INFLATION AND MONETARY POLICY IN JANUARY 2015

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On 15 January 2015, the Bank of Russia Board of Directors decided to reduce the key rate by 2 pp., to 15% per annum, due to the shift in the balance of risks of accelerated consumer price growth and an economic cooldown. In January 2015, the Consumer Price Index increased by 3.9% (vs. 0.6% in January 2014), which represented a 1.3 p.p. rise on December 2014. As a result, the inflation rate in per annum terms climbed to 15.0%. Over the course of the first 24 days of February 2015 the CPI rose by 1.9 p.p.

In January 2015, 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, increased by 3.9%, which is 3.3 p.p. above the same index for 2014. As a result, the inflation rate in per annum terms climbed to 15.0% (*Fig. 1*). The core inflation rate[1] in January 2015 was 3.5%, which is above its index for the same period of last year by 3.1 p.p.

In January 2015, the prices of foodstuffs rose by 5.7% (vs. 3.3% in December 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 of prices for the following products were on the rise: fruit and vegetable products (from 12.9% in December to 22.1% in January); granulated sugar (from 14.3% in December to 19.1% in January); meat and poultry products (from 1.5% in December to 7.6% in January); sunflower oil (from 6.3% in December to 7.6% in January); pastas (from 3.9% in December to 5.7% in January); fish and seafood (from 3.8% in December to 6.5% in January); bread and bakery products (from 1.9% in December to 3.6% in January); milk and dairy products (from 1.7% in December to 2.4% in January); butter (from 1.5% in December to 3.8% in January); alcoholic beverages (from 0.7% in December to 1.9% in January). The growth rates of prices for the following products were on the decline: grains and beans (from 11.5% in December to 7.4% in January); eggs (from 14.5% in December to 6.9% in January).

The growth rate of the prices and tariffs established for commercial services rendered to the population remained unchanged (2.2% in both December and January). The overall growth displayed by housing and utilities tariffs in January amounted to 0.6% (vs. 0.7% in December). Slower growth rates were displayed by the prices for out-bound tourism services (a decline from 17.6% in December to 6.0% in January), passenger transport services (a decline from 3.4% in December to 2.0% in January), and services in the education system (a decline from 1.5% in December to 1.4% in January). Faster growth rates were observed with regard to the prices of insurance services (an increase from 2.4% in December to 9.8% in January), pre-school education services (an increase from 0.8% in December to 7.5% in January), recreational services and spa resort services (an increase from 0.1% in December to 2.1% in January), medical services (an increase from 0.5% in December to 2.4% in January), personal consumer services (an increase from 0.1% in December to 2.1% in January), services provided in the field of physical culture and sport (an increase from 0.7% in December to 1.6% in January), and services rendered by cultural establishments (an increase from 1.3% in December to 2.0% in January).

Over the course of January, the growth rate of prices for non-food commodities amounted to 3.2%, which represented a 0.9 pp. rise on December. An accelerated upward movement was demonstrated by the growth rate of prices for pharmaceuticals (an increase from 1.4% in December to 6.6% in January), construction materials (an increase from 1.2% in December to 2.7% in January), tobacco products (an increase from 1.0% in December to 1.6% in January), clothes (an increase from 0.9% in December to 1.3% in January), textile and textile products (an increase from 1.6% in December to 3.3% in January), footwear (an increase from 0.6% in December to 1.4% in January), and detergents (an increase from 1.1% in December to 3.2% in January). Declining growth rates were displayed by prices for the following items: electrical equipment and other household utensils (a decline from 12.0% in December to 6.1% in January), and radio and television sets (a decline from 14.0% in December to 3.6% in

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).

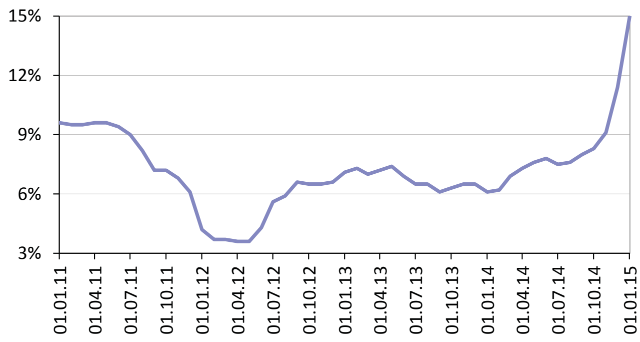
January). Motor gasoline prices continued to decline (-0.9% in December, -0.3% in January).

Thus, January's contribution to the per annum inflation growth rate amounted to 51.3% with regard to the prices of foodstuffs; to 27,6% with regard to the prices of nonfood commodities; and to 21.1% with regard to the prices and tariffs established for commercial services rendered to the population.

Over the course of the first 24 days of February, the CPI increased by 1.9% (while over the course of February 2014 it had grown by 0.7%). The sharp weakening of the ruble in December 2014 and January 2015 will inevitably result in yet another rise in the growth rate of inflation in the first half of 2015. The main factors capable of suppressing the inflation rate's upward movement will continue to 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.

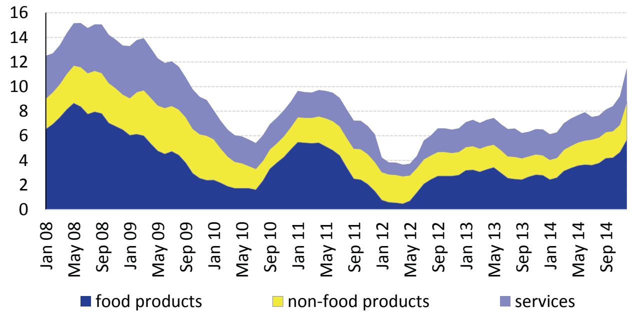
In January 2015, the broad monetary base shrank by 12.7% to Rb 9,898bn (*Fig. 3*). Among the shrinking components of the broad monetary base, one may point to the following ones: the volume of cash in circulation, including the cash balances of credit institutions (a decline by 12.3%, to Rb 7,752.1bn); banks' deposits (a decline by 4.6%, to Rb 767.8bn); and the monies kept on commercial banks' correspondent accounts with the RF Central Bank (a decline by 27.5%, to Rb 880.7bn). Required reserves increased by 5.5% to Rb 497.4bn. Over the course of January, the narrow monetary base (currency issued by the Bank of Russia plus required reserves) shrank by 11.4%, to Rb 8,249.5bn (*Fig. 4*).

In January, the average daily volume of reserves held by commercial banks amounted to Rb 1,544.5bn, which represented a 7.4% rise on December; besides, the volume of required reserves held on special accounts with the RF Central Bank amounted to Rb 497.4bn (a 5.5% rise on December), while the average amount of reserves over the period from 10 January 2015 to 10 February 2015 – to 1,047.1bn (an 8.3% rise on the previous period). Over the period from 10 January 2015 to 10 February 2015, the surplus reserves held by commercial banks[1] amounted on the average to Rb 706.1bn (a 14.8% decline 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 495.6bn (a 55% rise on the previous period), 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 210.5bn (a 58.7% decline on the previous period).



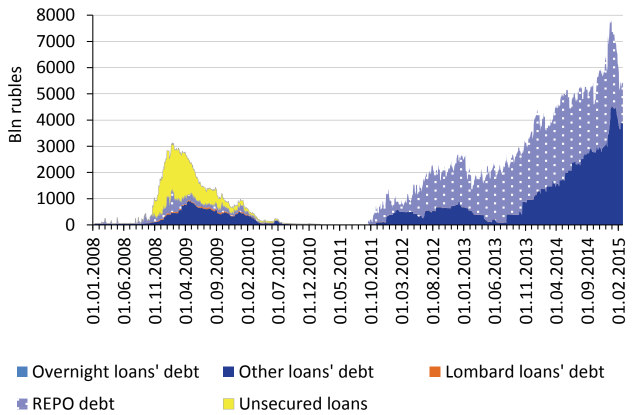
Source: Rosstat.

Fig. 1. The CPI Growth Rate in 2011–2015 (% Year-on-Year)



Source: Rosstat.

Fig. 2. Inflation Factors in 2008–2015 (%, Month on Same Month of Previous Year)



Source: RF Central Bank.

Fig. 3. The Movement of Commercial Banks' Ruble Debt to the Bank of Russia in 2008–2015 (with Regard to the Main Instruments)

As of 1 February 2015, the amount of credits, deposits and other attracted funds received by credit institutions from the Bank of Russia was Rb 7.73 trillion, which represented a 20.2% decline on early January. The amount of banks' repo debt shrank by 28%, to Rb 2.1 trillion; the amount of banks' debt against

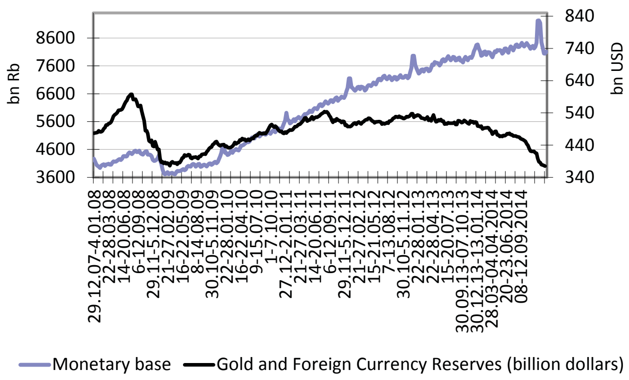
1 The surplus reserves held by commercial banks at the RF CB are understood as the sum of aggregate balance of their correspondent accounts, deposits with the RF CB, and the bonds issued by the RF CB and held by commercial banks, less the average amount of reserves.

loans secured by non-marketable assets dropped by 9%, to Rb 4.0 trillion. As of 24 February, the amount of banks' repo debt further declined to Rb 1.5 trillion; the amount of banks' debt against other loans was Rb 3.9 trillion. The Bank of Russia applied a fixed rate of repo transactions: the average daily volume of borrowing in January amounted to Rb 74.3bn, in February – to Rb 194.7bn.

In January 2015, the Moscow Interbank Actual Credit Rate **(**MIACR) on overnight ruble-denominated interbank loans did not exceed the upper border of the interest rate corridor: during that month the average interbank interest rate was 17% (vs. 15.5% in December 2014). Over the period from 1 through 19 February, the average interbank interest rate amounted to 15% (*Fig. 5*).

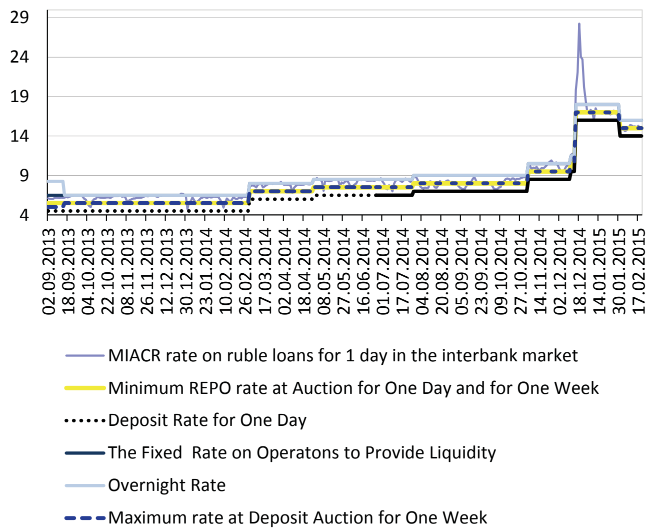
In January, the volume of currency swap transactions (their purpose being to provide the banking system with foreign exchange liquidity) amounted to $ 64.6m, while the volume of such transactions carried out during the first 24 days of February amounted to $ 406.1m. The low demand for such transactions displayed by banks can be explained by high interest rates (from 16 December, the interest rate on the ruble-denominated component in November amounted to 16% per annum, from 2 February – 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 January 2015, the allotted amounts for the 1-week FX REPO auction at a weighted repo rate of 0.68%, the 28-day FX REPO auction at a weighted repo rate of 0.68%, and the 12-month FX REPO auction at a weighted repo rate of 1.2% were $ 3.99bn, $ 10.9bn, and $ 0.8bn respectively. As of 24 February, the volume of foreign currency obtained as repo loans amounted to $ 4.6bn at the average weighted one-week repo rate of 0.7%; to $ 8.7bn at the average weighted 28-day repo rate of 1.2%; and to $ 8.7bn at the average weighted 12-month repo rate of 1.2%. It should be noted that the popularity of foreign exchange repo auctions increased due to the Bank of Russia's decision, of early December 2014, to set its minimum 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.

It should be noted that on 26 January, the Bank of Russia held its first auctions to provide US dollar loans secured by the pledge of claim on US dollar loans to credit institutions. The allotment amount for the 28-day auction was $ 620m. As a result of the auction, the cut-off rate was set at 0.92% per annum. The allotment amount for the 365-day auction was $ 895m. As a result of the auction the cut-off rate was set at 1.55% per annum. Similar auctions were held on 20 February. The allotted amount for the 28-day auction was $ 2.506bn. As a result of the auction, the cut-off rate



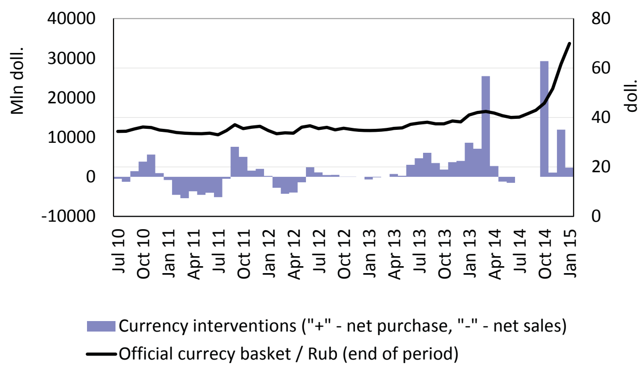
Source: RF Central Bank.

Fig. 4. Behavior of Russia's Narrow Monetary Base and Gold and Foreign Currency (International) Reserves in 2007–2015



Source: RF Central Bank.

Fig. 5. The Bank of Russia's Interest Rate Corridor and the Interbank Market's Behavior in 2012–2015 (% 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 – January 2015

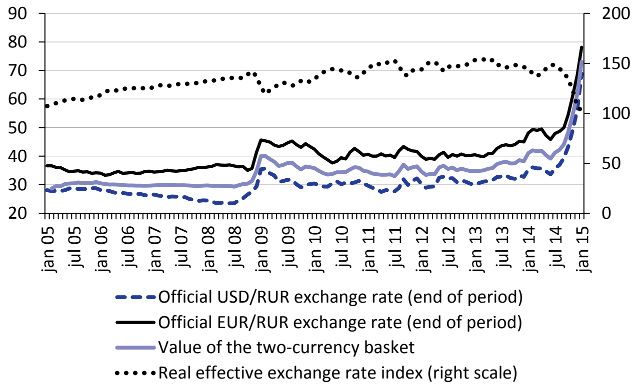
was set at 0.9235% per annum. The allotted amount for the 365-day auction was $ 922.1m. As a result of the auction, the cut-off rate at 1.4309% per annum.

As of 1 February 2015, the Bank of Russia's international reserves volume amounted to $ 376.2bn, thus having shrunk since the year's beginning by 2.4% (*Fig. 4*). In January, the volume of FX sales by the Bank of Russia amounted to $ 2,3bn, while that of its FX purchases – to $ 21.7m (*Fig. 6*). The FX interventions carried out by the Bank of Russia in January 2015 were prompted by the RF Federal Treasury's FX sales. In February, the volume of the Bank of Russia's transactions involving FX sales by the RF Federal Treasury amounted to $ 690m. It should be noted that, since 17 December 2014, the Bank of Russia itself has not carried out any FX interventions, thus fully abiding by its decision, of 10 November 2014, to abolish the then existing exchange rate policy mechanism and to switch over, from 2015 onwards, to the inflation targeting regime.

According to the Bank of Russia's preliminary estimates, net capital outflow from Russia in Q4 2014 amounted to $ 72.9bn, which is 4.3 times more than the same index for the corresponding period of 2013. On the whole, the volume of capital outflow over the course of 2014 amounted to Rb 151.5bn, thus surging 2.5 times above the corresponding index for the year 2013. Over the course of 2014, net capital outflow from the banking sector was $ 49.8bn, from the other sectors – $ 101.7bn.

In January, the ruble's real effective exchange rate against the two major foreign currencies lost 3.1% (vs. -13.0% in December 2014). On the whole, over the course of 2014, the ruble's real effective exchange rate declined by 29.3% in annual terms (January 2015 on January 2014). It should be reminded that, over the course of 2014, the real effective exchange rate of the ruble declined by 27.2% (*Fig. 7*).

Over the course of January, the exchange rate of the US dollar against the ruble rose by 23.9% to Rb 69.7, and the euro's exchange rate against the ruble – by 15.2% (to Rb 78.8). In January, the average exchange rate of the euro against the US dollar amounted to 1.16. 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 weaker than expected economic growth in the eurozone. Over January, the value of the bi-currency basket increased by 19.6% to Rb 73.8. Over the course of the first 25 days of February, the USD/ruble exchange rate declined by 8.8% to Rb 63.5, while the euro/ruble exchange rate dropped by 8.7% to Rb 71.9%. As a result, the bi-currency basket's value shrank by



Source: RF Central Bank.

Fig. 7. Behavior of the Ruble's Exchange Rate Indicators in January 2005 – January 2015

8.8% to Rb 67.3. In February, the average euro/USD exchange rate amounted to 1.14. It should be noted that the euro's further weakening against the dollar in February was caused by the European Central Bank's decision to launch a big program of quantitative easing and by political uncertainty in Greece.

The ruble's sharp weakening against the world's major currencies in December 2014 and January 2015 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 estimates, the ruble's real effective exchange rate significantly deviated from its value linked to fundamental factors alone, including the actual price of oil and the relative labor productivity rate. The significant underestimation of the ruble's exchange rate has had to do primarily with the negative expectations of economic agents resulting from their dramatic loss of trust in the RF Central Bank's policy. The strengthening of the ruble in February was caused by the improvement of Russia's current account in 2014, the rise of oil prices in February, the beginning of the tax period, and the U.S. Federal Reserve's decision to significantly postpone an interest-rate increase.

The Bank of Russia continued to widen the scope of its refinancing operations. Thus, on 16 December 2014, Russia's main financial regulator took the decision to increase the maximum allotment amount for 28-day FX REPO auctions from $ 1.5bn to $ 5.0bn, and to conduct 12-month REPO auctions on a weekly basis. However, it should be understood that unless devaluation expectations are lowered, it is unlikely that the announced widening of the scope of FX REPO operations will be capable of stabilizing the forex market, because economic agents will refrain from borrowing in foreign currencies, expecting their exchange rates to climb sharply against the ruble.

On 23 December 2014, the Bank of Russia Board of Directors took a decision to introduce a new instrument – FX loans secured by a pledge of claims on FX loans, simultaneously announcing that the CB would provide auction-based FX loans for 28 and 365 calendar days. This decision was aimed at expanding credit institutions' possibilities to manage their own FX liquidity and to refinance the external FX loans of Russian exporters.

On 30 January 2015, the Bank of Russia Board of Directors decided to reduce the key rate by 2 p.p., to 15% per annum. This decision was taken in response to 'the shift in the balance of risks of accelerated consumer price growth and economic cooldown'. It should be reminded that the extraordinary decision to radically increase the key rate from 10.5% per annum to 17% per annum had been taken by the RF CB in December 2014 in order to stop the rapidly unfolding panic on the foreign exchange market. We believe that the massive hike of the key rate in December was a fully justified short-term monetary policy action designed to render unprofitable the use of short-term loans in rubles for buying foreign currency in expectation of the ruble's weakening. However, once the exchange rate of the ruble became more stable and the economic growth rate significantly reduced, Russia's main financial regulator took a decision to modestly reduce the key rate. It should be noted that the setting of the real key rate close to zero at a time when inflation expectations are on the rise and the risks of an inflation-depreciation spiral are emerging could be considered to be an inconsequent monetary policy action. However, bearing in mind that the effect of exchange-rate pass-through into prices will lose its steam in the second half of 2015 (if the Bank of Russia's forecast is accurate), the decision to reduce the key rate can be interpreted as a signal that the key rate may be gradually reduced further when inflation risks abate.