Reflections on Reflections from the Russia's Mirror

Commentary to Dr. Jacob Frenkel's Article¹

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Dr. Frenkel's well-thought-out reflections on central banking, globalization and populism concern the global economy, developed countries in particular. However, his thoughts have important implications for Russia as well. They are summarized in this short note.

The perception of central banks as "the only game in town" common in developed countries is quite popular in Russia as well, though arguably less than it had been a couple of years ago. At the same time, the reasons for such perception in Russia are somewhat different. First, historically, the central bank was considered as a lender of first, not last resort to the real sector along with the financial sector. Second, public opinion in Russia does not clearly differentiate between monetary and fiscal policies, and between the Central bank and commercial banks.

Third, like in other major economies, monetary policy in Russia is often seen as an obvious and simple way to quickly support economic growth and institutions, both financial and non-financial, without macroeconomic costs or costs to taxpayers. In contrast, the use of fiscal and particularly structural policies has always been much more challenging, including from the political economy perspective.

Dr. Frenkel summarizes his views on central banking as follows: "The best way that the central bank can contribute to sustainable growth is through delivering price stability and financial stability. A strong banking system is key for such stability as well as for the effective transmission of monetary policy". Nothing better can be said. The Bank of Russia is fully up-to-date in its mandate and activities in regards to the newly emerged characteristics and functions of central banking. It pays significant attention to clear communication with the financial industry and markets, consistency in policy actions and regulatory principles. In bearing responsibility for the soundness of the financial industry underpinning the stability of the national economy, the Bank of Russia has been cleaning the banking system and other segments of the financial sector.

Dr. Frenkel offers important comments on risks for financial stability stemming from the delay in policy normalization in developed countries. These comments are also relevant for Russia, but from a different angle. Although policy normalization in Russia implies policy easing (i.e. the reduction of policy rates) rather than policy

¹ See p. 108.

tightening, the risks for financial stability may arise from too speedy policy normalization as a possible overreaction to low headline inflation observed in the last several months. Why? The so-called “missing inflation” (below-the-target inflation accompanying strong real business cycle indicators) appears to be a global phenomenon, embracing Russia among other countries. Thus, attempts to offset structurally low price growth in some goods by pushing up price growth in other goods and services with the help of monetary policy could put medium-term financial and price stability at risk.

Dr. Frenkel argues for inflation target to be interpreted as the mid-point of a wider target range in developed countries. He argues even stronger in favour of a vague and less time-bound interpretation of inflation targets in emerging markets, especially those that have to disinflate. Russia adopted its inflation targeting policy as a strategy for disinflation, so his arguments fully apply to Russia, as does the argument that in the medium term there are more upside risks than downside ones because of unanchored inflation expectations.

The Global Financial Crisis, as Dr. Frenkel explained, had challenged both economic theory and experts who “failed to predict it”, following traditional textbooks. The resulting mistrust in traditional economic theory and experts echoed in Russia in two ways. First, unconventional monetary policies that major central banks had had to run were often interpreted as a “new normal” in central banking globally, regardless economic stance. It was taken completely out of the context of the key central bank mandates. The Bank of Russia had to argue and prove that conventional monetary policy was alive and right medication for the Russian economy. Second, the mistrust in experts gave support to pseudoexperts with little knowledge of economic theory, but with strong ambitions to invent and propagate their own ideas, which were often derived from poor empirical data and primitive economic analysis. Fortunately, such views have not been translated into policy decisions, yet they got entrenched among the general public. It will take a massive and prolong educational campaign to get economic basics right.

The normalization of monetary policy in developed countries does not in itself carry high risks provided it occurs gradually and does not affect the global economy's growth rate, does not slow it and does not bring any surprises to financial markets. If, however, inflation starts accelerating, requiring faster policy tightening, this may hit assets hard, including in emerging markets, via capital outflows. In previous years, monetary policy tightening in developed countries or announcement about the launch of tightening tended to cause a rise in volatility in global markets. This is, for instance, what happened in 2013 after the Fed's announcement that it would start winding down quantitative easing. The conventional wisdom is that now monetary policy tightening in the US will have a milder impact on emerging economies today because, first, it is happening against the background of sustainable economic growth and, second, emerging markets themselves now have more shock

absorbers to alleviate these risks. Namely, these include macroeconomic stability, floating exchange rate and reserves.

Compared with other emerging markets, Russia looks better protected for two reasons. First, financial deleveraging has occurred: external debt dwindled from \$732.8 bln in mid-2014 to \$529.1 bln at the start of 2018, or by 28%. It dwindled even more dramatically in the banking sector – by half, from \$208.9 bln to \$104.5 bln, over the same period. The need to refinance debt, although relevant, is not problematic. Second, thanks to the interest rate difference, Russia can afford to pursue a policy opposite to that of the Fed by cutting interest rates, whereas the US is hiking them. This will be feasible until the Bank of Russia's key rate reaches a neutral level of 6–7%. That the rate is higher now makes Russian assets more attractive than those of other countries, damping the effect of the Fed's policy normalization. In addition, over the recent years, the Bank of Russia has developed an array of instruments to support financial stability. These include the provision of foreign exchange liquidity via repos and loans where there is a dollar shortage. This mitigates the perception of potential negative effects by market participants.

Finally, a few words on protectionism induced by changes in international trade and technological innovations. Dr. Frenkel makes the point that the use of fiscal measures (trade-adjustment assistance, retraining programs, social safety net adjustment, etc.) is the appropriate way to address this challenge rather than protectionism. This goes against common beliefs of policy makers in most countries. Thus, it is important to fully understand the point and act accordingly, with appropriate policy tools. In Russia decreased energy prices prompted economic rebalancing, fostering export diversification and integration into global value chains. Therefore, it is in Russia's interests that global markets remain open.