INFLATION AND MONETARY POLICY IN OCTOBER 2013

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The consumer price index stood at 0.6% in October 2013 (against 0.5% in October 2012), having shown a 0.4 p.p. increase as compared to September 2013. Therefore inflation increased more than 6.3% on a year-over-year basis at the end of the 10-month period. In the first 18 days of November 2013 the consumer price index stood at 0.3%. The Central Bank of Russia is still retaining the target interest rate despite a decline in the economic activity.

The Russian Federation saw accelerated inflation in October 2013: the consumer price index stood at 0.6% at month-end (against 0.2% in September 2013), having shown an increase of 0.1 p.p. over the corresponding value observed in 2012. As a result, inflation reached 6.3% on a year-on-year basis (*Fig. 1*). Core inflation[1] stood at 0.6% in October 2013, being equal to the corresponding value observed in the previous year.

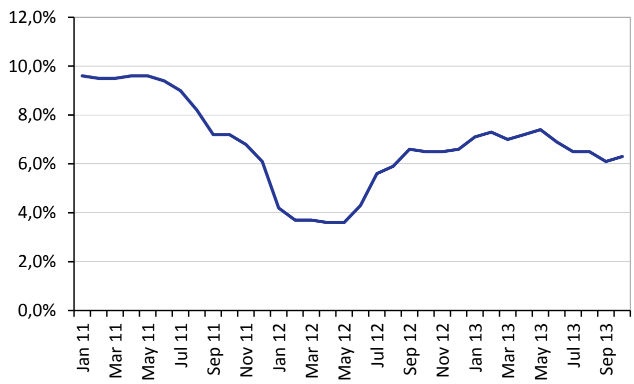
Prices of food products increased 1.1% in October 2013 against September 2013 (*Fig. 2*). Growth rate in prices of bread and flour products slowed down (from 0.5% in September 2013 to 0.3% in October 2013), fish and seafood products (from 1.2% in September 2013 to 0.8% in October 2013), milk and dairy products (from 2.7% in September 2013 to 2.1% in October 2013). Prices of meat and poultry didn't grow in October 2013 (against a 0.3% growth in September 2013). Prices of cereal and bean products declined by 0.2% in October 2013 (against a 0.6% growth in September 2013). Prices of sugar and granulated sugar fell 2.6% (against a 1.1% growth in September 2013). In general, prices of food products increased due to increased growth rates in prices of fruit and vegetable products (from -7.6% in September 2013 to 3.6%) and eggs (from 6.5% in September 2013 to 18.2%).

Prices and tariffs of retail paid services declined 0.1% in October 2013, whereas in September 2013 they increased 0.1%. Tariffs of housing and public utility services grew at a rate of 0.5% in October 2013. Prices of culture organizations increased by 0.8%, physical culture and sports services by 0.5%, personal services by 0.4%, medical services by 0.4%. Prices of passenger transport services and international travel services contracted 2.6% and 1.5% respectively. Growth rates of prices of education services, preschool education, and insurance services slowed down by 0.5%, 1.3%, and 0.1% respectively.

In October 2013, prices of non-food products grew at the same rate as in September 2013 and stood at 0.5%. Prices of the following products increased most in this group of products: medicaments by 1.0% (against +0.5% in September 2013), footwear by 0.9% (against 0.7% in September 2013), washing and cleaning products by 0.6% (against 0.3% in September 2013). Growth rates in prices of tobacco products slowed down from 3.0% in September 2013 to 1.9% in October 2013, motor gasoline from 1.4% in September 2013 to 0.4% in October 2013.

In November 2013, inflation kept growing mainly due to cessation of seasonal contraction of prices of fruit and vegetable products. The consumer price index stood at 0.3% after the first 18 days in November 2013 (0.3% in the corresponding period of 2012). As a result, accumulated since the beginning of the year inflation reached 5.6%, (against 6.0% in the corresponding period of 2012). It should be noted that increased growth rates of prices observed in October 2013 and November 2013 ensures a more than 6% increase in inflation at the year-end. No marked pressure upon prices on the demand side, as well as relatively favorable situation with basic crops is the key factor than is constraining inflation.

Broad money dropped 1.8% to Rb 8952bn in volume in October 2013 (*Fig. 3*). Banks' correspondent



Source: Rosstat.

Fig. 1. CPI growth rate in 2011–2013 (% year over year)

1 The reference consumer price index is an indicator which describes the level of inflation in the consumer market, net of seasonal (prices of fruit and vegetable products) and administrative (tariffs of regulated types of service, etc.) factors which is also calculated by the Federal State Statistic Service of Russia (Rosstat).

accounts (a contraction of 12.5% to Rb 960,1bn) and banks' deposits (a contraction of 39.0% to Rb 87,6bn) can be distinguished among the broad money's components whose volume shrank. The obligatory reserves increased 0.6% to Rb 508,9bn in volume. The volume of cash in circulation, including cash on hand at credit institutions, rose 0.4% to Rb 7395,4bn.

Narrow money (cash plus obligatory reserves) increased 0.4% to Rb 7904,3bn (*Fig. 4*) in October 2013.

In October 2013 the volume of excess reserves at commercial banks[1] dropped 15.6% to Rb 1047,7bn, while banks' debt under repo transactions contracted 5.7% to Rb 2,3 trillion. According to the data as of November 27, 2013, banks' debt under repo transactions exceeded Rb 2,5 trillion. It should be noted that growth in the debt due by credit institutions under other loans secured by non-market assets and guarantees amounted to 68.6% (Rb 864,7bn) in October 2013 due to a new instrument for bank liquidity provision – 3-month credit auction secured by non-market asset at a floating interest rate – which the Bank of Russia introduced in September 2013. This indicator increased 10.8% to more than Rb 957,7bn in November 2013. Given the persisting liquidity structural deficit in the banking sector, the interest rate in the interbank lending market[2] was at an average level of 6.06% in October 2013 (against 6.25% in September 2013), having exceeded 12.9% the corresponding value observed in January 2013 (5.4%). The interest rate averaged 6.15% (*Fig. 5*) in the period of November 1, 2013 thru November 25, 2013. It should be noted that the decline in the interbank interest rate which was observed in October 2013 is partially related to Rb 500bn of loans placed by the Bank of Russia at 5.76% at the 3-month auction of loans secured by non-market assets at a floating interest rate. In November 2013 interest rates increased in response to escalating tensions in the interbank lending market due to the revocation of the Master Bank's banking license.

A major part of banks' borrowings from monetary authorities remains at credit institutions' correspondent accounts with the Bank of Russia, which implies slowdown in growth rates of lending to the non-financial sector amid stagnation of the Russian economy.

Central Bank's international reserves totaled $524,3bn as of November 1, 2013, having declined 2.5% year to date (*Fig. 4*). At the same time, the mon-

1 Commercial banks' excess reserves with the Central Bank are referred to the amount of commercial banks' correspondent accounts, their deposits with the Central Bank, as well as Central Bank bonds held by commercial banks.

2 Interbank interest rate is the monthly average MIACR, an interest rate on ruble overnight interbank loans.

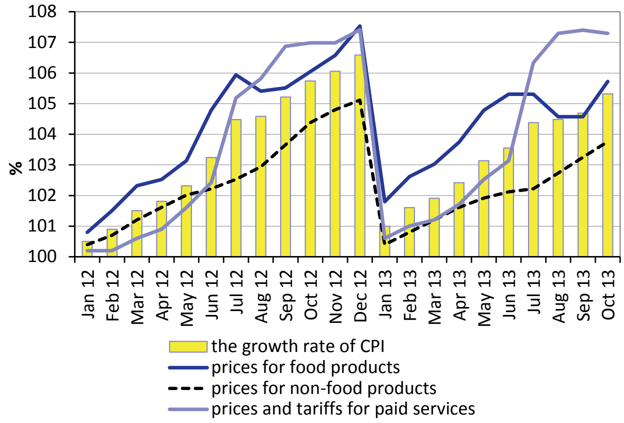


Fig. 2. Consumer price index growth rate in 2012–2013 (% of December previous year)

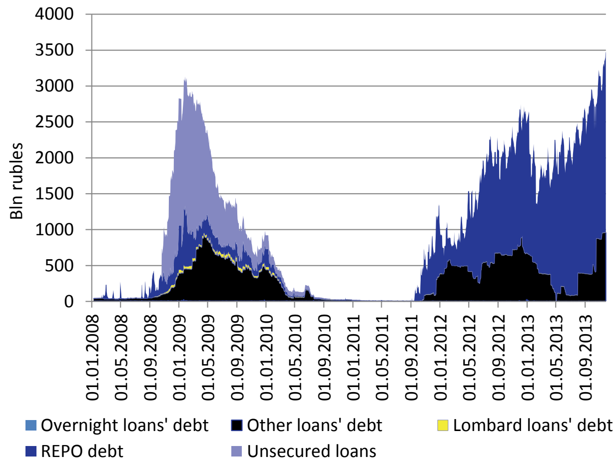


Fig. 3. Commercial banks' debt owed to the Bank of Russia in 2008–2013

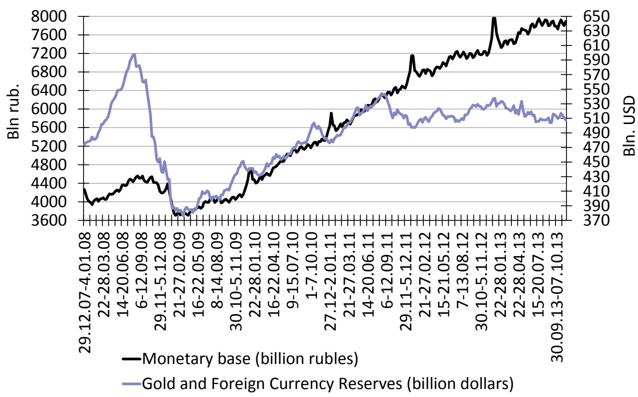


Fig. 4. Dynamics of narrow money and gold and foreign currency (international) reserves of the Russian Federation in 2007–2013

etary gold reserves increased $0,9bn in October 2013 in response to a positive revaluation of assets.

Bank of Russia's currency interventions through selling foreign currencies amounted to $2298m at the end of October 2013 and were aimed at flattening volatility of the ruble exchange rate (*Fig. 6*), the volume of foreign currencies purchased by the regulator in connection with the Federal Treasury replenishing or spending foreign currency resources of sovereign funds amounted to $308m. A one-time increase of 5 kopeks of the borders of the dual-currency corridor in October 2013 pushed them to a level of Rb 32,35–Rb 39,35. The regulator more than once shifted by 5 kopeks the borders of the dual-currency corridor in the period of November 1, 2013 thru November 27, 2013. As of November 27, 2013, the dual currency basket corridor's borders ranged between Rb 32,65 and Rb 39,65. In the period of November 1, 2013 thru November 26, 2013 Bank of Russia's foreign currency sales volumes amounted to $2956m, and the regulator made no currency interventions in connection with the Federal Treasury replenishing or spending foreign currency resources of sovereign funds.

According to the Bank of Russia's preliminary estimates, net capital outflow from the country reached $12,9bn in Q3 2013 and $48,1bn during the first nine months, having exceeded by $1,7bn the corresponding value observed during the first nine months in 2012. In the period of January 2013 thru September 2013 banks' and other sectors' net capital export reached $10,1bn and $38,2bn respectively.

In October 2013 the real effective ruble exchange rate vs. foreign currencies increased 2.3% (against 1.3% in September 2013) (*Fig. 7*). At the end of the first three quarters in 2013 the real effective ruble exchange rate dropped 2.6%.

The USD/RUB exchange rate dropped from 1.3% to Rb 32,1 in October 2013. The euro exchange rate stood at 0.6% (Rb 44,1) in October 2013. The EUR/USD exchange rate averaged 1.36 in October 2013. The value of the dual currency basket dropped 0.33% to Rb 37,46 in October 2013. The USD exchange rate gained 2.84% and reached Rb 33,0, while the euro exchange rate gained 1.6% and amounted to Rb 44,6 on the 27th day in November 2013. Therefore the value of the dual currency basket gained 2.2% to Rb 38,2. The EUR/USD exchange rate averaged 1.35 in November 2013. The ruble strengthened against USD in October 2013 in response to investors' lowered concerns about upcoming discontinuation of the U.S. FRS quantitative easing program, as well as uncertainty about an increase in the US foreign debt ceiling. It should be noted that the euro strengthened in response to the Euro-zone recovering from recession. The ruble

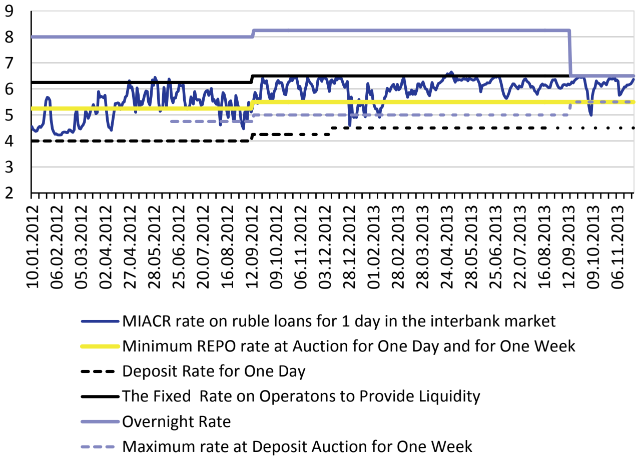
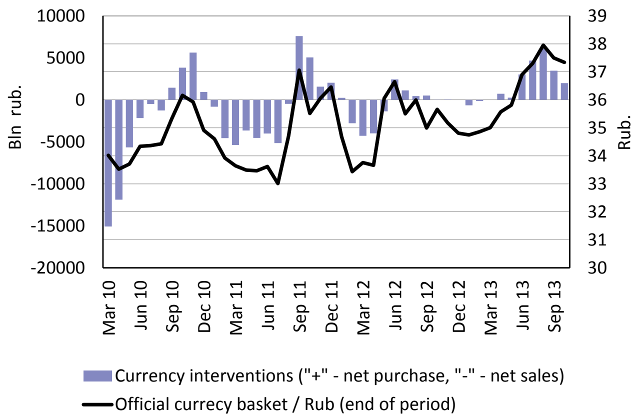
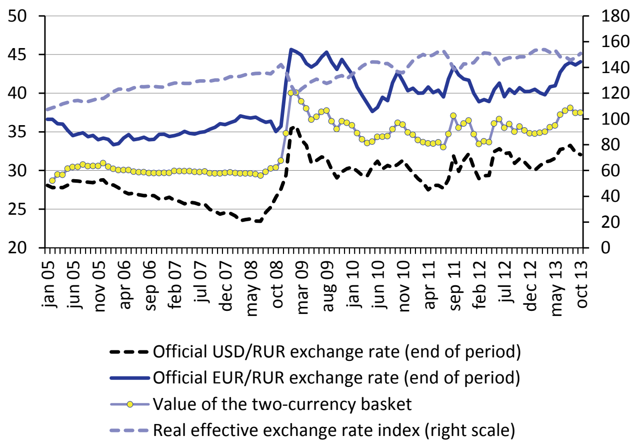


Fig. 5. Bank of Russia's interest rates corridor and dynamics of the interbank lending market in the period of 2012 thru 2013 (% p.a.)



Source: the Central Bank of Russia, author's estimates.

Fig. 6. Bank of Russia's currency interventions and ruble exchange rate vs. the currency basket in March 2010 – October 2013



Source: the Central Bank of Russia, author's estimates.

Fig. 7. Ruble exchange rate indicators in January 2005 thru October 2013

weakened against the US dollar in November 2013 mainly after the announcement that the FRS quantitative easing program will be discontinued within a few months, provided that positive statistical data on the U.S. economy are presented.

Central Bank's monetary policy decisions in October 2013 were basically aimed at enhancing flexibility of the exchange-rate regime. Since October 1, 2013 the Bank of Russia has adjusted its exchange rate formation mechanism so that parameters of Bank of Russia's foreign exchange purchase and sell operations in the domestic foreign exchange market be determined with due regard to Federal Treasury's operations aimed at replenishing or spending foreign currency resources of sovereign funds. In particular, volumes of Bank of Russia's foreign exchange purchase and sell operations in the domestic foreign exchange market, which are established with the aim of flattening volatility of the ruble exchange rate, will increase or contract by a value equal to the volume of Federal Treasury's operations of purchase (sell) of foreign exchange from/to the Bank of Russia, aimed at replenishing (spending) foreign currency resources of sovereign funds.

The foregoing adjustment to the exchange rate policy mechanism is a stage of the process towards creating conditions for the transition to the floating exchange rate regime. This measure will facilitate mitigation of the effect of Federal Treasury's operations aimed replenishing or spending foreign currency resources of sovereign funds on the banking sector liquidity.

On October 7, 2013, the Bank of Russia performed a symmetric expansion from Rb 1 to Rb 3,10 of the "neutral" range of floating operational interval of the dual currency basket acceptable ruble values. Furthermore, the total width of floating operational interval remained unchanged (Rb 7).

It is to be recalled that the "neutral" range is inside the dual currency basket operational interval. Exchange rate fluctuations within the range don't result in foreign exchange interventions by the regulator. Should the exchange rate go outside the "neutral" range, the Bank of Russia will conduct foreign exchange purchase and sell operations whose volume increases as the exchange rate approaches the operational interval borders.

The decision made will result in reduction of volumes of Central Bank's interventions given insignificant fluctuations of the dual currency basket. In general, the decision complies with the task of gradually increasing flexibility of the foreign exchange rate in order to enhance the effectiveness of the interest rate policy used to ensure price stability.

Since October 21, 2013 the Bank of Russia has lowered the volume of target foreign currency interventions down to $60m daily. This adjustment will make the dual currency basket operational interval borders more sensitive to volumes of Bank of Russia's interventions aimed at flattening excessive volatility of the ruble foreign exchange rate. All things being equal, such changes will ensure less frequent direct presence of the Bank of Russia in the domestic foreign exchange market.