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THEORETICAL FOUNDATIONS OF CONDUCTING MONETARY POLICY

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ABSTRACT

The article shows the monetary policy goals traditionally include price stability, economic growth, full employment, smoothing business cycles, preventing financial crises, and stabilizing interest rates and exchange rates. An alternative to exchange rate targeting is inflation targeting, and the use of this particular strategy has brought some price stability to developed countries. Developing countries followed suit, and already in 1999 inflation targeting was introduced in Brazil, later in Hungary and in other countries. Now the introduction of this mechanism is being discussed in Russia.

KEYWORDS: *Inflation, Banking System, Transaction Economy, Improving.*

INTRODUCTION

According to the conventional wisdom, the goal of any Central Bank is to maintain price stability, since high price growth impedes sustainable economic growth by distorting the decision-making process. If this problem is particularly relevant for the state, then the Central Bank can import price stability by pegging the exchange rate of the national currency to the currencies of countries that have succeeded in fighting inflation. This method was extremely successful in the 1990s and, among other things, was used in Russia. However, it turned out to be very vulnerable, which led many countries to abandon fixing their currencies and pursue an independent monetary policy.

An alternative to exchange rate targeting is inflation targeting, and the use of this particular strategy has brought some price stability to developed countries. Developing countries followed suit, and already in 1999 inflation targeting was introduced in Brazil, later in Hungary and in other countries. Now the introduction of this mechanism is being discussed in Russia.

Based on the currently dominant economic theory, the principle of inflation targeting, like any independent monetary policy, is in conflict with the desire of Central Banks to stabilize exchange rate fluctuations. The so-called "Impossible Trinity" argues that a central bank cannot simultaneously pursue an independent monetary policy and regulate the exchange rate if the economy seeks to be completely open to international capital flows.

At the present stage, the ruble exchange rate is actively supported through operations in the foreign exchange market, which is confirmed by the large-scale accumulation of international reserves of the Bank of Russia. In the absence of sterilization mechanisms, such a practice inevitably leads to inflation, since a huge mass of rubles flows into the market, the growth of which in many respects exceeds the growth of the economy as a whole.

These trends led to the appearance of this work. Its purpose is to prove the inflationary pressure of foreign exchange interventions carried out by the Bank of Russia. In accordance with the goal set during the study, several tasks were set:

LITERATURE REVIEW

Monetary policy goals traditionally include price stability, economic growth, full employment, smoothing business cycles, preventing financial crises, and stabilizing interest rates and exchange rates. Some goals are compatible with each other, while others are not. For example, the goal of price stability often conflicts with the goal of stable interest rates and maintaining full employment. Countries may assign equal weights to these targets, but there has been an increasing emphasis recently on keeping inflation low. This trend is due to empirical observations that high inflation (which is often associated with its volatility) distorts the decision-making of economic agents regarding the volume of investment, savings and production, thus leading to slower economic growth (see, for example, Fischer 1993).

Therefore, the widely held view is that the goal of monetary policy is to maintain stable prices. Alan Greenspan, the former head of the Fed, proposed the following indicator: "price stability is observed when economic agents do not take into account the factor of a possible price increase when making decisions." In the language of statistics, this definition corresponds to a single-digit inflation indicator (Greenspan, 1994).

METHODOLOGY AND ANALYSING

One of the most common mechanisms for maintaining price stability is inflation targeting. In contrast to alternative strategies - targeting the money supply or the exchange rate, which only indirectly support low inflation - this approach involves direct management and regulation of inflation. There are several different definitions of inflation targeting in the literature, but they all come down to highlighting only two key characteristics of this mechanism:

1. The Central Bank has an obligation to achieve a certain, expressed in numerical form, annual inflation rate. Moreover, this goal is a priority over all the others set by the Central Bank. Its numerical expression helps to communicate to the general public the level of inflation that the monetary authority considers normal.

2. Moreover, forecasting inflation is actually also the goal of the Central Bank, albeit an intermediate one. Therefore, inflation targeting is also sometimes referred to as inflation forecast targeting. Since part of the price level in the short run is predetermined (due to price inflexibility and the presence of rigid wages), the Central Bank can actually only influence the expected future inflation. By conducting operations in the money market, the Central Bank adjusts the expected inflation in accordance with the target.

Opponents of this mechanism argue that it brings many benefits compared to other strategies:

1. Inflation targeting helps to increase confidence in the monetary authority and more clearly form inflation expectations. It communicates to the public that monetary policy is aimed at keeping inflation low. Moreover, inflation targets are much more understandable and transparent than other targets, since they do not change over time and are controlled by the National Bank. Thus, inflation targeting contributes to a clearer understanding and assessment of the economic situation in the country than more complex and non-transparent mechanisms.

2. Inflation targeting is more flexible. Since the calculation of inflation requires a certain time, the target value of inflation is determined in the medium term. This implies that the Central Bank pursues an inflation target for a certain time horizon by adjusting inflation expectations. Short-term deviations of inflation from target values are normal and do not necessarily result in a loss of confidence in the monetary authority.

3. Inflation targeting leads to lower costs when the goal is not achieved. The costs of policy failure by the Central Bank under some alternative mechanisms, such as exchange rate targeting, can be significant - extensive loss of foreign exchange reserves, high inflation, financial and banking

crises, and even default. In contrast, the costs of a failed fight against inflation are limited to inflation itself and a lower level of economic growth than planned (because when inflation exceeds its target level, the Central Bank raises the interest rate).

CONCLUSION

In any open economy, the monetary authorities are faced with an even more serious problem, which is called the "Impossible Trinity" (Impossible Trinity). Roughly speaking, this theory argues that a central bank cannot simultaneously pursue an independent monetary policy and regulate the exchange rate if the economy seeks to be perfectly open to international capital flows. This problem is illustrated in Figure 1.1.

It is possible to reformulate the above-stated "theorem" in another way. Three goals cannot be achieved simultaneously: exchange rate stability, capital market integration, and monetary policy independence. Any pair of these goals can be achieved by pursuing a certain policy, however, this requires the rejection of the third goal. For example:

1. The goals of exchange rate stability and free convertibility of the national currency can be combined through a fixed exchange rate policy, which will require the Central Bank to abandon the implementation of an independent monetary policy. His policy of managing the interest rate will be reduced to maintaining a fixed exchange rate, and not to achieving internal equilibrium goals.

2. Independence of monetary policy and free convertibility of the national currency can be achieved through a floating exchange rate, which will lead to its volatility. The Central Bank can freely vary the interest rate, focusing, for example, on reducing inflation, but at the same time it will have to be content with the exchange rate that the market sets.

3. The stability of the exchange rate can be achieved with the independence of monetary policy, however, for this; the Central Bank must sacrifice the free convertibility of the national currency. In the presence of significant restrictions on the capital market, the relationship between the interest rate and the exchange rate is violated.

However, the question of the existence of intermediate options may arise here. Can the Central Bank, with capital mobility, partially regulate the exchange rate and have partial independence of monetary policy? This question disappears by itself when the case of the Central Bank realizes its goals in the pursuit of both policies. If he sets himself the goal of reducing inflation, he must also subordinate currency regulation to it, and vice versa. Without a clear idea of the desired trajectory of movement in any area, the Central Bank will not be able to come into conflict with anything at all, as well as to obtain satisfactory results.

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