INFLATION AND MONETARY POLICY IN AUGUST 2014

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The consumer price index stood at 0.2% in August 2014 (0.1% in August 2013), 0.3 p.p. lower than the value observed in the preceding month. Therefore, inflation stood at 7.6% on an annualized basis. The consumer price index reached 0.5% within the first 22 days in September 2014. Banks' repo debt in August dropped by 10.3% to Rb 2,43 trillion while debt on loans secured by non-market assets reached Rb 2,73 trillion, up 7.1%. Rapid growth in volume of the regulator's loans secured by non-market assets of commercial banks is associated with the depletion of the collateral for repo transactions.

Inflation slowed down slightly in Russia in August this year: the consumer price index stood at 0.2% at month-end (0.5% in July 2014), up 0.1 p.p. compared to the value observed in 2013. Therefore, inflation reached 7.6% on an annualized basis (*Fig. 1*). Core inflation[1] in August 2014 stood at 0.6%, up 0.1 p.p. against the value observed last year. The increase in the core inflation from 5.5% on an annualized basis in January 2014 to 8.0% in August 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 appreciation in the consumer market which is determined by geopolitical tensions and devaluation of the national currency.

This year in August prices of food products dropped 0.3% compared to July 2014 (*Fig. 2*), which is determined mostly by seasonal slowdown in growth of prices of fruits and vegetables (-8.1% in July, -10.7% in August). It's worth noting that prices of these categories of goods increased in response to the Russia's ban on supplies of certain types of agricultural and food products from the United States, Canada, Australia, Norway and the European Union. In particular, prices of the following food products kept growing in August: meat and poultry (from 1.8% in July to 2.5% in August), fish and seafood products (from 0.7% in July to 1.4% in August). Price growth rates of the following food products remained high: butter (from 0.4% in July to 0.5% in August), alcoholic beverages (0.6% in July, 1.1% in August). Price growth rates of the following food products slowed down: granulated sugar (from 1.6% in July to 1.0% in August), bread and flour products (from 0.7% in July to 0.5% in August), pasta products (from 0.6% in July to 0.0% in August), milk and dairy products (from 0.3% in July to 0.2% in August). Prices of the following food products dropped: eggs (-4.8% in August compared to a 10.9% growth in July) and sunflower oil (from 0.0% in July to -0.4% in August).

In August, prices and tariffs of retail paid services increased 0.7%, while in July they increased 1.4%. Overall, tariffs of public utilities in August increased 0.6% (2.8% in July). Growth rates of prices of the following services saw slowdown: international travel services (to 1.6% in August from 2.0% in July), passenger transport services (to 0.6% in August from 1.3% in July), sanatorium and therapeutic services (to 0.2% in August from 1.9% in July), preschool education services (to 0.2% in August from 0.4% in July). Growth rates of prices of the following services accelerated: medical services (to 0.8% in August from 0.4% in July), insurance services (to 1.2% in August from 0.7% in July), education services (to 1.8% in August from 0.3% in July).

In August, growth rates of prices of non-food products reached 0.5%, up 0.1 p.p. compared to those observed in July. Prices of the following non-food products kept growing: motor gasoline (1.5% in July and in August), tobacco products (to 2.0% in August from 1.8% in July), footwear (to 0.4% in August from 0.0% in July). Growth rate of prices of the following non-food products slowed down: washing and cleaning products (to 0.6% in August from 0.8% in July), audio visual goods (to 0.0% in August from 0.3% in July).

Overall, in August 2014, food products contributed 49.4%, non-food products 27.3%, prices and tariffs of retail paid services 23.3% to the inflation growth rate on an annualized basis.

In September, the consumer price index stood at 0.5% (compared to 0.2% during the same period in 2013). It's worth noting that inflation will be boosted up till the end of the year through the effect of reciprocal sanctions imposed by Russia and western countries and the devaluation of the ruble amid geopolitical tensions and large-scale capital flight. The lack of pro-

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).

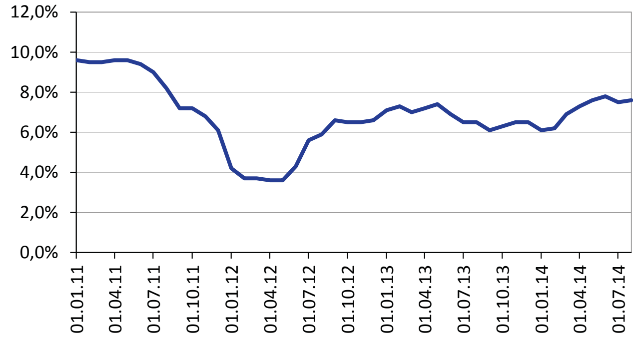
nounced demand-driven pressure on prices, as well as the Bank of Russia's measures aimed at tightening the monetary policy remain the key factors constraining the inflation.

In August 2014, the monetary base (broad definition) contracted by 0.8% to Rb 9537,2bn (*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 1.4% to Rb 7965,3bn), banks' deposits (up 24.3% to Rb 134bn), obligatory reserves (up 4.1% to Rb 448,8bn). banks' correspondent accounts saw a decline by 18.8% to Rb 989bn. The monetary base (narrow definition) (cash plus obligatory reserves) gained 1.5% to reach Rb 8414,1bn in August 2014 (*Fig. 4*).

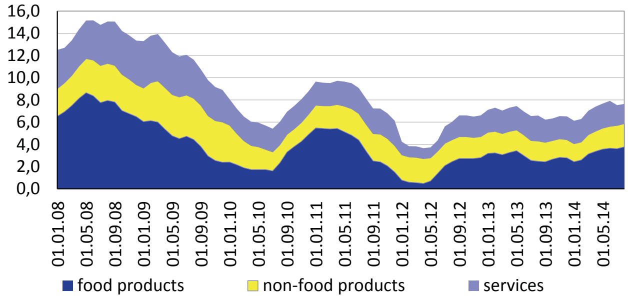
In August, commercial banks' reserves amounted to Rb 1282,4bn, with mandatory reserves on special accounts with the Central Bank amounting to Rb 448,8bn, while the average value of reserves in the period between 10.08.2014 and 10.09.2014 amounted to Rb 833,6bn. In the period of 10.08.2014 thru 10.09.2014. The volume of excess reserves at commercial banks [1] amounted to Rb 334,2bn on average, of which banks' deposits on accounts with the Central Bank averaged Rb 168,8bn, correspondent accounts less the averaged amount of reserves amounted to Rb 165,4bn on average during the period under review.

As of September 1, 2014, banks Rb 5,45 trillion to the regulator, down 2.5% since early in August. Banks' repo debt reached Rb 2,43 trillion, down 10.3% while debt on loans secured by non-market assets reached Rb 2,73 trillion, up by 7.1%. According to the data available as of September 24, 2014, banks' repo debt saw a decline to Rb 2,39 trillion, while the debt on other loans increased to Rb 2,84 trillion. It's worth noting that the Bank of Russia used REPO operations at a flat rate, with a daily average of Rb 25,4bn allocated in August and Rb 69,2bn in September. During the period under review the MIACR on overnight interbank loans denominated in rubles never broke through the interest rate cap. The interbank interest rate [2] in August 2014 stood at 7.9% on average (compared to 8.2% in July 2014). In the period of September 1 thru September 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 EU have restricted the access to sources of foreign financing to certain Russian state-run banks.

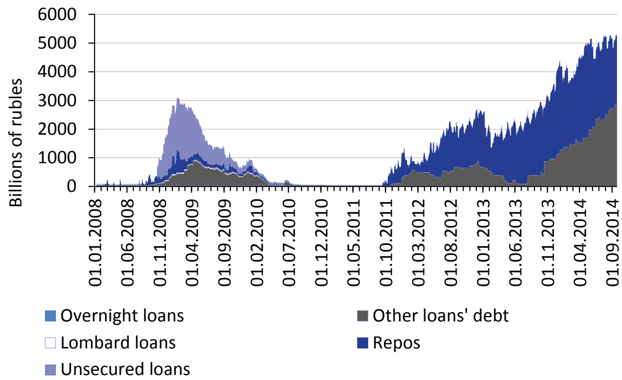
The Bank of Russia provided banks with Rb 600bn at a cut-off rate of 8.26% p.a. as part of a 3-month REPO auction secured by non-market assets held on August 11, 2014. However, only large banks which have the required collateral can afford such actions despite very beneficial terms of lending at a floating interest rate. The regulator allocated Rb 505,5bn at a rate of 8.26% p.a. to credit institutions as part of a 3-month auction held on September 8, 2014. It's worth noting



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



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



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

1 Commercial banks' excess reserves with the Central Bank refer to the amount of commercial banks' deposits on accounts with the Bank of Russia, regulator bonds held by commercial banks, as well as banks' correspondent accounts less the averaged amount of reserves.

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

that due to the projected seasonal 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 held in September 2014. Rapid growth by the regulator in volumes of loans secured by non-market assets of commercial banks is associated with the depletion of the collateral for repo transactions.

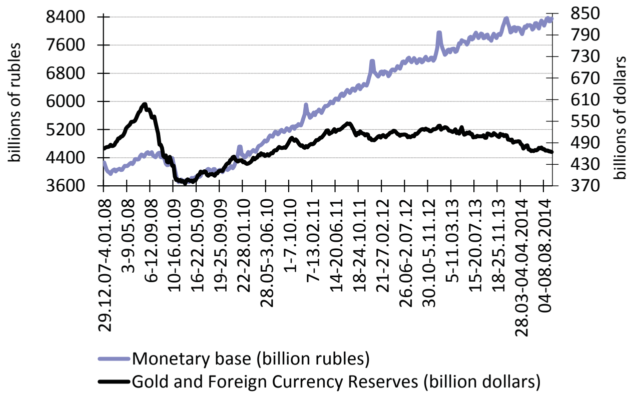
As of September 1, 2014, the Central Bank's international reserves amounted to $465,2bn, shrinking by 8.7% year to date (*Fig. 4*). At the same time, the monetary gold reserves shrank by $0.4bn in July 2014 due to a negative revaluation of assets.

This year in August and September the regulator didn't undertake currency interventions (*Fig. 6*). The Bank of Russia widened to Rb 35,40–44,40 the range of acceptable ruble values of the dual-currency basket on August 18 in an effort to enhance flexibility of the exchange rate formation mechanism. Furthermore, the regulator gave up 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.

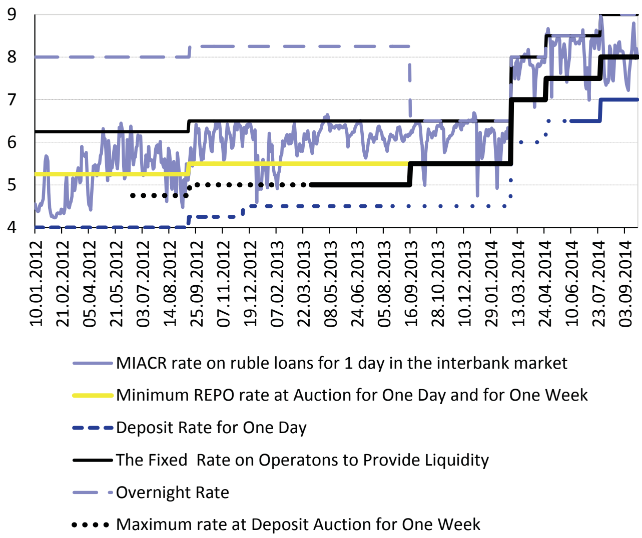
In August 2014, the real effective exchange rate of the ruble weakened 2.3% (-0.2% in July 2014) against foreign currencies. Overall, in Q2 2014, the real effective exchange rate gained 2.9% compared to Q1 2014. In H1 2014, the real effective exchange rate weakened by 6.4% compared to the corresponding period in 2013 (*Fig. 7*).

In August, the dollar-ruble exchange rate increased 5.2% to Rb 37,3 while the euro-ruble exchange rate gained 3.2% (Rb 48,97). In August, the euro-dollar exchange rate averaged 1.33. The value of the dual currency basket increased 4.1% to Rb 42,55 during the



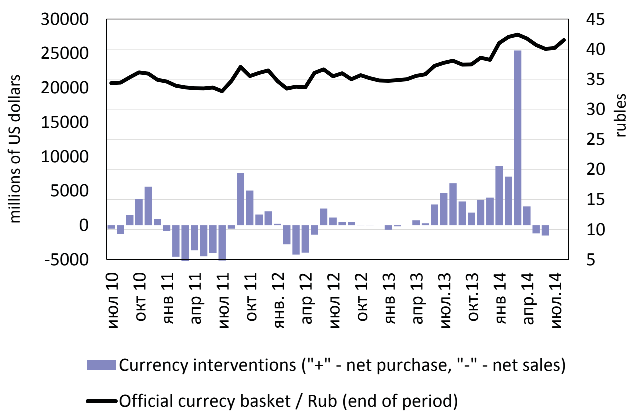
Source: The Central Bank of Russia.

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



Source: The Central Bank of Russia.

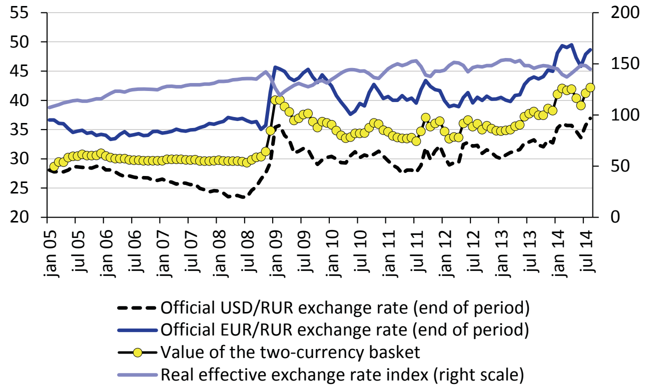
Fig. 5. Bank of Russia's interest rates band and dynamics of the interbank lending market in 2012 to 2014 (% p.a.)



Source: The Central Bank of Russia.

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

same month. Upon the first 25 days of September the dollar-ruble exchange rate reached Rb 38,4, up 2.9%, while euro-dollar exchange rate increased Rb 49,3, up 0.7%, thereby increasing to Rb 43,3 the value of the dual currency basket, up 1.8%. In August 2014, the euro-dollar exchange rate averaged 1.3. 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 driven down by western sanctions on Russia, thereby triggering capital outflow from the Russian Federation. The US dollar strengthening in August and September 2014 was associated with the exchange market players' expectations of the FRS lifting interest rates and adverse economic situation within the Eurozone.



Source: The Central Bank of Russia.

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