INFLATION AND MONETARY POLICY IN JUNE 2014

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In June 2014, the consumer price index stood at 0.6% (0.4% in June 2013), 0.3 p.p slightly below the value observed in May 2014. Therefore, inflation stood at 7.8% at the end of the 12-month period. The consumer price index reached 0.5% within 21 days in July 2014. As of July 1, 2014, banks' debt owed to the regulator amounted to Rb 5,4 trillion. On July 25, 2014, the Bank of Russia kept tightening the monetary policy, lifting the key interest rate from 7.5% to 8% p.a.

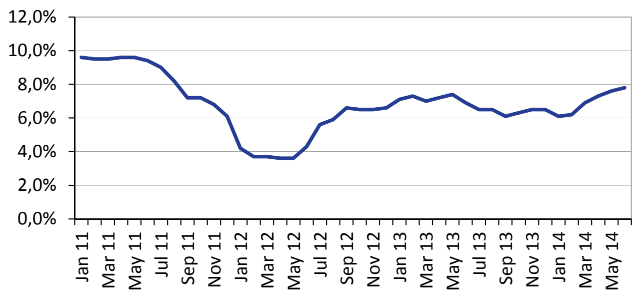
Inflation in the Russian Federation remained at a high level in June 2014: the consumer price index stood at 0.6% at the month's end (comparing to 0.9% in May 2014), showing an increase of 0.2 p.p. over the value observed in 2013. Therefore, inflation reached 7.8% on an annualized basis (*Fig. 1*). Core inflation[1] in June 2014 stood at 0.8%, also higher, up 0.5 p.p., than the value observed in the previous year.

In June 2014, prices of food products increased 0.7% compared to May 2014 (*Fig. 2*). Prices of the following food products saw higher growth rates: granulated sugar (from 1.5% in May to 3.9% in June), eggs (-11.7% in May, 1.0% in June). Prices of the following food products saw slower growth rates: meat and poultry (from 4.4% in May to 2.6% in June), milk and dairy products (from 0.9% in May to 0.4% in June), pasta products (from 0.8% in May to 0.6% in June), grains and beans (from 1.0% in May to 0.8% in June), butter (from 1.0% in May to 0.7% in June), alcoholic beverages (1.2% in May, 0.8% in June). Growth rate of prices of fruits and vegetables slowed down (2.4% in May, -2.8% in June).

In June 2014, prices and tariffs of retail paid services increased 0.9%, while in May 2014 they increased 0.8%. Overall, tariffs of public utilities in June increased 0.3% in June, falling 0.5 p.p. below the value observed in May 2014 of the same year. Prices of the following services increased in June: international travel services (from 1.6% in May to 2.9% in June), passenger transport services (from 1.2% in May to 2.6% in June), на sanatorium-and-spa treatment services (from 2.2% in May to 6.8% in June). Growth rates of prices of the following services slowed down in June: services rendered by culture organizations (from 0.5% in May to 0.2% in June), insurance services (from 3.2% in May to 1.5% in June), services rendered in the physical culture and sports sector (from 0.3% in May to 0.0% in June).

In June 2014, growth rate of prices of non-food products slowed down by 0.1 p.p. relative to May 2014 and stood at 0.4%. Prices of the following non-food products saw faster growth rate: textiles (from 0.6% in May to 0.8% in June), audio and video home appliances (from -0.1% in May to 0.2% in June). Growth rate of prices of the following non-food products slowed down: tobacco products (from 3.3% in May to 2.1% in June), medicines (from 1.2% in May to 1.0% in June), footwear (from 0.4% in May to 0.1% in June).

The consumer price index stood at 0.5% (comparing to 0.8% in the corresponding period of 2013) within 21 days in July 2014. Slowdown in growth rates of prices in July 2014 relative to the corresponding period of 2013 was associated with lower indexing of the tariffs on public utility services, as well as lower prices of fruits and vegetables. It's worth noting that a depreciation of the ruble exchange rate 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–July 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



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

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).

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 lack of pronounced demand-driven pressure on prices, as well as the Bank of Russia's policies aimed at tightening the monetary policy remain the key factors constraining inflation.

In June 2014 the monetary base (broad definition) increased 3.7% to Rb 9672,4bn (*Fig. 3*). An increase in the following components of the broad monetary base is worth noting: the volume of cash in circulation including cash balances in credit institutions (a growth of 0.3% to Rb 7779,9bn), bank's deposits (a growth of 1.0% to Rb 89bn), banks' correspondent accounts (a growth of 30.6% to Rb 1371,5bn). Obligatory reserves shrank 0.6% to Rb 432,1bn.

In June 2014, the monetary base (narrow definition) (cash plus obligatory reserves) shrank 0.3% to Rb 8212bn (*Fig. 4*).

In May, the volume of reserves at commercial banks amounted to Rb 1312,8bn, with mandatory reserves on special accounts with the Central Bank amounting to Rb 432,1bn, while the average value of reserves in the period of 10.06.2014 to 10.07.2014 amounted to Rb 880,7bn. As of July 1, 2014, banks owed Rb 5,4 trillion to the regulator, increasing 7% since the beginning of June 2014. Bank's debt on REPO transactions declined 6.9% to Rb 2,6 trillion, the debt on loans secured by non-market assets amounted to Rb 2,4 trillion, an increase of 15.5%. According to the data available as July 28, 2014, banks' debt on REPO transactions increased to Rb 2.9 trillion, while the debt on other loans decreased to Rb 2,3 trillion. It should be noted that the Bank of Russia used REPO operations at a flat rate, in particular, an average of Rb 16,8bn and Rb 47,9bn were provided daily in June a nd July 2014 respectively. Furthermore, on June 30, July 15, 21, 22, 2014, the MIACR on ruble-denominated overnight interbank loans interest rate crossed the interest rate cap. The interbank interest rate[1] in June stood at 8.2% on average (8.2% in May 2014). In the period of July 1 thru 25 the average interbank interest rate stood at 8.1% (*Fig. 5*).

The Bank of Russia provided banks with Rb 500,0bn at a cut-off rate of 7.75% p.a. as part of a 3-month repo auction secured by non-market assets which was held on June 9, 2014. During a similar auction held on July 14, 2014 the Bank of Russia provided at total of Rb 588,3bn at a rate of 7.76% p.a. A 12-month REPO auction secured by non-market assets was held on July 28, 2014, a total of Rb 495bn were provided at 8.25%. 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.

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

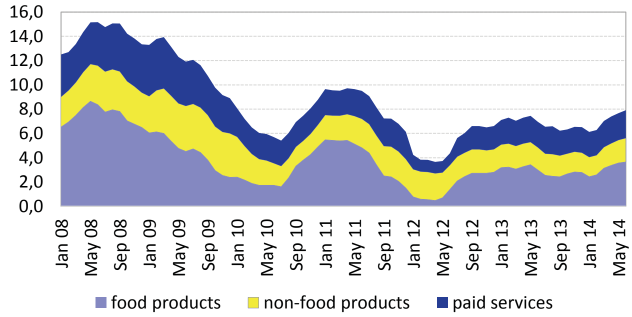


Fig. 2. Inflation factors in 2008 to 2014 (%, relative to the corresponding month of the previous year)

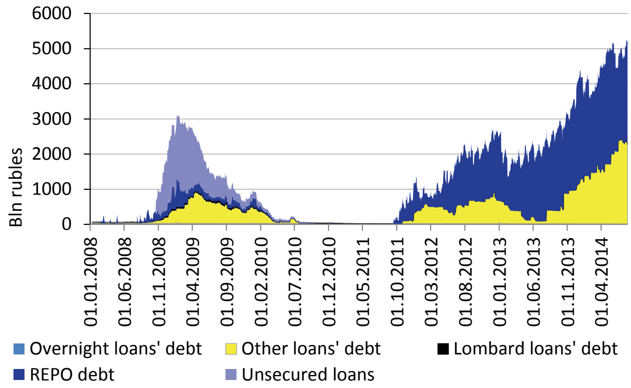


Fig. 3. Commercial banks' debt owed to the Bank of Russia in 2008 to 2014

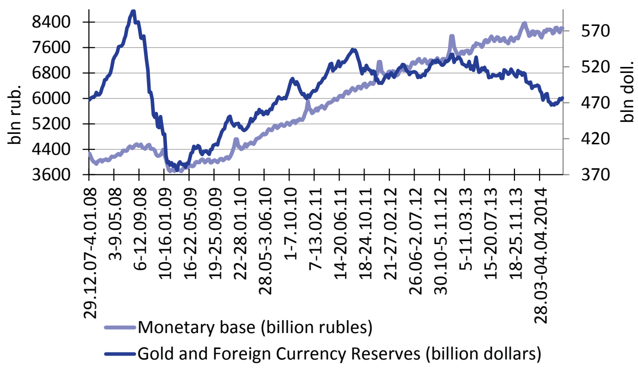


Fig. 4. Dynamics of the monetary base (narrow definition) and gold and foreign currency (international) reserves of the Russian Federation in 2007 to 2014

It should be noted that since June 30, 2014 the regulator has extended the maximum period of lending from 365 to 549 days on continuous operations such as loans secured by non-market assets or guarantees, as well as gold-backed loans. This policy is aimed at increasing credit institutions' ability to manage their own liquid assets. In our opinion, this policy will not have a significant effect on liquidity in the banking sector. For the time being, loans with a maturity of 1 to 3 months, accounting for an average of 60% of total banks' debt on secured loans in June 2014, are most popular among secured loans. Secured loans with a maturity of 181 to 365 days account for only 7% on average.

Weak demand on this instrument of liquidity provision is determined by a high flat interest rate, the lack of collateral with the required maturity (12 months), as well as high alternative costs of a shrinking collateral value available to credit institutions (missed opportunities to obtain short-term loans because of shortage of available collateral value).

On the 1st of July 2014 the volume of international reserves totaled $478,3bn, shrinking by 6.2% year to date (*Fig. 4*). At the same time, the monetary gold reserves increased $2,1bn in June 2014 due to a positive revaluation of assets. The contraction of the international reserves in the period of January 2014 to April 2014 was basically caused by the regulator's foreign currency interventions aimed at supporting the ruble exchange rate.

Bank of Russia's foreign currency interventions through net purchases of foreign exchange amounted to $1356,5m and 113,7m euro by the end of June 2014 (*Fig. 6*). In the same month 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 $1510m. In the same month the borders of the dual-currency trading band remained intact, being maintained within a range of Rb 36,40–43,40. In the period of July 1 thru July 28, 2014, the dual-currency trading band remained unchanged as well. At the same period, Bank of Russia conducted no foreign currency interventions.

According to the Bank of Russia's preliminary estimates, net capital outflow from the country reached $25,8bn in Q1 2014, 4.7 times more than in the same period of 2013. Overall, capital outflow from Russia amounted to Rb 74,6bn within six months, 2.2 times more than in the period of January–June 2013. Capital outflow from Russia amounted to $61,0bn within 12 months in 2013. In H1 2014, net capital exports by the banking sector and other sectors reached $38,3bn and $36,4bn respectively. A substantial capital outflow from Russia in H1 2014 was determined by economic slowdown in the country as well as geopolitical turmoil.

In June 2014, the real effective exchange rate of the ruble gained 2.4% (2.7% in May 2014). Overall, in Q2 2014 the real effective exchange rate gained 2.8% relative to Q1 2014. In H1 2014 the real effective

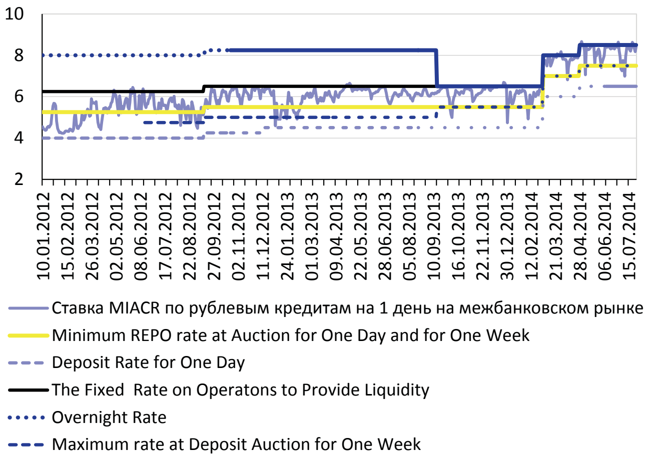


Fig. 5. Bank of Russia's interest rates band and dynamics of the interbank lending market in 2012 to 2014 (% p.a.)

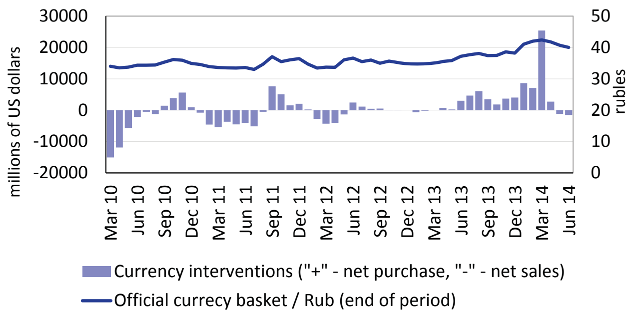


Fig. 6. Bank of Russia's currency interventions and ruble exchange rate vs. the currency basket in March 2010 to June 2014

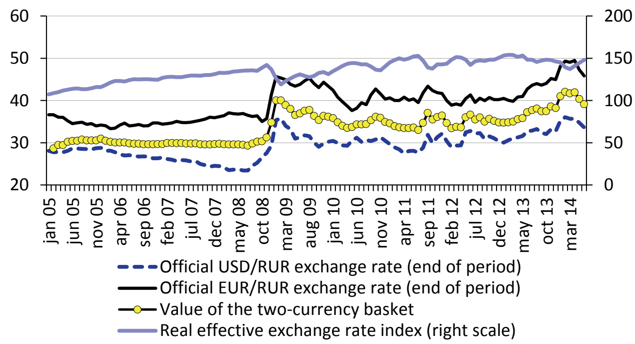


Fig. 7. Ruble exchange rate indicators in January 2005 to June 2014

exchange rate fell 6.4% relative to the corresponding period in 2013 (*Fig. 7*).

In June 2014, the dollar-ruble exchange rate lost 3.0% to Rb 33,63, while the euro-ruble exchange rate lost 2.9% (Rb 45,83). In the same month, the euro-dollar exchange rate averaged 1,36. The value of the dual currency basket declined 2.9% to Rb 39,1 during the same month. Within 29 days in July 2014, the dollar-ruble exchange rate increased 3.3% to Rb 35,35, while euro-dollar exchange rate declined 1.4% to Rb 47.48, resulting in an appreciation of the dual currency basket by 2.3% (to Rb 40.8). The euro-dollar exchange rate in June 2014 was equal to 1.36. It should be noted that dynamics of the ruble exchange rate in H1 2014 was governed by geopolitical factors and related capital outflow from the Russian Federation.

The Bank of Russia made a decision on June 17, 2014 to enhance flexibility of exchange rate formation mechanisms designed to mitigate risks related to financial sustainability. The regulator lowered the amount of foreign currency interventions as part of internal limits of floating operational interval, by $100m. The range within which the Bank of Russia conducts no foreign exchange interventions aimed at flattening the ruble exchange rate, was widened from Rb 3,1 to Rb 5,1. Furthermore, the Bank of Russia decided to lower the amount of accumulated interventions resulting in changing the limits of the operational interval by 5 kopeks, from $1500m to $1000m. It should be noted that these policies will allow the role of market factors to be increased in the process of exchange rate formation amid the transition to an inflation targeting regime.

On July 25, 2014, the Bank of Russia Board of Directors made a decision to tighten the monetary policy. The key interest rate was lifted from 7.5% p.a. to 8% p.a.. As a reminder, on March 3, 2014 the foregoing rate was lifted from 5.5% p.a. to 7% p.a. and another 0.5 p.p. to 7.5% p.a. on April 28, 2014. The introduction of this policy was associated with high growth rates in consumer prices, increase in inflation expectations because of mounting international tensions, as well as the likely tightening of fiscal and tariff policies being considered in the Government. Should inflation risks retain, the regulator intends to continue lifting the key interest rate to achieve a target inflation of 4% in the mid run.

It should be noted that the said decision of the Central Bank of Russia implies strategic priorities of the Bank of Russia. Amid weak and unstable dynamics of the economy the Central Bank of Russia could have given preference to quantitative easing in order to stimulate growth. All the more so, because Bank of Russia's economists' negative evaluations of the so-called "output gap" is an argument for decreasing interest rates. Instead, the monetary authorities have tightened the monetary policy to check inflation and make efforts to slow down its growth rates to the targeted level of 4% in the mid run. This is indicative of the fact that the Management of the Bank of Russia are focused on achieving their principal goal, i.e. ensure sustainability in the monetary sector.

The monetary authorities are seriously anticipating that inflation expectations boosted by devaluation of the ruble since the beginning of the year, political uncertainty, and the likely increase in taxes being discussed in the Government may provoke a new round of inflation. Having lifted the interest rate by 0.5%, as well as announced that interest rates will keep rising if inflation risks get higher, the Central Bank of Russia sends a signal that it intends to consistently suppress inflation and factors in inflation expectations in its decision-making process.

It should be noted that in general the decision of the Central Bank's decision to lift the key interest rate by 0.5% doesn't look like a tough monetary policy. However, lifting of the key interest rate gives a signal to market players that the monetary authorities are ready to further tighten the monetary policy, which in turn will help stabilize inflation expectations.