

5 Tips for Nabiullina and the Central Bank

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Central Bank head Elvira Nabiullina has been at the crossroads of macroeconomic, fiscal and markets policymaking for more than a decade. As a former economics minister and chief presidential economic adviser, her views on macroeconomic policy are no secret.

Still, it will take time for her policy priorities to evolve, particularly as Russia faces its biggest macroeconomic challenges since the global economic crisis in 2008-09. A few things she might want to keep in mind as she finds her feet in her new job:

1. Ignore the independence debate. Central bank independence is like vodka, soap or water: It's never completely pure. Central banks are supertankers in the economic policy debate, but they still bob in the seas of politics. On the surface, Nabiullina's predecessor, Sergei Ignatyev, has in recent months been fairly successful at standing up to pressure from President Vladimir Putin and industrialists to cut interest rates, in a bid to jump-start sluggish growth.

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But after nearly 13 years of Putin, it's pretty clear that he gets his way when he wants it badly enough. There is little question about what happens next after the red phone in Nabiullina's office rings, with Putin on the line suggesting that it would be nice if interest rates were cut. Investors and analysts regularly squawk about the catastrophic damage that would be done to Russia's investment environment if the thin veneer of Central Bank independence were scratched by politicians dictating interest rates. But the reality is that Central Bank independence doesn't really exist anyway.

2. Focus on banks. The banking sector is the mangy three-legged mutt in the pet store of central bank policy. It is ignored until it makes a mess. It's likely that Nabiullina will carry on with the hope-the-wreck-doesn't-happen approach to regulating Russia's banking sector that has been practiced to perfection by her predecessors. A first step would be for Nabiullina to put some sharp teeth in the regulations that are already on the books, to tackle conflicts of interest, poor transparency and directed lending that define the sector. Whether she'll be able to generate the requisite political will remains an open question.

3. Reduce the state's role in banking. An early step would be to address the supersized role of the state in the banking sector. The government directly and indirectly controls 59 percent of all bank assets. The dominance of state-controlled behemoths Sberbank and VTB in particular cripples the sector's competitive environment, crowds out private and market-driven investment and results in the huge misallocation of resources. These banks are, in the Soviet tradition, arms of state policy and thus by definition are bulletproof. Thanks to their too-big-to-fail status, the country's largest state-controlled banks enjoy a ridiculous competitive advantage over non-state banks. In return, they have to support state funding priorities when called upon.

Privatizing majority stakes in Sberbank and VTB are in theory on the Kremlin's long-term agenda. In practice, however, the government's control over the banking sector will likely be proven to be too convenient to surrender. Nabiullina needs to help cultivate an environment where market-driven banking is allowed to thrive, to reduce the economic distortions created by the excessive role of the government in the sector.

4. Get out of geopolitics. Another dimension of state banks' pact with the government is to support Russian foreign policy objectives with little regard for returns or risk. Huge soft loans to Belarus and Ukraine and cash allocations to infrastructure projects in Kazakhstan

may serve Russia's political ends by binding the near abroad more tightly to Russia. But from the perspective of a central banker focused on systemic risks and exposures, funneling bank funds to feed gigantic, foreign white elephants is a highly dubious proposition that should be challenged.

5. Expand the regulator, smartly. Nabiullina joins the Central Bank as it is in the midst of substantially enlarging its regulatory mandate by gobbling up the functions of the Federal Financial Markets Service, the primary financial markets regulator. Whenever one bureaucracy envelops another, much can go wrong: bureaucratic infighting, mission drift and attrition of key employees, for starters. The expanded Central Bank will have a lot on its regulatory plate and could be rife with internal conflicts of interest. Through a positive prism, the creation of a mega-regulator could also be the master stroke that lifts the regulation of the country's capital markets into the modern era. It will be Nabiullina's task to ensure that the revised regulatory environment moves Russia's investment environment forward, rather than backward.

Above all, Nabiullina should remember that the Central Bank is limited in what it can accomplish, particularly in terms of monetary policy. It can bring about policy and regulation, enforce existing rules and speak loudly from the pulpit to encourage or discourage particular market beliefs or behaviors. But in many ways, heading the Central Bank is like driving down a highway in a car on autopilot: The driver can slow down or speed things up a bit but has little control over the direction and destination. Changing interest rates, one of the most scrutinized policy levers available to the Central Bank, has little impact on inflation and a marginal effect on liquidity. Meanwhile, banks sometimes completely ignore the Central Bank and cut borrowing rates on their own, like Sberbank did earlier this year.

But the Central Bank isn't uniquely impotent. Central bankers in much of the rest of the world have for several years been wildly grinding gears, slamming the doors and fiddling with the sunroof in the cars they're trying to drive. Interest rates are at or near historic lows, but growth remains anemic throughout much of the global economy. So unless Nabiullina takes over as head of the U.S. Federal Reserve, which can print trillions of dollars but still have minimal impact on economic growth, she can't expect to be able to do much more than tweak Russia's economy at the margins. Perhaps she should focus on arenas, such as the banking sector and the regulatory environment, where she can create real and positive change.

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