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TRENDS AND OUTLOOKS

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R95 **RUSSIAN ECONOMY IN 2017. TRENDS AND OUTLOOKS** / [Alexander Abramov etc.; Doctor of sciences (economics) Sergey Sinelnikov-Murylev (editor-in-chief), Doctor of sciences (economics) Alexander Radygin]; Gaidar Institute for Economic Policy. – Moscow: Gaidar Institute Publishers, 2018. – 544 p. – ISBN 978-5-93255-530-9.

The review "Russian economy in 2017. Trends and outlooks" has been published by the Gaidar Institute since 1991. 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: the socio-political issues and challenges; the monetary and budget spheres; financial markets and institutions; the real sector; social services; institutional changes. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts confirming the conclusions.

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Russia's Monetary Policy in 2017[1]

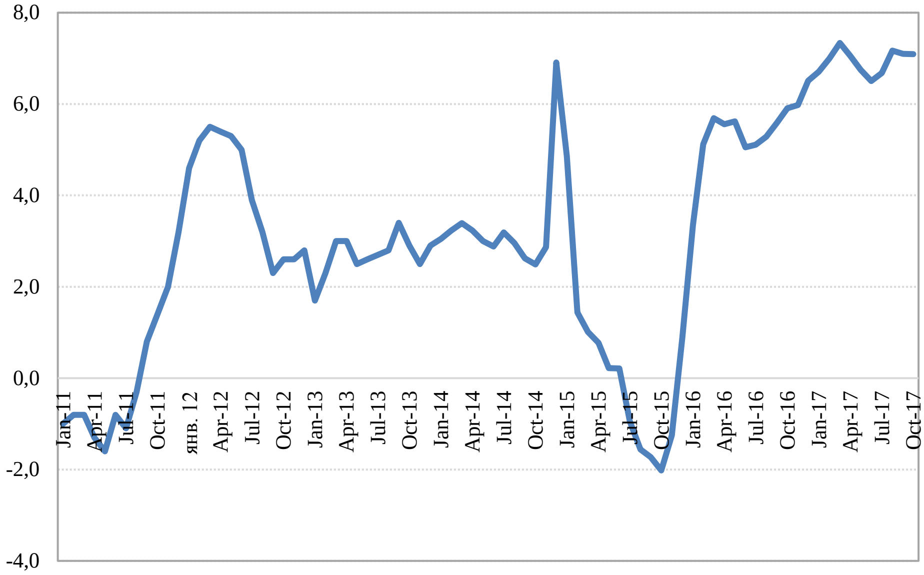
2.1.1. Monetary policy trends

The Bank of Russia eased at slow enough pace its monetary policy in 2017 despite substantial deceleration in inflation, holding that ongoing inflation risks were high, including a possible decline in crude oil prices and capital outflow, upturn in consumer demand, fiscal policy uncertainty, as well as a relatively high and unstable degree of inflation expectations. In 2017, the monetary policy rate was cut by 2.25 percentage points to 7.75 percent per annum as the inflation rate over the same period (same-month-year-ago comparison) was down 2.6 percentage points to 2.5 percent. The Russian central bank cut the key interest rate six times: by 0.25 percentage points on March 27, by 0.5 percentage points on May 2, by 0.25 percentage points on June 19, by 0.5 percentage points on September 18, by 0.25 percentage points on October 30, and by 0.5 percentage points on December 15.

Amid moderate cuts in the key interest rate, the substantial deceleration in inflation and inflation expectations in 2017, the causes of which are considered below, led to further tightening of terms of lending that started in 2016. For example, there were months when the real interest rate on corporate loans with maturities of less than one year reached the level seen in December 2014 (*Fig. 1*). Keeping a positive money market real interest rate was a headwind to growth in consumption, placing downward pressure on inflation, which nonetheless posed risks of economic growth deceleration.

International comparisons of the key interest rate with the inflation rate show that despite the fact that the Russian inflation reached low rates in 2017 that are comparable with inflation rates in developed countries, the key interest rate still remained at a relatively high level comparable with countries facing inflation rates that are 2–4 times higher than the Russian inflation rate (*Table 1*). The same is true only for Brazil with an inflation rate of 2.7 percent and the central bank key interest rate of 7 percent per annum. Therefore, the Russian Federation and Brazil rank on top in terms of real key interest rate (*Fig. 2*).

[1] This section is written by Alexandra Bozhechkova, the Gaidar Institute, the Institute of Applied Economic Studies (IAES) of the Russian Presidential Academy of National Economy and Public Administration (RANEPA); Anna Kiyutsevskaya, the Gaidar Institute, IAES-RANEPA; Alexander Knobel, VAVT under Russian Ministry of Economy, the Gaidar Institute, IAES-RANEPA; Pavel Trunin, the Gaidar Institute, IAES-RANEPA.



Note: The real interest rate was calculated using data on the inflation rate over the previous 12 months, based on the assumption of adaptive nature of inflation expectations in Russia.

Fig. 1. Real interest rate on corporate loans with maturities of less than one year in the Russian Federation in 2011–2017, percent per annum (based on inflation rate over the previous 12 months)

Table 1

Inflation rate and key interest rate in developed and developing countries*

	Inflation rate, %	Key interest rate, percent per annum
Developing countries		
Peru	1.4	3.25
Hungary	2.2	0.90
Poland	2.2	1.50
Chile	2.3	2.50
Russian Federation	2.5	7.75
Brazil	2.9	7.00
India	3.2	6.00
Indonesia	3.6	4.25
Colombia	4.1	4.75
South Africa	4.5	6.75
Mexico	6.8	7.25
Kazakhstan	7.3	10.25
Turkey	11.9	8.00
Developed countries		
Norway	1.6	0.50
Canada	1.9	1.00
European Union	1.7	0.00
Island	1.9	4.25
New Zealand	1.6	1.75
United States	2.1	1.50
Australia	1.9	1.50
Czech Republic	2.4	0.50
United Kingdom	3.0	0.50

* Data on 2017 inflation rate is presented on a December over December basis, data on key interest rate as of the end of December 2017

Sources: data posted on central banks' official websites.

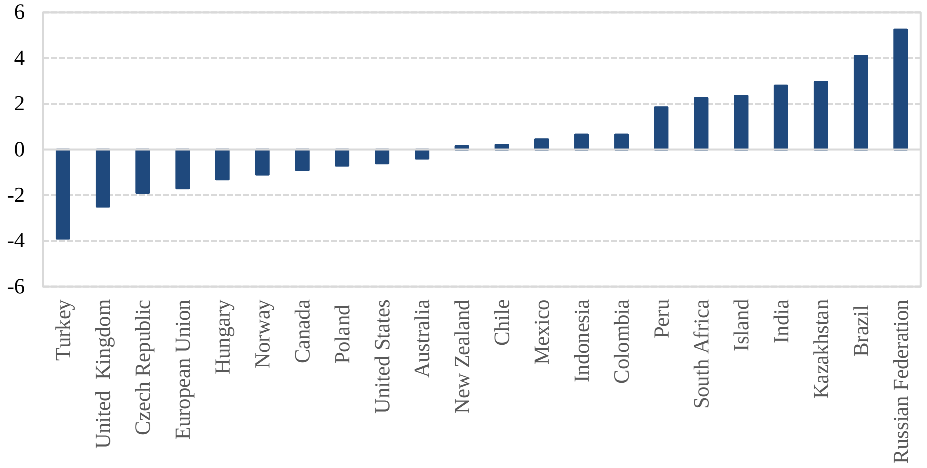


Fig. 2. Real key interest rate as of 2017 year-end, percent per annum (measures are based on inflation rate over previous 12 months)

Sources: data posted on central banks' official websites, own calculations.

Note that the Bank of Russia estimates 2–3 percent per annum of the equilibrium real key interest rate for the Russian economy with a target inflation rate of 4 percent. It appears that the Russian central bank will continue to ease its monetary policy by making incremental cuts (within a 1.5–2-year horizon) in the key rate to reach a neutral level of 6–7 percent.

2.1.2. Money market

Structural liquidity surplus in the Russian banking sector was a key feature of the money market in 2017. In this context, the Bank of Russia introduced measures to reduce the number of instruments providing liquidity to banks and to broaden approaches towards liquidity absorption.

Since April 3, 2017, for instance, the Bank of Russia discontinued providing gold-secured loans because of poor demand for this instrument from credit institutions faced with liquidity surplus. As a reminder, banks' debt on this instrument was zero since August 2016, averaging RUB 540.5 million in the period between March 2012 and June 2016.

With the aim to absorb ruble liquidity surplus, the Bank of Russia launched auctions for Bank of Russia coupon bonds (coupon OBRs). Outstanding securities were worth RUB 328.2 billion, according to data for November 1, 2017. The initial coupon OBR auction was held on August 15, 2017, at which the regulator offered OBRs worth RUB 150 billion to credit institutions, whereas the demand was worth RUB 173.5 billion (to mature on November 15, 2017). During the second OBR issue in October and November the supply surpassed the demand from banks: OBR issue was worth RUB 500 billion, whereas the demand was RUB 226.1 billion (to mature on January 17, 2018). The third OBR issue of RUB 500 billion was even weaker than the previous demand of RUB 77.8 billion. In December 2017, the fourth OBR issue worth RUB 200 billion saw a demand of RUB 48.4 billion. That was apparently associated with uneven distribution of liquidity between banks despite liquidity surplus.

On September 1, 2017, the Bank of Russia introduced a framework for emergency liquidity provision (FELP) designed for bank resolution, allowing banks faced with temporal liquidity problems to apply to the Bank of Russia for a 90-day loan at a fixed interest rate equal to the key interest rate plus 1.75 percentage points. Regulator's loan decision within the FELP framework relies on financial sustainability as well as systemic importance of the target bank. In 2017, for instance, RUB 1.06 trillion were allotted for the resolution of Otkritie Bank within the FELP framework as well as via fixed-rate repo loans.

Banks' demand for central bank's foreign-currency refinancing facility was on the slide during the year on the back of ruble appreciation and stable foreign exchange market. As a reminder, banks' demand for the foreign-currency refinancing facility was in great demand in 2014–2015. At the height of 2015 crisis, for example, banks owed USD 35 billion to the Russian central bank on foreign-currency repos, whereas in September 2017 their debt was considerably reduced, running at just USD 897.6 million. Note that the foreign-currency refinancing facility facilitated stabilization in the foreign exchange market in times of crisis. However, while banks' foreign-currency repo debt to the central bank averaged USD 14.3 billion in 2016, it was reduced considerably in 2017 to an average of USD 3.4 billion. Since the beginning of 2017, the bulk of funds allotted during foreign-currency repo auctions had a 28-day maturity (*Fig. 3*) at an average weighted interest rate of 3.1 percent (4.2 percent per annum in 2016). The Russian central bank discontinued holding regular foreign-currency repo auctions with maturities of 7 and 28 days since September 11, 2017.

In 2017, banks increased their demand for foreign-currency refinancing through foreign-currency swap lines. The average foreign-currency liquidity swap line for the banking sector stood at USD 576.7 million in 2017 (USD 498.4 million in 2016). Interest rates on the ruble and foreign-currency legs stood at 6.75–9 and 2.2–2.9 percent, respectively. Note that demand for foreign-currency swaps surged in December 2017, when the average foreign-currency swap line increased to USD 1.4 billion, 2.3 times higher than that of December 2016. The increase in demand for foreign-currency swaps was apparently associated with growth in banks' demand for foreign-currency liquidity by the end of the year amid discontinued foreign-currency repos.

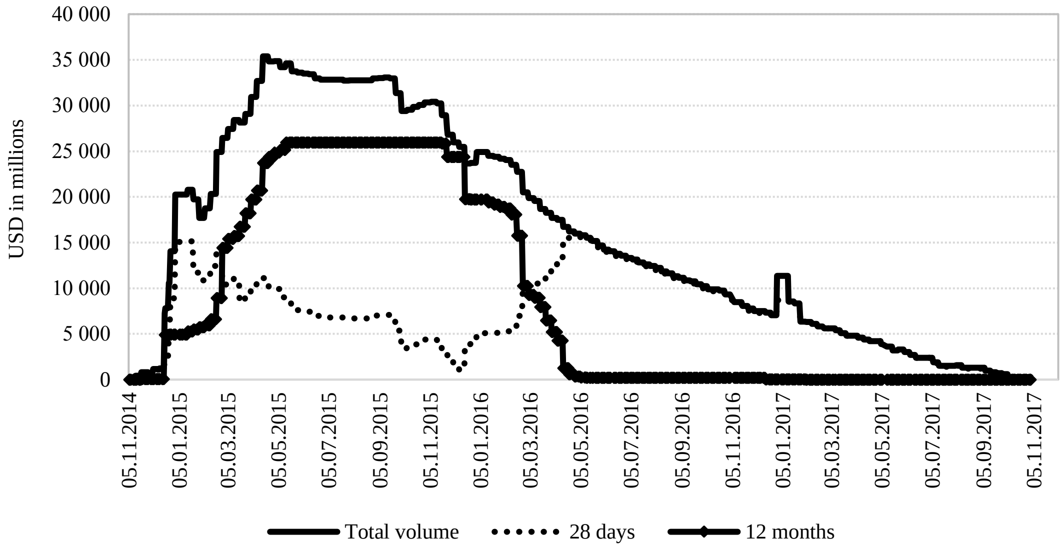


Fig. 3. Credit institutions' liability to Russia's central bank in second leg of foreign-currency repos in 2014–2017

Source: Bank of Russia.

It appears that liquidity surplus will continue in 2018 and, therefore, the regulator will continue to use in a flexible manner liquidity absorption instruments in the banking sector, seeking to maintain the money market overnight interest rate close to the monetary policy rate. Furthermore, the regulator will broaden the range of instruments to provide liquid assets as may be required.

In 2017, credit institutions' debt to the Bank of Russia was reduced amid structural liquidity surplus (*Table 2*). As of January-December 2017 period-end, loans, deposits and other funds raised by credit institutions decreased by 1.4 times to RUB 2.0 trillion (the value was halved to RUB 2.7 trillion in 2016) (*Fig. 4*). As a reminder, credit institutions started reducing their debt to the central bank in 2015 in response to influx of funds to the banking sector via the budget channel. Furthermore, banks' debt to the central bank peaked RUB 9.3 trillion, according to data as of the beginning of 2015.

Up until July 2017, loans secured by nonmarketable assets (RUB 329 billion, according to data dated June 30) prevailed in the structure of banks' debt to the central bank, whereas their debt on repo auctions was only RUB 77.2 billion as of the same date. In July-August 2017, however, banks' repo debt to the central bank climbed RUB 664 billion mostly due to regulator's loan to Otkritie Bank. Note that the foregoing amount does not include RUB 330 billion, according to our estimates, that were allotted via the FELP framework to Otkritie Bank. The structure of banks' debt to the central bank was back to its previous ratio in late September as a result of full repayment of loan by Otkritie Bank.

Table 2

Bank of Russia Balance Sheet of 2015–2017

	January 1, 2016		**January 1, 2017**		**December 1, 2017**	
	Rubles in billions	**percent of assets / liabilities**	**Rubles in billions**	**percent of assets / liabilities**	**Rubles in billions**	**percent of assets / liabilities**
Funds placed with nonresidents and securities issued by nonresidents	21,995,2	62.9	18,005,1	62.1	19,608,4	62.2
Credits and deposits	6,400,3	18.3	4,175,1	14.4	3,816,7	12.1
Precious metals	3,647,3	10.4	3,747,5	12.9	4,537,3	14.4
Securities	719,9	2.1	528,9	1.8	433,9	1.4
Other assets	920,4	2.6	1,013,4	3.5	1,616,1	5.1
Total assets	**34,947,2**	100	**28,974,1**	100.0	**31,523,7**	100.0
Cash in circulation	8,522,5	24.4	8,790,1	30.3	8,864,3	28.1
Balance of accounts with the Bank of Russia	12,573,3	36.0	9,985,5	34.5	11,697,2	37.1
of which: Russian government funds	8,130,7	23.3	4,662,0	16.1	5,950,7	18.9
funds of resident credit institutions	2,528,3	7.2	3,093,3	10.7	3,905,9	12.4
Float	0,4	0.0	2,8	0.0	10,5	0.0
Outstanding securities	-	-	-	-	306,2	1.0
Liabilities to IMF	1,074,2	3.1	1 392,9	4.8	1,417,6	4.5
Other liabilities	160,4	0.5	111,4	0.4	576,1	1.8
Capital	12,503,7	35.8	8,647,85	29.8	8,651,9	27.4
Profit for current FY	-	-	43,7	-	-	-
Total liabilities	**34,947,2**	100	**28,974, 1**	100	**31,523,7**	100

Source: Bank of Russia.

In 2017, banks actively increased their 1–7-day deposits in the Bank of Russia. Note that 1-week deposit auctions were most popular auctions. An average of RUB 814.6 billion were raised at like auctions, and the average weighted interest rate came out to be 9.0 percent per annum.

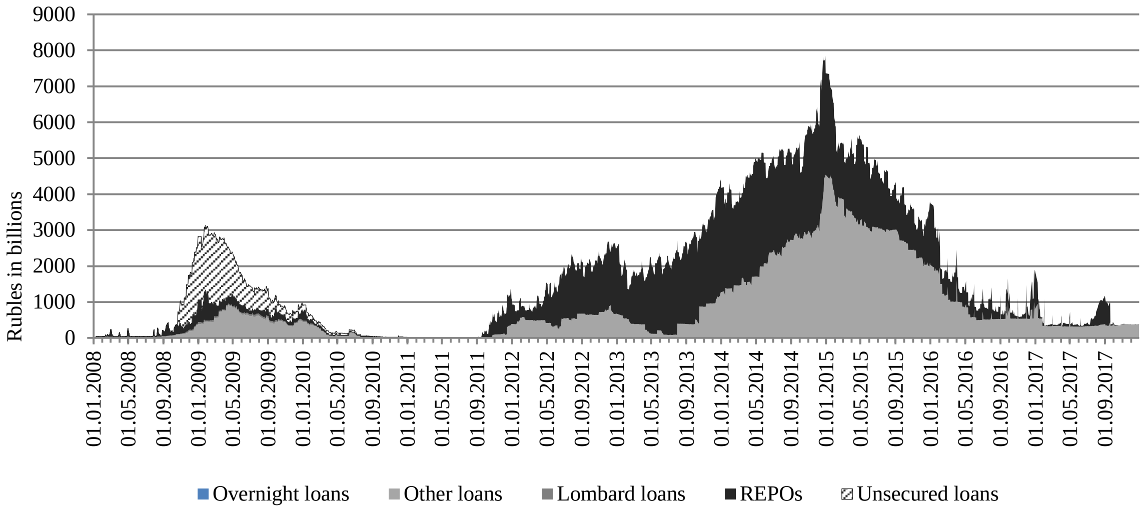


Fig. 4. Commercial banks' ruble-denominated debt (under key instruments) to Bank of Russia in 2008–2017

Source: Bank of Russia.

In 2017, the interbank interest rate[1] in the interbank lending market was down 2.4 percentage points (from 10.1 percent per annum on average in January 2017 to 7.7 percent per annum on average in November 2017). Overall, in 2017 the interbank interest rate stood within the boundaries of interest rate band set by the Russian central bank. At some periods of the second half of the year the money market saw excessive volatility and the MIACR shifted to the lower boundary of the interest rate band probably due to increased supply in the interbank lending market from banks facing a great influx of liquidity from their customers' operations/transactions as well as operations of the Banking Sector Consolidation Fund that was established in May 2017 for the resolution of failing banks. The average annual MIACR on overnight interbank ruble-denominated loans loosened from 10.5 percent per annum in 2016 to 8.9 percent per annum in 2017 (*Fig. 5*).

Like in 2015–2016, the principal sources of accumulation of the broad monetary base in January-December 2017 were changes in the balance on the general government's accounts with the central bank as well as Bank of Russia's operations providing liquidity to the banking sector. For instance, the monetary base in 2017 saw a positive increase of RUB 3.9 trillion through raising money from sovereign funds, whereas it contracted by RUB 3.2 trillion as a result of reduction of banks' debt to the regulator. Overall, in 2017 the broad monetary base swelled by 23.7 percent to RUB 14.7 trillion as of January 1, 2018. Note that in 2016 the monetary base advanced 7.6 percent to RUB 11.9 trillion (*Fig. 6*). It appears that the pattern for money supply formation will remain the same in 2018 because the National Wealth Fund will be a principal source to cover the federal budget deficit in 2018.

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

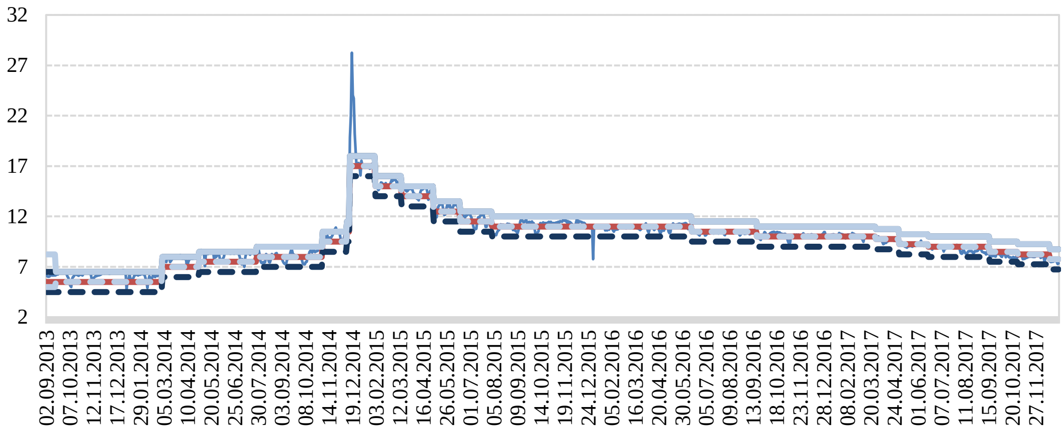
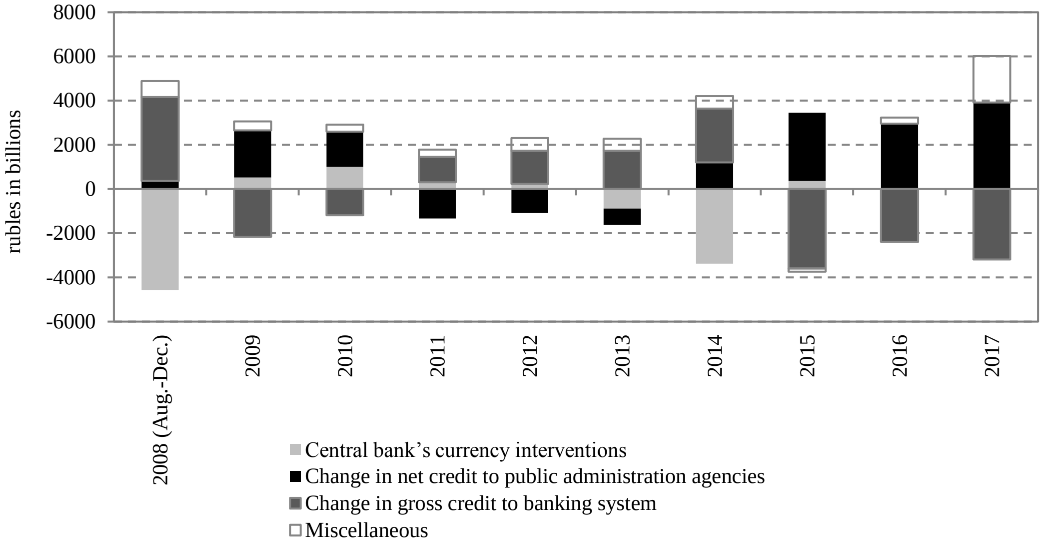


Fig. 5. Bank of Russia's interest rate band and dynamics of interbank lending market in 2013–2017

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



Note: No data on Russian central bank's currency interventions and balance sheet were available for 2017 at the time of this paper.

Fig. 6. Key factors that influenced monetary base (broad definition) in 2008–2017

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

Banks' deposits in the Bank of Russia that tripled to RUB 2373.2 billion were definable as fastest growing components of the broad monetary base as of 2017 year-end. That was associated with liquidity surplus in the banking sector and banks' low readiness to provide loans to other banks and companies due to persisting high risks and uncertainty surrounding Russia's economic development in years to come. Cash in circulation advanced 8.5 percent to RUB 9539.0 billion, correspondent accounts were up 5.9 percent to RUB 1930.7 billion as required reserves picked up 4.4 percent to RUB 506.2 billion. The Bank of Russia issued bonds worth RUB 352.4 billion. Overall, surplus reserves[1] doubled to RUB 4656.3 billion in 2017. (*Table 3*).

Table 3

Broad monetary base dynamics of 2017, rubles in billions

	January 1, 2017	April 1, 2017	July 1, 2017	July 1, 2017	January 1, 2018
Monetary base (broad definition)	11,882,7	11543,5	11596,4	12916,2	14701,5
- cash in circulation including cash in vaults of credit institutions	8,789,8	8394,9	8752,7	8895,1	9539,0
- correspondent accounts of credit institutions with the Bank of Russia	1,822,7	2143,9	1675,3	2225,0	1930,7
- required reserves	484,7	510,5	509,7	536,7	506,2
- deposits of credit institutions with the Bank of Russia	785,5	494,2	658,6	1109,8	2373,2
- Bank of Russia's bonds held by credit institutions	0	0	0	149,7	352,4
For reference: surplus reserves	2608,2	2638,1	2333,9	3484,5	4656,3

Source: Bank of Russia.

The Bank of Russia added USD 55 billion (14.6 percent) to its 2017 year-end international reserves that totaled USD 432.7 billion as of the beginning of 2018 (*Fig. 7)*. Russia's foreign exchange reserves increased USD 38.5 billion (12.1 percent). Note that the increase in foreign exchange reserves was in part due to foreign exchange purchases by the Russian Ministry of Finance in the internal foreign exchange market, a total of about RUB 827.7 million as of 2017 year-end (36.8 percent of the increase in foreign exchange reserves), and banks' repayment of their debt to the central bank (USD 7.9 billion as of 2017 year-end, or 20.5 percent of the increase in foreign exchange reserves). In 2017, Russia added USD 16.5 billion (27.3 percent) to its monetary gold reserves since the beginning of the year, due to positive revaluation (USD 7.4 billion) of the reserves in 2017 despite the fact that gold prices declined in the global market in some months of 2017. As a result, as of January 1, 2018, the foreign exchange reserves accounted for 82.3 percent of the total reserves (84.1 percent in 2016) and gold represented 17.7 percent (15.9 percent in 2016). Today, Russian reserves are sufficient to ensure a sustainable balance of payments in Russia because they cover both 16 months of imports of goods and services into Russia (17 months in 2016) and external debt repayments that fall due in 2018.

[1] Surplus reserves in the banking system comprise deposits of credit institutions with the Bank of Russia and correspondent accounts of credit institutions with the Bank of Russia, as well as Bank of Russia bonds held by credit institutions.

Fig. 7. Dynamics of monetary base (narrow definition) and Russia's foreign currency and gold reserves (international reserves) in 2008-2017

Source: Bank of Russia.

In 2017, M2 increased monthly by an the average of 10.3 percent (7.4 percent in 2014, 6.5 percent in 2015, 11.3 percent in 2016). In 2017, the annualized monetary base saw an average increase of 11.2 percent. As a result, the money multiplier (the M2 to monetary base ratio) remained almost unchanged, 3.2 compared to 3.3 in 2016 (3.2 in 2014, 3.3 in 2015). The money multiplier value equals the average for emerging economies (Ukraine, Belarus, Kazakhstan), whereas it tends to vary within a range of 5–8 in developed countries. Note that East European countries saw their money multiplier rise over the past two decades as their banking system advanced further. In Poland, for example, the money multiplier advanced to 5.7 from 3.1 in the period between 1993 and 2017.

According to preliminary estimates, the level of monetization of the Russian economy (the M2 to GDP ratio) in the period between 1999 and 2017 tripled to 59.4 percent in 2017, reaching the ratio seen in Central and East European countries that are traditionally characterized by higher degree of monetization. In Poland, for example, the M2 to GDP ratio in 2016 stood at 68.1 percent (40.2 percent in 1999). In contrast, the M2 to GDP ratio in the same period increased by 2.2 times to 36.0 percent in Belarus, by 3.1 times to 42.4 percent in Kazakhstan, by 2.8 times to 46.3 percent in Ukraine. Developed countries had even higher GDP monetization owing to a more advanced financial system: in 2016, for example, the M2 to GDP ratio reached 142.5 percent in the United Kingdom, 190 percent in Switzerland.

2.1.3. Inflationary developments

Inflation in Russia stood at 2.5 percent at 2017 year-end, way below the value (5.4 percent) seen in 2016. In January-December 2017, the inflation rate continued to slide to 2.5 percent from 5.0 percent, with just a minor spike in June (*Fig. 8*). Furthermore, the target rate was for the first time achieved in mid-May 2017, and the Russian economy saw a deflation of –0.5 percent in August and -0.1 percent in September 2017, for the first time since August 2011. Inflationary developments slowed on the back of ruble appreciation, good crop as well as a moderately tough monetary policy of the Bank of Russia. As a result, the inflation rate was down to a level surpassing the previous year's all-time low.

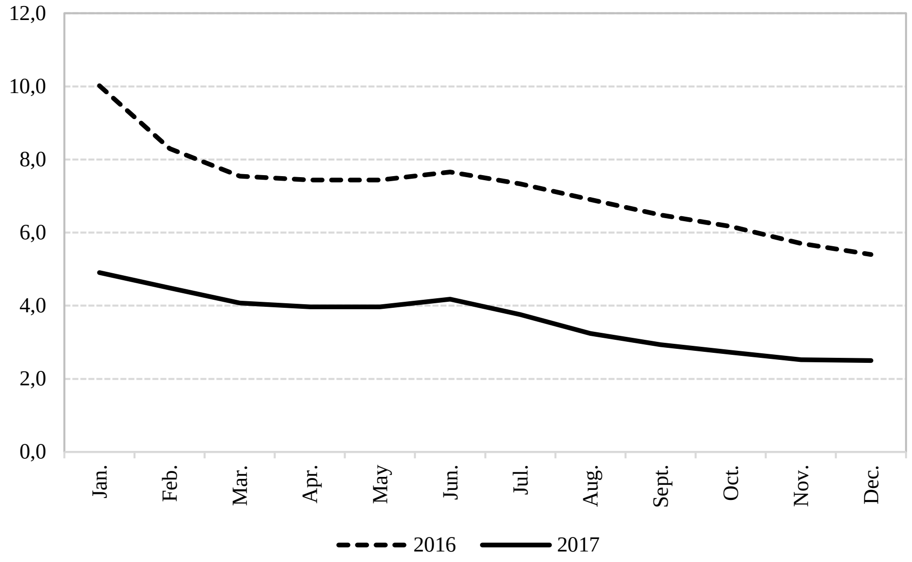


Fig. 8. CPI growth rate in 2016–2017, % change over the last 12 months

Source: Rosstat; Gaidar Institute's calculations.

As shown in *Table 4*, the deceleration of inflation in 2017 was driven by price movements for foodstuff products, a decline of 1.1 percent in December 2017 over December 2016 compared with 4.6 percent in December 2016 over December 2015 (*Fig. 9*). For instance, the industry saw a deflation in July-September 2017 (down 1 percent in July, 1.8 percent in August, 0.7 percent in September) driven mostly by falling prices of fresh fruit and vegetables (down 8.3 percent in July, 15.5 percent in August, 6.9 percent in September) because of a record-high crop. Note that a similar slump of foodstuff prices (down 1.7 percent) was seen only in August 2003, with a 7.2 percent fall of prices for fresh fruit and vegetables. Prices of foodstuff products in December 2017 over December 2016 were pushed up by increase in prices for butter (up 9.6 percent), milk and dairy products (up 5.2 percent), fish and seafood products (up 3.8 percent), alcoholic beverages (up 2.9 percent).

Non-foodstuff price growth decelerated from 6.5 percent in December 2016 over December 2015 to 2.8 percent in December 2017 over December 2016. The deceleration of inflation was led primarily by prices of home appliances (down by an average of 2.3 percent in December 2017 over December 2016) and medicines (down 3.4 percent in December 2017 over December 2016) that were dragged down by the ruble's appreciation given a large proportion of non-foodstuff imports. Note that prices of tobacco products (up 8.6 percent) and motor gasoline (up 7.3 percent) rose at higher rate than other products of this group due to heightened excise duties.

In December 2017, prices of paid services to individuals increased 4.4 percent over December 2016. The major contributors to the increase in prices of paid services were educational services (up 7.5 percent), passenger transport services (up 6.8 percent), early childhood educational services (up 5.2 percent), medical services (up 5.0 percent), communication services (up 4.7 percent).

The core inflation, an indicator excluding changes linked to seasonal and administrative factors, was on a smooth slide in 2017, from 5.5 percent year-on-year in January 2017 to 2.1 percent in December 2017, thus evidencing that the deceleration of inflation in 2017 was overall resistant to temporary factors.

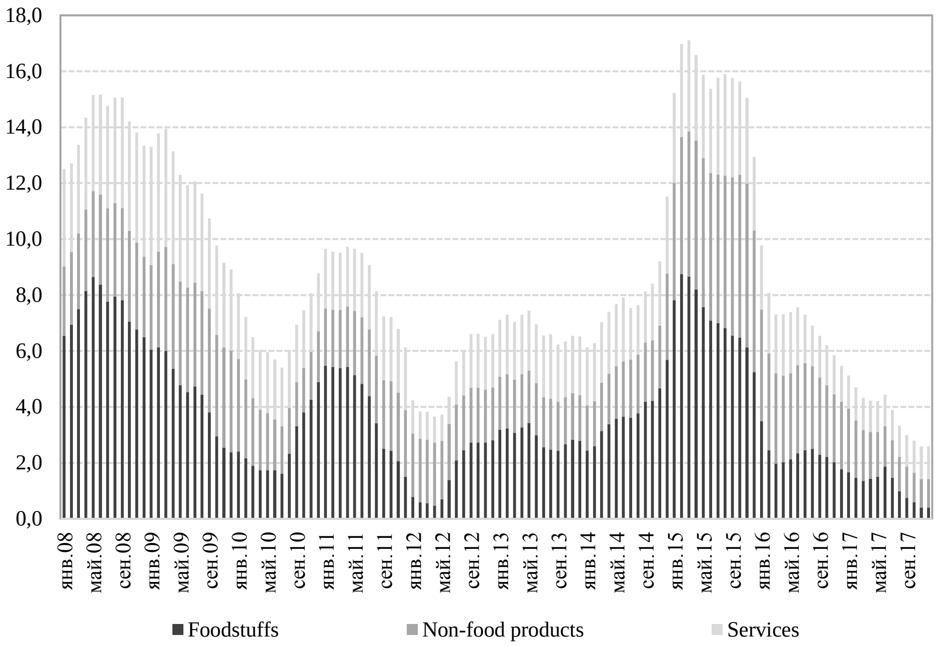


Fig. 9. Structure of inflation in 2008–2017, percent change compared to the previous year's month

Source: Rosstat, Gaidar Institute's calculations.

Household inflation expectations continued to fall in 2017. The median one-year ahead expected inflation rate was down from 10.9 percent in January to an all-time low (during the period of monitoring) of 8.7 percent in November and December 2017, according to InFOM's survey published by the Bank of Russia. Bank of Russia's estimates based on the data from respondents of an inflation expectation survey is another evidence of declining household inflation expectations. The inflation probability in December was estimated 2.4 percent, down 2.2 percentage points from the value recorded in January.[1] Note that the median one-year ahead expected inflation rate in January-November 2017 was higher than the actual inflation rate seen over the past 12 months by 5.8–7.1 percentage points. Overall, relatively heightened inflation expectations, including their unstable and sluggish nature, was a headwind to the transition

[1] The Bank of Russia Bulletin "Inflation Expectations and Consumer Sentiment", No. 8 August 2017.

from a tight to a neutral monetary policy. Note, however, that the fact that inflation expectations are higher than the target inflation rate is typical of both developed and developing countries. It's therefore unlikely that inflation expectations will slip to 4%. Inflation expectations in 2018–2019 will probably reach a steady-state level thus allowing the Russian central bank to switch to a neutral monetary policy.

Note that consumer demand recovery on the back of real wage increase amid decelerating inflation remained a source of risks of inflation. The retail trade turnover increased since April 2017 (for the first time since December 2014) to an average of 1.9 percent year-on-year in April-November, most likely due to the growth in consumer lending. Another source that can possibly boost inflation in the next few months is persisting uncertainty about external environment for the Russian economy; in particular, the oil market remains unstable, and capital inflows into Russia can be decreased if the Federal Reserve tightens its monetary policy along with a key interest rate cut in Russia.

Table 4

Annual growth rate of prices for certain consumer goods and services in 2015–2017, % change, December over December

	2015	2016	2017	2015–2017
CPI	**12.9**	**5.4**	**2.5**	**22.0**
Foodstuff products	**14**	**4.6**	**1.1**	**20.6**
Butter	10.6	20.5	9.6	46.1
Fish, other seafood and products thereof	20.9	8.6	3.8	36.3
Sunflower oil	37.2	3.4	-8.6	29.7
Milk and dairy products	11.5	9.5	5.2	28.4
Pasta-based food products	19.5	4.5	-0.7	24.0
Bread and bakery products	13.2	5.9	2.7	23.1
Alcoholic beverages	10.7	6.4	2.9	21.2
Fresh fruits and vegetables	17.4	-6.8	1.2	10.7
Grains and legumes	15.5	6.4	-13	6.9
Meat and poultry	4.3	1.6	-2.3	3.5
Eggs	9.8	-0.7	-14.2	-6.5
Nonfoodstuff products	**13.7**	**6.5**	**2.8**	**24.5**
Tobacco products	26.6	17.8	8.6	62.0
Textiles	19.7	7.6	3.7	33.6
Washing and cleaning agents	22.4	6.3	0.6	30.9
Footwear	15.1	9.2	4	30.7
Textile goods	13	7.5	3.3	25.5
Clothing and underwear	12.8	7.3	3	24.7
Medicines	19.6	4.9	-3.4	21.2
Motor gasoline	4.8	3.8	7.3	16.7
Services	**10.2**	**4.9**	**4.4**	**20.7**
Early childhood educational services	16.8	9.3	5.2	34.3
Passenger transport services	10.7	6.6	6.8	26.0
Medical services	11.1	7.8	5	25.8
Educational services	8.7	4.9	7.5	22.6
Utility services	10.1	5.4	4.6	21.4
Communication services	2.9	3.7	4.7	11.7

Source: Rosstat.

We finally compare Russia's consumer price growth rates with those of other countries (*Table 5*).

Table 5

Consumer price index dynamics of various countries in 2015–2017, percent a year

	2015	2016	2017	2015–2017
Azerbaijan	7.6	15.7	12.9	40.6
Armenia	-0.1	-1.1	2.6	1.4
Belarus	12.0	10.6	4.6	29.6
Kazakhstan	13.6	8.5	7.3	32.3
Kyrgyzstan	3.4	-0.5	3.7	6.7
Moldova	13.6	2.4	7.3	24.8
Russian Federation	*12.9*	*5.4*	*2.5*	*22.0*
Tajikistan	5.0	6.1	6.7	18.9
Ukraine	43.3	12.4	13.7	83.1
Germany	0.2	0.5	1.7	2.4
France	0.0	0.2	1.2	1.4
United States	0.1	1.3	2.1	3.5
The Netherlands	0.6	0.3	1.3	2.2

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

The Russian Federation ranked 1st among CIS countries with slowest consumer price growth rates at 2017 year-end. Ukraine and Azerbaijan ranked 1st and 2nd, respectively, among CIS countries with highest rates of inflation (13.7 and 12.9 percent, respectively). While the 2016 inflation rate in Russia averaged 16 times the inflation rate in developed countries, in 2017 Russia had consumer price growth rates comparable with developed countries (1.7 percent in Germany, 2.1 percent in the United States). Given the said risks and the ongoing inflationary dynamics, inflation can be expected to gear up in the first half of 2018, but it's highly likely that inflation will stay at about 4 percent, similar to the target inflation set by the Russian central bank.

2.1.4. Balance of payments and ruble exchange rate

In 2017, the Russian ruble appreciated substantially in nominal and real terms against national currencies of Russia's trade partners. In nominal terms, the ruble posted a 14.7 and 12.6 percent y-o-y annual average gain against the US dollar and the euro, respectively. The ruble nominal effective exchange rate against foreign currencies advanced 15.5 percent in 2017, which, given the consumer price dynamics deceleration to a historical low, became the key factor of ruble's 15.9 percent appreciation in real terms by 2016 (*Fig. 10*).

The ruble's appreciation in 2017 was determined mostly by rising energy prices in the global markets. At the same time, notwithstanding the continuing close correlation between crude oil prices and the ruble exchange rate, the 2017 average intramonth volatility of the US dollar and Euro exchange rate against the Russian ruble[1] fell furhter to 1 percent (compared with previous year's 1.6 percent) and to 1.1 percent (compared with 1.8 percent a year earlier), respectively. Note that the ruble exchange rate was generally in line with the dynamics of currencies of developing countries and of primary commodities' exporting countries, although the ruble appreciated at substantially high rates (*Fig. 11*, *12*).

Data for the 2017 Balance of Payments show that the current account surplus increased considerably over 2016. At the same time, private capital net ouflow increased mostly because Russian banks slimmed their foreign liabilities.

[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.

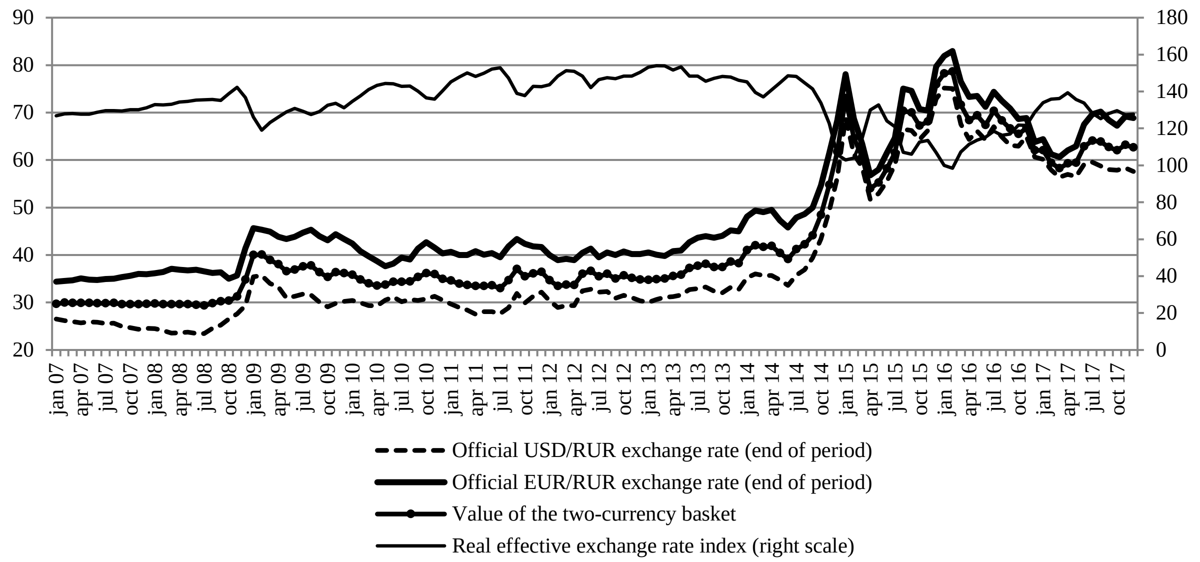
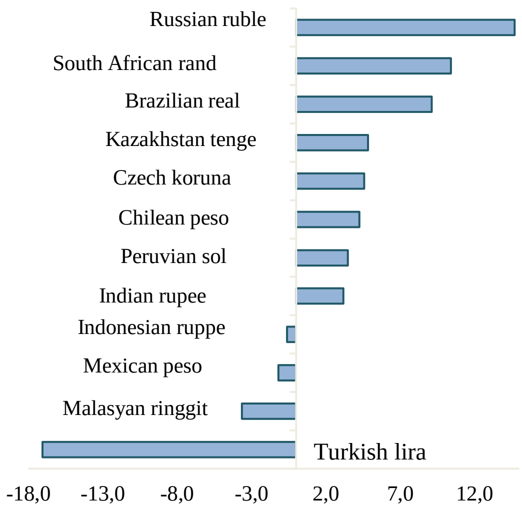
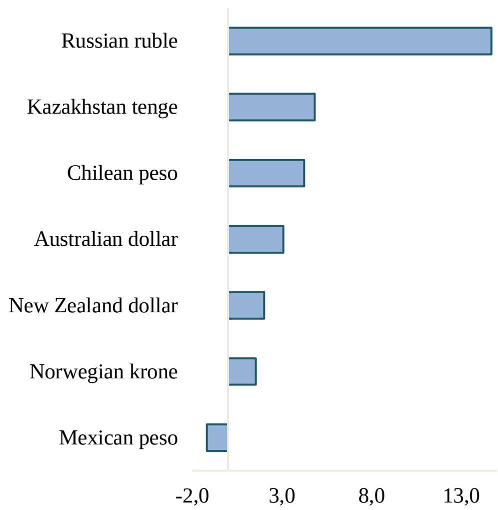


Fig. 10. Dynamics of Russian ruble exchange rate, 2003–2017

Sources: Bank of Russia, own calculations.





Note: The signs "+"and "-" denote appreciation and depreciation, respectively, of a national currency against the US dollar.

Fig. 11. Dynamics of nominal exchange rate for developing countries' currencies in 2017, percent change year over year

Fig. 12. Dynamics of nominal exchange rate for primary commodities' exporting countries in 2017, percent change year over year

Sources: data posted on central banks' official websites, own calculations.

According to Bank of Russia's preliminary data on the 2017 Balance of Payments, the current account balance ran at USD 40.2 billion, gaining 58 percent (or USD 14.7 billion in absolute terms) over 2016.[1]

The balance of trade in goods reached USD 115.8 billion, adding 28 percent, USD 25.5 billion in absolute terms, to the value (USD 90.3 billion) seen in 2016 (*Fig. 13*). The pivotal contribution came from increased exports, up 26 percent in value terms, USD 71.9 billion in absolute terms, from USD 281.8 billion in 2016 to USD 353.7 billion in 2017, governed by heightened average annual crude oil prices amid stable supplies in volume terms (crude oil export prices averaged ~USD 364 a ton in January-November 2017, whereas in 2016 they stood at an average of USD 289 a ton). That also pushed average annual prices for refined petroleum products (export prices of refined petroleum products averaged ~USD 388 a ton in January-November 2017, whereas in 2016 the average price was USD 295 a ton) and natural gas (export prices of natural gas averaged ~USD 179 TCM in January-November 2017, USD 157 TCM in 2016). Therefore, crude oil, refined petroleum products and natural gas accounted for 55.2 percent of Russia's total exports, adding 0.6 percentage points to the value recorded in 2016 (*Fig. 14*).

Prices for other Russian primary exports rose on the back of further global economic growth and therefore heightened demand for resources such as ferrous metals (up from USD 321 to USD 440 a ton), hard coal (an increase from USD 52 to USD 74 a ton), wheat and meslin (wheat-rye mixture) (up from USD 166 to 176 USD a ton), nonferrous metals (up 10–30 percent for aluminum, copper, nickel).

The balance of trade in goods was also influenced by a 24 percent growth in imports (up USD 46.3 billion in absolute terms) from USD 191.6 billion in 2016 to USD 237.9 billion in 2017, mostly as a result of the ruble's appreciation, leading to a substantial relative fall of costs of imports for Russian economic agents.[2]

In 2017, the balance of trade in services worsened to -USD 30.2 billion, which is (in absolute terms) 27 percent above -USD 23.8 billion seen in 2016. Export of services in 2017 increased 15 percent to USD 58.1 billion from USD 50.6 billion mostly due to inbound tourism and transport services as import of services gained 19 percent to USD 88.3 billion from USD 74.4 billion, mostly on the back of outbound tourism, transport services and other types of business services, with the latter surpassing the former both in relative and absolute terms. If the ruble's real effective exchange rate continues to appreciate, import of services would continue to outpace export of services, and therefore a negative balance of import of services would further deteriorate. However, since the ruble's appreciation may be led mostly by increasing prices for primary export items, such a deterioration is known to be offset by increase in the trade in goods balance.

Both the investment income balance and the compensation of employees balance underwent minor changes in 2017, with the former down USD 0.7 billion (from -USD 2.2 billion to - USD 2.9 billion) as the latter dropped USD 2.8 billion (from -USD 32.5 billion to - USD 35.3 billion). Like in 2016, the rent balance in 2017 came out to be zero as the secondary income balance contracted to -USD 7.2 billion (-USD 6.3 billion in 2016).

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[1] See A. Bojechkova, A. Knobel, P. Trunin. Russia's Balance of Payments of 2016 // Russian Economic Developments. 2017. Vol. 24. No. 2. PP. 3–6.

[2] For more details on the exchange rate influence on trade see A. Knobel, A. Firanchuk. Specifics of Russia's exports and imports in January-August 2017 //Economic Development of Russia. 2017. Vol. 24. No. 11. PP. 12–18.

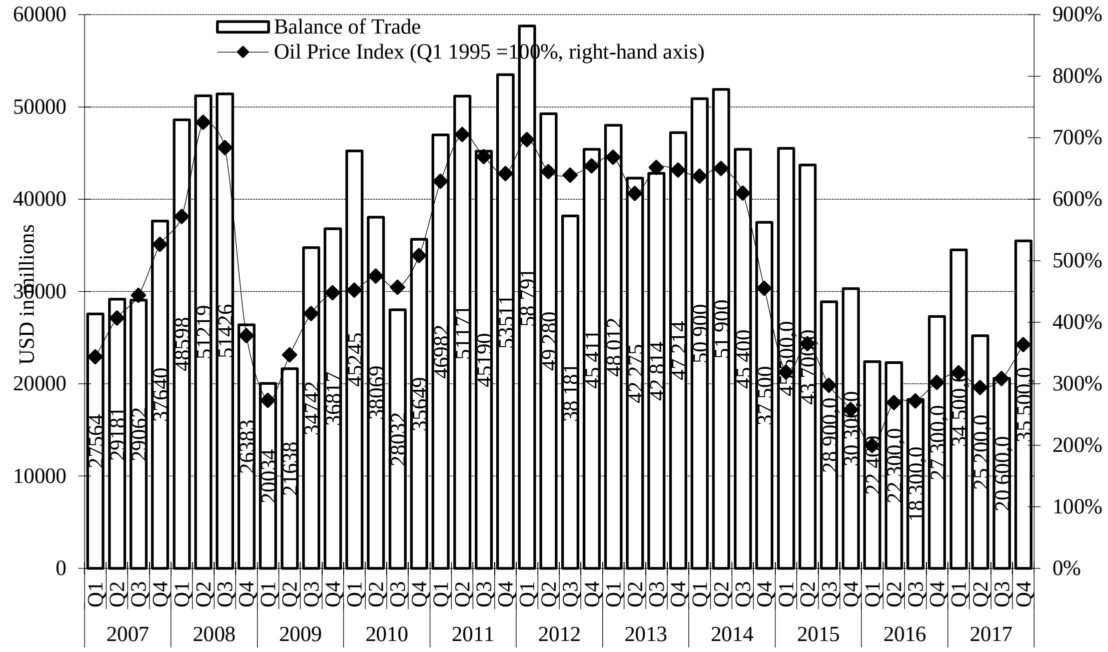

Fig. 13. Russia's balance of trade and global oil price index in 2006–2017

Sources: Bank of Russia, own calculations.

Therefore, the trade in services balance and the trade in goods balance, with the latter being heavily reliant on hydrocarbon price movements, continued to be the principal driver of the amount of the current account balance in the Russian economy.

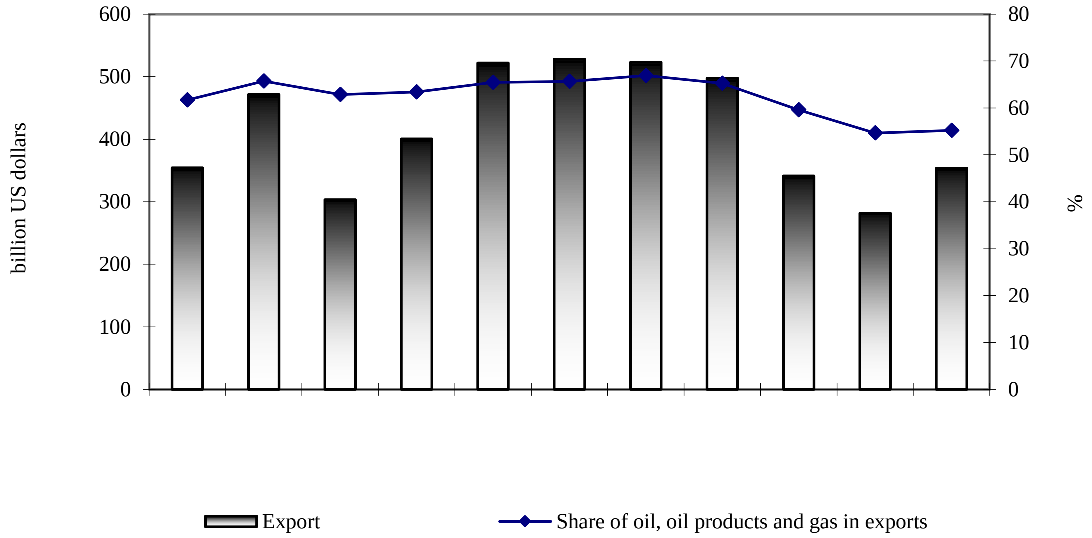

Fig. 14. Dynamics of exports of goods and of percentage share of fuel and energy sector products in 1994–2017

Source: Bank of Russia.

The increase in the current account surplus occurred with a comparable increase in financial account deficit, up USD 21.0 billion in 2017 (up USD 11.9 billion in 2016). In 2017, the non-government sector of the Russian economy saw a net capital outflow of USD 31.3 billion, a 1.6-fold increase over 2016 (*Fig. 15*). The dynamics of capital outflow was driven mainly by banks' transactions. In particular, banks saw a net capital outflow of USD 28.6 billion in 2017, whereas there was an inflow of USD 1.1 billion in 2016. The major contribution to the balance of bank transactions with the rest of the world came from the repayment of banks' foreign liabilities which in 2017 were trimmed by USD 31.4 billion (USD 27.1 billion in 2016) as banks' foreign exchange assets in 2017 were down USD 2.9 billion (USD 28.3 billion in 2016).

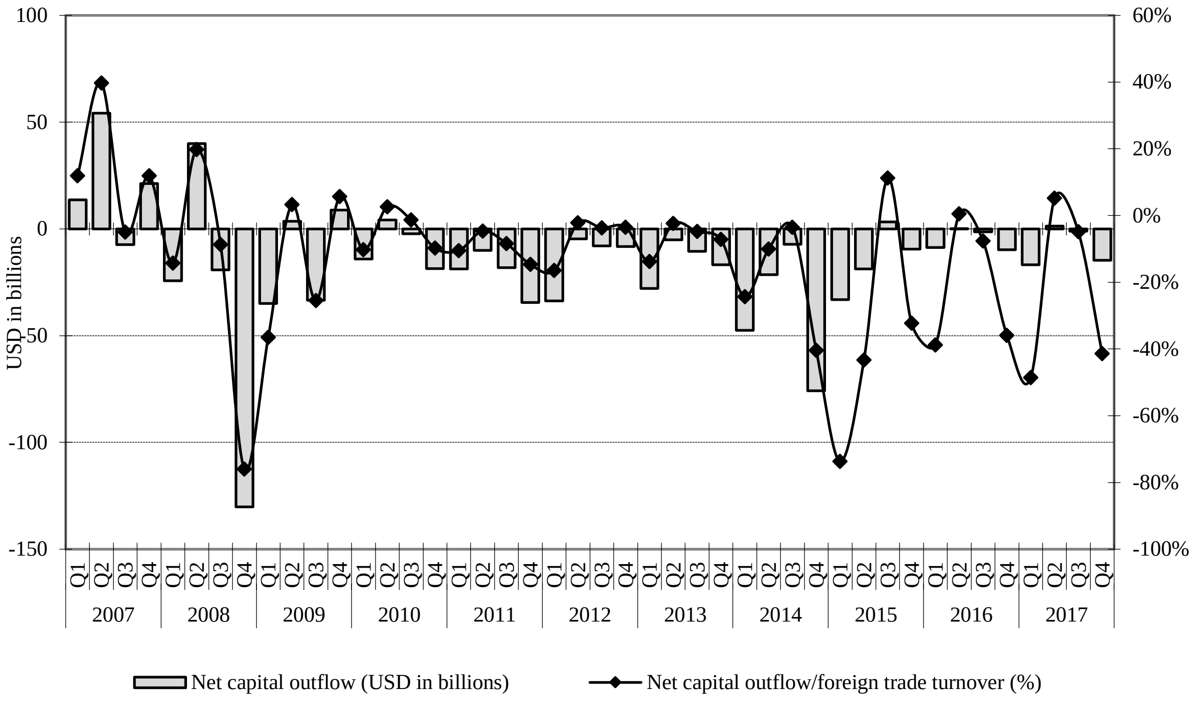

Fig. 15. Private sector's net capital outflows in 2005–2017

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

Meanwhile, other sectors saw a considerable decline in net capital outflow in 2017, down to USD 2.7 billion from previous year's USD 20.9 billion. The non-bank sector's foreign liabilities increased USD 15.7 billion compared with previous year's increase of USD 17.6 billion, mostly on the back of USD 23.2 billion in direct investment (USD 30.9 billion in 2016). At the same time, portfolio investment liabilities decreased by USD 5.9 billion (no changes were recorded in 2016) as total loans and credits dropped USD 1.7 billion (a decrease of USD 12.0 billion in 2016), whereas other liabilities increased USD 0.1 billion (an outflow of USD 1.3 billion in 2016). Overall, positive growth in foreign liabilities was indicative of the fact that the non-bank sector in 2017 managed to raise more funds than was needed for foreign debt repayments. That was also due to non-bank sector's successful foreign debt refinancing despite sanctions-induced limited access to global capital markets. Other sectors' foreign debt increased USD 10.7 billion to USD 354.0 billion (a decline of USD 1.9 billion in 2016). Other sectors' foreign exchange assets increased USD 22.7 billion in 2017 (up USD 34.9 billion in 2016), mainly as a result of outbound foreign direct investments of USD 30.1 billion (USD 20.1 billion in 2016). Other sectors' portfolio investments increased USD 5.0 billion (USD 3.6 billion in 2016).

Note that substantial contribution to the increase in foreign liabilities in 2017 also came from the growth in portfolio investments in liabilities of federal agencies of state administration (USD 15.3 billion in 2017 vs. USD 5.2 billion in 2016). That was due to foreign investors' heightened interest in the Russian Federal Loan Obligations (OFZs) amid a relatively high level of interest rates in Russia. A point to note, however, is that public sector inbound portfolio investments dropped considerably by the end of 2017 (down to RUB 1.2 billion in Q4 2017), probably as a result of weakening foreign investment demand for this type of assets amid lower interest rates in Russia and concerns surrounding an extension of Western sanctions against Russia.

In 2017, Russia saw its external debt increase USD 15 billion to USD 529.1 billion as of January 1, 2018 (*Table 6*). The debt of federal agencies of state administration increased by 1.8 times to USD 55.6 billion as a result of considerable foreign investment in Russian federal bonds (OFZ) was offset by a decline of 20.7 percent to USD 104.5 billion in banks' external outstanding loans.

Table 6

Balance of payments' principal accounts and dynamics of external debt in 2015–2017, USD in billions*

Indicator	2015					2016					2017				
	Q1	*Q2*	*Q3*	*Q4*	*Year*	*Q1*	*Q2*	*Q3*	*Q4*	*Year*	*Q1*	*Q2*	*Q3*	*Q4*	*Year*
Balance of current accounts and of capital accounts	30.0	16.5	7.7	14.5	68.8	12.9	2.0	0.4	10.3	25.5	22.6	2.3	-2.5	17.8	40.2
Financial account (excluding reserve assets)**	37.2	19.3	2.1	11.1	69.8	7.5	-1.7	-1.0	7.1	11.9	11.4	-2.2	-10.2	22.1	21.0
Change in foreign exchange reserves ('–' denotes decrease in reserves)	-10.1	-2.2	9.7	4.3	1.7	2.6	4.4	3.1	-1.8	8.2	11.3	7.5	6.5	-2.7	22.6
Net errors and omissions	-2.9	0.8	4.1	1.0	2.9	-2.8	1.9	1.7	-5.5	-4.6	0.1	3.2	-1.1	1.7	3.8
Change in Russia's external debt ('–' denotes decrease of debt)	-43.5	-0.4	-18.9	-18.0	-80.8	2.1	3.3	-4.3	-6.2	-5.0	11.4	7.1	4.0	-7.6	15.0
Change in Russia's sovereign external debt	-8.1	2.9	-4.1	-1.8	-11.1	1.5	3.9	4.4	-1.2	8.6	6.7	0.7	7.8	1.3	16.5
Change in Russian private sector's external debt	-36.0	-2.3	-15.0	-17.5	-70.9	1.4	-0.4	-8.9	-6.3	-14.2	2.7	3.4	-8.1	-2.2	-4.1

* preliminary estimate.
** excluding foreign currency reserves.
Source: Bank of Russia.

Our capital flight estimate for 2017 year-end (*Fig. 16*) came out to be positive, at a level of USD 6.1 billion (USD 4 billion in 2016).[1]

[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."

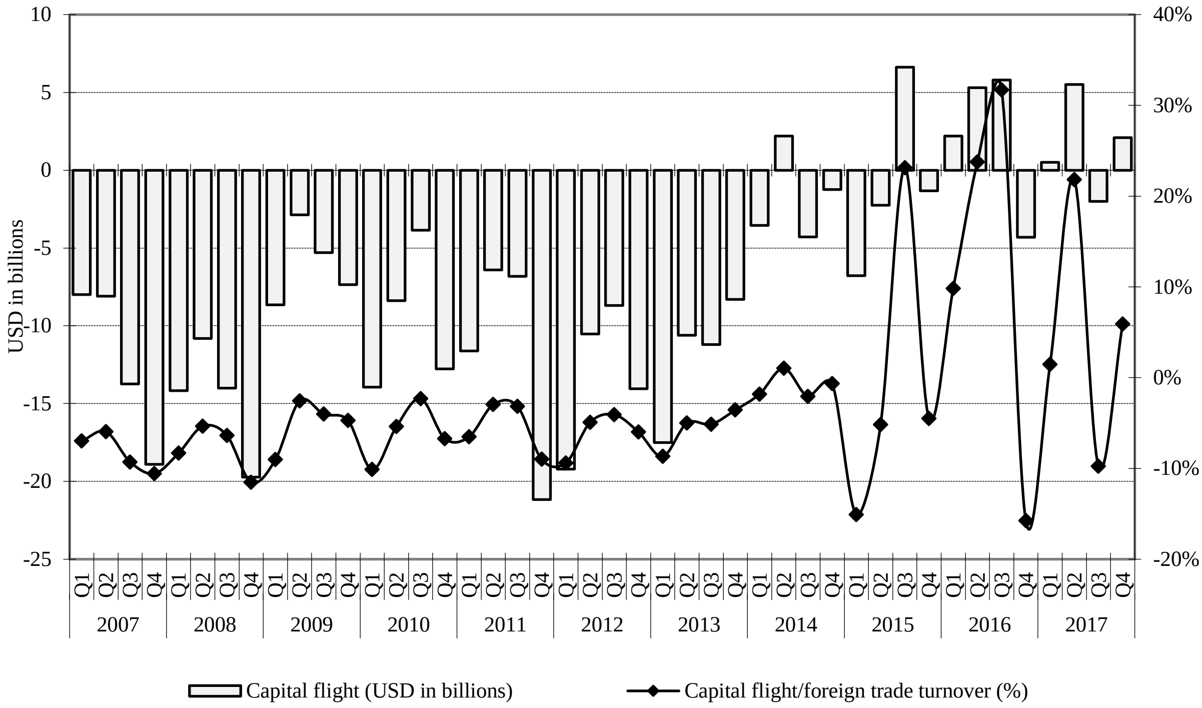

Fig. 16. Capital flight dynamics in 2005–2017

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

If the ongoing trends in the Russian economy and in the global energy market continue further, Russia's Balance of Payments and therefore the ruble's exchange rate will remain stable: a possible growth in the average annual crude oil price will be offset by increased imports as well as Ministry of Finance's much bigger foreign exchange purchases under a new budgetary rule. In addition, the ruble's appreciation will be dampened by a decline in short-term foreign capital inflows as the central bank continues to ease its monetary policy. What should not be left unnoticed, however, is risks that may come from a possible fall of crude oil prices induced by increased output and from new tough sanctions against Russian assets.