Bank of Russia

25.09.2024

SUMMARY OF THE KEY RATE DISCUSSION

DURING THE QUIET PERIOD AND IN THE COURSE OF THE MEETING OF THE BANK OF RUSSIA BOARD OF DIRECTORS ON 13 SEPTEMBER 2024

Discussants: members of the Bank of Russia Board of Directors, senior executives of the Monetary Policy Department, the Research and Forecasting Department, and a number of other Bank of Russia Departments and Main Branches.

The Monetary Policy Department together with the Research and Forecasting Department presented the results of the analysis of the current economic developments nationwide and worldwide as well as the comparisons of the unfolding economic trends against the July baseline macroeconomic forecast for 2024–2027 and its variations. The Bank of Russia Main Branches provided information on the situation in the Russian regions, including based on companies' surveys. Furthermore, the participants in the discussion considered the information from the Financial Stability Department and the International Settlements Department.

This Summary covers **the key points of the discussion**.

CONTENTS

ECONOMIC SITUATION AND INFLATION

MAIN FACTS

In August, current price growth equalled 7.6% (seasonally adjusted annualised rate, SAAR). Core inflation was 7.7% SAAR in August, which was below the average of 2024 Q2 and above that of 2024 Q1. Most indicators of inflation expectations went up. Economic growth slowed down in 2024 Q2 vs 2024 Q1. According to high-frequency data and surveys, economic growth continued to decelerate in July–August. The economy showed signs of a slowdown in consumer and investment activity. In September, the Bank of Russia's Business Climate Index was down in terms of current demand and output estimates. Companies' expectations regarding demand and output remained high. The unemployment rate hit its all-time low of 2.4% (seasonally adjusted, SA) in July. Growth in real and nominal wages slowed down in June. The overall financial performance of large and medium-sized enterprises (except for credit institutions) for the last 12 months was still strong, despite having decreased from ₽34.5 trillion in May to ₽32.4 trillion in June.

DISCUSSION

The discussants agreed that **inflationary pressures remained high and the disinflation process observed in early 2024 had not resumed as yet**. In July–August, inflation indicators adjusted for volatile components were within the range of 6–8% in annualised terms, which indicated persistently elevated inflationary pressures in terms of the underlying components of inflation. Headline inflation was largely driven by rising prices for a number of goods with highly volatile prices as well as services with administered prices. Specifically, the increased indexation of utility tariffs substantially contributed to inflation in July. In July–August, petrol prices were rising at a fast pace, while fruit and vegetables were not cheapening as much as they usually do this time of the year. According to experts, although this year's harvest will be below last year's high level, it will remain close to its multi-year averages. The participants in the discussion concurred that inflation risks related to harvest quantities persisted, while being low.

The meeting noted that **inflation in 2024 Q3 was higher than expected by the Bank of Russia**. High price pressures were mainly driven by the overheating observed in the economy in 2024 H1. The tightening of monetary policy over the past months had not yet fully translated into price dynamics due to time lags. Moreover, inflationary pressures turned out to be higher in July–August than estimated by the Bank of Russia when deciding on the key rate at the July meeting. The discussants shared the view that price growth rates in 2024 would exceed those forecast by the Bank of Russia in July. **According to the participants in the discussion, monetary conditions should be tighter to bring inflation down to the target in 2025**, considering the adjusted estimate of current price pressures.

Most indicators of inflation expectations went up. Households' inflation expectations had been rising for four consecutive months. Visible goods frequently purchased by households, in particular petrol and dairy products, were rapidly becoming more expensive over the past months, which could affect households' inflation expectations, considering their sensitivity to increasing prices for certain goods. Businesses' price expectations were up as well, most notably in retail. Analysts raised their inflation expectations for 2025. They are now above 4%. Following the July increase in the key rate, breakeven inflation for inflation-indexed federal government bonds (OFZ-IN) declined, while remaining elevated. The meeting pointed out that **inflation expectations were rising despite the tightening of monetary policy, which could suggest that they were becoming less anchored**, that is, more adaptive. This means that when making decisions regarding savings, consumption and investment, economic agents are increasingly guided by the price growth trends observed in the past, rather than the inflation target. As a result, households' and businesses' demand might continue to grow rapidly, which would hinder the disinflationary trend and require tighter monetary policy to be maintained for a longer period.

Nevertheless, **July–August saw first signs of cooling domestic demand** (consumer and investment demand) as compared to 2024 H1. The participants in the discussion concurred that the changes in demand were due to both the monetary policy pursued since mid-2023 and a number of autonomous factors additionally tightening monetary conditions (namely macroprudential measures). That said, the recent key rate decisions and tougher signals have not yet fully affected the domestic demand trend, considering time lags. Despite the signs of a slowdown, **domestic demand continues to grow at a fast pace**.

- Households' demand remains strong, with a large portion of increased incomes still being channelled into consumption. Consumer demand is also supported by the continuing growth of retail lending.

- Although current business climate estimates are down, companies remain optimistic about their business prospects. Enterprises have accumulated significant equity over the past years, and their financial performance remains steadily strong this year. This allows companies to keep investing as well as to take out and service loans even at high interest rates.

- Government demand remains high, contributing to rising aggregate demand both directly and indirectly, i.e. by influencing households' and businesses' behaviour and expectations. Various subsidised programmes, government orders, and transfer payments are supporting consumer and investment activity.

Given the existing supply-side constraints, high domestic demand outstrips the economy's productive capacity and remains the key factor in persistently elevated inflationary pressures. The expansion of supply in the economy usually takes a long time. A consistent macroeconomic policy should take these lags into account and ensure that demand grows commensurately with the capacity to boost supply and in step with its expansion. In the Russian economy experiencing a large positive output gap, disinflation requires domestic demand to grow at a slower rate than supply for some time. This is the only way to close the positive output gap and return the economy to a balanced growth path. This is the goal of the monetary policy pursued by the Bank of Russia. The discussants noted that the current rate of supply expansion was limited by a number of factors: labour shortages, high utilisation of production capacities, and external restrictions obstructing the import of equipment and technologies.

Labour shortages remain the major factor constraining further expansion of supply. The labour market is still tight, with the unemployment rate continuing to decline. Business surveys suggest that the number of companies experiencing labour shortages has been growing further. Many surveyed businesses reported higher labour costs. The meeting pointed out that in order to assess the state of the labour market, it was essential to look not only at the dynamics of wages whose growth had decelerated somewhat, but also at other costs incurred by businesses to attract and retain staff. According to the data provided by the Bank of Russia Main Branches, a number of companies are offering more employee benefits, a higher vacation pay, and coverage of employees' accommodation and transportation expenses. The growth of labour costs continues to surpass that of labour productivity. Given high domestic demand, businesses can pass through increasing costs to prices.

One of the focal points of the discussion was **the reasons behind the economic slowdown – whether it was caused primarily by cooling domestic demand or by supply-side constraints**. If the main reason is the slowdown in the domestic demand growth, the positive output gap should be shrinking and inflation should be declining. There are indeed signs of cooling in domestic demand; however, inflationary pressures are not easing. This means that the economic slowdown is largely attributed to supply-side factors. Labour shortages remain high and restrain the expansion of output. A number of surveyed companies said they were unable to ramp up production, despite high demand for their products. An additional temporary supply-side restriction is the fulfilment of the OPEC+ agreement, which affects oil production and is one of the factors contributing to the slowdown in economic activity in recent months. Generally weaker external demand amid the slowdown in the world economy constrains the growth in export revenues that are currently the major source of import financing. Combined with the sanctions pressure as well as more complicated and expensive imports, this factor narrows the opportunities to step up imports and negatively affects the expansion of aggregate supply. The participants in the discussion concluded that **the current slowdown in economic activity was most likely predominantly due to supply-side rather than demand-side factors**.

In its baseline scenario, **the Bank of Russia assumes that the announced path of fiscal policy normalisation will remain unchanged**. The forecast presumes that the Government will progressively normalise fiscal policy, return to expenditure budgeting in accordance with the fiscal rule principles in 2025, and keep the primary deficit at a zero level in the future. The Bank of Russia will factor the updated fiscal policy parameters into its macroeconomic forecast after a draft federal budget is published in autumn 2024.

The discussants noted that fiscal policy generally had a significant impact on demand in the economy. The size of the budget deficit and the pace of fiscal policy normalisation are of utmost importance here, while changes in the structure of revenues and expenditures may also have additional influence over demand and inflation. Furthermore, it is important to take into account the macroeconomic forecast parameters that serve as the basis for mid-term budget parameters. If the actual economic situation is unfolding according to a more conservative scenario than the one assumed when planning budget expenditures, it might be necessary to cut expenditures to bring them in line with revenues. In case expenditures stay the same while revenues drop, the deficit will grow. A deficit expansion means a greater contribution of the budget to the increase in monetary aggregates, and that of the public sector to aggregate demand. Therefore, other things being equal, a more moderate rise in lending to the economy and, accordingly, tighter monetary policy will be needed to keep the growth of aggregate demand balanced and inflation at the target.

MONETARY CONDITIONS

MAIN FACTS

From the meeting in July, money market rates as well as short- and medium-term OFZ yields increased considerably, while long-term OFZ yields dropped. The OFZ yield curve became more inverted. Real yields on OFZ-IN went up, while breakeven inflation edged down. Deposit and loan interest rates were up as well. The inflow of households' funds into banks, primarily ruble term deposits for up to one year, continued. Credit activity remained high in July, although the retail segment showed signs of a slowdown in lending on account of both mortgage and unsecured consumer loans. Corporate lending growth rates remained elevated.

DISCUSSION

The discussants highlighted that **monetary conditions had tightened substantially since the July meeting**, following the key rate increase, a tougher signal, and a higher forecast path of the key rate in the Bank of Russia's baseline scenario.

- Money market rates went up. The OFZ yield curve became more inverted. The decrease in long-term OFZ yields might suggest that market participants are more certain that inflation will decelerate in the medium term. Market expectations regarding the key rate path shifted upwards.

- Deposit and lending rates continued to rise. Their growth potential has not been exhausted yet, considering the lagging effect of monetary policy. Interest rates on deposits and loans will continue to adjust to the changes in OFZ yields and rising money market rates.

The meeting pointed to **persistently high, albeit decelerated in some segments, lending growth in July–August**. Increased incomes allowed households and businesses to continue taking out loans even at high interest rates. Monetary policy was influencing the lending market unevenly. Its impact was partly limited by a number of non-market factors in certain segments, including subsidised lending programmes. The change in monetary policy had a greater effect on the part of the lending market where loans were issued at market rates. The participants in the discussion emphasised once again that the greater the share of the loans insensitive to changes in monetary policy was, the higher the rates on all other loans should be to be able to influence overall credit activity, as well as demand and inflation.

- The growth of retail lending decelerated in July. Lower growth rates of unsecured consumer lending were attributed both to the tightening of monetary policy and to the macroprudential policy measures. The mortgage lending growth rate went down due to the termination of the non-targeted subsidised mortgage programme and the modification of the parameters of other subsidised programmes.

- Credit activity remained high in the corporate segment, supported by companies' positive expectations regarding demand, project financing in housing construction, and major borrowers' activity related to government demand. However, the demand for loans is declining in those corporate lending segments that are more sensitive to the change in the key rate. According to surveys, around a half of businesses are planning to reduce borrowings.

The meeting noted that the lending market had not yet finished adjusting to the monetary policy changes and would continue doing this in the next few quarters. **A more significant slowdown in the growth of the overall loan portfolio is needed to steadily decelerate inflation.**

The discussants pointed out that **the earlier increase in the key rate had not led to higher financial stability risks for most borrowers**. Public companies' reporting for 2024 H1 shows that they have generally maintained their financial stability in spite of worsening financial performance of some of them. In addition, high profits of recent years have allowed businesses to form financial safety cushions. Notwithstanding increased interest payments, the quality of loans issued by banks remains good: the percentage of bad loans in the portfolio stays low. Banks do not observe a rise in the number of loan restructuring applications due to deterioration of borrowers' financial standing. Nonetheless, monitoring of borrowers' financial stability should be continued to ensure timely identification of risks.

The meeting discussed **the reasons behind the decline in share prices**. The tightening of monetary policy, aimed at reducing inflation, pushed up money market rates, deposit rates, and bond yields. Furthermore, investors adjusted their expectations regarding future financial performance of companies and their value. Besides tighter monetary policy, these expectations were also determined by adopted tax changes and a deteriorating situation in external markets. The dynamics of stock market assets were also influenced by the revaluation of shares due to dividend payments (dividend gap). As a result, some investors sold their shares to put their money on deposits or invest it in money market funds and bonds.

The discussants highlighted that **households' saving activity stayed high, albeit with no signs of further expansion so far**. Quickly growing incomes allow households to both save and consume more.

The meeting concluded that the decline in lending growth was too slow, while saving activity was not expanding as needed. This could indicate insufficient tightness of monetary conditions. According to the participants in the discussion, **monetary policy should provide an additional impetus to saving activity, slowdown of lending growth, and development of a steady disinflationary trend**.

EXTERNAL ENVIRONMENT

MAIN FACTS

The growth of the world economy is gradually slowing down. Inflation in the key advanced economies is decelerating. Market expectations about the US Fed funds rate and the ECB policy rate suggest that monetary policy normalisation in the US and the euro area will be faster than predicted before. Since the key rate meeting in July, the index of prices for Russian exports has moved down primarily due to a substantial decline in oil and steel prices. The OPEC+ has delayed oil output increase until December 2024 to support oil prices. The current account surplus decreased in summer 2024, which is typical of this season. The value of exports was generally close to last year's levels. The value of imports was still below last year's levels, although the difference between them decreased.

DISCUSSION

The meeting highlighted that **the global economy was generally developing in line with the Bank of Russia's July forecast. However, risks of a decline in oil prices over the forecast horizon heightened over the past period.** This is because market participants are more concerned about the future growth of the world economy, namely the Chinese economy. As a result, the demand for oil might turn out to be weaker over the medium-term horizon. Moreover, accelerated global transition to energy-efficient technologies and expansion of oil production in the US might also push oil prices down in the next few years.

Because of slower inflation and economic activity in the key advanced economies, market participants expect a more notable and faster easing of monetary policies by the US Fed and ECB. However, persistent proinflationary risks in the US, linked to its large budget deficit, could limit the speed of the US Fed funds rate cuts, according to the discussants. Additionally, the analysis indicates a higher neutral rate of interest in the US.

The value of exports remained close to the 2023 levels. Imports were lagging behind last year's trajectory a little less. The participants in the discussion concurred that imports were below the level that could be expected with domestic demand being that high. This may indirectly suggest that problems with cross-border payments and logistics are having a dampening effect on imports. High-frequency surveys show that the percentage of companies experiencing problems with payments for imports has increased over the past few months. The meeting also highlighted that orders for imports were executed and paid for in advance. Therefore, the problems with payments and logistics might be expected to further affect import dynamics.

The participants in the discussion agreed that the earlier depreciation of the ruble would have a weak proinflationary effect. Overall, the exchange rate remains stable: the ruble has returned to the level of May 2024, following its considerable appreciation in the summer months. The discussants noted that pricing in the foreign exchange market had temporarily become less efficient, while the market segmentation had intensified. Nevertheless, in the future, market participants can be expected to adapt to the new conditions and the ruble to stabilise across different market segments.

INFLATION RISKS

The participants in the discussion inferred that **the balance of risks remained significantly shifted towards proinflationary ones**. Moreover, proinflationary risks associated with the deterioration of the terms of trade increased.

The main **proinflationary risks** mentioned by the discussants were as follows:

- *More severe supply-side constraints*. A further increase in staff shortages may lead to labour productivity lagging even more behind the growth of real wages. Alongside labour shortages, further expansion of supply is constrained by a high utilisation rate of production capacities and challenges related to their expansion and upgrading, including due to the toughening of sanctions. This could eventually have a dampening effect on the growth rate of the economy's potential. More severe supply-side constraints might lead to persistently high inflationary pressures or even their strengthening despite a slight cooling in domestic demand.

- *Worsening of the terms of trade due to the impact of the geopolitical situation and deteriorating conditions in global commodity markets*. In particular, a greater slowdown in the growth of the world's largest economies as well as a faster transition to more energy-efficient technologies might entail a reduction in the demand for commodities. This in turn might lead to a contraction of Russian exports, which, if coupled with persistently high demand for imports in ruble terms, might create risks to the ruble exchange rate and inflation dynamics.

- *High and unanchored inflation expectations sensitive to transitory rises in prices for certain products and services*. This might intensify secondary effects in inflation dynamics, leading to further expansion of demand and preventing the easing of inflationary pressures.

- *Expansion of the budget deficit and the emergence of secondary effects associated with the structure of extra revenues and expenditures of the budget system*. Fiscal policy has a significant impact on demand in the economy. The size of the budget deficit and the pace of fiscal policy normalisation are of utmost importance here, while changes in the structure of revenues and expenditures may also influence demand and inflation. If the medium-term parameters of fiscal policy turn out to be more expansionary than the current budget projections, additional tightening of monetary policy might be needed.

Disinflationary risks are minor and mostly associated with a potentially faster deceleration in domestic demand under the influence of the monetary policy tightening. Besides, if the growth of the economy is driven, to a greater extent, by the expansion of its potential rather than the cyclical component (gap), inflationary pressures in the economy might be weaker.

CONCLUSIONS FOR MONETARY POLICY AND THE KEY RATE DECISION

Taking into account the statistics released since the key rate meeting in July and the assessments of the developments relative to the Bank of Russia's July forecast, the participants in the discussion concurred that **additional tightening of monetary conditions was needed**. They noted that the required tightening could be ensured by raising the key rate or giving a clear signal about its potential increase at the upcoming meeting, or by combining the two.

Therefore, the discussants considered the following alternatives:

- In terms of the key rate, keeping it at 18.00% per annum or raising it to 19.00% or 20.00% per annum.

- In terms of the signal, giving either a tough (implying a possible increase) or a moderately tough (implying assessment of the necessity of an increase) signal regarding the possibility of raising the key rate at the upcoming meeting(s), depending on the assessment of the probability of this step.

The arguments in favour of **keeping the key rate unchanged** at 18.00% per annum were as follows:

- High inflationary pressures in July–August could reflect, to a greater extent, the considerable positive output gap that had formed in 2024 Q2. Considering certain high-frequency indicators point to a slowdown in economic activity during 2024 Q3, including the cooling of domestic demand, disinflation might resume in the upcoming months. As for now, a tougher signal could be enough to solidify this process.

- The effects of the monetary tightening over recent months, including those resulting from the key rate increase in July, have yet to manifest themselves in full in lending and domestic demand dynamics. In addition, phasing-out of the non-targeted subsidised mortgage programme, tightening of the macroprudential measures, and cancellation of the regulatory easing for banks (in terms of their compliance with the liquidity coverage ratio) remain important autonomous factors of the tightening of bank lending conditions. Against this background, it might be reasonable to wait for additional data that would show the effect of the earlier key rate decisions on credit and saving activity before considering the option of raising the key rate further.

The arguments in favour of **raising the key rate** were as follows:

- The slowdown in economic activity observed in recent months was most likely caused by the exhaustion of factors of production, namely labour and capital, rather than the cooling of domestic demand. As a result, the positive output gap could remain large or even grow amid decelerating economic growth.

- Considering the inflation data received in July–August, there is a strong probability that inflation in 2024 will be higher than assumed in the Bank of Russia's baseline forecast presented in July. Raising the key rate would promote the conditions for a resumption of disinflation and the return of inflation to the target in 2025.

- The situation with inflation expectations continues to deteriorate (except for lower breakeven inflation for OFZ-IN). More adaptive inflation expectations are strengthening the inertia of high current inflation. A further increase in the key rate would help lower inflation expectations and maintain the credibility of monetary policy.

- Given multiple non-market factors determining lending dynamics, more pronounced cooling in the market segment of the credit market is needed to ensure a balanced growth rate of banks' aggregate loan portfolio.

Having weighed the arguments in favour of keeping the key rate unchanged and those in favour of raising it, the meeting concluded that **the key rate needed to be raised further**. There were more signs that economic activity was slowing down due to increasing supply-side constraints rather than the cooling of demand, which was also confirmed by high current inflationary pressures, especially in terms of underlying components of inflation. Furthermore, the discussants noted that the actual price growth rates in July–August were higher than the initial estimates taken into account when raising the key rate in July and that inflation was likely to exceed the July forecast range as of the end of 2024. Accordingly, **monetary policy should further promote the conditions for returning inflation to the target in 2025, taking into account transmission lags**.

Having agreed that a further increase in the key rate was required, the meeting discussed whether it should be raised **to 19.00% per annum (a more moderate step) or to 20.00% per annum (a bigger step)**:

- The argument in favour of a bigger step referred to the problem of high inflation inertia. The longer high inflationary pressures persist in the economy, the more pronounced secondary effects of inflation expectations become. Therefore, raising the key rate to 20.00% per annum in September would more likely help reverse the inflation trends and lower inflation expectations.

- The rationale for a more moderate step was that, despite higher-than-expected inflation in July–August, it was not yet possible to definitively say that the medium-term inflation path had deviated from the July baseline forecast significantly. In other words, the key rate increase to 19.00% per annum was more commensurate with the updated assessment of current inflationary pressures.

Following the discussion, its participants reached a broad consensus that, given the current situation, **raising the key rate to 19.00% per annum in September was a more balanced decision**.

As in July, the discussants reiterated that **not only the key rate decision itself, but also economic agents' expectations regarding the future key rate path continued to play an important role in ensuring the sufficient tightness of monetary conditions**. When choosing between a tough and a moderately tough signal, the participants in the discussion noted that the probability of a further key rate increase was high, considering the observed inflation dynamics and the prevalence of proinflationary risks. In this context, it was more rational to give a tough signal communicating that the Bank of Russia held open the prospect of increasing the key rate at its upcoming meeting. The increase in the key rate, along with a tough signal, would be more efficient in ensuring the required tightness of monetary conditions. A tough signal would support economic agents' expectations as regards maintaining tight monetary conditions for a long period.

Following the discussion, **on 13 September 2024, the Bank of Russia Board of Directors made the decision to raise the key rate to 19.00% per annum from 16 September 2024 and give a guided signal of a possible key rate increase at its upcoming meeting**. The Bank of Russia Board of Directors agreed that this decision would ensure the monetary tightness required for bringing inflation back to the target in 2025. According to the Bank of Russia's forecast, given the monetary policy stance, annual inflation will decline to 4.0–4.5% in 2025 and stay close to 4% further on.