THE MAIN AREAS OF MONETARY POLICY: PRICE STABILITY, RESISTANCE TO SHOCKS[1]

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The draft Guidelines for the Single State Monetary Policy (hereinafter – the Draft) prepared by the Bank of Russia does not involve significant changes in monetary policy in the upcoming mid-term period. Russian monetary authorities see their main task in maintaining price stability and improving financial sector resilience to possible macroeconomic shocks. The Bank of Russia does not give up the goal of reducing consumer inflation to 4% by the end of 2017, so the regulator plans to maintain a moderately tight monetary policy. There are no plans for active intervention in the foreign exchange market, and the exchange rate will remain floating.

The consistency of the monetary authorities is due to the fact that the actual macroeconomic dynamics generally corresponds to that predicted by the regulator when determining the target parameters of monetary policy. Foreign economic background has been relatively stable in the last year, and Russian economy has continued to adapt to the new levels of oil prices and the new level of the exchange rate.

The risk of emission lending

The Draft emphasizes that rapid economic development is impossible without changing the growth model from that oriented on raw materials to that oriented on investment. High prices for hydrocarbons was the factor leading to the increase in output in Russia in the 2000s. The growth was extensive in nature and not accompanied by diversification of the economy. The potential of this model is now exhausted, so steady growth is only possible if there are structural reforms, which, according to the Bank of Russia, should be focused on increasing productivity and management efficiency, renewal of fixed assets, development of infrastructure and creation of high-quality institutions.

The monetary authority considers its role in this process to be to create conditions for economic growth, which involves ensuring normal money circulation with predictable inflation, maintaining substantial margin of safety of the financial system which excludes the possibility of a large-scale financial crisis, and managing interest rates in order to stimulate people to have a sufficient level of savings.

The Bank of Russia is critical of the possibility of large-scale use of concessional lending as a mechanism to stimulate growth, but allows some limited use of such measures to support individual businesses and industries. Massive emission financing of the industry, according to the Central Bank, will only accelerate price growth, undermine economic and social stability, but will not be an effective instrument for production development due to the lack of effective mechanisms of selecting the most promising investment projects. At the same time, the regulator estimates the

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total debt burden in the corporate sector as high, so further expansion of lending will lead to increasing imbalances and create the risk of bad debt crisis.

Also, the Bank of Russia is negative about the idea of returning to active monetary policy since they assume that free market pricing makes the exchange rate more responsive to external conditions, which helps the economy to adapt smoother to the changing environment. Exchange rate fluctuations may be significant, which would have a negative impact on macroeconomic processes, but as low diversification of the Russian economy and the dominance of raw materials in the structure of exports are fundamental causes of these fluctuations, monetary policy measures alone can not solve the problem of exchange rate volatility.

The Bank of Russia's viewpoint set forth in the Draft seems to us reasonable and justified. The strategic choice made by the Russian Central Bank when it decided for inflation targeting and switching to the regime of floating exchange rate has a solid scientific foundation and corresponds to the best international practices of monetary policy. The monetary regime chosen by the Bank of Russia can help manage the problems that can be solved with measures of monetary policy, while it does not involve attempts to influence the macroeconomic parameters which the Central Bank cannot effectively influence in the long term. These parameters include the potential level of output, rate of monetization of the economy, real exchange rate and real lending rate.

One can agree with the Bank of Russia's position that massive lending to industry by the Central Bank is undesirable. Moreover, soft lending, as well as other industrial policy measures, in our opinion, are not intrinsically related to monetary policy. If the government finds it necessary to actively give loans to selected sectors at lower rates, it would be right to use financial resources of the budget for these purposes. Those resources would be distributed through the corresponding development institutions. In this case, the costs and risks associated with non-profit lending will explicitly be on the budget reflecting the real cost of this policy and providing incentives for more efficient allocation of resources. At the same time, in case of emission lending by the Central Bank, the costs and risks will be on the entire economy as inflation tax burden.

Factors of macroeconomic dynamics

The Bank of Russia determines internal and external factors that will play a decisive role in mid-term macroeconomic dynamics. Among them, there are hydrocarbons market conditions, economy growth rate in Russia's partner countries, monetary policy in major economies (primarily the USA), and Russian government's fiscal policy. The Russian Central Bank is considering three scenarios, from oil prices dropping to $25 per barrel to their growth up to $50. Presumably, the fiscal policy in all scenarios will follow the approved conservative course. The proposed scenarios appear to be reasonable, but the Draft does not provide detailed commentary on the Central Bank's actions in case the actual policy of the Russian Ministry of Finance will be softer than planned. This course of events cannot be excluded, so it would be interesting to have a more detailed discussion on the measures that could be taken by the Central Bank in such case.

Interest rates

The policy of high real interest rates deserves a special comment. The aim to achieve price growth of 4% by the end of 2017 is very ambitious given the inertia of Russian inflation. In order to realize these intentions and anchor inflation expectations of economic agents, the Bank of Russia conducts conservative interest rate policy. Over the past year, the key interest rate was reduced by only 1 p.p. while the inflation rate over the same period fell by nearly 9 p.p., and this, considering the simultaneous reducing of the expected inflation, means a significant increase of the real interest rate and tightening of monetary policy. Maintaining the positive value of real interest rate of the money market helps to curb the rise in prices by increasing the attractiveness of savings and thus helps to achieve the inflation target of 4% by the end of 2017. At the same time, it carries downside risks to economic activity. The main areas of last year's monetary policy were accompanied by commentary on recession risks; in the new Draft, these risks are not discussed. In our opinion, the document lacks the estimates of the probability of growing real interest rates' possible negative impact on economic growth.

Information policy and market expectations

The effectiveness of the regulator's information policy which implies influence on economic agents' expectations could be higher, in our opinion. It is the rate of inflation, when it's targeted, that is the most important factor of the effectiveness of monetary authorities' influence on the dynamics of prices and output through the expectations channel. To date, according to the Draft, economic agents expect that inflation will be higher than the one expected by the Russian Central Bank, and the key interest rate will be lower, respectively.

This mismatch between the market's expectations and the regulator's plans poses a threat of recession. If the Bank of Russia continues to follow the chosen course, the monetary policy will be tighter than expected by economic agents, which will be followed by a reduction in investment, a fall in aggregate demand, and the economic downturn. If the monetary authorities give up the target goals and adapt to current expectations by lowering the rate, economic agents will take it as an additional reason not to trust the regulator's declarations about achieving inflation target goals. The consequence of this would be increased inflation due to the background of high inflation expectations.

Thus, the mismatch between the Bank of Russia' plans and market players' expectations can have adverse effects either as a recession or as a loss of the regulator's reputation.

Although monetary authorities see the discrepancy between market expectations and their own intentions, they do not acknowledge the lack of efficiency of their information policy. In fact, economic agents' lack of trust in the Bank of Russia' claims is a significant limitation to the effectiveness of its policies, so the monetary authorities should pay special attention to this problem. In our opinion, the reason for limited trust in the Bank of Russia's declarations is not so much a lack of transparency of the interest rate policy, but rather the lack of provided information and outreach. Besides that, economic agents' trust in the Bank of Russia is strongly negatively impacted by the fact that the Bank of Russia has historically almost never reached the stated inflation targets.

In general, the monetary authorities' policy described in the Project is quite reasonable and justified from both the theoretical and practical points of view. The clear orientation of the monetary policy on achieving only the goals that can in principle be achieved with monetary measures seems right. The overly optimistic plan to reduce price increase to the target level by the end of 2017 causes some doubts, but after the Central Bank publicly announced this intention, giving it up for a softer policy will lead to a loss of trust in the Bank of Russia. At the same time, economic agents' expectations regarding the interest rate policy differ markedly from the monetary authorities' plans, and the Bank of Russia has not yet succeeded in winning their full confidence in its policy.