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INFLATION TARGETING POLICY PROSPECTS IN RUSSIA

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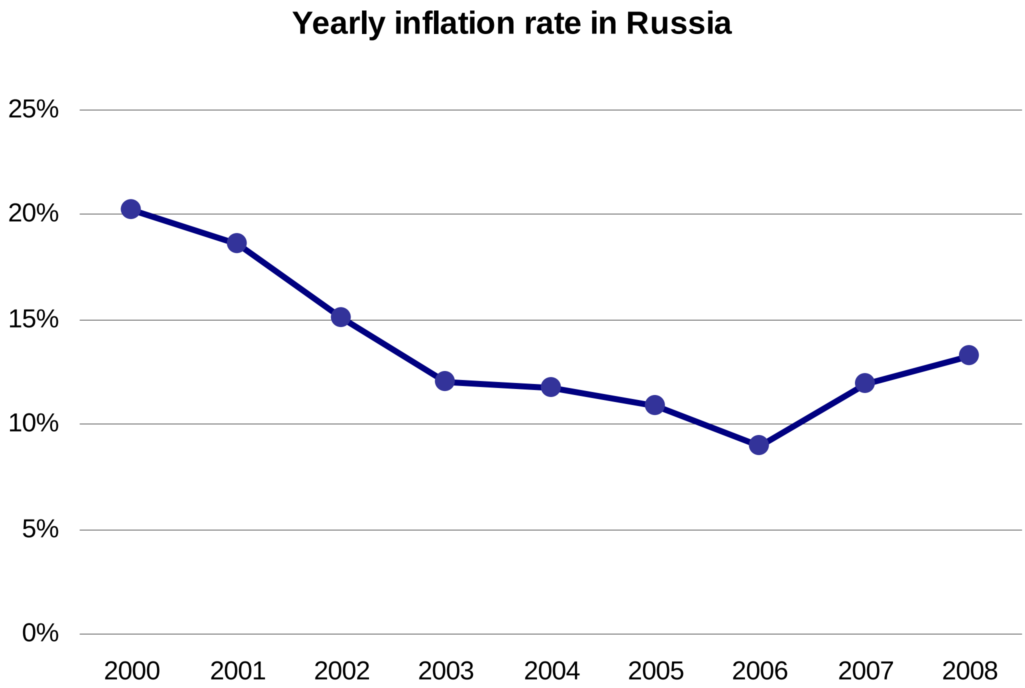
The yearly inflation rate has not fallen below 9% in Russia over the past years, averaging 13.6% between 2000 and 2008.



Source: Federal State Statistics Service

This rate is much higher than in the developed economies. In the US it averaged 2.6% in the same period, in France and Great Britain – 1.9%, in Germany – 1.7%, in Italy – 2.4%, in Canada – 2.2%. Emerging economies also see a lower inflation rate: between 2000 and 2008 annual inflation rate in China averaged 2%, in India – 5.2%, in Brazil – 6.9%, in Malaysia – 2.2%. Neighboring Ukraine and Belarus are facing inflation rates exceeding 10%. Obviously, the current inflation rate in Russia is high and impedes economic growth of the country in the long run.

Although Russia's finance minister Alexey Kudrin has repeatedly emphasized the importance of fighting inflation, in reality the government seems not to consider it a priority task. Under crisis conditions, price growth tends to slow down due to objective reasons like lower consumer demand. This situation can be utilized for lowering inflation, which is strategically important.

Russia's monetary authorities are deciding whether to follow the policy of inflation targeting and flexible exchange rate as a major effort to lower the inflation rate. The idea of inflation targeting and flexible exchange rate has been long discussed in Russia[i]. In mid-June 2009, Sergey Ignatiev, chairman of the Central Bank, said in statement to the State Duma that one of the goals of the Bank of Russia's monetary policy was establishing a flexible exchange rate and inflation targeting. Alexey Ulukaev, the first deputy chairman of the Central Bank, confirmed that statement and said that the new policy might be started in 2010, i.e. a year earlier than intended[ii]. These statements pose a number of questions, however.

Are there any grounds for the central bankers' optimism? Does the Central Bank have appropriate instruments to curb inflation? Is it expedient to use a flexible exchange rate and follow the policy of inflation targeting?

The monetary policy led by the Bank of Russia in the past years boils down to gradual controlled strengthening of the ruble versus a dual currency basket – made up of the US dollar and euro. In official documents it was called 'the use of controlled flexible exchange rate'. With regular inflows of foreign currency from energy exports, this policy, in fact, consisted in the Central Bank's buying all the foreign currency. Because it is very difficult to control exchange rates and inflation without limiting the capital flow, the Bank of Russia, regulating the exchange rate through the ruble emissions, de-facto refused to counteract inflation.

Importantly, the Finance Ministry's budget policy influenced the inflation process. For instance, the extremely uneven spending of budget funds during the year caused inflation surges that were hard to handle for the Central Bank.

The practice of controlled exchange rate has a number of advantages. In particular, this policy is relatively easy to conduct, because it remains efficient even if a country lacks advanced institutional structures; and the exchange rate can be successfully regulated by means of ruble and foreign exchange interventions. A monetary policy like this is transparent and predictable to market players. However, its 'easiness' leads to uncontrolled price increases, in other words, to a central bank's inability to secure financial stability and curb inflation. This in turn pushes up interest rates and slows down economic development.

The Bank of Russia states that it is set to cease control over the exchange rate, which means that for the moment, it can focus on curbing the rising prices. Inflation targeting assumes that a central bank first projects an inflation rate and then, using available tools, adjusts price movements to the set inflation range[iii]. This approach does have reason, all the more so because there is some empirical evidence that instruments of the monetary policy alone are not sufficient to speed up economic growth in the long term, and that inflation is the only parameter that can be influenced upon by a monetary policy. Therefore, there is logic in monetary authorities' controlling this parameter.

Widely spread nowadays, the policy of inflation targeting is in use in Canada, Sweden, Norway, Great Britain, Chile, the Czech Republic, Spain, Austria, Israel, Finland and New Zealand among others. Countries that use inflation targeting normally see marked improvements in their macroeconomic parameters. It is important to remember, however, that inflation targeting only makes sense when a country's banking sector, financial system and the economic institutional environment meet certain requirements.

Letting the ruble exchange rate float freely, the Bank of Russia would fulfill the first condition of successful inflation targeting – refusal from long-term regulation of several macro-parameters. True, if the Central Bank's main task is to control the inflation, it should stay out of controlling other macroeconomic parameters such as the currency exchange rate. Keeping several macroeconomic parameters within a certain range often turns to be an unrealizable task. In particular, Israel, Chile, Hungary and Poland attempted to combine inflation targeting and keeping a fixed exchange rate, but eventually they dropped that policy. Thus, to follow the policy of inflation targeting, a country needs to let its national currency exchange rate float freely.

The key element of the inflation targeting policy is forming expectations in the markets. The markets should believe that a central bank is able to control the inflation and is ready to undertake commitments and fulfill them.

What is needed for the Central Bank to efficiently control the situation? Above all, it should be clear what factors affect inflation rates and how monetary authorities can impact inflation in short- and medium term. To understand this, a quality economic model should be used to project how the economy would react to certain actions undertaken by the monetary authorities. Besides, the Central Bank should have appropriate statistical data.

For the moment, Russia does not have any economic models that could clearly explain inflation. No doubt, inflation is influenced by the factors whose movements are extremely hard to predict. One of these factors is the state of the global energy market. Another factor feeding the inflation rate growth is state-regulated tariffs that cannot be influenced by the Central Bank through its instruments and policies. Certainly, long-term inflation is of monetary nature, while short- and medium-term inflation is hard to predict and control.

A sound economic model can be helpful in figuring out what measures should be undertaken to reach the set goals. Also, to carry out such measures, the government needs powerful instruments. There are no efficient monetary policy tools in Russia. Regulating the inflation process through money supply is efficient in economies with developed financial and banking sectors. It can be hardly carried out in Russia with its underdeveloped financial system. In other words, Russia's economy is specific in the sense that monetary interventions have no direct influence on the consumer price index and are almost unpredictable.
Another important condition for efficient inflation targeting is monetary authorities' transparency and accountability that can influence market expectations. Normally, in

countries that use inflation targeting central banks regularly make public reports where they present target inflation rates, describe the policy instruments in detail, give outlines of economic development and provide plans of actions for various scenario options. Monetary authorities report failures to fulfill their obligations to the parliament, social committees or other institutions. This institutional structure is a guarantee that a central bank fulfills its obligations, therefore markets take its commitments seriously.

Market players' trust in a central bank's promises is an important factor of inflation targeting because coordination of the central bank's policy with market players' actions is only possible in an atmosphere of confidence. Confidence is only possible when a central bank is truly independent. The central bank's independence in setting goals and undertaking measures to reach these goals is crucial for market players' belief in that the monetary authorities will keep their promises even under political pressure.

What is the probability that Russia starts using the policy of inflation targeting? From the formal point of view, under the legislation in force, the Bank of Russia is accountable to the State Duma. Is Russia's Central Bank really (not formally) independent? It is probably not. Actions undertaken by the Central Bank between September 2008 and February 2009, when the so-called 'soft devaluation' was carried out, prompt us to think that it is not independent. Many analysts agree that it was the head of the Russian government, not the Central Bank leadership, who initiated gradual ruble depreciation that cut the Central Bank's gold and foreign currency reserves by one-third. Therefore, there no grounds to think that when inflation targeting is in use the Bank of Russia will be able to concentrate its efforts exclusively on curbing the soaring prices and keeping the inflation rate within the target range when under the government's pressure. Therefore, the market will hardly take the Central Bank's commitments seriously, and forming of market expectations will not be very effective.

To sum it all up, strictly speaking, none of the conditions necessary for successful inflation targeting exists in Russia. Yet it does not mean that the movement towards a free exchange rate and inflation targeting is a mistake. Inflation targeting requires the same conditions as any active monetary policy. After all, the question of the monetary policy quality boils down to the level of professionalism and independence of the monetary authorities as well as the condition of the financial system. These characteristics are extremely inert, thus are hard to be replaced quickly. Any economic policy, whether it is inflation targeting or anything else, will have limited success. From this point of view, there is nothing bad in the Bank of Russia's shifting to regulating price rises and publishing its projections and target inflation rates on a regular basis. The economy will benefit from the greater transparency of the monetary policy.

Academic economists' opinions regarding the toughness of the above stated requirements vary. Are they requirements to be met or just predilections? The experience of the countries that already use inflation targeting evidences that this policy can lead to considerable improvements even if the requirements were not fulfilled initially[iv]. Researchers agree that inflation targeting should not be viewed as a strict monetary rule, but as a monetary policy where the monetary authorities' priority is keeping inflation within the target range. They can also manage other macroeconomic parameter provided it does not contradict to stabilization of long-term inflation. In other words, neither stabilizing and stimulating monetary policy, nor smoothing of short-term exchange rate fluctuations contradicts the inflation targeting requirements. We may state that inflation targeting, to date, is just a monetary policy conducted by a central bank whose main task is to handle long-term inflation.

If the Central Bank, with its limited abilities to influence inflation, starts inflation targeting, the target inflation range will be wide. It is likely that the Central Bank will not always succeed in keeping inflation even within this wide range. There is nothing unusual in it. In Norway, for example, the medium-term inflation deviation from the target rate of 2.5% stands at more 1.5%. Yet, Norway is believed to have highly successful inflation targeting.

In reality, for successful inflation targeting it is important that monetary authorities focus on curbing inflation. If they do, even substantial deviations of the actual inflation rate from the target rate are not a big problem, because predictability of monetary authorities' actions plays the key role in successful inflation targeting.

On the whole, refusal from regulating the exchange rate and transition to inflation targeting seems a right economic policy for years to come. It can play a key role in lowering interest rates and curbing inflation which in turn is strategically important for long-term economic development. The main threat for this policy is pressure and restrictions of the Bank of Russia's sovereignty imposed by the Russian government. Thus, the government's readiness not to interfere with the Central Bank's activities is the key to the policy success.

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[i] The article by A. Ulukaev, O. Zamulin and M. Kulikov, 'Preconditions and Consequences of Inflation Targeting in Russia' in the 'Economic Policy' magazine (2005) provides a detailed discussion of various aspects of using inflation targeting in Russia. See also 'The Prospects of Inflation Targeting in Russia' by A. Ulukaev, S. Drobyshevsky and P. Trunin, 'Economics Issues', No. 1, 2008.

[ii] The Bank of Russia's plans for inflation targeting are laid down in 'The Principal State-led Monetary Policies for 2009 and the Period between 2010 and 2011'.

[iii] There are many research works focusing on inflation targeting. See, for instance, Ben S. Bernanke, Frederick S. Mishkin, Inflation Targeting: A New Framework for Monetary Policy?, Journal of Economic Perspectives, Vol.11, №2, 1997.

[iv] See, for instance, Carare A., Shaechter A., Stone M., Zelmer M., Establishing Initial Conditions in Support of Inflation Targeting, IMF Working Paper 02/1002, Washington, 2002 и Truman E., Inflation Targeting in the World Economy, Institute for International Economics, Washington, 2003.