

## INFLATION AND MONETARY POLICY IN AUGUST 2013

A.Bozhechkova

*In August 2013, the Consumer Price Index (CPI) amounted to 0.1% (same as its level in August 2012), which is by 0.7 pp. lower than its value recorded in July 2013. Thus, the inflation rate in per annum terms, as seen by the results of the first 8 months of 2013, increased above 6.5%. Over the period from 1 September through 23 September, the CPI amounted to 0.2%. In Q2 2013, according to the Bank of Russia’s preliminary estimates, net capital outflow from Russia reached the level of \$ 10bn; on the whole over the first half year of 2013, it amounted to \$ 38.4bn, which is by \$ 1.7bn below its index for the first half year of 2012.*

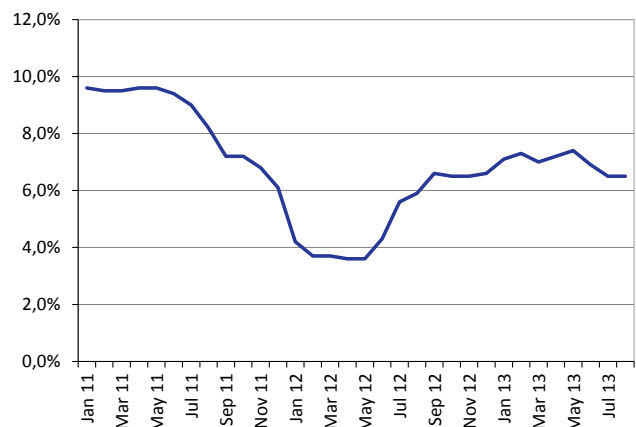
In August, the inflation rate in the Russian Federation became slower: the Consumer Price Index (CPI), as seen by the month-end results, amounted to 0.1% (against 0.8% in July 2013), thus reproducing the similar index for 2012. Thus, the inflation rate in per annum terms climbed to 6.5% (Fig. 1). The core inflation rate<sup>1</sup> in August 2013 was 0.5%, which is below its index for the same period of last year by 0.1 pp.

The prices of foodstuffs in August declined by 0.7% (Fig. 2), due in the main to the drop in the prices of fruit and vegetable products on July 2013 (from -0.3% in July to -11.3% in August). At the same time, the growth rate of prices for eggs increased (from -1.1% in July to 7.4% in August), as did prices for granulated sugar (from 0.1% in July to 4.4% in August), butter (from 1.1% in July to 2.6% in August), milk and dairy products (from 0.8% in July to 1.2% in August), fish and seafood (from 0.4% in July to 0.7% in August). As for the growth rate of prices for bread and bakery products, and those for alcoholic beverages, they remained unchanged since July – 0.3% and 0.5% respectively

The growth rate of the prices and tariffs established for commercial services rendered to the population in August amounted to 0.9%, thus plummeting below its July level 3.1%). Towards the start of the new school year, the prices for services in the education system displayed the highest growth rate (+2.0%). The growth rate of the housing and utilities tariffs in August was 1.3%. The prices of out-bound tourism services continued their upward movement, having increased by 2.6%. The prices of medical services (+0.4%), physical culture and sport (+0.4%), and personal consumer services (+0.3%) were also on the rise.

In August, the growth rates displayed by the prices of nonfood commodities increased on July 2013,

amounting, by the month-end results, to 0.5% (against +0.1% in July). In this commodity group, the steepest upward movement was demonstrated by the prices of motor gasoline (+3.1% against +0.1% in July 2013), tobacco products (+2.0% against +1.2% in July 2013), pharmaceuticals (+0.5% against +0.5% in July 2013), radio and television sets (+0.3% against -0.1% in July



Source: Rosstat.  
Fig. 1. The CPI Growth Rate in 2011–2013 (% Year-on-Year)

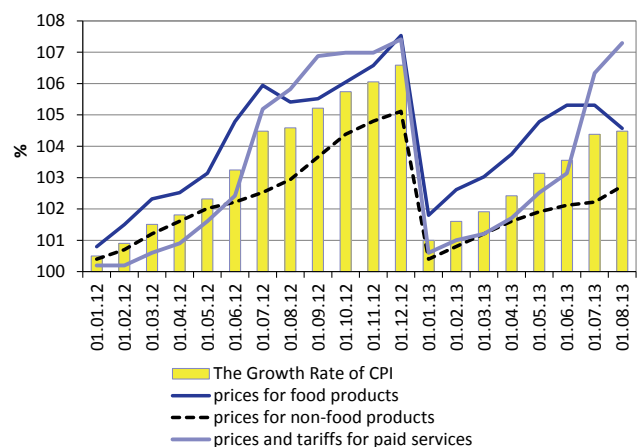


Fig. 2. The CPI Growth Rate in 2011–2013 (as % on December of Previous Year)

1 The core consumer price index reflects the level of inflation on 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. This index is also calculated by the RF Statistics Service (Rosstat).

2013), clothes and underwear (+0.3% against +0.1% in July 2013), footwear (+0.3% against zero growth in July).

In September, the inflation rate continued its downward trend in response to both the cheapening fruit and vegetable products and the waning economic activity. The CPI, as determined by the results of the period of 1–23 September, amounted to 0.2% against 0.5% in the same period of 2012. Thus, the cumulative inflation rate since the year’s beginning rose to the level of 4.7% (against 5.1% over the same period of 2012). On the whole, the current inflation trends make it possible to believe that, in absence of any new price shocks, the year-end CPI can amount to approximately 6%.

In this connection, prices may come under upward pressure later this year in response to the expected lower crop yields resulting from the unfavorable weather conditions in some regions (drought in the south of Russia and heavy rains across the Middle Volga Region and Siberia); another contributing factor may become the weakening of the Russian ruble. The factors suppressing the inflation rate’s growth will be the declining domestic demand (a phenomenon that has already been observed for a year) and the continuing slowdown in the growth rate of money supply (the per annum growth rate of M2 dropped from 18.0% as of 1 August 2012 to 17.0% as of 1 August 2013).

In August 2013, the broad monetary base increased by 0.4% to Rb 8,896.2bn (Fig. 3). Among the increasing components of the broad monetary base one may point to banks’ deposits (growth by 4.9% to Rb 131.8bn), the monies kept on commercial banks’ correspondent accounts with the RF Central Bank (by 0.3% to Rb 820.1bn), and cash in circulation, including the cash balances of credit institutions (by 0.4% to Rb 7,442.8bn). The banking sector’s required reserves shrank by 1.2% to Rb 501.6bn.

The narrow monetary base (currency issued by the Bank of Russia plus required reserves) over August increased by 0.3%, amounting to Rb 7,944.4bn (Fig. 4).

In August 2013, the surplus reserves held by commercial banks<sup>1</sup> rose by 0.9% to Rb 951.9bn, while the amount of banks’ repo debt increased by 16.1% – to a level in excess of Rb 2.3 trillion. As of 23 September, banks’ repo debt was above Rb 2.4 trillion. In face of the continuing structural liquidity deficit experienced by the banking sector, the interest rate in the interbank market<sup>2</sup> in August was on the average at

1 The surplus reserves held by commercial banks at the RF CB are understood as the aggregate balance of their correspondent accounts, deposits with the RF CB, and the bonds issued by the RF CB and held by commercial banks.

2 The interbank interest rate is the average monthly interest rate on overnight ruble-denominated interbank loans (Moscow Interbank Actual Credit Rate – MIACR).

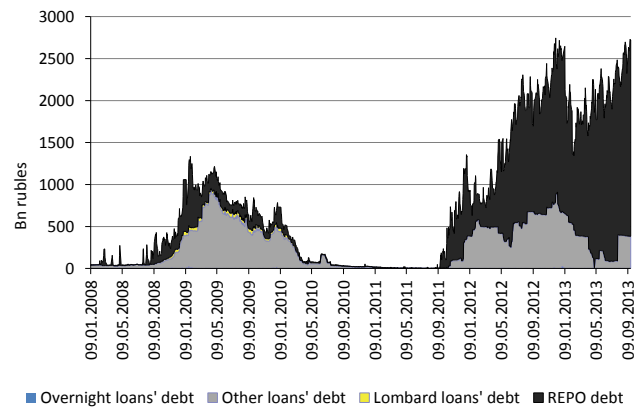


Fig. 3. The Movement of Commercial Banks’ Debt to the Bank of Russia in 2008–2013

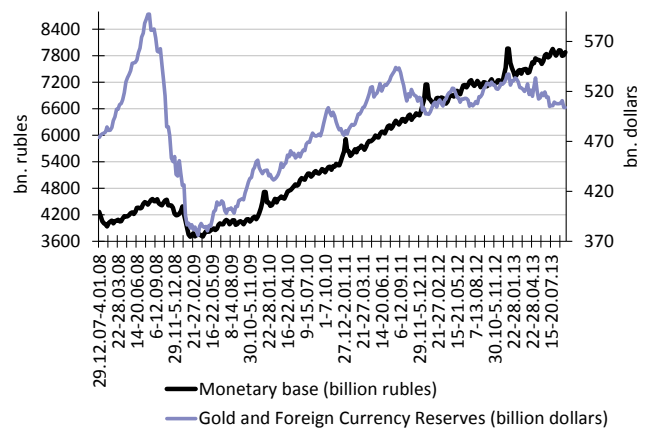


Fig. 4. Behavior of Russia’s Narrow Monetary Base and Gold and Foreign Currency (International) Reserves in 2007 – 2013

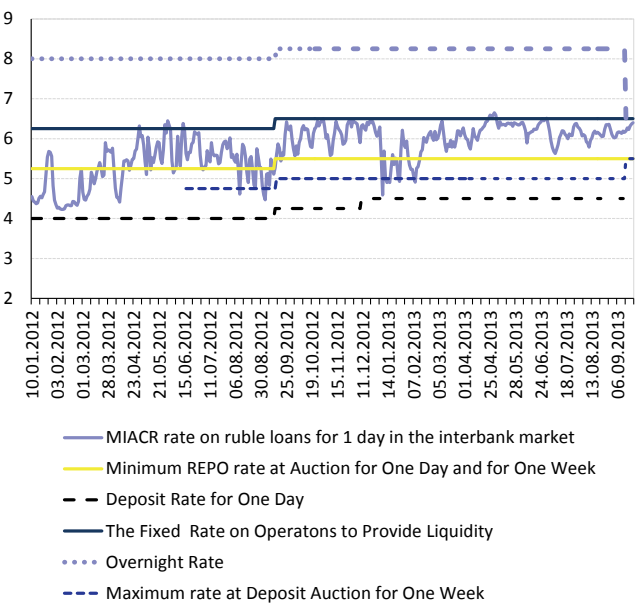
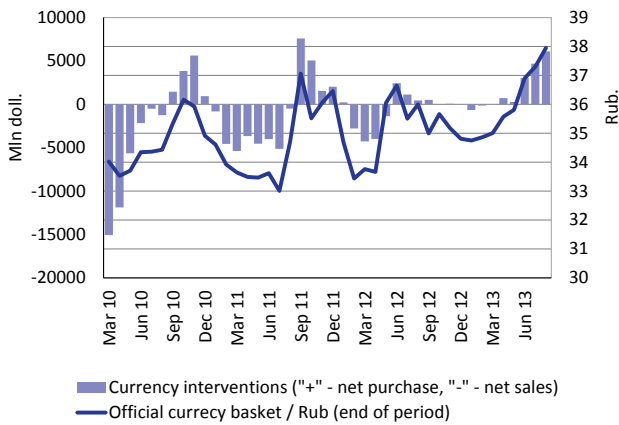
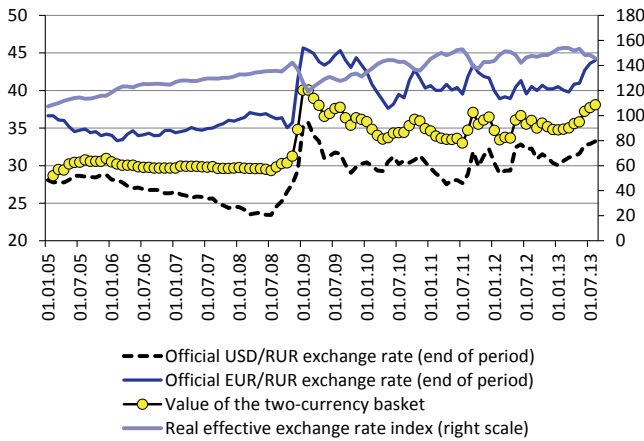


Fig. 5. The Bank of Russia’s Interest Rate Corridor and the Interbank Market’s Behavior in 2012–2013 (% per Annum)



Source: RF CB; the author's calculations.

Fig. 6. The Bank of Russia's Currency Interventions and the Ruble Exchange Rate against the Bi-currency Basket in March 2010 – August 2013



Source: RF CB; the author's calculations.

Fig. 7. Behavior of the Ruble's Exchange Rate Indicators in January 2005 – August 2013

the level of 6.11% (against 6.08% in July 2013), having risen above the similar index for January 2013 by 12.8% (5.4% in January 2013). Over the period from 1 through 23 September, the average interest rate was 6.18%, thus approaching the upper border of the interest rate corridor (Fig. 5).

As of 1 September 2013, the Bank of Russia's international reserves volume amounted to \$ 509.7bn, having shrunk since the year's beginning by 5.2% (Fig. 4). The downward movement of the volume of international reserves in August resulted from the Bank of Russia's sales of foreign currencies on the domestic market. At the same time, the reserves backed by monetary gold over the month of August increased by \$ 2.8bn due to an upward adjustment of asset value. Meanwhile, it should be noted that on the whole, the shrinkage of Russia's international reserves volume denominated in USD over the first half year of 2013

was caused in the main by the upward movement of the euro-to-USD exchange rate, and only in part – by the Bank of Russia's currency interventions.

As seen by the month-end results, the scale of currency interventions by the Bank of Russia in July was \$ 5,455.9m and € 475.6m, their purpose being to level down the volatility of the ruble's exchange rate during the periods of its rapid weakening (Fig. 6). The volume of currency sales in August hit its record high since September 2011. Over that month, the regulator repeatedly revised the boundaries of the bi-currency basket's floating corridor by 5 kopecks. As of 31 August, the boundaries of the bi-currency basket's floating corridor were set at Rb 32.15–39.15. In September, the bi-currency basket's corridor had been twice adjusted upwards by 5 kopecks, thus moving its boundaries further up, to the new level of Rb 32.15–39.15.

According to the Bank of Russia's preliminary estimates, net capital outflow from Russia in Q2 2013 increased to \$ 10bn, and on the whole for the first half year this index amounted to \$ 38.4bn, which is by \$ 1.7bn less than the same index for the first half year of 2012. From January through June 2013, net capital outflow from the banking sector was \$ 19.4bn, while that from the other sectors amounted to \$ 18.9bn.

In August, the ruble's real effective exchange rate against the two major foreign currencies lost 0.8% (having demonstrated no changes in July 2013) (Fig. 7). As seen by the quarter-end results of Q2 2013, the ruble's real effective exchange rate declined by 1.7%.

The exchange rate of the US dollar against the ruble over August rose by 0.64%, to Rb 33.2, which happened as a result of a decline of Russia's balance of trade following the downward movement of international prices for some metals and mineral fertilizers, as well as capital outflow from the developing markets in response to the continuing uncertainty as to whether the US Federal Reserve System's third round of quantitative easing (QE3) was going to be halted towards the year's end. The growth of the euro's exchange rate over August amounted to 0.54% (Rb 44.0). In August, the average exchange rate of the euro against the US dollar amounted to 1.33. The value of the bi-currency basket over August increased by 0.59%, to Rb 38.1. As seen by the results of the period of 1–21 September, over that month the USD/ruble exchange rate dropped by 4.6%, to Rb 31.7., the euro/ruble exchange rate – by 2.3%, to Rb 43.0. As a result, the bi-currency basket's value declined by 3.4%, to Rb 36.8. The ruble's strengthening in September had to do with the start of a new tax period, the responses of market participants to the declaration, by the RF Ministry of Finance, that it might refuse to buy currency on an open market for

the sovereign funds, and the diminishing investors' concerns that the US Federal Reserve System's third round of quantitative easing was indeed going to be halted soon. Thus, the average euro/USD exchange rate for September was 1.33.

On 13 September, at a planned meeting of the Bank of Russia's Board of Directors, it was announced that a set of measures designed to improve the existing system of monetary policy instruments should be implemented. The Bank of Russia decided to cut interest rate on overnight loans and on one-day loans secured by non-marketable assets and guarantees to 6.50% per annum, and to raise the maximum interest rate cap on one-week deposit auctions to 5.50% per annum, whilst the interest rates on the Bank of Russia's other operations and refinancing rates were to remain unchanged. At the same time, the system of monetary policy instruments was complemented by the auction for the provision of loans, secured by non-marketable assets, for 3-month term with floating interest rate.

The Bank of Russia's Board of Directors has declared the interest rate on Bank of Russia one-week liquidity provision and absorption open market operations (5.50 percentage per annum as at 13 September 2013) to be the Bank of Russia's key rate. The choice of a key rate appears to be well-substantiated, given that the main channel for obtaining liquidity by credit institutions from the Bank of Russia are one-week auctions (on the average over Q2 2013 – Rb 1.4 trillion), whereas the same indices for one-day auctions (on the average over Q2 2013 – Rb 317.2bn) and auctions for longer terms (3, 12 months) are significantly lower. The regulator intends to use the key rate as the main indicator of the monetary policy stance. It should be noted that, during the transition period, one-week repo rate will serve as a key one. By 1 January 2016, the Bank of Russia is going to make the refinancing rate equal to the key rate. Before that, the refinancing rate will play a minor role. The interest rates on Bank of Russia one-day liquidity provision and absorption standing facilities are to form the lower (4.50 percentage per annum as at 13 September 2013) and upper (6.50 percentage per annum as at 13 September 2013) borders of the interest rate corridor, respectively, which are symmetric relatively to the key rate (*Fig. 5*).

Among the innovations introduced by the Bank of Russia, an important one is that the inflation target is set as a point and not as a spread – a measure designed to facilitate a better understanding of monetary policy decisions by economic agents. The target consumer inflation growth rate continued is estimated to be at 4.5% in 2014 and 2015, and at 4% in 2016.

However, the inflation targets are set with a tolerance band of  $\pm 1.5$  pp., with a view towards possible effects of unpredictable factors. In our opinion, considering the current trends in Russia's national economy, the RF Government's decision to freeze the tariffs set by natural monopolies until the end of 2014, and the recent improvements to monetary policy, such inflation targets appear to be quite realistic; however, their actual achievement will strongly depend on the situation in the world economy.

In the draft *Guidelines for the Single State Monetary Policy in 2014 and for 2015 and 2016* published on 13 September, the Bank of Russia also proclaimed its intention to further increase the exchange rate flexibility. The regulator plans to complete the transition to a floating exchange rate regime by 2015, by reducing the volume of interventions it conducts which are aimed at cushioning fluctuations in the ruble exchange rate and by increasing the sensitivity of the operational band borders to Bank of Russia interventions, in order to facilitate market participants' ability to adapt to exchange rate fluctuations that are caused by external shock. Over the course of 2013, the Bank of Russia has been moving in that direction, progressively expanding the ruble's exchange rate corridor.

The draft establishes that, in the course of the transition to an inflation targeting regime, the Bank of Russia will continue increasing the effectiveness of the interest rate channel of the monetary policy transmission mechanism. Keeping overnight money market rates close to the Bank of Russia key rate will be an operational goal of the monetary policy. The regulator points out that interbank lending will play a major role in the redistribution of liquidity between market participants. At the same time, we must note the high segmentarization level of the interbank lending market in Russia, from which it follows that, in an event of financial instability, the Bank of Russia will have to be the main source of liquidity.

To alleviate the problem of liquidity deficit faced by some credit institutions, the Bank of Russia will continue conducting operations using various types of assets in addition to securities, including non-marketable assets. Besides, the Bank of Russia may use outright purchases or sales of assets as an additional instrument for regulating banking sector liquidity.

As one of the main monetary policy tools, the Bank of Russia will consider the possibility of unifying interest rates on same-term operations irrespective of the type of collateral, as well as combining refinancing operations with the same term and different types of collateral into a single auction.

The planned upward adjustment of the coefficient of averaging for the calculation of average size of re-

quired reserves is regarded by the regulator to be one of the measures designed to improve the efficiency of liquid asset management, thus creating better conditions for reducing the volatility of interest rates on the interbank market.

The regulator plans to pursue an aggressive information policy, including the explanation of the Bank of Russia's goals and the purpose of its measure to economic agents. This principle of Bank of Russia's accountability will increase the level of public confidence in its monetary policy and help shape the expectations of economic agents.

It should be noted that, on the whole, the intended modification of the system of monetary policy instruments will improve the functioning of the money market and the manageability of interest rates, while the inflation risks will become lower. However, to supply the economy with 'long money' is the task for the entire financial system, and not for the central bank alone. So, the issues of developing the institutional environment and deepening the financial sector's capacity are by no means losing their importance for the Russian economy. ●