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The review provides a detailed analysis of main trends in Russia's economy in 2010. 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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Pavel Trunin

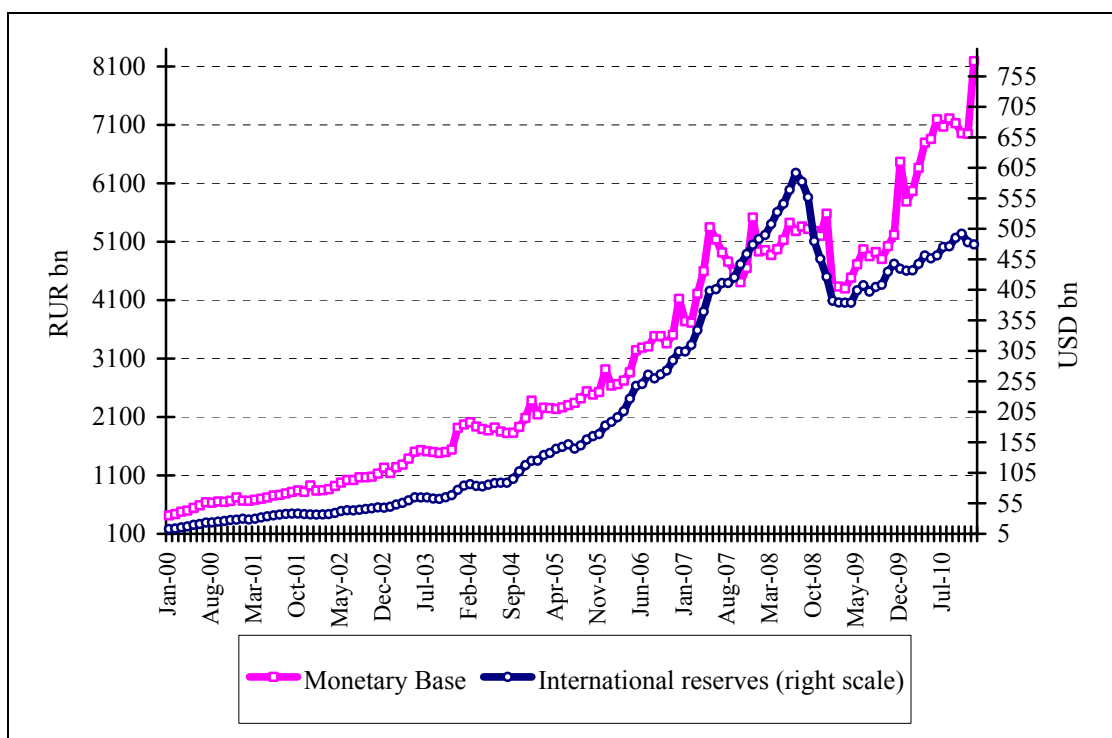
Russia's Monetary Policy in 2010

A major trend in the monetary and credit sphere of the Russian Federation in 2010 was the cutting-down of support to anti-crisis Russian financial system by the Bank of Russia in the course of the gradual recovery of the Russian economy. Herewith, the resumption of monetary supply growth by monetizing the total balance of payments, as well as a significant negative shock of aggregate supply in summer (as a result of the drought) again caused an acceleration of inflation in autumn. Reduced dependence of the banks of the RF Central Bank and the sustained net flow of currency to the country once again bring the Bank of Russia at a choice between reducing inflation and managing the exchange rate. At the same time, representatives of the Central Bank of Russia declare the inflation reduction as their priority goal.

2.1.1. The Monetary Market

During 2010, there was again observed a substantial increase in the RF international reserves (*Fig. 1*). The main factors of growth were relatively high prices for Russia main exports, primarily oil, gas and metals. Furthermore, the reduction for the year Euro against the USD in the global currency markets brought about a decline in the dollar value of the reserves denominated in Euro. As a result, there was a trade surplus of the Russian Federation, and the national international reserves were growing, as the Bank of Russia bought foreign currency to slow down the growth of the nominal exchange rate.

By the end of the volume of international reserves amounted to 479.4 billion dollars, while at the beginning of the year they accounted for 439.5 billion dollars, i.e., during the year reserves grew by 9.1%. The volume of the RF international reserves remains sufficiently large by international standards: they are in the third place in the world in absolute value after the reserves of China and Japan. However, the experience of winter 2008/2009 showed that the sharp deterioration in external economic conditions and massive capital outflows, even such large reserves can be quickly spent in case of maintenance of the RF Central Bank rate. In addition, the rapid growth of imports, while maintaining net capital outflows from Russia caused by the persistence of high economic and political risks of investments in Russia, as well as the need to service a large external debt, reducing the supply of currency in Russia. Therefore, with the stable energy prices in 2011, international reserves will probably grow more slowly than in 2010.



Source: RF Central Bank.

Fig. 1. The Dynamics of the Monetary Base and Foreign Reserves in 2000-2010

As one can see from *Fig. 1*, after the crisis, the monetary base was growing at progressive rate as compared to international reserves. An important source of monetary supply growth in 2010, in addition to the operations of the Central Bank of Russia in the foreign exchange market was the use of the Reserve Fund to finance the budget deficit. During 2010, the accounts of the Ministry of Finance of Russia declined by 1.7 trillion rubles. In fact, the monetization of fiscal deficits causes expansion of monetary supply to Russia

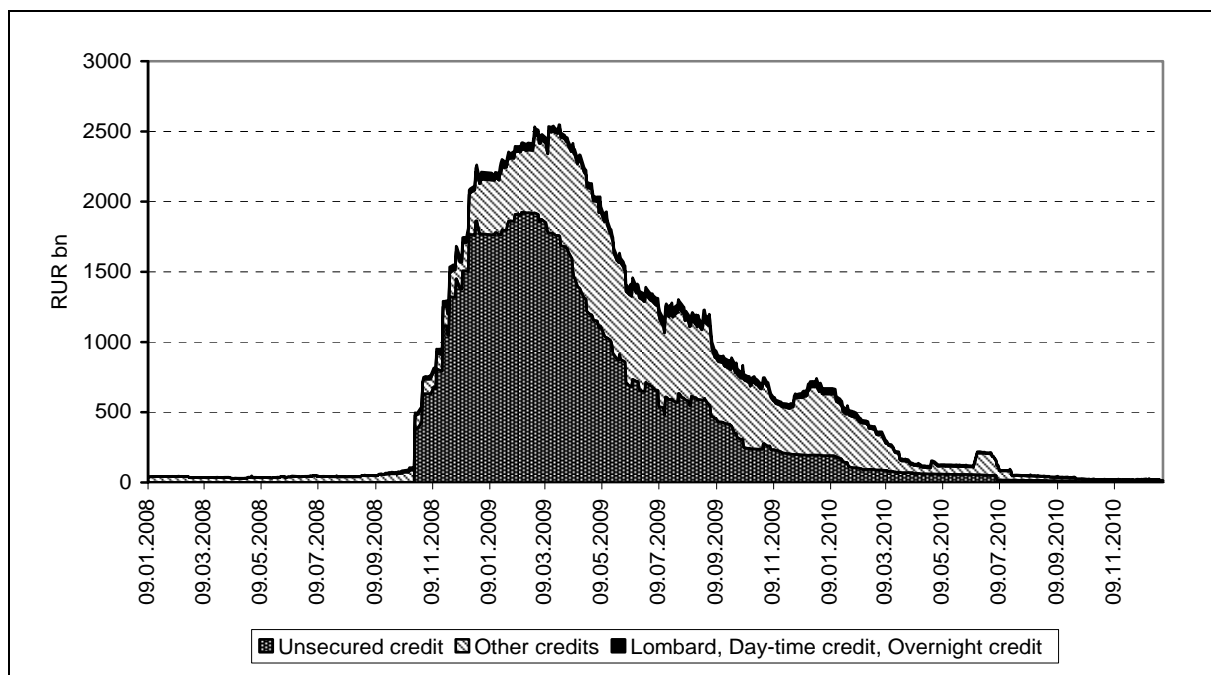
Herewith, the constraint of the growth of the monetary base at the beginning of the year was the reduction of the net debt of credit institutions to the RF Central Bank (see *Table. 1* and *Fig. 2*). However, already in summer of 2010 credit to the banks on the part of the RF Central Bank has been reduced to the pre-crisis level and further had no significant effect on the balance sheet of monetary regulation. Therefore, in case of continued balance of payments and budget deficit of 2011, one can expect a significantly higher rate of growth of money supply, which increases the risk of inflation.

Table 1

Bank of Russia Balance, 2009–2010

	01.01.2009		01.01.2010		01.12.2010	
	RUR. bn.	% assets/ liabilities	RUR. bn.	% assets/ liabilities	RUR. bn.	% assets/ liabilities
Funds placed with non-residents and foreign issuers' securities	12091.1	71.3	12383.3	80.3	13752.2	85.8
Credits and deposits	3871.3	22.8	1705.8	11.1	551.4	3.4
Precious metals	450.3	2.7	764.6	5.0	1172.0	7.3
Securities	441	2.6	465.9	3.0	446.6	2.8
Other assets	110	0.6	100.3	0.7	105.1	0.7
Assets, total	16963.7	100	15420	100	16027	100
Cash in circulation	4378.2	25.8	4629.9	30	5153.0	32.2
Cash on accounts with the Bank of Russia	10237.6	60.4	7979.7	51.7	6978.7	43.5
<i>Including the government of Russia</i>	7093.9	41.8	4980.2	32.3	4434.2	27.7
<i>Those of resident-credit institutions</i>	2010.1	11.8	1731.3	11.2	934.2	5.8
Cash in settlements	16.1	0.1	8.4	0.1	44.8	0.3
Securities issued	12.5	0.1	283.1	1.8	870.8	5.4
Other liabilities	319.2	1.9	168.3	1.1	818.8	5.1
Capita	1902.4	11.2	2099.1	13.6	2161.1	13.5
Profit by the reported year	97.8	0.6	251.4	1.6	0	0.0
Profit by the reported year	16963.7	100	15420	100	16027.3	100

Source: the Bank of Russia.



Source: the Bank of Russia.

Fig. 2. Debts of credit institutions under the loans of the Bank of Russia in 2009-2010.¹

¹ "Other" credits include loans secured by the Bank of Russia under promissory notes, rights of claim under loan agreements with organizations or guarantees of credit institutions.

Dynamics of the assets of the Central Bank of Russia has led to the expansion of the monetary base during 2010 the monetary base (in wide terms¹) increased by 1.7 trillion rubles - up to 8.2 trillion rubles (26.6%) (*Table 2*). Recall that in 2009, this figure rose by 15.9%. Cash in circulation, with the account of credit institutions' cash balances accounted on January 1, 2011 amounted to 5.8 trillion rubles (25.1% as compared with January 1, 2010), the correspondent accounts of credit institutions with the Bank of Russia - 1 trillion rubles (10.5%), compulsory reserves - 188 billion rubles (+24.4%), deposits of credit institutions with the Bank of Russia - 633.2 billion rubles (+24.4%), the value of Bank of Russia bonds with credit institutions - 588.9 billion rubles (grown in 2010 by 2.1 times).

Table 2

The Dynamic of the Monetary Base in Broad Terms in 2010 (RUR. Bn.)

	01.01.2010	01.04.2010	01.07.2010	01.10.2010	01.01.2011
<i>Monetary base (in broad terms)</i>	6467.3	6 363.90	7 195.00	7 126.00	8190.3
Including:					
Cash in circulation, with account of credit organizations' cash balances	4622.9	4 411.20	4 828.10	5 024.50	5785.2
Credit organizations' corresponding accounts with the Bank of Russia	900.3	579.5	603.6	590	994.7
Compulsory reserves	151.4	167.7	175.5	182.2	188.4
Credit organizations' deposits with the Bank of Russia	509	469.6	637	519.4	633.2
The bonds of the Bank of Russia held by credit organizations	283.7	735.9	950.8	810	588.9

Source: the Bank of Russia

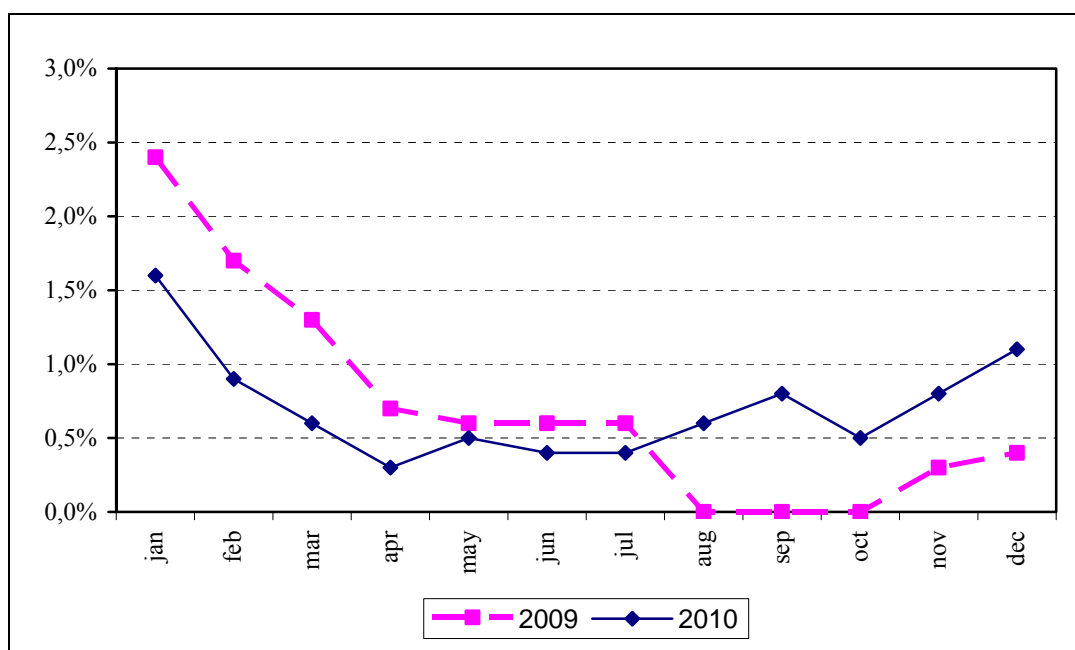
Monetary supply M2 in national terms has increased over the 2010 by 28.5% and amounted on January 1, 2011 to RUR 20173.5 bn or 45.3% of GDP (on January 1, 2010 monetary aggregate M₂ amounted to RUR15,697.7 billion (40.5% of GDP). Consequently, in 2010, the monetization of the Russian GDP was growing due to a rapid increase in the monetary base and expanded lending to the economy from commercial banks. In the conditions of high uncertainty about the RF future prospects of economic development, the monetary growth in the medium term will be largely determined by foreign economic situation, as well as the volume of the budget deficit, on the one hand, and speed economic recovery and credit activity of the banking sector on the other hand.

2.1.2. Inflationary Processes

One of the important consequences of the 2008-2009 economic crisis for the Russian economy as a significant slowdown of inflation due to the decline in aggregate demand and due to the reduced monetary supply (within September 2008 - February 2009 M₂ monetary supply decreased by 17.3%). In the first half of 2010 inflation continued to reduce, but in the

¹ According to the RF Central Bank methodology, the monetary base in wide terms characterizes the Bank of Russia's monetary and credit liabilities denominated in the national currency, which determine growth in money supply. The monetary base in wide terms comprises cash the RF Central Bank issued in circulation (with account of credit institutions' cash balances), balances of the compulsory reserves accounts which credit organizations deposit with the Bank of Russia, monies on correspondent accounts (including averaged balances of compulsory reserves) and deposit accounts the credit organizations have with the Bank of Russia, their investments in the Bank of Russia's bonds, backup funds by forex transactions deposited with the RF Central Bank, as well as the Bank of Russia's other liabilities with respect to operations with credit organizations in the currency of the Russian Federation.

beginning of the year conditions were created for the acceleration of inflation in the form of rapid monetary supply growth (see previous section) (*Fig. 3*). A drought, which hit Russia in summer of 2010, has made practically inevitable the acceleration of inflation in autumn. Let us consider inflation in 2010 in more detail.



Source: Russian State Statistical Service.

Fig. 3. The Dynamics of CPI of the RF in 2009–2010

In January - December 2010 food prices grew on average across the country by 12.9% (versus 6.1% in 2009) (Table 3). The main contribution to the growth of food prices has made a rise in cereals and beans (+58.8%), fruit and vegetables (+45.6%), sunflower oil (+ 27.6%), butter (+23.3%) and sugar (+22.5%). The rapid increase in food prices has made the most significant contribution to the CPI growth in 2010. Prices for commercial services have grown in 2010 by 8.1% (against 11.6% in 2009). During January - December the utmost growth in prices were observed in housing and utilities (+13%) for passenger transport services (+8.7%), services of cultural organizations (+8.6%) for medical services (+8.4%). Non-food products have increased in price in 2010 by 5% on average (against 9.7% in 2009). During the year the utmost growth took place in the price of tobacco products (+19.5%) for knitwear (+7.8%), clothing and underwear (+7.1%) and motor gasoline (+6.5%). The rate of increase basic consumer price index for 2010 made 6.6% (against 8.3% for the same period of the last year). Therefore, the main factors of inflation dynamics in 2010 were the effect of a low base in 2009, on the one hand¹ and monetary supply growth against the background of a slow recovery of economic activity and aggregate supply shock in the summer - on the other hand.

From the *Table 3* one can see that the major component of inflation in 2007-2010 was the growth in food prices, the expenses for which are the substantial share of household expendi-

¹ In early 2009 accelerated inflation was recorded in Russia.

tures. At the same time, in 2010 food expenses growth was twice faster than in 2009. The main reason for this was the summer drought. Such a conclusion can be drawn basing on the fact that a significant acceleration of growth in food prices began in the fall, while the growth in price was faster for the products, affected by the drought. At the same time, we would like to note that the rapid rise in food prices in 2010 took place all over in the world, but the CPI in the most developed countries remained at a low level. This may indicate either the great possibilities of Russian companies to raise prices due to low competition, and the effects of faster growth in monetary supply in late 2009 - early 2010, as well as the mature high inflationary expectations.

In the sector of commercial services sector one should note the continued growth in prices for housing services. At the same time, in 2010 housing services rose much less than in 2009, whereas in 2008-2009 accelerated pace of appreciation of service were observed. A further slowdown in price increases for housing and communal services in view of the alignment of their prices for population and industrial enterprises, as well as reducing the level of subsidy rates for utility services from the state will decrease the contribution of higher prices of housing services in inflationary pressures.

Non-food products in 2010 rose in price more slowly. Herewith, a rapid increase in tobacco prices was due to primarily an increase excise taxes on them, and the price for knitwear, clothing and underwear - rise in price for cotton due to low yield.

Table 3

The Annual Price Rise Rates for Some Kinds of Goods and Services in 2007–2010 (as% December/ to December of the preceding year)

	2007	2008	2009	2010	2007–2010
CPI	11.9	13.3	8.8	8.8	50.1
<i>Food stuffs</i>	15.6	16.5	6.1	12.9	61.3
<i>Grits and beans</i>	24.7	25.8	-2.5	58.8	142.9
<i>Butter</i>	40.3	10.5	7.9	23.3	106.3
<i>Sunflower- oil</i>	52.3	22.1	-19.8	27.6	90.3
<i>Pasta</i>	23.6	33.8	1.6	4.7	75.9
<i>Milk and dairy products</i>	30.4	12.2	2.3	16.7	74.7
<i>Bread and bakery</i>	22.4	25.9	2.4	7.6	69.8
<i>Meat and poultry</i>	8.4	22.2	5.0	5.3	46.5
<i>Fish and seafood</i>	9.0	15.1	10.6	4.8	45.4
<i>Non-food goods</i>	6.5	8.0	9.7	5.0	32.5
<i>Construction materials</i>	16.2	11.3	2.1	4.6	38.1
<i>Gasoline</i>	8.5	1.2	8.0	6.5	26.3
<i>Services</i>	13.3	15.9	11.6	8.1	58.4
<i>Housing and utilities</i>	14.0	16.4	19.6	13.0	79.3
<i>Preschool education services</i>	11.8	20.7	16.2	7.7	68.9
<i>Sanatorium and rehabilitation services</i>	15.6	21.2	9.5	5.4	61.7
<i>Passenger transportation services</i>	13.6	22.5	6.5	8.7	61.1
<i>Cultural institutions' services</i>	14.5	15.5	11.3	8.6	59.8

Source: Russian Statistical Service.

In conclusion, let us compare the consumer price rise rates in the RF with those in other CIS Countries (*Table 4*).

Table 4

**Consumer Price Indices in the CIS Countries in 2000–2010, %
versus Relevant Period of Preceding year**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010*
Azerbaijan	2	2	3	2	7	10	8	17	21	1	5,2
Armenia	-1	3	1	5	7	1	3	4	9	3	7,8
Belarus	169	61	43	28	18	10	7	8	15	13	7
Kazakhstan	13	8	6	6	7	8	9	11	17	7	7
Kyrgyzstan	19	7	2	3	4	4	6	10	25	7	4,9
Moldova	31	10	5	12	12	12	13	12	13	0	7,2
Russia	20	22	16	14	11	13	10	9	14	12	6,4
Tajikistan	24	37	10	17	7	8	12	21	20	6	5,6
Ukraine	28	12	1	5	9	14	9	13	25	16	9,3

*Data for January-September.

Source: The CIS Intergovernmental Statistics Committee (<http://www.cisstat.org/>).

Inflationary processes in the CIS countries in the recovery period after the economic crisis were determined mainly by two groups of factors. On the one hand, in many countries, the crisis led to depreciation of the national currency, which in early 2009 contributed to higher prices by raising import prices and inflationary expectations. In early 2010, there was an effect of a low base, stimulated some moderation in inflation. In addition, economic recovery in the most CIS countries is still rather slow, which imposes constraints on inflation from aggregate demand.

On the other hand, in 2009-2010 the monetary supply was growing. In addition, the resumption of increasing consumer demand also increases the inflationary pressure. As a result, the combination of the above factors determines the rate of price growth in the CIS countries.

In the Russian context recovery in prices for the Russian main export goods (despite the outflow of private capital), a negative supply shock, as well as financing the budget deficit at the expense of the Reserve Fund have caused inflation in the second half of the year. Due to the low inflation in the first half of 2010, in general, CPI remained at the level of 2009. However, in case of continuation of these trends, inflation up to 2011 may not show further decrease and remain at 8-9%.

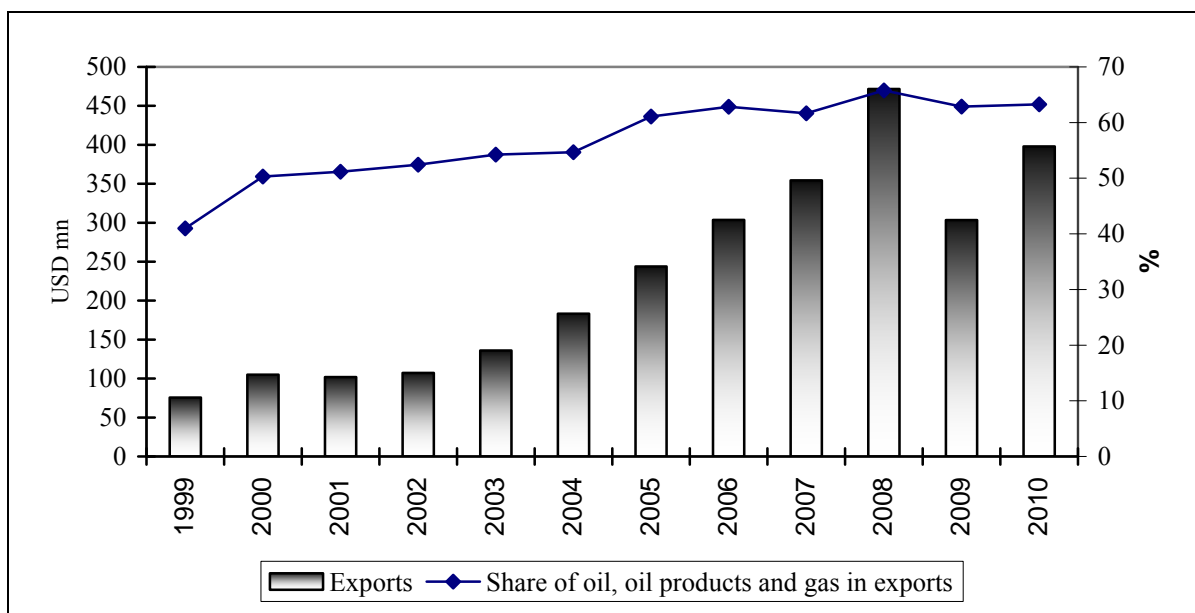
2.1.3. The State of the Balance of Payments¹ and Foreign Currency Market

Balance of payments stability of the Russian Federation in 2010 was ensured at the expense of exports, especially fuel and energy complex products. Global economic recovery after the crisis, as well as the preservation of mitigated monetary and credit policy in the US and the EU have inspired growth in commodity prices, resulting in the growth of fuel and energy exports from Russia by the year-end by 32% as compared with the previous year. At the same time, the outflow of capital from the country within the year was much greater than expected by the Government and the Bank of Russia, which reflects the high risks of investing in the Russian economy. In view of combination of the above factors, the balance of payments appears to be quite stable, but in the medium term such stability of the balance of payments would be in danger as a result of the rapid growth of imports in Russia compared to

¹ The analysis of the balance of payments was conducted on the basis of the RF Central Bank's preliminary data: http://cbr.ru/statistics/credit_statistics/print.asp?file=bal_of_payments_est.htm

exports from the country, and continued growth of the balance of account deficit of operations with capital and financial instruments.

According to the published by the Bank of Russia preliminary assessment of the balance of payments of the Russian Federation in 2010, positive current account balance amounted to 72.6 billion dollars, i.e., increased by 47,1% as compared with 2009 (*Table 5*). Herewith, trade balance surplus grew by 33.7% (from 111.6 billion to 149.2 billion dollars), while exports of goods increased by 31.2% (from 303.4 billion to 398 billion US dollars), and imports of goods increased by 29.7% (from 191.8 billion to 248.8 billion dollars). The share of exports of oil and natural gas amounted to 63.3% in the total value of exports, having increased by 0.4 percentage points as compared with 2009 (*Fig. 4*). Therefore, as in previous years, the main factor determining the scope of the balance of current account, was the balance of trade, which, in turn, largely depends on the changes of energy prices and other major Russian export commodities in the global markets. The data presented in *Fig. 5*, shows that the relationship between oil prices and the trade balance of Russia, observed in 2002-2009, was demonstrated within 2010 as well.



Source: RF Central Bank .

Fig. 4. The Dynamics of Commodities Export and the Share of Fuel and Energy Complex Products in 1999-2010

Deficit in the balance of services reached 27.3 billion dollars and increased (in absolute value) compared with 2009 by 37.3%. Exports of services amounted to 44.1 billion dollars, an increase against the previous year by 2.6 billion dollars (+6.1%). Imports of services for 2010 has increased by 16.2% and reached 71.4 billion dollars. Balance of labor compensations in 2010 has increased in absolute value and amounted to -9.2 billion dollars (in 2009 it made -8.6 billion dollars). Deficit of balance of investment revenue in 2010 as compared with 2009 increased by 6.9% and reached 36 billion dollars. Investment gains due rose from 30.7 billion to 32.8 billion dollars, which is based on a significant decline in non-financial companies revenues (from 15.1 billion to 20 billion dollars). The rise of income receivable was due to the

global economic recovery and growth of investment abroad. Increased revenues receivable by non-financial enterprises from 46.6 billion to 56.4 billion dollars has identified the growth of general income receivable from 61.5 billion to 68.8 billion dollars.

The balance of current transfers¹ in 2010 accounted for -4.1 bn US dollars, having decreased by 8.8% as compared with 2009.

Table 5

**Main Items of the Balance of Payments and the Dynamic of External Debt
in 2008–2010 (USD bn.)**

Balance Item	2008					2009					2010				
	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.*	Year*
Current account	38.7	26.8	29.6	8.5	103.7	9.7	8.2	15.4	16.1	49.4	33.3	19	6	14.3	72.6
Capital and financial instruments account ²	-20.5	35.2	-15.9	-130	-131.3	-32.4	3.1	-27	12.1	-44.3	-11.2	8.1	-6	-21.4	-30.5
Change in forex reserves («+» – “decline of reserves”, «-» – growth in reserves)	-12.1	-64.9	-8.9	124.8	38.9	30.5	-14.2	9.1	-28.8	-3.4	-16.6	-26.1	-2.7	8.6	-36.8
Net mistakes and omissions	-6.1	2.9	-4.7	-3.3	-11.3	-7.8	2.9	2.6	0.6	-1.7	-5.5	-1.1	2.7	-1.5	-5.4
Change in external debt of RF («+» – growth in debt, «-» – decrease of debt)	19.1	51.5	6.3	-60.3	16.6	-34.2	19.6	7.9	-6.7	-13.3	-3.5	-7.3	19.1	7.4	15.7
Change in the external public debt of RF	0.2	-1.5	-2.0	-3.7	-7.1	-2.4	4.1	9.4	2.5	13.7	-2.4	3.8	-0.3	-0.2	0.9
Change in the external debt of the private sector in RF	19.0	53.0	8.4	-56.6	23.7	-31.8	15.5	-1.5	-9.2	-27.0	-1.1	-11.1	19.4	7.6	14.9

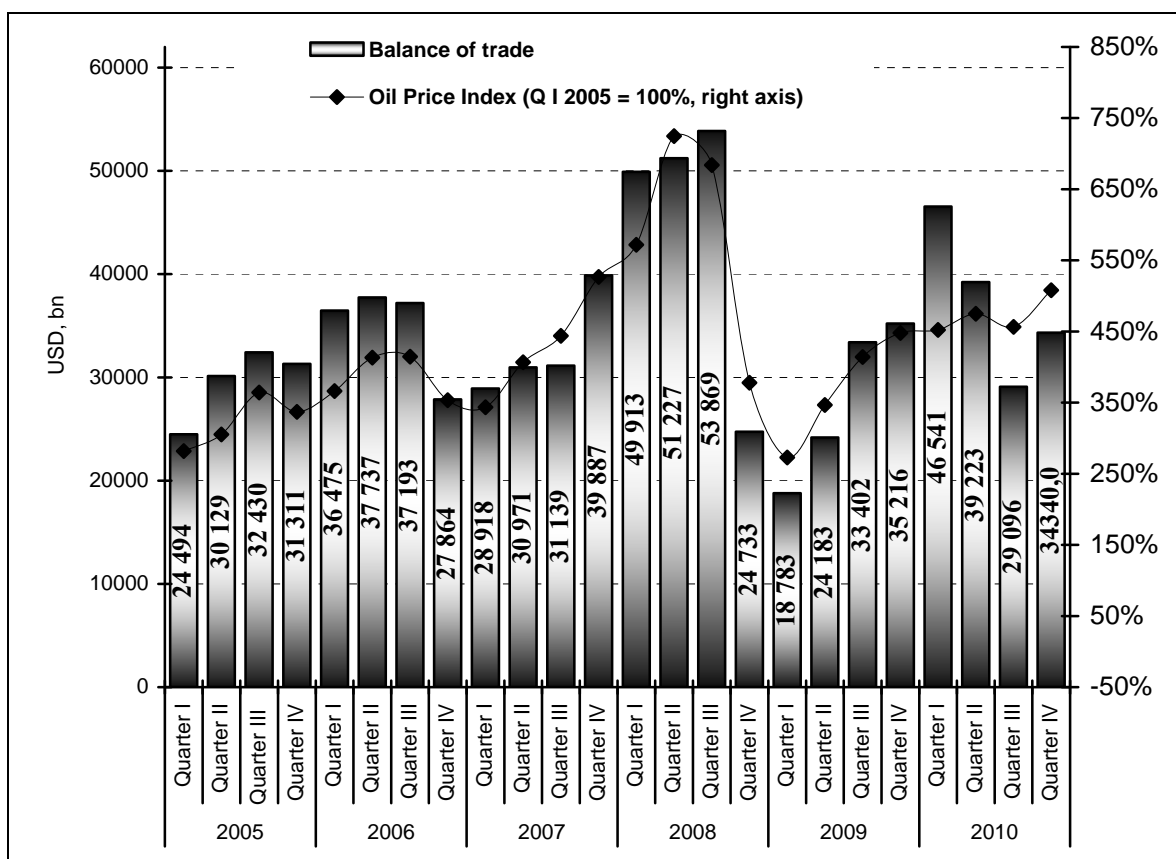
* Preliminary estimates.

Source: The Bank of Russia.

Thus, it was high prices for major Russian exports that were behind a huge positive balance of current accounts of the Russian balance of payments in 2010. Let us note that at the end of the year, the debt of has resumed its growth again (see *Table 5*). As to foreign debt, it has changed slightly for the year, having increased only by 0.9 billion dollars. In the medium term, one can expect recovery rates of external debt growth, both, in private and public sector of economy, due to the lack and high cost of financial resources domestically, as well as the continuing budget deficit.

¹ According to the RF Central bank, the current transfers bolster the level of disposable income and consumption of the recipient’s goods and services and decrease the donor’s disposable income and possibilities for consumption, for instance, humanitarian aid in the form of consumer goods and services. The current transfers are reflected in current accounts. Transfers other than current are conceived of as capital ones. They lead to a change in the volume of the donor or recipient’s assets or liabilities and are reflected in capital accounts. In the event the donor and the recipient are non-residents to each other, the capital transfer engenders changes in the level of national wealth of the economies they represent. Examples of capital transfers are a free-of-cost transfer of property rights for capital assets or debt forgiveness.

² Less foreign currency reserves.



Source: the RF Central Bank, IEP estimates.

Fig. 5. RF Balance of Trade and the World Oil Price Index in 2005-2010

In 2010, the balance of operations with capital account and financial instruments has significantly declined in absolute terms, amounting to USD -30.5 billion. The balance of capital transfers in 2010, amounted to USD 0.2 billion. Therefore, in 2010 the deficit of financial account amounted to USD -30.7 billion.

Increase of liabilities of the Russian economic agents against foreign economic agents as per the year results totaled to 36.6 billion dollars, which is 5.5 times more than in the previous year (6.6 billion dollars).

Like in 2009, the federal administrative bodies likewise became net payers in relation to non-residents. Their external liabilities have grown by USD 3.6 bn, resulting from repayment of Russia's external public debt.

Their external liabilities rose by 3.6 billion dollars, which resulted from sales of the newly issued debt securities of the Government of Russia by non-residents. The balance of external liabilities across the RF Subjects remained unchanged. Reduction of monetary regulation authorities' commitments in 2010 reached 2.1 billion dollars.

The resumption of the global economy growth after the financial crisis, demonstrated, among other things, in gradual recovery of the global capital markets and the growing interest of investors to risk by maintaining low interest rates in developed countries has resulted in the fact that the banking sector of the Russian Federation obligations to non-residents once again began to grow, increasing within the year to 18.1 billion dollars. At the same time, invest-

ments of economic agents of other countries in the non-financial sector of Russia accounted to only 16.4 billion dollars as compared with 34.4 billion dollars in 2009. Therefore, non-resident investments in non-financial sector of 2010 decreased compared to 2009, despite the resumption of economic growth in Russia. Consequently, foreign investors consider investing in Russia quite risky at the current level of profitability. Direct investments in non-financial sector accounted for USD 28.6 billion over 2010, as compared with 30.3 billion dollars in 2009, and the growth of portfolio investments has expressly declined by 1.6 billion dollars, as compared with the growth of 2 billion dollars a year earlier. The volume of non-financial sector under the debt on loans to non-residents declined in 2010 by USD 10 billion as a result of earlier received credits redemption.

Foreign assets of residents (liabilities of foreign economic agents to the Russian ones) increased within 2010 by 67.2 billion dollars (against 39 billion dollars within 2009).

Herewith, foreign assets of the federal government and monetary-credit regulation authorities have practically unchanged, and banks rose by 6.7 billion dollars.

Export of capital from the sector non-financial enterprises and households, as compared with 2009, has decreased by 1.2% and amounted to 60.3 billion dollars. Herewith, it is important to note that significant changes have occurred in the dynamics of the article "cash in foreign currency", which indicates, that in 2010 the export of foreign currency from Russia amounted to 14.4 billion dollars as compared with 4.1 billion dollars in 2009. Therefore, due to the stability of the national currency and foreign currency savings of population, converted into rubles, made during the fall of the ruble in winter of 2008/2009, the public and non-financial sector reduced their investments in foreign currency.

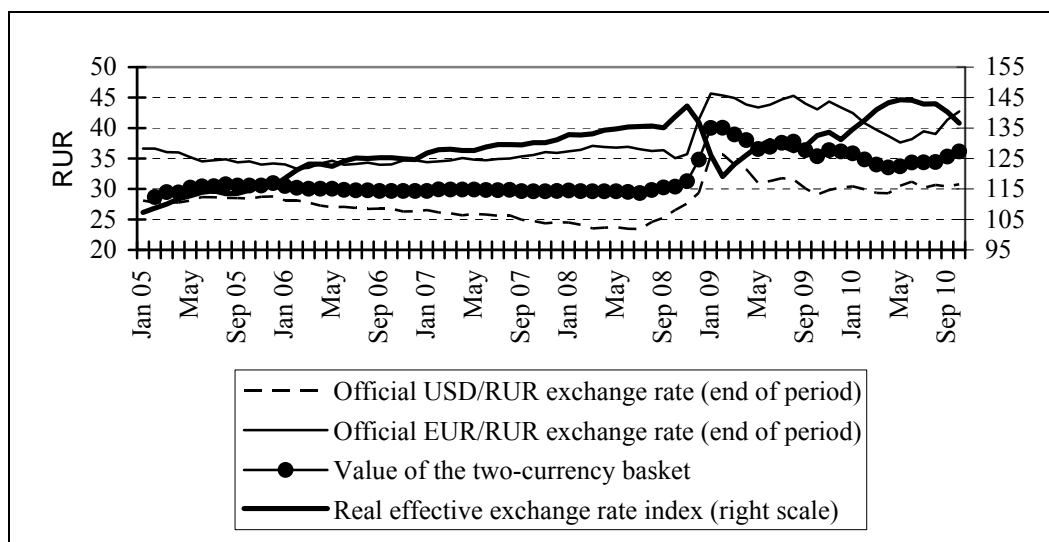
The situation in the foreign exchange market of the Russian Federation in 2010 was determined by the inflow of currency into the country via the current account operations, the outflow of capital account and financial instruments and the actions of the RF Central Bank. Herewith, a key factor in the dynamics of the course was the dynamics in the imports of the Russian Federation. With minor changes in exports, nearly constant increase in imports caused a reduction in current account balance of payments, which, when private capital outflows from the country became the only channel of foreign currency inflow to the Russian Federation. As a result, with a relatively large current account balance (see above), in January - April there was strengthening of the ruble in nominal terms (in real terms the ruble was strengthening in January - May). Then, till the year end, ruble was continuously depreciating, both in nominal and real terms. Only a renewed rise in oil prices late in the year, which came close to the level of USD 100 per barrel, caused the ruble strengthening in nominal and in real terms as of December results.

In general, as a result of January - December, the real effective exchange rate of RUR rose by 9.6% and almost reached pre-crisis level of the mid-2008 (see *Fig. 6*)¹. The official dollar rate against ruble in 2010 increased by 24 kopecks: by the end of December, the dollar made 30.48 rubles as compared with 30.24 rubles on December 31, 2009. Herewith, ruble strengthened against the two-currency basket²: the value of the two-currency basket has declined over the same period by 1 rub. 25 kopecks: from 36.16 rubles. up to 34.91 rubles. Within the year, there was a gradual strengthening of the US dollar to Euro at the background of the situation

¹ The level of January 2002 is accepted as 100 per cent.

² Two-currency basket is the RF Central Bank operational indicator in its foreign currency policy. Currently the share of EURO in the currency basket makes 45 per cent, USD – 55 per cent.

improvement in the US economy and worsening of the debt problems in the EU. As a result, the Euro rate against the ruble at the end of December amounted to 40.33 rubles.



Source: the RF Central Bank, IEP estimates.

Fig. 6 Indicators of RUR Exchange Rate between January 2005 and December 2010

Thus, in 2010 due to favorable foreign economic situation, strengthening of the ruble was continued. We would like to recall that the rise in energy sources prices in the 2000-s before the crisis also led to a rapid increase in the surplus current account balance of payments in Russia and inspired ruble strengthening. To prevent nominal RUR strengthening, the RF Central Bank was buying foreign currency and increased monetary offer. Even the formation of the Stabilization Fund in 2004, which often helped to sterilize intervention of the Central Bank interventions in the foreign exchange market, did not allow to stop the real ruble strengthening, observed up to the crisis in 2008. Herewith, the main reason of ruble strengthening restriction to the Russian authorities was the reluctance to allow the loss of the national companies' competitiveness. However, with the significant monetization of the trade balance and the lack of opportunity for the sterilization, the inflation in Russia still remained high, despite the rising monetary demand. A rise in prices, in turn, resulted in a real strengthening of the ruble (See in the insert the description of a similar situation in the foreign exchange market in China).

The issue of the Bank of Russia interest rate policy efficacy is still open. It is not excluded that in the absence of the Bank of Russia interference in the functioning of the foreign currency market ruble would be much stronger in nominal terms, but due to lower inflation the dynamics of the real exchange rate would be only slightly different from the current one. Restraining of the ruble, even in view of a partial sterilization, has inspired a rapid growth in monetary supply and inflation, still remaining at the high level in terms of the world standards. Herewith, an important role in expanding the monetary supply has played a capital inflow in 2006-2007, which, in contrast to foreign currency exchange inflows from trade operations could not be sterilized in the Stabilization Fund, which was formed through taxes. One should note, that a possibility of further sterilization, including through the emission of the RF Central Bank bonds and the accumulation of even a larger scale of the government accounts

with the RF Central Bank (i.e., in the Reserve Fund), also raises doubts as to the economic and political reasons.

At first sight, the current situation is similar. However, we believe that an important difference lies in the instability of the global economic recovery. In the event of new problems or tightening of monetary and credit policy in the US and the EU (as the economy recovers), energy prices may fall down, which will inevitably result in an outflow of capital from Russia and create conditions for the weakening of the ruble. In our opinion, under conditions of high uncertainty about the future situation in the global and Russian economies, the Bank of Russia, one should not actively intervene in the domestic foreign exchange market and should focus on reducing inflation.

The dynamics of the National Currency of China

We would like to note that the problem of yuan exchange rate, which is recently under discussion, is relevant to our country as well, because Russia, like China, is heavily dependent on commodity exports. Herewith, the sharp devaluation of the ruble after the 1998 crisis along with rising energy prices and a recovery growth has caused the process of import substitution, which was an important factor in rapid economic growth in Russia in the early 2000's. It is considered that China also supports the competitiveness of their exports by an undervalued yuan.

However, as we have seen above, during the 2000-s and until the crisis ruble was strengthening in real terms, whereas it can be seen in Figs. 7 and 8, that the real effective exchange rate of the yuan over the past 10 years has not changed. With control over the nominal exchange rate by the People's Bank of China, a stable real effective exchange rate means similar inflation in the USA (the main trading partner of China) and China.

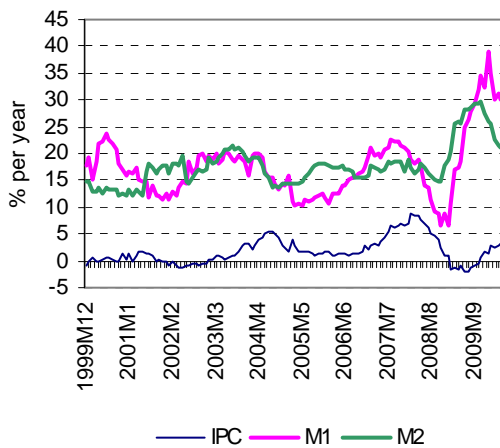


Fig. 7. The monetary instruments growth rate and CPI in China in 1999–2010 (% to the relevant period of preceding year¹)

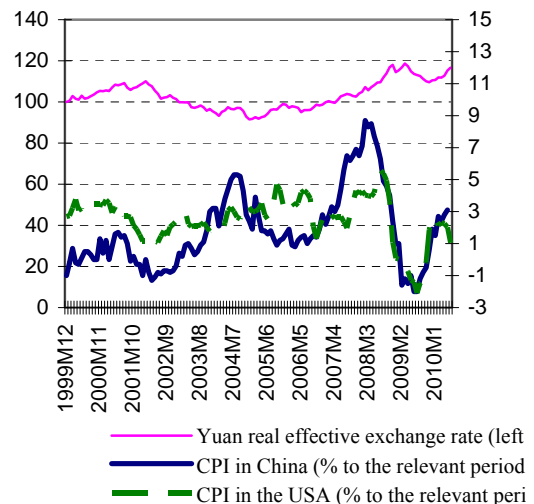


Fig. 8. Yuan real effective exchange rate (01.1999=100) и CPI in China and US in 1999–2010.

Achievement of a moderate level of inflation in China was made possible by a large sterilization through purchased by the Central Bank reserves, accumulated not only in the government accounts in the People's Bank of China, but also (to a much larger scale) by selling bonds of the Central Bank to credit institutions (see Figs. 9 and 10). Such policy, coupled with the rapid economic growth, as well as restrictions in capital inflows, limiting further inflow of foreign currency to China, has allowed the Chinese authorities to curb monetary supply growth and inflation.

¹ The same period last year.

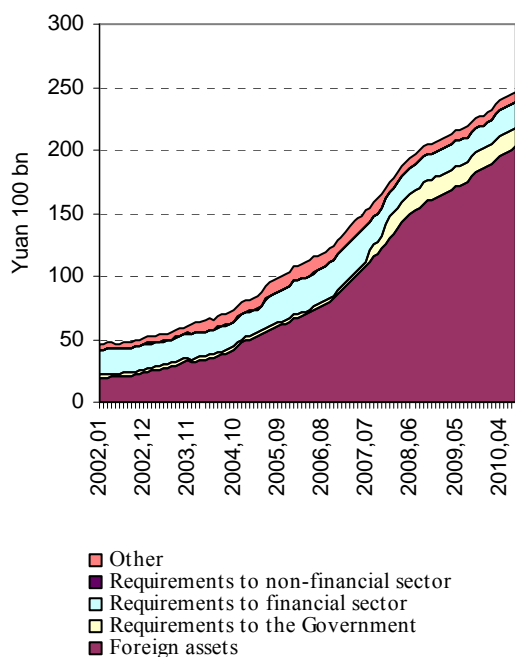


Fig. 9. People's Bank of China assets dynamics in 2002–2010

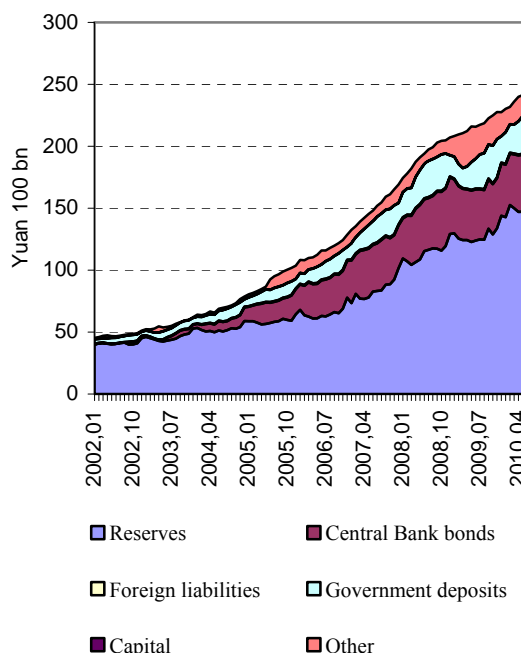


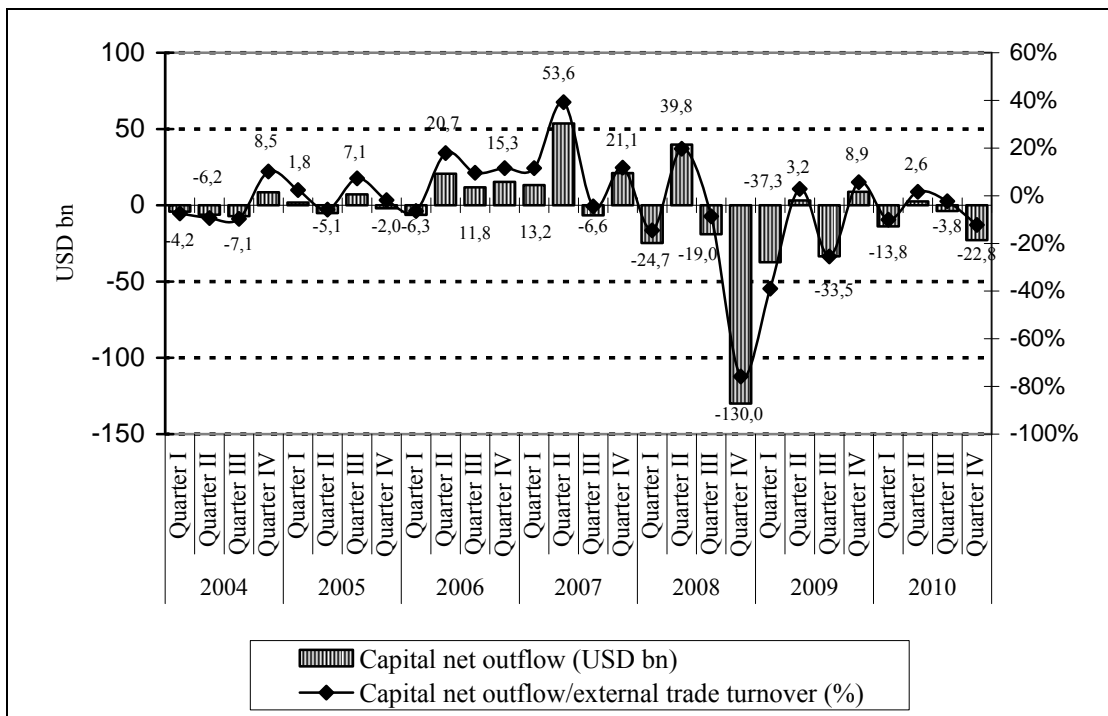
Fig. 10. People's Bank of China liabilities dynamics in 2002–2010

One of the major trends in the dynamics of balance of payments in 2010 was the dynamics of net capital outflows from non-financial sector, which reached USD 37.9 billion as of the year results (in 2009, due to the crisis, the outflow amounted to USD 58.7 billion) (See Fig. 11). After the outflow of capital in the I quarter in the amount of USD 13.8 billion, in II quarter the inflow (USD 2.6 billion) was recorded. However, in the second half of the year the outflow of capital has accelerated (USD 3.8 billion and 22.8 billion in the III and IV quarters, respectively). At first glance, it might seem that the outflow of capital is gradually decreasing at the background of the Russian economy recovery from the crisis.

However, a comparative analysis shows that while private capital inflows were growing to many developing countries, where investors were ready to run the risk and where low interest rates were sustained, private capital is still flowing away from Russia. The reasons for this situation, apparently, is the maintained strong economic and political risks of investments in the RF with the level of profitability comparable to other developing countries.

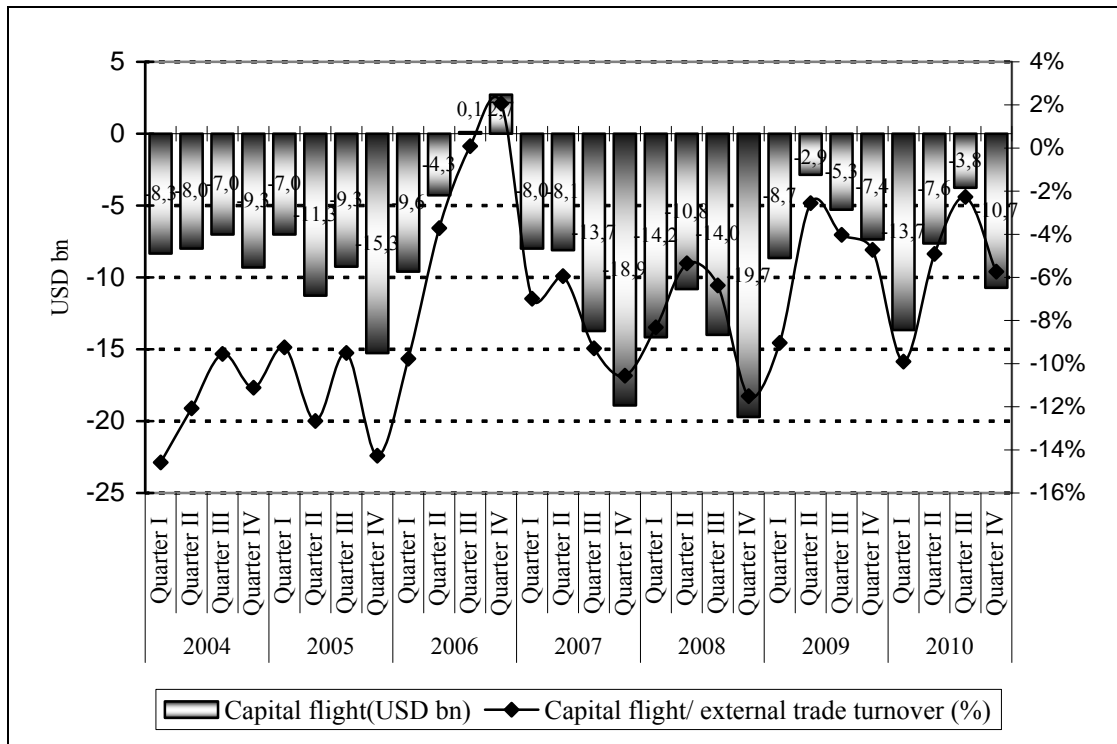
Another evidence of the unfortunate situation with the inflow of capital is acceleration of the so-called capital flight¹ in 2010. As a result of capital flight in 2010 (Fig. 12) reached, according to our estimates, 35.8 billion dollars, which is by 11.6 billion dollars more than in 2009. In 2010, respectively, an increase was recorded in the share of capital flight in foreign trade turnover from 4.9% in 2009 to 5.5%.

¹ We estimate the capital flight by the methodology of the IMF, which represents the sum of "commercial loans and advances", "delayed receivable export revenue and receivable goods and services on the account of remittances under import contracts" and "net errors and omissions".



Source: the RF Central Bank, IEP estimates.

Fig. 11. Capital net outflow dynamics in 2004–2010.



Source: the RF Central Bank, IEP estimates.

Fig. 12. Capital flight dynamics in 2004–2010.

Summarizing the analysis of the balance of payments, we should note that the decline in energy prices during the crisis has demonstrated the vulnerability of the domestic balance of payments. Restoration of oil prices in 2009-2010 helped to stabilize the balance of payments. However, with improvement of the Russian economy, imports began to recover. In addition, if during the III quarter of 2009 - II quarter of 2010 the restoration of imports was slower than exports, in the second half of 2010 the growth rate of imports has nearly twice exceeded the growth rate of exports. As a result, despite the continued rise in oil prices, late in the year, at the background of accelerating capital flight, in order to stabilize the balance of payments, it was needed to reduce Russia's international reserves amounting by 8.6 billion dollars. In the case of preservation of this trend, declining in the current account balance will continue, which will create downward pressure on the ruble.

As for balance of capital operations account and financial instruments, the capital flows apparently will remain quite volatile. However, with other terms being equal (especially in the case of stability in energy prices), in the absence of efforts on the part of the Russian government to reduce the risks of investments in Russia, one can hardly expect private capital inflows into the country as per 2011 results.

2.1.4. Main Measures in the Monetary Policy Area

Measures taken by the Bank of Russia in order to ensure the stability of the financial system can be divided into two groups: the interest rate policy and other measures.

If we talk about *interest rate policy* of the RF Central Bank in 2010, then in the first half of the Bank of Russia continued the policy of 2009 addressed to mitigate the monetary and credit policy. In particular, in January – May, the RF Central Bank reduced interest rates four times. During this period, the refinancing rate (together with the rates on Bank of Russia) was reduced from 8.75 to 7.75% per annum. The reason for such action of the RF Central Bank was that lending to the real sector of the economy has been dramatically slowed down with the reducing inflation. Slowing inflation enabled the Bank of Russia to reduce the cost of resources provided to commercial banks, slightly amending the interest rate in real terms, as nominal rates were maintained at the level of inflation. The reasons to reduce the rates, published in the RF CB press release, were in all cases approximately the same. In particular, among the reasons for lower rates there were mentioned the decline in inflation and the need to promote the recovery of the unstable economic growth.

However, as we noted earlier, the summer slowdown in inflation has stopped, and in autumn it was accelerated. Herewith, already on June 30 the Bank of Russia decided to terminate interest rate reductions. We believe that the termination of interest rate reductions was a timely decision. Moreover, the acceleration of inflation in late 2010, it is expedient to raise the issue of tightening monetary policy, as the current low interest rates t the background of excessive liquidity in the banking system encourages credit institutions to take additional risks, despite the fact that the economic situation in Russia is still far from favorable. In addition, a soft monetary policy is not helpful in inflation curbing, which acceleration is based on both, non-monetary and monetary factors. We believe that this low inflation at the level of no more than 4-5% per year should be an important factor in the growth of savings and investments in the Russian economy.

We should also note that during the crisis, interest rates of the Central Bank first began to work as a tool of monetary policy. This proved to be the result of increasing share of credits, provided by the Bank of Russia in the form of liabilities to commercial organizations, to

whom the crisis resources, available to the RF Central Bank, were practically the only source of relatively inexpensive funds. However, by mid-2010, commercial banks have returned to the Bank of Russia nearly all borrowed funds. ☒ Therefore, the possibility of the RF Central Bank to take the situation in the monetary market under control with interest rate policy once again declined. In this situation, to reduce inflation, the Bank of Russia should reduce its intervention in the foreign exchange market, smoothing only the exchange rate volatility, but not increasing (or decreasing) the volume of international reserves, thereby affecting the monetary supply. We should also note, that the sterilization of the Central Bank intervention in the foreign exchange market also provokes problems (see an insert), a detailed discussion of which is beyond the scope of this review.

The Problems of the effectiveness of the Central Bank Sterilized Interventions

The basic macroeconomic models suggest the ineffectiveness of sterilized interventions of the Central Bank¹ (i.e., the interventions in which the operations of the Central Bank in the foreign currency market do not lead to a change in the monetary base) to control the exchange rate, since such interventions domestic interest rates do not change, and according to the classical model of the formation of the exchange rate in the foreign exchange market rate also remains unchanged². However, there are entire classes of models, which showed that sterilized intervention can influence the foreign currency market. Herewith, there are two main channels of influence - the portfolio balance channel and the channel of expectations (or signaling channel).

Portfolio balance channel is usually considered in the model determining the exchange rate on the market based on comparing the economic agents profitability of investments in domestic and foreign financial assets (with the expected exchange rate changes). The differential yield is the inflow of capital to the country, which is more attractive in terms of asset returns, that leads to a strengthening of the national currency. However, in contrast to classical models of the countries, in which the assets of different countries are perfect substitutes, when considering the portfolio balances, it is assumed that economic agents pay attention to other characteristics of assets, other than returns. For example, sterilized intervention of the Central Bank in developing countries, aimed at preventing the national currency strengthening and at purchasing foreign currency in the market, may become effective due to the fact that investors consider the assets of developing countries as more risky than the assets of the developed countries.

The channel of expectations (or information channel, signaling channel) consists in the fact that sterilized intervention, without causing changes in the monetary supply, is still able to exert significant influence on the expectations of economic agents, as an intervention enables market participants to have information about the current (and future) behavior of the Central Bank. In other words, as the behavior of the players in the foreign exchange market is largely determined by their expectations about future dynamics in exchange rates, changes in expectations can significantly adjust the behavior of investors. In particular, if the national Central Bank holds sterilized interventions to support the national currency and market players believe in its ability to keep the exchange rate, then its actions may be successful, despite the fact that the interventions did not affect the monetary supply.

Other measures of monetary and credit policy, implemented by the Bank of Russia in 2010, include the following basic steps.

1. On March 19 the Bank of Russia reported that since May 1 limits for credit risk established for credit institutions to provide loans without collateral will be lowered. In other words, the Bank of Russia has reduced the maximum amount of loans granted to credit insti-

¹ See, for instance: Krugman P., Obstfeld M. *International Economics: Theory and Policy*. 8th ed. 2009.

² See: Sarno L., Taylor M.P. *Official Intervention in the Foreign Exchange Market: Is It Effective and, If So, How Does It Work?* // *Journal of Economic Literature* Vol. XXXIX. September 2001.

tutions. This step was aimed at cutting down the anti-crisis measures to support the banking sector.

We would like to note, that at the background of the economic situation stabilization in the country the indebtedness of lending institutions under the loans without collateral has decreased as it is. The majority of credit institutions have tried to reimburse the unsecured loans because of their high cost and the opportunity to attract market financing on better terms. Thus, we can assume that most of the remaining debt belongs to the banks that are still in a difficult situation. With the account to consolidation in the Russian banking sector, the measures taken will contribute to force out inefficient banks from the market.

2. On June 3, The Bank of Russia reported on the approval of Bank of Russia regulation № 2459-U of 03.06.2010, "On the Specifics of credit risk on some outstanding credits, loans and similar debts". In accordance with that Regulation, the Bank of Russia is slowly returning to the pre-crisis requirements to in the credit risk assessment. The mitigated reserve requirements to the loans, imposed during the crisis, were aimed at supporting Russian banks and allowed them to form a smaller volume of reserves in a crisis situation. Currently, the state of the banking sector has improved, and it allows the regulator to tighten the requirements to credit risk assessment, bringing them in line with general regulations.

3. On June 7, the Bank of Russia has informed on improving its information policy : from the above date the RF Central Bank started to disclose the information not only on the aggregate amount of intervention in the foreign exchange market, but also on the amount of so-called targeted interventions. We would like to recall, that the volume of targeted interventions are not considered by the Bank of Russia for adjusting the boundaries of floating exchange rate threshold, and are regulated by the situation with the Russian main exports in the world market. In fact, while maintaining oil prices at the current or higher level, the target interventions are the main channels for the formation of the monetary supply in the Russian Federation (like it was before the crisis).

Subtracting targeted interventions from the total amount of interventions, one can get the value of interventions, committed in excess of the established volume. Herewith, the Bank of Russia in its statement officially informed about the rules of such interventions: in case of the volume excess over the planned interventions in the value of USD 700 million, adjustment of the permissible threshold of the two-currency basket is made by 5 kopeks.

We believe that increasing the information transparency of the Bank of Russia is welcome. Such measures increase the confidence of economic agents to monetary policy the Bank of Russia, and help to increase its effectiveness. However, the establishment of clear rules of the exchange rate policy of the Bank of Russia is not quite justified in terms of high dependence of the Russian economy on foreign economic conditions, as the predictability of Bank of Russia in the foreign exchange market can create the preconditions for increasing the volatility of the exchange rate. For example, increasing the inflow of foreign currency to Russia the players of the foreign exchange market will know that the Bank of Russia will buy a certain amount of currency, and then increase the ruble rate. At the same opportunities to gain on ruble strengthening will rise in comparison with the situation in which the Bank of Russia are less predictable. It is reasonable to transfer to a free floating exchange rate of the ruble coupled with the smoothing of sharp exchange rate fluctuations.

4. From October 13 the Bank of Russia has symmetrically extended operating range of valid value the two-currency basket from RUR 3 to 4 and reduced the amount of accumulated interventions, leading to the shift in the operational threshold by 5 kopeks, from UDF 700

million to 650 million. In addition, the RF Central Bank has revoked the fixed threshold for the allowable fluctuations of the two-currency basket (RUR 26 and 41), which were established on January 23, 2009.

Thus step of the RF Central Bank has demonstrated its commitment to stop intervention in the foreign exchange market situation and the transition to a regime of free floating of the ruble rate. At the same time, the Bank of Russia intends to continue to mitigate the significant ruble fluctuations. We would to note, that this step can be generally welcomed, as the maintenance of the ruble, coupled with the transition to inflation targeting (see the insert), as well as the free movement of capital is a difficult challenge. We believe that in future the Bank of Russia should further reduce the scale of its operations in the foreign exchange market. In this case, the RF CENTRAL BANK in a volatile export prices will inevitably be present in the foreign exchange market, smoothing out fluctuations. Herewith, the RF CENTRAL BANK will inevitably interfere in the foreign exchange market in a stable situation there. There is concern that in case of a sustained trend towards the strengthening or weakening of the national currency, the Bank of Russia may revert to targeted exchange rate, which would nullify its actions on the transition to inflation targeting with the help of interest rates.

Inflation Targeting

Inflation targeting is a relatively new regime of monetary policy, which nevertheless is now widespread in the world. For the first time about the transition to a direct inflation targeting was informed by New Zealand in 1990, later the regime was adopted by the monetary authorities in Canada, Britain, Sweden, Finland, Australia, Spain, Israel, the Czech Republic and Chile. In Russia, some elements of inflation targeting were declared by the RF CENTRAL BANK in 1996.

In most cases, the transition to inflation targeting was the answer to those difficulties the country faced in conducting monetary policy with exchange rate monetary instruments targeting. For several years, inflation targeting was used exclusively in developed countries, but at the end of 1990 it started to be applied by developing countries and countries with economies in transition.

Inflation targeting involves several elements. These include:

- 1) public announcement of medium-term target inflation indicators;*
- 2) the institutional choice of price stability as the primary long-term goal of monetary policy;*
- 3) the communication strategy that pays less attention to the intermediate goals;*
- 4) greater transparency in the execution of monetary policy and plans of the monetary authorities;*
- 5) increasing the responsibility of the central bank in achievement the target inflation indicators.*

Inflation targeting has several important advantages. Firstly, like the targeting of monetary aggregates, it allows the monetary authorities to focus on internal problems of the economy. Since the authorities of monetary and credit regulation in this case do not establish rigid relationship between the dynamics of monetary aggregates and the rate of price growth, inflation targeting enables more flexible reaction to changes in the macroeconomic situation. Secondly, inflation targeting is more obvious and understandable to the public than the exchange rate targeting. Setting specific targets of inflation indicators increases the responsibility of the central bank for its performance and helps to solve the problem of inconsistency in monetary policy.

However, it should also be noted that the inflation targeting regime is often criticized. First, inflationary processes are not always under complete control of the monetary and credit regulation authorities. In periods of economic shocks (financial crisis, external price shocks), non-monetary factors play an important role in the dynamics of inflation and the instruments of control, available to monetary authorities, may be insufficient to achieve targeted levels of inflation. This disadvantage is particularly important for developing countries and economies in transition, where after reaching the medium and low inflation rates, the impact of the exchange rate, structural changes in the economy and prices, external shocks, etc. increases dramatically.

Second, inflation targeting implicitly assumes that the monetary authorities focus on one of the macroeconomic targets (on inflation), not paying much attention to the dynamics of other target variables (in the first place, employment and production output growth).

Third, there is a fairly long lag between the actions of monetary authorities and the change in price growth. If during periods of stable economic development that does not matter, under conditions of economic shocks (when government actions are the most important), inflation targeting leads to the need of the monetary authorities to address the problem of intermediary optimization with rigidly defined local conditions, and herewith, they have to take into regard the consequences of their previous decisions.

5. On October 18, the RF Central Bank reported on the recovery from January 1, 2011 of the approaches to the formation of a list of the Bank of Russia, which were in force until February 2009. We would like to recall, that the companies included in this list, enjoy the majority of the Central Bank credits, granted to commercial banks.

Like before the crisis, the List of the Bank of Russia will include organizations, whose rating of the long-term creditability in foreign currency under the assessment of at least one of the foreign rating agencies is at the level not less than “B-” by rating agencies Standard & Poor's or Fitch Ratings or “B3” under classification rating agency Moody's Investors Service. In addition, the Bank of Russia will excluded from the listing the entities, included in the list of strategic organizations, approved by the Governmental Commission on Sustainable Development of the Russian economy. Herewith, the liabilities of systemically important institutions, which will serve as loans to the Bank of Russia as of January 1, 2011, will remain in the pledge before their maturity.

Thus, the Bank of Russia took another step on the “exit” from the crisis management measures to support the banking system, increasing quality requirements for collateral under the loans granted to them, which can be considered correct and timely measure. At the same time, due to a small number of systemically important institutions included in the List and at the same time having to use a significant amount of debt liabilities, this move will hardly have a serious impact on the Russian economy.

6. In early November, the RF Central Bank has submitted to the RF State Duma the “General Directions of monetary policy in 2011 and for 2012 and 2013”. In that document the Bank of Russia has clearly outlined its major task for 2011-2013, which should be inflation curbing within 5-7% per year. Herewith, the RF Central Bank does not set quantitative indicators in the dynamics of the ruble rate and declared the continuation of the movement toward a free exchange rate, while smoothing the volatility of the exchange rate. In our view, such a formulation of the purposes of the Bank of Russia allows it to conduct monetary policy more effectively without trying to simultaneously achieve two largely conflicting goals: reducing inflation and maintaining exchange rate. At the same time, it is obvious that in the medium term the Bank of Russia will be unable to restrain from interfere in the exchange rate (in addition to smoothing volatility), due to the high dependence of the Russian economy from external economic situation. Herewith, the intervention of the RF Central Bank is likely to increase in periods of abrupt changes in supply and demand in the foreign exchange market. We believe that namely in such periods the willingness of the Bank of Russia to the free exchange rate regime will be tested in practice.

Among other monetary and credit policy indicators in the medium term are the follows:

- enhancing the role of the RF Central Bank interest rate policy in reducing inflation and inflationary expectations (the narrowing interest rate corridor) within the framework of this purpose, the RF Central Bank plans to gradually reduce the difference in interest rates on credits provided to banks and resources attracted from them, in case of significant volumes of transactions between the Bank Russia and banks and the restriction of the corridor will more accurately affect the interest rates in the RF;

- cutting down counter-crisis measures;
- consolidation and capitalization of the banking sector;
- taking into account the situation on financial markets when conducting monetary and credit policy, the question is, in particular, about the decision to change monetary policy, taking into account the dynamics of not only inflation, but also prices in financial markets;
- increased transparency and improvement of monetary and credit policy analysis.

With regard to the macroeconomic forecast, included in the "Guidelines", the growth of the monetary base in narrow definition in 2011, according to the forecast the RF Central Bank will make 7.7-19.4%. International reserves at the end of 2011 could reach from 478 to 576 billion dollars. The forecast is based on three versions, with an intermediate variant, based on the price of oil in 2011 at the level of 75 dollars per barrel, which is consistent with macroeconomic forecast of the Russian government. In general, the forecast of the Bank of Russia, in our opinion, is fairly realistic and roughly coincides with the IEP assessments. Implementation of the Central Bank estimates in terms of monetary growth will largely depend on the dynamics of capital flows. In the version of "Guidelines", submitted to the RF States index of private capital outflows from Russia for 2010wqszxd has been increased from 9 to 22 billion dollars, which demonstrates once again the volatility and poor predictability of this index, as its outlook has changed several times in During the year, and actual results for the year several times differed from the forecast of the Bank of Russia, given at the beginning of the year.