

# Monetary Policy in Russia: Recent Challenges and Changes in Unstable Economic Conditions<sup>\*</sup>

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**Abstract.** The purpose of the article is to identify actual condition and recent changes in monetary policy of the Bank of Russia. The article considers the main directions of the monetary policy of the Bank of Russia, especially in correspondence with Russia's deep political and economic problems. The author underlines negative aspects of the Bank of Russia's monetary policy that took place in 2014. The attention is focused on consequences of inflation targeting policy influence on the economy, and on the use of monetary control instruments at the level of bank lending, rates of economic growth, etc. The research conducted by the author is based on dynamics of macroeconomic indicators. The author makes the conclusion that there is a change of the Bank of Russia's monetary policy paradigm, which tends to correspond with the purposes of economic growth. The author also offers possible directions of improving Russia's monetary policy, including double-purpose, which, in the author's opinion, is of paramount importance at the present stage of Russia's economy development under the conditions of economic and political instability, crisis and shocks.

**Аннотация.** Целью проведенного исследования явилось выявление изменений в денежно-кредитном регулировании Банком России, произошедших в последнее время. В статье рассмотрены основные направления денежно-кредитной политики Банка России, проводимой им на современном этапе развития российской экономики, а именно в условиях глубоких экономических и политических проблем. Автором выделены негативные аспекты проводимой в последние годы Банком России политики, акцентировано внимание на последствиях влияния политики по инфляционному таргетированию на состояние российской экономики, исследовано влияние инструментов денежно-кредитного регулирования на уровень банковского кредитования субъектов экономики, темпы экономического роста. По результатам проведенного автором исследования на основании динамики макроэкономических показателей в статье сделан вывод о смене парадигмы денежно-кредитного регулирования, корреспондирующего с целями достижения экономического роста. Автором предложены возможные направления совершенствования денежно-кредитной политики в России, в частности, осуществление бицелевой политики.

**Key words:** Central bank, economic growth, monetary policy, key rate, refinancing system, inflation, bank loan.

## 1. INTRODUCTION

In this day and age, major economies place special emphasis on monetary policy and its target-oriented constituent (for example, the United States, China, the United Kingdom, Japan, Switzerland, etc.)

In view of the pressure on Russian economy, monetary policy may currently become real mean of influencing the rates of economic growth.

Monetary policy has been traditionally one of the most important tools of governmental influence on economic life. Issues associated with the

theory and practice of state monetary policy were reflected in works by many authors. Among Russian economists, the following can be mentioned: M. A. Abramova, S. R. Moiseyev, A. V. Ulyukayev, A. J. Simanovsky. In foreign countries, the specific issues of monetary policy were worked out at different times by W. Allen, S. L. Brue, C. R. McConnell, F. Mishkin, N. Mogud, S. Reinhart, G. Sather, W. Smith, J. I. Harris, D. L. Hicks, G. Hogarth, J. Schumpeter, etc.

Some important aspects of monetary policy, in particular, for example, flexibility in the conditions

<sup>\*</sup> Денежно-кредитная политика в России: текущие проблемы и изменения в условиях экономической неопределенности.

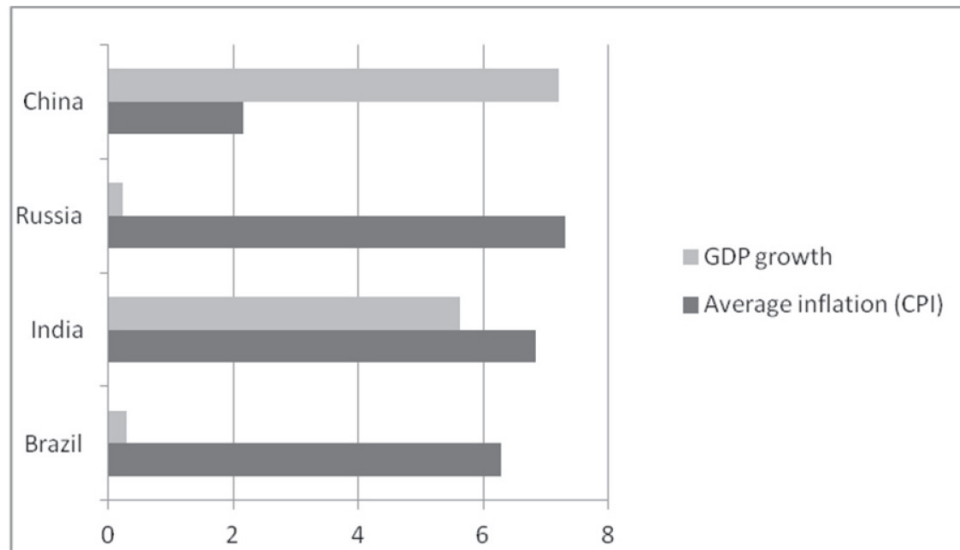


Figure 1. Values of GDP growth and inflation at year-end 2014.

of unstable economy and financial crisis, are underrepresented in the available publications.

Despite the analysis of mainly Russian experience in terms of the impact of monetary policy on economic growth, the present research may be interesting for other economies belonging to the group of emerging markets.

## 2. THEORETICAL PRINCIPLES OF THE BANK OF RUSSIA'S MONETARY POLICY

Economic growth, price stability and high employment rate are usually distinguished as basic and long-run objectives of monetary policy. Unfortunately, despite the critical condition of domestic economy, the main target of Russia's monetary policy is inflation, so Russia's monetary policy is still pursued by the Bank of Russia as a tool for restricting rather than facilitating economic growth.<sup>1</sup> The steps made by the Bank of Russia during exchange market crisis in November and December of 2014, confirm this point once again. In accordance with the applicable legislation, i.e. the federal law "Main directions of governmental monetary policies for 2015 and for the period of 2016 to 2017", the main purpose of Russia's monetary policy consists of "...protecting and ensuring ruble sustainability by reaching and maintaining low inflation rate" It is an interesting fact that in the same document for the last three-year period of 2014 to 2016 the main purpose of monetary policy was "...protecting and ensuring ruble sustainability by maintaining price stability, in particular, for creat-

ing conditions of balanced and sustainable economic growth...".

Thus, among the variants of target-oriented goals for monetary management, the Bank of Russia chose to maintain price stability, which was called the Inflation Targeting. Moreover, recently the Bank of Russia has excluded economic growth from monetary policy targets. As a result, we can see negative tendency in Central Bank's understanding of monetary policy.

## 3. CURRENT CONDITION OF THE RUSSIAN ECONOMY

Currently, Russia's economy is in diseased state. The comparison of rates of economic growth and inflation in a number of countries shows negative tendencies in the development of Russian economy (Fig. 1).

The World Bank predicts that GDP growth in Russia will be at the rate of -2.9% at year-end 2015, inflation would be between 13 to 15%.

During financial and economic crisis of 2008 to 2010, the drop-down of Russia's GDP was very noticeable. The dynamics of changes in these indices for the period between 2000 and 2014 shows considerable deviations and sharp drop-downs point at the instability of Russian economy compared to other countries (see Figure 2).

Similar situation is observed when analyzing the dynamics of changes in inflation rate for the period under consideration (Fig. 3).

The disproportion between the amount of money in Russia and the size of the market still exists and is the factor of inflation. The reasons for

<sup>1</sup> In general, that corresponds to the Inflation Targeting policy.

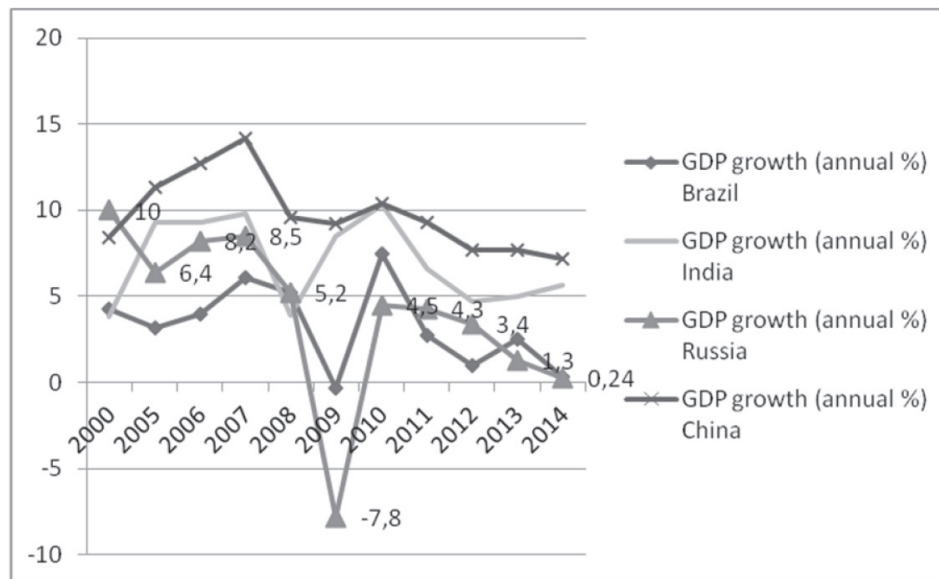


Figure 2. GDP growth rate for the period between 2000 and 2014.

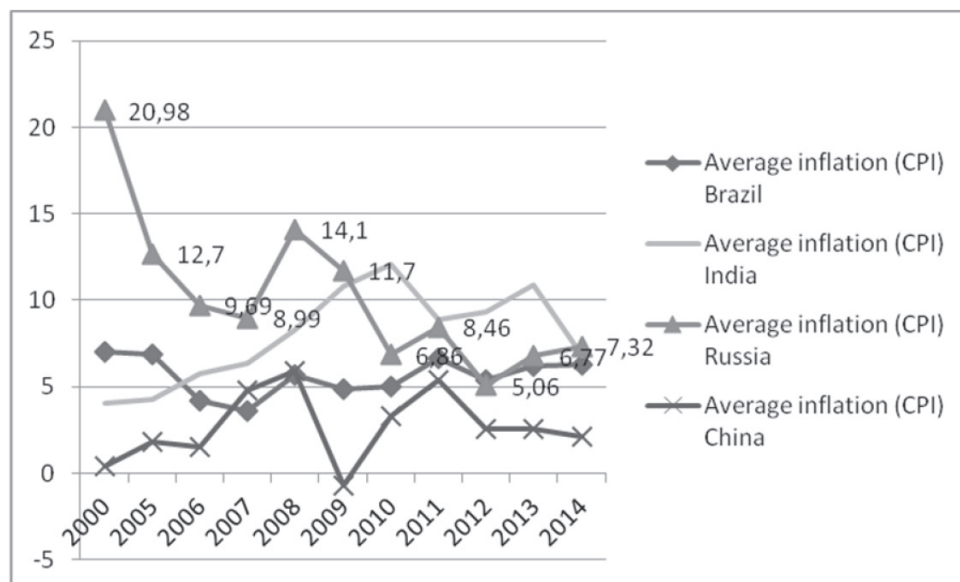


Figure 3. Inflation rate for the period between 2000 and 2014.

this can be found in the unbalanced money supply, which has been increasing over the past decade due to continuously increasing government spending<sup>2</sup> (during the active phase of the crisis in 2008 to 2009, budget expenditures have increased by 23% and 15%, respectively), and export earnings from the sales of resources, along with the reduction of real domestic production (production of consumer goods and import in 2009 have decreased more than 1.5 fold). As a result, the

<sup>2</sup> The increase in government spending in time of crisis in economy on its own is a justified and appropriate measure, provided, however, the funds are directed precisely to economy in order to ensure the normal course of the reproduction process of the real sector of the economy, and to maintain the business activity of economies.

amount of money in circulation has significantly exceeded the need for it in the existing turnover of goods and services.

The excess in money supply is distributed unevenly among economic entities. As a result, the real economy industries are experiencing the serious deficiency of resources, along with their general excess in the country, and, with the existing level of interest rate, are not able to act as borrowers.

According to the estimates given by a number of economists, stagnation, even recession has already begun in the country. Without doubt, external factors (geopolitical risks)<sup>3</sup> make a significant impact

<sup>3</sup> China successfully coped with economic sanctions applied to it at

on current situation. However, it is not just them, it is the problems accumulated within the country. The Russian government has been turning a blind eye to these problems a long while, just stating them as facts.

The main problem lies in the structural imbalance of Russian economy, its high dependence on energy source exports and, respectively, on currency incomes, and lack of the country's own internal industries in major sectors.

The energy prices that have been increasing over nearly 15 years allowed to successfully finance all expenditures of national budget (over half of which is formed based on oil and gas transfers), to maintain acceptable rates of economic growth, and to increase salaries for the population, despite the fact that the economy was not developing *de facto*.

However, the situation in Russia has changed dramatically. What do we see?

- Political and economical sanctions;
- High interest rates in the market;
- The reduction of oil prices, and other energy resources, subsequently: since the beginning of 2014, oil prices have been decreased by more than 50%;
- Ruble devaluation: since the beginning of the year, by over 50%;
- Significant capital outflow;
- The slowdown of Russian stock market: since the beginning of the year, the RTS-index has decreased by over 40%. The most significant decrease — 40% — occurred in machine-building industry.

Performance indices of Russia's economy are going down: the drop-down of labor productivity index compared to the maximum of 2006 is 4%. As a result:

- Increase of inflation;
- Decrease in the purchasing power of national currency and at the same time in real disposable money income of citizens;
- Growth rate reduction in the economy.

According to the estimates of the Ministry of Finance of the Russian Federation, Russia's losses caused by these factors are more than 300 bln USD.

Unless we move away from the dependence on energy source exports and, respectively, on currency incomings, the amounts of which can be significantly influenced by external operators, we will not have a chance for fundamental improvements in Russian economy.

It is necessary to develop internal market, which requires investments. Until recently, such resources have been actively attracted from foreign markets (the consequences of such tactics are described above). Currently, in the changed political and economic situation, resources for financing the investments need to be generated internally within the country, not in external markets. However, due to current monetary policy, finding the opportunity for such financing does not seem possible.

#### 4. ROLE OF BANKS IN ENSURING ECONOMIC GROWTH

The role of banking sector in ensuring economic growth is to transform the temporarily free funds of various economic entities, including short-term funds, into long-term capital, which in turn is the source of investments in the real sector of economy. At the same time, by loan granting and the possibility to participate in stock market as investors, credit institutions create the channels for floating temporarily free funds to the businesses, which are in need of investments for the purpose of modernization, as well as overcoming the consequences of crisis.

Investments are exactly the main driving mechanism of the economy. Thus, the role of banking sector in ensuring economic growth is to accumulate funds from various entities and transform them into investments.

Global practice shows that banking sector actively copes with the above role. For example, according to various estimates, the contribution of European banks to economic development is 250 to 500% of GDP. In the source-based structure of investment financing, the share of bank loans in the USA is 32.5%, in China — 15%, in Germany — 41.8%.

A reverse trend is typical of Russia (Fig.4).

According to the Federal State Statistics Service, Russia's current investment financing is carried out mainly due to internal sources of business entities and their parent companies — 58%; on bank loans there is only 10%.

The ratio of banking sector assets to GDP as of 2015 is 109.4%. It is noteworthy that assets exceed twofold the value of consolidated national budget. Loans (excluding loans granted to financial institutions and population) make 41.6% of GDP. However, only about 3% of credit resources are allocated to investment financing, which is manifold lower than in other countries. Within the structure

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the end of 1990's. Moreover, since the beginning of 2000-s, growth rates in China have been at the level of 8%.

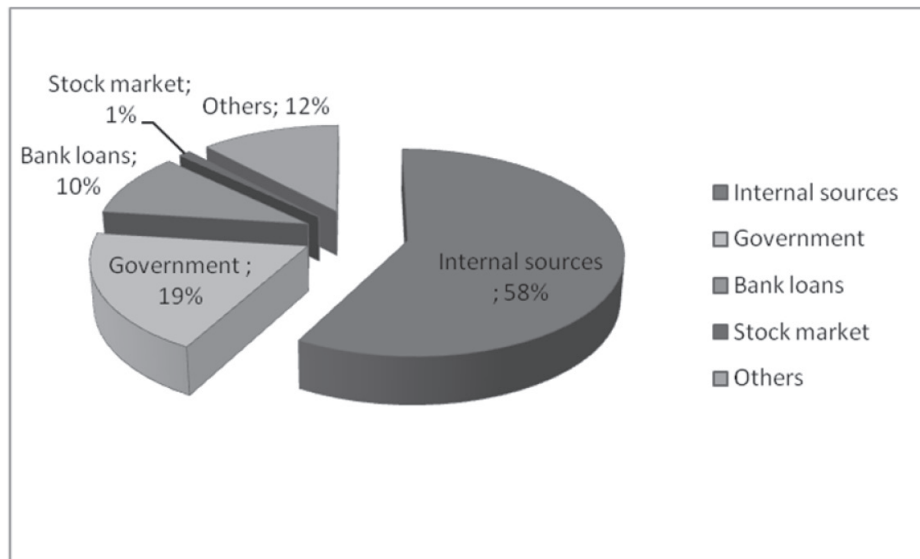


Figure 4. The structure of Russia's current investment financing in 2014.

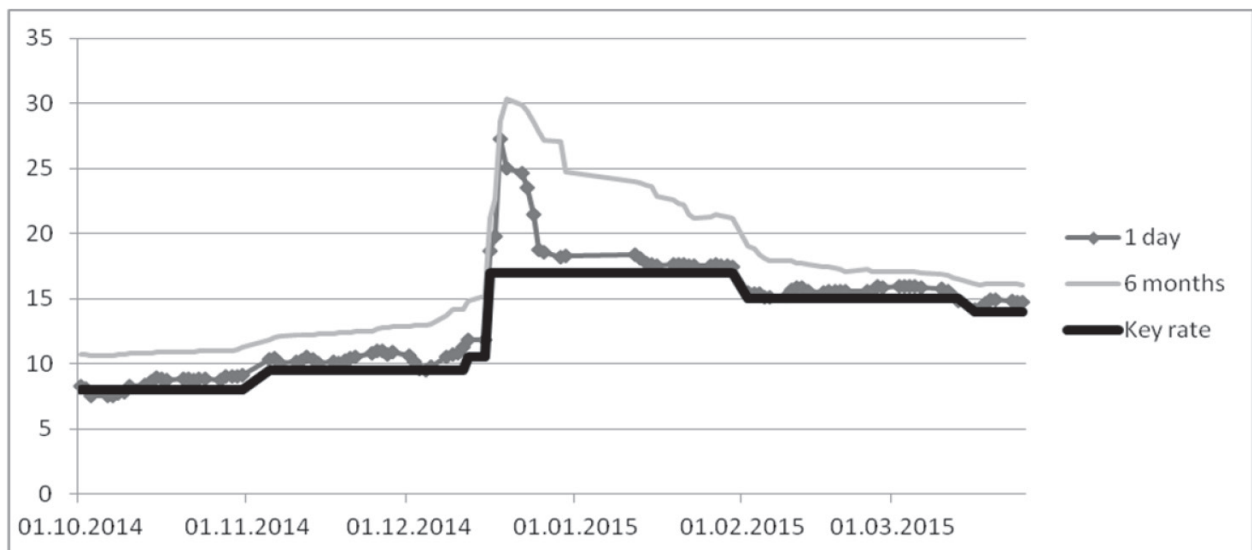


Figure 5. Dynamics of the change in interest rates on interbank market (MosPrime Rate), %.

of corporate loans granted by banks, only 1.5% is used in machine-building industry. The share of bank loans to investments in fixed assets of entities makes only 1.5% against GDP. At that, Russia's GDP value is considerably lower than that of the world's major economies.

During the economic forum held in St. Petersburg in 2014, president Vladimir Putin specified that "...Russia needs real technological revolution..." To implement these large-scale modernization activities, enormous resources are required. In this regard, major hopes are traditionally laid on banking sector and loans. In such circumstances, Russian banking sector has often been criticized for its inability to fulfill its most important purpose – to meet the financial needs of the economy, thus restraining economic growth.

It is important to note that the inflation targeting policy, provided by the Bank of Russia, implies reducing of monetary stock in the economy, and tightening of credit conditions through higher interest rates. Thus, during 2014, key rate in Russia was increased six times from 5.5% to 17%. On December 16, unprecedented rate increase by 6.5% at a time happened. Such serious increase has not happened in Russia since 1998. Despite the fact that such a significant increase in key interest rates was due to the need to stabilize the situation on Russia's currency market and reduce the speculative appetites of major players, this tool is primarily used for monetary management, and therefore, its influence extends far beyond foreign exchange market.

The increase in key interest rates led to the increase in market borrowing rates, first for credit

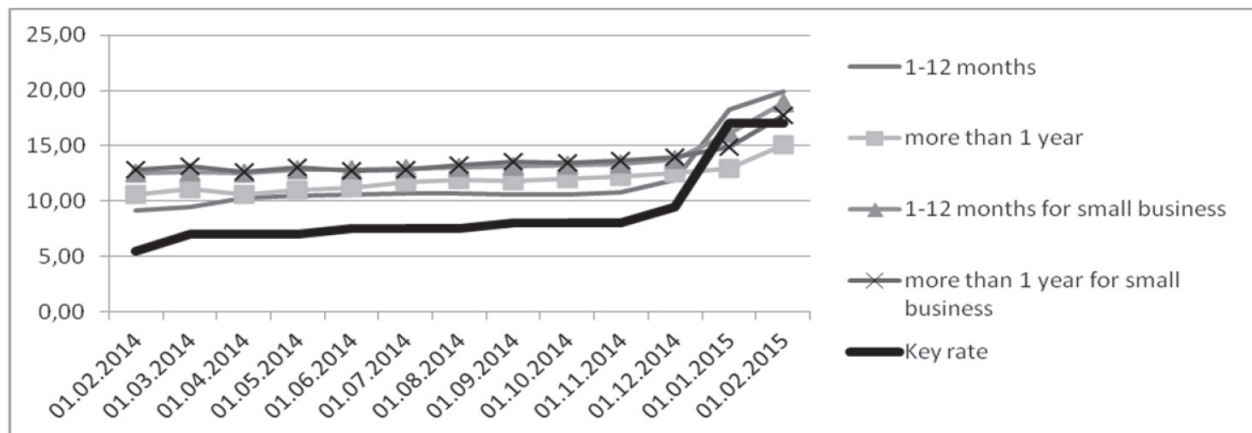


Figure 6. Dynamics of the change in loan rates for business, %.

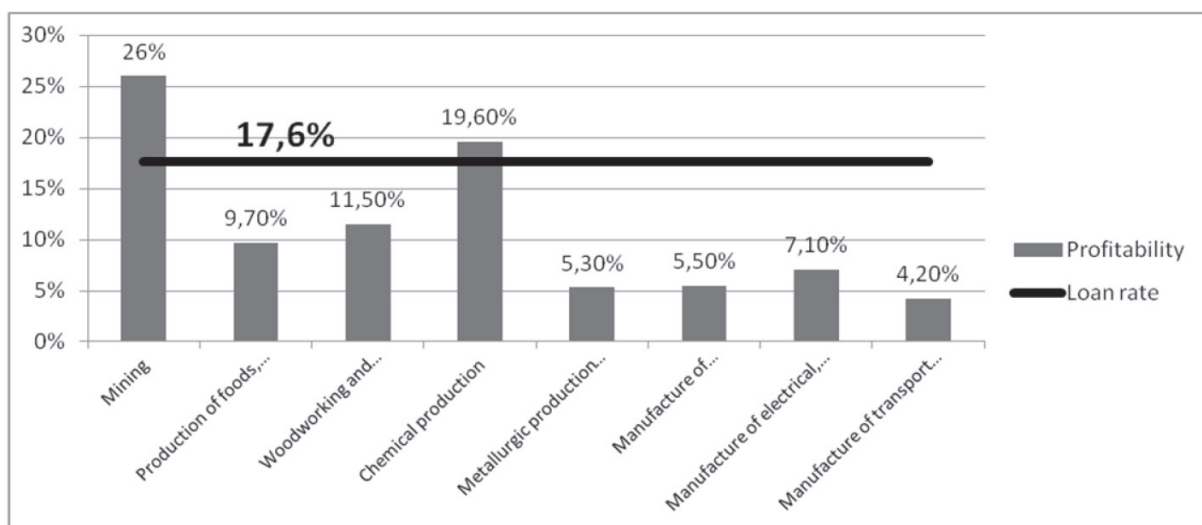


Figure 7. Sales profitability level in key sectors of Russian economy in 2014.

institutions through interbank market (in December, 2014 MosPrime Rate grew to 30% per annum, see Figure 5), as well as deposits, and then, for end consumers including businesses (Fig. 6).

The strong relation of interbank and loan rates dynamics to changes in key rate is obvious. The increased borrowing costs will be added to the prime costs of products by manufacturers, and therefore, it will lead to the increase in costs with regard to financial resources, as well as goods and services. At the same time, such panic-like increase in interest rates will lead to increase in inflation expectations. Thus, instead of constraining inflation and stabilizing prices, further ruble devaluation and strengthening of inflation expectations will take place, which will ultimately lead to even more dramatic inflation growth.

The second dramatic effect of high market rates is that effective demand is also lacking on the part

of business entities for credit resources necessary to make investments. According to statistics of the Central Bank of Russia the average loan rate for business is between 17 to 20%. In fact, it reaches 25–30%. With the profitability of sales in general in the Russian economy at the level of 7% such high interest rates are back-breaking and inexpedient (see Fig. 7).

Appreciation grown rates and decrease in resources volume have obviously affected the size of lending to the economy. Thus, analyzing the total volume of lending to resident legal entities and individual entrepreneurs (in RUR), including the industries related to manufacturing, descending trend with a negative outlook for further development has been identified (see Figure 8).

In these circumstances, due to the lack of any specific measures of government support to subsidize interest rates of investment loans for busi-

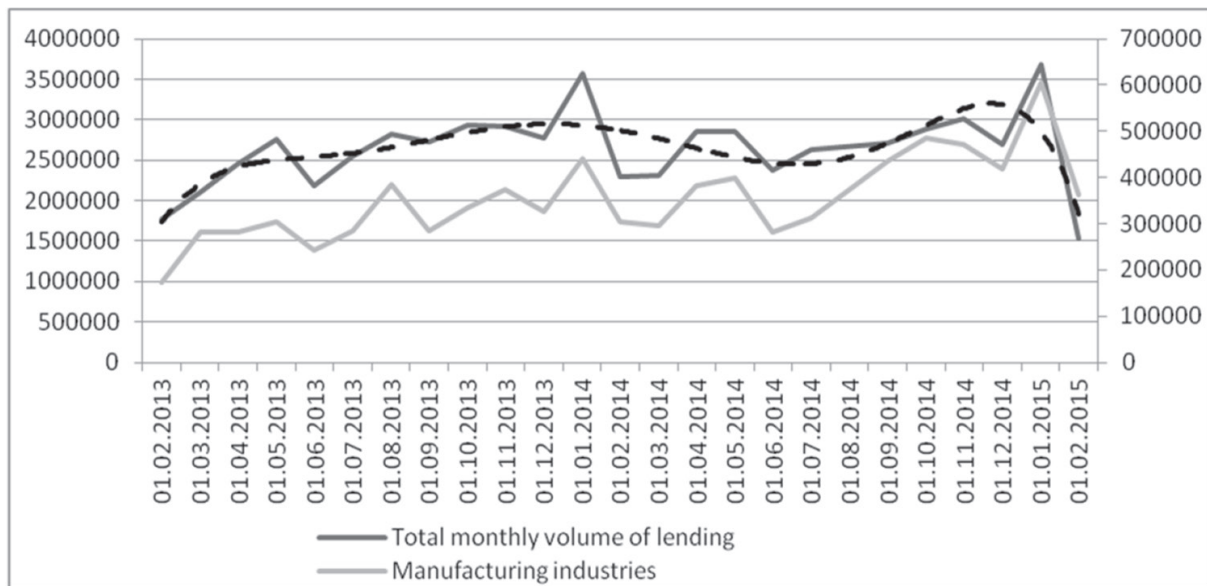


Figure 8. Monthly volume of lending to legal entities and individual entrepreneurs, mln.RUR

ness entities in key sectors of economy, economic growth becomes totally impossible.

## 5. REFINANCING SYSTEM

Apart from direct impact on interest rates on the market (through key interest rate), the Bank of Russia also can actively apply tools for refinancing credit institutions. Refinancing is of dual nature. On the one hand, it is an efficient measure to regulate the liquidity in banking sector, and, on the other hand, it is an effective tool of monetary management.

The two key factors influencing the scope of refinancing are as follows: the demand on the part of credit institutions themselves, which may be at the same time artificially limited by high interest rates, and the offering of funds by the Bank of Russia.

As a tool of monetary policy, the scope of crediting by the Bank of Russia as to credit institutions is of paramount importance, since the scope of crediting various economic entities by commercial banks depends, to a greater degree, just on this index through banking multiplication. The introduction of money into economic circulation through crediting mechanism contributes to the performance of money-specific functions, the expansion of production and of the ensuring of economic growth.

However, in accordance with inflation targeting policy, it is the monetary growth ensured by way of increasing crediting scope that is one of the main inflation factors to fight against.

Taking into consideration that the reduction of the scope of crediting by the Bank of Russia for credit institutions can lead to serious difficulties with liquidity in banking sector and to banking crisis, the Bank of Russia makes an impact on this market by regulating interest rates (see above – increasing key interest rate).

In our opinion, this policy, as well as the negative perception of credit in the specified context, cut down its positive role as the source of investments and the catalyst of economic development.

Refinancing of credit institutions is mainly performed in two ways – direct lending and repo transactions.

Figure 9 shows the dynamics of changes in credit institutions' indebtedness to the Bank of Russia in repo transactions.

The data shows that in 2012 the volume of indebtedness was increasing steadily, despite some fluctuations. This was due to liquidity problems in banking sector, the increasing needs of the banks in cash (as evidenced by the rising trend line). As of December 1, 2014, the volume of credit institutions' indebtedness to the Bank of Russia in repo transactions has exceeded 3.3 trillion RUR. Similar situation is observed in studying the volume of direct lending to credit institutions by the Bank of Russia (see Fig. 10): significant volumes – 3.1 trillion RUR as of December 01, 2014, and sharp increase in indebtedness since the second half of 2013.

However, the existing refinancing volumes are aimed just at ensuring the liquidity of banking sector, and are allocated by banks primarily to cover

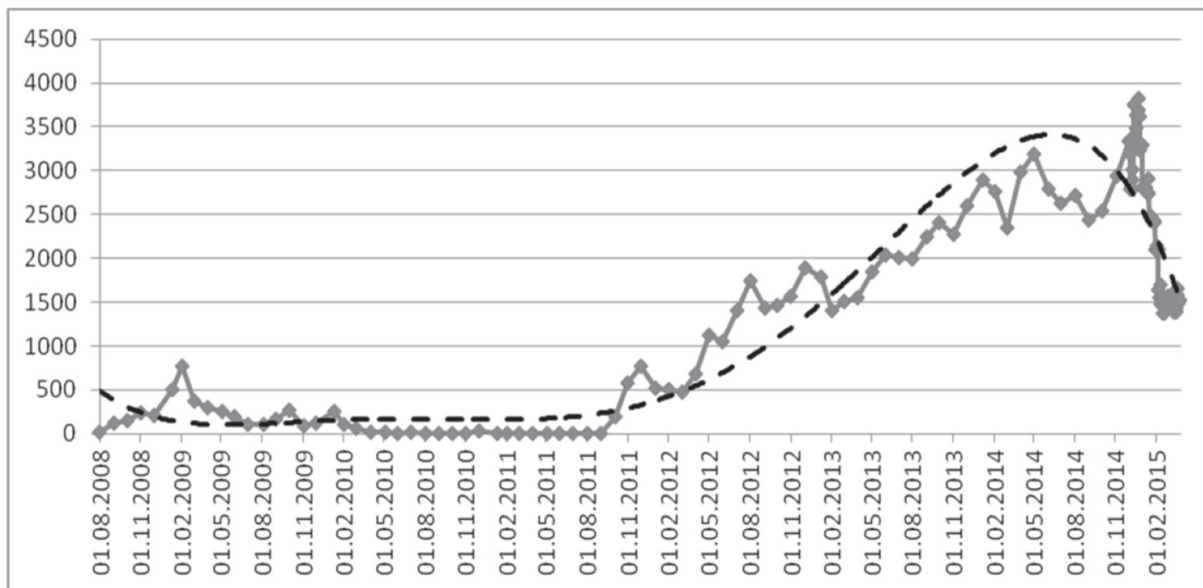


Figure 9. Indebtedness of credit institutions to the Bank of Russia in repo transactions (mln. RUR).

their current liabilities, and do not allow to use the banking multiplier effect in full directing resources for lending to the economy.

## 6. POSITIVE TRENDS

Despite the increasing volumes of credits attracted by the banks from the Bank of Russia, the indicators characterizing money supply had the reverse dynamics in 2014. According to the Bank of Russia, during the first three quarters of 2014, the money supply (M2) has decreased by 4%, amounting to 30.3 trillion RUR. But in the fourth quarter of 2014 and in the beginning of the year 2015 the trend changed its direction. M2 reached its peak in December and amounted 32.1 trillion RUR. Once again, it's worth mentioning that it is a positive sign because the increase in money supply can lead to increase in amount of banking loans in the nearest future (see Fig. 10).

The other positive trend is that key rate was reduced two times: from its highest level of 17% to 15% in February and then to 14% in March. According to Bloomberg forecast to the end of the year 2015 Russian key rate may be reduced to 11%.

The total increase of amount of net liquidity, given by the Central Bank to banking sector, in January-March, 2015, up to 6 trillion RUR also tells us about refusing from hard restrict policy.

## 7. GLOBAL PRACTICE

The practice of implementing the policies of long-term money expansion in the economy and long

financial resources emissions by national regulators in developed countries is quite interesting. We know a lot about the role of money in the monetary transmission mechanism during periods of quantitative easing.

Unfortunately, the Bank of Russia has been acting in the reverse way. As to refinancing instruments, short-term and super-short-term instruments were primary applied.

During the post-crisis period, there appeared a worldwide tendency of attracting the interest of entities, including commercial banks, to invest in internal economy, also known as *home bias*. For example, the standards making financial investments abroad less attractive for banks were applied in Switzerland.

In order to provide access for the real sector enterprises to bank loans, the Swedish National Bank has introduced the world's first negative rate on deposits of commercial banks at the central bank equal to minus 0.25%, and the base repo rate was reduced from 0.5% to 0.25%. This extraordinary measure of the Central Bank of Sweden was aimed at stimulating the real economy crediting by banking sector.

The British government, together with the Bank of England, has launched a program of lending to banks at interest rates lower than in the market, providing the latter allocate resources for lending to non-financial sectors of the economy, i. e. to the real sector — Funding for Lending, FLS. This program was not aimed just at stimulating lending, and it consisted of several stages: at the first



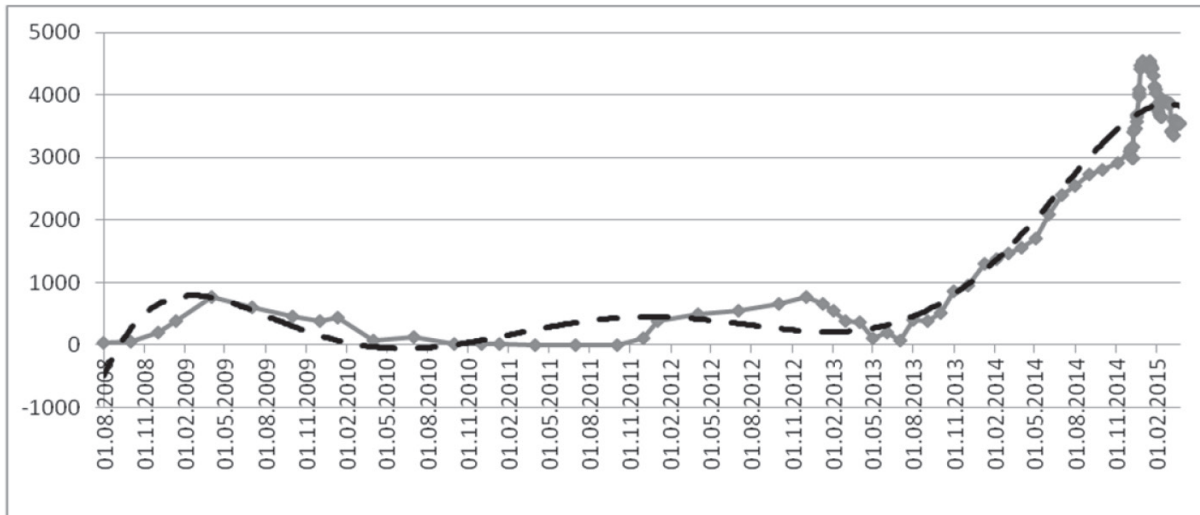


Figure 10. Indebtedness of credit institutions to the Bank of Russia on secured loans (bln. RUR.)

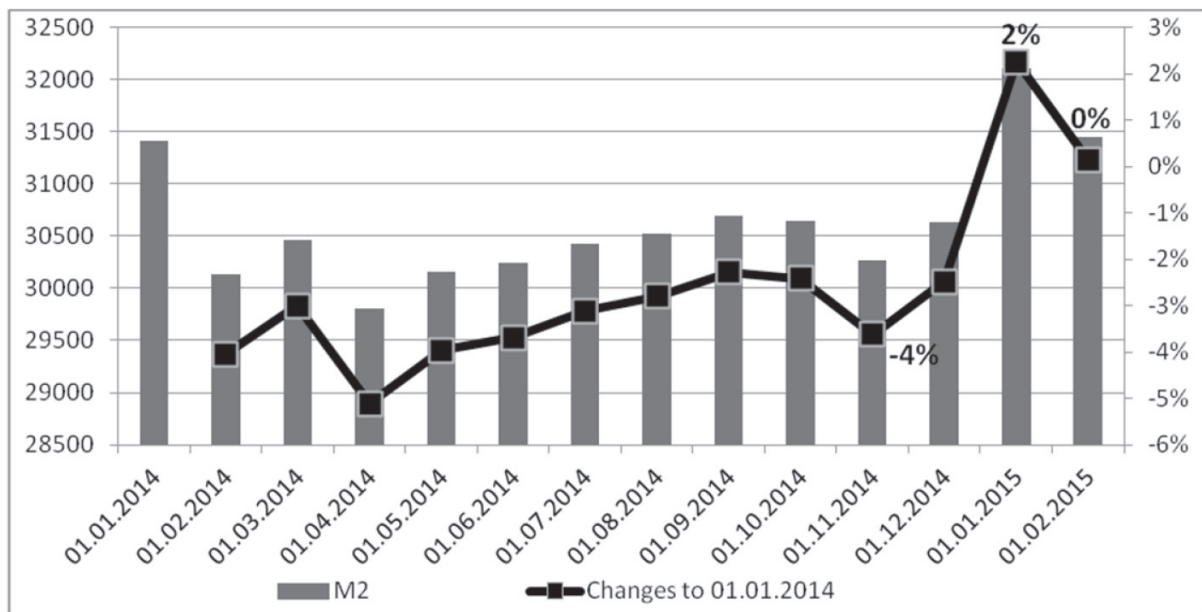


Figure 11. Dynamics of the change in M2.

stage, banks could receive only 5% of the total volume of their loan portfolio, at the second stage, 100% of the newly provided loans to the real sector from the moment of the receipt of the first loan until the end of 2013. Herewith, banks were obtaining loans at 0.25% per annum, provided the loan volume at least was not reduced. In case the loan portfolio volume was reduced, for example by 5% or more, the rate would increase to a maximum level of 1.5%<sup>4</sup>. Not only large UK banks, such as HSBC, Royal Bank of Scotland Group PLC, and

Lloyds Banking Group PLC, have taken part in the implementation of this scheme, as it was designed to encourage lending interaction between banking and real sectors of economy by providing cheap central financing in the limited resources conditions, but also the European Central Bank. It decided to launch a similar program Longer-Term Refinancing Operations (LTRO), with the only difference that the access to the preferential terms would be provided to those banks that would agree to lend to the real sector of the economy, and provide shorter crediting period (4 years for FLS, and 3, 6, 9, and 12 months for LTRO)<sup>4</sup>. Thus, the rate shall vary, depending on the dynamics of the

<sup>4</sup> British banks received 60 bln GBP within the framework of Funding for Lending.

loan portfolio: the initial rate is 0.25%, and, in case of reduction of the loan portfolio by 1%, the rate shall be increased by 0.25% to the maximum level of 1.5%. It is believed that the new technology of bank lending will allow for the expansion of volumes and accessibility of lending for the real sector enterprises by providing cheap central financing. The majority of UK banks have joined the implementation of this scheme.

## 8. CONCLUSIONS

It should be mentioned that unfortunately, nowadays the Russian monetary policy acts as a negative factor of economic growth. Despite some positive changes that took place recently the objective to promote economic growth is not reached *de facto*. Along with the rising inflation, the interest rates are too high, resources are growing in price, money supply and volumes of lending to the real sector are decreasing, the size of the latter is being reduced, and, as a consequence, there is absence of the so much-needed economic growth, which is particularly complicated due to the geopolitical and international economic situation.

However, in Russia, inflation is of non-monetary nature, and, therefore, the struggle against it by implementing austerity measures does not lead to the desired result, as the current situation proves. Moreover, in current economic situation, the inflation targeting includes more threats than benefits, leading to financial instability, the negative effects of which will ultimately affect entrepreneurs. The latter aggravates business situation more and puts pressure on economic growth. In our opinion, at current stage, it would be reasonable to shift the focus of the monetary regulatory approach from inflation targeting to ensuring economic growth.

The nature of inflation is too complicated and ambiguous. Struggle against it by exclusively fiscal measures leads to mainly negative results, such as the decrease in production, the decline in GDP growth, along with the increasing inflation rate.

That's not the amount of money we need to fight against, but the weakness of Russian economy, and serious structural imbalances, as those are the reasons for "invincible" inflation. Consequently, the aim is to ensure economic growth, to allocate resources specifically for these purposes. The fight against inflation will only exacerbate the existing problems (namely, the enterprises of the real sector of the economy suffer from the in-

creasing interest rates and the reduction of financial resources supply in the first place), will lead to greater economic recession, and further spiral increase of inflation.

There are historical examples of focusing monetary policy on more than one key goal (which is considered to be a traditional option for monetary paradigm development). For example, the USA and China have effectively applied the bi-purpose system within different time periods.

For the purpose of economic recovery and acceptable growth rates within monetary regulation, it is required, in the first place, to focus on refinancing mechanism, to affect its scope and interest rates level correlated with the needs of the economy. Particularly, these tools are major levers in advanced countries, and they allow to seriously affect financial markets, as well as national economy as a whole.

In our opinion, the Bank of Russia has to revise the fundamental directions of national monetary policy towards ensuring economic growth in the country, in the first place. It is also necessary to pay attention to the best international practice and adopt its positive aspects, in particular, to develop long-term lending to commercial banks for the purpose of providing investment credit resources to the enterprises of the real sector of the economy, as well as to establish various key interest rates, depending on the purposes of attracting resources by commercial banks.

Now we see some steps of the Central Bank in this direction: decrease of key rate to 14% and grown M2. It is not enough, but is a good sign.

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