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Kremlin Should Focus on Inflation Targeting

By Anders Aslund

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The peculiar exchange rate and monetary policy Russia has pursued in the last year has become a little noticed fact, but it has led to capital outflows and rising inflation. It might have been useful in the short term, but it can hardly continue for long because inflation is becoming the dominant concern.

A year ago, authorities were most worried about large capital inflows, which could cause traditional overheating, high inflation and a rising exchange rate — all of which would render Russia less competitive. But such short-term capital inflows could easily reverse, and if this is accompanied by large capital outflows it could destabilize the economy. Russian officials were talking about finally moving to full inflation targeting — that is, to let the exchange rate float somewhat freely and use interest rates and other monetary policy to keep inflation at an acceptable level.

Many emerging economies are struggling with such undesired capital inflows. Brazil has introduced a capital inflow tax of 6 percent. Others are regulating capital inflows through various controls, and China never abolished its capital controls. Yet large carry trade — defined as credits you borrow when interest rates are low to buy financial assets having higher interest rates — from the United States, Japan and Europe, where loose monetary policy persists after the Great Recession, continues and has boosted the reserves of many countries in Latin America and Asia.

Against this backdrop, the current Russian situation is perplexing. Instead of inflows, Russia had capital outflows of $38 billion in 2010, according to the Central Bank. Despite a rise in oil prices approaching $100 per barrel, the exchange rate to the dollar was virtually the same at the end as at the beginning of 2010. Inflation, however, increased from a low of an annualized rate of 5.5 percent in July to 8.8 percent in December.

Regardless of the capital outflows, Russia's international reserves rose from $439 billion at the beginning of the year to $479 billion due to a large current account surplus of $73 billion. This left Russia with the third-largest international reserves in the world, after China and Japan but before Saudi Arabia. Its official policy, however, is that total reserves need not be larger than imports, which stopped at $249 billion last year, according to the Central Bank estimate.

Rather than looking upon the capital outflows as a failure, or trying to explain them by focusing on oligarchs who are taking their money out of the country before the 2012 election, the capital outflows make national sense.

If Russia has large reserves and a windfall gain in foreign revenue because of the high oil prices, then it is actually better that the surplus cash flows out of the country. Unlike China, Russia is contributing to easing global imbalances on current account.

The Central Bank has pursued this policy in a simple and transparent way. It has kept interest rates very low. Its most relevant deposit rate was raised from 2.5 to 2.75 percent for overnight deposits on Dec. 24. Market interest rates have actually fallen during 2010 while inflation gained force, leaving Russia with ever-larger negative real interest rates. Any investor with means and common sense has moved free cash out of Russia, which has kept down the exchange rate. These factors, in turn, have mitigated stock prices, which are still almost a quarter below the peak of RTS in May 2008.

This is a highly unorthodox monetary policy, but Russia is not the only country that is pursuing it. Turkey's central bank seems to be following Russia's lead and has recently cut its interest rates to persuade investors to move short-term capital out of the country to avoid overheating, and it appears to be successful in doing so. But Turkey has much higher interest rates and lower inflation.

By contrast, Brazil's capital inflow tax appears quite ineffective, and it has been forced to keep high interest rates to control inflation, which attract more short-term capital. In addition, its exchange rate has soared, making Brazilians worried about the country's competitiveness. Yet, the Brazilian model of inflation targeting with a floating exchange rate and an independent monetary policy will check inflation in the long run.

Arguably, Russia's policy has been reasonably successful in the short term. But it no longer seems viable because inflation is rising, and the current policy cannot stop it. With negative real interest rates, Russia's monetary policy is highly expansionary. The fiscal policy, with a planned budget deficit of a few percent each year for the foreseeable future, is also expansionary. With an exchange rate currently close to the declining dollar, Russia is importing inflation through higher food and commodity prices. Nor does Russia have any need for economic stimulus as unemployment had fallen to only 6.7 percent in November.

High inflation is always distortionary and never popular. Even if Russia will not have a real presidential election in March 2012, Russian politicians are worried about the popular mood. This was evident when the government took the populist move of hiking pensions significantly last year.

Rising inflation as high as 9 percent can easily spin out of control and reach dangerous levels. Recall what happened to Ukraine when inflation suddenly spiraled out of control to 31 percent in May 2008. It makes no sense to keep the nominal exchange rate down at the cost of high inflation. Then, the real exchange rate could easily rise even more.

In the end, Russia might have benefited temporarily through its loose monetary policy in 2010 as it kept short-term capital out. Now, however, inflation has become such a threat that the authorities can no longer gamble with such a risky policy. They need to fulfill their old idea of full inflation targeting — letting the exchange rate float up and down with the oil price and tighten monetary policy to reduce inflation.

Moreover, the threat of carry trade because of the extremely loose monetary policy in the United States, Japan and the European Union is fading. It is likely to go away within a year as the specter of rising inflation becomes the dominant economic concern to most of the world.

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