

RATES, RISKS AND M2: FACTORS AFFECTING THE RATE OF INFLATION¹

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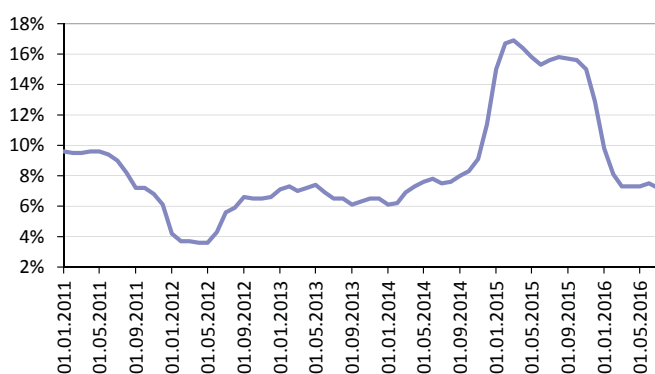
In September, the Central Bank of Russia made a decision to cut the key rate by 0.5 p.p. to 10%. The intention of the Central Bank of Russia to stick to a moderately tough monetary policy is justified by the need to consolidate the trend towards sustained reduction of the rate of inflation.

Taking into account the continued slowdown of the rate of inflation, reduction of economic agents' inflationary expectations, as well as the ongoing stagnation, in September the Central Bank of Russia cut the key rate by 0.5% to 10%. In August and early in September 2016 consumer prices remained on average unchanged. It is to be noted that in the past 12 months the accumulated inflation indicator fell from 7.2% in July to 6.9% in August which value is equal to the level of March 2014 (Fig. 1). Slowdown of the rate of inflation was contributed to by a seasonal factor, low aggregate demand, as well as appreciation of the ruble.

Also, in August the level of households' inflationary expectations decreased considerably. According to the estimates published by the Central Bank of Russia, the median value of the expected rate of inflation for a year ahead fell by 1.7 p.p. and amounted to 12.6%, which is the minimum value of that indicator since October 2014.

In August, the core inflation² amounted to 0.4%, having increased by 0.1 p.p. as compared to the previous period. It is to be noted that within that month it exceeded by 0.4 p.p. the rate of growth of the consumer price index which means that upward pressure on prices was put on by factors which are mainly of administrative and seasonal nature.

In August, consumer goods depreciated by 0.6%, mainly, due to a seasonal reduction of prices on fruit and vegetable products. On the contrary, growth rates of prices on non-food products increased to 0.4%. As a result, the contribution of the group of non-food products to the dynamics of the consumer price index (CPI) tuned out to be the highest one as compared to that of other components and amounted to 45.1%. In August, prices and tariffs on paid services to households rose by 0.4%.



Source: The Rosstat.

Fig. 1. Growth rates of CPI in 2011–2016, % a year

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² The baseline index of consumer prices shows the level of the rate of inflation on the consumer market with exclusion of seasonal (prices on fruit and vegetable products) and administrative (tariffs on regulated types of services and other) factors which are calculated by the Rosstat of the Russian Federation, as well.

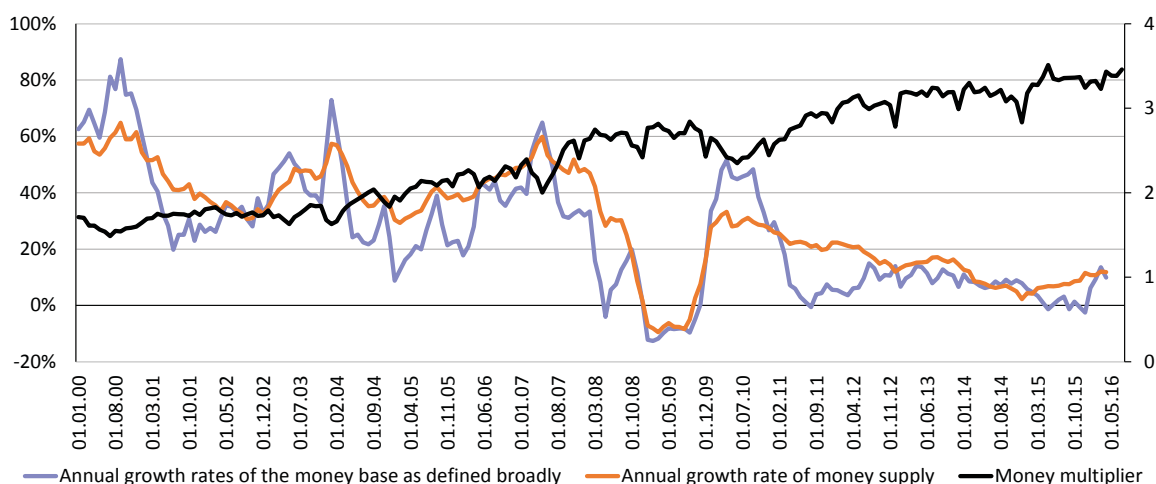
The highest contribution into appreciation of services in August was made by seasonal growth – which took place despite appreciation of the ruble – in prices on foreign tourism services.

A possible renewal of the aggregate demand which with all other conditions being equal may lead to upward pressure on consumer good prices is still a source of inflation risks. In particular, both in Q1 and Q2 2016 nominal wages rose by 7.7% as compared to the same period of 2015, having continued their growth in July 2016 (7.8% against July 2015). In September–December 2015, that index grew on average by 3.4% year-on-year. Due to slowdown of the rate of inflation in Q2 2016 (for the first time since Q3 2014) positive growth rates – 0.3% on the same period of 2015 – of real accrued wages were observed.

In 2016, an additional source of risk of inflation rate growth is a speed-up of M2 money supply growth rates justified both by an increase in the money base as the Reserve Fund's sources for budget deficit financing were spent and renewal of the lending activity. In January–July 2016, M2 growth rates amounted on average to 11.7%, while during the same period of 2015 they did not exceed 6.0% (Fig. 2).

Money base growth at the expense of spending of the Reserve Fund's sources exceeds reduction thereof which factor can be explained by a decrease of the banking sector's debt to the Central Bank of Russia, as well as holding of depositary auctions by the latter. Due to the above, in Q1 and Q2 2016 despite the fact that the key interest rate remained unchanged till mid-June interest rate cuts were observed. In particular, interest rates on deposits to individual for a one-year term fell from 8.53% per annum in January to 7.2% per annum in June 2016. As an additional measure to prevent expansion of the money base, in September 2016 the Central Bank of Russia made a decision to issue bonds for the terms of three, six and 12 months with a three-month coupon.

Risks of a speed-up of inflation rate growth due to the exchange rate dynamics are not high. So, in August the ruble appreciated by 1.1% to Rb 65.3 per \$1, while early in September, by another 1.2% to Rb 64.4 per \$1. Strengthening of the ruble is justified by appreciation of oil prices which in August amounted to 1.3% (up to \$47.3 a barrel). In addition to the above, the



Source: The Central Bank of Russia.

Fig. 2. Dynamics of money aggregates and money multipliers in 2000–2016

ruble was underpinned by depositary operations carried out by the Central Bank of Russia in August and aimed at withdrawal of funds received by the banking sector through a budget channel.

Among the factors which may contribute to depreciation of the ruble, one can point out the uncertainty related to the dynamics of oil prices (including that justified by economic problems faced by China), possible toughening of the US Federal Reserve's monetary policy and dramatic growth in Russia's budget deficit.

So, despite some stabilization in the economy the Central Bank of Russia still has to take into account both domestic and external factors which affect economic agents' inflation expectations and prevent reduction of the key rate this year. It is to be noted that as the rate of inflation and inflation expectations are reduced with the key rate remaining unchanged the monetary policy is getting tougher. So, in the next six months the Central Bank of Russia will have to look for a delicate equilibrium, that is, to secure inflation targets (that will become a significant result of the monetary policy) and prevent its policy from producing an adverse effect on economic activities. ●