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Breaking monetary policy rules in Russia

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Abstract

This study estimates whether the monetary policy rules of Bank of Russia have changed recently. Russia has moved towards inflation targeting over the past years, which is reflected in our empirical estimations. We start by estimating various monetary policy rules for Russia, concluding that a variant of the Taylor rule depicts Bank of Russia's monetary policy over the past decade well. Moreover, there have been two clear breaks in the coefficients of the estimated monetary policy rule, possibly signifying a shift towards traditional inflation targeting and also the current recent economic turbulence.

JEL classification: E31, E43, E52, P33.
Keywords: monetary policy rule, Taylor rule, McCallum rule, Russia, inflation.

1. Introduction and motivation

In this paper, we analyze whether the monetary policy rules of the Bank of Russia have changed over the past years. This could be possible a priori, given the changes in the explicit monetary policy framework, as well as the further development of Russia's financial system.

Broadly, previous studies (see section 2 for a brief literature review) determined that, in recent years, Russia's monetary policy can be described in terms of the Taylor rule, where the central bank's steering of the interest rate responds to deviations from its inflation target as well as the output gap. The central bank's aim is to stabilize inflation around its target and output around the level of potential output. In Russia, as in numerous other open economies, the exchange rate is often included in estimations.

We find that estimated monetary policy rules do indeed contain breaks, or at least a break. We observe a break in the estimated Taylor rule in February 2015, broadly

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coinciding with the formal start of inflation targeting. It is also interesting that before the summer of 2006, the Taylor rule did not explain Bank of Russia's interest rate policy. This would hint that the changes in Russia's monetary policy have been gradual, and the central bank perhaps behaved differently in earlier periods.

This paper is structured as follows. The subsequent section offers a short introduction to Russia's monetary policy, as well as a review of the literature on the estimated monetary policy rules in Russia. Section 3 introduces the data and the estimated monetary policy rules. In the fourth and fifth sections, we estimate different versions of monetary policy rules, with and without breaks. Section 6 concludes the paper.

2. Evolution of monetary policy in Russia

Our data sample runs from the beginning of 2004 to August 2017.[1] During this time, the Bank of Russia has had several goals for its policy, although the entire period has been marked by a gradual shift towards fully-fledged inflation targeting, which was officially introduced from the beginning of 2015. At the same time, exchange rate stability has been explicitly mentioned as a key target of the central bank for almost the entire sample period. Moreover, the exchange rate target was only given up in November 2014, although the Bank of Russia announced then it would stand ready to intervene on the foreign exchange market to dampen undue volatility. However, it should be noted that the Bank of Russia had continuously widened the allowed fluctuation band around the central parity of its exchange rate basket (consisting of the US dollar and the euro, and reflecting both Russia's foreign trade orientation and the dollar's traditionally significant role in the Russian economy). Moreover, the targeted exchange rate was also allowed to change as to reflect underlying market pressures, especially after 2008.

The Bank of Russia first stated price stability as its primary policy objective in the 2007 monetary policy guidelines (Bank of Russia, 2006). This can be seen as the starting point for the gradual move towards inflation targeting in Russia.

Fig. 1 shows the inflation targets (or target ranges) of the Bank of Russia, as well as the realized inflation from 2000 to 2017. (It should be noted that, especially during earlier periods, it was sometimes difficult to discern inflation targets from forecasts, although these ranges were called inflation targets in the Bank of Russia's annual monetary policy guidelines.) One can see that the realized inflation overshot inflation targets on several occasions, and that the largest deviations from the inflation target have happened in the aftermath of large currency depreciations, such as in 2008 and 2015. This empirical regularity can be used to justify the inclusion of an exchange rate variable in the empirical estimates of Russia's monetary policy rules. Moreover, the official role of the exchange rate basket shows the importance of this variable.

While empirical estimates of different monetary policy rules are relatively common in advanced OECD countries, similar exercises for emerging market countries are still rare. Moreover, there are only a handful of published papers

[1] Our sample starts from 2004, as inflation had decelerated close to 10% by that time. At the same time, our current data sample contains several different monetary and exchange rate policy regimes, which allows us to search for breaks.