ECONOMIC AND FINANCIAL RELATIONS BETWEEN THE EURO AREA AND RUSSIA

This article reviews economic developments in Russia, as well as the economic and financial relations between the euro area and Russia. It analyses the factors that have contributed to strong growth and macroeconomic stabilisation in Russia, focusing on the conduct of monetary policy as well as key steps in banking sector reforms. Trade and financial links between the euro area and Russia have also strengthened in recent years, while the EU and Russia are seeking to create an open and integrated EU-Russian market in the long term. Against this background, the Eurosystem and the Bank of Russia have intensified their dialogue and cooperation, as demonstrated by the high-level Eurosystem-Bank of Russia Seminars, the first two being held in May 2004 and October 2005, and the EU's two-year TACIS project in the field of banking supervision, which the Eurosystem implemented together with the Bank of Russia.

1 INTRODUCTION

Russia, with a population of more than 140 million, is the largest country neighbouring the European Union and a strategic partner. The country's transition from a planned to a market economy was difficult at first, culminating in the financial crisis of August 1998. Since then, however, the economy has seen a period of strong growth, macroeconomic stabilisation and structural reforms, supported by a substantial increase in the prices of energy and metals, Russia's main export goods. Economic links between the euro area and Russia have strengthened in the areas of trade, finance and investment.

Nevertheless, various challenges remain. The achievement of sustainable growth is seen by the Russian authorities as requiring the diversification of the economy. Strong capital inflows are making it more difficult for the authorities to achieve their twin monetary policy goals of reducing inflation and containing the appreciation of the real effective exchange rate. And while progress has been made in banking sector reform, there is a need for further strengthening of the legal and regulatory framework. In terms of economic relations, the EU and Russia are seeking to create, in the long term, an open and integrated EU-Russian market. This will foster real integration between the euro area and Russia via the further development of trade and euro area investment in Russia.

The Eurosystem has enhanced cooperation with the Bank of Russia, complementing the bilateral relations that several national central banks have been developing since the 1990s. The two-year training programme on banking supervision, implemented by the Eurosystem for the benefit of the Bank of Russia and funded by TACIS, the EU's technical assistance programme for the CIS countries, has been the most visible form of that extended cooperation. The Eurosystem and the Bank of Russia have also held high-level seminars focusing on the central banking dimension of the economic and financial links between the two economic areas.[1] Against this background, this article examines economic developments and policies in Russia, analyses economic and financial linkages between the euro area and Russia, and provides an overview of relations between the Eurosystem and the Bank of Russia.

2 THE RUSSIAN ECONOMY

Since the 1998 financial crisis Russia has seen an unprecedented period of growth, with real GDP increasing by almost 50% at an average annual rate of 6.8%. The initial real depreciation of the rouble, combined with significant increases in both the prices of Russia's main export goods – energy and metals – and the volume of such exports,

1 Over the last few years the Eurosystem has held several high-level seminars with regional groups of central banks. See the articles entitled "The Barcelona partner countries and their relations with the euro area" and "Economic integration in selected regions outside the European Union" in the April and October 2004 issues of the Monthly Bulletin.

Table 1 Key economic indicators

(annual percentage changes, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	2004
Real GDP	-5.3	6.4	10.0	5.1	4.7	7.3	7.2
Private consumption	-3.4	-2.9	7.3	9.5	8.5	7.5	10.7
Fixed capital formation	-12.4	6.4	18.1	10.2	2.8	12.8	10.8
Current account balance (as a percentage of GDP)	0.1	12.6	18.0	11.1	8.4	8.2	10.3
Inflation, at year-end	84.4	36.5	20.2	18.6	15.1	12.0	11.7
General government balance (as a percentage of GDP)	-8.2	-3.1	3.1	2.7	0.6	0.9	4.5
Unemployment (as a percentage of workforce; annual averages)	11.9	12.9	10.5	9.0	8.1	8.6	8.2
Nominal GDP (EUR billions)	242	184	281	342	365	382	468

Sources: Federal State Statistics Service, Bank of Russia, IMF and ECB calculations.

provided a strong stimulus to growth and led to current account surpluses of between 8% and 18% of GDP. From 2000 corporate investment and private consumption turned the recovery into a broad-based expansion, supported by macroeconomic stabilisation and structural reforms in areas such as business deregulation, taxation and land ownership. More recently, despite the continuous rise in energy prices and a record current account surplus, growth rates have declined somewhat, reflecting the real appreciation of the rouble and an uncertain business and regulatory environment, highlighting the need to implement further structural reforms in areas such as energy, health, education, public administration and the judiciary.

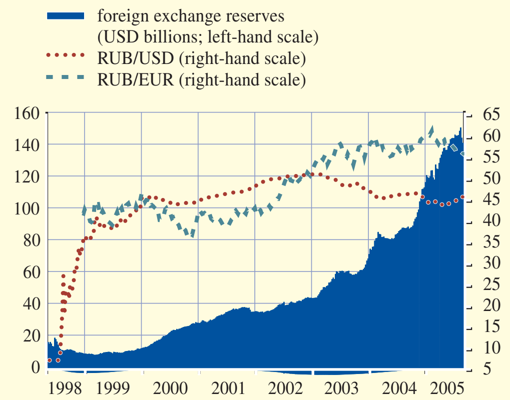
Growth is the priority of Russian economic policies, with the goal of doubling real GDP in a decade, implying an average annual growth rate of over 7%.[2] Currently Russian GDP per capita stands at around 15% of euro area GDP per capita in nominal terms and around 35% of euro area GDP per capita in purchasing power parity terms.

Russia accounts for 6.1% of the world's proven oil reserves and 26.5% of the world's proven gas reserves, making economic development considerably dependent on the energy sector. Domestically, the energy and metals sectors are estimated to account for as much as 25% of GDP.[3] Moreover, the oil and gas sectors make up more than 50% of total exports of goods and services and generate up to 40% of all federal budget revenues. Econometric analysis suggests that the effect of oil price changes on Russian GDP growth is substantial.[4] Over the last few years Russia has benefited not only from rising world prices for its main export products, but also from increased production. For example, output of crude oil rose from 6.2 million barrels per day (bpd) in 1998 to 9.8 million bpd in 2004, making Russia the second largest oil producer in the world. Looking ahead, the creation of a more diversified economy is seen by the Russian authorities as a prerequisite for the achievement of sustainable growth.

The economic recovery after the financial crisis was accompanied by a decline in annual inflation, from more than 80% at end-1998 to 10% in mid-2004, and a stabilisation of the exchange rate (see Chart 1). Currently the Bank of Russia has two monetary policy goals, namely reducing inflation and slowing the pace

2 The government recently projected GDP growth of 5.9% in 2005.
3 This figure, published by the World Bank for 2000, takes into account transfer pricing between producers and their trading companies in the various sectors. The figure is twice as high as that indicated in official data.
4 See, for example, International Monetary Fund (2002), *Russian Federation: Selected Issues and Statistical Appendix*, IMF Country Report No 02/75, Washington, DC, and Rautava, J. (2002), *The role of oil prices and the real exchange rate in Russia's economy*, BOFIT Discussion Paper 3/2002, Helsinki.

Chart 1 Foreign exchange reserve and exchange rate developments



Sources: Bank of Russia and Bloomberg.

of real exchange rate appreciation to support growth in the non-energy sector of the economy, and foreign exchange market interventions have been the main instrument to achieve these goals. Against the background of sizeable current account surpluses, this has led to a rapid accumulation of foreign reserve assets, from USD 12 billion at end-1998 to more than USD 140 billion in mid-2005, making Russia the seventh largest holder of foreign exchange reserves worldwide and an international net creditor.

Foreign exchange interventions have been accompanied by high rates of growth in monetary aggregates, even though prudent fiscal policies have helped to partly sterilise interventions via government deposits held at the Bank of Russia and – since the beginning of 2004 – via the newly established oil stabilisation fund. Thus, inflation has picked up since summer 2004, with year-on-year inflation standing above 12% in mid-2005, compared with the end-year goal of 7.5-8.5%.[5] Moreover, owing to persistent inflation and appreciation pressures, the rate of appreciation of the rouble's real effective exchange rate stood at 8.3% year on year in mid-2005, i.e. slightly higher than the upper limit of 8% within which the Bank of Russia aims to maintain real effective appreciation by the end of 2005.

Rising income from oil exports has, together with strong growth, led to a turnaround in government finances compared with the pre-1998 period. Since 2000 the government budget has seen five successive years of surpluses. For 2005 a new record surplus is expected, despite some increases in government spending, for example in relation to social security reforms. At the same time, the amounts deposited in the oil stabilisation fund increased from less than 1% of GDP at the beginning of 2004 to more than 3% at end-June 2005. In addition, Russia prepaid all of its remaining debt to the IMF in early 2005 and made substantial prepayments of its previously rescheduled Soviet-era debt to the Paris Club of official creditors in summer 2005. The government's strong fiscal position and improving external position has been a major reason for both a continuous upgrade in sovereign credit ratings, which have reached investment grade, and a major decline in sovereign spreads, which stood below 100 basis points in autumn 2005 (see Chart 2).

The strong macroeconomic environment also supported the recovery of the Russian banking sector, the main pillar of the Russian financial system. Profitability and asset quality improved, and the capital adequacy ratio of banks with positive capital recovered after the crisis, standing at 17% at end-2004. Assets, deposits and loans have been surpassing pre-crisis levels as a percentage of GDP. Lending to the private sector, in particular household lending, has seen strong growth, raising the question of whether this development reflects a catch-up in "financial deepening" or whether credit is expanding at a pace that – also given the experiences of other emerging market countries – could risk becoming unsustainable. Reflecting increasing confidence in the stability of the domestic currency, rouble deposits have recorded strong growth, leading

5 The government recently projected an inflation rate of 10-11% for 2005.

Table 2 Key monetary and financial indicators

(annual percentage changes, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	2004
Foreign exchange reserves (USD billions), at year-end	12.2	12.5	28.0	36.6	47.8	76.9	124.5
Broad money (rouble M2)	21.3	57.5	61.6	39.7	32.4	50.5	35.8
Money market rate (percentages per annum)	50.6	14.8	7.1	10.1	8.2	3.8	3.3
Banking sector assets	50.3	51.6	48.9	33.7	31.2	35.1	27.4
Credit to the private sector	64.2	53.7	53.6	52.0	30.0	44.8	48.6

Sources: Bank of Russia and ECB calculations.

to a drop in the share of foreign currency-denominated deposits in total deposits, from around 40% at end-1998 to 25% at end-2004.

State-owned credit institutions continue to play a substantial role in banking sector structures, with approximately 38% of total banking sector assets being held by such institutions and the two largest banks being state-owned. Moreover, the entire banking sector shows a substantial degree of concentration, as 20 out of a total of 1,270 banks account for over 60% of assets, 75% of household deposits and over 50% of corporate accounts. While banks with foreign capital account for less than 8% of banking sector assets, the majority of financial institutions are banks with private, domestic ownership. Many of them remain small and continue to display poor governance, with opaque ownership and capital structures. Moreover, although banks have made efforts to enter new markets, balance sheets are still highly concentrated on a small number of borrowers and depositors.

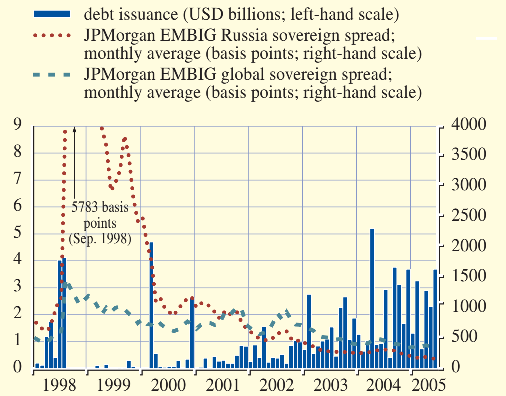
Reflecting these structural weaknesses, a crisis of confidence struck the private domestic banking sector in the early summer of 2004.[6] This confirmed the need for an acceleration of banking reforms, as laid down in the authorities' banking sector strategy. Principal goals include enhancing the effectiveness of intermediation services, increasing the transparency and international competitiveness of the industry and preventing illegal activities, especially money laundering and the financing of terrorism.

A key element in this strategy has been the introduction of a general deposit insurance system. By the end of September 2005 more than 920 banks – representing almost 99% of total household deposits – had been admitted to the scheme, leading to some consolidation in the sector. The scheme was initially seen as an instrument for creating a more level playing field with the state-owned banks. However, it has also proven instrumental in exploring the ownership and capital structures of Russian banks in the course of the process of reviewing the applicant banks. Together with a number of regulations issued in 2004, including those aimed at fighting the fictitious capitalisation of banks, it represents a further step in the Bank of Russia's efforts to supplement compliance with risk-based banking supervision. Nevertheless, there is a need for further strengthening of the legal and regulatory framework.

Russian banks have only recently joined large non-financial corporations in raising funds from global capital markets. International bonds and loans issued by the non-financial corporate sector, mainly companies in the oil, gas, metal and telecommunication sectors, totalled over USD 18 billion in 2004, up from USD 3 billion in 2001 (see Chart 2). In the

6 The crisis was triggered by the withdrawal of the licence of a medium-sized bank on charges of money laundering, followed by tensions in the interbank market. In mid-summer a relatively large bank was struggling to meet payments to customers, which led to deposit withdrawals from some private banks. See also Box 1 in the ECB's December 2004 Financial Stability Review.

Chart 2 International debt[1] and bond spreads



Sources: Bondware, Bloomberg and ECB calculations.
1) International bond issuance and borrowing by Russian entities.

same period the exposure of BIS reporting banks to the Russian corporate sector rose by USD 14 billion to more than USD 27 billion. Thus, the corporate sector's stock of gross foreign debt (excluding debt to foreign owners) stood at 10% of GDP at end-2004, up from 5% at end-2000.

3 ECONOMIC AND FINANCIAL LINKS BETWEEN THE EURO AREA AND RUSSIA

Economic and financial links between the euro area and Russia have strengthened over the last few years. The euro area is Russia's most important trading partner, accounting for around 35% of Russia's total trade in goods (while the European Union as a whole accounts for around 50% of Russia's total trade in goods). While Russia's share in the trade of the euro area is considerably smaller, it has increased by more than 80% from the low level of 1999, driven by rising global energy and metal prices,[7] as well as strong Russian growth. In 2004 Russia accounted for around 3% of the euro area's goods exports and almost 5% of imports (see Table 3), making it the fourth largest non-EU destination for euro area exports, after the United States, Switzerland and China, and the third largest non-EU source of euro area imports, after the United States and China.

Trade developments are strongly influenced by the fact that Russia provides around one-quarter of the EU15's total net imports of oil and around one-third of its gas imports. Against the background of rising prices on world markets, imports from Russia have become even more dominated by energy supplies and metals (see Chart 3). At the same time, growth in euro area exports has been driven by strong consumption and investment demand in Russia for machinery and transport equipment, including passenger cars and telecommunications equipment, as well as various manufactured goods.

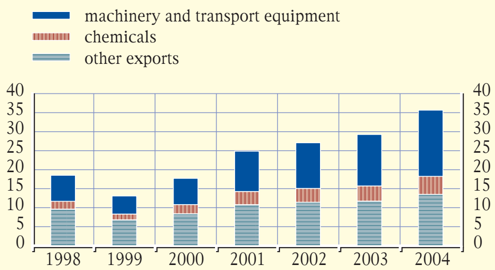
While the 1998 financial crisis had a severe effect on financial links between the euro area and Russia, the subsequent recovery has confirmed the prominent role of euro area banks as creditors of the Russian economy, with those banks providing a significant amount of the funds that the Russian corporate sector has been raising in global markets over the last few years. At the same time, the Russian banking sector is holding part of its foreign assets in euro area banks and securities. The EU is a major source of foreign direct investment (FDI) in Russia, accounting for around 37% of total FDI flows. However, the current level of FDI flows into Russia is, at around 2% of GDP, still low compared with other countries in Central and Eastern Europe. Correspondingly, Russia receives less than 1% of all FDI by euro area investors. Further positive changes in the investment climate, including better protection of ownership rights, the enhancement of the rule of law and the strengthening of market economy institutions, will be needed to foster real integration via euro area investment in Russia. At the same time, while total FDI flows from Russia are

7 See also Box 1 in the July 2005 issue of the Monthly Bulletin, which stresses that euro area exports have benefited from increasing import demand by oil-exporting economies in the CIS.

Chart 3 Euro area trade in goods with Russia

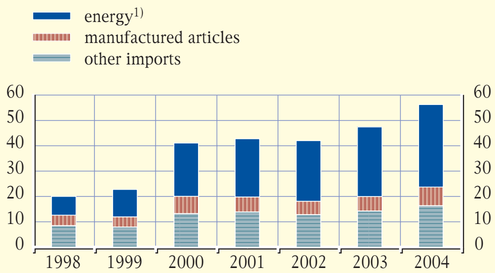
(EUR billions)

Euro area exports to Russia



Source: Eurostat.

Euro area imports from Russia



Source: Eurostat.
1) The chart understates the importance of energy in imports from Russia, since the data in that product group do not include most of the imports of Russian gas into the euro area (instead, most of the gas imports are included in "other imports").

roughly equal to FDI flows into Russia, the EU and the euro area have until now received only a small share of Russian FDI.

In recent years the Bank of Russia has taken steps that have led to the increased use of the euro as an anchor and reserve currency. Since 2003 the Bank of Russia's exchange rate policy has aimed to limit the real effective appreciation of the rouble against a trade-weighted currency basket composed of the currencies of a large number of Russia's trading partners. Euro area countries, and hence the euro, have a weight of over 36%. In February 2005 an operational US dollar-euro basket was introduced as a point of reference for the daily management of the rouble exchange rate. The weight of the euro in this operational basket, initially set at 10%, increased to 35% by August 2005. In line with this change in exchange rate management, daily volatility in the rouble/euro exchange rate has decreased slightly. Euro-denominated assets have also increasingly been included in the Bank of Russia's foreign exchange reserve holdings, with the authorities recently indicating that euro-denominated assets make up around one-third of total foreign exchange reserves. Thus, Russia has become a significant holder of euro-denominated reserve assets.

Data on foreign exchange cash transactions by authorised Russian banks also suggest that demand for euro cash by Russian households has increased following the euro cash changeover, mainly – as indicated by the seasonal pattern of banks' euro sales – for tourism purposes. By contrast, the use of the euro as a vehicle currency in the foreign exchange market and as an investment and financing currency remains limited. While the euro's share in the foreign assets of Russian banks rose to around 20% in early 2005 (up from around 7% in early 2002), the share of the euro in banks' foreign liabilities has remained at around 7%. Foreign banknotes and foreign exchange deposits are mainly held in US dollars.[8]

4 RELATIONS BETWEEN THE EUROSYSTEM AND THE BANK OF RUSSIA

Relations between the Eurosystem and the Bank of Russia have strengthened considerably in recent years, complementing the bilateral relations and cooperation that several national central banks of the Eurosystem have been developing and implementing since the 1990s. The cornerstones of that process have

8 2002 estimates put the amount of US dollar cash circulating in Russia and the former Soviet Union at USD 178 billion, close to 30% of total US dollar cash held abroad. See Botta, J. (2003), *The Federal Reserve Bank of New York's experience of managing cross-border migration of US dollar banknotes*, BIS Papers No 15, Basel, pp. 152-162.

Table 3 Selected indicators of economic and financial integration between the euro area and Russia

	2000	2001	2002	2003	2004
Trade					
Share of Russia in the euro area's trade in goods					
Exports	1.8	2.3	2.5	2.8	3.1
Imports	3.9	3.8	3.6	4.1	4.6
Share of the euro area in Russia's trade in goods					
Exports	29.2	32.5	30.0	30.7	32.8
Imports	28.0	34.4	34.1	32.7	40.8
Share of Russia in the euro area's trade in services	1.2	1.3	1.2	1.2	...
Finance					
Claims of euro area BIS reporting banks on Russia					
USD billions	30.8	30.8	24.1	33.3	40.7
As a percentage of total claims on Russia	85.0	83.4	71.9	72.8	72.4
Direct investment (EUR billions)					
Euro area foreign direct investment in Russia					
Flows	1.5	1.6	1.9	4.0	...
Stocks	4.8	6.8	7.3	...	...
Russian foreign direct investment in the euro area					
Flows	0.3	0.5	0.1	0.5	...
Stocks	2.1	2.5	2.8	...	...

Sources: Eurostat, IMF, BIS and ECB calculations.
Note: No data are available for the share of the euro area in Russia's trade in services.

been (1) the high-level Eurosystem-Bank of Russia Seminars, the first two being held in May 2004 and October 2005, and (2) the EU's two-year TACIS project in the field of banking supervision, which the Eurosystem implemented together with the Bank of Russia.

Cooperation between the Eurosystem and the Bank of Russia has been advancing against the general background of EU-Russian relations. Those relations are based on the Partnership and Cooperation Agreement (PCA), in force since 1997, which covers a number of areas, including trade and economic cooperation. In particular, the PCA envisages the establishment of an EU-Russian free trade area. In 2003 both sides agreed to develop, in the long term, four common spaces in the areas of economic relations; freedom, security and justice; external security; and research and education. Against the background of the experience gained in Europe and many other parts of the world about the role of markets in promoting trade and economic growth, the objective of the Common Economic Space is to create an open and integrated EU-Russian market once Russia has joined the World Trade Organization (WTO). The road map towards this goal foresees a wide range of actions, including a regulatory dialogue on industrial products, competition legislation, investment regulation, the stability of the financial system, accounting and auditing, trade facilitation and customs, as well as telecommunications, transport and the environment. The EU and Russia also aim to maintain the momentum of the energy dialogue established in 2000, dealing with questions of common interest relating to the most prominent sector in EU-Russian trade.

The increasing degree of real and financial integration and economic cooperation between the EU and Russia was also one of the issues discussed intensively at the first high-level Eurosystem-Bank of Russia Seminar in May 2004 in Helsinki. Participants agreed that EU enlargement had created new opportunities to explore the mutual benefits of economic integration in terms of trade and investment flows. Thus, there is a strong basis for a constructive dialogue between the Eurosystem and the Bank of Russia on the central banking dimension of this integration process. Against this background, the Helsinki seminar focused on the conduct of monetary policy under free capital mobility as well as banking system development and financial sector stability. In view of developments in the Russian banking sector over the last two years, the St Petersburg seminar, held in October 2005, analysed in more depth issues of banking sector development and stability, as well as the use of certain tools, such as the introduction of a deposit insurance system, to promote confidence and financial stability.

The high-level seminar in St Petersburg coincided with the end of the two-year TACIS project in the field of banking supervision. The training programme aimed to contribute to financial stability in Russia via a transfer of knowledge from EU banking supervisors to the supervisory staff of the Bank of Russia. Unique in terms of scope, concentration and complexity, the project was based on the contract signed by the Delegation of the European Commission to Russia and the European Central Bank in October 2003. It was coordinated and implemented by the ECB in partnership with the Deutsche Bundesbank, the Banco de España, the Banque de France, the Central Bank and Financial Services Authority of Ireland, the Banca d'Italia, De Nederlandsche Bank, the Oesterreichische Nationalbank, the Banco de Portugal, Suomen Pankki – Finlands Bank, Rahoitustarkastus (the Finnish Financial Supervision Authority), Finansinspektionen (Sweden) and the Financial Services Authority (United Kingdom).

800 Bank of Russia supervisors attended 64 courses introducing them to the EU standards and methods of risk-based supervision. Half of the courses were dedicated to topics such as market, liquidity, credit and operational risk, early warning systems and bank rehabilitation. More than 30 Bank of Russia managers, mainly from its head office, conducted one-week study visits to national central banks and supervisory agencies in the EU in order to gain an insight into the practical implementation of banking supervision techniques. Finally, the programme included four one-day seminars addressing financial stability, Basel II and the fight against money laundering, as well as corporate governance and operational risk. These four seminars were characterised by policy discussions between high-level EU and Eurosystem speakers and representatives of the Bank of Russia's Board of Directors and senior management in banking supervision, the Russian legislative branches, the Presidential Administration, the Finance Ministry, Russian academia and the Association of Russian Banks.

The Steering Committee supervising the project – which was chaired by the Bank of Russia – evaluated it as making an important, well-timed contribution to the reform efforts of the Bank of Russia in the field of banking supervision.[9]

As a supplement to the training activities, a book on EU experiences and Russian practices in banking supervision has been published, aimed at those Bank of Russia supervisors who were unable to attend the training courses offered. While one chapter of the book was prepared by the Bank of Russia, the other chapters and annexes were drafted by the ECB, drawing on the fundamental banking supervision courses held by its partner institutions.

5 CONCLUSION

Over the past few years the Eurosystem and the Bank of Russia have significantly enhanced cooperation, complementing the bilateral

9 Additional information about the project is available on the Bank of Russia's website (www.cbr.ru).

relations and cooperation that several national central banks of the Eurosystem have been developing and implementing with the Bank of Russia since the 1990s. That cooperation between the Eurosystem and the Bank of Russia has been centred around a two-year training programme on banking supervision implemented by the Eurosystem together with the Bank of Russia and funded by the EU's TACIS programme, as well as high-level Eurosystem-Bank of Russia Seminars focusing on the central banking dimension of the EU-Russian integration process.

That cooperation has taken place against the background of positive macroeconomic developments in Russia, growing economic and financial links between the euro area and Russia, and developing EU-Russian institutional relations. In particular, the euro area is Russia's most important trading partner, while Russia has become the euro area's fourth most important non-EU trading partner. The recovery of the Russian banking system and the acceleration of its banking reforms, as well as the challenges facing monetary and exchange rate policies, have provided further stimulus for the development of a fruitful exchange of views. Against this background, the Eurosystem will continue its dialogue and cooperation with the Bank of Russia at various levels.