Monetary and fiscal policy interactions in the wake of the pandemic: Russia's experience

Bank of Russia[1]
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Abstract

The existing framework for coordination between the government and the Bank of Russia has proven effective enough for authorities to quickly adapt to changing financial and economic conditions with an efficient and timely response, without jeopardising the central bank's independence or monetary and fiscal discipline. Monetary and fiscal policy complemented each other efficiently and appropriately. The borrowing needs of the government, households and companies were provided for by accommodative monetary conditions and other measures. These measures were designed to limit the risks of fiscal dominance; they included a shift to an accommodative stance, with an explicit commitment to return to a neutral stance; temporary enhancement of the emergency mechanism for FX sales to reinforce the stabilising effects of the fiscal rule, which are diminishing due to oil prices dropping below $25 per barrel; and the introduction of a new Special Refinancing Facility for SMEs, with specific end dates, amounts and conditions.

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1. Monetary and fiscal policy before Covid-19

Russia's experience has shown that the unique scale and nature of the pandemic shock, with its unprecedented restrictions on supply and demand, can be swiftly mitigated even by an oil- and gas-producing country facing a dramatic drop in oil demand and prices, like Russia. This was possible because the government and the Bank of Russia have been rebuilding and maintaining policy space for economic stabilisation in case of tail risk events in order to increase the resilience of the institutional framework and the credibility of their commitments to long-term goals, namely achieving balanced and sustainable economic growth under price stability and public debt sustainability over time. Before the pandemic, the resilience of the Russian economy had been steadily improving as a result of the introduction of the Inflation Targeting framework. Before Covid-19, long-term inflation expectations were consistently anchored close to 4%, while the three-year breakeven inflation rate was 3.9%; in 2019 and implied inflation for the period 2023–28 stood at 4.3%.[2] Additional elements included: the shift to the floating exchange rate regime, the introduction of the fiscal rule,[3] conservative fiscal policy featuring budget surpluses (1.9% of GDP in 2019; 2.8 % in 2018) as well as low levels of domestic and external public debt[4] (9.2% and 3.1% of GDP in 2019, respectively; the average share of non-residents in domestic debt is ~30%),[5] and macroprudential policies (aimed at the de-dollarisation of the Russian financial sector and the build-up of capital buffers in the fastest growing segments of credit).

1.1 Fiscal policy before the pandemic

In 2018–2019, fiscal policy hinged on the fiscal rule based on a threshold for federal budget spending and the sterilisation of extra oil and gas revenue resulting from oil prices exceeding their baseline level. It was a period of budget consolidation, with the VAT base rate increased from 18% to 20% and the federal budget's non-oil and gas deficit contracting from 8.0% of GDP in 2017 to 5.4% in 2019.

As a result of the fiscal rule mechanism, the economy reduced its dependence on commodity markets, with economic, financial and fiscal conditions becoming more predictable. The accumulation of resources by the National Wealth Fund (NWF) strengthened the resilience of public finance to external economic shocks. As of the end of 2019, the NWF totalled 7.1% of GDP (or $125.5bn), and another 2.6% of GDP (or $45.9bn) was added to the federal budget's extra oil and gas revenue accounts. The liquid part of the NWF passed the threshold of 7% of GDP (taking into account the funds in the special transit account), allowing for the funds to be invested in Russian assets. Thus, by the beginning of 2020, thanks to its consistent and well-balanced policy, Russia's budget system had accumulated a substantial safety cushion and thus, extra policy space.

2 Implied inflation for inflation-linked federal government bonds (OFZ-IN).

3 The rule entails FX purchases by the Ministry of Finance if the price of oil exceeds the fixed benchmark, and FX sales otherwise.

4 External foreign currency debt is capped by law at 25% of all liabilities.

5 Low risk for capital outflows and exchange-rate dynamics in the event that non-residents leave the market.

1.2 Monetary policy before Covid-19

The Bank of Russia has been implementing its current monetary policy framework since 2015, when the fully-fledged Inflation Targeting (IT) regime was introduced. The Bank of Russia has been conducting monetary policy (MP) by strictly adhering to the following key principles over time: permanent public quantitative inflation target (close to 4%), floating exchange rate regime, a conventional system of instruments whose main policy tool is the key rate, and transparent and understandable communication of MP.

After the IT regime was introduced, MP was aimed at gradually slowing down heightened inflation (16.9% at its peak in March 2015) caused by negative external factors and inflation expectations, as well as reaching the inflation target.[6] In order to achieve this, the Bank of Russia has implemented a restrictive MP since January 2015, gradually decreasing the key rate from 17% in accordance with actual and expected inflation dynamics relative to target and economic developments over the forecast horizon. This led to a sustainable downward trend in inflation and inflation expectations. Even once the inflation target was reached, the Bank of Russia continued to implement a tight MP, because a moderate inflation path was not appropriate and a sustainable decline in inflation expectations was necessary in order for inflation to become anchored close to 4%. By mid-2019, the key rate was 7.5%. At that time, the Bank of Russia's estimates of the neutral/natural interest rate (R*) were equal to 2–3% in real terms and 6–7% in nominal terms.[7] After that, disinflationary factors substantially impacted inflation, while disinflationary risks prevailed over the short-term horizon. By the end of 2019, inflation had decreased to 3% – below the target – and the Bank of Russia lowered the key rate to 6.25%; towards the end of the forecast horizon, professional market participants' expectations were strongly anchored at the target. Households' and businesses' inflation expectations were at their lowest in Russia's history (but still above target inflation). Therefore, at the beginning of 2020, the MP was neutral and enjoyed considerable space (far above the effective lower bound). Additionally, under the IT framework, the Russian economy's overall macroeconomic resilience increased compared to 2014, which played a significant role in lowering inflation and inflation expectations.

The Bank of Russia also adhered to a strictly conventional MP and has not used asset purchases as a policy tool.

1.3 Policy mix before the pandemic

The legal framework in Russia clearly distinguishes between the government's areas of responsibility and expertise and those of the Bank of Russia. The Bank of Russia pursues its objectives through the means it deems fit and carries out its monetary

[6] In 2015, the Bank of Russia was set to reduce inflation to 4% by 2017 and keep it close to this level in the years to come. Then the MP goal evolved into "keeping annual inflation close to 4% on a continuous basis."

[7] The Bank of Russia's estimates of the real natural interest rate were 2.5–3% for January 2015–August 2017, 2–3% for September 2017–May 2020 and 1–2% for June 2020 to date.

policy independently of any level (federal, regional or local) of government authority. This is guaranteed by both the Constitution and federal law.[8]

However, the government and the Bank of Russia do interact with each other on a continuous basis in order to efficiently conduct their own policies. For example, each side considers the key medium-term objectives and parameters of the other's monetary and fiscal policies in its forecasting process. On one side, the government takes into account the monetary policy target for maintaining price stability, ie inflation close to 4%. On the other, the Bank of Russia takes into account projections of the subsistence minimum and other social standards, pensions and social transfers, budget sector wages, and medium-term parameters for federal and consolidated budget revenues, expenditures and deficit financing. This interaction and cooperation is carried out through government correspondence, official meetings, the use of official publications and a working relationship between representatives of the Bank of Russia, the Ministry of Economic Development, the Ministry of Finance and other federal authorities. Regularly exchanging opinions makes it possible to make views on the Russian economy's development more cohesive and effectively deliver stability in the short and long run within fiscal and monetary authorities' individual, independent mandates.

2. Monetary and fiscal policy during Covid-19

In 2020, unlike during previous crises, the policy mix in Russia became accommodative and highly congruent due to strong fundamentals; ie both policies took a countercyclical stance. The unprecedented crisis called for prompt and complementary monetary and fiscal policy responses, so the temporary increase in interaction and coordination was a natural step to take. Two-way policy space creation allows for implementation of the stimulus that is most successful without compromising the central bank's independence in the event of tail risks. Covid-19 did not impact the main channels through which the state of public finance affects the room for monetary policy manoeuvres, ie monetary policy's operational independence. The Bank of Russia is still able to freely determine the best way to achieve its policy objectives, including the types of instruments used and their timing. Overall, conventional monetary policy impulse should be enough to support aggregate demand while keeping inflation close to 4%.

2.1 Fiscal policy during Covid-19

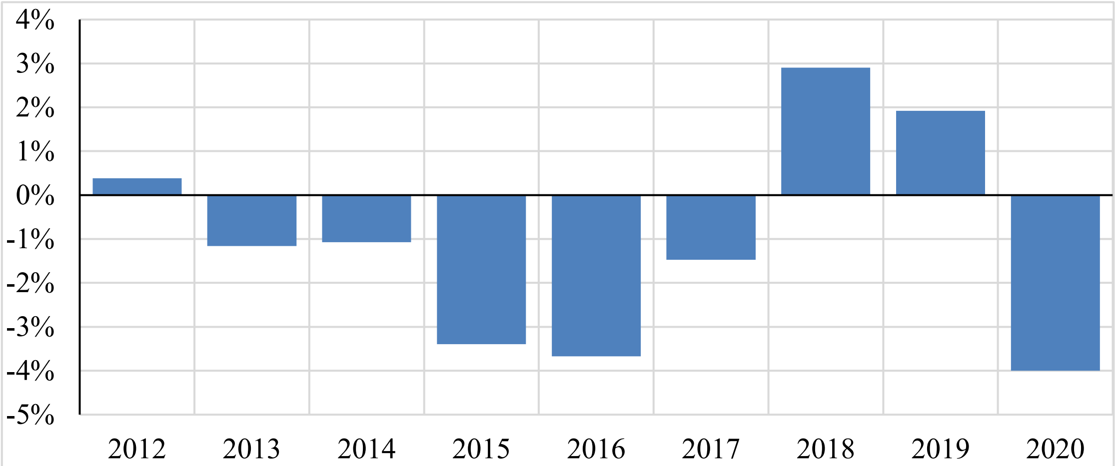
More sustainable public finance, inflation stabilisation at a record low, the improved stability of the financial sector and the Russian economy's decreased dependence on external factors helped the country weather the pandemic period more easily, and the Russian government was able to implement and fund the appropriate support measures necessary to address negative trends.

After two years of budget surplus in 2018–2019, the rapid increase in anti-crisis budget spending and declining oil and gas revenues led to a budget deficit in 2020

8 Federal Law No. 86-FZ, dated 10 July 2002, "On the Central Bank of the Russian Federation (Bank of Russia)."

(Graph 1). The positive effect of Russia's fiscal policy in 2020 amounted to about 4–5 percentage points of GDP, with the federal budget's non-oil and gas deficit (excluding the one-time profit from the sale of the equity stake in Sberbank)[9] expanding by 4.4 percentage points of GDP (from 5.4% to 9.8% of GDP) and the budget system deficit by 4.8 percentage points (from 5.3% to 10.1% of GDP).

Budget system balance in 2012–2020, as a percentage of GDP Graph 1



Sources: Ministry of Finance of the Russian Federation; Federal Treasury; Federal State Statistics Service; Bank of Russia's calculations.

The government's measures were largely aimed at maintaining households' incomes and employment, which helped prevent a deeper slump in final consumption. Companies were granted support both directly (eg through subsidies and preferential loans) and indirectly, namely through a temporary reduction in, write-off of, or suspension of mandatory payments to the budget. The majority of direct aid to businesses was used to maintain employment in the industries hit hardest by the pandemic.[10] Along with that, the government introduced additional measures to aid companies in specific sectors, including construction, air transportation, tourism, and more. To support housing construction, the government expanded preferential mortgage lending programmes to boost households' demand for housing amid declining incomes. The 2020–2021 anti-crisis measures total an estimated amount of 4.0–4.5 trillion rubles (3.75–4.2% of GDP), of which up to 3.5–4.0 trillion rubles (3.3–3.75% of GDP) were spent in 2020 (Table 1).

As the government adopted anti-crisis measures, expenditures planned for 2020 increased, thus significantly exceeding the threshold under the fiscal rule parameters. In 2020, the government significantly increased its issuance of federal government bonds (OFZ), totalling a gross amount of 5.2 trillion rubles and a net of 4.6 trillion rubles, while actively managing the debt structure in terms of bond types – most of the OFZs placed were variable-rate liabilities (see Appendix 2).

[9] Acquisition of equity stake in Sberbank by the Russian government from the Bank of Russia using the National Wealth Fund's resources.

[10] Motor transportation; air, water and rail transport; tourism; exhibition activities; hotels; entertainment and leisure; public catering; personal services; culture and sports; non-food retail; dental care services; continuing education and mass media.

Anti-crisis measures of the Russian government in 2020-2021, as a percentage of GDP

Table 1

	2020	2021
Sanitary and epidemiological measures	0.2	0.0
Incentive payments to fight Covid-19	0.2	0.1
Socio-demographic measures	0.8	0.0
Business support	1.0	0.1
Tax and quasi-fiscal benefits	0.8	0.1
Government guarantees	0.4	0.1
Total	3.4	0.4

Source: Bloomberg, Q4 2019–Q4 2020.

According to the IMF's estimates, direct budget support expenditures helped minimise the decline in Russia's GDP by 2.25 percentage points. According to estimates based on fiscal multipliers,[11] Russia's fiscal policy helped reduce GDP contraction in 2020 by 1.3 percentage points of GDP (a weaker effect compared to the IMF's estimates, since the model relying on fiscal multipliers accounts for the time lag, due to which a significant part influence on output is expected in 2021).

2.2 Monetary policy during Covid-19

The pandemic and the measures taken to contain it put pressure on the global economy, which simultaneously reduced both output and demand, while influencing the behaviour of businesses and households. In addition, the spread of Covid-19 in February and March shook global financial markets and triggered massive capital outflows from risky assets, including emerging markets (EM) bonds. Russia also saw a significant spike in volatility in its financial markets, accompanied by depreciation of the ruble, widening credit spreads, non-residents' abandonment of local bonds and equities, the oil glut and the drop in oil prices. Under the influence of negative external factors, the Russian economy's moderate growth at the beginning of the year became a downturn. Russia's economic growth path depended in many ways on the scale of the fallout from the coronavirus spread and the actions taken to counter it, along with the impact of these actions on production and demand as well as business and consumer sentiment. The dynamics of domestic and external demand had a significant constraining influence on inflation in Russia following a pronounced slowdown of global economic growth and increased uncertainty.

In the early stages of the Covid-19 crisis, key issues involved deciding on the appropriate timing for the shift to accommodative MP and the increments of rate change as financial stability risks also had to be taken into account. In March 2020, the Bank of Russia decided to keep the policy rate unchanged while boosting foreign currency sales under the fiscal rule mechanism (see Appendix 1). Key rate cuts started

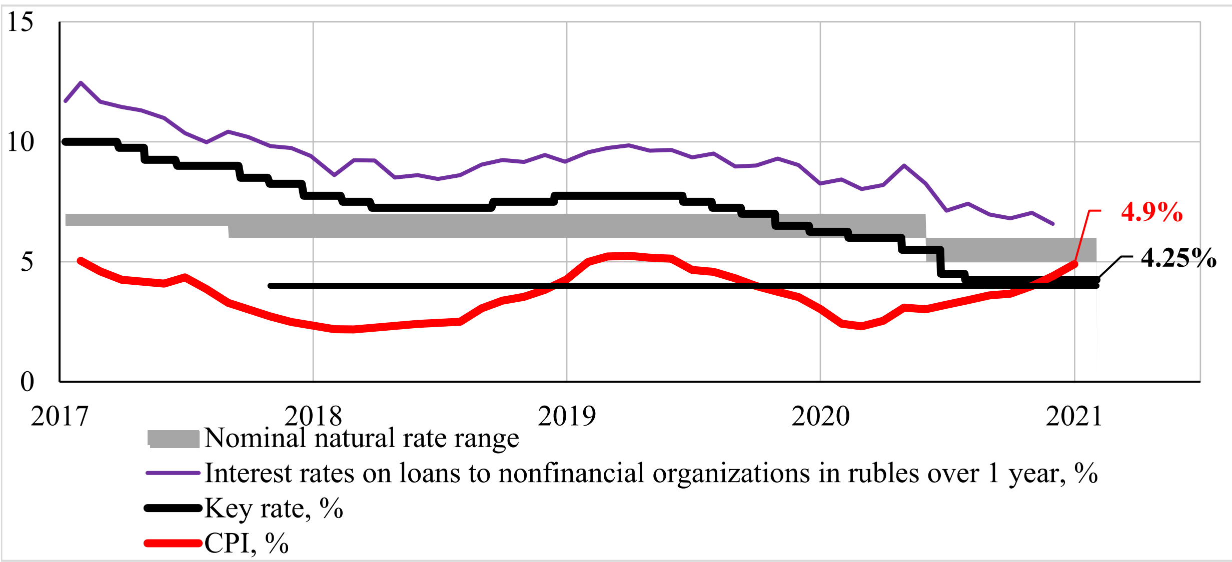
11 See I Zyablitsky, "Estimating fiscal multipliers in Russia's economy", *HSE Economic Journal*, 2020, no 2, pp 268–294.

in April as a response to Covid-19. Over five months, the Bank of Russia lowered the key rate from 6% to 4.25% and shifted to an accommodative MP stance. There was still some space for further easing if needed. This monetary policy response was necessary to foster the conditions that would drive the economy back to its potential and to avoid a long-lasting downward deviation of inflation from the target. Thus, in contrast to previous years when pro-inflationary risks predominated, the Bank of Russia implemented measures to mitigate disinflationary risks induced by a significant decline in aggregate demand. Consistent use of the IT regime, along with a prudent macroeconomic policy, made it possible to stay within the traditional range of central bank policies.

As a result, a significant reduction in the key rate translated to the easing of monetary conditions. The local yield curve moved below historic lows in February and, as of 31 August 2020, remains much lower than it was on average in 2017–19: the two-year is down 284 bp (4.46 vs 7.30), the five-year is down 213 bp (5.37 vs 7.50) and the ten-year is down 182 bp (6.28 vs 7.80). The OFZ curve has gotten steeper since the beginning of the pandemic, with the two-year/ten-year slope increasing from around 50 bp to 185 bp. A steep curve is what should be observed at times when accommodative monetary policy is implemented, so the contraction in lending was prevented in 2020. Lending amounts expanded considerably: credits in rubles to non-financial organizations increased by 8.3% (vs 6.9% in 2019), residential mortgages increased by 21.2% (vs 16.9 in 2019), and unsecured consumer credits increased by 8.8% (vs. 20.8% in 2019).

Lending rate, OFZ yields, inflation and the Bank of Russia key rate in 2017–2021

in per cent Graph 2



Source: Bank of Russia.

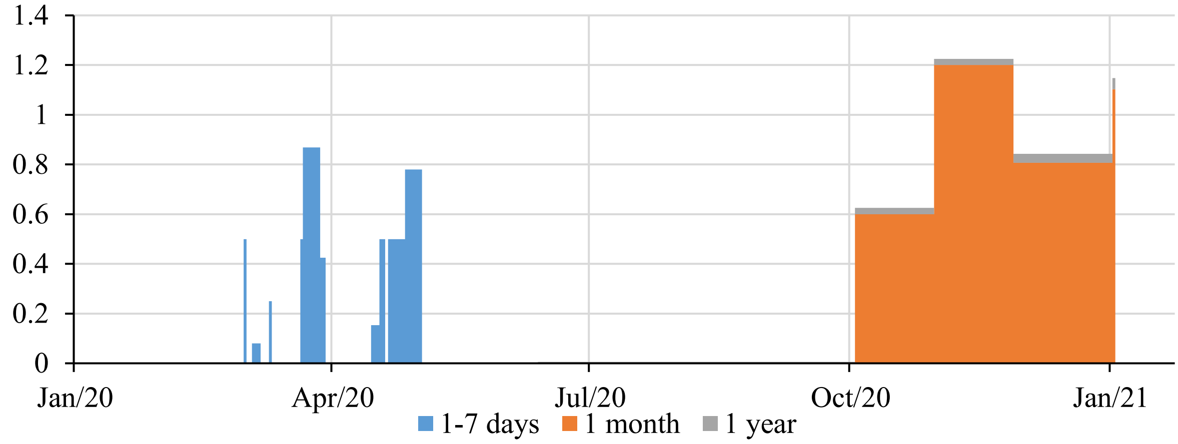
Monetary policy operations. In March and April, uncertainty about a probable lockdown and its effect on the economy led to a “dash for cash” by households and firms, increasing the cash in circulation and leading to a substantial reduction in banking sector liquidity surplus and shortening the maturity of banks’ liabilities. In light of significant fluctuations in the banking sector’s reserves due to fiscal flows and increased demand for cash, the Bank of Russia introduced long-term repo auctions with 1-month and 1-year maturities to ease the financial stress. The collateral pool for long-term repo auctions includes federal and regional government bonds, while the collateral pool for "standard" repos – standing facilities and fine-tuning auctions – also includes a variety of corporate bonds. The limited collateral list for long-term repos and interest rates set above the key rate reflect these operations' higher risk and encourage banks to primarily use market opportunities.

The take-up in repo auctions, however, was modest until autumn, when the Ministry of Finance substantially increased the volume of OFZs offered on the market. This led to another temporary withdrawal of liquidity which was not fully compensated by government expenditures or increases in Federal Treasury deposits with the banking sector. The liquidity outflow also affected different banks to varying degrees. The resulting inconsistency in the distribution of liquidity between banks translated into an increased demand for long-term repos amid an enduring liquidity surplus. Against this backdrop, long-term repo operations ensured a stable transition from structural surplus to a neutral liquidity level.

The Bank of Russia's repo auctions by maturity (amounts outstanding)

in trillions of rubles

Graph 3



Source: Bank of Russia.

Special Refinancing Facilities. Another supporting mechanism that proved its efficiency during the pandemic was an expanded toolkit of the Special Refinancing Facilities mechanism (SRF) designed to support lending to SMEs. The new SRF was developed jointly with the government and an existing SME support mechanism was changed: industry-related restrictions on loans to SMEs were lifted; the rate on Bank of Russia loans was lowered by 2 pp to 4%; and the final borrower rate was capped at 8.5%. A new SRF with a lending rate at 2 pp below the key rate was introduced to encourage lending to SMEs and corporations for urgent needs and to ensure job security for a total amount of 500 billion rubles, including:

- uncollateralised loans or loans backed by the guarantees of JSC Russian Small and Medium Business Corporation to banks to provide financial assistance to SMEs (and later expanded to other corporations) with their payroll liabilities and other urgent needs, with the effective lending rate for final borrowers established at 0% for the first six months (interest rates have been subsidised by the government) and

- uncollateralised loans to support lending to SMEs. The actual interest rate on the Bank of Russia loan will depend on the increments of banks' SME ruble loans.

After November 2020, no new loans were created under the new SRF. The Bank of Russia's claims on credit organisations under this SRF amounted to 454 billion rubles as of 1 February 2021.

3. Monetary and fiscal policy mix during Covid-19

The economic downturn in 2020 required the government and the Bank of Russia to take decisive measures and boost coordination of their efforts to support households, businesses and the economy in general. As a result, 2020 saw the simultaneous effects of accommodative monetary policy and expansionary fiscal policy; in other words, policies were countercyclical. During previous crises in 2008–9 and 2014–15, responses from the Bank of Russia and the Ministry of Finance went in different directions: contractionary procyclical monetary policy and expansionary countercyclical fiscal policy. These crisis episodes were associated with depreciations of the ruble, high inflation, high dollarisation of the economy and a sharp drop in oil prices. These factors significantly limited monetary and fiscal policy space and did not allow the Bank of Russia to shift to an accommodative monetary policy.

At the start of the crisis, providing a prompt fiscal response was of the utmost importance because fiscal impulse can influence economic agents nearly instantly, allowing the monetary policy impulse to reach the economy with a time lag (inherent in its nature). Countercyclical fiscal policy, support for economic sectors (loan restructuring, FLP for SMEs), and administrative and regulatory relief for the financial sector (banks' capital buffers at approximately 5% of GDP) also helped address the impact of primary shocks on aggregate demand, sustain financial sector intermediation and ensure effective MP transmission. Uniformity in the responses of the government and the Bank of Russia helped reduce the impact of Covid-19 on the Russian economy: in 2020, Russia's GDP fell just by 3.1%, one of the smallest contractions among the major economies.

The fiscal policy measures implemented to support the economy will gradually come to an end, and the fiscal stimulus reached its peak in H2 2020. Subsequent budget consolidation is expected to start in the middle of 2021. According to the path defined by the Ministry of Finance, the budget system balance will be –4.6% of GDP in 2020, –3.2% of GDP in 2021 and –1.3% of GDP in 2022, with budget system expenditures at 38.7%, 36.8% and 35.1% of GDP, respectively. The decreasing fiscal stimulus in H2 2020 will be offset by accommodative monetary policy since its stimulating effect experiences a time lag.

Transparency and certainty about future fiscal policy prospects are positive factors for implementing monetary policy. Despite the substantial increase in budget-funded aid in 2020, the government is scheduled to return budget expenditures to the thresholds provided for by the fiscal rule. The clearly defined path of fiscal consolidation reduces uncertainty regarding the effect of fiscal policy on output and inflation.

The design of these measures has ensured that finance and regulatory relief comes to those most in need and that withdrawal can be conducted in a timely manner. Most of the Bank of Russia's pandemic measures were adopted with an end date, mainly for the period up to September 2020, and some of them were extended. Certain measures had agreements and conditions for financial institutions. Such design communicates the inevitability of a return to conventional/neutral policy over a foreseeable horizon. Timely and transparently and clearly communicated policy normalisation is crucial; it requires the creation of adequate space for further support action and of incentives for market participants to return to a balanced risk management policy.

4. Conclusion

Although both monetary and fiscal policy influence aggregate demand and inflation, their respective roles are as follows: during normal times, fiscal policy is conducted for its own purposes, and monetary policy, taking into account the budget's influence on demand and inflation, corrects aggregate demand as necessary while bringing demand to its full potential and inflation to its target. In Russia, due to strong fundamentals, these roles remained unchanged even during the pandemic. Certainly, the coordination and interaction between the Bank of Russia and the government naturally increased in response to the shock and high uncertainty. Both institutions had to track and forecast adopted and potential measures, as well as the effects of the measures taken by the other institution, more closely. However, the fundamental principles of interaction between monetary and fiscal policy remained intact. Therefore, the risks of fiscal dominance remain low in Russia.

Appendix

1. The Bank of Russia's operations in the foreign exchange market under the fiscal rule

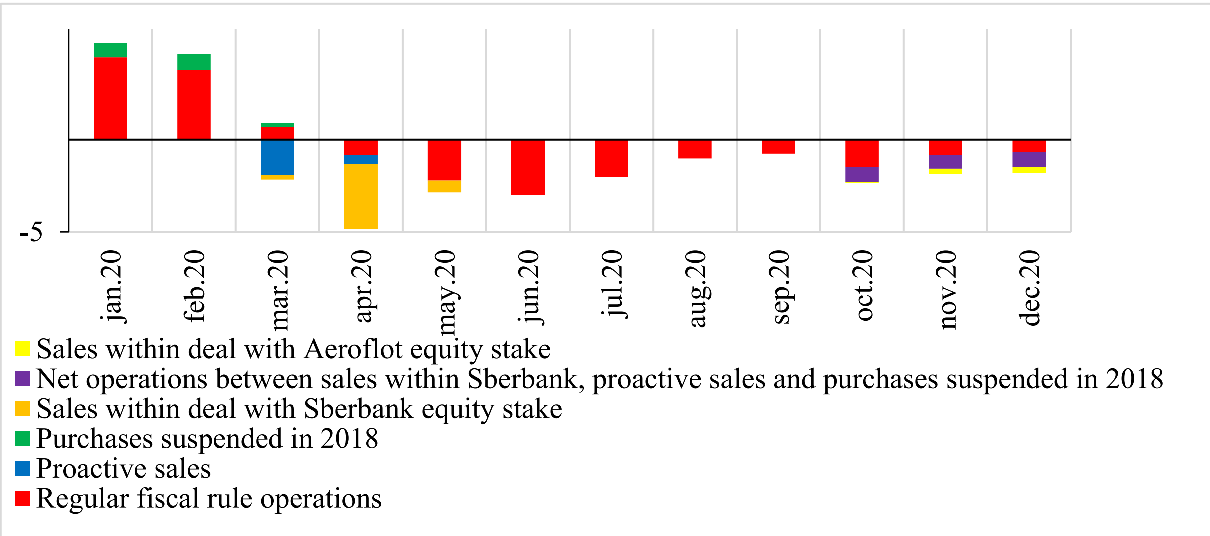
Due to increased volatility in the financial markets, the Bank of Russia developed a foreign currency sale mechanism intended to reinforce the stabilising effect of the fiscal rule amid low oil prices and thus contribute to financial stability. In accordance with this mechanism, additional foreign currency sales were calculated to fully offset the shortage of foreign currency supply in the domestic foreign exchange market due to a decline in export revenues from the sale of oil, petroleum products and natural gas against the backdrop of the slump in the Urals crude price to less than $25 per barrel. Taking into account price levels in the oil market, the Bank of Russia did not conduct these operations between 19 March 2020 and 12 May 2020. The mechanism of proactive foreign currency sales was used through 6 April 2020.

In Q4 2020, the Bank of Russia netted against each other the remaining amount of foreign currency to be sold in the Sberbank deal, the amount of proactive sales carried out in March and April and the purchases postponed for this period, as well as the amount of foreign currency purchases suspended in 2018 and not performed until this time. The Bank of Russia also started to sell foreign currency via the transaction for Aeroflot shares purchased by the Russian government using the NWF's resources (50 billion rubles through the end of 2020).

Given the amount corresponding to these extra operations and their uniform execution, there was no significant impact on the domestic foreign exchange market. Nonetheless, the Bank of Russia's efforts in March and April 2020 helped prevent excess exchange rate volatility amid the unprecedented slump in the price of oil and the decline in export revenues (Graph 5). Since January 2021, the Bank of Russia has only been carrying out fiscal rule-based operations in the foreign exchange market.

The Bank of Russia's operations in the foreign exchange market in 2020, in billions of US dollars

Graph 4



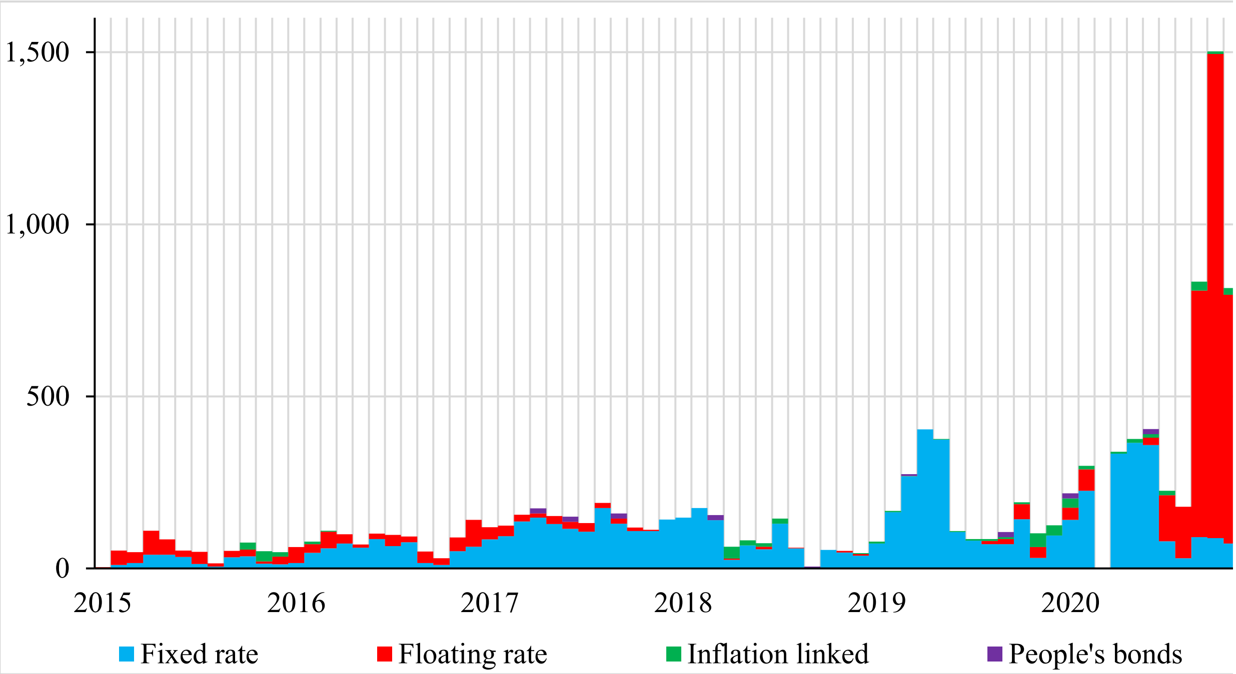
Sources: Ministry of Finance of the Russian Federation; Bank of Russia.

2. The effects of variable-rate sovereign debt

The growing share of floaters (Graphs 2 and 3) makes the transmission mechanism more efficient, speeding up the impact of monetary policy impulses (key rate changes) on the cost of borrowing and further servicing of public debt, with these effects then spreading to other debt market segments (corporate bonds, lending to the non-financial sector, etc).

The depth, capacity and liquidity of the public debt market increased as a result of extensive borrowing to finance the budget deficit in 2020–2021, paving the way for expansion of the range of collateral assets (the Lombard List) under the Bank of Russia's traditional liquidity-providing operations. In addition, as the amounts of listed OFZ bonds rise along the entire yield curve, the pricing quality of corporate bonds with various lengths (weighted-average maturities) increases, which also improves monetary policy transmission.

Types of OFZ placed in 2015–2020, in billions of rubles — Graphs 5



Sources: Ministry of Finance of the Russian Federation; Moscow Exchange; Bank of Russia's calculations.