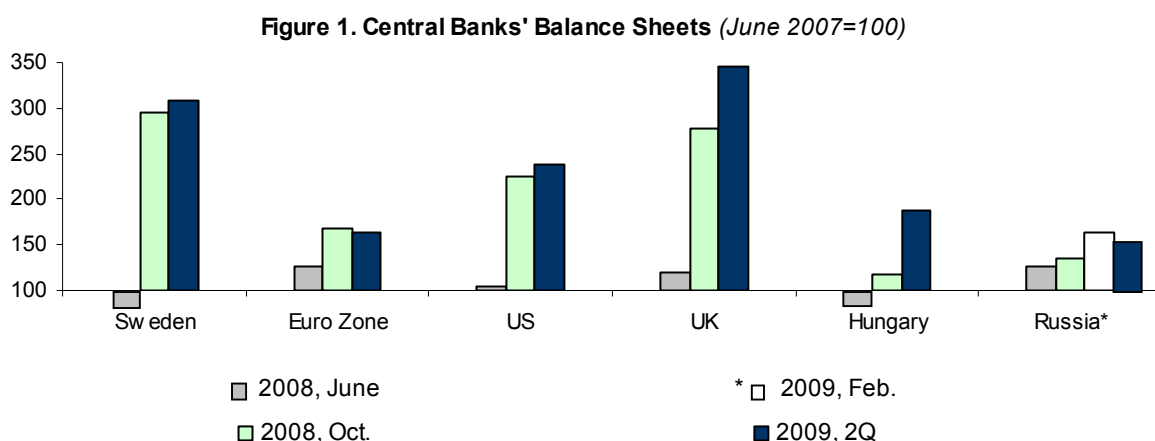


SOME RISKS OF RUSSIAN FINANCIAL SYSTEM*

* The article reflects the personal opinion of the author

The crisis events of 2008-2009 and the ensuing outflow of funds, problems of raising credits from foreign markets has emphasized again the need of internal sources to finance economic growth in turbulent external environment. Obviously during the crisis the role of monetary authorities rises. In many countries regulators had to be the main sources of finance, with a substantial increase in the balances of central banks in developed nations (Fig. 1).



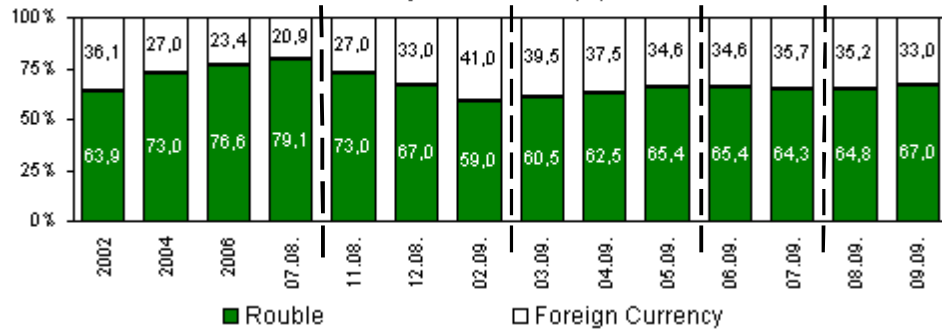
Source: IMF, WEO, Oct 2009; calc based on CBR data.

For internal financial stabilization a well-balanced foreign exchange policy is highly important. It should contribute to an increase of attractiveness of rubles and its role in savings and investments.

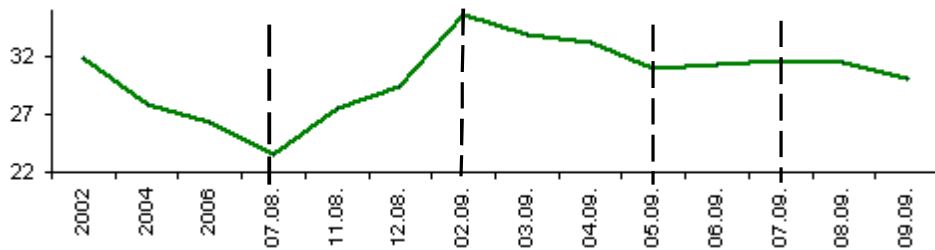
Let us note in this regard that the ruble devaluation conducted in late 2008–early 2009 had a considerable effect on the currency structure of business and household deposits, and substantially lowered attractiveness of the ruble. Several months of ruble devaluation have undone all the progress of the growth of ruble which it has been continuously showing several years in a row (Fig. 2).

It is also interesting to note how closely the changes of exchange rates and changes of “currency preferences” are related (ruble deposits grew with the ruble’s appreciation and vice versa), which should be taken into consideration in the foreign exchange policy.

Figure 2. Currency Structure of Deposits of Households and Corporate Funds¹ (%)



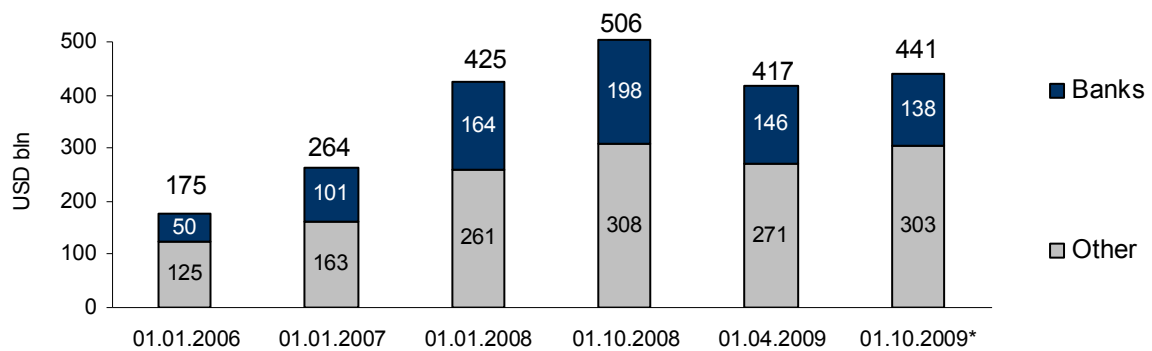
USD Nominal Exchange Rate (RUB/USD)



* Corporate funds incl. money on deposits, settlement accounts and other accounts.
Source: CBR; calc. based on CBR data.

It's particularly relevant when there is a high level of liquidity in the world (which means that these resources will seek spheres for their use and may lead to inflow of funds into Russian economy) and Russian companies have begun to obtain external financing more actively (which may be the cause of ruble appreciation) (Fig. 3).

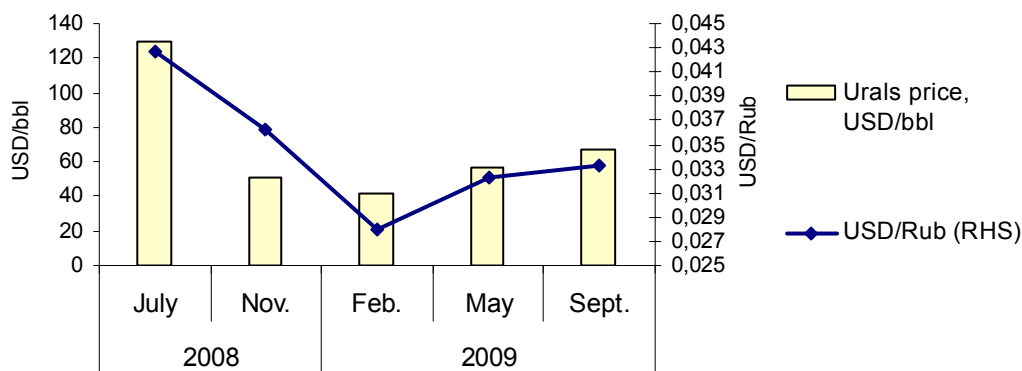
Figure 3. External Debt of Private Sector (USD bln)



* Est. of CBR
Source: CBR

The trend of oil prices is also important. Its correlation with ruble exchange rate is high enough (Fig. 4). The possible rise of oil price up to 100 \$/ton in H1 2010 (as some international organizations forecast) may enhance the upward trend of the ruble.

Figure 4. Oil Price and Ruble Exchange Rate (USD/bbl, USD/Rub)



Source: Ministry for Economic Development, CBR

The risk of reliance on external financing became obvious in full during the crisis. Companies faced difficulties in obtaining the credits from abroad, the cost of credits rose, and the problems of margin-calls became more acute; the companies faced the problem of repaying credits ahead of schedule. All these factors made their business activity more complex, increasing the risk of bankruptcy. In view of the foregoing an important anti-crisis measure is to replace external sources of financing by internal sources, which may play its stabilizing role in the future.

In this regard the mechanisms of money supply creation become highly important.

About Monetary Policy

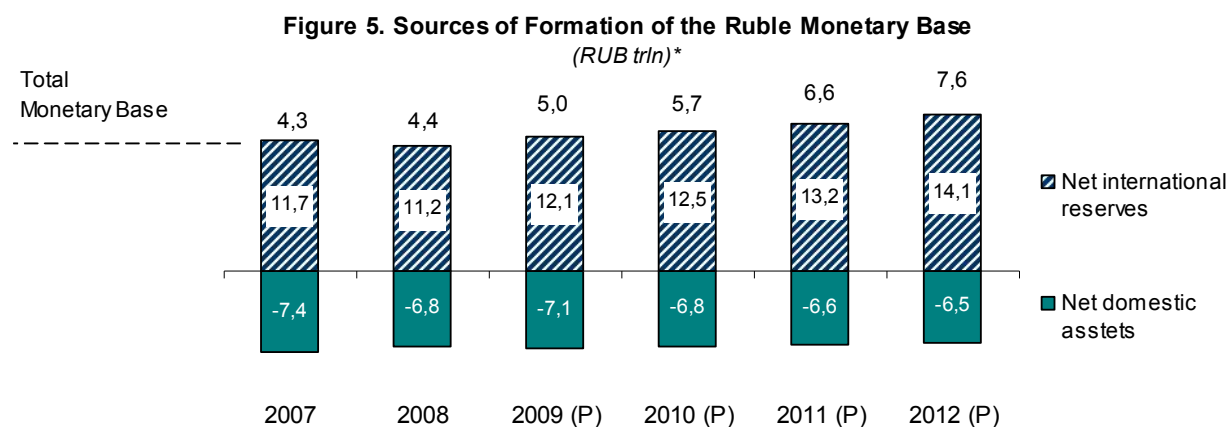
Already during 2008 when the crisis phase was high and the risks of external financing became more obvious, the Bank of Russia took into account these new conditions. “The Guidelines for the Single State Monetary Policy in 2009 and for 2010 and 2011” for the first time in many years began to put emphasis on domestic channels as the main source of money supply creation. It was planned that net domestic assets were to grow while external factor had to decrease. The regulators planned to use these new approaches in order to “use more effectively the interest rate instruments of monetary regulation and make the interest rate channel of the monetary policy transmission mechanism work”¹ as well as “to scale down the presence of the Bank of Russia on the domestic forex market which will help make the exchange rate policy more flexible and implement a gradual transition to the free floating exchange rate regime”².

However, the monetary program for 2010 was based on the assumption of growing net international reserves as the main source of growth of the monetary base. This basically meant a

¹ See: Guidelines for the Single State Monetary Policy in 2009 and for 2010 and 2011 / Bank of Russia. P. 27.

² See: *ibid.*

departure from the approaches, announced by the Central Bank a year ago, when CBR under the crisis pressure switched to using domestic sources of monetization as the main ones. Now (again, like during preceding years) external sources will serve the main role in the formation of monetary base (Fig. 5).



* 2009 - est. of CBR; 2010-2012 -projections of CBR according to the basic (second) variant of monetary program of 2009.

Source: according to *Guidelines for the Single State Monetary Policy in 2009 and for 2010 and 2011*; *Guidelines for the Single State Monetary Policy in 2010 and for 2011 and 2012*/ Bank of Russia.

One can hardly say however that the aims outlined in the document of 2008 have lost their relevance. What will then be the ways to meet the systemic structural challenges that Russian economy has to undergo? One should bear in mind that the external channel of monetization involves primarily a translation into Russia of external risks related to the attraction of resources (or impossibility of such, as was the case during the crisis). In addition, the mentioned approaches promote conservation of the export and raw material orientation of the Russian economy, a departure from which is set as an important systemic objective. Since an exporter of raw materials, by selling currency earnings and receiving additional rubles thus basically forms a demand for the other economic sectors which increasingly start to serve the interests of raw material sectors. As a result, position of oil and gas sectors in exports and GDP grow (which we observed for many years). In this connection, financial flows into non-export sectors decrease, transmission mechanisms cannot ensure efficient crossflows of resources, while interest rates cannot adequately reflect the price of funding for the economy³.

Another question that one might ask is: how do the objectives to reduce the presence of the Bank of Russia in the domestic currency market comply with the aim of retaining the currency earnings as the main source of money creation. After all it's the Bank of Russia that has to buy foreign exchange and to create rubles in this case.

³ These and other shortcomings of similar approaches were repeatedly pointed out before. See, for example, *M. Ershov. Economic Growth: New Problems and New Risks // Voprosy Ekonomiki [Economic Issues]. 2006. No. 12.*

Growing international reserves obviously increase strength for the economy (it was seen during the crisis). However, it does not mean that we should switch to the “currency board” mechanism (at least in its essence), where the entire liquidity is formed only on the basis of exchange inflows into the country, while the Central Bank actually refrains from its main function as a primary source of financial resources to which export and non-export sectors have equal access.

Export earnings and foreign loans will enter the economy anyway. Their role in the formation of the monetary base, however, should be balanced by mechanisms which are domestic by nature. Such origination should reckon with the needs of non-export sectors. Without their development, one can hardly count on real diversification of the economy and its departure from its raw-material profile.

Raw material supplies are surely necessary for the global economy. And since there are no efficient alternatives, Russia has to serve as such supplier. But should this function suffice and will it enable Russia to ensure its long-term systemic role in the world? And what should the Russian economy do when its non-renewable reserves shrink?

With balance of payment surplus in place (which is quite probable with relatively high oil prices), external monetization (with all its importance) should not be the only channel of money resources in the economy. If the objectives to improve the structure of the economy and to lower external risks remain acute, then it is necessary to carefully assess the possibility of a mixed approach, when the mechanisms of providing funds to the domestic sectors (while keeping optimal level of exchange rate) come to the forefront. (Using this approach, currency earnings, for example, can be purchased by the regulator not in full, but remain in the currency market (which will promote appreciation of the ruble, on the one hand, and an incomplete formation of monetary base resulting from purchase of the currency, on the other hand). To neutralize these consequence, a smaller (than planned) monetization can be compensated with the replenishment of resources through domestic channels, for which purpose combined use of refinancing, gross credits to banks, budgetary channels etc. can be applied. The additional liquidity entered through the above channels may promote a more even distribution of resources among the export and non-export sectors. It may also bring about the adjustment of exchange rate (as some of this liquidity may return to the currency market and cause depreciating tendencies).

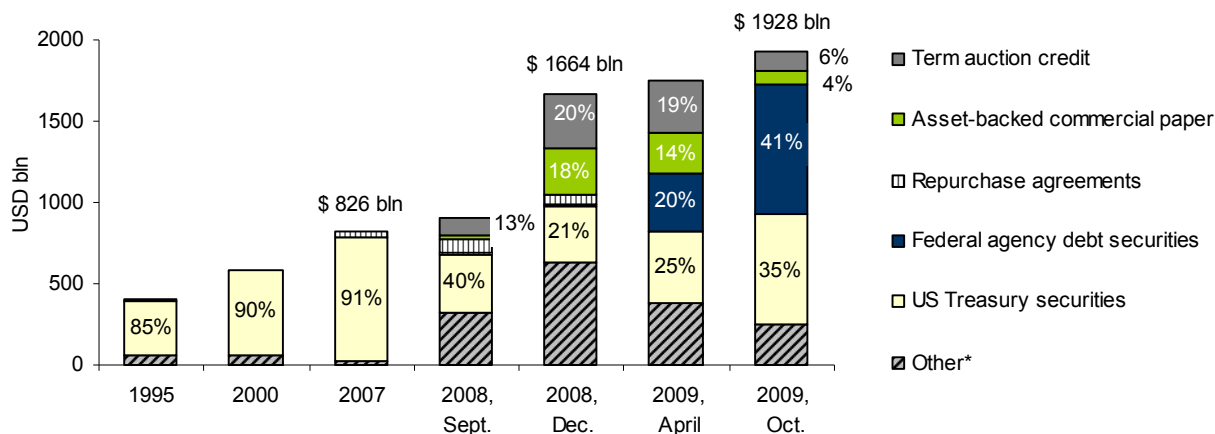
It is also possible to use the currency instruments of the Ministry of Finance or the Central Bank (with a sufficient rate of return) to accumulate some part of currency earnings. In this connection, one should assess the practical side of ensuing direct sale of this currency from the Minfin (if purchases were made using its instruments of the Minfin) to the Central Bank at

the market rate as of the date of the operation (which, firstly, would replenish the ruble liquidity to the market and, secondly, would not have a direct impact on the exchange rate).

About International Approaches

In developed economies multifaceted approaches of monetary base creation have been used for a long time. An important role belongs to budgetary instruments (treasury bills) which, in the first place, provide long-term basis of financing, and secondly, promote more target oriented flow of funds due to economic priorities and anti-crisis measures (Fig. 6-7).

Figure 6. USD Monetary Base (USD bln; %)



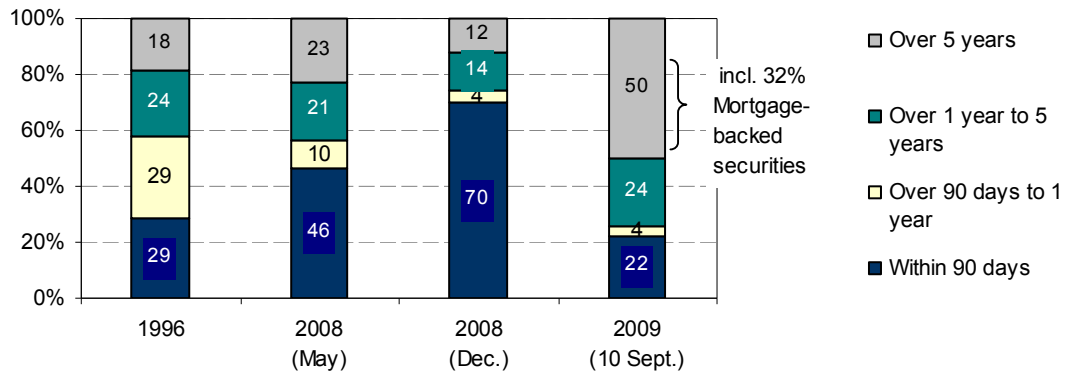
* Incl. other loans, gold stock, central bank liquidity swaps etc.

Source: US Fed, calc. based on US Fed data.

The latest recessionary developments forced FRS to substantially increase the monetary base itself (actually 2-fold by now) as well as to radically change the structure of its components.

The term structure of monetary base components also requires attention. During a long period the creation of dollars was based on the FRS purchase of the long-term instruments (which accounted for at least 40% of the entire monetary base). This made it possible to form a more stable long-term basis of financial resources in the economy. During the acute phase of the crises, the short-term instruments came to the forefront (this was caused by the need to provide emergency funds to the market). By mid-2009, however, the component of long-term resources regained importance (instruments whose term exceeded 1 year accounted for more than 70% of the entire portfolio). Let us point out, however, that the greater share of long-term securities (which can be seen recently) may be explained by the purchase of mortgage securities to support this market segment, which in total makes the FRS balance less stable than before.

Figure 7. Maturity Distribution of Monetary Base Components (%)



Source: calc. based on US Fed data.

An increase of the US budget deficit and the government debt became more significant as a result of anti-crisis measures which were taken by US regulators recently. If these tendencies continue, the solving of the problems that caused the crisis may transform them into the new sources of new crises and will reinforce new risks. This may cause the emergence of new external risks for Russian economy.

In this connection mechanisms to mitigate risks and support development which will be possible even in turbulent external environment are necessary. The approaches to the creation of monetary base should be well-balanced and risky assets should play a diminished role in its creation.

The monetary base should lay basis for long-term finance of the economy and may provide systemic flow of funds, which are necessary for structural reforms.