

INFLATION AND MONETARY POLICY IN FEBRUARY

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Due to the fact that the balance of risks has moved towards a substantial cooling down of the economy, the Bank of Russia Board of Directors decided at its regular meeting on 13 March 2015 to lower by 1 p.p. the key interest rate to 14% p.a. In February 2015, the Consumer Price Index stood at 2.2% (0.7% in February 2014), i.e., making it 1.7 p.p. below the value seen in January 2015. As a result, inflation increased to 16.7% year-over-year in February 2015. The CPI reached 0.7% in the first 23 days of March 2015.

Russia again saw inflation boost in February 2015: the month-end Consumer Price Index (CPI) stood at 2.2% (3.9% in January 2015), 1.5 p.p. higher than the value seen in 2014. As a result, inflation in February 2015 reached 16.7% compared to that seen in the same month previous year (Fig. 1). The core inflation¹ in February 2015 stood at 2.4%, 1.9 p.p. higher than that in the previous year.

The growth in prices of food products slowed down to 3.3% (5.7% in January) (Fig. 2). As a reminder, it is the ban on supplies of agricultural and food products of certain types from the United States, Canada, Australia, Norway and the European Union that was responsible for much of the growth in prices of goods of these categories. Growth rates of the prices of fruits and vegetables slowed down substantially (to 7.2% in February from 22.1% in January) following the 1.4-fold growth in the period of December 2014 – January 2015. Growth rates of the prices of granulated sugar went down to 1.2% following the 1.4-fold increase in the period between December 2014 and January 2015. In March 2015, positive growth rates of the prices of eggs slowed down too (0.4%), following the 1.3-fold increase in the period of November 2014 to January 2015. Growth rates of the prices of food products of other types saw a moderate decline. Growth rates of the prices of milk and dairy products saw an increase (to 2.8% in February from 2.4% in January).

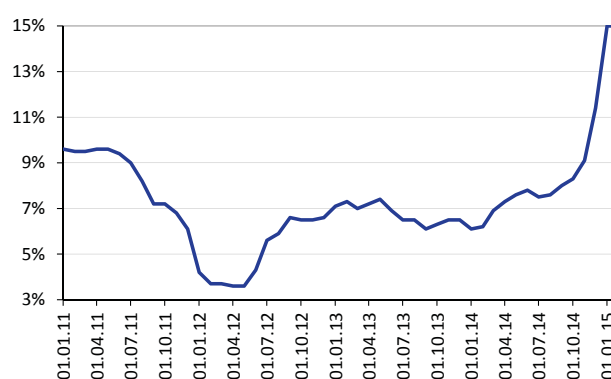
The prices of tariffs of retail paid services in February 2015 increased 0.8%, whereas in January they raised 2.2%. Utility tariffs went up by 0.4% for all of February (0.6% in January). Given the observed appreciation of the ruble, growth rates in the prices of the following services slowed down: outbound tourism (6.0% in January, 0.8% in February) and insuran-

ce services (9.8% in January, 1.8% in February). The downtrend was also seen in growth rates of the prices of preschool education serves (7.5% in January, 2.0% in February).

In February growth rates in the prices of non-food products stood at 2.1%, 1.1 p.p. below the value seen in January 2015. In February, growth rates of the prices of the following items of commodities slowed down: electric products and other household appliances (to 2.2% in February from 6.1% in January), audio visual goods (to 0.7% in February from 3.6% in January). Positive growth rates in the prices of medicines slowed down insignificantly to 4.6% in February from 6.6% in January, further making these products less affordable for individuals. The prices of motor gasoline saw a further decline compared to January (to -0.6% in February from -0.3% in January).

For all of February, products, non-food products, prices and tariffs of retail paid services, and non-food products contributed 51.6%, 28.9%, and 19.6%, respectively, to the inflation growth rate on a year-over-year basis.

It is worthwhile noting that the effect of exchange rate depreciation pass-through to prices reached beyond its highs and its effect on the price dynamics will subdue in the future. In the first 23 days of March,



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

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).

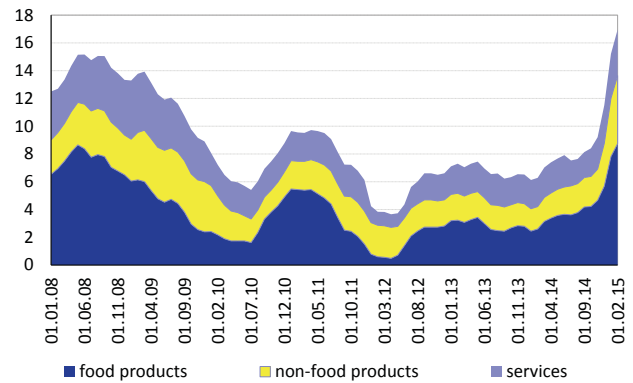
the Consumer Price Index stood at 0.7% (1.0% for all of March 2014). The lack of pronounced demand-driven pressure on prices, as well as the Bank of Russia's measures aimed at tightening the monetary policy remain the key factors constraining the inflation.

In February 2015, the monetary base (broad definition) shrank by 2.3% to Rb 9665,5bn (Fig. 3). The following components of the broad monetary base saw a decline: the volume of cash in circulation including cash balances in credit institutions (a 0.5% decline to Rb 7715,8bn), obligatory reserves (a 0.8% contraction to Rb 493,3bn), bank deposits (a 59.7% contraction to Rb 309,7bn). The funds on banks' correspondent accounts increased 30.2% to Rb 1146,7bn. The monetary base (narrow definition) (cash plus obligatory reserves) declined in February to by 0.5% and reached Rb 8209,1bn (Fig. 4). It is worthwhile noting that it is the decline in the ruble-denominated debt owed by businesses to the Bank of Russia that was basically responsible for the decrease of the broad monetary base in February, but the effect was partially offset by the declining balance of general government's accounts.

In February 2015, the average daily volume of commercial banks' reserves was running at Rb 1560bn, up 7.4% compared to that in January, and the obligatory reserves on special accounts with the central bank were running at Rb 493,3bn (down 0.8% compared to that in January), while the mean value of the reserves reached Rb 1066,7bn in the period of 10.02.2015 thru 10.03.2015 (a 1.9% increase compared to the value seen in the previous year). In the period between 10.02.2015 and 10.03.2015, commercial banks' surplus reserves¹ were running at Rb 340bn on average (a 51.8% decline compared to the volume seen in the previous period), of which banks' deposits on accounts with the central bank averaged Rb 197bn (a 60% increase compared to the amount seen in the previous period), while correspondent accounts, less the averaged amount of reserves, were running at Rb 143,4bn (a 31.9% decline compared to the value seen in the previous period).

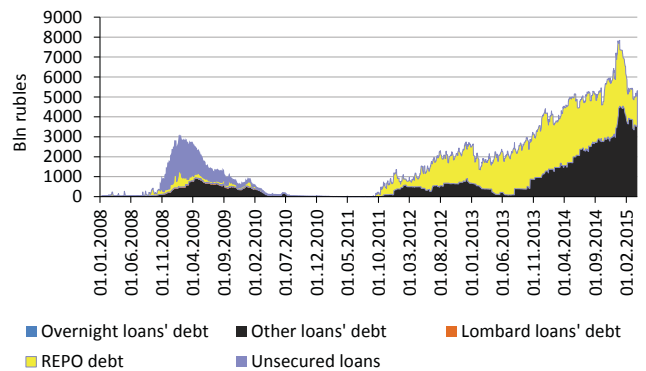
As of 1 March 2015, loans, deposits and other funds raised by credit institutions from the Bank of Russia reached Rb 7,69 trillion, having decreased 0.5% since earlier in February. Banks' debt on repo transactions diminished by 28.3% and was running at Rb 1,6 trillion, the debts on loans secured by non-marketable assets reached Rb 3,9 trillion, up 0.5%. According to

1 Commercial banks' surplus reserves with the Central Bank refer to the amount of commercial banks' deposits on the 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 2015 (in percent compared to the same month previous year)



Source: The Central Bank of Russia.

Fig. 3. Commercial banks' ruble-denominated debt (on basic instruments) owed to the Bank of Russia in 2008 to 2015

the data on 27 March, bank's debt on repo transactions increased to Rb 1,8 trillion, while the debt on other loans was running at Rb 3,5 trillion.

In February 2015, the interbank interest rate (Moscow InterBank Actual Credit Rate) MIACR on overnight interbank loans denominated in rubles saw no crossing beyond the cap of the interest rate band and averaged at 15.1% (17% in January 2015). In the period of March 1 thru 25 March, the average interbank interest rate stood at 14.9% (Fig. 5).

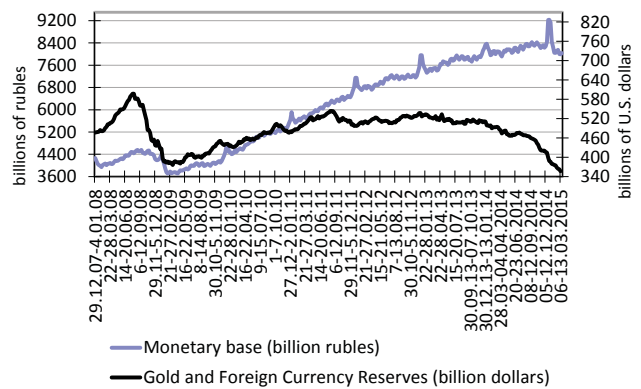
In February, the volume of FX swap transactions for the provision of FX liquidity to the banking system was running at \$406,1m, and in the first 27 days of March it was running at \$70,5m. There was weak demand for such operations (transactions) because of high interest rates (the interest rate for the ruble-denominated part of transaction was set at 14% effective since 2 February, 13% since 16 March, 1.5% for the part denominated in foreign currencies). The volume of foreign currencies allotted during a repo auction in February was running at \$6,2bn at an weighted average rate of 0.69% for a term of one week, \$10,4bn at an weighted average rate of 0.7%

for a term of 28 days, \$8,7bn at an weighted average rate of 1.2% for a term of 12 months. The data on 24 March show that the volume of foreign currencies allotted during the repo auction was running at \$7,3bn at an weighted average rate of 0.7% for a term of one week, \$9.3bn at an weighted average rate of 0.7% for a term of 28 days, and \$3,8bn at an weighted average rate of 1.2% for a term of 12 months. It is worthwhile noting that the increasing demand for FX repo auctions is determined by the Bank of Russia decision in December 2014 to establish minimum interest rates for the given auction, equaling LIBOR rates in respective foreign currencies for a comparable term increased by 0.5 p.p. The lowering of interest rates on operations for the provision of FX liquidity will facilitate a demand and supply equilibrium in the FX market. On 20 February, the Bank of Russia held a credit auction at which the Bank of Russia provided credit institutions with loans denominated in U.S. dollars and secured by claims on such loans. The volume of funds allotted for a term of 28 days was running at \$2500,6m at an interest rate of 0.9235% p.a. The volume of funds allotted during a credit auction for a term of 365 days was running at \$922,1m at an interest rate of 1.4309%. the regulator allotted \$949,7m for a term of 365 days at an interest rate of 1.4469% p.a. during a similar auction held on 20 March. The auction for 28-day loans was declared void because no bids were available.

As of 1 March 2015, the volume of the central bank international reserves was running at \$360,2bn, a 6.6% decline year to date (Fig. 4). In February, the Bank of Russia undertook no FX interventions (Fig. 6). As a reminder, the regulator has undertaken no FX interventions since 17 December 2014, thus adhering in full to the decision of 10 November to revoke the previously applicable exchange rate formation mechanism and migrate by 2015 to an inflation targeting regime.

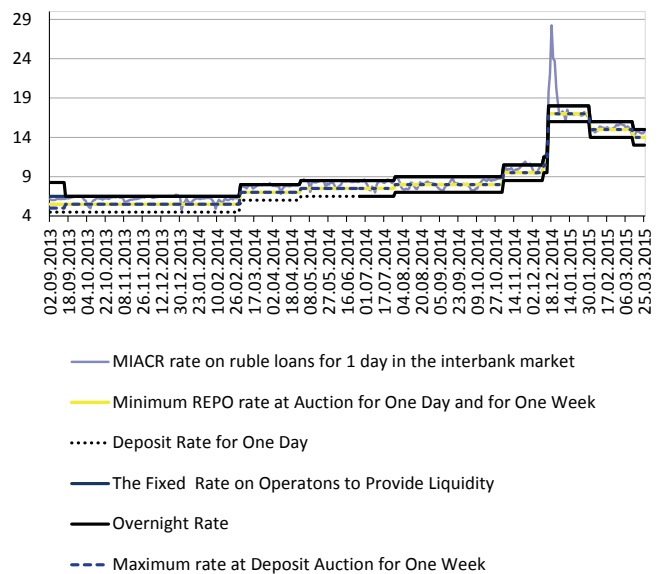
According to the Bank of Russia preliminary estimation, the net capital outflow from the country in Q4 2014 reached \$72,9bn, 4.3 times the amount seen in the same period of 2013. Capital outflow was running at Rb 151,5bn for all of 2014, 2.5 times the value seen in 2013. Banks' net capital exports in 2014 reached \$49,8bn, while other sectors' net capital exports was running at \$101,7bn.

The ruble's real effective exchange rate against foreign currencies was for the first time since July 2014 determined by an uptrend. In February, it strengthened by 2.1% (-2.8% in January 2015). The real effective exchange rate weakened by a total of 26.8% in the period between February 2014 and February 2015. As a reminder, in H2 2014, the ruble's real effective exchange rate lost 28.5% (Fig. 7).



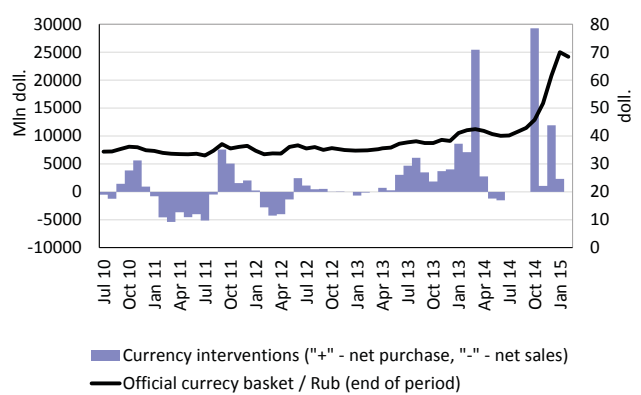
Source: The Central Bank of Russia.

Fig. 4. The dynamics of the monetary base (narrow definition) and the gold and foreign currency (international) reserves of the Russian Federation in 2007 to 2015



Source: The Central Bank of Russia.

Fig. 5. The Bank of Russia interest rate band and the dynamics of the interbank lending market in 2012 to 2015 (in percent per annum)

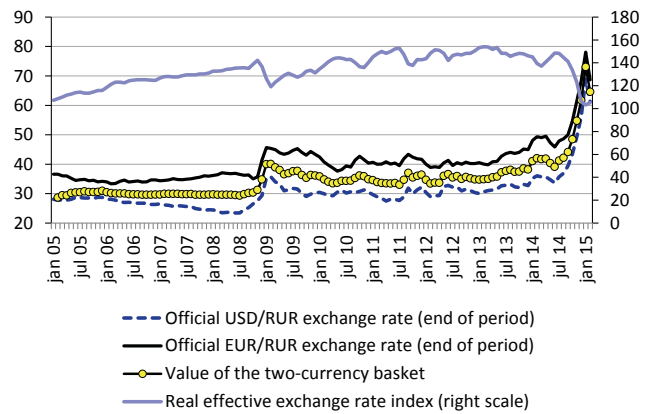


Source: The Central Bank of Russia.

Fig. 6. The Bank of Russia FX interventions and the ruble exchange rate vs. the currency basket in March 2010 to February 2015

The USD/RUB exchange rate in February declined by 10.7% to Rb 62,2, while the EUR/RUB exchange rate was down by 11.7% (Rb 69,5). In February, the EUR/USD exchange rate averaged 1.14. The value of the dual-currency basket in February decreased 11.2% to Rb 65,5. In the first 27 days of March, the USD/RUB exchange rate dropped by 9.3% and reached Rb 56,4, while the EUR/RUB exchange rate lost 10.7% and was running at Rb 62,1, resulting in a 10% decline, to Rb 59, of the dual-currency basket value. The EUR/USD exchange rate in March averaged 1.08. It is worthwhile noting that the ongoing decline of the EUR/USD exchange rate in March was caused by the implementation of a quantitative easing program in the Eurozone, as well as the uncertainty concerning the repayments of the Greece's external debt and a likely restructuring of the debt. It is worthwhile noting that a certain appreciation of the ruble in February–March was governed by the growth in crude oil prices in February and second half of March, at the beginning of a fiscal period and with higher demand for ruble-denominated liquidity from Russian corporate taxpayers, as well as the Fed's rescheduling a rise of interest rates, which prevents the U.S. dollar from strengthening at faster rate.

The Bank of Russia Board of Directors decided at a regular meeting on 13 March 2015 to lower the key interest rate by 1 p.p. to 14% p.a. The rate was lowered because the balance of risks had shifted towards a substantial cooling down of the economy. As a reminder, the key interest rate was urgently increased to 17% p.a. from 10.5% p.a. in December 2014 amid the development of panic sentiments in



Source: The Central Bank of Russia.

Fig. 7. Ruble exchange rate indicators in January 2005 to February 2015

the FX market. It is our opinion that the decision was a reasonable short-term measure as part of the monetary policy, because with higher key interest rate, it would be economically worthless to use short-term ruble-denominated loans for the purpose of buying foreign currencies in anticipation of a ruble's depreciation. However, the regulator decided to moderately lower the key interest rate as the exchange rate dynamics stabilized, the risks of credit contraction (crunch) increased and economic growth rates slowed down substantially. It is worthwhile noting that setting a negative or a near-to-zero real key interest rate when inflation is expected to rise high, the occurrence of risks of unwinding an inflation and depreciation spiral can be regarded as inconsistency in the monetary policy. ●