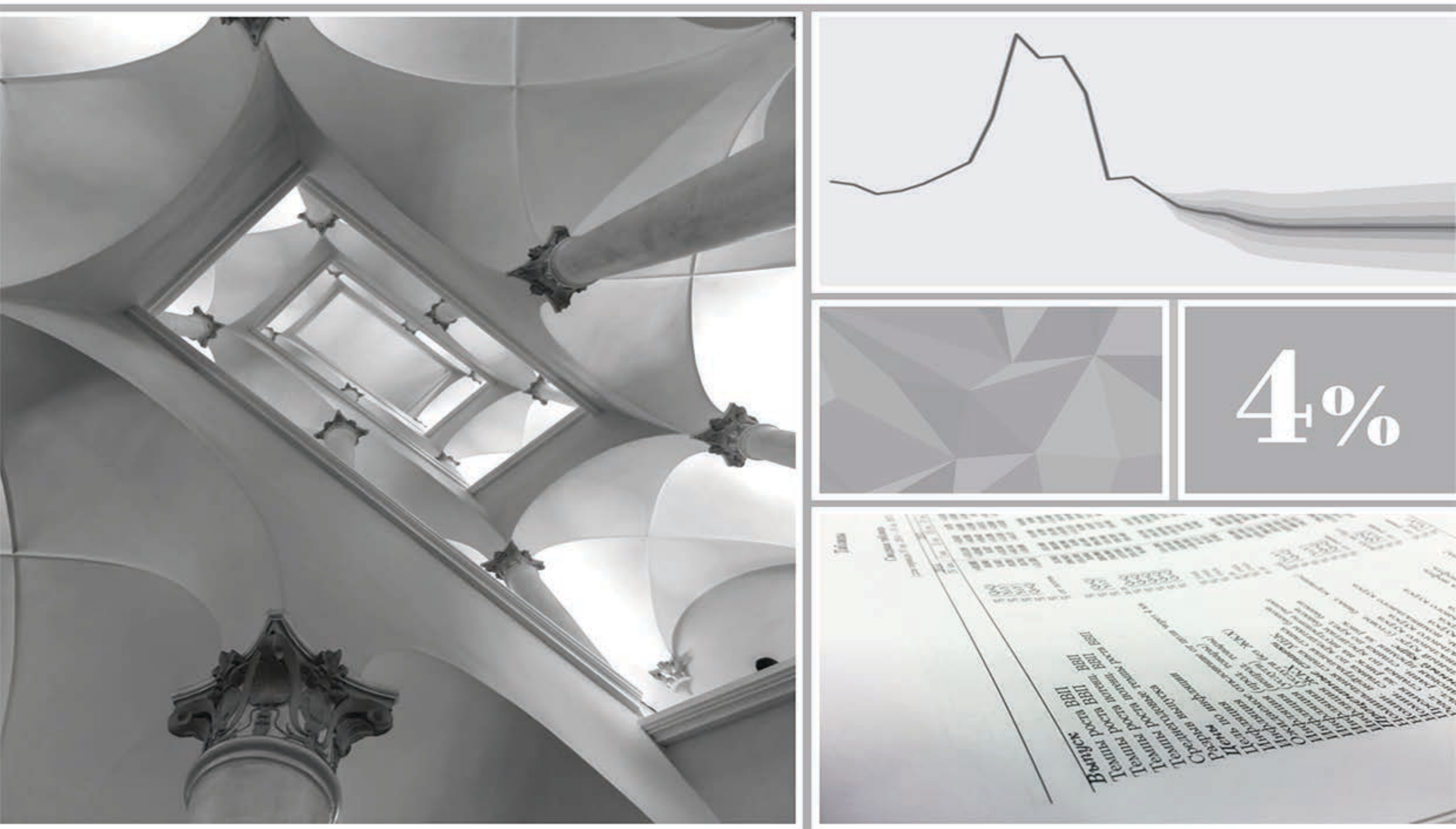
Bank of Russia

The Central Bank of the Russian Federation



No. 2

JUNE 2017

MONETARY POLICY REPORT

Moscow

DEAR READERS,

In order to improve the effectiveness of the Bank of Russia's information policy with regard to its monetary policy and to assess the relevance of and demand for the materials published, we would be grateful if you could answer the following questions.

1. Do you consider there to be an optimal level of detail in the material presented?

2. Which subjects, in your opinion, should be illustrated in this report?

3. Do you have any other comments or suggestions regarding the report?

4. What is your professional field of interest?

Many thanks in advance for your assistance.

The report has been prepared based on statistics as of 9 June 2017.
Data cut-off date for forecast calculations is 2 June 2017 (if statistics and other information relevant for decision-making appear after the data cut-off date, they are included in the text of the Report and may be used for the adjustment of the mid-term forecast).

An electronic version of the information and analytical review can be found on the Bank of Russia website at http://www.cbr.ru/publ/.

Please send your suggestions and comments to monetarypolicyreport@mail.cbr.ru.

SUMMARY

In March-June, the situation in the Russian economy has evolved broadly in line with the forecast presented in the March release of the Monetary Policy Report (hereinafter, the Report).

Inflation has approached the 4% target. In January-May, the average monthly consumer price growth (seasonally adjusted) was 0.3%. The current price dynamics corresponds to the baseline scenario path. Growth in prices for non-food goods and services continued to decline. A slight increase in food price inflation was a result of the depletion of the previous year's vegetable and fruit stocks, while remaining within the range expected by the Bank of Russia. The influence of the unfavourable weather conditions of the 2017 spring on the new harvest may produce another temporary surge in food price growth rates during several months ahead.

Short-term inflation risks linked to changes in the external economic situation skewed a little to the downside. This was helped by subdued uncertainty in the commodity markets' dynamics in 2017 – early 2018, given the extension of the oil production restriction agreement. However, the uncertainty will remain over the mid-term horizon, thereby forcing the Bank of Russia to maintain a conservative approach to the selection of oil price assumptions and to keep considering alternative scenarios depending on external conditions. Legislative adoption and implementation of the budget rule will alleviate the economy's dependence on changes in the external economic situation.

In spring, the decline in price growth was supported by the consumer demand dynamics which demonstrated gradual recovery, though remaining rather moderate. Inflation expectations also declined; their dynamics contributed to inflation slowdown. Exchange rate dynamics also produced a downward pressure on price growth rates, though the scale of this influence was much less pronounced than at the start of the year.

Recovery in the Russian economy continued and became robust. As previously, revival was observed in industrial sectors, it was most noticeable in the production of raw materials and consumer goods. Investment activity continued to expand. This was helped by the steadily improving financial position of enterprises and the positive influence of the ruble appreciation on capital-intensive and high tech sectors. Sustainable recovery processes are also observed in the consumer activity dynamics. According to Rosstat, retail trade turnover stopped declining in April. The rebound in demand seen in 2017 Q1 was supported by positive dynamics of real wages, taking place since the end of 2016. This comes largely as a result of generally increased demand for labour together with consistently low unemployment rate, close to its natural level. At the same time, real household income generally continued to reduce. This, in combination with the persistent and moderately tight monetary stance, shaped a gradual recovery in consumption.

Given the inflation closing on the target, inflation expectations staying on the downward track and economic activity recovering, the Bank of Russia decided to reduce the key rate to 9.00% p.a.

The prolongation of the oil production restriction agreement up to March 2018 did not change the Bank of Russia's medium-term view, however, it formed the basis for minor changes to the forecasts in all scenarios, mainly regarding short-term prospects. According to the Bank of Russia's baseline scenario, in 2017 GDP growth rates will be close to the potential level at 1.3-1.8%. In 2018, despite a temporary deterioration in external conditions, there are no grounds to expect a considerable slowdown in economic growth or a deterioration in domestic economic conditions in Russia in general. Relatively short-term growth adjustment amid aggravated external conditions is a result of a gradual increase in the economy's resilience against external shocks and lower sensitivity to the fluctuations in the commodity markets. This

trend will be further supported by setting the budget rule, whose transitional version has been implemented by Russia's Finance Ministry since February 2017. Additionally, the safety margin achieved due to the continued recovery processes will support the economy's resilience to various shocks. In 2019-2020, GDP growth rates will be around 1.5-2.0%, which is close to the current assessment of its potential level. The possibilities of higher growth will be mainly shaped by the speed and scale of structural reforms and institutional changes.

Economic activity recovery will improve the quality of bank's credit portfolios and will create conditions for the easing of requirements for borrowers and other non-price lending conditions. However, the on-going conservative approach maintained by banks will help avoid risks and select most reliable borrowers. Consistent moderately tight monetary stance will support incentives for saving in the Russian economy. In these settings, the recovery in demand will be the result of growth in incomes, and the transition from the saving behaviour model to the consumption behaviour model among households will be gradual and will not cause inflation deviate from the target. However, a sharper fall in households' propensity to save might lead to increased inflationary pressure. Accelerated growth in wages that exceeds the rise in labour productivity might also become a pro-inflationary factor given increased structural labour shortages. Moreover, the final anchoring of inflation expectations close to the inflation target may take a long time. This is due to the high sensitivity of inflation expectations to the price and exchange rate fluctuations, even short-term and transitory by nature. An additional source of uncertainty may come from the non-oil and gas tax manoeuvre which may cause a short-term inflation hike.

Thus, despite a decline in the short-term, inflation risks remain over the mid-term horizon. The moderately tight monetary policy is a must to maintain inflation close to the 4% target.

The Bank of Russia sees room for cutting the key rate in the second half of 2017. While making its decision hereinafter, the Bank of Russia will assess inflation risks, the inflation dynamics and economic developments against the forecast.

Table 1

Key parameters of the Bank of Russia's baseline forecast

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

	2016 (actual)	2017	2018	2019	2020
Urals price, average for the year, US dollars per barrel	42	50	42	42	42
Inflation, % in December year-on-year	5.4	4.0	4.0	4.0	4.0
Inflation, yearly average	6.5	4.0	4.0	4.0	4.0
Gross domestic product	-0.2	1.3-1.8	1.0-1.5	1.5-2.0	1.5-2.0
Final consumption expenditure	-3.5	1.3-1.8	1.0-1.5	1.5-2.0	2.5-3.0
– households	*-4.5*	*1.7-2.2*	*1.5-2.0*	*2.0-2.5*	*3.0-3.5*
Gross formation	1.5	4.0-5.0	1.0-2.0	2.0-3.0	1.5-2.5
– gross fixed capital formation	*-1.8*	*2.3-2.8*	*1.0-1.5*	*1.0-1.5*	*2.3-2.8*
Net exports	20.7	-(17.4-12.9)	-(3.0-2.0)	-(7.5-3.0)	-(7.5-3.0)
– exports	*3.1*	*2.5-3.0*	*0.5-1.0*	*0.5-1.0*	*0.5-1.0*
– imports	*-3.8*	*7.0-7.5*	*1.0-1.5*	*2.0-2.5*	*2.0-2.5*
Money supply in national definition	9.2	9-12	9-12	10-13	8-11
Monetary base in narrow definition	3.8	3-7	3-7	4-8	4-8
Loans to non-financial organisations and households in rubles and foreign currency	-0.6	5-7	5-7	7-10	7-10

Table 2

Russia's balance of payment indicators – baseline scenario*

(USD, bn)

	2016 (actual)	2017	2018	2019	2020
Current account	**25**	**37**	**14**	**8**	**8**
Balance of trade in goods	90	105	82	80	85
Exports	*282*	*323*	*309*	*308*	*318*
Imports	*-192*	*-219*	*-226*	*-228*	*-233*
Balance of services	-24	-26	-27	-29	-30
Exports	*51*	*55*	*58*	*58*	*60*
Imports	*-74*	*-82*	*-85*	*-86*	*-90*
Primary and secondary income balance	-41	-42	-42	-44	-47
Capital account	-1	0	0	0	0
Current and capital accounts balance	**24**	**37**	**14**	**8**	**8**
Financial account (excluding reserve assets)	**-16**	**-10**	**-5**	**-8**	**-8**
General government and the central bank	3	9	6	6	6
Private sector (including net errors and omissions)	-19	-19	-11	-14	-14
Change in reserve assets («+» – decrease, «-» – increase)	**-8**	**-27**	**-9**	**0**	**0**

** Signs according to BPM5.*

Note: owing to rounding the sums of the separate items may differ from the totals shown.