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R95 **Russian Economy in 2012. Trends and Outlooks.**

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The review provides a detailed analysis of main trends in Russia's economy in 2012. 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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2.1. Russia's Monetary Policy in 2012

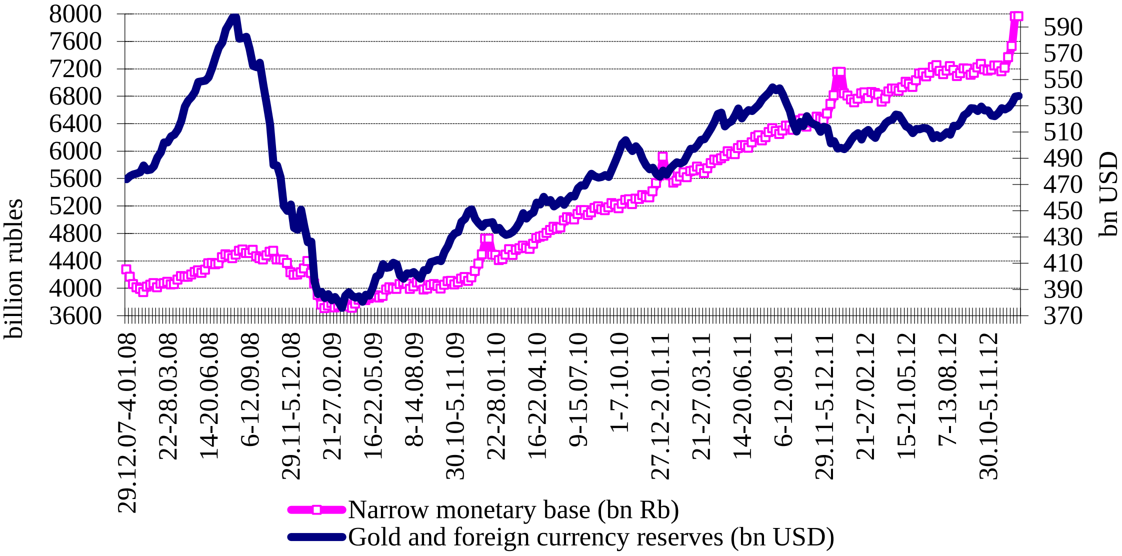
In 2012, the RF Central Bank continued to bring down the scale of its interference in the foreign-exchange market's functioning: the volume of its currency interventions carried out over the course of that year hit a ten-year low. Besides, the monetary policy's key feature in 2012 was that the Bank of Russia completed its switchover to the practice of money supply formation through the issuance of loans to commercial banks. As seen by the year-end results, the amount of debt owed by banks to the RF Central Bank had exceeded the level of late 2008 – early 2009. However, in contrast to the crisis period, the bulk of debt growth was produced by repo operations (and not by unsecured loans), which means that the credit portfolio's quality had improved.

In accordance with the new monetary policy mode the main target indicator for the RF Central Bank is the inflation rate, which by the year's end had exceeded its 2011 level, thus getting beyond the target interval of 5–6% outlined in the main directions of the RF Central Bank's monetary policy for the period of 2012–2014. Most probably, a key role in speeding up the inflation rate was also played by some non-monetary factors, including the growth of food prices at a rate faster than that predicted by the Bank of Russia. However, the surge of inflation so far above its targeted value is a phenomenon that requires an in-depth analysis of the current policy, the instruments applied by the monetary regulation agencies in building their forecasts, and the mechanisms of response to negative price shocks.

Below we discuss in more detail the processes that have been occurring in the monetary sphere as part of Russia's national economy.

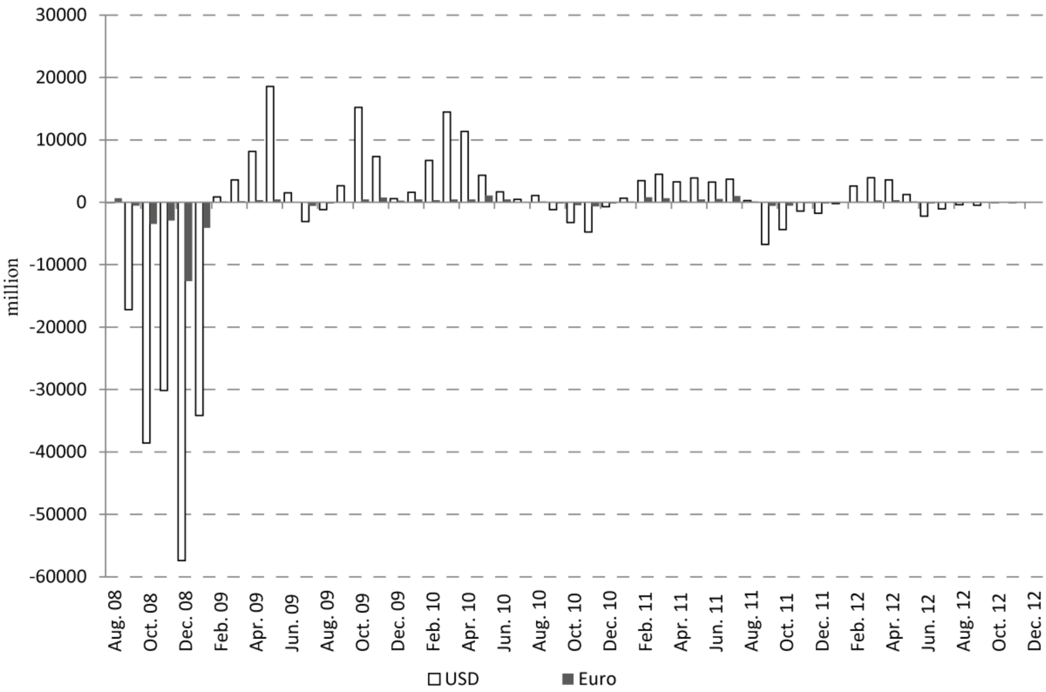
2.1.1. The Money Market

In 2012, the volume of net purchases of foreign currency on the market by the RF Central Bank dropped to $ 6.8bn from $ 10.5bn in 2011. As a result, towards the year's end the volume of international assets held by the RF Central Bank as reserves had changed only slightly: from $ 498.6bn as of 1 January 2012 to $ 537.6bn as of 1 January 2013 (see *Fig. 1* and *2*).



Source: RF Central Bank.

Fig. 1. The Behavior of the Narrow Monetary Base[1] and the International Reserves Held by the RF Central Bank in 2008–2012



Source: RF Central Bank.

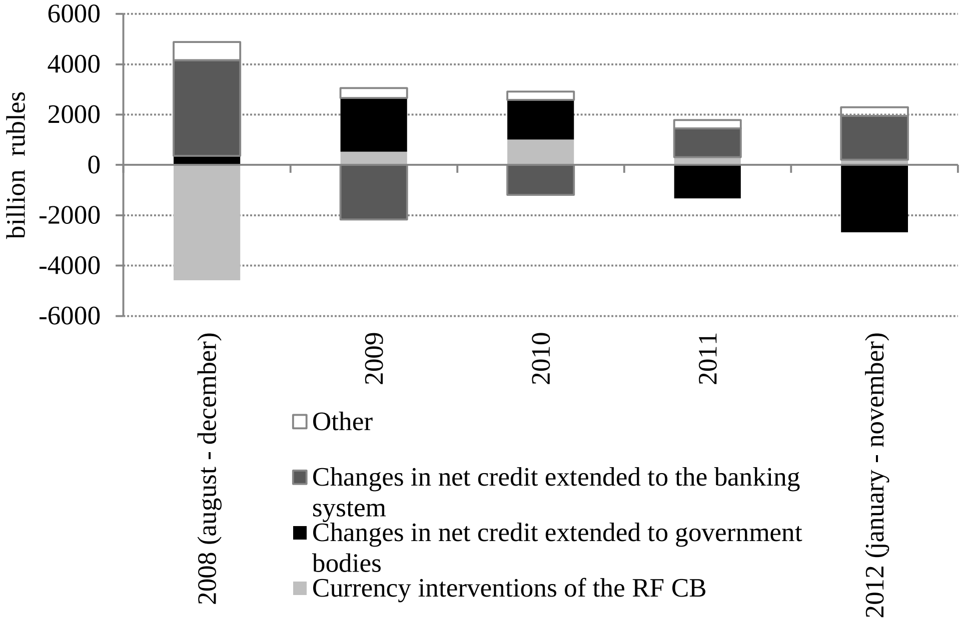
Fig. 2. The Bank of Russia's Currency Interventions (Net Currency Purchases) in 2008–2012

As a result, in 2012 – just as it had been a year earlier – the currency interventions undertaken by the RF Central Bank had practically no influence on the monetary base's behavior (see *Fig. 3*). Nearly throughout the entire last year's period, the broad monetary base[2] was on the decline: over January–November its value dropped by 4.5% to Rb 8.257bn. It should be noted that in the second half-year the monetary base was shrinking at a slower rate than it had done in the first half-year. In Q4, however, the broad monetary base began to increase in response to the traditional upsurge of government expenditure at a year's end. The shrinkage in the monetary base was caused, on the one hand, by the markedly reduced volume of the regulator's currency interventions in 2012 (the year's highest level of currency interventions

[1] The monetary base (narrow definition) consists of the currency issued by the Bank of Russia (including cash in vaults of credit institutions) and required reserves balances on ruble deposits with the Bank of Russia.

[2] The broad monetary base describes the Bank of Russia's monetary liabilities denominated in the national currency that determine money mass growth. The monetary base (broad definition) consists of the currency issued by the Bank of Russia (including cash in vaults of credit institutions), the balances in the required reserve accounts deposited by credit institutions with the Bank of Russia, the correspondent account balances (including averaged amount of the required reserves) and the balances on the deposit accounts of credit institutions with the Bank of Russia, the Bank of Russia bonds (OBRs) held by credit institutions, the balances on the required reserve accounts deposited by credit institutions with the Bank of Russia against their attracted funds in foreign currency, and other liabilities of the Bank of Russia against its operations with credit institutions in the currency of the Russian Federation.

achieved in March ($ 4.3bn) dropped 180-fold to $ 23.6m in October, and on the other, by the accumulating budget surplus on the government's accounts with the RF Central Bank (see *Table 1*). At the same time, the principal source of the monetary base's growth, as before, were the resources of Bank of Russia – the latter having increased the volume of its credits issued to commercial banks.



Source: RF Central Bank; the IEP's calculations.

Fig. 3. The Principal Factors Influencing the Behavior of the Monetary Base (Broad Definition) in 2008–2012 [1]

Table 1

The Bank of Russia's Balance Sheet in 2011–2012

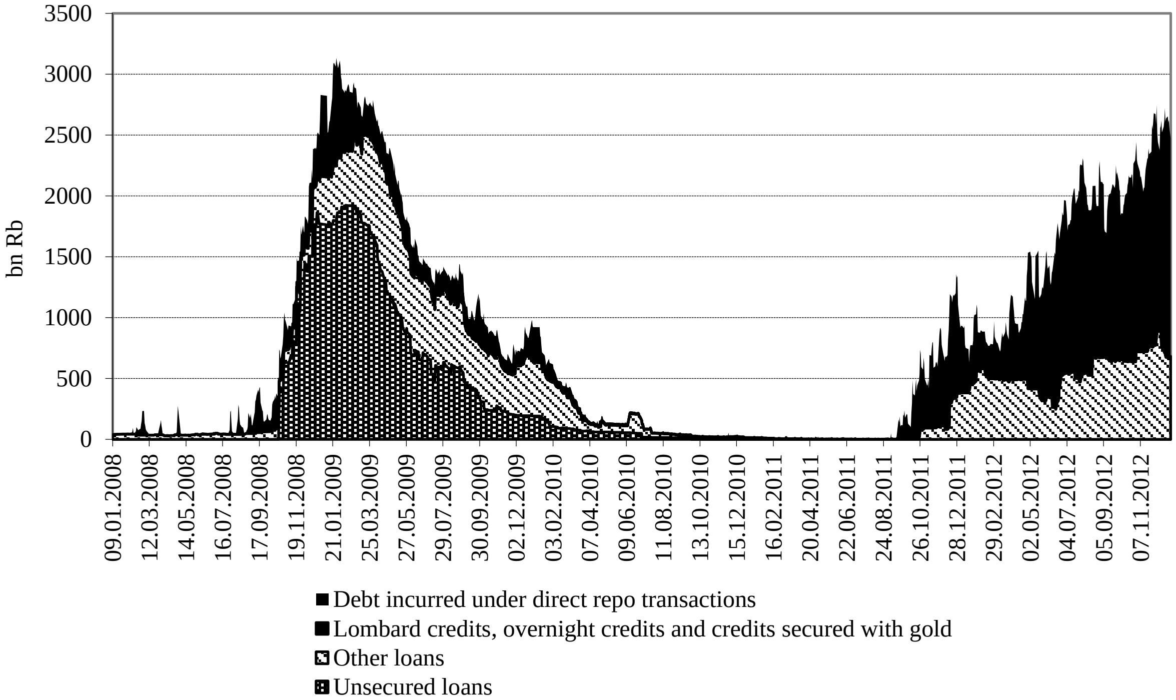
	1 January 2011		1 January 2012		1 November 2012	
	Bn Rb	**% of assets/ liabilities**	**Bn Rb**	**% of assets/ liabilities**	**Bn Rb**	**% of assets/ liabilities**
Funds placed with nonresidents and securities issued by nonresidents	13,272	85.5	14,245.3	76.7	14,575.7	68.7
Credits and deposits	514	3.3	1,663.3	9.0	3,404.6	16.0
Precious metals	1, 201	7.7	1,527.5	8.2	1,720.8	8.1
Securities	441	2.8	426.2	2.3	453.6	2.1
Other assets	99	0.6	97.9	0.5	1,066.0	5.0
Total assets	**15,526**	**100**	**18,562.7**	**100**	**21,220.7**	**100.0**
Cash in circulation	5,792	37.3	6,896.1	37.2	6,872.0	32.4

[1] The period under consideration in 2008 and 2012 is determined by the availability, during the preparation of this overview, of data released by the RF Central Bank on its currency interventions and its balance sheets.

Funds in accounts with the Bank of Russia	6,431	41.4	7,742.2	41.7	10,131.7	47.7
Of which: Russian government funds	3,270	21.1	4,443.5	23.9	6,196.7	29.2
funds of resident credit institutions	1,817	11.7	1,748.4	9.4	1,387.2	6.5
Float	7	0.0	36.2	0.2	22.3	0.1
Bank of Russia bonds	589	3.8	0	0	0.0	0.0
Liabilities to the IMF	-	-	472.3	2.5	458.2	2.2
Other liabilities	145	0.9	158.6	0.9	496.4	2.3
Capital	2,359	15.2	3,235.4	17.4	3,240.1	15.3
Profit of a fiscal year	204	1.3	21.9	0.1	0.0	0.0
Total liabilities	**15,526**	**100**	**18,562.7**	**100**	**21,220.7**	**100.0**

Source: RF Central Bank.

As seen from *Fig. 4*, the amount of debt owed by commercial banks to the RF Central Bank began to grow rapidly in late 2011. In 2012 its level practically reached its record high observed over the period of 2008–2009. Thus, at present it so happens that the monetary base is mainly formed by credits issued by the RF Central Bank. However, it should be noted that, in contrast to the situation typical of the crisis period, the size of debt is now increasing mainly as a result of the expansion of repo operations instead of unsecured credits, and thus the quality of the RF Central Bank's credit portfolio is improving. The high degree of dependence of commercial banks on the monies loaned by the RF Central Bank enables the latter to exert a stronger influence on market interest rates by regulating the interest rates on its loans through the application of liquidity provision and absorption instruments.



Source: RF Central Bank.

Fig. 4. Outstanding Debt of Credit Institutions against Loans Issued by the Bank of Russia in 2008–2012

Let us have a closer look at the structure of monetary base (broad definition) (see *Table 2*).

Table 2

Behavior of Monetary Base (Broad Definition) in 2012 (bn Rb)

	1 January 2012	1 April 2012	1 July 2012	1 October 2012	1 January 2013
Monetary base (broad definition)	8,644.1	7,787.8	8,129.3	8,082.8	9,852.8
- cash in circulation, including cash in vaults of credit institutions	6,895.8	6,450.8	6,809.7	6,826.8	7,667.7
- correspondent account balances of credit institutions with the Bank of Russia	981.6	812.5	790.7	753.7	1,356.3
- required reserves	378.4	385.2	393.1	411.5	425.6
- deposit account balances of credit institutions with the Bank of Russia	388.3	139.3	135.8	90.8	403.3
- Bank of Russia bonds (OBRs) held by credit institutions	0	0	0	0	0

Source: RF Central Bank.

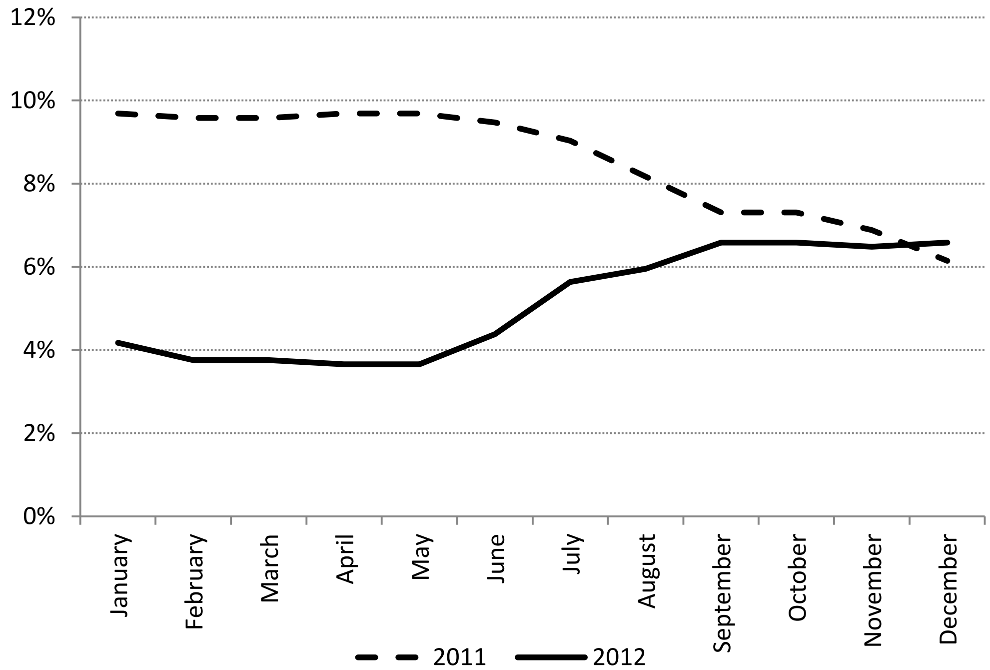
Over the course of 2012, the cash in circulation volume increased by 11.2%, amounting as of the year’s end to Rb 7,667.7bn. The amount of required reserves rose from Rb 378.4bn to Rb 425.6bn. The money market ran a ruble liquidity deficit practically throughout the whole year. From January through November 2012 were on the decline: the correspondent account balances of commercial banks with the Bank of Russia dropped by Rb 154.2bn, the deposit account balances of credit institutions with the RF Central Bank dwindled by Rb 250bn, while the amount of their investment in the Bank of Russia bonds remained at zero. However, the sharp rise in government expenditures in December resulted in a growth of excess reserves: on the whole, over the course of 2012, the correspondent accounts balances increased by 38.2%, to Rb 1.4 trillion, while the deposit account balances rose by 3.9%, to Rb 403.3bn.

While in Q1 2012 the annual growth rate of the M2 ruble money supply was relatively stable (approximately 21–22% in per annum terms), it continually decreased from Q2 2012 onwards, to 11.9% as of 1 January 2013. The decline in the growth rate of the money supply will apparently have a restraining effect on inflation in early 2013.

In 2012, the money multiplier's value (ratio of M2 to monetary base) remained practically unchanged – at a level of 3. This value of a money multiplier represents a typical average for a developing economy, while in developed economies it is usually higher – somewhere in the 5 to 8 interval.

2.1.2. Inflation Processes

In 2012, the year-over-year growth rate of consumer prices was higher than in 2011, when it hit a record low for the entire post-Soviet period of Russian history (+6.1%) (see *Fig. 5*).



Source: Rosstat; the IEP's calculations.

Fig. 5. The Growth Rates of Consumer Prices in the Russian Federation in 2011 and 2012 (in Annual Terms)

In the first half-year of 2012, the main factors behind the drop in inflation were the shifting of the regular date of the annual indexation of the state-regulated prices and tariffs for paid services provided to the population from 1 January to 1 July, and the decline in the growth rate of the money supply in 2011. Also, the decline in inflationary pressures was contributed to by the moderate growth in producer prices (in the first half-year of 2012, the Industrial Producer Price Index rose by 6.1% on the first half-year of 2011 vs. a 19% rise in the first half-year of 2011 on the corresponding period of 2010), and by rather moderate global food prices[1].

However, in the summer of 2012, the growth rate of consumer prices began to steadily increase. It should be noted, that both the deceleration of inflation in the first half-year 2012 and its acceleration in the second half-year 2012 were largely caused by non-monetary factors. The rise in the growth rate of food prices, greatly contributed to by the poor cereal harvests in a number of Russian regions and around the world, was a major inflation factor. Food prices in Russia were also boosted by the worsening state of the global agricultural market. Furthermore, the rise in consumer prices in the second half-year of 2012 was caused by significant increases in administratively regulated tariffs.

Over the course of October–December 2012, inflation stabilized around 6.5% per year. This drop in inflation was caused by a combination of several factors, including the reduction in the negative impact of the failed harvest, the decline in base inflation, and the deceleration in economic activity.

As shown in *Table 3* below, over the course of 2012, the prices of food products were rising at a rate 1.7 times higher than that in 2011. Alcoholic beverages, whose prices rose by 12.1% owing to an increase in excise taxes, were among the main contributors to inflation. Adverse weather conditions pushed up the prices of fruit and vegetable products (+11%), bread and bakery products (+12%), and meat and poultry (+8,3%), whose prices usually grow after a rise in grain prices.

In 2012, the lowest increase in prices was registered for non-food products (+5,2%). Nevertheless, the prices of tobacco products rose by an unprecedented 22.6%, which represented the highest price increase recorded by any category of consumer goods and services. This sharp rise in the prices of tobacco products was caused, in the main, by a considerable increase in excise taxes. The growth rate of motor gasoline fell from 14.9% in 2011 to 6.8% in 2012. This drop resulted from the retail prices of fuel being frozen in January-March 2012 at 2011 levels.

In 2012, the prices of paid services provided to the population increased by 7.7% on 2011. It should be noted that the growth rate of prices for most categories of services registered a decline.

Table 3

The Annual Growth Rate of Prices for Individual Categories of Goods and Services in 2010-2012 (as a Percentage of December of the Previous Year)

	2010	2011	2012	2010–2012[2]
1	2	3	4	5
CPI	**8.8**	**6.1**	**6.6**	**23.1**
Food Products	12.9	3.9	7.5	26.1
Grains and Pulses	58.8	-8.0	-7.0	35.9
Butter	23.3	6.6	3.0	35.4
Sunflower Oil	27.6	4.6	3.4	38.0
Pasta	4.7	3.4	7.6	16.5
Milk and Dairy Products	16.7	6.3	4.4	29.5
Bread and Bakery Products	7.6	8.9	12.0	31.2
Meat and Poultry	5.3	9.2	8.3	24.5

[1] http://www.fao.org/worldfoodsituation/wfs-home/foodpricesindex/ru/
[2] The cumulative inflation rate over three years.

cont'd

1	2	3	4	5
Fish and Seafood Products	4.8	10.3	1.9	17.8
Fruit and Vegetable Products	45.6	-24.7	11.0	21.7
Alcoholic Beverages	8.3	8.4	12.1	31.6
Non-food Products	5.0	6.7	5.2	17.9
Building Materials	4.6	7.9	5.1	18.6
Motor Gasoline	6.5	14.9	6.8	30.7
Tobacco Products	19.5	21.1	22.6	77.4
Services	8.1	8.7	7.3	26.1
Housing and Utilities Services	13.0	11.7	9.4	38.1
Pre-school Education Services	7.7	11.3	6.4	27.5
Sanatorium and Health Recovery Services	5.4	9.0	5.9	21.7
Passenger Transport Services	8.7	9.1	6.9	26.8
Cultural Institutions' Services	8.6	11.3	8.8	31.5

Source: Rosstat.

In conclusion of this section of our paper, let us compare the growth rates of consumer prices in Russia and the other CIS countries (*Table 4*).

Table 4

The Movement of Consumer Price Indices in the CIS Countries in 2010-2012, % Per Annum

	2010	**2011**	**2012***	**2010–2012*[1]**
Azerbaijan	6	8	–2.7	11
Armenia	8	8	–1.5	15
Belarus	8	53	16.1	92
Kazakhstan	7	8	3.9	20
Kyrgyzstan	8	17	3.1	30
Moldova	7	8	2.4	18
Russia[2]	*7*	*8*	*5.2*	*22*
Tajikistan	6	13	5.6	26
Ukraine	9	8	–0.3	17

*Data for January-September.
Source: Interstate Statistical Committee of the CIS (http://www.cisstat.com/).

By the end of the first three quarters of 2012 (see *Table 4*), Russia ranked 3rd place among the CIS countries, below Belarus and Tajikistan, in growth rate of consumer prices. It should be noted that a number of countries in that region faced deflation. Those countries were as follows: Azerbaijan (-2.7%), Armenia (-1.5%) and Ukraine (-0.3%). Thus, Russian inflation remained to be high not only in comparison with developed countries, but also with the other countries of that region.

In early 2013, inflation will be restrained by a number of factors, including the stabilization of food prices, which began in late 2012; the slow-down of economic activity; and the moderate growth of the money supply. As a result, it can be expected that by mid-year 2013 the rate of consumer inflation will drop to around 6%. At the same time, the further movement of inflation in Russia will be determined by both the situation in the global economy, including in

[1] The cumulative inflation rate for 2010 - September 2012.
[2] It should be noted that Russia's annual inflation rates presented in *Table 4* differ from official *Rosstat* data, which results from the peculiarities of the calculation methodology adopted by the Interstate Statistical Committee of the CIS. Nevertheless, we have decided to present here the Committee's data in order to make it possible to compare the annual inflation rates of different countries.

the global food market, and by Russia's domestic trends in the field of tariff regulation of housing and municipal utilities services as well as in her anti-monopoly and tax policies.

2.1.3. The Main Developments in the Field of Monetary Policy

Over the course of 2012, the RF Central Bank changed the refinancing rate only once, on 14 September, when it was increased by 0.25 pp., from 8 to 8.25% per annum. Simultaneously, the RF Central Bank increased by 0.25 pp. the interest rates on liquidity provision and absorption operations. In effect, this measure was the RF Central Bank's response to Russia's rising inflation. It should be mentioned that consumer inflation, after dropping in April and May 2012 to around 3.7% in annual terms, then started to creep up once again: in August Russia's CPI rose to an impressive 6% on a year-on-year basis, while the inflation target established by the Government for 2012 also amounted to 6%.

As we have already pointed out, the main causes of the rapid acceleration of inflation in the second half-year of 2012 were the growth in tariffs for consumer services and the rise in the global prices of food products, which resulted from the adverse weather conditions in a number of agricultural producing countries. Formally, these factors do not depend on the monetary policy of the RF Central Bank. However, base inflation was also on the rise, which set the stage for a rise in interest rates, given the situation created by the policy of inflation targeting declared by the Bank of Russia. We believe that this policy of the RF Central Bank was absolutely justified from the point of view of the current goals of Russia's monetary policy; in fact, it could be regarded as a signal to economic agents that the top priority goal of monetary policy should be to restrain inflation. At the same time, bearing in mind Russia's lackluster economic growth, and the largely exogenous character of Russian inflation, it should be admitted that the potential for a further significant rise in interest rates is rather limited.

Apart from changing the refinancing rate, the Bank of Russia undertook a number of measures designed to increase the effectiveness of its policy on interest rates. Thus, on 29 March 2012, the RF Central Bank announced that it would resume auction-based allocation of Lombard credits and direct repo auctions for a term of 12 months. It should be reminded that as the Russian economy recovered from the 2008-2009 economic crisis, the Bank of Russia gradually rolled back its anti-crisis measures aimed at propping up Russia's banking system. This bank bailout policy included the suspension, by the Bank of Russia, of direct repo auctions and Lombard credit auctions for a term of 12 months, put into effect in April 2010. However, the reduction in the RF Central Bank's interference in the functioning of the foreign-exchange market and the resulting decline in the Bank's foreign currency interventions caused a considerable shrinkage of its influence on the money base of the monetization channel of Russia's balance of payments. In due course, this development gave rise to the issue of bank refinancing extension, on the part of the RF Central Bank, for the purpose of maintaining the money supply at an adequate level. One of the methods for solving this issue is to increase the periods of the Bank of Russia's credits extended to banks. Thus, the RF Central Bank's decision can be considered justified. At the same time we cannot support the demand put forth by a number of Russia's biggest banks that the RF Central Bank should either provide long-term unsecured credits to commercial banks or considerably mitigate its collateral security requirements towards credits. In our view, in order to prevent the emergence of 'bubbles' and to exercise control over risks, the RF Central Bank should predominantly grant secured credits.

On 9 April 2012, the Bank of Russia introduced a new monetary policy instrument – a one-week deposit auction facility with a maximum interest rate of 4.75%. On Tuesdays, starting from 17 April, the Bank of Russia regularly held auctions for a term of one week either designed to provide funds to banks (a direct repo auction and a Lombard loan auction) or designed to absorb liquidity (deposit auctions introduced from 10 April 2012).

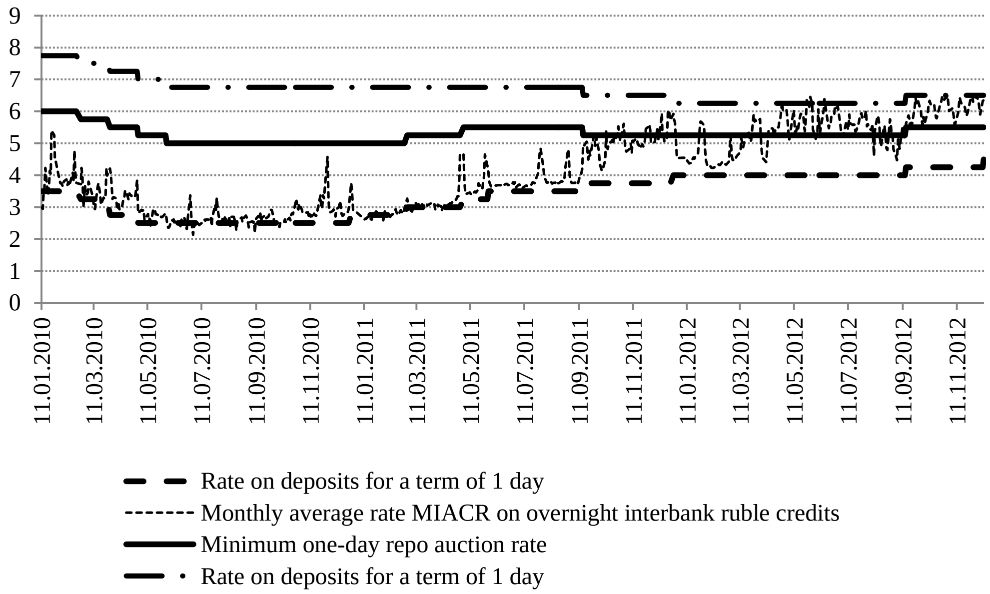
According to representatives of the RF Central Bank, the implementation of these decisions would contribute to the reduction of money market interest rates volatility and would enhance the effectiveness of the interest rate policy pursued by the Bank of Russia. In our view, the newly introduced measure conforms to the Bank of Russia's strategy aimed at increasing the role of the RF Central Bank's interest rates in Russian monetary policy. Under the adopted scenario, deposit auction interest rates are used as a tool to influence the setting of the minimum interest rate at the interbank loan market, while interest rates on liquidity-provision operations (direct repo and Lombard loans) – as a tool to influence the setting of the maximum interest rate at that market.

On 22 May 2012, the RF Central Bank announced its decision to resume direct repo operations with banks, collateralized by shares included in the Lombard list of the RF Central Bank. This step was taken to offset the liquidity concerns of Russia's banking system, which has become increasingly dependents on the provision of funds by monetary regulatory bodies. It should be reminded that in the post-crisis period the funds provided by the RF Central Bank to commercial banks became the main source of money supply formation in the Russian Federation. It was in response to this situation and the growing instability of global financial markets that the RF Central Bank made the decision to resume the extension of credits to banks against the security of shares. At the same time, it should be noted that the rapid growth in the RF Central Bank's credit lending to banks taking place against the background of a relatively slow growth of the deposit base sets the stage for future financial instability – if there happens to be a slowdown in such credit lending. Bearing this in mind, the RF Central Bank should take a more cautious approach to the issue of refinancing credit institutions and strictly control the risks faced by banks.

On 11 December 2012, the RF Central Bank once again narrowed the spread between the interest rates on some of its liquidity providing and absorbing operations. At the same time, the Bank of Russia reduced the interest rate on the ruble leg of its currency swap transactions from 6.75 to 6.5% per annum. Also, the RF Central Bank decided to raise - effective from 11 December 2012 - the interest rates on the Bank of Russia's fixed-term deposit operations by 0.25 percentage points, to 4.5% per annum.

It should be noted that, over the course of 2012, the Bank of Russia discontinued the use of some of its less effective and not popular instruments. The RF Central Bank suspended, from 17 April 2012, fixed-rate deposit operations conducted on standard conditions and Lombard loans for a term of one week. Also, the RF Central Bank suspended, from Q3 2012, deposit auctions for a term of one month – and replaced them with deposit operations at fixed interest rates.

Thus, as shown in *Fig. 6*, over the course of 2012 the Bank of Russia continued to narrow the spread between the interest rates on its liquidity providing and absorbing operations with banks. However, it should be noted that in 2012 interest rates in the interbank loan market systematically exceeded the upper limit of the interest rate corridor established by the RF Central Bank for auction-based operations. This trend reflects credit institutions' high demand for funds in a situation characterized by tight liquidity conditions in the money market and the limited possibilities of attracting money from foreign sources. At the same time many banks are simply incapable of attracting funds from the RF Central Bank РФ because of the insufficiency of their borrowing bases.



Source: RF Central Bank.

Fig. 6. The RF Central Bank's Interest Rates on Liquidity Providing and Absorbing Operations, and the Rate on the Interbank Loan Market, in 2010 – December 2012

However, on the whole, this country's money market is being strongly influenced by the Bank of Russia's current interest rate policy – which represents an important condition for a successful switchover to the inflation targeting regime. Another aspect of that switchover is the foreign exchange policy of the RF Central Bank. In 2012, it continued to pursue the top-priority goal of that policy – to scale down its direct interference with setting the exchange rate on the domestic foreign-exchange market, thus making possible significant fluctuations of the ruble's nominal exchange rate.

On 24 July 2012, the Bank of Russia widened from 6 to 7 rubles the bi-currency basket floating operational band and decreased the cumulative interventions threshold for shifting the boundaries of the operational band by 5 kopecks from $ 500m to $ 450m. It should be reminded that, from 27 December 2011, the bi-currency basket floating operational band had already been widened from 5 to 6 rubles, and the cumulative interventions threshold brought down from $ 600m to $ 500m.

The decision to decrease the cumulative interventions threshold influencing the bi-currency basket floating operational band is indicative of the increasing flexibility of the RF Central Bank's exchange rate policy. The measures undertaken by the Bank of Russia point to a gradual abandonment of its policy of regulating the exchange rate and the beginning of a switchover to inflation targeting. During the period of instability on the foreign exchange market in the autumn of 2011 and the spring of 2012, the Bank of Russia demonstrated its preparedness to minimize its interference with the operation of the foreign exchange market and to allow some noticeable fluctuations in the ruble's nominal exchange rate. Such a policy results in a lower volume of speculations in the foreign exchange market, because the exchange rate's movement becomes less predictable.

In accordance with one of the priority goals of its monetary policy – *to promote information openness* – the Bank of Russia, from 7 August 2012 onwards, began to publish on its official website the information on the volume and structure of money supply M2 (national definition). From 1 January 2011, the data on money aggregates are to be broken down by level of liquidity (where M0, M1 and M2 are shown separately); another new feature is the by-sector distribution of deposits, where the funds of non-financial and financial institutions (with the exception of credit institutions) are presented separately from the population's funds.

From 4 December 2012, the Bank of Russia began to publish its forecast of factors underlying the formation of banking sector liquidity. The forecast highlights the following four key factors: changes in the volume of cash in circulation (outside the Bank of Russia); changes in balances of the general government's accounts with the Bank of Russia, and other operations; the Bank of Russia's regulation of the size of credit institutions' required reserves; and the balance of the Bank of Russia's liquidity providing and absorbing operations. On the whole, the appearance of such a forecast is a welcome development because, in addition to greater openness of the RF Central Bank's information sources, it will also conduce to a higher transparency of its monetary policy, and so increase the confidence of economic agents in the RF Central Bank's policies.

On 4 November, 2012 the Bank of Russia published on its official website the draft of *Guidelines for the Single State Monetary Policy in 2013 and for 2014 and 2015* (hereinafter referred to as *the Draft*). As stipulated in the Draft, by 2015 the RF Central Bank is planning to complete the switchover to inflation targeting. We believe that the Draft should be analyzed, in the main, from the point of view of that principal goal set by the Bank of Russia for its monetary policy in the medium-term perspective. Thus, this document has given rise to a number of serious questions.

Within the framework of the strategy of continual reduction in the growth rate of prices, it envisaged that, by 2014, the inflation rate must drop to 4–5% per annum. In this connection, the inflation target range for 2013 is set at 5–6%. It should be reminded that the inflation target range for 2012 was also set at 5–6%, but the Draft's authors admit that it might be possible for actual inflation indicators to move above the upper margin of that range. However, in the document it is simply stated that such a risk has indeed emerged as a result of rapid growth of food prices.

It must be noted in this connection that a detailed analysis of the ongoing inflation processes and the measures applied by the regulatory monetary authorities in order to keep the inflation rate within the established target range is a key component of an inflation targeting regime. The international experience in the sphere of inflation targeting by central banks point to the necessity to analyze very carefully the causes of the inflation rate slipping beyond the established target range. As noted earlier, the factors that have determined the surge of the inflation rate above the forecast level are largely beyond the RF Central Bank's control. Nevertheless, judging by the specific features of the current situation, it can be concluded that the RF Central Bank still failed to thoroughly analyze and take into account the existing inflation risks.

It is a noticeable fact that, in recent years, the rate of inflation has been declining in response to external factors rather than to the policies pursued by the RF Central Bank. Besides, as the Bank of Russia has rarely achieved its proclaimed inflation targets, the trust of economic agents in its forecasts must evidently be rather low. In such a situation, it will be very important to accurately explain the meaning of the planned anti-inflation measures, as well as the reasons why the inflation rate is moving beyond the target range. However, judging by the Draft's content, the RF Central Bank holds a different opinion.

The main goal of its exchange rate policy is perceived by the Bank of Russia as that of reducing its direct interference with its level and creating appropriate conditions for a switchover to a floating exchange rate mode (by 2015). The Draft puts forth the idea that, as such interference with the foreign exchange market on the part of the RF Central Bank becomes lesser, the policy aiming at the regulation of interest rates through liquidity provision and absorption operations will become a key component of the process of monetary regulation.

However, it must be borne in mind that the RF Central Bank's interest rates began to significantly influence the money market only after the 2008–2009 crisis, when the RF Central Bank's funds became an important component of commercial banks' liabilities. Indeed, in recent years the Bank of Russia has minimized its monetary interventions in the market, with the result that its refinancing operations are now the main channel for money supply growth. In the Draft it is assumed that if the average annual price of Urals increases to the level of $ 121 per barrel, the growth of the RF Central Bank's international reserves in 2013 will exceed $ 90bn. However, this will, in fact, mean a reversal to the pre-crisis monetary policy model, when the Bank of Russia suppressed the ruble's strengthening in nominal terms through foreign exchange purchases on the market. If such a policy is indeed resorted to, the monetary base will once again be formed in the main by monetary interventions undertaken by the RF Central Bank, and the role of interest rates will be waning. A considerable increase in net credit extended to banks is planned only in the event of a considerable worsening of the economic situation and a decline of prices for top Russian exports.

Besides, the Bank of Russia sets the following important medium-term goals:

- maintenance of financial stability (in order to achieve this goal the activity of the Bank of Russia will based on international best practices in the field of risk-oriented supervision; maintenance of the transparency of credit institutions' activity; and differentiated supervision over financial institutions depending on their systemic importance). We believe that in order to achieve this goal, special emphasis should be placed on analyzing the banking system's resilience to shocks with taking into account their strong dependence on government-sponsored refinancing;
- development of the infrastructure of Russia's financial markets and the enhancement of their capacity. As the switchover to inflation targeting gathers pace, the derivatives market assumes special importance for hedging foreign exchange risks that will progressively increase due to the growing volatility of the exchange rate of the ruble;
- ensuring coordination between the monetary policy of the RF Central Bank and the budget and tax policies of the RF Government. The importance of such coordination in Given the considerable impact of government-regulated tariffs on inflation and the influence of fiscal policy on the money supply in the Russian Federation, the importance of such coordination is difficult to overestimate. It is absolutely clear that a balanced budgetary policy aimed at reducing the budget deficit and Russia's sovereign risk would be conductive to the achievement of the RF Central Bank's inflation target. However, it should be noted that the RF Central Bank's possibilities to influence the government's fiscal policy are extremely small;

- increasing the transparency of the Bank of Russia's policy in the field of monetary policy. In recent years, the RF Central Bank has achieved some progress in enhancing the transparency of its policy and almost reached international best practice standards. At the same time, the Bank still has plenty of room to improve the quality of its analytical output, including macroeconomic situation analysis, and to furnish economic agents with more-detailed explanations of the causes and consequences of its decisions.

On the whole, it can be said that so far the Draft has not been sufficiently adapted to the changing priorities of Russia's monetary policy. It seems that the principles of composing such documents have not been updated for many years for they do not take into account the latest shifts in the RF Central Bank's priorities and, first of all, the change of the monetary policy regime. This is deplorable, because if the RF Central Bank wants to increase economic agents' trust in its policy, it should offer them a thorough explanation thereof, which the Draft clearly fails to do. In its current form the Draft is simply not substantive enough and thus cannot be used as an independent tool for forming expectations.

2.1.4. The Balance of Payments[1] и and the Exchange Rate of the Ruble

In 2012, the Bank of Russia switched over to disseminating RF balance of payments data on the basis of the methodology set out in the 6th edition of the *Balance of Payments and Investment Position Manual* (BPM6). Conceptually, BPM6 maintains the overall framework of the methodology of the previous edition of the Manual (BPM5).

The main changes in the accounts of the balance of payments include the following: within *balance on trade in goods – goods for and after processing* are excluded and *net exports of goods under merchanting* are included; within *balance on trade in services – manufacturing services on physical imports owned by the others* and *financial intermediation services indirectly measured* are added; within *balance on income – rent* is included; within *capital account - migrants' transfers* are excluded; within *financial account – transactions of other sectors* are further broken down into *other financial institutions* and *nonfinancial enterprises, households and nonprofit organizations servicing households.* The *balance on income* and *balance on current transfers* accounts have been respectively renamed as the *primary income* and *secondary income* accounts.

According to the RF Central Bank[2], earlier balance of payments statistics compiled in accordance with BPM5 recommendations remain overall relevant for comparisons with the aggregates compiled under the new methodology. As the Bank of Russia has so far failed to publish the revised time series of all external sector statistics for the period from 1992 through 2011, recalculated under the new methodology, we will compare, in our overview, the data for 2012 (compiled under the new methodology) with data for previous years (compiled under the old methodology).

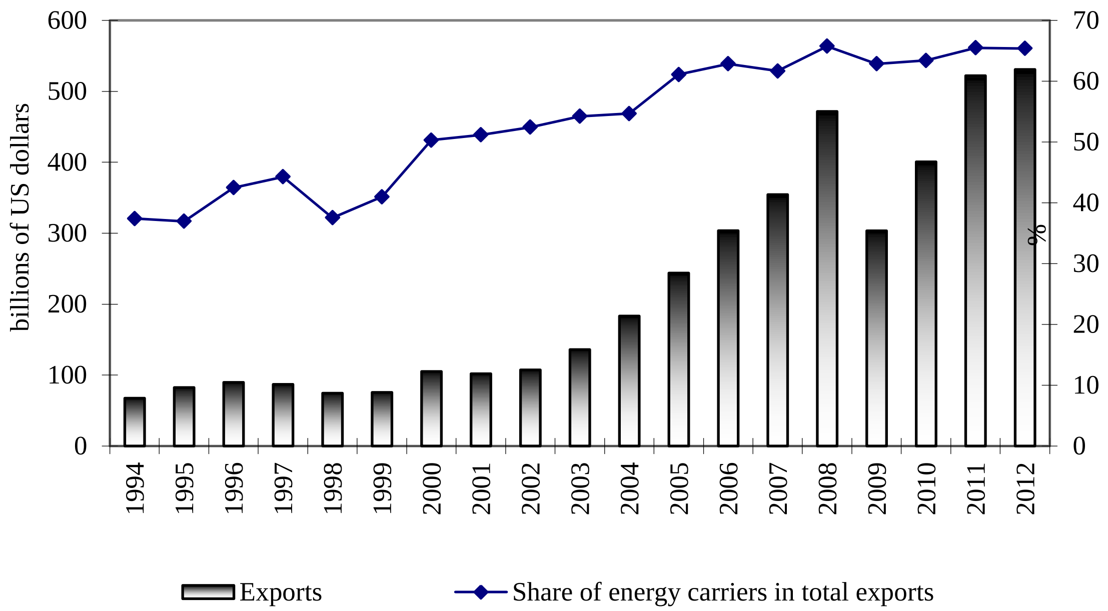
In 2012, the leading world economies continued to pursue soft monetary policies, which encouraged raw material prices to stay high. As a result, the balance on the current account of Russia's balance of payments remained solidly positive. As noted above, in 2012, the RF Central Bank practically abstained from interfering in the functioning of the foreign exchange market. Given the stability of the exchange rate of the ruble over the course of 2012, that

[1] The analysis of the balance of payments is based on preliminary data released by the RF Central Bank: http://cbr.ru/statistics/print.aspx?file=credit_statistics/bal_of_payments_est_new.htm&pid=svs&sid=itm_45297
[2] See http://cbr.ru/press/Plugins/Archive_get_blob.aspx?doc_id=120627_180506intern1.htm

meant that both the demand and supply of foreign currencies were well balanced. At the same time, net private capital outflow from Russia over the course of 2012 significantly exceeded its values predicted in the forecasts of the RF Government and the Bank of Russia, which once again emphasized the fact that investing in the Russian economy can be fraught with serious risks. As a result, although Russia's 2012 balance of payments looks healthy enough, it is clear that in the medium-term perspective the RF balance of payments will be vulnerable to changes that may occur in the international market situation.

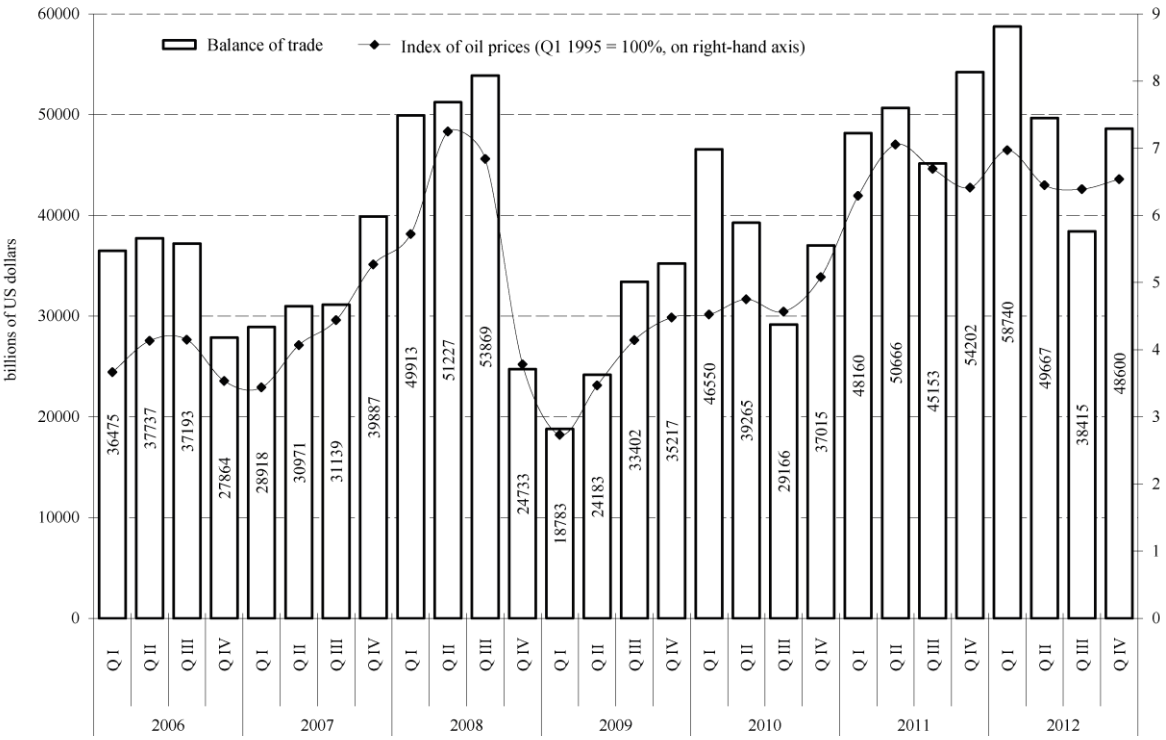
According to the Bank of Russia' preliminary estimate of the RF balance of payments for 2012, the current account surplus amounted to $ 81.2bn, which represents a 17.8% drop on 2011 (*Table 4*). The balance of trade surplus dwindled by 1.4% (from $ 198.2bn to $ 195.4bn), while commodity exports increased by 1.7% (from $ 522bn to $ 530.8bn), and commodity imports rose by 3.6% (from $ 323.8bn to $ 335.4bn). The share of oil, petroleum products and natural gas in total exports amounted to 65.4%, which represents a 0.1 pp. drop on 2011 (*Fig. 7*). It should be noted that, in 2012, both exports and imports rose to post-Soviet record highs.

Thus, as in previous years, the main factor determining the size of Russia's current account surplus is the trade balance whose size largely depends on the price behavior of energy carriers and other top Russian exports on global markets. *Fig. 8* shows that the equilibrium relationship between global oil prices and the size of Russia's trade surplus observed in 2011–2011 was continuing over the course of 2012.



Source: RF Central Bank.

Fig. 7. The Movement of Commodity Exports and the Dynamics of the Share of Energy Carriers in Total Exports, 1994-2012



Source: RF Central Bank; EIA; the IEP's calculations.

Fig. 8. The RF Trade Balance and the World Crude Oil Price Index in 2006-2012

The deficit on the services account (reflecting the trade in services) rose to $ 44.8bn, or by 24% in absolute terms compared with 2011. The export of services amounted to $ 63.2bn, having increased by $ 9.2bn (+ 16.9%) from the previous year. Over the course of 2012, the import of services rose by 19.9%, to $ 107.9bn.

The balance on the compensation of employees account in 2012 increased in absolute terms, thus amounting to $ –12/3bn (in 2011 it was $ −9.5bn). The deficit demonstrated by the investment income balance in 2012 increased on 2011 by 5.1% and reached the level of $ 53.3bn. Investment income receivable increased from $ 38.5bn to $ 41.8bn. The growth in the amount of investment income payable for 'other sectors' from $ 75.4bn to $ 78.8bn, and for banks – from $ 11.7bn to $ 14.1bn determined growth of total income payable from $ 89.2bn to $ 95.1bn.

The balance on the rent account[1] for 2012 amounted to $ +1bn. (the data on this index is published from 2012).

The balance on the secondary income account (previously referred to as the balance on the current transfers account)[2] in 2012 amounted to $ −4.7bn (in 2011 – to $ –3.2bn), and the bal-

[1] Rent covers income receivable for putting natural resources at the disposal of another institutional unit. Examples of rent include amounts payable for the use of land, extraction of mineral resources and other subsoil assets, and for fishing, forestry and grazing rights.

[2] According to the RF Central Bank, current transfers, for instance, humanitarian aid in the form of consumer goods and services, increase the receiver's level of disposable income and consumption opportunities and decrease the disposable income and potential consumption opportunities of the donor. Current transfers are recorded in the current account. Transfers which are not current by definition are capital ones. If the donor and the recipient are residents of different countries a capital transfer results in a change in the level of national wealth of

ance on the capital account – to $ –5.1bn (in 2011 – to $ –0.1bn). The substantial deficit demonstrated by the capital account in 2012 is caused by the writing off of outstanding debt against the government loans issued by the former USSR.

Table 5

The Main Items of the Balance of Payments and the Dynamics of Russia's External Debt in 2010-2012 (bn USD)

Index	2010					2011					2012				
	Q1	Q2	Q3	Q4	*Year*	Q1	Q2	Q3	Q4	*Year*	Q1	Q2	Q3	Q4*	*Year**
Balance from current and capital account	33.9	18.4	5.6	13.3	*71.2*	30.8	21.9	17.8	28.3	*98.7*	34.3	18.2	6.4	17.3	*76.2*
Financial account (excluding reserve assets)**	-11.8	9.1	-6.8	-16.6	*-26.1*	-16.0	-8.9	-20.2	-31.0	*-76.1*	-24.7	-1.4	-6.7	-3.0	*-35.8*
Change in reserve assets ('+"- decrease,'-' - increase)	-16.6	-26.1	-2.7	8.6	*-36.8*	-10.1	-12.9	1.8	8.6	*-12.6*	-4.6	-15.0	-1.5	-8.9	*-30.0*
Net errors and omissions	-5.5	-1.4	3.9	-5.3	*-8.3*	-4.7	-0.1	0.6	-5.8	*-10.0*	-5.0	-1.8	1.8	-5.4	*-10.4*
External debt of the Russian Federation ('+"- decrease,'-' - increase)	-3.8	-6.0	19.2	12.3	*21.7*	20.7	29.2	-11.1	17.4	*56.2*	19.2	11.0	23.9	29.3	*83.4*
RF government external debt	-2.4	3.8	-0.3	-0.5	*0.6*	1.3	0.0	-2.7	-0.8	*-2.1*	2.2	4.6	2.7	3.8	*13.3*
External debt of the RF private sector	-1.5	-9.8	19.5	12.8	*21.1*	19.4	29.2	-8.4	18.1	*58.4*	17.0	6.3	21.3	25.5	*70.1*

* – preliminary estimate; ** – foreign exchange reserves are not included.
Source: RF Central Bank.

Thus it can be concluded that, in 2012, the main factor that determined the continuing positive current account balance (at a substantial level) in the RF balance of payments were the high prices for top Russian exports – just as it happened in previous years. For example, the average per annum price of Brent crude oil remained practically unchanged, amounting to $ 111.6 per barrel. It should be noted that the year 2012 also saw a continually increasing growth rate of the Russian private sector's external debt (see *Table 5*). If over the year 2010 the size of external debt owed by banks and the non-financial sector increased by $ 21.1bn, in the next year (2011) the growth of that category of debt amounted to $ 58.4bn, and in 2012 – to 70.1bn. As for RF government external debt, over last year it also increased by $ 13.3bn. Owing to the favorable situation in the energy carriers market, it became possible, towards the year's end, to form a practically deficit-free state budget – and to increase the size of the RF Reserve Fund by approximately Rb 700bn. However, the government still resorted to borrowing on the external market. This measure was necessitated by the fact that government borrowing sets some target values that can be applied by the companies in the private sector in their own borrowing activity – which is carried out by them on a large scale. In the medium term one may expect the size of external debt to continue its growth – both in the private and public sectors of the national economy, which can be explained by the shortage – and the resulting high cost – of domestic financial resources, as well as by the possibility that foreign trade conjuncture may worsen because of the RF Government's ambitious plans to further increase budget expenditure.

the economies they represent. Examples of capital transfers are debt forgiveness and a free of charge transfer of the title of capital assets.

In 2012, the deficit of the financial account amounted to \$ 35.8bn. The size of liabilities of Russian economic agents to foreign economic agents increased over that year by \$ 80.4bn, which represents a17.1% increase on the previous year (\$ 68.7bn).

Over the course of 2012, the size of the federal government's external liabilities increased by \$ 9.6bn. As far as RF subjects are concerned, their external debt shrank by \$ 0.4bn. In 2012, the size of liabilities of the monetary authorities increased by no more than \$ 2.9bn.

The banking sector's liabilities to non-residents over the course of 2012 increased by \$ 39.6bn, whereas in 2011 the growth of banks' liabilities did not exceed \$ 7.9bn. Given Russian banks' high demand for funds provided by the RF Central Bank, this movement pattern displayed by their liabilities may be indicative of the difficulties experienced by Russian banks in their attempts to attract funding from the domestic private sector.

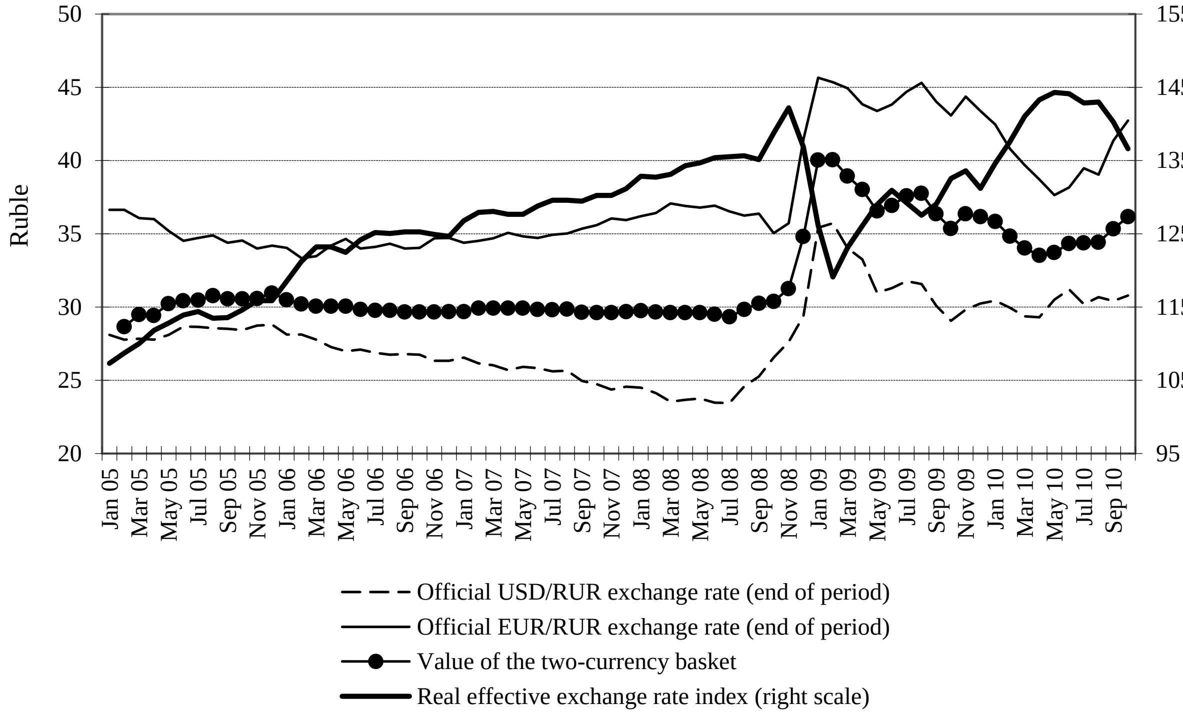
The liabilities of 'other sectors' to non-residents over 2012 increased by \$ 28.9bn (against by \$ 62.2bn in 2011); the amount of direct investment in 'other sectors' was \$ 38.9bn (against \$ 47.3bn in 2011). There was an outflow of portfolio investment in the amount of \$ 8bn (against \$ 6.4bn one year earlier). The shrinkage of direct investment in Russia's non-financial sector points to its insufficient attractiveness in the eyes of investors from the point of view of the risk to yield ratio. However, the main reason for the slower capital inflow (by comparison with 2011) in the non-financial sector was the movement of liabilities to nonresidents, the size of which in 2012 increased by only \$ 2.7bn vs. by \$ 21.4bn in 2011.

Thus, in spite of the increasing liabilities of RF residents to foreign economic agents, the structure of borrowed funds may be regarded as rather alarming because, in contrast to the situation in previous years, the size of borrowings made by banks has for the first time exceeded that made by the non-financial sector, while foreign liabilities of the latter have turned out to be much lower than in 2011.

The size of foreign assets held by residents (the liabilities of foreign economic agents to Russian economic agents) in 2012 increased by \$ 116.2bn (vs. by \$ 144.7bn in 2011). At the same time, the size of foreign assets held by the monetary authorities and federal government bodies remained practically unchanged.

The foreign assets held by the banking sector in 2012 increased by \$ 15.9bn (vs. by \$ 32bn in 2011). Capital outflows from 'other sectors' dropped on 2011 by 9%, and thus amounted to \$ 100.3bn. The share of direct and portfolio investment abroad amounted to \$ 45.4bn (\$ 26bn less than in 2011). The population and the non-financial sector increased their investment in foreign cash, and so its inflow amounted to \$ 2.5bn.

The situation on the RF foreign-exchange market in 2012 was determined by the inflow of foreign currency via the current account channel coupled with its outflow via the capital and financial account (reflecting operations with capital and financial instruments). As noted earlier, the RF Central Bank has markedly reduced its involvement in the foreign-exchange market's functioning, and so the ruble's exchanged rate was being determined in the main by market factors, while the regulator only smoothed over its most pronounced and consistent fluctuations. As a result, while the prices for top Russian exports stayed at a sufficiently high level, and the rate of inflation in the RF remained moderate, the ruble's real effective exchange rate over the period of January – December 2012 increased by 5.5% (over the course of 2011 – by +1.6%), but towards the year's end it still remained at a level lower than in mid-2011 (see *Fig. 9*). Over the course of 2012, the official USD-to-ruble exchange rate declined by Rb 1.83: by the end of December 2012, it was Rb 30.37 per USD against Rb 32.20 per USD as of 31 December 2011. At the same time, the ruble strengthened against the bi-currency basket[1]: over the period under consideration, the value of the bi-currency basket declined by Rb 1.65, from Rb 36.46 to Rb 36.81. As a result, the ruble-to-euro exchange rate as of the end of December 2012 amounted to Rb 40.23, having increased since the year's beginning by Rb 1.44.



Source: RF Central Bank; the IEP's calculations.

Fig. 9. The Movement of the Ruble's Exchange Rate in January 2005 – December 2012

Thus, in 2012, the situation with the balance of payments was such that, by the year's end, the ruble's exchange rate slightly increased both in nominal and real terms – practically without any interference of the RF Central Bank in the foreign-exchange market. In other words, the market situation was developing rather favorably for the Bank of Russia, enabling it to switch over to the inflation targeting regime in absence of any fundamental changes in the ruble's exchange rate.

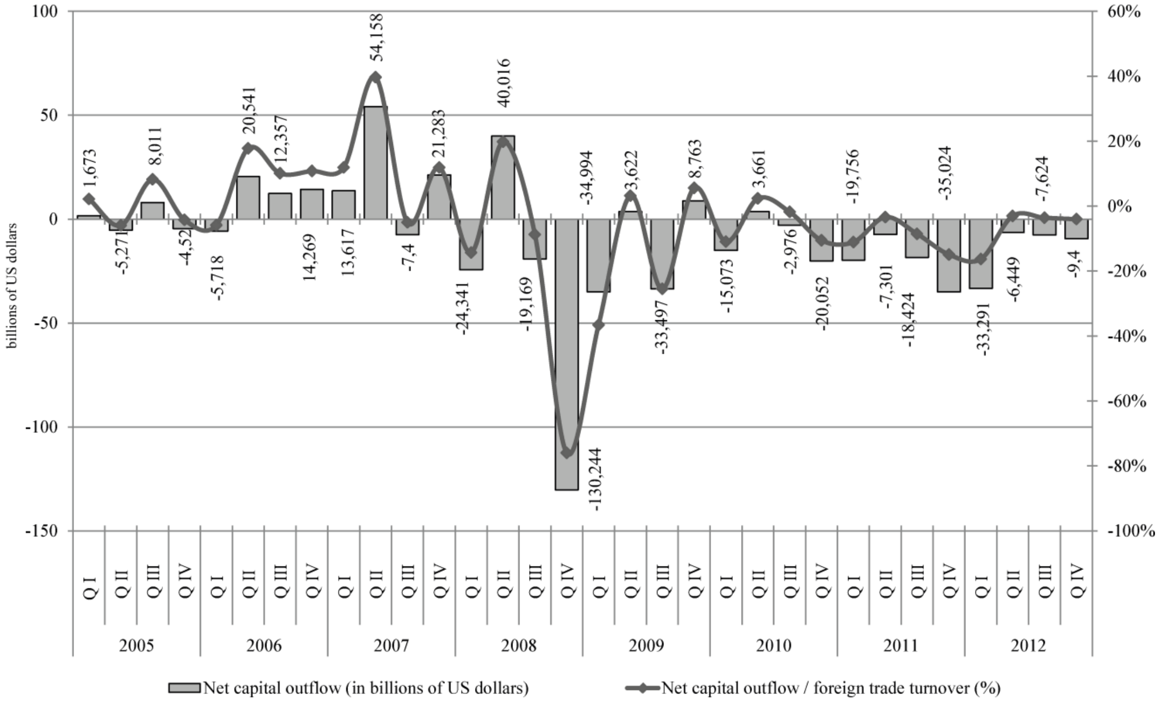
One of the major trends displayed by the balance of payments in 2012 was the behavior of net capital outflow from the non-financial sector, which by the year's end rose to $ 56.8bn (in 2011 – $ 80.5bn) (see *Fig. 10*). Capital outflow continued nearly throughout the entire year's period - with the exception of June, when the amount of net capital inflow in the private sector was $ 4.3bn.

It should be reminded that, until August 2012, the annual capital outflow was forecast by the RF Ministry of Economic to be as low as $ 15–25bn, with several subsequent upward adjustments. Interestingly, a similar situation has already been observed for a few years in a row, when at a year's beginning the authorities released their highly optimistic estimate of potential capital outflow. Meanwhile, it is evident that while the world economic situation

[1] The bi-currency basket serves as a target for the RF Central Bank in its monetary policy. At present, the share of euro in the basket is 45%, that of US dollar – 55%.

remains unstable, Russia's economy heavily depends on the export of energy carriers, and the institutional environment's quality is poor, it will be very difficult to make nonresidents increase the amount of their investment in the RF - or to prevent residents from moving their assets abroad.

However, it should also be noted that an important factor that in recent years has been pushing up the level of capital outflow is the RF Central Bank's orientation towards minimizing its interference with the foreign-exchange market. In such a situation a positive balance on the current account of Russia's balance of payments is neutralized by a negative balance on the capital and financial account. Evidently, if the balance of international reserves is constant, capital outflow will correlate with foreign cash inflow as a result of foreign trade. In this connection, the relatively stable nominal exchange rate of the ruble points to an equilibrium of demand and supply on the foreign-exchange market.

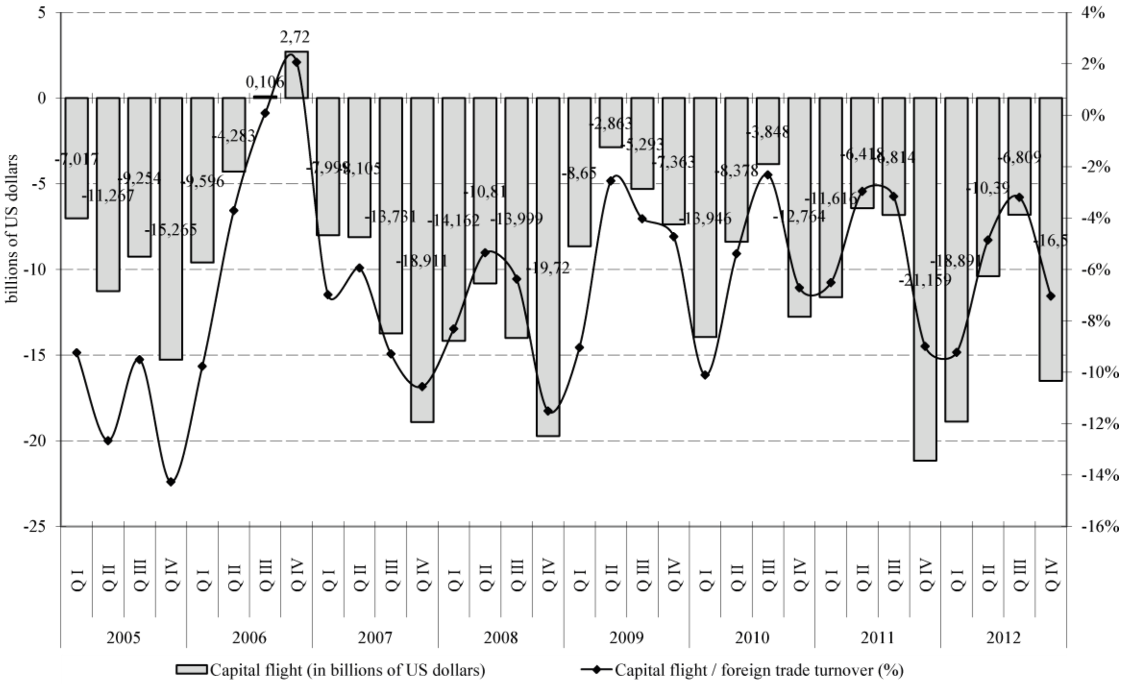


Source: RF Central Bank; the IEP's calculations.

Fig. 10. The Movement of Net Capital Outflow in 2005–2012

One more fact confirming the unfavorable situation with capital inflow is the increasing prominence, over the course of 2012, of the phenomenon termed *capital flight* [1]. As of the end of 2012, according to our estimations, capital flight (*Fig. 11*) amounted to $ 52.6bn, which is by $ 6.6bn more than in 2011.

[1] We calculate capital flight in accordance with the IMF's methodology, where capital flight represents the sum of trade credits and advances, export proceeds in arrears and financial claims relating to the delivery of goods or services where payment has not taken place under import contracts, and net errors and omissions.



Source: RF Central Bank; the IEP's calculations.

Fig. 11. The Dynamics of Capital Flight in 2005–2012

By way of summing up our analysis of Russia's balance of payments, we should like to note that the fact of it having only a small surplus is beneficial for the Russian economy because it increases the stability of the foreign-exchange market and conduces to sustainable development of the financial system. At the same time, due to the high dependence of the current account of the RF balance of payments on a limited number of top exports, the existing situation can hardly be estimated as being sustainable in the long run, as the movement of prices for energy carriers is unpredictable and, consequently, so is the situation in Russia's foreign trade. As for the balance on the account of operations with capital and financial instruments, it can be expected that capital flow in and from Russia will, most probably, remain sufficiently volatile – among other things, because of the uncertain prospects for further development of the world economy. However, all other conditions being equal (first of all, if prices of energy carriers should remain stable), if the RF Government makes no efforts to reduce the risks for foreign investment in the Russian Federation, Russia may hardly expect to receive any private capital inflows by the end of the year 2013.