Sergey Ignatiev: The macroeconomic situation and monetary policy in Russia

Speech by Dr Sergey Ignatiev, Chairman of the Central Bank of the Russian Federation, at the 2007 Money and Banking Conference "Monetary Policy Under Uncertainty", hosted by the Central Bank of Argentina, Buenos Aires, 4 June 2007.

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Ladies and Gentlemen,

First of all, allow me to thank you for the opportunity to speak at this conference.

Since the severe financial and economic crisis of August 1998, the Russian economy has recovered quite fast.

During the past eight years – from 1999 to 2006 the annual average GDP growth was 6.7%.

High economic growth rates have sustained during recent years. In 2005, GDP grew by 6.4%, in 2006 by 6.7%, and in the first quarter of 2007, GDP gained 7.9% year-on-year.

Investments in the fixed assets have increased at an even faster pace, mounting up to 11-14% annually over the past four years.

Meanwhile, investments to GDP ratio remains fairly low, at approximately 18%.

Real income of the population is also rapidly growing. For the past four years, it has risen by an average of 12% annually. Rapid growth in real personal incomes (compared to GDP) is due to dramatic improvements in terms of trade, caused by world oil price growth.

From 2000 onwards, the federal budget enjoyed a surplus of revenue over expenditure.

The last two years have seen a particularly large federal budget surplus. In 2005 and 2006, the budget surplus equalled to 7.5% and 7,4% of GDP, respectively.

As you probably know, Russia took on the entire external debt of the former Soviet Union, despite the fact that Russia accounted then for only half of the Soviet Union's population. This debt totalled around 100 billion dollars.

Russia has completed advance repayment of all its debt to Paris Club creditors, and to the International Monetary Fund.

Government external debt reduced from 158 billion dollars as of the end of 1998 to about 45 billion dollars beginning of 2007. At present it totals to approximately 4% of GDP.

Russia's international reserves are expanding rapidly.

The reserves increased from around 12 billion dollars at the end of 1998, to the current total of about 400 billion dollars.

Clearly, Russia's economic success in recent years is largely due to high world prices of the country's exported commodities, particularly oil and gas.

However, it is also the result of implemented economic reforms as well as the consequence of general social and political stability in Russia.

Tax reforms carried out from 2002 to 2004 are worth noting.

1. The income tax rate for individuals was lowered, and fixed at a flat rate of 13%.
2. Corporate profit tax rate was lowered from 35% to 24%.
3. The so-called "turnover taxes", levied at each sale of an item and equalled to 4% of the item's price, were cancelled. These taxes posed obstacles to effective production specialization.
4. Sales tax, levied in retail at a rate of 5%, was cancelled.
5. The base value added tax rate was brought down from 20% to 18%.

At the same time, many tax privileges were removed. Improvements were made to tax administration.

Taxes on the production and export of oil and gas were raised. These tax rates are linked to the world oil prices.

In general the tax system has been made simpler and fairer.

The process of preparing and executing both federal and local budgets has been substantially improved.

At the beginning of 2004, the Stabilization Fund of the Russian Federation was set up. The Stabilization Fund receives the part of the taxes, paid to the federal budget by producers and exporters of crude oil. This part is the result of the high world oil prices. The purpose of the Stabilization Fund is to provide a substantial level of backup for the federal budget expenditures in the event of a sharp decline in the oil price on the world market. It currently holds a total of around 110 billion dollars. The Stabilization Fund resources are held in the Finance Ministry's foreign exchange deposits with the Central Bank. These resources can be used to repay external debt. The funds can only be spent on current budget needs if there is a sharp decline in budget revenue due to a large drop in world oil prices.

Besides, the Stabilization Fund plays an important role in sterilizing excess liquidity and restraining money supply growth.

In recent years, due to the strong balance of payments, foreign currency purchasing by the Central Bank has become the sole channel for increasing money supply. The Central Bank does not provide loans to the Government, nor does it expand its government securities portfolio. The refinancing of commercial banks is carried out by the Central Bank on an insignificant scale. In order to sterilize excess money supply caused by growth in international reserves, the Central Bank uses a range of instruments; specifically, it attracts deposits from commercial banks and issues its own bonds.

The Stabilization Fund's role in sterilizing excess liquidity was particularly prominent between 2004 and 2005, when the Stabilization Fund resources increase was about 60% of the total increase of Russia's international reserves. In 2006, and especially in 2007, international reserves have increasingly boosted by the inflow of private capital.

Even though inflation in Russia remains high, it is gradually going down. In 2004, consumer price growth (December-to-December) was 11.7%; in 2005, the figure was 10.9%, and in 2006, 9.0%. In 2007, inflation is expected to be reduced to 6.5-8.0%. From April 2006 till April 2007 the inflation rate was 7.6%.

Russia applies a managed floating exchange rate regime.

The Central Bank aims to attain two goals in implementing its monetary policy.

The first principal goal is to gradually reduce inflation.

The second task is to prevent a sharp real effective appreciation of the ruble, so as not to harm the conditions for economic growth.

I would like to stress that we understand that the Central Bank can only exert a temporary influence on the real effective exchange rate of the national currency. For example, if there is a strong balance of payments and the Central Bank doesn't allow nominal appreciation of the ruble, this will inevitably lead to growth in foreign exchange reserves, a rise in money supply, and eventually, after a certain period, to higher inflation. This means a real strengthening of the national currency.

Besides, we acknowledge that the set goals are contradictory in principle. Given that the world prices for exported goods are very high and there is a strong inflow of capital, to attain the two goals simultaneously may be impossible.

The Central Bank of Russia gradually enhances the focus on achieving its inflation goal and reduces its responsibility for preventing a sharp rise in the real effective ruble exchange rate.

We think that with the development of market mechanisms, increased flexibility of the economy, greater production factors mobility, and the development of the financial system, the degree of negative impact on economic growth caused by ruble real appreciation should decrease.

In the future we intend to stop taking on any obligations in restricting appreciation of the real effective ruble rate, and to move on to inflation targeting, and free floating regime.

It is not easy to achieve considering our strong dependency on world commodity prices.

In order to reduce inflation, the Central Bank allowed the increase of the nominal effective ruble rate: from December 2004 to December 2005, by 3,2%, and from December 2005 to December 2006 – by 2,2%.

The real effective ruble exchange rate grew 10.5% in 2005, and another 7.4% in 2006.

Analysis of the economic situation does not yet allow us to definitely state that appreciation in the real effective ruble rate has negatively affected GDP growth to date.

However, it should be noted that growth in industries producing tradable goods is slower than in sectors producing non-tradables. In 2006, industrial output grew 3.9%, while retail trade went up to 13.9%, and construction volume increased by 15.7%.

An important and quite unexpected factor for us, which influenced the macroeconomic situation over the past 18 months, has been the large inflow of foreign private capital.

Previously, up to and including 2004, we saw a net outflow of private capital. For example, the outflow totalled 25 billion dollars in 2000, and 15 billion dollars in 2001.

The year 2005 saw the first net inflow of private capital in a volume of 1 billion dollars.

In 2006 the net inflow of private capital grew sharply, reaching around 42 billion dollars. During the first four months of 2007, it exceeded 30 billion dollars.

Private capital inflow has been boosted by anticipations of further nominal ruble appreciation. In 2006, the volume of foreign currency held in cash by the population and non-financial institutions shrank by 12 billion dollars. The process of dedollarization of the economy has been intensively developing. According to the Central Bank estimates, the proportion of foreign currency at the end of 2006 (both in cash and in bank deposits) in overall money supply was around 15%, while at the end of 1999 this share exceeded 60%.

The powerful inflow of private capital was partly due to the fact that as of July 1, 2006 all restrictions and burdens on foreign currency operations linked to movement of capital and effective until then were removed. The process of foreign exchange liberalization was fully completed.

The improved investment climate and the stable economic situation also contributed to net private capital inflow.

The powerful private capital inflow boosted money supply. The M2 aggregate rose by 39% in 2005, and by 49% in 2006.

In order to restrict money supply growth, the Central Bank raised interest rates on commercial banks' deposits with the Central Bank several times in 2006 and 2007. Currently, the interest rate on one-week deposits is 3%. We are very cautious here, and are closely monitoring interest rates on international markets. A large rise in interest rates on deposits attracted by the Central Bank could lead to an additional inflow of speculative capital and make deposit operations useless.

Recently, in May 2007, the Central Bank raised the required reserve ratio from 3.5% up to 4.0-4.5%. Here, we are also trying to avoid radical changes.

While adjusting the ruble exchange rate, the Central Bank considers the following as significant.

The import of goods grows very fast under the influence of a high real ruble appreciation. In 2006, goods imports expanded by 31%. During the first quarter of 2007, they gained 39% compared to the first quarter of 2006.

According to our estimates, if the nominal effective exchange rate of ruble remains unchanged, and oil prices stay at the level of the first five months of 2007, by 2010 imports of goods could exceed exports. In principle there is nothing wrong with it. But this will force us to consider very carefully the possibility of further nominal appreciation of the ruble.

Thank you for your attention.