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Restrictions to Monetary Policy Choice in Belarusian Economy

In the article the nature of monetary policy in the advanced market economy and in the transition economy is analyzed. The following definitions are highlighted: a target economic parameter used by the central bank for implementation its monetary policy; a nominal stabilization anchor; a transmission mechanism; monetary instruments of the central bank. Various regimes of monetary policy differ from each other in the matter whether this monetary policy of the central bank is aimed at the ultimate object of regulation (the regime of inflation targeting) or its monetary policy is aimed at interim objects (exchange rate targeting, monetary aggregate targeting). Content-based characteristics of the established economic relationship and the degree of its market maturity lay a foundation of choosing a certain regime of monetary policy. For the central bank to successfully carry out its regulatory functions, it is important to consider the extent of stability and predictability of the formed functional ties among monetary instruments, interim objects and the ultimate object of the monetary policy. In the article the preliminary conditions that should be realized before introducing of the inflation targeting regime in Belarusian economy are considered. The author focuses upon the strategy aimed at gradual liberalization of the currency market and transition from usage of the BYR exchange rate as an 'anchor' to direction through the interest rate channel of its transmission mechanism. Changes in targeting strategies of the National Bank and those of the Government from achieving interim objects to reaching the ultimate aim of their economic policy (the targeted level of 'open' inflation) are also considered in the paper.

1. The essence of a monetary policy regime in the advanced market economy and in the economy in transition.

A **monetary policy regime** is an organizational-administrative method undertaken by the central bank to achieve its monetary targets through using different channels and instruments of its transmission mechanism. The central bank by using the regime of monetary policy coordinates the chosen **target parameters of economy** or **target instruments** with the means of achieving the target and with the mechanism of realization this monetary policy. For effective economic regulation, the central bank should create a specific fixating economic base, which is known as a **nominal anchor**. Due to it the central bank centralizes and forms monetary policy. While shaping its monetary policy the central bank may not be necessarily and explicitly based on the nominal anchor. In this case, however, the chances to suppress inflation effectively will be limited. Experience in monetary regulation of the market economy gained by the central bank and theoretical summarization of these processes make it possible to categorize monetary policies as follows: exchange rate targeting, monetary aggregate targeting, inflation targeting, and monetary policy without introducing a nominal anchor.

A **transmission mechanism** implies methods of channelling national currency emissions (reserved money) to the economy, which is implemented due to specific market instruments. Qualitative and quantitative parameters of the transmission mechanism embrace the following: first, a totality of interconnected targets of the central bank and national currency issue lines for the circulation, and quantitative characteristics of national currency emissions; second, terms of the central bank's granting loans to business entities and the Government and their repaying the borrowed money; third, a system of monetary instruments practised by the central bank; fourth, a mechanism of quoting interest rates in the na-

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tional currency and on state securities, their levels; fifth, a mechanism of quoting exchange currency rates and their levels, fixed on the financial market.

The central bank employs three transmission channels: 1) granting refinancing credits to commercial banks; 2) purchasing foreign currency alongside with emission BYR into circulation; 3) purchasing state securities on a secondary market. Refinancing credits and state securities purchased by the central bank on a secondary market constitute the interest rate channel of a transmission mechanism, while foreign currency purchases accompanied by BYR brought into circulation refer to the mechanism of currency transmission channel. The order of national currency emission into the circulation by using the interest rate channel is closely connected with the exchange currency channel of a transmission mechanism. By employing the interest rate channel of a transmission mechanism, the central bank influences upon the level of interest rates in foreign currency, affects the dynamics of demand for and supply of foreign currency and the level of exchange rates. That is why the regime of exchange rate targeting, constructed by the central bank, is closely connected with the realization of a transmission mechanism of BYR emission.

Specifically, credit money can be considered as market obligations and orders. They are issued by the central bank only at supporting short-term liquidity of commercial banks on the principles of obligatory loan repayment, priority-based loan making, and paid loan servicing. The central bank's observance of the mentioned rules allows it to properly carry out its functions with a particular concern about the creation of credit-deposit money by commercial banks in accordance with the order short-term loans are granted by these commercial banks to business entities in the real sector of the national economy. It becomes virtually important that the interbank channel of refinancing short-term liquidity of commercial banks should not be substituted for a truly bad practice of granting credits for special purposes ('investment' credits) to commercial banks for further transferring these credits to their clients (business entities in the real sector of the national economy), financing their activity. A short-term interbank credit is not a credit for special purposes, or an 'investment credit'. In fact, these are absolutely different things. Following by the wrong practice of granting credits for special purposes ('investment credits'), the central bank within the two-tier banking system executes the functions of the main creditor of priorities of the so-called planned national economy, meaning it imitates the execution of functions of the state bank during the epoch of the so-called planned nationalized (quasi-money) economy. The central bank can not adequately perform these functions within the two-tier banking, as it is not staffed with a number of people necessary to implement credit transactions. Further explanation relates to the fact that the central bank cannot trace the way the given credits are used. Under such circumstances the central bank performs, rather ineffectively, the functions of commercial banks.

In a market economy the central bank's firm credit money sets an extremely strenuous debt relationship between commercial banks while they grant loans to clients of the real sector of economy. The high extent of debt relationship in the banking system entails the establishment of very rigid standardized obligations and requirements towards the business entities of the real sector of economy. Very rigid conditions of granting loans and repaying the borrowed money in the banking system form the standard of the inevitability of the repayment by enterprises to their contractors. The stricter the terms of loan repayment are, the more likely the borrowed money will perform its functions, the lower the rate of inflation will be.

The major factors influencing the choice of monetary policies by organs of the state administration are as follows: a national economy type (market, non-market, or transition economy), its quantitative parameters, the degree of rigidness of budgetary restrictions to banks and enterprises, the volume of a social component in the national economy's structure, availability or lack of social consensus, allowing to

achieve a low rate of inflation. The choice of a monetary policy is also influenced by the configuration of a financial market and a commodity market and particularities of their functioning, the volume and the character of ties established between the domestic market and the world market (the level of the national economy's openness). Depending on the matter, what economic parameter is chosen by the central bank as the target parameter, and what kinds of monetary mechanisms are used to achieve the appointed goal, the essence of a monetary policy regime is defined.

The main purpose of the monetary policy pursued by the central bank is the attainment of price stability. The core of one monetary policy which makes it radically different from another consists in a parameter chosen by the central bank as the target parameter. Other differences may include monetary tools used to practically implement the chosen policy.

A **nominal anchor** may be identified as a nominal macroeconomic variable, targeted by the central bank. The nominal anchor allows to create a valid mechanism to suppress inflation through a system of monetary instruments specifically tailored to it. Monetary policies may also differ from each other depending on whether they are aimed at achieving the final regulation goal (inflation targeting), or at reaching some intermediate goals (exchange rate targeting, monetary aggregate targeting). The content-based characteristics of the existing economic relationship and the degree of their market maturity lay a sound foundation of choosing a monetary policy. For the central bank to be able to carry out its regulatory function it is important that stability and predictability of the existing economic links among the mentioned final goal, intermediate objectives and monetary instruments be well established.

The level of digit "open" inflation suppressed to the indicator of 1 – 3% per year within a long-term period of time inexorably leads to a drastic decrease of inflationary expectations in the national economy and serves as a criterion to evaluate the effectiveness of the monetary police held by the central bank. The lower is the mentioned level, the higher is the level of stability and predictability of economic links among monetary and macroeconomic parameters, and monetary tools regulated by the central bank. Attaining, in the long run, stable and sustainable pricing conditions will enable the central bank to make use of more advanced and hence economically more effective monetary policies.

2. Exchange rate targeting in a market economy

Exchange rate targeting implies the central bank's pegging the national currency exchange rate to hard currency (a currency basket) of a country (countries) in which the indicator of digit inflation is very low. This mode of pegging is opted for due to the fact that the currency of a country-anchor is characterized as being internationally sound and is widely used in global production and trade. Exchange rate targeting appears to be particularly often used to combat high inflation in small open economies. What makes the above targeting exceptionally attractive is that in a small open economy the exchange rate is a key factor affecting considerably the process of price formation. Simultaneously, it serves as an effective tool to control capital and commodity flows. Globally accumulated practice shows that exchange rate targeting comes handy when a country's central bank looks for the ways to constrain potential speculative attacks upon its national currency.

The mentioned targeting is often practised at a point in time when a transition economy transforms into a market economy. The inflation rate in a transition economy is very high while the economy itself is extremely vulnerable to outside shocks. Exchange rate targeting makes it possible to considerably reduce the level of imported inflation. When the rates of price growth are high, it may lead to disinflation, which is decreasing prices within a given period of time. The described target-

ing approach causes business entities to rely upon their national currency and the implemented monetary policy. It proves to be an effective means of curbing inflationary expectations.

Alongside with positive features typical of the regime of exchange rate targeting, it may be disadvantageous in the way that the exchange rate policy of the central bank domineers over its monetary policy, restricting its flexibility and changeability. This regime simplifies functional interconnections of monetary and macroeconomic parameters, making them, on the other hand, all too more rigid. Provided the conditions under which the national economy is functioning, drastically change, the central bank's activities get confined to a limited number of them, thus making the central bank a hostage of the policy it has been carrying out.

The regime of exchange rate targeting may be presented in several models. One of them may be described as a regime of the strictly fixed national currency exchange rate under which the national currency is particularly tightly pegged to the currency (currencies) of the countries considered to be a stabilization anchor. The central bank may also adhere to another model when the nominal exchange rate after having the volume of its fluctuations fixed, will be freely fluctuating within the fixed boundaries. The merit of this model directly arises from a very high degree of the exchange rate's volatility and the same high degree of the central bank's independent behaviour on the market, and expresses itself in a decrease of the degree of intensity with which short-term speculative capital flows. An extreme toughness of the said regime dictating its terms to the monetary and macroeconomic policies led by the central bank may be somewhat lessened. As a result, the central bank operationally becomes more independent while using monetary instruments and the economy appears to have acquired more flexibility.

The third model of exchange rate targeting is reported to have been widely used by central banks. It is based on the "sliding" fixation of the exchange rate. This model makes it possible to gradually carry out a fully controlled devaluation of the currency exchange rate at a pace somewhat slower than the one expressed as the difference among the rates of inflation in different countries. The "sliding" fixation restricts excessive re-evaluation of the real exchange rate, preventing the price competitiveness of the national economy from going down. All that will finally result in a greater degree of responsiveness of the monetary and economic policies of the national economy to possible outside shocks.

If the level of the national economy instability is exceedingly high, the government may decide to introduce the regime of "a currency committee", which is the toughest of all the models of exchange rate targeting. Under this regime the central bank emits the national currency only through a currency transmission channel, i.e., following the purchase of foreign currency on the market alongside with replenishing its foreign currency reserves. In this case, the process of credit money multiplying occurs at the level of "commercial banks — clients" and is highly restrictive by nature. It happens because reserve money emitted by the central bank is not used in the capacity of credit money in circulation. Credit money emission becomes a prerogative of commercial banks, and the interest transmission channel is idle, for the central bank's instruments are fully involved in securities transactions held on the open market, or their use may be very heavily restricted. The regime of "a currency committee" introduces simplified and at the same time extremely rigid functional interconnections among macroeconomic parameters, thus restricting very noticeably the central bank's autonomy and the nature of its functions.

Major instruments with the help of which the central bank carries out the above mentioned models (excluding the regime of "a currency committee") are as follows: positive interest rates on refinancing credits granted to banks and on state securities purchased on the open market; currency interventions, when administrative interference with the functioning of market mechanisms is inadmis-

sible. If the central bank's market instruments are not administratively restricted, it will allow the central bank to send accurate signals to business entities of the real sector of the national economy through transmission mechanism channels, evoking adequate reactions from them. Consequently, the central bank manages to establish a stable exchange rate, simultaneously reducing inflationary expectations and the rate of inflation, thus stimulating the GDP growth.

An effectively devised regime of exchange rate targeting allows for a small difference between rates of inflation recorded in the national economy and those of a country (countries) to which currency (a basket of currencies) the national currency exchange rate is pegged. It also becomes possible to suppress inflation and to simultaneously take measures to support the country's competitiveness. However, if the country's rates of inflation with regard to commodity prices tend to be higher than the rates of its national currency devaluation, hindrances to the country's competitiveness may be many. This discrepancy between inflation and devaluation rates may predictably lead to a gradual appreciation of the national currency and a reduction of the country's export potential. As often as not such situations occur when the central bank together with the country's government cannot effectively prevent "cheap" money from penetrating into the country's economy via transmission and budgetary channels, respectively. The then possible breakage of the recorded foreign economic disbalance of commodity and services flows may gradually create conditions endangering the national currency of speculative attacks.

What makes the regime of exchange rate targeting particularly challenging is that it is necessary to constantly keep the country's interest rates and inflation rates of the country-anchor at approximately the same level. If one of these — the central bank or the country's government — happens to break the rules of properly maintaining the regime, the stable development of the national economy may be trialled. Key problems related to the regime arise when the national economy is affected by inner or outside shocks. Drastically increased disproportions between commodity and capital flows may break its earlier achieved stability level thus putting the regime of exchange rate targeting through rigorous validity tests. Again, lessened volatility of the exchange rate may reduce the effectiveness of monetary instruments' responsiveness to challenge. Monetary instruments are very closely linked to the currency transmission channel and the exchange rate which fact will in particular manifest itself in case of outer shocks. As interest instruments of the given monetary policy are underdeveloped, and the policy itself comes to the prevalence of the central bank's currency policy, the rigid nature of the government's fiscal policy insures the smooth functioning of the regime of exchange rate targeting.

3. Monetary aggregate targeting

Under this regime, market control over commodity prices is exercised by the central bank's emitting money through the chosen target money aggregates. Unlike the regime of exchange rate targeting, the regime of monetary aggregate targeting allows the central bank to create a naturally operating monetary system embracing three transmission mechanism channels and allowing for free penetration of monetary signals into the country's economy. Under the regime described there is no need using the exchange rate as "a disciplinary measure" aimed at exerting a stricter control over other monetary instruments and very considerably reducing the central bank's independence in carrying out its activities. As the central bank manages to create conditions characterized by a low level of inflation and that of the national currency devaluation, it starts to control the currency market through currency interventions accompanied by free fluctuations of the exchange rate.

The regime of monetary aggregate targeting is based on the quantitative theory of money in accordance with which the growth of commodity prices, in the long run, is determined by supply of

money. The theory asserts that there exists a one-way causal relationship linking money, commodity prices and income (the GDP), while a backward causal relationship, making commodity prices and income (the GDP) dependent on money is non-existent. The theory maintains that the volume of supply of money is proportional to the growth of the nominal volume of production (the GDP). The regime of monetary aggregate targeting enables the central bank to ensure the well-controlled growth dynamics of the chosen money aggregate, and that, in its turn, leads to the GDP growth. The choice of concrete measures to realize that regime relies on what exactly money aggregate is controlled by the central bank, what exactly target channel may be applicable for money aggregate growth, and what exactly instruments will be used to regulate the target money aggregate.

To effectively regulate monetary relationship the central bank needs to form a well functioning interest channel with the help of which commercial banks, by changing interest rates, transform reserve money into credit money. An obvious advantage of the said regime is that for the central bank to establish it the central bank should be truly independent of the government's control. It will enable the central bank to pursue an independent monetary policy and to adequately respond to various economic challenges through exercising control over supply of credit money.

The major difficulty in realizing the regime in question is in creating valid conditions for the regime to function properly. It implies, first and foremost, the availability of a strong and stable link between the target money aggregate regulated by the central bank and inflation rates. In a two-tier banking system the central bank very rigidly controls the monetary base and the narrow aggregate (M0), while changes in the broad aggregates (M1, M2 and M3) fully depend on banks' activities and those of their clients. Their joint effort is aimed at transforming central bank's reserve money into deposit-credit money within the process of reserve money multiplying. Formation of the broad aggregates of the overall money supply involves two parties — banks and their clients, and in a market-driven economy may turn out to be hardly predictable. The central bank may only influence the process of deposit-credit money multiplying by employing market leverages, which will result in provoking the national economy's added value growth.

Money is not just a medium of exchange, mediating in the process of exchanging goods for money and vice versa, it is an active credit instrument, which creates a competitive capital market, on which the interest rate (the cost of credit money) operates in the capacity of a market regulatory device. It explains why the character of economic functional links under the regime of monetary aggregate targeting is far more complex than that under the regime of exchange rate targeting. Besides, ideas of monetarists claiming that the regulation of increases of money supply is a key variable allowing for the control of commodity prices growth do not correspond to real life situations. It should be stressed that an increase of money supply to a larger extent depends on demand for credit money announced by business entities operating in the real sector of the national economy, on the one hand, and the central bank's credit money supply, on the other hand, and is reflected in the balanced level of the interest rate the role of which monetarists generally tend to underestimate. Practice shows that the central bank cannot at one and the same time regulate both credit price and supply of money, demand for money being a key variable. As a rule, an effective monetary policy of the central bank presupposes the fixed character of one variable, while demand for and supply of money on the money market determines the other, indirectly influencing it through the central bank's transmission mechanism.

It is necessary to mention that between the effect produced by the central bank's monetary policy upon the chosen money aggregate and inflation there, exists a big and an unstable time lag, dependent on many factors difficult to predict. In fact, a constant spread of financial innovations stimulating the appearance of diversified financial instruments on the market, new computer tech-

nologies, allowing for banks' clients to be quickly provided with new financial services, the impact of global market tendencies upon an economy (particularly, a small open economy), inevitably cause the links among economic variables to become highly volatile and difficult to forecast. Taking the totality of all the reasons mentioned above into consideration, the central bank turns out to be unable to control the chosen money aggregate with a required degree of predictability. It has already been proved more than once that a relatively rigid control exerted by the central bank over the monetary base will entail a high volatility of short-term interest rates and may influence very considerably the dynamics of price changes and those of the GDP. Moreover, it becomes next to impossible to simultaneously control the overall money supply, commodity prices and interest rates. At the outset of the 1980ies the USA, Great Britain and Canada made their decision not to ever practise the regime of money aggregate targeting, as the instability of functional links among indices identifying the dynamics of money aggregates and the levels of target variables did not allow to reach the set goals.

4. A monetary policy without introducing an anchor

A monetary policy, not oriented towards a certain nominal anchor, means a certain nominal variable targeted by the central bank unofficially, i.e., it is not announced by the central bank as chosen as an official macroeconomic parameter. Under this regime the central bank enjoys a far greater degree of autonomy, as it does not take upon itself rigid and clear obligations to achieve certain nominal indices (it concerns the exchange rate, the rate of inflation, the rate of growth of money aggregates). It announces its long-term objectives (a sustainable economic growth, a high level of employment, and a low rate of inflation) alongside with establishing its intermediate aims. A high level of trust in the central bank originated from its successful effort to preserve a long price stability situation in the national economy is a sound prerequisite for the central bank's effective implementation of the named regime. Normally, this regime is practised in an advanced market economy. It is based on smooth and well-organized functioning of the central bank's transmission channels and its highly autonomous activities. This autonomy is reflected in the central bank's independence of the government's budgetary and financial policies. Demerits of the non-nominal-anchor-based policing may be many, as the character of it implies lack of transparency in the central bank's choosing its hierarchy of objectives and instruments to reach them.

5. The regime of inflation targeting in a market economy

In order for the regime of inflation targeting to be executed effectively the central bank must be highly autonomous in its activities which are solely aimed at reaching the only target index, i.e., the target inflation index. The central bank is free to choose a system of instruments with the help of which the target index is intended to be reached. Under the said regime the government cannot simultaneously set other target indices, such as the GDP level, wage (salary) levels, the level of employment and the exchange rate. This requirement adds additional responsibility to governmental regulatory bodies' activities.

The government exercises control over market processes by forming a competitive market environment and producing a regulated impact upon this environment. It is necessary to emphasize that the regime cannot be introduced without establishing effectively performing interest and currency channels of the central bank. These channels serve the central bank to send its signals to business entities in the real sector of the national economy via commercial banks. To ensure a smooth operation of these transmission channels it is expedient that a competitive market environment be created. It should be characterized by relatively stable functional ties between macroeconomic variables and the level of inflation. These contributions are very responsive to effective

controlling measures carried out by the central bank. The ultimate goal of the described regime in a liberalized economy consists in achieving a stable level of market prices on condition that the prices in question are determined by business entities following in their price quoting effort the demand-and-supply pattern prompted by commodity markets. This, in fact, is the central bank's major strategic goal. As an independent monetary institution, the central bank is entitled to set the target inflation index which is achieved by its using available market instruments. The central bank and the government are doomed to coordinate their economic effort trying to achieve the common goals reflected in the target inflation index, which, as a matter of fact, is seen as the only "anchor" of a stabilized economy. The regime described is extremely difficult to execute as it necessarily requires the introduction of certain terms and prerequisites prior to the introduction of the regime itself. Both the central bank and the government bear responsibility for the outcomes of the said regime.

The regime of inflation targeting is successfully realized subject to the national economy's adequate response to the outcomes arisen from the central bank's and the government's regulatory activities on commodity and money markets. What is also important is that the central bank's interest channel used for putting credit money into circulation should operate effectively (or, as they say, it should be "cleared up" in accordance with market requirements). Now, the exchange rate is viewed as a market regulated parameter influenced by the currency market; in other words, the central bank is to stop using it as a kind of "anchor" in case it has been used in the said capacity previously. To this effect, the central bank no longer adheres to currency interventions, exercising control over the nation's markets through interest rates.

The greater the degree of a small open economy's exposure to the "external" environment is, the more difficult it becomes for the central bank to control the exchange rate which earlier fulfilled the function of "an anchor" in stabilization processes, without practising currency interventions. While carrying out current transactions the national currency must by all means undergo the process of conversion. Capital transactions in the international economic arena should be very strictly observed in order to restrict the negative influence produced by speculative capital on the national economy. The transition period within which conditions for introducing the regime of inflation targeting are created should take a longer time, while preliminary arrangements related to further market reforming and carried out by the central bank and the government must be more sizable and more intensive by nature.

Under the regime of inflation targeting the government is expected to expedite the formation of a market mechanism valid for adequate evaluation of inflationary expectations of business entities in the real sector of the national economy and for effective regulation of their level and development dynamics. The basis of the regime is constituted by a stable linkage of inflationary expectations of business entities in the real sector of the national economy to the phenomenon of "open" inflation, which level and dynamics are controlled by organs of state administration, mainly through their using market instruments (regulating commodity and money markets).

Different budgetary, financial and quasi-money instruments used to achieve specific budgetary and financial support targets with regard to some sectors of the national economy, and typical of the previous stage of the monetary policy should be entirely abandoned while passing on to the regime of inflation targeting. Introduction of monetary policy market instruments must be accompanied by a gradual, successive and determined riddance of non-market regulatory mechanisms used earlier for resources redistribution. Monetary instruments known to have become deformed and considered to have lost their primary predestination must never be used by the central bank again as not corresponding to the very essence of monetary relationship.

6. Major preliminary conditions necessary to introduce prior to establishing the regime of inflation targeting in the economy of the Republic of Belarus

6.1 Transition to the regime of “open” inflation and formation of stable and predictable relationship among macroeconomic parameters

The economy of the Republic of Belarus is characterized by the phenomenon of “suppressed” inflation due to a very strict control exerted by the government over a considerable number of prices. This prevents business entities and the government itself from having adequate information related to inflation. Hence the relationship among macroeconomic parameters is unstable and unpredictable and cannot be fully regulated by monetary instruments due to the fact that channels transmitting the overall money supply influence on prices and the GDP are deformed. A considerable excess of price growth rates over increment in the overall money supply and the GDP testifies well to the previous statement. For example, in 2005 increment in the real money supply amounted to 59.5%, while the level of inflation achieved 8%; in 2006 increment in the real money supply was equivalent to 44.5%, while the level of inflation equalled 6.6%.

In connection with the above it should be mentioned that the government controls not only commodity prices (on commodity markets), but also money prices (interest rates and exchange rates on financial markets). The priority task of the government, therefore, is a gradual transformation of inflation from its “suppressed” form into its “open” form. For this to become possible it is necessary to elaborate a state programme, to determine the time for its execution (not more than 2 or 3 years), and to release prices on commodity and money markets. While executing the programme, the government will aim at reaching two ends. One consists in business entities adjusting their activities to the liberalized structure of commodity and money prices. The other implies the creation of a governmental system the purpose of which will be to regulate market demand-and-supply prices. Meanwhile direct (much the same as command) regulation of non-liberalized structure of prices is still operative. Under the regime of inflation targeting the establishment of a stable price level is assumed as a basis of a long-term cooperation between the National Bank and the Government.

“Open” inflation forecasting should be carried out by state bodies and independent research centres specifically created to objectively measure it. An important precondition for such measurements is that it needs to be executed in the conditions of free pricing. At the current moment the experience accumulated with regard to “open” inflation evaluation, its dynamics and forecasting is, indeed, very limited.

6.2 Joint efforts undertaken by the National Bank and the Government to create conditions for regulating its economy on a market basis

At the current stage of cooperation between the National Bank and the Government in the sphere of economic regulation and responsibility division aimed at achieving the “projected” “suppressed” level of inflation what has already been achieved in this direction proves that the activities of state regulatory organs are far from being coordinated and effective. The National Bank bears responsibility for monetary base and money supply increment, which being a monetary factor, influences the level of inflation. The Government has the right to manage commodity prices using administrative measures, which being a non-monetary factor, influence very considerably the “suppressed” level of inflation. The situation described leads, objectively, to the appearance of inflationary “shed” hidden behind the “suppressed” inflation, which does not reflect a true picture of how the demand-and-supply pattern functions on the commodity market. The National Bank and the Government, both within the scope of their responsibilities, answer for target financial support of economic growth making use of monetary and budgetary-financial instruments passing them through their

own monetary and budgetary-financial channels. Recently accumulated practice of establishing goals and working out mechanisms impacting inflation causes monetary instruments to be replaced by financial-budgetary instruments used to regulate economic processes and appearing to be deformed. The said deformation primarily embraces interest mechanisms, which do not function to the fullest extent possible.

Establishment of the regime of inflation targeting is only possible on condition both the National Bank and the Government are held responsible for effective regulation of the level of “open” inflation. Only if this is the case, they will be able to effectively affect the level of “open” inflation turning to adequate means of government regulation. At the moment, the Government is focused on the achievement of current aims, pursued by the Ministry of Finance of the Republic of Belarus whose responsibility is to provide for budgetary financing of the national economy. In case of tax arrears the Government exercises pressure upon the National Bank making the latter adjust its monetary policy to the aims of the Ministry of Finance. This results in the National Bank’s policy being simplified and deformed, acquiring the features of quasi-money policy which entails lessened validity and reduced efficacy of monetary instruments of both the National Bank and commercial banks of the country.

Summing it all up it is again necessary to underline that in order to introduce the regime of inflation targeting the National Bank and the Government should unite their effort to perform in harness. Joint effort is called for by the necessity to reach their common market-oriented target, that of a direct projected control over the level of inflation. On their way to achieving the outlined goal the National Bank and the Government will attempt at the reasonable and effective distribution of their roles and obligations so that to effectively regulate the national economy being transformed into a market-driven economy. Only in this case the formation of adequate instruments to suppress “open” inflation on the liberalized commodity and money markets will come true. In such circumstances the role and the status of the Government is of primary importance as about 50% of the GDP is reflected in the country’s consolidated budget, and this cannot but tell upon the monetary policy of the National Bank. The goals of the Ministry of Finance and the National Bank, both allocating funds to the national economy, though through different channels, should coincide. At present, however, the Ministry of Finance does not always involve the National Bank in the process of decision making when deciding to what budget users to direct its money. This may produce a detrimental effect on the level of regulatory processes with regard to the money market.

6.3 Creating conditions under which the rate of refinancing becomes a sole and a universal instrument of the money market

The key instruments of the country’s banking system have acquired features incompatible with their nature, and that prevents them from adequately performing their functions which consist in measuring how effectively funds are used. For example, the National Bank’s rate of refinancing does not reflect the money demand-to money supply ratio, due to which the said instrument fails to fully execute its function. The National Bank carries out non-standard target financing of the priority economic sectors and its exclusive clients at the rate of refinancing and below it, thus undermining the appropriate functioning of the monetary market.

There has long been existing a three-tier refinancing mechanism (the level below the rate of refinancing, the rate of refinancing, and the level above the rate of refinancing). Interest rates on the so-called permanently accessible and auction liquidity regulation instruments (earlier called the “second” level of refinancing) are overly higher than the “initial” rate of refinancing. The rate of refinancing has distanced itself from the existing realia of the money market, it does no longer reflect demand for and supply of money, and actually has become a formal market indicator.

Interest rates of the “second” level of refinancing carry out a “penalty” function with regard to banks lacking liquid means. Overstatement of the “second” level of refinancing made it possible for the National Bank to force other banks to sell their currency funds to it, thus enlarging its gold and foreign currency reserves. This, in its turn, resulted in the decrease of net foreign holdings of commercial banks from a positive meaning in 2000 to a negative meaning equalling minus 1,2 milliard USD (as of March 1st, 2008). The policy in question entailed a huge disproportion between the banks’ assets and liabilities and the situation still deteriorates due to a rapidly growing credit balance of the payment balance’s current account (2006 – 2007). So, the country’s banks have to contribute heavily to its financing. In case the demand for foreign currency goes up, the National Bank may be faced up with a risky possibility of widening the already existing gap between the banks’ assets and liabilities, on the one hand, and the recorded disbalance on the money markets, on the other. Consequently, the system of commercial banks may become even more fragile.

The policy of goal establishment and the choice of means to execute the set goals by state organs is based upon the priority task of exercising budgetary and quasi-budgetary support of the production sphere, which maintains that the National Bank and the country’s other banks carry out quasi-functions with regard to target financing of the country’s national economic priorities. Following the outlined policy, the functional meaning of credit refinancing gets deformed, as partially it starts to be used not only to supply the banks with short-term liquid funds which is exactly what it should do as a market mechanism. A specific feature of non-standard “credit” transactions held by the National Bank is that the substance of them is the same as that of target quasi-budgetary transactions. What comes out of the above is that credit refinancing granted by the National Bank is used as an instrument of quasi-financing of enterprises via commercial banks. Credit refinancing is to serve the purpose of short-term support provided to commercial banks if, temporarily, liquid funds in their possession are insufficient. Credit refinancing should not carry out the function of quasi-investment refinancing in case system-forming banks and their clients are constantly experiencing shortages of money on their accounts.

A multi-vector system of refinancing rates created by the National Bank together with an inadequate three-tier “spread” of these rates used for diametrically different purposes, have created an unprecedented situation when, quantitatively and qualitatively, they have distanced themselves from the money market realia. What happens then is that the two-tier bank system mentioned above begins to also function inadequately, and is merely transformed into a replica of a state bank system.

The National Bank’s interest rate channel as well as that of other banks in the country has been deformed; its original substantive functions need to be restored. The National Bank must get down to creating conditions under which commercial banks will have equal chances to perform their activities on the money market. The task may be implemented through the rate of refinancing being attached to the status of a sole and a universal instrument of the money market. This done, the formation of a unitary competitive market of interbank credits and a competitive credit capital market will follow.

6.4 Establishment of stable and predictable interlinks between macroeconomic parameters and formation of adequate instruments of the National Bank, aimed at regulating the credit market, the deposit market and the state securities market

The “initial” refinancing rate of the National Bank serves as a kind of an administrative “starting point”, i.e., it is the rate at which banks start to grant credits to their clients. In its refinancing policy the National Bank strictly follows a from-top-to-bottom instruction according to which a bank credit rate should be equivalent to the “initial” refinancing rate + 3% (the so-called margin). Due to

the above practice, other banks' credit rates at present do not reflect the real demand for and supply of money on the credit market, in connection with which it is possible to speak about a gap between the determined credit rate and the degree of risk borne by both a creditor-bank and its client-borrower. The true level of credit rates appears to be hidden and tends to be posted up to different payments affected by a client-borrower to a commercial bank for the allowed credit and other services. The National Bank does not practise systematically processing information collected from the country's banks concerning the real credit rates on the credit market.

The said practice has resulted in systemic functioning breakages on the commodity and money markets. They hinder the "initial" refinancing rate of the National Bank from being used effectively; they do not allow for a valid use of the bank margin when extending credits to clients, thus, preventing a clear and exact monetary signal from being delivered to business entities. The established information asymmetry makes it impossible to influence the level of firm commodity prices. Vicious circle has been closed, and it means that the Government is incapable of effectively impacting the said prices using quasi-market instruments. In such conditions what is necessary to be done is as follows: to abolish administrative restrictions on the use of the National Bank's interest rate channel to influence the country's economic development through market instruments; to "clear up" the channel from malfunctioning which leads to deforming stable and predictable links between macroeconomic parameters and hinders the process of formation of adequately operating instruments aimed at regulating the credit and the deposit markets, as well as the state securities market.

6.5 Elimination of the established practice of non-market financing of the state budget's deficit through system-forming banks and formation of an open competitive market

Since abolishment, on January 1st, 2004, the practice of direct credits the National Bank used to grant to the Government at an annual rate of 6.5% as non-market financing of the state budget's deficit, the majority of the Government's transactions with securities has been carried out on a market basis. Some blocks of the Government's securities, however, distributed through system-formation banks, are used for subsidizing. These securities are characterized by non-market features, are issued on a non-market basis, and are used as instruments of quasi-budgetary financing. The practice of non-market financing of the state budget's deficit through system-forming banks must be abolished. Its abolition will benefit the given segment of the financial market making it structurally more effective. It will also allow for "clearing up" of the National Bank's interest rate channel, used to influence the national economy, of administrative layers. Moreover, an overall process of introducing blocks of securities of joint stock enterprises into the market should be urged in order to expedite the formation of a channel influencing the market of financial assets being created at the moment. That's where a vast potential for further and more effective economic growth is hidden, and in order to make it work the Government should display a stronger will towards implementing reforms of all kinds.

6.6 Suggestions pertaining to the ways of reforming the banking system

Accumulation of capital in the largest commercial banks, authorized to carry out governmental programmes, obstacles the development of competition on the money market. A peculiar feature about the banking system of the Republic of Belarus is that the capitalization scheme of system-forming banks proves to be ineffective. It means that whenever deposits and credits are granted by the Government and the National Bank to their exclusive clients to support financially their economic activities, they, practically yearly, tend to be transferred to an ever growing Government's share in the banks' capital. This practice deforming the financial result of the largest banks and their market value, breaks the rules of open competition on the banks' market. It is clear that it should be gradually eliminated. As far as the

low level of banks' capitalization is concerned, it needs to be struggled through by attracting capital, including foreign capital, to the banking system on a market basis. The situation when huge financial resources are accumulated in several largest banks should be step by step changed using measures which will encourage a competitive struggle among banks to win their clients' benevolence and attract their resources. Conditions for banks' recapitalization should be created which is based on their restructuring and de-statisation, supplemented by attracting the needed amount of capital. Search for new strategic investors to invest in the banking system, attraction of foreign capital to increase competitiveness is viewed nowadays as task Number 1.

The largest banks (the open joint-stock company "Agroprombank" and the open joint-stock company "JSSB Belarusbank") adheres to such measures as allocation of fixed deposits of the Government to cover the deficit of liquid funds, thus increasing risks arisen from the Government's money being placed on banks' accounts. This unfavourable practice when the Government's money placed on system-forming banks' accounts is used to cover their shortages of liquid funds should be abolished. All governmental funds should be placed on the National Bank's accounts, taking into consideration that this type of funds is very special and cannot be used by banks for their non-target purposes. Then the structural liquidity distortion in the banking system is expected to be eliminated, and governmental interests are sure to be fully met.

The practice when state securities on a non-market basis are transferred by the Government to the largest banks through some formal procedures, thus breaking the rules of their market-oriented allocation, alongside with which the National Bank carries out quasi-budgetary financing, should be stopped. It is expedient that the formation of a liquid state securities market be started. With the help of the above market non-market financing of the state budget's deficit will be executed, while the National Bank will be using the open market for regulating short-term liquidity of banks on a market basis.

Alongside, banks' assets should be inventoried so that to sort out bad assets. Such assets should be then directed to the debt market currently being formed and through selling-purchasing of assets participating in the procedure of market discounting their book value should be transformed into their commercial value. This is necessary for identifying the banks' commercial value and estimating their true financial outcome. By selling-purchasing assets of banks and enterprises the banking segment enters into stable links with the real sector of the national economy. These links will lay a foundation of restructuring debts of enterprises belonging to the real sector of the national economy, thus stimulating the process of the banking system recovery. The development of the debt market of banks and of the real sector enterprises will allow for the establishment of price equilibrium on the commodity and money markets as well as to deepen the process of forming the market of financial assets.

Existing administrative constraints with regard to the currency channel of the National Bank's transmission mechanism are considerable. The currency market is under control of the National Bank, this control being exercised with the help of two categories of regulatory measures. On the one hand, depending on the currency and rouble market situations, the National Bank exerts its control over the markets using monetary instruments. But the National Bank's awareness of the way currency interventions should be used is not yet complete, and this makes the functional links among macroeconomic parameters unstable. On the other hand, following increasing disproportions on the rouble and currency markets the National Bank, the Ministry of Finance and the Government widely use methods of "manual" control over demand for and supply of currency experienced and held by banks and enterprises. Administering the foreign currency market, the National Bank aims at dosing access to the currency in possession of the country's largest importers (for example, "Beltransgas" and others), which have accumulated huge rouble resources. This approach makes it possible for the National Bank to rigidly control the exchange rate by parallelly using ad-

ministrative and economic measures. Owing to the existing practice, the exchange rate has been fixed for already more than three years and is devoid of market flexibility. The National Bank's regulation instruments relative to the foreign currency market are weak and this makes the regime of exchange rate targeting functionally limited.

Gradual introduction of the regime of inflation targeting requires constant liberalization of the foreign currency market, complete refusal to use methods of "manual" control over demand for and supply of foreign currency. Another important requirement is that the National Bank should start using only currency interventions to control the exchange rate. A prerequisite for transition to a free rate fixing treatment is the National Bank's economic control over the exchange rate volatility and the latter's greater degree of flexibility within the set range of fluctuations. While carrying out the said measures the National Bank is recommended to simultaneously execute measures aimed at increasing the impact of the universal interest rate on the interbank market. Upon the formation of the interest rate channel, the National Bank is supposed to proceed with the creation of a system of measures purposed to regulate the currency market on a market basis without turning to currency interventions. Under the conditions of a small open economy this task is even more than just being complicated, so its realization should be postponed till 2011, when world prices for mineral resources used as sources of power will start functioning in the economy of the Republic of Belarus.

6.7 Development of a system of non-bank financial intermediaries and non-bank instruments of the financial market

Further development of the financial market and its instruments is viewed as urgent as at present bank credit transactions prevail over any other activity carried out on the financial market. Enterprises are not willing to borrow funds from a poorly developed financial market using other (non-credit) instruments. The banking system appears to be overloaded with credit transactions, part of which by its nature is quasi-budgetary. Commercial banks are engaged in carrying out a redistribution function aimed at channelling target resources to ineffectively performing business entities. This function is totally irrelevant to the nature of banks. A natural conclusion that follows is that part of the borrowing transactions should be transferred to non-commercial financial intermediaries and to the non-banking sector of the national economy, presently being in need of a dynamic development. The new Government's policy should be directed towards the development of a system comprising different non-bank financial intermediaries as well as entities belonging to the non-banking sector of the economy. Following the new policy requirements the Government will have to take pains to create new non-bank financial intermediaries and establish conditions under which diversified financial instruments are sure to be emerging. They will enlarge the range of market regulation, widen the financial market segmentation and increase the level of its depth. As a result, the excessive loan overload experienced at the moment by the banking sector will start reducing, gradually approaching its optimal indicator.

6.8 Increase in the length of the saved money (2 to 5 years), invested in the national economy

To ensure a successful functioning of the regime of inflation targeting a more diversified structure of financial intermediaries and a wider variety of financial instruments should be created, which will entail "lengthening" of saved money (2 to 5 years), invested in the national economy. This will allow for widening of the financial market segmentation, will lead to the creation of a larger variety of assets and liabilities (compared to the variety that is available now) of different financial intermediaries. Thus, the ever growing savings of business entities of the real sector of the national

economy will turn to be fastened through the activities of the newly-established financial intermediaries and banks will undergo the off-loading process.

At present the length of money attracted to the banking sector is not really big, and this does not allow banks to create greater “amortization” chances to diminish the damaging effect produced on the national economy and its banking sector by external shocks. The process of money length increase, further diversification of financial intermediary types, and creation of new financial instruments is hindered by a huge sector of the national economy whose activities aimed at redistributing free and “cheap” money are executed under the conditions of very mild budgetary restrictions. Moreover, the said sector sets standards of financial discipline seen as poor, unreasonably grasps the credit money, emitted by the banking sector, as well as the money granted by the Government’s budgetary-financial system. A regular character of the mentioned factors restricts the structural effectiveness of the financial market and prevents money length from increasing.

6.9 Setting strategic goals to gradually liberalize the currency market and refusing to use the BYR exchange rate as an “anchor”

Transition from the BYR exchange rate pegged to foreign currencies (USD, EURO, and RUB) as an “anchor” to the regime of the currency market liberalization and the BYR exchange rate, alongside with its releasing to freely fluctuate is extremely complicated from the organizational-technological view point and may be economically dangerous. Liberalization of the currency market urges to stop using the exchange rate as an “anchor” with the help of which the National Bank’s currency channel may be employed to influence the economy. The constraints which considerably complicate the process of transition to the regime of inflation targeting under the existing economic policy are as follows. First, it is the nature of the national economy itself being a small open economy, strongly subjective to the impact produced by imported inflation and severe external shocks. Second, it is the existing system of well-trying control mechanisms which allow for regulating inflation through the BYR exchange rate. The use of the said mechanisms is accompanied by a strong influence of the governmental non-market regulation on the process of purchasing currency. Third, huge accumulations of currency and BYR resources of physical persons and legal entities with commercial banks, with the said depositors having got accustomed to the fixed currency rate.

Transition to a free establishment of the BYR exchange rate in a small open economy is an exceptionally dangerous undertaking as it requires a radical reconsideration of the current economic policy of the Government. The problem is that within the framework of this policy the role and the functions of the National Bank are restricted to those of a modest monetary body, engaged in target financing of the sectors of the national economy through putting reserve money into circulation following the established national economic priorities.

6.10 Ranging the National bank’s pricing strategy and that of the Government from achieving intermediary objectives to reaching direct goals of the economic policy (the projected level of “open” inflation)

Transition from the regime of exchange rate targeting to the regime of inflation targeting suggests that the pricing policy of both the National Bank and the Government should be turned all the way round from achieving intermediary objectives to reaching direct economic goals (the projected level of “open” inflation). If now the Government achieves its pricing goals through administrative measures, the pricing aimed at the establishment of long-term, low, and digit inflation cannot be reached without enforcing market regulation instruments, the mere character of which fits the defined goal. Needless to say that the transition in question means a radical change in the character and structure of economic relationships, typical of the present state of the national economy. In

order to carry it out the present substance of vertical regulation relationship between organs of state administration and business entities should be altered drastically; the current horizontal interaction pattern embracing business entities should be completely ruined, too. Such changes in case they occur will lead to the creation of a stable and predictable relationship among macroeconomic parameters regulated by the National Bank and the Government on a market basis.