

INFLATION AND MONETARY POLICY IN MARCH 2014

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In March 2014, the Consumer Price Index (CPI) amounted to 1% (vs. 0.3% in March 2013), which represents a 0.3 p.p. rise on February 2014. As a result, the inflation rate in per annum terms, as seen by the results of the past 12 months, rose to about 6.9%. Over the period from 1 April through 21 April, the CPI climbed to 0.3%. On 3 March 2014, the Bank of Russia temporarily increased the key rate from 5.5% to 7% per annum. On 25 April 2014, Russia's financial regulator again increased the key rate, to 7.5% per annum, thus continuing the toughening of monetary policy.

In March, the inflation rate in the Russian Federation visibly accelerated: the Consumer Price Index, as seen by the month end's results, rose to 1% (vs. 0.7% in February 2014), thus climbing 0.7 pp. above its year-earlier level. As a result, the inflation rate in per-annum terms went up to 6.9% (Fig. 1). The core inflation rate¹ in March 2014 was 0.8%, which represented a 0.4 p.p. rise on March 2013.

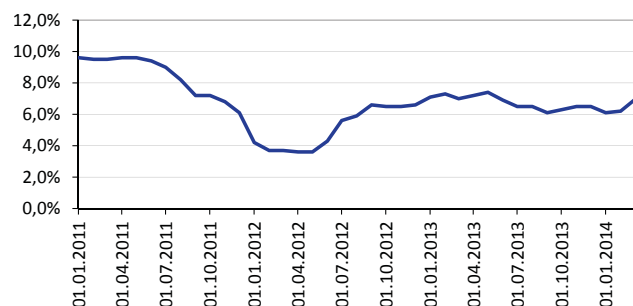
During March, the prices of foodstuffs rose by 1.8% (Fig.2). By comparison with February 2014, the growth rates of prices for cereals and legumes, meat and poultry, milk and dairy products, fruit and vegetable products, alcoholic beverages, fresh eggs, and granulated sugar increased from 0.0% to 0.9%, from 0.1% to 0.4%, from 1.6% to 2.6%, from 5.1% to 5.3%, from 2.0% to 2.3%, from -7.4% to 2.9%, and from 1.7% to 7.8% respectively. The growth rates of prices for butter dropped from 2.2% in February to 1.8% in March.

The prices and tariffs established for commercial services rendered to the population increased by 0.4% in March after rising by 0.4% in February. The growth rate of tariffs for housing and utilities services in November amounted to 0.2%, which represented a 0.1 p.p. rise on February. By comparison with February, the growth rates of prices for outbound tourist services, services provided in the field of physical culture and sport, services rendered by cultural establishments, and recreational services increased from 2.4% to 2.7%, from 0.4% to 0.8%, from 0.7% to 1.2%, and from 0.1% to 0.6% respectively. The growth rates of prices for medical services and preschool education services continued to decline. By comparison with February, they dropped from 1.1% to 0.5%, and from 2.1% to 0.7% respectively.

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).

Over the course of March, the growth rate of prices for non-food commodities amounted to 0.7%, which represented a 0.3 pp. rise on February. In this commodity group, the steepest acceleration was recorded by the growth rates of prices for tobacco products (+3.5% in March vs. +1.7% in February), motor gasoline (+1.5% in March vs. +0.4% in February), pharmaceuticals (+1.1% in March vs. +0.7% in February), construction materials (+0.5% in March vs. +0.2% in February, textile and textile products (+0.6% in March vs. +0.3% in February), and footwear (+0.5% in March vs. +0.2% in February).

During April, the rate of inflation continued its upward movement, mainly due to the seasonal rise in prices for fruit and vegetable products and the unfa-



Source: Rosstat.

Fig. 1. Growth Rates of the Food Price Index in 2011–2014 (% Year-on-Year)

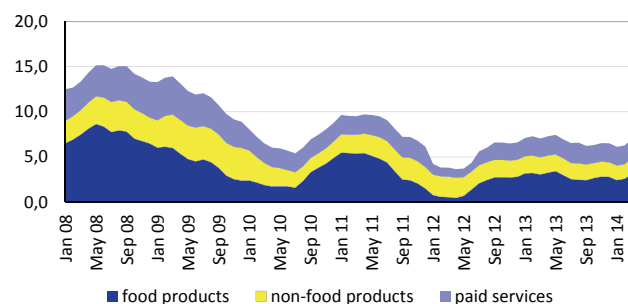


Fig. 2. Inflation Factors, 2008–2014 (as a Percentage of the Previous Year's Corresponding Month)

avorable situation on the dairy products market, pork market and gasoline market. Bearing in mind that imports make up a considerable share of total consumption in Russia, it should be noted that Russian inflation might be pushed up, to some extent, by the weaker ruble. The Consumer Price Index for the first 21 days of April amounted to 0.6% (vs. 0.4% for to the same period of 2013). At present, the main factors that are keeping inflation at bay are the lack of significant demand pressure on prices and the current drop in global prices for agricultural prices.

Over the course of March 2014, the broad monetary base increased by 1.2% to Rb 9,344.7bn (Fig. 3). Its increased components included the monies kept on commercial banks' correspondent accounts with the RF Central Bank (growth by 16.1% to Rb 1,162.6bn), banks' deposits (growth by 11.0% to Rb 118.7bn), and required reserves (growth by 6.5% to Rb 442.7bn). The volume of cash in circulation, including the cash balances of credit institutions, dropped by 1.1%, to Rb 7,620.7bn.

The narrow monetary base (currency issued by the Bank of Russia plus required reserves) over March shrank by 0.7%, to Rb 8,062.4bn as of 1 April (Fig. 4).

During March 2014, the surplus reserves held by commercial banks¹ dwindled by 15.6%, to Rb 1,281.3bn, while the amount of banks' repo debt increased by 29.9%, to Rb 3.05 trillion. As of 25 April, banks' repo debt amounted to Rb 3.2 trillion. The interest rate in the interbank market² in March was on the average at the level of 7.9% (against 6.0% in February 2014). Over the period from 1 April through 25 April, the average interbank interest rate was 7.7% (Fig. 5). The sharp rise in the interbank interest rate was caused by the Bank of Russia's decision, of 3 March 2014, that the key interest rate should be temporarily increased by 1.5 pp., from 5.5% to 7% per annum, and that the interest rates on liquidity provision and absorption instruments should also go up because of the rapidly worsening situation on financial markets, brought about by the turmoil in Ukraine.

At the three-month REPO auction for loans secured by non-marketable assets, held by the Bank of Russia on 6 March 2014, the cut-off rate was set at 7.41%, while total amount allotted was Rb 200bn. In the course of another such auction held on 14 April 2014, a total of Rb 700bn was allotted, the cut-off rate being set at 7.26% per annum. It should be noted that, al-

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).

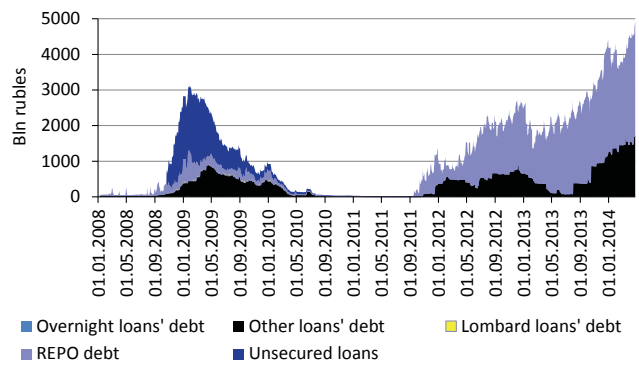


Fig. 3. The Movement of Commercial Banks' Debt to the Bank of Russia in 2008–2014

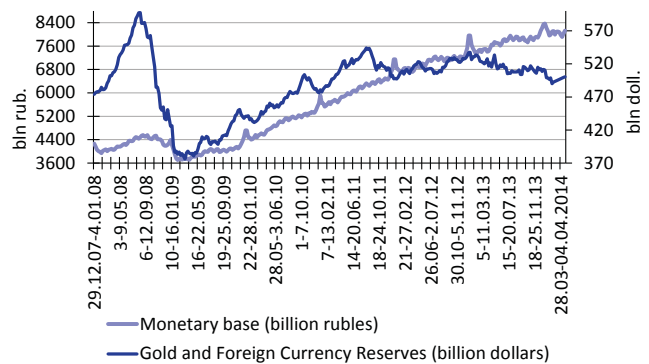


Fig. 4. Behavior of Russia's Narrow Monetary Base and Gold & Foreign Currency (International) Reserves in 2007–2014

though the terms of lending at such auctions are very soft (the Bank of Russia provides loans under floating interest rates), only big banks are capable of participating in these REPO auctions, because they alone possess the assets to be pledged as collateral thereat.

As of 1 April 2014, the Bank of Russia's international reserves volume amounted to \$ 486.1bn, having shrunk since the year's beginning by 4.6% (Fig. 4). At the same time, over the course of November, the reserves backed by monetary gold declined by \$ 1.2bn due to a downward adjustment of asset value. In the main, the dwindling of the Bank of Russia's international reserves in the period January–March 2014 was caused by the financial regulator's foreign exchange interventions designed to support the ruble in a situation characterized by the weakening of developing-country currencies and the geopolitical consequences of the Ukrainian unrest.

As seen by the March 2014 end results, the Bank of Russia's foreign exchange interventions in the form of foreign exchange sales comprised \$ 22.3bn and EUR 2.3bn (Fig. 6). In March, the financial regulator purchased \$290m for the purpose of replenishing or spending the monies held by the Federal Treasury as part of sovereign funds denominated in foreign cur-

rencies. It should be noted that the March 2014 interventions exceeded threefold the previous three-year high (\$8.6bn in January 2014). Over the course of March, the financial regulator eight times revised the boundaries of the bi-currency basket's floating corridor by 5 to 10 kopecks, thus pushing them up to the level of Rb 36.25 – 43.35. In the period from 1 April through 24 April, the financial regulator twice revised the boundaries of the bi-currency basket's floating corridor by 5 kopecks. As of 24 April, the boundaries of the bi-currency basket's floating corridor were set at Rb 36.35–43.35. Over the period from 1 April through 24 April, the volume of foreign exchange sales by the Bank of Russia amounted to \$ 2.4bn, while the scope of foreign exchange interventions undertaken by the financial regulator in order to replenish the monies held by the Federal Treasury as part of sovereign funds was \$ 878bn. In April, the situation on Russia's foreign exchange market became relatively stable, but in the short term-term perspective the behavior of the ruble will still be determined by geopolitical factors.

According to the Bank of Russia's preliminary estimates, net capital outflow from Russia in Q1 2014 climbed to \$ 50.6bn, which represented a 1.8-fold increase on the same period of 2013. It should be noted that over the whole year 2013, net capital outflow from Russia amounted to \$ 59.7bn. Over the course of Q1 2014, net capital outflow from the banking sector rose to \$ 18.9bn, and that from all the other sectors – to \$ 31.7bn. The main factor behind this huge capital outflow in Q1 2014 was the tense geopolitical situation.

During March, the ruble's real effective exchange rate against the two major foreign currencies dwindled by 1.75% (vs. -3.9% in February 2014). On the whole, over the course of Q1 2014, the ruble's real effective exchange rate against the USD and the EUR dropped by 4.6% on Q4 2013 and by 8.5% on Q1 2013 (Fig. 7).

During March, the exchange rate of the US dollar against the ruble dropped by 0.5% to Rb 33.0; the euro's exchange rate against the ruble dropped by 1.6% to Rb 38.4. The exchange rate of the Euro against the ruble shrank by 1.2% to Rb 49.1. In March, the average exchange rate of the Euro against the USD was 1.38 USD per Euro. During that month, the value of the bi-currency basket declined by 1.4% to Rb 41.7. It should be noted that in March the value of the bi-currency basket hit its all-time high of Rb 43.1. As seen by the results of the first 25 days of April, the exchange rate of the USD against the ruble went up by 0.2% to 35.7 rubles per USD, while the exchange rate of the Euro increased by 0.7% to 49.3 rubles per Euro. As a result, the value of the bi-currency basket grew by 0.5% to Rb 41.8. In April, the average exchange rate

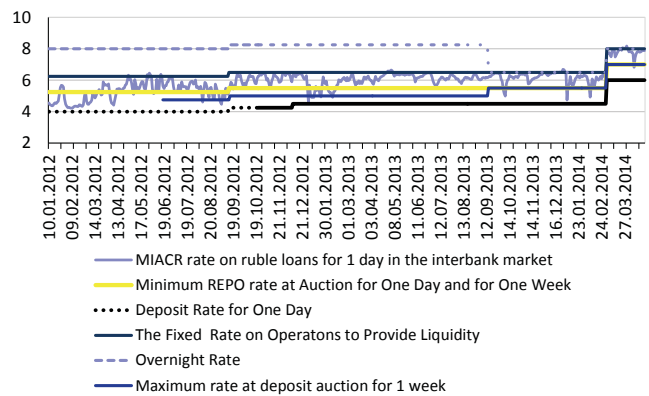


Fig. 5. The Bank of Russia's Interest Rate Corridor and the Interbank Market's Behavior in 2012–2014 (% per Annum)

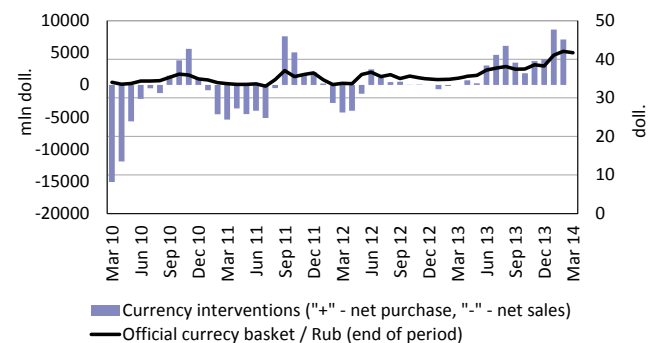


Fig. 6. The Bank of Russia's Currency Interventions and the Ruble Exchange Rate against the Bi-currency Basket in March 2010 – March 2014

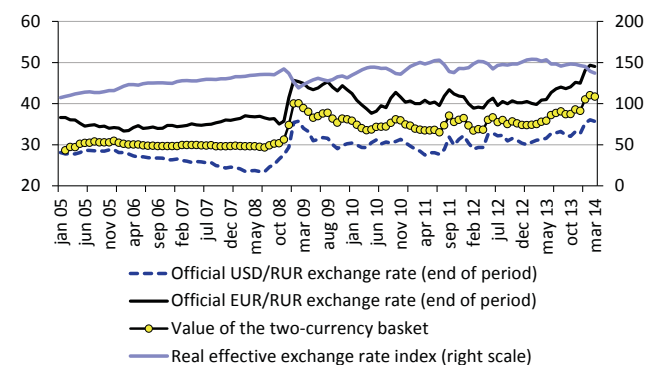


Fig. 7. Behavior of the Ruble's Exchange Rate Indicators in January 2005 – February 2014

of the Euro against the USD was 1.38 USD per Euro. It should be noted that the strengthening of the Euro is caused by both the Euro zone's economy exiting recession and by the conservative monetary policy pursued by the European Central Bank. The weakening of the ruble against the USD in the period January–March 2014 was caused in the main by the considerable intensification of capital flight from Russia resulting from the unstable geopolitical situation in Ukraine, optimistic forecasts for US and EU economic growth, and the ongoing slowdown in the growth rates of the

Russian economy. The relative strengthening of the ruble in late March was caused by the fact that no stiff economic sanctions had been imposed against Russia over the Crimea.

On 25 April 2014, the Bank of Russia's Board of Directors announced its decision that the key rate should be increased to 7.5% per annum. This measure was aimed at reducing the risk of a considerable rise in inflation and at maintaining financial sustainability in the current situation characterized by the weakening of the ruble and growing political tensions.

On the same day, the Bank of Russia announced that the key rate would not be decreased in the next few months. The financial regulator explained that raising its key rate would slow annual inflation to no more than 6% by the end of the year. We believe that, bearing in mind the current panic in financial markets, the temporary increase in the key rate was the right decision. However, if the increased rate is kept for a long period of time, it will adversely affect Russia's shrinking economic activity. ●