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R95 **Russian Economy in 2015. Trends and Outlooks. (Issue 37) /**
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The review provides a detailed analysis of main trends in Russia's economy in 2015. The paper contains 6 big sections that highlight single aspects of Russia's economic development: the socio-political context; the monetary and credit spheres; financial sphere; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts.

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Russia's Monetary Policy in 2015¹

In 2015, the Bank of Russia faced global challenges while implementing measures as part of its monetary policy. The economic situation in 2015 was marked by the following: Western sanctions and Russia's countersanctions remained in effect, prices of Russia's key export commodities continued to fall, economic agents' expectations for high inflation remained intact. The sweeping depreciation of the Russian ruble in late 2014/early 2015 resulted in an inflation shock which kept the year-end inflation at high level: the Consumer Price Index (CPI) stood at 12.9% at the 2015 year-end, much higher than the 2017 mid-term target level (4%) set forth in the central bank's Guidelines for the Single State Monetary Policy for 2015–2017. In its official 2015 forecast, Russia's Ministry of Economic Development predicted inflation will not move beyond 6.3% in late 2014/early 2015, and Russia's central bank expected it to stay at 8.2–8.7% under the baseline scenario and 9.3–9.8% under the risk scenario. At the same time, the Bank of Russia cut its key rate gradually from 17% in January down to 11% in December 2015 as inflation slowed down over the course of the year.

2.1.1. Money market

In the period between January and December 2015, the broad monetary base shrank by 2.5% to Rb 11.04 trillion as of January 2016. It was the first time since 2010 that Bank of Russia's lending operations with commercial banks contributed most to the shrinking of the monetary base. Adding to the factor which contributed to the 2015 increase in the monetary base was the decline of balances on the accounts held by the general government with Russia's central bank, due to spending of funds from the Reserve Fund (see *Fig. 1*). As a reminder, the monetary base in 2014 was up 7.9% to Rb 11.3 trillion, while the Bank of Russia's currency interventions aimed at bolstering the ruble was the main headwind to money supply growth.

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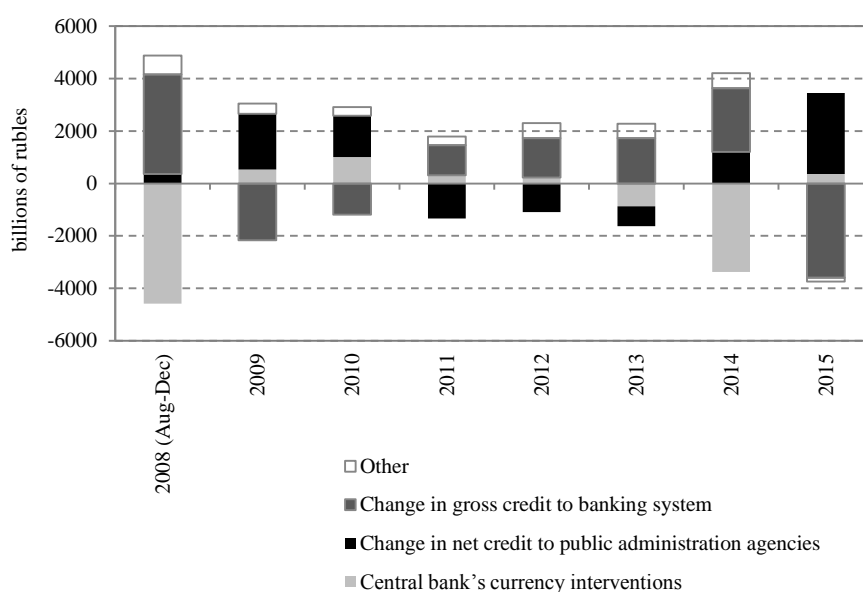


Fig. 1. Key factors that influenced change in the monetary base (broad definition) in 2008–2015¹

Sources: Bank of Russia, Gaidar Institute's own calculations.

In 2015, the Bank of Russia diminished substantially its presence in the FX market: the bank's foreign currency net purchases were worth as little as \$780m in the period between January and December 2015. For comparison, yearly net purchases of foreign currency amounted to \$34.1bn in 2010, \$12.4bn in 2011, \$7.6bn in 2012. However, the bank's foreign currency net sales increased to \$27bn in 2013 and to \$83.4bn in 2014. Note that the Bank of Russia decided in November 2014 to abandon its currency intervention policy as part of the transition to an inflation targeting regime. The decision aimed to ensure that the economy adapts faster to change in external conditions and is resilient to negative shocks. In our view, this decision was quite reasonable in view of the fact spending of the international reserves on bolstering the ruble in 2014 failed to prove efficient.

Russia's international reserves in 12M/2015 shrank by \$17.1bn (down 4.4%) to \$368.4bn as of the beginning of January 2016 (see *Fig. 2* and *3*). In 2015, the foreign currency reserves dropped by \$19.9bn (down 5.9%) largely because of foreign currency repos with banks. The year-to-date monetary gold reserves swelled by \$2.5bn (up 5.4%) because the Bank of Russia purchased gold. As a result, as of January 2016, foreign currency accounted for 86.8% (88% in 2014) of the total reserves, and gold made up 13.2% (12% in 2014). Russia now holds sufficient reserves to ensure sustainability of its balance of payments, because they cover both 16 months of imports of goods and services in Russia (11M/2014) and external debt payments that are due in 2016. Note that the adequacy of international reserves which have recently seen no change in volume enhances as imports of goods and services contract and the external debt becomes smaller. This allows Russia to ensure its macroeconomic and financial sustainability amid economic problems arising from worsening terms of trade and from Western sanctions freezing Russian economic agents out of global capital markets.

¹ The period under review covers 2008-2015, for which the data on the central bank's foreign currency interventions and balance sheet were available at the time of this review.

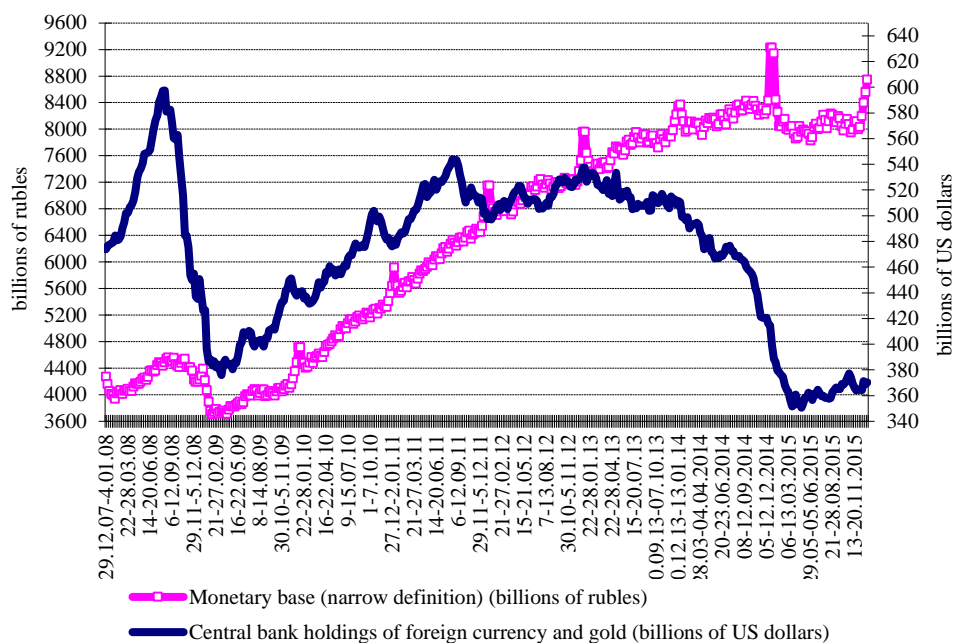


Fig. 2. Dynamics of monetary base (narrow definition) and Central Bank holdings of foreign currency and gold (international reserves) in 2008-2015

Source: Bank of Russia.

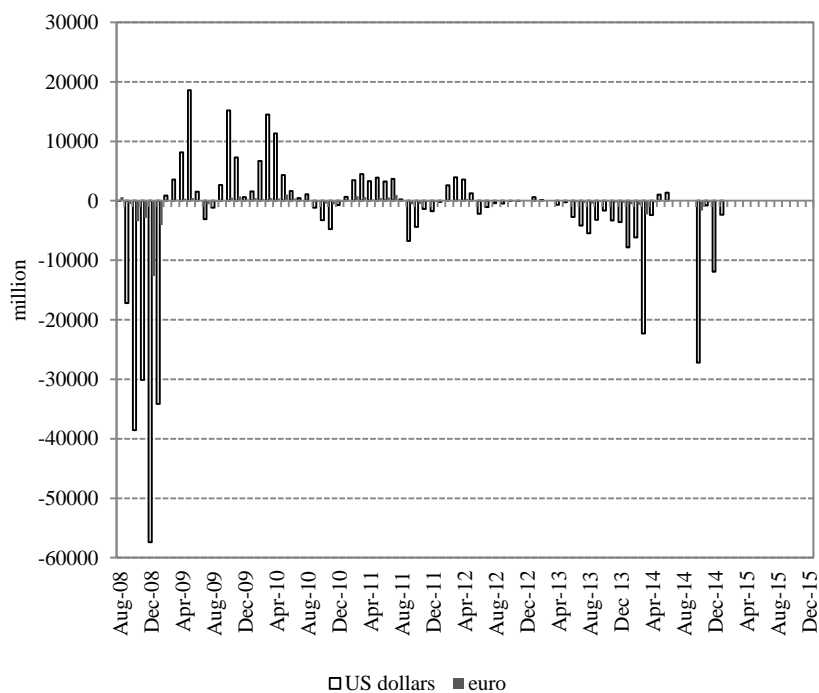


Fig. 3. Bank of Russia's currency interventions (net purchases of foreign currency) in 2008–2015

Source: Bank of Russia.

Table 1

Bank of Russia Balance Sheet, 2013-2015

	January 1, 2014		January 1, 2015		December 1, 2015	
	billions of rubles	% of assets/liabilities	billions of rubles	% of assets/liabilities	billions of rubles	% of assets/liabilities
Funds placed with nonresidents and securities issued by nonresidents	15,091.1	66.9	18,378.6	55.9	19,798.5	62.2
Credits and deposits	4,881.4	21.6	9,950.2	30.3	6,057.4	19.0
Precious metals	1,394.2	6.2	2,726.3	8.3	3,258.9	10.2
Securities	450.3	2.0	622.5	1.9	747.6	2.3
Other assets	99.5	0.4	186.6	0.6	841.6	2.6
Total assets	22,562.4	100	32,897.6	100	31,839.4	100
Cash in circulation	8,307.8	36.8	8,840.9	26.9	7,725.8	24.3
Funds in accounts with the Bank of Russia	10,359.0	45.9	13,876.0	42.2	12,106.2	38.0
<i>of which: Russian government funds</i>	5,848.8	25.9	9,144.3	27.8	8,667.6	27.2
<i>funds of resident credit institutions</i>	2,196.8	9.7	2,869.7	8.7	2,169.7	6.8
Float	5.7	0.03	1.9	0.01	22.4	0.1
Bank of Russia bonds	-	-	-	-	-	3.0
Liabilities to the IMF	500.0	2.2	840.8	2.6	966.9	6.1
Other liabilities	108.8	0.5	100.4	0.3	1,945.9	28.5
Capital	3,151.9	14	9,054.1	27.5	9,072.3	24.3
Profit of a fiscal year	-	-	-	-	-	38.0
Total liabilities	22,562.4	100	32,897.6	100	31,839.4	100

Source: Bank of Russia.

As noted above, the monetary base dynamics in 2015 was largely determined by the debt owed by credit institutions to the Bank of Russia (see Fig. 4). As a reminder, the trend of strong growth of the Bank of Russia's operations to provide loans to credit institutions has been afoot since 2011. As a reminder, the central bank's currency interventions was the key source of money supply prior to the global financial crisis of 2008–2009. However, Russia's central bank began to play key role in providing liquidity to the banking system, because it diminished the volume of its currency interventions in the FX market. In 2014, the debt was twice the peak values seen during the global financial crisis (H2 2008 – 2009), a 2.1-fold 12M increase, staying at Rb 9.3 trillion as of January 2015. The trend reversed in 2015: as of January 2016, loans, deposits and other borrowings of credit institutions stood at Rb 5.4 trillion, down 42% from 2014. The central bank's key lending instrument was one-week repo auctions under which banks borrowed Rb 1.4 trillion (Rb 2.69 trillion in 2014) in 12M/2015, as well as loans secured by non-marketable assets and guarantees, under which banks borrowed an average of Rb 3.0 trillion (Rb 2.3 trillion in 2014) in 12M/2015. The Bank of Russia diminished the volume of liquidity provision to commercial banks due to spending of funds of the Reserve Fund. In particular, banks borrowed Rb 3.1 trillion in January-December 2015, the funds were debited from the accounts held by the general government with the Bank of Russia.

The decline in banks' debt to Russia's central bank under repo auctions had a positive effect on the volume of unencumbered market collateral; in particular, the market asset utilization coefficient varied within a range of 40-50% in Q3 2015, whereas it reached 70% by the end of Q4 2014. According to the Bank of Russia's estimates, with a slowdown in lending and money supply, there is low risks associated with running short of market collateral in the short run.

Hence the volume of market collateral available in banks can be characterized as sufficient or adequate.

In 2015, the Bank of Russia continued to perform fine-tuning liquidity absorption operations through 1- to -6-day deposit auctions which were introduced in February 2014. Such operations were carried out in January (7 operations) and February (3 operations) of 2015, and from Rb 114.2bn to Rb 410bn of liquidity were absorbed per auction. Fifteen to 61 bidders (business entities) attended the auctions, this figure being indicative that the auctions were in low demand.

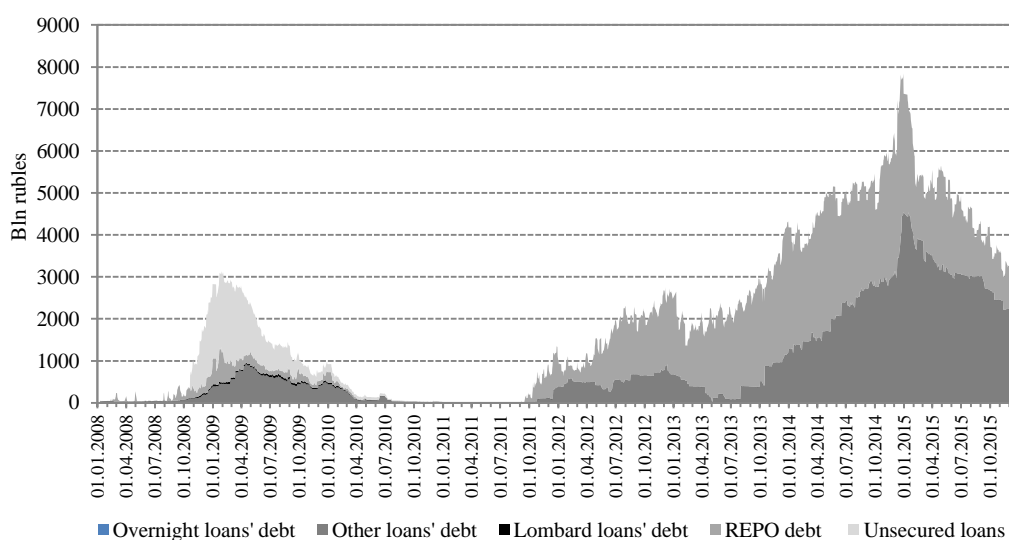


Fig. 4. Commercial banks' ruble-denominated debt (the key instruments) to the Bank of Russia in 2008–2015

Source: Bank of Russia.

The Bank of Russia' dollar-denominated loans to credit institutions was one of the key measures as part of its monetary policy, which were introduced in late 2014 and were aimed to push down the rush for foreign currency. Foreign currency swaps, foreign currency repos for a term of one week, 28 days, one year, as well as credit auctions to provide dollar-denominated loans secured by the pledge of claim on dollar-denominated loans to credit institutions were used as instruments of foreign currency refinancing.

Repos were the key instrument to provide foreign currency. Banks' foreign currency repo debt to the central bank continued to grow till late April 2015, hitting a peak of \$33.9bn, and then declined gradually till December 2015. According to the data available as of January 2015, banks' debt stood at \$24.9bn, including \$19.7bn under one-year foreign currency repos and \$5.1bn under 28-day foreign currency repos (see *Fig. 5*). The average weighted interest rate on one-year repo auctions increased from 1.2% per annum on January 12, 2015 to 3.2% on May 8, 2015¹, and the average weighted interest rate on 28-day repo auctions was up from 0.68% to 2.36% per annum in the period of January till early January 2016.

Note that foreign currency refinancing operations through repo auctions were first of all aimed at calming down panic sentiments in the FX market, and this objective was achieved in

¹ On 18 May, the Bank of Russia abandoned 365-day foreign currency repos. See "Key monetary policy decisions" for details.

January–February 2015. In our view, a wide use of foreign currency repos proved efficient and helped release pressure from the FX market.

As to foreign currency swaps, an average of \$166.4m were allotted to banks through such swaps in 2015. Banks showed low demand for this type of swaps because of high interest rates (the interest rate on the ruble leg (of a swap) was gradually cut from 16% on January 12th to 10% on August 3rd, and the interest rate on the FX leg reached 1.5%).

In 2015, the Bank of Russia held credit auctions to provide 28- and 365-day dollar-denominated loans secured by the pledge of claim on dollar-denominated loans to credit institutions. In Q1 2015, \$2.8bn were allotted at an average weighted interest rate of 1.47% as part of one-year auctions. Later, such auctions were not held because the FX market was stabilized. In January and in February, \$0.6bn and \$2.5bn, respectively, were lent via loans with a maturity of 28 days at a rate of 0.92% per annum. Later, an average of \$0.44bn were lent in loans at an average weighted interest rate of 2.35% per annum (except March, May and November, when no bids arrived from credit institutions). Note that the Bank of Russia’s list of counterparties eligible for this type of lending includes credit institutions with an equity of at least Rb 100bn, as well as Vnesheconombank (VEB).

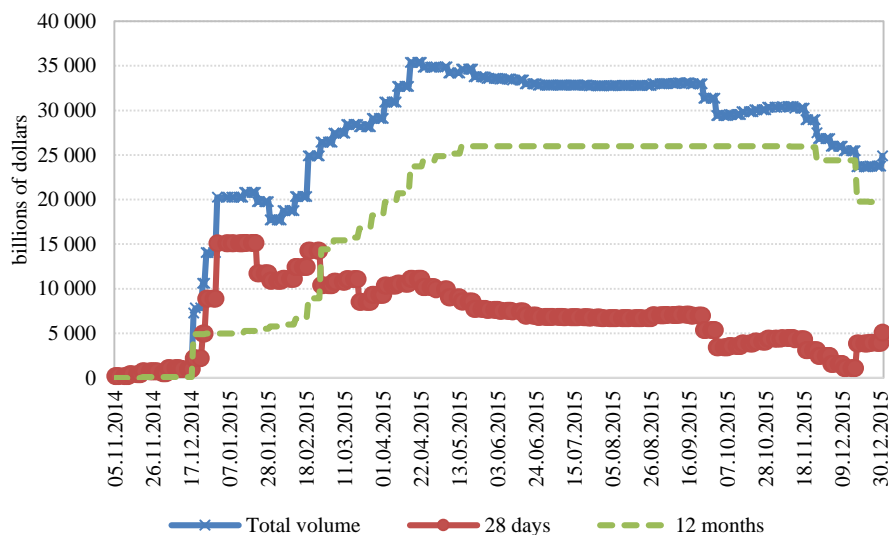


Fig. 5. Amount of funds to be repaid by credit institutions under second FX repo leg in 2014-2015

Source: Bank of Russia.

Let us consider in detail the dynamics of the broad monetary base (see Table 2).

Overall, emphasis should be placed on the following contracted components of the broad monetary base: required reserves for banks (down 21.5% to Rb 369.8bn), deposits of credit institutions with the Bank of Russia (down 30.7% to Rb 557.8bn), cash in circulation (down 3.6% in 2015 to Rb 8522bn). Only credit institutions’ correspondent accounts saw an increase (up 31.1% to Rb 1594bn). Overall, surplus reserves in 10M/2015 increased 6.5% to Rb 2152bn.

Table 2

Dynamics of broad monetary base in 2015
(billions of rubles)

	January 1, 2015	April 1, 2015	July 1, 2015	January 1, 2016
Monetary base (broad definition)	11,332	9,662.5	9,706.5	11,043.8
- cash in circulation, including cash in vaults of credit institutions	8,840.5	7,522.7	7,639.3	8,522.2
- correspondent accounts of credit institutions with the Bank of Russia	1,215.5	1,342.3	1,308.1	1,594.0
- required reserves	471.3	505.3	466.0	369.8
- deposits of credit institutions with the Bank of Russia	804.6	292.2	293.2	557.8
- Bank of Russia's bonds held by credit institutions	0	0	0	0
For reference: surplus reserves	2,020	1,635	1,601	2,152

Source: Bank of Russia.

In 2015, Russia's central bank cut gradually its key rate following its drastic hike (17% per annum) in December 2014, attempting to stabilize the financial market. The reason for easing the monetary policy was gradual slowdown of inflation amid deep recession (GDP lost 3.3% in Q1, 6.2% in Q2, 5.1% in Q3 over the same quarters of 2014). The key rate was lifted in emergency from 10.5% to 17% per annum in December 2014 amid turmoil in the FX market. In our view, the Bank of Russia's decision to raise the key rate was adequate under the circumstances. Had the real interest rate been cut amid surging inflation, the ruble would have been hit even harder, producing no effect on economic growth rates, because economic agents tend to cut their fixed investment in a volatile FX market.

The key rate cut coupled with offering more options to credit institutions for refinancing in rubles or in foreign currency contributed to the stabilization of the interbank lending market. The interbank lending market rate¹ dropped 34.9% in 12M/2015 (from 17.0% on average in January 2015 to 11.1% on average in December 2015). As a reminder, the MIACR rate overnight interbank ruble-denominated loans moved beyond the upper boundary of the interest rate band in December 10-24, 2014 due to a turmoil in the interbank lending market amid tumbling crude oil prices, a weakening ruble, and a key rate hike. However, the money market was stabilized as early as January. Overall, in 2015, the interbank interest rate did not move beyond the boundaries of the interest rate band, nearing sometimes the lower boundary in H2 2015. Note that the MIACR rate on ruble-denominated interbank overnight loans dropped below the key rate because there was less demand from banks for liquidity, which came via the budget channel while the provision of funds through one-week repos was diminished. Overall, the annual average MIACR rate on overnight interbank ruble-denominated loans increased by 1.5 times, from 8.6% per annum in 2014 to 12.7% in 2015 (see *Fig. 6*). Hence the Bank of Russia's interest rate policy in 2015 proved efficient in terms of achieving the objective of narrowing the gap between interbank lending rates and the key rate.

¹ Interbank interest rate (Moscow InterBank Actual Credit Rate) is monthly average MIACR on overnight interbank ruble-denominated loans.

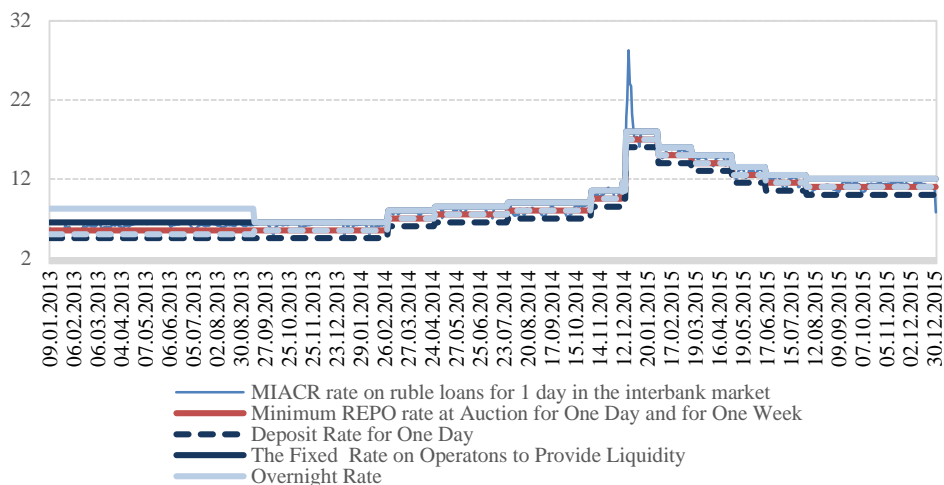


Fig. 6. Bank of Russia's interest rate band, and dynamics of interbank lending market in 2013–2015.

Sources: Bank of Russia, Gaidar Institute's own calculations.

Despite gradual key rate cuts in 2015, the money supply increased at moderate pace. In January-December 2015, the annualized M2 was growing at an average of 7.1%. The money supply increased from 2.2% year-on-year in January 2015 to 11.4% year-on-year in December 2015, whereas the money supply saw its annualized growth rate slow down through much of 2014, from 14.6% in January to 5% in December. Note that the annual growth rate of the money supply stood at 32.5% in 2010, 24.3% in 2011, 19.4% in 2012, 15.3% in 2013, 8.4% in 2014. The trend was first of all determined by low lending activity of banks. In 12M/2015, the annualized monetary base increased 1.3% and the annualized money multiplier (ratio of M2 to Monetary Base) advanced 1.1%. The money multiplier increased 14.5% given the fact that in December 2015 the monetary base shrank by 2.5% from December 2014, and the money supply increased 11.4% during the same period. In January-December 2015, the money multiplier averaged 3.3, which is an average value for developing economies (Ukraine, Belarus, Kazakhstan), whereas it tends to vary within a range of 5–8 in developed countries. Note that the money multiplier rose in Eastern Europe countries over the past two decades with the advancement of their banking system. For example, the Poland's money multiplier increased from 3.1 to 6.5 during the period of 1993–2015.

The level of monetization of the Russian economy (ratio of M2 to GDP) in 1999–2014 tripled to 45% in 2014. According to the data available as of October 1, 2015, the level stood at 45%, either. For comparison, the ratio of M2 to GDP during the same period increased by 1.8 times to 30.8% in Belarus in 2014, by 2.5 times to 33.7% in Kazakhstan, by 3.6 times to 61.1% in Ukraine. However, a higher level of monetization is typical of the most of Central and East Europe countries. For example, the ratio of M2 to GDP in Poland stood at 61.3% in 2014. GDP monetization is even higher in developed countries due to a more advanced financial system: e.g., it reached 164% in Germany in 2014.

2.1.2. Exchange rate policy decisions and exchange rate dynamics

As noted above, in late 2014 the Bank of Russia nearly put on hold its operations in the FX market, restricting itself to foreign currency purchases to replenish sovereign funds by the Federal Treasury. The central bank abandoned its currency interventions on February 3, 2015,

letting the exchange rate be governed by transactions in the private sector. As a result, the ruble exchange rate at that period was driven by a balance between foreign exchange supply and demand in the corporate sector, which was influenced by oil prices, the state of global economy, geopolitical context, as well as development parameters of the Russian economy.

The domestic FX market saw the official US dollar exchange rate strike the highest level on December 31st, up to 72.88 rubles per dollar, and the euro rose to 81.15 rubles per euro on August 25th.

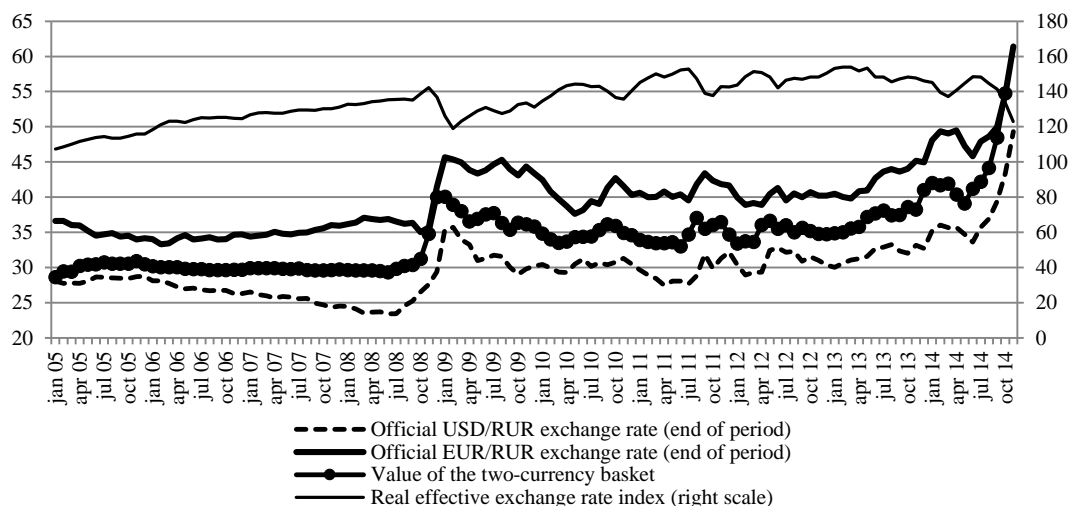


Fig. 7. Dynamics of ruble real exchange rate

Note: for ruble’s real effective exchange rate in January 2008=100%.

Sources: Bank of Russia, own calculations.

The situation in the FX market was improved by surging crude oil prices as well as stabilized geopolitical context. After hitting a local low of \$53.3 a barrel in mid-March, the monthly Brent crude price averaged \$61.6 a barrel as early as April and \$66.8 in the first half of May. As said above, the increase in volume of foreign currency provided by the Bank of Russia to credit institutions through repos contributed considerably to easing the turmoil which reached its highest level in the domestic FX market in December 2014.

With a rapidly strengthening ruble, the Bank of Russia announced on May 14th it will restart daily foreign currency purchases in the domestic FX market to increase its international reserves. The bank was expected to limit itself to purchasing \$100–200m a day. At that period the actual volume of Bank of Russia’s daily purchases neared the upper boundary of \$191m, and the total amount was slightly more than \$10bn in 2015. The Bank of Russia continued its currency interventions to build up the international reserves till July 28, 2015, when the US dollar official exchange rate moved beyond 58.78 rubles per dollar. Facing a new fall of crude oil prices and expectations for high inflation, the regulator decided to abandon its currency interventions. In our view, the decision to restart currency interventions was not rational, because it was inconsistent with the central bank’s key objective of taming inflation. As a consequence, the central bank failed to increase considerably the international reserves, and FX market players took the decision as a signal that the central bank was going to prevent nominal strengthening of the ruble, letting it go down.

The ruble continued to fall for five straight months: by September, the average monthly exchange rate of the US dollar rose to 66.77 rubles per dollar from 50.58 in May and of the euro increased to 75.04 rubles per euro against 56.52 rubles, respectively. Nevertheless, the ruble exchange rate went up as early as October, when Russia-West tensions relaxed a bit and the US dollar edged down, and hence global crude oil prices surged. However, the effect died out soon. In November-December the ruble lost 4.9% against the dollar and 1.0% against the euro following the October annualized increase of 5.9% of the ruble over the US dollar and over the euro.

Note that the swing to a free floating exchange rate policy amid drastically worsening external economic conditions resulted in a highly volatile ruble. As a consequence, intramonth volatility¹ of the dollar/ruble exchange rate in 2015 was more than 10%, which is way below the 2014 level (16.6%), but it is three times the value seen in 2010–2013 and in 2008, when the exchange rate was driven by a guided floating exchange rate policy (see *Fig. 8*).

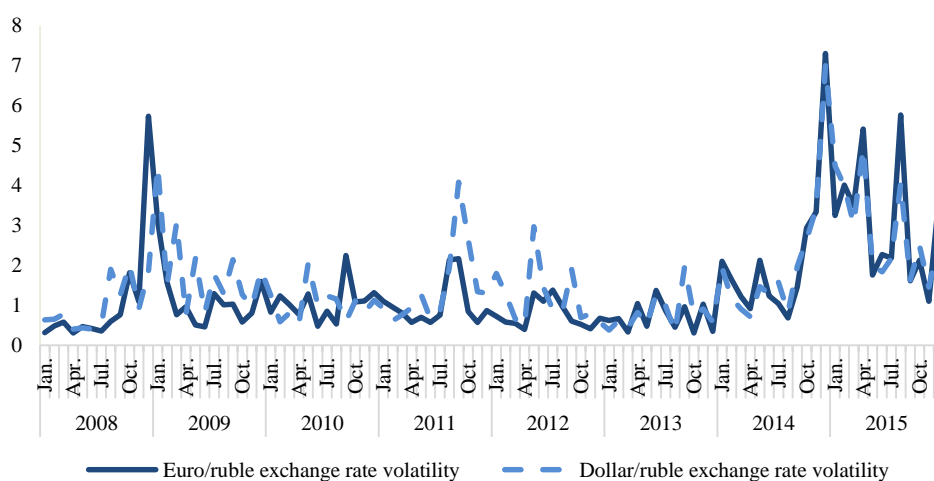


Fig. 8. Volatility of euro/ruble and dollar/ruble exchange rate

Sources: Bank of Russia, own calculations.

A growth in exchange rate volatility on the one hand may elevate FX risks of economic agents, but on the other hand this is what can curtail both speculative “games” in the FX market and growth rates of foreign currency deposits. As a result, although at the 2015 year-end the Russian ruble’s depreciated by 37.4% year-on-year against the US dollar and by 25.2% year-on-year against the euro, the foreign currency deposits² in credit institutions, which are held by the corporate sector (except banks) and individuals increased 18.3% in 2015 from the 2014 increase of 15.4%. Ruble deposits were up to 7.7% compared to a growth of 5.4% in 2014. As a result, the level of dollarization of the Russian economy measured as the ratio of foreign currency liabilities to the corporate sector and individuals to their end-November 2015 total value increased to 30.0% over 25.4% earlier in 2015, reflecting first of all the effect of exchange rate revaluation. For comparison, the level of dollarization stood at 15.7% earlier in 2014.

¹ Intramonth volatility of the ruble exchange rate against foreign currencies is calculated using daily official exchange rates and is expressed as a percentage ratio of exchange rate standard divergence to its average monthly value.

² An FX equivalent.

Hence, quick adaptation of the exchange rate to new economic realities helped avoid massive cash outflows from ruble accounts towards foreign currency accounts, as was the case during the crises of 2008–2009 and of 2014.

Overall, the dynamics of Russia’s ruble exchange rate against the key world currencies in 2014–2015 displayed the trends typical of developing countries’ currencies. However, the Russian ruble depreciated at faster rates, thus reflecting the effect of geopolitical risks, as well as a strengthening dollar in the global FX market and falling global crude oil prices. As a result, in that period the Russian ruble saw a 1.9-fold devaluation against the US dollar, while the Brazilian Real was down 1.6-fold, and the Turkish lira saw a 1.3-fold slide (see *Fig. 9*).

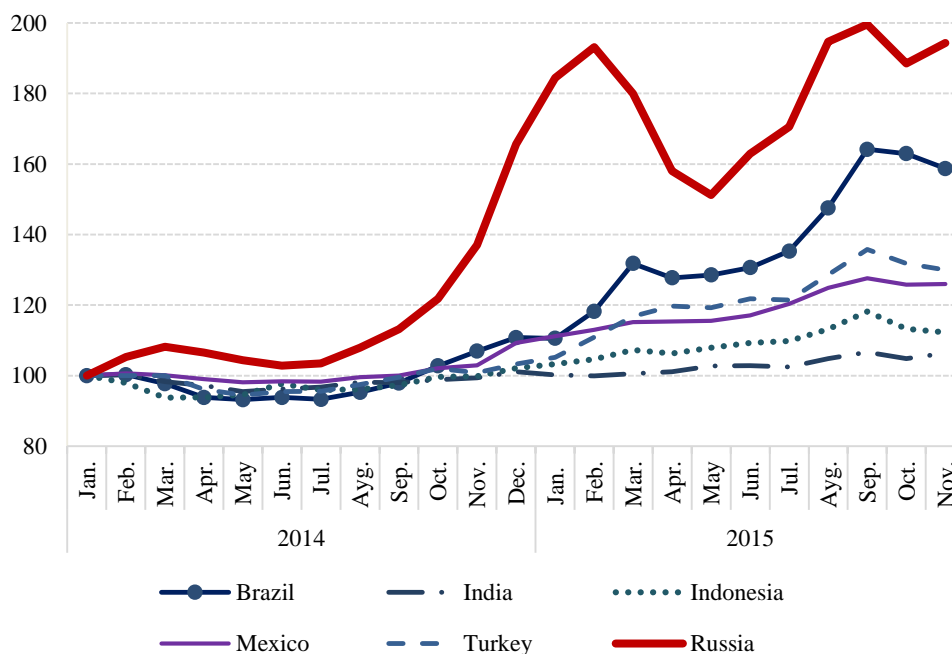


Fig. 9. Dynamics of US dollar exchange rate against currencies of developing countries (January 2014 = 100%)

Sources: International Financial Statistics (IMF), own calculations.

2.1.3. Inflation processes

In December 2015, inflation rate stood at 12.9% from December 2014, which was higher than the 2014 level (11.4%), and it was way above the target inflation rate for 2017 (4%) set forth in the central bank’s Guidelines for the Single State Monetary Policy for 2015–2017. March 2015 saw the highest inflation rate (up 16.9%) because of the peak of exchange rate depreciation pass-through to prices (see *Fig. 10*).

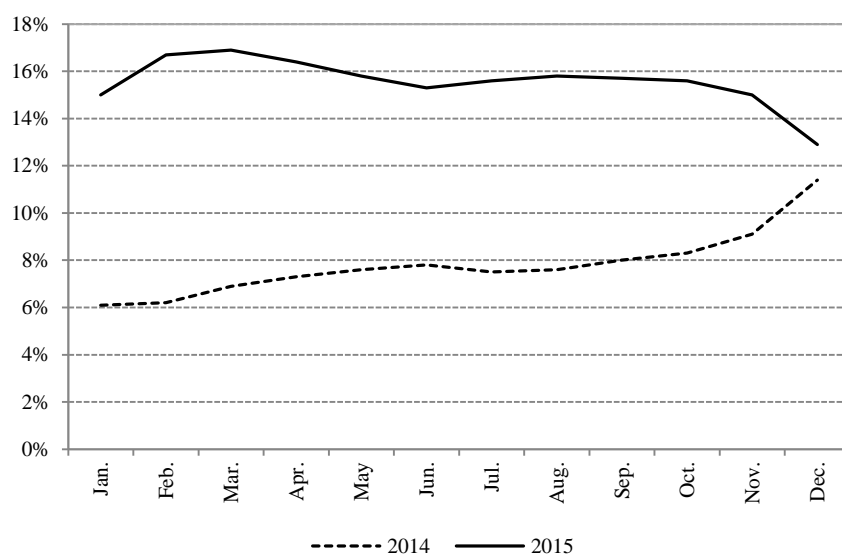


Fig. 10. CPI growth rates in 2014–2015 (% over the previous 12 months)

Sources: Rosstat; Gaidar Institute’s own calculations.

Inflation in 2015 was boosted basically by the effect of nonmonetary factors. The key factors that contributed most to the build-up of inflation, considering the fact that Russian economic agents consume a considerable share of imported goods, was the ruble devaluation which reached its peak earlier in the year due to massive capital outflows, expectations for further devaluation and falling crude oil prices, as well as in August 2015 (the ruble lost 10.6%), when the ruble sank in response to plummeting crude oil prices, from \$51.8 to \$42.4 a barrel. Note that, according to our estimates, the effect of exchange rate pass-through to consumer prices in Russia varied from 10% to 20% according to a currency and revaluation period. In other words, consumer prices increase 0.1–0.2% if the ruble slides by 1%. According to our estimates, the 2015 cumulative contribution of the ruble devaluation to the annual inflation as of the beginning of December was 9.5–10.2 percentage points. Note that according to the estimates of Russia’s Ministry of Economic Development, the ruble exchange rate depreciation pass-through contributed 8 percentage points to the annual inflation in August 2015.¹

Considering the magnitude of exchange rate pass-through to prices and heavy dependence of the Russian economy on highly volatile global hydrocarbons market, as well as rigid expectations for inflation in Russia, the central bank’s mid-term inflation rate target (up 4%) for 2017 will unlikely be fulfilled. Note that the M12/2015 inflation stood at 12.9%, whereas expectations for inflation rose to 16.4%. Furthermore, it should be borne in mind that the Bank of Russia failed since 1999 to reach the inflation targets set forth in its Guidelines for the Single State Monetary Policy, except in 2003 (the actual inflation rate was 12%, the target rate was 10–12%), in 2010, when the actual inflation rate was below the target range (the actual inflation rate was 8.8%, the target rate was 9–10%), and in 2011 (the actual inflation rate was 6.1%, the target rate was 6–7%). In that context, economic agents’ confidence in target inflation rates remains low, thus being a headwind to the fulfillment of the targets set. In our view, Russia’s

¹ Concerning the Current Situation in the Economy of the Russian Federation as of the end of January-August 2015. Russia’s Ministry of Economic Development.

central bank should set more realistic inflation rate targets, including a narrow range of permissible deviations (+/-1 percentage point), in order to increase economic agents' confidence and lower expectations for inflation.

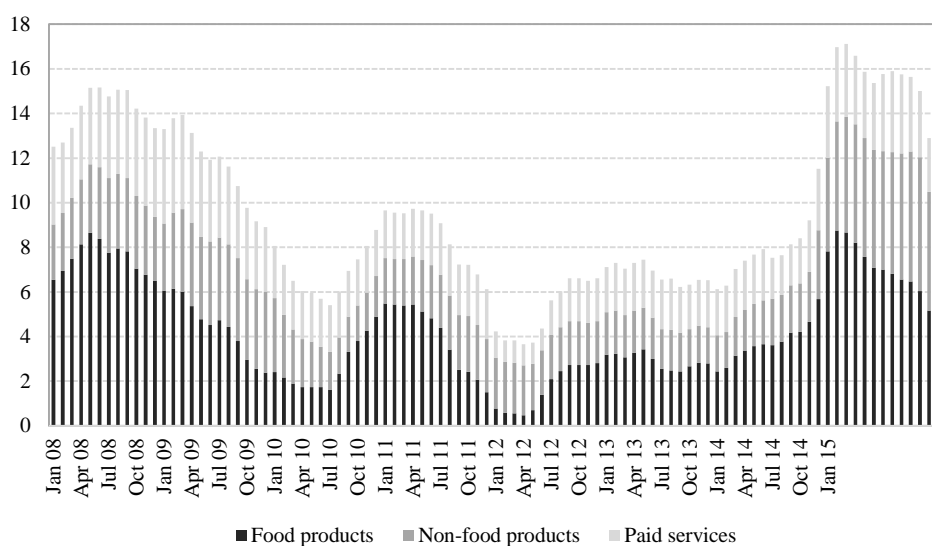
As shown in *Table 3*, consumer prices in the period between January 2015 and December 2015 grew up at slower rate than those in 2014. The price of the following food products contributed much to the increase in food prices: sunflower oil (up 37.2%), fish, other seafood and products thereof (up 20.9%), pasta-based food products (up 19.5%), fruits and vegetables (up 17.4%), cereal grains and beans (up 15.5%), bread and bakery products (up 13.2%). Note that the price of pasta-based food products, bread and bakery products was driven up by a considerable increase in the price of raw materials, including wheat and other grains. The sunflower oil price hikes were driven by the global oleaginous food market as well as lower per-hectare yield of sunflower as a result of a hot summer in some of the Russian regions. At the same time, the exchange rate depreciation pass-through to prices was a main tailwind to inflation build-up for certain types of food products.

In our view, the decision to maintain the ban on food imports from EU countries, Norway, the U.S.A., Canada and Australia, which the Russian government introduced in late June 2015, had no stronger effect on the dynamics of prices of the sanctioned goods, because manufacturers and retailers almost adapted to the ban, as was evident from slowing down growth of prices of the respective types of products.

Nonfood products saw their price grow faster in 2015 (up 13.2%). Prices of tobacco products rose faster (up 26.6%) than of other products in the same group due to an excise tax lift and depreciation of the ruble. A point of note is growth in prices of washing and cleaning agents (up 22.4%), medicaments (up 19.6%), textiles (up 19.7%), electrical and other household appliances (up 16.8%), footwear (up 15.1%). Overall, the price of nonfood products was pushed up by ruble depreciation, too, amid heavy dependence of the Russian market on foreign supplies.

In January-December 2015, the price of paid services to individuals increased 10.2% from 2014. The following services contributed most to the price rise: insurance services (20.5%), outbound travel (tourism) services (19.8%), early childhood education services (16.8%), utility services (12.1%), medical services (11.1%). Note that the increase in prices of outbound travel (tourism) services and insurance services was triggered by a weakening ruble. Insurance rates were affected considerably by the increase in the MTPL (Mandatory Third Party Liability) rates.

According to OOO INFOM's public opinion polls which are published monthly by the Bank of Russia, the median one-year ahead expected inflation rate in late 2014 spurred a considerable increase in the actual inflation rate over the prior 12 months (by 4–5.5 percentage points). The gap was narrowed (by 1.4–1.6 percentage points) in January-February 2015, thus showing that economic agents' panic sentiments settled down a little bit. Expectations for inflation in March-August 2015 were below the actual inflation rate largely due to a stable FX market. Expectations for inflation again rose by 0.5 percentage points to 15.8% in November and by 0.6 percentage points to 16.4% in December, because individuals expected the ruble exchange rate to decline at year's end. Note that high expectations for inflation hampered monetary easing, thus keeping inflation up.



*Fig. 11. Structure of inflation in 2008–2015
(% over the same month last year)*

Sources: Rosstat; Gaidar Institute’s own calculations.

Table 3

**Annual growth rate of prices of certain types of consumer goods and services
in 2012–2015 (% from December last year)**

	2013	2014	2015	2013–2015 ¹
CPI	6.5	11.4	12.9	33.9
Food products	7.3	15.4	14.0	41.2
Cereal grains and beans	3.2	34.6	15.5	60.4
Butter	18.6	14.5	10.6	50.2
Sunflower oil	-3	5.0	37.2	39.7
Pasta-based food products	4.7	8.4	19.5	35.6
Milk and dairy products	13.1	14.4	11.5	44.3
Eggs	28.8	4.6	9.8	47.9
Bread and bakery products	8.0	7.5	13.2	31.4
Meat and poultry	-3	20.1	4.3	21.5
Fish, other seafood and products thereof	7.6	19.1	20.9	54.9
Fruits and vegetables	9.3	22.0	17.4	56.5
Alcoholic beverages	14.6	13.7	10.7	44.2
Nonfood products	4.5	8.1	13.7	28.4
Medicaments	2.5	13.1	19.6	38.6
Motor gasoline	5.7	8.6	4.8	20.3
Tobacco products	29.3	27.1	26.6	108.1
Services	8.0	10.5	10.2	31.5
Utility services	9.8	9.4	10.1	32.3
Early childhood education services	9.9	15.6	16.8	48.4
Health and leisure services	5.7	7.6	14.4	30.1
Passenger transport services	8.9	7.3	10.7	29.4
Cultural organizations services	10.5	9.9	7.2	30.2

Source: Rosstat.

Finally, we will compare consumer price growth rates in Russia vs. other countries (see *Table 4*).

¹ Inflation rate in 2013–2015

Table 4

**Consumer prices dynamics in various countries in 2013–2015,
% a year**

	2013	2014	2015*	2013–2015**
Azerbaijan	3.5	-0.1	2.7	6.2
Armenia	5.6	4.6	-2.4	7.8
Belarus	16.5	16.2	10.1	49.0
Kazakhstan	4.8	7.4	8.2	21.8
Kyrgyzstan	4.0	10.5	1.4	16.5
Moldova	5.2	4.7	11.5	22.8
<i>Russia</i>	6.5	11.4	11.2	31.9
Tajikistan	3.7	7.4	4.1	15.9
Ukraine	0.5	24.9	39.5	75.1
Germany	1.5	0.9	0.4	2.8
France	0.9	0.5	0.2	1.6
The United States	1.5	1.6	1.3	4.5
The Netherlands	2.5	1.0	1.3	4.9

* The data for January–October.

** Inflation rate in 2013– October 2015.

Sources: Interstate Statistical Committee of the Commonwealth of Independent States (CIS STAT) (<http://www.cisstat.com/>), OECD database (<http://stats.oecd.org/>).

In the period between January and October 2015, Russia was ranked 3rd among CIS countries for consumer price growth rate, after Ukraine and Moldova. The inflation rate in Russia in January–October 2015 was 14 times the inflation rate in developed countries (see *Table 4*). Thus Russia kept facing high inflation vs. both developed countries and emerging market economies.

In 2016, low economic activity, moderate growth of the money supply will present a headwind to inflation build-up. However, the ruble's exchange rate pass-through to prices due to its devaluation by 3% in November 2015 and by 10% in December 2015 will keep inflation up, which will most likely stay at 1.5–2 percentage points (6.4%) above the 2016 level predicted by Russia's Ministry of Economic Development. Note that Russia's economic sanctions against Turkey which took effect on 1 January 2016 may have an extra proinflation pressure in 2016.

Overall, in our view, the target inflation rate (4%) will highly unlikely be reached by 2017 amid geopolitical tensions, highly volatile crude oil prices and exchange rate, although monetary factors have a suppression effect on inflation processes.

2.1.4. Key monetary policy decisions

In 2015, the Bank of Russia carried out a moderately tight monetary policy aimed to tame inflation with due consideration of the slugging economy. Russia's central bank lowered the key rate gradually from 17% in January to 11% in November 2015. On January 30, 2015, the key rate was slashed from 17 to 15% per annum, then it was cut by 1 percentage point to 14% on March 13th, slid to 12.5% on April 30th, to 11.5% on June 15th and to 11% on July 31, 2015. Note that it was absolutely reasonable to retain a relatively high key rate (in nominal terms) because interest rates in Russia are still low in real terms, and they are also low compared with other developing countries (see *Fig. 12–13*).

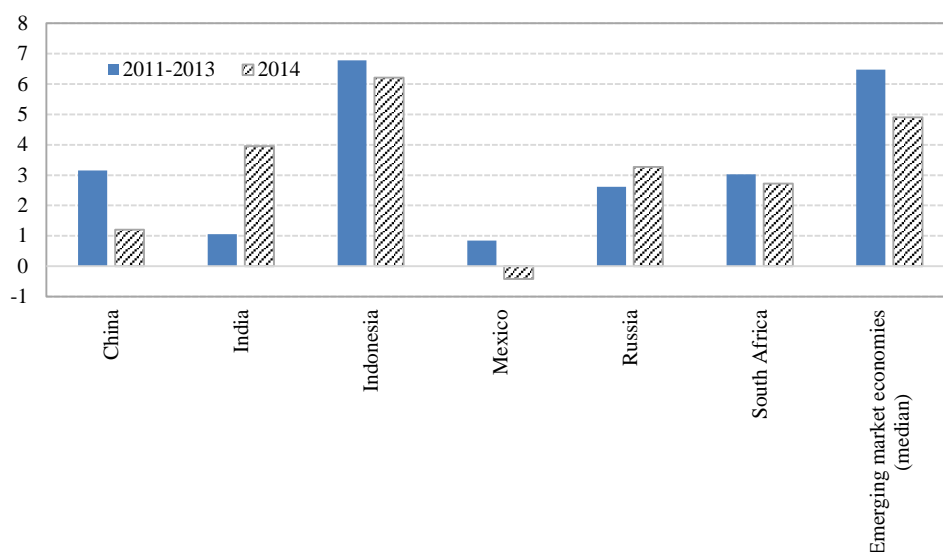


Fig. 12. Real money market interest rates in emerging market economies, G20 states (% per annum)

Source: IMF.



Fig. 13. Real interest rate on loans with less than one-year maturity to legal entities in Russia, 2011-2015 (% per annum)

Source: Russia's central bank.

Note that the price growth rate eased off at very slow pace (on an annualized basis, 15.7% in September, 15.6% in October, 15% in November) after inflation increased 15.8% year-on-year in August 2015. It would be unreasonable to cut the key rate amid expectations for high inflation, ruble depreciation risks attributed among other things to uncertainty about dynamics of oil prices, geopolitical tensions, investors' expectations for a tighter U.S. Fed's monetary policy.

With a stable FX market and low risks of financial instability, Russia's central bank in March-April 2015 cut the key rate and lifted (three times) minimum interest rates on foreign currency liquidity provision instruments. In particular, on March 30, 2015, the Bank of Russia lifted minimum interest rates on foreign currency repo auctions to LIBOR plus 1 percentage point (from LIBOR plus 0.5 percentage points). The new rates still remained appealing to borrowers, especially amid financial sanctions, but this measure showed that the Bank of Russia was positive that banks had sufficient liquidity. At the same time, there was still demand for foreign currency repo auctions which allowed foreign currency to be purchased at low rates and invested in, e.g., Eurobonds of major Russian companies, which deliver a much higher yield.

On April 21, 2015, Russia's central bank lifted again minimum interest rates by 0.5 percentage points to LIBOR plus 2 percentage points for 28-day foreign currency repo auctions, and by 2.5 percentage points for 12-month auctions. Furthermore, the central bank lifted minimum interest rates for auctions to provide FX loans secured by the pledge of claim on FX loans to LIBOR plus 2.25 percentage points for such loans with a maturity of 28 days and by 2.75 percentage points for loans with a maturity of 365 days. As in the case with the interest rates lift-off on April 13th, the value of one-year loans was much higher (by 0.75 percentage points) than that of loans with a maturity of 28 days and one week (by 0.5 percentage points). This measure aimed to prevent the ruble from strengthening on the back of stronger optimistic sentiments of investors inspired by raising oil prices and relaxing geopolitical tensions.

With a stable FX market, the Bank of Russia on May 18th abandoned 365-day foreign currency repos. However, the bank announced on November 27th it will restart such repos from December 14, 2015. This measure was dictated by the need to refinance commercial banks' debt on previous one-year foreign currency repo auctions and by the necessity to help Russian companies pay their external debts, as well as by upswing of demand for foreign currency after the U.S. Federal Reserve raised its benchmark interest rate in December 2015. However, we think this instrument should only be used when financial stability is at risk, and a free floating exchange rate regime should continue so that the economy adapts to change in terms of trade.

In order to offer more options for credit institutions to manage their liquidity, the Bank of Russia decided to raise from 0.7 to 0.8 (in effect from September 10, 2015) the averaging ratio used by banks for calculating the averaged value of required reserves. The averaging ratio for nonbank credit institutions involved in deposit/credit operations was elevated from 0.7 to 1.0. The decision aimed to redistribute funds between the balances of credit institutions' required reserves accounts and correspondent accounts with the Bank of Russia. As a reminder, the mechanism of averaging allows a bank to hold a part of its required reserves on its correspondent account, not special accounts, with the central bank.

On June 16, 2015, USD/RUB and EUR/RUB buy/sell fine-tuning 1- to 2-day foreign currency swap auctions were introduced as part of the system of monetary policy instruments introduced. With regard to fine-tuning 1- to 2-day foreign currency swap auctions, the Bank of Russia will decide on the expediency of holding such auctions according to the situation in the money market. A common maximum volume of funds is established for repo auctions and fine-tuning foreign currency swaps. The minimum interest rate on the ruble leg of foreign currency swaps equals the key rate, and there is zero interest rate on the foreign currency leg.

With this decision made, credit institutions were offered a wider range of options for managing their ruble liquidity and assets accepted by the Bank of Russia as collateral for refinancing operations. Such auctions can be held when the Bank of Russia sees more demand from banks for ruble liquidity, seeks to encourage demand for standing foreign currency swaps, reduce volatility of short-term interest rates in the money market and narrow the gap between

them and the key rate, as well as to enhance the effectiveness of the interest rate channel of the monetary policy's transmission mechanism.

With limited collateral available in the market, the Bank of Russia sought to create more options of refinancing for credit institutions. The Bank of Russia Lombard List was updated several times with new issues of securities in 2015. Additionally, the settlement dates of foreign currency repos of various maturities were synchronized with the settlement dates of one-week ruble repos so that credit institutions can manage more efficiently their market collateral portfolio. Furthermore, credit institutions were offered an option of using unrated bonds of non-financial enterprises and mortgage bonds, state guarantees of the Russian Federation, or AHML's (Agency for Housing Mortgage Lending) sureties in security for refinancing operations.

Finally, note that the Bank of Russia in 2015 continued working on making its monetary policy more open through regular releases of analytical reviews and statistics, including information on people's expectations for inflation, an external debt repayment schedule, etc., as well as a series of reports on economic studies of pressing matters. In our view, providing information about goals and performance of monetary policy measures, and discussing the nature of inflation processes in Russia can help raise economic agents' confidence in the central bank's policy, thus making it more efficient.

2.1.5. Balance of payments and ruble exchangerate

In 2015, Russia's balance of payments was adapting to drastically worsened terms of trade. The year-end positive current accounts balance was above the negative financial account balance, and the central bank's gross international reserves saw a small growth. In that context, Russia's net capital outflow in 2015 decreased considerably over 2014 in response to the contraction of bank's foreign assets and substantially slower growth of foreign assets in other sectors.

According to the Bank of Russia's preliminary estimate of Russia's balance of payments, the positive current accounts balance in January-December 2015 stood at \$65.8bn, an increase of 12.7% over 2014 (see *Table 5*). The positive trade balance fell by 23.2% (from \$189.7bn to \$145.6bn) due to a sweeping fall of prices of Russia's key export commodities (see *Fig. 14*). In particular, the 2015 exports of goods dropped by 31.8% (from \$498bn to \$340bn). Imports of goods dropped by 37.0% (from \$308bn to \$194bn) due to a weakening ruble and falling economic agents' income. Imports will quite likely decline considerably in 2016, too, because the ruble continued to tumble in early 2016.

Exports of crude oil, refined petroleum products and natural gas accounted for 58.3% of total exports, declining by 7 percentage points over the same period of 2014 largely because the crude oil fell by 22.5% in 2015, down to an average of \$38.8 a barrel in December 2015 (see *Fig. 15*).

Although the trade balance declined in 2015, the increase in the balance of current accounts was driven up by a decline in the deficit of the service balance, investment income balance and remuneration balance. For instance, the service balance deficit in 2015 reached \$37.1bn, declining by 32.9% (absolute value) over the same period of 2014. Exports of services stood at \$49.7bn, down \$16bn year-on-year (by 24.4%). Imports of services in 12M/2015 dropped by 28.3% to \$86.8bn over 2014, first of all because the Russians retrenched their foreign travel costs.

The remuneration balance in January-December 2015 was down 57.4% to -\$4.3bn (-\$10.1bn in 2014) possibly due to a reduction of the remuneration of migrants whose services were in less demand.

The investment income balance deficit in 2015 decreased by 44.7% year-on-year to \$32.0bn due to a decline in external debt service costs. The investment income receivable dropped 19.2% from \$42.2bn to \$34.1bn. The income payable by nonfinancial enterprises fell by 30.8% to \$55.5bn and by banks by 49.4% to \$8.6bn, cutting the total income payable by 34.0% to \$66.1bn. The rent balance¹ in 2015 stood at \$0.0bn (+\$0.1bn in 2014). The 12M/2015 secondary income balance² was -\$6.4bn, (-\$8.2bn in 2014), and the capital transfers balance was -\$0.2bn, (-\$42.0bn in 2014) as a result of the write-off of the debt owed to Russia by Cuba, Uzbekistan and North Korea).

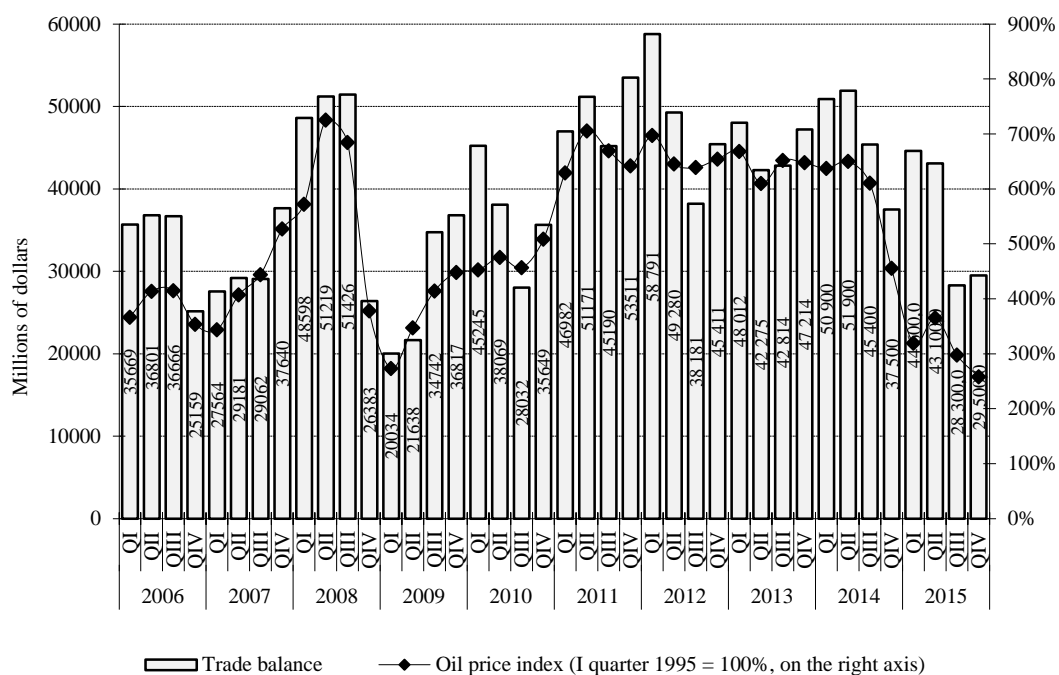


Fig. 14. Russia's trade balance and global oil price index in 2006–2015

Sources: Bank of Russia; EIA; Gaidar Institute's own calculations.

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

² Formerly called the balance of current transfers. According to Russia's central bank, current transfers tend to boost the recipient's disposable income, consumption of goods and services, whereas they tend to diminish the originator's disposable income and potential capacity to consume, e.g., a humanitarian aid provided in the form of consumer goods and services. Current transfers are recognized in the current account. Non-current transfers are by definition regarded as capital transfers. Capital transfers tend to change the volume of assets and liabilities of the originator and the recipient, and they are recognized in the capital account. Should the originator and the recipient be residents of different states, capital transfer alters the level of the national wealth of the economies they belong to. An example of capital transfers is free transfer of title to fixed assets, and debt write-offs.

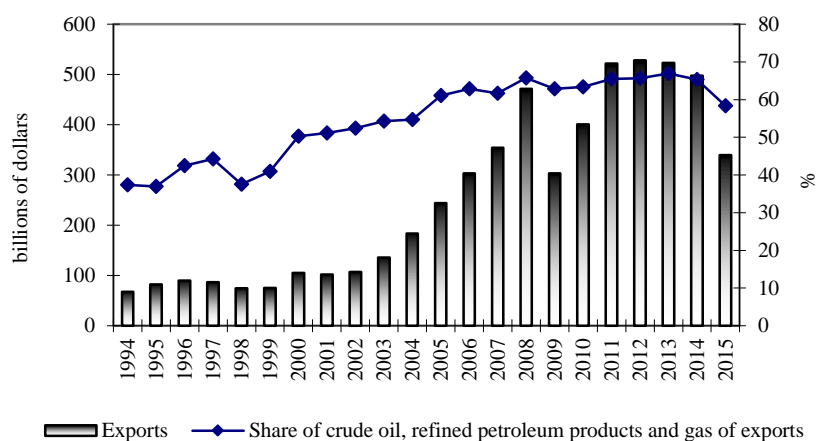


Fig. 15. Dynamics of exports of goods and of the share of fuel and energy sector products in 1994–2015

Source: Bank of Russia.

In 2015, the financial account deficit stood at \$61.1bn (\$130.2bn in 2014). Russian economic agents' liabilities to foreign economic agents were cut by \$69.8bn in 12M/2015, 20.9% less than the value (\$48.9bn) recorded last year. Federal authorities' external liabilities decreased by \$7.5bn in 2015. The subjects of the Russian Federation saw their external liabilities increase \$0.1bn. Monetary regulators' liabilities in 2015 did not go beyond \$2bn. Banks in 2015 continued to slash their foreign liabilities which decreased by \$61.6bn during the year (down \$37bn in 2014). In 2015, nonbank institutions cut their external liabilities by \$2.7bn as compared to an increase of \$1bn in 2014. The inflow of foreign direct investments was \$6.7bn against \$18.5bn in 2014, lowest since 2003. Other external liabilities (portfolio investment, loans and credits and other liabilities) decreased by \$9.5bn in 2015 (a decline of \$17.8bn in 2014). Note that \$82.6bn should have been paid according to schedule in 2015, however external obligations contracted by \$2.7bn possibly due to in-house external debt management operations whereby banks pay debts to related lenders who use the money to pay the "real" external debt.

Residents' foreign assets (foreign economic agents' liabilities to Russian economic agents) dropped by \$8.6bn in 12M/2015 (up \$81.3bn in 2014). Monetary regulators' foreign assets increased \$0.4bn (down \$0.5bn in 2014). Russian banks' foreign assets were cut by \$28.2bn in 2015 (up \$48.5bn in 2014). The cut of banks' foreign assets was partially due to banks paying their foreign currency debts to the Bank of Russia. In H2 2015 banks paid back \$10.9bn to the central bank, they also used foreign currency from their correspondent accounts with the Bank of Russia. Note that banks' assets shrank by \$7.8bn (+\$50.4bn in 2014) due to foreign cash transactions with nonresidents, according to the data available for January-September 2015. Banks' foreign cash holdings were cut as little as \$0.6bn (-\$38.1bn in 2014) due to retail operations. In other words, in 2015 there was much less foreign cash demand from individuals as compared to the previous year. Foreign cash in hand in 9M/2015 dropped by \$11.8bn to \$40.5bn, according to the Bank of Russia estimates.

Foreign assets held by private nonfinancial enterprises in 2015 increased as little as \$17.8bn as compared to a growth of \$72.6bn in 2014. In absolute terms, Russian residents' direct investments abroad decreased most of all (from \$54.5bn in 2014 to \$20.5bn in 2015). Also, note that dubious operations continued to see the downtrend in volume, a decline by \$2.8bn to \$4bn. Portfolio investment abroad dropped from \$5.6bn in 2014 to \$1.5bn in 2015. Other assets held

by nonbank institutions in 2015 saw an increase which was 41.2% less than a year earlier (\$4bn against \$6.8bn in 2014).

Table 5

**Balance of payments' principal accounts and dynamics of external debt
in 2013–2015 (billions of dollars)**

Indicator	2013					2014					2015				
	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4*	Year
Balance of current accounts and of capital accounts	25.0	1.8	-0.3	8.2	34.8	25.8	12.1	6.2	14.3	58.4	29.3	15.9	7.5	13.0	65.8
Financial account (excluding reserve assets)**	13.3	8.2	4.9	19.8	46.2	47.1	27.8	6.0	49.4	130.2	36.7	19.0	2.4	3.1	61.1
Change in foreign exchange reserves ('+' denotes an increase, '-' denotes a decrease in reserves)	4.9	-4.4	-7.4	-15.2	-22.1	-27.4	-10.3	-5.7	-64.2	-107.5	-10.1	-2.2	9.7	3.8	1.3
Net errors and omissions	-6.8	1.9	-2.0	-3.4	-10.3	-5.9	5.4	4.1	2.7	6.2	-2.8	1.1	4.6	-6.1	-3.2
Change in Russia's external debt ('+' denotes an increase, '-' denotes a decrease of debt)	55.3	16.1	8.5	12.6	92.4	-13.0	16.9	-51.9	-81.8	-129.8	-42.9	0.5	-18.5	-22.9	-83.8
Change in Russia's sovereign external debt	3.1	-1.5	6.7	-0.9	7.3	-8.1	3.5	-7.7	-7.8	-20.1	-8.1	2.9	-4.1	-1.6	-10.9
Change in Russian private sector's external debt	48.3	18.2	3.2	15.1	84.8	-4.4	12.6	-43.8	-68.8	-104.3	-35.9	-1.5	-14.4	-22.0	-73.9

* – preliminary estimate; ** – net of foreign currency reserves.

Source: Bank of Russia.

Russia's external debt in 2015 was down by 14% to \$515bn as of January 2016. Note that in 2015 the Russian private sector's external debt was cut by \$73.9bn (down by \$104.3bn in 2014) (see Table 5). Russia's sovereign external debt in 2015 dropped by \$10.9bn, whereas in 2014 it contracted by \$20.1bn.

In its preliminary estimate, the Bank of Russia estimated \$56.9bn in net capital outflow from nonfinancial enterprises in 2015, which is 2.7 times less than in 12M/2014. In 2015, net exports of capital by banks reached \$33.4bn and by private financial enterprises – \$23.5bn. Net capital outflow was worth as little as \$50.2bn, as adjusted for FX operations between banks and the Bank of Russia. Note that in Q3 2015 the Bank of Russia for the first time in a long period recorded \$1.8bn in net capital inflow in the private sector, as adjusted for operations between banks and the regulator. Q2 2010 was the last time before that, when \$4.1bn in net capital inflow

were recorded. The net capital inflow in Q3 2015 was determined by growth of external liabilities of other sectors due to new fundraising, an indication that economic situation was stabilized in some way at that period.

In 2015, net exports of capital by banks reached \$33.4bn, by private nonfinancial enterprises – \$23.5bn. Note that it is extremely difficult to encourage nonresidents to invest in Russia which faces a volatile economic situation worldwide and a recession, the heavy dependence of the Russian economy on exports of energy producing materials, as well as poor quality of institutional environment. As noted above, a key determinant of capital outflow from emerging markets in 2015, like in 2014, was investors’ expectations for the Fed’s QE taper.

We estimate the capital flight (see Fig. 17) was \$7.8bn at the 2015 year-end (\$9.4bn in 2014).¹

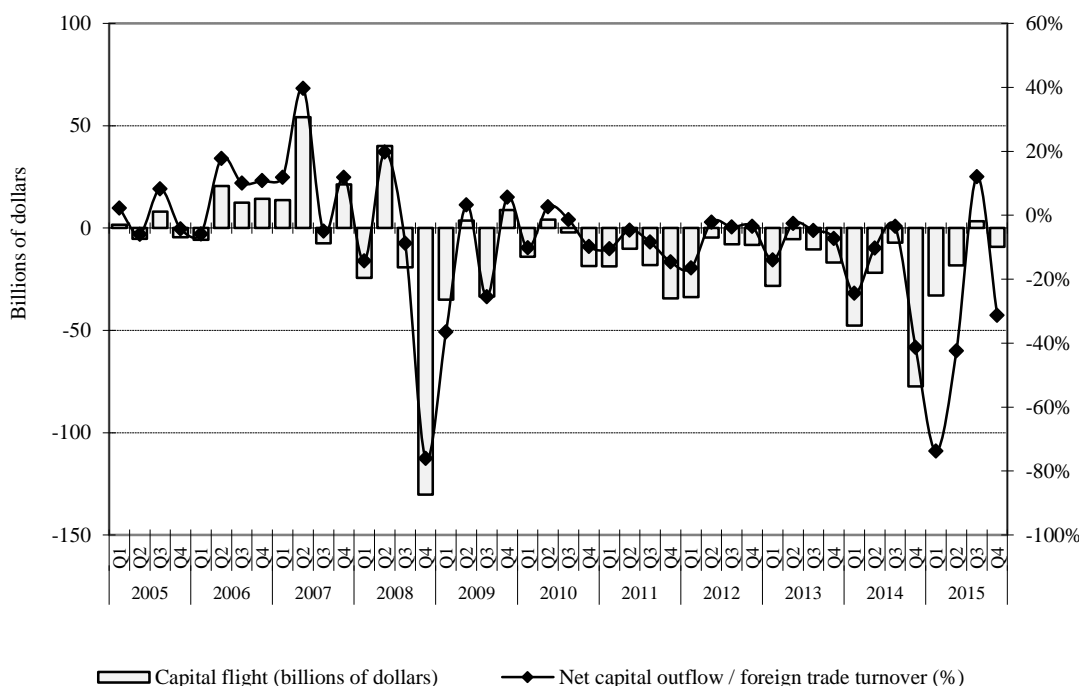


Fig. 16. Dynamics of net capital outflows in 2005–2015

Sources: Bank of Russia, Gaidar Institute’s own calculations.

Overall, the trends towards change in the balance of payments lead to a conclusion that the balance of current accounts will continue to grow in the medium term due to the ruble depreciation and lower demand for imported goods. Bank of Russia’s foreign currency repos, as well as a possible increase in volumes of external financing of other sectors, will contribute to releasing the pressure from the FX market. As a result, the 2016 balance of payments will most likely remain stable, thus helping stabilize the ruble.

¹ We use the IMF method to measure capital flight, that is, the sum of “trade credits and advances”, “dubious operations” and “net errors and omissions.”

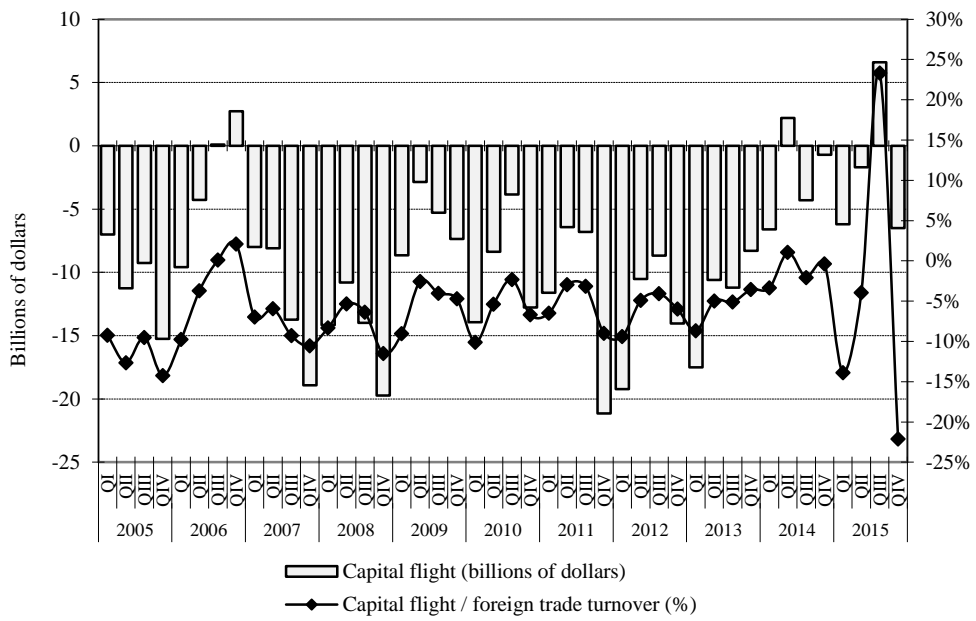


Fig. 17. Dynamics of capital flight in 2005–2015

Sources: Bank of Russia, Gaidar Institute’s own calculations.