

## Analysis of Monetary Mechanism Functioning in Belarus

*One popular American textbook contains a phrase meant to make an example: "The main task of the FRS /the Federal Reserve System – the Central Bank of the USA/ is to lay down a firm foundation of monetary policy in order to ensure a high and stable level of production of goods and services" (Miller, 2001). It appears to be fair for each country because the monetary sector is part and parcel of the economic system of a state. Therefore, the monetary policy mechanism must also be considered as part of a single economic mechanism that is implementing stable extended reproduction. Accordingly, a systematic analysis of the monetary mechanism reflecting interrelation of the monetary sector with other sectors of the economy, as well as coordination of objectives and instruments of monetary, fiscal, foreign economic, and production regulation would enhance monetary policy effectiveness.*

In the Republic of Belarus, consideration and estimation of a variety of monetary mechanism channels as well as the adverse effect of macroeconomic measures on the monetary sector are considered, above all, from the organizational and methodical point of view.

### Organization of Monetary Policy Development and Implementation

Article 4 of the Banking Code of the Republic of Belarus prescribes that monetary policy is a component part of a single state economic policy. At the same time, Article 24 specifies that the National Bank is independent in its operation. In accordance with these principles, monetary policy is formulated and implemented as part of a single process of developing and implementing monetary policy strategy and tactics. In doing so, internal coordination of arrangements aimed at developing the monetary sector as well as external coordination thereof with the directions of evolution of other economy sectors are ensured.

Therefore, three key stages of monetary policy development and implementation could be identified in the system context (*figure 1*).

Stage 1. Defining strategic macroeconomic and monetary objectives, methods and means of their achievement. This stage includes the design of long- and medium-term programs. In accordance with the world practice and economic concepts the said programs constitute a strategic basis for justifying the implementation mechanism of both macroeconomic and monetary policies. The programs define parameters of major objectives; directions of macroeconomic development of the state and its monetary sector; fundamental principles and means of the achievement thereof, the main objectives being the achievement of sustainable economic growth; high employment level; price stabilization; foreign economic balance; and, based thereon, improvement of living standards.

Forecasts are based on the analysis of social, economic, population, and ecological environment, scientific, technological and production capacities of the country, external conditions, natural resources and prospects of changes of the said factors. Besides, forecasts are made in several variants, taking into consideration probabilistic changes and the extent of influence of internal and external economic and other reasons.

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In accordance with the Law "On State Forecasting and Programs of Social and Economic Development of the Republic of Belarus", two major long-term documents – the national strategy of sustainable social and economic development and guidelines of social and economic development for 15- and 10-year periods, respectively, are to be developed.

Medium-term social and economic development programs, in turn, are designed to ensure continuity of a long-term economic strategy. These 5-year programs are considered to be the most significant document that determines the development of the country's economy in the foreseeable future. At the same time, economic stabilization, accumulation of the domestic and world theoretical and practical experience, and, accordingly, the expansion of the possibility of real estimation of the consequences of structural and institutional changes resulted in an increase in the importance of medium-term programs.

At the same time, in long- and medium-term programs, monetary policy which is aimed at the achievement of common strategic objectives by means of ensuring the soundness of the national currency, increasing banking system liquidity and soundness of the banking system, and ensuring the effective and secure functioning of the payment system, stands out against other significant means and financial and economic mechanisms.

Besides, it is important to note that conditions of implementation and parameters of macroeconomic programs serve as a basis for preparing relevant forecasts and programs of development of virtually all sectors of the economy and regions of Belarus. To assist in the implementation of social and economic development of the country, and as part of meeting the targets and parameters, the 5-year Program of development of the banking sector of the economy of the Republic of Belarus for 2006 – 2010 is being implemented. This program determines the following objectives of banking sector development: first, enhancing stability and effectiveness of the banking sector; and, second, improving and updating the list of banking instruments in line with the increasing needs of the economy and households.

It is worth noting that, based on the strategic objectives, tasks, means, and mechanisms of monetary policy determined within the framework of said programs, the conceptual directions of the development of instruments of the National Bank as well as basic regulations regarding their implementation and functioning are devised at the National Bank. These include: the Concept for developing the national payment system of the Republic of Belarus until 2010 which takes account of the world trends, the Concept for developing the system of non-cash settlements of retail payments until 2010; the Principles of foreign exchange reserves management by the National Bank of the Republic of Belarus; the Principles of regulation of the banking system's current liquidity by the National Bank of the Republic of Belarus, and others.

Overall, the Republic of Belarus has established quite clear procedures, which are in line with the world experience, for the design of long- and medium-term macroeconomic and monetary programs. Still, it is necessary to strengthen the financial part of the programs, and take into account more foreign economic factors, which, in addition to the development of the methodological and information mechanism, implies amending the Law "On State Forecasting and Programs of Social and Economic Development of the Republic of Belarus".

There is a need for the development of short-term tactical objectives and measures (they are being developed at present), with a view to meeting the strategic objectives established at the current stage, as well as ensuring the relevant forecast trends and structural changes.

**Stage 2. Coordinated development of tactical social, economic, and monetary programs for the subsequent year.**

This stage implies coordinated analytical and forecast work primarily aimed at preparing key documents: forecast of economic and social development of the country, including its balance of payments; state budget; and monetary policy guidelines. They also serve as a basis for devising sectoral and regional programs.

Importantly, the parameters of social and economic development forecast form the basis for drafting the republican and local budgets and monetary policy guidelines. At the same time, the financial and monetary proportions, worked out on their basis, might necessitate certain adjustments of the initial target estimation of macroeconomic indicators. Therefore, the procedure for preparing said three documents is iterative.

In accordance with the Banking Code, monetary policy guidelines are considered to be a legal framework of monetary policy of the Republic of Belarus. They include key parameters of monetary sphere development, determine objectives, tasks, and priorities of state monetary policy, and provide for a complex of activities and regulation and control mechanisms aimed at ensuring their implementation.

In addition, the qualitative structure of the Republic of Belarus Monetary Policy Guidelines takes account of the necessity of coordinated attainment of monetary and macroeconomic objectives and therefore includes:

- brief characteristic of the economic situation of the country;
- estimation and analysis of implementation of key parameters and usage of the monetary policy instruments in the current year;
- key parameters of the forecast of social and economic development of the Republic of Belarus for each subsequent year, including the forecast of the main indicators of the balance of payments;
- key parameters and instruments of monetary policy of the Republic of Belarus for each subsequent year; and
- activities aimed at the improvement of the banking system, banking supervision, financial markets, and the payment system of the Republic of Belarus.

At the same time, taking into consideration the increasing importance of medium-term macroeconomic and monetary forecasts at a time of stabilization and accumulation of domestic and world theoretical and practical experience is stabilized and accumulated, it is possible to consider expanding the time period of the Republic of Belarus Monetary Policy Guidelines, specifying the Banking Code provisions, in particular, Article 4.

It should be noted that the forecast monetary documents similar to the Republic of Belarus Monetary Policy Guidelines, are prepared and implemented by the central banks of a significant number of countries, though the status, form, and time period of forecasts vary due to different economic and monetary regulation systems of the countries. At the same time, we can single out the trend of development of the National Bank's objectives and means as part of the processes of harmonization of activities of CIS central banks, EurAsEC (EuroAsian Economic Community), and other integration structures. Besides, the world monetary experience, including that of the neighboring countries, is widely used.

Yearly (starting from 2004) preparation of a consolidated document, which combines the activities aimed at the achievement of objectives of the development of all sectors of the economy – Joint Plan of Action of the Council of Ministers and the National Bank Aimed at Meeting the Targets of Social and Economic Development, the Budget, and Monetary Policy Guidelines for the Subsequent Year – may be regarded as a logic completion of the development of a single state economic policy

of the Republic of Belarus. It includes primarily measures that, in order to be adequately implemented, require coordinated and quite long preparation work, as well as exchange of information or consideration when the Government and the National Bank carry out particular activities independently.

Stage 3. Implementation of monetary policy measures during the year taking into consideration existing economic and monetary trends.

This stage reflects activities required of all the services of the National Bank for the subsequent year. The dynamics during the year that takes into consideration forecast economic trends and makes it possible to use a systemic approach to prepare and implement the entire set of monetary instruments, is estimated for the key monetary parameters.

At the same time, real changes in the economic and financial situation determine the need for the coordination and adjustment of the monetary instruments on an ongoing basis. Therefore, monetary policy implementation, especially in the sphere of monetary operations, includes gradual stages of preparation of interrelated quarterly, monthly, weekly, and daily forecasts and decisions during the year. They, accordingly, justify and determine conditions for conducting particular monetary operations, as well as applying regulatory means and carrying out organizational activities (Lobanov, 2006).

Virtually all the instruments of the National Bank are aimed at the economic regulation of the banking sector which provides the non-financial sector of the economy with direct monetary support, conducting necessary assets, liabilities, and agency operations. Therefore, it would be appropriate to say that it is banks that form the institutional foundation of the monetary mechanism. However, as all financial market segments develop, the number of subjects of the monetary mechanism should expand.

The following three groups of the National Bank interrelation with the banks may be singled out:

- monetary relations;
- relations in the course of banks' performance regulation (directly regulatory) that are connected primarily with the state registration of banks and licensing of banking activity, regulation of and supervision over banks' activity regarding safe and liquid performance thereof, establishment of rules and procedures for banks' operation, and coordination of certain activities thereof; and
- relations in the course of ensuring the functioning of the payment system, that also affect banks' activity;

Besides, additional information relations of the central bank with the banking sector emerge deriving from them.

Eight major forms can be identified in the structure of monetary relations of the National Bank with banks (*figure 2*). They reflect the functional structure of operations of the central bank with resident banks. The list of operations shows that the National Bank and banks are the active operators in the monetary and foreign exchange markets, as well as in the securities market.

**Figure 2: Major forms of monetary relations of the National Bank with banks**

- 1. Refinancing operations:**
  - 1.1 Lombard credit: auction; at fixed rates
  - 1.2 Purchase of Government securities: REPO; to maturity
  - 1.3 Forward purchase of foreign exchange (SWAP)
  - 1.4 Intraday credit (overnight)
- 2. Attraction of resources:**
  - 2.1 Banks' required reserves
  - 2.2 Sale of Government securities: (REPO); to maturity
  - 2.3 Taking money into deposits: auction; at fixed rates
  - 2.4 Issue of securities of the National Bank
- 3. Purchase and sale of foreign currency** (in the segments of the open foreign exchange market for regulation of the foreign exchange rate)
- 4. Purchase and sale of precious metals and precious stones**
- 5. Purchase and sale of cash** (to ensure cash circulation)
- 6. Regulation of market prices** (through prices of the National Bank operations)
  - 6.1 refinance rate — rates of the National Bank operations
  - 6.2 official exchange rate
  - 6.3 prices for precious metals and precious stones
- 7. Participation in the authorized capital**
- 8. Agency operations:**
  - 8.1 operation of correspondent and other bank accounts
  - 8.2 through accounts of the Treasury of the Ministry of Finance with the National Bank
    - a) transfer of the Treasury's funds to banks
    - b) transfer of banks' funds to the Treasury

Each operation of the central bank with Tier 2 banks has the main target purpose, which to some extent becomes clear from the name of operation. At the same time, all operations in the aggregate have a significant effect on the financial stability of the banking sector, foreign exchange market, and consolidated monetary parameters. Therefore, they must be forecasted and conducted within the framework of coordinated technology.

In the totality of the National Bank's instruments, the refinancing operations and operations aimed at the attraction of banks' resources fulfill a sort of balancing function. They ensure the maintenance of banking sector liquidity — banks' ability to meet their obligations in due time — at a reasonable level. These operations are part of the system regulating the monetary sphere and therefore they are subordinate to the common objectives of the central bank of the country, i.e. protection and stability of the Belarusian ruble, assurance of payment system functioning, and the development and strengthening of the banking system. The most developing among them are auction operations of refinancing and auction operations designed to attract banks' resources. The policy of current liquidity regulation, on the whole, is based on the following underlying principles: targeted orientation, market relations with banks, security, transparency, efficiency, accessibility, and flexibility. Refinancing of banks is a form of providing monetary funds on the conditions of collectability and repayability on the part of the National Bank. It is one of the functions of the National Bank, the lender of last resort (both in respect of banks and the majority of central banks of other countries). But since the refinancing operations are one of the money issue channels, their volumes and principles thereof are determined within the framework of the overall monetary program.

Purchase and sale of foreign exchange is carried out by the National Bank in all foreign exchange market segments, primarily in order to regulate the exchange rate of the Belarusian ruble and smoothen its fluctuations that are not desirable for the foreign exchange market. At the same time, purchase (sale) of foreign exchange causes an increase (a decrease) in the foreign exchange reserves

of the National Bank as well as changes in banks' resources in the national currency, which ought to be taken into account in the system of liquidity regulation of the Belarusian banking system.

Purchase and sale of precious metals and precious stones is conducted by the National Bank primarily for the purposes of setting up a fund of precious metals and precious stones, as well as of operational management thereof within its competence. Besides, said operations facilitate the development of the precious metals and precious stones market, which is necessary in order to expand the sphere of the commodity-money relations and, accordingly, increase the level of the economy's monetization. Importantly, precious metals and precious stones are purchased more actively for Belarusian rubles which makes it possible to improve the balance of commodity-money proportions in the domestic consumer market and thus enhance the stability of the national currency.

Cash operations are carried out by the National Bank to ensure the functioning of cash money circulation in the country. Such operations result in the relevant changes in cash and non-cash money at the central bank and banks, which affects banks' resources and requires that it be taken into account in the system of liquidity regulation of the banking system.

Participation in the building up of banks' authorized capital is considered an interim measure of the central bank that is determined by the need to support the resource base of individual banks. At present, the National Bank owns shares of four banks. At the same time, the downside of its participation in the banking capital is, first, the issuing character of such financing and, second, the collision of interests of the central bank as an owner and a supervisory body. Therefore, the strategic objective of the National Bank is the reduction of its participation in the authorized capital of the country's banks.

Prices in the money market are regulated via two major channels. Firstly, through conducting operations, on a systematic basis and in significant volumes, for payment charged, depending on the instrument, in the form of interest and discount rates, tariffs, or difference in exchange rates. This determines the price for the common monetary resources of banks and other market participants and, accordingly, prices when they conduct assets operations thereafter. This channel is used primarily to conduct operations of banks' liquidity regulation, as well as foreign exchange trading operations, which are significant in volumes and are conducted on a regular basis. Secondly, price targets announced by the National Bank (above all, the refinance rate and the official exchange rate of the Belarusian ruble) are, to a great extent, directly considered by banks and other financial market operators when forecasting and setting their prices. Obviously, the significance of the second price channel depends on the systematic confirmation of the actuality of the central bank's targets.

Correspondent and other bank accounts are operated primarily to ensure uninterrupted and secure banks' settlements with their clients and fulfill monetary obligations to the state and other banks. In the Republic of Belarus, the mechanism of effecting interbank settlements via the single correspondent account of a bank opened with the National Bank was introduced in January 1993. Its introduction made it possible to enhance the effectiveness of the payment system, ensure control over banks' correspondent accounts, and regulate bank liquidity on the basis of step-by-step development of monetary instruments.

Operations conducted when the National Bank provides services to the Government in different segments of the financial market are also connected with the National Bank's monetary relations with commercial banks. Said operations ensure settlement and cash servicing of Government institutions; agency services provided to place Government securities; and the servicing of the state debt. Accordingly, significant monetary funds do not just move within the accounts of the Treasury of the Ministry of Finance opened with the National Bank, but are also transferred to banks or, vice-versa, are transferred by banks to these accounts. Therefore, the central bank is required both

to organize the settlement and payment process and carry out the activities agreed with the Ministry of Finance, that are aimed to streamline said money flows and regulate banking sector liquidity with a view to solving the tasks of a single economic policy of the country.

Thus, practical implementation of monetary policy by means of purposeful implementation of monetary instruments is the result of multistage and coordinated technology of functioning of the monetary regulation system as part of the overall and developing economic regulation system of Belarus.

## Monetary Forecasting Methods

Ensuring monetary policy effectiveness implies also the need for the design of scenarios of forecasts and decisions made by the central bank based on models and methods that take into consideration the totality of the channels of monetary policy influence on the economy.

Basic forecast calculations of monetary indicators are based primarily on the system of econometric models (SEM – MP-2) which includes three interconnected blocks: 1) interest rate channel; 2) exchange rate channel; and 3) the balance of money supply, the economy's demand for money, and prices. SEM includes four main models: consumer price index model; money supply model; model of the Belarusian ruble exchange rate; and interest rate model. The main interrelations of monetary and macroeconomic indicators of this system are shown in *figure 3*.

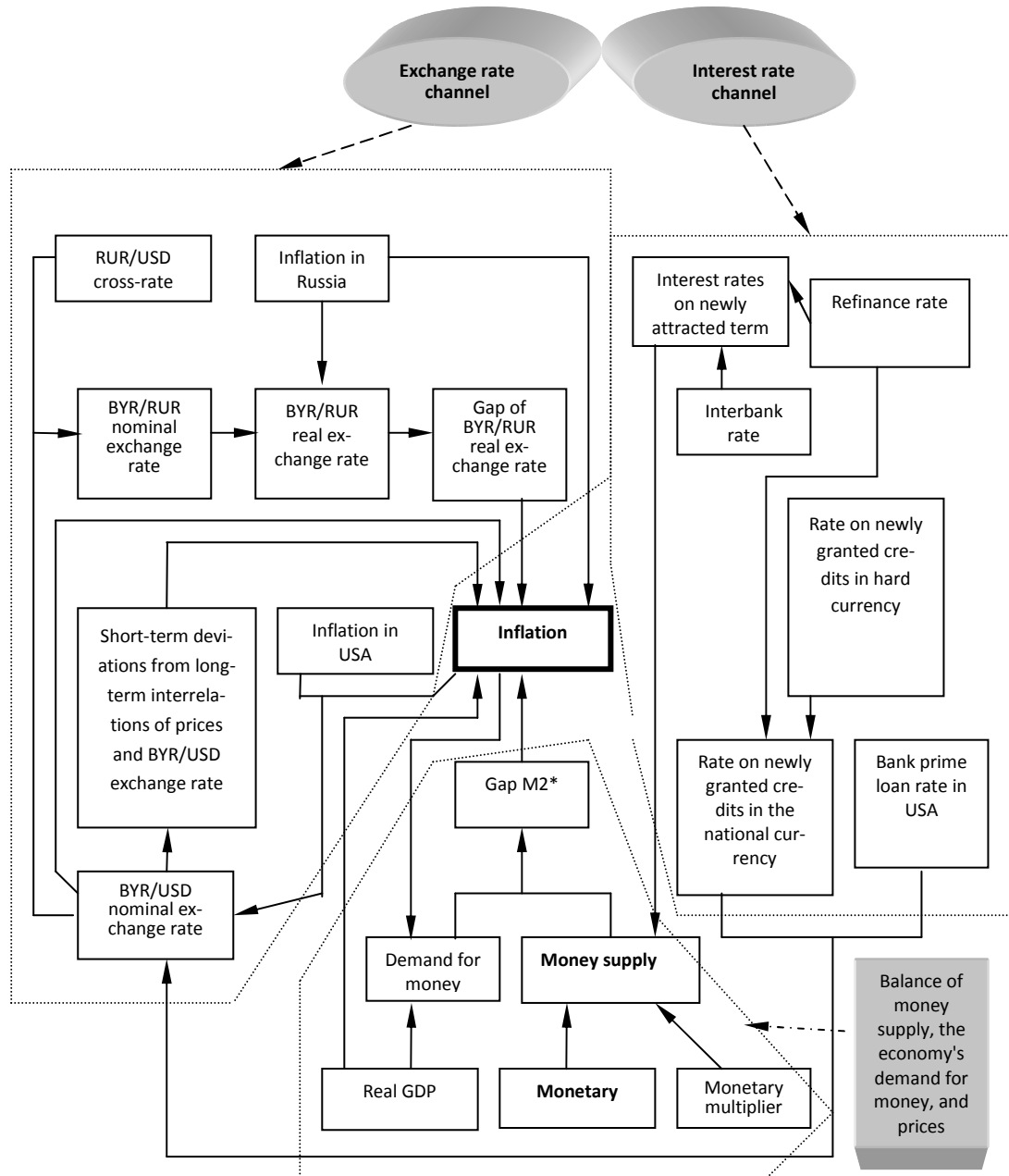
The system of SEM – MP-2 is designed to solve the tasks of formulating monetary policy of the Republic of Belarus (MP): 1) analyzing and forecasting monetary indicators on the basis of scenario calculations and 2) defining the required level of influence on the part of the MP instruments and exogenous variables which would make it possible to reach permissible values of intermediate and target indicators. The logic of its construction reflects the process of MP formulation which is based on the description of communication channels between the instruments that are under the direct control of the central bank and the final objectives of the country. There are three major stages of MP formulation: 1) setting strategic (final) objectives, 2) defining intermediate objectives, and 3) choosing monetary instruments.

The technology of scenario forecasting using this system makes it possible to take into account the complexity of macroeconomic relations when choosing monetary instruments (the ruble money base, the refinance rate, the ratio of the required and excess reserves to deposits, and the Belarusian ruble-US dollar official exchange rate). This is reflected in the fact that, firstly, forecast development takes into consideration foreign economic trends, and, secondly, the calculations are coordinated with the forecast parameters of the non-financial sector of the economy.

Besides, to obtain alternative variants of forecasts, the National Bank uses the Quarterly Projection Model (QPM) which is based on the New Keynesian concept (Mironchik, 2006). The model describes interrelations between the main macroeconomic variables: inflation, GDP in terms of the aggregate demand of the economy, exchange rate, and interest rate (*figure 4*). It makes it possible to make forecasts for a period when the effect of monetary impulses generated by the National Bank by means of interest and exchange rates regulation, on the aggregate demand and inflation (up to 12 quarters) is most effective.

The calculations made as part of said basic models, the estimation and detailed description thereof are supplemented with the forecasts of foreign exchange receipts on the basis of the balance of payments, price indices, the economy's demand for money, households' monetary incomes and expenses, as well as a number of other economic and monetary indicators. The calculations are made using a set of different methods, including the equation of exchange, purchasing power parity, uncovered interest rate parity, equations of money multiplication, VAR, simple regression models, and others.

Figure 3: Structure of the System of SEM – MP-2



The significance of influence of monetary mechanism channels on the economic variables is monitored on a regular basis. This makes it possible to identify monetary policy priorities and estimate the effectiveness of its regime.

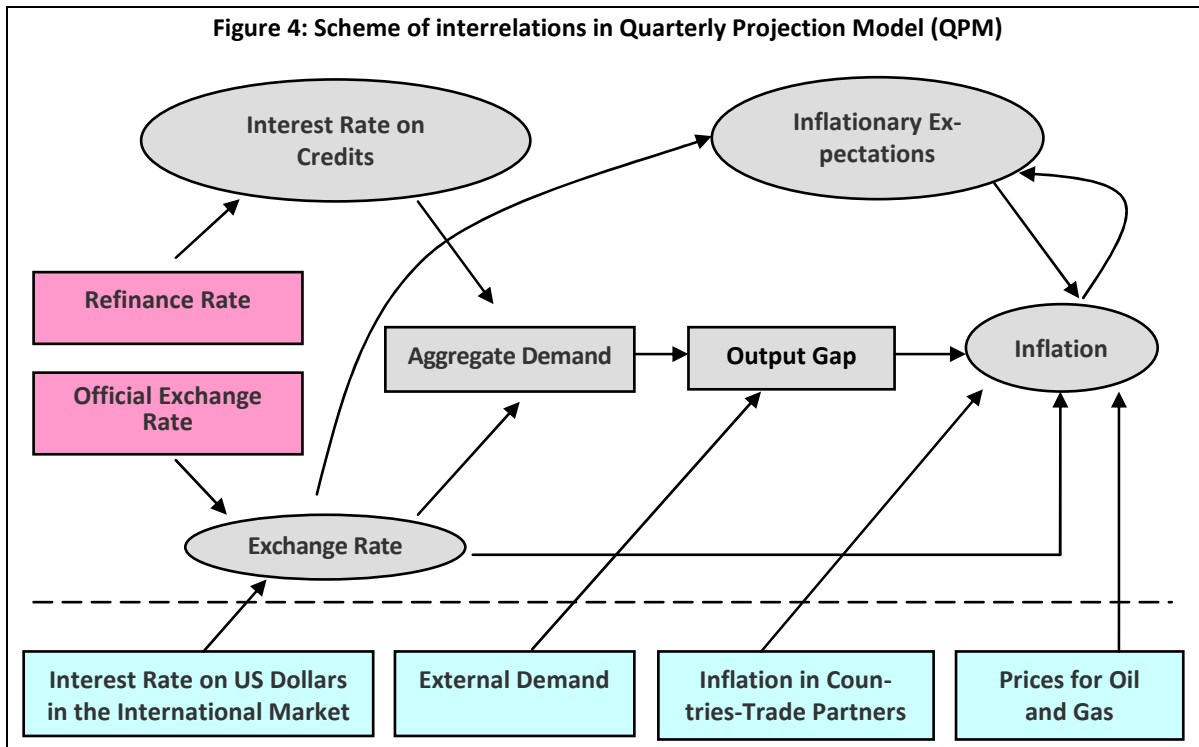
For example, modern estimations on the basis of SEM-MP-2 that, in principle, coincide with the results of the analysis carried out using VAR, suggest that changes in the exchange rate of the Belarusian ruble against the US dollar determine the inflationary processes in Belarus.

This is explained by a significant share of the US dollar in the domestic foreign exchange market, in the structure of foreign exchange savings of households, as well as in the foreign trade operations settlements.

Accordingly, the most effective channel of monetary policy influence on the domestic and external sustainability of the Belarusian ruble is the maintenance of stability of the exchange rate of the Be-

larusian ruble against the US dollar. Therefore, the Belarusian ruble exchange rate is used as a monetary target.

In 2008, the National Bank plans to keep the fluctuations of the official exchange rate of the Belarusian ruble against the US dollar within the +/- 2.5% band compared with the exchange rate as at the beginning of 2008, allowing for a gradual increase in the exchange rate fluctuations within the established band with a view to ensuring a more flexible response to the changes in the demand and supply in the foreign exchange market



Setting parameters for changing the exchange rate of the Belarusian ruble with respect to the US dollar would make it possible to influence the lowering of inflationary and devaluation expectations that determine, to a great extent, the behavior of the economic agents, thereby stabilizing the price level and exchange rate dynamics.

Given transparency of the Belarusian economy, the exchange rate may also be used as an instrument of influencing the dynamics of domestic prices by curbing prices for imported goods. Restraining the growth of the ruble equivalent of the prices for imported raw and other materials and components will make it possible to reduce costs growth rates and, accordingly, domestic prices for the Belarusian products. But, given world trends of mutual dynamics of the world currencies' exchange rates, this exchange rate policy will not be conducive to strengthening the real exchange rate to the extent that could adversely affect price competitiveness of the domestic producers.

At the same time, the estimations show quite high significance of the credit channel in the monetary transmission mechanism of the Republic of Belarus which principally reflects the following interrelations: *money supply*  $\Rightarrow$  *deposits*  $\Rightarrow$  *credits*  $\Rightarrow$  *investments*  $\Rightarrow$  *output* (figure 5). Therefore, the National Bank does not abandon monitoring the dynamics of parameters of the banking system's monetary survey taking into account its influence on the entire complex of economic indicators, including both inflation growth rates and production volumes.

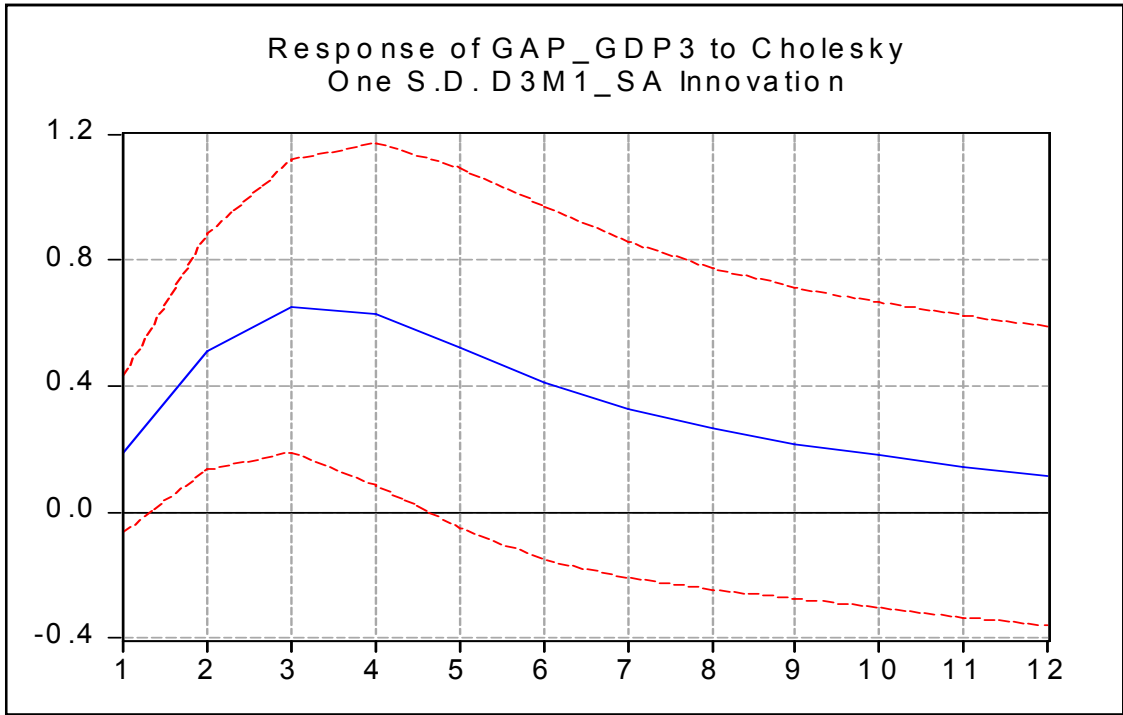


Figure 5: Response function of GDP gap to money supply

Besides, systematic estimations show the significance of the interest rate channel of the monetary mechanism in the Republic of Belarus. *Figure 6* shows a VAR-based chart that describes impulse response function of inflation to the changes in the real interest rate on credits. It suggests that there is significant negative response with a lag of up to 12 months, while the maximal effect will be felt in 6-10 months which, on the whole, corresponds to the nature of the inflationary processes that have a sticky character, i.e. they are persistent and gradually adjust to their target. Therefore, the National Bank pays significant attention to the interest rate policy when accomplishing monetary and macroeconomic objectives.

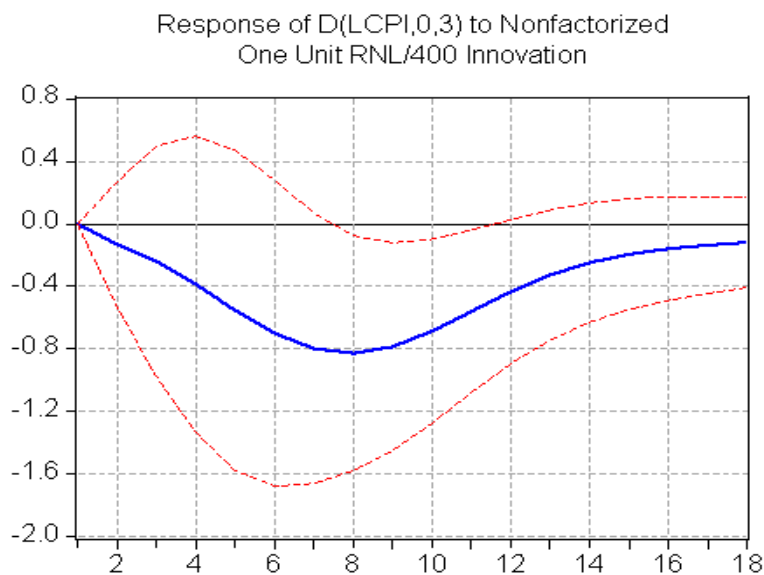


Figure 6: Function of inflation response to interest rates

At the same time, maintaining interest rates at the level facilitating both the growth of savings in the national currency and the expansion of credit availability to the economic agents is considered to be a basic principle of interest rate policy. Ensuring attractive terms for savings in the national currency promotes the attainment of the monetary policy objectives of curbing inflationary and devaluation processes, while expanding the availability of credit resources acts as a stimulus to economic growth.

The overall dynamics of interest rates on the National Bank's operations is determined by the refinance rate which sets the minimal level of interest rates on auction operations designed to provide banks with liquidity and the maximal level of interest rates on auction operations designed to withdraw liquidity.

In pursuing monetary policy, the National Bank gives priority to the interest rate as the main operational instrument for exerting influence on the monetary sphere. The intraday interbank credit rate in the national currency is an operational objective. The range of its fluctuations is determined by the rates on standard facilities (overnight credit, SWAP operations, and fixed interest rate deposits with the National Bank). At the same time, the rates on the National Bank operations in the financial market are designed to ensure the movement of the rate of intraday interbank credit in the national currency within the required range/band while reducing its daily fluctuations.

Thus, the models and methods that are used as part of said technology make it possible to take into account and estimate the versatile character of macroeconomic interrelations and create scenarios of monetary parameters forecasts with a view to making decisions in the future regarding the specific usage of monetary instruments of the National Bank.

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On the whole, it may be noted that a stable monetary mechanism that satisfies the needs of the sectors of the country's economy is in place in the Republic of Belarus. Operation of the National Bank and banks is coordinated within the framework of the two-tier banking system. The attainment of monetary policy objectives and the development of the banking sector constitute part of a single complex of the state economic policy, are based on the strengthening of the potential of industries of the national economy, and stimulate, in turn, the dynamics of their growth and living standards.

At the same time, ensuring long-term social and economic development of the country and the evolution of domestic and foreign economic relations require the improvement, on an ongoing basis, of the monetary regulation system and the overall system of economic regulation. Taking into consideration specific features of the state and development of the economy, the pursued monetary regime should be adequately modified to ensure the effectiveness of monetary policy in meeting the priorities of social and economic development.

Further increase of monetary policy effectiveness will be stimulated by:

- a systematic extended analysis of the monetary transmission mechanism that reflects qualitative and quantitative interrelations between the monetary sector and other sectors of the economy. This will make it possible to timely modify the list of monetary targets and monetary policy regime as a whole;
- coordination of the objectives and mechanisms of monetary, fiscal, foreign, economic, and production regulation. It would be also advisable to strengthen the financial part therein, and to take into account more foreign economic factors;
- an increase in the monetary mechanism of the significance of interest rates as a monetary regulation instrument on the basis of financial market development; and
- targeted development of monetary instruments and coordinated technology of application thereof.

As part of methodology, the development of model instruments is considered as an urgent issue with a view to:

- taking into account the production functions in order to show more extended economic mechanism interrelations; and
- expanding the forecast horizon, which is advisable for taking into account cycles of macroeconomic and monetary processes.

On the whole, improving the monetary policy mechanism as part of macroeconomic policy of the country should facilitate the activities aimed at ensuring the macroeconomic balance that implies an internal and external balance of the economy, optimal combination of economic growth parameters, employment, prices for goods and services, and the balance of payments of the country.

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