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MONETARY POLICY OF RUSSIAAND ITS IMPACT ON FOREIGN DIRECT INVESTMENT

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ABSTRACT
The Russian economy has gone through a turbulent decade. It has been hit hard by the global financial crisis and falling commodity prices between 2014 and 2016. During this period, foreign direct investment in Russia was at a medium to high level of volatility for several reasons. First, not only oil and gas are Russia's main exports, but the Russian oil and gas industry is also a major target for foreign direct investment. Russia's dependence on oil has made direct investment highly vulnerable to changes in oil prices. Second, due in part to the pressure that low oil prices are putting on the Russian currency and the economy as a whole, the macroeconomic environment has been highly volatile. Monetary policy has been used to mitigate these effects. The article examines impact of measures taken by the Central Bank of Russia on FDI. It was revealed that the monetary policy pursued significantly affects the investment climate. The high unregulated US dollar exchange rate and the high key rate of the Bank of Russia caused capital flows to the speculative financial market, and then abroad.

KEY WORDS: *Monetary Policy; Russia;foreign direct investment.*

1. Introduction

Russia has one of the largest economies in the world, which relies on its vast natural resources. Major industries include oil and natural gas production, as well as other economic drivers - agriculture, forestry, fishing, and manufacturing serving. Oil and natural gas constitute a significant part of the country's economy. Russia is also one of the world's largest exporters of military weapons, second only to the United States[19].Over the past 25 years, Russia has undergone dramatic economic changes, with the difficult reforms and catastrophic economic collapse of the 1990s, the boom years of the new century, the global economic crisis, and the recent downturn.

Russia is a former communist country, stuck in the middle of the transition to a more liberal market economy. The country endowed with an abundance of oil and natural resources, whose economic condition is growing and falling along with the prices of these resources. After the collapse of the Soviet Union, Russia underwent a radical transformation, moving from a centrally planned economy to a globally integrated market economy. However, the corrupt and random privatization processes in the 1990s turned large state-owned companies into politically connected "oligarchs," making stock ownership extremely concentrated [13].

The Russian economy experienced two major shocks in recent years, narrowly avoiding recession. The first shock was the sharp decline in oil prices during the third and fourth quarter of 2014, exposing Russia's extreme dependence on global commodity cycles. The second shock was the economic sanctions resulting from geopolitical tensions, which negatively affected investor appetite for Russian investments. Also, it can be added that appearance of COVID-19 caused a shock for a whole world, including Russia, and it is still ongoing.

As it is known, an economic policy is a course of action that is intended to control or influence the behavior of the economy. Monetary policy is a part of economic policy and is managed by central

banks. The Central Bank of Russia (CBR) keeps inflation close to the target level of 4%. This policy is called inflation targeting. The main instrument of monetary policy is the key rate. The key rate is the interest rate at which the central bank lends to commercial banks and accepts money from them for deposits. A change in the key rate affects demand through rates in the economy and, ultimately, inflation. At the same time, the central bank relies on a macroeconomic forecast and takes into account the situation in the economy and financial markets[1].

The Central Bank of Russia actively explains the reasons and expected results of its decisions in the field of monetary policy. However, it is not always clear if these decisions make expected impact. It is known that decisions of monetary policy affect a capital movement as well. Thus, this paper is an attempt to define the impact of monetary policy of Russia on its foreign direct investment.

2. Monetary Policy of Russia

Monetary policy is part of the state economic policy aimed at improving the welfare of Russian citizens. Its priority is to ensure price stability[1]. The main actor that manages the monetary policy of the country is the Central Bank of Russia.

The Central Bank of Russia is a legal entity. The Constitution of the Russian Federation establishes the special legal status of the Central Bank of the Russian Federation. It also gives it the exclusive right to issue currency and protect the ruble and ensure its stability. A key element of the legal status of the Bank of Russia is its independence, which implies, first of all, that the Bank of Russia is a special public legal institution with the exclusive right to issue currency and organize its circulation. The Bank of Russia is not body of state power. However, its powers, in fact, are the functions of a body of state power, since their implementation involves the use of state enforcement. The Bank of Russia is accountable to the State Duma, which appoints and dismisses the Governor of the Bank of Russia and members of the Board of Directors of the Bank of Russia [2].

Thus, the Bank of Russia develops and implements, in cooperation with the Russian Government, a unified state monetary policy. The Bank of Russia, acting as the main coordinating and regulatory body of the entire credit system of the country, acts as an economic management body. The Bank of Russia controls the activities of credit organizations, issues and withdraws licenses from them for banking operations.

The main goal of the monetary policy of the Bank of Russia is to maintain price stability, that is, consistently low inflation. Price stability is an important element of an enabling environment for people to live and do business, as it:

- protects national currency income and savings from unpredictable depreciation. This allows to maintain a standard of living, as well as more confidently plan daily and long-term expenses.
- protects low-income citizens. Such families mainly buy inexpensive basic necessities. Stable low inflation allows to maintain consumption.
- helps to increase the availability of borrowed finance for companies, as it reduces the inflation premium that banks put in interest rates.
- simplifies financial and investment planning for a business
- increases confidence in the national currency and creates conditions for reducing the proportion of foreign currency-denominated assets and liabilities in the economy.

The Central Bank of Russia pursues a monetary policy as part of the inflation targeting regime. The main principles of the monetary policy:

- Bank of Russia sets a constant public quantitative inflation target
- Inflation targeting involves a floating exchange rate determined by supply and demand in the foreign exchange market.
- The key rate is the main instrument of the monetary policy of the Bank of Russia.
- The Bank of Russia makes decisions on monetary policy based on a macroeconomic forecast and analysis of a wide range of data.

- The Bank of Russia follows the principle of monetary policy transparency in order to improve understanding and credibility of its current monetary policy and create a predictable economic environment for all economic agents [3].

The CBR uses the key rate to influence inflation. Through the chain of economic relationships, the key rate affects a wide range of economic processes that ultimately affect the rate of growth in consumer prices. A change in the key rate almost instantly leads to a change by the same amount in the overnight rates of the interbank lending market. The formation of interbank money market rates near the key rate is the operational goal of monetary policy. The operational goal is achieved using monetary policy instruments by the Bank of Russia, through which the Bank of Russia manages the liquidity of the banking sector.

The CBR seeks to maintain money market rates within the interest rate corridor and keep them close to the key rate. One of them is reserve requirements applied to the banks. The reserve requirements create the need for credit institutions to keep a certain amount of funds on correspondent accounts with the Bank of Russia. Then the CBR, either by providing insufficient liquidity or absorbing excess liquidity, ensures that actual funds in correspondent accounts meet the established demand for liquidity and maintains money market rates at the key rate.

Auction-based one-week operations are the main instrument used by the Bank of Russia to bring the volume of banking sector liquidity in line with its demand and to regulate money market interest rates. The CBR conducts these operations once a week in the form of auctions to provide liquidity (repo auctions) or auctions to absorb liquidity (deposit auctions). The Bank of Russia defines the maximum volume of provision (absorption) of liquidity based on the forecast of the banking sector liquidity.

Another tool is overnight standing facilities that used to limit fluctuations in money market rates. Deposit operations are a standing facility instrument for absorbing liquidity. To provide liquidity a set of instruments differing in the form of transactions (repo, secured loans) and types of collateral (foreign currency, bonds, credit claims to non-financial institutions) is used [4].

Interest rates on overnight standing facilities to provide and withdraw liquidity for a period of 1 day are fixed. They form the upper and lower borders of the Bank of Russia interest rate corridor. Its borders are symmetrical with respect to the key rate. The width of the interest rate corridor sets the acceptable range of fluctuations in money market rates and is currently 2 percentage points (Figure 1).

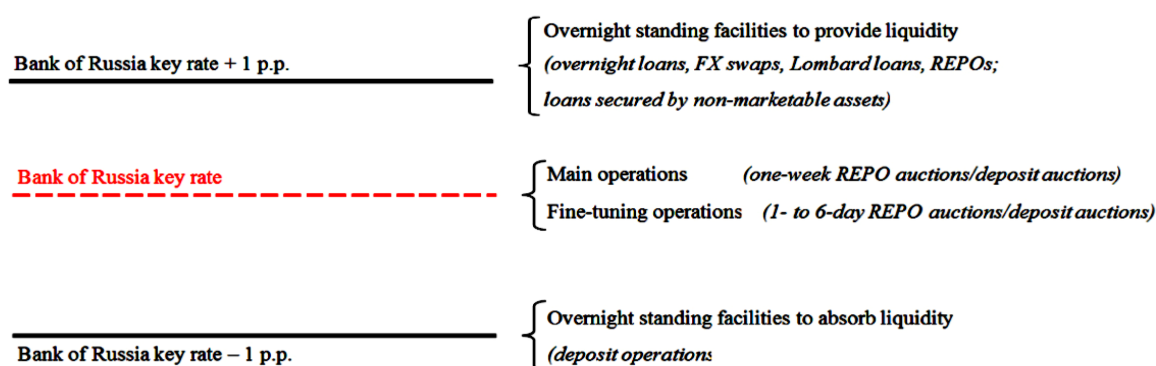

Fig. 1. Interest rate corridor [4]

On certain days, when the banking sector's demand for liquidity significantly deviates from its supply, the Bank of Russia may conduct “fine-tuning” auctions for periods of 1 to 6 days in order to prevent excessive fluctuations in money market rates within the interest rate corridor. Every morning, the CBR updates its assessment of the banking sector's liquidity and, if necessary, makes a decision

and announces a fine-tuning auction, as well as its timing and the maximum amount of funds provided (withdrawn).

In addition to short-term operations, the system of instruments of the Bank of Russia also includes operations to provide or absorb liquidity for long periods. In the context of a structural liquidity surplus, the Bank of Russia withdraws funds from banking sector for long periods through the issuance of Bank of Russia bonds (OBR). The bonds are issued for a period of 3, 6, 12 months, the coupon period is set equal to 3 months. Coupon income is accrued for each day of the coupon period at the key rate effective on that day. The OBR issue allows the Bank of Russia to absorb medium-term liquidity surplus and increase the impact of underlying operations on money market interest rates [4].

3. Monetary policy during a crisis

The full-scale spread of the financial crisis in the Russian economy began in July-August 2008, accompanied by an outflow of foreign capital and a drop in exports. Following the decline in exports, there was a drop in production and a reduction in investment programs for enterprises in energy sector. According to Nekipelov and Golovnin[15] the CBR's response to the crisis developed in two main directions.

Firstly, the monetary policy of assistance to the banking system was continued. Since August 2018, the Bank of Russia has sharply increased the provision of funds to commercial banks through traditional channels. At the same time, repoauctions were the main mechanism of bank lending. The peak of the provision of assistance was in late 2008 - early 2009.

The second direction of monetary policy in Russia during the crisis was the regulation of the exchange rate. If the first direction was in line with the main trends of the anti-crisis monetary policy of developed countries, then the second is more typical for countries with developing market economies. This was due to the desire to maintain the export and import competitiveness of domestic producers, with a high level of foreign borrowing, with the presence of significant assets in foreign currency and circulating in the national economy.

After financial crisis years the Central Bank of Russia began to simultaneously implement a more transparent monetary policy, explicitly declaring the borders of the currency band, and to reduce the degree of exchange rate regulation. At the end of February 2009, the range of the floating corridor was 2 rubles, then it gradually increased and at the end of July 2012 reached 7 rubles. By the summer of 2010, the volume of foreign exchange interventions by CBR had significantly decreased, and from the summer of 2012 to the spring of 2013, they were reduced to a minimum.

The role of the main instrument of monetary policy shifted to repo actions, the volumes of which increased sharply by the end of 2011. Thus, the Bank of Russia sought to increase the role of interest rates in the transmission mechanism of monetary policy. This was aimed at the transition to the inflation targeting regime in Russia, which was announced a long time ago, but significant practical steps towards its implementation began just in the specified period [11].

The advantages of inflation targeting, which is widespread in developed countries, are not clear to countries with economies in transition. For such countries, the transition to inflation targeting means a decrease in the attention of the CBR to the exchange rate fluctuations, up to the transition to its free floating. However, the exchange rate in this group of countries plays a special role. It relates to the limitation of the possibilities of borrowing in the national currency both in foreign markets and, in part, within the national economy; also, to the dollarization of assets and the impact of exchange rate fluctuations on inflation. In addition, it is more difficult for economies in transition to determine the optimal inflation rate[17].

Until 2014, according to Golovnin[11] the Bank of Russia reacted to the emergence of individual external shocks that created pressure on the foreign exchange market with moderate interventions to support the national currency rate. In a situation of a gradual slowdown in economic growth, the Russian economy faced a series of external shocks in 2014, which sharply increased the degree of uncertainty in decision-making by economic agents. These shocks were:

- the political crisis in Ukraine, the associated annexation of Crimea to Russia and the introduction of the first sanctions by the US and the EU against Russia.
- the introduction of sectoral sanctions by the US, EU, and a number of other developed countries.
- falling oil prices on the world market.

As a result, the Russian economy found itself under the simultaneous impact of a trade shock (falling oil prices) and a halt in capital flows as a result of financial sanctions. During this period, the policy of the Bank of Russia was notable for its inconsistency. As part of the strategy of transition to inflation targeting from July to September 2014, it abandoned foreign exchange interventions, but at the same time carried out significant interventions to support the ruble exchange rate in October 2014. In a situation of continuing pressure on the foreign exchange market, the CBR in November 2014 announced on the de facto early introduction of a free-floating ruble exchange rate regime. Although it was planned for early 2015. Formally, these actions were explained by the need to move to inflation targeting. However, in fact, it was recognized that the Bank of Russia was not ready to go on further spending of foreign exchange reserves to maintain the ruble exchange rate.

In comparison to December 2013, the nominal exchange rate of the ruble against the US dollar decreased in December 2014 by 40.6%, and against the euro - by 34.1%. The fall in the exchange rate led to an increase in the rate of inflation in 2015, which contradicted the goals set by the Bank of Russia itself. In addition to rising inflation, the fall in the exchange rate has led to other problems for the Russian economy. First of all, the problems associated with financial stability should be noted. As a result of the sharp change in the exchange rate, the risk of insolvency of borrowers in foreign currency has sharply increased, which has put the banking system at risk.

The CBR, in response to pressure on the foreign exchange market, raised its key interest rate in the second half of 2014, sharply raising it in December to 17% (Figure 2). Thereby, there was a sharp tightening of monetary policy in the context of the economy entering the crisis under the influence of internal and external factors. In this situation, the Central Bank of the Russian Federation faced a dilemma - a rate cut would create pressure on the exchange rate, and a high rate would suppress economic activity. Although it attracted depositors to the banking system in the short term, the possibilities of placing assets at a similar rate in the context of the onset of the economic downturn were very limited and steadily declining. In 2015, the Central Bank began to cut interest rates[11].

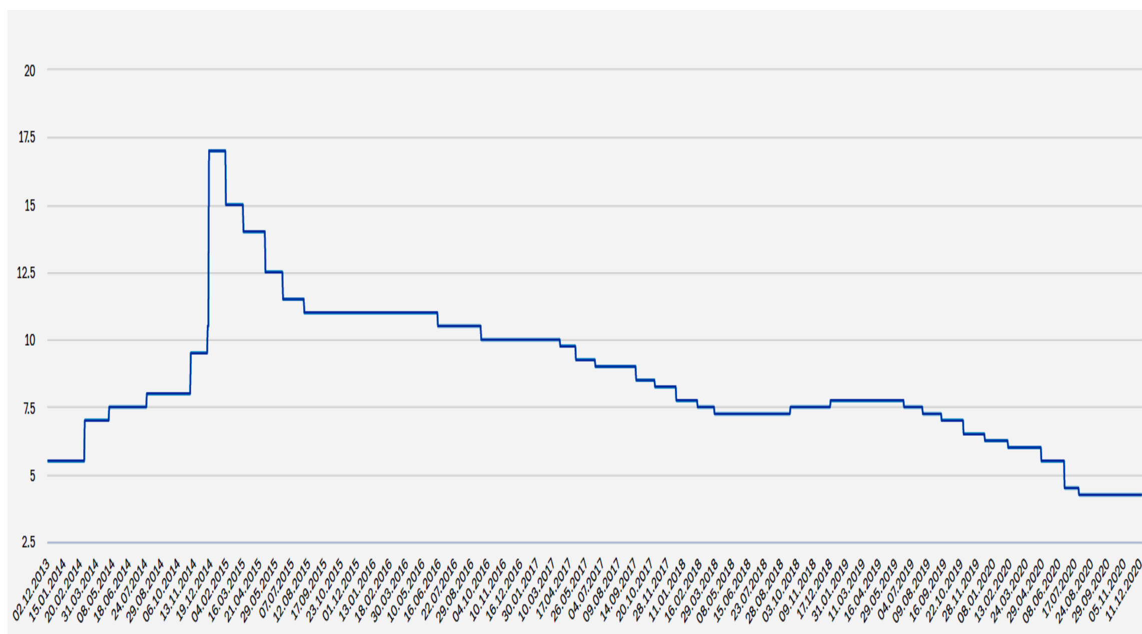

Fig. 2. Key rate of CBR, % [5]

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After several years of negative growth due to the massive flight of capital, the collapse of the ruble, falling oil prices and trade sanctions imposed by the West after the Ukrainian crisis, the Russian economy has returned to modest growth since 2017, mainly due to mineral resource extraction and private consumption. According to the latest IMF estimates, GDP growth slowed to 1.3% in 2019 due to falling oil prices and the negative impact of rising VAT on private consumption.

The economy of the country continued to grow moderately in 2019, but industrial activity slowed due to weaker external demand, lower oil production in line with quotas agreed upon by OPEC and oil exporting countries, and higher financing costs related to sanctions introduced in 2018. After the 2015–2016 recession, the Russian government pursues a cautious macroeconomic policy aimed at maintaining financial stability, and the Bank of Russia carefully controls inflation. Even though they showed a decrease compared to 2018, public finances remained in surplus in 2019. The budget surplus is estimated by the IMF at 1% of GDP and should remain in surplus in 2020 (0.2% of GDP). Government debt increased, but remains low, by 16.5% of GDP in 2019. According to IMF forecasts, public debt should continue to grow, reaching 17.7% of GDP in 2020 and 18.3% of GDP in 2021. Inflation, estimated at 2.9% in 2018, rose to 4.5% in 2019, reflecting an increase in introduced VAT in 2019 [18].

In 2019, the Bank of Russia decided to reduce the key rate by 0.25 percentage points up to 7.5%. This decision is due to a decrease in annual inflation in April-May 2019 to 5.1% and a weakening of inflation risks. The inflation forecast for 2019 was revised from 4.7–5.2% to 4.2–4.7%. The Bank of the Russia expected that in 2020 annual inflation would fluctuate near the target level of 4% and planned to complete the transition to a neutral monetary policy [8].

On April 24, 2020, the Bank of Russia lowered the policy rate by 50 bps up to 5.5 percent. It began selling foreign exchange reserves from the National Wealth Fund on March 10, reflecting a fall in oil prices below the base price in accordance with the fiscal rule, and later for the purchase of Sberbank by the government. The Bank of the Russia temporarily introduced a long-term refinancing instrument; regulatory mitigation for banks intended to help corporate borrowers, and a more favorable regime for loans in foreign currencies issued to certain sectors [12].

4. Impact of Monetary Policy on FDI

The Bank of Russia has been active in the foreign exchange markets over the past two decades. Since 2000, the ruble exchange rate has changed from very rigidly controlled (2000-2005) to freely floating in an inflation targeting regime. But the CBR still reserves the right to intervene in the foreign exchange markets and prevent excessive volatility. The CBR has managed to mitigate the worst effects of exchange rate fluctuations, often caused by oil price fluctuations [7].

Following the financial crisis, according to Dominguez-Jimenez and Poitiers [7] the Bank of Russia identified downward pressure on the ruble, fueled by capital flight and erosion of the current account balance. The CBR allowed a gradual depreciation of the ruble. It happened through gradually expanding the currency band, but at the same time the CBR supported it with market operations, as a result of which one third of the reserves of the Bank of Russia was depleted in three months. In 2014, the intervention played an even bigger role as the announcement of exchange rate flexibility increased pressure on the currency, which had already been weakened by the oil crash and sanctions. The CBR supported the currency with reserves and made a great use of the key rate.

In 2014, the Russian economy experienced two serious shocks, barely escaping a recession with moderate growth of 0.6%. The first shock was a sharp drop in oil prices in the third and fourth quarters of 2014, which revealed Russia's extreme dependence on world commodity cycles. After

fluctuations in a narrow band of about $ 105 per barrel in 2011-2013, crude oil prices ended in 2014 at less than $ 60 per barrel. The second shock was the economic sanctions caused by geopolitical tensions, which negatively affected investors' appetite for Russian investments. The outflow of capital and high inflation exacerbated the economic problems in Russia, as the economy experienced the serious recession since 2009 contracting 3.7% in the full year 2015 [9].

The unstable macroeconomic environment in Russia and the country's monetary policy have significantly affected FDI flows. FDI flows have traditionally been viewed as less volatile than other capital flows. The fundamental idea behind international capital flows is that short-term flows can be easily reversed, while long-term flows are more stable. However, foreign direct investment in the oil sector tends to be more speculative given the volatility in oil markets. The high degree of uncertainty caused by the volatile exchange rate discouraged foreign investment. In recent decades, the ruble has been heavily influenced by the price of oil. Oil exports are the largest source of dollar reserves for the country, which until 2015 regularly intervened in foreign exchange markets to manage the exchange rate. The transition from exchange rate management to inflation targeting of monetary policy was formalized in 2014[7].

The volume of foreign direct investment in the Russian economy and from the country increased sharply and reached its peak in 2013. In 2014 the volume of inflows to Russia fell by almost 2 times. In 2015, when developed and developing countries showed steady growth, the inflow and outflow of capital from Russia continued to fall, and, on the contrary, in 2016 the opposite trend was observed.

The increased flexibility, coupled with the 2014 announcement of the pursuit of a fully floating exchange rate and inflation targeting system, has had the opposite effect of previous policies. The 2014 announcements came at a time when pressure on the currency was mounting and likely added additional pressure, contributing to a sharp depreciation of the ruble. The hint that the CBR would allow the currency to float naturally weakened confidence in the ruble and triggered a moderate capital flight. In the months that followed, the Bank of Russia did its best to prop up the currency and allay market concerns, partly undermining monetary policy to that end. Although the official exchange rate target was lifted in November 2014, the CBR took major interventions to prevent a currency collapse before the end of 2014 and in the beginning of 2015. While the decline in reserves is indicative of the CBR's efforts, reserves fell by almost 30% between 2013 and 2015, this period was characterized by a rapid increase in the key rate, up to 17% (Figure 2) [7].

In recent years, the main trend in investment has been the growth of the positive balance, i.e. Russian investment abroad grew faster than foreign investment in Russia. However, after external shocks, primarily the decline in world oil prices and the introduction of financial sanctions against Russia, this trend has weakened, primarily due to the active repatriation of Russian investments from abroad and foreign investments from Russia. Thus, like the movement of goods and services, the outflow and inflow of investments began to decrease after 2013-2014, with a tendency to some recovery in 2017.

According Bulatov[6], in Russia, the outflow of capital systematically exceeds its inflow, as can be seen from the balance of the financial account, if to exclude from it the movement of reserve assets (Table 1). Thus, a significant part of potential domestic investment goes abroad, mainly to offshores, not being compensated by the inflow of foreign capital. And after 2014, i.e. during the period of low oil prices, Western sanctions, economic crisis and stagnation, capital outflows exceeded its inflows. Even in 2015 the partial repatriation of Russian assets accumulated abroad was less than the repatriation of foreign assets from Russia, which statistically means the excess of capital outflow over its inflow.

	2001	2003	2005	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Net Inflows/ Outflows	13.6	0.3	0.3	-87.8	133.6	57.5	30.8	81.4	53.9	60.3	152.1	57.0	18.4	24.8
Outflows	20.0	33.6	74.8	128.4	240.6	49.7	73.7	148.1	126.9	174.9	114.4	-7.0	7.3	13.4
Inflows	6.4	33.4	74.4	216.3	107.0	-7.8	43.0	66.7	71.1	114.6	-37.7	-64.0	-11.1	-11.4

Table 1. Outflows and inflows of Russian capital, billion rubles [6]

The main exporters of capital were relatively narrow and as a result of this high-yield industries - mining, chemistry and metallurgy, which is indirectly confirmed by their high profitability and, consequently, a large weight of these industries in the profits received by all Russian organizations. Strong monopolistic barriers to entry into other Russian industries, low profitability of these industries, uncertain prospects of the Russian economy pushed the exporters of raw materials and semi-finished products to export a significant part of their profits abroad in the form of outflow of capital. Thus, from 40 to 60% of revenues from oil and gas exports were used to export capital and pay incomes of foreign investors[14]. According to the calculations of the author, the volume of outflow of capital from Russia for 2001-2017 amounted to 6.2% in relation to total GDP for this period.

According to Dominguez-Jimenez and Poitiers [7] during 2018 the Russian currency has grown reasonably well and has not been hit by shocks, and capital flight in other emerging economies is a testament to the resilience of this inflation targeting system. It is worth noting that the oil sector in Russia remains fairly dollarized. Many contracts, both commercial and investment, are concluded in foreign jurisdictions and are denominated in foreign currency; as such, they are not devalued by ruble fluctuations. Likewise, energy companies hold fairly large stakes in dollar-denominated debt. Thus, foreign direct investment in the energy sector can remain relatively independent of exchange rate fluctuations. However, the uncertainty that exchange rate volatility creates for the management of the value chain in multinational companies does create uncertainty, while the associated political tensions discourage foreign investors. Moreover, energy companies remain dependent on domestic revenues and expenses. Thus, excessive dollarization, especially a very large share of dollar-denominated debt, can leave companies vulnerable to large fluctuations in the ruble exchange rate. It makes difficult for them to meet their dollar obligations and thus increasing the likelihood of default. Recently, however, Russian oil giants have been signing contracts for the euro. Rosneft, the state-owned oil company and one of the largest in the world, announced in the summer of 2019 that all contracts would henceforth be in euro.

The developed countries, primarily Western Europe, have been and remain, despite the sanctions, the main source of FDI for Russia. It is important to note fact that these investments bring the necessary technologies, managerial experience to the country's economy. The developed states, in turn, are the main destination for the outward FDI of Russia. The importance of offshore jurisdictions in the movement of investments for the country's economy also remains.

5. Conclusion

Under the influence of macroeconomic and geopolitical problems, the level of FDI inflows and, in part, the outflow of foreign direct investments from the country are steadily decreasing. Also, under the influence of the ongoing deoffshorization policy, there has been a tendency to reduce the return to Russia of domestic capital from offshore jurisdictions, which previously formed a relatively balanced position with FDI in the country.As a result, Russia is gradually moving to the periphery of the world capital market and remains a passive participant in modern trends in the development of international economic relations. And this provision determines the degree of integration of the country into the world economy and the scale of positive effects for the development of the national economy [16].

It was revealed that the monetary policy pursued by the Bank of Russia significantly affects the investment climate. Under the influence of the high unregulated US dollar exchange rate and the

high key rate of the CBR, cash flows are directed to the speculative financial market, and then capital flows abroad, to the detriment of the development of the national economy of Russia.

A solution can be capital controls, which are fairly widespread in the world, especially in developing countries. In modern Russian conditions, this could be the measures proposed, for example, by S.Yu. Glazyev - the introduction of a tax on the capital export (Tobin tax); termination of suspicious transactions, especially with offshores; introduction of benefits in the Russian economy for national companies that are not affiliated with non-residents; expanding the exchange of tax information with offshores [10].

Also, as suggested by Golovnin[11], it is advisable for the CBR to introduce certain restrictions on the cross-border movement of capital. In a period of instability in the foreign exchange market, it is advisable to return to mandatory repatriation and 100% sale of export foreign exchange earnings, as well as to introduce licensing of capital outflow operations. In addition, it seems advisable to use the regulation of the open currency position more actively, establish higher reserve requirements for liabilities in foreign currency domestically and attracted from abroad. An important task of introducing such restrictions is to combat the dollarization of the national economy.

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