



**THE CENTRAL BANK
OF THE RUSSIAN FEDERATION
(BANK OF RUSSIA)**

Monetary Policy Report

No. 2 (6) • June 2014

Moscow

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The report has been prepared on the basis of data as of 6 June 2014.
Data cut-off date for forecast calculations is 27 May 2014.

An electronic version of the information and analytical report can be found on the official website of the Bank of Russia: <http://www.cbr.ru/publ/>.

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Summary

In March-June 2014, the Bank of Russia conducted its monetary policy under challenging conditions. The heightened political tension caused by the developments in Ukraine had a strong impact on the Russian financial market, the banking sector and the economy as a whole. Given increased inflation risks, in the period under review the Bank of Russia raised the key rate twice: from 5.50% to 7.00% per annum in March 2014 and then to 7.50% per annum in April 2014. In June, the key rate was maintained at 7.50% per annum. If existing inflation risks materialise, and threats to medium-term inflation targets emerge, the Bank of Russia will continue increasing the key rate.

In February-March 2014, an increased uncertainty with regard to the developments in Ukraine and their consequences for the Russian economy brought about a further depreciation of the ruble, intensified capital outflow and deterioration of external financing conditions. Against this background the Bank of Russia decided on 3 March 2014 to raise the volume of cumulative interventions triggering a 5-kopeck shift in the operational band borders from \$350 million to \$1.5 billion. The move helped to prevent a more substantial depreciation of the ruble. In April – first half of June 2014, the situation in the foreign exchange market stabilised, the rate of deposit dollarisation started to decline, and non-residents began to regain interest in Russian financial assets.

Inflation substantially accelerated in February-May 2014. The year-on-year consumer price growth rate increased from 6.2% in February to 7.6% in May 2014. The ruble depreciation affected the prices of a wide range of goods and services becoming a major factor behind inflation acceleration. The contribution of exchange rate dynamics to year-on-year inflation rate in May is estimated at about 0.8 percentage points. Besides, prices for some food items were boosted by a number of specific factors affecting their markets, including temporary restrictions on imports. Increased inflation expectations exerted additional pressure on prices.

According to the Bank of Russia estimates, the recent ruble depreciation will continue to affect consumer prices in the coming months. However, in the second half of 2014 inflation is expected to decelerate as a result of foreign exchange market stabilisation, lower planned increases in administered prices and tariffs compared to the previous year, good expected harvest, and total output of goods and services remaining below potential.

While the structural factors continued to contribute to economic slowdown, in 2014 Q1 economic growth was negatively affected by heightened geopolitical uncertainty. The latter caused a reduction in investment which is most sensitive to the impact of this factor among GDP components. Against this background, the Bank of Russia lowered its GDP growth forecast for 2014 from 1.5–1.8% to 0.4%. Given the declining producer confidence and reduced availability of borrowed funds to non-financial companies, fixed capital investment is expected to contract. Lower growth rates of real wages and household lending will lead to a slowdown in consumer demand growth. However, it will remain the major driver of economic growth. In 2014, net exports will make a positive contribution to GDP growth since imports will fall due to weaker domestic demand while exports growth rates will remain positive.

The Bank of Russia forecasts that in the medium term economic growth rates will increase: to 0.9% in 2015 and 1.9% in 2016.

Since monetary policy influence on the economy is distributed over time, inflation slowing to the 5.0% target in 2014 is unlikely. According to the Bank of Russia forecast, consumer price growth rate will decline to 6.0% by end-2014. Thereafter, the effect of factors behind the observed inflation

acceleration will be exhausted. Maintaining current monetary policy stance will ensure a slowdown in consumer price growth to the target levels in the medium term. A decline in inflation expectations is a necessary condition for inflation deceleration.

Nonetheless, the risks of inflation exceeding the target levels in the medium term are high. If the geopolitical situation deteriorates, the ruble may continue to depreciate. In this case inflation expectations will increase thus impeding the slowdown in inflation. Consumer price growth acceleration may also occur as a result of deteriorating conditions in the food commodities markets caused by unfavourable weather conditions. Should these risks materialise, the need for the monetary policy response will be assessed taking into account its expected influence on consumer prices in the medium term.

Introduction

Major developments and trends affecting Bank of Russia policy after the publication of the February 2014 Monetary Policy Report

The period after the publication of the previous Monetary Policy Report was marked with unusual developments which affected trends in the financial sphere and the economy, as well as the Bank of Russia's policy. While the main focus of market participants from mid-2013 to early 2014 was targeted on changes to the policy pursued by the US Federal Reserve (Fed) and their impact on the situation in emerging markets, from February 2014 geopolitical factors came to the fore. The shift in power in Ukraine, the accession of Crimea to Russia, sanctions by certain countries against Russian individuals and legal entities and tension in the eastern and southern provinces of Ukraine, all had a significant adverse impact on the situation in the financial market and in the banking and real sectors. As a result of the increased uncertainty and the ruble's depreciation, inflation accelerated rapidly and inflation risks rose. Against this backdrop, the Bank of Russia took active measures to stabilise the situation. At present, the situation in the domestic financial market has largely normalised, but a number of problem areas have emerged which may require further measures from the Bank of Russia.

The main factors outlined below had their impact on the Bank of Russia's policy.

A sharp increase in pressure on the ruble in early March

The trend towards ruble depreciation began shaping even before the onset of the geopolitical developments mentioned above. After the Fed had announced its plans to gradually curtail its asset purchase programme in May 2013, the exchange rate of the ruble and other currencies of emerging market economies started to gradually decline against the US dollar. Thanks to the more stable position of Russia's current account, the ruble depreciated slower than many other currencies such as the Brazilian real, the Indian rupee and the Turkish lira. In January 2014, the pressure on the ruble intensified amid investors' reassessment of the Russian economic growth prospects, together with the slowing growth of the Chinese economy and the increasing tension in the shadow banking sector in China, both of which affected the currencies of commodity exporters, including the ruble. Moreover, while the Bank of Russia did not change its key rate from the second half of 2013 to January 2014 in line with the forecast decline in inflation to its target by the end of 2014, many central banks of emerging market economies increased their interest rates during this period. Against this backdrop, the rates and yields in the Russian financial market became less attractive to foreign investors, which intensified the speculative pressure on the ruble. The escalating tension in Ukraine came into play in early 2014 when international portfolio managers started to sell Russian securities, which was partly aimed at hedging illiquid Ukrainian investment positions. With this, active discussions in the Russian economic community and media on the after-effects of the transition to the floating exchange rate only intensified the ruble depreciation expectations. In this regard, the Bank of Russia is aware of the need to increase the effectiveness of its communication policy.

Furthermore, after the shift in power in Ukraine, the announcement of a referendum on the status of Crimea and the approval by the Federation Council of sending a limited contingent of Russian troops to guarantee the security of Russia's Black Sea Fleet and Russian citizens in Crimea, the situation in the domestic foreign exchange market became strained. Indicative quotes for the

major global currencies against the ruble had increased by more than 1.5% compared with the close of the previous session before trading had even started on the Moscow Exchange on 3 March.

To prevent any speculative attacks on the ruble, prior to the start of trading on 3 March, the Bank of Russia decided to change the parameters of its operations in the domestic foreign exchange market within the existing exchange rate policy mechanism and simultaneously significantly increase interest rates on its operations in order to mitigate inflation risks. The cumulative volume of interventions triggering a 5-kopeck shift in the operational band borders was increased from \$350 million to \$1.5 billion. This helped contain any sharp depreciation of the ruble caused by panic among domestic foreign exchange market participants. On the very first day, 3 March, the Bank of Russia sold foreign currency worth the equivalent of \$11.3 billion to stabilise the ruble exchange rate. In the following days, the situation normalised somewhat, though there was also an increase in foreign currency sales by the Bank of Russia on 12–14 March due to external political developments. From April to May, as the situation stabilised Bank of Russia currency sales dropped significantly. In the first ten days of May, the ruble was in the neutral range of the operational band, and the Bank of Russia only purchased foreign currency to transfer funds to Russia's Reserve Fund. Overall, in the period from March to May 2014, net currency sales by the Bank of Russia totalled \$27 billion (gross sales amounted to \$28.6 billion and gross purchases were \$1.6 billion).

The scale and nature of the pressure on the ruble in the period under review are reflected by data on the private sector net capital outflow. In 2014 Q1, it accounted for an estimated \$50.6 billion, and excluding the impact of the Bank of Russia's foreign exchange swaps and resident banks' operations on correspondent accounts with the Bank of Russia¹ it was \$63.7 billion. The corresponding indicators in March stood at \$16.8 billion and \$36.7 billion, according to estimates. Companies and households converted their ruble deposits into foreign-currency deposits and exporters decreased sales of foreign-currency receipts. Consumer deposit dollarisation rose from 17.0% at the start of January to its peak of 21.0% on 5 March. Thus, the increase in capital outflow was predominantly caused by domestic reasons: the conversion of household and legal entities' savings into foreign currency rather than withdrawal of funds by non-residents from Russia to foreign jurisdictions. This conclusion is also supported by data on net household purchases of foreign cash: about \$12.4 billion in 2014 Q1, compared with net household foreign-currency sales of \$1.3 billion in the same period of 2013. Net foreign cash imports by authorised banks totalled more than \$20 billion, with a significant proportion of the currency remaining in credit institution vaults to be used in case of further growth in consumer demand.

By the end of March, the US dollar/ruble exchange rate had returned to the level of the end of February 2014, and by the end of May it had returned to the level of the second half of January 2014. The slight decrease in external political tension contributed to the ruble's appreciation. Nevertheless, the Bank of Russia also made its contribution: it increased the key rate by two percentage points to curb inflation. The increase in interest rates in the financial market made 'short' ruble sales unprofitable and also made Russian assets more attractive to foreign investors compared with other countries' assets.

According to estimates, from April to May, global funds investing in Russian assets increased their investment in Russian bonds by \$727.3 million and in stocks by \$240.9 million (from February to March, global funds decreased their investment in bonds and stocks by \$888.2 million and \$1,044.6 million respectively). The demand from foreign investors was mainly focused in the

¹ Growth in outstanding foreign exchange swaps with the Bank of Russia and the increase in the amount of funds in banks' currency accounts with the Bank of Russia are reflected in the balance of payments as a fall in the foreign assets of credit institutions (and an increase in central bank assets), thus underestimating the value of the private capital outflow.

government securities segment. In May, foreign investors, whose share in the primary OFZ bond market turnover had reduced from 30% in January-February to 17.2% in April, started to play an active part in OFZ auctions. Consequently, the share of non-residents in total securities purchases in the primary market increased to 49.3%. Household deposit dollarisation fell to 19.6% as of early June 2014. According to preliminary estimates, the total private sector capital outflow, excluding Bank of Russia's foreign exchange swaps and resident banks' operations on correspondent accounts with the Bank of Russia, dropped in April to less than \$10 billion and continued to fall in May.

Despite temporary adjustments in the exchange rate policy mechanism to ensure financial stability, the Bank of Russia adheres to its strategy of transition to a floating ruble exchange rate. With the stabilisation of the situation in the foreign exchange market and the diminishing threat to financial stability, on 22 May the Bank of Russia reduced the amount of interventions aimed at smoothing out exchange rate fluctuations within the internal ranges of the operational band by \$100 million. Nonetheless, despite a slight reduction the risks to financial stability remained. In view of the above, the cumulative volume of interventions triggering a 5-kopeck shift in the operational band borders was left unchanged at \$1.5 billion².

Inflation acceleration

In January 2014, the annual rate of inflation fell compared with December 2013. However, later the ruble exchange rate dynamics created prerequisites for inflation acceleration and growth in the devaluation and inflation expectations of economic agents. To stabilise expectations and inflation dynamics, the Bank of Russia Board of Directors decided to raise the key rate by 1.5 percentage points at its unscheduled meeting on 3 March and by 0.5 percentage points at its meeting on 25 April.

In March, annual inflation accelerated to 6.9% from 6.2% in February. An increase in price growth rates was witnessed, *inter alia*, in sectors not directly linked with imports of goods. The annual rate of inflation continued to increase to 7.3% in April and 7.6% in May. Core inflation also rose, to 7.0% in May from 5.5% in January, while core inflation excluding food products rose to 5.4% in May from 4.8% in January. Survey data suggest an increase in household inflation expectations in May 2014 after their marginal decrease at the start of the year. Moreover, producer prices rose considerably in a wide range of industries: the producer price index increased to 7.2% in April against the corresponding period of the previous year, compared with 4.7% in January.

The price growth acceleration in the Russian economy was caused by unforeseeable factors, namely the increase in geopolitical tension and the resulting depreciation of the ruble. However, taking into account the fact that the impact of this shock would not disappear in the medium term without changes in monetary policy, according to macroeconomic forecasts, the Bank of Russia resorted to increasing its key rate. It is commonly known that the main effects of a central bank's monetary policy on inflation are felt over a 12- to 18-month timeframe, however a central bank can exert some influence upon the economic agents' expectations in the short term. An increase in the Bank of Russia key rate and stabilisation of the exchange rate dynamics are conducive to stabilising inflation along the three monetary policy transmission channels: by reducing the contribution of the exchange rate pass-through effect, by limiting growth in inflation expectations, and by restoring the households' propensity for savings to normal levels. In addition, the observed growth in interest rates

² After the preparation of this Report, the parameters of the exchange rate policy were changed. See the press release, dated 17 June 2014, 'On the Parameters of the Bank of Russia's Exchange Rate Policy' under the 'Press Releases' section of the Bank of Russia website (http://www.cbr.ru/press/PR.aspx?file=17062014_100351dkp2014-06-17T09_47_56.htm).

on bank ruble deposits suspended converting and withdrawing deposits in the national currency, having contributed to the fall in bank deposit dollarisation.

While taking a decision on the key rate, the Bank of Russia proceeds from the need to achieve inflation targets in the medium term. This year, due to the lags in the impact of monetary policy measures on the economy there are significant risks of inflation exceeding its target at the end of the year (5.0%), as defined in the Guidelines for the Single State Monetary Policy in 2014 and for 2015 and 2016. According to Bank of Russia forecasts, inflation will fall to about 6% by the end of 2014, with risks skewed towards a less substantial slowdown in inflation, while in 2015 and 2016 it will reach the targets of 4.5% and 4.0% respectively.

'Banking scissors': the slowdown in growth of deposits and long-term liabilities and the rising structural liquidity deficit amid increasing demand for loans

In the period under review, there were three trends which had a negative impact on banking sector liabilities.

Firstly, there was a slowdown in the deposits growth. This process was influenced by anxieties surrounding the threat of sanctions against Russian banks and enforcement of restrictions on dollar deposits in banks, as well as the consumers' desire to purchase durable goods for future use amid the expected inflation acceleration. During the period of the first sanctions (5–31 March), there was a net outflow of deposits from credit institutions, including major banks. Later, the outflow stopped and gave way to an unstable inflow. However, the annual rates of growth in household deposits dropped sharply compared with the previous year: from 18.1% at the end of 2013 to estimated 10.5% as of 1 June 2014 adjusted for currency revaluation.

Secondly, due to the Bank of Russia's foreign exchange interventions, structural liquidity deficit rose sharply, which means that the proportion of Bank of Russia loans in total banking sector liabilities also rose. The Bank of Russia absorbs ruble liquidity by selling foreign currency in the domestic market. The ensuing liquidity outflow is offset by the increase in funds provision through refinancing operations. Over the period from 1 March to 1 May 2014, the share of refinancing operations on the Bank of Russia's balance sheet increased from 19.1% to 23.8%. Through its foreign exchange interventions over the period from March to the first ten days of May, the Bank of Russia withdrew ruble liquidity for a total amount of 1.1 trillion rubles³. As a result, the Bank of Russia's liquidity provision through refinancing operations reached 5.3 trillion rubles⁴ by mid-May, of which 3.2 trillion rubles were repo operations and 2.0 trillion rubles were loans secured by non-marketable assets or guarantees. According to estimates published in the previous Report, this amount of refinancing operations was not expected before October–November 2014. As the structural liquidity deficit increased, the share of Bank of Russia loans in total banking sector liabilities grew from 6.7% as of 1 March 2014 to 8.4% as of 1 May 2014 (according to balance-sheet data from credit institutions). This intensified the collateral scarcity problem, in part due to the low activity in the bond market in the period under review, which constrained collateral base growth. Against this backdrop, the Bank of Russia increased the amount of funds provided through auctions of loans secured by non-marketable assets. As a result, an outstanding amount of these operations rose by 1.1 trillion rubles between January and May. There was also an increase in the frequency and volume of foreign exchange swaps with the Bank of Russia.

³ From 3 March to 8 May 2014.

⁴ Gross credit to the banking sector, excluding subordinated loans to Sberbank of Russia and Bank of Russia deposits with credit institutions.

Thirdly, despite the fact that enforced sanctions affected directly only isolated 'second tier' banks, the threat of sanctions generated a rise in uncertainty which, coupled with the downgrading of Russia's sovereign credit rating, significantly changed the foreign funding conditions for Russian borrowers and impacted their activity. CDS spreads for Russia rose sharply, while a number of foreign banks reduced or shut off their limits on Russian counterparties. Overall, access to the international financial market has been made significantly more difficult for Russian companies. From early March, private transactions dominated in Russian companies' and banks' corporate Eurobond flotation operations and there was a perceptible fall in the number of public offerings. According to data from the Cbonds.ru news agency, the total volume of Russian corporate Eurobond flotations fell drastically: from \$19 billion in March-May 2013 to less than \$2 billion in March-May this year. In January-February 2014, Russian issuers attracted almost \$6 billion.

This situation impacted the Russian banking sector in two ways. On the one hand, Russian companies, including large corporations, which traditionally source long-term funds in the global markets, were to some extent deprived of this possibility. Those companies which witnessed a marked reduction in the accessibility of foreign funds had to switch their attention to the Russian lending market. On the other hand, there may have been another effect: while limiting the sale of currency receipts, exporters attracted ruble loans to service their current liabilities. As a result, despite the deterioration of price and non-price lending conditions in the period under review caused by growing uncertainty, shrinking resource base and the tighter monetary policy, lending growth rates have not declined, as one would expect, but have in fact increased. Growth in outstanding corporate loans accelerated to 17.5% in May compared with 12.7% at the end of 2013 (adjusted for currency revaluation, 14.1% and 9.3% respectively). Growth in lending to corporate customers registered in Russia was 12.9% (adjusted for currency revaluation), almost unchanged from 2013 (13.3% on average over the year, 11.0% as of the end of the year). The annual growth in lending to foreign borrowers (adjusted for currency revaluation) was 35.6% in May, substantially exceeding its 2013 level (3.8% on average over the year, 8.9% as of the end of the year). This growth was linked to the major Russian holding companies registered in foreign jurisdictions switching to borrowing from Russian banks.

Amid a growing demand for loans the decline in loan accessibility for banks and the deterioration in the term structure of bank liabilities are posing further challenges to the Bank of Russia's policy. Under these circumstances, the Bank of Russia has been forced to engage in operations to provide medium- and long-term liquidity and to use non-standard instruments, which are not typical of central banks. In particular, to increase long-term liquidity accessibility, on 25 April the Bank of Russia introduced a new refinancing instrument with a three-year term secured by loans provided to finance investment projects, and later from 29 May it extended the programme to bonds on the Bank of Russia Lombard List issued to finance such projects. The provision of funds to participant banks at an interest rate below the Bank of Russia key rate for terms exceeding those of standard instruments, offers further incentives for banks to provide investment loans. At the same time, taking into account the limited demand for such loans from companies, a significant increase in the amount of refinancing through this instrument is not expected (the programme's maximum allotment amount is set at 50 billion rubles). These operations will not change the monetary policy stance, which remains moderately tight.

As already mentioned, given the growth in structural liquidity deficit, the problem of collateral scarcity, including non-marketable assets, is becoming more protracted. The Bank of Russia is adopting measures to expand the range of assets which can be used as collateral for refinancing operations.

I. Macroeconomic conditions

I.1. External economic conditions and balance of payments

The external economic conditions over the period from publication of the previous Report saw a marked deterioration for Russia under the influence of both economic and external political factors: growth in the economies of some of Russia's trading partners slowed significantly, funding conditions in the global market deteriorated and the capital outflow intensified. The ruble exchange rate dynamics, the level of prices in Russia's trading partners and global food prices caused inflationary pressure to increase. The Bank of Russia does not foresee any further deterioration in external economic conditions, but does nonetheless expect external economic risks to remain high in the short term.

Global economy and financial markets

The accelerating growth in aggregate GDP of Russia's trading partners¹ witnessed throughout 2013 switched to a slowdown in 2014 Q1 which, according to estimates, will continue in Q2. The most marked fall in economic growth rates is observed in the CIS countries and is linked to the increased uncertainty surrounding the political crisis in Ukraine. Devaluation and inflation acceleration in Kazakhstan and Ukraine also had an adverse impact on consumer demand in these countries. The Chinese economic growth rates continue to slow down. Developed countries remain the main driver of global economic recovery. At the start of 2014, GDP growth rates in the US and a number of European countries fell. This, however, can be partially explained by temporary factors and

is therefore not viewed by the Bank of Russia as a change in trend. The dynamics of leading indicators suggest the continuation of positive trends in the majority of developed countries.

According to Eurostat, in 2014 Q1 GDP of the euro area – Russia's largest consolidated trading partner – increased by 0.2%², in line with Bank of Russia expectations. At the same time, aggregate output dynamics differed among countries in the region: Germany's GDP rose by 0.8%, France's GDP remained unchanged, and GDP of Italy and the Netherlands dropped by 0.1% and 1.4% respectively. The fall in output in the Netherlands can largely be explained by lower energy production against the backdrop of the warm weather. In recent months, leading indicators have mostly pointed to a rise in business activity in euro area countries, suggesting a likely acceleration in economic growth in the region in the future.

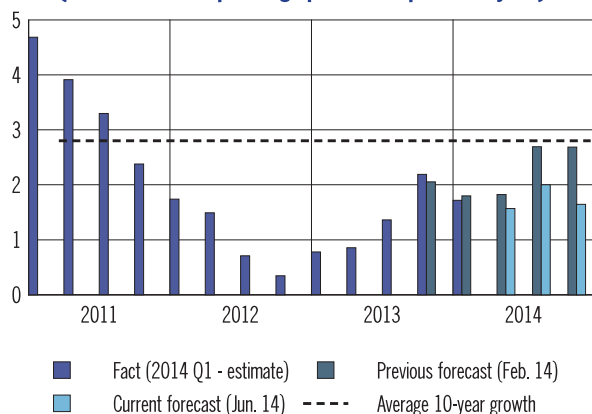
The United Kingdom saw its robust economic recovery continue, with GDP growth in 2014 Q1 at 0.8%, increasing against the corresponding quarter of 2013 to 3.1%, its maximum value since 2008. This growth was accompanied by improvements in the labour market where the unemployment rate dropped to 6.6% in April from 7.2% at the start of 2014.

2014 Q1 saw goods and services output in the US drop by 0.2% (GDP increased by 0.7% in the previous quarter), significantly less than expected by the Bank of Russia. However, this slowdown can largely be explained by the impact of short-term factors. In particular, the unusually cold and long winter caused a slump in investment activity. The Bank of Russia expects the US economic growth to move along the path observed in the second half of 2013,

¹ Aggregate GDP growth for 23 foreign trading partners accounting for the majority of Russian exports (countries whose share in the exports of goods from Russia in 2008–2012 was at least 0.9% annually; the share of each country is determined according to the structure of goods exports to these main trading partners). See also Table 5 in the Annex.

² Here and below in Section I.1, period-on-period seasonally adjusted growth rates are given, unless stated otherwise.

**Aggregate GDP of Russia's trading partners
(as % of corresponding quarter of previous year)**



Note: Bank of Russia projections are prepared with consideration of outlooks published by the IMF, World Bank, OECD, European Commission, Asian Development Bank, national central banks, and consensus forecasts produced by Bloomberg, Consensus Economics, and Thomson Reuters.

Sources: national statistics agencies; Eurostat; Bank of Russia calculations and projections.

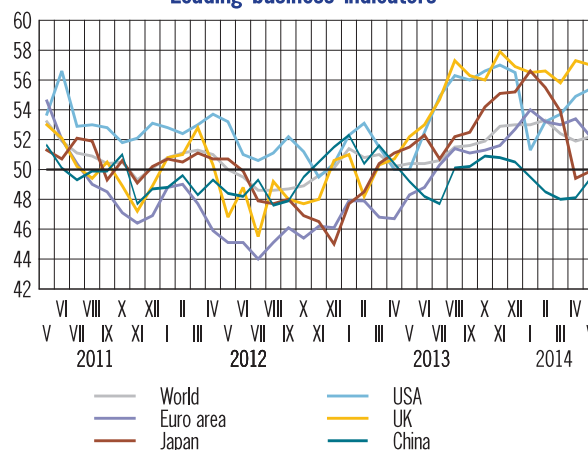
supported by the improvement of the situation in the labour market (the unemployment rate dropped to 6.3% in May from 6.6% in January 2014).

Japan's GDP in 2014 Q1 increased by 1.6% (the previous quarter it rose by 0.1%), buoyed up by a rise in consumer spending in anticipation of the increase in sales tax from 5% to 8% from 1 April 2014. However, industrial production indicators for February-April 2014 and the current sentiment indices have dropped significantly, reflecting the anticipated negative effect of the tax burden increase and the diminishing effect of accommodative measures of its monetary policy.

The economic growth rates of a number of major emerging market countries continue to decline. The dynamics of leading indicators published by the Organisation for Economic Co-operation and Development (OECD)³ have pointed to a continued slowdown in

³ The OECD Composite Leading Indicators are calculated on the basis of a set of components such as import quantities, the dynamics of inventories, the level of orders for industrial products, etc., which are combined in the index with identical weights following the procedures of detrending, smoothing and normalisation. The components represent time series showing the leading dynamics against an explained variable (industrial production or GDP index) at points of shifting trends and are selected for each country individually on the basis of such criteria as the economic importance, quality, timeliness and accessibility of data.

Leading business indicators



Note: PMI indices in manufacturing industries, ISM in the USA, and PMI of HSBC in China. Data for the world as a whole are calculated by J.P.Morgan based on the data for the USA, Japan, Germany, Spain, Italy, France, BRIC nations, Australia, Mexico, etc.

Source: Bloomberg.

growth in Turkey, Brazil, China, South Africa and India. Growth in the Chinese economy, which accounted for about 6% of Russian exports on average between 2008 and 2012, slowed in 2014 Q1 to 1.4% (1.7% in the previous quarter) with annual GDP growth rates dropping from 7.7% to 7.4%. The rates of growth in industrial production, fixed capital investment and retail sales fell to their several-year low. In April-May, the Chinese government announced a number of targeted measures to support the economy, including lowering taxes for small businesses and implementing infrastructure projects, while the People's Bank of China lowered its reserve requirements for banks operating in rural areas. The significant cooling of the real estate market could serve as a premise for more active accommodative measures by the authorities, which will make it possible to avoid any significant slowdown in the Chinese economic growth.

Over the period under review there was a significant deterioration in the economic growth prospects of the CIS countries as a result of increased economic uncertainty. The Ukrainian economy shrank by 1.1% in 2014 Q1 compared with the corresponding quarter in 2013. It is expected that the tightening of fiscal policy and an increase in administered tariffs will cause further recession. GDP growth in

2014 GDP growth rate forecasts prepared by international organisations (%)

	IMF			OECD		
	2013	2014 (Apr.14)	2014 (Jan.14)	2013	2014 (May 14)	2014 (Nov. 13)
World*	3.0	3.6	3.7	2.8	3.4	3.6
Advanced economies	1.3	2.2	2.2	1.3	2.2	2.3
USA	1.9	2.8	2.8	1.9	2.6	2.9
Euro area	-0.5	1.2	1.0	-0.4	1.2	1.0
Germany	0.5	1.7	1.6	0.5	1.9	1.7
France	0.3	1.0	0.9	0.3	0.9	1.0
Italy	-1.9	0.6	0.6	-1.8	0.5	0.6
UK	1.8	2.9	2.4	1.7	3.2	2.4
Japan	1.5	1.4	1.7	1.5	1.2	1.5
Emerging market economies	4.7	4.9	5.1	--	--	--
China	7.7	7.5	7.5	7.7	7.4	8.2
India**	4.4	5.4	5.4	4.5	4.9	4.7
Brazil	2.3	1.8	2.3	2.3	1.8	2.2
S. Africa	1.9	2.3	2.8	1.9	2.5	3.0
Memo item: Russia	1.3	0.2***	2.0	1.3	0.5	2.3

* Measured by PPP.

** IMF data and projections are on a fiscal year basis, OECD - on a calendar year basis.

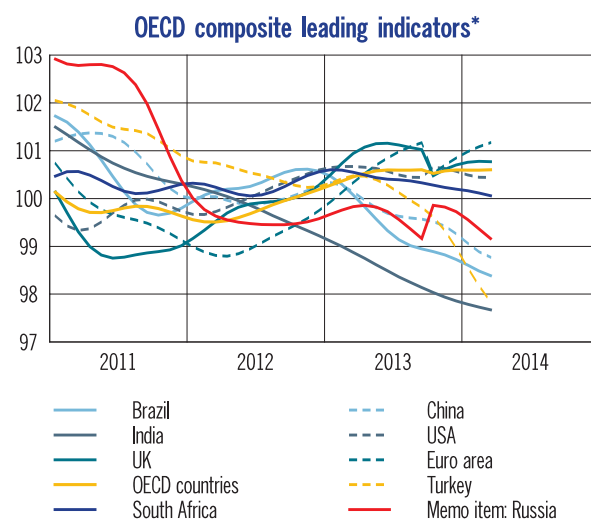
*** According to the latest IMF IV Article staff report.

Sources: IMF, OECD.

Kazakhstan relative to the corresponding period last year slowed to 3.8% (the previous quarter, GDP growth was 6.8%), reaching its low since 2010. Growth rates in the Belarusian economy remain low. In 2014 Q1, the country's GDP rose by 0.5% compared with the corresponding period in 2013. The main driver of growth was trade, which increased by 11.8%, while manufacturing output shrank by 4.0%.

According to forecasts by various international organisations, in 2014 growth in the global economy will accelerate compared with 2013, but it will be slower than predicted earlier. The International Monetary Fund (IMF) and OECD expect the global output of goods and services to increase in 2014 by 3.6% and 3.4% respectively, which is 0.1–0.2 percentage points lower than the previous forecasts by these organisations. The main source of the increase in global economic activity will continue to be accelerating growth in developed countries amid a scaling down of economic austerity measures

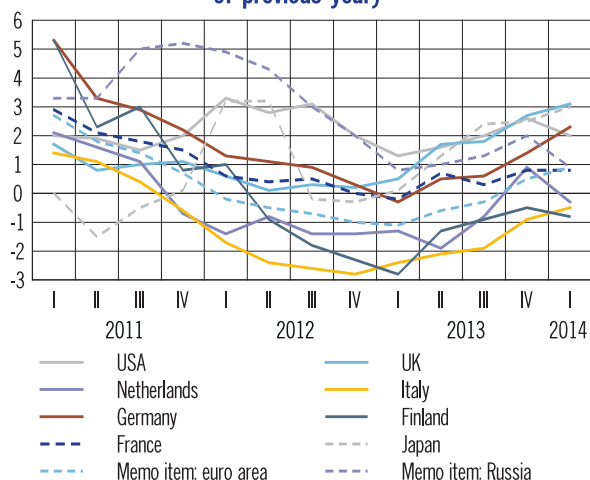
and the preservation of a loose monetary policy. The increase in the growth rates of emerging market countries, according to IMF forecasts, will be less pronounced due to the tightening of financial conditions and the structural slowdown in growth in a number of countries.



*The horizontal line at 100 represents a long-term trend of economic activity. Indicators tend to precede the trend by approximately 6 months.

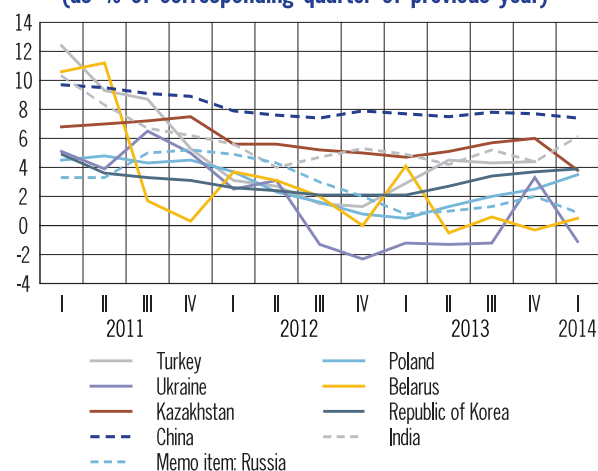
Source: OECD.

**GDP growth rates of Russia's trading partners:
developed economies (as % of corresponding quarter
of previous year)**



Sources: national statistics agencies, Eurostat.

**GDP growth rates of Russia's trading partners:
emerging economies and the Republic of Korea
(as % of corresponding quarter of previous year)**



Sources: national statistics agencies, Eurostat.

Over the past quarter, the Bank of Russia significantly reduced the forecast of annual growth in the aggregate GDP of Russia's trading partners and now does not expect its acceleration throughout 2014. This revision was largely caused by the downgrading of forecasts for the CIS countries: the 2014 forecast for Ukraine was reduced from 1.6% to -5.0%, Kazakhstan from 6.1% to 5.6% and Belarus from 1.5% to 1.1%. Turkey's GDP growth forecast was also revised downwards from 3.3% to 2.5% due to weaker than expected growth in the country's economy in recent quarters (see Table 5 in the Annex).

In February-May 2014, the monetary policy of central banks abroad remained loose. With low inflation and weak business activity in the euro area the European Central Bank (ECB) adopted the following set of accommodative measures at its session on 5 June 2014:

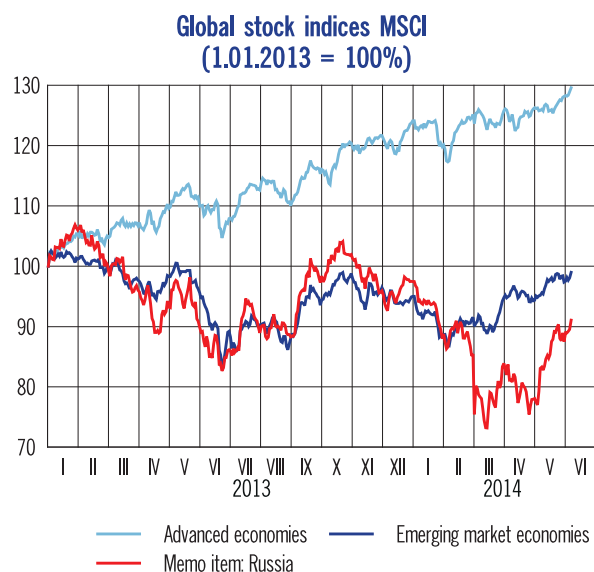
- all three main interest rates forming the interest rate corridor were reduced, with the key rate and rate on credit institutions' deposits decreasing by 0.1 percentage point to 0.15% and -0.10% respectively (a negative interest rate has also been set for credit institutions' current accounts with the ECB) and the upper boundary of the corridor decreasing further by 0.35 percentage points to 0.4%, which clearly limits the potential volatility of the money market rates;

- refinancing operations are to be continued at a fixed interest rate with full allotment at least until 2016 (previously the ECB announced that it would continue these operations at least until mid-2015), which is a signal that the key rate will be maintained at a near-zero level for longer period than was previously assumed by market participants;

- the absorption of liquidity created in the course of implementation of the Securities Markets Programme⁴ will be curtailed, which, in terms of its effect, will be equivalent to the injection of 160 billion euros of liquidity;

- to improve the functioning of the monetary policy transmission mechanism through support for bank lending, the ECB announced a series of targeted long-term fixed-rate refinancing operations (at a rate 0.1 percentage points above the key rate at the time of transaction); the settlement amounts and terms of these operations will

⁴ The Securities Markets Programme (SMP) is a bond purchase programme introduced by the ECB to restore the normal functioning of the financial market in May 2010 and discontinued in September 2012 after the announcement of the new Outright Monetary Transactions programme. Bonds purchased under the SMP remain on the ECB's balance sheet until their maturity, while the liquidity created as a result of the purchase was subject to sterilisation through weekly fine-tuning deposit operations at a rate exceeding the rate on main deposit operations.



be dependent on banks' lending activity, with banks potentially being provided with up to 400 billion euros⁵ during 2014 at two auctions to be held in September and December with maturity in September 2018. From May 2015 to June 2016, banks will also be able to obtain additionally up to 300% of the value of the net increase in loans provided by them to the real sector (excluding household mortgage loans) over the period from 30 April 2014, exceeding the certain threshold value⁶;

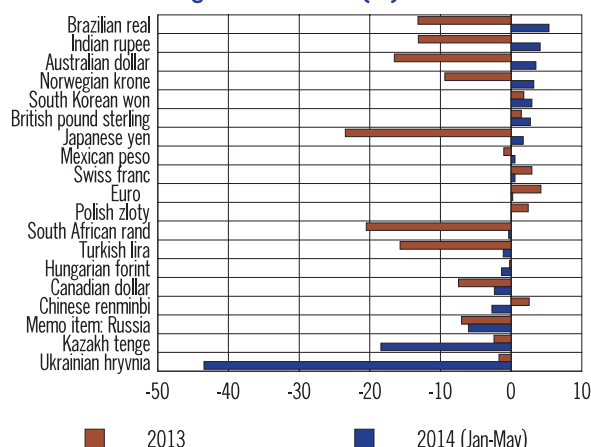
– an announcement was made regarding the ECB's intensified preparations to purchase securities backed by bank loans to the real sector.

The Bank of Russia expects that the measures announced by the ECB will not only support economic activity and reduce deflation risks in the euro area, but will also lead to an increase in the inflow of international investors' funds to emerging market economies and, at least in part, offset the effect of the phasing out of accommodative measures by central banks of other developed countries, in particular the Fed.

⁵ For comparison, in the course of three-year operations conducted in December 2011 and February 2012, banks were supplied with a total of 1,020 billion euros. As of the beginning of June 2014, a large part of this amount had been repaid, with the liquidity in the current accounts of the Eurosystem totalling about 190 billion euros.

⁶ Growth in loans of the corresponding bank over the 12 months up to 30 April 2014 is used as the threshold value.

Nominal exchange rate indices of foreign currencies against US dollar (%)*

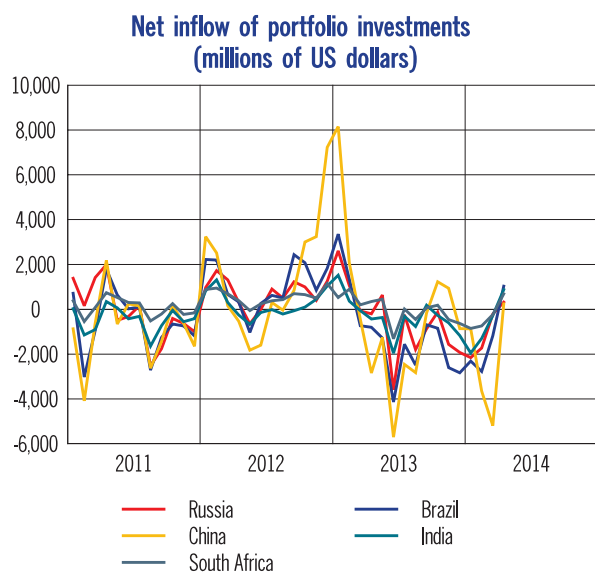


* Last month average to previous year December average, '+' US dollar decline (national currency strengthening).
Source: Reuters.

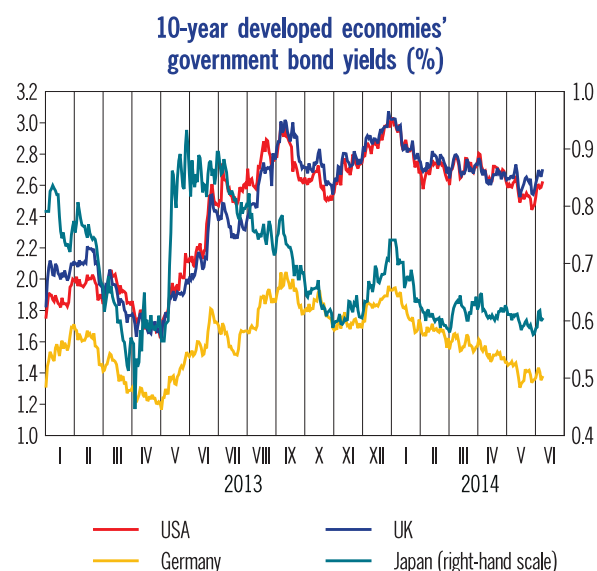
The central banks of Turkey, Hungary, Israel, Romania, Chile, Thailand, Mexico, and Belarus have also resorted to reducing their interest rates over recent months. The People's Bank of China, striving to support the country's economy and banking sector, increased the amount of liquidity being provided to banks, lowered the reserve requirements for certain financial organisations in April, and also recommended that banks should fast-track on mortgage lending.

At the same time, faced with increasing inflation risks some central banks tightened their policies (Brazil, New Zealand, and Ukraine). Although maintaining a loose policy, the Fed continued to reduce its asset purchases in the open market by \$10 billion at its meetings in March and April. It is expected that the tapering of the programme will continue at the same pace and will be brought to a close by the end of 2014. The further normalisation of the Fed's monetary policy in the medium term will create the necessary conditions for interest rate increase in the global market.

From February to May 2014, the situation in the global financial markets improved on the whole: risk indicators fell, stock indices rose, and the currencies of emerging market countries appreciated against the US dollar. From the end of March, according to EPFR Global data, there was a marked inflow of funds into emerging



Source: Bloomberg.



Source: Bloomberg.

market economies, including Russia, following the record outflow in 2014 Q1. Decreasing uncertainty with regard to the future actions by the Fed and the expected easing of the ECB's policy contributed to the improvement of market participants' sentiment. The escalation of external political tension due to the crisis in Ukraine had only a limited impact on the financial markets of the majority of emerging market economies, with the exception of the CIS countries.

In the period under review, lending conditions in the global market eased for most countries compared with the previous quarter. The yields on bonds of the major developed

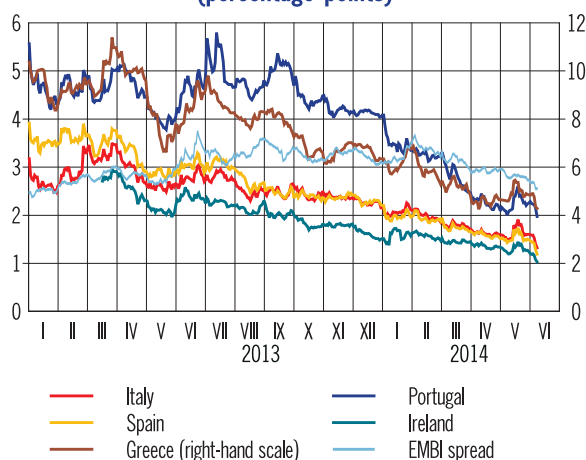
countries were stable or fell (excluding a short-term segment of the US yield curve, which shifted upwards amid the continued reduction in the pace of asset purchases by the Fed), with the yield spreads of emerging market countries and countries on the European 'periphery' narrowing. The expected easing of the ECB's policy and the actions of credit-rating agencies contributed to the reduction in the yields of European bonds: Fitch revised its rating forecast for Italy from negative to stable and increased those of Spain and Greece one notch up to «BBB+» and «B» respectively. Moody's upgraded Portugal's⁷ rating one notch to «Ba2» and that of Ireland two notches to «Baa1».

Despite the positive worldwide trends, the impact of specific factors caused deterioration of financial conditions in a number of countries. The slowdown of economic growth, corporate defaults and the risk of excessive cooling in the real estate market in China led to a significant outflow of global investors' funds and the retention of the higher risk premium. This caused some restraint in stock index dynamics and the renminbi's depreciation. The increase in the amount of banking sector liquidity by the People's Bank of China and the twofold expansion of the corridor for free float in the US dollar/renminbi exchange rate were reflected in the exchange rate dynamics of the Chinese national currency.

On 11 February, the National Bank of Kazakhstan abandoned support for the national currency on its previous scale and devaluated the tenge against the US dollar by 19% with a view to preserving its foreign exchange reserves and improving the foreign trade balance of the country. In March, the National Bank of Ukraine ceased its foreign exchange interventions amid the heightened pressure on the hryvnia. From February to May 2014, the hryvnia depreciated by 37% against the US dollar.

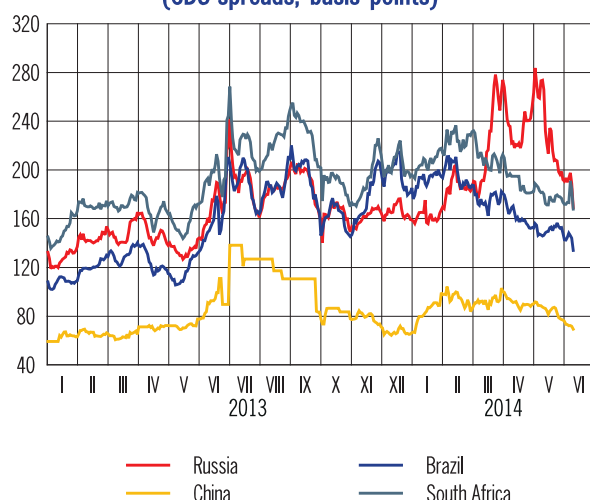
⁷ On 17 May, Portugal announced the end of its external financial support programme from the European Union (EU) and the IMF, having become the second country after Ireland to successfully complete the programme.

10-year euro area government bond yield spreads against Germany, Emerging markets bond index (EMBI) spread (percentage points)



Source: Bloomberg.

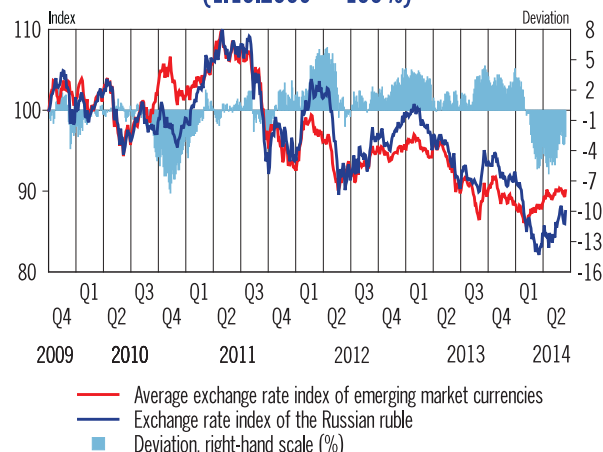
Sovereign risk premium (CDS-spreads, basis points)



Source: Bloomberg.

The developments in Ukraine had a significant impact on the dynamics of Russian financial market indicators. At the start of the year, the ruble exchange rate, Russian stock indices and bond yields largely changed in line with the dynamics of average indicators for other emerging markets. However, from February 2014, the increasing uncertainty surrounding the situation in Ukraine and its consequences for the Russian economy, together with the enforcement of sanctions against Russia by a number of countries and the ensuing downgrading of Russia's sovereign credit rating by S&P, all led to the ruble's depreciation against

Exchange rate indices against the US dollar (1.10.2009 = 100%)

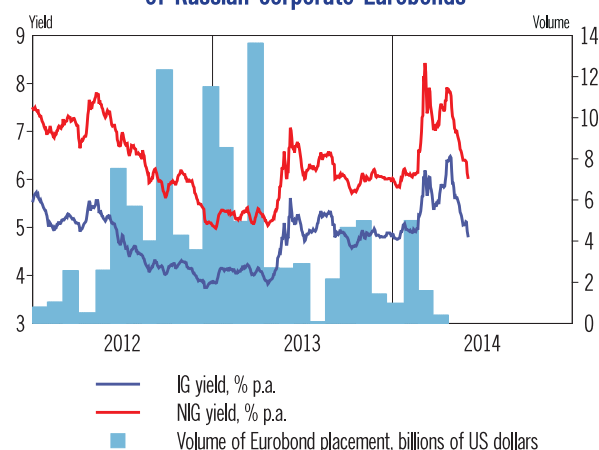


Note: average exchange rate index of emerging market currencies is calculated based on the exchange rates against the US dollar of Hungarian forint, Brazilian real, Turkish lira, Mexican peso, Polish zloty, Romanian leu, Malaysian ringgit, Philippine peso, Indonesian rupee and Indian rupee.
Source: Bloomberg.

the majority of global currencies, a fall in Russian stock indices, growth in the sovereign risk premium, an increase in capital outflow, as well as deterioration in external funding conditions. The maximum tension was observed between mid-March and the start of May 2014. The deviation of the index of the ruble/US dollar exchange rate from the average index of exchange rates of a number of emerging economies' currencies against the US dollar reached -7% (the average deviation in 2012 and 2013 was +2.3% and +2.5% respectively). Since then, the situation in the Russian financial market has partly normalised (in the second half of May, the deviation of the ruble/US dollar rate from the index of exchange rates of emerging economies' currencies dropped to -3%, the risk premium fell, and stock indices showed rapid growth), but was still characterised by heightened volatility.

For a large part of the period under review the ruble was among emerging market currencies which depreciated the most. At the end of April, the ruble/US dollar rate dropped by 7.8% compared with December 2013 and the nominal effective ruble exchange rate index fell by 5.2%. Bank of Russia interventions in the foreign exchange market and the rise in the Bank of Russia key rate at its unscheduled meeting in March made it possible to avert a more significant depreciation of the ruble.

Effective yield and volume of placement of Russian corporate Eurobonds



Note: yield and duration for IG and NIG are calculated on the basis of indexed portfolio of Eurobonds with investment-grade and upper non-investment grade ratings respectively.

Source: Cbonds.ru news agency.

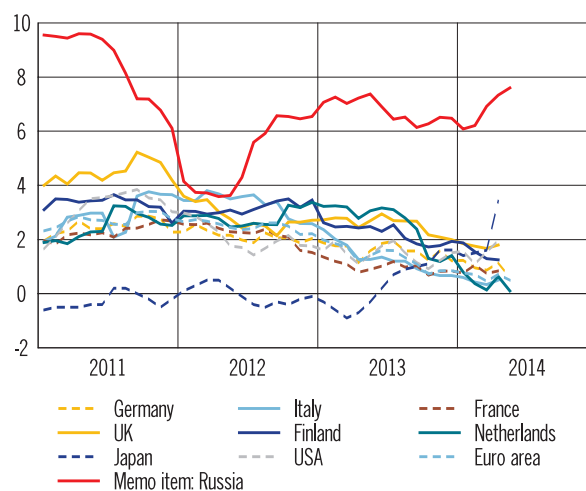
Further tightening of the monetary policy at the end of April amid inflation risk growth and the easing of external political tension contributed to the ruble being one of the leaders in terms of appreciation among the emerging market currencies in May.

Over the same period in 2014, growth was observed in the yields of Russian Eurobonds, while the amount of funds raised by Russian companies in the international market fell considerably. As a result of the worsening in external funding conditions, from January to May 2014, Russian companies raised funds through issuing Eurobonds over 4 times less than they did over the same period last year: \$7 billion compared with \$33 billion⁸.

The Bank of Russia does not expect any further deterioration in external financial conditions for Russia. However, taking into account the downgrading of the country's sovereign credit rating, the continuing high volatility of the financial markets and the worsening economic growth prospects, foreign investors' interest in Russian assets will likely to remain strained in the coming quarters.

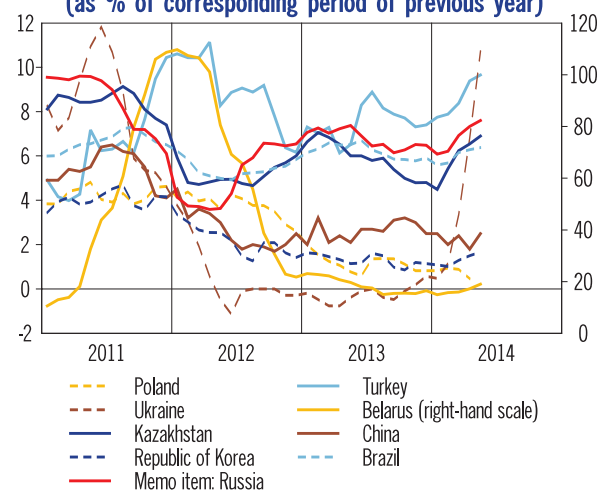
The risk of unfavourable developments in Ukraine continues to be high. Given the growing external political uncertainty, the large

Inflation in Russia's trading partners: developed economies (as % of corresponding period of previous year)



Sources: national statistics agencies, Eurostat.

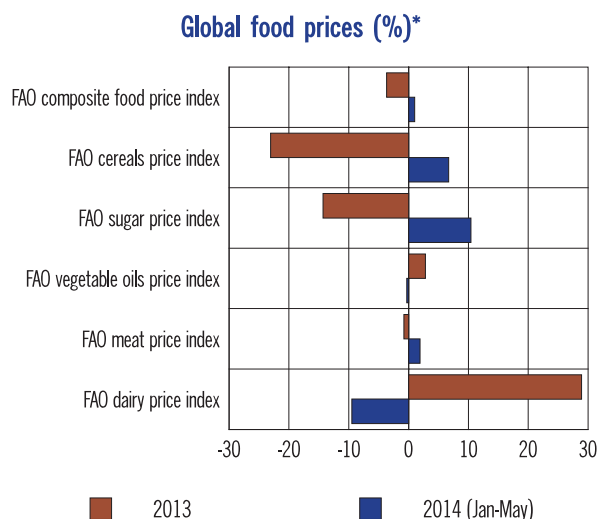
Inflation in Russia's trading partners: emerging economies and the Republic of Korea (as % of corresponding period of previous year)



Sources: national statistics agencies, Eurostat.

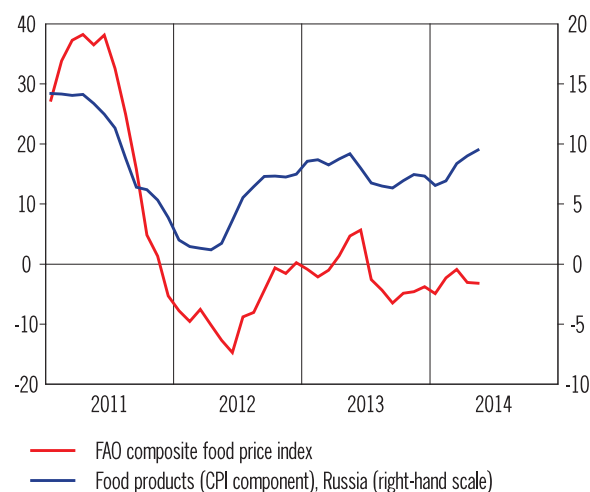
volumes of capital outflow from Russia could be preserved, while the economic recession in Ukraine could have an adverse impact on the economies of Russia, other CIS countries and a number of European countries. Negative risks are also linked to the situation in the Chinese financial sector and the possibility of a more substantial than expected slowdown in the Chinese economic growth. Another risk is a possible overvaluation of certain asset classes in the global market, which could lead to a significant drop in their prices as the Fed scales down its accommodative measures. As before, there are still risks linked to unstable growth in

⁸ According to data of the Cbonds.ru news agency.



*Last month average to previous year December average.
Source: FAO.

**Global and Russian food prices
(as % of corresponding period of previous year)**



Sources: FAO, Rosstat.

European countries amid the threat of deflation in certain economies.

Over the past months, inflationary pressure from external factors has increased, which was connected with inflation acceleration in

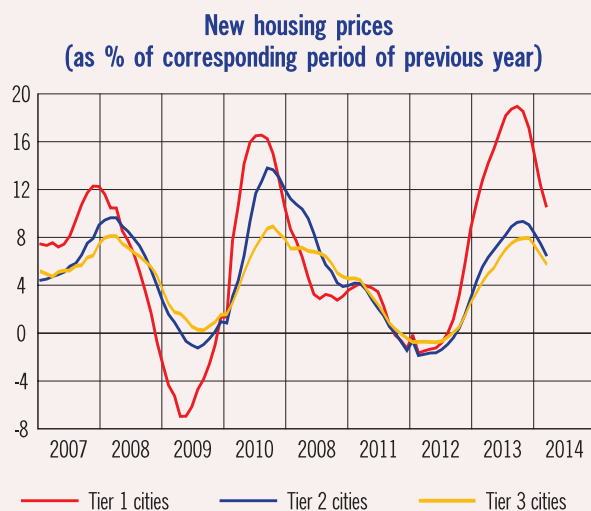
a number of Russia's trading partners and the renewed price growth in the global food market.

The inflation dynamics in Russia's trading partners were diverse. In the majority of European countries, the annual rates of growth

The state of the Chinese real estate market

At present, one of the greatest risks linked to the Chinese economy is the cooling of the real estate market which started in late 2013 and became more and more pronounced in early 2014.

From January to April 2014, the Chinese real estate market saw a rapid decline in activity. New home prices fell in April compared with the previous month in eight of the 70 cities surveyed by the National Bureau of Statistics of China (four cities in March), and in the secondary housing market 22 cities saw a fall (14 cities in March). Home sales shrunk by 6.9% from January to April relative to the corresponding period in the previous year and new construction activity fell by 22%. March saw the announcement of the first bankruptcy of a Chinese developer. Against the backdrop of these events, Moody's revised its credit rating forecast for the real estate sector from stable to negative.



Note: cities are categorised into tiers by their size: tier 1 cities are the largest ones, including Beijing and Shanghai
Source: Bloomberg.

The cooling observed in the real estate market can be explained by both cyclical and speculative factors. Since 2013, the Chinese government has been implementing measures to tackle overheating in the financial sector, which has led to an overall tightening of monetary conditions in the economy. The real estate market has also seen the introduction of specific measures such as limiting the number of real estate properties held by a single owner and increasing initial mortgage payments. However, the swift deterioration in this segment of economy can also be explained by the speculative nature of the previous price rise and new construction growth. This is shown in particular by the formation of excess real estate supply amid accelerated growth in construction against housing sales volumes. According to

Moody's estimates, the level of housing stock in the eight cities monitored by the agency at the end of April 2014 was 14 months' worth, close to the previous local peak of 16 months reached in early 2012.

At the end of 2013, the real estate sector accounted for 6% of GDP and provided roughly 25% of fixed capital investment. However, the worsening situation in the real estate market will have a wider impact on the economy and will affect the construction sector (7% of GDP) and a number of manufacturing industries. The financial system is likely to see negative consequences: the debt of companies of the real estate sector makes up one fifth of the lending portfolio of banks, with these companies actively seeking funds in the financial market and in the shadow banking sector. Moreover, for a significant proportion of debt liabilities in the Chinese economy, either the real estate is used directly as collateral, or real estate price dynamics influence the financial flows of borrowers in some way. In particular, the fall in real estate prices will affect local budgets, the total debt of which was close to 18 trillion renminbi (or 32% of GDP) in mid-2013, and for which a significant proportion of the income is made up of revenue from land sales to developers (up to 30–50%, according to various estimates).

The Chinese real estate market has previously seen episodes of rapid price growth and subsequent price adjustments, however this situation could pose further risks to the country's economy. Firstly, at present there is a general cooling of economic activity and a slowdown in the growth of the households' income: the increase in income per capita for the urban population, excluding earnings from real estate, was 9.5% in 2013 (12.5% a year earlier), which is the lowest level over at least the past ten years. Secondly, there is a slowdown in urbanisation processes which previously stimulated accelerated growth in demand for real estate (nonetheless, the urbanisation level is currently relatively low at 54% in 2013 against 74% in Russia). Moreover, in recent years the financial risks linked to the rapid growth of the shadow banking sector have increased (see the box 'Situation in the Chinese financial sector' in the previous Report).

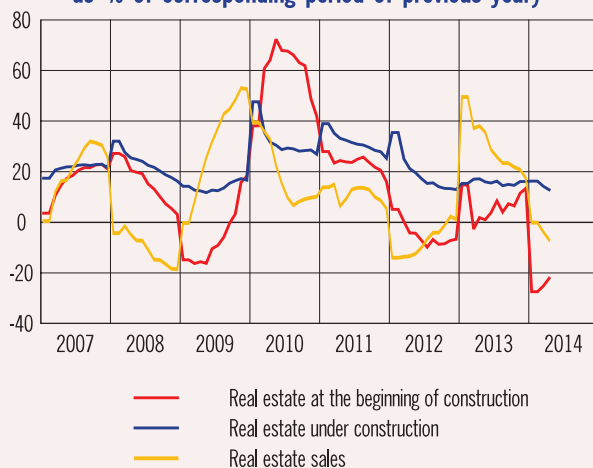
The slump in the real estate market may turn out to be more significant than in 2011–2012, in part as a result of the tighter policy of the new Chinese government in relation to the overheating in the financial sector. In particular, the Chinese authorities have repeatedly announced their willingness to accept lower economic growth rates and certain corporate defaults as part of their policy to restructure the financial sector. Thus, the government is not expected to resort to large-scale accommodative measures to support the real estate market. Nonetheless, the list of targeted measures the authorities have already started to adopt is likely to be expanded. In particular, according to news agency reports, local authorities have begun to loosen restrictions on real estate purchases in certain regions. The People's Bank of China has reportedly recommended banks to fast-track mortgage lending to first-time home buyers.

In its baseline scenario, the Bank of Russia expects that the correction in the real estate market will not result in significant slowdown in economic growth or destabilisation of the situation in the Chinese

financial sector. Government accommodative measures together with recovery in external demand as the situation improves in China's trading partners should sustain growth rates in the country at a relatively high level. According to Moody's estimates, the losses of leading developers resulting from the fall in real estate prices and sales will be limited, as they have a sufficient amount of liquidity and access to funding.

Nonetheless, the risks of a negative revision of China's economic growth forecast by the Bank of Russia, gauged at 7.4% in 2014, are currently estimated to be high. The materialisation of an unfavourable scenario will hinder growth in the global economy, prompt capital outflow from emerging markets, and lead to a fall in prices in commodity markets and a deterioration in terms of trade for Russia.

Real estate market indicators
(cumulative volumes since the beginning of the year,
as % of corresponding period of previous year)



Source: National Bureau of Statistics of China.

in consumer prices over the first few months of 2014 were lower on average than those in the previous quarter. The European Commission once again revised its inflation forecast for the euro area downwards (from 1.0% to 0.8% in 2014). Weak domestic demand, the previously witnessed trend of falling prices in global commodity markets, and the euro's appreciation all had a constraining effect on prices in the region. Inflationary pressure eased in China, largely due to lower rates of growth in food prices. Meanwhile, inflation in the CIS countries, Turkey and Brazil accelerated considerably in the past months due to depreciation of their national currencies which took place earlier.

Having reached its minimum levels between late 2013 and early 2014, inflation in countries accounting for the bulk of imports of Russian goods has, on average, started to accelerate over the last few months. This tendency is expected to continue and to be connected with both inflation growth in emerging market countries and the start of the cycle of inflation rising in a number of European countries as economies in the region recover. The expected dynamics of foreign inflation could cause accelerated growth in prices for products imported by Russia. At the same time, this effect will be partially offset by the depreciation of both the Ukrainian hryvnia and the Kazakhstani tenge against the ruble.

In 2014 Q1, growth in global food prices started to recover after more than six month decrease. In May, the UN Food and Agriculture Organisation (FAO) food price index rose by 2.6% compared with January 2014, when it hit its lowest level in the past year and a half. Prices increased for virtually all commodity groups considered by FAO, which was due to both high demand for food and the effects of supply factors, inter alia, the expectations of a low cereals harvest in the USA due to the cold winter; anxieties over the stability of cereals supplies from Ukraine; problems with sugar supplies due to the drought in Brazil; and limited supply of meat resulting from unfavourable weather conditions in a number of regions of the world.

At the same time, from April to May, certain food prices fell, and the FAO composite price index remained below the levels of previous years. The coming quarters may see a fall in cereals prices due to the improved weather conditions in the USA and less uncertainty over supplies from Ukraine. Nevertheless, meat and dairy prices could still rise due to the increase in demand from emerging market economies. The natural phenomenon of El Niño⁹, which is expected to occur over the coming months, could also lead to a rise in prices for certain food items as a result of worsening weather conditions.

Commodity markets

From February to May 2014, oil prices in the global market saw slight change. The price of Urals crude during this period averaged at \$107.4 per barrel, 0.9% lower than from October 2013 to January 2014. On the one hand, the fall in oil prices resulted from supply outstripping demand amid weak economic activity in emerging markets, growth in oil output and exports in Iraq, and an increase in stocks of crude oil in the USA to the maximum level in the entire period of observation. On the other hand, the tense situation in Ukraine, interruptions in the oil supply from the Middle East and North Africa, and the increasing demand from China to establish oil reserves prevented a more significant drop in oil prices.

Bank of Russia expects prices for oil and oil products, which accounted for 54.1% of the total value of Russia's exports in 2013, to fall as a result of slower growth in global demand for these commodities compared with the increase in global supply. This will be brought about by a slowdown in economic growth in China (according to International Energy Agency data, 11.2% of global demand for oil was attributed to

⁹ A temperature anomaly manifested as an increase in surface temperature of the equatorial Pacific, usually occurring once every few years. When El Niño develops, changes occur in the circulation of the atmosphere which can cause a serious deterioration in weather conditions in Southeast Asia, South America and Australia (droughts, floods, hurricanes).

The impact of price changes in Russia's trading partners on Russian inflation

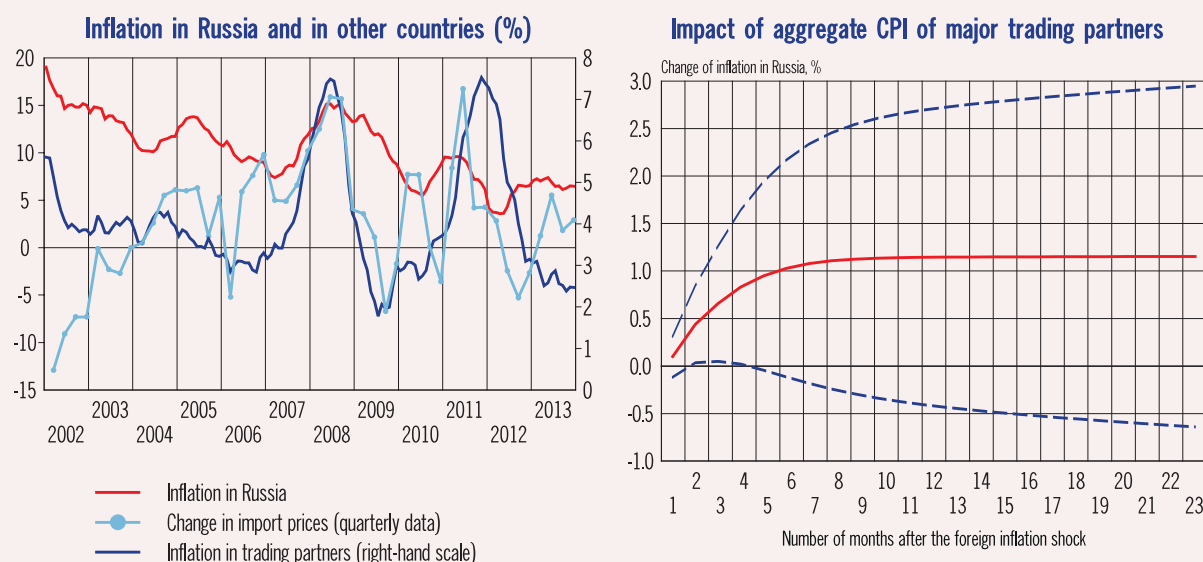
The Bank of Russia assessed the impact of foreign inflation on price changes in Russia. Three of Russia's biggest trading partners were selected for the analysis: China (the largest in terms of trade turnover and imports to Russia¹), Germany (third in terms of turnover and second in terms of imports) and Ukraine (fifth in terms of turnover and fourth in terms of imports).

The main channel through which foreign inflation impacts the Russian inflation is imports: when prices rise abroad, the prices for goods imported to Russia also rise, which naturally affects consumer price level in the country. Therefore, one would expect that as global prices rise, prices would also rise in Russia as large number of goods are imported from abroad. According to Rosstat data, the share of imported goods in retail trade in Russia was 44% in 2013.

There is no direct statistical correlation between price indices in Russia and abroad: the correlation between inflation rates in Russia and its trading partners is only 3%. This is clearly illustrated on the graph showing the annual growth in the consumer price index in Russia, the consumer price index in trading partners², and the Russian import price index. It is easy to see that the indicators do not always behave in the same way. The CPI growth rate is shaped by other factors in the first place, however after taking into account their impact and applying the econometric estimation methods (which are widespread in academic literature) described below, it becomes possible to uncover a perceptible link between Russian and foreign inflation.

For a quantitative assessment of the impact of price changes abroad on Russian inflation, a vector autoregression model (VAR) was used, in line with conventional international practices. The variables included Russian and foreign consumer price indices, as well as a number of Russian macroeconomic indicators affecting inflation. The domestic determinants included the index of goods and services output in key industries (this variable is calculated by Rosstat and is closely linked to GDP); the nominal effective exchange rate of the ruble against foreign currencies; the M2 monetary aggregate; and the money market rate (MIACR). The estimation was carried out on monthly data from January 2002 to December 2013.

Two models were considered. In the first one, aside from Russian macroeconomic variables and the consumer price index, only the aggregate consumer price index in trading partners was used. In the second model, aside from the aggregate index, Chinese, German and Ukrainian consumer price indices were included, as well as the aggregate price index of other major trading partners of Russia (excluding the three countries mentioned).



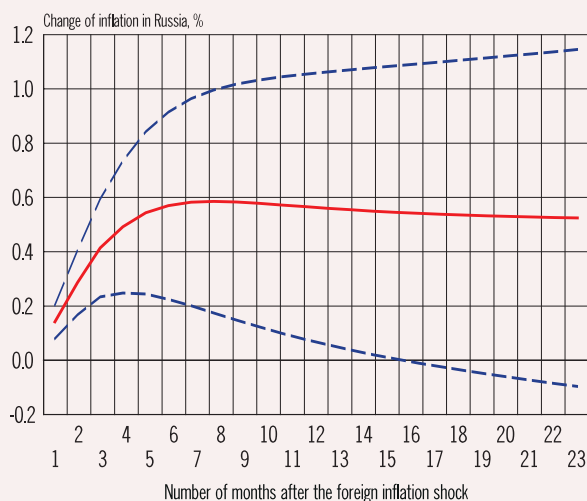
Sources: Rosstat, Russian Federal Customs Service, national statistics agencies.

Source: Bank of Russia.

¹ Out of all of Russia's trading partners, according to Federal Customs Service data for 2013.

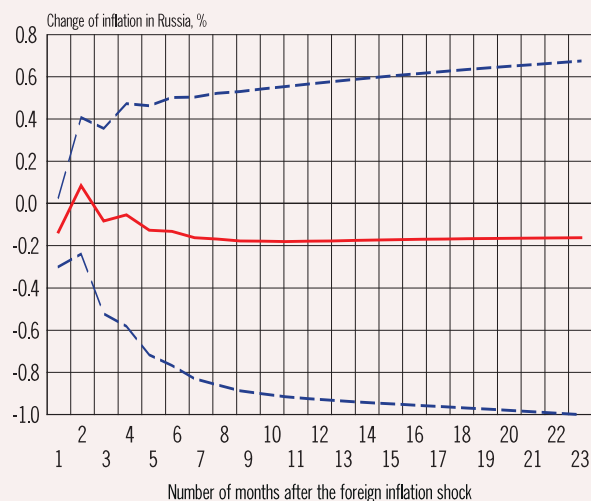
² This index is calculated as a weighted average of the CPI for the 22 largest importers to Russia, with the weight of each country determined by its share in the total imports to Russia.

Impact of Ukrainian CPI



Source: Bank of Russia.

Impact of German CPI



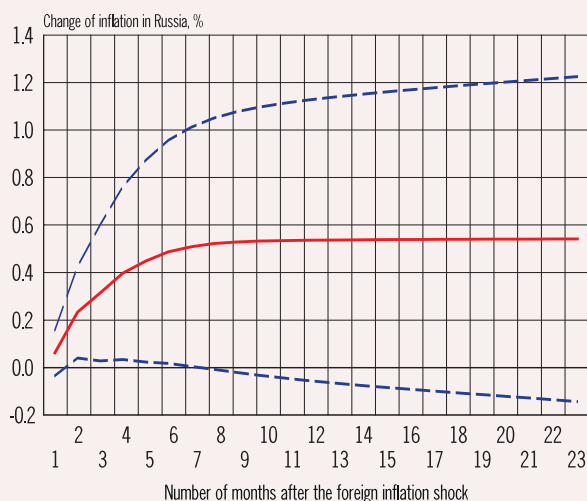
Source: Bank of Russia.

As a basic illustration of the impact of foreign inflation on Russian domestic inflation, impulse response functions were calculated, which make it possible to single out the influence of one variable on another, taking into account a mediated influence through other variables. This function estimates the change in the selected variable which may occur in future in the event of a sudden change in another variable at the present moment in time. The graphs show the accumulated impulse response functions, i.e. graphs of the total change in a variable over all periods preceding the period indicated on the horizontal axis. The vertical axis value shows the change in inflation rates in Russia (as a percentage) when there is a sudden acceleration in foreign inflation by 1%. In addition to the impulse response function, there are also dotted lines on the graphs corresponding to two standard errors deviation up and down from the function value. Standard errors are calculated using the Monte Carlo simulation method.

The graph depicting the response of Russian inflation to the aggregate inflation for all of its trading partners shows that in the event of a momentary 1% change in the aggregate index Russian inflation can be expected to increase by the same amount over the course of six months. However, the issue of difference in the impact of inflation in individual countries on Russian inflation provokes more interest.

As the graphs show, the price dynamics in China and Ukraine have a significant positive impact on inflation in Russia. Aside from the aforementioned considerations regarding the connection through import prices, it is also worth noting that Ukraine and China are emerging markets alongside with Russia and the macroeconomic processes within them are frequently similar in nature, with the changes in the economy of one country capable of influencing investors' and market participants' sentiment with regard to another country.

Impact of Chinese CPI



Source: Bank of Russia.

As for inflation in Germany, this has a weak impact on Russian prices (all of the impulse response function values for the impact of German inflation on Russian inflation were statistically insignificant). This may be partially caused by the phenomenon known in academic literature as pricing-to-market, when prices rise for goods within a country (in this case Germany) and prices for export goods see either significantly lower increase or remain

unchanged. One of the explanations for this situation is the competition for the Russian market with other suppliers of similar products forcing not to raise prices following their growth within the country of production. In case of imports from Germany, this competition could exist in the pharmaceutical industry, vehicle and household appliance imports, and chemical industry. As for key import items from China (clothing, furniture, plastics), these do not experience such strong competitive pressure in many respects because prices for Chinese products are low. For the same reason, it is worth expecting Chinese producers to increase prices if there is a sudden change in inflation in China – keeping prices at a constant level could lead to losses for companies. As regards Ukraine, many of the most important import items from the country (such as heavy machinery) are extremely specific and do not have any close substitutes at least in the short term. Therefore, a sudden change in inflation in Ukraine could be a sufficient catalyst for Ukrainian producers to increase prices for exports to Russia.

China in 2014 Q1), the introduction of energy-saving technologies, inter-fuel competition and increased oil output in Libya, Iran and Iraq.

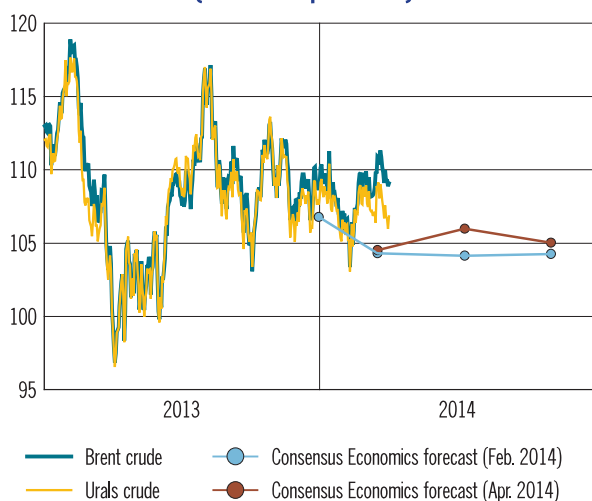
Natural gas, Russia's second important export commodity (12.8% in 2013), continued to go down in price over the period under consideration due to high stocks and the fall in demand in Europe as a result of the mild winter. With the reduction in the price difference between cheap gas in the USA and expensive gas in Europe and Japan, largely resulting from developments in the supply of liquefied gas, the downward trend of gas prices in Europe is likely to continue. After growth in 2013 Q4, by June 2014, prices in the coal market fell to their lowest levels in several years with the overstocking of the market. It is expected that coal price will continue to fall if supply continues to outstrip demand as a result of slowing consumption growth in China

(accounting for half of global consumption), the shutdown of coal power plants in the USA and the development of renewable energy sources.

From February to May 2014, prices for Russia's principal metal exports showed diverse dynamics. Iron ore price dropped by 22% due to persistently low demand from the steel industry, sufficient ore stocks in Chinese ports and increased extraction in Australia. At the same time, following a ban on nickel exports introduced by Indonesia on 12 January, nickel price increased by 38% from February to May. According to World Bank estimates, with the slowdown in China's economic growth, which accounts for roughly half of global metal consumption, prices for iron, aluminium and nickel will fall in 2014 compared with 2013.

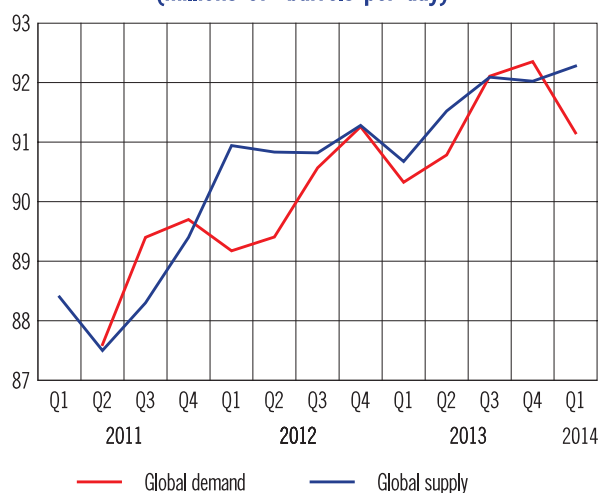
According to Bank of Russia estimates, terms of trade will continue to deteriorate as prices

**Global oil prices
(US dollars per barrel)**

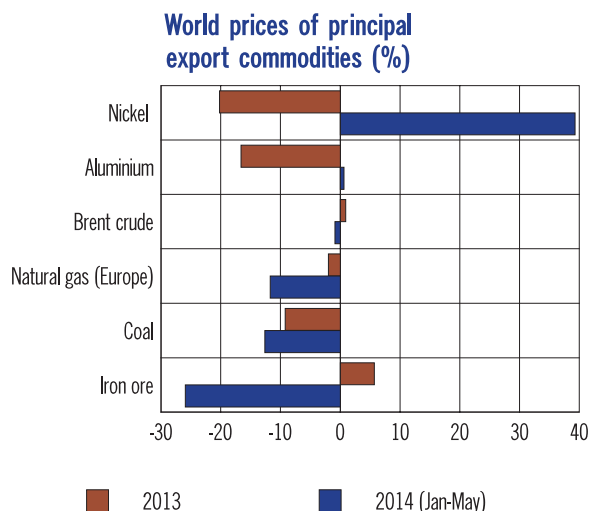


Sources: Reuters, Consensus Economics.

**Global oil supply and demand
(millions of barrels per day)**



Source: International Energy Agency.



* Last month average to previous year December average.
Source: World Bank.



* Estimate.
** Bank of Russia forecasts.
Sources: Russian Federal Customs Service, Bank of Russia calculations.

for Russia's principal export commodities fall and import prices rise in line with the expected inflation dynamics in Russia's trading partners.

Balance of payments

In 2014 Q1, the current account balance was estimated at \$27.6 billion, an increase by 13% over 2013 Q1. This largely resulted from the advance fall in imports compared with exports. Exports of goods fell by less than 2%, while imports fell by more than 7%. According

to estimates, the fall in exports was primarily due to the price factor, while in real terms there was some increase in its volume. The depreciation of the ruble, as well as the general slowdown in economic growth and, as a result, the fall in demand for imports impacted import dynamics.

The increased volatility in the global financial market at the start of the year, as well as increased uncertainty over the events in Ukraine, gave rise to high demand for foreign assets from

Long-term trends in the global food market

Prices in the global food markets are influenced by many factors: fluctuations in weather conditions and harvest volumes in producer countries; tariff policies and other regulatory measures by governments; investors' speculative activities in commodity exchange markets, and others. However, long-term price trends are largely determined by changes in consumer preferences, which are in their turn related to household per capita income.

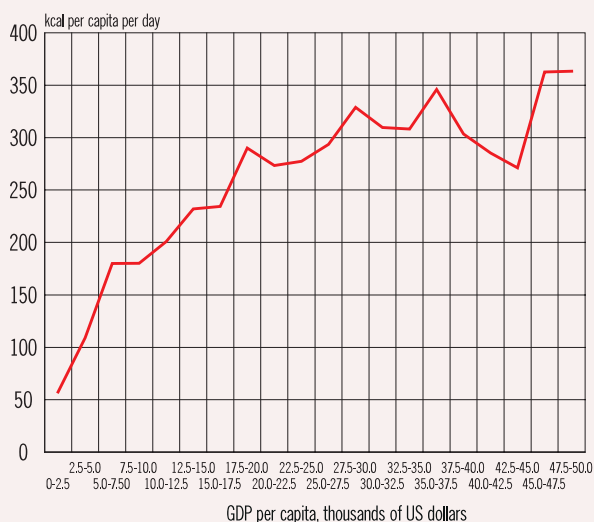
The food consumption structure changes considerably in line with growth in household per capita income and demand for various commodity groups shows substantially differing dependence on income level. However, global trends in household per capita income are generally relatively stable on the 5–10 year horizon and allow for conclusions to be drawn as to the prospective growth in demand for various commodity groups.

The Bank of Russia has analysed the dependence of food consumption both on GDP per capita for the aggregate indicator as well as for five groups used by the UN Food and Agriculture Organisation to calculate the Food Price Index, i.e. cereals, meat, dairy products, vegetable oils, and sugar. Data on 44 developed countries and emerging market economies (making up almost 90% of global GDP and more than 75% of the global population) were used as a basis for the study¹.

On average, the total amount of food consumed by all countries (expressed in kilocalories per day) grows rapidly in line with growth in GDP per capita until the latter reaches the \$12–13 thousand

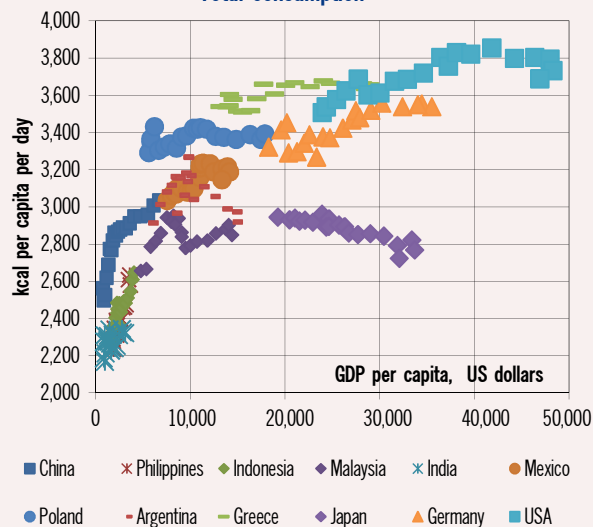
¹ Here and throughout this section, the source of the data and forecasts on population size and GDP per capita is the IMF, World economic outlook, April 2014.

Total food consumption



Sources: FAO, IMF.

Total consumption



Sources: FAO, IMF.

threshold. Consumption growth rates then fall, but on average still remain positive irrespective of GDP per capita levels.

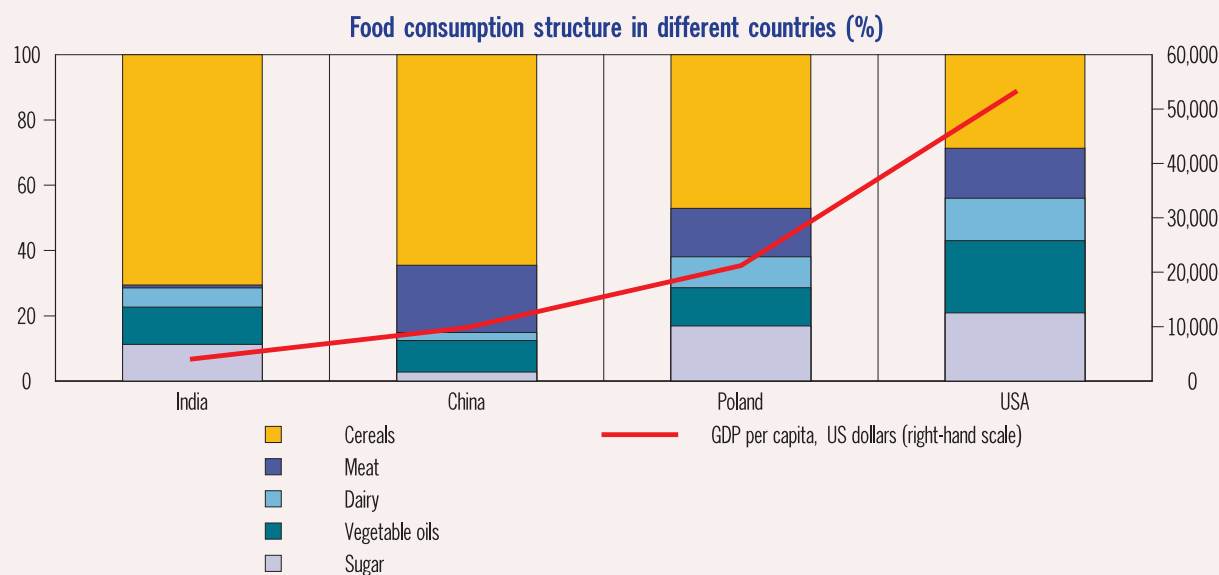
However, the breakdown of consumption will change considerably. As population well-being improves, the focus of consumption shifts towards more 'complex' (and often more expensive) food items. Thus, in countries with low GDP per capita, a comparatively large proportion of consumption will be made up of cereals as the main source of affordable calories. In India, for example, cereals account for more than 70% of consumption. Conversely, with improvements in well-being an ever greater role is played by other components: meat and dairy products, vegetable oils and sugar.

The average demand for cereals from all countries quickly peaks in line with growth in GDP per capita somewhere around the \$5 thousand level, and then falls by 30–40% from this peak, thereafter remaining virtually unchanged as well-being increases. In 2013, barely more than 35% of the population in these countries had a GDP per capita of less than \$5 thousand, and by 2018 this share will reduce to approximately 10% of the population. Of course, demand for cereals will continue to increase due to both population growth, and production of cereals as forage crops, for conversion into biofuels, etc. Nonetheless, it would appear that the period of accelerated growth in demand for cereals is already over with supply shocks potentially being the main cause of price hikes and slumps.

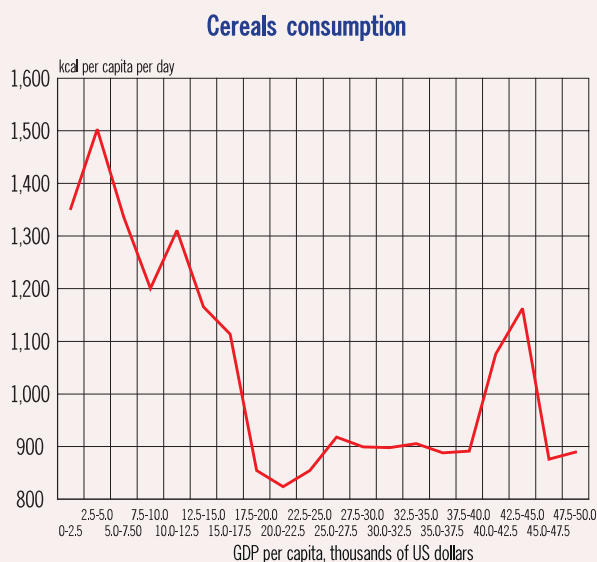
Unlike cereals, growth in demand for meat remains positive at virtually all levels of GDP per capita. Meat consumption rises particularly quickly when GDP per capita is in the range of up to \$15 thousand. There are pronounced differences between countries in the consumption of meat products. Meat consumption in Japan remains significantly below the global average (fish and seafood take the place of meat), while China and Argentina, for example, are significantly above average. Nonetheless, per capita meat consumption in China is continuing to grow at present. The average level of GDP per capita in 2013 for the countries under consideration was \$13.5 thousand, still in the zone of rapid growth in demand for meat. Almost 75% of the population of these countries had below-average income. This means that continued high growth rates in demand for meat can be expected over the coming years.

Sugar consumption grows very rapidly when GDP per capita is low, in the range of up to \$10 thousand. However, when it reaches this level, growth rates slow down virtually to zero. The global average level of GDP per capita has already exceeded this level, and in China and a number of other Asian countries making the major contribution to growth in GDP per capita, demand for sugar is hardly growing. Thus, potential growth in demand for sugar is slightly above the potential growth in demand for cereals, but is not too high.

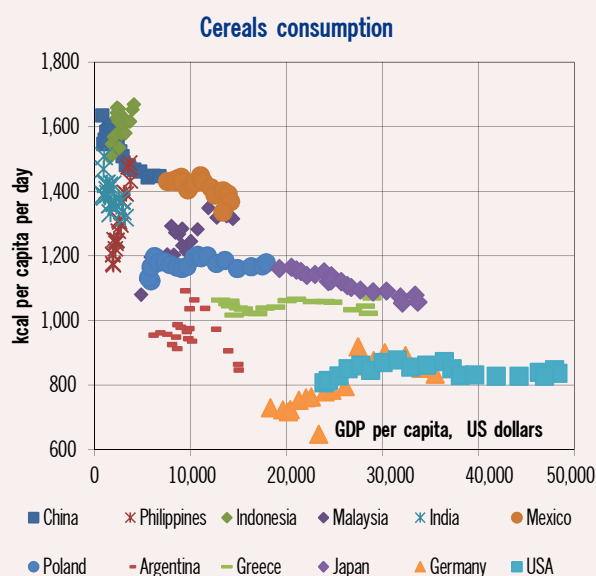
Unlike sugar, vegetable oils consumption grows steadily right up to the very high levels of GDP per capita, reaching its maximum at the level of \$30 thousand. Inter-country differences in the dynamics



Sources: FAO, IMF.



Sources: FAO, IMF.



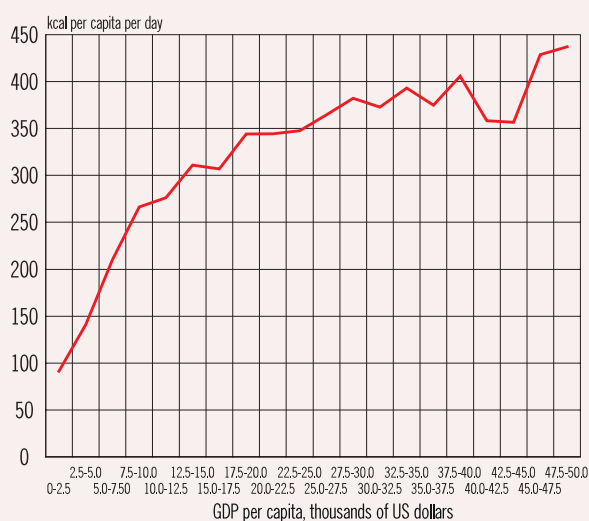
Sources: FAO, IMF.

of vegetable oils consumption are the least pronounced out of all of the commodity groups under consideration. This means that a continued trend of growth in global demand for vegetable oils can be expected over a protracted period.

Global demand for milk shows stable growth in line with growth in population well-being, peaking after \$35 thousand. However, there are more pronounced differences in dairy consumption dynamics across countries. For example, the Japanese consume significantly less milk than the average global trend would suggest, and the average consumption per capita remains virtually unchanged. In China, the average milk consumption per capita also lags significantly behind the global trend, however, unlike in Japan, demand for milk in the country has started to grow rapidly in recent years. From 2009 to 2013, actual imports of dried milk to China rose threefold, increasing in relative terms from 17% to 40% of all global imports. A number of other emerging market countries with large population (for example, Indonesia and the Philippines) and low GDP per capita show similar dynamics. This offers prospects for rapid growth in demand for milk over a protracted period.

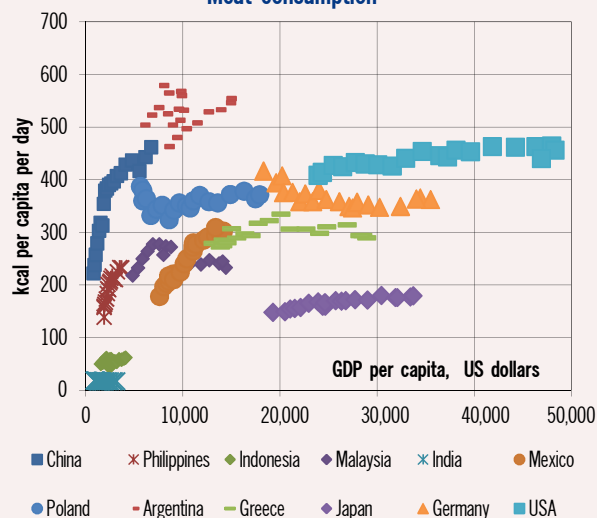
The demand for various groups of food products depends on consumer well-being in different ways. As GDP per capita grows, demand shifts towards more 'complex' and expensive products requiring greater investment. Thus, demand for cereals reaches its peak at a relatively low level of GDP per capita (around

Meat consumption



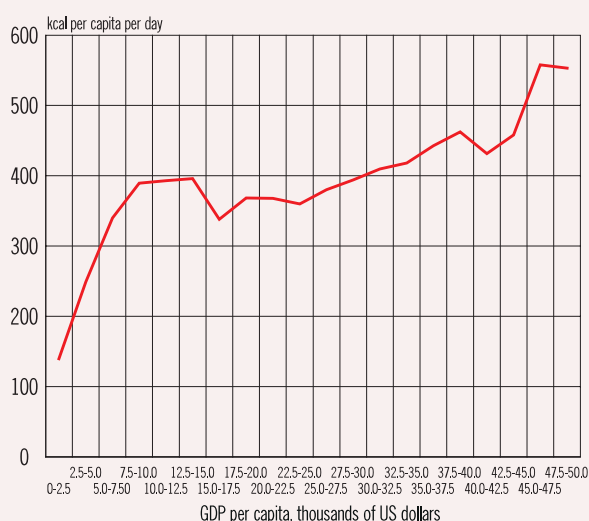
Sources: FAO, IMF.

Meat consumption



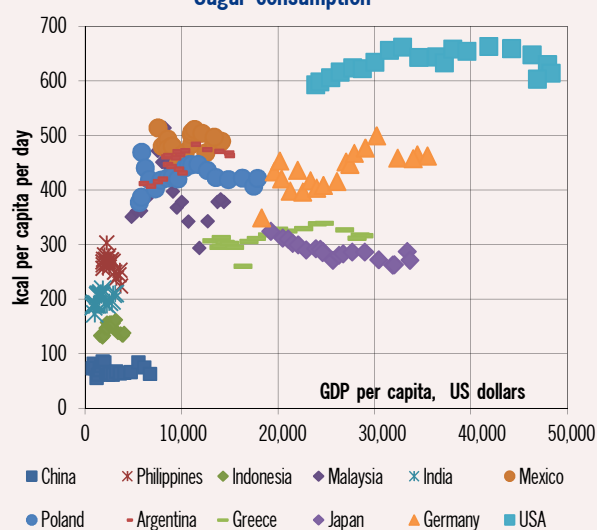
Sources: FAO, IMF.

Sugar consumption



Sources: FAO, IMF.

Sugar consumption



Sources: FAO, IMF.

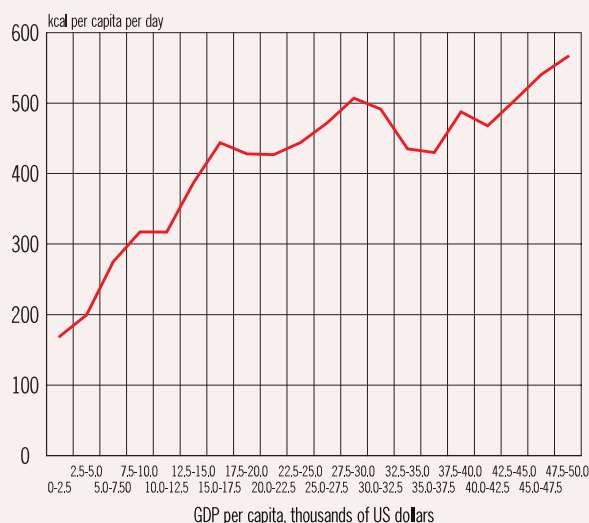
\$5 thousand) before falling significantly. Demand for sugar stops growing when GDP per capita reaches roughly \$10 thousand. Conversely, demand for vegetable oils, meat and dairy continues to grow until population well-being becomes relatively high.

The average GDP per capita of the countries under consideration amounted to \$13.5 thousand in 2013 and the median was \$8.2 thousand. By 2018 (the last year for which the IMF gives forecasts), the average GDP per capita will rise by more than 25% to \$17 thousand and the median will rise by almost 80% to \$14.7 thousand.

This should lead to:

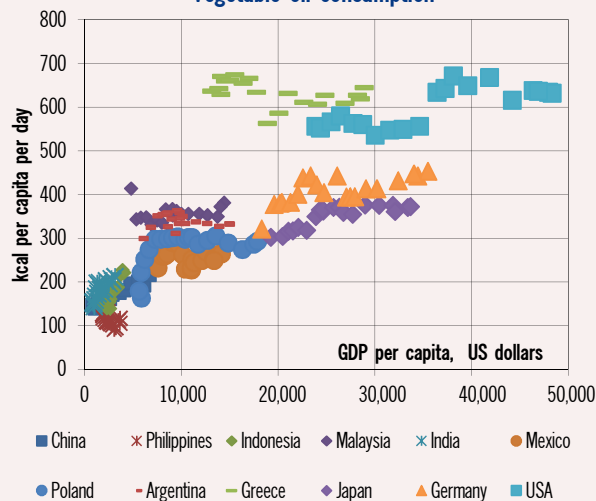
- comparatively low growth in demand for cereals, as the peak level of demand was at lower levels of GDP per capita which have already been passed for the most part, and the main drivers for growth in demand will be the increase in population size and greater use of cereals as forage crops, for conversion into biofuel, etc.;
- moderate growth in demand for sugar (as poorer countries pass the stage of accelerated growth in consumption of sweet products);
- significant growth in demand for vegetable oils, meat and especially for milk and dairy products. The level of GDP per capita in fast-growing and densely-populated emerging market countries corresponds

Vegetable oil consumption



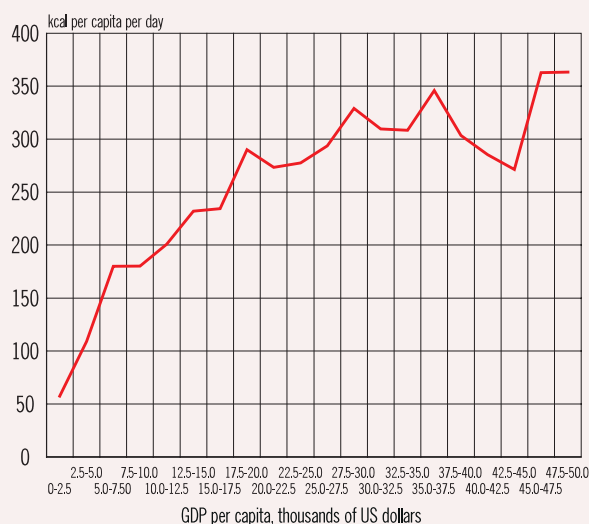
Sources: FAO, IMF.

Vegetable oil consumption



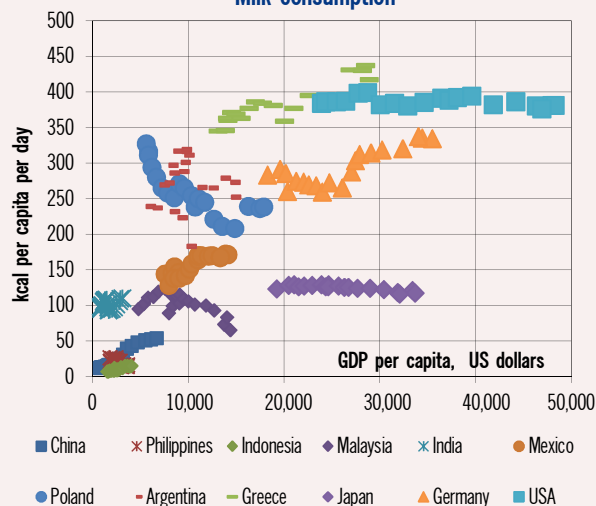
Sources: FAO, IMF.

Milk consumption



Sources: FAO, IMF.

Milk consumption



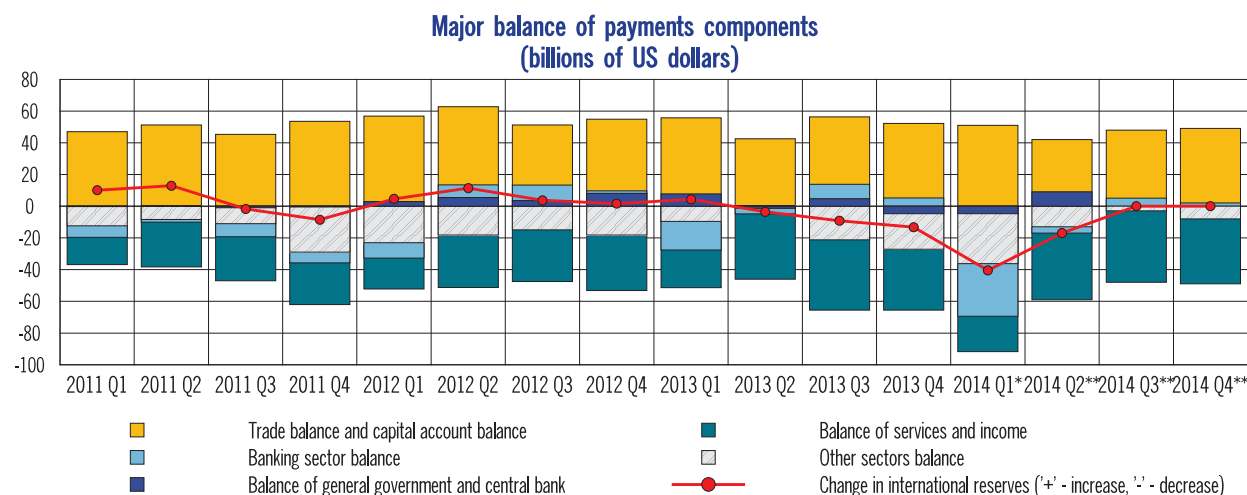
Sources: FAO, IMF.

to the stage of accelerated growth in demand for these groups of products. A further source of growth in demand for milk will be closing of the gap between consumption volumes in China and some other countries, on the one hand, and the global average, on the other hand. Moreover, Chinese demand for food imports will be supported by low confidence in the quality of Chinese raw materials due to the unfavourable environmental conditions in the country.

the private sector. In spite of the sharp fall in the number of dubious transactions (\$2.1 billion in 2014 Q1 compared with \$9.2 billion in 2013 Q1), net capital outflows from banks and other sectors in 2014 Q1, excluding the influence of foreign exchange swaps by the Bank of Russia with resident banks and changes in the balances of credit institutions' correspondent foreign

currency accounts held with the Bank of Russia, exceeded \$63 billion. A substantial amount of the outflow was caused by resident operations, in particular the growth in demand for foreign currency cash.

From January to February 2014, net imports of foreign currency cash by banks amounted to \$6.2 billion (compared with \$-0.4 billion over



* Estimate.
** Forecast.

Note: items 'Banking sector balance' and 'Change in international reserves' are adjusted by the amount of currency swaps of the Bank of Russia with resident banks and operations on resident banks' - correspondent accounts with the Bank of Russia; item 'Other sectors balance' includes item 'Net errors and omissions'.

Source: Bank of Russia.

the corresponding period in 2013). The increase in the supply of cash resulted from higher demand from institutional buyers and did not lead to any perceptible change in the balances with banks.

Considerable increase in foreign currency imports to \$15 billion in March (significantly higher than the 2013 monthly average) and the two-thirds reduction in exports (\$0.3 billion) was in its turn redistributed within the banking sector and manifested itself through \$8.9 billion increase in foreign currency cash with banks. Thus, currency imports were only partially caused by the further increase in demand of other sectors.

The increased capital outflow contributed to the continued high pressure on the ruble, and the Bank of Russia sold foreign currency in the domestic market with a view to smoothing out the volatility of the ruble exchange rate. From January to March 2014, the volume of interventions by the Bank of Russia exceeded \$41 billion, which was the key factor in the reduction of its foreign exchange reserves (by \$40.5 billion at the end of 2014 Q1, excluding the influence of foreign exchange swaps by the Bank of Russia with resident banks and operations on their correspondent accounts held with the Bank of Russia).

Preliminary data suggest that from April to May 2014 private sector capital outflow had already shrunk several fold.

In 2014 Q2-Q4, according to Bank of Russia estimates, the current account balance will remain positive, and its value will be higher than in 2013, primarily due to the reduction in imports of goods. In 2014 the current account surplus will be roughly \$35 billion (after \$32.8 billion in 2013). 2014 Q2-Q4 are expected to see a significant reduction in private capital outflow due to the return of foreign exchange demand to normal levels after a rapid rise at the start of the year, as well as the lack of significant difficulties in the corporate sector over refinancing any foreign liabilities maturing during this period. Under these conditions, the outflow of private sector capital in 2014 is expected to be \$85–90 billion.

This scenario, which assumes a gradual reduction in external political tension and the absence of further international sanctions towards Russia and any other significant external shocks, is viewed as the most likely by the Bank of Russia. However, in the event of any deterioration in the geopolitical situation, there is a risk of more intensive capital outflow, which will lead to ruble depreciation and current account balance increase.

I.2. Financial conditions

Amid the rapid liquidity outflow from the banking sector from March to April 2014 caused by growing tension in the domestic foreign exchange market, the Bank of Russia increased the volume of banking sector refinancing, maintaining the necessary liquidity level and establishing conditions for the normal functioning of the money market. The tightening of the monetary policy by the Bank of Russia led to a corresponding growth in the money market interest rates. Yields in the domestic bond market increased. These tendencies were accompanied by an increase in short-term deposit and lending rates to the corporate sector in March. From April to May 2014, there was also some growth in rates on other categories of bank lending and deposit operations. Under these circumstances the dynamics of annual growth rates of banks' loan portfolio were not uniform. Growth in consumer lending slowed down while mortgage lending accelerated. Corporate lending growth rates increased, predominantly due to the revaluation of foreign currency loans and operations with companies registered abroad.

Money market and Bank of Russia banking sector liquidity management

In February the inflow of funds through fiscal channels contributed to the fall in the structural liquidity deficit and, as a result, demand from credit institutions for refinancing. Consequently, over the course of the month, the Bank of Russia's gross credit to credit institutions¹ fell by 0.5 trillion rubles, to 3.9 trillion rubles. However, March saw further liquidity outflow from the banking sector.

Aside from the expected impact of seasonal factors, the withdrawal of liquidity was caused

by large-scale foreign exchange interventions² by the Bank of Russia within its current exchange rate policy framework amid the aggravation of the external political situation in early March, which caused a sharp depreciation of the ruble. In March alone, the Bank of Russia sold foreign currency in the amount of 1.0 trillion rubles. In April, amid the easing of tension in the foreign exchange market, the outflow of liquidity resulting from Bank of Russia interventions dropped. For most of May 2014, the value of the dual currency basket was in the 'neutral' range of the operational band of the exchange rate policy. At the same time, the Bank of Russia's operations related to sovereign funds accumulation by the Federal Treasury contributed to a slight inflow of liquidity into the banking sector in the amount of 34 billion rubles.

From March to May, the impact of other liquidity factors and the dynamics of credit institutions' demand for correspondent accounts with the Bank of Russia were in line with seasonal trends. In particular, the combined impact of the fiscal channel and the change in cash in circulation contributed to a small inflow of liquidity in the amount of 0.1 trillion rubles. In order to offset the growing demand of banks for refinancing, the Bank of Russia increased its gross credit by 1 trillion rubles, to 4.9 trillion rubles.

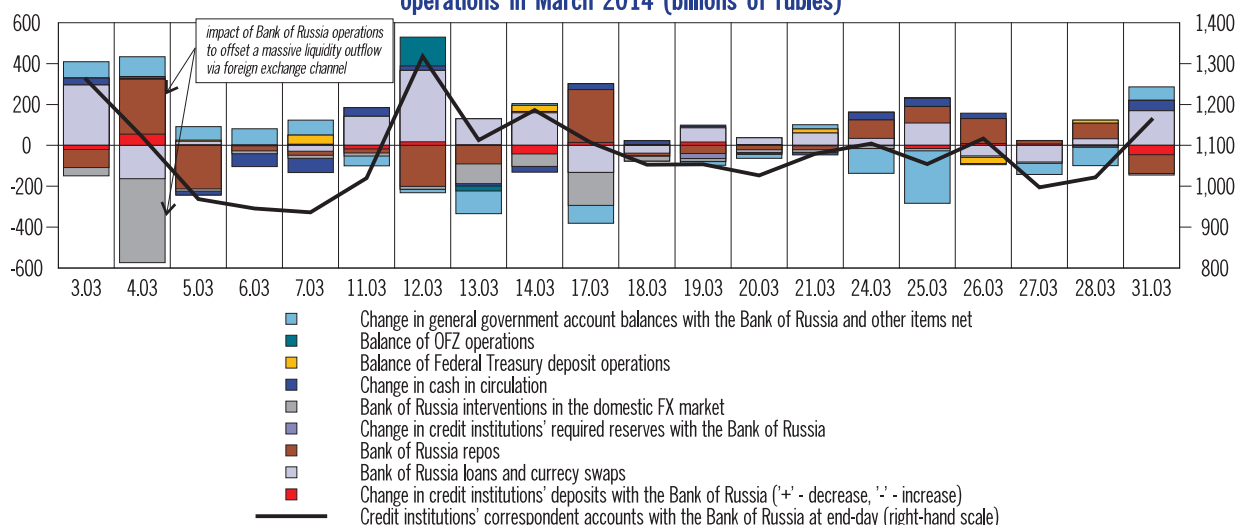
Repo operations continued to be the Bank of Russia's principal liquidity providing instrument. However, as borrowing from the central bank continued to grow faster than the amount of marketable assets on the balance sheets of credit institutions, demand for operations secured by other types of assets increased.

From February 2014, the Bank of Russia has been holding regular one-week repo auctions

¹ Here and throughout this section, the Bank of Russia's gross credit excluding subordinate loans to Sberbank of Russia and Bank of Russia deposits with credit institutions.

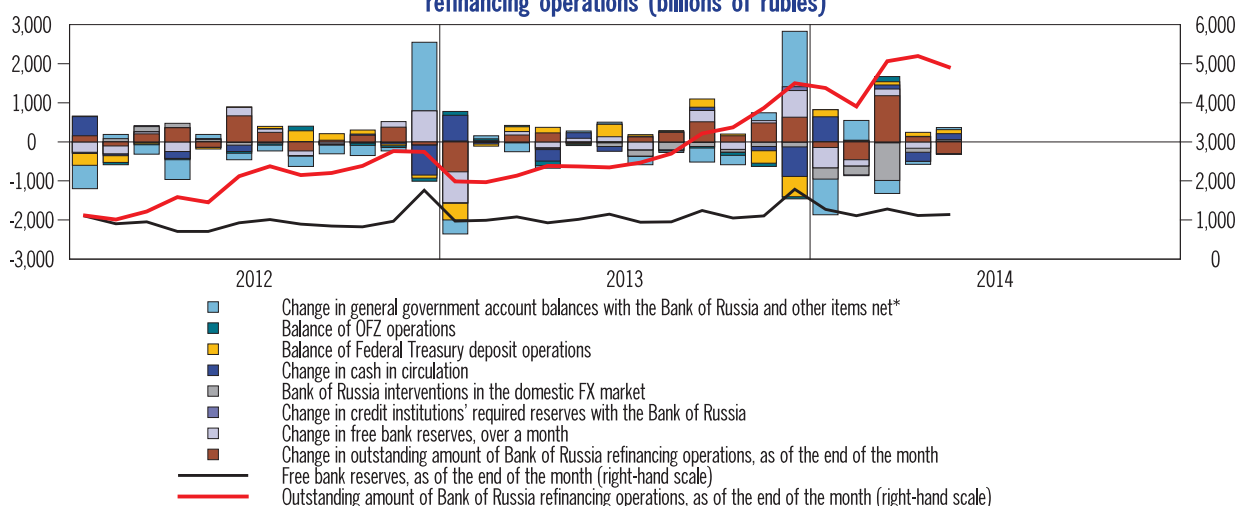
² For the details of Bank of Russia's operations in the foreign exchange market see the sub-section 'Exchange rate policy decisions' in Section II.3. Changes to the system of instruments and other monetary policy measures.

Liquidity factors and change in outstanding amount of Bank of Russia operations in March 2014 (billions of rubles)



Source: Bank of Russia.

Liquidity factors and change in outstanding amount of Bank of Russia refinancing operations (billions of rubles)



* Excluding OFZ and Federal Treasury deposits.

Source: Bank of Russia.

only³. The average outstanding amount of these auctions increased from 2.4 trillion rubles in February to 3.1 trillion rubles in May, while its highest level reached 3.3 trillion rubles. With the continuing problem of the market collateral scarcity and its uneven distribution in the banking sector, demand at auctions in certain periods was lower than the maximum allotment amount set by the Bank of Russia.

To offset significant deviations in liquidity demand from its supply, the Bank of Russia conducted 'fine tuning' repo auctions on certain days. Over the period under review, this situation only arose relatively frequently in March, which was due to the sharp rise in demand for refinancing amid the large-scale foreign exchange interventions and increased tension in the money market. In February, April and May, there was no significant need for such operations.

With a view to reducing the burden on repo operations and offsetting part of the structural liquidity deficit using longer-term operations,

³ From February 2014, 3- or 12-month repo auctions were suspended. Overnight repo auctions also stopped being held on a daily basis. In the event of any significant deviations in liquidity demand from supply, there are provisions in place to carry out 'fine tuning' operations: 1- to 6-day repo auctions or deposit auctions.

Factors increasing gross credit of the Bank of Russia to the banking sector

The central bank provides or absorbs liquidity in order to offset the difference between the demand of credit institutions for liquidity (credit institutions' correspondent accounts with the central bank) and its supply, which is shaped by factors beyond the direct control of the central bank's liquidity management system – autonomous factors. In the event of a liquidity deficit, the liquidity outflow, caused by any of the liquidity factors automatically causes an increase in banking sector need for refinancing. In the event of insufficient liquidity supply by the central bank at auctions, this demand will be met by standing facilities. These processes are reflected in a change of corresponding items on the central bank's balance sheet.

In March 2014, gross credit of the Bank of Russia rose by 1.2 trillion rubles. This change was chiefly caused by the outflow of liquidity resulting from the Bank of Russia's foreign exchange sales worth of 1.0 trillion rubles. The correspondent account balances of credit institutions at the end of March increased due to seasonal factors and returned to their previous level at the end of April. Consequently, despite the growth in the volume of refinancing, there was no significant change in the Bank of Russia's balance sheet total.

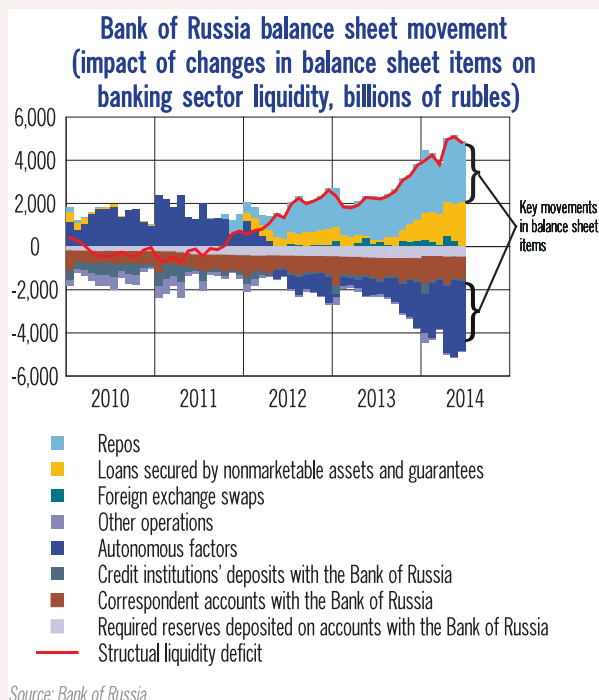
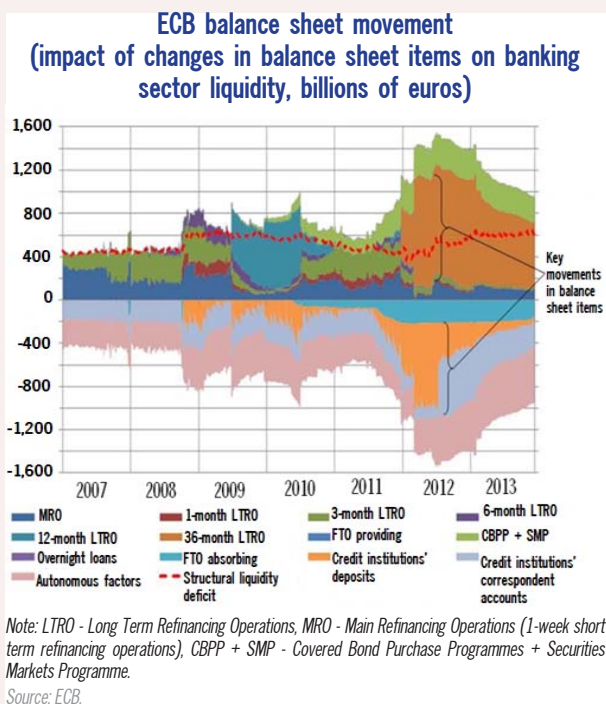
The nature of the increase in the Bank of Russia's refinancing volume was fundamentally different from the anti-recessionary measures of a number of central banks: US Fed, ECB, Bank of England and Bank of Japan. Unlike the traditional monetary policy aimed at steering money market rates, the outright asset purchases conducted in the course of quantitative easing programmes are aimed at increasing the bank reserves at the central bank. The active central bank operations stimulated an expansion of its balance sheet. The policy of the ECB had a similar effect: the gradual increase in refinancing on the asset side of the central bank's balance sheet was brought about neither by growth in averaged required reserves nor by autonomous factors and led to an instant increase in the correspondent account balances and banks' deposits on the liabilities side of the central bank's balance sheet. Thereby the banking sector shifted to liquidity surplus.

Bank of Russia simplified balance sheet
(impact of changes in balance sheet items on banking sector liquidity)

March 2014.		April 2014.	
Assets	Liabilities	Assets	Liabilities
Net foreign assets -960 billion rubles (Bank of Russia sales of foreign currency) Net loan to general government, incl. other items net -122 billion rubles (change of account balances with the Bank of Russia)	Free bank reserves (credit institutions' correspondent accounts and deposits with the Bank of Russia) +173 billion rubles (change)	Net foreign assets -101 billion rubles (Bank of Russia sales of foreign currency) Net loan to general government, incl. other items net 26 billion rubles (change of account balances with the Bank of Russia)	Free bank reserves (credit institutions' correspondent accounts and deposits with the Bank of Russia) +166 billion rubles (change)
Bank of Russia liquidity providing operations (balancing operations) +1,180 billion rubles	Cash in circulation -102 billion rubles (change) Credit institutions' required reserves with the Bank of Russia +27 billion rubles (change)	Bank of Russia liquidity providing operations (balancing operations) +128 billion rubles	Cash in circulation -230 billion rubles (change) Credit institutions' required reserves with the Bank of Russia -11 billion rubles (change)

■ – demand for liquidity; ■ – liquidity supply factors; ■ – Bank of Russia operations determined by the difference between liquidity demand and supply.

In Russia the consistent growth in central bank refinancing volumes from late 2011 resulted, like in March 2014, primarily from offsetting the impact of autonomous liquidity factors. The increase in the correspondent account balances of credit institutions was minor and on the whole reflected the increase in the averaged value of required reserves. The expansion of the Bank of Russia's balance sheet, unlike the cases described above, can mostly be explained by a change in its liabilities – growth in cash in circulation, and in general government funds in Bank of Russia accounts. After the reduction in foreign currency purchases the change in liabilities was offset by refinancing operations.



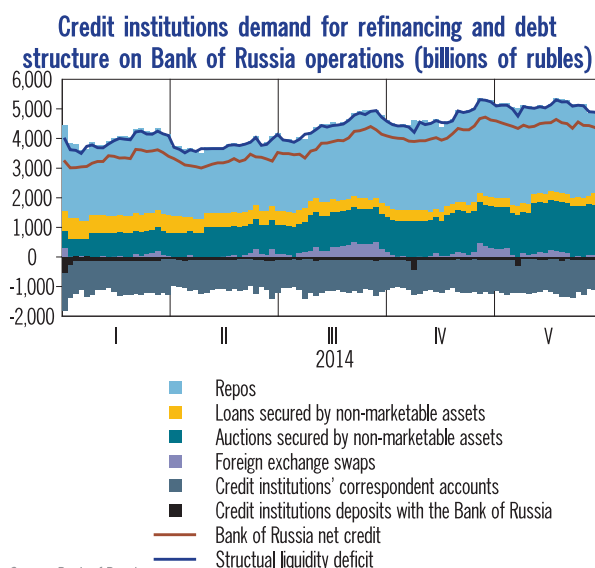
the Bank of Russia increased the maximum allotment amounts at auctions to provide loans secured by non-marketable assets for a 3-month term at a floating interest rate. As a result, the outstanding amount of such operations from the start of the year increased by 1.1 trillion rubles to 1.7 trillion rubles. Meeting medium-term demand for liquidity through such operations contributed to mitigating the problem of the marketable collateral scarcity and reducing the demand of credit institutions for corresponding operations at fixed rates.

Credit institutions continued to actively use foreign exchange swaps to acquire funds to cover short-term liquidity needs and also due to a shortage of other assets eligible as collateral for auction operations. Amid rapid growth in refinancing needs in March the frequency and

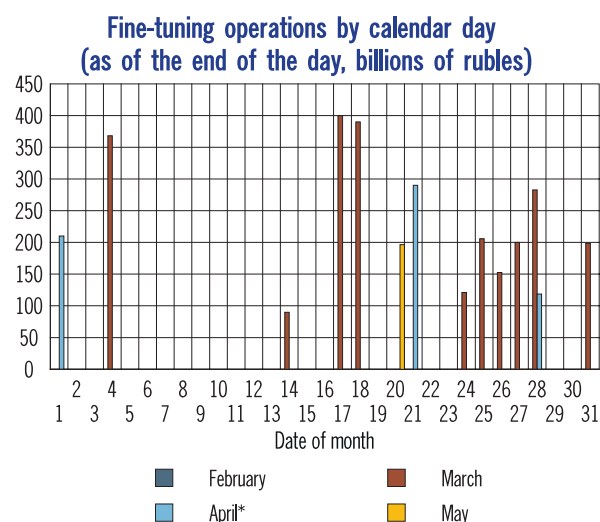
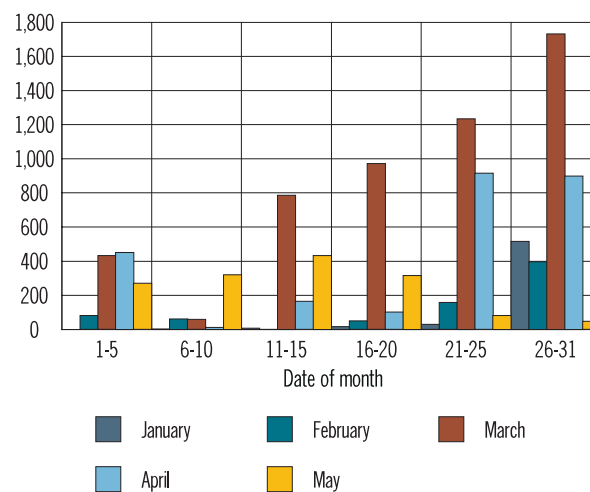
volume of foreign exchange swaps with the Bank of Russia increased considerably.

Amid the renewed growth in structural liquidity deficit in March after its decrease in the first few months of this year, money market rates returned to the upper border of the Bank of Russia interest rate corridor. As a result, while the average spread of money market rates to the Bank of Russia key rate was equal to 50 bp from January to February, from March to May the spread increased on the average to 70–90 bp. In the last ten days of March and April, when current liquidity deficit increased substantially, the cases of money market rates moving outside the borders of the Bank of Russia interest rate corridor became more frequent.

The increase in the spread between interbank lending rates and the key rate resulted



**Bank of Russia foreign exchange swaps
(intramonth activity distribution, billions of rubles)**



* On 21 and 28 April 2014, the Bank of Russia conducted 2-day fine-tuning operations.

Source: Bank of Russia.

in interbank lending rates growth beyond the extent of the Bank of Russia key rate increase in March and April 2014. The average MIACR on overnight ruble interbank loans increased from 6.02% p.a. from January to February to 7.86% p.a. from March to April, and to 8.21% p.a. in May 2014. Changes in interbank repo and swap rates had similar dynamics, which suggested that the dynamics of these rates were influenced largely by the same factors that affected the interbank lending rates.

The structure of money market turnover in the period under review remained almost unchanged. Like in previous months, foreign exchange swaps dominated market turnover. In

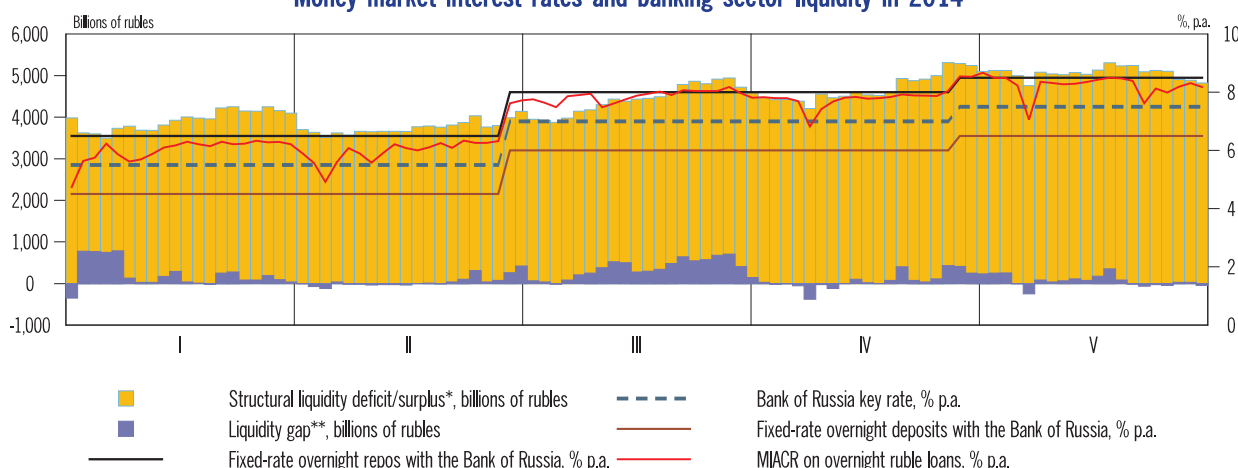
May 2014, these operations accounted for more than 60% of the overnight operations turnover in the Russian money market.

Despite the threat of sanctions against certain Russian banks and the rising macroeconomic risks, no increase in risk premiums was witnessed in the money market, as evidenced by the dynamics of the spread between rates on loans to banks with investment grade and speculative credit ratings (spread between MIACR-IG and MIACR-B). The spread dynamics showed that money market participants did not expect any significant deterioration of the situation in the short term.

The increasing refinancing needs of the banking sector were accompanied by the Bank of Russia's measures to expand the list of eligible marketable collateral for refinancing operations. However, the unfavourable situation in the domestic bond market resulted in a fall in issuing activity. As a result, the total volume of assets at the disposal of credit institutions and eligible as collateral for Bank of Russia operations did not change significantly amounting to roughly 6.0 trillion rubles as of 1 May 2014 (approximately 3/4 were securities and 1/4 were non-marketable assets⁴). In May 2014, in order to

⁴ Credit agreements and claims that passed the Bank of Russia's verification procedure and can be eligible collateral on Bank of Russia loans.

Money market interest rates and banking sector liquidity in 2014

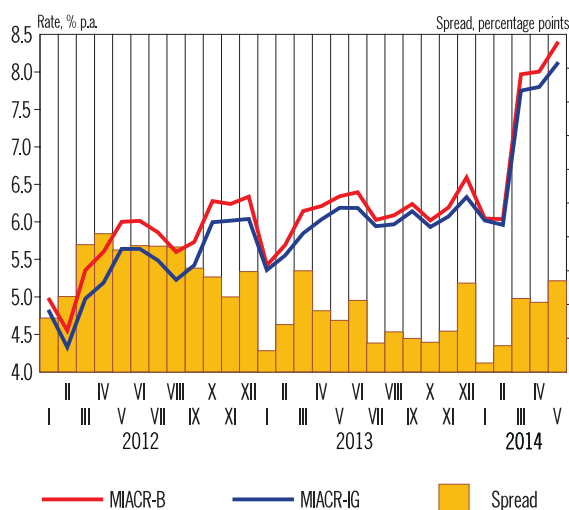


* Difference between Bank of Russia gross credit to credit institutions (excluding the deposit with Vnesheconombank and the subordinated loan to Sberbank) and outstanding amount of Bank of Russia liquidity absorbing operations.

** Difference between liquidity demand and supply as of the beginning of the day.

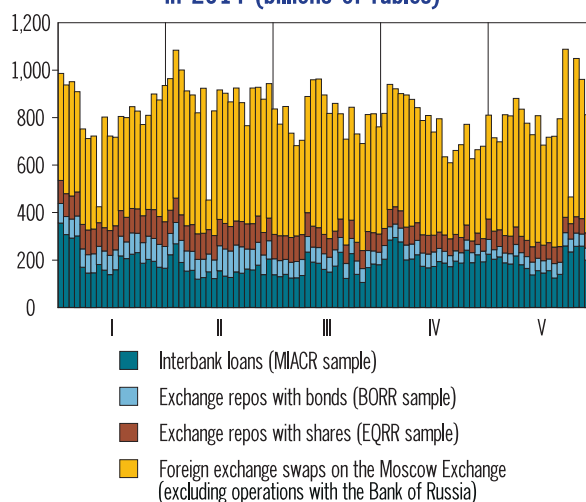
Source: Bank of Russia.

Spread of rates on overnight interbank ruble loans



Source: Bank of Russia.

Overnight operations in the Russian money market in 2014 (billions of rubles)



Sources: Bank of Russia, MICEX SE.

improve the procedure for extending Bank of Russia loans secured by non-marketable assets and guarantees, the Bank of Russia expanded the List of entities, credit claims to which are accepted under a simplified procedure⁵. This year, the Bank of Russia will continue to take measures aimed at increasing the potential volume of collateral.

From June to December 2014, the dynamics of banking sector liquidity factors is

not expected to see significant deviations from the path typical of corresponding periods in previous years. Given the cyclical nature of intra-year fiscal flow dynamics, an increase in demand for refinancing is expected up to mid-December 2014. The withdrawal of liquidity during this period due to the federal budget revenues exceeding its expenditures will be offset by the Federal Treasury operations to deposit federal budget funds with credit institutions. Due to the decision to switch to targeting of the federal budget balances in the accounts with the Bank of Russia, these operations will be carried out more actively.

⁵ Press release dated 6 May 2014 'On Expanding Bank of Russia List' can be found in the 'Press releases' section of the Bank of Russia official website (http://cbr.ru/press/PR.aspx?file=06052014_141312intern3.htm).

The forecast of banking sector liquidity factors (trillions of rubles)

		2012	2013	2014 (forecast)*, **
Total for autonomous factors	$1 = 2 + 3 + 4 + 5$	-1.3	-1.7	[-2.3; -1.8]
of which:				
– change in general government accounts with the Bank of Russia (incl. other operations)	2	-0.8	-0.4	[-0.4; 0]
– change in cash in circulation	3	-0.6	-0.5	[-0.4; -0.3]
– Bank of Russia interventions in the domestic FX market	4	0.2	-0.9	-1.5
– change in credit institutions required reserves with the Bank of Russia	5	0	0	0
Change in free bank reserves***	6	0.4	0	[0.0; 0.1]
Change in outstanding amount of Bank of Russia refinancing operations	$7 = 6 - 1$	1.7	1.7	[1.8; 2.4]
Memo item: outstanding amount of Bank of Russia refinancing operations	8	2.7	4.5	[6.3; 6.9]

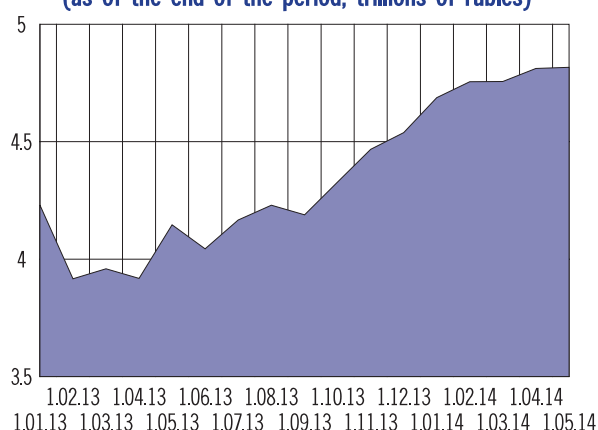
* January-May - fact, June-December 2014 - forecast.

** The forecast does not include the impact on the banking sector liquidity exerted by Bank of Russia operations in the domestic FX market, as well as operations with OFZ and Federal Treasury deposits. The impact of these factors will be shaped by the situation in respective financial market segments.

*** During the forecast period the demand for free bank reserves is determined on the basis of credit institutions' correspondent account balances with the Bank of Russia (taking into account the averaged amount of required reserves held at correspondent accounts, banks' need to perform settlements and precautionary motives) and the volume of credit institutions' deposits with the Bank of Russia.

**** Excluding the subordinated loan of Sberbank and Bank of Russia deposits placed with credit institutions.

Credit institutions securities included in the Bank of Russia Lombard List (as of the end of the period, trillions of rubles)*



* Including securities pledged as collateral for repo operations.

Source: Bank of Russia.

The growth rates of gross credit of the Bank of Russia to the credit institutions are expected to surpass those of the portfolio of marketable securities eligible as collateral. Thus, the average money market rates will mostly stay close to the upper border of the Bank of Russia interest rate corridor in the coming months.

Asset prices and bond market

From February to May 2014, the situation in key segments of the domestic stock market was shaped by the growing geopolitical risks, uncertainty over the growth prospects of the

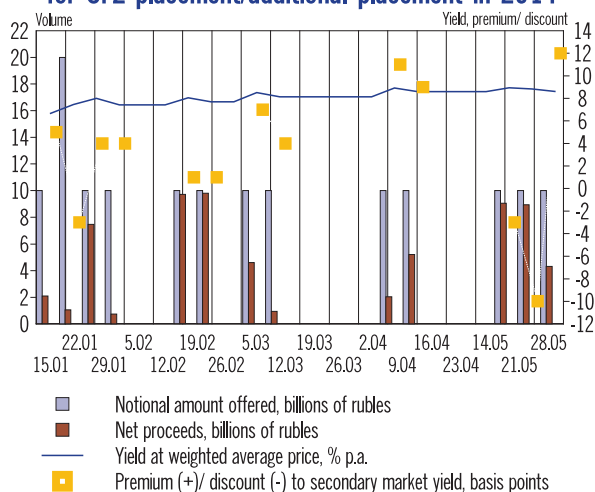
Russian economy, and Bank of Russia monetary policy decisions.

With the intensification of economic and external political uncertainty from February to May 2014, securities quotes saw increased volatility in key segments of the domestic stock market. The increase in money market rates following the raising of the Bank of Russia key rate resulted in securities yield growth. The downgrading of Russia's long-term credit rating and the ratings of a number of major Russian companies and banks by the international rating agencies affected the dynamics of Russian financial asset prices and yields.

The negative price trends in the stock market from February to May impacted other segments of the financial market through the negative revaluation of the securities portfolios of credit institutions. However, the impact of this factor on the state of the Russian banking sector was limited due to the low investments of credit institutions in equities regarded as high-risk assets. During the periods of increased instability and deterioration of the situation in the domestic stock market, Russian credit institutions curtailed their investments in both stocks and bonds.

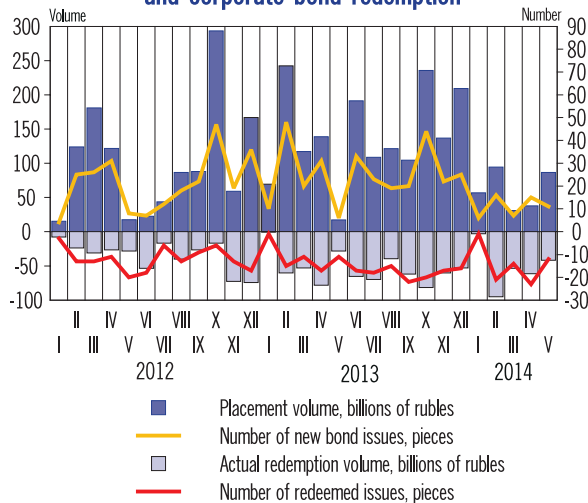
The increase in investment risks contributed to continued flight of non-residents from the domestic bond market exerting downward

Ministry of Finance auctions for OFZ placement/additional placement in 2014



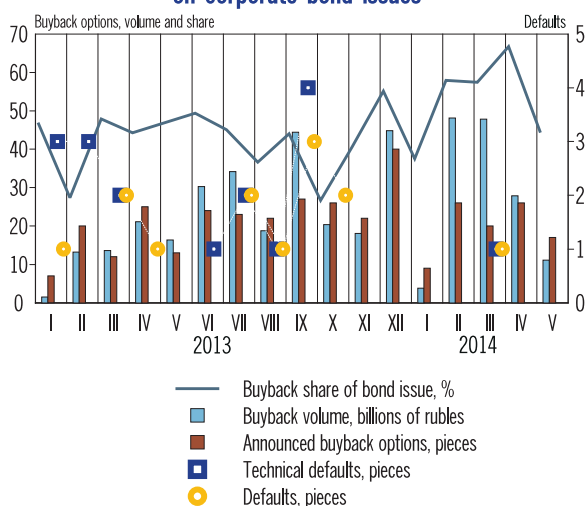
Source: MICEX SE, Bank of Russia calculations.

Primary placement on MICEX SE and corporate bond redemption



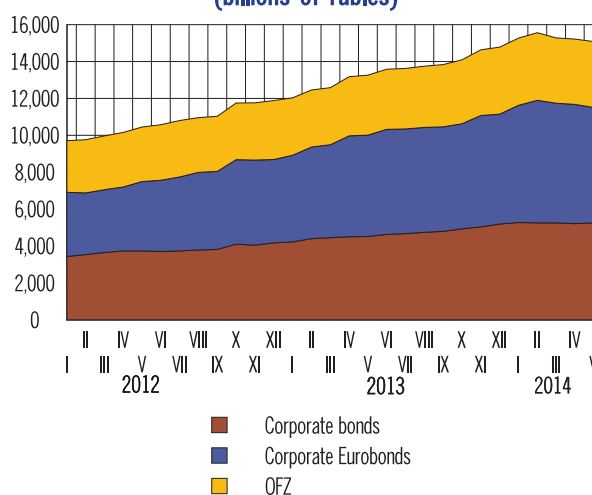
Sources: MICEX SE, Cbonds.ru, Bank of Russia calculations.

Buyback options and defaults on corporate bond issues



Sources: Cbonds.ru, Bank of Russia calculations.

Volume of Russian bonds outstanding (billions of rubles)



Sources: MICEX SE, Cbonds.ru.

pressure on bond quotes. At the same time, the easing of tension in the domestic stock market in mid-April and May was accompanied by a renewed inflow of non-resident capital to the federal government bond (OFZ) market and stabilisation of OFZ yields.

Due to unfavourable market conditions, the Russian Ministry of Finance reduced its borrowing in the domestic primary OFZ bond market. From February to May 2014, seven OFZ bond auctions were cancelled and four auctions were recognised as failed due to the lack of offers at prices reflecting the credit quality of bonds placed. At nine of the auctions that took

place during the period under review (excluding two in May), OFZ bond issues were floated with premiums to their yields in the secondary market.

The domestic corporate bond market saw a sharp fall in issuing activity. Half of the placements of new corporate bond issues were made by non-bank financial institutions (including mortgage agents), some of which were affiliated with major Russian banks. The demand for securities of mortgage agents was supported by active development of the housing mortgage lending market in Russia. At the same time, the corporate bond market saw

**Government and corporate bond yields
(%, p.a.)**



* The yield on bonds included in MICEX CBI CP index calculation base.
Source: MICEX SE.

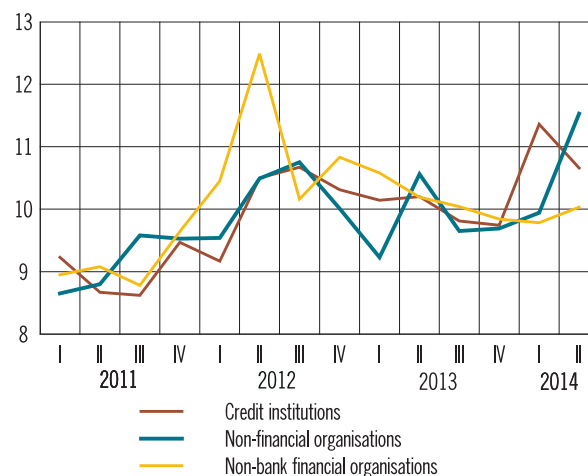
few placements of new issues by non-financial organisations. From February to April, there was a significant increase in the volume of corporate bond issues sold by their holders during the buyback periods.

The recovery of issuing activity in key segments of the domestic bond market was only witnessed in the second half of May. During this period, demand exceeded supply at OFZ bond auctions. Corporate bond issuers from among non-bank financial institutions and credit institutions announced new placements and closed their order books with coupon rates fixed at lower than the initial guideline range.

The increased risks on operations with Russian financial assets resulted also in lower interest from investors in the foreign capital market. The fall in Russian corporate Eurobond quotes made borrowing in the foreign market less profitable for the Russian corporate sector than in 2013. Under these circumstances, the volume and number of Russian corporate Eurobond placements reduced significantly from February to May 2014 compared with October 2013 to January 2014.

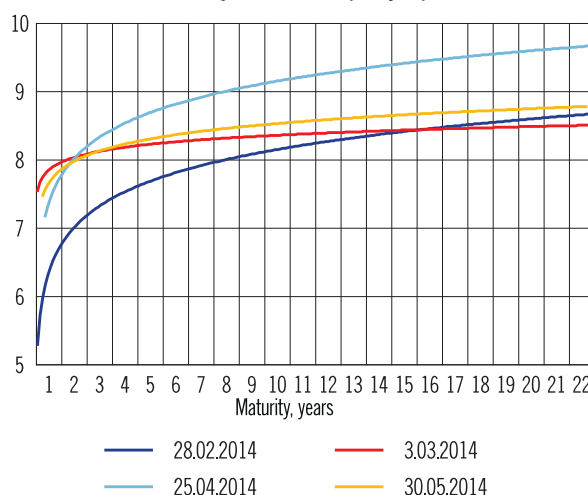
The period under review saw termination of growth in OFZ and corporate bond market portfolios resulting from the exceeding volume of redemption over the volume of bond placement.

**Average yield on bond issues placed
on MICEX SE (%, p.a.)***



* Quarterly average.
Source: MICEX SE, Cbonds.ru, Bank of Russia calculations.

OFZ yield curve* (%, p.a.)

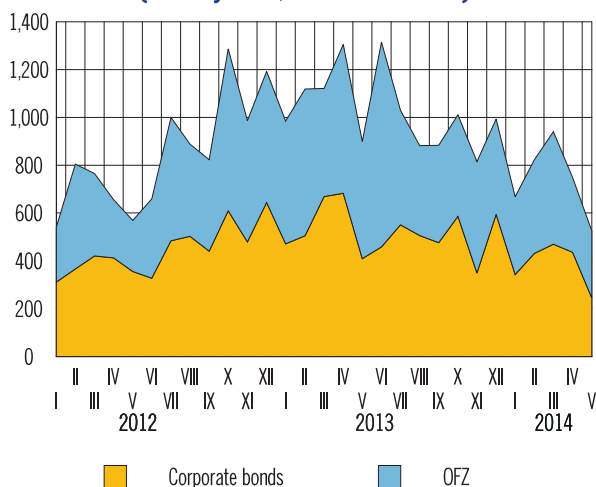


* The yield curve is adjusted by the logarithmic function.
Source: MICEX SE, Bank of Russia calculations.

From February to May 2014, the total placement of government bonds fell 5.4 times compared with similar indicator from October 2013 to January 2014, to 58.5 billion rubles at par value. The value of corporate bonds placed by issuers in the domestic primary market reduced 2.6 times to 249.1 billion rubles at par value, and in the foreign market 1.6 times to \$7.0 billion (247.6 billion rubles).

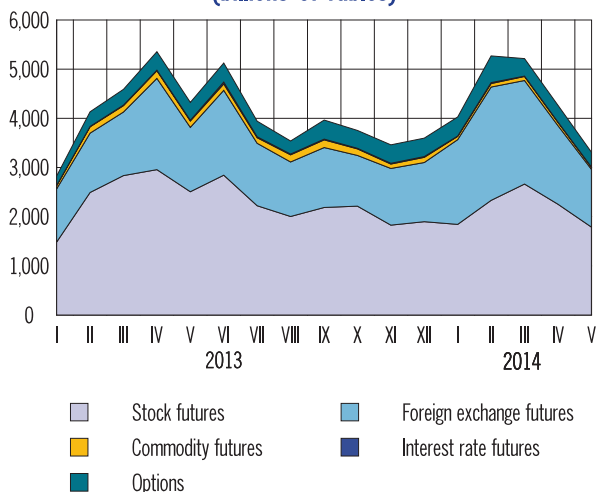
As a result, at the end of May 2014, the par value of OFZ market portfolio fell by 2.2% compared with the end of January, to 3,566.1 billion rubles, the par value of corporate bond market portfolio dropped by 0.3% to

**Domestic bond market secondary trade turnover
(monthly total, billions of rubles)**



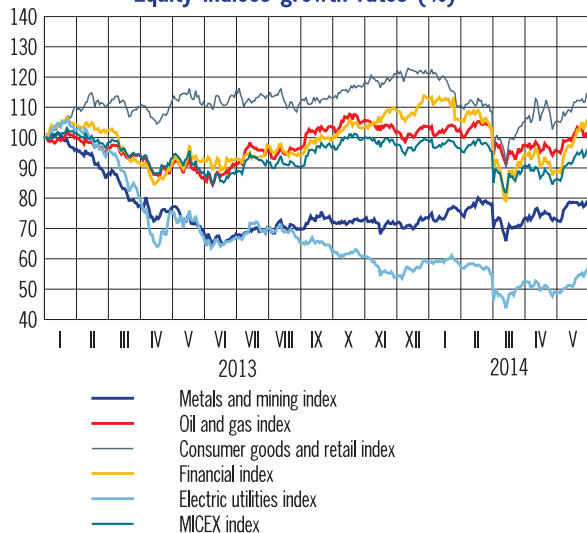
Sources: MICEX SE, Bank of Russia calculations.

**Exchange-traded derivatives turnover by underlying assets
(billions of rubles)**



Sources: MICEX SE, Bank of Russia calculations.

Equity indices growth rates (%)



Sources: MICEX SE, Bank of Russia calculations.

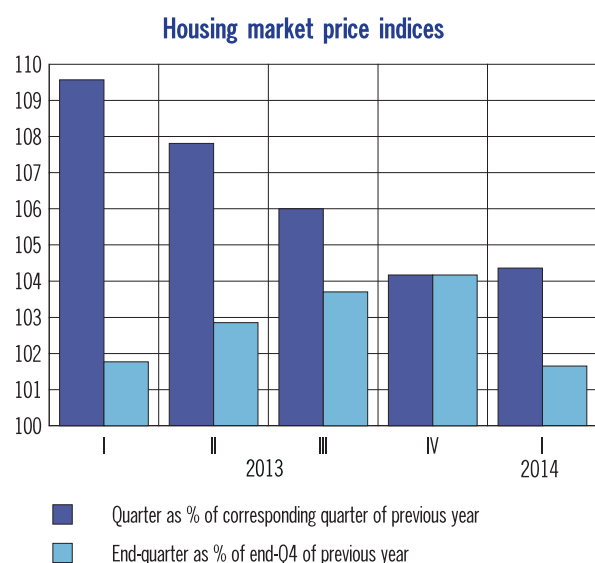
5,252.0 billion rubles in the domestic market, and rose by 0.2% to \$180.7 billion in the foreign market (falling by 1.5% to 6,261.9 billion rubles in ruble terms). The current year is not expected to see any significant growth in the OFZ market portfolio due to the announcement made by the Russian Ministry of Finance to curtail its borrowing programme in 2014.

Amid high price uncertainty, the downgrading of Russia's credit rating by S&P followed by the decrease in corporate ratings, investors reassessed the risk premium on Russian debt market instruments. This reassessment, together with the increase in rates on Bank of

Russia operations (in March and April) and the corresponding growth in the money market rates, contributed to a rise in bond yields which significantly surpassed the level forecast at the end of January.

The cost of borrowing in the domestic primary corporate bond market increased for all types of borrowers. From February to May 2014, the average yield on bonds of credit institutions, non-financial organisations and non-bank financial institutions increased by 131, 126 and 22 bp compared with October 2013 to January 2014, to 11.0%, 11.0% and 10.0% p.a. respectively.

Government and corporate bonds yields in the domestic secondary market increased by mid-March and then fluctuated without any clear trend. By the end of April, the OFZ yield curve moved upwards on average by 1.5 pp as against the end of January. The yield of short-term bond issues showed the most significant response to the increase in rates on Bank of Russia operations which resulted in flattening of the OFZ yield curve. In May, OFZ bond yields dropped and its slope reduced considerably, which could suggest that market participants did not expect the Bank of Russia key rate and, consequently, money market rates to remain at current levels in the long term. At the end of May, compared with the end of January, the



Sources: Federal State Statistics Service, Bank of Russia calculations.

average OFZ bond yields (RGBEY index) and corporate bond yield rose by 0.7 pp and 2.0 pp to 8.4% and 10.5% p.a. respectively.

Despite the deterioration in borrowing conditions, Russian companies and banks continued to timely and fully service their debt (coupon payment and principal redemption), which resulted in reduction in the number of defaults on corporate bond issues from February to May 2014 compared with the corresponding period in 2013.

From February to May, the activity in the domestic secondary bond market was generally low. Compared with October 2013 to January 2014, the average daily volume of transactions with OFZ bonds on the Moscow Exchange fell by 8.9% to 17.7 billion rubles, volume of transactions involving corporate bonds decreased by 14.5% to 19.3 billion rubles.

In mid-March, stock price indices sank to their lowest levels in the past four years, and fluctuated in the horizontal trend until the end of May after having regained some of their losses. The volatility of quotes and market portfolio risk premiums increased. As of 30 May, the MICEX index decreased by 1.5% to 1,432.03 points compared with the end of January.

After the growth in activity in the foreign exchange derivatives market from January to March, the following months saw trading

volumes fall. This suggested the decrease of interest in instruments for hedging foreign exchange risk amid the stabilisation of the situation in the foreign exchange market and ruble appreciation from April to May. The volume of transactions involving interest rate exchange-traded derivatives remained small.

On the whole, in 2014 Q3, as external political risks reduce, an improvement in market conditions in key segments of the Russian stock market is expected.

From January to March, amid the heightened volatility in the foreign exchange market and increased consumer interest in residential real estate for investment purposes, prices in the housing market continued to grow. Price indices in the primary and secondary housing markets increased on the average by 1.6% during this period compared with the end of the previous quarter (by 4.4% compared with 2013 Q1). The expansion of the mortgage market, the fall in interest rates and easing of certain non-price lending conditions by banks contributed to the rise in prices for residential real estate.

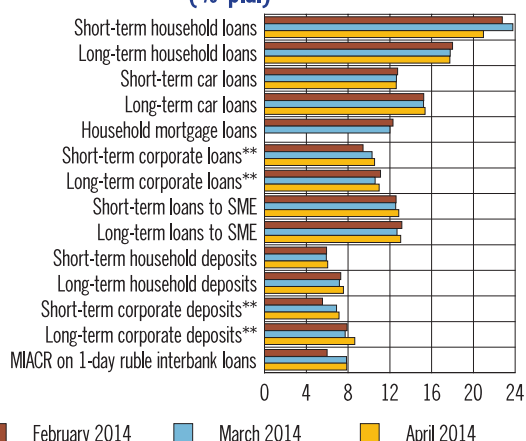
Bank interest rates and non-price lending conditions

From January to February 2014, bank loan and deposit rates did not see any significant change.

Meanwhile, the increase of the Bank of Russia key rate in March and April and the resulting growth in money market rates and yields in the domestic bond market established prerequisites for an increase in the bank ruble loan and deposit rates. Another factor affecting the banks' interest rate policy was increased dollarisation of their liabilities (see the box 'Change in bank funding structure'). Seeking to avoid an excessive rise in currency risk amid the increased volume of foreign exchange deposits, banks reduced their rates on foreign exchange transactions and simultaneously increased interest rates on ruble operations.

These trends only began to show in March 2014. Nonetheless, March already saw increase

**Interest rates in the Russian lending and deposit market*
(% p.a.)**

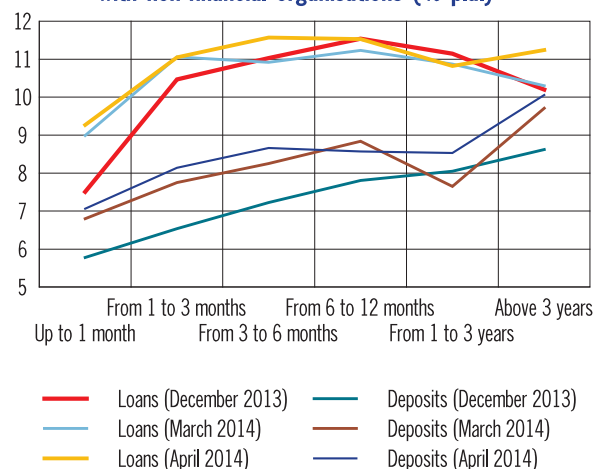


* Weighted average rates on the loans granted (deposits received) during the reported month.

** Excluding banks and financial organisations.

Source: Bank of Russia.

**Term structure of rates on bank operations
with non-financial organisations (% p.a.)***



* Weighted average rates on the loans granted (deposits received) during the reported month.

Source: Bank of Russia.

in interest rates for short-term (up to 1 year) ruble operations (primarily involving organisations) by 1.0–1.3 pp compared with February.

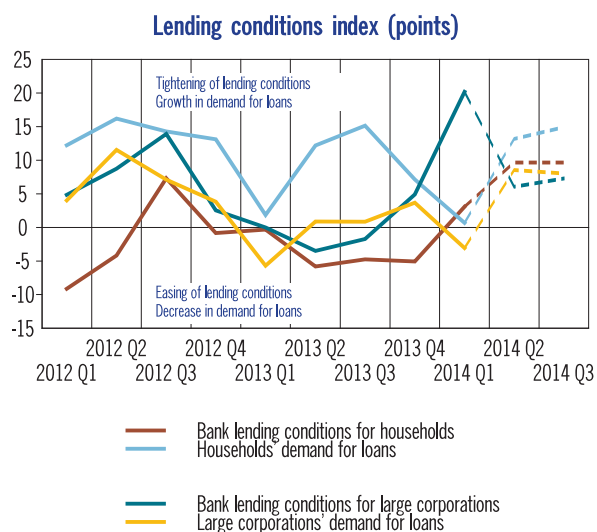
From April to May, deposit rates continued to increase with banks increasing longer-term deposit rates alongside with short-term deposit rates. According to estimates, for the ten largest Russian banks operating in the deposit market, the average rate on one-year ruble deposits over 100,000 rubles increased from 7.96% p.a. in early April to 8.24% in late May.

However, the extent of the increase in ruble deposit rates differed considerably across various market segments.

Firstly, banks increased rates for corporate deposits more intensively than for household deposits. At the same time, the growth in rates for short-term corporate deposits surpassed significantly the growth in long-term deposit rates (1.6 and 0.7 pp respectively). Banks aspiration to avoid increasing long-term deposit rates could suggest that there were no market expectations of an increase in interest rates in the long term, and that banks were concerned about burdening their balance sheets with high-cost long-term liabilities. It is worth mentioning that a substantial proportion of rate increases on household deposits occurred within the context of seasonal offers with limited timeframes.

Secondly, 'second' tier banks increased their rates more significantly than major banks. Although the inflow of household deposits to major banks stopped in 2014, the share of deposits with the 30 largest banks in the total household deposits attracted by the Russian banking sector exceeded significantly the 2013 level. At the start of May 2014, this indicator amounted to 77.4%, 2.8 pp higher than at the start of November 2013 when the share of deposits with major banks started to increase.

Higher cost of funding contributed to a rise in loan rates. Similar to the deposit market, growth in rates in March was largely seen in the short-term ruble loans segment (the short-term ruble loan rate for households in March exceeded the previous month by 1.0 pp, and the short-term ruble loan rate for non-financial organisations by 0.9 pp, while the average rates on long-term loans continued to fall). In April, rates for both short- and long-term loans to non-financial organisations increased commensurably (24 bp and 37 bp respectively). From April to May, a number of banks increased interest rates for their standard mortgage and car loans. However, despite the increase in rates by the majority of banks, the average market rate on household loans dropped in April due to the flow of clients to banks with lower rates on operations and



Source: Bank of Russia.

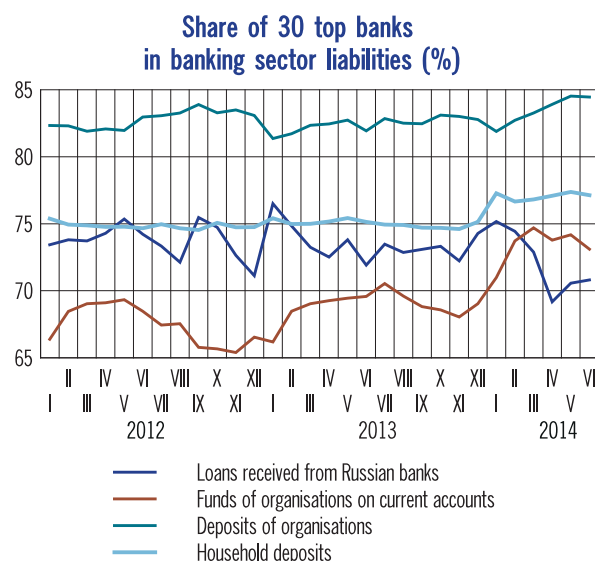
tighter requirements to borrowers, as well as outstripping growth in mortgage lending.

2014 Q1 saw tightening of non-price bank lending conditions. Credit institutions tightened requirements to borrowers and loan collateral, and certain market segments (loans to large corporate borrowers, consumer lending) also saw reduction of maximum lending terms. A slight easing of non-price lending conditions was only seen in the mortgage lending segment.

According to banks, the main factors contributing to the tightening of lending conditions were lower accessibility of external and internal funding, and deterioration of the situation in the non-financial sector. Besides, bank survey data shows that the increase of the Bank of Russia key rate also contributed to the tightening of lending conditions⁶.

Banks expect that tightening of lending conditions will continue in Q2-Q3, with demand for loans also recovering.

With the growing cost of funding, further moderate growth in rates on ruble lending operations by banks can be expected in the second half of 2014. At the same time, the tighter



Source: Bank of Russia.

requirements to borrowers and, accordingly, the decrease in the share of loans extended to high-risk borrowers will constrain the increase in the general level of loan rates.

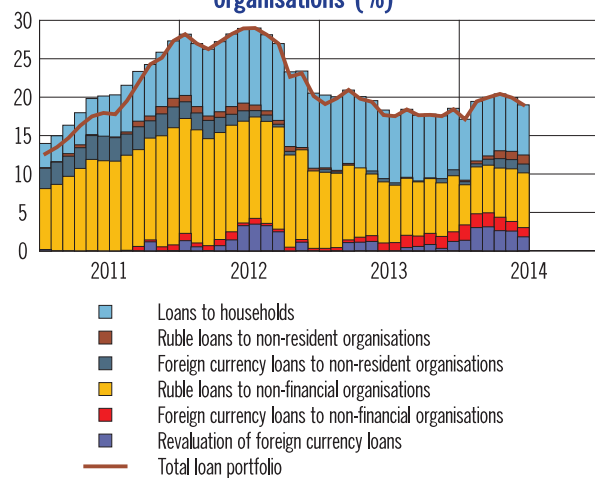
Another factor constraining the growth in rates could be the change in the banks' market shares. The persistently high share of large banks in household deposits and the ongoing growth of their share in sight and time corporate deposits contributed to the growing activity of these banks in the lending market. From January to May, the share of the 30 largest banks in the total amount of loans provided by Russian banks to non-financial organisations and households increased by 0.8 pp and by 1.2 pp respectively. Since the largest banks commonly have lower rates and tighter requirements to borrowers, the consolidation of these banks' positions in the market will continue to constrain growth in loan rates.

Bank lending and monetary aggregates

From February to April 2014, amid the tightening of price and non-price lending conditions growth of banks' loan portfolios exhibited varied patterns. The growth rates of banks' loan portfolios increased in certain market segments and decreased in others resulting in a change in the market structure.

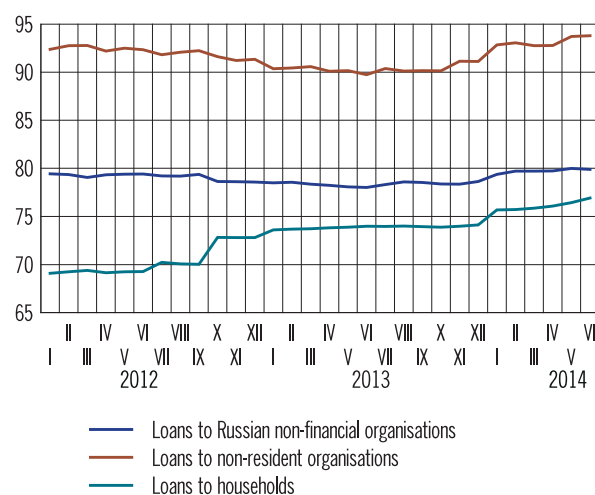
⁶ Bank lending conditions are assessed on the basis of data from quarterly surveys of credit institutions carried out by the Bank of Russia. The assessment method and results of the research have been published on the Bank of Russia website in the section 'Monetary policy'.

Contributions of various components to the annual growth rates of bank loans to households and non-financial organisations (%)



Source: Bank of Russia.

Share of 30 top banks in banking sector assets (%)

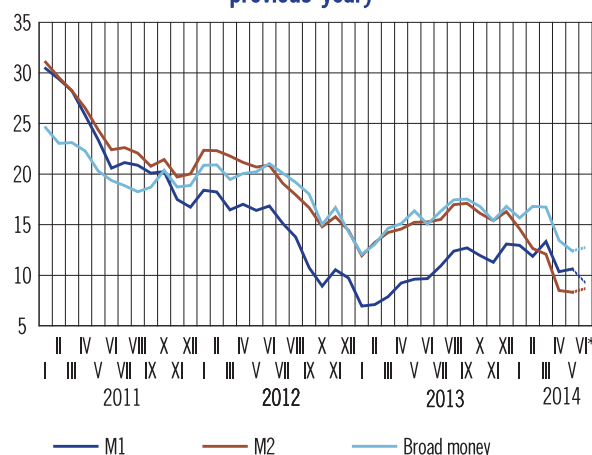


Source: Bank of Russia.

As of 1 June, the total amount outstanding on household loans was 10.5 trillion rubles, 22.6% higher than on the corresponding date of the previous year (on 1 February, the annual growth rate of household loans amounted to 28.0%). There was a fall in consumer lending growth rates and a slight acceleration in mortgage lending growth. The growth rates of car loan portfolio saw further decrease after the termination of the government car finance incentive programme.

Annual growth rates of loans to non-financial organisations increased from February to May, rising to 17.5% as of 1 June from 16.1%

Monetary aggregates (as % of corresponding date of previous year)



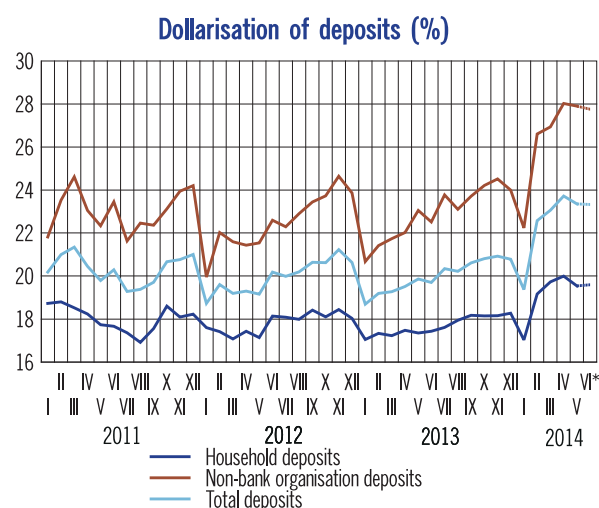
* According to preliminary data.

Source: Bank of Russia.

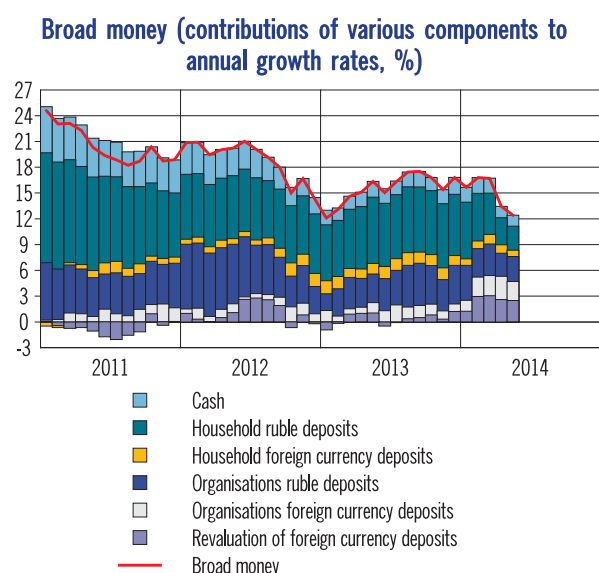
as of 1 February, but this increase resulted predominantly from the revaluation of foreign exchange loans and sharp increase in lending to non-resident organisations (the annual growth rates of outstanding amounts of loans provided by Russian banks to non-resident organisations rose from 24.8% as of 1 February to 44.0% as of 1 June, of which foreign currency revaluation accounted for 8.3 pp).

The increased activity in lending to non-residents could have been caused, *inter alia*, by the expansion of operations with non-resident companies affiliated with Russian organisations and banks having limited access to foreign capital markets. Long-term lending to non-residents rose at advanced rates. As of 1 June, the share of loans with terms over three years in the total number of loans to non-residents exceeded 80% (it was less than 65% as of 1 February). Should many Russian issuers and affiliated non-resident companies continue to experience limited access to international markets, one can expect that lending to non-residents will grow at a faster pace than lending to Russian companies.

In this case, the supply of loans in the domestic market could shrink somewhat for Russian borrowers, although this reduction will be insignificant. On the one hand, despite the considerable growth rates, the amount of lending to non-residents is still relatively low



* According to preliminary data.
Source: Bank of Russia.

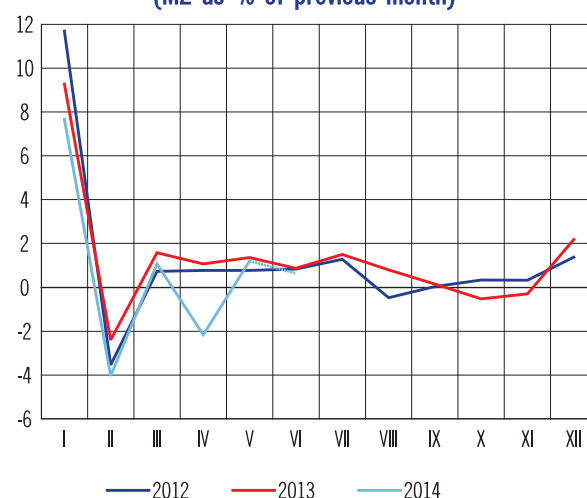


Source: Bank of Russia.

(9–11% of the corporate loan portfolio). On the other hand, major banks dominate the non-resident lending segment (almost 95% of all loans to non-residents are provided by the 30 largest banks). The increase in lending to non-residents will not affect the operations of the medium-sized banks oriented to lending to Russian organisations and households.

In 2014 Q1, the corporate loan portfolio tended to be dominated by loans to the manufacturing organisations and wholesale and retail trade businesses. But while the annual rates of growth in loans to manufacturing organisations increased noticeably compared

**Money supply growth
(M2 as % of previous month)**



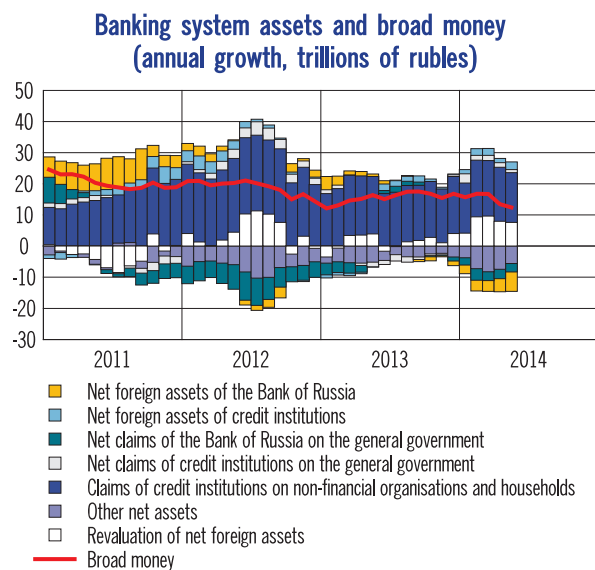
Source: Bank of Russia.

with the start of the year, growth in lending to trade businesses slowed gradually. In 2014 Q1, Russian banks continued to expand their lending to small and medium-sized enterprises (SMEs). The annual rates of growth in SME lending were comparable with the similar indicator for large companies. However, in April there was a slowdown in SME lending accompanied by a slight decrease in the proportion of loans to SMEs in the banking sector corporate portfolio.

2014 Q1 saw a sharp slowdown in money supply growth⁷. The annual rate of growth in money supply dropped from 14.6% at the start of 2014 to 8.5% as of 1 April, hitting its low since 2010. The slowing growth in ruble money supply was linked to the shift in savings preferences of bank customers in favour of foreign currency assets (see the box 'Change in the structure of banking sector funding').

Amid persisting uncertainty and the ongoing ruble's depreciation, in Q1 households reduced their ruble deposits with banks (from January to March 2014, they fell by 5.8%, whereas in the same period last year they increased by 2.6%), at the same time increasing balances in foreign currency deposit accounts (growth by 5.1% in US dollar terms) and acquiring foreign currency cash. As a result, total household deposits

⁷ Monetary aggregate M2 in the national definition.



Source: Bank of Russia.

with banks dropped, while household deposit dollarisation grew.

In addition, household depositors changed the structure of their deposits in terms of volumes. Amid the continued uncertainty, large depositors split up their deposits. According to Deposit Insurance Agency data, in 2014 Q1 the total volume of large deposits (over 1 million rubles) in Russian banks fell by 1.2%, while the number of such deposits actually increased by 2.8%.

Organisations also changed the structure of their bank deposits, reducing ruble deposits (by 4.1% from January to March 2014) and increasing foreign currency deposits (by 19.8% in US dollar terms). With regard to the maturity structure, organisations reduced the proportion of fixed-term ruble deposits, while the proportion of funds in current accounts in the total amount

of corporate deposits increased from 52.4% at the start of 2014 to 56.0% on 1 April. In the absence of similar changes in the term structure of bank assets, the gap in the term structure of bank assets and liabilities increased.

Given the growth in foreign currency deposits and the reduction in the terms of ruble deposits, the growth rates of the M2 monetary aggregate lagged behind those of the M1 aggregate and broad money (the M2X aggregate).

The intra-year broad money dynamics remained cyclical in 2014. The exception was March, the end of which saw the greatest outflow of funds from ruble deposits to foreign currency deposits and, accordingly, a reduction in ruble supply.

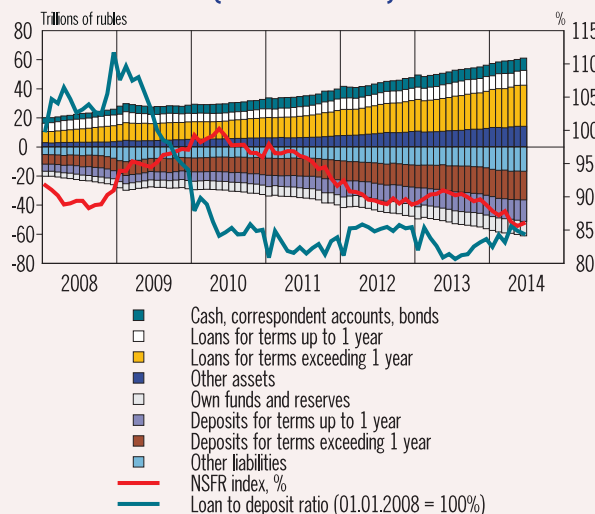
With regard to the money supply components, its growth slowed down due to the reduction in the Bank of Russia's net foreign assets and the increase in balances of general government accounts with the Bank of Russia. Consequently, an increase in banks' credit and in banks' net foreign assets was the main driver of money supply growth in Q1.

From April to May, the situation in the monetary sphere started to level out. Growth in corporate and household ruble deposits resumed, and monthly growth rates of the M2 aggregate returned to the level observed in the similar periods of previous years. Bank deposit dollarisation showed a downward trend. If there are no new significant shocks in the second half of 2014, a partial recovery of money supply growth rates with an increasing share of ruble deposits can be expected.

Change in the structure of banking sector funding

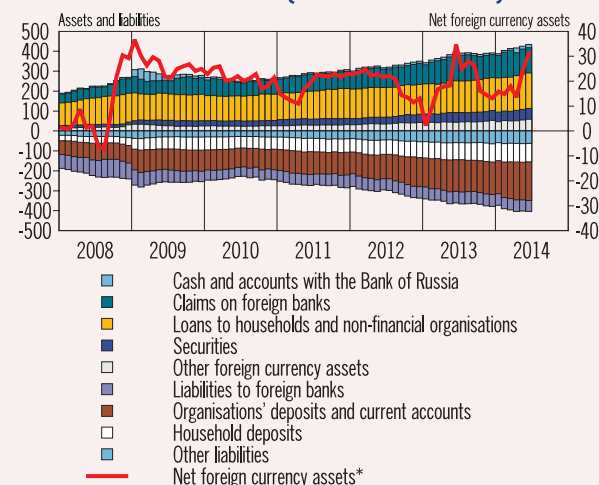
At the start of 2014, macroeconomic uncertainty contributed to significant shifts in the financial priorities of bank customers, forcing many banks to revise their policies. The terms of bank liabilities went down. Non-financial organisations increased current account balances (this figure rose by 12.4% over Q1). Households reduced the amount of their funds in bank deposits (from January to March 2014, the total amount of household deposits in banks shrank by 2.3%, in the same period last year this figure rose by 3.4%). As the structural liquidity deficit grew, credit institutions increased their borrowing from Bank of Russia (the amount of borrowing over the first three months of the year increased by 5.9%). By the end of 2014 Q1, over 85% of growth in banking sector liabilities came from borrowing from the Bank of Russia, as well as corporate current accounts and short-term deposits. The increase in the share

Assets and liabilities structure of Russian banks (trillions of rubles)



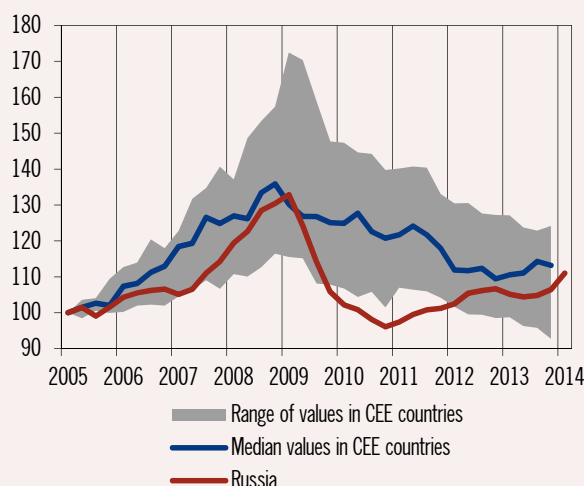
Source: Bank of Russia.

Foreign currency assets and liabilities structure of Russian banks (billions of US dollars)



* Excluding off-balance sheet claims and liabilities in foreign currency.
Source: Bank of Russia.

Loan to deposit ratio in CEE countries (2005 Q1 = 100%)



Source: Bank of Russia.

of unstable (predominantly short-term) liabilities in banking sector liabilities combined with the persisting trend towards growth in the share of long-term bank assets with low liquidity led to a fall in the liquidity of banks' balance sheets. This manifested, in particular, in a sharp drop in the Net Stable Funding Ratio of banks¹ (to 86.0% at the start of June) falling below its low of 2008 (88.3%).

The loan to deposit ratio widely used to assess the liquidity of banks' balance sheets has been increasing gradually from mid-2013 and as of the start of June reached 119.5% (compared with 116.8% at the start of the year and 115.3% as of 1 June 2013), which could also be suggestive of some growth in the liquidity risks of banks.

To assess how significant the change in the structure of the balance sheet of the Russian banking sector is, the dynamics of the loan to

deposit ratios in Russian banks and in Central and Eastern European² (CEE) banks were compared. Despite the fact that this comparison shows a perceptible acceleration in the growth of the loan to deposit ratio in Russia in the past few months amid its steady reduction in CEE countries, this indicator has more than likely

¹ The NSFR index is being developed as part of Basel III. To calculate this index, the methodology of the Basel Committee on Banking Supervision (BCBS) (see 'Basel III: The Net Stable Funding Ratio', BCBS Consultative Document, January 2014) was adapted to Russian accounting practices. Assets are included in the calculation of the index with the following weights: cash, correspondent accounts with the Bank of Russia and other banks – 0; government bonds and Bank of Russia bonds, interbank loans provided for a term of up to 1 year – 0.15; other bonds, stocks, loans to organisations and households with terms of up to 1 year – 0.50; promissory notes, loans to organisations and households with terms of over 1 year – 0.85; fixed capital, pledged securities and other assets – 1.0. Liabilities are included in the calculation of the index with the following weights: equity capital and established provisions – 1.0; interbank loans obtained, corporate and household deposits with terms of over 1 year, outstanding bonds – 0.9; corporate and household deposits with terms of up to 1 year, funds obtained from the Bank of Russia, outstanding promissory notes – 0.5; interbank loans obtained for a term of up to 1 year, current accounts and other liabilities – 0.

² The sample included Azerbaijan, Armenia, Belarus, Bulgaria, Hungary, Georgia, Kazakhstan, Latvia, Lithuania, Macedonia, Poland, Romania, Serbia, Slovakia, Slovenia, Ukraine, Croatia, Czech Republic, and Estonia. The 25th and 75th percentiles of all of the sample values are provided.

not reached the threshold values reflecting a significant deterioration in the liquidity of banks' balance sheets, as it is below the median value in CEE countries (compared with the level at the start of 2005).

The reduction in banks' net foreign assets was another trend in the changing structure of banking sector balance sheets amid a significant drop in the nominal ruble exchange rate. Bank customers converted some of their ruble deposits into foreign currency deposits, including through conversion transactions with banks. The amount of corporate foreign currency deposits (including non-residents) from January to March 2014 increased by \$23.4 billion (to \$189.5 billion) and that of household foreign currency deposits by \$3.7 billion (to \$94.1 billion).

Faced with the advancing growth of foreign currency liabilities compared with foreign currency assets, banks took measures to avert any further reduction in their net foreign currency assets. Russian banks increased their foreign currency holdings with foreign banks (by \$1.3 billion over Q1, to \$114.4 billion) and reduced rates on foreign currency loans and deposits. This led to a stabilisation of the net foreign currency assets of banks at around \$12–15 billion, which was virtually unchanged compared with the start of the year.

The trends towards reduction in the terms of banking sector liabilities and growth in their dollarisation were inter-related. Corporate current accounts in foreign currency accounted for more than a half of the total growth in banking sector liabilities in 2014 Q1. The growth in the loan to deposit ratio on bank ruble operations outstripped the growth in the corresponding indicator on foreign currency transactions.

From April to May, the above trends illustrating the change in the structure of banking sector funding weakened or gave way to opposing trends. The inflow of funds to household deposits resumed (albeit dominated by short-term deposits), organisations reduced their current account balances, and bank customers started to replace foreign currency deposits with ruble ones.

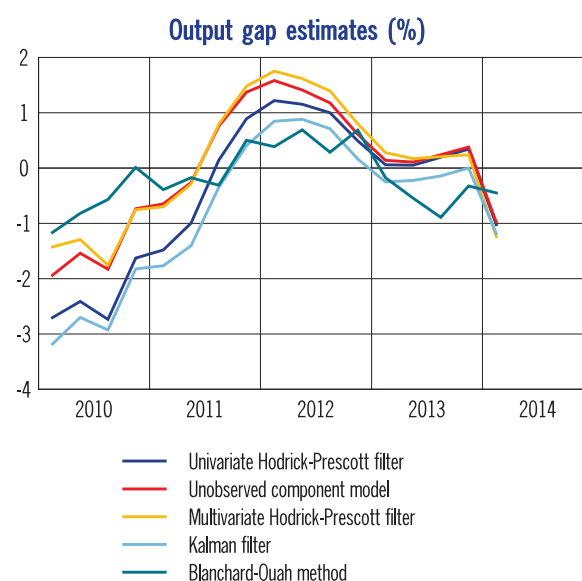
This suggests that a shift in the structure of banks' balance sheets will not have any significant macroeconomic consequences and that balance sheets will gradually normalise. A further drop in deposit growth rates could force banks to increase the liquidity of their assets, which will have a restraining influence on the expansion of loan supply and, accordingly, aggregate demand.

I.3. Internal economic conditions

Growth in economic and external political tension in the first few months of 2014 led to a significant slump in investment demand. In contrast, consumer activity increased between February and March. The significant growth in consumption during this period was caused by a surge in demand in anticipation of inflation acceleration amid the ruble's depreciation. Overall, economic growth rates during this period slowed. At the same time, economic activity is expected to recover further as geopolitical uncertainty subsides and economic agents' sentiment improves. The rate of inflation was slightly higher than the forecast due to the larger than expected impact of the exchange rate dynamics. The pro-inflationary effect of the ruble depreciation was amplified by growth in prices for a number of food products resulting from specific factors. According to Bank of Russia estimates, taking into account the pass-through effect, the increase in inflation could continue into June (up to about 7.8%), after which it is forecast to fall to 6.8–7.0% in September 2014 and to about 6% by the end of 2014 amid the anticipated stabilisation of the exchange rate dynamics, good harvest, lower planned increases in administered prices and tariffs for housing and utility services in 2014, and weak demand dynamics.

Economic activity

In 2014 Q1, the positive quarterly GDP dynamics registered in 2013 gave way to negative dynamics. According to estimates, GDP dropped by 0.9% compared with 2013 Q4 (seasonally adjusted) following growth over four consecutive quarters. Year-on-year GDP growth slowed from 2% in 2013 Q4 to 0.9% in 2014 Q1, which is below Bank of Russia estimates made in February this year. The deviation of actual GDP growth in Q1 from the February forecast can be explained primarily by the higher than expected drop in gross capital formation (largely due to a fall in inventories).



Source: Bank of Russia calculations.

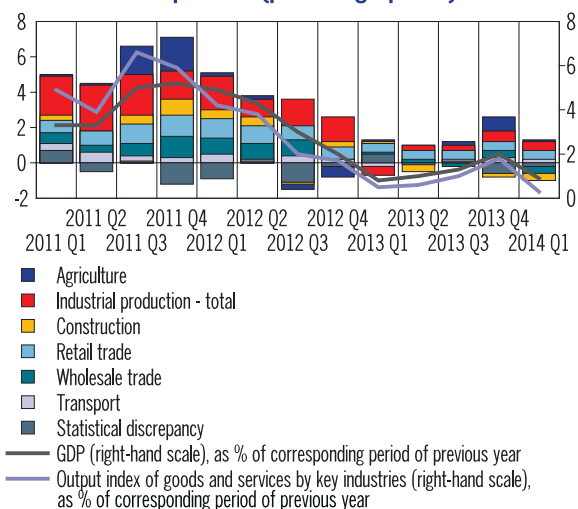
The relatively sharp fall in annual GDP growth rates from levels over 1.5% on average in the second half of 2013 led to the opening of a negative output gap estimated to be in the range of 0.5–1.2%¹. According to various estimates, the drop in economic activity witnessed in 2014 Q1 was caused by a cyclical fall in demand and the effects of temporary factors. Potential growth rates also decreased as a result of structural factors. A prolonged period of declining fixed capital investment could lead to a further slowdown in potential output growth over the next 1.5 to 2 years.

As for production, according to estimates, wholesale trade, mining, agriculture, and transport all made a significant contribution to reduced economic growth rates, while the negative contribution of construction increased. Overall, in 2014 Q1, output growth in key industries slowed to 0.3% compared with the corresponding quarter in 2013 (against 1.8% in 2013 Q4).

The dynamics of production activity indicators were volatile from January to April

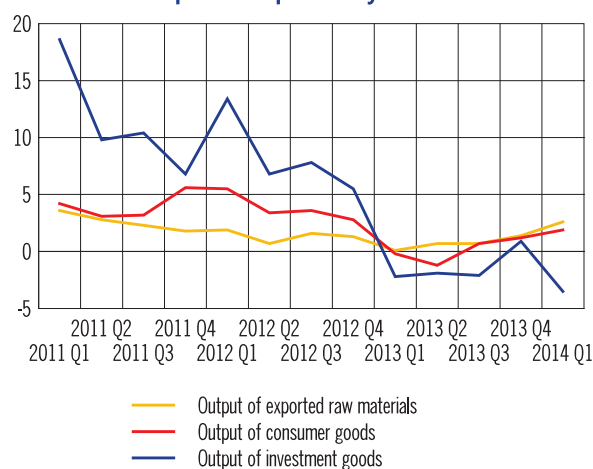
¹ In the previous Report, the output gap was estimated to be slightly negative. After Rosstat had revised its GDP data for 2011–2013, the output gap in Q4 was estimated to be close to zero.

Output of goods and services by key industries and its components (percentage points)



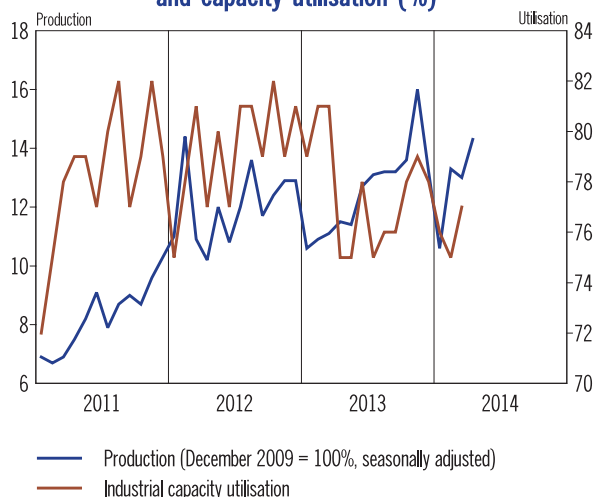
Sources: Rosstat, Bank of Russia calculations.

Industrial production in export-, consumer- and investment-oriented industries, as % of corresponding period of previous year



Sources: Rosstat, Bank of Russia calculations.

Industrial production growth and capacity utilisation (%)



Sources: Rosstat, Bank of Russia calculations, Russian Economic Barometer.

2014. January's fall in industrial production (by 0.2% compared with the corresponding period of the previous year) was followed by growth from February to April. In Q1, growth in industrial production was 1.1% compared with the corresponding period in 2013, while in April it was 2.4%.

The highest growth rates were seen in total output of manufacturing industries. Production growth rates in mining industries were moderate. The fall in heating and electricity output due to the abnormally warm weather in the first few months of this year had a negative impact on the industrial production dynamics.

The ruble's depreciation witnessed at the start of 2014 had differing effects on industrial output.

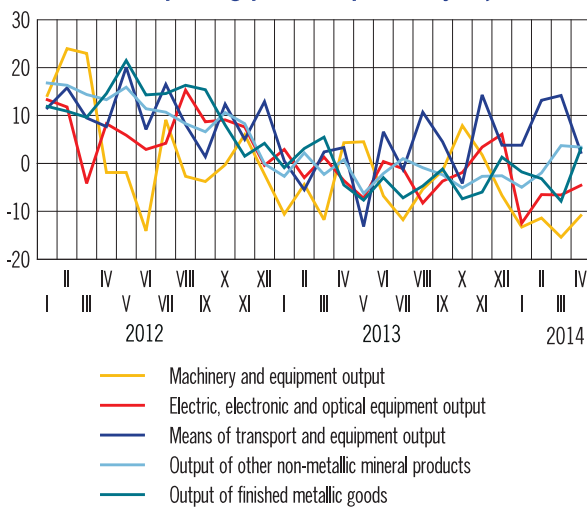
According to estimates, the depreciation of the national currency had some positive impact on the production of consumer goods. From February to April, the most marked growth in output of consumer goods was seen in the leather, leather goods, footwear, textile and clothing manufacturing industries, as well as in production of other goods². This provides some evidence of the potential for import substitution in these industries. A spike in consumer activity also buoyed up the production of consumer goods.

The increase in the price competitiveness of exports provided some support for output in a number of export-oriented industries (the most significant increase in growth rates was seen in coke and petroleum product output).

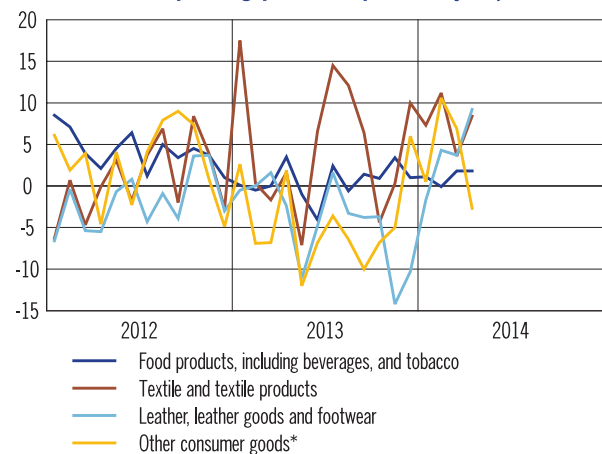
However, the ruble depreciation had a negative impact on the financial situation of businesses with a high share of foreign currency liabilities. Moreover, there was a fall in profitability as a result of the increase in prices for imported intermediate products. In terms of production costs, the industries with a low share of imports

² Furniture, jewellery, musical instruments, sports goods, games and toys, household appliances and interior objects, haberdashery and other consumer goods.

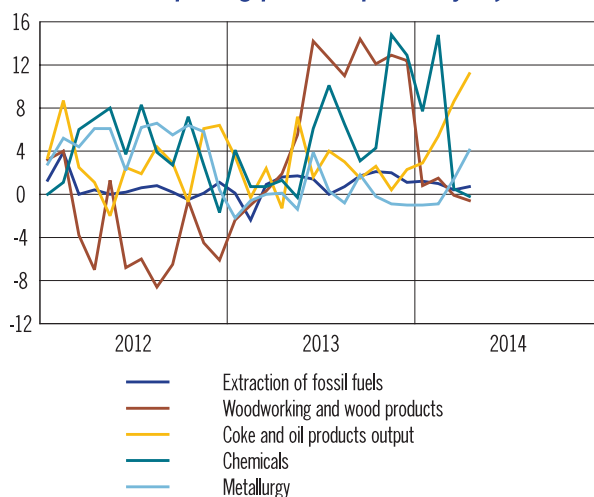
Output in investment-oriented industries (growth as % of corresponding period of previous year)



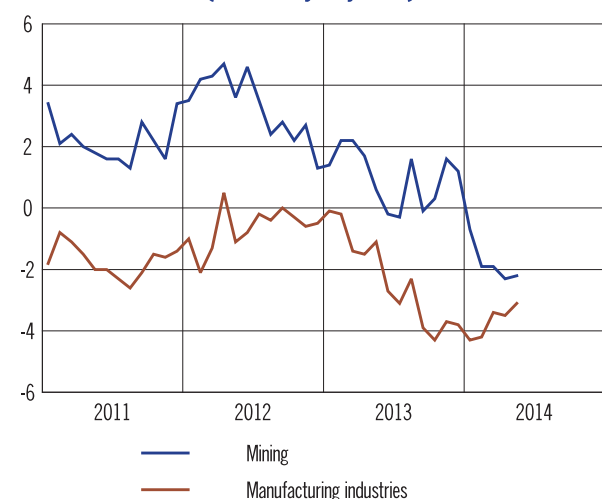
Output in consumer-oriented industries (growth as % of corresponding period of previous year)



Output in export-oriented industries (growth as % of corresponding period of previous year)



Business confidence indices by activity type (seasonally adjusted)



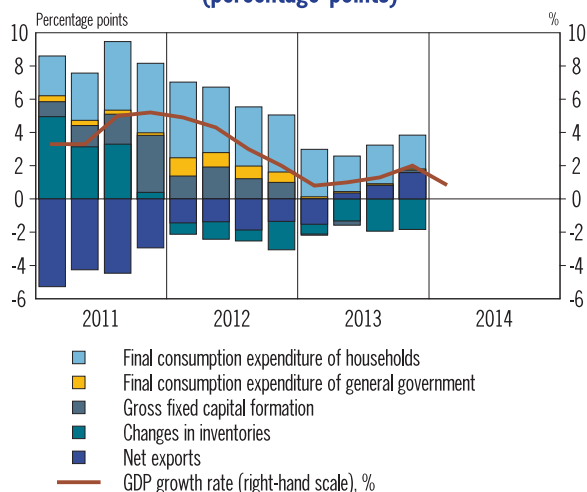
in the costs of finished products (mining industries, timber processing, pulp-and-paper, chemical and metallurgical industries, the coke and petroleum product industry and other non-metallic mineral product industries) were the least sensitive to the change in exchange rate dynamics. Conversely, according to estimates, the industries with a high share of imports in their finished product output, including high-tech industries, experienced the greatest negative impact from the ruble's depreciation.

A high share of imports in costs and the slump in investment demand were the factors shaping a further fall in output volumes in investment-

oriented industries. The greatest drop was seen in the machine-building and equipment production, as well as in the electrical, electronic and optical equipment production.

Despite the acceleration in industrial production growth from April to May, indicators of producer sentiment remained low. According to business managers, the dominant factors holding back output growth tended to be insufficient demand for products in the domestic market (in manufacturing industries), high taxation, and a shortage of funding. At the same time, the manufacturing industry saw a

**GDP growth structure by expenditure
(percentage points)**



Sources: Bank of Russia calculations, Rosstat.

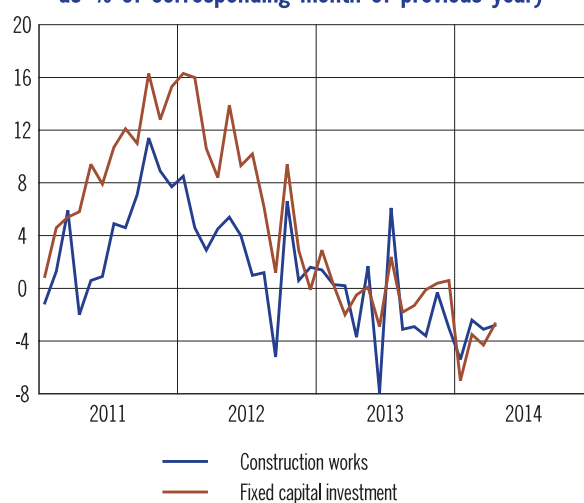
trend suggesting an improvement in producer sentiment.

In terms of GDP components, household consumption continued to be the main driver of economic growth. According to estimates, net exports also made a positive contribution. The weak economic dynamics were above all caused by the fall in gross capital formation. In 2014 Q1, fixed capital investment dropped by 4.8% compared with the corresponding period of 2013. The fall in inventories was even greater, according to estimates. The reduction in fixed capital investment continued into April (by 2.7% on the corresponding period of the previous year).

The fall in fixed capital investment this year was caused by the increased economic uncertainty, the deteriorated financial position of companies in the real sector, and the tighter bank lending conditions. The growth in corporate sector deposit dollarisation suggests that businesses are currently adhering to a 'cautious' asset management strategy preferring to hedge currency (and other) risks rather than channelling funds into production or investment projects.

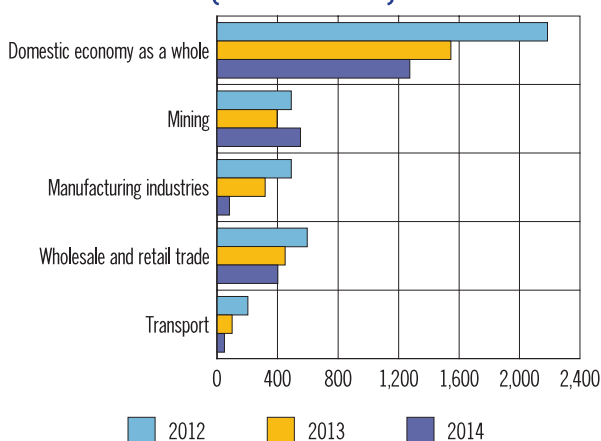
The high consumer activity, which supported GDP growth rates, was reflected in a significant increase in the growth rates of the retail trade turnover (from 2.6% in January 2014 to 4.0%

Fixed capital investment and construction works (growth as % of corresponding month of previous year)



Source: Rosstat.

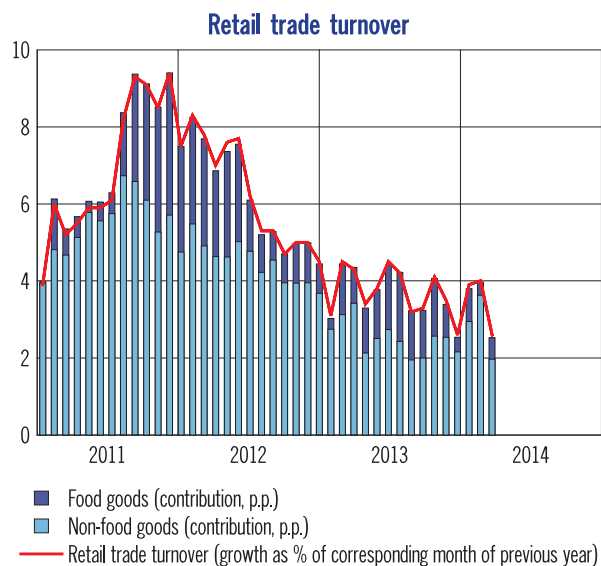
**Net financial result* for large and medium Russian enterprises in January-March 2012-2014
(billions of rubles)**



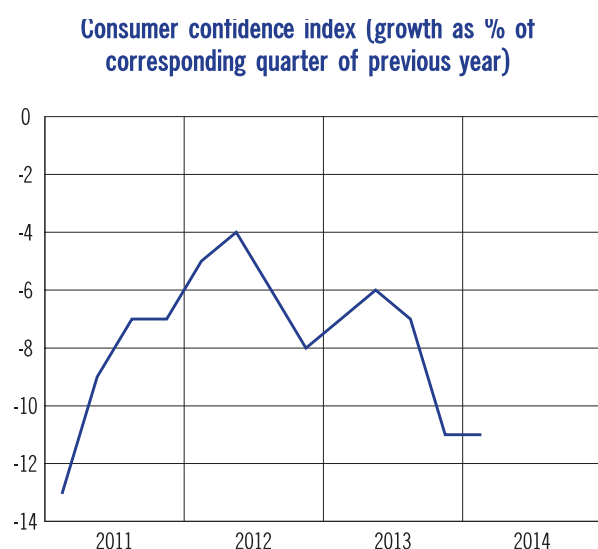
* Profit (loss) before taxes.
Source: Rosstat.

year-on-year in March). The accelerated growth of the retail trade turnover was primarily a result of the increased sales of non-food products likely caused by household desire to make large buys in store (especially durable products) in anticipation that prices would rise following the considerable ruble depreciation from February to March 2014. For this purpose households used part of their savings³: from January to March there was a fall in savings rates. In April,

³ Savings include growth (reduction) in deposits, the acquisition of securities, changes in funds in the accounts of individual entrepreneurs, changes in outstanding amounts of loans, real estate purchases, and household livestock and poultry purchases.



Source: Rosstat.



Source: Rosstat.

as the shock of the increased demand for durable goods waned amid significant growth in consumer prices, growth in the retail trade turnover slowed to 2.6% compared with the corresponding period last year.

Despite the negative economic backdrop, consumer sentiment did not tend to deteriorate. The consumer confidence index, calculated by Rosstat, was unchanged in 2014 Q1 compared with 2013 Q4. The consumer confidence index dynamics (according to a survey by the Institute of Public Opinion Foundation (inFOM LLC) commissioned by the Bank of Russia) are suggestive of some improvement in April-May 2014.

However, population welfare indicators showed opposing dynamics: in January-April 2014, real wages growth rates shrank (from 5.2% year-on-year in January to 0.8% in April) as a result of both accelerating inflation and slowing growth of nominal wages.

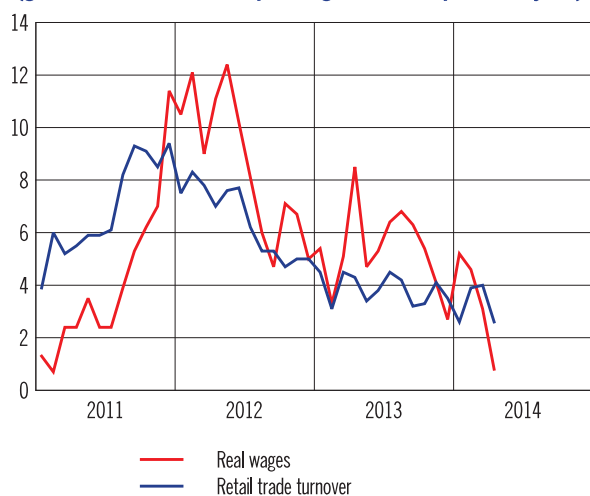
At the start of 2014, there was a fall in the unemployment rate (5.6% from January to February, 5.4% in March and 5.3% in April). The aggregate labour market indicator⁴ calculated using 16 alternative indicators (not including unemployment rate) fell, also suggesting an increase in the labour force deficit at the start of 2014. The greatest contributions to the fall of this indicator were made by the reduced number of the officially unemployed per vacancy, the reduced share of unemployed receiving unemployment benefits, and the reduced share of unemployed with work experience discharged due to redundancy.

Despite persistently low unemployment rate, there was a fall in wage growth rates in the private sector, which could suggest that the labour force deficit in the labour market will narrow over the coming months.

According to estimates, the weak dynamics of household real disposable income together

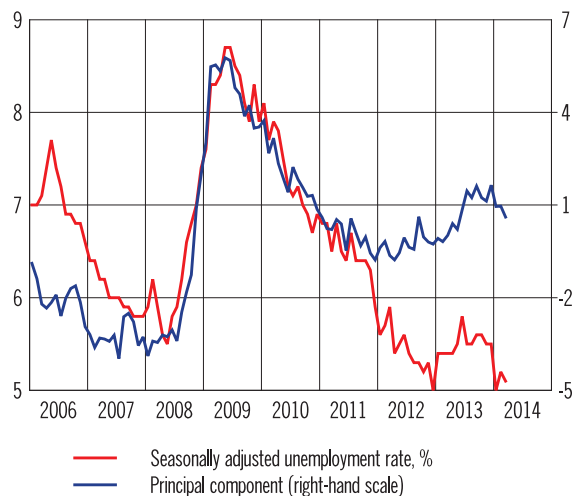
⁴ The aggregate labour market indicator is calculated using the principal components method. The following input data were used to calculate the principal component: the ratio of those employed to the number of people aged between 15 and 72; the Russian Economic Barometer (REB) employment index; the labour force utilisation index of those employed in the manufacturing industry (REB); index of growth in the number of employed (REB); the Rosstat indices showing employment at the enterprises from C and D industry classification groups (according to economic activity surveys); Rosstat indices showing shortages of qualified workers at enterprises from C and D industry classification groups (according to economic activity surveys); the employment component of the global HSBC PMI index; the number of the officially unemployed per vacancy (Rosstat); the percentage of the unemployed receiving unemployment benefits (Rosstat); the ratio of the number of unemployed (ILO) to the number of officially registered as unemployed (Rosstat) reflecting job seekers' incentives; the number of working hours per employee per month (Rosstat); the share of employees working more than 41 hours per week (Rosstat); the average job search time (Rosstat); the share of unemployed with work experience discharged due to redundancy (Rosstat).

Real wages and retail trade turnover
(growth as % of corresponding month of previous year)



Source: Rosstat.

Unemployment rate and principal component
of 16 labour market indicators



Sources: Rosstat, HSBC, Russian Economic Barometer, Bank of Russia calculations.

with the recovered households' propensity for savings will ensure stabilisation of growth in spending on final consumption in 2014 Q2-Q3 at a lower level compared with that seen in Q1. Nevertheless, estimates suggest that consumer demand will remain the key driver of economic growth.

GDP growth rates in 2014 Q2 compared with the previous quarter are expected to be close to zero (seasonally adjusted). In the second half of the year, in the absence of any significant external shocks, GDP growth rates will show slightly positive dynamics. In 2014 Q2 and Q3, GDP growth compared with the corresponding period of 2013 is estimated at 0.4–0.6% and 0.2–0.4% respectively. The fall in year-on-year growth rates in the second half of 2014 is due to the effect of high base of the second half of 2013, when economic growth accelerated due to the dynamics of agriculture and associated industries, as well as significant growth in exports.

The forecast of gradual recovery in economic activity is based on the assumption that geopolitical tension and economic uncertainty will subside in the second half of 2014. It is expected that amid the decreasing capital outflow and improving producer sentiment, the fall in fixed capital investment will slow and the destocking cycle will be over. Besides, economic

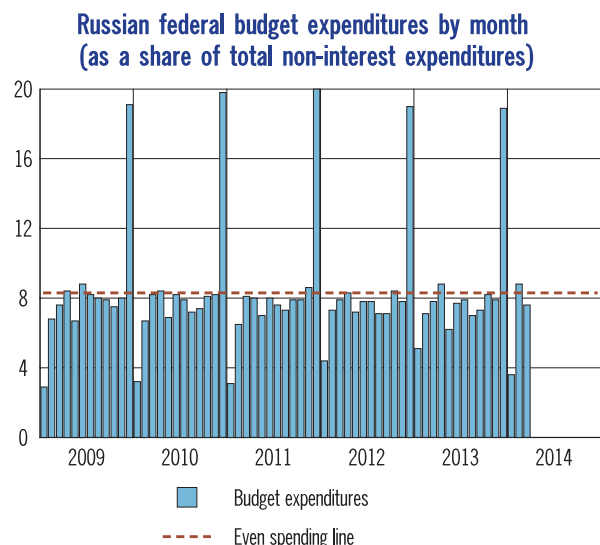
growth will be supported by an increase in exports against the backdrop of global economic recovery.

It should be noted that the direct impact of the economic sanctions already announced by a number of countries is estimated as insignificant. According to estimates, the implementation of the announced measures could damage the economies of the countries imposing sanctions, and is therefore expected to be done with caution.

Fiscal policy

According to data of the Federal Treasury and the Ministry of Finance, the expenditures of the Russian federal budget system from January to March 2014 accounted for 34.0% of GDP, while non-interest expenditures accounted for 33.0% of GDP, which is 0.9 and 1.0 percentage points less respectively than the same indicators for the corresponding period in 2013.

Amid the growth in budget revenues relative to GDP, the budgets of the Russian federal budget system were executed with a surplus of 3.3% of GDP, or 1.3 percentage points higher than the same indicator for 2013. This was shaped by an increase in oil and gas revenues following the drop in the ruble exchange rate, while non-oil and gas revenues dropped. The non-oil and gas primary deficit of the Russian federal budget



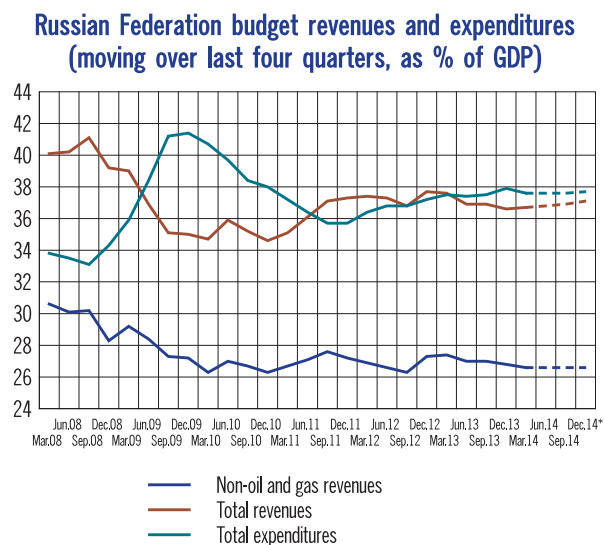
Sources: Federal Treasury, Budget Policy Guidelines for 2014 and the Period of 2015 and 2016, Bank of Russia calculations.

system was 7.1% of GDP in 2014 Q1, which is only 0.2 percentage points lower than the same indicator for the corresponding period in 2013.

According to Bank of Russia estimates, the total and structural non-oil and gas primary deficit of the Russian federal budget system is expected to decline in 2014 against 2013 by 0.7 and 0.5 percentage points of GDP, to 0.6% and 10.3% of GDP respectively. The reduction in the total deficit indicator can largely be explained by the positive dynamics of oil and gas revenues, while the structural non-oil and gas primary deficit is due to the fall in non-interest expenditures.

According to Bank of Russia estimates, it is expected that the public sector will make a positive contribution to aggregate demand in 2014, at 0.1–0.2 percentage points. This positive impact can be explained by the dynamics of key government finance indicators in previous years, whose effect on economic activity is distributed over time, despite the negative impact from budget indicators in sole 2014. The planned use of a part of the National Wealth Fund for priority investment projects could have a further positive impact on economic growth if the funds reach the real sector already this year.

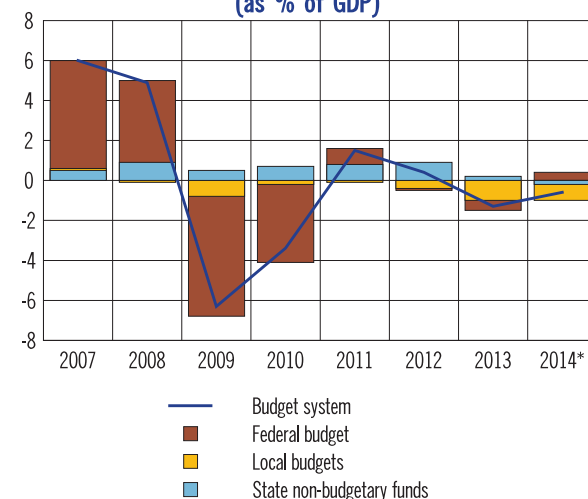
Assessments of the public finance stability based on a fiscal stress indicator make it possible to conclude that the high level of public finance



* Bank of Russia forecast.

Sources: Federal Treasury, Ministry of Finance, Rosstat, Bank of Russia calculations.

**Russian budget aggregate surplus (+)/deficit (-) structure
(as % of GDP)**



* Bank of Russia forecast.

Sources: Federal Treasury, Rosstat, Bank of Russia calculations.

sustainability in Russia will be preserved in the short term. As before, a group of indicators describing long-term trends suggest that there are still risks to the stability of public finances, although the main budget indicators are at safe levels. However, should the uncertainty surrounding the geopolitical situation continue, we can expect that certain indicators will signal an increase in risks to the public finance stability, notably the reduction in the weighted average term for public debt repayment and growth in the public debt interest rate amid reduced forecast GDP growth rates.

It is expected that the volume of additional oil and gas revenues transferred to the Reserve Fund will be revised downwards in 2014 following the decision not to take out foreign loans, the substantial planned reduction in borrowing in the domestic market and privatisation volumes, and the increased lending to the Russian Federation constituent territories.

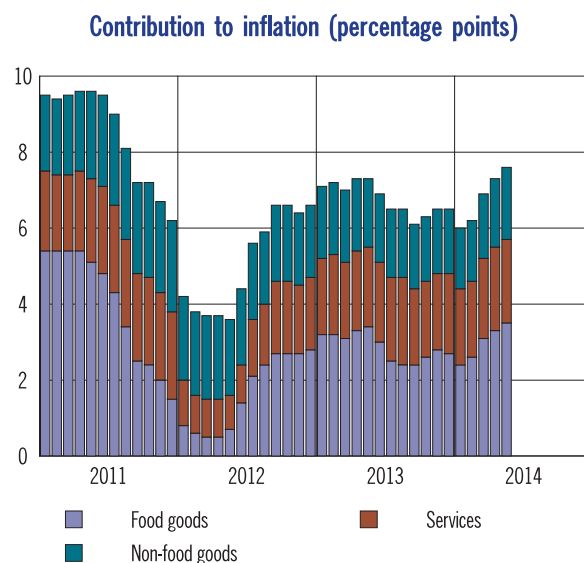
The expansion of regional lending programmes was due to the fact that some regions were probably experiencing some difficulty in attracting funds in the market to finance their deficits. This in turn is a consequence of a persistently high deficit of consolidated budgets of the Russian Federation constituent territories and a significant growth in their outstanding amounts of their debt (1.0% and 3.0% of GDP respectively at the end of 2013).

The state of regional finances has been the main source of the budget system deficit since 2012, which is linked to the slowdown in economic growth, insufficient efforts by regional authorities to increase the quality of financial management, in particular, to improve spending efficiency, as well as the increased public spending following the implementation of the 'May Decrees' in 2012.

The accession to Russia of the Republic of Crimea and the federal city of Sevastopol also had an impact on the key Russian public finance indicators. The additional expenditures on social benefits in line with the Russian standards, as well as on investment in the development of these territories will presumably be financed by redistributing funds under the current budget rules.

Inflation

In the first few months of 2014, inflation accelerated significantly. Annual growth rates in consumer prices rose from 6.1% in January to 7.6% in May, hitting their high since September 2011. Core inflation increased from 5.5% to 7.0% respectively. Key consumer price sub-indices (which exclude the impact of the most



Sources: Rosstat, Bank of Russia calculations.

volatile components and administrative factors) also rose. The trend towards falling annual growth rates of prices for non-food goods, excluding petrol⁵, observed since November 2011, came to a halt. The growth rates of prices for this group of goods increased from 4.3% in January and February this year to 4.9% in May.

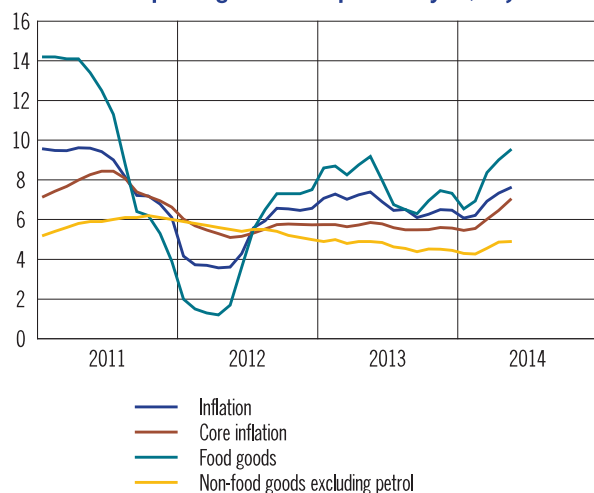
The ruble depreciation was the main factor causing the increase in inflation. Estimates of the pass-through effect of the exchange rate dynamics on prices of food and non-food goods lie in the 0.1–0.2 range⁶. The impact of exchange rate dynamics on service prices was less significant, as a substantial proportion of them are made up of administered prices and tariffs that are insensitive to the exchange rate dynamics. The effect of changing exchange rates on consumer price growth rates lasts approximately two quarters.

According to estimates, the contribution of the ruble exchange rate dynamics to consumer price growth rates stood at about 0.8 percentage points in May (0.5 percentage points from the ruble depreciation in 2014, and 0.3 from the ruble depreciation at the end of 2013). Estimates

⁵ The price sub-index least susceptible to the influence of volatile and administrative factors.

⁶ A 1-percentage-point fall in the ruble exchange rate (ruble depreciation) will lead to inflation acceleration by 0.1–0.2 percentage points.

Prices of consumer goods and services (month on corresponding month of previous year, %)



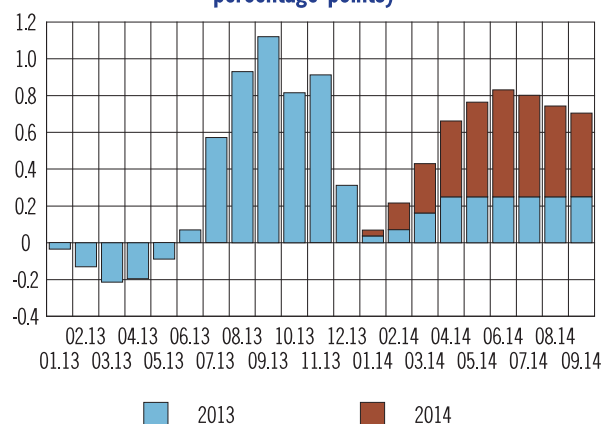
Sources: Rosstat, Bank of Russia calculations.

suggest that the impact of the exchange rate dynamics on annual inflation from January to April 2014 will wane by September 2014.

The acceleration in food inflation was the most significant, with food price growth rate rising to 9.5% in May 2014. The pro-inflationary pass-through effect of the exchange rate dynamics was amplified with the increase in global prices for certain types of agricultural products, growth in spending, and a reduction in the supply of a number of food products (see the box). In particular, the low harvest of last year caused acceleration in the growth of prices for potatoes and some other vegetables. Measures to protect the Russian market (the introduction of temporary restrictions on pork and fish imports) were a factor shaping the fall in supply and accelerating growth in prices for these products, as well as substitute products. The increase in global prices governed the continuing high growth rates of prices for sugar and milk and dairy products.

There was also an increase in the annual growth rates of prices for the majority of non-food goods and services groups. The rise in prices for goods and services was particularly pronounced in markets where the share of imports is high or where imported components and materials are actively used in production. The greatest acceleration in price growth among

Cumulative response of consumer price inflation to the nominal effective ruble exchange rate against foreign currencies in 2013-2014 (VAR-model estimates, percentage points)



Source: Bank of Russia calculations.

non-food products was seen in audio and visual equipment, electrical goods and other household appliances, and among services related to foreign tourism. One factor which exerted additional pressure on the prices of certain non-food goods was the temporary increase in consumer demand from February to March.

The impact of the exchange rate dynamics distributed over time will cause a further rise in inflation in June.

Taking these factors into account, the inflation forecast for the coming months of 2014 has been raised. Instead of the previously predicted fall in inflation to 5.8–6.1% in June 2014 compared with June 2013, there is a forecast of its increase up to 7.7–7.9%.

By September 2014, inflation is forecast to slow down to 6.8–7.0% against the backdrop of stabilising exchange rate dynamics, the good harvest, lower planned increases in administered prices and tariffs for housing and utility services⁷, and weak demand dynamics.

Inflation expectations

Households

Following the fall at the start of 2014, assessments of observed inflation and inflation

⁷ According to estimates, the lower growth rates in tariffs of housing and utility services will bring inflation down by 0.4 percentage points compared with 2013.

Dynamics of food prices

At the start of 2014, there was a marked increase in annual food price inflation caused by the ruble depreciation, the impact of supply-side factors and production costs.

To a large extent, the acceleration in food price growth was caused by the depreciation of the ruble. Exchange rate dynamics can have a direct impact on the prices of imported finished food products (for example, on cheese, meat products, fruit and citrus fruit, in particular). They account for a large share of the Russian market: in 2013, imports stood at 36% of the total volume of the retail trade in food products. A change in the ruble exchange rate could also impact consumer prices implicitly: through the prices of imported agricultural raw materials (dried milk, raw meat, raw sugar). The degree of the exchange rate dynamics pass-through to a change in the ruble price depends on the level of competition in the market for certain product, the pricing method (in the currency of the producer or of the consumer), and the share of the import costs in the price (even in the price of finished imported products there is a 'domestic' component – transport expenses, trade mark-ups, taxes, etc.), as well as on the scale and duration of the currency depreciation. The elasticity of food prices at their nominal ruble exchange rate is estimated at 0.1–0.2 (the pass-through effect estimates differ depending on the models used¹). According to estimates, in 2014 Q1 up to a half of accelerations in food prices (by 1.1 percentage points) were caused by the ruble depreciation (including lagged impact from previous periods).

Nonetheless, exchange rate dynamics are not the only factor shaping food inflation (they have virtually no impact at all on the prices of certain food products). Other important factors include the situation in the markets for certain goods, determined by specific supply and demand factors (harvest yields, harvest quality, export and import volumes, change in stocks), global agricultural market price dynamics, and government measures to support producers.

The supply-side factors affected the dynamics of prices for cereal products, fruit and vegetables, pork, and fish. For instance, in the first few months of this year the trend towards the reduction in annual growth rates in bread and bakery product prices continued. It began in the middle of last year when there was a good harvest of the main types of cereals. The dynamics of pasta and grain product prices were similar. At the same time, from March to May 2014, the growth in prices for rice and millet accelerated as a result of the low production volumes of these crops and the poor quality harvest. The same factors caused an increase in annual growth rates for potato and other vegetable prices.

As a result of the receding of factors, which had caused the fall in supply and the increase in production expenses in 2013, the decrease in egg prices from January to May 2014 (by 22.7%) largely offset their price hikes in 2013.

Government measures to provide financial support to agricultural producers (in particular, with regard to the increase in prices of purchased fodder²) also had a positive effect. These measures were taken in

Indicators of financial position of large and medium agricultural enterprises

	2012	2013
Net financial result, as % of previous year		
– total (memo item)	109.9	85.7
– agriculture	123.3	59.1
Share of unprofitable organisations in the overall number, %	22.3	22.6
Loss, as % of previous year	124.9	197.8
Return on sales, %	11.4	6.4
Expenditure on interest for loans, as % of profit from sales*	60.1	122.1
Federal budget compensation for interest expenditure on short-term loans as a share of total interest expenditure*, %	26.0	25.5

* Estimate.

Sources: Rosstat, Bank of Russia calculations.

¹ See, for example: Ponomarev U., Trunin P., Ulyukaev A. (2014). The pass-through effect of exchange rate dynamics on prices in Russia. // *Economic Issues*, No. 3, pp. 21–35.

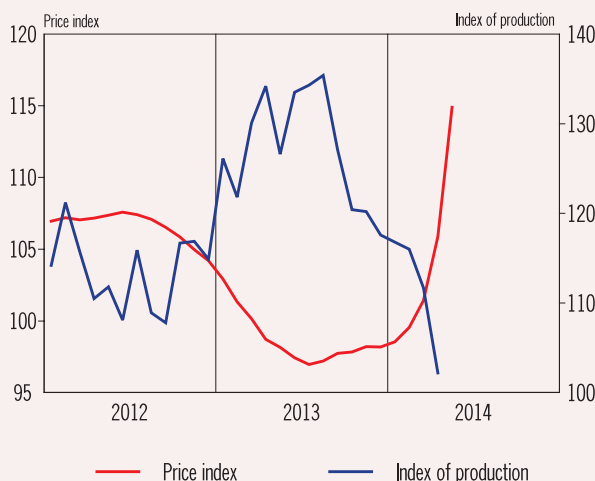
² Federal Law No. 133-FZ, dated 7 June 2013, 'On Amending the Federal Law 'On the Federal Budget for 2013 and the Plan Period of 2014 and 2015'.

connection with the deterioration in the financial position of agricultural organisations. In 2013, their net financial results fell noticeably following the growth in costs and the drop in return on sales, which led in part to growth in the debt burden.

The accelerating growth in pork prices (estimated at 0.2 percentage points in May) made a significant contribution to the increase in annual inflation. The increase in price growth rate was caused by a deficit in the pork market: the fall in imports from January to April following temporary restrictions on pork supplies from the EU countries (caused by the outbreak of African swine fever) was only partially offset by growth in domestic production.

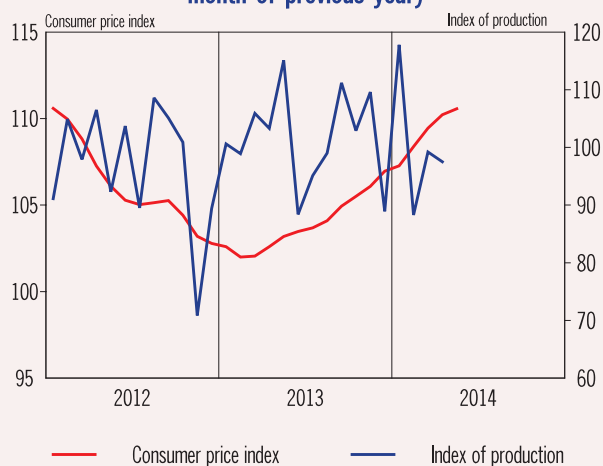
January-April 2014 also witnessed a fall in fish import volumes as a result of the introduction by the Russian State Veterinary and Phytosanitary Service of bans on imports of certain types of fish and fish products (from Russia's largest supplier: Norway, as well as from Estonia, Latvia and Vietnam) due to violations of veterinary and sanitary regulations by suppliers. The continuing growth in contract prices, the further depreciation of the ruble, and the fall in domestic fish production were also pro-inflationary factors in the fish product market (in May, the contribution of the growth in fish product prices to inflation was estimated at 0.2 percentage points).

Consumer price index for pork and pork production index (as % of corresponding month of previous year)



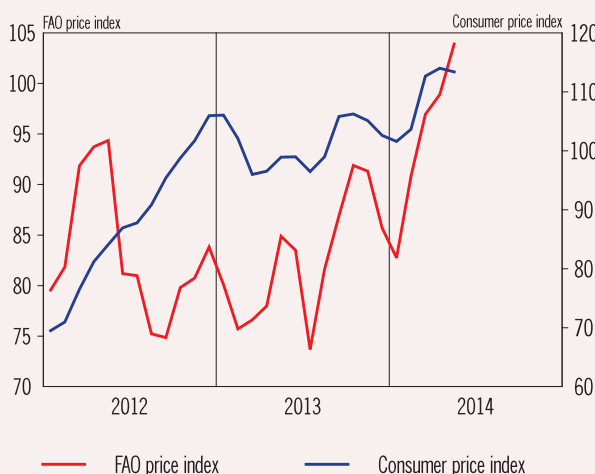
Source: Rosstat.

Consumer price index for fish products and frozen fish (excl. herring) production index (as % of corresponding month of previous year)



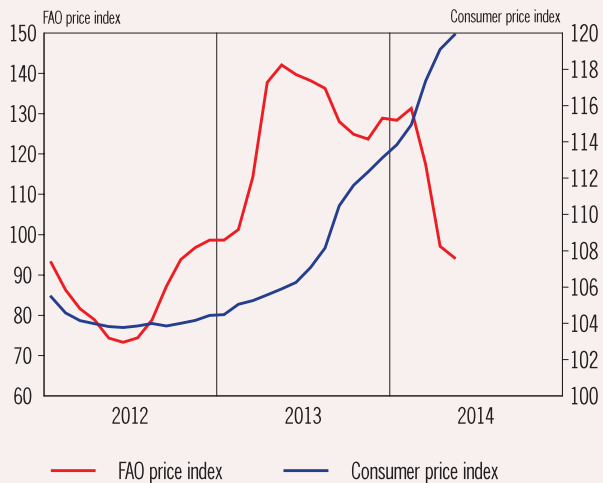
Source: Rosstat.

Consumer price index for sugar and FAO sugar price index (as % of corresponding month of previous year)



Source: Rosstat.

Consumer price index for dairy and FAO dairy price index (as % of corresponding month of previous year)

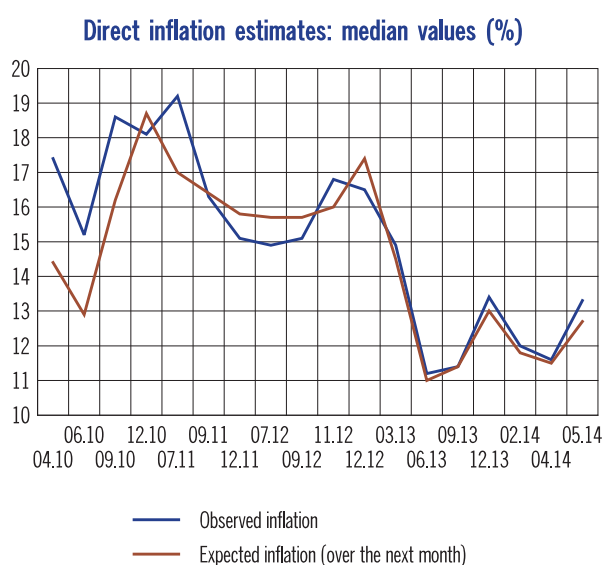


Sources: Rosstat, FAO.

The increased growth rates in prices for cheese, milk and dairy products were observed in the first few months of 2014. In May, they added about 0.8 percentage points to annual inflation. Unlike 2013, the acceleration in price growth occurred amid increased production volumes. Combined with the ruble depreciation, the increased growth rates of global prices for finished dairy products and dried milk (widely used by Russian producers in this season) between the end of 2013 and the start of 2014 acted as a pro-inflationary factor.

The significant increase in the growth rates of consumer prices for sugar in the Russian market was also caused by the accelerated rise in global prices for imported raw materials in a period of the seasonal increase in demand. Sugar price growth accelerated to 14.0% in April and its contribution to inflation rose to 0.1 percentage points. In May, price growth slowed somewhat.

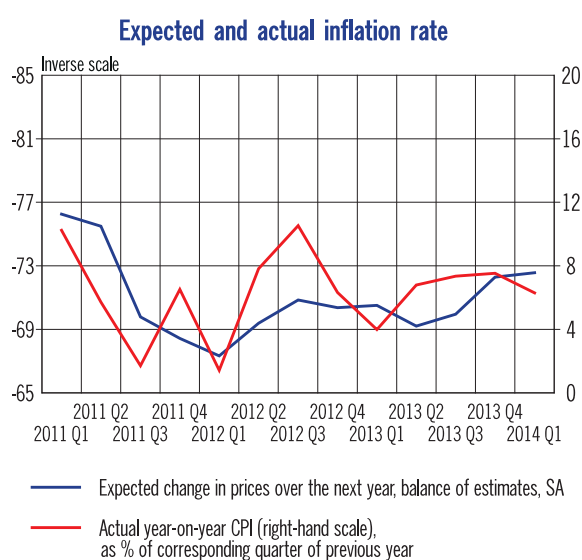
Thus, at the start of 2014, the acceleration of growth in food prices was caused by further depreciation of the ruble, the rise in global prices for certain types of agricultural products, the fall in the supply of certain types of food products, and increased costs. The high level of supply of cereal-based products to the domestic market and growth in the production of certain food products (meat, animal fat and vegetable oil) constrained the rise in prices.



Sources: Public Opinion Foundation, inFOM.

expectations for the forthcoming year increased in May. On the monthly horizon, assessments of observed and expected inflation also rose in May compared with April, which could be a consequence of the acceleration in actual inflation.

According to the results of a population survey commissioned by the Bank of Russia and carried out by inFOM LLC⁸ in May 2014, the median estimates of observed and expected annual inflation rose. The dynamics of these



Sources: Rosstat, Bank of Russia calculations.

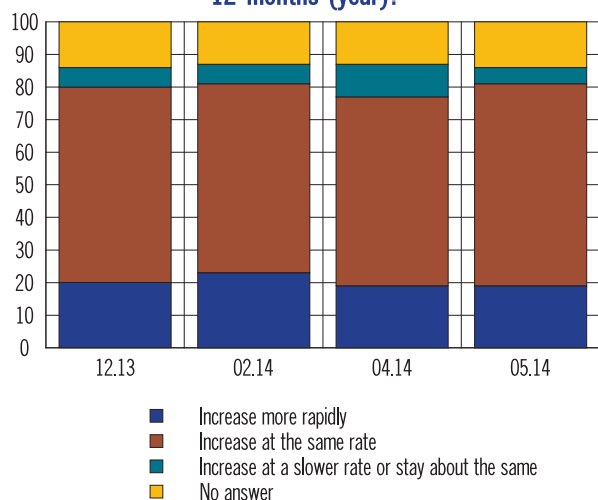
indicators are closely linked to population's perceptions of inflation over the previous period.

Most respondents still assume that price growth rates will be close to the current levels over the next 12 months. Following a short-term increase (in April) the number of respondents believing that prices would rise slower or would stop growing decreased. The share of those expecting annual inflation to accelerate in future did not change compared with the previous survey.

According to surveys carried out by the Russian Public Opinion Research Centre (VCIOM), 62% of respondents indicated inflation as the country's most pressing problem

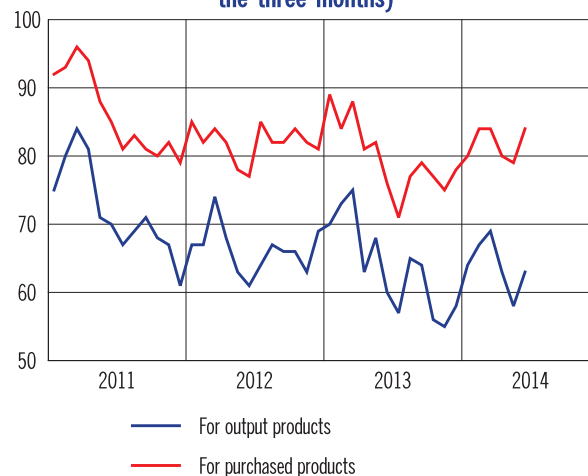
⁸ To compare data for previous periods, here and throughout this section the results of the FOM survey on 'Measuring inflation expectations and consumer confidence on the basis of household surveys' have been used.

In your opinion, how will the prices develop in the next 12 months (year)?



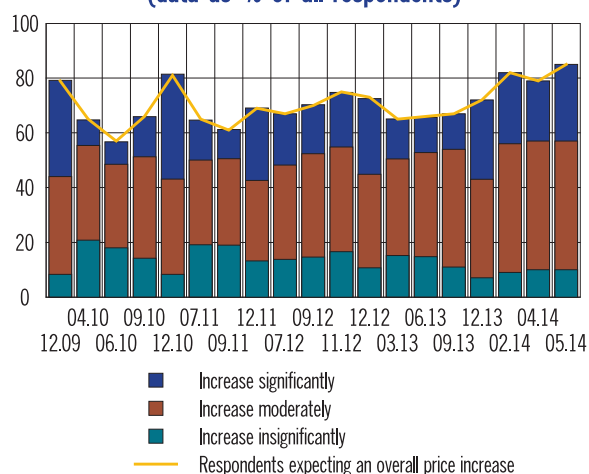
Sources: Public Opinion Foundation, inFOM.

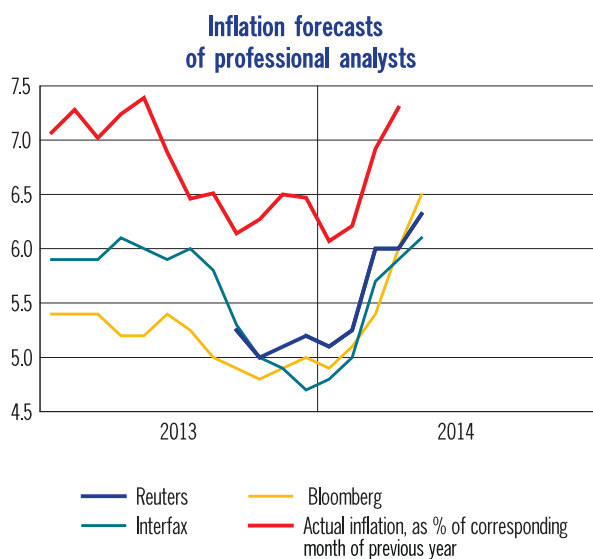
Diffusion price index for industrial production, expected changes (share of enterprises showing higher rates over the three months)



Source: Russian Economic Barometer survey results.

In your opinion, how will the prices for food products, non-food goods and services develop in the next month? (data as % of all respondents)





Sources: Rosstat, Interfax, Bloomberg, Reuters.

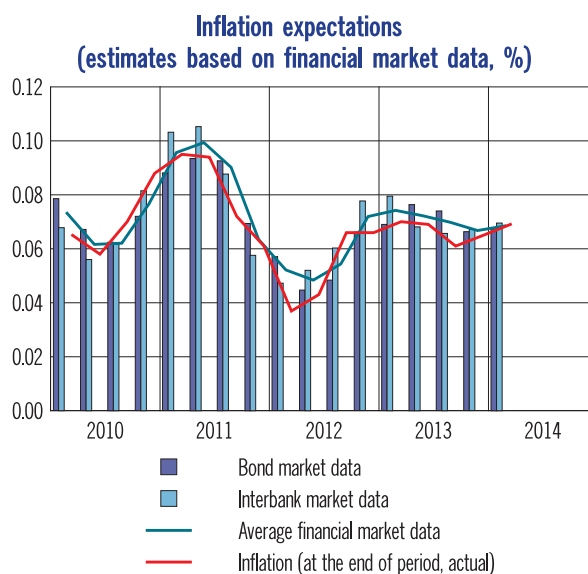
According to Rosstat quarterly survey, from January to March 2014, household inflation expectations increased slightly.

Businesses

Surveys of businesses from various economic segments show differing dynamics in expectations of output price change in 2014 Q2: producers of finished products, including industry, expect general slowdown in price growth, whereas trade and services enterprises expect continuing buoyant pricing dynamics.

According to the Russian Economic Barometer survey, in March 2014 businesses expected output and sale prices to have similar dynamics in the next three months: slowdown in growth from April to May followed by growth acceleration in June in line with seasonal factors. Surveys carried out by the Bank of Russia in April show that enterprises expect certain slowdown in price growth over the next three months. Enterprises seem to forecast a stabilisation of exchange rate dynamics and, consequently, less pronounced upward pressure on prices from the ruble depreciation.

According to Rosstat surveys carried out in Q1, businesses expect the buoyant price dynamics to continue in Q2 in the retail trade and services sector amid general economic uncertainty and the persistent pass-through effect of the ruble depreciation.



Source: Bank of Russia calculations.

Professional analysts

Following the acceleration in actual inflation, 2014 inflation forecasts by professional analysts significantly grew in April-May, also taking into account the potential continuing impact of exchange rate dynamics. Inflation expectations factored in the interbank lending rates and OFZ bond yields also increased.

Following the acceleration in actual inflation, professional analysts continue revising their 2014 inflation forecasts upwards, also taking into account the pass-through effect of exchange rate dynamics. The median value of the latest forecasts for 2014 (as of the end of May) was 6.3–6.5%.

The median value of expected inflation at the end of 2014, calculated by Bloomberg with consideration of the accuracy of the survey respondents' forecasts, was 6.2%. Short-term inflation expectations, calculated using financial market data, indicate an increase in inflation expectations in Q1 for the forthcoming quarter¹⁰.

Long-term professional analyst expectations also increased. The Development Centre's

¹⁰ The interbank lending market data model is based on the analysis of the combined dynamics of actual interest rates and expected inflation (the MIACR 31–90-day term rate is used as the nominal interest rate). The bond market data model is based on the analysis of inflation dynamics as one of the factors explaining OFZ bond yields over various terms.

consensus forecast for 2016 rose from 4.9% in February to 5.2% in May, which is higher than the medium-term inflation target set by the Bank of Russia for the end of 2016 (4%).

Thus, the dynamics of most indicators of short-term inflation expectations of economic

agents suggest high inertia. At the same time, long-term inflation forecasts by professional market participants (for several years ahead) take into account Bank of Russia target values for the corresponding period in terms of the long-term downward trend.

Current ruble position relative to equilibrium

One of the approaches the Bank of Russia uses to assess short-term deviations in the ruble exchange rate dynamics from its equilibrium is the behavioural equilibrium exchange rate, or BEER. This approach was first proposed by P. Clark and R. MacDonald in 1999¹ and is based on an empirical analysis of the dependence of the exchange rate on a number of fundamental macroeconomic factors when determining a trajectory for the exchange rate which ensures both domestic (non-tradable goods market) and foreign (tradable goods market) equilibrium.

The following variables are typically considered as fundamental factors: terms of trade (*tot*), the interest rates differential with the rest of the world (*i_dif*), the Balassa-Samuelson effect as the ratio between labour productivity in tradable and non-tradable goods sectors (*bs_effect*), as well as other indicators.

In the course of empirical estimation of the equilibrium ruble real effective exchange rate against foreign currencies (REER), modified least squares method was used to parametrise the dependence of the reduced form as a cointegration equation:

$$REER_t = \beta_1 tot_t + \beta_2 bs_effect_t + \beta_3 i_dif_t + \varepsilon_t$$

where:

ε_t – is an error term

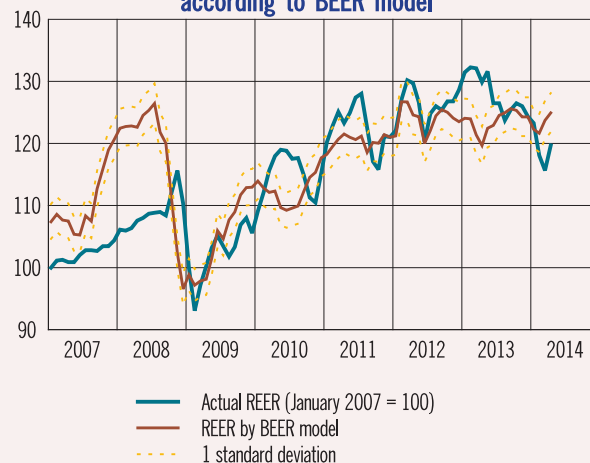
$\beta_1, \beta_2, \beta_3$ – are the unknown parameters under evaluation.

To-date estimation results suggest that the changes in the terms of trade, approximated for the Russian economy by real prices of Urals crude, among other fundamental factors, shape the real effective exchange rate by more than 70%. The relative contribution of the interest rate differential and the Balassa-Samuelson effect are estimated to be around 20% and 10% respectively.

In accordance with the estimates from the behavioural equilibrium exchange rate model, the ruble real effective exchange rate against foreign currencies from January to March 2014 was significantly undervalued relative to its short-term equilibrium value. This was explained by the high uncertainty regarding the development prospects of the Russian economy amid the continuing geopolitical tension. The appreciation of the national currency in April was corrective and contributed to a decrease in the exchange rate gap.

Should the exchange rate return to its equilibrium level during this year, which could occur in case there are no significant fluctuations in financial markets, the depreciation of the ruble real effective exchange rate against foreign currencies in 2014 will not exceed 2.0% compared with 2013.

Ruble real effective exchange rate against foreign currencies and estimates of its equilibrium level according to BEER model



Source: Bank of Russia calculations.

¹ Clark, P. B. and R. MacDonald (1999) 'Exchange rates and economic fundamentals: A methodological comparison of BEERs and FEERs', in R. MacDonald and J. L. Stein: *Equilibrium exchange rates*, Norwell, MA., 285–322.

II. Economic outlook, risk assessment and monetary policy decisions

II.1. Economic outlook and decisions on Bank of Russia key rate level

According to IMF forecasts, global economic growth rates will increase from 3.6% in 2014 to 4.0% in 2016. Unlike 2014, the accelerated growth of the global economy over the following years will primarily result from GDP growth in emerging market economies. GDP in this group of countries will rise on the average by 5.4% in 2016 compared with 4.9% in 2014, while advanced economies will see GDP growth accelerate from 2.2% to 2.4% over the same period. However, the differential of economic growth rates in emerging market economies and developed countries will be significantly lower than pre-crisis levels.

Despite the expected acceleration in global economic growth rates, external demand will continue to be a factor constraining the economic growth in Russia from 2014 to 2016. Compared with previous estimates, the forecast of growth in Russia's trading partners is decreased due to the deterioration of economic growth prospects in the CIS.

The output gap in the USA and the euro area will continue to be negative by 2016, though it will have reduced significantly (to –1.3 and –1.1% respectively, compared with –3.3 and –2.2% in 2014)¹.

The economic situation in developed countries will contribute to normalisation of monetary policy. Recovery in business activity, curtailment of accommodative measures and increase in central bank key rates will contribute to growing interest rates in the global financial market. For emerging market economies, this will mean a tightening of the price component of external financing conditions, which will

be partially offset by the willingness of foreign creditors to provide larger funding volumes as the global financial markets recover and investor optimism rises.

In the next three years, the Bank of Russia, like international organisations, expects gradual fall in oil prices. According to Bank of Russia forecasts used to calculate its baseline medium-term scenario, the price of Urals crude will fall from \$108.3 per barrel in 2013 to \$102 per barrel in 2016. The price decrease will result from accelerated growth in global supply against global demand and sufficient profitability of oil extraction from unconventional sources (for example, introduction of additional capacity to extract oil from Canadian oil-bearing sands would be profitable at prices from \$80 per barrel upwards²).

From 2014 to 2015, global demand for crude oil will grow by less than 1.5%³ per year, mainly driven by emerging market economies. However, even these countries will see slowdown in oil demand growth. An increase in oil demand from OECD countries will be constrained by low economic growth rates.

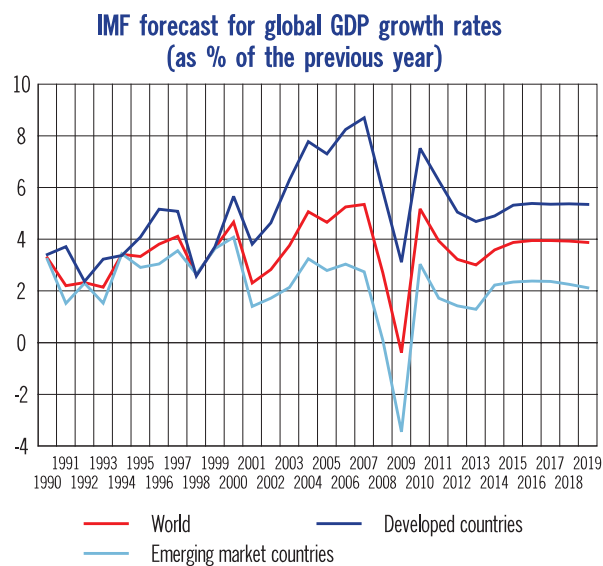
The expansion of global supply will result from expansion of innovative exploration technologies (including deep-water exploration drilling and the extraction of shale fuel) and new methods of oil extraction from existing oil wells. From 2014 to 2015, global oil extraction will grow by an average of 2.7% per year due to the rapid increase in extraction in the USA, Canada and Iraq⁴. In February 2014, oil extraction in Iraq

² World Bank, *Commodity Markets Outlook*, April 2014.

³ *Ibid.*

⁴ *Ibid.*

¹ According to IMF forecast.



had already reached its highest level since the invasion of coalition forces in 2003.

Thus, oil price decrease together with deterioration of the situation in other commodity markets, as well as the expected growth in Russian import prices will cause the deterioration in the terms of trade to continue in the medium-term, which will become an additional factor constraining economic growth.

The economic development forecast was revised downwards⁵ as a result of the change in estimates of domestic demand growth rates. Amid growing uncertainty over the future developments in Ukraine, there was an increased capital outflow from the domestic financial market and a significant deterioration in producer sentiment, which, in conjunction with weak financial results of companies and tighter lending conditions, resulted in a decline in investment demand. Later in 2014, the limited access to foreign capital markets is likely to result in shrinkage of the banks' resource base, while growth in the risk component of loan rates will increase the cost of borrowed funds for businesses. Against this backdrop, investment

⁵ Since the forecast set out in the Guidelines for the Single State Monetary Policy in 2014 and for 2015 and 2016 was revised in the February Monetary Policy Report, this forecast is provided for comparison with the forecast set out in the February Monetary Policy Report.

activity will remain weak throughout 2014. However, the second half of the year will see a slowdown in fixed capital investment decrease amid stabilisation of the foreign economic situation and improved producer sentiment. According to estimates, the reduction in fixed capital investment in 2014 will be roughly 3%.

Looking forward to 2015–2016, investment demand (fixed capital investment growth is forecast to be around 2–4%) will see a revival as a result of growing activity of private sector companies. No significant additional contribution from the public sector to the increase in investment activity is expected in view of the limited opportunities to increase government spending within the scope of budget rules and taking into account the moderate scale and protracted effect from the allocation of National Wealth Fund resources to finance infrastructure projects.

A positive event which could be conducive to an improvement in assessments of the Russian economic outlook by economic agents is the signing of a gas supply agreement with China in May. The terms of the agreement provide for annual gas supplies totalling \$400 billion starting from 2018. Russia's spending on infrastructure will amount to \$55 billion which will undoubtedly support



Note: Terms of trade are approximated by the real price index of Urals crude (oil prices adjusted by foreign inflation).

Long-term forecast for global oil demand

Global oil demand will increase by 2035, but its growth will slow down. According to OPEC estimates, 88%¹ of growth in global oil demand will come from emerging market economies in Asia, while developed countries will decrease their consumption. The greatest contribution to the expansion of global oil demand will come from the transport sector, increasing its share from 57% to 60% over the period from 2014 to 2035².

Growth factors

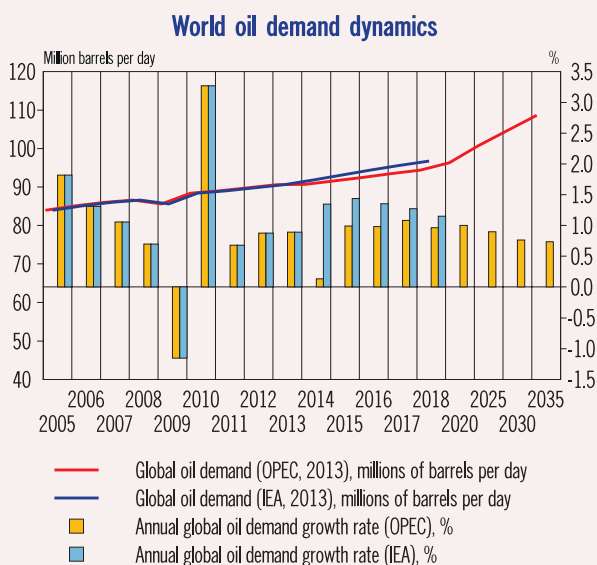
The long-term growth in global demand for energy (including oil) will be driven by social and economic factors. The 2 billion³ increase in the global population by 2040 is directly linked to growth in energy consumption, which will slow down with the end of the demographic shift towards low birth and mortality rates.

The increase in global oil demand will also be driven by the higher level of urbanisation around the world, which will increase from 52% to 60%⁴ over the period from 2014 to 2040 (cities are characterised by higher levels of energy consumption than rural areas). Emerging market countries in Asia, primarily China and India, will show the highest urbanisation rates.

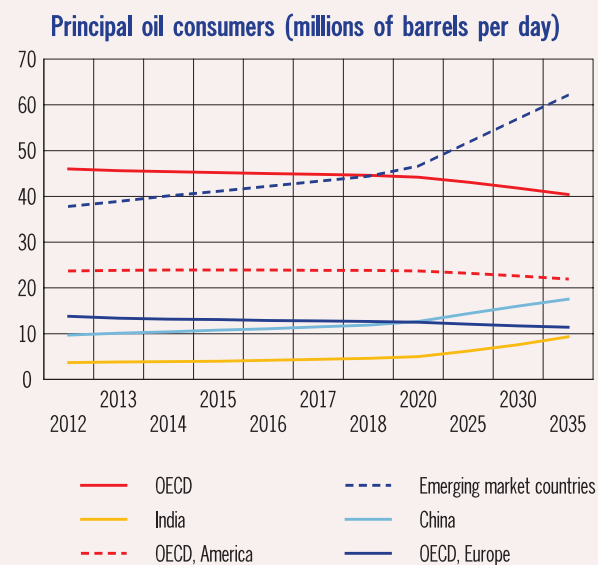
The key factor behind the growth in global oil demand will be the increase in population well-being, which will lead to growth in demand for energy-intensive goods. This will be most evident in the transport sector due to the number of cars in emerging market economies increasing by 800 billion over the period from 2014 to 2035⁵. The global economic recovery will also contribute to growth in oil demand.

Contraction factors

The decrease in consumption in developed countries will constrain growth in global oil demand as a result of the recent peak in demand for oil and oil products, a shift in energy policy in favour of active introduction of energy-saving technologies, renewable energy sources and the increase in domestic oil production.



Source: OPEC.



Source: OPEC.

¹ World Oil Outlook 2013. OPEC. P.58

URL: http://www.opec.org/opec_web/static_files_project/media/downloads/publications/WOO_2013.pdf

² World Oil Outlook 2013. OPEC. P.72

URL: http://www.opec.org/opec_web/static_files_project/media/downloads/publications/WOO_2013.pdf

³ United Nations, Population Division of the Department of Economic and Social Affairs, 'World Population Prospects 2012 Revision', June 2013.

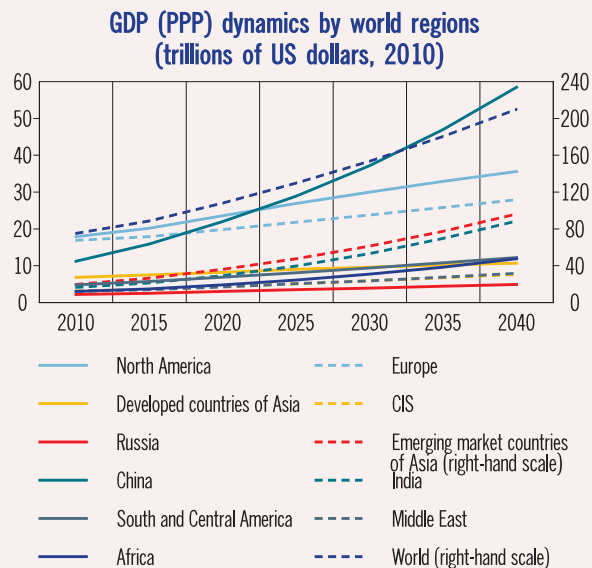
⁴ Global and Russian Energy Outlook up to 2040. ERI RAS. 2014. P.9. URL: http://www.eriras.ru/files/forecast_2040.pdf

⁵ World Oil Outlook 2013. OPEC. P.11

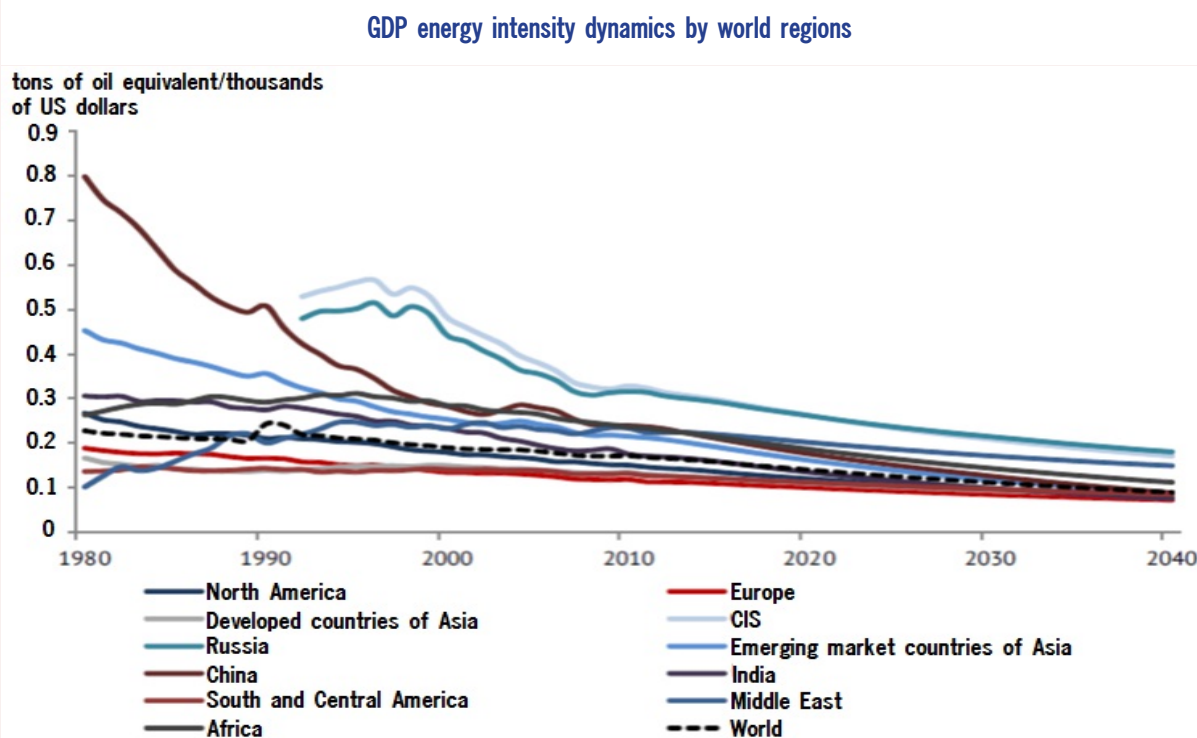
URL: http://www.opec.org/opec_web/static_files_project/media/downloads/publications/WOO_2013.pdf

The main factor behind the fall in global oil demand will be the increasing use of energy-saving technologies. According to the forecast by the Energy Research Institute of the Russian Academy of Sciences, the energy intensity of the global economy will fall by 44%⁶ over the period from 2014 to 2040. Energy-saving technologies will spread across all sectors, including transport. Technological improvements have helped decrease fuel spending by 30% for the aviation over the last decade, by 10% for the cargo motor transport over the period from 1990 to 2010, with a further projected 43% reduction by 2040, and by 50% for motor cars over the period from 2010 to 2040⁷. Energy efficiency of the economy benefits significantly from the countries' energy policy. For example, in Japan, introduction of energy efficiency standards for domestic and imported goods has increased energy efficiency of vehicles by 50% compared with 1995–2010 levels, and there are further plans to reduce energy consumption in homes through improvements in thermo-insulation⁸.

Interfuel competition and development of alternative energy sources are other factors affecting the decrease in oil demand. In the transport sector, demand for oil and oil products



Source: Energy Research Institute of Russian Academy of Sciences.



Source: Energy Research Institute of Russian Academy of Sciences.

⁶ Global and Russian Energy Outlook up to 2040. ERI RAS. 2014. P.5.
URL: http://www.eriras.ru/files/forecast_2040.pdf

⁷ Global and Russian Energy Outlook up to 2040. ERI RAS. 2014. P.31–32. URL: http://www.eriras.ru/files/forecast_2040.pdf

⁸ Energy Policy Highlights. 2014. IEA. P.29, 35, 39–40.

URL: http://www.iea.org/publications/freepublications/publication/Energy_Policy_Highlights_2013.pdf

could fall due to the development of production of vehicles running on cheaper natural gas (\$1.5/gallon cheaper than gas-oil or diesel)⁹. However, in view of the underdeveloped refuelling infrastructure, in the medium-term gas will not be a serious competitor of oil in the transport sector. Gas could potentially constrain global oil demand in other industries. In the USA, shale gas will be actively used in the petrochemical industry and for electricity generation instead of oil.

⁹ World Oil Outlook 2013. OPEC. P88.

URL: http://www.opec.org/opec_web/static_files_project/media/downloads/publications/WOO_2013.pdf.

investment activity. However, the distribution of infrastructure investments over time has not yet been determined. It is highly probable that the investment programme will not be launched until 2015. Looking further ahead, the supply of gas to China under this agreement will give considerable boost to Russian exports.

Consumer demand will remain the main driver of economic growth, however it is not expected to see any perceptible acceleration in 2014 as the increase in demand at the start of the year was mainly driven by short-term factors. In 2014 the increase in household spending on final consumption will be constrained by low growth rates in wages both in the private sector (with companies being unable to increase wages) and the public sector (taking into account lower indexation parameters for public sector employees). At the same time, growth rates in real disposable household income in 2014 are expected to be somewhat lower than growth rates in real wages due to the fall in income from property and business activity. Besides, over the period from 2014 to 2016, growth in real disposable income will be constrained by increased loan payments. From 2015 to 2016, amid the increase in aggregate demand, wages growth rates are forecast to see gradual recovery, which will result in some acceleration in consumer demand growth.

Taking into account the relative lack of flexibility in the Russian labour market, as well as the impact of demographic factors (such as the fall in working-age population numbers and the increase in the proportion of groups with typically low unemployment rates in the economically active population), the negative economic trends will have a minor effect on

the labour market conditions. The average unemployment rate is not expected to exceed 5.5% in 2014, while from 2015 to 2016 it will return to the low levels of the start of this year (5.1–5.3%).

Net export dynamics are likely to contribute significantly to GDP growth rates in 2014. Imports are expected to contract in real terms amid the drop in investment demand, the fall in consumer spending growth rates and the ruble depreciation. At the same time, goods and services exports will retain their slightly positive dynamics.

From 2015 to 2016, the contribution of net exports is forecast to be slightly negative, as a result of balanced growth rates in exports (roughly 1–2% per year) and imports (2–4% per year) in proportion to the expected dynamics of foreign and domestic demand amid stable ruble exchange rate dynamics. According to Bank of Russia estimates, the dynamics of goods and services exports and imports will cause a gradual decrease in Russia's current account surplus from roughly 2% in 2014 to less than 1% in 2016. At the same time, there is expected to be some proportional reduction in net capital outflow, provided that there are no unfavourable external shocks, the positive differential of foreign and domestic interest rates is maintained and the financial and real sector gradually adapt to the floating exchange rate regime.

According to the Bank of Russia forecast, 2014 GDP growth rate will be roughly 0.4%. Throughout 2014, the significant negative output gap will persist, which will be one of the factors contributing to the slowdown in price growth. The forecast baseline scenario expects the output gap to decline perceptibly

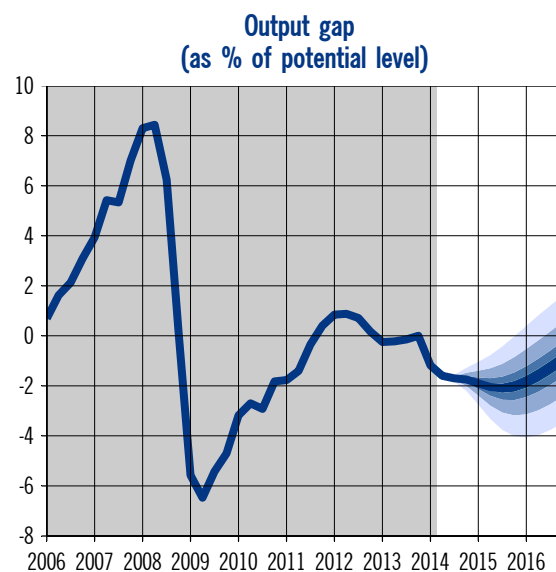
by the end of 2016. In the medium term, there is expected to be a fall in potential growth rates amid unfavourable demographic trends, the deterioration in terms of trade, and the decrease in the potential growth rates of Russia's trading partners.

The Bank of Russia forecasts economic growth in Russia to be 0.9% in 2015 and 1.9% in 2016. Government policy aimed at implementing structural reforms will play the crucial role in increasing economic growth rates later on.

If the macroeconomic forecasts up to the end of 2014 described above turn out to be correct, the Russian financial sector will see the continuation of trends witnessed in the first half of 2014. With the Bank of Russia keeping its key rate at the current level and the credit risks increasing amid the economic slowdown and a slight deterioration in the quality of the loan portfolio, ruble loan rates for ultimate borrowers will see moderate increase. At the same time, given economic uncertainty, banks will continue to tighten their non-price lending conditions, especially in terms of borrowers' financial position, which could constrain interest rate growth to certain degree.

Demand for corporate loans will be constrained by weak investment activity of enterprises. Meanwhile, lower accessibility of external funding could stimulate increased demand from enterprises in the domestic lending market. The household lending segment can be expected to see further slowdown in the annual growth rates of the loan portfolio. The growth in loans to households and non-financial organisations will generally be in line with the baseline scenario of the Guidelines for the Single State Monetary Policy in 2014 and for 2015 and 2016.

Bank deposit rates will continue their moderate growth amid increasing competition between banks for long-term liabilities. The growth in rates and the gradual stabilisation of the situation will contribute to a renewed inflow of households' funds to banks. If the ruble



exchange rate stabilises there will be an ongoing decrease in deposit dollarisation to last year's average values, as a result of which the growth rates of the M2 monetary aggregate will exceed those of broad money (the M2X aggregate).

In the medium term (2015-2016), the inflation slowdown will contribute to a fall in bank lending and deposit rates. The recovery of economic growth and the associated fall in credit risks could be an additional factor affecting the reduction of lending rates. Growth rates of loans to households and non-financial organisations are still forecast to be approximately 15%. Lending will continue to be the main driver of broad money growth. If there are no shocks in the foreign exchange market, some stabilisation in the currency structure of bank deposits and, accordingly, a rapprochement of M2 and M2X monetary aggregate growth rates can be expected.

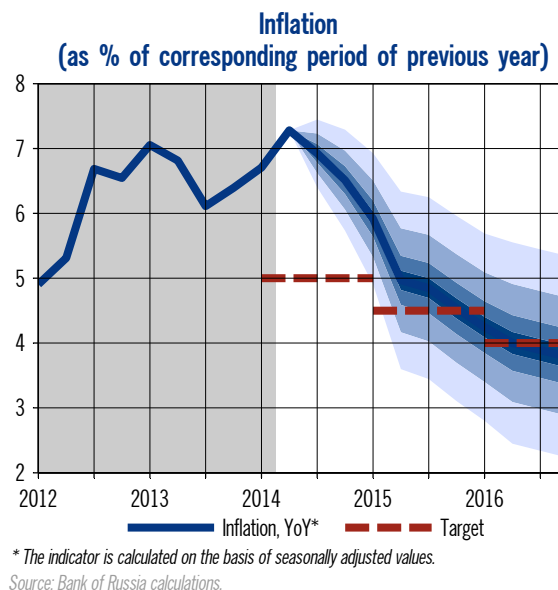
If there are no new external shocks, the projected slowdown in inflation and gradual recovery of economic growth in Russia will contribute to an improvement in financial market confidence, an increase in the investment appeal of Russian assets, and a reduction in interest rates and bond yields in the domestic market. Significant drop in OFZ and corporate bond supply in 2014 combined with existing high demand from the banking sector for refinancing provided by the Bank of Russia, and the scarcity

of marketable collateral will also stimulate growth in demand and reduction in the cost of borrowing in the government and corporate bond markets from 2015 to 2016.

From the end of February to the start of March, amid the developing negative trends in the financial markets and the increasing economic uncertainty, the probability of inflation exceeding the 5.0% target at the end of 2014 increased substantially. To curb inflation pressures, on 3 March 2014, the Bank of Russia increased its key rate by 1.5 pp, to 7.00% p.a.

From March to April 2014, inflation risks continued to increase due to the impact of exchange rate dynamics on consumer prices, persistently high inflation expectations, and the unfavourable conditions in the markets for some goods. Under these circumstances, in April 2014 the Bank of Russia raised its key rate by additional 0.5 pp, to 7.50% p.a.

In the second half of 2014 the consumer price growth rates are expected to decrease. This will be supported by, *inter alia*, stabilisation of the ruble exchange rate dynamics; the expected good harvest; lower planned increases in administered prices and tariffs compared with the previous year; the decline in inflation expectations; and aggregate output of goods and services remaining below the potential level. Recognising that the influence of monetary policy on the economy is distributed over time,



the slowdown in inflation to the 5.0% target in 2014 is unlikely. In line with Bank of Russia forecasts, consumer price growth rates will fall to 6.0% by the end of 2014. At the same time, the risks of inflation exceeding the 6.0% level in 2014 remain high. The effect of the factors behind the observed inflation acceleration will wane in future. If there are no new shocks, maintaining the current monetary policy stance will ensure a slowdown in inflation to target levels in the medium term. In this regard, the Bank of Russia maintained its key rate at the 7.50% p.a. level in June 2014.

II.2. Risk assessment

Under the baseline scenario, inflation will reach its target levels in 2015 and 2016. As before, the risks to the inflation forecast are skewed to the upside but the risks of inflation exceeding its target in the medium term increased over the last quarter. Among the major risks is the uncertainty over the future developments in Ukraine and their impact on the Russian economy, including the issues of Russian companies' access to the capital market. Other risks are related to the high inertia of inflation expectations and possible deterioration in the situation in the food market.

In case of any delay in settling the conflict in Ukraine, there could be both direct and indirect negative consequences for the Russian economy. In addition to the likely losses from trade curtailment and the increased risks of transiting Russian gas to Europe, such a situation could give rise to expectations of extended sanctions against Russia from the USA and the EU which could have a significant negative impact on both international and domestic investor sentiment. The likely consequence of deterioration in investor expectations could be a further slump in business activity and renewed ruble depreciation in the second half of 2014, caused by a further fall in demand for ruble assets. In this case, the Bank of Russia's response will be determined based on the expected impact of the pass-through effect and the drop in business activity on consumer price growth rates. Should this scenario materialise, the Bank of Russia will conduct an active monetary policy aimed at containing inflation risks.

The adaptive nature of inflation expectations could also be a significant factor

preventing reduction in inflation. The baseline forecast scenario assumes a significant inflation deceleration by the end of 2014 due to a fall in business activity and stabilisation of exchange rate dynamics. Under these conditions, persistently high expectations or further growth in expectations caused by high inflation rates at the start of 2014 will impede the achievement of the 2015 to 2016 inflation targets. If this risk materialises, a tighter monetary policy might be required.

The situation in the food products market could also be a source of inflation risks in the period up to the end of 2014. The baseline scenario assumes that the growth in food prices will have slowed down by 2014 Q3 amid the expected good harvest and sufficiently quick stabilisation of the situation in the markets for certain food products. These assumptions are currently considered to be realistic for forecasting the situation in the food market. However, taking into account the high price volatility typical of this market, as well as the uncertainty over weather conditions, it is impossible to rule out any significant fluctuations in food prices during the rest of the year. Such fluctuations could have a perceptible impact on price growth rates, as food products account for a significant proportion (up to 40%) of the CPI basket. The Bank of Russia typically views such shocks as exogenous and short-term. A monetary policy reaction to such shocks will only follow if they lead to significant revision of medium-term inflation forecasts or acceleration in price growth for other commodity groups and growth in inflation expectations.

II.3. Changes to the system of instruments and other monetary policy measures

The Bank of Russia takes monetary policy decisions on the basis of a medium-term macroeconomic forecast and an assessment of inflation risks, and impacts the economy on an aggregate level. At the same time, the Bank of Russia also adopts measures aimed at stimulating individual segments of the lending market, the development of which is held back by structural factors. For this purpose it uses specialised refinancing mechanisms which are designed to address issues not related or only partially related to monetary policy.

One of the structural characteristics of the Russian banking sector is a relatively underdeveloped long-term lending segment while the overall growth rates in lending to non-financial organisations remain high. With the ongoing decrease in profits of real sector enterprises, borrowed funds will gain in importance as a source of funding for investment projects. In this regard, in April 2014 the Bank of Russia Board of Directors decided to introduce a new specialised refinancing programme¹. Under this mechanism, credit institutions will be able to obtain funds from the Bank of Russia for up to 3 years at a fixed rate of 6.5% p.a. against the collateral of receivables on loans extended to fund investment projects selected in accordance with the rules approved by the Government of the Russian Federation. In addition, loans have to be guaranteed by Russian government to be eligible as collateral. Since 29 May 2014, the programme also embraces bonds from the Bank

of Russia Lombard list, placed for the purposes of investment project funding².

In accordance with the decision of the Bank of Russia Board of Directors, 16 credit institutions with own funds (capital) amounting to more than 50 billion rubles, have been admitted to the new programme. The lending limit has been set at 50 billion rubles.

Lending to participant banks at the interest rate below the Bank of Russia key rate over a longer term than standard instruments offers further incentives to fund investment projects. The Bank of Russia has not set any requirements related to rates for ultimate borrowers or the growth rates of loan portfolios.

From March to April 2014, the Bank of Russia implemented a technical increase by a total of 2.0 pp in interest rates on all suspended operations, which is in line with the change in the key rate during this period³. This decision was made taking into account the fact that interest rates on suspended operations are used to calculate cash flows for some financial instruments in Russia, including debt securities and bank loans. At the same time, the Bank of Russia sees no rationale for continuing to set interest rates on these operations in future. On

¹ Press release dated 25 April 2014 'On Refinancing Investment Project Loans' can be found under the section 'Monetary Policy' ('Press releases on monetary policy') on the official website of the Bank of Russia (http://cbr.ru/press/PR.aspx?file=25042014_134515ref.htm).

² Press release dated 29 May 2014 'On Supplementing Refinancing Mechanism for Investment Project Loans' can be found under the section 'Monetary Policy' ('Press releases on monetary policy') on the official website of the Bank of Russia (http://cbr.ru/press/pr.aspx?file=29052014_200826inform.htm). The Bank of Russia Lombard list currently includes bonds of OJSC Western Rapid Diameter, North-West Concession Company LLC, GK Russian Highways and OJSC Main Road which have the appropriate characteristics.

³ Press release dated 3 April 2014 'On Interest Rates on Bank of Russia Suspended Operations' can be found under the section 'Monetary Policy' ('Press releases on monetary policy') on the official website of the Bank of Russia (http://cbr.ru/press/PR.aspx?file=03042014_202550dkpnw.htm).

Lending support programmes: international experience and Bank of Russia instruments

Lending support programmes are non-standard measures taken by a central bank to increase lending activity and expand domestic demand by increasing the accessibility of loans for target groups of borrowers, in particular small and medium-sized enterprises (SMEs). During the term of such programmes, credit institutions can obtain refinancing from a central bank on preferential terms, and thus, as a rule, they take on certain obligations in terms of lending to the economy. For example, such programmes were launched in Great Britain (Funding-for-Lending Scheme, FLS) and Hungary (Funding-for-Growth Scheme, FGS), and in part in the USA (Term Asset-Backed Securities Loan Facility, TALF). The Bank of Russia also has an experience in implementing lending support programmes.

Under the programme to incentivise lending in Great Britain (FLS), the **Bank of England** carries out a collateral swap, providing credit institutions with treasury bonds in exchange for a wide range of assets (from high credit quality securities to credit claims) for a term of up to 4 years. The applicable fee depends on the change in the bank's credit portfolio. In turn, the treasury bonds can be used by banks as collateral on Bank of England main refinancing operations or for raising funds in the interbank market. Thus, the cost of refinancing for banks exceeds the central bank key rate by the cost of the fee for the collateral swap under the FLS. The total volume of the programme is unlimited, though there are individual limits on the amount of treasury bonds exchanged under the FLS. Thus, the initial limit for a bank is set at 5% of its loan portfolio. In the future, the limit is due to be increased in proportion to the net growth of the bank's loan portfolio; however it will not be reduced if the portfolio shrinks. The programme is due to end in January 2015.

The programme to revive lending to SMEs and to support financial stability in Hungary (FGS) envisages for the **Bank of Hungary** to provide refinancing secured by a portfolio of loans extended to SMEs under the programme. The funds provided can be channelled into lending to SMEs to finance fixed or working capital or refinancing outstanding foreign currency loans. The Bank of Hungary provides funds at a zero interest rate for a term equal to the term of the SME loan, but not exceeding 10 years. The interest rate for end borrowers is fixed at 2.5% p.a.¹. The maximum amount of funds which can be provided under the FGS mechanism has been set at 2,750 billion forints since September 2013 (9.1 billion euros as per the ECB exchange rate as of 28 May 2014). The FGS programme is due to end in December 2014.

Throughout the financial crisis, the **US Federal Reserve** also introduced a range of additional instruments to stabilise the financial markets, stimulate lending and revive economic growth. Unlike the programmes of the Bank of Hungary and the Bank of England, not only credit institutions, but also all companies registered in the USA holding certain assets meeting the programme criteria were able to participate in the TALF programme launched in 2009. The programme was aimed at supporting lending to households and small businesses by incentivising the securitisation of loans provided to such borrowers (car loans, student loans, credit cards, small business loans) and was conducted in collaboration with the US Treasury². Later, commercial mortgages and loans to cover insurance premiums were added to the list of eligible assets. Under this programme, the Federal Reserve Bank of New York provided funds against the collateral of bonds backed by eligible types of loans, which should have a guarantee of a high credit quality from leading ratings agencies. The borrowing term was initially limited to one year, but later the decision was made to provide funds for terms of up to three and five years against certain collateral types. Interest rates under the TALF programme were dependent on the term and collateral type and were linked to market rates (LIBOR, OIS), with a fee being paid when each transaction was carried out. The maximum amount of funds approved under the TALF programme totalled \$200 billion and this was spread out in fixed amounts for each month. This programme ended on 30 June 2010.

¹ The key rate of the Bank of Hungary has been set at 2.4% p.a. since 27 May 2014. In April 2014, there was a deflation of 0.1%, while the target inflation rate is 3%.

² The US Treasury provided the Fed with 'loan insurance' of \$20 billion to redeem collateralised bonds under the TALF mechanism in the event of any potential losses, and from January 2013 the decision was made to stop providing loan support from the Treasury, as the value of the fees taken for providing funds under the TALF programme exceeded the value of the loans extended.

*In addition to the loan refinancing programme for investment projects introduced in April 2014, the **Bank of Russia** uses other special mechanisms to stimulate lending, aimed at supporting lending to SMEs, as well as to export-oriented industries.*

Since August 2009, the Bank of Russia has been providing the open joint-stock company Russian Bank for Small and Medium Enterprises Support (SME Bank) with loans secured by claims under interbank lending agreements concluded by SME Bank with partner banks³ under the Financial Support Programme for the Development of Small and Medium-sized Enterprises. Loans are provided by the Bank of Russia for a term of up to one year at a fixed interest rate, which is currently set at 4% p.a.

The programme implemented by SME Bank was called upon to facilitate the provision of long-term, accessible loans to solvent small and medium-sized enterprises (SMEs) across the Russian Federation, as well as to bring about a change in the SME industry structure through priority lending to the non-trade and innovative sectors. For this, SME Bank inter alia refinances loans provided to SMEs by partner banks.

As of 1 May 2014, the SMEs' outstanding amount of such loans totalled 80 billion rubles. As of 1 April 2014, the weighted average interest rate on the portfolio of loans extended to SMEs by partner banks stood at 12.65% p.a.⁴

Since August 2013, in order to provide indirect support to export-oriented businesses (including SMEs), the Bank of Russia has been providing credit institutions with funds against the collateral of claims under loan agreements which are secured by open joint-stock company Russian Export Loans and Investment Insurance Agency (EKSAR) insurance agreements. Loans are provided to banks for terms of up to one year at a fixed interest rate of 6.5% p.a. The unique feature of this mechanism is the absence of any claims from the Bank of Russia to ultimate borrowers with regard to the loans provided, insofar as the risk associated with these borrowers is offset by EKSAR insurance agreements. Nine credit institutions working together with EKSAR to provide export loans have been admitted to this programme.

³ A partner bank is a resident bank of the Russian Federation selected in accordance with the procedure established by SME Bank and providing loans to SMEs in accordance with SME lending standard, as defined by SME Bank. The standard includes requirements relating to the term, collateral and the effective interest rate on the loan to an SME, as well as the requirements on the documents provided by SMEs.

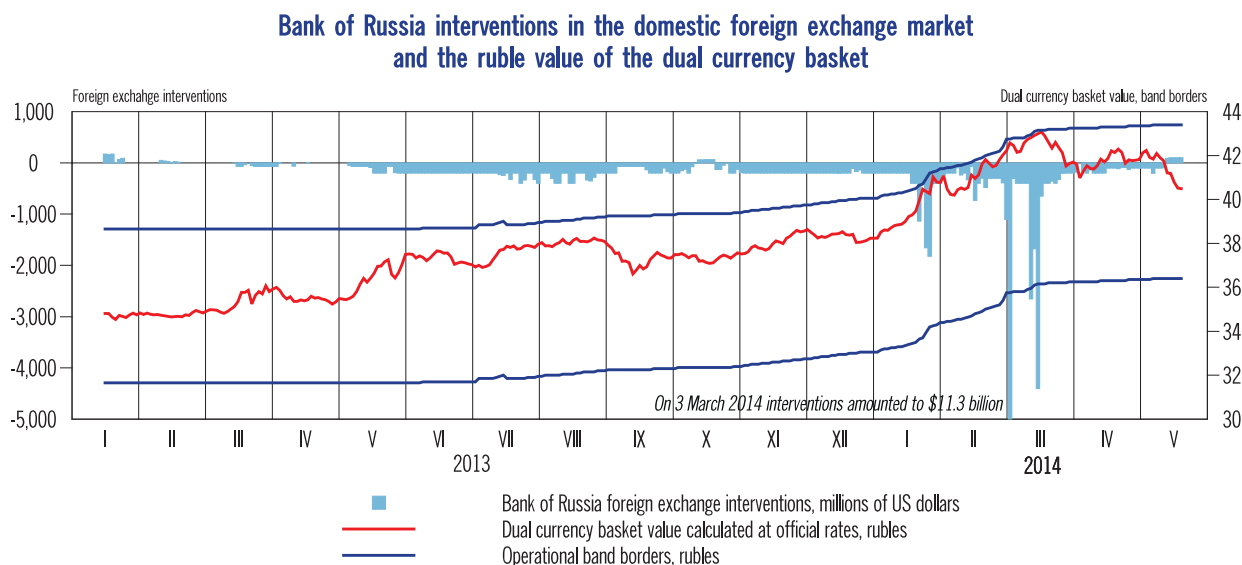
⁴ The interest rates and fees for SMEs are set by partner banks independently, and restrictions on the interest rate under loan agreements concluded between partner banks and SMEs (when financed using SME Bank funds) are stipulated in the loan agreement concluded between the partner bank and SME Bank.

the whole, the development of the system of monetary policy instruments is now complete. The number of suspended operations has risen significantly in February 2014 after several decisions adopted in September 2013 came into effect. In order to avoid possible distortions in the public understanding of the monetary policy, from 25 July 2014, the Bank of Russia will cease to set interest rates on these operations, excluding 12-month repo standing facility. Until this time, financial market participants can accordingly adjust their methods for calculating cash flows linked to interest rates on Bank of Russia suspended operations.

Exchange rate policy decisions

For a substantial part of this period, the Bank of Russia conducted its exchange rate policy amid the increased volatility of the ruble exchange rate against major global currencies. The Bank of Russia used the same exchange rate policy mechanism, however, its parameters were significantly altered with a view to maintaining financial stability.

The aggravation of the external political situation between the end of February and the start of March 2014 provoked strong ruble depreciation which could pose a threat to the stability of domestic financial markets. In order to limit fluctuations in the ruble exchange



Source: Bank of Russia.

rate, from 3 March the cumulative volume of interventions triggering a 5-kopeck shift in the operational band borders was increased to \$1.5 billion compared with \$350 million in the period from 10 December 2013 to 28 February 2014. This adjustment resulted in reduction in the sensitivity of the operational band to the amount of Bank of Russia foreign exchange interventions aimed at smoothing exchange rate fluctuations. Other parameters of the mechanism were left unchanged.

On some days from 8 January to 18 March, when the value of the dual currency basket reached the upper border of the operational band, the Bank of Russia conducted foreign exchange interventions without quantitative limitations on their volume, in line with the effective exchange rate policy mechanism.

The adopted measures contributed to the normalisation of the situation in the domestic foreign exchange market. The stabilisation of the ruble exchange rate reduced depreciation expectations in the economy, which allowed to mitigate the inflationary effects of the ruble depreciation and to prevent significant growth in deposit dollarisation.

The Bank of Russia considers the change in the parameters of foreign exchange market operations described above to be temporary.

Completing the transition to the floating exchange rate regime by 1 January 2015 remains one of the key objectives in view of the ongoing transition to the inflation targeting regime.

Starting 22 May 2014, the Bank of Russia has been gradually increasing the flexibility of the national currency exchange rate through decreasing foreign exchange intervention volumes aimed at smoothing the volatility of the ruble exchange rate by \$100 million in the internal ranges of the floating operational band. At the same time, taking into account the persistent uncertainty over the development of external conditions, the cumulative volume of interventions triggering a 5-kopeck shift in the operational band borders has been retained at the level of \$1.5 billion⁴.

The unstable situation in the domestic financial market also impacted the conversion operations of the Ministry of Finance. Since 20 February 2014, the Ministry of Finance and the Federal Treasury have started the transfer of funds to the Reserve Fund based on the

⁴ After the drafting of this Report, the parameters of the exchange rate policy were changed. Press release dated 17 June 2014 'On Parameters of Bank of Russia Exchange Rate Policy' can be found under the section 'Press Releases' on the official website of the Bank of Russia (http://www.cbr.ru/press/PR.aspx?file=17062014_100351dkp2014-06-17T09_47_56.htm).

results of 2013, amounting to an equivalent of 212.2 billion rubles. This was implemented through the Federal Treasury purchasing foreign currency from the Bank of Russia in the amount equivalent to 3.5 billion rubles per day. The growing uncertainty in the domestic foreign exchange market and the ruble depreciation prompted the Ministry of Finance and the Federal Treasury to suspend these operations from March 4.

Since 14 April, following the normalisation of the situation in the domestic foreign exchange market, the transfer of additional funds to the Reserve Fund was resumed. Therefore, in order to ensure the flexibility of the mechanism for conducting purchases in the event of any change in the market situation, the amount of foreign currency purchases started to be defined according to the operational band range the dual currency basket was in⁵.

⁵ Press release by the Russian Ministry of Finance dated 10 April 2014 'On the Resumption of Currency Purchase Operations to Supplement the Reserve Fund' can be found under the section 'Russian Ministry of Finance Press Department' ('Press releases') on the Russian Ministry of Finance website (http://www.minfin.ru/ru/press/press-releases/index.php?id_4=21466).

Glossary

Autonomous factors shaping the liquidity of the banking sector

Changes in the balance sheet of a central bank which affect the liquidity of the banking sector, but are not the result of central bank operations to manage liquidity. These autonomous factors include changes in cash in circulation, changes in extended government account balances with the Bank of Russia, Bank of Russia operations in the domestic foreign exchange market (excluding operations regulating banking sector liquidity), as well as changes to the value of required reserves of credit institutions as a result of changes to the reservable base.

Average rate on interbank loans

An average rate on Russian banks' operations to provide loans to other banks. Rates are calculated on all interbank loans (MIACR), loans extended to Russian banks with investment grade ratings (MIACR-IG), and loans extended to Russian banks with speculative grade ratings (MIACR-B). The spread between MIACR-B and MIACR-IG is one of the indicators of credit risk assessment by interbank market participants.

Averaging of required reserves

The right of a credit institution to meet ratios set by the Bank of Russia on required reserves by maintaining a share of required reserves equal to the averaging ratio on a correspondent account with the Bank of Russia during a specified period.

Banking sector liquidity

Credit institutions' funds held in correspondent accounts with the Bank of Russia to carry out payment transactions and to comply with the Bank of Russia's reserve requirements.

Bank lending conditions index

A generalised indicator of changes to bank lending conditions, as calculated by the Bank of Russia based on the results of a quarterly survey among leading Russian banks operating in the credit market as follows: (proportion of banks reporting a significant tightening of lending conditions, as a percentage) + 0.5 x (proportion of banks reporting a moderate tightening of lending conditions, as a percentage) – 0.5 x (proportion of banks reporting a moderate easing of lending conditions, as a percentage) – (proportion of banks reporting a significant easing of lending conditions, as a percentage). Measured in percentage points (pp).

Bank of Russia interest rate corridor (interest rate corridor)

The basis of Bank of Russia interest rate system. The interest rate corridor is structured as follows: the centre of the corridor is set by the Bank of Russia key rate; the upper and lower bounds are symmetric relative to the key rate, and are determined on the basis of overnight standing facilities (deposit facilities and refinancing facilities).

Bank of Russia key rate

Interest rate on main operations of the Bank of Russia to manage banking sector liquidity. A key monetary policy indicator.

Broad money (monetary aggregate M2X)

Total amount of all the components of the monetary aggregate M2 and foreign currency deposits placed by residents of the Russian Federation (households, non-financial and financial (excluding credit) organisations) in operating credit institutions.

Consumer price index (CPI)

The CPI tracks changes over time in the overall price level of goods and services purchased by households for private consumption. It is calculated by the Federal State Statistics Service and is measured as the ratio of the value of a fixed set of goods and services at current prices to the value of the same set of goods and services at prices of a previous (reference) period. The CPI is calculated on the basis of data on the actual structure of consumer spending and is therefore one of the key indicators of household living costs.

Core inflation

Inflation as measured on the basis of a core consumer price index (CCPI). The difference between the CCPI and the consumer price index (CPI) lies in the CCPI calculation method, which excludes a change in prices for individual goods and services subject to the influence of administrative and seasonal factors (fruit and vegetables, fuel, passenger transportation services, communications services, and the majority of housing and public utility services).

Countercyclical currency

A currency which conventionally demonstrates appreciation in periods of instability in global markets and/or recession in the global economy. Specifically, this category of currencies includes the US dollar, Japanese yen, and Swiss franc.

Current liquidity deficit

A situation on any given day where the demand for liquidity from the banking sector exceeds the supply of liquidity covered by daily Bank of Russia operations in the money market. A reverse situation, called 'current liquidity excess', is characterised by the excess of the banking liquidity supply over demand on any given day.

Dollarisation of deposits

Share of foreign currency deposits in total deposits in the banking sector.

Dual currency basket

Operational indicator of the exchange rate policy of the Bank of Russia expressed in the national currency (in rubles) and made up of US dollars and euros (effective since February 2005). The ruble value of the dual currency basket is calculated as the sum of 0.55 US dollars and 0.45 euros in rubles (effective since 8 February 2007).

Fiscal stress indicator

An approach developed by experts at the IMF using an aggregate early crisis warning indicator, calculated on the basis of studies of signals from three complementary groups of indicators: primary budget indicators; long-term budget trends; and, asset and liability management (a total of 12 indicators). For each indicator a threshold is calculated, which, if exceeded, signals the threat of a crisis in the following year (a signal strength is also estimated, i.e. its weight in the fiscal stress indicator). For more details see the methodology in: Baldacci E., McHugh J., Petrova I., 'Measuring Fiscal Vulnerability and Fiscal Stress: A Proposed Set of Indicators'. IMF Working Paper, No. 94, 2011, and Baldacci E., Petrova I., Belhocine N., Dobrescu G., Mazraani S., 'Assessing Fiscal Stress'. IMF Working Paper, No. 100, 2011.

Floating exchange rate regime

Under this regime the exchange rate of the domestic currency is determined predominantly under the influence of market factors, and its path is not predictable. The central bank does not set targets for the level of, or changes to, the exchange rate. In this case, the central

bank conducts foreign exchange interventions to smooth out any excessive exchange rate fluctuations not associated with fundamental factors.

Floating interest rate on Bank of Russia operations

An interest rate tied to the Bank of Russia key rate. If the Bank of Russia Board of Directors decides to change the key rate for loans previously provided at a floating interest rate the interest rate applied will be adjusted in line with the change to the key rate with effect from the corresponding date.

Foreign exchange swap operation

A deal which consists of two legs: one party to the deal initially exchanges a certain amount in a domestic or foreign currency for an equivalent amount in another currency provided by the second party to the deal. Then, once the deal term has expired, the parties reverse-convert the currency (in the corresponding volumes) at a predetermined rate. Foreign exchange swaps are used by the Bank of Russia to provide credit institutions with refinancing in rubles.

Free credit institution reserves

These include balances of correspondent accounts in the currency of the Russian Federation and of deposit accounts of credit institutions with the Bank of Russia, as well as credit institutions' investments in Bank of Russia bonds.

Funds on extended government's accounts

Funds on accounts with the Bank of Russia representing funds of the federal budget, the budgets of constituent territories of the Russian Federation, local budgets, government extra-budgetary funds and extra-budgetary funds of constituent territories of the Russian Federation and local authorities.

Generalised (composite) consumer confidence index

Calculated by Rosstat on the basis of quarterly surveys, as an arithmetical mean value of five indices: occurred and expected changes in personal wealth; occurred and expected changes in the economic situation in Russia; and, the favourability of conditions for high-value purchases. Partial indices are calculated by drawing up the balance of respondents' estimates (as a percentage). The balance of estimates is the difference between the sum of shares (as a percentage) of decisively positive and 1/2 of the rather positive answers and the sum of shares (as a percentage) of negative and 1/2 of the rather negative answers. Neutral answers are not taken into account.

Gross credit of the Bank of Russia

Includes loans extended by the Bank of Russia to credit institutions (including banks with revoked licences), overdue loans and overdue interest on loans, funds provided by the Bank of Russia to credit institutions through repos and foreign exchange swaps.

Inflation targeting regime

A monetary policy framework where the central bank's main aim is to guarantee price stability. Under this regime a quantitative inflation target is set and announced. The central bank is responsible for achieving this target. Typically, under an inflation targeting regime, the monetary policy may affect the economy through interest rates. Decisions are made primarily on the basis of economic forecasts and inflation dynamics. An important aspect of this regime is the practice of offering regular explanations to the public of decisions adopted by the central bank, which guarantees its accountability and transparency.

Interest rate corridor

See Bank of Russia interest rate corridor.

Monetary aggregate M1

Total amount of cash in circulation and balances of funds of non-financial and financial (excluding credit) organisations and households who are residents of the Russian Federation in settlement, current and other on-demand accounts opened in the banking system in the currency of the Russian Federation.

Monetary aggregate M2

Total amount of cash in circulation and cashless funds of non-financial and financial (excluding credit) organisations and households who are residents of the Russian Federation in on-demand accounts and time deposit accounts opened in the banking system in the currency of the Russian Federation.

Monetary policy stance

The characteristics of a monetary policy's impact on the economy. A tight stance suggests the restraining effect of the monetary policy on economic activity in order to reduce inflationary pressures, whereas a loose monetary policy stance suggests economic stimulation with possible upward pressure on inflation.

Monetary policy transmission mechanism

The process which serves to transfer the effect of monetary policy decisions (in particular, decisions made by a central bank in relation to changes to interest rates on its operations) on the economy as a whole and on price dynamics, in particular. The most important channel of monetary policy transmission is the interest rate channel. The impact of the latter is based on the influence of a central bank policy on changes to the interest rates at which economic agents may deposit and attract funds, and as a result on decisions regarding consumption, saving and investment and, thereby, on the aggregate demand, economic activity and inflation.

Money supply

Total amount of funds held by residents of the Russian Federation (excluding general government and credit institutions). For the purposes of economic analysis various monetary aggregates are calculated (see Monetary aggregate M1, Money supply in the national definition and Broad money).

Money supply in the national definition (monetary aggregate M2)

Total amount of all the components of the monetary aggregate M1 and time deposits in the currency of the Russian Federation placed by residents of the Russian Federation (households, non-financial and financial (excluding credit) organisations) in operating credit institutions.

Net credit of the Bank of Russia to credit institutions

Gross credit of the Bank of Russia to credit institutions net of correspondent account balances in the currency of the Russian Federation (including the averaged amount of required reserves) and deposit account balances of credit institutions with the Bank of Russia, and investments by credit institutions in Bank of Russia bonds (at prices fixed as of the start of the current year).

Net private capital inflow/outflow

The total balance of private sector operations involving foreign assets and liabilities recorded on the financial account of the balance of payments.

Nominal effective ruble exchange rate index

The nominal effective ruble exchange rate index reflects changes in the exchange rate of the ruble against the currencies of Russia's main trading partners. It is calculated as the weighted average change in the nominal exchange rates of the ruble to the currencies of Russia's main trading partners. The weights are determined according to the foreign trade turnover share of Russia with each of these countries in the total foreign trade turnover of Russia with its main trading partners.

Non-marketable assets eligible as collateral for Bank of Russia loans

Promissory notes and credit claims eligible as collateral for Bank of Russia loans in accordance with Bank of Russia Regulation No. 312-P, dated 12 November 2007, 'On the Procedure for Extending Bank of Russia Loans Secured with Assets or Guarantees to Credit Institutions'.

Non-price bank lending conditions

Bank lending conditions aside from the cost of a loan to the borrower, such as maximum loan amount and lending term, collateral requirements and the financial standing of the borrower.

Open market operations

Operations carried out on the initiative of a central bank. This type of operations includes auction-based refinancing and sterilisation operations (repo auctions, deposit auctions, etc.), as well as purchases and sales of financial assets (government securities, currency, gold).

Output gap

Deviation of GDP from potential output, expressed as a percentage. Characterises the balance between demand and supply and may be regarded as an aggregate indicator of the effect which the demand factors have on inflation. If the actual output is larger than the potential output (positive output gap), all else equal, inflation is expected to accelerate. A negative output gap is an indicator of an expected slowdown in price growth. Output fluctuations around its potential level are called cyclical fluctuations.

Potential output

The aggregate level of output in the economy achieved under normal utilisation of production factors with existing resource and institutional constraints. Reflects the volume of products that may be produced and sold without creating prerequisites to a change in price growth rates. The level of potential output is not linked to a certain level of inflation; it merely indicates the presence or absence of conditions for the inflation acceleration or deceleration.

Procyclical currency

A currency which conventionally demonstrates appreciation in periods of global economic growth. Specifically, this category of currencies includes the euro, the Canadian dollar, and the Australian dollar.

Real effective ruble exchange rate index

Calculated as the weighted average change in real exchange rates of the ruble to the currencies of Russia's main trading partners. The real exchange rate of the ruble to a foreign currency is calculated using the nominal exchange rate of the ruble to the same currency and the ratio of price levels in Russia to those in the corresponding country. When calculating the real effective exchange rate, weights are determined according to the foreign trade turnover share of Russia with each of these countries in the total foreign trade turnover of Russia with its main trading partners. The real effective ruble exchange rate index reflects changes in the competitiveness of Russian goods in comparison to those of Russia's main trading partners.

Repo operation

A deal which consists of two legs: one party to the deal initially sells securities to the other party in return for cash, and then, once the deal term has expired, buys them back at a predetermined price. Repos are used by the Bank of Russia to provide credit institutions with liquid assets in rubles in exchange for collateral in the form of securities.

RGBEY index

RGBEY (Russian Government Bond Effective Yield to Redemption) index reflects an effective yield to redemption of Russian government bonds calculated as an average gross yield to redemption without accounting for bond issue duration.

Risk premium on the market securities portfolio

Calculated in accordance with the capital asset pricing model as the difference between the yield of a market securities portfolio and the yield of a risk-free asset. The yield of a risk-free asset is, as a rule, taken to be the yield of government securities (for example, OFZ – federal government bonds). Measured in percentage points (pp).

Shadow banking sector

Financial intermediaries providing credit intermediary services whose activity is not regulated by banking legislation.

Standing facilities

Operations carried out by the Bank of Russia to provide and absorb liquidity at fixed interest rates.

Structural deficit of banking sector liquidity

The state of the banking sector characterised by a stable demand by credit institutions for liquidity through operations with the Bank of Russia. The reverse situation, characterised by a stable demand by credit institutions to deposit funds with the Bank of Russia is a structural liquidity surplus.

Structural non-oil and gas primary budget deficit

Budget items that are not dependent on the phase of the business cycle and are determined by general government decisions. It is the aggregate budget deficit, excluding oil and gas revenues, net interest payments, one-off budget revenues, and other items directly dependent on changes in economic activity.

Annex

Table 1

Consumer prices by group of goods and services (month on previous month, %)

	Inflation	Core inflation	Food price growth	Food price growth ¹	Vegetable and fruit price growth	Non-food price growth	Non-food price growth, excluding petrol ²	Service price growth
2012								
January	0.5	0.5	0.8	0.6	2.8	0.4	0.5	0.2
February	0.4	0.4	0.7	0.5	2.1	0.3	0.4	0.0
March	0.6	0.5	0.8	0.6	2.7	0.5	0.5	0.4
April	0.3	0.4	0.2	0.3	-0.4	0.4	0.4	0.3
May	0.5	0.2	0.6	0.0	5.8	0.4	0.3	0.7
June	0.9	0.4	1.6	0.3	13.4	0.2	0.2	0.8
July	1.2	0.5	1.1	0.8	3.5	0.3	0.3	2.7
August	0.1	0.6	-0.5	0.8	-10.8	0.4	0.4	0.6
September	0.6	0.7	0.1	0.8	-5.6	0.7	0.6	1.0
October	0.5	0.6	0.5	0.8	-2.2	0.7	0.6	0.1
November	0.3	0.5	0.5	0.6	-1.3	0.4	0.4	0.0
December	0.5	0.4	0.9	0.7	2.4	0.3	0.3	0.4
Total for the year (December to December)	6.6	5.7	7.5	7.1	11.0	5.2	5.0	7.3
2013								
January	1.0	0.5	1.8	1.2	7.4	0.4	0.4	0.6
February	0.6	0.4	0.8	0.6	2.8	0.4	0.4	0.4
March	0.3	0.4	0.4	0.5	0.1	0.4	0.4	0.2
April	0.5	0.4	0.7	0.4	3.6	0.4	0.4	0.5
May	0.7	0.3	1.0	0.3	6.5	0.3	0.3	0.8
June	0.4	0.3	0.5	0.2	3.0	0.2	0.2	0.6
July	0.8	0.3	0.0	0.4	-3.0	0.1	0.1	3.1
August	0.1	0.5	-0.7	0.6	-11.3	0.5	0.3	0.9
September	0.2	0.7	0.0	0.8	-7.6	0.5	0.4	0.1
October	0.6	0.6	1.1	0.9	3.6	0.5	0.5	-0.1
November	0.6	0.6	0.9	0.7	3.0	0.4	0.5	0.2
December	0.5	0.4	0.8	0.5	2.8	0.2	0.3	0.6
Total for the year (December to December)	6.5	5.6	7.3	7.1	9.3	4.5	4.4	8.0
2014								
January	0.6	0.4	1.0	0.5	5.8	0.3	0.3	0.5
February	0.7	0.5	1.2	0.7	5.1	0.4	0.4	0.4
March	1.0	0.8	1.8	1.3	5.3	0.7	0.6	0.5
April	0.9	0.9	1.3	1.2	2.3	0.6	0.6	0.7
May	0.9	0.9	1.5	1.3	2.4	0.5	0.5	0.8

¹ Excluding vegetables and fruit.

² Bank of Russia estimate.

Sources: Rosstat, Bank of Russia calculations.

Table 2

**Consumer prices by group of goods and services
(month on corresponding month of previous year, %)**

	Inflation	Core inflation	Food price growth	Food price growth ¹	Vegetable and fruit price growth	Non-food price growth	Non-food price growth, excluding petrol ²	Service price growth
2012								
January	4.2	6.0	2.0	6.3	-30.5	6.2	5.9	4.7
February	3.7	5.7	1.5	5.8	-30.8	6.2	5.8	3.9
March	3.7	5.5	1.3	5.5	-29.9	6.2	5.7	3.9
April	3.6	5.3	1.2	5.2	-29.1	6.1	5.6	3.7
May	3.6	5.1	1.7	4.9	-23.8	5.6	5.5	3.7
June	4.3	5.2	3.6	5.1	-10.8	5.4	5.4	3.8
July	5.6	5.3	5.5	5.6	1.7	5.5	5.5	5.9
August	5.9	5.5	6.5	6.1	8.0	5.3	5.5	6.2
September	6.6	5.7	7.3	6.7	13.1	5.4	5.4	7.3
October	6.5	5.8	7.3	7.0	10.1	5.3	5.2	7.2
November	6.5	5.8	7.3	7.0	9.8	5.2	5.1	7.2
December	6.6	5.7	7.5	7.1	11.0	5.2	5.0	7.3
2013								
January	7.1	5.7	8.6	7.8	16.1	5.1	4.9	7.8
February	7.3	5.7	8.7	7.8	16.8	5.3	5.0	8.2
March	7.0	5.6	8.3	7.7	13.8	5.2	4.9	7.9
April	7.2	5.7	8.8	7.7	18.3	5.1	4.9	8.1
May	7.4	5.9	9.2	8.0	19.1	5.0	4.8	8.3
June	6.9	5.8	8.0	7.9	8.2	4.9	4.9	8.1
July	6.5	5.6	6.8	7.4	1.3	4.8	4.6	8.4
August	6.5	5.5	6.5	7.2	0.8	4.9	4.6	8.7
September	6.1	5.5	6.3	7.2	-1.4	4.7	4.4	7.8
October	6.3	5.5	6.9	7.2	4.4	4.5	4.3	7.7
November	6.5	5.6	7.5	7.3	8.9	4.5	4.4	7.9
December	6.5	5.6	7.3	7.1	9.3	4.5	4.4	8.0
2014								
January	6.1	5.5	6.5	6.4	7.7	4.3	4.3	7.8
February	6.2	5.6	6.9	6.5	10.1	4.3	4.3	7.9
March	6.9	6.0	8.4	7.5	15.9	4.6	4.5	8.2
April	7.3	6.5	9.0	8.3	14.4	4.9	4.7	8.5
May	7.6	7.0	9.5	9.5	10.1	5.1	4.9	8.4

¹ Excluding vegetables and fruit.

² Bank of Russia estimate.

Sources: Rosstat, Bank of Russia calculations.

Table 3

Macroeconomic indicators
(seasonally adjusted, growth as % of previous period)

	Industrial production ¹	Agriculture	Construction	Freight turnover	Retail trade turnover	Fixed capital investment	Household consumer spending	Output index of goods and services by key economic activities ²	GDP ³
2012									
January	0.7	0.7	-0.3	2.0	0.2	-0.2	-0.6	0.0	0.9
February	1.7	0.9	0.2	-1.6	1.0	1.0	1.3	0.2	
March	-1.6	0.8	-0.1	1.1	0.1	0.1	0.2	0.0	
April	-0.4	0.7	1.2	-0.3	0.4	-0.1	0.2	0.5	
May	1.1	0.7	-0.8	-0.4	0.7	1.0	1.1	0.5	0.5
June	-1.0	0.5	1.7	0.1	0.4	0.4	0.8	0.0	
July	1.0	1.4	-1.2	0.3	0.1	-0.7	-0.4	-0.2	
August	0.9	0.7	-0.3	0.1	0.3	0.2	0.4	0.6	
September	-1.1	1.4	-5.3	0.9	0.6	0.0	0.7	-0.4	0.4
October	0.7	-1.7	6.5	-2.2	0.2	0.6	0.5	-0.1	
November	-0.4	1.7	-1.8	1.6	0.2	-1.3	0.4	-0.2	
December	1.0	-0.6	0.8	0.2	0.4	0.1	0.5	1.1	
2013									
January	-1.2	0.4	-0.5	-0.9	0.4	1.9	0.7	-0.3	0.1
February	-1.0	0.3	-0.5	0.3	-0.2	-1.2	-0.3	-0.3	
March	1.0	0.3	0.0	-0.2	0.6	-0.1	0.5	0.5	
April	0.2	0.2	-0.9	0.8	0.5	-0.8	0.7	-0.2	
May	-0.2	0.2	0.4	-0.3	0.1	0.7	0.0	-0.1	0.5
June	0.9	0.4	-1.4	-0.5	0.4	-0.8	0.5	0.1	
July	0.0	0.7	13.4	0.3	0.4	0.7	0.6	0.4	
August	-0.1	0.2	-11.6	0.4	0.2	-0.7	0.3	-0.3	
September	0.4	0.2	-0.8	1.0	0.1	-0.7	0.0	0.1	0.7
October	0.3	1.9	-0.3	1.3	0.2	0.5	0.2	0.6	
November	1.0	-0.6	0.4	-2.2	0.4	0.2	0.3	0.4	
December	-1.0	-0.5	-1.0	1.7	0.1	-0.6	0.3	-0.8	
2014									
January	-0.9	0.2	0.0	0.2	0.1	-1.9	-0.4	-0.3	-0.9
February	0.8	0.2	-0.1	-1.3	0.4	0.9	0.8	0.7	
March	0.2	0.3	-0.4	-0.1	0.2	-0.6	0.3	-0.2	
April	0.8	0.3	-0.1	0.0	0.0	0.3	-0.2	0.1	

¹ Rosstat estimate.

² Output index of goods and services by key economic activities.

³ Quarterly data.

Sources: Rosstat, Bank of Russia calculations.

Table 4

Macroeconomic indicators
(as % of corresponding period of previous year)

	2014					Memo item: January-April 2013
	January	February	March	April	January-April	
Output of goods and services by key economic activities	-0.5	1.1	0.4	0.6	0.4	0.7
Industrial output	-0.2	2.1	1.4	2.4	1.4	-0.6
Agricultural output	0.8	1.0	1.3	1.8	1.3	1.2
Fixed capital investment	-7.0	-3.5	-4.3	-2.7	-4.3	-0.1
Construction	-5.4	-2.4	-3.1	-2.8	-3.3	-0.7
Retail trade turnover	2.6	3.9	4.0	2.6	3.3	4.1
Household real disposable money income	-0.5	0.5	-7.0	1.9	-1.2	6.3
Real imputed per employee wage	5.2	4.6	3.8	0.8	3.4	5.5
Number of unemployed	-6.6	-2.5	-5.4	-4.7	-4.8	-5.8
Unemployment (as % of economically active population, at end-period)	5.6	5.6	5.4	5.3	5.3	5.6

Sources: Rosstat, Bank of Russia calculations.

Table 5

Change in Bank of Russia forecasts of GDP growth of Russia's main trading partners in 2014

		Forecast of GDP growth in 2014, %		Memo item: country's share in aggregate GDP of trading partners, %
		June	February	
	Total	1.7	2.2	100.0
1	The Netherlands	0.6	0.4	15.7
2	Italy	0.3	0.5	8.7
3	Germany	2.0	1.7	8.0
4	China	7.4	7.5	7.0
5	Ukraine	-5.0	1.6	6.5
6	Turkey	2.5	3.3	6.4
7	Belarus	1.1	1.5	5.9
8	Poland	3.3	2.9	4.9
9	United Kingdom	3.0	2.4	3.5
10	United States	2.5	2.8	3.5
11	Finland	0.1	1.1	3.4
12	Kazakhstan	5.6	6.1	3.4
13	Japan	1.3	1.7	3.3
14	France	0.8	0.8	3.2
15	Korea, Republic of	3.7	3.6	2.8
16	Switzerland	2.0	2.2	2.6
17	Latvia	3.5	4.2	1.9
18	Hungary	2.3	1.8	1.8
19	India	5.1	5.4	1.7
20	Belgium	1.3	1.1	1.5
21	Czech Republic	2.0	1.8	1.5
22	Slovakia	2.5	2.2	1.5
23	Spain	1.1	0.6	1.3

Source: Bank of Russia.

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