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## Inflation and Monetary Policy

*In August, the consumer price index was the lowest in the current year and amounted to 0.1% (against 0.2% decline in August 2011). The main inflation curbing factor was the inflation decline in food prices (-0.5%). The second phase of regulated tariffs indexation urged the acceleration of inflation in September, which made 0.4% within 17 days. As a result, cumulate inflation from the beginning of the year exceeded the relevant indicator of the previous year, amounting to 5% as of September 17 (vs. 4.6% in 2011). Foreign currency and gold reserves in mid-September reached the maximum peak of the four months and amounted to \$522.8bn. From September 14, the Bank of Russia has tightened the monetary and credit policy, having raised the interest rate by 0.25 p.p. to 8.25%. On September 21, the Bank of Russia decided to reduce the maximum interest rate on deposits from October 1.*

Related seasonal decline in foodstuffs prices encouraged an expressed inflation decelerating in August: as per the month results, the consumer price index has reached 0.1% , which is the lowest indicator for this year (in August 2011, deflation by 0.2% was noted). Regardless price reduction for fruit and vegetable products, growth rate for other foodstuffs was positive and amounted to 0.8%. In view of grain crop wreckage, the utmost price growth was observed in bread and bakery products (+2.2%), as well as pasta (+1.8%). Sugar price was quickly growing as well (+1.8%).

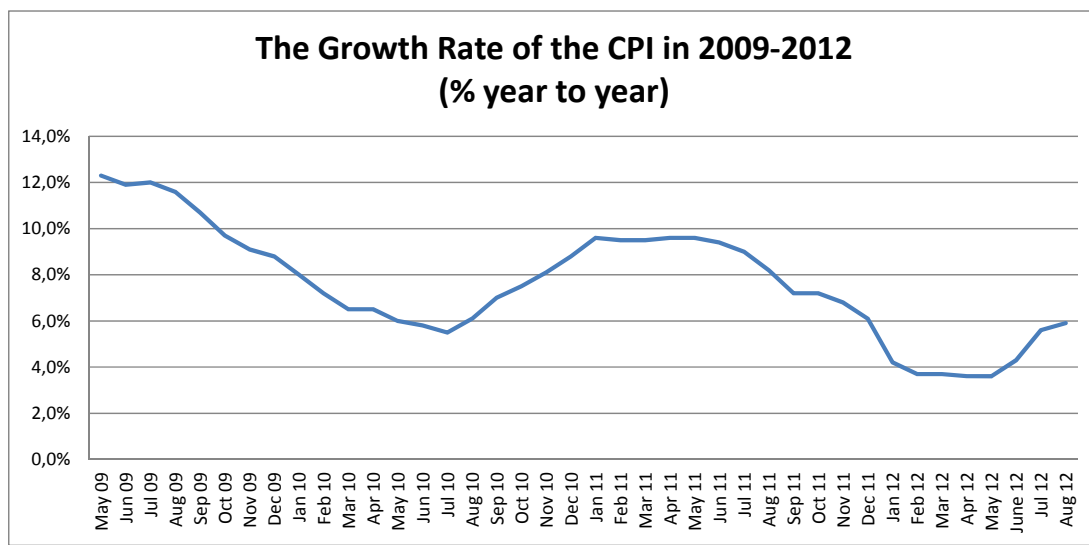
Growth rate of non-food items prices continued its growth, having increased from 0.3% to 0.4% (vs. 0.5% in August 2011). The greatest contribution to the rise in prices, as in previous months, was made by tobacco (+1.5%), which growth rate has increased more than two-fold (+3.5%). At the peak of construction season, prices have grown for construction materials (+0.6%). After a brief pause in August, gasoline prices rose again (+0.5%), which is provoked by the July increase in excise tax. Like in previous period, the only cheapening products were still video and audio appliances (-0.3%).

After the July indexation of tariffs for housing and public utilities, price growth for public commercial services has substantially slowed down; in August they went up only by 0.6% (against +2.7% in July 2012 and 0.3% in August 2011). In August, the growth rate in tariffs for housing and public utilities by 0.4% was noted (vs. 5.7% in July of the current year). In the expectation of the forthcoming new school year, education prices went up (+2.7%), in particular, for higher education (+6.7%). High demand was observed for foreign hotel vouchers, and the ongoing summer vacations contributed to their cost upgrading by 1.7%. There was no reduction in any type of commercial services in August.

In August, the annual inflation (August 2012 against August 2011) has accelerated to 5.9% (see Fig. 1), which is 1.5 times lower than in the relevant period of the last year. In early September the annual

inflation indicator has exceeded the bottom threshold of the official estimates. The core consumer price index<sup>1</sup> went up again, having made 0.6% (vs. 0.4% in 2011).

In the first days of September the second stage of the government-regulated tariffs was implemented, which has spurred inflation again. As of 17 days of September, the index of consumer prices increased by 0.4% (against a decline in prices by 0.1% for the same period in 2011). As a result, the cumulative inflation since the beginning of the year has surpassed the indicator of the previous year (+4.6%), amounting to 5% as of September 17. In September, the seasonal reduction in prices for vegetables and fruits was observed. In addition, significant growth was noted in eggs (+5%) and wheat flour (+3.6%). Among industrial goods, accelerated growth rate of gasoline prices was noted (+1%).



Source: RF Statistical Service.

Fig. 1.

After three months of growth, in August the monetary base in broad definition has decreased by 1.3% to Rb 8,107.8bn. The growth was based on the reduced commercial banks correspondent accounts with the Central Bank of Russia (-17.6%). Other components of the monetary base in broad definition were growing: the amount of cash in circulation (+0.1%), mandatory reserves (+1%), commercial banks deposits with the Central Bank of Russia (+26.6%).

In August, the excessive reserves<sup>2</sup> of commercial banks were still decreasing, having amounted to Rb 8898bn at the end of the month (-11.7%). The situation with the banks' liquidity has not changed: the banking sector continues to experience a shortage of liquidity, as evidenced by the growth in dynamics of borrowing from the Bank of Russia (see Fig. 2).

<sup>1</sup> The core consumer price index reflects the level of inflation in 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, which is also calculated by the RF Statistical Service (*Rosstat*).

<sup>2</sup> Under the excessive reserves of commercial banks with the RF Central Bank is understood the sum of correspondent accounts of commercial banks, their deposits with the RF CB and the RF CB bonds of commercial banks.

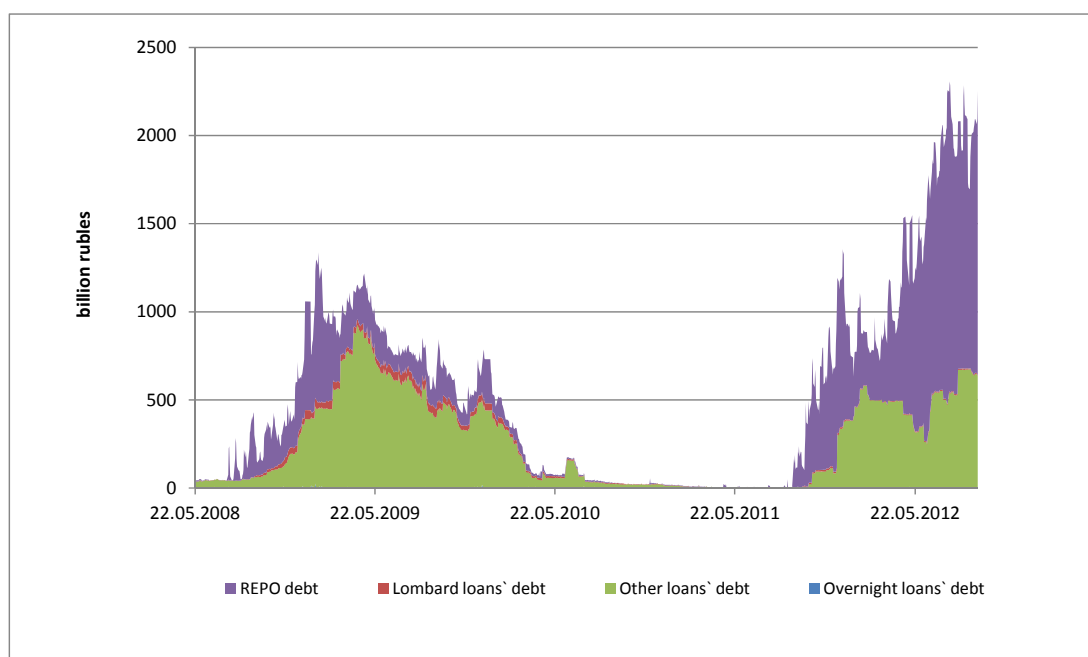


Fig.2. Arrears of commercial banks with the Bank of Russia in 2008–2012.

In August the monetary base in narrow definition (cash plus mandatory reserves) has somewhat increased, having reached at the end of the month Rb 7,217.9bn (see Fig. 3).

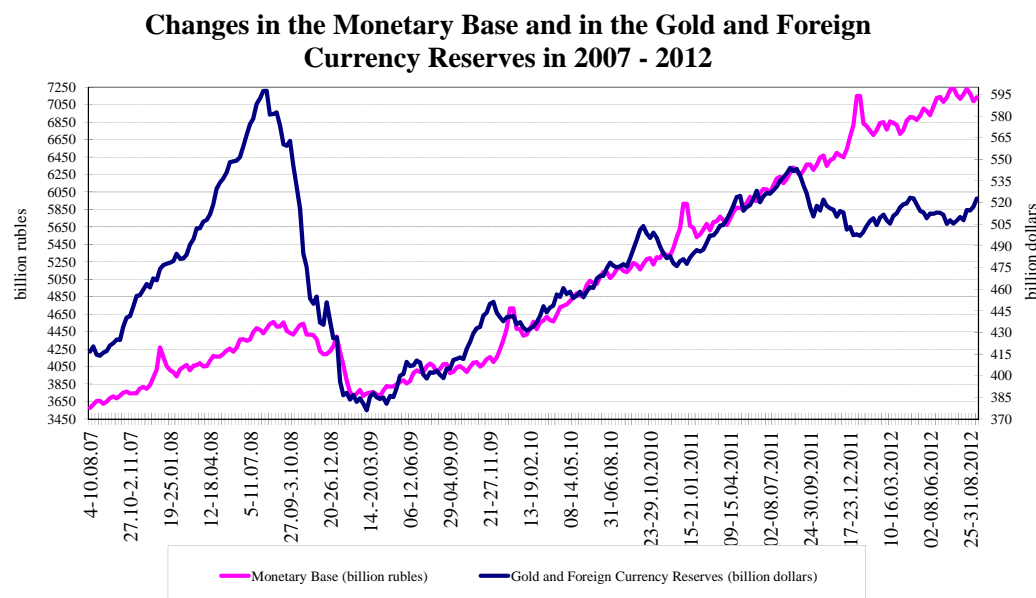


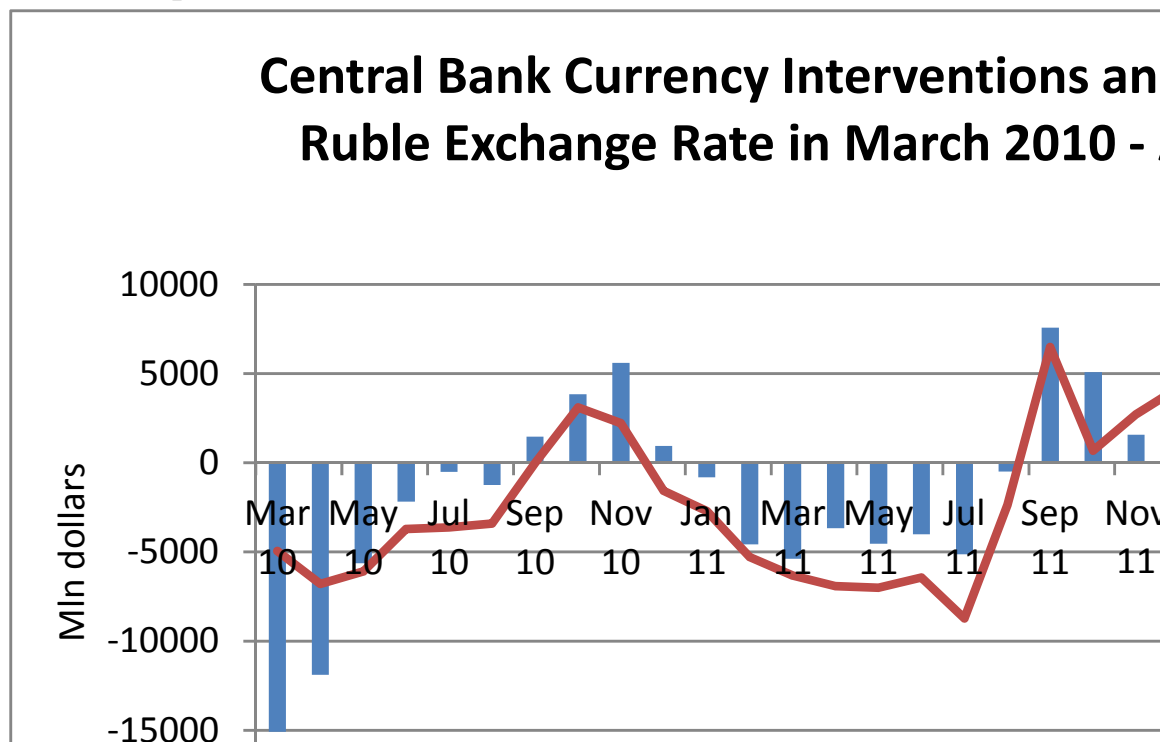
Fig.3. Dynamics of the RF monetary base (in narrow definition) and gold and foreign currency (international) reserves in 2007–2012.

In August, the Bank of Russia has decreased the amount of foreign exchange intervention by 2.5 times. Like in the last three months, the Controller acted as a net seller of currencies: \$385.4m and Euro 47.5m were sold in the domestic market (see Fig. 4).

Within month, from mid-August, international reserves were growing. On September 14, their volume amounted to \$ 522.8bn (+2.9%), having reached the maximum of the four months. It was contributed by the revaluation of foreign currency and gold reserves, which price has grown at the background of dollar decline in anticipation of the adoption of the US FRS decision to mitigate monetary policy.

In August an outflow of capital was observed again. According to tentative assessments of the Bank of Russia, it remained at the July level and amounted to about \$3bn. According to the Ministry of Economic Development of Russia, the capital flight was slightly lower - about \$1bn.

*In September, the Bank of Russia expects capital inflow from sales of 7.58% of Sberbank shares. It also does not rule out capital inflows in QIII and QIV. Nevertheless, as per the year performance, the Regulator has increased the official forecast of capital outflow from July level of \$40bn to \$65bn. the Ministry of Economic Development gives a more optimistic assessment - \$60bn.*

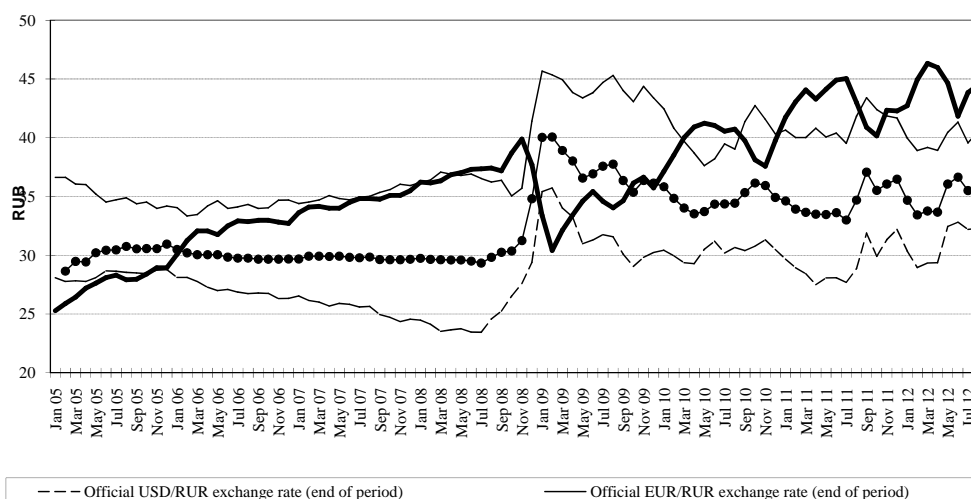


Source: RF Central Bank, author's estimates.

*Fig. 4.*

The ruble real effective exchange rate was strengthening. Within the month it has grown by 1%. As a result, index of the real effective exchange rate increased to 150.13 (see Fig. 5).

### Indicators of Ruble's Exchange Rate Dynamics



The level of January 2002 is accepted as 100%.

Source: RF Central Bank, author's estimates.

*Fig. 5.* Indicators of ruble exchange rate dynamics in January 2005 – August 2012.

In early September, the dollar was weakening against the ruble: over 18 days of the month, it fell down by 6.1%, having decreased to the four-month minimum - 30.57 Rb / \$1. In the third week of the month US currency managed partially to gain the lost positions. As a result, within three weeks of September the ruble has strengthened against the dollar by 3.5%, i.e., Rb 31.17 / \$1 as of September 22.

In the first two weeks of September, the European currency against the ruble was relatively stable, fluctuating between Rb 40.48-4072 / Euro 1. In the third week of the month Euro has initially weakened by about 1%, and then has grown by the same amount. As of three weeks of September, Rb exchange rate against Euro remained practically unchanged, amounting to Rb 40.45 / Euro 1 on September 22. As a result, the value of the two-currency basket has decreased by 1.8% to Rb 35.36.

Strengthening of the Russian ruble against dollar and Euro in the middle of the month was encouraged by the FRS decision to hold a third round of quantitative mitigation of monetary policy, as well as by the decision of the Bank of Russia to raise the refinancing rate. In the third week of September, the depreciation of the ruble was due to the renewed downgrading in the global oil prices, following the publication of new data on oil reserves in the United States. In addition to external factors, the depreciation of the domestic currency was urged by the deterioration of the balance of payments current accounts. In QIII 2012, according to the HSE National Research University estimates, the current account balance of payments can amount to \$17bn, which is 20% less than in QII (\$21.2bn).

From September 14, 2012, the Bank of Russia raised the refinancing rate and the other key interest rates on providing and absorbing liquidity by 025 p.p.

From that day, the refinancing rate is set at 8.25%. Thus, in nine months the Regulator has returned to the rate effective from May 3 to December 26, 2011.

This decision of the Bank of Russia is associated with the accelerated inflation in recent months, which annual rate of in early September has exceeded the government's official forecast of 6%. The main factors of inflation growth now are nonmonetary ones: upgrading of housing services and utilities tariffs, as well as an increase in the global prices for foodstuffs due to adverse weather conditions in some countries. In addition to this, base inflation started to accelerate in summer. It is also important to note that in addition to reducing inflation, another objective of the Regulator is to restrain the rapid pace of crediting growth. The credit boom, observed in the present time in Russia can involve bad loans' growth. According to Alexander Simanovsky, the RF CB First Vice-President, as of 2012 results, credit growth will make 20-25%.

On September 21, the Bank of Russia decided to reduce the maximum interest rate on deposits. From October 1, the Regulator will switch to the average rate assessment by a new method. The combined deposit products (pension funds or insurance funds) will be excluded from the assessment, which will reduce the interest rate by more than 1 p.p. This decision is aimed at reducing the risk of banks' default, resulting from the fact that credit institutions excessively increase interest rates on deposits to attract individuals' assets.

Currently, the average interest rate on ruble deposits amounts to 9-10%, except the top-10 banks. Herewith, the inflation rate estimate does not exceed 6-7%. Thus, the difference is at least 3%. A fair real interest rate on deposits should not exceed 1-2%. Taking this decision, the Bank of Russia pursues the objective to reduce interest rates to that level.