INFLATION AND MONETARY POLICY IN NOVEMBER 2014

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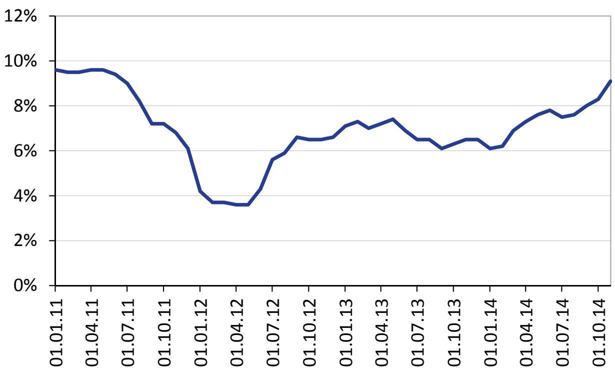
In November 2014, the Consumer Price Index (CPI) amounted to 1.3% (vs. 0.6% in November 2013), which is 0.5 p.p. above its value recorded in October. In response to the mounting panic in the foreign exchange market, from 16 December the Bank of Russia raised its key interest rate to 17% per annum in an attempt to curb the ruble's rapid depreciation.

In November, the inflation rate in the Russian Federation was once again on the rise: the Consumer Price Index (CPI), as seen by the month-end results, amounted to 1.3% (vs. 0.8% in October 2014), which is 0.7 p.p. above the same index for 2013. As a result, the inflation rate in per annum terms climbed to 9.1% (Fig. 1). The core inflation rate[1] in November 2014 was 1.0%, which is below its index for the same period of last year by 0.5 p.p.

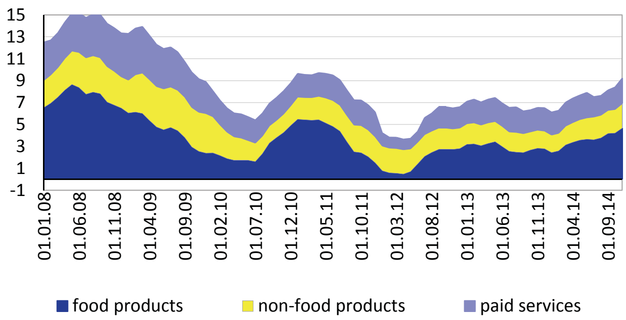
The prices of foodstuffs in November rose by 2.0% (vs. 1.2% in October 2014) (*Fig. 2*). It should be noted that the significant factor responsible for the upward movement of prices was the introduction of restrictions on supplies of certain agricultural products and foodstuffs from the USA, Canada, Australia, Norway and the European Union. The growth rates displayed by prices for the following products were on the rise: grains and beans (from 0.1% in October to 15.3% in November), fruit and vegetable products (from 2.8% in October to 8.7% in November), granulated sugar (from -3.0% in October to 8.5% in November), eggs (from 1.0% in October to 7.8% in November), sunflower oil (from 0.2% in October to 2,2% in November), pastas (from 0.2% in October to 1.3% in November), bread and bakery products (from 0.3% in October to 0.7% in November). The growth rate of prices for meat and poultry products declined (from 1.3% in October to 0.2% in November). The growth rate of prices for butter likewise became slower (dropping from 1.2% in October to 1.1% in November), as did the growth rate of prices for milk and dairy products (declining from 1.2% in October to 1.0% in November). The growth rate of prices for fish and seafood remained unchanged (1.8% in both October and November), as did that of prices for alcoholic beverages (0.5% in both October and November).

The growth rate of the prices and tariffs established for commercial services rendered to the population in November increased by 1.2% vs. 0.6% in October. The overall growth displayed by housing and utilities tariffs in November amounted to 1.9% (vs. 1.0% in October). The downward movement of prices for passenger transport services and the services of health resorts became slower (changing from -1.4% in October to -0.5% in November, and from -1.7% in October to -1.1% in November respectively). Slower growth rates were displayed by the prices for services in the education system (a decline from 2.0% in October to 1.9% in November), pre-school education (a decline from 0.9% in October to 0.3% in November), and physical culture and sport (a decline from 0.5% in October to 0.4% in November). Faster growth rates were observed with



Source: Rosstat.

Fig. 1. The CPI Growth Rate in 2011–2014 (% Year-on-Year)



Source: Rosstat.

Fig. 2. Inflation Factors in 2008–2014 (%, Month on Same Month of Previous Year)

1 The core consumer price index reflects the level of inflation on the consumer market after adjustment for the seasonal (prices of vegetable and fruit products) and administrative (regulated tariffs for certain types of services, etc.) factors. This index is also calculated by the RF Statistics Service (Rosstat).

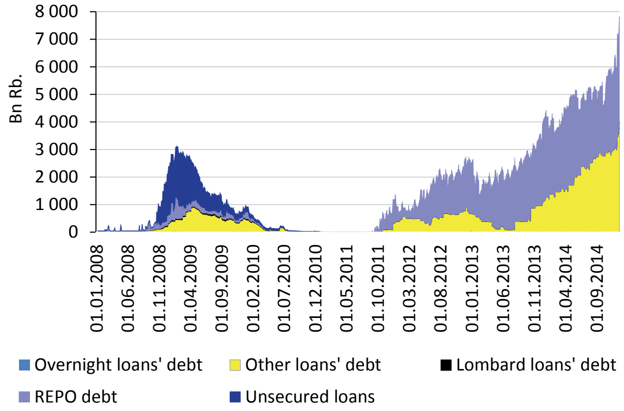
regard to the prices of out-bound tourism services (an increase from 0.9% in October до 3.0% in November), insurance services (an increase from 2.8% in October to 3.2% in November), and medical services (an increase from 0.4% in October to 0.6% in November).

In November, the growth rate displayed by the prices of nonfood commodities amounted to 0.6%, thus remaining at the same level as in October. An accelerated upward movement was demonstrated by the growth rate of prices for electrical equipment and other household utensils (an increase from 0.6% in October to 0.9% in November), and radio and television sets (0.1% in October vs. 0.8% in November). Declining growth rates were displayed by prices for the following items: tobacco products (from 1.1% in October to 0,8% in November), pharmaceuticals (from 1.3% in October to 0.9% in November), footwear (from 1.1% in October to 0.6% in November), clothes (from 1.1% in October to 0.8% in November), knitwear (from 1.1% in October to 0.9% in November), and motor gasoline (from 1.2% in October to 0.7% in November).

Thus, November's contribution to the per annum inflation growth rate amounted to 50.6% with regard to the prices of foodstuffs; to 24,4% with regard to the prices of nonfood commodities, and to 25.0% with regard to the prices and tariffs established for commercial services rendered to the population.

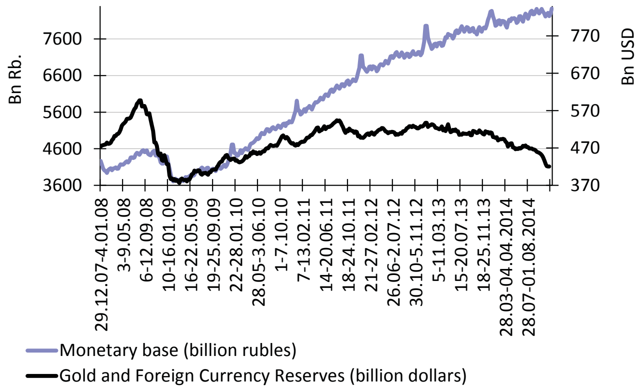
The CPI, as determined by the results of the period of 1–15 December, amounted to 0.8% (vs. 0.5% for the period of 1–31 December 2013). The inflation rate will continue to be pushed up by the mutual economic sanctions imposed by Russia and the Western countries, as well as by the effects of the ruble's weakening. A new plunge of the ruble's exchange rate over the course of November–December 2014 will inevitably translate itself into a new surge of the inflation rate in early 2015. The main factors capable of suppressing the inflation rate's upward movement will be an absence of demand's upward pressure on the price level, and the Bank of Russia's measures designed to toughen its monetary policy.

In November 2014, the broad monetary base increased by 3.2% to Rb 9,950.9bn (*Fig. 3*). Among the increasing components of the broad monetary base one may point to the following ones: banks' deposits (growth by 33.6% to Rb 188.9bn), the monies kept on commercial banks' correspondent accounts with the RF Central Bank (growth by 29.0% to Rb 1,381.4bn), required reserves (growth by 5.4% to Rb 458.6bn). The volume of cash in circulation, including the cash balances of credit institutions, declined (by 1.0% to Rb 7,922.1bn). The narrow monetary base (currency issued by the Bank of Russia plus required reserves)



Source: RF Central Bank.

Fig. 3. The Movement of Commercial Banks' Debt to the Bank of Russia in 2008–2014



Source: RF Central Bank.

Fig. 4. Behavior of Russia's Narrow Monetary Base and Gold and Foreign Currency (International) Reserves in 2007–2014

over November shrank by 0.6%, thus amounting to Rb 8,380.7bn (*Fig. 4*).

In November, the volume of reserves held by commercial banks amounted to Rb 1,367.6bn, having increased on October by 4.7%; besides, the volume of required reserves held on special accounts with the RF Central Bank amounted to Rb 458.6bn (growth by 5.4% on October), while the average amount of reserves over the period from 10 November 2014 to 10 December 2014 – to Rb 909.0bn (growth by 4.3% on the previous period). Over the period from 10 November 2014 to 10 December 2014, the surplus reserves held by commercial banks[1] amounted on the average to Rb 321.2bn (growth by 13.8% on the previous period), of which the average amount of banks' deposits held on their accounts with the RF Central Bank was found to be Rb 138.2bn (growth by 26.3% on the previous period),

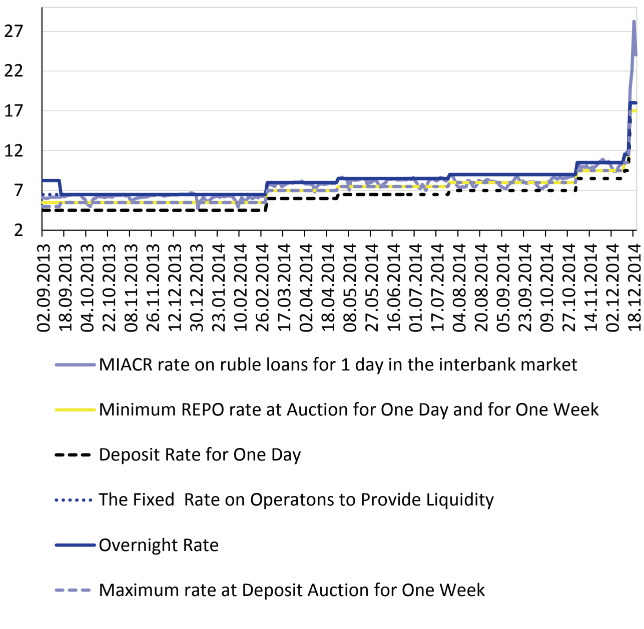
1 The surplus reserves held by commercial banks at the RF CB are understood as the sum of aggregate balance of their correspondent accounts, deposits with the RF CB, and the bonds issued by the RF CB and held by commercial banks, less the average amount of reserves.

while the monies kept on commercial banks' correspondent accounts with the RF Central Bank less the average amount of reserves over the period under consideration amounted to Rb 183.0bn.

As of 1 December 2014, the amount of banks' debt outstanding to the RF Central Bank was Rb 6.74 trillion, having increased since 1 November by 9.5%. The amount of banks' repo debt increased by 13.3% to Rb 3.3 trillion; the amount of banks' debt against loans secured by non-marketable assets rose to Rb 3.1 trillion, having increased by 6.1%. As of 22 December, the amount of banks' repo debt further increased to Rb 3.8 trillion; that of banks' debt against other loans amounted to Rb 3.97 trillion. The Bank of Russia applied a fixed rate of repo transactions: the average daily volume of borrowing in November amounted to Rb 208bn, in December – to Rb 265bn.

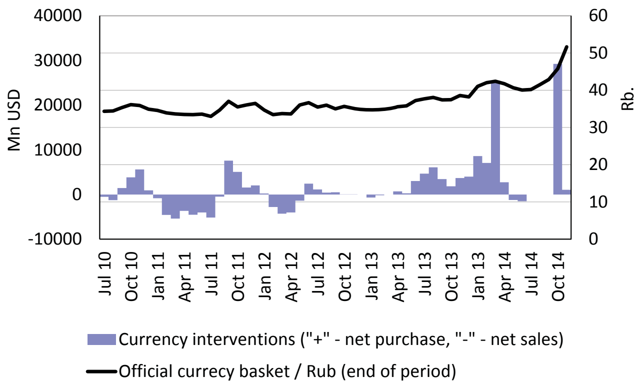
In November 2014, the Moscow Interbank Actual Credit Rate (MIACR) on overnight ruble-denominated interbank loans was rising to levels above the upper border of the interest rate corridor over the period of 21–26 November and on 28 November. That period saw a surge in the volume of fixed-rate repo operations, which amounted on the average to Rb 336bn. Over the period from 10 through 19 December, the MIACR once again surged above the upper border of the interest rate corridor over, while the average volume of repo operations conducted at the Bank of Russia's fixed interest rate amounted to Rb 340bn. The interbank interest rate[1] in November was on the average at the level of 10.2% (vs. 8.24% in October 2014). Over the period from 1 through 19 December, the average interbank interest rate amounted to 13.9% (*Fig. 5*). It should be noted that the growth of MIACR can be explained by the Bank of Russia's decision to impose temporary liquidity constraints in order to achieve some stabilization of the foreign exchange market. The surge of the interbank interest rate from 16 December onwards was its response to the key interest rate having been raised to 17% per annum.

In November, no currency swap transactions (their purpose being to provide the banking system with foreign exchange liquidity) were carried on. The low demand for such transactions displayed by banks can be explained by high interest rates (the interest rate on the ruble-denominated component in November amounted to 8.5% per annum, from 12 December – to 9.5% per annum, from 16 December – 18% per annum; the interest rate on the component denominated in foreign currencies amounted to 1.5%). In November 2014, the allotted amounts for the 1-week FX REPO auction at a weighted repo rate of 1.63%, the 28-day FX REPO auction at a weighted repo rate of 1.66%, and the 12-month FX REPO auction at a weighted repo rate of 2.14% were $ 19.9m, $ 512.3m, and $ 87.7m respectively. As of 22 December, the volume of foreign currency obtained as repo loans amounted to $ 880.4m at the average weighted one-week repo rate of 1.4%, $8.9bn at the average weighted 28-day repo rate of 1.65%, and $4.9bn at the average weighted 12-month repo rate of 1.12%. It should be noted that the popularity of foreign exchange repo auctions in December 2014 increased due to the Bank of Russia's decision to set its foreign exchange repo rate at LIBOR plus 0.5 percentage points. The reduced rates on liquidity provision operations will serve as an instrument for properly balancing supply and demand on the foreign exchange market.



Source: RF Central Bank.

Fig. 5. The Bank of Russia's Interest Rate Corridor and the Interbank Market's Behavior in 2012–2014 (% per Annum)



Source: RF Central Bank.

Fig. 6. The Bank of Russia's Currency Interventions and the Ruble Exchange Rate against the Bi-currency Basket in March 2010 – November 2014

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

As of 1 December 2014, the Bank of Russia's international reserves volume amounted to $ 418.9bn, thus having shrunk since the year's beginning by 17.8% (*Fig. 4*). At the same time, the reserves backed by monetary gold over the month of November shrank by $0.8bn due to a downward adjustment of asset value.

In November, the scale of currency interventions by the Bank of Russia was significantly played down to $ 0.8bn and € 0.2bn (the only interventions over that month took place on 6, 7 and 10 November – *Fig. 6*). It is noteworthy that, on 10 November, the Bank of Russia made a fundamental monetary policy decision when it abolished the previously applied exchange rate mechanism – the bi-currency basket's floating corridor and the CB's regular interventions on Russia's foreign exchange market. True, the Bank of Russia's currency interventions failed to stabilize the foreign exchange rate, while at the same time succeeded in bringing down the international reserves sufficiency level which determines, among other things, a country's credit rating and macroeconomic stability. However in December, in view of the looming threat to financial sustainability, the Bank of Russia once again resorted to currency sales. The total volume of currency interventions over 22 days in December amounted to $ 11.2bn; the transaction involving currency sales by the RF Federal Treasury amounted to $ 0.9bn.

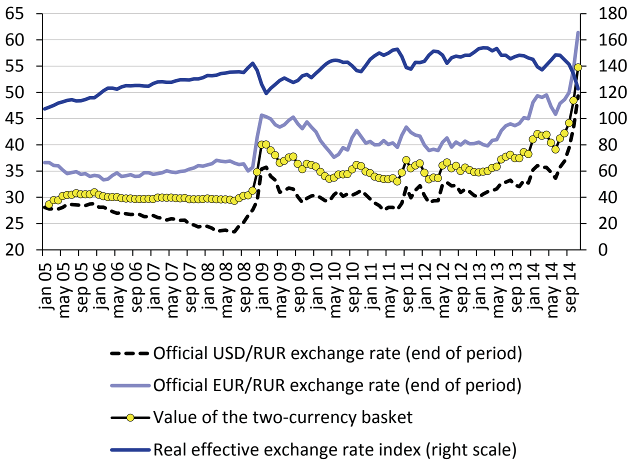
According to the Bank of Russia's preliminary estimates, net capital outflow from Russia in Q3 2014 amounted to $ 13.0bn, which is 1.25 times more than the same index for the corresponding period of 2013. On the whole, the volume of capital outflow for the first three quarters of 2014 exceeded Rb 85bn, thus surging 1.9 times above the corresponding index for January–September 2013. The capital outflow from Russia overa 12 months of 2013 amounted to a total of $ 61bn. Over the first three quarters of 2014, net capital outflow from the banking sector was $ 16.1bn, from the other sectors – $ 69.1bn. Such an impressive scale of capital outflow from Russia was caused, first of all, by the mounting geopolitical tension and worsening economic situation in this country.

In November, the ruble's real effective exchange rate against the two major foreign currencies lost 8.3% (vs. -5.4% in October 2014). As seen by the quarter-end results of Q3 2014, the ruble's real effective exchange rate gained 0.1% on Q2 2014. Over the period of January–November 2014, the ruble's real effective exchange rate declined by 6.4% on the corresponding period of 2013 (*Fig. 7*).

The exchange rate of the US dollar against the ruble over November rose by 23.5% to Rb 51.8, and the euro's exchange rate against the ruble – by 22.2% (to Rb 64.4). In October, the average exchange rate of the euro against the US dollar amounted to 1.25. The US dollar's strengthening against the euro occurred due to the foreign exchange market participants' expectations that the US Federal Reserve System might raise its interest rates, coupled with the adverse economic situation in the eurozone. The value of the bi-currency basket over November increased by 22.8% to Rb 57.5. As seen by the results of the period of 1–23 December, over that month the USD/ruble exchange rate gained 9% and rose to Rb 56.5, while the euro/ruble exchange rate gained 7.5% and amounted to Rb 69.3. As a result, the bi-currency basket's value increased by 8.2% to Rb 62.2. Thus, the average euro/USD exchange rate for November was 1.25.

The ruble's downfall over the period of November–December 2014 was caused by plummeting oil prices, massive capital outflow, mounting international political tension, and increasingly strong depreciation-oriented expectations of foreign exchange market participants. According to our estimations, the ruble's real effective exchange rate significantly deviated from its value linked to fundamental factors alone, including real price of oil and relative labor productivity rate. The significant underestimation of the ruble's exchange rate has to do primarily with the negative expectations of economic agents as a result of a dramatic loss of trust in the RF Central Bank's policy.

At the Bank of Russia Board of Directors' meeting on 11 December 2014, it was decided that the key interest rate should be raised by 1 pp. to 10.5% per annum. However, as early as 16 December, the key interest rate was increased even further – to 17% per annum. It should be noted that, in view of the mounting panic in the foreign exchange market, the dramatic



Source: RF Central Bank.

Fig. 7. Behavior of the Ruble's Exchange Rate Indicators in January 2005 – November 2014

raise of the key interest rate appears to be a well-justified monetary policy measure, because it makes unprofitable the use of short-term ruble-denominated loans for foreign currency purchases with a view towards the ruble's further weakening.

In order to restrict the inflow of ruble liquidity into the foreign exchange market, on 11 November 2014 the Bank of Russia also introduced a limit on the allotment amount of the ruble liquidity using FX swaps. During the period from 12 December through 21 December 2014, the maximum allotment amount was established at $ 2bn per day. It should be noted that on 19 and 22 December the maximum allotment amount was temporarily (each time for one day only) increased to $ 10bn for the purpose of stabilizing the situation on the money market. In a separate development, in early November 2014, Russia's main financial regulator cut the previously planned allotment amounts for 1-week REPO auctions by more than Rb 100bn. It should be said that the aforesaid actions of the Bank of Russia designed to limit banking-sector ruble liquidity can create painful problems for a number of banks, including big ones. In order to prevent such a situation, the Bank of Russia quite reasonably expanded its foreign exchange refinancing operations. Thus, on 16 December 2014, the Bank of Russia increased the maximum allotment amount for 28-day FX REPO auctions from $ 1.5bn to $ 5.0bn and took the decision to conduct 12-month FX REPO auctions on a weekly basis. At the same time, unless devaluation expectations are reduced, it is unrealistic to expect that the expansion of FX REPO operations can stabilize Russia's foreign exchange market, because economic agents are not going to borrow foreign exchange if they expect its price to increase sharply.