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Does inflation or currency depreciation drive monetary policy in Russia?

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Abstract

This paper analyses the persistence of inflation in post-communist Russia, with interest rate, exchange rate, and money supply as key arguments. The paper then derives a monetary policy feedback rule, which has been used to show empirically in the context of Russia that the official interest rate has reacted more to exchange rate changes than reacting to inflation, thereby keeping inflation as a persistent problem. This implies a need to have a 'flexible targeting rule' for inflation so as to bring it under control, which would make interest rate as a key monetary policy instrument for price stability.

JEL classification: C13; E43; E58; P24; P34

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1. Introduction

The Russian economy has experienced dramatic economic events since the dismantlement of the Soviet Union. Those events have led to periods of very high and volatile inflation rates followed by successive stabilizations. For such an interesting economic environment the question as to what determined the central bank's policy arises naturally.

The central bank of a matured economy can be expected to use interest rates to regulate the inflation rate. In early Russia, the absence of an effective monetary policy framework was due not

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only to the challenge of establishing new institutions and regulations, but especially also to the difficulty of overcoming the legacy of central planning where budget and credit financing were indistinguishable.[1] The role of the central bank was not well defined. During certain periods, the central bank acted as the banker of the government providing liquidity without consideration for the financial markets. During other periods, its action focussed on the financial markets to provide a restrictive monetary policy or to provide funds to a weak financial industry. In any of these cases one can expect a disconnection between inflation and interest rates.

Post-communist Russia's monetary policy has passed through two monetary regimes: a money based programme was used from July 1992 to June 1995 and September 1998 to the present (February 2005);[2] an exchange rate based stabilisation programme was used in the period from July 1995 to August 1998. Behind these variations in the policy regime lies a continuity in the tension between price and exchange rate stability. A common factor can be discerned underlying this tension. This factor is the authorities' use of macroeconomic policy as a direct instrument of social welfare provision. In the period through to the August 1998 crisis, this phenomenon took the form of a lack of fiscal adjustment, in turn generating heavy budget deficit financing requirements. The subsequent period has seen sustained budget surpluses (since 2000) due to fiscal discipline rather than to the strength of the oil price.[3] High world oil prices have widened the balance of payments surplus. The monetary authorities have been pulled between the goal of reducing inflation and the goal of restraining the real exchange rate appreciation resulting from the balance of payments surplus in order to shelter domestic employment from import competition. The Bank of Russia seems to have preferred slowing the real exchange rate appreciation rather than the rate of inflation, as a result inflation proxied by the consumer price index changes has stayed quite high reaching 11.7 percent in 2004 compared with 12 percent in 2003, exceeded a government target of 8 percent to 10 percent.

To remedy the conflict taking place between price stability and currency appreciation, this paper recommends a move to inflation targeting that may give more control over price stability to the Central Bank while reducing its interventions in the foreign exchange market.[4] Other economies in transition such as the Czech Republic, Poland and Hungary have adopted inflation targeting for reasons of joining the EMU.[5] Our contribution here is to analyze Russian inflation dynamics and monetary policy suggesting that adopting inflation targeting could help the Central Bank of Russia to reduce the tension between the exchange rate and the monetary policy.

The paper is organised as follows. In Section 2, we present the state of the monetary and exchange rate policies in Russia, with a model, deriving optimal interest rate rule in Section 3. The data, and the empirical results are presented in Section 4. The study of the time series behaviour and the search for a possible relation between interest rate, inflation rate, exchange rate and real money growth is expected to indicate what type of policy has been followed by the central bank. It has been found for Western type economies that inflation and interest rates are integrated processes.[6] Integrated processes have a long memory, meaning that any change to the current level of inflation will have a permanent effect. If series are integrated then tests for integration and

[1] See Granville (2003).
[2] Since February 1, 2005, the Bank of Russia is using a basket consisting of € 0.1 and $ 0.9.
[3] See OECD (2004), p. 7.
[4] See Bernanke et al. (1999) for a review on the pros and cons of inflation targeting.
[5] Orlowski (2000); Jonas and Mishkin (2003).
[6] Barsky (1987); Crowder and Hoffman (1996); Mishkin (1992); Evans and Lewis (1995).