

RUSSIA'S INFLATION AND MONETARY POLICY IN APRIL 2015

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On 30 April 2015, the Bank of Russia reduced the key interest rate from 14% to 12.5% per annum, noting in this connection that the inflation risks had become less pronounced, but that the risks of a more significant cooling of the economy were still there. By all indications, the RF Central Bank believes that any further strengthening of the ruble can hardly be feasible. On 14 May, the RF Central Bank announced that it would once again resort to interventions in the form of foreign exchange purchases in order to replenish its international reserves in the amount of \$ 100m – 200m per day. Over April 2015, the Consumer Price Index's growth amounted to 0.5% (vs. 0.9% in April 2014.), which is 0.7 pp. below its March 2015 level. As a result, the inflation index in April 2015 amounted to 16.4% of its April 2014 level, thus having declined for the first time since July 2014. Over the first 25 days of May 2015, the Consumer Price Index's growth rate dwindled to 0.3%.

In April 2015, the inflation rate in the RF continued its downward movement: as demonstrated by the month-end results, the Consumer Price Index (CPI) had dropped to 0.5% (in March 2015 it amounted to 1.2%), which is 0.4 p.p. below the corresponding index for 2014. As a result, the inflation index in April 2015 amounted to 16.4% of its April 2014 level, having declined for the first time since July 2014 (*Fig. 1*). The core inflation rate¹ in April 2015 amounted to 0.8%, which is 0.7 p.p. below its index for the same period last year.

The growth rate displayed by prices of foodstuffs in April declined to 0.3% (vs. 1.6% in March) (*Fig. 2*), and prices for fruit and vegetable products shrank by 3.7% (in March, this group of commodities displayed a price rise by 1.2%), which can be explained by both the ruble's strengthening and the onset of seasonal cheapening of fruits and vegetables. It should be noted that the downward movement of the growth rate of food prices was caused not only by the respective movement of the official exchange rate of the ruble against foreign currencies; the other factor was the record low hit by world prices for foodstuffs for the first time since June 2010.

Over April 2015, the prices and tariffs established for commercial services rendered to the population remained unchanged. At the same time, due to the ruble's strengthening, the prices of out-bound tourism services continued to decline (from -2.1% in March to -5.2% in April), while the growth rate of prices for insurance services accelerated (from 2.6% in March to 3.5% in April). This group of services remains the leader

in price growth: over the past 12 months, prices here had increased by 39.1%. The cost of insurance services was significantly pushed up by the increased prices of automobile spare parts and raised OSAGO tariffs.

In April, the growth rate displayed by the prices of nonfood commodities amounted to 0.9%, which is 0.5 p.p. below its March 2015 level. Thanks to the ruble's strengthening, the growth rates displayed by the prices of pharmaceuticals became slower (rising by 2.1% over March and by only 0.9% over April), which was also true for the prices of electrical equipment and other household utensils (these increased by 0.9% over March and by 0.2% in April). Simultaneously, prices for motor gasoline increased in April over 0.2%, while in *тогда* March they had displayed no change.

Thus, on the whole, April's contribution to the inflation growth rate estimated as a percentage of its index for the corresponding month of the previous year amounted to 49.5% with regard to the prices of foodstuffs; to 32.1% with regard to the prices of nonfood commodities; and to 18.5% with regard to the prices and tariffs established for commercial services rendered to the population.

In the first two weeks of May 2015, the annual inflation growth rate continued its decline. Over the course of the first 25 days of May, the CPI increased by 0.3% on the previous month (while over the course of May 2014 it had grown by 0.9%). As before, the main factors suppressing the inflation rate's upward movement were the ruble's strengthening (largely sustained by the rising oil prices) and the absence of demand's upward pressure on the price level. Changes in the expectations of economic agents represent yet another significant factor: according to the Bank of Russia's Monetary Policy Report (released in March), where the recent changes in household inflation expectations and consumer outlooks are estimated using various

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).

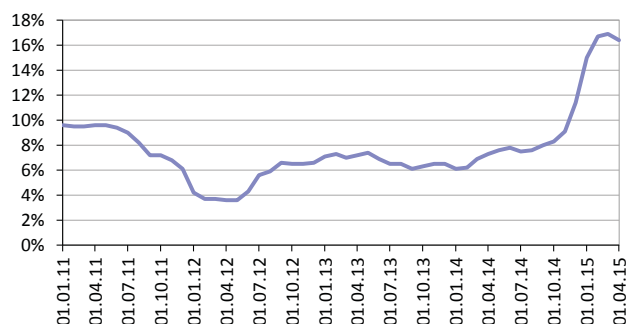
statistical methods on the basis of population surveys, the share of respondents who expected the exchange rate of the ruble against foreign currencies to rise (26%) is higher than the share of those who believe that it will further decline (19%).

In April 2015, the broad monetary base shrank only slightly, amounting as of 1 May to Rb 9,520.0bn (Fig. 3). Among the shrinking components of the broad monetary base, one may point to the following ones: monies kept in commercial banks' correspondent accounts with the Bank of Russia (a decline by 23.9% to Rb 1,021.1bn); and required reserves (a decline by 3.9% to Rb 485.8bn). The volume of cash in circulation, including the cash balances of credit institutions, increased by 2.3% to Rb 7,699.2bn, while banks' deposits increased by 7.4% to Rb 313.9bn. The narrow monetary base (currency issued by the Bank of Russia plus required reserves) increased over April by 2.0% to Rb 8,185bn (Fig. 4).

Over the course of April 2015, the average daily volume of reserves held by commercial banks remained practically unchanged since March, amounting to Rb 1,549.1bn, while the volume of required reserves held in special accounts with the RF Central Bank amounted to Rb 485.8bn (having increased by 3.9% on March), and the average amount of reserves for the period from 10 April 2015 to 10 May 2015 – to Rb 1,063.3bn (a drop by 3.6% on the previous period). Over the same period, from 10 April 2015 to 10 May 2015, the surplus reserves held by commercial banks⁸ amounted on the average to Rb 356.8bn (a 20.8% rise 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 198.2bn (growth by 15.9% on 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 158.6bn (a 27.6% rise on the previous period).

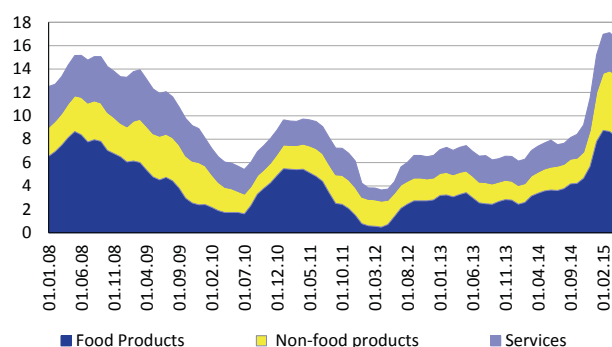
As of 1 May 2015, the amount of credits, deposits and other attracted funds received by credit institutions from the Bank of Russia was Rb 7.52 trillion, which represents a 0.8% decline on early April. The amount of banks' repo debt increased by 8.6%, to Rb 2.2 trillion; that of banks' debt against loans secured by non-marketable assets amounted to Rb 3.3 trillion, having declined by 6.3%. As of 25 May, the amount of banks' repo debt remained practically unchanged, amounting to Rb 2.2 trillion; and the amount of banks' debt against other loans shrank to Rb 3.1 trillion.

In April 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, staying at the average level of



Source: Rosstat.

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



Source: Rosstat.

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

14.4% (vs. 14.9% in March 2015). Over the period from 1 through 25 May, the average interbank interest rate amounted to 12.8% (Fig. 5). It should be reminded that the reduction of MIACR occurred in response to the Bank of Russia's decision of 30 April that the key interest rate should be lowered by 1.5 p.p. to 12.5%.

In April, no currency swap transactions took place (the purpose of such transactions being to provide the banking system with foreign exchange liquidity). The low demand for such transactions displayed by banks can be explained by high interest rates (from 16 March, the interest rate on the ruble-denominated component amounted to 13%, and from 5 May – to 11.5%; the interest rate on the component denominated in foreign currencies amounted to 1.5%). In April 2015, the allotted amount for the 1-week FX REPO auction was \$ 2.4bn at a weighted repo rate of 1.5%; \$ 12.5bn for the 28-day FX REPO auction at a weighted repo rate of 1.0%; and \$ 5.5bn for the 12-month FX REPO auction at a weighted repo rate of 2.1%. As of 26 May, the volume of foreign currency obtained as repo loans amounted to \$ 0.1bn at the average weighted one-week repo rate of 2.3%; to \$ 5.0bn at the average weighted 28-day repo rate of 2.2%; and to \$ 0.8bn at the average weighted 12-month repo rate of 3.2%. It should be noted that the shrinkage of demand for foreign exchange repo loans 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.

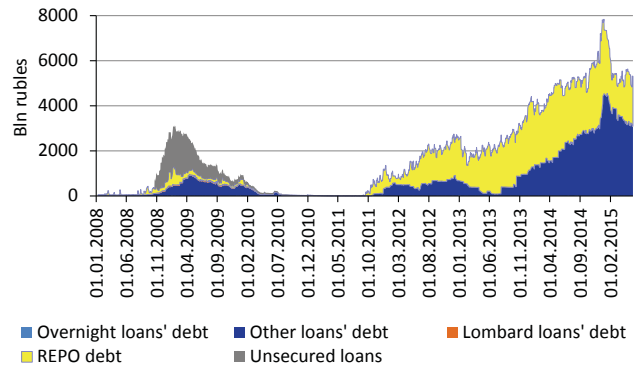
On 17 April, the Bank of Russia held an auction to provide US dollar loans secured by the pledge of claim to credit institutions. The allotment amount for the 28-day auction was \$ 451m. The announced 365-day auction was cancelled due to the participation of only one credit institution. On 15 May, the allotted amount for the 28-day auction was \$ 451.0m at a cut-off rate of 1.9311% per annum. Another 28-day auction announced for May was cancelled due to the participation of only one credit institution.

Over the course of April 2015, the Bank of Russia's international reserves volume remained practically unchanged, amounting as of 1 May to \$ 356bn. The increased amount of the banking sector's FX debt to the Bank of Russia was set off by the rising euro/USD exchange rate, as well as by the rising price of gold. From 14 May 2015, the Bank of Russia launched its FX interventions, purchasing foreign currencies in order to replenish its international reserves. As of 26 May, the aggregate volume of the Bank of Russia's FX interventions amounted to \$ 1,781m. In this connection it should be noted that the regulator's decision to resume its FX interventions is not aimed at sustaining any specific FX rates.

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 same period, net capital outflow from the banking sector was \$ 14.6bn; that from the other sectors – \$ 18.0bn. It should be reminded that the entire volume of net capital outflow in 2014 amounted to Rb 151.5bn, which is 2.5 times more than the corresponding index for 2013.

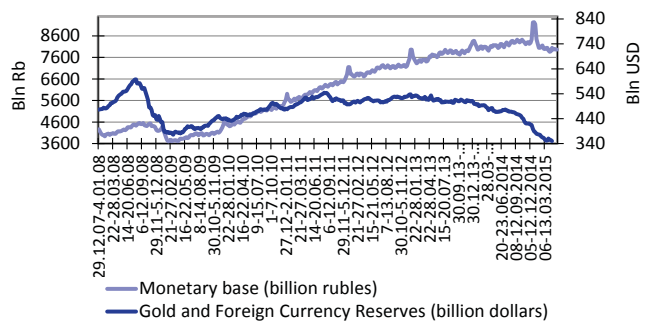
In April, the ruble's foreign exchange rate in real terms continued to be on the rise. The ruble's real effective exchange rate against the two major foreign currencies gained 13.2% (vs. 10.5% in March 2015) and presently corresponds to the 2007 rates. On the whole over the four-month period (January–April 2015 vs. January–April 2014), the ruble's real effective exchange rate in annual terms declined by 19.8%. It should be reminded that, over the course of H2 2014, the real effective exchange rate of the ruble had lost 28.5% (Fig. 7).

Over the course of April 2015, the exchange rate of the US dollar against the ruble declined by 11.3% to Rb 51.1, and the euro's exchange rate against the ruble – by 7.9% (to Rb 57.2). In April, the average exchange rate of the euro against the US dollar amounted to 1.08. Over April, the value of the bi-currency basket



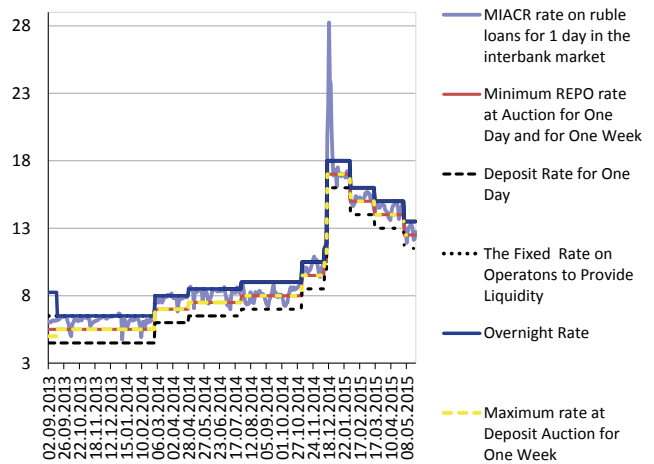
Source: RF Central Bank.

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



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)

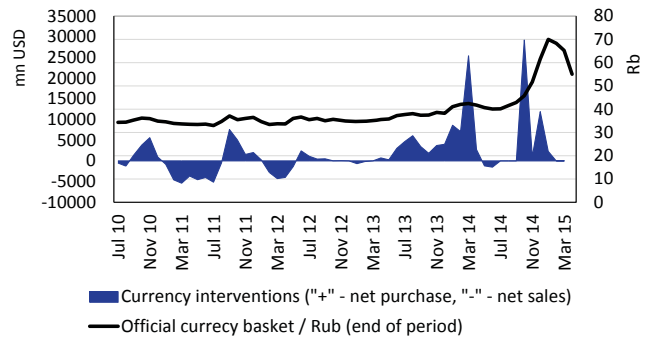
declined by 9.7% to Rb 53.8. Over the course of the first 27 days of May, the USD/ruble exchange rate declined by 1.6% to Rb 50.3, while the euro/ruble exchange rate dropped by 4.1% to Rb 54.8; as a result, the bi-currency basket's value shrank by 2.8% to Rb 52.4. In May, the average euro/USD exchange rate

amounted to 1.12. The strengthening of the ruble over the period February–May occurred in response to the current account surplus, the stabilization 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. Given the fact that over the period January–April 2015 the Bank of Russia undertook no foreign exchange interventions, the upward pressure on the ruble's foreign exchange rate was also in part exerted by FX repo transactions.

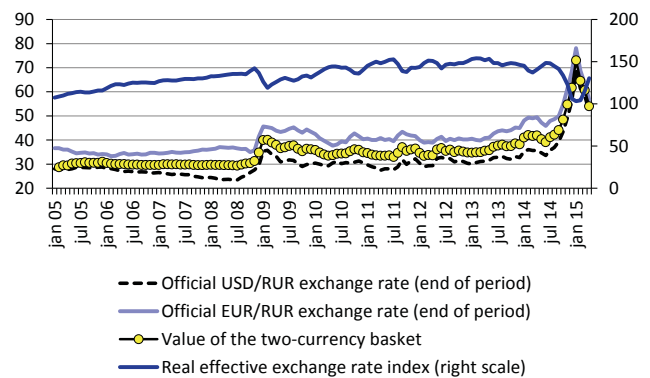
Thus, the ruble's strengthening has occurred primarily due to the effects of fundamental factors affecting the balance of payment (for further details, see the Gaidar Institute's *Operative Monitoring of the Economic Situation No 8, 2015*¹). As for the significant drop in the USD/ruble exchange rate over the period H2 2014 – January 2015 to Rb 68.9 followed in February–April 2015 by an increase to Rb 51.7, this FX movement pattern reveals the high volatility of the ruble's exchange rate. However, we know from international experience that the increasing volatility of a national currency's foreign exchange rate is a typical feature of the period of a switchover to inflation targeting, observable in the developed and developing countries alike. However, while in developed countries the national currency's FX rate volatility index typically peaks in the year preceding that of the switchover to inflation targeting, in developing countries it occurs in the same year as the switchover to inflation targeting.

The most significant surges of their national currency's FX rate were experienced by those countries that undertook their monetary policy reform at the time of a FX crisis. Thus, for example, the per annum volatility index of the South Korean won jumped to 18.2% in 1997; that of the Thai baht – to 11.5% in 1998. On the other hand, the FX rate volatility index of the South African rand hit its record high in 2001, after that country's switchover to inflation targeting. Against the backdrop of such developments, the per annum volatility index of 16.6% displayed by the Russian ruble in 2014 due to the combined effects of several negative shocks produced by the switchover to a new monetary policy regime does not appear to be extraordinary in any way (Fig. 8).

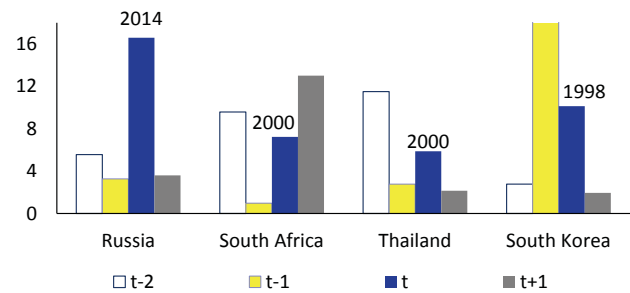
In view of the significant strengthening of the ruble, the RF Central Bank was forced to toughen its policy with regard to rates and terms of refinancing for FX loans. So, from 21 April, the RF CB increased the mini-



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 – April 2015



Source: RF Central Bank.
 Fig. 7. Behavior of the Ruble's Exchange Rate Indicators in January 2005 – April 2015



* t – year of official switchover to inflation targeting
 Sources: RF Central Bank; IMF; authors' calculations.
 Fig. 8. The FX Volatility Indexes of Some Countries after Their Switchover to Inflation Targeting Policies

um interest rates for foreign currency REPO auctions by 0.5 p.p., to LIBOR plus 2 percentage 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 percentage points 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

1 <http://www.iep.ru/ru/publikacii/7497/publication.html>

interest rates introduced from 13 April 2015, the minimum interest rates on FX loans 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.). This measure introduced by the Bank of Russia is designed to prevent an excessive strengthening of the ruble, which occurred not only due to the impact of some fundamental factors, but also to investors' overoptimistic estimations of the state of the Russian economy and its geopolitical background. Moreover, it should be borne in mind that the Bank of Russia will be able once again to soften its terms for providing the market with foreign exchange – if and when necessary.

The stabilization of the inflation rate and the ruble's FX rate made it possible for the Bank of Russia Board of Directors, on its meeting as of 30 April 2015, to lower the key interest rate from 14% to 12.5% per annum. By way of providing justification for the further reduction of the key rate, the regulator noted that the inflation

risks had become less pronounced, but that the risks of a more significant economic cool-down were still there. The news of the key rate reduction had practically no effect on the foreign exchange market, whose behavior was influenced in the main by the upward movement of oil prices. At the same time, by all indications, the Bank of Russia does not believe that any further strengthening of the ruble should be feasible, because on 14 May, as we mentioned earlier, Russia's main financial regulator announced that it would once again resort to interventions in the form of foreign exchange purchases in order to replenish its international reserves, in the amount of \$ 100m – 200m per day. These will be interventions on a comparatively small scale, and they are unlikely to significantly influence the market situation. However, this decision can be interpreted as a signal that the Bank of Russia considers the current FX rate of the ruble to be justified and appropriate. ●