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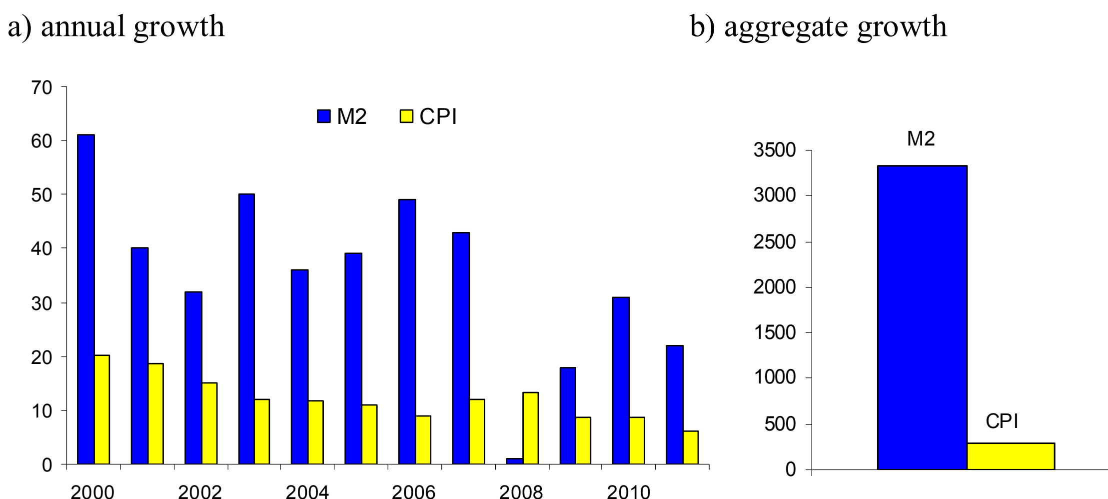
About Inflation and Monetization

According to the approved text of the monetary policy of the Bank of Russia, its top priority is to ‘ensure price stability, i.e. keep price growth rates consistently low’.[1] Inflation is, indeed, planned to stay at 5-6% in 2013 (November forecast by the Bank of Russia and the Ministry of Economic development), which implies a further inflation reduction trend that started in 1998. In such context, the economy is supposed to attain sustainable growth rates, which will require appropriate financing and might lead to a price growth. Are these tasks compatible with each other? The rouble monetary base (i.e. rouble creation) is assumed, among other things, to grow at rates about 10%, which, subject to the multiplier effect, may result in an almost 19% growth of the money supply. In other words, getting more money into the economy is not expected to result in a proportional increase in prices.

We would note that the above trend of prices lagging behind the liquidity growth has been observed in the Russian economy for more than 10 years! (Fig. 1a)

Fig. 1 Money supply growth and inflation (CPI) in Russia in 2000-2011, %

a) annual growth b) aggregate growth



Source: Bank of Russia

* The article reflects the personal opinion of its author.

[1] “Guidelines for the Single State Monetary Policy in 2013 and for 2014 and 2015” / Bank of Russia. P. 3

It would seem that additional liquidity growth should 'spur on' price growth. This doesn't happen however in our case, and for a quite long while. Moreover, the resulting difference between these indicators is quite significant (Fig. 1b).

We did forecast such scenario 12 years ago when inflation was either subject of critical comments or nothing at all. Among other things, we highlighted that due to low monetization the Russian economy 'showed itself capable of absorbing additional rouble resources with zero inflation'.[2] In this connection, we concluded that 'non-monetized operations … may, to a significant extent, contribute to a successful expansion of the capital base of the economy'.[3] Such conclusions and forecasts were justified given the 'monetary collapse' that took place in the first half of the 1990s' when price growth rates outpaced the growth of money supply by a factor of 10, which, led to its (i.e. money supply) reduction by the same magnitude! (Fig. 2, 3).

Fig. 2 Consumer price indices and M2 in 1992-1996 (1992 = 1) in Russia

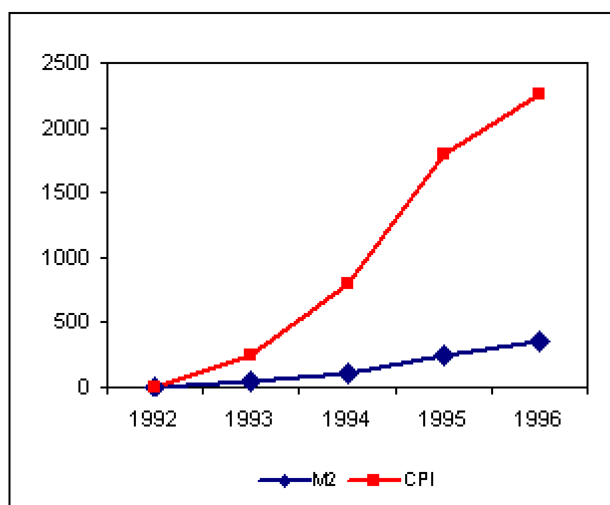
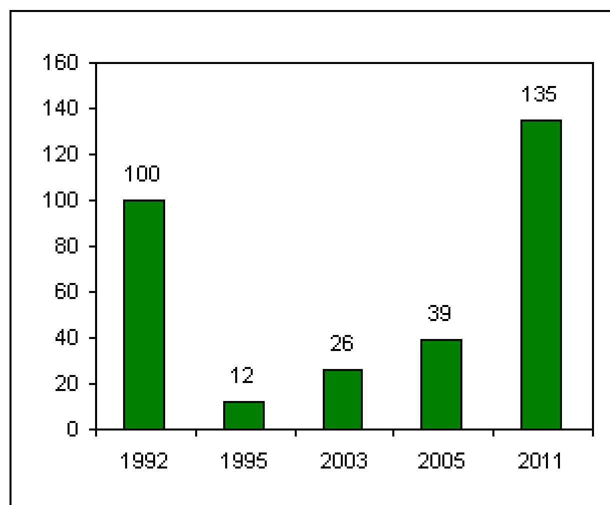


Fig. 3 Real money supply growth in 1992-2011 (1992 =100%) in Russia



Source: calculated based on data by the Russian State Statistics Service

Such 'monetary shock' quite naturally resulted in non-payments, barter, surrogates and other 'quasi-money' that the economy could use to compensate the emerging misbalances. It was evident that inflation implications from money growth in such circumstances would be limited. 'Money contraction' led to a decrease in both bank capitalization and monetization of the economy on the whole, which have grown in the recent years, but are still low and may substantially constrain the economic growth potential (Fig. 4, Table 1).

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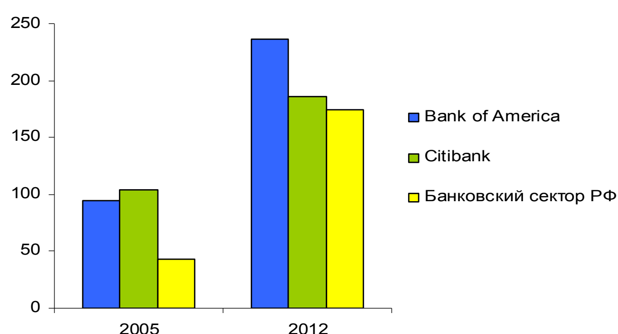
[2] Ershov M.V. Monetary and Financial Mechanisms in the Today's World: Crisis Experience of Late 90s. Moscow. Ekonomika. 2000. P. 318

[3] Idem P. 317-318

Fig. 4 Capital of major banks and Russian banking system (USD bln)



Source: based on data of the Bank of Russia and US Fed

Table 1 Monetization ratio in a number of countries

	1996	2011
China	213	184
Japan	109	178
UK	92	131
Germany	35	74
US	50	64
Russia	**13**	**45**

Source: International Financial Statistics, Bank of England, Bank of Japan, US Fed, Bundesbank, National bureau of statistics of China, Bank of Russia

Moreover, the low capital base of the economy does not allow effectively neutralizing the destabilizing effect of the 'hot' money inflow, while this risk becomes more and more pronounced. In the context of the global liquidity surplus, even the IMF, despite its traditionally liberal approaches to capital flows, has to admit recently that 'introducing CFMs (capital flow management measures) can be useful for … safeguarding financial system stability'.[4] Long before the crisis, M. Mussa, a prominent economist and IMF official (Director of the IMF's Research Department for 10 years) pointed out: 'High openness to international capital flows, especially short-term credit flows, can be dangerous for … inadequately **capitalized** (bolded by the authors – M. E.) and regulated financial systems.'[5]

Subject to new risks, a number of emerging countries (e.g. Brazil, South Korea) have already started introducing measures in order to neutralize the negative effect of speculative inflow of short money. Many countries are considerably increasing their monetization and capital base as it is obvious that the larger the national economy's scale and monetization is, the less it is exposed to the destabilizing impact by 'hot' money. In such case, undesirable outflow of resources are regulated by ratios and other measures that make transactions with the national currency more attractive.

[4] The liberalization and management of capital flows: an institutional view. IMF. 2012. 14 November. P. 18.

[5] Quoted from: Kaplan E., Rodrik D. Did the Malaysian Capital Controls Work?-NBER Working Paper 8142, February 2001, p. 2.

All this is extremely important for the Russian economy, which does need to assure in full sustainable growth and minimize external risks. To this end, the Russian economy needs an appropriate supply of financial resources that should primarily be driven by domestic rather than external sources of monetization, with the leading role to belong to national monetary authorities (as is the case in mature financial systems). Such supply should be targeted (i.e. should be focused on economic development priorities). Inflation risk should be limited by the low level of monetization of the Russian economy, while the resulting economic growth potential will lay the foundation for economic growth for many years to come. Where necessary, the negative impact of external factors (including those related to both inflow and outflow of financial resources) may be minimized by regulation of capital flows.