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R95 **Russian Economy in 2019. Trends and outlooks. (Issue 41)** / [V. Mau et al; scientific editing by Kudrin A.L., Doctor of sciences (economics), Radygin A.D., Doctor of sciences (economics), Sinelnikov-Murylev S.G., Doctor of sciences (economics)]; Gaidar Institute. – Moscow: Gaidar Institute Publishers, 2020. – 596 pp.: illust.

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The review "Russian Economy. Trends and Outlooks" has been published by the Gaidar Institute since 1991. This is the 41th issue. This publication provides a detailed analysis of main trends in Russian economy, global trends in social and economic development. The paper contains 6 big sections that highlight different aspects of Russia's economic development, which allow to monitor all angles of ongoing events over a prolonged period: global economic and political challenges and national responses, economic growth and economic crisis; the monetary and budget spheres; financial markets and institutions; the real sector; social sphere; institutional changes. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts confirming the conclusions.
By contrast to the previous publications the present issue includes also a short analysis of the first three months of 2020 from the perspective of the COVID-19 pandemic impact on the Russian economy development.

Reviewer: Faltsman V.K., Doctor of science (Economics), Professor, main researcher, Department of Institutional and Financial Markets Analysis, IAES RANEPA.

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Alexandra Bozhechkova, Alexander Knobel, Pavel Trunin

2.1. Monetary policy in 2019[1]

2.1.1. Monetary policy trends

In 2019, a sharp and largely unexpected slowdown in inflation led to a significant easing of monetary policy. Over the course of that year, the Bank of Russia reduced its key rate five times: four times by 0.25 percentage points on June 14, July 26, September 6, and December 13; and by 0.5 percentage points at a meeting of its Board of Directors on October 25. As a result, the key rate declined from 7.75% to 6.25% per annum, thus approaching, according to the estimates of the RF Central Bank,[2] its neutral level.[3]

Over the course of 2019, the movement pattern of the key rate was shaped, on the one hand, by the rising inflation risks in the H2 2018 and early 2019 caused by the raise of the VAT rate at the beginning of 2019, a decline of the world market for energy prices, and an increase in inflationary expectations. As a result, in January-May 2019, the regulator did not ease its monetary policy, keeping the key rate unchanged. At the same time, the RF Central Bank's rhetoric regarding future decisions began to somewhat relax in March-April 2019, as the inflation index passed a local peak (5.3% in March 2019 compared to March 2018). It was only in June 2019 that the Bank of Russia switched over to actually reducing the key rate.

However, in reality, the surge in inflation turned out to be more moderate, and its duration shorter than expected. This happened due to both an early tightening of monetary policy in 2018 and a combination of several other circumstances, in particular the ruble's strengthening as trading conditions improved and the risk of capital outflows decreased in response to monetary policy easing in a number of developed countries, as well as a slow growth demonstrated by domestic demand following fiscal policy toughening. As a result, over the course of 2019, the Bank of Russia repeatedly adjusted its inflation predictions. Thus, in March, the year-end inflation projection for 2019 was reduced from 5.0–5.5% to 4.7–5.2%, and in October, to 3.2–3.7%. At the end of 2019, actual inflation was below its forecast values and amounted to 3%.

As monetary policy eased, banks' lending conditions also softened. Thus, the real interest rate on newly issued corporate loans with maturities of more than three years, calculated on the basis of actual inflation movement over the previous 12 months, decreased from 5.8% per

[1] This section was written by *Bozhechkova A. V.*, Candidate of sciences (Economics), Head of the Monetary Policy Department of the Gaidar Institute, senior researcher at the Center for Central Banking Studies of the IAES RANEPA; *Knobel A.Yu.*, Candidate of sciences (Economics), Head of the International Trade Department of the Gaidar Institute, Director of the RANEPA Center for International Trade Research, Director of the Institute for International Economics and Finance of the RFTA under the RF Ministry of Economic Development; *Trunin P. V.*, Doctor of sciences (Economics), Director of the Center for Macro-Economics and Finance of the Gaidar Institute, Director of the Center for Central Banking Studies of the IAES RANEPA.

[2] Guidelines for the single state monetary policy for 2020 and the period 2021–2022, p. 38.

[3] A neutral key rate secures the achievement of an inflation target and a zero output gap. A neutral interest rate level has neither a stimulating nor a restraining effect on economic activity.

annum on average in January-November 2018 to 4.5% per annum over the corresponding period of 2019 (*Fig. 1*).

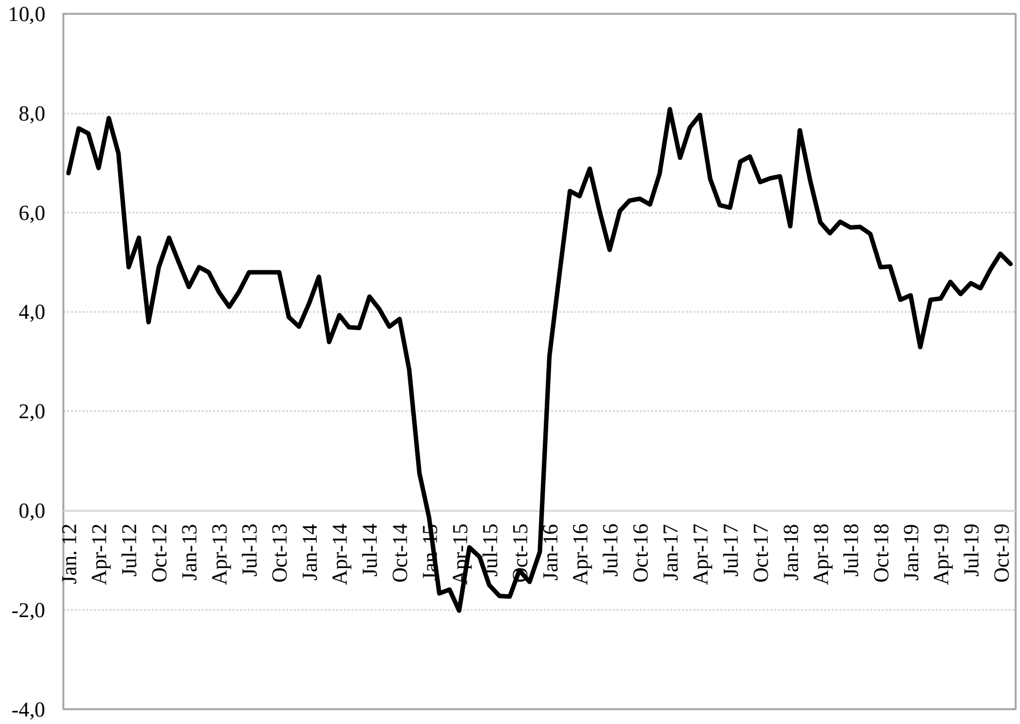

Fig. 1. Real interest rate on corporate loans with maturities of more than three years in Russia, 2011–2018 (% per annum, based on the actual inflation pattern over the previous 12 months[1])

Source: Bank of Russia; Rosstat; own calculations.

Nevertheless, in 2019, the real key interest rate remained at a relatively high level compared to the other developing countries that were implementing inflation targeting (*Fig. 2, Table 1*). At the end of 2019, the RF Central Bank's key rate exceeded inflation by 3.25 percentage points, which is lower than in Mexico (4.5 percentage points) and Kazakhstan (3.9 percentage points), but slightly higher than in the other developing countries that were targeting their inflation (for example, in the Republic of South Africa (2.5 percentage points) and Indonesia (2.3 percentage points)).

Table 1

Inflation and key rates in some developed and developing countries

	Actual inflation (December 2019 to December 2018,%)	Key rate (end of year, % per annum)
Developing countries		
Peru	1.9	2.3
Indonesia	2.7	5.0

[1] The real interest rate was calculated using data on accumulated inflation over the previous 12 months (December 2019 to December 2018), based on the assumption of the adaptive nature of inflationary expectations in Russia.

Mexico	2.8	7.3
Chile	3.0	1.8
Russia	**3.0**	**6.25**
Poland	3.2	1.5
Columbia	3.8	4.3
Hungary	4.0	0.9
RSA	4.0	6.5
Brazil	4.3	4.5
Kazakhstan	5.4	9.3
India	7.4	5.2
Turkey	11.8	12.0
Developed countries		
EU	1.3	0.0
UK	1.3	0.8
Norway	1.3	1.5
New Zealand	1.9	1.0
Australia	1.9	0.8
Iceland	2.0	3.0
Canada	2.2	1.8
USA	2.3	1.5
Czech Republic	3.2	2.0

Source: Central banks' websites.

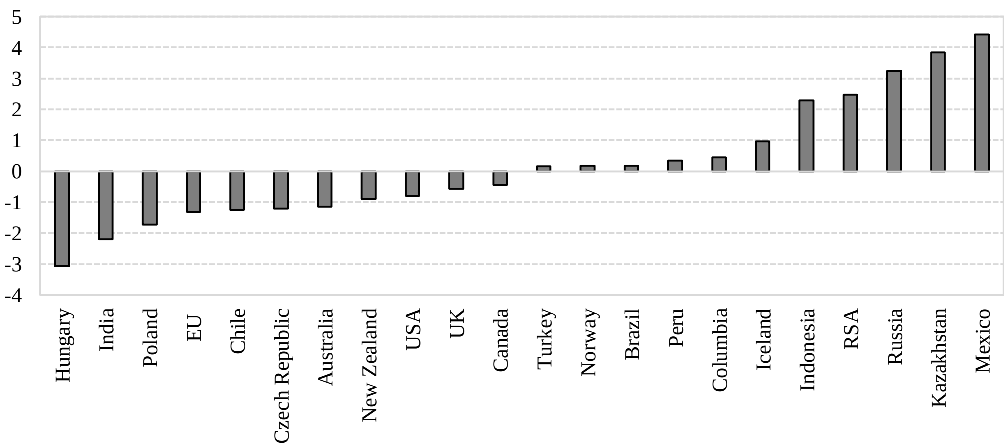

Fig. 2. The real key rate at year-end 2019 in Russia (% per annum, based on the actual inflation pattern over the previous 12 months)

Source: Central banks' websites; own calculations.

In 2020, with the global economy slowing down as a result of the coronavirus epidemic, increased global uncertainty and a sharp drop in oil prices, we can expect a temporary increase in inflation above the target level and its return to 4% in 2021. However, given the significant fall in below-target inflation in late 2019 and early 2020, as well as a possible significant slowdown in economic activity, we believe that monetary policy tightening is only possible if there is a serious threat to financial stability in Russia.

2.1.2. The money market

In 2019, the money market continued to operate in the context of a structural liquidity surplus in the banking sector,[1] which had first appeared back in 2017 as a result of spending the

[1] The structural surplus is characterized by the formation of a steady excess of liquidity among credit institutions and the need for the Bank of Russia to carry out operations to absorb it in order to keep interest rates on the

sovereign wealth funds and the implementation, by the Bank of Russia, of measures designed to secure the financial recovery of certain banks. In 2019, the liquidity surplus averaged RUB 3.0 trillion, remaining at the level of 2018.

In order to absorb liquidity and keep the interest rates within the established interest rate band, the RF Central Bank relied on deposit auctions and placed additional issues of Bank of Russia coupon bonds (KOBR). As a result, the amount of funds raised through the deposit auctions in 2019 averaged RUB 1.6 trillion, while in 2018 this index had reached RUB 2.2 trillion. At the same time, in 2019, the RF Central Bank slightly increased its KOBR offer for a period of 3 months. Thus, in 2019, the volume of KOBR in circulation jumped from RUB 1.4 trillion to RUB 1.9 trillion (*Table 2*).

It should be noted that, according to the forecasts released by the Bank of Russia, liquidity surplus in the banking sector can persist for the next 3 years. So, with due regard for the deferred purchases of foreign currency in the domestic market,[1] the regulator expects the structural liquidity surplus to rise to the level of RUB 5 trillion in the situation of the fiscal rule being applied under the basic scenario.

In 2019, in the context of a significant liquidity surplus, there was a slight shrinkage in the amount of debt owed by credit institutions to the Bank of Russia. At the end of 2019, the amount of loans attracted by credit institutions from the Bank of Russia decreased by 6%, to RUB 2.5 trillion (*Fig. 3*). At the same time, in 2019, in the structure of requirements established by the RF Central Bank for the banking sector, a large share was taken up by debt on loans secured by non-marketable assets (the average monthly volume of loans issued amounted to RUB 242 billion), while the average monthly volume of loans allotted through repo auctions over the same period was only RUB 1.4 billion.

Table 2

The Bank of Russia's balance sheets in 2017–2019

	01.01.2017		**01.01.2018**		**30.11.**	
	billions of rubles	**% of assets / liabilities**	**billions of rubles**	**% of assets / liabilities**	**billions of rubles**	**% of assets / liabilities**
1	2	3	4	5	6	7
Funds placed with non-residents and foreign issuers securities	18,878.5	61.3	24,496.1	62.2	25,500.9	59.7
Loans and deposits	3,517. 8	11.4	3,672.5	9.3	3,392.6	7.9
Precious metals	4,505.2	14.6	6,123.9	15.6	6,867.1	16.1
Securities	886.1	2.9	1,038.8	2.6	1,127.4	2.6
Other assets	1,535.7	5.0	2,286.0	5.8	4,254.8	10.0
Total assets	**30,815.1**	**100.0**	**39,368.9**	**100.0**	**42,726.0**	**100.0**

Cont'd

1	2	3	4	5	6	7
Currency in circulation	9,539.4	31.0	10,312.8	26.2	10,175.9	23.8
Funds in accounts with Bank of Russia	11,003.2	35.7	14,526.6	36.9	17,732.0	41.5

interbank lending market close to the key rate. It is measured by the difference between the requirements of the Bank of Russia for credit institutions and the requirements of credit organizations to the Bank of Russia for standard instruments for the provision and absorption of liquidity, supplemented by the balanced amount of claims of credit institutions and the Bank of Russia for specialized Bank of Russia refinancing instruments.

[1] The implementation of deferred purchases from February 2019 is associated with the suspension of the purchase by the Bank of Russia of foreign currency for the RF Ministry of Finance under the fiscal rule in the domestic foreign exchange market from August to December 2018.

including RF Government	4,565.7	14.8	7,894.7	20.1	11,154.6	26.1
resident credit institutions	4,812.4	15.6	4,381.7	11.1	4,828.6	11.3
Credit float	0.7	0.0	0.05	0.0	-	-
Securities issued	356.8	1.2	1,388.3	3.5	1,510.0	3.5
Liabilities to IMF	1,407.8	4.6	1,616.4	4.1	1,404.1	3.3
Other liabilities	120.8	0.4	130.6	0.3	514.2	1.2
Capital	8,386.5	27.2	11,394.3	28.9	11,389.8	26.7
Profit for reporting year	-	-	-	-	-	-
Total liabilities	**30,815.1**	**100.0**	**39,368.9**	**100.0**	**42,726.0**	**100.0**

Source: Bank of Russia.

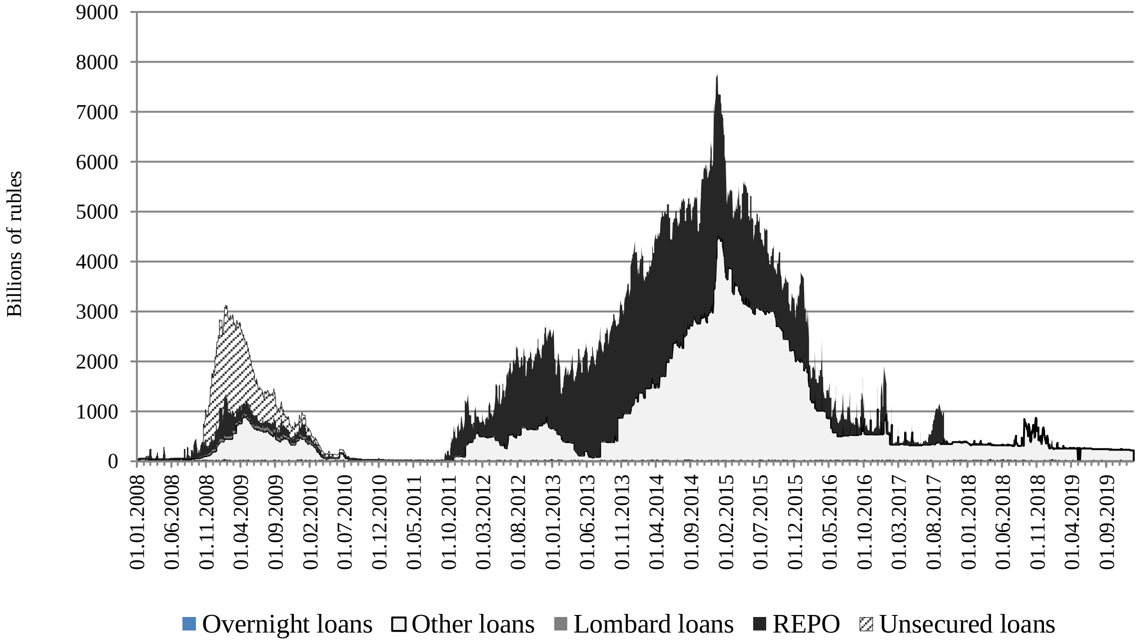

Fig. 3. Debt of commercial banks to the Bank of Russia, rubles, 2008–2019

Source: Bank of Russia.

Under the conditions of a structural liquidity surplus, the money market interest rate in 2019 stayed mainly in the lower part of the interest rate band. The interest rate on the interbank lending market[1] slid from 7.6% per annum on average in January 2019 to 6.2% per annum on average in December 2019. The dynamics of the one-day interbank rate followed the movement pattern of the Bank of Russia's key rate. In this regard, from January to May, it remained at a stable level, which then gave way to a smooth decline until the end of the year. In general, over the course of 2019, the interbank interest rate did not go beyond the boundaries of the interest rate corridor established by the RF Central Bank, which indicates that the regulator has indeed achieved the operational objective of its monetary policy. The average deviation of the one-day MIACR rate from the key rate became significantly smaller (plunging from 3.8% in 2018 to 1.8% in 2019). The average annual MIACR rate for interbank overnight ruble loans increased from 7.1% per annum in 2018 to 7.2% per annum in 2019, due to the continuing relatively tight lending conditions over the period January-May 2019 (*Fig. 4*).

[1] The interbank rate is the average monthly MIACR index for interbank overnight ruble loans.

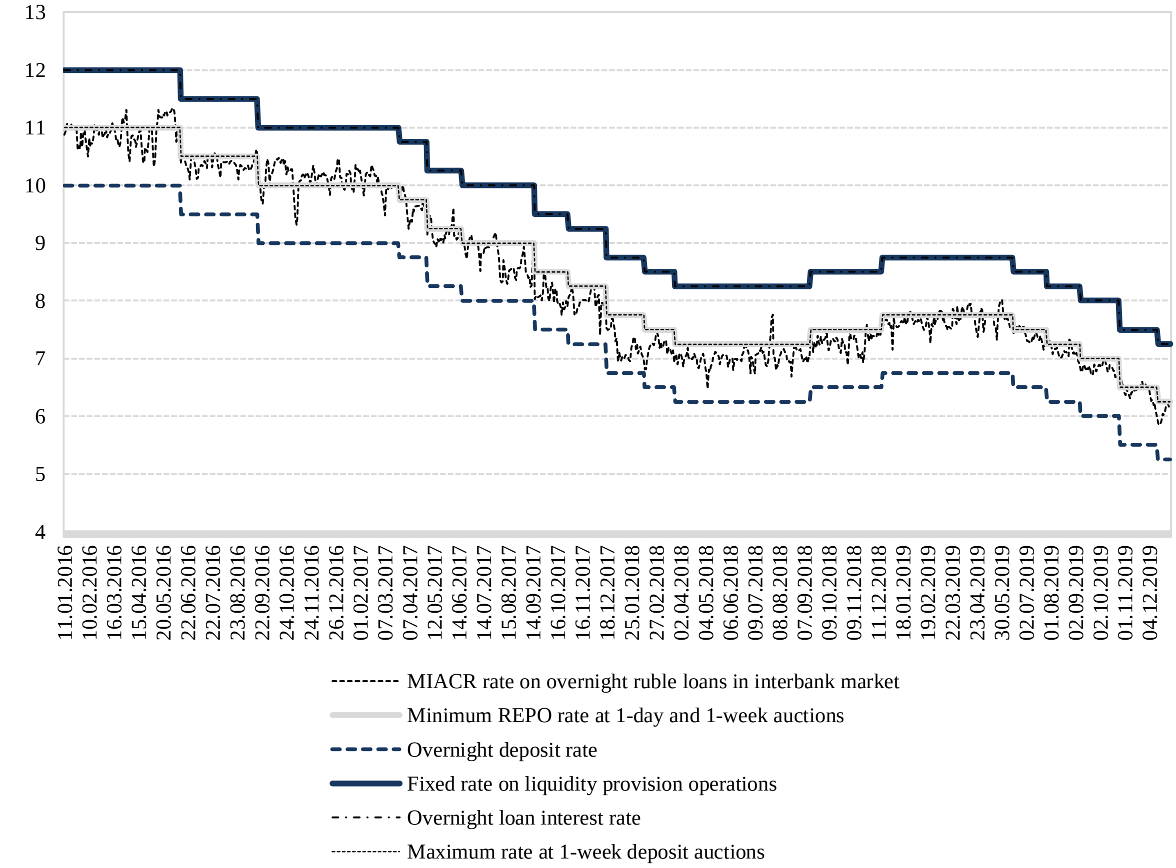

Fig. 4. The Bank of Russia interest rate band and the movement of interbank market interest rates in 2013–2019

Source: Bank of Russia; own calculations.

In 2019, broad money increased by 4.7%, to RUB 16,823.4 billion (in 2018, by 9.3% to RUB 16,063.4 billion). Among the fastest-growing components of broad money by the end of 2019, we can point out Bank of Russia bonds held by credit institutions and the correspondent accounts of credit institutions with the Bank of Russia, their volume having increased 41.0% to RUB 2,052.8 billion, and 38.3% to RUB 2,621.7 billion, respectively. The amount of required reserves increased by 7.3% to RUB 617.6 billion. Note that the growth of required reserves occurred in the main due to the Bank of Russia's decision to raise required reserve ratios on liabilities to individuals in foreign currency for banks with a universal license, banks with a basic license and non-bank credit institutions by 1 percentage point to 8.00%, effective from 1 July 2019. Also note that this decision aimed at playing down the incentives for banks to increase their foreign currency liabilities. The amount of bank deposits with the Bank of Russia decreased by 46.0%, to RUB 1,766.6 billion. The volume of cash in circulation increased by 2.9%, to RUB 10,241.5 billion. Overall, the volume of excess reserves for 2019 increased by 9.8% and amounted to RUB 5,680.8 billion (*Table 3*).

Table 3

The broad money dynamics in 2019 (billions of rubles)

	01.01.2018	01.01.2019	01.01.2020

Monetary base (broad)	14,701.5	16,063.4	16,823.4
- currency in circulation, including cash balances of credit institutions	9,539.0	10,312.5	10,616.1
- correspondent accounts of credit institutions with Bank of Russia	1,930.7	1,898.2	2,625.5
- required reserves	506.2	575.3	617.4
- deposits of credit institutions with Bank of Russia	2,373.2	1,903.5	1,027.7
- Bank of Russia bonds held by credit institutions	352.4	1,373.9	1,936.7
For reference: excess reserves	4,656.3	5,175.7	5,589.9

Source: Bank of Russia.

The structure of the money supply formation in 2019 is similar to its structure established in 2018 (*Fig. 5*). From January through November 2019, the most significant factors that shaped broad money were changes in the balances of the general government accounts with the RF Central Bank, as well as the Bank of Russia's liquidity provision/absorption operations with the banking sector. Thus, an increased money supply due to an increase in the net credit to government bodies (RF government deposits on accounts with the RF Central Bank less government bonds acquired by the Bank of Russia) over the period of January-November 2019 amounted to RUB 0.3 trillion, while as a result of a shrinkage in the net volume of liquidity provision (absorption) operations, the monetary base lost RUB 0.1 trillion. An analysis of the factors underlying the money supply formation points to neutrality of the foreign currency purchase operations in accordance with the fiscal rule established for monetary policy: the funds withdrawn by the RF Ministry of Finance in order to replenish the National Welfare Fund go back into the national economy as a result of currency purchases by the Bank of Russia.

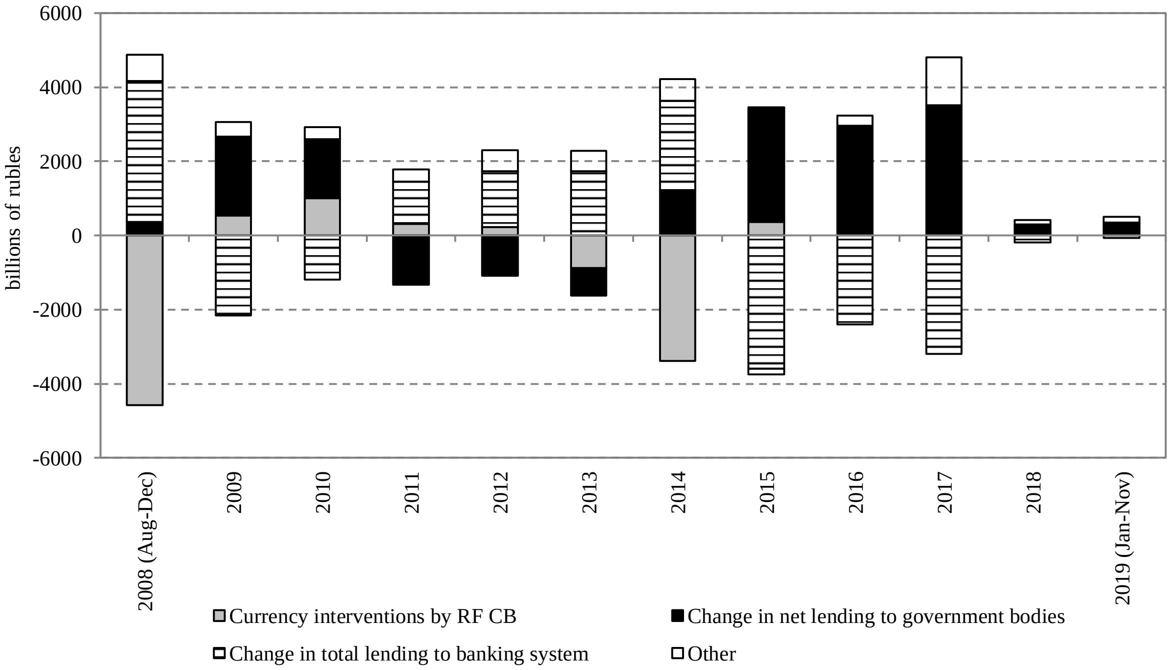

Fig. 5. The money supply formation factors

Source: Bank of Russia.

The dynamics of foreign exchange reserves in 2019 was almost totally determined by the volume of Bank of Russia's foreign currency purchases for the RF Ministry of Finance in accordance with the fiscal rule. Since the beginning of 2019, the Bank of Russia has resumed its foreign currency purchases in the domestic foreign exchange market to the value of the surplus oil and gas revenues received whenever the actual price of oil jumped above USD 41.2 per barrel. In addition, in February 2019, the regulator began making deferred purchases, which increased the daily volume of foreign currency purchases by an average of USD 2.8 billion. In 2019, the regulator acquired RUB 3.5 trillion. In 2018, the volume of the RF Central Bank's foreign currency purchases in the domestic foreign exchange market was approximately RUB 2.1 trillion. Thus, as demonstrated by the year-end result for 2019, the value of the Bank of Russia's international reserve assets gained USD 85.9 billion (18.3%), and as of January 1, 2020, it amounted to USD 554.4 billion, thus hitting its record high of the period after the global financial crisis (*Fig. 6*). It should be reminded that the historic high was reached by the volume of international reserves in August 2008, and amounted to USD 596.6 billion. It should be noted that the index of monetary gold reserves for 2019 increased by USD 23.5 billion (27.0%), due in the main for its upward revaluation in response to the rising gold prices on world markets during certain months of 2019, to the value of USD 16.5 billion. As of January 1, 2020, the share of foreign exchange reserves in the total amount of reserve assets amounted to 80.1% (vs 81.5% in 2018), and the relative share of gold was 19.9% (vs 18.5% in 2018).

It should be remembered that the year 2018 saw some significant changes in the structure of foreign exchange reserves: the relative share of assets denominated in RMB soared from 2.8% to 14.2%, while that of assets denominated in USD plummeted from 45.8% to 22.7%. Later on, according to data for H1 2019, the new structure of foreign exchange reserves remained basically unchanged (USD 24.2%, RMB 13.2%). The shift in their structure was apparently caused by the need to minimize the potential geopolitical risks. However, as a result, the monetary authorities had to sacrifice their returns on investment denominated in US dollars, because over the period 2018–2019, in response to the problems faced by the Chinese economy, the yuan was losing in value relative to the US dollar. Meanwhile, in our opinion, the medium-term prospects for the US economy look better than those for the Chinese economy. Besides, US economic policies are more consistent and predictable, making US dollars the preferred asset for investing in international reserves.

At present, the volume of reserves is sufficient to maintain the sustainability of the RF balance of payments, because it covers 16 months of imports of goods and services into the Russian Federation (vs 16 months in 2018), as well as the interest on external debt due to be paid in 2020. In view of such a high level of sufficiency of international reserves, it is doubtful that the deferred purchases indeed need to be realized under the fiscal rule, given that these operations, being neutral with respect to money supply and interest rates, would exert an additional downward pressure on the ruble exchange rate. The weakening of the ruble, in its turn, can give rise to increased inflationary risks, as well as a slowdown in the industrial production growth rate across several sectors of the Russian economy that depend on imports of investment goods.

In 2019, the average monthly growth of M2 (compared with the corresponding period of last year) was 8.7% (vs 11.0% in 2018), and that of the monetary base was – 1.9% (vs 29% in 2018). As a result, the money multiplier (the ratio between M2 and the monetary base) amounted to 3.0 (vs 2.8 in 2018). The accelerated growth of M2 relative to the monetary base occurred in the main due to an increase in the corporate lending volume in a situation of softening loan conditions, both in terms of loan price and otherwise. It is noteworthy that the achieved money multiplier index corresponds to its average value for developing economies (Ukraine, Belarus, Kazakhstan), while in the developed countries it is usually in a range of 5 to 8. It should also be noted that over the past 20 years in the countries of Eastern Europe, as their banking systems developed, the money multiplier was demonstrating an upward movement pattern. Thus, for example, in Poland over the period 1993–2019, the money multiplier increased from 3.1 to 5.1, while in Russia over the same period it increased from 1.4 to 3.0.

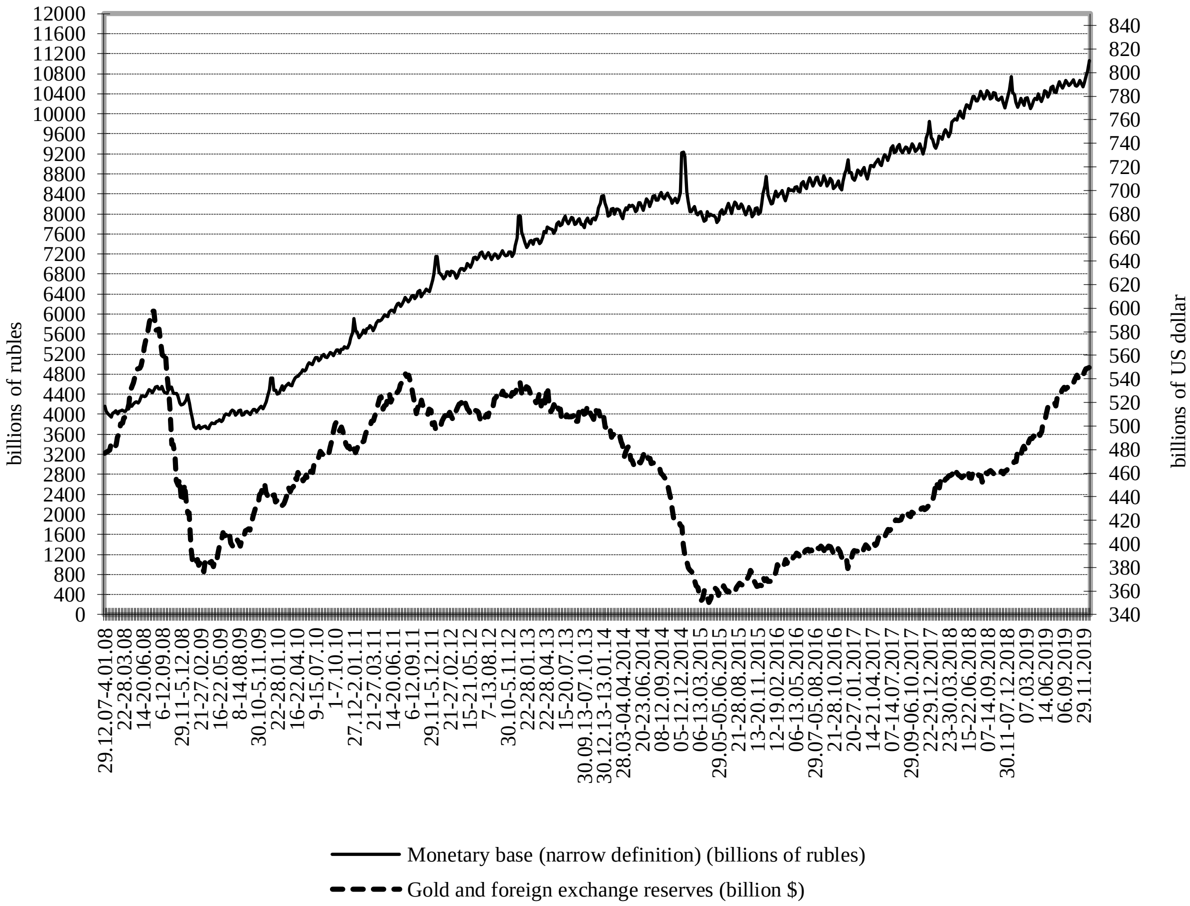

Fig. 6. The movement of the monetary base (narrow definition) and gold and foreign exchange (international) reserves in the Russian Federation, 2008-2019

Source: Bank of Russia.

According to preliminary estimates, the level of monetization in the Russian economy (the ratio of M2 to GDP) over the period 1999–2019 jumped threefold to 47.3% in 2019, almost reaching the level of the countries of Central and Eastern Europe, which have been traditionally characterized by a higher monetization level. For example, in Poland, the ratio of M2 to GDP in Q3 2019 amounted to 69.0% (vs 40.2% in 1999). For reference, in Belarus the ratio of M2 to GDP over the same period (in Q3 2019) increased 2.1 times to 35.6%, in Kazakhstan 2.6 times to 35.9%, in Ukraine 1.9 times to 35.7%. In the developed countries, the index of monetization relative to GDP is even higher, due to a higher level of the financial system's development: for example, in the UK this indicator in Q3 2019 rose to 152.1%, and in Switzerland to 192.7%.

2.1.3. Inflationary processes

Having reached a local maximum in March 2019 (5.3%), over the period of April to December 2019 the growth rate of prices for consumer goods and services (relative to the previous 12 months) was continuously sliding. The acceleration of inflation at the beginning of 2019 was caused by the raise of VAT and the weakening of the ruble over H2 2018. Nevertheless, the proactive measures that the regulator was implementing in the fall and winter of 2018 coupled with the efforts to tighten monetary policy made it possible to minimize the upward inflation deviation from its target. Later on, a gradual decline in the rate of inflation was also facilitated by the slow growth of domestic demand in the context of a tight fiscal policy, the strengthening of the ruble, a good harvest, and a relatively stable situation in the global financial markets. At the end of 2019, annual inflation (relative to the previous 12 months) amounted to 3% (vs 4.3% at the end of 2018) (*Fig. 7*).

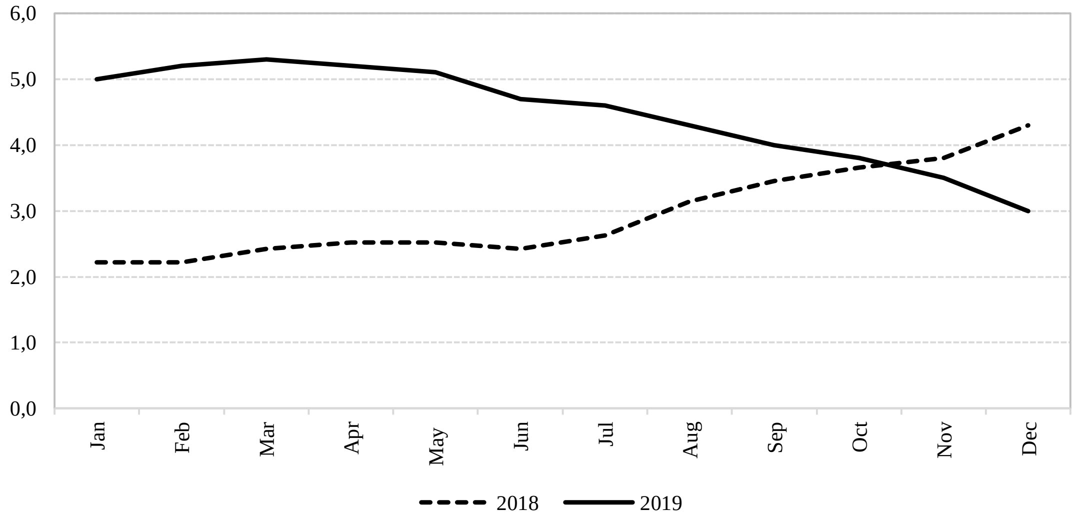

Fig. 7. The CPI growth rate in 2018–2019 (% for the previous 12 months)

Source: Rosstat; own calculations.

Food inflation accelerated from 4.7% in December 2018 to 6.4% in May 2019. Thereafter, along a slow growth of household incomes, the ruble strengthening, and a good harvest, the growth rate of food prices declined. Thus, in June-September 2019, deflation was observed in the food sector (-0.5% in June, -0.3% in July, -1% in August, -0.5% in September). It should be noted that such a long period of disinflation has been recorded for the first time since 2011. As a result, in December 2019, the growth rate of food prices in annual terms (relative to the previous 12 months) amounted to 2.6% (vs 4.7% in December 2018) (Figure 8).

Non-food inflation peaked in March (4.8% on March 2018), and then steadily declined to 3.0% in annual terms in December 2019 (vs 4.1% in December 2018). At the year end, the highest surge was demonstrated by the prices of tobacco products (11.0%), medicines (6.9%), and washing and cleaning products (4.9%).

A significant slowdown in the growth rate of gasoline prices from 9.4% (in December 2018 relative to December 2017) to 1.9% in December 2019 (in annual terms) occurred as a result of the agreement between the RF Government and a number of major oil companies, effective until July 1, 2019. It should be reminded that the surge of gasoline prices in April-June 2018 was associated with the high oil prices and the ruble's depreciation in April in response to the toughening of economic sanctions imposed on Russia.

According to the year-end results of 2019, paid services to the population rose by 3.8% (vs 3.9% in 2018). The leaders in price growth were passenger transport services (6.1%) and education services (5.6%).

Core inflation (cleared of seasonal and administrative factors), after a lengthy period of growth (throughout 2018 and the first 5 months of 2019), began to decline in June and reached 3.1% in annual terms in December 2019.

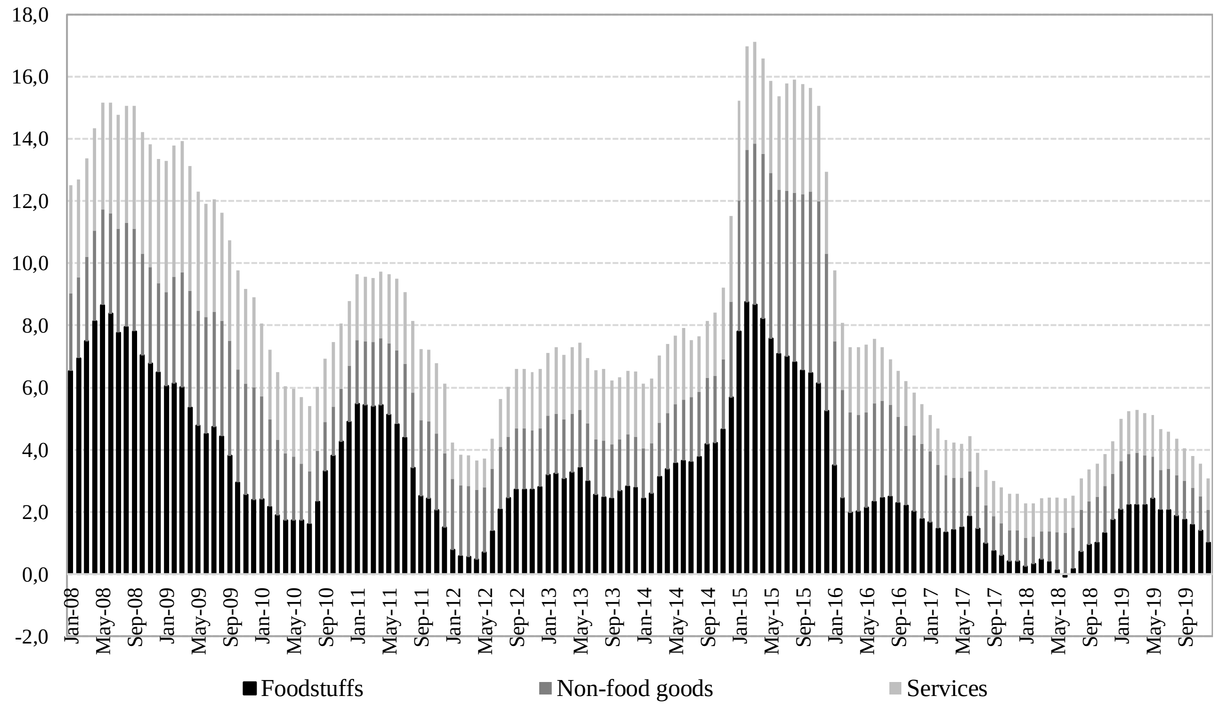

Fig. 8. The structure of inflation in 2008–2019 (%, month to the corresponding month of the previous year)

Source: Rosstat; own calculations.

The inflation slowdown was accompanied by a decrease in inflationary expectations. According to the InFOM survey results released by the Bank of Russia, the median one-year forward inflation expectation rate was 8.3% in November, down 2.1 percentage points on its year-beginning value (*Fig. 9*). In December 2019, inflationary expectations rose to 9%, but in January 2020 their index once again returned to the level of 8.3%. In general, inflationary expectations have remained quite high. However, given the adaptive nature of inflationary expectations, the observed slowdown in the current inflation index creates the conditions for their further decline.

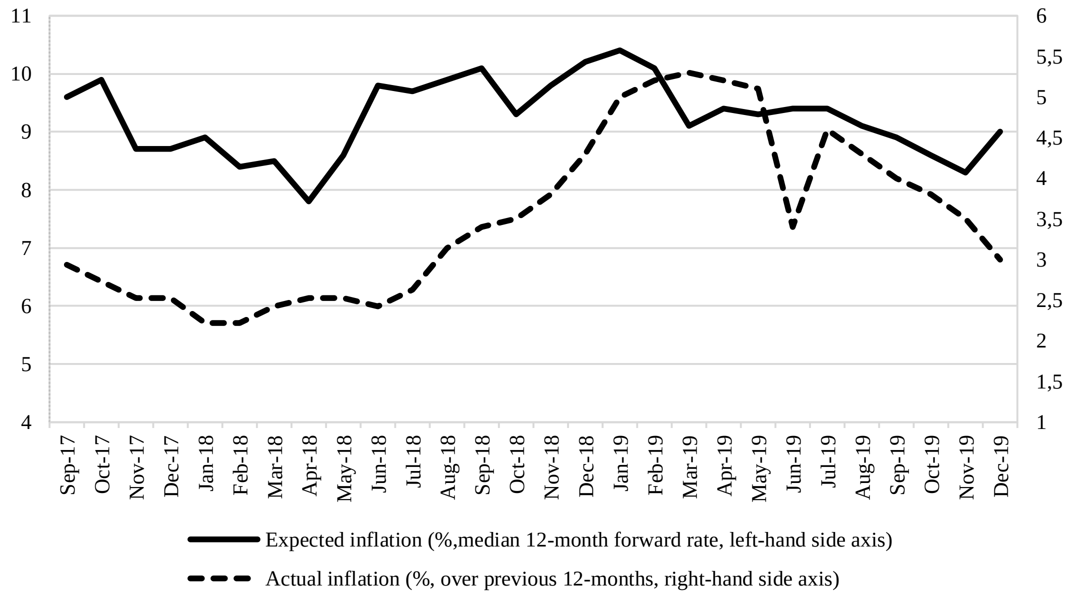

Fig. 9. Inflation and inflationary expectations

Source: Rosstat; Bank of Russia.

The movement pattern of real personal income continues to be the factor that harnesses inflation. In 2019, it gained 1.5% compared with 1.1% in 2018. At the same time, real personal income is still below its 2014 index. In 2019, the average growth rate of real wage amounted to 2.7% (vs 7.0% in 2018). Retail trade turnover is also growing at a slower rate: 1.6% in 2019 compared with 2.8% in 2018. The ruble strengthening against the US dollar, by 11% in 2019, has also contributed to a slowdown in the Consumer Price Index (CPI) growth. The temporary weakening of the ruble in August 2019 (by 4.9%), due to a plunge of oil prices coupled with capital outflows from emerging markets, did not significantly affect the CPI dynamics.

Table 4

The annual growth rate of prices for certain types of consumer goods and services in 2017–2019 (%, December relative to December of previous year)

	2017	**2018**	**2019**	**2017–2019**
1	2	3	4	5
CPI	**2.5**	**4.3**	**3.0**	**10.1**
Foodstuffs	**1.1**	**4.7**	**2.6**	8.6
Butter	9.6	3.6	10.0	24.9
Fish and seafood	3.8	3.7	5.2	13.2
Sunflower oil	-8.6	1.8	-2.9	-9.7
Milk and dairy products	5.2	2.9	6.1	14.9
Pasta	-0.7	1.4	5.7	6.4
Bread and Bakery	2.7	5.2	6.3	14.8
Alcoholic beverages	2.9	1.3	1.2	5.5
Fruits and vegetables	1.2	4.9	-2.0	4.0
Cereals and legumes	-13	1.2	15.2	1.4
Meat and poultry	-2.3	9.7	0.2	7.4
Eggs	-14.2	25.9	-5.0	2.6
Non-food goods	**2.8**	**4.1**	**3.0**	**10.2**
Gasoline	7.3	9.4	1.9	19.6
Tobacco products	8.6	10.1	11.0	32.7
Textiles	3.7	1.7	1.3	6.8
Washing and cleaning products	0.6	3.1	4.9	8.8

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Footwear	4	1.9	1.2	7.2
Knitwear	3.3	2.5	2.4	8.4
Clothes and underwear	3	2.3	2.2	7.7
Pharmaceuticals	-3.4	4.6	6.9	8.0
Services	**4.4**	**3.9**	**3.8**	**12.6**
Preschool education services	5.2	3.8	3.8	13.3
Passenger transport services	6.8	4.3	6.1	18.2
Medical services	5	4.3	3.8	13.7
Education services	7.5	8.4	5.6	23.1
Housing and utilities	4.6	3.7	4.3	13.1
Communications	4.7	2.4	4.2	11.7

Source: Rosstat.

Let us compare the CPI growth rates in Russia and some other countries (*Table 5*).

Table 5

The movement of CPI in some countries in 2017-2019, % per annum

	2017	2018	2019	2017–2019
Azerbaijan	7.9	1.5	2.4	12.1
Armenia	2.6	1.8	0.7	5.2
Belarus	4.6	5.6	4.7	15.6
Kazakhstan	7.1	5.3	5.4	18.9
Kyrgyzstan	3.7	0.5	3.1	7.4
Moldova	7.3	0.9	7.5	16.4
Russia	*2.5*	*4.3*	*3.0*	10.1
Tajikistan	6.7	5.4	8.0	21.5
Ukraine	13.7	9.8	4.1	30.0
Germany	1.7	1.7	1.5	5.0
France	1.2	1.6	1.5	4.4
USA	2.1	1.9	2.3	6.4
Netherlands	1.3	2.0	2.7	6.1

Source: Interstate Statistical Committee of the CIS (http://www.cisstat.com/), OECD database (http://stats.oecd.org/).

Since 2017, Russia has reached a CPI growth rate comparable to that in the developed countries. In 2019, inflation in Russia amounted to 3.0%, while in the Netherlands it was 2.7%, and in the USA, 2.3%. Moreover, among the CIS members, Russia has been one of the countries with the lowest rates of inflation. According to the intermediate results for 2019, the highest CPI growth rates were typically observed in Tajikistan (8.0%) and Moldova (7.5%) (*Table 5*).

In 2019, the Producer Price Index (PPI) also demonstrated a significant decline, while deflation lasted for 7 months, which is a record of the entire observation period. The growth rate of PPI amounted to -4.3%, while in 2018 this indicator stood at 11.7%. A PPI plunge was noted in the Russian economy for the first time since 2008, when the PPI growth rate amounted to -7%. Moreover, in 2008, deflation lasted for only 4 months. The slowdown in PPI growth in 2019 will continue to exert a downward pressure on the CPI dynamics in 2020.

Thus, the Bank of Russia' policy of high interest rates and their slow decline, designed to curb inflation after its surge in 2015 (12.9%), proved to be successful. Over the past 3 years, inflation in Russia stayed either below its target or slightly above it. The temporary tightening of the monetary policy in 2018 helped minimize the risks of an accelerated inflation in 2019. However, long-term hovering of the real interest rate in positive zone is fraught with the risks of an economic growth slowdown. In addition, economic growth in 2019 was sustained by the implementation of national projects, which turned out to be slower than expected, and a tight fiscal policy imposed an additionally constraints on aggregate demand.

In the context of external shocks in 2020, the key objective of monetary policy is to ensure financial stability and keep inflation close to the target level, as well as to prevent a significant increase in inflationary and devaluation expectations of economic agents.

2.1.4. The balance of payments and the ruble exchange rate

According to the preliminary balance of payments estimates for 2019 released by the Bank of Russia, the current account balance amounted to USD 70.6 billion, which is 38% (or USD 42.9 billion) less than the corresponding figure for 2018.[1]

The goods trade balance amounted to USD 163.1 billion, which is 16% less (USD 31 billion) than in 2018 (USD 194.4 billion) (*Fig. 9*). A decisive role in this decline was played by a shrinkage of exports by 5.7% (by USD 25 billion) from USD 443.1 billion in 2018 to USD 417.9 billion in 2019.[2] This decline is primarily due to the downward movement of the average annual export prices of oil, petroleum products, natural gas, and Russia's other main exports (*Table 6*) with a stable supply volume (*Fig. 11*). One exception was liquefied natural gas, whose export price plunge by more than 12% was accompanied by a 75% increase in its physical supply volume, due to Yamal-LNG's capacities, which translated into a 58% increase in its deliveries abroad, from USD 5.3 billion to USD 8.4 billion.

The goods trade balance shrinkage, in addition to the downfall of export prices, was also contributed to by an increase in imports of 2.5% (USD 6 billion), from USD 248.7 billion in 2018 to USD 254.8 billion in 2019, which can be explained by the ruble's strengthening: according to the Bank of Russia, in 2019 the real effective exchange rate of the ruble against foreign currencies gained 2.5% on 2018.[3]

There was also a shrinkage in the balance of trade in services, which amounted to USD -34.8 billion in 2019, compared with USD -29.9 billion in 2018, i.e. the year-end negative balance increased by 16.4%. At the same time, service exports fell insignificantly, by 1.5% (or by USD 1 billion in absolute terms, from USD 64.6 billion to USD 63.6 billion), while service imports rose significantly, by 3.9%, from USD 94.6 billion to USD 98.3 billion.

Table 6

The movement of prices for Russia's main exports, in 2019 relative to 2018

Goods group	Share of in total exports, %	Average export price, USD/t		Price increase, %
		2019	2018	
1	2	3	4	5
Crude oil	28.6	454	496	-8.5
Petroleum products	15.8	468	520	-10.0
Natural gas*	9.8	189	223	-15.0
Ferrous metals	4.3	446	503	-11.2
Coal	3.8	78	85	-8.8
Mineral fertilizers	2.0	243	241	+0.5
Natural gas, liquefied **	1.9	121	144	-15.8
Wheat and meslin	1.5	201	192	+4.8
Aluminum	1.1	1,696	1,727	-1.8

[1] See Bozhechkova A., Knobel, A., Trunin, P. Russia's balance of payments 2018: current account balance hits highest // Russian Economic Developments. 2019. Vol. 26. No 2. P. 3–7.
[2] The data on exports and imports in this section, and in the section of the overview on foreign trade, differ slightly, due to the use of different sources of information. The data on the shrinkage of exports were extracted from the balance of payments of the RF Central Bank.
[3] On the effect of exchange rate dynamics on trade, see Knobel A., Firanchuk A. Foreign Trade of Russia in January-August-August 2017 // Russian Economic Developments. 2017. Vol. 24. No 11. P. 12–18.

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1	2	3	4	5
Timber	1.1	227	234	-2.8
Copper	1.0	5,892	6,327	-6.9
Fish, fresh and frozen	0.7	1,830	1,794	+2.0
Vegetable oil	0.5	712	762	-6.5
Nickel	0.4	13,712	12,821	+6.9

* price in USD/m^3
** price in USD/thousands of m^3
Source: Federal Tax Service; own calculations.

In 2019, the balance of investment income and the balance of wages both changed very significantly. The former declined by USD 5.9 billion (from USD -38.6 billion to USD -44.5 billion), due in the main to an increase of USD 5.8 billion in incomes payable (investment income repatriation), while incomes receivable remained unchanged; and the latter lost USD 0.3 billion (from USD -3.0 billion to USD -3.3 billion).

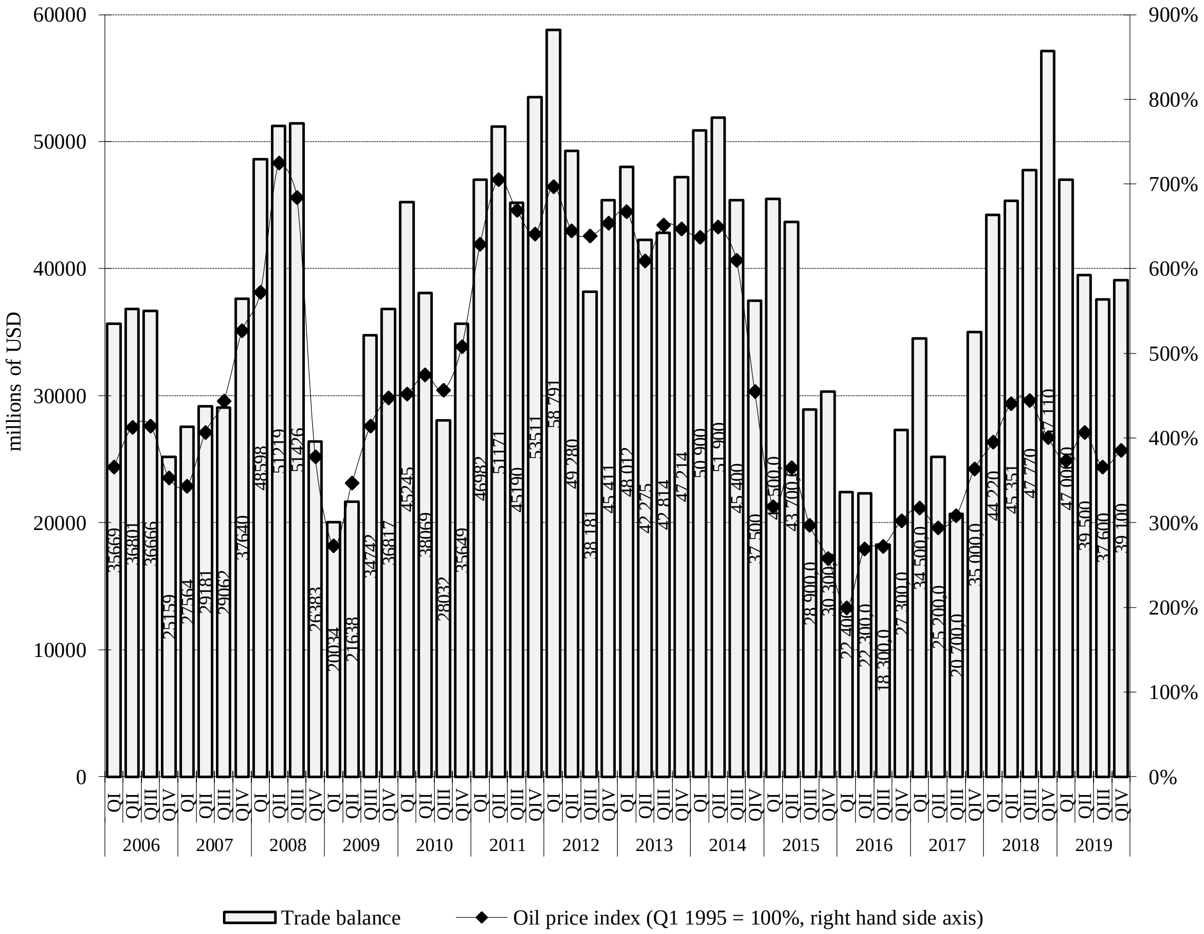

Fig. 10. Trade balance and the movement of oil prices

Source: Bank of Russia; IMF.

A significant reduction in the current account balance was in part offset by a financial account surplus, which in 2019 amounted to USD 1.8 billion, compared with a deficit of USD 76.5 billion in 2018. The net capital inflow was secured by an increase in financial liabilities by USD 28.3 billion by the year-end of 2019 (in 2018, financial liabilities lost USD 36.7 billion) coupled with a smaller increase in financial assets compared with 2018 (USD 26.5 billion in 2019 vs USD 39.8 billion in 2018).

In 2019, growth of foreign liabilities occurred in the main due to the operations in the non-banking sector (USD 25.7 billion in 2019 vs -4.2 billion in 2018) and those conducted by federal administration bodies (USD 22.0 billion in 2019 vs USD -5.5 billion in 2018). By contrast, the banking sector over the same period reduced its foreign liabilities: USD -20.1 billion in 2019 vs USD -25.0 billion in 2018.

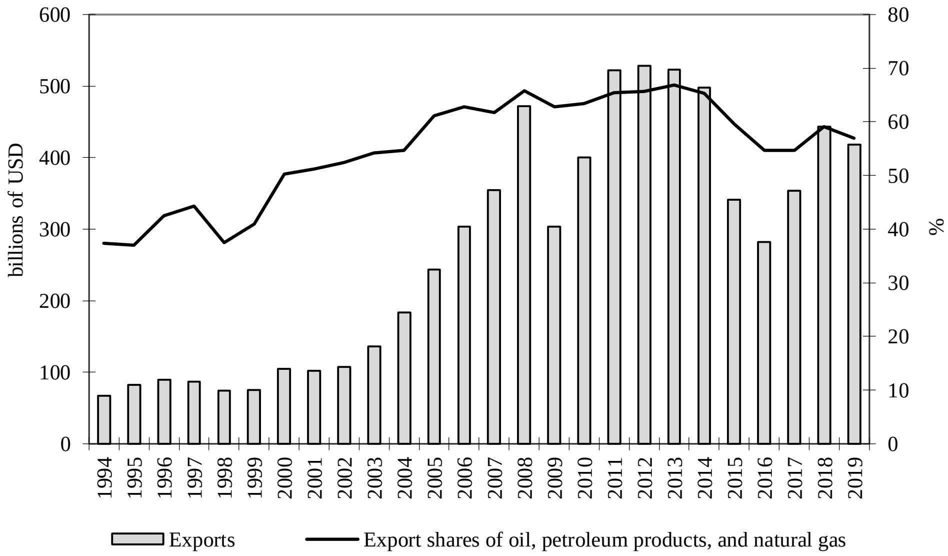

Fig. 11. The movement of goods exports and the export shares of products of the fuel and energy complex, 1994–2019

Source: Bank of Russia.

The growth of financial assets of Russian residents abroad occurred predominantly due to operations in the non-banking sector. Thus, in 2019, the foreign assets in the other sectors grew by USD 25.7 billion (in 2018, their growth amounted to USD 30.8 billion), while those held by banks gained USD 1.7 billion (vs USD 7.6 billion in 2018). The amount of foreign assets held by government administration bodies shrank by USD 0.9 billion (vs an increase by USD 1.4 billion in 2018).

In 2019, the volume of foreign direct investment inflow in the non-banking sector (USD 26.9 billion vs USD 5.9 billion in 2018) was almost completely offset by its outflow (USD 26.3 billion vs USD 29.6 billion in 2018). There was a decrease in the inflow of portfolio investment into Russia's non-banking sector in 2019 (by USD 3.2 billion vs USD 0.7 billion in 2018), which took place alongside a growth in portfolio investment outflow (by USD 2.1 billion vs USD 1.4 billion in 2018). The other liabilities of the non-banking sector increased by USD 1.9 billion (vs USD 1.3 billion in 2018), while the other assets increased by USD 3.5 billion (vs USD 10.1 billion in 2018).

As a result, net capital outflow from the private sector in 2019 fell sharply, to USD 26.7 billion (vs USD 63.0 billion in 2018) (*Fig. 12*). At the same time, in 2019, net capital outflow from the banking sector was USD 21.8 billion (vs USD 32.6 billion in 2018). In the non-banking sector, net capital outflow plunged even deeper, to USD 4.9 billion (vs USD 30.4 billion in 2018).

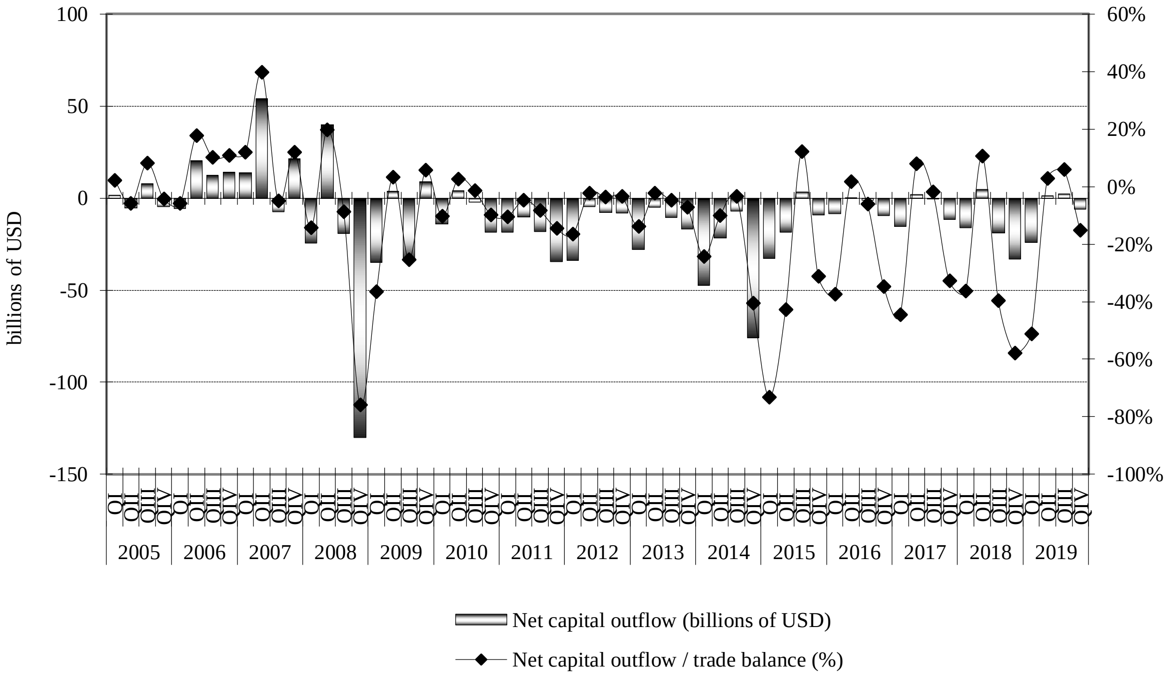

Fig. 12. Net capital outflow from the private sector in 2005–2019

Source: Bank of Russia; own calculations.

The international reserve assets over the course of 2019 gained USD 66.5 billion (vs USD 38.2 billion in 2018), thus amounting to USD 554.4 billion at the year-end – as noted earlier, this is their record high after the global financial crisis. It should be reminded that the previous record high of the international reserves index had been reached in August 2008 and amounted to USD 596.6 billion. The movement pattern of international reserves in 2019 was primarily shaped by the purchase in the domestic forex market, by the RF Ministry of Finance implementing the fiscal rule, of foreign currencies to the total value of RUB 3.5 trillion (vs RUB 2.1 trillion in 2018). The increased amount of foreign currencies purchased in the domestic forex market under the fiscal rule in 2019 can be explained by the fact that the Bank of Russia carried out not only its planned but also deferred purchases, caused by their suspension in August-December 2018.

As a result of the fiscal rule, the ruble exchange rate has become less dependent on oil prices, and is now being determined to a higher degree by capital flows. Therefore, due to an improved situation with capital inflows into the Russian Federation, in 2019 the ruble climbed 10.9% against the US dollar, to 61.9 per USD. The capital inflow into the Russian economy was facilitated by the fact that the US Federal Reserve and the ECB resorted to monetary policy easing, as well as by the positive rhetoric of trade negotiations between the USA and China since September 2019.

It should be noted that in 2019, the ruble gained more in nominal terms than the national currencies of the other developing countries where inflation is targeted. Thus, in 2019, while in

Peru and Mexico the increase of the national currency's nominal effective exchange rate amounted to 2.8% and 7.3%, respectively, Russia's national currency strengthened by 10.4% *(Fig. 13*). At the same time, the national currencies of many other developing countries were weakening (-9.4% for the Turkish lira, -2.1% for the Colombian peso, -1.8% for the Brazilian real). The ruble's strengthening can be explained by the high attractiveness of the Russian OFZ market in the context of high interest rate differentials between the Russian economy and the economies of developed countries, in absence of tougher sanctions. Thus, the share of non-residents in the Russian OFZ market in 2019 increased from 24.4% to 32.2%.

In 2019, the foreign debt of the Russian Federation increased by USD 26.8 billion, amounting to USD 481.5 billion as of January 1, 2020. The foreign debt of government administration bodies grew by 58.0%, to USD 69.5 billion, as a result of foreign capital inflow into the Russian OFZ market. The foreign debt of banks and enterprises remained practically unchanged at the level of USD 399.1 billion.

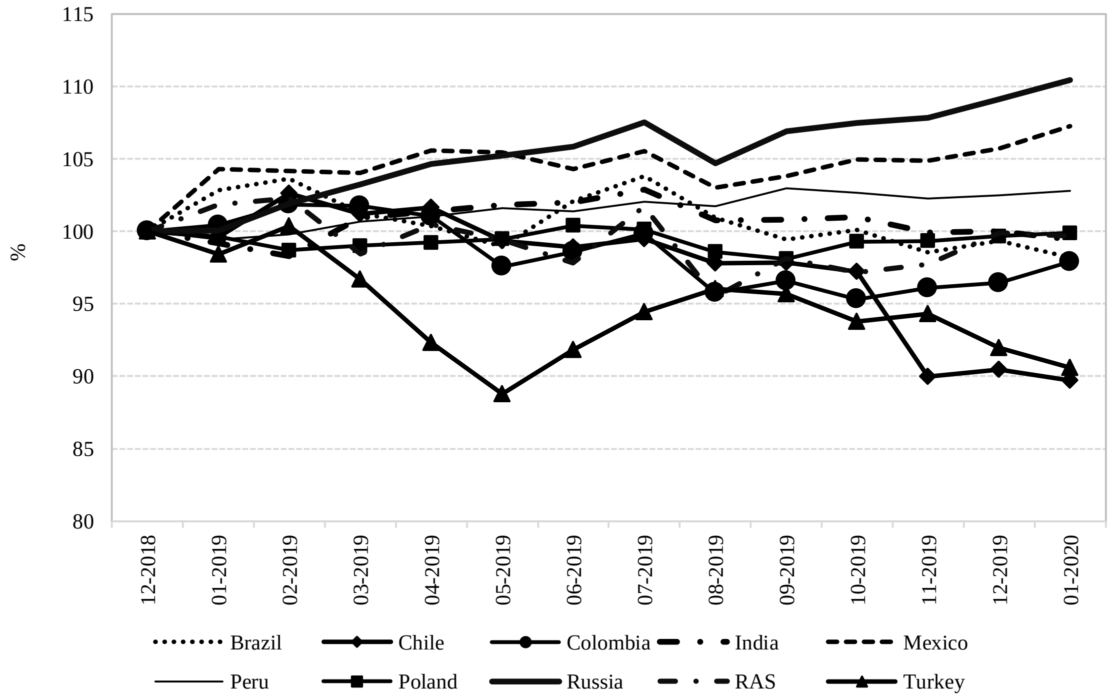

Fig. 13. The movement of nominal effective exchange rates of national currencies in the developing countries targeting inflation (December 2018 = 100%)

Source: BIS; own calculations.

Our year-end estimate of capital flight for 2019 (*Fig. 14*), which amounted to USD 7.9 billion for 2018, now shrank to USD 6.3 billion,[1] reflecting the success of Russia's authorities in blocking illegal channels of capital flight.

[1] Capital flight is calculated according to the IMF methodology; it is the sum of 'trade loans and advance payments', 'questionable deals', and 'net errors and omissions'.

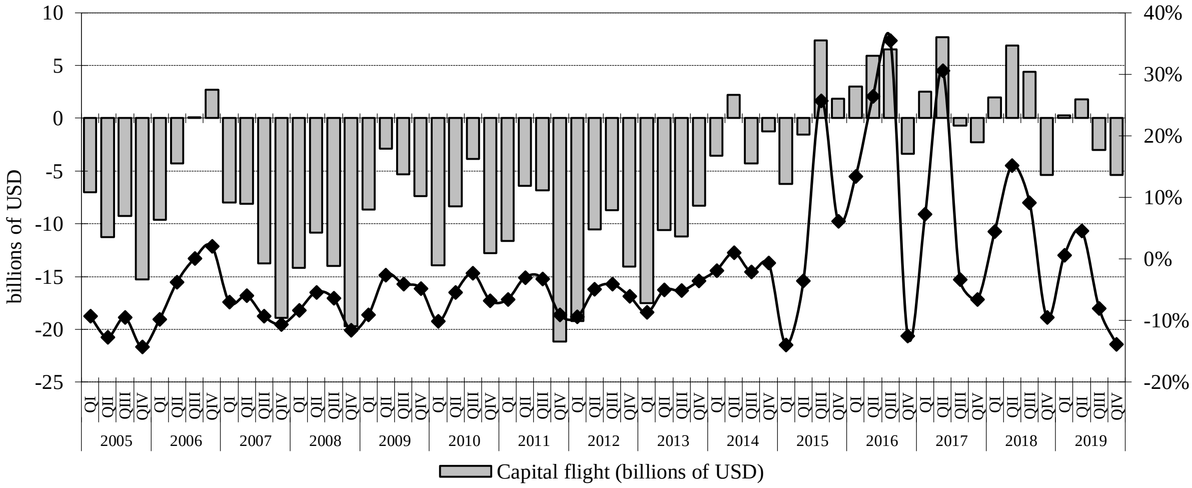

Fig. 14. Capital flight dynamics in 2005–2019.

Source: Bank of Russia; own calculations.

In 2020, in the context of a large-scale fall in oil prices and the weakening of the ruble, the current account will be significantly reduced. At the same time, the negative balance of the financial account is unlikely to reach the values of previous crises (in 2014 it was -130 billion dollars, in 2008 -140 billion dollars), given that the external debt of Russian economic agents has significantly decreased, which reduces the demand for currency for its refinancing. At the same time, the Bank of Russia, within the framework of the budget rule and the sale of a controlling stake in Sberbank to the government, will sell foreign currency, which will help stabilize the ruble exchange rate.

According to our estimates, the fundamental exchange rate of the ruble to the dollar at the price of oil is 30-35 dollars per barrel. it is 74-76 rubles / USD, and at 45-50 dollars / bbl - about 70 rubles/USD. Accordingly, monetary policy measures should be aimed at preventing significant exchange rate deviations from these levels due to the development of panic, since in the event of a sharp weakening of the ruble, the foreign exchange market may stabilize on a much weaker ruble, which will cause a strong deviation of inflation from the target level, a re-evaluation of country risks and large-scale capital outflow.