Monetary policy in Russia: Recent challenges and changes

Central Bank of the Russian Federation (Bank of Russia)

Abstract

Increasing trade and financial flows between the world's countries has been a double-edged sword for emerging market economies (EMEs). On the one hand, it has given EMEs ample opportunities to benefit from world economic growth and from the significant financial resources accumulated by developed countries. On the other hand, EMEs have become more vulnerable to shocks in global financial markets, the origins, scope and size of which are often beyond the control of EME governments and monetary authorities. This paper describes the specific set of external and internal conditions the Bank of Russia has had to take into account, as well as some features of its monetary policy and the way these have evolved in recent years to cope with the challenges posed by a changing external environment.

Keywords: Money supply, liquidity, intervention, Russia

JEL classification: E58, E52, E51, F31

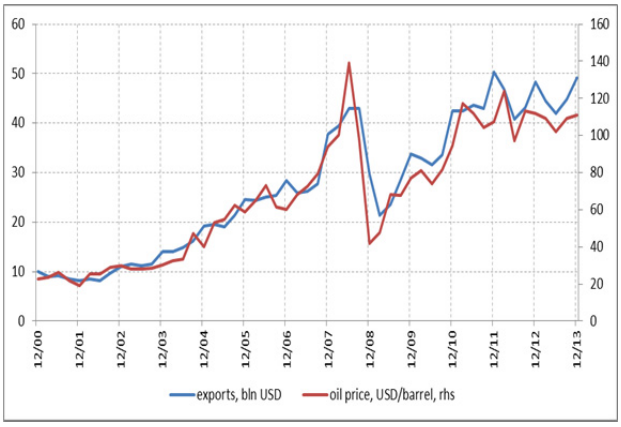
Policymakers in emerging market economy (EME) central banks are facing difficult choices. The world economy is becoming more and more integrated, with cross-border trade and financial flows increasing rapidly in volume. On the one hand, this gives EMEs many opportunities to benefit from world economic growth and from the vast financial resources of developed nations. However, on the other hand, as EMEs become increasingly integrated into the world economy and thus more dependent on external demand and financing, they become more vulnerable to external shocks. Most EMEs are quite small, especially compared to the volumes seen in the world financial market, and fluctuations that are more or less manageable by the central banks of the world's largest economies are much harder to control with the tools available to an average EME central bank.

Furthermore, many EMEs are undergoing structural changes. Their economic and financial conditions are subject to sudden and quite significant shifts even without external influence, and local central banks often have to focus on specific functions that at best are of secondary importance among the priorities of a "textbook" central bank. Some policy tools might be unavailable to them, while others may not be that efficient due to the specifics of the local economies or financial markets. Monetary policy itself becomes somewhat path-dependent, determined by past economic developments and policy responses, which greatly complicates the process of adopting central banking best practice.

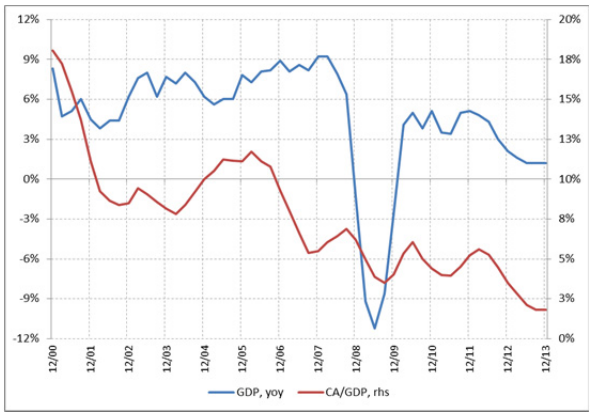
That said, the beginning of the 2000s was undeniably a prosperous time for most EMEs. Economic growth in these countries was much faster than the world average (6.7% per year in 2001–07 compared with 4.2% for the world economy). Global investors were happy to buy EME assets, fuelling a rally in the countries' stock and commodity markets.

Russia was one of the main beneficiaries of this favourable global environment. Commodity prices boomed during the period, with oil prices alone growing by about 350% in 2001–07. As oil accounts for over 50% of Russian exports – and oil and other commodities making up more than 70% – the sharp rise in oil prices fuelled a threefold increase in Russia's export volumes over the period. Meanwhile, the current account balance exceeded 10% of GDP in 2005–06, and economic growth accelerated as well, with GDP growing faster than 9% year-on-year by 2007.

Oil price and exports



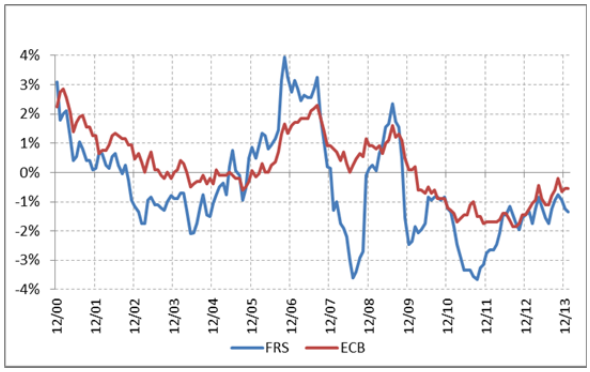
GDP and external balance



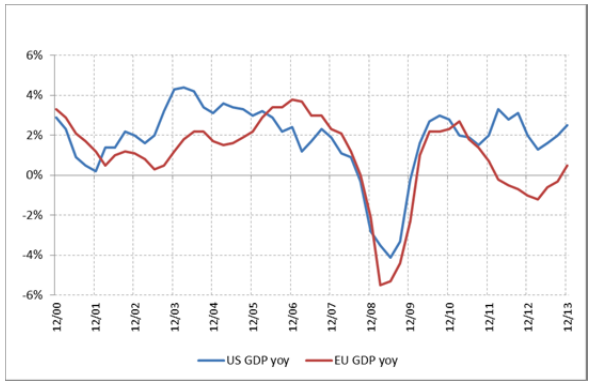
Source: Federal State Statistics Service, Bloomberg

Of course, the boom was not restricted to commodity markets. Risk appetite was high in all segments of the world financial system, and leverage ratios were rising, as were the prices of risky assets and the capital flows to EMEs. Such an extreme (though still favourable) set of external conditions was at least partly caused by the monetary policy stance of the world's major central banks. The Federal Reserve and the ECB were conducting loose monetary policies; the real policy rate in the United States was significantly negative during 2002–05, reaching –2%, while in the euro zone the real policy rate fell below zero as well, though not as much. Historically, these levels were very low, especially given the relatively high world economic growth rates during the period.

Real key rates



GDP growth rates, yoy



Source: Bloomberg

One can argue about the extent to which the loose monetary policies of major central banks were responsible for the accumulation of the imbalances in developed economies that finally resolved themselves in the 2008 financial crisis. However, for a relatively small EME central bank such a set of external conditions was obviously too much to handle. For Russia, rapid commodity price growth and an increase in the external trade surplus, given no restrictions on cross-border capital flows, caused significant upward pressure on the rouble, with demand for local currency greatly exceeding supply throughout most of the pre-crisis period.

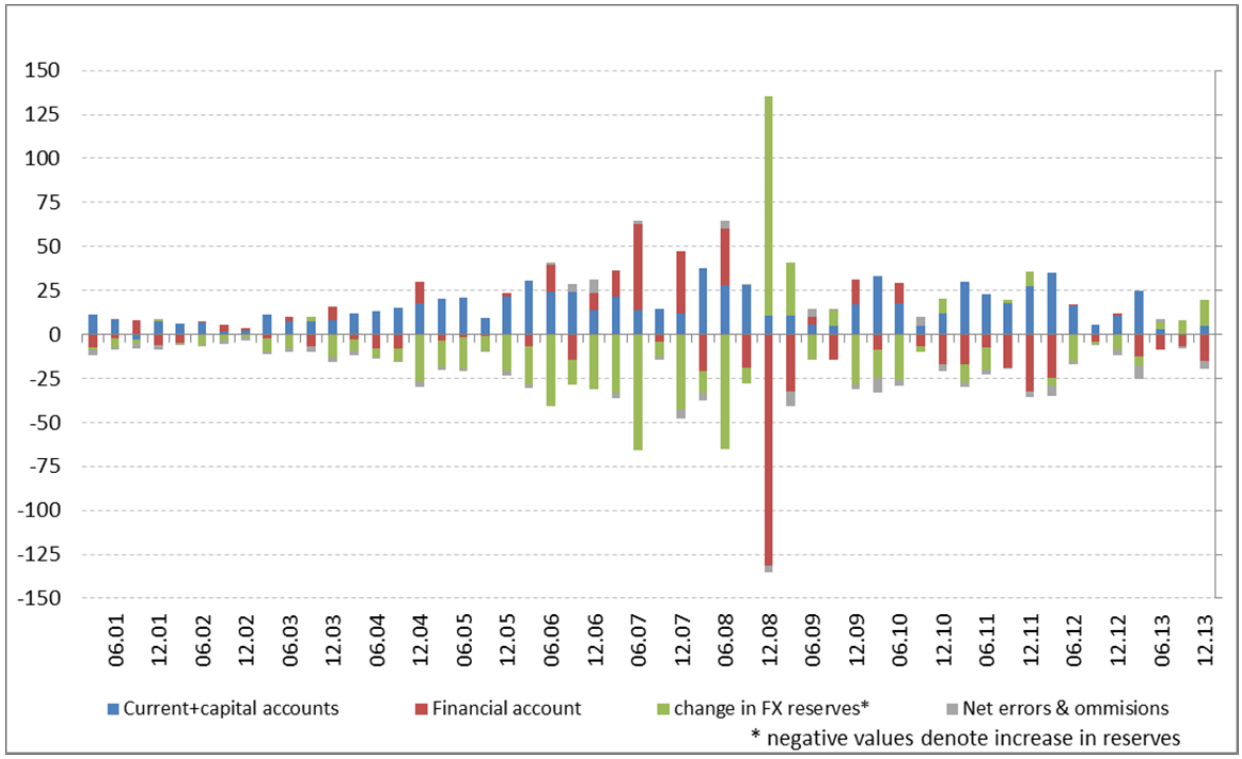
Were the exchange rate to be determined by private market participants alone, the rouble would have appreciated sharply, making for a perfect example of "Dutch disease". In this scenario, upward pressure on the exchange rate, caused by a temporary rise in world demand for a product in one sector of the economy, drives the exchange rate high enough to make other sectors of the economy uncompetitive, with no positive implications for the economy as a whole.

However, exchange rate stability means a lot for Russia's economy and population. Not so long ago, the country had passed through another major currency crisis, with foreign exchange, the USD in particular, widely used for household savings. In addition, exports and imports are quite high relative to the country's GDP, and foreign lending is an important source of funding for investments. So, the Bank of Russia obviously cannot ignore exchange rate dynamics; in fact, exchange rate stability is stated first in the Bank of Russia's mandate, as set out in "The Law of the Central Bank of the Russian Federation".

Consequently, the Bank of Russia had to try to counter the threat of "Dutch disease". Given the absence of capital controls, the one effective instrument the

Bank could use to combat excessive rouble appreciation was FX intervention in the domestic market. And intervene it did – quite considerably – with FX reserves increasing from less than USD 40 billion in 2001 to over USD 400 billion in 2007.

Balance of payments structure, bln USD



Source: Bank of Russia

The problem was that the external (upward) pressure on the rouble was so high that the Bank of Russia's goal of exchange rate stability (and its operations aimed at achieving it) started to conflict with, and even dominate, its other goals and instruments of policy. FX purchases in the domestic market injected vast amounts of liquidity into the financial sector, but local financial markets were fragmented and not deep enough for the Bank of Russia to be able to sterilise these interventions via liquidity-absorbing operations. Large-scale FX purchases created a structural liquidity surplus in the local financial sector. Virtually the entire increase in the money supply during the pre-crisis period was due to FX interventions. The Bank's liquidity instruments were not used much, and the relationship between market interest rates and the rates on the Bank's instruments was vague at best.

This was a good example of the classic "impossible trinity" of the central bank: of three possible policy options – free international capital flows, a managed exchange rate and independent monetary policy – the central bank is able to achieve only two simultaneously.

In Russia's case, the measures aimed at achieving exchange rate stability (FX interventions), the volume of which was actually determined by external, uncontrolled factors (world oil prices, demand for risk in world financial markets), outweighed any other instrument the Bank of Russia had to control the money supply and the interest rate level. As a result, under the given policy mix, the Bank had fairly limited potential to use the interest rate channel of monetary policy to

influence the situation in local financial markets. The volume of liquidity and the price of money were determined to a much higher degree by external conditions than by the Bank's own operations.

And while the Bank of Russia was coping quite well with ensuring nominal exchange rate stability, the rapid growth in the money supply at least partially resulted in higher inflation rates. Persistently higher price growth in Russia than in its main trading partners led to rouble appreciation in real terms, gradually eroding the competitiveness of local producers.

However, the risks of such a situation were clearly visible, and the Bank of Russia moved steadily towards resolving them. The general course of action for the Bank, outlined in the Guidelines for the Single State Monetary Policy for 2004, was to shift gradually from a focus on exchange rate targeting to inflation targeting, to increase the role of interest rate instruments and to gradually move towards a freely floating exchange rate. Unfortunately, the world financial crisis in 2008 and the need to take emergency measures to mitigate its effect on the Russian economy forced a delay in this transition, but, on the other hand, it highlighted the drawbacks of the current monetary policy stance. After the crisis, work on the transition to inflation targeting was intensified.

During the post-crisis period, Russia's external conditions changed considerably. After a brief period of rapid growth, oil prices stabilised and have remained at approximately the same level since the second quarter of 2011. The rouble appreciated sharply in real terms, leading to faster growth in imports than in exports. The upward pressure on the rouble was gone, and automatic FX interventions were no longer the primary source of money growth. Better ways and better instruments of monetary policy were needed, and changes followed.

First of all, important changes were introduced to the mechanism of FX intervention, aimed at allowing for greater flexibility in the rouble exchange rate and reducing the amount of interventions needed to smooth excessive exchange rate volatility. Fixed bands for the rouble value of the dual-currency basket were abandoned in favour of the floating operational band, the boundaries of which are automatically adjusted depending on the amount of FX interventions. The current mechanism for smoothing exchange rate volatility allows purchases or sales of FX currency not only on the boundaries of the bands, but also inside the bands. The parameters of the Bank of Russia's FX operations in the domestic market are determined by taking into account the goal of smoothing exchange rate volatility. As a result, the rouble exchange rate is now determined to a much greater extent by market forces than it was during the pre-crisis period.

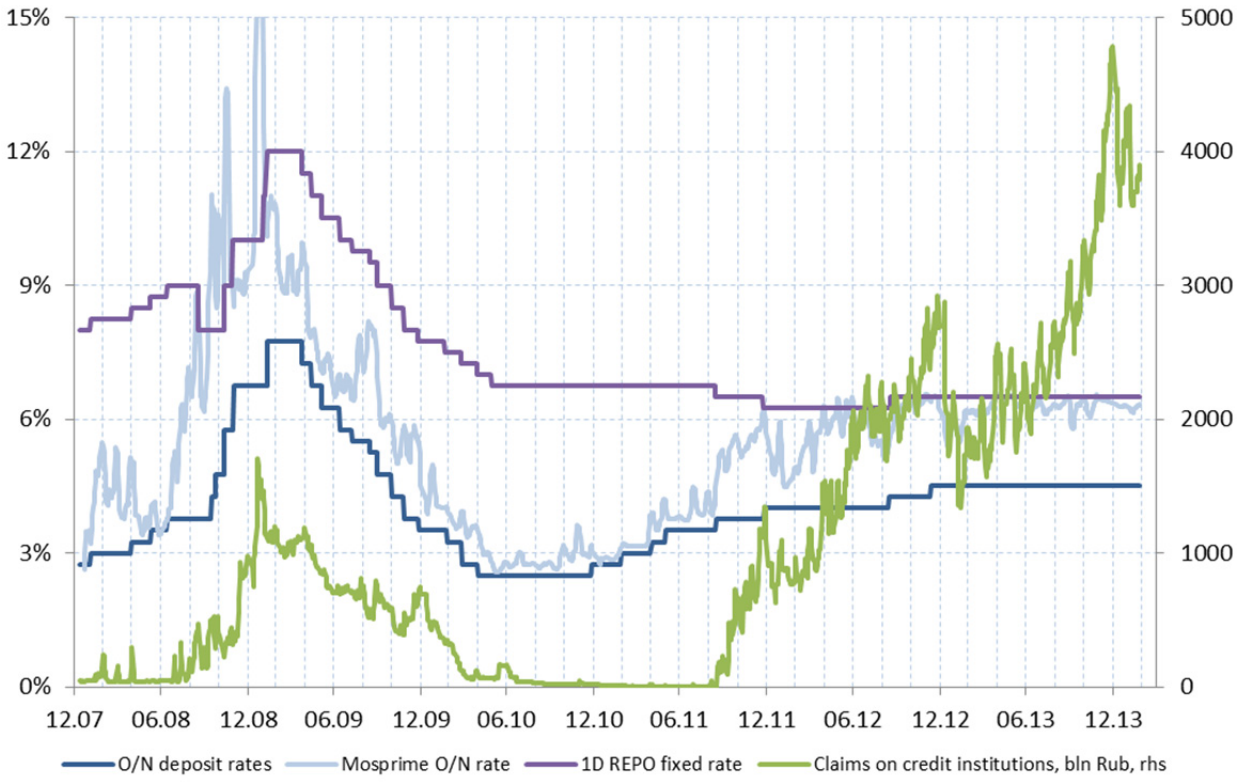
The instruments of interest rate policy were also modified significantly. In order to enable interest rate policy to be effective, credit organisations should be using the policy instruments frequently, and the rates on these instruments should influence market exchange rates. This was not exactly the case during the pre-crisis period, when commercial banks used the Bank of Russia's liquidity facilities mainly during brief periods with liquidity deficits. In order to increase the significance and volume of the liquidity management operations, the rates on the Bank of Russia's instruments were brought closer to market rates, and the gap between the rates on the liquidity-absorbing and liquidity-providing operations was narrowed.

By 2011, the structural liquidity surplus was gone, the commercial banks started using the Bank of Russia's liquidity facilities on a regular basis, and the rates and

volumes of the liquidity-providing/absorbing operations were having a direct effect on market conditions, making interest rate policy much more effective.

September 2013 saw the most recent changes to the Bank's system of monetary policy instruments. First, the Bank of Russia introduced its key rate – the interest rate on the Bank's one-week liquidity provision and absorption open market operations, including a maximum interest rate on one-week deposit auctions and a minimum interest rate on one-week repo auctions. Second, an interest rate band was established by setting rates on the standing liquidity-absorbing/providing facilities at 1% lower/higher than the key rate.

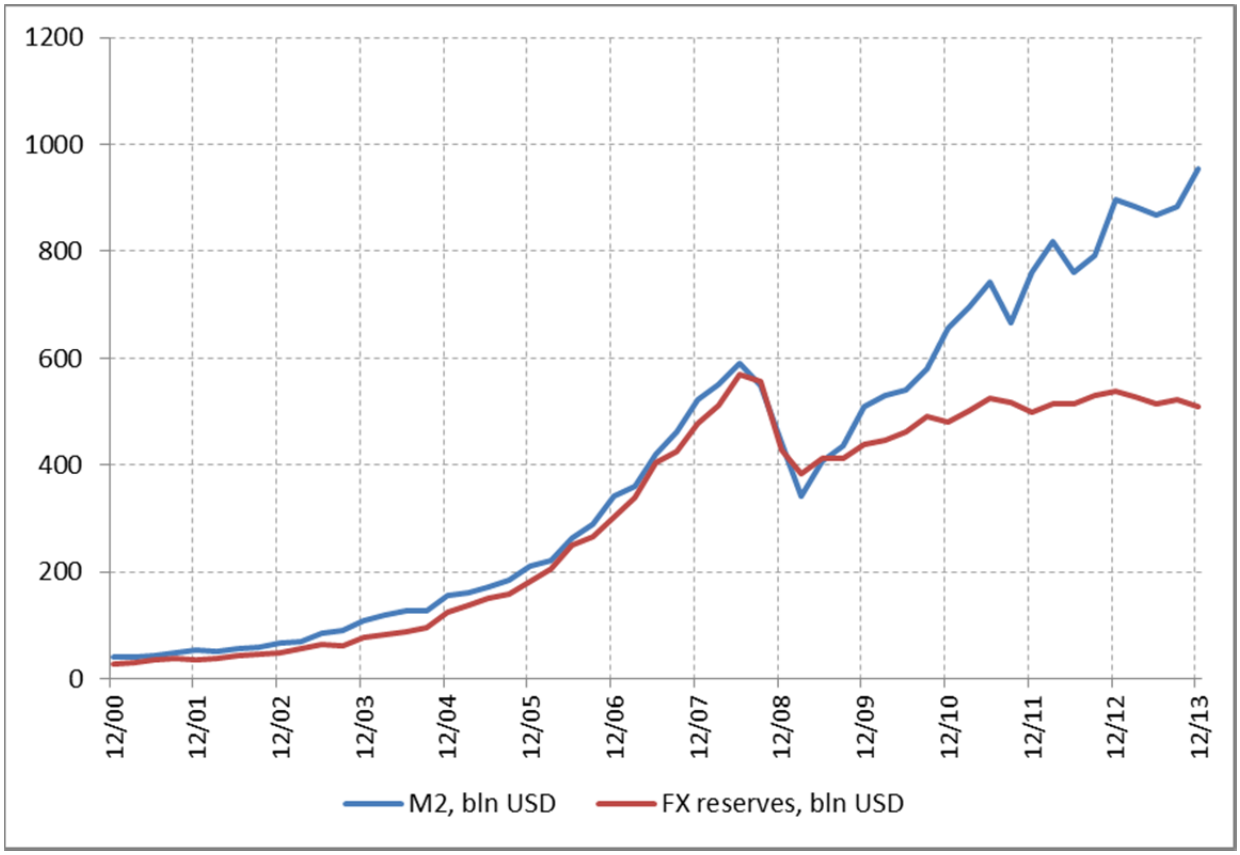
Interest rate instruments of the Bank of Russia



Source: Bank of Russia

To sum up, the Bank of Russia has modified its mix of policy instruments considerably in response to changes in macroeconomic and financial conditions during and after the world financial crisis. A transition was made from a policy that was primarily exchange-rate-stability-oriented, by which the money supply and interest rates were at least partially beyond the control of the Bank, to a policy by which the monetary aggregate dynamics are no longer tied to FX interventions by the central bank. The Bank of Russia now has much greater control of the money supply and interest rates via its interest rate policy instruments, while still maintaining the ability to smooth undesirable exchange rate fluctuations thanks to a more flexible FX intervention mechanism.

Money supply dynamics



Source: Bank of Russia