

# MONETARY POLICY OF EAEU MEMBER STATES: CURRENT STATUS AND COORDINATION PROSPECTS

Analytical Summary to the Joint Report  
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## Analytical Summary

The Treaty on the Eurasian Economic Union stipulates the need to deepen economic integration, *inter alia*, through implementation of coordinated macroeconomic and foreign exchange policies.

The main purpose of this research is to analyze the current status of monetary policies in EAEU member states. The research also seeks to provide answers to the following questions: How efficient are the current exchange rate and the monetary regimes, and do they permit attainment of the stated objectives? How efficient are the channels used by regulators to influence the economy? What obstacles hinder the efficient coordination of monetary policy within the framework of the integration association? What could be the common aims and objectives for the central (national) banks?

The report uses the following classification of **forms of financial and monetary cooperation**: regional payment agreements; regional financial-cooperation funds; regional development cooperation; initiatives designed to enhance certain elements of the common financial market or its segments; and exchange rate mechanisms and currency unions. A review of international best practices in the area of monetary policy coordination by developing countries has shown that the forms listed above help reduce exchange rate volatility and stimulate international trade.

- **Regional payment agreements**, being the simplest form of coordination, are instrumental to reducing transaction costs. They can form the foundation for deeper monetary cooperation. Besides, they impose few, if any, additional costs on the member states.
- **The creation of regional financial-cooperation funds (currency reserve pools)** with a view to combine reserves available to member states enables them to counter shocks, including external shocks, by preventing them from “spilling over” from one country to another. If any such fund has a large “anchor” state, it may be beneficial to the smaller countries.
- **Regional development cooperation** implies the creation of international financial organizations to facilitate economic development, regional integration, and expansion of trade between member states.
- **Initiatives designed to enhance certain elements of the common financial market or its segments** – for example, the bond market – can promote structural reforms and facilitate de-dollarization by making available loans denominated in national currencies.
- **Exchange rate mechanisms and currency unions**, being a form of deep integration, contribute to the convergence of member states, considerably reduce the risk of pursuing the “beggar-thy-neighbor” policy, and stimulate the development of intraregional trade. This form of financial and monetary cooperation, however, requires a very high level of monetary policy coordination and entails massive negotiating costs. Because of that, several regional initiatives envisaging the creation of regional currency unions and the introduction of a single currency never got off the ground.

**Stability of exchange rates within the regional economic association contributes to the success of any of the forms of financial and monetary cooperation listed above.** There may exist both formal and informal coordination mechanisms.

The current report describes and classifies exchange rate and monetary policies<sup>1</sup> pursued by EAEU member states on the basis of the methodology used for the preparation of the IMF's *Reports on Exchange Arrangements and Exchange Restrictions* (with some modifications). The exchange rate regime announced by the government (the *de jure* regime) is being taken into consideration, but the classification relies on actual statistical data, i.e. it reflects the *de facto* regime.

The findings demonstrate that, **at this point in time, exchange rate and monetary regimes in various EAEU member states are quite different. This means that, to assure their coordination, it will be necessary to both formulate common policy goals and define relevant implementation mechanisms that may not be the same for different regimes.** Monetary policy should be placed in a broader context as an instrument that can be used to assure macroeconomic stability and maintain internal and external balance. EAEU member states currently report significantly different inflation levels, which testifies to varying efficiency of their macroeconomic policies. In the event of internal and external shocks, this may lead to major changes in exchange rates and mutual trade terms and affect business activity and prices. Besides, shocks emerging in one economy may infect other economies. Coordination of monetary policies makes it possible to reduce the vulnerability of individual economies and the economy of the entire region, design collective response mechanisms to mitigate external risks, and boost response effectiveness by harnessing available synergies.

The main purpose of monetary policy is to attain and maintain low and stable inflation. In this respect, the central (national) banks have already made a step towards coordination by publishing mid-term inflation targets that mostly fit within a relatively narrow range. Besides, most EAEU member states have announced that they **plan to implement inflation targeting with flexible exchange rates.** Still, policy differences persist.

Mid-Term Inflation  
Targets in EAEU  
Member States

Armenia	Belarus	Kazakhstan	Kyrgyzstan	Russia
4%	5%	3–4%	5–7%	4%

Source: central (national) banks of EAEU member states.

<sup>1</sup> In this report, we follow the classical definitions of monetary and exchange rate policies, where the latter is understood as a part of the former. However, in situations where it is necessary to place special emphasis on exchange rate policy, it is mentioned in the text alongside monetary policy.

**Foreign exchange (exchange rate) policy** — a set of economic, legal, and organizational measures in the area of money circulation and foreign exchange relations, as implemented by states, central banks, and international financial bodies; one of the main segments of economic policy pursued by individual states or groups (unions) of states.

**Monetary policy** — government policy designed to regulate the quantity of money in circulation with a view to assure price stability, employment, and real growth. Monetary policy is implemented by the central bank. Macroeconomic processes (inflation, economic growth, unemployment) are managed by the application of various monetary regulation mechanisms.

The findings indicate that **heterogeneity of economic structures and economic policies of EAEU member states leads to differences in their monetary transmission mechanisms**. Those differences are manifested both in the time required for political decisions to impact target macroeconomic variables and in the operation of main monetary transmission channels.

To understand the nature of the operation of transmission mechanisms in various EAEU member states, the research has studied the correlation between monetary policy measures and major macroeconomic indicators. **The analysis has shown that EAEU member states have indistinct monetary transmission mechanisms, which limits the ability of monetary policy to influence the real sector**. The exchange rate channel has been the most efficient monetary transmission channel since the late 1990s. In all countries of the region, devaluation of the national currencies was accompanied by an acceleration of inflation, but its overall impact on economic growth has been neutral. However, only countries with sufficient international reserves could efficiently use that channel within the framework of exchange-rate-targeting (stabilization) policy. The lack of significant reserves required to compensate for the deficit of the balance of payments caused by interference in exchange rate formation prompted EAEU member states to review their exchange rate policies, which, undoubtedly, affected the operating efficiency of the other monetary transmission channels.

**More and more central (national) banks of Eurasian integration member states consider the possibility of transitioning to inflation targeting or implementing some of its elements. Incidentally, historical data confirm the limited effectiveness of the interest rate channel both in countries using (or moving towards) inflation targeting and countries using other monetary policy regimes**. For example, in Belarus the impact of key interest rate changes, made by the National Bank, on inflation is limited by high devaluation expectations. In Armenia, where the inflation-targeting regime was formally introduced in 2006, the operation of the interest rate channel is hindered by the weak impact of the repo rate on market credit and deposit rates, and by the significant level of dollarization of the economy. In Russia, until the end of 2014 and the official transition to the inflation-targeting regime, the impact of the key interest rate was generally subordinated to the operation of the exchange rate channel and, accordingly, had no systemic implications. In Kazakhstan, the impact of interest rates was distorted by the 2007–2010 financial crisis, when the growth of external-debt interest rates revealed the problem of the banking sector’s unsustainability. In Kyrgyzstan, interest rates could not have any material impact on inflation because the foreign exchange channel *de facto* prevailed over the other monetary policy instruments while the refinancing rate was determined endogenously. Besides, the weak development of financial intermediation, and the dominant position of demand deposits in the banking system imposed additional restrictions on the operation of the interest rate channel.

**The implementation of efficient monetary policies in certain EAEU member states is prevented by high dollarization, considerable inflation and devaluation expectations, an underdeveloped financial sector, the existence of a shadow economy, dependence on remittances of labor migrants, weak diversification of the economy, and dependence on external price shocks. Until these problems are resolved, the possibility of deeper monetary policy coordination remains limited.**

An important precondition of successful monetary coordination is faster convergence between the countries and stronger synchronization of their business cycles. The research has established that **EAEU member states experience real, nominal, and institutional convergence. Those processes, however, proceed unevenly and do not affect all members of the economic association at the same time.** There is real convergence between Belarus, Kazakhstan, and Russia. This convergence is of the catch-up type, with levels of the purchasing power parity GDP *per capita* in Kazakhstan and Belarus consistently getting closer to the similar indicator in Russia. This convergence can also be described as proceeding at a medium rate. Armenia is gradually reducing its PPP GDP *per capita* lag from Russia, but it is happening extremely slowly. Kyrgyzstan is currently demonstrating almost no convergence with EAEU leading member states despite its very low initial *per capita* income level.

**Consumer price indices in EAEU member states demonstrate a tendency to converge. In this case, the situation in the economic union can be described in terms of “club convergence” (the relevant indicators are converging in all countries).** This conclusion is very much in favor of using, within the EAEU, a single inflation target to coordinate member states’ monetary policies.

**The other aspects of nominal convergence in EAEU member states are not as strongly pronounced.** In some cases, exchange rates and money supply appear to be driven by common trends, but in most situations there is no convergence of indicators. Interest rates set by the central (national) banks of EAEU member states, which pursue independent monetary policies, are significantly variable.

**As for institutional convergence, based on available information, it is possible to draw the conclusion that EAEU member states are at approximately the same level of development in terms of maturity of market institutions and conditions for doing business.** Based on the EBRD’s composite reform index, Belarus lags behind the other EAEU member states, but according to the World Bank’s ease-of-doing-business index, it is faring no worse than its integration partners. The conventional nature of such indicators points to the need to undertake a more in-depth analysis of the institutional aspects of integration and of the related information and analysis tools.

The convergence of monetary policies is an important precondition of their efficient coordination. In other words, it can be used as a qualitative measure of coordination. An assessment of monetary policy convergence over the short-term and long-term horizon usually involves the following indicators: short-term interest rates; various money supply indicators (money aggregates); money base; and nominal exchange rates.

**Imposition of common price-stability targets can become the first step to improving the efficiency of monetary policy coordination in EAEU member states.** This step appears to be expedient for a number of reasons. First, imposition of common optimal price-stability targets (and, as a consequence, stabilization of inflation) can contribute to de-dollarization of the economy. Second, if the central (national) banks of EAEU member states strive to keep inflation at the same level, changes in nominal exchange rates within the union will reflect, on average, changes in real exchange rates and the level of competitiveness of individual economies.

**A high level of dollarization remains a material obstacle of monetary coordination in the EAEU.** It diminishes the effectiveness and efficiency of monetary policies, thereby restricting the ability of the government to manage macroeconomic indicators. Inasmuch as a weakening of the exchange rate increases the debt burden of FX debtors, this may trigger the effect of contraction of the economy typical for a tight monetary policy. Moreover, interest rate changes do not affect FX loan and deposit rates, which hinders monetary transmission. Also, since the local central (national) bank cannot act as the lender of last resort to provide FX liquidity, financial dollarization increases liquidity and solvency risks of the financial system. Member states of an economic union where economies are heavily dollarized remain vulnerable to external shocks. Consequently, enhanced monetary integration cannot be imagined without low dollarization and trusted national currencies. The best way to make a national currency more trusted is to make sure that it has constant purchasing power, i.e. to assure low and stable inflation combined with a free-floating and moderately volatile exchange rate.

**The efficiency of the monetary policy pursued by the members of an integration association largely depends on the efficiency of their fiscal policy.** Fiscal policy instruments are often the only effective tool that the countries can use to respond to asymmetric shocks and stabilize their domestic markets. For example, austerity measures can be used to perform domestic devaluation, which then brings down production factor costs. **Many theoretical and empirical studies stress that the approach where the coordinated monetary policy for a regional integration association is designed to control inflation, and where the fiscal policy is defined at the local level and designed to mitigate country shocks, is the optimal approach.** This, however, is only true if all countries pursue good-faith economic policies that assure the preservation of a macroeconomic equilibrium. Any movement towards stronger monetary policy coordination will require a willingness to maintain strict budget discipline on the part of all countries involved in Eurasian integration and an ability to coordinate policies in other areas.

**Coordination of fiscal policy in EAEU member states is a technically challenging task.** Its completion is complicated by “additional” budget policy functions related to significant contingent liabilities of the budget sector caused by the retention of control over the key (but not necessarily efficient) areas of economic activity (in certain EAEU member states, the state maintains a visible presence in the real and banking sectors). As a consequence, economic policy is heavily affected by quasi-fiscal operations, which increases public debt without making an appropriate impact on the budget balance. The only way to deal with this problem in EAEU member states is to impose stringent budget discipline rules and extremely harsh conditions for the provision of urgent external financial aid.

**Development by the countries of adequate fiscal rules is an important practical fiscal-policy-coordination task. Simple imposition of debt and/or budget deficit thresholds leads to procyclical fiscal policy, which makes it possible not to react to external shocks.** The problem is resolved by setting targets relative to the structural budget balance, which is adjusted to reflect the cyclical component of income and expense items and one-off shocks.

All further efforts aimed at the coordination of fiscal policy may prove inefficient unless and until the governments manage to reduce inflation and its volatility, increase the level of the credibility of national currencies, minimize dollarization, and carry out responsible fiscal policies.