INFLATION AND MONETARY POLICY IN MARCH 2015

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Due to a shift in the balance of risks towards a more significant cooling of the economy, at the Bank of Russia Board of Directors' meeting on 13 March 2015 it was decided that the key interest rate should be reduced by 1 p.p. – to 14% per annum. In March 2015, the Consumer Price Index's growth amounted to 1.2% (vs. 1.0% in March 2014), which is 1 p.p. below its value recorded in February 2015. As a result, the inflation index increased in March 2015 on March 2014 by 16.9%. Over the first 20 days of April 2015, the Consumer Price Index's growth amounted to 0.5%.

In March, the inflation rate in the RF became slower: as demonstrated by the month-end results, the Consumer Price Index (CPI) had increased by 1.2% (in February 2015 – by 2.2%), which is 0.2 p.p. above the corresponding index for 2014. As a result, the inflation index in March 2015 rose to 16.9% on March 2014 (*Fig. 1*). The core inflation rate[1] in March 2015 was 1.5%, which is 0.7 p.p. above its index for the same period of last year.

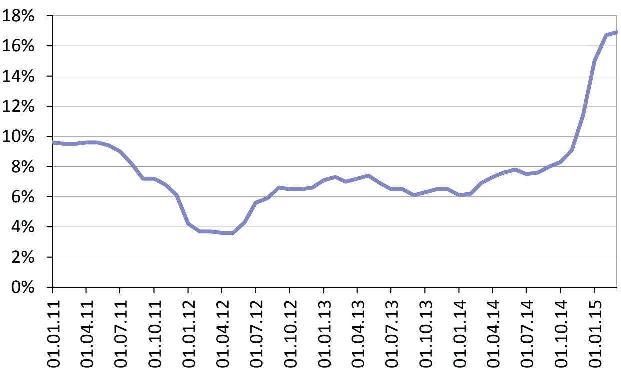
The growth rate displayed by prices of foodstuffs in March declined nearly by half to 1.6% (vs. 3.3% in February) (*Fig. 2*). The growth rates of prices for fruit and vegetable products shrank significantly (from 22.1% in January and 7.2% in February to 1.2% in March).The growth rates displayed by prices for the following products were on the decline: pastas (from 5.2% in February to 2.7% in March), grains and beans (from 4.5% in February to 1.8% in March), fish and seafood (from 5.5% in February to 3.1% in Marche), milk and dairy products (from 2.8% in February to 1.3% in March), butter (from 3.1% in February to 1% in March), sunflower oil (from 5.6% in February to 3.4% in March). The prices for granulated sugar, after having risen more than 1.4 times over the period from December 2014 through February 2015, in March dropped by 2.9%. March also saw declining prices for eggs (-0.5%), which over the period from November 2014 through February 2015 increased more than 1.3 times.

The prices and tariffs established for commercial services rendered to the population in March increased by 0.3%, while this index for February amounted to 0.8%. The overall growth displayed by housing and utilities tariffs in March amounted to 0.1% (vs. 0.4% in February). As a result of the ruble's strengthening, the prices of out-bound tourism services somewhat declined (0.8% in в February vs. -2.1% in March). The growth rate of prices for pre-school education services slowed down (2.0% in February vs. 0.9% in March). Insurance services, however, became more expensive (growth of 1.8% in February vs. 2.6% in March).

In March, the growth rate displayed by the prices of nonfood commodities amounted to 1.4%, which is 0.7 p.p. below its February 2015 level. Besides, March saw a slowdown in the growth rate of prices for electrical equipment and other household utensils (2.2% in February vs. 0.9% in March), radio and television sets (0.7% in February vs. -0.6% in March), and pharmaceuticals (4.6% in February vs. 2.1% in March).

On the whole, the contribution of the price growth component observed in March to the per annum inflation growth rate amounted to 50.6% with regard to the prices of foodstuffs; to 30.3% with regard to the prices of nonfood commodities; and to 19.1% with regard to the prices and tariffs established for commercial services rendered to the population.

It should be noted that the effect of exchange-rate pass-through into prices has already reached its peak, and thereafter it can be expected to lose its steam in the second half of 2015. As demonstrated by the



Source: Rosstat.

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

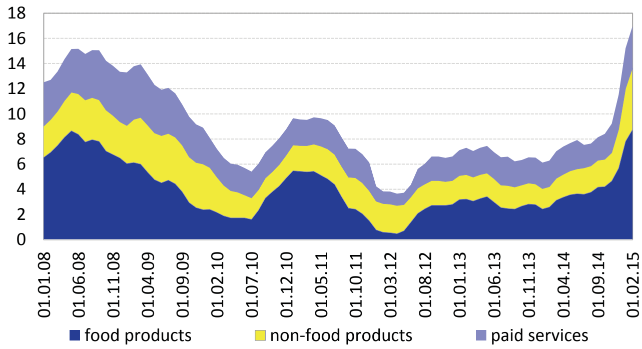
1 The core consumer price index reflects the level of inflation on the consumer market after adjustment for the seasonal factors (prices of vegetable and fruit products) and administrative factors (regulated tariffs for certain types of services, etc.). This index is also calculated by the RF Statistics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

period-end results of the first 20 days of April 2015, the Consumer Price Index amounted to 0.5% on the previous month (vs. 0.9% for April 2014). As before, the main factors capable of suppressing the inflation rate's upward movement are the absence of demand's upward pressure on the price level, and the Bank of Russia's measures designed to toughen its monetary policy coupled with the recently emerging trend towards the ruble's strengthening.

In March 2015, the broad monetary base remained almost unchanged, amounting as of 1 April to 9,662.5bn (*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 2.5%, to Rb 7,522.7bn); and banks' deposits (a decline by 5.7%, to Rb 292.2bn). The monies kept in commercial banks' correspondent accounts with the RF Central Bank increased by 17.1%, to Rb 1,342.3bn; and the amount of required reserves increased by 2.4% to Rb 505.3bn. Over the course of March, the narrow monetary base (currency issued by the Bank of Russia plus required reserves) shrank by 2.2%, to Rb 8,028bn (*Fig. 4*).

In March, the average daily volume of reserves held by commercial banks amounted to Rb 1,560bn, having increased on January by 7.4%, while the volume of required reserves held in special accounts with the RF Central Bank amounted to Rb 505.3bn (having increased by 2.4% on February), and the average amount of reserves over the period from 10 March 2015 to 10 April 2015 increased to Rb 1,102.8bn (a rise of 3.4% on the previous period). Over the same period from 10 March 2015 to 10 April 2015, the surplus reserves held by commercial banks amounted on the average to Rb 295.3bn (a 13.2% decline on the previous period), of which the average amount of banks' deposits held in their accounts with the RF Central Bank was found to be Rb 171bn (a 13.2% decline in the previous period), while the monies kept in commercial banks' correspondent accounts with the RF Central Bank less the average amount of reserves over the period under consideration amounted to Rb 124.2bn (a 13.4% decline on the previous period).

As of 1 April 2015, the amount of credits, deposits and other attracted funds received by credit institutions from the Bank of Russia was Rb 7.57 trillion, which represents a 1.5% decline on early March. The amount of banks' repo debt increased by 23%, to Rb 1.9 trillion; that of banks' debt against loans secured by non-marketable assets amounted to Rb 3.5 trillion, having declined by 9%. As of 28 April, the amount of banks' repo debt further rose to Rb 2.5 trillion; the amount of banks' debt against other loans was Rb 3.1 trillion.

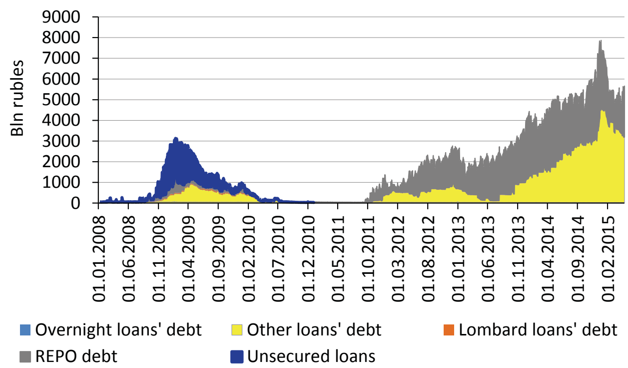


Source: Rosstat.

Fig. 2. Inputs of IPC Main Components in 2008–2015, in per Annum Terms

In March 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 14.9% (vs. 15.1% in February 2015). Over the period from 1 through 24 April, average interbank interest rate amounted to 14.3% (*Fig. 5*).

In March, the volume of currency swap transactions (their purpose being to provide the banking system with foreign exchange liquidity) amounted to $ 70.5m, while no such transactions were carried out in April. The low demand for such transactions displayed by banks can be explained by high interest rates (from 2 February, the interest rate on the ruble-denominated component amounted to 14%, and from 16 March – to 13%; the interest rate on the component denominated in foreign currencies amounted to 1.5%). In March 2015, the allotted amount for the 1-week FX REPO auction was $ 10.9bn at a weighted repo rate of 0.75%; $10.9bn for the 28-day FX REPO auction at a weighted repo rate of 0.8%; and $5.3bn for the 12-month FX REPO auction at a weighted repo rate of 1.4%. As



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)

of 27 April, the volume of foreign currency obtained as repo loans amounted to $ 2.3bn at the average weighted one-week repo rate of 1.5%; to $ 9.9bn at the average weighted 28-day repo rate of 1.6%; and to $ 5.2bn at the average weighted 12-month repo rate of 2.5%. It should be noted that the slight shrinkage of demand for foreign exchange repo loans observed over April was caused, among other things, by the Bank of Russia's decisions of 30 March, 10 April and 21 April to raise its foreign exchange repo rates.

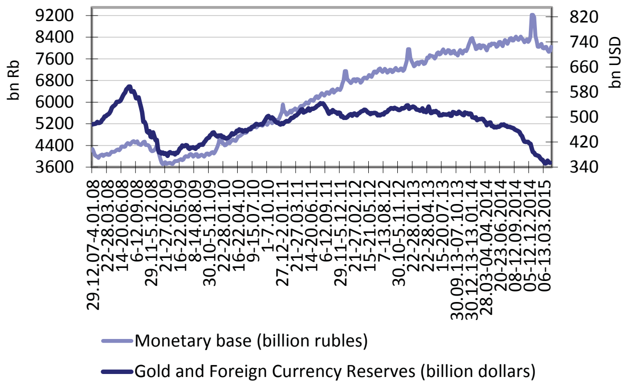
On 20 March, the Bank of Russia held auctions to provide US dollar loans secured by the pledge of claim on US dollar loans to credit institutions. The announced 28-day FX REPO auction was cancelled due to absence of applicants for the loans. The regulator allotted a total of $ 949.7m for the 365-day auction, at a cut-off rate of 1.4469% per annum. On 17 April, the allotted amount for the 28-day auction was $ 451.0m at a cut-off rate of 1.9311% per annum. The 365-day auction announced for that date was cancelled due to the participation of only one credit institution.

As of 1 April 2015, the Bank of Russia's international reserves volume amounted to $ 356.4bn, thus having shrunk since the year's beginning by 7.5% (*Fig. 4*). In March, the Bank of Russia chose to abstain from any FX sale (*Fig. 6*). It should be reminded that, since 17 December 2014, the Bank of Russia itself had 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 Q1 2015 amounted to $ 32.6bn, which is by 31.7% less than the same index for the corresponding period of 2014. Over the course of Q1 2015, net capital outflow from the banking sector was $ 14.6bn, from the other sectors – $ 18.0bn. In this connection it should be reminded that the entire volume of net capital outflow in for 2014 amounted to Rb 151.5bn, which is 2.5 times more than the corresponding index for 2013.

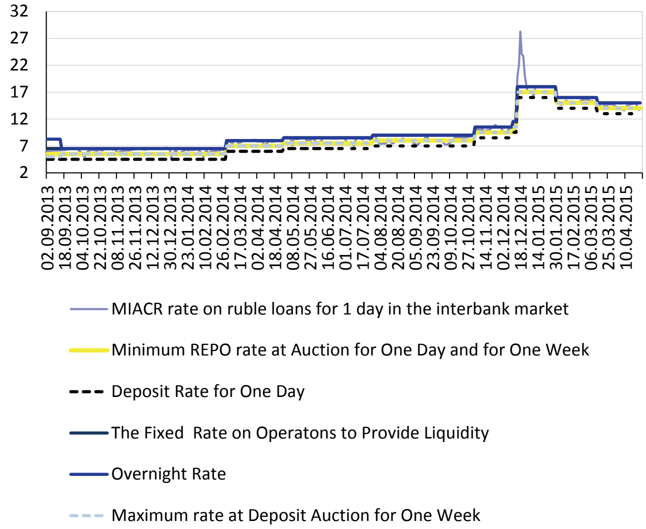
In March, the ruble's foreign exchange rate in real terms continued to be on the rise. The ruble's real effective exchange rate against the two major foreign currencies gained 10.6% (vs. 1.1% in February 2015) and corresponds to the 2006 rates. On the whole in annual terms (March 2015 on March 2014), the ruble's real effective exchange rate declined by 23.6%. It should be reminded that, over the course of H2 2014, the real effective exchange rate of the ruble lost 28.5% (*Fig. 7*).

Over the course of March, the exchange rate of the US dollar against the ruble declined by 7.4% to Rb 57.7, and the euro's exchange rate against the ruble – by 10.8% (to Rb 62.0). In March, the aver-



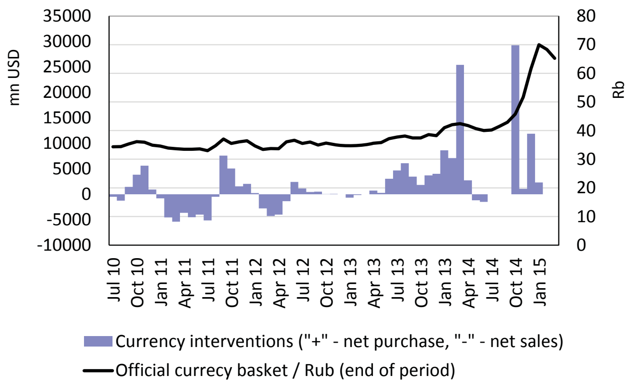
Source: RF Central Bank.

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)



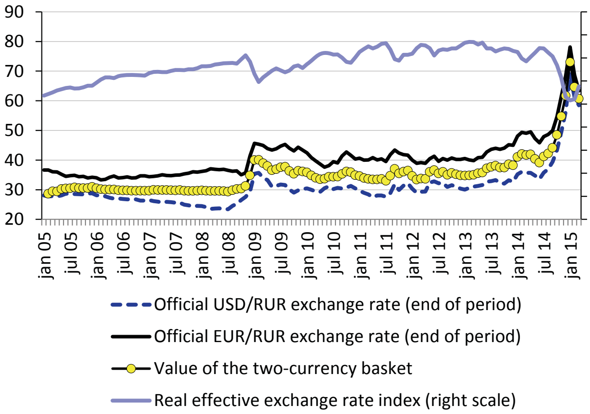
Source: RF Central Bank.

Fig. 6. The Bank of Russia's Currency Interventions and the Ruble Exchange Rate against the Bi-currency Basket in March 2010 – March 2015

age exchange rate of the euro against the US dollar amounted to 1.08. Over March, the value of the bi-currency basket declined by 9.0% to Rb 59.6. Over the course of the first 28 days of April, the USD/ruble exchange rate declined by 10.7% to Rb 51.5, while the euro/ruble exchange rate dropped by 10.0% to Rb 55.9; as a result, the bi-currency basket's value shrank by 10% to Rb 59. In March, the average euro/USD exchange rate amounted to 1.08. It should be noted that the euro's further weakening against the dollar in March was caused by the launch of a big program of quantitative easing in the eurozone, as well as by the uncertain prospects of redemption, by Greece, of her foreign debt and the probability of its restructuring in the future. The slight strengthening of the ruble over the period of February–April occurred in response to the current account surplus, the optimistic trends in the movement of oil prices, the high refinancing rates set by the Bank of Russia, the gradually declining capital outflow, the corporate and the banking sectors' subsiding demand for foreign exchange as a result of their declining foreign debt, as well as the shrinking demand for foreign currency cash on the part of the population as the negative expectations receded, and no panic could be anticipated. Considering the fact that over the period of January–March 2015 the Bank of Russia undertook no foreign exchange interventions, the upward pressure on the ruble's foreign exchange rate was in part exerted by FX repo transactions.

On its meeting as of 13 March 2015 the Bank of Russia Board of Directors took a decision to lower the key interest rate by 1 p.p. to 14% per annum. The reason for the key rate reduction was the shift in the balance of risks towards a significant economic cooldown. It should be reminded that the 'emergency surge' of the key interest rate from 10.5% to 17% per annum in December 2014 had been caused by the unraveling panic in the foreign exchange market. In our opinion, that was a well-justified short-term monetary policy measure resorted to in that particular situation, because a soaring key interest rate can make it unprofitable to attract any short-term ruble loans in order to fund foreign currency purchases in anticipation of the ruble's further weakening. However, as the movement of the ruble's foreign exchange rate was becoming more stable, the risks of credit squeeze increased, and the rate of economic growth became much slower, the regulator decided to moderately reduce the key interest rate.

The Bank of Russia increased, from 21 April 2015, the minimum interest rates for foreign currency REPO auctions by 0.5 p.p., to LIBOR plus 2 percent-



Source: RF Central Bank.

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

age points for one-week and 28-day REPO auctions and to LIBOR plus 2.5 percentage points for 12-month REPO auctions. Also, Russia's main financial regulator increased the minimum interest rates at auctions to provide FX loans secured by a pledge of claims on FX loans to LIBOR plus 2.25 p.p. for 28 days term and to LIBOR plus 2.75 percentage points for 365 days term. It should be noted that similarly to the previous hike in interest rates, the minimum interest rates on FX loans introduced from 13 April 2015 were increased more drastically (by 0.75 p.p.) for 12-month loans than for 28-day and one-week loans (+ 0.5 p.p.).

It should be reminded that initially the current instruments of FX refinancing at relatively low interest rates were introduced in response to the November–December 2014 boom in demand for foreign exchange on the part of the banking sector, population and corporations, when refinancing within the framework of REPO transactions was provided at a rate equal to LIBOR plus 0.5 p.p., while the minimum interest rates for FX loans was set at LIBOR plus 0.75 p.p. However, once the situation on Russia's foreign exchange market began to stabilize, the RF Central Bank started to gradually increase the cost of FX refinancing: the above-mentioned hike in interest rates was the third in the course of last month.

The ongoing increase in the minimum interest rates for FX provision is designed to reduce the banking sector's impetus to invest the received funds into more profitable assets denominated in foreign currencies and rubles. The main purpose of these instruments of the RF Central Bank was to curb the panic at Russia's FX market. This purpose was successfully achieved in January–February 2015. The current excessive growth in the banking sector's foreign currency debt to the RF Central Bank increases the FX risks faced by the banks and raises the possibility of the ruble's weakening at a time of their loans' repayment.

The rise in the minimum interest rates carried out by the Bank of Russia will also make it possible to prevent an excessive strengthening of the ruble in response not only to the impact of some fundamental factors but also to investors' being overoptimistic concerning the state of the Russian economy and its geopolitical background. Moreover, the Bank of Russia will be able once again to soften its terms for providing the market with foreign exchange – if and when necessary.