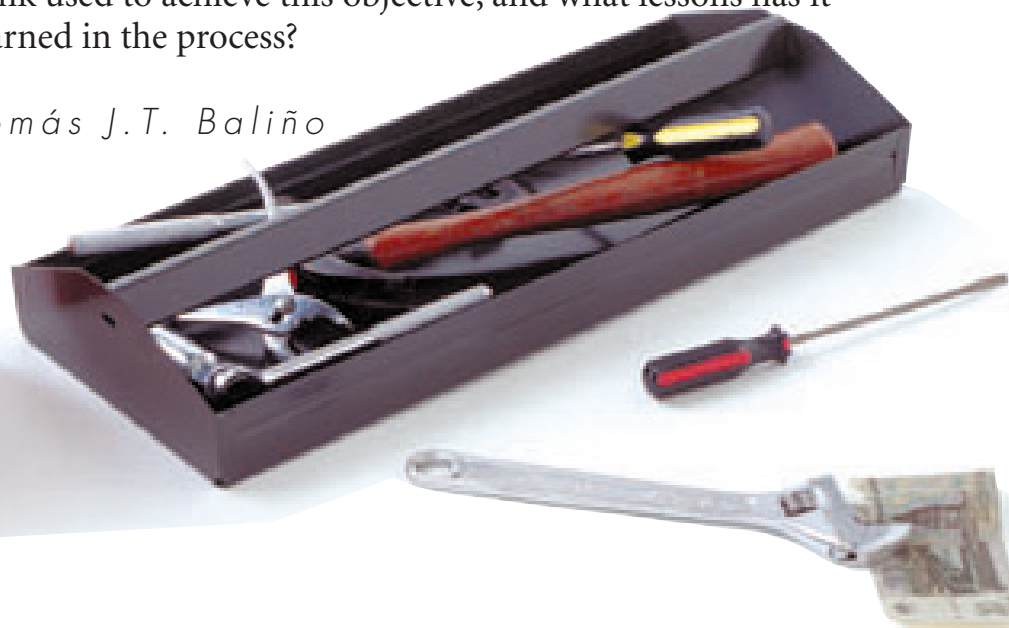


Monetary Policy in Russia

Over the last few years, Russia has succeeded in developing the tools to carry out an effective monetary policy in a market economy. What monetary policy instruments has the central bank used to achieve this objective, and what lessons has it learned in the process?

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RUSSIA became independent at the end of 1991, when the Soviet Union dissolved into 15 states. Thus, it had not only to adapt institutions to new political realities but also to transform a centrally planned economy into a market economy. In the Soviet era, monetary policy simply accommodated the plan's decisions on resource allocation and pricing. In the emerging market economy, however, monetary policy had to be geared toward attaining price stability while allowing the market to play the major role in allocating resources.

Changing the role of monetary policy required a major effort. The public and officials at many levels of government had to be educated about what that role should be in a market economy. Moreover, the monetary institutions (central bank, commercial banks, and monetary instruments) had to be established or adapted at the same time that the economy had to be stabilized and had to adjust to market realities and the collapse of the Soviet state.

The Soviet Union's monetary policy

Monetary policy had two main roles in the Soviet Union: ensuring the fulfillment of the economic plan and controlling households' purchasing power. The economic plan defined how much of each good had to be produced and set its price. It served as the basis for the credit plan, which assigned earmarked credits to each producer. The credit plan flows thus served as a tool to monitor the economic plan's execution. Lending rates were administratively fixed, and investment funds were allocated by the branch ministries. Enterprises paid each other using bank transfers and could use cash only to pay wages and salaries. Their deposit balances could be used only for the purposes specified in the credit plan.

By controlling households' purchasing power, the authorities sought to avoid queues and shortages. Because cash was the only form of payment outside the plan's control, monetary policy focused on targeting the amount of cash in circulation. A cash plan established how much currency the

Gosbank—the controlling institution in the Soviet Union’s banking system—would issue and the sums to be allocated to enterprises to pay wages and salaries. Households could hold liquid funds either in cash or in savings deposits. Interest rates were low and were rarely changed. The government issued bonds sporadically, and the amounts placed were small, owing to their low and uncertain yields and frequent suspension of debt servicing.

The Gosbank issued currency, cleared interenterprise payments, and formulated and executed both the credit and the cash plans. It also financed the budget deficit. Thus, it was a hybrid institution, carrying out functions that in market economies are split between the central bank and commercial banks. In addition, the Soviet banking system comprised the Savings Bank, which mobilized household savings, and several specialized banks. The Gosbank tightly controlled specialized banks, setting ceilings on their credits and providing most of their funding. Soviet financial arrangements also included a foreign exchange plan. The ruble was non-convertible. The exchange rate was set administratively, and a system of subsidies and taxes offset differences between export prices and domestic prices.

Further reforms took place in 1990 and 1991. The Gosbank remained as the central bank of the Soviet Union, to which the central banks of the various republics, including Russia, were made subordinate. However, political developments in 1991 made Russia’s central bank practically independent of the Gosbank; there were now two de facto monetary authorities in Russia.

Monetary policy in the ruble area

Poorly designed monetary arrangements following the collapse of the Soviet Union impeded an effective monetary policy. The Gosbank disappeared, and monetary policy functions were vested in the central banks of the countries in the ruble area. Russia and the other former republics (except the Baltics) agreed to maintain the ruble as their common currency. The Central Bank of Russia became the sole issuer of cash, but all the central banks could grant credit. Those credits increased ruble deposits with the central banks in the area, which could be used for both interregional and intraregional trade. Thus, the central banks, seeking to collect seigniorage and promote economic growth in their jurisdictions, had an incentive to expand credit, while the resulting inflation spilled over to the whole ruble area.

Because payments between ruble area countries were automatically settled, the Central Bank of Russia could not control them. Thus, the rate of growth of the Central Bank of Russia’s credits to other central banks in the ruble area (as a percentage of base money) jumped from 11 percent in the first quarter of 1992 to almost 50 percent in the next quarter at a time when prices were being liberalized. Several attempts to coordinate monetary policy among central banks in the ruble area failed. To deal with this problem, the Russian central bank centralized all interstate transactions in Moscow

and decided to settle them only to the extent that each other country in the ruble area had funds in its bilateral account with Russia. If a country ran a deficit, it had to negotiate a “technical credit” to cover it. As a result, the rate of growth of interstate credits fell sharply between the second quarter of 1992 and the second quarter of 1993.

Fiscal deficits created serious monetary problems, owing to both their magnitude and the lack of public debt instruments, which forced the central bank to finance these deficits. Erratic policies failed to curb them. In the first quarter of 1992, the government tightened up on expenditures,

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lowering both the deficit and its domestic financing. During the rest of the year, however, expenditures rebounded, and so did credit to the government.

Directed credits (those earmarked for specific enterprises or sectors) were another major source of monetary expansion. Credit planning ended in 1991 and, with it, the aggregate ceilings on bank credits. Moreover, during 1992, Russia’s central bank gave priority to restarting economic growth over fighting inflation. In this regard, it organized a clearing of interenterprise arrears, financing the bulk of those that insolvent enterprises were unable to cover when the clearing was finished.

Despite those difficulties, the Central Bank of Russia began developing monetary instruments—directed credits and reserve requirements on ruble deposits. However, these were mostly ineffective initially, chiefly owing to the central bank’s passive monetary stance. Required reserves were blocked for one month in non-interest-bearing accounts with the central bank. In January 1992, the reserve ratios were set at 15 percent for deposits with maturities of less than one year and at 10 percent for all other deposits. However, design shortcomings severely undermined the effectiveness of reserve requirements: an insignificant penalty for shortfalls, banks’ ability to draw down their reserves if they had a fall in deposits, and the rapid growth in foreign exchange deposits made the monetary impact of changes in reserve requirements unreliable.

During the ruble area period, exchange rates were flexible. The Central Bank of Russia began to intervene in the Moscow International Currency Exchange foreign exchange auctions to smooth exchange rate fluctuations and allow the ruble to depreciate gradually.



Russia achieves monetary independence

In July 1993, the problems of the ruble area led Russia to introduce the Russian ruble and demonetize the pre-1993 rubles. This marked the end of the ruble area and the beginning of Russia's full monetary independence. To make monetary policy effective, however, Russia still had to reduce the monetary financing of the government deficit, control refinancing, and develop appropriate monetary instruments.

Financing the deficit. The size and volatility of the fiscal deficit undermined monetary control. In 1993, expenditure cuts reduced the federal deficit from the equivalent of about 10 percent of GDP to 6 percent. As a result, growth in central bank credit to the government fell from almost 25 percent of base money in the last quarter of 1992 to less than 14 percent in the first quarter of 1993 and became negative the next quarter. Higher expenditures and lower tax revenues in the second half of the year, however, increased the deficit and central bank credit to the government. The larger deficit in 1994 required central bank financing equivalent to about two times the stock of base money as of the end of 1993. The central bank reacted, reducing interest subsidies and tightening control over directed credits; nonetheless, its net domestic assets more than quadrupled during 1994.

The government more than halved the deficit in 1995. Moreover, the development of the market for government securities drastically reduced central bank financing of the budget, to the equivalent of 91 percent of base money (as of the end of 1994). While lower tax revenues and higher interest expenditures raised the deficit during 1996, central bank credit to the government expanded by the equivalent of less than 50 percent of base money. In 1997, weaknesses in revenues and in expenditure control raised the fiscal deficit to the equivalent of 8 $\frac{1}{4}$ percent of GDP.

Control over refinancing. The Russian authorities tightened access and conditions regarding directed credits. As of mid-1993, the interagency Commission on Credit Policy received the mandate to authorize all credit allocations of the central bank and to set and monitor quarterly credit ceilings. It moderated growth in directed credits, which were discontinued as of late 1994.

The Central Bank of Russia also made all its lending more expensive by making the interbank lending rate the basis for its lending rates. This encouraged banks to rely on the central bank only as a lender of last resort, thus virtually eliminating their overdrafts with the central bank.

Development of monetary instruments. The disappearance of the ruble area, tighter control over the monetary financing of the fiscal deficit, and the elimination of directed credits

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made it possible for the Central Bank of Russia to implement monetary policy with indirect instruments and, in particular, those that are market based. (For a discussion of indirect monetary instruments, see Alexander, Baliño, and Enoch, 1995.) The introduction of credit auctions in February 1994 was a significant step in that direction. Since the central bank set a minimum rate for the auctions that exceeded interbank lending rates, however, take-up was limited to banks that had little or no access to interbank loans. Consequently, the credit auctions were gradually abandoned, and in early 1996 the central bank introduced two Lombard facilities (which provided short-term credit, collateralized with government

securities, to banks): one in the form of an auction and the other in the form of a standing facility at a fixed (nonpenal) rate. These facilities had limited success. Demand at the Lombard auctions was weak because of the high floor interest rate the central bank had set. The Lombard standing facility failed to meet banks' emergency credit needs. Banks did not know whether they needed an overnight credit until late in the day, but transferring the collateral required to borrow under the facility took at least one day. In 1996, to deal with this problem, the central bank allowed bank primary dealers to get uncollateralized overnight credit at a penal rate.

In 1995, the central bank added monetary instruments to mop up liquidity promptly at its initiative. It began to sell more treasury bills than were necessary to meet the treasury's financing needs. However, to have an instrument fully under its control, the central bank introduced deposit auctions: banks would offer to deposit funds with the central bank, each indicating the interest rate it wished to receive. Initially, though, the central bank set the rate in advance. This type of auction met with little success and was discontinued in late 1995. In 1996, the central bank changed the arrangements. It now monitors interbank market rates, and if they fall below the level it deems desirable, it offers overnight deposits to selected banks.

Although the market for treasury bills—issued by the ministry of finance through the Central Bank of Russia—has not been fully used for monetary operations, it has enjoyed remarkable growth. An active secondary market in treasury bills developed over time. The central bank intervened in the market, chiefly to avoid volatility in yields. In late 1996, it started repurchase operations (using treasury bills), which it subsequently carried out twice a day.

In addition to developing market-based instruments, the central bank continued to use changes in reserve requirements as a major monetary policy tool. It also improved the way these requirements were computed. In particular, it extended them to foreign exchange deposits and defined the deposit

base as an average of daily balances. Since required reserves have been unremunerated in Russia, extending requirements to foreign currency deposits reduced the latter's attractiveness. Averaging reduces the scope for window-dressing operations. The central bank also got the authority to transfer deposits from a bank's correspondent account, if necessary, to meet reserve shortfalls. Moreover, to be eligible to use 5 percent of their reserve holdings temporarily, banks had to have fully complied with the reserve requirement over the preceding six months. These measures sharply improved compliance with reserve requirements beginning in 1996.

Instrument coordination. Shortly after the demise of the ruble area, the central bank introduced a monetary programming framework to set monetary policy goals, monitor execution, and coordinate its monetary instruments to ensure attainment of those goals. Taking into account the effects of various factors outside the direct control of the central bank, the exercise has allowed the central bank to project how much base money it has had to inject or absorb to reach its goals.

The central bank has monitored the program's implementation through a five-day liquidity management framework, introduced in 1995. It also reviews other information, such as treasury-bill yields, interbank interest rates, and exchange rate movements. This monitoring allows the central bank to determine the combination of instruments it needs to use to achieve the desired monetary stance.

Exchange rate policy. Since the ruble area was abandoned, the Central Bank of Russia has intervened regularly to prevent sharp fluctuations in the exchange rate. In 1993, large capital inflows led to heavy intervention in order to prevent a major nominal appreciation of the ruble. That intervention fueled monetary growth, however, and inflation accelerated.

In 1994, concerns about the expansionary fiscal policy led the public to shift its funds out of ruble-denominated assets. A foreign exchange crisis took place in October, leading to a sharp depreciation of the ruble and a jump in inflation in the corresponding quarter.

The 1994 crisis led to tighter fiscal and credit policies, and central bank purchases of foreign exchange became the main source of monetary growth in 1995. To stabilize exchange rate expectations, the central bank introduced an exchange rate band in July 1995. The band's shape was changed one year later to allow for a gradual depreciation of the ruble. The rate of exchange rate depreciation slowed steadily, from 23.5 percent in 1995, to 16.5 percent in 1996, and to only 6.7 percent in 1997.

Recent developments

In 1998, disappointing revenues and the absence of corrective measures led to fiscal imbalances that became difficult to



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finance in a context of international financial turmoil. In August, the authorities took drastic measures, which included a widening of the exchange rate band, a moratorium on repayment of foreign debt, a restructuring of domestic government debt, and a prohibition on foreigners investing in ruble-denominated treasury bills. While these measures are outside the scope of the issues discussed in this article, they have shown once again that fiscal disequilibria can make it impossible to preserve macroeconomic stability, even if monetary policy remains appropriately tight. In addition, the disruption to Russia's market for government paper will seriously jeopardize the future of such paper, both for government financing and for monetary policy.

Conclusion

Russia made striking progress in developing a range of monetary instruments appropriate for a market economy, in the face of severe difficulties: the disintegration of the Soviet Union, the transformation from a centrally planned economy to a market-oriented one, pressures to use credit policy as an engine of growth, and the ill-fated attempt to maintain a poorly designed ruble area. In addition, inadequate legal arrangements, lack of experience with the workings of a market economy, and a payment system ill-suited to a market economy further complicated the central bank's task.

Monetary instruments in Russia have evolved through a process of trial and error. Little could be achieved while the main objectives assigned to the central bank's credit policy were financing a large fiscal deficit and providing subsidized credits to certain sectors and enterprises. Bringing those elements under control—an objective largely achieved after the foreign exchange crisis of late 1994—was a key element in allowing the central bank to move forward by developing a market-oriented approach to monetary policy implementation. This approach involved development of a set of indirect monetary instruments: open market operations, a Lombard facility, deposit auctions, and reserve requirements. There have been important institutional achievements. Unfortunately, the sharp deterioration in the macroeconomic environment and the measures taken in August 1998 have resulted in major setbacks, illustrating once more the close interrelationship between structural reforms and macroeconomic stability. **F&D**

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Reference:

William E. Alexander, Tomás J.T. Baliño, and Charles Enoch, 1995, The Adoption of Indirect Instruments of Monetary Policy, IMF Occasional Paper 126 (Washington: International Monetary Fund).