INFLATION AND MONETARY POLICY IN FEBRUARY 2014

A.Bozhechkova

The consumer price index stood at 0.7% (0.6% in February 2013) in February 2014, rising 0.1 p.p. above the value recorded in January 2014. As a result, inflation stood at 6.2% at the end of a 12-month period. The consumer price index reached 0.7% within 24 days in March 2014. The Bank of Russia made a decision on March 3, 2014 to provisionally raise the key interest rate from 5.5% to 7% p.a. with a view to preventing the threat of financial instability and inflation growth.

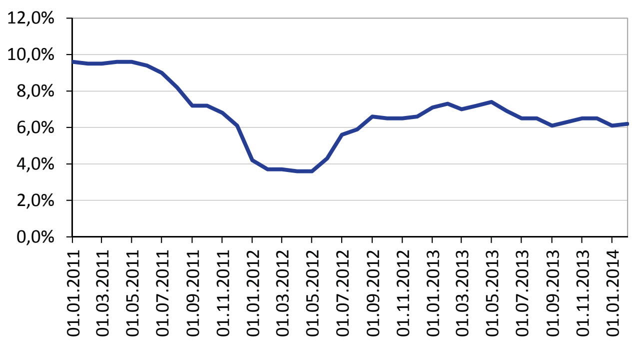
Inflation in the Russian Federation remained at a high level in February 2014: the consumer price index stood at 0.7% at the month's end (compared to 0.5% in January 2013), declining by 0.1 p.p. below the level recorded in 2013. As a result, inflation reached 6.2% on an annualized basis (*Fig. 1*). Core inflation[1] stood at 0.5% in February 2014, also seeing a decline of 0.1 p.p. below the level recorded in 2013.

Prices of food products increased 1.2% in February 2014 compared to January 2014 (*Fig. 2*). Growth in the price of fish and seafood slowed down from 1.8% in January 2014 to 1.4% in February 2014. Prices of eggs kept falling (-7.4% compared to -6% in January 2014), sunflower oil (-1.2% as compared to -0.8% in January 2014). Growth in the price of alcoholic beverages accelerated from 1.6% in January 2014 to 2.0% in February 2014, butter from 1.3% in January 2014 to 2.2% in February 2014, milk and dairy products from 1.1% in January 2014 to 1.6% in February 2014, granulated sugar from -0.8% in January 2014 to 1.7% in February 2014 . Prices of fruits and vegetable products kept growing at a fast rate (5.1% in February 2014, 5.8% in January 2014).

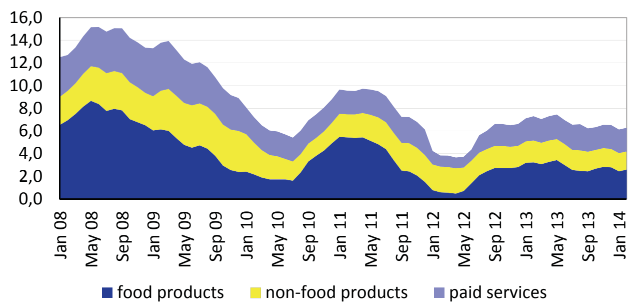
Prices and tariffs of retail paid services in February 2014 increased 0.4%, while in January 2014 they gained 0.5%. Tariffs of housing and public utility services in February 2014 grew up at a rate of 0.1%, being equal to the value reported in January of the same year. Growth rate in prices of international travel services increased from 0.4% in January 2014 to 2.4% in February 2014, passenger transport services advanced from 0.1% in January 2014 to 0.3% in February 2014. Prices of the following services slowed down during the period under review: medical services (from 1.4% in January 2014 to 1.0% in February 2014), culture organizations' services (from 1.6% in January 2014 to 0.7% in February 2014), personal services (from 0.7% in January 2014 to 0.4% in February 2014), insurance services (from 1.0% in January 2014 to 0.4% in February 2014), preschool education services (from 6.6% in January 2014 to 2.1% in February 2014).

In February 2014, growth rate of prices of non-food products increased 0.1 p.p. to 0.4% as compared to January 2014. Prices of the following non-food products saw the fastest growth: tobacco products – 1.7% (+0.8% in January 2014), motor gasoline – 0.4% (-0.2% in January 2014).

In March 2014, inflation kept growing basically through growth in the price of fruits and vegetables



Source: the Federal State Statistic Service of Russia (Rosstat).
Fig. 1. CPI growth rate in 2011 thru 2014 (% year over year)



Source: the Federal State Statistic Service of Russia (Rosstat).
Fig. 2. Inflation factors in 2008 thru 2014 (%, month over month)

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

and dairy products. Note that weakening of the ruble made a certain contribution in pushing up inflation, factoring in a big share of imported goods in the consumption of economic agents in the Russian Federation. For the first 24 days in March 2014 the consumer price index stood at 0.7% (0.3% in the corresponding period of 2013). Lack of pronounced demand-driven pressure on prices as well as falling prices of agricultural products in the global market is the key factor constraining inflation.

In February 2014, the monetary base (broad definition) contracted 1.3% to Rb 9230,1bn (*Fig. 3*). The following components of the monetary base (broad definition) saw a decline: banks' correspondent accounts (a decline of 12.3% to Rb 1001,1bn), bank deposits (a contraction of 15.2% to Rb 106,9bn). The volume of obligatory reserves increased 1.1% to Rb 415,8bn while the volume of cash in circulation, including cash on hand at credit institutions increased 0.4% to Rb 7706,2bn.

In February 2014, the monetary base (narrow definition) (cash plus obligatory reserves) advanced 0.5% to Rb 8122,0bn (*Fig. 4*).

In February 2014, the volume of excessive reserves at commercial banks [1] contracted 12.6% to Rb 1108bn while bank's debt on repo transactions was reduced 17.5% to Rb 2,3 trillion. According to the data on March 27, 2014, banks' debt on repo transactions increased to Rb 2,9 trillion. In February 2014, the interest rate in the interbank lending market [2] averaged 6.0% (6.1% in January 2014). In the period of March 1, 2014 thru March 26, 2014, the same average interest rate increased to 7.8% (*Fig. 5*). The rapid increase in the interest rate on interbank loans was associated with the March 3, 2014 decision of the Bank of Russia to temporary increase the key interest rate by 1.5 p.p. from 5.5% to 7% p.a., as well as interest rates on the liquidity provision and absorption instruments because of drastic deterioration of the situation in the financial markets in response to the events in Ukraine.

On February 10, 2014, the Bank of Russia provided Russian banks with Rb 200bn as part of a 3-month repo auction secured by non-market assets, with the hurdle rate standing at 5.85%. During a similar auction which was held by the Bank of Russia on March 6, 2014, the allocated amount totaled Rb 200bn at a hurdle rate of 7.41% p.a. It should be noted that it is only large banks with a distinctly bigger collateral base that can afford such actions despite fairly easy terms of lending at a floating interest rate.

The Central Bank's international reserves totaled $493,3bn as of March 1, 2014, seeing a decline of 3.2% year-to-date (*Fig. 4*). At the same time, the monetary

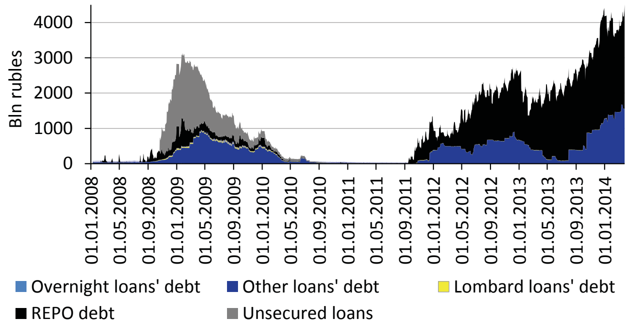


Fig. 3. Commercial banks' debt owed to the Bank of Russia in 2008 thru 2014

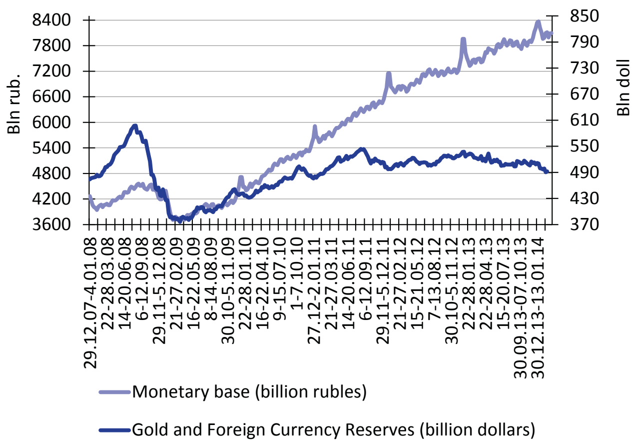


Fig. 4. Dynamics of the monetary base (narrow definition) and gold and foreign currency (international) reserves of the Russian Federation in 2007 thru 2014

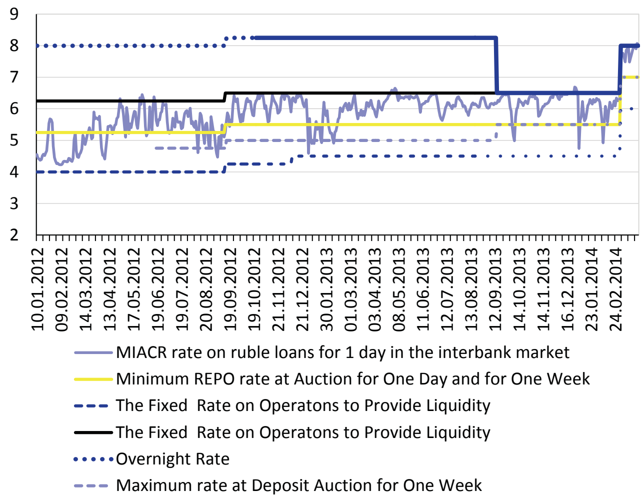


Fig. 5. Bank of Russia's interest rates band and dynamics of the interbank lending market in 2012 thru 2014 (% p.a.)

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-denominated overnight interbank loans.

gold reserves increased $2,6bn in February 2014 after a positive revaluation of assets. In general, the contraction of the international reserves in the period of January 2014 – thru February 2014 was basically caused by the regulator's foreign currency interventions aimed at flattening volatility of the ruble exchange rate and its retaining amid the weakening of the national currencies in developing countries and unstable geopolitical situation in Ukraine and the Crimea.

Bank of Russia's foreign currency interventions through selling foreign exchange amounted to $6158m and 679m euro by the end of February 2014 (*Fig. 6*). in February 2014, the regulator conducted operations to purchase foreign currencies in connection with the Federal Treasury replenishing or spending foreign currency resources of sovereign funds which amounted to $688m. In February 2014, the borders of the dual-currency trading band was extended 17 times within a range of 5–10-kopeks, widening the band to a level of Rb 35,4–42,4. In the period of March 1, 2014 thru March 20, 2014, the regulator repeatedly shifted the dual-currency trading band within a range of 5 to 10 kopeks. As of March 27, 2014, the dual-currency trading band was maintained within a range of Rb 36,2–43,2 In the period of March 1, 2014 thru March 26, 2014, Bank of Russia's foreign currency sales volumes reached $25,8bn while foreign currency interventions associated with the Federal Treasury replenishing or spending foreign currency resources of sovereign funds totaled $290m. Note that the previous record of foreign currency interventions ($8,6bn in January 2014) has been overtaken by 3 times.

According to the Bank of Russia's preliminary estimates, net capital outflow from the country reached $16,6bn in Q4 2013, making a total of $64,7bn within 12 months, by $10,1bn more than the amount recorded within 12 months in 2012. Net capital exports by banks reached $5,1bn while the same by other sectors amounted to $59,6bn in the period of January 2013 thru December 2013. Net capital outflow from Russia was anticipated, according to the preliminary estimates made by Gaidar Institute, to reach $73bn in Q1 2014. The substantial capital outflow from Russia in Q1 2014 was determined by economic slowdown in the Russian Federation, as well as a tension dramatically mounted in Ukraine's Crimea region.

In February 2014, real effective ruble exchange rate vs. foreign currencies weakened by 3.5% (-0.7% in January 2014). As a reminder, the real effective ruble exchange rate lost 2% in 2013 in general (*Fig. 7*).

In February 2014, the ruble-to-dollar exchange rate increased 2.9% to Rb 36,1. The ruble weakened against the euro by 4.1% (Rb 49,6) in the same period . In February 2014, the euro-to-dollar exchange rate averaged

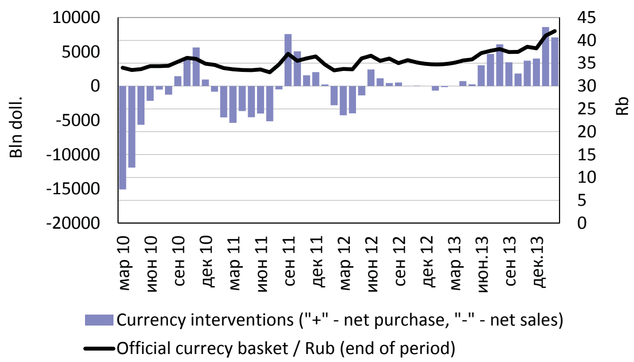


Fig. 6. Bank of Russia's currency interventions and ruble exchange rate vs. the currency basket in March 2010 thru January 2014

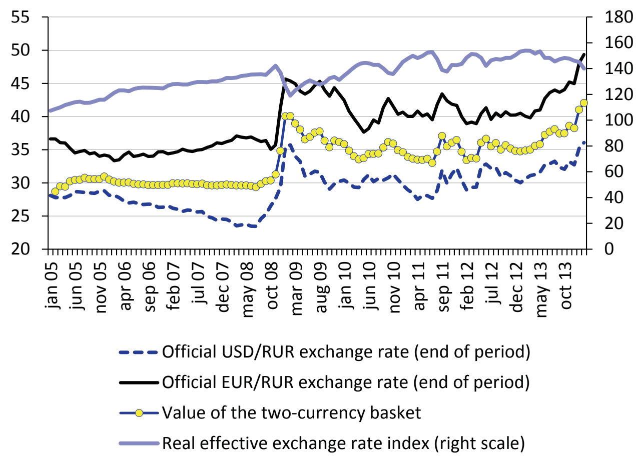


Fig. 7. Ruble exchange rate indicators in January 2005 thru January 2014

1.37. The value of the dual currency basket increased 3.5% to Rb 42,2 in February 2014. Within 28 days in March 2014 ruble-to-dollar exchange rate dropped 1.7% to Rb 35,6, whereas the euro-to-ruble exchange rate increased 1.2% to Rb 49,0, eventually increasing by 1.6% to Rb 41,6 the value of the dual currency basket. In March 2014, the dual currency basket value hit a historical high of Rb 43,1. The euro-to-dollar exchange rate averaged 1.38 in March 2014. Note that the Euro strengthened in response to the Euro-zone recovering from recession. The ruble weakened against the US dollar in January 2014 thru February 2014 mainly because accelerated capital outflow from the country in response to unstable geopolitical situation in Ukraine and the Crimea region, optimistic projections about economic growth in the United States and European Union, economic slowdown in the Russian Federation. The ruble exchange rate bounced back insignificantly at the end of March, because no strict economic sanctions were imposed against Russia in connection with the tension in the Crimea region.

On February 3, 2014, the regulator introduced "fine tuning" operations on liquidity provision due to the abolishment of daily repo overnight auctions. The intensity of using "fine tuning" operations by the Bank of Russia is planned to be reduced to 2–3 times monthly as the banking system adapts to the use of the key instruments of liquidity provision and absorption of the Central Bank of Russia for longer periods (from 1 week to 1 year).

On February 17, 2014, the Bank of Russia supplemented its monetary policy system with "fine tuning" operations aimed at absorbing liquidity. Such operations will be conducted as 1–6-day deposit auctions at a maximum rate equal to the key rate (5.5%).

According to the Bank of Russia, "fine tuning" deposit operations are aimed at absorbing excessive liquidity in the banking sector at moments when the supply of liquid assets outstrips largely the demand due to autonomous factors. The introduction of "fine tuning" instruments will allow liquid assets to be managed more efficiently, which will eventually create preconditions for flattening interest rates volatility in the interbank lending market.

The Central Bank of Russia's Board of Directors made a decision on March 3, 2014 to temporary raise the key interest rate 1.5 p.p. – to 7% p.a. The decision was intended to prevent the occurrence of risks for inflation and financial stability related to devaluation of the ruble amid mounting political tension. In our opinion, the temporal raise of the interest rate amid the panic in financial markets was the right measure, however maintaining this interest rate for a long period may have an adverse effect on the economic activity.