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The review provides a detailed analysis of main trends in Russia's economy in 2011. The paper contains 6 big sections that highlight single aspects of Russia's economic development: the socio-political context; the monetary and credit spheres; financial sphere; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts.

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Russia's 2011 Monetary Policy

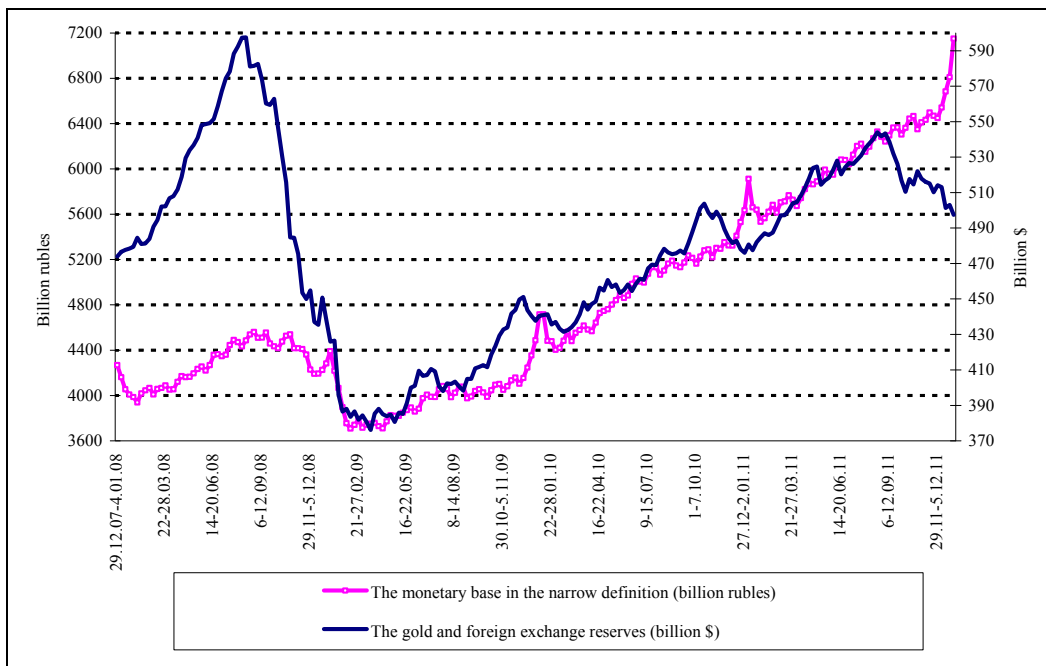
The main developments in the monetary sphere in 2011 can be nominally divided into two periods: from January till August and from August till the end of the year. In the first six months, continuation of the trends typical of the year 2010 was observed, that is, a smooth recovery of the financial sector of the economy with simultaneous growth in the money supply, international reserves of the Bank of Russia and moderate inflation rate. In the above period, the Bank of Russia kept scaling down its anti-crisis support of the financial sector. In August, the second period began and it formally resembled to a great extent the beginning of the crisis of 2008–2009: due to the outflow of the private capital and closing of foreign markets to Russian borrowers the banking sector started to experience again difficulties in attraction of liquid resources, interest rates went up, while the international reserves decreased. It is to be noted that the growth in the outflow of the capital took place in a situation where global prices on the main commodities of the Russian export remained high. The main factors behind that outflow were the negative trend in the global economy (the debt problems in the EU and the USA in a situation of slow economic growth in those countries).

In all appearances, the development of the global economy will be inconsistent within quite a long period of time, so, the above mentioned fluctuations on the Russian financial market are likely to remain in the next few years. In such a situation, the Central Bank of the Russian Federation gradually gave up its substantial interference in the functioning of the foreign exchange market by means of currency interventions and concentrated its efforts to reduce the inflation rate in the Russian Federation by trying to use the interest rates as the main instrument of the monetary and credit policy.

2.1.1. The Money Market

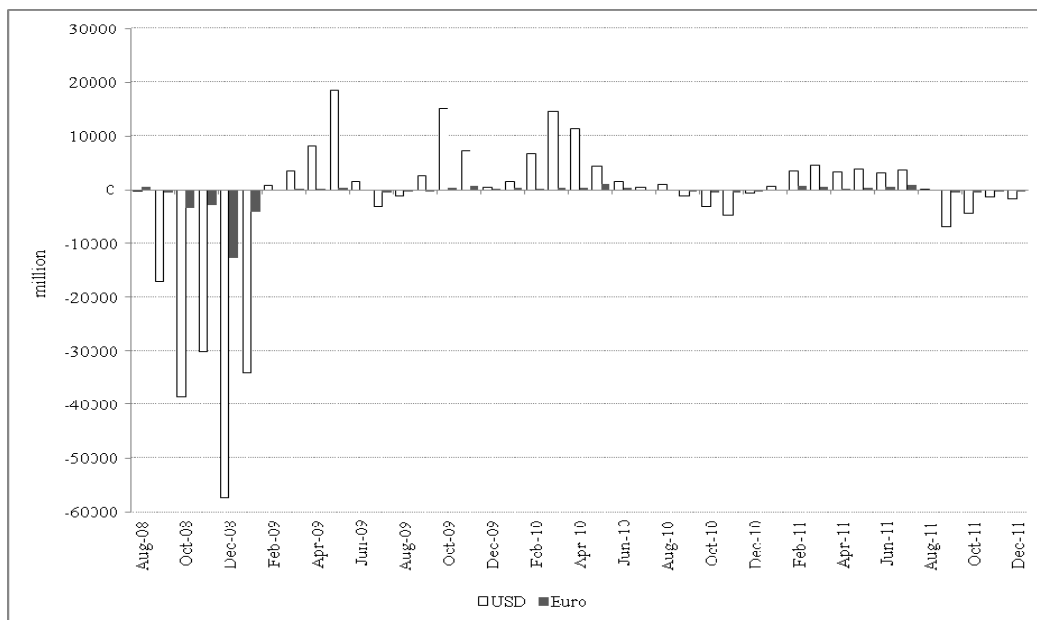
From the beginning of the year till August 2011, as well as in 2010, growth in the international reserve assets of the Bank of Russia was observed (see *Fig. 1*). The main factor behind such growth in reserves became rising oil prices which in the Q2 2011 reached the record-high levels in the past three years. In addition to the above, due to the volatile situation on the global financial markets in the first six months of 2011 prices on gold which is a part of the international reserves of the Bank of Russia rose dramatically. As a result, in August the international reserves amounted to \$544bn which is a 13.2% increase from the beginning of the year. The above value was the maximum one since autumn 2008.

Intensification of the capital outflow in September was related to the aggravation of the global financial crisis, that is, downgrading by Standard & Poor's, an international rating agency of the US credit rating from AAA to AA+ and the subsequent fall of international stock markets and oil prices. Investors started to withdraw funds from risk assets worldwide, including the Russian Federation. However, a dramatic decrease in the reserves was primarily related to depreciation of the Euro exchange rate against the USD as a drop in the Euro/USD exchange rate resulted in a decrease in the USD value of the portion of the Euro-denominated reserves. The Russian Central Bank's interventions on the foreign exchange market were insignificant: the mere \$7.5bn and Euro 0.6bn were sold (see *Fig. 2*).



Source: The Central Bank of the Russian Federation.

Fig. 1. The dynamics of the monetary base in the narrow definition and the international reserve assets of the Central Bank of the Russian Federation in the 2008 – 2011 period



Source: The Central Bank of the Russian Federation.

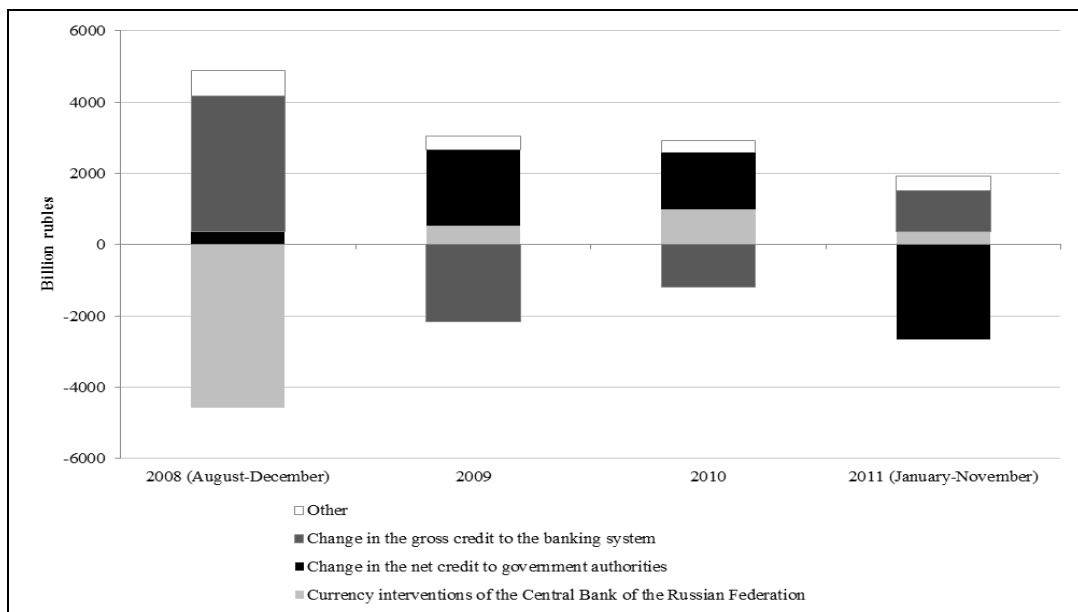
Fig. 2. Net purchases by the Bank of Russia of foreign exchange in the 2008–2011 period

After the 2008 crisis, the monetary base in the broad definition grew at a higher rate than the international reserves, however, in 2011 the expansion of the monetary base virtually

stopped. The rapid recovery of the monetary base in 2009 and 2010 was related primarily with utilization of the resources of the Reserve Fund to finance the budget deficit (see *Fig. 3*). It is to be noted that commercial banks returned loans received during the crisis to the Bank of Russia which situation led to a shrinkage of the money supply.

In 2011, the budget was administered with a surplus and there was no need to spend the resources of the Reserve Fund. In addition to that, the surplus of the budget accumulated in the accounts of the Government of the Russian Federation restrained growth in the monetary base. As was stated above, in 2011 the currency interventions by the Bank of Russia happened to be insignificant as well.

During the 2008–2009 crisis and the post-crisis period, operations of the Central Bank of the Russian Federation as regards provision of funds to commercial banks had a considerable effect on the money supply (see *Fig. 4*). In autumn 2011, when credit institutions were in need of liquid resources again the Bank of Russia increased the volume of funds extended to commercial banks and that situation became the main factor behind the growth in the monetary base. It is to be noted that on a year on year basis the monetary base increased by the mere Rb 0.5 trillion (+5.5%) with the December growth in the monetary base amounting to Rb 1.2 trillion. In 2010, the monetary base grew by Rb 1.7 trillion (+26.6%).



Source: The Central Bank of the Russian Federation, the IEP calculations.

Fig. 3. The main factors behind the change in the monetary base (in the broad definition) in the 2008–2011 period¹

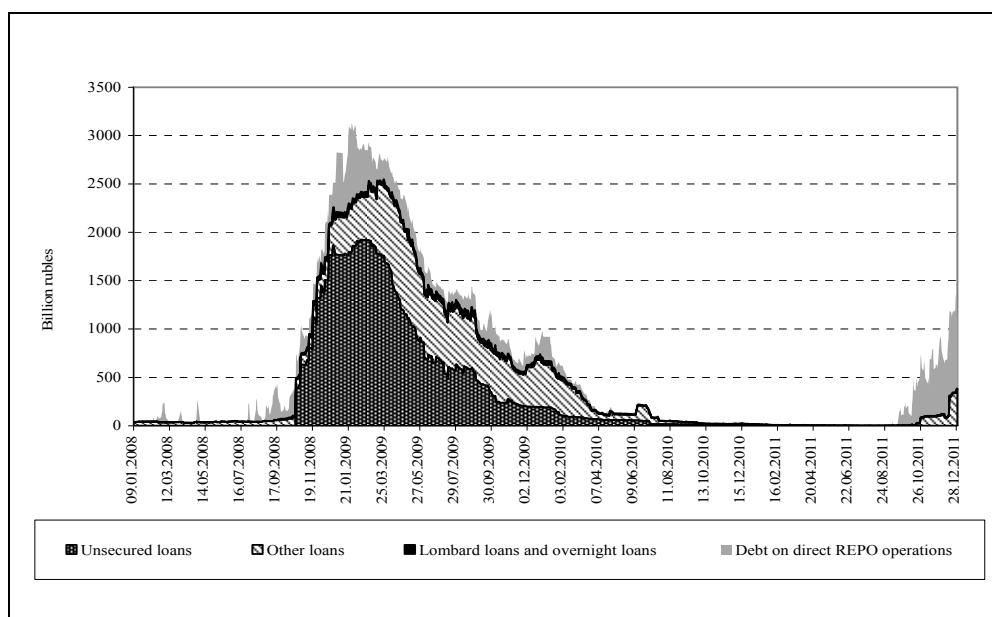
¹ The period under review in 2008 and 2011 is determined by availability of the data on the currency interventions by the Bank of Russia and the balance of the Bank of Russia as of the date of preparation of this review.

Table 1

The balance of the Bank of Russia in the 2010–2011 period

	01.01.2010		01.01.2011		01.12.2011	
	Billion rubles	% of assets/liabilities	Billion rubles	% of assets/liabilities	Billion rubles	% assets/liabilities
Funds deposited with non-residents and securities of foreign issuers	12383.3	80.3	13272	85.5	14142	76,4
Loans and deposits	1705.8	11.1	514	3,3	1657	8.9
Precious metals	764.6	5.0	1 201	7.7	1602	8.7
Securities	465.9	3.0	441	2.8	421	2.3
Other assets	100.3	0.7	99	0.6	697	3.8
Total assets	15420	100	15526	100	18519	100
Cash in circulation	4629.9	30	5792	37.3	6150	33.2
Funds in accounts with the Bank of Russia	7979.7	51.7	6431	41.4	8532	46.1
<i>Including those of the Government of Russia</i>	4980.2	32.3	3270	21.1	5263	28.4
<i>Resident-credit institutions</i>	1731.3	11.2	1817	11.7	1328	7.2
Funds in settlements	8.4	0.1	7	0.0	33	0.2
Issued securities	283.1	1.8	589	3.8	0	0.0
Other liabilities	168.3	1.1	145	0.9	1397	7.5
Capital	2099.1	13.6	2359	15.2	2407	13.0
Profit of the reporting year	251.4	1.6	204	1.3	0	0.0
Total liabilities	15420	100	15526	100	18519	100

The source: The Bank of Russia.



Source: The Central Bank of the Russian Federation, the IEP calculations.

Fig. 4. The commercial banks' debt to the Central Bank of the Russian Federation on individual instruments of refinancing in the 2008–2011 period

Here is a more detailed analysis of the structure of the monetary base in the broad definition (see Table 2). In 2011, the growing components of the monetary base were the cash funds and mandatory reserves. Growth in the mandatory reserves was related to a threefold increase by the Central Bank of the Russian Federation of mandatory reserve requirements in the first six months within the frameworks of return of such requirements to the pre-crisis level. At the same time, lack of channels for such a sustained expansion of the monetary base as was stated

above, as well as problems in the global economy which resulted in the capital outflow and difficulties in refinancing of Russian companies caused a reduction in liquidity in the banking sector. As a result, bank's excessive reserves fell within a year: correspondent accounts of commercial banks with the Central Bank of the Russian Federation remained virtually unchanged at on a year-on-year basis (–1.3%), however, banks' deposits decreased by 38.7%, while credit institutions' investments into bonds of the Central Bank of the Russian Federation dropped from nearly Rb 600bn as of the beginning of the year to zero.

Table 2

The dynamics of the monetary base in the broad definition in 2011 (billion rubles)

	01.01.2011	01.04.2011	01.07.2011	01.10.2011	01.01.2012
Monetary base (in broad definition)	8 190.3	7 514.2	7 410.3	7 407.9	8644.1
- cash funds in circulation with cash balances at cashier's offices of credit institutions taken into account	5 785.2	5 482.7	5 787.8	6 059.5	6895.8
- correspondent accounts of credit institutions with the Bank of Russia	994.7	597.2	786.5	781.6	981.6
- mandatory reserves	188.4	244.1	331.3	347	378.4
- deposits of credit institutions with the Bank of Russia	633.2	786.7	486.4	209.5	388.3
- bonds of the Bank of Russia with credit institutions	588.9	403.4	18.3	10.3	0

Source: The Central Bank of the Russian Federation.

In 2011, the M2 money supply in the national definition increased by 22.6% and amounted to Rb 24.5 trillion as of January 1, 2012 or 45.1% of the GDP. In 2011, monetization of the GDP rose by 0.8%. In 2011, as the financial system of Russia developed the growth of the money multiplier continued; within a year it grew by 16% and was equal to 2.8 as of January 1, 2012 as compared to 2.4 as of January 1, 2011.

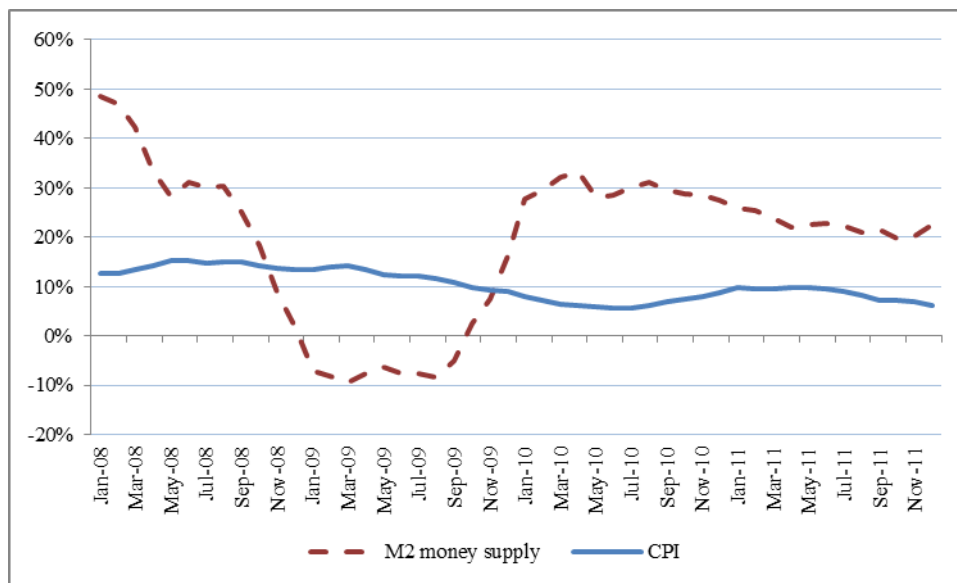
Thus, in 2011 the main factors behind slow growth in the money supply became insignificant interventions by the Central Bank of the Russian Federation on the foreign exchange market; the stable and positive balance of payments which was formed as a result of a positive current account balance and negative capital and financial instruments account balance (see the relevant section of the review) contributed to limitation of such interventions. It is to be noted that the Reserve Fund was not spent, but replenished. In such a situation, the main sources of the money supply growth became the Russian Central Bank's operations related to refinancing of the banking sector. At present, it can be asserted that the existing trends are likely to continue in 2012 which factor results in a slow expansion of the money supply in case of absence of external shocks.

2.1.2. Inflationary Developments

At year-end 2011, the inflation rate in the Russian Federation turned out to be the minimum one in the entire latest history of the Russian Federation. Such a result became feasible thanks to a good combination of both monetary and non-monetary factors. It is to be noted that judging by the inflation rate in January-May it was difficult to predict such a slowdown of the growth rates of prices because the growth in prices in that period in general was the same as in the corresponding period of 2010. A drop in the inflation rate against 2010 was achieved in the second half of the year.

As seen from *Fig. 4*, the growth rates of the money supply began to fall from autumn 2010 which situation could not but have an impact on inflationary developments in 2011. Non-

monetary factors behind the rate of inflation include, among other things, the stable exchange rate of the ruble (see the section which deals with the analysis of the balance of payments of the Russian Federation), slow economic growth and a good yield of agricultural products. It is to be noted that despite some weakening of the ruble at the end of summer and in autumn the nominal effective rate of the ruble on a year on year basis did not change much (+2.4%) which situation means that with all other things being equal ruble prices on imported goods remain stable.



Source: Rosstat, the Central Bank of the Russian Federation and the IEP calculations

Fig. 5. Growth rates of consumer prices and M2 money supply in the Russian Federation in 2008–2011 (on a year-on year basis)

Here is a more detailed analysis of the dynamics of inflationary developments in 2011. As seen from *Table 3*, the main factor behind the slowdown of the inflation rate was the fact that growth rates of prices on food products were slower as compared to the previous years. Price rises on meat and fowl (+9.2%), fish and seafood (+10.3%), as well as bread and bakery products (+8.9%) made the main contribution to the growth in prices on food products.

Prices on housing and utilities services continued to grow (+11.7%), but at a slower rate than in 2010. A noticeable growth in prices on pre-school education services (+11.3%), health and recreation services (+9.1%) and services rendered by entities of culture (+11.3%) was observed.

In 2011, prices on non-food products grew at a higher rate than in 2010. It can be partly explained by the growth in prices on gasoline (14.9%), tobacco products (21.1%) and building materials (7.9%).

It is to be reminded that in 2012 the annual raising of the tariffs (regulated by the government) on paid services to the households was postponed from January 1 to July 1. Due to the above, in the first six months the inflation rate on a year on year basis is likely to go down. If the Central Bank of the Russian Federation goes ahead with its policy of limited interference into functioning of the foreign exchange market provided that no serious external shocks take

place and a reasonable budget policy is carried out a further drop in the inflation rate may be expected in the Russian Federation by the year-end 2012.

Table 3

**The annual growth rates on individual types of goods and services
in the 2008–2011 period (% of December of the previous year)**

	2008	2009	2010	2011	2008 – 2011
CPI	13.3	8.8	8.8	6.1	42.3
Food products	16.5	6.1	12.9	3.9	45.0
<i>Cereals and bean products</i>	25.8	-2.5	58.8	-8.0	79.2
<i>Butter</i>	10.5	7.9	23.3	6.6	56.7
<i>Sunflower oil</i>	22.1	-19.8	27.6	4.6	30.7
<i>Pasta</i>	33.8	1.6	4.7	3.4	47.2
<i>Milk and dairy products</i>	12.2	2.3	16.7	6.3	42.4
<i>Bread and bakery products</i>	25.9	2.4	7.6	8.9	51.1
<i>Meat and fowl</i>	22.2	5.0	5.3	9.2	47.5
<i>Fish and sea products</i>	15.1	10.6	4.8	10.3	47.2
Non-food products	8.0	9.7	5.0	6.7	32.7
<i>Building materials</i>	11.3	2.1	4.6	7.9	28.3
<i>Motor gasoline</i>	1.2	8.0	6.5	14.9	33.7
Services	15.9	11.6	8.1	8.7	52.0
<i>Housing and utilities services</i>	16.4	19.6	13.0	11.7	75.7
<i>Pre-school education services</i>	20.7	16.2	7.7	11.3	68.1
<i>Health and recreation services</i>	21.2	9.5	5.4	9.0	52.5
<i>Passenger transport services</i>	22.5	6.5	8.7	9.1	54.7
<i>Services of entities of culture</i>	15.5	11.3	8.6	11.3	55.4

Source: Rosstat.

2.1.3. The main measures in the sphere of the monetary and credit policy

Early in 2011, after numerous cuts in the interest rate on its instruments during and after the crisis the Bank of Russia made its monetary and credit policy tough again. Last year, the rate of refinancing was raised twice. It is to be noted that it took place in the first six months (on February 28 and May 3); within that period the rate of refinancing rose from 7.75% to 8.25%. Simultaneously, with raising of the rate of refinancing by a comparable value the interest rates on operations related both to absorption and provision of liquidity increased. Late in May, the rates on deposit operations of the Central Bank of the Russian Federation were raised by 0.25% with other rates (including the rate of refinancing) remaining unchanged.

In the same period, the Central Bank of the Russian Federation raised three times the mandatory reserve requirements. Starting from February, for three months running the Bank of Russia declared about toughening of the reserve requirements: as regards ruble and foreign currency liabilities of credit institutions to non-resident-legal entities the reserve requirements were raised from 2.5% to 3.5% from February 1, then, from 3.5% to 4.5% from March 1 and, for the third time, from 4.5% to 5.5% from April 1; as regards liabilities to individuals and other ruble and foreign currency liabilities of credit institutions the reserve requirements were raised from 2.5% to 3% from February 1, then, from 3% to 3.5% from March 1 and, for the third time, from 3.5% to 4% from April 1. It is to be noted that reserve requirements as regards liabilities to non-residents were raised to a greater extent which factor reflects the intentions of the Bank of Russia to discourage borrowings from abroad in a situation of financial instability in order to reduce foreign exchange risks. As a result of raising of the reserve requirements, they returned to the level of the first half of 2008.

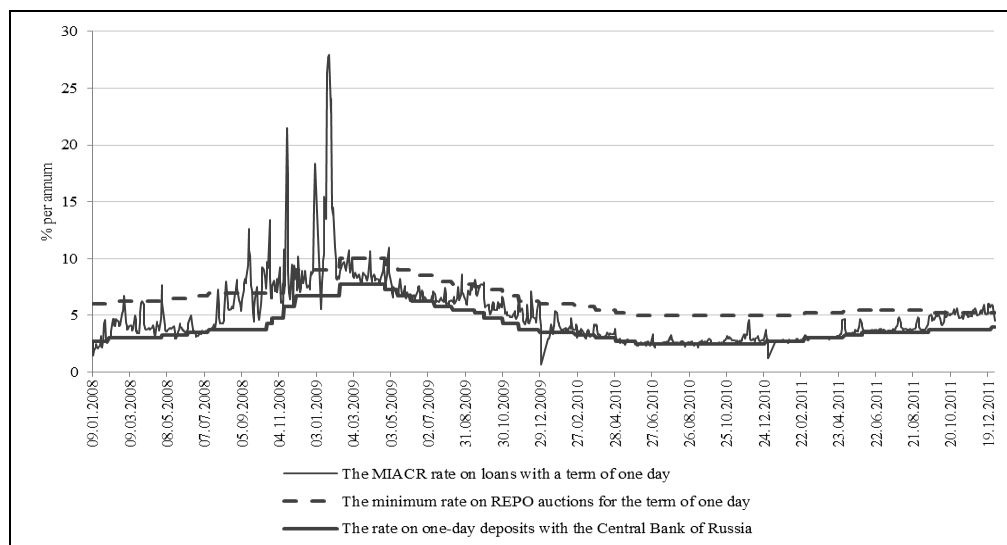
Additional efforts as regards toughening of the monetary and credit policy and scaling down of anti-crisis measures included the following:

- On January 31, 2011, the Central Bank of Russia made a decision to raise requirements to the ratings of issuers whose securities were included in the Lombard list of the Bank of Russia. From April 1, 2011, the minimum rating was raised from B-/B3 to B/B2, while from July 1, 2011, from B/B2 to B+/B1 according to the classification of rating agencies Standard & Poor's, Fitch Rating and Moody's Investors Service.
- From February 10, 2011, the Bank of Russia suspended operations as regards extension to credit institutions of loans (secured with assets or sureties) for the period from 91 days to 180 days, as well as Lombard loans at a fixed interest rate for the period of 30 days.
- From July 1, the Bank of Russia suspended conclusion of direct REPO deals with credit institutions in which deals equities of Russian companies were used as a collateral.

The main reason for toughening of the monetary and credit policy was a speed-up of the inflation rate in the beginning of the year. In addition to that, the above decision was aimed at sterilization of such an accumulated excessive liquidity in the banking system as was formed due to banks' huge profits which were received as a result of reduction of loan loss reserves, growth in the value of investments in securities as a result of the post-crisis recovery of stock markets and increase in the interest margin. To attract banks' available funds into deposits with the Central Bank of Russia, the latter kept raising interest rates on such deposits. It is to be noted that the Central Bank of the Russian Federation narrowed the spread between the rates on provision and absorption of liquidity (see *Fig. 6*). Such a policy contributed to greater role of interest rates as PSA instruments within the frameworks of a switchover to the inflation targeting regime. It is to be noted that in a situation of excessive liquidity the market interest rates were primarily influenced by the rates on deposits with the Bank of Russia (for instance, in 2010), while in the periods of a shortage of liquidity (autumn – winter 2011), by the rates on the Russian Central Bank's liquidity provision instruments. Thus, by changing interest rates and setting limits on provision of loans to commercial banks, the Bank of Russia has a significant impact on the situation on the money market and actually determines both the volume of the supply and the cost of money.

In mid-September, in a situation of the growing financial instability the Bank of Russia reduced by 0.25 % the minimum rates both on operations related to provision of liquidity on the open market (Lombard auctions and direct REPO auctions) and most of its permanent operations (Lombard loans, direct REPO operations, gold-secured loans, non-market assets or sureties). Simultaneously, the Bank of Russia increased interest rates on permanent deposit operations by 0.25 %. Thus, the Central bank of Russia reduced ever more the spread between the rates on loans and deposits which factor is to contribute to higher efficiency of its interest rate policy.

Also, as the situation with liquidity on the banking market was getting worse the Bank of Russia made a decision to expand the banks' refinancing opportunities. From November 1, the Central Bank of Russia resumed extension of loans secured with non-market assets or sureties for the period from 91 days to 180 days at the rate of 7.5%. In addition to that, from the above date the term of the gold-secured loans was extended to 180 days. Thus, the instruments of refinancing which the Bank of Russia used for backing the liquidity of banks during the 2008-2009 crisis became available again to commercial banks.



Source: Rosstat, the Central Bank of the Russian Federation, the IEP calculations.

Fig. 6. The rates of the Central Bank of the Russian Federation on the main operations related to provision and absorption of liquidity, as well as the rate on the inter-bank lending market in the 2008–2011 period

On November 25, the Bank of Russia declared that from December 5, 2011 the minimum ratings which the securities issuers were required to have in order to be included in the Lombard list of the Central Bank of Russia would be lowered. Also, starting from December 1 the Bank of Russia stopped applying a discount in calculation of the cost of a security in direct REPO operations for the period of up to six calendar days with federal loan bonds and bonds of the Bank of Russia. And finally, from December 1 the adjustment ratio which is applied for adjustment of the cost of the federal loan bonds which are accepted as security for loans of the Bank of Russia was raised from 0.98 to 1. The decisions made were aimed at providing commercial banks with more opportunities to attract refinancing from the Bank of Russia.

The activities of the Bank of Russia in the second half of the year were aimed at support of the banking sector and demonstrated that in case of worsening of the global economic situation the Central Bank of Russia was prepared to make up promptly for the shortage of liquidity.

In general, to our opinion, judging by the results of 2011 the Bank of Russia has made progress in its switchover to inflation targeting by means of interest rates. However, it is to be noted that the external factors were favorable for doing that. In particular, the total surplus of the balance of payments was insignificant, a good harvest contributed to reduction in prices on agricultural products and no urgent measures to support the financial sector or “cool” the economy were required. At the same time, the efficiency of further steps in introduction of inflation targeting will depend to a great extent on the global economic situation which remains highly uncertain. However, it is believed that the policy of the Bank of Russia aimed at both reduction of its interference in the functioning of the foreign exchange market and management of the money supply by means of the interest rates is a correct one.

In conclusion of this section, it is to be noted that early in November the Bank of Russia submitted for consideration to the State Duma the draft Guidelines for the Unified State Monetary and Credit Policy in 2012 and the 2013-2014 period. In the next three years, the Central

Bank of Russia is planning to complete the switchover to inflation targeting. Within the frameworks of the strategy of the consistent reduction of the growth rates of prices, a goal was set to reduce the inflation rate to 4%–5% a year by 2014. According to the Central Bank of the Russian Federation, the main objective of its interest rate policy consists in reduction of its direct interference into the exchange rate mechanism and creation of conditions for a switchover to the floating exchange rate regime. With interference of the Central bank of the Russian Federation into functioning of the foreign exchange market becoming less substantial, the interest rate management policy will have a key role to play in the process of monetary and credit regulation. The decision on changing of interest rates will be normally passed on a monthly basis with the analysis of inflationary developments taken into account.

Other important objectives set by the Bank of Russia in the mid-term prospect are as follows:

- Support of financial stability (for that purpose the Bank of Russia will pay a particular attention to a timely identification and evaluation of the risks taken by banks and ensuring of transparency in credit institutions' activities); it is believed that within the frameworks of attainment of the above goal a particular attention is to be paid to the issues of the macroprudential regulation and counter-cycling supervision over commercial banks;
- Development of the infrastructure of the financial markets and expansion of their capacity; it is believed that the best contribution of the Central Bank of the Russian Federation in solution of that issue is ensuring of financial stability and the low rate of inflation which prompts economic agents to saving;
- Raising of information openness by the Bank of Russia in the sphere of the monetary and credit policy; in the past few years the Bank of Russia has made large progress in making its policy transparent and at present it is catching up with the world's best prototypes; at the same time it has got the potential for upgrading the quality of the analytical work and analysis of the macroeconomic situation.

2.1.4. Balance of Payments¹ and the RUR Exchange Rate

In 2011, continuation of the soft monetary and credit policy by leading global economies and rising tensions in the Middle East and North Africa prompted growth in prices on primary products. As a result, the export of products of the fuel and energy complex from the Russian Federation rose by 34% as compared to the previous year. At the same time, at year-end the capital outflow from Russia turned out to be much higher than it was expected by the Government and the Bank of Russia which situation points to the fact that the risks of investment into the Russian economy are high. As a result, at year-end the country's balance of payments was quite strong, however, in the mid-term prospect its vulnerability to the foreign economic market situation is apparent.

According to the preliminary evaluation of the 2011 balance of payments of the Russian Federation published by the Central Bank of the Russian Federation, the current account balance amounted to \$ 101.1bn, which is an increase of 44% as compared to 2010 (*Table 4*). The trade balance rose by 31% (from \$151.7bn to \$198.1bn) with export of goods increasing by 30% (from \$400.4bn to \$ 21.4bn) and import, by the same 30% (from \$248.7bn to \$323.3bn).

¹ Analysis of the balance of payments was carried out on the basis of preliminary data of the Central Bank of Russia. http://cbr.ru/statistics/print.aspx?file=credit_statistics/bal_of_payments_est.htm&pid=svs&sid=opb

The share of the export of oil, petroleum products and natural gas amounted to 65.3% of the total value of export and increased by 1.9 % as compared to 2010. It is to be noted that in 2011 the volume of both the export and import turned out to be the record-high in the entire latest history of the Russian Federation.

Thus, as in the previous years the main factor which determined the value of the current account balance was the trade balance which in its turn depended to a great extent on movement of prices on energy carriers and other important goods of the Russian export on global markets. On the basis of the data shown in *Fig. 7*, it is seen that such a relation between the global prices on oil and the trade balance as was observed in the 2002–2010 period was evident throughout 2011 as well.

The deficit of the balance of services amounted to \$37.1bn and rose (in absolute value) by 27% as compared to 2010. The export of services amounted to \$55bn and rose by \$9.9bn as compared to the previous year (+2%). In 2011, the import of services rose by 24% and amounted to \$92.1bn.

In 2011, the balance of labor remuneration increased in absolute value and amounted to \$9.4bn (as against \$8.5bn in 2010). In 2011, the deficit of the balance of investment income rose by 18% as compared to 2010 and amounted to \$47.3bn. Investment income receivable rose from \$ 3.7bn to \$39.3bn. Growth in income receivable as regards non-financial institutions from \$ 61.7bn to \$73.1bn determined the growth in the total income receivable from \$73.8bn to \$ 86.6bn.

In 2011, the balance of current transfers¹ amounted to \$3.2bn (against \$3.6bn in 2010).

So, in 2011 the main factor behind preservation of a considerable current account balance of the balance of payments of the Russian Federation was growth in prices on the main commodities of the Russian export. In particular, the average annual price on Brent oil increased by 40%. It is to be noted that in 2011 growth in the external private sector debt of the Russian Federation renewed (see *Table 4*). If in 2010 the external debt of banks and the non-financial sector decreased by \$27bn, in 2011 the growth in their debt amounted to \$51.3bn. As regards the external public debt, it did not change much within the year and decreased by \$1.3bn. A favorable situation on the market of energy carriers permitted to form the state budget with a surplus and do virtually without borrowings on the foreign market. In the short-term prospect, growth in the external debt, both private and public, due to a shortage and high cost of financial resources on the domestic market, as well as the budget deficit can be expected.

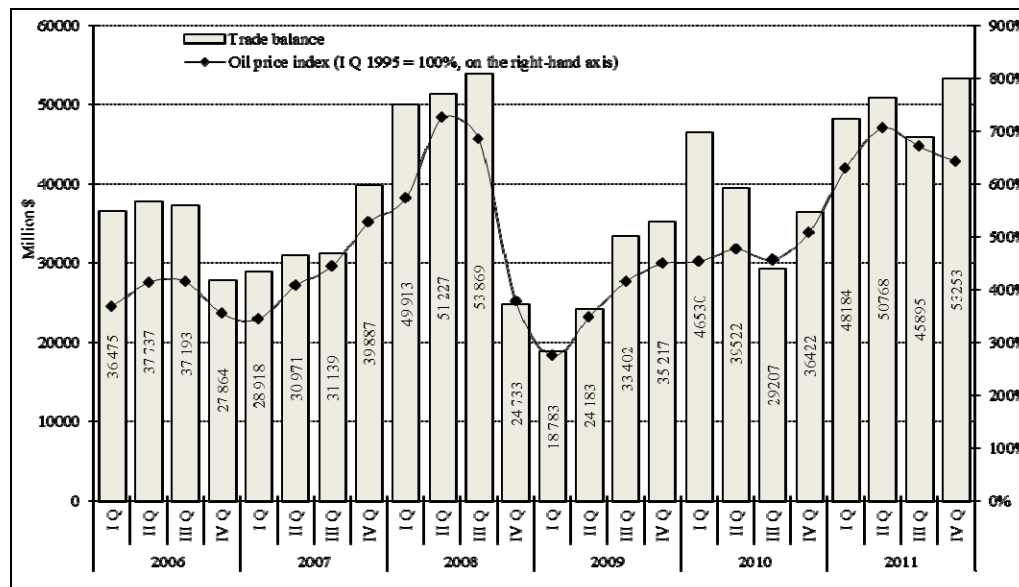
¹ According to the information of the Central Bank of Russia, the current transfers increase the level of the disposable income and consumption of goods and services on the part of recipients and decrease the disposable income and potential consumption opportunities of the donor, for instance, humanitarian aid in the form of consumer goods and services. The current transfers are recorded in the current account. Transfers which are not current by definition are capital ones. Capital transfers result in changes in the volume of assets and liabilities of the donor and the recipient and are recorded in the capital account. If the donor and the recipient are residents of different countries the capital transfer results in a change in the level of national wealth of the economies they represent. An example of capital transfers may be a free of charge transfer of the title to property to capital assets and debt forgiveness.

Table 4

The main items of the balance of payments and the dynamics of the foreign debt in the 2009–2011 period (billion \$)

Index	2009					2010					2011				
	I Q.	II Q.	III Q.	IV Q.	Year	I Q.	II Q.	III Q.	IV Q.	Year	I Q.	II Q.	III Q.	IV Q. ¹	Year ²
Current account	9.7	8.0	15.1	15.9	48.6	33.6	18.5	5.5	12.7	70.3	31.2	21.9	18.4	29.6	101.1
Capital and financial instruments account ³	-32.4	3.3	-26.7	12.2	-43.5	-11.6	9.2	-6.6	-16.5	-25.5	-15.9	-8.7	-20.2	-30.5	-75.3
Change in the foreign exchange reserves ("+" means reduction, while "-", growth in the reserves)	30.5	-14.2	9.1	-28.8	5.1	-16.6	-26.1	-2.7	8.6	44.8	-10.1	-12.9	1.8	8.6	-12.6
Net errors and omissions	-7.8	2.9	2.6	0.6	-1.7	-5.5	-1.6	3.8	-4.8	-8.0	-5.2	-0.3	0.1	-7.7	-13.1
Change in the external debt of the RF ("+" means growth, while "-", debt reduction)	19.1	51.5	6.3	-60.3	16.6	-34.2	19.6	7.9	-6.7	-13.3	20.7	29.2	-11.8	11.9	50.0
Change in the external public debt of the RF	0.2	-1.5	-2.0	-3.7	-7.1	-2.4	4.1	9.4	2.5	13.7	1.3	0.0	-2.7	0.0	-1.3
Change in the external private sector debt of the RF	19.0	53.0	8.4	-56.6	23.7	-31.8	15.5	-1.5	-9.2	-27.0	19.4	29.2	-9.1	11.8	51.3

Source: The Central Bank of Russia.



Source: The Central Bank of the Russian Federation, ICE Stock Exchange and the IEP calculations.

Fig. 7. Trade balance of the Russian Federation and the global oil price index in 2006–2011

¹ Preliminary evaluation.

² Preliminary evaluation.

³ Without taking into account foreign exchange reserves.

In 2011, capital and financial instruments account balance grew considerably in absolute value and amounted to \$75.3bn. In 2011, the balance of capital transfers amounted to \$0.1bn. So, in 2011 the deficit of the financial account amounted to \$75.2bn.

Growth in liabilities of Russian economic agents to foreign economic agents amounted on a year-on-year basis to \$ 65bn which figure is 50% higher than the index of the previous year (\$ 44.4bn).

In 2011, external liabilities of federal regulatory authorities rose by the mere \$ 0.3bn, while the reduction in external liabilities by the constituent entity of the Russian federation amounted to \$0.8bn. A reduction in liabilities of monetary regulation authorities did not exceed \$0.3bn.

In 2011, liabilities of the non-financial sector of the Russian Federation to non-residents increased by \$58.2bn as compared to + \$24.9bn in 2010. Consequently, foreign investors believe that investments in Russia are quite attractive with the existing level of return. Noteworthy, in 2011 direct investments into the non-financial sector amounted to \$48.5bn as against \$37.8bn in 2010, while portfolio investments decreased by \$4bn (\$5.1bn a year before). In 2011, the volume of the loan debt of the non-financial sector to non-residents increased by \$15bn.

In 2011, it is to be noted that the liabilities of the banking sector to non-residents rose by \$7.6bn, while in 2010 the growth in liabilities of the banks exceeded \$17.6bn. The main factor behind the slower growth in liabilities was the reduction in the value of the attracted loans from \$19.3bn in 2010 to \$11.8bn in 2011. Taking into account the high demand of Russian banks in resources of the Central Bank of Russia and the non-financial sector of the Russian Federation, such a dynamics of liabilities points to difficulties of Russian banks in attraction of external financing which situation can be explained by the fact that investment in the financial sector worldwide is becoming less attractive.

In 2011, foreign assets of residents (foreign economic agents' liabilities to Russian economic agents) rose by \$140.2bn (in 2010, by \$70bn.). It is to be noted that foreign assets of monetary regulation authorities virtually did not change, while those of federal regulatory authorities rose by \$2.6bn.

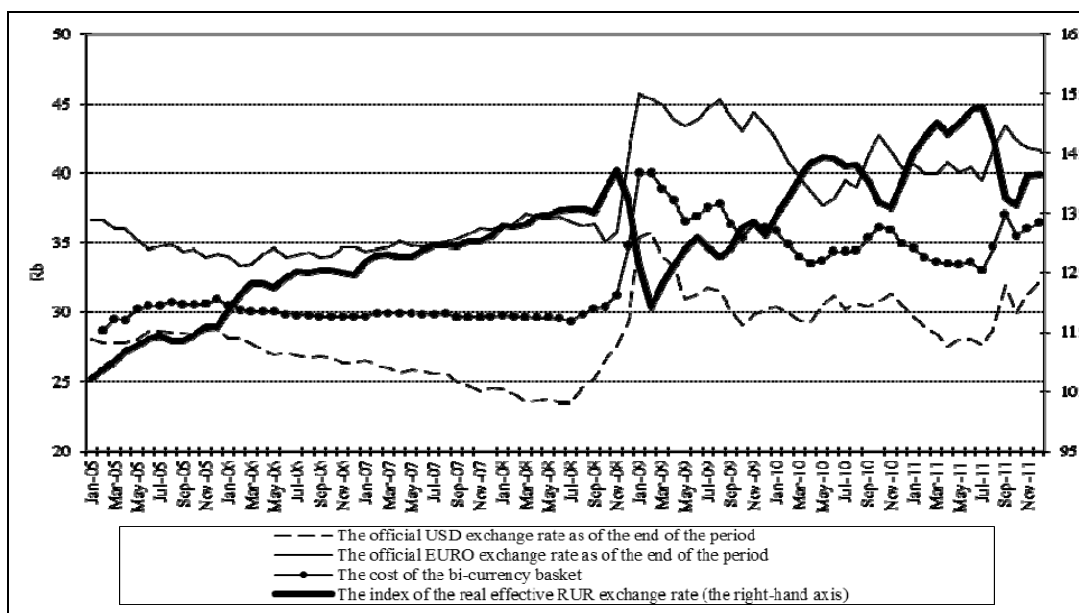
In 2011, foreign assets of the banking sector increased by \$33.8bn. It is to be noted that growth in Russian banks' loans and deposits provided to foreign economic agent accounted for \$25.5bn of the above amount. In 2010, growth in foreign assets of Russian banks amounted to \$1.8bn.

As compared to 2010, the outflow of capital from the sector of non-financial enterprises and households rose by 54% and amounted to \$103.8bn of which amount direct and portfolio investments accounted for \$70bn. (\$19bn more than in 2010). Households and the non-financial sector reduced their investments into cash foreign currency whose volume of import to Russia amounted to \$2.7bn.

In 2011, the situation on the foreign exchange market of the Russian Federation was determined by the inflow of the foreign exchange into the country through the current account with a simultaneous outflow of funds in the capital and financial instruments account. As was stated below, the Central Bank of Russia reduced to a great extent its interference in the functioning of the foreign exchange market by permitting the ruble exchange rate to be formed mainly under the impact of market factors and limited its role to smoothing of sharp fluctuations of the exchange rate. In the first six months, the ruble appreciated both in nominal and real terms under the impact of the considerable trade balance surplus despite the large outflow

of capital. However, in August-October a considerable depreciation of the exchange rate took place and it was justified by a decrease in the current account balance due to a drop in prices on energy carriers and growth in the outflow of the capital from Russia as a result of worsening of the global economic situation.

Generally, in January-December the real effective exchange rate of the ruble grew by the mere 4.7% (at year-end 2010 it was +9.6%) and by the end of the year remained at the level of the mid-2008 (see Fig. 8). In 2011, the official USD/RUR exchange rate grew by Rb 1.72: by the end of December the USD exchange rate amounted to Rb 32.20 against Rb 30.48 as of December 31, 2010. It is to be noted that the ruble depreciated against the bi-currency basket¹: in the same period the cost of the bi-currency basket appreciated by Rb 1.55 from Rb 34.91 to Rb 36.46. Late in December the Euro/RUR exchange rate amounted to Rb 41.67 and increased by Rb 1.34 on a year on year basis.



Source: The Central Bank of the Russian Federation and the author’s calculations.

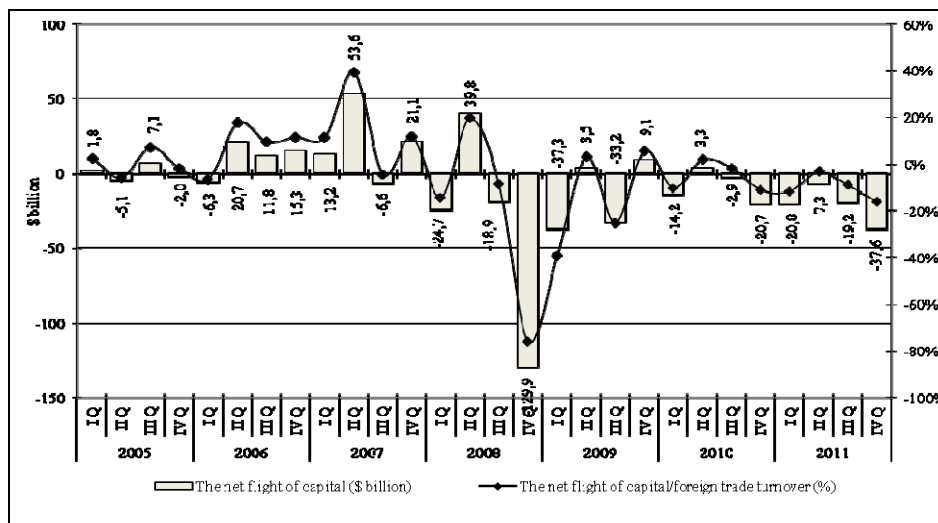
Fig. 8. Indices of the RUR exchange rate in January 2005 – December 2011²

In 2011, the situation with the balance of payments developed in such a way that on a year on year basis the RUR exchange rate both in nominal and real terms did not change much with virtually no interference by the Central Bank of Russia into functioning of the foreign exchange market. In other words, the situation was favorable to the Bank of Russia and permitted it to switch over to the inflation targeting regime with absence of fundamental changes in the RUR exchange rate. At the same time, the Central bank of the Russian Federation let the RUR exchange rate depreciate in August-October, however, thanks to growing surplus of the balance of payments at the end of the year the RUR exchange rate started to grow again.

¹ Bi-currency basket is an operating benchmark of the Central Bank of the Russian Federation in carrying out of the foreign exchange policy. At present, the share of the Euro in the basket amounts to 45%, while that of the USD, to 55%.

² The level of January 2002 is equal to 100.

In 2011, a trend which determined the dynamics of the balance of payment was the dynamics of the net flight of capital from the non-financial sector; on a year on year basis the capital flight amounted to \$85bn (in 2010 it amounted to \$34.5bn) (see Fig. 9). It is to be noted that the flight of capital was observed throughout the year: the minimum flight of capital was registered on the basis of the results of the 2nd quarter (– \$7.3bn), while the maximum one, on the basis of the results of the 4th quarter (– \$37.6bn). The factor behind the flight of capital was in all appearances the prevalence of high economic and political risks related to investment in the Russian Federation with a level of return comparable to that in other developing countries.



Source: The Central bank of Russia; the IEP calculations.

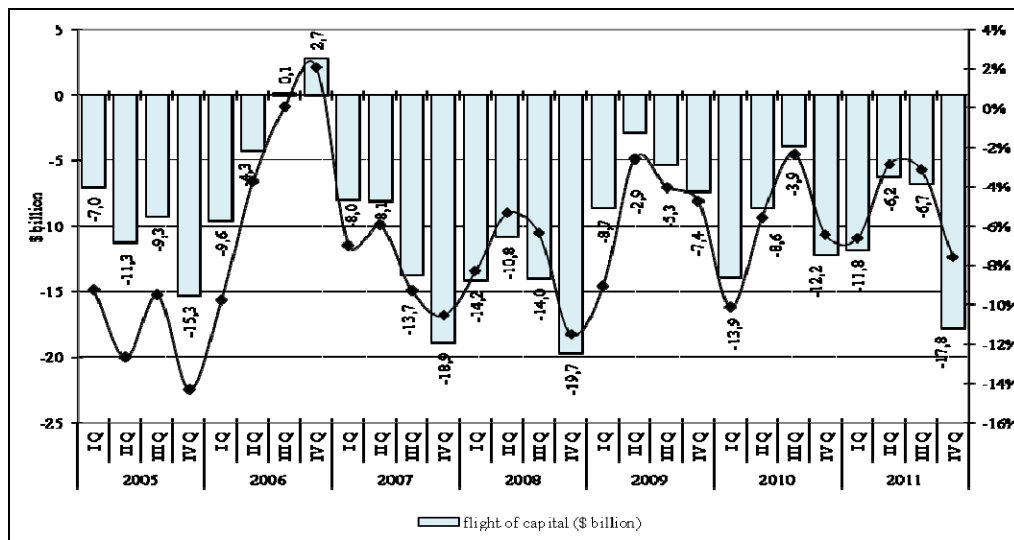
Fig. 9. The dynamics of the net flight of capital in 2005–2011

Another evidence of the unfavorable situation with the inflow of capital is the speed-up of the so called capital flight¹ in 2011. According to our evaluations, in 2011 the flight of capital (Fig. 10) amounted on a year on year basis to \$ 42.6bn which figure is \$ 3.9bn higher than in 2010.

Summing up the result of the analysis of the balance of payments, it is to be noted that in general the insignificant total balance of payments is favorable to the Russian economy as it contributes both to stability on the foreign exchange market and sustained development of the financial system. At the same time, due to the fact that the current account of the balance of payments of the Russian Federation depends to a great extent on the export of several commodities the existing situation with the balance of payments is unlikely to be stable in the long-term prospect due to the unpredicted dynamics of prices on energy carriers and, consequently, the situation of the Russian foreign trade. As regards the capital and financial instruments account balance the flows of capital both to and from Russia are likely to remain quite volatile due to, among other things, uncertainty about the global economic development. However, in case of absence of efforts by the Government of the Russian Federation to reduce

¹ The capital flight was calculated on the basis of the IMF methods and represents the amount of “trade loans and advance payments”, “export revenues which failed to be received timely and goods and services which failed to be delivered against remittance of funds under import contracts” and “net errors and omissions”.

investment risks in the Russian Federation with all other things being equal (primarily, in case of stability of prices on energy carriers) the inflow of private capital to the country can hardly be expected on the basis of the results of 2012.



Source: The Central Bank of the Russian Federation, the IEP calculations.

Fig. 10. The dynamics of the flight of capital in the 2005–2011 period