

INFLATION AND MONETARY POLICY IN APRIL 2014

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In April 2014, the consumer price index stood at 0.9% (0.5% in April 2013), 0.1 p.p. down the value observed in March 2014. Therefore, inflation stood at 7.3% at the end of 12-month period. The consumer price index reached 0.5% for the first 19 days in May 2014. The regulator further tightened the monetary policy by increasing the key interest rate to 7.5% p.a. on April 25, 2014.

Inflation in the Russian Federation remained at a high level in April 2014: the consumer price index stood at 0.9% at the month's end (compared to 1% in March of the same year), showing an increase of 0.4 p.p. over the value observed in 2013. Therefore, inflation reached 7.3% on an annualized basis (Fig. 1). Core inflation¹ stood at 0.9% in April 2014, also higher, up 0.5 p.p., than the value observed in the previous year.

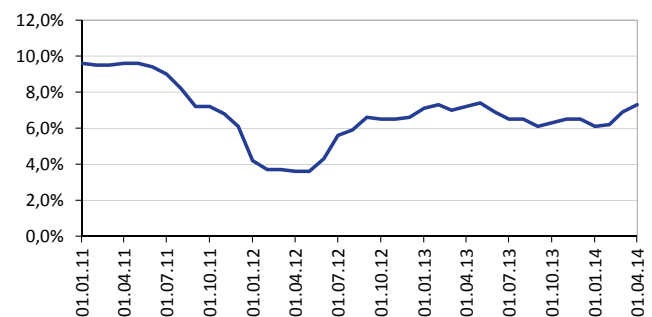
In April 2014, prices of food products increased 1.3% compared to March 2014 (Fig. 2). Prices of the following food products saw higher growth rates: grains and beans (from 0.9% in March to 1.4% in April), red meat and poultry (from 0.4% in March to 1.5% in April), pasta products (from 0.0% in March to 0.3% in April). Prices of the following food products saw slower growth rates: granulated sugar (from 7.8% in March to 3.0% in April), fruits and vegetables (from 5.3% in March to 2.3% in April), eggs (from 2.9% in March to -2.3% in April), milk and dairy products (from 2.6% in March to 1.8% in April), alcoholic beverages (from 2.3% in March to 1.2% in April), fish and seafood (from 1.4% in March to 1.0% in April), butter (from 1.8% in March to 1.4% in April).

In April, prices and tariffs of retail paid services increased 0.7%, while in March they increased 0.5%. Overall, tariffs of public utilities remained unchanged in April, while in March they grew up at a rate of 0.2%. Prices of the following services increased in April: passenger transport services (from 0.2% in March to 2.4% in April), medical services (from 0.5% in March to 1.4% in April), and insurance services (from 0.3% in March to 2.2% in April). Prices of the following services fell in April: international travel services (from 2.7% in March to 2.3% in April), services rendered in the physical culture and sports sector (from 0.8% in March to 0.2%

in April), services rendered by culture organizations (from 1.2% in March to 0.6% in April).

In April, growth rate of prices of non-food products slowed down by 0.1 p.p. compared to March and stood at 0.6%. Prices of the following non-food products saw the fastest growth rate: tobacco products by 4.6% (+3.5% in March), motor gasoline by 1.5% (+0.4% in February). Prices of the following non-food products saw a decline: motor gasoline (from 1.5% in March to 0.8% in April), knit goods (from 0.6% in March to 0.3% in April).

In May 2014, inflation kept growing due to growth in prices of certain categories of fruit and vegetable products, red meat and poultry, millet. It's worth noting that a depreciation of the ruble exchange rate



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

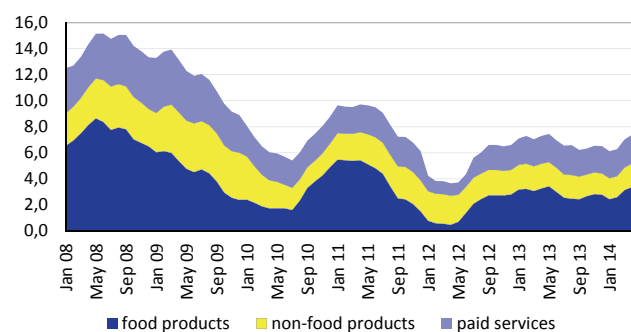


Fig. 2. Inflation factors in 2008 to 2014 (% compared to the same month of the previous year)

1 The baseline 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).

made a major contribution to the acceleration of inflation having regard to a great share of imported goods in the consumption of economic agents in the Russian Federation. There were more nonmonetary factors that pushed up inflation in January–May 2014: the restrictions imposed by the Rosselkhoznadzor (Federal Service for Veterinary and Phytosanitary Surveillance) on import of meat from the EU countries and the United States early in the year, livestock reduction due to a fodder shortage, adverse weather conditions in certain countries, as well as decline in shipments of certain categories of agricultural products from Ukraine. The consumer price index stood at 0.5% at the end of the first 19 days in May (0.4% in the same period of 2013). The lack of pronounced demand-driven pressure on prices, as well as the Bank of Russia's measures aimed at tightening the monetary policy remain the key factors constraining inflation.

In April 2014 the monetary base (broad definition) increased 0.9% to Rb 9427.9bn (Fig. 3). The volume of cash in circulation including cash balances in credit institutions increased 3.4% to Rb 7881.2bn. The following components of the broad monetary base saw contraction: banks' correspondent accounts (a decline of 12.6% to Rb 1016.4bn), bank deposits (a decline of 17.0% to Rb 98.5bn), obligatory reserves (a decline of 2.5% to Rb 431.8bn).

In April 2014, the monetary base (narrow definition) (cash plus obligatory reserves) advanced 3.2% to Rb 8168.4bn (Fig. 4).

In April, the volume of excessive reserves at commercial banks amounted to Rb 1315.2bn, with mandatory reserves on a special account amounting to Rb 431.8bn, while the average value of reserves in the period of 10.04.2014 thru 10.05.2014 amounted to Rb 883.4bn. As of May 1, 2014, banks' debt owed to the regulator was Rb 5.05 trillion, an increase of 7.4% since the beginning of April. Bank's debt on REPO transactions increased 10% to Rb 3.3 trillion, the amount of debt on loans secured by non-market assets amounted to Rb 1.7 trillion, a growth of 10%. According to the data as of May 27, 2014, banks' debt on REPO transactions saw a decline to Rb 3.1 trillion, while the debt on other loans increased to Rb 2 trillion. It should be noted that the Bank of Russia used REPO operations at a flat rate, in particular, an average of Rb 24.9bn and Rb 11.1bn were provided daily in April and May respectively (On April 25, 28, 29, 30 the MIACR fell beyond of the interest rate cap. On the foregoing dates the volume of REPO operations at the flat rate amounted to Rb 23.1bn; Rb 1.6bn; Rb 6.3bn; Rb 38.4bn respectively). The interbank interest rate¹ in April stood at

¹ Interbank interest rate is the monthly average MIACR, an interest rate on ruble-denominated overnight interbank loans.

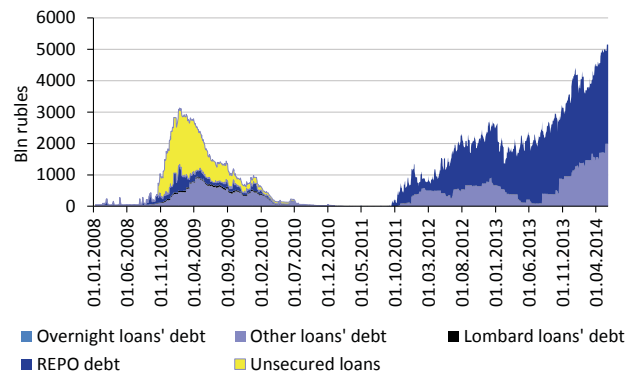


Fig. 3. Commercial banks' debt owed to the Bank of Russia in 2008 to 2014

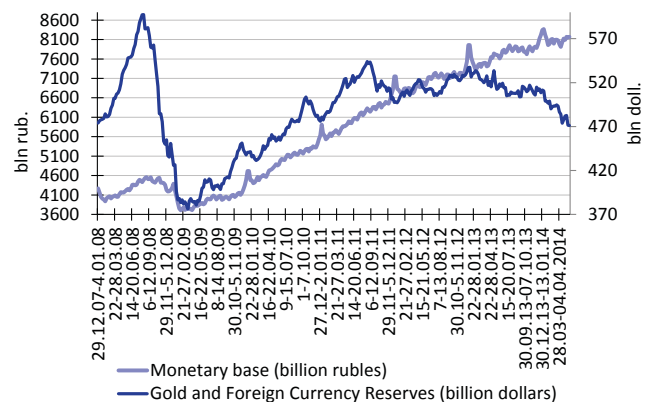


Fig. 4. Dynamics of the monetary base (narrow definition) and gold and foreign currency (international) reserves of the Russian Federation in 2007 to 2014

7.9% on average (7.9% in March 2014). In the period of May 1 thru May 23 the average interbank interest rate stood at 8.23% (Fig. 5). The average interbank interest rate increased in May 2014 in response to the Bank of Russia's April 25, 2014 decision to lift the key interest rate, as well as interest rates on liquidity provision and absorption instruments, from 7.0% to 7.5% p.a., in order to mitigate risks of accelerating inflation and ensure financial stability.

The Bank of Russia provided banks with Rb 700bn at a cut-off rate of 7.26% p.a. as part of a 3-month repo auction secured by non-market assets held on April 14, 2014. During a similar auction held on May 12, the Bank of Russia provided at total of Rb 485.8bn at a rate of 7.77% p.a. However, only large banks which have the required collateral base can afford such actions despite very beneficial terms of lending at a floating interest rate.

As of May 1, 2014, the Central Bank's international reserves totaled \$472.3bn, shrinking by 7.3% year to date (Fig. 4). At the same time, the monetary gold reserves shrank \$0.2bn in April due to a negative revaluation of assets. The contraction of the international re-

serves in the period of January 2014 to April 2014 was basically caused by the regulator's foreign currency interventions aimed not only at flattening volatility of the ruble exchange rate, but also its retaining against in the face of the observed depreciation of developing countries' national currency exchange rate and unstable geopolitical situation in Ukraine.

Bank of Russia's foreign currency intervention-through selling foreign exchange amounted to \$2401.9m and 247.9m euro by the end of April 2014 (Fig. 6). In April, the regulator's operations on the purchase of foreign currency with regard to the Federal Treasury replenishing or spending foreign currency resources of sovereign funds amounted to \$1268m. In April, the borders of the dual-currency trading band were extended three times within a range of 5 kopeks and reached Rb 36.35–43.35. In the period of May 1 thru May 26, 2014, the regulator repeatedly shifted the dual-currency trading band within a range of 5 kopeks. As of May 26, 2014, the dual-currency trading band was maintained within a range of Rb 36.4–43.4. In the period of May 1 thru May 26, 2014, the Bank of Russia sold \$0.5bn or less of foreign currency, while foreign currency interventions with regard to the Federal Treasury replenishing or spending foreign currency resources of sovereign funds totaled \$1492m.

According to the Bank of Russia's preliminary estimates, net capital outflow from the country reached \$50.6bn Q1 2014, 1.8 times more than in the same period of 2013. Capital outflow from Russia amounted to \$59.7bn over 12 months of 2013. In Q1 2014, net capital exports by the banking sector and other sectors reached \$18.9bn and \$31.7bn respectively. A substantial capital outflow from Russia in Q1 2014 was determined by economic slowdown in the country as well as geopolitical turmoil.

In April 2014, the real effective exchange rate of the ruble gained 2.8% against foreign currencies (-1.7% in March 2014). Overall, in Q1 2014, the real effective exchange rate fell 4.6% as compared to Q4 2013 and 8.5% as compared to the same period of 2013 (Fig. 7).

In April, the dollar-ruble exchange rate increased 0.3% to Rb 35.7. The euro-ruble exchange rate grew up 0.7% (Rb 49.3) in the same period. In April, the euro-dollar exchange rate averaged 1.38. The value of the dual currency basket increased 0.5% to Rb 41.8 in the same month. At the end of 28 days in May 2014 the dollar-ruble exchange rate fell 4.1% to Rb 34.3 while the euro-ruble exchange rate dropped 5.2% to Rb 46.8, eventually decreasing the value of the dual currency basket by 4.7% to Rb 39.9. The euro-dollar exchange rate in May was equal to 1.38 on average. The ruble weakened against the dollar in January–April 2014 basically in response to a more intensive capital outflow

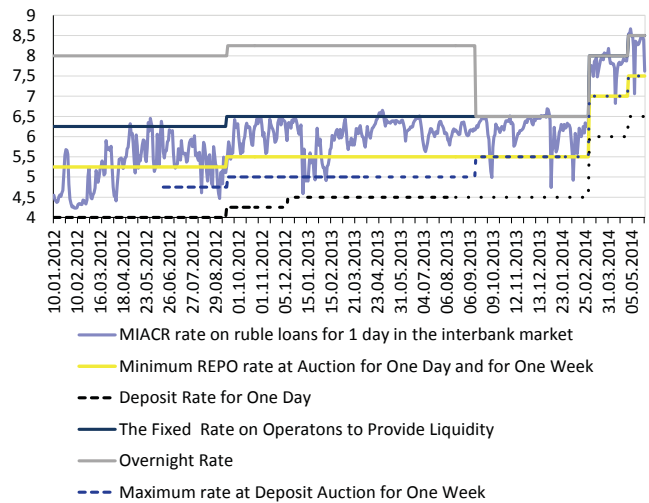


Fig. 5. Bank of Russia's interest rates band and dynamics of the interbank lending market in 2012 to 2014 (% p.a.)

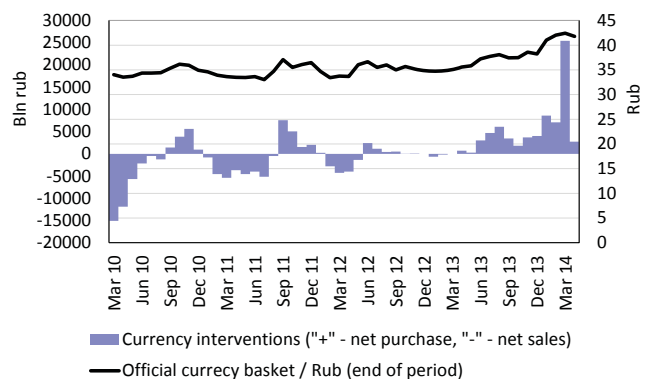


Fig. 6. Bank of Russia's currency interventions and ruble exchange rate vs. the currency basket in March 2010 to April 2014

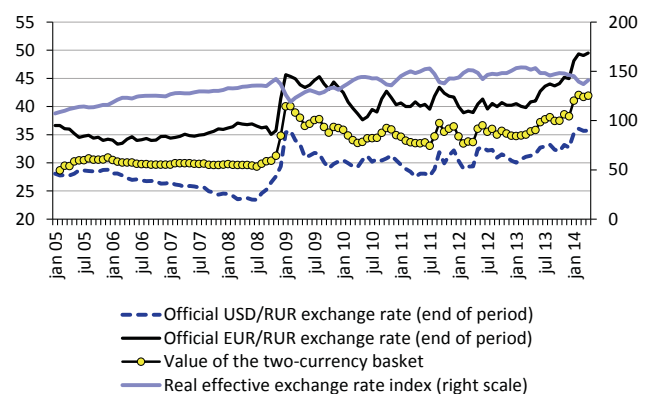


Fig. 7. Ruble exchange rate indicators in January 2005 to April 2014

from the country due to unstable geopolitical situation in Ukraine, optimistic projections about economic growth in the United States and European Union, economic slowdown in the Russian Federation. The ruble appreciated in May in response to the Bank of Russia's

policy aimed at lifting the key interest rate, mitigating panic investor sentiments about the likelihood of Russia's intervention into the political situation in Ukraine, as well as the lack of severe economic sanctions against Russia over the Crimea's accession to the Russian Federation.

We anticipate the ruble exchange rate to further stabilize under the influence of the basic factors. In particular, the downtrend in capital outflow, observed since April 2014, due to a rise of foreign investor interest in the Russian economy, as well as growth in current operations accounts in Q1 2014 (+13.6% as compared to the same period of 2013) may create terms and conditions required for stabilization of the ruble exchange rate amid de-escalation of the geopolitical turmoil in Ukraine.

The Central Bank of Russia's Board of Directors made a decision on April 25, 2014 to lift the key interest rate to 7.5% 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. According to the regulator's estimates,

the lift of the key interest rate will help slow down inflation to a level of 6% or less. In our opinion, a temporal lift 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.

At the same day the Bank of Russia made a decision to introduce a New Mechanism for Credit Institution Refinancing whereby the regulator will issue loans to banks for up to and including three years at a rate of 6.5% p.a. This refinancing mechanism allows the banks to use as a security the rights of claim on loans to finance investment projects which are guaranteed by the state. At its initial stage, the new mechanism will be accessible to large banks whose equity capital exceeds Rb 50bn. The introduction of the new mechanism may in the long run expand banks' capabilities to borrow long money and resolve to a certain degree the liquidity shortage issue if the borrowing base is exhausted. However, the question will arise in the mid-run perspective of the demand for this instrument amid substantially low investment activity in the Russian economy. ●