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Central Bank's War for Independence

By Konstantin Sonin

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Central Bank officials have recently spoken of the threat of "stagflation" in Russia. But critics quickly pointed out that economists first coined the term to describe unsuccessful attempts by several U.S. administrations to spur economic growth in the 1970s through active monetary policy.

That differs fundamentally from what is happening in Russia today.

Inflation is lower than it has been in recent years and almost at a record low for the entire post-Soviet period.

Unemployment is low and not expected to climb.

In fact, with stagflation resulting from high unemployment, high inflation and low economic growth, only the low growth is a problem, with last year's rate expected to continue for the next several years.

Still, Central Bank officials and economists are deliberately referring to stagflation in the current situation, arguing that only inflation can result from the more active monetary policy that some industrialists and politicians are urging the bank to adopt.

Under different circumstances, the simple and traditional method of easing monetary policy by decreasing the discount rate would lead to increased production. The discount rate is the rate at which banks borrow money from the Central Bank. Obviously, those banks cannot extend credit to businesses at a lower rate than they borrow it themselves, so lowering the discount rate would make more credit available to business.

Some countries — such as the U.S.in the early 2000s — have managed to lower their discount rates without triggering inflation. However, the situation in Russia is aggravated by a weakening ruble, making it all but certain that lowering the discount rate would accelerate inflation and cause a further decline in the purchasing power of ordinary citizens.

(Strictly speaking, this discussion is only a working hypothesis, and it would take more research on the subject than Russian economists are currently doing to prove or disprove its accuracy.)

Raising concerns about stagflation also indicates that the Central Bank is worried that President Vladimir Putin and the State Duma will pressure it on monetary policy.

As is always the case, concentrated political pressure carries greater force than the sum total of widespread sentiment, however significant it is. Collectively, millions of citizens would lose a great deal from the consequences of inflation, although individually their losses would be less noticeable.

However, only a handful of industrialists would profit from lower discount rates, but they have far more political influence than most Russians.

In fact, the same logic applies to the ruble exchange rate.

The public stands to gain the most from a floating exchange rate, but the lobbyists arguing for a fixed or even pre-determined exchange rate carry much more weight.

In both issues, the overriding principle is the need to respect the Central Bank's independence in determining monetary policy.

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