

# **Topic: Russia's Rocky Road to the (Inflation) Target**

## **Lecture in honor of M. Camdessus**

### **Introduction**

I am truly honored to be here at the IMF and speak about the Bank of Russia's monetary policy. It is a particular honor to be speaking here in honor of Michel Camdessus. My topic today -- "Russia's Rocky Road to Inflation Targeting" -- is one I hope he would enjoy. After all, he helped us begin the journey.

This year is a great time to reflect on some of the "speed bumps" we've encountered. As you know, the last 5 years have been far from easy. 2018, though, also marks the anniversary of not just one, but two major financial crises that deeply affected us. In just a few days, it will be 10 years since the collapse of Lehman Brothers. Just a few weeks ago, it was the 20<sup>th</sup> anniversary of Russia's financial crisis.

Michel Camdessus, as you know, was involved in addressing the consequences of the 1998 crisis. As well as Stanley Fischer who is with us here today, and I'm very grateful for your advice and contribution that time.

Camdessus's connection however to Russia runs much deeper.

In the 1990s, the IMF and Mr. Camdessus's main job was to support countries making the historic transition to market economies. A full 3 chapters of Mr. Camdessus's memoir are dedicated to Russia and our struggle to build the foundations of a market economy and reach macroeconomic stability.

Here is what Mr. Camdessus wrote about the Russian Central Bank in 1992:

"The [IMF] teams discovered in Moscow the actual existence of a Central Bank which was hardly anything more than an office of the Treasury, itself little acquainted with the most basic facts of financial economy”.

While, say, New Zealand and Canada had already begun their transition to inflation targeting, Russia had only just started its transition to a market economy. And the Bank of Russia had yet to become a modern institution for monetary policy.

Many years have passed and a lot has changed. Some of the key points of the original program - like mass privatization, tax reform and fiscal consolidation - have been implemented. In the 2000s when oil prices were high, we built both fiscal and FX reserves.

Bringing the inflation rate down to low single-digits was probably the last item on the list.

Over the last 25 years we have experimented with a number of different monetary and exchange rate policy regimes in order to stabilize inflation, but like many other emerging markets before us - we were only able to reach low inflation after the introduction of inflation targeting.

Still, our experience differs from those of other EM countries. Most of them introduced inflation targeting in the early 2000s after the Asian crisis. It was the time of the Great Moderation, when global markets were relatively stable, risks to financial stability were low and domestic macroeconomic and financial stability was fully dependent on domestic policies.

Inflation targeting worked relatively well for EMs in that environment, although even then inflation in emerging markets was somehow more volatile than in advanced countries.

The value of inflation targeting in emerging markets was proven during the global financial crisis, the European crises, the Taper Tantrum and so on. One of the conclusions from this experience though is that in order to preserve financial stability central banks need more instruments at their disposal in addition to the ones required for inflation targeting.

Russia's experience underscores the importance of that conclusion. In 2014, Russia introduced inflation targeting in the midst of financial turmoil. Since then, external volatility and potential financial stability risks have been permanent features of the agenda.

I should underline that inflation targeting has not only allowed us to decrease inflation; it has also become the basis for preserving financial stability. When a monetary policy framework is transparent, and the policy itself is implemented in a classical, even orthodox way, markets are able to react to shocks in a more orderly manner. And eventually markets become more self-stabilizing.

However, our experience also shows that inflation targeting is not enough when there is constant uncertainty and risks to financial stability. Inflation targeting needs to be accompanied by macroprudential tools and special instruments to manage volatility. These tools are necessary even if a country has sufficient buffers, including international reserves and fiscal buffers.

Allow me to illustrate this point with a story from our experience over the last few years.

I begin by pointing out that the IMF - and not only the IMF - felt that the pre-conditions for Inflation targeting in Russia were very poor in the early 2000s.

Many of the problems we faced were quite standard for an emerging market.

- Our financial markets weren't deep enough and poorly segmented
- our market institutions were weak
- there was a high level of dollarization
- fiscal dominance prevailed
- food and utility prices had an outsized share in the consumer prices index
- and Russians - largely financially illiterate at the time - were haunted by the memory of persistently high inflation.

And that is not an exhaustive list.

All of these factors restrained the transmission of monetary policy and inhibited the process of anchoring inflation expectations.

Further complicating matters, Russia as an oil exporter suffered from Dutch disease. As a consequence, from time to time Russia sustained significant terms-of-trade shocks and exchange rate shocks. It also had excessive private external borrowing.

That is why we had to do a lot of preparation. Over the course of 5 years, the Bank of Russia built liquidity management instruments, gradually widened the exchange rate band and developed in-house modeling and forecasting capacities.

I would like to take this opportunity to thank the IMF for all the technical assistance during that time.

But despite all our preparation, however, there were still doubts about whether we should take the final step - and introduce full-fledged Inflation targeting and a floating exchange rate.

Those doubts only grew after the Taper Tantrum and two other significant shocks Russia faced in 2014.

The first shock was related to the collapse of the oil price. Lest anyone has forgotten - this slide shows exactly what oil prices have done over the last 10 years.

Plummeting oil prices required large balance of payment adjustments. Exports decreased by 40% between 2014 and 2016. A similar correction of imports was also needed.

The second shock that required adjustments to the balance of payments was geopolitical. That shock caused large capital outflows that were intensified by the forced de-leveraging of external debt. You can see just how quickly the Russian banking and corporate sectors de-leveraged.

Our opponents of inflation targeting had two main arguments.

One - that Inflation targeting isn't appropriate for a commodity exporting country.

And two - that it is particularly inappropriate to introduce Inflation targeting in a volatile period as it would significantly increase the exchange rate's volatility and destabilize markets.

But we believed that the current account shock was precisely why we needed to accelerate the move to Inflation targeting.

One of the alternative suggestions was to apply capital controls. The Bank of Russia never gave that any thought. We believed capital controls would have a very negative effect in the long run - even if the short-term effect can be positive. If we use such a measure once, investors would expect us to use it again and again. Those kinds of expectations can significantly increase capital outflows and make the job of managing volatility more complicated.

I would like to highlight 4 elements of our policy that proved to be essential in a situation when a central bank has to tackle two issues simultaneously. The first is to achieve its goal – low inflation – through radical change in monetary policy regime. And the second is to preserve financial stability.

Those four elements are:

1) volatility management, 2) resilience of the banking sector, 3) a central bank's independence and effective coordination with the government, and 4) an active communication policy.

Allow me now to elaborate.

I'll begin with volatility management.

The balance of payment shock was particularly acute in our case because of the combination of a terms of trade shock (prompted by the decline in oil prices) and a capital account shock due to sanctions. Capital account shocks are common in emerging markets even without sanctions. They usually amplify current account shocks, or may be a result of policy changes in reserve currency countries.

Capital account shocks can be quite disruptive as they may cause excessive exchange rate volatility. However, while in the case of terms-of-trade shocks exchange rate adjustment usually works as an automatic stabilizer, in the case of capital account shock, this is often not the case due to disruptions on the FX liquidity market and balance sheet effect.

Therefore, I think that the central banks of countries that do not have reserve currencies need to have both local currency and FX liquidity management instruments.

Of course, such tools should only be used temporarily, to smooth out liquidity shocks rather than to mask actual exchange rate targeting.

Finding a source of FX liquidity for central banks is another problem. In our case, we relied on our international reserves. In theory, there are also other sources, ranging from the IMF and regional reserves arrangements and credit lines, to swaps with the Fed or other advanced countries central banks.

So, what did we do to address our volatility problem, and adjust the balance of payments while getting inflation under control?

First of all, we let the exchange rate adjust freely by switching to a floating exchange rate. While exchange rate volatility initially spiked, it then quickly fell. Furthermore, especially with introduction of a fiscal rule, the exchange rate considerably decoupled from the price of oil.

Second, we tightened monetary policy by sharply raising the key rate to 17%, and have retained some tightness of monetary policy since then. That policy allowed us to quickly stabilize inflation and inflation expectations after the initial jump. It also prevented deposit dollarization.

That's why in 2016, during the second fall in oil prices, people and the market reacted much more calmly than they had in 2014.

Russians did not rush to the bank to convert their ruble accounts into foreign currency as they had in previous times of uncertainty.

A very slow and cautious easing policy - which we have conducted since then - was the main factor that brought inflation down to our 4% target last year. Nonetheless, these two policy measures alone were not enough to resolve the issues with liquidity and volatility.

And as I mentioned earlier, we also introduced special FX liquidity tools to deal with companies' and banks' abrupt loss of access to the global financial market.

The second issue is the financial sector's resilience.

In volatile times, the financial sector needs to be resilient enough to withstand shocks and to manage unavoidable credit

and interest rate risks. We started working on strengthening the banking sector back in 2013. That policy involves improving regulation and supervision. It also means ridding the banking sector of weak institutions. Over the last 5 years, as Kristin\ve already said, we have withdrawn about 400 banking licenses. That's more than a third of all our banks.

The financial sector's resilience is not only about the health of its individual institutions. We were very lucky we didn't have any major bubbles in the market in 2014. Just a year before, unsecured retail lending was growing at an excessive rate of 60% year-on-year - a highly dangerous situation we managed to resolve with macroprudential measures.

Had we not started cleaning up the banking sector and dealt with runaway lending, we would have faced much more severe problems.

In times of volatility, many emerging markets face another serious concern. Their financial institutions often have a high level of FX lending.

In this situation, central banks face a dilemma: they need to allow the exchange rate to adjust, while ensuring that a financial system with excessive FX exposure remains stable.

It's not always easy to find the right combination of tools to preserve financial stability and curb inflation. We had this trade-off too.

When we hiked the key rate, we restrained inflation by stabilizing the exchange rate and dampening aggregate demand.

At the same time, this rate hike along with currency depreciation increased the risk of a systemic banking crisis through the spike of interest-rate, FX and credit risks on the bank's balance sheets.

We had to account for the weak balance sheets of quite a few banks that had not built sufficient capital buffers. We used forbearance measures to buy them time to adjust.

One of the measures allowed the banks to calculate the regulatory ratios using a notional fixed exchange rate for 15 months. Unsurprisingly, many of the banks wanted this holiday period to continue indefinitely.

Throughout that period, we took steps to convince the banks that forbearance was only temporary and that the policy of strengthening regulation and supervision would be maintained in order to guarantee the financial sector's resilience.

The government for its part introduced a banking recapitalization program. Both state and privately owned banks were able to participate. That program really helped the banks and their clients calm down.

Nonetheless, these measures were not able to solve all of the problems.

Many emerging markets face a problem of excessive external corporate borrowing.

A large part of these loans can be sourced directly from global markets. For example, at the end of 2014, the Russian market was deeply concerned about corporates' massive debt repayments coming due when we were shut out of international market. That concern was one of the reasons market volatility spiked.

Unfortunately, central banks do not have enough macroprudential tools to influence corporate borrowing. It is a financial stability issue which central banks need to address together with governments. In Russia, we are currently

discussing whether it is worth introducing something like DTI (Debt-to-income) for corporate lending into banking regulation.

Many banks also had to address the growing problem of FX borrowers who did not have export-based FX revenues and failed to make their payments. NPLs were particularly high in such cases.

We began to stimulate banks to decrease the share of FX lending and FX deposits on their balance sheets. Such measures include higher risk weights for FX loans and higher reserve requirements for FX deposits. While we appreciate the IMF has frowned on this in the past, we found it to be very useful.

Let us get back to our policy elements. Item 3 on my list is the issue of central bank independence and coordination.

In emerging markets countries with mostly weak institutions, the independence of the central bank is only trusted after it's tested. While Russia's central bank is independent by law, the real test of its independence came in 2014. That's when we took decisive action despite strong criticism from many in business, society and the government. Our opponents didn't always behave nicely.

For example, one businessman asked me if we had come from outer space...and suggested it was a good time to send us back. Many thought the inflation target was the stuff of science fiction.

We had to be consistent in implementing and communicating our policy to gain the markets' confidence. That made risk premiums go down - making the job of managing volatility easier for us.

You can measure that in the yield curve.

For a couple of years, it was inverted, until recent it was flat because the market trusts our ability to decrease inflation.

Even after the recent geopolitical shocks, Russia's long-term rates are not all that different than those of the countries with similar inflation targets. I hope I'm not jinxing anything here.

I should say gaining the market's trust once doesn't guarantee that you will always have it in the future. That trust gets re-tested every time there is a crisis.

Meanwhile, central bank independence should not lead to the lack of coordination with the Government. Yes, we have our own lanes, our own areas of responsibility. But governments and central banks need to take into consideration measures introduced by the other party. Coordination with fiscal policy is especially important. Fiscal dominance is a major problem for many central banks.

Thankfully, Russia is in a relatively good position on that front. We have a new and very strict fiscal rule. When oil prices are above \$40 a barrel, we will put the excess income into our reserves. Budget consolidation has helped a lot in achieving our goals. These measures have not only improved macro stability, but have also contributed to a reduction in the exchange rate volatility.

And, of course, fiscal buffers decrease the probability of currency crises in the future.

A central bank's communication policy can also be a very important tool for gaining trust and anchoring inflation expectations. We had to change our approach to communications significantly over the last several years in order to build market trust.

In the past, the Bank of Russia rarely explained or announced its actions. In fact, the central bank rarely said anything at all. With inflation targeting we had to develop the various tools for communicating to increase the market and general public's understanding of what we were doing.

I remember one episode from 2014 particularly well. When we raised the key rate to 17%, the information about our decision was published late at night. The following day, the markets were very nervous. They thought because it was announced in the middle of the night it must have been taken in panic. All kinds of rumors started to circulate. But the answer why we did it at night was actually very simple. Russia has eleven time zones and we needed the banks in the Far East - hours and hours ahead of Moscow - to know the new rate before they opened their doors. Needless to say, we didn't communicate our rationale very well.

Since then we've developed a whole set of communication tools:

- fixed times for key monetary policy releases
- regular meetings with journalists, analysts and investors
- press-conferences
- interviews

- social media outreach
- a financial literacy website and so on.

Of course, all of that sounds pretty standard. It is after all the standard of communication for a modern central bank. But it wasn't standard for us and we have spent a lot of time building this system.

First we needed people to acknowledge: "Ok, we understand what you're saying". Our task now is to get them to say, "We believe you and we trust your judgement."

#### Results of inflation targeting in Russia

Despite the severe shocks, the Russian economy has adjusted rather quickly thanks at least in part to these four elements of policy. The economy contracted 3.6% in the wake of the 2014 crisis – three times less than what we saw during the Great Financial Crisis. The balance of payment adjusted as well. The current account surplus is now about 5% of GDP (our expectations for this year). Drastic financial consolidation reduced the budget's break-even price for oil to \$60 a barrel from \$100.

Corporate debt levels are normal and public sector and household debt is very low.

Unemployment is at a historically low level and close to the natural unemployment rate. Now it is 4.7%

Inflation, meanwhile, was brought down to 2.5% by the end of 2017 and is now on its way back to our 4% target. And although inflation has been below our target for the last few quarters, the Bank of Russia hasn't rushed to cut rates. We need to keep our monetary policy relatively tight to control current internal and external risks to inflation.

Growth, at the same time, is between one and a half and two per cent - in line with our estimations for potential growth but it is too low.

Like everywhere else, monetary policy can only do so much in Russia. It cannot increase potential growth. Potential growth's low level is Russia's main domestic challenge. Structural policies must address economic diversification as well as the issues related to our ageing population and improve productivity.

These highly needed structural policies, fiscal policies could have an impact on monetary policy. The Russian government, for example, has recently announced a number of fiscal initiatives. The expectation is that they will have a positive supply side effect. At the same time, measures like a hike in VAT could prompt inflationary pressure which can in turn amplify inflationary pressure from external shocks. If that happens, our monetary policy will have to remain tight and even might get tighter.

We believe that our monetary policy does not have any material negative effect on economic growth because the main restraints are of a structural nature. Moreover, our low inflation rate policy is stabilizing market, consumer and business confidence. This positive externality offsets the negative effect of tightness. This is why we believe that the sacrifice ratio in Russia was close to zero.

Structural changes, fiscal consolidation and cautious monetary policy are interrelated parts of domestic economic policies.

But as an open economy (with a big share of international commerce in GDP and with an open capital account), Russia is not immune to external shocks.

The Russian economy's three biggest external risks are related to oil, policy normalization and geopolitics.

The first two are well known and expected risk factors. And we have taken precautionary measures for them.

Geopolitical events - not only sanctions, but also “trade wars” and potential “currency wars” - are different. They are much less predictable, and subject to contagion and spillover effects which are often not clear ahead of time. It forces us to build even more buffers.

We are in an interconnected world where trade measures against one country, or sanctions against one company can have global effects.

And when countries need to answer by building outsized buffers it can become a drag on the global economy.

I believe that we should at least discuss these issues in a similar manner as we discuss monetary policy spillovers.

To conclude my lecture, I would like to reiterate the thesis I made at the beginning. Our experience shows that inflation targeting in an emerging market country can be an essential part of the financial stability framework, but it needs to be augmented by volatility management instruments and buffers.

All of these – the Inflation targeting framework, its instruments -- are well known and widely implemented. They're commonplace. The trick lies in getting their application

right - getting their combination, exact doses and timing correct. All decisions need to be adjusted to local market conditions and specific shocks.

We, central bankers, tend to construct policy with ready-made bricks and pieces like we're building something with Lego. But modern policy making and its constituent parts are very different from the Lego you know. It's a lot more like the "Lego-equivalent" we had when I was a kid in the Soviet Union. The bricks were imperfect and to get them to fit together, you had to make manual improvements - cutting angles, drilling holes and so on. Sticking to the analogy: central bankers need to be flexible not only when it comes to choosing the parts, but in reshaping them to better fit local market composition.

That said, once a policy framework has been decided - there is no room for compromise - especially in volatile times where there are constant risks to financial stability. If there's one thing I've learned over the last 5 years: We must be persistent and consistent.



Bank of Russia

# Russia's Rocky Road

to the (Inflation)

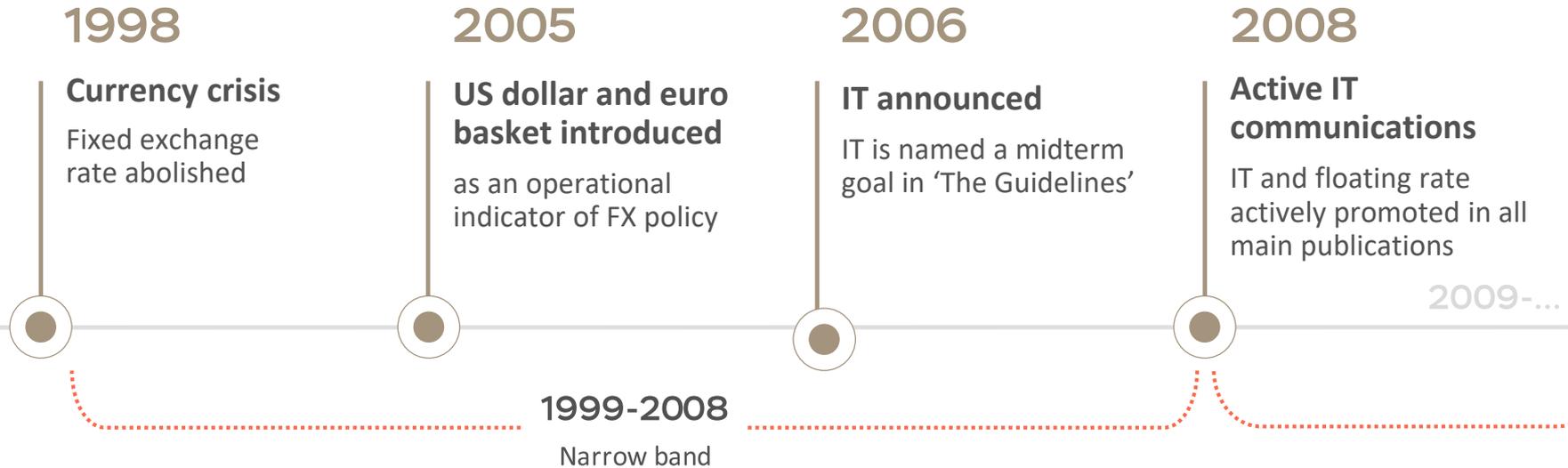
Target

Elvira Nabiullina  
Governor, Bank of Russia

# Monetary policy evolution



## Before inflation targeting



# Monetary policy evolution



## Preparation for Inflation targeting

2009

### Liquidity management

Instruments are developed, interest rate corridor is narrowed

2012

### Transition deadline set

'Floating rate and IT by 2015'

2013

### Mandate amended

The central bank law now identifies inflation as the main goal

2013

### Key rate introduced

Symmetrical corridor is formed, QPM is updated

...-2008

2014-...

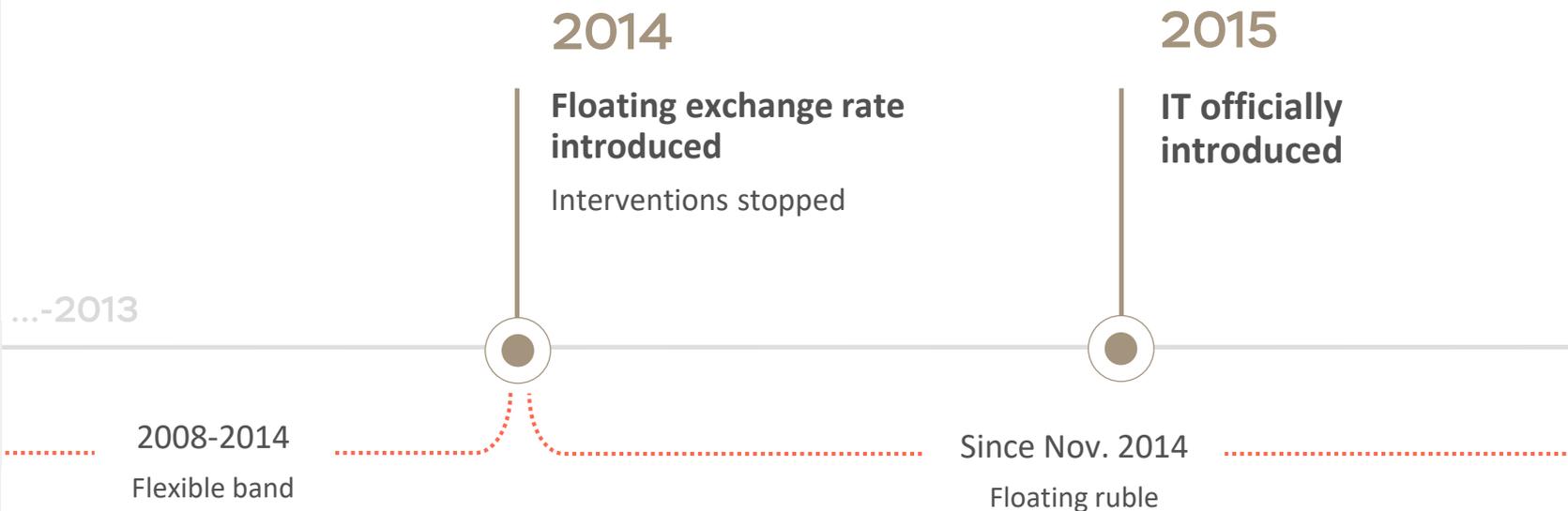
2008-2014

Flexible band

# Monetary policy evolution

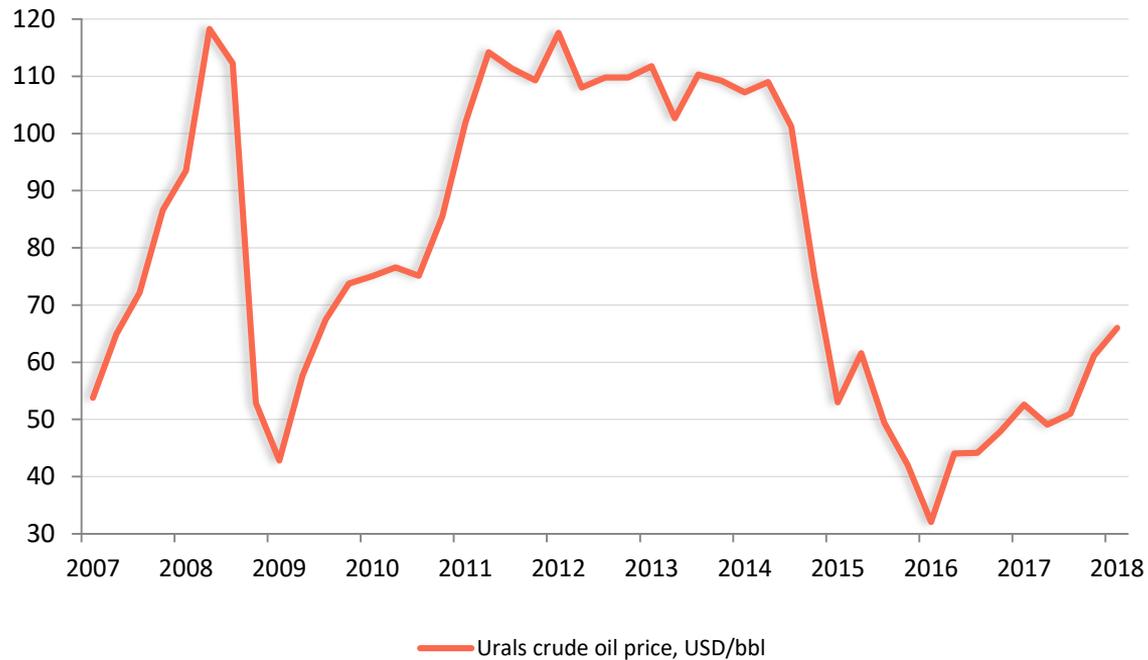


## Inflation targeting introduction



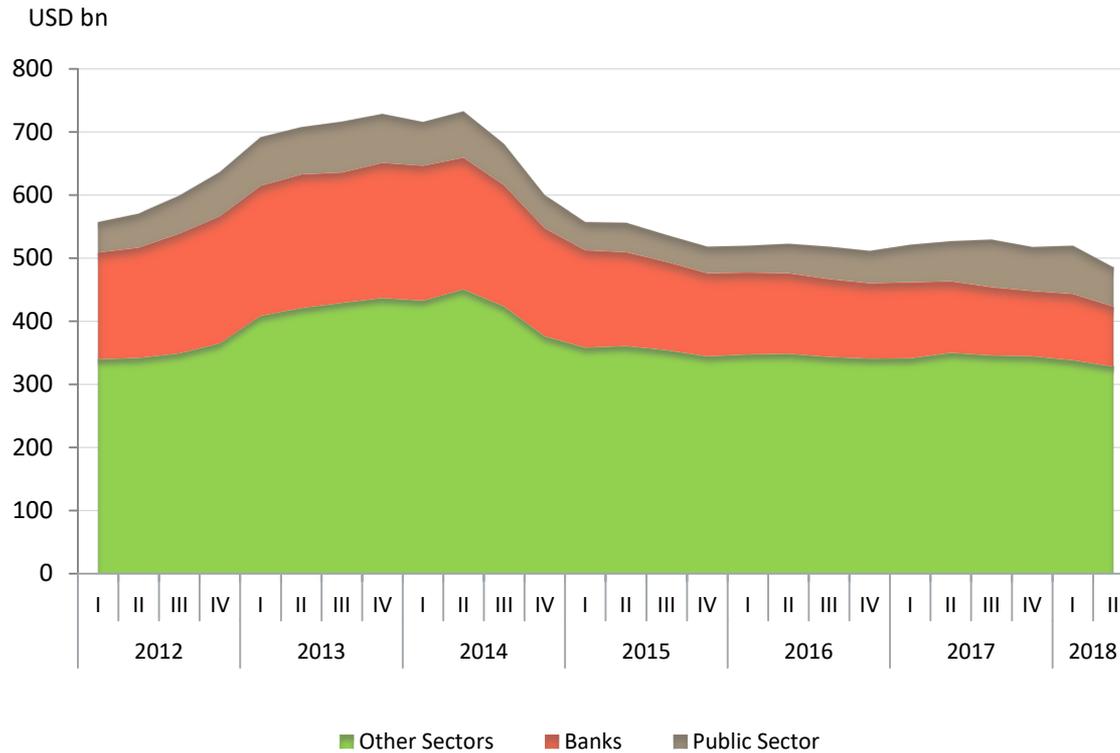
# Oil price

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Source: Rosstat, Bloomberg Finance L.P., Bank of Russia calculations.

# External debt fell post-2014



Source: Bank of Russia

# 4 key elements

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**1 /** Volatility management

**2 /** Resilience of the banking sector

**3 /** Central bank's independence and coordination with the government

**4 /** Active communication policy

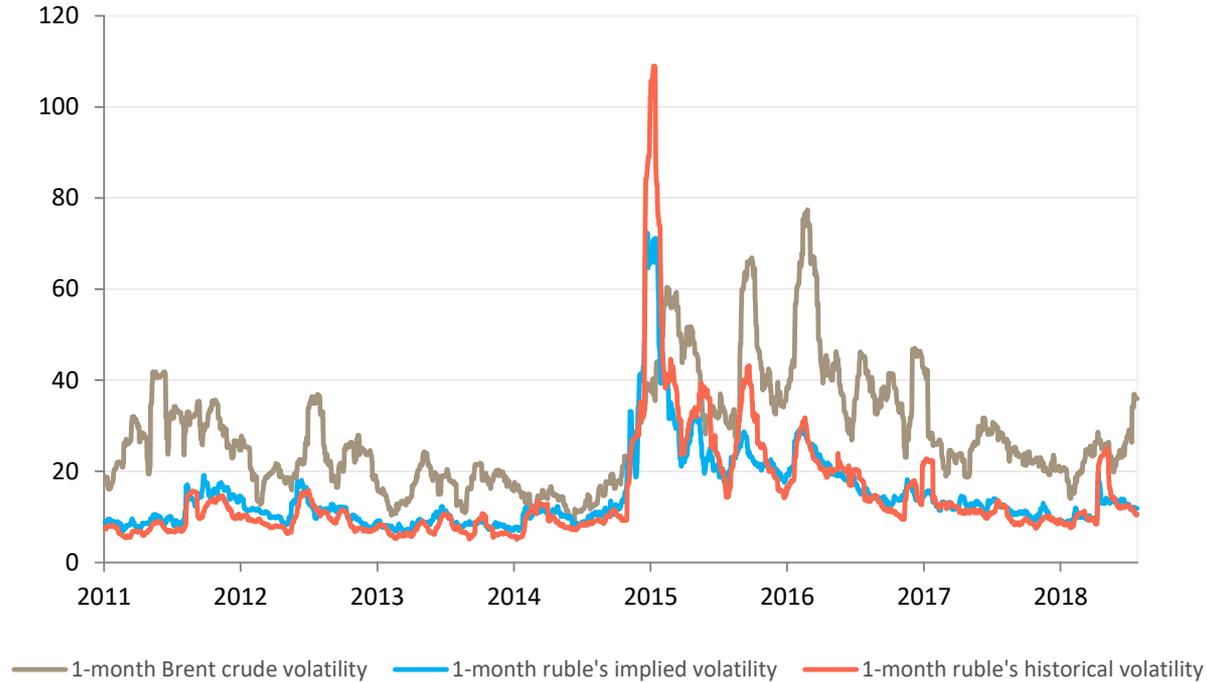


# Liquidity and FX volatility management

# Ruble volatility is back to 'normal'

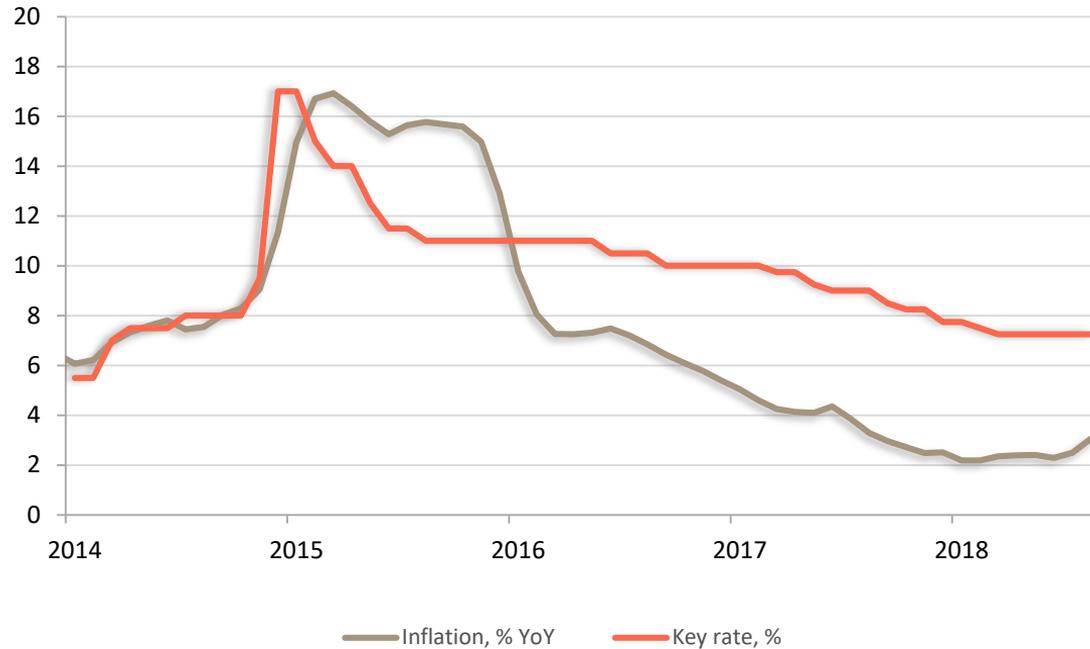


Oil price and Ruble volatility



Source: Bloomberg Finance L.P.

# Inflation and key rate in Russia



Source: Rosstat, Bank of Russia  
Data for August 2018 is preliminary and based on weekly price reports by Rosstat

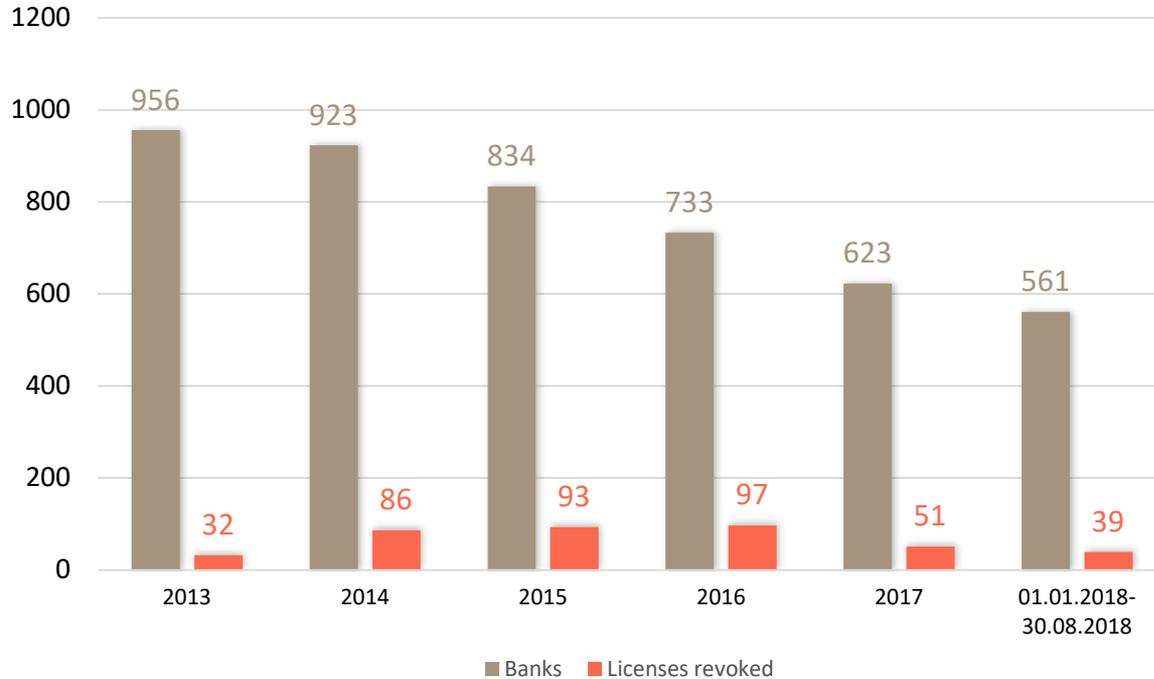


**Resilience of**

**financial**

**sector**

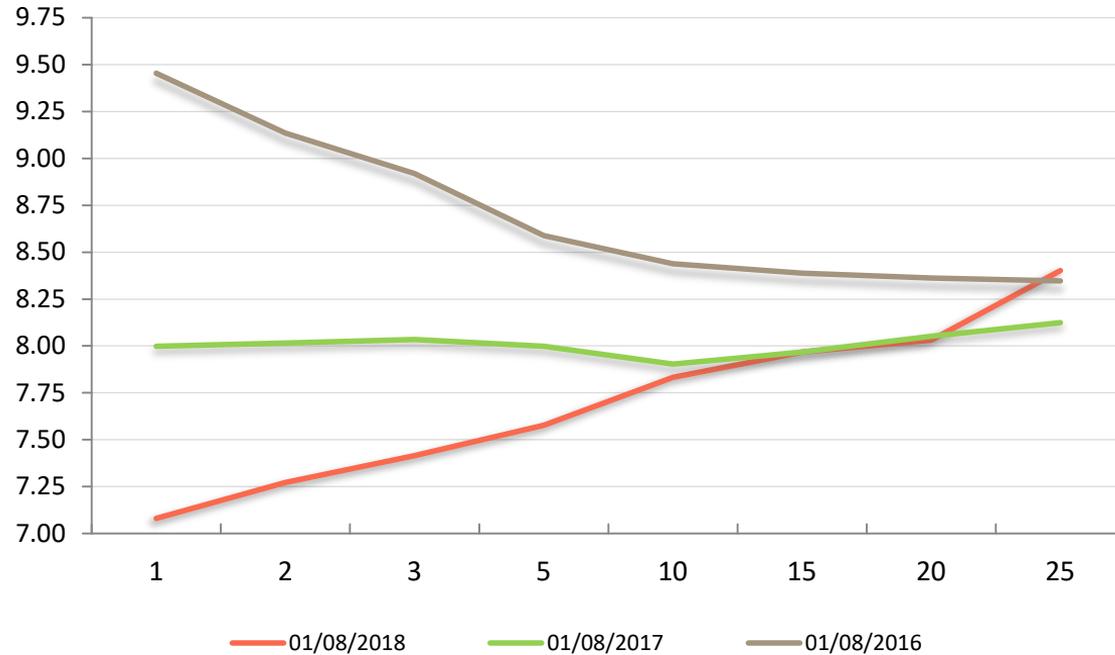
# Cleaning-up of the banking sector





# Independence and coordination

# OFZ yield curve: from inverted to normal



Source: Bloomberg Finance L.P.



# Communication policy

# Inflation



Source: Rosstat.  
Data for August 2018 is preliminary and based on weekly price reports by Rosstat



Thank you

for your  
attention