16 February 2000

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THE MONETARY POLICY: IS NORMALIZATION REALLY ACHIEVED?

The undoubted progress achieved by Russia's monetary authorities in reducing the rate of inflation does not allow supposing the normalization of the monetary policy in Russia has taken place. There are three main arguments in favor of this opinion:

1) The federal budget has been the main source of demand for the Bank of Russia's additional liquidity. The fact that the Government did not receive the budgeted external loans made it more actively use the Bank of Russia's credits in order to service its obligations under the portion of the external debt that Russia has agreed to fully service.

2) The Bank of Russia found itself to have a very limited choice of instruments for the conducting of the monetary policy and management of aggregate liquidity. Foreign exchange transactions have become nearly the only instrument available.

3) A relatively steady (not growing) demand for the rubles by the nonfinancial sector of the economy has resulted in the emerging of the problem of money overhang, excessive liquidity accumulated by the banking sector.

Crediting the Government

The needs of the federal budget in the provision of financing of its expenditures obviously exceed its revenue capacity or ability to attract sources of financing from the market. Given this situation, the Russian authorities, beginning in late September 1998, resumed actively and consistently the policy of state debt monetization by using the Central Bank credits for financing the needs of the federal budget in the servicing of its obligations. As a result, the growth of money supply is caused to a significant extent not by the growing demand for money by the economy, but rather by the budget's needs in financing its expenditures. For instance, over the last 100 days in 1998, the share of the budget[1] in the increase of reserve money reached about 68%, while the same indicator for 1999 was equal to 65%.

It is easily understandable that the entire increase in the money supply through credits extended to the budget is free of charge for the economy; moreover, this money is all but free

[1] The sum of the ruble–denominated credits from the Bank of Russia *plus* the ruble equivalent of foreign exchange–denominated credits *plus* government securities purchased by the Bank of Russia for the formation of the charter capital for the ARCO.

and, perhaps, not subject to repayment for the federal budget either[2]. An economy that receives great volumes of monetary resources for free (9% of the quarterly GDP in late 1998 and 3.35% of GDP in 1999) has naturally no additional need in money.

One implication of this is the lack of demand for money by the banking sector — during 1999, all the credit auctions of the Bank of Russia were recognized invalid because no bids had been received. This is no surprise, because it was the refinancing rate of 60% (before mid–June) or 55% (as from mid–June till the year–end) that served as a mark for the interest rates in the Bank of Russia’s crediting. For the Bank of Russia, the above interest rate level, to all appearances, was caused by the level of yield at the secondary market for government securities. A supposition that the Bank of Russia, in its determining the refinancing rate, was being guided by the target marks relative to the real interest rates does not pass the practical test: the current rate of inflation was steadily declining in 1999 (82% per annum in the first quarter, 32% per annum in the second quarter, 24% per annum in the third quarter, and 16% per annum in the fourth quarter), which led to a considerable growth in the real interest rates of the Bank of Russia. Obviously, neither the real shape of the Russian economy, nor the views of the senior management of the Bank of Russia required so sharp an increase in the real interest rates.

Financial markets

A second and, perhaps, more important from the institutional point of view, consequence of the monetary policy oriented to the meeting of needs of the budget, was that in the absence of an operational market for government papers and demand for money by the financial and nonfinancial sectors, the Central Bank has nearly completely lost the opportunities for liquidity regulation in the banking sector. The Bank of Russia did not have instruments other than transactions on the foreign exchange market for day–to–day regulation of the volume of money supply.

Ruble–denominated deposits attracted by the Bank of Russia served to a certain extent as a day–to–day regulator of this kind, although this instrument has a number of disadvantages. Firstly, the yield on deposits, especially short–term deposits, was staying at a very low level throughout the year. Secondly, deposits at the Bank of Russia are illiquid assets that are impossible to sell or pledge if there is a need in liquid resources.[3] Thirdly, this

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2 In compliance with the legislation, the Bank of Russia may extend credits to the federal budget at an interest rate of 2 to 10 percent per annum for a period of 6 to 19 years in case of ruble–denominated credits and “at the minimal market rates” for a period of up to 5 years in case of foreign exchange–denominated credits. The practical experience with the Russian budget legislation from 1997 to 1999 has shown that once the credits previously extended by the Bank of Russia to the Russian Government become mature, the legislator will decide on a roll-over from the Bank of Russia to the federal budget, so that such credits can be considered not subject to repayment.

3 In the middle of 1999, the Bank of Russia allowed early withdrawal of banks’ deposits, however, at a two–days’ preliminary notice and with a significant loss in revenues.

instrument is unidirectional for the Bank of Russia, because its use can lead only to liquidity withdrawal, but it cannot help provide additional liquidity to the banking sector. Furthermore, the principles applicable to attraction of deposits and determination of interest rates on deposits do not allow the Bank of Russia achieving qualitative goals, making it take a passive stance, inasmuch as the initiative in the use of this instrument belongs to banks.

An obvious solution to the current Bank of Russia's situation could have been either a restoration of the market for government borrowings, or an active use of bonds issued by the Bank of Russia. Initially, novation of government papers that dragged on for over six months and the related termination of transactions on the secondary market prevented the GKO–OFZ market from restoration after the 1998 financial crisis. Later on, in spite of the repeated statements on the possible issuance of new debt notes, the Ministry of Finance has never undertook this measure that is critical for the restoration of normal operation of the market and normal "dialogue" between the issuer and investors. The stance of the Ministry of Finance in this matter obviously had an exclusively fiscal explanation: new domestic borrowings, due to constraints on the level of budget deficit, were to become an alternative to the Central Bank credits, that alternative being more expensive and less convenient in terms of maturity, because borrowings from the financial market can be made for shorter periods, and their repayment is obligatory.

Bonds to be issued by the Bank of Russia, the decision on whose issue was taken back in the summer of 1998, could have been an alternative instrument for the restoration of the financial market. However, initially the Government, under the influence of a deconstructive stance of the Federal Security Commission that deemed it illegal to have bonds issued by the Central Bank, made the Central Bank to suspend the issue of debt instruments pending adoption of appropriate amendments to the legislation. Later on, after the above amendments were adopted in July 1999, it was the Bank of Russia itself that did not use the opportunity at hand.[4]

Thus, none of the two state institutions that were able to undertake practical steps for the restoration of the financial market has done anything to make it happen, this way constraining even more the capacity of the Government in day–to–day regulation of the money supply.

[4] After the amendments to the legislation were adopted, it "all of a sudden" appeared that there were unsettled technicalities, for instance, those relating to bond registration and taxation of the Bank of Russia. Once all bureaucratic barriers were removed, the Bank of Russia announced an issue of its bonds in the middle of December of 1999, but… recognized the auctions held for their placement invalid, deeming that the price expectations of the potential investors were overcharged. The term of validity of the law regulating bond issue by the Bank of Russia was over on December 31st, 1999.

"The money overhang"

Every central bank in the world faces a challenge of regulation of the money supply, regardless of whether it is quantitative parameters of money aggregates or the level of interest rates that it uses for targets. At certain points in time, the need in a more active use of such instruments becomes especially acute. In case of the Russian situation, the monetary instruments, perhaps, are even more important, because one of the specific features of an economy in transition is inescapable efforts to be applied by the monetary authorities to fight excessive liquidity.

Inflow of capital into the economy and the related growth of foreign exchange reserves are the sources of such excess in countries that are successful in their reforms. This "threat" is obviously not the case for Russia yet. However, one of the reasons that the Russian reforms have not been successful so far is the lack of independence of the monetary policy, whose trends are predetermined by the needs of the federal budget.

This kind of dependence unavoidably brings about a mismatch between the behavior of the money supply growth and the behavior of demand for money by the Russian economy. The events that took place in 1999 have shown that the financing by the federal budget will not only cover all the requirements for money in the economy, but will also regularly generate "surplus" ruble resources.

The banking sector appears unable to absorb the liquidity generated by the Central Bank, because the demand for the ruble resources by the nonfinancial sector, obviously, cannot grow faster than the economy[5], while the capacity of the financial sector is also limited due to the lack of sustainable operational financial markets.

As a result, from time to time there The Russian banking sector accumulated considerable amounts of excessive monetary resources, which were concentrated either at correspondent accounts with the Bank of Russia, or at bank deposits with the Bank of Russia. The volume of "excessive" ruble resources in circulation in the Russian economy can be evaluated at approximately 30 billion rubles[6], that is, about 6% of the total amount of monetary reserves.

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[5] This point may turn out to be unworkable, if the government starts to conduct a tougher policy in tax collection: a greater pressure from the government may force the taxpayers to abandon noncash settlements, which would lead to a higher demand for money, while in the statistical reports the transition to monetary settlements may result in reduced value–based volumes.

[6] This is made up with two summands. The first one is the average amount of deposits attracted by the Bank of Russia, that was in the range of 15 to 20 billion rubles during 1999. The second summand is excessive funds held at banks' correspondent accounts, which we estimate at 15 billion rubles. The following estimation method was used: the total funds held at banks' correspondent accounts in the first quarter of 1998 amounted to approximately 20 billion rubles and to 63 billion rubles in December of 1999. Consumer prices have grown 2.5 times and producer's prices, 2 times over 1998–1999; given the increased share of monetary settlements in the Russian

Obviously, the fact of there being so large a “money overhang” causes a certain concern with the Russian monetary authorities and often shows itself as a source of pressure on the exchange rate of the national currency. The lack of appropriate instruments for the conducting of monetary policy prevents the Central Bank from sterilizing the excessive liquidity somehow or other in the ordinary working manner. Raising the legal reserves ratio remains the only way of doing it, which was strikingly demonstrated by the Bank of Russia in early January of 2000, when, amid expectations of the seasonal increase in demand for foreign exchange, the balances on banks’ correspondent accounts had grown by more than a third to reach 90 billion rubles. The Central Bank’s response was to raise the legal reserves ratio up to 7% for the ruble–denominated deposits of physical persons, and up to 10% for both ruble–denominated deposits of legal persons and foreign–exchange–denominated deposits of legal or physical persons, which allowed withdrawing about 15 billion rubles from the banking sector.

It is obvious, however, that, firstly, due to the specificity of the Russian monetary and fiscal policies, generation of excessive liquidity will continue and, secondly, the use of the legal reserves ratio for liquidity regulation cannot be a permanent tool and would lead to significant problems in the development of the banking sector.

Conclusion

On the whole, the evolution of the situation in the area of Russia’s monetary policy and exchange rate policy has consolidated their dependent, subordinate character relative to the federal budget agenda. The Central Bank has practically no opportunity (incidentally, no desire either) for conducting an independent monetary policy aiming at regulation of money supply and interest rates.

In spite of there being no efficacious instruments available for conducting the monetary policy, the Russian monetary authorities have succeeded in stabilizing the macroeconomic situation in 1999, although to a large extent that was possible because of an exclusively favorable foreign trade situation.

The projected further improvement of the commodity market situation in 2000 may result in the Bank of Russia’s facing the following problem: the supply of foreign exchange on the home market could significantly exceed the demand for it, and the increasing gold and foreign exchange reserves could cause excessive growth of the money supply and the emerging of a problem of necessary sterilization of the excessive liquidity; whereas restricted purchase of foreign exchange by the Central Bank could cause the [relative] depreciation of the US dollar and considerable strengthening of the exchange rate of the ruble in real terms. The first option is fraught with inflationary consequences (although, most likely, going beyond the year of 2000), and the second option, with the growth in imports and reduced competitive power of Russian products on the home market. However, this problem would

economy, a 2.5 times growth of the balances on correspondent accounts may be objectively justified; therefore, 13 billion rubles can be considered “excessive”.

become visibly acute not earlier than in the second semester of the year, and for this reason the behavior of macroeconomic indicators in 2000 would not significantly vary regardless of the responses by the monetary authorities.

A possible new decline in the world prices for Russian exportable products poses another threat for Russia, which would aggravate the balance on current account and would create a problem of excessive pressure on the ruble. This threat, however, will definitely go beyond the year of 2000 and, probably, 2001.

The fact that there is a whole range of problems of structural and institutional character in the monetary area does not allow deeming the current stabilization in Russia sustainable or, even less so, hoping that Russia would be able to cope with the problems that it seems to face in the medium term.