EUROJÄRJESTELMÄ
EUROSYSTEMET

Focus/Opinion
Expert view
5/2007 • 6.11.2007

Iikka Korhonen and Aaron Mehrotra: Will the inflation target be met in Russia?

In recent years, the Russian central bank has been up against a difficult task. Export revenue growth and capital inflows have added to the build-up of liquidity in the Russian economy. This has been reflected in a pick-up in inflationary pressures, although, for example, labour productivity has also simultaneously improved and people have been more willing to hold rouble balances in response to economic policy gaining a higher degree of credibility. Given strengthened public confidence in the rouble, the velocity of circulation of money has declined.

Since the turn of the Millennium, the Russian central bank has been moving towards a monetary policy regime that incorporates inflation targeting concurrently with ceilings for appreciation of the rouble's real exchange rate. On top of this, a reference value for monetary growth has been set, which is deemed to be consistent with inflation and expected changes in velocity. Inflation targeting has normally been defined by means of a target band set for year-end consumer price increases. The targeted inflation figure for 2007, for instance, is a year-on-year increase of 6.5%–8% in consumer prices in December. Table 1 lists both targets and actual outcomes for inflation and growth in the broad monetary aggregate M2 since 1999. The table shows that actual broad money growth has continuously overshot the central bank's projection, which has hampered the achievement of inflation targets. On the other hand, tight fiscal policy in the post-1998 period has helped Russian monetary authorities in lowering inflation. Budget surpluses and – especially from 2004 onwards – growth of the Stabilisation Fund have absorbed liquidity from the economy.

The current year's exchange rate target allows a maximum appreciation of 10% for the rouble's real effective exchange rate. By August 2007, the real exchange rate had strengthened by slightly more than 4%. In principle, the central bank's targets for inflation and exchange rate may be in conflict with each other. If, for example, the nominal exchange rate of the rouble had been allowed to appreciate by slightly more this year, inflation would probably be lower. But the central bank places great emphasis on the external competitiveness of Russian companies, thus preferring not to allow an overly strong appreciation of the rouble's nominal exchange rate. Exerting influence on the real exchange rate over a longer term is difficult considering that – if the nominal exchange rate is to be kept stable – upward pressure on the exchange rate will be reflected in higher inflation.

Money supply useful in forecasting inflation

In our study ‘Money demand in post-crisis Russia: De-dollarisation and re-monetisation’ (BOFIT DP 14/07) we estimate money demand functions for Russia following the 1998 crisis. The study finds a stable money demand relationship when augmented by a deterministic trend signifying falling velocity in Russia. As predicted by theory, higher income boosts demand for real rouble balances. The income elasticity of money is found to be close to unity, ie a 1% growth in income leads to an equivalent 1% increase in real money demand. This is very close to outcomes from other countries.

These results warrant the assumption that the deviation of the actual monetary growth outcome from the long-run equilibrium anticipate changes in the inflation rate in Russia. Accordingly, Russian monetary authorities have been correct in focusing attention on changes in the money stock for the formulation of monetary policy. The presence of a stable money demand function is a prerequisite for the use of monetary aggregates as useful indicators of potential inflationary pressures in the economy. It should be noted, however, that the velocity of circulation of money has continued to decline in Russia during this decade, which may cause difficulty in inflation forecasting. The Russian central bank also appears to believe in an ongoing fairly rapid decline in velocity. This is suggested by the quite high reference value for monetary growth in 2008 (24%–30%) relative to targeted inflation and projected GDP growth.

The impact of the exchange rate on money demand is also likely to continue despite de-dollarisation of the Russian economy. The study finds that the rouble's exchange rate against the US dollar remains an important determinant of demand for rouble balances.

Development of the financial system poses challenges for the conduct of monetary policy

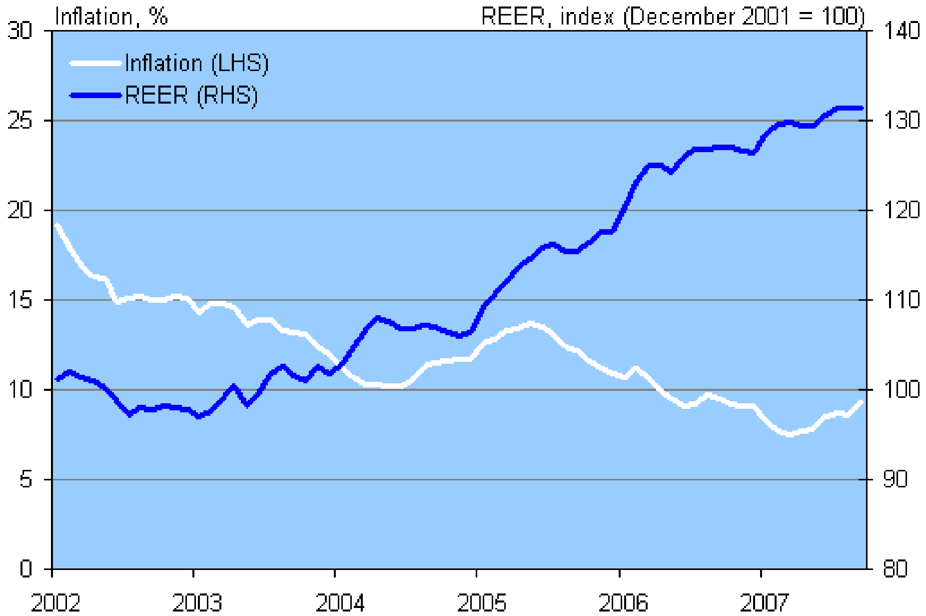
Looking ahead, the Russian central bank is likely to pursue a policy where inflation and exchange rate take centre stage, even if the long-term objective is to change over to mere inflation targeting. Money supply also plays an important role as an indicator variable, but the constantly changing and evolving banking system may increasingly constrain its use in forecasting. In a number of countries, financial system changes have brought more instability into money demand, thereby obstructing the use of money supply as an indicator variable for monetary policy purposes.

Table 1. Inflation targets, monetary growth projections and actual outcomes

Year	Year-end inflation target	Inflation outcome	Year-end broad money (M2) growth projection	Broad money (M2) growth outcome
1999	30	36.5	18-26	57.2
2000	18	20.2	21-25	58.9
2001	12-14	18.6	27-34	40.1
2002	12-14	15.1	22-28	32.3
2003	10-12	12.0	20-26	45.9
2004	8-10	11.7	19-25	35.8
2005	8.5 (original, later revised to 11%)	10.9	19-28 (target for narrow or base money)	30.0 (outcome for narrow or base money)
2006	8.5	9.0	19-28	40.5
2007	6.5-8	8.6 (in August)	19-29	53 (in August)
2008	5-6	-	24-30	-

Sources: CBR and Rosstat

Chart 1. Inflation and real trade-weighted exchange rate, 2002–2007



Sources: CBR and Rosstat

Iikka Korhonen and Aaron Mehrotra are economists at BOFIT.