INFLATION AND MONETARY POLICY IN OCTOBER 2014

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The consumer price index stood at 0.8% in October 2014 (0.6% in October 2013), 0.1 p.p. higher than the value observed in September. As a result, inflation boosted up to 8.3% at an annualized rate. The consumer price index reached 1.0% as of the 24th day of November. The Bank of Russia decided the 10th of November to discontinue the existing exchange rate formation mechanism, abandoning the interval of allowed values for the euro-dollar basket and regular interventions within currency trading band boundaries and beyond.

Inflation accelerated in the Russian Federation in October this year: the consumer price index stood at 0.8% at month-end (0.7% in September this year), 0.2 p.p. above the value observed in 2013. Therefore, inflation reached 8.0% at an annualized rate (*Fig. 1*). Core inflation[1] stood at 0.8% in October 2014, down 0.1 p.p. against the value observed last year. The increase in the core inflation in 2014 from 5.5% at an annualized rate in January to 8.4% in October 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 October this year increased 1.2% compared to September 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, the following food products saw price growth rates in October: fruits and vegetables (to 2.8% in October from -1.2% in September), butter (to 1.2% in October from 0.6% in September), milk and dairy products (to 1.2% in October from 0.8% in September), grains and beans (from -0.1% in September до 0.1% in October), sunflower oil (to 0.2% in October from -0.4% in September). Price growth rates of the following food products slowed down: meat and poultry (to 1.3% in October from 2.9% in September), fish and seafood products (to 1.8% in October from 1.9% in September), eggs (to 1.0% in October from 1.9% in September), pasta products (to 0.2% in October from 0.5% in September), alcoholic beverages (0.6% in September, 0.5% in October), bread and flour products (to 0.3% in October from 0.5% in September). Prices of granulated sugar kept down (-3.0% in October, -4.0 in September).

Prices and tariffs of retail paid services increased 0.6% in October while in September they increased 0.3%. Overall, tariffs of public utilities increased 1.0% in October (0.6% in September). Growth rates of prices of the following services saw slowdown: passenger transport services (to -1.4% in October from -2.9% in September), sanatorium and therapeutic services (to -1.7% in October from -2.5% in September). The same is true with education services (to 2.0% in October from 4.7% in September), preschool education services (to 0.9% in October from 1.1% in September), medical services (to 0.4% in October from 0.6% in September), physical culture and sports services (to 0.5% in October from 1.6% in September). Growth rates of prices of the following services accelerated: international travel services (to 0.9% in October from -1% in September), insurance services (to 2.8% in October from 1.1% in September).

In October, growth rates of prices of non-food products reached 0.6% like in August. Prices of the following non-food products kept growing: footwear (to 1.1% in October from 0.9% in September до), clothes (to 1.1% in October from 0.8% in September), knitwear (to 1.1% in October from 0.8% in September). Growth rate of prices of the following non-food products accelerated: motor gasoline (to 1.2% in October from 1% in September), electrical products and other home appliances (to 0.6% in October from 0.4% in September). The decline on prices of audio-visual goods gave way to growth (-0.1% – in September, 0.1% – in October). Growth in prices of tobacco products slowed down (to 1.1% in October from 1.7% in September).

Overall, in October 2014, food products contributed 50.1%, non-food products 25.8%, prices and tariffs of retail paid services 24.1% to the inflation growth rate on an annualized basis.

The consumer price index as of the 24th of November stood at 1.0% (overall 0.6% in November 2013).

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).

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. A new round of devaluation of the national currency in October–November will inevitably result in further acceleration of inflation early in 2015. 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.

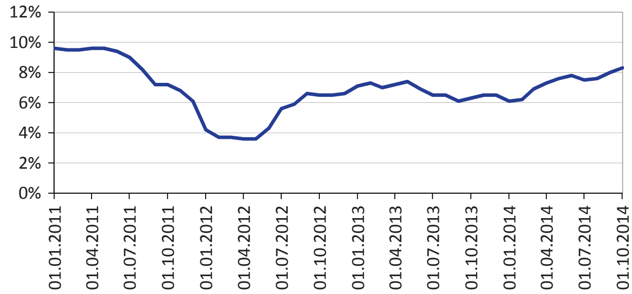
In October 2014, the monetary base (broad definition) decreased 4.3% to Rb 9646,4bn (*Fig. 3*). The following components of the broad monetary base contracted: banks' deposits (down 34.6% to Rb 141,4bn), banks' correspondent accounts (down 21.2% to Rb 1070,9bn). The following components of the broad monetary base increased: the volume of cash in circulation including cash balances in credit institutions (up 0.7% to Rb 7999bn) and obligatory reserves (up 1.3% to Rb 435,1bn). The monetary base (narrow definition) (cash plus obligatory reserves) in October increased 0.5% to Rb 8434,1bn (*Fig. 4*).

In October, commercial banks' reserves amounted to Rb 1306,8bn, with mandatory reserves on special accounts with the Central Bank amounting to Rb 435,1bn, while the average value of reserves in the period between 10.10.2014 and 10.11.2014 amounted to Rb 871,7bn. In the period of 10.10.2014 to 10.11.2014, the volume of excess reserves at commercial banks[1] amounted to Rb 282,3bn on average, of which banks' deposits on accounts with the Central Bank averaged Rb 109,4bn, while correspondent accounts less the averaged amount of reserves amounted to Rb 172,9bn on average during the period under review.

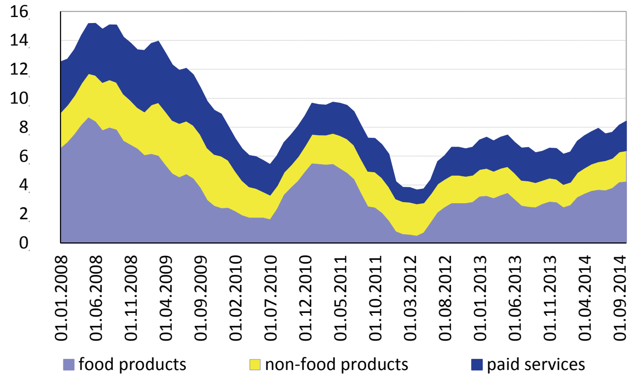
As of November 1, 2014, banks' debt to the regulator reached Rb 6,16 trillion, an increase of 9.1% since the beginning of September. Banks' repo debt reached Rb 2,9 trillion, up 15.7%, while the debt on loans secured by non-market assets reached Rb 2,9 trillion, up 4.5%. According to the data available as of November 27, 2014, banks' repo debt increased up to Rb 3,1 trillion, while the debt on other loans amounted to Rb 2,98 trillion. The Bank of Russia used REPO operations at a flat rate, with a daily average of Rb 22,1bn allocated in October, Rb 160bn in November.

During the period under review the MIACR on overnight interbank loans denominated in rubles broke through the upper boundary of the currency trading band between November 21 and 26. REPO operations at a flat rate increased drastically, averaging Rb 286bn, in the same period. It's worth noting that the MIACR growth is conditioned to the Bank of Russia's decision to temporally impose limits on the provision of liquidity in order to stabilize the foreign exchange market, as well as the beginning of new fiscal period. The interbank interest rate[2] averaged 8.24% (7.9% in September 2014). In the period of November 1–27, 2014 the average interbank interest rate stood at 10.2% (*Fig. 5*).

The Bank of Russia provided banks with Rb 596,1bn at a cut-off rate of 8.25% p.a. as part of a 3-month REPO auction secured by non-market assets held on October 13, 2014. However, only large banks which have the required collateral can afford such auction despite very beneficial terms of lending at a floating interest rate. The regulator allocated Rb 561,9bn at a rate of 9.75% p.a. to credit institutions as part of a 3-month auction held on November 10, 2014. In November the regulator increased to Rb 900bn the maximum amount of money to be allocated due to the projected seasonal increase in commercial banks' demand for liquidity. The Bank of Russia also held



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)

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.

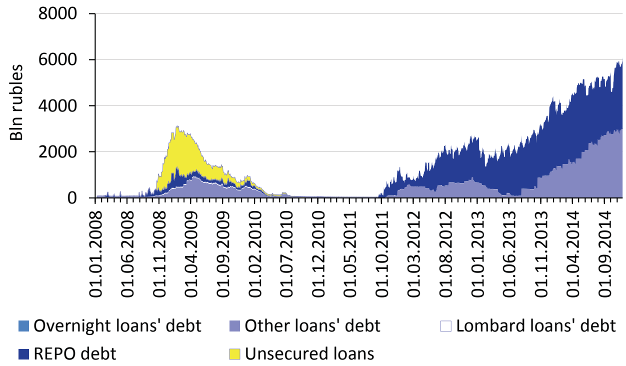
2 Interbank interest rate is the monthly average MIACR, an interest rate on ruble-denominated overnight interbank loans.

on November 10, 2014 a REPO auction secured by non-market assets for 18 months, at which banks obtained Rb 150bn at a rate of 9,75%, corresponding to the maximum volume of funds to lend. 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.

In October, the Bank of Russia provided commercial banks with $896,1m through foreign exchange swap operations. As a reminder, 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 8.5% and 1.5% p.a. respectively). The volume of foreign exchange provided at the USD repo auction amounted to $19,9m at an average weighted rate of 1.63% for one week, $512,3m at an average weighted rate of 1.66% for 28 days, $87,7bn at an average weighted rate of 2.14% for 12 months. Weak demand for fundraising at such auctions is associated with that credit institutions are facing no deficit no currency liquidity deficit.

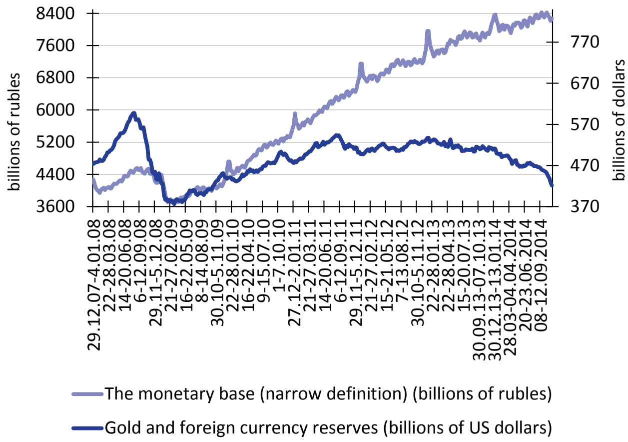
As of November 1, 2014, the Central Bank's international reserves amounted to $428,6bn, shrinking by 15.9% year to date (*Fig. 4*). At the same time, the monetary gold reserves shrank by $0,5bn in in September 2014 due to a negative revaluation of assets.

In October, the regulator undertook currency interventions of $27,2bn and 1,6bn euro (*Fig. 6*). In November, currency interventions were undertaken only on the 6th, 7th and 10th of the month, totaling $1,05bn. In October , the floating currency trading band boundaries of acceptable ruble value of the dollar-euro basket were shifted repeatedly (a total shift was Rb 4.1) to reach Rb 39,55–48,55. 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 in October. The Bank of Russia made a key decision on the 10th of November to discontinue the existing exchange rate formation mechanism, abandoning the interval of allowed values for the euro-dollar basket and regular interventions within currency trading band boundaries and beyond. Indeed, the previous currency interventions of the Bank of Russia failed to stabilize the ruble exchange rate while lowered the international reserves adequacy level which also determines the credit rating and international stability of the country.



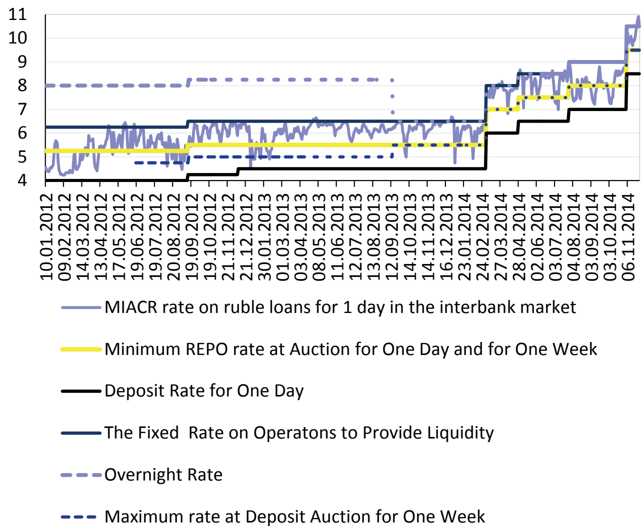
Source: The Central Bank of Russia.

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.)

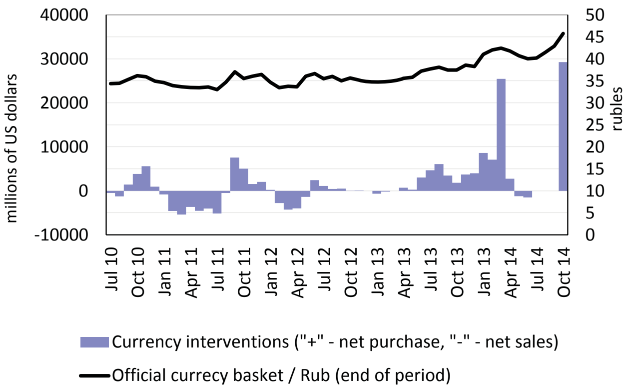
According to the Bank of Russia's preliminary estimates, net capital outflow from the country reached $13,0bn in Q3 2014, 1.25 times the amount observed during the same period in 2013. Overall, capital outflow amounted to Rb 85,2bn within the past three quarters, 1.9 times the amount observed in the period between January and October in 2013. Russia saw $61,0bn of capital outflow within 12 months in 2013. Within the past three quarters of 2014 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 October 2014, the real effective exchange rate of the ruble weakened by 5.5% (-2.3% in September 2014). Overall, in Q3 2014 the real effective exchange rate increased 0.1% against Q2 2014. In the period of January 2014 to October 2014 the real effective exchange rate lost 5.3% compared to the corresponding period in 2013 (*Fig. 7*).

In October 2014, the dollar-ruble exchange rate increased 6.5% to Rb 41,96, while the euro-ruble exchange rate gained 5.5% (Rb 52,72). The euro-dollar exchange rate averaged 1.27 during the same month. 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 dollar-euro currency basket gained 6.% to Rb 46,8. As of the 28th day of November, the dollar-ruble exchange rate increased 13.6% to Rb 47,7 while the euro-ruble exchange rate went up 13.1% to Rb 59.6, thereby increasing to Rb 53.0 the value of the dollar-euro currency basket, up 13.3%. The euro-dollar exchange rate averaged 1.25 in November this year.

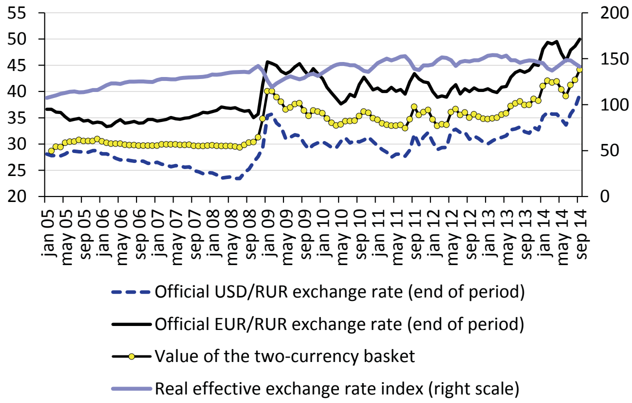
One can anticipate the decision to lift the key interest rate amid rapid contraction of the international reserves, regulator's transition to a floating exchange rate regime and inflation targeting. Given a high probability of inflation being higher than 8% at year end, setting beyond zero the real key interest rate may become an important factor of price growth rates. It's worth noting that such a tightening of the monetary policy may in the mid run entail higher credit contraction risks and further slow down growth rates of the Russian economy.

We also believe that the decision to lift the interest rate can hardly replace the rates of ruble devaluation which allows market buyers of foreign currencies to earn more than 1% daily. At the same time, in an effort



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 October 2014



Source: The Central Bank of Russia.

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

to maintain the target level of the interest rate, the Central Bank repeatedly provides credit institutions with new ruble liquidity which instantly appears in the foreign exchange market. Under the circumstances, it is only contraction of the excess reserves at commercial banks accompanied by substantial growth in interest rates in the interbank lending market that can stabilize the situation in the foreign exchange market (with the same macroeconomic and political factors in place).

This is why on the 11th of November the Bank of Russia imposed a limit on the provision of ruble liquidity using currency swap operations. The limit will equal $2bn in equivalent daily within a period of November 12–30, 2014. Additionally, the regulator limited volumes of funds provided as part of 1-week REPO operations for more than Rb 100bn compared to the previously predetermined parameters.