Reinvigorating Growth Potential: Priorities for the Central Bank of Russia

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The pace of global recovery remains weak. More than twelve months since the G-20 summit in Los Cabos, G-20 members are laboring their way towards "Strong, Sustainable and Balanced Growth" in a clouded world economic outlook, with the eurozone in a state of recession, a combination of policy stalemate and across the board fiscal consolidation constraining growth in the U.S., and emerging markets and developing countries experiencing a clear slowdown compared to their rapid pre-crisis expansion.[1] A durable recovery that creates good jobs, which G-20 leaders agreed to cooperate for in September 2009, proves to be an elusive objective. Fiscal consolidation acts as a drag on economic recovery and the G-20's capacity to deliver on the growth and jobs agenda is questioned by its citizens. This calls for the G-20 members' commitment to a balanced and coordinated mix of policies and instruments, reflective of the state of their economies, which would gradually strengthen economic growth and promote macroeconomic stability. Responding to global and domestic priorities, Russia has placed growth and jobs at the core of the G-20 agenda[2] within the fundamental question of what should be the main macroeconomic and financial policy requirements for growth.

Growth prospects for Russia are projected at 2.5 percent in 2013 and 3.25 percent in 2014, a downgrade from the targeted 5 percent.[3] In this context, a domestic debate is unfolding on what instruments can be most effective for unleashing the growth potential. At the front and center of the debate is the course of monetary and fiscal policies, financial regulation and structural reforms, as well as the role of the Central Bank of Russia (CBR), soon to acquire the functions of a mega-supervisor. There are two schools of thought which advocate different approaches. Some experts and certain authorities propose that the CBR should explicitly prioritize support for economic growth in its policy, stimulating the real sector of the economy using all the instruments and resources it has. These include lowering interest rates, depreciating the ruble, expanding refinancing instruments, and slowing down financial supervision reform by delaying the adoption of Basel 2.5 and Basel III capital frameworks. According to the competing second school of thought, the CBR should focus on inflation targeting, consolidate its liquidity instruments, raise flexibility of the ruble exchange rate with limited interventions to soften short-term fluctuations, strengthen the supervisory framework and build a reliable, stress-resistant financial markets infrastructure.

Proponents of the first approach claim that in times of weak economic growth, measures to stimulate economic activity should be a priority. According to this approach, central banks should bear responsibility not only for purely monetary policies, but for implementing other growth-oriented policies as well. Special measures could include providing financial support to large scale investment projects using excess reserves. Central banks using this approach keep interest rates at a low level by buying government bonds. During the global financial crisis and its aftermath, with short-term interest rates in major advanced economies close to zero, their central banks started buying instruments with longer maturity than short-term government bonds, thus increasing the monetary base. The rationale for this policy is that given low interest rates which cannot be further decreased, an increase in the monetary base remains the last available source for stimulating economic growth.[4]

However, this is not the case for Russia, where the refinancing rate currently equals 8.25 percent.[5]

Another growth-stimulating factor within this strategy is currency devaluation. Increased money supply associated with quantitative easing leads to national currency depreciation, which benefits domestic export-oriented industries and import substitutes. Some experts claim that this effect can be further strengthened by central banks measures such as direct interventions in the currency markets. Control over inflation under this line of defense is not a priority as most countries which resort to these instruments have low inflation. This policy is believed to have helped reduce systemic risks and strengthen trust in the G-7 countries' financial markets.[6] While there are different views on the relationship between quantitative easing and inflation, the risk of higher inflation, especially during an exit from such a policy, should not be underestimated. For Russia, where the inflation target for 2013 is within the range of 5 to 6 percent,[7] further increases would mean enhanced investments risks, higher nominal interest rates, lower predictability and shorter planning horizons, as well as a decline in business and consumer confidence.

CBR's monetary policy is guided by the second approach, though there has been pressure to reconsider the strategy, especially after recent growth projections and a change of the CBR Governor. To manage inflation expectations, the CBR pursues the adoption of formal inflation targeting to cut inflation down to 3-4 percent over the 2013-2015 time horizon, a trajectory which is estimated not to undermine growth prospects.[8] To enhance transparency and efficiency, the CBR has shifted its focus from currency interventions to bank refinancing,[9] expanding the set of instruments and optimizing interest rates on different types/durations of operations and retaining the one-day auction repo rate at 5.5 percent, below inflation. A case in point is the decision of the CBR Board of Directors in June. For the first time in its recent history, the central bank set the minimum floating interest rate of 5.75 percent on the auctions for provisions of loans secured by non-marketable assets and guarantees for 12 month terms, thus expanding the set of available monetary policy instruments.[10] Resisting the call to devalue the national currency to help export-oriented, mostly extractive industries, the CBR is pursuing a managed floating exchange rate regime,[11] protecting the economy from speculative capital flows and allowing companies to adapt their expenditures in periods of abrupt exchange rate fluctuations by currency interventions. According to CBR data, its foreign exchange interventions amounted to $4.3 billion and €382 million in the first half of 2013, which is a significant change in pattern compared to 2012 interventions of $15.2 billion and €1.1 billion over an equal period.[12] By 2015, the CBR intends to fully switch to a floating exchange rate by gradually increasing exchange rate flexibility. Thus, its currency interventions to influence the short-term ruble exchange rate dynamics will be terminated.[13]

Effective financial regulation and supervision is regarded as a cornerstone of ensuring financial stability and growth. As a response to the crisis, G-20 member governments have launched reforms aimed to strengthen control over financial markets, expand the coverage of the regulatory system to include new financial products and address systemic risks to prevent future crises. To make financial market reforms more effective and comprehensive, the Russian authorities proposed a concept of establishing a mega-supervisor responsible for the supervision of both banks and non-banking entities. In January 2013, this idea was supported by the President,[14] and in July 2013, the draft law on a potential mega-regulator was adopted by the State Duma.[15] The law provides for a gradual take-over of the Federal Financial Markets Service functions, currently responsible for regulating the non-banking financial sector (insurance companies, pension and investment funds, exchanges etc.), to the central bank. The creation of a mega-supervisor aims to ensure effective control and oversight across the entire Russian banking and financial sector. The new authority, expected to be fully operational by September 2013,[16] will be combining traditional monetary functions of the

central bank with the overall financial markets supervision, thus avoiding inconsistencies between the two policy area objectives.

The CBR has begun implementing internationally-agreed financial sector reforms proposed mainly by the Financial Stability Board (FSB), including new banking capital and liquidity standards, sound compensation practices and systemically important financial institution resolution regimes. Similar to the inflation curbing strategy, the CBR tries to calibrate the pace of reform such as to not hinder growth prospects. For instance, at the above-mentioned Board of Directors meeting, the central bank decided to synchronize the implementation of the Basel III framework with the EU and the U.S., and to postpone it from the original national implementation plan to help commercial banks better prepare for the new regulations. The new standards set the core Tier 1 and Tier 2 ratios at 5 and 5.5 percent, respectively, starting on January 1, 2014, with the latter to be increased to 6 percent by 2015. The total (Tier 1 + Tier 2) capital ratio will remain unchanged at 10 percent. The CBR has also provided for additional capital requirements for the risk of credit valuation adjustments (CVA) on derivatives and over-the-counter (OTC) contracts to become effective October 1, 2014, which is in line with FSB recommendations.[17]

Thus, the CBR envisages its contribution to generating strong, sustainable and balanced growth by decreasing inflation and developing a healthy financial sector. It regards macroeconomic stability as a key factor for economic growth, and low inflation as a key factor for investment-led growth at the current stage of Russia's economic development.[18] Indeed, the new growth model can only be based on stable macroeconomic conditions, more efficient use of resources, long-term investment and a sound financial sector. These ingredients will help implement the much-needed structural reforms where progress remains subdued. A historically low unemployment level and a narrow output gap imply that Russia may face constraints in economic growth if no actions are taken to stimulate investment and expand productive capacities and to stimulate innovations that make the national economy more competitive. Much-needed structural reforms will certainly be facilitated by providing macroeconomic stability and consolidating financial market infrastructure on the basis of internationally-agreed standards, strengthened supervision and sufficient powers acquired with the establishment of a mega-regulator. Greater stability, transparency and trust are the levers for improving the Russian investment climate, which is a priority for boosting economic growth.

To conclude, it would be safe to assert that the CBR, given its strong balance sheet and good track record of independent performance, could make a major contribution to reinvigorate the country's growth potential. Looking forward, it seems appropriate to suggest that central bank governors should play a greater role in G-20 decision-making, where finance ministers have so far tended to dominate the discussion. The latest G-20 Finance Ministers and Central Bank Governors communiqué, released following the meeting on July 19-20, 2013, has gone in this direction with an explicit statement on central bank mandates for macroeconomic policy, directed towards domestic price stability and the support of economic recovery.[19]

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Endnotes

[1] See IMF (2013).

[2] See report at the official website of The Russian Presidency of the G20 (2012).

[3] See IMF (2013).

[4] See Bank of England (undated) online document for a description of quantitative easing (QE).

[5] Data obtained from Macroeconomic Indicators on Bank of Russia website. (http://cbr.ru/eng/daily.aspx).

[6] See Kluyev, de Imus, and Srinivasan (2009).

[7] Data obtained from "Key Indicators", Russian Ministry of Finance. (http://info.minfin.ru/project_fb_fbproject.php).

[8] See CBR (2013a).

[9] See CBR (2013b) for an interview of the Governor of CBR, E. Nabiullina to the Kommersant (in Russian).

[10] See CBR (2013c) for an unofficial translation of the Board of Directors' decision on the Bank of Russia Interest Rates.

[11] See CBR (2013a).

[12] Data on CBR interventions on the domestic foreign exchange market from CBR (2013d).

[13] See guidelines for the single state monetary policy in CBR (2012).

[14] See reports from the meeting on stock market development on January 25, 2013, Russian Presidential Executive Office (2013).

[15] See Draft Law No. 249469-6. Russian State Duma (2013).

[16] See Ostroukh (2013) in *The Wall Street Journal*.

[17] See CBR (2013e) for CBR press release of information on introducing regulation of lending agencies in accordance with Basel III.

[18] See CBR (2013b).

[19] See the final communiqué of the meeting of Finance Ministers and Central Bank Governors in Moscow, July 19-20, 2013 in the lead up to the G-20 Summit in St. Petersburg at official website of The Russian Presidency of the G20 (2013).