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Prospects for a Transition Towards Inflation Targeting in Russia[1]

1. Reasons for adopting inflation targeting.

For a number of years, the authorities of the Russian Federation pursued a policy of controlling inflation whilst at the same time trying to avoid too rapid an appreciation of the ruble. This policy changed somewhat in the second half 2006, after the final liberalization of foreign exchange controls. The Central Bank of Russia then abandoned its support of the ruble. In a document entitled “Monetary Policy Guidelines for 2007”, the CBR for the first time proclaimed that its principal objective was the struggle against inflation, which reached 6.5-8% at the end of 2007. As a guideline for the real ruble exchange rate, this document proposed a variation of between 0 and 10%. All of this indicated that the CBR was gradually moving towards a policy of inflation targeting - a policy whereby control over the parameters of inflation is the principal goal of monetary policy.

A key lesson learned during the late twentieth century from the application of fixed exchange rates was that in conditions of high capital mobility, this policy is incapable of ensuring stability in the monetary and foreign exchange markets[2]. Artificially high exchange rates, a lack of confidence on the part of economic agents in the government’s monetary and fiscal policies and an increase in the volume of foreign debt increased the probability of speculative attacks against national currencies and the development of financial crises in those countries that applied fixed exchange rates (it was, incidentally, adherence to a fixed exchange rate in conditions of huge capital outflows that was one of the principal reasons for the crisis of 1998 in Russia). This is why, in proportion as national financial markets become increasingly open, their vulnerability to shocks, if they are adhering to a fixed exchange rate, increases. By the same token, the use of a floating exchange rates has become more

[1] The original version of this paper was published in “Voprosy ekonomiki”, 2008, № 1. The present version was extended and edited, to take into account new statistical data.

[2] Obstfeld M., Rogoff K. (1995). The mirage of fixed exchange rates // Journal of Economic Perspectives 9. P. 73–96.

widespread and has resulted in greater stability and, consequently, in an acceleration of economic growth.

Inflation targeting publicly setting targets for inflation over a certain period and declaring price stability to be a long-term objective of monetary policy. Other objectives, such as employment or relative stability of the exchange rate may be factored in, but only as secondary objectives. If the authorities adhere strictly to the set goals and succeed in attaining them, the policy of inflation makes for a lowering of expectations of inflation.

Inflation targeting is a relatively new régime in monetary policy but it is widely applied. New Zealand was first to announce transition to direct inflation targeting in the 1990s and was followed by Canada, the UK, Sweden, Finland, Australia, Spain, Israel, the Czech Republic and Chile. Originally, only developed economies implemented this policy, while practically all developing economies adhered to a policy of fixed exchange rates. But by the late-1990s developing and transitional economies had also gone over to this régime. As of early 2007, as many as 23 countries were applying inflation targeting, of which only 7 were developed economies.

It is anticipated that in the years to come the number of countries employing inflation targeting will increase. An IMF survey of 2006 of representatives of the monetary authorities of 88 developing and transitional economies[3] showed that over half of them would most probably switch to inflation targeting in the near future, whilst almost three-quarters of them planned to do so by 2010.

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[3] Batini N., Breuer P., Kochhar K., Roger S. (2006). Inflation Targeting and the IMF. Prepared by Monetary and Financial Systems Department, Policy and Development Review Department, and Research Department.

2. Inflation targeting and the institutional environment

Until recently, the view prevailed in the economic literature that inflation targeting depended more for its success on the quality of the institutional and macroeconomic environment than did other monetary policy régimes. The fairly strict conditions that were deemed to be a precondition of inflation targeting made for caution in developing and transitional economies regarding any possible transition to this new monetary policy. The issues in question have been outlined in detail in the work of by Eichengreen et al.[4] who have argued that in the absence of essential technical skills and of genuine independence of the central bank, here is no point in going over to inflation targeting. They even recommend that any developing countries that had already adopted the new policy should return to their former monetary policy.

Now that many countries have reported positive outcomes of their transition to the new régime, a more neutral point of view has found expression in the literature. For example, Carare et al.[5] argue that there are no absolutely strict conditions governing the introduction of inflation targeting: the non-fulfillment of a number of conditions need not be an obstacle to transition. Truman[6] has also concluded that most of the conditions usually cited as being essential for a successful implementation of inflation targeting, in the event turn to be desirable, rather than necessary conditions.

It is worth noting that the majority of these conditions are relevant not only to a policy of inflation targeting, but to any monetary policy. What is more, practice shows that applying strict technical conditions may turn out to be less important than a steady improvement of these conditions following the transition to inflation targeting. Let us consider the conditions

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4 Eichengreen B., Masson P., Savastano M., Sharma S. (1999). Transition Strategies and Nominal Anchors on the Road to Greater Exchange-Rate Flexibility //Essays in International Finance. Vol. 213. (Princeton, New Jersey: International Finance Section, Department of Economics, Princeton University).

5 Carare A., Schaechter A., Stone M. and Zelmer M. (2002). Establishing Initial Conditions in Support of Inflation Targeting. IMF Working Paper 02/102. Washington, IMF.

6 Truman E.M. (2003). Inflation Targeting in the World Economy. Institute for International Economics, Washington.

in question[7] and analyze the degree to which they are present in the Russian Federation. (See *Table 1*)

- Institutional independence: the central bank should enjoy legal autonomy and be under no pressure from government that might lead to conflict over the bank's inflation target;

- Highly qualified analysts and reliable statistics: if inflation targeting is to be implemented, the central bank should be capable of producing credible forecasts;

- Requirements regarding the structure of the economy: successful implementation of inflation targeting requires that prices should be free, that the economy should not be over dependent upon raw materials and that fluctuations of the exchange rate and that dollarization of the economy should be minimal;

- A developed financial system: stability of the financial system during the period of introduction of inflation targeting, and efficient functioning of the transmission mechanisms of monetary policy, require a stable banking system and developed financial markets.

[7] These conditions have been derived from a series of questionnaires submitted by IMF experts to the heads of a number of national central banks.

Table 1

The extent to which conditions deemed desirable for the introduction of inflation targeting are met in the Russian Federation

Condition	RF	Comments
Institutional independence of monetary regulatory bodies	Partially	CBR enjoys autonomy, but regularly finds itself under pressure from both the executive and legislative branches of government
Highly qualified analysts and trustworthy statistics	Partially	The CBR experts are sufficiently qualified to be able to produce fairly reliable inflation forecasts;[8] however not all of the reliable statistics that are required for forecasting are at present available.
Structure of the economy	Does not meet condition	The economy of the RF is highly dependent upon raw material prices; many prices *de-facto* are not free; dollarization of the economy, though diminishing, is still high,.
Mature financial system	Partially	The financial system is developing rapidly, but when compared with the financial systems of other transitional economies, it is still not large and it is subjet to considerable risks.

It is clear that Russia does not yet fully meet any of the conditions. But it is evident that all of the conditions in question are important in any monetary policy régime, and some of them are even more important in régimes that do not target inflation. For example, the independence of the Central Bank vis-à-vis the fiscal authorities and in relation to budgetary and fiscal policy would appear to be more crucial in a fixed exchange rate régime than in a régime of inflation targeting. At the same time, some conditions that are more important under inflation targeting, for example, reliable statistics describing the principal macroeconomic indicators.

Having said this, it is worth noting that any improvement in the condition of institutions in countries that introduce inflation targeting usually comes about after transition rather than

[8] It should be noted that over recent years the inflation forecasts of the CBR were repeatedly lower than actual inflation rates. We believe this phenomenon to be attributable to political factors, given the great social and economic significance of this indicator, rather than to any inadequacy of the staff of the CBR.

before. None of the countries that completed the transition to inflation targeting complied with the above conditions at of the moment of the transition, but came closer to compliance following implementation.

Batini and Laxton[9] have argued that there are no strict prerequisites of a successful transition to inflation targeting. This does not mean, of course, that conditions at the outset are irrelevant – the record shows that the more favourable the conditions at the outset, the better the subsequent macroeconomic performance. However, under an entire range of starting conditions, those developing and transitional economies that have embarked upon the transition to inflation targeting have achieved a dynamic economic growth than those that did not.

3. Results of transition to inflation targeting in developed and developing countries

It should be noted that the subsequent performance of developed economies that implemented inflation targeting was superior to the subsequent performance of developing and transitional economies. Most often this is attributed to the fact that developing economies more frequently failed to achieve their inflation targets than developed ones. For example, Roger and Stone[10] assert that developing and transitional economies did not achieve their targets in 50% of cases, whereas only 33% of developed economies failed to do so (see *Table 2*). However, there were substantial differences in the conditions of policy implementation in the two groups. The results for the most part display two trends. The first is that, having gone over to the new monetary policy, developing and transitional economies, as a rule, aimed for a significant lowering of the rate of inflation. The second is that a high volatility of inflation and, accordingly, more frequent failures to attain preset targets, are characteristic, above all, of countries that aspire to a significant reduction of inflation, and not of those ones that from to year announce slightly modified targets.

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[9] Batini N., Laxton D. (2005). Under What Conditions Can Inflation Targeting Be Adopted? The Experience of Emerging Markets. Paper prepared for the Ninth Annual Conference of the Central Bank of Chile «Monetary Policy Under Inflation Targeting». Santiago, Chile. October 20 and 21, 2005.

[10] Roger S., Stone M. (2005). On Target: The International Experience with Achieving Inflation Targets. IMF Working Paper 05/163. Washington, IMF.

Table 2

Attainment of inflation targets by countries employing inflation targeting

Categories	**Number of countries in category**	**Average deviation of actual inflation rate from target (p.p.)**	**Frequency of failure to meet the inflation target (%)**	**Period during which the actual inflation rate deviated from the target (in months)**
All countries	22	0.1	43.5	17.3
Developed economies	11	– 0.2	34.8	15.5
Developing and transitional economies	11	0.3	52.2	19.1
Countries where inflation significantly decreased upon transition to inflation targeting, including	14	0.4	59.7	16.3
Developed economies	5	– 0.1	52.1	17.6
Developing and transitional economies	9	0.7	63.9	15.5
Countries with a stable inflation upon transition to inflation targeting, including	17	– 0.4	32.2	15.1
Developed economies	11	– 0.3	28.6	13.9
Developing and transitional economies	6	– 0.6	39	17.3

Source: Roger and Stone (2005).

The experience of countries that have gone over to inflation targeting also demonstrates that poor starting conditions can be improved over a fairly short period of time. For example, according to Roger and Stone, the volatility of inflation in those countries where inflation has diminished following introduction of inflation targeting is reduced twofold in the three years that follow adoption of the new policy

Generally speaking, the fact that macroeconomic indicators significantly improve as soon as an inflation targeting régime is introduced, even if the initial conditions were not particularly favorable, indicates that the belief of economic agents that the central bank will strive to achieve the set inflation target is of a great significance. According to Sherwin[11] political support for the transition to inflation targeting is crucial to the success of the policy.

It should also be noted that many countries that intend to introduce inflation targeting enjoy better macroeconomic conditions than some countries that have already made the transition. As a rule, candidates for the introduction of inflation targeting have more moderate rates of inflation, smaller budget deficits and faster economic growth. There are, therefore, grounds for assuming that such countries would derive even greater benefit from inflation targeting than the countries that acted earlier.

4. Political conditions favoring transition to Inflation targeting

Let us enumerate the conditions in which transition to inflation targeting is undesirable[12] and ask to what degree these conditions are present in Russia (see *Table 3*).

- In some small economies with low per capita GDP, the ability of the central bank to pursue a monetary policy and the independence of the financial system are so limited that effective implementation of inflation targeting is practically impossible.
- In a number of small open economies, wages and prices are almost entirely determined by foreign prices and by the exchange rate. In such cases, inflation targeting would have no advantage over fixed exchange rates.

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[11] Sherwin M. (2000). Institutional Frameworks for Inflation Targeting? Reserve Bank of New Zealand Bulletin. Vol. 63.

[12] See: Laurens B. (2005). Monetary Policy Implementation at Different Stages of Market Development. IMF Occasional Paper № 244. Washington, IMF.

- Up to the present, practically no country has introduced inflation targeting in conditions of double-digit inflation. Notwithstanding the fact that even under such circumstances the setting of an inflation target can have the effect of reducing inflationary expectations, the central bank risks suffering a considerable blow to its reputation, since, in all probability, targets will not be met. Furthermore, should the targets not be met several times in succession, expectations of inflation may return.

- Transition to inflation targeting may be undesirable if the government in question does not support the policy. Moreover, effective implementation of the policy is impossible without a balanced budgetary and fiscal policy.

- Inflation targeting should be introduced in circumstances where the leadership of the central bank is prepared to adhere strictly to the targets and objectives it sets. Inflation targeting is a flexible instrument of monetary policy, but if it is to be effectively implemented economic agents must have complete confidence in the policy and in the declarations of the leadership of the central bank.

Table 3

Existence of pre-conditions of inflation targeting in the RF

Condition	RF	Comments
A relatively large economy	Present	The Russian economy is advancing steadily and GDP is relatively high
Prices are determined within the country	Absent	The Russian economy is to a significant degree dependent upon foreign trade foreign. World energy prices exert a significant influence on the dynamic of money supply,
Inflation rates below 10%	Absent	Only in 2006 was the annual CPI below 10%, after which it began to rise above this level
Government agencies support a transition to inflation targeting	Present	The suppression of inflation is currently a government priority and inflation targeting is the best means of achieving this goal
Monetary regulatory bodies adhere strictly adhere to targets set	Partially present	Representatives of the CB repeatedly declare that targets will remain unchanged, but these targets are not always achieved.

At a time, therefore when inflation targeting is acquiring increasing support within the Russian government, the Russian economy can be said to display, for the most part, the conditions necessary for introduction of this policy. The economic crisis that the country experienced, whilst it accelerated inflation, at the same time, enhanced the importance of the interest rate policy of the Bank of Russia. This, in turn facilitated transition to inflation targeting. Therefore, in the medium term, given the necessary political will, the introduction of inflation targeting is feasible.

5. Aspects of the transition to inflation targeting in developing economies

There are countries where a transition to the inflation targeting seems inappropriate, but inflation targeting is a very flexible instrument of monetary policy and it can easily be adapted to take account of specific circumstances. As a rule, developing economies and transitional economies encounter economic problems that differ from those faced by developed economies. Calvo and Mishkin[13] have identified five particularly important challenges that, typically, are encountered by developing countries[14]:

- low-quality financial management in the public sector;
- a weak financial sector and underdeveloped financial market institutions;
- a low level of confidence on the part of economic agents in the government authorities that are responsible for monetary policy;
- a significant degree of dollarization of the economy;
- a high vulnerability of the economy to international capital flows.

Additionally, in developing economies there is considerable confusion in the functioning of the mechanisms of delivery of monetary policy.

[13] Calvo, G.A. and Mishkin, F. (2003). The Mirage of Exchange Rate Régimes for Emerging Market Countries. NBER Working paper 9808.

[14] See also: Fraga A., Goldfajn I., Minella A. (2003). Inflation Targeting in Emerging Market Economies. NBER Working Paper № 10019. Cambridge, Massachusetts, NBER.

Improvement of the quality of management of public finances is a necessary pre-condition for building up the confidence of the population in the monetary policy of the central bank. At the same time, a transition to inflation targeting can in itself contribute to the introduction of a more rigorous monetary policy. This can apply in cases where a significant budget deficit systematically jeopardizes the attainment inflation targets.

Where inflation targeting is to be introduced, any weakness of financial institutions must be taken into account. As the work of Laurens and others shows, such weakness affects the operational efficiency of the mechanisms for delivery of monetary policy. Underdeveloped financial markets can also adversely affect the effectiveness of market instruments of monetary policy. This said, it should be remembered that the ability of the central bank to influence market interest rates is of crucial importance in the introduction of inflation targeting. If inflation targeting is to be introduced, special measures must be taken to enhance the sustainability and development of the financial system.

The problem of lack of confidence in the actions of the monetary authorities on the part of economic agents in developing and transitional economies is a serious one, given that the successful implementation of inflation targeting in many ways depends upon inflationary expectations. If inflation targets are not achieved, expectations of inflation may be grow, rather than diminish. However, during the first stage of the transition to inflation targeting there are a number of steps that monetary regulators can take to increase the probability of targets being attained. Such steps include the selection of an appropriate inflation target in one range or another; and the fixing of a range of permissible fluctuations of the actual inflation rate around the target.

A significant degree of dollarization of an economy will also impede successful transition to inflation targeting, since it can exert a strong influence on the mechanisms of delivery of monetary policy. For example, a high degree of dollarization enhances the importance of exchange rates relative to domestic interest rates; the central bank is inclined to devote greater attention to the balance of payments than to inflation. At the same time, the degree of dollarization tends to be a function of the pre-existing monetary policy and inflation targeting by itself is capable of reducing, over time, the degree of dollarization.

Finally, a successful transition to inflation targeting can be impeded by the absence of reliable statistics, and this is an area of weakness in the majority of developing countries. Where statistics are unreliable, the implementation of inflation targeting is problematical and there is greater volatility of inflation than would otherwise be the case.

6. Inflation targeting and the exchange rate

During the transition to inflation targeting, some countries have to cope with significant incoming and outgoing capital flows. In a number of countries monetary regulators have attempted to combine inflation targeting and the setting of exchange rates within a fixed corridor. But in almost all of these countries, including Chile, Israel, Poland, and Hungary, a conflict arose between the need to achieve the inflation target and management of the exchange rate. This led to a broadening of the corridor for permissible exchange rate fluctuations and, ultimately, to an abandonment of the corridor. In general, an actual transition to inflation targeting was fully achieved only after other monetary policy targets had been abandoned.

It is worth noting that countries can opt for a gradual transition from fixed exchange rates to inflation targeting. An intermediary monetary policy of this kind involves a managed, floating exchange rate and an informal inflation target. Such a policy can make sense, in that it gives a government time to prepare the principal components of comprehensive inflation targeting. But there comes a point when the monetary regulators have to abandon unequivocally the exchange rate target in favor of the inflation target, since only thus can the advantages of inflation targeting be obtained.

Under inflation targeting, the exchange rate policy should not be overly pro-active. Too strict a control of the exchange rate can destabilize other instruments of monetary policy, the real exchange rate, and make for instability in the real sector of the economy. Over rigid control over the exchange rate can redirect the concerns of the population away from inflation towards the exchange rate. There also is a risk that economic agents will misinterpret abrupt fluctuations in the exchange rate and subsequent adjustments.[15] This can have an adverse effect on economic performance. Even so, some degree of regulation of the exchange rate by the monetary authorities is necessary. The degree to which the central bank influences the dynamic of the exchange rate should correspond to the degree of openness of the economy.

In the expert community there is no consensus as to the permissibility of active interventions by the central bank in the foreign exchange market for the purposes of maintaining the exchange rate stability. Caballero and Krishnamurthy[16] are in favour of limiting of such interventions, on the grounds that this can increase an economy's susceptibility to fluctuations of capital flows. Disyatat and Galati[17] argue that the experience of foreign exchange interventions points to a greater efficiency of interventions in developing than in developed economies. However, such interventions exert a significant influence on the exchange rate only in the short run.

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[15] Thus, a depreciation of the nominal exchange rate may be driven by portfolio decisions, which means it would result in a future increase in inflation. This is why monetary regulators are obliged to raise interest rates in response to an abrupt change in the exchange rate. At the same time, the depreciation of a given currency may be the consequence of a negative shift in the terms of trade that reduces demand for exports. Such a shift entails a fall in aggregate demand and would probably be accompanied by a decline in the increase in prices. It is for this reason that a reduction in interest rates is required.

[16] Caballero R., Krishnamurthy A. (2003). Inflation Targeting and Sudden Stops. In Bernarke B., Woodford M. (2003), pp. 423–442.

[17] Disyatat P., Galati G. (2005). The Effectiveness of Foreign Exchange Intervention in Emerging Markets: Evidence from Czech Koruna. BIS Working Paper 172. Basel, Bank for International Settlements.

Holub[18] proposes two simple rules, observance of which would make it possible to combine exchange rate intervention and inflation targeting:

- interest rates should be adjusted solely in response to changes in the rate of inflation;
- foreign exchange interventions should be used only as an auxiliary instrument of monetary policy.

Observance of these rules would make it possible to reduce the frequency of foreign exchange interventions and to employ them for the purpose of limiting fluctuations of the exchange rate.

7. Prospects for a transition to inflation targeting in Russia

As the experience of countries that employ inflation targeting shows, its use results in an improvement in macroeconomic performance. However, some countries, notably China, have been reluctant to adopt this policy, deeming it to be inconsistent with aspects of their economic strategy. By maintaining an artificially low exchange rate for the Rmb, the Chinese government has been able to achieve export-oriented growth. Recently, however, as alternative sources of growth have emerged and domestic consumption has increased, the Chinese authorities have hinted at the possibility of abandoning their rigidly fixed exchange rate.

In the case of Russia, the principal obstacle is dependence upon raw materials. When raw material prices increase, the strengthening of the ruble has an adverse effect on the export of non-raw material exports, given the increase in costs. In these circumstances, the ability of the CBR to counteract the appreciation of the ruble is limited, since it also has the task of ensuring price stability, and maintaining the exchange rate at a constant level would results in an increase in the money supply and an increase in inflation. On the other hand, producers for the domestic market can benefit from an appreciation of the ruble, since this brings down the cost of imported equipment and machinery. Finally, the Reserve fund and the National Welfare Fund can be very effective in absorbing any excess liquidity generated by a surplus

[18] Holub T. (2004). Foreign Exchange Intervention under Inflation Targeting: The Czech Experience. Czech National Bank Internal Research and Policy Note.

on the current account. All things considered, the special features of the Russian economy do not present insurmountable obstacles to a transition to inflation targeting. Experience shows that it is possible for economies that are highly dependent on the prices of mineral exports successfully to implement inflation targeting. Chile, Mexico, and Norway are examples.

That the CBR does not possess effective means of acting upon inflation poses a far more serious challenge. At present, the Bank of Russia responds to inflation primarily by adjusting the money supply by buying and selling foreign currency. But this method cannot be applied under inflation targeting, since it depends to a considerable extent upon conditions in the foreign exchange markets. If inflation targeting is to be administered effectively, the CBR must have the power to influence the money markets by adjusting interest rates. This power can be acquired by developing the market for bonds of the Bank of Russia. The interest rate policy of the CBR will also become more significant as refinancing instruments of the CBR become more attractive to credit organizations.

In Russia, the pre-conditions for a successful transition to inflation targeting are beginning to emerge. The economy remains highly dependent upon the external economic conjuncture, but the financial crisis made for a steep increase in the demand of commercial banks for refinancing by the CBR. This has given the Bank of Russia the power to exercise real influence in the monetary sphere by the management of its interest rate. The CBR has persisted with its policy of gradual transition to a floating exchange rate for the ruble. Furthermore, if, as it appears, the time of extremely high energy prices has passed, this also strengthens the role of the CBR as a lender of last resort and source of liquidity in the economy. Whilst, in view of the problems described above, an official announcement by the CBR of transition to inflation targeting is unlikely in the near future, a gradual shift of emphasis in its policy from exchange-rate targeting to inflation targeting would be entirely justified. In the longer term, transition to inflation targeting will be a priority.