

THE METAMORPHOSIS OF RUSSIA'S MONETARY POLICY AND ECONOMIC GROWTH

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Unlike many countries, Russian economic growth is not limited by macroeconomic factors, while economic policy has enormous potential to improve

- **External factors will not be favorable for Russia in the next few years.** Global economic growth will remain tempered, as will global demand for Russian exports. A revival in economic growth will require improving the quality of economic policy and business decisions made.
- **The debt problems in advanced economies have not been solved.** Quantitative easing, though it has helped avoid a global economic collapse, does not provide for a transition to sustainable high growth – partly because it provides support for areas of business that are not the most effective in financial and non-financial entities.
- **In addition, one of the results of quantitative easing has been that global wealth disparity has risen.** This, in particular, is illustrated by the fact that amid sluggish economic growth, stock indexes have grown significantly over the past few years. A result of quantitative easing is asset inflation amid low consumer inflation. Extremely low levels of inflation in advanced economies are a result of limited demand due to persistent debt problems. Sluggish demand complicates investment decisions and limits investment, despite the availability of financial resources.
- **The situation in Russia is similar in some ways.** Consumer demand contracted in 2015-16, and investors struggled to make decisions. Artificially supporting demand is not just pointless, but impossible given the government's limited access to financial resources. Economic policy should be focused on achieving stably low inflation, which will require a more consistent and reasonable policy from the CBR.
- **Russia's most important advantage is its lack of significant debt – both external and domestic.** But at the same time, this is a weakness, as the undeveloped domestic debt market limits CBR refinancing under market collateral.

Financial sector far outstripped GDP growth for too long

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---------------------------------------|-------------|------------|------------|------------|-------------|-------------|-------------|-------------|
| GDP (market prices) | 5,2 | -7,8 | 4,5 | 4,3 | 3,5 | 1,3 | 0,7 | -3,7 |
| GDP (basic prices) | 5,2 | -6,7 | 4,1 | 3,8 | 3,5 | 1,3 | 0,9 | -3,3 |
| of which: | | | | | | | | |
| Agriculture | 6,4 | 1,5 | -12,1 | 14,7 | -1,5 | 4,8 | 2,0 | 3,1 |
| Fishing and fish farming | -5,8 | 5,6 | -9,1 | 4,1 | 6,9 | 3,2 | 1,8 | -0,7 |
| Mining | 1,0 | -2,4 | 6,6 | 3,4 | 2,0 | -3,5 | 2,0 | 1,1 |
| Manufacturing | -2,1 | -14,6 | 8,6 | 6,3 | 5,4 | 4,4 | 0,6 | -5,1 |
| Gas, electricity, water | 0,7 | -4,7 | 4,0 | 0,0 | 1,6 | -1,9 | -1,1 | -1,4 |
| Construction | 11,1 | -14,7 | 4,4 | 7,6 | 4,0 | 0,1 | -2,8 | -7,4 |
| Trade, repair of household appliances | 9,9 | -5,8 | 5,8 | 3,2 | 3,4 | 0,4 | 1,4 | -10,0 |
| Hotels, restaurants | 10,1 | -14,9 | 6,5 | 6,6 | 4,5 | 2,3 | 0,1 | -5,3 |
| Transport, communications | 5,2 | -8,6 | 5,5 | 6,5 | 4,0 | 2,1 | -0,8 | -1,5 |
| Finance | 13,5 | 1,5 | 0,3 | 3,5 | 19,6 | 12,0 | 10,5 | -3,6 |
| Real estate, letting | 10,9 | -4,5 | 6,0 | 2,2 | 2,8 | 0,9 | -0,2 | -0,9 |
| State administration, defence | 3,0 | -0,1 | -0,3 | -3,2 | 0,9 | 1,0 | 0,5 | -0,8 |
| Education | -0,1 | -1,4 | -1,8 | -0,8 | -2,9 | -2,1 | 1,9 | -4,1 |
| Healthcare, social services | 0,9 | -0,2 | 0,3 | 1,1 | 2,4 | 0,7 | 1,7 | 0,4 |
| Utilities, other social services | 1,4 | -20,0 | 2,2 | -0,4 | 0,8 | -0,1 | -2,3 | -1,4 |
| Activities of households | NA | NA | NA | -8,0 | 4,7 | 1,8 | 1,5 | 1,4 |
| Net taxes | 5,4 | -14,0 | 7,3 | 7,0 | 3,5 | 1,0 | -0,3 | -6,8 |

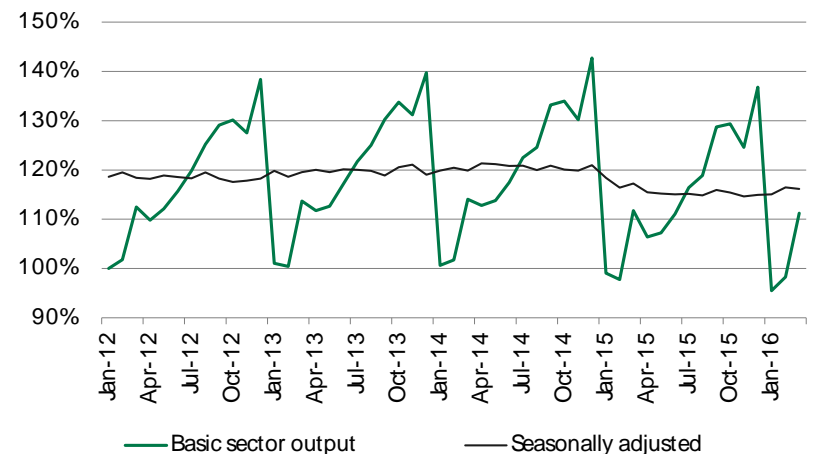
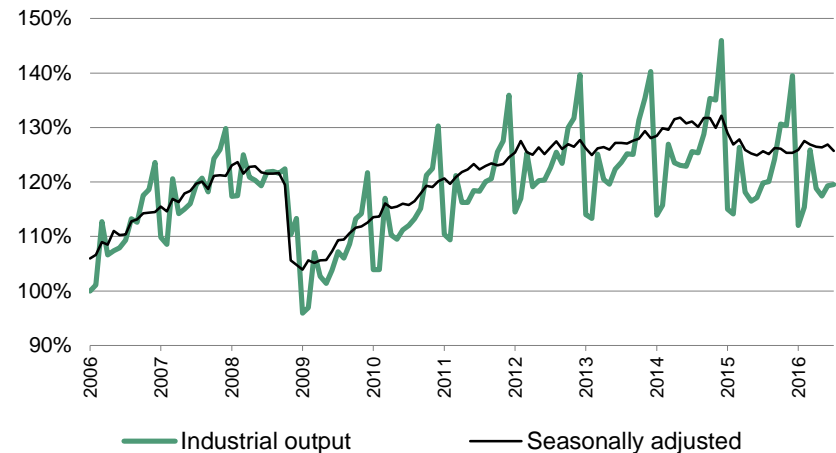
The State Statistics Service more fully brought its methodology in line with IMF standards. While this had little effect on real GDP dynamics, the nominal figures grew by 8-9% over 2014-2015

| | 2011 | 2012 | 2013 | 2014 | 2015 |
|------------------------------------|-------------|-------------|-------------|-------------|-------------|
| Nominal GDP, new methodology, Rbln | 59,698 | 66,927 | 71,017 | 77,945 | 80,804 |
| Nominal GDP, old methodology, Rbln | 55,967 | 62,176 | 66,190 | 71,406 | - |
| Real GDP, new methodology, y-o-y | 4.3 | 3.5 | 1.3 | 0.7 | -3.7 |
| Real GDP, old methodology, y-o-y | 4.3 | 3.4 | 1.3 | 0.6 | - |

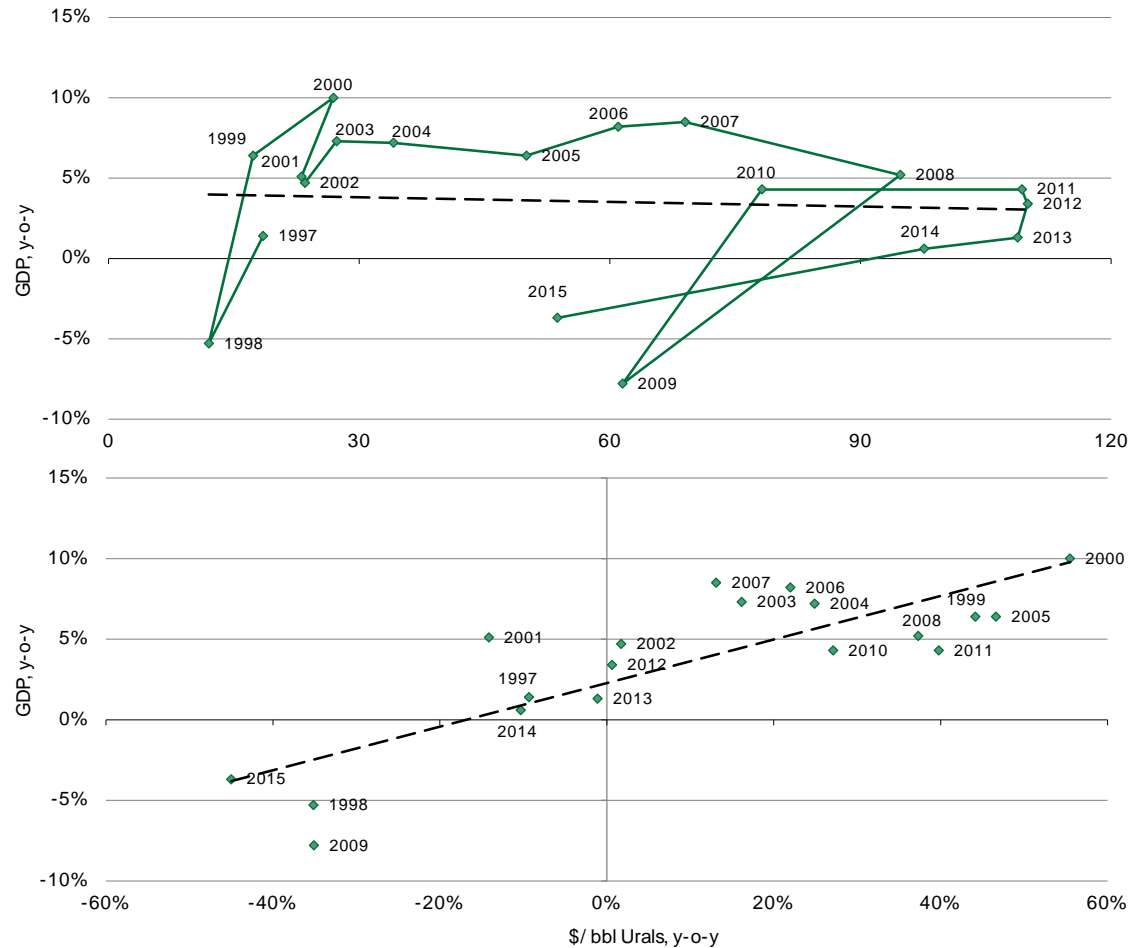
Source: State Statistics Service

Industrial production and basic sector output y-o-y growth turned negative in 2015 (after moderate growth in 2014) but has bottomed in mid-2015, and largely remain flat since then

- Even though the economy demonstrated quite strong resilience to external shocks it has yet to demonstrate equally strong ability to grow.
- “Low” oil prices, institutional bottlenecks and some peculiarities of the investment climate cannot take all the blame for Russia’s poor economic performance.
- Russia’s poor performance largely stems from weak domestic demand, which is suppressed by excessively high real interest rates.
- Macroeconomic policy, which keeps evolving in an unknown direction, can in principle be corrected relatively quickly, and thus help to unlock Russia’s growth potential.

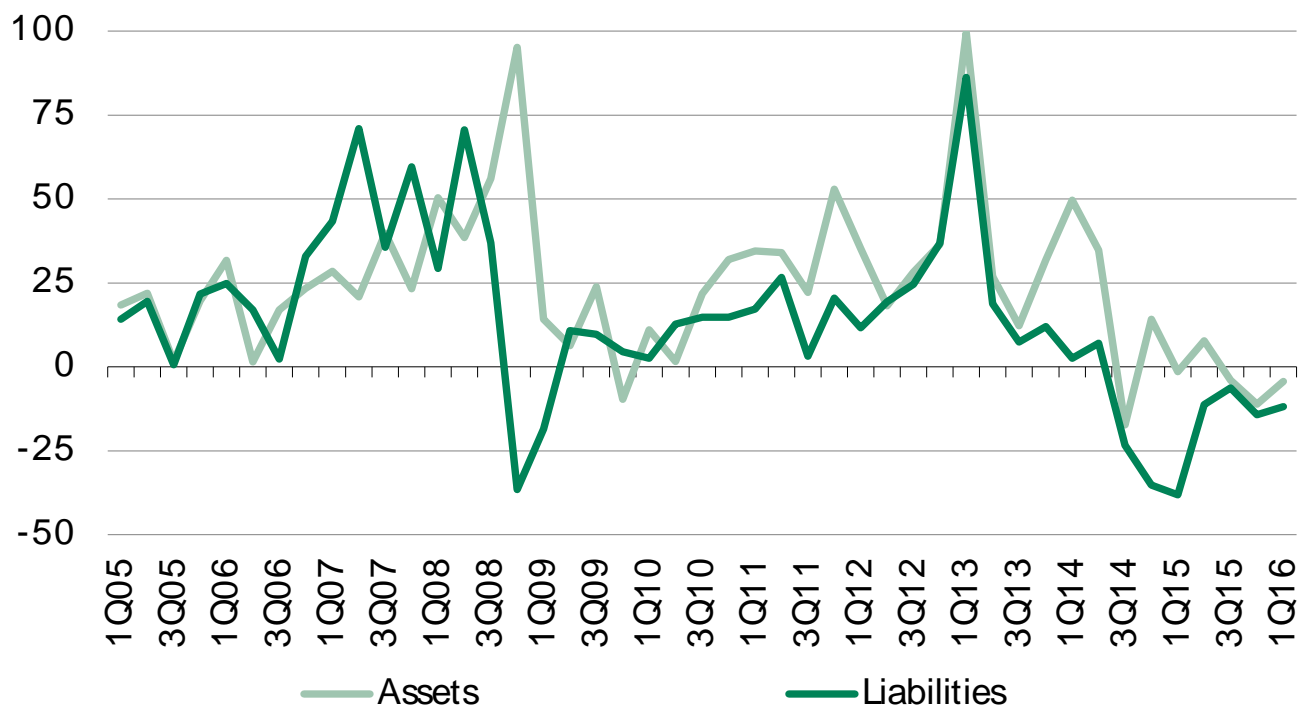


Oil price itself does not affect the Russian economy – it is the change in the price and the rate of that change that is most important.



Source: State Statistics Service

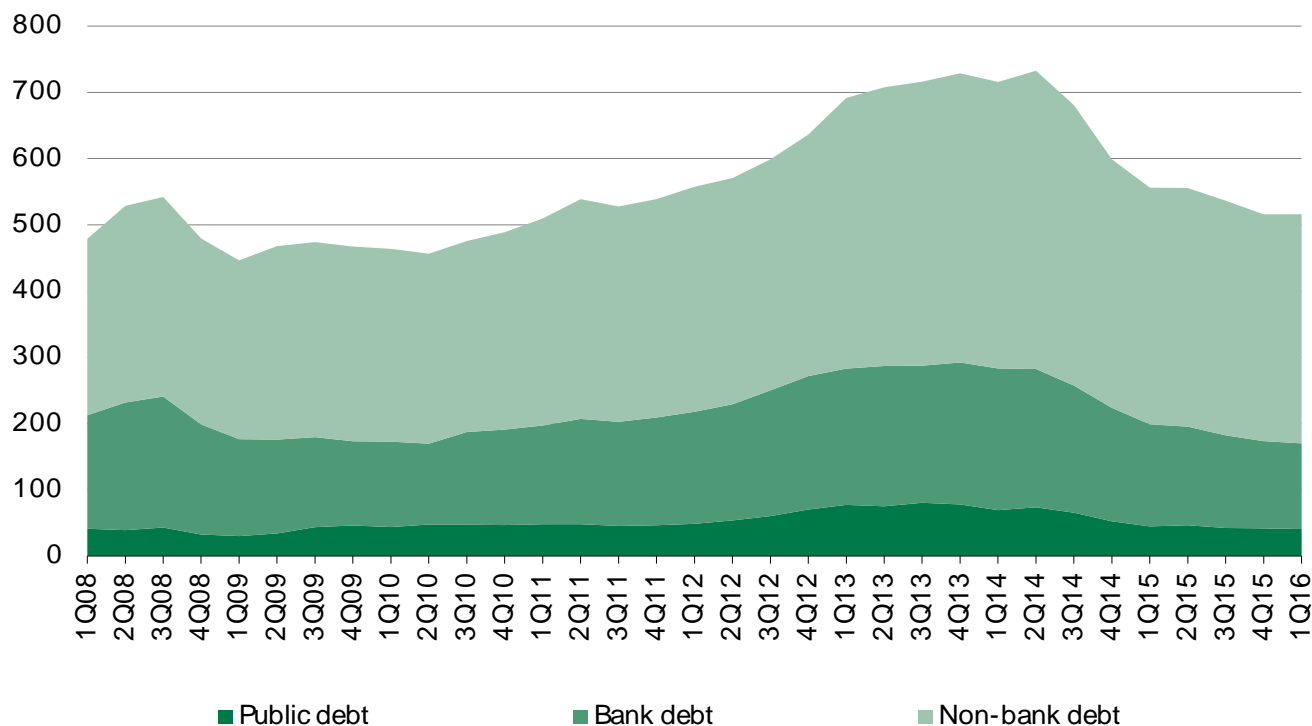
Russia's financial account was almost symmetrically inflated on both sides (i.e. assets and liabilities), implying that on a net basis foreign borrowing was largely used to acquire foreign assets



Note: "+" - increase, "-" - reduction
Source: CBR

Sanctions helped to prepare the economy for the oil price shock, an effective macroprudential measure that forced deleveraging, kept foreign debt to GDP ratio relatively stable amid weaker ruble

Total foreign debt as of April 1, \$ bln



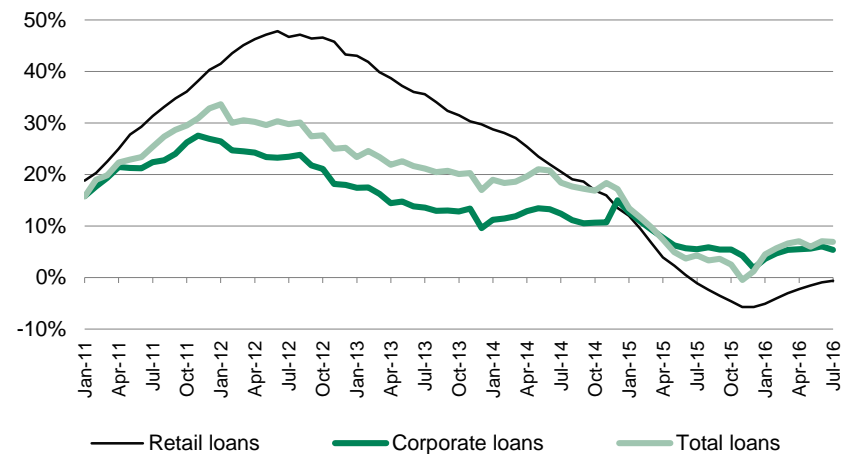
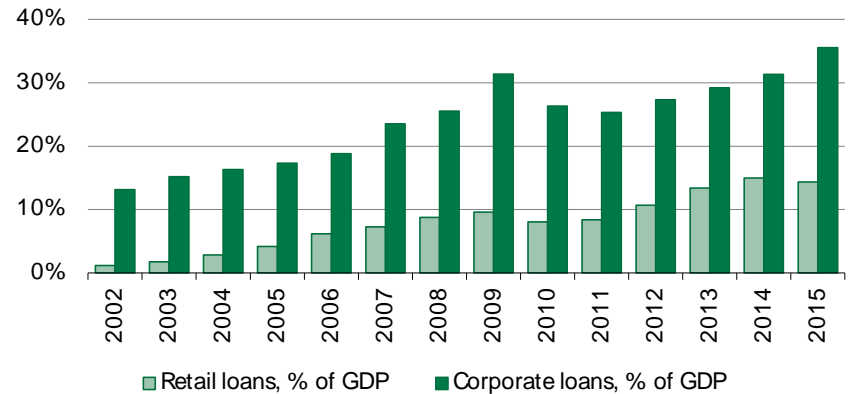
Source: CBR

Monetary policy is in the spotlight as budgetary policy offered no surprises and was relatively stable and predictable

- **Economic policy is an essential factor for economic growth, which has a huge potential to improve in Russia.** Economic growth almost evaporated already in 2013 amid high oil prices, the economy nearly stagnated in 2014 before going into recession in 2015. Economic growth is not guaranteed even in 2017 unless the CBR corrects its policy.
- **Despite lip-servicing on inflation targeting inflation remained high and unstable.** Hence, unlike many countries interest rates in Russia remain high not only in nominal terms but in real as well, which impedes economic growth despite low debt levels.
- **Few years ago the Russian Central bank attempted to imitate quantitative easing policies of global major central banks.** As Russia's key policy rate was never close to zero, this "easing" became very expensive as refinancing to banks was provided on almost exponential scale against junk collateral on a relatively long-term basis. After the crash of the ruble the regulator was forced to change its policy.
- **A combination of policy tools which the Central Bank applied while conducting its experiments, such as the aforementioned generous but expensive easing, interventions on the FX market (which have been finally abolished) etc., reduced the effectiveness of its interest policy.** As a result the CBR remained behind the curve and it is still there.
- **The Central bank temporary lost its role of a lender of last resort.** Amid high rates the Ministry of Finance became the major supplier of liquidity as it finances the budget deficit from the Reserve fund (sold off-market to the CBR) and is not willing to borrow. Russia's bond market remains thin as a result. What happens after Minfin's savings evaporate, and how refinancing mechanism is going to work is just one of many questions to be answered.

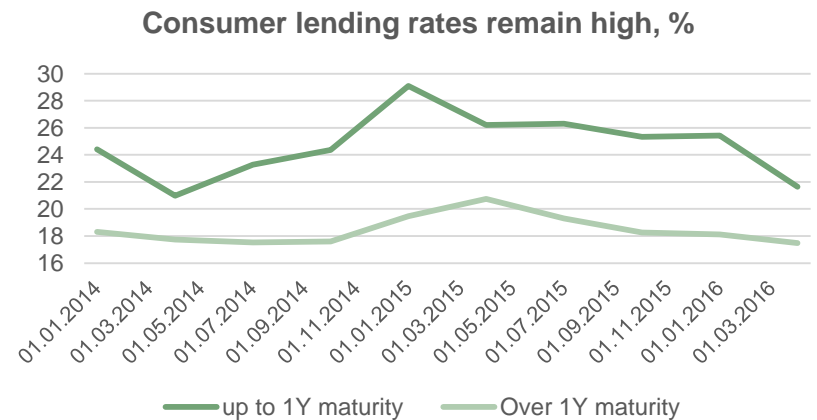
Apart from 2009-10, consumer lending inflated retail and GDP growth in the 2000es (albeit from low base). It no longer supports growth as combination of low debt and high rates became toxic

- Consumer lending growth increased too quickly in 2011-13; it started to decelerate sharply in 2014-15 amid deleveraging.
- Consumer debt to GDP ratio is still below 15% of GDP and as nominal terms it is not growing its ratio to GDP is sent to decrease in 2016.
- Corporate loans to GDP ratio in Russia is also low relative to many other countries.

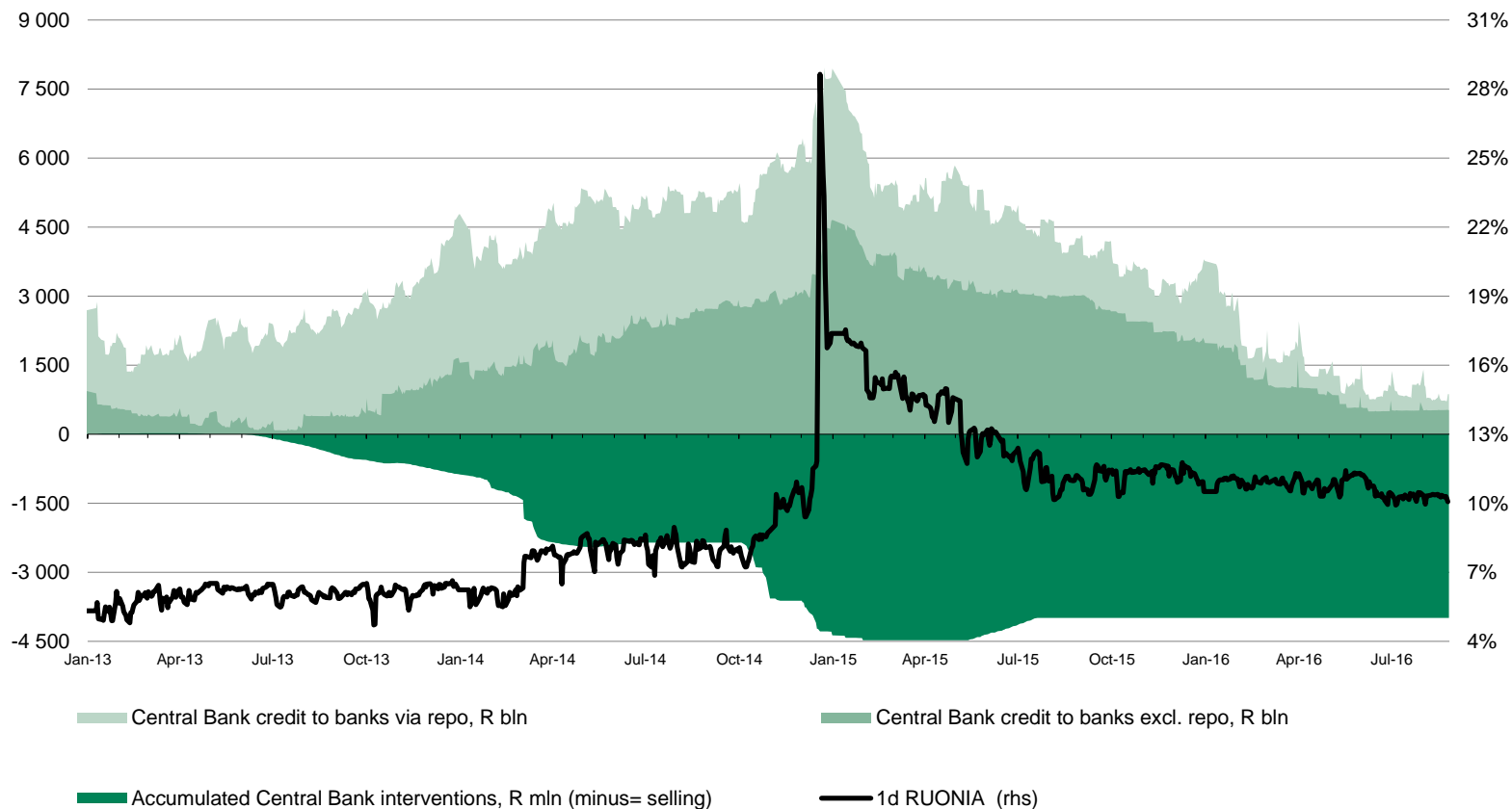


Even though consumer lending rates declined recently, they are still prohibitively high – particularly as nominal income growth moderated

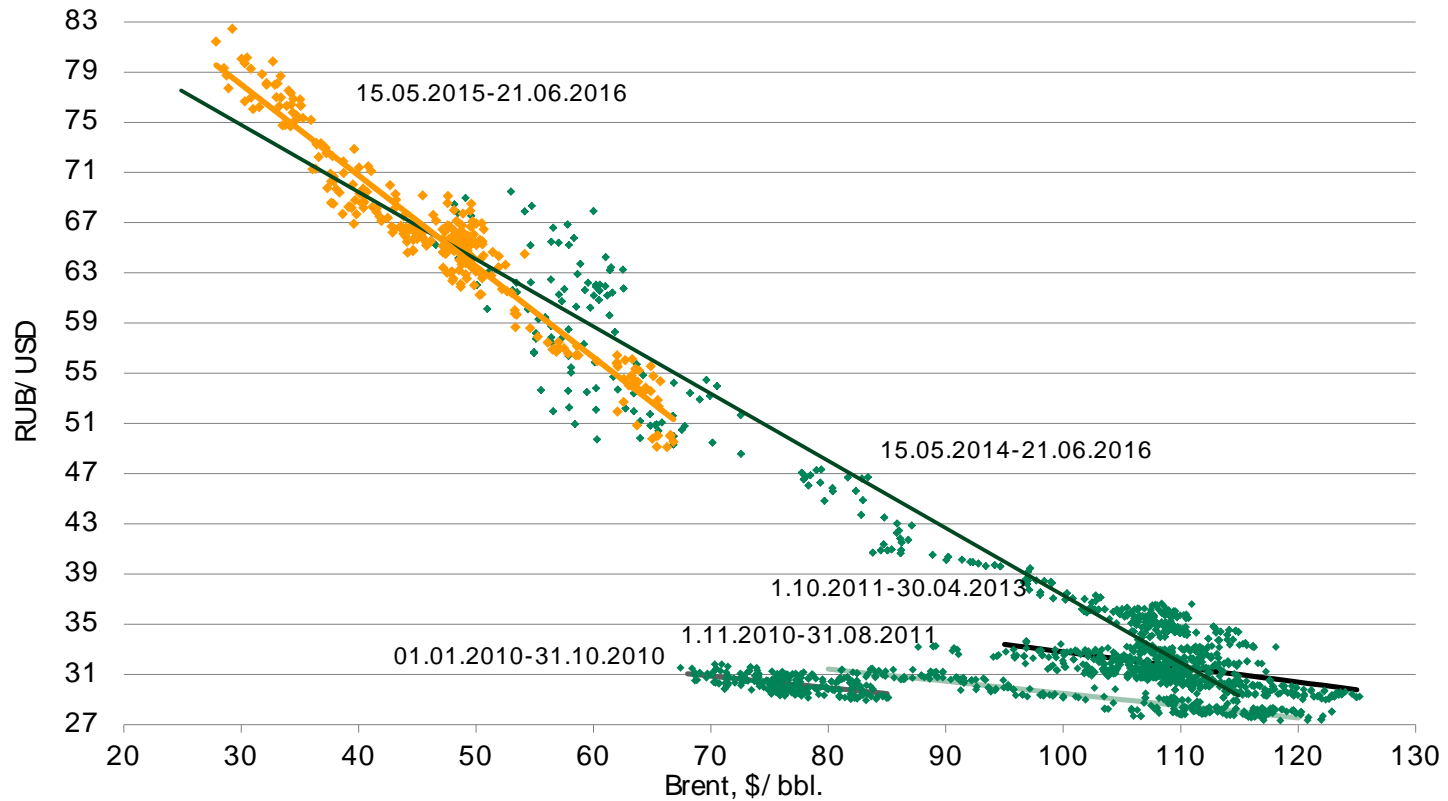
- Hence the country doesn't need deleveraging – it needs re-leveraging amid lower rates to eliminate disconnect between the financial sector and the rest of the economy.
- Expensive debt still servicing eats significant part of the current income of households and is similarly a heavy burden to businesses.
- Credit growth is negative in real terms as a result.



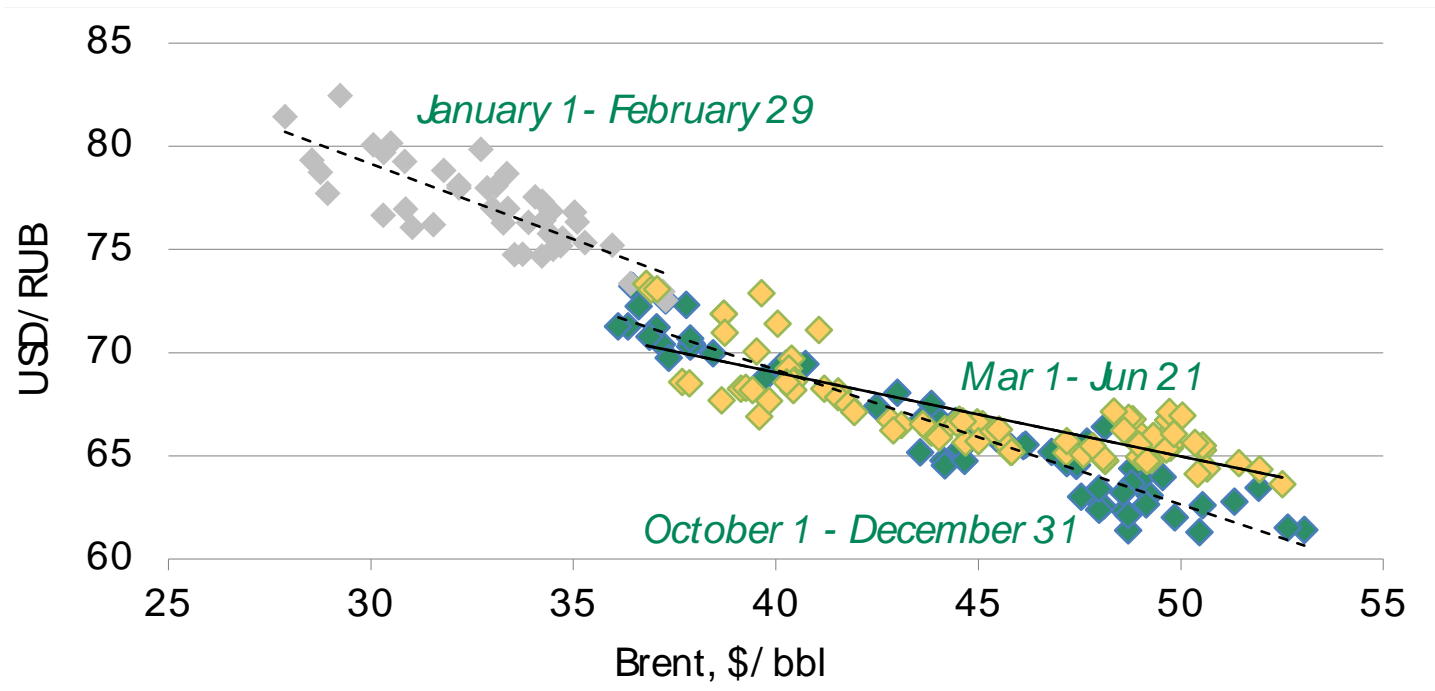
Since 1H13, the CBR has increased its efforts to refinance banks but has also absorbed liquidity by buying FX; inflation accelerated and rates jumped as a result of the CBR's key rate hike



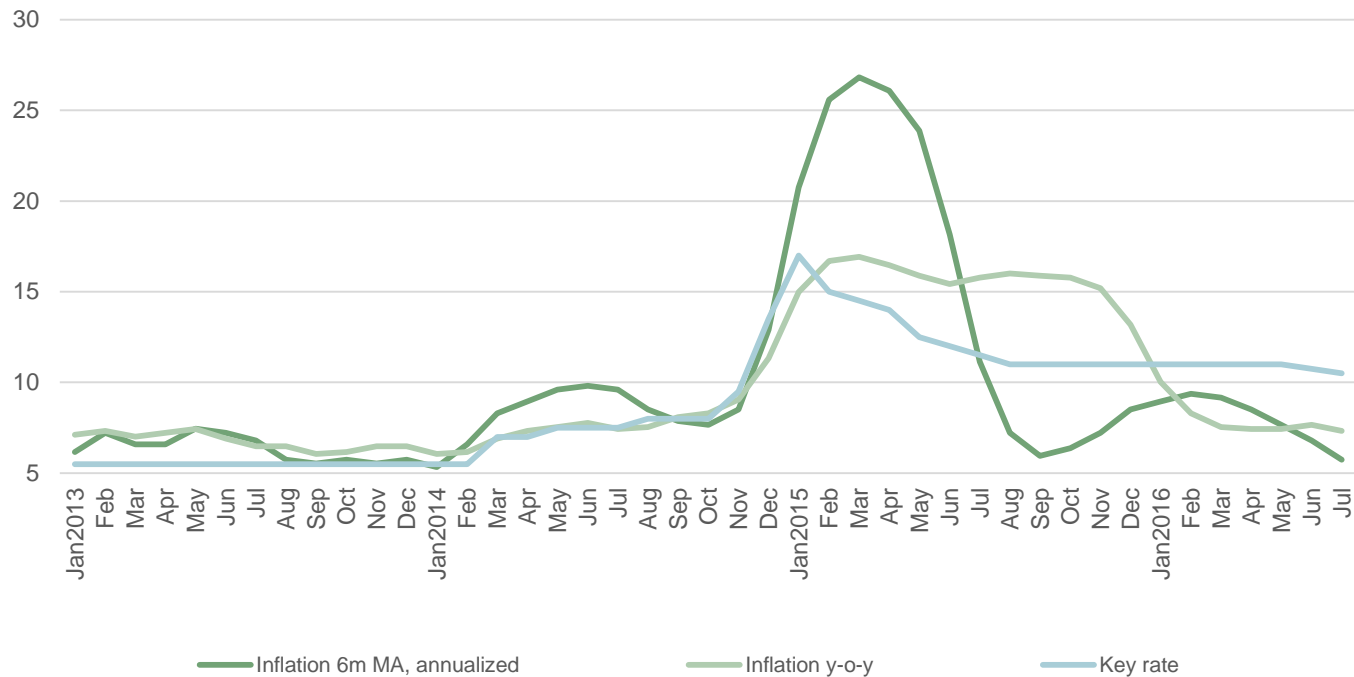
Due to chaotic CBR interventions starting in mid-2013, the ruble has deviated far from equilibrium; and the exchange rate became much more sensitive to the oil price fluctuations



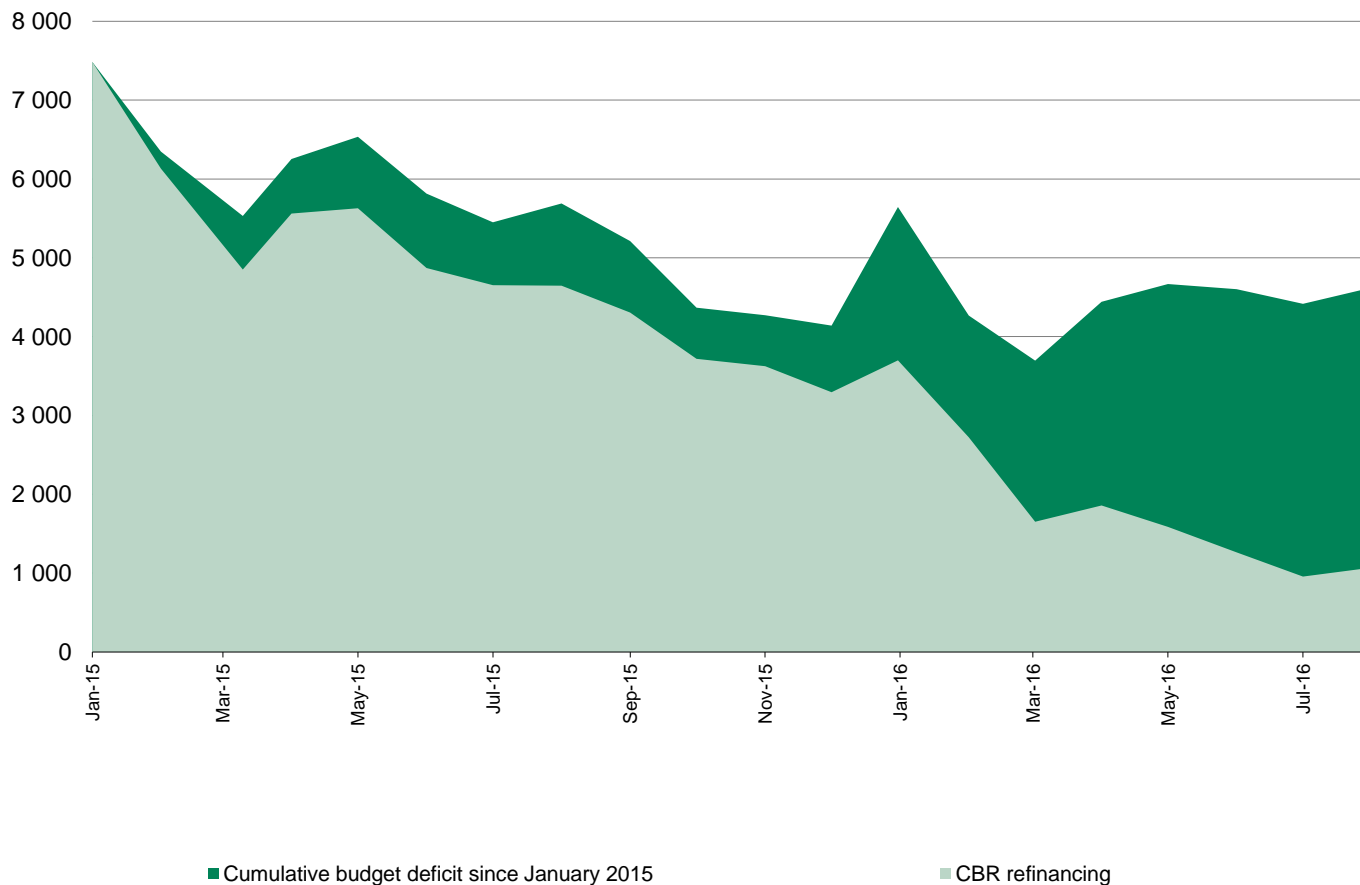
Regression line has flattened in 2Q16



The CBR was always late with moving its key policy rate, %

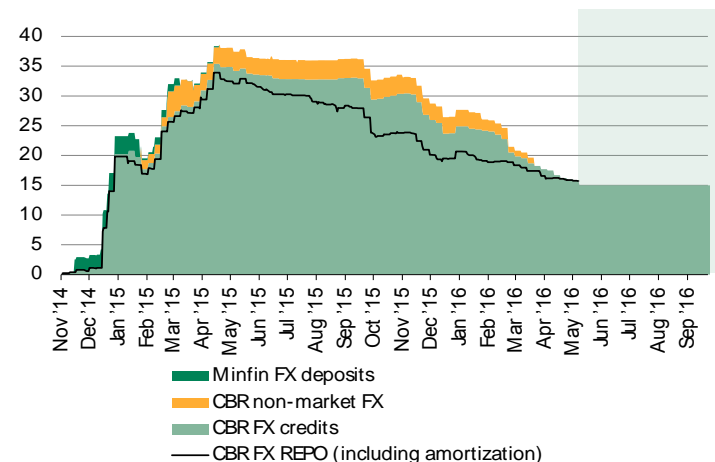
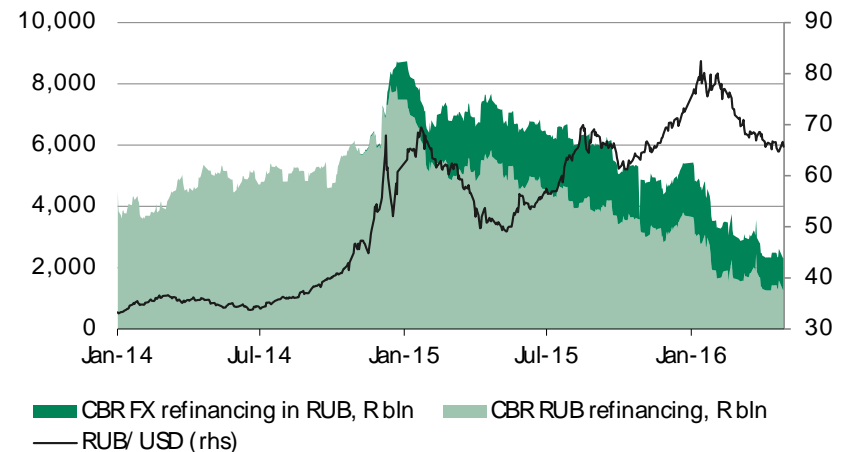


Vicious circle: Inflation remains high, CBR keeps key rate high, Minfin as a result monetizes its deficit and injects cheap money



CBR provided refinancing in FX, which was unnecessary for the economy and distortive for the markets

- The bulk of refinancing in FX the CBR provided to banks in the early 2015 when the current account massively widened which later caused various distortions on all market segments, including the Russian Eurobond market.
- At some point refinancing in FX and refinancing in rubles became more or less comparable, which increased risks for banks in the case of another sharp fluctuation of the currency.
- As long as this refinancing exists and is a possibility in the future the ruble cannot be treated as fully floating currency.



Despite talking about inflation targeting, until November 2014 the CBR had in fact two incompatible targets – currency band and band for the overnight rate

- On November 10, 2014 the CBR eliminated the bi-currency band (it was designed in such a way that the CBR could only spend reserves), allowing the ruble to move more freely, which it eventually did.
- The band still exists for the overnight rate, and after rate hikes it in fact narrowed on a relative basis.
- Meanwhile, due to asymmetrical pass through effects (inflation is up if ruble weakens, but its appreciation brings no deflation) more volatile ruble means higher inflation (assuming other factors equal).

