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## **Improving Monetary Policy in the Economies in Transition: Making Choices about Effective Regime or Enhancing the Efficiency of the Chosen Regime?**

*Issues pertaining to monetary policy improvement in the economies in transition are linked, as a rule, with the need to employ more effective monetary policy regimes existing in the world. From the authors' point of view, changes in the monetary policy regime should not be viewed as "an end in itself". In countries where gradual transformations are carried out against a background of certain macroeconomic stability, while the monetary regime corresponds, on the whole, to the current economic conditions and ensures the attainment of its objectives, enhancing the efficiency of the channels of the monetary policy mechanism which is already in use might be more appropriate and of top priority.*

The issue of making choices about the most effective monetary policy regime, for the economies in transition in particular, is traditionally one of the most debated problems among both scientists and experts who work in the sphere of monetary regulation. In tackling this problem, the advantages and disadvantages of each of the established regimes are usually substantiated, while measures taken in different spheres of the economy whose implementation is desirable or necessary for evolving into a more perfect monetary mechanism are viewed, more often than not, as action-oriented recommendations. At the same time, the economic measures proper may be quite radical, including even substantial changes in the elements of the social and economic development model which is in place in a given country.

As a result, burning questions arise: Is it worthwhile talking about the choice of a more effective monetary policy regime for the economy in transition if the implementation thereof requires substantial changes in the elements of monetary policy; Isn't it, to a certain extent, the issue of changing the "objective" for the sake of the improvement to the "means"?

Nowadays there are four basic monetary regimes in theory and in practice: foreign exchange rate targeting, monetary aggregates targeting, inflation targeting, and an implicit regime. Their merits and demerits have been researched fairly well in the scientific literature.

Also, the long-term advantages of the inflation targeting regime, including in comparison with the foreign exchange rate targeting, have been described quite a long time ago. However, the IMF's data on monetary regimes adopted in different countries all over the world in 2003-06 suggest that only about 13% of 192 surveyed economies employ the inflation targeting regime and around 47% the foreign exchange rate targeting.

Hence, further questions arise: Why do nearly half of the countries around the world employ the regime which has, as theory and practice show, major shortcomings in the long term in comparison with inflation targeting? In particular, under certain circumstances, say, in case of free movement of foreign capital, it is fraught with a substantial loss of the state gold and foreign exchange reserves. Is such practice linked with the problem of choosing the monetary policy regime out of, basically, four well-established regimes?

This paper deals with the above-mentioned problems.

Let us differentiate between concrete situations against the background of which the issue of improving monetary policy is decided. It is well-known that there are two/ There are two well-known ways to carry out transformations in the economies in transition:

- “shock therapy”; and
- gradual transformations method (or the “gradualist approach”).

For an economy which employs the “shock therapy” method to effect transformations the issue of choosing a more perfect monetary policy regime as part of a search for a more effective mechanism of entire economic policy is justifiable indeed. The situation which requires radical changes in the methods of economic regulation is generally characterized by financial and social destabilization as well as by substantial unpredictability of its development.

In general terms, top priority tasks tackled by the state in such situation are as follows: the stabilization of inflation, reduction in the foreign exchange rate volatility, elimination of external and internal causes underlying financial and social instability, and others. In such case, the state and, in particular, monetary authorities in particular face the problem of making choices about the forms of and methods for pursuing further economic policy. And a radical change in the monetary policy regime may temporarily become an effective instrument for dealing with the assigned tasks because in these conditions it looks as if the economic system is formed anew.

A fairly rapid change in the monetary regime is also advisable in cases where there are substantial contradictions between the economic system and mechanisms of the current monetary policy regime, with the result that such regime fails to effectively ensure the attainment of its objectives. The experience of the Czech Republic is a shining example of this. Failure to effectively employ the foreign exchange rate targeting regime against the background of substantial flows of external capital brought about, at one point, strong antagonisms and the threat of financial destabilization, as well as the foreign exchange crisis. In this situation, the Czech Republic abandoned in 1997 foreign exchange rate management and made a rapid transition to the inflation targeting regime which was most suitable for the economic conditions existing in the country.

So, the problem of choosing an effective monetary policy regime is given the highest priority in cases where it is vitally necessary for the country to adapt to the internal and external fundamental changes and therefore effective solutions are urgently required to clear the backlog of problems.

At the same time, the answer to the question as to whether it is advisable to choose a new effective regime is equivocal for an economy in transition which transforms by gradual implementation of consistent reforms and employs the monetary regime that allows for fairly effective accomplishment of its objectives and tasks, and, therefore, matches the macroeconomic conditions, especially if required conditions have not yet been created for such a regime.

Here is some theory to prove this assertion.

The foreign exchange rate targeting regime is based on exchange rate fixing and implies, above all, a close interrelationship between the national currency exchange rate and inflation. Accordingly, rigid fixing, fluctuations within the band, different forms of foreign exchange rate pegging to other currencies, and some others can be designated as foreign exchange rate regimes which can be employed in this case.

Underlying the monetary targeting regime is the quantity theory of money which implies that over time the money supply grows in line with economic growth rates. It is not recommended that the fixed exchange rate regime be used in monetary targeting because its maintenance requires substantial expenditures relating to interventions. “Softer” regimes, such as the crawling peg and dif-

ferent forms of exchange rate “bands” are employed in case of foreign exchange current convertibility whilst managed floating regimes are more appropriate for capital convertibility.

The inflation targeting regime implies that intermediate targets for the exchange rate or monetary aggregates are replaced by a number of macroeconomic indicators which are indicative in character and are used to forecast the inflation rate. The employment of foreign exchange rate regimes which are close to free floating is most appropriate for the inflation targeting regime.

The above arguments regarding compatibility of monetary policy regimes with exchange rate setting is also supported by practice. For example, according to the IMF’s data, all inflation targeting countries employed in 2006 either the freely floating exchange rate or the managed exchange rate regime with an unpredictable trend, all of them enjoying current and capital convertibility. At the same time, countries which are categorized as exchange rate targeting economies employed the following regimes: currency board, crawling peg, pegged exchange rate within the band, fixing to anchor currency, and etc. And only a few countries enjoyed capital convertibility.

All this points to the conclusion that in such countries at issue is, as regards monetary policy, the improvement of the efficiency of the monetary policy instruments’ influence on the processes taking place in the economy or, in other words, the enhancement of its efficiency rather than the selection of the monetary policy regime. At the same time, since certain financial and social stability as well as predictability of economic entities’ performance have been achieved in the country, it is vital, while improving monetary policy, to maintain current stability.

Monetary policy has an impact on the economy by means of the transmission mechanism consisting of a certain set of channels. It means that, in fact, the central bank exerts an impact on some parameters of the monetary sphere thereby influencing redistribution of financial flows therein. Such changes in the monetary sphere are transmitted, in turn, to other sectors of the economy still by redistributing their financial flows.

Strictly speaking, it means that the structure of financial flows in the existing economic system undergoes changes with the economic relations system, infrastructure development level, the extent of the economy’s integration into the global economy, etc. remaining unchanged. Also, the characteristic feature of the economies in transition is that by no means all financial mechanisms, e.g. the financial markets system, “operate” effectively and at full capacity. And, if the central bank employs instruments designed to bring the “idle” financial mechanisms back into operation, the economy’s response may go beyond the scope of expected results, being both positive and negative,.

Thus, monetary policy efficiency depends not only on what instruments help to exert influence on the monetary system, but also on the state of the economy as a whole and the environment in which it functions. In turn, the very monetary regime does not, in fact, substantially change the economic system and relations therein. It imparts transparency to the central bank’s decision-making process, i.e. the model of its behavior in certain situations. At the same time, the existing economic system predetermines to a large extent the type of the monetary regime which can be used as a key regime in pursuing monetary policy.

Here are some examples in support of the above-mentioned statement.

First, as stated above, both theory and practice suggest that rather rigid regimes of exchange rate setting as well as the lack of capital convertibility require, as a rule, the exchange rate targeting regime. Given this, it would not be reasonable to adopt the managed or floating exchange rate setting regime for the sake of carrying out the efficient inflation targeting regime. For example, in the Republic of Belarus, against the background of vigorous structural reforms and modernization of the

non-financial sector, as well as the negative foreign trade balance and inadequate gold and foreign exchange reserves, the issue of exchange rate stability is strategic. All this is against the relatively independent exchange rate setting and, as a consequence, against inflation targeting.

Second, in our country, for example, individual industries, such as house building, are funded, to a great extent, at the expense of the banks' soft credits. Therefore, the level of interest rates does not directly affect credit activity of such economic entities which is required for the efficient use of the interest rate channel of the transmission mechanism. As a result, this channel may not be used as the key one. Hence, such system of financing also influences the type of monetary policy.

Third, a number of international organizations note that the financial markets of transition economies are underdeveloped and, therefore, funds cross-flows related to the changes in mutual profitability do not always occur and do not involve all financial market participants. This hinders and, in a sense, distorts the signal formed by the central bank within a certain monetary regime that may weaken monetary policy efficiency, for example, under inflation targeting.

More examples could be cited here. Said arguments confirm, to a great extent, the assumption that in the transition economy that implements its reforms step-by-step the monetary regime options are substantially limited and predetermined by the model of the economic system. Besides, the problem of monetary regime selection is beyond the scope of a simple understanding of the mechanism of its operation within the monetary sphere as well as creation of certain empirical assessments. In our opinion, it is transformed into the problem of setting criteria for assessing the performance of the monetary sphere proper and the transmission mechanism with respect to its channels. The results of such assessment, in turn, may form the basis for deciding which channel is most efficient under the existing economic conditions.

Besides, in the course of the gradual transformation the efficiency of the transmission mechanism channels may vary erratically, and it is not certain that the interest rate channel will be the most efficient one. In this case, if several efficient channels are available, the implicit monetary policy regime may be selected, which happened, in our opinion, in the Russian Federation.

As a result, the majority of the transition economies that have been successful in implementing gradual reforms should opt to improve the already successfully functioning monetary regime and all channels of the transmission mechanism rather than switching to a more advanced one.

The issue of the monetary policy improvement with a view to increasing its efficiency in attaining macroeconomic targets within the selected model of social and economic development is of current importance for the Republic of Belarus as well.

At present, the monetary policy regime which is used in the Republic of Belarus is based, virtually, on targeting the exchange rate of the Belarusian ruble versus the US dollar. Taking into account the important role of the exchange rate in the open economy in regulating imported inflation, foreign trade price competitiveness, and economic entities' expectations, its use as a monetary target proved efficient in the Belarusian economy and was one of the key factors that led to the financial stabilization.

For instance, in the Republic of Belarus the exchange rate of the Belarusian ruble is used against the US dollar as a monetary target due to the latter's dominating share in the foreign economic settlements, domestic foreign exchange market, and households' foreign exchange savings. Therefore, maintaining a stable Belarusian ruble – US dollar exchange rate contributes to both curbing the growth of import prices in the ruble equivalent and lowering inflationary and devaluatory expectations of the economic entities, while the long-term trend of the US dollar depreciation versus the

currencies of the main trade partners of the Republic of Belarus makes it possible to improve, to a certain extent, the price competitiveness of the domestic goods and services.

At the same time, in light of the changing role of the US dollar in the world markets an increase in the share of other foreign currencies, above all, the euro and the Russian ruble in the servicing of the foreign economic and foreign exchange spheres of the republic becomes indispensable. Therefore, choosing another, probably, more complicated exchange rate target, such as the basket of currencies, is not a long-term issue any longer.

Besides, as the period of maintenance of exchange rate stability lengthens, its importance as one of the factors influencing inflation is declining and, consequently, the restraining effect of the stable exchange rate on inflation is gradually losing its efficiency as well. At the same time, the possibility of significant external strengthening of the Belarusian ruble is objectively constrained by the state of the current account of the balance of payments of the country.

Finally, the level of the state's gold and foreign exchange reserves makes it possible to ensure quite confidently a stable exchange rate under current restrictions related to capital movement. In case of liberalization of the above-mentioned operations a fixed exchange rate may, in certain conditions, cause a reduction in the level of the gold and foreign exchange reserves.

Is it appropriate, taking into account the above-mentioned problems, to talk today about the need for the Republic of Belarus to move to another, more advanced, monetary policy regime, or is the approach based on the improvement of the transmission mechanism of the existing regime more weighted?

On the whole, inflation targeting seems more effective. At the same time, for the purpose of an efficient transition to this regime in the Republic of Belarus, a variety of significant transformations affecting essential elements of economic policy is needed. This involves the current system of soft credits in some industries, financial market development, including on the basis of privatization, and a number of other areas affecting the existing system of social and economic priorities. It is clear that these spheres ought to undergo evolutionary change within the general strategy of the national social and economic development. Therefore, it is not until the entire set of required conditions is created in the economy that the transition to a more advanced monetary policy regime could be considered. Given current conditions, including, *inter alia*, the lengthy effect of rising external energy prices, the regime which is being used in the Republic of Belarus is totally adequate and its improvement in the near future may include an increase in the performance of the individual channels of the transmission mechanism.

The following key conclusions may be drawn from the above-mentioned arguments:

- first, the prevailing behavior of the economic agents in the corresponding country, as well as a number of economic and institutional factors predetermine the selection of an efficient monetary policy regime;
- second, the problem of monetary regime selection goes beyond the scope of understanding the mechanism of its operation within the monetary sphere as well as creation of certain empirical assessments. In this context it may also be added that the selection of a monetary policy regime and switching to a new one may not be viewed as an objective of economic transformation. It is a means of increasing monetary policy efficiency. At the same time, it must be borne in mind that the monetary regime is a sort of the means of imparting transparency thereto and a form of bringing the information on the principle that will underlie the central banks' future actions to the notice of the economic entities; and

- third, in the context of monetary policy improvement in the countries that are implementing their reforms step-by-step the issue of monetary regime selection is transformed into the problem of developing criteria for assessing monetary system efficiency and its interaction with other sectors of the economy. Such criteria must be developed on the basis of a comprehensive analysis of the role of the monetary mechanism in the system of attaining all of the targets of the country's economic policy. In turn, the results of such assessment may serve as the basis for taking a decision as to the most advisable channel of the transmission mechanism in the current economic environment.

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