INFLATION AND MONETARY POLICY IN RUSSIA IN DECEMBER 2014

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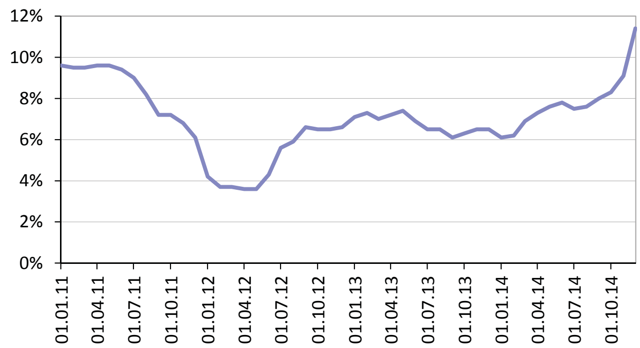
Due to the turmoil in the foreign exchange market, the Bank of Russia lifted on the 16th of December the key interest rate up to 17% p.a. in an effort to stop the ruble's rapid depreciation. In December 2014, the consumer price index stood at 2.6% (0.5% in December 2013), up 1.3 p.p. above the value seen in November. As a result, inflation went up to 11.4% on an annualized basis. The consumer price index reached 1.5% within the first 19 days in January 2015.

Inflation kept accelerating in the Russian Federation in December 2014: the consumer price index stood at 2.6% at month-end (1.3% in November 2014), 2.1 p.p. above the value observed in 2013. Therefore, inflation reached 11.4% at an annualized rate (*Fig. 1*). Core inflation[1] stood 2.6% in December 2014, 2.2 p.p. above the same value last year.

Prices of food products increased 3.3% in December this year (2.0% in November) (*Fig. 2*). It's worth noting that prices of these categories of goods increased in response to Russia's ban on supplies of certain types of agricultural and food products from the United States, Canada, Australia, Norway and the European Union. The following food products saw price growth rates: fruits and vegetables (up to 12.9% in December from 8.7% in November), granulated sugar (8.5% in November, 14.3% in December), eggs (up to 14.5% in December from 7.8% in November), sunflower oil (up to 6.3% in December from 2.2% in November), pasta products (from 1.3% in November up to 3.9% in December), fish and seafood products (1.8% in November up to 3.8% in December), bread and flour products (up to 1.9% in December from 0.7% in November), milk and dairy products (up to 1.7% in December from 1.0% in November), butter (from 1.1% in November up to 1.5% in December) and alcoholic beverages (0.5% in November up to 0.7% in December). The following food products saw their price grow further at high rates: grains and beans (15.3% in November and 11.5% in December). Prices of meat and poultry overtopped the value seen in November 2014 (-0.2% in November, 1.5% in December).

Prices of tariffs of retail paid services in December increased 2.2%, while in November they grew up by 1.2%. Overall, tariffs of public utilities in December increased 0.7% (1.9% in November). Growth rates of prices of the following types of service saw growth: outbound tourism services (from 3.0% in October up to 17.6% in December), preschool education services (from 0.3% in November up to 0.8% in December). The following types of service saw a slowdown: insurance services (from 3.2% in November down to 2.4% in December), education services (from 1.9% in November down to 1.5% in December), services provided in the physical culture and sports sector (from 0.4% in November down to 0.2% in December). Prices of the following types of service stopped growing: passenger transport services (-0.5% in November, 3.4% in December) and sanatorium and therapeutic services (-1.1% in November, 0.1% in December).

In December, growth rates of prices of non-food products reached 2.3%, up 1.7 p.p. over the value seen in November. Prices of the following non-food products increased: electrical products and other home appliances (from 0.9% in November up to 12.0% in December), audio visual goods (0.8% – in November, 14.0% – in December), drugs (from 0.9% in November up to 1.4% in December), constriction materials (from 0.3% in November up to 1.2% in December), tobacco products (from 0.8% in November up to 1.0% in December), clothes (from 0.8% in November up to



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

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).

0.9% in December). Growth rate of the prices of motor gasoline slowed down (from 0.7% in November down to -0.9% in December).

Overall, in December, food products, non-food products, prices and tariffs of retail paid services contributed 49.3%, 26.8%, and 23.9% respectively to the inflation growth rate on an annualized basis.

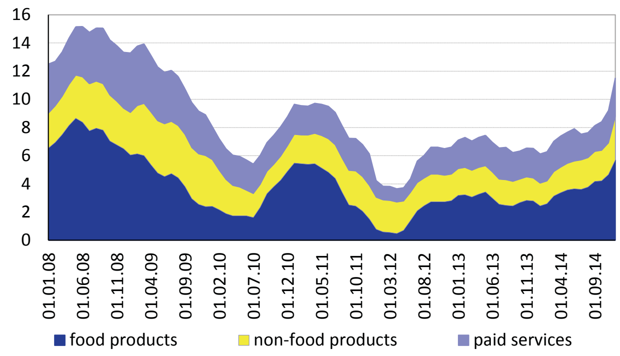
The consumer price index reached 1.5% within the first 19 days of January (0.6% overall in January 2013). Inflation will be boosted up till the end of the year through the effect of reciprocal sanctions imposed by Russia and western countries and the devaluation of the ruble. A new round of devaluation 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 December 2014, the monetary base (broad definition) increased 13.9% to Rb 11332bn (*Fig. 3*). The following components of the broad monetary base increased: bank deposits (up 3.3 times to Rb 804,6bn), the volume of cash in circulation including cash balances in credit institutions (up 11.6% to Rb 8840,5bn), obligatory reserves (up 2.8% to Rb 471,3bn). The funds on banks' correspondent accounts decreased (down 12.0% to Rb 1215,5bn). In December, the monetary base (narrow definition) (cash plus obligatory reserves) increased 11.1% and reached Rb 9311,8bn (*Fig. 4*).

In December, commercial banks' intraday reserves amounted Rb 1438,2bn, overtopping by 5.2% the value seen in November, with mandatory reserves on special accounts with the Central Bank amounting to Rb 471,3bn (up 2.8% compared to November), while the average value of reserves in the period between 10.11.2014 and 10.12.2014 reached Rb 966,9bn (up by 6.4% compared to the previous period). In the period between 10.12.2014 and 10.01.2015, the volume of excess reserves at commercial banks [1] amounted to Rb 829,1bn on average (up 2.6 times compared to the previous period), of which banks' deposits on accounts with the Central Bank averaged Rb 319,7bn (up 2.3 times compared to the previous period), while correspondent accounts, less the averaged amount of reserves, amounted to Rb 509,4bn.

As of January 1, 2015, loans, deposits and other funds raised by credit institutions from the Bank of Russia reached Rb 9,29 trillion, having increased

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: Rosstat.

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

37.7% since the beginning of December. Banks' repo debt diminished by 15.2% to Rb 2,8 trillion, while the debt on loans backed by non-market assets reached Rb 4,5 trillion, up 46.6%. According to the data available as of the 27th of January, banks' repo debt diminished to Rb 2,4 trillion, while the debt on other loans amounted to Rb 4,1 trillion. The Bank of Russia used REPO operations at a flat rate: with a daily average of Rb 212,7bn allocated in December, Rb 71,9bn in January.

In December 2014, the MIACR on overnight interbank loans denominated in rubles broke through the cap of the currency trading band in the period between the 10th and 24th of December. During the same period, repo operations at a flat rate increased rapidly in volume and averaged Rb 298bn. The interest rate in the interbank lending market[2] in December stood at an average of 15.5% (10.2% in November 2014). In the period between the 1st and 26th of January, the average interbank interest rate stood at 17.0% (*Fig. 5*). 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. The substantial increase in the interbank interest rate, beginning on the 16th of December, is determined by the growth in the key interest rate up to 17% p.a.

In December, no FX-swap operations aimed at providing foreign exchange liquidity to the banking system were conducted. A weak demand by banks for such operations can be explained by a high level of interest rates (the interest rate was 8.5% p.a. on the ruble-denominated part of transaction in November, from 9.5% p.a. on the 12th of December, from 16% p.a. on the 16th of December, while the interest rate was 1.5% on the foreign exchange part of transaction). In December, the volume of foreign exchange provided at the USD repo auction amounted to $1,1bn at an average weight-

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

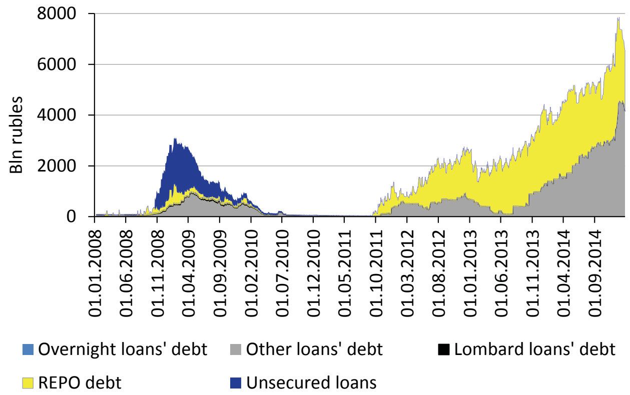
ed rate of 1.3% for the term of 1 week, $15,6bn at an average weighted rate of 1.02% for the term of 28 days, $4,9bn at an average weighted rate of 1.1% for the term of 12 months. According to the data available as of the 27th of January, the volume of foreign exchange provided at the USD repo auction amounted to $4,0bn at an average weighted rate of 0.7% for the term of 1 week, $10,9bn at an average weighted rate of 0.7% for the term of 28 days, $0,8bn at an average weighted rate of 1.2% for the term of 12 months. It's worth noting that the popularity of foreign exchange REPO auctions in December 2014 was boosted by a decision of the Bank of Russia to establish minimum interest rates on this type of auction, equal to LIBOR rates denominated in respective currencies for comparable terms and increased by 0.5 p.p. Lower interest rates on operations providing foreign exchange liquidity will facilitate the balance between supply and demand in the foreign exchange market. It's worth noting that on the 26th of January the Bank of Russia conducted its first credit auctions as part of which the Bank of Russia provided USD loans to credit institutions against pledge of receivables on USD loans. A total of $620m was lent for the term of 28 days at an interest rate of 0.92% p.a. A total of $895m was lent as part of the credit auction for the term of 365 days at an interest rate of 1.55% p.a.

As of December 1, 2014, the Central Bank's international reserves amounted to $385,5bn, shrinking by 24.4% year to date (*Fig. 4*). Facing the escalating threat of financial sustainability in December, the Bank of Russia resumed selling foreign exchange, amounting to $11,9bn (*Fig. 6*). The Bank of Russia's foreign exchange interventions in January were determined by the Federal Treasury selling of foreign exchange, amounting to $2,2bn.

According to the Bank of Russia's preliminary estimates, net capital outflow from the country reached $72,9bn in Q4 2014, which is 4.3 times the amount seen in the corresponding period of 2013. Overall, capital outflow amounted to Rb 151,5bn in 2014, which is 2.5 times the amount seen in 2013. In 2014, net capital outflow through banks and other sectors reached $49,8bn and $101,7bn respectively.

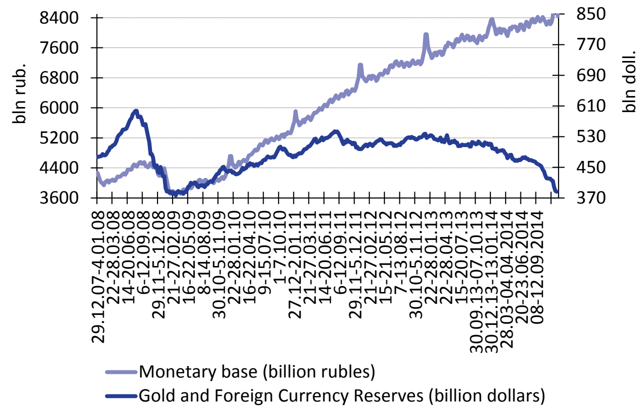
In December, the ruble's real effective exchange rate against other currencies weakened by 13.5% (-8.0% in November 2014). Overall, in Q4 2014, the ruble's real effective exchange rate lost 16.7% relative to that in Q3 2014. In 2014, the ruble's real effective exchange rate depreciated by 27.2% (*Fig. 7*).

The US dollar-ruble exchange rate in December increased 8.6% to Rb 56,2 while the euro-ruble exchange rate gained 6.1% (Rb 68,4). In December, the euro-dollar exchange rate averaged 1.23. The US dollar appreciated against the Euro because the players in



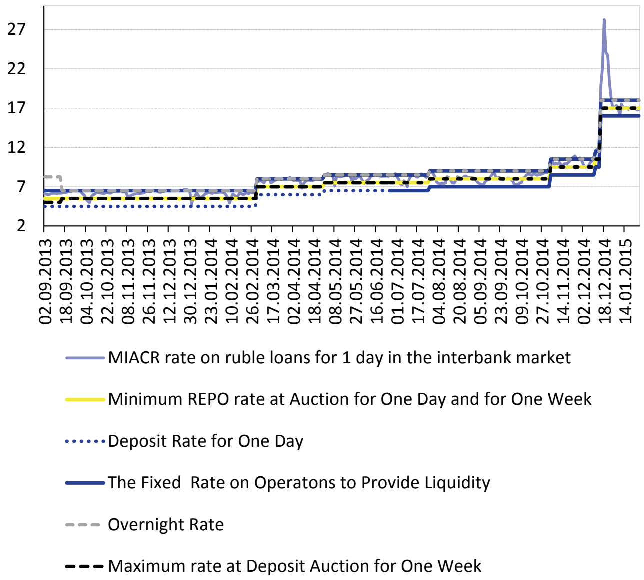
Source: The Central Bank of Russia.

Fig. 3. Commercial banks' debt (on basic instruments) 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 rate band and the dynamics of the interbank lending market in 2012 to 2014 (% p.a.)

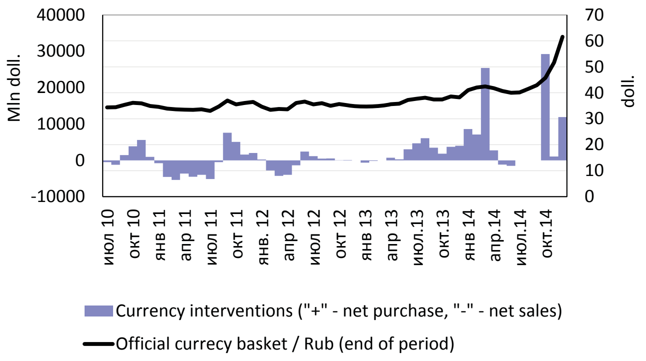
the foreign exchange market expected the FRS to raise interest rates and the economy in the Eurozone was growing below the anticipated value. The value of the dollar-euro currency basket gained 7.3% to Rb 61,7in December. As of the 27th of January, the US dollar gained 20.6% against the ruble, reaching Rb 67,8, while the Euro strengthened 11.6% against the ruble, reaching Rb 76,3. As a result, the value of the dual currency basket appreciated by 16.1% to Rb 71,6. The euro-dollar exchange rate averaged 1.16 in December. It's worth noting that the euro kept depreciating against the US dollar in January in response to the launching of quantitative easing (QE) in the Eurozone, as well as political uncertainty in Greece.

The ruble's depreciation in the period between December 2014 and January 2015 was governed by the substantial fall in crude oil prices, large-scale capital outflow, external political tensions, foreign exchange market players' reinforced expectations about ruble's devaluation. According to our estimates, the ruble's real effective exchange rate has substantially deviated from the level determined by the fundamental factors, including the real crude oil price, relative level of labor productivity. Considerable underestimation of the ruble is first of all associated with economic agents' negative expectations caused by drastically lowered confidence in the central bank's policy.

On December 11, 2014, the Bank of Russia Board of Directors decided at its regular meeting to lift the key interest rate by 1 p.p. up to 10.5% p.a. However, as early as the 16th of December, the key interest rate was increased to 17% p.a. It's worth noting that the drastic increase in the key interest rate is, in our opinion, a reasonable short-run monetary policy amid panic-driven expectations in the foreign exchange market, because growth in the key interest rate can make short-term ruble-denominated loans be economically unsound for buying foreign currencies, counting on the ruble's depreciation.

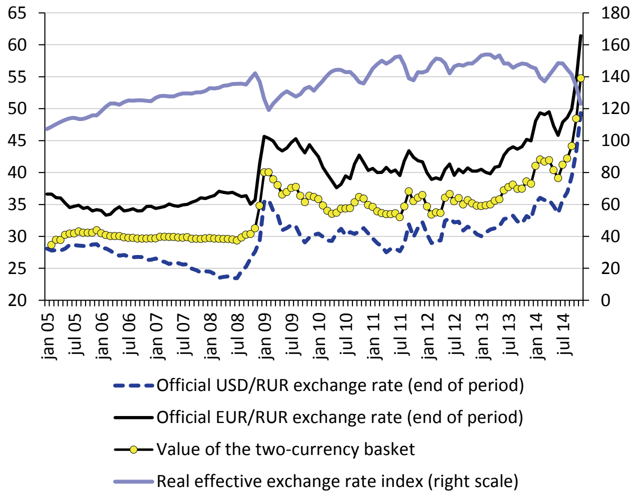
With a view to restricting the game against the ruble in the foreign exchange market, the Bank of Russia announced on the 11th of November the introduction of a limit on the provision of ruble-denominated liquidity using FX swap operations. The limit in the period of December 12 to 21, 2014 amounted to $2bn daily in the equivalent. It's worth noting that on some days, between 19the and 22nd of December, the Bank of Russia increased limits equivalent to $10bn on the provision of ruble-denominated liquidity in an effort to stabilize the situation in the money market. Additionally, early in November the regulator imposed a limit on the volumes of funds provided as part of weekly REPO operations of more than Rb 100bn compared with the previously preset parameters. It's worth noting that the limit on ruble liquidity may cause problems for a few banks, including large banks. The Bank of Russia's polices aimed at expanding foreign exchange refinancing operations are seem to be reasonable in this respect. In particular, the Bank of Russia decided on the 16th of December to increase the upper value of lending at foreign exchange REPO auctions for the term of 28 days to $5,0bn from $1.5bn, as well as for similar operations for the term of 12 months on a daily basis. At the same time, it should be realized that the extension itself of foreign exchange REPO operations can hardly be regarded as efficient tool to stabilize the foreign exchange market, because economic agents will not borrow foreign exchange if they expect it to drastically appreciate.

The Bank of Russia Board of Directors decided on the 23rd of December to introduce a new foreign exchange liquidity provision instrument – foreign exchange loans backed by pledge of receivables on USD loans for the term of 28 and 365 days. The introduction of this tool is intended to expand credit institutions' capability to manage their own foreign exchange liquidity, as well as refinance external loans.



Source: The Central Bank of Russia.

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



Source: The Central Bank of Russia.

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