Bank of Russia 28.12.2024

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 20 DECEMBER 2024

Discussants: members of the Bank of Russia Board of Directors, senior executives of the Monetary Policy Department, the Research and Forecasting Department, the Financial Stability 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 October 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 the surveys of companies and banks. 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**.

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ECONOMIC SITUATION AND INFLATION

MAIN FACTS

Current price growth edged down to 11.1% (seasonally adjusted annualised rate, SAAR) on average between October and November from 11.3% SAAR in 2024 Q3. Underlying inflation measures moved diversely, with most of them going upwards. Core inflation went up to 10.9% SAAR on average over October–November from 7.6% SAAR in 2024 Q3. According to high-frequency data, the Russian economy grew at a rate close to the values of 2024 Q3 between October and November. Strong domestic consumer and investment demand was still the main driver of the increased economic activity. The Bank of Russia's Business Climate Index (BCI) was down in December vs the previous months. October saw the unemployment rate hit its all-time low of 2.3% (seasonally adjusted). The net financial performance of large and medium-sized enterprises (except for credit institutions) for the first nine months of 2024 lost 18.0% year-on-year.

DISCUSSION

Inflationary pressures intensified in October and November. According to preliminary estimates, inflation remained high in the first weeks of December. The faster price growth was in part driven by temporary factors. For instance, prices for fruit and vegetables and some other food products rose rapidly due to a modest harvest this year. Higher communication rates largely contributed to inflation in November. However, volatile components and temporary factors were not the only drivers of inflation. Most of the underlying inflation measures reached their highs since early 2024. The discussants agreed that **stronger underlying inflation pressures resulted from overheated demand, which had been rising for the most part of 2024.** In the recent weeks, the price growth was also affected by the depreciation of the ruble. The meeting also noted that since inflation was the last link in the monetary policy transmission mechanism, the considerable tightening of monetary conditions in the recent months had not yet passed through to prices.

Inflation expectations continued to rise over December. Business price expectations reached their highs since the beginning of the year. Household inflation expectations were also up. Analysts raised their inflation forecast for 2025–2026. The participants in the discussion highlighted the fact that in December, inflation expectations were affected by a weaker ruble, among other factors. The discussants concurred that **high inflation expectations had secondary effects on price dynamics** when even one-off factors became persistent inflation drivers. Rising inflation expectations resulted in an easing of monetary conditions, higher demand, faster inflation and its stronger inertia.

The economy continued to grow fast. Considerably higher incomes, fiscal stimuli, and quickly expanding lending in the past months boosted domestic demand. The latter remained the key driver of the economic growth. However, **stronger inflationary pressures implied that the output gap was still positive**. According to the discussants, the output gap could have remained positive due to more constrained supply in addition to strong domestic demand. For instance, new sanctions complicated logistics even more and pushed up the cost of supplies. This hindered the expansion of production capacity and the usage of new technologies. The growth in supply of goods and services was still constrained by labour shortages, the high rate of production capacity utilisation, OPEC+ agreements, and lower harvest volumes in 2024.

The participants in the discussion noted that **there were certain signs of changes in the labour market though labour shortages remained**. Some industries and companies saw demand for labour decline. Spare workers were employed in those industries that still faced acute labour shortages. The number of vacancies continued to go down, while the number of CVs was up. The discussants believed that these changes in the labour market had not yet had a material effect on wages, the growth of which edged down but was still high and outstripped the growth of labour productivity. According to surveyed companies, they were going to raise wages at a more moderate pace in 2025 than in 2024. The meeting agreed that as labour shortages were still high, wages would continue to rise much faster than labour productivity for some time.

The recent months saw **more evidence of a gradual cooling in economic activity**. The discussants highlighted some of them. Rail shipments of construction materials continued to go down, which could suggest weaker investment demand. Moreover, December saw the BCI drop again. It had been declining for two consecutive quarters. According to the participants in the discussion, recent surveys showed that companies registered a slight rise in payment delays and hence a decrease in the supplies with payment after delivery and an increase in those with payment before delivery. On the top of that, increasingly more representatives of the Bank of Russia Main Branches reported that companies located in their regions tended to set more moderate production targets and postpone new projects. Finally, lower corporate profits might also indicate a tentative cooling of economic activity, as they prevented companies from raising their demand for production factors, including human resources.

The meeting concluded that **annual inflation would continue to rise in early 2025** due to the base effect and would likely peak in April. As assessed by the Bank of Russia, **the current inflation rate would start to go down in the coming months and gain momentum as the effects of the considerable tightening of monetary conditions would become evident**. In the year to come, the important disinflationary factor would also be a return to normal fiscal policy and fiscal rule-based budgeting of expenses.

MONETARY CONDITIONS

MAIN FACTS

Money market rates and yields on federal government bonds (OFZ) rose over the period since the key rate meeting in October. The OFZ yield curve became more inverted: OFZ yields on short- and medium-term maturities soared but those on longer maturities changed negligibly. Real yields on inflation-indexed federal government bonds (OFZ-IN) remained historically high. Banks' transfer curves shifted upwards to a much greater extent than the increase in money market rates. Deposit and loan interest rates rose considerably. The growth of credit slowed down noticeably in all market segments, including corporate lending. The inflow of household funds into time deposits remained considerable.

DISCUSSION

Monetary conditions tightened substantially (both price and non-price ones) in November and December. Nominal interest rates soared in all financial market segments. Banks applied more conservative approaches to borrower risk assessments and tightened their lending criteria. The discussants highlighted the following key factors underlying the considerable tightening of monetary conditions.

The first factor was **the October monetary policy decision** including both the key rate increase itself along with a tight signal and an upward shift in the key rate path forecast for the coming years. As more inflation data were released and given the ruble depreciation, market participants raised further their expectations for the future key rate path.

Second, **monetary conditions were largely affected by factors autonomous from monetary policy**, such as the planned normalisation of banking regulation and the tightening of macroprudential policy. These included the gradual termination of the liquidity coverage ratio (LCR) easing; the step-by-step return to the systemic importance capital buffer; the introduction of the countercyclical capital buffer and the update of its increase schedule; plans to set add-ons to risk weights for bank loans to large businesses with sizeable debt burdens; the scheduled introduction of higher minimum risk ratios for loans to large businesses to be applied by banks calculating credit risks using the internal ratings based (IRB) approach. Although banking and macroprudential regulation measures are not designed to solve monetary policy tasks, their impact on monetary conditions is taken into account when making monetary policy decisions. The discussants noted that **the said autonomous factors had a greater impact on monetary conditions than assumed by the Bank of Russia's October forecast**.

Most of the above measures were announced earlier. They were aimed at enhancing the resilience of banks and the banking sector amid the increasing overheating in the credit market. Households and businesses had been showing an elevated appetite for loans for the last two years. However, the accumulated capital buffers and the regulatory easing enabled banks

to build up their loan portfolios quickly without any commensurate increase in equity. The fast growth of lending led to a drop in the accumulated capital cushions and the portions of highly liquid assets in banks' books. As a result, banks needed to build up capital and enhance the liquidity of their balance sheets to comply with the regulatory requirements.

Competition for deposits, including those of corporate clients, toughened among banks seeking to ensure the LCR compliance. Since October banks had been significantly raising their deposit rates. Notably, they did it to a greater extent than it was necessary for them to adjust to the key rate increase. As a result, banks' transfer curves shifted upwards, the spread between transfer rates and money market rates, and spreads for floating loan rates widened due to a rise in the liquidity premium.

In turn, higher transfer rates, the necessity to increase capital adequacy to ensure regulatory compliance, and more conservative approaches to borrower risk assessments brought about a surge in the margins included in the loan rates offered to ultimate borrowers and hence the overall rapid growth in loan rates.

As assessed by the Bank of Russia, the spread between the key rate and the loan (floating) rate offered to the safest borrowers increased from 2–3 percentage points to 5–6 percentage points on average between November and December under the impact of autonomous factors. The discussants noted that the actual considerable tightening of monetary conditions was essentially comparable with a key rate increase to 24% per annum or more if the spreads observed before October had not changed at all.

The participants in the meeting highlighted the fact that **it was the interest rate offered to borrowers that affected demand for loans. Its surge noticeably cooled lending activity in the past period.** November saw lending slow down in all market segments already.

- Corporate lending registered a strong slowdown in November for the first time since the beginning of 2024. The effects of the changes in banking regulation and the monetary policy decisions were instrumental in reducing the growth in corporate loans. According to some discussants, the cooling of corporate lending might be in part associated with the fact that budget spending exceeded the usual seasonal values in late autumn.

- Retail lending continued to decelerate. This segment had been cooling for a long period of time – since July. Unsecured consumer lending virtually stopped growing as a result of monetary policy decisions and tougher macroprudential requirements. Mortgage lending continued to expand at a relatively low pace because of high interest rates, the termination of the non-targeted subsidised mortgage programme, and the modification of parameters under other subsidised mortgage programmes. Growth in car loans edged down too but remained high.

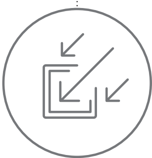
According to high-frequency data, the November trends continued to evolve in the credit market over December.

The meeting agreed that the past period showed a **likelihood of a more considerable slowdown in lending over 2025 than assumed by the Bank of Russia's October forecast**. Banks were changing their focus from the rapid growth to the more moderate and reasonable utilisation of their capital and liquidity. Further on, lending growth rates would depend on banks' capabilities to build up capital, among other factors. Surveys showed that banks tended to announce more moderate loan targets for the coming year (a decrease in loan supply). Companies also declared more reasonable borrowing targets amid high interest rates (a decline in demand for loans). According to the Bank of Russia, given the current monetary policy stance and the effects of autonomous factors, total lending growth may be close to the lower bound of the October forecast range of 8–13% by the end of 2025. The discussants agreed that it would take some time to assess the sustainability of the current trends in the credit market. There would be a certain amount of statistical noise in the data over the coming months due to seasonal factors (fiscal payments under public procurement contracts, weak demand for loans at the beginning of the year).

The meeting highlighted the fact that **high-frequency indicators did not imply a drastic deterioration in the credit quality**, which remained generally strong. There was a slight rise in the number of small and medium-sized businesses with debt servicing problems. According to recent information, some large companies also tended to apply for loan restructuring somewhat more often. The participants in the discussion concurred that **it was necessary to continue to closely monitor and analyse developments and trends in the credit market**.

The inflow of household funds into time deposits sped up, backed by rising interest rates. Coupled with the slower increase in unsecured consumer lending, this would push up the savings rate. Growth in household income was strong enough to support the high rate of growth in consumption as well.

The meeting concluded that the **existing tightness of monetary conditions was an important disinflationary factor**. This would help resume disinflation in the coming year.



EXTERNAL ENVIRONMENT

MAIN FACTS

The growth of the world economy was gradually slowing down. Market expectations about the US Fed funds rate movements suggested that monetary policy normalisation would be slower than predicted before. Prices for most Russian export goods edged down over the period since the October key rate meeting. The current account surplus fell below the last year's figures between October and November 2024. The value of exports was close to the last year's

level in November but declined against October. The value of imports went down too in November but to a lesser extent than that of exports.

DISCUSSION

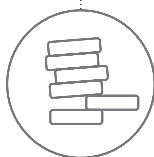
The discussants noted that the growth of the world economy still differed from region to region. The economies showed robust growth in the US and some large developing countries. In the euro area, the economic growth was still weak. The growth of the Chinese economy was lower than expected due to a moderate expansion of domestic demand. Government stimulus measures, however, were supposed to support the Chinese economy over the course of time.

The participants in the discussion agreed that the US monetary policy would be returning to normal more slowly than the Bank of Russia and market participants expected in October due to both high inflation and the US election results. Markets expected that the US might register a wider fiscal deficit in the coming years and higher import duties. This might affect inflation and moderate the pace of the US Fed funds rate decreases.

The discussants took into account that the oil market witnessed a greater impact of some factors that pushed prices down, i.e. growing market concerns about weaker demand for oil and the expansion of production outside OPEC+.

The meeting pointed to the fact that the current account surplus was close to the multi-year low in November. The value of exports was pushed down by drops in oil prices amid restrictions on the expansion of export quantities related to the OPEC+ agreements. The value of imports rose in anticipation of the increase in the recycling fee between September and October but declined in November. The value of imports, however, stayed above the last year's level, implying persistently strong domestic demand, among other things.

The discussants recognised **the ruble depreciation in November and early December as a proinflationary factor**. Apart from the deterioration in the balance of trade, this ruble depreciation was caused by temporary distortions in the market after the introduction of new sanctions. Tougher sanctions pressure pushed down the sales of foreign currency by exporters and boosted its purchases by importers who sought to stock up on foreign currency for future payments. Companies also showed greater demand for foreign currency in November in order to settle their obligations in foreign currency. To reduce the volatility in the foreign exchange market, the Bank of Russia suspended its foreign currency purchases in the domestic foreign exchange market to mirror regular fiscal rule-based transactions made by the Russian Ministry of Finance until the end of 2024. The meeting noted that the ruble exchange rate might stabilise as the economy adapted to new sanctions and domestic demand, including for imports, cooled as a result of the current monetary policy.



INFLATION RISKS

The participants in the discussion inferred that the **balance of risks remained substantially shifted towards proinflationary ones**. **Disinflationary risks, however, rose.**

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

- *The persistent significant positive output gap (overheating) in the economy,* which could be the result of both persistently high domestic demand and more severe supply-side constraints. Strong domestic demand might be supported by the resumption of faster growth in lending in part due to an increase in the share of loans insusceptible to changes in monetary conditions. If labour shortages rose further, labour productivity would lag even more behind the growth of real wages. Intensifying sanctions pressure might eventually have a dampening effect on the growth rate of the economy's potential. Irrespective of the reasons, a persistent large positive output gap in the economy would lead to persistently high inflationary pressures. To reduce them, an additional monetary policy tightening could be required.

- *Persistently high inflation expectations over a long period of time or their further rise,* which might both directly influence demand and prices and amplify the secondary effects of one-off factors on inflation.

- *Worsening of the terms of external trade due to the impact of adverse changes in global commodity markets and the geopolitical situation*. In particular, a greater slowdown in the growth of the world's largest economies as well as a faster transition to energy efficiency might entail a reduction in demand and hence commodity prices. In addition, prices for Russian exports might fall because of a faster increase in oil production outside OPEC+ and a greater fragmentation of the world economy resulting from protectionism and tougher sanctions. This would cause a contraction in the value of Russian exports, which, if coupled with persistently high demand for imports in ruble terms, might create risks to the ruble exchange rate and the risk of inflation.

- *Expansion of the budget deficit and the emergence of secondary effects associated with the structure of fiscal revenues and expenditures*. In case of fiscal policy easing or the expansion of subsidised lending programmes monetary policy might need to be tightened to contain proinflationary effects.

- *The 2025 harvest*. The area of winter crops sown in the autumn of 2024 declined against the previous year and the sowing targets due to bad weather. The condition of crops was assessed to be poorer than in the previous years. This might serve as another proinflationary factor.

The key **disinflationary risk** appeared to be related to a possible sharper slowdown in the growth of lending, which might result from tighter price and non-price lending conditions in part owing to a drop in bank risk appetite

caused by the aggregate effect of the Bank of Russia's decisions and a steeper decline in demand for loans from borrowers. The sharp slowdown in the growth of lending would considerably cool domestic demand and accelerate the return of inflation to the target.

CONCLUSIONS FOR MONETARY POLICY AND THE KEY RATE DECISION

Given the statistics released after the key rate meeting in October and the assessment of the developments relative to the Bank of Russia's October forecast, the meeting discussed the following options for the key rate decision:

- keep the key rate unchanged at 21.00% per annum;
- raise the key rate by 100 basis points to 22.00% per annum;
- raise the key rate by 200 basis points to 23.00% per annum.

When discussing their decision, participants tried to determine which of the following factors would be the main driver of future inflation: the higher rate of current inflation and the increased inflation expectations or the evidence of the considerable tightening of monetary conditions and the slowdown in the growth of lending.

The discussants considered the options to **raise the key rate** and presented the following main arguments:

- Inflationary pressures, including underlying ones, intensified. This implied that the positive output gap was not shrinking. Entering 2025, the Russian economy witnesses higher inflation and a wider output gap than forecast in October. This means that in order to return inflation to the target in 2026, policymakers might need to tighten monetary policy further despite the existing tightness of monetary conditions.
- Inflation expectations of a broad range of economic agents continued to rise. This might push down real interest rates in the economy and hence prevent lending and demand from cooling sustainably. Moreover, one-off inflationary factors tended to persist amid high inflation expectations because of secondary effects. This might imply that a further tightening of monetary policy was needed to reduce inflation expectations.
- Most market participants expected that the key rate would be raised in December given the intensification of inflationary pressures in the recent months. This meant that this step was already included in financial asset pricing. Therefore, if the key rate remained unchanged, monetary conditions might ease. To additionally secure the existing tightness of monetary conditions, it appeared more reasonable to raise the key rate.

The discussants supporting the **sharper increase of 200 bp** pointed to the fact that this option seemed to be more commensurate with the actual acceleration of inflation even with the more considerable tightening of monetary conditions. Inflation had been above the target for too long. This affected expectations and behaviour of economic agents and might trigger an inflationary spiral. Those in favour of the **more moderate step of +100 bp** said that it appeared to be a logical reaction to higher inflation and inflation expectations but also was sufficiently cautious given the continuing adjustment of monetary conditions.

The arguments in favour of the option to **keep the key rate unchanged at 21.00% per annum** were as follows:

- Monetary conditions had tightened to a greater extent over the recent months than assumed by the Bank of Russia's October forecast. The actual tightness of monetary conditions had already resulted in a significant cooling of credit activity in all market segments. Due to autonomous factors, among others, the tightening of monetary conditions would constrain credit activity to a greater extent in 2025 than expected earlier. This would be an important factor in the cooling of demand in the economy and in turn push inflation down.

- A coordinated tightening (or easing) of monetary policy and prudential regulation always produced a nonlinear effect on the economy and inflation. In other words, disinflationary effects of tight monetary policy would be more pronounced in a situation when banking regulation was tightened at the same time. Given high interest rates and a strong impact of autonomous factors, it appeared reasonable to take a pause to assess the further adjustment of monetary conditions.

- The volume of subsidised lending programmes had shrunk considerably over the last six months. This had already improved the effectiveness of the monetary policy transmission mechanism in various segments of the credit market. Moreover, the Government of the Russian Federation demonstrated its intention to continue streamlining the existing subsidised lending programmes, especially in the corporate segment. This implied that subsidised programmes would be more susceptible to changes in the key rate, in particular. This would have a meaningful disinflationary effect in 2025 in addition to the return to normal fiscal policy and fiscal rule-based budgeting of expenses.

Weighing the risks of the discussed options, the meeting pointed to the fact that these risks would become more serious if the key rate was raised rather than remained unchanged given the current stage of policy development. If the key rate remained unchanged in December, the growth of lending might speed up again in the coming months, with inflation and inflation expectations continuing to rise. Therefore, the Bank of Russia would have to tighten monetary policy again. To reverse trends in lending and inflation, policymakers would likely need to raise the key rate considerably. Alternatively, if the key rate was raised in December, there would be a risk of overtightening monetary conditions given their current tightness. Consequently, economic activity

might overcool, pushing down inflation significantly below 4% in the future. This would contravene the principles of the Bank of Russia's monetary policy under the inflation targeting regime whereby to anchor inflation sustainably at the target, monetary policy should help reduce cyclical fluctuations in output (the countercyclical role of monetary policy). To this end, it appeared more reasonable to take a break in changing the key rate at this point.

Nevertheless, the meeting noted that although the key rate remained unchanged in December, it was necessary to **mention that the key rate might be raised at the next meeting**. However, the signal should be moderately tight implying a lower probability of this step. Rising inflation and inflation expectations, and the persistent overheating of the economy remained a matter of concern. If the current trends in lending did not develop further, lending resumed expanding quickly, and inflation trends did not reverse by the key rate meeting in February, policymakers might come back to the issue of raising the key rate. Moreover, a moderately tight signal would not give a rise to any expectations of a faster decrease in the key rate in the future, which would help secure the necessary tightness of monetary conditions.

Following the discussion, **on 20 December 2024, the Bank of Russia Board of Directors kept the key rate at 21.00% per annum and gave a guiding signal that it would assess the need for a key rate increase at the next meeting based on further changes in lending and inflation**. The Bank of Russia forecasts that given the monetary policy stance, annual inflation will decline to 4% in 2026 and will remain at the target further on.