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Inflation and Monetary Policy

In September the growth rate of food prices, higher cost of fuel, as well as a new stage of regulated tariffs indexing have provoked acceleration of consumer price inflation: as per the month results, CPI amounted to 0.6% (vs.0% in September 2011). Within three weeks of October, there was no reduction in the growth rate of consumer prices, and on October 22 it was recorded at the level of 0.3% (against 0.2% in the same period of 2011). As a result, the cumulative inflation since the beginning of the year made 5.7% (vs. 4.9% in the same period of the last year). According to tentative estimates of the Central Bank, the net capital outflow from the country in Q3 reached $13.6bn, exceeding the outflow in Q2 of this year. Thus, over the first nine months of 2012 capital outflow amounted to $57.9bn (vs. $45.5bn in the relevant period of 2011).

As of September results, the growth rate of consumer prices increased from 0.1% in August to 0.6% (in September 2011 prices were not growing). This acceleration in inflation is urged by another upsurge in regulated prices of natural monopolies, as well as growing prices for foodstuffs (in September 2011 food prices decreased by 0.6%).

The utmost contribution to the increase in consumer prices was made by commercial services, which rose in September by 1% (for comparison, in September 2011 those services decreased by 0.1%). The leaders in the growth of prices at the beginning of the new school year were educational services, which rose by 5.1%. Among other services under review the greatest price growth was noted in housing and public utilities (+2.4%), as well as fitness services (2.3%). With the completion of the peak of vacations season, healthcare and recreation services got cheaper (-2.6%), passenger transport (-2.8%) and international tourism (-1.4%). Prices for insurance services have also declined (-0.1%).

In September the growth rate of non-food goods has nearly doubled (+0.7%), having matched the indicator of September in the last year. Significant growth was observed in petrol (+2%). This is due to both, the seasonal demand for fuel, and the increase in the excise tax on petroleum products. The price of tobacco products continued to increase (+2.4%). At the same time, video and audio appliances were still getting cheaper (-0.2%).

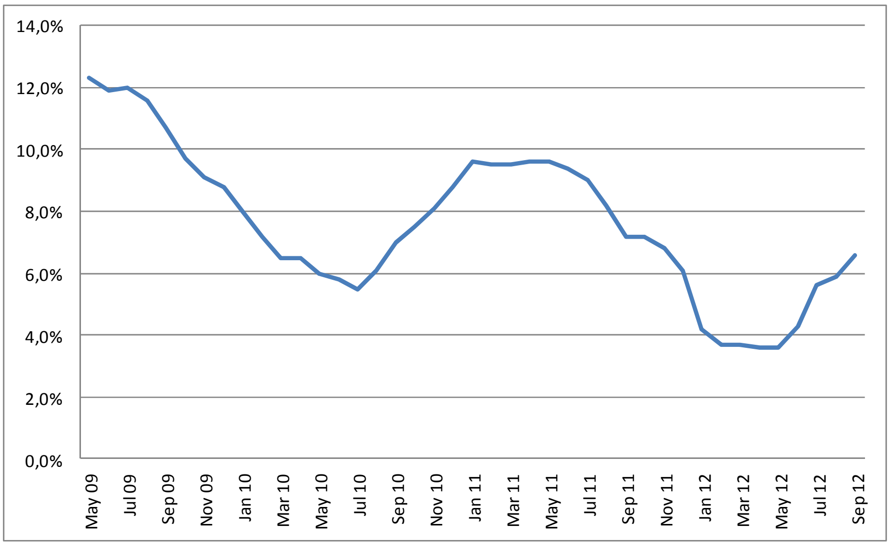
Despite the seasonal price reduction in fruit and vegetable products, the growth rate for foodstuffs accounted to 0.1%, which is higher than the indicator of the same period in the last year, when in September food prices fell down by 0.6%. The greatest decrease in prices of the foodstuffs under review was noted in fruit and vegetables (-5.6%) and sugar (-5.4%). However, there was a significant price growth for eggs (+8.1%), as well as bread and bakery products (+2.1%) and pasta (+1.5%).

In September, the annual inflation (September 2012 against September 2011) has accelerated to 6.6% (see *Fig. 1*), having exceeded the bottom threshold of the official estimates and coming close to the indicator of the last year (+7.2%).

In September the core consumer price index[1] has grown from 0.6% to 0.7%, went up again, having made 0.6% (vs. 0.4% in 2011), and the core inflation indicator in annual terms made 5.7%, having also exceeded the target indicator 5.5%.

In the first half of October, inflation has not slowed down and within a little more than three weeks of the month, on October 22 reached 0.5% (vs. 0.2% in 2011). The main factors of inflation were wheat flour (+4.1%), millet (+2.2%) and gasoline (+1.8%). Despite the record production of sunflower oil in September of this year (about a quarter more than in 2011), its prices were also increasing rapidly: in 22 days of October, oil prices rose by 3.5%. At the same time, there was a seasonal reduction in the prices of vegetables: potatoes (-3.7%) and cabbage (-9.2%).

Inflation accumulated from the beginning of the year, on October 22 reached 5.7% (against 4.9% in 2011). *According to Ye.T. Gaidar IEP assessment, by the end of the year inflation will exceed the estimated by the Ministry of Economic Development value of 7%.*



Source: RF Statistical Service.

Fig. 1. The Growth Rate of the CPI in 2009-2012 (% year to year)

In September the monetary base in broad definition has continued to decline: over the month it decreased by 0.3% to Rb 8,082.8bn. This happened due to almost two-fold reduction of commercial banks' deposits with the RF Central Bank; on October 1, they made Rb 90.8bn. After the reduction of correspondent accounts of credit organizations by 17% in August, in September they increased by 4% to Rb 753.7bn. Other components of monetary base in broad definition were also growing. The volume of monetary base in broad terms has decreased in January-September of this year by 6.5% (against 9.6% over nine months of 2011).

[1] The core consumer price index reflects the level of inflation in the consumer market after adjustment for the seasonal (prices of vegetable and fruit products) and administrative (regulated tariffs for certain types of services, etc.) factors, which is also calculated by the RF Statistical Service (*Rosstat*).

In September, the excessive reserves[2] of commercial banks were still decreasing. At the end of the month they decreased by 5.4% to Rb 844.5bn. Herewith, the average rate on overnight MIACR bank loans in September rose to 5.5% against 5.3% in August. The total debt of banks to the RF Central Bank at the end of September remained at a high level, amounting to about $2.2 trillion (see *Fig. 2*). Note that the Bank of Russia has no intention to reduce the refinancing rate to the banks: according to the First Deputy of the Central Bank A.Ulyukaev, gross liability of Russian banks to the Regulator will grow more than two-fold in the next 3 years and reach Rb 7.6 trillion.

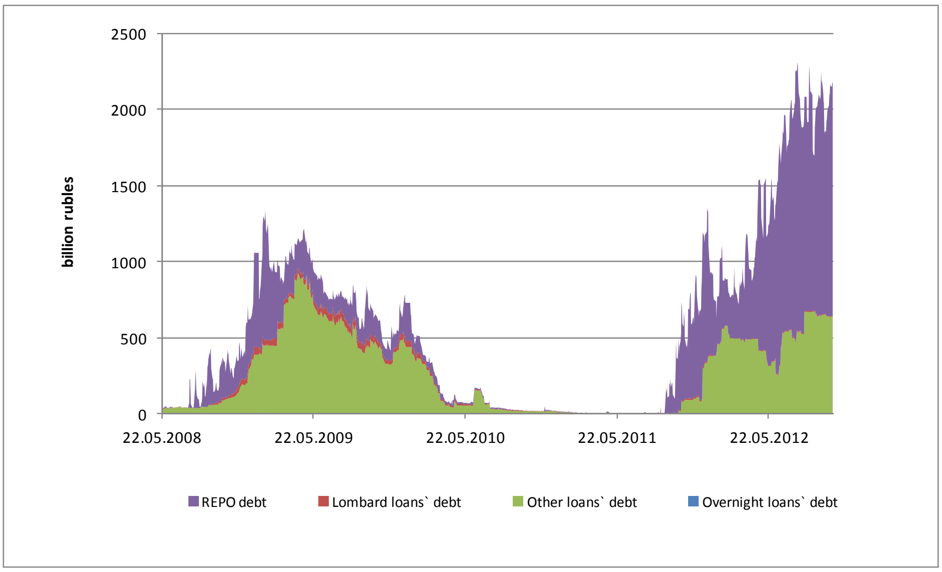


Fig.2. Arrears of commercial banks with the Bank of Russia in 2008–2012

In September the monetary base in narrow definition (cash plus mandatory reserves) remained virtually unchanged, having slightly increased by 0.3% to Rb 7238.3bn (see *Fig. 3*).

[2] Under the excessive reserves of commercial banks with the RF Central Bank is understood the sum of correspondent accounts of commercial banks, their deposits with the RF CB and the RF CB bonds of commercial banks.

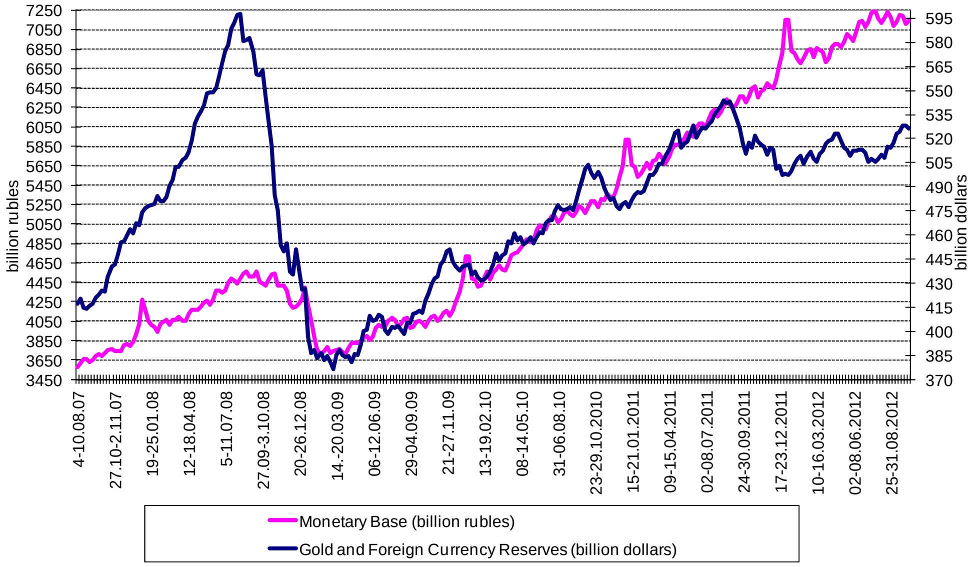
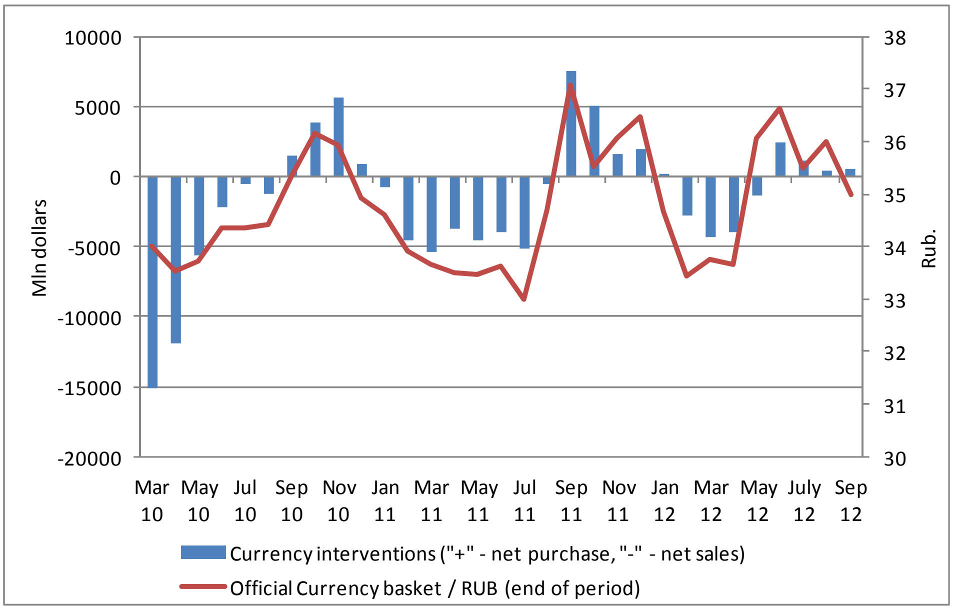


Fig. 3. Changes in the Monetary Base and the Gold and Foreign Currency Reserves in 2007–2012

In mid-October, the volume of international reserves amounted to \$526bn (as of October 12), having increased by 0.6% over the month.

Whereas in the first half of October, the Bank of Russia did not participate in currency trading, in September, on the contrary, the Regulator made foreign exchange interventions: there were sold \$453.81m, which is by 18% more than in previous month and Euro 43.99m, which is, in contrast, by 7% lower than in August (see *Fig. 4*). Therefore, foreign exchange interventions of the RF Central Bank remain insignificant.

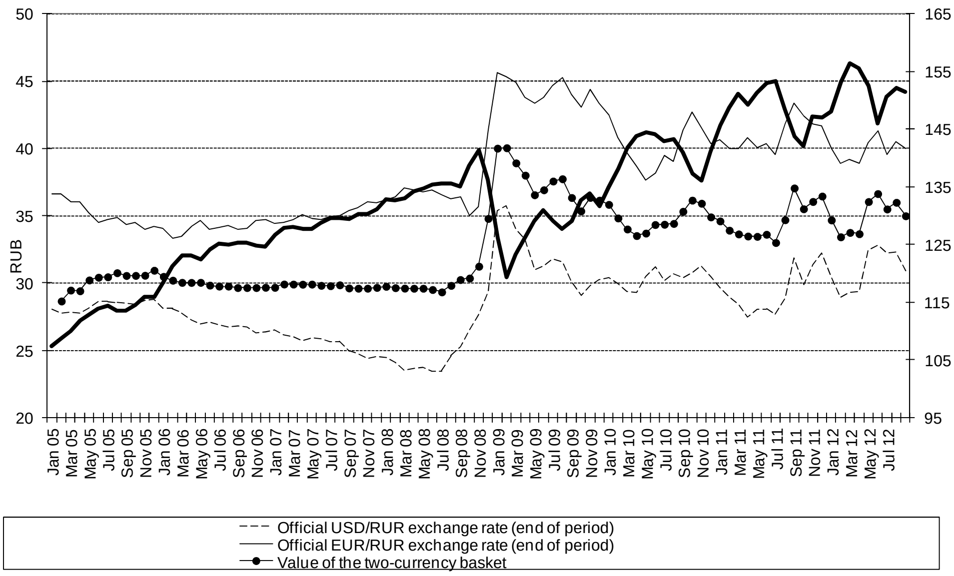
In August an outflow of capital was observed again. According to tentative assessments of the RF Central Bank, in Q3 the net outflow has exceeded the outflow of Q2 by \$4.2bn and made \$13.6bn. However, it is lower than in the same period of the last year, when the outflow reached \$18.4bn. As per result of three quarters of the current year, capital outflow from the country amounted to \$57.9bn, which is by \$12.4bn more than in 2011. It should be noted that the *official forecast of the Bank of Russia remains unchanged: the net capital outflow by the year result is expected in the amount of \$65bn.*



Source: RF Central Bank, author's estimates.

Fig. 4. Central Bank Currency Interventions and Dynamics of Ruble Exchange Rate in March 2010 - September 2012

After growth in July-August, the real effective exchange rate of ruble in September started to decline again (-0.4%). As a result, index of the real effective exchange rate fell down to 151.52[3] (see *Fig. 5*).



Source: RF Central Bank, author's estimates.

Fig. 5. Indicators of ruble exchange rate dynamics in January 2005 – September 2012

Since the beginning of October to the end of the second decade of the month the dollar/ruble rate was reducing: within 19 days of the month the dollar has declined by 1.7%. In this period, the ruble was supported by increasing global oil prices. Then, from October 19 to 24,

[3] The level of January 2002 is accepted as 100%.

due to decline in oil prices, the U.S. currency has grown by 1.3%. In addition to oil price, the dollar growth was urged by the investors' disappointment with the effect of the open EU summit, which led to a reduction in long-term risky assets, which include Russian currency.

During three weeks of October Euro against ruble was relatively stable, varying around the rate of Rb40.2/ Euro. After successful placement of bonds of Spain and Italy and the elections in Spain, Euro started to grow. As a result, in 24 days of October the European currency strengthened by 1%, reaching the level of Rb40.58/Euro. During the same period, the two-currency basket has grown by 1.1% to Rb35.38.

On October 4 the Bank of Russia has published on its website the draft Guidelines for the Consistent State Monetary Policy for 2013 and the period of 2014 and 2015. By 2015, Russia plans to complete the transition to inflation targeting. In the framework strategy of progressively reducing growth rates the objective is set forth to reduce annual inflation to 4-5% by 2014. Herewith, for 2013 inflation target range is 5-6%. The Bank of Russia sees the reduction of direct involvement in the exchange rate and creating the conditions for the transition to a floating exchange rate (2015) as the main purpose of the exchange rate policy. With reduction of the RF Central Bank involvement in foreign currency market the interest rate management policy through liquidity provision and withdrawal will be used as a key tool in the process of monetary regulation. The interest rates will be revised, as a rule, monthly, based on the analysis of inflation and economic activity.

Other important medium-term objectives set up by the Bank of Russia are as follows:

- maintaining financial stability (for the realization of this objective, the Bank of Russia will use international best practices in risks supervision, transparency of credit institutions, differentiated monitoring of financial institutions in view of their systemic importance). We believe that in pursuit of this objective great attention should be paid to the analysis of the banking system resistance to stresses given its high dependence on the refinancing from the government authorities;
- infrastructure of financial markets development and enhancement their capacity. In the transition to inflation targeting, particular importance will acquire the market of financial derivative instruments of risk hedging, including currency risks, which will be increasing with the volatility of ruble exchange rate;
- coordination of monetary and fiscal policy of the Russian government. The importance of such coordination in the situation of regulated tariffs contribution to inflation, as well as the impact of fiscal policy on the monetary supply in the RF is hard to be overestimated. Of course, balanced budget policy aimed at reducing the budget deficit and the national macroeconomic risks will help the RF Central Bank to achieve the objective in terms of inflation, but the influence of the Central Bank on fiscal policy is minimal;
- increasing transparency of the Bank of Russia in terms of monetary policy. In recent years, the Central Bank has made progress in improving the transparency of its policy and is now close to the best world practices, while at the same time, there are resources to improve the quality of analytical work, the analysis of macroeconomic

situation and a more detailed presentation of grounds and effects of its decisions to the economic agents.