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R95 **Russian Economy in 2018. Trends and Outlooks. (Issue 40**) / [V. Mau at al; ed. Editors – Alexei Kudrin, doctor of sciences (economics), Alexander Radygin, doctor of sciences (economics), doctor of sciences Sergey Sinelnikov-Murylev, doctor of sciences (economics)]; Moscow: Gaidar Institute Publishers 2019. – 616 pp. – ISBN 978-5-93255-556-9

The review "Russian Economy. Trends and Outlooks" has been published by the Gaidar Institute since 1991. This is the 40th 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: the socio-political issues and challenges; 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.

Reviewer: Lev Yakobson, Doctor of sciences (economics), professor, first pro-rector, NRU-HSE.

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2.1. Russia's Monetary Policy in 2018[1]

2.1.1. Monetary policy trends

Russia's central bank adopted a new monetary policy regime in 2018 by raising the key interest rate for the first time since December 2014. After slashing the key interest rate on February 9th and on March 23rd by 0.25 percentage points to 7.5 and 7.25 percent per annum, respectively, the central bank lifted the rate on September 14th by 0.25 percentage points to 7.5 percent per annum, with another hike on December 14th of 0.25 percentage points to 7.75 percent per annum.

The transition to a neutral monetary policy regime[2] slowed as far back as in 2017. There were more constraints to interest rate cuts in 2018 that came from new April and August anti-Russia sanctions that spurred capital outflows from the country and depreciation of the Russian ruble, a VAT hike decision scheduled for 2019, a late-year fall in energy prices, and concerns about possible heightening of inflation expectations. The key interest rate hike suggested that the Bank of Russia is committed to bring inflation back down to target in the medium term. For instance, according to a forecast of the central bank, end-of-year inflation for 2019 may reach 5–5.5 percent, and it is not until 2020 that inflation is back to its target.

Another important decision the central bank took in August 2018 besides changes in the monetary policy was a decision to suspend until January 2019 its sales of rubles in the domestic foreign exchange market to purchase foreign exchange for Russia's Finance Ministry in order to comply with the fiscal rule in effect. The goal of the policy was to reduce volatility in financial markets. Amid unfavorable external environment currency interventions could indeed constitute an extra source of pressure on the Russian ruble and spur growth in exchange rate volatility. Decision on the suspended in 2018

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[1] This section was written by A. Bozhechkova, Gaidar Institute, RANEPA; A. Kiyutsevskaya, Gaidar Institute; A. Knobel, Gaidar Institute, RANEPA, VAVT; P. Trunin, Gaidar Institute, RANEPA.

[2] A neutral monetary policy means setting a key interest rate that is suitable for achieving a target inflation rate and a zero output gap. A neutral level of interest rate has neither stimulating nor restraining effect on real economy.

foreign currency purchases in the domestic market will be adopted as soon as they are resumed on a regular basis in January 2019. The suspended foreign currency purchases can be brought into effect, as planned by the central bank, in 2019 and beyond.

Credit terms remained relatively tight despite some surge in inflation and inflation expectations in 2018. For instance, there were months when the real interest rate on corporate loans with maturities less one year that is calculated using actual inflation rate over past 12 months was equal to levels seen late in 2014/early in 2015 (see *Fig. 1*). Maintaining a positive real interest rate in the money market dampens growth in consumption and investment, putting downward pressure on inflation, as well as keeps savings attractive, while posing downturn risks for the economy.

Fig. 1. Real interest rate on corporate loans with maturities of less than one year in Russia, 2011–2018, percent per annum[1]

In 2018, the real rate of interest under the monetary policy in place remained one of the highest in the world (see *Fig. 2* and *Table 1*). The 2018 year-end key interest rate stood at 3.5 percentage points above inflation.

Table 1

Inflation and key interest rate in developed and developing countries (2018 year end)*

	Actual rate of inflation	Key interest rate
1	2	3
Developing countries		
Poland	1.19	1.5
Peru	2.19	2.75
India	2.19	6.5
Chile	2.57	2.75
Hungary	2.71	0.9
Indonesia	3.13	6

[1] Real interest rate is measured using inflation data for the previous 12 months, assuming that inflation expectations in Russia are adaptive.

Cont'd

1	2	3
Columbia	3.18	4.25
Brazil	3.75	6.5
Russia	**4.27**	**7.75**
South Africa	4.4	6.75
Mexico	4.83	8.25
Kazakhstan	5.3	9.25
Turkey	20.3	24
Developed countries		
E.U.	1.6	0
Australia	1.8	1.5
New Zealand	1.9	1.75
U.S.A.	1.91	2.5
Canada	1.99	1.75
U.K.	2	0.75
Czech Republic	2.02	1.75
Norway	3.49	0.75
Iceland	3.74	4.5

* Data for 2018 inflation are defined on a December to December basis, data for 2018 key interest rate are defined on a year-end basis.
Source: data from central banks' official websites.

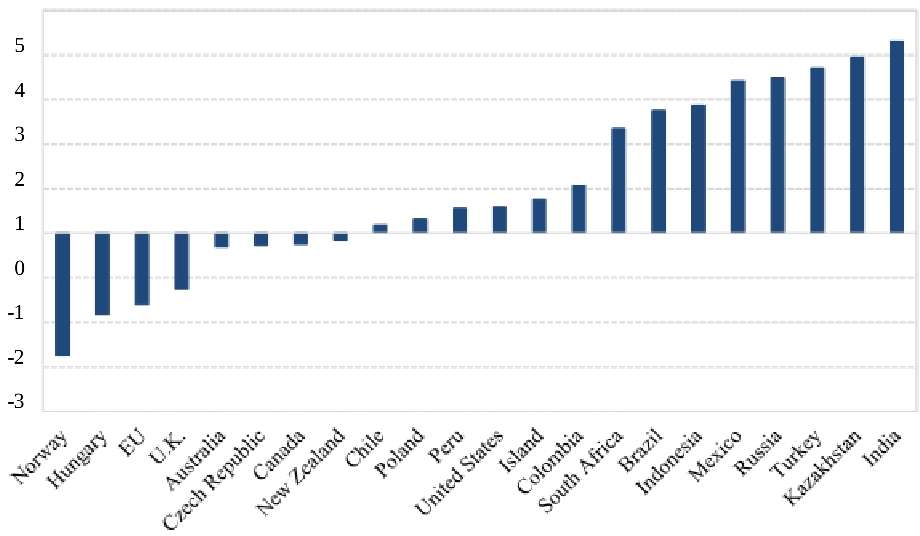

Fig. 2. Real key interest rate as of end-October 2018, percent per annum (measured on the basis of inflation rate over previous 12 months)

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

Thus, faced with old and new extra risks of inflation, as noted above, the Bank of Russia has not yet been able to move to a softer monetary policy. It is not until inflation is at its highest projected for mid-2019 that the Bank of Russian is expected to cut the key interest rate. That said, the emergence of new risks may even further set back efforts to move to a monetary policy easing.

2.1.2. Money market

The money market in 2018 continued to operate against a backdrop of banking sector liquidity structural surplus[1] that emerged as far back as in 2017 as a result of liquidity creation through spending from sovereign wealth funds as well as Bank of Russia's rescue policies applied to a few banks. It is against this background that the Bank of Russia introduced polices directed towards providing less liquidity to banks and broadening liquidity absorption. The liquidity surplus increased in 2017 from – RUB 0.7 trillion to RUB 2.6 trillion, with a RUB 4.5 trillion rise in January/first half of August 2018. The liquidity structural surplus started declining since the second half of August to reach RUB 2.7 trillion by the end of December as a result of Bank of Russia's decision to suspend until late in the year buying foreign currency in the domestic foreign exchange market in conformity with the fiscal rule in place.

In 2018, one-week deposit auctions were one of the most sought-after monetary policy instruments amid liquidity surplus in the banking sector. An average of RUB 2.6 trillion were raised in 2018, whereas the 2017 fundraising was RUB 1.0 trillion or less. The Bank of Russia also increased the frequency of deposit auctions "fine tuning" so that interest rates in the money market are close to the key interest rate.

In 2018, the central bank increased the placement of Bank of Russia coupon bonds (coupon OBRs) with 3 months to maturity. Outstanding coupon OBRs in 2018 rose from RUB 0.4 trillion to RUB 1.4 trillion, hitting highs in October 2018 (RUB 1.8 trillion). As a reminder, the Bank of Russia started issuing coupon OBRs in August 2017. According to our estimates, coupon OBRs helped absorb around one third of the amount that would have been accumulated by the banking sector if absorbing operations had not been in place.

Note that the Bank of Russia projects that the banking sector will continue to experience liquidity surplus for three years to come. Amid structural liquidity surplus in 2018 credit institutions increased their liabilities to the Bank of Russia. The 2018 year-end amount of loans, deposits and other funds raised by credit institutions were up 29.3 percent to RUB 2.6 trillion (compared to a 4-fold decline to RUB 2.0 trillion in 2017) (see *Fig. 3, Table 2*). It appears that credit institutions' liabilities to the central bank is due to the fact that liquidity surplus that is identified at the macro-level is not typical of each bank taken separately. In this context, banks that are faced with liquidity deficit show demand for central bank funding.

In 2018, loans secured with non-marketable assets (RUB 403 billion on average) prevailed in the structure of central bank's claims on the banking sector, while banks' liabilities on REPO auctions in the same period averaged as little as RUB 4.5 billion.

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[1] The structural surplus is described as stable liquidity surplus at credit institutions and the necessity for the Bank of Russia to carry out liquidity-absorbing operations with the aim to maintain interest rates in the interbank lending market close to the key interest rate.

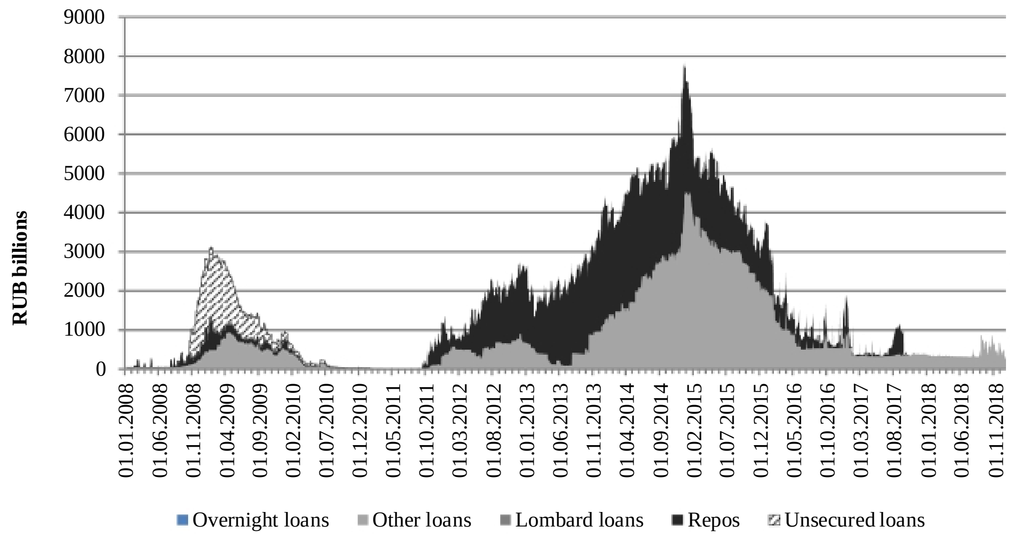

Fig. 3. Commercial banks' ruble-denominated liabilities (on key instruments) to Bank of Russia in 2008–2018

Source: Bank of Russia.

Table 2

Bank of Russia Balance Sheet 2016–2018

	January 1, 2017		January 1, 2018		December 1, 2018	
	RUB billions	**as a percent of assets / liabilities**	**RUB billions**	**as a percent of assets / liabilities**	**RUB billions**	**as a percent of assets / liabilities**
Funds placed with nonresidents and securities issued by nonresidents	18.005.1	62.1	18878.5	61.3	23242.1	61.6
Credits and deposits	4.175.1	14.4	3517. 8	11.4	3928.2	10.4
Precious metals	3.747.5	12.9	4505.2	14.6	5594.5	14.8
Securities	528.9	1.8	886.1	2.9	948.2	2.5
Other assets	1.013.4	3.5	1535.7	5.0	2316.8	6.1
Total assets	**28.974.1**	100.0	**30.815.1**	100.0	**37.702.3**	100
Cash in circulation	8.790.1	30.3	9539.4	31.0	9788.9	26.0
Balance of accounts with the Bank of Russia	9.985.5	34.5	11003.2	35.7	14698.5	39.0
of which: Russian government funds	4.662.0	16.1	4565.7	14.8	8477.6	22.5
funds of resident credit institutions	3.093.3	10.7	4812.4	15.6	4294.9	11.4
Float	2.8	0.0	0.7	0.0	1.4	0.0
Outstanding securities	-	-	356.8	1.2	1636.7	4.3
Liabilities to IMF	1.392.9	4.8	1.407.8	4.6	1537.8	4.1
Other liabilities	111.4	0.4	120.8	0.4	1653.3	4.4
Capital	8.647.85	29.8	8.386.5	27.2	8385.7	22.2
Profit for accounting FY	43.7	-	-	-	-	-
Total liabilities	**28.974. 1**	100	**30.815.1**	100.0	**37.702.3**	100

Source: Bank of Russia.

Amid structural liquidity surplus the money market interest rate in 2018 varied mostly within a lower boundary of the interest rate band. The interbank loan rate[1] increased in 2018 0.4 percentage points (from 7.1 percent per annum on average in January 2018 to 7.5 percent per annum on average in December 2018). The MIACR in April-August 2018 was at its lowest (7.0 percent) since late in 2014. The MIACR started moving upwards after the central bank decided to raise the key interest rate by 0.25 percentage points. Overall, the interbank loan rate varied during 2018 within the interest rate band set by the central bank, thus suggesting that the regulator achieved the goal of its monetary policy. The average annual MIACR on overnight bank loans denominated in Russian rubles fell to 7.1 percent per annum in 2018 from 8.9 percent per annum in 2017 (see *Fig. 4*).

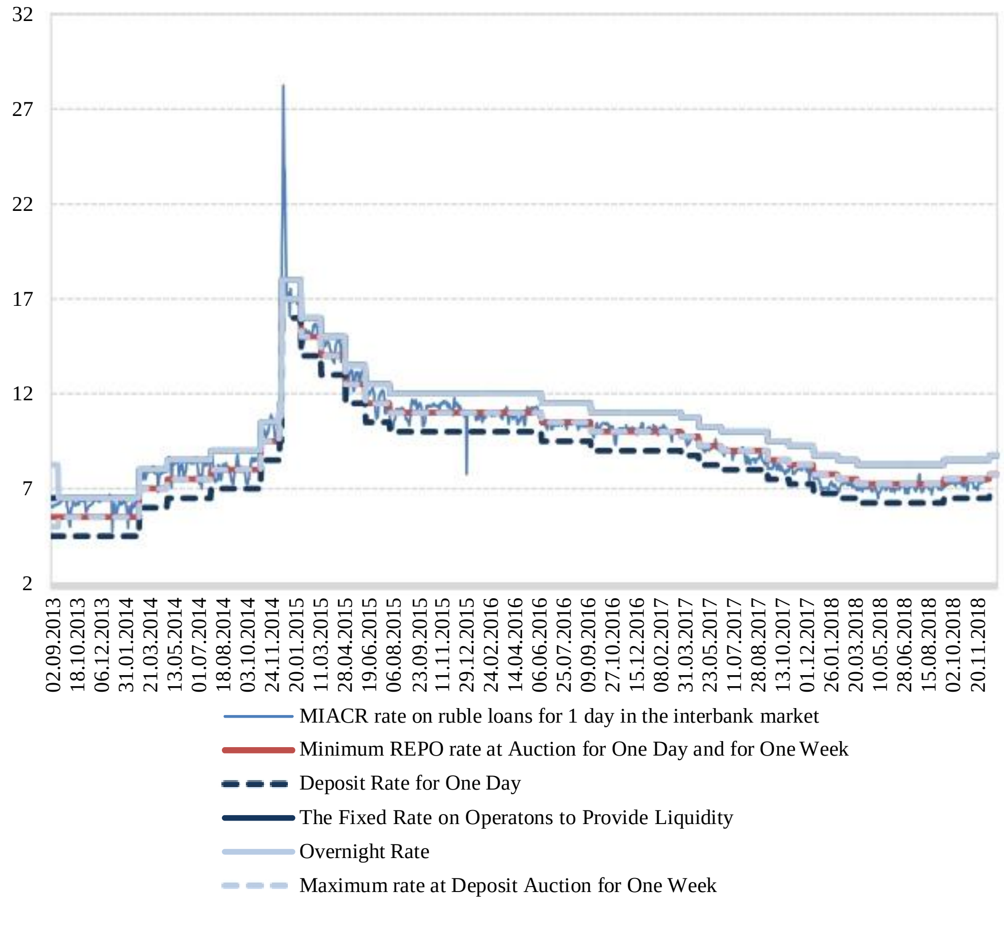

Fig. 4. Bank of Russia's interest rate band and dynamics of interbank lending market in 2013–2018

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

[1] The interbank loan rate is the monthly average MIACR (Moscow InterBank Actual Credit Rate) on overnight interbank loans denominated in Russian rubles.

The accumulation of liquidity surplus in the banking sector influenced the dynamics of the monetary base. The broad monetary base picked up 9.3 percent to RUB 16063.4 billion in 2018 (an increase of 23.7 percent to RUB 14701.5 billion in 2017). Bank of Russia bonds held by credit institutions was one of the broad monetary base components with fastest pace of growth at 2018 year-end that saw a quadruple growth to RUB 1373.9 billion. The required reserves swelled by 13.6 percent to RUB 575.3 billion, cash in circulation advanced 8.1 percent to RUB 10312.5 billion. Banks' deposits with the Bank of Russia dropped 19.8 percent to RUB 1903.5 billion, corresponding accounts slid 1.7 percent to RUB 1898.2 billion. Overall, excessive reserves[1] increased in 2018 by 11.2 percent to RUB 5175.7 billion (see *Table 3*).

Table 3

Broad monetary base dynamics of 2018
(RUB billions)

	April 01, 2017	January 07, 2017	January 07, 2017	January 01, 2018	January 01, 2019
Monetary base (broad definition)	11543.5	11596.4	12916.2	14701.5	16063.4
- cash in circulation including cash in vaults of credit institutions	8394.9	8752.7	8895.1	9539.0	10312.5
- correspondent accounts of credit institutions with the Bank of Russia	2143.9	1675.3	2225.0	1930.7	1898.2
- required reserves	510.5	509.7	536.7	506.2	575.3
- deposits of credit institutions with the Bank of Russia	494.2	658.6	1109.8	2373.2	1903.5
- Bank of Russia's bonds held by credit institutions	0	0	149.7	352.4	1373.9
For reference: excessive reserves	2638.1	2333.9	3484.5	4656.3	5175.7

Source: Bank of Russia.

Like in the 2015–2017 period, the principal sources of accumulation of the broad monetary base in January-November 2018 were changes in the balance on the general government's accounts with the central bank as well as Bank of Russia's liquidity-providing/absorbing operations in the banking sector. For instance, RUB 0.3 trillion were added to the monetary base through increasing central government's net borrowing in January-November 2018, whereas the monetary base shrank by RUB 0.2 trillion as a result of decrease in net volumes of liquidity-providing/absorbing operations. Amid structural liquidity surplus the structure of money supply creation will likely remain unchanged in 2019 as well. Note that operations that the Finance Ministry and the central bank performed in compliance with the fiscal rule were neutral for the monetary policy (see *Fig. 5*). The money the Finance Ministry uses for increasing the National Wealth Fund is brought back to the economy as a result of Bank of Russia's foreign currency purchases.

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

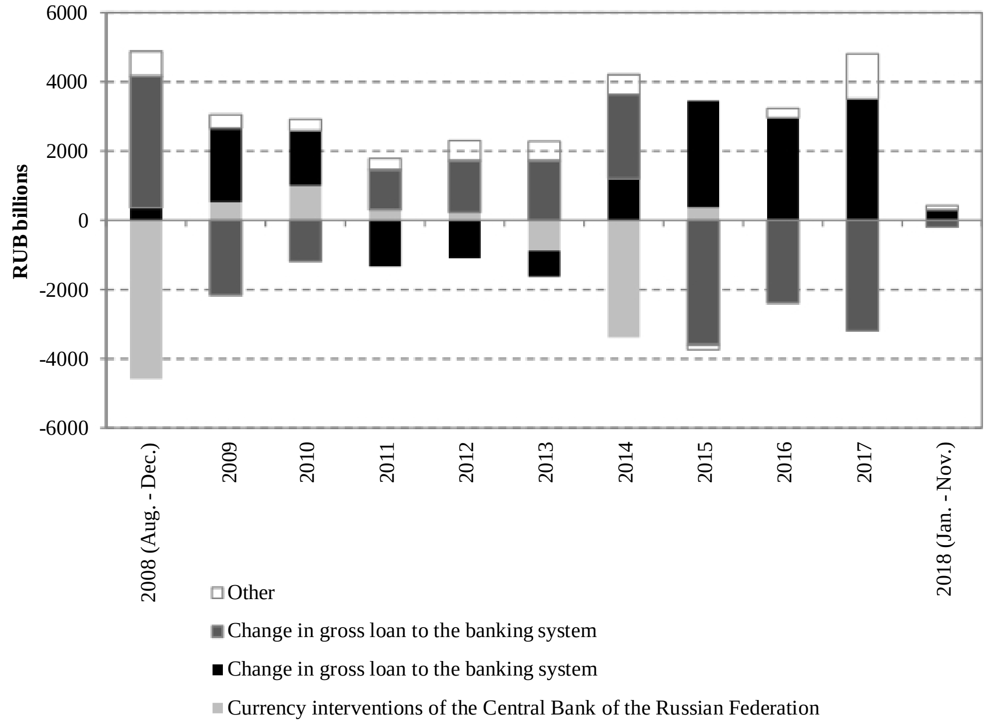

Fig. 5. Factors that influence monetary base

Source: Russia's central bank.

The dynamics of foreign currency reserves in 2018 was almost totally led by volumes of Bank of Russia's foreign currency purchases for the Finance Ministry in conformity with the fiscal rule in place. As a reminder, under the new fiscal rule in effect since early in 2018, extra federal budget revenues that come from a crude oil price that is higher than the actual price of USD 40.8 per barrel shall be converted into foreign currency to feed into the sovereign wealth fund. Such operations, as noted above, were carried out until they were suspended in the second half of August 2018 due to unstable financial markets. In January-August 2018, central bank's foreign currency purchases in the domestic foreign exchange market totaled around RUB 2.1 trillion. As a result, Bank of Russia's year-end international reserves increased USD 35.8 billion (8.3 percent) to USD 468.5 billion as of January 01, 2019 (see *Fig. 6)*. Note that USD 10.3 billion (13.4 percent) were added to the monetary gold reserves on a year to date basis in 2018 despite of their negative revaluation (-USD 10.1 billion) in January-August 2018 due to falling gold prices in global markets. As of January 01, 2019, the proportion of foreign currency reserves accounted for 81.5 percent (82.3 percent in 2017) as gold represented 18.5 percent (17.7 percent in 2017) of gross reserve assets. At present, the reserves are adequate to ensure a stable balance of payments because they cover both 16 months for imports of goods and services in Russia (16 months in 2017) and external debt payments due in 2019. An important point to note is that 2018 saw a major change in the foreign-currency reserves composition: the proportion of Yuan-denominated assets advanced from 0.1 percent in mid-2017 to 14.7 percent in mid-2018, whereas the proportion of assets denominated in US dollars dropped from 46.3 percent in mid-2017 to 21.9 percent in mid-2018. The above change was likely led by the need to minimize potential geopolitical risks. Furthermore, the monetary authorities had to sacrifice dollar-denominated returns on investment because of problems facing China's economy in 2018. The Chinese Yuan weakened against the US dollar.

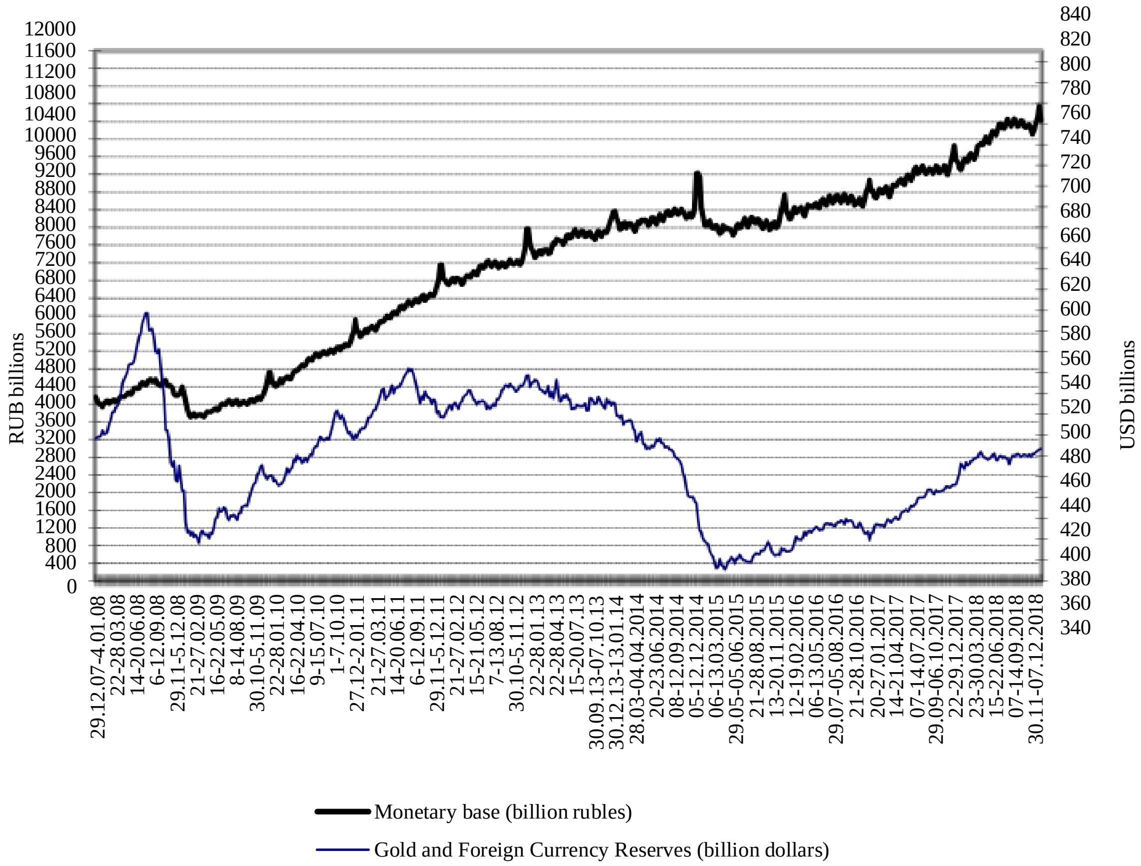

Fig. 6. Dynamics of narrow monetary base and Russia's foreign currency and gold reserves (international reserves) in 2008-2018

Source: Bank of Russia.

In 2018, the year-to-year average monthly growth in M2 and the monetary base was recorded at 11.0 percent (10.2 percent in 2017) and 29.0 percent (11.9 percent in 2017), respectively. As a result, the money multiplier (the ratio of M2 to the monetary base) stood at 2.8 (3.3 in 2016–2017). Such a sharp contraction of the money multiplier was due to faster than normal growth rates in the monetary base spurred by a 4-fold increase in volumes of Bank of Russia bonds held by credit institutions as well as increase in banks' deposits with the central bank (average monthly growth in banks' deposits with the Bank of Russia in 2018 saw a 2.5-fold average monthly growth) in order to absorb liquidity surplus in the banking sector and to maintain market interest rates within a prescribed boundary of the interest rate band. The money multiplier equals the average for emerging economies (such as 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 5.8 from 3.1 in the 1993–2018 period, whereas in Russia it was up to 2.75 from 1.4, hitting its highest in 2015–2016.

According to preliminary estimates, the level of monetization of the Russian economy (the ratio of broad money (M2) to GDP (the M2/GDP ratio)) in the period between 1999 and 2018 tripled to 60.1 percent in 2018, almost 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/GDP ratio in 2017 stood at 66.8 percent (40.2 percent in 1999). By contrast, the M2/GDP ratio in Belarus increased during the same period by 2.3 times to 37.9 percent, by 2.9 times to 37.4 percent in Kazakhstan, and by 2.2 times to 40.5 percent in Ukraine. Developed countries had even higher GDP monetization owing to a more advanced financial system: in 2017, for example, the M2/GDP ratio in the U.K. and Switzerland reached 148.5 and 190 percent, respectively.

2.1.3. Inflation-related processes

After hitting an all-time high of 2.2 percent in January 2018, there was a gradual rise in inflation during the year (see *Table 4*). While the first half of the year saw inflation vary within a range of 2.2–2.5 percent, the second half marked an inflationary spike that was triggered by increase in prices for some groups of food products due to poor crop figures, depreciation of the Russian ruble, and expected VAT rate hike. By the end of November 2018, inflation reached 3.8 percent year-to-year (percentage change over previous 12 months) (versus 2.5 percent at 2017 year-end) (see *Fig. 7*).

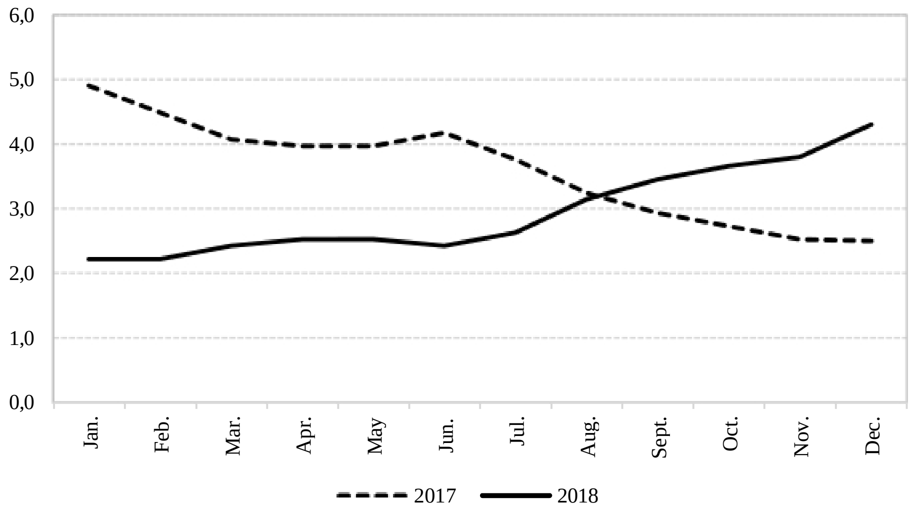

Fig. 7. CPI growth rate in 2016–2018, percentage change over past 12 months

Sources: Rosstat; own calculations.

Table 4

Annual growth rate of prices for selected consumer goods and services in 2015–2018, Dec.-to-Dec. percent change

	2016	2017	2018	2016–2018
CPI	**5.4**	**2.5**	**4.3**	12.7
Food products	**4.6**	**1.1**	**4.7**	10.7
Butter	20.5	9.6	3.6	36.8
Fish and seafood	8.6	3.8	3.7	16.9
Sunflower oil	3.4	-8.6	1.8	-3.8
Milk and dairy products	9.5	5.2	2.9	18.5
Macaroni, noodles and similar farinaceous products	4.5	-0.7	1.4	5.2
Bread and bakery products	5.9	2.7	5.2	14.4
Alcoholic beverages	6.4	2.9	1.3	10.9
Fresh fruits and vegetables	-6.8	1.2	4.9	-1.1
Cereals and legumes	6.4	-13	1.2	-6.3
Meat and poultry	1.6	-2.3	9.7	8.9
Eggs	-0.7	-14.2	25.9	7.3
Nonfood products	**6.5**	**2.8**	**4.1**	14.0
Motor gasoline	3.8	7.3	9.4	21.8
Tobacco products	17.8	8.6	10.1	40.9
Textiles	7.6	3.7	1.7	13.5
Washing and cleaning agents	6.3	0.6	3.1	10.3
Footwear	9.2	4	1.9	15.7
Textile goods	7.5	3.3	2.5	13.8
Clothing and underwear	7.3	3	2.3	13.1
Medicines	4.9	-3.4	4.6	6.0
Services	**4.9**	**4.4**	**3.9**	13.8
Early childhood educational services	9.3	5.2	3.8	19.4
Passenger transport services	6.6	6.8	4.3	18.7
Medical services	7.8	5	4.3	18.1
Educational services	4.9	7.5	8.4	22.2
Utility services	5.4	4.6	3.7	14.3
Communication services	3.7	4.7	2.4	11.2

Source: Rosstat.

There was a 4.7 percent acceleration in food prices in January-December 2018 versus 1.1 percent in 2017 (see *Fig. 8*). Note that in July-September 2018 the food sector experienced a deflation (-1 percent in July, -1.8 percent in August, -0.7 percent in September) that was driven by decline in prices of fresh fruits and vegetables on the back of good crop figures (-5.1 percent in July, -6.4 percent in August, -6.8 percent in September). Inflation acceleration in the food sector in September-December 2018 was due to a 40.3 percent price rise for eggs and 13.8 percent for sugar sand as well as gradually increasing meat and poultry prices during 2018 (9.7 percent up in January-December 2018).

Non-food prices in 2018 picked up 4.3 percent (2.5 percent in 2017). The following products saw most of the price acceleration in January-December 2018: motor gasoline (up 9.4 percent), tobacco products (up 10.1 percent), construction materials (up 4.9 percent) and brown goods and other household appliances (up 3.7 percent). Note that the surge in motor gasoline prices in April-June 2018 stemmed from high crude prices and the April slump in the Russian ruble exchange rate amid tighter anti-Russia sanctions. Overall, the 2018 appreciation of some groups of nonfood products was in a large part due to the effect of ruble exchange rate depreciation pass-through to prices. What is important to note is that, according to Bank of Russia’s estimates, the effect of exchange rate pass-through to prices in 2018 declined to around 0.1, suggesting that the 8.2 percent weakening in the ruble nominal effective exchange rate in January-December 2018 would add 0.82 percentage points to the annual inflation over the immediate 3–6 month horizon.

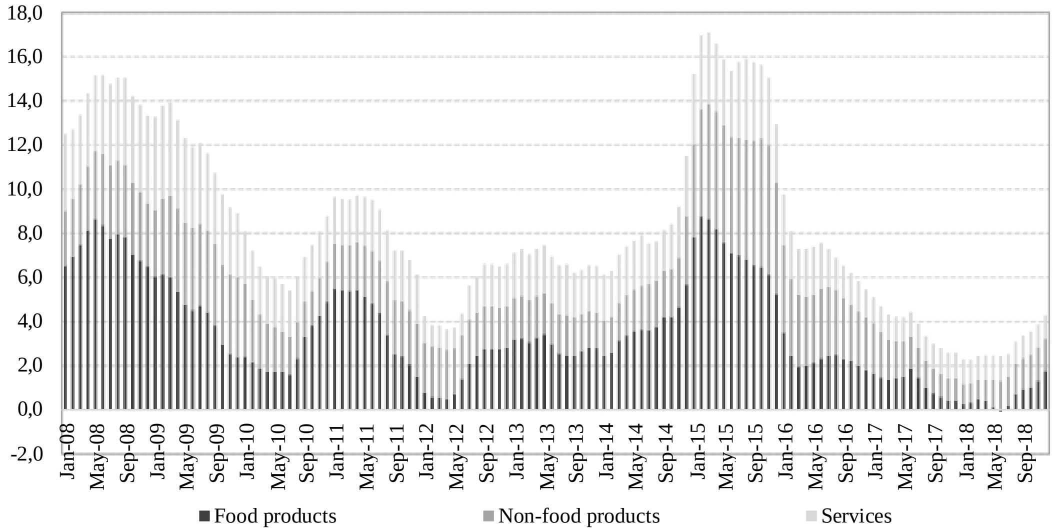

Fig. 8. Inflation structure in 2008–2018, percent change from previous year's month

Sources: Rosstat; own calculations.

Chargeable services to individuals increased 3.9 percent in 2018 (compared to a 4.4 percent rise in 2017). Overall, in January-December 2018, the highest increase in prices due to the ruble depreciation was seen for outbound tourism services (up 9.8 percent).

The 2018 year-end core inflation (an indicator excluding changes linked to seasonal and administrative factors) reached 3.7 percent (versus 2.1 percent in 2017). Note that the core inflation is on the rise since March 2018, thus suggesting that the country is faced with a steady acceleration of inflation.

Individuals' inflation expectations in 2018 followed the actual inflation trajectory. The median one-year ahead expected inflation rate reached 10.2 percent in December 2018 after April's lows (7.8 percent), according to InFOM's survey published by the Bank of Russia (see *Fig. 9*). Not only inflation expectations but also respondents' assessment of actual inflation rate (10.2 percent) remained at high levels. The onset of the 2018 reversal trend in inflation expectations and high risks of their further increase amid plans to raise early in 2019 the VAT and the motor gasoline excise tax became important factors prompting the Bank of Russia to lift the key interest rate.

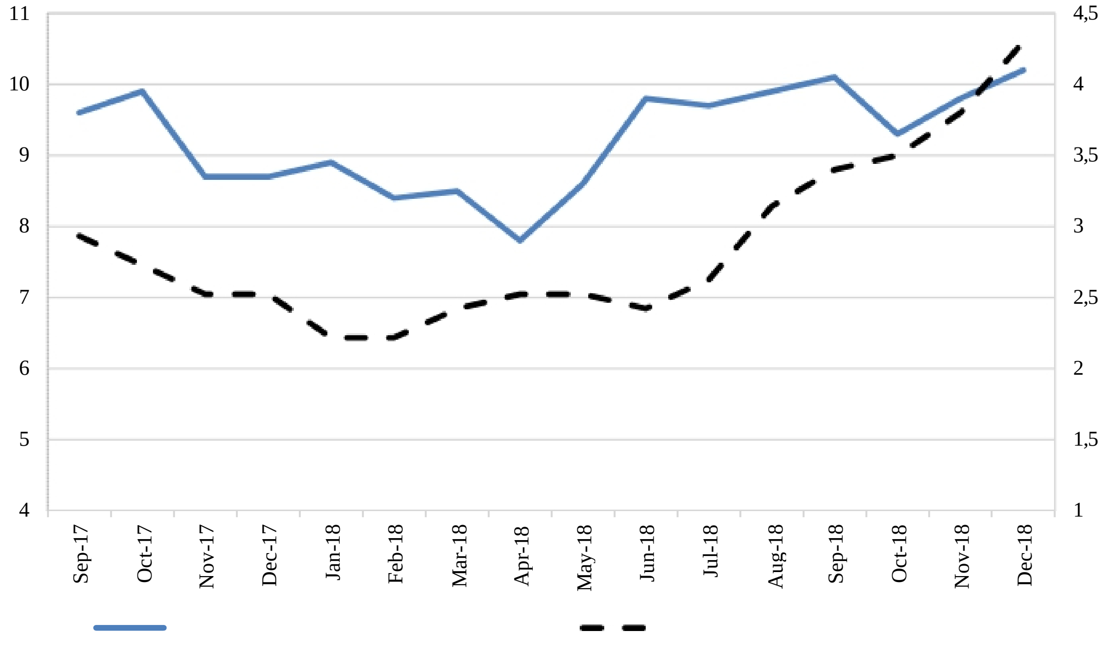

Fig. 9. Inflation and inflation expectations

Sources: Rosstat, Bank of Russia.

The ruble exchange rate dynamics remains a significant source of inflationary risks. For instance, depreciation of the Russian ruble remains a key driver of inflation at a backdrop of tighter sanction rhetoric in April and August 2018 as well as accelerated capital outflows from emerging markets due to the U.S. Fed's tighter monetary policy.

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

Table 5

Consumer price index dynamics of various countries in 2015–2018, percent a year

	2016	2017	2018	2016–2018
Azerbaijan	15.7	12.9	2.3	33.6
Armenia	-1.1	2.6	1.8	3.3
Belarus	10.6	4.6	5.6	22.2
Kazakhstan	8.5	7.3	5.3	22.6
Kyrgyzstan	-0.5	3.7	0.5	3.7
Moldova	2.4	7.3	0.9	10.9
Russian Federation	*5.4*	*2.5*	*4.3*	*12.7*
Tajikistan	6.1	6.7	5.4	19.3
Ukraine	12.4	13.7	9.8	40.3
Germany	0.5	1.7	1.7	3.9
France	0.2	1.2	1.6	3.0
United States	1.3	2.1	1.9	5.4
The Netherlands	0.3	1.3	2.0	3.6

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

At the end of 2018, the Russian Federation ranked in the middle of the list of CIS countries in terms of consumer price growth rates. Two CIS countries – Ukraine and Belarus – posted highest rates of inflation of 9.8 and 5.6 percent, respectively (see *Table 5*). Note that while the 2016 inflation rate in Russia averaged 16 times the inflation rate in developed countries, Russia in 2017 had consumer price growth rates comparable with developed countries (2.6 percent in the United States, 2.3 percent in The Netherlands).

Thus, the Bank of Russia managed in 2015–2017 to lower drastically the inflation rate and to adopt a stepwise monetary policy easing. However, new high risks that emerged in 2018 prompted two cuts in the key interest rate by a total of 0.5 percentage points. Inflation may reach 5–5.5 percent at the end of 2019, and it is not until 2020 that inflation can be brought back down to its target rate, according to central bank's estimates. It is therefore not until the second part of 2019 that Bank of Russia will be able to cut the key interest rate.

2.1.4. Balance of payments and ruble exchange rate

In 2018, Russia posted the highest on record positive current account balance since 1992, according to BoP data for 2018. At the same time, the private sector saw substantial capital outflows that were driven by reduced foreign liabilities and increased foreign assets for banks and enterprises.

According to preliminary data on the Balance of Payments 2018 from the Bank of Russia, Russia's current account balance was recorded at USD 114.9 billion, or 2.5 times (an increase of USD 81.6 billion) the amount recorded in the preliminary data for 2017[1]. In absolute terms, the country saw its current account balance hit its highest on record since 1992. As a percentage of GDP, however, the current account balance was even higher in the period between 2001 and 2006.

The balance of trade in goods amounted to USD 194.4 billion, posting an increase of 68 percent (adding USD 79 billion in absolute terms) over the amount recorded in 2017 (USD 115.4 billion) (*Fig. 10*). The pivotal contribution came from a 25 percent rise in exports (adding USD 90 billion in absolute terms) from USD 353.5 billion in 2017 to USD 443.4 billion in 2018. The growth was mostly due to increase in the annual average price of crude oil, petroleum refined products and natural gas as well as other Russia's primary export commodities amid stable physical volumes of exports (see *Table 6, Fig. 11*).

[1] See A. Bojechkova, A. Knobel, P. Trunin. Russia's Balance of Payments 2017 // Russian Economic Developments. 2018. Vol. 25. No 2. PP. 8–11.

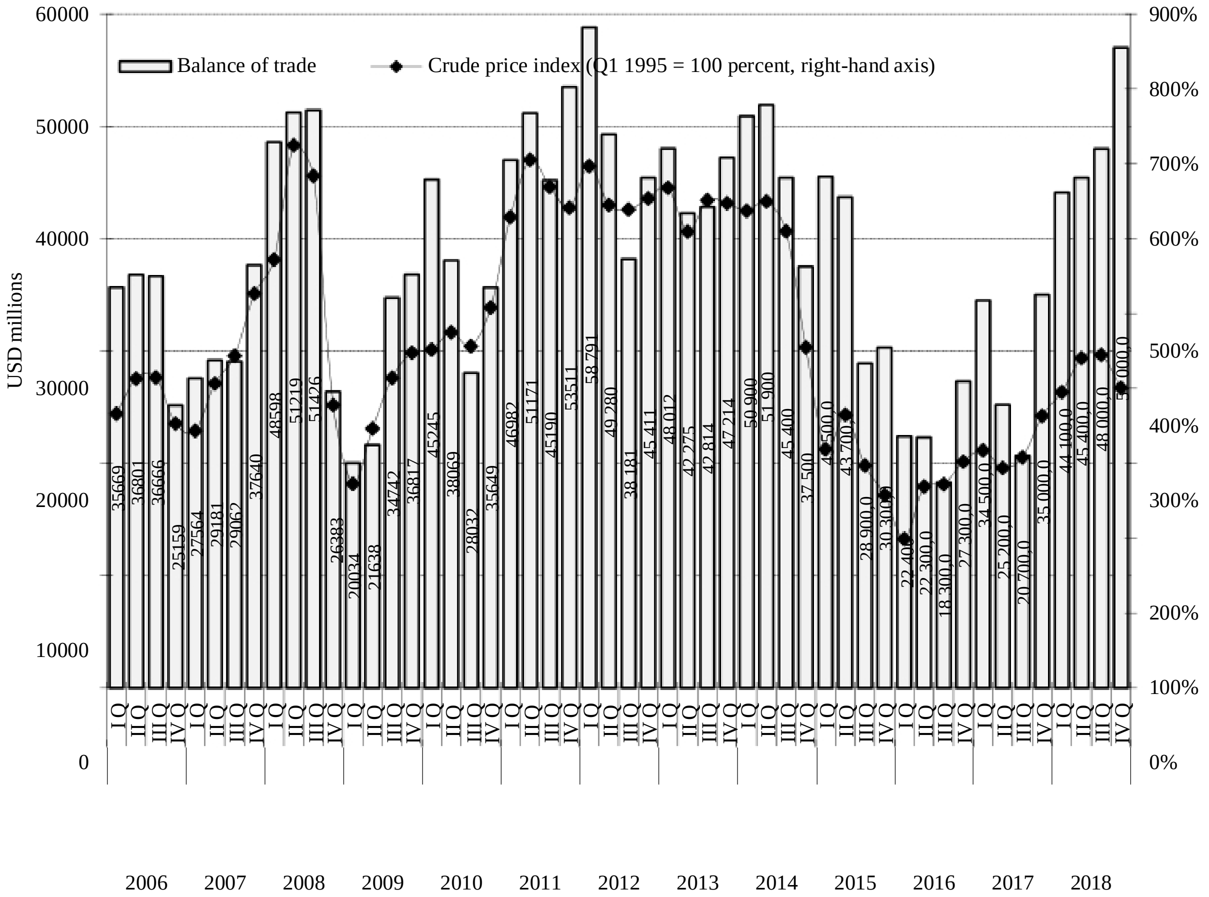

Fig. 10. Russia's balance of trade and oil price dynamics

Sources: Bank of Russia, IMF.

Table 6

Prices of Russia's principal export commodities in 2018 compared to 2017

Commodity	Commodity's share of exports, percent	Average export price in January-November 2018 (USD thousands / tonne)	Average export price in January-November 2017 (USD thousands / tonne)	Gains in prices, percent
Crude oil	29	501	365	37
Refined petroleum products	18	521	388	34
Natural gas*	11	221	180	23
Ferrous metals	5.2	506	440	15
Hard coal	3.8	85	75	14
Wheat and meslin	1.9	190	176	8
Fertilizers	1.7	237	209	14
Liquefied natural gas (LNG)**	1.2	142	131	9
Aluminum	1.2	1.757	1.646	7
Sawn timber	1.0	234	217	8
Copper	0.9	6.355	6.133	4
Fresh and frozen fish	0.7	1.822	1.587	15
Nickel	0.4	13.058	10.044	30

* – for billion cubic meters
** – for thousand cubic meters
Sources: Russia's Federal Customs Service, own calculations.

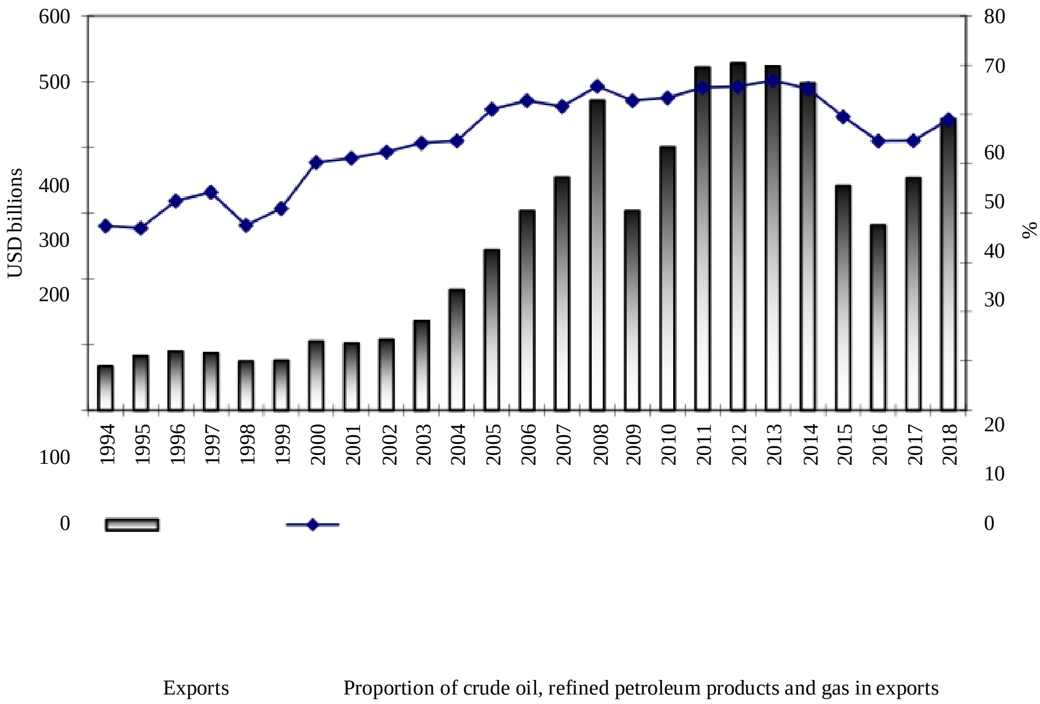

Fig. 11. Dynamics of exports of goods and proportion of fuel and energy sector products in 1994–2018

Source: Bank of Russia.

The growth in the balance of trade in goods was also due stagnant imports with a growth of 4.6 percent (the growth in absolute terms was USD 11 billion) to USD 249 billion in 2018 from USD 238 billion in 2017. However, the second half of the year saw imports drop 2.3 percent (or USD 3 billion) compared to H2 2017. The decline was in most part due to a weakening ruble: according to data from the Bank of Russia, the index for the ruble's real effective exchange rate against foreign currencies lost 7.7 percent in 2018 compared to 2017 – a substantial decline indicating a relative appreciation of imports[1].

Russia's balance of trade in services in 2018 amounted to -USD 30.2 billion, or 2.9 percent in absolute terms less than the amount (-USD 31.1 billion) recorded in 2017. In 2018, exports of services increased from 2017 (mainly due to inbound tourism to Russia and transport services) and imports of services rose (due in large part to travels, transport and other business services). Furthermore, exports saw a bigger rise in both relative and absolute terms that first of all was due to the FIFA World Cup 2018 hosted by Russia. Exports saw an annual rise of 13 percent from USD 57.7 billion to USD 65 billion as imports were up 7.5 percent from USD 88.8 billion to USD 95.5 billion.

The investment income balance and the *compensation of employees balance* underwent minor changes in 2018. The former was up USD 0.9 billion (from -USD 39.8 billion to -USD 38.9 billion) as the latter increased USD 0.5 billion (from -USD 2.3 billion to -USD 1.8 billion).

1 For more details on the exchange rate influence on trade see A. Knobel, A. Firanchuk, Russia's foreign trade in January-August 2017 // Economic Development of Russia. 2017. Vol. 24. No. 11, pp. 12–18.

Thus, the key factor that governs the current account balance in the Russian economy still remains the same – the balance of trade in services and the balance of trade in goods which depends largely on, *firstly*, prices of hydrocarbons (energy commodities) and other Russia's primary export commodities and, *secondly*, the nominal exchange rate of the Russian ruble.

Russia's current account surplus increased alongside the rise in the financial account deficit which in 2018 was 6 times (USD 76.8 billion) the amount recorded in 2017 (USD 12.6 billion). Banks and enterprises in 2018 saw net capital outflows reach USD 67.5 billion, while in 2017 they were USD 25.2 billion (see *Fig. 2*). While in 2017 capital outflows in the private sector were almost entirely linked to banks' operations, the contribution of banks and enterprises in 2018 was comparable: USD 30.9 billion (USD 23.3 billion in 2017) and USD 36.6 billion (USD 1.9 billion in 2017), respectively.

Capital outflows in the banking sector were driven on the one hand by a USD 7.0 billion growth in foreign assets of banks (2017 saw foreign assets drop USD 4.4 billion) and on the other hand by a USD 23.9 billion reduction of foreign liabilities (foreign liabilities in 2017 were reduced by USD 27.7 billion).

Net capital outflows at enterprises were triggered mainly by a USD 30.3 billion increase in their foreign assets (an increase of USD 18.2 billion in 2017). Enterprises raised them mainly in the form of foreign direct investment (up USD 25.8 billion in 2018 from USD 35.9 billion in 2017) and other assets (up USD 13.0 billion in 2018 from -USD 11.7 billion in 2017).

In 2018, enterprises started reducing their foreign liabilities (a decline of USD 7.1 billion), whereas in 2017 they ramped them up by USD 14.2 billion. For instance, credits and loans were reduced as low as USD 9.6 billion (down by USD 8.5 billion in 2017) and portfolio investments were down USD 0.5 billion (USD 4.5 billion down in 2017). Their foreign direct investment were merely USD 1.9 billion versus USD 27.1 billion in 2017 as other liabilities reached USD 1.1 billion (USD 0.1 billion in 2017).

The OFZ bond (ruble-denominated Russian government bonds) market in 2018 was driven in large part by investors' expectations of tighter sanctions against Russia's sovereign debt. In 2018, non-residents reduced their holdings of OFZ bonds by USD 5.7 billion (compared to an increase of USD 13.6 billion in 2017). As a result, the proportion of non-residents in the OFZ market reached its highest (34.5 percent) in April 2018 and then dropped by early December 2018 to 24.7 percent.

In 2018, Russia reduced its foreign debt by USD 64.4 billion to USD 453.7 billion as of January 01, 2019. The central government's foreign debt was reduced by 20.7 percent to USD 44.1 billion on the back of, as noted above, outflows of nonresident OFZ bond holders. As a result of reduced foreign liabilities in the private sector, banks' foreign liabilities were reduced by 11.3 percent to USD 397.6 billion.

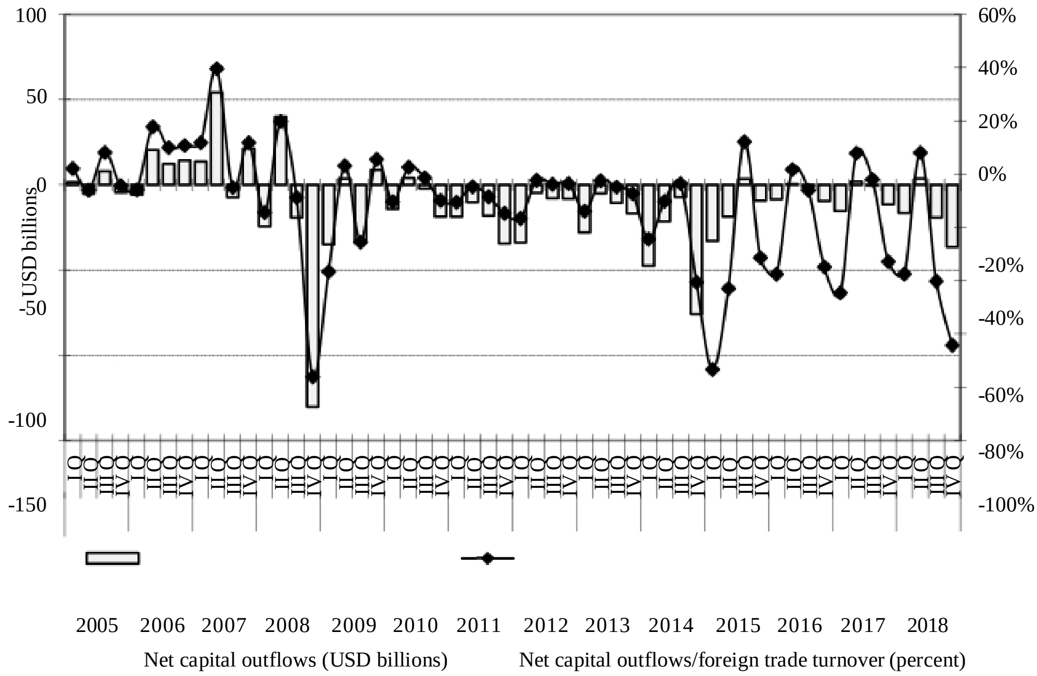

Fig. 12. Private sector's net capital outflows, 2005–2018

Sources: Bank of Russia, own calculations.

We have revised downward our capital flight estimate for 2018 year-end (*Fig. 13*) (it was estimated at USD 6.1 billion in 2017) to USD 3.3 billion[1], which reflects successful efforts of the Russian government to counteract capital outflows via illegal channels.

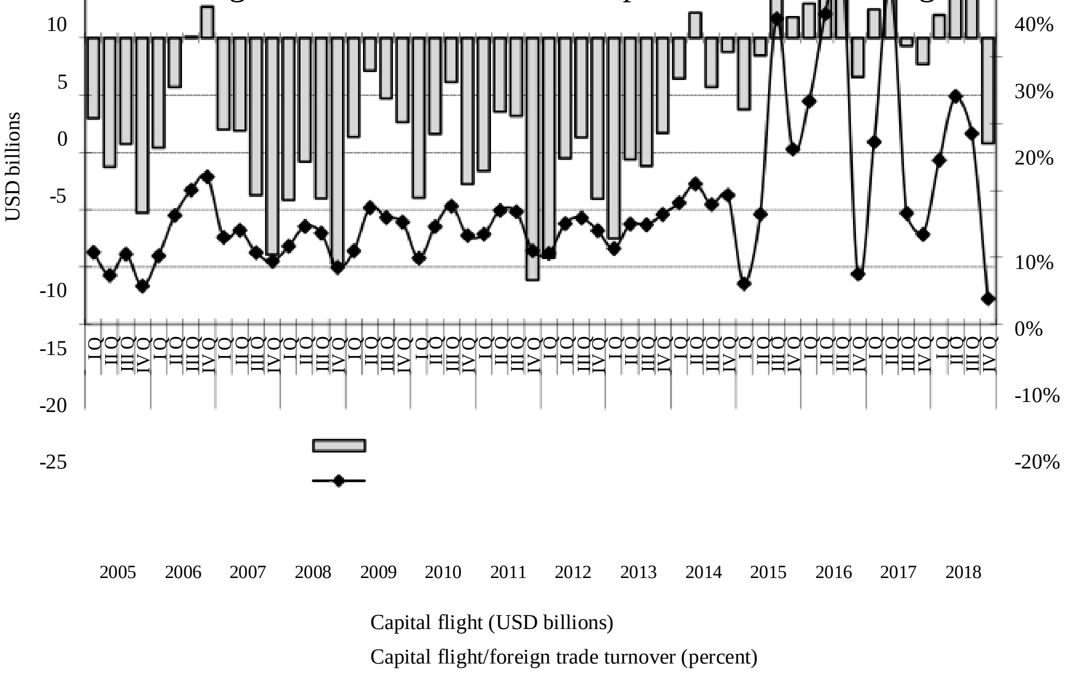

Fig. 13. Capital flight dynamics, 2005–2018

Sources: Bank of Russia; own calculations.

[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."

Substantial capital outflows from Russia in 2018 despite high prices of energy commodities led to a substantial depreciation of the Russian ruble as of 2018 year end. The ruble plummeted to its weakest in April (down 8.3 percent to 62 rubles per dollar compared to late in March) and in August (down 8.4 percent to 68.1 rubles per dollar from late July). The ruble devaluation was triggered primarily by capital outflows driven by tightened anti-Russia sanctions. In addition, the ruble in 2018 was driven by a downturn in all emerging markets as a result of the U.S. tighter monetary policy, trade wars, heightened risks of investing in emerging markets because of financial turmoil facing Argentina and Turkey.

As a result, the Russian ruble in nominal terms lost in 2018 by an average of 6.7 percent against the US dollar and 11.0 percent against the Euro; the Ruble nominal effective exchange rate against foreign currencies declined by 7.6 percent. By the end of 2018 the Ruble in real terms was traded against the currencies of U.S. trade partners at the level seen in September 2016 (see *Fig. 14*).

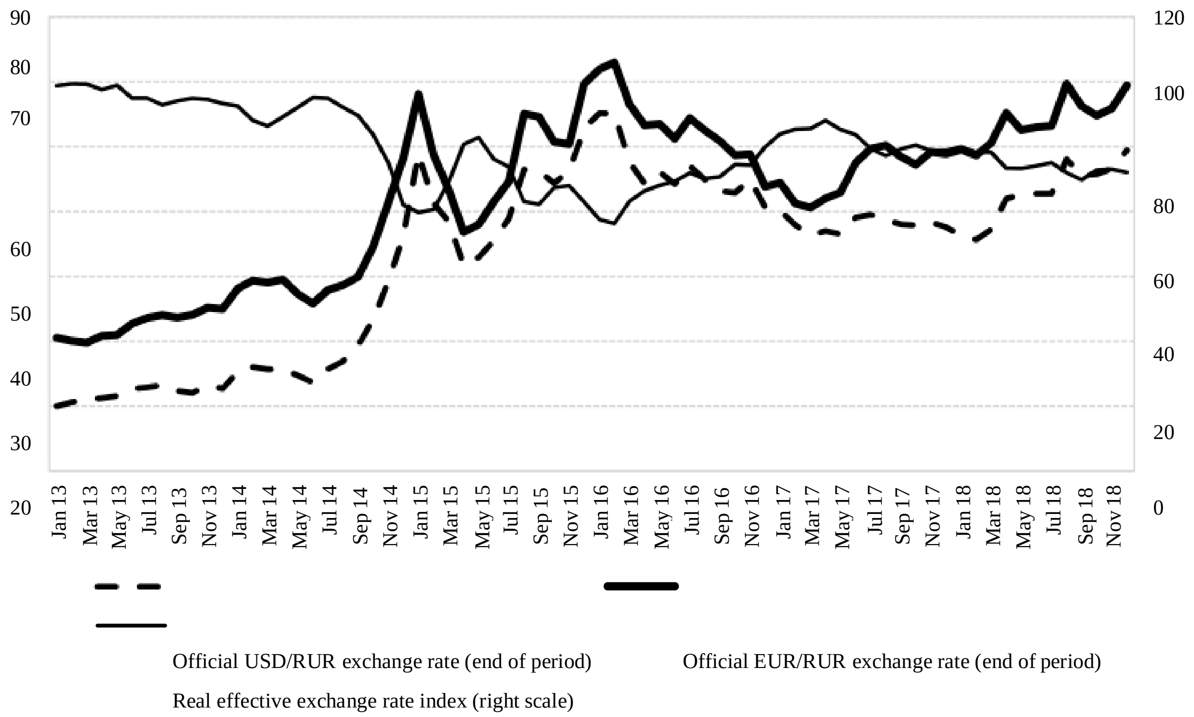

Fig. 14. Dynamics of Russian ruble exchange rate

Sources: Bank of Russia, own calculations.

The dynamics of the Russian ruble in 2018 was mostly led by Bank of Russia's foreign currency purchases in conformity with the fiscal rule in place. In 2018, the Bank of Russia spend RUB 3705.8 billion (3.6 percent of GDP) to buy foreign currency, the key factor of increasing Bank of Russia's foreign currency reserves until September 2018. The Bank of Russia adopted a decision in August 2018 to suspend its foreign currency purchases until late in September and then until late in 2018. It was not until mid-December that a decision to resume, from January 15, 2019, Bank of Russia's foreign currency purchases was announced. Until then foreign currency was purchased in planned volumes by the Federal Treasury directly from the Bank of Russia which had no access to the domestic foreign exchange market.

In 2018, the Russian ruble exchange rate as well as national currencies of other developing countries were influenced by the U.S. Fed's tighter monetary policy. The appeal of U.S. assets increased also due to heightened foreign-policy risks that can arise from U.S. protectionist measures against some of its trade partners.

A minor appreciation of the ruble real exchange rate, stabilization in value terms of export and import volumes, thus keeping a high current account balance unchanged – that is what seems to be expected in 2019 if *global crude prices remain as they are now* (around USD 60 per barrel) and *the ruble's nominal exchange rate is at 65–70 rubles per dollar*. However, risks of further tightening in sanctions, particularly sanctions against Russia's sovereign debt, may lead to capital outflows and a highly volatile ruble's exchange rate in 2019.