World Economic Situation and Prospects

Weekly Highlight

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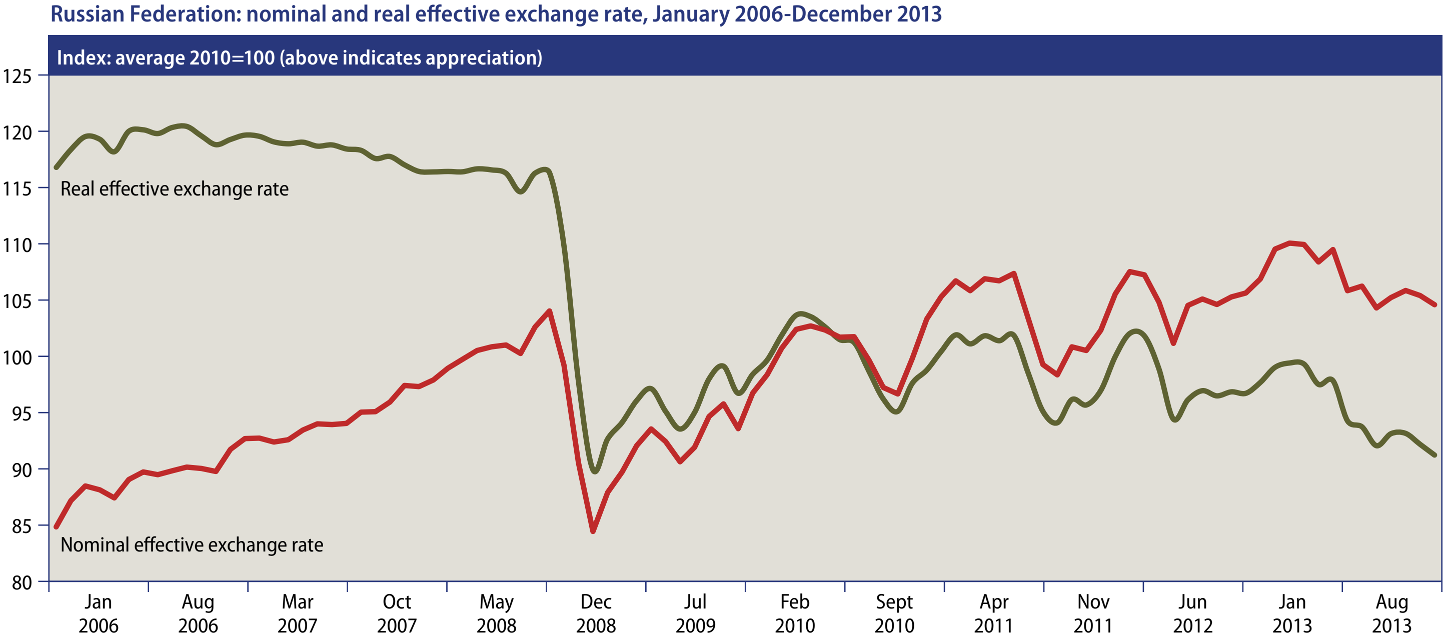
Shifting monetary policy priorities in the Russian Federation

For several years, monetary policy of the Central Bank of the Russian Federation (CBR), while declaring inflation control as a main goal, was based on targeting the exchange rate. In fact, the value of the rouble against a dual currency basket (comprised of the dollar and the euro) has acted as a target since 2005. However, the monetary policy started to modify its priorities and to increase flexibility in recent years. Prior to the financial crisis of 2008-2009, the country enjoyed a buoyant current-account surplus, and following the complete liberalization of its capital account, experienced a strong supply of foreign capital, which exerted an upward pressure on the exchange rate (figure 1). Concurrently, the CBR repeatedly used direct interventions into the currency market, which resulted in excess liquidity. However, the situation drastically changed in 2009 with the fall of commodity markets. The rouble lost about one third of its value and the CBR depleted a significant share of its foreign-exchange reserves. The monetary authorities then decided to widen the acceptable corridor of currency fluctuations in order to have more flexibility in their interest-rate policy, thus reducing the volatility of interest rates in the interbank market. The fixed band for the exchange rate versus the dual currency basket was subsequently replaced with a floating band in 2010. By the end of 2013, the CBR implemented a new technique incorporating the Federal Treasury's operations in the foreign-exchange market.

Looking ahead, the CBR is committed to making inflation targeting its primary objective from 2015 onward, in order to eventually bring annual inflation down to the range

Figure 1
Russian Federation: nominal and real effective exchange rate, January 2006-December 2013

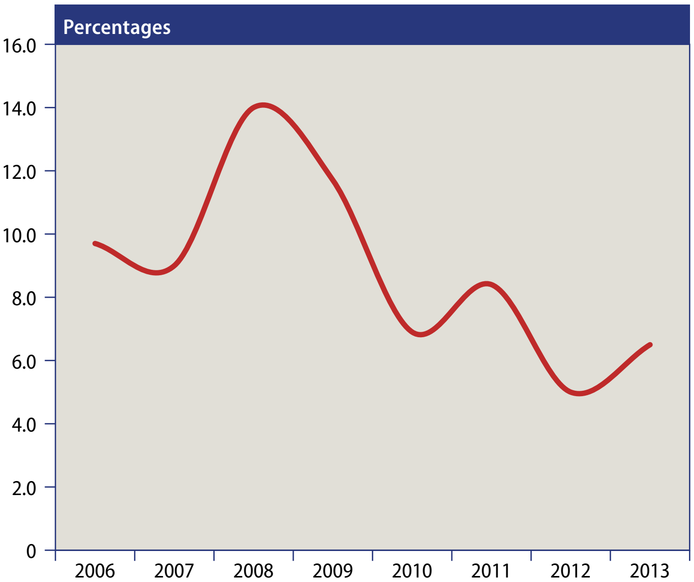


Source: Bank of International Settlements.

of 2-4 per cent. Like other emerging economies, the implementation of such a strategy will face a number of challenges, such as excessive dependence on the exports of raw materials (which would affect volatility of the exchange rate, with the consequent effect on inflation), underdeveloped financial markets, and insufficient influence of the central bank on money markets through its policy rates. To improve the system of the monetary policy instruments, in 2013 the CBR adopted several decisions aimed at strengthening the interest rate pass-through and improving liquidity management by the financial sector.

Most importantly, however, the monetary policy cannot simultaneously target the exchange rate and interest rate—which is becoming the main instrument to regulate inflation through money supply—under an open capital account. Therefore a gradual transition to a free float is a necessary prerequisite for efficient inflation targeting. In early 2014, the CBR reiterated its earlier commitment to move to a free float beginning in 2015, so that money supply will be regulated by conventional monetary policy instruments to combat inflation, which remained above the target of 5-6 percent in 2013 (figure 2). However, that coincided with the start of the tapering of the United States Federal Reserve's quantitative easing programme, which contributed to significant emerging market sell-off and currency volatility. The rouble plummeted to a several-year low against the dual basket, and the CBR had to intervene heavily (the volume of daily interventions in early 2014 in some cases exceeded $1.1 billion). Apparently, this experience prompted the CBR to announce that direct interventions into the currency market will not be abandoned completely even after eventual transition to a free float in early 2015. This may create additional challenges for monetary policy.

Figure 2
Russian Federation: annual inflation rate, 2006-2013



Source: UN/DESA, based on official data.