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Russian Economy: On the Current Situation and the Prospects

(Slide 2) A way out of the global financial and economic crisis was beginning encouragingly in Russia. Gross domestic product in 2011 grew by 4.3%, inflation dropped to 6.1%. In 2012 the economic dynamics subsided (GDP growth, though calculated with the use of slightly modified methodology, equaled 3,5%), but this has not yet caused serious concerns. In 2013 and 2014 doubts about the possibility of economic growth returning to the pre-crisis trajectory emerged: GDP growth continued to decline quickly, reaching respectively 1.3 and 0.7%. But still there was hope that, having lived through a period that a well-known Russian economist Prof. Victor Ivanter called "investment pause", the government initiates new large-scale projects similar to those related to Olimpics in Sochi or Far-Eastern Summit in Vladivostok and thus provides the necessary impetus to economic development.

However, in 2014, the country faced economic sanctions and the collapse of oil prices in the world market. Under normal circumstances, the deterioration in the terms of trade would lead to lower net exports. (Slide 3. It should be mentioned here that during all the period 2000-2015 Russia had a significant surplus of the balance of payments current account: its accumulated amount over this 16-year period equals nearly one trillion US dollars, or approximately 60 bln. US dollar a year).

In fact, in 2015 the current account surplus increased significantly (from 58.4 billion in 2014 to 65.8 billion dollar in 2015) in view of the fact that imports declined much more than exports. Several factors contributed to this result.

First, the demand for foreign currency of the private sector to repay its external debts increased sharply, because Russian companies had lost the opportunity to attract foreign loans to refinance the debt. Second, in the autumn of 2014 the Central Bank of Russia introduced a free-floating regime for the ruble and its volatility increased dramatically (Slide 4). As a result economic agents have increased demand for the currency as a financial asset, which allows them to effectively store their wealth. From the beginning of 2015, according to the Central Bank, the share of foreign currency deposits grew from 26.1 to 30.1% for individuals and from 43.8 to 50.9% - for legal entities. A substantial proportion (31.5%) of loans both to individuals and businesses began to be provided in the foreign currency.

The ruble foreign exchange rate to US dollar fell approximately two times and a half. But the fall of the ruble could have been even more dramatic if the authorities had not used a substantial portion of international reserves - 124 billion dollars in 2014, and 17 billion dollars - in 2015 (Slide 5).

The increase in net exports produced by the above-mentioned factors, unfortunately, was accompanied by a massive collapse in domestic demand (Slide 6). In 2015 final consumption fell by 7.1% (including household consumption - by 10.1%), gross accumulation - by 18.3% (including capital formation - by 7.6%). As a result, GDP fell in 2015 by 3.7%, together with a significant increase of inflation: in 2014 - 11.4%, 2015 - 12.9%. As a result the economy fell into a zone of stagflation - adverse condition, characterized by the simultaneous decrease in the level of output, on the one hand, and rising prices, on the other.

The sharp decline in imports hit not only for the consumption of the population, but also for the production - fewer resources than before turned out to be in the possession of the real sector of the economy. The action of this factor could not be, at least partially, compensated for by commissioning of the idle capacity; on the contrary, the latter began to grow. This happened because of worsening financial conditions for economic activity, especially because of extremely high level of key interest rate, and serious problems in the budget sphere. The collapse of the ruble exchange rate sparked a sharp rise in prices of imported products, whereas the diminishing supply of imported goods has pushed up other prices.

Authorities have taken steps aimed at encouraging exporters to return foreign exchange earnings in the country, and selling the currency in the domestic market. The Central Bank started using very actively its tools of pressure on commercial banks to prevent them from all-too-active transformation of ruble resources in foreign assets. The government also began to provide targeted support to numerous producers by subsidizing the interest rate on loans granted.

Some positive results have been achieved. There are sectors which succeded in taking advantage of depreciation of the ruble. Agriculture, which even grew by 3% last year, is a good example. Measures taken by the authorities helped others to stay on the surface. In February 2016 a slight growth in industrial production was registered. But I have to admit that we have not succeded in reversing the negative trends. High interest rates block access both to short-term credit needed for normal day-to-day business activities and long-term borrowings. Reduction of credit, coupled with the sharply increased risk of default on borrowed funds, creates problems in the banking sector. Prolonged fever on the foreign exchange market pushes the economic agents to search for "currency shelter", hampers decision-making about the production of goods intended for export and import substitution.

But is it possible, in principle, to expect better results under such an unfavorable confluence of internal and external circumstances? Isn't it better to be patient and, maintaining the approach based on the solution of particularly acute problems in "manual mode", wait until the natural course of events will lead to the normalization of the economic situation? The answer would be "yes" if we knew that it does not take too long for our economy to adapt itself to the shocs it encountered with. But we do not know and can, therefore, make no robust forcasts of the costs we will bear on this path. By the way, after financial default of 1998 more active policy stance let us overcome much more serious crisis in less than half a year.

What is more or less clear is that there are no alternatives to the maximum mobilization of domestic opportunities. It is also understandable that, in the short run, the path to success lies through the normalization of financial and economic conditions for business activity and ensuring, on this basis, significant improvement in utilization of the existing production facilities. And, it is also clear this task is impossible without radical reduction of interest rates.

Some experts in my country believe that to lower interest rates it is necessary to increase the M2/GDP ratio - the so called level of "monetization" of the economy - simply by issuing more money. And to prevent that extra money from raising inflation and/or flowing to the foreign exchange market, it should be, according to them, directly sent to finance selected state investment projects.

The direction of the planned money issue to finance major projects has an attractive side, indeed. It consists in the support of investment activity, which is so much needed to overcome the crisis. But the idea to use this channel for the so-called "monetization" of the economy is, in my view, erroneous and, therefore, dangerous.

Firstly, there is no particular reason to worry about the level of "monetization". The proponents of the idea refer to the somewhat diminished amount of monetary base during 2015. But the M2/GDP ratio has been steadily increasing during all recent years and that is the indicator, which is relevant here (Slide 7). In the pre-crisis year of 2007 it accounted for 32.8% whereas in 2015 -

45.1%. Secondly, indiscriminate build-up of money supply in the situation of high inflation and impressive outflow of capital from the country pose a serious risk of further aggravating the financial situation. Hopes that channelling of nearly unlimited portions of new money in the above-mentioned projects can radically change this development are baseless. “Project money” will very quickly move into the hands of suppliers of materials, equipment, workers, and further control of their flow becomes impossible. A small initial effect associated with new contracts needed to realize the projects very quickly comes down to nothing because of a rise in inflation and the outflow of capital from the country.

To my understanding, the only way to quickly turn the tide is the introduction of restrictions on capital account for legal entities. It comes to adopt rules requiring exporters to return foreign exchange earnings in the country, and sell some of it in the currency market, prohibiting the purchases of currency just "for the future", allowing the Central Bank to officially restrict the amount of open foreign-exchange positions of commercial banks. To limit speculative cross-border capital flows that have a destabilizing impact on the foreign exchange and stock markets, introduction of one or another variant of the "Tobin tax" (or a broader alternative - tax on financial transactions) is needed.

The proposed measures do not destroy the foreign exchange market. They only limit its scope to foreign exchange operations related to exports and imports of goods, external debt service. If such a decision is taken then a significant rise in the ruble exchange rate should be expected. This is because, according to all existing estimates, it is three times underestimated now in relation to the purchasing power parity of the ruble. I believe that special measures restraining the appreciation of the ruble will then be needed in order not to expose the Russian economy to a new shoc.

Of course, fluctuations in the world market for oil, gas, and other products of Russian exports will continue affect the ruble exchange rate. But its volatility would be drastically reduced, as these changes will not be repeatedly strengthened by cross-border flows of speculative capital, which quickly change their direction, and by firms and banks permanently fleeing "in currency and out of it". And, most importantly, monetary authorities will be able to quickly reduce a key interest rate to a normal level. This decline will be accompanied by a slight increase in the money supply, but it will happen more or less in line with the increase in the demand for money by the economic agents. Economic conditions for the real and financial sectors should normalize quickly as shows our own experience of taking the economy out of the deepest crisis produced by the financial default of 1998.

Introduction of foreign exchange restrictions is an emergency response to an emergency situation. This reaction, of course, does not provide an answer to long-term strategic challenges facing our economy. Its function is different - to clean up the financial rubble blocking the normal economic development and immersing our economy deeper and deeper in “manual control mode”. And then will adequate conditions for long-term decisions emerge.

Thank you very much for your attention!