

## **Wrong Emphasis**

The Central Bank's monetary program for 2010 puts major emphasis on external factors in the formation of national money supply. This makes our monetary policy more subordinate to the global commodity and financial market environment, making it more vulnerable to global risks.

The wide use of antirecessionary measures has led to an increase in liquidity in the world. These resources will seek spheres for their use, thus making large-scale cross-border flow of funds (often short in the nature) highly possible and will increase risks for recipients of such funds. A potential increase in net inflows of foreign capital into the Russian economy gives rise to "hot money" risks, which draws attention of the regulators.

Mechanisms for forming internal sources of financing should play an equally important role of antirecessionary stabilizers. They would make the development of domestic economic processes to be less dependent on the global market environment and replace short-term external funds.

A large attention should be paid to mechanisms that create money supply. In Russia, money supply has for many years been based on an inflow of export earnings and foreign loans. This increased our economy's dependence on the external commodity and financial market environment and eventually aggravated the overall recessionary developments.

New risks forced Russian regulators to apply new approaches toward their minimization. They started to make extensive use of refinancing mechanisms, unsecured lending, and other antirecessionary forms of lending.

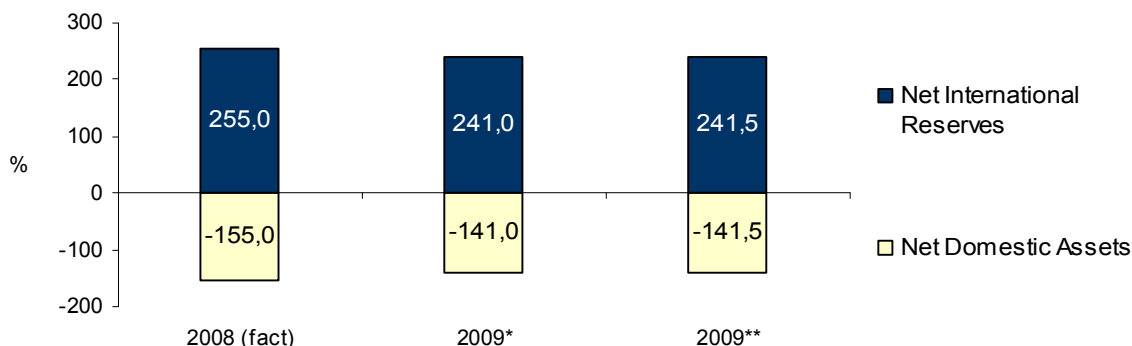
Adopted last year, "The Guidelines for the Single State Monetary Policy in 2009 and for 2010–2011" actually for the first time in many years focused on an increase in domestic sources (net domestic assets) for forming money supply, reducing the role of external factors. The Guidelines emphasized that this would be of "paramount importance for the implementation of the monetary policy" and make it possible to "use more effectively the interest rate instruments of monetary regulation and make the interest rate channel of the monetary policy transmission mechanism work." In addition, it was expected that "the scaling down of the Bank of Russia

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\* The article reflects the personal opinion of the author.

presence on the domestic forex market will help make the exchange rate policy more flexible and implement a gradual transition to the free floating exchange rate regime.” It is also obvious that these approaches were supposed to diminish the influence of external risks and facilitate financial flows into non-export sectors, promoting structural transformation. All this was very important for the economy. The strengthening role of the internal factor could indeed be observed in 2009 (Fig. 1).

**Figure 1. Monetary Base of the Ruble in 2008 and 2009:  
the Share of External and Internal Sources, %**



\* calc. based on the basic (third) variant of CBR monetary program of 2008.

\*\* est. of CBR (Nov. 2009)

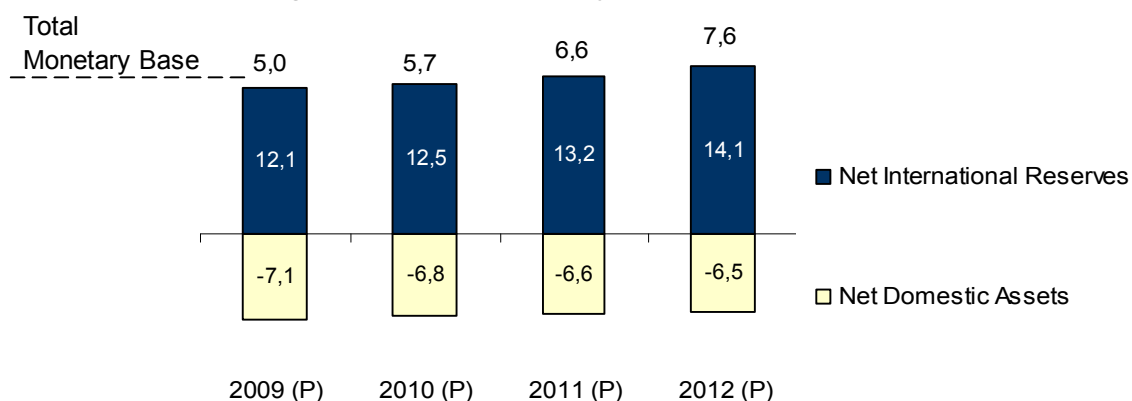
Source: calc. based on Guidelines for the Single State Monetary Policy in 2009 and for 2010 and 2011; Guidelines for the Single State Monetary Policy in 2010 and for 2011 and 2012/CBR.

However, the plans for 2010 have been changed.

### **A Step Back**

The monetary program for 2010 was developed based on the assumption of growing net international reserves as the main source for the growth of the monetary base. This actually means a departure from the approaches that were announced by the Central Bank a year earlier and which were taken to reduce the crisis risks. These approaches aimed to use domestic monetization sources as the main ones. Now again, as during many preceding years, external sources will again serve as a main source in the formation of the monetary base (Fig. 2).

**Figure 2. Sources of Monetary Base Formation\*, Rub trln.**



\* 2009 - est. of CBR, 2010-2011- projections of CBR according to the basic (second) variant of monetary program. Source: based on Guidelines for the Single State Monetary Policy in 2010 and for 2011 and 2012/CBR.

Can one say that the aims indicated above in the document of 2008 have lost their relevance? On the contrary, they appear to have become even more relevant. One should bear in mind that the external channel of monetization involves primarily a translation into Russia of external risks related to the attraction of resources (or impossibility of this attraction, as was the case during the crisis). In addition, these approaches work toward preserving the export and raw-material orientation of the Russian economy, since by selling currency earnings and thus receiving rubles, an exporter of raw materials actually forms demand for the other economic sectors, which increasingly start to serve the interests of raw-material sphere. We have to bear in mind that departing from the raw-material orientation is set as an important systemic objective, which was again reaffirmed by the Russian President in his recent address.

Another question that one might ask is: how do the objectives to reduce the presence of the Bank of Russia in the domestic currency market comply with the aim of retaining the currency earnings as the main source of money creation. After all it's the Bank of Russia that has to buy foreign exchange and to create rubles in this case.

Growing international reserves obviously increase strength for the economy (it was seen during the crisis). However, it does not mean that we should switch to the "currency board" mechanism (at least in its essence), where the entire liquidity forms only on the basis of exchange inflows into the country, while the Central Bank actually refrains from its main function as a primary source of financial resources, to which export and non-export sectors have equal access.

Export earnings and foreign loans will enter the economy anyway. Their role in the formation of the monetary base, however, should be balanced by mechanisms which originate resources domestic by nature. Such origination should reckon with the needs of non-export

sectors. Without their development, one can hardly count on real diversification of the economy and its departure from its raw-material profile.

However, the Monetary Program for 2010–2012, as compared with the plans adopted a year earlier, provides for a considerable reduction in gross credit to banks and a decrease (although a much smaller one than it was planned) in net credit to general government.

Indeed bearing in mind a possible increase in budget deficit and non-active role of many banks in the crisis the government channels of money transmission including budgetary ones may play more important role. Combined role of all domestic channels should be more significant since in the opposite case the lack of financing will be offset by external funding with all ensuing risks attached to it.

With a continued external surplus (which is quite probable with relatively high oil prices), external monetization, although being an important source, should not be an exhaustive source of monetary resources in the economy. If the objectives toward improving the economic structure and lowering external risks retain their relevance, then it is necessary to carefully assess the possibility of a mixed approach, where to the forefront comes the objective for providing funds to the domestic economic sectors while maintaining optimal level of exchange rate. In this regard, it might be worthwhile to assess the need for additional opportunities of the Ministry of Finance to accumulate some part of currency resources from the market by placing its securities and other instruments (with a subsequent currency sale without the use of currency market and without direct influence on exchange rate) and other approaches. In this connection, currency earnings may remain in the currency market rather than be purchased by the regulator in full, which will promote appreciation of the ruble, on the one hand, and an incomplete formation of money supply on a currency basis, on the other. The parallel use of additional mechanisms of monetization will balance the above tendencies and will replenish the monetary base as well as lower the exchange rate of the ruble. With this approach in place the financial resources will be less concentrated in oil and gas sectors and will reach other spheres. It is also possible to use other mechanisms.