The history of the Bank of Russia's exchange rate policy

Central Bank of the Russian Federation

Abstract

During the post-Soviet period of 1992–98, the monetary policy of the Bank of Russia was essentially exchange rate-oriented due to overall economic and financial instability combined with hyperinflation (1992–94) and high inflation (1995–98). An exchange rate corridor system was introduced in 1995. The government debt crisis of 1998 triggered a shift to a managed floating exchange rate. After that crisis, exchange rate dynamics were largely market-driven. The exchange rate continued to be tightly managed through 2002–05. In 2004, less restrictive capital control regulations were adopted, marking a move from an authorization-based system to flow controls. The rouble experienced steady upward pressure and the Bank of Russia intervened repeatedly in the foreign exchange market to contain the rouble's appreciation.

In 2005, the Bank of Russia introduced a dual-currency basket as the operational indicator for it exchange rate policy, again to smooth the volatility of the rouble's exchange rate vis-à-vis other major currencies. Following the global financial crisis, the Bank of Russia changed its policy focus towards moderating the rouble's depreciation. Interest rates were steadily raised, and a range of control measures was implemented. During 2009–12, the Bank of Russia further increased the flexibility of its exchange rate policy. Intervention volumes have steadily decreased. The overall scale of the exchange rate pass-through in the Russian economy has diminished in recent years. Greater flexibility on exchange rates has also let the Bank of Russia put increased emphasis on its interest rate policy.

In 2013–14, the Bank of Russia plans to further increase the flexibility of the rouble exchange rate regime with a view to creating the conditions for a transition to a fully floating exchange rate regime by 2015.

Keywords: Bank of Russia, rouble, foreign exchange market, exchange rate policy, exchange rate regime

JEL classification: E58

The post-Soviet period of 1992–98 was characterised by overall economic and financial instability combined with hyperinflation (1992–94) and high inflation (1995–98). Waning confidence in the domestic currency due to persistent inflation led to the dollarisation of the economy. During this period, monetary policy was essentially exchange rate-oriented. An exchange rate corridor system was introduced in 1995, strengthening the role of the rouble exchange rate as the nominal policy anchor.

The government debt crisis of 1998 triggered a shift to a managed floating exchange rate. After that crisis, exchange rate dynamics were largely market-driven and allowed official reserves to be rebuilt after oil prices revived. But the emphasis continued to rest on exchange rate policy in view of continued weaknesses in the transmission mechanism and the financial sector as a whole. The policy was intended to prevent excessive movement in the rouble exchange rate that might threaten macroeconomic and financial stability, thus compensating for a relative lack of experience and tools among economic participants and in the household sector for managing exchange rate risks. The exchange rate policy also helped to restore confidence in the country's financial system after the crisis and to dampen the effect of volatile commodity prices on the economy.

The exchange rate continued to be tightly managed through 2002–05. At the same time, the Bank of Russia started to gradually relax capital controls. In 2004, less restrictive capital control regulations were adopted, marking a move from an authorisation-based system to flow controls. The Bank of Russia lifted its last capital controls in July 2006.

After the capital account was liberalised, the rouble experienced steady upward pressure as rising oil prices swelled the current account surplus and capital flowed in at ever-faster rates. The Bank of Russia intervened in the foreign exchange market to contain the rouble's appreciation with its associated threats to the competitiveness of Russian exporters and to economic and financial stability. These operations were the main reason for a corresponding increase in the money supply; indeed, the country's monetary aggregates consistently outgrew the Bank of Russia's targets during this period. Inflation, however, slowed gradually, as economic agents de-dollarised their balance sheets. At the same time, strong economic growth also contributed to a steady increase in demand for money.

In 2005, the Bank of Russia introduced a dual-currency basket as the operational indicator for its exchange rate policy. Again, the aim was to smooth the volatility of the rouble's exchange rate vis-à-vis other major currencies. The dual-currency basket consisted of the US dollar and the euro in unequal shares that were designed to keep the dynamics of the basket's value in line with changes in the rouble's nominal effective exchange rate. The basket's value remained more or less stable during the 2005–08 period, thanks to the growing weight of euro within it (in the first quarter of 2007, the composition of the dual-currency basket was fixed at 55% for the US dollar and 45% for the euro).

In May 2008, the Bank of Russia introduced a mechanism for regular purchase of foreign exchange with a view to countering the persistent mismatch of supply and demand in the domestic foreign exchange market, which was caused by the transfer to the sovereign funds of tax revenues from the export of mineral resources.

The global financial crisis led to a sharp decline in oil prices. This sharply eroded Russia's current account balance and triggered massive capital outflows, thus putting the rouble under significant downward pressure. In response, the Bank of Russia changed its policy focus towards moderating the rouble's depreciation, a trend that threatened to put a heavy strain on the balance sheets of banks, firms and households via the significant level of foreign currency-denominated debt that these agents had taken on.

Between November 2008 and January 2009, the Bank of Russia allowed the rouble to depreciate gradually by widening the dual-currency band. At the same time, the Bank conducted large-scale interventions in the domestic foreign exchange market in order to slow the pace of the rouble's depreciation with the aim of allowing the economy time to adjust to these ongoing changes. From November 2008 to January 2009, the level of Russia's international reserves fell by one third.

In order to curb capital outflows, slow the rouble's depreciation and prevent instability in domestic financial markets, the Bank of Russia raised interest rates steadily and implemented a range of additional measures. Banks were advised to maintain stable levels of net foreign assets and currency positions, and their observance of these recommendations was taken into account when credit limits were set for individual banks' access to Bank of Russia unsecured loans (the main anti-crisis refinancing tool during that period). Limits were substantially reduced for banks that did not adequately respect the recommendations.

In January 2009, the Bank of Russia announced a wide fixed band for the rouble value of the dual-currency basket (allowing fluctuations from 26 to 41 roubles) and it also introduced a floating operational band. The gradual move to a more flexible exchange rate regime was intended to create favourable conditions for market participants to adjust to a fully floating exchange rate environment.

Starting from the first quarter of 2009 the exchange rate policy mechanism permitted foreign exchange interventions both within the floating operational band for the rouble value of the dual-currency basket and at its borders. The operational band included a "neutral" range where no interventions were conducted. When the value of the dual-currency basket moved outside the "neutral" range, the Bank of Russia started buying or selling foreign currency. The closer the value of the dual-currency basket approached the borders of the operational band, the more heavily the Bank of Russia intervened. The borders of the operational band were adjusted automatically as soon as the cumulative volume of foreign exchange interventions reached a set level. In order to neutralise the systematic imbalance between demand and supply in the domestic foreign exchange market, only the excess of the total volume of foreign exchange purchases and sales over a set level (ie target interventions) was taken into account when calculating the aforementioned cumulative volume. The Bank of Russia calibrated the volume of its target interventions according to balance of payment factors, the budget policy and domestic and foreign financial market conditions.

During 2009–12 the Bank of Russia further increased the flexibility of its exchange rate policy: the floating operational band was widened from 2 to 7 roubles, the cumulative interventions volume triggering a 5 kopecks shift in the operational band was reduced from \$700 million to \$450 million and the parameters of the target intervention mechanism were modified.

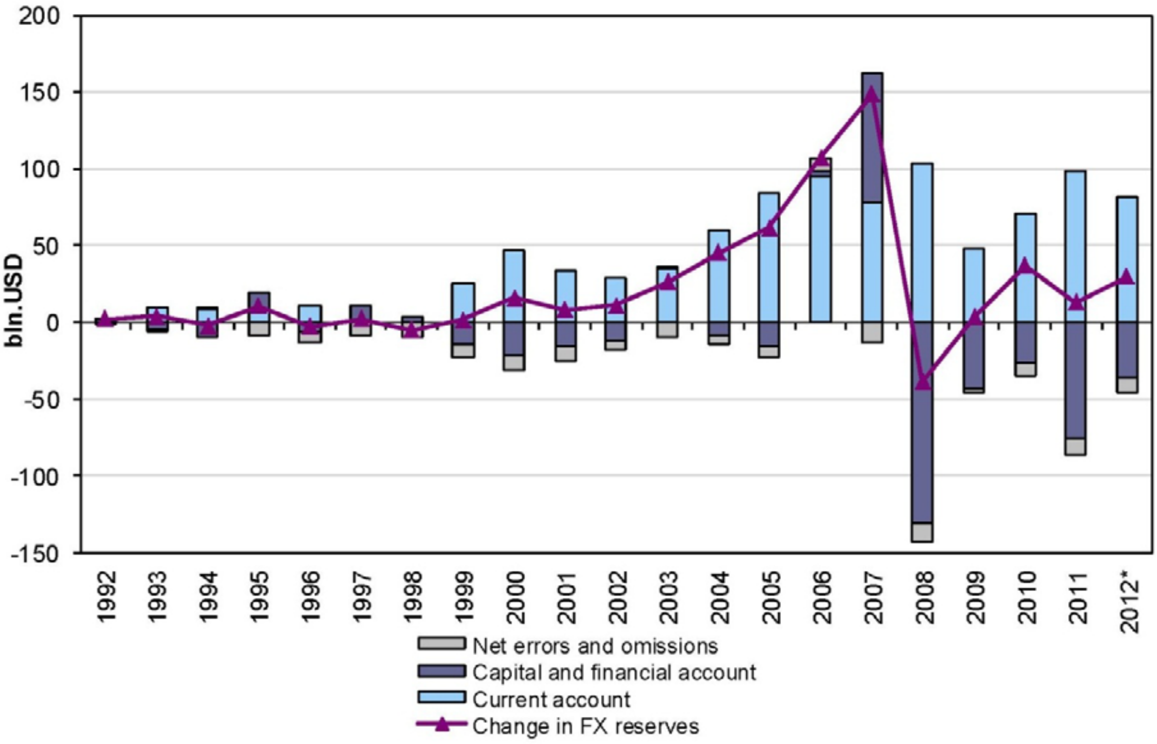
Following these changes, intervention volumes have steadily decreased. Yet the foreign exchange market has remained stable, and the rouble's moderate volatility and exchange rate trends have stayed in line with the dynamics of other emerging markets currencies, including those of the BRICS.

The gradual shift to more flexible rouble exchange rate helped economic agents adjust to the growing level of rouble volatility promoting continued de-dollarisation and making households' foreign exchange deposits and foreign exchange cash purchases dynamics less vulnerable to rouble exchange rate changes. According to Bank of Russia estimates, the overall scale of the exchange rate pass-through in the Russian economy has diminished in recent years. The move towards a fully floating exchange rate has also promoted the further development of Russia's hitherto nascent derivative markets for managing exchange rate risks

Greater flexibility on exchange rates has also let the Bank of Russia put increased emphasis on its interest rate policy. This has helped to reduce volatility in money market rates, thus strengthening the interest rate channel of the monetary policy transmission mechanism.

In 2013–14, the Bank of Russia plans to further increase the flexibility of the rouble exchange rate regime with a view to creating the conditions for a transition to a fully floating exchange rate regime by 2015 – an important prerequisite for the introduction of inflation targeting. After moving to a floating exchange rate regime, the Bank of Russia will abandon exchange rate-based operational indicators for its exchange rate policy. Even then, however, the Bank will retain the right to make interventions in the domestic foreign exchange market, especially for the purpose of managing liquidity in the banking sector.

Fig.1. Balance of Payments of the Russian Federation



**2012 estimate according to revised methodology*

Fig.2. Ruble's Effective Exchange Rate Dynamics

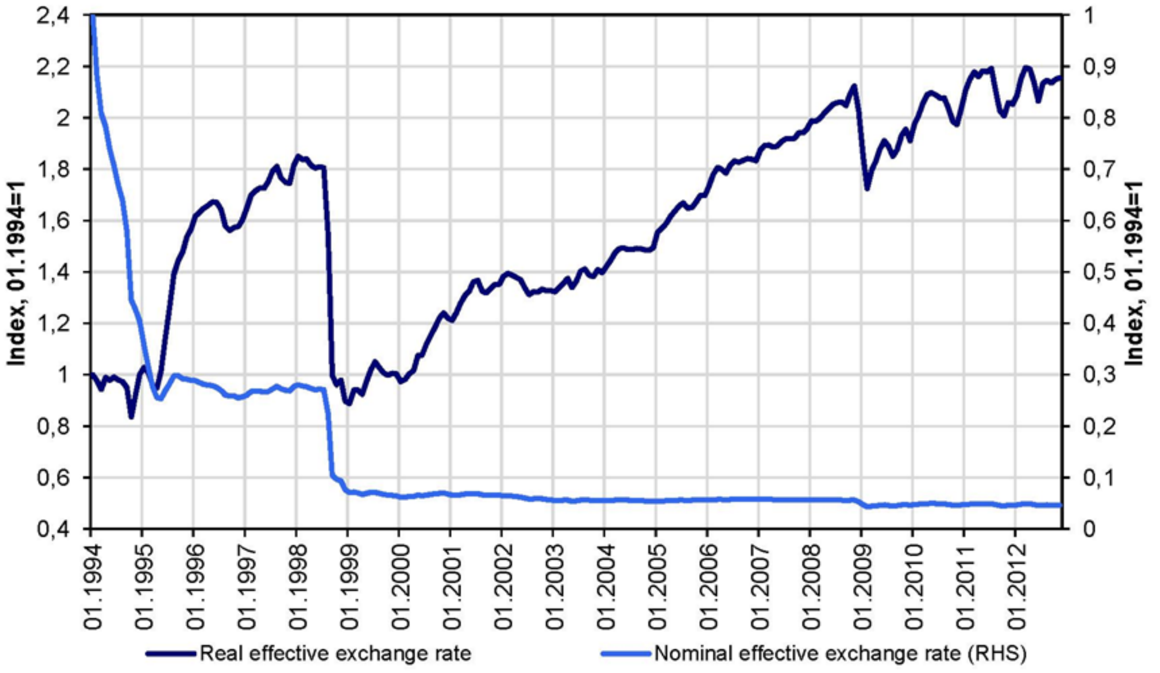


Fig.3. The Bank of Russia Net Foreign Assets and Monetary Aggregates

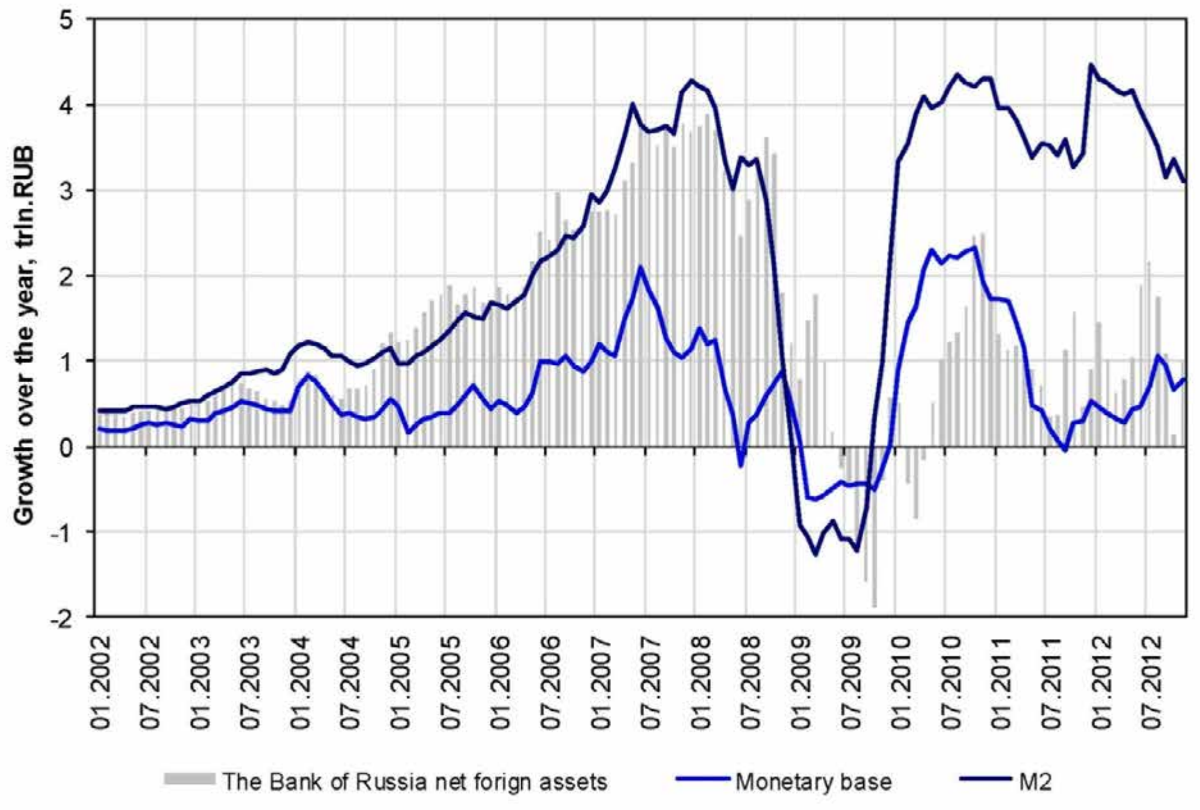


Fig.4. GDP Growth and Inflation in Russia

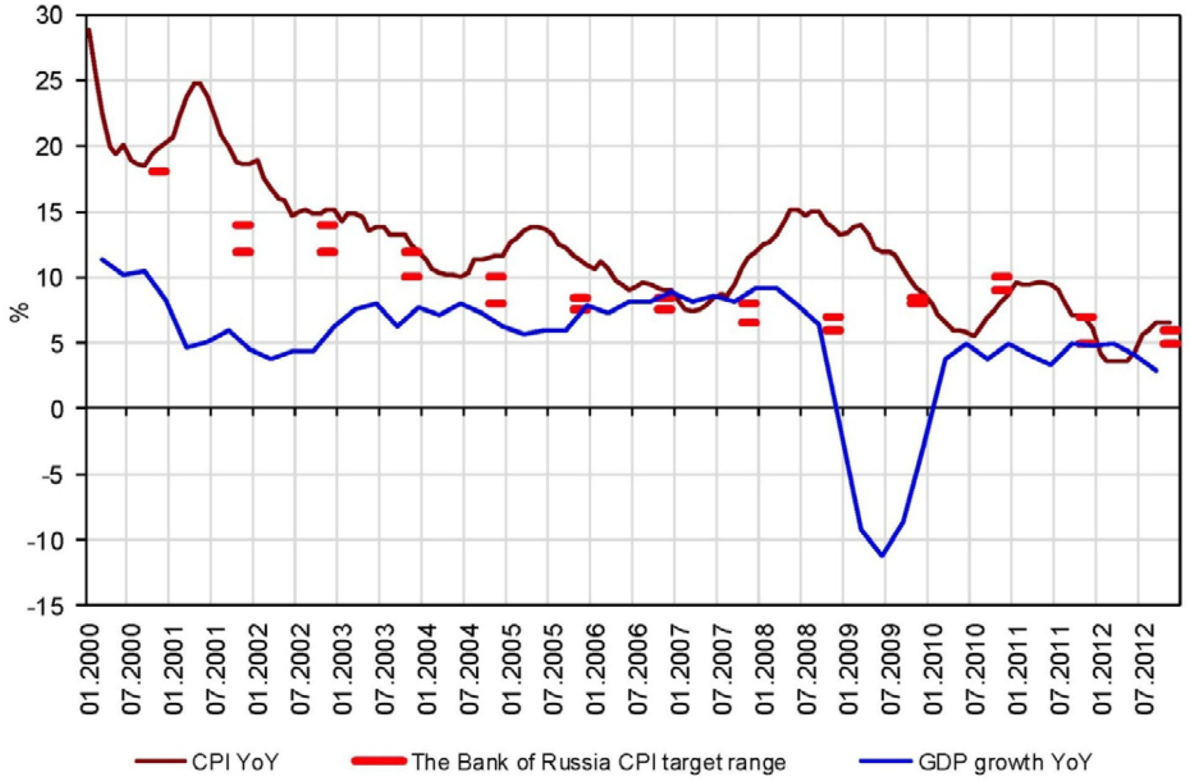


Fig.5. Rouble Exchange Rate and Inflation in 1992-1997

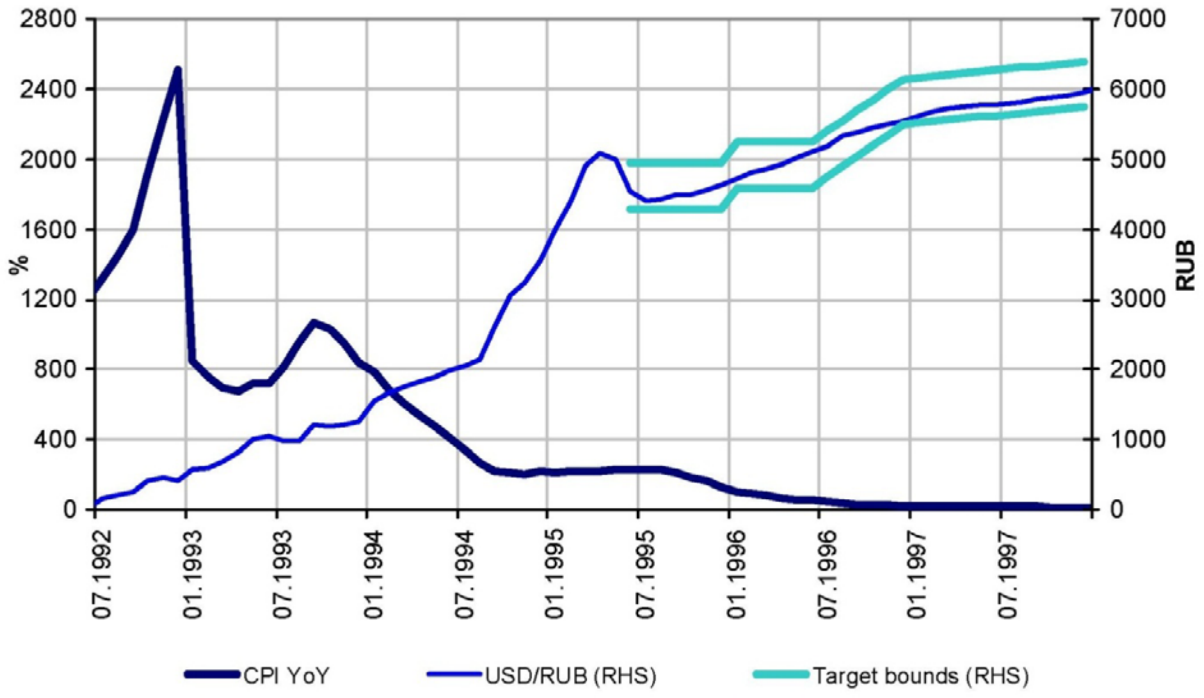


Fig.6. Rouble Exchange rate and the Bank of Russia FX Interventions in 1997-2004

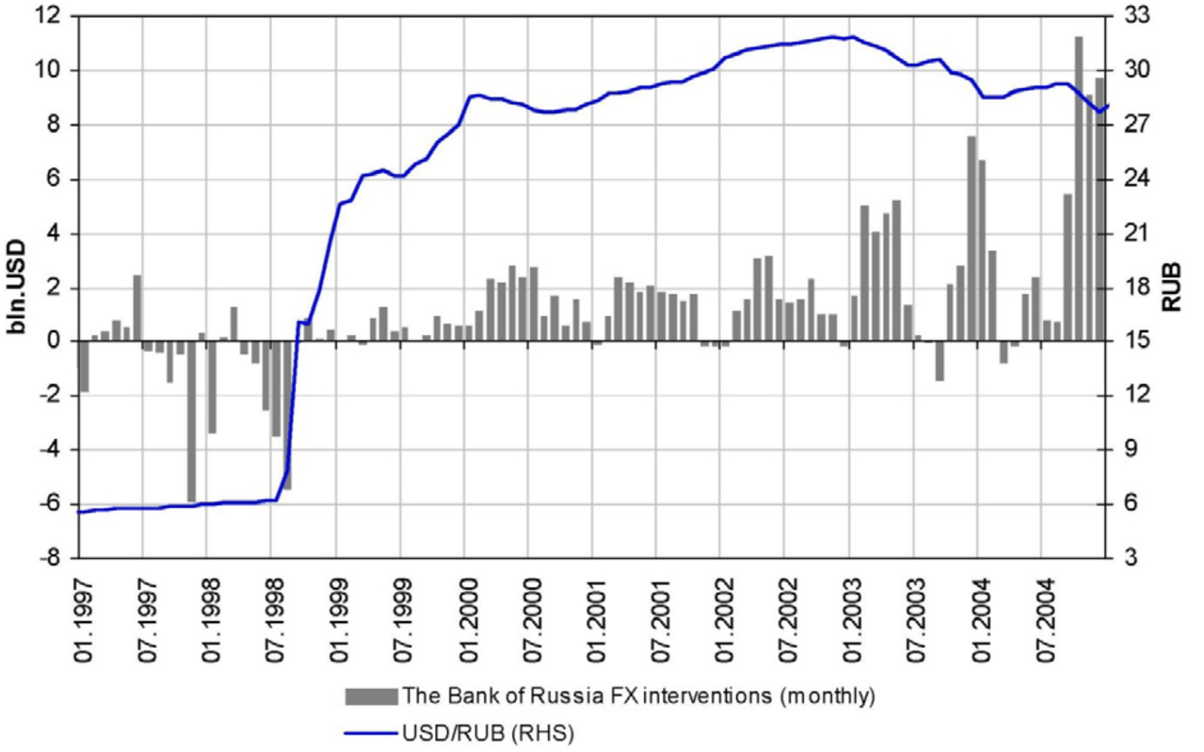


Fig.7. Rouble Exchange rate and the Bank of Russia FX Interventions in 2005-2012