

Exchange rate flexibility and Russia's monetary policy shift

Central Bank of the Russian Federation

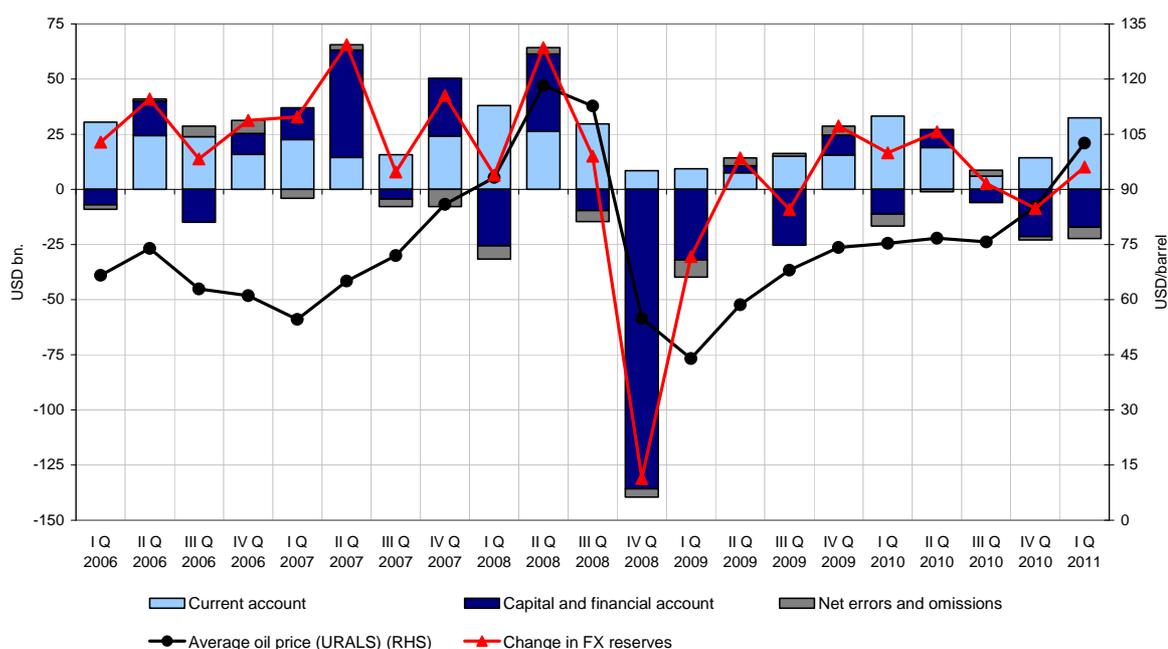
The global financial crisis that started in 2008 deeply affected Russia's economy and financial markets. It also precipitated a monetary policy shift that had been on the policy agenda for the previous few years. The Bank of Russia has since entered into a transition path from an exchange rate-based monetary policy to one focused on price stability. Increased exchange rate flexibility and, ultimately, a shift to a floating exchange rate regime are considered by the Bank of Russia to be part of its medium-term strategy.

The rouble's appreciation before the crisis was driven largely by Russia's significant current account surpluses on the back of strong global commodity markets. This, together with prevalent high inflation and interest rates, created a so-called one-way bet on the rouble and, after the complete removal of capital controls in 2006, attracted significant short-term capital inflows. Under these conditions, the domestic foreign exchange market was characterised by an excess supply of foreign currency, with the Bank of Russia playing the part of the foreign exchange buyer of last resort. Foreign exchange interventions were at that time the main means of money emission and resulted in excess banking sector liquidity.

In the wake of the crisis, the rouble came under strong pressure from the substantial capital outflows that accompanied falling export revenues owing to the decline in commodities prices (Graph 1). Ultimately, the currency depreciated by more than 30%. The Bank of Russia intervened in the domestic foreign exchange market in order to slow this depreciation but, at the same time, it softened the degree of exchange rate rigidity and introduced significant changes to its exchange rate policy mechanism.

Graph 1

Structure of the Russian balance of payments and oil price dynamics



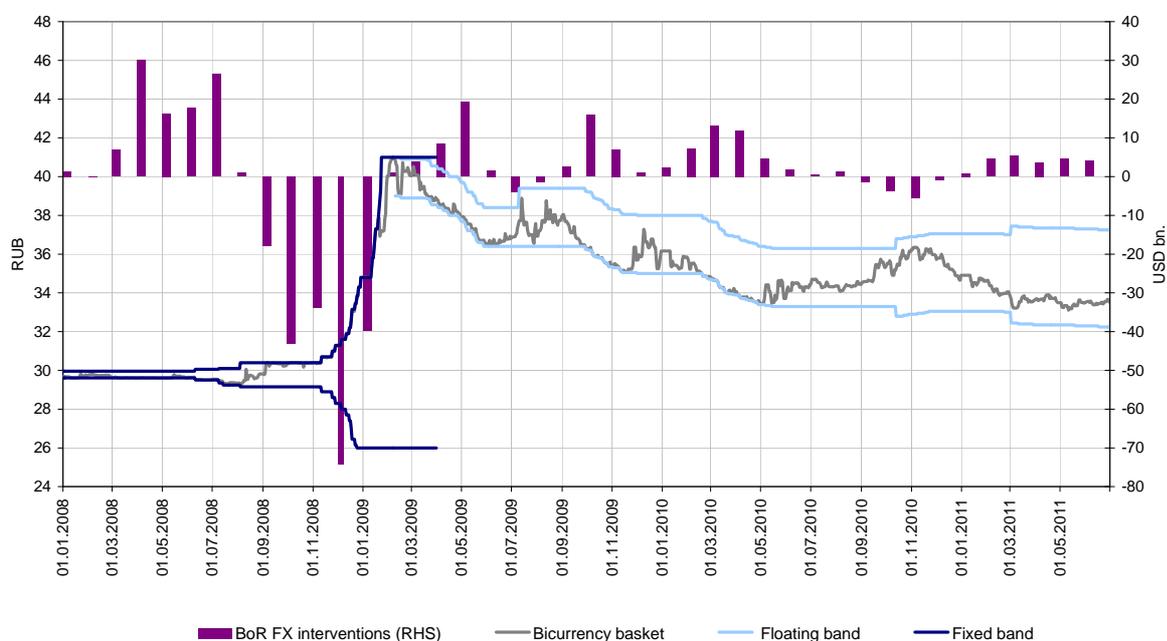
The fixed exchange rate band was eliminated. Under the current mechanism, exchange rate fluctuations are limited by the operational band with floating rather than fixed boundaries, which are moved automatically according to an established rule after the accumulation of a threshold volume of interventions. However, the daily interventions are accumulated only in excess of a set amount (target interventions). The aim is to compensate for the systematic imbalances between supply and demand in the domestic foreign exchange market.

This mechanism is intended to promote a gradual transition to a floating exchange rate regime. Since it was introduced, the Bank of Russia has several times increased the width of the operational band and has simultaneously lowered the threshold amount of interventions that trigger a shift of its boundaries in order to achieve greater exchange rate flexibility.

The new exchange rate policy mechanism has effectively kept the exchange rate within the floating operational band and, for more than a year, the Bank of Russia has not bought or sold currency at either the floor or ceiling levels of the operational band (Graph 2).

Graph 2

Foreign exchange interventions and exchange interventions rate dynamics



Exchange rate flexibility has proved to be a crucial precondition for a more effective interest rate policy. The introduction of a more flexible exchange rate policy mechanism has allowed the Bank of Russia to strengthen its control over money market interest rates and has helped to reduce their volatility. At present, money market interest rates are close to the level of the Bank of Russia's deposit rates, owing to the excess liquidity of the banking sector (Graph 3).

In the medium term, the Bank of Russia will continue to increase the flexibility of the exchange rate and to put greater emphasis on its interest rates policy. The money supply will be steered mainly by monetary policy instruments as the Bank of Russia reduces its presence in the foreign exchange market. However, during the transition period towards a floating exchange rate, the Bank will continue to conduct interventions in order to mitigate the excess volatility of the rouble exchange rate and to compensate for the systematic imbalances between supply and demand in the domestic foreign exchange market.

Graph 3

Money market interest rates and interest rate corridor of the Bank of Russia

