

EMERGING EUROPE FOCUS

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Editors: Roger Bootle and Jonathan Loynes

Will deficit financing trigger a surge in Russian inflation?

- **There are good reasons to think that monetisation of Russia's budget deficit will not necessarily lead directly to a pick-up in inflation. But it adds to the downside risks facing the ruble. We expect the currency to fall by 10% against its dollar/euro basket over the next six months or so, breaching the current lower bound of its trading range.**
- Russia's budget deficit looks set to top 9% of GDP this year and despite some planned fiscal consolidation is unlikely to fall much below 5% of GDP by 2011. While the government has plenty of scope to finance its shortfall by issuing debt, the immediate plan is to tap its pot of savings made during the oil price boom (the so-called 'Reserve Fund').
- Yet while in a pure accounting sense, the Ministry of Finance is drawing on its savings to fund the budget shortfall, the manner in which this transaction is carried out via the Central Bank (CBR) means that it is equivalent to printing money – or so-called monetisation of the deficit.
- However, fears that this might lead to a surge in inflation look overdone. For a start, the CBR has partly sterilised the associated rise in the monetary base, for example by withdrawing funding to commercial banks or by issuing short-term debt. Admittedly, it is coming under increasing political pressure to stimulate bank lending, so this could change. But even so, frailties in the financial system mean that an increase in the monetary base is unlikely to feed through into an increase in the broader money supply and thus inflation.
- Indeed, the bigger picture is that with huge amounts of spare capacity opening up, inflation is likely to *fall* further over the coming months and quarters. We think it could reach 8% by the end of 2010.
- A more pressing concern is that any move by the CBR to sterilise less of the increase in the monetary base could add to the downside risks to the ruble. If the CBR allows ruble liquidity in the banking system to build, a shock to oil prices could put downward pressure on the ruble and trigger a mass exit into foreign currency (similar to that experienced earlier this year). This, in turn, would exacerbate the ruble's decline and force a sharp tightening of monetary policy.

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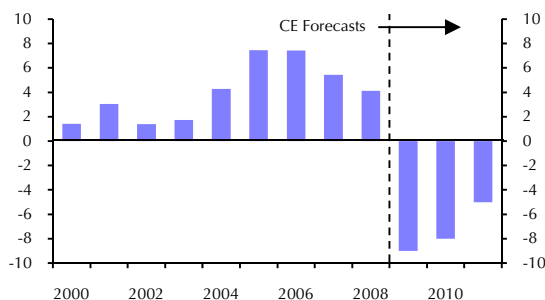
Concerns that the Russian government is printing money in order to finance its ballooning fiscal deficit are growing. But are these justified? And if so, what are the implications for inflation and the ruble? In this short *Focus* we take a closer look.

How did we get here?

Between 2000 and 2008, Russia ran a series of large budget surpluses. This was driven initially by a recovery in tax receipts following the 1998 financial crisis and sustained in later years by a boom in oil and gas prices. By 2008, oil and gas accounted for just under half of all government revenues.

However, over the past year the budget has swung from large surplus to an even larger large deficit, driven by a combination of the slump in oil prices from last year's high, a deep recession in the real economy and one of the largest discretionary fiscal stimulus packages in the G20 (worth around 5% of GDP). We think the deficit could hit 9% of GDP this year and, despite a planned fiscal tightening over the next couple of years, think it is likely to still be around 5% of GDP by 2011. (See Chart 1.)

CHART 1: FEDERAL GOVERNMENT BUDGET (% OF GDP)

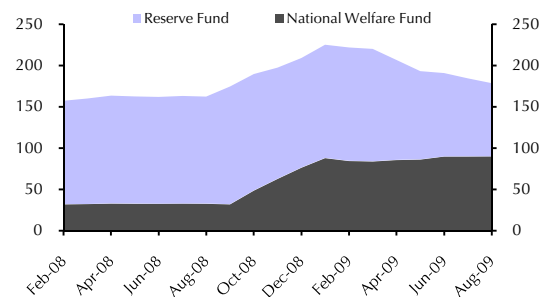


Sources – Bloomberg, Capital Economics

This has raised questions as to how the government will finance its shortfall. **While there is plenty of scope for the government to issue debt (general government debt was just 7% of GDP last year), the immediate plan is to fund the deficit using its Reserve Fund** – a pot of savings accumulated during the boom in oil prices

between 2005 and mid-2008 and stored in foreign currency. At its peak at the start of this year, this totaled \$137bn - about 12% of GDP and enough to fund the deficit until mid-2010. Beyond that, the government looks set to rely on a combination of debt issuance and the National Welfare Fund, which currently holds an additional \$90bn of oil savings. (See Chart 2.)

CHART 2: RESERVE FUND & NATIONAL WELFARE FUND (\$BN)



Source – Russian Ministry of Finance

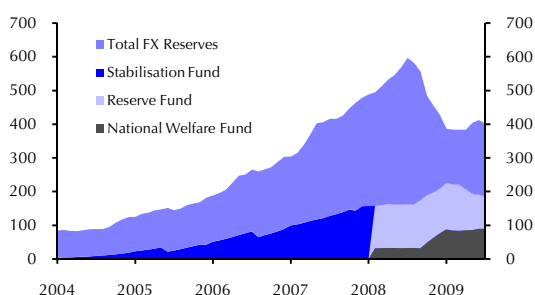
What's the fuss about monetisation?

On the face of it, financing the deficit from the Reserve Fund simply requires the government to convert its foreign currency savings into rubles. So how do we explain growing fears that it is monetising the deficit, or printing money to finance the shortfall?

The key lies in understanding how the Reserve Fund is managed. This is where matters become complicated. While the Fund belongs to the Ministry of Finance (MoF), it is stored at the Central Bank of Russia (CBR) and is counted as part of Russia's overall foreign exchange (FX) reserves.

It is therefore also included on the CBR's balance sheet. On the assets side, the Reserve Fund appears within the overall FX reserves, while an equivalent amount owing to 'Federal Government Funds' is included on the liabilities side. As of June 30th, around half of Russia's \$410bn FX reserves belonged to the CBR, while the other half belonged to MoF. (See Chart 3 overleaf.)

CHART 3: FX RESERVES & OIL SAVINGS FUNDS (\$BN)



Source – Russian Ministry of Finance, Central Bank of Russia

Crucially, when the MoF wishes to convert part of the Reserve Fund from FX into rubles, the transaction is not carried out on the open market. Instead, the MoF transfers a chunk of its foreign currency savings to the CBR, which, in return, prints the equivalent amount of rubles and gives them to the MoF.

As a result of the transaction, the overall size of Russia’s FX reserves is unchanged – the CBR’s share rises, while MoF’s falls. Likewise, because the Reserve Fund was already included on the CBR’s balance sheet, its overall size is also unchanged. However, the *composition* of the CBR’s balance sheet does change in a way that could potentially increase the monetary base – specifically, on the liabilities side a reduction in government funds is offset by an increase in cash in circulation. (See Table 1.)

TABLE 1: CHANGE IN CBR’S BALANCE SHEET AS A RESULT OF DEFICIT FINANCING VIA RESERVE FUND

Assets	
FX Reserves	↔
Credits & Deps	↔
Securities	↔
Liabilities	
Cash	↑
Total Funds at CBR	↓
<i>Of which:</i>	
Russia Govt Funds	↓
Funds of Banks	↔
Others	↔

Source – Capital Economics

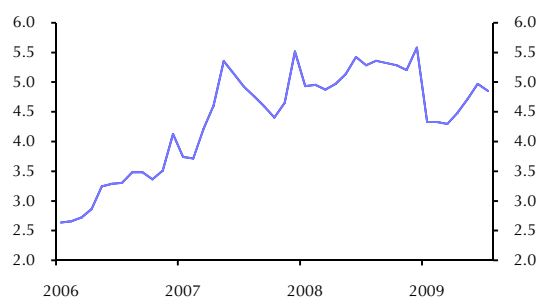
Are inflation fears justified?

Printing money to fund a fiscal deficit is perhaps the most basic form of quantitative easing. Critics argue that it is one thing for central banks in the developed world to embark on QE, but quite another for central banks in the emerging world to do so. Indeed, monetisation of the deficit calls to mind the recent experience of Zimbabwe, which invoked a similar policy and was, of course, ravaged by hyperinflation.

However, there are good reasons to think that fears of a surge in inflation in Russia are overdone. **For a start, the CBR can choose to sterilise the expansion in the monetary base that results from its transactions with the MoF.** This can be done in a number of ways. For example, it could issue debt to mop up the additional liquidity or it could withdraw funding to commercial banks.

Indeed, it seems that this has been the case – while the government has drawn down around 1.9trn rubles from the Reserve Fund since the start of the year, the monetary base has only increased by 0.6trn rubles. (See Chart 4.) In other words, around 1.3trn of the increase in the monetary base has been sterilised.

CHART 4: MONETARY BASE (Rb TRN.)



Source – Central Bank of Russia

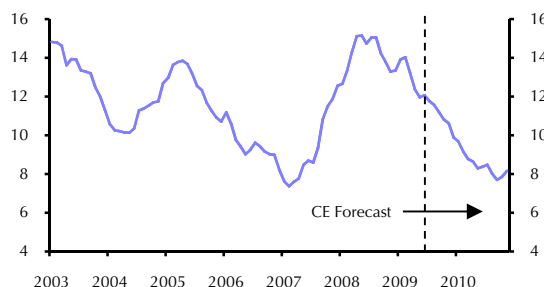
Admittedly, it is likely to become increasingly difficult for the CBR to sterilise its operations over the second half of the year. For a start, the government’s deficit is likely to get much larger. This is partly due to strong seasonality in Russia’s public finances (spending typically rises in the final months of the year). But in addition, recent

comments from MoF officials suggest that up to two-thirds of the stimulus spending ear-marked for this year has yet to be spent.

More generally, the CBR is coming under increasing pressure from the Kremlin to stimulate lending in the economy, which suggests that it could opt to leave an increasing amount of the deficit financing unsterilised.

But even if this is the case, **frailties in the financial system mean that an increase in the monetary base is unlikely to feed through into an increase in the broader money supply and thus inflation.** The bigger picture is that with huge amounts of spare capacity opening up, inflation is likely to fall further over the coming months and quarters. We think it could reach 8% by the end of 2010. (See Chart 5.)

CHART 5: CONSUMER PRICES (% Y/Y)



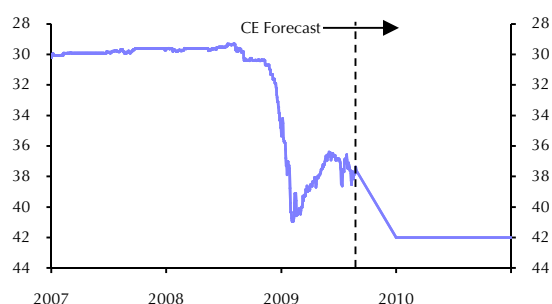
Sources – Thomson Datastream, Capital Economics

Renewed ruble weakness on the horizon

A more pressing concern is that any move by the CBR to sterilise less of the increase in the monetary base could add to the downside risks facing the ruble. Admittedly, the currency has rallied by 8% against its dollar/euro basket from the lows seen in February 2009. But we have long argued that oil prices are likely to fall back towards \$50pb next year as the pace of recovery in the global recovery disappoints, and that this is likely to lead to a renewed sell-off in the ruble. **We think it could fall by 10% against the basket by mid-2010, breaching the current lower bound of its trading range of 41 to the basket.** (See Chart 6.)

If the CBR allows ruble liquidity in the banking system to build, a shock to oil prices could trigger a mass exit into foreign currency (similar to that experience earlier this year). This, in turn, would exacerbate the ruble's decline. (Note, however, that the pass-through to higher inflation is likely to be limited by a general weakness in demand).

CHART 6: RUBLE (VS. DOLLAR/EURO BASKET)



Sources – Bloomberg, Capital Economics

In response, the CBR would be forced to tighten monetary policy aggressively, with obvious implications for a fragile banking sector. **At the very least, currency concerns mean that there appears little further room for cuts in official rates, despite mounting pressure from the government** – we have pencilled in a further modest fall in the key refinancing rate to 10% (from 10.75%) by the end of the year, and a similar drop in the repo rate to 9%. But aside from the mounting risk that official rate cuts will have to be reversed in order to shore up the ruble, a fragile banking sector means that credit conditions in the real economy are likely to remain tight for some time yet.

Conclusions

To sum up, while in a strict accounting sense, the Ministry of Finance is drawing on its savings to fund the budget shortfall, the manner in which this transaction is carried out via the Central Bank means that it is equivalent to printing money – or so-called monetisation of the deficit.

However, the resulting increase in the monetary base has been partly sterilised and, in any case, a fragile banking sector means that any increase in

base money poses little threat to inflation. Instead, the bigger concern is that if the CBR allows ruble liquidity in the banking system to build, a shock to oil prices could trigger a mass exit into foreign currency and exacerbate the drop in the ruble.