

# Does Central Bank Independence Matter in Russia?

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According to conventional wisdom, since taking office in March 2000 Russian president Vladimir Putin has adopted a two-pronged policy of political centralization and economic liberalization. Russia's banking system, however, has actually come under increasing state influence during that time. In particular, the Central Bank of Russia (CBR), once a fairly independent (if occasionally troublesome) institution, has lost significant policy autonomy under Putin. While this does not matter (and may even be beneficial) in the short term, in the long run it raises the possibility for governmental abuse of the central bank's powers and resources. Putin's taming of the CBR reflects his overall economic strategy for Russia, which aims to increase state coordination and influence over the "commanding heights" of finance and the natural resource industries while simultaneously further liberalizing the rest of the economy.

## **Central Bank Independence Has Declined Under Putin**

To be considered independent, a central bank must have both formal, legal autonomy and de facto policy autonomy. The CBR has lost ground in both areas under Putin, although more in practice than in law. The CBR has enjoyed a relatively high level of legal independence since the mid-1990s, on par with that of the U.S. Federal Reserve and the National Bank of Canada. The 1993 Constitution and the 1995 revised Law on the Central Bank enshrine the CBR's policy and financial independence into law, and give the central bank governor a four-year term not coinciding with the electoral cycle. However, in July 2002, after a year of acrimonious debate, Putin signed amendments to the Law on the Central Bank giving a National Banking Council (NBC) greater control over CBR activities. The twelve-member NBC includes three representatives from the government, three from the presidential administration, five from the legislature, and only one from the CBR. The NBC's main responsibilities include approving a common state monetary and credit policy, evaluating the CBR's annual report, and approving CBR expenditures. The NBC takes much of the responsibility for monetary policymaking and internal financial decision making out of the CBR's hands, increasing the CBR's accountability to the government but decreasing its formal autonomy.

More important, however, has been the decline in the CBR's de facto autonomy under Putin. By ousting the CBR's influential governor and, in effect, subordinating the

CBR to the Finance Ministry, Putin ensured that the CBR could no longer win (or often even fight) policy battles with the government.

The Putin administration's initial efforts to tame the CBR reflected opposition to long-time, fiercely independent CBR governor Viktor Gerashchenko. Gerashchenko, who began his career as head of Gosbank, served as CBR director from July 1992 through October 1994, and then took up the reins again in September 1998 after the financial crisis. Earlier in the year, Gerashchenko had strongly denounced the then-proposed legislation in the State Duma subordinating the CBR to the redesigned National Banking Council. Gerashchenko condemned the bill as "unconstitutional" and managed to postpone the second Duma reading of the bill, but could not garner enough support to kill it. Tensions between the government and CBR over this and other issues soon became extreme, and Putin forced Gerashchenko's resignation in March 2002. Using a standard Soviet-era formulation, then-presidential administration head Aleksandr Voloshin announced that Gerashchenko had resigned for "health reasons."

Putin immediately moved to bring the CBR under the Finance Ministry's thumb by nominating Deputy Finance Minister Sergei Ignatiev -- the author of the draft bill curbing the CBR's powers -- to replace Gerashchenko. Ignatiev is politically beholden both to Putin and to Finance Minister Aleksei Kudrin, and is not a particularly prominent figure. Ignatiev's first statements as CBR governor underlined the political nature of Gerashchenko's ouster, as he promised to pursue the same "reasonable policies" as his predecessor. Since then, several other Ministry of Finance officials (including two first deputy finance ministers) have moved into top posts at the CBR and Finance Minister Aleksei Kudrin has been named chairman of the NBC. Illustrating this subordination, Kudrin rather than Ignatiev presented the government's long-term strategy for banking sector development in July 2004. Even more telling, despite CBR protests the Ministry of Finance successfully introduced a change in the 2004 state budget requiring the CBR to turn over 80 percent of its profits to the Ministry of Finance, rather than the legally mandated 50 percent (requiring a temporary amendment to the Law on the Central Bank).

As a result of this subordination, the CBR has either lost or not fought a series of battles with the government that it might have won in the past. Three key examples include:

? Losing control over Vneshtorgbank – cheaply. Since the Soviet collapse, the CBR had controlled 99 percent of Vneshtorgbank, the state's profitable foreign trade bank. Although Gerashchenko had earlier agreed in principle to cede control of Vneshtorgbank to the government, he had insisted that the government fairly compensate the CBR for handing it over. After Ignatiev's takeover, however, the CBR agreed to sell its stake in Russia's second-largest bank for the bargain price of 42 billion rubles'-worth of ten-year government bonds. Meanwhile, as of January 2003 the Ministry of Finance and the Federal Property Ministry jointly assumed ownership of the bank.

? Losing control over deposit insurance. The CBR had long insisted that when Russia finally introduced a deposit insurance system it should be controlled by the CBR, since the CBR conducts banking supervision in Russia. However, the law on deposit insurance signed by Putin in December 2003 provides for a separate state agency for

deposit insurance and instructs retail banks to make contributions to a separate state insurance fund, not the CBR.

? Losing control over monetary policy. Putin and the Ministry of Finance have forced the CBR to adopt what most economists consider to be mutually exclusive policy goals: simultaneously restraining inflation and maintaining a stable ruble. Both record high oil prices (which have sent money flowing into Russia, the world's largest oil and gas producer) and the precipitous fall of the U.S. dollar (previously Russians' foreign currency of choice) have put massive upward pressure on the ruble. The government wants to restrain the ruble's rise in order to protect domestic manufacturers, whose products become progressively less competitive in comparison with imports and internationally as the ruble appreciates. The CBR has responded by buying dollars and printing rubles, running its foreign exchange reserves to record levels and spurring inflation. In April 2004, Putin increased the pressure by instructing the CBR to limit the ruble's rise against a dollar-euro basket to between 5 percent and 7 percent during the year, but without changing the previously agreed-upon inflation target of 8 to 10 percent. The International Monetary Fund has complained about the CBR's greater focus on ruble stability than on inflation since 2002, and blames "external pressures" for forcing the CBR's hand.

### **CBR Subordination May Not Matter in the Short Term...**

Economists and central bankers typically argue that central banks should be independent for three reasons, none of which especially matter in the current Russian context:

**1) Independent central banks restrain inflation.** Economists have long argued that domestic economic necessity drives politicians to create independent central banks. According to this view, independent central banks promote lower inflation because they curb politicians' ability to manipulate the money supply in tune with the electoral cycle, thus creating short-term growth (and political credit) at the expense of longer-term macroeconomic stability. However, most evidence indicates that in post-communist economies, central bank independence has at best a mixed relationship to inflation and none at all to economic growth. This has certainly been true of Russia, especially in the early 1990s when a fairly independent CBR under Gerashchenko contributed to massive inflation. More importantly, it presumes that fighting inflation should always be the primary goal of the central bank. Despite IMF concerns, Putin's current preference for preserving exchange rate stability at the expense of moderate inflation is quite defensible, especially given the macroeconomic pressures involved in dealing with unusually high oil prices. Finally, needless to say, under "managed democracy" the electoral cycle is not a central concern of Putin's government and would be unlikely to engender significant politically motivated inflationary impulses.

**2) Independent central banks provide international credibility.** Central bank independence, so the story goes, sends an important signal to international markets that a country's government is committed to macroeconomic stability, which will lead to increased foreign portfolio and direct investment. However, Putin's Russia has seen an overall rise in foreign investment and credibility with international financial markets at the same time that central bank independence has declined precipitously. The reason is

simple, for a resource-rich transition economy like Russia, central bank independence is a far less important signal to international markets than are budget, tax, and privatization policies. Indeed, only six years after Russia's devastating financial meltdown, 70 percent of Certified Financial Analysts polled in November 2004 saw the Russian investment market as "attractive" or "very attractive." The YUKOS affair has done much more damage to Russia's international standing than has subordinating the central bank, especially since the central bank did not enjoy a great deal of international respect in the first place.

**3) Independent central banks respond better to domestic financial markets.** In theory, independent central banks maintain macroeconomic stability in part because they serve the needs of domestic financial institutions rather than the government. Domestic banks are often the strongest supporters of central bank independence. This theory, however, assumes that domestic central banks are already conservative and well-regulated institutions, a condition that does not hold in Russia. Commercial banks in Russia have actively lobbied against allowing foreign banks to compete in the domestic market, against the greater transparency and accountability that introducing deposit insurance would require, and against effectively dealing with the far-too-numerous problem banks in Russia. In previous years they also preferred that the CBR conduct an inflationary monetary policy because of its potential for quick profits. With a powerful government committed to at least some reform of the commercial banking system, a subordinate CBR may ironically find it easier to ignore the demands of commercial bankers and clean up the problematic sector.

In short, a subordinate CBR does not necessarily have the downsides that proponents of central bank independence might lead us to believe, and it has the added benefit of improving policy coordination among the CBR, the Ministry of Finance, and the government more broadly, a coordination often not evident in the past.

### **. . . But Carries Risks in the Long Term**

In the long run, however, a subordinate CBR could represent a problem for Russia. The CBR's subordination means that its activities are even less transparent than before, and increases the potential for governmental abuse of the CBR's influence. If economic times grow worse for Russia, could the government restrain itself from using the CBR's extensive financial resources to shore up its popularity? More importantly, CBR subordination is part of a broader pattern of increasing governmental control over the financial sector. State shareholdings in Russian banks grew after the 1998 financial crisis, plateaued, and have increased again since then despite repeated government commitments to privatize these financial institutions. After the financial mini-crisis in early 2004, Vneshtorgbank took over troubled but large Gута Bank and subsequently acquired a major stake in Promstroibank. In July 2004, the government postponed any consideration of privatizing Sberbank and Vneshtorgbank until at least 2007. With the government controlling both the CBR and the country's two largest banks (and dollarization decreasing), it has an ever-increasing ability to manipulate Russia's monetary and financial affairs. Although independent central banks are often criticized for their undemocratic nature, a central bank that is merely one more institutional tool in

a centralized Russian state apparatus may turn out to represent an equal if not greater threat to what remains of representative politics in Russia.

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