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New Monetary Policy Challenges

The global economy remains volatile and highly uncertain. Regrettably, regulators in developed countries have only achieved short-term positive results in their attempts to address profound challenges posed by global developments. The underlying problems and contradictions of the global economic and financial system are still unresolved.

The world economic recovery has been slow and difficult in the post-crisis period. The IMF predicts that the global output growth is likely to slow down in the fourth quarter of 2012 to 3.0% from the actual growth of 3.8% in 2011. Advanced economies are projected to grow only by 1.1%, with a 0.5% drop expected in the euro area. Growth rates of emerging and developing economies are also sliding down and are expected at 5.3% in 2012 as compared to 6.2% a year earlier.

The aggregate deficit of developed countries is expected to come down from 7.6% of GDP in 2010 to 5.6% of GDP in 2012, which nonetheless exceeds the pre-crisis level by a factor of almost five. In the meantime, unemployment sustains its high level of about 8%. The totality of these factors suggests a weak consumer demand; therefore, government budgets inflated by big deficits are the key drivers of economic activity in developed countries. Deep indebtedness of certain countries in the euro area has necessitated ever greater sacrifices from other countries, while financial markets have been sending recurrent signals that in addition to Greek, Irish and Portuguese debts they may also “recall” those of Spain and Italy. Recent efforts have been focused on creating a pan-European banking regulator, which is not a bad thing in and of itself. But it is unlikely to be able to stem economic slowdown in the euro area.

Against the backdrop of European problems, the US “fiscal cliff” is looming large. The US economy, unlike Europe, has enjoyed relative stability in recent years. In many ways, this was achieved due to a temporary easing of fiscal policy by reducing the tax burden and boosting public debt. The tax breaks are to expire in early 2013 along with incoming plans to reduce US government spending, which combined together are to bring down the federal budget deficit by 3.5 percentage points of GDP. Such a sharp decline is bound to slow down economic growth, which, according to the US Congressional Budget Office, could cause a recession of 0.5% as early as in 2013.

All these factors create a highly uncertain environment in which the Russian economy will have to function in the near future. So it is clear that probability of adverse external developments is not diminishing, thus leaving the Bank of Russia with a difficult trade-off between the necessity to improve the safety margin and to provide incentives for economic activity. In this context, the Bank of Russia intends to maintain the continuity of its monetary policy principles, and to complete the migration to inflation targeting by 2015.

In this setting, the monetary policy priority is to keep price growth stable and low. Inflation control measures will contribute to the achievement of broader economic objectives. A controlled and low inflation rate will diminish price uncertainty in the economy, which will boost overall investment and economic activity. Ultimately, this is a necessary (though not sufficient) condition for a sustainable and balanced economic growth, and financial stability. The implementation of the Bank of Russia’s monetary policy involves target-setting for the consumer price index movements. The overriding objective of this policy is to bring the consumer price growth down to 5-6% in 2013 and to 4-5% in 2014 and 2015.

The inflation rate started to slow down in mid-2011 and stayed on this course from January through May 2012. It picked up in June until August but still remained within the 2012 target (5-6%). In September, the annual growth rate of consumer prices continued to rise, reaching 6.6% during that month. Core inflation was up, suggesting that inflationary processes had enveloped broader segments of the consumer market. This prompted a rise of the refinancing rate to 8.25%, followed by increases in other regulated interest rates in the money market.

The central part in the monetary policy implementation belongs to the interest rate policy. The Bank of Russia has realised a series of actions to improve its tools and enhance the flexibility of the rouble's exchange rate, which made the money market interest rates more manageable. The interest rate band managed by the Bank of Russia, considered to be the foundation of the current system of monetary policy tools, will retain its role in the next few years, with the Bank of Russia contemplating the possibility of narrowing the band to improve the effectiveness of its interest rate policy.

The Bank of Russia's policy to compile a list of assets accepted as collateral for liquidity provision transactions and to define adjustment ratios for the collateral value will be of a counter-cyclical nature in view of the task to ensure accessibility of refinancing facilities to credit institutions. The Bank of Russia intends to increase the number of intraday loans extended against the pledge of securities included on the Bank of Russia Lombard List and other assets in order to give credit institutions more flexibility in managing collateral securing refinancing transactions and their own accounts with the Bank of Russia.

As it works to improve its own system of tools, the Bank of Russia is focusing on cooperation with government agencies to implement its monetary policy and promote financial markets. It will continue to work closely with the Ministry of Finance and the Federal Treasury to design a mechanism for depositing temporarily unallocated budget funds in the banking sector with a view to mitigating the impact of seasonal budget flows on the size of the banking sector liquidity.

To further improve the effectiveness of its interest rate policy, the Bank of Russia will continue to ramp up the flexibility of the exchange rate in the coming three-year period and will seek to shift to a floating exchange rate by 2015. Against such a background, foreign exchange interventions would be the only possible solution amid high market volatility to serve to iron out excessive rate movements.

A further development and use of Bank of Russia tools will aim both to achieve monetary policy objectives and ensure financial stability and smooth functioning of the payment system of the Bank of Russia and the settlement systems used for transactions involving Russian financial market instruments.

Considering the lessons of the global financial crisis and the negative impact of the destabilised financial sector on the entire Russian economy, the Bank of Russia intends to pay close attention to financial stability issues. The banking system is the key transmitter of the interest rate policy signals to the real economy. Financial stability, therefore, is the prerequisite for a proper functioning of the monetary policy transmission mechanism. In order to maintain financial stability, the focus is to be on early identification and assessment of systemic risks in the banking sector and other segments of the financial market, and on ensuring the transparency of credit institutions. The key tool for achieving these objectives is the elaboration of risk-based approaches to supervision, based on international best practices. Differential treatment will continue to be used to supervise individual credit institutions, subject to their systemic significance, transparency, business complexity and the level of their compliance with regulatory standards. Alongside with international experiences and specific features of the national economy, additional regulatory and supervisory mechanisms will be used with regard to systemically important banks.

A success of implementing monetary policy will largely depend on how effectively we respond to the challenge of building up the financial market infrastructure and capacity. An area of the major concern for the Bank of Russia will continue to be the promotion of the financial derivatives market, which enables business entities to hedge against exchange rate risks and interest rate risks, along with the development of modern regulation and oversight mechanisms to control the risks faced by credit institutions in these segments of the financial market.

The effectiveness of monetary policy in many ways depends on the state of public finance as well. A consistent implementation of fiscal policies aimed at a gradual reduction of the non-oil and gas budget deficit and a long-term and well-balanced fiscal sustainability will make a positive contribution to financial and overall macroeconomic stability, thus fostering economic growth and ensuring the attainment of monetary policy objectives.

The Bank of Russia will continue to expand its engagement with the public at large to explain its long-term monetary policy goals, objectives and measures. As said earlier, the outlook for global growth remains highly uncertain. This may generate adverse effects on the Russian Federation's balance of payments both in terms of the current account and capital inflows. In its forecasts, the Bank of Russia has to factor in a wide range of future oil prices from 70 to 120 dollars per barrel. Thus, it is not surprising that estimates of the balance of payments and other key macroeconomic indicators differ greatly, depending on the oil price scenario selected. So, the Bank of Russia believes that only a gradual transition to inflation targeting is acceptable, followed by a phased out broadening of the exchange rate band and a consistent elimination of exchange rate controls. It is essential to get the public to understand that the exchange rate is bound to become more volatile to be able to cushion the volatility and unpredictability of external developments. The lessons learned in 2012 inspire a certain degree of optimism because rather dramatic short-term exchange rate movements did not bring about any sufficient changes in household economic behaviour. This gives grounds to believe that the Bank of Russia will be able to actively participate in shaping inflation expectations in the future and that it will gain economic agents' confidence in the monetary policy it pursues.