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The review provides a detailed analysis of main trends in Russia's economy in 2008. The paper contains five big sections that highlight single aspects of Russia's economic development: the socio-political context; the monetary and credit and financial spheres; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts.

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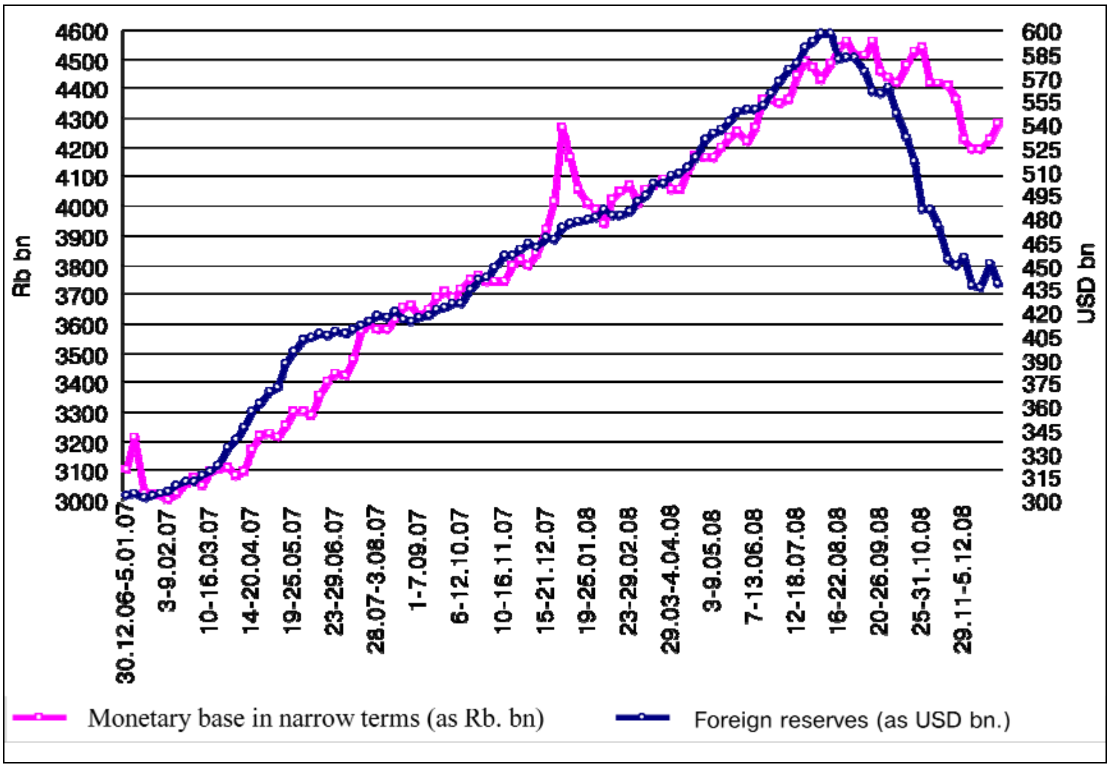
Russia's Monetary Policy in 2008

The financial crisis was central to Russia's monetary and credit sphere in 2008. It exerted a significant influence on the national economy on the whole and the CBR's policy in particular. While over the first half-year the situation on the financial market was relatively calm, it sharply deteriorated between August and September. Below, we will consider in a greater detail causes for such developments and analyze inflationary processes, main tendencies and correlations on the national monetary market, and measures the CBR embarked upon in an effort to stabilize the situation on the financial markets.

2.1.1. The Monetary Market

Russia's foreign reserves have been rising substantially up to the early-August 2008 (Fig.1). Underpinning their rise were record-high prices for major Russian exports, primarily for oil, natural gas and metals. But the crisis developments on the global financial market, which were further aggravated by the military action in the Southern Ossettia triggered a sizeable capital outflow from the country. Plus, the slowdown of growth in the largest world economies engendered a substantial deterioration of trading conditions for Russia, because of which the inflow of foreign currency began to dry out sharply. As a result, the nation's foreign reserves started to shrink rapidly, as the CBR was compelled to spend them to maintain the Rb. exchange rate. In addition, the USD appreciated against the Euro on the global forex market, which caused a fall in the USD-equivalent value of the fraction of the foreign reserves denominated in Euro-.

So, by the end of the year the volume of the nation's foreign reserves accounted for USD 427.1bn (30.2% of GDP) against 478.7bn (35.5% of GDP) as of the beginning of 2008, while in August 2008 it accounted for the record-breaking USD 597.5bn. Hence, by the end of the year Russia's foreign reserves had dwindled at 28.5% against their peak value. Meanwhile, the volume of the reserves is still high by international parameters. More specifically, in the 4th quarter 2008, the reserves-to-imports ratio was 5.9, while a sufficient one is 1. But it should be understood that given a considerable capital flight (bolstered by the private sector repaying its debts in particular) and a sizeable negative balance of the trading account of the balance of payments, maintaining the Rb. exchange rate may coerce the Bank of Russia to spend a greater part of its reserves. Furthermore, had the monetary and credit authorities decided not to depreciate the national currency, they might have wasted all the reserves but had had to face the depreciation, nonetheless.



Source: the CBR.

Fig. 1. The Dynamic of the Monetary Base and Foreign Reserves in 2007-2008

The dynamic of money supply over the year of 2008 also went through two sub-periods. Let us consider it in a greater detail.

Over the year of 2008 the monetary base (in wide terms[1]) grew just by Rb. 65m and accounted for Rb. 5.6trln (+1.2%). As a reminder, by results of 2007 this index grew at 33.7%. As of January 1, 2008, the volume of monetary base in wide terms was Rb. 5.5trln (*Table 1*). As of January 1, 2009, the cash in turnover with account of credit institutions' cash balances accounted for some Rb. 4.4trln (+6.2% vs. January 1, 2008), the credit organizations' correspondent accounts with the Bank of Russia – Rb. 1,027.6bln (+28.1%), compulsory reserves – Rb. 29.9bn (-86.5%), the credit organizations' deposits with the Bank of Russia – Rb. 136.6bn (-49.5%), the value of the CBR's bonds held by credit organizations – Rb. 12.5bn (-87.6%).

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

A 6.2% growth in the volume of cash in circulation over the year, along with a drastic fall in the amount of compulsory reserves (-86.5%) resulted in a 2.9% expansion of the monetary base in narrow terms (cash + mandatory reserves)[2].

A considerable fraction of inpouring export revenues continued being accumulated in the national reserve funds, that is, the Reserve Fund and the National Welfare Fund. As of January 1, 2009, their aggregate volume accounted for Rb. 6,612.1bn (USD 225.1bn, or 15.9% of GDP) – up at Rb. 2763bn vs. January 1, 2008, when the respective figures were Rb. 3849.1bn (USD 156.8bn, or 11.8% of GDP). So, the favorable state of affairs on international markets allowed replenishing the reserve funds during the whole 2008. But their considerable fraction will be spent in 2009 to support the economy and finance the government's anti-crisis measures.

Table 1

The Dynamic of the Monetary Base in Broad Terms in 2008 (as Rb. Bn.)

	01.01.2008	01.04.2008	01.07.2008	01.10.2008	01.01.2009
Monetary base (in broad terms)	5513.3	4 871.4	5 422.9	5 317.8	5578.7
including:					
Cash in circulation, with account of credit organizations' cash balances	4118.6	3 794.4	4 077.2	4 285.3	4372.1
Credit organizations' corresponding accounts with the CBR	802.2	596.3	592.4	702.9	1027.6
Compulsory reserves	221.6	339.3	360.3	152.1	29.9
Credit organizations' deposits with the CBR	270.3	122.7	369.3	154	136.6
The CBR bonds held by credit organizations	100.7	18.8	23.7	23.5	12.5

Source: the CBR.

Let us note that the structure of the monetary base has undergone considerable changes in 2008. Underpinning these changes were crisis processes on the national financial market. First, despite problems with liquidity, in 2008, cash balances on the credit organizations' correspondent accounts with the CBR grew at nearly one-third. The trend is explained by the fact that with the crisis unfolding, the CBR provided banks with a sizeable volume of financing, particularly on the uncollaterilized basis. But, facing mounting risks, banks opted for scaling back volumes of lending and placing the funds with the CBR. Second, by results of the year the volume of credit organizations' compulsory reserves shrank dramatically, as the Bank of Russia had lowered the rates of their contributions to the compulsory reservation fund, to give credit institutions with additional liquidity.

The 2008 growth rate of the monetary base was very low, which can be attributed primarily to the crisis developments on the Russian financial market in the fall of the year. To pillar the Rb. exchange rate, which was under a strong pressure generated by capital outflow fueled by the deepening financial crisis, the Bank of Russia was selling foreign reserves to buy Rubles, thus reducing the monetary base. Interestingly, while the foreign reserves shrank to their October 2007 level, the value of the monetary base has grown over the year, nonetheless. An analysis of changes in the structure of assets in the CBR's balance sheet (see *Table 2*)

[2] By the CBR methodology, the monetary base in narrow terms is the monetary aggregate (one of characteristics of money supply) fully controlled by the CBR. The monetary base in narrow terms comprises cash the Bank of Russia issued in circulation (with account of credit organizations' cash balances) and balances on accounts of compulsory reserves by attracted by credit organizations resources in the national currency equivalent deposited with the Bank of Russia.

reveals that between January and November 2009 it was credits and deposits provided to the national credit organizations that demonstrated the greatest growth rates (+Rb. 2.5trln, or 76% of the overall rise in the CBR's assets), while funds placed with non-residents[3] posted just a Rb. 0.7trln growth (or 21% of the rise in the CBR's assets). In the respective period of 2007, the increment by these items was, accordingly, Rb. 24.5bn (a 0.6% rise in assets) and Rb. 3.4trln (a 85% rise in assets). In other words, in the crisis conditions, it is the CBR's operations on refinancing credit organizations which gradually become a major source of shaping the money supply – the practice long inherent in most developed economies. In such a situation, interest rates by the CBR's credits play a far greater role, as using them, the Bank of Russia can exercise a substantial influence on the situation in the monetary and credit sphere.

Table 2

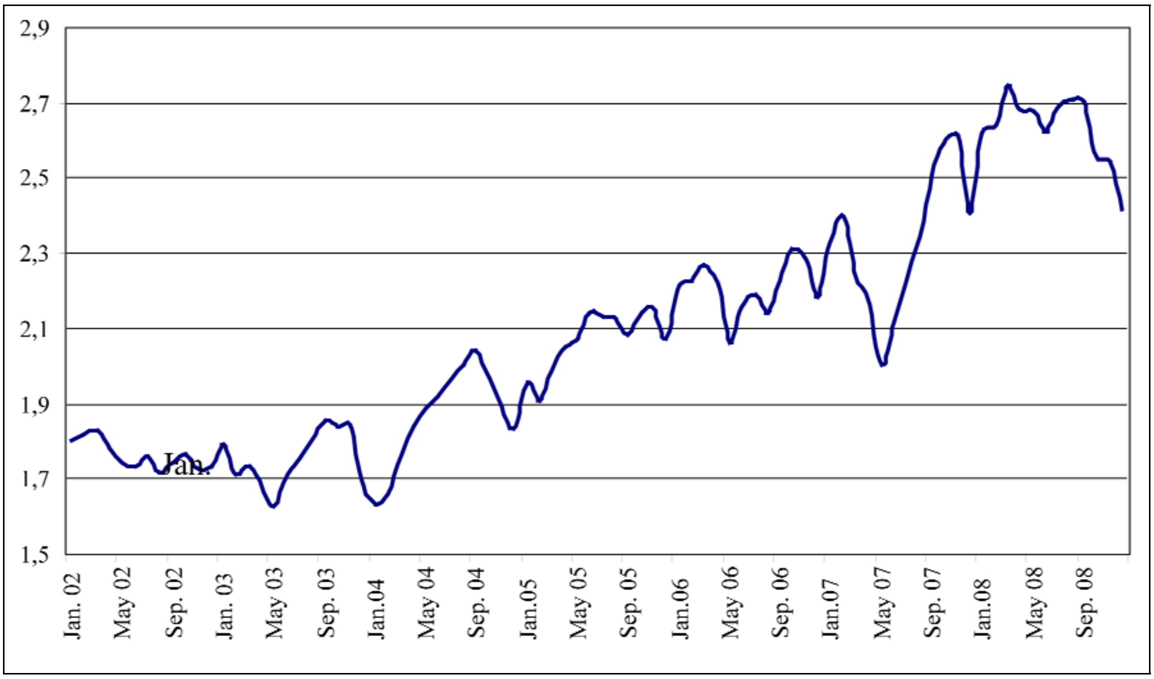
The Balance Sheet of the Bank of Russia in 2008

	01.01.2008		01.12.2008	
	Rb. bn.	% assets/liabilities	Rb. bn.	% assets/liabilities
Funds placed with non-residents and foreign issuers' papers	11,511.6	92.6	12,222	77.6
Credits and deposits	37.1	0.3	2540.8	16.1
Precious metals	346.5	2.8	388.6	2.5
Securities	441.9	3.6	490	3.1
Other assets	99.5	0.8	106.5	0.7
Assets, total	**12,436.7**	**100**	**15,747.9**	**100**
Cash in circulation	4,124.3	33.2	4,215.9	26.8
Cash on accounts with the Bank of Russia	7609	61.2	9,841.5	62.5
Cash in settlements	20.8	0.2	68	0.4
Securities issued	0	0	23.7	0.2
Other liabilities	196	1.6	1,125.1	7.1
Capital	462.1	3.7	473.8	3
Profit by the reported year	24.6	0.2	0	0
Liabilities, total	**12,436.7**	**100**	**15,747.9**	**100**

Source: the CBR.

In 2008, money supply M_2 in national terms grew just by 1.7% and as of January 1, 2009, it accounted for Rb.1,3493.2bn, or 32.5% of GDP (as of January 1, 2008, monetary aggregate M_2 was Rb. 1,3272.1bn (40.2% of GDP). So, over 2008 the monetization of GDP plunged considerably. Underpinning the slowdown of the money supply growth rates were basically the same factors as in the case of the monetary base. In addition, in late-2008 the money multiplier plummeted considerably vs. its respective values reported between late-2007 and early-2008 (*Fig.2*). The fall was caused primarily by an overwhelming deceleration of the banking system's rate of lending to the private sector. In all likelihood, the money multiplier will keep on falling until Russian banks sense a growing attractiveness of lending to the private sector.

[3] This item reflects change in the Bank of Russia's foreign reserves

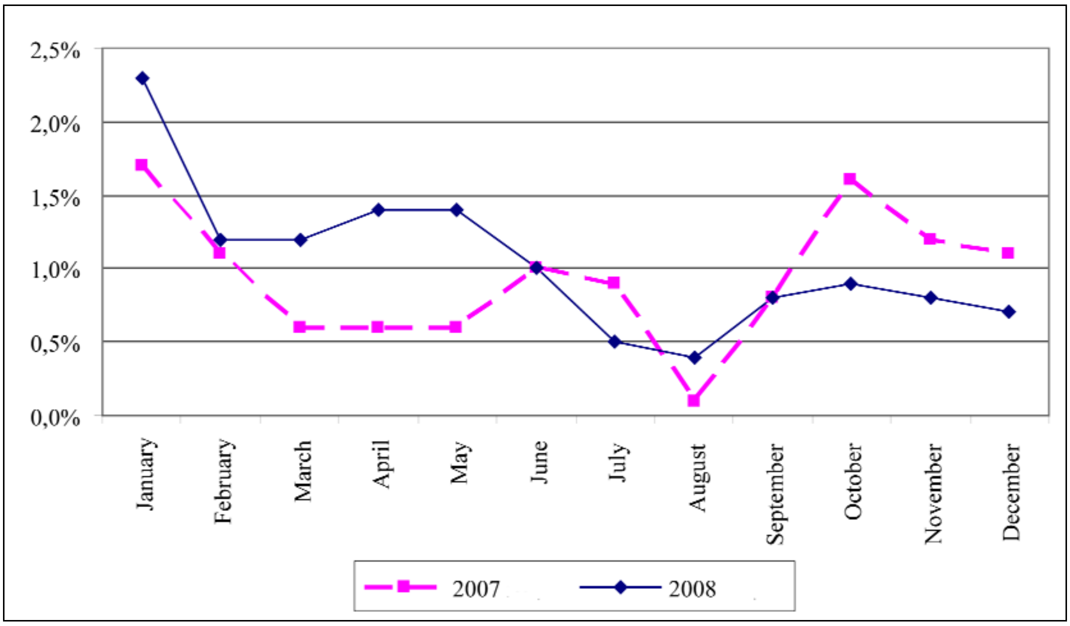


Source: CBR RF, the IET calculation.

Fig. 2. The Money Multiplier in RF in 2002-2008

2.1.2. Inflationary Processes

In early-2008, the inflationary pressure was still high compared with the respective period of the prior year (*Fig. 3*). The measures the RF government undertook in January to extend the October 2007 agreement on price freeze on some socially significant goods between largest producers and retailers proved to be fairly ineffective. Meanwhile, a rapid rise in money supply in late-2007 put an upward push on the price rise. But in the second half-year, because of the contraction of its foreign reserves the CBR was selling to maintain the Rb. exchange rate, money supply began to fall, while the price rise rate started to decelerate. In all, by results of the year CPI accounted for 13.3% vs. 11.9% reported in 2007. Let us consider the dynamic of inflationary processes over the year.



Source: Rosstat

Fig. 3. The Dynamics of CPI of RF in 2007–2008

As evidenced by data of *Table 3*, prices in the group of food stuffs grew at 16.5% (15.6% in 2007). So, like in 2007, food stuffs made the greatest contribution to the CPI increment over the year. Between January and December 2008, it was the price rise for pasta (+33.8%), bread and bakery (+25.9%), grits and legumes (+25.8%), meat and poultry (+22.2%) and sunflower-seed oil that made a major contribution to the price rise for food stuffs. The paid services to the population surged at 15.9% over the year (13.3% in 2007). It was prices for overseas tourism services (+22.9%), passenger transportation services (+22.5%), sanatorium and rehabilitation services (+21.2%), physical culture and sport services (+21%), preschool education services (+20.7%), household services (+18.7%), housing and communal services (+16.4%) and medical services (+16.3%) that demonstrated the greatest price rise rates over the year. As concerns non-food merchandise, prices for this group of goods rose at 8% on average over the year (in 2007 - at 6.5%). The price rise was powered chiefly by prices for tobacco goods (+16.1%), medicines (+16%), cleaning and washing goods (+17.5%) and construction materials (+11.3%). The growth in the basic index of consumer prices in 2008 accounted for 13.6% (vs. 11% reported over the respective period of the prior year). Thus, the main causes behind a significant inflation rate in 2008 were a rapid price rise for food stuffs, construction materials and paid services.

As shown by *Table 3*, between 2005 and 2008 it was the rise in the housing and utilities tariffs, which soared more than two-fold over the period in question that formed a pivotal element of inflation. They are followed by the price rise for passenger transportation services (+86.8%), services delivered by institutions of culture (+79.9%), sanatorium and rehabilitation services (+79.5%), and some food stuffs. It is worth noting that gasoline prices demonstrated an insignificant rise over the year, which can be attributed to a drastic downfall in oil prices in the fall 2008. At the same time, prices for numerous food stuffs were rising at a pace greater than that in the prior years.

Table 3

The Annual Price Rise Rates for Some Kinds of Goods and Services in 2005–2008 (as%)

	2005	2006	2007	2008	2005 – 2008
CPI	**10.9%**	**9.0%**	**11.9%**	**13.3%**	**53.3%**
Food stuffs	9.6%	8.7%	15.6%	16.5%	60.4%
Sunflower-seed oil	*2.1%*	*-1.2%*	*52.3%*	*22.1%*	*87.6%*
Cream butter	*8.2%*	*6.8%*	*40.3%*	*10.5%*	*79.2%*
Pasta	*1.9%*	*4.7%*	*23.6%*	*33.8%*	*76.4%*
Grits and legumes	*0.2%*	*12.1%*	*24.7%*	*25.8%*	*76.2%*
Bread and bakery	*3.0%*	*11.1%*	*22.4%*	*25.9%*	*76.3%*
Milk and dairy products	*10.5%*	*8.7%*	*30.4%*	*12.2%*	*75.7%*
Meat and poultry	*18.6%*	*5.9%*	*8.4%*	*22.2%*	*66.4%*
Fish and seafood	*12.7%*	*7.8%*	*9.0%*	*15.1%*	*52.4%*
Non-food goods	6.4%	6.0%	6.5%	8.0%	29.7%
Construction materials	*9.1%*	*11.5%*	*16.2%*	*11.3%*	*57.3%*
Gasoline	*15.8%*	*10.9%*	*8.5%*	*1.2%*	*41.0%*
Paid services to the population	21.0%	13.9%	13.3%	15.9%	81.0%
Preschool education services	*32.1%*	*28.5%*	*11.8%*	*20.7%*	*129.1%*
Housing and utilities	*32.7%*	*17.9%*	*14.0%*	*16.4%*	*107.6%*
Passenger transportation services	*15.8%*	*14.2%*	*13.6%*	*22.5%*	*84.0%*
Cultural institutions' services	*17.7%*	*15.6%*	*14.5%*	*15.5%*	*79.9%*
Sanatorium and rehabilitation services	*11.2%*	*15.2%*	*15.6%*	*21.2%*	*79.5%*

Source: Rosstat.

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

Table 4

Consumer Price Indices in the CIS Countries in 2000−2008, as%

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

Source: The CIS Intergovernmental Statistics Committee (http://www.cisstat.com/).

Clearly, all the CIS nations saw inflation accelerate in 2008. At the same time, the global financial crisis that hit the world economy had a dual influence on inflationary processes in Russia and the other CIS countries. On the one hand, a sharp deceleration of growth rates of money supply in the second half-year leads to compression of the monetary inflation. Let us note that the compression of money supply took place despite the government's considerable anti-crisis spending, as economic agents opted for a mass conversion of their funds into hard currency and the money multiplier was on decline. So, for the first time over the recent years Russia's economy once again experiences dollarization. The trend to decrease in money supply would continue in 2009, should the Bank of Russia further maintain the Rb. exchange rate at a level higher that the equilibrium one. If that happens, even a considerable budget deficit, which, as the government assumes, should in 2009 account for 8-10% of GDP, may not entail a serious expansion of money supply, but compensate its contraction, due to the above factors.

On the other hand, depreciation of the national currency engenders a price rise for imports and sparks inflationary expectations. Plus, the latter are on the rise along the growth of financial instability. Finally, a slowdown of economic activity gives rise to a lower demand for money, while economic agents loose confidence in the banking system and strive to convert their savings into foreign currency. In our view, in the conditions of Russian economy the Rb. depreciation will result in a mounting inflationary pressure and by results of 2009 CPI will prove to be greater than in 2008. Meanwhile, the pace of inflation acceleration is hard to estimate – it depends on numerous factors, including the volume of additional budget spending, the Bank of Russia's exchange rate management policy, and the magnitude of dollarization of the economy in particular.

According to the scenario-based forecast by the IET, in 2009 CPI should account for 15-25%, depending on the state of the nation's balance of payments, the mgnitude of depreciation of the national currency, and the size of the budget deficit.

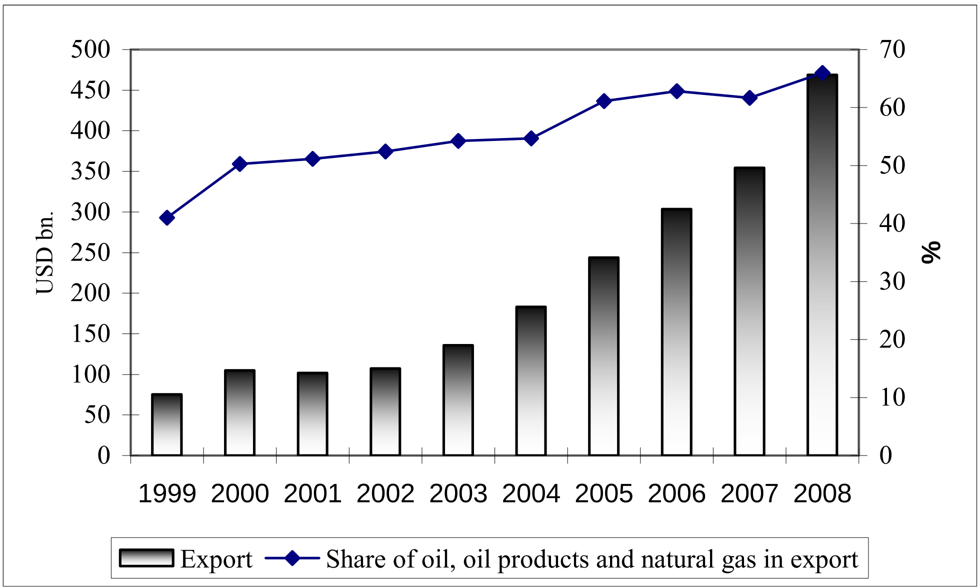
2.1.3. The State of the Balance of Payments[4]

In 2008, the sustainability of Russia's balance of payments was traditionally maintained thanks to exports, primarily, the fuel and energy sector's outputs. Despite a sharp downfall in prices for energy sources in the fall of 2008, thanks to a rapid rise in the prices over the first half of the year, the balance of trade ultimately posted a 34.9% growth, while that of balance of payments was up at 29.7%. Against the backdrop of high prices for energy sources Russian exports surged at 32%-plus, while imports showed a 30.9% rise. But the world financial crisis has so far resulted in a downfall in prices for major Russian exports and a massive capital flight out of the country. As a result, while by the end of the year the balance of payments seems fairly sustainable, a fast fall in exports and the private capital outflow noted in the 4th quarter have resulted in contraction of the nation's foreign reserves for the first time since 1998.

According to the CBR's preliminary evaluation of Russia's 2008 balance of payments, the positive balance of current account made up USD 98.9bn., i.e. at 29.7% up compared with 2007 (*Table 5*). More specifically, the positive balance of balance of trade soared at 34.9% (from USD 130.9bn to 176.6bn), with exports growing at 32.3% (from USD 354.4bn to 469bn) and imports surging at 30.9% (from USD 223.5bn to 292.5bn). The share of exported oil, petroleum derivatives and natural gas in the overall value of export accounted for 65.9% (in 2006- 62.8%, in 2007 – 61.7%) (*Fig. 4*). Thus, like in the prior years, the main factor that determined the value of the balance of current accounts was the balance of trade, whose balance in turn appeared to a significant degree dependent on dynamics on international markets of prices for energy sources and other major Russian exports. As evidenced by *Fig. 4*, the cor-

[4] The analysis of the balance of payments was conducted on the basis of the CBR's preliminary data: http://cbr.ru/statistics/credit_statistics/print.asp?file=bal_of_payments_est.htm

relation between world oil prices and Russia's balance of trade noted over 2002-2007 survived unchanged through 2008.



Source: the CBR.

Fig. 4. The Dynamic of Export of Merchandise and the Proportion of the Output of the Fuel and Energy Complex in 1999-2008

Deficit of the balance of services accounted for USD 25.8bn and posted a 30.5% growth vis-à-vis its 2007 index. Export of services was USD 50.8bn (+11.4bn, or 28.9% vs. the 2007 figures), while import of services soared at 29.4% and hit the level of USD 76.6bn.

The balance of labor compensations in 2008 continued to slide (to grow by module) and accounted for -14.5bn USD (vs. -7.9bn in 2007). The 2008 deficit of the balance of investment revenues surged at 45.5% vs. 2007 and accounted for USD 34.2bn. Driven by a substantial rise of the index in the banking sector (from USD 4.7bn to 7.4bn[5]) and across non-financial corporations (from USD 21.5bn to 26.4bn), investment gains due rose from USD 44.8bn to 53.3bn. Russia continued collecting sizeable investment earnings (USD 18.2bn) resulting from investing of a fraction of its foreign reserves. The rise of income receivable by non-financial corporations from USD 55.9bn to 71bn and that by banks from USD 9.9bn to 14.4bn was behind the growth in the overall income receivable from USD 68.3bn to 87.5bn.

The balance of current transfers[6] in 2008 accounted for -3.2bn USD (down 8.8% compared with 2007).

[5] Such a significant rise in earnings is attributed to the investing of a fraction of the nation's foreign reserves in other countries' bonds.

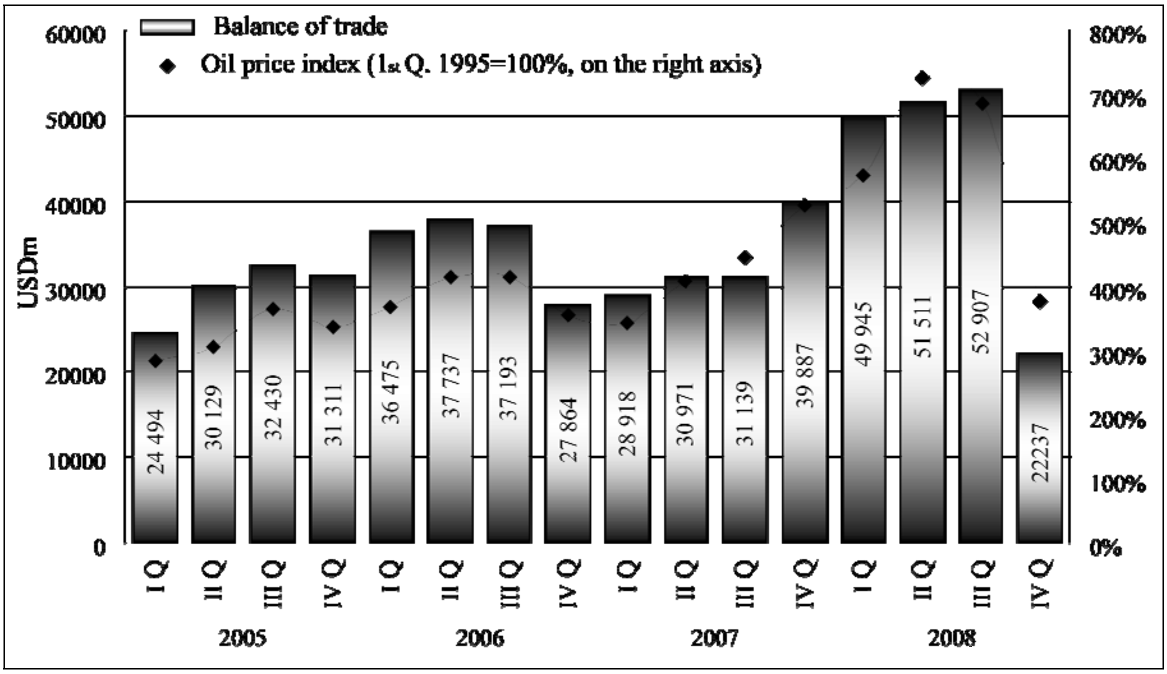
[6] According to the CBR, the current transfers bolster the level of disposable income and consumption of the recipient's goods and services and decrease the donor's disposable income and possibilities for consumption, for instance, humanitarian aid in the form of consumer goods and services. The current transfers are reflected in current accounts. Transfers other than current are conceived of as capital ones. They lead to a change in the volume of the donor or recipient's assets or liabilities and are reflected in capital accounts. In the event the donor and the recipient are non-residents to each other, the capital transfer engenders changes in the level of national

Table 5

Main Items of the Balance of Payments and the Dynamic of External Debt in 2006–2008 (as USD bn.)

Статьи баланса	2006					2007					2008				
	I Q.	II Q.	III Q.	IV Q.	*Year*	I Q.	II Q.	III Q.	IV Q.	*Year*	I Q.	II Q.	III Q.	IV Q.*	*Year**
Current account	30.4	24.3	23.9	15.7	*94.3*	22.4	14.4	15.5	24	*76.2*	37.4	25.8	27.6	8.1	*98.9*
Capital and financial instruments account**	-7	15.7	-14.8	9.5	*3.4*	14.5	48.5	-3.6	26.5	*85.9*	-24.7	35.4	-9.4	-129.7	*-128.4*
Change in forex reserves («+» -"decline of reserves", «-» – growth in reserves)	-21.4	-40.9	-13.8	-31.3	*-107.5*	-32.9	-65.5	-7.9	-42.6	*-148.9*	-6.4	-64.2	-15	131	*45.3*
Net mistakes and omissions	-1	0.9	4.8	6	*9.7*	-4	2.7	-3.9	-8	*-13.2*	-6.3	3.1	-3.2	-9.4	*-15.8*
Change in external debt of RF («+» growth in debt, «-» – decrease of debt)	16.0	15.6	-19.5	41.3	*53.4*	37.4	43.9	39.1	32.5	*152.9*	13.9	47.4	15.7	–	–
Change in the external public debt of RF	4.0	-7.6	-24.5	-5.1	*-33.2*	3.6	-3.2	3.5	-6.1	*-2.2*	-5.4	-2.1	3.8	–	–
Change in the external debt of the private sector in RF	12.1	22.7	5.1	46.9	*86.8*	34.0	47.1	35.5	38.7	*155.3*	19.2	49.5	11.9	–	–

* Preliminary estimates.
** Less currency reserves.
Source: The Bank of Russia.



Source: the CBR, IFS, the IET calculations.

Fig. 5. Russia's Balance of Trade and the World Oil Price Index in 2005-2008

So, it was high prices for major Russian exports that were behind a huge positive balance of current accounts of Russia's balance of payments between the 1st and the 3rd quarters 2008. Their downfall in turn triggered a fall of the positive balance of current accounts. Let us

wealth of the economies they represent. Examples of capital transfers are a free-of-cost transfer of property rights for capital assets or debt forgiveness.

note that at the background of a sharp decline in the balance of current accounts at the end of the year, a huge debt private sector had accumulated to that date (see *Table 5*) engendered growth in the negative balance of investment earnings, even despite sizeable investment revenues the monetary and credit regulatory agencies collected from investing the nation's international reserve assets. Hence, the private sector repaying its external debt should have a significant impact on the balance of payments in 2009-2010.

In 2008, the balance of capital accounts slid substantially and reached-128.4bn USD. That was determined by the financial turmoil on the world and national markets stirred by the downfall in prices for energy sources. The 2008 balance of capital transfers accounted for USD 6bn. So, without regard to capital transfers, the 2008 deficit of the financial account amounted to USD 129bn.

The rise in the Russian issuers' liabilities before foreign creditors by results of the year was USD 87.5bn, or down at 58.1% vs. 2007 (USD 208.9bn).

As in the prior year, the federal administrative bodies likewise became net payers in relation to non-residents. Their external liabilities slid at USD 7.4bn resulting from repayment of Russia's external public debt. The balance of external liabilities across the RF Subjects remained unchanged. The liabilities held by the monetary and credit authorities amounted to USD 4.7bn. The intensifying global financial crisis sharply diminished possibilities for Russian economic agents to attract (refinance) their overseas borrowings. Consequently, the increment of the banking sector's liabilities (+USD 9bn) plunged by 87.4% compared with the same period of 2007. Investments by foreign economic agents in Russia's real sector accounted for USD 90.6bn (in 2006 - 144.7bn). So, while in 2008 non-residents' investments in the non-financial sector were down compared with the 2007 figures, they nevertheless were in excess of their investments in the banking sector. Direct investments in the non-financial sector posted a 22.7% growth over the year and accounted for USD 58.7bn vs. 47.9bn reported in the prior year. As concerns portfolio investments, they were down at USD 10.8bn compared with the USD 6.5bn rise in 2007.

The residents' foreign assets (foreign economic agents' liabilities before Russian ones) grew over 2008 at USD 216.5bn (in 2007 - at 112.8bn), with the bulk of the increment being secured by the private sector's operations.

Foreign assets of the federal administrative bodies rose at USD 2.4bn, while those of the monetary and credit authorities remained practically unchanged.

Because of the turmoil on the national financial market coupled with the downfall in prices for major Russian exports and, consequently, expectations of a significant depreciation of the national currency, Russian banks in 2008 began vehemently accumulating foreign assets. More specifically, by results of the year the rise in the banks' foreign assets accounted for USD 66.4 bn, while the respective 2007 indicator did not exceed 25.2bn.

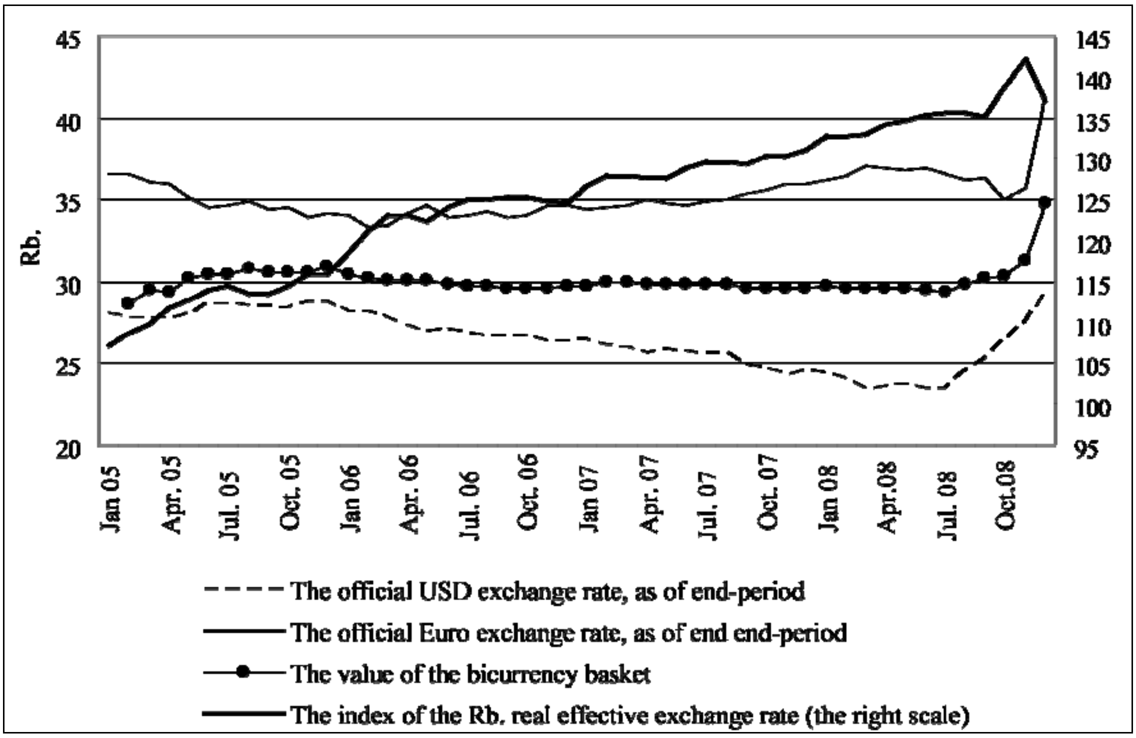
Export of capital out of the sector for non-financial enterprises and households rose at 56.3% compared with 2007 and accounted for USD 145.6bn. The volume of "the export gains not received on time, goods and services not supplied against transfers of monetary resources under import contracts, and transfers by fictitious operations with securities" practically remained unchanged when compared with 2007 and made up USD 33.2bn. At this point, it must be noted that it was "cash in foreign currency equivalent" that underwent the most profound changes, which evidences that the 2008 import of foreign currency in RF accounted for USD 24.8bn. compared with its USD 15.7 bn-worth export in 2007. In other words, once the Rb. began to depreciate (both in nominal and real terms) against the bicurrency basket in the fall of 2008, the population and the non-financial sector once again began to vigorously buy foreign currency; that was noted for the first time since 1997.

Up to the end of the year growth in offer of foreign currency was fueled by its influx from overseas and its sales by the non-financial sector within the country. That resulted in a rising real effective exchange rate of the Rb - by results of the year it appreciated at 5.1% (see *Fig. 6*), primarily because of inflation rates in Russia being higher than in the countries that are Russia's major trading partners. Meanwhile, a massive fall of the balances of current accounts and capital account and financial instruments of the balance of payments in the 4th quarter resulted in a considerable excess of demand for foreign exchange over its offer. To maintain the Rb. exchange rate, the Bank of Russia was selling its foreign reserves. But in September, the Rb. began to gradually depreciate against the bicurrency basket – that was done in order not to waste all the CBR's foreign reserves. The pace of the Rb. depreciation was accelerating along with the downfall in prices for major Russian exports and with the acceleration of capital outflow. As a result, in December alone, the Rb. real effective exchange rate slid by 3.6%, while yet in October in November it was up at 2.7% and 2.5%, respectively. It was back in January 2000 when the index declined so dramatically. By results of 2008, the Rb plunged against the USD from 24.55 to 29.38 and against the Euro – from 35.93 to 41.44, while the bicurrency basket rose from 29.67 up to 34.81.

With the volume of the forex revenues inflow in the country drastically diminishing, it was possible to maintain the overvalued Rb. exchange rate by means of spending foreign reserves only over a limited time. Meanwhile, as the CBR was pursuing a gradual depreciation of the national currency, buying foreign exchange has become for economic agents a relatively low-risk and highly lucrative investment instrument, which led to an increasing demand for foreign exchange and the imperative for the CBR to spend more and more of its foreign reserves.

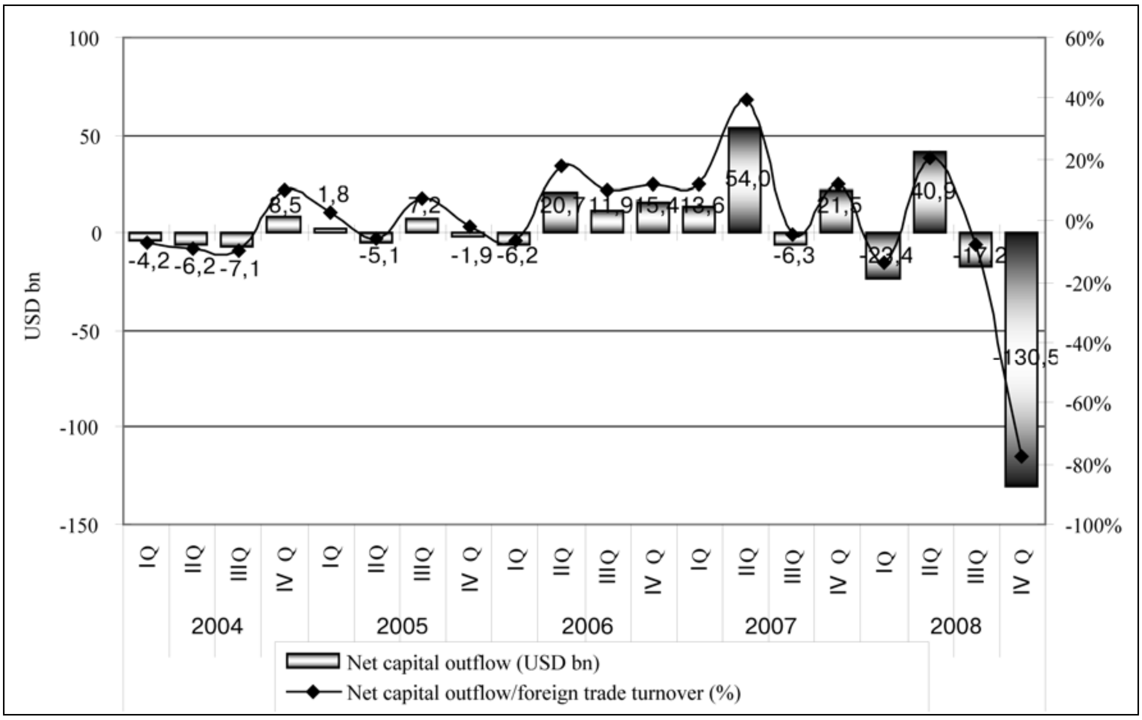
We believe that a single-step depreciation of the Rb. with a subsequent maintenance of a new announced level would become the most optimal move under such circumstances, as it would have enabled the CBR to save its reserves and lower depreciation expectations. The key factor that makes such a policy a success lies with the CBR's commitment to support a new exchange rate. Let us note that this commitment is in many ways determined by the Bank of Russia's ability to accurately estimate the equilibrium exchange rate. We presume that the level of support to the Rb. that would enable one to get demand and offer balanced on the forex market under the economic parameters of the early-2009 can be found within the range of 40-45 Rubles for the bicurrency basket. The problem is, in the conditions of the global financial crisis many factors are hard to estimate, which is why, should prices for energy sources decline further on, setting equilibrium on the forex market may demand for a further depreciation of the Rb.

Let us also note that to ease its mission on supporting the Rb. exchange rate the CBR is able to undertake measures aimed at restriction of capital outflow from the country. In all likelihood, the set of such measures may include cutting volumes of liquidity provided to commercial banks, raising interest rates, as well as some administrative measures, such as a coercive reservation for legal entities a part of funds they are going to export and a compulsory sale by exporters of a part of their forex-denominated receipts.



Source: the CBR, the authors' calculations.

Fig. 6 Indicators of the Rb. Exchange Rate between January 2005 and December 2008



Source: the CBR; the IET calculations.

Fig. 7. The Dynamics of the Net Capital Outflow in 2004-2008

Addressing key tendencies in the dynamic of indicators of the 2008 balance of payments one should reference to contraction in the balance of current accounts of the balance of payments in the 4^{th} quarter and a fairly sizeable net capital outflow from the non-financial sector which was worth a total of USD 130.2bn (in 2005-07, there was noted a capital inflow at the level of USD 2bn, 41.9bn and 82.8bn, respectively) (see *Fig. 7*).

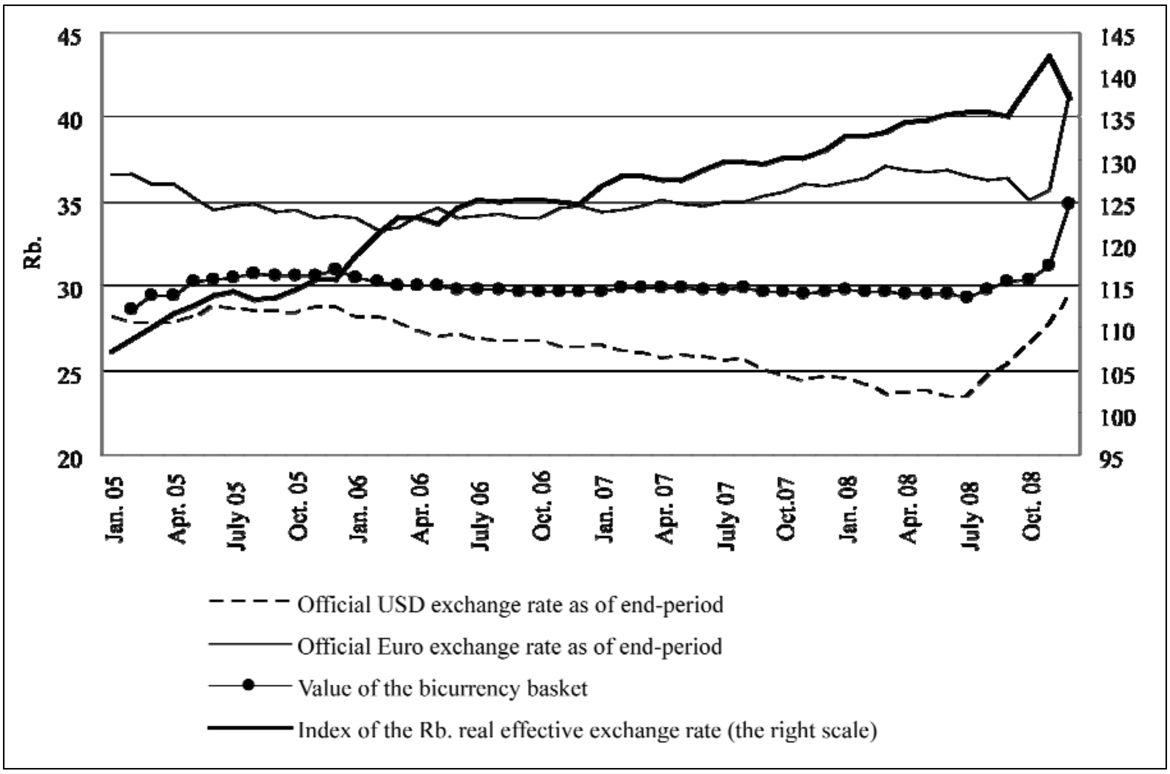
By results of the 2^{nd} quarter 2008, there was registered a USD 40.9bn-worth capital inflow. However, the overall result for the period between January through September equals just USD 0.3bn, because of the capital outflow in the 1^{st} and 2^{nd} quarters. Between October and December, steered by a sharp slowdown in economic activity, expectations of the Rb. depreciation against the bicurrency basket and growth in risks for foreign investors, the capital outflow from the country accounted for USD 130.5bn. Thus, the net 2008 capital outflow is USD 130.2bn, or 17.1% of the nation's foreign trade turnover.

Let us note that against the background of a drastic shrinkage of the balance of current accounts of Russia's balance of payments, the problem of sustainability of the latter is further complicated by a huge foreign debt accumulated by Russian corporations, including quasi-public ones (i.e. banks and non-financial companies in which the public administration bodies and monetary and credit regulators hold, directly or indirectly, over 50% of participation in capital or otherwise exercise control over them). According to the Bank of Russia, as of October 1, 2008, the quasi-public companies' aggregate debt amounted to USD 146.1bn, including 14.4bn in a short-term (up to 1 year) debt. The aggregate external debt the private sector had accumulated as of the date in question was USD 351.6bn, including USD 87.5bn in short-term liabilities. So, in 2009 the national corporations will have to repay their USD 136bn-worth external debts (including repayment of the body of the debt and interest payments). In all likelihood, with chances for attracting foreign investors' resources into Russia being low, that will give rise to a sizeable negative balance by capital accounts and those on financial instruments.

In 2008, the unofficial capital outflow (capital flight) out of the country (*Fig. 8*) remained practically unchanged when compared with 2007. We estimate[7] its volume at the level of USD 49bn, or up just at 0.4bn compared with 2007. Accordingly, the year of 2008 evidenced a drop in the proportion of capital flight in the foreign trade turnover to 6.4% from 8.4% reported in 2006.

As concerns other peculiarities of the 2008 balance of payments, let us note that the proportion of revenues from export of energy sources in export of goods was still great. The downfall in prices for energy sources in late-2008 highlighted vulnerability of Russia's balance of payments. In 2009, the oil prices may stabilize at a low level or even demonstrate a further decline, which, given a stable exchange rate of the Rb., may lead to a further decrease in the balance of current accounts of the balance of payments. Hence, in the event a net capital flight from Russia continue, the balancing of the balance of payments may be secured by further depreciation of the Rb. exchange rate and, accordingly, decrease in import, as well as by the CBR selling its foreign reserves.

[7] We calculate capital flight using the IMF methodology: accordingly, it constitutes the sum of "trade credits and forward payments", "export gains not received on time, goods and services not supplied against transfers of monetary resources under import contracts", and "net mistakes and omissions".



Source: the CBR; the IET calculations.

Fig. 8. The Dynamic of Capital Flight in 2004-2008

2.1.4. Main Measures in the Monetary and Credit Policy Area

1. On March 1, the RF Statistical Service posted on its Homepage on the Internet a personal inflation calculator. Using it, one can calculate an individual consumer price index proceeding from one's personal structure of consumer expenses. It is known that the CPI published in RF is computed on the basis of the average statistical structure of the consumer basket. This structure is revised fairly rarely, while the structure of consumer expenses of each individual consumer may differ significantly from the average statistical one, which may result in the personal inflation deviating greatly from the average nationwide one.

Let us note that such tools are available to residents in many developed countries. Their use allows their governments to bolster economic agents' confidence in inflation indicators published by government statistical agencies.

2. On May 14, the Bank of Russia modified procedures of exercise of currency interventions. In addition to carrying out spot operations aimed at maintaining the value of the bicurrency basket, the CBR started to hold regular currency interventions depending on the state of affairs on the domestic and overseas financial markets. This move was launched in the frame of a gradual transition to the floating exchange rate mode. While the pressure on the Rb. was mounting in the fall of the year, the CBR once again became a leading player on the forex market by selling resources from its foreign reserves to maintain the Rb. exchange rate. As noted above, the 2008 gradual depreciation policy cost the CBR more than one-fourth of its foreign reserves. At the same time, we believe that, unlike the situation in the aftermath of

the1998 crisis, in the current conditions depreciation does not bear explicitly favorable consequences, both because of a smaller volume of idle production capacities that may be engaged in the import substitution process and due to a considerable amount of the national corporate sector's debt, which is on the rise because of the Rb. depreciation. Plus, by contrast with 1998, the current crisis has battered the developed economies, too, which has entailed contraction of demand worldwide and the absence of possibilities for a rapid renewal of the capital inflow in RF. At this juncture the monetary and credit authorities should estimate the Rb. exchange rate which would enable them to get the balance of trade balanced and protect an announced level from the bearish mood on the financial market.

3. Since July 1, 2008, the CBR modified its methodology of calculation of international reserve assets of RF. Since that date the bonds that are included in the composition of the reserves are accounted in the composition of the reserves at their market value. In the past, these instruments were included in reserves at their depreciation value, i.e. by their effective price plus interest accrued. Such an approach better matches the best international practices, and its employment allows a more adequate estimate of the current volume of reserves. At the same time, the new approach may lead to a greater volatility of the amount of foreign reserves.

4. In 2008, the CBR continued to publish reports on the structure and results of its foreign reserve management. This move is aimed at enhancement of transparency of the Bank of Russia's operations. But it should be noted that the respective data are published with a more than 6-month lag, which, in our view, goes well beyond reasonable limits. Plus, the report does not cite yields rates by all the investment instruments with a breakdown by kinds of currencies. If supplied, such information would allow a more complete assessment of the foreign reserve management outcomes.

The most interesting section of the reports is information on results of the foreign reserve management. According to the last report posted on the CBR's Homepage on the Internet in January 2009, between April 2007 and March 2008 the Bank's reserve assets soared by USD 167bn, including USD 28.5bn (15.4% of the overall rise) in interest earnings and revaluation of bonds. So, in the conditions of a sizable influx of foreign currency in the country, these earnings constituted a relatively insignificant factor of the dynamic of the nation's foreign reserves. But once the state of affairs in the foreign trade area aggravated and capital inflow began to dry out, the foreign reserve management outcomes undoubtedly started playing a greater role than before.

To evaluate the CBR performance with regard to its reserve management, the report suggests employing the so-called "normative portfolios", which essentially represent indices of markets whereinto the Bank carries out its interventions. In the composition of the CBR's assets denominated in reserve currencies, there are the operational portfolio and the investment one. In all likelihood, the operational portfolio is supposed to support a high level of liquidity of reserve assets the CBR needs to exercise its functions on pursuance of the monetary and credit, and currency policies. The investment portfolio, whose name speaks for itself, was established to invest respective funds in less liquid and more risky assets.

The yield rate of reserve assets management operations between April 2007 and march 2008 was 7.3% in USD equivalent, 4.5% in Euro equivalent, 7.9% in British pounds and 0.6% in Yen equivalent.

5. In 2008, the Bank of Russia continued to raise interest rates by instruments of attraction of credit organizations' funds. More specifically, interest rates by deposits on standard

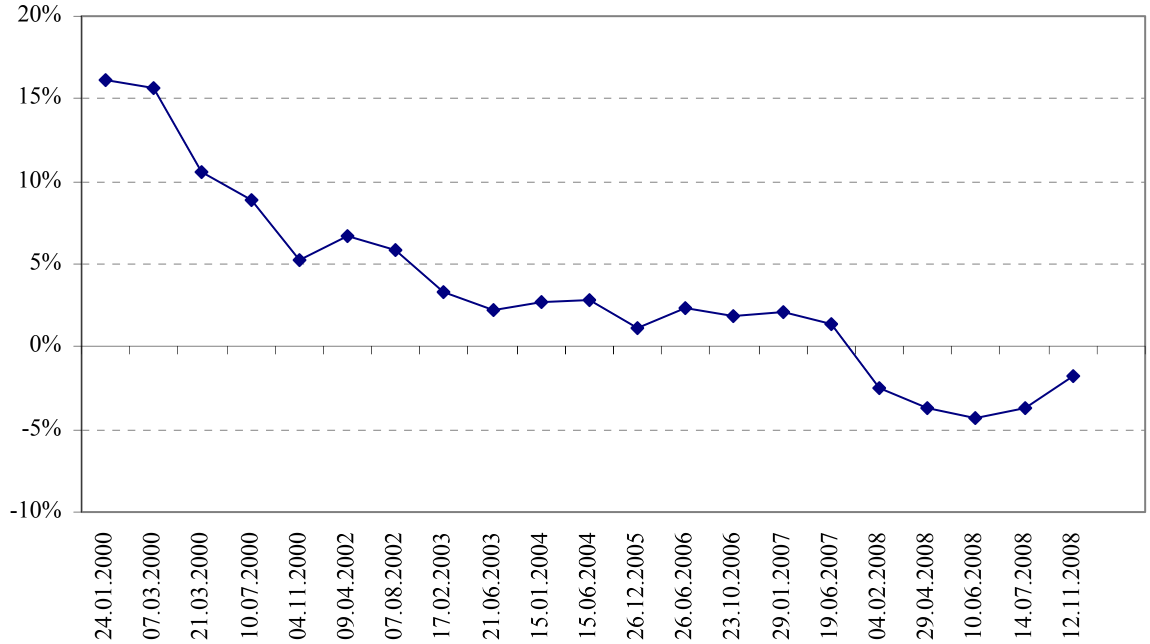
terms “tom-next”, “spot-next” and on-demand deposits were raised from 2.75% annualized to 6.75% annualized, while those by “one-week” and “spot-week” deposits were raised from 3.25% to 7.25% annualized. That was done for the sake of sterilizing the excessive liquidity in the summer and became possible thanks to changes in the domestic and external economic conditions. With the use of these measures the Bank of Russia continued its course towards a greater role played by interest rates in implementation of its monetary and credit policy. Meanwhile, because of the rise of liquidity shortages on the Russian market due to the financial turmoil on international markets, in 2008, the volume of commercial banks’ deposits with the CBR did not exceed Rb. 300bn vis-à-vis 1.2trln reported in 2007.

6. In 2008, the Bank of Russia also vehemently employed such a monetary and credit policy measure as modification of the compulsory reservation rates. They were raised four times through September and ultimately reached 8.5% annualized by the Russian banks’ debts before foreign credit organizations, 5.5% - by their Rb.-denominated liabilities to private individuals and 6% - by other liabilities. It is worth noting that it was the compulsory reservation rate by the banks’ debts to non-residents that was growing at the greatest pace. Apparently, that was explained by the CBR’s desire to decelerate the growth rate of the bank’s external debts to bolster their financial sustainability in the event of aggravation of problems on the world financial markets.

With the domestic financial turmoil on the rise, the Bank of Russia ruled to drastically decrease rates of contributions to the CRF effective as of October 15. In the aftermath of a two-stage decrease across all kinds of reserved obligations the rates were set at the level of 0.5%, but only for a certain period of time – they should have been raised up to 1.5% since February 1, 2009 and further up to 2.5% since March 1, 2009. Bu in January 2009, the Board of Directors of the bank of Russia decided to shift the timelines for a stage-by-stage raising of the rates of contributions to the CRF. According to the new decision, the new dates were set for May 1, 2009, and June 1, 2009. In all likelihood, the CBR made this decision because of a complex situation in the national financial sector steered by the world financial downturn. The Russian credit organizations should shortly face a rapid growth in failures to repay loans they have earlier issued, which should derail their financial health. Withdrawal of liquidity in the form of deductions to the CRF in such conditions would fuel the rise of financial instability.

7. In 2008, the Bank of Russia for six times raised its refinancing rate, which ultimately has grown from 10 to 13% annualized. Let us note that it was done in parallel with the raising of rates by the credit organizations’ deposits with the CBR and the acceleration of inflation in the country. But because of a rapidly mounting inflation pressure, the refinancing rate in real terms has remained negative practically over the whole year.

In the autumn of 2008, in the conditions of aggravation of the situation on the financial market, the commercial banks’ demand for the Bank of Russia’s credits grew sharply, which resulted in a higher value of the CBR’s interest-rate policy, as its resources have formed a major source of formation of money supply (see above). The CBR employed maintenance of low interest rates in real terms to vigorously credit commercial banks. Meanwhile, in the fall of the year the Bank of Russia increase the momentum of raising the refinancing rate to counter the capital outflow that started because of the development of the world financial crisis and was fueled by downfall in prices for major Russian exports (*Fig.9*).



Source: The CBR, the Statistics Service of RF.

Fig. 9. The CBR's Refinancing Rate in 2000-2008, in Real Terms

8. Due to the outgrowth of the financial crisis in late-2008, the national financial intermediaries in Russia faced liquidity shortages, which compelled the Bank of Russia to embark on a series of emergency measures (apart from lowering interest rates by its credits and reducing the CRF deduction rates), aimed at preclusion from a spreading of instability in the national banking sector.

More specifically, on October 10, the State Duma passed an act that allowed the bank of Russia to disburse unsecured loans to Rusian credit organizations. Such loans became available to credit organizations whose credit rating is not below a set value, and they could be disbursed for the term up to 6 months. This measure was aimed at supporting the national banking sector that had found itself in a hard situation. Because of a large-scale outflow of private capital from the country, a sizeable external indebtedness accumulated over the previous years, and the crisis in the real sector. Prior to the promulgation of the act, The CBR had been able to disburse credits to the national commercial banks against securities, hard currency, receivables under credit agreements or against a credit organization's pledge. But because the banks' huge need in credit resources, they lacked assets that might serve as a collateral against a CBR's lending. In such a situation, granting the CBR the possibility to disburse unsecured loans enabled it to support Russian banks, albeit it has increased potential risks associated with the borrowers' inequitable conduct.

To support the banking sector in the conditions of the deepening financial crisis the CBR began entering in agreements with large Russian banks on compensation for a fraction of their possible losses in the interbanking lending operations. As well, the Bank of Russia has undertaken such measures as provision of the REPO financing on security of an extended list of assets, extension of the REPO financing term, disbursement of subordinated credits to the so-called "backbone" banks, and adoption of the legislation on loan guarantees for corporations. Plus, the capitalization of the Deposit Insurance Agency was boosted for the sake of financial rehabilitation of the banking system.

Finally, on December 30, 2008, the Bank of Russia modified procedures of formation by credit organizations of reserves to withstand possible credit losses. According to the effective procedures, credit organizations are bound to form reserves to back possible credit losses, depending on credit risks assessments. The procedures also imply that this diminishes the volume of funds available for commercial banks to carry out their current operations.

In compliance with the above decisions, the credit institutions were granted the right not to increase their credit reserves until December 31, 2009, in the event:

- the duration of the overdue indebtedness by the loan principal or interest on loan extends for the term of not more than 30 calendar days relative to the effective timeline;
- the loan has been restructured (for instance, the currency in which the loan was denominated was changed, or the loan period (with regard to the loan principal and/or interest on loan), or a change of the interest rate) has been modified in the period since October 1, 2008);
- the loan received since October 1, 2008, has been used to repay the earlier extended loan.

So, this measure has de-facto stimulated banks to credit more risky borrowers. But it should be understood that an overly liberal approach to the credit risk assessment procedures may derail the financial stability. In other words, this measure should be conceived of as a solely temporary help to the national financial system. Furthermore, in the late-2008, there appeared information that the government authorities instructed the largest Russian banks to bolster their credit portfolios at a certain rate. With the financial instability on the rise, such an approach may just entail accumulation of “bad’ debts on the banks’ balance sheets and trigger further challenges facing the credit organizations.

The Russian banks are going to shortly face yet another major challenge, that is, the rise in the volume of overdue debts on earlier extended credits. We think that at this juncture the main tasks in the area of support of the banking system are development of approaches to the diminishing of the banks’ “bad” assets, easing the M&A processes in the banking sector, refinancing the banks’ external debts on the arm’s length terms, and improving the regulation and oversight procedures in the sector. International experiences show that an increasingly popular measure that complements the provision of banks with additional capital has been redemption of their bad assets by a special agency. Such a structure might be established in Russia, too; however, to minimize risks associated with the banks’ inequitable conduct, it should redeem only the debts on loans extended in the pre-crisis period.

In conclusion, let us note that key factors that fuel the rise in volumes of crediting the real sector are subsidence of depreciation expectations and clarification of the magnitude and intensity of the crisis, which would enable banks to more accurately assess credit risks.