, the insufficiency of domestically-produced goods will boost demand for imports; this will weaken the ruble and push inflation upwards. High inflation will depreciate incomes, bring considerable uncertainty and hamper business planning. Soaring inflation will discourage depositors from placing their funds at low rates, and banks will have to raise their interest rates. In order to cover losses from rising costs of deposit sourcing, banks will increase lending rates. This will further constrain investment and undermine economic growth. Thereby, the efforts to unreasonably ease monetary policy will not ensure a sustainable acceleration of economic growth and will bring inflation upwards.

## KEY MONETARY POLICY PRINCIPLES

### Setting a permanent public quantitative inflation target

Under its inflation targeting strategy, the Bank of Russia sets a quantitative inflation target and publicly announces it for households, businesses and financial market participants to take it into account in their planning and decision-making. The Bank of Russia pursues its monetary policy to deliver on the inflation target.

The monetary policy goal is to keep annual inflation close to 4% on a permanent basis. ‘Close to 4%’ means that inflation may slightly deviate from the target. Such deviations are natural, given that prices are shaped by multiple factors, and complex interconnections exist in the economy. At the same time, monetary policy influences price dynamics indirectly during a certain period of time; therefore, its measures are insufficient to deliver on the target to a great precision.

The inflation target is set for the annual consumer price growth rate, that is, a change in prices of goods and services consumed by households over the past 12 months. The consumer price growth rate is determined based on the consumer price index (CPI) calculated for Russia by Rosstat. Price growth rates may fluctuate around 4% in the markets of different goods and services across regions due to specific local factors.

The Bank of Russia seeks to permanently keep inflation close to 4%. If inflation deviates from the target, the Bank of Russia will assess the causes and length of such deviation and decide accordingly on the need to resort to monetary policy measures so as to bring inflation back to the target. The pace of inflation returning to the target will be chosen taking into account the scale of the deviation and the impact of key rate decisions on the economic activity. Furthermore, if financial stability risks materialise, the Bank of Russia may factor in the sustainability of financial sector actors and financial stability when making this choice.

A floating interest rate is an essential condition for monetary policy's effective influence on the economy under the inflation targeting regime. When exchange rate flexibility is low, the central bank's foreign exchange interventions affect banking sector liquidity and lead to high dependence of the money market and other segments of the financial market on external economic developments. This makes it harder for the central bank to independently steer interest rates and may render monetary policy less efficient.

A floating exchange rate acts as a 'built-in stabiliser' allowing the economy to adjust to changing external conditions and smoothing their impact.<sup>3</sup> In the pursuit of

a floating exchange rate regime, the Bank of Russia has refrained from interventions in the domestic foreign exchange market aimed at sustaining a certain exchange rate or the pace of its change. Having said that, the Bank of Russia may conduct foreign currency transactions in the domestic market if a threat to financial stability emerges and in order to replenish (use) foreign currency reserves to deliver on the Ministry of Finance's fiscal rule.

### Key rate and communication as monetary policy instruments

Under the inflation targeting regime, **the key rate is the main instrument of the Bank of Russia's monetary policy.** The Bank of Russia Board of Directors makes key rate decisions on a regular basis, eight decisions a year in accordance with the approved and released schedule (see Appendix 5 'Bank of Russia Board of Directors' monetary policy meetings and related events in 2020'). With its key rate revisions the Bank of Russia impacts interest rates in the economy; their movements, in turn, influence domestic demand and inflation. For the key rate to translate into financial market rates, overnight money market rates should form near the key rate. This is enabled by the Bank of Russia's operational procedure under which the central bank carries out operations with commercial banks at an interest rate that is close to the key rate on a regular basis (for details, refer to Section 4).

In the case of long-term equilibrium in the economy, that is, if inflation and inflation expectations hold close to the target and the economy grows at the rate close to potential, monetary policy should not exert either a constraining or accommodative effect on the economy, that is, this policy should be neutral. If the economy is in equilibrium, the key rate is neutral (see Box 'Neutral interest rate'). The neutral level is determined by multiple factors and can be

<sup>3</sup> For details of the role of a floating exchange rate as a 'built-in stabiliser' of the economy, refer to Appendix 9 of the Monetary Policy Guidelines for 2018-2020.

estimated in different ways. Depending on the key rate reading relative to the neutral level, its effect on economic activity and price dynamics, monetary policy can be accommodative, contractionary or neutral.

Accommodative monetary policy is resorted to when inflation persistently deviates downwards from the target or if there are risks that such deviations may emerge unless monetary policy measures are taken. It suggests that the key rate is retained below its neutral level, which helps inflation rise to a target.

In contrast, contractionary monetary policy is resorted to when inflation persistently deviates upwards from the target or when there are risks that such deviations may emerge unless monetary policy measures are taken. It suggests that the key rate is retained above its neutral level, which helps inflation slow down to a target.

**A key rate decision always comes with an explanation of its logic and reasons, and is generally accompanied with a signal of possible monetary policy moves** which may be made if the economic development and inflation dynamics are close to the Bank of Russia's baseline forecast. Thereby, the monetary policy signal is conventional in nature and demonstrates the intents which may be effectuated if the central bank's baseline scenario materialises. The monetary policy signal is no less important than the key rate decision itself, because it impacts market participants' expectations for further moves by the central bank and the shape of the yield curve. That said, the Bank of Russia may use the signal of intentions to both communicate its monetary policy outlook to the public, and adjust expectations of financial market participants. This is essential if market expectations for interest rates considerably deviate from the central bank's estimate of their possible movements.

**The Bank of Russia's explanation of its decisions and intentions is an important instrument for steering inflation expectations, their so-called anchoring to the inflation target.** Inflation expectations influence both inflation dynamics and interest rates in the economy. The level and movement of inflation expectations determine, among other things, the risk premium included in interest rates. The anchoring of inflation expectations of both households and businesses to the inflation target is critical for the efficiency of the central bank's measures. Therefore, it is important that economic agents be confident in monetary policy aimed at keeping inflation close to the target level. To shape this confidence, it is essential that the inflation target be successfully achieved and economic agents understand the central bank's policy, its goals, approaches and measures taken to deliver on the target. Such explanations are especially important when certain factors cause a temporary deviation of inflation from the target, and the central bank takes measures to bring it back to the target level. This makes the Bank of Russia focus on its information policy, while transparency is one of the core monetary policy principles (see the Transparency subsection).

### **Monetary policy decision-making based on the macroeconomic forecast and analysis of a wide range of information**

The Bank of Russia takes monetary policy decisions based on its macroeconomic forecast. The effect of monetary policy on price dynamics is not immediate: it takes time and a long chain of interconnections known as the transmission mechanism. The main channel of influence is interest rates. The revision of the Bank of Russia key rate impacts market interest rates on which saving and lending activity depends.



The propensity to save or spend (consume/invest) shapes domestic demand in the economy that influences price dynamics. It takes from two months to three quarters for a key rate revision to translate into interest rates on loans and deposits with various maturities. In the light of this, the key rate pass-through to demand and price dynamics takes from three to six quarters (for details, refer to Appendix 1 ‘Monetary policy transmission mechanism in Russia’). Therefore, the assessment of the effect of a key rate decision on the economy and inflation requires a macroeconomic forecast. The Bank of Russia employs up-to-date macroeconomic models in its forecasting.

When preparing a macroeconomic forecast the Bank of Russia estimates the duration of factors affecting the economy and prices, and the stability of emerging economic trends. Given the long pass-through of monetary policy measures on the economy, **the Bank of Russia is guided by sustainable economic trends and long-term factors in its key rate decision-making.** The Bank of Russia revises the key rate if current trends point to a persistent deviation from the target on the forecast horizon or if long-term factors are in place which are highly likely to lead to such a persistent deviation. The Bank of Russia abstains from monetary policy measures if inflation is expected to return to the target reading over a short-term horizon despite its current deviation. If the Bank of Russia takes measures in response to such a short-term deviation, they will continue to affect price dynamics after inflation returns to the target. This may push inflation to the opposite side, which contradicts the task of keeping annual inflation close to 4%.

At the same time, factors, which are short-term in nature, may have a longer impact if they affect inflation expectations. Inflation dynamics are largely determined by inflation expectations, as they guide

economic agents in their decision-making regarding procurement, wage and price-setting. For instance, households may respond to inflation acceleration triggered by short-term factors with elevated demand for goods, expecting that their prices may soon go up. This process may affect both the goods that have become more expensive and other products, particularly staples. In this environment producers may decide to raise prices for a wider range of goods and services. Inflationary pressure will rise and inflation deviation from the target will become more persistent. Such a situation may call for monetary policy measures. In contrast, when inflation expectations are low and anchored to the inflation target, consumers limit their purchases of goods in response to accelerated price growth, as they expect inflation to slow down and return to the target. Thus, when inflation expectations are anchored, demand is more sensitive to price increase, and limits inflation growth triggered by proinflationary factors.

**The Bank of Russia conducts an in-depth analysis of a wide range of information when preparing its macroeconomic forecast.** The Bank of Russia analyses, among other things, current statistics for the Russian economy and the state of global commodity and financial markets, information on economic policies in major foreign economies, and possible changes in fiscal, tax, social and other areas of Russia’s economic policy. The Bank of Russia uses these data to formulate assumptions for forecast scenarios – external and internal economic factors which may have a tangible effect on the Russian economy and inflation dynamics, and estimates inflation risks.

**When formulating assumptions for the macroeconomic forecast and estimating current risks, the Bank of Russia takes a conservative approach with a focus on proinflationary factors and risks.** Price

expectations of households and businesses alike remain elevated and sensitive to short-term factors. At the same time, their response to price movements is asymmetrical. Households and businesses are more responsive to price growth acceleration than slowdown. Therefore, at the current stage, underestimation of proinflationary factors and risks may lead to persistent and long-lasting deviations of inflation upwards from the target.

In order to change the nature of inflation expectations, it is essential to anchor inflation at the target. The reduction and anchoring of inflation expectations will, in turn, help support price stability. Therefore, when formulating forecast assumptions, the Bank of Russia deeply analyses proinflationary factors and seeks to factor in inflation risks in the forecast if they are highly likely to manifest themselves.

**Measures in other domestic economic policy directions as well as economic policy measures in major foreign economies are all important factors for the Bank of Russia to consider in its macroeconomic forecast building.** They all have a bearing on the current state of the Russian economy and price movements; hence the need to take them into account in implementing Bank of Russia monetary policy.

In accordance with the legislation, the Bank of Russia is responsible for several areas of economic policy. Along with monetary policy, these areas include, among other things, financial stability, sustainability and development of the banking sector, financial market and payment system. Cross-impact and mutually consistent measures are attained through a decision-making process at the Bank of Russia Board of Directors, as well by engaging representatives of multiple activities in the operations of field-specific committees and working groups within the Bank of Russia.

**Monetary policy and fiscal policy.** Fiscal policy makes a considerable impact on monetary policy conditions: economic growth rates and structure, movements in prices for goods and services. The Bank of Russia therefore takes into account fiscal policy measures in its macroeconomic forecast and in making key rate decisions.

The budget formation approach is a key driver behind price movements. Maintaining a balanced fiscal policy is an indispensable condition that ensures absence of inflationary pressure along the fiscal channel. In contrast, imbalanced fiscal flows and a considerable build-up of budget expenditure may have inflation consequences.

One of the key elements of the fiscal strategy is a fiscal rule. It works to smooth out the impact of changes in the external climate on the domestic economic environment, including exchange rate movements and demand in the economy. This results in a lower volatility of the exchange rate and prices, which, in turn, enables the successful conduct of monetary policy.

The running fiscal rule alongside foreign currency market operations acts to reduce fluctuations of the real ruble exchange rate, triggered by a changing commodity price environment. This promotes increased competitiveness of Russian goods, enabling the advent of domestic conditions for industrial development in non-commodity sectors and, therefore, gradual change in the economic structure.

Under the fiscal rule, the federal budget's excess oil and gas revenue to be used for foreign currency purchases to replenish the National Wealth Fund (NWF) or the volume of foreign currency out of the NWF to be allocated for subsequent transfer to the budget are both calculated by the Ministry of Finance. The Bank of Russia carries

out fiscal rule-based transactions in the FX market in such a manner that exerts only minor influence on exchange rate dynamics. Furthermore, the Bank of Russia may temporarily suspend these operations if volatility in the domestic FX market is elevated, among other things, due to materialisation of external risks or financial stability threats.

Government investment targeting the development of specific economic sectors of relevance may drive structural changes in the economy. If they help overcome structural constraints in the economy, this contributes to the expansion of the production capacity. As a result, accelerated economic growth driven by the rise in public expenditures will not exert upward pressure on inflation.

The nature and specifics of the effect of budget expenditures on the economic activity and inflation in the short term depend not only on their structure and performance, but also on their uniformity over time.

Moreover, tax policy measures may influence price dynamics. Revisions of taxes, chiefly indirect ones, entail one-off price adjustments and call for no monetary policy response provided that economic entities' inflation expectations are anchored at a low level. However, inflation expectations currently remain substantially sensitive to proinflationary drivers. Steadily growing inflation expectations against the backdrop of tax increases may lead to inflation deviating upwards from the target – a factor the Bank of Russia takes into account in the conduct of its monetary policy.

Thus, long-term priorities, the strategy and specific measures of fiscal and structural policy have a significant impact on the Bank of Russia's macroeconomic forecast and its estimate of the balance of risks for inflation. In turn, this has a significant effect

on choosing the monetary policy stance needed to deliver on the inflation target.

Russia's Ministry of Finance and Ministry of Economic Development, in preparing a draft federal budget and the social development outlook, also take into account the inflation target and the influence of monetary policy on the economy and price movements. Cross-impact and mutually consistent monetary and fiscal policy measures are attained through continual interaction between the Bank of Russia, the Ministry of Finance of Russia and the Ministry of Economic Development of Russia. In particular, regular joint meetings are held to enable macroeconomic forecast discussions and the cross-checking of estimates and factors impactful on key macroeconomic indicators. At the same time, central to improved credibility and efficiency of monetary and fiscal policies are consistent communications on related matters.

**Monetary policy and other types of state policy.** A number of other government bodies' measures contribute towards efforts to support price stability. Their impact is a factor the Bank of Russia considers in its macroeconomic forecast building. Efforts to reduce the impact of non-monetary factors on price movements are critical in curbing price growth and volatility. The Bank of Russia alone is unable to make a difference here. Having said that, the influence of these factors may bring about marked inflation fluctuations, which, in turn, may have a negative effect on inflation expectations.

Government bodies' measures help weaken the influence of non-monetary factors on inflation. The Bank of Russia is involved in these efforts, providing its own expertise to analyse the markets of goods and services and proposing ways to address problems. At the regional level, the Bank of

Russia's regional branches cooperate with public authorities on a regular basis on these issues.

Other currently applied state policy measures aimed at reducing the effect of non-monetary factors on prices include the fine-tuning of the infrastructure of the agricultural produce and food market, measures to promote competition, among other things, in the motor fuel market, and regulation of utility rates (see Box 'Effect of non-monetary factors on inflation' in Section 3).

The implementation of agricultural policy measures will help reduce the negative effect of agricultural produce supply-side factors on inflation, exchange rate movements and developments in global commodity markets. This will result in a decrease in food price volatility which remains the highest of the key inflation components and has a tangible effect on inflation expectations.

Measures to constrain monopolisation of goods and service markets will also reduce the negative effect of non-monetary factors on prices. Business in a weak competitive environment has fewer incentives to improve efficiency and cut costs, which leads to higher prices. For example, when unfavourable factors push costs upwards, monopolies increasingly pass them on to customers. In a more competitive environment, companies will seek to keep their market share and pass increased costs on to ultimate retail prices only partially, although reducing their profits. At the same time, they will try to increase their efficiency and cut costs – otherwise they will have to leave the market. Ultimately, unfavourable factors will have a weaker effect on the price level in a more competitive market.

A critical framework to reduce the effect of imperfect competition on price formation is 'The Standard for Promotion of Competition in the Constituent Territories of the Russian Federation' (further referred to as the

Standard). Bank of Russia representatives participate in the operations of collegial bodies established in compliance with the Standard. In order to reveal commodity markets in the constituent territories of the Russian Federation where high market concentration curbs the reduction of inflationary pressure and to overcome this phenomenon, the Bank of Russia expands cooperation with the Federal Antimonopoly Service of the Russian Federation and extensively improves the Standard.

An additional effect on prices may be exerted by domestic institutional factors associated with the regulation of individual markets, including the revision of required ratios, commissions, and approaches to rate-setting. Despite the fact that their effect on inflation is usually minor and sporadic, it may prove significant for certain markets and regions, as well as for inflation expectations of households and businesses. In the light of this, the Bank of Russia continues to focus on the actual and planned changes in this field and discuss their effects with businesses, the financial community and authorities.

The majority of the said measures aimed at smoothing the effect of non-monetary factors on inflation takes time to deliver. The Bank of Russia will take the changes in consumer price dynamics caused by these measures into account when building its macroeconomic forecast and making its policy decisions.

**Monetary policy and financial sector stability.** The Bank of Russia adheres to the principle of independent target setting for monetary policy and financial sector stability policy. Within this strategy, the Bank of Russia uses monetary policy and the key rate as its core mechanism to maintain the inflation rate close to the target, while the financial sector stability is secured through other policy measures. Firstly, this is regulation of bank and non-

bank financial institutions (microprudential regulation), supervision, financial resolution measures aiming at sustainability of financial institutions and preservation of depositors' and creditors' funds. Secondly, this is macroprudential policy supporting the stability of the financial system in general and helping mitigate crisis events and their adverse economic consequences. Thus, a key priority of monetary policy is maintaining price stability.

In today's international practice, central banks more often pursue the strategy of independent target setting for the two policies (see Box 'Monetary policy and financial stability policy: striving for balance'). Global experience shows that price stability does not guarantee financial stability. Thus, systemic risks emerging in individual segments may accumulate in the financial sector as a whole amid generally stable macroeconomic conditions. However, if such risks materialise in future, this may entail major economic losses. In other words, there can be a mismatch between financial cycle and business cycle phases. And they can also substantially differ by their intensity. These effects were most pronounced in the 2000s when overheating in global financial markets against the backdrop of a stable economic growth and low inflation caused considerable losses for the real economy. Therefore, to maintain financial stability it is essential to enhance microprudential regulation by implementing special macroprudential policy measures that would successfully prevent accumulation of systemic risks.

At the same time, the stability of the financial sector is a prerequisite for an efficient monetary policy transmission. Thus, a stable financial sector ensures smooth operation of payment systems and transformation of savings into investments. By limiting the accumulation of systemic risks, it is possible to reduce the probability

of financial crises and increase the degree of certainty for financial market participants. In case of adverse changes in financial conditions, including due to external factors, macroprudential measures enable the financial sector to stably perform its core functions and help mitigate negative effects for the real economy. All this promotes trust towards the national financial sector, its attractiveness for all groups of participants, and, consequently, influences the level of risk premiums, the depth and liquidity of financial markets, and the financial sector expansion and development. As a result, the financial sector stability policy ensures a sustainable and efficient transmission of the impact of key rate decisions into dynamics of main macroeconomic indicators.

In most cases, changes in microprudential regulation influence long-term and structural aspects of financial institutions' operations; therefore, relevant decisions are made irrespective of medium-term monetary policy decisions. In addition, modifications in microprudential regulation are generally neutral in relation to monetary policy conditions. However, at the stage of extensive alterations in the approaches to regulation (e.g. introduction of the Basel III requirements), analysis can identify that they do significantly affect parameters of financial institutions' operations. In such conditions, the Bank of Russia takes into account such impact when making decisions on necessary adjustments to the operational procedure of monetary policy.

Macroprudential policy decisions are largely associated with cyclical fluctuations in the economy and financial markets; therefore, macroprudential measures take into account the effect of monetary policy decisions on macroeconomic indicators. In turn, macroprudential policy measures can impact the monetary policy environment, including lending trends and interest rates in individual segments. Therefore, making

decisions on how to limit systemic risks through macroprudential policy, the Bank of Russia assesses the intensity of their impact on dynamics of the financial sector indicators and, where necessary, takes such influence into account when approving monetary policy decisions.

Other measures aiming at stable operation of the financial sector can also influence the monetary policy environment. Thus, financial resolution measures cause liquidity provision to credit institutions to increase a surplus or reduce a deficit of banking sector liquidity. The Bank of Russia takes these changes into account when it sets the limits on operations to absorb or provide liquidity, thereby setting off their possible impact on monetary conditions.

Pursuing the policy of independent target setting, the Bank of Russia normally changes the key rate only in response to macroeconomic developments affecting inflation. A situation where systemic risks ultimately materialise generally requires a closer coordination in the implementation of monetary policy and financial stability policy. In such cases, making key rate decisions the Bank of Russia can take into account the need to both stabilise financial markets and maintain the sustainability of the financial sector as a whole.

In addition, if there is any threat to financial stability, the Bank of Russia may carry out foreign exchange transactions in the domestic FX market. The Bank of Russia sees as a threat to financial stability such situation in the FX market which may cause a considerable shrinkage in domestic FX market liquidity, the emergence of persistent devaluation expectations coming with elevated demand for foreign exchange, an increased share of foreign currency in the economy in general, and a short-term increase in risks to sustainability of credit institutions and businesses.

**Monetary policy and financial market development.** A mature financial market enables effective redistribution of financial resources, which in turn creates conditions for growing investment activity and national economic development. The Bank of Russia implemented financial market development strategy and its priority of maintaining price stability through monetary policy measures promote better availability of funding for a wide range of economic agents. Furthermore, the financial market is one of major transmission links for the key rate signal to be transmitted into the economy. The greater the size and liquidity of the financial market, the more impactful and quicker is the transmission of key rate changes into economic indicators. A mature financial market is therefore essential for the successful conduct of monetary policy.

In order to widen the circle of financial market participants and involve them in an extensive exchange of financial resources, the Bank of Russia takes action to extend the line of financial services, enhance their availability, improve the financial inclusion in remote and hard-to-reach areas, including through digital channels. In particular, this will be promoted by the initiated mechanism of individuals' biometric identification for remote provision of financial services, the Faster Payments System enabling clients to instantly transfer funds to one another, even if their accounts are with different banks, and the elaboration of the Marketplace, a project granting individuals access to the services of various financial institutions through a single point of contact.

The Bank of Russia deploys innovative technology and platform solutions in the financial market, which improves its accessibility, reduces market participants' costs, speeds up operations in the financial sector, and favours the competitive environment enabling small and regional

financial institutions to offer their services to a broad range of consumers.

Mutual trust among market participants, information transparency and consumer protection are also essential for encouraging investors' and borrowers' interest in financial market transactions. In view of the above, the Bank of Russia implements measures to counteract unfair practices, prevent and suppress violations, improve conduct supervision and the quality of corporate governance, enhance the institute of business reputation, and raise the qualification requirements for financial institutions' key officials.

The Bank of Russia takes action to improve financial literacy of the general public focusing on various social groups in order to help households navigate the services offered in financial markets and to use them more extensively. These efforts are focused on the development of citizens' skills for efficient personal financial management, adequate risk assessment and expansion of their knowledge about various financial products.

Generally, the measures taken to develop the financial market will contribute to a higher engagement of domestic private investors in the financial market operation, which will become a driver for the evolution of the long-term money institute and economic growth and will also help increase the efficiency of monetary policy.<sup>4</sup> However, the financial market development package will take time to deliver. Hence, decisions within this lane have no major implications for the conduct of monetary policy in the short term. As the financial market evolves, the changes unfolding in it will gradually modify the monetary policy transmission mechanism.

**Monetary policy and economic policies in major countries.** Given its openness, the Russian economy is strongly influenced by global financial and commodity market developments. These are shaped by, among other things, economic policies in key advanced economies and, in the first place, central bank policy measures. Major central banks' decisions first and utmost shape domestic economic developments. Developments in major economies shape global demand and, consequently, prices in global goods and services markets including commodity markets. Given Russia's extensive involvement in global trade, prices in global goods and services markets are among factors driving domestic price movements.

Changes in major central banks' interest rates are also drivers for change in financial asset prices across global markets, investor risk appetite, country risk premiums and exchange rate movements. With cross-border capital flows unrestricted, Russian economic entities' borrowings in foreign markets, Russian entities' overseas investment, as well as foreign investment in the Russian economy are dependent on global financial market developments. The Bank of Russia builds its macroeconomic forecast taking into account the versatile effect of economic policy measures in developed countries on the state of the Russian economy.

### Transparency

**The Bank of Russia's monetary policy transparency aims to enhance the understanding and credibility of its current monetary policy stance and enable the emergence of a predictable economic environment for all economic agents.** In turn, a credible monetary policy stance which is socially understood helps achieve better efficiency and successful sustainability of price stability. If households and businesses

<sup>4</sup> For details about financial market development measures and their effects, please see 'Guidelines for the Development of the Russian Financial Market in 2019–2021'.

are confident that inflation will stay low and that the Central Bank is capable to support price stability, then in response to short-term fluctuations in prices or to the emergence of proinflationary factors, they keep their inflation expectations largely unchanged. Furthermore, the understanding of the Central Bank's decisions and its signals helps in their sooner and more accurate account by economic agents as the latter form their interest rate expectations and make decisions regarding loans, savings, wage indexation and pricing. As a result, the impact of monetary policy on the economy and inflation amplifies, the scale and duration of inflation deviation from the target decline, and so does the need for a strong monetary policy response.

Information transparency is critical in today's practices of central banks. Therefore, communication policy is becoming an independent tool of monetary policy. To efficiently manage expectations of a wide range of economic agents, establishment of the quantitative inflation target and its stable achievement through key rate decisions are not the only measures needed, as was earlier believed. It is also essential to take active targeted efforts to deliver the information on inflation and monetary policy to various audiences. This is proved by modern empirical studies carried out using extensive data arrays on different countries. A key element of information policy is the signal of future changes in monetary policy. Along with actual key rate decisions, such signal directly influences interest rates in the economy, primarily longer-term rates (see Annex 'Monetary Policy Transmission Mechanism of the Bank of Russia').

Information delivered by the Central Bank is especially important for forming expectations of households and the non-financial sector due to their lower motivation and opportunities for accessing and processing specialised economic

information (in contrast to professional financial market participants). Thus, today the Central Bank's information policy should take into account the specifics and needs of various target audiences.

**As part of its transparency policy, the Bank of Russia seeks, in the first place, to disclose, as soon and as full as possible, information about its monetary policy goals, principles, measures and results, as well as about its view of the current economic situation and outlook.** Key monetary policy goals and principles are set forth in the Monetary Policy Guidelines. On the day the Bank of Russia Board of Directors makes its key rate decision, the Bank of Russia posts a press release elaborating on the specifics and rationale for this decision. Four times a year following the Board's key rate decision, a live press conference of the Bank of Russia Governor is held, supplemented by a publication of the Monetary Policy Report. It presents a more detailed account of the Bank of Russia's view of current economic developments and its mid-term outlook based on which key rate decisions are made. The Bank of Russia on a monthly basis publishes its commentaries on the state of the economy, inflation dynamics and inflation expectations.

**Also, the Bank of Russia works towards expanding the outreach of monetary policy and further specifying the target audience.** The Bank of Russia increases the frequency and content of its communications, the number of publications, making use of non-conventional communication channels. For this purpose, the Bank of Russia takes into account the degree to which the audience is knowledgeable about monetary policy and general economic issues, selecting the most appropriate channels and tools to send its message, information complexity, granularity, the extent of disclosure and communication format. In view of the above, the Bank of Russia publishes a



sufficiently broad range of materials, from research papers to educational cartoons for various audiences, including schoolchildren. Aiming to expand the coverage of its communications and specify their target audience, the Bank of Russia develops, among other things, information policy at a regional level.

The Bank of Russia will continue to raise efficiency of its monetary policy communications, employing the complete range of instruments at its disposal and improving their use taking into account the specifics of the audience.

## Neutral interest rate

The neutral rate (natural rate of interest, neutral interest rate, equilibrium interest rate) has been a key term in the macroeconomic theory since it was invented by Knut Wicksell in 1898.

The natural rate of interest is the interest rate (in particular, the central bank's key rate and overnight interbank interest rates set close to the key rate) that sustainably supports the economy at full employment (the output is at its potential) and inflation at the target level. The neutral rate is deemed to be a benchmark for assessing a monetary policy stance. It is also considered to be a benchmark for longer-run average interest rates in the economy.<sup>1</sup>

The real natural rate of interest is determined by the economy structure, the level of risks associated with investments in financial and non-financial assets, and economic agents' risk appetite. There are the following key factors:

- *Multifactor productivity growth rate.* The higher it is, the higher is the neutral rate, as, all other things being equal, businesses make larger investments and, accordingly, are willing to pay more for raising additional capital.
- *Demography.* The structure of the population and changes in its size, both in general and of individual age groups, influence both economic growth rates (and, consequently, investment activity) and the saving ratio. Thus, as the proportion of middle age groups in the population structure with a high saving ratio increases, the neutral rate will go down.
- *Financial sector maturity and regulation.* A higher maturity of the banking sector and capital markets contributes to growth of the saving ratio in the economy and, accordingly, a neutral rate decrease. The latter are also driven by economic agents' longer planning horizon making the future more important than the present, which encourages savings.
- *Neutral rate level in other economies.* The neutral rate in an open economy with free capital flows will be comparable with the neutral rate in the world financial market, adjusted for a country risk premium and inflation volatility premium. A country premium characterises the differences in economic agents' perception of sovereign credit risks and predictability of economic conditions in a particular economy as compared to the environment in key economies determining the level of the world natural rate of interest.

In turn, the *nominal* neutral rate is the total of the real neutral rate and expected inflation. Where inflation expectations are anchored to the target, expected inflation coincides with the central bank's target (for the Bank of Russia, the target is 4% p.a.).

<sup>1</sup> Economists distinguish between the longer-run neutral rate (or trend interest rate) and shorter-run neutral rate. In this case, we only refer to the longer-run neutral rate that depends on structural factors. The shorter-run neutral rate fluctuates around the longer-run neutral rate being affected by cyclical factors (e.g. external environment, current business activity, and fiscal policy measures). The shorter-run neutral rate is also impacted by the extent of anchoring of inflation expectations to the inflation target and other factors. This is the shorter-run neutral rate that should be referred to when discussing the current monetary policy stance. Quantification of the shorter-run neutral rate is quite complicated, even in economies with a much longer inflation targeting history than in Russia. Moreover, central banks do not announce the results of such quantifications (Bank of England, 2018; Brainard, 2018). However, making monetary policy decisions, central banks do factor in the direction and extent of the current deviation of the shorter-run neutral rate from the longer-run rate and future dynamics of the former.

However, the central bank would be *unable* to keep inflation at the target level by simply preserving the key rate equal to the neutral interest rate. The economy is a complicated system continuously impacted by diverse and often poorly predictable factors (both internal and external), due to which both the output and inflation may deviate from the potential and target respectively. If being affected by certain factors, the output in the economy is above (below) the potential, this would basically cause acceleration (deceleration) of inflation. Inflation may also deviate from the target for other reasons that are not connected with fluctuations in the output (e.g. due to changes in the external environment and exchange rate). If there are grounds to believe that such changes may entail a significant upward (downward) deviation of inflation from the target, the central bank would have to set the key rate above (below) the natural rate of interest so as to encourage inflation return to the target level.

Unfortunately, the neutral rate cannot be measured directly, but can only be roughly approximated on the basis of other economic indicators and their dynamics. Moreover, the range of such estimates would be very broad.

The first group of methods uses macroeconomic models that are based on structural relations between key economic variables (output, inflation, interest and exchange rates) and, depending on their past dynamics, generate a range of estimates for non-observable values, including the neutral interest rate. Obtaining robust estimates requires extended (20 to 30 years) data series for the economy in question. That said, if during the period which is used as the basis for generating a neutral rate estimate the economy faced material structural shifts, including significant changes in the monetary policy regime, the variation of obtained model estimates for the neutral rate will be quite high.

The other group of methods is based on the above-mentioned relationship between the neutral interest rate in the open economy with the neutral rate in key economies. These methods, however, are rougher and assess financial investors' perception whether interest rates in a certain country are adequate (considering all risks) vs interest rates in key economies. Effectively, they measure the relative attractiveness of financial assets denominated in the national currency. These estimates cannot explicitly account for the specifics of the economy in question; therefore, they can only indirectly signal the existence of any relation between interest rates, inflation and economic growth. If these methods are used, the final estimate largely depends on the assumptions regarding the nature and size of the country premium in relation to the global neutral rate. This is exacerbated by the uncertainty of neutral rate estimates for key economies that are used as the calculation basis. On the positive side, these methods allow obtaining estimates in a relatively narrow range.

Therefore, it should be noted that, although the neutral interest rate level is an important notion for macroeconomic analysis as a whole and monetary policy in particular, in practice it can only be calculated very approximately. Moreover, this level is not constant: it fluctuates as the economy structure (in particular, the above-mentioned factors) varies and economic agents adapt to the inflation-targeting regime.

The large variation and instability of neutral interest rate estimates are used, among other things, by critics of the use of the neutral rate to determine the level of monetary policy tightness (softness). Truly, the neutral interest rate is a convenient tool to explain monetary policy decisions, including to the public. However, the uncertain character of its estimates even in developed economies points to a high price of errors of such communication.

Quantitative estimates of the long-term neutral interest rate for Russia available in research publications gravitate towards the 1-3% range. For example, Kreptsev et al. (2016) – 1.0-3.2% (various models); IMF (2019) – 1-3% (various models); Isakov (2019) – 1.5-2.5% (various parameters). At the same time, the above estimates are characterised by wide confidence intervals. Although these estimates can be potentially useful as a general-purpose benchmark and must form part of any central bank's toolkit, it is very important to be aware of their limited practical applicability for the regulator due to their high uncertainty.

Today, the Bank of Russia considers the interval estimate of the long-term real neutral interest rate to be in the range of 2 to 3%. With the inflation target at 4%, the respective estimate for the nominal neutral rate lies in the range of 6 to 7%. However, it does not mean that the key rate will eventually end up in this range. The level of the short-term real neutral interest rate, which strongly affects the current level of the key rate, can be higher or lower than the long-term rate. The Bank of Russia key rate is currently located in close proximity to the estimated interval of the long-term neutral rate after five years of moving towards

anchoring of inflation and inflation expectations to the target level of 4%. Therefore, although a central bank might formally have empirical estimates of the neutral interest rate, it should take them with a grain of salt and use them together with a large number of other factors related to observed economic dynamics and characterising monetary conditions in the economy.

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## Monetary policy and financial stability policy: striving for balance

The balance between monetary policy and financial stability policy is still a matter of discussion because it is hard to unambiguously assess the benefits and drawbacks of using monetary policy for limiting financial stability risks. However, most central banks follow the principle of independent target setting and do not use the key rate as an instrument for limiting systemic risks. Instead, they opt for macroprudential instruments to address the financial stability maintenance task.

Along with this, some central banks actually took into account the financial stability issues when making policy decisions,<sup>1</sup> simultaneously applying macroprudential instruments to limit the emergence of imbalances in financial markets. In addition, they intentionally extended the inflation target horizon, assuming a longer-term inflation deviation from the target as compared to the situation where the key rate is used for the monetary policy purposes.

Imbalances occurring in various economies may be similar (this is often relevant for the real estate market and households' borrowings). Yet, the macroeconomic context and the decision-making authorities' assessments of the costs required for implementing a particular strategy for combining monetary policy and macroprudential policy may differ. Below are several examples of how central banks implement in practice different approaches to maintaining price and financial stability.

### Monetary policy and financial stability policy pursued independently

The **Czech National Bank** adheres to the principle of independent target setting in monetary policy and financial stability policy. In 2013–2017, on the back of its loose monetary policy (the two-week repo rate stayed at the level of 0.05%), the Czech Republic needed macroprudential measures to limit risks in the overheated domestic market segments. The expansion of mortgage lending was accompanied by growing real estate prices that had increased by approximately 30% during the period of 2013–2016 (Chart 1).

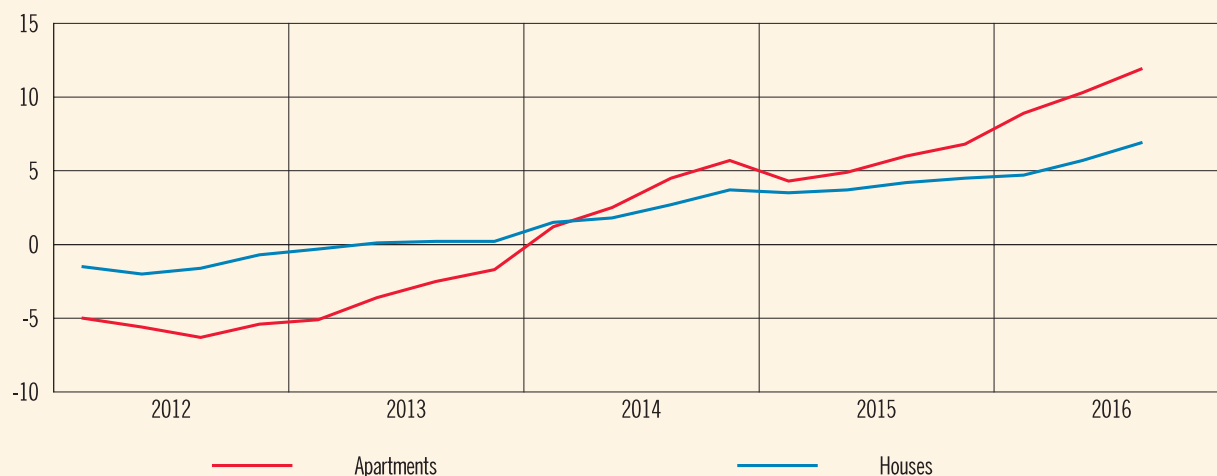
To limit risks in the financial sector, the Czech National Bank set a 1% countercyclical capital buffer.<sup>2</sup> In addition, the Czech National Bank continued to maintain accommodative monetary conditions to achieve

<sup>1</sup> Theoretical approaches to considering financial stability in the monetary policy function are devised within integrated inflation targeting regimes (see Agenor, da Silva – 'Integrated Inflation Targeting – Another Perspective from the Developing World', BIS, CEMLA, February, 2019) and financial stability-oriented monetary policy (see Borio – 'Towards a Financial Stability – Oriented Monetary Policy Framework?' Speech at the Oesterreichische Nationalbank conference 'Central banking in times of change', Vienna, 2016).

<sup>2</sup> Macroprudential policy instrument establishing additional requirements for a credit institution's capital ratio.

**REAL ESTATE PRICES IN THE CZECH REPUBLIC**  
 (% change vs the same quarter of the previous year)

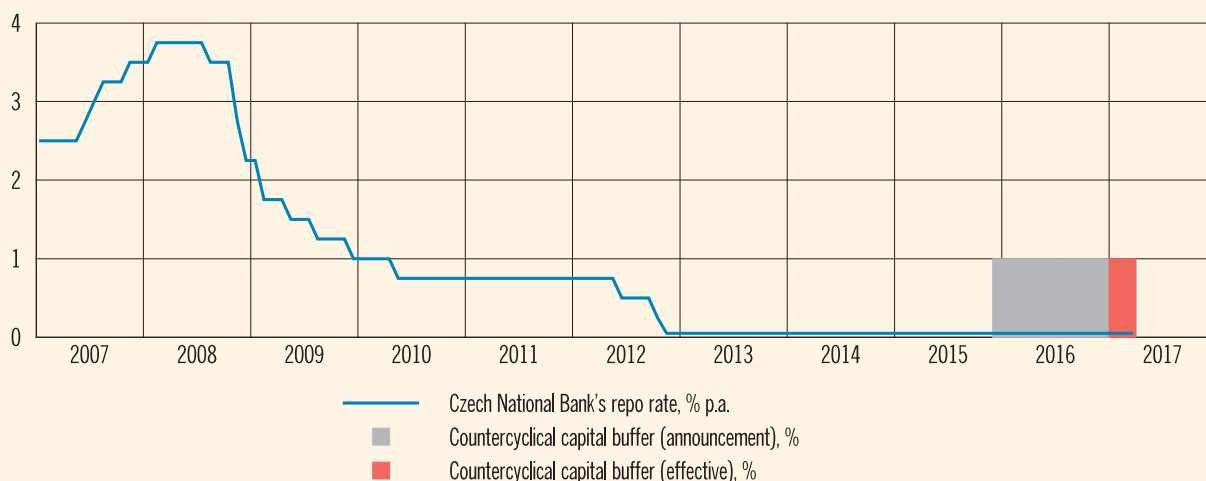
Chart 1



Source: Czech National Bank.

**CZECH NATIONAL BANK'S MONETARY AND MACROPRUDENTIAL POLICY**

Chart 2



Source: Czech National Bank.

the inflation target and increase economic activity that had remained relatively moderate after the 2008–2009 global recession (Chart 2).

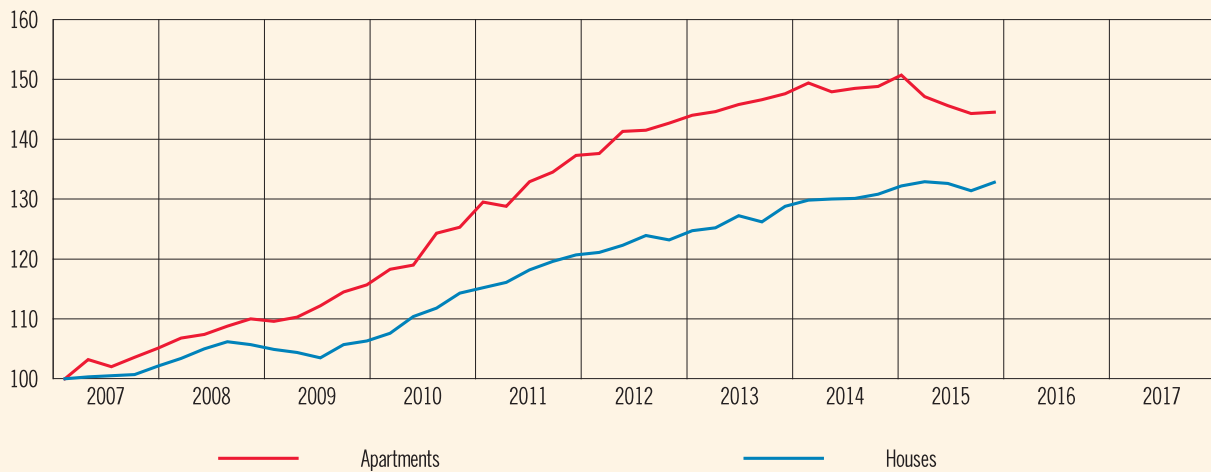
The **Swiss National Bank** also follows the principle of independent target setting in its monetary policy and financial stability policy. Having faced the threat of deflation in the post-crisis period, the Swiss National Bank switched to a super-loose monetary policy by first lowering the target interest rates down to zero and further on limiting the appreciation of the national currency.

Such conditions caused imbalances in financial markets: real estate prices were annually increasing by nearly 5% for several years, while the inflation rate was close to zero, mortgage lending growth quickly accelerated, and banks started to lower their requirements for mortgage borrowers. As a result, the Swiss banking sector saw the emergence of elevated risks associated with mortgage lending (Chart 3).

Maintaining the super-loose monetary policy, the Swiss National Bank made the decision in 2013 to limit systemic risks by introducing a 1% sectoral countercyclical capital buffer, and in early 2014 increased that buffer to 2%. While tightening its macroprudential policy, the Swiss National Bank still continued to

REAL ESTATE PRICES IN SWITZERLAND  
(2007 = 100%)

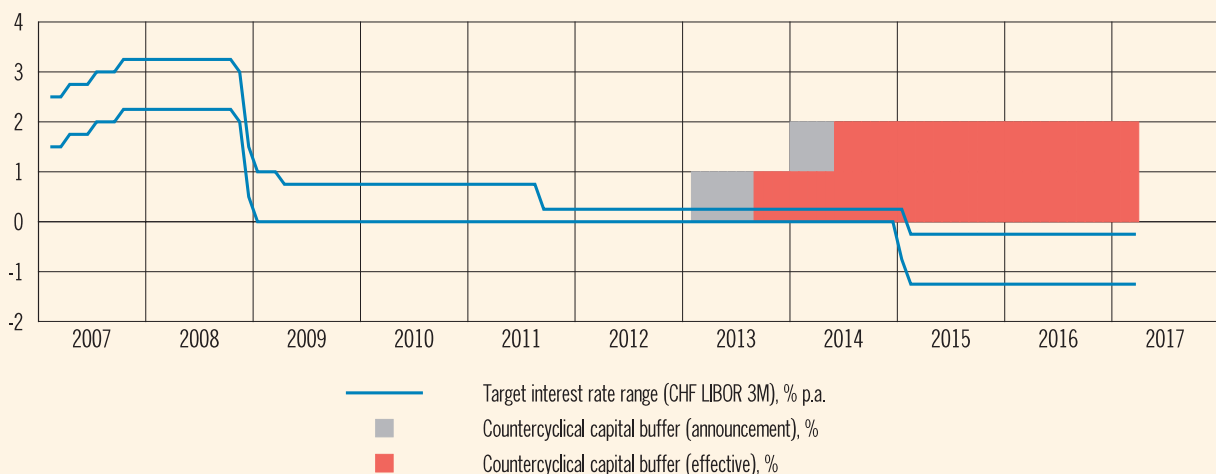
Chart 3



Source: Swiss National Bank.

SWISS NATIONAL BANK'S MONETARY AND MACROPRUDENTIAL POLICY

Chart 4



Source: Swiss National Bank.

ease monetary policy by terminating to limit the exchange rate dynamics and introducing negative interest rates in March 2015 (Chart 4).

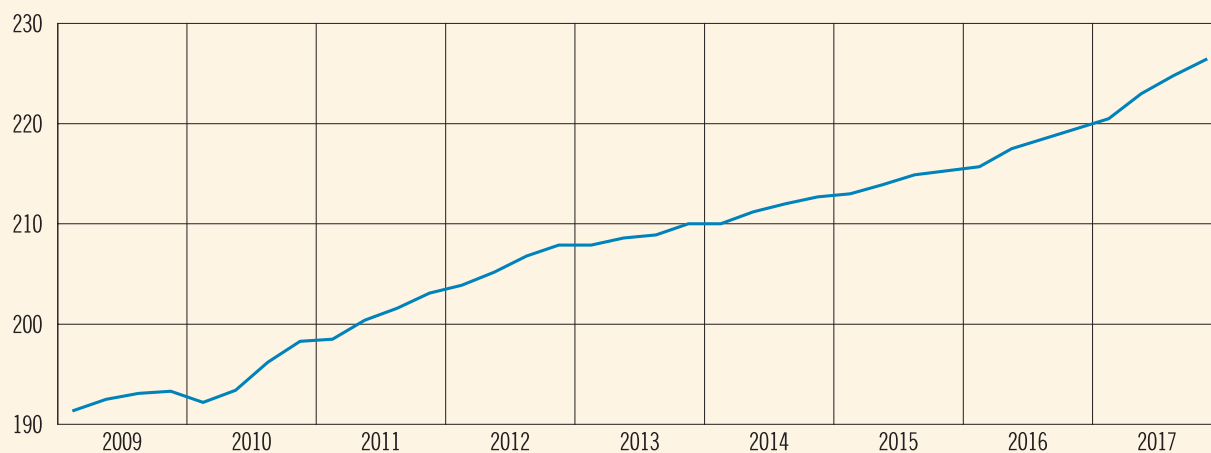
### Conduct of monetary policy with account of financial stability

Pursuing its monetary policy, the Norges Bank takes into account financial stability as a continuous goal. The Norges Bank's strategic document stipulating the key monetary regime parameters reads as follows: 'To some extent, monetary policy can contribute to counteracting the build-up of financial imbalances and thereby reduce the risk of sharp economic downturns further ahead. If there are signs that financial imbalances are building up, the consideration of high and stable output and employment may in some situations suggest keeping the policy rate somewhat higher than would otherwise be the case.'<sup>3</sup>

<sup>3</sup> Norges Bank, *Monetary Policy Objectives and Instruments*, <https://www.norges-bank.no/en/topic/Monetary-Policy/Mandate-Monetary-Policy>.

**HOUSEHOLDS' BORROWINGS IN NORWAY**  
(household debt to household disposable income ratio)

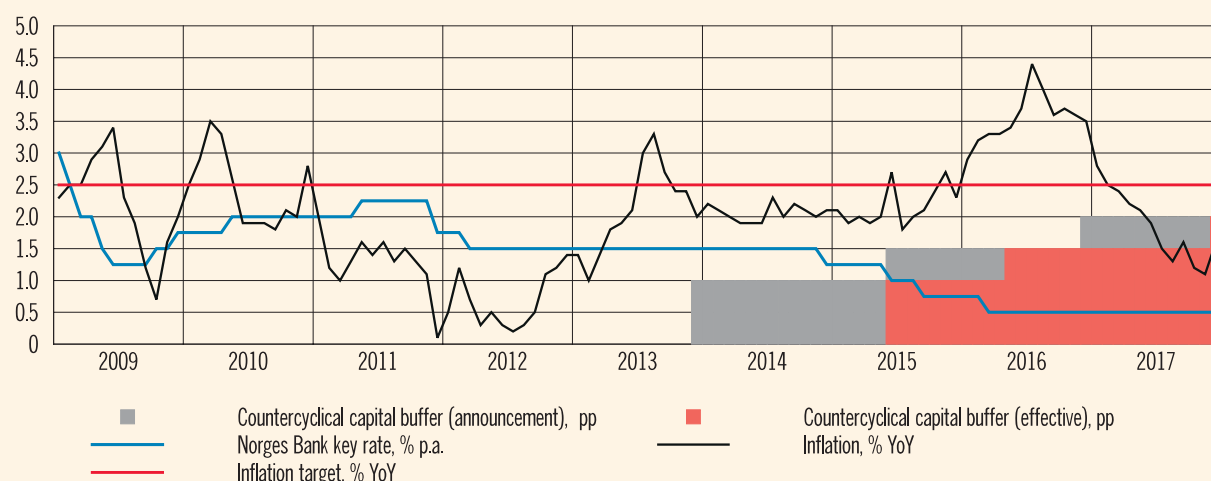
Chart 5



Source: Norges Bank.

**NORGES BANK KEY RATE AND INFLATION**

Chart 6



Source: Norges Bank.

In the post-crisis period, the Norwegian economy faced imbalances in the real estate market: beginning from late 2009, housing prices were annually growing by 5–15%, and households' borrowings were increasing (Chart 5).

In addition, inflation was below the 2.5% target ranging from 1% to 2% (Chart 6). In such conditions, the Norges Bank approved the decision to maintain an increased monetary policy rate assuming that its reduction might entail higher risks of imbalances. Thus, in its Monetary Policy Report published in March 2012, the Norges Bank noted: '...household debt has continued to rise faster than disposable income. Debt burdens are high. <...> A prolonged low interest rate level can amplify house price inflation and lending growth and induce households and enterprise to take excessive risks and accumulate excessive debt.'<sup>4</sup>

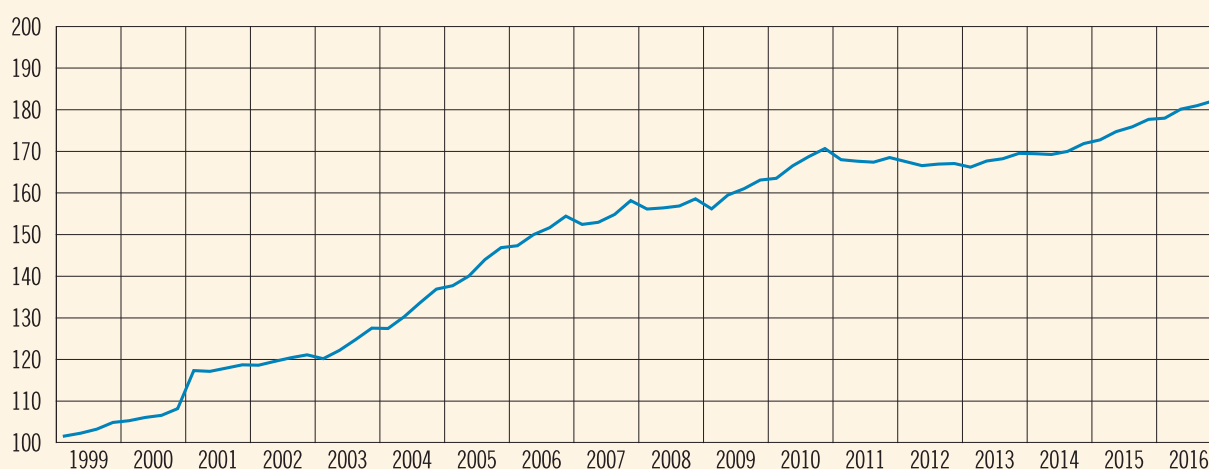
The monetary policy measures limiting systemic risks in Norway were then enhanced with a range of macroprudential measures: at the end of 2013, the central bank set the requirement for Norwegian banks

<sup>4</sup> Norges Bank, *Monetary Policy Report (March, 2012)*, <https://norges-bank.no/en/news-events/news-publications/Reports/Monetary-Policy-Report-with-Financial-Stability-Assessment/2012/112-Monetary-Policy-Report>.

## HOUSEHOLDS' BORROWINGS IN SWEDEN

(household debt to household disposable income ratio, %)

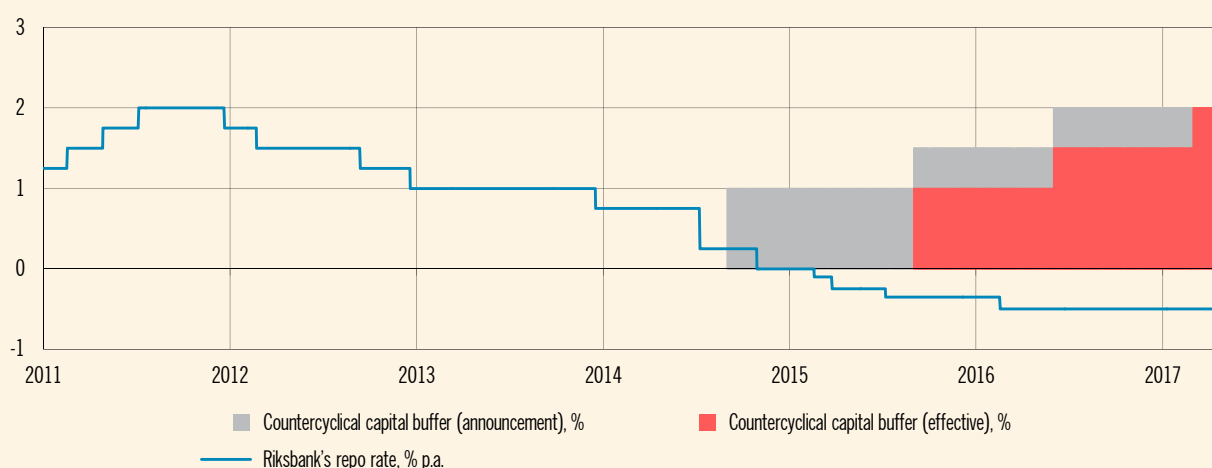
Chart 7



Source: Riksbank.

## RIKSBANK'S MONETARY POLICY AND MACROPRUDENTIAL MEASURES

Chart 8



Source: Riksbank.

to form a countercyclical capital buffer in the amount of 1% of the value of risk-weighted assets, and later on increased the buffer to 2.5%.

The Riksbank took account of financial stability aspects in its monetary policy for several years. During that period, inflation ranged from 1% to 1.5% while the target was 2%. In such conditions, the Swedish central bank increased the monetary policy rate (repo rate) by 1.75 pp. The Riksbank conducted such monetary policy in order to maintain financial stability on the back of a substantial growth in households' debt burden and increased activity in the mortgage lending market. In its Monetary Policy Report published in February 2011, the Riksbank commented on one of its decisions involving a repo rate increase: 'A gradual rise in the repo rate reduces the risk of imbalances building up in the Swedish economy, and may also contribute to a slower growth in household borrowing.'<sup>5</sup> (Chart 7).

According to expert estimates, those measures resulted in at least 0.5 pp unemployment growth in the Swedish economy in 2010–2011, while the rate increase did not significantly impact mortgage lending

<sup>5</sup> Riksbank, *Monetary Policy Report* (February, 2011).

growth rates and households' debt burden. In 2012, the Swedish economy also faced the deflation problem, and the central bank ceased to pursue a very tight monetary policy.

Later on, Sweden used macroprudential instruments to limit systemic risks. In 2014, on the back of persisting imbalances, Sweden introduced the countercyclical capital buffer. Initially, it was set at 1% to be increased to 2.5% later (Chart 8).

**Drawbacks of using monetary policy for securing financial stability.** Most experts agree that an extension of the inflation target horizon is a considerable drawback of using the key rate as an instrument limiting systemic risks. Merged target setting and a prolonged inflation deviation from the target due to keeping increased interest rates may adversely affect the level of confidence in monetary policy, especially for central banks that have switched to the inflation targeting regime only recently. There may also be losses in economic growth that could have been achieved in case of a lower interest rate. In addition, imbalances basically occur in individual segments of the financial market, while the monetary policy rate impacts the market in general, including segments without imbalances. This also entails negative effects caused by monetary policy measures aimed at limiting systemic risks.

As regards the strategy of independent target setting, experts consider that it is hard to implement largely because macroprudential policy in general is still in the making and there is no adequate experience of using macroprudential instruments for limiting systemic risks.

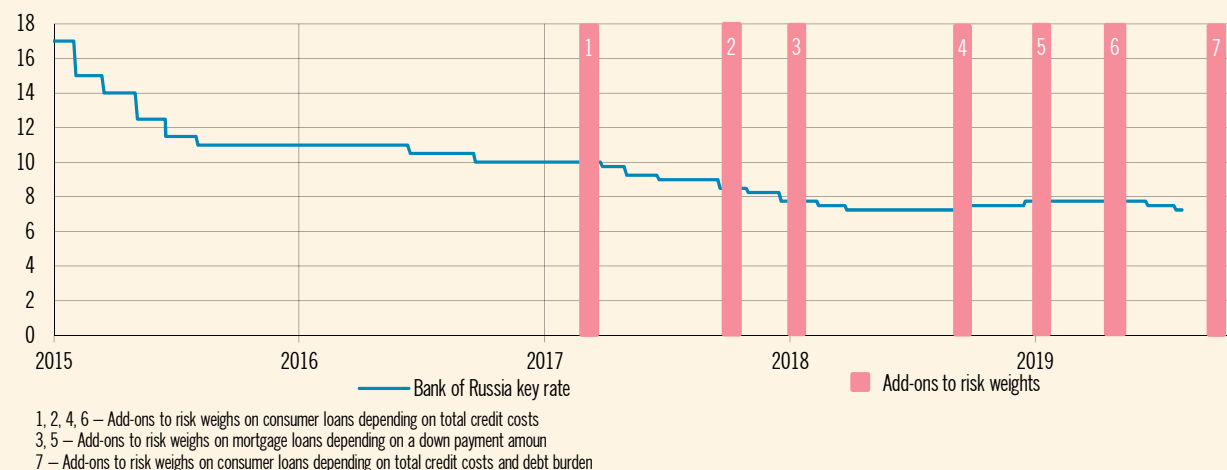
**Approach applied by the Bank of Russia to combine monetary policy and financial stability policy.** The Bank of Russia adheres to the principle of independent target setting in its monetary policy and macroprudential policy. While the Bank of Russia's monetary policy is focused on maintaining price stability, financial stability risks are limited through macroprudential measures.

During the period of 2015–2019, the Bank of Russia has managed to substantially decelerate inflation to the level close to 4%. As major macroeconomic indicators stabilised and monetary policy gradually eased, some market segments saw a significant increase in credit activity: annual growth of unsecured consumer and mortgage lending reached 25%, while real disposable household income slightly reduced.

Assuming that retail lending expansion had been associated with additional risks accepted by the banking sector, beginning from 2017 the Bank of Russia started using the following macroprudential instruments to maintain the financial system stability: risk ratio buffers depending on total consumer loan costs (and from 1 October 2019 – depending on debt burden) and the collateral coverage ratio for mortgage loans (Chart 9). In addition, the Bank of Russia has been gradually lowering the key rate, having decreased it from 10% p.a. in 2017 to 7.00% p.a. in September 2019.

BANK OF RUSSIA KEY RATE AND MACROPRUDENTIAL POLICY MEASURES  
(% p.a.)

Chart 9



Source: Bank of Russia.



## BANK OF RUSSIA'S MEDIUM-TERM FORECAST IN THE FOLLOW-UP TO THE BOARD OF DIRECTORS KEY RATE MEETING ON 6 SEPTEMBER 2019

KEY PARAMETERS OF THE BANK OF RUSSIA'S FORECAST UNDER THE BASELINE SCENARIO  
(growth as % of previous year, unless indicated otherwise)

Table 1

	2018 (actual)	Baseline			
		2019	2020	2021	2022
Urals price, average for the year, US dollars per barrel	69.8	63	55	50	50
Inflation, as % in December year-on-year	4.3	4.0–4.5	4.0	4.0	4.0
Inflation, average for the year, as % year-on-year	2.9	4.6–4.8	4.0	4.0	4.0
Gross domestic product	2.3	0.8–1.3	1.5–2.0	1.5–2.5	2.0–3.0
Final consumption expenditure	1.8	1.0–1.5	1.5–2.0	1.5–2.0	1.8–2.3
– households	2.3	1.0–1.5	2.0–2.5	2.0–2.5	2.0–2.5
Gross capital formation	0.8	0.0–1.0	3.5–4.5	3.5–4.5	2.5–3.5
– gross fixed capital formation	2.9	0.0–1.0	3.5–4.5	3.5–4.5	2.5–3.5
Exports	5.5	-(0.3–0.8)	2.0–2.5	2.0–2.5	2.5–3.0
Imports	2.7	-(0.3)–0.2	3.0–3.5	3.5–4.0	2.5–3.0
Money supply in national definition	11.0	8–12	7–12	7–12	7–12
Banking system claims on the economy in rubles and foreign currency*	11.5	8–12	7–12	7–12	7–12
– corporates, annual growth, %	8.4	7–10	6–10	6–10	6–10
– households, annual growth, %	22.0	15–20	10–15	10–15	10–15

\* Banking sector claims on the economy mean all claims of the banking system on non-financial organisations and financial institutions and households in the currency of the Russian Federation, foreign currency, and precious metals, including loans extended (including overdue loans), overdue interest on loans, investments of credit institutions in debt and equity securities and promissory notes, other forms of stakeholding in the capital of non-financial organisations and financial institutions, and other receivables under settlement operations with non-financial organisations and financial institutions and households.  
Source: Bank of Russia.

RUSSIA'S BALANCE OF PAYMENTS INDICATORS UNDER THE BASELINE SCENARIO\*  
(billions of US dollars)

Table 2

	2018 (actual)	Baseline			
		2019	2020	2021	2022
<b>Current account</b>	<b>113</b>	<b>83</b>	<b>56</b>	<b>39</b>	<b>28</b>
Balance of trade	194	166	141	126	120
Exports	443	415	395	389	396
Imports	249	249	254	263	276
Balance of services	-30	-31	-34	-36	-39
Exports	65	64	63	65	67
Imports	95	95	97	101	106
Primary and secondary income account	-51	-52	-51	-52	-53
<b>Current and capital account balance</b>	<b>112</b>	<b>83</b>	<b>56</b>	<b>39</b>	<b>28</b>
<b>Financial account (net of reserve assets)</b>	<b>77</b>	<b>20</b>	<b>19</b>	<b>14</b>	<b>14</b>
General government and the central bank	9	-20	-6	-6	-6
Private sector	68	40	25	20	20
<b>Net errors and omissions</b>	<b>2</b>	<b>-3</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Change in FX reserves ('+' is increase, '-' is decrease)</b>	<b>38</b>	<b>60</b>	<b>37</b>	<b>25</b>	<b>14</b>

\* As per the 6th edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6). In financial account, '+' denotes net lending and '-' denotes net borrowing. Final values may differ from the total of the respective values due to rounding.  
Source: Bank of Russia.

KEY PARAMETERS OF THE BANK OF RUSSIA'S FORECAST UNDER THE SUPPLEMENTARY SCENARIOS

Table 3

(growth as % of previous year, unless indicated otherwise)

	2018 (actual)	High oil prices				Risk			
		2019	2020	2021	2022	2019	2020	2021	2022
Urals price, average for the year, US dollars per barrel	69.8	63	65	75	75	63	25	31	35
Inflation, as % in December year-on-year	4.3	4.0–4.5	4.0	4.0	4.0	4.0–4.5	7.0–8.0	3.0–4.0	3.0–4.0
Inflation, average for the year, as % year-on-year	2.9	4.6–4.8	4.0	4.0	4.0	4.6–4.8	6.5–7.5	4.0–5.0	3.0–4.0
Gross domestic product	2.3	0.8–1.3	2.0–2.5	2.0–3.0	2.0–3.0	0.8–1.3	-(1.5–2.0)	1.0–2.0	3.5–4.5
Final consumption expenditure	1.8	1.0–1.5	2.0–2.5	1.8–2.3	1.8–2.3	1.0–1.5	-(1.3–1.8)	2.3–2.8	3.5–4.0
– households	2.3	1.0–1.5	2.3–2.8	2.0–2.5	2.0–2.5	1.0–1.5	-(1.5–2.0)	2.7–3.2	4.0–4.5
Gross capital formation	0.8	0.0–1.0	4.5–5.5	4.0–5.0	2.5–3.5	0.0–1.0	-(14–15)	1.0–2.0	8.0–9.0
– gross fixed capital formation	2.9	0.0–1.0	3.5–4.5	4.0–5.0	2.5–3.5	0.0–1.0	-(5.5–6.5)	1.0–2.0	8.0–9.0
Exports	5.5	-(0.3–0.8)	2.7–3.2	2.7–3.2	2.5–3.0	-(0.3–0.8)	0–0.5	-(0.8–1.3)	1.5–2.0
Imports	2.7	-(0.3)–0.2	3.3–3.8	4.0–4.5	2.5–3.0	-(0.3)–0.2	-(12.5–13.0)	2.3–2.8	4.7–5.2
Money supply in national definition	11	8–12	8–13	8–13	8–13	8–12	2–7	3–8	4–9
Banking system claims on the economy in rubles and foreign currency*	11.5	8–12	7–12	7–12	7–12	8–12	6–11	4–9	8–13
– corporates, annual growth, %	8.4	7–10	6–10	6–10	6–10	7–10	10–15	3–8	7–12
– households, annual growth, %	22	15–20	11–16	10–15	10–15	15–20	-(5)–2	7–11	9–14

\* Banking sector claims on the economy mean all claims of the banking system on non-financial organisations and financial institutions and households in the currency of the Russian Federation, foreign currency, and precious metals, including loans extended (including overdue loans), overdue interest on loans, investments of credit institutions in debt and equity securities and promissory notes, other forms of stakeholding in the capital of non-financial organisations and financial institutions, and other receivables under settlement operations with non-financial organisations and financial institutions and households.

Source: Bank of Russia.

RUSSIA'S BALANCE OF PAYMENTS INDICATORS UNDER THE SUPPLEMENTARY SCENARIOS\*

Table 4

(billions of US dollars)

	2018 (actual)	High oil prices				Risk			
		2019	2020	2021	2022	2019	2020	2021	2022
<b>Current account</b>	<b>113</b>	<b>83</b>	<b>84</b>	<b>111</b>	<b>99</b>	<b>83</b>	<b>17</b>	<b>9</b>	<b>4</b>
Balance of trade	194	166	171	200	198	166	63	67	68
Exports	443	415	436	488	507	415	240	266	287
Imports	249	249	265	288	309	249	177	199	219
Balance of services	-30	-31	-34	-35	-42	-31	-14	-25	-31
Exports	65	64	67	75	76	64	59	61	63
Imports	95	95	101	110	118	95	73	86	94
Primary and secondary income account	-51	-52	-53	-55	-57	-52	-32	-33	-33
<b>Current and capital account balance</b>	<b>112</b>	<b>83</b>	<b>84</b>	<b>111</b>	<b>99</b>	<b>83</b>	<b>17</b>	<b>9</b>	<b>4</b>
<b>Financial account (net of reserve assets)</b>	<b>77</b>	<b>20</b>	<b>24</b>	<b>29</b>	<b>29</b>	<b>20</b>	<b>55</b>	<b>35</b>	<b>19</b>
General government and the central bank	9	-20	-6	-6	-6	-20	10	0	-1
Private sector	68	40	30	35	35	40	45	35	20
<b>Net errors and omissions</b>	<b>2</b>	<b>-3</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>-3</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Change in FX reserves ('+' is increase, '-' is decrease)</b>	<b>38</b>	<b>60</b>	<b>61</b>	<b>82</b>	<b>70</b>	<b>60</b>	<b>-38</b>	<b>-26</b>	<b>-15</b>

\* As per the 6<sup>th</sup> edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6). In financial account, '+' denotes net lending and '-' denotes net borrowing. Final values may differ from the total of the respective values due to rounding.

Source: Bank of Russia.



