INFLATION AND MONETARY POLICY IN JULY 2014

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The consumer price index stood at 0.5% in July 2014 (0.8% in July 2013), down by 0.1 p.p compared to the value observed in June 2014. Therefore, inflation stood at 7.5% on an annualized basis. The consumer price index reached 0.2% within 25 days in August. The Bank of Russia Board of Directors decided on July 25 to tighten the monetary policy. The baseline interest rate was lifted to 8% from 7.5% p.a.

Inflation in the Russian Federation remained at a high level in July 2014: the consumer price index stood at 0.5% at month-end (compared to 0.6% in June 2014), down by 0.3 p.p. compared to the value observed in 2013. Therefore, inflation reached 7.5% on an annualized basis (*Fig. 1*). Core inflation[1] in July 2014 stood at 0.6%, up by 0.6 p.p. against the value observed in the previous year. The increase in the core inflation from 5.5% on an annualized basis in January 2014 to 7.8% in July of the same year amid lower indexing rates on regulated tariffs of the services rendered by natural monopolies vs. 2013 is indicative of substantial price hikes in the consumer market which are determined by geopolitical tensions and devaluation of the national currency.

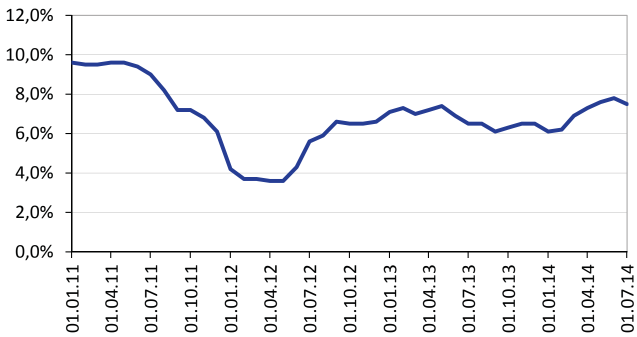
In July 2014, prices of food products dropped 0.1% compared to June 2014 (*Fig. 2*), which is determined mostly by seasonal slowdown in the growth of prices of fruits and vegetables (-2.8% in June, -8.1% in July). The Russia's ban on pork imports led to further increase in prices of meat and poultry (from 2.6% in June to 1.8% in July) and related products, including eggs (1.0% in June, 10.9% in July). Price growth rates of the following food products remained high: bread and flour products (0.7% in June and July), pasta products (0.6% in June and July). Prices of the following food products saw slower growth rates: granulated sugar (from 3.9% in June to 1.6% in July), grains and beans (from 0.8% in June to 0.4% in July), butter (from 0.7% in June to 0.4% in July), alcoholic beverages (0.8% in June, 0.6% in July), milk and dairy products (from 0.4% in June to 0.3% in July).

In July, prices and tariffs of retail paid services increased 1.4%, while in June they increased 0.9%. Overall, tariffs of public utilities in July increased 2.8% (compared to 0.3 p.p. in June). Growth rates of prices on the following services saw slowdown in July: international travel services (to 2.0% in July from 2.9% in June), passenger transport services (to 1.3% in June from 2.6% in May), sanatorium and therapeutic services (to 1.9% in June from 6.8% in May), medical services (to 0.4% in July from 0.7% in June), insurance services (to 0.7% in July from 1.5% in June).

In July prices of non-food products grew at a rate of 0.4%, similar to that in June. Prices of the following non-food products saw faster growth rate: motor gasoline (to 1.5% in July from 0.6% in June). Growth rate of prices of the following non-food products slowed down: tobacco products (to 1.8% in July from 2.1% in June), textiles (to 0.4% in July from 0.8% in June), washing and cleaning products (to 0.8% in July from 1.2% in June).

Overall, in July 2014, food products contributed 48%, non-food products 27.7%, prices and tariffs of retail paid services 24.3% to the inflation growth rate on an annualized basis.

The consumer price index stood at 0.2% within first 25 days in August 2014 (compared to 0.1% during the same period in 2013). Growth rates in prices in August 2014 compared to the corresponding period of 2013 is in many ways associated with the Russia's ban on imports of certain food products, including pork (+1.7%), frozen fish (+1%), some types of cheeses (+0.5%) etc. from EU member states, the United



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).

States, Norway, Canada, Australia. It's worth noting that the effect of both Russia's and western sanctions and the devaluation of the ruble amid geopolitical tensions and large-scale capital flight will push up inflation till the end of the year. 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 the inflation.

In July 2014, the monetary base (broad definition) contracted by 0.6% to Rb 9613,5bn (*Fig. 3*). The following components of the broad monetary base saw an increase: the volume of cash in circulation including cash balances in credit institutions (up by 1.0% to Rb 7856,3bn), banks' deposits (up by 21.1% to Rb 107,8bn), whereas banks' correspondent accounts saw a decline by 11.2% to Rb 1218,3bn, obligatory reserves diminished by 0.2% to Rb 431,1bn.

The monetary base (narrow definition) (cash plus obligatory reserves) gained 0.9% to reach Rb 8297,4bn in July 2014 (*Fig. 4*).

In July, commercial banks' reserves amounted to Rb 1308,5bn, with mandatory reserves on special accounts with the Central Bank amounting to Rb 431,1bn, while the average value of reserves in the period between 10.07.2014 and 10.08.2014 amounted to Rb 877,4bn.

As of August 1, 2014, banks owed Rb 5,6 trillion to the regulator, an increase of 4.2% since the beginning of June. Bank's debt on REPO transactions increased 3.7% to reach Rb 2,7 trillion, the debt on loans secured by non-market assets reached Rb 2,5 trillion, up by 5.8%. According to the data available as of August 29, 2014, banks' debt on REPO transactions saw a decline to Rb 2,4 trillion, while the debt on other loans increased to Rb 2,7 trillion. It's worth noting that the Bank of Russia used REPO operations at a flat rate, with a daily average of Rb 43,2bn allocated in July and Rb 25,7bn in August. Furthermore , on July 15, 21, 22 the MIACR по overnight interbank loans denominated in rubles broke thorough the interest rate cap, the amount of funds allocated as part of REPO operations at a flat rate was Rb 11,2bn; Rb 3,7bn; Rb 2,5bn respectively. The interbank interest rate[1] in July stood at 8.2% on average (compared to 8.2% in June 2014). In the period of August 1 thru August 29 the average interbank interest rate stood at 7.9% (*Fig. 5*). It's worth noting that the banking sector's demand for the Central Bank liquidity will be growing till the end of the year because the United States and EC have restricted the access to sources of foreign financing to certain Russian state-run banks.

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

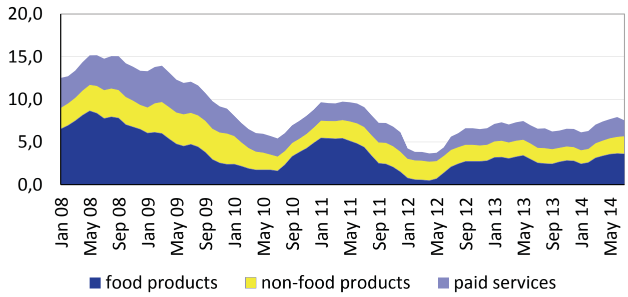


Fig. 2. Inflation factors in 2008 to 2014 (%, relative to the corresponding month of the previous year)

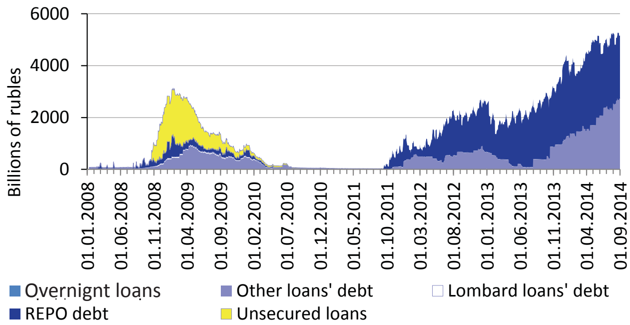


Fig. 3. Commercial banks' debt owed to the Bank of Russia in 2008 to 2014

The Bank of Russia provided banks with Rb 588,3bn at a cut-off rate of 7.76% p.a. as part of a 3-month REPO auction secured by non-market assets held on July 14, 2014. A total of Rb 495bn were allocated at a rate of 8.25% as part of 12-month REPO auction secured by non-market assets held on July 28, 2014. 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. The regulator allocated Rb 600bn at a rate of 8.26% p.a. to credit institutions as part of a 3-month auction held on August 11, 2014. It's worth noting that due to the projected increase in commercial banks' demand for liquidity the regulator has increased to Rb 700bn the maximum amount of money to be allocated during the next similar auction to be held in September 2014,.

As of August 1, 2014, the Central Bank's international reserves amounted to $468,8bn, shrinking by 8.0% year to date (*Fig. 4*). At the same time, the monetary gold reserves shrank by $0.6bn in July 2014 due to a negative revaluation of assets.

The regulator undertook exchange market interventions both in July and August of the current year (*Fig. 6*). In July the range of the dual-currency trading band was not shifted, remaining at a level of Rb 36,40–43,40. On August 18, in order to enhance flexibility of the exchange rate formation mechanism, the Bank of

Russia widened to Rb 35,40–44,40 the range of acceptable ruble values of the dual-currency basket. Additionally, the regulator has cut to zero the volume of exchange market interventions aimed at flattening volatility of the ruble exchange rate within the internal range of the floating trading band, as well as reduced the amount of accumulated interventions shifting by 5 kopeks the range of the floating trading band, to $350m from $1000m. It's worth noting that these policies will help enhance the role of market factors in the process of exchange rate formation amid the transition to the targeting inflation regime, which will increase the exchange rate volatility.

According to the Bank of Russia's preliminary estimates, net capital outflow from the country reached $25,8bn in Q2 2014, 4.7 times the amount observed during the same period in 2013. Overall, capital outflow amounted to Rb 74,6bn during the first half of the year, 2.2 times the amount observed in the period between January and June 2013. Russia saw $61,0bn of capital outflow 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 the geopolitical turmoil.

In July 2014, the real effective exchange rate of the ruble weakened 0.2% against foreign currencies (+2.7% in June 2014). Overall, in Q2 2014, the real effective exchange rate gained 2.9% compared to Q1 2014. In H1 2014, the real effective exchange rate weakened by 6.4% compared to the corresponding period in 2013 (Fig. *7*).

In July, the dollar-ruble exchange rate increased 4.7% to Rb 35,44, a while the euro-ruble exchange rate gained 2.8% (Rb 47,47). In July, the euro-dollar exchange rate averaged 1.36. The value of the dual currency basket increased 3.7% to Rb 40,86 during the same month. At the end of August the dollar-ruble exchange rate increased 5.2% to reach Rb 37,29, while euro-dollar exchange rate gained 3.2% to Rb 48,97, thereby increasing 4.1% the value of the dual currency basket, to Rb 42,55. In August 2014, the euro-dollar exchange rate averaged 1.33. It's worth noting that the dynamics of the ruble exchange rate in the first half of the current year was mostly determined by geopolitical factors and related capital outflow from the Russian Federation. Furthermore, the ruble exchange rate will be pushed down driven by western sanctions on Russia which trigger capital outflow from the Russian Federation. The US dollar strengthening in August is associated with the exchange market players' expectations of the FRS lifting interest rates and adverse economic situation within the Eurozone.

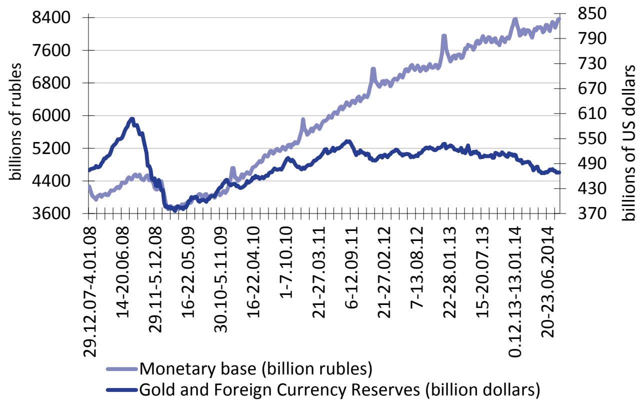


Fig. 4. Dynamics of the monetary base (narrow definition) and gold and foreign currency (international) reserves of the Russian Federation in 2007 to 2014

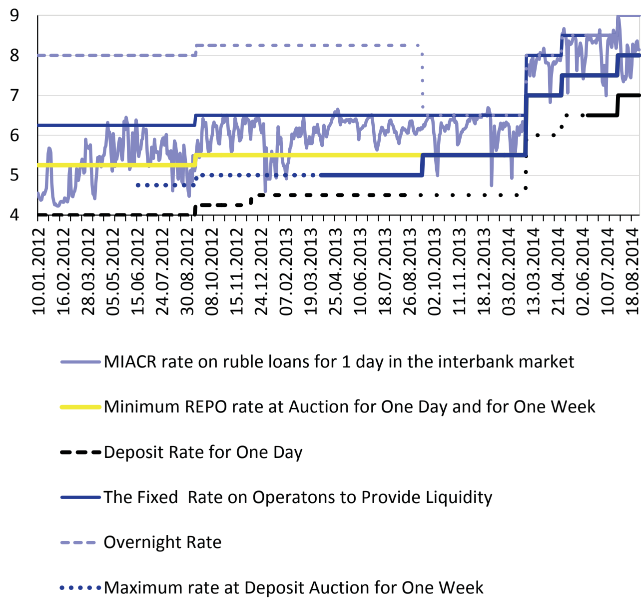


Fig. 5. Bank of Russia's interest rates band and dynamics of the interbank lending market in 2012 to 2014 (% p.a.)

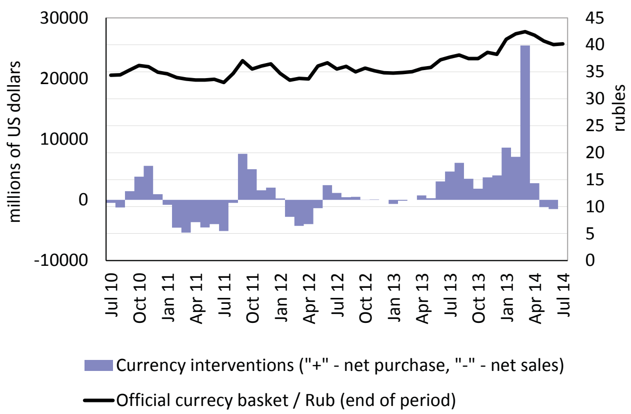


Fig. 6. Bank of Russia's currency interventions and ruble exchange rate vs. the currency basket in March 2010 to June 2014

The Bank of Russia Board of Directors decided on July 25, 2014 to tighten the monetary policy. The key interest rate was lifted to 8% p.a. from 7.5% p.a. As a reminder, the rate was lifted to 7% p.a. from 5.5% p.a. on March 3 and 0.5 p.p. to 7.5% p.a. on April 28. The introduction of this policy is associated with high growth rates of consumer prices, increase in inflationary expectations due to mounting international tension, as well as a likely clampdown on the fiscal and tariff policy which is being considered by the Russian Government. Should inflation risks persist, the regulator is going to further lift the key interest rate to achieve the target inflation rate (4%) in the mid run.

It's worth noting that the foregoing decision of the Central Bank of Russia shows Bank of Russia's strategic priorities to ensure a monetary stability. Facing weak and variable economic dynamics, the Central Bank of Russia could have opted a quantitative easing policy to promote growth. Moreover, Bank of Russia's economists have negative estimates of the so called "output gap", which is an argument in favor of lowering interest rates. Instead, the monetary authorities have opted a monetary clampdown to keep inflation in check.

The monetary authorities are seriously concerned about a new round of inflation which may be driven by the inflationary expectations warmed up by the devaluation of the ruble earlier this year, political uncertainty, and a likely tax boost which is being considered by the Russian Government. By lifting by 0.5% the key

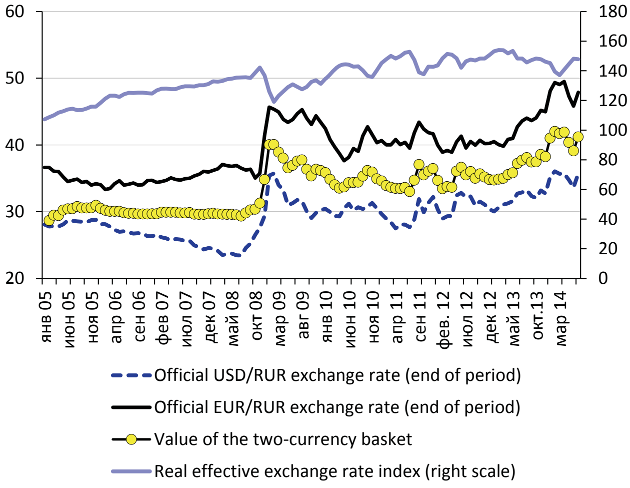


Fig. 7. Ruble exchange rate indicators in January 2005 to July 2014

interest rate and stating that interest rates will further be lifted if inflation risks persist, the Central Bank of Russia demonstrates its intention to consistently suppress inflation.

All in all, the Central Bank's decision to lift by 0.5% the key interest rate doesn't seem to be a tough monetary policy. At the same time, the decision sends a signal to market players that the monetary authorities are ready to continue the monetary clampdown in the future, which in turn will help stabilize inflationary expectations.