INFLATION AND MONETARY POLICY IN SEPTEMBER 2014

A.Bozhechkova

The consumer price index stood at 0.7% in October 2014 (0.2% in September 2013), 0.5 p.p. higher than the value observed in August this year. Therefore, inflation increased to 8.0% on an annualized basis. The consumer price index reached 0.7% within the first 20 days of October. On September 20 the Bank of Russia for the first time provided commercial banks with $581,4m of foreign currency through foreign exchange swap operations. The operations are intended to increase commercial banks' capability to manage their short-term foreign exchange liquidity.

Inflation accelerated in the Russian Federation in September this year: he consumer price index stood at 0.7% at month-end (0.2% in August this year), by 0.5 p.p. above the value observed in 2013. Therefore inflation reached 8.0% on an annualized basis (*Fig. 1*). Core inflation[1] stood at 0.9% in September 2014, up 0.2 p.p. against the value observed last year. The increase in the core inflation in 2014 from 5.5% on an annualized basis in January to 8.2% in September 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.

Prices of food products in September this year increased 1.0% compared to August 2014 (*Fig. 2*). 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 September In particular, prices of the following food products kept growing: meat and poultry (from 2.5% in August to 2.9% in September), fish and seafood products (from 1.4% in August to 1.9% in September). Price growth rates of the following food products slowed down: fruits and vegetables (from -10.7% in August to -1.2% in September) and eggs (from -4.8% in August to 1.9% in September). Furthermore, the following food products also saw growth in the price: butter (from 0.5% in August to 0.6% in September), pasta products (from 0.0% in August до 0.5% in September), milk and dairy products (from 0.2% in August to 0.8% in August). Price growth rates of the following food products slowed down: alcoholic beverages (1.1% in August, 0.6% in September), bread and flour products (from 0.5% in August to 0.3% in September). Prices of granulated sugar dropped (to - 4.0% in September, up 1.0% in August) while prices of sunflower oil remained unchanged (-0.4% in August).

In September prices and tariffs of retail paid services increased 0.3%, while in in August they increased 0.7%. Overall, tariffs of public utilities in September increased 0.6% (0.6% in August). Prices of the following services dropped: international travel services (from 1.6% in August to -1% in September), passenger transport services (from 0.6% in August to -2.9% in September), sanatorium and therapeutic services (from 0.2% in August to -2.5% in September). Growth rates of prices of the following services saw slowdown: medical services (from 0.8% in August to 0.6% in September), insurance services (from 1.2% in August to 1.1% in September). Growth rates of prices of the following services accelerated: preschool education services (from 0.2% in August to 1.1% in September), education services (from 1.8% in August to 4.7% in September).

In September, growth rates of prices of non-food products reached 0.6%, up 0.1 p.p. compared to those observed in August. Prices of the following non-food products kept growing: footwear (from 0.4% in August to 0.9% in September), clothes (from 0.4% in August to 0.8% in September), knitwear (from 0.3% in August to 0.8% in September). Growth rate of prices of the following non-food products slowed down: motor gasoline (from 1,5% in August to 1% in September), tobacco products (from 2.0% in August to 1.7% in September).

Overall, in September 2014, food products contributed 51.3%, non-food products 26.1%, prices and tariffs of retail paid services 22.5% to the inflation growth rate on an annualized basis.

At the end of the 20th day of October the consumer price index was 0.7% (overall 0.6% in October 2013). It's worth noting that inflation will be boosted up till

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).

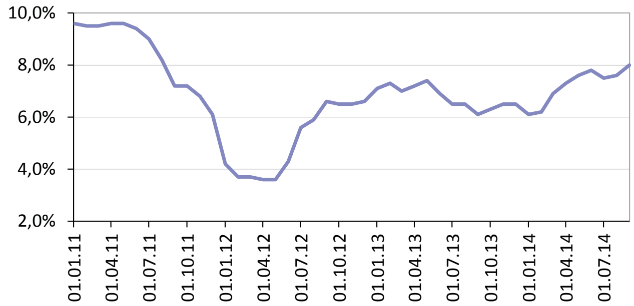
the end of the year through the effect of reciprocal sanctions imposed by Russia and western countries and the devaluation of the ruble. A new round of devaluation of the national currency in October will inevitably result in further acceleration of inflation early in 2015, making it basically impossible to reach a target inflation rate of 4.5% for 2015 as set forth by the "Guidelines for the Single State Monetary Policy ...". 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 September 2014, the monetary base (broad definition) increased 4.3% to Rb 9947.9bn (*Fig. 3*). The following components of the broad monetary base saw an increase: banks' deposits (up 61.3% to Rb 216.1bn), banks' correspondent accounts (up 37.4% to Rb 1359bn). The following components of the broad monetary base saw a decline: the volume of cash in circulation including cash balances in credit institutions (down 0.3% to Rb 7943.8bn) and obligatory reserves (down 4.3% to Rb 429.4bn). The monetary base (narrow definition) (cash plus obligatory reserves) in September contracted by 0.5% to Rb 8373.2bn (*Fig. 4*).

In September, commercial banks' reserves amounted to Rb 1290.5bn, with mandatory reserves on special accounts with the Central Bank amounting to Rb 429.4bn, while the average value of reserves in the period between 10.09.2014 and 10.10.2014 amounted to Rb 861.1bn. In the period of 10.08.2014 thru 10.09.2014, the volume of excess reserves at commercial banks[1] amounted to Rb 355.4bn on average, of which banks' deposits on accounts with the Central Bank averaged Rb 213.9bn, while correspondent accounts less the averaged amount of reserves amounted to Rb 141 on average during the period under review.

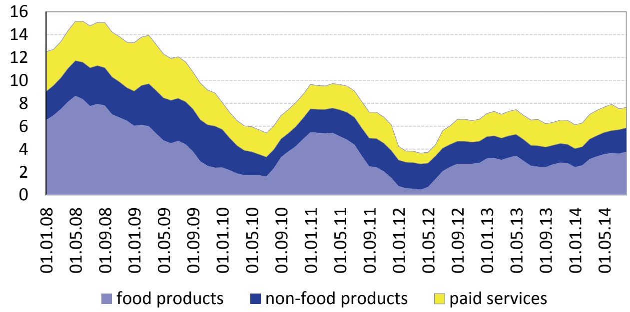
As of October 1, 2014, banks' debt to the regulator reached Rb 5.64 trillion, an increase of 3.5% since the beginning of September. Banks' repo debt reached Rb 2.5 trillion, up 4.3%, while the debt on loans secured by non-market assets reached Rb 2.9 trillion, up 7.0%. According to the data available as of October 28, 2014, banks' repo debt increased up to Rb 2,9 trillion, while the debt on other loans increased to the same amount (Rb 2,9 trillion). It's worth noting that the Bank of Russia used REPO operations at a flat rate, with a daily average of Rb 76.6bn allocated in September, Rb 12,3bn in October.

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.



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)

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 September averaged 7.9% (7.9% in August 2014). In the period of October 1 thru October 27, 2014 the average interbank interest rate stood at 8.1% (*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. Amid the devaluation of the ruble, however, the liquidity provided by the Central Bank is instantly traded in the FX market, thereby increasing the pressure upon the ruble. At the same time, the Bank of Russia keeps spending the reserves to slow down the devaluation of the national currency. This policy can, in our opinion, do nothing but just feed the devaluation expectations among economic agents, stretching the period of devaluation. Furthermore, the international reserves are being wasted in many respects.

The Bank of Russia provided banks with Rb 505.5bn 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 September 8, 2014. However, only large banks which

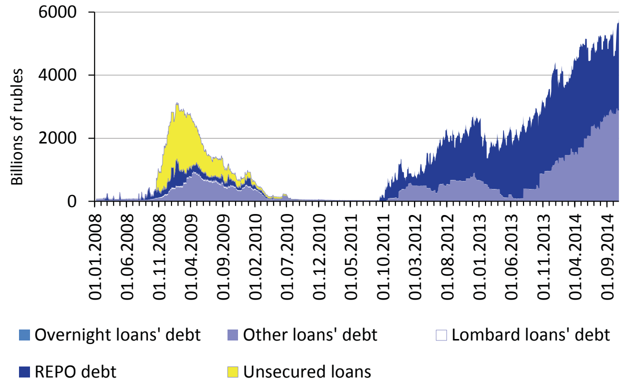
2 Interbank interest rate is the monthly average MIACR, an interest rate on ruble-denominated overnight interbank loans.

have the required collateral can afford such actions despite very beneficial terms of lending at a floating interest rate. The regulator allocated Rb 596.1bn at a rate of 8.25% p.a. to credit institutions as part of a 3-month auction held on October 13, 2014. It's worth noting that in September the regulator has increased to Rb 700bn the maximum amount of money to be allocated due to the projected seasonal increase in commercial banks' demand for liquidity. In November this value was set Rb 900bn. It's worth noting that on November 10, 2014 the Bank of Russia plans to hold an repo auction secured by non-market assets for 18 months. 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 well as mounting banks' debt on refinancing operations.

On September 30, the Bank of Russia provided commercial banks with $581.4m through foreign exchange swap operations. The operations amounted to $473.1m on the 2nd of October, $285.0m on the 3rd of October, $137m on the 7th of October. This instrument is designed to narrow the gap between the foreign currency demand and supply on specific dates. It's worth noting that a relatively weak demand for such operations is determined by high level of interest rates (the interest rate on the ruble and foreign currency part of a transaction is 7% and 1.5% p.a. respectively). It's worth noting that the Bank of Russia plans to hold a 28-day and one-week USD repo auction on October 29–30, 2014. Repo transactions can be secured by all of the securities, except shares, included in the Lombard List of the Bank of Russia. These operations are intended to extend banks' potential to manage short-term foreign currency liquidity amid strong demand for the same.

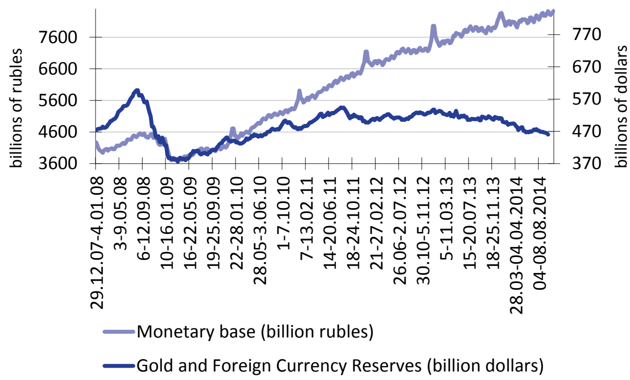
As of September 1, 2014, the Central Bank's international reserves amounted to $454.2bn, shrinking by 10.9% year to date (*Fig. 4*). At the same time, the monetary gold reserves shrank by $2.5bn in in September 2014 due to a negative revaluation of assets.

In September the regulator didn't undertake currency interventions (*Fig. 6*). However, the volume of currency interventions aimed at selling foreign currencies reached $18.6bn within 27 days in October. In the period of October 1 thru October 27, the limits of the floating currency trading band of acceptable ruble denominated values of the dual-currency basket were shifted repeatedly (a total shift was Rb 3) to reach Rb 38.4–47.4. It is falling crude oil prices, as well as persisting geopolitical tensions amid deteriorating economic situation in the Russian Federation that became the key factors of the ruble devaluation.



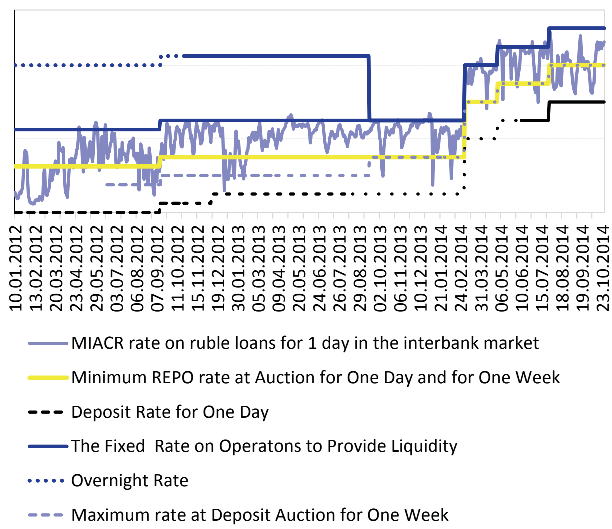
Source: The Central Bank of Russia.

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



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



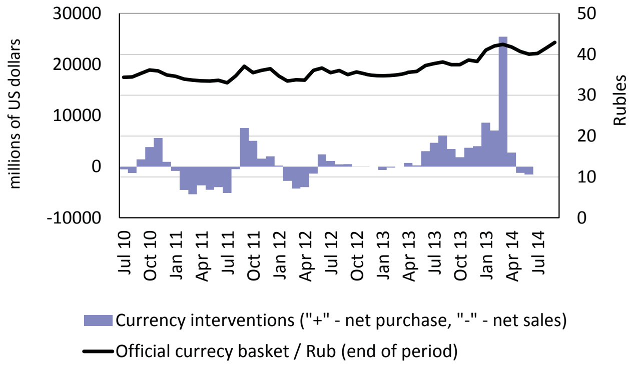
Source: The Central Bank of Russia.

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

According to the Bank of Russia's preliminary estimates, net capital outflow from the country reached $13.0bn in Q3 2014, 1.25 times the amount observed during the same period in 2013. Overall, capital outflow amounted to Rb 85.2bn withing the past three quarters, 1.9 times the amount observed in the period between January and September in 2013. Russia saw $61.0bn of capital outflow within 12 months in 2013. Within the past three quarters net capital exports by the banking sector and other sectors reached $16.1bn and $69.1bn. A substantial capital outflow from Russia was determined by economic slowdown in the country as well as the geopolitical turmoil.

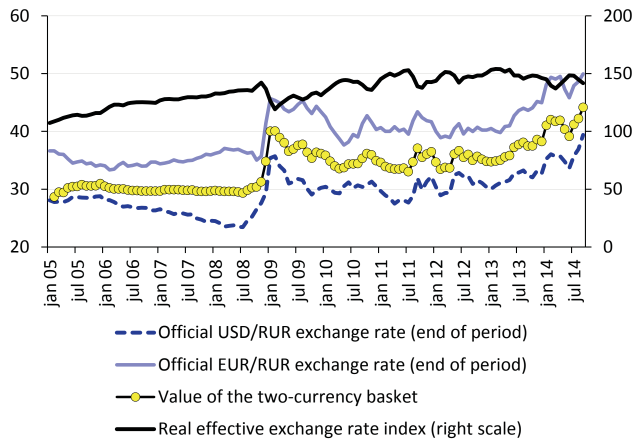
In September 2014, the real effective exchange rate of the ruble weakened by 2.1% (-2.4% in August 2014). Overall, in Q3 2014 the real effective exchange rate increased 0.2% against Q2 2014. In the period of January 2014 to September 2014 the real effective exchange rate lost 4.8% compared to the corresponding period in 2013 (*Fig. 7*).

In September, the dollar-ruble exchange rate increased 5.6% to Rb 39.4, while the euro-ruble exchange rate gained 2.1% (Rb 49.98). The euro-dollar exchange rate averaged 1.29 during the same month. In the period of August 2014 to October 2014 the US dollar exchange rate gained because market players were expecting higher FRS interest rates and the Eurozone was facing an adverse economic situation. The dual-currency basket gained 3.8% to Rb 44.15. Upon the first 29 days of October the dollar-ruble exchange rate increased 7.6% to Rb 42.4 while the euro-ruble exchange rate went up 7.8% to Rb 53.9, thereby increasing to Rb 47.6 the value of the dual-currency basket, up 7.7%. The euro-dollar exchange rate averaged 1.27 in October this year.



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 September 2014



Source: The Central Bank of Russia.

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