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MONETARY POLICY ARCHITECTURE DURING THE TRANSITION FROM FINANCIAL STABILIZATION TO SUSTAINABLE ECONOMIC GROWTH

The article outlines approaches to determining the essence of monetary policy and its strategic goals. The main features are considered, the priorities and functional dependencies of monetary policy which are characteristic of transitional financial systems, in accordance with the classification of the transitional process as the consistent implementation of the tasks of financial stabilisation, the transition to sustainable economic growth, and subsequent anticyclical regulation after reaching a certain equilibrium level of income, are determined. The conditions for the implementation of monetary policy, which differ depending on the macroeconomic situation – financial stabilisation, transition to sustainable economic growth or anti-cyclical regulation, are substantiated. It is also substantiated that the evolution of monetary policy can be conveniently monitored with the help of indicators of the economy monetization and the real exchange rate, which can show the way of reaching the equilibrium state.

Key words: monetary policy, money supply, balance of payments, monetization, demonetization, financial stabilization, sustainable economic growth, financial system

Fig. – 2

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АРХІТЕКТУРА МОНЕТАРНОЇ ПОЛІТИКИ ПІД ЧАС ПЕРЕХОДУ ВІД ФІНАНСОВОЇ СТАБІЛІЗАЦІЇ ДО СТІЙКОГО ЕКОНОМІЧНОГО ЗРОСТАННЯ

У статті окреслено підходи до визначення сутності грошово-кредитної політики та її стратегічні цілі. Розглянуто основні риси, визначено пріоритети та функціональні залежності грошово-кредитної політики, характерні для перехідних фінансових систем, відповідно до класифікації перехідного процесу як послідовної реалізації завдань фінансової стабілізації, переходу до стійкого економічного зростання та наступного антициклічного регулювання після досягнення деякого рівноважного рівня доходу. Обґрунтовано умови проведення монетарної політики, що відрізняються залежно від макроекономічного стану — фінансова стабілізація, перехід до стійкого економічного зростання чи антициклічне регулювання. Обґрунтовано, що еволюцію монетарної політики зручно відстежувати за допомогою показників монетизації економіки і реального обмінного курсу, які можуть сигналізувати траєкторію досягнення рівноважного стану.

Ключові слова: монетарна політика, пропозиція грошової маси, платіжний баланс, монетизація, демонетизація, фінансова стабілізація, стійке економічне зростання, фінансова система
Рис. – 2

Statement of the problem. Increased attention to various aspects of monetary policy in transitional financial systems caused by several factors. First, the beginning of the transformation process was marked by the expansion of the sphere of monetary circulation and mutual influence of commodity and money markets deepening. Secondly, during the transition from an administratively managed to a market economy, there were significant deviations from the path of equilibrium income, which were mainly accompanied by payment imbalances. Thirdly, the process of demonetisation of transitional economies remains rather controversial, which in many cases causes discussion on a number of interrelated issues: a) the nature of inflation; b) the effectiveness of monetary policy as a means of stimulating income; c) the influence of the money supply on the balance of payments accounts equilibrium – current and financial. In the aggregate, the dynamic nature of these relationships significantly hinders the implementation of an effective monetary policy, so that instead of stabilising income and equalising the balance of payments, changes in the money supply can deep deviations from the macroeconomic equilibrium in the sense of maintaining the "natural" level of income and balance of payments, which emphasizes the relevance of the chosen problem.

Analysis of the latest research. Many scientific works are devoted to the problems of monetary regulation, in particular, these are scientific publications of foreign scientists, namely: G. Calvo, V. Claus, J. Dorn, M. Feldstein, B. Horvath, R. Maino, A. Laffer, D. Sachs, S. Fischer and others. Monetary policy, as a purely economic phenomenon, is actively studied by Ukrainian economists: O. Vovchak, A. Galchynskyi, I. Hutsal, V. Lagutiny, V. Litvytskyi, I. Lyuty, N. Ostrovskaya, V. Shevchuk, V. Sheludko and other scientists. However, various aspects of this problem require additional analysis, which is especially relevant in the context of modern challenges.

The purpose of the publication is to study the architecture of monetary policy during the transition from financial stabilisation to sustainable economic growth.

Tasks: to outline approaches to determining the essence of monetary policy and its strategic goals; to justify the main features and functional dependencies of monetary policy, characteristic of the transitional economies of Central and Eastern Europe and the former Soviet Union, in accordance with the classification of the transition process as the consistent implementation of the tasks of financial stabilisation, the transition to sustainable economic growth and anti-cyclical regulation after reaching some equilibrium level of income; to justify the conditions for the implementation of monetary policy, that differ depending on the macroeconomic situation.

Presentation of the main material. In the literature [1], several approaches to determine the essence of monetary policy are used. Representatives of one of them explain monetary policy as a government policy of the amount of money in circulation influence. Representatives of another approach define it too widely – as one of the sectors of economic policy of higher state authority [2; 3]. Monetary policy is a policy of economic regulation through the mechanisms of changing the supply of money and its price on the money market.

So, monetary policy is a complex of interrelated, coordinated to achieve social goals measures of money circulation regulation, including changes of the exchange rate, which are carried out by the state through the central bank. Such a definition is an acceptable compromise between a narrow interpretation of monetary policy in terms of the influence on the amount of money in circulation, monetary and credit conditions in the economy or money circulation, credit and banking system and its broader interpretation as a means of state regulation of the sphere of monetary circulation and credit relations or one of economic policy sectors of higher authorities. Although the majority of domestic economists equate the concept of monetary and money and credit policy [4], using the title "monetary policy" instead of "money and credit policy", that seems more logical, because it additionally takes into account the regulation of the money supply through the currency mechanism [5], that is especially important for transitional financial systems.

Stable growth of GDP (industrial production), low inflation (price stability), high level of employment and equilibrium of the balance of payments are usually considered the final or strategic goals of monetary policy. Intermediate goals include the size of the money supply and the level of the interest rate, as well as the stability of financial and money markets.

The central bank tools provide the interest rate, minimum reserve requirements, open market operations, monetisation of currency reserves, as well as moral persuasion using.

For the transition economies of Central and Eastern Europe and the former Soviet Union countries, changes in monetary policy were considered an important element of the transition process, as price and monetary instability undermined the liberalisation foundations of the economic environment [6]. Achieving financial stabilisation and the subsequent transition to sustainable economic growth predicted a change in the priority of intermediate goals and the tools of the central bank, and even the sequence of achieving strategic goals. In particular, the question of the expediency of immediate reduction of inflation, even through the income reduction, while the alternative point of view was the priority of maintaining the maximum level of income, the decrease of inflation was relegated to the background.

In general, the basic features of monetary policy are presented in fig. 1 in accordance with the classification of the transition process as the consistent implementation of the tasks of financial stabilisation, the transition to sustainable economic growth and subsequent anti-cyclical regulation after reaching a certain equilibrium (or "natural") level of income.

The beginning of economic reforms in 1990-1991 in the Central and Eastern Europe and the former Soviet Union countries was marked by significant instability of monetary aggregates [7]. Until the middle of 1990s, the discussion on the advantages and disadvantages of financial stabilisation and the way to achieve it – as fast as possible or gradually – had a decisive influence on the monetary policy formation. Supporters of the "shock therapy" argued that the opposite inhibition of inflation is the shortest way to resume economic growth, which simultaneously reduces income losses. Instead, supporters of gradualism paid attention to the need to minimise the costs of the anti-inflation policy, which provided for a sharp limitation of the budget deficit and money supply, but could suffer from shortcomings in obtaining information or incomplete control over inflation [8].

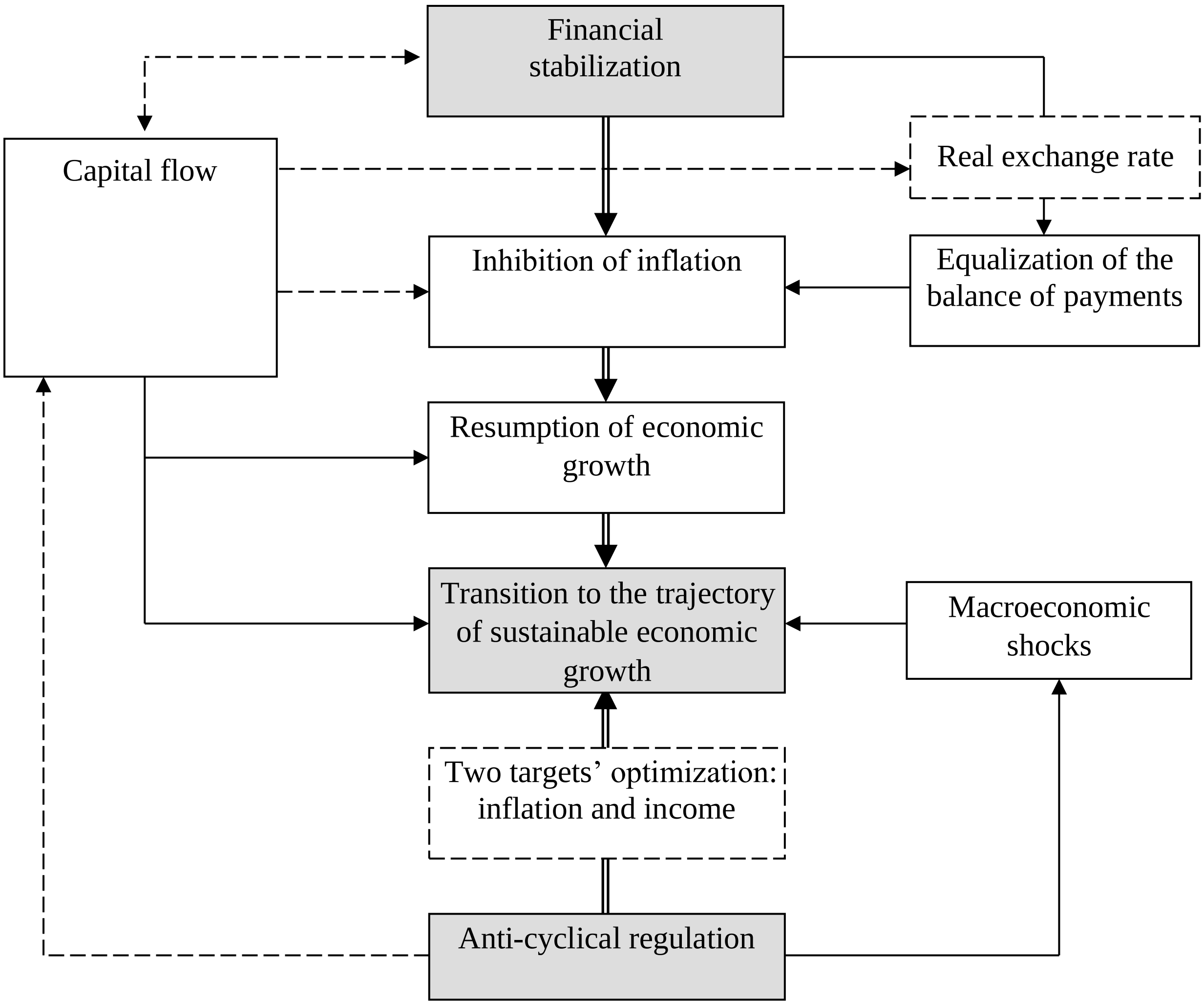

Fig. 1 – Monetary policy priorities during the transition from financial stabilization to sustainable economic growth
Source: completed by the author

In both cases, monetary policy was considered as a central element in inflation inhibition and the economic environment liberalisation, and financial stabilisation was considered a priority for economic growth, but attention was payed to the following barries: a) decline in production; b) lack of adequate external financing; c) excessive depreciation of the real exchange rate [9]. Supporters of "shock therapy" suggested the money supply maintaining at the level of the real Growth Domestic Product growth, while gradualism supported a more moderate limitation of monetary aggregates [10].

In 1992-1994, the lowest growth rate of the money supply was observed in successful reforming countries, while the opposite applies to the countries that were late with economic reforms [11]. Restrictive monetary policy not only contributed to the financial stabilisation, but also facilitated liberalisation measures, which, in turn, consolidated the results of financial stabilisation and strengthened incentives for economic growth, despite of an unexpected for many economists deep decline in production immediately after the beginning of the transition process, which was not always identified with the excessively restrictive policy.

No confirmation was found for the assumption that a lower rate of financial stabilisation will improve the budget balance [11]. For "slow" reformers, the biggest problem is the monetization of the fiscal and quasi-fiscal deficit, which is usually motivated by efforts to prevent unemployment [11]. The former Prime Minister of the Czech Republic, V. Klaus, noted that at the initial stages of the transition process, it was necessary to implement a restrictive monetary policy, and the decline production should not have worried, because it had a transformational nature and did not depend on aggregate demand [12]. The sooner the economy got rid of inefficient production, the better. The result of expansionary monetary policy could only be the acceleration of inflation. The problem was when exactly to switch to a higher rate of growth of the money supply, which would correspond to the restoration of the demand for money due the transactions with real assets and market participants increasing. Additional difficulties were created by the behavior of state enterprises, which did not show features of business activity, and commercial banks, which avoided risks.

Slowing down of inflation below 10 per cent in Czech Republic, Slovakia and Croatia took place already in 1995, which can naturally be explained by a more contrasting limitation of the growth rate of money supply and maintenance of a fixed exchange rate. Next year, single-digit inflation was achieved by Slovenia, and a year later by the Baltic countries. More time was required to overcome inflation in Poland and Hungary, where the central banks supported government policy the most [10]. In both countries, the policy of a "weak" monetary unit was supposed to increase price competitiveness and improve the trade balance, but in fact created significant inflationary pressure. The inflow of capital potentially strengthened the monetary unit ─ without the threat of the balance of payments deterioration, but in most countries there were no adequate prerequisites for this, primarily from the point of view of inflationary expectations. First, in economies with a higher index of openness, interest rate parity is maintained, which provides more space for adapting the cost of credit resources to macroeconomic shocks, and secondly, the expanded interpretation of the balance of payments equilibrium, allows greater flexibility of the real exchange rate. Another motivation for more intensive attraction of foreign capital is the need to increase productive investments, which should contribute to the renewal of economic growth.

Without denying the significant advantages of openness for capital flows in both aspects - the strengthening of the currency unit and the development of the production base, it creates significant problems for monetary policy from the point of view of sterilisation of the monetary effects of the balance of payments and the possible occurrence problems with prices, when a short-term strengthening of the currency creates prerequisites for its subsequent devaluation [13]. Such a feature strengthens the arguments in favor of gradualism in the implementation of second generation reforms, which include the liberalisation of capital movement [14]. Countries with a low budget deficit mostly limited the volume of bank lending, not resorting to lowering the monetary multiplier (with the exception of the Czech Republic and Slovakia), however, in Poland, the increase in the monetary multiplier had a negative effect on the conditions for the sterilisation of capital inflows, and in Ukraine, sterilisation concerned only the outflow of capital [1].

Increased vulnerability to macroeconomic shocks complicates the use of anti-cyclical monetary policy to optimise the two conflicting goals of inflation and income. The majority of well-known Western economists, such as A. Aslund, K. Wegh, D. Sachs, S. Fischer, proposed maintaining a fixed exchange rate in the initial stages of financial stabilisation and then the transition to a floating exchange rate, which gave greater freedom to monetary policy [10]. Many Eastern European economists, in particular V. Klaus, believed that at first it was necessary to maintain a floating exchange rate, and only later to attach it to one of the "hard" monetary units, but practice showed that the reverse did not contain any threats [12].

In the vast majority of studies, openness to capital flows strengthens the direct relationship between inflation and income or the inverse relationship between inflation and unemployment, as described by the well-known Phillips curve [15]. Such a feature may mean that maintaining limited control on capital flows may have contributed to reducing income losses during financial stabilisation, while in the current situation, high openness facilitates the conditions for stabilisation policies. At the same time, there is no comments that the steeper Phillips curve and the associated significant increase in GDP per unit of inflation does not mean an increase in the stabilisation capabilities of monetary regulators of aggregate demand. Specific explanations are not given, but from the context it can be understood that trade and capital flows have a better effect on small economies than large ones, and therefore only the former have opportunities for effective stabilisation policy. At the same time, this contradicts the conclusion of M. Feldshtein that small economies are much more vulnerable to macroeconomic shocks, and this encourages the implementation of a restrictive monetary policy [16].

Without rejecting the logic of the Phillips curve for certain structural conditions, empirical studies for the Central and Eastern Europe and the former Soviet Union countries show a negative relationship between inflation and production [17], which generally corresponds to the characteristics of other countries [19]. The acceleration of inflation is a consequence of the increase in the money supply and the depreciation of the monetary unit [17; 19]. E. Alympiev established that the exchange rate and budget expenditures have the greatest impact on income in Ukraine, while the price level is most significantly influenced by impulses of the credit channel of monetary transmission [20]. Nevertheless, V. Pryadko and N. Ostrovska support the assumption that in Ukraine it is necessary to revise the refinancing rate of the National Bank of Ukraine downwards, because its inflated level forms speculative capital [21]. In order to reduce the dependence of the real economy on the influence of negative external factors, it is proposed to introduce temporary currency control and restrictions on the export of capital. O. Vovchak and M. Khmelyarchuk recognise the need to reform the monetary sphere in Ukraine [22].

Today, the debate about the advantages and disadvantages of financial stabilisation and the way to achieve it has lost its sharpness, but its echoes are easy to see in the attitude to inflationary „spikes” and cases of politically motivated weakeness of fiscal and monetary policy. The most obvious is the example of Hungary, where since 2002 the increase in the budget deficit and the decrease in the real interest rate led to a loss of macroeconomic equilibrium in 2006-2008. In the 2008, Hungary became the recipient of a package of financial assistance with a total value of 25 billion dollars from the International Monetary Fund and the European Union. At the end of the 1990s, the phenomenon of repeated acceleration of inflation was observed in Romania, but in the future it was possible to correct the situation without the intervention of international financial institutions. "Food" inflation of the 2007-2008 was observed in Poland and Slovakia, but the increase in prices was comparatively insignificant. References to "food" and "energy" inflation have become a popular explanation for accelerating price dynamics in Ukraine and other countries of the former Soviet Union.

The functional characteristics of monetary policy are presented in figure 2.

The faster the inhibition of inflation occurs, the more operatively the prerequisites for overcoming structural deformations and accelerating GDP growth [23] arise, which objectively supports the logic of "shock therapy".

Empirical studies show that the liberalization of the economic environment has a negative effect on GDP growth in the current period, but with a lag of one year the result becomes positive [23]. It increases the incentives to start reforms as soon as possible, as the overall positive effect becomes more tangible. D. Zalduendo believes that the faster changes in economic policy are introduced, the higher the GDP growth rate [24]. Traditionally, it was believed that a fully expected and convincing decrease in the growth rate of the money supply leads to an operational decrease in inflation, which does not create a decline in production, but this is not enough for economies with a high equilibrium value of inflation. In such a case, a nominal exchange rate contributes to overcoming inflationary inertia. Because of supply and demand for money depend on the exchange rate, the attachment of the currency unit should limit the dollarization of the economy [25].

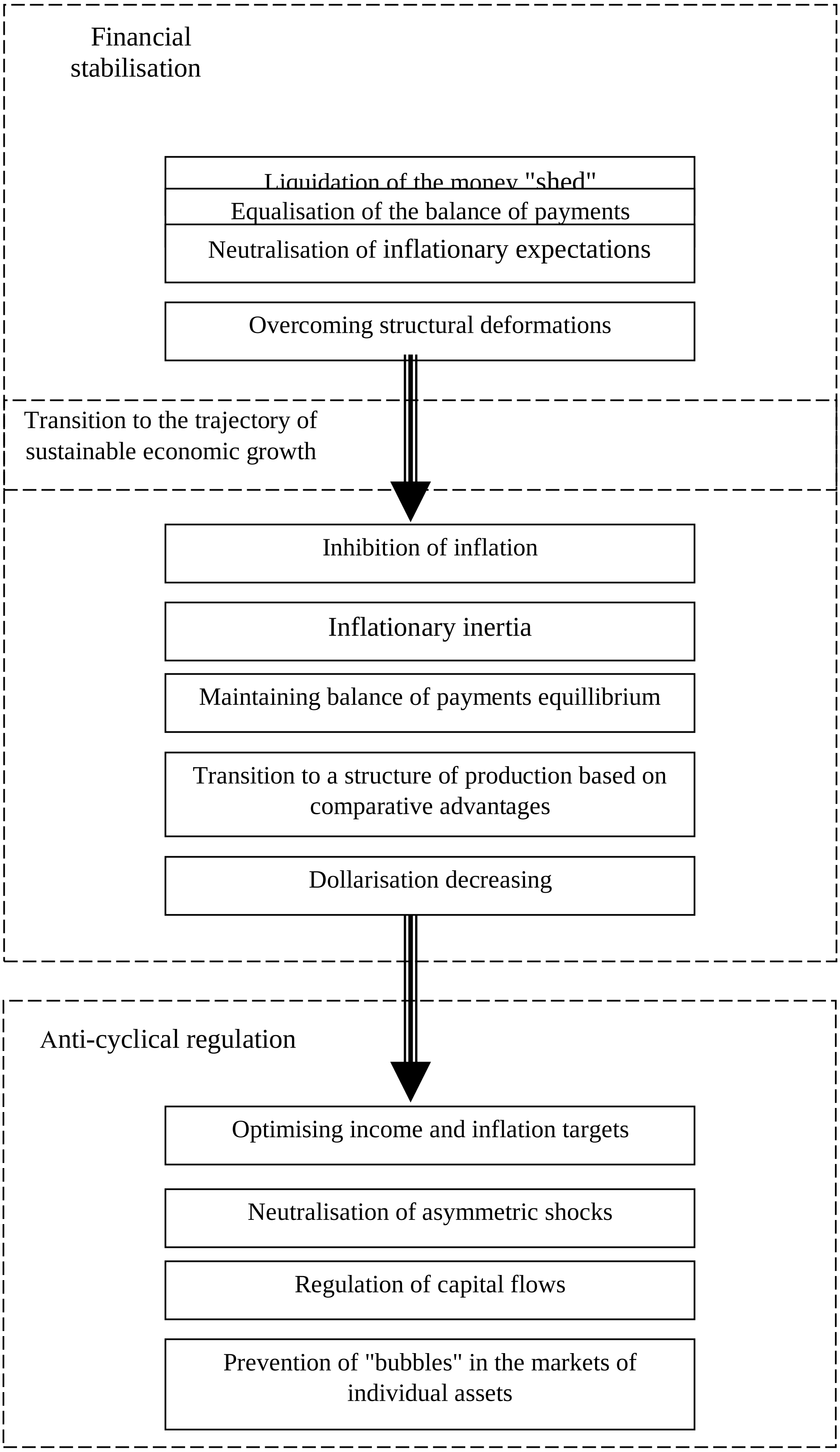

Fig. 2. – Functional dependencies of monetary policy

Source: completed by the author

On the other hand, the level of attachment of the monetary unit is important – overvalued, undervalued or balanced. The introduction of a fixed exchange rate at an undervalued level facilitates the balance of payments equilibrium, which appears to be of primary importance at the stage of financial stabilisation, however, in the future, increased inflationary pressure associated with convergence to purchasing power capacity may arise: where P and P* ─ are level of prices in this country and abroad, and E – is the nominal exchange rate.

Fixation at an inflated level has the opposite effect, however, short-term benefits from an operational inflation reduction may be offset by a worsening of the current account balance in the longer term.

Deviations from the equilibrium value of prices can be correlated with a corresponding imbalance for the monetization indicator M/Y, where M – is the money supply and Y – is income (GDP or industrial production). Traditionally, the monetisation M/Y is considered as a value that is inverse to the value of the speed of money circulation and, among other factors, characterises the effectiveness of the banking system as a financial intermediary [26], but the dependence on the price index, which directly follows from the well-known equation, deserves no less attention:

$$MV = PY, \qquad (1)$$

where V ─ speed of money circulation.

Taking into account the purchasing power capacity, it is possible to argue about connection between monetisation and real exchange rate, which can be traced in different ways at different stages of the transition process. It is easiest to assume that the undervaluation of the exchange rate leades to the demand for the currency unit and monetisation indicator decreasing. In the future, the strengthening of the exchange rate may signal a tendency to the level of monetisation increasing. It is clear that both processes can be characterised by a tendency towards some equilibrium value, which corresponds to the trajectory of sustainable economic growth.

Conclusions. Thus, there are reasons to believe that the conditions for conducting monetary policy differ depending on the macroeconomic situation – financial stabilisation, transition to sustainable economic growth, or anti-cyclical regulation around the "natural" level of income. In our opinion, it is convenient to monitor the evolution of monetary policy using the indicators of monetisation of the economy and the real exchange rate, which can signal the trajectory of achieving an equilibrium situation.

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