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R95 **Russian Economy in 2013. Trends and Outlooks.**

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The review provides a detailed analysis of main trends in Russia's economy in 2013. 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 2013

In 2013 inflation exceeded the target range (5-6%) established for 2013 in accordance with the Guidelines for the Monetary Policy of the Bank of Russia for 2013-2015, having reached 6.5%. On average, between January and December 2013 the M2 money supply had grown by 15.3% and as of 1 January 2014 was Rb 31,404.7bn. The international reserves reduced by 5% to $509.6bn during the year.

In 2013 the Bank of Russia continued to improve its monetary policy within the framework of transition to inflation targeting. In particular, the Bank of Russia introduced the concept of a key interest rate reflecting the course of its monetary policy and, thus, completed the formation of an interest rate corridor.

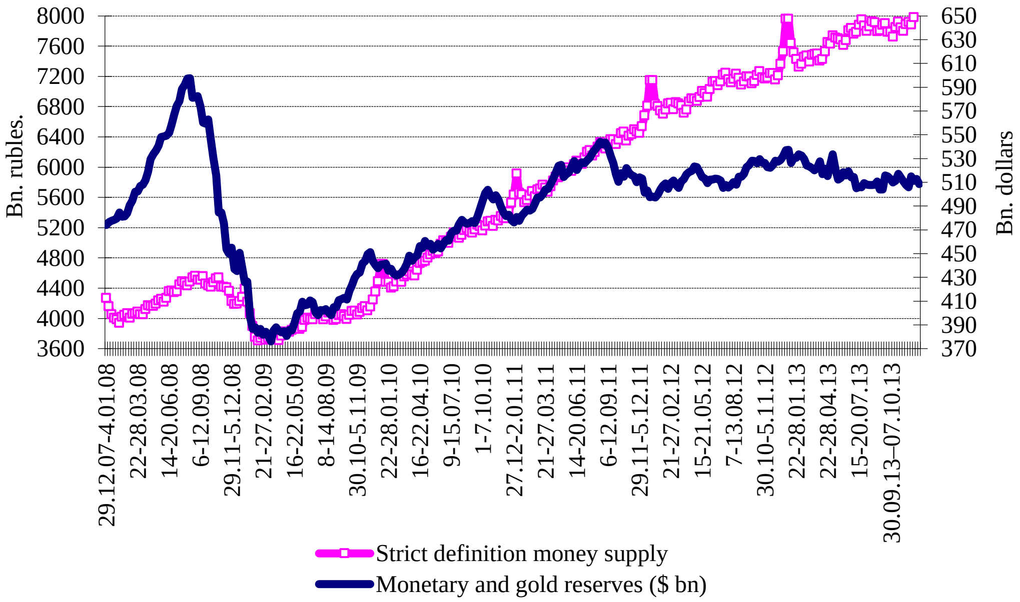
The Bank of Russia continued increasing the flexibility of the exchange-rate regime by increasing the sensitivity of the boundaries of the operational band to the number of FX interventions performed by the Bank of Russia and adjusting the mechanism of the exchange rate policy aimed at ensuring the neutrality of the Federal Treasury's FX transactions related to accumulation (expenditure) of sovereign funds.

2.1.1. Money market

Based on the results of 2013 the amount of the international reserve assets decreased by $28bn (5%) and as of the beginning of January 2014 was $509.6bn (*Fig. 1* and *2*). This reserve amount is more than sufficient for ensuring the stability of Russia's balance of payments, covering 13 months[1] of imports of goods and services in the RF. We should note that in 2012 the international reserves increased by $38.97bn (7.8%) to $537.6bn as of 1 January 2013 and the adequacy of reserves reached 14.5 months. In 2013 the volume of foreign exchange reserves decreased by $16.97bn (–3.5%) compared to the beginning of the year due to implementation by the regulator of FX interventions aimed to smooth the volatility of the ruble exchange rate

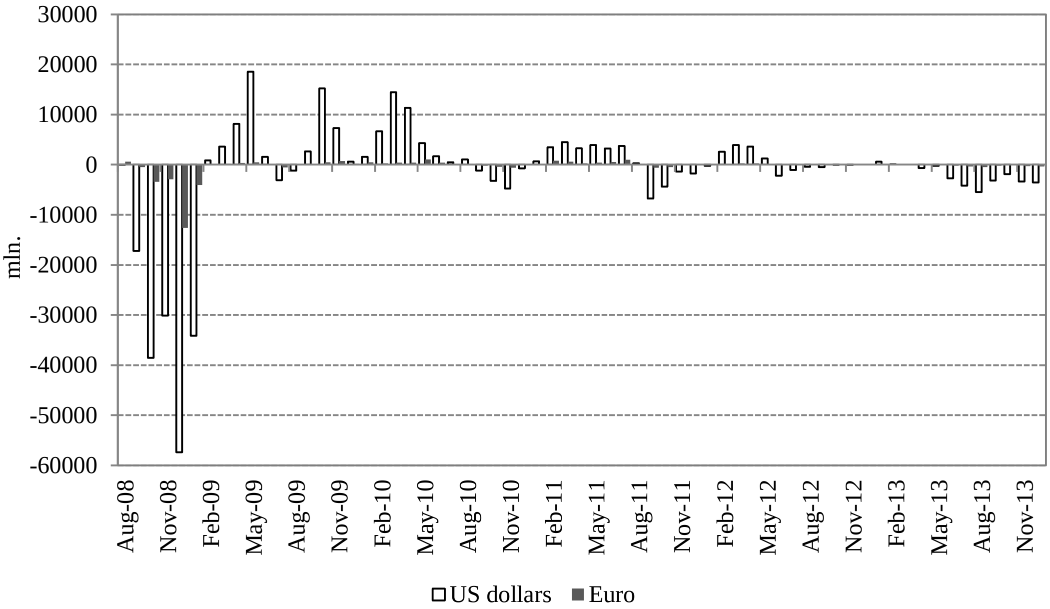
[1] Calculated on the basis of the monthly average cost of imported goods and services for the period from October 2012 to September 2013.

during periods of its fast weakening. In contrast, in 2012 the foreign exchange reserves grew by $32.6bn (+7.2%), which was mainly due to transactions performed by the Ministry of Finance of Russia, repo transactions with non-residents and currency swaps, while the number of interventions in the domestic market was insignificant. The monetary gold reserves decreased by $11bn (–21.6%) compared to the beginning of the year, which was mainly due to their negative revaluation. As a result, as of 1 January 2014 the share of currency exchange reserves in the total reserve assets was 92.2% (90.5% in 2012), with the share of the gold component being 7.8% (9.5% in 2012).



Source: Bank of Russia.

Fig. 1. Dynamics of the monetary base (in a strict definition) and foreign exchange (international) reserves in the RF in 2008-2013



Source: Bank of Russia.

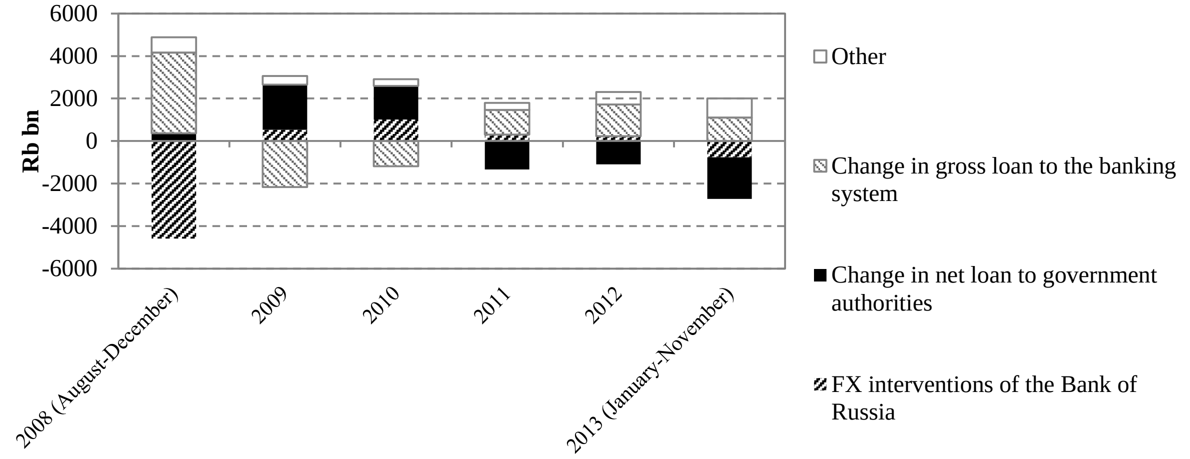
Fig. 2. FX interventions (net purchase of foreign currency) of the Bank of Russia in 2008-2013

In 2013 the broad definition monetary base had increased by 6.6% and as of the beginning of 2014 was Rb 10.5 trillion. The main factors contributing to the reduction in the monetary base in 2013 were the Bank of Russia's transactions for the sale of foreign currency in the domestic market and accumulation of the funds of the enlarged government in the Bank of Russia accounts (*Fig. 3*). At the same time, the key factor of the monetary base growth in 2013 was performance by the Bank of Russia of transactions for the provision of funds to commercial banks. We should note that in 2012 the monetary base had increased by 14% to Rb 9,853bn but here the accumulation of funds of the enlarged government in accounts in the Bank of Russia was the main factor restricting this growth.

The amount of the enlarged government's accumulated funds in accounts in the Bank of Russia for the first 11 months of 2013 has increased by Rb 1.9 trillion (38.6%) (*Table 1*).

We should note that despite the Bank of Russia's announcements about transition to an inflation targeting regime and taking measures aimed at increasing the flexibility of the exchange-rate regime, the Bank of Russia, in 2013, increased its presence in the FX market, performing considerable transactions for the sale of foreign currency. For comparison, since 2010, the net sales of foreign currency have been decreasing (in 2010 – $34.1bn, in 2011 – $12.4bn, in 2012 – $7.6bn). However, in 2013 foreign currency net sales amounted to $27bn. Apparently, such measures of the Bank of Russia were not only due to the necessity to smooth the ruble exchange rate volatility but also due to its intention to slow down the rates of ruble impairment under the conditions of decreasing current account balance and capital outflow from the country.

We should note that such an interventional policy by the Bank of Russia, perhaps, does not conflict with the task of transition to inflation targeting because, due to the effect of transfer of exchange rate into prices, ruble weakening causes a growth of inflation in Russia. At the same time, a considerable expansion of one-way (sale only) transactions of the Bank of Russia in the foreign exchange market appears to be unreasonable under the conditions of the fundamental tendency towards a reduction of the general balance of payments of the RF due to an expansion of the physical volumes of import with simultaneous export stagnation (both in physical and monetary terms) and the acceleration of private capital outflow from Russia.



Source: Bank of Russia, calculations of the Ye.T.Gaidar IEP.

Fig. 3. Key factors of the monetary base change (in a broad definition) in 2008–2013[1]

Table 1

Balance sheet of the Bank of Russia in 2012-2013

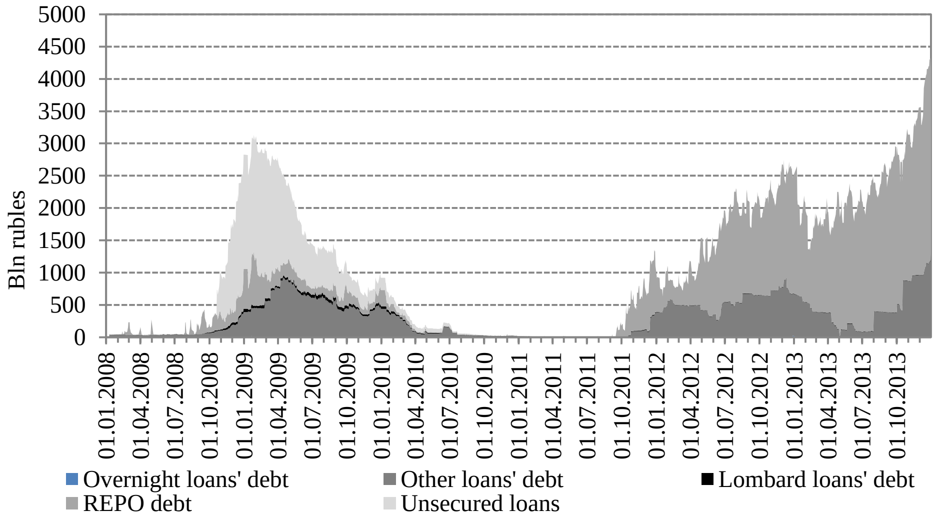
	1 January 2012		**1 January 2013**		**1 December 2013**	
	Rb bn	**% of assets/ liabilities**	**Rb bn**	**% of assets/ liabilities**	**Rb bn**	**% of assets/ liabilities**
Funds deposited with non-resident organisations and securities of foreign issuers	14,245,276	76.7	14,525,436	70.4	15,433,355	68.1
Loans and deposits	1,663,280	9.0	3,158,355	15.3	4,259,354	18.8
Precious metals	1,527,545	8.2	1,646,187	8.0	1,429,894	6.3
Securities	426,150	2.3	456,314	2.2	451,833	2.0
Other assets	97,857	0.5	251,549	1.2	451,350	2.0
Total assets	**18,562,735**	100	**20,630,744**	100	**22,675,450**	100
Cash in circulation	6,896,064	37.2	7,667,950	37.2	7,522,845	33.2
Funds held in accounts with the Bank of Russia	7,742,221	41.7	9,404,984	45.6	10,745,922	47.4
including of the RF Government	4,443,546	23.9	4,913,764	23.8	6,811,932	30.0
of resident credit institutions	1,748,402	9.4	2,185,349	10.6	1,616,635	7.1
Accounts receivable	36,217	0.2	158	0.0	23,290	0.1
Securities issued	-	-	-	-	-	-
Liabilities to IMF	472,335	2.5	447,686	2.2	497,885	2.2
Other liabilities	158,612	0.9	138,183	0.7	1,139,868	5.0
Equity	3,235,383	17.4	2,724,457	13.2	2,745,640	12.1
Profit in the reporting year	21,903	0.1	247,326	1.2	-	-
Total liabilities	**18,562,735**	100	**20,630,744**	100	**22,675,450**	100

Source: Bank of Russia.

Fig. 4 shows the dynamics of the debts of commercial banks to the Bank of Russia. Since 2011 there has been an observed tendency towards considerable growth in the provision of

[1] The period in question (2008-2013) is determined by availability of data on FX interventions of the Bank of Russia and the balance sheet of the Bank of Russia.

liquidity to credit institutions by the Bank of Russian. In 2013 debt exceeded the peaks of the crisis period, having increased by 65% and reached Rb 4.4 trillion as of 1 January 2014. The main source of attraction of liquidity by credit institutions on the part of the regulator are repo auctions, the average debt on which was Rb 1.95 trillion in 2013 (Rb 1.1 trillion in 2012, Rb 0.2 trillion in 2011). The maximum amount of funds is provided through 1-week repo auctions (on average Rb1.6 trillion for 2013).



Source: Bank of Russia.

Fig. 4. Debt of commercial banks to the Bank of Russia in 2008-2013

Provision of liquidity to credit institutions by the Bank of Russia was carried out mainly using short-term repo transactions, the average-weighted interest rates on which were 5.5-5.6% from January to December 2013. Since certain credit institutions lacked securities accepted as collateral on repo transactions and due to insufficiently active redistribution of funds in the interbank market, “currency swap” transactions with a 6.5% rate were used for the ruble part of transactions.

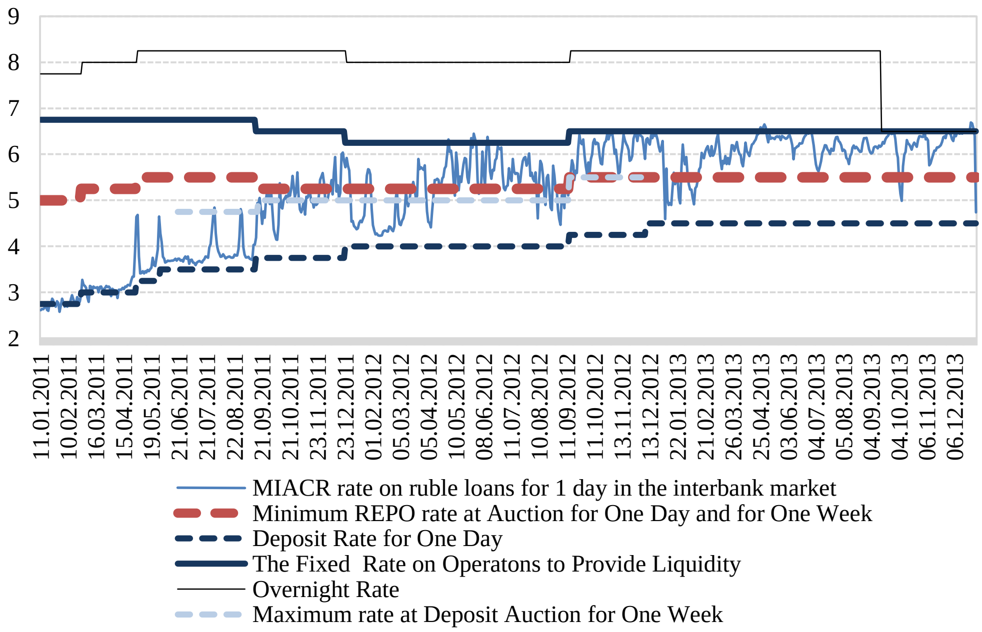
The second half of 2013 saw an increase in debt of the banking sector under loans of the Bank of Russia secured by non-market assets and guarantees. This was partially due to the introduction by the Bank of Russia of a new instrument of bank liquidity provision, a three-month credit auction secured by non-market assets (promissory notes, loans receivable) with a floating interest rate. Within the framework of the first such auction held on 15 October 2013 the regulator provided Rb 500bn at 5.76% per annum. The minimum cost of credit is linked with the key rate of a one-week repo, which was 5.5% at the moment of holding the first auction, plus 0.25 p.p. The advantage of a three-month auction over a similar one-year auction introduced by the regulator in June 2013 is the higher availability of collateral of required term for credit institutions and an increase in the collateral base of the banks by means of reducing the term for disbursement of funds. We should note that before the regulator introduced this instrument banks had shown low interest in refinancing instruments secured by non-market assets due to the high level of the fixed rate (7.5%). Despite the conditions of loan provision at a floating rate being quite favourable, only large banks with a notably higher collateral base can participate in such auctions.

The interest rate on interbank loans[1] has increased by 18.5% in 2013 (from an average of 5.4% in January 2013 up to an average of 6.4% in December 2013). The interest rate on interbank loans has been in the upper part of the interest rate corridor of the Bank of Russia, from time to time coming very close to its upper limit (*Fig. 5*). In general, the annual average MIACR on overnight interbank loans in rubles has increased by 10% from 5.5% in 2012 to 6.1% in 2013. We should note that, given that the key channel of the monetary base growth are the transactions of the Bank of Russia, it is the decisions of the Bank of Russia that determine the dynamics of the interest rates. Furthermore, revocation of the licences of certain Russian banks became an additional factor in the interest rate increase in the interbank market in the IV quarter of 2013.

As of 1 January 2014 the 70% share of total indebtedness of credit institutions to the Bank of Russia was owed by the 5 largest market participants (according to data as of 1 January 2013 a 70% share of indebtedness of banks to the regulator for the total amount of Rb 2.7 trillion was owed by 13 banks). In turn, the high degree of market concentration is evidenced by the fact that as of 1 January 2014 the 70% share of indebtedness of banks to resident credit institutions which accounted for Rb 2.6 trillion was owed by 10 banks (as of 1 January 2013 70% of debt for the total amount of Rb 2.7 trillion was recorded in the balance sheet liabilities sections of 13 banks)[2].

We should note that prospectively extension of the regulator's use of long-term liquidity provision instruments (three-month or one-year repo auctions secured by non-market assets) will enable banks to release market collateral and create conditions for additional growth in the volumes and availability of interbank loans.

Let us consider the monetary base structure (broad definition) in more detail (*Table 2*).



Source: Bank of Russia, calculations of the Ye.T.Gaidar IEP.

[1] Interbank interest rate is an average monthly MIACR on overnight interbank loans in rubles.
[2] Based on calculations by the Centre of Structural Research of the Ye.T. Gaidar IEP.

Fig. 5. The interest rate corridor of the Bank of Russia and dynamics of the interbank market in 2012-2013

Table 2

Dynamics of the broad definition monetary base in 2013 (Rb bn)

	1 January 2012	1 January 2013	1 April 2013	1 July 2013	1 October 2013	1 January 2014
Monetary base (broad definition)	8,644	9,853	8,628	9,063	9,117	10,504
– cash in circulation, taking into account cash balances on hand in credit institutions	6,896	7,668	7,102	7,420	7,369	8,308
– correspondent accounts of credit institutions with the Bank of Russia	982	1,356	856	1,002	1,098	1,270
– mandatory reserves	378	426	450	498	506	409
– deposits of credit institutions in the Bank of Russia	388	403	220	145	144	518
– bonds of the Bank of Russia in credit institutions	0	0	0	0	0	0
For information only: excess reserves	1,370	1,759	1,076	1,147	1,242	1,788

Source: Bank of Russia.

Among components of the broad monetary base, the number of which has decreased, the following should be highlighted: correspondent accounts (decrease in January-December 2013 by 6.3% to Rb 1,270bn) and mandatory reserves of banks (by 4% to Rb 409bn). Deposits of credit institutions in the Bank of Russia have increased by 28.5% to Rb 518bn and cash in circulation has increased by 8.3% to 8,308bn). For the 12 months of 2013 the total excess reserves increased by 1.6% and amounted to Rb 1,788bn. The decrease in balances of correspondent accounts in the Bank of Russia under the conditions of a growth of interest rates on interbank loans suggests a structural deficit[1] of liquidity in the banking sector.

On average, in January-November 2013 M2 money supply increased by 15.3% on an annualised basis. In 2010 the average money supply growth rate was 32.5%, in 2011 – 24.3% and in 2012 – 19.4%. In general, it can be noted that the tendency towards the gradual decrease in the money supply growth rates (compared to the correspondent period of the previous year) that had been observed since 2011 reversed in the first half of 2013, with M2 monthly growth rate stabilising at the level of 15.4-16.7% (on an annualised basis) in the second half of the year. We should note that the average M2 growth rate in the first half of 2013 (on an annualised basis) was 16.8%, with an average increase of the monetary base by 13.5% and of the money multiplier by 3%.

Thus in general, an increase in the rate of growth of the M2 money supply for the 12 months of 2013 was moderate compared to the previous periods taking into account the relatively low basic inflation of 5.6% (on an annualised basis) (5.7% in 2012) and, by itself, does not create any preconditions for a disturbance of price stability as a result of monetary factors.

Taking into account that in 2013 the monetary base increased by 6.6% and the money supply grew by 14.6%, the money multiplier growth rate was 7.5%. From January to December 2013 the average money multiplier (M2/monetary base ratio) was 3.2, showing a slight increase compared to 2012 (3.0 in 2012, on average). This value of the money multiplier is typical of emerging economies whilst in developed countries it is usually with the 5 to 8 range. We should

[1] According to the Bank of Russia's definition, a structural deficit of liquidity means a condition of the banking sector characterised by the existence of a stable necessity for credit institutions to obtain liquidity by means of transactions with the Bank of Russia (from "Guidelines for the Single State Monetary Policy for 2014 and for 2015-2016").

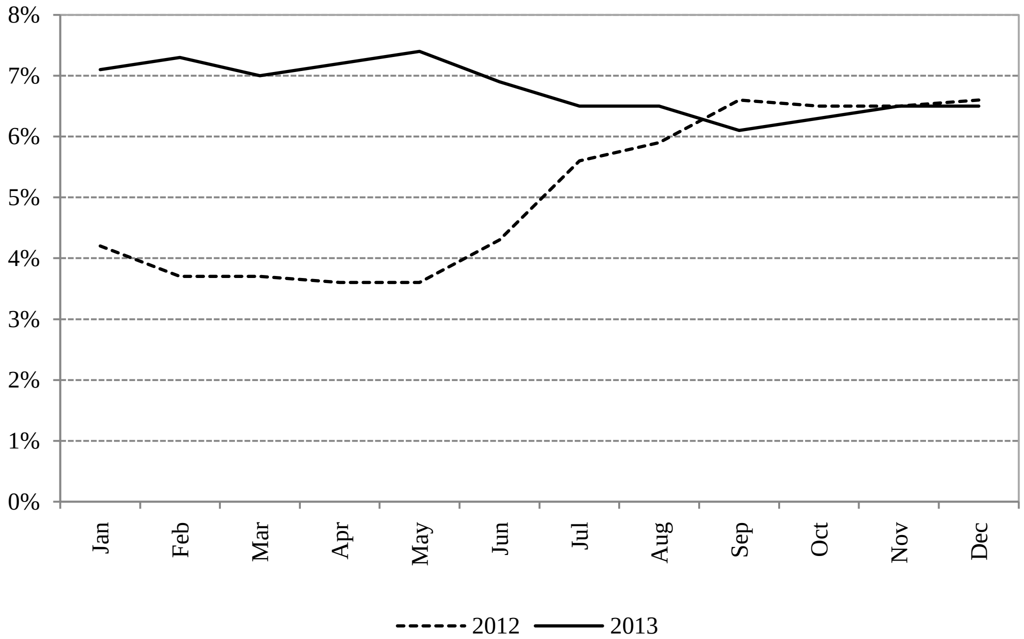
note that in eastern European countries during the last 20 years, money multiplier growth was observed as their banking systems developed. For example, in Poland from 1993 to 2013 the money multiplier increased from 3.1 to 6.1.

The monetisation level of the Russian economy (M2 to GDP ratio) for the period from 1999 to 2012 increased by 2.5 times to 51.5% in 2012. For comparison, in Belarus the M2 to GDP ratio for the same period increased by 1.8 times to 30.5%, in Kazakhstan – 2.6 times to 34.7% in 2012 and in Ukraine – 3.3 times to 54.9%. A relatively lower GDP monetisation growth rate in the period from 1999 to 2012 was typical of the majority of the Central and Eastern European countries, for example, in Poland the M2 to GDP ratio increased by 1.4 times to 57.9% in 2012, in France – 1.5 times to 158% in 2012, in Germany this indicator remained relatively stable, having reached 173% in 2012. We should note that the relatively low level of monetisation of the Russian economy was due to the comparatively low level of development of the financial system in the RF.

If we analyse the components of the money supply, we can note that individual saving in 2013 showed an average increase of 18.3% on an annualised basis (19.9% in 2012) and deposits by non-financial organisations and financial organisations showed an average increase of 12% (18.3% in 2012). M0 money supply demonstrated an average growth of 8.2% (on an annualised basis) in 2013 (12.7% in 2012) and its share in M2 was, on average, 22.6% (24% in 2012). Thus, in 2013 the share of cash in the money supply continued to decrease, which reflects the gradual development of the financial system of the RF, however, this proportion is still very high compared to developed countries where, as a rule, it is about 10%.

2.1.2. Inflation processes

In 2013 inflation was again above the target range (5-6%) established in the Guidelines for the Monetary Policy of the Bank of Russia for 2013-2015, having come very close to its upper limit in September 2013, and reached 6.5% based on the results of the year (6.6% in 2012) (*Fig. 6*).



Source: Rosstat; calculations of the Ye.T.Gaidar IEP.

Fig. 6. CPI growth rate in 2012-2013 (% per year)

Inflation exceeded the upper limit of the target range mainly due to non-monetary factors, in particular, the quicker than in 2012 increase in prices for domestic food products. We should remember that the average M2 money supply growth rate on an annualised basis for the 12 months of 2013 slowed down, amounting to 15.3% on an annualised basis. The increase in consumer prices was also pressurised by the indexation of tariffs for services provided by natural monopolies and the increase in excise duties on certain goods. Moreover, taking into account the considerable share of imported goods in the consumption of economic agents in the RF, the ruble weakening also contributed to the accelerated inflation. We should note that the effect of the transfer of exchange rate fluctuations on prices in the Russian economy is incomplete. On average, the one-month effect of transfer of the exchange rate on the CPI is 5% with the major part of the adjustments of the price levels to the ruble exchange rate fluctuations occurring within the following 6 to 12 months[1].

Meanwhile, we should add that when the Bank of Russia established the inflation target for 2013, it should have been important to take more accurate account of the possible influence of accidental factors (influence of the 2012 harvest on the conservation of fodder to be used in 2013; analysis of the market structure of different food and non-food products; consideration of the effect of the transfer of national currency depreciation into the prices for goods; introduction of new trade restrictions, etc.) and to assess possible deviation of inflation from the target range. Hence, inflation in excess of the target range is an unambiguous failure of the policy of the Bank of Russia.

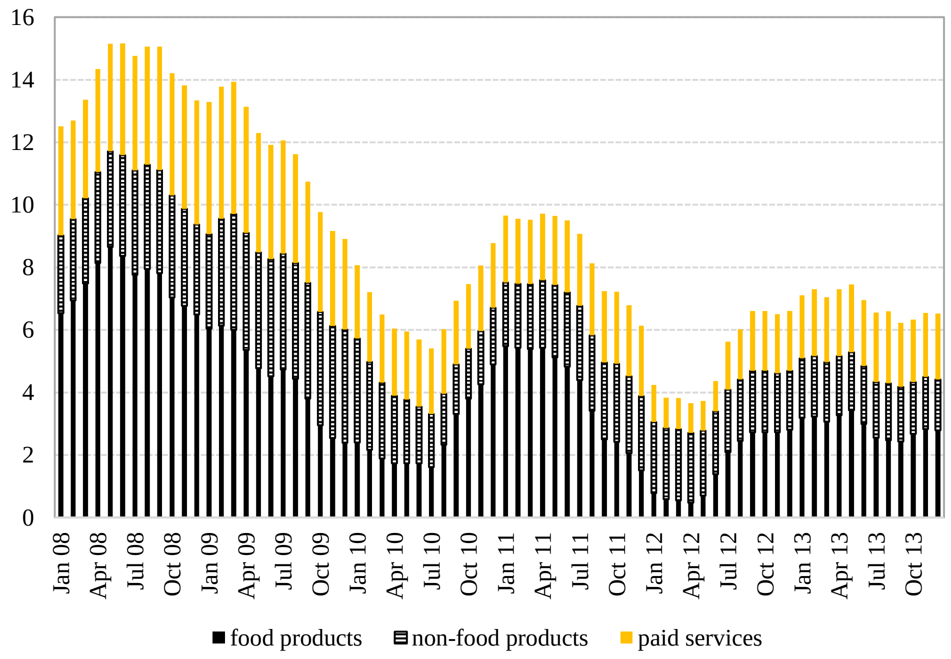
Let us consider the 2013 inflation process in more detail. As shown in *Table 3*, the growth rate of prices for consumer goods in the period from January to December 2013 was slightly lower than in 2012. Growth of the following prices contributed greatly to the increase in prices

[1] According to estimates of the Ye.T. Gaidar IEP.

for food products: eggs (+28.8%), butter (+18.6%), alcoholic beverages (+14.6%), milk and dairy products (+13.1%) and fruit and vegetables (+9.3%). The increase in prices of butter and dairy products as well as of eggs resulted from the deficit of raw materials due to the limited availability of fodder, caused by the poor harvest in 2012. The rise in prices for fruit and vegetables which had begun in October 2013 was associated with the poorer harvests due to heavy rain in the central part of Russia. We should note that restrictions on the import of certain goods to Russia from Belarus, the Baltic countries and Ukraine also contributed to the increase in food prices.

The rate of growth of non-food prices (+4.5%) also slowed down in 2013 compared to 2012. The quickest growth in this product group was observed for tobacco products due to the increase in excise duties. Furthermore, the increase in excise duties and wholesale fuel costs in the second half of 2013, due to the closing of several oil refineries, resulted in acceleration in the growth rates of gasoline prices.

In 2013 the prices for paid services rose by 8% compared to 2012. This was notably due to the indexation of regulated prices and tariffs for the services of organisations providing infrastructural activity. A slight acceleration in the rates of growth of prices for most groups of services should be noted. At the same time, the postponement of indexation from January to July seems reasonable to us, because, when a new harvest goes to market after tariff indexation, it causes a decrease in food prices and partially damps the effect of tariff indexation.



Source: Rosstat; calculations of the Ye.T.Gaidar IEP.

Fig. 7. Inflation structure in 2008-2013 (% per month to the corresponding month of the preceding year)

Table 3

Annual price growth rates for certain types of consumer goods and services in 2011-2013 (% to December of the preceding year)

	2011	2012	2013	2011-2013*
CPI	**6.1**	**6.6**	**6.5**	**20.5**
Food products	**3.9**	**7.5**	**7.3**	**19.8**
Grains and legumes	-8.0	-7.0	3.2	-11.7
Butter	6.6	3.0	18.6	30.2
Vegetable oil	4.6	3.4	-3	4.9
Pasta	3.4	7.6	4.7	16.5
Milk and dairy products	6.3	4.4	13.1	25.5
Eggs	6.2	5.1	28.8	43.8
Bread and bakery	8.9	12.0	8.0	31.7
Meat and poultry	9.2	8.3	-3	14.7
Fish and shellfish	10.3	1.9	7.6	20.9
Fruit and vegetables	-24.7	11.0	9.3	-8.6
Alcoholic beverages	8.4	12.1	14.6	39.3
Non-food products	**6.7**	**5.2**	**4.5**	**17.3**
Construction materials	7.9	5.1	2.5	16.2
Petrol	14.9	6.8	5.7	29.7
Tobacco products	21.1	22.6	29.3	92.0
Services	**8.7**	**7.3**	**8.0**	**26.0**
Housing and utility services	11.7	9.4	9.8	34.2
Early childhood education services	11.3	6.4	9.9	30.1
Recreation and health services	9.0	5.9	5.7	22.0
Passenger transport services	9.1	6.9	8.9	27.0
Culture organisation services	11.3	8.8	10.5	33.8

* Inflation for 2011-2013.
Source: Rosstat.

To end this section we compare the growth rates in prices for consumer goods in Russia and the other CIS countries (*Table 4*).

Table 4

Dynamics of consumer price indices in CIS countries in 2011-2013, % per annum

	2011	2012	2013*	2011-2013**
CIS countries				
Azerbaijan	8	1	1.7	10.9
Armenia	8	3	4.5	16.2
Belarus	53	59	13.8	176.8
Kazakhstan	8	5	4.2	18.2
Kirgizia	17	3	2.9	24.0
Moldavia	8	5	4.4	18.4
Russia	*8*	*5*	*5.95*	*20.1*
Tajikistan	13	6	3.35	23.8
Ukraine	8	0.6	0.0	8.6
Developed countries				
Germany	2.1	2.0	1.3	5.5
France	2.1	2.0	0.7	4.9
USA	3.2	2.1	1.2	6.6
Netherlands	2.3	2.5	1.5	6.4

*Data for January-November.
** Inflation for 2011-2013
Source: Interstate Statistical Committee of the CIS (http://www.cisstat.com/), OECD database (http://stats.oecd.org/).

For the period from January to November 2013 Russia was in second place after Belarus among the CIS countries by growth rates in consumer prices. Based on the results of the 11 months, Ukraine saw a zero level of inflation. Inflation in Russia from January to November 2013 increased 2.5-8.5 times compared with the value for the developed countries (*Table 4*). Thus, inflation in the RF continues to remain relatively high, both in comparison with developed countries and emerging economies.

In 2014 factors restraining inflation could be a slowdown of economic activities, moderate growth of monetary supply, the favourable situation with grains and legumes in 2013, improvements in the worlds agricultural market. Factors which could potentially accelerate inflation in 2014 include a possible continuation of ruble depreciation and the effect of the transfer of the exchange rate into prices, the consequences of the depression in fruit and vegetables yield in 2013 and further increase in excise duties.

In general, the prospects for achieving the inflation target level (5%) in 2014 seem realistic, taking into account the current trends in the Russian economy and modifications of the interest rate policy of the Bank of Russia (the introduction of a key interest rate as a main instrument of the monetary policy, under the conditions of inflation targeting and completion of the interest rate corridor aimed at reducing the volatility of short-term interest rates in the interbank market).

A decision on the "freezing" of tariffs for the services of legal entities having natural monopolies and the use of a decreasing coefficient for the indexation of regulated prices and tariffs for the population in 2014 will also facilitate achievement of the inflation target.

2.1.3. Key measures in the sphere of monetary and FX policy

In 2013 under the condition of a gradual transition to inflation targeting, the Bank of Russia made a number of important decisions in the area of improving the system of its interest rate instruments and an increase in the flexibility of its exchange-rate regime.

Decisions in the field of the monetary policy

The most important decision made by the Bank of Russia in 2013 was the introduction of a key interest rate by unification of the interest rates on operations and the provision of liquidity absorption through an auction for the period of 1 week (5.50% per annum as of 13 September 2013). At the same time, the Bank of Russia completed the formation of the interest rate corridor. Interest rates on continuous transactions of the Bank of Russia for absorbance and provision of liquidity for 1 day constitute, respectively, the lower (4.5% per annum as of 13 September 2013) and upper (6.5% per annum as of 13 September 2013) limits of the interest rate corridor symmetrically in respect to the key interest rate (*Fig. 5*).

The choice of a key interest rate seems reasonable because the main source of attraction of liquidity for credit institutions on the part of the Bank of Russia are auctions for the period of one week (average value for January-December 2013 Rb 1.6 trillion), with indebtedness on overnight auctions (average value for January-December 2013 Rb 0.2 trillion) and long-term auctions (3, 12 months) being considerably lower than on weekly auctions (*Fig. 8*).

The regulator intends to use the key interest rate as the main indicator of the direction of the monetary policy. The Bank of Russia officially recognised the secondary part of the refinancing rate. From 1 January 2016 the refinancing rate will be adjusted to the level of the key interest rate, which will enable an increase in the transparency of the monetary policy, not only for economic agents within the country, but also abroad, increasing investors' trust in signals from the Bank of Russia. Under the conditions of the inflation targeting regime, the main instrument of the monetary policy is the interest rate affecting the volume of loans, money supply and other macroeconomic indicators. Any change in the key rate may serve for economic agents as a potential signal of softening or toughening of the monetary policy directly affecting their expectations.

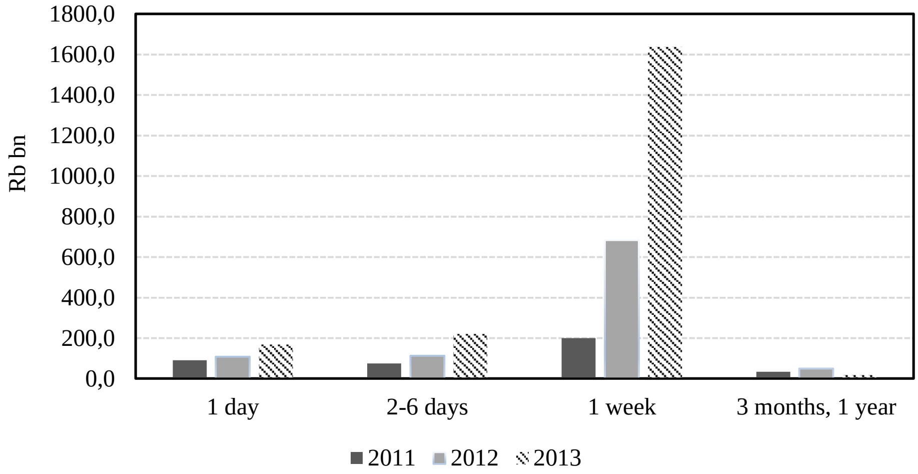


Fig. 8. Average debt of commercial banks to the Bank of Russia on repo transactions of different terms in 2011-2013

On 12 July 2013 the Bank of Russia announced the introduction of a new instrument of refinancing the banking system – auctions for the provision of loans secured by non-market assets or guarantees for a 12-month term. The introduction of the new instrument was aimed, not at the growth in the volume of refinancing, but at its redistribution in favour of instruments with longer terms. The minimum interest rate under the new refinancing instrument was 5.75% per annum, which is 0.25 p.p. higher than on direct repo auctions for a 1-day term. Based on the results of the first auction, held in late July 2013, the volume of funds loaned was Rb 306.8bn with the maximum allotment being Rb 500bn. One-year loans at the minimum interest rate of 5.75% were issued to the 31 borrowers which participated in the auction. The low level of interest in this new instrument of the Bank of Russia can be explained on technical grounds, since not all the banks willing to participate in the auction have received the regulator's approval. Another, and, in our opinion, more important reason for the low demand for the auction held, is that most banks lacked collateral of the required term (12 months) and the high alternative costs of the reduction of the collateral value of relevant credit institutions (lost opportunity to obtain short-term loans due to the deficit of available collateral value). We should note that the second of such auctions with the Rb 500bn limit that had been planned for 13 January 2014, did not take place due to an insufficient number of applications.

On 13 September the Bank of Russia announced a reduction of interest rates on overnight loans, and loans secured by non-market assets or guarantees for a 1-day term, to 6.50% per annum and the increase of the maximum interest rate on deposit transactions on an auction basis for 1-week period to 5.50% per annum. Interest rates on the remaining operations of the Bank of Russia and refinancing rates remained unchanged.

The Bank of Russia plans gradually to increase the average terms of liquidity provision, using overnight instruments only in emergency situations. In particular, from February 2014 onwards auction transactions for 1-day terms and transactions with fixed rates for a term longer than 1 day will cease. However, if necessary, the Bank of Russia will use point repo transactions on an auction basis for terms from 1 to 6 days. The regulator points out that interbank lending should start playing a major part in the redistribution of liquidity amongst market participants. Let us consider these measures in more detail.

Firstly, the reduction in the number of short-term transactions in the open market (up to 7 days) may result in decreased control over interest rates. As seen from the practice of developed countries, the regulation of interest rates on overnight interbank loans is possible precisely through one-day maturity repo transactions. The absence of this instrument may result in an increase in interest rates on short-term interbank loans and an increase in their volatility. The cancellation of auctions with fixed rates may also cause interbank loan interest rates to increase, because auctions with a floating interest rate are not limited to any maximum value.

Secondly, we should note that the interbank lending market in the RF is highly concentrated: as of 1 January 2014 the 10 largest market participants accounted for 71%, 20 commercial banks — for 83% and 50 banks — for 96% of the debt to credit institutions, the total amount of which was Rb 2.6 trillion[1]. This means that the major proportion of small banks have very limited access to the interbank lending market.

We should note that an improvement to the system of refinancing instruments of the Bank of Russia is a necessary but not a sufficient condition for further development of the interbank lending market. To that end, measures must be taken to reduce the concentration of the interbank lending market.

However, in the mid-run, an increase in terms of liquidity provision by the regulator may incentivise credit institutions to carry out effective management of liquid assets, which, in the end, will create conditions for a reduction of the volatility of interest rates in the interbank market. At the same time, the formation of "long money" in any economy is not the central bank's task but that of the entire fiscal system. Hence, issues relating to increasing the depth of the financial sector and the development of the institutional environment, remain relevant for the Russian economy.

In October 2013 the system of monetary policy instruments was supplemented by auctions for the provision of loans secured by non-market assets for a 3-month term with a floating interest rate. We should note that the results of this auction, held in October 2013, showed a high demand for this instrument of the Bank of Russia (the demand was Rb 563bn with a Rb 500bn limit). The benefits of a three-month repo secured by non-market assets are due to a lower floating rate compared to auctions with a fixed rate, and to one-year auctions with floating rate, secured by non-market assets. Participation in a three-month auction, in contrast to an equivalent one-year auction, enables banks to increase their available collateral value and to facilitate the provision of collateral of the required term.

In order to mitigate the shortage of liquidity for individual credit institutions, the Bank of Russia will continue to perform auction based transactions using not only securities but also other types of assets, including non-market ones. However, under the conditions of gradual reduction in the capacity to provide liquidity to banks and which is secured by collateral of proper quality, the Bank of Russia plans an active use of the purchase and sale of assets

[1] According to data of the Centre of Structural Research of Ye.T. Gaidat IEP.

(securities, gold, foreign currency) as an additional instrument of liquidity regulation. A higher diversity of the regulator's mechanisms for liquidity provision may facilitate stabilisation of the liquidity situation in the banking sector.

Among innovations adopted by the Bank of Russia at the meeting of the Board of Directors held on 13 September 2013, we should note the establishment of a target inflation level as a point, not an interval range, which potentially enables the Bank of Russia to transfer a strong signal regarding its target priorities to economic agents. The Guidelines for the Monetary Policy for 2014-2016 specify that the target change in consumer prices will be 5% in 2014, 4.5% in 2015 and 4% in 2016. However, in the case of unforeseen factors, the limits of tolerance of inflation upwards and downwards from the target value were established at the level of 1.5 p.p. In our opinion, taking into account the current trends in the Russian economy, the inflation range of 3.5-6.5% covers almost all possible scenarios in the next year. In other words, in the absence of global shocks, inflation will remain within this range with almost any course of the monetary policy of the Bank of Russia. We should note that, in 2012, 41% of countries applying inflation targeting used levels of tolerance +/– 1 p.p., 18% of countries were oriented on point values, 11% of countries applied the range +/– 1.5 p.p. and the remaining countries were characterised by a larger range or interval approach to the establishment target inflation values[1]. We assume that the targeting interval in the Russian conditions should be narrower than +/– 1.5 p.p., or the Guidelines should specify in more detail the actions of the Bank of Russia in the case of any notable deviation of the actual inflation value from the centre of the established interval.

In general, this last modification of the system of instruments of monetary policy will facilitate improvement of the functioning of the non-money market, increased control over interest rates, and the mitigation of inflation risks. The created interest rate corridor which, in prospect, can improve the predictability of interest rates in the money market will contribute to the workability of the interest channel. The use of target inflation values with narrower fluctuation ranges, acceptable for the regulator, and an explanation to economic agents of the peculiarities of the application of the instruments of the monetary policy in the mid-term, will increase their trust and stabilise expectations related to interest rates in the money market, which, in turn, will improve the operation of the entire transmission mechanism of the monetary policy.

Decisions in the field of FX policy

In 2013 the Bank of Russia proposed to improve the mechanism of the exchange-rate policy. All decisions made in the field of the FX policy were aimed at increasing the flexibility of the exchange-rate regime under the conditions of transmission to inflating targeting.

Within the framework of implementation of the exchange-rate policy the Bank of Russia used, as an operational landmark, the ruble cost of the dual currency basket consisting of 45 eurocents and 55 US cents. The range of values of the ruble cost of the dual currency basket acceptable for the Bank of Russia is established as a floating operational band, the boundaries of which are adjusted depending on the amount of FX interventions performed. Since 24 July 2012 the width of the interval has been 7 rubles. On 9 September 2013 the Board of Directors of the Bank of Russia passed a resolution on decreasing the amount of accumulated

[1] D. Hammond. Practice of Inflation Targeting - 2012 // Bank of England. Centre for Central Banking Studies. Guideline 29. 2012.

interventions resulting in an automatic movement of the boundaries of the operational band by 5 kopeks, to $400m instead of the $450m approved in the middle of 2012. From 10 December 2013 the accumulated amount of sale (purchase) of foreign currency by the Bank of Russia resulting in adjustment was again decreased, this time to $350m.

From 1 October 2013 the Bank of Russia has performed adjustment of the exchange-rate policy mechanism. According to this adjustment, the parameters of the Bank of Russia FX sale and purchase operations in the domestic foreign exchange market are determined by taking account of the Federal Treasury operations for the accumulation or expenditure of funds of the Reserve Fund and National Wealth Fund. In particular, the amounts of the Bank of Russia FX operations on the domestic market, aimed at smoothing the rouble exchange rate volatility, may be increased or decreased by an amount equal to the Federal Treasury FX purchases (sales) with the Bank of Russia, related to the accumulation (expenditure) of sovereign funds in foreign currencies. Such an adjustment will allow smoothing of the ruble exchange rate fluctuations and the maintenance of stability of the FX and money market during periods of Federal Treasury FX operations. In order to increase the transparency of the exchange-rate regime, preliminary information on the volume and date of the performance by the Federal Treasury of its FX operations will be posted on its official website.

We should remember that, in order to smooth the ruble exchange rate volatility, the floating operational band is split into internal intervals, for each of which a particular amount of intervention is established (in $ mn per day). In the central part of the floating operational band a "neutral" range is outlined, within which the Bank of Russia does not perform FX interventions aimed at smoothing the ruble exchange rate volatility. In 2013 the operational band of the cost of the dual currency basket in which the Bank of Russia performs FX interventions, was supplemented by an inner "technical" range. As in the neutral range, in the technical range the regulator will not implement any FX interventions, including those related to the Federal Treasury operations for the management of sovereign funds. As a result of the introduction of the "technical corridor" the range in which Russian ruble exchange rate is formed only by market factors, was expanded by Rb 0.1. Additionally, on 7 October 2013 the Bank of Russia performed a symmetrical expansion (from 1 to 3 rubles) of the "neutral" range of the floating operational band of acceptable cost of the dual currency basket. Thus, the FX corridor within which the Bank of Russia does not influence the dynamics of the Russian ruble exchange rate was increased to Rb 3.1 in 2013.

Important parameters in calculating the amount of operations performed by the Bank of Russia in the FX market, which causes movement of the boundaries of the operational band, are the target interventions. Implementation of target interventions is aimed mainly at neutralisation of the expectations of economic agents for ruble exchange rate fluctuations formed under the influence of existing foreign economic conditions. From 21 October 2013 onwards, the Bank of Russia reduced the amount of target FX interventions to $60m per day whilst in September average daily FX sales amounted to $104.3m and over 7m euro. This adjustment will result in an increased sensitivity of the boundaries of the operational band of the dual currency basket to the amount of interventions implemented by the Bank of Russia and aimed at smoothing excessive volatility of the ruble exchange rate. These changes, all other conditions being equal, will ensure a reduction of the direct presence of the Bank of Russia in the domestic FX market. From 1 January to 31 December 2013 the boundaries of the floating corridor of the dual currency basket changed 31 times. For example, on 31 December 2013 the boundaries of the corridor of the dual currency basket cost were Rb 33.05-40.05, while, as early as in the beginning of January 2013, their level was Rb 31.65-38.65. For comparison, in 2012 the boundaries of the operational corridor changed only 11 times from Rb 32.2-38.2 to Rb 31.65-38.65.

We should note that gradual increase in flexibility of the exchange-rate regime, and in the sensitivity of the boundaries of the operational corridor to the amount of interventions implemented by the regulator, create conditions for the adaptation of economic agents to exchange rate fluctuations and their learning to use the instruments of FX risk management. Given the above, the intention of the Bank of Russia, to retain the right to perform point operations in the FX market in order to maintain financial stability in the case of any external shock, seems reasonable, and is associated with the considerable dependence of the situation in the Russian economy on the world prices for energy resources and the high sensitivity of the condition of the capital account to the foreign economic and political environment.

2.1.4. Balance of payments and ruble exchange rate

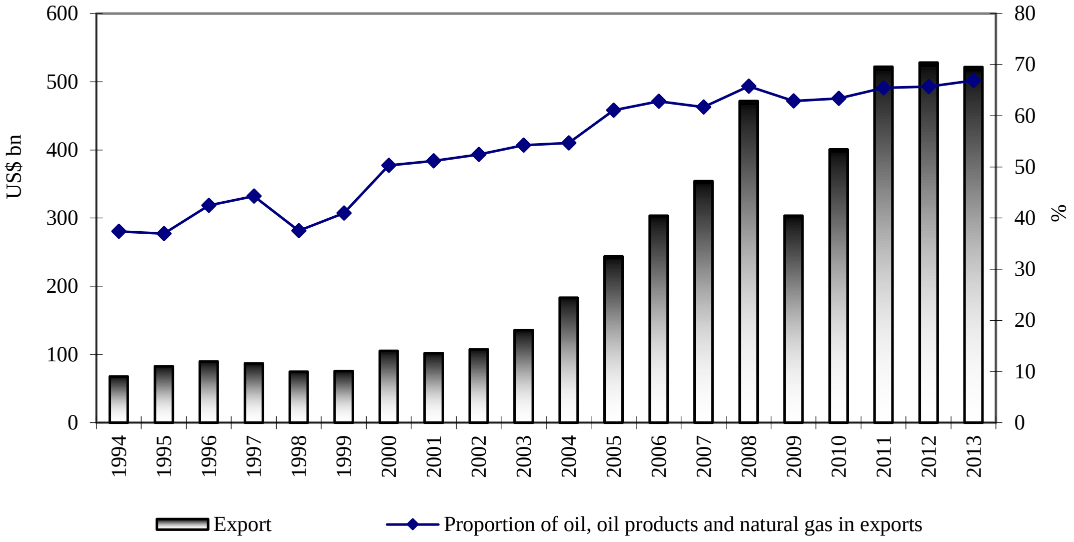
In January-December 2013 unfavourable external conditions in the world's raw materials markets had a considerable impact on the formation of the balance of payments in the RF. The reduction in demand for raw material resources was driven, among other things, by the low growth rates of emerging economies and the implementation of budgetary policy measures by the governments of a number of developed countries. A substantial decrease in the current account balance and an outflow of funds from the financial account resulted in a reduction in the international reserves of the Bank of Russia, and in depreciation of the ruble. As was mentioned above, in 2013 the Bank of Russia, despite to its transition to the inflation targeting regime, increased its presence in the FX market. Based on the results of the 12 months of 2013 the net capital outflow from the country exceeded the 2012 figure, which reflects a high-risk assessment of investing in the Russian economy.

In accordance with the preliminary estimate of the RF balance of payments for January-December 2013 published by the Bank of Russia, the positive balance of the current account was \$33.0bn, having decreased by 54% compared to 2012 (*Table 5*). The positive trade balance decreased by 7.8% (from \$192.3bn to \$177.3bn), with the export of goods decreasing by 1.2% (c \$528bn to \$522bn) and the import of goods increasing by 2.6% (from \$335.7bn to \$344.3bn). The share of export of oil, oil products and natural gas was 66.9% of total exports, having increased by 1.2 p.p. compared to the corresponding period of 2012, despite an observed reduction in oil prices in 2013, on average by 2.8% to \$108.8/barrel (*Fig. 9*).

In the 2000s the main factor determining the current account balance in the Russian economy was the trade balance, which, in turn, depended on price fluctuations for hydrocarbons. This tendency continued in 2013 (see *Fig. 10*).

The services balance deficit in 2013 reached \$59.0bn and grew (in absolute terms) by 26.9% compared to the corresponding period of 2012. Services export was \$69.9bn, having increased by \$7.6bn (+12.2%) compared to the preceding year. Services import for the 12 months of 2013 exceeded the corresponding 2012 figure by 18.6% and reached \$129bn, and was primarily associated with the increased expenditure of Russian citizens on international travel. The balance of compensation of employees in January-December 2013 remained almost unchanged, amounting to \$−11.9bn (in 2012 it was \$−11.8 bn). The investment income balance deficit in 2013 compared to 2012 increased by 16.5%, having reached \$66.2bn. Receivable investment income has dropped by 2.8% from \$42.8bn to \$41.6bn. Income payable to non-financial institutions has increased by 4.6% to \$86.2bn and to banks – by 23% to \$18bn, which determined a growth of total income payable by 8.2% to $107.8bn. Rent balance[1] for 2013 was $+0.9bn ($+1bn in 2012). Based on the results of the 12 months of 2013 secondary income balance[2] was $(−8.1)bn (in 2012 $(–6.1)bn) and capital transfer balance was $(–0.4)bn, (in 2012 – $(–5.2)bn).

Thus, more than two-fold reduction of the current account surplus in 2013 was not only due to a decrease in trade balance but also to an increase in the deficit of services balance and the balance of primary and secondary incomes.



Source: Bank of Russia.

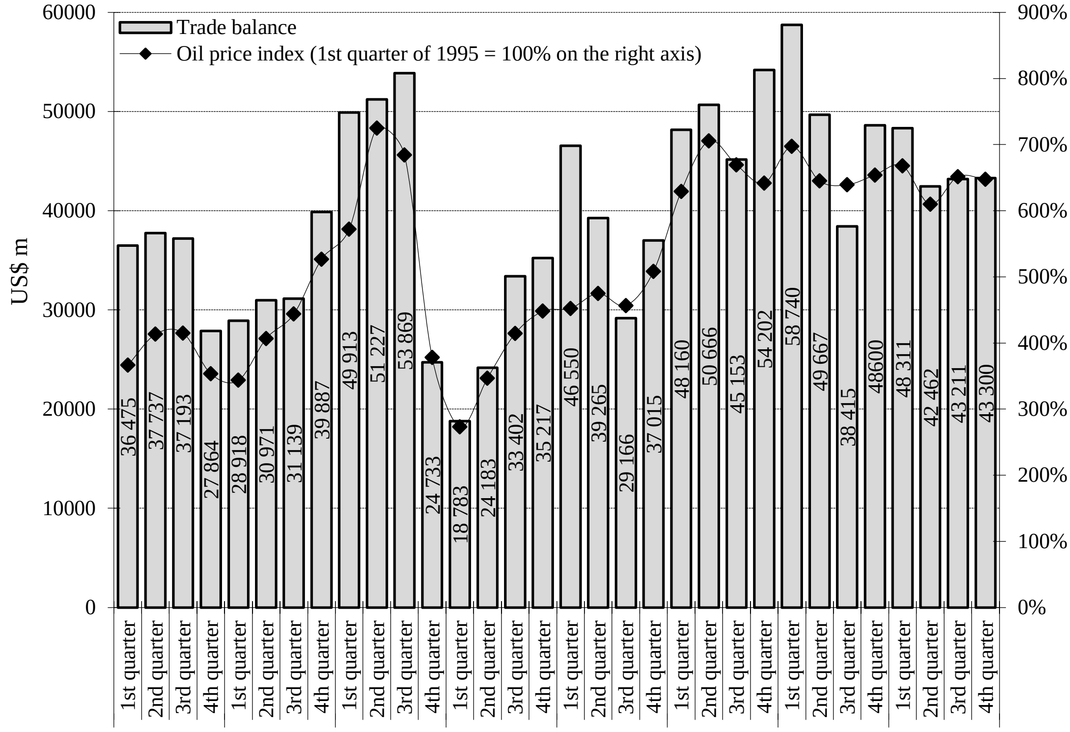
Fig. 9. Dynamics of export of goods and the proportion of fuel and energy products in 1994-2013

In 2013 the financial account deficit was $–43.0bn ($–26.5bn in 2012). The increase in the financial account deficit was associated with the outrunning growth of foreign assets against liabilities. The growth of liabilities of Russian economic agents to foreign economic agents based on the results of the 12 months of 2013 was $141bn, which is 52.6% higher than in the preceding year ($92.4bn. The external liabilities of federal administration bodies increased by $11.3bn in 2013. Considerable money inflow in the state administration sector is associated with the acquisition by non-residents of Eurobonds issued by the Ministry of Finance of Russia. The external liabilities of constituent entities of the RF were $0.2bn. The increase in liabilities of monetary authorities in 2012 was less than $0.3bn. The liabilities of the banking sector to

[1] Rent is income receivable for the provision of natural resources and the rights to dispose of any other institutional unit. Rent includes, for example, amounts payable for land use, mineral extraction, fishing rights, forest rights and rights of pasture.

[2] Formerly, current transfer balance. According to the Bank of Russia, current transfers increase the level of available income and consumption of goods and services of the recipient or decrease the available income and potential consumption opportunities of the donor, for example, humanitarian aid in the form of consumer goods and services. Transfers that are not current are, by definition, capital transfers. Capital transfers result in a change in the amount of assets and liabilities of the donor and recipient and are reflected in the capital account. If the donor and recipient are residents of different countries, capital transfer will result in a change in the level of national wealth of the economies which they represent.

non-residents grew by $20.2bn in 2013, while in 2012 the banks' liabilities increased by $33.3bn. The liabilities of other sectors to non-residents in January-December 2013 increased by $109.4bn compared to $+39.8bn in 2012, with direct investment in other sectors amounting to $78.4bn compared to $42.8bn in 2012. We should note that a considerable part of this amount is associated with the completion of the takeover of TNK-BP by Rosneft in the 1st quarter of 2013.



Source: Bank of Russia; EIA; calculations of the Ye.T.Gaidar IEP.

Fig. 10. Trade balance of the Russian Federation and world oil price index in 2006-2013

In 2013 the outflow of portfolio investments from the non-financial sector of the RF in the amount of $11.3bn was observed ($-8.1bn in the preceding year). The decrease in portfolio investments in the non-financial sector of the RF illustrates the insufficient attractiveness of investments in it in terms of the risk-return ratio. The amount of loans and credits provided by non-residents grew in 2013 by $42.4bn compared to $+6.7bn in 2012.

The foreign assets of residents (the liabilities of economic agents to Russian economic agents) increased by $184bn for the 12 months of 2013 (by $118.9bn in 2012). At the same time, the foreign assets of monetary authorities increased by $4.1bn (decrease by $0.4bn in 2012). The foreign assets of the banking sector increased by $26.3bn in 2013 ($14.8bn in 2012). Capital withdrawal from other sectors compared to 2012 increased by 47.5%, amounting to $154.1bn. Of this amount, $97.4bn stood for direct and portfolio investments abroad ($53.1bn more than in 2012).

The external debt of the RF increased by 15% in 2013 and as of 1 January 2014 was $732bn. We should note that in 2013 the growth rates of external debt in the private sector continued accelerating (*Table 5*). Whilst in 2011 the external debt of banks and the non-financial sector grew by $58.4bn, in 2012 their debt grew by $73.8bn and in 2013 – by $86.4bn. The State external debt increased by $9bn $ in 2013, which is considerably less than in 2012 ($19.7bn). In December 2013 Russia repaid its state external debt to the Czech republic, Finland and Montenegro in the total amount of $3.6bn, almost entirely clearing "Soviet" debt, and forgave Cuban debt in the amount of $29bn. In the mid-run we can expect continuing growth of both private and state external debt due to the lack and high cost of financial resources in the country and a deficit of the RF state budget.

Table 5

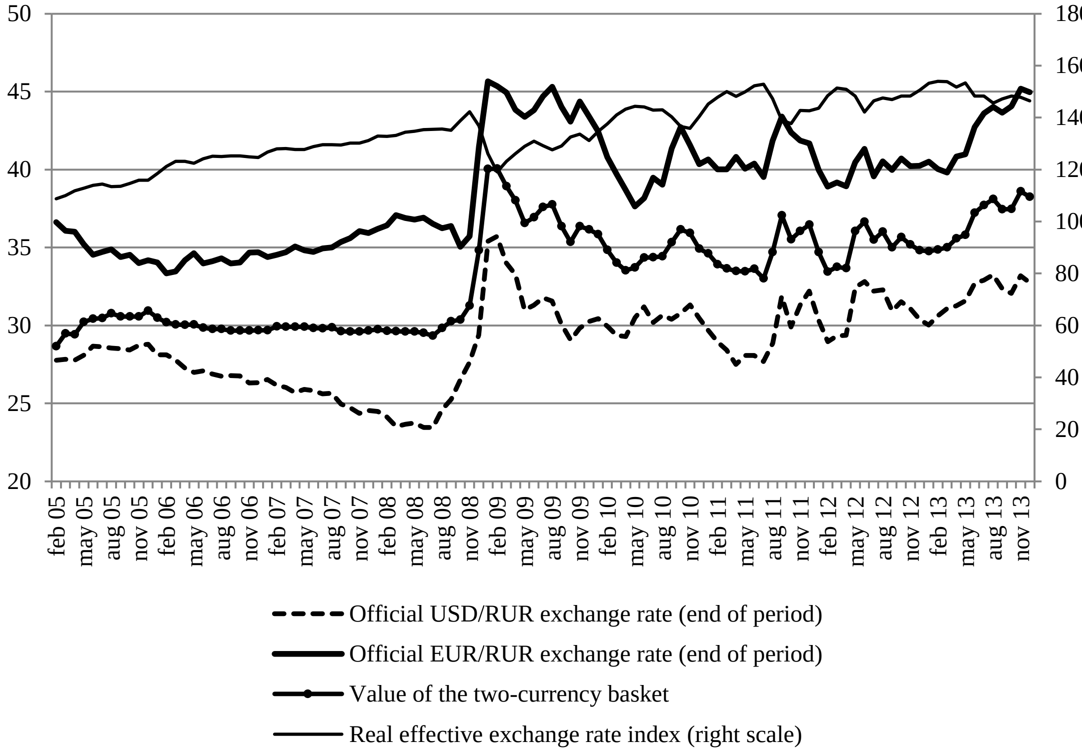
Main items of the balance of payments and dynamics of external debt in 2011-2013 ($ bn)

Indicator	2011					2012					2013				
	Q1	Q2	Q3	Q4	*Year*	Q1	Q2	Q3	Q4	*Year*	Q1	Q2	Q3	Q4	*Year*
Current and capital account balance	29.8	22.9	17.6	27.1	*97.4*	34.7	16.1	5.6	10.3	*66.8*	25.1	2.6	0.4	4.6	*32.6*
Financial account (excluding reserve assets)**	-17.3	-7.4	-19.0	-32.4	*-76.1*	-24.8	0.8	-4.0	1.6	*-26.5*	-12.8	-8.8	-6.6	-14.8	*-43.0*
Change in FX reserves ('+' – decrease, '–' – increase in reserves)	-10.1	-12.9	1.8	8.6	*-12.6*	-4.6	-15.0	-1.5	-8.9	*-30.0*	-4.9	4.4	7.4	15.2	*22.1.*
Net errors and omissions	-2.4	-2.7	0.3	-3.3	*-8.7*	-5.3	-2.0	-0.1	-2.9	*-10.3*	-7.3	1.8	-1.2	-5.0	*-11.7*
Change in external debt of the RF ('+' – increase, '–' – decrease in debt)	20.7	29.2	-11.1	17.4	*56.2*	18.6	13.1	28.3	37.5	*97.6*	53.8	15.9	8.0	17.8	*95.6*
Change in state external debt of the RF	1.3	0.0	-2.7	-0.8	*-2.1*	1.7	5.1	5.0	7.9	*19.7*	3.1	-1.5	6.7	0.8	*9.0*
Change in private external debt of the RF	19.4	29.2	-8.4	18.1	*58.4*	16.5	8.0	21.7	27.6	*73.8*	46.8	18.1	2.8	18.6	*86.4*

* – preliminary estimate; ** – excluding FX reserves.
Source: Bank of Russia.

The dynamics of the ruble exchange rate is 2013 were similar to those of emerging countries. The tendency of ruble weakening against the main world currencies that had started forming in the second quarter of 2013 continued in the third and fourth quarters due to the substantial decrease in the trade balance of the Russian economy, capital outflow from the country and a reduction of investors' risk tolerance due to the expected wind-down of the Quantitative Easing Program by the Federal Reserve System of the USA (US FRS) before the end of the year. Some ruble strengthening in nominal values at the end of the 3rd quarter of 2013 was partially due to FX interventions implemented by the Bank of Russia and the unfavourable geopolitical situation in the Middle East resulting in a rise in oil prices.

Owing to a certain decrease in prices for major Russian export commodities and moderate inflation in the RF the real effective ruble exchange rate decreased by 2.7% based on the results of 2013 (in 2012 a strengthening of 5.3% was recorded) (*Fig. 11*). The official USD to RUB exchange rate in January-December 2013 increased by Rb 2,31: at the end of December the USD exchange rate was Rb 32.7 compared to Rb 30.4 as of 31 December 2012. The EUR to RUB exchange rate at the end of December was Rb 44.9, having increased by Rb 4.74 for the year. As a result, ruble depreciation against the dual currency basket was observed: the cost of the dual currency basket increased by Rb 3.43 (from Rb 34.8 to Rb 38.2) during the same period.



Source: Bank of Russia; calculations of the Ye.T.Gaidar IEP.

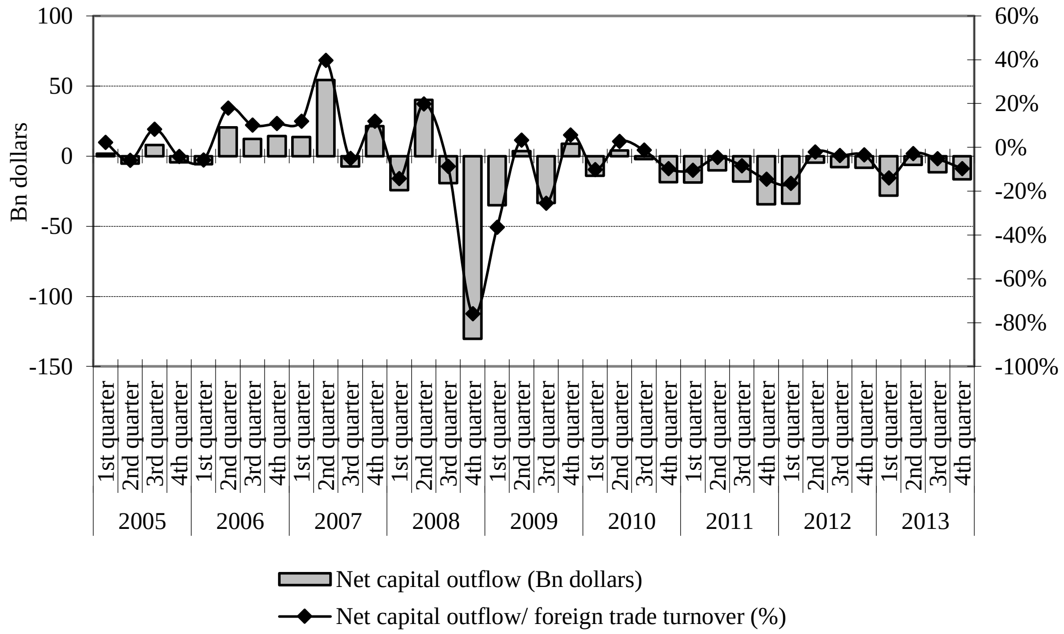
Fig. 11. Ruble exchange rates in the period from January 2005 to December 2013

According to preliminary estimates of the Bank of Russia, one of the critical tendencies in dynamics of the balance of payments figures in 2013 was the dynamics of a net flow of capital from the financial sector, which was $64.7bn ($10.1bn more than for the 12 months 2012). Capital outflow was observed during almost entire year, with the exception of June, when a net capital import by the private sector in the amount of $9.6bn was observed.

For the period from January to December 2013 the net capital income by banks had reached $5.2bn and by the private non-financial sector – $59.7bn.

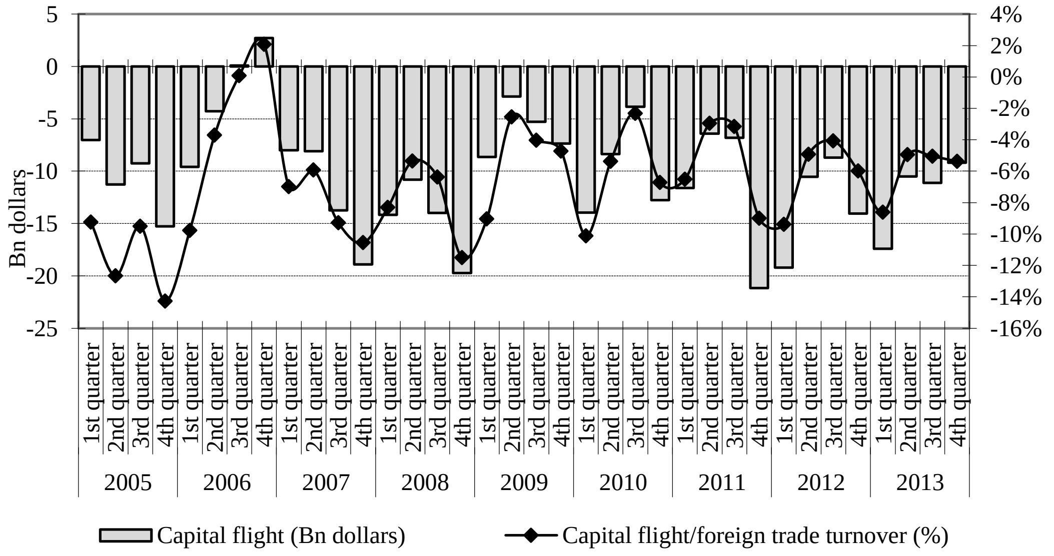
We should note that under the conditions of the unstable global and Russian economic situation, the high dependence of the Russian economy on the export of energy resources and the poor quality of the institutional environment, it is extremely difficult to achieve an increase in investments in the RF by non-residents or a reduction of the outflow of residents' funds abroad. As was noted before, one of the drivers of capital outflow from emerging markets in 2013 were the expectations of investors regarding the intentions of the US FRS to wind down the Quantitative Easing Program.

The increased capital outflow in 2013 was also associated with the continuing high level of the so-called "capital flight"[1]. Based on the results of 2013 capital flight (see *Fig. 12*) was, according to our estimates, \$48.2bn (\$52.5bn in 2012) (*Fig. 13*).



Source: Bank of Russia; calculations of the Ye.T.Gaidar IEP.

Fig. 12. Dynamics of net capital outflow in 2005-2013



Source: Bank of Russia; calculations of the Ye.T.Gaidar IEP.

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[1] Capital flight was calculated by us using the IMF methodology and represents the sum of "trade credit and advances", "non-receipt of export earnings and goods and services paid but not received under import contracts" and "net errors and omissions".

Fig. 13. Dynamics of capital flight in 2005-2013

We should note that further the prospects of the RF balance of payments are quite ambiguous. On the one hand, it is possible that the tendency towards a decrease in the current account balance that started forming in 2013 will continue in the mid-term. A possible decline in oil prices driven by the slowdown of economic growth in a number of countries that are the main consumers of raw materials, including China; the uncertain prospects for the global economy; a winding down the Quantitative Easing Program by US FRS; and a lower risk tolerance by investors will become the factors having a negative impact on the state of the balance of payments of the RF. On the other hand, a possible decline in the ruble nominal exchange rate will help to increase the trade balance surplus. However, in general, one should hardly expect any considerable improvement in the state of the Russian balance of payments in 2014.