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CRB's High Interest Rates: Triumph of Market Fundamentalism in Russia

ABSTRACT
Ongoing Ruble crisis reflects irrelevance of CRB's policy measures. Tighter monetary policy and currency free float implemented by CRB to stabilize Ruble led to directly opposite result. Several months of "managed devaluation" changed into panic selloff in December 2014. The panic in the currency market took place despite massive FX reserves controlled by CRB and translated into serious economic distress. With key policy rate at 17% Russian economy is moving towards artificially depressed growth along with weak currency and high inflation. Stagflationary trap became a material risk for the economy. The main reason behind Bank of Russia's policy choices is its commitment to market fundamentalism framework. CRB failed to recognize that its retracement from the currency market created far from equilibrium conditions and triggered irrational behavior of market participants along the board. Should external conditions remain hostile for Russian economy and oil prices keep moving lower CRB's policy irrelevance will bring into question regulator's credibility. That all might cause unnecessary damage to Russian economy.
Key words: *Ruble crisis, Russian economy, Central bank of Russia*

Throughout 2014 Russian currency experienced a considerable decline against US Dollar and Euro losing more than 50% of its value by mid December. Ruble devaluation unraveled against the backdrop of falling oil prices and unprecedented economic sanctions imposed on Russia by Western countries. Till December 2014 most of international and local observers were agreeing on the consensus opinion that Ruble weakening looked like very similar to what had happened in Russian currency market during 2008-2009 and was described later as so called "managed devaluation". This hypothesis was reinforced by numerous comments made by high rank Russian officials who stressed constructive nature of moderate devaluation that would finally lead to increase of national producers' competitiveness. Russian Central Bank took very similar stance refraining from expressing any serious concern about weakening currency rate. However CRB implemented some limited policy actions to arrest strong downward moves in the currency market, namely very gradual liquidity tightening together with targeted interventions on the peaks of speculative pressure against Ruble. In December 2014 the existing model of exchange rate management was abandoned that brought all economic agents of Ruble zone to brand new economic reality. First Central Bank had announced Ruble free float and several weeks after in response to Ruble sharp decline on December 15th unexpectedly (in a midnight gathering) increased interest rates up to 17%. Market reaction the next day was a total loss of confidence in CRB's policies and its ability to support national currency. Ruble collapsed more than 20% during the trading day and reached historical lows of around RUB 80 per one USD.

Considering latest dramatic events in the financial markets an important question arises: what are the key determinants and theoretical frameworks that Russian financial authorities follow when making monetary decisions and what is the likely outcome of those decisions. Generally CRB has been openly articulating key guidelines that it sees as crucial in policy making. In short this theoretical approach is based on the concept of market fundamentalism derived from the neoclassical model of supply demand balance for the liquidity markets. Market fundamentalism postulates that there is only one equilibrium point where supply and demand are equal to each other and this point can be reached exclusively as a result of free market participants interactions, in other words by the means of market "invisible hand". Under this framework financial regulation that intervenes into free markets leads to distortions and misallocation of liquidity resources and henceforth should be restricted to allow market forces to take care of right equilibrium point without external pressure. On practice CRB's adoption of efficient markets theory means that it will pursue tight monetary policy in attempt to restrict supply of Rubles as much as possible and allow new exchange rate equilibrium to emerge. It is worth noting that during the whole 2014 Bank of Russia did exactly the same thing though causing the reverse effect as Ruble continued to plunge every time CRB raised key rate. Now with 17% interest rates regulator expects Ruble to strengthen. According to CRB the negative result of restricted liquidity policy would be a formidable economic slowdown but on the positive side the deficit of Ruble liquidity will force economic agents to convert previously accumulated Dollars into Rubles in order to maintain economic transactions and partially to earn higher interest on savings. Once the tendency of Ruble buying is strong enough to stabilize the exchange rate, interest rates will be lowered and economy will get some relief so necessary for the recovery. This is approximately how Russian monetary authorities view the situation.

Unfortunately Russian monetary authorities strongly dedicated to market fundamentalism principles do not take into consideration modern criticism of market efficiency theory that continues to be a corner stone of CRB's policy actions. In a course of several decades significant fraction of western academic community has been focused on studying irrational behavior of market participants and important inefficiencies in markets functioning: manias, panics, financial bubbles and collapses. All these phenomena cannot be explained on the grounds of efficient market theory that presumes a unique and rational point of supply demand equilibrium determined solely by free market players. In response to inadequacy of market fundamentalism in explaining way how financial markets work, several new approaches were developed including multiple equilibria theory. According to multiple equilibria theory there could be many different equilibrium points some of which may lead to self-reinforcing processes of financial collapse and prolonged periods of economic distortions. If irrational behavior of market participants is not confronted by regulator intervention in one or another way a systematic risk increases dramatically. Monetary authorities can easily lose control over the situation and face steady tendency for economic self-destruction. Multiple equilibria theory gained wide recognition

not only in academia but also among practicing financiers and policy makers including international financial speculator George Soros and former US Federal Reserve chairman Alan Greenspan who publicly admitted fundamental fallibility of efficient markets hypothesis.

Russian currency crises reflects general problem of policy makers who blindly follow market fundamentalism doctrine and henceforth lack understanding of financial markets nature in current economic environment. During 2014 Russian central bank restrained liquidity flow into economy through higher interest rates policy and every time after CRB's rate hike ruble value decreased even further. Notably the bigger were the interest rate increases the sharper were ruble selloffs. After the events of December 15th-16th 2014 there is a risk that market participants' and general publics' confidence in CRB has been damaged irrecoverably. We have already seen numerous examples of companies stand-stilling transactions nominated in national currency as well as population buying consumer goods in panic. Under these circumstances there is no guarantee that policymakers optimistic projections regarding liquidity market will materialize. We might not see a turning point where the tendency to accumulate Dollars will reverse due to scarce Ruble supply. On the contrary a "vicious circle" of flight from national currency and total loss of confidence in Russian monetary system emerge now as a material risk resulting from CRB's policy choice. In "vicious circle" scenario an economic downturn caused by the rate hike and December's devaluation shock is likely to reinforce flight to Dollars despite tight Ruble liquidity conditions. Market participants frightened by unraveling spiral of negative economic growth and falling Ruble will start using foreign currency as informal unit of transactions. In other words we might face a full scale dollarization of the economy as it was the case in Russian economic history during 90-es. This model of "vicious circle" can be summarized in a rather simple relationship: ruble devaluation — interest rate increase — economic decline — ruble devaluation. Oil price will be certainly an important factor impacting economic conditions. If it continues to move lower the "vicious circle" described above seems to be inevitable provided current monetary policy remains unchanged.

Apparently the Bank of Russia made a clear commitment to follow every postulate of liberal fundamentalism while managing recent Ruble crisis. It is unclear what would be the outcome of these policies in 2015 but it is quite obvious that the risks for Russian economy created by CRB's actions are way too high to justify such one-sided approach.

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